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's podcast features Chief Investment Officer Andrew Marchese. Andrew is also portfolio manager of Fidelity Canadian Disciplined Equity Fund.

Andrew recaps some of the trends that impacted markets in 2020 and will discuss what to expect in 2021. This includes reflecting on the rotation from long duration growth to short duration growth, and more cyclical oriented and value stocks, which started in September and accelerated in Q4 2020.

Andrew also shares with host Pamela Ritchie how Fidelity Canada's portfolio managers and analysts - despite working remotely since mid-March 2020 – have maintained the "learning through osmosis" feel of the office.

This podcast was recorded on January 6th, 2021.

[01:47]

Pamela Ritchie: Welcome Andrew, great to see you again. Happy New Year.

Andrew Marchese: Happy New Year to you, Pamela. Great to be here.

Pamela Ritchie: Great to have you join us. We're going to begin with the minutiae because we are looking at these headlines and we need you to interpret them a little bit. So here we are in the midst of getting election results from the Georgia race in the United States. Investors seem to have taken an unofficial conclusion at this point and piled it into a bit of a reflation trade. Is that what you're seeing right now?

Andrew Marchese: Yes. I think the reflation trade, the rotation from long duration growth to short duration growth, more cyclical oriented and value … things like autos, industrials, material stocks, that started kind of in September. You started to see some of that rotation occur then. It really got kick-started and accelerated through Q4 and now, again, we're seeing it kind of today. As it relates to the election, I think you're seeing things in renewable energy really get going and there's been a lot of speculation built into that and higher prices as a result. The belief that monetary and fiscal policy in the U.S. will continue to be accommodative and that will further fuel that rotation as I talked about from long duration growth, higher multiple stocks to those cheaper stocks that rely on economic tailwinds and tend to be shorter cycle in nature.

[03:21]

Pamela Ritchie: We'll point to what we saw yesterday in the oil price because of a move by Saudi Arabia and maybe you can sort of take a look at that for us. But all of the things that we're talking about here are more cyclical trade, if you will, are sort of the Canada trade. Is it going too far to look at it that way?

Andrew Marchese: No. I think Canada obviously with a high constituency in material stocks, gold stocks, oil, a robust financial sector and even a lot of small- to mid-cap industrial names that participate globally all are naturally beneficiaries of that, so you will see that emerging markets also play into that as well. I think the expectation for lower rates eventually leading to reflation and inflation and you're seeing that somewhat in the rise in 10-year bond yields in the U.S. and the decline of the U.S. trade-weighted dollar. All of that trade is correlated to a degree. When you see these two things from a macroeconomic standpoint, a weaker U.S. trade-weighted dollar and 10-year bond yields backing up with the expectation of further economic growth globally, markets like Canada, Australia, the emerging markets are usually beneficiaries thereof.

[04:43]

Pamela Ritchie: Where are we in the cycle here? When we spoke a year ago we were kind of at the end of a bull market. You were bringing some thoughts about a much more balanced approach. This is in January of last year. That was the end of a market. Where are we now?

Andrew Marchese: I think the discussion about having a barbelled approach to one's portfolio probably is even more prescient at this point in time. A year ago I was talking about the fact that we had come through a 10-year period of time where growth had dominated over value. The global pandemic hit, obviously the market declined sharply in through March. For at least that first quarter to quarter and a half coming out of it large-cap and to a lesser degree small-cap growth in the U.S. was the best performing style and area of the market. As I mentioned the hand-off started to occur somewhat in September. I talked about back in January having a little bit more of a balance from a style perspective, growth and value, so a barbelled approach to one's portfolio. Greater diversification because you had come through a 10-year period of time where if your portfolio was fairly narrow and concentrated around one region, i.e. the U.S., and number two, around large-cap long duration growth you won handsomely.

The likelihood of that continuing for the next 10 years is probably pretty small so you were starting to see some remnants of very accommodative monetary policy being built. We had come through a period of time where the Federal Reserve cut rates by about 75 basis points to stave off a further slowdown. Then with the global pandemic, you've had more liquidity in the marketplace than we've ever seen. It's moved up exponentially. All the more reason I think to get a little bit more balance and diversified in one's portfolio because if we look out over a multi-year basis — and I talked about this 12 months ago — the potential for an increase in inflation, not necessarily this year but the years ahead, rises. I think to offset some of that, and you had some pretty cheap valuations for some of the value securities, not en masse but for some of them back in March, diversification would have been your friend and I think it will continue to be your friend going forward. I think that also … gold has gone up, Bitcoin's gone up exponentially, people are looking for ways to diversify their portfolios away from the traditional equity and fixed-income balanced portfolio. I think a lot of that is because of the monetary environment we're really in.

[07:29]

Pamela Ritchie: How does Fidelity help you do that? As you're saying there's some different strategies in there that you can employ. How do you speak to that?

Andrew Marchese: At Fidelity we have a great collection of growth investors, value investors, I think we have a number of portfolios and portfolio managers who manage in a core vein, so really don't lean their portfolio one way or another by style, but aim to really capture a lot of the excess returns via stock selection. I think we have sector-specific portfolios like a Natural Resources Fund or communication services and technology funds.

I think we also have liquid alternatives products that we recently launched back in October that help generate returns that are lowly or decorrelated from general market returns. So I think there's a lot of ways to build in diversification into one's overall portfolio using a suite of those products.

[08:27]

Pamela Ritchie: You manage all sorts of portfolio managers for all those different offerings as you suggested to traders, analysts, people are obviously not working in the office these days. How do you keep the collegial … Fidelity is known for not having walls between people and everyone hanging out to an extent in between moments of important trade and so on, how do you keep that going when you're all in your houses or apartments?

Andrew Marchese: One thing that's vitally important to maintaining in this type of work-from-home environment is that aspect of the office where you learn a lot through osmosis or just bumping into people or walking over to somebody's desk and that general learning that takes place. When we went to a work-from-home structure in March of last year, my goal was to try to replicate that as best you can. It requires you to be a little bit more formal, or prescriptive or scheduled in doing that, but I think our team rallied together really, really well to make sure that we're conversing in person as a large group of people sharing ideas above and beyond what we would typically do in our previously scheduled team meetings. I think by doing that we maintain the flow of information really well. Just making sure also people are just in a good state of mind, just generally which is obviously a concern that everybody has during this period of time.

I think the organization, Fidelity as a whole has done a really good job of paying mind and attention to people's wellbeing, making sure we're all in good shape and focused on our job, but also in good spirits as best you can in dealing with whatever we have to deal with in our personal lives as we're all kind of locked down in this environment. I think that's gone exceedingly well. If I look back on the last nine, ten months the organization has behaved tremendously. It's an A++. Our investment team in Toronto and Montreal has done exceptionally well. We had a really good year from a portfolio perspective but even more importantly I think the flow of information, the dialogue, the ability to reach out to our clients, the responsiveness to questions on behalf of all parties was exceptional. I don't see there's any reason why we can't keep that going. I think the largest reason for that, in addition to everything I just mentioned, is the fact that we've had remarkably low turnover in our team. On the investment side we haven't had anybody leave the organization for over nine years, going on ten. I think it's that rapport that you have with everybody, those long-term professional relationships that allow you to thrive in this environment. I think the numbers bear that out.

[11:18]

Pamela Ritchie: That's sort of astonishing just to hear that particular statistic. I want to go back to what you were mentioning about early cycle. Early cycle can be fascinating because there's so many options on some level. But one of the options you've mentioned before should not be sitting in cash. Just kind of go back through the reasons why this is the moment where you actually really do not want to be sitting in cash.

Andrew Marchese: I think it's a good sense to always try to see the forest for the trees. For those of you have heard me speak before, back in 2018 and 2019 I think I and other members of our team were getting a little more nervous about where we were in the cycle because you saw some forms of tightening come in, and you know that any time there's tightening from a monetary or fiscal perspective the economies globally tend to slow and that puts equities at greater risk. You can keep going and keep going until you just short circuit the cycle and then risk assets reprice and sometimes very quickly. We've certainly seen that over the last two cycles. Now you sit back, we've had the global pandemic, central banks have come to the rescue, fiscal policy has become quite accommodative and the market retrenched and has now moved off the bottom considerably.

As long as we remain accommodative, I think what you will see then still to come from an economics perspective is consumer spending should begin to increase. Balance sheets across the world from a consumer standpoint are actually quite good. Even in Canada and Australia where I wouldn't put them quite in that camp they've gotten better. So that's really positive. The next point would probably be capex. We haven't seen any capex yet. Some equities are starting to kind of anticipate that through higher equity prices but we haven't seen it. That's still to come.

I think volatility is going to be here to stay. There's no question about that. A lot of the moves as I just illustrated have been predicated about currencies and interest rates. There'll be days that we wake up where you might hear headline news about the Fed thinking of changing course, or things like this which from a macroeconomic standpoint causes risk assets, at least in the short term, to reprice. I would urge investors not to get shaken out by that. You can see a small retrenchment in the market in any given week or any given month. That's normal. But if you look at the length of cycles, investment cycles tend to be anywhere from five to ten years. We're kind of in month ten of all this really, so I would say that focus more on the active-return basis going forward as opposed to what the markets are doing on a day-to-day basis. I think as we see every cycle the first year of a bull market is basically rising tides tend to raise all boats more or less, but it's really about the price moving before the earnings show up. So you get huge multiple expansion. That's kind of what we've seen over the last nine months now.

Then the earnings have to come to fruition and that's where active managers, people like Fidelity, really need to shine because for those companies that meet or exceed earnings and cash flow estimates going forward, those stocks will continue to be rewarded while those that do not they will give back some of their price gains that have occurred over the last nine months. I think this point as we kind of transition through this year, I think probably towards the back half of the year, earnings are going to become more and more important. They do have to show up because we've had that move off the bottom in terms of equity prices.

[15:26]

Pamela Ritchie: We look to the past to help inform the future. It's a normal, well-established part of the way we look at things, but there are new things. To what extent do you use history, do you use past shocks and then reflations to guide you, and to what extent is it, in fact, new this time?

Andrew Marchese: I think the thing that's always the same, and people have heard me say before it's never different … it's never different from a leadership perspective of where you are in the cycle. The timing can be a little challenging month to month or even year to year, but the natural flow of handoff from certain styles or certain sectors to others in terms of outperformance versus underperformance, that occurs every cycle. You can look over 100 years of market history and it will demonstrate that. We are mindful of that from a leadership perspective and what stocks are telling you about where we are in the cycle, and you can then dovetail that with what we are checking from an earnings and cash flow perspective. So that's never different.

What I think you have to be mindful of here is we've never seen interest rates where they are, and we've never seen the amount of liquidity in the system. When I say liquidity it's kind of M2 money supply minus GDP growth. That would kind of be the best proxy for liquidity. What you find is that multiples over history tend to follow liquidity, so times when liquidity is more abundant multiples tend to move up. When you start taking liquidity out of the system then multiples tend to contract for equities. But the absolute level of interest rates do a lot to your discount rates. So it changes the way you should think about risk in general and how you're going to price one group of assets versus another. When you think about people will say equities look expensive historically. That may be true. Relative to where interest rates are, not so true. Relative to fixed income, even over 100 years, not so true. Alternative asset classes like gold, and if you want to use Bitcoin or certain pockets of real estate, those asset classes are going to be priced differently relative to each other and it all has to do with what we're talking about from an interest rate perspective.

I would urge investors out there never to make an absolute price call on an asset class without having some context of where other asset classes are priced, and where your interest rates are and where you think they're going to go over time. So context is exceptionally important as opposed to an absolute discussion.

[18:29]

Pamela Ritchie: Right. Where you just sort of get flung out a PE number that sounds extremely [audio cuts out]. It's very interesting to have you go through all these things and I'll just let you know so many questions have rolled in and you've just answered them as you've gone through. So there's a whole bunch that have come in, but you've already answered them. One coming in here, they would like you to expand a little bit more as an investor on digital currencies. Bitcoin, it's hard to avoid the fact that it's roughly sitting at $35,000 for Bitcoin right now. Any comments?

Andrew Marchese: I'm a novice in my understanding of cryptocurrencies, but I'll do my best. I've said before the idea of a cryptocurrency makes a lot of sense. It makes a lot of sense from a transaction standpoint. That does. Whether you anoint Bitcoin or any other cryptocurrency as being the standard, I don't know enough about the topic. I haven't read anything that makes one think that one should be a standard over another. When I think about it, I think currencies should be backed by some group of assets. That kind of makes sense. At least it has been historically. Otherwise you get into a barter system which actually reminds me that's kind of what I think Bitcoin is. Its value is extracted sheerly from a supply and demand perspective, not necessarily being backed by assets. So I don't know what the FX rate, whether 35,000, 10,000, 2,000, 100,000 makes sense, but if you're pricing it on supply demand then the intersection of supply and demand should equate to the price. We know supply is fixed or limited, finite.

Pamela Ritchie: It's different from gold sitting under the ground that can still be mined, for instance.

Andrew Marchese: Right. But even gold, it's not finite but it's not infinite either. Bitcoin is actually finite, right? I think it's 21 million coins, and then so you know the supply side, what you don't know is the demand side, but unlike a bar of gold, there are now vendors accepting Bitcoin. So there is a demand aspect as long as people like PayPal or independent vendors actually adopt it as a means to transact. Much like a fax machine. By itself, one vendor there's no real value in it, but if 10 people or 100 or a million people had a fax machine, every incremental person who has a fax machine, the value of that fax machine goes up. Well, Bitcoin would be the same analogy. Every vendor that adds the ability to accept Bitcoin, the value of that Bitcoin then goes up because demand rises. So you have finite supply and the potential for rising demand. I don't know what that means in terms of price, but that would be the calculus I would use to kind of say, does that make sense? So I can't do a purchasing power parody like I maybe can do for the Canadian dollar or U.S. dollar, but I could think of it more like a supply demand matrix, almost like a commodity that you would barter with. And that's kind of my novice approach to it.

[22:17]

Pamela Ritchie: I'd rather have you doing a modest approach to it than basically anyone else lining up here to do it. But it is fascinating to think of … throw out fashion retail or something that a dress or a pair of shoes or something that I might like to buy one day is priced in X bitcoins but then with the currency, if you want to call it a currency, doing what it's doing, how does that change the value of the actual goods it's trying to sell? It's going to be a fascinating thing to watch unfold.

Andrew Marchese: Right. I think it's perceived as a store of value because it's scarce. I mentioned there's a finite supply. The only difference is you can't touch it. You can go to a bank and you can see gold coins, or a gold bar or whatnot, and know that your store of value is there and it will protect you to some degree from all the debasement of fiat currencies that have been going on basically since the global financial crisis. You can't do that with Bitcoin. Does that pose a security threat? I don't know. So that's why art, which is a store of value because there's a finite … you have one Van Gogh painting, you have one Jackson Pollack painting. Land is a store of value. It's scarce and it may be more scarce in certain geographies. You can touch all those things. You may not be able to spend them quickly or liquidate them quickly which Bitcoin offers an advantage of, but you can't touch it. And that's an interesting one.

[23:49]

Pamela Ritchie: There's more to say on this clearly. Just as you mentioned land, what do you think of some of the real estate numbers in Canada? I know you're not necessarily on behalf of Fidelity going investing in houses, but what does that say to you? We just saw massive numbers come out.

Andrew Marchese: I think when the whole work-from-home world we're living in started back in March for most employers, you saw —and you've seen it throughout the U.S. and you're seeing it to some degree in Canada — this migration away from urban centres that commercial real estate would take a hit. That was the initial knee-jerk hypothesis. I don't think there's been anything to suggest that … like I said nine months ago, I don't think you're talking about the end of an urban centre like the death of New York or the death of Toronto or what have you. But there's going to be some capacity that gets freed up in a commercial sense, and from a real estate perspective a personal real estate, people will move further away from urban centres if they figure that they can … you can live in Sudbury and your employer's in Toronto because maybe you only have to go in once a month or once every two weeks or kind of that. So there will be some arbitraging of real estate, personal and home real estate, going forward. I think there'll be further move out to more rural areas and I think that's a natural kind of trend that will take place over time. Like I said, I think we have to be very careful of pronouncing the death of a New York, or an L.A. or something like that because history is fraught with those types of predictions that never came to fruition. So I would be very hesitant on making such a call.

[25:45]

Pamela Ritchie: I want to end off … we talked at the beginning about tectonic plates shifting within capital markets, and I wonder if ESG is one of those tectonic plates shifting within capital markets. We've only got two minutes to answer a very large question, but what do you think?

Andrew Marchese: It is probably the most topical thing we've discussed in the investment team over the last six to 12 months. If you look at what's happening in Europe, in the Nordic states, continental Europe, also in Asia with respect to the financial services industry, the asset management industry there is increasing regulation and documentation that will be necessary for asset managers to fill out, certify, research that will need to be done to explain from several ESG criteria about why you as an asset manager are investing in a given security. That justification, we've seen it in Europe already happening that, if asset managers aren't doing their necessary diligence and documenting it in a way, they won't be on DC platforms for certain European clients. Now that trend hasn't started in vigour here in North America, whether it's Canada or the U.S. Personally I think it's coming. If you see the way the rest of the world is working, that will be coming to North America probably very quickly. So we at Fidelity have dedicated research, long ESG measures and ratings systems by ESG metrics internally, much like we do fundamental research. That, I think, thematically will also impact equity valuations going forward for certain groups of stocks.

[27:45]

Pamela Ritchie: So it's a lot of new energy that might be put into, pardon the pun, but into this particular area. Andrew Marchese, there's more to talk about always with you. Thank you for joining us today. We look forward to the next conversation.

Andrew Marchese: Thank you. It's a pleasure.

Ending: [28 :01]

Voiceover :

Thanks for listening to the FidelityConnects podcast. If you haven't done so already please subscribe to FidelityConnects on your podcast platform of choice - and if you like what you're hearing leave a review or a 5-star rating.

You can visit fidelity.ca for information on future live webcasts - and don't forget to follow Fidelity Canada on Twitter. Thank you, see you again.

[end of podcast]