PALM CAPITAL

Q1 2018

April 2018 | Mahomed Ibrahim

At Palm Capital, we look for businesses with durable competitive advantages run by exceptional managers. We patiently wait to invest when their prices are less than we think they are worth, aiming to benefit as they compound economic value over time. We only sell if fundamentals deteriorate, or we find others offering potentially better after-tax returns.

Our performance

It's been three months since we started our internal portfolio. This is made up of our own savings which we intend to invest in the same way as our clients'.

Our portfolio fell by 1.0% over the period, outperforming the MSCI World Index by 0.7%.

The virtues of volatility

Given our long-term approach, a quarter is a short period – but the last three months have seemed anything but short!

After a year of exceptionally stable prices, volatility returned: in less than three months of 2018, the S&P500 saw three times as many moves greater than 1% as in the whole of 2017.

That's good for us. At the start of the year, most businesses we wanted to buy were trading well above what we were willing to pay. By the end of March, we had managed to buy many at prices even better than we'd hoped. No-one likes to see the value of the shares they own fall, but it's an incredible opportunity to buy them cheaply when they do.

The media, as always, offered many explanations for the increase in volatility: sabre-rattling between the US and North Korea, Trump's trade war and scandals over Facebook's privacy violations. But it's worth noticing that these same issues were in play throughout the previous year -- and the market marched higher over that time regardless.

The media makes its money from creating dramatic narratives. We try not to be caught up in them.

Are markets expensive?

Many commentators say that markets are expensive at the moment, pointing to the relatively high P/E (price-to-earnings) ratio of the S&P500. We think this analysis is flawed, and here's one of the reasons why.

Tech companies such as Amazon and Google nowadays make up a large part of this index. And, because of different accounting standards, companies like these report earnings differently to the sort of companies that used to be heavyweights in the index.

Most companies spread their capital investments over their useful life; but tech companies expense most of their investments at once in their income statements. That depresses their earnings (the 'E' in their P/E ratios). So P/E comparisons between different sectors are next to valueless.

Come to that, why worry about 'the market'? We don't own the market: we own our portfolio. And even if the market as a whole is over-valued, our portfolio is not.

Our portfolio

Since our portfolio is young, we made quite a few purchases in the quarter, deploying just over half of our cash. We discuss some of these below.

The overall quality of businesses we own, measured by our own risk rating, is 3.5 out of 5.0. This compares well to the market average of around 2.1. And since we estimate that these businesses are approximately 15% undervalued, this bodes well for future returns.

We will now comment on some of our sizable new holdings.

British American Tobacco

BAT is the world's largest cigarette manufacturer and part of an oligopoly. Tight regulation ensures that it stays this way. A ban on advertising together with the addictiveness of its products reinforce the power of its brands. It is able to consistently increase prices to more than offset the decline in smoking. The company also has room to improve margins through operational efficiencies, increasing customer migration to premium brands and the integration of its recent acquisition of Reynolds.

In March, the US FDA announced that it is considering banning menthol and limiting the amount of nicotine in a cigarette stick. BAT's share price fell to a two-year low.

While this will undoubtedly hurt its short-term profits, it is important to remember how powerful the addictiveness of its products is. With astute managers at the helm, these companies have overcome tough regulation before including a ban on advertising, plain packaging, graphic warning signs and a ban on flavouring. It is highly likely that they will overcome new regulation as well.

According to our estimates, even if menthol volumes disappear, the share is worth more than its current price, offering a suitable margin of safety.

AIA Group

AIA is the largest long-term insurer in Asia Pacific. In an industry where it is difficult to build lasting competitive advantages, its unique strategy of focusing on the long term has set it apart from competitors and helps generate high quality earnings. Most of its new business is from higher margin, more stable and regular business sold via sustainable sales practices.

The company is run by an excellent management team. Since its spin-off from AIG, they have grown margins, increased persistency and solidified the company's balance sheet.

Importantly, AIA is operating in a structurally growing insurance market. In particular, a third of its new business is from China where insurance premium growth is gaining momentum as wealth is increasing and the population is ageing.

Royal Dutch Shell

Shell's Price-to-Book ratio is at a 30-year low and its dividend yield is at a 10-year high, indicating that the market is questioning its weak balance sheet following an aggressive capital expenditure and acquisition cycle.

What the market is missing is that while the long lead time of large projects strains a company's balance sheet, it takes time to reflect on its income statement. In fact, Shell's recent investment cycle makes the company the best-placed oil supermajor to grow production from low-cost fields which are already on-stream and has given the company the longest life of reserves amongst peers. This implies that the company has more within its own control and is less dependent on an oil price recovery.

The company is also executing an impressive cost-cutting strategy which will slash their costs of production even further.

Even assuming low oil prices for longer, the share is attractively priced.

Top Holdings as at 31 March 2018

Share	% of fund
Amazon.com, Inc	10.2%
AmerisourceBergen Corp	9.9%
British American Tobacco plc	9.6%
AIA Group Ltd	5.4%
TJX Companies Inc	5.2%
Philip Morris International Inc	4.9%
Royal Dutch Shell plc (Class A)	3.9%
Alphabet Inc (Class C)	2.0%
The Blackstone Group	1.5%

Disclosures: This document is for information purposes only and does not constitute investment advice. All portfolio data is obtained from Direct Market Access (South Africa). All calculations are carried out by Palm Capital (Pty) Ltd. This fund not open for client investments and this commentary is only provided for illustration purposes. Potential clients should please contact Palm Capital (Pty) Ltd for more information regarding the investment of their monies on a segregated basis. Potential clients should also obtain independent investment and tax advice before investing with Palm Capital (Pty) Ltd on a segregated basis.

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Performance figures are quoted after the deduction of all costs (including manager fees and trading costs) incurred within the fund. Annualised performance figures represent the geometric average return earned by the fund over the given time period.