Portfolio performance

The Swell Global Portfolio returned 12.99% after fees and expenses over the six months to 31 December 2017. The performance was led by our investments in Information Technology 7.82%, Financials 3.15% and Energy 1.55%.

The currency provided a 1.62% headwind to performance as the Australian dollar strengthened to 78.0 cents from 76.8. From a company perspective, the largest contributors were PayPal (2.63%), Deere & Co. (1.44%) and Phillips 66 (1.30%).

Market conditions

It is over a year since President Trump was sworn in as the 45th President of the United States. Within 12 months, on 20 December 2017, the Senate passed the "Tax Cuts & Jobs Act", lowering the corporate tax rate to 21% from 35%. These tax cuts will undoubtedly impact the US economy in a material way.

The government's claim on income will be reduced by 14 points allowing businesses to invest the windfall. Management may choose to lower their cost structure; grow their business and/or increase entitlements for employees. Our expectation is that business will favour some combination of the three.

Apple has unveiled plans to bring back the majority of the US$252 billion in cash that is held abroad. Apple has committed to use this economic windfall to invest for growth adding 20,000 new jobs, a new domestic campus and other key spending initiatives. CEO Tim Cook said "We have a deep sense of responsibility to give back to our country and the people who help make our success possible."

Portfolio Investments

Out top performing stocks were in information technology, financials and energy. We discuss each below.

Information technology

Our investments in Information Technology continue to drive the portfolio performance contributing 7.82% over the prior six months. Despite being categorised as Information Technology, they have distinct underlying drivers. We discuss two of these drivers below; the mobile economy and the payments economy.

Mobile economy

The mobile economy is estimated to be larger than US$3 trillion. Our portfolio investments are well placed to 'tap' into this opportunity as the behavioural and economic decisions of consumers are captured by the ecosystem and its applications.

- **Ecosystems:** Our investment in mobile ecosystems, namely IOS and Android (Apple and Alphabet) offer vast potential to monetise the user interface as the mobile phone becomes the gateway to personal computing.
- **Applications:** Our investments in Applications (Facebook, Instagram, Messenger and WhatsApp) stand to benefit from the monetisation of consumer data, generally through advertising.

Payments economy

The addressable cash economy is estimated to be greater than US$17 trillion. Our portfolio investments facilitate both online and offline commerce (Visa, Mastercard). The infrastructure they provide is critical to the migration of cash to digital payments, whether in-store, in-app, or online.

The transition from brick-and-mortar retail to e-commerce including through websites, mobile devices and applications is supporting our investment in PayPal. The global retail market is US$25 trillion of which e-commerce is 10%. PayPal has an opportunity to consolidate this industry, as online becomes a larger share of the retail market. In addition, Braintree (a PayPal subsidiary) powers some of the world's largest companies including Uber, Airbnb and Facebook, enabling users to transact in any context.

Artificial Intelligence and the productivity renaissance

We have written extensively about the technologies that shape our portfolio investments. Artificial Intelligence, Augmented Reality, Internet of Things (IOT), Edge Computing and 5G will influence productivity over the next decade in a material way.

One of the drivers of the productivity renaissance is Artificial Intelligence (AI), which will be more evolution than revolution. Infusing AI into existing products will create more useable and more intuitive products.

It impact on our portfolio investments is broad:

- Oracle is set to release its autonomous database in January that uses AI to reduce human interaction, thereby lowering cost, whilst increasing security.
- Alphabet, Apple and Microsoft are using AI to improve their voice assistants, 'Google Assistant', 'Siri' and 'Cortana', to help better understand context, your interests and how you use your device. In addition, they have each built AI

platforms to facilitate the democratisation of AI. These platforms will allow the development community to unleash innovation.

- Facebook is using AI to enhance the relevance, accuracy and appeal of content, increasing engagement and community on the platform.

Financials

Our investments in Financials contributed 3.15% to performance over the six months. We acquired Wells Fargo and J.P.Morgan when we seeded the Swell Global Fund in June 2015, adding Bank of America in May 2017. We were attracted to these investments due to their strong balance sheets, leverage to the US economy and opportunity for capital management. Our investment thesis has not changed since.

As our bank investments digitise and optimise their omni-channel experience, we see an opportunity to materially improve their cost-to-income ratio. This will have a direct impact on profitability and return on equity. In addition, the prospect of higher interest rates and capital management will serve to increase total shareholder return.

Energy

Our investments in Energy contributed 1.55% to performance over the six months. We acquired these investments in February 2016 when the oil price fell from US$90 a barrel to US$40 a barrel. The price drop presented an opportunity to acquire these high quality companies at bargain prices.

At Swell, we are focused on acquiring high quality companies at discounts to their intrinsic value conservative stated. To do this, we need to focus on the long term, hold a non-consensus view and be correct. The strength of our investment process is our unwavering commitment to quality. Quality means different things to different people. To us, quality means exceptionally managed companies with a clearly articulated strategy for creating value over the long term.

2018 Outlook

We see synchronised global economic growth and rising inflation. The IMF raised 2018 global growth forecast to 3.7% (up from 3.6%), basing the revision on a broad-based recovery in the EU, Japan, emerging Asia, emerging Europe, Brazil and Russia.

The US economy has been growing at around 2% since September 2009 and we see this growth continuing in 2018 as the recovery broadens to more sectors. After adjusting for inventory build in the final quarter of 2017, the economy grew at an annualised rate of 2.5%. Unemployment continues to hover around 4.1% with the participation rate climbing to 62.7%. It is projected that wage and price inflation may finally emerge after years of sub-trend growth.

China's economy continues to shine. GDP growth in the final quarter of 2017 was 6.8% (targeting 6.5% in 2018). While fixed asset investment continues to grow, the growth rate continues to fall to 7.2%, down from nearly 25% in 2012. Pleasingly, retail sales have been buoyant rising 10.2% in 2017. The government is navigating the dual threats of rising house prices and rising debt levels.

Nearly a decade after the Global Financial Crisis (GFC), we are seeing the awakening of 'animal spirits'. Bitcoin and its cryptocurrency peers (Ripple and Ethereum) are a monument to the return of speculation. We don't profess to have any superior insights around the future path of these currencies. However, they are not investments we would ever consider.

The underlying blockchain technology however, may be applied to a wide variety of industries. Blockchain is a shared public ledger that everyone can inspect, but which no user controls. Walmart is testing the technology in its supply chain. The result has been amazing, reducing the length of time to trace a case of mangoes from farm to store to 2 seconds from days or weeks previously. This is just one of the many applications in which a distributed ledger can improve current ways of doing business.

Competitiveness

Investment capital, unlike human capital, moves relatively freely across borders. It is incentivised by many factors that contribute to competitiveness such as an attractive corporate tax rate, an educated labour force, innovative and productive industries, access to cheap and plentiful energy and the rule of law.

The US is currently leading the world in this regard, having undergone an energy regeneration since the depths of the GFC. US oil output is expected to surpass Saudi Arabia and may surpass Russia for the number 1 position in 2018, where they are expected to produce more than 10 million barrels a day. A lower oil price enhances competitiveness as lower prices reduce transportation costs, and lower industrial chemical and manufacturing prices, thereby increasing competitiveness.

The Australian economy continues to grow at its trend rate. Business conditions have been positive and capacity utilisation remains high. Business investment continues to improve, and public infrastructure spend is supporting growth. However, the structural imbalance, namely a high level of household debt to disposable income, is a major concern.

Globalisation and liberalisation of trade increase the importance of a competitive tax system. The OECD average corporate income tax rate has dropped from 32% in 2000 to 24% today. Unless Australia lowers its corporate tax rate, we may suffer a permanent reduction in GDP per capita and real wages. The Turnbull government has stated it is committed to legislating a 10 year tax plan.

Environmental, Social, Governance (ESG)

ESG cannot be ignored when making long term investment decisions. The risk of a company's weak ESG policies will ultimately influence stock prices. For example, fractious employee relationships will ultimately lead to increased absenteeism and therefore affect company performance over the long term.

Loose environmental controls may lead to unexpected remediation costs which cannot be captured in static valuation multiples or on a company's balance sheet.

We view ESG as an important pillar of our long-term investment process. We believe it is critical to evaluate ESG risks as they can often have a meaningful impact on long- term investment performance.