Portfolio performance

The Swell Global Portfolio advanced 8.02% after management fees in calendar year 2018. Over the same period the All Ordinaries Index and MSCI World Index returned 3.53% and 1.26% respectively in a year that presented unprecedented volatility.

Investment returns cannot be considered in isolation, they must be weighed relative to comparative opportunities. With our long term focus we believe the most appropriate comparison for the Fund is to the US 10 year government bond rate, also known as the risk free rate. If held to maturity, this investment would currently produce a return of 27% over the next 10 years (10 years x 2.7% coupon). This investment comes with zero risk if it is held to maturity. Each coupon is received by the investor at predetermined dates and the par value returned to the investor at maturity.

Equities on the other hand have no guarantee with respect to the return of capital. However, they provide exposure to the future earning potential of the business. As equity returns are not guaranteed, it is essential that each investment can stand the test of time.

Despite the market volatility the portfolio performed well in 2018. Since inception the strategy has exceeded the index return during market rises and has fallen less than the market during market declines. This is consistent with our capital preservation focus and is highlighted by the upside-downside capture.

As of 31 December 2018, the up-capture is 112% and the down-capture is 75%, with a capture ratio of 1.49. (A capture ratio above 1 indicates a manager has captured more during up periods than they have lost during down periods.)

If you view portfolio performance by company you see we generate significant portfolio edge over the benchmark simply by avoiding the losers. This can be attributed to the depth and rigor of the investment process. Investing, like professional sports, is won on defence. This is why we are so selective when it comes to each potential investment.

Market conditions

The prospect of a prolonged trade war between the world's two largest economies, rising global interest rates and concerns around the length of the economic recovery contributed to an environment of uncertainty in 2018.

As the market rose through the year, we found it harder to identify attractive investment opportunities and our cash weighting swelled to 19% by August. The stock market surged as investor sentiment was bolstered by synchronised global growth, low unemployment and large corporate and personal tax concessions in the US.

Towards the end of the year, as investors began to fret about the impact of a prolonged trade war and less accommodative monetary policy, market sentiment soured. When the stock market is buoyant and investors feel good about the future, asset prices rise, reducing their potential future return. This is the environment we faced in the first half of the calendar year.

We generally find the best investment opportunities when the market becomes fearful, and this is what happened as the year progressed. Diverging views among investors together with ETF outflows and large algorithmic funds created exceptional market volatility, but we view this as more of an opportunity than a risk.

If we can buy an asset for $100, knowing its value will be $150 in three years' time, why should we concern ourselves with the path it takes to get there? Accordingly, we used this market dislocation to reduce our cash weighting to 11%.

Portfolio Investments

Our investments in Facebook and Google attract significant media attention, typically relating to the perceived utility of their service, privacy concerns and the prospect of government regulation. Both businesses continue to deliver higher revenue and earnings, although undoubtedly, they will face tougher regulation. Europe has already introduced the General Data Protection Regulation (GDPR) to reshape the way data is handled. However, we believe these businesses are well positioned to respond to changing regulatory environments around the world as they have done in Europe.

Several of our investments including PayPal, Facebook and Google own strategic assets which are currently under earning or losing money including Venmo for PayPal, WhatsApp, Instagram and Messenger for Facebook, and YouTube and Waymo for Google. The value of these assets is overlooked by most investors who focus on current earnings. However, they represent attractive long term opportunities to us and we include their future growth prospects in our valuations.

Unfortunately, despite the strong performance of the Fund last year, the overall return was dragged down by the performance

of Facebook. 2018 was Facebook's *annus horribilus* with its share price falling from $217 at its peak in July to $124 by year end, a decline of 43%. Despite this fall, we continue to like its long term outlook. Accordingly, we increased our weighting as the stock price declined. We are confident that 2019 and beyond will be better years and have positioned the portfolio accordingly.

After tax returns

As our investment strategy is designed to optimise returns to investors it is important you understand the difference between pre-tax and post-tax returns so your expectations align with our approach. All fund returns are not created equal.

Let's assume Fund A produces a 10% return pre-tax with no turnover of stock, which equates to an after tax return of 10%. No tax is payable by the fund's investors as Fund A has not sold any investments. Fund B also returns 10% pre-tax but turnover 100% of their holdings. This may reduce the 10% pre-tax return to 5.5% [assuming 45% tax rate], a reduction of 4.5%! This can make a meaningful difference to investor returns over the long term.

As the price of PayPal increased in 2018, the share price discount to our valuation reduced. If we paid no attention to after-tax returns, we may have decided to reduce the stock's weighting as the share price rose. However, this would have crystallised a large tax gain in 2018.

In instances where we like the long term economics of the business, we are inclined to let certain positions rise and then fall a little to avoid the crystallised tax event. We believe this approach will deliver the best long term after tax result for our investors.

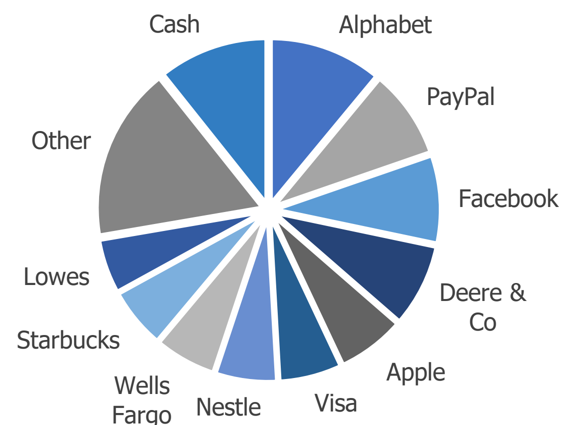
2019 Outlook

The outlook for 2019 will be influenced by several key factors including:

- A resolution in the trade war between the US and China
- Extent of a slowdown in China
- The impact of monetary and fiscal policy in major markets

However, our portfolio investments will be influenced to a greater extent by their unique business drivers and less by the direction of the broader economy. To focus exclusively on the economy does a huge disservice to the opportunities for each company.

Whether it is our ecosystems and applications businesses, exposure to the payments economy or the technological advancements in agriculture, these companies will earn more in the future than they do today. Our portfolio is exposed to a large cross section of the 'new economy' in large global multi-national businesses. We include our portfolio holdings below.



While we cannot provide any insight about the return on the broader market in 2019, we can ensure that we will continue to focus on the acquisition of high quality global businesses at discounts to their intrinsic value conservatively stated.

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