PALM CAPITAL

# Q2 2018

July 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

Our portfolio increased 1.4% in USD over the quarter, marginally outperforming the MSCI World Index which increased 1.1%. Since we started it six months ago, our portfolio has increased 0.3% while the same Index has fallen 0.7%.

We make the comparison only to give our returns a context. As you know, in the short-term share prices tend to move *en masse*, and for reasons unrelated to the underlying businesses. They also give us an indication of what we could have earned had we invested in the Index instead.

However, this is as far as the comparison is useful.

The Index is made up of almost 3,000 shares from around the world. We own 10. The Index includes shares of low and high-quality businesses. We aim to own only high-quality ones. Finally, the Index includes over- and under-valued shares. We aim to own only under-valued ones.

These structural differences result in different risk profiles. Comparing returns alone paints an incomplete picture.

Regardless, we're confident our approach, over the long term, will yield better returns with less risk.

## 'Hot Stock Tips'

People often ask us for 'hot stock tips': shares we expect to increase quickly. We just shrug: we don't pretend to have an answer. Picking 'hot stocks' is the opposite of what we do.

Share prices reflect the amount people are willing to pay. Over long periods they will reflect the underlying quality of the businesses, but in the short-term they're subject to irrational sentiment.

Picking hot stocks – momentary fashions, or companies that enjoy an unexpected windfall -- is a dice roll. We're not interested in gambling.

Instead we aim to benefit from businesses which by virtue of their competitive advantages grow their profits and economic value over time. Investing when they are under-valued gives us a margin of safety and higher potential returns. We can't predict how long it will take for share prices to reflect their growth in profits or their true value, and we don't try to.

We're happy to be up front about this. Look at our own portfolio. The share prices of TJX, Amazon and AIA have increased quickly since we bought them: they are up 25%, 24% and 11% respectively. We also hold BAT and Philip Morris, which are down 12% and 9% respectively.

We bought all with the same rationale – they were high-quality and undervalued – but had no way of knowing which would rise or fall over this short period of time.

That's why it's important to build a portfolio of shares, each weighted pragmatically, rather than choosing just one or two.

## We didn't trade much over the quarter

Although the Index has fallen – circumstances in which you might think we'd go on a shopping spree -- we remained cautious.

We made one new investment over the period, in the drug company Allergan. Allergan has a dominant position in aesthetics drugs such as Botox and Juvederm. This market has a high level of doctor and patient loyalty, and doesn't face imminent patent expiries which threaten profits. We think this is an excellent business, attractively priced.

We also increased our holdings of BAT and Philip Morris as their share prices fell. The market is panicking over proposed regulatory changes – and though we take those concerns on board, we think the anxiety is excessive; which makes the shares an attractive buy. These businesses are selling a product with steady demand. They have strong brand, scale and distribution advantages. And they have weathered aggressive regulation before. Based on the prices we paid, we will earn a 5% return from dividends alone and we expect this to grow.

Overall, the quality score of our holdings remained at 3.7 out of 5.0 – against a market average of 2.1 -- and the discount to fair value is 14%. We are happy with that. Our cash holding is still significant, so we have the resources to exploit new opportunities. Our top holdings are shown overleaf.

## Top holdings as at 30 June 2018

| Share | % of fund |
|---|---|
| Philip Morris International Inc | 12.0% |
| Amazon.com, Inc | 11.8% |
| British American Tobacco plc | 11.2% |
| AmerisourceBergen Corp | 9.6% |
| Allergan plc | 7.1% |
| TJX Companies Inc | 5.9% |
| AIA Group Ltd | 5.5% |
| Alphabet Inc (Class C) | 5.3% |
| Royal Dutch Shell plc (Class A) | 4.2% |
| The Blackstone Group | 3.6% |

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.