Fidelity Connects

U.S. Markets in Focus

Steve DuFour, Portfolio Manager

Pamela Ritchie, 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.

Today, we welcome portfolio manager Steve DuFour, who manages Fidelity U.S. Focused Stock Fund for Canadian investors. Steve runs a concentrated fund and focuses on mitigating risks to ensure the limited companies he puts into his fund meet his stringent standards.

Steve explains to host Pamela Ritchie that over the next few years everyone will want to go out and do what they couldn't do throughout the last year. Because of this, Steve notes there are a lot of attractive sectors in the markets today – consumer discretionary for example – which Steve owns more of now than in the last few years. Cosmetic manufacturers, retailers, casinos and auto suppliers are all attractive areas that Steve believes could benefit from the vaccine rollout and re-openings.

Steve also touches on ESG in his fund, as well as tech valuations, homebuilders and home improvements, crypto and inflation.

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[01:50]

Pamela Ritchie: While some investors are writing off the U.S. large-cap space, some are saying today's moment is truly a stock-picker's market: to be nimble and to be extra selective about certain themes that have plenty of alpha opportunity over the long term.

To share his perspective on the outlook for the world's largest companies, we're joined by portfolio manager, Steve DuFour. Steve runs the U.S. Focused Stock Fund for Canadian investors. Steve, welcome back.

Steve DuFour: Thank you for having me.

Pamela Ritchie: Steve, we just mentioned U.S. large-cap several times in that introduction. Tell us a bit about what you are laser-focused on within this universe right now.

Steve DuFour: Most people running funds in the U.S. have a lot of large growth stocks, so I'm probably a very good example of what other portfolio managers are doing. We're taking a look at other sectors now and saying how does that growth compare to what we had existing that we own. So as you're seeing the swings in the market, it's because most investors are fully invested and they're usually having to sell some of their winners to buy some of the new types of names. I'm doing the exact same thing. I'm spreading out into new sectors. We started that back in October, November, and so we're diversifying into other groups which have very strong relative earnings growth.

[03:17]

Pamela Ritchie: Relative earnings growth, we're talking about comparisons to last year which are rock bottom. Give us some subtleties within the earnings story for you.

Steve DuFour: As we look right now into 2021, the S&P 500 earnings — and it's a moving target right now because it's very volatile, but earnings for S&P 500 are going to be up well over 30% in 2021. But if you look at the value part of the market, their earnings are going to be up well over 50%. So the strong relative earnings growth is showing up in areas that were the worst performers last year because of the easy comps, industries that really were hard hit by the shutdowns across the world.

[04:13]

Pamela Ritchie: It's a focused fund. How many stocks do you have within it. Give us a sense of where you can play or where you have to be more focused. Can you give us the one, two, threes?

Steve DuFour: Currently the fund has 44 names. My goal is to own 40. I usually always find one or two extras that I want to own. I can own up to 60 stocks, but the fund has typically been between 38 and 45—is what I do. As we talked a little bit earlier, what I try and do: there are inherent risk on running a focused stock fund, so I sit down and try and mitigate, you can't get rid of all of it, but I try and mitigate the risks of having a concentrated portfolio by focusing a lot on, first of all, what I don't own. A lot of people who come on your show and come talk about what they own, they're really excited to talk about what they own. I'm very excited of what I don't own.

I don't own companies that don't grow the revenue. I don't own companies that lose money. I don't own companies that are over-levered. I don't own companies, try not to own companies, that don't grow their earnings faster than the market, and I try not to own companies that are overpriced and both those, that's more of an art than a science, because you have to take into account a lot of things like interest rates and everything else to figure out the appropriate multiples.

I spend a lot of time…I try and mitigate the risk in the fund by getting rid of binary decisions. Is the drug going to get approved or not approved? Is the government going to give them a contract, not give them a contract? Things like this. I have companies that have earnings today and are growing them, and that is my way of reducing the inherent risk of running a concentrated fund.

[06:18]

Pamela Ritchie: Does that mean that you don't own, and this has become a metaphor on some level, the so-called FAANGs, it's beyond what the acronym stands for, but does that mean you can't be there or where is the line?

Steve DuFour: The FAANGs are right in the sweet spot in some ways. As you look at a Facebook who has strong earnings, no debt, billions of dollars in cash, and trading at, depending on how you calculate it with stock options and the rest, but let's call it 25 times earnings, that's an attractive stock. So a Facebook, a Google, again, it's less than 30 times earnings, has tens of billions of dollars in cash, no debt, and is growing faster than the market. So there are parts of the FAANGs that work. If you get a little further out, I don't like to talk things I don't own, but if you're a large producer of shows that are distributed to people at their TVs, maybe that one is a little too expensive for me.

[07:30]

Pamela Ritchie: I don't watch TV or shows, so I have no idea who you're talking about! So tell us whether we can sort of surmise that there's a little bit of a barbell. Is there a little bit of this rotation to so-called value? Certainly companies that had their earnings blown out last year, which is most companies, versus the so-called FAANGs. How does that fit?

Steve DuFour: Last year in order to do well in the market you had to be … I also call them secular growers versus cyclical companies. Last year, the secular growers, primarily in technology, accounted for the majority of the relative performance in the United States. That's a generalization, but it's not far off. As we headed into 2021 and as I looked at the relative earnings growth, the cyclical parts of the market look more attractive than many parts of the secular market. That is what we started to do in October and more in November, December, January, February, to the point where we have a very good diverse group of cyclical recovery plays around the world. So there's some great stocks that we've been able to pick up at very attractive prices.

[09:00]

Pamela Ritchie: Let's go through some of the themes. I'm thinking about the ones that we hear about all the time. We're listening to financials, listening to energy. Where within that are there themes and sectors that you like?

Steve DuFour: The great thing about this market is doing what I did. Most of the things that were passing our screens the last couple of years were in technology. Today, you're seeing things pop up to the top of our screens across many sectors, to answer your question. We own, today, a lot more in consumer discretionary than we did a year ago, two years ago, or even three years ago. It's an eclectic group of names. We own cosmetic manufacturers; we own cosmetic retailers; we own casinos. Not in consumer discretionary, but we've added banks and auto suppliers.

But what I don't want people thinking, as I went through the whole list of names that I could invest in, I didn't just go for total cyclical recovery, I went with cyclical recovery with a secular twist. The casinos got hit really bad last year because they shut down Vegas. It's hard to make money when your casino is shut. This year, they're going to be open. The number's going to be off the charts relative next year, but the big thing that's happening in the United States is online gambling. Two, three years ago there was only two, three states that allowed online gambling. During the lockdown of COVID, a lot of states saw this as a great way to bring in more revenue, and people were demanding it because they were going to the neighbouring state to do gambling and they wanted to keep the gambling in their own territory. I own a couple names that will benefit from the recovery of the opening, but they'll really benefit from the long-term secular growth in online gambling. That's what I did in casinos.

With cosmetics, a lot of the places where the cosmetics were sold, the department stores and the like were closed and cosmetics historically has been sold through department stores and now it forced them to go online which is materially higher margins for the companies because they're selling them directly to the end consumer.

They now know who the end consumer is. They can market to the end consumer and it's a little known fact, there's very little returns on cosmetics. The worst part of online e-commerce is the returns. People order six pairs of shoes, they look for the one they like, and they return five of them. So the returns is the worst part of e-commerce. Cosmetics and particularly skin care, people do not return. They're lightweight, high cost, and they don't get returned. It's a great business for online. So that's another area.

When I went to autos, the big thing going on in autos is we're going to go from internal combustion engines to electric vehicles, or versions of electric vehicles, maybe hydrogen vehicles. Who knows where we'll end, but as that transition happens I was looking for recovery in autos but I didn't want to be hit with the secular decline in internal combustion engines. We own a company that does seating which, whether you have an electric vehicle or an oil or gas vehicle, you're going to use seating, and seats is a very high margin business because today, particularly in the luxury vehicles, a seat is not a seat. It reclines; it's heated; some of them are air conditioned, some of them have vibration, so the seat is becoming a thing to itself.

So that's a long answer to your question, but I'm looking for recovery with a secular kicker and whether it's online gambling, whether it's online retail for cosmetics, or whether it's the growth of electric vehicles, I'm getting the recovery of half their business and the growth on the other. I found a number of companies like that are very exciting.

[13:40]

Pamela Ritchie: Sounds like the seating side is like the sleeker version of a La-Z-Boy trend or something. It's very comfortable to be sitting in your car. You can probably watch TV in your car anyway and escape your family which I find useful sometimes. Tell us a little bit about the home-building trend. To some they'll say, well, that's already happened. Is that an example of a secular trend? Do we continue to look at the home front as a place where we spend a lot of money or is that kind of wrapping up?

Steve DuFour: In the fund, we own a home improvement store because the number of home owners has changed as people are moving from the cities, escaping COVID to the suburbs, and buying houses for the first time. Then you go to the Lowes and the Home Depots of the world, and you start buying things for your new house. We're still in that trade. The home building industry, we owned before, but we were less … Interest rates are going to rise, I don't know how much, but with the amount of debt and consumption … I'm not a bond person, so I'm not telling the magnitude of the increase, but the trend appears to be upward sloping. That is going to hurt and the other thing hurting homebuilders right now is it's very hard to get craftsmen to do the work. There's a shortage of labour, and lumber prices and copper prices are all-time high. So the cost of the end product is going up just because of building materials and interest rates are going up which is hurting the financing. I think there's a lot of great stocks right now and those don't percolate to the top of my list right now.

[15:30]

Pamela Ritchie: With inflation and with rates going up, again, you said you don't know by how much, but that trend, what gets hit? You talked a lot about what you don't own. Can you expand that to fit the rising rate environment around that?

Steve DuFour: Rising rates will not be good for home building. Rising interest rates in the sense that it will affect the terminal multiple on fast-growing tech stocks will hurt the outer edges of the tech universe, which you've seen over the last couple weeks, and they're going up and down, up and down, is because as you do your DCF and you do your valuation, it brings it back. There's an old adage, it's called the rule of 21, and basically you take

21 minus the interest rate and that gives you the P/E as you should pay for the average stock. When interest rates were at zero, your P/Es are 21, but as your interest rates starting going to 1, 2 and 3, you start bringing your P/Es down a little bit. That's very simplistic understanding that some of the higher-priced tech stocks, where you have to go out three, four, five years to get the valuations to work, they will not do well in a higher interest rate environment.

[17:05]

Pamela Ritchie: As you mentioned banks are an area where you can catch some of that higher interest rate environment for the good. I'm curious a little bit more about where technology goes from here. As you just mentioned in the markets right now we have seen, certainly in the last couple of days, bid back in to tech, lots of people saying good place to enter. When you watch something like that, what do you notice happening? Is it a froth that's come off some of the big tech names and therefore they look attractive, or again do you find better opportunities on value, however you want to define that?

Steve DuFour: Right now I'm finding better ideas outside of technology. A lot of the technology names are going to be very good steady earnings growers for the next two or three years. But their growth rate is not going to be as high as some of the recovery plays. I'm spending more of my time on recovery than I am on the Steady Eddie tech names. We still own a lot of great tech names, but what I'm doing though is I'm creating a watch list. So there are names, we talked earlier about names that I wouldn't own, I do the valuation on the companies and there's some names of great companies. Everything's great and everyone knows they're great.

Give you an example: we're on BlueJeans today, a competitor of BlueJeans who I probably can't talk about 'cause I don't own them, would be a company that I'm doing a lot of work on. I haven't pulled the trigger, but I'm fascinated by the growth rate, I'm fascinated [inaudible], but I'm not fascinated by the valuation. So I make a list of companies like that and stranger things have happened in the world, particularly as we head into the summer months when markets even get more volatile than they are right now.

[19:10]

Pamela Ritchie: Let's talk about something that's volatile which is Bitcoin and it speaks to a broader crypto discussion. I'm very interested in what you think about the developments that we've watched there, maybe the rapidity of the developments that we've seen there. We've seen massive swings. What interests you about watching the crypto space right now?

Steve DuFour: I started my journey years ago reading a book called Digital Gold and learning about how bitcoins are created, and the technology behind it and some of the characters. As I learned more about it, it builds on itself. The more people who use it the more valuable it becomes in the sense that as Square, and PayPal, and some of these other companies start putting it on their balance sheet as a complement to their cash holdings, and as they offer it — I digress. Square has a peer-to-peer transaction app called SquareCash. They now are offering you, you can get a debit card off of that. We all get frequent flyer miles or hotel miles like this. They will allow you to get Bitcoin, you won't get a full Bitcoin 'cause today they're trading at 52,500, but you're getting paid back in Bitcoin which is then potentially able to transact in other things.

I'm watching this area. I'm watching. It's been a great way for companies like PayPal and Square to bring in new users to their financial apps at a very low cost because part of the problem with Bitcoin is how and where you store it. You don't really want to store it on your IBM PC at home because your IBM PC is eventually going to die after 6, 7, 8, 10 years, and it's a digital certificate. If someone else can hold it for you, that's a very valuable service for you. I am watching it. I'm looking who the competitors are. One of the top 10 names we own is the company that makes the chips that allows you to mine Bitcoin which is Nvidia. I spend a lot of time trying to understand where this is going, and we are in very early innings, very early innings.

[22:02]

Pamela Ritchie: It's interesting you brought up chips there. Let's talk about broadly the topic of scarcity and some of your overall thoughts on it. Clearly semiconductors are experiencing scarcity almost across every industry that needs them right now, but there is thoughts that scarcity as we reopen will be felt almost across every aspect of our lives. Like sort of the toilet paper times XXX. Where do you see scarcity? How does that play into secular so-called re-opening plays for you?

Steve DuFour: I believe there's going to be scarcity. I think there's going to be scarcity in rental houses. I think there'll be scarcity in flights. I think there's going to be scarcity in steel. I think there's going to be scarcity in copper. I think there's going to be scarcity in lumber. I just think as we all come out of our home offices and finally take some time off and do things, you have a list of 10 things, I have a list of 10 things. They're not identical, but you know what, I bet 2.5 of them are similar. As we all have 2.5, we're all trying to do the exact … down here, 4th of July weekend I want to go here, well, I think everyone else wants to go there on 4th of July weekend. I think that's why we own the casinos.

I think all of our clothing — well, maybe not yours, definitely not yours — but all of our clothing has gotten old. I haven't bought any clothes, I can't tell you the last time I bought anything. I think there's people going to be wanting clothing, shoes. I think there's going to be … we own a little bit of Uber. I think there's going to be people taking cars downtown to go out to dinner. I'm a big believer that this is going to be a period and it's not going to be six, nine months. I think it's going to be a two-year-plus period where people are just: I want to go out to dinner,; I want to go to a show; I want to get away; I want to go to the beach; I want to go the mountains; I want to go skiing. I think there's a lot of ways. I'm spending a lot of time trying to figure out where the pinch points are, but as you do all of that stuff, it comes down to copper, steel, the raw ingredients, caustic soda, some of the stuff we just don't … you talked about toilet paper, or 3M masks or whatever. If everyone goes to get the exact same thing at the same time, we just don't have enough of it, so the prices will rise, and so that's what the 10-year bond is telling you.

The 10-year bond is smarter than all of us. The 10-year bond started moving. The Federal Reserve is saying interest rates are going to be low. Everyone is saying interest rates low, but the 10-year bond went from 50 basis points to 161 in a very short period of time because the 10-year bond is saying, uh oh, if everyone does get vaccinated and all of a sudden, we're going to have higher prices, and I don't think there's any way around it. I think airlines prices are going to be high. I think everything is going to be higher priced for a period of time until they get their capacity back up.

[25:27]

Pamela Ritchie: Something that has done very well in anticipation of different political landscapes, all kinds of different reasons, a renewed sensitivity about how we invest, sustainability, is ESG. We've spoken about this before, and in fact, I think you've been interested in ESG almost longer than anyone. How does that filter through the way that you are looking at stocks for the long term?

Steve DuFour: The last few years and the last few weeks, I've been spending a lot of time on ESG. One of our largest positions in the fund is Standard & Poor's which has a number of businesses, but they are really, they're doubling down or tripling down with the recent acquisition in the ESG field. They are basically, as you talk to the CEOs of S&P and CFO and go through, the growth rate is very substantial off a small base. We're talking 60, 70% growth off a very small number, but they're seeing growth…

Pamela Ritchie: This is for data. This is for ESG data basically.

Steve DuFour: ESG data, ESG indexes and so the great thing about ESG for these companies is you are the CEO of a Canadian company, and you want to make sure that you are getting a good ESG rating and you also want to prove what you're doing. You are working with them to understand where you are, compare your company versus other companies that are similar to you. You pay them for that. You want to do a bond offering, and you want to get a good stamp of ESG approval on the bond 'cause it will help your interest rate you're paying them for that. I then own your stock in my mutual fund, I want to make sure that the ESG ratings of the companies I own, I pay them for the rating. So they're getting paid by portfolio managers, issuers, companies and governments.

So as this is growing off a very small base, it's great because basically it's also another way to learn which companies are embracing it, which ones are forward thinking, and which ones have good management. We saw this, this was a great example, I was talking with my kids about this. This COVID hit, we have 50 governors, each governor, him or her had their ability to run their state. Some of the states were run really well, some of the states not so well, and so as ESG is evolving and growing, we're seeing which companies have strong leaders. And while I talk about strong relative earnings growth, one way to get strong relative earnings growth, one easy way, is make sure you have a good leader at the helm. This is another way to confirm whether your leader, he or she, is doing a good job.

[28:32]

Pamela Ritchie: That is fascinating and we'll leave it there 'cause it brings you right back to where you started on the strong relative earnings growth. Steve DuFour, thank you so much for joining us and sharing with us how you're looking at the world and investing.

Steve DuFour: Thank you, Pamela.

Ending: [28 :45]

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