

Q&A with Colm Friel, Fund Manager

Q: Gary Corcoran (GC), Head of Corporate Communications and Content, Polar Capital:

Colm, you have recently come back from the US. What were the key takeaways for you from the meetings you had with companies' management while you were there?

A: Colm Friel (CF), Fund Manager, Polar Capital North American Fund: It's almost business as usual. There was a period a few months ago when the entire focus was on tariffs and how companies were navigating their supply chains and finding ways to cut costs to offset some of the impact. Now that's much less of a focus. It seems like businesses have figured out how to deal with this environment – even if what they are dealing with is changing – and they are carrying on with things as they should be. The adaptability and pragmatism of management teams is shining through. They are dealing with the hand that they have been dealt and carrying on with day-to-day operations.

The US is buzzing; it's a hive of activity, with busy airports and restaurants. There is also a real tension, because the US has become a very expensive place. It has had cumulative inflation of 30% – higher in certain pockets – since 2019, together with higher interest rates, making other, larger purchases much more expensive. Against that, US productivity growth has far outstripped the UK and Europe over recent years and there has been good wage growth. This has created a tension for households trying to balance their budgets. Overall, there is a lot of activity at a consumer and business level and I had a real sense that the entrepreneurial spirit of the US and its ability to innovate and carry on and be pragmatic is alive and well.

Q: GC: How have the Trump administration's ever-changing policies, particularly around trade and tariffs, impacted your Fund and how and where you invest?

A: CF: There are two ways to break this down: the direct effects and the indirect effects. The direct effects are easier to get your arms around and include looking at what businesses are doing about reorienting the supply chain or cutting costs elsewhere in the business. The indirect effects are a lot less clear – what are the longer-term effects of these policies? Will they lead to higher inflation or have an impact on growth?

We look at the characteristics of the portfolio in a number of ways. Overall, the portfolio is biased towards services rather than goods and is driven by IP, innovation and capital-light businesses. We also look at the adaptability of our holdings' business models and of their management teams. We think that the way in which they can deal with an ever-changing environment is more important than the specifics of what is going on in the environment at any point in time. Another consideration is pricing power – when we invest in a business, we look at its ability to pass on higher costs and not see a degradation of profitability or a drop in demand. We think the combination of those characteristics makes the portfolio relatively resilient to a changing environment.

To put some context around this, according to JP Morgan, the overall impact of tariffs on the market will be about a 4% hit to S&P 500 earnings. Interestingly, there is also the move in the dollar to take into account.

The dollar has recently weakened after a long period of strengthening which was a headwind to US businesses' profitability. We think that a 10% drop in the dollar for a market where about 40% of revenue comes from overseas is somewhat of an offset or a hedge to the direct impact of the tariffs.

Q: GC: You have recently highlighted a misperception in the valuation gap between the US and the rest of the world. How has that gap changed in recent months and what does that mean for investors allocating to the US?

A: CF: If you compare the P/E of the US with the P/E of the rest of the world, using EAFE (Europe, Australasia and the Far East) to represent the rest of the world, at the start of the year the gap was about eight multiple points. It has recently come in slightly to about six and a half. However, we think the direct comparison of one index against another is not reflective of the true picture – there is a composition effect which is much more important to consider.

One way I would illustrate the difference between the indices is to think of two warehouses that are the same size. One is 75% filled with luxury, high-end goods and 25% low-end commodities. The second is 25% high-end luxury goods and 75% low-end commodities. Somebody is selling the warehouses, full, on a price-per-square-foot basis, but you would not expect them to have the same per-square-foot price. That is a way of illustrating the fact that the US has proportionately more high quality, high growth, high ROIC businesses and proportionately less of the lower growth, lower ROIC businesses.

To illustrate with some numbers, taking banks as an example there is an 11% weighting in banks in the rest of the world and 3% in the US but if you take the averages of each, they are on about 11x P/E, so there is not much difference on a like-for-like basis. It is the same in the materials and food and beverage sectors, where the weight in the rest of the world is double that of the US and the price-to-earnings ratios are very similar. On the other side, if you look at something like semiconductors where the price-to-earnings ratio is high, the US has around 11% compared to the rest of the world's 2-3%, and it is a similar situation for media and entertainment.

We think that if you break down the index by sector and industry, the US P/E premium of around six and a half points keeps coming in. On a company-by-company or sector-by-sector basis, there is not much difference in the headline multiples but when you aggregate things up the US appears to be trading on a premium. We think that given some of the characteristics about high growth, high ROIC, shareholder-friendly culture and entrepreneurial spirit, the US deserves to be at a substantial premium. Based on this analysis, we would even suggest there is a valuation argument for the US, which is not something you hear very often.

Q: GC: What is your long-term outlook for the Fund and what most excites you about being a US equity investor?

A: CF: One thing we think people own our Fund for is its long-term compounding potential. We define that using the term 'value creation', which is the return from the underlying business, the operational growth of the business plus the capital return, being dividends or buybacks. Since the inception of the Fund, the value creation has cumulatively been almost 400%, compared with the Index at around 270%.

We think the potential for compounding can continue, as our process allows us to have a diversified portfolio of businesses that can deliver double-digit compounding over time. Coupled with that, we think there's a valuation argument for the Fund. On a price-to-free cashflow basis, it is trading at a 40% discount to the Index, which is extended historically. While not a big reason to invest in a Fund like this, the valuation discount is a potential tailwind over time.

Looking at the composition of the portfolio, it is very diversified by fundamental drivers and by market cap, compared to an Index that is very concentrated not only by market cap, but also by fundamental drivers increasingly focused around a single theme. We are very deliberate about how we invest in the US. We believe investors should be very deliberate about how they allocate to the US and think about how best to get exposure to a broad set of companies and a broad set of fundamental drivers.

GC: Colm, thank you very much.

Colm Friel

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Find out more



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Polar Polar Capital North American Fund

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- 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.
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