Fidelity Connects

In Focus: From Value to Global Small-Caps

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

This episode features Institutional Portfolio Manager, Naveed Rahman. Naveed takes us through the value trade moving forward in 2021 and tells host Pamela Ritchie where he is finding opportunities in the global market.

Naveed works closely with portfolio managers Joel Tillinghast and Salim Hart on Fidelity Global Intrinsic Value Class. We also recently posted a podcast featuring Joel and portfolio manager Will Danoff, so please give that episode a listen as well.

Naveed notes that after a long time of not being interested in financials, that sector has now been a big topic of discussion between Naveed and Joel. He also notes that the global nature of their portfolio allows them to go anywhere in the world for opportunities with the best combination of value and quality.

This podcast was recorded on February 25, 2021.

[01:48]

Pamela Ritchie: Hello and welcome to Fidelity Connects. I'm Pamela Ritchie. One thing we know about the markets is that leadership changes, and the tough part is the when to try and decipher that leadership can change. Because of that timing issue, it's prudent to be diversified across asset classes, sub-asset classes and different styles. With all of that in mind some investors believe that market rotations to value, to small-caps and to cyclicals has already been underway for the last few months and will only accelerate. The big question is is it a bit too late to consider tactical allocations or re-balancing to gain exposure to these areas, or is the window of opportunity still very much open?

We're joined today by institutional portfolio manager, Naveed Rahman. Naveed works very closely with portfolio manager Joel Tillinghast, who co-manages the Global Intrinsic Value Class, Global Growth and Value Class and the NorthStar Fund. Naveed, a warm welcome back to you. Good to see you.

Naveed Rahman: Thanks Pamela. Thanks for having me.

Pamela Ritchie: Naveed, can we begin with how much has actually happened in the last week? It's been quite a week in fact. The bond market, well, you'll tell me what it's showing us, but it seems to be liking the prospects of growth actually coming through. That could mean higher rates going forward in a continued rising. What does all this do for the value/equity discussion?

Naveed Rahman: Very accurate observation there on the bond markets. As an example the U.S. 10-year yield before the election that we had here in November was below 80 basis points and 75 basis point range, and that is approaching 1.5%, only about 2½ short months later. To your point, it's actually moved up a lot in the last week. What the bond market generally is telling us is that the combination of the massive amount of fiscal stimulus around the world, and specifically in the U.S., $5 trillion in aggregate roughly, as well as the deployment of various approved vaccines around the world is really focusing the market on what will this economy in the world look like in a post-COVID world where we have this virus under control. The expectation is that we're going to see a pretty sharp snapback here because not only does the vaccine physically enable us to kind of get back out and do what we need to do, but in the meantime consumers around the world, including the U.S., have amassed a war chest of savings. The U.S. consumer has north of $2 trillion of unspent savings, which is not typical. You typically don't come out of a recession with the middle-class consumer in a really strong shape. People have generally spent down their money to fight through a difficult period, and that's not the case this time.

The bond market is telling us that economic growth could be quite robust in the back half of this year going into 2022, and that the prospect for inflation could actually be more robust. I know we've thought that that was going to happen many times in the last 10 years and it hasn't, but I actually think there is some really good things, or really interesting things, that make this time a little bit different.

[05:17]

Pamela Ritchie: Let's go to what makes this time a little bit … as you say for a decade or so this hasn't really been the case, so you come to the why now? What are the pieces that come together now in your mind?

Naveed Rahman: You're exactly right that lots of market watchers, lots of investors have been anticipating inflation for a long time. It hasn't happened. What's different about this time versus the financial crisis of '08, '09 is that the size of the intervention has been bigger right out the gate. The timing has been faster, and it has really been simultaneous. In 2008, 2009 the large developed economies around the world in North America, Europe and Japan tried some fiscal stimulus, backed off that, then did some monetary stimulus, and things never really took from an interest rate or inflationary perspective. We now have sort of a double barrel, I'd like to call it, where they were simultaneous and massive fiscal stimulus, monetary stimulus, and the U.S. Federal Reserve has changed its stated policy objective to, in practical terms, let the economy run hot, let inflation actually run above the targeted goal of 2% before they really take corrective actions by raising the interest rates on the short end of the curve.

All of this would suggest that the setup is a little bit different this time. I'm always leery that many people have said this time is different, four of the most dangerous words in the financial market. We try to be very humble about that, but we are seeing, the facts on the ground do tell us that there are some really good prospects for sustained increases and rates and inflation.

[07:05]

Pamela Ritchie: We'll go into some of those things more deeply as well. Just for everyone's benefit, remind us where within the universe you're looking. Are we looking at value, but now more of a large-cap or small-cap? Just kind of situate us even globally how you [audio cuts out].

Naveed Rahman: I might just touch upon something you said at the outset as well, that we have had a little bit of a value bounceback as you observed in the last two months of 2020 and to begin 2021. But let's put this in context. Value stocks over long periods of time, 50, 60, 70 years, generally outperform growth stocks empirically by 3 to 4% per annum. The last 10 years has been an exact flip of that. Growth stocks have massively outperformed as most of us know to the tune of about 500 or 600 basis points per annum ending 2020. So it's been a massive and long sustained period of growth outperformance. Value has clawed a little bit of that back in the last four months, but as we look at the markets the opportunity still looks really compelling to us for reasonably priced companies with high ROEs that we think can deliver really attractive returns.

That's where we focus. We focus on the intersection of value and quality with a bias towards small and mid-cap companies, but with the flexibility to go up and down the cap spectrum. We really see opportunity up and down the spectrum. We are a little cautious on the margin on the smaller end of things because small-cap stocks have really ripped off the bottom in the November, December, the last four months effectively. In fact in the U.S., as an example, the Russell 2000 is the benchmark of choice for small-cap investors in the U.S. In 2020 the first quarter of the year was the worst return for the Russell 2000 in history, and the fourth quarter was the best return of the Russell 2000 in history. So we had a full market cycle in a really short period of time.

I am cautious that the most low quality, the most volatile companies in small-cap have bounced back the sharpest. We should be a little cautious that that may not be the most interesting opportunity going forward.

[09:32]

Pamela Ritchie: Talk to us about financials, which is one of the areas that fits into the universe of what you're talking about. In Canada we had a bunch of bank earnings recently, so it's top of mind. What is the longer-term prospect for the financial industry in areas that you look at?

Naveed Rahman: After a long time of not being that interested in financials, my colleague, Joel, who's been investing for three decades, he and I have talked about financials a lot more of late than we have in the past. We're getting pretty constructive that financials, apropos to the conversation we had just a couple of minutes ago, typically investors are worried about financials coming out of a crisis because of the prospect of massive credit losses, which impinge the earnings of these companies. However, coming into this crisis 1) financials were heavily regulated the last 10 years, are really well capitalized relative to history, relative to 2007, 2008. It's night and day how much better capitalization levels are. Secondly, because of the massive amount of fiscal stimulus that we're seeing, the consumer and the typical business is actually in a much better position, and the credit losses that the market feared in March, April, May of last year may prove to be more modest than is typically the case.

These two things got us interested in financials, and as I was talking to Joel about this, there is very little of the upside of [indecipherable 00:12:49] increased interest rates that are priced into these financials as well. In our view we're able to buy some companies at below book value at 9, 10, 11 times earnings that should be modestly impacted by credit, not as much as the market fears, and could be materially helped by interest rates because obviously the net interest margin of these companies, the regional banks that we're looking at, would be much healthier if the 10-year sustains this increase that we talked about.

[11:35]

Pamela Ritchie: Couple of questions rolling in here for you, and I want to get to some of them. If you could paint the picture a little bit for us because it's global. Global Intrinsic, for instance, obviously goes globally. Can you talk a bit about what global means? I know in the past we've talked about Japan. The Japanese market actually hasn't been massively successful as you look through the headlines for instance. But tell us about what you like there, and I guess the global mandate really, just to get into that.

Naveed Rahman: The really interesting and fun part of this portfolio, this mandate, as the name says, and as you implied, it is global. We will go to where the best opportunities are, the best combination of value and quality. It's also fair to observe that at the index level the Japanese equity market has been fine, pretty good, double-digit returns over the last several years, but they're not blowing the socks off at the aggregate level. Underneath the surface we have found a number of really fantastic companies, the hidden gems within Japan that have really embraced this more shareholder-friendly, more efficient management style that is more the norm in the West historically.

I point to a name in our top 10 historically, Itochu Group. It's not … 1) it's hard to pronounce, it's I-T-O-C-H-U. It's a really interesting company. It's a trading company in Japan that has some exposure to resources, some exposure to the consumer sector, some industrials exposure. They're buying and selling these goods and making markets. They are a company that trades at less than 10 times earnings, has a 3½% dividend yield, has grown earnings at a double-digit CAGR for the last three years, and in our portfolio has compounded at 21% per annum over the last three years. It's the kind of … that fable the tortoise and the hare. It's not the hare, it's not up 80, down 40, up 60, but it's a consistent 15% earnings grow or a 3% dividend on top of that. A little bit of multiple expansion and that can really provide some fantastic ballast and return to the portfolio.

There are a dozen companies like that in the portfolio that, while not dominating the limelight, really are delivering fantastic results for us. We're still constructive. After the 21% CAGR for the last three years, it's still trading at below nine times earnings on pretty conservative earnings estimates.

[14:16]

Pamela Ritchie: More questions rolling in, so I'll just put these to you right now. How do you view Europe specifically? Are there regional markets that hold more opportunities? Can you speak to European opportunities?

Naveed Rahman: I'll start by saying one of the most inexpensive markets in Europe is the UK. We are not overweight in the UK market. That's a good example of just because something is cheap does not mean we will necessarily be there in size because it really has to be inexpensive, but where we see upside relative to market expectations looking out 18, 24 months. The market is cheap for good reason. We have a slight allocation to the UK, but it's a meaningful underweight from a percentage basis. As I'm looking through the portfolio we have single-digit exposure to Europe, but it's an underweight in the aggregate. What the bottom-up research is telling us is that the recovery will happen in Europe, but as we talked offline before, the vaccine rollout, the approval process in Europe has been slower than it has been in other parts of the world including in the U.S. So that just adds another dimension of time and distance to the recovery, and the economy was actually more on its knees through the crisis. The combination of those things leaves us underweight that region.

[16:01]

Pamela Ritchie: Really interesting and great to get the nuance within there. I feel like it's a good moment to discuss or get your take on risks, risks that are out there. Here we have interest rates rising. It seems to be some sort of endorsement that growth is on the way, and you said you note snapback entirely looking good so far. That said, that question of what keeps you up at night, or what do you see out there that could interrupt some of what we're seeing?

Naveed Rahman: That's a fair question. We always have to think about the positives and the negatives as you assess these opportunities. On the negative side we worry about the pace of the vaccine rollout, there could be logistical hiccups. This is a gargantuan effort on a global basis, and you really need to deal with the virus globally. It can't be sufficient to have it … Quebec has it dealt with, but it's raging in B.C. That's not the kind of solution we need on a global level. That's one thing we worry about. The second thing we worry about, as you observed, the pace of the change has been pretty fast. You always want to make sure that the fundamentals are changing in line with what's happening and things are not getting ahead of themselves.

I guess the last thing I'll say is that, if this does prove to be a sustained increase in interest rates followed by a healthy increase in inflation, we have an underweight to technology, but I suspect that we might push that underweight even further because the tech sector and growth has been a disproportionate beneficiary of low rates. Their earnings are far out in in the future, and the present value of future earnings looks a lot better when the discount rate goes down. If the discount rate is up on a sustainable basis, a lot of these companies can deliver the same level of growth that we expected, but the math, the discount math would suggest that their stocks are worth less. So the market is starting to think about that. There's been a little bit of a pullback there, but that could be, that's a meaningful risk. It's a bigger issue if you manage a growth-oriented portfolio where you've got much bigger exposure there, but it's not de minimis for us. We have 10% of the portfolio in technology-oriented companies. It's a 3, 400 basis point underweight for us, but nonetheless we want to make sure that those companies can outgrow any diminished expectations from rates being higher.

[18:46]

Pamela Ritchie: Can we just add to that a bit, some comments on … cyclicality is talked about a lot right now. We're talking about commodities a lot right now 'cause they are cyclical. Just speak a bit more broadly about where we are right now.

Naveed Rahman: I guess the thing I'll say is that the answer depends a little bit on the commodity and the nature of the cyclicality that we're talking about. The energy companies are, as we all know, pretty exclusively driven by the spot commodity price and the expectation of where the commodity is going. Oil has rallied quite sharply in the last three to four months. That's on balance good for energy companies. We have a neutralist position in energy, but it's a small part of the portfolio. You want to watch the supply response that comes from OPEC and other producers around the world. We're modestly constructive on energy short to medium term just because the capital that left the energy sector, and the decrease in capex spending that the sector has experienced would suggest to us that it'll take a while before the spigot can really be turned back on. A lot of these companies, at the request of institutional investors like Fidelity and others, have really taken to heart a commitment to return capital to shareholders and not put 105 cents of every dollar that they get back in the ground, which has been the practice historically.

We're constructive there. We've really added in our portfolio in the material sector, in packaging-related companies. They're an interesting way for a value-oriented portfolio to participate in the tech revolution that we're seeing. One of the consequences of all of us ordering so much more from home is the pile of packages that are, I'm sure, in front of Pamela's house on a regular basis. The container board that supports that has enjoyed a pretty robust longer-term recovery, and we think there's some really well-managed, high-quality companies there. You can think of that as sort of a little bit of a back door play into the tech revolution that we've had.

We're looking for the intersection again, so we're not going to buy the lowest quality, most marginal company. It's really the good balance sheets, the higher-margin companies in materials, in energy.

[21:34]

Pamela Ritchie: Recycling day at my house is embarrassing actually. I sort of cringe. There's a question on gold leading from higher interest rates, discussion of inflation. Does gold have a place for you? How do you look at gold as useful to your investment style, if at all?

Naveed Rahman: People are asking a little more about it. Gold, after a long period of underperformance post the GFC, has had a little bit of a moment in the sun. What I've learned from Joel, and what we think about in the portfolio is that we like to focus the investments on securities that have an internal rate of return. They are generating earnings that they are returning to us in the form of share buybacks, dividends, something that we can see. Generally the issue with the commodity itself is that it doesn't have an internal rate of return. Obviously gold miners do, and do pay dividends. We tend to be underweight the more volatile commodity-oriented companies and gold really falls into that. This is not typically the kind of sector that gets a lot of exposure in this portfolio, doesn't fit our process that well.

[22:57]

Pamela Ritchie: How do you like housing right now? It seems like we literally can't even get a 2 x 4. I wasn't actually going to hammer it myself, but I was looking into [audio cuts out] hammering it, and it's outrageous where it is right now. Do you look at the housing sector?

Naveed Rahman: We certainly do. The observation that you have is certainly happening around the world. The fact that many of us have worked from home for 11 or 12 months means we've put a premium on space, and we all want a little bit more of that space. Housing has been really robust. We have a number of stocks that are exposed to housing. We own some home builders in the U.S. and in Japan that are trading at attractive valuations. We own some companies that supply into the home-building business – flooring companies, things of that sort. The thing we want to be mindful of is that we talked about rates moving up a little bit earlier in the conversation, and so you want to watch for, rates are still very low by historical standards, but they are not as low as they got in the summer of 2020. I think where we are, we're still constructive on housing. We do think that working from home more often is a long-term trend. We will not be spending five days a week from home obviously once the vaccines are rolled out, but neither are we Pollyannish in thinking that everything will be exactly as it was in January of 2020 once the vaccines are rolled out.

The demand for housing around the world for more housing to accommodate home offices and things of that sort is going to be sustained, so we're still constructive on it but watching rates because you could get too much of a good thing there.

[24:52]

Pamela Ritchie: Do you think the design of homes is going to be different if we all have to think about having a room for an office or that kind of thing?

Naveed Rahman: Unquestionably. Maybe one of the more interesting things that we talked about, I think this was a conversation I had with Joel, is that coming out of the Spanish Flu pandemic housing design around the world actually fundamentally changed. The parlours that we used to see in old houses were really initially an attempt to have your guests be able to clean themselves, wash their hands before they came to visit. Obviously they evolved as the memory of the Spanish flu faded, but that's just one simple illustration of how something that was comparable to what we experienced in 2020 fundamentally shifted the layout of houses around the world.

We do think that there will be some changes, not just in the house, but we keep close contact with our colleagues at Fidelity that design the real estate that we occupy, and we are in store for some changes there, as are many offices around the world.

[25:59]

Pamela Ritchie: That's very interesting. There's sort of a new era opening up there. Does health care interest you? Health care in Canada is always a slightly different situation, but you have such a robust market that seems to be doing so well in the U.S. How do you look at health care?

Naveed Rahman: We have a whole set of businesses here that you don't have in Canada with the health care insurance companies, the for-profit health care insurance companies that loom large for us. That's been a place we have been consistently invested in for a number of years. It's the kind of recurring revenue, predictable business, very cash generative that we're constructive on. We also, I might add, have a pretty large allocation to the U.S. and global pharmacy retail companies. That's companies like CVS in the U.S., Cosmos Pharmaceuticals in Japan, these also, combination of good valuation, strong earnings growth, really nice businesses for us. We expect them to get a little bit of a lift in 2021 from the COVID vaccination efforts because in the U.S. CVS is one of the partners of the federal efforts to actually distribute the vaccines. They're not going to profit from the vaccination per se, but there are some really nice ancillary benefits. If we are all visiting CVS one time more a month because of this pandemic, the ancillary benefits of everything else they sell is actually pretty material. CVS, in our mind, is good combination of value, quality. They did a really interesting acquisition of a health insurance company about a year and a half ago that they're in the process of integrating, which should enable them to do what some other companies in the U.S. have done which is to lower the cost of health care delivery and improve outcome. So we've got a nice allocation to health care. It's a little bit of an overweight for us, and it's got the combination of offence and defence that we like.

[28:20]

Pamela Ritchie: Very interesting. Anything you want to just leave with us as a final thought on where we're going and how you're looking at that as an investment [audio cuts out].

Naveed Rahman: Maybe I would end with where we started which is that it's been a long time for growth-oriented stocks to have done really well. They've had their moment in the sun. There's some fantastic companies in that universe. But coming off a difficult global recession we think that the setup is really good for the kinds of companies we're invested in. If we're right, they should deliver better than market earnings growth and below market valuations. That's a really good setup for value companies because generally speaking what they have going for them is that they're cheap with decent earnings profiles. But coming out of 2020 they are not only cheap, but they should actually out earn the market just because of the potential for the reopening that we talked about earlier. It's a really interesting time to be looking for value and quality stocks, and we remain very, very optimistic.

[29:31]

Pamela Ritchie: Great. Naveed, great to have a chance to catch up with you. Thanks so much.

Naveed Rahman: Thank you for having me, Pamela. Have a good afternoon.

Ending: [29:42]

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