Portfolio performance

In the six months to June 2019 the Swell Global Portfolio rose 19.74%. It advanced 17.78% in financial year 2019 and over the same period the All Ordinaries Index and MSCI World Index returned 11.95% and 11.04% respectively.

We commented on Facebook in our December 2018 newsletter and called out the impact of the company's poor performance in 1H19. We stated then:

> *"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."*

We are pleased to report Facebook was the top performing company in the portfolio over the last six months, rising 45%. We attribute the investment success to our investment philosophy which values a long term orientation together with independent proprietary analysis.

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 Portfolio 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 17% over the next 10 years (10 years x 1.7% coupon), coming with zero risk if held to maturity.

Equities on the other hand have no guarantee with respect to 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. This is why we take a laser focused approach to our investment decisions.

Owning high quality companies has two advantages:

- They will rise with the market
- They are beneficiaries of a flight to quality when market sentiment sours

To date the Swell Global Portfolio has risen more than the market on the way up and fallen less than the market on the way down. This is known as the upside-downside capture and is consistent with our capital preservation focus. As of 31 August 2019, the up-capture is 119% and the down-capture is 79%, 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.)

Market conditions

Investor sentiment fluctuated wildly in 1H19 as weaker than expected economic data, trade uncertainties, US federal government shutdown and concerns about the outlook for corporate earnings took their toll on the market. In the six months to 31 December 2018 our benchmark index, the MSCI World Global Index fell 4.60% while the ASX All Ordinaries fell 7.28%. Pleasingly, the Swell Global Portfolio fell significantly less, down 1.64% over this period.

Market conditions improved significantly in 3Q19 as investors anticipated more accommodative monetary policy and a resolution to the trade dispute between the US and China. Economic data was supported by a strong labour market, benign inflation and elevated levels of household net worth.

However 4Q19 saw concerns about downside risks weighing on financial markets while prospects for a positive resolution to the trade war declined amid tit-for-tat rhetoric that ultimately moved both parties further away from a resolution. The bearish sentiment extended to the bond market where the spread between 10 year and 3-month treasury yields fell to the bottom decile of its distribution. A level not seen since 1971.

Ultimately the yield curve inverted in August leading market pundits to foreshadow an elevated risk of recession in the US. Softer economic data provided further evidence of a slowing economy.

At Swell we are focused on the *important* **and** *knowable*. While the direction of the economy is important, we do not believe it is knowable and though we are interested in economic developments they do not instruct our decision making. We prefer to focus our attention on acquiring the world's best businesses that we believe will outperform the market over the long haul irrespective of whether the next GDP print will show 2.4% or 2.3% growth.

As the market rose through 2H19 we lifted our cash levels to 15% capitalising on rising equity markets and stellar performance by a number of portfolio investments. We are comfortable with this cash weighting.

Portfolio Investments

Our top three investments in the half were Facebook, PayPal and Visa. Each investment enjoyed strong returns driven by growing revenue and profitability. We discuss each investment below.

Facebook

Facebook released its second quarter result in July delivering revenue growth of 28% to US$16.6 billion and operating profit of US$4.6 billion.

Our investment in Facebook continues to deliver above average revenue and earnings growth despite the company attracting negative media attention, typically relating to the perceived utility of their service, privacy concerns and the prospect of government regulation. We believe Facebook is taking the necessary steps to ensure the interests of all stakeholders, including governments, users and advertisers are considered.

While we acknowledge regulatory outcomes are an unknown and privacy concerns linger, the business model and the case for our investment in Facebook has not changed. Innovation and product development have continued, with the rapid growth of Instagram "Stories" being a prime example. Introduced late last year, Stories is now being used by over 500 million people daily and has attracted more than 3 million advertisers.

We have reported previously that a number of Facebook services currently under-earn or lose money including WhatsApp, with more than 1 billion users in 180 countries, which generates no meaningful revenue. We believe this will change and is another example of the many opportunities to grow revenue and earnings over coming years.

At the industry level the shift from traditional to digital advertising continues. Advertisers cannot ignore the higher returns offered by the digital platforms and are allocating more of their budget to the digital world. This trend is expected to continue for a number of years.

Finally, it is worth reiterating that 2.7 billion people use one of Facebooks "family" of applications each month. We continue to believe it is highly unlikely the company will be displaced as the world's leading social media platform, and we remain excited about Facebook's prospects.

PayPal

PayPal released its second quarter result in July with total payment volume growing 26% to US$172.4 billion and revenue rising 19% to US$4.31 billion. The business drivers were in line with our expectations with net active users up 9 million and payment transactions per active account up 9% to 39.

To put this growth in context, PayPal added 100,000 new accounts per day or 69 per second. Growth in users is an important metric which reflects the success of the platform's partnership strategy.

In the last quarter PayPal announced a partnership with Visa to launch real-time transfers in Canada. The partnership will allow consumers and small businesses with a PayPal account to transfer money instantly to a bank account using the Visa Direct platform. According to research commissioned by Visa, 85% of small businesses say they would readily switch banks if they offered real-time payments.

Visa

Visa released its third quarter earnings result in July reporting net revenues of US$5.8 billion (+11%) driven by continued growth in payments volume, cross-border volume and processed transactions. Total processed transactions were 35.4 billion an increase of 12% on the prior year.

Notable achievements included:

- partnership with PayActiv to enable real-time wage payments through the Visa Direct platform
- investment in African microfinance fintech Branch and launch of crypto debit card in collaboration with Coinbase
- integration into the New York City's public transport system allowing commuters to tap and ride using their Visa card
- £247 million (US$320 million) acquisition of Earthport, the world's largest independent ACH network which provides Visa with access to most of the world's banked population

Today almost $80 trillion is remitted globally via wire transfer, a system considered slow, complex and outdated by modern standards. Visa can now integrate these payments into their new Visa Direct platform to facilitate faster payroll, peer-to-peer (P2P) and Business-to-Business (B2B) remittances. In the last 12 months Visa Direct has grown at over 100% indicating strong demand for faster more secure payment options.

2020 Outlook

Financial markets in 2019-20 will respond to unpredictable financial and political issues including:

- The ongoing trade war between the US and China
- Central bank monetary and fiscal policy in major markets
- Uncertain electoral outcomes in Europe and North America

Our portfolio investments will be influenced to a greater extent by their unique business drivers and less by the direction of the broader economy. An exclusive focus on the economy does a huge disservice to the opportunities for each company.

Whether it is our ecosystems and applications businesses, those exposed to the payments economy or 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.

While we cannot provide any insight about the return on the broader market in 2019, we ensure 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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