This Fund's Superior Stock Picking Should Drive Outperformance

Despite the shortcomings of accounting-based metrics such as price-to-earnings ratios, return on equity, or accounting book value to pick stocks, many mutual fund managers continue to use them.

When analyzing[1] the holdings of over 7,500 U.S. ETFs and mutual funds every day, we occasionally find a fund whose managers look beyond accounting earnings and focus on economic profit and free cash flow. This week we are featuring one such fund, the Fidelity Advisor Mid Cap Value Fund (FIDFX and other share classes), as this week's Long Idea.

Traditional Fund Ratings Underrate this Fund

Fidelity Advisor Mid Cap Value Fund (FIDFX) has underperformed its benchmark, the iShares Russell Mid Cap Value ETF (IWS), over the past one and three years. As a result, the fund earns 2-Star and 3-Star ratings (depending upon share class) from Morningstar.

However, past performance has little predictive value for future results. Research from Morningstar itself recently showed that there's almost no difference in the long-term returns of 3-star vs. 5-star funds. Per Figure 1, FIDFX, and five other share classes receive a 2-Star or 3-Star rating from Morningstar. These share classes receive a "Hold" rating from Zacks.

Instead of looking at past performance, we analyze the forward-looking risk/reward of funds based on their holdings. When viewed through our Fund Rating methodology, all share classes earn a Very Attractive rating. Higher quality holdings and below average costs mean FIDFX is more likely to outperform going forward, which is something traditional fund research doesn't usually tell you.

Figure 1: Fidelity Advisor Mid Cap Value Fund Ratings

Ticker	Morningstar Rating	New Constructs Rating
FIDFX	3 Star	Very Attractive
FMPAX	3 Star	Very Attractive
FMPOX	3 Star	Very Attractive
FMPTX	3 Star	Very Attractive
FSMVX	3 Star	Very Attractive
FMPEX	2 Star	Very Attractive

Sources: New Constructs, LLC, company, ETF and mutual fund filings, and Morningstar

Holdings Research Reveals Superior Stock Picking Methodology

The primary manager of Fidelity Advisor Mid Cap Value Fund, Kevin Walenta, recognizes the importance of fundamental analysis and drivers of shareholder value. In a "portfolio manager Q&A" Mr. Walenta says:

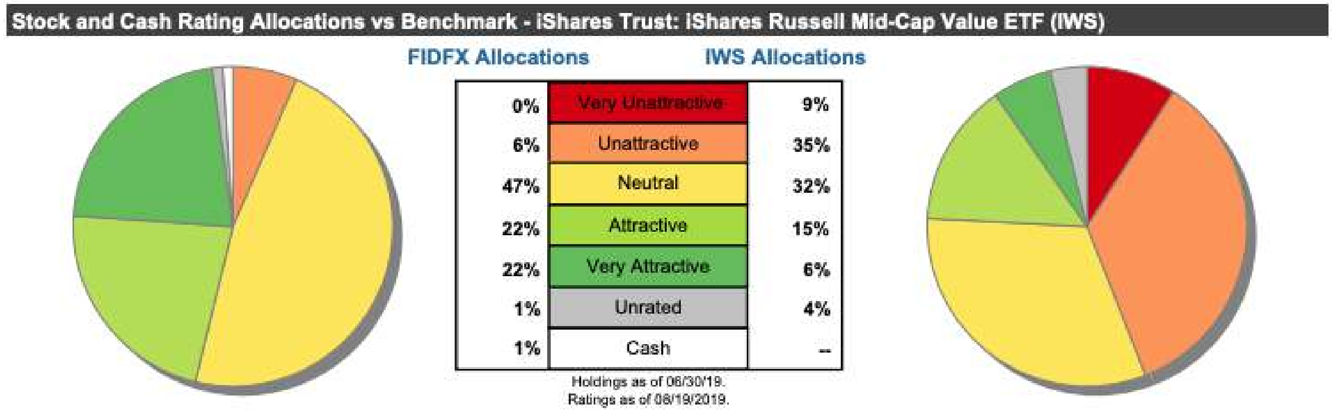
"My focus is on buying strong mid-cap franchises when they are temporarily out of favor with investors, resulting in mispriced free cash flow and economic profit."

From the fund's summary prospectus, the manager looks for stocks that are "undervalued in the market place in relation to factors such as assets, sales, earnings, growth potential, or cash flow, or in relation to securities of other companies in the same industry."

[1] Harvard Business School features our Robo-Analyst research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

Figure 2 shows that FIDFX allocates a significantly higher percentage of its assets to Attractive-or-better rated stocks and a significantly lower percentage to Unattractive-or-worse rated stocks than its benchmark, the iShares Russell Mid Cap Value ETF (IWS).

Figure 2: FIDFX Asset Allocation Compared to IWS



Sources: New Constructs, LLC and company filings

Specifically, FIDFX allocates 44% of its assets to Attractive-or-better rated stocks compared to just 21% for IWS. On the flip side, FIDFX allocates just 6% of its assets to Unattractive-or-worse rated stocks compared to 44% for IWS.

FIDFX's portfolio includes many stocks we've featured as Long Ideas: Williams-Sonoma (WSM), Cummins Inc. (CMI), Best Buy (BBY), Lear Corp (LEA), Omnicom Group (OMC), Snap-On (SNA), NVR Inc. (NVR), Oshkosh Corp (OSK) and Regal Beloit Corp (RBC). These stocks make up over 15% of FIDFX's total portfolio allocation.

Given this favorable allocation to quality stocks relative to the benchmark, Fidelity Advisor Mid Cap Value Fund appears well positioned to capture more upside with lower risk. Compared to the average mutual fund, FIDFX has a much better chance of generating the outperformance required to justify its fees.

Superior Stock Selection Drives Superior Risk/Reward

Figure 3 shows how FIDFX's managers excel at finding higher-quality companies (as measured by ROIC) with lower-risk valuations.

Figure 3 breaks down our overall rating for FIDFX, which includes each of the criteria we use to rate all funds under coverage. These criteria are the same for our Stock Rating Methodology, because the performance of a fund's holdings equals the performance of a fund after fees.

Figure 3: Fidelity Advisor Mid Cap Value Fund Rating Breakdown

Fidelity Devonshire Trust: Fidelity Advisor Mid Cap Value Fund (FIDFX)

Closing Price: $20.66 (Aug 19, 2019)
Total Net Assets: $1.8 Billion
Style: Mid Cap Value

	Portfolio Management						
	Quality of Earnings		Valuation			Asset Allocation	
Risk/Reward Rating	Economic vs Reported EPS	ROIC	FCF Yield	Price to EBV	Market-Implied GAP	Cash %	Total Annual Costs
Very Unattractive	Misleading Trend	Bottom Quintile	<-5%	>3.5 or -1<0	>50	>20%	>4%
Unattractive	False Positive	4th Quintile	-5%<-1%	2.4<3.5 or <-1	20<50	8%<20%	2%<4%
Neutral	Neutral EE	3rd Quintile	-1%<3%	1.6<2.4	10<20	2.5%<8%	1%<2%
Attractive	Positive EE	2nd Quintile	3%<10%	1.1<1.6	3<10	1%<2.5%	0.5%<1%
Very Attractive	Rising EE	Top Quintile	>10%	0<1.1	0<3	<1%	<0.5%
Actual Values							
FIDFX	Positive EE	11%	5%	1.1	4 yrs	1%	0.8%
Benchmarks							
Style ETF (IWS)	Neutral EE	6%	0%	2.9	28 yrs	-	0.3%
S&P 500 ETF (SPY)	Positive EE	18%	2%	2.9	37 yrs	-	0.1%
Small Cap ETF (IWM)	Positive EE	5%	-1%	3.3	36 yrs	-	0.2%

Sources: New Constructs, LLC and company filings

As Figure 3 shows, FIDFX's holdings are superior to IWS in all five of the criteria that make up our holdings analysis:

- FIDFX's holdings earn an Attractive Economic vs. Reported EPS rating compared to Neutral for IWS.
- FIDFX's return on invested capital (ROIC) is 11%, which is greater than the 6% earned by IWS.
- FIDFX's free cash flow yield of 5% is well above IWS' 0% and the S&P 500's (SPY) 2%.
- The price to economic book value (PEBV) ratio for FIDFX is 1.1, which is less than the 2.9 for IWS and SPY.
- Our discounted cash flow analysis reveals an average market-implied growth appreciation period (GAP) of just four years for FIDFX holdings compared to 28 years for IWS and 37 years for SPY.

The stocks held by FIDFX generate superior cash flows compared to IWS, but the market expects stocks held by IWS to grow profits for much longer and by a greater amount.

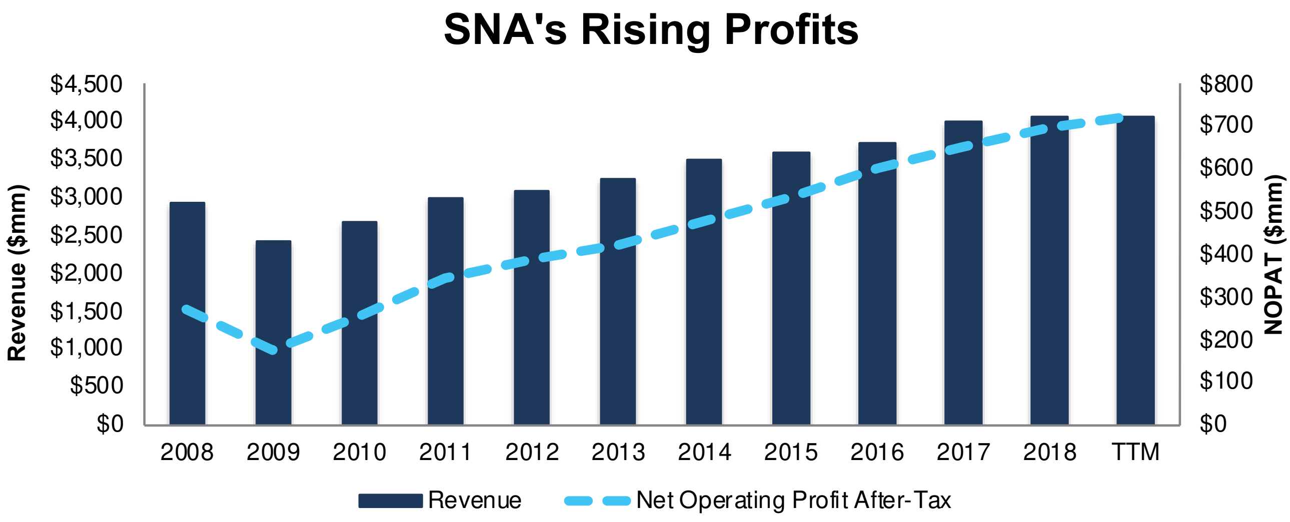
Below Average Costs Benefit Investors

Not only does FIDFX offer high-quality stock selection, it does so at a reasonable price. The fund's total annual costs of 0.84% make it cheaper than 92% of the 173 Mid Cap Value mutual funds that we cover. Its costs are also below the Mid Cap Value mutual fund average of 1.73% and the asset-weighted average of 1.53%. Other share classes, such as FMPOX and FSMVX, also charge below average TAC. FMPEX, FMPTX, AND FMPAX charge above-average total annual costs, but these share classes justify higher fees through superior holdings.

Deep Dive on a Quality Holding

Snap-On (SNA: $149/share) is an undervalued stock with positive strong free cash flow and economic profit/earnings. Its 14% ROIC over the trailing twelve months (TTM) is up from 12% in 2008. Over the past decade, it has grown after-tax profit (NOPAT) by 10% compounded annually. Over the past five years, the firm generated $1.4 billion (17% of market cap) in free cash flow. TTM NOPAT is also up 9% over the prior TTM period.

Figure 4: SNA's Revenue & Profit Growth Over Past Decade



Sources: New Constructs, LLC and company filings

At its current price of $149/share, SNA has a price-to-economic book value (PEBV) ratio of 0.9. This ratio means the market expects SNA's NOPAT to permanently decline by 10%. This expectation seems overly pessimistic for a firm that has grown NOPAT by double digits over the past decade.

If SNA can maintain 2018 NOPAT margins of 17% (below TTM margins of 18%) and grow NOPAT by just 3% compounded annually for the next decade, the stock is worth $199/share today – a 34% upside. See the math behind this dynamic DCF scenario.

FIDFX's Methodology Isn't Perfect

With just 6% of assets allocated to stocks with an Unattractive-or-worse rating, it's difficult, but not impossible, to find a low-quality holding, such as Ameren Corporation (AEE: $77/share).

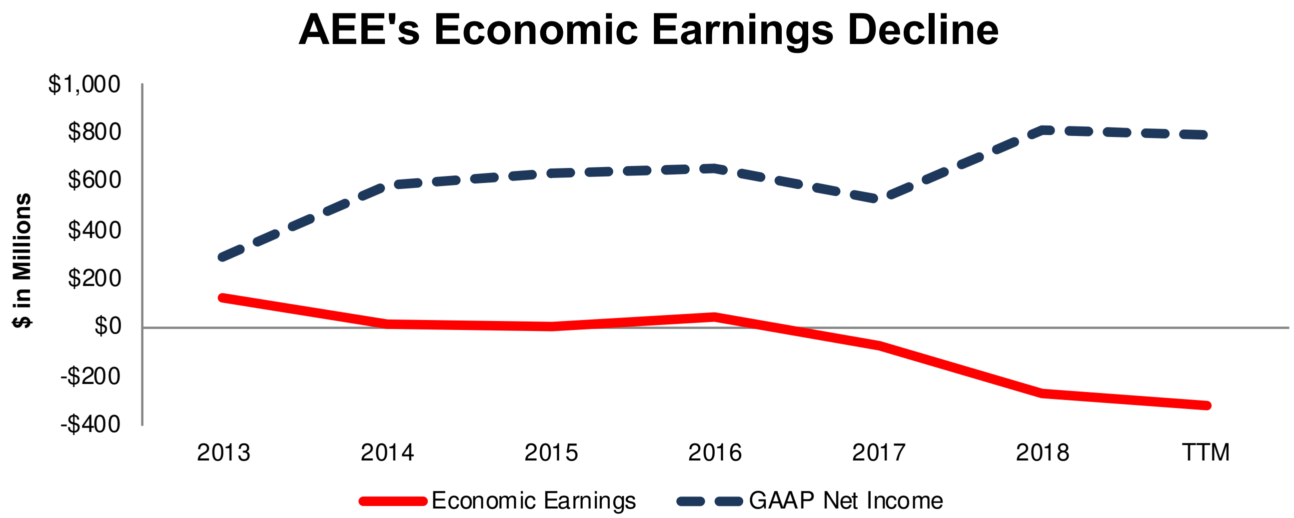
Up 26%, Ameren was one of FIDFX's top performing holdings in fiscal 2018. FIDFX management attributed this performance to an "improved regulatory environment that would eventually aid revenue and earnings growth." Unfortunately, after the big increase last year, the stock is significantly overvalued.

Here's what we think FIDFX's managers are missing:

1. Accounting and economic earnings are headed in opposite directions. Per Figure 5, AEEs economic profit/earnings have declined from $121 million in 2013 to -$320 million over the trailing twelve months (TTM). GAAP net income has risen from $289 million to $795 million over the same time. This disconnect stems from the company's balance sheet expansion, which is not captured in GAAP net income and similar metrics.
2. AEE's invested capital is growing faster than NOPAT. Specifically, invested capital has grown by nearly 3% compounded annually over the past decade while NOPAT has increased less than 1% compounded annually over the same time. Over the last five years, average invested capital turns, a measure of balance sheet efficiency, declined from 0.26 to 0.21.
3. AEE's weighted average cost of capital (WACC) is up from 2.4% in 2012 (lowest in the history of the firm) to 4.3% TTM.

Managers (and investors) not seeing the decline in invested capital turns and rise in cost of capital are missing the disconnect that has emerged between economic and accounting profit/earnings, which means the stock is more expensive than it appears based on accounting metrics.

Figure 5: AEE's Economic Earnings Reveal Growing Losses



Sources: New Constructs, LLC and company filings

Given the deteriorating fundamentals above, and our analysis of the expectations baked into its stock price, AEE appears to be a low-quality company and overvalued stock – not a winning combination.

To justify its current price of $77/share, AEE must maintain 2018 NOPAT margins (15%) and grow NOPAT by 5% compounded annually for the next 10 years. See the math behind this dynamic DCF scenario. This expectation might not seem unrealistic, until one considers that AEE has grown NOPAT by less than 1% compounded annually over the past decade.

If AEE traded at its economic book value, or no-growth value of the stock, it would be worth $33/share today – a 57% downside.

Luckily for investors, AEE appears to be an outlier in what is largely a strong portfolio.

The Importance of Holdings Based Fund Analysis

Smart fund (or ETF) investing means analyzing the holdings of each mutual fund. Failure to do so is a failure to perform proper due diligence. Simply buying a mutual fund or ETF based on past performance does not necessarily lead to outperformance. Only through holdings-based analysis can one determine if a fund's managers are sticking to their stated methodology and are allocating to high-quality stocks, as FIDFX does.

However, most investors don't realize they can already get the sophisticated fundamental research that Wall Street insiders use. Our Robo-Analyst technology analyzes the holdings of all 182 ETFs and mutual funds in the Mid Cap Value style and 7,500+ ETFs and mutual funds under coverage to avoid "the danger within." The number of holdings in these Large Cap Value ETFs and mutual funds varies from just 26 stocks to 2076 stocks in a given fund. Our diligence on holdings allows us to cut through the noise and find mutual funds, like FIDFX, with a portfolio and methodology that suggests future performance will be strong.

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Disclosure: David Trainer, Kyle Guske II, and Sam McBride receive no compensation to write about any specific stock, style, or theme.

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Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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