ticker

October 31, 2017

Cost of Capital Beaters

Companies generating profits exceed their cost of capital, display healthier business profiles, and are also attractive investments, especially if their stocks are out of favor for temporary reasons. Bernard R. Horn, Jr., president of Polaris Capital Management, LLC and portfolio manager of the Polaris Global Value Fund (PGVFX), builds his portfolio from this narrow list of stocks discovered from around the world.

What is the history of the fund?

I started managing global equity accounts for individuals back in the early 1980s, and by 1989 I decided it would be far more efficient to pool these accounts into one fund versus manage separate accounts. So the Global Value Limited Partnership began in July 1989, but when we hit the threshold of our investor limit, we converted it to this mutual fund, the Polaris Global Value Fund, in 1995. It is now our flagship product.

Today, the fund is just over $500 million, and the firm has over $10 billion under management total. Most of our business is sub-advising other funds, but we manage this fund on our own.

What are the underlying principles of your investment philosophy?

We believe in a strictly disciplined approach, to only invest in a company when it's priced to beat the benchmark. We calculate what we call cost of capital, Polaris' Global Cost of Equity, by adding 2% to the benchmark's historical return after inflation, plus another measure to cushion against currency fluctuations—that number differs by country and is basically the real bond rate in that country.

So, for a country with a 1% real bond rate, if the benchmark's historical rate of return after inflation is 7%, that plus another 2% equals 10%, and that's our cost of capital. If a company isn't poised to beat that, it doesn't make it into the portfolio.

How does this philosophy translate into your investment process?

We have a database of 40,000 companies which we distill down into about 75 holdings. We screen the database using a variety of value measures, the primary one being that a company has to generate sustainable positive cash flow.

It must also have sufficient cash flow to cover its maintenance capital spending. If it does, the value of that spending relative to the firm's market capitalization has to meet our required rate of return for that country.

It's a very bottom-up analysis, but while we consider macro factors, that's not part of our fundamental work. We are primarily concerned with the particular niche the company occupies, and whether it's a sustainable and growing business.

We are benchmark-agnostic when it comes to what companies get through our screens. Any company that meets our rate of return requirement is fair game, no matter what size it is or where it is situated, in terms of both geography and industry. So, even if we don't particularly like the sector or the country, if a company passes our screening, we look at it, no exceptions.

We don't always know where the best values are, and that often leads us to shift the portfolio. We might be light or we might be overweight emerging markets, for example, but that asset allocation as to where clients should invest their money is a decision we are in a position to make because we survey where the best values in the world are, every day.

Bernard R. Horn, Jr.
President and Portfolio Manager

Bernard R. Horn, Jr. is president and portfolio manager of Polaris Capital Management, LLC, a leading Boston-based global and international value equity firm. Mr. Horn founded Polaris in April 1995 to expand his existing client base dating to the early 1980s. Mr. Horn's pure global value philosophy combines investment technology with traditional fundamental research. His 30+ year track record exceeds most current competitors in length and has produced admirable risk-adjusted returns since inception. Known as forerunner in global and international investing, Mr. Horn has been profiled in national media outlets and his written works have been published throughout the investment industry.

Prior to founding Polaris, Mr. Horn worked at Freedom Capital Management as a vice president and portfolio manager and at MDT Advisers, Inc. From 1980 to 1990, Mr. Horn was the founder of Horn & Company. In July 1989, he formed the Global Value Limited Partnership (predecessor to Polaris Global Value Fund – PGVFX) for the purpose of serving existing and new clients. Mr. Horn holds a master's of science degree in management (M.S.) from the Alfred P. Sloan School of Management at M.I.T (1980). Thesis title: "The Pricing of Commodity Options", Faculty Advisors: Professors Fischer Black, Robert C. Merton.

"We believe in a strictly disciplined approach, to only invest in a company when it's priced to beat the benchmark."

How would you describe your research process?

After we do our initial cash flow screening, we analyze the company's financial reports to see if they align with our findings. There may be minor differences but for the most part, our screens are fairly accurate. The quantitative data available on companies around the world does omit certain important measures, however, which is when we look at the companies individually. After that, we look at the industry and decide whether it's a sector that looks promising to us.

Once we judge that a company looks like it has a sustainable future, then we build a financial model, a long checklist of items that require considerable management contact to uncover, for example, financial statement analysis, balance sheet, income statement, and cash flow.

We want to understand the business model and spend a lot of time talking to management about their plans to sustain cash flow and what they intend to do with the leftover cash flow after reinvesting to maintain the company. We want it to grow, but with limited downside risk.

We look at its competitors to determine where the company fits into the competitive environment and whether they possess sufficient competitive advantage to allow them to withstand competition, even when the economic cycle is weak.

In terms of cash flow, we are conservative in our estimates to protect our downside as much as possible. Only then is a company presented to the investment team for further analysis and discussion.

It's important to note that, typically, the companies that pass our screening are not darling stocks. They are cheap for the very reason that some investors view them negatively.

If a company can survive our process, there is a good chance it will be added to the portfolio. And when we add something, we generally must sell something else, something that doesn't represent as good a value or outlook.

We have made many more changes this year, shifting the portfolio more toward Asia, and away from Europe and Scandinavia where we have had overweight positions for quite some time.

Can you furnish some examples of your research process?

One example is Magna International Inc., a Canadian automotive supplier. It has a good diversified car parts business and it's been inexpensive for a while. It came into our range—U.S. car sales have been a bit weak, relatively speaking, so some of the auto parts stocks have come down a bit.

From a sector perspective, the number of parts suppliers has substantially reduced over the years, primarily because OEMs, the original equipment manufacturers, often make their suppliers invest quite a lot in research and development, tooling, practice runs, etc. It wasn't unusual for an OEM to change its mind and send the little parts company out of business because it couldn't afford to sustain those sorts of losses.

Nowadays, it's just a few parts suppliers responsible for keeping the OEM production lines running, at a level of millions and millions of parts.

Magna has done a great job. Being in Canada, they have a slightly lower cost structure to some degree, yet have plants all around the world. It met our cost of capital and we think it's going to give us a good 10% return or better going forward, and it's in a good sector.

Another example would be Nexon Co., Ltd., a Japanese computer gaming company. They mostly sell their games online, into the Asian market. Many of the games can be downloaded for free, but the only way to win the game is to buy certain components, like more characters or weapons. Nexon has a fairly strong development team that turns out many new games each year, some of them hits and some not, but they have a strong history of creating new games.

Nexon was also a low-beta stock, and the company operated in the fast-growing Asian market, and we felt it was a great value. The CEO comes from the U.S. based Electronic Arts Inc., and we think at some point they will expand into western markets, which would provide a lot more growth opportunities. But if not, it's still a good cash generator. Also, the people who play electronic games are less likely to be influenced by the kinds of economic cycles that affect car companies, chemicals, or even food, to some degree.

Which stock do you prefer, Samsung or Apple?

While Apple generates, and has on hand, a considerable amount of cash, about 80% of it depends on iPhone sales, so to buy it would be to essentially make a one-product bet on the company. iPhone sales would have to continue at the current pricing and high volume expectations forever. There isn't a single company that has continued on forever in the cell phone business; at some point it changes.

Apple will no doubt continue to innovate—there are iPads, laptops, and so forth—but for the most part, Apple now relies on suppliers to execute their innovation. And what we see among those suppliers is that they are so dependent on Apple, and their margins ground down so low by Apple, that it's not clear they have the free cash flow to support the R&D and innovation and, most important, the capital investment needed to keep up with innovation.

Samsung, on the other hand, which we own instead of Apple, has generated a huge amount of innovation in terms of computer, TV, and cell phone screens. They more or less own the NAND flash memory market so critical to cell phones, and so they dominate the market. But they also make large appliances and make a lot of money selling chips and TVs. It's a more diversified product line, and they have the capital and cash flow to reinvest in and build factories. And Samsung is cheaper than Apple.

What is your portfolio construction process? Does diversification play a role in it?

Our process is bottom-up and equally weighted, so, for example, if we have 75 positions, each would represent an equal portion of the portfolio, that is, 1.33%. We don't play favorites because there are factors that could disrupt our cash flow estimates which we can't predict, like the earthquakes or hurricanes we've seen recently. Equally weighting the portfolios serves to randomly distribute any mistakes we make throughout the portfolio.

As a multi-cap manager, we can buy small, mid, and large cap stocks. So, in addition to rightsizing positions based on their market cap, everything is equally weighted—we don't tend to trim on a mechanical basis.

If a company outperforms other stocks in the portfolio, it may be overweight relative to the 1.33% weighting. If it underperforms, we might trim or add something, but we may elect to wait for whatever caused the company to stumble to right itself and bring it up to model weight.

The fund's benchmark is the MSCI World Index.

What drives your sell discipline?

The typical portfolio turnover in the last 12 months has been 30%. As we only buy companies priced to give us 2% excess return over the benchmark, when the stock price or company value moves up faster than the cash flow to where it's no longer priced to give us that 2% excess return, it becomes a sell candidate.

It's also not unusual for our companies to be bought out in acquisitions, so sometimes we'll sell merely because it's been taken over. And if we make a mistake and volumes or price or industry competition has changed beyond our initial expectations, we will change our financial model. If it's no longer a great value, then we look at selling it.

Sometimes it's simply a matter of when we find low-beta stocks that are very cheap, with very clean balance sheets, better value than what we own, and something that would improve the overall portfolio. At that point, we'll sell something to make room for it.

How do you define and control risk?

To me, risk is losing money. Everything in our investment process is designed to minimize the chance we'll lose money, and we do this by applying a high discount rate, cost of capital, conservative financial models, and equally weighting the portfolio. We consistently try to find lower-risk companies to put into the portfolio.

We manage the beta of the securities that come into the portfolio, and when constructing the portfolio, we want a minimum variance in future cash flow and as little downside risk as we can possibly get. If the cash flows of the companies we own as a whole have less downside risk, then that usually translates to the stock prices having less downside risk. T

POLARIS GLOBAL VALUE FUND

Adviser	Polaris Capital Management, LLC
Symbol	PGVFX
Address	121 High Street Boston, MA 02110-2475
Phone	888-263-5594
Website	www.polarisfunds.com

Source: Company Documents

	2017				Annualized as of September 30, 2017						
	YTD	QIII	QII	QI	1 Yr	3 Yrs	5 Yrs	10 Yrs	15 Yrs	20 Yrs	ITD*
Polaris Global Value Fund	14.32%	3.74%	5.20%	4.76%	20.06%	9.90%	13.73%	5.24%	10.72%	7.55%	9.76%
MSCI World Index, net dividends reinvested	16.01%	4.84%	4.03%	6.38%	18.17%	7.69%	10.99%	4.22%	9.01%	5.60%	6.58%

* Inception-to-date (Inception date 07/31/1989)

Performance data quoted represents past performance and is no guarantee of future results. Current performance may be lower or higher than the performance data quoted. Returns for more than one year are annualized. Investment return and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than original cost. For the most recent month end performance, please call (888) 263-5594. ***As stated in the current prospectus, the Fund's total annual operating expense ratio is 1.27%. The Fund's annual operating expense ratio has been reduced to 0.99%, effective as of January 1, 2014 through April 30, 2018, due to the Adviser's contractual agreement to waive its fee and/or reimburse expenses to limit Total Annual Fund Operating Expenses. Shares redeemed or exchanged within 180 days of purchase will be charged a 1.00% fee. Fund performance returns shown do not reflect this fee; if reflected, the returns would have been lower. Short-term performance is not a good indication of the Fund's future performance, and an investment should not be made based solely on returns.***

As of September 30, 2017, the Fund's largest equity holdings and the percentages they represent in the Fund's portfolio market value were as follows and are subject to change:

Issuer	Percentage of Total Net Assets	Issuer	Percentage of Total Net Assets
Samsung Electronics Co., Ltd.	1.78%	Solvay SA, Class A	1.50%
Yara International ASA	1.60%	WESCO International, Inc.	1.49%
Taylor Wimpey PLC	1.55%	DNB ASA	1.49%
Bellway PLC	1.53%	International Bancshares Corp.	1.49%
Barratt Developments PLC	1.51%	Tyson Foods, Inc., Class A	1.49%

Before investing, you should carefully consider the Fund's investment objectives, risks, charges and expenses. This and other information is in the prospectus, a copy of which may be obtained by calling (888) 263-5594 or visiting the Fund's website at www.polarisfunds.com. Please read the prospectus carefully before you invest.

The Fund invests in securities of foreign issuers, including issuers located in countries with emerging capital markets. Investments in such securities entail certain risks not associated with investments in domestic securities, such as volatility of currency exchange rates, and in some cases, political and economic instability and relatively illiquid markets. Options trading involve risk and are not suitable for all investors.

On June 1, 1998, a limited partnership managed by the adviser reorganized into the Fund. The predecessor limited partnership maintained an investment objective and investment policies that were, in all material respects, equivalent to those of the Fund. The Fund's performance for the periods before June 1, 1998 is that of the limited partnership and includes the expenses of the limited partnership. If the limited partnership's performance had been readjusted to reflect the second year expenses of the Fund, the Fund's performance for all the periods would have been lower. The limited partnership was not registered under the Investment Company Act of 1940 and was not subject to certain investment limitations, diversification requirements, and other restrictions imposed by the 1940 Act and the Internal Revenue Code, which, if applicable, may have adversely affected its performance.

The MSCI World Index, net dividends reinvested measures the performance of a diverse range of global stock markets in the United States, Canada, Europe, Australia, New Zealand and the Far East. The MSCI World Index is unmanaged and does include the reinvestment of dividends, net of withholding taxes. One cannot invest directly in an index.

Foreside Fund Services, LLC, is the Fund's Distributor.

The disclosure page must accompany the October 31, 2017 Ticker Magazine's article entitled "Cost of Capital Beaters: Polaris Global Value Fund".

POLARIS GLOBAL VALUE FUND