BLUEBOAT

January 2022 update

The overall portfolio performance for the quarter to 31 December was broadly a continuation from the previous quarter. Blue Boat gained +2.0% for the second quarter. Set our below are the results for the first half of FY22:

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

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	Hang Seng
FY22 (6 months)	-0.9%	-1.3%	3.8%	-15.8%
Since inception	58.6%	44.5%	51.6%	13.3%
CAGR	10.2%	8.1%	9.2%	2.7%

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.

2021 was a challenging yet triumphant year for the world. Societies overcame significant challenges, but many of those have been replaced with new issues we will face in 2022. A new variant of Covid-19 surges throughout the world, creating uncertainty. There are growing concerns about the sustainability of inflation in major western economies and mixed outlooks for markets that are about to face the unwinding of the enormous fiscal stimulus programs that supported economies through the pandemic.

Given we feel we have little to no edge in predicting the outcomes any of these significant and incredibly complex issues, we prefer a strategy of observation of the present. When we look back at 2020 and 2021, the great investment opportunities arose from situations where the market consensus drifted materially from the present reality. Interpreting the present, particularly when significant change occurs, is far more valuable than attempting to forecast change.

Today we note the following observations:

- We have no idea about future variants of Covid-19 but observe that the human attitude towards the virus has changed dramatically. Vaccines have shown to be very effective at lowering critical illness and death, and we think there is no political appetite for a return to the lockdown policies of 2020.
- Humanity's scientific ingenuity was unleashed in 2020 to protect society against the pandemic, with no sign of this slowing down as we enter 2022. This should not be underestimated in the future.
- Restrictions have changed saving and spending habits. In Australia, we saw that during the lockdowns of 2021, tens of billions of dollars were saved, and personal balance sheets are in excellent shape. Consumer confidence is very high, and we see evidence of elevated spending in almost all areas of the consumer economy.
- This boost in spending, along with technical disruptions, has meant that supply has struggled to keep pace with demand. In certain industries such as housing, this is causing a significant backlog, which appears to be smoothing and prolonging elevated activity levels.

- Inflation is no longer a future issue; it's a present issue. Price inflation is everywhere and is largely being accepted by consumers. In the past 6 months we noted companies in almost all parts of the market providing anecdotal and financial evidence of cost inflation.
- We have recently seen numerous profit downgrades from companies in competitive industries that cannot pass through higher costs. The Australian building industry is seeing bankruptcies and a "profitless boom" in some regions.
- In Australia and elsewhere, consumer demand and inflation have begun to translate into elevated wages and incentives in both white and blue-collar industries to retain and attract staff.
- House prices are generally high, most equity indices are around record highs, and there has been aggressive merger and acquisition activity globally.
- The US Federal Reserve has indicated it will speed up the end of quantitative easing and has guided to multiple interest rate increases in 2022.
- China's quest to expand the middle class and raise their standard of living, known as 'common prosperity', may come at the expense of corporate profitability. We observe leading companies shifting their priorities to 'serving' the people and aligning with the new political direction across numerous industries.

When we look at these observations, we have cause to be optimistic for the year ahead. We believe the human spirit displayed throughout the pandemic will continue to surprise the doubters and create better than expected outcomes related to living with and moving beyond Covid-19. New vaccines and treatments will emerge, and we expect societies to adapt and innovate. At Blue Boat we have been optimistic with regards to the battle against Covid-19 since the beginning of the pandemic and will retain this position in 2022.

Supply chain issues are plaguing many industries. Whilst a very significant problem, we believe this is mainly technical and will be solved in time. Regarding sustained future inflation, we do not have a conviction stance. We see cyclical economic expansion and buoyant consumer behaviour, which could be highly inflationary for some time. Offsetting this, we see the deflationary forces of technology and globalisation accelerating. Nonetheless, in Australia, we expect the RBA to be reactionary rather than precautionary regarding interest rates and retain a very positive outlook for our related consumer and cyclical exposures.

With the shift in the attitude of the US Federal Reserve and other central banks, we expect a change in asset values. We are cautious on assets, including stocks, which experienced a material positive re-rating due to interest rates being cut to zero. For 2022, the prospects for broad valuation multiple expansion seem unlikely. When looking at the observations of central bank commentary and the withdrawal of stimulus, we believe the tailwinds for some of the best performing sectors of 2020 and 2021 have peaked and will likely become a painful headwind for the foreseeable future. As always, this calls to be very selective on companies and guarded on valuation.

China's announcements regarding common prosperity and associated regulations have significantly impacted companies in affected sectors. We note that over the last six months the main Shanghai stock index is up 3%, whilst the Hang Seng is down 18% in local currency, officially in a bear market and in stark contrast with the rest of the world. The Hang Seng has now dropped below book value, a level it hasn’t previously breached over the last 3 decades. We suspect the discrepancy between the Shanghai and Hang Seng indices highlights the difference in perception toward China between local and foreign investors.

As value-orientated investors, we find it very interesting that one market has seemingly been singled out and sold off in an otherwise very bullish world. We suspect this presents another 'pessimistic perception versus reality' opportunity where the risk is skewed significantly to the upside from current valuations.

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Our portfolio company managers continue to perform admirably. An impressive feature of the quarter was that several of our companies took advantage of their strong positions to make acquisitions, strengthening their earnings base and customer proposition.

A particular highlight was the performance of Beacon Lighting. We earlier set out our view that Beacon Lighting has tremendous growth potential through multiple channels beyond the Australian brick and mortar retail presence for which it is known. This quarter Beacon publicly presented the significant progress that has occurred in their emerging international business over the last five years. International sales have been growing at a very healthy 30% per annum, and Beacon is adding further resources into this channel. This growth is very encouraging and was well received by the market. We think Beacon has much further to go in growing both their international and their trade businesses, which will warrant a positive re-evaluation in the market.

Another positive came from our investment in Jackson Financial, which is listed on the NYSE. Jackson is a US annuities business that was recently spun out from Prudential, one of the world's major insurance companies listed in the UK and Hong Kong. In recent years Prudential has chosen to focus on Asia and divest its non-core businesses such as Jackson. The way the Jackson divestment was structured (each Prudential shareholder gets 1:40 Jackson shares) meant that Jackson shares were given to many 'unnatural holders'. Jackson is much smaller than Prudential, and it is focused on a different business in a different market. Consequently, the new Jackson holdings may be token, unwanted or even ineligible for the portfolios of many Prudential shareholders.

Such spinoffs can create attractive situations as the unnatural holders sell. Indeed, this appeared to be the case here as Jackson was trading around 1x P/E shortly after the shares were listed. Moreover, the company pledged to make a significant return of capital to shareholders, which equated to c20% of the market capitalisation. This quarter the company reported its results and, sure enough, announced a hefty dividend and buyback. Jackson directors have been individually buying shares on the market. Jackson shares have gained significantly (now c1.7x P/E), and as the unnatural holders ‘shake out’ runs its course, we expect the stock to gain further market recognition for its value.

As with last quarter, our Hong Kong-listed stocks have been a material drag on the portfolio performance. Whilst fully acknowledging the regulatory risks hanging over our China facing investments, we believe the future growth and fundamentals outweigh them. Our Chinese companies each service the middle-class consumer, and we are satisfied that they align with the goals of the common prosperity pledge and future policy. These companies are materially undervalued, and their earnings continue to compound at healthy growth rates. It is always difficult to hold such investments when the overall market perception has turned very bearish. Still, we know that these are often the most rewarding investments in the long run.

Significant uncertainty remains and parts of the market look overstretched. The unwinding of the most considerable stimulus seen since World War II is underway and will undoubtedly create volatility. We believe that this is not the time to spread the net wide, and it is crucial to understand the fundamentals and valuation support of all investments. Accordingly, the Blue Boat portfolio is currently quite concentrated as we focus on the individual merits of our investments. Today the top 5 holdings account for c45% of the portfolio, and the top 10 represent c70%.

As always, many thanks for your trust and support. We vow to do our best to honour the faith you have shown in us.

Yours sincerely,

David Nelson and Tim Evans
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