October 2019 update

It's been an up & down quarter, but we are pleased to come out ahead and we're very confident in our concentrated portfolio of 17 stocks. The current NAV/unit is now $1.146 (this post the 4.4c per unit distribution that was just paid). The FY20 year-to-date and since inception results for the fund are set out below:

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

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	S&P 500	MSCI World
FY20 YTD (3 mths)	3.4%	3.2%	2.0%	1.7%	1.0%
Since inception	31.6%	21.7%	27.5%	32.0%	24.9%
CAGR	11.6%	8.2%	10.2%	11.8%	9.2%

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.

This quarter saw another volatile market, driven by political and economic headlines surrounding US-China trade relations, Brexit, a weak EU economy, falling interest rates, the questioned independence of central banks and now a serious enquiry into whether US President Trump should be impeached.

On top of the noise created by these issues, we've noticed a considerable slow down in earnings growth both domestically and internationally. Australian industrial companies (ASX 200 excluding resources) grew earnings at just 1% for the last financial year. The S&P 500 has now had two consecutive quarters of negative earnings growth and consensus expectations are for a further 2% fall in the third quarter reporting season earnings.

Following one of the sharpest market falls in a decade in the fourth quarter of last year, markets have risen strongly throughout this calendar year despite the weak earnings growth, fuelled by expectations of falling interest rates. We now note that consensus earnings growth expectations for the current year have eroded, with the ASX 200 industrials earnings growth forecast to be circa 6%, compared with the 9% expected previously.

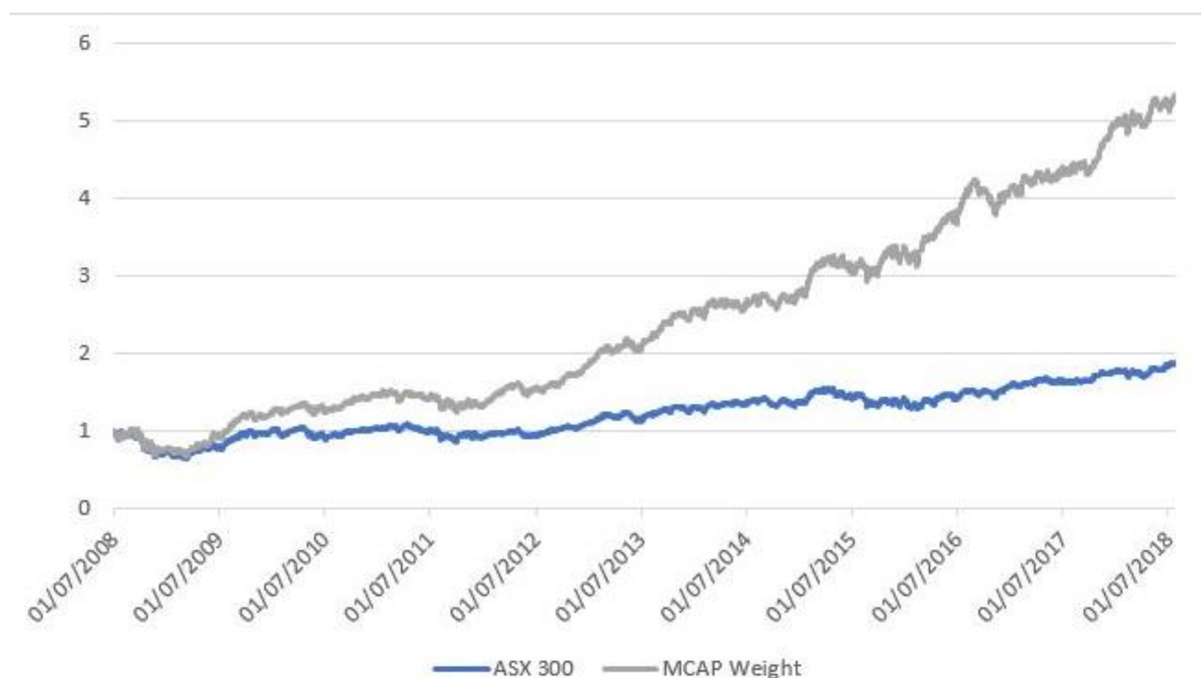
Our investment strategy is based around individual companies, not markets, and we feel we are well positioned in stocks with earnings growth well in excess of the broader market. Interest rates cannot justify prices rising into perpetuity and we believe very strongly in investing in businesses that generate growth above that of the broader market, or are well positioned in a cyclically impacted part of the market which has been overlooked. We feel that that the high returns from simply holding the index in the last two years are unsustainable given the lack of earnings growth.

We have bought assertively into a number of ASX listed stocks in the past six months which have suffered from what we believe are cyclical issues that many in the market have deemed structural. Peter Lynch said *that "the most money is made and lost by accurately diagnosing or misdiagnosing the cyclicality of a business."* In the ASX listed portion of the portfolio we are positioned in several companies that have traded at more than a 100% premium to the current share price in the last 4 years, the price which we believe to be the cyclical peak when sentiment was at its most euphoric. This portion of the portfolio has outperformed the market by a significant margin this quarter and we are very bullish on the outlook for these businesses, which have all gained market share and expanded their businesses during the downturn.

Due to our contrarian nature and focus on unfavourable sectors we must accept that the portfolio will be volatile, but we think patience will be rewarded as we continue to back companies with a long track record of success that are led by people who have almost their entire net worth invested in their company's shares. We strongly agree with Warren Buffett's quote that *"The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long term values".*

We currently own 11 stocks in our domestic portfolio and 9 of them are founder led. Of this group of 9, the average ownership by the founder/board is 34% of the listed shares. History has shown (see chart below) that founder led companies clearly outperform those that are led by professional managers. This data is based on the performance of 38 businesses (see Appendix) across all sectors of the market including a number that have failed, but the cumulative outperformance is compelling. We feel very comfortable aligning ourselves with people who have their livelihoods at stake and a track record of winning, even if it is in tough and undesirable corners of the market.

Outperformance of Owner-Managed Companies



This chart shows the divergence in performance between a market capitalisation-weighted basket of shares from 38 owner-managed companies (see Appendix) and the ASX 300 index over the 10 years to 30 June 2018. Source: Airlie Funds Management, Macquarie.

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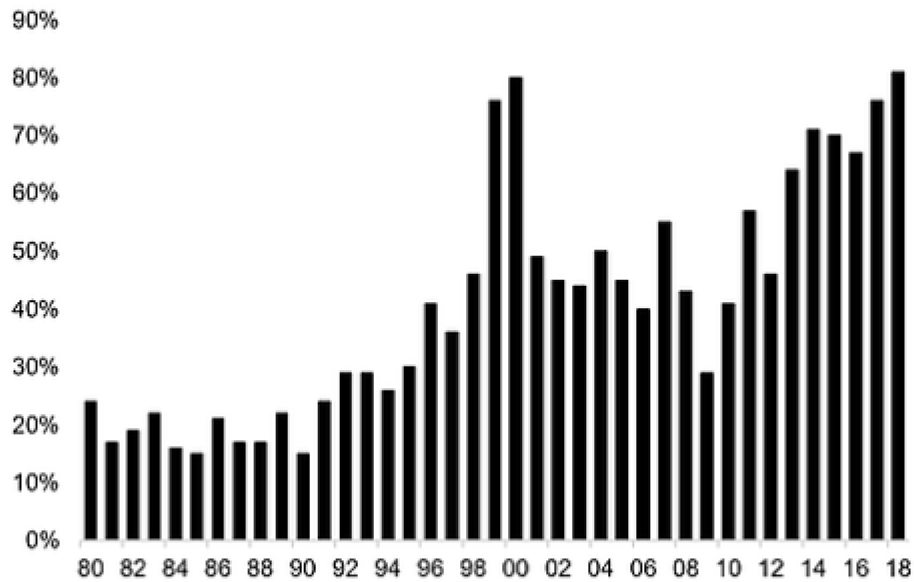
In previous updates we've talked about the extremely aggressive valuations seen in the tech space, particularly in the venture capital (pre-IPO) arena. Lately we have seen some high profile casualties of these very highly valued loss making companies dropping significantly upon listing in the public market, which we believe will cause reverberations through the venture capital industry where an estimated $2 trillion of value has been prescribed to tech companies. Lyft, Uber, Slack, Peloton and SmileDirect have all faltered on the listed market, while WeWork failed to even secure enough support to list at a 60% discount to the last VC valuation and is currently scrambling to restructure the business to survive.

Percentage of US IPOs with negative earnings



This chart highlights the dramatic rise in proportion of loss making companies that have gone public in the US. The 2019 figure is expected to be even higher than 2018. Source: Topdown Charts, Jay R Ritter.

This indicates to us that listed equity investors are showing greater caution than their VC counterparts, which is an encouraging sign for the overall health of the equity market. An asset 'bubble' starts when there is widespread belief from all participants involved that something can only rise in value, which then drives further aggressive behaviour premised on the acceptance of this simple view. We feel there has been a very large and dangerous bubble building in the VC market for some years now and this could be the start of that bubble bursting. When any bubble bursts there is a great deal of pain and collateral damage and no doubt there will be market volatility as a result, but we believe this is a healthy and necessary part of any market cycle that will add to the sustainability of the current market expansion, even if there is a short term contraction.

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We don't plan on discussing individual positions in our ASX portfolio, but we will continue to highlight and explain some of our international positions. It's obvious that there are many more outstanding businesses listed outside of Australia, but there are more variables to consider and therefore additional risks in our view. Having said that, and following our previously mentioned belief in the investment opportunities in China, a stock we have great conviction in and have been adding to recently is Alibaba which is listed on the NASDAQ exchange. Alibaba demonstrates many qualities which give it an enduring competitive advantage, its growth is very strong, and yet the shares are priced reasonably.

The Alibaba Group essentially consists of four components – its core commerce business, cloud services, a host of other supporting businesses, and its investment portfolio.

The core commerce business incorporates all of Alibaba's online ecommerce platforms, as well as brick & mortar and logistics infrastructure. This is a true behemoth and the numbers are staggering. For example, there are 860 million annual active users on their platform. On Singles' Day 2018, over the 24 hours, transactions on Alibaba's platforms totalled US$30.8bn and the company processed more than 1 billion delivery orders. Needless to say the scale of this business is immense and it is a prime example of the benefits accruing to network effects. As more shoppers use Alibaba's platforms, it becomes increasingly attractive for merchants to sell their products through these channels, paying for advertising

& commissions along the way. Then with a greater variety of products available, it attracts more shoppers and so the virtuous circle continues.

With such network benefits, Alibaba can grow and extend its lead over its much smaller rivals. And with superior scale economies, the company can invest in logistics, technology and marketing to further enhance its value-add proposition. This business has been growing strongly (FY19 revenues were up 51%) and runs very profitably with 42% EBITA margins and excellent cash flow.

The Alibaba cloud services business is now third largest in the world and biggest in Asia. Currently this business roughly breaks even, but it has been growing revenues at c80% compound. With substantial operating leverage, this business looks to be a significant contributor to profit going forward. (To compare, note that Amazon's AWS cloud business was its most profitable division in 2018, making US$7.3bn operating profit at 28% margin). About half of Amazon's valuation is now attributed to AWS and we feel Alibaba's cloud business is currently undervalued by the market just as AWS was prior to it being profitable.

Alibaba also has a variety of other businesses which are all currently loss making but either promise to grow to profitability in the future, or serve a greater purpose in widening/deepening the competitive moat for the core commerce ecosystem (essentially these could be viewed as expense lines for the core business).

Finally, Alibaba has a large number of investments in public & private companies, including most notably its 1/3rd stake in Ant Financial, a payment system that complements transactions on Alibaba platforms. Overall these investments are valued at over US$83bn (about 20% of the Alibaba's market cap).

In total Alibaba is a company with very strong earnings growth, supported by immense competitive advantages & barriers to entry. The stock currently trades on a multiple of 23x its FY20 (March 2020) earnings, and this gives essentially no credit for either the cloud business or the investment portfolio. We think this presents a great opportunity and will deliver good returns for the fund. We hope to continue to accumulate a bigger position in Alibaba whilst the valuation remains attractive.

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We remain fully invested and eager to capitalise on the opportunities we see in the market. 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 1 – The basket of stocks used in the chart showing the performance of “owner-managed companies” is: Ainsworth Gaming (AGI), AMA (AMA), AP Eagers (APE), Australian Agricultural Company (AAC), ARB Group (ARB), Ausdrill (ASL), Brickworks (BKW), Computershare (CPU), Crown Resorts (CWN), Event Hospitality and Entertainment (EVT), Flight Centre (FLT), Fortescue Metals (FMG), Goodman Group (GMG), Gazal (GZL), Gowing Bros (GOW), Hansen Technologies (HSN), Harvey Norman (HVN), Magellan Financial (MFG), Monadelphous (MND), Mineral Resources (MIN), Navitas (NVT), News Corporation (NWS), Nick Scali (NCK), Oroton Group (ORL), Premier Investments (PMV), Primary Healthcare (PRY), Platinum Asset Management (PTM), Promedicus (PME), Ramsay Healthcare (RHC), ResMed (RMD), Servcorp (SRV), Sunland (SDG), Seven (SVW), Technology One (TNE), TPG Telecom (TPM), Washington H Soul Pattinson (SOL), Westfield (WFD).