Polar Capital North American Fund

April 2022

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In another tumultuous quarter, the Fund (US$ I Share Class) declined by 5.3%, slightly behind the broader performance index, the MSCI North America Net Total Return, which declined by 4.9%[1].

The dominant event of the quarter was Russia's invasion of Ukraine and the tragic humanitarian disaster it has caused. The most immediate impact of this, from an equity market perspective, is the exacerbation of an already tightening situation in many commodity markets. Based on the policy reactions thus far, it would seem the Ukraine crisis marks another step backwards in the globalisation trend of the past 30 years. The combination of these factors has further embedded concerns of inflationary pressure.

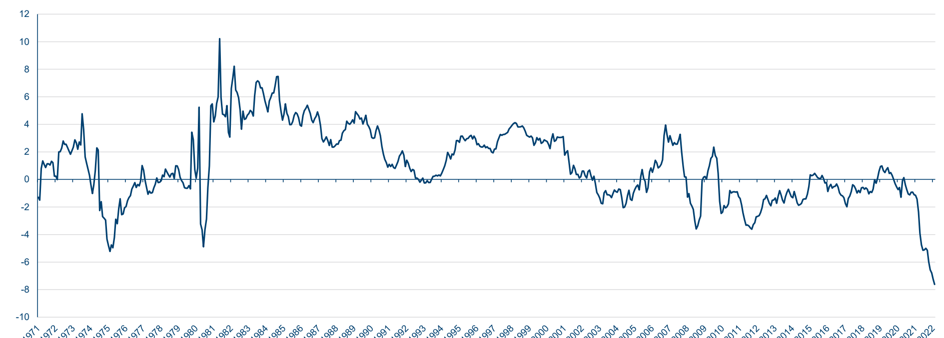
From the roaring '20s to the 1970s

The spikes in commodity prices, particularly agricultural commodities and fossil fuels – which have seen meaningful supply disruption due to the Russia/Ukraine conflict – underlined the lack of spare capacity in such areas following a long period of low investment. An extended period of low prices and cash flows, uncertainty over future royalty and carbon taxation agreements and pressure from investors over environmental considerations are some of the reasons behind lower investment in capital projects over the last decade. This meant that the balance of demand and supply was already tight in many markets and the invasion of Ukraine exacerbated this issue. The price of oil, for instance, rose from under $80 per barrel of Brent Crude at the beginning of the year to $108 at the end of the quarter. This helped the energy sector to be by far the best performing sector during the quarter. We provide a profile of the oil and gas producer, Canadian Natural Resources, at the end of this update to highlight what we have found attractive about the business and how we have considered the investment from an ESG perspective.

Inflation is driven by myriad factors, not just what is happening with commodities, and it is far from straightforward to work out the path it will follow over the next several years. However, even if year-on-year price increases do diminish as we lap the big increases, it seems to us that inflation is not going away any time soon. The longer high inflation exists, the harder it is to choke off as inflationary expectations become more ingrained.

While the Federal Reserve now appears more concerned about the threat of persistently higher inflation, monetary policy is still very accommodating. Of note, money supply[2] still grew at a double-digit rate during Q1, a level higher than at any period over the past 60 years except for the recent aftermath of the Covid crisis and a few short periods in the 1970s and early 1980s. In addition, the Fed Funds Rate in real terms is at its lowest level since just after WW2. Material tightening of monetary policy is the obvious and most likely path from here.

The Real Fed Funds Rate 1954-2022



Source: Effective Federal Funds Rate – CPI y/y

1. Northern Trust International Fund Administration Services (Ireland) Ltd and Bloomberg. Benchmark performance shown in USD. Performance relates to past returns and is not a reliable indicator of future returns. **2.** As measured by M2, which is defined as money in circulation plus checkable and savings deposits in banks.
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Awards & ratings

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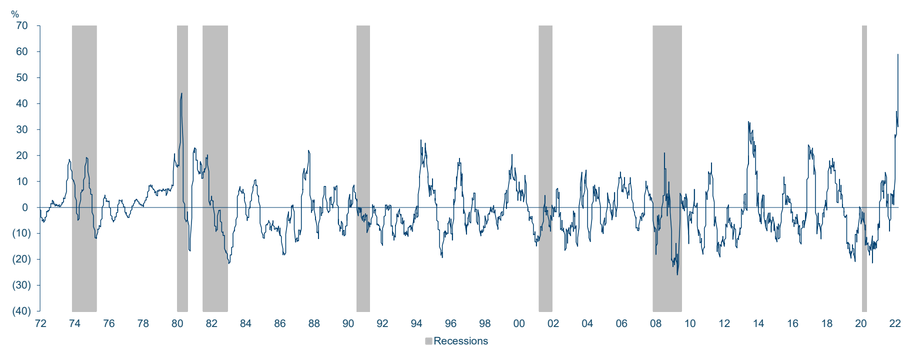
Although the Fed has been slow to realise the need to tighten policy, market forces have already started to tighten credit conditions. This can be seen, for instance, in the changes in mortgage rates in the US. Around 90% of US mortgages are fixed at rates determined by the 30-year bond yield at the time of origination. Rising interest rates do not impact those who already have mortgages and intend to stick with them. However, the cost of a new mortgage has gone up as mortgage rates have sharply increased (see chart below). Therefore, anyone who would like to move house would very likely see a sharp rise in their mortgage rate. Combined with booming house prices, house affordability has, as a result, declined to its lowest levels in 14 years (although it does remain better than most of the time preceding that). This is one example where a less supportive monetary and interest rate environment impacts economic activity.

Percent Change in 30-year Fixed Mortgage Rates Relative to the Rate 6 months Earlier - 1972 - Late March 2022



Source: Freddie Mac, National Bureau of Economic Research, Empirical Research Partners Analysis

"While wages are not going up faster than prices, wage increases may prove to be stickier than commodity price rises"

These dynamics have implications for many companies, not least those directly linked to the buying and selling of houses. Partly related to this, we sold the Fund's position in house builder Taylor Morrison during the quarter. We still feel the long-term outlook for new house volumes is decent after years of underbuilding following the great financial crisis. However, we are concerned that the combination of inflating costs and potential headwinds to revenue given current high housing prices and declining housing affordability could result in a meaningful deterioration in profitability from levels that are currently very high for the industry. The shares have a low valuation multiple and are certainly not pricing in buoyant conditions for an extended period. However, we expect circumstances to be materially more challenging for the business and have also grown concerned about management's ability to handle a tougher environment.

More generally, US consumers are seeing costs go up – in most cases, more than their wages. Consumer spending is the primary driver of the economy and there is legitimate concern that higher costs and tightening monetary policy could slow the economy meaningfully. In less than a year, it seems the most commonly cited prospective scenario for the economy has gone from the roaring '20s to a one that more closely resembles a stagflationary 1970s, or at least slow economic growth combined with a period of higher sustained inflation. Certainly, there is an increased chance of a meaningful slowdown in consumer real expenditure and economic growth. However, on the plus side, the labour market remains very tight and wages are going up meaningfully, particularly for the bottom quintile of earners. While wages are not going up faster than prices, wage increases may prove to be stickier than commodity price rises, for instance. Consumer balance sheets are also in good shape following many years of deleveraging after the financial crisis.

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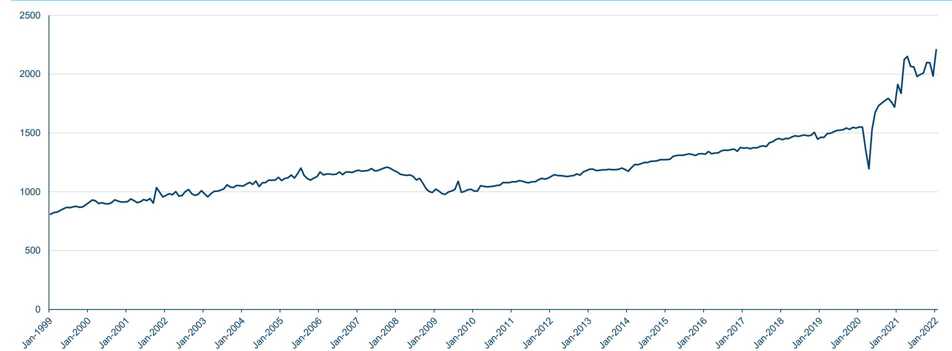
This squeeze on consumers' finances comes just as many areas of durable or highly discretionary consumer expenditure are in the latter stages of a remarkable boom in demand. If consumer nominal expenditure on durable goods (defined as goods that typically last more than three years) had grown in line with the 2.8% CAGR it grew at from 1999-2019 it would have registered 6.2% cumulative growth between December 2019 and February 2022. It actually increased at a staggering 40%. It is reasonable to expect a sizeable normalisation in such expenditure over the next few years.

Personal Consumption Expenditure ($bns - Seasonally Adjusted Annual Rate) – Durable Goods, 1999-2022

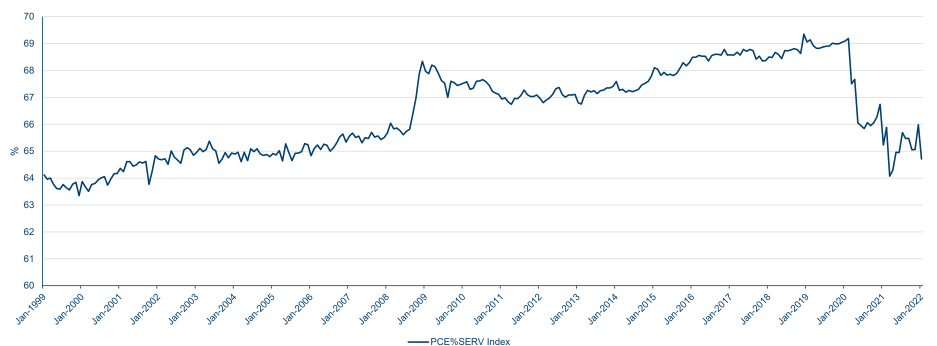


Source: Bloomberg, Polar Capital.

"Many service-oriented companies the Fund is invested in could be beneficiaries of inflation as well as benefitting from the post-Covid recovery in services-related spending"

The portfolio has a relatively more meaningful exposure to consumer expenditure on services or experiences such as eating out (US Foods, a distributor of ingredients to restaurants and canteens), holidays and travel (**Booking.com**, the online travel booking website) and taxis (Uber). In these areas, we still see pent-up demand, or at least a level of normalised demand that is much higher than it has been recently. Just as importantly, we find such businesses to be attractively valued given their normalised cash flow and long-term compounding potential. In short, we expect spending on experiences and services to take meaningful share from spending on discretionary consumer goods following a very unusual two year reversal in the long-term trend.

Personal Consumption Expenditure – Percentage Spent on Services, 1999-2022



Source: Bloomberg, Polar Capital.

We think that many service-oriented companies the Fund is invested in could be beneficiaries of inflation and beneficiaries of the post-Covid recovery in services-related spending. For example, the revenues of **Uber** and **Booking.com** are largely royalties on nominal taxi fares and hotel expenditure respectively and typically come with attractive incremental free cash flow margins. Relatedly, **Visa**, a top five investment in the Fund, will also benefit from taking a clip of rising nominal consumer expenditures while also benefitting from the ongoing move to electronic payment at very high incremental free cash flow margins.

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From 'growth at any price' to 'growth at a more reasonable price'

Another notable feature of Q1 was the sharp share price underperformance of companies with high sales growth, including many that are considered to be disruptors. As we have noted in previous updates, the valuations of many businesses with such characteristics had reached extreme levels. Higher inflation expectations and a rising interest rate environment are seen as the catalyst for the underperformance of this group of stocks as, theoretically, the effect of a higher discount rate on longer-duration cash flows is greater than on shorter-duration or steadier cash flow streams. Rising rates may partly explain this, though we suspect the weak performance has not been driven simply by investors recalibrating their discounted cash flow models. Rather, it seems more likely to us that such stocks, which generated strong growth in the past few years in an environment where growth was more scarce, were simply revalued unsustainably as a result of the excess liquidity that was also a feature of the prior investing environment. In addition, many of them also enjoyed a sharp boost to operational performance following the outbreak of Covid-19 – a boost that was then extrapolated too far into the future. We are now seeing an unwinding of those factors.

"We think it is highly unlikely that we are going back to a period of such extreme and continually expanding valuations for so many companies – more likely, this marked a once in a generation situation."

There are some other fundamental issues which, combined with certain stocks having been 'priced for perfection', contributed to the recent weakness in share prices of many disruptors. These include: meaningful execution issues in delivering expected growth; hitting maturity earlier than expected; a higher cost of maintaining growth than expected and, in an ever changing technology world, mounting concerns that some disruptors themselves will be disrupted by the time they reach mature profit margins.

We think it is highly unlikely that we are going back to a period of such extreme and continually expanding valuations for so many companies – more likely, this marked a once in a generation situation. In many cases, we think valuations need to reset further still. However, we also observe there have been many high quality, high growth businesses which have seen a meaningful adjustment in their multiples. From lower bases, there could be attractive investment opportunities for genuinely durable businesses with appealing long-term growth prospects (if not now, then potentially at some point in the next couple of years). We have done a great deal of work on many disruptive and high growth businesses in recent years, sometimes to understand if they would make attractive investments and sometimes to better understand their potential impact on the industries in which they exist. We have passed on the vast majority of companies we have looked at, either for valuation reasons or because they have not made it past our fundamental checklist. However, we continue to run a valuation analysis on those that do pass our fundamental criteria and are prepared for investment opportunities arising from any dislocation.

Conclusion

The main impact of the tragic invasion of Ukraine, from a US macroeconomic perspective, is the exacerbation of inflationary pressures that were already in place. This, in turn, has legitimately increased concerns regarding a tightening of monetary policy and the impact of higher interest rates. Growth will likely slow partly as a result of these factors and the risk of a recession cannot be completely dismissed. However, consumers are generally in a good position, helped by a buoyant labour market, wage rises and healthy balance sheets.

In general equities are a good hedge against inflation and many businesses are benefitting from a pick up in nominal earnings growth as a result of higher inflation. This is the case for many of the portfolio's holdings, for instance those that earn a royalty or fee on nominal expenditure, those benefitting from higher commodity prices following years of industry under-investment as well as those that earn more in a higher interest rate environment.

Some of the extremes in valuation we've commented on over the past few years or so have corrected but there may be more to go. We expect that we won't go back to the extreme conditions of the recent past. However, the quality of many businesses is unchanged. This creates opportunities for valuation-disciplined approaches with a focus on value creation, such as ours. Despite the difficult backdrop we are optimistic about the prospects for the fund from here given the attractive near- and long-term value creation prospects of the holdings and their appealing valuations.

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Case Study: Canadian Natural Resources – not your typical ESG case study

Given **Canadian Natural Resources'** recent strong performance, its reasonably large position in the Fund and the length of time we have held it (>5 years), we thought it worth profiling what we find attractive about the business and, accordingly, how we view it from an ESG perspective.

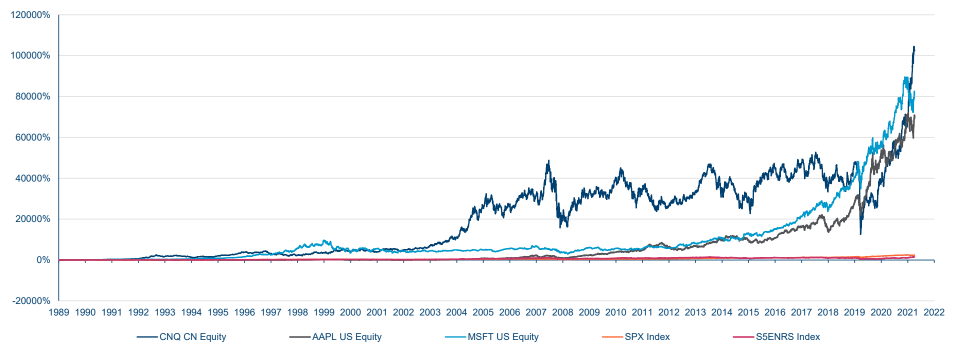
A great company in a tough industry

Canadian Natural Resources is a producer of oil and natural gas and most of its assets are located in Canada. There are a number of fundamental attractions that have made the company stand out to us, despite operating in a tough, capital intensive and highly cyclical industry.

First, it has been and continues to be extremely well managed. The company's Chairman, Murray Edwards, has been instrumental in setting and acting on the company's capital allocation strategy since 1989. He is backed by a strong team and together they have been successful at taking a long-term approach to running the business. The company has sound corporate governance practices which have helped provide a framework to allow management to make the right long-term capital allocation decisions which at times have been counter-cyclical in nature. Good long-term decision-making is not easy nor commonplace in highly cyclical industries where cash flows are typically only forthcoming at cyclical peaks and when reinvestment of such cash flow typically can occur at a peak prices and subsequently deliver low returns. Also of note, Canadian Natural has higher insider ownership than most resource businesses. The strong management record is reflected in its phenomenal stock returns. Since 1989, the shares have provided a per annum return to shareholders of around 24%, or over 100,000% in total. This compares with 1,500% in total for the S&P 500 energy sector and 2,400% for the S&P 500. In fact, it is even better than Apple and Microsoft's amazing records over that period.

"There are a number of fundamental attractions that have made Canadian Natural Resources stand out to us, despite operating in a tough, capital intensive and highly cyclical industry"

Canadian Natural Resources Long-Term Total Return



	Total Return	Annual Equivalent
Canadian Natural Resources	102,332%	24.0%
Microsoft Corp	80,718%	23.1%
Apple Inc	69,201%	22.5%
S&P 500	2,404%	10.5%
S&P 500 Energy	1,528%	9.0%

Source: Bloomberg, Polar Capital, December 1989 - March 2022.

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"We think the company could still be producing oil at least at the current production rate long after many companies cease to exist, not just in the energy sector, but across the equity market overall."

Second, it has an incredibly strong asset base, something the company's long-term-oriented management team has patiently created over time. Canadian Natural has an audited proven reserve base of over 30 years' worth of its current annual production but in practice it will likely last decades beyond that. We think the company could still be producing oil at least at the current production rate long after many companies cease to exist, not just in the energy sector, but across the equity market overall. The company has a much lower decline rate in its asset base than most listed oil producers, which means less investment is required to keep production flat or growing.

Excellent management and an appealing asset base result in the third key attraction: impressive financial characteristics. Because the company is well managed operationally and has such a long-lived reserve base where less investment is required to sustain production, its free cash flow generation is significant. For example, the company has proven it can reach breakeven from a free cash flow perspective (after capital expenditure to enable it to sustain production) even at an oil price in the low $30s per barrel. This is a lower breakeven point than most oil companies. In the current environment, the company is gushing cash. This year, the company will likely return nearly 10% of its market cap to shareholders through dividends and buybacks, while paying down debt and growing production volumes 5%. From the current valuation of around 6-7x free cash flow, assuming a price of Brent Crude in the mid-$90s per barrel, we think the company could theoretically return around 15% of the market capitalisation to shareholders per annum for a very long time. However, history suggests the company can add more value through other forms of capital allocation than simply returning capital to shareholders.

It should go without saying that we are not providing capital to the oil industry – in fact the flow of capital is very clearly the other way around, particularly in the case of Canadian Natural.

Thinking deeper about environmental challenges

In our view, environmental issues are the largest risks to the company and have naturally been a vital part of our research.

The most important environmental issue is the likely decline in the demand for oil over the next several decades as it is substituted by more environmentally-friendly alternatives in a number of applications. We welcome a shift away from carbon-intensive sources of energy. However, an energy transition does not happen overnight and oil has a key role to play in making the transition as smooth as possible. Even if oil demand declines steadily after a few years of topping out, it is likely that oil will likely still be consumed in some form (eg polyolefins) in 2050, even if the world achieves its carbon neutral target.

For any commodity, it is not just demand that drives the price but supply too. This can sometimes be overlooked. Unless prices are high enough and significant investments are made, then given the natural decline rate in oil wells, supply might not keep up with demand, even if demand declines consistently over the next few decades. Interestingly, last year the International Energy Agency (IEA) concluded that oil demand must decline by at least 4% pa from 2020-50 in order to achieve net zero emissions. This hit the headlines but what was missing was their statement that even if investment continued in existing producing fields but not in the development of new fields, production would decline by 4.5% pa. Environmental concerns and an uncertain demand and fiscal future are naturally only discouraging investment in exploration and stifling investment in the development of fields with long-term paybacks. Canadian Natural is competitively advantaged in such an environment as they have a low-decline reserve base which should enable them to produce for decades without taking meaningful incremental investment risks.

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A second key area of environmental concern for us is the risk to profitability driven by carbon taxes and/or investment required to meet environmental goals. Although the production of oil emits on average one fifth the carbon that the consumption of oil does, it is still naturally a controversial process. Over time, we expect higher carbon taxes (the company already pays a material amount of carbon tax) and simultaneously expect and welcome accelerated investment to reduce its environmental footprint.

We are encouraged by Canadian Natural's credible carbon reduction plans, which go further than many peers, and note they have executed very well on reducing their broader environmental footprint so far. We do not think this has been fully appreciated yet. Interestingly, the company has demonstrated that in many cases its projects to reduce its adverse environmental footprint have been additive to productivity and return on invested capital. Meanwhile, we consider carbon tax/investment risk to be manageable in most scenarios (and could curtail industry supply further). If the company was to be levied with carbon taxes to account for its total emissions or to absorb the costs from carbon sequestration over time to fully offset its carbon emissions, the incremental cost would likely be not much more than $5 per barrel based on our analysis. This should be digestible over time, especially if recent oil prices are sustainable.

As an aside, we note that views from politicians and the public on Canadian oil producers might be shifting on account of their superior ESG record compared to producers of hydrocarbons elsewhere in the world. The chart below highlights this. Russia's invasion of Ukraine has only sharpened the focus on the importance of where hydrocarbons are coming from. It is worth noting that Canadian Natural scores highly with its 'social' credentials in an industry context, in part because of the region they operate in and in part because of a strong record of working alongside local communities. Such positive credentials are starting to be appreciated more.

When engagement can add more value than exclusion

We believe that in many cases considered engagement is more likely to result in positive change in corporate behaviour compared to a policy of exclusion. For instance, having conversations and communicating with management as well as carrying out thoughtful and considered voting on important issues can lead to positive change and add value to shareholders and broader stakeholders. Exclusion, where a holding in a business might be sold to a shareholder who cares less about those issues and is less likely to engage or vote, could actually detract value for society at large.

"We are encouraged by Canadian Natural's credible carbon reduction plans, which go further than many peers, and note they have executed very well on reducing their broader environmental footprint so far"

A high proportion of our engagement with Canadian Natural has logically focused on how the company deals with the risks of carbon emissions and the direct environmental impact the company has – this includes their strategy to reduce carbon emissions as well as water management and land reclamation projects. In recent years, we have had a number of conversations on topics including but not limited to their significant investment in carbon-reducing technology; technology collaboration with Canadian peers; planned carbon capture projects (they are the sixth largest owner of carbon capture capacity in the world across any industry) and other innovative processes to reduce emissions. In these conversations we have explicitly encouraged ongoing investment in, and tangible progress towards, the reduction of emissions. We have complemented our verbal engagement in management meetings with written engagement encouraging the need for further tangible progress, the sharing of best environmental practice with peers and a greater prominence of environmental goals when considering incentive compensation for management and senior employees.

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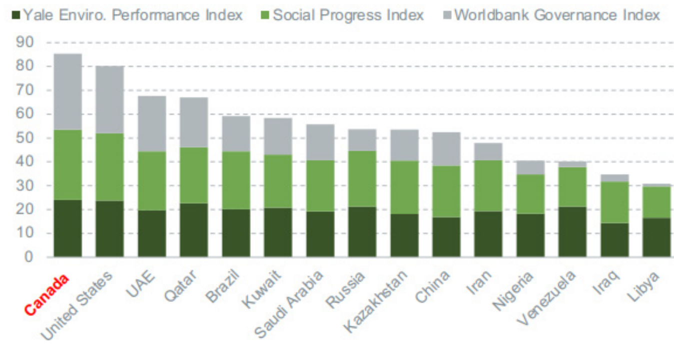
Top Oil Reserve Holders ESG Index



Source: BMO Capital Markets; presentation uses an equal weight of each index represented
Note: The Environmental Performance Index (EPI) is created jointly by Yale/Columbia Universities in collaboration with the World Economic Forum and ranks 180 countries on 24 performance indicators on environmental health and ecosystem vitality; the Social Progress Index (SPI) is developed by the Social Progress Imperative and ranks 149 countries on 51 measures of social responsibility that are independent of economic indicators; World Bank's Worldwide Governance Indicators (WGI) rank over 200 countries on six dimensions including political stability, regulatory quality and corruption control

We were pleased to learn last year that the company became part of, and helped drive, the Oil Sands Pathways to Net Zero initiative – a collaboration between a group of peers where technology is shared and joint investment is made to help achieve net zero greenhouse gas emissions by 2050, in line with Canada's climate goals. It is a collaborative plan between peers/competitors, of the like we have not seen elsewhere. We were also encouraged to hear in our most recent meeting with the company that they are looking at how to improve the alignment of management incentivisation with environmental goals. We do not know the exact extent to which our engagement has driven management's evolution of thought and action with regards to collaboration and incentivisation. Management has always been thoughtful, forward-looking and generally has a good record of doing the right thing. However, engagement with the company in this case has to be better than the alternative of selling to an investor who does not care and chooses not to engage on such issues. We will continue to actively engage with the company, encouraging progress, innovation and more significant alignment of management compensation with environmental goals.

A sensible approach to responsible investing

Canadian Natural Resources might, at first glance, seem like an unusual case study of responsible investing and certainly one that does not fit into most conventional ideas of what constitutes ESG investing. We are often troubled by more simplistic methodologies where exclusion is the end result of a one-sized fits all, formulaic approach. We believe that taking account of real-world trade-offs and incorporating judgement and pragmatism results in a more realistic and sensible application of the principles of responsible investing. This means combining analysis of the ESG-related risks and opportunities with other fundamental characteristics and running an active engagement strategy consistent with being responsible owners of shares in businesses.

We hope the Canadian Natural example helps illustrate that considered, holistic and forward-looking analysis paired with thoughtful engagement is a better way than knee-jerk, exclusion-first greenwashing. We believe our approach is more likely to add long-term value to clients and at the same time also has a better chance of adding value to the world.

Polar Capital North American Team

14 April 2022

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