INVESTMENT MANAGER COMMENTARY

PALM CAPITAL

Q1 2022

April 2022 | 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

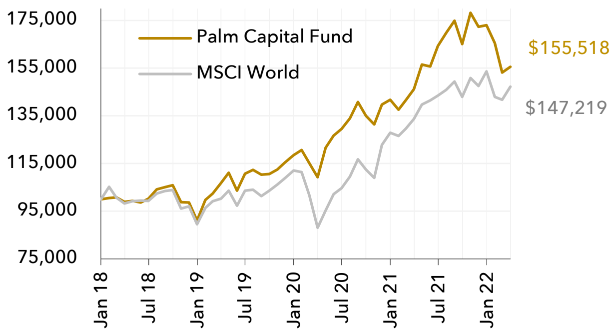
Over the three months ending 31 March 2022 our portfolio fell by 10.1% after management fees & trading expenses.

Since we started, just over four years ago, our portfolio has returned 11.0% per annum after management fees & expenses. We have outperformed the MSCI World Index by 1.3% per annum while holding better businesses and patiently waiting to buy them below their worth.

Period ending 31 March 2022	Our Return[λ]	MSCI World	Out-performance
Quarter	-10.1%	-4.2%	-6.2%
1 year	+6.4%	+10.1%	-3.4%
Since inception (annualised)	+11.0%	+9.5%	+1.3%

[λ]after management fees & trading expenses

Growth of US$100,000 investment



The future is never clear

Right now, the future appears murkier than ever.

The world's largest nuclear power, Russia, is deeply entrenched in a war that could engulf NATO. China's government is pursuing city-wide COVID lockdowns at a time when its economy and financial markets are already reeling from a real estate debt crisis and a regulatory crackdown on a range of companies. Commodity prices have spiked. In the developed world inflation is increasing at the fastest pace in 40 years. And the US Fed is raising interest rates by the most in over 20 years.

We think that it is impossible to tell how these things will play out.

Take high inflation, for example. It is unclear how much of it is due to temporary as opposed to structural factors.

The COVID pandemic resulted in shortages, port congestion and labour market frictions, disrupting supply chains and pushing up prices. As consumers spent more time at home and received subsidies from government, they spent more on durable goods exacerbating these issues. And once lockdowns were over, pent-up consumer demand for certain goods and services added to these pressures. More recently, the war in Ukraine and the West's subsequent sanctions on Russia have severely disrupted commodity markets. These drivers of inflation are mostly temporary.

At the same time, high inflation is also due to structural long-term factors such as an underinvestment in raw material exploration and the de-globalisation of supply chains.

It's difficult to differentiate the relative impact of these short and long-term factors.

To complicate this further, even if most of high inflation is due to temporary factors, it's impossible to know if short term inflation causes a wage-price spiral where the perception of higher future prices feeds the demand for higher wages that feeds back into prices like we saw in the 1970s. This would cause temporary inflation to drag on for longer than expected.

And if a large part is due to structural factors, the long-term outlook is complicated by the impact of technology on productivity. Increases in productivity could alleviate some of the structural drivers of inflation by keeping unit labour costs stable and moderating inflation.

Finally, if you do manage to accurately forecast the interplay of those variables, you then need to consider the impact of a possible recession on inflation. There are signs that the increases in interest rates are already impacting the US consumer. Home inventories and consumer credit are both rising. And higher inflation is starting to bite with many companies announcing hiring freezes. A recession will slash inflation.

As you see, inflation - like other macroeconomic and geopolitical factors - is extremely difficult to forecast. So, while we keep abreast of these factors, we don't spend our time trying to predict them.

Instead, we search for businesses that are likely to survive and thrive in all conditions. These are ones that provide unique and critical products and services to their customers, have strong balance sheets, are profitable, growing, run by strong management teams, and attractively priced.

Our technology exposure

Over the past two decades, advances in computing technology have revolutionised the world and have had a profound impact on the way business is done. It's therefore no surprise that the market has mispriced many businesses on the front line.

Some exceptional 'tech' businesses have been underappreciated and undervalued for a long period of time. We've previously written about the rise of the 'winner takes all' model that has benefited companies such as Alphabet, Amazon and Meta Platforms and the Software as a Service model that has benefitted companies such as Microsoft, ServiceNow, Salesforce and Adobe. These are amongst the strongest business models around. Over the time that we have been investing, these businesses have also been the most attractively priced. And for this reason, a large part of our portfolio has been allocated to them.

At the same time, the market had also overvalued many weak 'tech' businesses that had no uniqueness in their business models and were unprofitable. This situation was pushed to an extreme during the COVID pandemic. Work-from-home distorted the earnings of many of these tech companies that were beneficiaries. To add to this, the Fed's stimulus cheques and lockdowns turned bored individuals into market speculators. It inflated a bubble that was defined by meme stock crazes and crypto mania.

With a return to the office, inflated earnings are now being normalised downwards. At the same time, money is being sucked out of the markets as stimulus cheques come to an end and the Fed raises rates. Liquidity has dried up – as is clear from the wild price swings on even the largest shares. The bubble has popped. And it has dragged down the entire tech sector. The 'tech' businesses we own, which do have exceptionally strong business models and are very profitable haven't been spared. And while these businesses will be affected by high inflation and a slowdown in the economy, their strong advantages should allow them to weather this storm better than most.

The future is never clear. But heightened uncertainty creates opportunities. A quote by Warren Buffett sums this up best:

" you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."

The correction has created an ideal investment opportunity which we have taken advantage of by deploying all our cash holdings. While prices may fall further, we have no way of knowing whether this will be the case. However, we are confident that investing now will yield attractive returns over the long term.

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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.