PALM CAPITAL

Q4 2020

January 2021 | 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 December 2020 our portfolio increased by 5.0% after management fees & trading expenses. Over the same period our benchmark, the MSCI World Index, increased by 13.6%.

Since we started, exactly three years ago, our portfolio has returned 41.8% in US Dollars cumulatively after management fees & expenses. We have outperformed our benchmark by 10.9% cumulatively or by 3.5% per annum.

Period	Q4 2020	1 year	3 year (annualised)
Our Return$^{\lambda}$	+5.0%	+19.7%	+12.3%
MSCI World	+13.6%	+14.1%	+8.5%
Outperformance	-7.6%	+4.9%	+3.5%

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

A three-year milestone

Good investment returns are the result of both skill and luck. A manager can have a sound process and apply it well, but his performance will still partly depend on factors outside of his control. However, the role that this 'luck' plays decreases the longer the investment period. So, it's important to judge performance over the long term to understand a manager's skill or the repeatability of his process.

Three years is still a short period relative to our investment horizon of 10^{+} years. However, we are nearing the point at which our performance provides some validation of our investment skill. So far, we have managed to beat the benchmark index while taking on less risk - by investing only in exceptional businesses, doing so at discounts to their worth, holding a fair amount of cash (an average of 30% of our portfolio since we started) and making few decisions.

Our differentiation

We are often asked by potential clients about our differentiation. There are lots of other investment managers out there, many of whom are smarter than we are, have more resources at their disposal and even have similar holdings in their portfolios. So, how do we expect to perform better?

Our response is that the source of our advantage is not intellectual, but rather behavioural. And it stems from differences in our objectives. Let us explain.

Most investment managers' primary aim is to win assets. This forces them to constantly come up with new ideas and to trade often in an attempt to generate excitement and good short-term performance. But making more decisions increases the likelihood of error. Looking for new ideas forces them to consider poorer businesses that are more difficult to value. And because share prices move mostly with unpredictable factors over the short-term, focusing on this period requires them to forecast things that they have a low likelihood of getting right.

As the main goal of most managers is to beat an index benchmark, their primary measure of risk is underperformance of the index as opposed to protecting or growing client assets. They may invest in a poor-quality business that they don't like at 3% of fund because it is 6% of the index as this reduces their risk of underperforming if its share price increases.

Instead, our objectives are different. Our primary aim is to compound the real wealth of clients, i.e., to comfortably beat inflation over the long term. Our measure of risk is therefore the probability of losing capital. We therefore only look for those businesses that we think we have the greatest chance of valuing correctly and which will grow in economic value over time.

And we aren't set up to chase assets. This allows us to take longer term views, only make calls on things we think we have a high chance of getting right and to make fewer decisions, reducing the likelihood of error.

In other words, our competitors are playing a different game. As a result, they are running a lot harder, we would argue, to stay on the same spot. And their strategy may be great to win assets but is not great for compounding client wealth over the long term.

A lesson we have learnt

The biggest mistake we have made over the past three years has been our hastiness in trimming our investments when they reach our estimate of their worth.

Because our investment approach is to consider only the best businesses and invest in them only when they are attractively priced, we seldom have opportunities to invest. There are few good businesses around and even fewer times when they trade at attractive prices. So, when we are quick to sell, we are left with a cash holding that acts as a drag on performance.

Our lesson from this is to be as patient selling as we are buying. Our quarter to quarter and year to year performance may suffer as a result, but importantly, our return on our initial capital will benefit. A few months ago, we created some rules to help us implement this and fight our inner 'value' investor and so far, they seem to have worked well.

'Big tech' and regulation

Our investment approach leads us to companies that have strong advantages over competitors and are in industries with high barriers to entry. These companies typically dominate industries or niches. And as a result, the greatest threat that many of them face is from regulation.

The 'big tech' companies we own - Amazon, Alphabet and Facebook are currently facing significant regulatory scrutiny. They are being investigated in a number of countries for their dominance and some of their practices.

We cannot be sure how this will play out. However, we have not sold out of these businesses for two reasons.

The first is that the most likely regulatory action is a forced break-up of the businesses. And we think that this has the potential to unlock significant value from operational improvements in the underlying businesses once they must stand on their own and from an improvement in capital allocation. Ultimately, we think that in this case, the sum of the parts is more valuable than the whole.

The second reason is that not only are these some of the best businesses around as they have strong advantages, have lots of room to grow and need little additional capital to do so, they are also reasonably priced. And not to forget, our entry costs were much lower (almost half) than their current prices.

Nonetheless, the three shares made up 16% of our portfolio at the end of December and we are looking out for any indications that the course of regulation will be more detrimental to our investment cases, in which case we will review our decision.

Our activity

We have not bought any shares since March of last year. Not only are all of the shares we would like to own either overpriced or not offering a sufficient margin of safety, we also think that the optimism since the COVID-19 vaccines announcements is overdone.

There is still much that is unknown about the virus. How long will it take for the developed world to roll out the vaccines? When will the developing world get access to them and how will they roll them out? Will the virus mutate to render the vaccines ineffective before then?

These are all important but difficult questions to answer. The outlook is murky at best. We are happy to spend the time trying to uncover investment opportunities while ignoring all the noise and short-term market movements and waiting patiently for the right time to invest.

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