

## Portfolio performance

The Swell Global Portfolio returned 17.27% over the twelve months to 30 June 2017 after fees and expenses.

## Market conditions

In a year dominated by political machinations, the global economy continued its recovery in FY17.

The US FOMC raised the target range for the federal funds rate to 1.25% in June. The decision to increase this rate was driven by moderate economic growth, solid household spending and improvements in the labour market.

The Euro region recovery started later than those in other advanced economies. However, they have now enjoyed 16 straight quarters of growth, with the dispersion of GDP and employment growth rates falling to record lows. For the first time since 1999, spending is rising with indebtedness falling.

China is likely to meet its annual growth target of 6.5% after strong growth of 6.9% in the first quarter, however the momentum will inevitably lose some steam in the months ahead amid a regulatory crackdown on debt. The growing debt mountain is an ongoing concern we have with the Chinese economy.

In Australia, consumption growth remains subdued reflecting slow growth in real wages and high levels of household debt. The housing market continues to remain at elevated levels despite the recent supervisory measures. We remain concerned about the risk of a housing correction owing to the high levels of household debt.

## Portfolio Investments

Contribution to performance of the Swell Global Portfolio was largely driven by our technology investments delivering nearly 60% of the return. Our technology investments have a number of underlying drivers:

- New media and the shift to online advertising: Alphabet and Facebook
- Cash to cashless economy: Visa and Mastercard
- Cloud services: Alphabet and Microsoft

## Shift to new media

Alphabet (previously Google) and Facebook together collect nearly half of global media spending. Last year, the US online ad market expanded by nearly \$12 billion, and the two firms accounted for over 77% of that spending growth, according to eMarketer. Google and Facebook each touch over a billion people on a daily basis. Their growing influence is coming at the expense of TV and print advertising, and we see this structural trend continuing to benefit these two investments over the coming years.

## War on Cash: Cash to Cashless

Visa and Mastercard process the majority of global cashless transactions. Both investments will benefit from the growing acceptance of electronic payments over cash. Both companies process thousands of transactions per second on their proprietary networks. Currently 83% of transactions and USD\$21 trillion of purchase volumes are cash-based.

This structural trend is aided by a growing middle class in emerging countries and governments' desire to shrink the black economy.

## Cloud: Tech Arms Race

The tech arms race continues to gather steam. Amazon, Microsoft and Alphabet spent \$31.54 billion in 2016 on capital expenditures and capital leases, according to company filings. Technology companies are spending lavishly on a global footprint of sophisticated data centres to run every start up and enterprise business in the cloud.

The large investment creates a powerful moat for these players. This makes it very difficult for other players attempting to operate in the generic data centre market.

We discuss below the current and future trends in technology affecting the industry broadly and our portfolio investments specifically.

## Technology Outlook

### Artificial Intelligence (AI)

The rapid digitisation of our world combined with the ubiquity of the cloud has created the perfect environment for AI to flourish. The most recognised uses are the personal assistants such as Siri, Google assistant, Alexa and Cortana. However, AI is also being infused into almost everything we do and it is making us more efficient and productive.

At a recent analyst conference, Microsoft demonstrated how it used AI, fully hosted in the cloud, to increase farm yields. The AI was trained on years of satellite imagery to develop a prescription of soil treatments and hybrid seeds for each square metre of land. The prescription was then downloaded into semi-autonomous John Deere tractors to variably plant fields, resulting in a 3-5x increase in crop yields. This is just one area for AI to improve agricultural productivity.

### Driverless Cars: The new Operating System

Intel estimates a new “passenger economy” may be worth USD\$7 trillion by 2050 and technology companies are locked in a fierce battle to produce the first driverless vehicle. Two of our portfolio companies, Alphabet and Apple are directing billions of dollars into this technology. Waymo, a subsidiary of Alphabet, appears to be in the lead, having logged over 4.8 million driverless kilometres. It also has the lowest reported levels of disengagements (when a human driver is forced to take control), 0.12 per 1,000 kilometres, which is significantly better than its closest rivals.

We believe self-driving technology developed by Waymo may in time become the primary operating system for cars, in much the same way as Microsoft holds a 90% share of the computer market with its Windows operating software. However, if Waymo does not succeed the impact to the valuation will be minimal. We love investments with hidden value.

### Augmented Reality: The Next Computing Platform

We believe the next widespread computing platform after the PC and mobile will be Augmented Reality (AR). This has the potential to be an USD\$80 billion industry. Alphabet, Facebook, Apple, and Microsoft have been investing in AR and we are beginning to see the results of these investments.

While each company has taken its own approach to developing the technology, they share three common elements.

1. A focus on developing the platform and not just the hardware;
2. The success of each business is not reliant on the success of AR; and
3. AR has not been factored into their market valuations despite the potential size of the industry

### Manufacturing Revolution: 3D Printing

3D printers allow a product to be designed on a computer and then “printed” as a solid object by building up successive layers of material. 3D printing has many applications, from dentistry to manufacturing components. For example, GE has spent \$1.5bn on the technology to make parts for jet engines. The GE Leap engines contain printed fuel nozzles. They are lighter, simpler, and more intricate than existing fuel nozzles. The number of parts used to make the nozzle has been reduced from 18 to 1. Despite being in the early innings, additive manufacturing has significant potential to shorten lead times for low volume, highly detailed products.

#### Summary

Our job as a global investment manager is to allocate capital to the highest producing sectors and select the highest quality companies that can benefit from the prevailing economic conditions and entrenched structural themes.

We will continue to take a long-term orientation to our investments and look forward to providing our next update in December.

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