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 welcome back Portfolio manager David Way who runs the Fidelity Long-Short Alternative fund.

David discusses his thoughts on inflation, current themes in the market, and how he's finding opportunities for alpha on both the long and short side of the fund.

David often uses a boat analogy to explain how he approaches long/short strategies. When the tide is high, it is a lot of fun and all the things that work below the surface can't hurt you.

When the tide goes down, that all changes - and you need to put the experienced person in charge and make sure you are in the widest channel possible to keep the boat safe.

David notes that there are many ideas starting to pop up on the short side, giving him more opportunities. He also points out that his fund is for people who are optimistic about the future. We can't necessarily time the market he says, but we can acknowledge that in today's market, there are many pockets of excess.

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[01:15]

[02:01]

Pamela Ritchie: David, I'm going to begin with the story that's in the markets today, is moving markets today. It's a long-term story though. Inflation. We are seeing yields clearly rising. What is that telling you about inflation and the potential for rates to go higher and for how long?

David Way: Yeah, it's certainly a very topical issue and I think it reminds me of almost ten years ago when I was covering life insurers when we saw the other side of this where rates fell to levels that we thought were unimaginable. And the effects on those companies and that industry was non-linear. It was quite a step change and what the future meant for those group of companies. And I think the way that I'm looking at inflation and interest rates today is thinking about this really in two parts. What does this mean for the real economy and what does this mean for the financial economy, the stock market, and financial assets?

And so, in the real economy the reality, for me anyway, is that interest rates are really low. Credit spreads really low. You might think of an industry that would be under the most supreme pressure imaginable, so Simon Property operates in the mall sector and they just raised $1.5 billion below 2% interest rate. So, one of the most stressed companies in the world has enormous access to capital at very low prices.

As far as running a business, if we do see some moderate increases in interest rates, I think it'll be more of a speedbump than a brick wall in terms of what it means for actually running a business. And for a reasonably levered company they should be able to absorb higher interest expense in their business. It's an altogether different question what it means for financial assets which rely on interest rates to set how much we're willing to pay for a dollar earned one year, two year, five year, ten years from now. And you can see in some of the more richly valued sectors of the market, the market is looking really far out because interest rates are low and there's low cost of doing that because you can't make money in five, ten-year bonds. And so there's really a connection, as Andrew Marchese was talking about in the session last week, between interest rates and how much we're willing to pay for a stock. That might not have any leverage on its balance sheet.

[04:26]

Pamela Ritchie: Very interesting. I'll follow up with this, and I know they're connected. When does politics, and we'll put it broadly, sort of referring to the United States but in some cases globally, when does politics get in the way of the reflation trade that we are currently sitting in? I mean we seem to be in the middle of this reflation trade. Does politics interrupt it, when? What do you think?

David Way: Well, thinking back to 2008 when I was sitting around with my colleagues trying to figure out through '08 and early 2009 what the government could do to help us with the great financial crisis, I think the lesson there was the fed didn't do enough quickly enough. Governments didn't do enough with fiscal stimulus quickly enough. And I think as we saw nine months ago as we entered into the COVID period drawdown, governments acted much more quickly, taking risks that they would do too much, too fast or too long versus the bigger risk of not doing enough. And I think that more recent lesson will be the more relevant one. I think the fed will remain more accommodative for longer because the risk of making a policy mistake if we see a little bit too much inflation is a better risk to take than not doing enough.

[05:42]

Pamela Ritchie: So, it seems like the [inaudible 05:44] on the fiscal and also monetary front can sort of help us bypass the political situation. Can investors rest at night a little bit on that?

David Way: Sure. That's like the big headline, which is I think that the Federal Reserve and the government with at least a clear majority in control or alignment of the houses of government under one party ensures that we will see accommodative action on the fiscal side. But I think the stock market to some degree has reflected that, and I think the Federal Reserve will continue on the path it's gone. Now I think when you dive down, and this is really my job at the picking stocks level, this will mean different things for different companies. I think one thing we've seen is that global supply chains really experience a lot of pressure, both from the political effects of tariffs we saw over the last three years, and more recently over the logistical problems associated with the virus. And I think as a result we've seen some of those supply chains shorten and the reason they got long in the first place was to help bring cost down. And when they shrink, we'll see the opposite happen. So I think we're seeing upward prices on almost everything.

[06:56]

Pamela Ritchie: It's a really interesting timing issue that you've just brought to bear there and you also used the terms "long" and "short", so I'm going to press you on those right now because that's exactly your strategy.

What kind of tools do you have with a long-short strategy to help you lean into exactly for example what you just talked about?

David Way: Yeah, it's a great question and it's something I've been asked quite frequently since the fund launch. One of the things I try to explain, I think Pamela you can join me on this little adventure. My brother is on the line too I think, and he's an advisor and he's been on this trip with me before. But my family vacations in Hilton Head, South Carolina, which is sort of a coastal area of South Carolina. I think most people on this have been to Florida. So, just kind of imagine you're with me there, we're on a small boat, obviously social distancing is a thing of the past, and it's an area where the tide goes up and it goes down, not unlike what we see in the financial market. And when the tide is high, it's a lot of fun. The dolphins swim beside the boat. You can take your boat and get really close to the land where some of the dolphins might be hanging out and feeding. You can let your kids drive and it's a great place for them to learn boating and water safety. And when the tide is high all the things that lurked below the surface can't hurt you because the water is kind of between you and the sandbank that threatens to beat your boat and stop you from getting to your destination. But when the tide goes down or goes out, that all changes. The water gets lower, the channels of safe navigation narrow and that's when you need to put the experienced pilot in charge, and that's when I sort of take control of the boat and make sure that I'm in the widest possible channel to keep the boat safe, keep me and my family onto our destination.

A long-short fund is a lot like that, and you're kind of looking for the widest possible opportunity set to stay safe and make money, to keep going, keep heading towards your objectives. And if you can only buy stocks on the long side as valuations creep up, as risks creep up, your opportunity set for finding great ideas narrows. What we're seeing now is more ideas pop up on the short side. "Hey, this reopening stock has gotten way ahead of itself," or, "This COVID beneficiary is still trading like it's going to have the same kind of business fundamentals in two years like it had last year," and that's just not going to happen. And so, my inbox of ideas around the short side are really starting to pile up. In a long-owned fund you can be like, "These are stocks to avoid," and in my fund these are opportunities for alpha and absolute profitability for unit holders.

[09:41]

Pamela Ritchie: I can't avoid asking you about tech regulations and the discussion around them, and obviously the events by some technology companies that they have deemed they needed to take recently. But you know, down the road how do you look towards this? It's been discussed for a long time but it seems like it's actually happening now.

David Way: Yeah. I mean it's been a topic for conversation. It's been in the papers in the past, and I think we've seen some unfortunate events in the last three to six months, and more recently in the last three to six days, that are really pushing this issue to the front. And I think the first thing is you have to be prepared. So we've been talking to tech companies for multiple years about regulation, what regulation would be good, what regulation would be bad. And I think it is still a little too soon to tell what the net effects will be, but I think more regulation is coming.

I think it's inevitable, and I think the other thing that might be more controversial and a surprise to people is I think there are opportunities where even amongst big tech players there could be beneficiaries. There could be companies forced to change the way they do business in a way that will be more shareholder friendly, more of an opportunity for higher earnings, etc. and there will be losers. And so, in a long-only fund you're kind of looking for those winners and in a long-short fund I'm trying to identify the losers as well on the short side. And so, I kind of have two hands of opportunities and as long as something is changing that's different from the market expectation, I have a chance to profit from it in the fund.

[11:12]

Pamela Ritchie: I'm just going to push you a little bit further on that exact example because it's a good illustrator about timing. So something like tech regulations, we don't know the date that they're going to be introduced, but as you say in your words, they're coming, but you don't know when, but they are. And so how does long-short allow you to sort of work with something that there is a cloud there, pardon the pun, but how do you work timing into that so that you don't just sit and wait for the eventuality? You can work in between.

David Way: Yeah, it's a great point and one of the things that I can use in a long-short fund is, if you're more of a venture than manager you might say, "I'm going to wait until the day before I think these changes get announced so that I don't have to take any risk about the earnings profile of these companies, or what happens to the overall valuation in the market." Whereas I can take a longer-term approach and use the analysis that our team has done, the conclusions that I've taken as a portfolio manager, and I can put them into action a lot earlier and worry less about the timing. Because if I'm worried about overall valuations, I can hedge out the valuation risk by perhaps shorting a company that may not gain from regulation, or may lose from regulation that trades at a pretty high valuation. And I can go long the company that I think benefits from regulation, and I can worry less about whether the stock is going to be more expensive or cheaper on an earnings multiple basis in the future. So, this gives me the flexibility to actually manage and reduce risk of taking an investment decision around something that could be uncertain in terms of timing.

[12:53]

Pamela Ritchie: It's so interesting. Tell us a bit about your geographic mandate. Is this largely North America? Where can you look for opportunities globally?

David Way: The fund is primarily focused on North America, Canada and the U.S. and I think that's 90% plus of the fund. And I currently own a small number of ideas outside of that area where I see really high conviction on the long-short side where I have really high confidence that the thesis will play out and will add to performance. But the focus is principally on North America and we have huge ability or track record in adding alpha in those markets. And the reason why I wanted a North American fund, and why I think it's relevant to investors today is we're seeing a re-emergence of commodity cycle. Corn is almost $5 a bushel again and kind of takes me back to when I was in metals and mining and ag analyst in 2007 and 2008. For me, the interesting thing is Canada offers a really nice opportunity set to the extent that the commodities cycle restarts to some degree. So, being on top of that market in addition to the U.S. market and some of the great businesses that we know and love and own, it's a really nice balance for unit holders to make sure that they're exposed to both these long-duration, exciting, long-term growth and value-creating businesses, but also some of the shorter-cycle businesses that have generated a lot of alpha opportunity in the nearer term.

[14:27]

Pamela Ritchie: How does energy fit into that for you?

David Way: Well I think for me the way that I've thought about energy is that we have a price that's moved quite substantially in a trading range. We had a global supply challenge where there was just too much supply.

And so I think what we've seen is we've seen sort of a cap on where oil prices can go, at least given the current technologies and regulations. And they also have off in the distance a real commitment amongst investors and governments to have a decarbonization of their economy. So, kind of a long-term demand challenge, short-term supply challenge, but you also have a bunch of people who haven't been driving who are going to restart driving. And oil traditionally has been a great inflation hedge, so I've actually always had room in the portfolio for best-in-class energy companies which were trading at a meaningful discount to the market because people were worried about all these other issues. But the reality is people are going to get in their cars a lot more in 12 months than they did 12 months ago, and we're starting to see that upward pressure on the oil price. By the time you see it it's kind of too late to make it a meaningful part of your portfolio, so just as I'm sort of style agnostic, I was there when it was hated and relatively unowned. And obviously we'll re-evaluate it as the share prices and commodity prices progress, but it's been a really nice inexpensive inflation hedge for the fund.

[15:58]

Pamela Ritchie: So fascinating. There's a very specific question that's come in, but it really goes to bigger issues as well. I'll put this to you from one of the investors. With COVID numbers still rising, vaccine programs rolling out lower than expected in many parts of the world, do you think the market has overshot the earnings picture, particularly for the second and third quarters of this year? Does this present opportunities for your short strategy wave of the fund? How do you look at earnings?

David Way: It's an interesting question and I think as far as the vaccine rollout, I think the very initial phases of the rollout have been slower than expected. But I expect to see a strong acceleration of the trend. We're even seeing it locally. In Toronto there was a vaccine centre that just opened or is just in the process of opening in the Metro Convention Centre and it's coming a month early. The hope is that the vaccine supply will follow that, and I think based on everything we know, we should expect it to. So it's kind of a hurry up and wait kind of scenario, but I think we will see accelerating deployment of the vaccine. We've seen countries like Israel do it very well, vaccinating 10% of their population in the first 20 days. Really incredible. And I think we will catch up. So, I'm optimistic about that.

I think the challenging thing is, I think we're about to enter the very darkest days of the COVID pandemic from a human toll perspective, and as someone who follows this very closely, from a human perspective it's kind of hard to see how can the market just see through this? I think the market is looking ahead to saying, "Okay, there could be some hiccups." Within the fund, I'm trying to position some of the short positions for companies that are really set to disappoint. They have overshot. But the market as a whole is saying, "We're kind of headed to a better future." And there's companies that maybe they've recovered to their pre-COVID levels, but business can actually be better in the future than it has been in the past. Think about the concert industry where you have a bunch of bands. Imagine sitting around as a band. You haven't had the ability to earn a living for 12 months and their fans are sitting at home. They haven't had a chance to see their fans. I've participated in a couple of virtual concerts, and while it is a novelty and the best we can do, it's really not a kind of thing you can repeat for a long time. I can just imagine in Budweiser Stage in Toronto being full every night. All those dark nights in-between shows gone, just bands trying to make money. Fans trying to reconnect with their friends, reconnect with the musicians they really enjoy, kind of the normalization stage could be really good for some of these companies.

[18:53]

Pamela Ritchie: If you can get two sets of tickets to two bands coming right out of this, who would they be? Let's say you need to get two in Toronto or something.

David Way: The Avett Brothers is my favourite band, and I'd love to see a reunion tour of Weezer. I think those would be the two I would choose.

[19:17]

Pamela Ritchie: Awesome. Awesome. Well, I hope that they make a trip up north for you on both of those. More questions coming in. We want to know about your favourite sector says this investor. What's your favourite sector and why?

David Way: Good question and I think really two and somewhat linked. And I think it's related to this normalization phase that we're about to go through. I think within the consumer discretionary space, we are seeing a meaningful change in consumer behaviour. It's been forced on us by COVID restrictions and when these restrictions open, we have formed a bunch of new habits. And I think in some ways that's going to lead to a hangover. There's going to be a bunch of companies that are suffering now. The world's going to reopen and they're going to hope business kind of returns, and it may not. Consumers will have moved on to new habits and new patterns and so we can debate about whether companies that service online shopping, ecommerce, etc. are too expensive relative to their growth or whatever, but there are a bunch of companies that will be accelerated in terms of their long-term decline towards obsolescence and bankruptcy.

And so there's a bunch of companies that I'm short and there's also a bunch of companies that I'm long in the consumer space. I also think in some respects retail real estate is a really out-of-favour sector. People think that malls are dead. My 12-year-old daughter is upstairs and she's part of the digital economy and before they closed the malls, I was sitting in the parking lot of Sherway Gardens where she was with her friends and she was asking me for more time in the mall. So, I have a lot of confidence that the very best malls will have a place in young consumers' hearts as they grow into their prime spending years, and the market is basically saying malls are dead. So, that's another area where I'm really looking to go against the tide of what people expect. I think really those two things are a little bit connected and not playing on opposite ends of the spectrum.

[21:34]

Pamela Ritchie: Very interesting. So, one theme, but as you say playing at different ends of the spectrum. The follow up to that particular question was actually comments on the green race. I don't know if you're going to fit that into energy, or if it goes more broadly to ESG which of course involves social and the governance as much as the environmental side of things. What do you think of this scheme that many are very optimistic about right now?

David Way: Yeah. I mean it's remarkable. The fund has been positioned to benefit from some of the less obvious ways that companies can contribute to the green revolution. I think it really is a very long-term unstoppable megatrend for sure. The world will look different in 10 years. I covered auto stocks in the mid-2010s and I felt we were really early, that we wouldn't really see electric vehicles take off until mid this decade and really become the leading source of propulsion as we head into 2030. But I think what we're seeing now is the future is now, and so I think the market has in large part reflected this technological shift. I think there are still some opportunities on the long side, but I also think we're in a bit of a – we've had a gold rush before but I don't think we've ever had a green rush like this. What that attracts are people who maybe don't have a great business model for introducing green technologies, but they have a great business model for stealing investors' money.

And so, I'm participating in a lot of these meetings and looking at companies that are new to the public markets that have massive market capitalizations in applied values and no product, no path to profitability. It's sort of like being able to see an industry that will change positively, and you just can't assume that everybody is going to win. There will be a handful of winners. There won't be a single winner. Some of the incumbents will change. Some of the new entrants will become incumbents. There's going to be a lot of failure. There's just so much money chasing this that that's what the fraudsters look for, people who are excited about a trend and don't ask too many questions about the business model. That's what I'm here for. I'm excited, but I'm here to ask the questions on behalf of my unit holders. What is your path to building a valuable business versus just kind of throwing darts at the board like some people might be doing today?

[24:16]

Pamela Ritchie: Fascinating. The question of where does this fit, I think you addressed where does the strategy fit in this moment in the markets. We did that kind of off the top, but where does this fit for individuals? Who is this for, this strategy?

David Way: I think the answer is it's for people who are optimistic about the future, that the world will be a better place in ten years, we'll have all these new technologies that help at least address or mitigate climate change, we'll have a better social world, we'll have economic growth, but who acknowledge that we don't know where we are from a valuation perspective. I think I would share Andrew Marchese's macro review that he shared last week that you can't necessarily time the market, but what you can do is you can acknowledge that in today's market there are pockets of excess. The overall market may not be overvalued and there may be big pockets of opportunity. There are periods and pockets of excess in the market like we're seeing today, and this fund is here to take advantage of that. And so the net effect for people who own this fund should be better performance with lower volatility and a chance for the fund manager to, again, kind of going back to earlier, navigate through the widest channel possible.

So, taking care for safety, but still focused on the end goal which is capital appreciation and helping clients achieve their long-term financial objectives. So, maybe the index funds or technology-focused funds if people are concerned about the risk or reward in those funds, this I think is a really good opportunity to participate in economic growth. I've generated alpha relative to the market from sectors outside technology in addition to generating returns from some of the exciting technology pieces. So this is a differentiated product both in its structure, how I approach the market and how I plan on or hope to achieve returns for clients.

[26:19]

Pamela Ritchie: I was really interested the last time we spoke about a phrase that you used, and you said that this long-short strategy allows you to fully invest your long positions, which I needed some explaining. Can you go through that? Why does it allow you to fully invest your long ideas?

David Way: I think there's really two things. The first is the actual structure, so being able to own 130% of the assets in long stocks, so I get to own 30% more of my best ideas versus a long-only fund, because I'm short 30% on the short side. And so the net exposure is $100, but I own $130 of our best ideas and I'm sure $30 of our best worst ideas. That's the first part. And the second part is it allows me to overcome the fear of losing money over things that we can't control as investors, whether it's valuation, regulatory risks, interest rate risk, things that we've talked about in our meeting today. It really allows me to invest in a way that I can put my money in what I view as the best opportunities in the market and sleep well at night that, if things bump in the night and some of these things that we can't control go the other way, that our unit holders are still going to be ahead.

[27:42]

Pamela Ritchie: It's great to speak with you David Way, particularly again at this moment in the market. It's very interesting to see what's unfolding. Thanks for giving us a really good look at the strategy that you're working with right now.

David Way: Thanks very much Pamela.

Ending: *[27:56]*

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