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Fidelity Australian Equities Fund update

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Global Cross Asset Specialist, Lukasz de Pourbaix, recently sat down with Fidelity's Head of Investments, Paul Taylor, to discuss performance and positioning.

The Fund has generated a significant amount of alpha since inception, but in more recent times performance has softened against the benchmark. Can you elaborate on some of the key points relating to recent performance and talk about similar periods?

We are extremely proud of the returns we've generated for investors, but we do go through periods of underperformance. And over the last 20 years we have experienced three of these:

- The first was 2005/06, when we saw a lot of private equity interest in the stock market and a big focus on financial engineering. Basically, private equity firms were looking at buying low-quality businesses but gearing up the balance sheet. Over time, those businesses, were going up on the back of takeovers, but in addition other low-quality businesses were similarly buoyed. We don't think long-term value is created by re-gearing a balance sheet and taking money out of a business, and therefore didn't participate. Ultimately, this turned out to be a good decision as highly leveraged companies were hit hard by the GFC, and under-performance was reversed.
- The second period, 2016/17, is what I call the Trump bump. When Donald Trump became president of the US, there was a lot of initial excitement that he would cut red tape, get things going and lower taxation, and what tends to happen in that environment is that a rising tide lifts all ships. So once again, some of the lower-quality businesses did better in that environment. As Trump's term went on, we saw a much greater focus on tariffs and protectionism, which is negative for growth, and we saw higher quality business outperform.
- Over this last period of 2022/23, we've definitely seen macro factors at play. Higher inflation, higher interest rates, and what I describe as a big dislocation in macro variables. And because inflation and interest rates went up, structurally challenged or lower quality businesses tended to out-perform.

It's interesting, because the common theme in each of those three periods is that non-fundamental things have driven underperformance. And once the market refocuses back to fundamentals, you tend to see those quality stocks show value once again. It's probably an opportune time, then, to recap your process and explore the concept of an ideal company in terms of the structural forces as well as the cyclical forces. Can you elaborate on that?

It's a good point, because we do spend a lot of time analysing companies and looking at what we think are cyclical moves and what are structural moves. So, obviously, the ideal scenario is you want to be investing in a company that's in cyclical decline but which has structural growth.

What we have to be really careful about, though, is thinking it's structural when really it's cyclical, as that's where you can get caught out. And that's where we spend a lot of time – working out what we think is cyclical, what's structural, and where we are within the cycle.

It might be a good time to talk about stocks, especially some of the stocks that have detracted from performance. The two that come to mind are IGO and Domino's, both of which have been long-term holdings within the portfolio. Has your base case changed?

I'll start with IGO, which is a lithium, nickel and copper producer. The long-term investment thesis is strong, as these metals are crucial for the transition but, as you'd expect, there are demand cycles. To use electric vehicles as an example, initial demand was quite strong, but more recently we've seen this come off a bit. Demand will rebound as the long-term thesis for EVs is still very much intact.

Another thing we really like about IGO is that their primary lithium asset is Green Bushes, which is a tier-one, low-cost asset; one of the best in the world. And even now, when the lithium price is down, they're still in a profitable situation because of their low-cost nature. And that's what you want. You'll have cycles – lithium prices will come down, nickel prices will come down – but if you are at the low end of the cost curve, (unlike higher-cost producers who may need to pause production or close mines), you're going to be okay through those cycles and benefit from long-term demand.

So it's really that fundamental long-term investment thesis that you're looking for. Can you talk about Domino's, because I know that's an interesting one?

Yes, Domino's is very similar. So long-term structural growth, but currently in cyclical decline for a couple of reasons. Covid was a strong period for Domino's as everybody got things delivered to their homes. E-commerce and food delivery both experienced very strong cyclical growth. As we've come out of Covid, we've seen that normalise. In addition, Domino's did make a couple of missteps, by putting prices up and charging a delivery fee during an inflationary period – which they've acknowledged. Looking ahead, the growth of food and beverage delivery is expected to remain strong, and Domino's should benefit from this.

There have been some challenges, but there have also been some stocks that have done really well in the portfolio, and one that comes to mind is Suncorp. Can you talk about what's happening there?

Suncorp is the largest overweight position in the portfolio and has been a good performer, particularly more recently. It's an interesting one, because it's been quite a slow burn. If you go back a few years, it was a bank, a general insurance company, a life insurance company, and a wealth manager. It also had a repairs business. Quite a complicated structure that never really worked.

Suncorp's closest competitor IAG has historically traded at a significant premium to Suncorp, because it's a nice, simple general insurance business – and the market loves simplicity. So over the last few years, we've seen Suncorp really streamline its focus and, with the sale of its banking business to ANZ now initially approved, this process is getting closer to completion. Furthermore, the $5 billion of capital raised from the sale should result in a valuation uplift and bring it into line with the likes of IAG.

Another point I'd add is we've seen a lot of capital come out of the sector over the last few years, largely due to past climatic events, but insurers are getting much better and more accurate at pricing risk. Combine that with the strong premium growth we're seeing at the moment, and the outlook is definitely stronger for insurers.

A good way to finish up is to look at the outlook and how you're positioning the portfolio for the next 12 months.

After a difficult 2023, it might sound funny to say, but I'm feeling pretty positive about 2024. We've gone through the macro dislocation coming out of Covid, and I think a lot of those macro variables are now starting to stabilise. Interest rates have likely peaked, inflation is more under control, and things feel a lot more normal. What we should start to see is a refocus back on individual company fundamentals and that should benefit bottom-up investors, so I'm feeling more comfortable. In addition, as conditions normalise and there's greater certainty in the market, we should see corporates move forward with plans and projects which will be exciting.

So, the key message is a real refocus on fundamentals and, if we do see that macro environment settle down, a good environment for stock picking. Paul, thank you very much.

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