



Andrew Holliman
Fund Manager

Andrew joined Polar Capital in August 2011 to establish the North American Equities team.



Richard Wilson
Fund Manager

Richard joined Polar Capital in August 2011 to establish the North American Equities team.

North American Q1 Update

The Polar Capital North American Fund (inst class) delivered a 9.6% return in the first quarter. This exceeded the return of the performance benchmark (the MSCI North American Index with net dividends reinvested) which increased by 5.6%.

The absolute and relative progress of the portfolio recently has partly reflected its appealing value creation and value characteristics.

In the 2020 fourth quarter results season, the majority of the portfolio's holdings demonstrated continued encouraging operational progression, from those that benefitted or were relatively unscathed from the pandemic to those that have had to overcome near-term challenges but are improving their long-term cashflow potential. We feel the prospects for value creation for the portfolio are as good as they have been for many years.

We also feel our approach's valuation discipline is really starting to benefit performance. Some commentators have pointed to increasing inflation expectations and the related rise in bond yields from all-time lows (illustrated in the chart below) as being catalysts for a change in the relative performance of different cohorts of stocks. For instance, companies whose market values arguably have looked more stretched or have been disproportionately dependent on longer duration cashflows started to lag the broader market following a period of strong outperformance.

US 10 year inflation expectations and 10 year bond yields



Source: Bloomberg, March 2021

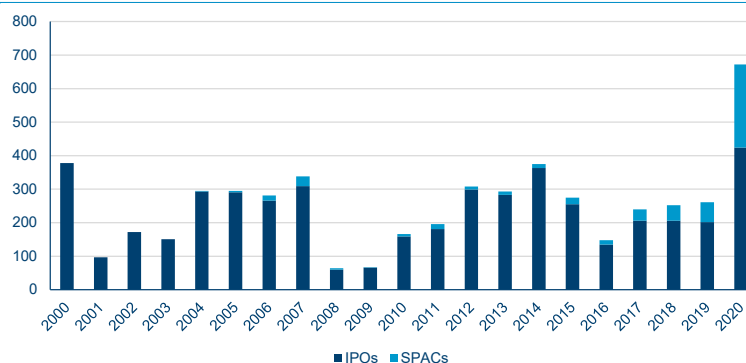
Another potential explanation for this change is the growing appreciation that we are at the beginning of a potentially strong economic cycle and no longer towards the end of one, and that there are better multi-year growth prospects for a broader array of companies than there have been for some time. This has led to investor sentiment improving towards companies whose medium-term growth potential has recently improved markedly, and whose long-term potential was never as badly impacted as stock prices implied.

Meanwhile, the premium paid for high growth (that became historically large in recent years) has started to compress given an apparent greater selection of opportunities for growth. The greater choice of potential growth opportunities has not just come from companies that have seen macro headwinds turn into tailwinds but also from a greater selection of companies promising secular growth given a large supply of new issues over the past year, particularly from the technology sector.

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“Our all-cap approach in general has contributed positively given strong performance from companies further down the market-cap spectrum.”

Number of US issues (IPOs and SPACs) by year. 2000-2020.



Source: Bloomberg.

Some of the portfolio's best performers in the quarter came from stocks where valuation metrics have, in a more traditional sense, been extremely low and where we felt they were discounting a prolonged period of operational headwinds. Many such stocks have started to perform better as appreciation has grown that the next several years could be more conducive to improved operational performance.

Examples of long-held stocks which have seen a resurgence of performance recently after a long period of derating include the boutique asset management holding company Affiliated Managers Group and the flooring manufacturer Mohawk Industries. Examples of stocks with similar characteristics that we have added to the portfolio within the past 12 months include the equipment rental company United Rentals and, to some extent, the semiconductor capital equipment company Applied Materials.

The internet conglomerate InterActive Corp was another noteworthy performer as the market ascribed a higher value to its stake in the video sharing site Vimeo and as the apparent discount to its sum of its parts closed. We have sold the position on valuation grounds though continue to monitor the business. Not owning Apple was also a large contributor to relative performance given its lagging performance and its size in the index. Our all-cap approach in general has contributed positively given strong performance from companies further down the market-cap spectrum.

On the negative side, the online advertising software platform LiveRamp Holdings was a notable poor performer. LiveRamp Holdings was weak after Google announced plans to change how it targets advertising within its ecosystem. While the long-term impact on LiveRamp is uncertain, and may not necessarily be negative, it could have an adverse impact on the near-term fundamentals as its customers adjust to the changes. The wireless communications semiconductor company Qualcomm and Amazon underperformed following strong previous performance. T-Mobile, a top five position in the Fund, also performed weakly for no obvious fundamental reasons. Not owning the large banks JP Morgan and Bank of America were drags to relative performance though the Fund has exposure elsewhere in the sector. The small cash position was also a mild drag during another strong period for equities.

Why we focus on value creation and value

We thought it would be an opportune time to shine a spotlight on why we focus on both value creation and value in our approach, how we value businesses and ultimately how we decide what price is worth paying and what is not.

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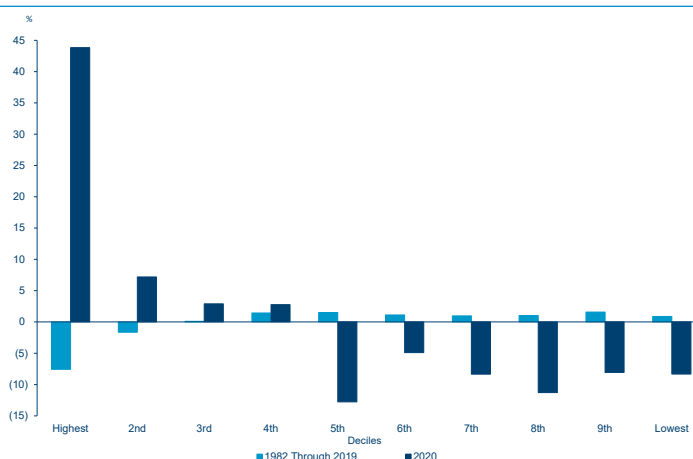
The aim of our process is to identify attractive long-term value creation that is not adequately encapsulated in the share price of a business. To achieve this goal, our approach focuses on an analysis of value creation and value. Both are necessary and neither, on its own, is sufficient. They are inextricably linked and depend on each other to drive shareholder returns. Focus on both, and you stand a better chance of delivering attractive long-term returns for investors.

Long-term value creation is an integral part of our investment approach. Indeed, most of our day-to-day work involves building a holistic picture of the important drivers of long-term value creation and assessing how they could shape the evolution of the business and its future cashflow potential. To us, this is common sense – as an owner on behalf of our clients in shares of businesses, it stands to reason that we want to see an attractive underlying return, through operational growth and capital deployment, from those businesses. This provides a compounding tailwind to the portfolio. If this tailwind is greater than that of the opportunities represented by the market as a whole then, all other things being equal, the Fund should out-compound the market or a passive representation thereof.

However, we do not believe that value creation can be looked at in isolation. Simply buying the highest growing or best business is no surer a way to investment success than consistently selecting the favourite at a horse race is a way of outsmarting the bookies. The chart below shows that for most of the past 40 years, the stocks of the companies with the highest earnings growth underperformed the average stock. This has changed dramatically recently, particularly last year when such stocks performed very well, as we discuss later.

“We strongly believe that the price you pay is a key driver in determining the value you get”

Relative returns of stocks split by forecast growth rates (1982-2020)



Source: Factset Research Systems, Empirical Research Partners Analysis, December 2020. US large-cap stocks relative returns by forecast long-term earnings growth rates (equally weighted data). Monthly returns compounded on an annual basis 1982 through late December 2020.

By applying a disciplined approach to valuation, we increase the probability that we pay an attractive price for that long-term value creation. Therefore, it increases the likelihood of an attractive return from a stock should progression of business fundamentals go as we envisage. It can also intensify gains if things go better than expected as such optionality has not been fully paid for. On the other side, it potentially mitigates losses should the business fundamentals not progress as we would have hoped given a presence of a potential long-term valuation margin of safety. An approach that adds valuation discipline to a focus on long-term value creation is key to underwriting risk and generating attractive returns for clients. We strongly believe that the price you pay is a key driver in determining the value you get.

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How we value businesses

Our valuation process puts the concept of long-term, normalised free cashflow at its heart. We use analysis and judgement to work out what that free cashflow is worth.

Long term and normalised: The value of a business is determined by its future cashflows and how management deploys that cashflow. So, at any point in time, the vast majority of the value of a business is accounted for by what will happen beyond the next couple of years. Therefore, we think a long-term approach is a logical starting point when thinking about buying a share of a business.

As part of our long-term approach we normalise the cashflow potential of a business, which means we are trying to control for elements including cyclical changes in investment and demand. A long-term and normalised approach to valuation is necessary to identify those companies that are great value looking further out but which may look expensive in the near term. It may be the case that near-term profits or cashflows are depressed because of weak cyclical demand (which has been the case for many businesses over the past year), a high level of investment impacting profit or cashflow margins, or because the company is at a nascent stage of its growth.

We have learned more over time that discarding a company from our research agenda because it appears expensive in the near term due to abnormally high investment levels, or because it is at a nascent stage of growth, can lead to errors of omission – an opportunity cost of not investing in what could be a great business at an attractive price. We have sought to make our process more inclusive of such opportunities while maintaining a valuation discipline. Amazon is a good example of a business which, at first glance, looks expensive due to its heavy investment profile, but to us looks very good value when considering its normalised free cashflow potential.

Similarly, this approach helps to avoid those companies that may appear cheap based on near-term valuation metrics but are perhaps poor value from a longer-term perspective. Cashflow could be above normalised for a number of reasons – perhaps because sales, profits and cashflow are extended due to abnormally high demand at a peak of a cycle or it could be because the company has under-invested or faces disruption and material adverse changes to its demand and/or competitive position.

We believe that time horizon is a key source of market inefficiency. Taking a longer-term approach is a logical way of taking advantage of that.

Free cashflow: Ultimately, we focus on free cashflow, or the cashflow after the capital expenditure it takes to grow the business at a reasonable rate, as this is what can be returned to shareholders or reinvested to expand the business at an abnormal rate. If a value of a business is determined by its future cashflows then it is this cashflow, not accounting earnings, that matters.

Furthermore, when a stock gets derated on a free cashflow basis it can also be the case that potential value creation can increase as a result. For example, returning more cash to shareholders when a stock has a high free cashflow yield drives higher returns to the shareholder, all other things being equal, than when the stock is more richly rated and has a low free cashflow yield. In such circumstances, when a stock gets derated on earnings, gross cashflow, sales or book, future returns are not necessarily increased as such measures cannot be allocated to accelerate value creation.

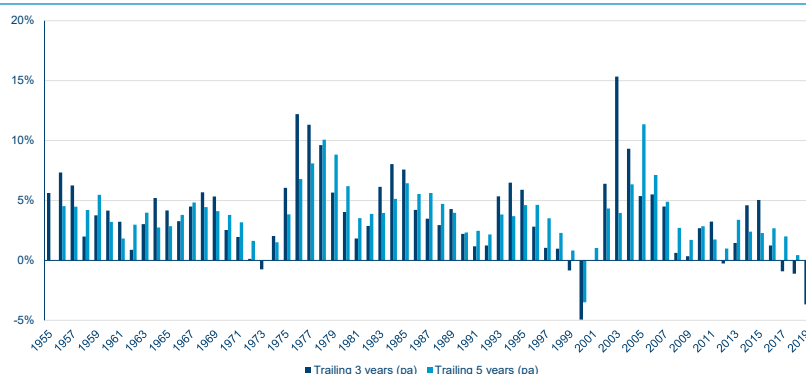
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“What we are prepared to pay is therefore dependent on long-term value creation and, in our view, the potential return for shareholders is driven by *both* value creation and our approach to valuation.”

One example of this was Affiliated Managers Group which traded on a consistently increasing free cashflow yield over the past few years. This derating in valuation has, of course, hurt the performance of the stock but it means the cash available for the company to return to shareholders in relation to its market capitalisation has increased. At one point last year, the stock reached a c20% free cashflow yield, meaning the market was implicitly pricing in a sharp decline in long-term operational cashflows (or a great deal of value destruction with the cashflow). From such a point, if operational growth were zero and the company just returned cashflows to shareholders, then per annum returns could theoretically have been equal to the free cashflow yield. Despite a strong rally in the stock, the yield is still double digits so we continue to see any operational growth over the next five years (which we see as likely) as a ‘free option’ on top of the value the stock could deliver to holders from capital deployment.

Another reason we favour free cashflow is it has one of the best empirical efficacies of all valuation factors. Perhaps this is because of the reasons we highlight above, or perhaps it is because a historical focus on accounting measures such as earnings or book value meant that cashflow measures were often overlooked. The below chart plots over 60 years of data (from 1955 to 2019) and demonstrates the outperformance of a cheapest quintile free cashflow yield strategy versus the US large-cap universe. Over time this outperformance has averaged over 3.5% pa, with outperformance occurring over every five-year period except in the Nifty Fifty period, the NASDAQ bubble and the current period (the data goes to 2019; we strongly expect sharper underperformance to 2020). Note after previous periods of underperformance, the subsequent performance was strong. This empirical tailwind may not necessarily continue for the next 65 years – things change and one cannot expect an arbitrage such as this to last indefinitely – but we would rather embrace it in our approach than fight it.

Relative returns per year of a cheapest quintile free cashflow yield portfolio



Source: Empirical Research Partners, Polar Capital.

How we work out value

The long-term, normalised free cashflow discussed above is used to determine the value of a business. In practical terms, this involves an objective assessment of how a company's cashflow potential will progress over our typical five-year investment horizon. We assess whether the value creation from now to that point is attractive enough, and ask ourselves what we would be willing to pay for the business's normalised free cashflow given its future prospects at that point in time. We require a double-digit per annum return from both the underlying business and the stock, and ideally a good chance of a doubling in stock price over that five-year period. What we are prepared to pay is therefore dependent on long-term value creation and, in our view, the potential return for shareholders is driven by both value creation and our approach to valuation.

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While cashflow metrics are paramount, we do use other valuation measures to support our analysis. For example, although we tend not to invest in many asset-heavy businesses, where an opportunity arises, we might consider net asset value to be appropriate. We have considered such a measure to highlight potential value for insurance businesses or housebuilders, for example. In some special situations we have considered alternative measures such as sum-of-the-parts if the opportunity strikes us as compelling – and if we like the parts. One good example of this was the investment made last year in InterActive Corp. Implicitly, in all cases, we still consider long-term value is driven in essence from the underlying cashflows that those assets, or parts, will create over time.

The ability to analyse and make judgments about inherently uncertain future scenarios is essential to fundamental investing. We place a great deal of emphasis on the qualitative aspects of valuing a business. In our view, the lack of forward-looking analysis and judgment is a downside of a purely quantitative portfolio or ETF that depends entirely on historic valuation metrics and fundamental data. Such strategies struggle to consider fundamental change which can be reasonably anticipated with judgement. They are, therefore, more prone to invest in a business which may look cheap and high quality on historical financials but because it may be on the cusp of disruption is perhaps making peak returns on capital and hence is unattractive from a long-term perspective. Equally, such strategies can overlook companies that may be experiencing a cyclical downturn in their cashflows/prospects but where the long-term picture is still intact.

While the above highlights the limits of short-term valuation measures, we do from time to time use them to demonstrate potential value, to illustrate broader context or to flag possible opportunities. For example, while only a minority of investment ideas come from valuation screens, they can be a useful in alerting us to good businesses where there could be an attractive longer-term valuation opportunity. We may also refer to shorter-term valuation measures to illustrate an opportunity in a stock that is cheap in the near term and where we feel we are getting superior fundamentals or durable growth as a cheap or free option. For example, we have pointed out that Alphabet has traded at a similar earnings multiple to the market/average stock once we made adjustments for things such as abnormally high investment in some of its nascent businesses and cash on the balance sheet. Given this, you are getting many good things without paying a premium for them, including a durable competitive position, abnormally high growth, free options on undermonetised businesses, appealing long-term free cashflow metrics and a clean balance sheet.

Considering risk and scenarios

The world is not a simple place and we have to consider various paths a company might take over time when considering its value creation and value. As part of our analysis we have always considered what can go wrong and the potential downside when assessing value and as a key driver of our risk assessment. As we have evolved and understood more about the potential skew in rewards that has been exhibited by certain equities with exceptionally strong value creation, we have also realised that we must place an emphasis on what the potential is in a best-case scenario.

Why now for value creation and value?

We think our dual focus on value creation and value is the right approach over the long term and such a balanced approach should work in most investing environments. In recent years, our focus on value creation has added value to performance, but we feel our disciplined approach to valuation has not. There are good reasons to think the tide is turning and that both value creation and a focus on value will contribute to strong performance.

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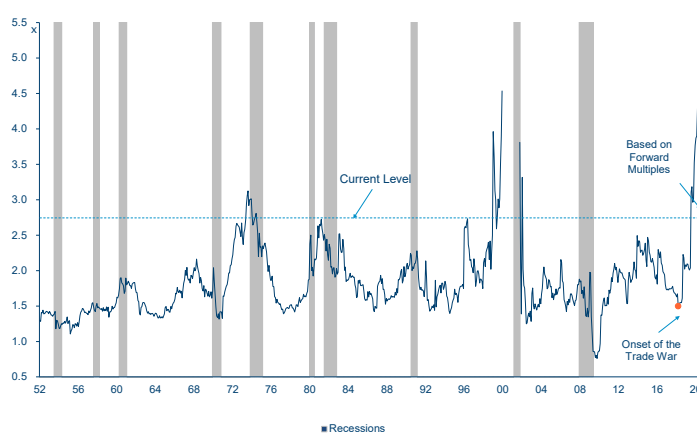
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“Naturally, there is a limit to the returns that can be generated from a stock price moving ahead of its fundamentals. During that time, a disciplined approach to valuing businesses can appear to be broken or old-fashioned, but it is exactly at points of extreme that the future payoff to a more disciplined approach is usually at its most appealing”

As we showed above, the fastest growing companies do not always outperform and, in fact, have not done so for most of the past 40 years. This is often because their growth prospects are well admired and more than encapsulated in the value of such businesses.

Part of the recent strong performance of the highest growth cohort of the market is, of course, down to fundamental reasons as relative growth prospects diverged dramatically for a time and, in many cases, as long-term cashflow potential was brought forward given the acceleration of technological trends. However, as we have highlighted before (and illustrated below) this acceleration in the rate of growth has been accompanied by a significant expansion in the premium being paid for faster growth¹. In our view this premium expansion in such a short period of time has been over and above that justified by fundamentals.²

The big growers' relative trailing P/E ratios (1952-2020)



Source: Empirical Research Partners Analysis, December 2020; equally weighted data; excludes negative earnings during the New Economy era; monthly returns compounded 1952 through December 2020.

Naturally, there is a limit to the returns that can be generated from a stock price moving ahead of its fundamentals. During that time, a disciplined approach to valuing businesses can appear to be broken or old-fashioned, but it is exactly at points of extreme that the future payoff to a more disciplined approach is usually at its most appealing.

The changes in broader conditions that we highlighted above – from increasing inflation expectations and potentially higher interest rates to the prospect of a broader set of companies seeing improved growth – portend a different environment for stock-picking. This backdrop is likely to be more conducive to investors with a pragmatic valuation discipline.

Indeed, a pragmatic approach is preferable to a dogmatic one, especially when it comes to valuing businesses. We continue to look for and monitor what we see as great growth businesses with an aim to invest in them at prices where we feel we are not over-paying for the future free cashflow potential. Given prices are subject to more change than the long-term fundamentals, it is important to be opportunistic and wait for a more attractive entry point. As Warren Buffett said: “The trick in investing is just to sit there and watch pitch after pitch go by and wait for the one right in your sweet spot”. We have a rich archive of research on such businesses, where we are waiting for an opportunity to swing the proverbial bat.

¹ It is often the case that a premium is paid for certain factors, for instance we observed a large premium being paid for income for much of the last decade and a large premium being paid for geographic growth during the boom in emerging market equities over a decade ago. However, the recent expanded premium for growth has arguably impacted a greater part of the US market than those examples.

² It is also worth highlighting how substantial it has been. The expansion in relative P/E in this group has been 120% over the three years to December 20 – a huge driver of returns – to anyone invested solely in this cohort of stocks.

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Conclusion

We continue to be encouraged by the operating performance of the companies in the portfolio. We feel that the future prospects for value creation are as good as they have been for many years.

A focus on long-term value creation remains vital – a business that does not create any durable long-term value cannot create attractive and enduring long-term returns for shareholders. Such a focus is especially important given so many industries are undergoing change.

We also take a disciplined approach to valuing businesses. This disciplined approach has been a headwind to performance for much of the past three years as parts of the market have stretched beyond fundamentals. Importantly in a world where the market values of many securities look excessive, we feel the portfolio's holdings remain attractively valued.

It is exactly at points of extreme that the future payoff to a more disciplined approach is at its most appealing. We feel we are at a juncture where our combined focus on value creation and value could be a material tailwind to performance in the future and there are definite signs this is starting to be the case.

Polar Capital North American Team

19 April 2021

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