Vision 2021 – Embracing Change and Innovation in 2021

Dave Bushnell, SVP, Advisor National Sales

Mark Schmehl, 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.

Today we welcome back portfolio manager Mark Schmehl. For Canadian investors – Mark manages Fidelity Special Situations Fund, Canadian Growth Company, Global Innovators, and the newly launched Fidelity Multi-Asset Innovation Fund – which uses a flexible equity strategy aiming to capitalize on innovative ideas globally, combined with a multi-sector fixed-income strategy focused on risk mitigation. More information on Multi-Asset Innovation Fund can be found on fidelity.ca.

In today's discussion, Mark explains to host Pat Bolland his process of positive change investing, in what he calls the tails of the market, investing in places where things are changing rapidly.

Mark reflects on the volatility and opportunities from 2020, looks at what 2021's landscape might be, speaks about how he filters the positive innovation from the noise and offers some thoughts on the future of cryptocurrency.

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[01:58]

Pat Bolland: Walk me through your process which you call positive change investing.

Mark Schmehl: I invest in what I call the tails of the market. I like to invest in parts of the market where things are changing, so changing rapidly usually for the better. I try not to own things that are changing rapidly in a bad way because those tend to be bad stocks. Over time I found that the more things that you can find that are getting better at any given company or industry, the better that stock will do over time. It tends to lead me to what I call those tails, as I mentioned. It's the parts of the market that most investors fear to tread. Maybe they're too expensive, or maybe they seem really dangerous because there's a lot of stuff that no one can understand, and that's what I really like to invest in. I like to invest in that stuff that it's not very clear what is really happening, and those could be really great stories that are executing really well. On the other side it could be situations that are not doing very well, and if you think about industries that aren't doing very well right now, you might think of travel and leisure.

So those are tails, those are the tails I like to invest in, and I've kind of done the same thing for the last 15 years. There's always new tails, that's the nice thing. As the market changes new things move into those tails of the market, and so I'm always refreshing the portfolio, buying new things, selling old things because I like to be where things are changing the most.

[03:29]

Pat Bolland: You know, it's interesting Mark, when I think about your process and investing in the tails, I get that the right-hand side, the right tail is growth and those kinds of things. I would also probably put momentum in there, is that a fair assessment? And then the left-side would be more value-oriented, but what are your thoughts along those lines?

Mark Schmehl: I really struggle with the labels that we give to these things like momentum or growth or value. I feel like that leads people astray. I know we have to describe these buckets, but as investors we're all really doing the same thing. We're trying to buy something that isn't as good today as it's going to be tomorrow. So do I own a lot of stocks that are categorized as momentum? Yes. Because they weren't as good yesterday as they are today, and hopefully they'll be even better in the future, and as a result the stock will go up and it will be termed a momentum stock. But it's really the same sort of stock as a value investor. This is why I sort of do both things. I tend to own value stocks, and I own growth stocks, and I own momentum, and I own GARP because I don't really care about the category. All I care about is the incremental change that you can find. Often you'll end up in sectors of the market that don't fit a category, but things are changing so rapidly that there's opportunity there.

To give you a current example of a sector that I think is undergoing that sort of shift right now is if you look at utilities. Utilities are bonds in equity land. If you think about what we see as a green revolution utilities could be transforming from a very, very boring sector to maybe an exciting sector. It's changing. I never thought that utilities would ever change. They're regulated, they're boring. Things change, things change all the time. So value, growth, momentum, I don't really care about those labels, I just want to own something that's getting better, and that could be any type of stock in any sort of industry.

[05:30]

Pat Bolland: You do have to concede though that there is an increasing volatility in the marketplace, and we might expect more in 2021. Do you invest on the basis of themes or sectors in that kind of an environment? Or stock by stock?

Mark Schmehl: I do. I do both of those things. I think that those long-term fanatic trades where you can look at the sector and go, for the next 10 years this sector is going to continue to grow because of the following seven different reasons. Those are great sectors to be in, and you don't need to be as focused on did I buy it at the right price or did I get it at the right time? You can be more focused directionally on how is this improving, how quickly is this improving and what's the magnitude of the total size of the business in the future? So those are thematic trades. People always say, well, what's the theme of the day? Some of those thematic trades last for years, right? If you think about the digitization and cloud computing, it's been going on for what, eight years now? It's a theme, but it just revolutionized the way we do work.

Again, themes are a label, we have to have labels. I think that the secular trades are very powerful, and traditionally I do own a lot of secular trades because things are changing rapidly, and there's a lot of opportunity. There's not a lot of defined, discreet knowledge in these spaces. To give you an example, if you think about the hydrogen economy right now, nobody really knows what it looks like, right? If you fast forward 15 years, I defy anyone to tell you what this is going to look like. So for a traditional investor, trained in a traditional way where you look at earnings and cash flow and profit and loss and try and figure out your upside, downside, it's really hard to bucket what the heck that's going to look like on an investment basis. But if you're more of an investor like me, or I would say maybe like Kyle earlier, where you're looking at that broad trend and the broad fundamentals, and you're just saying, "wow, there's a lot of stuff we have to do here," you just own the space, you don't worry about that stuff. So that's kind of a long answer to your question, but that's how I think about these things.

[07:43]

Pat Bolland: It's not, it's an appropriate answer though because it sounds like you're not always looking for the same old thing. Do you consider yourself a disruptive or an innovation investor?

Mark Schmehl: I certainly think that's true. I like the term innovation more than disruption. Disruption to me is a discreet thing, right? Disruption happens over an 18-month, 2-year window and then it's over, and it has a negative connotation to it in my mind. But innovation is one of those things that can drive a business forward for years. So if you think about a company like Shopify, Shopify started off as we're going to make this really great website so that anybody can sell stuff online. Very simple. That's what they did first. And then they implemented a widget that goes onto it, let's call it payments. Then they implemented another widget, and they just keep iterating, and they keep innovating which continues to make the business more and more powerful, the product more and more powerful and the business bigger and bigger because they continue to iterate and innovate.

If you think of a company like Square, it's another one like that. They started off with the little dongle that they put on the little phone, and then they moved into payments, and then they moved into Cash App, and then they moved into all these things because they kept innovating on a product. Those are such powerful stories, and you can't see all that when you start, right? You initially go, hey, this is kind of a neat idea, they're doing a website for stores. You don't anticipate that they're going to have 54 different products, huge TAM that they can go after because they simply innovated so quickly. So yes, I am an innovative investor, that's absolutely what I am, but innovative investing is also a part of the secular trade, and there's a lot that goes into understanding how that innovation is going to transform a stock over time.

[09:26]

Pat Bolland: During the dot-com bubble though there was a lot of innovation that was happening at that time, but through that all there was a lot of noise. How do you pick the individual stocks that will pay off, if you will?

Mark Schmehl: That's a great example of innovation run amuck. I was investing through that, and it's hard to compare, so what was happening then is the internet was so new nobody understood what it was, and so we had all these ideas ahead that we were going to do all this stuff with the internet. Actually, most of those ideas turned out to be true. Pets.com failed but selling pet food on the internet is a huge business now. It's just that the way we went about it was too new, and nobody actually understood how it would work. It took Amazon 15 years to really make selling stuff online the behemoth that it is right now. Innovation can happen all at once, and the market prices it all in, and then the market goes, wait a minute, none of these companies actually work and we're not ready for prime time.

That's a different sort of analysis, and it's one I think you can wrap your arms around versus a company that if you look at the modern bubble stocks as they call them, the software names and whatnot, they're very different than the dot-com names of 1999. They come with cash flow and earnings and a business, and they're actually getting money for the product that they serve versus back in the day in the dot-com bubble nobody was making any money, they were just taking shareholder money and blowing it on stuff. So I think you can really see the difference, and that's where you need a fundamental approach to understand what does this company do, how does it do it, and then are the economics behind this, do they make sense, right? The economics of this crazy idea makes sense in the future, now, what's the interim period? I think that in the 1999 dot-com bubble nobody could figure out what the economics were for a lot of these dot-coms. And it was just a very, very, very different scenario.

So I don't see that today. I see that in certain sectors. If you think about electric vehicles, now there's, I don't know, 15, I'm gonna make this great electric, pick your truck, car or vehicle, whatever it is. Are they all going to work? No, absolutely not. So maybe there's some speculative activity going on there, and that's where the stock picking comes in. That's where you have to trust your manager to say, "I'm not just going to buy everything, I'm going to try and find the ones within this secular trade where there's the most upside or the most durable business or the best ideas." That's ultimately what we're always trying to do. So as long as you trust the manager to screen through the bubbly stuff, you can still make money and even in speculative sectors.

[12:14]

Pat Bolland: At what point do you sell? What is your sell discipline?

[12:18]

Mark Schmehl: Selling is important. It's a way to reduce risk in the portfolio. The big point's to sell when management did something you didn't expect and you're not really happy with, you invested on a thesis that turns out not to be true, or maybe you just found a really great idea that's better and maybe it's in a similar business but honestly, selling those ones where you've invested in a certain argument and it didn't work, that's crucial.

The other thing you need to do too is you need to weed your portfolio. Traditionally, especially at Fidelity, we see so many companies, we get excited about all these different things, and you end up with a portfolio, like 500 different things, and you've got all these tiny little bets. You have to go through and weed them out so that you really stay focused on your best ideas. That's another thing, I call it portfolio name creep, but it's more like weed creep because you have all these stocks that you're just not really that interested in but you can't bring yourself to sell.

The other thing you have to watch too is you can't hope a stock is going to get better. If you're sitting on a stock, and you're hoping things are going to change and get better, it's never going to work. Hope is a killer in this business. You have to go into it saying there's no hope. If it didn't work, don't hope it's going to change. It's likely going to continue to not work, and you need to move on. That's really hard to do, it's really hard to bring yourself to let go of your children in your portfolio, and it's a skill that you learn over time.

[13:44]

Pat Bolland: You bring up an interesting situation though, and name creep is the one I'm referring to. When you talk about name creep, do you buy by buying just a little bit of everything and then see if it works and then accumulate and conversely, do you sell the same way? Say, okay, I've got to get rid of a little bit of this because it doesn't seem to be working right now, and I might sell more later on.

Mark Schmehl: That is absolutely true. I'd say there's no one way to run a portfolio, but incrementally buying and selling is definitely a method. I would say that if you're learning a space, or let's say you have a big secular trade on, and you believe that this is going to be a powerful move, you might buy a whole bunch of stocks in that group because you don't know which one is really going to work, but the whole group is going to move. In that case, yeah, you buy a lot. You do a whole bunch of work, and you figure out which ones are the ones you really want to own and trim out the ones you don't. The same is true on the other side. When you have stocks that are working, let's say you have a stock that's up 30% on a given day, it's a pretty good day to sell a little bit of that stock. When you run a lot of money, you have to continually buy and sell on a daily basis just to manage the liquidity needs of the portfolio.

[14:53]

Pat Bolland: Is it harder to run a large … success breeds success. You've got a lot more assets to manage these days. It is harder to manage the larger amount or easier?

Mark Schmehl: Will Danoff always says that the degree of difficulty goes up a lot as the assets go up, and he's completely correct. I would also say what happens though is the longer you do this job the better you get at it. I'm a much better portfolio manager now than I was 10 years ago. So I continue to learn, and those skills continue to accrete to my portfolios. So as my assets go up, my skill level also goes up. It's not an even race. So the answer is yes, it does get more difficult, but what I would say is that so far stylistically I haven't had any trouble moving around in the portfolio despite the increased amount of assets. The market is relatively liquid in the stuff I want to be in, so I haven't noticed any real issues yet. But it is more difficult, no question. I'm glad I'm not starting out with $20 billion as a new fund manager. That would be really tough.

[16:02]

Pat Bolland: Is there anything that keeps you up at night?

Mark Schmehl: You almost have to take away the fear because then you can't invest. I would say that the key is to not worry about stuff, which is sort of strange, but the more you worry about the things that could go wrong in your portfolio the less ability to take action that you have. You need to keep your degrees of freedom wide open in order to say, "I'm going to invest in this, and I know it could be a little bit uncomfortable, but uncomfortable is where the money is in a portfolio." I worry about everything, but I try not to let it get to me. You really have to step back and say, invest through the storm is the way I think about it.

You have to just look through it and say, "what do I want to own?" It's the same stuff I wanted to own yesterday, now it's 10% cheaper or it's 15% more expensive. So you invest through the storm. That's sort of what we did in March. At the time you're like, okay, I'm losing money all over the place, but what do I want to do? Don't freeze, don't paralyze yourself with fear, you have to invest through the storm and just keep buying and selling and doing the things that you need to do to make the portfolio work. In many ways it's trying to stop the worry. I don't want to worry, I want to worry less. My family will tell you that's not what happens, they say I'm always engaged and always thinking about work and it's a bit crazy, but that's the key is to not let the worry eat you alive.

[17:29]

Pat Bolland: Here's a question, what's your long-term view on energy, clean energy in particular, specifically solar and hydrogen? You mentioned hydrogen earlier on but maybe in more detail.

Mark Schmehl: I think that the green economy and hydrogen, solar, wind, etc., is the trade of the next decade. I think that we're in the first inning of this. I can remember doing investing in this space 18 years ago, and it was way too soon. Now, a lot of the engineering problems have been sort of solved. You can get to cost parody with fossil fuels especially if you put on the correct cost of what carbon is doing to the planet. I think there's broad political support worldwide for this. There's consumer support. The ESG movement, which is relatively recent, is pushing companies down this path. You've got all the things arrayed to go after this carbon neutrality target. I think that it's just a huge, huge market that is going to be with us for the next 10 years.

How does it shape? I don't know. What do we end up with? Windmills everywhere, solar, I'm not sure. But the world is going to move this way, and it's going to move this way faster than people expect, which is what always happens. I think it's really exciting, really exciting to live in a world where we have just a lot less air pollution, you'd have so many other benefits from the fact that you can see through the atmosphere. I don't know, it just seems like a really great thing. It's a sector I'm happy to invest in, and I think I'm going to continue to invest in. I'm doing a ton of work in this space, all across the spectrum. It's not something anyone can know, it's too complex a problem to say, this is the winner, right?

When Tesla came out it took 10 years before anyone actually believed that this was a real product, and this was a real market. The same thing is going to happen with all these hydrogen, solar, wind plays, but it's a problem that needs to be solved. It is a problem that can be solved, and the amount of money that is going to come into the space is enormous.

The other thing that's very interesting about this trade is it reminds me about building the internet. Building the internet was a fundamental thing that was really important to the world. This is the same thing. When you built the internet, you had all these telecom companies that were building it. Boring, boring telecom companies spent oodles of money to build the internet. Now you've got all these electric utilities. Boring, boring electric utilities, they're all regulated, that are paid to spend money. They're going to build this new economy, this electrified economy. They have the capacity to spend so much money because of the way their business works that it could make the internet bubble look like chicken feed. So for me, this is a really big market that could be really big for a long period of time. Are the stocks a little ahead of themselves? Probably. But if you're investing for 10 to 12 years, this is a really good space to be looking at.

[20:19]

Pat Bolland: Another question, what do you think of the future of cryptocurrency, and what it looks like?

Mark Schmehl: Crypto's hard. I spend a lot of time trying to learn crypto. It's hard to learn, it's hard to understand what the companies do, it's hard to see the value. It's one of those things where it's a technology in search of a problem to solve. Bitcoin makes sense, it's a store of value, it's like a replacement to gold, but the other stuff, what do you do with it? So it's a very, very difficult space that I have spent a lot of time thinking about. The easiest way to think about it is a lot of tremendously smart people are spending a lot of time and money to try and figure out what to do with crypto. Usually that's a good sign, but it's hard to invest, especially as a public investor. An equity investor has almost no way to invest in crypto. You can go at Bitcoin, a lot of brokerages now sell it, but you're really just speculating on the store of value of trade which, for me, is too hard. It's like buying gold. I would prefer to analyze a business and understand the fundamental value of that business over time as it grows. Bitcoin, I can't get there. So very neat space, very hard to invest in.

[21:27]

Pat Bolland: 2020 was a huge success, and that's putting it modestly. What worked for the portfolio, and how are you currently positioned? From the audience.

Mark Schmehl: My portfolio, I like to think, is always new. I'm always trying to put new things into the portfolios. I owned a lot of stocks that benefitted from the pandemic. It's not like I invested assuming there was a pandemic. I would also say I shifted gears pretty well in March. I didn't own Peloton going into that. It seemed pretty obvious that Peloton was going to do well in a pandemic. So I felt like some of the obvious moves that you could've made worked out really well, which is unusual, normally that doesn't happen. So being able to pivot and change your portfolio when the world changes is super important, and I feel like that's a skill that I've developed pretty well over the years.

Going forward I don't think I have the virus portfolio anymore. I think if we stay in lockdown for the next two years, I don't own the right things. I don't believe that's going to be the case so that's why I'm not invested that way. This year's going to be more challenging on a lot of fronts. Market's up a lot, it's discounted a lot of good news. I think that there's a lot of really great stories out there. I don't believe we're at the end of a bull market because there is still lots of opportunity.

[22:46]

Pat Bolland: Okay, where do you think you fit in investor's portfolio? What's the percentage or psychology or whatever it is? Walk me through where you think you are in the spectrum?

Mark Schmehl: The way I would position it in peoples' accounts is the same way I think about a stock. If I own a stock, and I am thinking about it 24-7, I am [audio cuts out] too much. I think that that's how you have to think about my portfolio. This is how I like people to do — own as much as you're comfortable not thinking about my portfolio. So just own the level that you don't think about it very often. I think that over time, as the fund does well over time, you'll get more comfort. For me, it's just like buying a stock. It's a steady, slow, get comfort with me, get comfortable with the strategy and just don't own too much that you can't sleep at night.

[23:40]

Pat Bolland: So you're asking people to self-assess on risk and to trust you.

Mark Schmehl: Yes.

Pat Bolland: Okay. I think that that's kind of a fair thing to do. Mark, always a pleasure. Appreciate your time today.

Mark Schmehl: Thanks, Pat.

Ending: [23:58]

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