TRANSCRIPT

Introducing active equity ETFs

Adina Taylor: Hi, everyone, and thanks for joining us today in our discussion on Fidelity's active-equity ETFs. It has taken a very long time for us to be able to offer these products. And we're really excited that we have time today to share with you what they are, how they work, and how you can invest. We'll start with a little bit of background on the ETF industry and the opportunity for active-equity ETFs in particular. Then we will share Fidelity's innovative new product structure that we use to bring them to market. And finally, we'll hear from Sonu Kalra, the portfolio manager of one of these ETF, Fidelity Blue Chip Growth ETF, ticker FBCG.

To start and just talk a little bit about why active-equity ETFs, we'll go look into first why ETFs. And what we have here highlights some of the inherent benefits of the ETF vehicle. As many of you know, the ETF industry has been growing in popularity. And these features are part of the reason why. Starting at the bottom, ETFs have been known to exhibit lower average expense ratios than mutual funds. While much of this is driven by the passive nature of most ETFs, there are also different administrative expenses that can lead to lower cost. Next, we get to tax efficiency of the vehicle. The creation and redemption process to add shares or to absorb shares from the market is done

in kind. This compares to mutual funds, where all flow activity occurs in cash. Because of this in-kind creation and redemption process, there's not the same likelihood of capital gain from the buying and selling of securities within the underlying portfolio. And this leads ETFs to be naturally more tax efficient than mutual funds. ETFs, as their name implies, are traded on an exchange. Therefore, they benefit from the same tradability features of individual securities. Intraday trading, limits, stop orders, traditional orders, the ability to short are some of the key examples of features that ETFs experience. How they differ from individual securities, though, is the diversification benefit that they provide. ETFs provide exposure to a particular segment of the market. Could be a sector. Could be a factor. But they do so without the idiosyncratic risk of investing solely in individual securities. And then, finally, transparency. Traditional ETFs have disclosed full holdings daily. While this requirement is now lifted for certain new ETFs, and we'll spend a good amount of time today talking about that, the full transparency is still largely relevant for nearly all of the funds in the market.

And so, given all of these features, it's really no surprise at the strong growth trajectory that we've seen in recent years for the ETF market. This shows how assets have grown, over the last 20-plus years, growing at an 18 percent

average annual rate. And we now have, at least as of the end of 2019, almost four and a half trillion in assets under management, across the ETF industry.

The popularity of the vehicle is also clearly demonstrated when you look at industry flows. Looking at flows into both ETFs and mutual funds over the last several years, we can see that, for the past five years in particular, ETFs have experienced tremendous inflows, to the tune of 1.6 trillion, while mutual funds, during that same time period, were largely flat in terms of flows, with only 33 billion in inflow.

If we break down the ETF industry, looking at active and passive, we would see that the active segment of the market is much, much smaller. Meanwhile, we do know that there are investors who like and appreciate the benefits of active management. And part of the reason why the active-ETF industry is so much smaller is because of a structural component of it. Essentially, the holdings disclosure policy that I referenced before around ETFs has been a hindrance to active-ETF development. As I mentioned before, ETFs traditionally disclose their holdings on a daily basis to the market. This has been a regulatory requirement. The full transparency into daily holdings has been a real hurdle for a lot of active-equity managers, thus far. We know portfolios managers, as their job, are seeking to identify price dislocations in the market. And you can

imagine how signaling your daily trading activity to the market has the potential to open you up to front-running, which ultimately hurts your shareholders, by eroding the manager's alpha potential. Essentially, if others in the market know what you're buying while you're still buying it, price could be bid up and it could be disadvantageous for the shareholders of that strategy. Now, we do still have some active ETFs in the industry today. But a lot of that has been within the fixed-income space. A lot of these are fully transparent. So, while on the equity side there are a lot of concerns, on the fixed-income side, the same types of concerns around front-running don't seem to exist. Essentially, it's a lot harder to replicate one of these portfolios, because in many instances the same bonds just aren't available for purchase. That said, there are some fully transparent active-equity ETFs in the market today. These are largely run by smaller asset managers or they're quantitative strategies, without the same fundamental stock-picking that you see in a lot of other active portfolios.

So, using this as a backdrop, we want to get into why there is potential for active-equity and what Fidelity has done to address the challenges inherent in the industry. This timeline demonstrates the length of time that Fidelity has but also how we've persevered and committed to being able to deliver active management in the ETF vehicle. Starting in initial discussions with regulators

in 2007, Fidelity has filed multiple updates to our exempted application, seeking to get permission from regulators for a new flavor of ETF which are not required to disclose full holdings on a daily basis. With a lot of back and forth, a lot of discussion, we were finally able to get their approval for our structure at the end of 2019. And just three weeks ago, we were able to launch our first three active-equity ETFs.

Why did we take so many years, 13 years of partnership with the SEC in order to get to that point? And it's really because of what we show here. We wanted the ability to solve for this problem of giving investors the features of the ETF that they know and love and combining that with the benefits and alpha potential of active management. We like to refer to this as exchange-traded alpha, which is the ability to have the features that you want of the vehicle but with the benefits that active management can provide. The way I like to think about this is essentially bringing the best of both worlds. With active management, you get the portfolio manager's decision-making. You get the professional management from that portfolio manager, in partnership with research analysts. And you get all of that, wrapped in the ETF vehicle that a lot of our investors know and love. This way they get the benefits of those features that we discussed earlier, like the tax efficiency of the in-kind creation

and redemption process, the potential for lower investment cost, the possibility to trade like a stock and buy on margin, with stop or limit orders.

And so, the real question gets to how were we able to accomplish this. And we'll talk a little bit about the mechanics of it today. But this really capitalizes on the three pillars which were of the utmost importance for us, as we were developing this methodology. The first, and we covered this a little bit -- but we didn't want to compromise. We really wanted to be able to offer all of those features of ETFs that our investors know and love with the potential of active management. And we wanted to make sure that we were preserving all of these features together but also delivering it in a product that offers a seamless experience to investors. We wanted your experience to be just the same as if you were buying any other ETF, basically giving you the benefit but not taking away the simple user experience that you're accustomed to. Second, we needed to figure out an approach that would allow us to shield daily trading activity but also provide sufficient transparency to the market, allowing authorized participants to effectively arbitrage and keep spreads tight. Essentially, there's a reason why daily holdings disclosure was a requirement for ETF. For authorized participants in the market to be able to issue new shares, they needed to know what was in the portfolio. And without having access to full daily holdings, that could be a challenge. And so, we

wanted to come up with an approach that gave them sufficient transparency, sufficient insight into the portfolio, without revealing so much of the daily trades that it costs the shareholders alpha potential that could be eroded with front-running. We've been avoiding the term *nontransparent* here, when we talk about this, although it is a term you'll see in the industry, used quite a lot. But we believe the structure still gives enough insight into current holdings to make an effective product, while still delivering the alpha potential that our clients are looking for. And then, finally, we wanted to ensure our approach was what we'll call ecofriendly. Essentially, we didn't want to require any additional infrastructure or operational build-out to accommodate on the part of end investors like yourself but also for the other firms and partners that we have within the industry. There is a well-working ETF ecosystem that's already established. And we really wanted to make sure that our approach fit nicely into that and was as seamless as possible for investors, advisors, and asset managers.

So next we'll get into a little bit of the methodology and how we actually achieve this sufficient transparency that we were striving for. And essentially, it all ties to this concept of a Tracking Basket. So, the three pillars that I talked about earlier, it's the Tracking Basket approach that is really what allows us to facilitate all of them. It shields the daily trades, preserving alpha, for our

excess-return potential. And it also allows the marketplace to understand what kind of exposures are within the portfolio, which facilitates effective creation and redemption. And finally, it fits neatly into the already established ETF ecosystem, by serving as a daily file that gets published day about the ETFs holdings. If we look at the schematic here and you look at the characters on the right-hand side, the shareholder, the broker-dealer, the authorized participant, that diagram would look exactly the same if you were talking about any other type of ETF. Shareholders will still be able to buy through a broker or on an exchange. Authorized participants play a role in creating new shares and managing the spreads in the industry. And all of that works in the same way with these products. The one nuance is this teal box, which is called Fidelity's Tracking Basket. Essentially, traditional ETFs provide a daily file to the market, that says exactly what securities are held and exactly those weights. We're simply providing a different file, every single day, that looks a lot like the underlying exposure but shields some of the individual trading activity that is done. Our active-equity ETFs will disclose our full holdings, just like our mutual funds do, and instead will use this daily file, to facilitate the creation and redemption process that's needed for the daily market activity. The way we create this Tracking Basket is to take the last publicly disclosed holdings, include a set of representative ETFs to augment any exposure that may have changed since the last disclosure period. And then we run a

quantitative optimization model, to develop a portfolio whose performance should track closely to that of the ETF.

Another way that I like to think about it is thinking about your grandmother's famous cookies. You want to enter a baking competition using grandma's famous cookies. And so, you bake them. You include all of those secret ingredients, the recipe that she's perfected over years. And when it comes down to entering into the baking competition, you're supposed to submit a copy of the recipe. But if you submit the recipe, then everybody knows all of grandma's secret ingredients. And so, you instead submit a recipe that's close, is still a cookie recipe, it's still going to taste really good if anyone follows it, but you keep those secret ingredients to yourself. Now, the judges of the competition, they're tasting grandma's actual famous cookies, because you baked them with those secret ingredients. You just don't want all of the secret ingredients out there, for anyone who looks at the recipe. And that's essentially how this works. The Tracking Basket is like the recipe that you submit. It gives insight into the fact that it's a cookie, it's grandma's recipe, had chocolate chips. This one will too. But it doesn't have every single secret ingredient in there. The judges can still evaluate her actual cookie. And the end investors of the ETF are going to hold the actual holdings that the

portfolio manager wants them to. We're just using this one step in the process to help protect the IT of those portfolio managers.

And so, with this as a background into the structure, I just want to introduce our product to the market. So, we were really excited. After so many years of designing this structure, we were finally, three weeks ago, able to bring to market three active-equity ETFs, that utilize this approach. Our goal was to bring a suite of capabilities to the market. So, we have a value strategy, and opportunistic or core strategy, and a growth strategy. The Fidelity Blue Chip Value ETF, ticker FBCV, is a large-cap, value-oriented strategy, seeking capital appreciation. Fidelity New Millennium ETF, ticker FMIL, is an opportunistic strategy, that will invest across all sectors, market capitalizations, and styles. And then Fidelity Blue Chip Growth ETF, ticker FBCG, is a domestic-equity growth strategy, with a large-cap bias. And we'll hear from Sonu Kalra in just a few minutes, to talk a little bit more about that strategy. But essentially, these three represent our first suite of active-equity ETF. They utilize this Tracking Basket approach that we discussed. They are available for purchase on fidelity.com. You can buy these the same way you would any other ETF. And they are our best approach at giving you the active-management capabilities that Fidelity has been developing over our 70-plus-year history but with the flexibility of an ETF trading vehicle. They're available for 59 basis points. And

we're really excited that we have this offering for you and can bring both the benefits of active management -- and combine that with the features of the ETF. With that, I will stop and turn it over to Sonu, who's going to take you through Fidelity Blue Chip Growth ETF and the investment process and philosophy that he's using in that strategy. Sonu, I'll turn it over to you.

Sonu Kalra: Thanks, Adina. And thanks, everyone, for taking the time out of your schedule with us today. Just to start, maybe I thought I'd tell you a little bit about the overall strategy for the Fidelity Blue Chip Growth ETF. The overarching theme that we're trying to really focus on is identifying companies where the market is not only mispricing the absolute rate of growth but also the durability or the sustainability of the growth. So, if you look over history, the market does a pretty good job of identifying what we classify as traditional growth companies. So historically, if you looked at an Apple or a Starbucks, the market does a really nice job of figuring out that these companies are good companies, with good business models and show the characteristics of a growth company. Where the market really has trouble is trying to figure out the durability or the sustainability of the growth rate. So, if you take Apple as an example... I was actually the Apple analyst, you know, in the early 2000s, when they introduced the iPod. Everyone thought that they were a hardware maker -- get commoditized. Next thing you know, they took the iPod,

introduced the phone, and then kind of continued, created an ecosystem around it. And that growth rate around Apple has persisted for much longer than investors anticipated, which has led to outsized returns for investors. And that's really what to do, as a portfolio manager, is trying to find these companies that can grow sustainably over long periods of time.

Just a little background on me. I've been at Fidelity for over 20 years. I've headed up our technology research group for several years and then started managing several funds, technology-focused funds, in the early 2000s. And for the past 10-years-plus, I've been running the Fidelity Blue Chip Growth Fund mutual fund and just launched the Fidelity Blue Chip Growth ETF. Which, I'm really excited to put that same strategy to work, with the advantages of active management.

Tell you a little bit about my philosophy and process. The one thing that I really try to focus on is trying to find companies that can grow earnings double-digits over the long term. And I'll touch on why I focus on that double-digit hurdle. And to simplify it, it's really trying to identify, really, fish in a pond, where there's a lot of fish. Focus a lot on fundamentals. I spend a lot of time with our global research department, trying to identify companies that are in good industries, have competitive barriers that can lead to pricing power. We

used to travel a lot. We haven't been, the last few months, given the pandemic. We're doing a lot of Zoom calls, meeting with management, not just what I would call the CEO level or CFO -- the C-suite but really the business-unit-level managers, and trying to understand how the strategy flows down from the top, throughout the organization. And that's really important to me. I still think of myself as an analyst, at heart. I spend a lot of time doing fundamental analysis and really trying to identify companies where the market is, really, mispricing the durability of the growth.

The reason I focus on that double-digit hurdle... If you look at the bottom chart there, you see a blue line that really separates itself from the other lines, the light-blue line. That's a portfolio of companies that grow earnings double digits each year. And so, it's really as simple as that. If you can find these companies early on and hold onto them for a long time, you can really compound that growth rate and participate in the upside all the time, versus portfolios of the companies that don't grow their earnings double digits or the S&P 500, which are the other two lines.

In terms of how I think about defining blue-chip and growth, it really boils down to three buckets. First, on the blue-chip side, I look at the business model, I look at the returns, and then the growth characteristics. On the

business model side, it's really trying to do the traditional competitive analysis. Think of it as Porter's five forces. I pay a lot of attention to capital intensity. Does the business require repeated access to capital to fund its growth? I started out as a media analyst, here at Fidelity. And one of the industries that I covered was the radio industry. And it was going through a period of consolidation. And what I learned really quickly is, even though the companies looked very expensive on the surface, they actually were really good businesses. Because you could operate a radio station in a very small footprint and generate very high returns. And they were generating a lot of cash flow. And so, they were really good businesses. And that kind of really set my high, on trying to identify companies that can generate cash. They don't have to be generating cash today. One of the things, as a growth investor, that I focus on is a company that can have the potential to generate cash in the future. Doesn't need to be generating cash day one. A lot of times, you need to reinvest that cash back in the business.

The second thing I focus on is returns, and return on equity, return on assets, return on invested capital. They really guide me, in terms of the quality of the business. And really pay attention to management teams and their history of allocating capital. Have they made good acquisitions, bad acquisitions, they've reinvested in the business? The other thing that I focus on is really the

direction of those returns. Are the returns improving or are they deteriorating? That's really important to me. What I find is, when companies can reinvest in their business in opportunities that are better than their existing business, that typically leads to improving margins and also a higher P/E, that the market's willing to pay. And so not only do you participate in the earnings growth but the multiple usually goes up. And so, you get paid twice.

The third bucket that I focus on is really growth. Organic revenue growth is typically the first question that I ask an analyst when they bring me a new idea. It's the one metric that really puts all companies on an even scale. And so, you know, earnings, there's different accounting characteristics associated with how different industries calculate earnings. But revenue is revenue. And I really try to focus on organic revenue growth. And one of the other questions I typically ask is market share. Is the company gaining market share or losing market share? And it really gives me an indication of the competitive intensity of the business.

On the growth side, I also break it down into three buckets, secular growers, cyclical growers, opportunistic growers. On the secular side, it's really trying to identify companies that can benefit from secular trends. You know, some trends that we're focused on currently, health and wellness -- more recently,

with the pandemic, work-from-home has become a big trend -- 5G, e-commerce, health and wellness, which I mentioned, also personalized medicine, artificial intelligence. So, when we can identify these trends, what we'll try to do is find companies that can benefit and participate in these trends. And the market is really typically underestimating the magnitude of the growth opportunity here and really the duration or the sustainability of that growth. So, if you think about Apple again as an example, that mobility trend has been around for many years, over a decade. And when they launched the iPhone, their initial goal was to capture one percent of the overall handset market. And they're well above that today.

On the cyclical side, it's really companies focusing on the business cycle, and where companies can benefit from where we are in that business cycle. This is a great time to identify some cyclical companies, where the consensus can typically get overly pessimistic during downturns. The energy industry is a great example of that a few years ago, where oil prices had fell, the industry cut production, and oil prices recovered. The housing industry, another example, in the global financial crisis, which was the epicenter. And typically, the market assumes that the future will look like the past and really doesn't fail to rebound. And so cyclical industries like those -- semiconductors can fit into that category as well -- can provide opportunities.

And the last bucket is what I characterize as opportunistic opportunities. These are companies that may be benefiting from industry dynamic changes or what I consider self-help stories. A lot of these can be a new management team coming in, a new CEO, or a turnaround -- sometimes there are new-product introductions -- where the company is really not depending on outside forces but really controls its own destiny in terms of providing an opportunity to show some growth.

In terms of how all this comes together on the portfolio construction side, it's really, as I mentioned identifying these themes. I touched on some of them. These are long-term themes, that really don't change, and they should be secular tail winds for several years. So some of these include e-commerce, internet advertising, cloud computing, data, as more and more people get access to data, personalized medicine -- I think we're seeing real technological medical advances on personalized medicine -- artificial intelligence, how that's impacting the healthcare industry, as well as autonomous driving, and then sustainable energy, electric vehicles. I think we're on the cusp of the penetration curve there and so we should see dynamic changes on that front. So, we'll try to identify some of these themes and then really try to dig deep down and find companies that can benefit from some of these themes and can

really show that durability of growth that I touched on earlier. In terms of what we've seen over the last, what I would say, several decades and why, you know, growth and technology, in particular, are so important, one of the biggest themes has been just the declining cost of technology is enabling mass adoption. So, when you look at the cost of storage, the cost of memory, computing trend, that's really gone down, by orders of magnitude, over the last 50 years. And that's making technology more pervasive in our lives. And I almost equate it to technology is becoming more like a consumer staple. And I think the pandemic has been a great example of that, where we've replaced, you know, human interaction or physical interaction with digital interaction. And companies are really focused on digital transformations inside their enterprises, in order to accomplish that. And I think that's a trend that we're going to continue to see for many, many years.

Another theme is e-commerce. In terms of where we are in penetration, in the United States we're still at about 10 percent of overall retail sales, which is actually smaller number than where China is. China's closer to 20 percent of overall retail sales. And so, I think that number's going to continue to grow. And we've identified companies that can take advantage of that secular growth theme and participate in the growth of the shift from traditional bricks-and-mortar sales to e-commerce.

Another theme is internet advertising. As a former media analyst, when we look at how media's being consumed today, it's completely different than how media was consumed a decade ago or two decades ago. My kids don't even know what linear TV is. Everything is on-demand. They want to watch what they want, when they watch it. And that has huge implications for how advertising is spent. And so, we're seeing those changes take place, where we're seeing shifting ad dollars from those traditional media mediums to more digital medias. And again, that's a long-term secular trend.

Another one is AI or artificial intelligence. And I think it's really at the intersection of a lot of trends, including healthcare. I mentioned autonomous driving. We're seeing lots of examples of where companies are really deploying artificial intelligence. And one of the great things about this right now is how it's being used to find a cure for COVID-19. The CEO of NVIDIA, which is one of the semiconductor makers that makes chips to enable artificial intelligence, talked about, on their last earnings call, how they saw a big increase in their business as a result of demand from healthcare institutions and universities on trying to identify a cure for COVID-19. So, we're pulling out all the stops, in order to do this. So that's one example. Another example is autonomous driving. We're at the early stages of that. When you see what

can be done, I'd say we're at level three right now. But over the next three to five years, I think we're going to see big advances on autonomous driving. So that's artificial intelligence.

And kind of adjacent to that is sustainable energy and electric vehicles. We're seeing battery cost come down very quickly. Just in a few years, we're going to see the cost of an electric vehicle and a combustion engine kind of hit the crossover point. And we think that's going to be a big factor in driving EV adoption. And so, we're at the very early stages of that today but we think that's a trend that's here to stay. And then along with that are other alternative energy sources as well, that can participate in that.

In terms of how the fund is managed, I manage the day-to-day fundamental aspects of the research. My co-manager, Michael Kim, helps me execute what we're doing, on the ETF side, as Adina mentioned, about the recipe. He kind of holds the secret sauce on the recipe and helps execute that, so we can do it in a manner that doesn't impact the mutual fund shareholders. But the strategies are very similar. And the great thing is is I'm really excited to be able to bring this strategy to the ETF front.

END OF AUDIO FILE

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The objective of the actively managed ETF Tracking Basket is to construct a portfolio of stocks and representative index ETFs that tracks the daily performance of an actively managed ETF without exposing current holdings, trading activities, or internal equity research. The Tracking Basket is designed to conceal any nonpublic information about the underlying portfolio and only uses the Fund's latest publicly disclosed holdings, representative ETFs, and the publicly known daily performance in its construction. You can gain access to the Tracking Basket and the Tracking Basket Weight overlap on Fidelity.com or i.Fidelity.com.

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