Dear fellow shareholder,

We have taken refuge from the severe London weather by coming to Italy where the weather is still more severe. Fortunately, we have use of a pool so we can dip in and out to refresh ourselves. Go outside, get terribly hot, go for a swim in the (unheated) pool, shiver a bit, warm up, repeat. It is not much of a life and, indeed, thinking about it as I write it seems more like lunacy. But it is what we have got.

Being a fund manager feels like this at the moment. Buy a nice little share. Watch as it gets pummelled by the Brexit vote – buy some more – watch it grow – watch it get decimated by lockdown – think about buying some more – watch it recover as lockdown ends – see it pulverised by inflation. Lunacy? It is what we have got.

It has been a rough time in the markets, especially for our UK fund which, for the first time in its history has cumulatively underperformed the FTSE 100. Our European fund has had a gentler fall and continues its long record of cumulative outperformance.

Let me reproduce here some private correspondence (our side only) with one of the shareholders in the UK fund which may be of interest to all.

First, the returns themselves. The fund of its nature is apparently volatile because it marks all of its prices to market in real time. A private equity or property fund does not and so they seem to have smoother returns, which gradually approximate reality as assets are revalued. Many private equity funds are slowly reporting large downward revaluations as we speak. The UK fund appreciated 72% in the eighteen months to September 2021 and gave up all of that and a little bit more in the past nine months.

Why has this happened? The market is in a very nervous state as the logistics and capacity issues caused by the Covid lockdown, and which seemed to be transitory, have now been exacerbated by the high oil price following from Russian sanctions and the feed through to inflation and higher interest rates. This has lead to many companies, especially smaller ones, suffering higher costs, some companies suffering lower demand, and a revaluation of many stocks by the market, especially those so-called growth stocks with a long but uncertain future.

However, I am not in a bad state or poor mood about any of this for the following three reasons:

1. I have been investing for well over twenty years and have seen this story play out a number of times, for example in the global financial crisis (aka Lehman), which was a far worse situation.
2. The value of our businesses will ultimately be related to their earnings and not temporary problems. Of the fund's large holdings only one has turned out to be a dud, Morses Club, which was hit by unsustainably large legal claims out of left field. The other holdings are strong and, I think, just suffering in their prices from temporary pessimism. I'll just spell out one example, as it is a company I have mentioned a few times in the letters and it is the second highest holding in the fund today, at just under 10%. Robert Walters is a recruitment company. We bought it at a rather low price in the pandemic, around £4 a share, which is around six times its cash adjusted profits. It appreciated rapidly to £8.50 last October and has now come back down to £5.20. There is no logic to this as the company's business is now really strong again and, for reasons you will find in our last letter, its prospects are even stronger now than when we found it (it ought to be an

inflation beneficiary). This is the strange pattern of many of our holdings – weirdly volatile share prices but strong prospects.

3. We have a very high cash balance again (26% in the UK fund), which you will recall last happened just before the Covid crisis and which means we can opportunistically buy more shares in good companies at low prices

For those of you who did not see the Polar Capital note we sent out under separate cover, it is reproduced below. It is typical of what we are looking for in ideal combination – apparently extremely cheap, rock solid balance sheet, a long history of compounding returns at very high returns on capital.

Polar Capital Holdings plc (LSE: POLR)

Prelude

Derby Street's most successful investment to date was Impax Asset Management, which was realised over six years at a compound annual return of 43%. Impax was that ideal combination of a great business, with impeccable economics (net cash and high operating leverage) together with a low price (Enterprise Value was six times profits). The business grew, the multiple grew and our position grew. Polar Capital has a similar set up. We maintain a watching brief over the 18 quoted peers in this sector that are liquid enough to be investable.

History

Polar was founded in 2000, with support from the notably far-sighted anchor investor, Caledonia Investments. It floated on the London Stock Exchange in 2007, with Assets under Management (AUM) of £1.7 bn. Its AUM is now £22.1 bn, a 19% compounded growth rate. Operating profits, excluding performance fees, have increased ten times, and dividends received have far outstripped the IPO price. In addition, Polar has earned substantial performance fees, and these are further detailed below.

Business

Polar's investor base is predominantly in the UK (57%) but it is well represented in Europe (33%), also, with the investors being a mix of retail and institutional. Net management fee yield on assets is a respectable 83 basis points. Polar has for a long time been identified with the technology sector, which accounts for 46% of AUM and it also has notable investment vehicles focussed on healthcare, value and insurance.

Although most of the book is long only, Polar has generated significant performance fees since flotation, with the average earned per year nearly the same as "core operating profit", that is EBIT excluding performance fees.

Economics

Investment management can be a highly lucrative industry. Consider these three facts. Polar's operating margin before performance fees is 36%. Including average performance fees, this margin would be about 47%. Either figure would put Polar (and a few of its peers) in the first rank of businesses in the world (for example, famously profitable Microsoft's operating margin is 41%). Secondly, the business is very cash generative. Even after paying out generous dividends (the

current yield is around 8%), the company has built up cash reserves of £103m; moreover it has invested £71m in its own funds, primarily to seed them. Netting off certain provisions, its net cash and investments total £152m. It is a very light model, with hardly any other significant assets or liabilities. For example, it spends around £100,000 a year on fixed assets and if you consider almost any business of any size that is a rather small amount.

This is all summed up in the third fact. Polar has negative tangible net assets. In other words, its creditors more than finance its entire asset base. This is really quite rare and means that Polar's return on capital (a key measure of overall profitability) is infinite.

Another way of looking at the economics of the business is to think about its key drivers. Revenue is made up of fees and, again, ignoring performance fees for reasons I shall come to, management fees are a function of AUM and fee margin. AUM itself is essentially a sum of net subscriptions from clients and fund performance. For example, a fund that starts the year at £1 bn in assets and ends the year at £1.2 bn can only have got there if assets grew from profits of 20% or if net subscriptions were £200m, or some combination, say 10% from each. A shareholder in Polar is ex post indifferent between the two sources: 20% growth is 20% and will lead to good things. But ex ante, we prefer growth from subscriptions. Growth from the market can just be luck. Moreover, growth from clients will likely compound as the clients become wealthier. Polar's AUM has more or less doubled in the past four years and net subscriptions have made up about half of this. This compares very well with its peers.

Expenses are predominantly staff-related (77% of total costs) and a large part of these are performance related – more evidence of a lean structure. Of course, there are many industries that have large staff components to their expenses and pay generous bonuses but do not manage to sustain profitability (we are looking at you, investment banking) but fortunately asset management is not one of them. Asset managers have traditionally been generous to both staff and shareholders (with quite a big cross over between the two). Although there was significant dilution in the early years, as teams were established and acquired, the level has slowed in recent periods.

In summary, if Polar continues to attract clients it ought to be able to sustain high levels of profitability.

Threats

Polar earns half of its income from managing investments in the technology sector, which has seen boom times and a couple of busts in the last two decades. Right now, a number of prominent technology companies, especially those associated with the pandemic or those which are not profitable, have had share price collapses. Zoom is down 75% from its highs last year, for example, and Peloton is down 90%. This kind of price action can damage an asset manager two ways – the value of funds drops through market performance and can further decline because of client withdrawals. Polar is not exempt from these effects. Although its AUM is up £1.2 bn in the past year, in the last quarter it was down £2bn, mainly because of market performance. The reduction is not at Zoom/Peloton levels for a couple of reasons. Polar's technology investments have been in the more sheltered area of large cap, profitable companies. Its largest holdings are in Microsoft, Alphabet and Apple, which are some of the most profitable businesses in the world. And secondly, Polar has successfully attracted new money to its non technology funds, especially in sustainable investments and healthcare. Nevertheless, if you think technology will continue to

be torrid for the next decade, you won't like Polar. We think technology will continue to be core provider of corporate profits and, therefore, shareholder value.

On a wider canvas, Polar has benefitted from stock markets that have multiplied in value over the past two decades (the S & P 500 has quadrupled in the past twenty years). This has largely been a function of rising profitability but it has also been helped by falling interest rates, which have pushed up all asset prices, and especially financial assets. Yesterday's 6% yield (on stocks, bonds and rental properties) is today's 3%. If interest rates continue to rise and do so substantially, stock markets may find it difficult to rise at their historic rate.

Finally, not all asset managers have prospered equally. There has been a long-term trend towards indexing, which will no doubt continue with the rise of robo-advisors and similar programmatic vehicles. Index funds are cheap, and efficient because they are cheap. Many average and below-average managers have suffered asset outflows *and* margin compression. Polar has thrived because of its performance and its sector specialisations but that is not a given.

Valuation

Although there are several industry ratios, such as market cap compared to AUM, our standard is EV/NOPAT. EV is enterprise value, the market cap adjusted for cash and investments. NOPAT is net operating profits after tax. The latter is preferred to profit after tax simply to avoid double counting the interest and dividend income earned from cash and investments.

We paid £5.75 per share, for a market cap of £575m on fully diluted shares and an EV of £423m. NOPAT is around £58m, to give an EV/NOPAT multiple of 7.3 times. But – surprise! – we excluded performance fees. The reason is that these are volatile and of inherently lower quality; in particular, they will be low or zero if markets misbehave. As such, we have tended to regard them as "cream", an unmeasurable but welcome bonus when they turn up. For the sake of the numbers, if performance fees continued at their historic average, the multiple would drop to below four.

(Footnote. Since publishing this note we have continued to buy and our cost base is somewhat lower.)

In sum, we are buying businesses and not being distracted by the macro storms. Thank you for supporting Derby Street. We look forward to speaking to you all soon,

Richard Simmons
Portfolio Manager
Derby Street Investments

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