Fidelity Connects

Thinking Outside the Box: Founder-led Companies in 2021

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 Dan Kelley joins us again today for a discussion on how founder-led companies fared in 2020 and how thinking outside the box positions them well in the ongoing changing investing landscape.

Dan shares with host Pamela Ritchie how he has been growing the international focus of his fund – Fidelity Founders Class. As of December 31, 2020, 13% of the fund was invested outside of the United States. Dan believes that leveraging Fidelity's global research resources is very important.

Also, Dan is a big believer in ESG, and he believes that customers will demand high quality ESG. Dan will share how he is looking for founder-led companies that are mispriced and also committing resources to ESG.

Today's podcast was recorded on February 23, 2021.

[01:40]

Pamela Ritchie: Great to see you again, Dan. How are you?

Dan Kelley: Great to see you, Pamela. Thanks for having me.

Pamela Ritchie: Very glad to have you join us. Just quickly, because it's sort of been in the news and we have been talking about inflation a lot, what did you glean out of some of the comments there and how they're affecting markets and their moment in the markets?

Dan Kelley: I think it speaks to how much liquidity is driving the capital markets right now. You've seen incredible stimulus from the U.S. government both on the monetary side with Chair Powell, and on the fiscal stimulus side and bridging the consumer to get out of this pandemic. I don't think we've ever seen an emergence from recession where the consumer has been this healthy from a balance-sheet perspective, and so everyone has their eyes on the Fed wondering when the punch bowl of liquidity might be pulled away. I try not to get caught up in the noise. Obviously liquidity is important, the capital markets' drivers are important, but I'm trying to pick interesting stocks that are mispriced relative to their long-term growth potential.

[02:44]

Pamela Ritchie: And they need to be led by a founder. I feel like we need to just go back to remind us what you find attractive about the approach of entrepreneurs, how they lead companies a little bit differently and clearly for growth, can you dip back into what the Founders Class is?

Dan Kelley: Sure. Thank you for asking the question. We really think founders are unique individuals. They tend to be very innovative. They come up with a new idea for a product or service that can be done differently, sometimes at a lower cost, providing superior value. They tend to be customer-obsessed, focusing on that customer first and working their way backwards. Also importantly they tend to have a lot of skin in the game, so their interests are very aligned with us. We're betting on the same thing over the long term. We think in our extensive work that founders can be a positive alpha signal. We've been running money under this mandate for many years now, and I think the empirical data supports the work we've done.

[03:50]

Pamela Ritchie: I can think of a bunch of founders off the top of my head. I'm sure everyone can. But what is the universe or the mandate, how extensive can you make it around the world [audio cuts out] large-cap, small-cap.

Dan Kelley: It's actually quite interesting. I think a lot of people think that founder-led companies are this small basket of companies. According to our work in terms of minimum liquidity requirements, etc., there are 700 companies in the U.S. that meet our definition of founder-led, and we see upwards of three times that many companies outside the U.S. So the sandbox is plenty big enough, we're able to leverage Fidelity's extensive resources, offices all over the globe and get to know these founders really early in the company's life cycle to see if they're doing something different, and there's the potential for the company to be much bigger over time.

[04:43]

Pamela Ritchie: I'm going to bring up the example that's very recently in the news. Jeff Bezos has stepped away from the CEO role at his company. When that happens, what do you do? Companies do mature, and they choose new leaders sometimes.

Dan Kelley: It's funny, a lot of folks say "What do you do when the founder leaves the company?" Traditionally, let me just step back. We define founder-led, founder-involved in a broader concept than just the traditional CEO founder-led company. We include a universe where the founder's involved with the company. They're either the traditional CEO, which more often than not they are CEO. They're either on the board, they're in an executive position or they own a superior or significant percentage of the company. In Jeff Bezos's case he's still going to be chairman of the company. Although he won't be running the day-to-day, he still has the bulk of his net worth in the company, he's a large holder and so he would still meet the definition of founder-led.

[05:46]

Pamela Ritchie: But if they do leave, what do you do?

Dan Kelley: I apologize, I didn't get to the heart of your question. We put the company on a one-year shock clock. I have a very simple rule which is: you never want to be a forced seller of any stock. Typically what happens is with founder-led companies there's either an heir apparent, sometimes there's another person that's not related to the founder but that can carry the culture, and so often times the founder has baked the cake so to speak and you don't want to sell it just because the founder has exited the company. So I give it a year, particularly if there's something, a new idea, a product going to market, so that we can take advantage of all that good will that the founder put in place in terms of their expertise.

[06:34]

Pamela Ritchie: When I'm in my small brain here looking about a whole bunch of names that I can think of that are entrepreneurs, they're founder-led companies, but they're also … nothing wrong with all the fabulous growth companies, but what do you do now when there's this discussion about whether tech high-flyers give way, and we are seeing it a bit in the markets, for a more rotation to value? Are there still lots of value players that are founder-led?

Dan Kelley: It's an interesting question. I think of this fund as growth leaning with a multiple-year time horizon. We have seen some elevated valuations for growth companies over the past 6 to 12 months, but I'm still finding on the growth side of things companies that are founder-led that are compounding at high rates of growth, many of them turbo-charged by what happened with the pandemic and the move to digitization. To address your question specifically, I find the founder-led universe to be quite diverse. So I am increasing the underlying cyclicality in the fund. It's a little harder to do in a founder-led fund as you allude to because in many cases very old-economy companies, I think of commodity companies, miners, banks, the founder has long since passed away, and the company probably looks very different today than it did back then and doesn't meet our definition.

But there are a lot of innovative financials companies. I'm finding some industrials companies that are founder-led that are interesting. I am a believer, just to level set on how I'm thinking about the market, I do think we have a lot of favourable tenets to this market, which is one, we have a lot of liquidity in the system, which I talked about previously. We have more fiscal stimulus coming in the U.S. most likely over the next coming weeks which is important to continue to bridge the consumer, but that liquidity is going to hit right as we're starting to see an inflection in the curve of what percentage of the population has been vaccinated. As I've observed, and as I've talked to various end markets and CEOs over the past month or two, as people get vaccinated they feel safer, they start to come out of their shell from a purchasing behaviour perspective and services, they start booking a trip for six months out, and so I do think there's a potential when you layer all that together for a pretty sharply accelerating economy in the U.S. later this year, and that would benefit a lot of, I would say, cyclical end markets. I wouldn't say value, a lot of the traditional value companies that aren't growing, those tend to not be an ideal fit for this fund and they don't mesh well with my approach and philosophy.

[09:32]

Pamela Ritchie: What about all of the tech regulations? Let's just go back to some of the main names that we know of, founder-led, so on. Are tech regulations, one, it looks like they're coming, I guess I'll ask you if you think they're coming, but more than that, are they necessarily bad for the stock prices?

Dan Kelley: Traditionally people hear the word regulation and they think it's a big red flag. What I've observed over the past few decades, when regulation comes a) it's late. A lot of the companies, regulation is an output of the scale that these companies end up garnering and then the potential anti-competitive effects of that scale, so regulation is late. Second, regulation can create rules that actually act as competitive moats for these large companies because now it's hard for some up and comer to come along and steal all their market share because they have to deal with all the cost burden etc. of these new rules, if you will.

So regulation isn't all that bad. It's bad if the market expectations are really high and the rules are more onerous than one might be expecting, which is why it's important to have someone picking the correct stocks that are hopefully going to be able to use regulation to their advantage. But I don't see regulation as all bad.

[10:55]

Pamela Ritchie: I did want to ask you about the all-important question of ESG and how that plays into the way, or does it play into the way that you invest? Is it something that you look to first as an overall way of getting interested in a company and a founder?

Dan Kelley: I'm glad you asked the question because I'm a big believer in ESG. I think ESG is in the early innings. When you think about what ESG encompasses, I think you're going to have customers demanding from their companies that they're purchasing from, demanding high-quality, high-standard ESG metrics. You're going to have employees demanding it to retain talent, companies are going to have to move aggressively to make sure that they're providing an environment that fosters diversity and inclusion. Then from a governance standpoint shareholders are going to demand it. I think you have this virtuous circle that's just getting started. The good news is within the founder-led universe there are a lot of, I would say, industry-leading ESG companies that see this as the important initiative that I just described, and I think that's because a lot of these companies, when you think of founder-led, they're newer companies. They've only been around 5, 10, 15 years, and they've kind of grown up within this environment where I think they feel a responsibility to all stakeholders.

I'm still sticking true to my process of finding stocks that are mispriced relative to their long-term growth prospects, but I do want companies that are actually committing resources to ESG because I think that will ultimately get reflected into a company's cost-to-capital which means either a higher valuation multiple or a lower cost debt access, etc. So ESG is important and I'm a big believer.

[12:46]

Pamela Ritchie: There's been a reflection of how … I think your colleague Nicole Connolly calls it the stickiness of ESG through the pandemic, which people didn't know one way or the other whether in a moment like that it would stick. Are there examples of where you actually saw companies stepping up amidst the [audio cuts out]?

Dan Kelley: One Canadian company is a great example that I own in the fund. It's Aritzia. Here's an apparel retailer that was hard hit by the pandemic with stores having to be shut down, etc. And what they did despite that, they did have a digital sales side of their business that was helped by the pandemic, but most importantly they said "What can we do to help people during this crisis?" They paid all their employees, the associates in the retail stores still got paid while the stores were closed, and then they actually donated a lot of inventory to health care workers to help them as they were leading the charge to take care of all those people that were impacted, that fell ill, families, etc. What that did, which was I don't think their intention in doing this, I think it just spoke to who they were as a company, it really helped their brand. They were trending all over social media for doing this, and a lot of the health care workers wanted to go back and purchase from them. I think this is the type of virtuous circle that I'm talking about where doing what's right can really create a loyal customer base, loyal employee base, and I thought that was a good example recently. I'm glad you asked the question.

Pamela Ritchie: Do I recall that this fund also piloted in Canada at one point, didn't it? Have I got that wrong?

Dan Kelley: It did pilot in Canada. The original Founders Fund was piloted up in Canada, and we're actually going to hit our three-year track record in a few months.

[14:53]

Pamela Ritchie: I was hoping I got the right fund there, but anyway I did. This is great, and I think we kind of touched on how globally focused you are or not, how much global bandwidth you have to look around the globe.

Dan Kelley: I've been increasingly growing the international component of this fund. It's about 12 or 13% today is outside the U.S. I'm finding particularly now that the dollar has been weaker, I'm finding some really interesting ideas outside the U.S. I think with all the … you talk about the liquidity and how flush the capital markets have been, we're meeting a lot of companies outside the U.S. that are private, that are thinking about going public, or starting to test the waters and get to know some investors. I think that's really important to leverage Fidelity's scale and resources and all these different global offices and get to know these companies that could be the next hundred billion dollar company down the road. I'm spending a lot of time getting to know them, doing the due diligence, talking with our analysts, and I would guess over time if those companies do come public, that that share could grow.

[16:11]

Pamela Ritchie: When you mentioned that it made me think of just how many IPOs we've seen over the course of the last several months. Are there some new founders out there that you like, that you might put in the fund? Can you comment on new options coming into the market?

Dan Kelley: The founders are new to the public markets, but a lot of these companies have been around for a decade plus and they're just now choosing to come public, but I love it. To your point there, new options for me as a predominantly public equity investor. I am going to know a lot of companies. I would caution, some of the activity is a little bit speculative in terms of some of these SPACs and some of these companies that have no earnings, and you're betting on earnings three or four or five years out. Those names don't tend to fit with my process. I'm looking for mispriced growth, so companies where I feel confident that I can underwrite their growth trajectory, the market doesn't believe in that growth trajectory, I think that that growth can compound over time and hence the company could be a lot bigger than the market thinks. Generally I'm staying away from some of those names that give you pause. I do think it's just a reflection of the liquidity environment, so I don't think by any means it means the cycle is over, it's just another data point that you need to keep in mind that we are in a flush liquidity environment and to the extent that environment changes, that may impact some of the stocks you own.

[17:44]

Pamela Ritchie: Are there any nuances with regards to turnover when you are perhaps buying, and being loyal to and sticking with a founder through the vision that you know this person has? Maybe it's the same as other funds or is it quite different? How do you look at turnover?

Dan Kelley: I'm a believer that turnover is a function of what the market gives you, and what's been weird the last year is we've had three mini cycles within a year. We're going into recession, a deep recession, then we've got tons of liquidity that kind of surprised the market. Then we were waiting on innovation to address this pandemic, could innovation outrun the stimulus, and now the market's starting to feel more comfortable that the economy is going to accelerate, and that all happened in a year. So I didn't know that was going to happen and during that we had 40% swings, and 30% swings, and so I tend to embrace that volatility for my shareholders. If I can get long term winners, unique founder-led companies where I wanted to buy them at a certain price and the price was not where I wanted, if I can get them on sale, I am chomping at the bit. I have taken advantage of some of this volatility and just the kind of mini cycles I just described to embrace that volatility for my shareholders. Ironically, going into the pandemic, this fund was heavy digital innovation, we've got digital innovation on steroids, so the turnover went way down, and as I alluded to more recently with the underlying adding to the cyclicals out of the barbell it has picked up, but it's not super high. It's under 100%.

[19:37]

Pamela Ritchie: I know that Fidelity has incredible depth of research and there's so many other ways that you look at things but there must be something to … how do I say this this charitably … there's a je ne sais quoi about an entrepreneur, there's a mystique. Sometimes it's pretty hard to pin down. Could you comment on that at all? You must have conversations with a lot of these leaders of these companies.

Dan Kelley: I do. It's funny, I think picking the ones with the mystique that kind of ends up translating into leadership and execution is really the tricky part because I do think a lot of founders, they beat to a different drum, and they tend to see something that the market can't see, the market might think is heresy, that they don't believe, and then they start to make it a reality. Jeff Bezos, who you brought up, was a great example. Elon Musk is another example of no one believed him for years and ultimately executed quite well. Initially the mystique can be a mirage at times. A lot of folks have this great idea that you don't believe. You're like, wow, if he or she could executive on that that would be amazing, and then they don't come close to executing on it. I think that's what important for someone like me to get to know them, get to know them through our analysts and find the ones that are unique, that have that special sauce, and then I love when they have their whole net worth betting on the finish line. That means they believe it themselves; they're not taking money out because it's a coin flip whether they're able to execute. So yeah, it's hard to describe. It's a special sauce, but you know it when you see it. I'm sorry I'm not answering your question.

Pamela Ritchie: That is the trouble [audio cuts out]. They just got it, whatever that is.

Dan Kelley: They take years to figure out too, so oftentimes bets will start small and as they're executing, as I'm getting to meet regularly with the management team, my confidence is growing, hopefully the stock's outperforming, and then the bet is also getting bigger over time.

[21:53]

Pamela Ritchie: It must be a fascinating process from so many angles, but that part must be very, very interesting. So question rolling in here, what is your criteria for selling a stock? What is your sell strategy?

Dan Kelley: As a growth at a reasonable price investor, first and foremost I'm always kind of reassessing what I'm paying for that growth rate, and so there are stocks that have way exceeded what I think is a fair value, and I will sell stock if we're in nosebleed valuation territory. I will sell a stock if my thesis is called into question. I'm always creating guardrails for myself and how I'm thinking about fair value, and I write down my thesis, and I write down the key pillars of the thesis and often times one of those pillars starts to wobble. If it wobbles, and it falls down, the key is that you can't have thesis creep, and you have to stay true to why you bet on the company originally. Usually when one pillar starts to wobble, you generally start to see more red flags and problems so that would be another reason I'll sell. Then often working with our analyst team if some sort of negative catalyst is going to change the growth rate that I was expecting, and hence that growth rate is not on sale because the growth rate is much lower than I appreciated, or is likely to be lower than I appreciated, I will also sell the stock.

But first and foremost it's what am I paying for the growth; can the growth keep compounding; is it a reasonable valuation a few years out and is the founder doing what he or she said they were going to do in executing on it? Those are the ones I want to ride for many, many years.

[23:34]

Pamela Ritchie: So interesting you mentioned that the portfolio had been structured towards a huge digitization trend that we saw across the boards, and therefore did very well through those months and weeks and we're still in it, work from home. Do you think even once most of us are vaccinated or we've reached whatever the elusive herd immunity is, do we still work from home? Do those stocks that aid us in doing that, is that a continuum?

Dan Kelley: It's a bit of a loaded question 'cause I'm sure it will be all across the board. I do think we're going to retain more of what we've been utilizing from a tools, digital tools standpoint of doing work. I think there'll be a lot more flexibility to work a few days outside of the office, work in different locations. Rather than travel you'll be able to Zoom into a meeting if you'd like. When I think about it, yes, there's a rotation going on and how long that lasts is anyone's guess, but I think what people fail to appreciate is people change. Once consumer behaviour changes and you start doing something a different way, that behaviour tends to stick and think about this, can save companies lots of costs in terms of their real estate needs. I do think that these companies that onboarded so many new users, that like the ease, and the convenience and the value that they receive, I think those companies are going to likely grow a lot faster than I anticipated a year ago, and then the question is, is the market still discounting that sort of growth rate that I'm expecting over the next couple of years? In many cases they thought earnings were going to go down because of the economy going into recession, and earnings actually went up materially. In many cases these companies didn't get that expensive because they grew through the pandemic. I still feel really good about some of the long term, more digital-oriented companies that I own in the Founder's Fund.

[25:32]

Pamela Ritchie: Let's finish out with the other side which you also mentioned, so a bit more exposure to cyclicality. Does that include energy? I'm thinking what we might start to call traditional energy. What type of cyclicality are you introducing to the fund?

Dan Kelley: Yeah, it does. When you step back and you say, okay, the economy is likely to accelerate as people feel safe, and we hopefully continue to get this pandemic under control. That leads to areas of the economy that have not grown materially for many years. Energy is one of those sectors where supply growth has been coming down materially. Obviously we have OPEC, which is a bit of a wild card, but in a capital-intensive industry where your access to capital has been curtailed, if you're in this global accelerating economy, synchronized accelerating economy coming out of this, then you simply can't ramp supply as quick as you need to meet demand, and that usually leads to a tightening by demand dynamic and higher prices. I do own a few energy companies. I own a few financials, credit card companies, I own some innovative banks, and so I am finding some cyclicality that benefits from potentially a little bit of inflation, a little bit of a steeper yield curve. The consumer has never been this flush coming out of a recession, so they are ready to spend that flush balance sheet, and there are areas of the economy that have not had a lot of spending in quite some time and I think those cyclical areas are going to do quite well.

[27:15]

Pamela Ritchie: It's great to get your thoughts, Dan, and also this very different time in the markets than from when we spoke to you a few months ago. Thanks for bringing us up to date.

Dan Kelley: Any time. Thanks Pamela.

Ending: [27:25]

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