25th January 2019

Half Year to 31 December 2018

Performance Measures

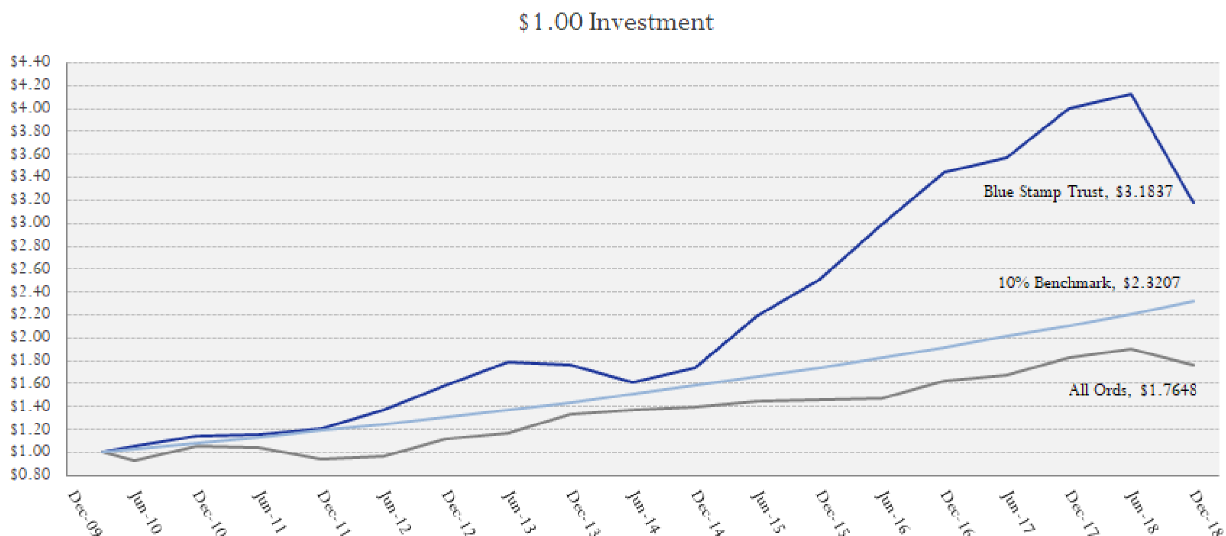
The half year saw Blue Stamp Trust experience a large amount of volatility and its steepest fall yet, declining 24.5% (after all fees) to $2.8135/unit for the Lead Class. If you hold units in classes other than the Lead Class, please login to your account at www.bluestampcompany.com/investors/ to find the relevant pricing information.

A summary of this performance is shown in the table below, together with a comparison to the 10% Benchmark and the All Ordinaries Accumulation Index (Index) – the broadest measure of performance for the Australian stock market.

	Blue Stamp Trust (Lead Class units)			
	Before PF	**After PF**	**Benchmark**	**Index**
01-Jul-18	$3.7284	$3.7284	$3.7284	62,434.90
31-Dec-18	$2.8135	$2.8135	$3.9148	57,887.91
Return	**-24.54%**	**-24.54%**	**5.00%**	**-7.28%**

No performance fee has been provisioned at 31 December for any unit classes that have not experienced a proportionate 10% increase in their value. It is important to note that the Trust must recoup the value lost (from the greater of the high water mark or entry price), a 10% return and any amount paid as management fees, before any performance fee is provisioned – so it is safe to say your Manager is acutely aware of the ongoing need to ensure capital is being protected and an adequate return is expected to be achieved over time.

The following graph compares the historical performance of $1 invested in the Trust versus the Index and the 10% p.a. benchmark. The investment in the Trust is for Lead Class units, is after all fees and *includes any distributions which have been paid*.



Operating Review

Income

The most significant components to the Trust's performance are the change in value of our long-term investments (both realised and unrealised) and any dividend income the Trust might receive.

Consistent with recent history, the majority of our performance for the half year was driven by unrealised gains on our investments, though as shown below, we also recorded a significant negative contribution from realised investments.

	1H 2019	1H 2018
	$	$
Investments - Realised	(1,691,102)	441,314
Investments - Unrealised	(3,506,271)	1,708,975
Short term transactions	757	1,851
Dividends	17,450	146,545
Interest	2,748	1,469
Total Income	**(5,176,418)**	**2,300,154**

Given our approach is to be patient, long-term investors, you may question the consistency of those words with the numbers you see above – rightfully asking what business we had with selling some of our holdings in such a market as we've recently experienced. Did we get our projections wrong? Were we prioritizing the near-term performance over the longer term? Or were we trying to make the most of a finite pool of capital amongst a rapidly shifting landscape of prices and value? As explained below, unfortunately it was a case of all of the above.

The major contributors to the realised loss for 1H19, were sales we made in Silver Chef and Superloop, where the decision to reduce our holdings in each was a difficult one.

Early in the new financial year, Silver Chef announced there were still a number of items they were dealing with from their legacy GoGetta division – including the continued realisation of the GoGetta assets and the negotiation and introduction of subordinated debt into their capital structure. The significance of these factors meant the medium-term growth and profitability of their hospitality division would be compromised. Ruing the flat footedness I previously acted with when protecting the fund against near-term headwinds, I was swifter with my actions, deciding to pare back our holding as the medium-term outlook became obscured. Though given our investment is (and has been) predicated on their hospitality operations – we still retain a holding in the company as the longer-term opportunity remains.

The decision to lighten our holding in Superloop was due to a stubbornly slower run rate of sales than expected – though still in line with what we were projecting (where the difference between expectations and projections is an important component of our margin of safety). The opportunity to deliver fibre connectivity in Singapore and Hong Kong is vast and the sales the Group has generated thus far indicate an attractive pricing environment. With significant network assets in these regions, together with a blended fibre, fixed wireless network in Australia, Superloop is uniquely positioned to take advantage of the opportunity from the internet's centre of gravity shifting to the Asia-Pacific region. Ordinarily, we would have been more than happy to maintain our holding, however opportunities presented elsewhere compelled us to make a difficult decision. Accordingly, we retain a meaningful, albeit reduced, position in Superloop and look forward to the chance to add to it in the future.

Ultimately though, the list of culprits responsible for our half year performance was comprehensive – from the very large, in Facebook to the relatively small, in Kogan. Our bias to technology left us almost no place to hide during the recent turbulence and clearly our results stand to show it. While the turbulence brings its own challenges, what made this recent experience tolerable was that it was not characterised by company specific trading updates that warned of underperformance. That's not to say there weren't issues for many of our holdings to deal with – however, long horizons tend to blur short term headwinds and looking at incredible businesses over long horizons means you can really set your projections quite low and in doing so, build capital protection into the holding. And as we've all been told before, it is always best to wear protection and practice safe… investing (what were you thinking?). And Blue Stamp's protection is using patient capital to invest in businesses with a sustainable differentiation in their product or service that produces a durable stream of growing earnings.

While I suspect the discounts to many of our investments will unwind in their own time and pace, it goes without saying the decision to hold investments in any of our companies was based on my understanding of their longer-term operating outlook and how this compared to the price they were then trading at. Clearly this is a subjective task, which is why investing is more art than science – though a paintbrush in my hand was always a lost cause… Let's hope I have more luck painting the Blue Stamp canvas with a calculator instead!

Selling '80 cent dollars' to buy '50 cent dollars' is never a fulfilling experience and much of our work in this area during the half year was directed toward reinvesting capital into Afterpay, which delivered us little to show for it. Though as we know, it is not the next half year's performance that we make decisions for.

The strength of Afterpay's business came blazing through in their 2018 results, with their credit underwriting improving on almost every measure, despite experiencing breakneck growth in customers and transaction volumes. That is, regarding a point-in-time perspective, the quality of Afterpay's arrears showed improvement and combined with increased provisioning, suggests management is adopting a proactive and conservative approach to reporting and governance – important factors for any underwriter. In addition to this, over the year, the weight of bad debt charges continued their downward trend, on an absolute basis and relative basis – with Afterpay's performance comfortably out-shining their competitors' – suggesting the consumers' affinity and loyalty to the Afterpay brand may be resulting in behaviour that encourages them to 'look after it' and repay their loans. While improved credit performance that has resulted from 'loyalty to a brand' may sound a bit 'wishy-washy', it nonetheless seems reasonable given that Afterpay's business is built around being paid by the merchant and not the consumer – flipping the idea (and economics) of traditional credit underwriting on its head and creating a strong alignment between company and consumer – a dynamic that to my knowledge, has never before existed for a lender.

This 'wishy-washy' notion is also supported by the data, where returning customers are accounting for a rapidly increasing share of the total transaction volume (rising from ~50% in 2015, to ~60% in 2016, then 80% in 2017, and >90% in 2018) assisting the Group's bad debt experience, as over time the platform weights toward those higher credit quality, returning customers. However, given that customers who have payments in arrears are locked out of the platform, then (provided the Group's fraud protection controls are adequate) the performance of Afterpay's underwriting should naturally improve over time – taking the 'wishy' out of their provisioning and ensuring a 'washed' performance.

Another incentive for consumers to keep their Afterpay account up-to-date arises from offering the cheapest service (free for those who pay on time!) and widest array of retailers – no shopper wants to be locked out of a free, one-stop-shop.

While point-of-sale interest free financing is not necessarily a new concept, what is new is having this financing available for small-value, discretionary items and for the repayment terms to be set in stone. That is, normally the interest-free financing is provided within a window of time (6 months, 12 months etc.), and while offering

this 'flexibility' might seem appealing, in practice it encourages little (if any) fiscal discipline and budgeting skills. And so together with their busy lives, people on these traditional financing options often find themselves carrying far larger loads of debt than anticipated, for much longer periods of time and in doing so, incurring significant interest costs.

Afterpay's approach is to remove the repayment flexibility and the interest charges. This simple difference has an incredibly powerful effect on consumers; firstly, they feel a sense of safety with the Afterpay brand (shown by Afterpay's industry leading net promoter score) as they know they will never incur interest from using the service. This flows into the second powerful effect, which is through the short and fixed repayment dates and the absence of interest, the consumer is quickly paying off their purchases (in full), allowing them to move on to the next item, without dragging behind them a truck load of debt from their prior purchases (85% of Afterpay transactions are on a debit card). While Afterpay's service is a simple shift from current practice, it is nonetheless having a profound impact on spending behaviour, particularly for those younger generations that are showing a sensitivity to spending, budgeting and their overall indebtedness.

The universal appeal (for both consumers and retailers alike) of Afterpay's service, the replicability (without significant adjustments) of the product and the platform between regions, the capital light and universal nature of its customer acquisition model, together with the virality of its growth, make Afterpay's global ambitions completely plausible. Combining all of this with the incredibly short tenor to their receivables and the explosive (in a good way) returns on its capital, will likely result in Afterpay becoming a significant compounder for us – even if they only fulfill a fraction of their potential.

The fall in our dividend income during the half is almost exclusively explained by Silver Chef's suspension of its dividend, as it continues to work through the realisation of its problem assets and the deleveraging of its balance sheet.

At 31 December 2018, 6.6% of the Trust's net asset value was invested in foreign listed companies (1H18: 10.4% FY18: 15.2%). The fall in our foreign holdings was due to the fall in markets generally, through receiving new capital that was invested domestically, along with recycling capital into relatively more attractive domestic opportunities. I expect over time, our international holdings will increase again, as capital is made available and opportunities are identified. Also at the end of the half year, Trust had borrowings equal to 27.9% of its net asset value (1H18: 11.3% FY18: 24.3%). While we entered the period at the upper range of our intended limit of 25%, some selling activity early in the half year reduced this. Though, seizing on the prevailing opportunities during the period caused our borrowings to rise again to the upper range and combined with the volatility leading into the end of the period caused us to marginally exceed it. However, this ratio was brought back below the 25% threshold shortly into the second half. Our discipline in using leverage has served us well in the past and our modest, self-imposed limit provides the means to maintain a fully invested portfolio (should valuations justify it), whilst also the capacity to grab opportunities when available, without compromising our patience.

Expenses

	1H 2019	1H 2018
	$	$
Investing Expenses		
Brokerage	18,526	15,748
Interest expense	76,763	29,059
Other investing expenses	1,108	149
Total Investing Expenses	**96,397**	**44,956**
Management Expenses		
Management fee	96,384	73,678
Performance fee	6,608	369,147
Other fees	70	125
Total Management Expenses	**103,062**	**442,949**
Total Expenses	**199,460**	**487,905**

Investing expenses are costs that relate directly to securing and holding the assets of the Trust, of which drive the investment returns achieved. Specifically, the Other Investing Expenses comprise market access fees – which the pared back service from Interactive Brokers passes on. While it is a little frustrating to pay these fees, the upshot comes from the far lower brokerage rate that Interactive Brokers charges, which overall, sees the Trust well ahead when compared to using other providers.

The Management Fee is paid monthly and based on the net asset value of the Trust. The Management Fees paid for the half year equate to 0.50% (2018: 0.48%) of the average net asset value of the Trust over the period. While this is in line with the annual 1% limit, there is still work to be done, as our objective is to have this fee as far below the annual 1% ceiling as reasonably possible – though this will come with scale.

A Performance Fee has been provisioned on a parcel of new capital that came into the Trust at marginally lower prices than which we finished the half year at. Though obviously, with the fall in unit price over the period, no Performance Fee has been provisioned on Lead Class units (or any other class that has not met the performance metrics). The provisioned Performance Fee includes a rebate for the full amount of Management Fees paid by that class, during the relevant period. This Management Fee rebate further strengthens the alignment between the Manager and Unitholders and reinforces the Manager's focus on reducing, as much as possible, any fee that does not relate to the creation of Unitholder wealth.

Net Income

	1H 2019	1H 2018
	$	$
Total income	(5,176,418)	2,300,154
Total expenses	(199,460)	(487,905)
Net Income	**(5,375,878)**	**1,812,249**

The net income for the half year period drove a 24.54% decrease in the unit price to $2.8135

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Based on an understanding of the reasonable future operating results, together with our absolute return benchmark, I did not consider our holdings to be overvalued leading into the half year period. However as mentioned earlier in the note, this perspective is based on a whole lot of assumptions. Consequently, it is important that the vulnerabilities of those assumptions and by extension, the valuations, are intimately understood so the Trust is best prepared for volatile markets and our capital is protected. Just as a young, hot-blooded male may be supremely confident in his physical health and capabilities, he would be ignorant if he were to forget his ultimate fragility – that existence is a prerequisite for vulnerability is deeply ironic, though that's probably touching on something more profound, so we'll leave that for another note.

Unwaveringly, our focus is on building absolute wealth at an attractive average rate. There is nothing in our mission that suggests we should try to dampen volatility. Counterintuitively, a keen sense of our vulnerabilities underpins our resolve in weathering and exploiting that volatility. Indeed, for the investor with a steady gaze set long into the future and patient capital to match, volatility in the stock prices of durable companies is not synonymous with risk, but instead opportunity, and something that washes through over time. For this investor, risk would be better defined as operational volatility. Falling into that camp of investors, we naturally then concern ourselves more with the 'what' rather than the 'when' – ensuring that we are invested in businesses that exhibit the characteristics that will allow for the 'attractive average rate' we are looking for.

The opportunities which we took advantage of during the period were done so to try and enhance that average rate over the years to come. That is, if the market were to close for the next several years and we were not able to make any more trades, I would expect to return to a portfolio very much bigger than it is today – a size that would have delivered us an attractive average rate of return on our capital.

Luke Trickett

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