



Q4 2018

January 2019 | 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 fell 14.0% over the quarter. Over the same period, the MSCI World Index fell 13.7%. The S&P500 fell 9.0% in December alone, making it the 11th-worst performing month over the past 50 years.

Since we started a year ago, the portfolio has fallen 8.9%, outperforming the MSCI World Index by 1.7%.

Why did the market fall?

Everyone seems to have an answer to this question; rising rates, trade war, weak US housing - take your pick. We're skeptical of these answers as none of these concerns are new.

Another answer is that because the stock market is forward-looking, it may be predicting an up-coming recession. However, looking at history, this is also unlikely. Over the past century, in the three months prior to a recession, the S&P500 has risen six out of ten times and in the twelve months prior to a recession, it has risen nine out of ten times.

We think the answer to the question is simpler. As Nobel Laureate and behavioral economist, Daniel Kahneman's research shows, to reassure ourselves, we try to find reasons or narratives to explain random events such as market movements. The set of narratives 'explaining' markets turned from overly optimistic in the third quarter to overly pessimistic in the fourth. And naturally the stock market collapsed.

Will the market fall further?

Clients have been asking whether they should hold off on investing because larger corrections are on the way. Again, looking at history, it's difficult to say. Of the ten times the S&P500 has fallen by 9.0% or more in a month, on five occasions it has risen immediately, on three occasions it's risen within a couple of months and on two occasions it has taken more than ten months. There's no clear pattern to it. But what's certain is that if you have a long-term horizon, buying these dips has proven profitable.

Once again, we should be aware of another mental bias which may cause us to focus on the more extreme occasions and think these are more likely this time around.

In truth, we think it's impossible to predict short-term market movements. They are completely random. And we have evidence to back this up; looking through Forbes' Top 100

Wealthiest list, we can see that no-one has grown rich by timing the market.

In fact, Warren Buffet - who is on the list and is arguably the world's greatest investor - has a poor record of timing markets in the short-term. As an example, in October 2008, he penned an opinion piece in the NY Times encouraging people to invest in US stocks as he was doing so. The market took almost half a year to bottom from this time and fell by almost a third before it did.

Our portfolio

Importantly for our clients, we don't own the market. We own a handful of shares that we think are reasonably priced. As such, we expect to have large differences in performance from the index in the short term. In fact, the close performance of our portfolio to the market has quite a large element of chance to it. Expect more divergent returns over similar periods in the future.

Of our 8.9% decline over the year, British American Tobacco contributed 7.5% as its share price halved. As we've mentioned in past commentaries, we are still comfortable owning the share. We think that concerns over potential menthol bans and nicotine limits in the US are overdone and the share is undervalued. If our estimates are correct, at the current price, the share is offering a complete return of an investment over the next ten years from dividends alone.

We took advantage of a stronger relative price in Philip Morris and sold part of our holding in the share to keep our large weighting to the cheaper British American Tobacco without using our cash. We also took profits in TJX as its share price held up, raising cash for new opportunities.

In the quarter, we made our first exit out of a holding, selling AmerisourceBergen. In October, the company admitted to fraud relating to repackaging syringes and to paying kickbacks to doctors. While we think the share is undervalued, our trust in management was shaken and we were no longer comfortable owning it.

As can be expected, with prices falling, we had a very busy quarter. We managed to invest in a few exceptional companies which we had previously found expensive. We will summarize our investment cases in two of these below. However, we do still need prices to fall further for more buying opportunities.

Microsoft

Led by new CEO, Satya Nadella, Microsoft has revived itself, making good decisions to cut investments in mobile hardware, shifting the business towards cloud technology and renewing its innovative approach. Aside from its Windows and MS Office offerings which should continue to dominate operating systems for PCs and productivity suites respectively, the company is also winning in the cloud market and building strong scale and switching cost advantages which will grow profits for a while to come.

Adobe

Adobe has a near-monopoly in content creation software with dominant applications including Photoshop, Lightroom and Illustrator. Its applications are not only the best in the industry but also have high switching costs as they are widely used throughout the industry and designers invest many years becoming familiar with them. Additionally, management have an excellent track-record of making smart acquisitions and strategic decisions to strengthen and grow the business.

Top 10 holdings as at 31 December 2018

Share	% of fund
British American Tobacco plc	11.5%
Amazon.com, Inc	11.5%
Alphabet Inc (Class C)	6.5%
Allergan plc	6.3%
AIA Group Ltd	5.7%
Blackrock, Inc	5.7%
Facebook, Inc	5.5%
Microsoft Corp	5.3%
Philip Morris International Inc	5.0%
Adobe Systems, Inc	4.8%

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