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're joined by Institutional portfolio manager Naveed Rahman. He shares his outlook for 2021 on investing in global small-caps, and describes the fund positioning for Fidelity Global Intrinsic Value Class.

As institutional portfolio manager, Naveed supports portfolio managers Joel Tillinghast and Salim Hart on Fidelity Global Intrinsic Value Class, and they believe value will make a comeback. Currently, they believe the consumer discretionary sector is attractive, particularly home-building companies as people across North America are leaving city centres and buying homes in the suburbs, a trend that is expected to last long-term.

This podcast was recorded on January 15, 2021.

[01:46]

Pamela Ritchie: With a mass inoculation campaign underway now, seemingly aided by $2 trillion of additional fiscal support slated by what's going to be a Democratic controlled Washington, the question is, is this bridge that we're talking about the other side long and strong enough to hold? Will the market rotation into cyclicals, small-caps and value stories continue, barring, of course, any catastrophic missteps and setbacks? And in this environment of varying probabilities and multiple scenarios, how should investors think about positioning their portfolios? To help us think through these questions we are joined by institutional portfolio manager Naveed Rahman. Naveed works closely with legendary value-oriented portfolio manager, Joel Tillinghast. He's the key steward of the Global Intrinsic Value Class as well as other funds. Naveed, great to welcome you back. Happy New Year.

Naveed Rahman: Happy New Year, Pamela. Nice to be here, thank you for having me.

Pamela Ritchie: Okay, so we're going to hit you right off the top here with this question. Value. Why now? Give us the case. You're our man here, what's the deal?

Naveed Rahman: That's an easy question right off the bat. Thank you, Pamela. First I'll acknowledge that it has been a long time since value has outperformed. The last 10 years, growth stocks in the U.S., as an example, have outperformed value stocks by roughly 650, 700 basis points per annum. So the recency bias that we all have is that growth has outperformed 2½ times the return over the last 10 years, why shouldn't that continue? I guess I'll make two points. The first is the market moves in cycles, and things that have worked for a long time tend not to work in perpetuity. That's a given, otherwise there's no reversion in the market. Secondarily we have not seen the concerted fiscal and monetary stimulus that you began to allude to in your opening remarks. The U.S. is considering its fifth stimulus plan since COVID hit roughly 9, 10 months ago around the world. This is a $1.9 trillion plan. This hasn't passed Congress yet, but it's an indication of the magnitude of the problem and the size of the stimulus which, unlike the GFC in 2008, 2009, is happening at the same time, really simultaneously, as a very accommodative monetary stance from the U.S. Fed and from central banks around the world including Canada and Europe.

The double whammy of fiscal and monetary stimulus is very supportive, raises the odds of inflation that we haven't seen for a long time, and then probably most importantly, to answer your question, where we sit here today the value index is in the U.S. trading at less than 20 times earnings, the growth index is roughly twice that at 40 times earnings, but if you look out the next two years the market expects value-oriented stocks to grow at roughly the same to slightly better rate than growth stocks. That's a really interesting setup for us. Value stocks trading at half the P/E multiple of growth stocks with expected earnings that are potentially better, which is not unusual coming out of a cyclical recession that we've all experienced in 2020.

[05:09]

Pamela Ritchie: I'm just going to ask specifically about positioning and I will, but I just want to pick up on that because, when you're looking at earnings further out, which is big part of what you do, and the fundamental research that you look at, how do you look at tech regulations which are discussed about whether they're coming or [audio cuts out] but more in terms of money rotating out of them into so-called value. How do you look at that when you see an earnings outlook that you just mentioned?

Naveed Rahman: Part of the reason we are concerned about tech as a sector is one, valuation, it's the most expensive part of the market. It has outperformed the most over the last 10 years, so the expectations are elevated. Secondly the consensus forecast for earnings growth is slowing down in that sector. We're not saying it's going to be negative earnings, or these are going to be money-losing companies, this is not a Pets.com phenomenon from 1998 or 1999, but the rate of growth of earnings has come down. And then your interesting question on regulations is a really important one which is that the sector globally has benefitted from really light-touch regulation. As we have seen in Europe, increasingly in the U.S. and other jurisdictions around the world, there is an appetite to more rigorously regulate technology. The Department of Justice has multiple actions against big tech companies including Facebook and Google. Europe similarly has actions against Amazon. Just a handful of large tech companies there.

I guess what we would say is we're not macro experts that say this regulation or that regulation is going to come to pass for sure in 2021 or 2022. But what we can say on balance is looking out the next five years the prospect for higher regulation and potentially higher taxes on tech companies who have managed to really cleverly avoid max tax policies or tax rates around the world, the prospect of those getting more challenging is really unappreciated, unreflected in the stocks and could further decelerate the earnings growth that we were talking about just earlier.

[07:28]

Pamela Ritchie: Interesting view. I'm sure that will resonate with a lot of people. Let's talk a little bit about positioning. You kind of alluded to some of it, but can you drill down a little bit further about how positioning has worked, and actually buyouts. I want you to bring in that to us but maybe first on positioning.

Naveed Rahman: Maybe I'll start with buyouts and then end with positioning. One of the things that I have learned from working with Joel Tillinghast the last decade plus is, on the face of it, buying reasonably priced companies that are cash generative, with clean balance sheets and good management teams, as a rule, that's a good way to invest. You're going to make good returns on those companies, but above and beyond that precisely what we find attractive is what strategic buyers, be it private equity, large-cap companies, also find attractive. So ours is a portfolio that, in any typical year, is going to benefit from a half dozen to a dozen takeouts because we are finding the companies in many cases before the strategic buyers find them. And it's been nice to see in 2020 one of our top 10 holdings was Alexion Pharmaceuticals, an underappreciated rare disease biotech company which is being taken out by AstraZeneca at a 30, 35% premium to the undisturbed price of the company. That is expected to close in the third quarter of this year, but the stock already reflects the deal happening, so it was a nice boon for us towards the end of the year.

In a similar vein, we've had about a dozen companies, smaller-cap in nature, in Japan, in Europe, getting taken out this year. A good example in Japan is a company called Andor, it's a CAD computer-aided design company, 40% premium, clean balance sheet. There are a handful of companies, Pamela, in Japan where the cash on the balance sheet is almost the entire market cap of the company. So there are values and then there are real values. Andor is a good example of that. We thought it was worth much more and the buyer agreed. That's a 40% premium. Some of these are small positions, but none the less a 20 BP position that gets taken out at a 50% premium adds 10 BPS to the total return of the portfolio, so these things do help.

[09:57]

Pamela Ritchie: I was going to go to positioning, which I think you were too. Just sort of financials, industrials, just some commentary on how you're allocated in general.

Naveed Rahman: And maybe tying it back to why we're constructive on value now. The disparities are quite wide in the market place between growth and value stocks, and the sectors that we find most interesting, consumer discretionary and industrials are two examples of that. Financials would be a third as you said. We've done a fair amount of buying in the portfolio in the fourth quarter in the consumer discretionary sector in particular. There are home building companies like M/I Homes or a Mohawk which is a flooring/carpeting company based in the U.S. These are trading at attractive valuations, and we think there's actually a fair bit of upside to home building going forward as this recovery with stimulus and vaccines hopefully takes hold in the course of 2021 and beyond. These are well-positioned companies.

The phenomenon of more people leaving city centres and living a little bit further away from downtown is, we think, not just a COVID phenomenon. We're not making a point that the city centres are not going to see people anymore, but just the balance between more suburban work environments and urban work environments may be on balance more tilted towards the suburban side going forward, which will be a boon to home builders and building products companies, and it should sustain this housing recovery on a going- forward basis.

That's one area, and then you'd asked about industrials and financials as well. I should highlight that in financials as a sector, as an example, our exposure is not in banks that are super dependent on rates going up to get a lift from earnings from interest margins. We are more exposed really to insurance companies, consumer credit companies that entered this crisis in much better position from a capital-level perspective, have the wherewithal to survive should the crisis linger longer than we expected, and big positions like Synchrony and Discover Financial for us, we think, have the prospect of really strong earnings growth. And we don't expect that credit will be as big an issue because this was not your typical recession that we experienced in 2020. We typically don't have a recession which immediately gets a response from fiscal authorities around the world, and you get massive stimulus, so the balance sheet of the consumer actually we think is in pretty good shape, and as a result the consumer credit companies, we think, are actually poised to do better than they typically would in this kind of environment.

[13:03]

Pamela Ritchie: That's fascinating. And as you say, just the distinction between where in the financials you find things interesting. Let's go to … you've touched on it several times, but let's just get your thoughts broadly on inflation. How much is that changing the way you look at things? I feel like it's going to be the discussion du jour for probably this year. How are you looking at it and how are you investing around it?

Naveed Rahman: I think it's a really difficult topic to have a definitive perspective on in the moment, just because there's so many moving parts, but one of our analysts used a metaphor which we think is pretty interesting about inflation. When you tie a horse up to a pole, when things are calm it's a really easy thing to do. If you have agitated the horse, tying it down is next to impossible. I think that's a pretty good metaphor for inflation, which is to say you can poke at it a number of different ways and maybe you're not getting a response you want, but if you throw … how you opened the conversation today, if you throw collectively more than $5 trillion of stimulus, have the U.S. Federal Reserve buy $120 billion of bonds a month, pledge to hold interest rates down until the CPI in the U.S. runs well over 2%, and then you throw on a vaccine on top of that and Canadians, Americans, Japanese people sort of all collectively want to do what we couldn't do for the last 9 or 10 months, empirically and qualitatively we think the setup is pretty attractive for more inflation going forward because of all these things happening simultaneously. In the past crisis they happened in sequence, not really at the same time. So that's a really critical distinction.

On top of that, back to the spread between value and growth, it's so wide that should some of this inflation start to emerge, you're really going to see that in cyclically-oriented value companies in the sectors we discussed, financials, industrials, the kinds of companies and businesses that have the ability to pass on inflationary pricing to their customers and then shareholders can benefit from that. It's always difficult to say because people have been calling for inflation for the last six or seven years arguably and we haven't seen it yet, but back to that horse metaphor, I think we may be agitating the market and the beast of inflation enough that it really could actually surprise to the upside in '21 and going forward.

[16:06]

Pamela Ritchie: It's really great to get your views on that, and maybe just somewhat related to the cyclical side of things are these kind of so-called snapback industries. If we want to go and travel, be a tourist in the ways that we couldn't, do you look to that area of the market? Question coming in from an investor on that specifically, travel or tourism.

Naveed Rahman: That's a great question. As the crisis played out, the places we found value were in more higher quality cash-generative cyclical companies, so like I said, the home builders, retailers like a Best Buy or a Big Lots, which is a closeout retailer in the U.S. Where we did not dip our toe in, Pamela, are the epicentre stocks. We do not think the forward viability of movie theatres, gyms, cruise lines, those stocks have had dramatic falls and sharp rebounds, but the future viability of some of those businesses are not as good coming out of the crisis as they were in the crisis. Movie theatres are a prime example of that. The fact that so many of us have high-definition TVs at home or abundant streaming services, and that first-run movies that we would ordinarily go to the theatre for are increasingly available at the home, for a really decent alternative from a quality of the visual to the price. This creates an existential threat to some of these really epicentre stocks as we're calling them. They're bouncing pretty sharply, but we try to invest with a two-to three-year time horizon, and we see some of these businesses as being permanently hampered. They're not going to zero necessarily, but they are not the same businesses in '21 and '22 as they were in '19 pre COVID. We're really careful to avoid those 'cause those can really be sources of value traps where the market might get enthusiastic about a vaccine, but then the reality of lower revenues and lower growth on a permanent basis could impair those stocks.

[18:34]

Pamela Ritchie: That's one. The other one is an investor asking you to expand a bit on small-cap opportunities globally. You mentioned Japan and a couple other things, is there anything more broadly in terms of themes you could point to for small-caps?

Naveed Rahman: Small-caps, after languishing for a long period of time, have had a historic bounce back already, which is good to see. It's important to recognize that we actually think the power of active management in small-caps is critical. I'm actually jumping on a call in about 15 minutes after this is done to do a presentation to the research [indecipherable] at Fidelity with Joel, and one of the things we're going to highlight is that the small-cap investing universe, the Russell 2000 is the main small-cap index in the U.S. As we sit here today 47%, almost half of the constituents of that index, are money-losing companies. So the bounce back that we have seen has actually been led by a lot of unprofitable companies where we tend not to have a large exposure. They might have a moment in the sun for six or nine months as the market gets really euphoric about a vaccine, and what it looks like on the other side of that, but you want to be invested in viable, sustainable companies that generate free cash flow and don't depend on leverage or the funding markets to really sustain themselves. I think one of the things with small-caps is that the sharp bounce back that we've seen in the last three to four months has been led by really the more dodgy part of the small-cap market, the unprofitable low- quality companies. If history is any guide, and we've analyzed this, over the long haul the unprofitable part of the small-cap market is not what leads the market over long periods of time.

Obviously for intuitive reasons if everybody understands, it is the companies that are profitable that generate increasing profits over time. The small-cap rally, we think, probably has legs to go because if we're right and there's a rotation towards more value-oriented companies, more cyclically-rated companies, small-cap will really participate in that, but buyer beware. You want to be invested in the right kinds of small-cap companies for staying power not just for a two or three-month trade, if you will.

[21:14]

Pamela Ritchie: That's really interesting, that's fascinating. Did everyone just get that? You just learned what Joel Tillinghast and Naveed are going to talk about in their meeting in 15 minutes. That was sort of a nice little piece. Thank you for sharing just that observation. Almost half of the Russell, it's very interesting.

Naveed Rahman: And that's a historical high, Pamela. The average [inaudible] there is about 25, 26% so we are … a meaningful part of small-cap companies are unprofitable because they're trying to establish themselves, but 25 and 47 are far away from each other as we all know.

[21:51]

Pamela Ritchie: Bring energy into the picture for us. What do you think, how do you look at that? Where are the tailwinds, headwinds for you on that?

Naveed Rahman: Thank you for asking about that. Thankfully for us in kind of a small-cap oriented portfolio, energy doesn't loom as large as it is for some of our larger-cap strategies. It's really in the global small-cap universe only about 2½% of the index. We have a little over a 2% exposure to that sector. Joel's view over the long term is that commodity sectors are a hard sector to make money in on a sustainable basis because just the commodity nature. The chance for repeated positive cash generation is not abundant. That being said, he has bought more in energy and materials in the last 18 months, especially in the last six or nine months, than we have in the recent past. That's because the sharp downturns we've had in energy multiple times in the last five years has actually succeeded in taking a lot of capital out of the business, and the big competitors out there, whether they're the Suncors of the world or Royal Dutch, or Exxon.

Exxon, as an example, has the most capex spending in energy in the world, and they themselves have pulled back capex by 25, 30% for the next three to four years. They have written down the value of their assets really in a meaningful way. So with that on the one hand, and then recognizing the fact that the demand for energy is actually a lot more inelastic, so we think of energy prices moving and people responding to that, but as it turns out most of the energy that we use is for transportation, and most of the transportation that we spend our time doing is necessary for living our lives. We don't drive a lot more when gas prices are low, and we don't drive a lot less when gas prices are up. We drive when we have to drive. So the setup for energy is reasonably constructive. We have seen that in the commodity price. West Texas Intermediate and Brent are both well over $50 and rebounded pretty meaningfully. We're reasonably constructive, but it's not a big part of the investment universe that we have here, so we can express it in sort of roughly equal weight position in that sector.

[24:40]

Pamela Ritchie: That's really helpful to know. There's two questions, we'll see if we can get these both in, I think we can. Probably as a follow-up to that, the question is about renewables and perhaps a focus of the Biden administration trying to spend on that. That hasn't been made explicit, but your thoughts?

Naveed Rahman: The shift towards renewables globally is not just a trend. It is a real thing. There is explicit legislation in the European Union to move to a much greener mix for energy production, and the Biden administration, to your point, will probably tilt in a different direction than the exiting Trump administration for reasons we all know. That being said, I think our general view is that the pace of that transformation is probably not as fast as the most bullish EV-oriented investors anticipate. As an example, Tesla is the biggest cap auto maker in the world by order of magnitude. Tesla has more market cap than all the other OEMs in the world basically combined. Not to pick too much on one company, but we think that's probably a little overheated in the sense that the pace of the automobile transformation, the auto fleet transformation is really in the low- to mid-single digits per annum, and if you sort of put a really aggressive assumption and say 25, 30, 40% of the auto fleet, the new cars are EV, that still means that the auto fleet is changing at a 2, 2½% per annum rate from combustible to EV. Those numbers give you a sense that the transformation is happening, but it's not happening overnight. I guess tying it back to energy, this will have a dampening effect on the multiples of energy companies, but it's not going to have the near-term demand falling off a cliff that some investors are worried about from where we see the math.

[26:57]

Pamela Ritchie: We have time to squeeze this in. You have to dash to a meeting with Joel and we end at 12:00, so quickly here's the question. What does turnover look like in Global Intrinsic Value and Joel's sleeve of NorthStar? Just give us a sketch.

Naveed Rahman: Neither of these are high turnover portfolios. We tend to invest with an 18- to 24-month time horizon where we think there's a big discount between intrinsic value and the price of the company. That being said, if the market is experiencing extraordinary volatility as it did in March, April, May of this year, our portfolio turnover will tick up. What is historically a 50, 60% turnover portfolio on an annualized basis, may look more like 80, 90% if the market is going through an extraordinarily volatile time as we went through in 2020. But the envelope of turnover really should be sort of 70, 80 on the high end when things are really frantic, to 30, 40% on the low end when things are more normal and placid.

[28:09]

Pamela Ritchie: Brilliant. It's been terrific to speak with you. Thank you, Naveed, and we look forward to seeing you again soon. Hope you have a good weekend when you get there.

Naveed Rahman: Thank you so much, Pamela. Thanks everyone, I appreciate the time.

Pamela Ritchie: Great to have you with us. That's Naveed Rahman joining us on Fidelity Connects.

Ending: 28:27

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-dot-ca for more information on future live webcasts - and don't forget to follow Fidelity Canada on Twitter. Thanks again, we hope to have you back tomorrow.

[end of podcast]