January 2019 update

As Warren Buffett says, "hit me with the bad news first, the good will take care of itself." We present the returns for FY19 so far:

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 31 December 2018:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	S&P 500	MSCI World
FY19 (6 months)	-20.1%	-20.3%	-7.0%	-2.8%	-4.5%
Since inception	15.1%	7.5%	3.8%	18.2%	13.7%
CAGR	8.4%	4.2%	2.1%	10.1%	7.6%

Returns presented in AUD. Index returns include net reinvested dividends. CAGR is the compound annual growth rate since fund inception.

It was a rough quarter, with widespread declines across major equity markets combined with a significant increase in volatility. Together this had a pronounced adverse effect on sentiment and the market valuation of our stock portfolio.

Markets are stochastic, and it's important to remain level headed when it turns against you. We know that Mr Market's often erratic appraisal is not a good reflection of underlying value. As pleasantly surprised as we were by the portfolio's outsized returns last financial year; we are even more surprised by the sharp sell-off in some of our high quality stocks which has caused our disappointing underperformance. Nevertheless, we are confident that our investment process is the right one.

Our investment strategy focusses almost entirely on the prospects of individual companies, including their market positioning and industry cycle. We feel confident that by investing in businesses with a long history of successful operations, and after considering the quality of management, the cyclicality of operations and finally the price that the market is offering, we can make strong returns.

On the other hand there's macroeconomics, which reporters like to cover because its potential influence is so wide reaching. However macroeconomic outcomes are both extraordinarily difficult to forecast (given the complexity of relationships involved), and it's even harder to predict their actual impact on markets, commodities and currencies. Charlie Munger often says that if you think you fully understand what is happening in the world of economics today, you're almost certainly not looking closely enough. In the end, the long term prospects of companies are primarily driven by industry dynamics, company positioning and how management run their operations.

Unfortunately in the short term markets can react strongly to macroeconomic newsflow and that has hurt us in recent months. In addition we have made some mistakes in analyzing the fundamental robustness of companies within the portfolio. Roughly 1/4 of our stocks had unexpected negative announcements this quarter, requiring us to update our assessment. However, we also had a good deal of positive developments (which went largely unrewarded), such that on balance we believe the intrinsic value of the overall portfolio has in fact increased over the period, even though the valuation fell c20%.

In addition to the portfolio's steady accumulation of intrinsic value, we take great confidence in the attractiveness of the prices offered for our stock portfolio. Currently US 10 year government bonds are offering a 2.7% yield (with no possibility for growth); developed equity markets have an earnings yield of around 7-8%; and the Blue Boat portfolio is trading at an earnings yield of 9.5%. From this we can

conclude that equity investors in general are getting a healthy equity risk premium, and that our own stocks are even more attractively priced.

We are pleased to see the portfolio's improvement in intrinsic value and expect the significant discount offered between that and the market price to narrow in time. Earnings, and especially dividends, are readily appreciated by the market and that promises attractive returns going forward.

One market which has sharply underperformed is the Chinese market, which fell c25% during calendar year 2018. We think China, with its 1.3 billion population and rapidly growing middle class is going to generate tremendous growth for many companies and very strong returns for shareholders. In light of this we have made a significant investment in a market leading company with a long track record of profit growth and outstanding long term prospects. This company is Ping An.

Ping An is the world's second largest insurance business (after Berkshire Hathaway). It is a Chinese business listed in Hong Kong and is heavily exposed to the general growth in middle class wealth and proliferation of financial services in China. The company's growth has been seriously impressive. Its earnings have grown at a compound annual growth rate (CAGR) of 33% from 2013-2017, and up a further 20% for the first 9 months of 2018. We strongly believe this will be a growth market for the foreseeable future and Ping An is well placed.

There are two key aspects that make Ping An an especially outstanding business. The first is that it has excelled at developing technologies to offer superior services and grow both their retail customer base (now 182 million people) as well as the number of contracts per customer. These are technologies such as an app to allow you to fully handle a car insurance claim in under 10 minutes. The proposition here is better service for customers, lower costs for Ping An, and in turn scope more competitive pricing against other insurers. Ping An has become such a force in financial technology R&D that it has developed new business streams from licensing/spinning off solutions that were originally developed inhouse to streamline its own operations. All together this has enabled Ping An to develop significant competitive advantages in scale, brand, technical capability and customer stickiness to achieve superior growth and profitability.

The second factor is that a much of Ping An's future earnings are already locked in. The company's largest segment is the Life Insurance business, where most of the earnings come from the contracts already in force. Therefore, but for a slow attrition rate, Ping An has a base level of profit that is already banked for years ahead. On top of that, the company is continually writing new business which drives growth and adds to this base of future earnings, underpinned by the ever growing number of Chinese consumers entering the insurance market.

With an excellent track record and future growth prospects, as well as the robustness that comes from years of future earnings already in the bank, you would expect Ping An to be trading at a fairly high valuation. Yet the stock is on just 9x forecast 2019 profit, which we think this presents a compelling investment case. Consequently during the quarter we took a core position in Ping An, alongside Fu Shou Yuan (the Chinese funeral services business discussed in a previous note). Together, we think these positions give us great exposure to the economic development of the Chinese middle class consumer and should generate strong returns for shareholders.

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A note about performance fees. Clearly the recent results are disappointing. We reiterate that performance fees only accrue if the fund return exceeds the high water mark, plus a further 6%pa. Thus we have some catching up to do, and until we reach that threshold, no performance fees will be charged.

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In the February we will get another round of earnings reports which is an important marker for investors to reappraise stocks' intrinsic value. We feel very confident and see the current depressed state of the market as an excellent chance to pick up bargain stocks on sale.

We are now fully invested so would especially welcome further inflows to capitalise on the opportunities we see in the market. The current unit price for the fund has dropped to $1.05, which we think is a great time to top up. We have also elected to reinvest all management fees back into the fund.

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