Portfolio performance

The Swell Global Portfolio celebrated its fifth anniversary on June 17, recording a 5 year return of 17.06% per annum since inception. Over the same period the ASX All Ordinaries Index and MSCI World Index returned 6.22% and 9.28% respectively.

We are pleased to have delivered strong performance in FY20 including 9.09% over the last six months outperforming the MSCI World and All Ordinaries Index by 12.88% and 19.51% respectively.

This performance is a testament to our disciplined investment process and long term orientation. Investment returns cannot be considered in isolation, they must be weighed relative to comparative opportunities. With our long term focus the most appropriate comparison for the Portfolio is the US 10 year government bond rate, also known as the risk free rate, which has remained persistently low for some time, yielding 0.658% at June 30 2020.

Market conditions

Global equity markets have witnessed a period of extreme volatility since the World Health Organisation defined COVID-19 as a global pandemic on March 11, with record highs and lows recorded in the ensuing sixteen weeks. Supply chain disruptions and widespread lockdowns changed the dynamics of most businesses, and though many industries were hit hard, others flourished.

Government responses to the pandemic impelled a number of business and consumer trends, evident for some time, to progress more rapidly. The surge in online transactions was identified early in China, and multiplied exponentially as governments established social isolation policies around the world.

In mid March Amazon announced the suspension of deliveries of non-essential products and the addition of 100,000 employees to meet consumer demand for grocery staples. Later it added another 75,000 employees. Similarly, PayPal recorded 10 million new accounts in the quarter ending April 30

Our investment philosophy requires us to focus our attention on the acquisition of businesses capable of delivering higher revenue and earnings over the long term. While the direction of the economy is important it does not instruct our investment decisions. We are confident our portfolio investments will continue to navigate their way through these uncertain times and excited about the future of the Swell Global Portfolio

Portfolio Investments

In March we added Hong Kong listed Tencent Holdings Ltd to the Portfolio. Founded in Shenzhen in 1998 Tencent provides social networking, music, web portals, e-commerce, internet services, payment systems, smartphones, mobile games, and multiplayer online games. It is the world's largest gaming company, in the top ten by market cap, one of the world's largest social media companies, and one of the world's largest venture capital and investment businesses. We consider its exposure to the expanding middle class market in Asia a key growth opportunity.

We sold our holding in Lowe's Inc in May, despite it reporting first quarter earnings above market expectations and excellent progress on the growth strategies developed by the management team under CEO Marvin Ellison. Our investment thesis incorporates three reasons to sell a stock, one of which is the availability of more attractive opportunities with commensurate or less risk. We judge there are superior investments in the current environment, and will maintain our cash weighting while investigating prospective opportunities.

In June we sold our holding in Wells Fargo and allocated the proceeds to JP Morgan which we believe offers a similar return profile with less risk. Following the divestment, Wells Fargo announced its intention to cut its dividend for the first time in a decade.

We are attracted by JP Morgan's leading banking franchise, highly experienced management team and 'fortress' balance sheet. It is also investing significantly in its technological capability which should drive customer acquisition over the next decade.

Over the last six months our cash weighting has increased from 6.3% to 17.0%. Our investments in Alibaba and Tencent reduced our exposure to north America from 50.2% to 36.3%. This allocation is an outcome of our bottom up fundamental process rather than a strategic pivot to a particular region.

Our top three investments in 2H20 were Amazon, PayPal and Microsoft. Each company saw strong returns driven by changes in business and consumer activity brought on by the pandemic, with underlying business models which we believe will continue to sustain growth and profitability. We discuss each company below.

Amazon

Amazon reported first quarter results on May 1 with net sales growing 26.5% year on year to $75.5 billion, beating consensus estimates by $1.14 billion. The main drivers included strong growth in the North America region and Amazon Web Services which grew 29% and 33% respectively. Announcing the result CEO Jeff Bezos said "under normal circumstances, in this coming Q2, we'd expect to make some $4 billion or more in operating profit. But these aren't normal circumstances. Instead, we expect to spend the entirety of that $4 billion, and perhaps a bit more, on COVID-related expenses getting products to customers and keeping employees safe".

Throughout the half Amazon continued to roll out safety and employee assistance measures to deal with the spread of the virus, and the ultimate cost will be revealed in its second quarter results. Other notable achievements included:

- In February Amazon opened its first full size grocery store using its "just walk out" smart retail technology which combines ceiling cameras, computer vision and weight sensors to create a cashierless shopping experience for customers. The store was developed over five years utilising the technology pioneered in 25 smaller Amazon Go stores across the US. In March the company announced it had signed a number of deals with retailers, airport vendors and stadium concession operators to sell the retail technology.

- Amazon released its virtual health clinic app, Amazon Care, to its employees in Seattle early in the year, providing a range of services such as virtual medical consultations, easy scheduling of home follow up visits and prescription drug ordering and delivery. The app was widely used to assist employees as the virus spread, aided by the launch of Pillpack by Amazon Pharmacy, a full-service online pharmacy distributing prescription medications. Both apps are currently available only in the US, but global pharmaceutical sales in 2018 were $982 billion and are forecast to grow to $1.4 trillion by 2023, providing a significant opportunity for Amazon.

- Amazon entered the gaming sector this year, with the launch of its first in-house developed game, Crucible, in May. Amazon is investing hundreds of millions in game production through its own developer Relentless Studios, and is also planning to launch a cloud based gaming platform similar to Google's Stadia, known as Project Tempo, alongside its popular game streaming service Twitch. The gaming industry is expected to generate more than $160 billion in revenue in 2020 making it twice as large as the music and film industries combined.

PayPal

PayPal reported first quarter earnings in May with revenue growing 12% to $4.6 billion and adjusted EPS flat as the company increased its credit loss reserve by $237 million. CEO Dan Schulman noted revenue was growing at 17% to the end of February, slowed to 3% in March then recovered back to 17% in April. PayPal added a record 10 million new accounts in the quarter and another 7.4 million in April for an average of 250,000 new accounts per day. Mr Schulman told investors "The strength of our customer value proposition combined with the acceleration of digital payments adoption significantly accelerated in April, with increased demand and engagement".

Other notable achievements included:

- PayPal launched QR code functionality this year to enable buyers and sellers to make in-person transactions safely and securely, without the need for physical contact. The feature is available in 28 countries including Australia, Europe and the US and provides the safety, security and convenience of PayPal's online functionality for users in physical stores.

- PayPal participated in the US Small Business Administration Paycheck Protection Program launched in April. It was another form of support for its merchant partners after the company introduced a set of measures earlier in the month to assist small businesses impacted by COVID-19. The measures include waiving chargeback and instant fund transfer fees in addition to deferring repayments on business loans as requested for the 24 million merchants on its platform.

- PayPal joined a number of high-profile technology companies as investors in Gojek's fundraising in June. Launched in 2015, Gojek is Indonesia's first and fastest growing app for ordering food, shopping, ride-hailing and making digital payments across Southeast Asia. The investments bring Gojek's total raise to date to over $3 billion as the company reaches the milestone of 170 million users across the region. Farhad Maleki, Head of PayPal's Corporate Development and Ventures for APAC, said "Southeast Asia is at an inflection point in digital adoption that creates new opportunities to deliver financial services to previously unbanked merchants and consumers".

Microsoft

Microsoft reported third quarter earnings in April delivering better than expected revenue and EPS growth. Revenue grew 15% to $35 billion driven by strong growth in the Intelligent cloud segment and a better than expected result in the More Personal Computing segment, particularly Windows products. EPS for the quarter increased 23% to $1.40 driven by revenue growth and the repurchase of $7 billion worth of stock. Releasing the results, CEO Satya Nadella said COVID-19 had a negligible impact on revenues as the company had seen two years' worth of digital transformation in two months.

Microsoft co-founder Bill Gates announced in March he would step down from the company's board, after 45 years with Microsoft, to spend more time on his philanthropic pursuits.

Other notable achievements included:

- Microsoft is expanding its global data centres, announcing new facilities in Spain, Poland, Italy, Mexico and New Zealand in the last six months. In Spain Microsoft will use the local data centre to provide services to customers while local telecommunications company Telefonica will use it to house its non-network workloads, which it expects to shift to the Microsoft cloud by 2024.

  A $1.1 billion investment in Mexico over the next five years will focus on expanding access to digital technology for individuals and organisations. It will include construction of a new data centre, local training labs and skills programs.

  A similar five year investment plan in Italy, worth $1.5 billion, includes its first Italian data centre, to be based in Milan. "Ambizione Italia #DigitalRestart" aims to support economic growth by providing access to local cloud services, digital skilling and smart-working programs, local partnerships for business innovation and a new sustainability alliance.

  Microsoft will invest $1 billion in its data centre in Poland and an unspecified amount in New Zealand.

  The announcements bring Microsoft's footprint to 60 regions and over 140 countries, providing greater access to Microsoft's Azure cloud services, which grew revenue 59% year-on-year in the last quarter, and allowing it to cross-sell other products and services such as Microsoft 365 and Dynamics 365 usage.

- During the half Microsoft extended its partnerships with the US National Football and National Basketball Leagues. Both organisations use Microsoft's services and platforms to enhance business operations, communications, team fitness and skill levels as well as developing relationships with supporters and broadcasters. The NFL is harnessing Microsoft's chat and conferencing app Teams, which gained more than 12 million users in one week during March as people transitioned to remote work at the beginning of the COVID-19 outbreak.

- Microsoft continued to add new features to Teams throughout the half including providing offline and low bandwidth support to allow messaging without internet. The company released a business update late in March reporting a staggering 775% increase in use of its cloud services in the month. It also revealed Power BI users had grown 42% in a week, while use of virtual desktop software more than tripled.

- In mid March Microsoft closed all its 82 retail stores in response to the COVID-19 outbreak, and in a strategic change to its retail operations, announced in June it would not re-open the stores beyond the pandemic. Four of its flagship stores in New York, London, Sydney and Redmond will become Microsoft Experience Centres, joining Singapore. The store closures will reportedly result in a pre-tax cost of approximately $450 million ($0.05 per share) in the fourth quarter. The digital Microsoft, Xbox and Windows stores, which collectively reach more than 1.2 billion people in 190 countries every month, will become the company's retail focus.

2021 Outlook

Like everyone else, we have little idea when the crisis will subside and how financial markets will respond to unpredictable financial, political and social disruptions evolving from the pandemic. 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.

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