Fidelity Connects

Diversifying Amid Volatility with Market-Neutral Strategies

Voiceover:

Hello and welcome to Fidelity Connects. The Fidelity Investments Canada podcast connecting you to the world of investing and helping you stay ahead.

Portfolio manager Brett Dley explores liquid alternatives as an emerging asset class and how to use market-neutral strategies to diversify amid potential volatility.

Brett manages the Fidelity Market Neutral Alternatives Fund that was launched in October of 2020.

Brett breaks down the structure of the fund and what groups he's currently targeting. The fund works on the pair trade universe and areas of dispersion and change. The fund provides a different mechanism to generate absolute return above and beyond the traditional portfolio.

He comments on the current market landscape and suggests there are several new entrants into the market right now with high valuations. However, as the fund deals directly with pair trades, he says it doesn't matter what direction the market goes. Areas he's focusing on: technology, healthcare and industrial sectors.

This podcast was recorded on February 19, 2021

[01:54]

Pamela Ritchie: Brett, I'm going to begin with: does it matter really, it doesn't matter if the market goes up here, one way or the other?

Brett Dley: Not for this product, not for this fund. The purpose of the Fidelity Market Neutral Alternative Fund is to generate positive, absolute returns independent of the market direction. So, I do this by employing a pair-trading strategy. This strategy takes a dollar long, matches it with a dollar short, create a net exposure of zero and a beta of zero. With a beta of zero, that means the correlation to the underlying stock market is zero. There is no correlation. So whether the market goes up or goes down does not matter. As long as the stocks I'm long outperform the stocks I'm short, the fund generates a positive absolute return.

[02:44]

Pamela Ritchie: Let's get to why someone would use this. But first of all, why does it apply to markets that you're looking at now? What do you think of the markets? When you wake up, when you woke up this morning and you took a look at what's going on and the week we're about to book in markets, why now?

Brett Dley: I think simply if we think about a traditional portfolio, let's use a 60/40 type portfolio, you've got two asset classes: one is equities, one is bonds. Both of those are at all-time highs effectively. So we've got the stock market that makes all-time highs on any given day recently. Valuations are expensive; they're at the higher end of the range. And then on the other side, you've got your fixed-income portfolio. Yields are very low. They're near all-time lows and they're probably the direction forward is likely higher, which is not good for [bonds?]. So you're looking at two asset classes that have very, very elevated valuations making absolute returns potentially a little bit more difficult going forward. I think we need to think about a new way to generate absolute returns and doing so in a way that isn't correlated with these underlying expensive markets.

[03:52]

Pamela Ritchie: I feel like an example helps to illustrate this sort of thing. So when you actually mentioned some of the sectors that you looked at when you were an analyst with Fidelity, are there certain areas of the market that you can give an example that work well for pair trades?

Brett Dley: As Pamela mentioned, I've been at Fidelity for over a dozen years, The last several sectors I covered were tech, health care and industrials. These are stock-picking groups. These are groups that have different types of companies with different end-markets that have very different return profiles. These are the areas that I like to play in with this fund. So in my first stint as an analyst at Fidelity, I actually covered oil and gas. For this fund, oil and gas is not necessarily an area I play in. It's a commodity group; it trades as a group. It's not what I'm looking to do.

Let's give an example of what I'm trying to do in the pair trading. Here's a pair trade using the Canadian grocers. The investment thesis was approximately a year ago: that as COVID was beginning to take hold in the spring of last year, the thesis was grocers that sell mostly food will outperform those that have a higher makeup and cosmetics component. As COVID began to take hold in the spring, many of us began working from home. We didn't wear as much hair gel, we didn't shave as often, we didn't use as much makeup, but we all still had to eat. In fact, we were probably eating at home more than we used to. So, constructing a pair trade that goes long Grocer A, which sells mostly food, and short Grocer B which has a higher makeup and cosmetics component resulting in net negative bets on the makeup and cosmetics segment. That's something that you can't achieve in a long-only fund. Again, importantly, whether the grocer group as a whole trades up or down does not matter. As long as Grocer A, which sells food, does better than Grocer B, which sells makeup, the fund generates a positive absolute return.

[05:56]

Pamela Ritchie: It's really fascinating. I'm going to ask you for one more example because I think it just helps to really ingrain. Within technology, within health care, just remind us, these are the sectors that you said that are stock-picking potential. They're areas that you look at. How do you look at health care and technology, for instance?

Brett Dley: One of the major themes I play in within technology is digital payments. And digital payments is just a very fancy way of saying using something other than cash to pay for items. And so, again, this was a trend that was happening more and more and more, but COVID definitely accelerated it because we're doing very few things in person, and a lot of the things, the transactions we used to do in person are no longer in person. If you're not in person, you can't use cash to pay for something. One of the trades I had on was to go long a credit card company and short a company that manages and services ATM machines. The very simple way to play credit-versus-cash, and it was a very lucrative trade. Since then, I think this space is evolving rapidly. I've kind of changed that trade a little bit, and now I think there's even more interesting ways to pay for items that are not just credit cards. There's Apple Wallet, there's PayPal, there's Venmo, there's Square Cash, there's Buy Now Pay Later. It's growing rapidly. This is a theme that I continue to play in my fund just in a different way post-COVID.

[07:26]

Pamela Ritchie: So let's go a little bit back. You mentioned that you were doing some of these things X months ago when we were coming out of the worst, I guess, of the stock market reaction to the COVID pandemic. Has it been in beta or what's the timeline?

Brett Dley: That's a great question. February 19th, today actually, basically a year ago today. I think it was actually the 21st, this fund was funded. We ran a pilot with internal capital at Fidelity, and so it's been running for about a year. It's been live to the public since October 21st. And so over the past year…

Pamela Ritchie: This is of last year. So you were putting this together literally in the couple of weeks before everything happened.

Brett Dley: I actually think it was two days before the peak of the market.

Pamela Ritchie: Oh my goodness.

Brett Dley: One of the things we learned was that the strategy, when employed correctly — and again, that means keeping the beta at zero, having little to no correlation with the underlying stock market — did what it was designed to do. During the spring market crash, like I said, this fund got launched in beta, literally two days before the market crash. The underlying stock market crashed, right? It was down a little over 30%. We could have a case which happened, and I'll happily talk about a trade that I had in oil and gas where both the stocks were terrible. They went down a lot. But the long went down less than the short, and hence we captured all the value between the two. That's exactly what we're trying to do both when markets go up and markets go down.

[09:00]

Pamela Ritchie: Who does this work for? So I'm just sort of thinking there are younger investors that perhaps aren't able to invest a lot in the early stages of one's career. You don't have [audio cuts out] but then you also want to preserve, perhaps when you're closer to the end of your career. Is there a particular group that you're targeting here?

Brett Dley: Yeah. I think about it in terms of what asset classes can it help improve or what can it do amongst a person's total portfolio. We talked about fixed income being very challenged right now. Yields are very low. It looks like the direction of travel in yield is higher which is negative for bond prices. You're looking at an asset class that is supposed to have little to no correlation with equities. That's why you're in fixed income, 'cause it's less risky, but it's very expensive and the outlook for absolute returns is very challenged. What the Fidelity Market Neutral Alternative Fund does is provide zero correlation with the equity market and provide a different mechanism to generate absolute returns not reliant on the underlying yields. I think from that perspective taking a portion of your fixed-income portfolio, maybe allocating a little bit to the Fidelity Market Neutral Alternative Fund is a great strategy. It's a diversifier, and it's a way to sort of get yourself out of the fact that the valuation of your current asset classes are very, very expensive.

[10:23]

Pamela Ritchie: Let's look at big trends that people talk about, themes around investing. Lots of people will say 5G is one that people are looking pretty seriously at. Do you look at it sort of thematically, or how do you get into it? Do you back out from macro and then go in, or how does that process work?

Brett Dley: Actually 5G is a trend I play in the portfolio, but what I'm doing is it's built upon what we're strong at here at Fidelity, and what we have the resources for and that's our research team. And so as an analyst, the job of an analyst is you're given a sector: so you're looking at relatively similar stocks and you're trying to identify those that are going to outperform, and those that are going to underperform. What I've done for the past decade-plus as an analyst, what our analysts do every single day. And so to me, when I'm looking at a group of similar type of stocks, putting buys and sells on them, that's the definition of a pair trade. So what I'm doing in this fund is taking the process that we use at Fidelity, the process that I've been doing for the last 10 years and simply repeating it approximately 50 times. I usually have about 50 pair trades on in the fund. It's just the skill set we do, what we do every day, and we're building a fund around it.

[11:42]

Pamela Ritchie: Interesting, about 50 pairs within the fund at any given time. Tell us a little bit about how this fund is different because I think, am I right there were three alternative strategies that were launched in October? How does this differ from the other two?

Brett Dley: That's correct. There were three liquid alternatives that we launched on October 21st. The similarities between the three of us are we all have the ability to short stocks and, quite honestly, that's where the similarities end between this fund especially and the other two. Again, this is a market-neutral fund. We go equal parts long, equal parts short, net exposure of zero, beta of zero. The other funds, they would have some varying market exposure. It's not zero. It could be closer to one; it could be a little less than one; it could be a little bit more than one. So, they will trade somewhat like the markets. Nothing wrong with that, it's just a completely different strategy. It's a completely different product and completely different use case.

[12:38]

Pamela Ritchie: So, we talked a little bit about how you're looking at markets right now and why now and so on, but actually I just want to get your thoughts on what you think of these markets right now. What does this feel like? You've been watching markets for your whole career. What does this moment feel like to you?

Brett Dley: I think it's fair to say there are areas of froth within the market. We've kind of seen some of the melt-ups in certain spaces. I won't name them, but I think we kind of know what's just not trading on fundamentals. There's a lot of new entrance into the market. Markets have been very, very strong. It encourages people to invest, and it encourages speculation, and these are signs that we typically see approaching near term tops. So when I think about the market: we're at all-time highs, valuations are very expensive; there's areas of froth. That, to me, is not super exciting. When I think about where we are in the economic cycle, we've come through a big downturn, and now we're slowly working our way out of it, and I think there's line of sight to next year the world being in a little bit better place than it is this year.

What I have noticed is the markets have been anticipating this, and the markets have been anticipating cycles much faster than they have in the past. We're at a scenario where the world is likely getting better. Markets have already, I think, discounted that and so for me, I kind of think the stock market does a whole lot of nothing this year. Again, I don't spend too much time worrying about what the stock market is going to do or trying to make a forecast, 'cause it doesn't have relevance on the fund. I'm just looking for my longs to outperform my shorts. But, if I had to make a call, I think a whole lot of nothing with some stock picking underneath the surface, and that's an area where this fund should shine.

[14:21]

Pamela Ritchie: That's really interesting 'cause it's sort of a way to maintain what you have, I guess. It's a preservation strategy and as you mentioned, fits maybe within the fixed-income side of things if you're looking at 60/40. A couple of great questions coming in here, Brett. One of them, how much are you paying to borrow the short positions on an annual basis? What kind of drag might that have on the portfolio?

Brett Dley: Great question. Every day I get a dashboard that shows the cost of borrow of basically every stock in the market, so I can understand what I'm paying, and it's part of my analysis when I enter a new short position: what is the cost of borrow. When you start looking at higher short interest stocks, so popular shorts, the funding cost gets higher. That's actually good 'cause it serves as a deterrent for me to invest in those stocks because I would have to pay more, the return has to be a little bit more…has to be higher for me to make a break-even on it, and those, I think, are stocks that are dangerous. So when you're shorting what everybody is shorting, it's just a fundamental risk factor. Because we like to keep the cost of borrow very low and for me it is, it helps provide a governor on getting caught up in these high short interest stocks as well.

[15:36]

Pamela Ritchie: I think people have joined us, have been listening to this. I think we just need to go over a couple of the pieces again 'cause it's pretty fascinating and it's new. This question: can you speak a bit more about how you assemble your portfolio? So Brett, maybe just go through the sectors again that are useful to you.

Brett Dley: When I think about investing, I think about the world in terms of pair trades. So what I typically do is I run a portfolio of about 50 pair trades, give or take. That results in approximately 50 longs and 50 shorts. Sometimes a little bit more than 50 shorts as I try to diversify the shorts a little bit more for risk control. What I'm doing when I'm looking at these stocks is I'm trying to identify areas of dispersion, areas of change. I've covered tech and health care in my recent analyst stints, and I've worked with Mark on Innovators, so I have a growth bent, I look at the world through a growth lens. I participate in that area of the market. There's huge dispersion in the growth area of the market where change is happening.

So because of that, the sectors I do tend to focus on are tech, health care, industrials and a little bit of consumer discretionary. Not surprising, the last three sectors I covered as an analyst, tech, health care and industrials: stock-picking groups.

[16:57]

Pamela Ritchie: The world has digitized and we talk about this, and obviously things have come forward quickly, and they've had to and people have had to adapt, but is that one of the ways that you look at companies within a sector, whether they've gone through that process or not? How fundamental is that piece to you?

Brett Dley: When I think about the growth areas of the market, it's almost table stakes now. There could be laggards and legacy players that have not identified these areas of change. But I want to be clear that, again, because we keep the beta of the fund at zero and the dollar exposure at zero, I can't create a whole fund that is long the go, go, growth winners and short the lagging, value names. That would result in a beta that would be massively positive. So we can't do that. What I do is I try and pair growth versus growth. Top-tier companies with a better go-to market, a better product, versus second and third tier companies. That's the structure of the fund.

[17:56]

Pamela Ritchie: You mentioned what you've seen recently and that the over-shorted companies in the market that we've heard about. How do you not get caught up in that? Can you comment on what you saw there and again, how it, in some ways, helps you focus in on other areas?

Brett Dley: I think the cost of borrow is a very important aspect of that. Again, when you have a high short interest stock, the cost of borrow becomes very expensive, so basically your ability to make a lot of money on that trade, you're requiring two things to happen. One, for the stock to basically go to zero. When I short stocks, I want to be clear, I might not be doing what you think of a typical short seller. Again, I think about the world in pairs. But when I'm shorting a stock, I'm simply looking for a stock that's going to underperform the other side of the pair. I'm not looking for accounting frauds, companies are going to go bankrupt, that sort of business. That is not the area I play in. I could be short a fantastic company. I'm short several fantastic companies, but on the other side, I'm long on company that I think might grow a little faster, is trading a little cheaper, has a better product cycle or better product announcement. So that's what I'm doing. That leads me away from these high short interest sort of broken business type shorts.

[19:15]

Pamela Ritchie: That's really interesting to hear, clarifies things. Give us a sense of your global mandate. Can you go anywhere or what's the universe?

Brett Dley: It's a North American-focused fund, so I can go anywhere in North America, Canada, U.S., I suppose Mexico though I can't see that happening. I can go 10% outside of North America. I've been managing money here at Fidelity for over a decade, I've never owned a non-North American stock, so that 10%, to me it's a nice-to-have but I don't think it's something I'm really going to flex. Right now, the fund is a little bit more U.S. than Canada, like 55/45, and I would expect over time it probably stays that way, just on the aspect of the ability to find more companies to pair. There's more companies available in the States, and short capacity is higher in the States. So I would expect it to be a little bit more tilted to the U.S. In general, when I put on pairs, it's U.S. versus U.S., Canada versus Canada, to try and eliminate that currency exposure.

Pamela Ritchie: I was just going to ask about the currency exposure, if that plays in but it [audio cuts out].

Brett Dley: Yeah. Again, because I keep the pair trades within country and dollar long, dollar short. Whether the currency moves up or down, I would win on my long, lose on the short, nets up to zero.

[20:28]

Pamela Ritchie: You use technology within your strategy as a sector. What about regulation? How much of a flag? Are there some companies within there that are better to set up to weather a regulatory new cycle and others less so? How do you look at that?

Brett Dley: Yes, I think it's very interesting. One of the pair trades I've had on in the past, and so I think I can talk about this, was within the FANG stocks. Here's an example of something that I do. The FANG stocks are commonly grouped together as one big group of large-cap tech stocks that all trade the same and bang. It's going to the moon and whatever. Not the case. What Apple does is very, very different than what Facebook does. Apple makes products, they sell services, they have product cycles, they innovate new things. Facebook sells ads. Neither of those are bad, but they're very, very different. However, they often get treated the same. I think the regulatory impacts on the company that sells ads are far, far more daunting than a company like Apple that creates devices and sells things that we put in our ears. Again, regulation matters, but not all stocks are the same, and not even all the FANG and big tech stocks will get treated the same on that.

[21:42]

Pamela Ritchie: That's really fascinating, because we seem to discuss a lot about rotations away from areas of growth that have done obviously very well in the last little while, but this, in fact, you're playing right in them. You're playing right in the areas of growth and other areas as well. Can you comment on that? It slices through, again, kind of the growth value discussion. It doesn't really enter.

Brett Dley: Again, it's something I try not to play because, again, I couldn't structure the entire fund, growth versus value or value versus growth. So what I'm trying to do is look in the areas that I specialize in, which tend to be the growth areas, and look for companies that have maybe a different go-to-market, maybe a product cycle, maybe an area that's less susceptible to regulation, and pair those against companies that have the opposite effect.

It's what we're trying to do. We're trying to use pair trades, generate positive absolute returns whether the market is up, down or sideways, and do so in a way that has zero correlation with the underlying stock market.

[22:42]

Pamela Ritchie: It seems so intuitive. Can you give us a bit of a sense of the team that you work with? I think you mentioned that you've been doing this for a long time on some level. It's interesting that you're going to be deploying some of the skills that you've been using for a long time, but actually into the strategy as a fund. How did that come full circle?

Brett Dley: One of the studies we've done is we've looked at … I think one of the studies we've had, and a chart that maybe many people here have seen, has been the performance of the analyst buy ratings versus their sell rating. As I mentioned, the job of an analyst is you're given a group of relatively similar stocks; you rate them on a scale from buy to sell. So, as an analyst my performance mirrors that, and what I've tried to do is create a fund that allows us to buy our buys, sell our sells, capture all the value that's in between. So it's exactly what we do every, every day, and now we're just finding a way to generate real money off of our sell-rated securities.

[23:46]

Pamela Ritchie: It's a fascinating strategy and it sounds like an interesting time to have it available to a lot of investors. Brett Dley, thank you for joining us. Good to see you. Have a good weekend.

Brett Dley: Thank you very much, and I appreciate everybody's time and everybody's interest.

Ending: *[24:01]*

Voiceover:

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