July 2023 update

Dear Blue Boat Partners,

We are pleased to provide you with an update on the results for the Blue Boat Fund for the 2023 financial year and since its inception:

Blue Boat Performance vs Indices Total Returns: 3 April 2017 – 30 June 2023:

	Blue Boat Gross Return	Blue Boat Net Return	ASX 200	MSCI All Country
FY23	6.3%	5.7%	14.8%	17.1%
Since inception	41.7%	28.1%	56.7%	75.9%
CAGR	5.7%	4.0%	7.1%	9.2%

Source: Bloomberg. The returns for Blue Boat and 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.

Our Strategy

As investors, we commit to maximising the long-term returns for the capital we manage. This is a simple but challenging task. We have made mistakes, some costly, but equally, we have benefited from the mistakes of others, learning from them and improving.

The market environment remains highly uncertain. We are sticking with our strategy to position the portfolio into businesses that we understand and are trading at the most significant discounts to intrinsic value. We aim to hold quality companies for the long term whilst taking advantage of irrational situations that arise in the market.

This strategy sets us apart from many of today's conventional approaches. It is commonplace for funds to try to track and marginally beat a particular index by owning dozens of stocks, as is trying to time the market by trading in and out of 'positions' based on momentum or using financial engineering, derivatives and currency hedging. Themed funds, whereby the manager promotes their expertise in one style or sector, locking them into that niche regardless of the prospects elsewhere, are also popular. This gives the managers a platform to promote but stifles their ability to invest freely.

Our strategy, where there is no leverage, index benchmark and no theme or predetermined style, gives the flexibility to invest in a handful of companies with the most upside. The downside to this strategy is that it can be accompanied by significant volatility in short-term returns, testing our patience and conviction. We currently have circa 90% of our portfolio in our ten biggest holdings, concentrated in stocks that can grow earnings and re-rate materially in the medium term.

Current Market Environment – Is History Repeating (Or Rhyming)?

A key lesson from the manic markets of 2020 was that, in the face of a potential collapse of short-term earnings due to Covid-19 restrictions, stocks were priced for permanent impairment, creating one of the best buying opportunities in our lifetimes. In our investor letter in April 2020 (reproduced below in the appendix to this letter), we outlined how irrational this behaviour was. Investments, stocks and property alike, ought to be appraised according to the present value of the full lifetime of their future cash flows. This logic is often thrown out when the immediate year ahead looks overly good or bad.

In the case of consumer stocks, their share prices collapsed in 2020 when current-year earnings estimates evaporated. Then in 2021, their market valuations shot up 5-10x when earnings were exceedingly strong due to government stimulus and limited consumer spending options. With the benefit of hindsight, it is easy to see that both episodes were irrational.

During the Covid market crash in 2020, we went overweight consumer stocks in Australia based on the logic outlined in the appendix. We then exited most of these positions during the subsequent boom in retail, which we viewed as particularly cyclical. With clarity only available when looking back in time, we wish we had gone harder, given our accurate observation of the situation.

Once again, the market has become obsessed with the short-term earnings trajectory of consumer companies in Australia. We retain two core retail positions in Lovisa Holdings and Beacon Lighting. These stocks and the whole sector have recently sold off aggressively as we face a sharp downturn in consumer confidence. Today's situation is not as extreme as in 2020, and therefore we don't expect the same degree of recovery. Nevertheless, what remains consistent is that current year earnings expectations are being vastly overweighted in their contribution towards intrinsic value.

In our meetings with Beacon Lighting and Lovisa's management teams, we see businesses executing growth plans using well established and already successful models. Lovisa is now rolling out over 150 new stores each year worldwide. This expansion model is more akin to fast food than traditional fashion, as store growth has compounded at 16% per annum since the 2014 IPO, a remarkable achievement. Meanwhile, Beacon Lighting, which is already dominant in lighting retail in Australia with over 20% market share, is rapidly growing its trade business. Compared to retail, trade is a 3x larger, less cyclical market, and Beacon has significant room to grow with just 4% market share. Beacon's 120 retail stores are being adapted to house dedicated trade desks, a strategy which, along with their international expansion, we feel can more than double sales in the medium term.

Recession predictions are ever present, with retail considered the most prominent victim. While a downturn may transpire, our managers are set to benefit due to their superior business models and growth potential. When we look at the actions of Beacon Lighting and Lovisa (whose share prices are each down circa 30% from 2023 highs) and their exciting growth profiles in this environment, we are reminded of a quip from Walmart founder Sam Walton, who, when asked about the recession of the early 1990s said: "I've *thought about it and decided not to participate*."

As was the case in April 2020, there are now attractive opportunities where medium-term earnings potential is materially mispriced due to near-term earnings uncertainty. Retailers are one category standing out, and we see value elsewhere as well.

Portfolio Positioning – Three Areas of Focus

During the market downturn in 2022, we identified three areas of standout value. In China, we have meaningfully increased our exposure to three large, highly profitable market-leading companies, Alibaba, Ping An and Anta Sports, whilst also buying a new position in electric vehicle market leader BYD. These companies will grow earnings materially, aided by an alignment with government policy and the tailwind of improvement in Chinese middle-class prosperity.

Alibaba presents an extraordinary investment set-up. This quarter's results commentary indicated that a post-covid recovery in consumer activity began in March and accelerated further in April. Government support for the economy is slowly stepping up. Whilst not yet at a level deemed by markets to be sufficient, it is a markedly different environment to what was in place in 2022 and continues to improve steadily. Additionally, we received further details about Alibaba's plan to split itself into six individual companies, with the first of these to occur in the next 12 months.

The breakup helps brings to light the substantial value embedded within Alibaba's assortment of businesses. The smaller business units currently funded by the core e-commerce platforms and assigned little-to-no value by the market, will either be spun out or operate without financial assistance from Alibaba. This strategy will push the soon-to-be independent subsidiaries to set their own vision for growth and profitability whilst forcing the markets to value them appropriately.

Alibaba has a very profitable core e-commerce business that produced circa US$26bn in operating earnings over the past year, despite lockdowns and a challenged economy. These platforms account for 45% of all e-commerce transactions in China, a market that will expand exponentially in time.

On back-of-the-envelope numbers, this e-commerce division should be valued at US$250 billion or more. Then we must consider the five other businesses (cloud, logistics, international e-commerce, local services and media), which together we've seen market appraisals for over US$100bn. Finally, there is a further US$120bn in net cash and investments. We see a situation where, compared to the current market cap of US$213bn, we can be wrong by a long way and still see attractive upside.

On the strength of the opportunity, our Chinese exposure as a percentage of assets is currently at its highest since the fund's inception at circa 35% of the Blue Boat portfolio. This is a deliberate strategy, where we see tremendous upside in the medium term, but committing to it has thus far contributed negatively to the returns of Blue Boat. We do not believe that will be the case going forward.

Another compelling opportunity has emerged in small-cap stocks. A notable anomaly has developed where there is now a large and unsustainable valuation gap between small and large listed companies.

ASX Large vs Small Cap Index performance:

Source: Bloomberg

This divergence highlights an apparent trend where investors have flocked to large, liquid, relatively defensive stocks to provide safety in case of a market downturn. Moreover, it speaks to how widely anticipated an upcoming recession is, where liquidity is valued higher than company fundamentals. In markets, we know that it is the unexpected shocks that cause havoc. The fact that companies, consumers and investors alike have been able to prepare and adjust expectations for leaner times ahead actually improves the odds that such a recession will not be the shock to the system that investors are fearing.

We see this valuation disparity as irrational and likely to revert when sentiment changes. The two most extreme market events this century were the Covid outbreak and Global Financial Crisis. In both instances the returns off the market bottom from small caps outperformed that from large caps by roughly 2x. Australia houses some exceptionally high-quality small-cap companies with a track record of growing through difficult economic conditions. Most of these are ignored by the institutional market. We are actively searching for opportunities in this space.

Sitting out of the tech bubble in 2019-2021 was difficult, as was our staged entry into Spotify and Livechat Software which we bought in the depths of the tech bear market in 2022. The extremes of the highs and the lows in this sector were hard to believe, as has been the rapid recovery in share prices in the sector in the second half of FY23. Similar to what is happening in consumer stocks in Australia and Chinese companies, tech companies in 2022 were priced based on extrapolations of one or two weak quarters.

Spotify stands out as an extraordinary business, sharing the benefits of its economies of scale with its 500 million users worldwide. They have market leadership globally and untapped pricing power. The monthly subscription fee in USA has remained the same for 12 years, despite immense improvement in the offering. With further user growth and improving revenues as free users graduate to paid subscriptions, we expect the company to be on a path to strong profitability, warranting a much higher valuation.

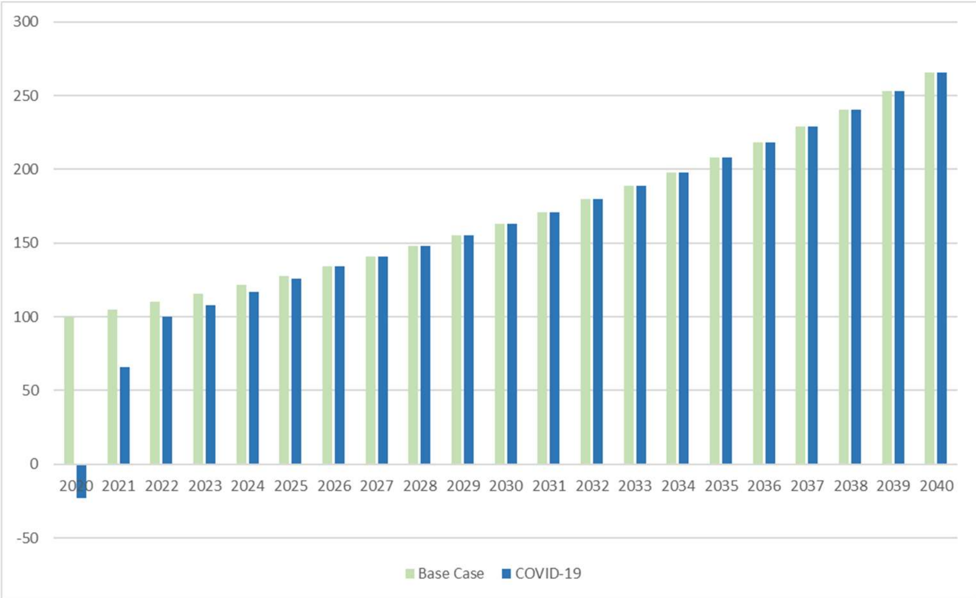
We are committed to our investment principles and continue to seek value to maximise long-term returns. We have a rigorous investment process which helps us hold steadfast in the face of volatility and be contrarian when markets become irrational. Our portfolio is positioned for a material re-rating as share prices converge towards intrinsic value, built on foundations of quality and earnings power. We want to express our sincere appreciation for the trust and support you have shown us. As partners we pledge to always be honest and do our upmost to serve the interests of the Blue Boat unit holders.

Yours sincerely,

David Nelson and Tim Evans

Appendix (*reproduced from the April 2020 investor letter)*

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.