The Art of Picking “Best of Breed” Stocks

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Christopher Luongo
Director, Investment Capability Management

For over twenty years at the helm of Fidelity Contrafund, Will Danoff has employed a disciplined investment approach and delivered compelling risk-adjusted performance results that have served to confound efficient market practitioners. Since taking over Contrafund in September of 1990, the fund has outpaced the S&P 500 Index by 354 basis points on an annualized basis, outperforming 97% of Morningstar Large Cap Growth peers while maintaining a lower-risk profile relative to the market (i.e. S&P 500) with a beta of 0.82. These results are a product of Will's rigorous investment process that has been consistently focused on trying to identify companies with superior business models and overseen by sagacious management teams that are capable of delivering robust long-term earnings growth. During his tenure, Will has been intensely focused on fundamental research, specifically geared toward unmasking the drivers of companies' earnings growth that he believes is under appreciated by other investors. In this paper we review the key tenets of Will's approach, some of the components that he's refined over time in order to adapt to changes in the market environment and provide an update on the fund's positioning based on opportunities he's seeing in today's dynamic market environment.

EXHIBIT 1: Average annual return (%) and Morningstar Peer Ranking.

As of 12/31/2011	1 Yr	3 Yr	5 Yr	10 Yr	20 Yr	Life of Manager (9/17/1990)	Inception Date	Gross Expense Ratio
Fidelity Contrafund	-0.12	14.70	2.58	6.96	10.58	12.47	5/17/1967	0.92
S&P 500	2.11	14.11	-0.25	2.92	7.81	8.93		
Morningstar Peer Ranking (%)	30	54	21	1	2	3		
Count	1,683	1,478	1,279	804	484	421		

Source: Fidelity Asset Management (FAM) as of 12/31/2011.
Understanding investment performance: As you review this update, please remember that the performance data stated represents past performance, which does not guarantee future results. Investment return and principal value of an investment will fluctuate; therefore, you may have a gain or loss when you sell your shares. Current performance may be higher or lower than the performance stated. To learn more or to obtain the most recent month-end performance, call Fidelity or visit www.fidelity.com
Total returns are historical and include change in share value and reinvestment of dividends and capital gains, if any. Cumulative total returns are reported as of the period indicated. Life of Fund figures are reported as of the inception date to the period indicated. These figures do not include the effect of sales charges, if any, as these charges are waived for contributions made through your company's employee benefit plans. If sales charges were included, returns would have been lower.
Expense Ratio is the total annual fund operating expense ratio from the fund's most recent prospectus.
Percent Rank in Category is the fund's total-return percentile rank relative to all funds that have the same Morningstar Category. The highest (or most favorable) percentile rank is 1 and the lowest (or least favorable) percentile rank is 100. The top-performing fund in a category will always receive a rank of 1. The number in parentheses represents the number of funds in the category. % Rank in Category is based on total returns which include reinvested dividends and capital gains, if any, and exclude sales charges. Past performance is no guarantee of future results.

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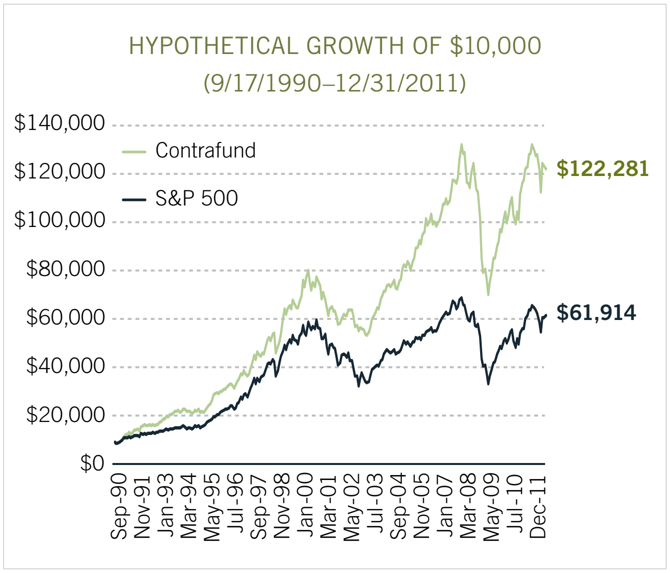
EXHIBIT 2: Twice the value creation of the S&P 500.



Source: FAM as of 12/31/2011.
The chart illustrates the performance of a hypothetical $10,000 investment made in the fund from 9/17/1990 to 12/31/2011 which reflects Will's tenure on Fidelity Contrafund. Figures include reinvestment of capital gains and dividends, but do not reflect the effect of any applicable sales charges or redemption fees, which would lower these figures. This chart is not intended to imply any future performance of the fund.

Casting a wide net

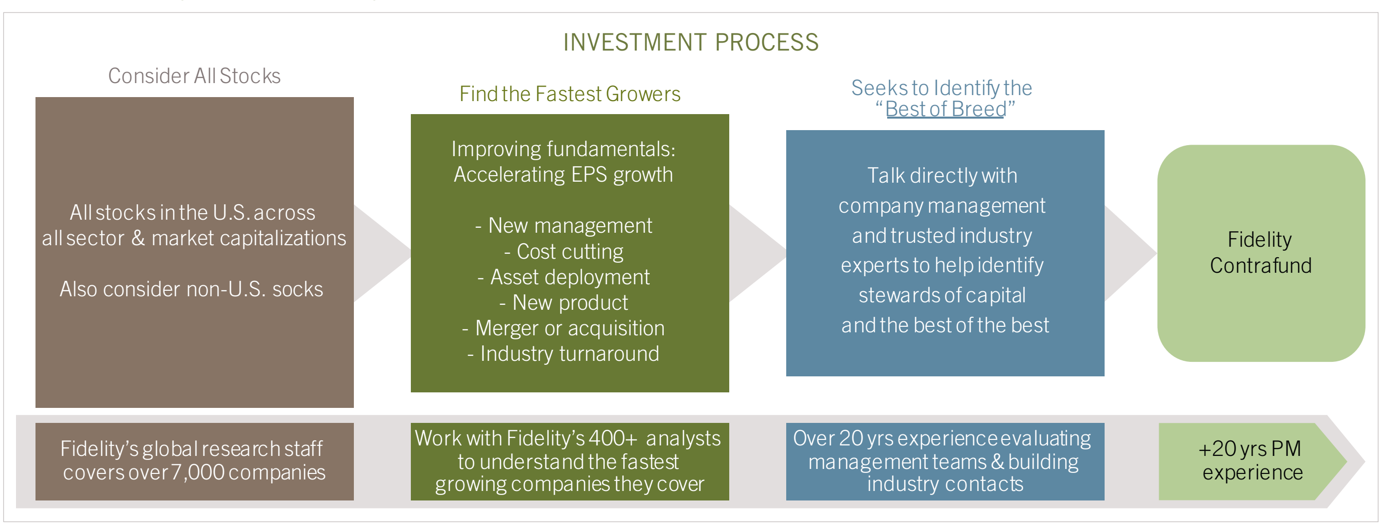
Ideas for holdings in Fidelity Contrafund are sourced from a wide range of places–Fidelity's global research department, quantitative screens, conferences and company meetings, to name a few. This reflects a cornerstone of Will's investment process–to cast a wide net across the globe and engage with as many companies and executives as possible. He tries to meet with anywhere from 5 to 7 companies a day, therefore he has the potential to meet with anywhere from 1,200–1,700 companies per year. In addition to speaking with companies, Will is constantly interacting with Fidelity's global research department, peppering analysts with questions about their coverage universe and areas of expertise. Ultimately, this enables him to take the pulse of the global economy and identify industries, companies or trends with a positive secular backdrop.

This large sea of opportunity is narrowed down through a meticulous investment process (Exhibit 3, below) as Will applies his overall philosophy on stocks. He seeks to identify companies poised to deliver strong relative earnings growth–relative to the market or peers–which has yet to be discounted by the investment community. Furthermore, he is looking for entrepreneurial managers and companies possessing "best of breed" qualities, which are factors he believes, can lead to durable earnings growth and sustained outperformance. While only a subset of the universe ultimately makes it into the portfolio, every company possesses valuable knowledge, such as insights into an industry or competitor. This is value Will seeks to harness and use to his advantage in managing Contrafund. Frequent interaction with companies has also resulted in the accumulation of a large rolodex of contacts and trusted experts that Will can engage with to help learn about their respective markets and industries.

A focus on "best of breed"

The companies that find their way into Contrafund typically have long pathways for growth driven by a novel product or service, in an industry that's under-penetrated and thereby having the opportunity to take a significant amount of market share. Will has tended to gravitate toward less-capital intensive business models, which have shown higher levels of profitability, less cyclicality and abundant free cash flow generation. He's focused on companies where something has changed for the better. This positive change

EXHIBIT 3: Disciplined investment process.



Source: FAM as of 12/31/2011.

could come in the form of a new management team or a stronger-than-expected earnings release which would then, upon further research, show that perhaps the company has a refreshed product line or they've made a shrewd acquisition that's strengthened their distribution, research and development (R&D) capabilities or market position. The catalyst may come from the sale of a loss making division or simply an improvement in the supply and demand dynamics in a particular industry. Will is constantly looking to quantify these positive catalysts by analyzing the income statement, balance sheet and cash flow statement, trying to identify factors that influence revenue growth as well as margin progression.

Will has found over time that each industry typically has one or two companies that have sustainable competitive advantages. These are companies that he refers to as "best of breed" or firms with superior operating and financial models, which are managed by forward thinking executives who are shrewd stewards of shareholder capital. A best of breed company has often grown into the dominant player in its industry with a wide economic moat around its business. Such a distinguished position is typically attributable to a very strong brand name or a particular capability. Unique capabilities could include low cost distribution, more productive R&D, better real estate, a stronger position with the customer, or historically the company was the founder of the industry so they have better expertise and better knowledge of their industry. These companies tend to have motivated management teams who often make the right decisions at different points in the business cycle. Typically, at the top of the cycle they tend to avoid overpaying for an acquisition and at the bottom of the cycle, they tend to gain market share by acquiring their weaker competitors or expanding aggressively at advantageous terms. Ultimately, Will believes that best of breed qualities are key contributors to durable earnings growth and sustained positive relative performance.

Once Will has identified companies possessing growth prospects that he believes aren't appreciated by the market, best of breed qualities and a management team he is comfortable investing with, he has historically, incrementally built his position in the company. Over time he has looked to continue to build conviction in that particular company and as he gets more comfortable he may look to increase its position size in the fund. To the contrary, if the company is unable to execute on its growth objectives, fundamentals deteriorate or makes poor decisions with shareholder capital he has historically sold down his position. Other sell signals could include extreme valuation or when an industry is experiencing a significant increase in capacity, which often follows a spike in financing activity to fund the targeted expansion. In taking these individual positions and constructing a portfolio, this approach has typically resulted in an aggregate portfolio of positions that is projected to grow sales and earnings faster than the benchmark, with higher-quality as measured by its return on equity, return on invested capital and balance sheet strength, and with a slightly more expensive valuation, as Will has been amenable to paying a higher-price for a superior business (Exhibit 4, left).

Investing with an increasingly longer-time horizon in mind

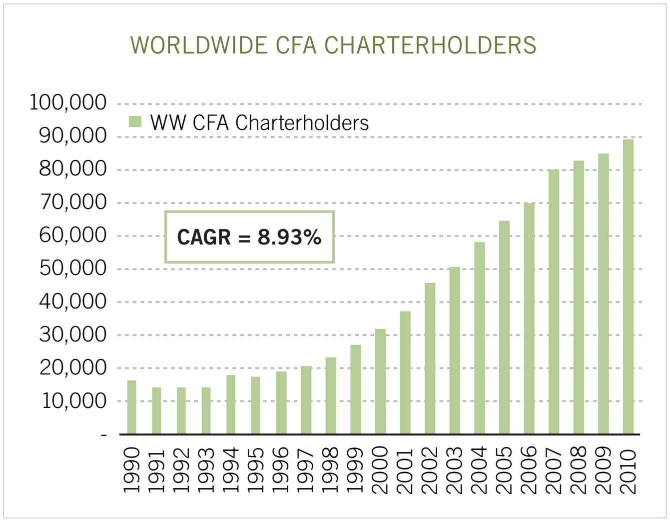
Will has managed Contrafund in accordance with the aforementioned approach for over twenty years. However, he has refined his process over time to adapt to the ever-changing investment and competitive landscape in addition to Contrafund's larger asset base. Notably, Will has been approaching investing with an increasingly longer-time horizon in mind owing to factors including:

EXHIBIT 4: Portfolio characteristics.

	Contrafund	S&P 500
Price to Earnings (1 Yr Trailing)	18.7	13.5
Price to Earnings (1 Yr Forecast)	15.1	11.8
Price to Book	3.2	2.2
Price to Cash Flow	12.4	8.5
Sales Growth (1 Yr Trailing)	22.5	13.2
Historical 3 Yr Sales Growth	16.1	5.4
Earnings Per Share Growth (1 Yr Trailing)	33.9	30.2
Earnings Per Share Growth (1 Yr Forecast)	24.8	15.3
Historical 3 Yr Earnings Per Share Growth	22.5	6.3
Estimated 3-5 Yr Earnings Per Share Growth	15.6	10.9
Return on Equity	23.5	21.6
Return on Invested Capital	19.4	15.5
Return on Assets	12.9	9.8
Debt as a % of Total Capital	22.9	36.1

Source: FAM as of 12/31/2011. All forecasted data according to IBES estimates. Past performance is no guarantee of future results.

EXHIBIT 5: Increased competition.



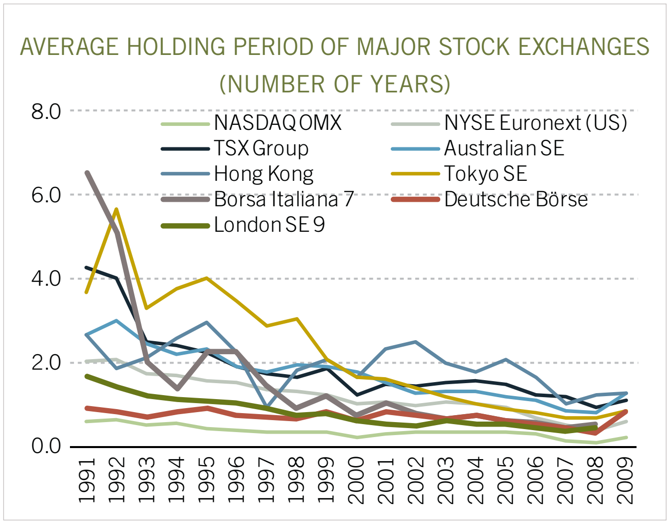
Source: FAM as of 12/31/2010.

- Industry reforms, such as Regulation Fair Disclosure
- The surge in available information stemming from technological innovation
- Increased competition, as evidenced by the growth in CFA Charterholders (Exhibit 5, page 3)
- Declining holding period among investors (Exhibit 6, right)

This longer-term approach seeks to capitalize on a strategy of time-arbitrage, as investors have become more myopically focused on quarterly results or what's being published on a little known blog. Fundamentally, it is also linked to Will's philosophy on stocks—i.e., investors are often wrong about the long-term earnings power of a company and by taking a long-term view, one could exploit such inefficiencies. This is illustrated through empirical research presented in Exhibit 7 (below), which plots the distribution of forecasted and actual compound earnings growth rates for S&P 500 constituents. The chart shows over the past five years, over 25 percent of S&P 500 companies were assumed to grow 13 percent for the next five years, but in reality, only about 10 percent of those companies achieved that growth rate. Furthermore, there was a big disparity where roughly 30 percent of the companies didn't grow earnings at all, yet no one predicted this. Conversely, 13 percent of the companies grew 25 percent or more and only 10 percent were predicted to grow that fast.

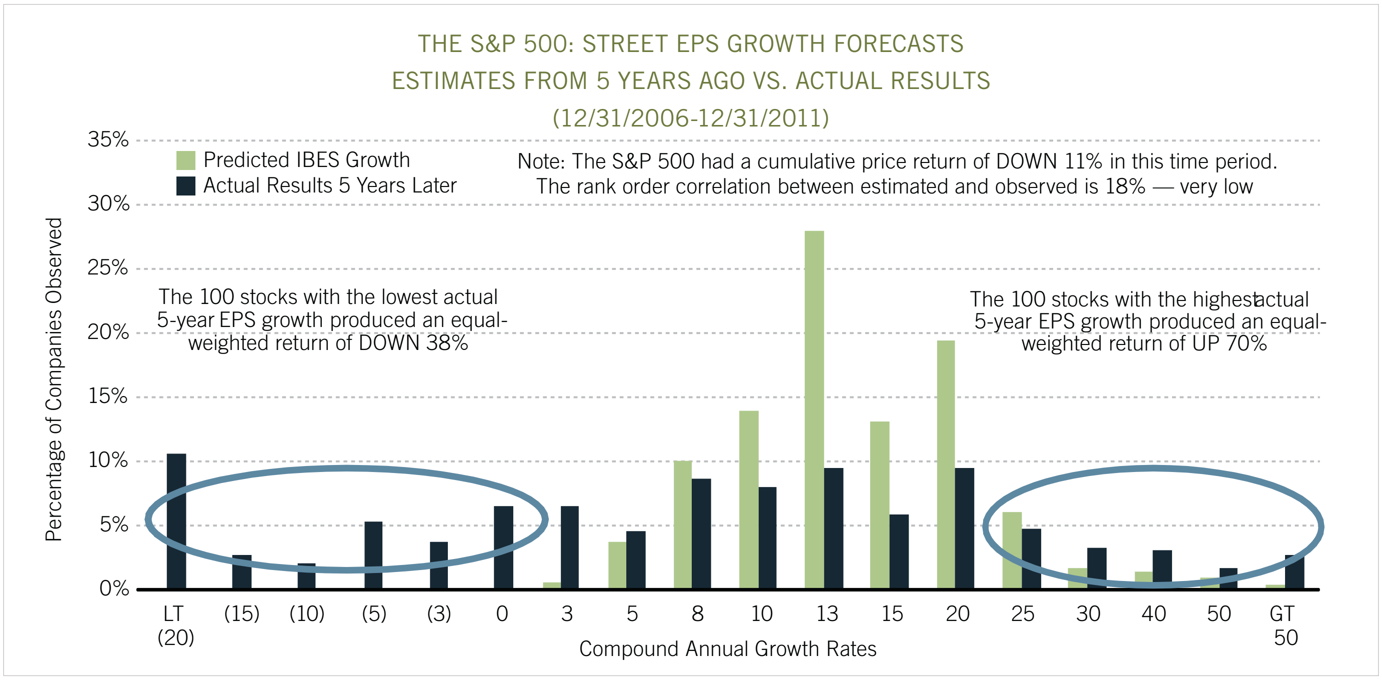
A longer term focus has manifested itself in Contrafund through a declining rate of turnover over time and has also impacted Will's thought process. He often asks himself, "If one couldn't trade their portfolio for three, five or even ten years, would this have been a company of interest?" Top positions in Contrafund have typically been companies that Will believes he can own for such a duration, while acknowledging the market is dynamic and subject to change those views.

EXHIBIT 6: Declining holding periods.



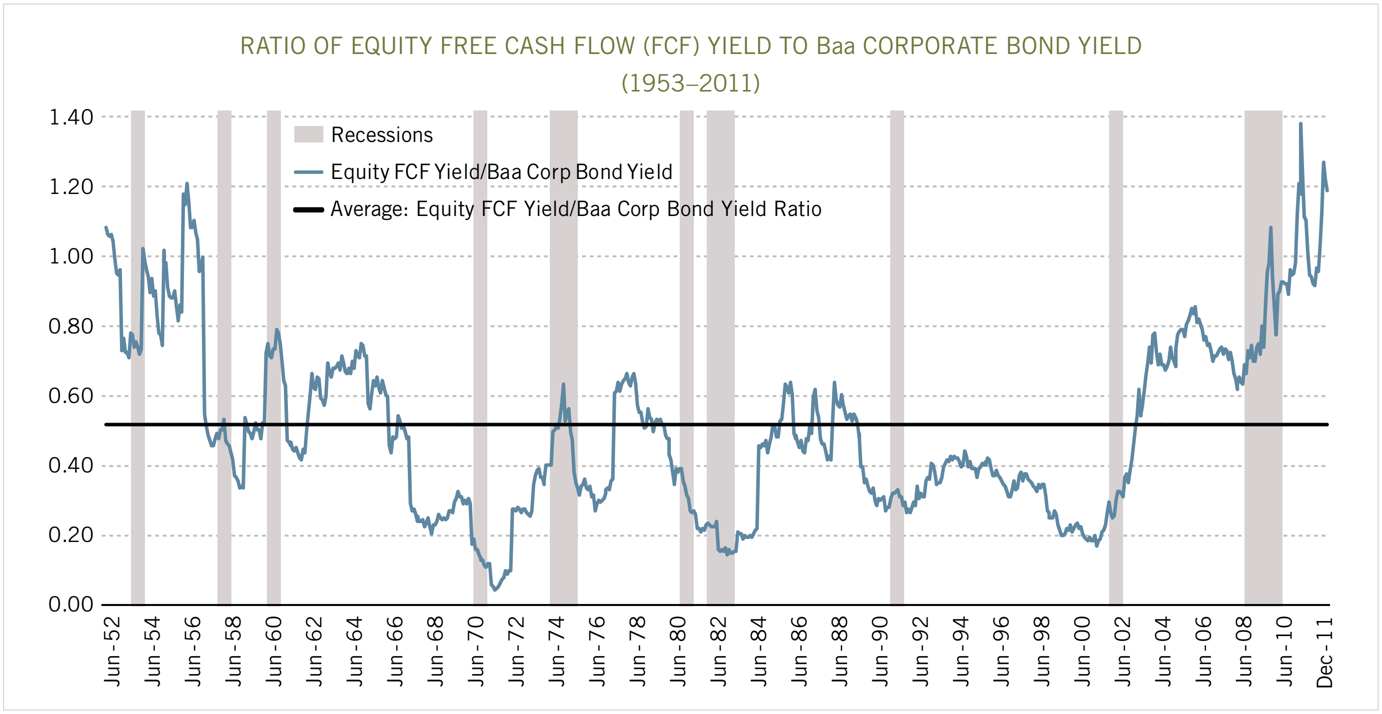
Source: World Federation of Exchanges Members as of 12/31/2009. Average holding period calculated by taking the average total market value based upon beginning and ending market values for each exchange in a given year divided by total value of volume traded in the same year.

EXHIBIT 7: Inefficiencies resulting from inaccurate long-term views.



Source: FAM as of 12/31/2011. IBES - Institutional Brokers' Estimate System.
Past performance is no guarantee of future results.Performance of an index is not illustrative of any particular investment and an investment cannot be made directly in an index.

EXHIBIT 8: Stocks appear attractively valued relative to bonds.



Source: Emprirical Research Partners; FAM as of 12/31/2011.

Opportunities in global blue chips

Owing to the fragile economic backdrop and heightened uncertainty stemming from the European sovereign debt crisis, Will has taken a conservative approach in managing Contrafund through these volatile times. His primary strategy has been to participate in the slow growth global economy by seeking companies that can grow revenues and earnings organically for the next three to five years. Despite the global economic challenges, he does believe investor sentiment has grown overly pessimistic with investors defensively positioned in cash and bonds. This is despite the fact that many large multinational companies have free cash flow yields of 6-8%, or more than three times the current yield of ~2% on the 10-year U.S. Treasury bond. With investors fleeing equities when equity free cash flow yields appear attractive relative to the yield on U.S. corporate bonds (Exhibit 8), and many large cap equities offer price to earning multiples at their lowest in more than 20 years, he's looking to take advantage of opportunities as they arise.

In particular, Will sees opportunity in large cap, global blue chip companies. Many of these companies have seen their share prices stay flat or increase only modestly for 12 years and during that time some have more than doubled or even tripled their earnings. In addition to trading at cheap historical valuations and unlike governments, he believes these corporations are financially strong. Most of them are benefiting from tight cost control, disciplined capital spending, market share gains, and opportunities in the emerging markets. Will believes this conservatism could bode well for future profits and free cash flow.

From a positioning standpoint, technology has been the fund's largest exposure on an absolute basis for several months and stood slightly behind consumer discretionary on a relative basis at the end of the third quarter. While the sector could be vulnerable to economic slowing and is intensely competitive—issues Will intends to monitor closely—the fund's technology holdings are beneficiaries of the growing adoption of the Internet, smartphones and cloud computing, to name a few examples. Furthermore, many have excellent margins, low capital intensity and huge opportunities to sell their products and services overseas. Within the fund's largest relative sector weight, consumer discretionary, Will has been targeting two themes: 1) companies that provide products and services that offer a strong value proposition to consumers and help them save money and 2) firms with strong brands that enable them to maintain pricing power.

As for underweighted areas, Will has struggled to find opportunity among financial and health care companies. The former has been inflicted by weak loan demand and compressing net-interest margins, plaguing growth prospects, while health care companies face patent expirations and pricing pressure. Despite these significant challenges both sectors are universally disliked by investors and Will is combing over both for opportunities. Lastly, Will has used the industrials sector as a source of funds as he believes the sector is exposed to competitive threats from emerging market companies and to slowing economic growth in the emerging markets where capital spending has been very robust for the last decade.

A tried and tested process has yielded positive results

For over twenty years Will Danoff has demonstrated success in delivering investors returns in excess of the passive alternative, which he's achieved by employing a disciplined and consistent investment approach. Working in concert with Fidelity's research department and his vast network of contacts, Will has continuously sought to construct a portfolio of companies that offer strong growth outlooks, which can be sustained through their differentiated business qualities and prescient leaders. Will's best of breed approach has resulted in a portfolio that has captured only 78% of down markets while still capturing 98% of up markets, which are qualities that differentiate him as a growth manager, particularly during such volatile periods.

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Past performance is no guarantee of future results.

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