PALM CAPITAL

Q1 2020

April 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

Over the quarter ending 31 March 2020 our portfolio fell by 7.8% after management fees & trading expenses. Over the same period our benchmark, the MSCI World Index, fell by 21.4%.

Since we started, just over two years ago, our portfolio has returned 9.2% in US Dollars cumulatively after management fees & expenses. We have outperformed our benchmark by 24.0% and the S&P500 by 13.0% over this period.

Period	Q1 2020	Since inception
Our Return$^{\lambda}$	-7.8%	+9.2%
MSCI World	-21.4%	-11.9%
Outperformance	+17.4%	+24.0%

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

The value of a business is the sum of its likely future profits valued at an appropriate discount rate. Future profits are inherently uncertain. And this uncertainty is higher for some businesses than for others. So, the value of a business lies in a range and is never a single number. For businesses where profitability is less clear, such as those that have commoditised sales, weak competitive advantages, lots of debt, high levels of fixed costs or are in decline, this range is very wide.

The Coronavirus outbreak has shone a spotlight on the uncertainty, or risk, inherent in these poorer businesses. Most of the difference in our performance versus the market over the quarter is attributable to us not owning these types of businesses. It once again highlights a point we often make – the risk in our portfolio is lower than that in the market. And this risk isn't measured by volatility of share prices but rather by the strength of the underlying businesses.

The second reason for our outperformance was our large cash balance. At the end of the previous quarter, this totalled 25% of our portfolio. And in January, we added to this by trimming a further 5% of our equity positions. We didn't hold such a large cash balance out of a prescience of the coming market collapse. Rather, it was the natural outcome of our approach – none of the high-quality businesses we wished to own were attractively priced. And the ones we did own were starting to look frothy.

Make no mistake, the timing of our cash balance was fortuitous. Had the virus outbreak not occurred, there's no knowing if the market would have corrected when it did. We could have been reporting very different quarterly returns.

An approach for all seasons

The impact of the virus outbreak on economies and businesses is still unclear. We don't know when it will be contained, when a vaccine will be developed, or herd immunity reached. And the longer it takes for any of these to occur, the more that businesses and economies will struggle. This effect is more pronounced the weaker the business or economy.

What we do know is that the world will overcome the virus. Strong businesses will survive and take up market share left behind by the weaker ones that don't. And the virus outbreak will continue to accelerate disruption and behavioural change. The growth of e-commerce, the shift to the cloud and cashless payments and the use and entrenchment of social media are all being sped up.

We think that owning businesses that are more likely to survive the virus and grow their advantages and market shares, as we do, is the best strategy for all likely scenarios.

Our activity

The past quarter was our busiest since we started our fund. As we have no skill in timing the market, we started investing in the businesses we like the most at levels reflecting our worst-case valuation estimates. Some of these new additions to our fund were businesses we had coveted for a long time but never had the opportunity to invest in at attractive prices.

While we may likely have been early and markets may continue to fall over the next few months, we'll happily give up the short-term pain of seeing our portfolio fall for the excitement of the long-term gains that we know will result from investing in the best businesses around at attractive prices.

As our clients will know, we've been invested in the tobacco shares, British American Tobacco and Philip Morris, almost since the outset of our fund. In the early days when we were still building up our coverage, these businesses looked to us to be some of the best around. As we've evolved in our thinking, we've come to question whether businesses that harm their customers and society, such as these, could be as strong as we had thought.

At a point during the market collapse in March, we took the opportunity to switch out of these two shares into better quality businesses. While we may have replaced businesses trading at larger discounts to their worth with those trading at smaller discounts, it reflects our thinking that the quality of a business is what matters more to long term gains. It's another case of short-term pain for long term gain.

9% of our portfolio is still held in cash and we think that this sets us up well to take advantage of any further falls in the market.

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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.