

The Upside

Chief Investment Officer's disciplined approach to investing

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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 and Chief Investment Officer Andrew Marchese is our guest today.

In speaking with host Emily Anonuevo, Andrew shares how he first got into investing and shares some highlights from his career which first started with Fidelity in 1998.

Andrew touches on his investing style for Canadian Discipline Equity Fund and promotes the benefits of investors taking a disciplined, long-term approach and to not be concerned over short-term market movements. In fact, events like March 2020's meltdown created a buying opportunity for active portfolio managers with long-term horizons. Andrew explains how investors today are surrounded by a lot of information and a lot of opinions on social media, the news and other places. Investors need to avoid the noise, have a clear idea of their personal goals and stay focused.

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Emily Anonuevo: If we took our phones out right now and searched for financial news, we probably would see a range of aggressive headlines about the U.S. Central Bank, rising inflation expectations and panic. On other days, however, you might be flooded with exuberance about cryptocurrencies, hot stocks to buy and chase and optimistic forecasts.

Research shows extreme emotions, fear and greed are among chief reasons why investors, all of us, are better off with professionals. Financial advisors and portfolio managers bring objectivity, discipline, training and experience to protecting and growing our hard-earned assets over time.

Today, we are pleased to be joined by Andrew Marchese. Andrew is portfolio manager and also the chief investment officer. As CIO he leads a team of other portfolio managers, analysts, traders and other investment professionals.

Through today's conversation we hope that you will take away what Andrew thinks about the markets, how he's approaching today's condition over the long term and some investing lessons he's learned throughout the years. Andrew, so happy to have you today.

Andrew Marchese: Good afternoon Emily. It's a pleasure to be here.

[02:59]

Emily Anonuevo: Andrew you help manage over \$15 billion in assets on behalf of hundreds of thousands, if not millions, of Canadians and many institutions. But you didn't start out as an investor. I believe you have a background in pharmacology. So tell us what sparked your investing career and your journey to becoming CIO.

[03:20]

Andrew Marchese: I did my undergraduate degree at the University of Toronto in pharmacy, and I would say in about the third or fourth year there, I kind of knew that I wasn't going to stop in pharmacy. I was going to go on to something in a postgraduate sense. It was either going to be medicine, or I had a growing interest in business which spawned a growing interest in investing. When I graduated, I worked for a couple of years, and then I was going to make the decision to go back to school. I really just wanted to invest from a career perspective.

Initially I thought I'd take my knowledge of health sciences and, as you say, pharmacology or clinical therapeutics or what have you and combine that with finance and invest solely in healthcare. But when I got to Western to do my MBA, I found a lot of interest in a lot of other industries, and so working for a mutual fund company made a lot of sense. I was fortunate eventually to leave Western and join Fidelity. So, and the rest is history.

[04:27]

Emily Anonuevo: Excellent. Just an interesting combination there with your undergrad that you said in pharmacology and then stepping into the investing world. You've been in the financial industry for over 20 years, so you're definitely doing something right now. As portfolio manager, Andrew, you have developed a strong track record in managing the Fidelity Canadian Discipline Equity Fund and other mandates. I wanted to get your thoughts on your investing principles. What has worked for you over the years and, in other words, what is your investment philosophy?

[04:58]

Andrew Marchese: I think the title of the fund, the name of the fund - Discipline Equity speaks a lot to my first principle about investing is to be disciplined, is to adhere to a group of principles and stick to them because over the long term and, more often than not, they tend to work. So I think any good investor tends to be disciplined in what they do.

What I also do is I preach a lot of moderation. I think we have a tendency to talk in extremes, not only in investing but in a lot of things. While that tends to garner some notoriety, and it can actually even help short-term returns, over the long term it actually doesn't work very well.

So moderation and then patience. Some of the best investments I've made both professionally and personally over my career have been because I've had a greater than five-year outlook in a given security. So I tend to always think in five-year or more increments of time. I don't really think about what's going to transpire over the next week or month, maybe not necessarily even the next year. So I think if you combine those things around discipline, moderation and patience, giving yourself a longer-term objective, the likelihood of you succeeding and generating above market returns increases dramatically.

[06:23]

Emily Anonuevo: I like how you mentioned the importance of looking over the long term because that's one of my questions. You've always stressed the importance of investors looking at a long-term horizon, whether that be five to 10 years. Why is that even more critical in today's market? I mean 2020 is behind us, we're now into 2021. What should investors hold on to in terms of looking out over the long term?

[06:47]

Andrew Marchese: I think through social media, the advent of the Internet, the advent of more media streams coming at us as both professionals and consumers of information, whether its financial news or other news, we're bombarded with a lot of information. A lot of that information is opinion that may be loosely tied to fact. Facts are sometimes in short supply, where opinion is in high supply. So when you're getting a lot of jolts of people or things telling you what to do, or what to think, it has a tendency to throw you off your track about what your goals are, where you want to be.

I think increasingly because of all these bits of information, the sources of those information increasingly become shorter-term focus because that's how you garner hits or eyeballs or whatever you want to call it, and so by doing that you have a tendency to, as I said, you get off your track, you get off your goals. And you end up getting whipsawed a lot, you turn left when you really should be turning right.

I think stripping out that noise, removing that noise, keeping a clear idea of what your goals are and how to get there, blocking all that stuff out is really important. Then you get to the five-year horizon that I talked about. It's just where do you want to be from an investing standpoint in five years' time? What kind of returns are you looking to generate or what's your end goal in terms of dollars generated, so to speak, or investment return or gains? Those are the things that really matter, and a lot of the information that you get through the media streams are just not helpful in that regard. In fact they're deleterious to doing really good analysis, as I said, about discipline, about moderation, all those things, patience.

So it seems like we live in an era now where there's more opinions being thrown our way to generate hits and eyeballs and clicks. It has to be more extreme in nature, so the use of language tends to go from guardrail to guardrail, and it tends to be more shorter-term focus in order to garner more attention. As I said all of that is a negative to actually doing what. Whether it's personally or professionally, the goal is to making money in excess of market returns.

[09:23]

Emily Anonuevo: I wanted to go back to what I said off the top, the value add of financial advisors and portfolio managers, obviously, like you said staying disciplined, staying focused, thinking the long term, not panicking in the short term. How do you navigate through all that market noise? We're coming up to the one-year anniversary of the big March meltdown of 2020. Was it a wild time for you then? Now that you've sort of gained a year perspective, what are you learning from then and applying it to now?

[09:55]

Andrew Marchese: Somebody told me a long time ago, one of the keys to success for any investment professional is to approach each day like a new day, and you reanalyze what you did the previous day or the previous week to make sure that everything that you've done from a diligence perspective still makes sense, and if it does, then you keep investing the way you have invested.

In March of last year, obviously, when the market kind of melted down as the world was facing a global pandemic, I remember, it's actually after the close on March 23 which actually marked the low for the market over the last 12 months or so. I said to one of our portfolio managers on our team, I said, "If you've got a five-year horizon right now, the market is most definitely a buy." And the reason I got to that is because I could draw a historical earnings path for companies in the United States, in Canada. And I proxied what we're paying for them, and I said, "You know more or less, the returns are going to be in excess of 10% per annum over the next 10 years if you just think about equities as an asset class based on history." Things can always go awry, but the probabilities suggested that you should be able to achieve better than historical market-like returns somewhere over the next five years.

And what you don't know is if you're going to get it all in the first year, if it's all going to be back-end loaded towards the fourth or fifth years. You don't know that. But if you're patient enough, and you give yourself a five-year horizon, then good things will probably happen. Well, lo and behold, because central banks stimulated beyond any historical measure that we've ever seen before in the modern era, and fiscal policy came to the rescue as well, the market started taking on more risk far faster than I think almost anyone would have anticipated. So it kind of brought forward some of those future returns. So I think that's why you always look at things. When people are fearful, you should be a little bit more aggressive, and when people are greedy and aggressive, you should be a little bit more cautious. Again, it comes back to that discipline. They're very simple principles, but I can really tell you that for 22 almost 23 years of doing this, they make a lot of sense, and they keep you on your goals and keep you out of trouble.

[12:26]

Emily Anonuevo: What are your overall thoughts on Canadian housing and the state of the consumer?

[12:30]

Andrew Marchese: If you asked me pre-pandemic, the Canadian consumer, I think, was a little unhealthy if you look at the amount of debt that Canadians on average were carrying. That and Australia would probably be the two countries where consumer debt didn't look that great, whereas a country like the United States, which went through its leveraging cycle back during the global financial crisis, which was 2008, looked a lot better. Now through this pandemic savings have increased; people have attended to their own personal balance sheets. So things are looking actually a little bit better on the consumer side.

I would say, generally speaking, in the developed world, actually in most of the world, consumer actually looks really good. Consumer balance sheets look good; debt-service costs as we know are pretty low. So that sets up a good long-term backdrop for consumption, which is obviously good for the economy. With respect to housing, I think, housing in certain markets is a lot like a lot of other asset classes, where, as I mentioned, monetary policy has been extremely accommodative. Fiscal policy in most countries has been very, very accommodative, and what it's caused people to do is go further out on the risk curve, in some cases speculate, in some cases look to diversify Fiat currencies to other asset classes, whether it's equities, real estate, art. If you look at the auction market, prices are going way up.

And I think Canadian housing is kind of part and parcel of all these various asset classes going up in price, so there's been asset-price inflation and Canadian real estate would be part of that.

So I think with the amount of money sloshing around in the system, people are looking for further ways to diversify their assets and their portfolio, and I think because of that you've seen asset-price inflation in just about every asset class.

[14:40]

Emily Anonuevo: Based on what happened with OPEC yesterday, have your views on oil changed at all?

Andrew Marchese: I think if you look at oil over the longer term, you're seeing some discipline out of OPEC. It started last month. It seems like it had good follow on from yesterday. The one thing about oil longer term is there is enough supply beneath the ground still, and there's enough supply in the world, so production discipline is necessary to keep a balanced market. Over the last almost 10 years, it's been almost a free fall in terms of the price of oil and oil equities.

So I think as long as you maintain some discipline from the supply perspective and the productions perspective, then you can hold crude prices in and around current numbers plus or minus \$10. We at Fidelity don't get really fixated on what the future price of oil or any commodity will be. We think it's generally within a range, but I think as long as producers remain disciplined, you can balance off a little bit more than demand and supply, and that's generally good for prices.

There's also some talk that all commodities, oil included, if we as a net result of all the monetary and fiscal stimulus that has gone on, if inflation starts picking up in the months and years ahead will there be more financial investment into commodities again as a diversification for currencies and investment in hard assets, which are generally speaking historically net beneficiaries of inflation? So there will be part of that going on too in the argument as well.

[16:40]

Emily Anonuevo: So I want to go back to the Canadian Discipline Equity Fund and just get your thoughts on how are you positioning your fund this year to capture as much upside and as little of the downside in response to what's driving the markets today?

Andrew Marchese: One of the hallmarks of the Canadian Discipline Equity Fund is that we are sector neutral, which means if a given sector in the TSX, let's say financials, are 30% of the TSX, then we invest 30% plus or minus around 3% into the financial sector, and we do that for all the 11 big sectors of the marketplace.

What that prevents us from doing is making a lot of top-down calls on the market. I think a lot of times people confuse investing in a single-security basis and stock picking with sector tilting or sector rotation, which we think has a very low probability of sustainable success.

You can find some people who can do it well in a given year, maybe even two years in a row.

But over time sector rotation doesn't tend to work as a strategy, so the consistency in implementing that strategy, we think is very low. What we'd rather do is take what the market gives you in terms of its separate composition and then pick the best securities in each sector.

What we always try to do is we try to highlight what has the best kind of 3, 5, 7-year outlook for a security in a given sector, and we do that by conducting extensive diligence on the fundamentals of a given company and then trying to be as prudent as we can on price.

And what we do when we think of an investment thesis is work, we build an investment thesis about why we should buy a security today. And as that investment thesis hopefully comes to fruition, then we're disciplined around our price and wish to sell it, and we sell out of that security and look to reallocate the capital to another security within that sector. So it's proven to be a very good long-term strategy for us.

And again, it really allows us to put our money where our mouth is, so to speak. We put a lot of emphasis and allocate a lot of resources internally to doing very good bottom-up fundamental diligence on companies. So it is kind of like the poster child, if you will, of looking at securities on an idiosyncratic basis as opposed to managing a portfolio from a top-down perspective and saying, "Well, you want to be long the banks, or you want to be long oil and gas, or you want to be short technology, whatever it is." We get into really at the single-security basis. It helps us control risk in a very predictable fashion and then really allows us to generate excess returns from the true stock-selection process.

[19:31]

Emily Anonuevo: All the talk about inflation these days. What are your general thoughts on that and how do you think this will affect your funds?

Andrew Marchese: I think we're kind of at a crossroads for inflation. I think there is an unprecedented amount of money supply in the system. I don't think you can go back at any point in history and find a really good analogy. I think we've really flooded the system with money globally, and that has potentially effects on inflation. I say we're at a crossroads for that because we would expect that inflation should tick up cyclically as the economy is improving and reflate as the global economy tends to open post-pandemic. Again, because monetary policy has been very accommodative globally, we would expect that to materialize in higher prices going forward for goods and services, at least on a cyclical basis.

Why I say it's not a slam dunk that we're going into a secular kind of move in inflation is because you have a similar precedent set in the country of Japan, which had a ton of debt relative to GDP on their balance sheet, and it really never materialized in terms of inflation.

They've been in a disinflationary period dating back to 1990 despite money supply that's been even in greater abundance than what you would see in the United States.

So I think the next couple of years will be really telling to see if really all this money supply and the Federal reserve's ability to manage it manifests itself in a secular-move inflation or if it's just cyclical, and the big disinflationary forces that exist in the world which are namely: an aging demographic in most of the world, particularly the developed world, technology, which is very disinflationary and increases productivity, and then there's more people leaving the workforce than are entering it globally. So those three big demographic factors have huge disinflationary effects on the world. But on the other side, you have big potential inflationary effects because of the abundance of the money supply. So we'll see over the next couple of years how that really ferrets itself out, and we will act accordingly in our portfolio. But again, we do so on a bottom-up basis. We don't think about these macro-economic factors in a huge way when it comes to managing and constructing our portfolios.

[22:17]

Emily Anonuevo: You talked about inflation and other big themes at our vision 2021 event a few months back. For investors today, Andrew, if you could just talk about how the economic story is playing out so far this year, and where do investors go from here.

Andrew Marchese: You think back to March of last year. Because of the pandemic, the global economy just basically shuttered. The central banks responded in kind as they always do in a period like that where the economies contract. And now we're at the recovery phase of a new economic cycle, and historically, just based on historical precedence of over 100 years, economic cycles typically last from five to 10 years. There's a lot of things that will go on during that time that may lengthen it or shorten it, curtail it.

But we're in the recovery phase of an economy, and you see manufacturing in the United States is already back to 2018 levels. You're seeing an uptick in services. I would expect that to increase as economies continue to open. So it's been a very much a goods type of consumption during the pandemic, and I would expect that to transition to more of a service type of consumption as the world reopens here. And I think it's important to keep that in mind that we're, by all accounts, at the early stages of an economic recovery.

Now I think what is a little different this time around has been the speed and the magnitude by which the stock market has anticipated a lot of this recovery. And I could go through just dozens and dozens of worth of graphs to illustrate this. The speed and the magnitude of the recovery has been far faster than anything we've ever seen in history, so the market really got ahead of a recovery.

So now I think what's very important for investors to think about in their portfolios is really understand your risk profile, and that's based on you as an individual. What are your goals from an investment perspective going forward over the next 3, 5, 10 plus years? And when allocating capital to certain asset classes or individual securities, just really have an idea of how much future success those asset classes, or maybe individual securities are really pricing in, just because the speed and the magnitude of the move off the bottom has been very rapid.

The market, I think it's very important to always remember the market is a forward-looking discounting mechanism. It will generally react positively before the economy does. I think this time around, though, not only was it.... It wasn't really when it reacted, it was by how much it reacted and how much good news it started to price in relative to history. That's not to say it can't continue, but I think what is really important to note is just what exactly are you paying for. In some cases there's still a lot of upside in certain securities. And I think with other securities, you have to really understand how much future success are we paying for today? And maybe there's more risk than reward in certain securities, and I think that's the exercises that each of our portfolio managers are going through.

[25:56]

Emily Anonuevo: At a high level, how are decisions made to buy or sell a company?

Andrew Marchese: We spend a lot of time examining a company from a future revenue cash flow and profit-generation standpoint, so in the process of doing that you're going to try to understand the industry the company competes in, where it fares competitively amongst its peers and its competitors in that industry. So what we're trying to do is forecast out what we think is a reasonable revenue, future revenue-generation potential for that company, how that revenue will manifest itself in terms of profits and cash flow, and generally what the consensus is for that profit and cash flow generation, on behalf of what we call the street, so whether it's Wall Street or Bay street. And to the extent that we think a company may have a brighter outlook from a revenue profit and cash flow perspective, and you're not paying for it then what many other investors anticipate, then we'll probably invest there.

The opposite is also true. If we think that maybe the company doesn't have a strong competitive position in the industry, or the industry has some big secular headwinds in front of it, the company may have allocated capital poorly from an M&A standpoint or a CAPEX- spending standpoint that will have future impact on profits and cash flow, or we've paid for a lot of future success, and we think there's probably a little bit more risk, there's more downside risks than upside rewards, so that's really not a good place you want to be, then we'll sell the security accordingly or just avoid the security altogether.

So it's really about having an understanding of, trying to have a good lens into future revenue cash flow and profit generation and making sure we're not overpaying for that. When the investment thesis does come to fruition, and we think a lot of the future success has been priced in, then we'll probably sell the security.

[27:59]

Emily Anonuevo: Just the value of financial advice, especially during these times. Everyone's situation is different. Your financial advisor can obviously help you with your long-term goals and you've hit on many points in this discussion today, Andrew, in terms of looking over the long-term horizon, staying focused and disciplined throughout your financial goals. A great summary there. Before we end I always ask our portfolio managers at the end of the show, if they weren't a portfolio manager, what career do you think you'd be in right now Andrew?

[28:32]

Andrew Marchese: I would probably have gone down the road of medicine. I still like reading about it in leisure time, and I'm fascinated by it and whether it's chemistry or health sciences or any of that.

Ending: [28:49]

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