Polar Capital North American Fund

January 2021

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North American Q4 Update

Performance

The fourth quarter was another remarkable period, capping off an extraordinary year for the US equity market. The Fund (US$ I share class) rose 20.2% compared with the benchmark (MSCI North American Net Total Return) which returned 13.1%.

In recent investment updates, we profiled how the portfolio is well positioned for an eventual return to pre-COVID-19 social norms. The positive vaccine news from Pfizer BioNTech announced in November marked an important step in the path towards a more normal environment and led to the notable outperformance in many stocks that had lagged.

Businesses which faced stiff near-term operational headwinds and whose valuations have been extremely depressed as a result on a longer-term perspective performed exceptionally in Q4, and it was pleasing to see our conviction in recovery rewarded. Strong performances included: Samsonite, the world's leading premium luggage manufacturer; US Foods Holding, a distributor of food to restaurants and institutional caterers; Sabre a leading airline travel booking systems operator; Envista Holdings, a manufacturer of dental consumables and equipment; Uber, the dominant ride-hailing platform; and Citigroup. We continue to find the risk/reward for these businesses attractive although in some cases we have altered positions as risk/reward has evolved.

We have also previously written about how the portfolio is poised to benefit from more than just a cohort of COVID-19 recovery beneficiaries. Dolby Laboratories and InterActive Corp are good examples of stocks that performed well for reasons unrelated to COVID-19. Dolby has been in the portfolio since 2017 and we have been continually impressed by its commitment to reinvest and maintain its IP leadership, yet the stock has not been an exceptional performer until more recently. It gained strongly during the quarter, boosted by further adoption of its technologies by Apple and the rolling out of its new Dolby.IO platform. Apple announced that its new iPhone would be the first consumer device to be able to capture video in Dolby Vision format, adding to Apple's already broad adoption of Dolby technologies. This could help drive further adoption by other consumer electronic device OEMs. Dolby.IO is potentially a game-changing technology for the company. It is the company's first self-service subscription platform that enables it to dramatically increase its addressable market to non-professionally-produced content. The use cases for Dolby.IO are broad, including video conferencing, telehealth, social media/video sharing and so on, and could in time be significant.

InterActive Corp, a media and internet business holding company, performed strongly as its discount to the sum of its parts closed significantly. This followed the announcement of plans to spin out its video production platform, Vimeo, to shareholders. We continue to like the long-term prospects for business value creation for InterActive Corp, however its valuation is less compelling following the significant narrowing of its discount to net asset value[1] and we have reduced the position.

To balance the discussion of the portfolio's strong performers, the main laggards to relative performance during the quarter were: not owning Tesla; S&P Global, the index and ratings company; not owning Walt Disney; the small cash position (which produced a drag in such a strong market); Taylor Morrison Home, the house builder; Amazon; Icon, the pharmaceutical contract research organisation; and Markel, the speciality insurer.

Awards & ratings

FE fundinfo Crown Fund Rating

1. Given its holding company nature looking at net asset value and the worth of its parts, it has been an important way of valuing the business in this instance.

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Of the stocks held in the portfolio listed above, S&P Global perhaps saw the most notable fundamental change in its circumstances. Part of its underperformance came after management announced the acquisition of the data company IHS Markit. Although we appreciate the enduring value of many of IHS Markit's data assets having followed the company for some time, and although the premium paid was reassuringly small, on balance we would have preferred S&P Global not to dilute its existing strong franchises. We continue to like its long-term prospects, but its position in the portfolio is smaller following reductions on valuation grounds earlier in the year and a further reduction following the deal announcement.

For the year, the Fund (US$ I share class) returned 15.2% compared with 19.9% for the index (MSCI North American Net Total Return). Unsurprisingly, given the Fund's significant underperformance during March as the COVID-19 pandemic hit, the stocks that underperformed the most during the entire year came from those sectors of the economy that were the most impacted by the pandemic. These include: Spirit Airlines, the low-cost airline; US Foods, a food distributor to restaurants and catering facilities; Canadian Natural Resources, the oil producer; Citigroup, the bank; and Arch Capital, the insurer.

Despite meaningful underperformance from the names listed in the prior paragraph, the top two detractors for the year to relative performance were from Apple and Tesla, which were not held in the Fund. As investors know, the Fund has a high active share and it is not our approach to focus our efforts on companies just because they happen to be a large part of the benchmark. Nonetheless it is unusual and remarkable that 2020 was the second year in a row when not owning a couple of stocks was more damaging to relative performance than the drag from any individual active position.

On the positive side, performance in 2020 benefitted from stocks that have been held in the portfolio for some time (Amazon, Qualcomm and Dolby, for instance), as well as a number of new positions that were purchased opportunistically during the year (Envista, InterActive Corp, Stitch Fix and Samsonite). While we do not seek instant gratification, it is encouraging that stocks added to the portfolio in 2020 have been meaningful positive contributors to performance. Furthermore, we are encouraged by the performance contribution of our new purchases over the past two and a half years following a more challenging period for new additions to the Fund in the prior 18 months.

Value creation and valuation

We continue to be encouraged by the operational performance of the portfolio's holdings in what is a tough environment. Indeed, the resilience of most US businesses and their ability to adapt, and in many cases thrive, has been a noteworthy characteristic of the past year. The third-quarter results season was an illustration of this. According to Credit Suisse, earnings for the S&P 500 declined only 7% which is remarkable given the circumstances. Furthermore, based on our calculations, despite the Fund's exposure to a large number of companies which were significantly impacted by COVID-19, earnings per share and business value creation for the portfolio actually fared much better than -7%.

In the second half of the year, we saw more and more signs of exuberance in equity markets, most of which were absent in the bull market of the previous decade. Some of the more notable examples include: an explosion of retail investing accounts and trades; a surge in initial public offerings and strong subsequent performance (though nothing like the strength seen in 1999-2000); a boom in issuance of special purpose acquisition companies (SPACs); some tenuous justifications being used for certain stock valuations and perhaps, more tellingly, a declaration by some that valuation is irrelevant when assessing future returns.

In general, stock price progression has outstripped business value progression for most equities in our investment universe in recent times. This means that returns are being borrowed from the future. Nonetheless, we are happy with both the value creation potential and the valuations of the stocks in the portfolio. Indeed, the portfolio owns many stocks that have seen good value creation over time, that continue to offer bright prospects, and yet carry valuations that have changed little in recent years. For example, we highlighted in our October update how our insurance holdings have compounded book value at an attractive rate over time yet their valuations have remained somewhat static (and indeed declined in 2020). Importantly, we continue to identify plenty of new opportunities across a number of different industries and across the market-cap spectrum that fulfil our value creation and value criteria and were able to take advantage of some outstanding opportunities last year.

US versus the Rest of the World

Although we note an increase in the valuations of most stocks, we find the assertion by some market observers that the US is an expensive market relative to others lacks rigour. First, making an overly simplistic index valuation comparison fails to take into account differences between one index and another. We have highlighted before that the US market on a sector-adjusted basis is no more expensive compared to European benchmarks than it has been in the past.

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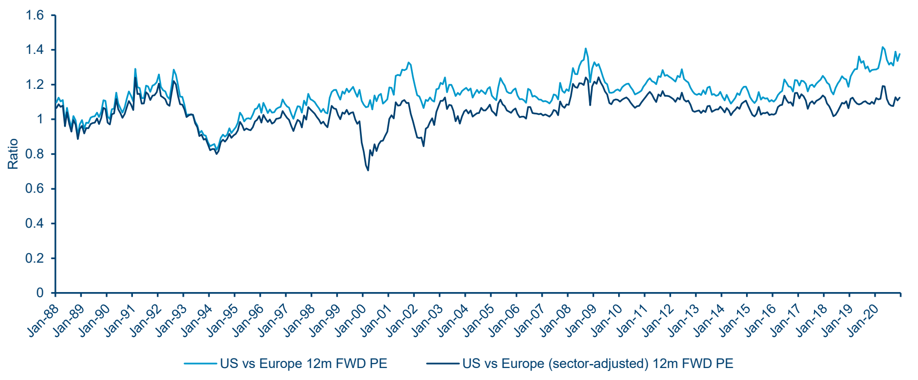
US and Europe P/E and sector-adjusted P/E ratios



Source: Sanford Bernstein; January 1988-January 2021.

Digging even deeper, we find that making this sector adjustment may not reflect the full picture. For example, Amazon is classified as a retailer and is by far the largest retailer in the S&P 500 by market capitalisation. By comparison, the largest retailer in Europe is Inditex. Inditex is unquestionably a fine and well-managed retailer but one we doubt has as attractive long-term fundamental prospects as Amazon. So, in this instance even sector adjusting does not give credit to the stark differences in the make-up of that sector.

We doubt the businesses held in the portfolio would carry lower valuations if they had the same fundamentals but were quoted or domiciled in London, Frankfurt, Stockholm or Sydney. Furthermore, consider companies held by the portfolio in less glamourous industries which trade at multiples that would look attractive in any market globally: Taylor Morrison, a house builder, is valued at around 6x next year's earnings and a small premium to tangible book value; Affiliated Managers Group, the diversified fund management holding group, is valued at 8x earnings, or a 12% free cashflow yield; United Rentals, an equipment rental company, is currently valued at a high single-digit normalised free cashflow yield; Citigroup trades at around 7x our assessment of more normalised earnings per share and is overcapitalised; while Arch Capital, a best in class insurer, trades at a small premium to its book value.

You would struggle to find cheaper valuations for similar businesses elsewhere in the world. This is also the case for companies not held in the portfolio that we have reviewed recently in industries such as hotels, industrial gases, aerospace and industrial services. Finally, we also doubt that higher growth technology companies (where like-for-like comparisons are harder to identify) such as Amazon, Alphabet, Microsoft, Visa, Uber Technologies or even some early-stage and as yet unprofitable tech companies would have lower market capitalisations for the same fundamentals if they were located elsewhere in the world[2].

We do not think it is a coincidence that these global leaders in their fields are all created and headquartered in the US. Despite some of its occasional foibles as a nation, the US is clearly still the dominant force when it comes to large global businesses at the leading edge of innovation and value creation as well as those at even earlier stages of their growth. We do not expect this to change as, when it comes to innovation and intellectual capital, success begets and attracts success and we believe the US will therefore continue to be a market that is hard to compare with global peers.

Portfolio and activity

We continue to see many ways to win in the portfolio. There is still good recovery potential for those businesses hit hardest in the short term by the pandemic and which are attractively valued versus their long-term prospects. In addition, the Fund has a core of free cashflow compounders trading at reasonable valuations. The portfolio also holds a number of world-class high-growth businesses which are attractively valued based on their longer-term free cashflows despite looking more highly valued on some metrics in the near term. All our holdings fit our strict long-term value creation and value criteria and the portfolio exhibits superior long-term growth potential, a more attractive free cashflow yield, as well as superior financial characteristics such as better free cashflow margin, free cashflow conversion and balance sheet strength.

Below we highlight two recent purchases:

United Rentals is the largest equipment rental company in the world, although nearly all its business is generated in the US, where it has a 13% market share. The company rents out a variety of industrial and specialty equipment, including aerial work platforms, forklifts, power equipment and earthmoving equipment.

The industry is well placed to grow over the long term as the penetration of equipment rental increases, given the flexibility and lower capital commitment it offers users compared to purchasing. Penetration particularly tends to increase following large economic shocks. United Rentals should grow faster than the industry as it chisels away market share and benefits from significant scale advantages versus mostly smaller, regional and 'mom and pop' competitors. This scale means it can purchase equipment cheaper and offer its larger customers more choice in more locations.

"There is still good recovery potential for those businesses hit hardest in the short term by the pandemic and which are attractively valued versus their long-term prospects."

Scale has also enabled the company to invest in added functionality to the customer via its digital capabilities, such as utilisation software which allows customers to manage their fleets better. This is cannibalistic to United Rental's business in the short term, but importantly builds loyalty and enhances relationships with customers over the long term.

The company is very cash generative and has allocated capital well over the years, something we think is somewhat underappreciated. A key positive for the company is that cashflows are counter-cyclical. In periods of weak demand revenues decline, but the company can also cut capital expenditure on new equipment. This counter-cyclicality of cashflow means that over time the company has been able to buy back stock cheaply. This is unlike many other cyclical companies who typically buy back stock during periods of strong demand and high stock prices.

2. Perhaps China is the exception although the regulatory and legislative environment is different.

Indeed, United Rentals bought more stock back in the global financial crisis than any company we follow. It also has been acquisitive over time, buying smaller companies at attractive prices, rolling them into its network and benefitting from their scale advantages. Even after the economy recovers, we think the company can compound cashflow per share at a teens rate as revenues grow in the mid-single digits, as it enjoys margin expansion from operational leverage and a positive mix effect in its fleet as it rolls out higher-margin speciality equipment, and as it deploys its significant cashflows. The stock was purchased at high single-digit yield of our assessment of normalised free cashflow.

Applied Materials makes equipment (specifically wafer fabrication equipment (WFE)) used by semiconductor manufacturers to make chips. The company has a strong competitive position. In this industry, five companies supply 85% of the equipment needs of the semiconductor makers but within that most individual pieces of equipment are made by only one or two suppliers. On top of that, Applied Material's customers are wholly and increasingly dependent on the innovation of the WFE suppliers in order to be able to make smaller and faster chips.

The long-term outlook for the semiconductor industry is very good, with increasing content in a greater and greater number of devices, spurred by an explosion in data and need for connectivity. We expect sales of the company's equipment to grow at least in line with the semiconductor industry's aggregate revenue.

Applied Materials also benefits from a stable and faster growing services segment, which generates recurring revenue from an expanding installed base of equipment. We expect business value creation, through the cycle, of low double digits, driven largely by mid-single-digit revenue growth plus capital return and deployment.

The lumpiness of how its customers spend their capex dollars leads to short-term fluctuations in the business and stock price. This can work in our favour as we can use our long investment horizon to look at the broader trends and buy the stock at attractive prices relative to normalised cashflow. We purchased shares for the Fund at an attractive 7% yield on this year's free cashflow.

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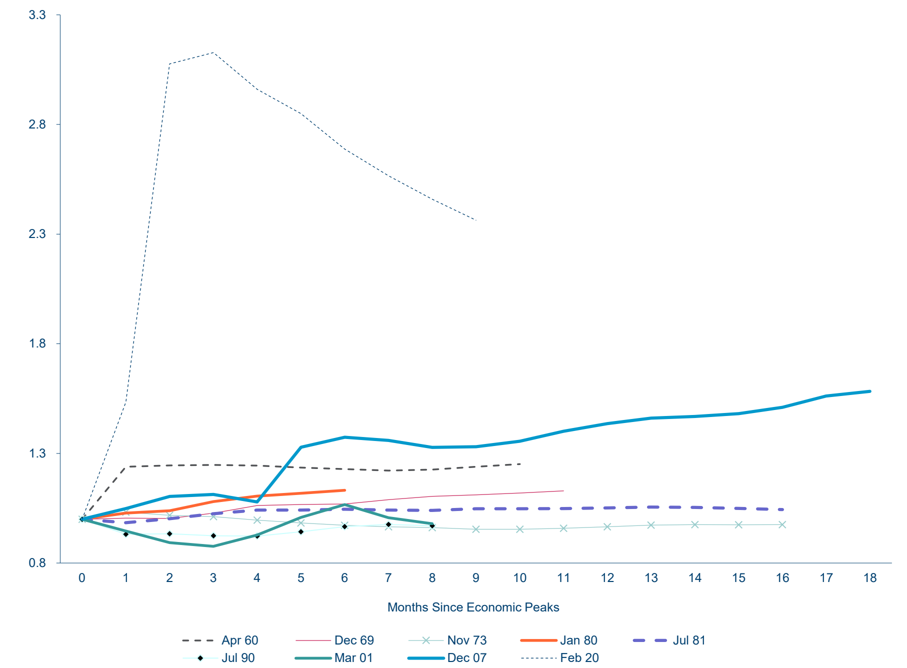
Investing environment

Not that we needed reminding, but 2020 highlighted perfectly the persistent difficulty of predicting stock market movements on the back of an assessment of macro conditions. Indeed, we would go so far as to say that even had one known the extent of the impact of the pandemic on social interaction and the ensuing economic shock, one would not necessarily have predicted a booming housing market, a resurgence in many industrial commodity prices and an equity market hitting all-time highs so soon after the previous peak.

Although we do not make specific macro predictions or forecasts, we nonetheless think there is a high probability that some broader factors influencing North American equities, not just over the next year but the next few years, could be very different compared to the recent past.

For instance, the past few years have been influenced either by fear of a deep recession (due, perhaps, to the extraordinary nature of the global financial crisis) or by experiencing the deepest one we have seen in our lifetime as the COVID-19 pandemic stalled so much economic activity. It seems much more likely than not that the next few years will be influenced by a broad economic recovery from this deep recession. Moreover, as the chart below shows, the savings rate has behaved very differently compared to other downturns and actually signals potential significant pent-up demand, which is likely to benefit many industries most impacted by COVID-19 as it normalises.

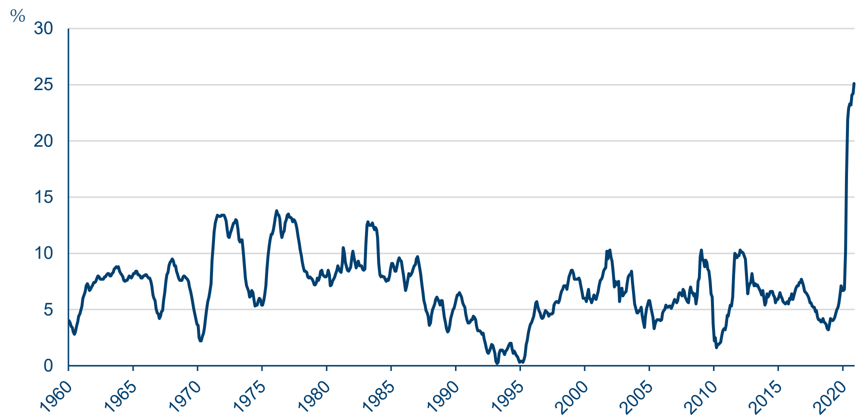
Personal Savings Annualized Nominal Growth Rates From the Onsets of Recessions (Economic Peaks = 1.0) 1960 Through November 2020



Source: Bureau of Economic Analysis, Empirical Research Partners Analysis, November 2020.

Another factor to consider is the unprecedented monetary and fiscal response to the COVID-19 crisis which, combined with pent-up demand following a long period of disinflation and a stalling in globalisation, raises the prospect that reflationary forces could be a factor over the next few years. Disinflation and a strong dollar have been headwinds for profit growth for many businesses in recent years. If reversed, we could see tailwinds to growth for a broader swathe of companies in the market and a resultant reappraisal of their prospects and valuations. We put the chart showing M2 money supply in our Q2 investment update, and we include an updated version below, as we believe this is still highly relevant when thinking about the possibility of a different investment backdrop.

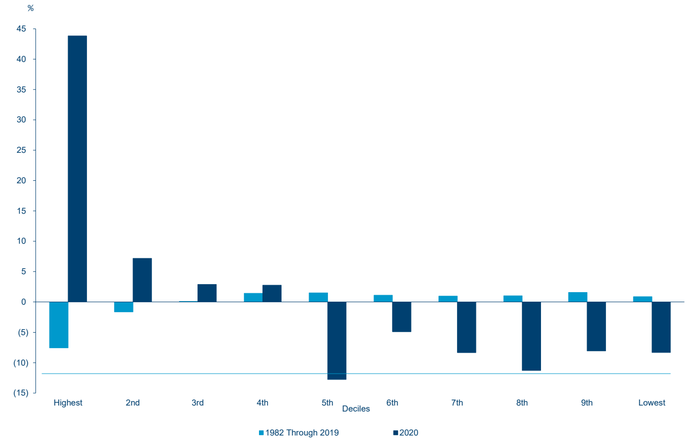
Annual Change in Broad Money Supply (M2), 1960-2020



Source: Bloomberg; Federal Reserve money supply (M2) year-on-year % change; February1960-November 2020.

As we have pointed out in the past, valuation spreads between companies have widened markedly. There has been unusually strong performance recently from companies with the highest growth expectations, illustrated in the chart below. This in part has resulted in the premium valuation awarded to the top decile of companies (as measured by earnings growth) reaching the highest level seen in the past 70 years. It would be foolhardy to extrapolate either trend over any longer-term investment horizon.

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 1982 through late December 2020.

"We are perhaps at a turning point in terms of how many companies' prospects and valuations are viewed."

Given potential meaningful changes in the macroeconomic landscape it is not unreasonable to think there could be some change in the nature and distribution of growth across the market over the coming years and hence a change in the landscape of extreme valuations. We are perhaps at a turning point in terms of how many companies' prospects and valuations are viewed. With so many investors on one side of the proverbial boat[3] we think it is extremely dangerous to extrapolate the trends of recent years when allocating capital.

Notwithstanding the above, we continue to think that ironically one constant is industry change. This necessitates a long-term mindset when assessing sustainable value creation and valuation. This is a vital part of our investment process and will continue to contribute positively in years to come, both in identifying great opportunities in companies (that might look expensive in the short term but are attractively valued in the long term), as well as avoiding potential value traps (companies that look cheap using short-term metrics but are poor value in the long run).

Conclusion

We are encouraged by the return to better form for the Fund during Q4 2020. This has been helped in part, although not exclusively, by the strong performance of stocks that were extremely cheap on a long-term basis due to short-term operational headwinds caused by the COVID-19 pandemic. We are also encouraged by the strong performance of stocks entering the portfolio in recent years and the number of attractive opportunities we are still identifying.

We continue to see many ways to win in the portfolio. This ranges from businesses with continued recovery potential and bright longer-term prospects, to attractively valued companies compounding their free cashflows at appealing rates as well as those companies with high growth prospects but trading at very reasonable normalised valuations. Compared to the investment universe, we believe the portfolio exhibits superior long-term growth potential, a more attractive valuation and more attractive fundamentals in the form of better cashflow conversion, margins and balance sheets.

The next five years will likely be very different to the past five and we are confident the portfolio is well placed given its attractive long-term value creation potential and valuation.

Polar Capital North American Team

15 January 2021

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