January 2023 update

The performance of the Blue Boat portfolio for the quarter to 31 December 2022 was an improvement on the prior quarters, gaining +6%. As has been the case throughout 2022, markets have been volatile with macroeconomic factors driving investor sentiment. Behind the headline index numbers, there was significant divergence in returns across different sectors in the market.

Set out below are results for the fund for the first half of FY23 and since its inception:

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

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	MSCI All Country
FY23 YTD (6 months)	1.0%	0.7%	9.8%	2.5%
Since inception	34.6%	22.0%	49.9%	54.0%
CAGR	5.3%	3.5%	7.3%	7.8%

Source: Bloomberg. The returns for Blue Boat & ASX are presented in AUD, MSCI in USD. Index returns include net reinvested dividends. CAGR is the compound annual growth rate since fund inception 3 April 2017.

At Blue Boat we believe there were three key events shaped 2022 in investment markets:

- Russia's invasion of Ukraine and the subsequent global energy crisis;
- Rampant inflation in Western economies and drastic interest rate policy shifts from central banks; and
- China's strict Covid-zero policy, which then reversed in the last quarter.

The market underestimated all these risks in late 2021, and their impact on asset values was immense. These events have created opportunities, where permanently negative effects have been priced in for issues that could prove to be more temporary than feared.

China – Same Regime, New Policies

We have held and recently added to our positions in leading Chinese companies through the bear market. The Hang Seng Index fell 54% between February 2021 and October 2022. This fall is comparable to that experienced by the S&P 500 and the ASX 200 during the GFC in 2008/09. This market capitulated and bottomed immediately after President Xi secured a historic third term. Investor fear peaked, with many suggesting that Xi would wind back China's extraordinary economic success by turning inward with a more socialist regime whilst sticking to a strict Covid-zero policy.

This consensus view was quickly contradicted. China has moved to end their zero-covid policies, and Xi has spoken publicly about his commitment to policies that stimulate economic growth and innovation in the private sector. China's economic transformation over the last 45 years is unrivalled in modern history regarding its scale and rate of change. Problems are inevitable, but we don't think the Chinese government would do anything to jeopardise the momentum in improving the prosperity and standard of living in their middle class.

In 2023, after a difficult period of adjusting to living with Covid, China is poised to benefit from a reopening boom with benign inflation, boosted by government stimulus. The government is resolved to grow GDP at 5% per annum to achieve Xi's goal of doubling income per capita and elevating China to middle-income country status by 2035.

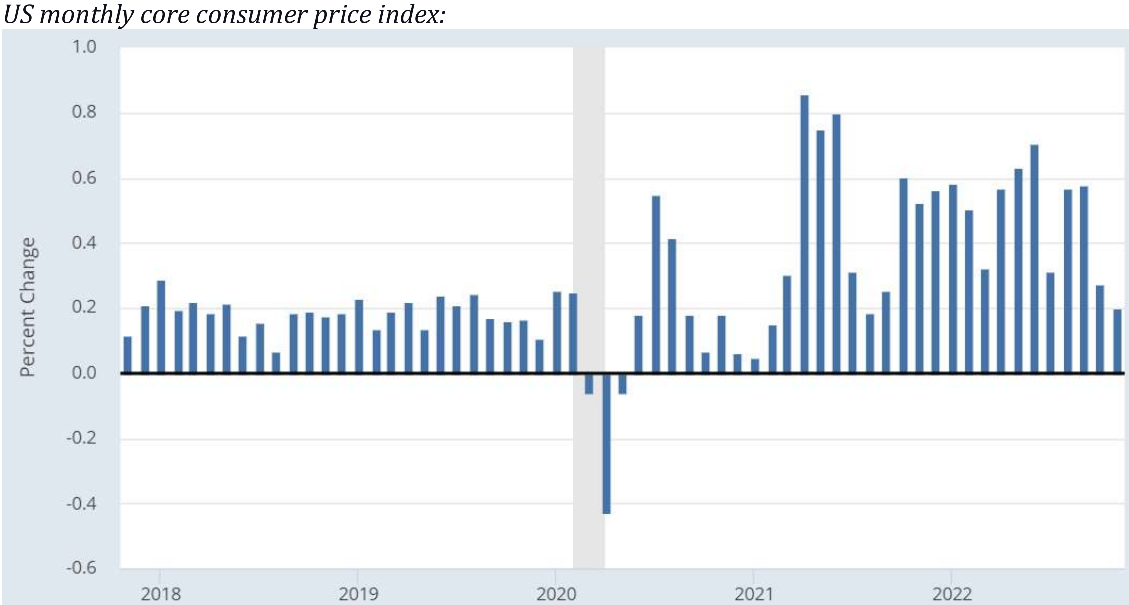
Like western countries during the pandemic's lockdown phase, China's personal savings has risen substantially by an estimated +42%. This, along with the changes mentioned above in government policy, should see a significant improvement in consumer confidence and activity in the years ahead, which will benefit Blue Boat via our positions in Alibaba, Anta Sports, BYD and Ping An Insurance.

Although the Hang Seng has risen by +35% since the low on 31 October, it still sits -36% below its February 2021 level. In contrast the MSCI All Country Index is +4% higher than February 2021. Given the superior growth prospects and attractive valuations of Chinese companies, we think this performance gap will narrow, and likely invert, in the years ahead.

Inflation – Signs of Easing Emerging

The biggest issue of 2022 and the focal point of central banks worldwide is inflation. After a period of surprising economists on the upside, inflation is now declining. In November, US core inflation was +0.2% month on month, implying a 2.4% annualised rate which is getting close to the pre-covid level and the Fed's target of around 2%.

US monthly core consumer price index:



Source: St Louis Fed

The US Fed has increased interest rates at a very aggressive pace, and the economic impact is starting to be felt, as shown by the decline in inflation above. Additionally, we know there are lagged effects, just as they were with the unprecedented monetary expansion in 2020, suggesting more disinflationary pressure to come in 2023.

With inflation coming off the boil, this permits the Fed, and other central banks, to moderate their policies. Meanwhile, economic activity remains healthy, and unemployment is historically low. The prospects for a 'soft landing' seem plausible, yet the prices of cyclical stocks leveraged to economic growth are priced for material and prolonged weakness in earnings.

Two of our investments, Beacon Lighting and Reliance Worldwide, have been particularly impacted by the cyclical sell-off. Beacon is Australia's leading lighting retailer and is showing great promise by evolving and expanding its business to focus on Australia's more significant, highly fragmented, and under-penetrated trade market. Reliance is also a high-quality business that owns market-leading brands in behind-the-wall plumbing fittings that are predominately focused on the US market. Both stocks were sold off materially in 2022 despite achieving record profit results, paying record dividends and investing in new growth verticals during the year. The market is pricing these companies for a significant decline in profitability ahead.

We know markets turn when the perceived outlook changes from terrible to slightly less bad. Already we are seeing improvements in inflation, lower mortgage rates and improving consumer confidence in USA. Residential housing is undersupplied in both Australia and USA, with rental vacancies at historically low levels. Together this suggests the likelihood and severity of a much-feared recession are declining. Thus, we believe there is a cyclical misdiagnosis in the price of stocks such as Beacon Lighting and Reliance Worldwide, and the prospects for a price recovery are strong.

Investor Sentiment – Unsustainable, But This Time Too Low

Inflation and interest rate adjustments became the central topic for markets and mainstream media in 2022. This macro focus drove major intra-market movements throughout the year, decimating investors' confidence who succeeded in the bullish market of 2020/2021. Initial public offerings, which we view as a barometer of investor sentiment, declined by 60% on the ASX and 86% in USA in 2022. Many special purpose acquisition companies, or SPACs, which were immensely popular in 2021, have been forced into liquidation, and many more are trading at 80% or more below their issue price. During December, 70 SPACs were liquidated, and the remaining funds returned to investors, more than the total number of SPAC liquidations in prior history.

Notably, with a higher interest rate environment, the valuations of the high-flying stocks of 2020/2021 have fallen dramatically. Highlighting this, the comparatively 'old school' Dow Jones Index has outperformed the broader S&P 500 Index by the most significant margin since 1960. Widespread pessimism has also triggered risk aversion and drained liquidity, which has acutely affected smaller capitalisation stocks. For example, on the ASX, the Small Ordinaries Index (the 101-300th largest companies) fell 18% during 2022, whilst the ASX 20 (1-20th largest companies) gained +5%. We do not see this divergence as sustainable.

We are actively investigating these market segments during their time of unpopularity. Investor sentiment is cyclical and challenging to predict, but the earning power of companies will determine valuations in the long term. We have increased our position in Spotify Technology and hold a core position in Livechat Software, which has been increasing high margin recurring revenue throughout 2022. In the December quarter Livechat's revenue increased 35% year on year. This is evidence that demand for their customer engagement software products remains robust beyond the pandemic, setting Livechat apart from many software businesses that have seen a moderation, or decline, in revenue growth in 2022. We remain confident holders of several small-mid capitalisation family and founder-led industrial companies on the ASX.

One company we have taken a position in during the quarter is Unibail-Rodamco-Westfield, where we see a turnaround opportunity.

Unibail-Rodamco-Westfield

A new addition to the portfolio is URW, the largest owner of A-grade malls and shopping centres in Europe. The malls were heavily impacted by the covid lockdowns, but traffic has fully recovered and now exceeds 2019 levels.

Along with the whole REIT sector, URW's shares are currently trading at depressed levels due to rising interest rates and their perceived effect on property values, as well as fears that a recession that might impact future rental income and earnings. Consequentially URW shares are trading around €49/share, a huge 62% discount to the value of their net tangible assets (NTA is property value less debt) of €128/per share.

The company has had a tumultuous history. Their previous acquisition of US assets left the company overly indebted, and the board proposed a highly dilutionary capital raising during 2020 at the bottom of the market. However there has been a reshuffle of the board with a new CEO and major activist shareholder, Xavier Niel, who blocked the capital raising. The new board is undertaking a plan to dispose assets, reduce leverage and resume paying dividends to shareholders in 2023.

The disposal plan is well underway and sales thus far have been at values much closer to NTA than the share price discount suggests. We believe the delivery of the disposal plan and the resumption of dividends this year should prove to be a major catalyst to draw investors and reduce the share price discount to NTA. We take great comfort in the fact the board are now aligned with shareholders, with Xavier Niel controlling 22% of the stock. Current guidance for 2022 recurring earnings per share is circa €9/share. Looking ahead, a 50-75% dividend payout ratio would imply a very attractive 9-14% dividend yield for owning some of the world's best quality retail property assets.

Outlook

Looking ahead, in 2023, we see an environment where inflation is much more benign. Central banks should have scope to be more gradual in their adjustments which will afford the market a comparatively static environment within which to appraise assets. This creates a setting where stocks will be judged on their merits again.

We invest in companies where we believe the earning power is undervalued and have a track record of growing through varying economic conditions. We see material upside in our portfolio, which currently has the widest divergence between intrinsic value and market pricing since the fund's inception.

Below is, in alphabetical order, the top 10 position in Blue Boat which account for approximately 86% of the total portfolio.

- Alibaba *(E-commerce and digital infrastructure, listed in Hong Kong)*
- Anta Sports *(Branded leisure apparel and sporting goods, listed in Hong Kong)*
- Beacon Lighting *(Vertically integrated lighting retailer, listed in Australia)*
- Corporate Travel Management *(Travel management solutions, listed in Australia)*
- Livechat Software *(Online engagement software as a service, listed in Poland)*
- Lovisa *(Vertically integrated global fast fashion retailer, listed in Australia)*
- Motorcycle Holdings *(Motorcycle retailer and accessories wholesaler, listed in Australia)*
- Ping An Insurance *(Life insurance, financial services, banking & fintech, listed in Hong Kong)*
- Reliance Worldwide *(Manufacturer of branded plumbing supplies, listed in Australia)*
- Spotify Technology *(Global audio-streaming platform, listed in USA)*

Yours sincerely,

David Nelson and Tim Evans