BLUEBOAT

April 2022 update

Markets were extremely unsettled in the March quarter and in turn the portfolio delivered a negative result.

Set our below are the results since inception and for the 9 months year-to-date for FY22:

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 31 March 2022:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	Hang Seng
FY22 (9 months)	-5.8%	-6.3%	6.1%	-23.2%
Since inception	50.7%	37.2%	55.0%	7.6%
CAGR	8.6%	6.5%	9.2%	1.5%

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.

23 March marked the 2nd anniversary of the market bottom when the panic surrounding Covid-19 and the impact of lockdowns reached its zenith. As we now know that day presented one of the greatest buying opportunities in history, as shortly afterwards the scientific community, governments, and society in general, all responded to combat the crisis.

The prices offered on 23 March 2020, driven by a complete collapse of conviction, implied the pandemic crisis would so be epically deep and prolonged that a permanent impairment of asset values was warranted. Thanks to the actions of many, we have seen that the pandemic proved to be more of a temporary setback (financially) followed by a strong rebound in economic activity.

Perhaps the key lesson from the March 2020 crisis is recognising the opportunity when the market is treating an issue as permanently bad, extrapolating the downbeat outlook long into the future without considering financial and stimulatory intervention, along with human innovation and adaptation.

In hindsight, we underestimated the short-term impacts caused by Covid-19 and associated restrictions. As naturally optimistic people we were too slow to sell stocks, but we bought assertively in the most affected sectors during the worst days of the market. Whilst terrifying at the time, this approach created significant value for Blue Boat. Our only regret was that we didn't buy more, but it's easy to say that today.

In a way, the March 2022 quarter echoed the March 2020 crisis. Several highly publicised macro and geopolitical concerns swung markets wildly:

- The Russian invasion of Ukraine.
- Fears that China would be tempted to do the same with Taiwan.
- Government and corporate sanctions against Russia, and the potential for these to be extended to any country supporting Russia.
- The threat of military escalation.

- Considerable increases in commodity prices, thanks in part to Russian sanctions.
- The subsequent impact on already high inflation from higher commodity prices.
- The commencement of an increasing interest rate cycle, with the US Fed raising the official rate and guiding for 6 further increases in 2022 to counter high inflation.
- The US 10-year treasury bond rate increased significantly from 1.5% to 2.5% during the quarter.
- A collapse in the share prices of 2020 & 2021's high flying tech stocks. The Nasdaq officially entered a Bear Market with a peak to trough fall of 22%.
- Netflix and Meta Platforms fell 25-30% on the day of their results, the latter being the biggest single-day company market cap decline ever.
- Concerns that high fuel prices will impact consumer spending and economic growth, potentially risking a recession.
- Rising Covid cases in China trigger lockdowns, which could affect growth and supply chains.
- The risk that non-compliant US-listed Chinese companies could be delisted from US exchanges in 2024.

These topics make eye-catching headlines and have served to throw markets into a frenzy. Almost every market sell-off is succinctly and immediately tied to a macro or geopolitical event by the media, and this was no different. As we survey the issues, we feel that the market is generally worked up over problems that will pass soon enough.

At Blue Boat, we have considered the recent period of zero interest rates to be a short-term anomaly. We were sceptical of the valuations of many high-flying companies on the Nasdaq and the ASX, where 'zero rates forever' were priced into many companies' share prices. We do not view the orderly normalisation of interest rates in countries like Australia as a negative, particularly where unemployment and economic activity are very healthy. Still, we are concerned about the subsequent devaluation of certain assets that will likely occur as the process continues.

Rising interest rates mean that a higher bar is set for the required return of any asset given its risk. For several years, the inverse has been occurring, with investors paying higher valuations for lower returns as interest rates fell. Recently that bar has been set very low, and confident investors have been happy to accept frighteningly low returns for quality assets.

Meanwhile, this quarter saw most of our portfolio companies report results, which we believe were broadly very positive. Some of our companies' profit results were significantly ahead of expectations, which has not been reflected in the market. We have topped up some of our ASX listed industrials, such as Beacon Lighting and Reliance Worldwide Corporation, at attractive prices during the market sell-off. There are several favourable tailwinds for housing, including a strong dynamic driven by hybrid work between the office and home, which has prompted people to invest in their home as it takes a more significant role in their lives. We expect this to be a long-term trend and a positive driver for lighting, plumbing equipment and general renovation and remodelling work. We're well-positioned to benefit from this trend with investments in innovative companies with commanding market share and product pricing power.

Our most significant portfolio changes this quarter occurred in the most volatile week of March, where Chinese internet companies collapsed in a way not seen globally since March 2020. During that week, analysts slashed their valuations without adjusting their earnings forecasts, and pundits declared China ‘uninvestable’.

The most high-profile example here was Alibaba which had fallen more than 40% in a month from $125/share in mid-February to a low of $73/share on 15 March. At this level, Alibaba shares were priced at a free cash flow yield of 14% and trading on a forward P/E multiple of just 7x. Alibaba stock was trading 20% below the close price of its first day of trading in September 2014, despite revenue being 1,200% higher today. We believed the share price action to be irrational for such a highly profitable business which provides critical services to circa 1 billion active users.

March was a very uncomfortable time, but we recognised the need to take advantage of the crisis. We were reminded of an article from Jeremy Grantham written in March 2009. The article was titled "Reinvesting When Terrified" and was written days before the bottom of the market in the Great Recession. Grantham argued that investors must have a battle plan to respond to a market meltdown and not become paralysed by trying to catch the low or feel attached to the cash you hold, for it will soon become a burden.

The final line of the letter stuck with us, "*Finally, be aware that the market does not turn when it sees light at the end of the tunnel. It turns when all looks black, but just a subtle shade less black than the day before".* Accordingly, as Alibaba shares fell day after day and the value on offer became ever more attractive, we steadily bought more and more. Pleasingly we note Alibaba has since announced a major increase of its share buyback program, now worth US$25bn. At current prices this represents 8% of issued capital and will still leave the company in a net cash position with tremendous long term growth potential.

This buying program has taken our Alibaba position to a 15% portfolio weighting, which is much larger than usual. However, as Warren Buffet once said, "when it's raining gold, reach for a bucket, not a thimble".

Yours sincerely,

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