Polar Capital
North American Fund

October 2023

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Co-Fund Manager
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Awards & ratings

MORNINGSTAR Gold

Exceptional value at the heart of a long-term compounding story

Over the third quarter, the Fund (USD I Share Class) returned -1.2%. This compares well to the performance of the benchmark, the MSCI North America Net Total Return Index, (all figures in dollar terms), as well as relevant equally-weighted and other market cap-weighted indices.

Investing environment

Concerns regarding both a recession and inflation have eased somewhat this year. However, despite the latter, nominal bond yields have risen, driven by an upward normalisation in real yields.

US 10-year Treasury real yield[1]

Source: Bloomberg, Polar Capital, October 2023.

A higher interest rate environment has led to a different investing environment to the one most investors had become used to. For example, for the first time in a long time it is possible to receive nearly 5% in a savings account or US Treasuries. One knock-on effect is that many bond-proxy stocks, which had become expensive by historical standards, have recently underperformed as investors found them less appealing, given a more abundant choice of near risk-free substitutes.

Unsurprisingly, higher interest rates are also impacting the economy. For instance, with the 30-year mortgage rate for new borrowers hitting its highest levels since 2000, home purchase mortgage applications dropped to their lowest level since 1995 during the quarter. Elsewhere, defaults of small businesses, which tend to have more stretched balance sheets, are at their highest levels (ex-Covid) since 2011.

Challenges lie ahead (though they always do). Many consumers face headwinds to their spending power as savings from the emergency fiscal stimulus during Covid have almost been exhausted, and nearly 30 million Americans now have to restart paying back student loans after a three-year repayment holiday. The fiscal deficit is high and unsustainable and non-discretionary commitments to spending and higher interest costs will force the Treasury to increase bond supply, potentially putting further upward pressure on real rates.

1. Calculated as the difference between the nominal generic 10-year US Treasury yield and the US 10-year breakeven inflation rate

At the same time, the largest buyer of Treasuries, the Federal Reserve, is shrinking its balance sheet, which is removing liquidity from the financial system. High interest rates, if sustained, will eventually impact the economy more materially as the cost of incremental borrowing is significantly higher than it was. Higher funding costs and deglobalisation will put upward secular pressure on costs for many businesses, and the less well-prepared ones may struggle after decades-long deflationary forces subside.

More positively, the demand environment is better than many had expected at the start of the year. Consumers are supported by a tight labour market and have balance sheets that are in reasonable shape, while parts of the economy (e.g. infrastructure spending) are accelerating and inflationary pressure is moderating from recent high levels. Furthermore, good businesses continue to pass on any inflationary pressure that does exist and there is no immediate interest rate shock for many businesses or mortgage holders given the amount of longer-term fixed debt. Finally, and importantly for investors, cashflow continues to be generated in abundance by American businesses.

Attractive portfolio fundamentals…

We are encouraged by the operational performance of the holdings in the Fund. This year we expect the portfolio to compound business value[2] at a double-digit rate, as it has done over the life of the Fund.

Similarly, we remain enthused about longer-term prospects and expect double-digit compounding of business value to continue long into the future. Every stock that enters the portfolio goes through our qualitative fundamental checklist and ultimately must be deemed likely to deliver double-digit compounding of business value over a long-term horizon. Fundamentals change and not every investment achieves this double-digit compounding ex-post. However, some businesses compound at a much better rate than our double-digit hurdle. This growth in underlying business value provides an attractive fundamental tailwind for investors.

> “We remain enthused about longer-term prospects and expect double-digit compounding of business value to continue long into the future.

It can often be the case in the investment world that the narrative around what constitutes an attractive investment is largely centred on a company's ability to compound sales at a high rate. This has particularly been the case in recent years, and we have seen the premium paid for sales growth as a factor driven to historically high levels, setting up an unattractive base for future returns. Very often there is a well-hyped (sometimes justified though often not) theme that is a driver of such sales growth. The human mind is naturally captivated by stories, and such themes and stories make for many an alluring investment pitch.

There are many businesses in the portfolio that do have attractive levels of organic sales growth potential with some of these benefitting from well-publicised top-down themes such as artificial intelligence (AI) – for example, Microsoft, Alphabet and Amazon – or what could be an extended pickup in fixed capital formation driven by manufacturing reshoring and infrastructure investment (for example, United Rentals, Ferguson and CRH). However, such investments are not solely dependent on the growth in demand driven by those themes in order to be able to achieve what we deem to be an attractive level of compounding from the underlying business.

We take a more rounded approach to investing by employing a holistic approach to business compounding that considers a broad array of drivers. Most of the holdings in the portfolio achieve our expectation of a double-digit level of business value compounding through a combination of attractive organic sales growth, deployment of cashflows and, for some, a potential expansion in margins.

Deployment of cashflows as a driver of equity returns is an often overlooked factor, especially during periods when growth particularly dominates the investment landscape, yet it can often be a more dependable driver of returns than sales growth. With the portfolio at a 7% free cashflow yield, the deployment of that cashflow is a particularly important driver of the Fund's compounding potential.

2. Typically defined as normalised cashflow per share plus dividends

Some companies in the portfolio see an outsized contribution to their compounding of business value coming from a judicious and value-added deployment of capital directed to attractive acquisitions (for example, Constellation Software (Constellation), SS&C Technologies Holdings and Littelfuse).

Constellation, for example, has consummated over 800 small acquisitions in its almost 30-year existence. Nearly all of these acquisitions have been miniature vertical market software (VMS) businesses, selling software customised specifically for a given niche industry. These markets tend to be dominated by a couple of vendors and the services provided are essential to the customers' operations, yet form a small part of their budgets, so pricing is sticky and revenue is recurring, even if organic revenue growth of some of these VMS businesses is no better than low/mid-single digits. A strategy focused purely on high top-line growth would have missed the fact that these acquisitions have been made at 1x revenue or 4x net operating profit after tax on average, generating high rates of return. With an average transaction size barely over $10m, Constellation faces limited competition from other potential buyers for whom such deals are too small. Indeed, competition for assets is likely to moderate given the increased cost of funding for other buyers, which contrasts with Constellation's strategy of self-funding such acquisitions from free cashflow. Their disciplined and repeatable capital allocation model has driven returns on capital in excess of 20% for years, and Constellation's free cashflow per share has compounded at 19% and 24% per annum over the past five and 10 years respectively, increasing 44-fold since its IPO in 2006.

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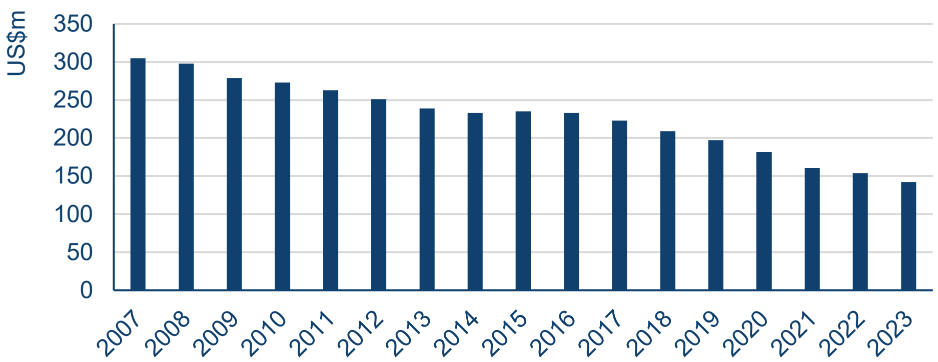
Other companies see an outsized contribution from returning capital back to shareholders, for example, Canadian Natural Resources, McKesson and T-Mobile US. Such companies often appear mundane in their activities and do not always make for gripping case studies. However, the nature of capital return in such instances can often be more dependable than the high sales growth in apparently more exciting investment stories, and such companies typically enjoy a higher valuation margin of safety.

Take McKesson, for instance. As one of only three national drug distribution businesses, it operates in a regulated oligopolistic market. The regulation means it has little pricing power, but we think it will grow low/mid-single digits organically given an aging US population and a mix that is moving towards more specialty drugs which require more value-added distribution. The company has consistently used its cashflows to retire its shares over time (including in downturns such as the global financial and Covid crises). The combination of capital return with dependably growing cashflows has resulted in the stock returning 14% per annum over the past decade, in line with the growth of its free cashflow per share. Again, while McKesson would not stand out on its organic top-line growth merits alone, we expect this ongoing visible capital return combined with upper single-digit per annum growth in profits to result in continued steady double-digit business compounding.

McKesson diluted shares outstanding (financial year ending March)



Source: Bloomberg, 31 March 2023.

Past performance is not indicative or a guarantee of future returns. All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital. It should not be assumed that recommendations made in the future will be profitable or will equal the performance of securities in this document. A list of all recommendations made within the immediately-preceding 12 months is available upon request. Past performance is not indicative or a guarantee of future returns.

The fundamental financial metrics of the portfolio remain appealing. The free cashflow conversion of the portfolio is high at over 120% (it has averaged well in excess of 100% since launch according to Style Analytics), far in excess of the broader index. The free cashflow margin is high at over 20% and the free cashflow return on equity (return on equity adjusted for free cashflow conversion) is in the high 20s. Balance sheet metrics are also appealing with the median net debt/EBITDA[3] of the portfolio at 1.2x and the median net debt/EBITDA less capex at 1.7x.

> The Fund's relative valuation versus the index for some metrics is at or close to its most attractive level ever.

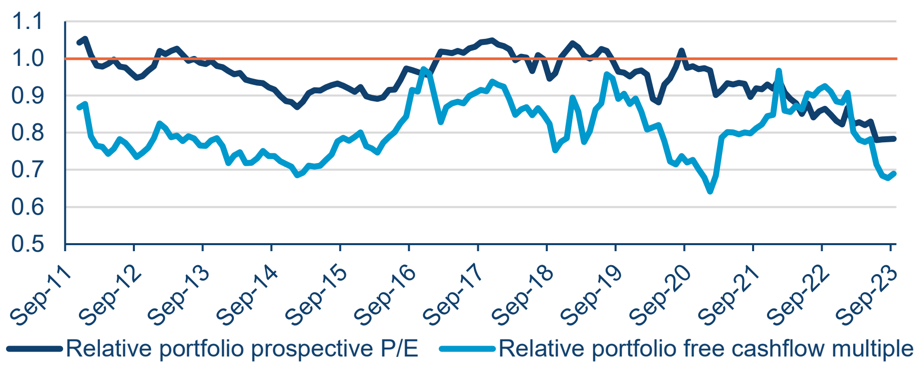
… at an attractive price

Our holistic approach means we also focus a great deal of attention on the price paid for potential long-term business compounding and the impact that can have on subsequent returns.

Despite the good fundamental progression of the portfolio's holdings this year, the Fund has derated on a number of valuation metrics. This has been driven by a lag in the Fund's return versus the underlying business progression. **The good news is that the Fund's blended valuation on a number of metrics is at its most attractive in many years.** At the end of the quarter, the historic free cashflow yield was 7.1% while the forward looking price/expected earnings ratio (mostly 2024) was 14.1x[4]. A derating should perhaps be of no surprise given the changing investing backdrop highlighted above. However, positively, it provides a more attractive long-term valuation margin of safety for investors.

The Fund is very different to a market-cap weighted index such as MSCI North America (with which the Fund has only ~15% overlap). **The Fund's relative valuation versus the index for some metrics is at or close to its most attractive level ever.** The relative forward price to consensus estimated earnings (mostly 2024) and the relative historic free cashflow multiple can be seen in the following chart.

Polar Capital North American Fund free cashflow yield and prospective P/E relative to the benchmark



Source: Style Analytics, Polar Capital, September 2023.

New additions

There were four new additions to the Fund in the quarter: Marriott International, the hotel operator; Ferguson, a distributor of industrial supplies; CRH, a manufacturer of building materials, and Interactive Brokers Group, a low-cost brokerage platform. As with existing holdings, they fit into our expectations of long-term, double-digit compounding in business value and were purchased at what we believe to be attractive prices that provide a long-term valuation margin of safety, or potentially an opportunity to see multiple expansion. Two of these new additions are profiled below.

3. Median net debt/EBITDA and net debt/EBITDA. **Source:** Bloomberg, as at 30 September 2023.
4. Style Analytics, as at 30 September 2023.

CRH is the largest construction materials company in North America. It was founded in Ireland but through decades of acquisitions and portfolio management, North America has become the centre of gravity for the company. The region accounts for 75% of profits, with the remainder coming primarily from a strong presence in Europe. Towards the end of September, the company moved its primary listing to the New York Stock Exchange.

We believe the company has a good mix of assets, with opportunities to grow faster than its end markets and see improving pricing power. A major driver for the business is the favourable backdrop for infrastructure spending and reshoring investments. The IIJA, CHIPS Act and IRA, together with some relocation of manufacturing in key industries, mean that the demand for construction materials should enjoy a demand tailwind. At the same time, we expect the supply side of the equation to remain constrained.

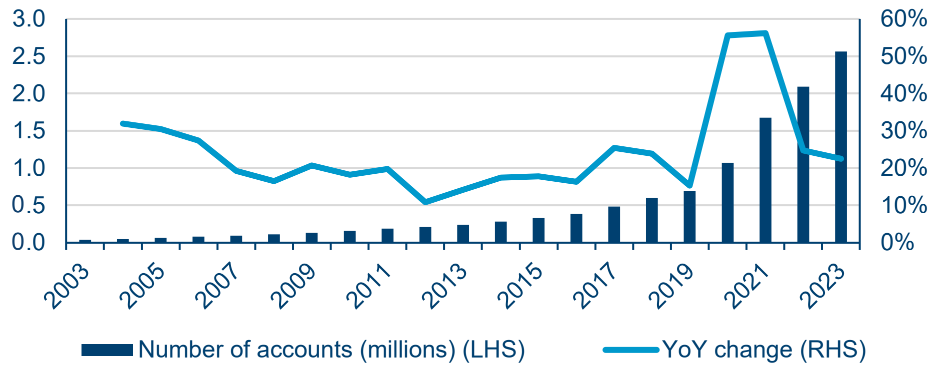
CRH has a good track record of capital allocation. The stock trades at an attractive free cashflow yield of around 8%, a sizeable discount to its US peers even after adjusting for the different mix of activities. We think that even in a normal environment the stock price does not reflect the growth opportunities ahead or the ability for the company to add value through the deployment of capital. The potential for a prolonged period of favourable demand adds further appeal to the investment case.

> We believe [CRH] has a good mix of assets, with opportunities to grow faster than its end markets and see improving pricing power.

Interactive Brokers is a provider of low-cost brokerage accounts and competes with the likes of Charles Schwab and Fidelity. However, there are notable differences. Interactive Brokers is the only provider of a full set of global products to a global audience. Their scaled peers are narrower, both in the set of products they offer and the regions in which they operate.

Interactive Brokers is also much lower cost than its digital peers, who in turn are significantly lower cost than traditional 'wirehouse' brokers. We believe the cost advantage is structural and that the global scope would be very difficult for others to replicate. The company employs a 'scale economy shared' strategy which creates a flywheel whereby ongoing growth enhances scale advantages which are shared with customers through lower prices and higher interest rates on cash balances, which supports stronger growth and so on. This positions the company to continue to take share and grow accounts at a fast rate (accounts have grown at a 34% compound annual growth rate over the past five years), from what is a relatively low base while continuously enhancing its competitive position. We think the runway is long and the opportunity is massive given the company's global market.

Interactive Brokers account growth



Source: IBKR, October 2023.

The company is still led, and majority owned, by its founder, Thomas Peterffy, and the culture of the firm reflects the low-cost, high-tech, disruptive ethos he has instilled since inception. The company has a customer value focus, for instance it pays industry-leading rates on cash balances and makes customers whole when there are exceptional events such as the oil price going negative.

Perhaps as a consequence of being founder-led, it is run in a conservative manner and carries a good deal of excess capital (we think there is strategic value to this as it means customers are comfortable that the company is far less likely to get into trouble). We have followed the company for a good while, but saw the recent compression in multiple at <14x price/earnings as an attractive entry point. Even allowing for a potential normalising lower in net interest margins, we believe the company can compound cash earnings per share at an attractive rate.

> We continue to find compelling new investment opportunities across the market.

Conclusion

We are encouraged by the operational performance of the holdings in the Fund. We expect the portfolio to grow business value at a double-digit rate this year and well into the future, as it has since inception.

A key attraction of the portfolio is it is not driven by one theme or one sole driver of returns. One of the great features of investing in American equities is the breadth and depth of opportunities – we have around 2,000 companies to choose from. Thankfully, there is a lot more to the American equity market than one or two top-down themes.

The holdings in the portfolio come from a wide variety of industries and have a diverse number of drivers contributing to their business compounding. We continue to find compelling new investment opportunities across the market.

Despite the progression of the Fund this year, it has derated on a number of valuation metrics. Perhaps with the exception of the very depths of the Covid crisis, the Fund's underlying valuation multiples are at the lowest level in almost a decade. Compared with the index, the Fund, on many metrics, is at its cheapest level ever.

We believe the ongoing compounding of the businesses in the Fund, coupled with valuations across various metrics being at the most attractive levels in many years, should help generate robust long-term returns as well as provide both long-term fundamental and valuation margins of safety.

Polar Capital North American Team

16 October 2023

Risks

- **Capital is at risk and there is no guarantee the Fund will achieve its objective. Investors should make sure their attitude towards risk is aligned with the risk profile of the Fund before investing.**
- **Past performance is not a reliable guide to future performance. The value of investments may go down as well as up and you might get back less than you originally invested as there is no guarantee in place.**
- The value of a fund's assets may be affected by uncertainties such as international political developments, market sentiment, economic conditions, changes in government policies, restrictions on foreign investment and currency repatriation, currency fluctuations and other developments in the laws and regulations of countries in which investment may be made. Please see the Fund's Prospectus for details of all risks.
- The Fund invests in the shares of companies, and share prices can rise or fall due to several factors affecting global stock markets.
- The Fund uses derivatives which carry the risk of reduced liquidity, substantial loss, and increased volatility in adverse market conditions, such as failure amongst market participants.
- The Fund invests in assets denominated in currencies other than the Fund's base currency. Changes in exchange rates may have a negative impact on the Fund's investments. If the share class currency is different from the currency of the country in which you reside, exchange rate fluctuations may affect your returns when converted into your local currency. Hedged share classes may have associated costs which may impact the performance of your investment.
- The Fund invests in a relatively concentrated number of companies and industries based in one region. This focused strategy can produce high gains but can also lead to significant losses. The Fund may be less diversified than other investment funds.

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A decision may be taken at any time to terminate the marketing of the Fund in any EEA Member State in which it is currently marketed. Shareholders in the affected EEA Member State will be given notification of any decision and provided the opportunity to redeem their interests in the Fund, free of any charges or deductions, for at least 30 working days from the date of the notification.

Investment in the Fund is an investment in the shares of the Fund and not in the underlying investments of the Fund. Further information about fund characteristics and any associated risks can be found in the Fund's Key Investor Document or Key Investor Information Document ("KID" or "KIID"), the Prospectus (and relevant Fund Supplement), the Articles of Association and the Annual and Semi-Annual Reports. Please refer to these documents before making any final investment decisions. These documents are available free of charge at Polar Capital Funds plc, Georges Court, 54-62 Townsend Street, Dublin 2, Ireland, via email by contacting Investor-Relations@polarcapitalfunds.com or at www.polarcapital.co.uk. The KID is available in the languages of all EEA member states in which the Fund is registered for sale; the Prospectus, Annual and Semi-Annual Reports and KIID are available in English.

The Fund promotes, among other characteristics, environmental or social characteristics and is classified as an Article 8 fund under the EU's Sustainable Finance Disclosure Regulation (SFDR). For more information, please see the Prospectus and relevant Fund Supplement.

ESG and sustainability characteristics are further detailed on the investment manager's website: (https://www.polarcapital.co.uk/#/professional/ESG-and-Sustainability/Responsible-Investing/)

A summary of investor rights associated with investment in the Fund is available online at the above website, or by contacting the above email address. This document is provided and approved by both Polar Capital LLP and Polar Capital (Europe) SAS.

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Benchmark

The Fund is actively managed and uses the MSCI North America Net Total Return Index as a performance target and to calculate the performance fee. The benchmark has been chosen as it is generally considered to be representative of the investment universe in which the Fund invests. The performance of the Fund is likely to differ from the performance of the benchmark as the holdings, weightings and asset allocation will be different. Investors should carefully consider these differences when making comparisons. Further information about the benchmark can be found www.mscibarra.com. The benchmark is provided by an administrator on the European Securities and Markets Authority (ESMA) register of benchmarks which includes details of all authorised, registered, recognised and endorsed EU and third country benchmark administrators together with their national competent authorities.

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Spain

The Fund is registered in Spain with the Comisión Nacional del Mercado de Valores ("CNMV") under registration number 771.

Switzerland

The principal Fund documents (the Prospectus, KIDs, Memorandum and Articles of Association, Annual Report and Semi-Annual Report) of the Fund may be obtained free of charge from the Swiss Representative. The Fund is domiciled in Ireland. The Swiss representative and paying agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, CH-8002 Zurich, Switzerland.

Austria / Belgium / Denmark (professional only) / Finland / France / Germany /Gibraltar / Ireland / Italy / Luxembourg / Netherlands / Norway / Portugal / Spain / Sweden / Switzerland and the United Kingdom

The Fund is registered for sale to investors in these countries. Investors should make themselves aware of the relevant financial, legal and tax implications if they choose to invest. Please be aware that not every share class of the Fund is available in all jurisdictions.

Morningstar

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