April 2020 update

It has truly been an extraordinary quarter where the COVID-19 pandemic has had an extreme impact upon markets and the Blue Boat Portfolio, as the results below highlight:

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 31 March 2020:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	S&P 500	MSCI All Country
FY20 YTD (9 mths)	-22.8%	-23.1%	-25.0%	-9.5%	-14.7%
Since inception	-1.6%	-9.2%	-6.3%	17.4%	4.8%
CAGR	-0.5%	-3.2%	-2.1%	5.5%	1.6%

Source: Bloomberg. 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.

Quarter in review

It seems like a lifetime ago now, but just six weeks ago stock markets peaked in Australia, USA and Europe and the world was a very different place. As we have noted in several recent investor letters, warnings were starting to flash in parts of the market. We noticed some troubling signs including:

- Limited earnings growth for the ASX 200 and the S&P 500, which concerned us given the fact that prices had been lifting steadily for over a year.
- Subdued volatility on markets, fueling complacency and ignorance of risk. This led to a boom in passive ETFs and the belief that indexes can only rise.
- Business models that were popular but proven to be catastrophic by the GFC were popular once more in the finance sector.
- Complex debt securities and debt funds masquerading as safe high yielding alternatives to term deposits were booming in popularity at a time when credit spreads were the narrowest since 2007.
- Companies with no obvious competitive advantage or remotely sustainable business models were surging in popularity and price based on their claim to an enormous 'total addressable market'. The rules of supply and demand and threat of competition were ignored, along with the notion that profit was necessary. These companies were priced on the market on a multiple of sales, not a multiple of profit or cash flow which was encouraged by promotors and investment bankers who knew these companies would require new capital to grow which generated huge fees for all involved. The term 'revenue multiple' had not been heard in listed equities since the late stages of the dotcom bubble until mid-2019.

We deliberately avoided what we thought would prove to be problematic areas of the market and focused on our narrow list of stocks that were either exceedingly cheap or strong growth businesses with low amounts of debt. Up until early February, our strategy had Blue Boat's performance comfortably above that of all major market indices around the world. Then things changed quickly.

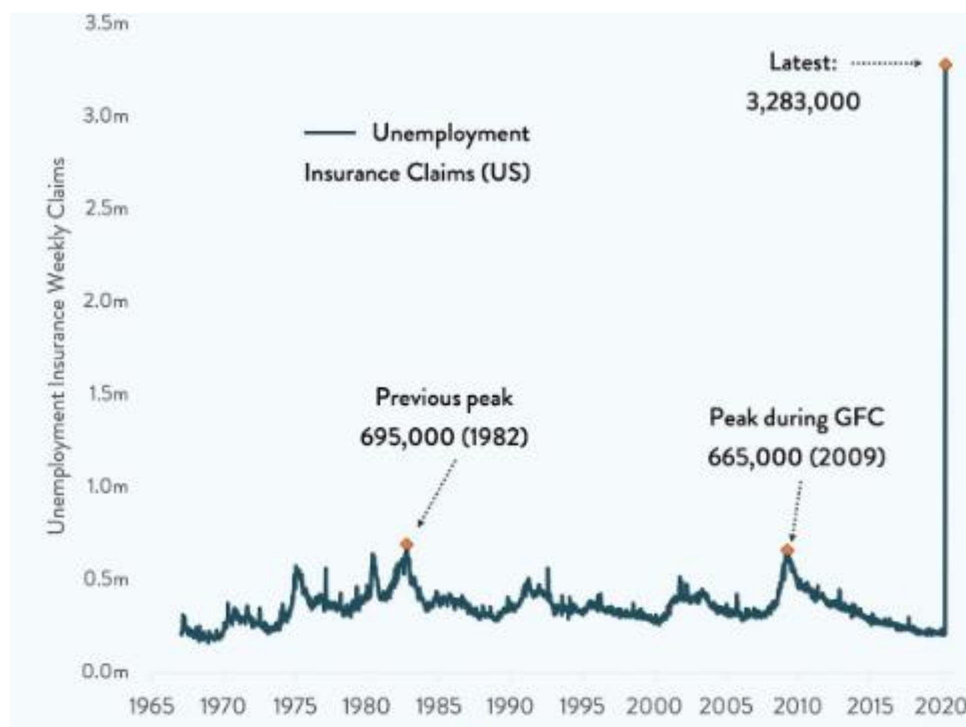
As you would be aware it was reported in January that coronavirus first took hold in China. The government there undertook unprecedented aggressive interventions paired with a population that embraced a civic duty to comply to control the outbreak. By mid-February it seemed that the interventions were effective at managing the transmission rate and isolating infected patients within China. The world was dealing with major supply chain disruptions and travel bans across Asia, but that was the extent of it and markets rose to record highs in the West. The S&P 500 and ASX 200 peaked on 19 & 20 February respectively at a time when most of China was in total lockdown.

However, despite significant warning time and travel restrictions, coronavirus infections are now present in almost every country on the planet. Tragically the power of compound interest is seeing infections and deaths grow exponentially, to the point now that many nations now must also impose drastic interventions to contain the pandemic.

If the pandemic were to be unleashed on the world unchecked, the human impact would be so significant that failure to contain it is not an option. Many governments have said they will do whatever it takes, which means healthcare mobilisation on scale never before seen.

Unfortunately for many major markets, the virus is now so widespread that very aggressive lockdown measures are required to reduce the transmission rate and bring the infection rate into decline. Shutting down economies obviously comes at extraordinary cost. Already US initial jobless claims (see chart below) have skyrocketed to 5x the previous high. Similarly, activity levels in China have plummeted which highlights the suddenness and severity of the virus' impact. Driving nations into a new Great Depression is untenable. Thus, with a similar commitment to do whatever it takes, we are also seeing governments launch the largest economic stimulus ever seen.

US initial jobless claims:



Source: Federal Reserve Bank of St. Louis

Most recessions reflect a painful unwinding of a period of excess; gradually returning the market to a balanced state of supply & demand. For example, a boom in construction might lead to a glut of supply

which prompts a collapse in prices until the surplus is absorbed by the market. This is what we saw in Australia in residential property over the past few years.

The Great Depression lasted 12 years and is being widely discussed now as a potential comparable, however today's scenario is radically different in our view. The primary impact to the economy is not as a result of some prolonged excess, but rather a severe and immediate shock to supply & demand, more akin to a natural disaster. This is not to say the economy was perfect before, but it is likely that once the pandemic is dealt with, economies have the potential to recover relatively quickly. Former US Federal Reserve Chairman Ben Bernanke, who devised the stimulus program used in the GFC based on his extensive work done on the Great Depression this week described the current situation as not remotely comparable to either event, stating it is "much closer to a major snowstorm than the Great Depression".

Whether global efforts to control the pandemic are effective remains to be seen. However, the world's leaders are now surely awake to the issue and the progress made by China and South Korea is an encouraging model for others to follow. Further we've generally seen that those countries who have taken proactive steps (including Australia) are showing decelerating growth in new cases & fatalities. Finally, with an enormous prize up for grabs, the scientific community is now fully mobilized and backed with immense resources to come up with solutions at record pace.

In the meantime, the stimulus provides a critical function to 'bridge the gap' between now and containment when the economy can start its path back to normality. Massive funding packages are designed to keep credit markets flowing and support workers and industries that are forced to abruptly stop. It would have been unthinkable three months ago, but conservative governments in Australia and the UK have announced they are effectively paying a wage to citizens who lose their job during the period of intervention. These are truly unpresented actions.

Beside the health & safety of the public, a key assessment is how long and how severe will the economic disruption be? We believe it is not so much the severity of the economic downturn that is the major issue, rather the biggest risk is that the length of time before restrictions are lifted is longer than first anticipated.

We would guess, and reinforce the word guess rather than accurately predict, that there will be severe disruption for 3 months, followed by a 'transition period' of declining interventions/disruption for at least a further 6 months. Should this be the case, or if the time frame is shorter, then we think the worst-case scenarios being priced in on markets are incorrect.

Meanwhile, markets have responded in dramatic fashion.

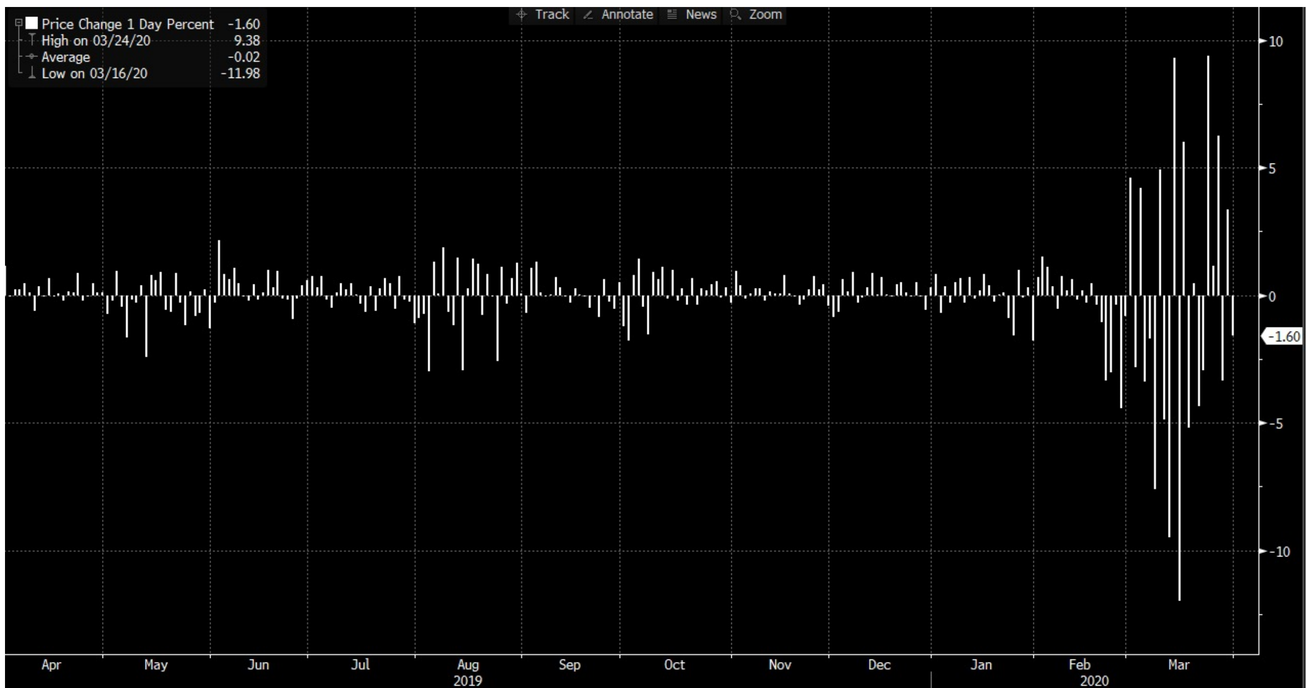
- Global stock markets have fallen sharply by c30% in a month. Australia is currently underperforming all other major indices globally since the crisis began.
- Volatility has increased dramatically, even surpassing the GFC.
- Investors have sold risky assets across the board and fled to safety buying US short term treasury bills and pushing yields to zero. This has tested liquidity in all asset classes.
- Credit spreads have expanded massively to 2008 crisis levels, decimating bond funds and debt securities that were previously deemed low risk.
- Yields on US treasury bonds have fallen to all-time lows (10yr now at 0.67%)
- Stock market P/E multiples have dropped well below their long run averages. Given interest rates have gone to practically zero, this move is twice as significant as prior market crashes.
- Against 10yr bonds, the earnings yield premium on US equities is among the highest level seen in 60 years. Australia's earnings premium is equally high.
- ETF funds have flipped to massive outflows and algorithms have broken down in some cases. They're designed to exactly track the value of the assets they cover but many are trading below

due to unprecedented selling. Investor sentiment towards these products has been severely dented.

- Saudi Arabia has taken the totally unexpected option of compounding weak demand with flooding the oil market to crush their rival producers. Oil has plummeted from $60 to $20, creating a second economic shock which in many countries is worse than the virus.

Without a doubt this is a truly extraordinary market.

S&P 500 daily percentage price change over the last 12 months:



Source: Bloomberg

Outlook

Clearly the pandemic will have a significant real-world impact on individuals' well-being and businesses' prospects. Against this the overall market reaction has been extreme and is clearly a reflection of the terrible outlook for 2020. However, equity prices (or any asset price) are supposed to incorporate the present value of all future cashflows (not just this year).

When you look into the mathematics that underpins intrinsic value (see the Appendix for further discussion in a worked example), the message is that for companies that are growing, who can survive a severe shock, and have a reasonably long future ahead of them, the impact of the shock doesn't impair the total intrinsic value significantly at all.

Investors however have a very difficult time incorporating material negative events in their assessment of companies' value as fear and uncertainty are powerful forces. Some traders will try to anticipate the bearishness of others and get their sell orders in first. When everyone expects everyone else to be fearful, a powerful herd movement can sometimes develop resulting in sharp falls. (This tends to occur more frequently with regards to selling than buying). As a result, impacts felt in the current year are almost always overstated in the share price compared to the change in actual underlying value.

Whilst the current panic rages we endeavor to stay rational, focus on the underlying value and block out the emotion. We have been observing and buying into stocks which have had price declines of up to 75%. Their earnings will certainly be negatively impacted in the next two years, but the price being offered implies that things will never recover. We believe this is far too pessimistic and therefore presents outstanding investment opportunities for Blue Boat.

The massive extent of government & private sector support available to deal with the pandemic and pacify the economy helps remove the risk of total collapse in 2020 and paves the way for a recovery through 2021 and beyond. This showering of seemingly 'free' money is anything but and will be the burden of society for the foreseeable future, which could have unusual ramifications in years to come.

It is our view that the events occurring in markets, where all assets are being sold without any consideration of the longer-term prospects of that asset or business, are causing highly irrational behavior which makes markets inefficient. The flood of money into short term US treasury bills (considered basically risk-free but guaranteeing next to no return) and out of everything else firmly points to an oversold market that is raptured by fear.

Nonetheless once investors get a sense that there is a resolution of the pandemic in sight and an economic recovery underway, the market will take a greater appreciation of long-term value. The speed at which sentiment swung from complacency and greed to outright fear and panic should be remembered. On the other side of this crisis the shift back will occur; the length of time it takes is the only uncertainty.

In March 2009, Jeremy Grantham put out a well-timed article where he discussed the psychological pain involved in trying to buy at the bottom. He said:

> "Finally, be aware that the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before."

2009 is an important year to understand and well worth remembering. Shortly after Grantham penned this letter, markets miraculously turned higher. This was accompanied by recapitalisations of companies via equity issues. The rapid shift from fear of the unknown, to being asked to invest in new shares issued by a company based on a clearer outlook saw a 180 degree turn in investor sentiment and investor focus.

In a recent note Howard Marks commented that the its impossible to know when the bottom of a market has been reached (as it's always the day before the recovery begins).

He uses the analogy that the market acts like a pendulum. You never know the exact moment the pendulum will swing back in the other direction, but the more extreme the current position, the higher the probability the momentum will turn.

Similarly, we would argue that the current status of the pandemic looks very black, and markets are very extreme. Accordingly, from a market perspective we would argue that the odds of a recovery are in our favour; at an individual stock level even more so.

Portfolio Positioning

It is evident that 2020 will be an incredibly difficult period for many businesses, and there will be casualties. Our top priority is to ensure portfolio companies can survive the year.

During this downturn we've seen good and bad companies indiscriminately sold down across the board, which has been reflected directly in the performance of our portfolio. This presents opportunities to enhance the portfolio by buying high quality companies at attractive prices that previously were unavailable.

The pandemic and stimulus package will likely have lasting effects on the way we all live. It will probably be a major catalyst for change in the fields of healthcare, travel and work life among others. It is our view that some of the trends that were already steadily changing the world will likely accelerate as a result of the virus. These trends will present many earnings opportunities for companies and we are pleased to have some exposure here.

For example Ping An Good Doctor is the leading online health platform in China and saw a tremendous boost in activity during the lockdown. China's reliance on online shopping was re-enforced during the lockdown and Alibaba has undoubtedly become even more of a necessity for its 700 million active users. With the growth in internet usage in China growing exponentially and many more businesses moving online, we are very bullish on the outlook for Alibaba's cloud business which has dominant market share in underpenetrated China. Even the funeral business is moving online, as seen by the strong demand for Fu Shou Yuan's virtual funeral business. They're also seeing explosive growth in the pre-payment of burial plots and services. This creates a 'float', like an insurance company, that will become increasingly valuable over time for Fu Shou Yuan who are able to invest that float. We are very excited about the outlook for these businesses which all announced record profits for 2019 during the quarter.

The containment battle also has the potential to affect governments. The US Presidential election especially will highlight the Trump administration's ability to manage the outbreak and the economy. The coming months will make or break the Trump administration. Geopolitical relationships may also change and that has wide implications including trade. At this stage China looks like a net beneficiary.

We cannot understate the scale of the stimulus being undertaken. This also will have major ramifications on markets. With stimulus currently pledged at US$8 trillion, the world's economies are set to be flooded with extraordinary quantities of newly printed money and issued debt. All else equal we would expect this to be very inflationary in years ahead, and accordingly impact interest rates and asset prices.

When we saw the coronavirus threat emerge in China in late January our focus turned to our Chinese investments which are major holdings in the fund. We decided that the businesses we own there are robust and the Chinese economy would be able to contain and manage the threat effectively. The profitability of Chinese companies will be badly impacted in the first quarter of the current calendar year and GDP will likely retract for the first time in 40 years, but by mid-February we decided that the competitive position and significant long term structural growth in our businesses was sufficient that we would not sell despite the outlook for the virus and the economy. We have in fact added to our position in Ping An, which announced its 2019 full year result with +19% in Operating EPS growth and in our view is entering a period of enormous growth for financial services in China. We now have 5 position in Chinese companies and remain very bullish on this portion of Blue Boat's portfolio.

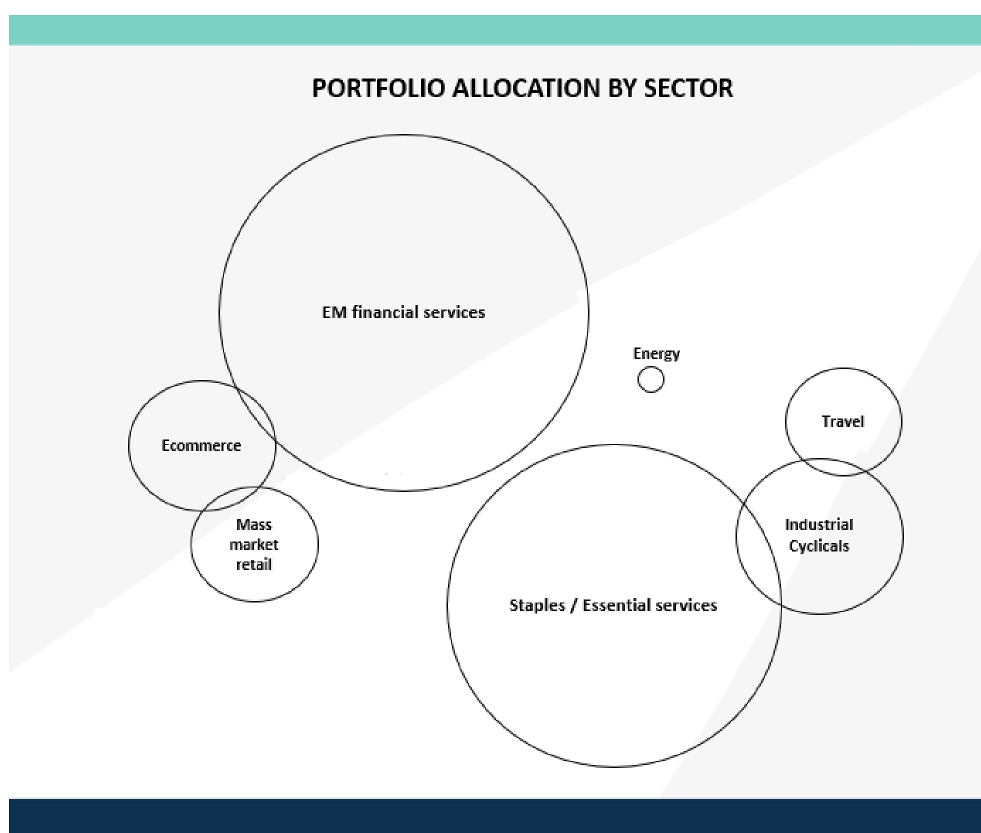
During this time we must admit that we also made the decision that the risk of the coronavirus spreading throughout the world was not something we had to worry about to the extent of selling out of our portfolio in the rest of the world. Many fund managers now claim that they foresaw the events that have unfolded, most of whom are overstating their actions.

We want to admit to you that we did not take action in our portfolio in protecting against the downside that was to follow. On this point we very much wish we did have the foresight to have sold at the top and buy back at the bottom. But it is not in our nature try and predict major health or macroeconomic catastrophes, nor is it our plan to sell all stocks in anticipation of expected market crashes. It is our view that attempting to sell at the first sign of trouble with the hope that you can buy back lower will have highly inconsistent results given the market has a clear historical record of rising over time. We will not attempt to beat the odds that are stacked against the investor that attempts to do so. The market has performed very well over the long term without the ability to close down during the many terrible events that have plagued the world in the last hundred years. We continue to believe that investing for the long

term in high quality businesses whilst avoiding bubbles and fads will produce better results in the long term than attempting to predict the next market shock by jumping in and out of the market.

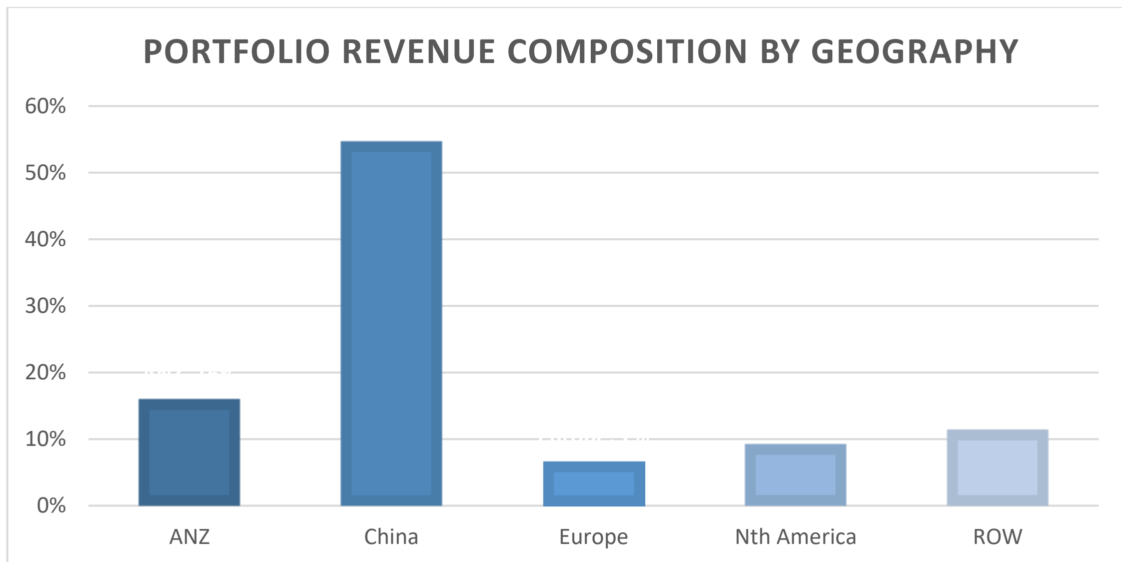
Unfortunately, when events like the current coronavirus induced stock market collapse occurs, there is no major differentiator in performance between high quality and low-quality companies if that sector is negatively impacted. Our action during the market sell off his been to exit all businesses that had potentially vulnerable debt positions or were not in a position ride out what we believe could be an arduous period in 2020.

We have narrowed our portfolio to focus on companies that we feel have the most upside on the other side of the virus induced lockdown which will affect businesses in countries all over the world. We had to make some tough decisions, but feel the portfolio is now very well positioned and the risk has been reduced significantly by focusing on such companies. The two things we have prioritized is balance sheet and competitive advantage. We feel that many competitors in industries directly affected by the virus restrictions will not survive, therefore the potential for market share gains and therefore much greater long term upside will occur for our companies.



The graphic above roughly illustrates the allocation of the portfolio by sector, where the size of each bubble represents the relative weighting in the portfolio (noting that there are some overlaps).

Broadly we expect the retail, travel and energy to be especially impacted in the short term by the disruption required to contain the pandemic. However we believe these are fundamentally strong businesses that can get through this difficult period, and their extremely depressed share prices make them very attractive investments.



The chart above sets out the composition of the portfolio according to the geographical source of the portfolio's revenues. As with our earlier comments, we see tremendous opportunity in the Chinese market and the portfolio is weighted accordingly.

In addition, we take great confidence in the performance of the portfolio companies:

- The 2019 weighted average profit growth was 24%.
- Current prices on 2019 earnings represent a weighted average P/E multiple of 14x.
- Half of the portfolio is allocated to companies with net cash balance sheets. Excluding financials, the remaining companies have a weighted average Net Debt/EBITDA gearing of 1.5x which we regard as secure.
- We currently have 15 active positions in the portfolio.

We believe that the quality & growth of the portfolio is very strong, and very attractive at the current price. We are very excited to see how our companies perform going forward as the threat of coronavirus recedes.

Clearly this has been an unsettling time for investors. We know that we cannot precisely pick the bottom of the market, but we feel very comfortable suggesting that it's an excellent buying opportunity at these levels. We are both personally adding to our Blue Boat investment this quarter and we strongly commend this to you as well.

Yours sincerely,

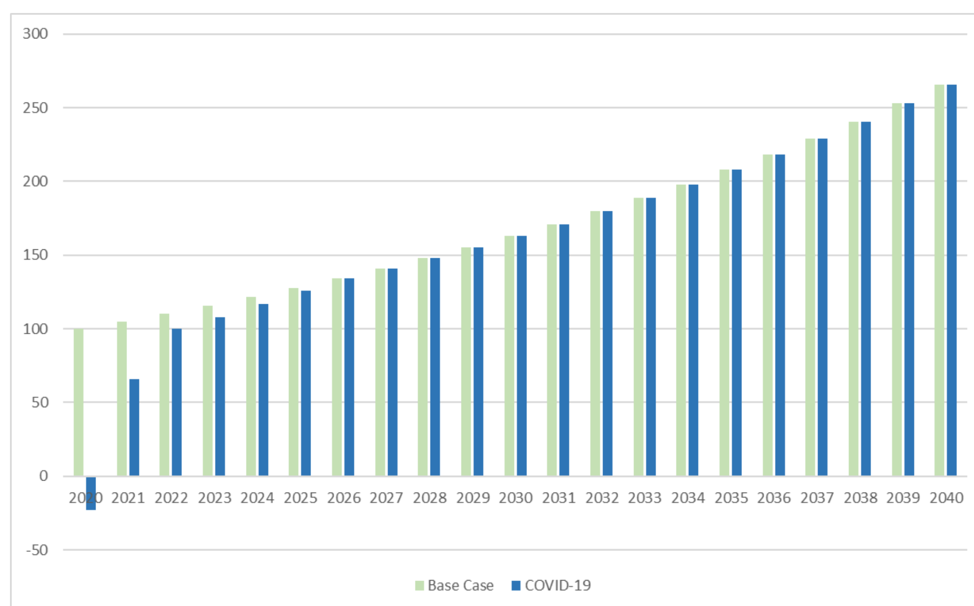
David Nelson and Tim Evans

blueboatcapital.com.au

PS: We hoped to host a lunch in May for all Blue Boat Investors which would be an opportunity to informally discuss our methods and ideas. Sadly given the pandemic state of affairs we will have to postpone this until a later date. In the meantime, if you have any questions at all, please feel free to ask us anytime.

Appendix

To measure the change in intrinsic value as a result of the pandemic, and therefore assess the appropriateness of the market downturn, let's take a theoretical exercise. Consider the chart below which sets out an arbitrary 20 year projection of cashflows from a 'Base' scenario growing at 5% per annum, alongside a 'COVID-19' Case setting out the kind of relative impact we might expect from the pandemic with the containment interventions:



Now take the net present value of each scenario (here using a 10% discount rate):

Base Case 20YR NPV (10%), with 5% growth	
Total PV	$1,211
PV of yr 1	$91
PV of yrs 2-20	$1,120

20YR NPV (10%)	2020	2021	chg
Base Case	$1,211	$1,272	5%
COVID-19	$1,050	$1,218	16%
difference	-13%	-4%	
30% price drop	$848	$1,218	44%

From the top panel above note that under the Base Case, only 8% of the NPV comes from the first year, whilst the vast majority of value lies within the cashflows thereafter.

The lower panel also presents the COVID-19 Case, where although the initial years are awful, over 20 years, the NPV declines by only 13% versus the Base Case. When we roll forward to 2021 the difference between the scenarios narrows to just 4%.

If we suppose as a result of the COVID-19 shock, market prices in fact drop by 30% from the Base Case, that implies there is 44% upside to the 2021 COVID-19 NPV.

This example features a number of assumptions, but when we flex them the general conclusion is robust: that a short term shock just doesn't impact long term underlying value that much of a company (or any asset) that has a future on the other side.