Polar Capital
North American Fund

January 2024

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Awards & ratings

Analyst-driven 10%
Data coverage 96%

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For disclosure and detailed information about this fund please request the full Morningstar Managed Investment Report from investor-relations@polarcapitalfunds.com.

More than seven: a broadening of opportunities across the market cap spectrum

The Fund (USD I Share Class) returned 12% in the fourth quarter of 2023 and 23.1% over the year.

The fourth quarter saw a strong rally in American equity markets. Strength was broader based than in previous quarters, with equally weighted and market-cap weighted large-cap indices as well as the S&P 400 mid-cap index all performing robustly, delivering similar returns to the Fund.

A strong fourth quarter meant there were robust gains across most parts of the market for the year overall. However, one of the key themes for 2023 was the remarkable strength of the so-called 'Magnificent Seven' and the divergence between the stock performance of the very largest companies and the rest of the market. For the whole year the MSCI North American Equally Weighted Index (with net dividends reinvested) returned 17% but, helped by the 'Magnificent Seven' return of 107%, the MSCI North America Net Total Return Index registered a return of 26% (in dollar terms). Indeed, data from Robert Baird shows that only 27% of S&P 500 companies beat the S&P 500 last year, the lowest reading since they started tracking the data in 1991.

Recent equity market performance has been driven, in part, by a better-than-expected economic outlook, in particular the likelihood that we have seen a peak in interest rates combined with a growing possibility of a prospective soft economic landing (or even 'no landing'). A soft landing with a more benign inflationary environment would be an impressive outcome given the dramatic changes in the monetary environment we have seen in recent years. We would caution that we are still seeing lagged impacts from tighter monetary conditions impacting demand in some areas of the economy, and there may still be the potential for unforeseen consequences given the swift change from the period of ultra-low interest rates prior to 2022. However, as we have highlighted before, the long-duration nature of much of the consumer and corporate debt in the US has cushioned many debt holders from the sharp interest rate increases in the short term.

The consumer, which drives the bulk of US economic activity, seems to be in good financial health. Despite pandemic-related excess savings depleting, the job market remains robust, wages are rising in excess of inflation and balance sheets are sound, helped by rising equities and resilient home prices.

Much of corporate America is in decent shape too and earnings have been somewhat better than feared by many a year ago. The S&P 500 excluding energy companies is likely to see earnings per share growth of mid-single digits for 2023. We believe the Fund is delivering higher growth than this, compounding its underlying business value at a double-digit rate. Although the median company in the S&P 500 Index and our universe will probably have seen relatively little earnings growth in 2023 following a strong 2022, we found the following chart from Empirical Research Partners reassuring, highlighting that the majority of companies in the S&P 500 are once again reporting improving pre-tax margins.

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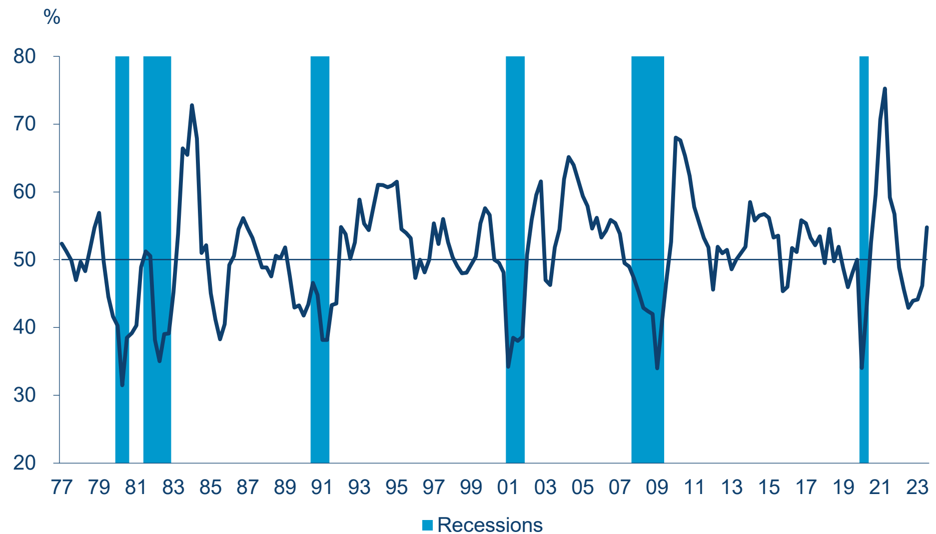
The S&P 500 share of stocks with rising pre-tax profit margins - 1977 through Q3 2023E



Source: Empirical Research Partners, October 2023. Excludes financials and REITS, margins measured versus the same quarter a year earlier.

This is particularly remarkable given that so many companies' profit margins benefitted from the inflationary environment in 2022, contrary to fears that margins might be squeezed, and that some companies now face higher interest expense levels. US corporate resilience has again been impressive, proving once more that it rarely pays to write off the compounding potential of US businesses.

The turn of every year brings a raft of economic and stock market forecasts. We do not know what 2024 will bring – as ever the macro environment is uncertain, even if the current consensus is more optimistic than it has been for a while. That said, we are confident the portfolio is well placed to continue compounding business value at a double-digit rate. Our optimism is based on the attractive long-term operational growth prospects of the companies in the portfolio in aggregate, as well as the abundance of free cashflow they can deploy. The expected forward free cashflow yield of the portfolio of around 7% means that, despite the bright prospects for operational growth, not much of that growth is actually required to reach double-digit compounding as long as capital is allocated reasonably well.

US corporate resilience has again been impressive, proving once more that it rarely pays to write off the compounding potential of US businesses.

Portfolio, performance and activity

Notable strong stock performances over the quarter came from businesses with more cyclical profit streams such as United Rentals (industrial and construction equipment rental), CRH (building materials) and Core & Main (a water-focused building products distributor). We continue to like the prospects for all these businesses.

Constellation Software, Microsoft, Amazon and Uber Technologies also performed well in the quarter, capping off a year in which they generated exceptional stock performance. We still see very appealing business compounding potential from these companies but have taken some profits in cases where higher valuations have resulted in a less appealing risk/reward outlook than before.

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For instance, Microsoft's stock performance has taken its share price to more than 30x its expected earnings and a higher multiple of its free cashflow, given its rapidly growing capital expenditure. We continue to think it is an exceptional business that is well placed to grow revenues and profits at an attractive rate thanks to a market-leading platform that should enable it to monetise artificial intelligence functionality as well as benefit from demand for broader cloud computing from an expanding pool of sticky customers. This, along with the resilience of the core business, in our view, justifies its valuation. However, one consequence of a much higher stock price and deteriorating free cashflow conversion is there will be less contribution to future returns from the cash being generated by the business. There may also be more scope for a derating of its free cashflow multiple over time given the current elevated starting point. In addition, in a diversified portfolio with plentiful investment opportunities there is a limit to how much capital we want to tie up in one position.

The insurance holdings in the portfolio (RenaissanceRe Holdings, Arch Capital and Fairfax Financial Holdings) were relative detractors from performance over the quarter, primarily on the back of falling bond yields. Insurers had previously been seen as beneficiaries of higher interest rates given a higher level of investment income being locked in on the reinvestment of maturing bonds (which form the bulk of most insurers' investment portfolios). Despite interest rates peaking, we continue to think the insurance holdings are well placed to compound earnings power and book value at an attractive double-digit rate from a combination of profitable underwriting, returns on their float and use of any surplus capital. We do not see a return to the prior period of overcapacity in the industry that was driven by an anomalous ultra-low interest rate environment resulting in external capital being attracted to the industry in search of returns. However, having taken profits in Arch Capital (a holding since the Fund's launch) throughout the year on valuation grounds following a period of very strong performance, we sold the remaining position during the quarter in order to fund other investments.

We do not see a return to the prior period of overcapacity in the [insurance] industry that was driven by an anomalous ultra-low interest rate environment.

Another company that was a modest relative laggard, arguably due to the change in expectations about the path of interest rates, was Interactive Brokers Group, a recent addition to the portfolio. The company has benefitted from a slightly above normalised net interest margin due to higher rates and an acceleration in its account growth and deposit flows given its highly competitive deposit rates. We incorporated a normalising in net interest margins into our assessment of its profit compounding potential at purchase, and still see a huge opportunity for it to deliver teens or better growth rate in customer accounts and profits for many years. We find the current valuation of around 14x this year's earnings very attractive.

The portfolio's holdings in the energy stocks, Canadian Natural Resources, Cenovus Energy and Ovintiv, were also detractors from performance in the fourth quarter, and over the year, largely due to the somewhat lacklustre oil price. This was mostly driven by a less tight supply situation than we, and many other investors, had anticipated due to production growth from North American basins exceeding expectations. This seems to be due to both better-than-anticipated productivity (which is unlikely to go away) and more rapid drilling of the best inventory from private producers (a state of play that has a finite life as the inventory will eventually deteriorate in quality).

Although this unfavourable situation for the commodity makes us less optimistic on the profitability potential of the holdings than before, we remain positive on the position of the Canadian oil producers with exposure to oil sands and heavy oil projects. Their long reserve lives, lasting decades, and low decline rates mean they are free cashflow positive at much lower oil price levels than most producers and can return large amounts of cashflow to shareholders at WTI oil prices in the $70s. Indeed, we replaced the holding in Ovintiv with Imperial Oil for this reason. Imperial Oil, one of the largest oil producers in Canada, has a clean balance sheet and at the current oil price should provide a double-digit capital return to shareholders while offering substantial upside should the oil market tighten again following years of capital starvation. We also funded the new position partly by paring down the position in Canadian Natural Resources, a holding in the Fund since 2016, based on an assessment of the relative value between the three holdings.

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We have always found that one of the enduring appeals of being an investor in the US market is its breadth and depth.

A Pathway to a cleaner future

We continue to have very constructive meetings with our energy holdings, highlighting encouraging progress being made in reducing carbon emissions during oil production. We learned more from recent meetings with Imperial Oil and Cenovus regarding the Pathways Alliance. This is an alliance of the top six oil sands producers, which involves sharing environmental research and development and investment in one of the world's largest proposed carbon capture projects, with a goal of reaching net-zero emissions from their projects by 2050. One interesting fact we learned is that the CEOs of all six companies involved in the alliance meet on a weekly basis to discuss its progress. We know of no other major global industry where the CEOs of some of the largest companies meet so frequently to discuss climate-related matters.

Admittedly, these companies started with a high base of emissions, and when considering an investment we still incorporate the potential decline in demand over the longer term and possible higher tax implications from transitioning to a world with, hopefully, lower carbon emissions as well as other environmental risks. However, they have already made significant strides in reducing emissions and have scope to make further progress – something we are encouraging them to do. We see these companies as among the most progressive in their industry given their viable plan to reduce emissions, and indeed do not know of any other cross-company industry initiative in the world which has so much potential to reduce emissions. Ultimately, we believe these companies will be among the last oil companies standing in future decades, and they will have returned huge amounts of cashflow to shareholders along the way.

A deep and broad equity market

Although the 'Magnificent Seven' have received a huge and arguably justifiable amount of attention given their stunning operational success and stock price performance, there is a lot more to the US equity market. We have always found that one of the enduring appeals of being an investor in the North American market is its breadth and depth. This has perhaps not been an enabler of relative success for stock pickers in recent years given the unprecedented increase in market concentration we have seen. However, we think making the most of a large investment universe is likely to be additive to returns in the future, as it has been in most periods over time. We continue to take advantage of this choice both within the portfolio, which has a high active share of over 80%, as well as when looking for new opportunities to invest in.

We highlight two such new opportunities that we have recently invested in below.

Core & Main is a leading distributor of water, wastewater storm drainage and fire protection products and services to municipalities, private water companies and professional contractors. The company has a critical role in the supply chain between its 4,500+ suppliers and its 60,000 customers.

The company is one of only two nationally scaled distributors (the other one is Ferguson, which the Fund also holds). Many of the products it distributes are highly specific and often come with exclusive distribution rights given that OEMs (original equipment manufacturers) want skilled fitters to install them to ensure compliance with US EPA (Environmental Protection Agency) oversight of any water system that serves over 25 customers. This means that anyone working in that market has to meet stringent local specifications and it is, therefore, difficult for new entrants to gain a foothold. Core & Main's scale also allows it to hold deeper inventory and brings procurement advantages. In addition, there is often a highly consultative element to the sales process given the value customers place on advice from the company's highly experienced field agents. These factors mean the company makes attractive free cashflow margins for a distributor, has scope to expand market share and is less likely to face the threat of being 'Amazoned'.

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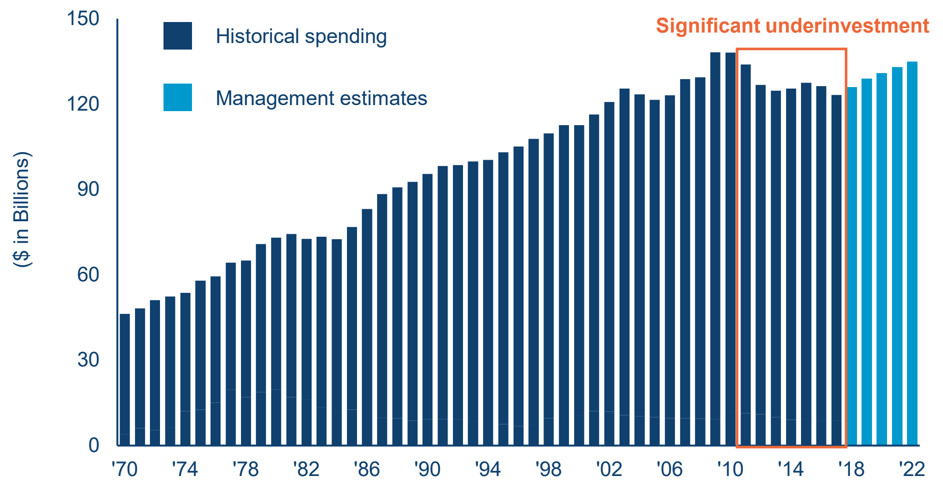
The company's end market is mature, growing somewhat slowly though reasonably steadily, and over 50% of its revenue is recurring in nature. Despite slow and steady end-market growth, we see potential for a period of above-normal growth as municipal water infrastructure is playing catch-up following a decade of underinvestment. Perhaps more importantly, the company has a significant opportunity to gain share organically in a large and fragmented market, resulting in organic growth meaningfully above industry growth.

US municipal water infrastructure spending



Source: March 2023. US Congressional Budget Office (1970-2017). Data from 2018-22 based on Core & Main management estimates.

Core & Main has a significant opportunity to gain share organically in a large and fragmented market, resulting in organic growth meaningfully above industry growth.

Given the fragmentation of the market and their existing distribution network, we see an attractive long-term opportunity for the company to reinvest a significant portion of its cashflow into synergistic tuck-in acquisitions at appealing prices.

The combination of steady end-market growth, organic market share gains and the deployment of cashflow (either returned to shareholders or reinvested in attractive acquisitions) should result in appealing double-digit compounding of business value over the long term.

The shares were purchased at around a 13x multiple of 2024 earnings and a 14x multiple of free cashflow per share, a valuation we believe to be attractive given the durability and compounding potential of the business.

Hyatt Hotels is a hotel operator. The company has a relatively high exposure to high-end properties, with 20 upscale brands and a disproportionate exposure to leisure and business convention customers compared with many hotel companies. Hyatt owns around 4% of its total room base, with 96% of its rooms being 'managed and franchised' properties where Hyatt earns a fee from the hotel owner that is linked to the revenue, and sometimes profitability, of the hotel.

We particularly like Hyatt's managed and franchised hotel business model. It has appealing growth prospects given branded hotel companies are growing at a faster rate than overall global hotel industry supply. This is because their brands, scale, best practices and loyalty programmes result in a superior return on capital for hotel developers in most situations compared to the alternative of running an independent hotel.

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[Hyatt Hotels'] share count has declined by around one third over the past decade, which has been an added driver of returns for shareholders.

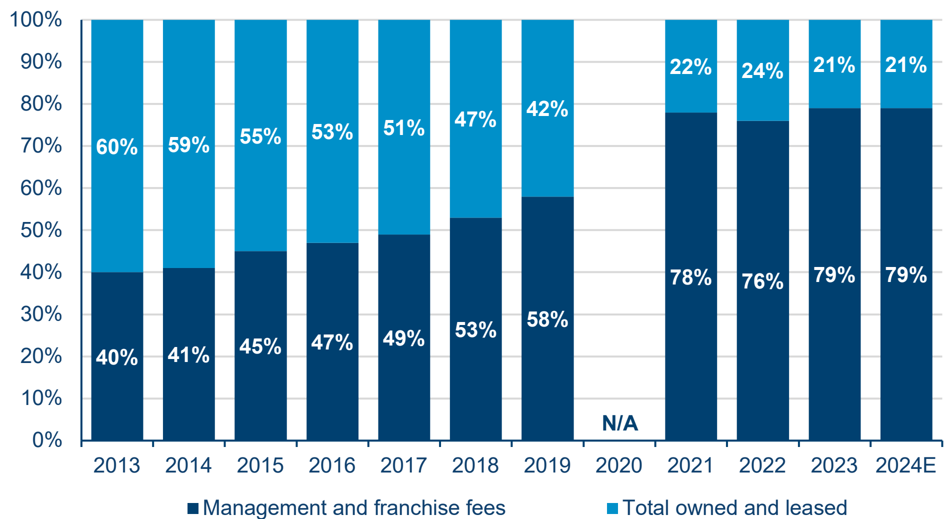
Hyatt is one of the fastest-growing of the branded hotel businesses. Despite its strong brand, Hyatt is actually considerably smaller than the likes of Marriott and Hilton because for decades it did not follow the same strategy of growing its management fee business. This now allows more white space for Hyatt to grow – for instance it has far fewer hotels in most key US cities than either Hilton or Marriott.

It has enjoyed 10% per annum unit growth over the past five years and, given its strong pipeline, we see 5-7% per annum growth over the next five years. This is despite the global hotel industry's supply growth being reasonably constrained by higher financing costs, a factor that should help support 'same store' hotel pricing.

Another key reason we admire the managed and franchised hotel model is that it is highly cash generative – the bulk of capital expenditure is borne by the hotel developers, not the management company or franchisor. This means that Hyatt can generate high and expanding free cashflow margins as well as attractive volume growth. Finally, although management and franchise fees are not immune to the vagaries of the economic cycle, profits from such fees are less cyclical than profits earned from owned hotels.

Although, as mentioned, only 4% of Hyatt's hotel rooms are owned, around 20% of profits still come from owned hotels. This is far lower than 10 years ago when 60% of profits came from owned hotels and even as recently as five years ago when 47% of profits were generated from owned hotels. The company has a clear plan to continue reducing its exposure to owned hotels over time through the disciplined sale of assets, usually at multiples of profits that are higher than where Hyatt stock has traded at. We expect that over the next five years, profits from owned hotels will fall to less than 10% of total profits. In the past, sales proceeds have been reinvested into either the acquisition of other fee/managed hotel businesses at attractive multiples or returned to shareholders primarily through share buybacks. The company's share count has declined by around one third over the past decade, which has been an added driver of returns for shareholders. There are a number of trophy properties still to be sold which, even in a higher interest rate environment, should command attractive valuations given their locations and allure.

Hyatt Revenue Mix: 2013 to 2024E



Source: Company reports and J.P. Morgan estimates, 4 May 2023. Forecasts are based upon subjective estimates and assumptions about circumstances and events that may not yet have taken place and may never do so. Forecasts contained herein are for illustrative purposes only and does not constitute advice or a recommendation.

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We think the combination of 5-7% unit growth, inflation in 'same store' room rates, a rising return on invested capital, attractive incremental free cashflow margins and the deployment of cashflow will result in teens compounding of business value over the next five years and beyond.

The shares were purchased at around 20x free cashflow, though a much lower multiple if looking out a few years given the compounding of the underlying business and the potential accretion from asset sales should proceeds continue to be sensibly deployed.

Outlook

2023 was a strong year for equity markets and Q4 was the strongest quarter of the year. In a year characterised by the dominance of a subset of mega-cap stocks, individual stock performance became more broad-based as 2023 drew to a close. This overall strength is especially notable given the concerns 12 months ago about a likely recession.

We do not think there is value in trying to second guess what might happen to macroeconomics in the near future. We are encouraged by the fundamental backdrop as inflation and interest rates moderate but, as ever, we are cognisant of the potential for adverse outcomes, predicted or otherwise.

Nevertheless, we are confident about the compounding potential of the businesses in the portfolio driven by bright operational prospects and the deployment of significant free cashflow generation. Given the huge and diverse set of businesses in our investible universe, we continue to find attractive investment opportunities across the market-cap spectrum.

Despite the rise of the Fund in 2023, on many valuation metrics the portfolio has not rerated and, compared with the index on valuation metrics we follow, is as close to or at its cheapest level ever. We believe this starting point, along with the compounding potential of the businesses held in the Fund, provide plenty of justification for optimism about future returns.

Polar Capital North American Team

11 January 2024

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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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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/)

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