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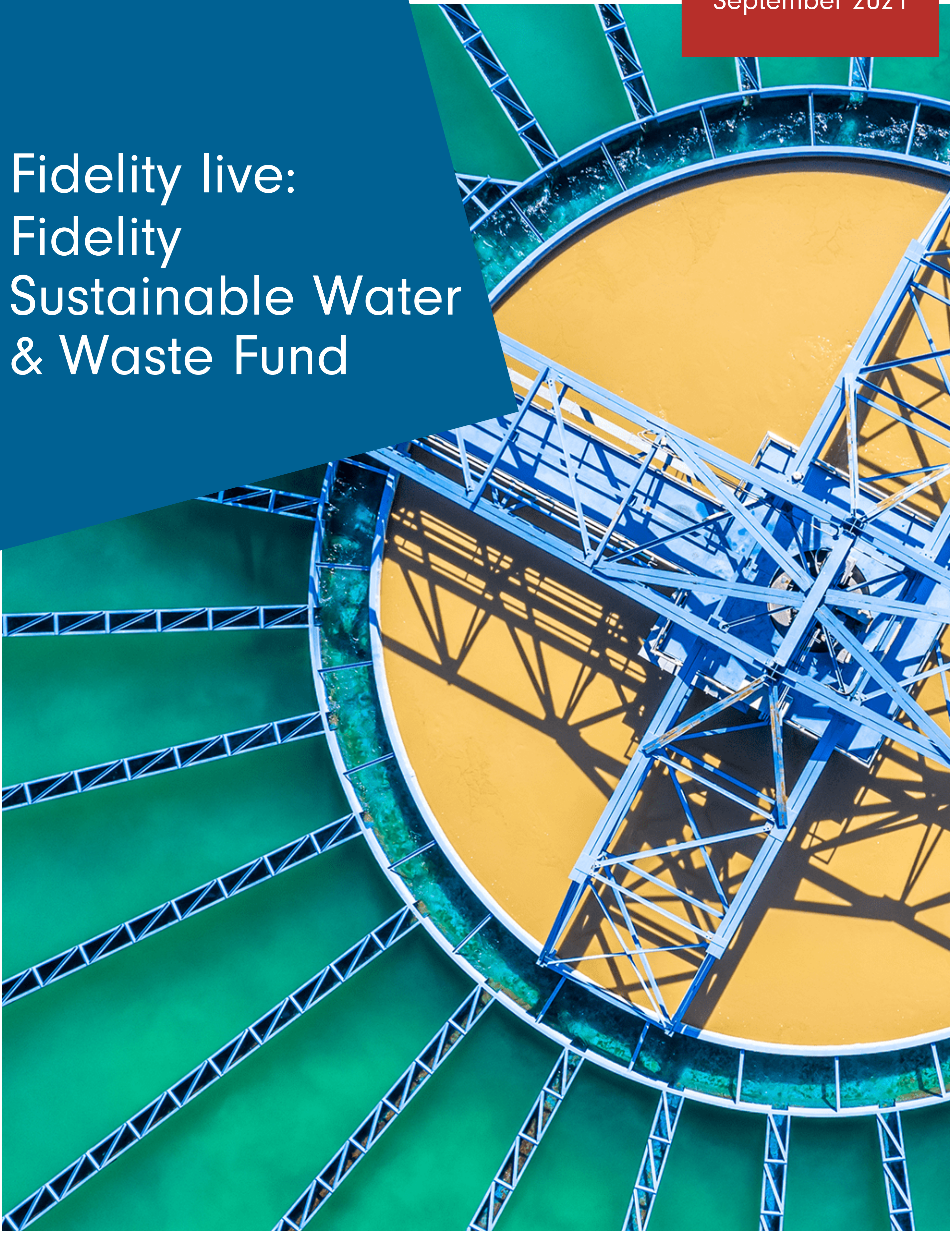
Fidelity live: Fidelity Sustainable Water & Waste Fund



Investment Professionals

Fidelity INTERNATIONAL

Moderator:

Radhika Surie, Equities Investment Director

With:

Cornelia Furse, Co-Portfolio Manager, Fidelity Sustainable Water and Waste Fund

Can we start with a refresh of the Fund - what are the structural underpinnings of the theme and how are you investing in it?

The water and waste theme has several long-term drivers, including population growth, urbanisation, aging infrastructure (that needs to be repaired or replaced), climate change and the effects of changing weather patterns on existing infrastructure, sustainabilityof resource consumption, changes in the volume and compositionof waste, etc. Generally speaking, we prefer companies with sustainable practices - e.g. we favour recycling businesses over those that use landfills, or companies that provide water filtration solutions over those that distribute replacement water cannisters.

You took over as Co-Portfolio Manager for the Fund around six months ago, what changes have been made in that time and how have these reflected in the Fund's sustainability metrics?

The changes we have made have been mostly on the waste side, where we have a slightly different approach to previous manager. Waste management not sustainable at present, but this will change over time; as a result, we have positioned the Fund in what we consider 'future waste solutions', as opposed to traditional players. By this, I mean businesses that recycle, recover, reuse, or reduce waste. This shift has increased the variation of businesses types to which the Fund is exposed, as well as reducing exposure to greenhouse gas emissions / dirty waste disposal practices. Future waste companies also tend to be more sustainable aware than traditional waste businesses. Overall, these changes have driven a 60% reduction in the Fund's carbon footprint and a material improvement in its overall ESG rating.

Can you give us some examples of names that have been bought and sold?

Two names sold we have sold, Republic Services and Waste Connections, were both incumbent traditional waste businesses in the US. This was part of the transition to future waste, but our analysis also showed that both were low return businesses with minimal upside potential. In terms of stocks we have added, Renewcell is a business that develops clothing cotton recycling technology (cotton is recyclable up to seven times). Its growth potential is massive as its end product is very affordable, priced in line with virgin cotton, whereas its closest competitor is priced at 30% premium. Consumers are increasingly aware of what they are buying and expect demand to continue to shift towards sustainably sourced materials like recycled cotton. Another name we have added is Azek, which uses waste plastic to make composite wood decking. This company is the number two player in a consolidated and rational market, but the market is also growing as it takes share from traditional wood decking - the product lasts longer, doesn't rot, etc. Azek is also proving able to increase the waste content of its products, which is allowing it to increase its profit margins.

You are both climate aware investors - how do you view recycling and the broader circular economy theme? How is this reflected in the portfolio?

To build a truly circular economy means solving the waste problems we face, i.e. reducing waste volumes, tackling waste composition issues and pollution, dealing with bad waste disposal methods such as burning and burying, etc. The mechanisms through which this can be achieved include waste reduction via reuse and repurposing, more efficient use of resources via efficient manufacturing and automation (for example, 3d printing), packaging reduction, etc. We can also develop and use better materials, i.e. replacing plastic with biodegradable plastic alternatives. We look at companies that enable all these solutions.

Clean Water and Sanitation (SDG 6) is a global need and its provision is one of the UN Sustainable Development Goals and obviously aligns with our water theme. How does the Fund support the achievement of this and other SDGs? Are there any specific aspects of SDGs that you look at?

Clearly clean water and sanitation provision is the most important SDG for the Fund, but it also addresses other SDGs as many of them are linked. Industry, Innovation and Infrastructure (SDG9) needs water to function properly; Sustainable Cities and Communities (SDG 11) requires access to water and reliable waste infrastructure; Responsible Production and Consumption (SDG 12) requires recycling and reuse; Life below Water and Life on Land (SDGs 14 and 15) require the management of waste water pollution prevention.

Reference to specific securities should not be construed as a recommendation to buy or sell these securities and is included for the purposes of illustration only.

We've seen a lot of infrastructure spending announcements come through recently, will this benefit any of the water companies you own?

In a word, yes. This effect will be more noticeable in the US, where the infrastructure spending bill currently supports around US$100bn ofwater infrastructure investment, including upgrading infrastructure, disaster mitigation measures (to protect against flooding, droughtsdue to climate change), modernisation, water quality remediation (PFAS treatment) to get rid of unwanted and persistently polluting chemicals. In the past, only areas with strong population growth could afford these kinds of investment, but federal support changes this.

A few of the Fund's investments stand to benefit. One is Evoqua, a leading player in waste-water management and water treatment, which will benefit from demand for PFAS treatment as it is the dominant player in this market. Another is Mueller Water Distribution Products, which provides water valves and hydrants and will benefit from the upgrading of infrastructure; it also has a leak detection business that will benefit.

In the UK, the green recovery package will seek to eliminate harm from storm overflows, reduce sewage pollution in rivers, encourage wildlife rehabilitation, etc. This will not be achieved through grants, but many companies will benefit from the government's spending, most pertinently Severn Trent, which will be able to grow its regulated asset base at accelerated rate.

What are the main macro sensitivities for the portfolio and how do water and waste companies interact with these?

There are various ways to categorise companies we own, but gaining exposure to a specific macro factor or style is not our main goal. Instead, we invest in stocks with attractive fundamentals while being cognisant of macro context. That said, the investment universe consists of various types of businesses such as cyclicals (industrials exposed to cyclical markets), defensives (i.e. regulated utilities), and structural growth companies (e.g. recycling). This range of business models makes it possible to position the portfolio more defensively or cyclically depending on the investment environment.

For example, when we took over the portfolio, we had high exposure to long-duration businesses whose returns were negatively correlated with bond yields. We have reduced that exposure and the Fund is now more balanced by exposure to cyclicals. We are also aware of the Inflation risks prevalent at present and have positioned the Fund to incorporate inflation protection via regulated business models with inflation-linked revenues and exposure to industries with pricing power; this inflation protection is validated by our risk models.

We have seen market leadership rotate between value and growth styles in recent months, how has the Fund fared in this environment?

We recently had the risk team investigate this. For the reasons we discussed earlier, the Fund doesn't skew strongly towards either growth or value, but is balanced. Nevertheless, the risk models show we are slightly underweight growth and although growth prospects improved this year, the Fund has performed well. This is because strong industry exposures and stock selection have contributed positively to performance. We are pleased by this, as it validates our bottom-up philosophy and process, although we expect an average holding period three years, so it is really too early to claim absolute success or failure.

Can you give us an overview of what has worked and what has not since you took over?

There will be some common drivers for certain groups of holdings, but idiosyncratic stories are what we look for as bottom-up investors. On this basis, Evoqua has performed well, given its attractive position in the US end market where outsourcing is growing, as well as the US infrastructure stimulus boost - this has rerated as investors have begun to appreciate its higher growth potential. Rexnord has also responded well to the spin out of its industrial business and it becoming a pure water play (which demands a higher multiple). The conclusion of Veolia/Suez saga has also been beneficial for the former as market has looked towards potential synergies.

Meanwhile, sector allocation has been detrimental. Detractors include handful of benchmark names we don't and won't own due to nature of the theme, such as Google, Microsoft, Facebook. Some other businesses with idiosyncratic factors have also underperformed. Nevertheless, overall positive stock selection has resulted in outperformance of over 650bps since we took over in February.

In terms of valuations, are you seeing dispersion between growth and value in the universe, as has been the case in the rest of the equity market? In terms of valuation, what areas are attractive? Are there any areas where valuations that are stretched?

The theme is broad and there are pockets of growth and value. At the growth end, there are businesses that provide nascent technologies, disruptors in recycling, and well-positioned companies

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growing share or increasing penetration. Some of these names have high multiples, but not all of them. Meanwhile, industrials are enjoying a recovery in earnings and valuations therefore appear lower, but we have been trimming industrials on strength. We have been adding to names where we have conviction that have underperformed; for examples, we have seen Chinese names sell off recently and this has presented opportunities.

Overall, the PE (Price-to-Earnings) of the Fund is slightly higher than that of its benchmark, which is perhaps not surprising given the long durationof the theme. We look at the sustainability of returns and growth ona five-year basis, rather than current valuations.

Can you provide an overview of the sectors that are most represented in the Fund?

The Fund is always overweight industrials and utilities, but as novel solutions are introduced in other sectors these become represented as well; for example, consumer discretionary through online reuse platforms, materials such as bioplastics. However, these exposures are only a small subset. The Fund is unlikely to invest in sectors like banks, healthcare, etc.

Are you finding any interesting opportunities in the emerging markets, given the need for infrastructure investment there?

Yes, there is a need for infrastructure expansion, but it can be difficult to gain attractive exposure in the emerging markets as companies are often small and regulatory risks are often greater. There are some good names in China we are looking at, a Brazilian water utility, but more of our emerging market exposure is via global companies selling into these markets. For example, we recently asked our analysts for ways to gain exposure to Modi'smission to supply more clean drinking water in India and they havebeen looking at some piping companies in the country - we are constantly looking for new opportunities.

Can you provide a market breakdown, i.e. list any biases in the universe and how do you deal with them?

The universe is biased towards small and mid-cap companies. As a result, the Fund is overweight US$2-$20bn cap companies and underweight +US$20bn cap companies versus the benchmark, but inline with this versus the universe. It is a natural position given the nature of the market. We also pay close attention to companies under US$2bn and work closely with traders on these positions.

Looking into 2022, how are you feeling about the outlook for the theme?

Whether 2022 or 2032, there will be a lot of consistency in our responses. Water and waste businesses are often viewed as boring, but what is not appreciated is the critical nature of this infrastructure. The theme has strong drivers in both the developed and emerging markets, particularly where traditional practices are unsustainable. Overall, activity will focus on maintaining and evolving within these markets - this will probably be the same answer we give in five years.

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