POLAR CAPITAL

Polar Capital North American Fund

July 2023

A rising tide lifts a few boats

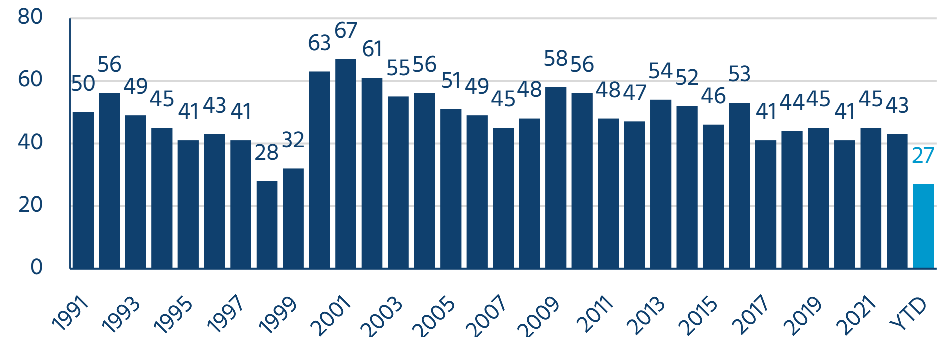
After a weak 2022, the first half of this year saw gains for North American equities. The Fund (USD I Share Class) delivered a return of 11.2%, lagging the benchmark, the MSCI North America Net Total Return Index, which rose by 16.4%. For the second quarter, the Fund rose by 7.2% compared to the benchmark return of 8.4% (all figures in dollar terms).

Investing environment

Strong headline performance for market cap-weighted benchmarks disguised more variable performance across the market. For instance, the top 10 stocks, made up mostly of the mega-cap technology companies, delivered a return of 31.6% and 20.3% in H1 and Q2 respectively[1]. By comparison, the S&P Equal Weighted 1500 Index, a good approximation of our investment universe, excluding Canada, delivered a return of 5.4% in H1 and 2.9% in Q2. The divergence in performance between mega-cap technology and the rest of the market was particularly prevalent between the end of February and May.

Remarkably, only 27% of the S&P 500 constituents outperformed the S&P 500 itself in the first half of 2023.

% of S&P 500 companies outperforming the market by year



Source: Robert W Baird, Bloomberg, 30 June 2023.

Headline inflation, a key concern for many investors over the past couple of years, continued to subside during the first half of the year. However, core inflation measures that strip out more volatile food and energy prices have been slower to normalise and stickier elements such as wages remain higher than typically seen over the past few decades. We continue to think we are likely past the worst of inflation and close to, or at, a peak in short-term interest rates as a result. However, we also think it is unlikely that we will see a return to a period of ultra-low interest rates such as the one that influenced the economy and securities markets so much over the past decade. We doubt investors have fully adjusted to the new reality.

Conditions in many parts of the economy have slowed over the course of 2023 and there remains a decent chance of a recession at some stage in the next 12 months. The following chart shows the ISM Manufacturing Purchasing Managers Index (PMIs) falling through the year.

Andrew Holliman
Lead Fund Manager

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

Richard Wilson
Co-Fund Manager

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

Colm Friel
Fund Manager

Colm joined Polar Capital in June 2014 to work on the North American Equities team.

Awards & ratings

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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.

Past performance is not indicative or a guarantee of future returns. [1]**Source:** Bloomberg, 30/06/2023. Calculated as a market cap-weighted portfolio of the top 10 stocks at the start of each period. **Note:** The top 10 at the beginning of the year did not include Tesla and NVIDIA though they were represented in the top 10 stocks in Q2.

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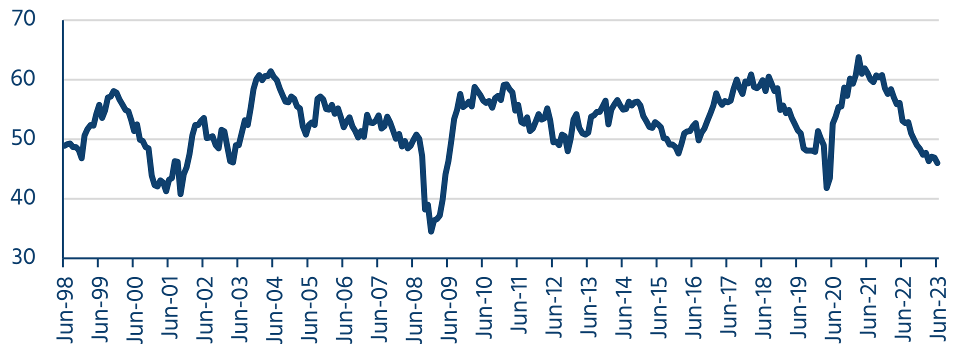
ISM Manufacturing Purchasing Managers Index



Source: Bloomberg, 30 June 2023, seasonally adjusted. **Note**: A PMI reading below 50 indicates a contraction in activity; above 50 is a sign of expansion.

"Profits for many businesses have recently proven to be more resilient than feared, future expectations for near-term profits have become more realistic and, encouragingly, the S&P 500 saw positive earnings revisions during the second quarter"

However, given expectations of a potential recession have been so broadly embedded, perhaps economic trends have not been as bad as feared. Indeed, estimates for 2023 GDP growth have risen year-to-date. In addition, the banking crisis that dominated March has not escalated and many parts of the economy are doing well. For instance, employment remains full, investment in infrastructure continues to grow rapidly and there are pockets of strength in areas that a higher interest rate environment might, under normal circumstances, have negatively impacted, such as new home construction.

Profit growth for American businesses has been lacklustre, largely driven by a squeeze of profit margins. We still see headwinds for profit growth for many businesses given slow demand growth in many parts of the economy, as well as a more challenging environment for those businesses that are still experiencing elevated profit margins having increased prices markedly during the early stages of rising inflation. However, profits for many businesses have recently proven to be more resilient than feared, future expectations for near-term profits have become more realistic and, encouragingly, the S&P 500 saw positive earnings revisions during the second quarter.

Artificial intelligence

Growing excitement around artificial intelligence (AI) has been a key feature so far this year and a major driver of the performance of mega-cap technology stocks. The outstanding illustration is NVIDIA which provided extremely bullish guidance in May that implied the company was seeing a major inflection point in AI-related demand for its specialist semiconductor chips. Its stock price nearly tripled in the first half of the year, adding around $700bn to its market cap. Excitement was not just contained to technology stocks – AI was mentioned in over a quarter of all S&P 500 constituents' Q1 earnings calls.

In much the same way as economists are said to consistently overegg the odds of recessions, financial markets have likely predicted far more technological revolutions than have actually taken place. AI is certainly in the 'predicted' camp. There is a good case for it being in the 'revolution' camp too but the latter is not clear cut and, as with anything, we, as investors, need to stand away from the hype to take a considered, holistic perspective.

As a discipline, AI has existed for several decades and has been applied in exciting ways for many years as computing power keeps getting better. The current wave of excitement is driven by AI being made much more accessible and usable, largely through the consumer-facing applications of large language models (LLMs), the most well-known of which is ChatGPT. These tools are impressive, not only in what they can currently do but also the speed at which they improve.

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The evolution of computing power has been relentless since its invention. Over that time, it has created new industries and new capabilities within existing industries as well as spelling the end of certain industries and human skillsets. Although AI is nothing new and LLMs mark an ongoing evolution of AI and computing technology, there are grounds to believe we are at an inflection point where progress could accelerate and use cases could expand materially, disrupting skills and industries previously considered resilient to technological change.

For instance, jobs like coding could change; ChatGPT can write code faster and often better than software engineers. This is a labour market that has arguably been undersupplied but could see a supply shock which could negatively impact the revenue base for some organisations. On a more positive note, it could lower the cost base of many other organisations and democratise certain areas of computing, lowering barriers for individuals and smaller organisations. Certain creative industries could also undergo a disruptive change in how content, from text to images to music and possibly even film, is created given the evolution of AI's capabilities.

As with any new era in computing, many jobs may be made less relevant or obsolete while others are likely to be created. This is nothing new for technological evolution though, arguably, it has the potential to take place at a more rapid pace and be more impactful for white collar work.

"While it is easy to fall for the narrative that businesses not at the forefront of technology are most prone to existential threats, this is not necessarily the case"

Similarly, many businesses may become less relevant while new businesses will likely be created. This is nothing new either. While it is easy to fall for the narrative that businesses not at the forefront of technology are most prone to existential threats, this is not necessarily the case. For instance, considering just a handful of holdings in the portfolio: AI is not going to dramatically alter the economics of companies transporting grain across the US (**Union Pacific**), producing raw materials (**Teck Resources**), providing industrial rental equipment (**United Rentals**), distributing pharmaceuticals (**McKesson**) or providing live sporting content (**Formula One**). By contrast, despite **Alphabet's** colossal investment in the field and its superior AI capability compared to nearly every other company in the world, LLMs have slightly negatively altered our view on Google's moat in search.

For most businesses, the impact of AI will be more subtle and gradual. How much a company harnesses AI or how much it is harmed by it will be determined by a variety of fundamental aspects including, but not limited to, the nature of its activities, the durability of customer value it provides, strength of customer relationships and other competitive dynamics. While it is important to be aware of the big picture when investing (and in this instance the broader impact AI can have), ultimately we prefer to approach analysing such situations on an industry-by-industry and business-by-business basis, thinking holistically about the risks and opportunities for each position.

It is important to strike a healthy balance between being open-minded regarding change and maintaining a grounding in fundamentals and a value discipline, especially when hype and narratives escalate. Being overly focused on multiples of near-term financial metrics can be dangerous when assessing the prospects of a stock where the business is undergoing transformative change, either positive or negative.

However, the price you pay still matters greatly. For instance, NVIDIA is undoubtedly very well placed to take advantage of any AI boom and its stock price could continue to do very well in the short term. It may also prove to be a rewarding long-term investment to shareholders from here. However, a higher level of anticipation at the outset, as reflected in the stock's price/revenue multiple, should provide a lower likelihood of skewed returns than was the case for similar companies in previous periods of technological disruption, where the extent of those companies' skewed success was also only largely seen with hindsight.

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As an illustration, if one had paid NVIDIA's current multiple of forward sales for Apple in 2007 at the time the first iPhone was released – an inflection point for the company and a period when Apple had a similar level of sales to NVIDIA now – returns for shareholders would have been roughly flat for the following 10 years rather than the more than seven-fold return shareholders actually enjoyed. This aligns with the company growing sales seven-fold, or at 22% CAGR, over the ensuing decade. Another example is Alphabet at its IPO, when it was at a much more nascent stage of growth. If one had applied a similar multiple to Alphabet's forward sales then, the stock would have delivered a respectable 10% pa return over the following decade, well below the 30% pa (or >14x) increase the stock actually enjoyed. During this period, Alphabet grew sales by more than 12x-fold or a 29% CAGR.

Overall, this is an active area of research for us and we continue to analyse the effects on businesses in the portfolio and look for opportunities where the market might be overly pessimistic about disruption or not optimistic enough – as ever, we are sticking to our core principles while adapting to the evolving landscape.

Fund performance and activity

Given the market dynamics discussed above, combined with the Fund's multi-cap and high active share approach, the strong performance of stocks NOT held in the portfolio had a significant impact on its return failing to keep up with the benchmark.

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Of our portfolio holdings, the biggest detractors to performance during Q2 were **Envista Holdings**, **RenaissanceRe Holdings**, **T-Mobile US** and **Cenovus Energy**.

Dental equipment manufacturer Envista Holdings performed poorly over the second quarter following the release of its Q1 results. Weakness in China and Russian revenues going to zero compared to the previous year offset the positive progression in orthodontic revenues, which benefitted from product innovation over the past couple of years. Despite this, the company kept annual organic revenue and margin guidance in place, suggesting the challenges will be shorter term in nature. We have retained a small position as Envista still meets our value creation hurdle and the valuation has become more attractive this year.

Reinsurance specialist RenaissanceRe fell on concerns over the supply of new capital to the reinsurance industry following a period in which successive natural catastrophes choked off risk-based investment in the industry leading to better pricing. In the event, the fresh capital raised by two peer companies is a rounding error in the context of the size of the industry and in both cases was raised for highly idiosyncratic reasons.

T Mobile, the wireless telecom provider, was weak over the quarter, partially on concerns that Amazon may be about to enter the US wireless market.

Cenovus, the oil producer, was weak given weakness in the oil price.

On the positive side, unsurprisingly given the market backdrop, there were strong performances from the Fund's mega-cap technology holdings.

Alphabet rose partially as it alleviated concerns that it may be an AI loser given the potential for a market share shift in search where it makes the majority of its profits. We are conscious of the risk of an unfavourable change in competitive conditions and have taken the position down slightly as a result. However, we also see the potential use cases of LLMs as additive for Alphabet's businesses (incredibly the company has nine products, each with over one billion users) and on balance see Google's position as defensible. The shares continue to look inexpensive to us at around 20x earnings and cashflow despite the strength of its franchises, its growth potential (with many of its products being under-monetised) and its robust balance sheet.

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"Even though there are some obvious [AI] winners from a business perspective, it does not automatically make them such obvious winners from an investment perspective"

Microsoft was another strong mega-cap technology performer. It is well placed to benefit from the AI boom given its deeply engrained, far-reaching platform and the investments it has made in its Azure business and in OpenAI. AI should help Microsoft add new features (such as Copilot) and tools to its platform, increasing monetisation. This will take time though and require substantial ongoing investment.

We continue to greatly admire the business. However, the valuation increasingly reflects the quality of its business model and the expanded growth opportunity. As a result, we reduced the position towards the end of the quarter.

Amazon performed well during the second quarter for reasons perhaps less related to AI (though there is growing anticipation of an acceleration in the cloud business as a result) and perhaps as investors look beyond shorter-term headwinds. We added to the holding in Q1 as we felt the long-term positioning and profit potential in e-commerce and the cloud were being overlooked because of short-term profitability issues caused by a large investment cycle in the retail business and slowing end demand.

Uber Technologies also performed well after delivering another encouraging set of results, raising confidence about its potential to generate attractive cashflow in a normalised state.

There were three new additions to the portfolio during the second quarter: McKesson, Black Knight and Fairfax Financial Holdings.

McKesson is a leading distributor of pharmaceuticals and medical products. It is an integral part of the healthcare system, delivering one third of all prescription medicines in North America. It operates in a relatively stable oligopoly with a sticky customer base. We see an opportunity for the company to compound organically at an attractive rate driven by increased consumption of pharmaceuticals. Within that, we expect the company to benefit from a growing share of speciality medicines – those that treat chronic, complex or rare diseases and possess additional distribution complexity requiring special management – which typically offers higher margins. It has become more focused in recent years, exiting non-core businesses, and we expect much of the free cashflow it generates to be returned to shareholders resulting in steady double-digit per annum value creation. The stock was purchased at around a 6-7% free cashflow yield, a valuation we find attractive given its competitive position and steady and appealing growth prospects.

Black Knight is the dominant provider of mortgage servicing software to US financial institutions. The software is deeply embedded into systems and processes at banks and other lenders, and helps ensure monthly mortgage repayments are managed efficiently and in compliance with myriad regulations. The company generates most of its revenue from the outstanding volume of mortgages as opposed to originations, which have declined significantly of late. Despite this, the company has seen cyclical headwinds over the past 18 months.

Our view is that Black Knight is well placed to generate attractive top-line growth and expand profit margins via operating leverage and productivity while being well placed to allocate its attractive cashflows. We also see a cheap option on higher near-term returns as **Intercontinental Exchange** (ICE) has offered to buy Black Knight at a considerable premium to the current price. The deal faces scrutiny from the Federal Trade Commission and, to assuage the concerns, the company has agreed to sell the only part of its business that overlaps with ICE's existing mortgage offering. The divestiture of the overlapping business unit is no guarantee the deal will go through. However, we see little priced into the stock for this positive outcome.

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Fairfax Financial Holdings is a Canadian company providing property and casualty insurance and reinsurance. We see Fairfax as well-placed to compound book value and cash earnings power at an attractive double-digit rate through a combination of the compounding of its investment book and the generation of underwriting profits. We view the stock as attractively valued, both in an absolute sense and versus the industry, with the stock trading at a low multiple of earnings, book value and investment float. We partially funded the addition through a reduction of the Fund's other insurance holdings.

During the second quarter, we made one complete sale, **Service Corp International**, a provider of funeral, cremation and cemetery services. When we initially invested in the company we were well aware there would be a period of normalisation in the excess death rate that (sadly) has been a feature of the post-Covid era. We still believe the company will manage through such a readjustment. However, during our holding period we came to appreciate better just how successful the company has been at upselling cemetery and funeral plans to older Americans, many of whom saw both their disposable income and net worth increase during Covid. We believe this boost to the company will normalise over the next few years resulting in a headwind to growth. At the same time, the valuation, while reasonable for the high quality, predictable nature of the company's business, was not compelling enough to remain invested and we found better risk/reward in the new companies we purchased.

Conclusion

The US market had a remarkably strong first half of the year despite a mini-banking crisis, the continuation of one of the fastest rate rises in history and a mixed picture in its economic data. However, aggregate performance was boosted by a very small number of mega-cap stocks and this created a huge divergence between market cap-weighted and equally weighted indices. These conditions made it tougher for all-cap investors and portfolios with high active shares.

AI was a huge topic in H1 given the rapid progress and adoption of the latest iteration, LLMs. We are taking a balanced, analytical approach and are trying to look at the full picture – for instance, there are plenty of businesses that will see little to no impact, while there may be some less obvious long-term winners. As ever, we believe the price you pay matters. Even though there are some obvious winners from a business perspective, it does not automatically make them such obvious winners from an investment perspective if a long period of high growth is reflected in the stock price.

Our portfolio activity has picked up recently with new positions in businesses that have diverse drivers of value creation. We remain confident that the appealing valuation and value creation characteristics of the businesses in the portfolio will continue to deliver attractive returns for investors over the long run. Thank you for your continued support.

Polar Capital North American Team

07 July 2023

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- 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.
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