October 2017 Update

This note caps off the end of the September Quarter and the first six months of Blue Boat's performance record. The results show that we are off to a good start with the fund up +8.8% since inception.

Blue Boat Performance vs Index total return: 3 April 2017 – 30 September 2017:

Blue Boat Gross Return	Blue Boat Net Return	ASX 200 with dividends	S&P 500 with dividends (in AUD)
+8.8%	+8.5%	-0.3%	+4.6%

It is early days still, but we are pleased with a solid set of results, especially in light of the prevailing market. The August reporting season was unforgiving for any company that missed expectations or gave subdued guidance, and we saw a number of high profile casualties. Meanwhile our portfolio fared quite well with a number of beats and positive updates.

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We try to scrutinise the results to test whether our methods are working, and that our performance is down to skill rather than luck. Over a short time frame it is always hard to tell, but there are several clues which support our case:

1. Our success has been broad based – we have made money on roughly 2/3rds of our investments.
2. Our gains on average have been much greater than our losses (around 2x).
3. The portfolio is somewhat aggressive (at least by conventional standards – which we could debate the merits of), but we have significantly outperformed in a weak market.

We certainly have not had it all go our way. There have been a few opportunities that we shouldn't have played at, and others which we let through to the keeper that should have been smashed for six.

Similarly in hindsight our weightings haven't been ideal, with some major gains coming from smaller positions. We can only judge ourselves against the actual scenario that played out, but at the outset there were many possiblities and we had to allocate prudently to manage our risk against the range of outcomes that may have occured.

Overall this suggests to us that our approach - by keeping the portfolio balanced, limiting our investments to companies with good prospects, and ensuring there is a good margin of safety in the purchase price – is managing our risk appropriately.

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In general we don't try to speculate on political or macro outcomes, nor guess when markets are going to turn or by how much. Notwithstanding we do think it is important to have a good handle on the current status of the market. We want to be greedy when others are fearful and vice versa, and so we try to discern where the pendulum of sentiment is positioned between pessism and optimism.

On the surface global equities markets appear to be running hot with several major indicies trading at record levels. But rather than absolute price levels, we need to examine whether risk is being adequately rewarded. We can do this by comparing the expected returns on equities against government bonds and see how that difference stacks up against the historical norm. The data shows that the expected return premium to US equities (S&P 500 index, cyclically adjusted) over government 10 year bonds is

currently 2.0%, which is slightly better than the historical average of 1.8% (since currencies were floated in 1971). This indicates that the additional risk undertaken by equity investors is currently rewarded with a fair premium.

Put another way, at 2.33% US treasury bonds are on a P/E of 42.9x. By comparison, equities (at least the ones we're invested in) are definitely not expensive. Of course the outlook for bonds is weak as yields will likely rise so this is a going to be something which we monitor closely.

Meanwhile on the ASX we're closing in on the 10 year anniversary of the all-time market high of 6851 points, sitting 17% below the mark and officially becoming the slowest recovery from a previous high in Australian history. It took 9 years for the All Ordinaries to surpass the 1987 high, but the index rallied a further 50% over the following 5 years. They're calling this a "lost decade" on the ASX, but we believe the outlook is considerably brighter. Last year the ASX 200 industrials (excluding resources and banks) achieved 6% profit growth. Banks grew a little while resources grew a lot but it was the first year since the GFC that all sectors in the ASX grew earnings, which we think is a major positive being overlooked.

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Our strategy remains focussed on investing in good assets offered at attractive prices. We want to go fishing where the fish are, and we have tended to concentrate our efforts in sectors where sentiment has been overly pessimistic. We have endevoured to manage our risk by balancing the portfolio across domestic & offshore allocations, sectors, and different levels of company scale & maturity, all the while sticking to our philosophy of what makes a good investment.

Looking ahead we believe many of our investments are still underappreciated and stand to gain as the market comes to realise their value. The coming quarter will feature a raft of AGMs where we are hopeful of further positive commentary and market guidance.

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We feel confident about the portfolio and again have elected to invest our fees back into the fund.

Please get in touch if you have any questions or feedback. We are very happy to discuss. We are learning all the time and hope to continually get better.

Finally, thanks all for your support.

Yours sincerely,

David Nelson and Tim Evans