2019 Annual Letter

Here we present our preliminary results, subject to finalisation with our accountants.

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 30 June 2019:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	S&P 500	MSCI World
FY17 (3 mths only)	1.3%	1.1%	0.1%	3.3%	4.4%
FY18	42.3%	32.7%	11.5%	14.5%	10.9%
FY19	-11.6%	-12.1%	11.9%	9.7%	6.8%
Total since inception	27.3%	17.9%	24.9%	29.8%	23.7%
CAGR	11.3%	7.6%	10.5%	12.4%	10.0%

Blue Boat and ASX returns are presented in AUD. S&P and MSCI returns are presented in USD. Index returns include net reinvested dividends. CAGR is the compound annual growth rate since fund inception.

We have now completed two full financial years and we thought it is timely to remind you of what we stand for, how the fund is designed, and our investment philosophy which we think will achieve outstanding long term results for our partners.

Our motivation for establishing the fund was sparked by the ever apparent lack of alignment between managers and investors across the funds management industry. It is now typical to see very short investment time horizons, benchmark hugging (so as to avoid underperformance, but guaranteeing mediocre performance) and misaligned fee structures.

Rather we endeavor to show a better way. Blue Boat is a high conviction, long-only fund. We are not benchmarked to any particular index and typically hold just 10-20 positions, forcing us to commit only to our best ideas.

We recognize that our positions will take time to compound value and along the way their share prices can be very volatile. As managers it is necessary to retain this long term mindset and we believe that our quarterly reporting (as opposed to monthly or even daily in many cases) is an important feature to avoid being drawn into short term thinking.

The Blue Boat fee structure was modelled from the Buffett Partnership which ran between 1957-1969. Performance fees (25%) are charged on the excess above a hurdle rate of 6%, which is subject to a high-water mark. This means that as managers we are fully incentivised to strive for strong returns in order to clear the hurdle. However, critically, the high-water mark also protects investors from the manager 'swinging for the fences'. In any year that the performance falls short of the 6% mark, the hurdle rolls over to the following year. Therefore in the event of a bad year, this year being a prime example, the fund has to get back above the high-water mark before any performance fees can be earned. In this way the manager is discouraged from undertaking excessive risk that might trigger a bad year where it would be very difficult to recover the lost ground. Earning a performance fee in a year where all you do is recover the losses from the year prior is immoral and we are appalled that many funds operate this way. In total the high-water mark structure both rewards and punishes the manager in line with investors' outcomes.

Charlie Munger highlighted this at the 2018 Daily Journal Corporation AGM, where he set out the '*5 aces of investment advisors/managers*':

- Total integrity
- Long runway (likes young managers)
- Uncrowded investment space
- Deep fluency in your work and commitment to clients, and
- Fee structure that is fair in both directions

He went on to say "*Why should he (the manager) on the downside not suffer right along with you the investor? I like the Buffett formula. He took 25% of the profits over 6% per annum with a high water mark. So if the investor didn't get 6% he would get nothing. And I like that system*".

We believe this system is the best we've seen and yet we are not aware of any other Australian fund using this structure.

Finally, as in the case when we are appraising stocks, we like to see managers with skin in the game, fully aligned with investors. Accordingly we both have the majority of our personal wealth invested in the Blue Boat Fund. We view the fund as a partnership with our investors where we are all in this together.

Our investment philosophy is based around rational long term thinking and deliberate contrarianism. In general we favour businesses with the following characteristics:

- A competitive advantage that has withstood downturns in their market. It is easier to value a business when you can quantify the downside inflicted by a cyclical downturn.
- Culture of outperformance and innovation, usually led by the CEO.
- Board and Management with significant shareholdings, especially Founder managed companies.
- Company has been around for a long time.
- Large addressable market. Can be a tough industry without growth. We prefer businesses that grow within a market than those relying on market growth.
- Stock trading at discount to fair value. We like cheaply priced companies that are cyclically impacted where short term risks are overplayed. We also believe that truly great companies deserve to trade at a premium and favour holding through periods of over valuation rather than attempting to time the market.

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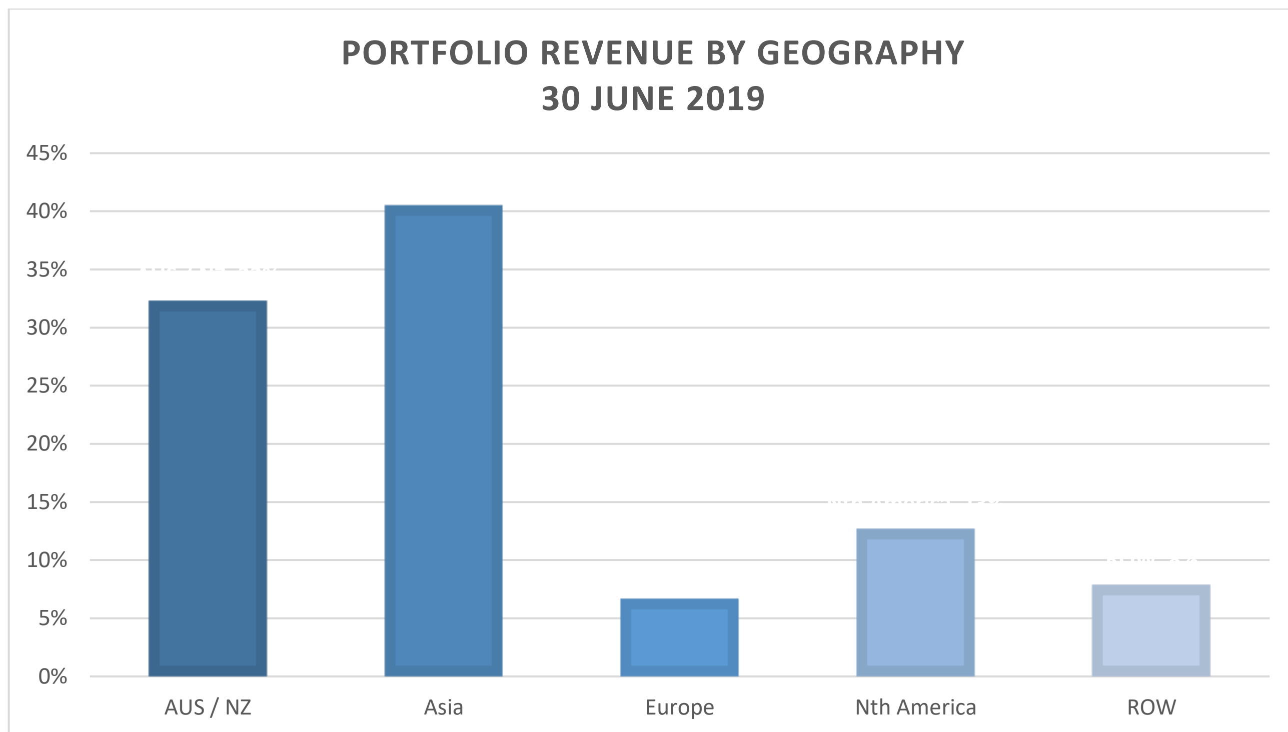
Since inception we have invested in a combination of Australian and overseas stocks. These positions have been carefully selected against the criteria above with the weightings balanced to control our exposure to individual risks. We are very bullish on the long term prospects of China, particularly in the opportunities created by the emergence of their middle class. We are also bullish on the long term outlook for Australia as an investment destination. We reject the consensus view that there is limited opportunity for prosperity for companies exposed to our domestic economy.

As a market Australia has a lot going for it. It has a stable political environment, which although Australians might not appreciate this, is far less divisive than other parts of the world. Institutions and the financial system are relatively solid. Immigration is high and generally accepted by the community, driving population and economic growth. With these factors together Australia has experienced a well-managed economy and, combined with some good luck, has generated a current record of 28 consecutive years of economic growth.

Despite this, we hear more and more that Australia is now a 'no growth' market. The latest IMF projections forecast Australian GDP to grow at 2.6% on average for 2019-2023. This is significantly stronger than the outlook for the G7 markets at 0.6%-1.8%. (Side note – the China forecast is 5.9%). Of course Australia and the businesses within are not without risk, but on balance we see far more

opportunity and potential than the market is currently giving credit. Furthermore, as Australia becomes more and more integrated into Asia (and the high growth rates associated), the ASX increasingly stands out as a well-regulated, liquid investment destination to participate in the growth of the region.



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FY19 was one of the more unusual years we've experienced with volatility at decade highs. Bond yields and interest rates peaked in November, prompting a sharp negative correction to equity prices in the run up to Christmas. This was a particularly damaging quarter for the Blue Boat portfolio. However, in an abrupt reversal, since the New Year central banks virtually in unison have adopted looser monetary positions. US 10 year rates now stand at 2.01% compared with 3.24% back in November. Interest rates are like gravity to asset prices, and the significant reversal in rates have provided a major boost to stock market prices.

Unfortunately our portfolio has underperformed the broader market and our expectations this year. This result is disappointing and draws attention to a few points worth raising.

The first is that we have made mistakes in our assessment of companies. We are dealing with the business of uncertainty and such forecasting errors will certainly continue. Nevertheless it is a reminder to stay vigilant and ensure that our portfolio companies are robust and their valuations contain adequate margin of safety to protect against the downside. The stellar result of FY18 was driven by outperformance of a handful of outstanding high-quality stocks. As long term investors we believe selling an outstanding business just because it is fully priced is a mistake most of the time, but as a result several of the stars of 2018 have been a drag on our performance this year. We have increased our positions in several of our key portfolio holdings during that market downturn and we are very excited about the outlook.

Secondly the prevailing macro sentiment hurt us this year. Global politics & macro events are influenced by a highly complex set of relationships. These are the most talked about, analysed and speculated upon topics in the investment world. We don't believe we have an edge here and not sure if anyone else does either. Rather we just stick to the strategy of investing in companies where we have high conviction in

their management, competitive position and valuation. Perhaps this leaves us vulnerable to swings in macro sentiment in the short term, however we believe that the fundamental value of our portfolio companies will shine through over time while the macro worries almost always recede into irrelevance.

In addition, the results highlight that we should expect volatility. 2017 and early 2018 showed record low levels of market volatility that should not be considered the norm. As we mentioned in the last note, markets rarely deliver a 'normal' year. Indeed, the threat of a trade war and yoyo-ing interest rate outlook casts a more typical setting than the very benign environment we saw earlier. What happened in late 2018 will likely be a preview as to what will happen to the valuations of those assets that are being priced for interest rates to remain low forever.

Notwithstanding, volatility and swings in sentiment are not the same as risk per se. The main thing is the underlying health of our portfolio companies and the development of their value over time.

Finally the emergence of the "growth vs value" debate has captivated markets, with many declaring the death of traditional valuation metrics and that new age industries are immune to the normal cyclical issues that have assisted and destroyed businesses in the past. We are concerned about the acceptance of this statement and related behavior currently present in the market.

"This time it's different" are the four most dangerous words in investing and we're hearing them more and more as the markets push higher. Consider periods where this phrase was accepted by the consensus:

- The Nifty 50 1969-72 (The consensus view was that the price you pay for stocks doesn't matter, only the quality of the business. This saw valuations soar for high quality growth stocks in the USA),
- the Tech Boom 1998-00 (traditional industries were set to be surpassed by unproven internet models),
- the GFC 2008-09 (the world would never recover and appetite for risk would never return),
- the Mining Boom 2010-11 (commodity prices would increase into perpetuity – "*stronger for longer"*).

In each episode investors were willing to discard historical norms to justify the current optimistic/ pessimistic environment. Today, particularly in the technology sector, there are elements of some of these previous periods which have shown themselves again where companies that are largely untested are trading at unbelievably high valuations. Mark Twain's famous saying that "history doesn't repeat itself, but it does rhyme" feels appropriate, as each of these four cases preceded markets changing dramatically when the consensus view proved to be very wrong.

In line with our investment philosophy we are unwilling to buy into an exciting business at any price, especially so if it is unprofitable. This has meant that we have 'missed out' on a corner of the market that has performed strongly. Note that whilst 'missed out' points to an opportunity cost for investors, we have also avoided the risk associated with buying into 'this time it's different'.

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As a unit trust Blue Boat is required to annually distribute all the realised net income (that is net realised capital gains and dividends received, less costs). Overall our FY19 return was negative, however we note that this consists of positive realised gains and negative unrealised losses.

Accordingly there will be a distribution to all unit holders, of approximately $0.063/unit (subject to finalisation). In turn the distribution will reduce the NAV/unit to a final year end price of $1.090.

As the FY19 hurdle rate was not met, there is no performance fee earned. For FY20 the high-water mark applies, where adjusting for the FY19 distribution the hurdle rate is set at $1.326.

These preliminary calculations are set out below. Once the accounting is finalised we will send out tax and distribution statements along with completed figures for FY19.

	FY17	FY18	FY19 (tbc)
Starting NAV/unit	$1.000	$1.002	$1.310
Ending NAV/unit before distribution	$1.011	$1.412	$1.152
Performance fee unit hurdle rate	$1.015	$1.051	$1.388
Performance fee earned per unit	Nil	$0.082	Nil
Net distribution to be paid per unit	$0.009	$0.020	$0.063
Final NAV/unit	$1.002	$1.310	$1.090
Next year hurdle rate	$1.051	$1.388	$1.326

To summarise the performance history so far. Since April 2017 all net realised income has been paid out to investors, representing a total of $0.092/unit; meanwhile the unit price has advanced from $1 to $1.090.

Including reinvested distributions, $100,000 invested in Blue Boat at the commencement of the fund on 3 April 2017 is now worth $117,910.

We have elected to reinvest all management fees back into the fund and welcome and encourage top ups. We are very bullish on the outlook of the portfolio and have a number of stocks on the watch list. 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