Fidelity Connects

Investing in Canada Through the Vaccine Rollout

Hugo Lavallée, Portfolio Manager

Pamela Ritchie, Host

Voiceover: Hello and welcome to Fidelity Connects – by Fidelity Investments Canada - connecting you to the world of investing and helping you stay ahead.

Today we welcome back portfolio manager Hugo Lavallée. Hugo shares his contrarian viewpoint as markets and economies adapt to living in the time of COVID-19 and experience a rollout of the vaccine at different speeds worldwide.

Hugo is bullish on leisure reopening, and he explains to host Pamela Ritchie that he is constantly talking to companies to determine what is next and stays focused on anticipating these changes to lay the groundwork in his portfolios for what is to come in the market in the future.

Hugo also unpacks the long-term trend of ESG investing, and he wants to carve his niche in the "E" – environmental – fighting the battle against carbon.

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[01:45]

Pamela Ritchie: Hugo, welcome back. Great to see you.

Hugo Lavallée: Good to see you, Pamela. Hi everyone.

Pamela Ritchie: Very glad you could join us here today. I want to talk a little bit about what we've seen in the last several days, but more to the point what you have been getting ready for that's kind of playing out right now. Can you talk to us a little bit about the last three, four months of your strategy?

Hugo Lavallée: As we've discussed in the past, one area I've been really bullish on is leisure reopening. We've been talking about it for a few months, and the news was so positive on November 9th, I believe, when we saw the efficacy of the vaccines. I was trying to get ready for it ahead of time, and I kept pushing that trade further in the funds, and today you're seeing it. The market is anticipating with the news out of Israel, out of the UK, the aggressive vaccination in United States that they should have a pretty good summer, and the market gets ahead of that. It's great to have hotel plays, concert plays, wedding plays, some small cruise ship plays, just people going back, seeing the world, some social interactions. These trades you have to get ready ahead of time. For me, especially on the leisure trade, it's something I've been working super hard. It's been probably my number one focus over the last four months.

[03:12]

Pamela Ritchie: And it sort of goes to what you saw as a contrarian investor X months ago. Let's talk about the banks. Essentially not an area that you focus on historically. Is that right?

Hugo Lavallée: Historically I barely have any bank holdings, and it's something that our clients can see that change in my top 10. On both funds Canadian banks appeared in my top 10. Pamela, you and I talked about it at Vision 2021 four weeks ago, and it was about getting ready for bank earnings that we're seeing this week. We're seeing non-performing loans coming in below expectations and the stock reacting positively to a steepening yield curve. It's one of the only industries that benefits from a steepening yield curve. Growth stocks sell off a little bit and financials go up, and you gotta get ready ahead of time. So we've talked about that a month ago, so it's not very surprising for me. You gotta just keep pushing for what you think is going to happen next, frankly.

[04:16]

Pamela Ritchie: It's not surprising except for here we are literally in the week of the main bank earnings, and we're watching what you were thinking and prognosticating about and investing towards X months ago. Anyway, it's just really interesting to see all of that. So that's what you were thinking X months ago; that's now what we're seeing come to fruition. What are you thinking about in terms of trying to invest right now for, say, the next three to six months?

Hugo Lavallée: I still like reopening leisure and the green trade. I know we'll talk about that later. But one thing that's really getting out of favour that I'm interested in is quality. So high free cash flow yield. That's really out of favour right now. The underperformance becoming really dramatic. So low-volatility names, good businesses, 5%+ free cash flow yields. It's really out of favour. It's not super surprising, but it's unusual considering how low the rates are, and that was an area that was really popular a few years ago, and so that's a bucket that I'm trying to grow in the fund. Frankly, people need to understand that. It's part of our job. We're always working everyday grinding to talk to more companies and figure out what's next. It's always evolving, and that's why you've heard me talk about in the past, it's a market of stocks, it's not a stock market.

I was talking to my boss earlier this week; he had a really good analogy. Our business is about pushing a rock uphill. And every day you have to come in and grind and do a lot of company meetings and try to figure out what's next, what's sounding better, what could sound better in a few months. If we're here, talking about the rock, and polishing the rock and staring at the rock, we're really not accomplishing much. For me, every day it's about hitting those company meetings and figure out what sounds better, what could sound a lot better that's contrarian right now. That's how you get ahead. I think we've talked about it with financials and leisure. Today I'm trying to lay the groundwork for what's going to come 3 months from now, 6 months from now, 18 months from now. It's always evolving and that's what … you've got to like the grinding process of it because unless you're in the wrong business, frankly.

[06:31]

Voiceover: So the boss that Hugo just referred to is Andrew Marchese, Chief Investment Officer at Fidelity Investments Canada, who oversees all of the portfolio managers, analysts and traders.

Andrew will be appearing on Fidelity Canada's live webcast "The Upside" on Friday March 5th at 12:30 pm eastern. "The Upside" webcasts are open to everyone - both personal investors and investment professionals.

Andrew will be taking questions from the audience, sharing his Canadian market outlook for 2021, how he is positioning his fund - Fidelity Canadian Disciplined Equity Fund, and will also speak to the structure of the Fidelity Canada investment team and how the various portfolio managers and analysts collaborate.

To register head to fidelity.ca - click on the "Investor education" heading, and then "The Upside investor webcasts". And again that's Friday March 5th at 12:30 pm eastern if you'd like to attend.

[07:29]

Pamela Ritchie: Let's talk about how much of what you're looking at right now that seems out of favour, or is just a long-term trend, is so-called green. Let's go into ESG and what you like about it, where you think it is right now. Is this the beginning, or is it getting a bit frothy? What do you think about this area right now?

Hugo Lavallée: That's a really long discussion. I think our business is changing. I have a good analogy, so on Monday we had an hour meeting with Uber and normally we talk to the CEO or CFO or IR, but these were different people. We're talking to legal people, their ESG people, the people that … Uber just came out with their first ESG report. And us, we're trying to understand as shareholders what do we own, what [indecipherable 00:10:52] are they on, did it have good intentions or not. So we've talked about compensation for their workers; we've talked about data privacy; we talked about their carbon footprint and that's how, frankly, our business is changing. Before we never used to have these meetings. It would be just about let's just try to figure out if the stocks are going to work in 2021.

Now we have a lot more involved discussions, trying to understand the business from an ESG perspective. So that's a positive, and that's new for us and it's new for me. It's been a year, say, so it's good. I don't have all the answers, but we're trying to get there, and corporates are trying to get there and trying to see Fidelity as a partner. We have board interactions more than we used to. We're doing that with multiple businesses. So that's very positive. I think you understand that for me, what I'm trying to do is carve my little niche on the E side and specifically more carbon, right? So as clients have heard me speak over the last 18 months, I've been really, really focused on that. You've seen stocks appear in my top 10; solution companies, companies that will benefit from climate change, companies that have solutions for climate change, and that's what I'm focused on.

We did a little conference, Fidelity International, a few weeks back. I think we've talked about that in the past, 18 companies worldwide. Solutions are global; they're not all made in Canada unfortunately. But we have to look at global companies, and I'm really, really focused on that. Some of the stuff as you mentioned got a little frothy. I think it's fair to say that maybe electric mobility or hydrogen got a little frothy. For me, the funds are always in movement. Hopefully you have some of these stocks six months ago, a year ago, and then they're discovered by other investors. It's not different than what I do with the rest of the portfolio. Then you just try to move, okay, what's misunderstood on the green trade? Maybe it's insulation stocks, maybe it's other benefiters, maybe it's some micro-caps, small-caps that people aren't focused on. Everybody talks about the same stocks, but there's a lot of new stocks, new IPOs in the background, private companies, and you're always trying to replenish and further your understanding of this.

So it's March break next week for the kids, and I got my Bill Gates book to read. It just came out last week. So it's ever-evolving process and that's what I'm focused on.

[10:52]

Pamela Ritchie: It is an ever-evolving process. You mentioned carbon, so I'm just curious. There's all these different types of measurements for how people are educating themselves to be looking at companies. There's a type of rating in terms of emissions and I think you had mentioned that you're rating some of the companies by that. Can you go into that?

Hugo Lavallée: We have our global ESG rating, but we're using also external sources at Fidelity as validators of our funds, especially Greater Canada, which I like, is starting to be recognized by external sources as having good overall sustainability ratings. One source that I can quote that we use internally is [ISS?]. One thing they look at is climate path. We know we're at 1.1 degrees of warming, and we know that at over 2 degrees, frankly, all hell breaks loose. You can push your fund to their models and see where is Greater Canada versus the benchmark and others. It's another tool. It's not perfect, but it's really helpful. So Greater Canada right now is at roughly half the degree path of the benchmark, which is 70% TSX, 30% S&P. So I'm pretty proud of that. It's not perfect, but being able to on the Venn diagram intersect not only good performance but also trying to run money a little bit differently is, frankly, pretty rewarding. I'm not perfect, but I'm just trying to keep pushing on that path.

[12:24]

Pamela Ritchie: Let's take this opportunity to talk a little bit about smaller companies you said that maybe aren't public, also the IPO sphere. There have been a lot of IPOs in the last [audio cuts out], we know that. I think you've mentioned that you've been involved in some and less involved in others, but as it speaks to opportunities and innovation that's available for you to look at, what do you think?

Hugo Lavallée: In the short term it's been great for us. It's been great for alpha especially for Greater Canada. The analysts are doing a great job. There's so many of them ramping quickly, offering recommendation pre-IPOs, and trading has done a great job positioning us so we can be top of mind with companies. Also we've got Liz Chow who's in charge of our private placement. She's done a great job gluing all this together, making sure that we get the right meetings at the right time. Some of them we get really good allocation and they're fantastic stocks. So that's kind of day one, and it's been a good source of alpha especially for Greater Canada.

The good news is in the long run it provides more companies for us to invest in. In Canada we're seeing IPOs, obviously United States and the rest of the world we're seeing IPOs. I think, Fidelity we do really well when we have more companies that decide to go public and we can invest in. So maybe some get really overextended on day one and they're less interesting, but now they're going to be public for the next 10, 15, 20 years, and there's going to be points in time where unfortunately a pandemic happens or recession happens. There's some names that I follow for years before I invest in them because there's nothing contrarian about them. So I think it's really positive for our business as active managers that we're just having this tidal wave of new companies that are deciding to come public. It's not just about the first-day return, but the opportunity for us to capture high returns over the next 10 years.

[14:18]

Pamela Ritchie: You just said something there, and it makes me think you've answered this question. I wanted to ask about the connection between contrarian and necessarily a more risky approach. But you just said that there's companies I look at for years because I look at things that are contrary, but I don't touch them for a while. Can you just comment on does contrarian mean a risker strategy?

Hugo Lavallée: I don't think so. If you're doing it well, you're buying pretty close to the bottom. People have to understand that when there's bad news it's not like the stock price is stagnant. With experience you're trying to get closer to the bottom that, okay, there's a lot of bad news discounted. So think about an example I've given you in the past: Five Below. I've watched Five Below for years. High-return business, my kids absolutely love it. It's a great store that provides exceptional value, but there's nothing contrarian about it. Things are going really well. They're generating super high returns, and then the pandemic happens, and they have to shut all their stores. And it's not an online concept, it's more of a treasure hunt concept, and they lose 96% of their revenue. So the stock goes down last March 60%. There's the contrarian opportunity. Something that I've tried to educate myself for years, and then you get to work. So Harriet who's our analyst on it, we're talking to the company; we're talking to the CFO; we're discussing the balance sheet; we're discussing liquidity. Harriet takes her best shot at … I'm talking 10 months ago, her best shot at 2022 earnings. We don't know what 2022 earnings are going to be, but we can try to figure it out in an income statement. She comes back to me, and she says "They have the balance sheet, we think they have the balance sheet to survive this, and it's 10 times earnings." And this is a stock historically that's 30, 40 times earnings. So there's the contrarian opportunity.

You're not buying it when things sound awesome; you're buying it after bad news. You're getting heavier and heavier into it as the stock just plummets during the pandemic 'cause people can't take the pain. It's typical human behaviour. Nobody runs normally towards danger, and you're staring at a really tough quarter next quarter. The stores are shut. But in a way I try to keep it easy when things were tough otherwise you'd just get lost in the noise. Do they have the balance sheet to make it, and what do you think the earnings recovery is? Then in a way it's never been this easy to analyze. The revenue's basically going to be zero, so we know that's what it's going to be like. So let's just focus on what could it be in the future. And that's how I do it. That's my secret contrarian sauce, and I think it's a little different than … the value probably won't look at it because there's no more earnings, so you can't say it's 12 times earnings. Obviously the stores are shut, so it doesn't sound good for a growth manager, they're chasing some other thing. That's where I think I've carved my little niche on the contrarians.

[17:22]

Pamela Ritchie: You spend a long time talking about leisure and the consumer, are there other consumer trends that you like, that speak to the health of the consumer? We've got a couple questions in on [audio cuts out] what you think.

Hugo Lavallée: I don't know if I had a new new thing. I think leisure has been my big trend. I think we as social animals we all miss social interaction, and the market is really starting to discount that. Some of these leisure plays are making all-time highs even though they're cruise ships or concerts. They haven't even reopened yet. That's the great thing about the stock market that people need to understand, it's a great discounting mechanism. So I still think we're going to see changing consumer behaviours on carbon. Some people think of it as incredibly painful to change their ways, but I think the pandemic with the concept of self-responsibility has changed that a little bit. I'm still bullish on changing consumer trends on the green economy, carbon footprint. I'm still really bullish on reopening plays, going to see a hockey game, and I think there's a path through that now which wasn't there pre-November 9th. Now obviously this is very fluid; the stock market is rapidly discounting that scenario, and I just have to work with the team to push the rock forward and figure out what's next. We've talked a little bit about quality and some of these staple stocks that are really out of favour that maybe I need to get a little bit heavier into that quality bucket.

[19:03]

Pamela Ritchie: We'll look for an update on that, that cash flow model as you mentioned, quality and some of the things that you're looking into. A question, this is interesting because we've been discussing a lot about access to markets further afield than North America. So the question is: How competitive are the opportunities in the Canadian market versus the U.S. and also other developed markets?

Hugo Lavallée: In IPOs we've done an amazing job getting involved in some of these Asian IPOs, and every now and then people will see sprinkled one or two Asian companies in my fund. The green, it's really global, so I'm trying to push globally what I can do, my global understanding of green solutions. A few weeks ago we were talking to Norwegian companies and they're really global, so that's important. In both of my funds I'm kind of maximizing my foreign shareholder ownership. The Americans are vaccinating super-fast. It looks right now that they're going to have a really normal summer. Same thing in the UK. So I'm trying to maximize those opportunities on leisure reopening with my foreign shareholder ownership.

In Canada, unfortunately, we're behind the curve there. But I think Fidelity has always done a really nice job finding those growth stocks in Canada. We have them. I think often time we don't talk about them enough. When I joined almost 19 years ago, Allan Radlow and Max Lemire [ph], we were in CGI and Couche-Tard, and Shopify has been an unbelievable spot for Mark. I've owned Constellation Software for almost nine years now. It's been really good. We're really good at finding these really good stories, and that's what I'm trying to do is to keep pushing forward with some of these names, and in Canada we're really good. There's a lot of pressure at Fidelity that if a stock is working and we're not in it, it's a good long-term [indecipherable] story to get it right, and that's what we're going to be focusing on.

[21:09]

Pamela Ritchie: Can you elaborate on that?

Hugo Lavallée: I just think it's kind of Will Danoff one-on-one, 101 at Fidelity that we're really good at finding these stories, and if you can nail just one or two of them, they can make a really big difference in your portfolio. And there's a lot of pressure that hey, this stock's been a great stock over the last few years; we don't really own it; it sounds like a great story; how come we're not heavier into it; let's call the company. That's kind of really Fidelity 101, and I think over time what happens is we're able to find in Canada a few really, really good stories that are going to be really, really positive for our returns for our fund holders.

[21:48]

Pamela Ritchie: I wanted to go back to the contrarian side of things. How did you come to this approach yourself? I guess it seems normal for you, but how did you know you'd be good at it?

Hugo Lavallée: For me it started … when I joined Fidelity in '02 you'll recall tech had been really, really tough. I started in July 2002. We're given 90, 100 days to initiate on our sector. So I was initiating on my stocks in October 2002 in tech. Companies were reporting, and I was initiating on them. The stocks were incredibly cheap. There were a lot of net nets, so companies that market caps were below adjusted net current assets, less all liabilities. That kind of opened my eyes to the fact that these stocks that people absolutely loved 24 months ago, 30 months ago, now they were left for dead and nobody cared. That's when I started dabbling. Some of our older clients might remember the Gennum or the Tundra Semiconductors. I'm showing my age a little bit here with these stories, but I got really, really interested into them. It kind of showed me I can do this, I can find really great opportunities in names that are less popular and that are left for dead. Some of them, at the time Apple was incredibly cheap. I remember RIM, Research in Motion, was $8 a share, they had $6 of net cash per share and then it was 100-bagger when they hit another product cycle with the Blueberry. It kind of showed me that I can do this and it's part of my personality, and over time you're encouraged at Fidelity just to kind of keep discovering your personality and go from there.

[23:43]

Pamela Ritchie: You find things and you spend time on whether that's an area that you're going to go into or stock that you're going to take part in. What does it mean about your turnover, I guess the nimbleness? I know in the last year a lot of people have been quite nimble about things. Can you speak a bit about how much you hold, how long, the turnover rate.

Hugo Lavallée: I don't manage my turnover frankly. It's not something that I manage to. We have unbelievable PMs, some of my colleagues that run with really low turnovers, and we have other PMs that run with really high turnover, and I don't really manage to it. As a contrarian investor I'm always trying to rebalance the portfolio and it really depends. Over last year, as you can imagine, in the pandemic I wasn't staying put. And the traders did a really nice job going down cap; let's find some small-, mid-cap; let's get us some liquidity in those more difficult names. My turnover shot up last year, but I think hopefully people are happy with the results. It's like fishing, when there's a lot of things happening and you just have to stay put and change the funds, and that's what I was trying to do last year. I don't manage to my turnover. It's been a little bit elevated as we've almost had three different markets over the last 12 months, but over time that should normalize.

[25:14]

Pamela Ritchie: I want to come back to something we talked about in the interim and this is really comments. We've had a lot of central banks eke over the course of the last week or so, and yesterday we heard the term excessive exuberance in our housing markets. It's not like this is a new discussion, the housing market in Canada, but as you mentioned financials take on a little bit more of interest for you these days. How do you look at the Canadian housing market?

Hugo Lavallée: Some parts definitely look frothy but I've been, to be perfectly honest, kind of negative on it for eight years. We've had good immigration trends, and like I said earlier, I think we were staring into the abyss unfortunately as a country in early April, and the federal government with their programs kind of took that tail risk off the table. That's why I, post-pandemic, I decided to … the banks didn't react super well initially on the rebound, but then I decided that okay, I need to own some bank stocks here because one derivative of the really good vaccine news is that eventually the yield curve is going to start steepening again, and that tail risk of absolute disaster, people losing their homes because unemployment rate is so high is kind of off the table, and eventually immigration will come back as people get vaccinated. For me, it's something that I pay attention to. I think unfortunately some people have too much debt in this country, but I'm also cognizant that interest rates went way down, fiscally and monetary-wise the agents above did their job and took the tail risk off the table, and that's why I decided to buy some Canadian banks.

[27:06]

Pamela Ritchie: Is there anything that you're looking to on the other side of this pandemic? Leisure clearly is one that you've flagged and that you're interested in, but are there other ideas that you're just sort of sorting through and you think might be part of the post-pandemic world that one day might be of interest?

Hugo Lavallée: We're talking later today. One company I'm interested in, they do ceiling office renovation. I own it in Greater Canada. I think it's still super fluid, and I don't have all the answers, but I'm trying to stay really flexible and open-minded about what is the post-pandemic work/life balance going to be like and that's what I'm focused on. As facts change I'll try to change my mind, but I think these hybrid models, I think it's creating a lot of opportunities in consumer discretionary, and I think we're pretty good at it and I'm pretty good at it. That's going to be something I'm going to be focused on. Office has been left for dead. I'm starting to pay more attention to it in both funds, Ops and Greater Canada. What are reopening back to the office trades that I can focus on because that's one thing that I think people are still really negative on and I think there might be some opportunities there so I'm definitely paying a little bit more attention to that.

[28:29]

Pamela Ritchie: The contrarian is at it. I like it. Hugo Lavallée, thank you so much for joining us today on Fidelity Connects. Great to see you.

Hugo Lavallée: Thank you very much. Thanks everybody.

Ending: [28:43]

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