Fidelity Compass

Global equity perspectives

Patrice Quirion, Portfolio Manager

Bryan Borzykowski, Host

[00:00:23]

Bryan Borzykowski: Hi and welcome to Fidelity Compass. I'm Bryan Borzykowski. The health of the financial sector continues to dominate the markets. North American and European equities opened sharply higher today as some investors believe the banking crisis has subsided. Are regional banks out of the woods? What does this mean for the Fed and its fight to tame inflation? Joining me today to discuss his investment style and opportunities in the current market environment is portfolio manager, Patrice Quirion. Patrice manages the Global Concentrated Equity Institutional Trust, a go-anywhere strategy that capitalizes on Fidelity's unrivalled global investment resources. Over the past year, Patrice's strategy was the third ranked amongst his peers in Canada. Patrice, thanks for being here.

[00:01:05]

Patrice Quirion: Pleasure to be here.

[00:01:06]

Bryan Borzykowski: The Global Concentrated Equity Trust, tell me about that. What is that exactly and how do you approach investing?

[00:01:14]

Patrice Quirion: I would say it's a fairly-differentiated product. As the name implies it is concentrated. It's about 50 stocks of the best ideas we find globally. It is very flexible; it's very different from indices. In terms of geographic allocations or sector allocations –not only it can but it often does deviate from indices weights by 20-30%. It's also across the market cap spectrum. It is not a large-cap only product. It's really dependent on where we find the best opportunities. There is usually a fair bit of small- and mid-cap stocks into the product. It looks very different, and it is also very active. Those weights will shift around in a fairly meaningful way, and it's always driven by the same investment process, investment style. It is the case where I think most investors –if we are true to ourselves– we all are looking to buy great companies at great prices. The question is not what are you looking for; it's how are you trying to achieve that?

[00:02:24]

In my case I try to approach that with a very contrarian view. My personal opinion and strong belief is that while the markets are directionally correct markets tend to overreact to trends, to dynamics that are well-established for some time, meaning not a few weeks but a few quarters, in some cases a few years, and as a result, too much capital flows into or out of that given trend. It can be by geography, it can be by sector, it can even be company specific. What I'm trying to do is go in the parts of the markets where a trend has been universally recognized as unfavourable, and where the market is likely to have overreacted. I always come back to that concept of where is market value versus long-term, normalized fair value.

[00:03:29]

The reality is ¬–I think for most businesses, at least that are of interest to me– the market is a lot more volatile than the intrinsic long-term value of those businesses. As a result, by utilizing a global research, by spending a lot of time on thinking of what is the fair value of a business in a normal environment –not necessarily today's world but the long-term average world that this company will operate in– where are the big disconnects between market value and fair value? This is how I try to find good-quality companies that have been overly discounted and approach them from a contrarian, longer-term focus opportunity and essentially just wait for the markets to pivot, for sentiment to change, for economic perspective to improve on a given sector, given geography. This is how I try to get those quality businesses at a reasonable price by hunting for those at times where others are scared and tend to have gravitated elsewhere in the market.

[00:04:40]

Bryan Borzykowski: What are some of those things that can impact a company's value where you're like, "okay, I'm looking at this and there may be an opportunity here"

[00:04:48]

Patrice Quirion: I would say there is a combination of things. Usually it can be very macro, so think global economy; think COVID shock. This impacts just everything. This is an opportunity to be contrarian at large scale in a way. Then there are things that are much more specific to one country. Think of China over the past few years, given slowdown, weakness in real estate, crackdown down on tech companies, trade tensions with the U.S.... just a lot sort of kept being piled on in terms of negative sentiment for an extended period of time. A lot of countries go through these phases. It might not all happen like this quarter or this year but, looking globally, there tends to be a region of the world that has sort of suffered a disproportionate amount of bad news or of good news. I won't be chasing the good news part, but I'll be spending a lot of my time on the bad news part. It can be countries; it can be sectors. I don't know.

[00:05:54]

Let's think about one that's been lasting for a very long time until recently: zero interest rates and the impact that add on the banking sector globally. Let's think about the banking sector in Europe, where rates were not only zero, they were negative. Just a devastating impact for that sector. But on the thematic of normalization, as we got closer, it provided opportunity. I would say there are some of these that happened at the very macro level; others that are more specific to a sector or country. And then there are a whole lot of them that are very specific to individual companies. A company like [TRIPS?] misses a product cycle or whatever it might be. That can create another source of, call it, more idiosyncratic as opposed to macro-driven disconnects and sort of excessive pessimism by the market that creates those opportunities to come in.

[00:06:51]

Bryan Borzykowski: There's obviously, certainly a lot going on right now in the markets, a lot of volatility. How does, more generally, just the volatility in the markets, impact your investments approach? Are you finding a lot of different opportunities today?

[00:07:06]

Patrice Quirion: I think, as a contrarian investor with the investment style I just described, I tend to welcome volatility. Volatility is what leads to those market overreactions. I'm not talking about volatility on a daily basis. It's more volatility that creates excesses after a trend has lasted for a period of time. I very much welcome that. This is where the portfolio

tends to be more active, capitalizing on those when they take place. And then, when we are in a period where that sort of normalization or there's less extremes being created, my turnover will reduce. I will rebalance the portfolio to some extent versus, as I said, I'm willing to go 20-30% overweight a sector or country at times of extremes. When we are not seeing those, we are sort of renormalizing. I will reduce those exposures and get ready to take advantage of the next one that will present itself.

[00:08:11]

Where are we today? I think we come back looking over past years of the period of, I think, great extremes. Growth had outperformed value to an extreme. The U.S. had outperformed the rest of the world to an extreme. Interest rates being at zero were probably an extreme. A lot of that seems to have started to inflect since September, October of last year. In a fairly short period of time, we've seen a fair bit of catch-up. We've seen Europe outperforming the U.S., value outperforming growth, interest rates obviously moving higher price significant way. We've seen the more cyclical value sectors coming up at the cost of the more tech growth sectors.

[00:09:01]

So where are we today? We are not at the extreme that we were mid- last year. I have reduced the bets; I have rebalanced the portfolio to some extent, but not to a full extent because I think that, while we have come some ways, if you stretch your time horizon the outperformance of all of what I've just described could be in the very early stages of that inflection point. What gives us that confidence? It's not looking at sort of long-term performance chart; it's really always coming back to the fundamental work. Where are those fair values versus market values? Despite some of that reversal we've seen, in a lot of cases –not to say in most cases– the stocks that I held, the exposures that I had built in the portfolios are looking less depressed versus fair value, but are still trading below fair value.

[00:10:03]

I think that could have more to go. Nothing happens in a straight line, so let's be careful about that. We come from a fairly-strong stretch of recovery. The portfolios have reacted fairly positively to that over the past six months or so. We've rebalanced, but I still remain confident on these trends, and that's where most of the exposures in the portfolios remain today.

[00:1030]

Bryan Borzykowski: We're going to get into all of this volatility, what's happening in the banking sector, but I have a couple more questions about the portfolio. One of the interesting things I think about what you can do, and what maybe not a lot of other managers can, is this go-anywhere approach. What does that mean? Can you actually look at any country around the world and find opportunities?

[00:10:49]

Patrice Quirion: Yes. It literally means I can go anywhere, any sector, any market cap. So, it is truly incredibly flexible of a product. That said, it is still managed within boundaries. Even if I were to be incredibly bullish on, call it, the more cyclical mid-cap European stocks, which I had a fair bit of exposure to that over the past few years, I will bring that up to, as I said, probably within bands of 20 to 30% overweights or underweights on sectors, on styles, on geographies, on market caps. It will remain somewhat diversified within that, so it is not a "let's move 100% of the portfolio on this," but let's move it meaningfully enough that it does make a difference, where it will act in a materially positive way if we are right on that.

[00:11:55]

I also try to manage it in a way where, as long as we identify a trend that seems to have been creating an opportunity; has overreacted to the downside. I think being contrarian we need to accept that I am more willing to be too early as opposed to too late. I am going to build exposures, build positions usually as the situation –or the sentiment towards that situation– has not pivoted yet because I think a lot of money to be made is around those inflection points. I want to be there before as opposed to chasing it afterwards. As a result, there's negative exposure to momentum.

[00:12:37]

But the reason I bring this is the perfect timing is elusive. I think it's nearly impossible to predict. I want to be in companies ¬–that's why there is this quality overlay on that contrarian value approach– I want to buy companies that if the stock continues to underperform for another week, another month, another quarter, another year at times ¬–hopefully not too often another year, but it happens– I want to have the confidence to be able to keep adding to those positions or to other similar securities to sort of increase the weights as they keep sort of going against us. To have companies where time is on our side is something that I keep stressing out because if you buy a low-quality business that is loss making or has a bad balance sheet, if the situation doesn't turn immediately you get nervous about adding to it because you might not see the other side of the environment, as opposed to if you buy highly-profitable good balance sheets, strong sector leaders. You have that confidence. For me, going everywhere means within boundaries and leaving the possibility to add to positions as they might –and usually don't– work right away.

[00:13:59]

Bryan Borzykowski: Just finally on the portfolio, concentrated, it's right in the name here and I think it's about 60 stocks that you ... 50 to 60. You have a huge universe to look at. First of all, why 60 and how do you get that down to such a small number given that go-anywhere strategy?

[00:14:16]

Patrice Quirion: A few things on that. I don't think there's a magic answer to how concentrated or not should a portfolio be. I came up with 50 and I know at times you'll look at the number of holdings, it might be a bit more. There's a few stocks that are being brought into, a few stocks that are being brought out of the portfolio, but I always target about 50. Why 50 or ballpark around 50? I would say one, it's a number that I'm comfortable being able...obviously, there's the Fidelity research team around us that's helping us stay on top of these businesses. I think it's also important for a portfolio manager, like a single individual, to be able to stay on top of the incremental developments; to make sure that we are frequently enough in touch with our analysts, in touch with the companies. To me, 50 is a number that I feel I can manage my time around.

[00:15:16]

If it was 100 stocks, I think it becomes challenging to be as intimate with the investment case, with the shorter-term developments, making sure the story stays on track, making sure, ultimately, our fair value estimates is something we have a lot of confidence in. Why 50 as opposed to 25? It would be even easier. I think there is an element of –as I mentioned earlier– to get the perfect timing is incredibly hard. I think if we have more balls in play it gives us more opportunities to have one of those stories that is starting to pivot and is working and gives us opportunity to take money off the table and put it elsewhere. I think if you have too small of a number of stocks, the odds are greater that you don't have that one where you can take profit to deploy capital elsewhere. I think it would lead to a portfolio that is maybe a little bit less active in terms of constant repositioning.

[00:16:25]

This is how I came to 50. At the end it's a number I'm comfortable with. It's a number that if there is one or two security that goes wrong –obviously not great, but it's not catastrophic for the entire portfolio. The last thing I would add is it allows me to target 2% weights. I know it will deviate in time, but I think the danger of having too many holdings is you become complacent on very small ways that are like 10 basis points of the portfolio that just don't move the needle, but you leave it there because you feel you can. I feel I cannot leave tiny positions in the portfolio. I need to make a call on it. If I'm not comfortable making it bigger, it probably tells me it shouldn't be in at all. I think that discipline around 2% weights brings that into action in the fund.

[00:17:20]

Bryan Borzykowski: Let's move to the economic picture, what's happening. Lots going on in the markets all the time –it seems like now but, obviously, the big news is banks, U.S., European banks. Where are we at? It's been two or three weeks since Silicon Valley Bank news came out. What are you seeing from the banking sector today?

[00:17:39]

Patrice Quirion: Obviously, the investor community is asking a lot of questions. It's never great to have banking incidents. It brings a lot of bad memories from prior financial stress periods. I would say a couple of things. I think the situation in the U.S. is likely to be very different than the situation in Europe. I say that despite acknowledging that the situation on Silicon Valley Bank is probably idiosyncratic. The situation on Credit Suisse is also probably idiosyncratic. Why are the situations different? First, I think that in the U.S. it brings a bigger focus and a level of risk around the entire regional banking system model or, basically, larger concentration of depositors, a few corporates or SMEs, and two very small banks. The risk of that creating nervousness, combined with the ease of moving deposits around in that very technologically-connected world that we are in today.

[00:18:50]

So, although Silicon Valley Bank was idiosyncratic, I think the risk is that it could bring increased concerns on the stability of deposit base in small banks in the U.S. at times of stress. And there will be times of stress. The economy is weakening. We can talk about what could happen to commercial real estate. We know regional banks are heavy into commercial real estate lending. I think there is a risk. Not saying it will happen, but I am not comfortable saying I will take 2% of funds, put it in a situation where there could be a risk of additional deposit flights following potential credit losses at some point over the next quarters and year. I am staying away from the U.S. regional banking market. It could be seen as contrarian. To me, it doesn't have that level of quality predictability that I'm looking for. The only banking exposure I have in the U.S. is via JPMorgan and I am in general not concerned about the globally-significant financial institution being at risk. If anything, they could be net beneficiaries from that deposit slice. So that's on the U.S.

[00:20:12]

In Europe, the portfolios I manage have a fair bit of European bank exposure. We spent a lot of time asking ourself, what does that Credit Suisse event mean for European banks? Is there any read-throughs from risk of deposit flights on European banks? We are generally fairly optimistic about that not being a meaningful risk. I think, although there are a lot of European banks, if you look on a country basis or direct competition or direct number of alternatives to a European household, there are not that many large financial institutions in each market. It's a little bit like Canada, where you have a handful of options. There are not very many very small banks that could be at risk of having deposit flights. I think this is a very different story.

[00:21:06]

Secondly, in terms of what happened in the U.S. where some regional banks were not forced to mark to market securities portfolios when they are held to maturity. This is not the case in Europe. I think the duration mismatch we saw in some instances of U.S. regional banks is not allowed in the European banks. I think the situation seems a lot more sound. And then, is there a little bit of risk from exposure to Credit Suisse. There was a concern about that. I think now that's being taken over by UBS ¬–that reduces that risk quite dramatically. All that to say, any bad news on banks –it's a highly sentiment-driven sector; will create oversized reactions. But my assessment today is the fundamentals are still sound. The European banks are still big beneficiaries of higher interest rates. I don't think it's still fully reflected in market valuations and, as a result, we are exposed to the sector. If anything, the last few weeks have probably brought incremental opportunity.

[00:22:13]

Bryan Borzykowski: What's interesting in all this is that the talk around interest rates has changed where people are now maybe expecting an interest rate cut in 2023. How have interest rates impacted the crisis in regional banks and how do central banks proceed from here?

[00:22:32]

Patrice Quirion: I think that's the big question in the markets right now, is interest rates led to that idiosyncratic event on Silicon Valley Bank; now it flipped around. The question is, is that stress on the U.S. regional banking system going to lead to a change of direction by the Federal Reserve? If I can explain in a second how that would actually take place is if we start to see lending being somewhat restricted at regional banks, we will see spreads on new loans increasing. In a way that could have provoked a situation where banks start to do the tightening work of the Fed. We know the Fed was sort of nearing the point where they were almost done. We can debate how much further they had to go, but we were getting there.

[00:23:29]

And if suddenly we were –it's still an open debate, we don't have the answer; we're monitoring that on a daily, weekly basis, but still an unknown– are the banks going to increase spreads on loans, essentially creating that additional tightening that another one or two Fed hikes would have done, which could provide the Fed with the story of "the work on inflation is continuing, we don't need to hike further", which means we are just that much closer to peak rates or at peak rates at the moment. That's what the fixed income market has essentially baked in over the past few weeks.

[00:24:08]

That said, the fixed income market has moved in a big way. If we had to remove one or two rate hikes, I think it would be a bigger debate. Now, the fixed income market I think is pricing in seven or eight rate cuts between now and the next two years, which seems like a lot at a time where the economy has been questioned, but has been resilient so far. The labour market has been incredibly resilient. Inflation is on its way down because over the next quarter or so, we will see incredibly easy comps in terms of commodity prices being down year-over-year, used car pricing being down year-over-year, transportation costs being down year-over-year. But the core wage-driven service inflation problem is still there today. And I think I am willing to take the view that there are higher odds that the Fed is not going to pivot to that extreme that the market is seeing right now.

[00:25:15]

We might be at peak; we might be looking at eventual cuts, but if it happens later as opposed to sooner, what the market is now expecting, I think it could bring some reversal of what happened over the past few weeks. I am, at the moment, working with the hypothesis that central banks will try to address banking system failures like we saw with very targeted liquidity measures as opposed to pivoting to the extent the market is pricing in on its overnight rates.

[00:25:55]

Bryan Borzykowski: Right. You make a good point. The issues with the regional bank have not stopped inflation. Inflation is still here, but we are entering this point where that year-over-year number could decline just because it was so high last July. Does that give sort of maybe a false impression that things are under control, which could send people in all sorts of different ways?

[00:26:18]

Patrice Quirion: I've been pretty vocal about that over the last quite a few months. I think the headline inflation number is going to contract significantly. The market could get excited about that return to 2% inflation. I am not saying it's going to 2, but in that vicinity. We could get initial excitement. I think we have seen some of that. Look at how cost of capital-driven securities have performed over the past few months. We've seen big rerating in that. I think it potentially leads to disappointment, as I suspect the odds are high or higher than maybe perceived that, although inflation comes back towards that 2% range over the next three or four or five months, the Fed won't move on rates because it will be transitory elements that are driving inflation lower while the core problem on the inflation picture could remain above target.

[00:27:24]

If we see that initial excitement by the market followed by disappointment because central banks don't move –or, as we saw by the ECB a week or two ago; they still increased– that could lead to some reversion. But this is all very technical short term. I don't want to leave the impression that this is how the portfolios are managed. I want to leave the impression that we think about that, and we have a lot of resources to help us think about those kinds of questions.

00:27:52]

Bryan Borzykowski: We did talk about banking, but there's obviously many other sectors and opportunities out there. Given all that's going on or your long-term outlook on the markets, what other opportunities or areas in the market are you looking at?

[00:28:04]

Patrice Quirion: I would say in terms of the larger buckets of exposures in the portfolios we would find European banks still there, we would find China –it is not large, it's not to the extent of 20, 30% mentioned earlier, but some overweight positions in China. On the reopening theme, so playing, an example of a retailer that would benefit directly from a reopening. We're seeing a lot of pressure in large cap tech, so there is some exposure through that just based on very discounted prices versus fair values. That will lead to events. We just saw Alibaba in the news a couple of days ago splitting the business. I think sometimes we may not have the catalyst, but when there is a big enough disconnect between price and value, things happen. I rely on that to some extent. I'm not relying on a catalyst per se to close that. I'm relying on time and value being recognized eventually. That's another pocket of exposure in China.

[00:29:08]

I would say there's also a bit of exposure across sectors that are recovering, reopening, but have not fully recovered or reopened yet. I would name a couple of those. I would say travel –travel has rebounded domestically, but international travel has not rebounded significantly yet. Yes, the stocks have rebounded; I think there's potentially quite a bit more to go on companies that are exposed to that. In the portfolio you would find not cruise lines or airline –those are low quality stocks– but you would find commercial aerospace suppliers. Think of Airbus, which is a large position, or GE, which is a large position. You'll find a software company that sells to hotels and global distribution systems like GDS for travel. What Expedia and bookings rely on; a Spanish company called Amadeus. That has high-quality characteristics, but it's driven by a further improvement into the travel recovery.

[00:30:19]

Those are the kind of exposures I like to continue to maintain exposure to. I would say a little bit on trucks and autos, basically sectors that have been really impacted by supply chain issues, that are typically very cyclical exposed to the economic environment stocks where the markets turn quite negative as the outlook for the economy is clearly not rosy here. You look at car manufacturers or truck manufacturers and their production volumes are still meaningfully below normal and there's still a ton of pent-up demand. I think they might prove to be more resilient in the cycle simply because you're starting from trough conditions that I think is not fully reflected in the market. So that's another pocket of opportunities.

[00:31:07]

Bryan Borzykowski: We just have a minute left, 30 seconds left. You have talked about kind of the opportunities today and a little bit more in the short term. When you're looking longer term, what is the long- term case that you're making for investing and the opportunities that you're looking for?

[00:31:25]

Patrice Quirion: From my standpoint there will always be disconnects. There will always be overreactions. The market tends to crowd one way or the other. I think this is systemic; that's how markets work. As a decision maker am I going to follow the trend or am I going to take advantage of the trend that has been over overexaggerated? So, that's always a strategy. There will be points in time where there is a lot of these opportunities while/where we'll build meaningful positions in the portfolio to take advantage of that. It becomes waiting for inflection points. The last message I would like to leave is I feel quite strongly, actually, that we are at one –or have passed like six months ago– one of those big inflection points where the market is starting to realize that the world of zero interest rates is long gone and all the repercussions that will have –initially it's a bit of economic stress. I understand we have seen some of the move, but not all of it.

[00:32:27]

But let's think what happens when we are on the other side of that economic stress, when the market starts to think about economic recovery as opposed to how bad does it get? I think the world is going to look very different, where we will have a positive growth outlook with rates that are, hopefully –and, I believe, not at zero–, in a world where suddenly the big drivers could again be like China reopening. China has been really weak for a number of years, and that will have implications like driving a lot of emerging markets with it. It will have a lot of implication on European exporters that have big exposures to China.

[00:33:09]

I think that could be a pivot point of geographies ex U.S. performing better, style that is more value working better because there's more cyclicality into that style and we could be in a world where we will look for reaccelerating earnings – not saying for the next few months or even a couple of quarters, but let's think like further out, and maybe a world less driven by valuation expansion that has been a big part of the story up until a year or so ago. I think my style, I'm looking at that world as something that I very much welcome. We'll keep maximizing our resources and our discipline in that style to try to take full advantage of it.

[00:33:53]

Bryan Borzykowski: Great. I'm sure everyone tuning in today was also welcoming that recovery and seeing those investments go up. Thank you so much for being here today.

[00:34:02]

Patrice Quirion: Thank you, Bryan.

[00:34:03]

Bryan Borzykowski: Thanks for tuning in. As always, if you have suggestions on future topics or guests you'd like to see on the show please share your ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. I'm Bryan Borzykowski. Thanks for being here.

Issued by Fidelity Investments Canada ULC ("FIC"). Read this important information carefully before making any investment. Speak with your relationship manager if you have any questions. This document is based on information believed to be reliable and is provided for information purposes only. Fidelity, its affiliates and related entities are not liable for errors or omissions or for loss or damage suffered.

Fidelity portfolio managers, analysts or others may express views about a company, security, industry or sector. Their views may not represent the views of Fidelity and should not be relied on as an indication of Fidelity's trading intent or strategy performance.

This document may contain statements that are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Fidelity Investments Canada ULC ("FIC") does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed by FIC when developing forward-looking statements. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

Past performance is no guarantee of future results. An investment may be risky and may not be suitable for an investor's goals, objectives and risk tolerance. Investors should be aware that an investment's value may be volatile and any investment involves the risk that you may lose money.

Fidelity does not provide tax or legal advice and this webcast is not an offer or solicitation to buy. This document cannot be reproduced without the prior written consent of Fidelity.