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[INTRODUCTION]

Staci West (SW): Welcome back to the Investing on the go podcast brought to you by FundCalibre. Contrarian investing – picking the stocks other people avoid - has traditionally paid handsome returns, but investors must be patient. Today's guest, Alex Wright, talks to us about the UK market and reveals why he thinks banks – after a decade of no profits - are the most exciting sector today.

Chris Salih (CS): I'm Chris Salih, and today we're joined by Alex Wright, manager of the Elite Rated Fidelity Special Values Trust. Alex, thanks for joining us once again.

Alex Wright (AW): Thank you for having me.

CS: It's no problem at all.

[INTERVIEW]

CS: Let's start with the landscape of all things UK. So, if you weren't an expert in financial services and you looked at a lot of the headlines, you'd see talk of recession and concerns, etc, around the market in the UK and globally. But when you look at the FTSE 100 - which is obviously the largest 100 companies in the UK - it's had a pretty strong 12 months compared to other [stock] markets and it's not far off all-time-highs. Does that mean the valuations of these companies are actually expensive now? Or do they still offer good value and if so, where?

AW: Yeah, you're right. So, it's been an encouraging year 2022 with the FTSE 100 up almost sort of 5%. And that's very different from international markets, which have clearly fallen, even in pound terms. So, it's great to see the UK market finally outperforming.

I think what, from a valuation point of view, what's more encouraging though, is despite actually that outperformance, that absolute increase in value, the FTSE 100 itself is actually about 20% cheaper than it was 12 months ago. And that's because the earnings of the market have grown. So, you've seen some very strong earnings growth coming through in 2022 which, again, is in contrast to other markets where there have been quite big downgrades. And so, the valuation on about 10x earnings today for the FTSE 100 looks really good versus its 14x long-term average. And actually, it looks particularly good compared to other markets. So, the US market, for example, despite having a really poor performance in 2022, still

trades on over 17x earnings. So, I think from a relative point of view, the UK is a particularly good place to be looking today, across all markets globally.

CS: Okay. There's two sides to that obviously; while the FTSE 100's been quite resilient, the smaller and mid-cap end of the spectrum has not had such a good year. As a sort of value investor or someone who looks for shares that are trading on - not on the cheap necessarily, but, you know, looking for those gems - does this mean you're finding lots of opportunities in that space? And maybe sort of talk us through the sectors and a couple of examples of where you are, if that's the case?

AW: So, the fund has always had a big bias to the mid- and small cap market, So, about 60% of the fund is in mid- and small caps. And that compares to only about 20% of the overall FTSE All Share [Index], which is the benchmark. So, always a big structural overweight to this part of the market. That said, I don't think the ideas are just coming in small cap land. And that's partly because actually if you look at how the valuations stack up, mid-caps and large caps are roughly trading on very similar multiples now, sort of 10, 11x - small caps are somewhat cheaper, kind of 8x earnings. So, the big underperformance you've seen of those mid- and small caps are partly [that] the earnings weren't as strong as the large caps last year, but also, you were starting at higher valuation levels. So, that's somewhat of a correction.

So, I would say pretty much all parts of the market now look largely, equally attractive maybe with a little bit of preference towards smaller companies. And part of that is because the smaller companies do tend to be a bit more cyclical in terms of, they are a bit more at risk from recession and that we're obviously starting to see now in some developed markets. That said, I think you do see opportunities where things like the baby gets thrown out with the bath water. So, a good example of a new idea in this space is TT Electronics [Plc]. That's something which is a cyclical business, but actually 50% of that business is to medical and aero markets. And so, probably only half of the business is probably going to be negatively affected because medical tends to be pretty much acyclical, and aero is still going through a recovery post-Covid. So, it's that kind of thing that we're looking to pick up and that's an example of a stock we bought in sort of Q2 and Q3 last year.

CS: In terms of sort of the wider opportunities then. So, obviously you've got a portfolio of stocks, do you have a lot that sort of sit on your bench because the market looks attractive in this climate, that you could easily bring in it? You know, is it [a] sweet shop scenario at the moment for the trust in terms of the opportunity in the market?

AW: So, I'm not sure the opportunity set is bigger than we've seen historically. I'd say it's good but it's not that different because I think you do have to bear in mind that while valuations are good and so, the trust itself trades on about 8.5x earnings, so, quite a discount to the market on sort of 10 or 11[x]. There are those economic headwinds out there and earnings are quite high versus history. So, quite a lot of our thoughts are thinking about downside protection in terms of what is a tougher economic environment going to mean for companies? And therefore, what are the realistic earnings going to look like compared to what the current forecasts are? So, I think you need to be careful, but just because valuations are low, that that's not the only signal, you need to think about the earnings as well.

CS: Okay. Let's talk about one specific sector, which is banks and wider financials. I mean the former has almost been a bit of a dirty word in the industry after the global financial crisis. Could you maybe explain why you've now increased your exposure to those at that area of the market, and just give us an example of why?

AW: You're right Chris. So, I think throughout actually most of my fund management career, which pretty much started in sort of 2007, banks and financials as a whole have been an area that investors have shied away from. Not just because of, I guess the issues through the financial crisis, but also the inherent complexity of the sector. It is much more difficult to work out what's going on in these businesses that have differential accounting, compared to industrial companies. And I think if you don't have specialists and analysts' teams to help you, it's quite hard to work out what's going on here.

Whereas yeah, it's a sector I've covered as an analyst here at Fidelity and we have special analyst coverage, career analysts, on the sector, and indeed I think today banks is the most exciting sector in the whole of the market, and indeed has one been one of the best performing over the last 12 months as well. And I think that may come as a surprise to a lot of people, as we're heading into tougher economic times. But it's because of the fact that there has been a sea change in the last year, in terms of interest rate levels. That's been a key reason why banks haven't been able to make a return over the last decade because you still had all the costs of running people's current accounts, which traditionally are a key source of cheap deposit funding for banks, so that the flip side of you getting free banking is that the banks get your deposits at zero and then they can lend them out at higher rate.

Clearly while rates were largely zero, that competitive advantage of large banks disappeared and that's now come back and you're starting to see banks finally earn decent returns on equity again. So, NatWest [Grp Plc] now for 2023 is forecasting around a 15% return on equity. So, that's above the market as a whole. So, this is now a higher quality than average company within the market, but yet it's trading on about 6x those earnings. So, dramatic discount. So, I think that's why banks look so interesting.

There's been a dramatic change in their returns compared to the sort of 5 or 6% levels you've seen for 10 years plus. And that also means they're a lot more resilient to a downturn because you've got that high levels of profit. So, even if you do see people default on some of your loans, you've got a big profit buffer, which is very different than we've seen at any time since 2006.

CS: Even if rates were to say - I mean obviously banks are far better capitalised now than they were in the sort of financial crisis or as a result of the financial crisis - obviously there's talk of, you know, inflation peaking and perhaps rates falling back. I mean you wouldn't be concerned about that because it would have to go back to the levels we've seen sort of in the past decade of almost negligible rates to be a concern? So, is that another reason to support the sort of idea behind the banking sector?

AW: Yeah, So, I think you are right. Like, in a recession we would expect interest rates to start to come back down. The question is, are they going to go back to the pretty much zero rates that they were at?

Because banks can still make pretty good returns at sort of a 1 or 2% interest rate level. It's once they get below that level [that] it becomes very hard to make a return.

Also, the effects of this feed in gradually. So, banks have what they call a structural hedge where they actually put the money they get on zero rate deposit out onto five year money. So, actually, some of the benefits of the '22 increase in earnings still are feeding in in '23, '24 and '25. So, again, if interest rates started to fall back down again, that effect would be delayed on the banks. And again, that's one reason why banks were such a painful investment for so long, because prior years of higher interest rates sort of bled out of the banks for quite a long time, over the last decade

CS: Obviously we mentioned the R word there in terms of 'recession' and whether it's going to be what type of recession, if there is going to be one, which there sort of looks like there is. Do you have any other areas beyond financials and sort of the banking sector where you feel you know there's a sort of recession proofing elements to the portfolio, any specific areas you might like beyond those?

AW: So, I think clearly there's a lot of more defensive sectors in the UK as well and we definitely have holdings there like Imperial Tobacco [Imperial Brands plc], is that the second biggest holding the fund; Serco [Serco group plc], which faces governments, is the third biggest holding. And so, those are decent areas that will be largely unaffected by a recession.

I think in a way though it's those areas that people think will be affected by a recession and therefore really cheap valuations that are more interesting. So, we obviously talked about banks and again, I think I want to be careful to sort of say a recession will hit the earnings of the banks if it comes through, and I just think the sort of the huge discounts you have protect you in share price terms, whereas somewhere like in insurance, which people also see as quite cyclical, that's much more recession resilient as we sort of saw through Covid.

So, through Covid, where banks earnings largely went to zero as they took big provisions for loans, admittedly provisions they then actually reversed because those didn't come through, but insurance did not have to do that and continued to pay their dividend yields, and their earnings were largely unaffected. So, that's an area that again, people traditionally think will be hit by a recession but actually is much more resilient and still offers sort of 7-8% dividend yields. So, that's actually the second biggest position in the fund after banks, because I think it's misunderstood and very lowly valued.

CS: You mentioned dividends, So, let's move to that as well then. What are your thoughts on dividends? Obviously, the fund doesn't specifically look for an income, it produces a reasonably good natural one. Do you think that's beneficial to investors in this climate?

AW: Yeah, definitely. So, dividends are always a key part of investors' returns over time - the total shareholder return - and we very much look at each individual stock [asking] what kind of total

shareholder return can it produce including dividends? Some companies we own, a very large percentage of, and I think the total return will come from dividends. So, something like an Imperial Brands that has a 7% yield, a lot of the return we think will come from that. Also, Ithaca [Ithaca Energy Plc], a recent buy for the fund; that has close to a 15% dividend yield which is particularly attractive.

But overall, the portfolio, as I said, sort of looks for both absolute return from the share price *and* the dividend. So, the natural yield is about 4.5% of the portfolio, which is a bit lower than the market on 5 [%] - as we don't own some big dividend payers - and I think both of those stack up very well compared to if you think about what you can get on gilts at about 3.5%. So, I think the dividend is very much something which is attractive in UK shares as a whole, particularly versus fixed income and other markets were dividend yields are much lower. Again, the FTSE is traditionally quite a high payer and continues to be so.

CS: Okay. And let's just finish on, on the companies that sort of drive the portfolio. You've got a couple of non-UK holdings which you prefer over the UK peers, the likes of Sanofi, the French healthcare company, and you've got an Austrian oil and gas company called OMV [OMV AG]. Could you maybe explain the rationale behind those, and maybe why you hold the latter over the likes of Astra [AstraZeneca plc] and BP [BP p.l.c.]?

AW: Yeah, definitely. So, the fund is primarily a UK investment trust, So, it has to have 80% of the assets in the UK but we do use that 20% - I think we're using about 15% of it today. And you've mentioned two of the most notable names, So, if you look at them specifically: to me, Sanofi just looks a better idea than Glaxo [GSK plc] in terms of both its growth from its key Dupixent franchise [*Dupilumab, sold under the brand name Dupixent, is a monoclonal antibody used for allergic diseases such as eczema, asthma and nasal polyps etc.]*, which is still growing very strongly. But also, it has a quite strong balance sheet. So, it has a much lower debt level than Glaxo and therefore it sort of stacks up both in terms of growth and downside protection.

And then OMV is a more complicated story, but one that I think is really quite interesting. So, we bought into that earlier this year as they fell quite a lot when the oil price went up in March compared to other oil companies, which did very well. And that's because OMV did distribute some Russian gas and had an oil field in Russia. So, while Shell an BP had JVs [Joint Ventures] in Russia, they didn't directly distribute Russian gas and people were very concerned about what that meant in terms of sort of OMV supply contracts and their obligations. And we were convinced that that was gas that they could substitute from elsewhere and those fears were overblown. And also, OMV being a much more gas-focused portfolio looked particularly attractive because clearly the global supply of oil hasn't really changed because of Russia/Ukraine; Russia is unfortunately able to divert where it sends its oil, away from sort of G7 countries, whereas actually most of its gas was piped to Europe and therefore again, there is a new demand for gas. The gas in Europe is increasingly not going to come from Russia, and therefore you now need to develop more gas. And OMV has new gas fields ready to go, particularly in Romania that have been stalled recently and I think can push forward. And so, that looks really quite attractive

CS: … as we had a warm winter this year, but it might not necessarily be the case next year.

AW: So, yeah, so, it's been very helpful to Europe that we haven't used the gas so, the near-term situation has been alleviated, but that long term still needs to be fixed. And in the meantime, yeah, gas, is still trading at high levels compared to history; nowhere near the highest levels that it's been over the last 12 months, but that's very beneficial to OMV and has in fact allowed them to double their dividend this year. So, it's yielding about 10% where[as] Shell is yielding about 5[%]. So, I think you've got both near-term earnings from gas, but also, that medium-term development potential, that looks much more interesting at OMV.

CS: Alex, once again, thanks for joining us and explaining everything, not just UK a little bit overseas as well. Thanks for your time.

AW: Thank you.

SW: The Fidelity Special Values trust aims to achieve capital growth by investing primarily in unloved UK companies and waiting for them to come back into favour. The trust can hold some overseas stocks too, although this is limited to no more than 20% of the value of the portfolio. To learn more about the Fidelity Special Values trust visit FundCalibre.com – and don't forget to subscribe to the 'Investing on the go' podcast, available wherever you get your podcasts.

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