Fidelity Connects

David Way, Portfolio Manager
Pamela Ritchie, Host

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

We are joined today by portfolio manager David Way of Fidelity's recently launched Long/Short Alternative Fund.

David and host Pamela Ritchie will be discussing some common misconceptions when it comes to alternatives, as well as his outlook on the markets, ESG investing in his fund and how short selling can help lower overall portfolio volatility. David also touches on how his Long/Short Alternative Fund has an investment philosophy anchored in the belief that skilled active management can consistently identify attractive investment opportunities through the economic cycle.

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Pamela Ritchie: To provide us with the one, two, threes of liquid alternatives, we're joined by portfolio manager, Dave Way. Dave has spent over 13 years in the industry, the bulk of which he spent as an analyst at Fidelity, producing fundamental research across many sectors. Welcome, Dave. Great to see you.

David Way: Thanks, happy to be here.

Pamela Ritchie: Let's, as always, begin at the beginning if you don't mind. How, Dave has the long-term evolution, really, of Fidelity's research sort of brought you to this moment?

David Way: Great question. Thanks for the opportunity. I think really there's two parts to it. One is why Fidelity offering liquid alternatives and why am I sitting in this seat as the portfolio manager on the Long/Short Alternative Fund. The first point to understand is that Fidelity's research has always been underpinned by identifying winners and avoiding losers. And so for a very long time as investors you've had the opportunity to participate in our efforts to find the winners. And now what we're doing, really, is taking something we've been doing for 20+ years and offering it to investors, the chance to invest alongside us in identifying those underperforming and loser stocks. That's sort of why Fidelity…

And why me? I've been at Fidelity for 13 years. I had six or seven years of work experience prior to joining Fidelity and I've always been just as interested as my colleagues have been in finding the winners. I've been always very interested in finding the bad guys, finding companies that are set to underperform because they're doing bad things, they're losing in an industry, or the industry as a whole is in decline. So it's been a real passion of mine and I got to do it as an analyst, and for the last few year I've been wishing really hard for the opportunity to do this in a diversified fund.

[03:31]

Pamela Ritchie: Fascinating. And we're going to dig into all of that. It's very interesting. Give us a broad description of what liquid alternatives are, because they actually can mean a number of different things.

David Way: In our case we're launching – or have launched – three products. One is a market neutral fund managed by Brett Dley. What differentiates that product from the other two is that it's intended to have a beta of zero. This is a pure alpha vehicle for generating alpha returns uncorrelated to the market. Brett has done a really great job.

The second fund that we've launched as well is with Dan Dupont who is very familiar to many people in the audience. Typical to his style, it's a low beta approach. I think he's targeting .3 to .7 beta in the market, so a lower exposure to the overall market and focusing on his downside protection that he's so good at.

My product is really designed to do a couple of things. One is to provide a little bit more of the offence in terms of taking advantage of long term economic growth and making sure my own assets in the fund and your clients are positioned to benefit from what I see as long term economic growth. But at the same time taking advantage of that other part of my investing that I'm good at, which is kind of being paranoid about what could go wrong in the near term and making sure that we've properly managed our risks, as well as taking advantage of those companies that we've identified that are very likely to underperform the market. Clients in my fund should experience exposure to long term market performance with lower volatility because I've got that focus in terms of managing risk in the near term that's enabled by the short part of the portfolio.

[05:18]

Pamela Ritchie: You've touched on this twice, but I'm just going to ask you to wrap it together for us. Essentially, being able to do some shorting within the portfolio actually allows you to fully invest on the long side. Just bring that together.

David Way: Sure. In my fund, it's designed to be effectively a 130/30 product. The fund in the end is fully exposed to the market over time in general, but at the same time what I'm able to do is I'm able to short those stocks that are set to outperform. When you short a stock you generate cash from the sale of that stock and hopefully buy it back at a lower price. Then you take that cash and you invest even more behind Fidelity's best ideas. Our army of analysts going out there, finding which ideas they think are best positioned to outperform the market as well as my own portfolio decisions.

[06:10]

Pamela Ritchie: Fascinating. Tell us a little bit about… there are misconceptions — I feel like you sort of addressed them — about alternatives. What would you say is the biggest misconception, reall<,y about trading and being invested in alternatives?

David Way: It's a good question. In my conversations with clients, I think one of the things that comes up is just the perception that these products are incrementally risky because we're doing something new, and we're doing something that sort of has a mystery around it in terms of shorting stocks. I think the key message I want to deliver today is that being able to short in my fund helps me reduce the overall risk of the portfolio. It helps me identify the potential risks that could exist in long stocks and hedge them out. As we're seeing, we're seeing a very exciting market, but also one that people are increasingly concerned about. As a long-only investor, you don't have the same tool to be able to say, "hey, I'm really worried about high valuations, do I own these really great companies or not?" What I can do is I can find a really great company I'm really excited about the prospects. *[Audio cuts out]* valuation might elevated, but what I can do is I can find a stock that maybe has a similarly very high valuation where I'm negative on their business prospects. I don't think the business is going to stay up to that level and I can afford that stock. Hopefully I'm right and that stock underperforms, but overall if the valuations of the market fluctuate over time, if I'm losing on the long position, I'm gaining on the short position. It allows me to actually manage risk in a way that we just can't do in a long-only portfolio. That's what excites me about this product.

[07:56]

Pamela Ritchie: Very interesting, it really is on the risk mitigation side. These are broad strokes, amazing descriptions, let's put some actual examples around it. You were there in the dark days of March. Maybe it was exciting to watch the markets, it was quite a ride. Take us back to that and put some of the pieces together for us that you were watching in real time take place and that interest you.

David Way: For me, one of the most interesting parts of the COVID drawdown is that early and mid-January I started to get worried about what was happening in China. One of the key things about me is…

Pamela Ritchie: In January?

David Way: Yes. In late January we started to see the first signals that there was a virus emerging in China. One of the things that's unique about my own process is I cast a very wide net of looking for information. Some of the Twitter accounts that might not have a blue check beside them, may not have very high follower numbers, they started to signal an alarm. I started to see information from emergency room doctors in China calling out this virus and I started to get concerned. If this virus came to North America, what the likely impacts would be. And so I moved pretty quickly to increase my exposure to, on the short side, to the companies that I thought would be most affected by the virus. You can imagine where the virus count and the fatality rates have been very high such as in long-term care, etc., those share prices were negatively affected rather quickly. I did a call with the company end of February. In that industry, they said they were a little bit concerned, they were monitoring things, but felt that their safety standards would hold them in good stead. Frankly, I didn't believe them. They were pretty calm about the situation, I was very nervous and those stocks were down 50% within two weeks.

The fund was able to take advantage of opportunities like that. One of the things it did for me psychologically, I had all these positions that were doing really well at the bottom of the COVID drawdown because I had short positions generating profits, and it allowed me to sort of look a little bit further out on the horizon to an ultimate recovery. I'm a student of history, and to me this felt like war and the tide of the war really started to turn after the Battle of Midway, and that's when the stock market started to recover in the U.S. Not on D-Day but when the tide of the war changed. I started to look out further and say "which of these companies have been bombed out and when will they recover?" Also, if we're in this for a year, which business models were going to be upended either negatively or positively? There was a number of businesses that might have had trouble scaling. There were exciting growth businesses maybe relaying on exercising or working from home, and this was an opportunity to really accelerate demand to unprecedented levels, completely changing the thesis.

I kind of had my tentacles out starting to think about these ideas, and as the share prices started to react to the news, I was kind of on to the next thing trying to stay one step ahead, making sure that the fund was positioned.

[11:15]

Pamela Ritchie: What do you think we're on the precipice OF right now? It's an interesting moment. There's an awful lot of people that… not surprising, it's been a bit of a brutal year for many and many think next year will be better. There's a little bit of a consensus forming around a U.S. dollar short on some level, things will be better, look to sort of the second half of next year for some normalization… Obviously, the vaccine seems to be absolutely key. How do you digest all this? What's on your dashboard?

David Way: The first thing I do is kind of reflect on what are the most important things that have happened. I think the most important thing that has happened is the monetary and fiscal response globally has been massive. Quite clear, the Federal Reserve, I remember on March 23rd seeing that the Federal Reserve was buying junk bonds. That was a signal to me. I had a number of stocks that I'd been short believing they would go bankrupt. These stocks might've been down 70-80% and that day those stocks were up 20%. that was the first time I saw things are different, things are going to be different going forward. The access to liquidity is going to be enormous. so we've come through this period where we have a recovery, we now have a vaccine and we have an unprecedented amount of stimulus, and likely more stimulus to come. I think the key thing is the economy in 2021 will be determined by the ongoing level of fiscal and monetary stimulus.

So what does that mean? I think it means that there's a lot of pent-up demand for all the stuff we couldn't do in 2020. We had to stay at home, we bought Lululemon pants, we basically took advantage of buying things, and I think 2021 is going to be a return to doing things and buying experiences. The opportunity that I think is still perhaps under-priced are those businesses that maybe are kind of back to where they were pre-COVID, but they're back to pre-COVID levels with a pretty healthy U.S. consumer and a lot of pricing power. There can only be so many people who fit in a theme park in a day. There can only be so many people in a concert. For me, what I'm looking for are those opportunities where yes, the consensus might be right that things are going to get better and we're seeing some stocks where that's pretty healthily priced into the stock. But we're also seeing some where maybe they're underappreciating that this business could actually be a lot better post-COVID than it was pre-COVID.

[13:46]

Pamela Ritchie: There's a couple of questions coming in just to reiterate some of the guidelines, 'cause this is new for a lot of people listening. Just remind us to what extent you're long, to what extent short, or can be. What's the potential?

David Way: I can be up to 150% long and 50% short for a maximum net exposure at all times of 100%. So there's no leverage, there's no additional leverage in the fund other than the cash proceeds redeployed into the longs. Generally the fund has run around 130% long and around 30% short, and from a position size perspective, between 50 to 60 long positons and about 30 short positions. So short positions, average size about 1% and long positions size a little bit above 2% on average.

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Pamela Ritchie: *[audio cuts out]* allows you to be North America, Canada, what's the mandate?

David Way: The main mandate is the index is roughly 50/50 S&P 500, TSX; so roughly it's North American in nature, but I can own some international stocks. There have been some really exciting businesses internationally. I was looking at one of my top 10 contributors, I can't disclose it because it hasn't been disclosed, but is an international stock. Great company, well respected. Business is down because they rely on their operations being open, and so the market's kind of looking elsewhere right now. But I had a chance to buy a really fantastic brand at a below market multiple with a clean balance sheet, and you've never had this opportunity in the time this company has been public. The stocks performed well out of that period, but it's still very well positioned. It's mostly North American focused, but we have this big global network of analysts who are able to find really excellent ideas and if I can pepper in one, two or three really high conviction international ideas to enhance returns, I feel really comfortable doing that and have seen some success in doing that as well.

[15:53]

Pamela Ritchie: Couple other questions rolling in here. There's a question about the use of options, and I might add to that. One of the headlines of the year has been the day trader, options trader in the market. It is a theme, there's no question. So one on how you use them or don't use them, and two on just sort of the phenomena of it in the market if you have any thoughts.

David Way: In terms of the fund itself, we don't currently use options. It may be something that we look into in the future, but we currently invest in cash equities on the long side and shorting equities on the short side. As far as the market goes, I think it's great to see a new generation of investors get interested in the markets. I am concerned individually for some who are investing exclusively in options because of the inherent leverage in those. What it does mean is that for those stocks that are retail favourites – the kinds of stocks that are in the top 20 of Robinhood traded stocks – it does have a levered effect on the share price because the broker that's underwriting those options needs to go out and buy those stocks, or hedge the exposure of that option in the marketplace. So it can have a big levering effect in the individual equity prices.

I would say I'm macro aware in terms of where the assets are coming from. It doesn't really drive an individual equity thesis. It basically contributes to the overall valuation, which in my process I'm more style agnostic, so I don't say "I only invest in companies trading below X times earnings, or I only buy companies with Y% growth or higher." So it becomes an input or part of an input in my process, but I think for a lot of individuals this is likely to end badly as it has in the past. For some individuals, they'll recover and we'll have a lifelong interest in the stock market, and I think that's generally one positive outcome. It helps people understand that stock picking can add value over time which is what we're here to prove and deliver to clients.

[18:10]

Pamela Ritchie: The question of the pre-COVID world, the post-COVID world, what will be different… One of the things that seems sure to be different is a focus on ESG investing. I'm wondering how you incorporate that into the fund.

David Way: As most people know, ESG stands for environmental, social and governance, and there's been a lot of focus on the E. The decarbonisation opportunities, the need for change in the face of climate change and government action to encourage that change, very clear. I think there are a number of exciting opportunities on the long side to invest behind companies that either have the technology, the infrastructure or the management wherewithal to deploy renewable energy globally. I think there's a lot of great opportunities. What's unique about my process is I can short stocks and I don't like bad guys. On the E and S, there are a lot of companies that have either bad environmental practices or they're fraudsters. They see all this capital flowing in and they want to create a business model, not designed to generate renewable energy, but designed to harvest investor dollars. We saw it in the cryptocurrency bubble, we saw in the cannabis bubble in Canada. These "entrepreneurs" tend to move around to wherever the money is flowing. So while I'm really excited on the long side, I also see opportunities on the short side. You're trying to take advantage of people who are never going to build a business, they're there to defraud people.

Then on the S side, I think one thing that I really believe that is not fully priced into the markets today is the social pressures. The expectations of consumers, particularly young consumers, to see companies doing the right thing all of the time is only going to build. I have a 12-year-old daughter and I see it every day in terms of what her standards are for how a company needs to act in order to win her business. I look for companies that do bad stuff. They treat their customers poorly, they charge exorbitant fees, they rely on very high pressure tactics – either sell their products or enforce their contracts – and I bet that things are going to change. I bet that regulation is going to increase, consumers are going to shift away from their business, and ultimately we're going to see earnings decline. Not only is there a chance for offence on the exciting E side, there's a chance to short the companies that just don't have as big a place in the future of the consumer and commercial world as they might have had in the past.

[20:52]

Pamela Ritchie: Fascinating. And it'll make us feel a bit better to say we did something about it to your kids at some point, right? *[indecipherable]* we tried. Some questions are coming in on the currency front. As you mentioned, your mandate can be North America, it can also be a little bit abroad; do you invest for currency? We've mentioned the U.S. dollar, seems to be in some version of a decline, what do you think of that?

David Way: I think in terms of the overall currencies, I actually think it's a slightly bigger question because you also have international currencies like the Euro. So as Canadians we sit here, we often think Canadian dollar or U.S. dollar, but if we have a scenario where a company's producing something in the U.S. and the U.S. dollar is weakening and the euro is strengthening, well they might have more sales. Their German competitors may struggle to compete in a market where their competitors' currency is declining and they're more competitive. So what you could see is you could see that company sell more widgets, selling it a higher U.S. dollar price and paying the same U.S. dollar costs. I think what I'm looking for first of all is understanding what my currency exposure is within an individual company. There are no large currency bets within the. And companies can't really hedge. They can sort of protect one or two years of cash flow, but in the end, if they're in the U.S. selling things to Europe they are short the dollar and long the euro. They need to understand that and plan their business, and there are times where they can't really move production. So if you have a company that's set to win, they may have two or three years of growth that is under appreciated by the market because people look at things on an ex-currency basis, a constant currency adjustment.

But what I care at the end of the day are dollars in my pocket, whether that's Canadian dollars or U.S. dollars. So I don't hedge the portfolio at a high level, I don't place really big currency bets, but I do try to take advantage of opportunities where we can generate alpha by taking advantage of those currency mismatches when things are changing.

[23:00]

Pamela Ritchie: When you watch the cyber security breaches that have been announced over the last five days rolling out, what kind of opportunities can you find there with your feelers out?

David Way: It's been a very interesting backdrop because in the past two weeks we've been meeting… we used to do these road shows and we would go out and see companies, but because of our technology that we have within the firm, and our relationship with companies, we're having Zoom calls like everybody with the CEOs of the largest industrial and technology companies. Within industrials is defence, and so in the past two weeks I've met with the software companies that help protect against these threats and the defence companies that help governments protect assets both physical and digital from foreign aggressors. We've actually had a pretty interesting and rich discussion about what this means.

I think I'll start in the very short run; what it means is that if a company has been very negatively impacted by a security breach, I'm actually looking at it as a potential opportunity. The stock price is down a lot, there's a clear negative short term pressure that everybody understands and a potential recovery on the horizon that maybe people are too afraid to pay attention to or invest behind. So I don't necessarily buy the situation, but I will look at that company with a fine toothed comb and say, has the market overly punished this company? Is this something that we could be buying at a very attractive price believing that there will be positive change in the future and the company will recover? So that's kind of what I do in the short run.

I think what's also very interesting in the long run is that, in speaking with the defence companies, clearly the rules of engagement are changing and that the wars that were fought 50 years ago will look very different than the wars that will be fought in the future. So one of the key fronts in terms of interstate warfare is cybersecurity and these appear to be state-sponsored attacks. What I'm looking for are how the dollars are shifting. Defence budgets over time will shift away from tanks and more towards ones and zeros. I think that creates interesting opportunities for both the middle men who help arrange those relationships as well as the companies that are coming up with the innovative technology that are protecting digital assets from foreign attack.

It's been something that I've been following for a little bit more than 10 years as these levels of attacks have increased in volume, sophistication and the degree to which they're state-sponsored against government assets. So this is clearly a durable long term growth driver, and it's really important for executives to be able to manage against this because you often see CEO turnover when these attacks have happened, and if a CEO wants to do one thing in general it's keep their job.

[25:59]

Pamela Ritchie: It has been fascinating talking to you. I wish it could go on for another few minutes but we're out of time so we'll have to have you back. David Way, thank you for joining us today.

David Way: Thanks for your time.

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