Portfolio performance

The Swell Global Portfolio fell by 6.48% in the six months to December 2021 as rising volatility was seen on global stock markets throughout the half. We sold three holdings and added two new companies to the Portfolio in the half year, with 14 stocks and 5% cash held on December 31.

Market conditions

The OECD reported GDP growth in most advanced economies had rebounded to 2019 levels by December 2021. They noted recovery was not uniform, and closely mirrored differences in vaccination rates. The impact of the highly infectious Omicron variant identified in November remains unclear, but is certainly affecting market sentiment.

Inflation is being fuelled by a number of factors which show no sign of short term relief: supply chain pressures, exacerbated by China's zero tolerance approach to the pandemic and persistent lockdowns; critical skill shortages in a number of industries; short supply of silicon chips; and rising commodity prices. Central banks are expected to raise interest rates in most countries throughout the first half of 2022.

Portfolio Investments

During the half we sold Alibaba Group, Mastercard and Tencent.

We sold Alibaba and Tencent because our investment thesis changed and better opportunities with less risk were available. A major component of our thesis on both companies was their highly defensible moats, which were being seriously eroded by changes in Chinese regulation introduced in the middle of the year. In addition, the Government's regulatory strategy for both the technology sector and business generally introduced a significant risk to the future earnings potential of both companies.

We sold Mastercard because we believe the threat posed by fintech companies and platforms such as Square will disrupt the market for traditional credit card payments and therefore the long term opportunity for Mastercard.

We added Booking Holdings and Square Inc to the Portfolio.

Our top three investments in 1H22 were Microsoft, Alphabet and S&P Global. We discuss each company below.

Microsoft

Microsoft finished both its fourth quarter of 2021 and first quarter of 2022 ahead of both company guidance and analysts' predictions. The results were driven by strong growth in a number of segments. Office 365 commercial grew 20% with growth in both number of seats and average revenue per seat. The software is increasingly being used by frontline workers, a largely untapped opportunity with more than 2 billion frontline workers globally. With continued product releases and updates Microsoft is also driving existing users to upgrade to higher-priced enterprise contracts which increases average revenue per seat. Cloud growth was strong with cloud revenue growing to more than $20 billion in the September quarter for the first time.

LinkedIn users climbed towards 800 million in September, increasing 26 million from the previous quarter. The platform has benefitted from a tight labour market and the so called "great reshuffle" as people reconsider where, how and why they work. LinkedIn revenue increased 39% driven by a 160% increase in confirmed hires and 61% growth in advertising.

Microsoft Teams surpassed 250 million monthly active users in November and Teams Essentials was launched. Essentials is a standalone product for small businesses and includes unlimited group video calls, group chat, file sharing and calendaring. With pricing at US$4 per user per month Microsoft expects small business productivity gains will be substantial, providing another demonstration of the company's strong value proposition for its customers across businesses of all sizes.

Gaming, which was expected to decline based on hardware supply constraints and a strong prior year comparison, grew 14% in the September quarter. The result was driven by hardware sales that increased 162% with continued strong demand and a better-than-expected supply environment.

At its Ignite conference early in November, Microsoft unveiled new products and features such as Microsoft Loop, Mesh for Microsoft Teams and Azure Open AI service. CEO, Satya Nadella, declared digitisation will be more rapid and pervasive across industries over the next 10 years than it was over the last 40. This is expected to elevate risks in areas such as data privacy and cyber security, with cyber crime expected to cost the global economy $10 trillion annually by 2025, up from current estimates of around $6 trillion.

Alphabet

Alphabet's results during the half reflected broad strength in advertising spend on its platforms, particularly in retail, as well as sustained consumer online activity.

Cloud revenue continues to accelerate and in the September quarter Google Cloud Platform grew significantly faster than the overall cloud segment. YouTube also accelerated, growing 83% in the quarter driven by recovery in brand advertising and direct response. Connected TV advertising was a highlight, with more than 120 million people watching YouTube on their TVs each month.

Management expects strong growth rates will continue, albeit at a slower pace given the lapping of a pick-up in ad spending in the second half of last year. Over the long term we remain excited about the many opportunities ahead for Google including the continued shift to digital advertising, cloud growth and ecommerce.

Alphabet will invest $10 billion over the next five years to strengthen cyber security capabilities after attending President Biden's White House Cyber Security Meeting in August. Its investments will focus on expanding zero-trust programs, helping secure the software supply chain and enhancing open-source security. The company also pledged to train 100,000 Americans in fields like IT support and data analytics to expand the nation's skill sets in areas such as data privacy and security.

Google is negotiating terms with the parent companies of TikTok and Instagram, ByteDance and Facebook, to incorporate their data into its video search function. Currently users searching for a video on Google see results from YouTube, many of which are lower quality copies of original TikTok and Instagram videos. The agreements recognise the importance of short form video in the current and future media landscape.

Google launched its latest smartphones in November, the Pixel 6 and 6 Pro. They are the first to use the company's custom designed chips to improve general performance and power the phone's AI and machine learning capabilities, as well as the company's most advanced camera.

Alphabet will invest $1 billion in Africa over five years to support digital transformation. It launched a new drug-discovery company which uses artificial intelligence from Google's DeepMind unit to commercialise healthcare ventures and research. The new company, Isomorphic Labs, will partner with pharmaceutical companies to accelerate drug discovery. It is the second standalone company to be established this year, following Intrinsic, its robotics focused venture.

S&P Global

Third quarter results were released in October. Revenue increased 13% to $2.087 billion, adjusted operating profit rose 18% and EPS was up 24% to $3.54, primarily due to strong revenue growth. Every market segment returned improved revenue in the quarter and the company expects revenue for the year to be "low double digits" ahead of its 2020 result.

The merger with IHS Markit, approved by shareholders in March 2021, is still to be finalised. Regulators around the world have given conditional approval for the deal, subject to the divestment of a number of businesses from the two companies on competition grounds. The cash sales have boosted the balance sheets of both companies, with FactSet Research Systems paying $1.925 billion for S&P's CUSIP Global Services and News Corp offering $295 million for IHS Markit's Base Chemicals business and $1.15 billion for its Oil Price Information Service.

The merger remains on track to close within the next three months.

2022 Outlook

Increased energy costs, and inflationary pressures, are impacting economies differentially around the world, and we do not expect central banks to continue their uniform responses to the pandemic which were evident over the last two years. Instead, central banks in each country will consider the speed of economic recovery, debt levels, current COVID-19 infections and vaccination rates and local market conditions when setting policy.

In the US, the Federal Reserve will continue to taper asset purchases in the near term and markets have factored in up to four interest rates rises over 2022. Labour shortages, increased wages and supply disruptions are stalling business recovery at the same time they are pushing up prices. As US households accumulated an additional 12% in savings during the pandemic, the market will tolerate inflation in the short term, but competition will restrict some businesses from passing on their additional costs to consumers.

The ECB remains accommodative and continues to support economic growth. While the wage pressure evident in the US is not yet obvious in Europe, increased vaccination rates following government mandates will encourage economies to open up. Nevertheless the outlook for growth is well anchored at or below 2%.

China's central bank has signalled an interest rate cut in response to a slowing economy and the new government in

Japan is grappling with stubbornly low inflation and continues to push stimulus measures.

Inflation is notoriously difficult to predict and a consistent global rate is unrealistic. If inflation were to persist, we are confident the high quality companies in our Portfolio have the capacity to lift prices to accommodate rising costs as they offer more value to their customers. Similarly, we expect long term interest rates to remain low, predominantly due to current levels of government debt and the costs of an aging population, with the proportion of the world's population over 60 set to reach 22% by 2050.

During 2021 investors prioritised return over risk, piling in to companies and industries hit hard in 2020 which began to emerge from the pandemic in 2021. Unpredictable gains and losses ensued, pushing share prices and market indexes to record highs. Consensus earnings estimates forecast growth for companies in the MSCI index to decelerate from 79% in 2021 to 6% in 2022.

Our investment thesis is to hold a concentrated portfolio of quality companies with the capacity to generate capital growth over the long term. These companies are both driving and harnessing structural trends to enable them to continue to grow earnings irrespective of the macro economic outlook. Their strong balance sheets provide capacity to absorb the additional costs all businesses will experience next year, but their competitive market positions and superior product and service offerings position them well to pass on higher costs to their customers.