Fidelity Connects

The Long/Short Method: A Closer Look at Alternative Investing

David Way, Portfolio Manager

Pamela Ritchie, Host

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

David Way, portfolio manager of Fidelity Long/Short Alternative Fund, is today's guest. As investors focus on the daily market moves and wonder where rates are heading, David notes it's important to consider how higher interest rates could affect company performance over time.

Today with host Pamela Ritchie, David shares where he's seeing opportunities, provides an update on the current positioning of Fidelity Long/Short Alternative Fund, explains how he approaches short selling, and unpacks how interest rates affect the housing market.

This podcast was recorded on August 30, 2022.

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And one more note before we get started: if you are looking for more market insights, circle Thursday September 8th on your Calendar. Fidelity's Vivian Hsu, Director of Product Innovation, is hosting a Reddit Ask Me Anything event from noon until 2:30pm eastern. All are welcome to stop by and ask their questions about markets and investing. Head to Fidelity Canada subreddit to participate. That's reddit.com/r/fidelitycanada

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Pamela Ritchie: David, a bit of a reminder, if you don't mind, on the set-up of this fund. It's a long/short fund, to what extent can you short the market, to what extent are your investments long? Just give us sort of the one, two, threes.

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David Way: Yeah, sure. The Fidelity Long/Short Alternative Fund is a long/short portfolio that consists really of two main parts that are working together. There's a long portfolio that consists of about 130% of the fund's net assets and our very best ideas put together in a portfolio designed by myself, and a short portfolio of around 30% of fund assets that really reflects our analyst views as well as my own views of companies that are likely to underperform both the market and the long positions in the fund. In general, I think the key message really is that the long/short fund widens the opportunity set, especially during periods of volatility, helps reduce the overall volatility of the fund by having part of the portfolio that's attacking opportunities that are profitable when the market is challenged or perhaps declining and, more importantly, over the very long run remains 80 to 100% net exposed to the market over time to benefit from longer term market appreciation that comes from the innovation that we see over time working its way into GDP growth and stock prices.

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Pamela Ritchie: You have a pretty fascinating way of looking at the markets. This sounds like an interesting time to have your mix of kind of eclectic ideas sometimes -the way you get into the ideas and looking at companies- ultimately bottoms-up. I know that's the way you begin and look at things. We have so many different things going on right now; let's begin with some of your views on the macro situation and then we'll kind of drill down into what that means in terms of your investing. We've heard from sort of an economist perspective; I think we've all read headlines on what Jerome Powell said in a very short address. What does it mean for your style of investing? The Fed is resolute at this stage, it appears. Is that what it appears like to you?

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David Way: I think that's the message they're trying to deliver. I think, as an investor, one of the things I try to do is keep things simple. The way that I look at the world today, there's a few things going on: You have a reopening in China combined with an economic slowdown where there is anticipation of stimulus to come in the coming months. The second thing that you have is clearly a political and energy crisis in Europe that seems to be pushing that economic block towards recession. As we get closer to home, in sort of the core of where the fund looks in North America, we have clearly an inflationary environment, an interest rate and monetary condition tightening that is ongoing and the market's really trying to sort out who are the winners and losers from that period.

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I tend to be a bottom-up investor, but I am macro aware and I guess the way that I kind of bring this all together is to understand that people are concerned about macro tightening, they've looked at some more recent playbooks whether it's the GFC or other tightening cycles as you go back to the '70s or '40s, and the market has tried to place their bets at least a sector level about how they think things are going to play out. As a bottom-up investor, one of the things that I need to do is dig in at a sector level and look for inefficiencies where, perhaps, a group of stocks has been sold off because there is concern about how interest rates might affect demand. There might be really good companies in there, whether it's because they have a product cycle or they're a smaller company gaining market share, they may prove to be less economically sensitive than that top-down sector view. Those are the kinds of places where I'm trying to dig and sort through this top-down macro environment and find really interesting companies on the long side. Of course, on the short side there's a lot of headwinds that you can point out as investor, and it's kind of a really interesting time right now where the list of companies where things could change materially and get worse versus expectation is kind of a long list right now. As a long investor, you just ignore that, and as a short investor, it's a great place to dig in to try to make money.

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Pamela Ritchie: Well, everyone wants to know what's being shorted, so let's start there, because it's eternally fascinating to see what's going on that side. What can you tell us? Is it a sector call, for instance? Or how much subtlety do you put within that?

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David Way: Well, it really depends. For me, anyway, I kind of go back to my framework for how I think about short selling. For me there's really three key things that I try to attack in the market when I'm looking at short selling ideas. There's one bucket that traditionally is less of an important bucket for me but is important now and that's what I call a hedge for long, where I might be taking a longer term view on an ultimate economic recovery and what I think is a great business trading at a depressed valuation because everybody's worried about higher interest rates and recession, and I may be uncertain about the timing of recovery, but I have high confidence that when we look two, three and four years out that this company will be making a lot more money than the market expects and generating strong returns for shareholders. That's one area right now and it could cut across all kinds of sectors. It really depends on where I find the matching long idea where I find shorts.

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The second bucket is what I call ESG detractors. These are companies that really fall into the bucket where they could be an environmental company, whether they're focused on decarbonization, alternative meats, or they could just be promising to solve another environmental problem and, unfortunately for shareholders of those companies, the promises they're making are quite large and built into market caps that aren't supported by what I think the ultimate profits of that business are. So, I can take a bet that there are companies out there making big promises that they can't keep, and I can go short those businesses. Even though we've seen the Inflation Reduction Act, which provides some targeted incentives that are quite interesting and meaningful to some companies, but that there are other companies that just don't have a product, they don't have the technology, they don't have the management team to really commercialize their business in a way that's going to allow them to take advantage of what are clear long-term trends. That's kind of the second bucket of areas where I look for shorts.

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An example of that might be a company like Beyond Meat, which operates in the alternative plant-based category. The stock's obviously down meaningfully from last year. I think it's down around 80 to 90% from its peak. But here's the challenge; sales are declining meaningfully within the category. They're losing market share within the category, so they've had to cut price at the very same time that their input costs are going up. So, this is a company that's losing money on every plant-based hamburger patty that goes out the door with no end in sight. I think they might have four to five quarters of cash flow remaining to support their business and they've got debt outstanding. So, it's a really challenging position for a company like that in an environment like this. As a short seller, you could take advantage of those opportunities where if you're concerned about a category losing market share, it can actually be exciting because you can short the company that you think is set to lose in an environment like that.

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Pamela Ritchie: And the third bucket, so that fits with the ESG detractors, I'm guessing. Does it?

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David Way: Yeah. The third bucket is what I call classic financial shorts. One of the things that we've experienced in this environment is that -I said this at the beginning of the year- my two key things that I was watching was just our long march towards whatever the new normal is for our economy.

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Pamela Ritchie: At the time, did you think, sorry to interrupt you, but at the time did you think it would be a long march? We're obviously not talking about the month of March, which is when a lot of the Ukraine stuff started, the end of February, I guess. Did you think it would be as long as it is right now? Are we kind of on track? I'm curious.

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David Way: It's been really different by sector. I think we saw leisure travel come back like wildfire and I think it's been messier than I expected. We've seen airport delays globally. I think we can all look at whatever our local airport is -mine is Pearson- and we have seen the logistical apparatus of flying and travel really struggle to keep up with what is surging demand at or above 2019 levels. The whole theme of revenge travel; we've seen hotel rates skyrocket, rental car rates skyrocket. We've seen a lot of demand and the sector… it's been very messy, but there really has been a strong increase in volume.

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Then you have other sectors where I have been surprised at how long it is. I would have expected that by the third or fourth quarter of this year we would be facing very normal automotive production and it's, maybe, in some ways worse than it was a year ago. We do remain on this long march towards normal in important sectors. That's interesting to me because it creates opportunity. It creates opportunities on the long side for companies where I don't think investors are being patient enough to what strong 2023 and 2024 could look like as recession or not. The automotive industry sees steadily increasing production volume. I also think it presents opportunities on the short side for companies that are not well-positioned to weather this really difficult storm of low production and high inflation.

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Pamela Ritchie: Would you say valuations on the long side of your portfolio… are valuations high for the things that you're long?

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David Way: I think I'm being very cautious about companies that trade at meaningful premiums to the market. We're always looking at stocks. How attractive are equities in general? How attractive are individual stocks relative to your alternatives? One of the things that I'm really looking at; whether there's any stocks in the portfolio that might trade at high valuations in absolute terms and really stress testing the investment thesis. I think with the interest rate environment we're facing there is clearly a downward pressure on equity valuations and the price earnings multiple. We saw a meaningful contraction. I think it was about six points of price earnings contraction from the peak of the market through to the trough. We've seen the market regain some of that premium and we've kind of now settled into a fair value range. I'm not a macro investor but the equity market might be fair, fairly value to slightly highly valued relative to where we are in the interest rate cycle.

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Setting all that aside, if you're a company that trades at 25 times earnings, you better be doing something really special where I can look forward 5 to 6 years, see very strong organic growth, you're generating a current level of profitability that is highly supportive of the business and this is where I put my short selling hat on. When I'm looking at a long investment, I ask myself, what's the earnings profile of this company? Is it very high-quality earnings? Are they relying on stock-based compensation? Are they doing a lot of acquisitions to drive growth? Or are we seeing an earnings profile where that sort of headline earnings number is dropping down to cash? There are companies out there that trade in that 20 to 25 times earnings that are generating a lot of cash and support their value because they have a lot of growth ahead of them.

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Pamela Ritchie: That's a good example of a company doing what you think is special, in that case. Because there are so many moving pieces with cost of capital going up, with interest rates going up and what that's going to mean ultimately for companies in a variety of different ways, there could be a lot of room for companies to fall. You mentioned equity premiums depending on the company. Is this fund especially useful for a so-called -once we get through some of that- a pivot by the Fed?

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David Way: Yes, I think so. One of the great things about this fund is that I can play offense on both the long side of the portfolio and the short side of the portfolio. I can look at where the best risk-reward is in the market at any given time. As conditions tighten, one of the things that I can look for are vulnerable companies whose share prices suffer because people worry about the balance sheet or their operations and their ability to navigate a difficult period as a fragile company. One of the things I look for when the market's pivoting is I look for the beginnings of what some people might call a junk rally, where some of these companies that have been shorted, have poor business prospects, the short thesis plays out, and you start to see the company stop responding to bad news and start responding positively to any good news.

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One of the great things that I have is I have a microscope that I can put on the market to see where things start to get better. That was actually one of the things I saw during the COVID downturn. It was March 2020. The world is over; there was no good news to be had. I still remember the day where the Fed came out and said, "we'll buy high-yield bonds". A number of companies that I had been short that were down 90% were up 20% that day. I'm like "okay, my bankruptcy thesis on all of these companies is over", so I need to cover those shorts. And, moreover, I need to start looking at the best of that bunch to include in the long portfolio because we're going to go from bad news being bad to bad news being good news. I think in a long/short fund you can kind of chase those opportunities on the way down and you really get a front row seat for when things stop getting worse and start to get better, when you start to see positive change.

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Pamela Ritchie: So fascinating. Do you use options with your strategy?

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David Way: It's a good question and the fund can use options, but I haven't used any options to date and it's not part of the current fund strategy. There're no exotic derivatives. This is a long/short fund that only uses the leverage from shorting stocks to add to the long portfolio, so there's no additional financial leverage in the fund and there's no additional leverage in the short positions. It's strictly equity shorts.

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Pamela Ritchie: Fascinating. Let's talk a little bit about interest rates as they affect the housing market and maybe not specifically house prices, but how you might invest around the thesis of where the housing market is going, what it's experiencing, what that means to the companies that are connected to it. Do you see those as interesting areas to look for shorts?

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David Way: It's an area where there is probably current opportunity in looking for shorts where companies that have been a little bit more resilient than the homebuilders. The homebuilders are like the purest play way to short a bearish view on housing starts and margins for selling new homes. You also have the added overlay of... we had this huge boon in renovation spend during COVID as people were stuck at home and do-it-yourself activity.

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Pamela Ritchie: Did you do a renovation?

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David Way: I did. I actually had a renovation plan before COVID, and it was definitely a white-knuckled process. Fortunately, mine was complete and I had ordered everything, so it was a smooth process. I wasn't alone. Everybody was busy doing painting and other things because they were at home. It's something we all know and we're starting to see the home renovation centres like Lowe's and Home Depot lack those numbers, but it's a really important driver of the economy. We're seeing the baton get passed from do-it-yourself to contractors, who might have had deferred demand because they only had so many crews last year. There's really been a smoothing of the post-COVID demand.

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Getting back to housing and rates; housing is the economy in many ways and rates are the most important driver of housing activity. It's a very difficult market, you could take the U.S. as an example where you've seen home prices appreciate, interest rates start to peak up. Purchasing a house now is 50% more expensive than it was last year based on prices and interest rates. This is clearly at a minimum room for pause in the resale market and it is absolutely room where you could expect declines in new housing volumes as we get into 2023 because there's a lot of houses already under construction; homebuilders can only move so fast. This is really kind of a next year event where we'll see the proof in the pudding.

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Pamela Ritchie: That's so interesting and it's connected. Of course, everything is connected, but it's connected to the story for consumer demand and for those that are paying more for their mortgages essentially, and energy, and crimping what they can spend elsewhere. Do you anticipate that to be maybe a structural shift?

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David Way: There's a medium-term theme where I could think that things like revenge travel, experience... experiences over things was a long-term secular trend prior to COVID. Live Nation, the concert operator, had a very strong secular theme around increasing the number of shows, increasing ticket prices as people sought experiences rather than sort of physical goods. I think we've seen a continuation of that trend. Really, just a resumption after the COVID interruption. I think just given all the disruption we've seen around travel: high cost of travel, high cost of transportation fuels like gas or jet fuel, I think you'll see that demand get spread over longer periods of time. As a result, I do think you will see multiple years of consumer services outpacing consumer goods in terms of how we spend our time.

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Pamela Ritchie: So interesting. It's very European to save up for the dishwasher… for the good one.

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David Way: Things are getting back to normal. New York rents are up meaningfully as people return to New York City against all odds, where people thought, people would depart to the suburbs forever. Here in Toronto. Florida. We're starting to see significant increases in apartment rents here in Toronto. You're starting to see the populations kind of get back to business in terms of how they live their lives and, as amenities reopen in cities, people taking advantage of that.

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Pamela Ritchie: Let's get into the question of everything surrounding the discussion of energy, commodities more broadly as well. You've said elsewhere that bringing down energy prices, the relief from that is not enough. We have inflation in other places, and we know that, and there's the discussion, obviously, of housing that we've been having just now, as part of it. What ultimately, though, do you think that energy prices, the commodity story, might produce over the next little while? Do you go long or short on that?

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David Way: It's a very interesting time for energy because, when you look at the inflationary playbook, one of the things that I'd mentioned is that in 2020, in October, when I launched the fund, one of the things that I had flagged in my view of the world is that I thought it was important to have select net energy exposure in the fund. So, I was actually short…

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Pamela Ritchie: Okay, wait, take us back there. The fall of 2021, where was oil? It had fallen out of bed–

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David Way: Yeah, 2020.

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Pamela Ritchie: –and had made it back to what levels by then roughly?

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David Way: I think at the time oil was $40 - 45. Gas prices were significantly lower. We were oversupplied. The companies had overleveraged themselves in some cases and cash flow for the sector was really divided between the low-cost producers who could still find a way to make money at low prices and high-cost producers, which were struggling under heavy debt load from acquisitions and production growth and were really in a difficult spot. At the time there were long and shorts available, but over time I wanted to have net exposure to the sector because, when you look ahead from the really unprecedented monetary and fiscal stimulus that we experienced in the post-COVID period, that we could see inflation and we didn't have any idea at that time that it could become this fast and be this severe, but it was important to have energy exposure because that's the one place to make money when inflation expectations go from low to high.

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I've had a long-term exposure to energy. I think Canada produces a couple of really important industry champions that have long life assets, low cost of production, a path towards carbon reduction, which I think is going to have to be an important part of the story for our oil sands producers over time. More importantly, it's in a safer political region. I didn't fully anticipate the political upheaval we would see in Europe. Clearly, now North American energy is structurally advantaged for the foreseeable future relative to other production basins. I do think that the cost curves shifted; it's created more of an opportunity for domestic producers to do well for a long period of time. What I'm constantly doing is I'm looking at the shorter-term trends in the commodity price because that drives kind of the near-term price's volatility, but also the 2 to 3 years of super profits that I anticipate that these energy companies will produce.

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In some cases whether it's fertilizers or renewable diesel or other sectors, the market has priced in a couple of really great years and then a return to normal. What I'm really looking for is mispricing relative to that kind of base case: that things should be really good for a couple of years. As of the last disclosure, I did have exposure to energy and fertilizer, which are two key beneficiaries of higher global energy prices, so the fund does have exposure to that, just based on the view that we really have entered an interesting new period because, otherwise we might say, "hey, we're in recession, energy demand is going to fall, these stocks are sells". I think there could be other much more important drivers for these stocks over the next couple of years.

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Pamela Ritchie: Very interesting. What do you think of the banks? Broadly, U.S. and Canada?

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David Way: I'll tackle Canada first. I think Canada… over the very long run, there are a number of industry champions within Canada *[to]* make it a great business. There are strong retail franchises with high ROEs. There is a mortgage market which is very favourable from equity returns to banking. There is a regulator that works with the industry to set high standards; to make sure everybody's well-capitalized. Having covered the insurance industry, the regulator is really there to help smooth bumps in the road and is much more less adversarial than you might expect from a banking regulator. It's a very favourable operating environment. The companies pay strong dividends and have demonstrated earnings growth over time. If you look back over the fund's history, you'll have seen a couple of the Canadian banks be larger positions within the fund. Broadly speaking, I've been underweight the Canadian banks in favour of other opportunities in the diversified financial space. That's kind of all in the rear-view mirror now.

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What we're facing going forward is a mortgage market that could be very difficult. As we all know Canadian mortgages are short-dated. We're starting to see some of the early pain in variable rate mortgages. If a five-year mortgage, on average, is maturing in two and a half years, if rates are at this level for the next two-and-half years, that's going to create significant financial strain on people with mortgages where that consumes a big part of their income. I do think that the operating environment for banks in Canada will be challenged on a go-forward basis. Valuations don't seem to be extreme at one end or the other, but the thing about financials is that you don't know something's going wrong until it's too late and things tend to happen … whether it's credit loan loss provisions or other sort of bumps in the night… these things tend to happen as surprises. As an investor, I'm always asking myself what's the best risk/reward? If things are fine, can these companies keep chugging along with decent dividend yields and fine earnings growth? versus if something goes wrong in the Canadian economy and things really break or start to deteriorate in housing beyond a modestly negative scenario, then that would create a very challenging environment for the banks.

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Pamela Ritchie: Just as a final word, a theme of resilience seems to be coming through in what you're saying right now. Would you sum that up as part of your positioning?

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David Way: Absolutely. I think in this environment there's a lot of uncertainty. We're coming off significant periods of monetary growth which stimulated the economy in ways we've never seen. The kinds of companies that I'm looking to build in my portfolio have three really common building blocks: They have visible revenue growth because they have pricing power, a unique product or some kind of business cycle that is really in their favour from reopening or something else, where you can have very high confidence that revenue is going to grow in a way that outstrips inflation.

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The second thing that you need to believe is that there is a strong margin structure underpinning that business and so you can be very confident that, as revenues grow, it's going to accrue to equity holders and not somebody else. The third and final bullet... you asked me about valuation earlier and the scenarios where I would own a higher multiple business, but this is really an environment where you want valuation on your side; you want expectations to be managed down to a lower level and we're starting to see companies trade in that market multiple or below like 14, 15, 16 times earnings that are still growing with great margins and returns, but just where our expectations have come down and that's sort of a safety net that I really look for.

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Pamela Ritchie: Okay. David Way, thank you so much for taking us through the fascinating strategy that you invest on behalf of investors in the long/short fund. Great to speak with you. Thanks for your time.

[00:30:42]

David Way: Thanks for your time, Pamela. Have a great day.

Ending: [00:30:43]

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