Vision 2021 – Asset Allocation: Global Perspectives

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Dave Bushnell: Welcome back. Asset allocation has always been a very important part of any portfolio. At Fidelity we are very lucky to have Geoff Stein, David Wolf and David Tulk heading our asset allocation efforts. This team runs 29 different mandates totalling more than $71 billion, with funds including the very successful Fidelity Managed Portfolios and Private Investment Pools. I know that when many of you here today meet with your Fidelity sales team, the main question you ask is "what's the asset allocation team thinking right now and where are they finding opportunities?" Here, to answer those two questions and more is David, David and Geoff. Pat, over to you.

[00:52]

Pat Bolland: I'll try, David, I'll try. Thanks very much. Okay, gentleman, great to see you guys again. Happy 2021, sort of. It started off a little bit bumpy. I'm going to start with the brass tacks. He mentioned $71 billion. David Tulk, walk us through what it is you actually manage at Fidelity Canada.

David Tulk: Thank you, Pat and thank you to all the advisors from coast to coast joining us today. You're right, we are managing all of the multi-asset class funds for Canadian retail investors. That does include 29 funds that you see on the slide in front of you. These include a couple of ETFs as well as the very popular managed portfolio series on the left-hand side. As you look across the slide, you'll see lots of different funds, and I think really here the objective is to have a fund for every type of investor, depending on their risk tolerance, depending on their investment horizon. As we bring all of these funds together, there's really three elements that Geoff will speak to in more detail, but really what we do as asset allocators is first to design a very strategic benchmark to keep you fully invested, to keep you properly diversified across geographies and across asset classes. We then follow through with manager selection. You've heard from a number of the managers we use in these funds today. The third element is to provide the tactical overlay which is our process, driving out of benchmark allocations as well as the under and overweights we take to the benchmark asset classes. That's really the essence of what we're talking about today, is all of the themes that come from our view of the world.

[02:36]

Pat Bolland: He indicated, Geoff you're going to have to explain these things. These Fidelity managed products obviously have been extremely successful. What has driven that success in more detail?

Geoff Stein: As David said, there are three key elements to all the products that we manage. Strategic benchmark development, active manager selection and harnessing the alpha of our world-class security selection experts, and our ongoing tactical management through the cycle. What we show on the chart here is the seven-plus years since our team has managed the Global Balanced Fidelity Managed Portfolio. You can see during that period of time our strategy has outperformed a straightforward 60/40 stock bond mix in Canada by 30 percentage points. That 30 percentage points, as you can see on the right side, was derived from all three key elements of our process. The strategic benchmark and the enhanced diversification provided about a third of the outperformance versus Canada alone. The security selection and the managers that we selected provided another half of that outperformance, and our ongoing tactical management was about 600 basis points. So all three components working together in sync to deliver tremendous value added for our advisors and our unit holders.

[04:10]

Pat Bolland: David Wolf, I want you to give me the positioning, how your views and your outlook are currently being reflected in the fund.

David Wolf: Good morning to everybody joining us. We're going to put up here the slide of our active positioning in the Global Balanced Fidelity Managed Portfolio. This is our active asset allocation or the tactical overlay that David Tulk was talking about before, and let me make four points in terms of our positioning and the thinking going in to it. The first point is we're overweight equities. You can see they're about 7% or so overweight, which is a moderate overweight for us. The main driver there is the macro signals that we use are pretty much green across the board. So the economy is doing better, it's going to take some time obviously to get back to full health, and we'll see what happens in terms of vaccine development and resistance to new strains, etc., but there is some visibility of a normalization, so to speak, in the economy, which means growth. Policy, which ordinarily would be working a little bit against the economy, if it got too strong pulling back a little bit, policy is full-bore, stimulative, both monetary and fiscal policy, and is intending to stay that way for an indefinite period of time as we crawl out of this economic hole.

So the economy and policy are both working together to lift risk assets. We've seen that generally over the past several months, and we think that it's going to continue. We're not max overweight in equities 'cause we do recognize that sentiment can be a little bit extreme and valuations are full, but we think this is a good environment in terms of being risk on.

The second thing I'll mention with respect to this slide is where we're taking that equity risk. It's increasingly an overseas market, so that's Europe, Japan, emerging markets. These are areas that are under-owned. They're relatively cheap and the earnings growth outlook is rather better, and so when we put that all together, we think that they're areas that can not only outperform but also give us a margin of safety, as it were, with respect to, if we do get a correction, the cheapness should help us put a floor under things.

Third, moving over to the bonds side, if we're overweight equities, we're obviously going to be underweight bonds, but we're significantly underweight in the usual government securities, investment grade, short term, etc., because we don't think those offer really any value, any yield and all that much protection either in this kind of environment against a drawdown in equities, so we're diversifying in a couple of ways. One, into credit areas where you have more of an income cushion. That's things like high yield, convertibles, emerging market, local currency debt, and the other thing we're doing a lot of is diversifying into real assets. In this fund that would be TIPS, but we're also talking about real return bonds, gold, etc., which we think we can provide additional diversification and defence in the bond part of our portfolio.

Finally, our underweight to the Canadian dollar. As many of you know we've been underweight Canada for quite some time. That's partly a view, but I think in this environment, what's really important about that position, is its risk mitigation which is to say that it's harder to protect portfolios when normal bonds aren't going to do the trick, and one of the ways to do that is with currency. You take a currency like the Canadian dollar which is risk-on, cyclical, which is associated with higher equity markets, and if you're underweight that and overweight defensive currencies, you can manage the risk in your portfolios much better. Today's a great example of that. Obviously markets are down, but the Canadian dollar is also down about a half a per cent, and so our underweight in the Canadian dollar helps to mitigate the volatility that we'd otherwise see.

[08:01]

Pat Bolland: I want to go back a little bit. A philosophical question, and Geoff I'll put this one to you because you oversee a lot of what's happening in Canada as well as the United States 'cause we're looking at an ultra-low interest rate environment. Is there still a place in the world for a 60/40 portfolio?

Geoff Stein: That is a very important question for all investors as we go forward now. By 60/40 what we're really talking about there is the favourable mix of stocks and bonds together in a portfolio, and we manage a number of portfolios with different weights, but the constant is that we do have stock and bond diversification there and of course for decades, what we've seen in the declining interest rate environment that we've all lived through is that we've had tremendous diversification value from putting those two asset classes together. Invariably whenever the stock market has stumbled, bonds have come to the rescue. We've had negative correlation in those stress environments, and that's really helped generate a fantastic Sharpe Ratio, fantastic long-term capital accumulation for investors.

The problem is, as you point out Pat, that now that rates are so low the question is can we still get that favourable combination, and can we still rely upon that negative correlation and bonds to bail out periods of stock market volatility? We think the answer is probably increasingly no. It doesn't make sense to rely on that as much. One issue is rates do seem like they only have one direction to go and that's up, and we've seen a little bit of increase in rates here even as we remain in the pandemic. Maybe more importantly what would drive interest rates higher? One of the key things as a potential driver that we think is potentially inflation coming back, and if that does happen, and you think back to periods historically like the 1970s when was really the last time we saw a big upsurge in inflation, that was not a good period at all for financial assets. 60/40 did not work during that decade, a long time ago obviously. But if we got in that environment again, it could be problematic.

What have we done to arm our portfolios to guard against that? It goes back to what David Wolf was just talking about in terms of the allocation of our portfolio. Thinking more about global assets, getting out of the Canadian dollar, the U.S. dollar, into more diversified currencies. Thinking about real assets, commodities, gold, inflation-protected bonds, all of that additional strategic and tactical diversification we think is important for investors to start thinking about now to get beyond that simple reliance on the stock/bond, 60/40 paradigm that has worked so well, but may not work so well going forward.

[10:56]

Pat Bolland: Okay. But you said the word inflation and David Wolf, I know you've got strong opinions on inflation, especially against the background of global debt, just keeps climbing around the world.

David Wolf: I think the explosion of debt is one of the fundamental reasons to expect inflation down the road. How you get there is to say "number one, debt really is exploding". We used to think a government deficit of 2% of GDP, 3% of GDP was big. We're now at 20% of GDP in Canada and most other advanced nations, and basically nobody is batting an eye. Even as economies heal from the pandemic, it's still likely that we're on a higher and steeper trajectory for government and overall debt. Frankly what's going to stop it? There's no cost to issuing the debt because interest rates are basically zero. The public isn't demanding it. There's certainly the incentives for governments to keep up the spending and stopgap a lot of areas that are still going to be hurting even after the economy heals. The question is, with debt exploding is there a constraint on it? And the constraint, whether you look at it from a classical macroeconomic framework or the increasingly popular MMT, Modern Monetary Theory approach, which I've been a student of for 20 years and now seems to be the dominant paradigm, is inflation is the constraint. That you can keep printing money, you can keep putting it out to people until inflation binds. And then once it binds, governments will say "well, you know, that's actually not the worst thing in the world" 'cause you have this massive pile of debt, there's only three ways to get out from under a massive pile of debt. You can grow your way out, you can default your way out or you can inflate your way out, and frankly the third is probably the path of least resistance. I think this explosion of debt we're seeing inevitably is going to lead to inflation.

I don't know if that's next month, next year, 10 years down the line, but to Geoff's point, it is a danger to both financial asset prices generally and the structure of 60/40 type funds, so it's something that we're diversifying gradually but significantly out of those nominal bonds into other areas, and maybe a very simple way to put it, to come full circle, is 60/40 can still work but you have to be really careful about the 40 'cause the old 40, the passive 40 that's worked in this very stable inflation environment is not likely to work going forward.

[13:21]

Pat Bolland: But if it's default, or grow or inflate that answers the debt problem, then how is the stock market forecasting that it's going to be growth because that's what the stock market's telling you, we're going to see tremendous growth.

David Wolf: I don't know if the stock market is really saying we're going to see tremendous growth. I think the stock market is saying we're going to see some growth, and the valuation we're putting on that growth is very high. The reason the valuation is high is the discount rate is low. Why is the discount rate low? Because interest rates are extremely low, and central banks have flooded the economy with money, and in a lot of cases its money that folks haven't been able to spend because we're all locked up in our homes. A lot of it has been finding its way into the market. So I wouldn't look at the [audio cuts out] in stocks and saying stocks are really discounting a much stronger growth outlook. I would look at it and say "liquidity has been so ample there's nowhere really else for it to go other than to bid up financial asset prices", which is why we see valuations at the level that they're at.

[14:23]

Pat Bolland: David Tulk, I want to get to you because I saw David Wolf's chart on positioning, and I thought it fascinating that Canada was underweight both on the equity and debt side, and yet you like commodities. Explain to me the Canada thesis.

David Tulk: The Canada thesis should be very familiar to most of the folks listening to us today. For those that have heard us talk before, you know we have expressed a great deal of concern around the Canadian outlook because Canada as an economy is incredibly vulnerable. A lot of that vulnerability comes from the accumulation of private sector debt, so most notably on household balance sheets, which has increased in an inexorable fashion in recent decades. We also have some additional challenges with respect to our commodity infrastructure, and we saw an example of that with the inauguration of the Biden administration cancelling the Keystone Pipeline. Those are our starting points with Canada, and that has been a strong motivator of the underweight we've had, but we're also trying to think a little bit about what a post-pandemic world looks like and what that type of world looks like for the Canadian economy. Unfortunately here that level of concern has only amplified because now we're taking a very significant level of public sector debt that David Wolf was discussing and adding that on top of the private sector debt. When we think about Canada, unfortunately we don't have the luxury of being a global safe haven where investors in Canadian government debt might be forgiving of unsustainable deficits. We have to go back to the early 1990s when this last created an issue where Canada was described as having the northern peso, and we had to endure a pretty long period of sub-par economic growth to wrestle that down.

That's certainly one of the issues that I think Canada will need to address. We can also think of a post-pandemic world as generally being less globalized, and this isn't exclusively as a result of the pandemic. It's something that we have seen from a couple of other factors as well, but taken together this is also a challenge for a small open market economy like Canada. As a result those challenges I think do resolve themselves in a weaker performance for Canadian assets over the longer term. Likely, as well, perhaps a depreciation in the currency, which is the macro side of the two-barrelled approach we take to the currency. That's really a view that I think does remain in place. As you saw from the positioning slide, it's definitely one of the high conviction views.

Having said all of that, it is a very fair question to say, if we do believe in the reflationary story, "should that not help an economy like Canada?" That is certainly true, but this is an important part of our process is that we're not just making an absolute call on Canada, we look at allocations very much from a relative perspective. Thinking about Canada we want to look at maybe other economies that share similar characteristics to Canada. They would also benefit from that reflationary backdrop but don't have some of the idiosyncratic challenges that we see really hurting Canada. The natural pair trade from our perspective continues to be underweight Canada, the fund overweights in, for instance, emerging markets and a little bit in global commodities as well. We can think of that commodity reflationary story but not maybe tied into some of the challenges that Canada as a country, or the commodity industry in Canada faces.

[18:24]

Pat Bolland: Gentlemen, as you know, one of the hallmarks of these Fidelity events is the access that is provided to the advisors, and we've got lots of questions lining up for you. Here's one - are there any particular macro factors that you're keeping an eye on more recently? Geoff, I'll put that one to you.

Geoff Stein: We've touched on a number of the issues. David just talked about Canada's vulnerability, we've talked about inflation. The critical macro factor really of the whole post-global financial crisis period has been policy support for the markets. We've seen that again in the last year or so of the pandemic. The ability of central bankers and the willingness of central bankers to continue to deliver unlimited policy support, and then now hopefully more and more in sync with fiscal support which has really picked up around the world, including in the U.S. recently with the election results. Those two double-barrelled elements of support for the economy in sync will continue to be very, very important. We're obviously watchful for signs that that's going to be changing. We don't see any real signs of that. We do think that that policy support will continue to come through, but if and when that changes, perhaps as a result of inflationary pickup or what have you, then that would be a sign that things could pretty dramatically change in the markets and we'd have to adjust accordingly.

The last thing I'd mention would be just the pandemic generally. Right now I think the consensus is vaccines coming, and the vaccines will be effective, and by later this year we'll see some significant reopening and normalization, in the direction of normalization in economies across the world. If that picture is to change, and we're not saying that it is, but if that was to happen all bets would be off.

[20:30]

Pat Bolland: I'll add into that, not just the COVID and the pandemic, but also how about the geopolitics? You've got a new president in the United States. Do you have concerns on things like trade or even the size of the stimulus package and the amount of debt that's being accumulated in the United States? David Wolf.

David Wolf: Geopolitics are always a consideration for us. As you mentioned, Pat, we have had a pretty big change in the U.S. administration. Obviously that's going to change attitudes of basically every country towards the U.S. and colour trade. The two points that I would make though are number one, we are far more interested in policy than we are in politics. There's obviously a lot of ink spilled and a lot of shots like this one where people talk about there's going to be a lot of new stuff with respect to the Biden administration, etc., etc. The fact remains that monetary policy had foot all the way to the floor in terms of the pedal before with Trump and is still there with Biden. Under Trump we had a lot of fiscal stimulus, under Biden we're having a lot of fiscal stimulus. You can argue about the size or the shape but those policy settings are really not that different.

When it comes to external interactions, the relationship between the U.S. and other countries will heal somewhat I would expect. But the trade issues that were brought to the fore over the last several years, particularly with respect to China, the Democrats certainly have the interest in still maintaining some degree of caution with respect to liberalization with China, and a lot of those tariffs that have come up are probably going to stay up. One of the big knock-on effects of that, thinking less about politics and more about policy and how it impacts economies and then financial markets. If you have barriers to trade, it means that you have less globalization, it means you have what we could call a negative supply shock, which means everything gets harder, less efficient and more expensive. It very much feeds back into that inflation narrative that we talked about, which is to say if you have more and more money out there and the productivity, the ability to supply and the economy is not what it used to be, you're going to have inflation. Again, don't know if that's next month, next year, five years from now but it's cheap to protect against and that's what we're doing in the funds.

[22:56]

Pat Bolland: The audience still wants to know some questions. What are your thoughts on emerging markets right now? I don't know who wants to tackle that, maybe David Tulk?

David Tulk: Sure, I'd be happy to. It really does dovetail with my comments on Canada as well, where as we look at emerging market economies they share some similar pro-cyclical qualities to Canada. You could think of those as having a higher beta to global growth. If the global recovery is proceeding then you can imagine an emerging market index outperforming against that backdrop. That provides us with some cyclical confidence in that position and we think a little bit longer over the horizon as well. When you think of some of the structurally stronger rates of growth maybe with instances of more favourable demographics, more favourable productivity growth in some of those regions as well, that is a definite motivation for a strategic or a structural longer-term allocation. Thinking quickly in terms of some of the valuation metrics, as we mentioned the market across the board has certainly reached a more fulsome valuation, but on a relative basis you can make an argument that emerging markets have trailed somewhat on that. From a relative valuation perspective an allocation into emerging markets does have some appeal. Some of the calm, maybe on the geopolitical front, could at least bring some of the diplomacy away from a Twitter account and back into back rooms and different types of conversation. That could maybe cool a bit of the rhetoric there which might provide a little more confidence in approaching emerging markets.

Another related issue is around the U.S. dollar. We'll certainly have a chance to talk about this in greater detail, but our view is that the U.S. dollar will continue to depreciate, and that will also motivate more of those financial flows into emerging markets. There are a lot of things pointing in the right direction for an allocation both over a strategic horizon as well as cyclically.

The last thing I'll quickly comment is that when we approach a region like emerging markets, we're not simply taking a passive exposure. We're working very carefully with our underlying managers, who can stick handle around the problematic parts of emerging markets and find very good securities to add into the portfolio. When Geoff showed the breakdown of our return and pointed to the security selection piece, our EM portfolio managers have had a phenomenal run of it lately, really finding some good stories to bring that to the portfolio and to support the wider return. So just a quick comment as to how we approach EM from an asset-allocation perspective.

[25:47]

Pat Bolland: I still like the Twitter to back room kind of story, David. Great line. Given the market environment that we're in now, are there any particular factors or styles that you're looking at a little bit more towards?

David Tulk: I can start with that one and then turn it over to the team. This is one of those age-old growth versus value type of conversations, and I think there's a value to the way we approach this, where we want to be able to employ managers of both styles so that you don't end up with a very significant style overhang to any one style versus another. For instance, in the managed portfolios we'll combine managers so that we'll have Mark Schmehl's Canadian Growth Company paired with Dan Dupont's Canadian Large Cap, take Will Danoff's Insights and bring it together with Joel Tillinghast's Intrinsic Value. The end investor won't get necessarily whipsawed by some of the market fluctuations between different styles. So that's really the starting point that we try to emphasize.

As we think a little bit about the evolution of that style dynamic, we have seen those big alligator jaws open quite widely, so growth has dominated in recent years and value has really struggled. We're seeing maybe perhaps a little bit of that reverse as some of the market optimism around a strong cyclical recovery takes hold. But perhaps it's just my own personal view, but I do think that those alligator jaws will remain wide because a couple of the prerequisites for value to sustainably outperform is very strong economic growth and a more normalized interest rate environment. We've heard from central banks that they're going to keep interest rates very low and that's a very durable policy statement on their part. As much as we're seeing the early V-shaped recovery from the dark days of the pandemic, there are still some structural challenges that the global economy will face, but I think does provide a little bit of a headwind to global growth over a longer-term perspective. That's just one asset allocator's view, but I'm certainly happy to invite my colleagues in as well.

[28:05]

Pat Bolland: Go ahead, gentleman. Which one wants to go?

Geoff Stein: We've had a prevailing growth market for as long as almost any of us can remember. You have to really go back to the pre-GFC days to have had broader market, value stocks, value sectors, smaller-cap names performing well. As David said, those valuation discrepancies have gotten pretty extreme. On the margin, that's the area that we want to allocate additional capital to. Having said that, I want to just reiterate the point that we do think diversification, picking the best of all the different styles that we have in our opportunity set and keeping them together as sort of the core structure of the portfolio makes a lot of sense. In my experience over 30 years in the markets it's very, very hard to time the style cycles. A lot of that comes down to sector rotation, and that's something that we don't think of as our strongest suit. We feel much more comfortable being able to make money consistently for clients at the broader asset class level.

[29:17]

Pat Bolland: David Wolf, I know this question is right up your alley. There seems to be certain parts of the market that are more speculative now. What's the broad market sentiment looking like right now?

David Wolf: It is certainly, and I won't name names, but there certainly have been some in the news where things have gotten a little overextended shall we say? A lot of folks who are perhaps sitting at home with not much else to do are buying very leveraged positions in certain names, again short sellers, and we're seeing the froth there. I don't think that really applies to the market as a whole. We look at a whole suite of indicators to try to gauge where sentiment is, and the summary of those indicators that I would give right now is they are somewhat risk-on, there is a little bit more greed than fear, but it's not outrageous. It's certainly not at the extremes that we've seen, again notwithstanding some of these individual stories.

Sentiment is a big part of how we think about things. As I mentioned earlier on, one of the reasons we're not more overweight equities is because sentiment has gotten a little bit more greedy than fearful, but we're not particularly concerned that we're in some massive bubble where everybody and their brother wants to get into the equity market and sentiment is so extreme that we're really due for a correction. We don't think it's that environment. We think that underlyingly the fundamentals for the market are fairly strong, and there will be certain points at which the market gets ahead of the fundamentals, and maybe that was true last week and so we have a bit of a correction, for example, today. We could get further correction going out, but are we likely to see something like we saw in March? I don't think so because policy isn't going to allow it. Again, policy is full guns blazing green and unless and until we get inflation that is really unlikely to change.

[31:11]

Pat Bolland: We've less than a minute left. Geoff, I'd love to hear your highest conviction idea for 2021.

Geoff Stein: I think the highest conviction idea, from a tactical asset-allocation perspective, would be owning emerging markets relative particularly to Canada, as David Tulk has so eloquently talked about, and also relative to the rest of the world. We think that's really where the best opportunity is, best growth, etc. Another-high conviction idea for advisors and all clients would be stay diversified all the time. That's the best strategy to deal with any market environment that we may encounter.

Pat Bolland: Good message, Geoff. Thanks very much Geoff, David, David. All the best in 2021.

[end of segment]