Celebrating our first anniversary at Polar Capital – what a year!

Polar Capital Emerging Market Stars Fund

July 2019

For non-US professional investor use only

A year of two halves

At the end of June our investment strategy celebrated its first anniversary with Polar Capital. To mark this milestone, we wanted to explain our approach and look at how the Fund has adapted over the past 12 months as well as give you our outlook on the market.

Our approach was tested hard by the markets in the second half of last year but has proved its robustness with a strong recovery so far this year. Our investment philosophy and process held firm and we continue to believe the best way to harness the long-term secular growth in emerging markets is by finding the future companies that deliver sustainable shareholder value.

Performance review

These past 12 months have certainly tested us, with a meaningful market selloff which began last summer and continued until October. A recovery then followed, with further corrections and recoveries in December/January and again in May/June. On top of these market corrections we have also seen meaningful rotation in the market which proved to be a challenge given our long-term investment horizon and growth and quality style bias.

The first half…H2 2018

The Polar Capital Emerging Market Stars Fund was launched on 29 June last year, almost directly into a storm created by:

- the US/China trade war;
- the Fed tightening further on the back of strong US economic data;
- a semiconductor inventory correction, which turned into a broader technology slowdown as the trade war tension resulted in a significant fall in demand.

This was close to a worst-case scenario for our approach given our style bias. However, we continue to believe in the significant long-term investment opportunities in the technology sector and in China, the two areas that were affected most in terms of increased risk aversion. The market reacted to these events with significant multiple contraction on all long-duration cash-flow assets. Significant earnings downgrades followed as the negative environment kept dragging on.

The implications of this multiple contraction in long-duration assets meant there was a divergence of performance between value and growth over this period which explains a large part of our relative underperformance during the early days of the Fund.

Value versus growth

Source: Bloomberg; 31 December 2018.

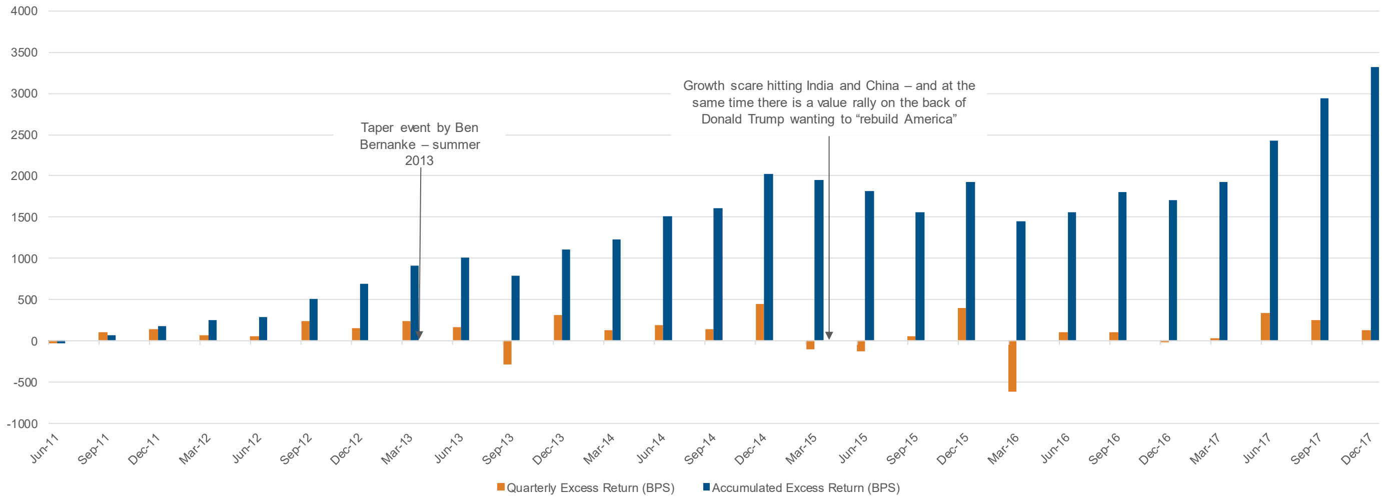
It should not be assumed that recommendations made in future will be profitable or will equal performance of the securities in this document. A list of all recommendations made since the Fund's inception are available upon request. All opinions and estimates constitute the best judgment of Polar Capital as of the date hereof, but are subject to change without notice, and do not necessarily represent the views of Polar Capital.

Past performance is not indicative of future results.

Given the inherent style bias as a result of our process, it is not a surprise to us that these periods of underperformance come when risk aversion is high and value is in favour.

We experienced this in 2013 and 2016 (see chart below) and by sticking to our process were able to regain lost performance and then go on to further outperform. This is precisely what happened during our first few months at Polar Capital as we saw this repeated at the end of 2018, with our recovery in early 2019.

Excess returns: long-term performance of the Nordea Emerging Market Stars Fund



Source: Bloomberg, 29 March 2019.

The second half…H1 2019

December 2018 was the markets' worst month since 1988 and last year was the worst calendar year for equity markets since 2008. Encouragingly, they have recovered strongly so far this year with the MSCI Emerging Markets Index returning 10.6% (in US$ terms) and the Fund recovering even more strongly, delivering 15% net of fees (US$ I share class).

The inflection point came early in 2019 after the Fed stopped tapering and introduced an easing bias in the market, the 'Powell put'. At that time a number of good companies were attractively priced though volatility has remained thanks to President Trump and his continued tweets, mostly around the trade war with China.

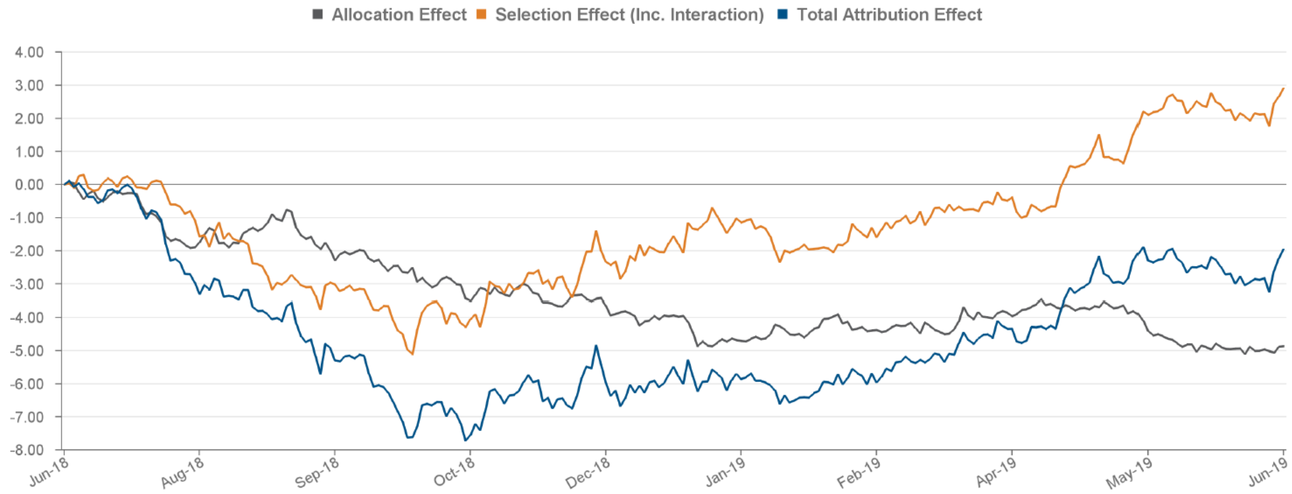
In terms of the drivers of our outperformance in H1, it was pleasingly driven by our stock selection (6.1%) with asset allocation proving a modest detractor (-0.6%), particularly in the communication service, financial, and healthcare sectors.

The five best contributors were Ping An Insurance (Chinese insurance company) up 80bps, Ivanhoe Mines (African copper company) 63bps, Notre Dame Intermedica (Brazilian healthcare) 56bps, CD Project (Polish technology/computer gaming company) 53bps and AIA (Asian insurance company) 47bps.

The five weakest contributors were Microport Scientific (Chinese medical device company) -33bps, NMC Health (UAE hospital company) -33bps, Samsung SDI (South Korean technology/EV battery company) -32bps, KingPak Technologies (Taiwanese auto sensor company) -27bps and Parag Milk (Indian dairy company) -27bps.

Finally, as we look back at the year in its entirety, we believe the graph below sums up our performance well, with a pleasing recovery from the October lows in both absolute and relative performance terms.

Sector breakdown—bottom-up aggregation (%)



Performance attribution

Sector Attribution	Average Weight (Fund)	Average Weight (BM)	Return Fund	Benchmark Return	Excess Return	Allocation Effect	Selection Effect (Inc. Interaction)	Total Attribution Effect
Polar Capital Emerging Market Stars Fund	100.00	100.00	-0.74	1.21	-1.94	-4.86	2.92	-1.94

Source: Polar Capital; relative performance, gross of fees, 28 June 2019.

Portfolio turnover

Against such a volatile backdrop we retested the investment case of each company to confirm that the desired sustainable shareholder value generation characteristics remained, resulting in a heightened level of portfolio activity:

- reduced exposure to the **smartphone supply chain** and that part of the technology value chain that has direct risk to the trade war/Huawei (sold Sunny Optical; reduced TSMC relatively significantly).
- reduced/changed our exposure to selective **Chinese consumer/eCommerce** names (we sold JD.Com, Baozun; increased exposure to Alibaba).
- reduced/changed our exposure within **Chinese healthcare and pharma** due to regulatory changes and for company-specific reasons (sold Shanghai Fosun Pharma, China Medical Systems; bought China Resources Sanjiu Medical).
- within technology we increased IT-services and software/internet security exposure (have been buying L&T Infotech and Avast).
- increased exposure to **India** (increased Phoenix Mills; bought Oberoi and InfoEdge; bought into Reliance Industries early on (this is one position where we expect to see a significant improvement in the sustainability model of the company)).
- significantly increased the number of high conviction positions in **Vietnam**. This is due to strong structural growth and the country benefitting from the US/China trade tensions. Vietnam was already quickly gaining market share before these events occurred and we believe it will now accelerate further (we now have positions in Vincom Retail (malls), Vinhomes (property), and Kin Bac City (industrial real estate)).

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- **copper.** We are constructive on the structural long-term outlook for copper given our belief in the outlook for increased levels of electrification and the implications from a transition towards a 'green and clean' world (selling Antofagasta; buying Ivanhoe Mines (African copper company), a company where we have evidence of strong sustainable shareholder value generation being created.

This level of activity is to a large degree in line with the activity level we saw during 2016. Both periods saw changes at the sector level in response to the evolving macroeconomic and geopolitical landscape so it is normal in these cases for us to be more active**.**

Portfolio positioning: future opportunities

Looking at how the portfolio is positioned today, we can essentially split it into two core areas of focus:

- **Leaders in advanced technology/industrial companies** that will be/are global leaders, even as global supply chains are being reshaped:
  - EV battery technology/EV revolution (such as ***Inovance***, ***Yunnan New Energy Materia***, ***Samsung SDI*** and ***Ivanhoe Mines***).
  - 5G and next-generation data centre (such as ***LandMark Optoelectronics***, ***Advanced Ceramic X***, ***Sporton***, and ***21Vianet***).
  - New semiconductor paradigm (such as ***SK Hynix*** and ***Samsung Electronics***).
  - Data and internet security (such as ***eMemory*** and ***Avast***).
  - eCommerce and electronic payments (such as ***MercadoLibre***, ***Alibaba***, ***InfoEdge***, and ***Linx***).
  - eSport/electronic entertainment (***CD Project***).
  - automation and testing (***Chroma ATE***).
- **Unique asset** or **brand companies** in structural economic growth areas:
  - aspirational consumption in India (such as ***Phoenix Mills***).
  - emerging 'sustainable fashion' (***JNBY*** in China).
  - aspirational consumption in Vietnam (such as ***Vincom Retail*** and ***Vinhomes***).
  - Brazilian consumption recovery (such as ***BR Malls***).
  - India's coming property boom (such as ***Prestige Estate*** and ***Oberoi***).
  - FDI into Vietnam (***Kin Bac City***).

Our search for sustainable shareholder value creation means there are many parts of the benchmark where we have no capital deployed. We are comfortable with that stance, as when it comes to emerging markets, we believe it is all about being selective – here, **sustainability is key**. There are a lot of weak corporate structures and badly governed companies, so we strongly advocate the case for an active approach and not allocating capital to everybody. As a result, our active share is typically 75-85% and beneath that we weight our positions such that where we like a company it has a materially active weight in the portfolio. Our top 25 names accounted for 63.34% of the Fund and an active exposure of 44.45% (as at 28 June 2019).

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Top 25 overweights

	Fund	Benchmark	Active
Samsung SDI	3.19%	0.20%	2.99%
Ping An Insurance	4.16%	1.29%	2.87%
AIA Group	2.49%	-	2.49%
ICICI Bank	2.59%	0.27%	2.32%
Alibaba Group Holding	6.64%	4.36%	2.28%
Naspers	4.12%	1.93%	2.19%
Ivanhoe Mines	2.07%	-	2.07%
Housing Development Finance	2.83%	0.94%	1.89%
Vincom Retail JSC	1.85%	-	1.85%
Samsung Electronics	5.82%	4.01%	1.80%
Phoenix Mills	1.78%	-	1.78%
CD Projekt Red SA	1.77%	0.07%	1.70%
Tencent	6.35%	4.67%	1.68%
BR Malls Participacoes SA	1.70%	0.05%	1.64%
Land Mark Optoelectronics Corp	1.59%	-	1.59%
Bank Mandiri Persero Tbk PT	1.61%	0.19%	1.42%
Apollo Hospitals Enterprise Lt	1.41%	-	1.41%
Info Edge India	1.38%	-	1.38%
Notre Dame Intermedica Partici	1.43%	0.07%	1.36%
Itau Unibanco Holding SA	2.19%	0.83%	1.36%
China Foods	1.31%	-	1.31%
Avast	1.29%	-	1.29%
Larsen & Toubro Infotech	1.27%	-	1.27%
MercadoLibre	1.27%	-	1.27%
Mail.ru Group	1.24%	-	1.24%
	63.34%	**18.90%**	**44.45%**

Top 25 underweights

	Fund	Benchmark	Active
China Construction Bank	-	1.51%	-1.51%
China Mobile	-	1.01%	-1.01%
Petrobras	-	0.97%	-0.97%
Banco Bradesco SA	-	0.91%	-0.91%
ICBC	-	0.89%	-0.89%
Vale SA	-	0.78%	-0.78%
Gazprom PAO	-	0.71%	-0.71%
Infosys	-	0.67%	-0.67%
Lukoil PJSC	-	0.63%	-0.63%
Bank of China	-	0.62%	-0.62%
Baidu	-	0.59%	-0.59%
Hon Hai Precision	-	0.56%	-0.56%
CNOOC	-	0.55%	-0.55%
Tata Consultancy Services	-	0.53%	-0.53%
America Movil SAB de CV	-	0.44%	-0.44%
Qatar National Bank	-	0.43%	-0.43%
China Merchants Bank	-	0.41%	-0.41%
Hyundai Motor	-	0.41%	-0.41%
Axis Bank	-	0.40%	-0.40%
JD.com	-	0.40%	-0.40%
Ambev	-	0.40%	-0.40%
Bank Central Asia Tbk	-	0.38%	-0.38%
BM&FBovespa SA - Bolsa de Valo	-	0.36%	-0.36%
Novatek OAO	-	0.35%	-0.35%
Femsa	-	0.34%	-0.34%
	-	**15.25%**	**-15.25%**

Source: Polar Capital, 28 June 2019.

We strongly believe that while a high conviction, concentrated portfolio approach may lead to short-term periods of underperformance, **we ultimately believe that allocating capital towards real and long-term sustainable companies will lead to alpha generation and continue to deliver outperformance for our clients over the long term.**

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Market outlook

We have a positive outlook for emerging markets and our Emerging Market Stars portfolio for the rest of 2019 and beyond, particularly as we will see some easing policies coming into emerging markets in the second half of the year. Furthermore, we see earnings expectations being reset significantly for H2 2019 and 2020. There is also a good chance of upside should we see an improvement in the economic environment and the earnings cycle for the technology sector.

We also see attractive upside potential for our holdings as the market is currently pricing in a very low growth scenario for the medium term (one to five years) which we view differently. This can be seen when we look at the overall valuation measures for the portfolio; **47% EPS growth expectations for 2020 against just 13.5% for the market** while trading on a PE of 17.4x against 11.5x. In our view, this is a modest premium to pay for this level of growth, especially in the broader context of a low-growth world.

Valuation snapshot

		Polar Capital EM Stars Fund	MSCI EM	Difference
PE (Median)	2019	21.53	13.04	65%
	2020	17.38	11.48	51%
	2021	15.09	10.24	47%
EPS Growth (Median)	2019	2%	5.56%	-70%
	2020	47%	13.55%	246%
	2021	18%	12.17%	47%
	3Y CAGR	21%	10%	100%

Source: Polar Capital, 18 July 2019.

We also acknowledge that fundamental supporting data will first emerge towards the latter part of 3Q19 or in 4Q19. Ahead of this, there are a couple of areas we are particularly enthused about right now:

Technology: We see particularly interesting opportunities in technology. Expectations in general are low and there is room for positive surprises over the next 12 months, assuming growth comes back to its trend rate. For some specific areas, such as 5G and next-generation data centre-related components, we will see a high growth rate start to emerge which will also be supported by the supply-side becoming increasingly concentrated. This technology thesis depends on a form of normalisation of the global technology supply chain which depends on a trade deal being reached between the US and China that will also give at least a partial solution to the Huawei situation. Longer term we expect a much more bipolar world which will be centred around an Asia sphere and a US sphere, where separate supply chains will evolve and only few very advanced technologies will be traded (ideas and concepts will still flow freely and efficiently).

In 2020 and into 2021 we feel we will move into a new technology product upgrade cycle driven by 5G and IoT (connectivity and data driven) which will be positive for the technology sector and, in particular, for the stocks we have in our portfolio. We do not see this in any way being priced into the stocks at their current valuation levels – we clearly have a very different view from the market here.

India: We believe the market is currently mispricing a number of interesting Indian growth companies. Our exposure is centred around financials (***ICICI Bank; HDFC***), property (***Prestige Estate; Oberoi***), India moving online (**InfoEdge;** ***Reliance Industries***) and aspirational consumption (***Phoenix Mills***). As well as these bottom-up cases, there is also a strong top-down case for India which is at the start of a new investment cycle driven by Prime Minister Modi's reform agenda and the recovery from the last cycle which was very badly managed. There is also a high likelihood of rates falling significantly in India, which should give a huge lift to equities, particularly to asset-heavy companies like malls and property where we have significant exposure.

Vietnam: This is a growth area where we have significantly increased our exposure and currently have four investments: ***Vincom Retail*** (malls), ***Vinhomes*** (property), ***Kinh Bac City*** (industrial real estate) and ***Vietnam Technological & Commercial Bank***. While there are a number of attractive bottom-up opportunities, we also see Vietnam as close to an inflection point from a top-down perspective. The country has been restructuring after its most recent crisis and a number of reforms have been undertaken so equity valuation levels are attractive. The structural story is compelling – young demographics, well educated, a strong human capital base compared to many other early stage emerging market/frontier economies, high female participation in the labour force (very important to us), vast resources and relatively good infrastructure. It is clearly open for business.

China: China is 100% about stock picking. Top-down growth will only decelerate and we still have structural issues around SOEs (state-owned enterprises) and government interference but beneath this there are a lot of really interesting companies and a service and technology society is evolving fast. We have the team and knowledge to navigate this new China so we believe we will find attractive companies even in a slowing GDP environment.

Growth and quality as styles were strongly out of favour in 2018, driven by the emerging fear over China's growth outlook and the technology sector. We believe in a more favourable economic growth environment for 2019 on the back of improved global liquidity conditions and domestic demand growth, coupled with a return of the technology cycle in the latter part of 2H19, which we believe will lead to attractive Fund performance during the second half of 2019 and into 2020.

Process enhancements: integrating sustainability (including ESG)

While our investment process remains broadly unchanged since 2011, we continue to enhance it where appropriate. One key area has been around how we integrate sustainability analysis into our company modelling. While the debates on ESG and the changing regulatory framework are hot right now, **sustainability and ESG are something we have been considering in our analysis for close to 20 years – ever since Jorry Nøddekær joined the industry.**

In order to deliver **sustainable shareholder value**, we aim to identify a company's growth in its **Economic Value Added (EVA)** which is mis-priced by the market:

- we define EVA as the return on invested capital (ROIC) that a company generates relative to their weighted average cost of capital (WACC).
- companies that can consistently grow their EVA generate what we describe as **sustainable shareholder value.**
- the essential drivers for that sustainable, long-term EVA creation must include an analysis of a company's opportunities, its competitiveness within its industry and its ESG profile.

We have observed strong links between a company's growth in EVA and its sustainability so it is important for us to move beyond a narrowly defined ESG checklist approach to ESG profiling. Each company's ESG profile is a unique combination of the factors material to its future success or failure.

This process enhancement was implemented when we launched the Fund at Polar Capital allowing us to:

- **directly link a company's sustainability profile into our EVA framework and financial modelling.**
- calculate how sustainability modelling directly impacts our assumptions for a company's cost of capital and fade rate assumptions for future growth.
- **quantify the future ESG impact on every company we research.**

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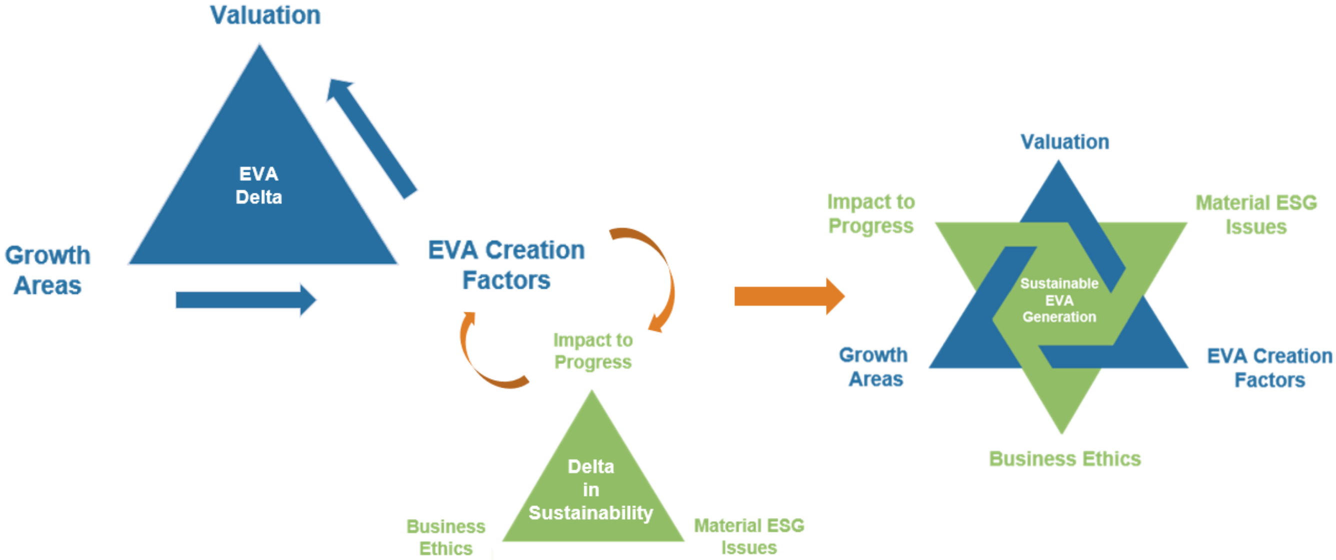
Economic value added (EVA)



Source: Polar Capital, June 2019.

The evolution of our sustainability model was both logical and essential and has created the critical link from a qualitative assessment of environmental, social and governance factors into the quantitative analysis of company's valuation model. This is detailed in our standard DDQ and we are happy to discuss this further.

Summary

While the past 12 months have provided a volatile backdrop, we remain upbeat about the outlook for both emerging markets and our portfolio where we see attractive levels of upside for our holdings. Given our approach is to seek out companies which can capitalise on areas of growth, there are many exciting areas of technological, industrial and structural change which our portfolio is currently exposed to. As **we ultimately believe this approach of allocating capital towards real and long-term sustainable companies will lead to alpha generation and continue to deliver outperformance for our clients over the long term, we are excited about the future.**

We thank our existing investors for their continued support of our strategy and remain very happy to engage with clients and interested emerging market investors. Please do get in touch should you wish to discuss the portfolio and where we see attractive return opportunities in emerging markets.

Polar Capital Emerging Market Stars Team
July 2019

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Please note that the prospectus of Polar Capital Funds plc and the supplement in relation to the Fund are only available in English.

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