PALM CAPITAL

Q2 2021

August 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.

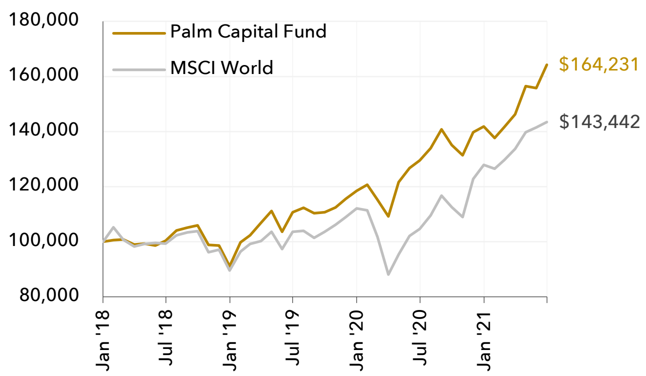
Our performance

Over the three months ending 30 June 2021 our portfolio increased by 12.3% after management fees & trading expenses.

Since we started, three and a half years ago, our portfolio has returned 15.2% per annum after management fees & expenses. We have outperformed the MSCI World Index by 3.9% per annum while holding better businesses and buying them below their worth.

Period ending 30 June 2021	Our Return$^{\lambda}$	MSCI World	Out-performance
Quarter	+12.3%	+7.3%	+4.7%
1 year	+26.8%	+22.9%	+3.2%
Since inception (annualised)	+15.2%	+10.9%	+3.9%

Growth of $100,000 investment



Volatility is a poor measure of risk

Risk is arguably the most misunderstood part of investing. Backed by academic theory, it has become synonymous with volatility of market prices. As a result, shares are seen as risky because they are volatile. And the more volatile an individual share is the riskier it is seen to be. But this is a misinterpretation of risk. We will use two examples to explain why.

If you're saving up for a holiday in a year's time, it is risky to invest this money in equities because share prices are unpredictable in the short term. You may lose some of this money. And it's less risky to keep it in cash because cash is steady.

On the other hand, if you're saving for retirement in ten years' time, it's risky not to invest in equities as these offer your best chance of growing your savings. It is risky to invest in cash as this will not grow your savings.

In the first example, equities increase your risk and cash reduces it, while in the second, the opposite holds true. So, risk depends on your objectives and may be unrelated to volatility.

But even in the first example, for investors with short time horizons, where it may seem sensible to use volatility as a measure of risk, its value is questionable. The past volatility of a share has very little predictive power because share prices move randomly in the short term. A good example of this is the forced selling and resultant spike in volatility of shares held by Archegos Capital after its recent collapse. This was unrelated to the underlying businesses and the volatility could not have been predicted. And while this may sound like an extreme example, more moderate factors similarly unrelated to underlying businesses drive share prices on a daily, monthly, and quarterly basis. So, a share with low volatility in the recent past may experience high volatility in the near future or vice versa. It's impossible to tell.

And in the second example above, for investors with long time horizons, not only is volatility an inappropriate measure of risk, but it can actually be used to your advantage to enhance your returns, i.e. it can lower your risk.

Yet short- and long-term investors alike have become obsessed with volatility. Measures such as standard deviation, maximum draw down and correlation are central to their decision-making process.

So, what is risk and how do we measure it?

As the examples above make clear, risk is the likelihood of not meeting your investment objective.

At Palm Capital, our objective is to sustainably grow our wealth well above inflation over the long term. Investing in equities gives us our best chance of doing this. And, because share prices move with the profits of a business over the long term, our biggest risk is therefore being wrong with our expectations of profits. These, in turn, depend on the fundamentals of businesses – their competitive advantages, their economics, the strength of their management teams and their growth prospects. Which means, in effect, that we think of risk as business risk. (As an aside, it is why we consider ourselves to be business analysts rather than share or financial analysts).

Now, it's important to note that the fundamentals of businesses that drive this risk are mostly qualitative. They can't be distilled into a single easily observable quantitative metric such as volatility. Instead, to understand them and the risk in our portfolio you must understand the strength of the underlying businesses and how we choose them.

Our approach to choosing shares is simple. We consider only the best businesses in the world. These are ones that we think have the highest certainty of future profits. They are highly differentiated, are in industries with high barriers to entry, are capital light and have recurring revenue.

Examples to show how we think of risk

We will explain further with some practical examples of businesses we consider and those we don't.

We don't invest in banks. It's difficult for one established bank to differentiate itself from another. This results in low profit margins. These are not necessarily bad for a defensive business. But for a business such as a bank that has lots of debt, has high fixed costs and is dependent on economic and credit cycles, a small change in interest rates or bad debt has a magnified impact on future profits. The timing and length of these cycles and the bank's navigation through them are all difficult to predict. There's therefore high uncertainty around its revenue and profits.

Instead, we do invest in credit data bureaus. Equifax, for example, is a share that we owned for a long time. The data these bureaus have is unique. It takes decades to build up. Their customers can't make their most important decision – lending – without this data. And the cost of this data is low relative to the value of the loans being made. These factors all result in attractive profit margins and give the bureaus an ability to raise prices above inflation. Furthermore, customers typically get data from more than one bureau to cross check it, so bureaus aren't incentivized to undercut each other on prices.

Because these businesses are capital light, they need little debt to operate. So, while their revenue is dependent on the economic and credit cycle, low levels of debt, high profit margins and the uniqueness of their business models mean that profits are less easily disrupted and less sensitive than those of banks. Equifax stands apart because it is building up data in other areas such as employment records that reduces its dependence on the credit cycle even further.

We also don't invest in pharmaceutical companies. While revenue and profits are protected by patents, their future revenue depends on how quickly their drugs are copied once they fall off patent and the success of their R&D. Both are unpredictable.

Instead, we prefer to invest in companies that sell testing equipment and related consumables to the industry. Waters, for example, is a share that we have watched for years and would like to invest in at the right price. The company's instruments are critical to the production and development of drugs and are the gold standard in the industry. Furthermore, they are often included in the patent applications of customers. This trust and reputation take years to build, resulting in high profit margins. At the same time, it also means that even when a drug of their customer falls off patent, the manufacturers of the generic version are likely to continue using the same instruments as these were already approved in the original application. So, the company's revenues and profits are less dependent on patent cliffs or the success of R&D than those of pharmaceutical companies.

A final example of our thinking is in the semiconductor industry. Because of the extreme complexity and significant costs in the manufacturing process, the industry has become highly specialised. It has fragmented into three types of companies – the designers of chips, the manufacturers, and those that make equipment for the manufacturers.

Revenue for designers is somewhat stable because of patents. And even when patents expire, designs are not easily copied, and customers don't easily switch because this would typically involve a redesign of their product and the risk that the new design does not work as well. However, revenue is still dependent on the length of the lifecycle of end products they are used for, how long it takes for those products to be replaced with new technology and the success of designers' R&D into new designs. So, while near term revenue and profit margins are typically stable, medium to long term revenue and profits are uncertain. And the large customers in this industry such as Apple, Google and Amazon are all beginning to design their own chips, raising this uncertainty.

The significant cost and complexity of manufacturing chips has turned manufacturing into an oligopoly with TSMC and Samsung dominant. Designers need the manufacturers. So, manufacturers aren't as exposed to new technology or product lifecycles as the designers.

This gives them more certainty of revenue over the medium term compared to designers. However, their long-term success is dependent on their ability to keep their lead at the bleeding edge. And the rivalry between the two large players is fierce limiting pricing power. Coupled with the considerable level of fixed costs, this creates high uncertainty in long-term profits.

On the other hand, revenue and profits for the companies that design and manufacture equipment for the manufacturers are steadier. An example of a company we like in this space is KLA. KLA provides tools and solutions to help manufacturers monitor and improve their highly complex manufacturing process and reduce costs. These are critical services to the manufacturers. Their tools are found in every major manufacturer globally. And the uniqueness of these tools is evidenced by KLA's market share which is more than four times its nearest competitor. Regardless of which design is successful in the future or which manufacturer manages to take the lead, KLA's tools will almost certainly still be needed. Its revenues and profits are less affected by technological change and therefore less uncertain that that of the designers and manufacturers.

While there are good companies along the entire value chain of the industry, we think that business risk in an equipment provider is the lowest.

In the three examples above, it's worth pointing out another aspect of risk that is also misunderstood – that of company size. Credit bureaus, testing companies and semiconductor equipment companies are typically smaller than their customers – the banks, pharmaceutical manufacturers, and semiconductor manufacturers. But they face less business risk. In fact, by shielding them from regulatory scrutiny, their size to an extent reduces their business risk further. It also makes them less popular amongst the investment community, meaning that they are more likely to be mispriced from time to time, giving us opportunities to further reduce our investment risk.

So, while a portfolio consisting of well-known and established businesses such as JP Morgan, GlaxoSmithKline and TSMC may appear to have little business risk, a portfolio consisting of Equifax, Waters and KLA would in fact have even less. This highlights the importance of knowing and understanding what you own.

It's important for investors to judge returns against the risk taken on to achieve them. And because investment risk is a likelihood, it cannot be calculated as easily as returns. An investment in a business with high risk may result in very high returns but this would be a poorer outcome relative to an investment that had lower returns but took on much lower risk.

While we are pleased with the returns that we have achieved to date, we are more pleased to have achieved these while taking on little risk.

Our activity over the quarter

Over the quarter, we took advantage of weak prices in the software-as-a-service businesses to add to our positions. Following better than expected financial results from Amazon, Alphabet and KKR, we increased our valuations in all three and took advantage of the resultant higher discount to fair values to also add to our positions in all three businesses.

The businesses we own in our portfolio are some of the best businesses globally and we are very comfortable with the portfolio's risk relative to its expected returns from this point forward.

Disclosures: This document is for information purposes only and does not constitute investment advice. All portfolio data is obtained from Direct Market Access (South Africa). All calculations are carried out by Palm Capital (Pty) Ltd. This fund not open for client investments and this commentary is only provided for illustration purposes. Potential clients should please contact Palm Capital (Pty) Ltd for more information regarding the investment of their monies on a segregated basis. Potential clients should also obtain independent investment and tax advice before investing with Palm Capital (Pty) Ltd on a segregated basis.

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