October 2018 update

We are now three months into FY19 and pleased to continue the positive results from last financial year. Our performances for FY19 to date and since inception, along with some major equity indices' results are set below.

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

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	S&P 500	MSCI World
FY19 (3 mths)	4.8%	4.7%	1.2%	9.6%	8.2%
Since inception	51.0%	41.2%	14.9%	33.3%	28.9%
CAGR	31.6%	25.9%	9.8%	21.3%	18.6%

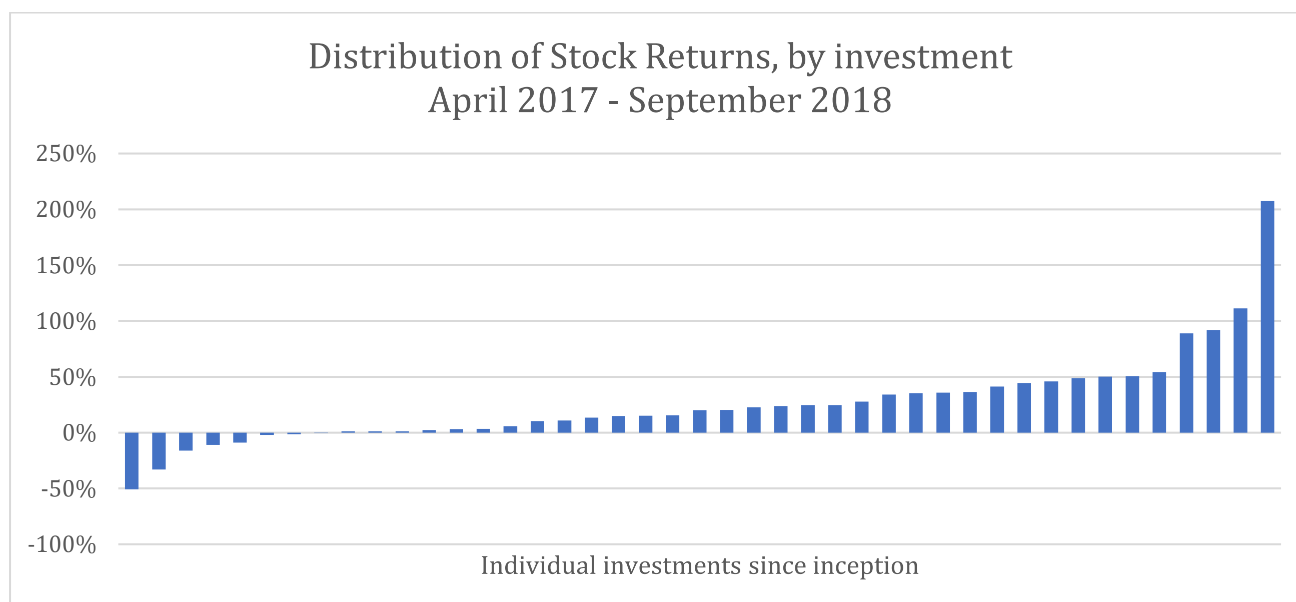
Returns presented in AUD. Index returns include reinvested dividends. CAGR is the compound annual growth rate since inception.

This quarter we had results announcements from all the stocks we hold and were able to hear from company management about their strategies and progress. This is a crucial and potentially volatile period for markets.

The vast majority of our companies presented a clean set of results and a positive outlook. In a couple of cases, stocks with which we have great belief in their long term potential had run ahead of themselves prior to the results and were pulled back to reality on very solid (but not stellar) results.

When we created this fund we made the decision that we would be happy to hold companies with outstanding long term prospects for the long term, even when they become over priced in the short term. Due to this stance we saw minimal turnover in the portfolio during and after reporting season we now hold a total of 16 stocks in the fund, roughly with a 60:40 split ASX to internationally listed.

The overall profile of our portfolio's returns since inception are illustrated in the chart below. It is encouraging that the gains have been widespread across our investments.



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A note about the structure of the fund post our full year results and distribution. Returns to investors in the fund come by way of growth in the unit price, plus annual distributions. So far the fund has delivered strong returns, but almost all of this gain is embedded in the rise in the unit price. From $1.00 at inception, the unit price has grown to $1.37, plus net distributions have been paid of $0.010 for FY17 and $0.013 for FY18.

The annual distribution is the net realised income for the trust for that year. This is the net gains/losses from selling stocks, plus dividends received, less any costs incurred. Each year we distribute the realised income, and what remains determines the unit price.

In FY18 the value of the portfolio appreciated significantly, however many of the winners are stocks we haven't sold (and mostly held since Day 1). Consequently much of the portfolio appreciation is unrealised and the distribution was relatively small compared with the gains made that year.

Going forward there may be more years like FY18 where the unit price grows a lot, but there is little to be distributed. Alternatively there may be years where we sell winners and crystalise large profits which would mean the return for the year will be captured mainly in the distribution rather than the unit price.

It is also worth noting that regardless of the realised/unrealised position of income for the fund, franking credits will always be distributed, which are valuable to Australian unit holders.

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"Trade wars" continue to dominate headlines and sentiment. This has produced notable divergence in performance of equity markets with real strength in the US contrasted with weakness in Europe and China.

Here the market is perhaps pricing in a favourable trade outcome for the US. However it also reflects strong corporate earnings, helped by a buoyant economy and tax reform.

China has been the major casualty here, with the Shanghai index down 15% since January. During the quarter we acted assertively and increased our positions in Chinese companies that we have great confidence in and were offered to us at attractive prices by the market We are very bullish on the long term outlook for China.

US interest rates have increased again, with more hikes to come in the year ahead. Officially, policy has now shifted from accommodative to neutral. Higher oil prices, consumer confidence, tariffs and tight labour markets are all likely to put upward pressure on prices and drive inflation. We do not make investment decisions based on macroeconomic factors but rising interest rates have a significant impact on valuations of all asset classes, including listed equities.

This highlights pockets of vulnerability in the market. We fully expect interest rates to continue creeping higher and this will have serious implications for companies (and investors) with heavily levered balance sheets.

Buffett regularly quotes Ray Devoe who once said that "more lives have been lost reaching for yield than at the point of the gun." We are very aware there is a great deal of 'reaching' going on around the world, where money is flooding into risky investments at inappropriate prices. As the risk free rate, which is globally accepted to be the 10 year US government bond, continues to rise the prices investors are willing to pay for the return they're hoping to get has to fall.

Fixed assets and bonds are impacted negatively due the yield comparison, but the rising discount rate is just as important when valuing the future cash flows of a listed company. When evaluating the value of a very high growth business with fabulous potential likely to be achieved in the distant future, an analyst has to discount that growth back to today's dollars. With the discount rate on an upward march, it will make it harder and harder to justify eye-watering valuations we see sectors such as technology and software.

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During the quarter the US market set a new record for the longest time without a 20% drop, which technically means we've been in a bull market since March 2009. As a result of this prolonged period of a rising market, we are noticing a number of funds popping up with the core thesis that the market is the enemy which should be neutralised. They often hope to do this by using a long/short (the new name for hedge fund) strategy. For example a fund may take a $100 long position and a $100 short position, such that their exposure to general market movements nets out to zero. In this way they hope to nullify the effect of the market and hone in on the specific prospects of the companies invested in. It sounds great in theory.

The reality however is somewhat different. This is supposed to be a risk mitigation strategy, but it is highly leveraged. The fund has taken 2 bets instead of 1. If the long goes down and the short goes up you are in big trouble. It's also twice as many assets that you need to analyse and manage, so most likely this is diluting the conviction in the original investment idea.

Secondly shorting is a tough game. When you go long, you get paid to wait. You can collect dividends and watch the company (if it is fundamentally good) build intrinsic value over time. If you are patient, value compounds.

On the other hand when shorting, time is against you. The investor has to pay interest on the borrowed stock and also personally cover any dividends that get paid. Meanwhile, stock prices can defy gravity for a long time. Waiting for a price to drop can be very costly business. John Maynard-Keynes famously said that "markets can stay irrational longer than you can stay solvent."

Alternatively, bad businesses can always be turned around. Effective or not, managers are incentivised to grow the companies they are stewards of. And if that's not working, there are thousands of ambitious executives, activist investors and potential acquirers out there ready to take the wheel and steady the ship. This is a lot of force to be betting against.

Finally, we believe the theory that the market should be neutralised to be a flawed one due to history. Statistically the market has risen seven years in ten and has been a compounding machine since inception. During the Great Depression in 1932 the S&P 500 was 4.7 points. In the past 86 years it has grown to 2924 points, but still has 500 companies. That's a 612,000% return, not including dividends. If you invested $1,000 in the Australian market (All Ordinaries) in 1979 and reinvested all dividends it would be worth $63,269 which is a 6,326% return despite the fact the market halved twice in that time.

At Blue Boat, we know the market will wobble around. Risk management for us lies in backing our best ideas where we believe the prospects are good and we are not overpaying for them. The market price will be volatile, but the underlying value will transpire over time. We have no plans to attempt to defy the odds and short or neutralise the market and promise to keep things simple.

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In the months ahead we have some specific company milestones coming up and a raft of company AGMs where we expect to get more news on progress. We feel good about the events ahead and the prospects for further solid delivery of business strategies. Accordingly we are very happy with how the portfolio is positioned and have elected to reinvest the 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 $1.37. 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