Polar Capital UK Value Opportunities Fund

July 2020

Q2 Update

During their latest webcast, Georgina Hamilton and George Godber, co-managers of the Polar Capital UK Value Fund, highlight where they are finding plenty of bargains in the UK as well as discussing recent equity raises and changes in positioning to capture the opportunities available.

Georgina Hamilton (GH): While we are pleased with our performance during Q2 – the Fund returned 14.9% versus the FTSE All-Share up 11.8% – we are frustrated not to have caught up more of Q1's underperformance.

George Godber (GG): Looking at the drivers of performance, one area in which we feel there is a significant chance to catch up is in small and mid-caps.

Overall, the Fund benefited from positive stock selection. Domestic earners did not appear to be much of a driver throughout the quarter and sterling is relatively unchanged against the major currencies. However, it has so far still failed to recapture the highs it saw at the back end of last year. This has probably helped lead the UK out of favour in investors' minds and, according to recent BAML survey data, we are back to record lows in terms of an under-allocation to the UK. So, while the UK remains very firmly out of favour, we do feel there is a chance it can change.

Performance

- The Fund returned +14.90% this quarter vs 11.80% for the market

Multi cap style

- The Fund benefitted from positive stock selection
- The Fund benefitted from positive allocation to Mid Cap and Small Cap
- Whilst some of the previous losses of mid and small relative to the FTSE 100 have been recovered, we feel this has further room to improve

Domestic Focus

- Sterling unchanged against the Dollar and slightly weaker against the Euro
- Currency has so far failed to recapture the strength after the political certainty of the election
- UK as an asset class remains firmly out of favour

Value style

- Fund out performed despite continued Value headwinds
- Near 40% collapse of the UK 10 year unhelpful back drop

Source: Polar Capital and Bloomberg. Date: end of Q2 2020 (30 June 2020), all data is I GBP Acc share class and 'market' refers to the FTSE All share TR Index. 1. Peel Hunt, June 2020.

As a style, value continues to be something of a headwind, not helped by the collapse in the UK 10-year gilt but, as you can see from the chart above, there were periods where value did a little better. Most notably, as we have seen before with previous market recoveries, this was often around improving economic data. From here, obviously starting from a very low base, there is a chance of economic data improving which we hope will provide a better backdrop for value as a style.

As it has a high active share, another key thing our Fund needs is falling stock correlation. We have seen correlation improve but compared to other market dislocations in crisis, it has not improved by much and there is still plenty of room for it to fall. Likewise, the FTSE 350 sector dispersion remains very, very high (see chart below). Even if it comes off a fraction, it is still above the level seen in the global financial crisis. What does that mean? What sector

George Godber
Fund Manager
George joined Polar Capital in April 2017 to manage the Polar Capital UK Value Opportunities Fund with Georgina Hamilton.

Georgina Hamilton
Fund Manager
Georgina joined Polar Capital in October 2016 to set up the UK Value Team.

Awards & ratings

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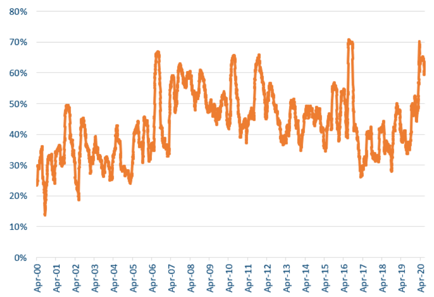
you are in matters more than the underlying stocks and, clearly, as an active fund we will always thrive in an environment when it is more important which stock you own rather than which sector you are in.

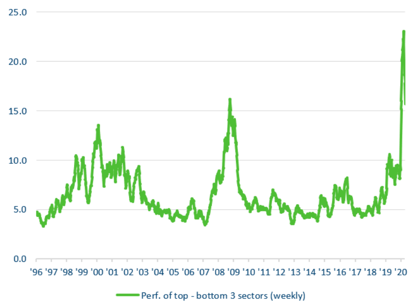
"Some areas remain extraordinarily cheap which is partly a function of the UK lagging other regions."

Performance

Stock by stock correlation
FTSE 250 Index ex Investment Trusts[1]



Sector Dispersion
FTSE 350[2]



- Stock by Stock correlation remains elevated but is slowly improving
- Sector dispersion still at extreme levels (Greater than the GFC)

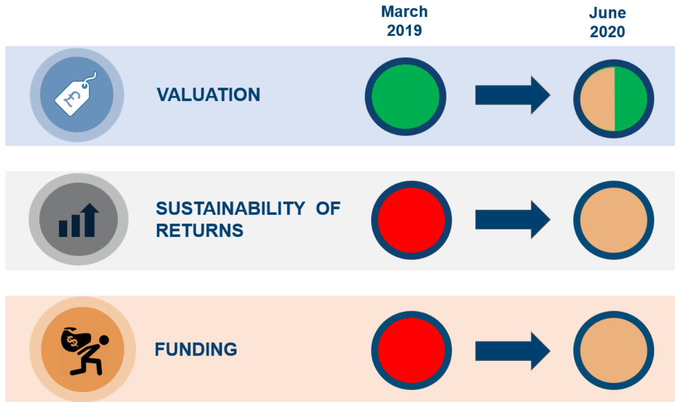
Whilst a headwind for performance, high correlation does give great opportunity for bargain hunting

Source: 1. Polar Capital Risk Team. Date: Q2 2020. 2. Liberum, Datastream, as at June 2020.

While these have been a headwind for performance, it does give a great opportunity to go bargain hunting and we will discuss below what we have added to the Fund during the quarter.

GH: The chart below summarises the market outlook according to our process. We feel some areas remain extraordinarily cheap which is partly a function of the UK lagging other regions. However, we note that some areas are starting to discount a reasonably aggressive profit recovery and, therefore, we do need to choose our stocks carefully.

Investment Process: Today



- Mixed valuations: some areas recovery is discounted others remain exceptionally cheap
- Medium term returns are becoming clear. Analyst expectations are much more realistic
- Overall peak debt will be high across the market but access to capital is good

Some companies have fantastic valuation and the balance sheet to capture the opportunities in the recovery

Source: Polar Capital UK Value Team.

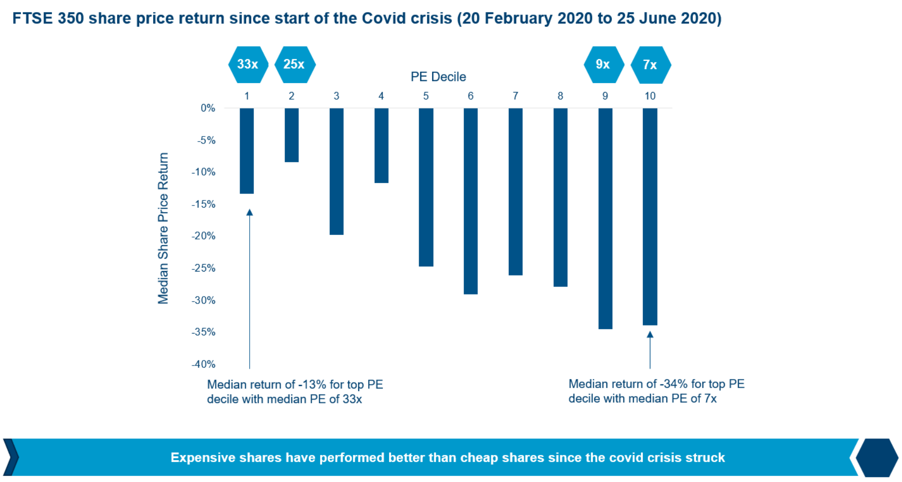
When it comes to sustainability of returns, the way forward is clearer that it was in March and April. However, significant uncertainty remains. On the positive side, analysts' expectations are much more realistic than they were back then and we believe the next meaningful step forward will be taken when company management teams themselves provide guidance because, since the crisis has hit, in many cases management teams have withdrawn guidance completely. We suspect this will be around September/October.

The third and final part of our process refers to funding and we believe that COVID-19 will have materially increased the peak debt levels across the market. However, the reason why the final circle on the chart above is not red is because capital is flowing into the listed space. Whether it be the CCFF (Covid Corporate Financing Facility) from the government or whether it be equity ratings or covenant waivers from banks, liquidity really is flowing into the market. We are not changing the way we look at this and still require all our companies to pass our safety check. As we have said before, we think that strong balance sheets are absolutely essential in capturing the recovery.

"We think that when it turns in the UK, it is going to turn markedly because those shares do not offer the same dynamics that those at the top of the Nasdaq do."

The valuation chart below shows more expensive shares have performed better than cheaper ones since the start of the COVID-19 crisis. It splits the FTSE 350 by valuation decile so you can see the top decile, the most expensive one, starts on an average P/E of around 33x. That has fallen just 13% since COVID-19 hit which has placed the bottom decile on around 7x, falling 34%.

Valuation: Expensive shares have done better



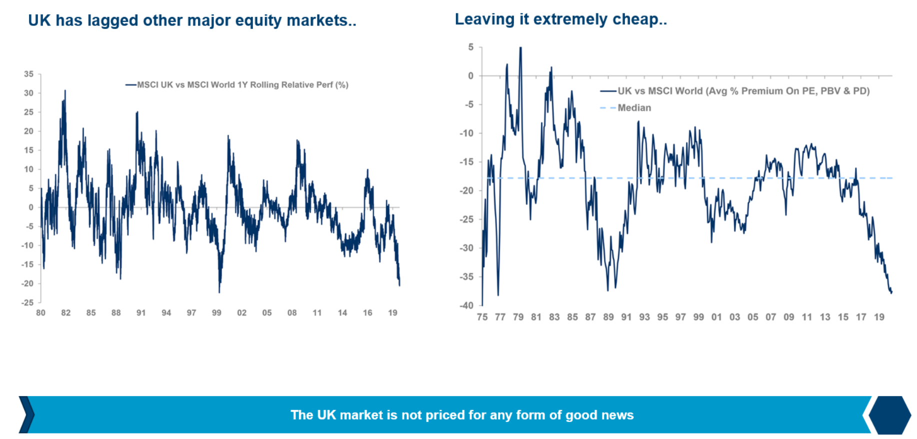
Source: Polar Capital Risk Team. Date: Q2 2020.

Clearly, it is a very difficult time for value investors. As George pointed out, value does better in times of recovery so we think that over time this position will correct. Also, anything that gives certainty on earnings refocuses investors' attention to the valuation matrix and, therefore, we think it will be positive when management teams start to provide guidance again. We also think it is a good thing that analysts' expectations are much more realistic.

GG: When we think about value versus growth in the UK, there is an interesting dynamic that the UK does not have the big tech companies that are dominating returns in other parts of the world, so the expression of value versus growth in the UK has become quite odd. If we look at companies we do not own, like Halma, Experian, the London Stock Exchange or Spirax, these are businesses that now find themselves at or around 40x earnings despite having a somewhat uncertain earnings outlook. Of course, that means they are trading at a premium to the growth shares that have been driving the returns elsewhere – Google, Microsoft etc. We think that when it turns in the UK, it is going to turn markedly because those shares do not offer the same dynamics that those at the top of the Nasdaq do.

The chart below shows by how much the UK has underperformed. This also means the market looks extremely cheap historically as we are back at around 40-year lows. One observation is that the UK market is not priced for any good news so were it to get some – say, some sort of Brexit resolution, or parts of the world that are hugely in favour becoming, for whatever reason, less favourable – then the UK looks well placed.

Valuation: The UK is cheap



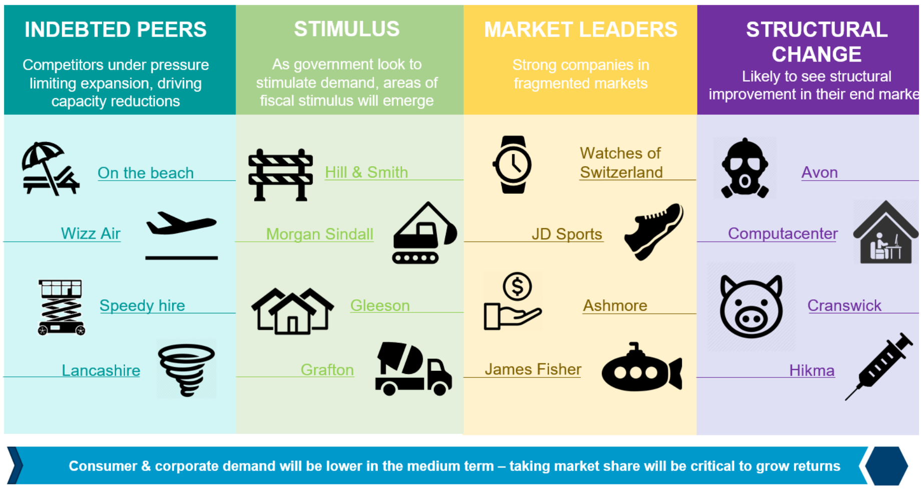
Source: Panmure Gordon, April 2020.

> **"This gives some of our companies a great opportunity to meaningfully grow market share and profits in the medium term."**

GH: As George has said, we think there are plenty of cheap shares around, so the key thing is – and this is the second part of our process – which stocks offer the chance of sustainable returns? The first key theme we are hearing from our management meetings is a number of companies are under severe pressure so are limiting expansion and, in many cases, reducing capacity. Therefore, this gives some of our companies a great opportunity to meaningfully grow market share and profits in the medium term.

The next theme is companies exposed to financial stimulus and there is considerable evidence that, for example in infrastructure, that there is more tendering, at a better risk/reward and cash flow is coming through the supply chain. You cannot underestimate the step changes happening here. No doubt there will be more areas of fiscal stimulus that will emerge as we go through the year, particularly in the autumn.

Sustainability of returns



Source: Polar Capital UK Value Team.

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The third theme is how the market leaders are doing as, in all crises, the strong tend to get stronger, especially in fragmented markets, while the final theme is those companies exposed to long-term structural change. This is not about companies trading well in the short term that might have a COVID-19 hangover as things recover. Instead, this is about much longer-term structural shifts in the end market and we do have exposure to some companies here.

GG: The image below details the equity raises we have participated in since the crisis began. There has been a huge number of raises in the UK and they may well continue. Our observation has been that defensive raises, where companies are looking to repair or shore up their balance sheet have been pretty good and those with more 'offensive' raises have, in general, also been fairly well received. However, it is important to avoid the group of companies that sits between the two, the sort of 'nice to have but not essential' where there is no clear objective to seizing market share through raising equity.

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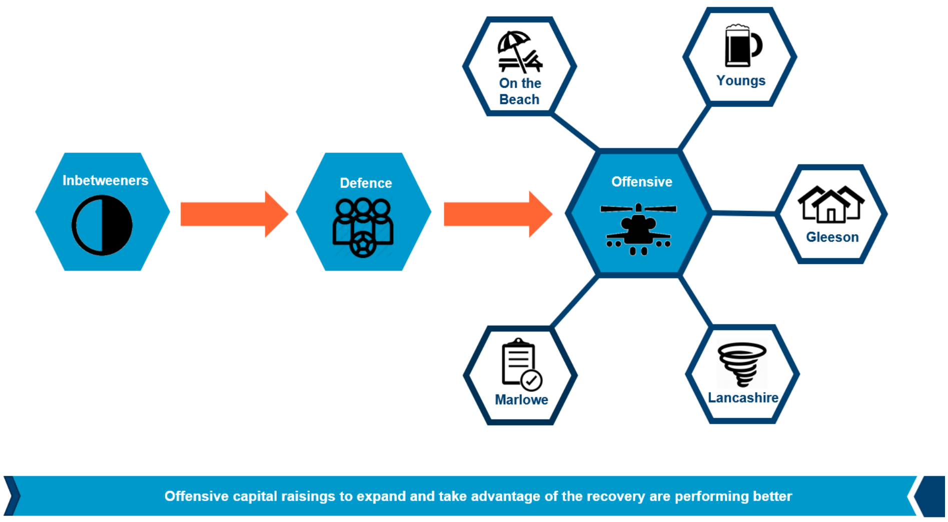
Equity raisings

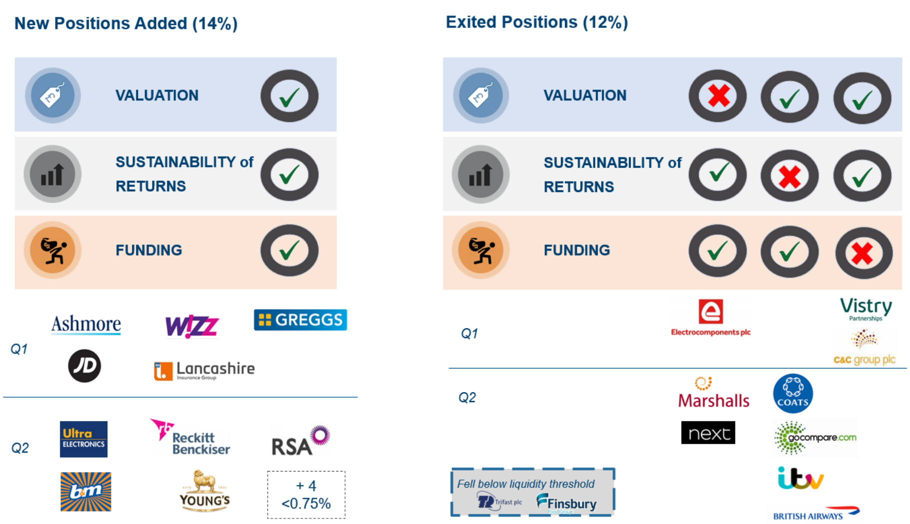


Source: Polar Capital UK Value Team.

The chart above shows five that we have been involved with. Each one of these companies has a clear objective on how they are going to use the money raised and the opportunity it is presenting them. On The Beach and Lancashire fall into the group facing peers with stretched balance sheets that Georgina talked about earlier. We feel they are really exciting in terms of the opportunity they have through the new capital which means they are in a position to actually make the recovery as exciting an event as it possibly can be.

The chart on page 6 shows our positioning changes, including some from Q1 2020 to show you the evolution through the year as a whole.

Positioning: Changes since COVID-19



Source: Polar Capital. Date: Q1 2020.

"We are really excited at having the opportunity to make the portfolio stronger and cheaper through this crisis. We felt that was our objective and we have stuck to it."

Q1 included positions badly affected by the early-year storms as well as FTSE 250 companies that struggled with significant underperformance against the FTSE 100. Portfolio additions in Q2 represent a broad opportunity set, from defence to consumer staples to pub stocks to insurance. We also have another four positions that we are nearly ready to disclose so we will update you on these shortly. Overall, we are pleased we have been able to take advantage of attractive pricing to improve the portfolio.

Our exits in the quarter represent almost normal portfolio activity. Marshalls and Next hit our estimation of fair value; another four shares fell down on our returns criteria where we felt we did not have enough conviction on their sustainability of returns and Coats, GoCompare, ITV and IAG, the owner of the British Airways franchise, left the portfolio.

We did not have anything that we felt move from pass to fail in our financial safety checks so there were no changes there. However, we will always focus on any share that fails to continue to meet our liquidity threshold, which caused Trifast and Finsbury Foods to leave the portfolio during Q2. As we mentioned in Q1, we are really excited at having the opportunity to make the portfolio stronger and cheaper through this crisis. We felt that was our objective and we have stuck to it.

GH: Three quarters of the Fund by weight is the same as pre-COVID-19. The fact the vast majority of the Fund is unchanged represents our focus on long-term returns on invested capital and our safety check ensuring lower leverage. Of the remaining 25% of the Fund, about half is new positions, including those George has just detailed, while the other half is additions/reductions to existing positions according to the upsides we see. To us, that is normal portfolio activity.

One other thing aspect to Q2 is cash has been reduced; it reached a low of 1% as we participated in equity raising. As for our market-cap exposure, we increased our allocation to FTSE 250 companies since COVID-19 hit. As George pointed out, that is because the FTSE 250 had a particularly tough Q1.

Sector-wise there are no material changes so our largest sectors remain capital goods, materials, and consumer durables and apparel, but there has been an increase in our insurance exposure.

Finally, the average weighted revenue of domestic earners is about 61%, up from the mid-50s, so a small increase in the UK domestic exposure to the Fund since COVID-19 hit. Again, that is a function of the domestic earners being weaker during this time period.

GG: In summary, as we see it on our scales, the valuation opportunity in the UK remains incredibly attractive and to that end we still have a market where you can find bargains and, importantly, companies in a position to capture the opportunity. We need to see greater earnings certainty and, as that comes through as companies return to giving guidance again, have a greater understanding of how their businesses are going to operate in the new world, then some of the risks that we talk about [on the right-hand side of the chart] may well start to tip the scales very firmly in favour of the valuation opportunity.

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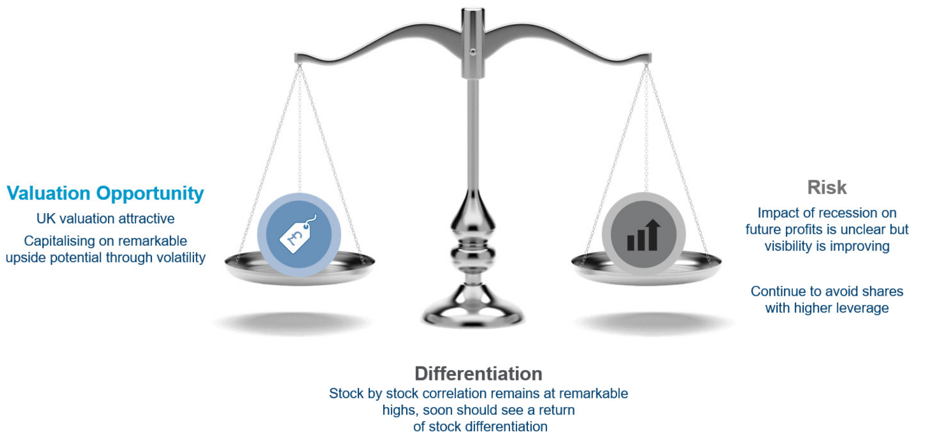
Market outlook



Source: Polar Capital UK Value Team. Date: Q1 2020.

If we could highlight just one thing, it would be our belief that those businesses in a position to give certainty to investors through paying a dividend sooner have a good potential to rerate. We have seen those that have paid their dividends through this crisis have done materially better than those that have not. Most of our Fund includes companies that have passed the financial safety check well and have strong balance sheets. By definition, we have a large number of companies whose dividend is on hold or that are waiting for the outlook to improve as they are in a position to return to the dividend payers list. If that is coupled with correlation reducing, what we have seen from previous crises means that values as a style can do well at that time.

Georgina Hamilton and George Godber

Co-managers, Polar Capital UK Value Opportunities Fund

23 July 2020

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