PALM CAPITAL

Q2 2019

July 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 returned 3.6% over the quarter after fees and expenses, outperforming the MSCI World Index by 0.2%.

Since we started one and a half years ago, our portfolio has returned 10.7% cumulatively after fees and expenses, outperforming the Index by 6.9%.

A large part of our outperformance is because of our higher weighting to shares in the US which have performed better than those in the rest of the developed world.

We'd like to remind you that this is still a short period of time. And in the short-term, sentiment plays a big role in share prices. Had technology shares, for example, been as unloved as our tobacco shares, our performance could easily have been reversed. A better judgment of our performance would be over a period longer than three years, when fundamentals matter more.

Our activity

Over the quarter, we sold out of our investment in Blackrock as we questioned the strength of its competitive advantages. While the company undoubtedly has scale advantages over its competitors, its passive products which account for two-thirds of its assets under management and are behind much of its growth are undifferentiated. As a result, we think fees will continue to fall, and we question whether the company's high profit margins and return on capital are sustainable.

There are dozens of other high-quality businesses with profit outlooks which we think are more certain, so we decided to take our 9% profit and look elsewhere.

We also took profits from a few of our shares that started to look expensive. Compared to our buying decisions and outright sales, this type of decision is a lot more art than science.

We know that share prices move with the profits of underlying businesses over time. Expensive shares eventually become reasonably priced again. However, we have no idea how long this will take. Furthermore, the high-quality growing businesses we like to own tend to stay overpriced for longer.

While we wait on the sidelines, our capital earns nothing. Or, if we don't wait for another opportunity, we open ourselves up to an additional risk – choosing a poor share as a replacement. Its why taking profits is a decision we often end up regretting over time. We seldom have a chance to re-invest in these good businesses at attractive prices. But as managers who look for value, we can't help ourselves.

It's tricky to find a balance between maintaining a reasonably valued portfolio and not selling out of our best investments.

Allergan

In the final week of the quarter, Allergan was subject to a buy-out offer from AbbVie. Allergan was quickly becoming one of our worst performers, and we were in a 20% loss before the offer was made. The share traded as low as 7 times its free cashflow and we even added to our investment over the quarter.

We liked Allergan because of its large aesthetics portfolio which has steadily growing revenue from brands like Botox and Juvederm. This portfolio isn't subject to patent cliffs, giving its revenue more certainty compared to its pharmaceutical peers.

For each Allergan share, AbbVie plans to pay owners $120 in cash and 0.9 shares in the new company. Interestingly, this values Allergan at half of what Pfizer was willing to pay for the company in 2015.

Although we think both shares are undervalued, we don't think AbbVie is a high-quality business. Almost 70% of its profits come from a single drug, Humira, and the company doesn't have a strong track record of innovation. In addition, Allergan's defensive aesthetics portfolio will now make up less than 10% of the new company. There's thus a lot of uncertainty in its future profits and valuation.

We'll look to sell our holding in Allergan as close to AbbVie's offer price as possible.

While we aren't finding many buying opportunities, we continue to add to our coverage of high-quality businesses. We'll be setting up meetings to discuss these with clients in the coming weeks.

Top 10 holdings as at 30 June 2019

Share	% of fund
British American Tobacco plc	10.3%
Amazon.com, Inc	8.6%
Allergan plc	7.7%
Booking Holdings Inc	6.4%
AIA Group Ltd	6.1%
Microsoft Corp	5.7%
Alphabet Inc (Class C)	5.6%
Facebook, Inc	5.0%
Philip Morris International Inc	4.8%
Royal Dutch Shell plc	3.6%

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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.