

Fidelity Viewpoints®: Market Sense

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TRANSCRIPT

SPEAKERS:

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HEATHER HEGEDUS: Hi, there. Thank you so much for making the time to join us for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity. Quarter three earnings season is underway right now. It is arriving at a time when investors could use more clarity. The markets have been struggling a bit as persistent inflation and rising bond yields weigh on consumer sentiment. And the technology sector in particular, has seen increased volatility as investors question whether higher interest rates could make it harder for companies to deliver the returns that they've been promising. Yet, still important to note, the S&P is still up double digits year to date.

So to help us make sense of these headlines and what they might mean for investors, we're thrilled to be joined today, as we often are, by Jurrien Timmer. Of course, he is Fidelity's Director of Global Macro. We're also really excited to bring to you today Ramona Persaud. She's a Fidelity portfolio manager with more than 30 years of industry experience. Not really sure how that's possible, Ramona. You don't look like you've had 30 years of experience. Must have started when you were a child, but she currently heads up the Fidelity Equity Income Fund, among other funds. And she's always looking for attractively priced stocks in unexpected places.

Basically, you're a value shopper, Ramona. You are looking for a good price point without having to sacrifice quality, which is something I think that most folks would really appreciate. So we asked her to come on the show today to talk about some of the trends she's seeing right now. Thrilled to have you both here. Ramona, welcome to *Market Sense*. And this is a particularly well-timed show to be talking about diversification.

RAMONA PERSUAD: Yes. Thank you for having us, Heather.

JURRIEN TIMMER: And I'm a super fan of Ramona, so this is a real treat. So welcome to the show.



HEATHER: All right. Let's get right into it today is Tuesday, October 20. Jurrien, let's start with you, as we always do. So it's been a challenging few weeks for investors while this bull market just passed its fourth anniversary—pretty remarkable. The market has moved a bit sideways, though over the past few weeks as we hit that anniversary, and it's experienced some volatility as bond yields move higher and investor sentiment cooled, as I mentioned earlier. Initially the market concerns were related to rates, but would you agree, it seems concerns may have shifted a little bit and now, those concerns are about whether earnings growth will deliver?

Can you talk about that shift and what's prompted these concerns?

JURRIEN: Yeah, so there are a lot of crosscurrents that the markets are having to digest. But you're right, the cyclical bull market that we are still in today started almost exactly four years ago, October 13. So four years and one month. Over that time span, the S&P is up about 120%, but of course, inflation since that time is up about 25% in total. So the actual real return is closer to 90%, which is still very respectable. And the main driver, obviously, has been earnings, rising margins, rising valuations, and right now, we're of course in an earnings boom, but we also have rate pressure from the bond market.

So if you think about how to value a stock—and Ramona can give a clinic on that—but you try to anticipate cash flows or project cash flows. And then, you have to discount those with a cost of capital and out comes the present value of those future cash flows. And that's the price you should want to pay for a stock or an index or a business or what have you. And so, the cost of capital has been rising, but earnings have been booming. So the two sides offset each other.

But now, there are some questions about not so much earnings growth in general, which is very, very robust, but the AI story. And last week of course, we had some news there about the more speculative sides of the CapEx, hyperscaler build out and yields rising on those names. And that again, rising cost of capital. And what's interesting is that for the last five years or so, it really has been pressure coming from rising rates, that has been the primary thing that might concern the market.

But last week when the AI names corrected some more, bond yields actually started to go in the other direction. And so, it almost is the bond market is getting concerned that the AI story is so big, what we call systemic, that if something goes wrong there, it's going to affect the economy, earnings growth, Fed policy, and interest rates. So again, we continue to navigate all of these crosscurrents.

HEATHER: Right. Let's stay on the AI topic for a moment, Jurrien. And some of that recent volatility was investors questioning the level of debt that's been issued and the credit worthiness of some of these companies—how valid do you think those concerns are?

JURRIEN: It's always a valid concern because the demand for capital during this AI boom is extraordinary. I mean, trillions of dollars. And on the equity side, the question is, will these companies, these hyperscalers, will they make enough of a return on that CapEx to keep taking to keep growing their earnings? But on the other side of it is the credit side. And that is, is too much money being borrowed. And what is the return on that borrowed money versus how much it costs to borrow the money? Again, cost of capital.

So if you're a big hyperscaler—like Amazon or Meta or Google, not to be too specific about it—but if you're a big investment grade company building out this compute infrastructure. And your investment grade, and you have good cash flows and you have other you're in other businesses as well then, so far, they've been relatively immune. But if you have these one-trick-ponies that are only in this space to do this CapEx and they're not investment grade, that's where the pressure is right now. So the question is, how contagious are they? Will that infect the bigger ecosystem?

And we don't really know the answer. My sense is that they won't. But it does bring back some memories of, for instance, the fiber optic build out during the 1990s, during the internet boom or even subprime during the financial crisis. Everyone thought that was not going to be contagious. But it was. And again, not to connect too many dots. But these are the questions that the markets are asking, that investors are asking. And I think it's good that they're asking it because otherwise it's just this runaway train and runaway trains sometimes go off the tracks, but if the train slows down, maybe it's more sustainable.

And I'm hoping that that's how this turns out with the questions that are currently being asked.

HEATHER: Yeah, I know you've said before, in a bubble there's so much euphoria. Those questions aren't even being asked. So at least we have some critical thinking going on. But like you said, the big question is this just some bad apples or is it a little bit more systemic? So this kind of segues perfectly to our discussion with Ramona. Ramona, in the last few weeks, investors have certainly understood the value of making sure their portfolios don't solely rely on the AI trade. One key asset class investors can consider as a counterbalance to AI are dividend stocks, which offer potential value diversification benefits as well as income.

And searched across all sectors of the market for what you call value-oriented needles in an expensive haystack. I was wondering if you can explain what you mean by that, and what your process is when you're seeking to uncover these kinds of opportunities.

RAMONA: Absolutely. Thanks for the question. So let me start with what I'm trying to achieve. I'm looking for excess return, like everyone else. But additionally, I care a lot about the volatility inherent in my return profile because this really impacts the investor experience. Investors are really susceptible to volatility in that they can buy and sell at the wrong times, and this can

negatively disconnect any realized return that they achieve from the underlying fund's return. So the smoother the return profile, the less churn there typically is, and the more aligned then the investor experience is with the funds. And from that, the more trust I then earn from the investor to navigate on their behalf.

Another thing we talk about a lot is crowds. So in terms of what I look for in companies, it's been a very crowded market. It's been crowded around the AI trade, as Jurrien highlighted so well. And as a value-leading person and an investor, and maybe even as an introvert, crowds to me can feel more like risk than reward. So I instead like to invest for three things—I call this my trifecta—of value, quality, and income.

Whereas, the crowd in the market of late has been more in structural growth and lately in very cyclical growth, it's been a really narrow market, again, very high momentum and very high concentration. So to me, crowd following has felt increasingly risky and definitionally, when you have crowds you don't have value, so you lose value the more and more something gets crowded. So I tend to companies that have either short term apathy or some controversy that gets reflected in their price, but not in their long-term quality or value.

Stocks generally de-rate or devalue from skepticism over setbacks or business changes from the market focusing elsewhere and forgetting about them or from what we call exogenous, which is things that are out of their direct control. So an example of this recently is geopolitics. So things like war or tariffs. I tend to like what I call purposeful companies that quietly build value behind the scenes and against apathy or controversy about their stocks. So I'll give you a couple of examples.

An example right now is in pharma. There's a lot of skepticism over their pipelines. Another example is in consumer stocks. They're challenged by affordability and we're seeing that in areas like housing and retail. By contrast, tech is now a huge part of the market. In my universe alone, tech is 20%, so I can't ignore it. So what I have to do instead is to wait for periods of a lot of fear, such as maybe what we're in right now, to consider derated valuations. And in very fast moving innovations, such as what we've seen with AI, fear and exuberance shift really quickly so there's always an opportunity if you're patient.

HEATHER: And you've talked about purposeful companies that their mission and also that build competitive moats. What do you mean by that?

RAMONA: Yes. So I tend to think of things on continuums. In this market, for instance, I think of glamor versus anti-glamor. These are, like, my terms. Or crowded versus isolated, as I just mentioned. I like to find balance in my portfolios using valuation as a guide. So especially in the last several years, there's a lot of exogenous risk, as I mentioned before, out of our direct control. So again, things like geopolitics wars, tariffs. So I've been focused on resiliency.

By resiliency, what I mean is building a portfolio that can sustain a range of outcomes. So because we've been living in a world where we don't what kind of headlines we're going to be waking up to on a daily basis. So this has meant, for me, building different kinds of baskets. I think of company turnarounds, just plain cheap companies, companies undisturbed by the glamor of things like AI or a couple of years back, GLP-1's or even AI laggards, because in each of these baskets, there's a way to protect against factors that we can't control. We can also argue that AI itself is a basket, but for me valuation has not been protective.

And to get to your question, usually I'm looking for what I call purposeful companies. They know their why for existing and how to execute on their mission. So through excellent operational and capital discipline, so how they run their operations and what they do with their cash flow—and these are really hard, hard skills to develop, hard capabilities—these companies build competitive moats. And then, they slowly and quietly expand those moats around their businesses—so moats are essentially like protection—and then they become industry leaders.

And then what I do, so I like to identify companies with moats. And then I like to wait very patiently for hiccups in their business so that I can buy that kind of quality business at D-rated prices. Or I look for companies that are becoming better businesses, they're early in their moat building, and the market doesn't see it yet. So what really helps us with this is having really deep research across many disciplines. This is what makes this kind of investing possible. So examples for us at Fidelity are fundamental research, quantitative research, investment grade, and high yield credit research, sovereign research, emerging market debt research, and so on.

So through every major market panic, I've found, there's a research team with really deep expertise who can help us to navigate through downturns.

HEATHER: Clearly, you're doing all that research every single day. You're on the ground and you're doing the hard work that it takes to uncover some of these opportunities. So speaking of looking beyond the glamorous stocks, I thought we should also talk about dividends. Many of the resilient, durable businesses that you are saying you're drawn to also happen to be dividend players, meaning, of course, they periodically distribute a portion of their profits to shareholders as cash or additional stock.

So this seems to fit your investment philosophy because dividend stocks aren't really typically known for explosive growth. What role do you see dividend stocks playing at a time when many investors do have they might be following the crowd, like you said, and they may have a little bit of overexposure to AI?

RAMONA: Yes. So by virtue of returning cash to shareholders, it means that a company is at a more mature stage of growth, they don't need all their cash for reinvestment. And because dividends are a commitment of ongoing cash returns. So you can't, one day do it in the next day,

not do it, you have to commit. They're really a signal from a company that the company is so stable and resilient that it has more cash than it needs. That's a signal of strength.

I sometimes say that this is a lot like marriage. When you're at a more grown up stage of life and you can make a really big commitments. And I come back to the word "purposeful" and "moat." So again, going back to moats, I especially like dividends for their protective features. So they can protect against portfolio volatility because they represent inherently more stable businesses, which stocks of which are going to be more stable than the market at large. And they can protect against inflation, because such companies tend to have what we call real pricing power, which means that they can price over inflation in their products. And so, that typically will translate into real income growth, meaning above inflation again.

And then lastly, dividend paying companies are fairly anti-correlated to the glamor trade. So the most negative correlations—Jurien mentioned this as well—against AI today are in health and staples, which are two really large dividend paying sectors. So as an example, just to bring this to life, there's a major biopharma company that has a big drug that lost exclusivity recently. The market is pretty fixated on this without believing that the rest of its portfolio can outgrow the loss. So this leaves the stock much cheaper and high yielding than the market and with less volatility. So that's entirely my trifecta of valuation, quality, and income.

So I look for situations like these across industries all around the world, and I wait for market skepticism to provide attractive buying points.

HEATHER: Jurrien, I just want to bring you in here to talk about income. Can you just talk a little bit about why income has become so important across asset classes in the backdrop that we're in right now?

JURRIEN: Yeah, I think for me, it's crucially important as we think about diversification. So again, in the old days, 60/40, it was fairly simple. I mean, it's never that simple. But for decades a simple 60/40 strategy worked really well. 60% in stocks, 40% in investment grade bonds. You got a 9% return and a volatility of nine. Those are risk-reward characteristics that a lot of people can live with.

But then four years ago, after COVID, when inflation rocketed higher and the Fed had to slam on the brakes, rates have been coming up and that has made bonds, but also other parts of the stock market, very competitive. And at the same time, we think about the last 10 or even 15, 17 years of this structural bull market that we've been in, and especially the last 10 years where it's been the Mag Seven and other mega cap stocks really running the show, leaving everything else sort of behind, not only within the S&P 500 in terms of value stocks, but also globally, Europe, Japan, emerging markets.

And now we're at a point where this structural bull market is so mature. And all of this stuff is happening with AI where again the Mag Seven, these big mega cap trillion dollar stocks are actually burning through their cash flow. Rather than returning the cash flow to shareholders as dividends and buybacks, they're spending it on CapEx. And that's not a bad thing, it might be a very good thing. But it creates a more unknown income stream to investors. Whereas if you get the earnings return as buybacks what you're getting. So I think Ramona's portfolio and just that whole style box in general, sort of income oriented stocks, I think can be a very important diversifier.

And if you divide the S&P into the AI side, which is about half the index, and the non-AI side, which is the other half, the non-AI side has almost no correlation to the S&P, which is remarkable. It's only about 30% correlated. So it actually truly acts as a diversifier. So that if the AI story continues to win, then it's great. But what if it doesn't? What does that do to the market beta, which is the market return, that we get? And at those times, you want to have some income producing sides, not only on the bond side but within the equity side, and I think Ramona's sort of sandbox is the perfect place to look for that.

HEATHER: Ramona's sandbox, I like that. Hey, Ramona, let me just play devil's advocate with you for a minute because obviously bond yields have been the big story. Not as much last week, but they're pretty attractive right now. And they're supposed to be the less risky asset class. So what can dividend stocks offer that investors might be able to get from fixed income alone?

RAMONA: And I just want to thank you for teeing that up so well. Thank you. That was very kind. So just to throw out more correlation numbers. Jurrien used 30%. If you put that on a time series, if you look at the most stable parts of the market on a time series versus a basket of AI, that correlation is at peak negative. So health and staples are right now negative 60 to negative 80% correlated, or call it anti-correlated with an AI basket, and it's even more impactful when you look at it over time. So just to throw that idea of anti-correlation out there. But what can bonds offer that stocks dividends from stocks cannot?

So yes, bonds, and stocks that pay dividends are each forms of income investing. Bonds tend to focus on capital preservation, stocks tend to focus on capital appreciation. What I'll say is, during periods of higher inflation, such as today, it's important to have growth in your income above inflation. Again, this is what we call real growth. In periods like these, the market values companies that can price their products above the rate of inflation. We call this pricing power, and if you combine that with some cost control, pricing usually has this really powerful effect on the bottom line such that earnings grow in real terms.

Since dividends are paid out of earnings, or more specifically, free cash flow, the companies paying dividends are also then providing you a cash stream that's growing in real terms. And so, that's the difference from your typical fixed-income security that's paying out a fixed amount every period. So with inflation hurting everything gas, consumer goods, high quality companies.

So those with, again, what we call real pricing power, which usually comes from businesses that have really strong competitive positions. So those purposeful, high moat companies, those companies protect the cash flows. The investor gets back in real terms. That's the advantage.

HEATHER: That's the advantage. Can you talk a little bit more about what types of companies might offer that kind of inflation protection, Ramona?

RAMONA: Yeah, so this is where quality really matters. So back to the, again, purpose and moats. So companies that have built competitive advantages, whether in the products that they provide or how they price those products or in running lean. And the ultimate trifecta is great product price really well with a company running its operations really lean. And so, I love those inside of the entire global marketplace. So those kinds of businesses build the moats that protect against the vagaries of decisions that they cannot control, such as, say, war.

And the problem is that it's hard to keep your moat a secret because it shows up in your superior results. So if I want to buy that kind of company, that kind of business, at a protective valuation, I have to be willing to wait a really long time for the market to be distracted by something shinier. A lot of times, those companies that are purposeful and have great moats, they're super boring. So it's like watching paint dry, but they're incredibly resilient companies, so I have to wait for the market to be distracted by something shinier, or for the market to just be highly skeptical because maybe the company had a difficult quarter. And so, the market just has a lot of skepticism, and I get my chances to do so, but I have to be what I call endlessly patient.

HEATHER: So you're a very patient person, and I get that from meeting you, too. You're very calm, cool, and collected, Ramona. You've talked about why quality matters. I know valuation also matters, though. How does that factor into your investment process, right now?

RAMONA: Yeah. So as we just went through, investors can now get their income more broadly from fixed income and from stocks, which is in strong contrast to 10 years ago, when the market expected rates to stay at 0 forever. And so there was really only income outside of fixed-income investors also can get their returns from hyper growth, as it's been a kind of growth that's far exceeding inflation. So I think of the choices—fixed-income, dividend stocks, hyper growth stocks—I think of those choices in terms of valuation. Hyper growth typically does not have the valuation protection that I would like. Bonds do not have the inflation protection that I would like. Dividend stocks currently have both.

So much of consumer and health, for instance, is cheap and is yielding. And if I can find that real pricing power that we've talked about, it's a nice setup for durable returns. I'll give you another example—housing affordability is terrible right now, of course, because rates are so high and that's due to inflation. Home improvement stocks are some of the higher quality parts of housing, and they're fairly cheap because housing activity is so low. So to me, this is like a coiled

spring for if we get any easing in inflation or any easing, more specifically in the geopolitical conflict that is contributing a lot to that inflation. So I tend to coiled springs where there is long term business durability.

HEATHER: It's 2:24, so I wish we could talk all day, but we do have to wrap the show in a little bit. But before you go, I wanted to ask you, I mentioned you've been doing this for three decades, which I really still do not believe, Ramona. But at any rate, you've managed money through all different kinds of market environments in those three decades. So just would love to hear from you about when you look back at your experiences, which ones taught you the most about building a portfolio that can weather uncertainty like we find ourselves in right now?

RAMONA: There are three over time that have been really meaningful to me. The first is the banks coming out of the global financial crisis. I covered the banks going in, I covered housing before that, and then I covered I did European stocks into the sovereign crisis. So I've had a lot of experience with all kinds of different crises. And the market was essentially looking backward instead of forward at an improving business. So there were many times coming out of the global financial crisis itself, of course, but then even coming out of it, when the banks were carrying tons of capital to absorb future shocks, they were carrying lots of legal costs. They were still putting up a double-digit return on equity, but they were at times being priced, being priced as if there were a crisis right around the corner. So that was incredibly powerful for my investor brain that was still learning at that time.

Another example is pharma companies around the same time were at single-digit multiples of earnings because their patents were expiring and the market did not have any belief in their pipelines. So we have a very similar setup today date, actually, in many of these pharma companies, an extremely good research. And then there are some other examples in tech. So about 15 years ago, certain tech companies were maturing. They were at rock bottom. They were starting to pay dividends and they were so cheap. So you really didn't need a lot to go. So you were getting dividend growth, far in excess of earnings growth because they were raising their payout ratio. That was a great setup and great learning opportunity.

And then, more recently, as I mentioned before, the market, during periods of extremely high innovation shifts between fear and exuberance rapidly. So if you can be patient enough, you can get some very strong companies during periods of fear. So examples recently are Google got to a market multiple a few years ago, Samsung got to 1 times book value a couple of years ago. And then these stocks have been really strong since then because you're able to buy ultimately strong businesses during periods of fear for deeply depressed valuations. So those are some examples through 20 years of investing.

HEATHER: So value, quality, and dividends, as well? That's the process. That's what you're looking for. And patience is a virtue. That's what I learned today, Ramona. Thank you for taking us through your process. Truly fascinating. Before we go, we have time for a quick Timmer's Take where we ask you Jurrien, what's on his mind and what he's watching for the rest of the week? We had an eventful week last week, Jurrien, coming out of that, what are you watching for the rest of this week as we look ahead?

JURRIEN: Well, of course, we're in earnings season, so we're all looking at that to see if this earnings boom will continue unfettered. But more importantly for me is just how interest rates are behaving relative to these opposing forces. You've got high oil prices, you've got sticky inflation. But now, you have this AI thing where yields are rising there and whether bonds are starting to switch from the inflation worry to the growth worry. So I think that's where I'm going to be spending my time for the next few weeks.

HEATHER: All right. We really appreciate that, Jurrien and Ramona. Terrific conversation today. I learned a lot. And like I said, it's just really cool to hear about what your process is like on a daily basis. To our audience, if you're interested in researching mutual funds like Ramona's, you can head to [Fidelity.com/FundScreener](https://www.fidelity.com/FundScreener), where you can choose your criteria and get fund picks from Fidelity portfolio managers, just like Ramona, hear what's in their sandbox and independent experts as well.

All right, on behalf of Ramona and Jurrien, I'm Heather Hegedus. Hope to see you back here next Tuesday right here at 2:00 o'clock Eastern. Have a great rest of the week, everybody.

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