## Fidelity Connects

**Dividend Investing in an Economic Slowdown**

**Ramona Persaud**, Portfolio Manager

**Pamela Ritchie**, Host

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**Announcer:** Hello and welcome to Fidelity Connects, a Fidelity Investments Canada podcast, connecting you to the world of investing and helping you stay ahead.

Portfolio Manager Ramona Persaud is back on the program as she shares her thoughts on investing during these uncertain times of economic slowdown.

Ramona says there is a lot of fear and unpredictability in the markets today leaving many investors concerned. But she says her approach to the markets during these uncertain times remains focused on a few core factors: downside protection and risk-adjusted return.

She adds, the type of investor that is attracted to a dividend-oriented strategy wants some amount of stability in returns and lower volatility. When you focus on the downside protection, you get these results.

Ramona practices a lot of patience these days and says she doesn't mind missing the beginning of a *turn-up* because she gets more by protecting the downside. She tends to be more discerning in a market that has higher-than-average emotionality because of higher uncertainty, which means Ramona will wait even more for results for valuations.

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**Pamela Ritchie:** Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. Great to see you again, Ramona. How are you today?

[00:02:10]

**Ramona Persaud:** I'm great. Nice to see you too, Pamela.

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**Pamela Ritchie:** Let's go through a little bit about what really matters most to you in terms of the way you invest. We've obviously mentioned dividends and we'll get into that but this is a moment where people are talking about capital preservation, being somewhat careful in these markets. Just remind us how you approach things.

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**Ramona Persaud:** We are looking for three things in combination. Just as a baseline, we're looking for excess return, like everyone else but two more things, also, downside protection and a reasonable level of income. If you put those three things together, we're really talking about risk-adjusted, total return. The way that we measure that is in something called an information ratio, which is essentially your excess return over the amount of risk that you've taken. In a market like this, the downside protection part of the things we're looking for really tends to stand out. It tends to be even more of a focus for me. The type of investor who is attracted to a dividend-oriented strategy wants, I think, some amount of stability in the return stream, some amount of lower volatility and so when you focus a lot on downside protection, you get that and the results over, I guess we've been doing this for 12 years or so, have sort of borne that out.

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The capture profile, how we do in down markets versus up markets [audio cuts out] the strategy has tended to produce sort of mid-90s of capture, so capturing mid-90s of the market. But then really importantly in the down markets we're in the 70s. That's a really big spread. For a strategy that tends to be fully invested, this is an important thing. A big philosophical way that we manage money is in this sort of fully invested way. If you take that spread and you let it compound over time, what you get is this very strong risk-adjusted return. The information ratio that we've done over 10-year is 0.6, which for an equity fully invested fund is pretty good. That's very much driven by this downside protection orientation that I think really benefits fund holders in environments like these.

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**Pamela Ritchie:** You started off saying excess return and you said, like everyone else. There's that, of course, but the way your style works and perhaps waiting for some interesting moments in the markets ahead, we'll get your thoughts on that in a minute. How does your style kind of differentiate from other people that are also looking for excess return in the markets?

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**Ramona Persaud:** You're right. You make a really good point. Everyone wants alpha, right, and real alpha, not beta masquerading as alpha. Yes, when I say like everyone else excess return, that's the alpha piece. For me, what's the differentiator are the other two objectives of downside protection and a reasonable amount of yield because that's how you get the alpha, that's how you end up with a pretty good down-capture profile and a sort of good enough up-capture profile. I think that is very differentiating. The incentives for managing funds tends to begin and end with just the alpha piece, just the excess return piece but to me, it's always been important to think about who the end investor is and does the end investor just want alpha that's very, very volatile? Many end investors do.

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Through a lot of market research and talking to clients over the last 10+ years, there's the, I like to say, the destination journey, there's the smoothness of that alpha. You can have really bad results for a very long time and then you get your 5- to 10-year performance in one year, that's one way to do it. One of the problems with that, though, is whether or not the client will stay with you. The job then expands to trying to make sure the client understands what you're doing and they can stick it out. If you lose that client to, say, a growth strategy or a hypergrowth strategy, have you really achieved

your objective of trying to give them a really good 10-year result? That's a different part of the job. We're talking about marketing at this point. I think really carefully about the stickiness of the end investor. To me, that's very much tied to the smoothness of the journey, especially if you're going to be taking cash off of the return stream in the form of dividends. I don't want that cash to be highly volatile. That's why I think about the smoothness of the ride.

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**Pamela Ritchie:** Let's get your thoughts on what needs to line up, what the market seems to be telling us. Sometimes the market tells us that a pivot by the Fed is imminent. Sometimes the market doesn't tell us that. We've seen some pain. Do you think we've seen most of the pain at this point? This goes to valuation, obviously.

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**Ramona Persaud:** I've called this market treacherous all year and I continue to call it treacherous. I'll get to your question about valuation and pain but I think it's good to at least tell you how I see it in more holistic terms. The reason I call it treacherous is because the factors driving this market are very unpredictable, more unpredictable than average. To me, that gets you into treacherous land. The primary factor is central bank policy. I'm not saying Fed policy. That's a big part of central bank policy. I'm saying central banks. All of a sudden you've got this variable that's really unpredictable, which is one central bank, and then you've got all the other big central banks, the BOJ, the BOE, all the people who track the U.S. Fed. And then you have to think about the interactions of all of them. That just takes you into sort of geometric math world, very unpredictable. That's just one factor.

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Then you've got exogenous factors like the war between Russia and its neighbours, specifically Ukraine, China's COVID policy, all these factors that have put you into extremely unpredictable land. Tied to this is the stickiness of inflation. That's the biggest question right now that's sort of at the centre of uncertainty and that's sort of shifted from supply constraints to central bank policy that's explicitly targeting demand. For instance, housing and employment, in the U.S. anyway, are in the crosshairs and we've not seen that in a really long time. That is the definition of treacherous. In my mind, when you get into a market like that, all that I just gave you, I'm just going to summarize and call it treacherous. The opportunities, you have to think about, okay, that sounds really scary. What's the opportunity? The opportunity is you can get outsized, higher-than-average price inefficiency because when you have higher-than-average unpredictability, you have higher-than-average outsized emotionality, fear.

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If you can assume there are more humans, more normally wired humans than machines in the marketplace, which I think is a reasonable assumption, it's like the analogy is assuming that there are more people driving cars on the road than autonomous cars. You're going to get surprises, negative surprises often. There's this higher emotionality which means you're going to cycle between fear and euphoria, depending on what comes in from unpredictable variables. What that means to me is my bar for valuation has to be even more stringent. I have to be even more discerning, especially if I've got a downside protection mindset in the way I do things.

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I don't mind missing the beginning of a turn, a turn-up, and I've sort of proven this to myself. I used to get frustrated when I started doing this at missing the beginning of a turn and I realized that's just not the kind of investor I am. I get it back and more by protecting the downside, so I will tend to be more discerning in a market that has higher-than-average

emotionality because of higher uncertainty, which means that I'm going to wait even more with more resolve for valuations. You had actually asked a valuation question. I just don't think we're there yet. We can get into it. I have numbers if you want.

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**Pamela Ritchie:** Well, yeah, let's look a little bit at sort of either what you need to see or, you know, where you think we are in terms of valuations. Here we are on the cusp of earnings. What do you see?

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**Ramona Persaud:** Let's do evaluation holistically and then later on, we can go into sectors. I look at it a lot of different ways. There's so many ways to look at it. You could look at the market, any given market, people like to point to the U.S. S&P 500 and that's derated a lot from a really high number but is it absolutely cheap? Not really, considering that that multiple tends to be extremely correlated to interest rates. If the direction of rates is up and there is a non-zero probability that our central bank, the U.S. central bank, is in a Volcker 2.0 type mindset, I don't know what probability to put on that but I think it's non-zero, then, is a 15 times on the S&P 500 enough? Unclear. To me, until that answer is clear, the decision to and pace of re-risking, we're just not there yet. That's kind of holistic looking at an absolute multiple.

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The thing I love to look at is fear. One of the best ways to measure fear is in dispersion, valuation dispersion in the market, and I talk about this a lot. There's so many different ways to measure dispersion and what's nice right now is that it's very consistent no matter how you measure it. What you see in valuation dispersion today is a good amount of fear around earnings. One way to put that is if you take a valuation super factor and you look at forward earnings of that super factor and you fractile it and you do whatever differences of the fractiles, what you'll see is that we're...

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**Pamela Ritchie:** Fractile it, come on, I love that. You fractile it.

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**Ramona Persaud:** You fractile it. That's an abstraction. Typically they quintile or quartile but I like to extract because you go do it however you want to do it. What you see is you're probably around one standard deviation in terms of the normalized valuation spread. I think it doesn't get interesting until it starts to approach two. One is good. We're kind of getting there but I'll contextualize that number.

In COVID, before the market turned, that same consistent way of measuring fear got to 4 to 5. That's one of the biggest we've ever seen. Typically, I like to get to around 2 before it really signals something to me. When I got 1, in fact, a little lower than 1. A couple of months ago, it was higher. It's sort of middling and then that's on earnings. That's actually a valuation super factor, so that doesn't really tell me anything per se right now. When you look at earnings specifically, Denise likes to measure it this way: she percentiles it, it's like 95th percentile or something cheap on earnings.

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What that says is there's a lot of fear around profitability as there should be. You've had all this stimulus in the last few years so peaky demand, and then you've got costs that are inflating rapidly, so only really high-quality companies can handle that through pricing power, so that would be above inflation.

So yes, the market understands that, and so it's showing up in fear in earnings. What I think is really interesting is when you look at fear beyond that. A way to do that quantifiably is when you look at book value, your balance sheet, the equity on your balance sheet relative to how your security is priced. Fear: it's creeping up but it's not that high. If on earnings it was 95th percentile, a couple of weeks ago it was a 60-something percentile on book. Maybe now it's 70, 75 and that's better but is that enough fear about solvency, about viability of a company? If this environment ... sorry, I'm like, really...

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**Pamela Ritchie:** No, no, I'm loving this because I was going to ask you about a default cycle but you're just answering all the questions.

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**Ramona Persaud:** If this environment is one where you've got peak demand and you've got really highly inflated costs, even if leading economic indicators of inflation are coming down, those costs can tend to be very sticky in your P&L. What that then means is only really well-run companies can handle that. That means there's a lot of viability risk in maybe the average company and that's not showing up in valuation. That's what gives me sort of conviction that we're not quite there yet. Especially knowing that as an investor, I don't mind missing some of the turn because over 12 whatever years, a lot of years of being a gladiator, if you will, being in the ring in this market, it's okay to miss a little bit of the turn because you more than get it back by being this careful right now.

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**Pamela Ritchie:** What are your thoughts on the benefits of rising rates, cost of capital, for banks and financials versus the drag of a slowing economy on the overall sector?

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**Ramona Persaud:** It's a really good question around financials, especially banks, because oftentimes you'll get the scenario where rates are rising to try to cool down an economy and you have to then realize the risk is whether the central bank that's doing that is really that capable of doing it in a very balanced, effective way. That is to say your margins at a bank would go up from higher rates but if the central bank is not that effective, then you're going to get a credit cycle. The question becomes the positive risk around higher margins versus the negative risk around credit. What I learned from doing banks through the global financial crisis all throughout the world is I don't tend to bet on margins over credit unless valuation is telling me that there is good alpha odds. When I look at banks, Wells Fargo is the only one in the U.S. that's just reasonably cheap. It's maybe 80% of book value. All the other ones are hovering around book value, maybe slightly lower than book value, without anyone really stress testing the book. That's okay. That's cheap but I don't think we're quite there yet.

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I've been adding risk extremely slowly and cheap banks is one place to do it but my pace there is quite glacial because I like for banks on book to really reflect that the investors have thought through NIM, net interest margin, versus credit costs. If you will, the range of outcomes or the sort of geometric-ness – I'm struggling to find the word – the variability around credit outcomes versus the variability around margin outcomes makes it, in my mind, from my experience, no contest. No contest.

Variability around credit outcomes is just so wide and the reason the word geometric came to me is when you get an economic slowdown, and it's better this time than going into the GFC in the sense that the balance sheets are better. When you get a recession the hit to credit is way less predictable and way higher, therefore much higher variability than when you're getting rates rising and margins expanding. You just have to be extremely careful.

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**Pamela Ritchie:** This is going to your process, ultimately. Can you explain or expand on your sell policy and process, considering your focus on downside protection?

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**Ramona Persaud:** Valuation is the biggest driver of selling. I've had companies that I've loved, just really respect the management, the way they run, the way they just view the world, a very broad mindset, so the ability to think strategically and execute tactically is rare. You love the company and then I will have sold them because the valuation just didn't really make any sense. Those can be hard decisions. That tends to be a pretty stock-specific way to get at selling. Another way is when the capital allocation priorities shift away from the investor who wants steady and stable dividends. Even if the fundamentals of the company seem good and the valuation's okay, if a company is going through a big capex cycle, if they have to go and spend a whole lot of money and it risks the free cash flow for a while, for a few years, and that would put pressure on the dividend, which would perhaps ultimately impact valuation. If I can get there before the market realizes this, that's a reason to sell.

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**Pamela Ritchie:** What do you think of energy companies on that? That's been the story of energy companies giving money back to shareholders in various different ways.

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**Ramona Persaud:** The opposite of what I'm ... improving capital allocation, they have in the prior cycle spent so much and not really gotten rewarded by investors for it. In fact, in an era of extremely low rates where there was huge free cash flow production in other sectors like more mature tech, for instance, very capital-light sectors, sectors that had become less capital intensive, so tons of accelerated free cash flow production, the market investors turned to these capital-intensive sectors and said, what are you doing? All this other stuff over there has gotten capital light and you guys are just throwing capital into the ground and you put the ESG overlay on it. They've heard this and now have, for many reasons, been more careful with capex.

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Where I'm going with this is all of a sudden, if you look at something like capex to sales, capex period but certainly capex to sales, it's at an unprecedented low which means that the other side of that, definitionally, assuming a reasonable environment, is huge free cash flow production because this is sort of what they've been hearing in so many different ways from the marketplace. They've been hearing don't invest.

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**Pamela Ritchie:** Do they still look good just because we've seen them come back, clearly. Do they still look interesting?

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**Ramona Persaud:** Exactly. I had gotten really interested in energy when you got the most stable parts of the sector that were at really healthy double-digit free cash flow yields on the back of what I'm talking about, this sort of supply demand imbalance. Supply because of reducing capital intensity, if you will. All of a sudden then the free cash flow production can be really high and the stocks weren't priced for that, so you're getting great free cash flow yields. I had, in last couple of years sort of in this COVID pandemic time, really increased my energy positioning for that reason. It was just really good valuation and a good fundamental backdrop and that worked quite well. Then we ended up with a portfolio construction problem which is that the sector ended up being a very big part of my funds.

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I tend to be careful on portfolio construction, especially with highly speculative industries like energy. So, I pulled some of that back, purely from a portfolio construction and sort of valuation perspective because they had run a lot, then the sector gave some back. At this point, I still have a lot of energy. It's just not as big as it was before. Valuations are, they're good, they're not what they were when I was really adding to it. If that were to happen again, I think I would add to it because the fundamental backdrop is, I think, one that is hard to bet against in terms of just simply supply demand, capex intensity, free cash flow production assuming that demand doesn't get really crushed.

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**Pamela Ritchie:** That's fascinating. There's a lot of questions around oil and the OPEC story, OPEC Plus today, but also just that overall question of the equity side of it. Do they still look interesting? Tell us a little bit more about your positioning right now and if you've seen Joel lately, actually, as well? Sometimes you tell us.

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**Ramona Persaud:** I see Joel all the time. Joel and I have met all throughout the pandemic, mostly by Zoom and now that we're back, I mean, he lives half a mile from my house. People run into each other in Boston, it's kind of a town, not a city, so I got to see him. What's really nice is continuing these conversations, these organic conversations about life, frankly, and about markets. He and I are still on the same page that we talked about in July, which is, the word I use is treacherous, which is like a heavy, intense word and the word he uses is confusing, which is a more neutral, generous word.

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We agree that in a market like that, we completely agree that uncertainty is higher, so predictability is lower and on your continuum of flexibility to conviction, you have to lean hard into flexibility. It's very hard to have conviction in much outside of the conviction that I've demonstrated to you all today around where valuation is and isn't. You lean into flexibility and you sort of watch essentially things like data and valuation very closely, more closely than average, and so the conversations he and I continue to have have that flavour to them that it's confusing and on the continuum of flexibility to conviction you're leaning more flexibility. Did you want to do other sectors?

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**Pamela Ritchie:** I did but I also want to get to international but quickly positioning, broadly.

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**Ramona Persaud:** I'll do it quick. I'm more defensive than not which is not surprising given everything that I've said. I own a lot of staples more for portfolio construction given relative defensiveness in an environment like this. I'm worried about inflation in staples, their ability to pass through, so tends to be really high-quality staples. I own a lot of energy for the reason I just said. I am pretty underweight industrials. I can't get there on valuation. I think margins have some risk. I still own a lot of health care. I think inside of health care you can get single-digit multiples of pretty high-quality companies with decent pricing power, especially given the administration we have here, which is a good setup, and an ability to handle inflation relative to other sectors. Financials and discretionary are the interesting ones. I've been pretty underweight those and that would be where my incremental re-risking would happen but very slowly off of a really big underweight. I've become overweight utilities where I can find some value. Couple of different things going on there.

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The clean energy spend that's still happening benefits some of these folks. Also from a portfolio construction perspective, you're able to bring your volatility profile down, so valuation is the tricky part there. Tech, kind of neutral. I don't tend to be your hypergrowth or even your growthy tech investor. I tend to be a legacy tech or mature tech investor. Inside of legacy tech you can find some tech that's derated a lot. Taiwan Semi, especially Taiwanese tech given the China geopolitical stuff, there's a lot inside of Taiwanese cyclical tech that has derated like crazy. If you look at Taiwan Semi, very good company over the long term, a lot less expensive today than recently. That's a rundown.

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**Pamela Ritchie:** Let's take that just to go geopolitical because part of the reason, the story there is, in fact, geopolitical, or part of it anyway. How do you look at the rest of the world right now? We can put the dollar in or not but the rest of the world seems to be going through some pain. How does that look further out?

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**Ramona Persaud:** Agreed. This is that question that we have talked about every time we meet. One of the burning questions as a global investor is U.S. versus ex-U.S. and specifically U.S. versus Europe because the valuation differential between U.S. and Europe, it just keeps getting wider and wider. What I've said consistently is yes, and especially as a person that likes value, you're drawn to it and you're drawn especially to the U.K. because you can get a lot of quality there.

What's really important is fundamentals. That valuation disparity has been justified because the fundamentals, if we just go to the thing I said before, free cash flow production in the U.S. in a globalization-type world from capital intensity going down, free cash-flow production has just been incredible in many sectors. The U.S. was appropriately, in that interest rate regime, appropriately rewarded for that relative to something like Europe.

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This is one of the places where being a valuey-type person you can get really tripped up because you get into these valuation differentials without putting enough weight on things like fundamentals and momentum. I think today, especially in Europe with so many different headwinds, different types of headwinds, one of which is just energy security and the hostility around energy supply, not only is Russia being reluctant, it's a nice way to put it, on supply but you've got terrorism to supply and then you've OPEC, so I think you've got so many headwinds that it creates geometric math in terms of the risk and normal human brains don't do geometric math.

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**Ramona Persaud:** I do have incredible respect for the complexity of geometric math and a clear understanding that the average investor, which is typically a normal brain, so not like standard deviations-type brain, doesn't do geometric math and I don't think I need to do geometric math. I think I just need to respect that. My respect for that tells me that even though there's this massive ever-widening differential, say, between the U.S. and Europe, because the risks are so compounded in what feels like a geometric way. So, a perfect example of geometric versus additive was the global financial crisis and how you had all of these crosscurrents that were combining in a geometric compounding way, because that's the case, there you can't really figure out what valuation makes sense. Your valuation bar has to be so high. When you look at fear based on valuation dispersion, it's just not there. Simply, simply put, it's not there. It could get a lot higher.

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**Pamela Ritchie:** It could get a lot higher. So fascinating and really great to get your positioning to tell us how you're positioned at this point and ultimately what you need to see. Ramona Persaud, thank you for joining us, for breaking our brains a little bit but on all the right ways. Great to see you.

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**Ramona Persaud:** Nice to see you, too. Thanks for the time. Bye.

[00:29:05]

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