Dividing labour, adding return

David Wolf | Portfolio Manager
David Tulk, CFA | Institutional Portfolio Manager

Key Takeaways

- Fidelity Canada's multi-asset class funds benefit not only from our stock and bond managers' performance…
- …but also from their insights and diversity
- Our 'bottom up' pillar is generally positive on equities amid overall mixed signals

As anyone who's listened to us present knows, we very much believe in a division of labour in the management of the multi-asset class funds at Fidelity Canada. As lead managers, we're not trying to do everything. My asset allocation colleagues and I are responsible for the top-down decisions that we know best regarding the overall positioning of the funds, and we let the Fidelity experts in the individual asset classes pick the stocks and bonds that go into the portfolios, based on the bottom-up work that they know best. We don't tell our underlying managers what securities to pick, and they don't tell us how to combine their portfolios to maximize return and manage risk for a given multi-asset class fund.

We think that harnessing this division of labour is the right approach for managing multi-asset class funds. Everyone involved in the process is focused on doing what they're best at – and held accountable for their ability to contribute alpha independently to fund performance.

We do, however, obviously pay close attention to what our underlying equity and bond portfolio managers are doing. As asset allocators, we have fiduciary responsibility for the fund as a whole, and we are compensated based on the performance of the fund as a whole. We don't

> Whether it's **equity style** or other dimensions of our asset allocation process, we are constantly looking for opportunities to **add value through active tilting** – but we do so around the **anchor of structural balance** within the funds, as always with the **goal of maximizing return** while **managing risk** across our multi asset class portfolios.

interfere in their alpha-generating process because we need it to be as effective – and as uncorrelated from our own top-down process – as possible.

The other reason we pay close attention to what our equity and fixed income managers are doing, and why they're doing it, is that we find their insights to be an important source of edge for us in making our asset allocation decisions – what we label the 'bottom-up' pillar of our process. This edge comes in two forms.

First, a key input in our decision regarding the weighting of a given asset class is the view of the managers that are living that asset class every day. For example, if our high yield bond managers don't like high yield bonds, we probably don't want to be allocating there.

Second, the intelligence that we glean from our individual managers is often helpful in filling out our 'market mosaic'. For example, if our managers in the various credit spaces see burgeoning distress among their borrowers, it can often be a sign of forthcoming equity market stress, which we can get ahead of by adjusting our allocations.

In sum, we consider our access to our internal experts to be an important advantage in the management of our multi-asset class funds.

Dealing with Divergence

But what happens when we get conflicting intelligence from our underlying managers? How do we reconcile the views of an aggressive growth manager who's really bullish on equities and a deep value manager who's really bearish? The answer is two-fold.

First, as with the macro, valuation and sentiment pillars of our process, we carefully weigh up all of the signals we glean through our bottom-up pillar. Those signals are almost always conflicting in some fashion, meaning we must make a judgment regarding the balance of evidence, which we do as a continuous part of our process.

As we begin 2018, we consider the balance of evidence regarding the equity market outlook coming from our bottom-up pillar to be positive on net. The same is true for our macro pillar, where we are seeing a solid synchronized expansion of the global economy. However, evidence gathered from our valuation and sentiment pillars suggest caution, with most asset classes looking expensive and greed displacing fear as the prevalent attitude among investors. Weighing it all up, we believe that a broadly neutral weighting in equities is most appropriate at this stage of the cycle, and we are positioned accordingly in our multi-asset class funds (see Exhibit 1).

The second point to be made regarding conflicting signals from underlying managers is that, particularly in our more flexible mandates like the Fidelity Managed Portfolios, we structure the funds so that systematic biases can be broadly balanced out in the fund as a whole over time. Put more succinctly, there's room for both bullish growth managers and bearish value managers. At any given point in time, one will be tend to be more right than the other. By holding both within our funds, we can allow

EXHIBIT 1: The four pillars in early 2018

MACRO	Global recovery increasingly synchronized. Above-trend economic growth is supportive of risk assets.
BOTTOM-UP	Earnings outlook improving nearly everywhere, supporting risk assets.
VALUATION	Risk assets looking increasingly expensive relative to history. Stretched valuations increase magnitude of potential retrenchment.
SENTIMENT	Complacently optimistic, with greed dominating fear for risk assets.

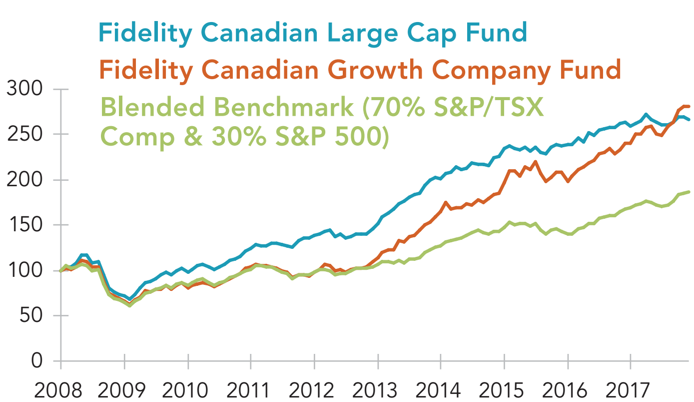
Source: FMRCo.

those style biases to balance out while reaping the stock selection alpha that our equity managers have shown skill in generating over time (see Exhibit 2).

When it comes to our holdings of different types of equity managers, however, it is important to point out that 'balanced' does not mean 'static'. We can and do tactically 'tilt' the overall equity style of our Managed Portfolios depending on the market environment. This tends to be less a function of a top-down view on value vs growth, which we think is hard to get right reliably, and more a consequence of the advantage discussed above in working closely with our underlying managers. For example, going back a year ago, our more price-conscious managers in Canada reported increasing difficulties finding opportunities that fit their process discipline. However, Mark Schmehl was becoming more excited about the opportunities emerging in the market that fit his process. Largely as a result, we reallocated capital within the FMPs towards Mark's Canadian Growth Company Fund, a decision that was significantly additive to performance in 2017, and a position that we are retaining as 2018 gets under way.

EXHIBIT 2: Different paths to outperformance

Growth in $100 invested vs benchmark, last 10 years



Note: Series F Fund returns shown. Sources: Fidelity Canada, FMRCo.

Whether it's equity style or other dimensions of our asset allocation process, we are constantly looking for opportunities to add value through active tilting – but we do so around the anchor of structural balance within the funds, as always with the goal of maximizing return while managing risk across our multi asset class portfolios.

David Wolf and David Tulk, January 31, 2018

Follow Fidelity Canada on Twitter @fidelitycanada

Authors

David Wolf | Portfolio Manager

David Wolf is a portfolio manager for Fidelity Investments. He is the co-manager of Fidelity Managed Portfolios, Fidelity Canadian Asset Allocation Fund, Fidelity Canadian Balanced Fund, Fidelity Monthly Income Fund, Fidelity U.S. Monthly Income Fund, Fidelity U.S. Monthly Income Currency Neutral Fund, Fidelity Global Monthly Income Fund, Fidelity Dividend Fund, Fidelity Global Dividend Fund, Fidelity Income Allocation Fund, Fidelity Balanced Managed Risk Portfolio and Fidelity Conservative Managed Risk Portfolio.

He is also portfolio co-manager of Fidelity Conservative Income Private Pool, Fidelity Asset Allocation Private Pool, Fidelity Asset Allocation Currency Neutral Private Pool, Fidelity Balanced Private Pool, Fidelity Balanced Currency Neutral Private Pool, Fidelity Balanced Income Private Pool, Fidelity Balanced Income Currency Neutral Private Pool and Fidelity U.S. Growth and Income Private Pool.

David Tulk, CFA | Institutional Portfolio Manager

David Tulk is an Institutional Portfolio Manager at Fidelity Investments. In this role, he serves as a member of the investment management team, maintaining a deep knowledge of portfolio philosophy, process, and construction. He assists portfolio managers and their CIOs in ensuring portfolios are managed in accordance with client expectations.

832360.1.0