Polar Capital
North American Fund

July 2024

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Awards & ratings

MORNINGSTAR ★★★

MORNINGSTAR Silver

Analyst-driven	**10%**
Data coverage	**96%**

The Fund (I USD Share Class) returned -0.4% over the quarter and 12.4% year-to-date.

We are happy with the fundamental progress the businesses within the Fund have made so far this year. However, despite a strong showing in relative terms during the first quarter, and indeed right the way through to mid-May, the Fund's return has not kept up with its official benchmark, the MSCI North America Net Total Return Index, which rose by 3.7% over the second quarter and by 14.1% year-to-date (all figures in dollar terms).

While the market's concentration has gradually been increasing all year, the uplift seen since mid-May is what really stands out – the outperformance of the S&P 500 compared to its equal-weight counterpart in Q2 was the third largest since the equal-weight index was established in 1989 (the other two quarters immediately preceded the dot.com crash). Sharply increased market concentration, driven by the outstanding performance of a few very large stocks, most notably NVIDIA, is once again making it very difficult to keep up with market-cap-weighted indices.

The Fund's returns compare much more favourably to equally-weighted or broader indices, which also provide useful comparisons. For instance, the MSCI North America Equal Weighted Net Total Return Index (a reasonable barometer for stock pickers) declined by 2.4% over the quarter and is up 5% year-to-date while the S&P Composite 1500 Equal Weight Index (a broader benchmark and a reasonable approximation of the Fund's universe excluding Canada) is up only 1.2% year-to-date. Indeed, the relative performance of the Fund versus such indices this year and over the past 18 months has been stronger than any comparable time period during our careers.

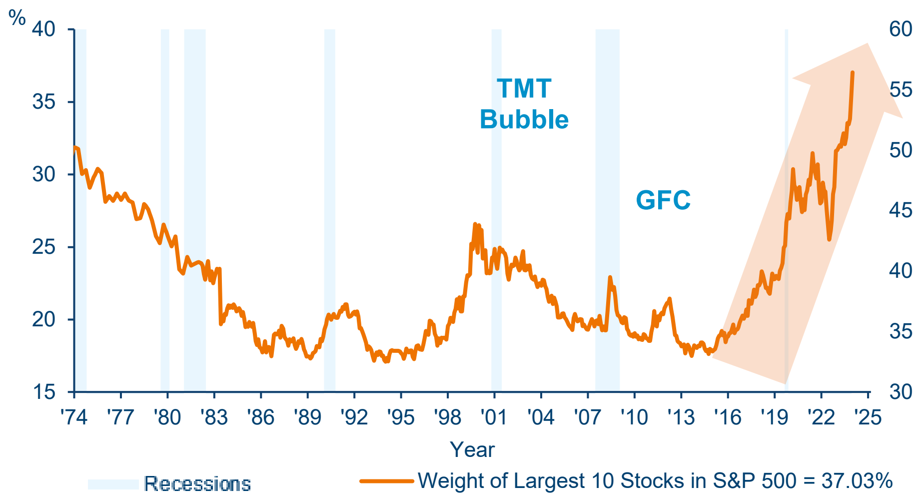
Record market concentration

As measured by the weight of the largest 10 stocks as a percentage of the top 500 companies, US market concentration reached an all-time high this quarter, going back at least as far as 1875.

The level of market concentration is not in itself a problem for genuine active managers. However, the increase in concentration is. As markets become more concentrated, it is mathematically harder for an active fund manager to outperform a market-cap-weighted benchmark. For instance, in a 40-stock fund, the theoretical probability of a given manager who is agnostic to market-cap picking one particular stock out of a 1,000-stock universe (we actually believe our universe to contain over 1,500 stocks), is 40/1000 or 4%. The chances of picking two particular stocks out of 1,000 is <0.2%. The chances of picking, say, the top five stocks by market cap in a 40-stock portfolio is effectively zero if one is agnostic to the market cap of a business when selecting an investment. One could argue that some of the mega-cap stocks driving the markets are great businesses so the chances of a fundamental investor picking them should be higher. They are also 'front and centre' which, in practice, means it is more likely for a fund manager to have analysed them. However, on the other hand one could argue that such businesses are very well followed and it should, arguably, be harder to have a differentiated view on their prospects.

To our knowledge there has never been a prior period where US market concentration has increased to the same extent as it has done over the past decade, with a particularly sharp increase over the past 18 months.

Market concentration — weight of largest 10 stocks within the S&P 500 Index



Source: Courtesy: JPMorgan Chase & Co, Copyright 2024, data as at 28 June 2024.

The Fund's active share has typically been above 80% since launch – this places it in the top decile of our peer group. One part of our investment philosophy is the idea that it matters more to think about what the Fund owns rather than what it does not, while acknowledging and reflecting on opportunity costs and mistakes of omission. Any investment we make for the Fund is primarily assessed on our view of the company's fundamental prospects and what we think the stock is worth rather than current market cap. This is notwithstanding the fact that since the Fund's launch we have found many fantastic investment opportunities among companies that happen to have very large market caps. However, as we look across the market-cap spectrum for our ideas and invest in an array of return drivers, it is unlikely the Fund will be dominated by a handful of very large companies.

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Despite the unprecedented headwinds to relative performance in recent years that go hand-in-hand with this approach, we continue to believe this way provides the best chance of delivering sustainable attractive returns. A key strength of the American market is the breadth of excellent businesses and appealing opportunities to invest in across the market-cap spectrum. Fishing in a larger pond, rather than just concentrating on the largest stocks, provides for the ability to access such opportunities. It also, importantly, provides a greater ability to diversify the drivers of returns rather than being reliant on one or two themes.

Indeed, since the launch of the Fund, its holdings have compounded business value (growth in earnings or free cashflow per share plus dividend; or growth in book value or NAV, if applicable) at almost 11% pa, significantly better than the benchmark's return, which we estimate has been closer to 8% pa. Importantly, the drivers of that value creation have been diverse in nature.

Over time, such compounding should also translate into attractive relative performance even if market concentration remains high but stable. Relative performance would very likely benefit if the unprecedented recent trend of increased concentration were to reverse. Even if market concentration reaches new all-time highs we still think our all-cap approach focusing on value creation and value will result in attractive compounding for our investors, while providing exposure to a diverse array of American businesses and offering something different to most mainstream US and global indices and funds.

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Portfolio

We continue to be encouraged by the compounding of underlying business value in the portfolio and the prospects for this to continue, driven by both operational growth and allocation of capital. Every investment candidate goes through our checklist which is broken into areas such as industry demand and supply, competitive dynamics, management and culture, financial strength and treatment of stakeholders. Not every investment outcome is favourable. However, applying such a checklist to new and existing holdings helps improve the probability of success of an investment and has contributed to the Fund's attractive aggregate compounding over time.

A disciplined approach to assessing value and buying at the right price are also key components of our investment approach. The portfolio remains very reasonably valued. For example, the Fund, in aggregate, has a 6.1% historic free cashflow yield (16x free cashflow) according to Style Analytics. The portfolio offers both absolute value, given the fundamentals and prospects of the businesses held, as well as relative value versus our benchmark index (which trades at a 4% historical free cashflow yield or 25x free cashflow) and the equally-weighted version of our benchmark (which trades at a 4.9% historic free cashflow yield or 20x free cashflow). In our view, the appealing value of the Fund gives us confidence that business compounding of the underlying assets will translate into attractive returns in the future.

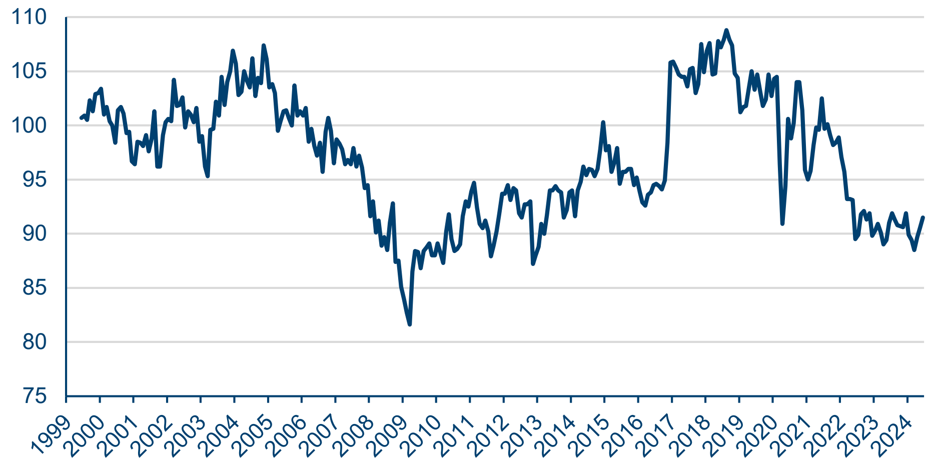
> We believe the portfolio offers both absolute value, given the fundamentals and prospects of the business held, as well as relative value

Business environment

In general, the business environment has remained supportive for our companies. As we have highlighted in recent updates, the economy and many American businesses appear to have dealt surprisingly well so far with higher interest rates after a long period of ultra-low rates, albeit helped along the way by some very supportive fiscal policy.

However, we have recently seen emerging pockets of softness in the economy. For instance, we have noted weakness in the operating trends of some short-cycle industrial businesses, some muted enterprise software spending (perhaps also due to a 'wait and see' approach to AI), a labour market that is less tight, soft housing activity, continued downward normalisation of consumer spending on goods following the Covid boom, as well as a general softening in spending from low-income consumer groups. Small businesses are a key driver of the US economy and employment – notably, small business optimism has been at some of the lowest levels we have seen with the exception of the global financial crisis over the past 30 years, although it has been subdued for a couple of years.

NFIB small business optimism



Source: Bloomberg, NFIB, as at 28 June 2024.

Meanwhile, inflationary pressure, in aggregate, is far lower than the levels it reached a couple of years ago with broadening disinflation and even pockets of deflation in some areas. We are somewhat wary of the sustainability of margins at companies that did very well out of the inflation spike and we have reduced some positions accordingly over the past year. On the plus side, disinflation has solidified expectations that we are almost certainly at the top of the interest rate cycle – all other things being equal this should be supportive of equity valuations.

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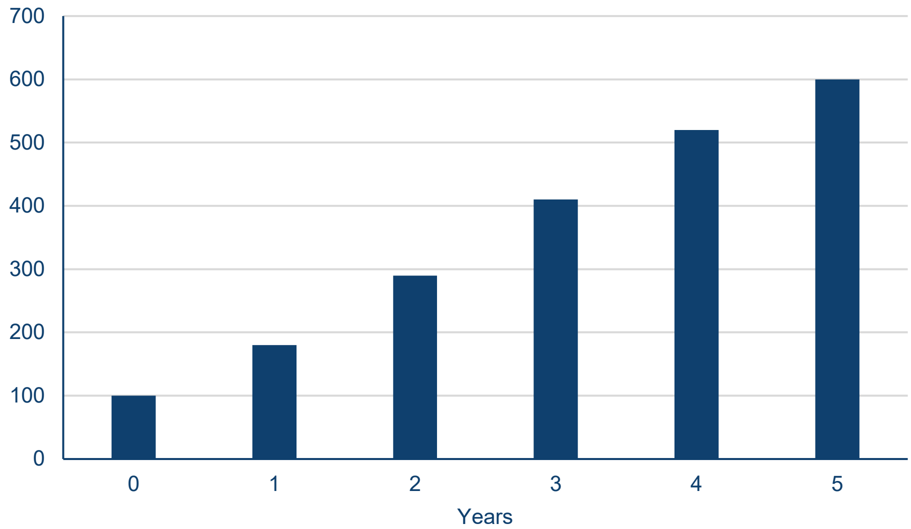
Performance

As noted above, market concentration has been a hinderance to relative performance this quarter and year-to-date. Not owning NVIDIA and Apple contributed more than half the lag in performance versus the benchmark during the quarter – NVIDIA has contributed 440bps or approximately one third of the broader index return year-to-date.

The fundamental inflection in NVIDIA has been as remarkable as anything we have seen from an already very large business, including Apple after the launch of the iPhone. Assuming the future consensus expectations are correct, NVIDIA's $97bn projected rise in operating profit, from $9bn in the year end to January 2023 to an expected $106bn in the year ending Jan 2026, represents more absolute profit dollar growth in three years than Alphabet has achieved since inception and, perhaps more remarkably, than Microsoft achieved from its founding in 1975 to its 2023 fiscal year. NVIDIA's expected operating margin this year of 65% is also higher than any gross margin it had achieved prior to its most recent fiscal year. If the company can maintain operating margins in the 60%s and continues to grow at a very high rate driven by the ongoing buildout of AI infrastructure, then the firm is worthy of its current market cap or more.

On the other hand, the nature of demand for such infrastructure spend can be highly cyclical, even during a strong secular uptrend. To illustrate, consider a hypothetical example of an economy which starts with 100 data centres equipped with up-to-date AI functionality. The number of such data centres grows to 180 after year one, 290 after year two, 410 in year three, 520 in year four and 600 in year five. That is a sextupling of AI data centre capacity in five years.

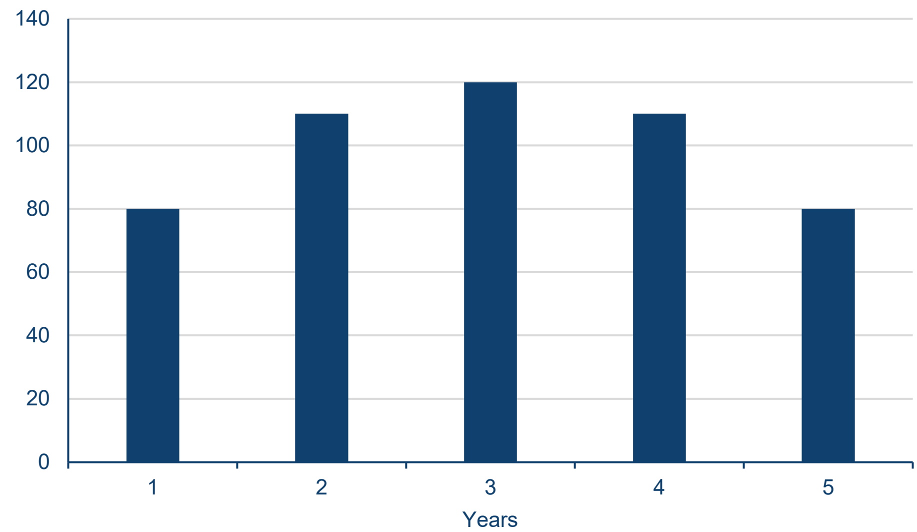
Total data centres



Source: Polar Capital.

However, the revenue growth for those companies supplying the buildout of those data centres is primarily driven by the second derivative of that capacity and, in this illustration, revenue actually declines after year three.

Incremental data centres



Source: Polar Capital.

Of course this is a simplified illustration. Nonetheless, it would not be surprising at all to see the extremely hot demand for NVIDIA's semiconductors cooling more quickly than many expect with negative ramifications for its expected growth, profit margins and market valuation.

Of stocks held, Centene, a healthcare insurance business, was weak after data released by the company showed Medicaid claims ticked up since they reported Q1 results. On top of this, we suspect the increase in the likelihood of a Republican presidency has cast a shadow over the outlook for Medicaid funding and for government-funded subsidies for individuals buying insurance, two important markets for Centene. Open Text, a provider of enterprise software, was weak after reporting results that missed market expectations. CRH, the building materials company; Core & Main, a distributor of fire protection, water and drainage management products; and United Rentals, an equipment rental company, all saw weaker stock performance after previous strong performance on concerns that demand in their end markets may slow.

> Qualcomm…has positioned itself as a leader in AI at the edge, providing processor chips that enable on-device LLMs and image generation

More positively, Analog Devices, a producer of analogue semiconductors, was strong on the hope that it is past the worst of an inventory cycle that has dampened demand. Qualcomm, a designer and producer of semiconductors for mobile devices, was strong as the downcycle in mobile handsets appears to be ending just as the company has positioned itself as a leader in 'AI at the edge', providing processor chips that enable on-device large language models (LLMs) and image generation, for instance. Interactive Brokers Group, a global provider of low-cost brokerage services, performed well on the back of continued strong account growth. Given the position size increased on the back of strong performance and the likelihood that we have seen the peak in its net interest margin, we decided to take some profits. We continue to like the long-term fundamental outlook for the business. Alphabet was also strong, after an encouraging set of operating results and increased enthusiasm regarding their AI capabilities.

We cannot think of many, or indeed any, instances where politics or the President of the day was a driving force of the success or failure of the biggest winners or losers we have invested in

Activity

Portfolio activity has been relatively light year-to-date. There has been one new purchase and two complete sales in H1.

We purchased Open Text, a Canadian software company which provides a wide range of products that manage and analyse structured and unstructured data belonging to their enterprise clients. It has a sticky revenue base and is a prodigious generator of free cashflow, a significant amount of which will be returned to shareholders through dividends and buybacks. The company is paying down debt following a large acquisition made at the start of 2023. It is also investing more heavily to try to take advantage of the opportunities provided by AI, for their customers to harness their proprietary data. We think the recurring nature of its cashflows is underappreciated by investors with the stock trading at potentially 6-7x its normalised free cashflow 2-3 years out.

We sold the position in Travelers, the insurance company, largely on valuation and 'competition for capital' grounds after the stock rerated substantially since we purchased it in 2020, at close to tangible book value. We also completely sold out of the small position in Sabre, an airline bookings software and processing business. The recovery in its business after the pandemic was more anaemic than expected, and we had growing concerns about its stretched balance sheet which had become more of an issue due to the lack of operational recovery.

Politics

With the US presidential election taking place in November, we have had a few questions from clients about how the outcome might impact the portfolio. We thought it would be useful to provide a few thoughts here.

First, it is important to note that, while we analyse and debate how politics and policy might impact the fundamentals of the businesses we invest in, in most cases the politique du jour has relatively little influence on how these businesses progress over time. We cannot think of many, or indeed any, instances where politics or the President of the day was a driving force of the success or failure of the biggest winners or losers we have invested in. That is not the case everywhere in the world, so we consider ourselves fortunate to be investing against such a backdrop. Indeed, most good businesses in America are largely immune to politics.

That is not to say changes in policy cannot have any impact. For instance, Trump's equalisation of tax rates between companies with domestic operations and international operations resulted in a meaningful pick up in net income for those companies with predominantly domestic operations in 2018 and 2019. A move to higher tariffs in recent years has also caused headaches for those managing businesses that manufacture in and serve China. Meanwhile, healthcare, as a sector, is often a political battleground and policy can impact those companies at risk of price regulation in the industry.

Markets and businesses do not like uncertainty, but at least on this occasion we will either see the re-election of the incumbent party or an election of a candidate who was the President just four years ago. We have met many management teams recently and asked if they have a strong preference as to who wins the election. While most have not been enthusiastic about the contest, they have been also largely ambivalent about who gets in in terms of the impact it would have for their business. We do not expect the replacement of Biden by Harris as the likely Democrat candidate to change this sentiment.

There are some differences to note between the current stances of the two parties. For instance, Trump would seek to reverse aspects of the Inflation Reduction Act, particularly impacting investment in green areas. He would likely inject any savings into extending tax cuts including certain corporate tax benefits. The Democrats would rather sustain spending and, if anything, increase the corporate tax take. Of note, neither party has voiced much concern about the size of the budget deficit – we are unlikely to see fiscal discipline.

> The Fund also offers something very different to the index and that difference has only increased as the market has become less diverse

Trump is more aggressive on tariffs, particularly related to China, which could have a knock-on impact on inflation, interest rates, the dollar and de-globalisation. However, the Democrats under Biden have not shied away from tariffs either or proven to be a great promoter of free trade. In healthcare, Trump may also seek to reverse parts of Obamacare and go lighter on price regulation, which could be beneficial for those impaired by price regulation such as drug companies.

Importantly, even noting the above differences, in US politics declaring a policy is one thing but enacting it is entirely a different matter; the balances of the US political system often make meaningful policy change difficult. Whether this is good or bad overall is a point of debate, but it means we are not kept up at night thinking too much about politics. We will remain vigilant, but based on the current knowns, we do not anticipate the portfolio's fundamentals being impacted materially by the outcome of the election.

Conclusion

A key characteristic of the US stock market over the past decade, particularly the past 18 months, has been increased market concentration. This has made it difficult for all-cap investors running portfolios with high active share to keep up with the most used benchmarks which are market-cap-weighted in nature. There are good reasons behind all of this, and these reasons suggest a reversal is not imminent, but equally a further increase of comparable magnitude is also unlikely. In a stable environment when concentration is neither increasing or decreasing materially, the relative headwinds facing high active share funds should abate and the ability to differentiate by what a fund owns, as opposed to what it does not, comes back to the fore.

The portfolio has been performing well compared to broader equally-weighted indices – relative performance of the portfolio over the past 18 months has been stronger than over any comparable period over our career. The Fund also offers something very different to the index – as exhibited by the high active share but also given its diverse set of fundamental drivers – and that difference has only increased as the market has become less diverse.

We continue to be encouraged by the operational performance of the portfolio though have noted some softness of late in parts of the economy. Compounding of operational performance has been a key driver to portfolio performance – given the fundamental strength of the businesses, long-term growth prospects as well as value inherent in the portfolio and diversity of drivers, we expect it to continue to be so in the future.

Polar Capital North American Team

16 July 2024

Risks

- **Capital is at risk and there is no guarantee the Fund will achieve its objective. Investors should make sure their attitude towards risk is aligned with the risk profile of the Fund before investing.**
- **Past performance is not a reliable guide to future performance. The value of investments may go down as well as up and you might get back less than you originally invested as there is no guarantee in place.**
- The value of a fund's assets may be affected by uncertainties such as international political developments, market sentiment, economic conditions, changes in government policies, restrictions on foreign investment and currency repatriation, currency fluctuations and other developments in the laws and regulations of countries in which investment may be made. Please see the Fund's Prospectus for details of all risks.
- 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.
- The Fund invests in a relatively concentrated number of companies and industries based in one region. This focused strategy can produce high gains but can also lead to significant losses. The Fund may be less diversified than other investment funds.

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Investment in the Fund is an investment in the shares of the Fund and not in the underlying investments of the Fund. Further information about fund characteristics and any associated risks can be found in the Fund's Key Investor Document or Key Investor Information Document ("KID" or "KIID"), the Prospectus (and relevant Fund Supplement), the Articles of Association and the Annual and Semi-Annual Reports. Please refer to these documents before making any final investment decisions. These documents are available free of charge at Polar Capital Funds plc, Georges Court, 54-62 Townsend Street, Dublin 2, Ireland, via email by contacting Investor-Relations@polarcapitalfunds.com or at www.polarcapital.co.uk. The KID is available in the languages of all EEA member states in which the Fund is registered for sale; the Prospectus, Annual and Semi-Annual Reports and KIID are available in English.

The Fund promotes, among other characteristics, environmental or social characteristics and is classified as an Article 8 fund under the EU's Sustainable Finance Disclosure Regulation (SFDR). For more information, please see the Prospectus and relevant Fund Supplement.

ESG and sustainability characteristics are further detailed on the investment manager's website: (https://www.polarcapital.co.uk/#/professional/ESG-and-Sustainability/Responsible-Investing/)

A summary of investor rights associated with investment in the Fund is available online at the above website, or by contacting the above email address. This document is provided and approved by both Polar Capital LLP and Polar Capital (Europe) SAS.

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Benchmark

The Fund is actively managed and uses the MSCI North America Net Total Return Index as a performance target and to calculate the performance fee. The benchmark has been chosen as it is generally considered to be representative of the investment universe in which the Fund invests. The performance of the Fund is likely to differ from the performance of the benchmark as the holdings, weightings and asset allocation will be different. Investors should carefully consider these differences when making comparisons. Further information about the benchmark can be found www.mscibarra.com. The benchmark is provided by an administrator on the European Securities and Markets Authority (ESMA) register of benchmarks which includes details of all authorised, registered, recognised and endorsed EU and third country benchmark administrators together with their national competent authorities.

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Spain

The Fund is registered in Spain with the Comisión Nacional del Mercado de Valores ("CNMV") under registration number 771.

Switzerland

The principal Fund documents (the Prospectus, KIDs, Memorandum and Articles of Association, Annual Report and Semi-Annual Report) of the Fund may be obtained free of charge from the Swiss Representative. The Fund is domiciled in Ireland. The Swiss representative and paying agent is BNP Paribas Securities Services, Paris, succursale de Zurich, Selnaustrasse 16, CH-8002 Zurich, Switzerland.

Austria/Belgium/Denmark/Finland/France/Germany/Gibraltar/Ireland/Italy/Luxembourg/Netherlands/Norway/Portugal/Spain/Sweden/Switzerland and the United Kingdom

The Fund is registered for sale to investors in these countries. Investors should make themselves aware of the relevant financial, legal and tax implications if they choose to invest. Please be aware that not every share class of the Fund is available in all jurisdictions.

Morningstar

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