MUTUAL FUND Investor Guide

THE Investor Guide TO FIDELITY FUNDS

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Matthew Sauer is the Founder and Chief Investment Officer of the Mutual Fund Investor Guide family of newsletters. Each month he analyzes and provides buy, sell and hold recommendations for hundreds of mutual funds and ETFs in the Investor Guide to Fidelity Funds, Investor Guide to Vanguard Funds, as well as the ETF Investor Guide.

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SPECIAL REPORT:
Best Fidelity Fund for 2015
FIDELITY PURITAN FUND (FPURX)

Stock investors have witnessed an incredible bull market since the last bear market ended in March 2009. Fidelity Spartan 500 (FUSEX) has rallied 209 percent, more than tripling from its lows. The rally has come amid the Federal Reserve's three rounds of quantitative easing, which helped suppress interest rates and volatility, driving investors toward risky assets as they hunted better returns.

In some cases, investors have increased the risk in their bond holdings by shifting into higher-yielding but lower-quality bonds. High-yield bonds are more correlated with stock market movements, which increases the total market risk in the portfolio. On the other hand, high-yield bonds are less sensitive to rising interest rates due to their generally lower duration. This makes them attractive to investors who want yield but are worried about rising rates, which certainly has occurred recently.

Other investors have gone full bore into the stock market and have reduced bond exposure. The 30-year Treasury currently yields less than an average dividend fund, while the 10-year Treasury yields less than the S&P 500 Index. However, unlike the S&P 500 payouts, bond coupons will not rise over time. An investor who buys a 10-year Treasury will receive the same payout for 10 years, whereas S&P 500 dividends paid in 2014 were more than 80 percent higher than those paid in 2004.

Even though traditionally low-risk bonds such as Treasuries look like a bad long-term investment today due to the risk of rising interest rates, they haven't lost their role in a portfolio. Aside from reacting differently to changes in interest rates and general economic conditions, stocks are more volatile than bonds. Even if the long-term trend in bonds is down, bonds still could be a better investment in the near term given this lower volatility factor.

Furthermore, volatility has been artificially low over the past few years because the Federal Reserve's intervention (via quantitative easing) suppressed volatility with a multitrillion-dollar blanket of liquidity. During the three rounds of quantitative easing, volatility in the stock market (as measured by the Chicago Board Options Exchange Market Volatility Index, more popularly known as the VIX Index), declined. At the expiration of each round of quantitative easing, there was a jump in volatility before it came down with the next round of easing. Now that the final round of easing is over and the Fed is looking at raising rates later this year, a return to normalcy is underway. In this case, a return to normalcy means more volatility. Since the expiration of the final round of easing in October, the VIX Index has been in an uptrend, and volatility looks set to be a major factor in 2015.

STAYING DIVERSIFIED

Diversification in a portfolio leads to lower volatility. For example, from 1972 through 2014, an investor holding a portfolio entirely in U.S. equities would have seen the investment grow at 10.4 percent on an annualized basis. The best year was a 38.4 percent gain and the worst year was a 37 percent drop. An investor holding a portfolio with the typical 60/40 split between stocks and bonds (in this case long-term bonds) would have seen a 10.1 percent annualized return since 1972. The best year was a 33.5 percent gain and the worst year saw a 14.8 percent loss. That is a significant decrease in volatility.

The level of volatility doesn't tell us too much about the direction of the market. The VIX was high in the late 1990s bull market but low during the 2000s bull market. However, it does signal that stocks are likely to rise and fall with greater amplitude in 2015, and the way investors dampen that volatility is to remain diversified, even if it means holding assets that appear to offer a low return at present, such as Treasuries and investment grade debt. The benefits of holding high-quality bonds in a portfolio is not only due to the income they generate, but the role they play in reducing portfolio volatility.

Although we generally do not favor allocation funds because investors can achieve similar, and more customized, results by picking a bond fund and a stock fund, in this case we are making an exception to highlight the benefit of diversification in a portfolio. For that reason we are selecting Fidelity Puritan Fund (FPURX) as the Best Fidelity Fund for 2015.

FIDELITY PURITAN (FPURX)

Established in April 1947, FPURX seeks capital growth and income consistent with realistic risks. In pursuit of this objective, the moderate allocation fund invests approximately 60 percent of its assets in stocks and other equity securities. The remainder is invested in bonds and other debt instruments. At least 25 percent of investable assets will be allocated toward senior fixed-income securities, such as secured bonds and preferred stock. The large growth fund has more than $24.5 billion under management, and Morningstar gives it a five-star rating.

INVESTMENT STRATEGY

Ramin Arani has guided FPURX since 2007 using a large growth equity strategy blended with a cautious bond policy that produces a mix of aggressive and defensive selections. Starting with the base concept of 60 percent equities and 40 percent fixed income securities, Arani has adjusted equity exposure up to as much as 70 percent in recent years. This additional risk is tempered with a low-risk fixed income strategy managed by Pramod Atluri and Harley Lank, manager of Fidelity Global High Income Fund. The change in portfolio balance is commensurate with perceived scarcity or abundance of opportunities.

Arani selects individual equity securities issued by companies with strong investment returns and good prospects of growing their dividends. Another strategy has been to invest in a basket of smaller stocks rather than single names. Although the S&P 500 Index is the benchmark, Arani will over- or underweight sectors and individual securities in pursuit of faster growing names. These strategies help the fund outperform the index generally, but a dramatic difference in returns from that of the S&P 500 Index is unlikely. The stock portfolio lands in the Large Cap Growth section of Morningstar's Stylebox.

The bond portfolio, managed by Atluri since 2012, takes a low-risk approach, while a small slice is given over to Lank, who invests in high-yield bonds. An overall low-risk bond strategy results in a concentration of U.S. Treasuries, plus an avoidance of volatility or bets on changes in interest rates because the aim of these managers is to reduce the overall volatility of the fund. Income is enhanced by laddered exposure to mid- and below-investment-grade debt instruments. The result is a portfolio that lands squarely in the middle of Morningstar's Stylebox for bonds, which indicates middle credit quality and moderate interest rate sensitivity.

COMPOSITION, DIVERSIFICATION AND HOLDINGS

At the end of 2014, domestic equities constituted 61.42 percent of the portfolio and another 6.46 percent was in international equities, for a total of 67.88 percent. Bonds were 29.57 percent of assets, and 2.55 percent was in cash.

The stock portion of the portfolio is dominated by exposure to the information technology, healthcare and financial sectors. The fund is overweight information technology and healthcare relative to the benchmark; it is underweight energy, consumer discretionary, utilities, materials, real estate and industrials. The fund is most exposed to technology at 20.85 percent of assets, more than 7 percentage points more than the benchmark. Healthcare has 19.70 percent of assets, more than 8 percentage points more than the benchmark. The heavy exposure to technology and healthcare is attractive here. Healthcare will do well thanks to the Affordable Care Act, which has increased healthcare spending and has generated higher profits for the sector. Technology has enjoyed a strong run and is better positioned for a stronger U.S. dollar since currency fluctuations are less important for cutting-edge technology that businesses rely on to survive.

The bond portion of the portfolio is heavily weighted toward investment grade (28.96 percent of assets), mortgage pass-through (19.21 percent), high-yield credit (15.00 percent) and U.S. Treasury securities (14.52 percent). The fund also holds municipal bonds and commercial mortgage-backed securities. Investment grade debt is attractive because it benefits if interest rates fall, but will also hold up well if rates increase because the companies behind the debt are financially strong. Breaking it down by credit quality, more than 85 percent of bond holdings are in investment grade debt or higher. Overall, the yield on the fixed income assets comes to 1.40 percent.

While 93.79 percent of the fund is invested in North America (1.4 percent in Canada and the rest in the U.S.), 5.12 percent is invested in Europe and 0.61 percent in emerging markets. In addition to the U.S. and Canada, the largest individual country exposures include Ireland, the Netherlands and the United Kingdom. Currency diversification includes the euro, Canadian dollar, Japanese yen, British pound and Swiss franc, but 98.68 percent of the fund is in U.S. dollar denominated securities. We like U.S. dollar exposure as long as the U.S. dollar remains in a bull market. A correction in 2015 is possible following the big run in 2014, but with a stronger economy and a more favorable monetary policy in the U.S., a major reversal appears unlikely.

The top 10 holdings of FPURX at the end of 2014 constituted 15.47 percent of the portfolio. The top holding was Apple at 2.9 percent of assets, followed by U.S. Treasury notes maturing in December 2017, Bank of America, Microsoft, Fannie Mae bonds, and 30-year Fannie Mae bonds with a 3.5 percent coupon. Other securities include Actavis PLC, Amgen, Facebook, Comcast and J.P. Morgan.

The annual holdings turnover for FPURX is 160 percent compared with the category average of 38.22 percent.

PERFORMANCE

Fund manager Arani's stock-picking acumen and asset allocation strategy have kept the fund ahead of its peers and the underlying benchmark even when adjusted for risk.

FPURX has outperformed its moderate allocation category in all but one year since 2007. The three-, five- and 10-year returns through the end of 2014 are 14.89 percent, 11.73 percent and 7.14 percent, respectively. This compares with the moderate allocation category averages for the same periods of 11.72 percent, 9.43 percent and 5.93 percent. The fund's equivalent 30-day yield is 1.45 percent.

Since its inception, the fund has seen a positive return in 53 years and a negative return in 14 years. In 2008, the fund lost 29.16 percent, and it was the one year the fund failed to beat its category. Still, the return was well ahead of the 37 percent loss in the S&P 500 Index. Given the roughly 30 percent weighting in bonds post-2008, the fund has kept pace very well with the S&P 500 Index. Although the fund consistently trails the equity index, in the past 10 years, the only year it trailed by more than 3 percent was in 2013, when the equity index rallied more than 30 percent. FPURX delivered a 20.34 percent gain that year.

RISKS, FEES AND DISTRIBUTIONS

FPURX has an expense ratio of 0.56 percent compared with the category average of 0.91 percent and does not have any 12b-1 fees. The low expense ratio places it in the cheapest quintile relative to its peers. FPURX has an initial $2,500 minimum investment for both taxable and nontaxable accounts. There is no minimum amount for subsequent investments. The fund has a minimum maintenance balance of $2,000. Although there are no check-writing features, the fund does support direct deposit and automatic account builder programs.

RECOMMENDATION

As noted above, we generally favor investors selecting equity and bond funds separately, but Fidelity Puritan is one of the strongest options in the moderate allocation category. The fund has been very competitive with the S&P 500 Index during the past five years, despite being a balanced fund. Investors who hold an unbalanced portfolio of assets should consider rebalancing their portfolio as soon as possible. The character of the markets has changed, with stock market volatility on the rise. A moderate allocation fund such as FPURX is already off to a good start in January, and has significantly outperformed the S&P 500 this year.

Runner-Up

Fidelity Strategic Dividend & Income (FSDIX) is an aggressive allocation fund with a 2.55 percent 30-day SEC yield. The fund has a default allocation of 50 percent in common stocks, 15 percent in REITs, 15 percent in convertible securities and 20 percent in preferred stocks. About 80 percent of the fund is invested in equity securities. Currently, the fund has 51.5 percent in common stocks, 17.7 percent in preferred stocks, 7.2 percent in convertibles and 15.9 percent in REITs. The remainder of the portfolio, aside from a small holding in cash, is in bonds that range from the lower end of investment grade to high-yield bonds. The fixed income portion of the portfolio delivers a 2.34 percent yield.

FSDIX uses a multi-manager approach. Scott Offen, who manages Fidelity Equity Dividend Income (FEQTX), manages a slice of the fund's common stock holdings. Adam Kramer manages the convertible securities and preferred stocks sleeve; he also manages some convertible bonds for Fidelity Equity Income (FEQIX). Samuel J. Ward manages the REIT assets.

Joanna Bewick is the lead manager and Ford O'Neill is the co-manager of FSDIX. They also manage Fidelity Strategic Income (FSICX). They mainly focus on the allocations for each sleeve of assets, while the submanagers make the security selections.

The fund had a solid 2014, finishing the year with a 13.33 percent gain. One reason for the strength was that the managers allowed the real estate investments to run, upping the weight in the portfolio. This helped the fund in early 2015 as well, with FSDIX down only 0.44 percent in January, beating its category (aggressive allocation) and the S&P 500 Index. Over the past three, five and 10 years, the portfolio has beaten its category by an annualized 2.75 percent, 3.16 percent and 1.11 percent, respectively.

If you have any questions or comments about these funds, we would be delighted to speak with you. Please call us at (888) 252-5372, Monday through Friday 8:30am to 5:30pm, eastern time. You can also email me at Matt@mutualfundinvestorguide.com.

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FIDELITY PURITAN FUND (FPURX)

Top 10 Holdings	% Assets	% Coupon
Apple Inc.	AAPL	3.31
US Treasury Note 0.875%	N/A	2.25
Bank of America Corporation Com	BAC	1.47
Microsoft Corporation	MSFT	1.39
Fannie Mae 3.5% 30 Year	N/A	1.34
Actavis PLC	ACT.IR	1.34
Amgen Inc.	AMGN	1.32
Comcast Corporation	CMCSK	1.23
Johnson & Johnson Common Stock	JNJ	1.16
JP Morgan Chase & Co. Common St	JPM	1.16

FUND CHARACTERISTICS	
YTD Return	10.75%
3 Year Average Annual Return	14.89%
5 Year Average Annual Return	11.73%
10 Year Aveage Annual Return	7.14%
Morningstar Category	Moderate Allocation
Beta	0.99
SEC Yield	1.55%
Turnover	160%
NAV	$21.52
NET Assets	$24.5 B
Morningstar Overall Rating	5 Star
Morningstar Risk Rating	Average
Investment Minimum	$2,500
Front / Deffered Load	N/A
Short - Term Redemption Period / Fee	N/A
Expense Ratio	0.56%
Stock Holdings	277
Bond Holdings	885

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