PALM CAPITAL

Q3 2020

October 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 three months ending 31 September 2020 our portfolio increased by 4.3% after management fees & trading expenses. Over the same period our benchmark, the MSCI World Index, increased by 7.5%.

Since we started, almost three years ago, our portfolio has returned 35.1% in US Dollars cumulatively after management fees & expenses. We have outperformed our benchmark by 20.0%.

Period	Q3 2020	Since inception
Our Return$^{\lambda}$	+4.3%	+35.1%
MSCI World	+7.5%	+12.5%
Outperformance	-3.0%	+20.0%

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

The 'value' vs 'growth' investing debate

The most important determinant of the return from an investment is the price paid relative to its value. It's no wonder that the words 'value' and 'investing' go so well together.

So, how is it that value managers and value indices have underperformed other styles of investing for such a long period of time?

The answer is simple. It's because of an incorrect definition of value investing. Most commentators, investment managers and index providers have defined it as investing in low Price-to-Earnings (P/E) and low Price-to-Book (P/B) shares. The assumption is that the historic earnings or book value of a company are good proxies for its value and prospective returns. The problem, however, is that these are accounting measures that differ from the true determinant of value – the actual cash profits that can be paid out to owners. Additionally, these metrics represent a point in time in the past and do not reflect the future. And lastly, because accounting standards differ by industry, they cannot be used to compare different businesses.

A business that converts a large proportion of its accounting earnings into cash profits should naturally trade on a higher P/E multiple than one that converts a lower proportion. The same applies to a business that has high prospects for growth. Similarly, businesses that amortise or expense investments in their most important assets have lower earnings and book values and should also have higher P/B ratios than businesses that capitalise these investments.

So, while a business trading on a low P/E or P/B may be cheap, it's more likely that it has a low conversion of earnings to cashflows, poor growth prospects, is capital intensive, or faces structural challenges. In other words, a poor business with an uncertain outlook.

As a result of the incorrect definition of value investing, value indices and value funds are mostly made up of these businesses.

For example, a quick search with the low P/E and P/B criterion returns oil companies, telecommunication companies, automakers and banks. Each of these industries is facing structural challenges making their outlooks very uncertain. Additionally, these companies have either weakening competitive advantages with falling profit margins or are dependent on factors outside of their control such as oil prices or interest rates. Forecasting cashflows to value these businesses is a very uncertain task.

On the other end of the spectrum, high P/E and P/B multiples may indicate expensive companies. But they may also indicate a company with a high conversion of earnings to cash, good growth prospects, a more certain outlook or one that needs little capital and physical assets to grow. In other words, a good and growing business.

A quick search with this criterion returns many online businesses and software providers. These businesses have been growing very quickly and, underpinned by a digitizing world, still have long runways of growth ahead. The search also returns many royalty-type businesses. These all tend to have high recurrence of revenue, dominate their industries, generate lots of cash and need little capital to grow.

Judging the value of these better businesses based only on their high P/E and P/B multiples is certainly incorrect. Just because they are growing quickly or are capital light does not make them expensive.

In fact, we would go one step further in this debate. We believe that the higher quality characteristics of these businesses mean that we are more likely to value them correctly – making them more suitable for value investing than poor businesses.

But, as a result of the incorrect definition of value investing, value indices and value funds have not included and will likely not include these businesses for some time to come.

It therefore isn't any wonder that 'value' investing has underperformed. Better businesses that are growing quickly have created more value for shareholders than poor businesses with uncertain outlooks.

As with much else in the financial media, we think that this debate of 'value' vs 'growth' investing is pointless and flawed. And while our approach doesn't fit the finance industry's misconstrued definition of value investing, we do think of ourselves as value investors.

Our activity

Over the past quarter, we did not place any trades.

As discussed with our clients, we did however uncover two exceptional businesses that we were able to add to our watchlist. While both proved to be beyond our reach throughout the period, given our patient approach, we know that we will be able to invest in them at attractive prices at some point in the future.

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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.