Fidelity Connects

Global Asset Allocation Outlook

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

It is believed that asset allocation - the strategy of selecting asset classes, could be responsible for 90% of the variability in portfolio returns. With rising inflation expectations and regional allocations being more important than ever, it is important to get the mix right.

David Tulk, portfolio manager on Fidelity's Global Asset Allocation team joins us today to shed some light on how the GAA team is positioning their funds, which total $71 Billion for Canadian investors heading into the second quarter of 2021. David explains to host Pamela Ritchie how they are currently overweight equities and credit, underweight bonds and cash, and this view is motivated by the economic optimism we're currently seeing – but also hinged on the expectation that central banks will keep stimulus in place.

David also touches on gold, bitcoin and emerging markets.

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Pamela Ritchie: David, let's begin very much with what we're observing right now. We've actually seen some record flows into TIPS and inflation protection assets, bonds in the U.S., but there's sort of this consensus that there's global synchronized growth in the making right now. Where is the balance?

David Tulk: That's a great way to start the conversation. It is certainly very topical. It's not just within financial market flows. I took a quick look at Google Trends, which looks at popular search terms around the world, and the search for inflation is at the highest level since March 2009, just to give you an indication that a lot of people are certainly thinking about inflation. And I think where that comes from is tied to the second part of your question. It is that expectation that economic growth does look fairly strong as the world comes out from under the drag of the pandemic, and as conditions start to normalize there is a great deal of stimulus in the system. There's a great deal of pent-up demand on the part of individuals that really do want to get back to life as normal. When you put those two pieces together, you have the desire to spend with the ability to spend that could certainly allow for a pretty sharp increase in growth through time.

We're also thinking a bit about some of the policy aftermath of the pandemic. I'm sure we'll have a chance to talk about this, and we've talked about it before as well, but the big increase we've seen in levels of public sector debt around the world is also likely to be a catalyst to future inflation. When you put both, I guess you can describe it as the demand side together with the supply side, a lot of arrows do point in the direction of inflation through time. It's not a universal view, there are some that still maybe want to question that, and we can debate that further, but as it stands right now that interest is being reflected in financial flows into those inflation protection assets as well as from the world more generally.

[03:57]

Pamela Ritchie: I'll just use this moment to say that you've sort of been sitting with that conclusion for some time. You certainly didn't come to it over the last week. Although over the last couple of weeks it's come, as you say, more to the attention of everyone else. Do you want to just back up a little bit and tell us how positioning over the last six months has evolved for you and the team?

David Tulk: We've been interested in inflation protection for a while, certainly prior to the pandemic. One of the trends that we were observing several years ago was increased fiscal commentary or influence over the conduct of monetary policy. That has been a worrying trend insofar as if you let central banks be dominated by the fiscal authority, you tend to see policy stimulus in place for longer, which itself is inevitably inflationary.

We've also been watching to a certain degree the trend towards more deglobalization. So globalization that had existed for the last couple of decades really was a strong disinflationary impulse around the world, but as we noted maybe more in the way of protectionism, maybe more in the way of questioning trade agreements was just really something that was a tide lifting a lot of boats within a country or within a society. Some of that trade rhetoric was also likely to create a less efficient world, and that could also potentially create a bit of a risk towards higher prices. That was a little bit of the thinking that we had going into the pandemic. Obviously, like everyone else, we were caught by surprise when it came to the pandemic, but a lot of those themes that we were thinking about before were really accentuated or magnified as a result of the pandemic.

That certainly was a nice coincidence. But another reason that we think a lot about inflation and wanting to protect against inflation is what it does for risk management. This really gets at the core of what makes a 60/40 fund work is that you have a negative correlation between stocks and bonds, and one of the things that can change that correlation is an increase in inflation. Knowing that was something we were thinking about from a macro perspective, it was doubly important for us to provide protection and risk management to mitigate the type of shock that inflation would imply for our type of funds that we manage specifically.

[06:31]

Pamela Ritchie: Let's talk about things that are co-related. There's been a big argument that everything is connected and maybe it still is. To what extent what we've been watching in the bond market; we're watching yields kind of back up. It's all tied to this expectation of growth. Are things becoming less correlated? How do you look at that right now? Is there nuance that we should be watching?

David Tulk: Correlation is a fantastically interesting topic for us because, as a multi-asset class manager or a balanced fund manager, we want to be very careful with all of our allocations not only on a standalone basis, but really how they play well with others. Looking at correlations between asset classes is a really important part of our quant process to make sure that at the end of the day our funds are diversified and are resilient to a wide range of market or economic outcomes. So monitoring how correlations evolve are certainly very important for us.

To get back to where we see things now, there definitely is a move higher in interest rates as you look at some of that economic optimism. A lot of that might also be tied to the market ostensibly calling out central banks saying that central banks have said one thing, but they're going to really need to maybe put a little bit more weight behind that policy to try to at least counterbalance what the market has done. That has changed a few of the correlations when you think about what different asset classes do to an interest rate environment. We can also get into the conversation, and I'm sure we will, about how crypto versus gold has evolved, and those correlations have started to change as well. There is, I guess, a lot of moving pieces, and from our perspective we're very mindful of keeping those correlations in check and making sure that all of our allocations are providing an enhancement to return, but almost more importantly an enhancement to diversification as well as resilience.

[08:41]

Pamela Ritchie: Let's begin a little bit with a 60/40, and then we'll break it apart a bit the way you are positioned across various funds. Let's get into the assets a bit as well. Bonds and stocks, where do you see a place for both of them in this balanced view that you need to have? And then maybe we'll get into other bond-like assets as well.

David Tulk: From our current tactical view we remain overweight equities and overweight credit, and that is funded from an underweight to bonds as well as an underweight to cash. The view certainly is motivated by some of that economic optimism that I touched on earlier. It also really hinges on our expectation that central banks will continue to keep that stimulus in place. That's a really important observation to make that is arguably unique to the current cycle, that in prior cycles once you see an economic recovery take hold, central banks will try to take some of the stimulus away. Maybe that's the narrative that the bond market is running with today. But we think that central banks will continue to keep that stimulus in place even in the face of an increase in inflation or a very well-defined observable recovery. So that keeps us comfortable being overweight equities, being overweight credit.

Within some of those views we can talk about the regional allocations, but I think that gives you a pretty good perspective of how we see the world from a 10,000-foot view.

[10:18]

Pamela Ritchie: Let's go into equities and maybe directly to EM because EM is an area that, again, you've been talking about the allocations you've had towards it for some time. It is all abuzz now. Again, take us back a little bit to why that made sense for Canadian investors to have that as part of their portfolio with you?

David Tulk: First off, on an objective absolute basis we like EM. One of the exercises that we go through in terms of structuring these portfolios is to go through a capital markets assumptions process. So what do we expect in terms of very long term? You could say maybe more secular returns from different regions around the world, and it's a combination of the earlier phase of industrialization, maybe better demographics on average. All of that does point to a stronger economic growth from emerging markets relative to developed market economies. That's an important tailwind that then flows through into our expectations for asset market returns for that region.

We generally like EM just as a standalone, but what we also want to view an allocation to EM is as part of a counterpoint to being maybe underweight something else in the world. That is our long-standing view on being underweight the Canadian equity market and Canadian assets more generally, to fund that overweight in EM. That motivation, again, we've talked about it in the past, but we view Canada in EM as having some similarities to global growth in the sense that they both tend to be higher beta, so they're more responsive to changes in economic growth.

That similarity between those two asset classes allows us to say, "Well, what would we prefer? Would we prefer emerging markets, or would we prefer Canada?" We've outlined the Canadian thesis, and I'm happy to go into that again, but we are very worried about Canada's economy. We were worried about Canada's economy prior to the pandemic. That concern is only magnified as we contemplate a post-pandemic world. And for those related reasons we want to maintain that overweight to emerging markets, and if anything, we think emerging markets can come out of the pandemic perhaps even stronger than they were before. All of that just really reinforces the view that we had prior to the pandemic, and we've made a couple of additional steps to strengthen that view and maybe even increase its magnitude over the last year or so.

[12:57]

Pamela Ritchie: We've seen GDP numbers come out for Canada in recent hours actually. It hasn't been news yesterday, and we've seen numbers that don't look that bad actually. It seems to be largely due to housing. Just run through where you see Canada going from here and some of the worries.

David Tulk: The GDP data, at least over the short term where we're just desperate to get growth of any kind, was encouraging. It suggests that at least the early part of the second wave of the pandemic did not really harm the economy as much as what people might have feared. But we also take a little bit of a longer view, and as you rightly pointed out, a big portion of that GDP increase was driven by housing and consumer spending to some extent. That only, from our perspective, increases the vulnerability of the Canadian economy because we went into the pandemic with a very high level of debt to income, or household debt more generally. That's a challenge that a lot of other economies have faced and have caused a lot of other economies around the world to experience a period of slower economic growth.

That is weighting in Canada's future, and if Canadians are responding to the interest rate environment, and justifiably so, by adding on even more debt, that just creates a larger challenge over the longer-term view that we consider that allocation. So we are happy to see at least a bit of progress in the short term. I would expect hopefully for some of that to continue as the economy globally rebounds, but if it's being driven by housing and consumer spending at the expense of the more productive sectors within Canada's economy, that just makes us really worried that this could potentially end in tears further on down the road.

[14:47]

Pamela Ritchie: Within the equity space, and I don't know if you can broaden this out to EMs as well, but the discussion between value and growth. Where do you sit within that; what do you lean towards?

David Tulk: Coming back to that theme of balance and resilience, one of the core approaches that we want to take is having managers of both styles built into the portfolios. On the Canadian equity side we have Dan Dupont's Canadian Large Cap, and that's paired with Mark Schmehl's Canadian Growth Company. Internationally we have Joel Tillinghast's Intrinsic Value paired with Will Danoff's Insights Fund. So what that means for the end investor is that they're not ultimately exposed to sudden shifts in style that have certainly happened over the last six months or so, and as a result the end investor is able to pick up four very strong security selectors. Even if their beta or their style is out of favour, they can still add a lot of value to the portfolio using our research platform and being able to choose the best of maybe a bad breed of style-typed companies.

That's an important addition that we want to make. That's really underpinning the structural design of our portfolios. We have certainly had from a manager-attribution perspective a little bit more on the growth side historically, so that does kind of reflect a little bit of the earlier macro environment. But more recently we have taken an attempt to look more at international developed versus the U.S. in terms of an equity market tilt, and that gives you a little bit more cyclical of an exposure, maybe a little bit less growthy just given the concentration of the tech sector in the United States. It's one of the ways that we can provide a little bit of a tactical spin, but ultimately protect the end investor from big shifts in styles by using managers of both styles in the portfolios.

[16:47]

Pamela Ritchie: So gold's falling out of bed. It has been for a while. What's that balancing?

David Tulk: That's a fascinating context to put gold, not just in what it's doing in isolation, but comparing it to Bitcoin as well. We'll start with the gold side of the equation, and we can certainly take the conversation further. One of the things that we have noted is very closely correlated with the price of gold is real interest rates. As we've seen the nominal interest rate increase in the U.S. and Canada and globally, that has put a certain amount of pressure under gold on a standalone basis. The interesting thing is comparing it to perhaps Bitcoin, or crypto more generally, that there might be this attempt to try and portray Bitcoin or crypto more generally as a new gold. To see a change in that correlation structure where crypto is able to continue to perform well as gold might struggle, that's just a fascinating conversation that I'm happy to talk about further.

But as it stands the environment for gold will be keyed off of what we expect for interest rates. Here again, I do worry that a little bit of the backup that we've seen in rates will prove to be self-defeating. What I mean by that is, if the bond market is expecting all that economic optimism, and that is why interest rates are higher, the higher interest rate cost will inevitably slow the economy down. As a result the premise of the market trying to push yields higher will become undone. It is effectively self-defeating.

Over a shorter period of time I wouldn't be surprised to see more communication from central banks, perhaps talking down interest rates. We've already seen the Reserve Bank of Australia, as a global example, actually increase their bond-buying program in response to what the market was doing. We know there's that adage that you don't fight the Fed, and I think that's a lesson the bond market might eventually encounter over the next little while. That could, again, put a bit of a lift under the price of gold again, but it is, from our view, it is an allocation. It is an important part of our future inflation thesis, and I do think that over time it's going to be a very valuable asset to hold.

We're comfortable in holding gold. It is, not surprisingly, a little bit painful in the short term, but if I could quote my co-manager, Geoff Stein, "You're not fully diversified unless there's something in your portfolio that kinda makes you feel bad." So that's what gold is doing for us right now.

[19:24]

Pamela Ritchie: That's great. We'll come back to Bitcoin in just one second, but just on the whole discussion of what could self-defeat on some level. What do you see out there as a macro risk? Inflation clearly is something that we're talking through right now, and that's one piece, but is there something on the virus front? Is there a scary variant discussion that you look to? What else do you look to as potential risks?

David Tulk: That's a great question, and we do spend a fair bit of time looking at not just the longer-term risk that is implied by inflation, but also some shorter-term issues that could upend the recovery. This might be a good opportunity to provide a little bit of a shout out to our internal researchers. We listen very carefully to our health care team. They're the ones that are pouring over all the science behind not only the variations in the virus, but also the developments of the vaccine. They're truly the scientists in the room. We just sort of pretend to be scientists when we look at their results. They're really highlighting the horse race between the variations in the virus with the development of the vaccines.

At this stage they still are inclined to give the victory to vaccines through time. Part of that involves projections as to when populations are vaccinated, which will inherently curtail the development of additional variations in the virus. Generally they come to a positive conclusion at the end of the day, but there's nothing stopping the market from getting too excited one way or the other. Maybe what we've seen with a little bit of wobbliness in the equity market over this year is the sense that maybe too much optimism was brought forward into the present environment, and any setback in particular may be related to the variants of the virus. That was all it took for the market to say, well, maybe we need to rethink a little bit of this.

That's the churn that makes the market. But our perspective is to really look through a lot of that volatility and really try to hang our hat on those more durable themes that are likely to persist well into the future.

[21:42]

Pamela Ritchie: As an asset allocator, how do you treat Bitcoin? Where does it belong, if it belongs?

David Tulk: It's a great question, and I would encourage everybody to look into Jurrien Timmer's paper, our colleague, that has spoken about this and has done a lot of interesting work on it as well. From our perspective, I guess I can give the punchline first. I don't think it's quite ready for primetime in terms of adding in Bitcoin. Within Fidelity there are a lot of people looking at this. There are a lot of folks looking at it from a number of different perspectives, and that includes our teams that really think about what it can do as an addition to a balanced fund.

Some of the early thoughts here is, if you were to come up with a purely optimal mean variance type of addition of Bitcoin, so what it can do to enhance volatility-adjusted returns, a 2, 3% allocation to Bitcoin makes sense because largely the history of Bitcoin. So abstracting away from some of the volatility, it has virtually been a one-way move higher. So that increase in its return has dominated the volatility associated with it, so it does improve Sharpe Ratios. That's maybe one checkmark for thinking about it.

We also look at it from a number of different perspectives. The second really concerns drawdown risk. We're managing these portfolios for investors who want to think of them as core holdings. The one thing that I think investors are sensitive to is … even if it's a short term, but any type of drawdown risk that can take place. Because Bitcoin and other crypto assets have shown pretty significant declines in pretty short periods, that does raise the drawdown risk that these funds face. That may be as an issue that we would think of as not justifying an allocation or at least maybe really moderating its size.

The third attribute that we look at, or maybe it's the second, is thinking about correlation. We touched on correlation before. One thing that made Bitcoin really interesting in the early stages is that it was truly diversifying relative to your more traditional financial asset classes. That was largely because not a lot of people were using it for that purpose, so it kind of marched to its own drummer. But as we think about going forward, it's become increasingly legitimized in the world in terms of institutional investors and retail investors. What that has done is that started to change the correlation matrix. So it now becomes more correlated with those traditional asset classes. It's an open debate as to saying whether it's truly as diversifying as it once was, or as diversifying as it needs to be to justify a role in a multi-asset class fund.

To reiterate the punchline, some of those issues I think do give us some pause, but we're obviously continuing to do a lot of work and thinking as the asset class matures it might have a couple of interesting applications for the type of funds that we manage.

[24:58]

Pamela Ritchie: I'm going to see if I can segue from Bitcoin to currencies. Sometimes people looked at Bitcoin as a currency, and there are many who do, but I'm thinking more broadly about other currencies and particularly the U.S. dollar. We saw Joe Biden, the President, announce that it looks like their vaccine program is going to be pretty robustly finished in May, which is astonishing. Does that strengthen the U.S. dollar? Does that just mean the U.S. is going to pull out of this even faster perhaps than we thought? Does that interrupt certain consensus views?

David Tulk: That's an interesting point. Just on the remarks of the President, I think that focus really was on securing enough quantity of vaccines as opposed to really getting shots into arms at a critical mass. Politicians have never tried to come up with a more optimistic interpretation, but setting that to the side there still is a little bit more time that I think is needed for that critical mass to be reached.

Setting that aside as an issue, the deeper resonance is that any optimism around the U.S. economy is certainly more than what is currently priced in, and there is a lot already priced in. That could potentially give the U.S. dollar a little bit of a lift, and you could also see some of that supported by a little bit of the wobbliness in equity markets as well.

I think you want to take a little bit of a step back and say let's compare the size of stimulus from central banks around the world. The Federal Reserve is clearly leading the way, and as a result I think that does leave the longer-term trend in the U.S. dollar as continuing to move lower through time. So that is an interesting implication for our positioning as well because, for those that are familiar with our funds, you know that we are underweight the Canadian dollar, and there's a tendency to say let's just compare the Canadian dollar to the U.S. dollar. Now both are falling, so how do you try to square that circle?

The answer from our view is to try to increase the exposure of the fund to currencies that we expect to do better against both the Canadian dollar and the U.S. dollar. There's a little bit more nuance in that traditional underweight that you would see relative to the Canadian dollar. So that's just an important distinction to make.

[27:21]

Pamela Ritchie: Can you just sort of briefly describe the funds that you oversee?

David Tulk: If I can get 31 funds into 60 seconds of time, I'd absolutely do my best.

Pamela Ritchie: Four?

David Tulk: Broadly speaking, we manage a wide number of funds. Really, the design is to have a fund for every type of investor. That starts from a strategic perspective where we have different benchmarks that have different regional exposures around the world, differing degrees of equity versus bond allocations. The layer deeper than that is that there are some funds that are very tactical, and we've spoken a lot about the tactical tilts we have. Some of our other funds are more strategic in their allocation, which puts more of a focus on building-block managers and their security selection to really define the return and the characteristics of those funds.

Again, I think it's tricky to put it all into a single nutshell, but I think as you look through the lineup there is ideally a fund for every type of investor when it comes to risk tolerance, investment horizon and country exposure.

[28:30]

Pamela Ritchie: And with this overarching theme of balance which we've been talking throughout the discussion today. David Tulk, I want to thank you for your time. Thank you very much for joining us.

David Tulk: It's absolutely my pleasure. Thank you.

Ending: [28:41]

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