

Conviction investing in US equities



Adrian Brass is the portfolio manager of Fidelity Funds - America Fund.

Adrian has over 15 years of investment experience. He joined Fidelity in 2006 and managed the Fidelity Funds - Global Consumer Industries fund until December 2007. He has been managing Fidelity Funds America since January 2008.

Adrian Brass has been managing Fidelity Funds – America Fund since January 2008. Over the last three years as at the end of May, the fund has outperformed its benchmark by 377 basis points beating 91% of its competitors. Adrian has a disciplined investment approach based on valuation and runs a fairly concentrated portfolio of 80-100 stocks.

WITH THE END OF QE2 AND THE LATEST RELEASE OF WEAK ECONOMIC DATA, HAVE YOU CHANGED YOUR OUTLOOK FOR THE MARKET?

Whilst I am a bottom up stock picker, I have had a cautious outlook for the economy for the past few months and my assumptions have been for a slower growth environment in the United States and the Western economies going forward due to high levels of consumer and government indebtedness. Recent economic releases have confirmed a slowdown of the economy although this is set against relatively bullish comments and better-than-expected reported earnings from US companies. My concern is that US companies have already seen margins recover to peak levels and valuations for the market as a whole are just fair at this level. With a universe of over 3,000 stocks to choose from however, my disciplined approach to investing continues to find good opportunities even in this environment.

CAN YOU TALK THROUGH THE CURRENT THEMES IN YOUR PORTFOLIO?

I have a number of running themes in my portfolio that will change overtime. These themes tend to translate into a 5% overweight in the fund. The current themes in the portfolio are:

Under-appreciated growth - GDP growth in the western world is likely to be constrained for the next few years. My assumption for the US is that the economy will carry on growing albeit at a much slower pace than seen in the past or seen in other regions such as emerging markets like India or China. Therefore the stocks which will still be able to generate growth in this low growth environment will do well and outperform. Examples of this theme include: Mastercard, which is well placed to continue to benefit from the growth of non-physical payment transactions; BMC Software, which will benefit from the growth in Cloud technology; and Ebay, which should outperform when the growth potential of its payment subsidiary Paypal is reflected in the valuation of the group.

Mid to late cyclicals - We are now entering the later stages of economic recovery and I favour late cyclical stocks that will benefit from this environment. For example, stocks exposed to infrastructure projects, power or housing should do well. In this theme, I own stocks like the leader in tools and security hardware, Stanley Black & Decker that will benefit from any pick up in the housing recovery. Another stock and one of my top bets in the portfolio is Towers Watson, a staffing and recruitment company that is highly geared to employment and will react when employment recovers.

Independent cycles - I also find stocks whose performance is uncorrelated to the economic recovery cycle, and therefore don't rely on an economic scenario to perform. For example, the move from branded to generics within the pharmaceutical sector will provide some uplift in the margins of pharmacy benefit managers. I have exposure to this theme through leading drug distributors and pharmacy benefit managers, McKesson and Medco and leading pharmacist Walgreen that are likely to benefit from substantially higher profitability in the shift to generics.

Cost cutting - This theme has been long standing in the portfolio. I rely on the analysts a lot who identify underappreciated cost-cutting potential in their stocks. In this category, I own Ingersoll Rand - a diversified industrial company that provides products such as compact construction equipment, refrigeration units, security systems, and compressors amongst others. I believe that the benefits of the rationalisation of the company will surprise on the upside in the coming years.

Special situations - Stocks where there is misunderstood risk/reward. For example, oil exploration stocks whose valuation are attractive based on existing assets offer free optionality on any new programmes.

TOP 10 OVERWEIGHT HOLDINGS (%)

as at 31.05.11	Fund	Benchmark
McKesson	1.7	0.2
Mastercard	1.7	0.2
Fidelity National Information Svcs	1.6	0.1
BMC Software	1.6	0.1
Towers Watson	1.5	0.0
TD Ameritrade Holding	1.4	0.0
Viacom B	1.6	0.2
Medco Health Solutions	1.6	0.2
Ebay	1.6	0.3
Accenture	1.3	0.0

Source: FIL Limited. Benchmark: S&P 500.

Top overweights and underweights are those securities that had the largest active positions relative to the benchmark holding. Holdings in different securities issued by the same company are listed separately and any exposure achieved by derivatives is not shown. This means that the data may not always represent the total exposure of the portfolio to any given company. References to specific securities are for illustrations only and are subject to change without notice. They should not be construed as a recommendation or advice to transact in the securities

CAN YOU PLEASE GIVE A BRIEF OVERVIEW OF YOUR INVESTMENT PROCESS?

I am a bottom-up stock picker and I seek companies with strong valuation upside and clear catalysts to release this potential. I focus on three aspects when trying to identify potential catalysts that could lead to a re-rating of a stock. These include the macro-economic backdrop (e.g. geographical, demographics, industrialisation and currency), industry-specific drivers (e.g. cyclicality, regulation and secular growth) as well as company-specific factors (e.g. sales growth, profitability and reorganisation). I tend to take positions in high-conviction ideas which have a strong valuation upside and where the above drivers will lead to a better-than-expected earnings growth.

I put a lot of importance on valuation and invest in stocks with a strong valuation upside of 30% to 50% and a limited downside potential. I am also disciplined in trading around my target prices.

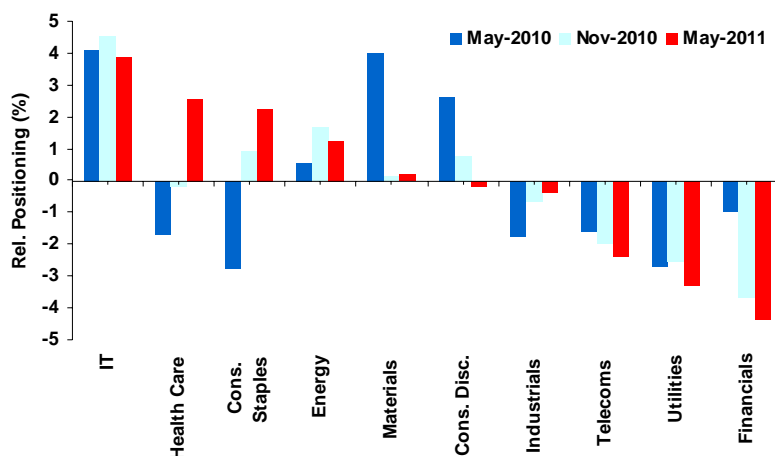
WHAT DIFFERENTIATES YOU FROM OTHER US FUND MANAGERS? WHAT IS YOUR SIGNATURE?

I would highlight four things that I believe differentiate and characterise my investment style. Firstly my disciplined process which concentrates solely on companies that meet the two sides of my investment criteria (strong valuation upside and catalyst). Secondly, following extensive work on building my convictions, I will always add on share price weakness and often I am betting against the consensus. Thirdly, I approach the US market from a global perspective which is appropriate for this very international market and draws upon the global team in London and one of the deepest buy-side research team in the US. Lastly, these strengths have translated to a strong performance record over the long term and I believe my disciplined approach is suited to deliver sustained performance in the future.

HOW WOULD YOU DESCRIBE THE CURRENT POSITIONING OF THE FUND?

Having been very overweight in cyclical names since the beginning of the recovery, I have gradually reduced this exposure as these stocks have performed well, and have recently shifted the fund to more defensive sectors such as healthcare and consumer staples. The fund, as a result, is now more balanced than it has been over the past three years. The fund's biggest overweight remains in the technology sector as it offers access to a diverse set of businesses with uncorrelated drivers. Consumer staples have been added to the portfolio including companies well positioned to deliver strong pricing and costs savings. I remain cautious on financials and this is the biggest sector underweight as there is still a lack of clarity on regulatory change. I also do not own any utilities and hardly any telecoms as I see few attractive stocks within these sectors.

SECTOR POSITIONING- CHANGES IN THE SECTOR WEIGHTINGS RELATIVE TO THE S&P 500 BENCHMARK OVER THE LAST 12 MONTHS



Source: FIL Limited 31.05.11, Benchmark = Standard & Poor's 500 Net Index, excludes cash. Cash position =0.5% (30.04.11), 1.6% (30.04.10), 0.0% (31.10.10). Sector exposure can be affected by the use of derivatives and this is not reflected here.

DO YOU OWN STOCKS OUTSIDE OF THE US?

The international exposure tends to be between 8% and 12% and currently stands just above 10%. There are several scenarios why I decide to invest outside of the US. Firstly and principally, in the case where companies that are directly comparable with their US counterparts but at a substantially cheaper valuation. One example of this would be WPP which presents similar geographical profile and fundamental drivers as its US advertising agency peers, Omnicom or Interpublic, yet trades at a substantial discount. Secondly, companies with great growth prospects and profitability where their success in the US market is key to the stock's success such as HeilderbergCement that derives over 20% of sales in the US and will benefit from the positive outlook for cement pricing in the US.

WHAT IS YOUR OUTLOOK FOR US EQUITIES IN 2011?

With the recent set of mixed economic data, the summer months might prove to be volatile with a lack of direction in the market.

The market is in a transition phase as there is confusion over whether slowing economic indicators represent a mid-cycle slowdown or, as others profess, a prelude to another recession. I believe that this is just a slowdown in the pace of growth. By the end of the year we should have a clearer view of where the economy is heading and the government will have announced the next set of measures to support a recovery, which will give investors more confidence.

In the current environment, I still find lots of companies with strong growth prospects and valuation upside and, in any case, the S&P 500 is not the US economy. It is an investable universe of over 3,000 stocks which offer access to most areas of the global economy from a geographical point of view or sectoral point of view. I believe that I can find many money-making investment ideas within this universe which will generate outperformance for the fund.

"I believe that we are set for a period of slower GDP growth; in this environment any companies able to generate superior growth will outperform. My aim to identify as many of these companies as I can."

Adrian Brass, Portfolio Manager



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