April 2021 update

It has been strong year so far for the Blue Boat Portfolio, as the results below highlight.

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 31 March 2021:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	MSCI All Country
FY21 YTD (9 mths)	37.9%	37.3%	18.0%	17.7%
Since inception	57.7%	44.7%	34.8%	64.8%
CAGR	12.1%	9.7%	7.8%	13.3%

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

This letter marks four years since the inception of the Blue Boat fund. We sincerely offer our thanks to all our investors who have shown tremendous faith in us. We vow to honour your trust by working hard with singular focus on performance. Having supportive investors with a long-term view is a massive advantage during such testing times.

We would also like to tip our hats to Fuyao Wang, a recent addition to the team. Fuyao has been enormously helpful in adding to our research process, especially concerning the Chinese companies we are investigating. We commend her for the high quality of her research and offer her our thanks.

One year on

One year ago, we, like most fund managers worldwide, were humbled by deeply distressed markets and a portfolio that had fallen sharply. Equity markets around the world had fallen 30-40% in 22 trading days, the fastest bear market ever. In extremely rapid fashion, the full impact of the pandemic was embraced by markets and priced in.... and then some.

This time last year, we attached an appendix to the quarterly investor letter examining the fair value impact of a short-term loss of earnings, which we have reproduced at the end of this letter. Our finding was that for companies that can survive a disaster, the impact on intrinsic value was limited. Although there was great uncertainty at the time, with the market down by around one-third, we concluded that the opportunities were far greater than the risks.

With this assessment, we felt that the market offered stocks in the ASX consumer discretionary sector as a once in a lifetime opportunity. In particular, we took the view that:

1. The financial pain would be shared between governments, lenders, landlords, tenants and consumers. The rule book would be thrown out;
2. The demographic of unemployed/negatively impacted people were markedly different from the GFC and more concentrated within millennials who were not heavily indebted. Many older/more affluent people, including most of those with mortgage debt, retained their jobs and income;
3. Due to a lack of spending options, many households would save money, helping repair personal balance sheets.
4. Spending would be re-allocated rapidly, creating clear 'stay at home' winners, and

5. The desire for people to travel once it is safe to do so will not be diminished by the pandemic.

As the market started to become less fearful, our views went from being radical to plausible. However, in the following months, the consensus narrative argued that the consumer discretionary sector's strength would unravel quickly once the supporting stimulus was reduced.

In fact, as we headed towards Christmas, we saw in Australia that the enthusiasm of consumers and the personal balance sheets of borrowers were strengthening, not weakening. We observed that the majority of dollars spent and saved were by people who never received JobKeeper stimulus funding. They were feeling both secure and optimistic about their financial position.

Today there are no more JobKeeper payments being made to Australians, yet personal savings have increased enormously. Along with this deleveraging, there is real strength in housing, autos and other cyclicals. We do not believe this is a short-term blip, rather a major cyclical recovery aided by, but not entirely due to, government stimulus.

Similarly, in the US, the impact of the pandemic was dealt inequitably. Nonetheless, the financial outcome for many people and the businesses that serve them has been positive. From Howard Marks' recent memo:

> *"I'm particularly impressed by the potential for well above average consumer spending. Think about all the things you didn't spend money on in the last 12 months, such as vacations, dinners out, concerts and shows, and clothing for special occasions, and about the millions of Americans of whom the same is true.*
>
> *Now consider the households that made more money last year than they did the year before – starting with those who received support checks but didn't suffer job losses. This caused real personal income to grow at the fastest rate in 20 years.*
>
> *Harvard economist Jason Furman estimates that the combination of above-trend income and below-trend spending has created roughly $1.8 trillion of extra disposable personal income since the beginning of the pandemic. Finally, add in the very positive wealth effect from last year's multi trillion-dollar appreciation on stocks and still more on homes.*
>
> *The combination of the extra disposable income with the ending of a prolonged period of isolation and release of pent-up demand has the potential to add substantially to short-term economic growth."*

This strength is displayed widely across the US economy. The US Federal Reserve raised their expectation for 2021 GDP growth to 6.5%, up sharply from the previous forecast of 4.2% made in December.

Looking ahead

There is a consensus in markets that 2019 was about as good as it gets. Unemployment was at record lows, and markets were at record highs. As economies recover from the pandemic, expectations are anchored to 2019 as the base year and the level we can get back to as a level of normality. However, this broad view glosses over a lot of nuances that are revealed in the details.

In reality, the pre-covid period was strong overall, but that strength was overwhelming attached to technology and associated consumer businesses. Whether looking at revenues, earnings or share price performance, almost all the growth was driven in these areas. In contrast, other (typically cyclical) sectors have been significant laggards for years.

Take, for example, new housing starts in the US. Until December 2019, this had been running below the long-term average since 2007, a 12-year cyclical trough. Just prior to the pandemic, this housing activity finally returned to the average level and this has continued since.

US total new privately-owned housing starts:

Source: St Louis Federal Reserve. US recessions are shaded. Long run average is shown in red.

When you consider that cyclicals have been subdued for many years, with an environment of optimism, comparatively high savings, pent-up demand, stimulus and investment (including in green infrastructure and critical resources), the scene is set for an earnings boom ahead. Already we see strong growth in areas such as property, as well as home improvement and lending, autos, commodities, and retail.

Unlike the consensus, we argue that 2019 is not a rational benchmark. We believe we are still in the early stages of this recovery and have positioned the portfolio accordingly.

Interest rates

For a long time now, the clear market winners have been 'structural growth' technology companies, driven by two main factors. The first is that in recent years the overall level of growth has been relatively sluggish. Therefore a generous premium has been afforded to that handful of businesses that can demonstrate growth where it was otherwise scarce. As mentioned above, this premium is now less deserving as the general level of growth appears to be improving significantly.

The second factor is that interest rates have been incredibly low. All valuation is relative. Bonds need to offer a higher return than cash given the default risk undertaken; equities need to provide an even greater premium for their additional risks. When the interest rates on cash drop towards zero, the required return across the whole asset spectrum declines, and inversely their valuations rise.

In addition, lower interest rates increase the discounted present value of future earnings. In the case of high growth technology companies, investors generally expect strong results far off into the future. These distant profits are valued today by discounting them at an appropriate rate. Their skew of long term over near-term earnings potential makes these types of companies especially susceptible to changes in interest rates.

Over the past quarter, the interest rate on the US 10-year bond has risen dramatically from around 0.9% to 1.75%. Whilst the absolute level remains accommodative, this is a significant increase, already sending shudders through the tech-heavy Nasdaq index and some of the biggest winners of 2020 such as Tesla.

Apart from the merits of their technology/product, the bull case for these companies relies on interest rates staying low. With the recent increase in bond yields, this is being queried. Nobody knows what the future holds for interest rates. There are vociferous advocates of both the 'lower forever' theory and those predicting a return of full-blown inflation and accompanying higher interest rates. There are good arguments either way, including:

- Inflation has been consistently running below target for a long time, even when unemployment was at record lows;
- In the US especially, there is slack in the labour market with relatively low participation since the pandemic took hold;
- Globalisation and technology are persistently driving down cost everywhere; whereas
- The economic rebound has been rapid. Far stronger than economists had forecast;
- Monetary policy has never been more accommodative. The scale of stimulus is genuinely off the charts; but
- Much of the stimulus has been saved/invested rather than spent (driving asset price inflation, but not 'core' inflation);
- Japan and Europe have been trying to boost inflation for many years with very accommodative monetary stimulus, without success.

Our acknowledgement is that we do not know the answer. We don't see how one could look at this scenario and have a clear view. We think it is perilous to have conviction one way or the other in this deliberation. The US Fed has said they do not see inflation as a near term risk and do not plan to raise rates any time soon. However, we recognise the asymmetric nature of this risk. Cash rates cannot go any lower after all. We have, therefore, ensured that the portfolio is not overly exposed to companies that would be especially hurt by rising rates.

Portfolio Positioning

We have primarily retained our Australian consumer stock positions. Of the five companies we owned or increased weighting during mid-2020, we still own four. This optimistic view is markedly contrarian to consensus. Still, we feel this is one area where we have both form and a competitive advantage over those looking at this part of the market through a lens far removed from their personal circle of competence. Critically the managers we are backing here have significant skin in the game. They've handled the crisis brilliantly and not one of them raised equity in 2020.

Whilst our recent outperformance is somewhat due to our decision making during the market crash, and during the period of disbelief that followed in ASX consumer and travel, we have not gone 'all in' on this theme. Currently circa 20% of the portfolio is focussed on the Australian consumer. We also have 18% invested in the global travel, education, and hospitality sector and a further 15% allocated to companies leveraged to a cyclical recovery.

We still own core positions exposed to the Chinese economy, particularly the growing middle-class consumer, which we think is a theme with massive long term growth drivers. With 20/20 hindsight, we could have sold these stocks, which did not pull back as much in March 2020, to opportunistically re-allocate to the distressed ASX consumer sector. However, we believe that this is a long-term investment, and we are happy to hold these stocks that have structural growth drivers and massive addressable markets to grow into.

Another part of the portfolio we have started to add select exposure to is in the resources sector. We observe an increasing level of 'nationalism' when it comes to natural resources, both in Australia and abroad. Australia is known as 'the lucky country' due to its abundant reserves of numerous highly valued commodities, which are the most significant Australian GDP drivers. Whilst well known for iron ore, coal and gas, there are major undeveloped projects in other critical minerals in Australia. These have potential to form a significant part of the supply chain

for strongly growing markets, including electric vehicles and batteries. Government assistance is being widely discussed, and capital markets are as supportive as they have been for a decade for companies seeking to develop new projects. Accordingly, we are actively looking for large scale projects that are undervalued and in the development phase.

Finally, in the last note, we cautioned about pockets of the market looking very speculative and trading at extremely high valuations. Indeed, we commented that SPAC funds raised in 2020 had exceeded that of the previous 17 years combined. Well, it's only three months into 2021, and already $96bn has been raised by 296 SPAC's, surpassing the mark for all of 2020, which concerns us.

This serves as a reminder to be extremely vigilant. We are very conscious to ensure that our investments are robust, both in terms of their earnings strength and intrinsic value support. We fully expect some market sectors to incur significant drawdowns, especially if interest rates continue to rise.

Outlook

One aspect the past year has highlighted is the opportunity cost of staying out of the market. Today the real return on cash is negative. For bonds, it's close to zero, with significant downside risk if inflation overshoots. Instead, the current environment is firmly in favour of equities, especially those that stand to benefit from the cyclical recovery we see.

This is likely a reversal of much of the momentum seen in the market (buy bonds and big tech) shown over the last several years. We expect this to increasingly become a stock-pickers market, favouring 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,

David Nelson and Tim Evans
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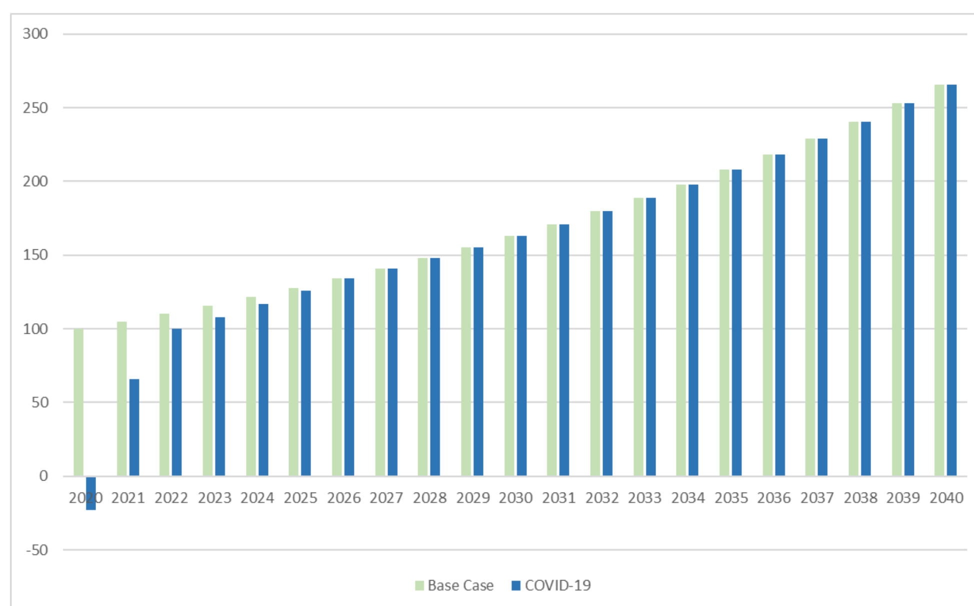
Appendix (from the April 2020 update)

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.