Financial Year in Review

Two powerful market themes combined to drive growth sensitive financial assets sharply higher over the first six months of FY2018. The first of these was the prospect of a sweeping package of US tax cuts, which ultimately became law in December 2017. These changes to the US tax code provided an unprecedented one-time boost to shareholders, adding roughly US$100Bn a year to US corporate earnings. The second driver for markets was a greatly improved outlook for the global economy. Global GDP growth reached 3.8% in 2017, its fastest pace since 2011 and - especially in the second half of the year - the global economy enjoyed a rare synchronised upswing, as all the major economies of the world began firing at the same time. For share markets this created something of a 'Goldilocks environment', with a surge of trade and investment happening against a backdrop of relatively low global interest rates. Most encouragingly, the biggest market surprises came from the two perennial trouble spots for the world economy, the European Union and Japan. Growth in both regions greatly surprised markets on the upside between July and December of 2017.

The impact of these two powerful macro drivers was stark. In the six months ending December 2017, global share markets rose by 11.2%[1,2] in US dollar terms. Returns were even higher for more growth sensitive asset classes. Emerging market share prices rallied by 15.9%[3], while the prices of key industrial commodities like iron ore and oil rose by 27.3% and 31.2% respectively. Given long-term *annual* returns for global share markets are just 5.1% in US dollar terms (or 4.2% in Australian dollar terms), the moves seen in the first half of FY2018 were extraordinary.

As the second half of FY2018 unfolded however, investors were reminded that share markets are not one-way bets. After rising for 15 consecutive months, global equities corrected dramatically during February, falling by 7.5% in US$ terms in the first week of February, before recovering some of these losses to end the month 4.2% lower. Since the correction in February, the tone in risk assets has been considerably subdued relative to recent years. The two themes driving this last leg of the nine-year old bull market, US tax cuts and the 'Goldilocks' economy, have now largely run their course. The one-time gains from the former have been booked, while the recent economic data that has been reported has taken much of the gloss off the latter. European economic data has disappointed expectations year-to-date, casting doubt on the sustainability of last year's growth rates, while in Japan the economy shrank by 0.6% in the first quarter of 2018. In contrast to the strong returns seen in the first half of the year, global equities fell by 0.4% in US$ terms in the final six months of FY2018, while emerging market shares fell by 6.7%.

In summary, FY2018 was another strong year for shares and higher risk asset classes. However, these impressive returns were largely generated in the first half of the financial year. Since February 2018, the mood in financial markets has changed noticeably as global growth has slowed and worries have begun to build about the risks of a prolonged trade war between the US and China.

Performance of the Portfolio

The GVF investment portfolio strives to be an all-weather investment proposition. Over the long run, we aim to generate equity market like returns, but with a portfolio that offers a much greater level of downside protection than a typical portfolio of global shares. The virtue of managing risk can easily be overlooked when markets are rallying strongly, but over time we believe it is a practice that will ultimately benefit investors greatly.

By necessity, a more conservative portfolio must forego some upside to protect against the downside. Throughout FY2018 the fund's see-through equity market exposure averaged just 25%[4], which represents the lowest level of equity market exposure the fund has run with since its launch in 2014. While we have never pretended to be able to call what broader markets will do next, after a nine-year uninterrupted equity bull market, our conviction that compelling risk-adjusted returns can be readily found in share markets today is low.

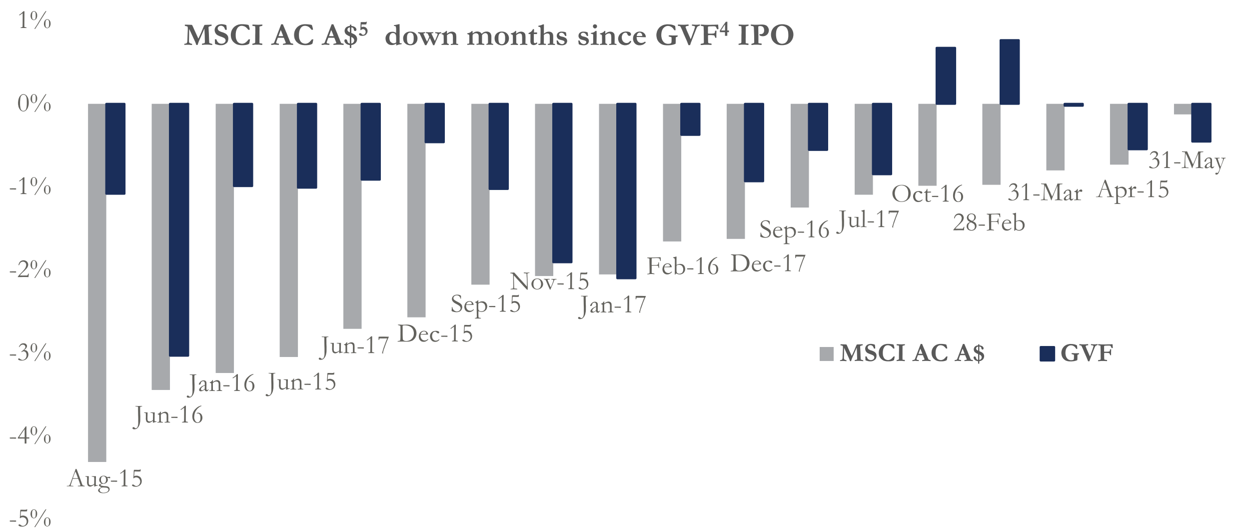
[1] All returns quoted are total returns, including net dividends. Source: Bloomberg LLP.
[2] Global share market returns refer to the MSCI All Country World Index.
[3] Unless otherwise referenced, all returns refer to US$ returns.
[4] Source: Staude Capital Limited.

Moreover, the success of our strategy turns on our ability to unlock value from a broad range of different asset classes. Throughout FY2018 we concentrated our efforts on unlocking value from lower risk asset classes, seeing no need to take on meaningful amounts of equity market exposure to deliver on our return targets. This approach showed its worth during February when equity markets corrected heavily. From peak to trough global share markets fell by 4.6% in Australian dollar terms from the end of January through to the 10th of February 2018. Over the same period the GVF investment portfolio was unchanged. GVF then ended the month of February 0.8% higher[4], while global share markets recorded a 1% fall in Australian dollar terms.

Despite running with a conservative portfolio throughout the year, the adjusted pre-tax NTA of the Company increased by 9.0%[5] over FY2018. The fund suffered just three down months during the year (global share markets recorded five), with the worst of these being a 1% monthly fall. Our positive FY2018 returns were chiefly the result of the successful application of our discount capture strategy. This added 5.0%[4] (gross) to performance and represents significant outperformance (or alpha) over the fund's underlying market and currency exposures.

Looking ahead, risk management will continue to remain a key focus for the team and I when it comes to investing the portfolio. While our investment performance will not always live up to the targets that we set for ourselves, to date the portfolio has demonstrated a resilience to periods of market stress that is in line with our aims.

The chart below shows the draw down history of the portfolio since IPO. The first column shows months where global equity markets[2] have fallen in Australian dollar terms, and beside this is the corresponding net investment return of the Global Value Fund portfolio in the same month.



Despite managing a significantly lower risk portfolio than one invested solely in international share markets, the fund has generated annualised adjusted NTA returns of 12.0%[4] since IPO.

Outlook

The bull market of the past few years has generated returns far greater than what long-run average share market returns have been. Hanging over this is one of the most powerful forces in finance, the notion of the return to the mean. It is a particularly brave investor who assumes that the double digit annual returns seen recently are sustainable in the long-run. Given this, we believe it is becoming increasingly important for investors to distinguish between the quality of returns, rather than just looking at absolute return numbers themselves.

[5] Global share market returns refer to the MSCI All Country World Index.

Following our successful capital raising earlier this year, the Company begins FY2019 with a larger portfolio full of attractive underlying value which the team and I are excited about unlocking. Importantly, our ability to unlock this value is independent of what broader markets might do, while the lower risk nature of our portfolio should offer an important level of protection against any significant market corrections ahead.

The team and I would like to thank all our shareholders for their support throughout FY2018 and especially for the many kind messages that we received over the year.

Miles Staude
Director and Portfolio Manager
30 August 2018

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