Portfolio performance

The Swell Global Fund returned 22.57% after fees and expenses over the 12 months to 30 June 2018. The performance of the Fund was led by our investments in Information Technology 13.20%, Financials 3.35% and Energy 1.33%.

The currency provided a 4.66% benefit to performance as the Australian dollar weakened to 74.0 cents from 76.8. From a company perspective, the largest contributors were PayPal (3.66%), Visa (2.13%), and Facebook (1.95%).

Market conditions

The Australian economy grew at 3.1% over the March quarter of 2018, above estimates of trend growth. Business conditions have been positive and capacity utilisation remains high. Business investment continues to improve and public infrastructure is supporting growth. Australia's terms of trade rose 3.3% in the March quarter, as commodity prices remain elevated, supported by higher demand from Asia.

However, the structural imbalance, namely high household debt to disposable income, continues to be a major concern. Despite macroprudential controls cooling household credit, we remain concerned about the housing market. After a decade of robust house price growth a slowdown is inevitable. The RBA noted in the July 2018 minutes that a material share of household debt is held by lower-income households. This enhances Australia's vulnerability to exogenous economic shocks, which may impact consumption and economic growth. We are carefully monitoring this data.

The US economy has been growing at around 2% since September 2009. Unemployment has reached an 18-year low at 3.8%, while the participation rate hovers around 62.7%. Wage and price inflation appear to be emerging after years of sub-trend growth. However, demographics continue to weigh on the economy.

The other significant influence on US inflation has been globalisation and free trade. Disinflation, prices rising but at a lower pace, has been a key feature of the global economic landscape since China joined the World Trade Organisation in 2001. On their arrival, China became the manufacturing epicentre of the world as they tapped into their vast pool of young, cheap labour. This brought down the cost of goods globally, as China produced and exported to retailers around the world.

Despite weak US wage growth, the purchasing power of consumers increased, as the prices of goods fell. The rise of online retailers, increased price discovery, leading to greater competition and lower prices. Broadly speaking, this has been positive for consumers.

However, any retreat in free trade, led by protectionist policies, will have an inflationary impact on prices. As we survey international trade, we are concerned about the prospect of tit-for-tat retaliatory tariffs and their unintended consequences.

The world's second largest economy continues to prosper. China's gross domestic product (GDP) growth in second quarter of 2018 was 6.7%, slightly lower than 6.8% in the first quarter of 2018. Despite fixed asset investment continuing to rise in dollar terms, the growth rate continues to fall. Capital investments grew 6.0% in the first half of 2018, down from nearly 25% in 2012. However, retail sales remain buoyant, rising 9% in June 2018, from a year earlier.

The government is navigating the dual threats of rising house prices and rising debt levels. We continue to be concerned about China's Total Debt-to-GDP of around 265% as at December 2017 and an estimated US$15 trillion shadow banking industry. However, with over US$3.1 trillion foreign exchange reserves as at 2Q2018, China has considerable firepower to manage a potential crisis

As we look across the EU, we see further evidence of the global recovery. The unemployment rate has fallen to 7.0%, down from 10% in 2013. However, the unemployment rate varies significantly from 3.4% in Germany to 20.2% in Greece. EU GDP growth has slowed to 2.4% (down from 2.8% in September 2017). The weak performance was driven by soft exports, buffeted by a slower global recovery, and a strengthening Euro. The Euro Stoxx 50, which includes Europe's leading blue-chip companies, is trading on 13.8x FY18 earnings.

Portfolio Investments

We discuss the three sectoral contributors to portfolio performance below.

Information Technology

Our investments in Information Technology continue to drive the portfolio's performance, contributing 13.20% over the prior twelve months. Despite being categorised as Information Technology, these investments have diverse underlying drivers.

Our investments in the mobile economy span the ecosystem and applications. These investments will benefit as the behavioural and economic decisions of consumers evolve. The mobile economy has an addressable market in excess of US$3 trillion.

Our investments in the payments economy, facilitate both online and offline commerce, providing infrastructure that is critical to the migration of cash to digital forms of payment, whether that is in-store, in-app, or online. The addressable market is estimated to be greater than US$17 trillion[1].

We discussed both these investments in detail in our December 2017 Newsletter.

Financials

Our investments in Financials contributed 3.35% to the portfolio's performance over the prior 12 months. We are 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 their acquisition.

As banks digitise and optimise their offering to clients, 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 increase total shareholder return.

Energy

Our investment in Energy contributed 1.33% to portfolio performance over the prior 12 months. We acquired Phillips 66 in February of 2016, after the oil price declined from US$90 a barrel to US$40 a barrel.

The falling oil price presented an opportunity to acquire Phillips 66 at an attractive price. We divested the stock toward the end of FY18 as the oil price recovered and allocated the capital to a more attractive investment, with lower risk, and better underlying economics.

2019 Outlook

At its June meeting, the Federal Reserve raised the target range for its policy rate to between 1.75% and 2.00%. The implied probability of the Federal Reserve raising target interest rates two more times in 2018 is around 50%. This would increase the federal funds rate to 2.25%-2.50% by end of 2018. The labour market continues to strengthen and economic activity is rising aided by corporate tax cuts.

The Chinese central bank has reduced the reserve requirement for three times this year as the prospect of a trade war with the US looms. This will release significant liquidity in the hope of reducing any resulting economic drag. China's policy makers continue to foster further debt-for-equity swaps to reduce non-performing loans within the financial system.

The European Central Bank (ECB) is gradually reducing its purchases of bonds, which is currently €30 billion each month. The ECB forecasts bond purchases to be €15 billion from October 2018. The removal of further monetary stimulus undoubtedly carries risk. However, we expect the ECB to be measured and accommodating with respect to economic growth.

In the US, the number of people aged over 65 compared with those aged 15 to 64, will be more than double in 2040 what it was in 2000. This has placed downward pressure on inflation as the demographic burden will weigh on economic growth. However, a circuit breaker to this malaise may arise from an unlikely source, technology.

We believe the next decade will unlock a productivity boom, but its extent will be limited by investments in important infrastructure including 5G, fibre optic networks, cloud computing, and software. These components will form the backbone allowing innovation to prosper.

To date, digital industries have been the primary beneficiary of technological innovations. However, the next 10 years will see these innovations applied to every industry. In the same way that the internet changed commerce, the proliferation of data, and the software to analyse this data, will lead to improvements in physical industries[2].

The largest physical industries, transport, healthcare, retail and manufacturing have, to date, significantly lagged digital industries. However technological innovations over the next decade will unlock the potential in many physical industries.

The gap between the world's most productive companies and their rivals is widening. The most productive 5% of manufacturing companies increased productivity by 33% between 2001 and 2013[3], compared to only 7% for all other manufacturers. With respect to service companies, the inequity was similar. Productivity leaders engaged in the

Services industry improved productivity by 44% over the same period, compared to only 5% for all other service companies.

We expect the coming decade will see the democratisation of technology, allowing smaller companies to take advantage of those technologies currently available to only the largest and best resourced companies.

Our role is to consider and allocate investment capital to those companies and industries standing to benefit from this progress. We are presently considering a number of investments. However, we will be prudent and cautious with respect to the allocation of capital.

While our investment returns over the last twelve months are pleasing, there is more work to do. We will continue to focus on the acquisition of high quality companies at discounts to their intrinsic value conservatively stated. We look forward to updating our investors after 31 December 2018.

Notes:

[1]Visa Investor Day 2017

[2] The Coming Technology Boom: Transforming the Physical Economy with Information, By Michael Mandel and Bret Swanson

[3] Wall Street Journal, The problem with Innovation: The Biggest Companies are Hogging all the Gains, By Jason Douglas, Jon Sindreu and Georgi Kantchev

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