Why Emerging Market Stars?

One of the most frequent questions we are asked as fund managers is: 'There are plenty of emerging market funds that are all looking for the best 50 stocks in the region, so what is different about Polar Capital Emerging Market Stars?'. Here is our answer.

Going further on EVA

Economic Value Added (EVA) is generated when a company's ROIC exceeds its WACC, when its returns are greater than its cost of capital. It is really the only way that companies create long-term value for shareholders, so for that reason our team focuses fanatically on analysing and understanding the inputs into sustainable EVA over the long term.

The system the team has developed seeks to establish the real drivers of returns for each investment, how they may change over time, how and why they differ from peer-group averages and, ultimately, how sustainable they are. Specific details are dovetailed with a bigger-picture view on how returns are achieved, in order to cut through the misrepresentations and short-term noise of accounting metrics.

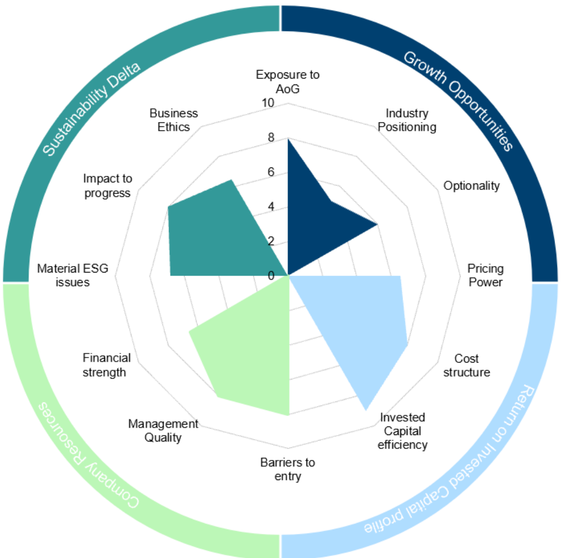
We score all companies on the 12 factors in our EVA wheel below. Each of these elements is directly related to a business's long-term, financial, returns-generating ability and is equally part of this whole, interconnected system that we analyse together.

Naomi Waistell
Fund Manager

Naomi joined Polar Capital in August 2020 as a Fund Manager on the Polar Capital Emerging Market Stars Fund and has 13 years of industry experience.

"One of the most frequent questions we are asked as fund managers is: 'What is different about Polar Capital Emerging Market Stars?"

EVA wheel



Source: Polar Capital

Our starting point is an assessment of growth potential. It is easier for companies to continue compounding cash flows at high rates of return if there are sustainable growth opportunities in which to invest. To identify these growth areas, we assess key country and industry or sub-industry trends in terms of supply/demand dynamics. An asset-heavy industry like utilities may find it more difficult to produce the same high levels of return as, say, an internet business, with few physical assets. The factors also need to be understood and analysed on a holistic, interrelated basis, not in isolation. For example, a realistic assessment of asset growth and debt profile has implications for revenue growth and cash generation.

Awards & ratings

@SharingAlpha FundForum Global ESG & Impact 2019 Fund Awards WINNER

@SharingAlpha IM|Power Sustainability & Impact 2020 Fund Awards WINNER

Signatory of:

PRI Principles for Responsible Investment

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If we further deconstruct returns into two of their constituent parts, operating margin and asset turns, it becomes clear that largely regulated businesses, such as utilities which have little pricing power and a highly variable cost structure that they can gain little leverage over, will more likely have low operating margins. The low growth environment the industry faces, set against the high asset base, mathematically makes asset turns low and invested capital usage inefficient. These businesses are often funded by higher-than-average debt, which supports the leverage factor which is added to their returns but does not change operating quality or long-term sustainability and increases risk.

Ultimately, we want to invest alongside high-quality management teams with histories of operational excellence to exploit areas of growth and astutely allocate capital to the best opportunities, leading to ongoing innovation, optionality and maintaining or improving industry positioning. All this creates enduring competitive advantage and barriers to entry and is what is needed for sustainability of high ROIC. The team spends countless hours understanding these details for each company we invest in.

We do not just look for a spot forecast or a single attractive spread of ROIC over WACC to tick a box. We need to go deeper and ascertain what is behind those numbers, what has caused them historically and be confident in why they should persist. Then we continue to ask why. It is not good enough to complete this exercise once and then look away. We monitor and engage with all businesses we are part-owners of and, almost like a curious child, determined to get to the root cause, we continue to ask: 'But why, but why?' until satisfied.

We are fanatical about EVA because it is the only thing that matters in creating sustainable shareholder value. However, it is often oversimplified, misunderstood or foreshortened which is why we go further, looking at the whole picture in the context of our 12 EVA Wheel factors in this way, and will only invest where we have high confidence in our EVA-based upside. We are not tempted to cut corners or use market multiples – that is what the market is doing and we are seeking to be different – pricing-in our long-term fundamental research. Our valuations can look materially different to what the market is willing to pay – this is the benefit of our longer-term view.

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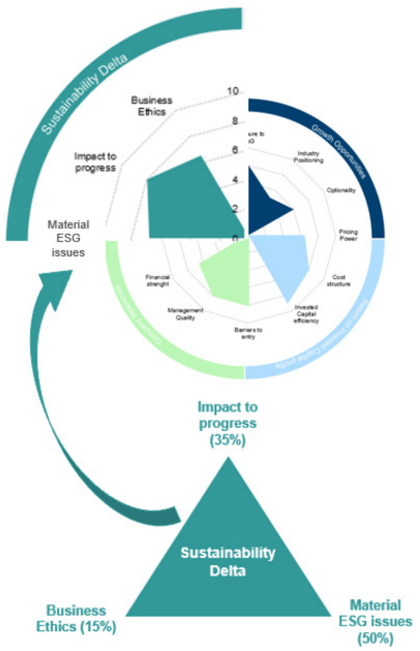
Pioneers in sustainability

The Polar Capital Emerging Market Stars Fund is a pioneer in its approach to sustainability – both now and since its inception in June 2018. As long as 20 years ago, the Fund's lead manager, Jorry Nøddekær, was part of a team that managed what we believe was the first emerging markets fund to have an ESG mindset. He went on to refine his own approach to reach true integration with the current team. In these intervening two decades we have seen the rise and rise of sustainable investing but the advances in quality of approach have not kept pace with the increase in quantity. Challenges include a still sceptical stance from some investors, branding not meeting reality or simply ESG analysis not being truly integrated.

Our team's approach is the polar opposite to all this. We are true believers and innovators, happy to be first, or to be different, just focused on creating truly sustainable portfolios, based around the question: 'How long-lasting is a business?'. This is grounded in the philosophy that the long-term value and competitiveness of an investment is ultimately determined by the relationship between all stakeholders – investors, directors, employees, customers, suppliers, regulators, society and the environment. The viability of a company over many years requires consideration and balance of all these groups.



Source: Polar Capital

For this reason, we have developed what we term a 'third-generation' approach to sustainable investing, where the first generation was negative screening and the second is the currently popular siloed model which keeps financial analysis separate from ESG analysis, without quantification and conducted by separate people. The key features of our approach are:

- **Integration:** We believe sustainability considerations are not distinct from financial analysis and should be conducted at the same time, by the same people. We are aligned in this with the Principles of Responsible Investment (PRI) which prescribes that all funds claiming to integrate ESG must do so fully, into all investment analysis and decisions, not as something separate from financial analysis. We believe the investment professionals who have expert company knowledge, frequently engage with management teams and conduct deep research are best placed for these insights.
- **Sustainability delta:** Our EVA Wheel scores each company on material ESG factors, impact to progress and business ethics. These are variables we believe play an essential role in the long-term returns profile of a business and therefore how long-lasting it can be. We follow SASB's Materiality Map to determine the material issues for each sector. Importantly, we score both the current level and future direction of these key factors, identifying the delta, as we want to support improving companies with greater potential for impact to progress and greater future EVA.
- **Impact to progress:** This element of our approach is highly differentiated and captures our thesis that we are in a growth and resource-constrained world. In that environment, we want highly selective exposure to the companies best able to drive innovation, productivity and growth, while optimising human, physical and environmental resources, thereby giving rise to positive societal contributions, inclusive action or environmental benefits.
- **Direct quantification into valuation models:** There is an industry-recognised need to measure and manage material ESG issues. We directly incorporate risk from negative externalities into our EVA valuation via the cost of capital which we believe is true integration. This is done in two ways: (1) via an additional risk premium applied to the WACC, as calculated using our proprietary scoring model, and (2) via our sustainability delta score carrying a 50% weight in how we fade returns over the company's 40-year modelled life.

We believe we are ahead of the market in how we apply sustainable investment and we will continue to innovate further to ensure our clients can have confidence that this important area is being addressed properly for the future. Via this fully integrated process, we search for improvement in EVA that is not priced by the market and can lead, over time, to sustainable value creation.

The team as flexible specialists

Our investment team is comprised of five highly experienced emerging market investors, with an average 13 years' investment experience and a huge depth of skill and knowledge. We believe having senior investment professionals with strong expertise across all emerging markets is a compelling offering. Importantly this includes an on-the-ground presence in Shanghai, China, and two native Mandarin speakers which, given the increasing weight of China within the emerging market universe, is invaluable.

While there are broad regional and/or sectoral specialisms across members of the team, there is an overarching culture of collaboration. We do not operate in silos. The world remains globalised and sector trends will play out across global supply chains, so it is important our conversations are always connected. By discussing investment cases on a team-wide basis we gain more dynamism in the debate, and by not having fully fixed ideas about coverage we ensure we get the best individuals for the job. In this way, we are flexible specialists, each with a clear primary research area but not constrained by that or limited in knowledge elsewhere.

It is also of great value to be very clear about what we do not do, which could otherwise cause costly performance mistakes or simply waste time. We do not believe we (or many others) have the ability to predict future macro trends with any degree of accuracy. For this reason, trying to time market gyrations is not something we profess to be experts in. We will, where possible, attempt to use contrarian entry points but, as long-term investors, our valuations will always be calculating considerable multi-year upside from our purchase price. Neither do we cover all areas of the market in terms of stock analysis, because there are key areas that both fit with our process and where we feel we can offer some analytical expertise or edge, and there are others that do not. Technology, the internet, the consumer, financials, healthcare services, property and some industrials comprise the bulk of our core universe. Utilities, telecoms, biotech and energy fall outside this. We believe we have a far higher chance of better returns by sticking to our strengths.

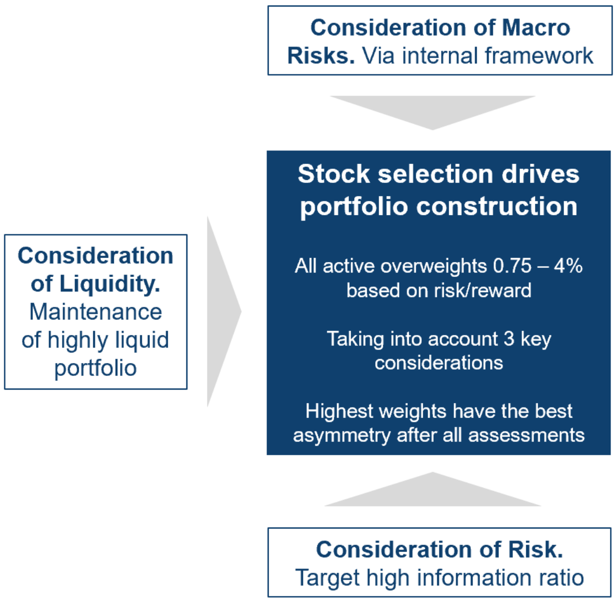
Investment infrastructure

The proprietary investment tools the team has built to support and manage the investment process are highly sophisticated. The lynchpin of this is the EVA model – completed for every stock analysed – the structure of which has a number of significant advantages.

The model integrates sustainability analysis as a quantifiable input directly into valuation calculations. This is true ESG integration and is market-leading in developing a way to incorporate sustainability analysis and material ESG risks into price targets. This is described in more detail above, but the conceptual innovations are to combine SDG (sustainable development goals) mapping, scoring systems, discount rate and process design.

"Technology, the internet, the consumer, financials, healthcare services, property and some industrials comprise the bulk of our core universe."

Having a standardised, uniform valuation tool that is used across all investments creates great consistency in the process. Constructing what is a relatively disciplined approach has the benefit of building repeatability and accuracy. All investment opportunities are examined through the same lens and under the same methodology. The process is flexible enough to allow for necessary qualitative and intangible features that exist within any company analysis, as well as being appropriate across sectors, with a separate format for financials. Most importantly, what this means is that it levels the playing field, providing a framework for genuine comparability across all investment opportunities and thereby directly helping decision-making. Portfolio management decisions are, however, always more complex than a single expected return number from a model. We must take this, together with a host of additional sector, country, liquidity or idiosyncratic share price influences – both positive and negative – for each stock, so there is an additional manager overlay and no over-quantification of decisions. What the discipline of the model instils is clarity of absolute view and the behaviour of asking better questions.



Source: Polar Capital

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As the outlook is never static and far from certain, our model creates three scenarios for each holding to give an indication of business resilience based on risk/reward. These are founded on the same underlying system for each company and leads to a distribution curve of expected return outcomes, which is highly positively asymmetric in the best cases. This helps with visibility to more efficiently allocate clients' capital in the right way at the right time, providing a clear framework for position sizing by conviction.

"Our process design means we are confident that what we are doing is consistent, repeatable and scalable."

The team are first and foremost numbers people, interested in financial and numerical evidence over nice narratives. This is where we spend the vast majority of our time: assessing what can be achieved over our investment horizon, valuing what is priced in and, of course, where we differ. We pay great attention to detail, to get something right or to unearth a variant perception.

Our model's 40-year time horizon is truly differentiated and keeps the focus on the much less efficient, longer-term forecasts where our high-growth companies, able to compound at a sustained high EVA spread, are continually undervalued by the market. This is what we seek most fervently to understand and what our proprietary tools enable. The central EVA valuation model and ESG analysis is integrated with other systems to generate ideas and manage the Fund, helping to make the team's ecosystem efficient and scalable. This is by design so as we happily continue to grow, we have the in-built means and capacity far in excess of the Fund we are currently running. Our process design means we are confident that what we are doing is consistent, repeatable and scalable.

Unique portfolio

Looking at top-ten absolute portfolio positions, many emerging market funds seem to share many large-cap holdings in common due to the likes of companies such as Alibaba Group Holding and Tencent which have grown to become large benchmark constituents. In many such cases, we held these stocks in size well before they entered the benchmark and their success means that while we want to retain overweight positions there, they are unlikely to be our largest active positions or drive the majority of performance.

Representation of more widely held large-cap names within the portfolio is around 50%. This leaves a further 50% which is made up of differentiated investments, many of which are off benchmark, and it is these lesser-known names which in fact drive the majority of outperformance. We do not set a dedicated weighting towards small and mid-caps, but over time it has tended to account for 25-30% of the portfolio. This is in line with our delta mindset as we often see far greater potential for transformational growth opportunities, or inflection points in smaller companies, which can become harder to achieve as companies get larger.

Source: Polar Capital. **1.** Typical range between 45-65 stocks but the manager prefers 50-55.

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We can also identify specific small/mid-cap companies with attractive exposure to a specific growth area, as these are frequently in new technologies or countries with less developed capital markets. We are also happy to entirely avoid and structurally underweight other widely held mega-caps and do not believe in holding underweights or positions purely for short-term relative risk mitigation.

Risk aware

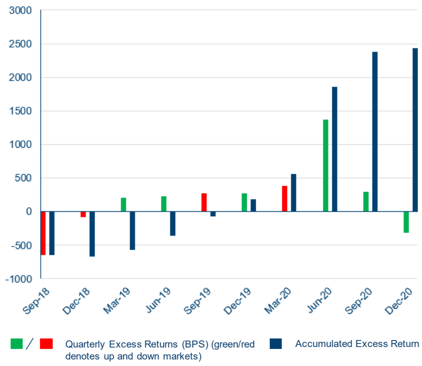
"Our objective is to generate leading relative and absolute returns, over rolling three-year periods…in a way that is risk aware, reducing volatility or delivering higher returns for the level of risk taken."

Our overriding objective is to generate leading relative and absolute returns, over rolling three-year periods. However, we want to do so in a way that is risk aware, reducing volatility or delivering higher returns for the level of risk taken. We therefore also target a high Information Ratio of 0.5-1 over a full investment cycle.

What is striking about the historic performance profile of the Fund is the enduring consistency of quarterly excess returns. The strategy has outperformed in in seven of its ten-quarter track record (see charts below), and in all but two of these quarters, excess returns are <500bps. The portfolio is constructed and managed to avoid frequent wild swings in return levels and instead, offer our investors a solution that is able to steadily accumulate moderate quarterly gains, which amount over months and years into significant cumulative increases in real wealth for clients. On occasion, owing to externally driven market dislocations, larger excess returns may still happen, in both directions, and as active investors we aim to take advantage of such moments, adding on a contrarian basis when there are growth scares.

Valuation Opportunities

Polar Capital - Emerging Stars Equity Fund
Quarterly excess return - net of fees



Source: Polar Capital, 31 December 2020. Performance figures are of the Polar Capital Emerging Market Stars Fund–US$ S Acc Share Class. Launched 29 June 2018. Versus the MSCI Emerging Markets Net Total Return Index. Performance is quoted Net of Fees. Past performance is not indicative or a guarantee of future results.

The Fund is managed dynamically to react in all market environments, aiming to constantly have the best ideas at the right weightings. Due to the high active share and long-term mindset we will not outperform in all market environments, though the Fund is not particularly market directional. In the short term, the market may be influenced by factors that conflict with our long-term view of the world. However, we believe these periods will be short-lived with the more powerful, structural trends dictating growth contours. There will naturally be quarters when we are offside, however our approach to sizing positions and managing risk is such that we calculate our risk budget in terms of how many basis points we can afford to lose in a single name, the likelihood of that loss – investment is after all probabilistic – and how long it may take us to recover those losses. It is this method of management that has led to our consistent profile of returns and why we believe it can continue.

Access to excellence

Polar Capital's structure allows the investment team to focus 100% on investment work, rather than demands on this time being diluted by a multitude of other competing layers of bureaucracy that can unintentionally but easily build up under other models. The Emerging Market Stars team has a single purpose: to deliver strong, responsible returns for our clients. The autonomy of our team to define our own process and philosophy, bespoke to best suit our own purposes, unencumbered by any need to attenuate this to fit a house process, as can occur elsewhere, is a rare and highly valuable freedom. This gives us the opportunity and confidence to shape the best possible emerging markets product, without compromise.

Great independence comes with great accountability, as it should, and we survive or fall by our investment decisions. We therefore believe it is right that we are highly aligned with our clients, as all team members are incentivised over the long term according to fund performance. This is done in a transparent fashion which keeps motivation high and all team members sharing a single vision, in contrast to highly complex, opaque sets of misaligned KPIs and remuneration structures elsewhere.

The final, crucial aspect of the way we are structured is the access to wider knowledge and expertise that being part of Polar Capital allows. We are able to learn, share and debate technology investments with one of the largest and most well-respected technology teams in Europe; healthcare investments with some of the most experienced and knowledgeable healthcare investors; and insurance investments with some of the sharpest minds in that sector, and this is to name just a few. In short, we have the best of both being autonomous and at the same time being able to leverage a vast depth of wider knowledge across the firm.

"The investment team focuses 100% on investment work, rather than demands on this time being diluted by a multitude of other competing layers of bureaucracy."

Specialists in a structure of support

It is a privilege to do the work that we do, we take it very seriously and do it with rigour and sophistication. We believe we can continue to manage a differentiated emerging market equity fund, which offers strong long-term returns via finding sustainable, value-creating companies – or, as we like to call them, Stars.

Naomi Waistell

Fund Manager, Polar Capital Emerging Markets and Asia Team

19 January 2021

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