Fidelity Connects

Podcast Title: Fidelity Global Innovators™ Class: Celebrating Five Years – Mark Schmehl

Mark Schmehl, Portfolio Manager

Pamela Ritchie, Host

Voiceover: Podcast Intro

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 Mark Schmehl is today's featured guest. For Canadian investors, Mark manages Fidelity Special Situations Fund, Canadian Growth Company, and Global Innovators.

We caught up with Mark on Tuesday, September 13 – a day where the U.S. CPI announcement caused volatility in the markets.

Is the current market environment ripe for stock picking, perhaps a time to opportunistically position one's portfolio for the eventual recovery? Mark shares his thoughts on these questions as well as providing his perspectives on this year's equity markets, and the current positioning of his portfolios.

Among other topics today, with host Pamela Ritchie, Mark comments on energy, financials, the state of innovation, when is or was the bottom of the market, and how he is shifting from defence to offense noting that now time for him to look for opportunities that he wants to own for next cycle.

As noted, today's podcast was recorded on September 13, 2022.

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Pamela Ritchie: So, that number came out, we're seeing a reaction to CPI, does it change, ultimately, how you are looking at the markets right now?

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Mark Schmehl: No. You and I talked about this earlier. It's interesting... I really do believe that visibility is improving. I think that you're getting to that point where six months ago —I'd say February timeframe or even December— it was like this fog, right, it was like the fog of war. You couldn't see through it. You had no idea what was coming at you. You just knew the Fed was going to raise rates until it killed the economy and shut down inflation. You had no idea what that's going to look like. And that is terrifying. Market just blew up, it continued to blow up and right through till June. We're at that point where we're starting to get an idea of what it actually looks like.

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Today's number is just part of the story. The market's like a juvenile child. It tries to price every little wiggle, so it bounces around all the time. What I like to do —I tell people this— you've got to back out to a five-year view and look at everything on a five-year view. It kind of smooths out all these little jiggly lines. It's really telling you that we have a lot of answers now that we didn't have six months ago. Some of the answers are we now know where the peak is in oil. That is something we didn't have a clue on before. We started to see demand destruction. I like to think of it in simplistic terms in the U.S. when oil got to ... or gasoline got to $5 an average gallon. Demand destruction hit $120 a barrel oil-ish. So, you know; you know where the peak is in oil. It's that number; that's the number. We didn't know that before. Supply is getting better; oil prices have eased. There's a lot of reasons; it's a very complex subject. Basically, you could say oil prices peaked at 120; oil drives inflation. It is the number one reason why inflation goes up. People talk about wages and all this stuff, oil...

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Pamela Ritchie: Not everyone looks at it that way.

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Mark Schmehl: Yeah. It bleeds into everything. It is an incredibly powerful inflationary force. That probably means inflation has peaked. If oil's peaked, inflation has likely peaked. Now, it doesn't mean it won't be persistent and won't stay higher for longer, and we could talk about where you want to be in that sort of environment, but the market is all about rate of change. The rate of change is changing. We're going from massive inflation to inflation that's starting to roll over. Where does it go to? I don't know. We don't have clarity on that yet, but we know it's peaking. So, oil's peaked, inflation has peaked, that probably means we have an idea where long rates are going to peak.

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That's the big variable for people like me in growth land who live in expensive stocks. I think it's pretty clear that the 10-year is probably going to peak around four. As a result, I feel as though the valuation destruction that we have seen over the last, probably 18 months, is likely over. If that's the case, it's time to start looking again at these really good secular growth stories because a big part of why they're all down so much is because 10-year backed up and valuation got crushed. Now, we can also argue about where earnings are, and I would argue earnings are still too high. I'm not saying that now's the time to put your whole portfolio into the market because I think it's still going to be bumpy. Today is bumpy; we're down 4%, but it is time to start looking for those opportunities that you want to own next cycle and...

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Pamela Ritchie: Is that what you're doing? Are you beginning???

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Mark Schmehl: Absolutely. What I'm trying to do now is ... it used to be I would cheer on days like today when I was up 100 basis points or 200 basis points and the market's down. If I look at my funds today, Innovators is up 100 basis points relative to the market. I feel like that's great. I don't want to be up that much anymore, so I want to start moving defense out of the portfolio and I want to move it towards offense. I'm starting to find ideas that are no longer expensive. Management teams have figured out "hey, the economy is slowing down, we are losing way too much money, we're going to fix that". And guess what? The business fundamentals are still fine.

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What happened in a lot of growth stocks is management never needed to run the business like a business, right? They just grew. They had all these projects and all this whiz-bang baloney and now they're starting to say "wait, I don't need all that whiz-bang baloney; my core product is still really good. I need to actually try and make money or drive what really matters". That's what recessions do. They're like this period of refreshing. We get rid of all the little projects we had and 600 people that are working on these little projects that are stupid, and we focus on what we're good at. Recessions are healthy. I think that the last 20 years has been a period where we haven't had a normal recession. We had the dot com blow up. We had the financial crisis. We had COVID. These are not normal recessions. You've got to go back to '80s and '90s to see a normal Fed-induced slowdown in the economy, a normal recession where things happen normally.

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I think that's what we're going to experience because the consumer is in a good shape pretty much everywhere. Balance sheets are in good shape; banking system's fine. There are imbalances, but, in general, it feels as though those imbalances aren't the ones I need to worry about from an economic level standpoint. There's a war going on. We know that and maybe it gets better and maybe it gets worse. I don't know. There's inflationary forces, absolutely, but as we slow the economy down those will start to get better. There's also supply response is starting to occur in a variety of places. The second derivative of all the bad stuff that has hit the market all year long is starting to improve and therefore we need to start getting interested in the stock market. Now, again, don't put all your eggs in. It's going to be bumpy and be careful and slow and move slowly. That's what I'm doing; I'm moving slowly. But yeah, now is the time to start buying stuff.

[00:08:16]

Pamela Ritchie: What does the innovation picture look like right now? You just mentioned a certain amount of rightsizing that's going on for obvious reasons. Are moments like this —whatever this is— a good time for innovation? Does it tend to be useful?

[00:08:33]

Mark Schmehl: It's great. It's funny; we've seen a lot of market destruction. My funds have been down a lot. There was just a lot of inefficient capital allocation going on, I would say, 12 months ago, 18 months ago. People were funding all kinds of crazy stuff. I was funding all kinds of crazy stuff. I look back and I look at some of the investments I made in 2021 and I'm like "what was I doing?" We all get caught up in it; it's an emotional procedure, but what happens now is we have this sort of cathartic look at my business and figure out what it is that I'm doing and what is it I'm doing well and become efficient around it.

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You would not believe how many conversations I've had in the last, probably even just six months, with a lot of luminaries in technology about that very thing. It's like we have 1,000 extra people we don't need. They're working on things that just don't matter and they're all going to get fired. This is a good thing. Basically, the more layoff announcements you see, the more bullish we can all get. The more bad news you see over the next three to four months, the better it is for everybody. The market is going to start to look through it because, as I said, a lot of those big variables that we didn't have a clue on, we can start to put pins in and say "okay, here's where they're going to be". I don't know where the market's going to go over the next 6 months to 12 months, but I do know that companies are rationalizing. Companies are trying to get more efficient —which is a healthy thing— and the economy's going to keep slowing down.

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So what do you own in a slowing economy? Remember the last 10 years; there was no growth, therefore, I'm going to own growth stocks because they're the only things growing and everything else isn't. Guess what? We're slowing the whole economy down and if you have some secular growers who are no longer spending money on stupid things all over the place, they could really show some leverage on the profits front. A common deterrent amongst a lot of my colleagues to owning, let's say, a software company is, well, they never make any money and it's not a real business. What happens when they start making real money? Anyway, I think there's a lot of opportunity right now. I'm not waving the flag like now's the time. But now is definitely the time to be looking and now's the time to be doing the work to find the ideas that you want to own 12 months from now when the market is ripping. That's sort of where I come down at the moment.

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Pamela Ritchie: Was June the bottom of the market? Sorry to ask you; it's such a throwaway question, but was it?

[00:11:14]

Mark Schmehl: I couldn't tell you that that's the bottom. Probably if I told you the bottom, I'd get yelled at anyway about compliance. I don't think that's the bottom necessarily, but it doesn't matter. We're getting close, right? We're quibbling. I mean; what did we hit, 3,500? What was the number? So, we go back there, who cares? It's like 10% in the time horizon of most investors. I'm investing peoples' money for 30 years. 10% is a meaningless number. Who cares? What I need to do is I need to take that, let's say, the next 10% down or whatever the number is —who knows what the number is— buy the right companies so that when things turn there's the 100% up. We've experienced the down already and we're still grinding through the down, but I can start to see the other side.

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Pamela Ritchie: I don't know if it is an interregnum but, as you say, there's a shifting going on of sorts. What do you like as you shift?

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Mark Schmehl: In terms of sectors, stocks or what do you mean?

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Pamela Ritchie: If you become somewhat less defensive and work towards being slightly more offensive, is there something in the middle that gets you through or is it, actually, you just switch from one to the other slowly?

[00:12:39]

Mark Schmehl: You basically slowly switch from one to the other. The things that have been working this year energy, utilities, staples, health care a little bit ... you start to say "well, do I want to own those in this next period?" The question is, what does that economy look like? Fast forward 18 months. We're coming out of this; what does the economy look like? I would argue that that economy is still relatively inflationary. So maybe inflation is not eight, maybe it's four. Rates are structurally higher, but we don't care because we've already priced that. Growth is not awesome; it's a little bit slow and we're working really hard on a couple of big things worldwide. You know, climate change; we're still doing technology, cloud transition, that kind of stuff.

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A lot of the secular trends we've been seeing for the last four or five years haven't actually changed that much. There's more and more electric cars coming. I actually just did a test drive yesterday and the electric Hummer is a crazy car. A lot of those secular changes that we've been investing in haven't changed. What's changed is that the capacity of the economy to grow quickly is reduced because inflationary pressures are real, and rates will be higher. Think about that economy. That's the economy I'm investing in. Where do I want to be in that sort of economy and what do I pay for the stocks in that economy? That's the question you need to answer. What I'm doing is I'm saying "okay, this is what I want to own in that type of economy two years from now" and that's what I'm buying today.

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Pamela Ritchie: So, what is that? Does crypto have a place?

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Mark Schmehl: I think crypto does have a place. It's really hard to come up with a value for it because it doesn't do anything yet. No one's found the killer app. The internet was a great thing until Google figured out search and then it became a business. Nobody's figured out search for crypto yet. I'm still there. I still pay attention to crypto; I own some crypto-exposed stocks. Picking away at it as it blows up is not a terrible strategy. Again, it's not one of those ones that like this is the best idea ever. I have two great ideas that I think are going to be amazing —I can't tell you what they are— up from zero five months ago and I buy them every day. I'm definitely getting that point where I think that there's opportunity in the market and it's not just in not losing money. The winning strategy for the last 12 months, which is "don't lose money". That's no longer going to be the winning strategy going forward, I don't think soon. It might be the winning strategy for the next couple of months or maybe through Christmas or whatever, but, if that's the strategy you're following, you're going to really miss out on when things start to get better again.

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Pamela Ritchie: The stock market can just look through so much ... well, so far, I guess, is the discussion of that. If the Fed ultimately breaks something, that will be the point when probably things have already taken off.

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Mark Schmehl: Yeah. By the time that the regular person is feeling this recession is the time the market will already be up 20%. The key, I think, for most investors, is visibility. I can't see through the... well, we're starting to be able to see what that's going to look like. You can pencil it out; you can come up with a scenario that makes sense and the visibility is the important thing.

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Pamela Ritchie: Asking about whether, in fact, growth as a style is somewhat redefined. Will it be different from what we thought of as growth before, is the question.

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Mark Schmehl: Growth is just growth. I think that the difference is the way people value growth. People were valuing growth in that low-rate / no-rate environment just strictly on sales because there was no interest rates and no other growth. I think that paradigm of valuation is no longer going to be with us because we are going to be in a higher-rate environment and a lower-growth environment in my opinion. That said, if you're in a lower-growth environment, you will pay more for growth, secular growth... whatever. Growth stocks are always the same; trade the same way for 100 years. It's just the valuation metrics people use to sort of figure out what they're worth will change.

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Pamela Ritchie: So, we don't have to chase ourselves out of a paper bag to redefine necessarily how that all comes to the fore. You mentioned a couple of big themes. One of them was energy transition. Where, if at all, do you find opportunities there? They obviously got priced massively and, also, kind of fell out of bed at some point.

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Mark Schmehl: In 2021 they were awful. There's a lot of science projects in that space and science projects work really well when rates are low and science projects don't work very well when rates are high. And we're going to be in a high-rate environment, so odds are good you don't want to own the science projects. But there are a lot of sort of industrial companies that are focused on the space that are actual real businesses that you can own that build into that. I own a lot of them.

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Pamela Ritchie: Are they so-called incumbents, though, or are they more innovative?

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Mark Schmehl: Yeah. They're incumbents but they are executing against the trend. So, if you're a utility and you want to put in a wind farm or whatever you need to use this company. It's not necessarily a good idea, in my opinion, to own the core technology in a lot of these spaces. For example, the battery guys; you know we're going to need bazillions of batteries. Battery guys are terrible stocks. Tesla's killed them all. The fundamental technology is not necessarily what you want to own because that's the science project. You want to own the integrator around it who creates the business around that. That's what I'm trying to find.

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A really good place for that right now ... utilities are fantastic. Utilities are like this little group that nobody ever owns and they're going to be the focus of a lot of capital spending for the next 10 years as we electrify the world. They are defensive, they pay dividends, and their earnings are going to be above trend for the next 10 years. So, it's not a terrible place and nobody would think about an electric utility as being a growth stock, but they're growing. It depends where you are. These are thematically things you can think about and try and find the right ideas.

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Pamela Ritchie: Do you think that markets ultimately ... it sort of goes to the question of the health of the consumer ... the idea that a so-called healthier consumer may go through dips if there's a recession or so on, but if you enter it as a healthier consumer, you generally fare better. Do you see it that way and are there opportunities because of that?

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Mark Schmehl: 100%. This is not the financial crisis when the market fell 50%. This is going to be a garden-variety recession. There's been a lot of argument about "we're in the '70s and it's going to be awful", whatnot. It's certainly not going to be the financial crisis because consumers are in a good place. Most consumers, with the exception of the low-end consumer, are in a really good place. The low-end consumer is never in a good place. They never have any money. That's just the way it always is. But most people have good balance sheets. Banks have good balance sheets. Companies have good balance sheets. Governments don't, but governments never have good balance sheets, so who cares? I just don't see it as a financial crisis, 50% Armageddon. That's why I really feel as though the market's come down 20 some odd per cent in the States and 40%, I think, for growth. I feel like we've priced a lot of this. I just don't see it as being as bad as the financial crisis. I lived that one and invested through it. This is not even close. I mean, not even close. For me, I feel like we're plumbing the depths. There's not tremendous downside. There's still downside but not tremendous downside, in my opinion, so far, and I feel like now's the time to start looking for ideas.

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Pamela Ritchie: You spoke about it a bit earlier but can you kind of circle back to how you're looking at energy at this moment?

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Mark Schmehl: Energy ... I think the group as a whole will continue to do well. I think that we're going to have structurally higher energy prices for a while, for lots of [crosstalk].

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Pamela Ritchie: Not just Europe; it's everyone.

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Mark Schmehl: Not just Europe, everybody. I think that the absolute price levels have probably peaked for a lot of them and take some of the heat out of that sector, but, if oil prices stay in the 80s for five years, a lot of these stocks are probably going to do very well because they generate a ton of cash. So, it is a really nice group to own, and I think you can stock pick your way through it. I'm overweight the group, but I don't think that early in the year it was the only thing you could own. If you fast forward to June, the only group that was working was energy. That is no longer true. The relative performance of energy to the rest of the market has really fallen because the rest of the market, there's simply more upside. So, energy is a good group. I think energy is a good space. I think it's good for Canada that energy probably stays high for longer, but I don't think that's where the most alpha is going to be found over the next couple of years.

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Pamela Ritchie: Interesting. Are there stocks right now that will ... you know, so-called secular trends that have been in the process of developing for some time now, but is there real sort of pinnacle to some of these stocks that you see coming through? Things that have done well, obviously been discounted lately, growth stocks, but just have that secular quality of where the future's going in five years from now.

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Mark Schmehl: Absolutely. There are lots of them, lots...

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Pamela Ritchie: And are they still kind of demolished in terms of their valuations?

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Mark Schmehl: Yes. Demolished in terms of their future valuation, 100%. A lot of stuff in my purview is down 80%. Some of these software names are down 80%. I think Snapchat went from 100 to 10. There's been real destruction in growth land and that presents opportunity. Now, can all these stocks go lower? Of course; can always go lower. But if you are investing in a stock's business that you don't think the business is impaired, but the valuation got extreme and maybe management hasn't done the best job. I don't know, I see a lot of opportunity right now.

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Pamela Ritchie: Have you seen management change at many so-called growth company ... I don't know, you can call it ... have you seen a fair amount of management either change over? We hear about some big names, of course, but has there been, on balance, some real change going on?

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Mark Schmehl: There's a lot of change occurring. We had another one yesterday, Peloton. The two founders left. That's awesome. I love to see that. You're seeing a lot of the visionary leaders just get hung and a lot of management teams are actually just ... we call it getting religion. They're starting to —like I said earlier— they're figuring out "well, I got 12 projects that are stupid and I'm going to cancel 11 of them and I'm going to focus on my core business". I'm hearing that a lot; like a lot, a lot. That is the most consistent message I'm getting from everybody in the world of growth. It takes time, right? It takes time. You've got to fire all these people; you've got to reposition. Some companies are further along in the journey than others. But that's bullish and that's what you want to see. You want to see change occurring and then, ultimately, that change will start to show up in results. If we don't have financial crisis level-like economy and the economy just slows down, I think a lot of these things are going to be fine. That's sort of my base case is we just don't have the end of the world nightmare recession.

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Pamela Ritchie: Talk a little bit, if you would, about financials, sort of broadly... I might just add to that where the fintech space fits right now. It's somewhat slimmed down. At some point we thought Wall Street would just buy all the fintech then that didn't really happen.

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Mark Schmehl: It could now. Fintech is absolutely blown up. It was one of the most toxic groups. If you owned PayPal or Coinbase ... oh my god, these things are down so much. This is what I'm saying. A lot of the speculative areas in the market ... like Square, I think Square went from 200 to 30. They've been destroyed. I think there's a lot of opportunity in those places because in many cases what those companies were doing hasn't changed and the trends that they were working on haven't changed and the value proposition hasn't changed. I would argue that the financial sector should be buying these companies now. Anyone with real vision, like you're J. P. Morgan; go buy PayPal. Just take them out of the game. That's what I think should be happening. It's not and that's super bullish, in my opinion. So, financials in general suck for me. There's no growth. A big Canadian bank ... when I own big Canadian banks in my funds that's because I have no other better ideas. They're banks; it's a bank. I had no value. Every fund manager...

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Pamela Ritchie: There are people giggling on this call right now [inaudible].

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Mark Schmehl: It's stupid. Everybody fund manager in Canada owns banks and nobody who owns my product owns it so that I will own Royal Bank. Every mutual fund that every planner has got, he's got Royal Bank in every single one of them except mine.

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Pamela Ritchie: I only have four minutes with you. Hang on, I've got to ask you this question, but emerging technologies, including hydrogen and also broadly biotech. Maybe you can quickly go into a couple of those. I know we don't have a ton of time. What do you think of hydrogen?

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Mark Schmehl: I think it's too soon and a lot of science projects. I think that you're not going to make any money investing in hydrogen stocks. I've tried it. In 2020 and 2021 I lost a fortune in hydrogen stock, again, I think the third time. I keep going back to that well and it keeps never working. I don't know, I'm going to stay away from hydrogen. I think that biotech is actually very interesting. Health care is a really good group for uncertain times. They have pricing power; it's not economically sensitive and I think it's actually a decent place to be hunting right now. Certainly biotech: there's been a lot of good data lately and I think that there's some really good stuff in health care that we should be taking a look at. I'm spending a lot of time on health care right now because it's not economically sensitive.

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Pamela Ritchie: It's binary, though. It's binary.

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Mark Schmehl: It is but there's growth. If you own Bristol-Myers, for example ... yeah, there's some binary action, but there's a really nice growth business that the binary action's attached to and in an economy where it's kind of squishy and inflation is high and there's not a lot of growth, these things pay big dividends, health care seems like a pretty good group to be in. Maybe not so much tools because hospitals have been wiped out by COVID, but a lot of the big pharma stocks look really good to me and then biotech, in general, looks pretty good as a group.

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Pamela Ritchie: That's great. Just a regional question; you're very focused on the U.S. Are you starting to find opportunities abroad? Or is this ... I mean, it looks pretty tough out there, but maybe that's good for hunting.

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Mark Schmehl: With the strength of the U.S. dollar, it's been really bad to be anywhere but in the United States. Actually, the Canadian dollar has been good. It's been very ... relative to the euro, I mean, everyone in Canada should be going to Paris right now. The Canadian dollar's been very, very strong. Both of those two currencies, it's the best place to be. North America has the cheapest energy, the most efficient economies. Europe, it looks awful, I mean, awful. Asia's a mess. So regionally, when you look around the world it's hard to say, well "why would I go and mess around with Latin American stocks when it just doesn't look like it's getting any better?" So, yeah, mostly still in the United States and Canada.

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Pamela Ritchie: A final message just to sort of wrap up a number of the thoughts that you've laid out for us, but just sort of where you're at right now.

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Mark Schmehl: Where we are at with respect to what?

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Pamela Ritchie: Where you are at in terms of the portfolio and positioning.

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Mark Schmehl: I would say I am probably 60/40 offense, defense. Maybe not quite that high. Working towards it. I'm slowly selling defense to slowly buy offense. That's a transition that I started about six weeks ago, maybe, and that will continue. My goal is so that when the market finally bottoms, I have as much offense as I can possibly stomach, so that when things get better the fund really moves. I have told people forever, traditionally my funds go down with the market and I'm looking at it now; I'm down 20 and the NASDAQ's down 24, so I always go down about the same as the market and then, as things get better, I tend to do much better than the market. That's how I want to position the funds. I'm slowly selling my defense to buy offense, every day.

[00:30:45]

Pamela Ritchie: It's great to have a chance to speak with you and thank you for joining us from, is it foggy San Francisco still or has that lifted?

[00:30:52]

Mark Schmehl: No, starting to lift.

[00:30:53]

Pamela Ritchie: Starting to lift; the morning fog is starting to lift. Great to see you, Mark. All the best.

[00:30:57]

Mark Schmehl: Thanks, Pamela.

Ending: [00:30:58]

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