Fidelity Compass

Unearthing Value in High-Quality, Mispriced Companies

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Bryan Borzykowski, Host

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Bryan Borzykowski: Hi and welcome to Fidelity Compass. I'm Bryan Borzykowski. There's been some optimism around a bounce back of small-cap stocks lately, but these companies have always played an integral part in a diversified portfolio. How are next guests using their small-cap strategy to find new opportunities, and why are small-caps an exciting asset class? Joining me today to discuss the global small-cap space are Portfolio Managers Connor Gordon and Chris Maludzinski. Connor and Chris co-manage the top-rated Fidelity Global Small Cap Opportunities Institutional Trust. Global Small Cap Opportunities has outperformed 100% of its Canadian peers since it was launched four years ago. Connor, Chris, thanks for being here.

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Connor Gordon: Thanks for having us.

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Chris Maludzinski: Thanks for having us, Bryan.

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Bryan Borzykowski: Why don't we start off with a bit of an introduction to the strategy. Connor, tell us what you're doing and a little bit about how you approach small caps.

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Connor Gordon: We start with the basis that to outperform the benchmark you have to do something different than the benchmark. We take a strategy of…we define it as quality plus change equals mispricing. Think of quality as the filter and change and dislocation as the trigger. I think we start with the basis that the market is pretty efficient, in the middle the market's pretty efficient but there's a bit of a flaw. The market extrapolates. We really search for situations where there is change and dislocation which creates uncertainty. Through that uncertainty with Fidelity's research advantage we try to find situations where we can form a differentiated view of the future.

So, 6,400 stocks roughly in the benchmark and then we use quality. To us that's profitability; it's predictability. We're looking for companies that have great free cash flow dynamics, high return on capital that allows them to grow at higher rates over time and then we're looking for predictability. We like to be able to look out at least three years and have a pretty good sense of what a company is going to earn in a reasonable range of outcomes, obviously. The future is uncertain, but really putting a big emphasis on predictability.

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Chris and I over our time at Fidelity we've met like hundred, thousands of companies and we have what we call focus list of, call it, 600 to 700 stocks globally that meet our quality hurdle. Then what we're doing is really just waiting for something to happen. We're waiting for that positive change. To us that can mean a new product, maybe it's a new management team, maybe a company's doing an acquisition or an investor or a spin off but something where the structural earnings power of the business is taking a bit of a step change. It looks a lot different than it has in the past. Through that uncertainty we can have a differentiated view.

On the flip side, we're looking for what we call temporary dislocation. Think of this as good business, temporary but fixable problem. The key is fixable because many problems are structural and what we're trying to do is say, okay, this is a good business, it has a temporary problem. We can continue to underwrite that earnings growth over three or four years and over a period as the problem resolves itself or the problem gets fixed, we can underwrite multiple expansion. I think what we do is when we focus on these kind of tails of the market we avoid the efficient middle. I think if you invest in efficient markets, you're going to get average returns. We're looking for those tails, those exceptions, the exception to the rule that can give us some really exceptional returns.

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Bryan Borzykowski: Chris, that's a great approach but you have beaten 100% of your peers since inception. Why do you think that might be? Why would you have that kind of performance, do you think?

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Chris Maludzinski: Well, first of all maybe just talking about the attractiveness of the small-cap asset class. Huge bond, over 6,000 stocks in the index so it's a stock-pickers paradise and that's exactly what both Connor and I do as well as the broader Fidelity complex. More importantly than the large universe in small caps is it's really prone to mispricing and dislocation. If you think about the average small-cap company, there's only four to five sell-side analysts that cover that company. This is versus the S&P that has 28 sell-side analysts. We're able to leverage the broader Fidelity complex, have a differentiated view from consensus and our job is to be right and it's much easier to be right when there's less eyeballs covering the companies.

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Bryan Borzykowski: You were talking just about exciting asset class. What are you seeing from the space? Why is it so exciting?

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Chris Maludzinski: For Connor and I, the big thing is it doesn't suffer from the law of large numbers. We're looking for these exceptional management teams, these exceptional companies that have really high return on invested capital but more importantly large growth runways in front of them. We're able to invest in these companies that have three, five, ten years of runway into the future to compound above market rates of return. It's much harder to do that in our large-cap counterparts when you're starting from a trillion-dollar market valuation.

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Bryan Borzykowski: When you're looking at the small-cap space, I guess what defines small cap in your fund? Are these companies across all sectors or any different areas of the market? What are you looking at?

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Connor Gordon: I think small cap in a Canadian context versus a global context maybe there needs to be a little bit of differentiation. The average market cap of the company that we're investing in is roughly $5 billion might be the average for the mandate. We tend to focus on companies in that billion to 10 billion market-cap range that have ample daily liquidity that we can invest in. I think in a Canadian context, I think many people think of small caps as junior mining companies or unprofitable tech companies with a strategy on a whiteboard and a couple of people in a garage. What we're really doing, kind of going back to that quality, that hurdle, focus on profitable proven businesses, business models that generate tons of cash that have proven growth prospects and can continue to grow into the future versus speculative companies that have unproven business models and shaky prospects.

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Bryan Borzykowski: What makes Fidelity just so well-positioned to run a global small-cap strategy?

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Chris Maludzinski: To our earlier point, we have over 140 analysts across the globe that Connor and I can leverage. These are analysts that are sitting in Asia, sitting in North America, sitting in Australia, sitting in Europe, and we're able to communicate with them in real time. We can send them a message, stay on top of our current holdings, generate new ideas and we're on a face-to-face Zoom conversation a few minutes after messaging them. I think that's a big differentiation between Fidelity and our peer set. I think that a lot of our peers have two, three or four people sitting in one office trying to cover the globe. I think we do things a little bit differently. Furthermore our emphasis on bottom-up research at Fidelity I think is a big differentiator. We spent over ten years as analysts, Connor and I, on respective sectors and as analysts you spend more than half your time on the road meeting with management teams, going to conferences, doing site visits, really kicking the tires, making sure that you have an edge on your existing holdings as well as generating new ideas. I think that the amount of resources we have to dedicate to the research process sets us apart from our peers.

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Connor Gordon: I'll maybe just add on to that, Bryan. With a global mandate, I think it's really imperative that the firm have global resources. Chris touched on 140 analysts around the world who wake up every single day. They are meeting companies, they are going to trade shows, they're publishing research on our internal system, and then filtering that up to portfolio managers like Chris and I. When you can sit down with a team and leverage those best ideas from around the world it becomes the job for Chris and I to then kind of put those ideas into a relatively concentrated portfolio. The bulk of the value at risk is in the top 40 to 50 names globally. We really get cream of the crop, try and find the best ideas from our analyst team that fit that criteria that I was speaking to earlier. We're looking for that positive change or that temporary dislocation. When we can do that we have the idea generation potential to really keep the bar high. When we keep the bar high, we think we can deliver some really nice returns over time.

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Bryan Borzykowski: Can you talk a little bit more just about how the analysts' work funnels up to you? Are you talking to them? You said there's a lot of research they're doing. How do you incorporate those ideas and how often are you and Chris kind of talking about where to take the strategy?

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Connor Gordon: Perfect example: I am flying to our London office on Saturday night. I'll be there, I think we have 60 people on the European team there, and I'm attending a conference. For example, so a U.K. SMID Cap Conference Monday, Tuesday and then sitting down with our team for two days. It's a really collaborative approach where some of the analysts will attend meetings with me and then I'll sit down with the people that — that's just U.K., obviously — and then our European team as well — sit down and just go through our best ideas and make sure, hey, are we on top of all the best ideas that our analysts have. I think that's really imperative when you're running a global mandate. There's obviously a lot of companies, a lot of news flow, a lot of things happening geographically, a lot of things happening within sectors. There are different sector trends within different geographies, so you need to be on top of these things and I think having a team with open lines of communication really enhance that dynamic.

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Bryan Borzykowski: Chris, I'm curious about meeting with CEOs. You both mentioned that you're meeting with people. How often are you having those conversations with the top people in these companies? On that best ideas list, are those the companies you're talking to or is it broader than that?

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Chris Maludzinski: If you look at our global meeting schedule, I think there's probably between 10 and 20 meetings that are hosted globally any given day. We use this obviously for idea generation as well as our existing holdings within the portfolio and it's a really good way to get a sense of their capital allocation ability. When we meet CEOs and CFOs, we want to make sure that they're putting fund holders' money to work in a profitable way. We want to make sure that those incremental returns that they're generating are extremely attractive. If you look across the globe, in Toronto, I think, today roughly ten meetings that are in-house.

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Connor Gordon: I think one of the interesting things — I hosted, for example, a Swedish company this morning. You asked about the quality list and we meet companies, we're constantly meeting companies and some people ask like, why do you keep meeting the same companies year after year after year? A big part of it is institutional knowledge and creating a baseline. Part of our job is to evaluate people and part of evaluating people is ultimately did they do what they said they were going to do? We have an internal research database that goes back 20, 30 years. When we are doing research on a name, one of the great things that we can do is we have this historical time capsule of we are meeting — it could have been three, four CEOs ago but you can kind of see that evolution of a company through historical research.

I think just for us, it's imperative to write that down, have it recorded so that we can go back and then the next time we meet a company maybe they are have delivered on the targets. Maybe they've changed the goalposts but you're not going to know whether what they're doing if you haven't recorded that and you haven't met and you have a historical baseline to compare against. That's one of the things that we that we like to do is just constantly meet new companies. The reality is too, sometimes you meet a company and say this doesn't sound like a company I might invest in but the world changes, the world changes, the economies change, businesses change and kind of going back to that emphasis that we have on positive change. Sometimes a company might have a new product and it can completely change the operating dynamics the business has. You're constantly meeting these companies because you don't know when there's going to be a new opportunity to come on.

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Chris Maludzinski: I guess just touching on Connor's point, with that note system it's a very quick way for Connor and I to get up to speed on a new company because if you look at the breadth of our research coverage spanning back decades, within an afternoon we have a pretty good idea of the corporate history and of the management teams and how they've changed over the years. I think that's a very big differentiator versus our peers.

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Bryan Borzykowski: Let's talk about the strategy itself. You've talked about your approach which we can dig into a little more but tell me about the Global Small Cap Opportunity strategy itself. You are looking for the best stocks. How does that sort of work around the world? Do you have more concentration in certain geographies or just what's in this strategy?

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Chris Maludzinski: It's a global go-anywhere best ideas fund. We're looking to just put the best ideas across the Fidelity complex into the portfolio regardless of where they may be located or what sectors they are in. We can leverage our own experiences as analysts rotating among different sectors over the past 15 years as well as our analysts' best ideas.

We're not looking to put X% of the fund in chemicals or X% in consumer. It's just building the portfolio from a bottom-up basis and delivering all the alpha from idiosyncratic stock returns. If you look across, I guess, the geographic kind of allocation we're overweight North America now but that's an output not an input. That's where we're seeing the most value. Given the concentrated nature of the fund those geographic allocations will move around over time depending on where our best ideas will surface from.

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Connor Gordon: I think philosophically Bryan, you just think of the Canadian context but if you're investing in a Canadian-only, small-cap fund, for example, you're only seeing 5% of the global opportunity set. If you're investing in a U.S.-only small-cap fund, you're seeing roughly 50, 55% of the opportunity set. As Chris said, our philosophy is let's take the biggest opportunity set we can find. Let's not be pigeonholed by geography and let's just go bottom-up and find the best opportunities that we can. Our allocations, we like to say that volatility creates dislocation, dislocation creates mispricing. It's in those times of volatility that we can really differentiate and the mandate and the strategy can really differentiate its return profile. I think what that allows you to do is when you're not constrained you can go where the opportunities are. Our turnover, our allocations are very opportunistic. Fidelity Global Small Cap Opportunities, it's in the name. We want to be opportunistic and have as few constraints as possible. Obviously, there's a few risk constraints around sector allocation, etc., but we really don't want to be pigeonholed.

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I think what you've seen historically is that global go-anywhere philosophy on the fund, really focusing on what Fidelity does well, and what Fidelity does well is idiosyncratic stock-specific research. What we want to do, we talk about that positive change, that temporary dislocation, focus on the companies, we want the returns to come from stock selection. Historically, a little over 90% of the alpha is attributable to stock selection and we don't want to get into the trap of making an implicit factor bet, making a very large geographic bet, making a very large sector bet. We want the returns of the strategy to come from that stock selection because I think that's what Chris and I do well. It's what Fidelity does well, and I think it's how we differentiate ourselves over time rather than making very large macro top-down bets.

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Chris Maludzinski: I think another point that we just can't emphasize enough is the amount of emphasis that we put on corporate governance. When you look at our geographic allocation, we're overweight North America and I think a lot of that is that that's where you find the best management teams. We want to make sure in the small-cap landscape that we don't get caught offside investing in a management team that's just looking to enrich themselves or make poor deals, bad capital allocation. We want to make sure that every dollar that they're investing for our clients is put to good use. I think that's something that we pay a lot of attention to.

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Bryan Borzykowski: How many stocks do you hold in the strategy. What's around the number?

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Connor Gordon: The core value at risk that we consider tends to be about 40 or 50 stocks. There's a tail of positions, obviously. I think the most recent disclosure is 72 stocks. Look, there's always a tail of things that we're working on. We'll take an initial position. We'll continue to prove out the thesis and then there's always things that are moving out. That's just the dynamic of portfolio management. The core value at risk tends to be that 40 to 50 names. Try to keep it relatively concentrated, try to maintain a high hurdle and try to make ideas count. When we're doing the research when you're right you want the idea to make an impact.

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Bryan Borzykowski: How do you know, when is it time to sell? Can you keep these companies or do they grow too big that, hey, now we have to sell these? What's that selling strategy to keep the best ideas in that concentrated portfolio?

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Chris Maludzinski: There's, I guess, a number of outcomes when we sell a stock. It's either we're wrong on the stock or our thesis is proven to be invalid, we take our losses, move on. One thing we make sure we don't do is if we have a losing position is to wed ourselves to that stock and add more as it's going down. We're pretty quick to cut our losses. On the flip side, if the stock hits the upper end of kind of where we feel that it should be trading, we'll either sell or trim the stock depending on its long term kind of growth outlook. The third one is just we have certain positions that we have that have an embedded catalyst that we're looking for and when that catalyst plays out the thesis is proved correct and we'll sell and move on to our other best ideas.

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Connor Gordon: I think that one of the things, just going back to risk. Chris touched on it but one of the key reasons to sell is sometimes you just have a better idea so keeping that hurdle high. What we try to do when we're looking at a new idea it's not just is this good enough to be in the strategy, it's is this better than something we already own. Going back to my prior point of not wanting to make large implicit bets, if we're looking at a chemical company, for example, it's not just, okay, is this better, it's like, do we already own, do we already have exposure to chemicals but maybe that idea is better. We're always looking to high grade the portfolio. We're always trying to maintain the embedded future returns and keep the prospective returns of the portfolio as high as it can be. A lot of it can just be hydrating the portfolio.

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You touched on size or had a question on size. The strategy does not have a hard sunset clause but 30% of the mandate can be above the small-cap index and the whole point of that is if we find a $2, 3 billion company that we know and have known for a long time, we've done a lot of the diligence, we don't want to be forced to sell if you find one of those really good long-term compounders. We do have a bit of wiggle room, call it, to continue to hold the small-caps that become maybe mid-caps.

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Bryan Borzykowski: Every time we do these webcasts with you guys, I always love the rapport between both of you. I'm sure people are wondering how do you complement each others' styles and why Connor and Chris together on this strategy?

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Chris Maludzinski: Yeah, sure, I'll take that one. We started at Fidelity back in 2008, 2009 and I don't know if you're familiar but we have a rotation program among analysts. Connor covered health care, IT as well as industrials, and I covered everything else, consumer, communication services, financials, and resources. The idea is Connor and I view the world very similarly, invest very similarly. They put us two together and we have the whole market covered. Over and above that, we also have built-in devil's advocate so we can debate ideas and really come to a better answer by putting us both together.

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Bryan Borzykowski: Connor, anything to add to that?

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Connor Gordon: No, it's exactly what Chris said. We have this historic, we call it spheres of influence. Chris is the financials expert and if we have a financial or insurance company in the fund, I get to poke holes in the thesis. I think it's probably a good point, our reasons for owning a stock are always recorded so if our thesis is X, Y, and Z, I get to say, well, on point Z, have you considered this?

I was in London last week, I was meeting with a competitor. They were saying this....how does that impact the stock? When you have two of us, when we have that team of 140 people around the world, you're always trying to update your information. Every day in the markets, it's like a card game. Every day in the market a new card gets turned over, you get new information and you're trying to constantly update your view for new information. I think when you have two people that view the world similarly but have a different historical background you can really push each other to try and get to the best answer.

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Bryan Borzykowski: We have just a couple of minutes left. I know we have a couple examples that illustrate your strategy. Chris, what's the stock example that you have that can really kind of drive this home?

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Chris Maludzinski: We have a ton of examples, probably only time for one each. Fairfax Financial is one that is in the fund that we've owned for a couple of years. If you think about Fairfax, really high-quality company, it's compounded its book value per share by 15% since inception in 1985. The tough part about being an insurance company is that you're subject to interest rates where you have a big fixed-income portfolio and the ten years post GFC under a zero interest rate regime was very tough for a lot of these companies. Returns went down, valuations came down, and especially so for Fairfax because they weren't willing to reach for yield as a lot of their peers did. If you look at their financial results from 2010 to 2020, they were actually very inferior to what they were from 1985 to 2010. Their returns came down to mid-single-digits, their book value multiple that they were trading out of the market came down to below one times, deservedly so, and the market kind of left it for dead.

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When we were looking at the market in 2021, the Fed started lifting off zero and we were looking at which insurance company globally is best positioned for that. You come back to Fairfax with that big cash portfolio that they had and they were and they were also trading at a 30 to 40% discount to book value.

That's exactly what we're looking for: an underearning company that has really bright future prospects and trading at a discounted valuation. You fast forward to today, they're earning $30 a share, now they're expected to earn 150 and their book value multiple's gone from 40% discount to trading at one times book. If you think about it today the future is really bright. They should deliver a 15, 16% return on equity which deserves a premium-to-book value and today it's trading at one times.

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Bryan Borzykowski: Connor, share an example.

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Connor Gordon: Maybe going back to my health care roots, a company we continue to own is a company called Demant. Demand is a Danish hearing aid company. This is kind of an example of why we go global. There's five companies in the world that make hearing aids, really four kind of core and they're all in Europe. When you expand that opportunities set, you expand that universe, you get access to companies that are only in a certain geography, for example. Hearing aids, always a great long-term industry structure. I'd always admired the company. They've grown at high single-digit rates for a long period of time, oligopolistic industry structure, four people, four companies that make it so margins were always really high, but the stock was always perennially too expensive. It would always traded at 25, 30 times earnings. It was always at a level that we couldn't underwrite the returns that Chris and I are looking for.

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Around the time we launched the mandate back in 2019, something happened. They got hit with a cyber attack. This is an example of that good business gets hit by a temporary problem. There's a lot of market uncertainty, their ERP system is screwed up, basically for six, nine months they have no idea what sales and profits are going to be, they profit worn, there are a lot of uncertainty. We can look out two or three years and be confident in what the earnings power of that business looks like. It trades down to a level that we think is, call it, 15 times earnings and we still get that underlying growth, call it, 8 to 10% and then over time you get that rerating in the multiple. That's kind of like an archetype of kind of what we are looking for and when I talk about that great business, temporary problem.

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Bryan Borzykowski: Great. I wish we could keep going but I'm going to leave it there. Thank you both so much for joining us today.

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Connor Gordon: Great.

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Chris Maludzinski: It's great to speak with everyone.

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Bryan Borzykowski: Thank you all for tuning in on Fidelity Compass. As always, if you have suggestions on future topics, 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 Brian Borzykowski. Thanks again for being here.