INVESTMENT MANAGER COMMENTARY

PALM CAPITAL

Q4 2019

January 2020 | 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 30.0% in US Dollars over 2019 after management fees and trading expenses. Our return for the last quarter was 7.0%.

Since we started, exactly two years ago, our portfolio has returned 18.5% in US$ cumulatively. We have outperformed our benchmark by 5.7% over this period.

Period	Our Return$^{\lambda}$	MSCI World	Outperformance
Q4 2019	7.0%	8.2%	-1.1%
2019	30.0%	25.2%	3.9%
Since inception	18.5%	12.1%	5.7%

$^{\lambda}$after management fees & trading expenses

Although our return over the year was impressive (especially considering that we held around 20.0% of our portfolio in cash that earned less than 1.0%), we aren't holding our breaths for a repeat.

If we think of the price of a share as the profit per share of the underlying business times a multiple representing how much the market is willing to pay for it, then we can decompose changes in prices over a period into changes in profits and changes in multiples. In 2019, the profits of the businesses we owned grew on average by 13% in US$. And a change in multiple accounted for the rest of our return.

Multiples change erratically over short periods such as a year. They move with narratives, sentiment, macroeconomics and politics. These factors are unpredictable.

Over longer periods however, multiples are mean reverting. This means that while we expect the businesses we own to continue to grow their profits at rates well above inflation, we're less likely to witness as big an increase in multiples from these levels as we did in 2019.

Process matters more than outcome

Profits and multiples are more predictable the longer the time horizon. It's therefore important to assess an investment manager's performance over long periods of time when judging their ability.

However, because there is still a level of uncertainty over long periods, there's still an element of luck in long term performance. It's therefore even more important to analyse an investment manager's process than her returns when judging her ability. This would entail, for example, assessing how sensible and repeatable her process is and investigating how closely she follows it.

So, what return do we expect to earn?

The return we expect to earn from a business depends on the price we pay for it relative to its future profits[1]. At Palm Capital, we only invest in a business when it is priced to offer us a potential return of 9.0% or more in US Dollars over a period of ten years or longer.

However, estimating a business's future profits is inherently uncertain. We will undoubtedly make mistakes and fail to anticipate factors that disrupt these cashflows. We can mitigate this to an extent by being conservative with our assumptions, allowing for a margin of safety, selecting only better businesses with profits that we can forecast with higher certainty and limiting our portfolio's exposure to any single business. Nonetheless, our errors will likely reduce our potential return to around 7.0% to 8.0% per year over the long term.

Of course, given the erratic behaviour of share prices over short periods, we don't expect to earn this return in a straight line. Some years - like 2019, will be better than others.

The good news from 2019 is that most of the businesses we own grew their profits by more than we expected. And more importantly, the majority continued to make decisions that maintained or grew their advantages over the year.

Our activity

Over the quarter, we reduced our investment in AIA. The share was one of our first investments. AIA's unique approach of prioritising business that is sustainable over the long term has enabled it to build a competitive advantage in its

[1] Our preferred metric for profits is free cashflow per share. Free cashflow is the cash an owner can take out of a business without affecting its ongoing operations. It is calculated as cash operating profit less interest, taxes, capital expenditures & working capital investments.

salesforce. It writes the highest quality of business in the region, as evidenced by its low policy lapse rates and high profit margins.

While this is not as strong an advantage as the intangible assets of a credit bureau like Equifax or the network effect of YouTube for example, we think it will take a competitor many years to replicate this sales approach. It would require a change in culture and patient shareholders. And given the surging demand for life cover in Asia and in China in particular, competitors have little reason to try.

AIA is perfectly placed to benefit from this growing demand. The company's new business volumes have been growing at double-digit rates over the past few years and are gathering momentum. An ageing population and increasing per-capita income will continue to fuel this growth.

While neither the quality of AIA’s sales nor the demand for life cover have changed, we are concerned about the impact on the company of the protests in Hong Kong where half of its new business volumes are from. Most of these sales are to Chinese mainlanders who view Hong Kong as a haven for their financial assets. Chinese mainlanders will still have growing life cover needs and will likely still prefer to purchase this outside of China. But although AIA has a strong presence in a many of the cities that this demand may shift to, there are some, e.g. Tokyo where AIA has little or no presence.

We think that there is a chance that this affects the company’s future sales and profits and more importantly its fundamentals and we therefore decided to reduce our exposure. Our investment in the company earned us a return of 28% in US Dollars to date.

Even though AIA’s share price continued to rise after our sale, we’re happy with our decision. And we will still be happy with our decision even if our concerns prove unfounded and we don’t have another chance to invest in the share at an attractive price. It’s an example once again highlighting the importance of judging the process and not the outcome. And in this case, we believe that we’ve followed our process and taken a prudent decision.

Over the quarter we also started building new positions in three companies. We’ll share our thoughts on these in future commentaries.

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