

Magellan Global Fund (Hedged)

ARSN: 164 285 661

Fund Facts

Portfolio Manager	Nikki Thomas, CFA and Arvid Streimann, CFA
Structure	Global Equity Fund, A\$ Hedged
Inception Date	1 July 2013
Management Fee ¹	1.35% per annum
Buy/Sell Spread ¹	0.07%/0.07%
Fund Size	AUD \$655.1 million
Distribution Frequency	Semi-annually
Performance Fee ¹	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (MSCI World Net Total Return Index (A\$ hedged)) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

¹All fees are inclusive of the net effect of GST

Fund Features

- An active, long only global equity fund
- Aims to substantially hedge the capital component of the foreign currency exposure of the Fund arising from investments in overseas markets back to Australian dollars
- Relatively concentrated portfolio of typically 20 to 40 high-quality securities
- Benchmark unaware
- Typical cash exposure between 0% - 20%
- \$10,000 minimum investment amount.

3 Year Rolling Returns (measured monthly)^{^*}

Against MSCI World NTR Index (A\$ Hedged)	1 Year	3 Years	5 Years	Since Inception
No of observations	12	36	60	76
Average excess return (% p.a.)	-5.4	-0.4	0.2	0.1
Outperformance consistency	0%	47%	63%	57%

Fund Performance[^]

	Fund (%)	Index (%) ⁺	Excess (%)
1 Month	-8.7	-8.8	0.1
3 Months	-5.9	-5.1	-0.8
1 Year	-20.6	-17.3	-3.3
3 Years (p.a.)	-1.8	4.0	-5.8
5 Years (p.a.)	3.6	5.4	-1.8
7 Years (p.a.)	6.2	8.2	-2.0
Since Inception (p.a.)	7.2	9.0	-1.8

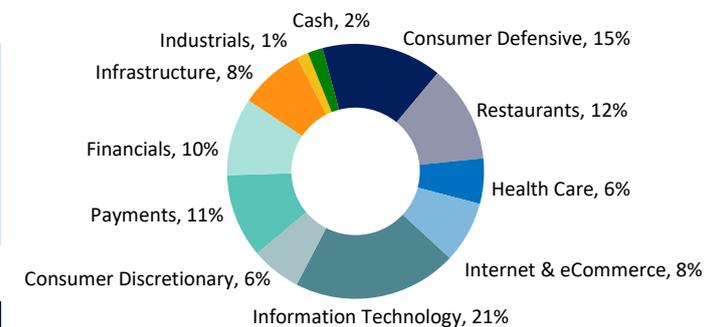
Capital Preservation Measures^{**}

Adverse Markets	3 years	5 years	Since Inception
No of observations	15	22	29
Outperformance consistency	47%	59%	69%
Down Market Capture	0.9	0.8	0.8

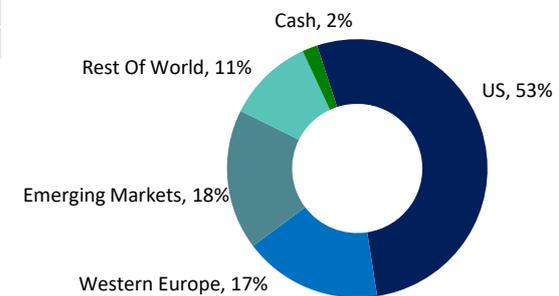
Top 10 Holdings

In alphabetical order	Sector [#]	%
Microsoft Corporation	Information Technology	7.4
Visa Inc	Payments	5.7
MasterCard Inc	Payments	5.0
Alphabet Inc	Internet & eCommerce	4.9
McDonald's Corporation	Restaurants	4.6
Yum! Brands Inc	Restaurants	4.4
Intercontinental Exchange Inc	Financials	4.4
Diageo Plc	Consumer Defensive	4.0
Reckitt Benckiser Group	Consumer Defensive	3.9
Nestlé SA	Consumer Defensive	3.7
TOTAL:		48.0

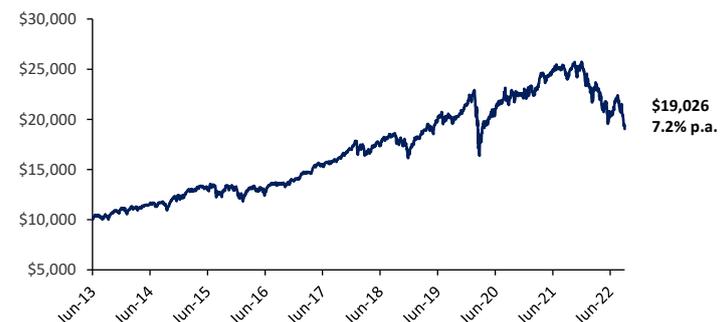
Sector Exposure by Source of Revenue[#]



Geographical Exposure by Source of Revenue[#]



Performance Chart growth of AUD \$10,000[^]


[^] Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Fund Inception 1 July 2013. Returns denoted in AUD.

^{*} 3-year returns are calculated and rolled monthly in AUD, with the outperformance consistency indicating the percentage of positive excess returns since inception.

⁺ MSCI World Net Total Return Index (A\$ Hedged). All MSCI data is the property of MSCI. No use or distribution without written consent. Data provided "as is" without any warranties. MSCI and its affiliates assume no liability for or in connection with the data. Please see complete disclaimer in www.magellangroup.com.au/funds/benchmark-information/
^{**} Risk measures are calculated after fees. An adverse market is defined as a negative three-month return rolled monthly for the MSCI World NTR Index (A\$ Hedged). Down market capture shows if a fund has outperformed a benchmark during periods of market weakness, and if so, by how much.

[#] Sectors are internally defined. Geographical exposure is calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio. Cash exposure includes profit/loss on currency hedging. Exposures may not sum to 100% due to rounding.

Asset markets have been difficult during 2022 and challenging for investors as many facets have evolved quickly. While worries about inflation, interest rates, geopolitics and recession risks may or may not persist in coming months, we consider this portfolio to be more attractive than other asset classes and more attractive than lower-quality, more speculative and commodity-exposed companies. During the quarter, these macroeconomic concerns gave us the opportunity to deploy more of our cash balance at what we believe are attractive prices. Indeed, as we enter the final 2022 quarter, we see a much larger proportion of Magellan's universe with positive medium-term expected returns than we have seen for years. We are delighted with the quality and diversity of the Magellan Global portfolio and the longer-term prospects for our companies. These are advantaged companies with excellent track records of outsized business returns, skilled management and disciplined capital management.

Market Commentary

September was a quarter marked by uncertainty and significant shifts in sentiment. After a 14% rally from lows in mid-June, global stocks fell for the third consecutive quarter to end September with the Morgan Stanley Capital International World Index down 6.2% in US dollars. We note in Australian dollars, the index eked out a 0.3% rise as the Australian currency fell. The key factor driving markets was that inflation data globally continued to run 'too hot' and thereby signalled to markets that central banks will continue aggressive interest-rate rises. The weaponisation of energy in Europe by Russia added to already rising energy prices in Europe, and US dollar strength continued. At the end of September, new UK Prime Minister Liz Truss announced new spending and tax cuts that lost the confidence of investors and saw a rapid repricing of gilts, which led to liquidity issues for some large UK funds. The Bank of England stepped in to stabilise the situation but the outlook for the UK remains troubling. During the quarter, nine of the 11 industry sectors fell in US-dollar terms. Communications (-12%) fell the most while consumer staples (+2.1%) managed to gain a little.

In the US, the S&P 500 Index fell 5.3% in the quarter as the inflation report for August fanned expectations the Fed would need to raise the cash rate more than expected and keep it higher for longer. While the report showed consumer prices were flat in August (for a 12-month rate of 8.3%), the core measure that strips out food and energy prices jumped a higher-than-expected 0.5% in the month (for a 12-month rate of 6.3%). The Fed has raised the cash rate by 0.75% in June, July and, for the fifth time since this hiking cycle began, in September to between 3% and 3.25%. Another important event for investors was the passing by US Congress of the CHIPS and Science Act and quickly thereafter the Inflation Reduction Act, which contained an estimated US\$375 billion in measures to accelerate the energy transition and so President Joe Biden hailed it as the "biggest step forward on climate ever". These policies have widespread implications for many companies and industries and will galvanise change in future investment decisions.

The Euro Stoxx 50 Index fell 3.3% in the quarter as the European Central Bank raised interest rates by 125 basis points, returning them to positive territory. It warned "sacrifice" was needed to tame inflation with eurozone inflation accelerating to a fresh record high, hitting 10% in September. The ECB also unveiled its "transmission protection mechanism" that is designed to stop excessive widening of the spread between sovereign yields in Europe. An energy crisis emerged as flows of gas from Russia to Europe slowed, then stopped, and Europe scrambled to work through the implications of spiking prices and a need for energy rationing as it heads into winter. Italy's government fell and sent the country to a snap election, and the UK also saw in a new prime minister. The Truss government's first new policy announcements for large but unfunded fiscal stimulus including tax cuts and subsidies to help offset huge energy bill increases saw big swings in Sterling and gilts. These moves ultimately led to market intervention by the Bank of England.

Fund Commentary

The portfolio recorded a negative return for the quarter.

The biggest positive contributions came from the investments in Chipotle Mexican Grill, Diageo and Lowe's, three relatively defensive consumer companies that recorded strong operating performances in their most recent results and are seeing upgrades to earnings expectations.

Given widespread falls across the market, the biggest detractors in local-currency terms were the strategy's largest holdings of Microsoft, Alphabet and Visa. There was no material news of note for these companies but the strength of the US dollar is expected to weigh on reported earnings given their multinational businesses and the pressure of rising rates on economic growth will likely be felt by most companies. A new push for increased regulation of credit cards in the US was made and this may have added to caution on Visa.

Stock contributors/detractors are based in local currency terms.

Outlook

2022 is shaping up to be one of those extreme years for investors across almost all, if not all, asset classes. The unprecedented actions by governments and central banks to lock down economies but support us through the pandemic has caused severe dislocations in supply and demand across many sectors. Layer in a Ukraine invasion by Russia, resulting sanctions, and severely reduced energy supplies out of Russia as well as several other extreme events and it is clear why prices of most assets are under pressure. The three-decade-long fall in interest rates has ended and our world must adjust.

Risks are everywhere and the difficulties we are facing rule the narrative. The climate crisis, fragmenting societies, and geopolitical escalations are simply adding to the concerns as Central Banks try to bring inflation back down to acceptable levels. While it is unclear exactly the timeline for bringing inflation down, we can be reasonably confident it will happen given the vigilance of Central Banks to this task. The possibility of recession is the trade-off and this seems highly likely, especially in Europe and China.

But all these things are known (the known unknowns) and investors are adept at pricing for such future risks. So, in our view, we must have courage and dig within our universe to find and invest in companies that have resilient, dependable and indeed even exciting outlooks that are now for sale at depressed prices.

We have taken the opportunity to put more cash to work in equities, which we anticipate can deliver our clients strong double-digit returns over coming years, even if broader indices fall further in the short term. We thank you for the trust you place in us.

Index movements are in local currency. US GDP statistics come from the US Department of Commerce, while US employment and inflation statistics are published by the US Department of Labor. EU economic statistics come from Eurostat. UK statistics are released by the Office for National Statistics. Japanese economic statistics come from the Ministry of Economy, Trade and Industry, the Ministry of Finance and the Ministry of Foreign Affairs (GDP). Australian economic statistics are released by the Australia Bureau of Statistics. China's economic statistics are compiled by the National Bureau of Statistics of China.

Stock Story: ASML

ASML

Lithography is the process by which powerful, fast and cheap microchips are made. Advances in how lithography systems imprint electronic circuitry patterns on silicon wafers govern enhancements in microchips and memory.

In more detail, a lithography system is essentially a manufacturing machine whereby light is projected through a blueprint of the pattern to be printed. The system's optics shrink and focus the pattern onto a photosensitive silicon wafer (whereby a wafer is covered with chemicals that react with light). A series of other non-lithography steps are also carried out. To make a microchip, the process is repeated layer upon layer to create the components of the chip including the transistors, which are miniaturised semiconductor devices. The most advanced chips have up to 150 layers. So advanced is lithography, the latest chips are printed at a scale of nanometres, where a nanometre is one billionth of a metre. The A16 processor in the iPhone 14 will contain about 16 billion transistors.

Lithography is so key to making the best microchips, the US stops the company that makes the most advanced of these manufacturing systems from selling its product to China.

That company is ASML. The Netherlands-based group sold 309 lithography systems on the way to earning revenue of 18.6 billion euros in fiscal 2021. The most advanced ASML lithography system today costs about 160 million euros.

ASML, which formed as a venture between Philips and ASMI of the Netherlands in 1984 and listed in 1995, extended its industry leadership in lithography with its development of 'extreme ultraviolet' lithography, which is an advance on its 'deep ultraviolet' lithography system. This system is regarded as the best system for reliably printing transistors on wafers at high volume using a light wavelength of just 13.5 nanometres.

ASML's customers are microchip manufacturers such as TSMC of Taiwan, Intel, Micron, Samsung and SK Hynix of Korea. All semiconductor producers rely on ASML's equipment to produce the most advanced chips. From an investor's point of view, ASML's technology leadership is its core competitive advantage that has given it an 83% stranglehold on one of the world's most crucial industrial systems. Nikon of Japan is ASML's nearest, even a distant, competitor.

Couldn't Nikon or another company invent a lithography system that betters that of ASML? Such questions have always existed but competitors have only fallen further behind over time. ASML's advantage is not in any singular aspect of the lithography system but across the many complex technologies, including the light source, optics, wafer stage, software, and process control, that need to come together in perfect unison. All of this would take incredible effort to replicate.

ASML has also set up a sophisticated production network underwritten by exclusive agreements whereby it outsources the making of components to about 4,000 companies around the globe. Many of the parts are complex. The mirrors in ASML's lithography machines, for instance, are the smoothest structures produced on earth. In fact, they are so flat, if someone expanded a mirror to the size of Victoria, the highest mountain would be 1 millimetre tall.

No rival, even if possessing a better design for a lithography system, could quickly or easily build a similar global manufacturing network. The biggest semiconductor manufacturers in the world have a vested interest in ASML's commercial success.

At the very least, it seems ASML is poised to hold onto its market dominance for the foreseeable future; in recent years, the company has widened its lead over competitors as it achieved double-digit sales growth. The stock is found in the Magellan global portfolio because ASML has the potential to generate excess returns on capital for the foreseeable future.

Even the best-placed companies, however, face challenges. Among threats to ASML, the shrinking of transistors could reach its physical limits in terms of tininess and finesse. If so, it would buy time for rivals to one day catch up to ASML's lithography standards. But somehow microchip-related technology keeps advancing. Another threat is the Chinese government. Beijing understands the strategic worth of microchips and is investing billions of dollars to catch up with the West and is willing to ignore patents to do so. ASML warned in February that an affiliate of a Chinese company it had accused of stealing its trade secrets is marketing products that could infringe on its intellectual property rights. Hence Washington is keen to keep ASML's lithography systems out of China.

ASML, however, has a record of delivering ever-improving lithography machines on time to its customers. If the company keeps doing that, investors will be looked after too.

Sources: ASML Annual Report 2021, company filings, Bloomberg and Dunn & Bradstreet.

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