BLUEBOAT

<u>January 2021 update</u>

It has been a productive half for the Blue Boat Portfolio, as the results below highlight. We continue to refine our processes and are pleased to see the results improving.

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

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	MSCI All Country
FY21 YTD (6 mths)	23.7%	23.3%	13.2%	11.3%
Since inception	41.4%	29.9%	29.4%	55.9%
CAGR	9.7%	7.2%	7.1%	12.6%

Source: Bloomberg. Returns are presented in AUD. Index returns include net reinvested dividends. CAGR is the compound annual growth rate since fund inception.

Many investors will be relieved to see the back of 2020, which will go down in history as one of the most volatile years ever. Global markets were strong this quarter as investors looked to 2021 and the prospect of a post-Covid-19 recovery. The critical ingredient to this recovery is an effective and widely available vaccine.

At Blue Boat, we have been optimistic about the prospects of such a vaccine for some time. Given the vast funding available, the fact that there were over 200 candidates in trial phase and the immense support from governments in what has become akin to a war-effort. Compared to early in the pandemic, many western nations are now in far worse positions regarding hospitalisations and deaths. Nevertheless, investors have shown their willingness to look ahead and appreciate companies' long-term earnings potential.

The current situation is the inverse of what we saw in March. During the early stages of the pandemic, investors ignored the future prospects of businesses favouring sheer panic about the short-term outlook. This produced what we believe was the best buying opportunity of our lifetimes in sectors directly impacted in the short term. In the April letter, we pointed out that a short-term loss of revenue has a minimal impact on a sound business's long-term value and prosperity.

Now it is upon us to warn that a short-term positive boost in prosperity also does not alter the long term returns of a challenged or unproven business. Much has been lauded about 'new paradigms' initiated by the pandemic and structural changes that will permanently exist in a post-Covid world. Capitalism's ability to nullify competitive advantages and profitability with competition cannot be understated. Whilst these changes may occur, as with the invention of the automobile and the aeroplane, we are not as optimistic on the prospects of companies currently leading the way in 'new' industries.

Uncertainty drives volatility in markets. Clearly, the pandemic has sparked significant uncertainty, but the outlook for vaccines now provides better visibility than we've had all year. The US election was also highly contentious, but the result delivered a 'goldilocks' outcome for markets. The Biden Presidency is expected to provide a more stable operating environment for businesses' decision making, whilst a divided house/senate is likely to prevent sweeping changes (to taxes especially) and, therefore, reduce uncertainty.

Portfolio Positioning

We were especially confident in our position when buying as the market fell in March for several reasons. We noted that this economic disaster was not the result of a cyclical unwinding after a period of excess, oversupply and debt-fuelled speculation as generally occurs in a recession. For example, in Australia the economic conditions before Covid-19 were anything but rosy with a cooling property market, tight lending restrictions, low consumer confidence and a culture of companies favouring dividends over growth. We contrasted this with the booms preceding 1929, 1987 and 2007 and concluded that 2020 was altogether different.

Today at an overall market level, we see signs of a classic cyclical recovery. In Australia, many economic data points are showing encouraging improvements. Residential property prices are rising, mortgage delinquency is far better than expected and retail spending is at record levels. Along with these, commodities have strengthened significantly, USD has dropped, and the market is showing rotation towards cyclical stocks for the first time in several years.

Comparing the current operating environment for cyclical companies, whose margins are sensitive to economic growth, to that of twelve months ago, we see a rapid improvement in the Australian market. Our positive position on the outlook for Australia is contrarian when compared to consensus, who remain anchored to the cyclically depressed years prior to Covid-19.

China, where we have significant exposure, has displayed a robust recovery. China is likely to be the only major economy to grow GDP in 2020 and will accelerate in 2021. Blue Boat's exposure is entirely focused on parts of the Chinese economy which we believe will demonstrate tremendous growth in the medium to long term. We believe that the Chinese consumer is one of the most apparent growth opportunities in the world for investors. Likewise, financial services will grow significantly faster than comparable western companies. Finally, we think the rapid aging of the Chinese population is an opportunity where we are well-positioned. Despite the relative outperformance of the Chinese economy and the underlying growth trends which will continue for the foreseeable future, Chinese stocks remain attractively priced compared to those in the USA, Europe and Australia.

The Blue Boat ASX portfolio had another quarter of substantial gains. Along with the general market strength, our returns were supported by healthy updates from our portfolio companies. As we mentioned in the last note, most companies elected not to provide guidance in their August reporting owing to uncertainty from the pandemic. As a result, many companies instead provided trading updates in October-December providing a kind of bonus reporting season. Across the board, we were impressed by the strength of the updates, and the ability of the managers of the companies we invest in to navigate the crisis and their business models sustainability. When we compare the fund's position today with where we were in 2019, we feel far more confident about our companies' outlook based on recent results and updates.

Areas of Concern

In the US, the major indices are setting record highs. Part of this is fuelled by areas of the market that are now looking dangerously speculative. Within sectors including cryptocurrencies, options, the tech

IPO market and popular stocks such as Tesla, there are strong indications that price discrimination is not present.

Perhaps the ultimate example of this is in the market for SPACs (Special Purpose Acquisition Companies). SPACs are blank-cheque companies where the sponsor raises money from investors to go into an empty vehicle, and then will go out and search for an acquisition. Typically, the sponsor has two years to deploy the funds, otherwise it must be returned to investors. With huge fees on the table, there is a big incentive for sponsors to pay a high price to ensure an acquisition is completed.

SPACs as a product initially might make some sense. For a privately-owned business, acquisition by a SPAC is a very efficient route to becoming publicly listed. For SPAC investors, the product effectively offers an opportunity to invest in a company IPO, which you otherwise probably would not get access. The investors don't know what the acquired company or terms will be, but rely on the sponsor's reputation to secure an attractive deal.

As with many financial innovations, SPACs have been taken to the extreme. More money has been raised for SPACs in 2020 than 2003-2019 combined. There is currently US$73bn in deployable SPAC funds now in competition to source attractive acquisitions, which is sure to bid up prices. SPAC investors do not know what the investment will be, or what the price is, yet demand for these products has been wildly popular. This form of speculation rests on the 'greater fool' principal, where investors are confident that no matter what is the price paid and there will always be some other person willing to pay more later on. These are the classic conditions of a bubble.

Like all bubbles, we have seen this before. In the 1980s there was a boom in 'Leveraged Buy Out' (LBO) funds. These companies raised debt in the form of junk bonds and aggressively acquired companies with a plan to either re-sell them or break them up and extract value.

These LBO's were successful for a time but spectacularly imploded in the recession following the 1987 market crash. What was evident was that a business didn't improve or become more prosperous in the hands of an LBO, just as we suspect they will not be in the hands of a SPAC. As Mark Twain said, "history doesn't repeat itself, but it does rhyme", so we're happy to remain highly sceptical on SPACs and are preparing for the inevitable fallout at the speculative end of the market.

Outlook

One thing that 2020 has demonstrated is just how difficult it can be to time the market. Since the March low, the S&P 500 has had significant declines in June, September and October and yet overall it has produced a stellar rally. It has been a volatile year, but the opportunity cost for those sitting on the sidelines has been very high.

With the deployment of vaccines, both economies and company earnings are poised to rebound. Combined with a very supportive fiscal & monetary background, this casts a positive environment for equities in the year ahead.

However, as discussed, there are concerning areas of the market, and we think it is prudent to assume that the vaccination process will have some hiccups along the way. Accordingly, we believe this environment especially calls for vigilance to ensure that portfolio holdings are genuinely supported by fundamentals.

We expect the path to recovery to be uneven, which likely spells a volatile market. We believe it is to our advantage should volatility continue in 2021. We expect this to increasingly become a stock-pickers market, which we think favours the concentrated Blue Boat portfolio for long term returns.
If you would also like to top up or refer someone who may want to invest in Blue Boat, please don't hesitate to contact either of us.

Yours sincerely,

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