

ETF #18 Corrections/Recoveries Rough Transcript

Speaker 1 [00:00:05]

Hello and welcome to the Fidelity ETF Exchange, powered by FidelityConnects, connecting you to the world of investing and helping you stay ahead. In the 18th episode of the Fidelity ETF Exchange, cohosts Etienne Joncas Bouchard and Himesh Patel welcome Michael Charanduk to the show. Michael is an ETF analyst at Fidelity Investments Canada. Today, Etienne, Himesh and Michael dive into market history. Their discussions revolve around the performance of various investment factors during market corrections and recoveries. This podcast was recorded on May 17, 2021.

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Etienne [00:01:26]

Hello, everyone, and welcome to the Fidelity ETF Exchange. I'm your host Etienne Joncas Bouchard, aka EJB. And joining me today, as always, is my co-host, Himesh Patel. HP, how are you doing?

Himesh [00:01:38]

Doing well, doing well. Seeing some light at the end of the tunnel now that we have some team members that are vaccinated,

Etienne [00:01:44]

Hopefully return to the office eventually. We're actually a little bit luckier here in Quebec. We can go out and do some activities. So I feel for you guys in Ontario. I've been out golfing, playing tennis a little bit. I don't want to rub it in too much. But I hope you guys get back to that soon, and to enjoy this lovely weather that we're having.

[2:01]

Today, we're also going to be welcoming a very special guest. So joining me and Himesh, we're going to have Michael Charanduk. Mike is an ETF analyst at Fidelity Canada. Mike has been a member of the ETF team since day one. So since 2018, here at Fidelity. And he's been a massive contributor to our success as a firm and growing this line of business. Mike is also responsible for overseeing relations with market makers, helping advisors with trade execution, producing in-depth research on investment factors and anything surrounding our ETF line-up and the industry as a whole, as well as supporting the entirety of Fidelity Canada's sales team in their business development initiatives. So it was only a matter of time before we were going to go and get this gem on the podcast. Mike, welcome to the show.

Mike [00:02:50]

Thanks so much, EJB. That was an awesome intro. Big fan of the pod, so I'm glad to be here today.

Etienne [00:02:55]

Awesome. Glad to hear that. I did my research a little bit, but obviously we know each other very well, so it wasn't too hard to get a couple, info on what you've been up to these days. But before we get into today's topic and the discussion that we're going to be having with you and with Himesh, a quick recap of our last episode. So actually, Himesh and I took the time to answer your questions about ETFs. So we did somewhat of an FAQ, or an audio FAQ via podcast where we answered your questions on topics ranging from ETF trading, the different types of ETFs, what is passive investing versus active investing? How are ETFs similar or different than mutual funds? And many, many more, so for those of you who didn't have a chance to listen to that episode and would like to, as always, they're available via FidelityConnects on your favourite podcast app or on Fidelity.ca.

[3:55]

All right, guys, let's dive into today's topic, which once again, we're getting pretty good at this. It's actually pretty timely. It's really based on a great research paper that you guys wrote together less than a year ago. It was as of July 2020. But it's more relevant now than maybe it even was back in July, looking backwards. And the title of the paper is Factor behaviours during corrections and recoveries: Portfolio ideas to navigate through volatile markets.

So in March of 2020 - I'm not going to announce something new to anyone here - global financial markets suffered one of the largest drawdowns in history as uncertainty around the covid-19 pandemic and its economic impact or potential impact started arising from a narrative standpoint. So this was one of the most unique bear markets in history as it was followed by one of the most significant V shaped recoveries ever. So a very large drawdown, followed by a very sharp recovery. And I'm pretty sure this is somewhat what sparked both of your interests in researching what investment factors typically do well in corrections, and then which one should we be allocating to in the recovery phase. So albeit last year was unique, I'm sure there were some similarities with past cycles. So my first question, and it's pretty broad for you, Mike, give us a bit of background on what you and Himesh worked on. What are some of the key ideas you researched? And what was the rationale behind putting this paper together?

Mike [00:05:29]

Yeah, for sure. So I think you set the background perfectly. March 2020, everyone switched to work from home. The S&P 500 just bottomed out on March 23rd. And what we saw was really a unique time because the S&P 500, in U.S. dollar terms, lost almost 34% in thirty three days, which really was never seen before and is basically the fastest drawdown in history of the U.S. markets as we know it. So really, this was also the biggest drawdown people in general have seen from just an absolute basis in the last 11 years as well. You'd have to go all the way back to March 2009 to see something this big at the height of the financial crisis. And you guys know me, I wasn't even invested at that point. I mean, I was barely in high school. So it felt like quite a long time ago, and especially for a lot of newer, younger investors, this really was the first test that we really had seen in that they were living it for the first time. It's one thing to read about it in history class or in a book, but to actually live it, is very different.

So that's kind of how it came about. Himesh and I were in a meeting brainstorming some ideas. And we were thinking, our focus here is really on the Fidelity factors, as in factors in general they really are the core of our line-up and really what kind of our speciality is here. So we were just kind of thinking and thought, hey, why not

help some investors and advisors navigate these turbulent times using factors? And how we decided to approach that was taking a historical perspective. And as you know, history doesn't always repeat itself, and history isn't an indication of future returns. But I think there's a lot to be learnt from what's happened in the past.

So basically what we did, we went back to 2000, looked at any correction of 10% or more in the U.S. market, and basically looked at how factors performed during the drawdown and in the ensuing recovery phase, over three, six and 12 months following the bottom. We came up with a lot of interesting results, which applies to factors in general (in our line up), which we really thought was interesting.

Himesh [00:07:31]

I'll take a little step back and just point out to everybody that when we're talking about factors, we're talking about equity style factors like low volatility, dividends, quality, momentum, small-caps, value stocks, for example. And, just like Mike said, we were in the thick of things in March and April of last year. For many investors, this was the first time that they would have ever experienced looking at their portfolio account on a daily basis and being down 1-2% on a daily basis consistently. So everything was going down. There was lots of noise in the market. And I think, for us, it was just a good way for us to figure out how to do some research and put sort of a guideline and a pathway to see what has happened historically to help us figure out what might happen next.

Etienne [00:08:31]

Awesome. That's really the interesting part as well in your research papers, is that it's understanding how to protect yourself on the way down and then rotating and taking advantage of opportunities that may arise in the early-cycle phase recovery. I think right now it's pretty clear that we're in a typical early-cycle recovery and however that's characterised, whether that be with obviously GDP growth picking back up, unemployment levels falling, inflation expectations are moving up. We talked about it a little bit at the beginning of the year. But how would you characterise the typical early cycle or, I guess, the recovery phase? It's not just black and white. Is there something that you guys look for in your research to say, OK, drawdown period is over, other than just simply the bottom from a market perspective? Was there anything other that was considered other than performance?

Himesh [00:09:30]

So it was all based on performance, but we tried to tie in some of the historical context around cycles and economic cycles and which factors will do well and which won't in those cycles. The problem with doing that way is that it's very difficult to put bands on those time periods. So, for example, you asked, when would you consider us being in early cycle? Typically, that's rising inflation, rising GDP. But those are all backwards looking.

Etienne: [10:01]

typically

Himesh: [10:03]

Yeah, typically, and those are all backwards-looking numbers. So you would never really know until one month later, at minimum. Then we have things like the ISM surveys, and the manufacturing surveys, and the PMIs that might help us identify which cycle we're in earlier than that. But it's still very difficult to put some bands around it.

So we went with just performance. And I think that was an easy way for readers to understand what periods we're looking at. And when we're looking at the data, I think it was more efficient to figure out: here is the drawdown; here's when it ended; here's the trough, and then here's when the recovery started from the trough.

Etienne [00:10:45]

Absolutely. Mikey, I'll ask you a question then. And I think, so we can get more into the nitty gritty of the subject. I think it's best to start with the conclusion on what you guys found, and then we can go into why instead of what actually was the final finding. So let's start with the correction period. Which factors tend to outperform in the drawdown in the correction period when you haven't hit the trough, if you will?

Mike [00:11:17]

Yeah, for sure. So, there weren't any groundbreaking discoveries here. It was mostly what we expected. Right at the forefront, out of the six main factors that Himesh mentioned, low vol was really at the forefront. And this is exactly what you'd expect, right? Stocks that exhibit lower volatility on average than the broad market in a draw down are usually going to outperform. That was what we found. And joining low vol, close behind was also dividend yield and quality factors. And again, this also makes a lot of sense, right? Dividend paying companies tend to be more stable. They have been around a long time. So usually they're going to be able to weather a storm in the form of a drawdown, and also quality companies. So really, these are companies with strong balance sheets, strong profits, which again, really helps them stay afloat during a really rough market time. So, yeah, at the start, that was pretty much what we found during the drawdown phase. But what I do want to mention, what was really interesting that came out of this research, is that on average, it's exactly what you'd expect, those three factors. But every correction is very different and is driven by a different set of catalysts, which I think I just stole Himesh's thunder because that's his favourite line.

Himesh [00:12:28]

It's not trademarked, so you're ok.

Mike [00:12:29]

It really is an important point, though, because it's easy to point to say, hey, low volatility is the best in protecting capital. Now, if you held low volatility during all six of the corrections we looked at, you'd have come out on top. But if you pick any individual one, there's always a different story depending on the set of circumstances. So I just wanted to mention that because it's very relevant now, right? I mean, if you look at covid last year, low vol didn't actually protect the best on the downside. It was actually quality. So every correction has its own set of circumstances and its own set of almost surprises and results, which can play out differently depending on the drawdown.

Himesh [00:13:11]

I'm really, really glad that you brought that up because last year was the classic example of not following history and our findings essentially. So like you just mentioned, low vol underperformed. Dividends also underperformed during that period, which is contrary to what our findings told us. And if you look at other periods, like the global financial crisis in 2008, dividends also didn't do well in that period because of the bank. The banking system was under extreme pressure. So I think moral of the story is it wasn't really surprising to us to see the results. But when

you look at things on an individual basis and in those time periods that we looked at, there's definitely some outliers and there's definitely lots of context around what you can put in terms of what those different cycles mean and why those corrections are occurring. And that helps you get that gauge of what might do well and what might not do well.

Etienne [00:14:08]

And I think also when you put into perspective... so you guys mentioned, you look at a drawdown 10%, right? That's what we're looking at. If it's 10%, then we can put this into the framework of the research study. But if you're down 10%, which is somewhat of a normal occurrence throughout a year, it's significantly different than if you're down 30%, which happens very few times over even 30, 40 years. Right? We've had it twice in the past 15 years. And that's the most frequent occurrence ever.

So I think when you put that in perspective and you have a crisis like covid-19, where it's very unique, where it wasn't credit related, it wasn't linked to necessarily... The economy was running pretty strong prior to covid-19. It wasn't in 2008 when literally financial institutions were rolling over due to their, I guess, maybe mismanagement of certain products. We won't get into that whole conversation. But that was a very unique scenario for dividend stocks in particular, which you guys mentioned you found that protect well. The reality is, if you cannot sell your goods or services anymore because of stay-at-home orders and quarantining measures, well, I'm sorry, but you're going to protect your balance sheet before compensating shareholders with dividends. So we saw tons of dividend cuts last year, which is somewhat of a unique thing that's happened in that drawdown. And, you know, low vol is another great example where real estate tends to be a very low-vol sector. Well, commercial REITs and industrial REITs and office REITs, I'm not so sure fared so well last year. So great. Great stuff.

And do you guys have anything else to add with regards to last year in particular? Maybe why quality or even momentum to a certain extent did really well. They're both factors that overweighted infotech. So there's one thing there. Is there anything that you guys found that might explain why those factors did better in 2020?

Himesh [00:16:16]

Essentially, it came down to being better positioned for a locked down, shut down economy and stay at home economy. So a lot of the consumer discretionary names and staples names that had an online presence, for example, and had a substantial online presence even prior to Covid, they tended to fare a lot better than obviously the big box stores and your mom and pop shops that don't operate online. And so one of the reasons why quality did well was because a lot of those companies were able to sustain their operations, continue generating cash flows. And in most cases, actually, they increased the strength of their balance sheets, and during that time period, just because of having to save on those fixed costs on infrastructure and real estate. So I think that's part of the reason.

The other part of the reason, I think, is what you just mentioned, is that quality was overweight in infotech. And a lot of the tech names like Zoom's and the Zoom's of the world, for example, Microsoft and Apples continue to do well last year. And I think that's another reason why quality also did well.

Mike [00:17:34].

And to build off that, I want to tie it back to, as you mentioned, dividend and low vol for a second. So on the positive side, like Himesh explained, you have quality, momentum really outperforming, which especially for momentum was very, very unique because, typically, if you look at the historical average, momentum is usually

pretty much in line with the market on the way down, and on the way back up in terms of correction recovery. But what you saw during Covid is it actually protected better than dividend and low vol, which was a first, and also on the way back up, at least in the first six months, it outperformed dramatically. And I'm sure I'll get back into that more later. But I won't get ahead of myself. But you have to really tie it back into the drawdown in the more defensive sectors.

So dividend and low vol, you had a bunch of things happening at the same time that really did not fare well for dividends. As you mentioned, the dividend cuts, which first, it's kind of ironic when you think about it, right? You have these stable companies paying out, say, healthy three, four or five percent dividends. But in an attempt to really strengthen their balance sheets and be a little more financially prudent, they cut back on the dividends or suspended them altogether in order to survive. And then the ironic part is that this actually tanked their stock price because the market reacts to dividend yields in a very straightforward way. If you increase your dividend yield, your stock price tends to go up. And if you reduce your dividend yield, suspend it or cut back, it tends to go down. So that was a definitely a big reason why a lot of dividend payers did not do well.

You also had the energy or oil crisis happening at the same time. So a pretty healthy weight of any dividend portfolio is going to be an energy sector, which was definitely a huge detractor, real estate, which you touched on, and then tying it back to low vol. This is really interesting. This wasn't part of our research, but this is more of an internal note that we had sent out, and I think had a catchy name, but it was called "Is Infotech the New Low Vol? Right? So basically, we looked at it, looked at the rolling one in three or beta of the infotech sector in the U.S. versus the utility sector over the last 20 odd years. And what you saw for the first time ever is that infotech actually did have a lower beta than utilities. So utilities beta went over one while infotech was just slightly at or below. So it just really was interesting. Tie it back to what we said before. Every drawdown really has its own set of circumstances. And usually utilities is kind of the rock, the stalwart that tends to do really well in most typical drawdown environments. But, like I mentioned, it had actually a much higher sensitivity to the market last year during the drawdown. It spiked in February, March and April, which really was never seen before. So also as a big detractor to low vol as a factor overall.

Etienne [00:20:34]

Very interesting stuff. And I think that also brings us to the fact that, you know what, factors change over time. And we had actually mentioned that, I think, in a previous podcast where who knows what low vol will look like in 5, 10 years. Are companies investing more in technology and less in real estate? Does that make it more volatile over time because you're willing to cut the office space versus not cutting on your ERP, for example? That's the beauty of factors. And I think we'll see how they change in the coming year and how they react to this trend that we've started to see with regards to going into the recovery names. So that brings me to my next question, which is which factors tend to outperform? Typically, if we go look at those six periods that you looked at, which ones tend to outperform in the recovery phase?

Mike [00:21:27]

So, those two, the answer is very straightforward, which is great. It's value, size. And the conversation, it's not even close. If you look at it on a historical perspective, on average, value dramatically outperforms along with size. But what's really interesting, actually, is how this is played out over the last year. So when we initially did this paper back in around March, April last year, we had six drawdown phases since 2000, but we only had five recoveries because obviously the one year since the bottom of Covid hadn't played out yet.

So what we did as a I guess you could call it a one-year anniversary paper, we basically went back and just updated the analysis to see, OK, now we have six full recovery periods for the 12 months. And what we saw here was honestly kind of shocking. So if you were paying attention to markets, this is going to come as a surprise. But it just shows you how much it really diverged over the past 12 months, specifically if you're dividing into equal six periods. So say the peak or the bottom of the drawdown was on March 23rd. In the first six months following the recovery, you had momentum leading by an outsized almost 10% ahead of the market and far ahead of any other factor. Size was pretty close, but momentum was easily the clear winner. But then what really, really shifted is in the next six months, it was just absolutely night and day, momentum and low vol were the worst performing factors. And you saw just a massive return from value. And this really coincided with early November, the positive news of the vaccine roll out. Big rotation out of growth into value weren't the cyclicals on the positive reopening news. But this chart really just paints an amazing picture. The S&P 500 did 22% in the next six months, whereas value did 42%. And the next closest factor was sized at 30%. So it not only did 20% better than the market, it did 10% better than the next closest factor.

Etienne: [23:34]

And that's of when?.

Mike: [23:36]

I just thought that was really interesting. So that's one full year as of March 23rd, but it's played out similarly over the last month or so.

Etienne [00:23:44]

Himesh, anything to add there before I jump in was a few comments?

Himesh [00:23:48]

I think just the fact that the correction was so sharp and vicious but extremely, extremely quick to recover, really just shows how the factors changed during this time period relative to historical findings that we saw on average. And when you think about it, as we started to come out of the recovery, because growth has been so scarce in the market and investors more generally have been overweight to growth stocks and quality stocks, those are favoured once again as we start to recover. And it was still quite uncertain as to what the market would hold for us in terms of the covid-19 pandemic. That's when we start to see the rotation in November, when we saw that news about the vaccine, and that's what signalled really, in my opinion, the early-cycle shift. I think you guys would agree with that as well. But when we started to come out of that recovery at the bottom of March 23rd last year, investors really just stuck to what they already owned before and started buying up those positions that were down but still had significant weights in their portfolios.

Etienne [00:25:00]

Interesting stuff, and that's also another thing, right... is that when you're looking at... recovery does not mean the next cycle or the next year or two years or three years. From a mathematical standpoint, it can. But if you look at last year, for example, from peak to trough, like you guys said momentum did really pretty well. Quality did well. And then, were they the first to get back up to a new all-time high, in a sense? And then we saw the rotation into those typical recovery factors?

Himesh [00:25:34]

That's exactly what happened. That's exactly that's exactly what happened.

Etienne [00:25:38]

So, in a sense, those in this correction were the fastest to recover, but it was somewhat different because of the covid-19 pandemic, once again, where those companies were continuing to be, I guess, given a premium by the market because we didn't really know when we'd find that early cycle. Like when was it time to buy cyclicals? When was it time to buy leisure and travel stocks, like all those things that fell into value, financials, the same thing. We had financials with rates coming down, coming maybe under pressure a little bit. But when there was that catalyst, it was back to the more typical other periods that you guys had looked at, where value and dividend and size, especially size also for everyone listening in, size is a small-cap buy. So you're buying companies with a smaller market cap than the broad index. So I guess we're in that normality once again. But it was delayed compared to other periods.

Himesh [00:26:42]

Yeah, that's exactly right.

Etienne [00:26:45]

It makes sense. How would you guys attribute the success of those factors in the recovery? Is it simply based on valuations, so small caps were trading at a discount? Is it a return to a medium, like a return to the average where they've underperformed, now they're going back? I think it also has to do with the rate cycle and inflation expectations. How would you guys perceive that? Because value and small caps were both trading at a discount to the broader market, I imagine.

Himesh [00:27:20]

Yeah, as everybody knows, they've been out of favour for the last 5-7 years, in the U.S. market especially. But I think inflation and the rate cycle has something to do with it. I don't think it has all of it to do with it. I think for the most part, what really triggered it and what really is the reason why small-cap stocks and value stocks are outperforming right now is because of that reopening play. And as the market predicts that we sort of return to normal in some capacity, at some point, now we're actually seeing that in the U.S. to some degree. We're seeing that in Europe to some degree as well. But I think the market was really just looking forward to that point in time where value stocks and small-cap stocks are tied more economically to the cycle and which phase we're in. And as we start to reopen, they'll be the highest beneficiaries of a reopening of the economies around the world.

Etienne [00:28:26]

OK, let me play devil's advocate here a little bit. So value stocks, small caps, dividend stocks to a certain extent because they had sold off last year, found themselves somewhat into the value bucket and tend to be a little bit more cyclical. Those have done extremely well, like you guys pointed out, since November, with reopening, even, especially in the U.S., where a large majority of the states are close to being fully reopened. I mean, not fully, but we're going to get there eventually. Is that going to be a catalyst to say, "OK, well, early-cycle phase is over. It took eight months and we're back to maybe favouring other factors?" Or do you guys still think that there's

some legs for those factors to run going forward, even as, I guess, that bounce, that initial bounce or it's often characterised maybe more from a fixed-income perspective as the junk rally. So everything that was struggling to stay afloat or not doing so well, it's going to benefit on a relative basis from positive news. But now that positive news is very baked into the market, can they still outperform in the short to medium term, or are we already getting close to another inflexion point where we maybe go back to, for example, momentum, quality, which are better in the mid to late cycle?

Himesh [00:29:50]

I certainly think that there's lots of room to go in that sort of reopening trade, if you will, but with definitely lots of uncertainty in the markets like you've seen today or even in past weeks, where if we do have like a one percent correction or one percent drawdown in the trading day, investors tend to flock back to quality technology stocks and some of those areas in the market that have done well over the past five to seven years. But I think the overall moral of the story is that the economy is not going to be open like a light switch. It's going to take multiple inflexion points in where? Yeah, some states in the U.S. are fully open, some are not. But the way that the economy is designed, it's not meant to just open up and everything will be OK. I think we're going to see lots of openings and a little bit maybe some closings again. But it will be a gradual, slow grind, I think, forward. And historically, when we look at the economic cycle periods, this early-cycle phase that we're in now, or that we're seeing that we're in now, will typically last 12 to 18 months. So we're about halfway there, I think, but again, who knows what the future will hold and who knows how things will go? But I certainly do think there's lots of room to go in that value, small-cap, reopening trade.

Etienne [00:31:24]

Awesome. Great comments. I think you're absolutely right in the sense that some segments of the economy are coming back online relatively quickly, some are not so much. Think about services, which are a much larger part of the economy than they were 20 years ago. I mean, that still has not recovered to an extent that you've seen goods and manufacturing. So, I tend to agree with you. And from a historical valuation standpoint, which we always tend to look at, we're still trading in the fourth quartile of historical value or historical discount for the value factor. So the value factor is always cheaper than the market by design. But how much cheaper is it than the broad market? And right now, we're still, once again, like I mentioned, in that fourth quartile. So probably some ways to go. Mikey, do you have anything to add on those points or some other comments you'd like to make with regards to these early-cycle factors?

Mike [00:32:20]

Yeah, for sure. We could probably debate in a whole other podcast episode if we think that reopening trades are overvalued or if all that excitement is already priced in. But you're really dealing with a lot of pent-up demand that I think, at least in my lifetime, I haven't really seen before. People literally can't travel. They can't go see their friends. Obviously different in the U.S.. But you know what? I'm not calling for a massive outperformance of travel stocks. But just as an example, talk to your friends, talk to your family, everyone's dying to go on a vacation. So, it's things like that that I think will help fuel value for a little bit longer, at least for a bit longer. I would agree with Himesh. I think we're about halfway through. But things can change quickly. But until there is really a shift in investor sentiment into slightly more risk off. But I think everything we've seen so far is it's pretty much full of risk on. Obviously it's come down in the markets the last couple of weeks. But I generally agree. I think value still has

a little bit of ways to go. And as you mentioned, valuations, they haven't hit all-time highs. They're actually in the bottom quartile. So if value stocks now hit all-time highs, maybe it'll be time to reconsider. But at least from the data we've seen, it's not really telling us that just yet.

Etienne [00:33:52]

Great. So we got a consensus here, which is great. We always like to have a consensus. Guys, we're coming up on time. It's already been more than 30 minutes, and I feel like we could have gone on for at least another 15, if not more. But I'm going to cut us off here in the interest of time. Mikey, thank you so much for joining us on the podcast. Loved your insights today. Keep pulling out some great research papers so we can bring you back on the show. Find some other stuff to talk about and you're happy to come on. We'd be happy to have you on any time. So thanks again for coming. HP, thanks as always. And we'll leave it at that for today. Thank you, everyone.

Mike [00:34:34]

Thanks. Thanks for having me. Been a pleasure.

Speaker 1: [00:34:38]

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