Digital Insights

Kyle Weaver, Portfolio Manager

Pamela Ritchie, Moderator

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Voiceover: Hello everyone 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 Kyle Weaver, joining us remotely from Boston. In October of last year, Kyle joined the team of portfolio managers on the Fidelity NorthStar and NorthStar Balanced Fund, and then in January his US Growth Opportunities Class was launched for Canadian investors.

Kyle takes a value approach to growth investing, and he looks for companies that have a set of secular business model drivers that can grow over a three to seven year horizon.

Today, Kyle explains to host Pamela Ritchie how he seeks out companies that have lower valuations relative to their long term earnings potential. He also reflects on investing through the ups and downs of 2020, and the overall theme of digitization.

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[01:48]

Pamela Ritchie: We're excited to have a chance to speak with you again, Kyle. How are you?

Kyle Weaver: I'm great. How are you?

Pamela Ritchie: I am very well, thank you. It's nice to see you. Let's get to that slightly counterintuitive value approach to growth investing. Just give us the definition of what that means to you specifically.

Kyle Weaver: It means that I'm looking for stocks that will prove to be extremely cheap over the fullness of time, ideally one or two or three times earnings or free cash flow, levels of cheapness that you don't traditionally see on any near term metrics even for what would be considered a traditional value stock. That's really what it comes down to. When you can compare current price to future value and see a discrepancy like that where you have a name trading at three or four times future earnings or future free cash flow, that tends to be a very attractive investment opportunity, especially if there's growth ahead of that. Those opportunities exist in the market. Luckily for us many, many market participants are very focused and very good at figuring out what earnings are going to be in the next six months or a year or two years. In my opinion that leaves a lot of room for us to try to figure out what a company's earnings might be three years, five years, seven years later, and fine the ones that really look absurdly cheap if you're willing to look out that far.

[03:18]

Pamela Ritchie: That's where I guess the magic happens because there are those that look cheap but are cheap for a reason, and then those that are cheap but you obviously expect them to do something very different. Do you have to take some bets within the fund? Explain how you manage to set up the framework for that to be the case.

Kyle Weaver: And cut me off if I'm starting to just tell an overlong story. I think it's helpful to just… The way that I came to kind of refine this philosophy was from running two different industry-focused funds for a number of years. People may or may not know I ran the Select IT Services Fund and the Select Wireless Fund beginning in 2009 up until 2015 or 2016. Those were very instructive to, kind of, I guess, crystalizing this investment philosophy and process. There were names in the IT Services Fund, IBM versus EPAM, which is a faster growing IT services company that was more leveraged to current trends in IT services spending. They both looked like they were about the same valuation on near term metrics, but one was a small unknown company with operations spread out through Eastern Europe as well as the U.S., and the other was IBM. IBM had a 4% dividend yield and was trading at $130 a share and was about 12 times earnings. EPAM was $12 a share and earning about $1, about 12 times earnings. You just fast forward 10 years and it is about 10 years from now. EPAM is $200+ stock, earning close to $6 a share. It was trading at two times earnings at the time. It has over that amount of cash on its balance sheet, and IBM is the same price at the same valuation. So which was really the cheaper stock? I would say EPAM was the cheaper stock.

The same if you look at AT&T versus American Tower. American Tower always looks much more expensive on all the traditional near term metrics, but you fast forward 10 years and American Tower has increased its earnings per share by around four- or five-fold and AT&T is still earning about $3 which it was 10 years ago. The stock that was cheaper in my opinion, the correct answer is very clear that the cheaper stock was American Tower or EPAM and that's what we're looking for just to crystalize that.

[06:05]

Pamela Ritchie: It's fascinating, that resilient steady approach. When we've spoken before, you've spoken about three buckets. I'll ask you to go through those because it's a good illustrative way of looking at the way you invest. Can you go through those for us?

Kyle Weaver: Sure, I love talking about the three buckets. Maybe I'll just talk about my favourite bucket first, which is the hyper-growth, breakthrough growth or tipping point stocks, call them a bunch of different things. The point that I'm trying to get across through the name of that bucket is the cheapness is far from being realized. It's very far out, it's very non obvious, at times these companies are losing money and it's hard… There's nothing in the current metrics that you would look at necessarily to say, "oh, this looks like a really cheap stock." These might be tech companies that are growing very fast but losing money, early stage biotech companies that haven't even gotten through a phase one or phase two or have any commercialized assets. And yet you know if you are right on the science for a biotech stock, or if you're correct about the unit economics on a technology or a consumer discretionary stock that it's inevitable, it's unavoidable that they will be extremely cheap at the price you're buying them at. Those are some of the funnest ones to find because often that's where they're unrecognized, they're trading the furthest away from what their fair value will prove to be. Those have really been where the funds, when it's distinguished itself, it's been because of those names.

The middle bucket is [indecipherable] strong long term growers. Those are the Blue Chip names that are in the index, they're well recognized and we're looking for continued durable growth when we invest in those.

Then the bucket that's maybe a little less conventional on a growth fund, because it's filled with what looked like value names, I call it the durable growth or resilient growth bucket. Those are names that… it's code for they look cheap even on current year metrics. The reason they look cheap is the market has decided that there's something wrong with the story potentially, or that the earnings is not sustainable, or there's no growth left and they'll go down so a market assigns a very low multiple to those names – like they have sometimes with credit card companies in the depth of a crisis or some basic material stocks that you'll find trading at trough multiples on trough earnings sometimes. There I think you can get paid to take the other side of the bet if our due diligence and our research suggests.

The thing that all three buckets have in common is all the names – whichever bucket they're in – have to look very, very cheap on a long term basis. You don't want to buy something cheap that's actually going to be expensive three years from now because the earnings went down, and you also don't want to buy something expensive today that's still going to be expensive because the earnings didn't grow up to expectations, or because it just absolutely started out at such a high level of valuation that it takes too long to grow into.

[09:30]

Pamela Ritchie: I was going to ask you this later, but just because you mentioned the biotech companies, early stages, really almost undeniable idea or piece of science that they're built around, but they're small and maybe haven't gone through testing. How do you find that? How do you find that and make it a possibility? What sort of expertise?

Kyle Weaver: With a lot of help. With biotech in particular, that's an easy one to answer because I never was a biotech analyst and it's been one of the areas that I've probably done the most work on just to catch up to the most basic level of competency to be able to follow people like Eirene Kontopoulos, and George Armstrong and others that are in our research department and running biotech funds of their own that helped me a lot with that part of the process. Other names in that space, it's a hodge podge, but a lot of working with analysts and just taking meetings and trying to cast a wide net and staying alert. Showing up, as Will Danoff says, is a big part of the process and just turning over those stones.

[10:43]

Pamela Ritchie: That's very interesting. We might swing back to some of those themes, telemedicine as well, within the health care space, but just to sort of narrow down further on the process. I think of Marie Kondo when I think of things that spark change, or spark reasons to change or whatever she calls it. But the idea that you would change the allocation within the buckets, or move… what does it take for that to happen?

Kyle Weaver: There is no top-down process for making that happen. My number one rule for what goes into the fund, whichever buckets it is in, is comparing price to future value. The number two rule is to be able to take advantage of volatility. If there are times in the market when, for example, a certain factor is leading or lagging a lot where the gap between price and value for certain kinds of names narrows quite a bit, or expands quite a bit. The great thing about a diversified fund is there's usually some of each happening which lets you reposition and take advantage of volatility. There's no top-down process. If I could fill the entire portfolio with high confidence names in the breakthrough tipping point bucket that I thought could be 10 or 20 baggers over a three or five year period of time, I may very well do that. That rarely happens because there's not that many ideas in that bucket, and in the spirit of wanting to be able to take advantage of volatility, you also want to have some things in the portfolio that if market conditions change you'll be protected with those and be able to take advantage of the volatility in another part. Does that answer your question?

[12:40]

Pamela Ritchie: It does, absolutely. One of the things I was also going to add to that is just the type of volatility and the market conditions that we've seen this year. It's been an extraordinary year. What did you need to do going through the crisis month, the March, April, into the spring? Do you just stick with it or what did you do?

Kyle Weaver: No, in March and April, full disclosure to the investors, I felt like I had to throw the original investment thesis out for every name in the funds and reconsider it. I was getting the news and the headlines and kind of responding, I would say, even in a lagging way than many people who really saw the eventual damage that the virus would do. The good thing was, as I went through the names in the fund to kind of re-underwrite the investment thesis for the new conditions that had arisen, the fund was extraordinarily well positioned for the new environment. I think now it seems maybe more obvious, but what really happened in 2020 was that secular trends that had been in place for a number years, and that were likely to remain in place for many numbers of years longer, many of those trends were accelerated and pulled forward. There is now a debate in the market where if we pulled forward does that mean we have to get back later and people are making those decisions and you have to get into the details of each business model.

We really saw e-commerce, that was a secular trend that had been in place for a while and it accelerated. Digitization of payments, shift away from cash, accelerated. Advertising, moving from traditional forums to the internet and to online video, accelerated. I think because I have been running a growth fund that focuses on finding idiosyncratic, secular long term winners with tailwinds propelling their business models forward, the fund just… many of the names in the fund were the ones that you wanted to own during that period of time. In some cases the disconnect between what was happening to the fundamentals and the price of the stock became extremely huge, and you had names like… Tesla is a good example of one that was very liquid, very large, so we could really put a lot of dollars to work. It went from – I have to the split adjusting now – just under 200 down to under $100 a share during that crisis in March and April. And we knew that company very well, it had been a long term holding in the fund, they had just raised debt so we had had a conversation with the company about how they were ramping operations, the balance sheet was in better shape than it had ever been, there is backlog, there's still supply constrain, not demand constrain on what they could sell. So it was a huge opportunity to just buy a lot of that stock at very attractive prices. They were cut in half even though their competitors were cutting back production, stopping their EV projects, probably giving up more ground to Tesla than they had before, and that's turned out to be a really good position for the fund.

Same with some of the e-commerce players that saw their business accelerate because their brick and mortar competition was literally shut down, just giving customers even more of a reason to shop online as they have for a Wayfair or a Carvana or Chewy's, for example. So those were some of the big repositioning events where the fund was able to take advantage of volatility that was right there in the marketplace.

[16:36]

Pamela Ritchie: The volatility, but just the amount of forced selling that was going on was such an extreme example of that but as you say…

Kyle Weaver: This is the best time to make a lot of money. When you have a forced indiscriminate seller, you can do them a favour and take it off their hands sometimes for an extremely great value.

[17:00]

Pamela Ritchie: We've spoken about digitization and you've spoken about it. It's a little bit of a given, to an extent, most companies have at least thought that through it appears. That said, how has the theme of digitization played out in the U.S. Growth Opportunities portfolio for you?

Kyle Weaver: Big question. It's so ubiquitous it's almost invisible. At the very foundations of digitization you have, how did the ones and zeros get there, and wireless data which we could start talking about the move to 5G and what that will bring, ways of monetizing that. There's digitization of commerce, there's the buy side, the sell side of that, there's the means of transaction. Not trying to dodge the question, but I think… let me use this as an opportunity to say identifying a theme tends to be the easy part of investing. I think the hard work that our team of research analysts, and then it's my job also to help that is, is the business model for this company in a position to take advantage of this theme that is likely to express itself through every aspect of our society. There are times when there's a company with high exposure to the theme but low exposure to the profit pools that are going to come from that.

Again, going back to running the wireless fund, it was very interesting to see that when smart phones and 3G wireless data – which was a huge step up, it was really kind of the first wireless data from 2G –became extant at the beginning of the last decade, or before the end of the last decade, there was reason to think that Nokia and Blackberry would be the huge beneficiaries as they sold more smart phones. There was reason to think that the equipment makers, Ericsson and it was also Nokia, would be beneficiaries selling the network equipment. There was reason to think that carriers would be able to add on $20 data plans to their existing voice [indecipherable] and that would be a huge benefit to the carriers. It turned out that really none of those companies benefitted because the business models were not robust enough to take advantage of the theme. Instead it really ended up being the tower companies that are big boring quasi… each tower is its own little monopoly on its own little piece of the network. Apple, which had not been considered part of the wireless ecosystem before, were the biggest beneficiaries of that change.

[19:48]

Pamela Ritchie: How do you look at 5G? Knowing all that and observing it, 5G is a theme, as you just mentioned it, but is it as easy as identifying… how do you identify the pieces within that that would be profitable?

Kyle Weaver: Again, with a lot of help. In many ways the players that'll benefit, there's echoes of what happened a decade ago with 3G in this. The difficulty now and what's a little different this time, or was different a year or two ago, is the people saw how 3G played out. There isn't the same… the market is a little smarter on this and names like American Tower and Crown Castle actually appreciated quite a bit into the 5G cycle. My job, no matter how much I like a company, I have to compare price to value at the end of the day and some of the opportunities in the tower companies were actually investing before everyone got excited about 5G. Since then, some of those opportunities, there's just less opportunity left so you go and find where the gap between price and value is again. That's kind of what we do.

[21:10]

Pamela Ritchie: Right. That's what you do. How much do you take a look at companies that are before an IPO, before being public companies? Is that part of the strategy? Are you looking at those stages when they're smaller companies?

Kyle Weaver: Yes. I love that we have the private equity team and have the private investing practice that we do. It adds a ton of value in two ways. First, we've had a good amount of success with the companies that we've invested in in that space, but secondly we learn a ton from them and we have relationships with these companies – many of which we go on to buy, be the largest buyers at the time of the IPO because we have the confidence and the conviction, we've seen them grow into the IPO-ready companies that they are later on. They also help us get insight into many of the mega-cap names that are potentially being disrupted by what these smaller companies are doing. I remember back to before I was running the Growth Opportunities Fund and I was a tech analyst in charge of the storage sector, we made a couple of investments privately in next generation storage assets that were using Flash and Cloud to disrupt the legacy storage carriers. Those investments turned out to be fine, they're both public companies now and we made good money on those. But as, or more, important was the insight they gave that EMC and NetApp and IBM, these legacy storage assets, they really do need to be… they're not as sustainable as maybe the company management teams would like all their investors to believe as they're being presented. You almost need to start from scratch from the ground up to build a next generation storage asset. You see echoes of this, some pattern of recognition there with EVs, for example, too. It's proved to be very, very difficult for legacy… Internal combustion engine, car companies make a great electric vehicle, but there too I think some of the insights we've had being public company investors in Tesla have helped us understand what's happening in the rest of the industry.

[23:29]

Pamela Ritchie: In the overall space. There's a question coming in right now looking out to 2021 and the vaccine rollout, which is certainly capturing the attention of pretty much everyone on the planet these days. To what extent do you wait to see how that rolls out to maybe wait to deploy cash? Are there any timings in and around the rollout of the vaccine that you're investing around?

Kyle Weaver: No, frankly. My investment posture on that theme is that I will be among the last to know, just like everyone else on this call, probably how things actually play out. Everybody has an opinion and I don't think anybody really knows. Similar to… this is the way I run the fund with respect to economic variables and macro factors and geopolitics also. I think it's better to just assume you don't know, or if you think you know you're probably wrong. But focus entirely on the business models that are going to be growing, strong, resilient, that have a secular tailwind that you know you can count on to continue, where you can have that conviction, rather than counting on an exogenous factor that you don't control. One thing I will say is that I do think there's value sometimes in investing on the basis of if not when. If you know something is going to happen but you don't know exactly when it is, don't worry about it – assuming you have the right business models with strong balance sheets and whatever and the gap between price and value is there. You could spend all day following the twists and turns and how the virus and the response to the virus is evolving, and really never figure out any business models that are going to be 5 or 10 times bigger than they are today if all you did was follow the news.

[25:38]

Pamela Ritchie: That's very refreshing, actually, to just say that it's an area that you just… because it is very noisy. That said, I'm going to ask you a further question on that front. For the discussion surrounding whether tech companies have breakups, whether regulations come in, all in that front, and the Biden administration's obviously getting itself together to take over in January. Is it clear that anything will happen on that front? Would it be horrible if tech companies, some of them, were broken up? Is that necessarily an awful thing?

Kyle Weaver: First, I don't think it's clear what will happen at all. Secondly, the reason that I have pretty sizable holdings, even though they are huge index positions, so having sizable holdings in them is not necessarily a statement of bravery. Most of the names that you're referring to are slight underweights. The reason that I still think that exposure to those companies is worthwhile – although I do think there's better opportunities elsewhere in the market – is that there is so much value in them. They are not expensive stocks and they're very, very strong companies. The reason we're having this debate right now is because people think that they're too strong. I think if you split them up there's actually so much value in the component pieces, when I look through those. It's not clear to me that that would be bad for the stocks, or bad for the market or bad for society. If you took Facebook and divided it into Facebook, Instagram and WhatsApp you'd have three… each of those would have a different investment profile a little bit, but those are still three pretty strong companies. Same if you took YouTube out of the Google core search, YouTube on its own would not be a unvalued company for what it has in its earnings potential going on. As I ponder the unponderables, what I try to think is is there support there, is there real value in these companies no matter what happens. I think there is a fair amount of value. That said, these are trillion dollar market caps, so in comparing price to value I often find that there are some less well-known names that hopefully can become close to a trillion dollars in their future.

[28:16]

Pamela Ritchie: Those are the ones that we look out in the decade to come. Kyle, I'll just ask you to leave us with a bit of a final thought, what you want investors to keep in mind about your fund, about your style going forward.

Kyle Weaver: I mean, because the fund has had, in the market generally, such a strong run I think it's a good time to tell investors be prepared for… there's going to be bumps in the road as there were in March and April. I think one of the things, one of the most maybe professionally gratifying parts of my career this year was to see that fund flows continued into the fund in March and April, which I thank the advisors for quite a bit because… and even if it wasn't my fund, even though it was my colleagues other growth funds, they were keeping their clients invested in the market at the most difficult time when there's massive uncertainty, when stocks are down a lot. But when the fund managers in charge of those funds are trying to reposition them to take advantage of what is yet to come and take advantage of the gaps between price and value just to come back to that again. I would just want to underscore that we're looking for ideas that can double or triple in value over a three to seven year period of time. It's hard to be too precise about what's going to come, but I think if you can hold two ideas in your mind there's going to be volatility, but I think businesses have proved to be very, very resilient over the last year or so, and I think there's a lot of really good business models out there.

[30:09]

Pamela Ritchie: Kyle Weaver, it's great to get your thoughts and as I say, it's quite refreshing, some of your approaches to things. Thank you for joining us and sharing your thoughts and process and ideas with everyone today.

Kyle Weaver: Thank you, Pamela. Great to see you.

Pamela Ritchie: Great to see you too. All the best.

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