PALM CAPITAL

Q3 2019

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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 0.0% over the quarter after management fees and trading expenses, underperforming the MSCI World Index by 0.1%.

Since we started, close to two years ago, our portfolio has returned 10.7% in US$ cumulatively after fees and expenses, outperforming the Index by 6.8%.

As a reminder, this is still a short period as far as equity investing goes. And because our fund is concentrated, we could just as easily vastly underperform the index over other similarly short periods. Furthermore, a large part of our outperformance is attributable to our higher weighting to US equities that have performed better than those in other developed markets in the Index.

Private vs Public Equity

A few of our clients have mentioned that they prefer to invest in Private Equity or private companies rather than publicly listed ones. We're not surprised. Many studies have shown that Private Equity has outperformed public equity markets over the past few decades. And because investing in private businesses is open to fewer investors and typically gives investors influence over these businesses, this exclusivity and control creates the perception that returns ought to be higher.

It's not only the potential for higher returns that convince clients. Because investments in private businesses are priced infrequently, they are less volatile than public equities and this creates the perception that risk is lower.

But we'd like to point out that this picture isn't complete.

Private Equity deals typically involve high levels of borrowing against the acquired companies. They're also often dependent on successful turnarounds. While these can enhance returns, they also increase the risk of failure. The bankruptcies of Toys 'R' Us or TXU Corp are good examples of this.

Private companies also tend to have poor disclosure. Their financials are typically unaudited and lack public scrutiny, giving management leeway with accounting practices. And they often are short on the detail and history needed to fully understand their profit drivers. This increases the likelihood of valuing private businesses incorrectly and, as a result, of overpaying.

And private companies tend to have weak governance structures. This increases the risk of mismanagement.

On the other hand, in addition to typically having lower levels of debt, better disclosure and better governance, listed equities have a few other advantages over Private Equity.

They are more liquid, allowing investors to build or exit positions quickly. By contrast, it can take a few years to build a position in a private business or to build a portfolio of them.

As listed equities are divisible, this makes it easier for investors to diversify their investments. On the other hand, Private Equity deals tend to be so sizable that they could make up most of a small investor's portfolio.

Investors in listed equities have a pick of almost every type, size and quality of business to invest in, in every industry in nearly every country, on almost a daily basis. In Private Equity, the range and quality of investment opportunities available is limited and depends on the strength of the networks of the people sourcing them.

And finally, for patient, disciplined investors, the short-term volatility of listed equities is, in reality, an advantage. It means that every so often, markets correct or share prices fall, presenting opportunities to invest in exceptional businesses with already great management teams at attractive prices.

As we often repeat, the return an investor earns from an investment depends on the price paid relative to its value or its future profits. And it's important to note that a large contributor to Private Equity's outperformance in the past is the multiples that deals occurred at. These have typically been much lower than the multiples publicly listed companies trade at. However, this is changing. The recent flood of new capital into private equity has raised multiples to record highs. So, aside from potentially higher risk, it's unclear if returns from Private Equity will even be as high in future.

Blackstone

We think that a good way to benefit from the potential returns from and growth of Private Equity while taking on less risk is by investing in a publicly listed Private Equity firm.

Blackstone, one of the first investments we made in this fund serves as an example. As the largest and one of the oldest Private Equity firms in the world, its scale, reputation and track record are competitive advantages in attracting capital. And its network, experience and expertise increase its likelihood of making successful deals.

The firm's profits are linked to the profits from the deals it makes. And because these number in the hundreds, this reduces the risk from overexposure to a single deal. Additionally, a substantial portion of the firm's profits are from management and other fees that are independent of the performance of their investments. So, the firm still profits if performance is poor.

Furthermore, the business is capital light, requiring little shareholder capital to grow and is run by an exceptional management team that is strongly aligned with long-term shareholders.

Blackstone has been one of our best investments so far. Its yielded almost 50% including distributions since we invested in it.

Our activity

We hardly traded over the past quarter as we found few opportunities. Our cash holdings at 26% of our portfolio are still large.

However, towards the end of the previous quarter and into the current quarter markets have pulled back. And this time around, many of the shares we like but thought were expensive have been falling by more than those that weren't. This is good news.

While corrections hurt our short-term returns, they give us an opportunity to invest at prices that yield good long-term returns. We hope the correction continues.

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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.