Q3 2018

October 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 5.6% over the quarter, outperforming the MSCI World Index by 1.0%. Since we started, our portfolio has increased 5.9% -- outperforming the index by 2.0%. That's largely down to the number of US shares we hold: the US markets have performed better than those of other countries in the index.

We have been pleasantly surprised by our outperformance given our large cash holdings throughout the period. We began the portfolio entirely in cash and over the last quarter held on average 21% of our portfolio in cash.

All the shares we've bought, aside from the tobacco companies and AmerisourceBergen have had high double-digit returns. Good news – but we don't expect this always to be the case over such a short period. In any given quarter, market valuation and results can be unpredictable – buffeted by geopolitics, random events or irrational investor sentiment.

That said, some of our holdings such as TJX, Amazon and Allergan outperformed our expectations – which we think reflects their strong underlying fundamentals. Let's look at Amazon's results, as a way to explain our thinking on our biggest holding.

Amazon's growth shows no signs of slowing

Amazon is already one of the largest companies in the world in terms of sales. And it's continuing to grow at an astonishing pace. In the second quarter, its overall sales grew 39% compared to the same period last year. Third-party sales grew 39%, its cloud business 49%, subscription services 57%, and other operations (including its nascent advertising business) 132%.

These businesses make up 40% of all its sales. Importantly, they all have much higher profit margins than Amazon's primary retail business and will continue to lift the company's overall margins over time. That primary retail business is no slug either. This division grew by 14%. These results are a testament to the company's strengthening competitive advantages and culture of innovation.

We think Amazon is still attractively priced. In 2017, Amazon spent US$35b or almost 20% of its sales on technology, content and capital expenditures; more than any other listed company in the US. This spend is enhancing its advantages in industries with long runways for growth. E-commerce in the US still makes up just 9% of total US retail sales -- or 20% of the retail sales we think it could disrupt. Similarly, just 19% of spend within key enterprise IT markets is in the cloud.

We're aware that it is risky to predict, still less to rely on, growth. But we take comfort in knowing that should it slow, so would the company's investment spend. The result would be much higher profit margins and levels of cash generated; not a bad outcome for shareholders.

We are comfortable with our tobacco shares

Our tobacco shares have performed noticeably less well, but we continue to think their long-term prospects are good. The market, as I noted in my last bulletin, is anxious about the prospect of tighter regulation and fears that will affect growth. We are not as concerned. These businesses have weathered tighter regulation before. And we think any new regulation will take a long time to be implemented. We also think they have room to grow.

The company has increased the price of its products on average by almost 7% per year over the past 10 years. This was well ahead of inflation and more than offset the 2 per cent annual decline in sales volumes. The company has even grown its market share in countries where it has launched its iQos vaping devices and maintained it in others. Management expect this to continue. They project sales growth of 5% per year over the next three years and are targeting US$1b of cost-saving (equivalent to a 4% increase in operating profit margins). This will translate to profit growth of around 8% each year; hardly signs of a business in decline.

Together with the healthy 5% dividend yield we expect to earn based on the price we paid, Philip Morris is likely to be a long-term holding in our portfolio.

Our portfolio

Once again, we hardly traded over the past quarter as the businesses we'd like to own were not attractively priced. We took advantage of Facebook's weak share price to initiate a position, though. Our reasoning is overleaf.

Facebook

As the world's largest social media company, Facebook has more than a billion users on each of four different platforms;

Facebook, Messenger, Instagram and WhatsApp. These platforms have strong network effects: their value to users increases as more users join. They also have high barriers to exit, as users leave behind contacts, pictures and memories when leaving. And the company has unmatched user data, which is invaluable to advertisers. Unlike most competing platforms, its content costs it almost nothing.

Though its share price has taken a pasting over its recent privacy issues, we think its competitive advantages remain intact. That makes it an attractive buy. We also think that the steps it is taking to improve safety, security and privacy -- while hurting short-term profit margins -- will strengthen it over the long term.

Furthermore, we are confident that the company will continue to increase user engagement with new products such as Instagram Stories and TV and also benefit from the structural growth in online advertising.

Top holdings as at 30 September 2018

Share	% of fund
Amazon.com, Inc	13.2%
Philip Morris International Inc	11.5%
British American Tobacco plc	9.9%
AmerisourceBergen Corp	9.8%
Allergan plc	7.7%
TJX Companies Inc	6.6%
Alphabet Inc (Class C)	5.4%
AIA Group Ltd	5.3%
The Blackstone Group	4.0%
Royal Dutch Shell plc (Class A)	3.9%

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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