The Upside

Three Themes to Watch in the Second Half

David Tulk, Portfolio Manager

Emily Anonuevo, Host

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

On today's show, portfolio manager David Tulk sits down with host Emily Anonuevo. David shares how he first got into investing and a bit about his time as an economist at the Bank of Canada.

David has now been with Fidelity since 2016 and is a portfolio manager on Fidelity's Global Asset Allocation Team. The G.A.A. team determine allocations to equity or fixed income managers in Fidelity's multi-asset class solutions and manages close to half of Fidelity's assets for Canadian investors.

As David explains, asset allocation is about providing diversification, and as we mark the mid-point of 2021, David looks at main global investment themes in short-, medium-, and long-term outlooks. This includes the pent-up consumer demand from spending nearly a year and a half locked down.

This podcast was recorded on June 17, 2021.

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Emily Anonuevo: Just curious, were you always interested in economics and finances and what actually sparked your career in investing?

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David Tulk: Well, I was the kind of kid that always wanted to figure out how things worked and at some point along the road I discovered this thing around us call an economy that was the aggregation of everyone's decisions they were making, whether it was where to go for dinner or eat at home, as the case may be today, what to buy, where to work. All of those individual decisions bubbled up to this massive thing that really influences everybody but not that many people took the time to try to understand and figure out how it works. So that was really the catalyst for my interest in understanding the economy and economics. Then I discovered that economics is sort of like a language and, once you have that language, you need to figure out what dialect you want to speak. Economics can be practiced in academics; it can be practiced in the public sector; it can be practiced within financials.

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I had the good fortune in my career to have spent time at the Bank of Canada, so seeing it in a public policy role, some time on the sell side as an analyst trying to understand how it impacted financial markets and that really led me to Fidelity which, in my mind, was the perfect combination of understanding the economy but understanding how all of those themes were reflected in the performance of financial assets and how I could help individuals retire in comfort, pay for their children's education, and bring those themes together. So that was really the motivation that brings me to you today.

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Emily Anonuevo: You're absolutely right on all those fronts and happy you're part of the Fidelity team. Now, for people who may not know what you do as part of the global asset allocation team, can you briefly explain your role and how you use active asset allocation in your investment strategy?

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David Tulk: Yes, absolutely. That's a great question. Asset allocation is all about providing diversification. What we do as asset allocators is to combine a group of different asset classes, so stocks and bonds together to provide an investor with the right type of portfolio to achieve what they want to accomplish. That involves choosing...within Fidelity, we have a huge stable of managers who are picking individual securities like stocks and bonds. So we bring groups of managers together so that the end portfolio achieves what the investor wants to have happen. So that really comes down to certainly earning a return, so that's a focal point for us, but it's almost more important for us to provide protection, to make sure that you don't have a concentrated bet on a single sector or a single stock. We're giving you other parts of your portfolio that when the market becomes a little bit more volatile, and we've certainly seen lots of examples over that in recent years, what we're able to do is protect in those periods of volatility.

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You can think of part of the portfolio as being return seeking but there's going to be another part of the portfolio that provides insurance in the event the market doesn't end up doing as well as what we would hope. If you think a little bit about our performance this year, this has been an interesting year coming out of the pandemic, as you mentioned, and in that theme of providing return, as well as providing protection, we've had elements of the portfolio that have done really well but there are other elements that have lagged a little bit, which I think is appropriate because those are the parts that will really shine in the event the market does start to become more unsettled. So making sure you have the discipline to stay diversified, to look for lots of opportunities in terms of different asset classes, that's really the essence of what we're trying to do, as asset allocators.

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Emily Anonuevo: That's a wonderful overview. Thank you for that. You mentioned about achieving returns and still having protection especially during these last 15, 16 months. I want to get into the bulk of our discussion. As we hit the midpoint of this year, we wanted to frame out this show around three main global investment themes in the short-, medium-, and long-term outlook. Let's start with the short-term outlook, David. What should investors be keeping an eye on?

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David Tulk: We're in the reopening phase of this cycle. It's been very strong. There's a lot of pent-up demand from everybody, having spent the better part of 18 months locked down. They want to be able to get out there and spend and re-engage with life as normal. That's been made easier, certainly by the rollout of the vaccine, so we're seeing those critical thresholds of vaccination rates reflected in various economies and that's allowed public health officials to scale back some of their restrictions. Another really important part of why we think the reopening will be very strong is that policymakers have provided just a tremendous amount of support. We've seen this coming from central banks who have pushed interest rates down to very low levels. They've created a great deal of liquidity in various financial markets and that's really helped to lift a lot of global markets and that's helped to benefit the wealth position of a lot of individuals.

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The second part of the policy apparatus has been governments. So fiscal policy has stepped in and basically tried to fill in the crater that was created by a lack of private sector demand as we were all locked down. So those efforts have helped to replace income, have helped to support businesses, and that stimulus is really the kindling that we would see that catches on fire as the economy reopens. That's really the thrust that we want to watch very carefully over the next year or so is how aggressive will the economy be in terms of driving growth rates? We think it will be pretty sizeable, but a related part of that is how willing will central banks and governments be to let it ride? And this is a very unique cycle because we think that central banks especially are going to remain very accommodative for a lot longer than they would otherwise be.

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We heard from the Federal Reserve that are only really hinting about thinking about slowing some of their purchase program of government securities and are only really talking about the risk of higher interest rates several years down the road. That's a unique stance for central banks. We've seen governments also really wanting to provide a lot of extended stimulus into the future to really encourage more inclusive rates of economic growth relative to what we've seen in the past. I think that does provide a very strong tailwind into the performance of the global economy but also in terms of financial markets.

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So that's the optimism. The need for insurance, as I mentioned, comes from the fact that what I just described is really not that controversial. Everybody sort of feels like this is going to happen. So that's allowed financial markets to perform pretty well in anticipating that narrative. Knowing that the market is somewhat expensive makes us a little bit more aware as to how much risk we want to take. Knowing that as a lot of good news is priced in, it might not take that much in the way of bad news to cause the market to pull back a little bit. We do believe in the positive theme of reopening and of markets doing well. We just want to be a little bit mindful that the market can get over its skis and we need to be prepared for perhaps greater volatility over the balance of the year as we shake out what's going to happen versus what the market expects will happen.

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Emily Anonuevo: Go back to your earlier point in your answer about government support and fiscal policy. On the flip side, many governments have taken on huge deficits and debt levels throughout this whole pandemic. So how could it be managed and who is it that governments owe money to?

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David Tulk: That's a really great question. It definitely gives me a chance to answer the long-term view and the long-term theme that we're really wondering a great deal about. So, yeah, the increase in debt levels has been entirely unprecedented. When you try and draw from history, maybe the closest analog you can come up with is the global response in the midst of World War 2, where we saw a very sizeable increase in spending for a very specific purpose. As we look at it today, one of the eyes we want to have is to the long term and this will be a risk that needs to be managed. When we've looked at prior examples of how debt becomes unsustainable, governments really have three options. They can try and use economic growth to grow their way out of their debt burden. As much as we think the economy is ready to spring back to life, maintaining that rate of growth over the next 20 to 30 years is probably a little bit too optimistic. So I think it'll be hard for governments to try and sustainably grow their way out.

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The second way out is to basically use austerity. So raise taxes, find other ways to cut back spending, and we'll probably see versions of that but politically, that's not going to be enough to really bring the deficit and the debt profile under control. That's not likely to be a sustainable solution either. Then that gets us to the third option, which coincidentally, is the second theme I was going to talk about is around inflation. So governments, I think, will encourage inflation because inflation reduces the real value of the debt that they've taken on. Normally what prevents that from happening is that the central bank is on the other side of that. So what they will say is, well, we don't want to see inflation, so we're going to raise interest rates, which then raises the debt burden of the government further but this time around central banks feel like they're a little bit more accommodating of inflation. So as a result, inflation can end up being a tide that lifts a fair number of boats and it helps governments come out from their debt burden but that's not a great theme, I would say, for financial markets.

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So one thing we want to we want to talk about, and certainly we can go into this in greater detail, is to make sure that all of our portfolios have protection against inflation coming back. That's something that we take very seriously. Inflation can be very damaging to an asset allocation strategy. Even if it's something that we don't necessarily think will happen for a little bit down the road, it's something that we want to be able to respond to now. In actual fact, we have taken steps in recent years to make sure we have that insurance in place in this eventuality that inflation is a bigger risk to manage.

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Emily Anonuevo: That's good to hear that. Planning for inflation, preparing for it doesn't happen overnight. Obviously, you've been thinking about it and the team's been thinking about two years prior and now there's talk that there won't be significant change until a few years down the road. They're saying 2023, but obviously you guys are taking that into consideration in all your portfolios. Real estate in both the U.S. and Canada are dominating headlines, of course. What are some of the drivers for the increased prices and how does the asset allocation team weave in real estate when balancing out the portfolios?

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David Tulk: That's a really great question. It allows me to talk a little bit about some of the views that we have related to the U.S. versus our outlook for the Canadian economy. To give a little bit of context as to why real estate has done well, notably here in Canada, but certainly in a lot of other countries as well, is largely the interest rate environment. You think of the cost of borrowing. That's become significantly cheaper, so it's allowed a lot of people to purchase larger homes or to get the onto the property ladder. Also, as much as we've seen a lot of damage done in the labour market, a lot of government stimulus programs provide at least a certain amount of income support. That's another driver of the real estate story.

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Right now, it's a very important driver of economic growth. If you think about the experience that we saw in the United States, they went through a really big real estate cycle through 2008 that proved to be very damaging when the bubble popped. As a result, the U.S. and U.S. households spent the better part of a decade rebuilding their balance sheets. They are much healthier now and much more able to have a sustainable increase in housing from here. In Canada, however, we never really experienced much of a downturn in the aftermath of '08, so we just kept on adding to our debt burden. Right now, Canada entered the pandemic in a much more vulnerable stage because of that higher level of household debt. Now we've added to that on top of things, which means that the Canadian economy is even more vulnerable to an increase in interest rates whenever that might come.

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When we think about that as an asset allocator, we have one country that seems to be able to withstand or be able to benefit from a stronger housing market and we have one country here at home that maybe is a bit more vulnerable. What we have done in one of our high-conviction views is to underweight the Canadian market in favour of other markets around the world that don't have the risk that's tied into our housing market. That's an example of one of the levers we can pull where we're avoiding what might be a very significant risk being realized in Canada's economy at some point down the road.

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Emily Anonuevo: Fantastic explanation there. David, I know you touched upon a bit about this in the short-, medium-, and long-term outlook you just explained but if you can just summarize how the global asset allocation team is positioned for the rest of the year, the next 6 months or 12 months to capture as much upside and as little downside as possible.

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David Tulk: Right now we are overweight equities and we're overweight credit. That means we have a larger allocation relative to our benchmark and that's consistent with the notion that the global economy is reopening. Corporate earnings are looking very strong and are likely to remain strong for the next couple of quarters, so we're pretty confident that the market will do relatively well this year. That's also supported by what we've heard from policymakers, again, discussing maybe longer-term plans to take some stimulus away but in the interim they're very much committed to keeping stimulus in place. That's the positive news. That's what keeps us overweight. The fact that a lot of that good news is already priced in means that we've scaled the overweight to be roughly halfway as far as we can go. We don't want to get too far over our skis and really embrace the market because we know it's expensive and we know that stuff can go bump in the night, to quote a co-manager of mine. That means that we want to have a little bit of protection.

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What does that protection look like? Well, I discussed the risk around inflation. That can be a very negative shock for both stocks as well as bonds. We've added in protection against future inflation. That comes in the form of an allocation to gold as well as an allocation to inflation-protected government securities. That gives us a little bit of protection in that scenario. Another way we have provided protection is to be underweight the Canadian assets. As I mentioned, that's a view partly related to how we see Canada's housing market and how we see Canada's market more generally but it's also a way that we can use currency. We've seen a lot of strength in the Canadian dollar this year relative to the U.S., and indeed relative to other currencies around the world, but what we know is that when the market encounters difficulty and we see equities weaken, such as we did yesterday, that also comes around when the Canadian dollar also falls.

So that's a correlated asset class. If we're worried that maybe equities might weaken at some point and nobody knows exactly when, we want to be underweight Canadian dollars because in that scenario, investors seek the safety of the U.S. dollar, of the Japanese yen, those so-called safe-haven currencies and that's a way that we can protect the portfolio. Those are just a couple of the examples of how we've tried to pair an optimistic view with just an acknowledgement of potential pessimism that can emerge at any point down the road.

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Emily Anonuevo: The value of seeking out financial advisors who add so much in terms of helping investors stay focused and disciplined through the market up and downs for sure. What's the advantage there and how do you navigate through all the market noise?

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David Tulk: I think it starts with the acknowledgement that this is really hard work. You're trying to predict the future, you're trying to – go back to how I described the economy, you're trying to understand the decisions that all of us make on a minute-by-minute basis and how that impacts not only how the economy evolves but how financial markets interpret the movements in the economy. It's difficult and a lot of the decisions that come from financial planning are very personal and very emotional. They're tied up into a lot of the decisions that we want to be able to make down the road. To reach out and get help is a totally logical thing and to rely on advice and to have an independent, neutral assessment of one's financial position to help with the decisions that are very difficult to make, to take some of the emotion out of that, that's something that I think is really valuable to have as all of us try and navigate, not just the economy, but our own personal lives. Our needs and circumstances change over the course of our existence and to try to take, again, as much of the emotion out of it as possible to get that unbiased advice that I try and take to the portfolios when we make our decisions. I'm a very patriotic Canadian, but right now we're worried about Canada. That requires a little bit of emotional detachment. I think that's really what advice is able to provide to individuals.

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Emily Anonuevo: You just mentioned emotional detachment there about the pandemic in general, unprecedented in so many ways. In your process and your investment process, did it change during that time and can you talk a little bit about that?

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David Tulk: To be honest, it didn't really change in terms of our approach. One of the things that I think has worked for us over the long term in terms of maintaining very strong long-term performance is discipline. We have a process, we look at the world in a way that tries to anticipate shocks and the reactions that governments and central banks and consumers and businesses, how everybody responds to the shocks that they're faced. We just really maintain that discipline. Obviously, nobody saw the pandemic coming and the extent to which it would impact all of our lives but we were able to make the transition to working from home in a relatively seamless manner. We just looked at the pandemic as if it were any other shock and went through a process and it gave some really strong conclusions. We've seen policymakers really step up. That's been a very key signal for us. As we progressed, we really relied on a lot of our internal resources.

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We have a team that helps us understand the world from a top-down perspective, a group of economists and market strategists, but we were also able to listen to a lot of our equity analysts who cover individual companies. Listening to the folks on the pharmaceutical team, I could pretend to be an epidemiologist and read the studies, but these were the real experts. Listening to what they were hearing from the studies and from meeting with companies, that was an invaluable source of intelligence for us that really allowed us to make informed decisions in a world that was very much uncertain. We did our best through that period and as we continue to see this year unfold, I think a lot of the stuff that we were worried about maybe happening in the first half of the year that we took insurance against, that some of that stuff now maybe has a higher probability of being realized.

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We're looking forward to maintaining that insurance and providing that security and providing that downside protection that I think investors, when they look at our funds, really want to have. We want to obviously, again, keep up in positive markets but where we really want to shine as asset allocators is when the world gets a little scary. Providing that defensive capital and that protection of capital is really a very important part of our process.

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Emily Anonuevo: Can you speak more about your global positioning? It seems like the world is opening at different rates so can you talk about more to your allocation to emerging markets?

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David Tulk: Emerging markets has been an interesting part of the world. Emerging markets are a composition of a lot of different countries, some of which have had a lot of success handling the pandemic, and other parts of the emerging market universe really have struggled. When we think of a region like emerging markets, we look through the pandemic in some sense. We look at their longer-term growth potential. We look at maybe more favourable demographics than some of the other countries we look at around the world. We look at generally cheaper valuations and we've seen periodically market sentiment turn quite negative against emerging markets, which only makes us more interested in investing there. We like the emerging market story. We like it especially as an alternative to Canada. I highlighted some of the challenges that we see with the Canadian economy and Canada and emerging markets, they share some similarities through the cycle. They both tend to be high beta to global growth, which means they grow faster than other countries when the global economy is expanding. It becomes a choice of saying, do we want Canada or do we want emerging markets? We've come down quite decidedly on saying there's more potential for us over the longer term to invest in emerging markets.

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The way we get our exposure to emerging markets, and this is an important point to stress, is that we use active managers as building blocks. I mentioned that there was not a uniform response amongst emerging markets to the pandemic, so using an active manager allows that team to be able to say, okay, I want this country and not that country or I want to be able to find this company and not that company. At the end of the day, what you're getting is you're getting nuanced level of management. You have us using our process that looks at broad regions and you have building block managers that use their security-by-security skill set to identify really good opportunities to bring into the wider portfolio.

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Emily Anonuevo: If there's one message you'd like to leave with the investors on the line about your stewardship, what would it be?

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David Tulk: In a word, diversification. I've probably said that too many times over the course of the last half an hour but I really can't stress how important that is. The world is uncertain. It's always going to be uncertain, so to be able to, again, have a portfolio that does well in all environments and averages through to a positive return through time, that's really what we want to be able to achieve. We have a lot of the resources we need internally. We have lots of resources from the rest of the world that we can tap into as well to make those type of decisions so that at the end of the day you're able to perform well through all market environments and achieve those goals that you set out to seek when you made the decision to invest.

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Emily Anonuevo: David, I want to thank you so much for this great discussion. I always learn a great deal when I speak to you, so thank you.

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David Tulk: It's my pleasure. Thank you.

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