From the desk of James Abela

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Fidelity Future Leaders Fund: Themes, lessons and thank you

The strong bounce in the Australian equity market in February was broadly interpreted as unsustainable due to lower earnings expectations and weaker outlooks. However, a number of companies reported a more confident outlook and as a result energy, metals, financials, technology, healthcare and industrials all performed better than expected.

Results season delivered some big positive price moves from those quality growth stocks or cyclicals that delivered strong results. Altium, Appen, A2 Milk, Bluescope Steel, Cleanaway and Breville were notable winners. On the flipside there were some big negative price moves from those that disappointed such as Blackmores, Bingo, Pact and Eclipx, proving that markets are still challenging companies that are exposed to cyclical softness or competitive market structures.

Some fundamental themes that emerged from the latest report season include:

- **Costs** – generally rising at a pace faster than could be recovered given rising competition in most markets, as revenues remain a challenge from those not experiencing structural growth or cyclical upswings
- **Capex** – is still at relatively low levels, with companies favouring buybacks or M&A
- **Capital management** – featured with numerous buybacks (Bluescope Steel and CSR)
- **Second half club** – many management teams are witnessing softness and expressed caution while expecting a recovery in the second half of 2019.

Moving into the second quarter, previous strong performers such as the Australian housing market, non-residential construction and some retail sectors are likely to cause headwinds for the economy. The Reserve Bank is becoming more cautious as global growth slows and a rate cut looks imminent.

For investors this will mean a greater focus on balance sheets as sustainability moves to front of mind. High risk/low quality businesses which have experienced phenomenal support in the search for yield over the last few years will see this wane as liquidity slows and risk tolerance declines.

Some critical lessons from history form the foundations of my portfolio construction process:

1. The Fund's Quality, Momentum, Transition and Value (QMTV) framework is a balanced approach that can deliver alpha throughout the cycle and is key from a portfolio risk management perspective.
2. Remember 2007 – high leverage is not an everlasting provider of growth.
3. Remember 2000 – valuations and risks are cyclical. And now being distorted by low discount rates, low risk premiums, low inflation, low costs of capital, liquid capital markets and low volatility.
4. Returns on capital, earnings and cash flows ultimately drive valuations – Viability, Sustainability and Credibility (VSC) are the long-term 'pillars of success'.

The popular quote 'Revenue is vanity. Profit is sanity. Cash is reality' is perhaps more relevant today than ever. Companies need to really drill down on fundamentals such as profit and cashflow rather than 'top line' revenue

For investors in the Fidelity Future Leaders Fund, my strategy in the current market is to maintain a strategic tilt toward growth at a reasonable price and value. Later in 2019, scarcity premiums will likely see a move towards growth and sustainable yield.

Morningstar Awards 2019

Winner of the Morningstar 2018 and 2019 Fund Manager of the Year, Domestic Equities Small Cap Category, Australia*

Conviction is driven by a high valuation discipline across the portfolio. I believe in holding companies with sustainable value yield, defensive positioning and sustainable quality. Concerns around the global slowdown have translated to a resolute move away from high risk momentum or companies that rely on equity or debt liquidity.

Finally, I'd like to take the opportunity to thank you all for your support over the past couple of years. I feel very fortunate to have picked up the Morningstar 2019 Australian Fund Manager of the Year – Domestic Equities Small Cap Category for a consecutive year.* Sincere thanks go to my clients, the Fidelity family and the rigorous client-centric risk–return framework of Morningstar.

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