BLUEBOAT

FY18 provisional results

We're proud to report our first provisional full year financial results for Blue Boat Investment Trust which we believe are well above satisfactory. For FY18 we achieved a gain of 41.7%, well in excess of the general market.

Our results alongside some of the major indices are presented below (*Please note - These figures are provisional and subject to finalization with our accountants, Bentleys)*:

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 30 June 2018:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	S&P 500	MSCI World
FY18	41.7%	32.8%	13.1%	18.8%	15.9%
Since Inception	43.5%	34.3%	11.2%	21.9%	20.3%

Returns presented in AUD. Index returns include reinvested dividends.

From $1.00 at the April 2017 inception, the closing unit price has grown to $1.304, plus gross distributions of $0.009 for FY17 and $0.108 for FY18.

The difference between the Gross and Net returns shown in the table above represents the fees charged. Almost all of this is performance fees, representing a win-win outcome for both manager and investor. A full account of the fees is set out in the Appendix.

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Overall the general market conditions in FY18 were favourable, with returns to major indices generally above their long-term averages.

Throughout the year there have been many gloomy headlines concerning trades wars, dysfunctional politics and even nuclear spats, but behind it all corporate earnings have been strong in the markets we're exposed to. Volatility was higher than we saw in previous years, something we believe will be an ongoing trend in markets which we will be watching closely.

It is often the case that things change slowly, and then all of a sudden. It now feels like we may be nearing that inflection point in rate markets. So far we've seen a very gradual normalization of interest & inflation rates from unsustainably low levels. However, with US employment now extremely full, it seems likely that the weight of a tight labour market and rising construction costs will begin press on rates more dramatically. Inflation, the silent tax that has been nonexistent in developed markets for some time, is starting to rear its head. Every time the US has reached full employment inflation has risen faster than expected which has had a negative impact on markets and quite often tips the economy into recession.

Markets are undoubtedly heading towards a negative scenario for asset valuations generally, but for equities with pricing power and decent balance sheets, this presents a promising environment to drive earnings growth and significantly improve intrinsic value. We feel our portfolio is well positioned.

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Rather than talk through the holdings in the portfolio, which we do not plan on doing, we thought we'd go back and talk about how the fund works and what our stock selection process is.

We have an unashamedly unstructured and random process for selecting stocks and will never profess to have a magic formula, nor a filtering system that guarantees success. We look for businesses that 1) we understand and have favourable long term prospects, 2) CEO's who we believe are exceptional and 3) prices which are not reflective of the underlying value of the company. The portfolio is comprised of stocks which have some or all of these characteristics and the returns this year have been due to a combination of fast growing stocks and also some deeply contrarian positions in industries which were considered to have no growth by the greater market.

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A quick word on our lack of disclosure and the reasons for it. We feel the funds management industry is becoming more and more short term focused and the disclosure expectations associated with monthly performance fees have almost certainly negatively impacted returns. Our structure is a competitive advantage for Blue Boat investors and for us as managers, as we have no fear of short term weakness and no benefit from short term gains. We report our results annually and hope our investors judge us on a track record over a number of years. If we reported on the moves of our portfolio as regularly as the majority of the industry we would find it impossible think clearly. If this year was anything to go by, the size of the moves in certain stocks would have scared our investors away and we probably would have panicked and acted irrationally. We agree with Howard Marks that the weight of money in passive funds and ETFs is making the market less efficient, which means the short term swings in stocks and sectors are greater, and the opportunities for us are more prevalent than ever.

As an example we were very assertive in retail and mining services in the early part of the financial year and also in the media sector in the second half. These sectors were badly out of favour and saw fund managers rushing for the exits at the same time for fear of short term downside, and then later on saw aggressive buying for fear of missing out when the sector became fashionable again. We experienced considerable short term pain in these trades, but during this year we feel we were assisted by the increasingly manic Mr Market who got the better of many, at least partially due to short term disclosure and performance requirements placed on fund managers.

We feel it necessary to disclose at this point what is probably the biggest mistake we made during the year, which was one which has had no negative accounting impact on the fund. We bought a position in Emeco Holdings, a mining and heavy equipment hire company, at 8c a share in April 2017. Emeco had nearly collapsed in the mining bust and was trading at a discount to asset replacement value. After a merger and capital restructuring there were unnatural owners, selling huge volumes of stock below the price of equity that had just been raised. We felt that with the mining cycle turning positively, the utilization of this equipment would increase and Emeco's earnings would increase rapidly resulting in the equity value rising as they earn their way out of debt. Just 3 months later the stock had risen 50%, back above asset backing, and our thesis was playing out in front of our eyes much faster than expected. We sold at an average of 12c, feeling very smart.

Emeco finished the 17/18 financial year at 38c, 216% higher than when we sold, making it one of the best performing stocks of the year. Our thesis was right, the mining cycle did turn, utilization increased and the earnings grew rapidly which has seen them pay down debt rapidly. However our short termism cost Blue Boat dearly and we learned an expensive lesson.

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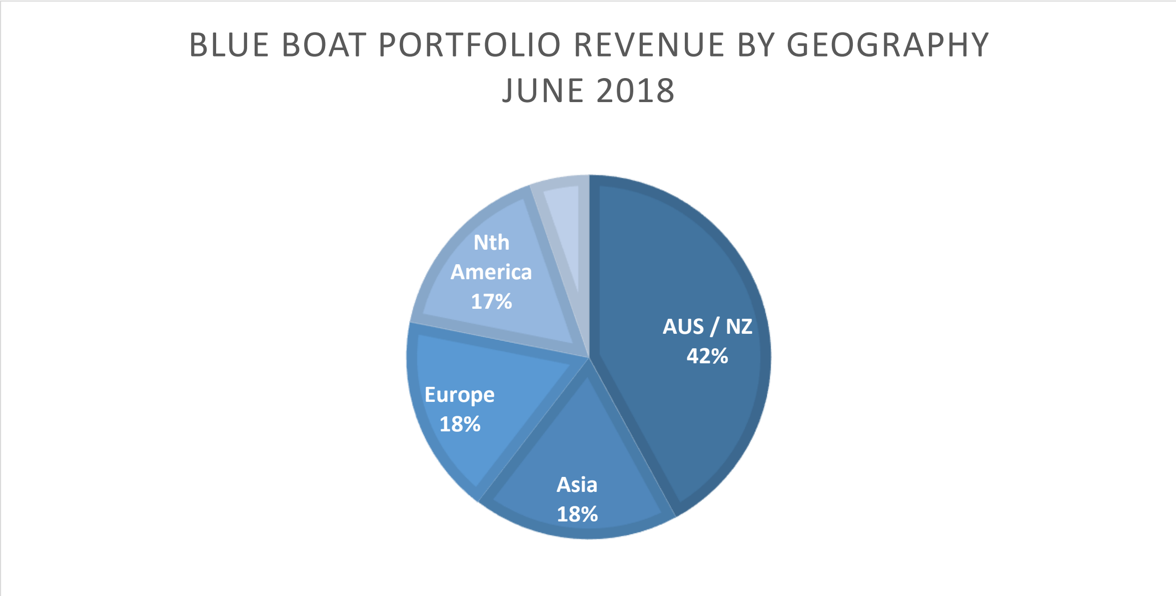
One thing we're happy to disclose is the diversification of the portfolio. In a previous Blue Boat newsletter we wrote up Fu Shou Yuan, which is the market leader in the Chinese death care industry and a key portfolio holding, which has returned circa 100% (unrealized) since purchase. We are very bullish on China and have since added two more positions to the portfolio which are based in China and listed in Hong Kong. We see the urbanization and modernization of China as a theme that will run throughout our life time and whilst the trajectory of stocks will not always be positive, we think it is an economy that we want exposure to over the long term.

Our primary focus is to invest only in the best ideas that exhibit the qualities we're looking for (something we understand, good prospects, outstanding management, attractive valuation). Beyond that we think about how to structure the portfolio in order to balance our exposure to different markets, industry cycles and external shocks. For example the portfolio's geographical allocation by underlying revenue is set out below:



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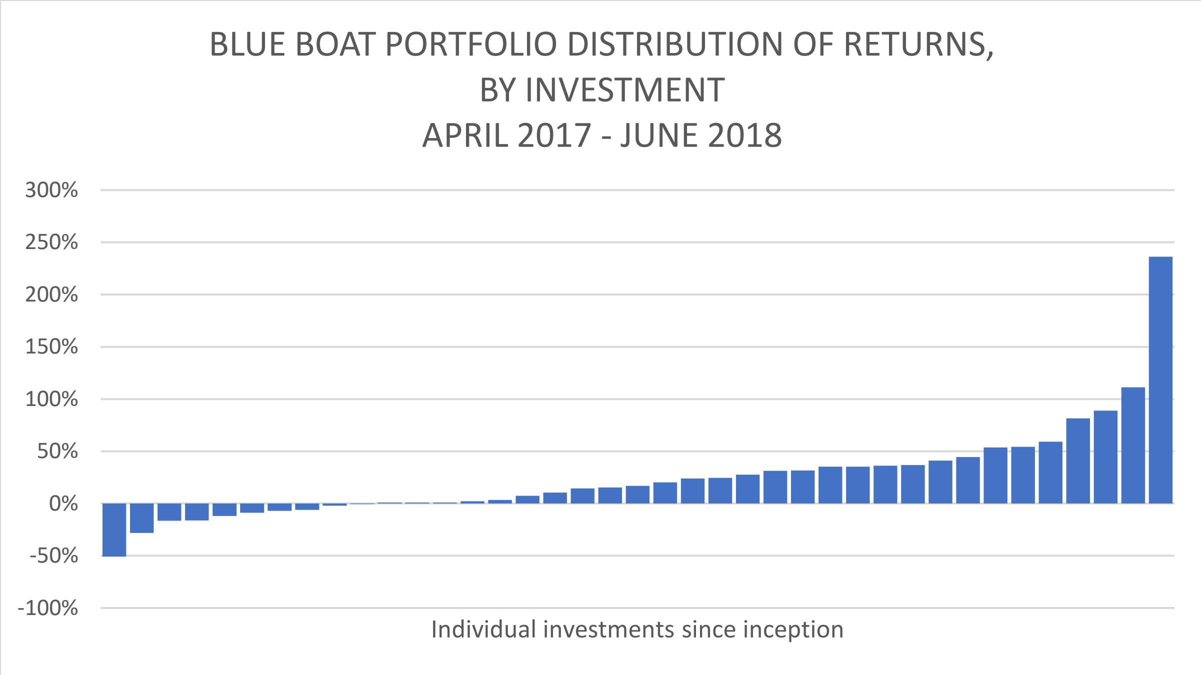
The underlying success in the portfolio has been broadbased, as highlighted in the chart below. We've had a lot more winners than losers; and the average gain has been significantly higher than the average loss. This has been driven by a combination of earnings improvement, accretive deals, and valuation re-rating. Earnings revisions and valuation multiples tend to go hand in hand. We were clearly on the winning side of the ledger this year where the market has rewarded us over and above the levels which our stocks improved due to PE expansion.

We see plenty of potential for this to continue. There is significant M&A activity occurring in the market and we may benefit further from this. Operationally our companies are progressing nicely and we look forward to the upcoming earnings announcements next quarter. Finally we still see significant scope for valuation improvement in the majority of our holdings.



*This is all investments made since inception, not the current portfolio which is appropriately concentrated to 19 stock holdings.

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It's also worth talking about incentives. We believe the funds management industry is rife with perverse incentives and we have deliberately structured Blue Boat to avoid that.

We have already mentioned our views on disclosure. Another important point is fee structure. We hope to have the vast majority of our fees strictly performance based. This means that we are incentivised to generate strong returns rather than just trying to grow assets under management (as a flat fee would encourage).

It is also critical that we use a highwater mark. This means if we underperform one year, we have to make up for that underperformance before we can charge performance fees going forward. The effect of this is that while we are highly incentivised to seek strong returns, we also face a significant disincentive to underperform as a large miss could take years to recover from.

Without the highwater mark, fund managers are incentivised to 'swing for the fences' – if it works performance fees are huge – and if not, they can start fresh next year. This is definitely not in the interests of investors, in our opinion.

In line with our incentives, we are heavily focussed on generating strong returns whilst containing downside. Our downside protection comes from buying robust companies with decent management, not overpaying for them and keeping the overall portfolio exposures balanced. Our definition of containing downside, centred around holding stocks we'd happily own for the long term, is very different to the definition used by most managers which means "we short stocks and indexes to smooth returns". We have no intention of shorting any stocks or indexes and view this strategy as flawed.

It is also worth noting that we have not used any leverage in our portfolio whatsoever. In hindsight our results would have been even better if we did gear up, given how low borrowing rates are, but had other market scenarios played out it could have been harmful. There may come a time when we think it is appropriate to use leverage, but not for the foreseeable future while markets remain rational.

Finally we have had a strong year, but we have not taken our foot off the pedal. We often hear about other fund managers locking in gains and moving to cash once they have hit their targets and putting their feet up for the rest of the year. There are so many things wrong with this and we vow never to do this at Blue Boat. We want to reassure you that as long we see attractive opportunities we will be actively investing, whatever our year-to-date results are.

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The Appendix sets out the provisional results for FY18 and since inception. It also details the accounting for distributions and fees charged. Once these results have been confirmed by the accountants we will send out the finalised results along with your distribution and tax information.

As it provisionally stands there is a gross distribution to be paid of $0.108. Those who have elected to reinvest the distribution will receive equivalent new units at the closing NAV of $1.304, and the rest will have cash distributions paid into their accounts.

We feel confident about how the portfolio is positioned and have elected to invest a portion of the performance & management fees back into the fund.

Finally, a reminder that our fund is open for new investment either from existing investors topping up or new unit holders at the current unit price of $1.304. If you would like to top up your investment or refer someone who would potentially become an investor please don't hesitate to contact either of us.

Yours sincerely,

David Nelson and Tim Evans

Appendix – FY18 Preliminary Financials

As this is the end of the first full financial year, we wanted to spell out in greater detail how the fund performance, distribution and fees have been calculated.

The numbers used here are preliminary and subject to finalisation by our accountants, Bentleys.

Table 1 - Blue Boat Performance since inception (April 2017 – June 2018):

	Gross Return	Net Return after all fees
FY17 (1 quarter only)	1.3%	1.1%
FY18	41.7%	32.8%
Compounded Return	43.5%	34.3%

Compound return and CAGR is assuming reinvested distributions

The Net Return presented in Table 1 is after deduction of both management fees (charged quarterly at 0.5% pa) and performance fees.

The performance fees are calculated as 25% of the excess of the Gross Return after management fees over a 6% pa hurdle rate.

Table 2 - Blue Boat Performance Fee calculation on funds invested at inception:

	Inception	FY17	FY18
Realised net profit per unit (after management fee deduction) = gross distribution		\$0.009	\$0.108
NAV/unit after gross distribution	\$1.000	\$1.002	\$1.304
Total gross value per unit accrued to investors		\$1.011	\$1.421
Performance fee unit hurdle rate		\$1.015	\$1.076
Performance fee earned per unit		Nil	\$0.086
Net distribution to be paid per unit		\$0.009	\$0.022

As set out in Table 2 above, in FY17 the fund operated for just one quarter. Here we did not meet the hurdle rate of 1.5% (\$1.015 per unit), hence no performance fee was accrued. As a result, for FY18 a new hurdle rate of \$1.076 per unit was set, based on a high watermark from FY17.

Happily, the FY18 performance was strong with the final NAV plus gross distributions accrued amounting to \$1.421 per unit as compared to the \$1.076 hurdle rate. Using the calculation above, a performance fee of \$0.086 per unit has been accrued.

As a unit trust, the fund is obliged to distribute the Realised Net Profit accumulated each year. This includes all realised capital gains, dividends received less any costs incurred.

For FY18 the Realised Net Profit for distribution comes to \$0.108 per unit. The performance fee is deducted from this amount, leaving a final net distribution to be paid out of \$0.022 per unit.

Table 2 shows the calculation of performance fees for those funds invested at inception. For other funds invested subsequently, the calculation is the same, however the respective hurdle rates are based on each application price and the time period between application and the end of FY18.

In FY18 the returns for all quarterly rounds of investment have beaten their respective hurdle rates. Thus each investment has accrued a performance fee and a new hurdle rate will be applied for FY19.

Going forward the returns for all current funds as well as any top ups or new applications made this quarter will be judged against a new hurdle rate of $1.382 for FY19 (being 6% over the FY18 final NAV/unit of $1.304).