Fidelity
INTERNATIONAL

Year in review
2019–2020

2020 Morningstar Australia Fund Manager of the Year and three-time winner of the Morningstar Australia Fund Manager of the Year – Domestic Small Cap*

MORNINGSTAR Awards 2020

Year in review 2019 – 2020

Alva Devoy
Managing Director
Fidelity International

It's hard to know how to feel about the last 12 months. Tumultuous is the word that immediately springs to mind, dare I say unprecedented? However you describe it, it's certainly a period in our lives that I think we'll look back on with very mixed feelings.

Going into the second half of 2019, I remember feeling pretty optimistic. The business was performing well, our diversification plan to bring more of Fidelity's global strategies to the Australian market was progressing, and the majority of our new hires to help grow the business were complete and happily settled. Everything seemed rosy and I was really looking forward to summer and having a bit of downtime after what has been an incredibly busy couple of years for the Australian business.

This of course didn't quite eventuate as the country was ravaged by bushfire and drought in what turned out to be our darkest summer on record. A couple of months later, we went into lockdown to face off against a global pandemic. You wouldn't read about it…

A couple of observations

It's certainly been a challenging period, but it's also been a very interesting time to be leading an investment management business. The first thing to note is, of course, the resilience of people. Within a matter of days, our business very quickly settled into a completely different structure of working. It was all remarkably flawless. Technology didn't let us down; collaboration levels have been high, and productivity is stronger than ever. No business continuity plan can prepare you for something like this (although I've certainly added it to mine going forward) but, to be honest, it's been a very smooth transition.

We've seen it in markets, too. There was some initial jitteriness and shock, but markets quickly settled down to the more traditional look-through approach. Periods of volatility are never easy, but I think investors are becoming increasingly sophisticated and understand that investing is a longer-term proposition. To paraphrase Paul Taylor, you must block out the noise and remain true to the fundamentals. Fidelity's lucky in this respect because active management is built into our DNA. Taking the time to really understand the businesses we invest in gives us a huge advantage in being able to assess their long-term viability and capacity to withstand periods such as these. The size and reach of our research teams provides unique insights and analysis, which I think we sometimes take for granted. We're very fortunate in this regard and it's allowed our investment teams to take a largely pragmatic approach and see the crisis as an opportunity to renew portfolios and upgrade, at a time when valuations have been more favourable.

The second thing I'd mention (and it seems crazy that we've needed a pandemic to bring it to light) is that our established office face-to-face work day is outdated and needs to be reviewed. Trying to cram work, family commitments, school pick-ups, commutes and the usual life admin into an often-conflicting timeslot just isn't practical. Add to this people's individual styles of working and productivity body clock, and there's quite a disconnect. Fidelity's been moving to more flexible options for a while, but I think this will really give us a push to accelerate this to the next level.

Celebrating the wins

The last six months has really brought home to me the importance of celebrating the wins and being thankful for the good things and there have been some terrific moments.

Early in the year we were delighted to be awarded Morningstar Fund Manager of the Year, a moment which was made even sweeter by James Abela's third consecutive win in the small to mid-cap category. These awards are the culmination of a huge amount of work right across the business and I couldn't be prouder of the team.

Another important milestone was the launch of our first sustainable strategy, the Fidelity Sustainable Water & Waste Fund. Today, our clients expect us, as stewards of their capital, to evaluate companies and company managements on both their financial merit and on their approach and commitment to ESG factors. We've responded not only through the launch of the Fund, but more broadly by substantially increasing our focus on sustainable investment analysis, including the recent introduction of our proprietary ESG, sustainability company ratings.

> You must block out the noise and remain true to the fundamentals.

One other thing I'm really proud of is the work we did with Core Data researching the value of financial advice. The last few years have been tough for the industry and I think research like this is essential to draw attention to the importance of being financially informed and having control over your financial future. I've been really pleased to see this being discussed more broadly and it seems to be gaining some momentum, which is really positive given some of the challenges that lie ahead. We'll be releasing stage two of this research, which digs deeper into demographics and some of the different segments, in the second half of the year.

Market outlook

The first half of 2020 will live long in the memories of Australian investors. Firstly, as a devastating health crisis and secondly, because of the massive impact that efforts to contain the spread of the virus has had on the real economy and investment markets. After the S&P/ASX 200 hit record highs in February, we all watched astounded as markets tried to grapple with the impact of lockdown measures on businesses and companies, resulting in a peak-to-trough sell-off of -37% in only 20 trading days. Following record amounts of international and domestic fiscal and monetary stimulus, the Australian equity market stabilised and has subsequently risen by 29% from the March low, while Australian government bond yields remain around their all-time lows.

The huge uncertainty surrounding what comes next has resulted in significant dispersion amongst countries, asset classes, sectors, and companies. Despite the rebound in risk assets, the short-term outlook remains murky, given that much of the global economy has not returned to normal, while in Australia many individuals and businesses are making use of emergency measures such as the JobKeeper allowance or mortgage holidays. The risk of a second or third wave of COVID-19 transmission is ever-present, and the international geopolitical backdrop suggests heightened levels of uncertainty for the remainder of the year, given US elections and Brexit.

This backdrop and the extreme volatility we saw earlier in the year has reminded many of us of the value of active management. Fidelity's active approach to investing has meant we've been able to navigate the crisis with less volatility than the market, helping our clients preserve capital and deliver a smoother journey. It's also reminded us that timing market swings is extraordinarily difficult, so staying invested over medium and longer time periods is critical. An active strategy that mitigates the downside risk and smooths the return over time can help investors maintain the confidence they need to stay invested and reach their investment objectives.

Our investment expert views

Australian equities

Paul Taylor
Head of Australian Equities and Portfolio Manager, Fidelity Australian Equities Fund

Australian equities were caught in the sharp weakness in global investor sentiment as the world grappled with COVID-19. This black swan event caught everyone unawares and the ensuing global contagion prompted a significant bout of volatility. Financial markets were enveloped by substantial uncertainty and stock markets worldwide experienced an indiscriminate sell-off as the COVID-19 contagion unfolded. March 2020 was an exceptionally dismal month as global economies simply shut down to contain the pandemic. It is important to mention that, up until then, Australian equities had been quite resilient against the backdrop of severe drought and large-scale bushfires in Australia and concerns about waning global growth, as well as the ongoing and prolonged US-China trade dispute.

I've often commented that equity markets do not follow the economy in a linear manner and tend to look much further ahead. This is true of the current crisis and we saw the Australian equity market begin to factor in positive sentiment from early April onwards, once the pace of the contagion tapered off in Australia. As the curve began to flatten out, domestic equities rebounded and regained some lost ground. Overall, Australia has demonstrated its relative resilience in the face of the pandemic. The Government was proactive in issuing significant stimulus measures aimed at providing employment and financial support to labour force, low-income households and the small-to-medium enterprises as economic activity came to a near-halt. These measures have provided some support, as evidenced by the Reserve Bank of Australia's recent remarks that the economic downturn will be less severe than previously expected given progress in curbing the spread of COVID-19, the easing of restrictions on businesses and households, and the scale of monetary and fiscal policy measures put in place to support the economy.

Looking ahead, COVID-19 contagion has impacted economies, markets and people's lives significantly. However, it is important to note that it is effectively one-off in nature and its impact on corporate earnings and economic growth should not be factored into perpetuity. Having said this, I am also mindful of some future market volatility as we assess the pace of economic activity, coupled with earnings downgrades. Simultaneously, we are also witnessing a notable acceleration in existing trends such as e-commerce, digital delivery of food and beverages, cashless transactions and work from home, which will only expand the universe of investment opportunities as more innovation and business models come to the market.

> Overall, Australia has demonstrated its relative resilience in the face of the pandemic.

Fidelity's strong suit continues to be its enviable team of equity and fixed income analysts on the ground, around the world, and I rely on this support as I search for the best investment ideas. The pandemic clearly demonstrated the scale of our investment research is unparalleled, and we are supported by well-developed technology systems that facilitate a seamless exchange of information and analysis. This has meant that we've been able to take advantage of recent volatility and upgrade the portfolio with stocks at attractive valuations, which bodes well for the longer term.

James Abela
Portfolio Manager
Fidelity Future Leaders Fund

It was impossible to overlook global growth concerns throughout 2019 as the pace of economic activity slowed down notably in leading economies such as China and the US. On the domestic front, concerns around falling residential housing prices, slowing credit growth and low wage growth were hard to ignore. Markets also had to navigate considerable speculation surrounding the US-China trade disputes and even – amazingly – managed to gain ground as we grappled with severe drought and bushfires in Australia.

Enter 2020 and the momentum continued until a biological curveball descended. COVID-19 was a black swan event the world hadn't prepared for, and it brought devastation across the globe in a very short time period. With it came a collective economic shutdown not seen before in peacetime and a global health care system under enormous pressure. Financial markets dislike uncertainty and this was evident as global stock markets spiralled downwards from mid-February, only to calm down somewhat in early April.

Australian equities felt the impact of this global risk aversion and experienced steep declines as well. The Australian government and policymakers moved quickly to proactively ease monetary policy and launch stimulus measures to safeguard jobs and businesses. This helped provide a cushion to the economy, particularly in the mid- to small-cap segment, which proved to be a relative outperformer in the review period.

When they said 'What a difference a year can make', perhaps they had the last 12 months in mind. COVID-19 was a case of reality bites. It caught us unawares and disrupted lives to an extent that few of us had seen thus far. It also brought age-old principles of investing to light yet again – diligent management teams, disciplined capital structures and debt-free balance sheets. Robust business models that may perhaps not be trendy, and secure cash flow streams – these are the true drivers of value creation and long-term alpha generation.

> The mid- to small-cap segment ... proved to be a relative outperformer in the review period.

It also reaffirmed that a disciplined investment process and well-considered portfolio construction methodology can withstand the test of extreme market environments. Paying consistent attention to the viability, sustainability and credibility of the positions held in the portfolio has held the Fund in good stead in these troubled times. Risk pricing is an important element of my process, and I do not overlook premium valuations, even

Our investment expert views

Australian equities (continued)

for high-quality business models. I consistently steer clear of crowded trades where the risk of being 'too certain' is often overlooked.

While we are far more familiar with the pandemic today than five months ago, I would not be in a rush to overwrite the uncertainty stemming from it. The world has seen significant disruption and its multiplier effects will be recognised over time. As a new semblance of normal emerges, we will continue to witness an evolution in the investment environment. Going forward, I expect to see valuation opportunities that arise in the traditional long-term clusters of future leaders: global health care, global technology, tier 1 global cyclicals and global consumer brands.

Global equities

Amit Lodha
Portfolio Manager
Fidelity Global Equities Fund

Global equities have been volatile over the last financial year. The period has been a tale of two halves, marked by strong market performance during the first six-month period, supported by major central banks' accommodative policies. However, markets fell sharply in the first quarter of 2020 as the outbreak of the COVID-19 pandemic weighed on global economic prospects.

Authorities across the world announced large-scale lockdowns and travel restrictions to curtail the contagion, and unveiled policy stimulus measures to mitigate its economic impact. Towards the end of this period, markets rebounded as progress on a potential COVID-19 vaccine, easing of lockdowns in several economies and substantial stimulus measures provided support.

The global pandemic crisis is now entering a new phase as economies start to gradually re-open from the lockdowns that were imposed in April and May. The nascent signs of economic recovery, albeit from very depressed levels, has boosted investor sentiment recently.

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Nonetheless, the high unemployment, weakening strength of US consumer and second wave of infections remain key threats that will negatively impact growth estimates for many companies. Revenue growth, operating leverage and financial leverage (increased cost of recent debt issuance for many corporates) suggest that earnings expectations still have significant downside.

Given the global spread of COVID-19, the difference in government response and the political nature of lockdown decisions, we think duration of this pandemic is incredibly difficult to model from a top-down perspective. The only certainty is that volatility will continue in the short to medium term. In this environment, markets are offering pockets of good value and I continue to deploy cash in high-quality names that are available at attractive valuations when taking a longer-term view. I remain committed to a bottom-up stock-picking approach with a focus on strong corporate fundamentals and management teams, while regularly re-evaluating the investment thesis of stock picks.

Our global equities portfolio is well diversified across a range of industries and sectors, with regional and sectoral positioning an outcome of where we are finding opportunities.

At a portfolio level, the Fund remains invested in high-quality franchises and undervalued managers in health care, financials and information technology sectors. Some of these health care and tech names have continued to do well and maintained market leadership as investors preferred their strong moats, best-in-class management teams and growing addressable markets.

A combination of luck and skill has ensured that the Fund was overweight several stocks and sectors which perform strongly under lockdown measures or in periods of heightened volatility. This has helped contribute to the Fund's performance over the period.

Going forward, impacts of 'war time' government stimulus packages and central bank balance sheet expansion on the case for inflation versus deflation will be of paramount concern. This 'regime shift' will have implications for the investment case in US versus the rest of the world, value versus growth, Europe versus the US, and developed markets versus emerging markets.

Investors and asset allocators will need to maintain a flexible mindset to successfully navigate these changing times. The old saying, 'Past performance is no guide to future performance', has probably never been truer. With all the seminal changes in the world around us, it's highly probable that the winners of the next ten years will be very different from those of the past ten.

Asian equities

Anthony Srom
Portfolio Manager
Fidelity Asia Fund

The last 12 months could be categorised as a period of significant swings in sentiment, which has created opportunities, but also leads to less attractive risk/reward when sentiment is too positive. 2019 was a good year for markets, but as the year progressed, I became more concerned. US-China trade tensions underpinned market rhetoric and there was a lot of positive sentiment towards a deal made. This happened in January 2020 and at this point the portfolio was at the lower end of the stock count range and at our maximum cash position.

> I think the recovery is going to take longer than many anticipate.

I did not believe the phase one trade deal was the full stop to trade tensions and market valuations looked too expensive. That said, some opportunities and positions in Hong Kong were added at the height of the protests there as valuations hit recent lows and saw good companies with international businesses caught up in indiscriminate selling. However, we ended January 2020 concerned that valuations were pricing in no room for error, and portfolio positioning reflected this.

No one could have predicted the COVID-19 outbreak that followed, but the volatility that followed meant there was a point in March

Our investment expert views

Asian equities (continued)

where I was a buyer in the market and was deploying cash in to new ideas. However, the subsequent rebound in Asian markets has been the sharpest in history and suggests the market is pricing in a V-shaped recovery, perfect execution by businesses and no second wave – all of this concerns me.

Therefore, I am cautious in my outlook. I think the recovery is going to take longer than many anticipate. While factories in China are back online, the virus has spread so far that we're now facing a global demand shortfall. New orders are not going to absorb the inventory that was already sitting in factories before the shutdown. Government stimulus packages do not create new consumption – they are just a replacement for consumption that's been lost due to the virus shutdown. In addition, the stimulus we have seen is for the real economy, so unlikely to filter through to markets quickly.

I think we'll have to go through a period of inventory destocking before things start to normalise again and that means the market is still too optimistic in pricing in a sharp V-shaped recovery.

That said, there are opportunities. Companies exposed to the travel sector have been hit across the board. The market took a pretty bleak view of earnings and balance sheet risk. Even though some have now bounced off their lows, if you take a two- to three-year view, I think there is still money to be made. I have added Galaxy Entertainment, a Macau casino operator with a rock-solid balance sheet, and Trip.com, an online Chinese travel agent, whose business will be impaired in 2020, but benefits from the long-term trend of Chinese people travelling and has already seen domestic travel bookings returning to normal.

I continue to avoid the big online names in the region like Alibaba and Tencent. It simply comes down to valuations. I thought they were overpriced before and they didn't fall far enough to become interesting. The market still isn't reflecting the lower margins and returns that I think these stocks will make in the future. Competitors can emerge very quickly – just look at the growth of ByteDance (TikTok) in a very short period of time. I'm also not sure how quickly or how well they can respond to device changes as we move away from smartphones to wearable tech or whatever comes next. They are essentially conglomerates but are not being priced at the discount you would normally see on such a business.

However, within the technology space I have added a new position in SK Hynix. Its stock price fell significantly amid the market sell-off, but structurally I think memory demand will be strong as we continue our shift toward AI, high-powered computing and automation. Although not part of the thesis, working from home should provide some support as this puts pressure on servers and data centres.

Global emerging markets

Alex Duffy
Portfolio Manager
Fidelity Global Emerging Markets Fund

The past 12 months have continued to be a volatile period for emerging market (EM) equities. In the second half of 2019, investors closely monitored the trade war developments between the US and China, as well as country-specific events, such as the social unrest in Hong Kong and Chile. Amidst this uncertainty, the US dollar proved resilient, acting as a headwind to the asset class.

As we entered 2020, sentiment improved somewhat on the back of an apparent resolution of the trade tensions, before coming again under significant pressure due to the spread of the COVID-19 pandemic on a global scale. The sell-off was further exacerbated by a breakdown in discussions between the Organization of the Petroleum Exporting Countries (OPEC) and Russia, which sent the energy sector into a tailspin, weighing on regional returns in Latin America and EMEA*, home to some of the world's largest exporters.

> Long term, the case for EM remains intact and will continue to offer many opportunities.

Against this backdrop, EM recorded their worst quarter since the Global Financial Crisis, with no country or sector posting positive returns. As we progressed into the second quarter, short-lived optimism supported risky assets, driven by a rollback in lockdowns and positive news stories surrounding the development of a vaccine. However, we then also saw a re-ignition in the conflict between the US and China.

Although this has been a tricky period to navigate, this volatility has offered stock-picking opportunities amid periods of indiscriminate selling, enabling us to upgrade the portfolio, buying into good quality names at a discounted price. Overall, we remain cautiously optimistic on the outlook for the asset class. Valuations remain supportive, with EM trading at historical lows versus developed markets.

More broadly, the composition of the EM universe has improved markedly over the last few decades, with many of the largest companies favourably positioned for the long term and to withstand periods of disruption such as this one. The vastness of the universe also offers diversification benefits and affords investors the ability to navigate away from risks and toward opportunities.

Long term, the case for EM remains intact and will continue to offer many opportunities, supported by structural growth drivers such as urbanisation and lifestyle changes. The rising purchasing power of EM consumers indicates opportunities also in many consumer-related businesses across a range of segments.

Within the portfolio, we hold businesses that can capture this trend, such as Zhongsheng Group – a premium auto dealer in China, and Lojas Americanas – a retailer in Brazil. Conversely, an area in which we have been more cautious is financials, reflecting the impact of a low-interest-rate environment on the profitability of some names in the banking sphere.

In general, the portfolio remains focused on owning high-quality businesses with well-capitalised balance sheets and sound corporate governance structures. We believe that these are characteristics that can enable companies to weather more challenging economic environments and add significant value for investors over the long term.

*Europe, the Middle East and Africa.

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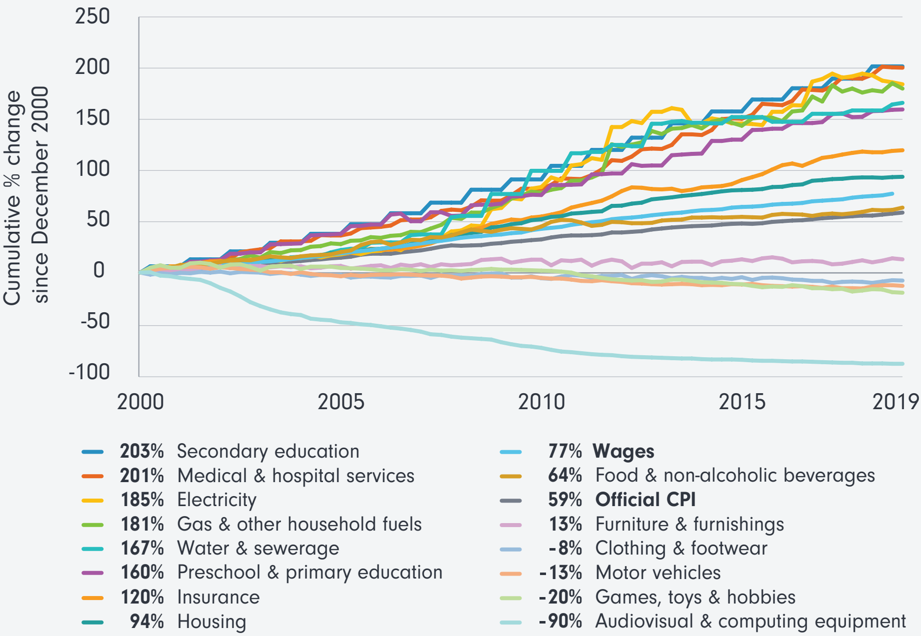
Chart of the year: The price of 'needs' versus 'wants'

Fidelity's Chart of the Week can be found in the Learning Hub. Our favourite from the year showed that there has been significant inflation in household 'needs' such as secondary education (+203%), medical and hospital services (+201%), and housing (+94%). Whereas household 'wants', such as the prices of motor vehicles (-13%), and audio visual and computing equipment (-90%) has fallen.

Selected Australian goods and services, CPI, wages
Q4 2000 to Q4 2019



Source: Fidelity, Australian Bureau of Statistics, January 2020. (Rebased to 0 as at December 2000.)

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