Fidelity Connects

Value investing for the late cycle

Naveed Rahman, Institutional Portfolio Manager

Pamela Ritchie, Host

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

We're shining a spotlight on value investing today with institutional portfolio manager Naveed Rahman. As inflation remains a stubborn thorn in the side of the global economy, Naveed begins today's show reflecting on the news of yet another 75-basis-point hike by the U.S. Federal Reserve.

Also on today's show, with host Pamela Ritchie, Naveed shares an update on positioning and the investing approach of Fidelity Global Intrinsic Value Class. This includes being constantly on the hunt for high-quality cheap companies that are cash generative.

Among other topics covered today include companies "right-sizing" their debt, positioning in Japan including a look at the Yen and Japanese Central Bank, valuations of small caps versus large caps, and consumer trends.

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Pamela Ritchie: You told us last time that you were never in Camp Transitory, but still, I mean, was yesterday not somewhat surprising on some level to you?

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Naveed Rahman: Yeah, absolutely, Pamela. I think that it's important to remember just what the market was thinking and what the Fed itself said a year ago. Reading commentary from the chairman a year ago saying that inflation was transitory; they didn't expect to raise rates until the back half of 2023; quantitative tightening would begin at some point this year. And we're in, as you point out, a profoundly different place. I mean, rates are up almost 250 basis points this year in the U.S. and around the world every major central bank except for Japan has hiked rates. I think it reminds us that if predicting the future from a macro perspective is difficult, and I'm not saying that we were so fantastic in predicting exactly what was going to happen, but from our perspective, the companies that we invest in were seeing inflation not just related to the supply chain but they were sort of really seeing inflation all through sort of their businesses.

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Our expectation was that what we were experiencing last year, Pamela, was a lot of goods inflation as people remain locked down and that we expected to gradually transition to services inflation because we were sort of unshackled at some point between last year and this year. But the economy globally, in the U.S. and Canada cannot turn on a dime. There are people that left professions in the services sector that found other jobs, demand spiked, and so we're here in a place where we think what we expected last year is playing out which is that inflation may have topped out in the summer of this year with the U.S. CPI readings in the 8, 8.5%% but the direction of travel may be a gradual one instead of a sharp...

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Pamela Ritchie: Remind us how you invest because you mentioned the way that we invest. It's global. It has a value style to it, ultimately, but it also isn't necessarily the biggest companies in every sector. Just try to go through exactly your universe.

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Naveed Rahman: The portfolio is called Global Intrinsic Value and we tend to focus pretty much exclusively on small- and mid-cap, high-quality, cheap companies that are cash generative. It's an investing style that's sort of a true north for us. We're not leading into the style when it's in favour and out of the style when it's not in favour. The data would back us up and say that if you do a good job curating a portfolio of reasonably priced, high-quality, cash-generative companies you will outperform not just the Canadian markets or the U.S. markets, you'll outperform global markets over the long haul.

And when you're in a period where rates are grinding up and inflation remains above what we've experienced the last decade and a half, that's a really nice tailwind for us as well because there is a preponderance of cyclical, reasonably priced companies that the market is not discounting a huge rate of growth and these companies are less impacted by rates going up, less hurt than sort of the fast growth company that's predicated on this fantastic earnings number 12 years out.

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Pamela Ritchie: You know, it's really interesting because we've spoken a lot about energy companies as an example but other companies too using a period through the pandemic in a lot of cases to sort of right-size their debt. Interest rates are obviously so low, a lot of people have renegotiated what they needed to do, companies. We know that about the energy side of things in that sector but from your perspective, the companies that you look at, were they also in the midst of doing that? Are they looking in better shape, ultimately?

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Naveed Rahman: Actually, we tend to be invested in companies that have low levels of leverage to begin with. I think one of the advantages of being a cheap, high-quality, cash-generative company is that you do not depend on the kindness of strangers. You do not have to go to the debt markets on a regular basis because your business throws off so much cash that if you are a good management team you can self-fund your investment, do a little bit of a share buyback and probably pay a dividend and not have to sort of depend on the vagaries. You're right, Pamela, if you are going out and trying to raise debt capital today, it is a much less hospitable environment than it was a year, a year and a half ago.

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Energy is a great example of where a lot of management teams got "religion". There's nothing like 12 years of suffering to really focus the mind on what needs to happen. Energy is a sector that ... this portfolio was launched in Canada, I think, in 2015. We were underweight energy the whole time until probably mid-2020, late-2020. It's a sector we avoided because it was consistently cheap but not high quality but a couple of things did change. One was that supply demand, the dynamics got much more favourable. A decade of underinvestment that set the seeds for a period of really tight markets.

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Secondarily, the management teams of a handful of the companies we've invested in, especially exposed to U.S. natural gas, are now compensated for free cash flow and earnings growth, not just the top line. That's a sea change in sort of the compensation structure of these companies. We paid attention to that and then we did extract a pound of flesh because energy companies need to be not just a little cheaper than the market but substantially cheaper than the market for us to be interested. They got to those places in 2020 and 2021. It's a bit more of a mixed call today because they have certainly outperformed but, optically, they're still the cheapest part of the market on a sector basis, fastest earnings growth and cheapest P/E.

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Pamela Ritchie: I'm assuming you're positioned within that, underweight, overweight, tell us about energy.

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Naveed Rahman: We are overweight energy and have been for the better part of a year. Again, that's a sector where I don't want to speak on a forward-looking basis. We are very mindful of valuations in that sector. Energy stocks are on a tighter leash than a consumer staples company that might be in our portfolio or an industrial company in our portfolio because you can only control so much as an energy management team in an energy company. You are a price taker and not a price maker.

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Pamela Ritchie: Interesting. That's completely fascinating. Since we're talking a little bit about positioning, where else, maybe things to update us on, where things have changed? Markets have certainly changed. Have you made any changes you can update us on?

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Naveed Rahman: We try to be flexible there. We had been underweight technology for a while but, as our viewers know, that's a sector that has been under duress and has underperformed the market. The market itself has been down, obviously, for the last year and change but tech has been down more, so that is a place that we have been slowly covering our underweight. It's a place where we are constantly on the hunt for opportunities and we're finding tech outsourcing companies that are trading at 10, 11, 12 times earnings, 6, 7, 8% free cash flow yields.

I should emphasize, as you said at the beginning, Pamela, when we say "tech" we're not talking about the large-cap U.S. FAANG names. They remain relatively expensive and we tend to focus on smaller and mid-cap companies, so it's a little bit outside of our wheelhouse. It's more the boring tech that enables technology to work: distributors, suppliers, business process, outsourcers, things of that sort, not-in-the-limelight tech, if you will.

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Pamela Ritchie: Fascinating to kind of get a sense of that. What else? I mean, we've also seen certain areas of so-called defensive plays ultimately do very well but then also change it up in the markets. A lot has changed in a year.

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Naveed Rahman: Right, right. Some of what is traditional defence, we are ... Let me back up for a second. One of the advantages of our portfolio, it's not an explicit goal that we had going in but when you buy cheap, high-quality, cash-generative companies, tend to have a lower beta profile, a lower risk profile. Historically, our portfolio has had a beta of roughly .8 versus the market, so call it 20% less volatile. We don't get there by explicitly seeking out the lowest beta companies. It's a really natural outgrowth of high-quality, cash-generative and reasonably priced companies. In fact, we have a lower beta than the market while being underweight some traditionally low-beta sectors like utilities and REITs. Part of that is a valuation driven call for us. Uts have already done well and you've been paid a little bit for their defensive qualities already. We're just finding better opportunities in other areas like the consumer staples sector, consumer discretionary. Health care is really a sector that, for the last several years, has been a really nice overlap ground for us where value, quality and cash generation have all come together really nicely.

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Pamela Ritchie: That's fascinating. It's just interesting to think about what you were talking about with energy and when the fund got going in Canada in 2015, last decade, decade before the pandemic, was very, very different ultimately to what it seems like this decade is shaping up to ... or is that wrong? I mean, do you feel like the lack of inflation for a decade is really going to change things going forward?

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Naveed Rahman: I think that's a great question. It is, in a way, coming back to where we began the conversation, that might be the reason that the market was so optimistic that the Fed would hike rates this year and then quickly pivot to lowering rates as soon as there was a sign of an economic slowdown. That was the playbook in an era of low inflation and low growth in the last decade. But we are in a really different time today where if was in the shoes of the Fed and I raised rates and that caused unemployment to tick up, that caused economic activity to slow down, I don't have the toolkit of lowering rates right away that I did in the last decade because headline inflation and core inflation might very well be in the 5 to 6% range while the economy is slowing down.

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If that were to happen, then this playbook that we've been accustomed to is not one that we can rely on because you certainly can't have ... The Fed has two mandates, it's important to remember, stable prices and full employment. They have indicated to us, and probably rightly so, that at different times in the economic cycle you've got to focus more on one versus the other. In an era of really low inflation they were not concerned with the prospect of inflation spiralling out of control, so they could really laser-like focus on full employment. Things have reversed in the other direction. They are much more concerned about getting inflation under control. It's interesting that Chairman Powell's, I think, PhD thesis at Princeton was about sort of some of the mistakes that the Fed made in the 1970s where it was too quick to ease at times of economic slowdown until Paul Volcker came down and sort of put the hammer down, as it were. The past doesn't always repeat itself but it does rhyme and so we should be wary that the reaction function that we were used to may be different going forward.

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Coming to our portfolio, that influence is sort of what we're thinking about. What are the kinds of stocks that can navigate a higher inflation environment, that have business models that do well? When I look at the portfolio, there's not a singular theme but it is interesting that we own distributor companies in technology, in industrials, in the consumer sector. One of the advantages of owning companies that are in the distribution business, you've heard of the middleman and in an era of 4, 5, 6, 8% inflation, you see that as a buyer but you pass that on to your end customer because you're really in that liminal in-between space and if you are a well-run distributor, you have a lock on the best supply and you have among the better customers and it's easy to pass on a 1% tick-up if input costs are rising 6, the end cost of the industrial good you're selling might be rising 7.5 and you're pocketing that as a distributor. It's a really nice inflation-hedged business model, as it were.

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Pamela Ritchie: That's fascinating. I feel like I want to ask you about whether supply chains are getting better or worse. Many will say they're getting better. Can they still pass along some costs, though? People are so scared about supply chains maybe the position of...

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Naveed Rahman: Broadly speaking, it is getting better. We see that in things like shipping container costs are down really meaningfully versus the peaks they hit a year ago, the lag time is shrinking. I think what we're observing is that that'll have a positive impact on inflation on a going forward basis but that is being more than offset by services inflation. Goods inflation is coming down but think of the cost of getting a haircut in Canada or going out to a restaurant or what have you. Those things, the labour costs associated with that is more than offsetting the goods inflation coming down. I am sympathetic to the challenge that these central banks have because it's difficult to control once inflation is percolating through the economy in myriad ways.

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The reason that all these central banks are, I think, taking a strident view is that the worst case outcome is that inflation expectations get unanchored. When you see surveys around the world, if you ask the average American consumer what they expect inflation to be in three or five years, those are still muted and lower than inflation levels today. If those expectations start to really get unanchored, then you sort of run the risk of it feeding on itself.

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Pamela Ritchie: Which is why they're stepping in with such, to some people, harsh measures but it seems to be the medicine that's being given at this point. You're global, you look around the world for opportunities. Can you speak to your positioning in Japan and how you might, ultimately, manage or look at the currency there given yesterday's news?

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Naveed Rahman: That's a very topical question.

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Pamela Ritchie: The news, of course, being that Japan getting in there, ultimately, to support *[crosstalk]*.

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Naveed Rahman: It's intervening in the currency markets, right. I think the yen is down 35 or 40% versus the dollar year-to-date, which is an extraordinary sum because if you think about it, the yen, along with a couple of other OECD countries, are haven currencies. In a period of volatility they typically strengthen. It's not happening now. It's really a function of the fact that Japan, the Japanese central bank, is kind of on an island having not tightened yet, maintained very loose *[indecipherable]* to policy while the Bank of Canada, the Fed, the European Central Bank have all been hiking, banks in emerging markets are hiking massively as well. Japan is, by a function of that, getting pressure. We tend not to make big macro bets. We're not *[crosstalk]*...

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Pamela Ritchie: We're exposed to Japan.

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Naveed Rahman: Right. We do have a small overweight position in that there are a lot of really high-quality, cash-generative businesses in Japan. Many of them, by the way, have input costs in Japanese yen and are selling into North America, Europe. So, they have higher revenues in dollars and euros and they have costs in yen. This weakening of the currency is very margin accretive for those companies. We're big believers, long term, on mean reversion, so it's not going to take a lot for the Japanese currency to start to stage a comeback.

Again, I'm not a currency expert, but if you look at history, if they get off the mat and start raising rates gradually, that will be a sea change and we could get ... historically, the Japanese yen has had violent periods of strength against other currencies when things like this have happened. I think it would be dangerous to kind of extrapolate that this weakening of the Japanese yen is going to persist forever. Hopefully, we get mean version, we'll get a bit of a catch-up and that should help our Japanese stocks. But we're not invested on that thesis. We're invested on sort of the fundamentals of those companies but we're really mindful of the exposure, given the historic movement that you're talking about.

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Pamela Ritchie: Fascinating. I was looking forward to asking you that as well, investors looking for your thoughts on that. A couple of other ... this question, Naveed, thoughts on small caps in this environment. Are you finding that valuations have dropped, creating opportunities? I mean, how do you look at that? There's sort of two edges to that sword as it were.

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Naveed Rahman: Right. I think I'll answer that question in two ways. First, relative to larger cap companies, the valuations are getting more and more interesting. Small-caps have underperformed in this broad market sell-off, so by function of that they're getting cheaper relative to their bigger cap brethren. Secondarily, a phenomenon, Pamela, that's important for our viewers to recognize is that we went through a long period of time where the number of public companies came down and that really impacted small caps. I think in the U.S., as an example, we had something like 6,000 listed companies 20 years ago and that was down to the low 4s not that long ago.

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But since the pandemic, there have actually been something like 450 U.S. small-cap IPOs. There have been about 200 companies that have de-SPAC'd or SPACs that have acquired companies and taken them public. The opportunity set is, for the first time in a long time, starting to reverse. There is a lot more stock-picking opportunity in small cap then there was just a few years ago.

The decline in the number of stocks one gets to choose from, that was a worrying trend. A lot of these companies were taken out by private equity companies and went away from the public markets. It's nice to see those come back. Now, not all of those are great investments and you've got to sort of do your work and pick and choose and find the ones that are good businesses run by capable management teams. That's what we're really trying to do.

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Pamela Ritchie: Completely fascinating. Tell us a little bit about the consumer as you see it right now. It fits into the small-cap story, obviously, the economic story. Many will say that they're actually healthier than you would think because we've had all this stimulus. How do you look at that?

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Naveed Rahman: Yeah, and I broadly agree with the line of questioning that you had, Pamela, which is that typically going into on the front end of a possible recession, you worry about the consumer and you worry about sort of credit losses that might ensue from a weakening consumer. Relative to other times in history when we're entering the cycle it's not as ... consumer is largely less leveraged than they are typically coming into a crisis. The pandemic-era stimulus that helped sort of the low end and middle end consumer around the world is sort of a game changing thing versus past cycles. The but there, it's a big one, is that housing and the home tends to be the biggest asset for most middle class consumers around the world. With the U.S. 30-year mortgage being above 6% today versus being at about 3% a year ago, we were watching for the impact on housing and home values because that will impact the consumer, their ability to access credit and sort of their overall credit worthiness.

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I think we're picking and choosing and I think it's important to remember that the stock market is really good at anticipating what's going to happen. A lot of consumer stocks, a lot of stocks in the two consumer sectors have already meaningfully underperformed anticipating a recession. Financials have underperformed anticipating a recession. We're actually finding opportunity on consumer-exposed financial companies within a handful of consumer stocks, more on the staples side where they're doing something absolutely crucial that is not that discretionary, where they offer good value to the consumer from a price standpoint.

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It is a classic sort of there are some risks but the market has started to discount many of those risks, so we're actually fishing in that pond, as we speak, especially if Fidelity's macroeconomic research team is correct and there is a chance that if a recession that we have may be more of a garden variety shallow recession dissimilar to the COVID pandemic, dissimilar to the global financial crisis. I mean, I think not every recession has to be a 40-year flood like we experienced. The U.S., as example, has had 12 recessions post-World War II, so some of those are not fun but certainly not as problematic as the last one we experienced.

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Pamela Ritchie: Maybe just on that, just speak to, ultimately, the value of compounding but when you have some downside capture there's just perhaps a better ability there which I think your fund will provide.

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Naveed Rahman: Yeah. I think the way it really comes home for me is that for U.S. investors, this team has managed a fund called Low Price Stock for 30 years. I think what's remarkable to me is that we have outperformed our benchmark after fees by roughly 350 basis points per annum, so a really exceptional number over a long period of time. But what I think is striking for our viewers is that the upside capture on that portfolio has averaged about 70%. In rising markets, when the market is up 10, we're usually up 7.

So how do you outperform the market by 3.5% a year while only having 70, 72% upside capture? You do that, to your question, Pamela, by protecting in down markets. When the market enters a choppy period, a period of volatility, by owning more stable, more cash generative, less earnings, volatile companies go down less in the market, protect the principal in down periods and then participate in up markets.

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The math really works out in your favour. If you're down 50%, you have to be up 100 just to get back to zero. The way you avoid that risk is try not to own stocks that go down 50% in the first place. It's very simple when we talk about it but that is … we are core quality value investors and most of the stocks we own don't have these massive drawdowns because we didn't pay a really high price coming in. The challenge in the market today is that there are these 40, 50 P/E stocks or 10 times sales stocks that have rerated. The earnings might still come through but the problem is you just paid way too much at the outset. That's a risk we really try to be mindful of on the way in.

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Pamela Ritchie: You introduced us to Sam, Morgan and also just to Salim and Joel also still being part of the team. I wonder if you can just briefly talk about the team.

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Naveed Rahman: Yeah, absolutely. We announced last November that Joel, after a long career, is planning to retire at the end of 2023, so kind of a 2.5 year premature announcement on purpose. He's with us, remains very actively involved. I just had coffee with Joel this morning talking about…

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Pamela Ritchie: Give him my best..

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Naveed Rahman: I will. We were talking about value and quality in the wine world and we agreed that Spanish wine, if global intrinsic value could invest in wine, we would own Spanish wine. Really good quality but much better prices than you might find elsewhere. He's very involved and he will remain so until next year. Sam and Morgan are the lead co-PMs taking over from Joel but they're not new to the portfolio. They have worked with Joel for 12 to 15 years, were, in fact, hired by him. He was the last interview on the way in, have been mentored by him and have been named on the U.S.-based portfolio that we have for U.S. clients for, I think, five or six years.

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There will be no change in the quality, value orientation of the portfolio. In fact, they are co-lead PMs today as we speak and as our clients can see, there's no noticeable change in sort of the tenor of the portfolio or how it's behaving in this very choppy market. Salim remains very involved, helping generate ideas for us from the quantitative perspective and helping very much with the risk management as well on the portfolio. We hope to sort of do more of these meetings in person as this permits in the coming year.

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Pamela Ritchie: Oh, good. We're looking forward to that, too. Thank you actually for taking us through your top thoughts on the big move yesterday but ultimately the positioning of how you see things going forward. All the best.

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Naveed Rahman: Thank you so much, Pamela. Great to be here.

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