BLUEBOAT

## January 2020 update

It has been a rewarding first half to the 2020 financial year for Blue Boat and in particular the second quarter has been strong. The fund NAV/unit is now $1.211.

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 – 31 December 2019:**

| | Blue Boat Gross Return | Blue Boat Net Return | ASX 200 | S&P 500 | MSCI World |
|---|---|---|---|---|---|
| FY20 YTD (6 mths) | 9.4% | 9.1% | 4.2% | 10.7% | 9.8% |
| Since inception | 39.4% | 28.8% | 30.1% | 43.7% | 35.8% |
| CAGR | 12.8% | 9.6% | 10.1% | 14.1% | 11.8% |

*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.*

We mentioned in a previous update that due to the concentrated nature of our portfolio and the low turnover of the stocks we hold, that we expect the volatility witnessed so far to continue. The FY18 gross return of +42.3% was outstanding and whilst the -11.5% decline we incurred last financial year was disappointing, we felt it reflected severe mispricing by the market. We are pleased to see our patience now being rewarded with continued re-rating in some of our contrarian positions in the portfolio.

The 2019 calendar year saw tremendous returns for most major indices with the ASX 200 up 20% and the S&P 500 up 29%. To make sense of this we need to zoom out a little to put these returns in context.

When we wrote to you 12 months ago, it was at the very trough of a sharp, sudden market correction that saw markets decline by close to 20% in less than three months. People often want to succinctly tie each major market sell off to some global macroeconomic or political event, but most of the time it is simply that fear overwhelms the minds of investors and they all rush for the exit at the same time.

This stampede for the exits is now easier and more pronounced than ever been before due to the tremendous weight of money in exchange traded funds (ETFs) which are controlled by algorithms that act without emotion (or judgement!) and indiscriminately sell across the board when the owner of the ETF decides to sell.

This time last year the consensus on interest rates, one of the most important considerations when valuing the future cash flows of any investment, shifted to an outlook of higher rates and higher inflation. Then in the first half of 2019 this swiftly reverted to the previously accepted theory of “lower for longer” which buoyed the lofty valuations for long dated growth stocks and anything producing predictable income.

In addition, we saw growing concerns surrounding a US-China trade war and the potential for a worst case Brexit outcome. However, as we moved towards the end of 2019 markets have taken confidence that these issues are steadily working their way toward rational outcomes.

In total it was a very sharp panic at the end of 2018 (which offered bargain prices for investors), followed by a steady recovery as fear subsided. Overall if you look at the returns from 1 October 2018 to 31 December 2019, the ASX 200 and S&P 500 each achieved a relatively average 15 month gain of 10% which we think is a more relevant figure to look at when judging the markets return.

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In a perfect world we would have exited our expensive or cyclically challenged positions at the top of the market in October 2018 and waited until late December for the very bottom to re-enter. This strategy, as ideal as it sounds, is not one we will pursue as the likelihood of successfully timing the sells and buys is close to zero and after considering friction costs like tax, the reward is also unlikely to be worth the risk. Our view is that volatility is impossible to avoid, so the far more sensible strategy is to hold one's nerve and ride out the swings in the market whilst constantly looking for opportunities in individual stocks to capitalise on when fear reigns supreme.

Since the Great Depression, there have only been four occasions where it proved beneficial to rush for the exit and sell after the market had fallen by 20%. The market halved in 1973/74, in 1987/88 and in 2008/09. It fell by 35% in 1981/82. Yet over this 90 year period there have also been dozens of 10-20% corrections where the stock market has acted as a very efficient platform to transfer wealth from impatient to patient investors. It is also worth noting that on average the market gained more than 50% in the twelve months following the bottom of those four super bear markets, so if you miss-timed your re-entry, your perfectly timed exit would have been wasted. With statistics like these, we think our strategy is the right one.

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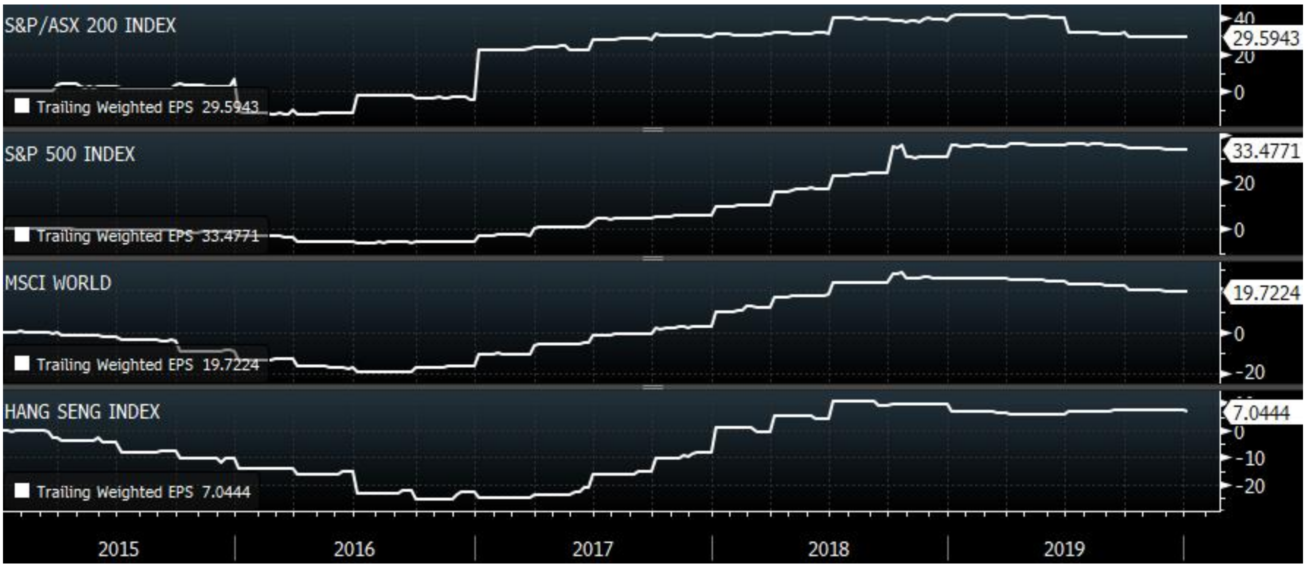
2019 was in fact a poor year for corporate earnings growth, with major indices showing flat or slightly negative earnings growth compared with 2018. It seems likely that the fears and concerns that hit the market at the end of 2018 prompted both consumers and businesses to pause and hold back major new spending. On balance, whilst we take hope from recent macro developments, with the lack of earnings growth the overall strength of the market has been attributable mainly to the shift to a lower interest rate outlook. Without a return in earnings growth it is highly unlikely that 2020 will produce widespread stellar results.

*Major Indices' 12 month rolling Earnings Per Share for the last 5 years.*




*Source: Bloomberg*

We think now, more than any time in recent years, it is important to narrow one's investment focus to outstanding or undervalued companies that can beat the index rather than attempting to benefit from a rising tide that we think is unlikely to rise much more for a while.

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This brings us to the broader topic of looking to capitalise on market inefficiencies in our investing. Academics like to talk about the efficiency of markets, whereby share prices fully reflect all available information and expected returns therefore only just compensate investors for the risk assumed. There are valid arguments to suggest that large, well-functioning markets dominated by institutional investors such as in the US are relatively efficient, at least on average. However, whilst averages might be efficient, any individual stock can be priced inefficiently from time to time.

A good example is the share price development of Apple. As one of the largest and most liquid stocks on the planet, Apple ought to be a stock with a very high likelihood of an efficient share price. Yet in the time since from Sept 2016 the Apple market capitalisation rose 117%, against an improvement in EPS of 44%, representing a massive expansion of its P/E multiple from around 12x to 22x. It's hard to rationalise that over this time the fundamentals of Apple improved so significantly to warrant such a transformation in the share price. In fact, you could argue that during this period Apple produced no new major innovations, faced growing competition from android phones & rival ecosystems, had a deteriorating balance sheet, and increasing anti-trust grumblings. Yet the share price went from strength to strength.

Most likely these developments don't illustrate a market efficiently incorporating very positive news but rather it underlines a major swing in investor sentiment towards Apple. Where previously the company was regarded as a producer of somewhat commoditised hardware, it's now seen as an extraordinarily powerful brand with loyal, returning customers that will buy regardless of price increases.

*Apple forward P/E ratio*


*Source: Bloomberg*

The Apple example highlights that inefficiencies do exist and if they can happen in Apple, they can happen anywhere. As Warren Buffett once said, "*The stock market is the only place where you put up the 'for sale' sign and people run out of the store*." Buffett, the biggest critic of the efficient market theory, spotted this inefficiency in Apple which is one of the most watched stocks in the world. He allocated 25% of Berkshire Hathaway's equities portfolio to Apple which has more than doubled from $36bn to $76bn in size.

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Part of our strategy is to look in places where we think profitable opportunities are most likely. In turn we think there are pockets of the market where inefficiency and mispricing is more probable.

One area is smaller companies which tend to have less media and analyst coverage and are often off the radar for large investors with liquidity requirements or major index ETFs. Australian Small/Mid caps in particular is an area where we think we have an edge. We can meet with management and get to understand the company, conduct thorough research and identify value that the market has underrated or has passed over.

Another interesting market that we have touched on is China, which we think is also primed for mispricing. Clearly it is a large market with the potential for enormous returns. However, the liquidity, access to information, relative lack of analyst coverage and other frictional aspects are deterrents for investors and efficient pricing. Institutional investors make up a small fraction of the market and stock turnover is high, both indicative of an immature market where mispricing can occur.

Furthermore, the outlook for Chinese companies is very positive. Howard Marks was quoted at the Sohn Hearts and Minds conference in November saying:

> *"What I tell people is that Europe and Japan are economic senior citizens, the US is a mature adult and China is a teenager. If anyone has ever had a teenager in their house you know it can be chaotic and tempestuous, and there are lots of good days and bad days, but you also know the teenager's best decades lie ahead. I think the analogy holds."*
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> *"Will China continue to grow faster than the rest of the world, and will China have the largest economy within the next 10 to 15 years? You can't say for sure, but it would be silly to say not. There's a non-zero probability that China's going to grow very strongly and so, over the long term, you probably want to have some significant investments there."*

We think this quote is very apt and like all adolescents, undoubtedly there is going to be inconsistencies and missteps. Likewise, there will be periods of time when the prospects are both over and underrated. With the Chinese/Hong Kong markets substantially cheaper than other major markets (trading on circa 11x P/E versus 17x in USA and Australia), we would argue that this is a time where it is inefficiently underrated.

We have three significant positions in China being Fu Shou Yuan, Ping An and Alibaba, all of which we added to in 2019. Since the peak of the market two years ago (before the trade war kicked off in January 2018) their EPS has increased by 27%, 72% and 87% respectively, yet only Alibaba is trading at a higher price. Given our view that share prices will follow earnings growth over time, we remain very bullish on the outlook for our Chinese portfolio and feel our patience will be rewarded.

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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.

Blue Boat is now online! We now have a new website which you can check out at www.blueboatcapital.com.au. The site holds all the investor letters as well as the performance record for you to access.

Finally to celebrate 3 years since the inception of the Blue Boat Fund, we would like to invite you to an investor lunch in Brisbane on Thursday 21 May 2019. Please save this date in your calendar and we will update you with further details in the near future.

Yours sincerely,

David Nelson and Tim Evans