Vision 2021 - U.S. Equities in an Age of Disruption

Dave Bushnell, SVP, Advisor National Sales

Stephen DuFour, Portfolio Manager

Pat Bolland, Moderator

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

We welcome back Steve DuFour on today's podcast. Steve is a veteran portfolio manager who has been with Fidelity since 1992, and for Canadian investors manages Fidelity U.S. Focused Stock Fund.

Steve speaks with host Pat Bolland about how he invests in companies poised to take advantage of disruption and details his 5-step screening process to arrive at a concentrated portfolio that meets his specific criteria.

Steve comments on current valuations in today's market environment, and how that affects his screening process. He also looks at the healthcare sector, bitcoin and crypto, building ESG into his portfolio, and reflects on the ongoing growth - in his words - ongoing growth of the digitization of doing things on the internet that you used to do in person, which was accelerated in 2020 by the Coronavirus pandemic. Contactless payments for example.

Today's podcast was recorded on January 27, 2021.

The views and opinions expressed on this podcast are those of the participants and do not necessarily reflect those of Fidelity Investments Canada ULC or its affiliates. This podcast is for informational purposes only and should not be construed as investment, tax or legal advice. It is not an offer to sell or buy or an endorsement, recommendation or sponsorship of any entity or security cited. Read a fund's prospectus before investing. Funds are not guaranteed. Their values change frequently and past performance may not be repeated. Fees, expenses and commissions are all associated with fund investments.

[01:58]

Pat Bolland: Steve, great to see you. Happy 2021. You know, in preparation for this Steve, I got to tell you, I went through your bio, and I saw that you've been in the industry for three decades and what impressed me was you did multimedia, you did transportation, energy, convertibles, balanced income, value. A lot of different roles and you've come up with a process. Walk me through your five screens for investment process.

Stephen DuFour: Okay. Well, good to be with you today, Pat. As a preamble, it's a focused fund. I try to have roughly 40 names. My actual goal is 35 names, but I never really get to 35. So, as I look to try and find 40 great names, because I'm going to have 2%, 3%, 4% in each name. I'm trying to make sure as I start the process that I'm not getting myself into trouble. So I start off at the top. I'm looking for companies that have a product that have revenues. My first step is – these are very simple questions Pat. First question is, "Do you have revenues, and are you growing them?" The second question gets down to, "Do you have earnings?" I don't want to be too early. No revenues would be like drug discovery. No earnings would be it's still too early in the ramp-up stage. "How are you funding your business? Are you generating free cash flow or using your balance sheet?"

So that gets me into the third question. Then I get down to the nuts and bolts of valuation which is, "How fast are you growing your earnings relative to the market?" Because I want to have earnings growth. I'm a big believer in stocks follow earnings. And then lastly, "What am I paying for?" I typically try and screen out companies that trade the PE over 30, 35 PE. So that's the process. It's not a hard truth, but it gets me to make sure that I'm in the right place to go fishing.

[03:51]

Pat Bolland: Okay, and it kind of creates a funnel effect. Where do you start? Do you start with the S&P 500? Is it all larger-cap, or do you have the whole Russell 2000?

Stephen DuFour: Typically it's the S&P 500 as I do the initial thing, but yesterday I went through the Russell 1000 growth using the year-end numbers, and more and more I'm adding international companies to the mix also. I'm looking for a type of stock, and that type of stock is available in large, medium, small, growth, value and international.

[04:32]

Pat Bolland: Why would you want to focus that fund? Why would you want to get down to 30 or 35 or 40 or whatever the number is? Why wouldn't you go beyond that?

Stephen DuFour: Well I actually love this fund, and I'm a large investor in the U.S. version of this fund. So I try and stay fully invested, and you have to earn your way onto the team. As you went through my bio, I've run many different funds over the 29 years I've been at Fidelity, and sometimes you end up with name creep, or you let in a name that's thinking like this, but you've got to earn your way onto my team. And so it makes me high grade the portfolio, and before I want to sell a name to add a new name, I got to go through and make sure it's a better name, and it doesn't dilute the upside potential of the fund.

So I love the way it is, and I think there's a lot of overpriced stocks in the world, and I think there's a lot of stocks that are not adapting to the digital world, and technology is passing them by, and I don't think you need to own them. So I think if you keep it concentrated, I'm selling my own story, but as you keep it concentrated that's what I like.

[05:50]

Pat Bolland: Okay. That's your job to sell your own story, and you live it on a day to day basis, but I want to go back to the screening a little bit because one of the things you talked about was price earnings and that ratio. What do you make of the market right now? What is the valuation? Is it getting harder to find companies that fit your team?

Stephen DuFour: It's actually not getting harder. There's a lot of press out there about the really, really high-priced stocks, but they're not what I'm looking at. The market was very narrow for the last two or three years. As it looks like the economy is going to snap back after the vaccine rollout, there's a number of areas that are going to have very strong earnings growth next year, whether it's auto parts, casinos, things that typically you wouldn't think of, I've been investing in the past. They're going to be very attractive going forward. So this is a very, very good time to be investing in the market.

[07:00]

Pat Bolland: One thing that I didn't hear in the process was any consideration of macro, or did I miss that?

Stephen DuFour: I think you did miss the actual word "macro," but I think that earnings are a function of macro. So I think you can only earn earnings to a certain extent based on the macro environment that you're in. So as I calculate the earnings, whether it's the earnings of a railroad, if the GDP of the economy is negative, it's hard for a railroad to have positive volume, and positive pricing and then positive earnings growth. But if the GDP is actually recovering next year, you can all of a sudden have 5%, 6%, 7% volume growth, 2% or 3% pricing, and all of a sudden you get 11%, and then you do a little margin, and all of a sudden you end up with 18% earnings growth. I'm giving you the earnings, but you can't get to the earnings without knowing what the macro backdrop is.

[07:54]

Pat Bolland: Okay. And then when I looked at your actual portfolio, I noticed that you had kind of themes in terms of what you invest in. In the internet for instance, and you and I have talked a few years ago, even back then you were talking about the internet when nobody else was considering it. It obviously is still part of your plan.

Stephen DuFour: Very much so. Microsoft reported last night at 4 o'clock, and I listened to the call at 5:30. And if you ever want to read one transcript, read the transcript of Microsoft, and you'll see they're digitizing and growing in the gaming business, in the computer storage business, in the PC business, and they've got a competing product with Zoom called Teams. This work from home is actually enhancing a lot of the businesses that are attached and growing through the internet. Adobe, which makes a lot of the software that allows you to create content, track content, and it's fascinating times the stuff that they're adding to their product suite.

[09:02]

Pat Bolland: But Microsoft and Adobe, they've been around forever and a day. Are you playing these new names that are around in the internet?

Stephen DuFour: A number of them. It depends how you define the internet. Internet Plus also, it's more like the digitization of things because basically a lot of things that you used to have to do in person, you now can do online, and so the growing area is payments and contactless payments. And so that area has some exciting areas where we own Square and PayPal. Started out as just basically another payment system but has merged into becoming a digital account, and they're taking business away from the brokerage firms, they're taking away business from traditional banks, and they're adding new products like trading with Bitcoin, they're adding on credit cards, they're adding on stock brokerage accounts. I think the day is going to be, soon they're going to be adding gambling. So, there's a fascinating area of new products coming along.

[10:21]

Pat Bolland: Do you have any thoughts on Bitcoin and cryptocurrencies? And I'll put a twist into it because, to a degree, Bitcoin and cryptocurrencies could threaten your electronic payments, but tell me what you think of Bitcoin first.

Stephen DuFour: Very much so. So both Square, which has a product called Square Cash, added Bitcoin trading and storage to their product, and it went very well, and then PayPal was a fast follower and did the exact same thing. I've read a number of books. One of them I think was called Digital Gold, to learn more about the technology behind Bitcoin. It's going to take a while. Right now people are using it as a trading vehicle, people are using it as a store of value potentially to offset gold. The problem is a lot of the people that invest in Bitcoin believe it's going to go higher, so they don't actually want to use their Bitcoin to do transactions because they don't want to give you Bitcoin today that they think is going to be worth 1.35 times higher a year from now. The only way this really takes off is if you can start doing transactions in Bitcoin, but right now I view it as a trading vehicle. I'm watching it, but it is something to watch.

[11:51]

Pat Bolland: Here's a question from the audience as well. What are your thoughts on the healthcare sector? And if I read my numbers correctly, healthcare is your second-largest sector in the fund, I believe right now, so give me an overview.

Stephen DuFour: Healthcare sector is fascinating. There is parts of the healthcare sector we typically avoid, so we don't own a lot of biological companies, where you have a binary decision on whether the drug is going to work or not work. We don't own a lot of the large pharmaceutical companies that kind of don't grow fast enough for us. But the one area we are invested in, and it's fascinating, is in the drug discovery, the drug manufacturing and testing. So as drug discovery equipment gets better, and we first started with the genome DNA, then we went to RNA and now we're going down to the proteins, as they actually get better at getting further down onto where the disease, virus or whatever else we're trying to solve for, the disease and virus that they are looking at is a smaller subset of a larger disease.

And so you need to then have smaller batch processing when you do the manufacturing, and also testing has gotten very exciting. I think all you need to know is in March we find out about the virus here in the United States, and in December they are giving out a vaccine, and that is because of the technology used in the discovery process, the technology used in the manufacturing process, and the future is going to be the technology in the testing process. And I'm not really talking about COVID testing, I'm more talking about heading toward liquid biopsy testing, DNA testing. As they get the prices down, you're going to go in and no longer have someone take fuzzy pictures of you, and someone look at the fuzzy picture and says, "Ah, I think you're doing better." You're basically going to have a DNA test, an RNA test, a protein test, and you're going to be able to look at it as the cost comes down, and they're going to be able to say, "All clear," or, "Do some more treatment." That's the area. So we're headed towards personalized medicine, and I'm trying to learn as much as I can in that area.

[14:12]

Pat Bolland: Yeah. It's interesting you bring that up because when I think about Pfizer, BioNTec, Moderna and Johnson & Johnson, the guys that have developed the vaccines that have come out, I wondered how sustainable that is on a longer and ongoing basis. You're suggesting that there's a shift that's going on in healthcare?

Stephen DuFour: There's a total shift, so pre, and since how long I've been running money. When I started running money 29 years ago, we hadn't done the sequenced genome, and now as that has happened over the last 10 to 15 years, they really are able to figure out. So in the old days you go back 20 years, they develop a drug, they do the drug against a disease, whether it's a cancer or whatever, and they come back and say, "Ah, it only works in 14% of the people." And they'd say, "Not that drug," and they'd move on. Now they can go back, and they can look and see what 14% it did work on. What did they have in common? And then they can target the drug as they screen people. They can target for the 14% it does work for, and all of a sudden it works for 100% of the target market, but that's a whole different way of doing things.

So instead of talking about drugs that are going to do millions and hundreds of millions of millions of doses, you're going to get smaller doses. So we own a company that actually does the production in a plastic bag, versus the old days you would spend three, four, five years building a factory and have huge steel vats to make huge different drugs. Now we're actually making small-batch drugs in very, very high-tech plastic bags which, and the key word, are disposable and are thrown away, and it's a very high-margin product.

[16:04]

Pat Bolland: You should also get in the plastic recycling business too with all those bags. Steve, back in 2018 Barron's named you one of the top sustainable fund investors around, and I'm talking about ESG. How do you build that into your portfolio?

Stephen DuFour: And last weekend Barron's just put out their top sustainable funds in the United States, and I was 36. I spend a lot of time looking at the data, and so your first question to me Pat, which was the most important question, is how do you screen for stocks into a concentrated fund? And so ESG data has two different ways of helping this fund. One is it helps me screen out bad actors, so companies that are on the wrong side of the environmental equation, which typically I'll screen them out anyway because, whether you're in the coal business or something like that, typically your revenues aren't really growing anyway, so that's easier. But on the governance side, it allows me to see where some of the bad actors are on the governance side, either on boards – actually one of the companies I did not know that I owned in healthcare is on product recalls and outstanding lawsuits. So that's very helpful to double screen on that.

But the most important way to find names is in the S. If you focus on the social part of it, and look at the companies and how they treat their employees, companies in consumer-facing businesses that are good to their employees do better than other companies. The best at it is Costco, and so you treat your employees well and they will treat your customers well, and you'll end up with all the magic that we're looking for which is revenue, margins, earnings, and prices going up.

[17:57]

Pat Bolland: Okay. I'll play devil's advocate because when you think of Google for instance they've had controversy in terms of the way they handle their employees. Yet on the other hand, it fits perfectly into one of your sectors. I have no idea whether you have Google or not, and I don't care. How would you balance the two of them overall from an ESG framework?

Stephen DuFour: That's a great question. As I tell people, and this fund is not called the U.S.-Focused ESG Fund, I basically tell people that I'm ESG aware. And so I'm more interested in… I like to understand what people have flagged. So a lot of times for Google, they also don't like the companies that have two types of stocks. So, one type of stock for the founders that have super voting shares. So there's a lot of corporate governance things like that, and everyone puts a different weight on that as they give them a score. It gets down into the nitty-gritty how we get there Pat.

If you have a bad ESG score, I don't say, "I'm not going to invest in you." You've got to also remember you've got Sustainalytics, MSCI, S&P, and we actually have an internal ESG score. So, there are four different scores to look at, and so a lot of times you have four different answers. But I'm more interested in, "What is the problem they're looking at, and are they improving it? Is there diversity on the board of directors, and how is it going? Did they have 5% diversity and now they're at 10% headed to 20%?" Sometimes these things you can't fix overnight. So it's more the trend and what is the problem, and are they working towards fixing the problem?

[19:44]

Pat Bolland: Yeah, common sense, it sounds like, approach. Here's a question from the audience. Have you rotated into any cyclical names?

Stephen DuFour: Yes.

Pat Bolland: Okay. Give me sector. Don't give me a name, give me a sector.

Stephen DuFour: I'll give you a couple of sectors. Casinos. They basically had to shut all the casinos in Vegas and around the country during COVID. As we come up to the second quarter and third quarter, the comps are very easy, and so as they reopen that's going to be very positive. In addition, the ones I own have a strong position on online gambling. And one thing, as you talked about, what's happened with contactless payments, ecommerce, everything during work from home, another thing that happened during this downturn is people couldn't go to casinos and the like, and they started to do more gambling online. That area in the States need money, so New York said they're going to open up, Michigan is going to open up. More states are opening up to online gambling, and so I have companies that are going to benefit from the opening of their casinos and the growth of online gambling.

I also own an auto parts supplier that is not tied to internal combustions in engines, but more focused, which will benefit from not only the reopening of the auto plants but also the growth of electronic vehicles. I'm trying to think of another area. Also I would say small-business software, so companies that do the accounting, that do the payroll, that do the payment systems for small businesses, and a lot of those small businesses had to close or temporarily shut. And as they reopen, that software business has a high incremental margin.

[21:50]

Pat Bolland: Here's another question from the audience. You mentioned that you're style agnostic overall. Can you expand more about the balance across factors and sectors?

Stephen DuFour: Okay. I think I'm better off on – a little bit, on sectors right now, technology, consumer discretionary which is also reopening because we own a couple of companies tied to reopening of some of the retail, two of the larger segment industries that I own right now. Some of the segment industries we do not own, so I have a hard time right now finding anything in energy, I have a hard time finding anything in real estate, a little bit underweight on UTEs. So that's, I look at it as, "Are these secular growers, or are they cyclical growers?" And so that's one way I look at the fund and the names that I'm buying.

[22:50]

Pat Bolland: Here's a question, and you've never answered this one for me, what are your thoughts on 5G technology?

Stephen DuFour: I love it. Just like everything else, it got talked about two years before it should have been talked about, and now it's slowly rolling out. The devices are too expensive, the coverage is poor, but they will fix both of that. Some of the device prices will come down, and the coverage will get a lot better, and the uses of 5G are going to be hard to imagine today, but whether we have cable TV in our houses or is it all going to be wireless TV in our houses? Autonomous driving or assisted driving. You're going to need two signals to the car, not just one signal to the car. Drones. You can go down a lot of different cutting-edge technologies that 5G is going to help, and particularly with the automobile and mobile activities. The access to information and data is going to be very, very good.

[24:05]

Pat Bolland: All right Steve, always a pleasure to talk to you. Have a great year.

Stephen DuFour: All right. Thank you Pat.

Pat Bolland: Steve DuFour.

Ending: [24:14]

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 more information on future live webcasts - and don't forget to follow Fidelity Canada on Twitter. Thanks again, see you next time.

[end of segment]