July 2020 update

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

Blue Boat Performance vs Indices (unaudited)Total Returns: 3 April 2017 – 30 June 2020:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	MSCI All Country
FY17 (3 months only)	1.3%	1.1%	-1.7%	4.6%
FY18	42.3%	32.7%	13.0%	11.3%
FY19	-11.5%	-12.0%	11.5%	6.3%
FY20	-10.5%	-11.0%	-7.7%	1.6%
Total since inception	14.1%	5.1%	14.3%	26.9%
CAGR	4.1%	1.7%	4.2%	7.6%

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

Financial year 2020 will go down in history as one of the most unusual in history. The series of events and volatility experienced throughout the year was truly extraordinary. Before discussing the market, which is incredibly important given the tremendous uncertainty in the world, we would like to discuss Blue Boat itself.

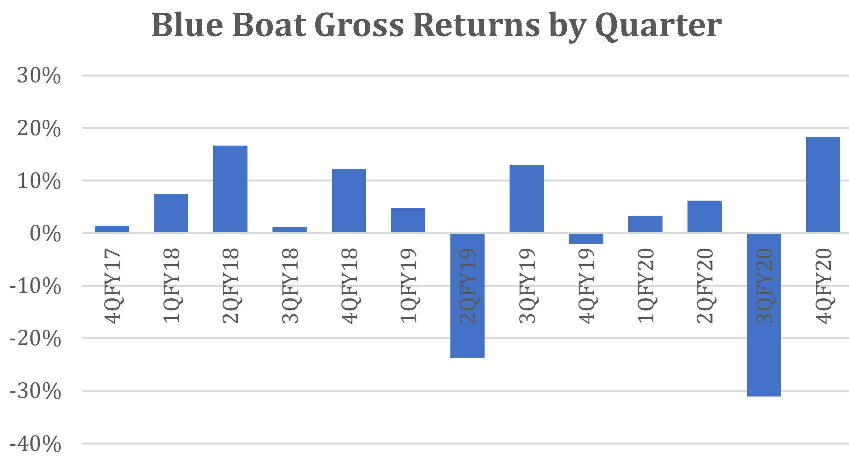
We have invested an enormous amount of time, effort and the majority of our investable capital into this project. We have developed a large database of financial models on companies across many different markets, covering more than 100 businesses which we update constantly. We attend dozens, maybe hundreds, of CEO meetings each year and listen to profit result conference calls and AGMs from all over the world.

We have learned a great deal about ourselves, our circle of competency and our ability to make decisions in difficult times. This learning curve has been steep, having now worked through two of the sharpest market sell offs in the last twenty years. These learnings have been very constructive and helped us to continually tweak and refine our approach. This reflects a tremendously helpful feature of Blue Boat's setup in that we are always looking to improve, and we have the agility to do so. We fully believe that our thinking, systems and processes are now better than ever. In another three years' time, they will be even better again.

We want to thank you, our partners, for having faith in us. Our single biggest goal is to repay that faith in the years ahead in the form of strong results for our partners. We vow to work harder than ever to reward you with exceptional returns and we remain highly motivated to do so.

Unlike most funds, our fees are only charged when performance is exemplary. Performance fees accrue only on the excess returns above +6% in any one year, provided the fund is above the 'high watermark'. This kind of structure is extremely rare among funds, but we think it's by far the best & fairest way to incentivise and reward performance. (Two notable proponents are Pabrai Investment Funds – run by Mohnish Pabrai, and Himalaya Capital – run by Li Lu, both of which are backed by Charlie Munger).

It has now been three full financial years, plus one quarter, making it 13 quarters in total since inception. We thought it important to show the performance of the fund throughout this time and point out how we have fared on a quarterly basis.



Portfolio Positioning

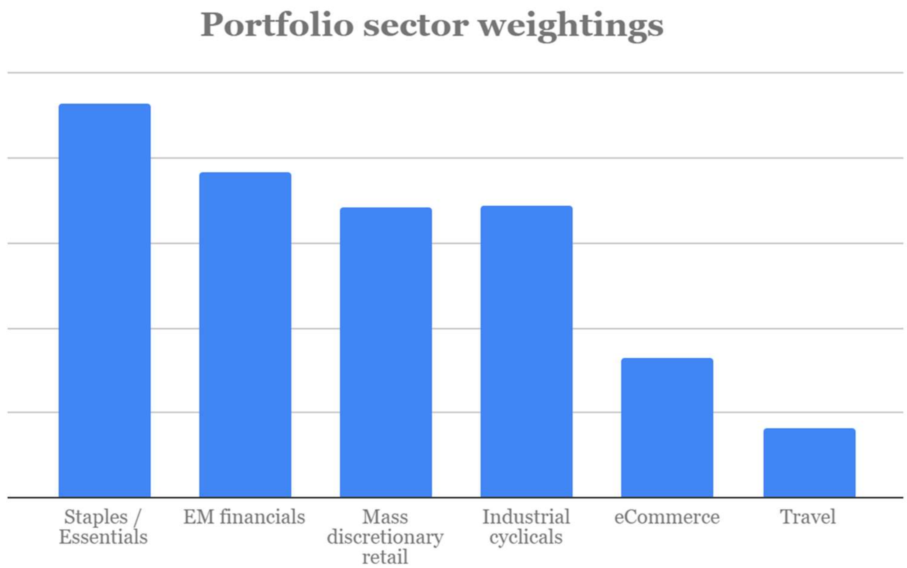
Two quarters stand out and between them account for almost all the negative returns in the past 13 quarters. On both occasions we were taken by surprise and the portfolio dramatically underperformed the market. In late 2018 we did not move quickly enough to sell stocks when the facts changed and instead, by holding on, also largely missed the opportunity to buy other excellent stocks that had been irrationally sold off. The latter group outperformed a strong market in 2019 while the former continued to struggle, meaning it was a costly mistake.

This financial year the portfolio was benefiting from steady economic growth. In February we were outperforming all global indices and felt comfortable about the outlook. We underestimated the impact COVID-19 would have on the global economy and the extent to which Governments would go in locking down their economies. Unfortunately, we missed the opportunity to sell stocks at fair prices, but we were able to make use of our lessons from 2018 and positioned the fund for the recovery.

A key point was the highly divergent impact COVID-19 would have on different businesses. We exited all positions in the oil and gas sector, companies with excessive leverage and turnarounds. Given the significant uncertainty of how the virus was going to be handled in different countries, we simplified the portfolio and refocussed on Australia where we have greater confidence in both the health and economic capability and understand the risks to each.

Despite the short term pain we experienced it was fortunate that one of the most heavily sold off sections of the market was in our sweet spot of understanding. We bought assertively into stocks in the consumer discretionary sector at valuations that were significantly more attractive than anything we've ever seen, including the GFC. Moreover, we noted dramatic shifts in discretionary spending patterns, for example consumers favouring home related products and furnishings after being forced to work at home. The companies selling these products have since reported amazing growth numbers for the current quarter and share prices have rallied.

Additionally, with the benefit of having cash available, we were able to participate in a handful of heavily discounted capital raisings. As we saw in 2009 these transactions can be beneficial for all involved, as they simultaneously offer a cheap price for investors whilst adding value by removing balance sheet risk for the company.



During the quarter we also increased our position in Alibaba, a stock we think has incredible structural growth with over 700m active monthly users across several business units that are all growing strongly. Our core holdings in Ping An (financial services) and Fu Shou Yuan (death care) were untouched. These three stocks are all going to compound in growth in the coming years, rewarding Blue Boat with fantastic returns. They are dominant market leaders, with high barriers to entry and enormous growth opportunities to sell to the world's largest middle class population. These companies lead the world in technological developments within what are traditional industries. Importantly, they are focussed internally on the Chinese consumer, therefore relatively insulated from the growing geopolitical risks. Due to these remarkable traits, we are happily overweight in these stocks which together now account for 38% of the portfolio.

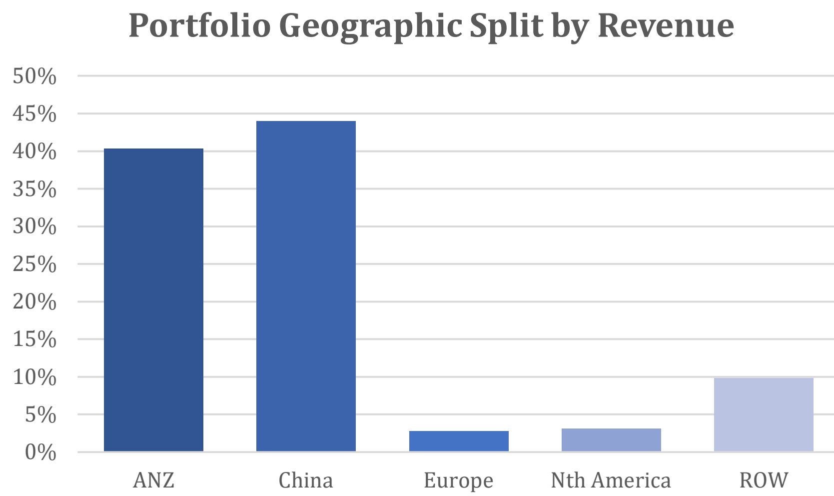
These three stocks underperformed in comparison to the sharp rally that has occurred in Australia, Europe and USA since late March. Nonetheless we note that the IMF forecast that China will still achieve positive economic growth in 2020, whilst the West contracts. We similarly believe these stocks are well placed with a very bright future.

Our fourth quarter performance reflects this the success of this positioning, offsetting some of the damage done in the third quarter. The ASX portion of the portfolio performed extremely strongly with a return of +57% for the quarter. In contrast the international stocks, including the three Chinese companies mentioned above, were roughly flat for the quarter. A component of this underperformance is that there was a c10% FX headwind to our international positions as the AUD has strengthened significantly.

We feel our portfolio is well positioned with the right mix of growth, defensive businesses and undervalued Australian cyclicals that are being ignored by investors. In the last three months several stocks we bought in April have doubled and we actively reduced our exposure to the travel and retail sectors in June at prices close to their recent highs.

As at 30 June 2020 we have 19 stocks in the portfolio. Due to the changes we made during the crash and the subsequent outperformance of our domestic companies, the portfolio split (by revenue) is now roughly 40% Australian and 60% international.

At present we are holding more cash in Blue Boat than any time in the last three years. We will look to deploy this assertively into stocks during the market downturns which we feel are highly likely, given currently volatility.



We believe in the long term investment in companies and accept the reality that volatility will be heightened from time to time. Meanwhile we do not engage in short selling, and rather choose to pass on vast portions of the stock market where valuations are not justified. We firmly believe that by investing in what we know and understand we will be able to stomach short term underperformance and unpopularity of stocks that have long term upside. This means we have not participated in the speculative boom that has taken place in the tech sectors on the ASX and Nasdaq. Right now this has been a major negative for Blue Boat, as these sectors have generated tremendous outperformance. But it is important to underline our preference to avoid this sector where profitability considerations are disregarded, inevitable future competition ignored and valuations are excessively optimistic.

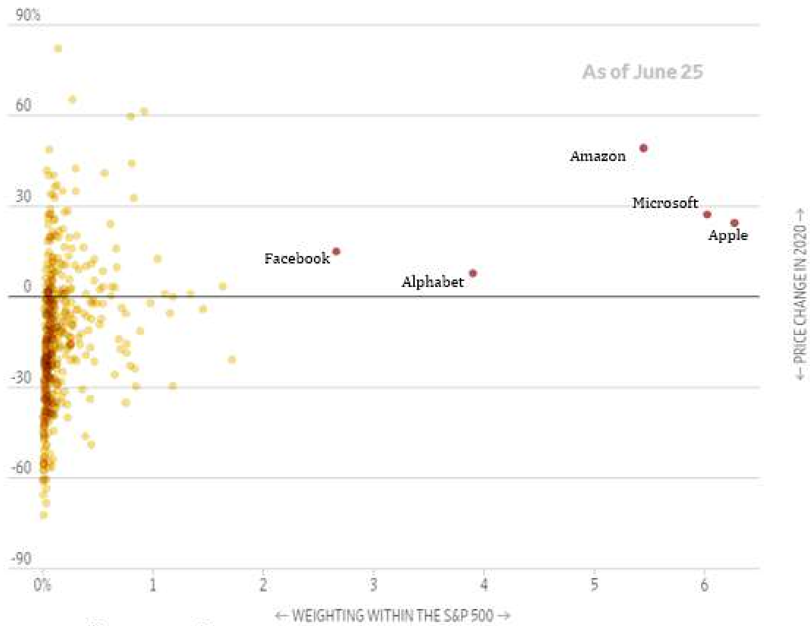
In general, our portfolio today is focussed on traditional industries in stocks where we have been able to observe the impact of a cyclical downturn in the past. These industries, due to their age and difficulty, tend to have higher barriers to entry and are not attracting waves of start-ups looking to disrupt the industry. They tend to be industries whose return on invested capital (ROIC) is sensitive to economic change. Whilst these industries will tend to underperform in times of extreme economic pessimism (and strongly outperform when the economy grows), our portfolio companies have a strong track record of winning market share during these downturns. With the prospect of a gradual economic recovery ahead, our companies' strengthening market positions is a very encouraging development.

Market Outlook

We have just witnessed stocks fall from all-time highs into a bear market decline of over 30% in the shortest time in history, followed by the fastest ever bull market recovery. We tend to think of the stock market as a barometer for the underlying health of the economy. Clearly, in the midst of a pandemic, an oil price collapse, riots, massive unemployment and a significant drop in GDP, the world economy looks in very poor health. However, this latest quarter shows a puzzling combination of extreme market strength and severe economic weakness. How can the market go up when the economy is so weak?

- As we wrote in the last note, the market seemed very oversold in the previous quarter (on the basis that a severe but relatively short term hit to earnings is just not as significant to long run asset valuations as the market drop suggested).
- The market is 'forward looking' and able to look through the current earnings trough, to more favourable periods ahead. This ability to look forward tends to temporarily disappear when volatility strikes, but always returns.
- At the bottom, the market was pricing in risks that did not materialise. Most notably there were fears that we might see another GFC-style credit squeeze where companies would not be able to attract financing to meet their obligations and get them through the downturn. Instead, central banks have acted incredibly swiftly to provide liquidity, enabling companies to refinance and extend their facilities surprisingly easily.
- Central banks have chopped interest rates and injected a staggering >$4tn in quantitative easing, spent on government treasuries, corporate bonds and even sub-investment grade 'junk' bonds. Indeed, the US Fed has said we "will do whatever it takes" and "we will not run out of ammunition".
- This QE has driven up the valuations of debt securities across the board, with interest rates around all-time lows and credit spreads significantly reduced. As valuation is a relative concept, this has provided a major boost to stock market valuations which still look very attractive compared with bonds at current yields.
- Much of the strength of major indices actually reflects a handful of very large technology stocks that dominate the index weightings, whilst masking the pain felt in other parts of the market. We see evidence of this in that the NYSE FANG+ index is up 33% for 2020 YTD, whereas the Dow Industrials Index is down -10%. Similarly, the chart below sets out the individual member returns for the S&P 500, where we see that without the tech giants, the majority of companies still remain underwater for 2020.
- Finally, just as we argued that the market was irrationally oversold last quarter, it may be overbought now as investors chase the upswing.

2020 YTD returns for every member of the S&P 500



Source: Wall Street Journal, Factset

This serves to remind ourselves to disentangle the status of the economy with asset valuation. The current monetary stimulus is an immensely powerful force, and the pledge to maintain it for as long as it takes is hugely significant.

In fact, it likely sets the stage for a scenario where mildly negative economic headlines are optimal for markets as it supposes that QE stimulus will continue further into the future (as we saw in 2012-15). As the world recovers from the pandemic, stimulus will be reduced before being removed altogether. Economic growth will be the sole driver of this, which means stocks sensitive to economic growth are likely to outperform should this scenario eventuate as it did in the last decade. In contrast stocks that are currently buoyed by stimulus are likely to struggle when it unwinds.

In general, we would contend that at a market level, indices are fairly valued, reflecting the strength of a handful of mega-cap stocks and supported by an unprecedented level of monetary stimulus. This stimulus may well continue for a while yet, but is not sustainable in the long term.

However, at an individual stock level, there are many areas of the market priced at levels corresponding to very pessimistic outlooks. We are focussed on businesses who are winning share through the downturn and positioned to perform strongly when growth recovers. We expect volatility to continue and to prudently deploy cash when extreme value presents itself.

Yours sincerely,

David Nelson and Tim Evans

blueboatcapital.com.au