Fidelity Connects

Sam Polyak, Portfolio Manager

Pamela Ritchie, Host

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Voiceover: Hello and welcome to Fidelity Connects, by Fidelity Investments Canada, connection you to the world on investing and helping you stay ahead. Portfolio Manager Sam Polyak shares his outlook on opportunities in emerging markets and what to expect in 2021. Sam manages the Fidelity's Emerging Markets Fund and he said this year was a great landscape for EM.

However, it caused a huge fire sale on pro-cyclical companies. This could cause a vicious cycle as denominated debt is no less expensive to pay back. For example Africa and South Africa have a lot of US dollar debt.

Sam comments on the year that was. Many investors are worried as the pandemic grows all over the world, but he stresses that we must get through it and focus on the light at the end of the tunnel. As a vaccine comes into play, he points out that Emerging Markets will be a little behind. As a vaccine comes into play, he points out that emerging markets will be a little behind. It probably won't be until the summer until the vaccine reaches EM countries.

Interestingly, he says India will come out of this pandemic with a lot of growth. It is still early stages, but Sam is confident that in the next year India will be a great place for growth

Commentary surrounding COVID-19 and financial markets is frequently changing.

Today's podcast was recorded on December 17th, 2020.

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[02:09]

Pamela Ritchie: Sam, I'll begin a little bit with — I think we saw a performance slide, we might put it back up in a second — your performance has been rather incredible. What phase of reallocation to EM are we in here? There's an awakening going on it seems like.

Sam Polyak: It's a great point. I think we're still in early phases, because we basically have had 10 years of underperformance for the asset class that's been brought on by some difficulties, country by country. Also we've had a period of very strong dollar, which we can talk about more later. Both those things have really weighed on the asset class. Now, coming out of this crisis, as you know, emerging markets places in Asia, places like China have been the first to come out of the COVID crisis in a much stronger position. So that's really helped the asset class a fair amount. Plus this year, performance wise, we got a fat pitch. You don't get a fat pitch every day, but we really got one during the crisis where a lot of folks were concerned about the pandemic and the effect it was going to have on global growth. And it has had an effect on global growth, but the point being is it was temporary. We had a huge fire sale at the start of the year which I was able to take advantage of on pro-cyclical companies that were just really beaten up during the downturn. So that's a big reason for the outperformance.

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Pamela Ritchie: The global asset allocation experts at Fidelity, they've allocated — I'm just looking through these numbers — about 10% to EM in the Fidelity Global Balanced portfolio which is a strategic mix of 60% equities, and then in the more aggressive Fidelity Global Growth portfolio which is 85% equity, they've allocated about 12%. You can see these allocations moving up, taking up more significant areas. Let's talk about the role of the U.S. dollar. It really, to an extent, the answer to the EM why now is the U.S. dollar, is it not?

Sam Polyak: Yeah, absolutely. It can become a vicious cycle into a virtuous circle, because the vicious cycle was the past 10 years where you had a period of stronger dollar. What does a stronger dollar mean? It means weaker currencies in emerging markets, and weaker currencies in emerging markets have a big side effect because these countries have to defend their purchasing power so they have to hike interest rates to protect their currencies. When they hike interest rates that really hurts growth and hurts consumption. Those effects have really been in place for a decade. You have a lot of pent-up demand now in a lot of these countries — not just Asia, but all emerging markets, that could really come through if we go through this period of a weakening dollar, which I believe we're at the early phases of.

[04:58]

Pamela Ritchie: Their dollar-denominated debt is cheaper to repay. They've got some room. I mean, that's a big piece of the picture.

Sam Polyak: That's definitely a big part of it. Not all countries have a lot of dollar-denominated debt. The dollar-denominated debts are mostly in Latin America and Africa. Most of the other countries have their own local currency debts, so it's less of a factor. But the strong dollar in terms of having to protect their currencies definitely is a factor and I think that's a big driving factor that should allow this vicious cycle that I mentioned to become this virtuous circle.

[05:36]

Pamela Ritchie: How much of where you're looking is in Asia? Give us the geographical general one, two, threes.

Sam Polyak: When I came into emerging markets, it was roughly 50/50 between Asia and the rest of emerging markets, which is Latin America and emerging Europe, Middle East and Africa. Today it's about 80/20 and a lot of it has had to do with really good innovative companies that have come up in Asia. In places like China, Taiwan, Korea, you have companies like Samsung, world leaders in memory and smart phones, Taiwan Semiconductor, world leader in fabs for manufacturing semiconductors. Intel had to give up because Taiwan Semiconductor was so strong. You have companies like Tencent, Alibaba, Meituan in China, Mercado Libre in Latin America, Yandex in Russia, just really good companies that are just really well managed and have done really well. It's been a big reason why emerging markets have this new leg of growth with these innovative companies as the country, especially places like China, that have really invested in research and development and internet and embracing new technologies to really help them grow.

[06:56]

Pamela Ritchie: It's been fascinating to watch. So much of the news flow around China equities opening up, their capital markets generally opening up, there are a lot of new opportunities within that. I'm just going to ask one of the obvious questions, sort of the headlines of Ant Financial or the IPO market, do you see froth in there? Is it overdone? Give us some context for how you're looking at the markets there.

Sam Polyak: There's definitely some froth. You have some companies where earnings aren't going to come through for 5 to 10 years that are trading at 10, 20, 30 times sales, so that froth is definitely there. You have SPACs, I think more than half of IPOs that have come have been SPACs which are these special vehicles that don't really have a business, they just have an individual that promises to buy an asset. Those are all signs of frothiness but I don't think we're anywhere near where we were in '99, the ultimate frothiness, whereby you have real businesses that are making real earnings. We can debate on what multiple you pay for them, but I think you have some really good companies that are doing a really great job. So within emerging markets, comparable companies in the developed market are much more expensive than they are in EM. So that's another big reason why I see the opportunity.

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Pamela Ritchie: Sam, how do you do your research? You're in the U.S., how do you make sure you have a real depth of knowledge around these companies?

Sam Polyak: Before the pandemic I would do a lot of travelling and I have over 20 years of experience that has helped me because I've been *[audio cuts out]* there places and met a lot of the senior folks of companies. But being at Fidelity we have a huge *[audio cuts out]* global company. We have offices in Hong Kong and in London, and we have people on the ground there that speak different languages and that are really good at being on top of things. We talk to them regularly. With the pandemic I was really worried whether we'd be able to stay on top of these businesses, but it's actually worked out great. In the past we'd wait for companies to come visit us, and being Fidelity a lot of them would just come by our offices either in Hong Kong, London of Boston and we'd be able to meet them that way.

But now through Zoom, mostly, WebEx a little bit, we can actually go through and have a lot of calls and meetings at all hours. My day begins very early. I usually start between 5:00 and 6:00 a.m. and get a lot of work done while some of the markets are still open, and then my day kind of slows down during mid-day and then after I have dinner with my family I have a lot of calls. Most nights I have a call at 8:00 or 9:00 with an Asian company. It's morning their time. It's worked out really well because before a lot of senior folks saw it as kind of a waste of time to come visit us and have a meeting. Now they see it as an opportunity. It's just a few minutes, turning on the Zoom call. They get on for either a full hour, or half hour or something like that and we get really good insight, and that's why it's been terrific. Our whole team has really benefitted from that.

[10:09]

Pamela Ritchie: I'll have to ask you how you mastered the art of catnaps at some point, because it sounds like you'd have to employ such a strategy throughout your day. Let's talk a little bit about where we are right now. We are seeing… stock markets are surging, they're hitting all-time highs, there's a big vaccine trade that's been going on for over a month. What do you see in the short term and what do you see in the mid-term?

Sam Polyak: I really look at this as the analogy with what happened during World War II. The news on the vaccine, in my opinion, is the equivalent of what happened with D-Day where the allies have landed, you know it's only a limited time where the Nazis and their allies stay in control, but you still are kind of stuck with them until the allies liberate you. So this is the situation that we're in today, where a lot of folks are still worried because we have the pandemic ravaging the world, and a lot of times in terms of new infections and deaths are hitting all-time highs. We have to just get through this because we see the light at the end of the tunnel. That light is going to be huge because there's a lot of pent-up demand out there in the developed world and the emerging world. Folks that want to go on a trip, folks that want to go out to eat, folks that want to spend money. Not everyone has it, but a lot of folks have been able to save a lot of money and pay down a lot of their debt during this crisis when they haven't been spending as much. So you're going to have this boom, in my opinion, that's going to come through second half of next year and into '22 that's going to carry emerging markets to new highs and most global markets. And that's why the stock market is doing what it is is because I think a lot of folks are anticipating this boom that's coming.

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Pamela Ritchie: What is the vaccine rollout plan broadly across the countries that we don't hear about as much? We seem to know bit by bit what's going on in the UK, but are emerging markets set to do this rollout?

Sam Polyak: Emerging markets are a little bit behind. They have some of their own vaccines. China has their own vaccine which is being rolled out. In theory, Russia has their own vaccine, although today President Putin came out and said that he's not taking the vaccine himself. It kind of sets a bad example for Russia. But I think all of these vaccines have reached agreements. Whether it's Pfizer or Moderna, they've reached agreements as well, whereby those vaccines might not be the first to see them, but they will see them going into the summer. Where most Americans, unless you're a risk group, probably won't see a vaccine – I assume it's the same in Canada – won't see the vaccine until probably May, maybe starting in April, and so we'll get kind of full vaccination by late summer. M my guess is emerging markets will probably be two months after that, and so you're going to see some of those emerging markets coming through by the third quarter of next year. But then the growth will be… the U.S. will get that little first growth coming through, but then afterwards you're going to get emerging markets coming through with that next leg of growth.

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Pamela Ritchie: So interesting, the timing and where you get ready to catch some of this upswing. Some of the upswing is going to be people doing things like they've been… there's pent-up demand, they put off buying cars, motorbikes. You hear a lot about EVs, how does the EV auto trend work, and is it one of the ones you're playing? I believe we talked about that last time.

Sam Polyak: I do have a few stocks that benefit from the EV trend. There are other trends that I think are as prominent, if not more prominent, than EV. The tricky part with EV is that it's tough to build the infrastructure. In the U.S. it's a little bit easier. Everyone parks their car in their garage, a lot of people do, and so you can basically build a charger for it overnight. But imagine if you live in China and most people don't have a parking spot 'cause they live in high rises in the big cities. You don't really have a place to charge. The government is trying to do this rollout. I think the EV story will happen, but because of infrastructure andbecause it takes time to charge the cars it just might take a little bit longer than folks would expect.

Some of the themes that I like that I think are much more, kind of, faster, one is 5G. I think there's going to be a lot of benefits from 5G. A lot of folks are going to be upgrading because basically you're not going to need to have a Wi-Fi network in your home because your phone or iPad or computers onto the network, it'll have just as good a speed as your Wi-Fi connections. It will also mean huge implications for things like Internet of things; so your freezer talks to your washing machine talks to your phone. Everything becomes much more connected. Cars really enable ADAS, and so you'll have cars being able to drive themselves much more quickly because the cars will communicate to each other to avoid crashes. You need 5G for that to really happen, so I think 5G is a big theme.

Automation is another big theme. Post-crisis, people feel much better about working next to a robot rather than working next to another person. So I think that coupled with higher wages will mean a lot more companies – it has meant – a lot more companies have spent a lot more on robots and I think that theme will continue.

E-commerce, infrastructure, consumption because of this pent-up demand that I told you before about, I think those are the themes that are going to be driving EM probably for the next five years.

[15:57]

Pamela Ritchie: I'll just ask you on banking. There's a lot of questions rolling in so we're going to get to all those. On banking broadly, it's been a rough go with interest rates where they are but there are other subtleties that are, obviously, affecting banks across EM. How do you look at the financial sector?

Sam Polyak: It's a good question. I think the financial sector has been in the dumps for a long time. Most banks in EM traded at one to two times book value previously based on expectations for return on equity and profitability. They've all de-rated. You have Korean and Chinese banks that are trading at half a book value or a quarter of book value, and I think some of it had to do with tough margin compression But I think if rates come up, that margin compression becomes margin accretion and then all of a sudden ROEs start to come back and the banks maybe start to rerate closer to book value. I've actually been a buyer of banks on the margin. It's not one of the big themes but I've been underweight banks and now I've closed that underweight a fair amount.

[17:01]

Pamela Ritchie: A number of questions coming in here. One, you touched on, certainly, it has to do with valuations – valuations in developed markets versus valuations in emerging markets. A couple of thoughts on there. You've touched on it but this investor would like to know the comparison.

Sam Polyak: It's a great question. Two things on valuation. One is you can't just look at valuation in a vacuum, you've got to look at valuation relative to growth. The U.S. trades at a premium – I think it's 18 times or something like that, maybe 19 times. Emerging markets are closer to 12, but the growth in the U.S. had been better especially with a weaker dollar, meaning stronger emerging market currencies. You have the prospects for better growth in emerging markets and it's kind of like the operating leverage where the companies — and we are seeing this in the U.S. —have done a great job cutting costs because a lot of folks will worry, a lot of company executives that I talk to are really worried that we're going to have a 2008 type of crisis coming out of this, and so they cut costs aggressively. Because of that, the market totally underestimated how much they were able to cut costs. When revenues did not collapse, but the costs came down, so they had huge margin expansion. I tracked how many of my companies that I own actually beat earnings versus expectations in the last two quarters, and historically it's been around 55 to 60% of the companies I own would be beating earnings. The last two quarters it's been closer to 80% just because they've been so aggressive on costs. I think costs will start to come back, because they deferred a lot of costs and they furloughed people, deferred capex, things like that. That all will come back next year but it won't be to the level a lot of folks expect, and that's why I think that growth, both in terms of profitability and revenue should continue in emerging markets.

[18:58]

Pamela Ritchie: I want to talk about India and your thoughts on the economy which is being absolutely ravaged by the COVID-19 pandemic. Just sort of fit in some of the banking discussions in there that you've already mentioned. There have been huge financial regulations that have been blanketing the country over the course of the last half decade. How do you look at India generally, but also specifically on the financial side?

Sam Polyak: I think you hit the nail on the head, Pamela. Financials have been the reason why India struggled so much. You had a lot of these non-bank financial institutions that had over expanded in India coming out of the last crisis. They were basically replacing the banks, but they were lending to companies that weren't in the strongest position, mostly real estate companies. They got into a difficulty and so these non-bank financial institutions got into a tough time, and the government's been forced to kind of wind them down, sell off some of the assets. A lot of that played out. That's been going on in the last three, four years.

India has also been hurt because the government, President Modi, has been very aggressive in terms of reforms. He's rolled out reforms in terms of taxes, the GST, demonetization, getting rid currencies that were, a lot of them were for black market transactions. It had huge negative effects on growth because it's really decreased the size of the grey economy because both taxes, forcing more companies to pay taxes, financial inclusions, things like that, and demonetization has hurt the black market companies that were just kind of not paying taxes. Unfortunately they employ a lot of people, so you've had employment under pressure. Now, that's all played out because that's been over the last five years. Now coming out of this pandemic shutdown you can actually have decent growth coming through on India and a lot of the banking crisis that they had been seeing have played out. Now you're actually going to… it's early stages, it might not come through in the next quarter or two, but I'm confident in the next year or two India will be a place that's real interesting for growth.

In terms of background, I was overexposed to India for about 15 years and about two years ago, or a year and a half ago, I actually went negative India and underweight India relative to my benchmark for the concerns you laid out correctly, Pamela. Just over the last month or two I'm warming up to India much more and have been increasing my exposure there.

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Pamela Ritchie: Is that one of the benefits? It strikes me as one of the benefits of running the EM fund. You can sort of move from an area into another area. Otherwise the question sometimes is why not just buy Asia, take a look at… but I guess this allows you to catch things on the upswing and move things around if you can see it. Is that right?

Sam Polyak: You bring up a great point. Earlier this year, when the crisis first hit, I was overexposed to China. I had bought more China at the start of the year because, if you recall, the pandemic started in China, so the Chinese market sold off aggressively and I had bought into that. When the crisis hit, a lot of the stocks, my overexposure to China really helped. But then when a lot of other stuff got cheaper, I actually sold down China. Because China's handled the pandemic so well I'm underexposed to China today, relative to the past where at the start of this year I was way overexposed to China. Even though China's a great market, has great companies, but on the margin I see more upside in places like Latin America today that were really ravaged by this crisis and have a lot more operating leverage at the company level coming out of it.

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Pamela Ritchie: Layer on top the sensitivities around global trade, sensitivities that might provide opportunity 'cause they're sort of at the forefront, countries that are ready to take a bit of an upswing. There are blockages to trade. We've seen a new partnership across Asia, the Regional Comprehensive Economic Partnership encompassing all Asian countries. But then you also have sort of TPP in the background, so I'm just curious how all the trade machinations you watch for your own purposes.

Sam Polyak: The TPP, when people look back at what happened the last 10 years, the scuttling of TPP will be looked at as kind of a watershed moment. This wasn't something that was set up by the previous regime in the U.S. that was going to basically link the U.S. to a lot of Asia and be able to kind of be a great counterbalance for growth, be able to build this lower trade barriers and really help growth. Scuttling of that really hurt and now Asian countries did their own RCP, as you rightly pointed out Pamela, that is an offset to TPP. So the U.S. has been left out of that and I think it will be very difficult for the Biden regime to try to rekindle the TPP because in the old days, if you back up 20 years, most Asian trades — I was just looking at Korea earlier this morning. Korea, back in 2000, more than half their trade was, I think, 60% of their trade was with the U.S and the rest of Asia was 20-30%. Now it's reversed. Asia is 60-70% and the U.S. is 20, so they don't need us as much as they once did. The TPP was a great opportunity to move that forward, to have the U.S. engaged with Asia, but I think it will be difficult to rebuild that now, but I'm hopeful that the Biden regime will try and I think they will.

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Pamela Ritchie: Sort of put parts of it back together. So questions coming in about specific countries. For instance, do you cover Vietnam? Is that an area of interest for you?

Sam Polyak: Vietnam is a real interesting market that's very fast growing, but it falls into the frontier category. There really aren't that many investible companies. While it's a great market that's doing extremely well in terms of taking some outsourcing share from China, it's really hard to find liquidity to be able to invest there. So I leave that to folks that invest in frontier.

[25:37]

Pamela Ritchie: Some questions coming in on, again, going back to how do you trust the numbers coming out of certain countries? I wonder if you can provide an example. I think you and I talked about a coffee example, but how do you use the research to avoid huge downfall potential?

Sam Polyak: One of the big advantages that we have at Fidelity… I've worked at a few shops outside and I've never seen anything like this. We deploy capital to things that help our investors that's really hard to quantify. One of those things is we have a team in Bangalore in India and in Hong Kong that just focuses on corporate governance. By corporate governance I don't just mean going through the finances of companies, which they do, and going through the financial statements and make sure everything adds up and the company is doing the right thing. It also means doing background checks on the individuals behind these companies and whether they've been difficult to work with before, whether they cheated minorities before, that sort of stuff. And they give ratings for us which are extremely helpful.

[26:42]

Pamela Ritchie: I know no one likes to talk about currencies, but let's talk about currencies. The Canadian currency is what it is. We've often compared it to the U.S. It's actually doing well because we have a declining U.S. dollar and to an extent I think people understand that dynamic. It's the exposure to companies that are listed in other currencies. What benefit is there for a Canadian investor – investor in a lot of countries, but specifically here.

Sam Polyak: It's great diversification. The Canadian dollar has had periods where it almost went to parody with the U.S. dollar, and then it went, as you and I joked before about going from a loonie to a toonie when it devalued by a lot as well. In that sense it has some similarities to emerging markets and a weaker dollar, which I believe will happen, will benefit Canadian investors and will benefit Canadian assets. But I think emerging markets – personally I'm biased – will benefit more because there's a lot more pent-up demand. In Canada you had a good cycle that's been very much linked to the U.S., so I don't think there's as much pent-up demand versus a place like Brazil that's really been in a recession or quasi-recession now for seven or eight years. So it's just not comparable in that sense.

Pamela Ritchie: It's fascinating. There's so many pieces that we need to come back to clearly throughout the year that unfolds 'cause so many of these pieces are… is it fair to say it is early days, just as kind of a final thought. Is this a rotation to EM that is in early days at this stage? Is the boat starting to leave? Or where do you see this.

Sam Polyak: I believe so. I've seen a few EM cycles. EM had a huge cycle in the early '90s. They were brought down when the U.S. started hiking rates in '94. As I mentioned earlier about the late '90s with the strong dollar period that brought on the Asia crisis. In the mid-2000s EM had a huge cycle coming out of post-2003 and the weaker period of dollar that kind of ended in the global financial crisis. I'm hopeful now, because we've had these 10 tough years, that this is really the early stages. You look at how much EM has underperformed developed markets over that period, especially the U.S., and I think there's a nice catch-up trade because we've had good GDP growth, mostly led by Asia, but we haven't really had great stock market performance and I think that we're in this early period where I think coming out of this growth. Coming out of this crisis we'll really see that acceleration.

[29:20]

Pamela Ritchie: Sam Polyak, I really want to thank you for joining us and taking us through some of the threads of this story. Fascinating. Thanks for joining us.

Sam Polyak: You bet, Pamela. My pleasure.

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