October 2021 update

We are pleased to present the unaudited results for Blue Boat Investment Trust for the 1st quarter of the new financial year (FY22).

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 30 September 2021:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	Hang Seng
FY22 (3 months)	-3.4%	-3.6%	1.7%	-10.7%
Since inception	54.6%	41.1%	48.5%	25.1%
CAGR	10.2%	8.0%	9.2%	5.1%

Source: Bloomberg. Returns are presented in AUD. Index returns include net reinvested dividends. CAGR is the compound annual growth rate since fund inception 3 April 2017.

Overall, the Blue Boat portfolio incurred a negative return this quarter which has been a function of three main drivers:

- Strong earnings results, mostly across the board from our portfolio companies;
- Weak sentiment towards Chinese technology stocks in response to sudden policy announcements from the Chinese Government; and
- Broad weakness in Chinese and China-related stocks driven by fears that an impending collapse of Evergrande (a major Chinese property developer) could trigger an insolvency crisis.

Our portfolio company earnings results are very pleasing, surpassing expectations in most cases. The bumper results are a credit to our portfolio companies' skill and determination to protect and grow their businesses.

Despite releasing exemplary financial results during the quarter, our portfolio's China exposure (c28% weighting) has been a significant drag on this quarter's portfolio performance. Our China exposed stocks contributed a -8.1% return to the overall portfolio to the quarter. At the same time, the remainder of the portfolio contributed a +4.7% return for the quarter. We believe this divergent performance is extreme and unwarranted. These events prompt us to reflect on why we are invested in China, which we address later in this letter.

We have maintained a relatively high weighting to Australian businesses, where our market understanding and the prevailing conditions helped us identify several compelling opportunities. Many of these stocks were laggards before the pandemic, then were among the hardest-hit stocks during the market crash in March 2020. As the market decimated their share prices, we could buy at prices that we believed were irrational. At the time, there was much uncertainty. We had to peg our convictions to the fundamentals and the long-term potential of the investment.

In August, these stocks reported full-year results, which were overwhelmingly positive. We are very impressed with their performance, particularly given most of them came from a position of being totally out of favour in 2020. Looking ahead, we are optimistic about the outlook for this portion of the portfolio, which is weighted towards consumer, travel and resources activity in Australia, Europe and the USA. Intense fear about the short-term impacts of the pandemic has subsided, and the market is looking upon these stocks positively once more.

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We strive to invest in the best companies, the most attractive opportunities, wherever they are listed. To use a Charlie Munger saying, "we want to go fishing where the fish are."

When we look around the world for large, profitable, fast-growing businesses with outstanding long-term potential, it is impossible to ignore China. Since inception at Blue Boat, we have had exposure to China via a handful of stocks listed in Hong Kong. We have favoured sector or market-leading companies with a track record of profitability and leverage to what we believe is the most compelling investment opportunity in the world – the massive and rapidly growing Chinese middle-class consumer.

Our current investments in China are all leaders in their niche and have demonstrated growth in the last five years that similar companies in Australia and the USA could only dream of. We believe the next five years will be just as good, if not better. Moreover, these companies are very attractively priced on the market. Of course, there are risks, including certain risks particular to China, but all considered, we judge that these are excellent investments for the long term.

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If we first consider the recent Chinese government policy announcements. The market reaction has been very adverse, with the Western media response to the 'crackdowns' going as far as to say that China is now '*uninvestable*'. The way these reforms have been communicated to the market has been very poor. As markets hate uncertainty, it has triggered volatility.

However, looking at the substance of the announcements, each reform seems to have a reasonable basis. The Government is addressing social inequality, monopolistic practices, ensuring large tech companies protect users' data and privacy and that gig workers are fairly paid. Indeed, these kinds of reforms are also being pursued in the West; it's just that the Chinese Government has the power to implement them more swiftly.

Moreover, the Chinese state media have been quick to reassure investors that they remain committed to further opening and developing their markets, encouraging private enterprise. They emphasise that the measures taken are targeted, necessary steps to set the country up for its next decade of growth. China recognises that private enterprise has driven nearly all its economic dynamism over the last few decades and has put the country at the forefront of many critical technologies.

It is in China's interest to continue this growth in a *sustainable* way – which is at the heart of these reforms. This serves as an essential guide for investing in China going forward. We must be even more careful that our portfolio companies' business models align with China's goals for sustainable development as if not, they are at risk of being the next target.

It is also worth saying that as long-term investors, sustainability makes for better investments. Investors have taken these reforms poorly, and the targeted companies will incur a near-term hit to profitability. However, these changes can set businesses on a more sustainable footing in the future. Moreover, it is likely to raise the standard required to participate in each industry, adding further barriers to entry to protect the market leaders that we are invested in. In the long term, this creates a higher quality business, which enhances value.

Secondly, there is the topic of Evergrande, noted as the world's most indebted property business, and the impact that its demise will have on the Chinese and global economies. Again, the media has sensationalised this event, likening it to China's '*Lehman Brothers moment*', suggesting that severe contagion will spread throughout the economy. This news prompted major sell-offs, with property, financial, and resources stocks the most significant casualties.

In reality, Evergrande is not a systemically important company. It is a property developer with around 4% market share in China. The company has tangible assets, including colossal land holdings and property developments which are very valuable; however, its US$300bn of outstanding debt is very substantial.

For a few years, the Chinese Government has wanted to reign in the excessive borrowing within the property development sector and imposed new 'red lines' on gearing levels. We suspect the Government will be content to see Evergrande investors incur significant losses to warn others about overstretching themselves and avoid moral hazard. Long term, this policy should put the Chinese real estate market on a more sustainable footing, which is a crucial goal of the Government.

Meanwhile, there is no benefit in seeing the demise of the operations and developments across the country. China controls most of the banks that lend to Evergrande, so we expect the Government to restructure the company's debt and asset ownership—buying time to liquidate assets in an orderly manner. This is necessary to protect millions of retail customers who have either paid deposits on apartments or bought Evergrande-sponsored wealth management products. This way, Evergrande shareholders will likely get wiped out, and bond investors will take a big haircut. Still, apartments can be completed and the issue resolved without escalating into a broader insolvency crisis.

Already we see signs of this, with announcements of new arrangements, agreed with onshore lenders and a significant asset sale to a state-owned company. In addition, the People's Bank of China is providing significant extra liquidity into the financial system. Together this all points to the Government using its tools for an orderly resolution.

Last year we saw a similar outcome with Virgin Australia, whereby equity holders lost everything, but the airline lives on, and customers and suppliers were protected.

Such contagion scenarios are exciting for the media as it makes great headlines. We saw the greatest ever example of this in March 2020, when the media overhyped fears about the impact of COVID related restrictions and lockdowns, promoting the worst-case scenario, which was quickly accepted and priced in…yet didn't go remotely close to happening.

Whenever a large corporate or a small sovereign collapses, the media and market commentators immediately go into overdrive, promoting a narrative of mass contagion and '*domino theory'*. Many will remember the Greece and Cyprus defaults in the last decade, widely touted to cause contagion. They didn't, and once more, we see similar claims with Evergrande.

We expect these events will take the edge off China's growth in the short term, as slower property development and negative wealth effect on consumption impact economic activity. However, equity markets have reacted far more severely. Notably, for Blue Boat, both Alibaba and Ping An, two of the largest companies in China, have each fallen by circa 50% from recent highs. This is, in our view, as extreme as anything we saw in the market crash of 2020.

In these companies, we see several parallels to the opportunities presented in March 2020:

- Track records of strong growth and earnings performance;
- Strong balance sheets;
- Issues are not structurally related to the businesses, but the market is pricing as such;
- Conviction that management can navigate the crisis.

Today's market is pricing in a very extreme outcome and ignores all the potential interventions that might stop such a calamity from precipitating. As it was in March 2020, things remain *uncertain*, but the odds are in our favour.

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In recent notes, we commented about the one-sided risk of inflation and higher interest rates and the adverse effect on the most highly valued companies in the marketplace. This quarter, and especially in recent weeks, has seen this development gain momentum. Specifically, commodity prices have been strongly rising, and in tandem, there has been a pronounced rise in interest rates – the US 10 year has risen from c1.2% in early August to c1.5% now.

These conditions urge us to be highly discerning with our portfolio selections as high P/E stocks, and long duration assets are very vulnerable in this environment. Meanwhile, we see other businesses that are attractively priced and likely to benefit from a more inflationary environment offering great opportunities.

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We have added selectively to our China-related positions during the quarter as we believe the long-term upside is not being appropriately priced in. As we learned from the experiences of 2020, along with those in prior market events, it is critical to look for opportunities during a crisis. We believe we are now looking at an event that may have just as much potential.

Yours sincerely,

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