

# Magellan High Conviction Fund

ARSN: 164 285 947



MAGELLAN HIGH CONVICTION FUND CLASS A | APIR: MGE0005AU

MAGELLAN HIGH CONVICTION FUND CLASS B | APIR: MGE9885AU

AS AT 30 SEPTEMBER 2023

## PORTFOLIO MANAGERS

NIKKI THOMAS, CFA AND ALAN PULLEN

### INVESTMENT OBJECTIVE AND PHILOSOPHY

**Objectives:** To achieve attractive risk-adjusted returns over the medium to long-term.

**Philosophy:** To invest in outstanding companies at attractive prices, while exercising a deep understanding of the macroeconomic environment to manage investment risk.

### PORTFOLIO CONSTRUCTION

A concentrated portfolio of 10-20 high quality companies meaningfully diversified in risk exposure and correlations seeking to achieve strong risk-adjusted, not benchmark-relative returns.

Cash and cash equivalents exposure between 0 - 50%.

The Fund may, from time to time, hedge some or all of the capital component of the foreign currency exposure of the fund arising from investments in overseas markets back to Australian Dollars.

### INVESTMENT RISKS

All investments carry risk. While it is not possible to identify every risk relevant to an investment in a fund, we have provided details of risks in the relevant Product Disclosure Statement or offer document. You can view the PDS for the relevant fund on Magellan's website [www.magellangroup.com.au](http://www.magellangroup.com.au)

## MAGELLAN HIGH CONVICTION FUND: KEY PORTFOLIO INFORMATION

CLASS	FUND SIZE	BUY/SELL SPREAD	MANAGEMENT AND PERFORMANCE FEES <sup>1</sup>	INCEPTION DATE
A	AUD \$167.8 million	0.07% / 0.07%	1.51% p.a. and performance fee of 10% of excess return <sup>^</sup>	1 July 2013
B	AUD \$38.0 million	0.07% / 0.07%	0.78% p.a. and performance fee of 20% of excess return <sup>^^</sup>	15 November 2017

<sup>^</sup> 10.0% of the excess return of Class A Units of the Fund above the Absolute Return Performance Hurdle of 10% per annum. Additionally, Performance Fees are subject to a high water mark.

<sup>^^</sup> 20.0% of the excess return of Class B units of the Fund above the Absolute Return Performance hurdle of 10% per annum. Additionally, Performance Fees are subject to a high water mark. The performance fee for Class B Units is subject to a cap of 2.22% per annum.

### PERFORMANCE<sup>2</sup>

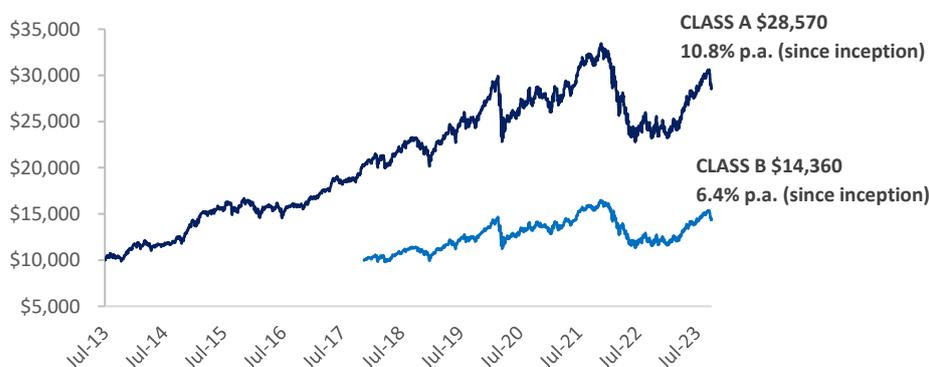
	1 MONTH (%)	3 MONTHS (%)	1 YEAR (%)	3 YEARS (% p.a.)	5 YEARS (% p.a.)	7 YEARS (% p.a.)	10 YEARS (% p.a.)	Since Inception (% p.a.)	OUTPERFORMANCE CONSISTENCY*
Magellan High Conviction Fund - Class A	-5.6	-1.1	22.7	1.2	4.3	8.8	10.8	10.8	73%
Magellan High Conviction Fund - Class B	-5.6	-0.9	23.7	1.9	4.7	-	-	6.4	34%

	CYTD (%)	2022 (%)	2021 (%)	2020 (%)	2019 (%)	2018 (%)	2017* (%)	2016 (%)	2015 (%)	2014 (%)	2013 (part year)
Magellan High Conviction Fund - Class A	22.4	-27.8	20.8	-2.4	29.6	3.4	23.3	3.5	13.6	19.8	17.7
Magellan High Conviction Fund - Class B	23.2	-27.3	21.1	-1.9	29.2	3.3	1.0	-	-	-	-

Past performance is not a reliable indicator of future performance. \*Class B part year return, inception date 15-Nov-2017

### PERFORMANCE CHART GROWTH OF AUD \$10,000<sup>2</sup>



Past performance is not a reliable indicator of future performance.

### FUND CHARACTERISTICS<sup>3</sup>

	3-YEAR	AVERAGE	HIGH	LOW
Cash Weight		5.8%	18.4%	1.0%
Number of Stocks		12	15	10
Hedging Weight		0.7%	16.5%	0.0%

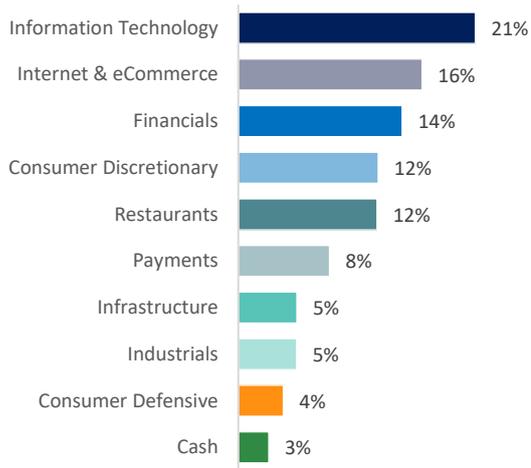
<sup>1</sup> Transaction costs may also apply – refer to the Product Disclosure Statement. All fees are inclusive of the net effect of GST.

<sup>2</sup> 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). Returns denoted in AUD.

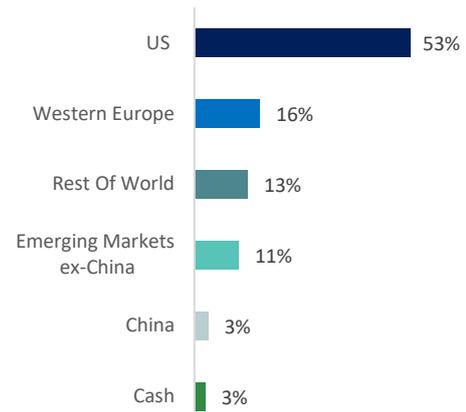
<sup>3</sup> 3 year average cash weight and hedging ratio are calculated using month end values over the period.

\* Outperformance consistency indicates the percentage of positive excess returns for rolling 3 year returns since inception.

## SECTOR EXPOSURE BY SOURCE OF REVENUE<sup>4</sup>



## GEOGRAPHICAL EXPOSURE BY SOURCE OF REVENUE<sup>4</sup>



## TOP CONTRIBUTORS/DETRACTORS 1 YEAR<sup>5</sup>

TOP 3 CONTRIBUTORS	CONTRIBUTION TO RETURN (%)
Booking Holdings Inc	5.1
Microsoft Corporation	3.7
Safran SA	3.1
TOP 3 DETRACTORS	CONTRIBUTION TO RETURN (%)
Meta Platforms Inc	-0.8
Alibaba	-0.6
ASML Holding NV	-0.6

## TOP 5 HOLDINGS (ALPHABETICAL ORDER)

STOCK	SECTOR <sup>4</sup>
Amazon.com Inc	Internet & eCommerce
Intercontinental Exchange Inc	Financials
Microsoft Corporation	Information Technology
Visa Inc	Payments
Yum! Brands Inc	Restaurants

<sup>4</sup> 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. Exposures may not sum to 100% due to rounding.

<sup>5</sup> Shows how much the stock has contributed to the fund's gross return for the period in AUD. Excludes non-disclosed positions established in the latest quarter.

## Market Commentary

The September quarter saw listed shares fall with the MSCI World Index declining 3.5% in USD and 0.4% in AUD as oil prices rose, the US dollar rose and 10-year government bond yields, used by investors as a “risk free” benchmark, rose materially. Gains were led by the Energy sector (+12.5%), as oil rose almost 30% to a peak just before month end, with Communication Services (+2.0%) and Financials (+0.4%) the other gainers. Sectors typically more sensitive to higher real rates – Utilities (-8.2%), Real Estate (-6.5%) and Information Technology (-5.8%) – led declines. In local currencies, the S&P 500 and Nasdaq Composite indices fell 3.6% and 4.1% respectively, Europe’s STOXX 600 declined 2.5% and China’s CSI 300 fell 4.0%. Japan’s Nikkei 225 bucked the trend to rise 5.6% as the Yen fell.

This was a quarter of a meaningful and unusual shift in long-term bonds, bringing commentary comparing it to 2007. The 10-year US Treasury bond yield rose 80bp around 4.6%, a level last seen in 2007. This large move seemed to have reflected a variety of factors and it is hard to distil what of them are transient: some are due to ongoing economic resilience despite the large monetary tightening of the past year; others are likely due to large Treasury issuance, ongoing quantitative tightening and falling holdings by foreign investors. That is, some of it is supply/demand imbalance; some other is a realisation that the neutral rate may be higher than during the last 10+ years. The latter may also be behind similar moves in Europe’s German Bunds and Japan’s government bonds, while in markets like Australia and the UK, economic resilience is less clear.

On the inflation front, data supported the trend for falling prices in most areas, with oil the obvious exception. In the US, annual core consumer price inflation, adjusted to exclude volatile food and energy prices, was 4.3% in August, the lowest annual rate in almost two years. In the 12 months to September, German core inflation was 4.6%, down from the annual rate of 5.5% recorded a month earlier.

China dropped its zero-covid policies late in 2022 but the economic rebound has been far less than seen in most developed economies. Policy to stimulate the economy has been incremental and relatively small in scale while weak consumer and business confidence has seen a propensity to caution on spending. Political events – the disappearance and subsequent removal of the Foreign Minister and Defence Minister and the purging of Xi loyalists soon after the National People’s Congress where they had been promoted by Xi – added to the uncertainty.

## Fund Commentary

After a strong start to the quarter, weakness in September saw the Fund finish slightly down.

Top contributors to the portfolio in the September quarter were Booking Holdings, Alphabet and Safran. Booking reported a strong second-quarter result where it demonstrated continued progress on direct bookings, performance marketing efficiencies and North American market share. Growth and sentiment were also bolstered by resilient travel demand in Europe. Alphabet reported solid second-quarter results demonstrating stable trends in advertising and continued cost control. Concerns of Search disruption from AI /ChatGPT continued to ease as Alphabet demonstrated its product innovation. Safran reported better-than-expected second-quarter results and raised its full-year 2023 guidance on the back of a faster-than-expected traffic recovery. It also initiated a share buyback.

Yum! Brands, Microsoft and Chipotle Mexican Grill were the largest detractors from the portfolio this quarter. The Yum! Brands share price has been affected by broader weakness in consumer defensive stocks and concerns about a stalled economic recovery in China. This is despite a strong 2Q23 result that included accelerating store roll-out activity and strong momentum in other international markets. Chipotle’s share price fell this quarter after the company gave near-term guidance that disappointed elevated market expectations, reflecting moderating inflation-driven price increases and some temporary impacts from higher avocado and beef costs on restaurant margins. Microsoft delivered good final-quarter (to 30 June) results but the widespread optimism around Azure’s growth inflecting higher (and perhaps some excessive) exuberance around the near-term benefits it will reap from generative AI was not met by the guidance as we lap the optimisation cycle.

*Index movements and stock contributors/detractors are based in local currency terms unless stated otherwise.*

## Outlook

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While we have long held that interest rates could prove stickier at around 4% and inflation would come down rather slowly, we certainly did not anticipate a material further move higher for the long end of the curve. Inflation has been gradually moving lower and the large yield curve inversion, alongside other leading indicators, has suggested economic growth would continue to slow. While this has been true, economic growth has been resilient. Thus, the risk that inflation could break higher has not been removed, driving the Federal Reserve to revise upwards its projections of growth and rates, and lower for unemployment. The Federal Reserve see GDP growth as higher in 2023 (2.1% vs 1% seen in June) and 2024 (1.5% vs 1.1%) and while it held the fed funds rate (FFR) projection at 5.6% this year, the same as in the June projection, it revised the FFR up 50bp to 5.1% in 2024, compared to 4.6% seen in June. The unemployment rate is projected lower at 3.8% (vs 4.1%) in 2023 and 4.1% (vs 4.5%) in 2024.

We sense the 80bp move up in US 10-year government bonds this quarter has come with a degree of sticker shock for most market participants. Higher long-term interest rates usually create their own headwind. US mortgage rates have jumped to over 7% and home purchases have again stalled due not to a lack of demand but instead due to the cost of borrowing. House prices have been resilient with turnover low and supply insufficient to be a drag. This is not 2007 for houses! Many banks have large undigested, unrealised losses on their loan books they are now forced to hold to maturity. This slows the cycling of capital back into the economy (which typically slows growth) but this time it is fuelling a unique opportunity for private credit and other non-bank players to provide credit for the new projects being undertaken as the trends of decarbonisation, digitisation and deglobalisation gain momentum. US non-residential construction spend is strong and has one of the highest growth multipliers (estimated at 3x) of any industry.

The environment thus strikes us as one where the US growth slowdown seen so far begins to reaccelerate, perhaps in early 2024. The timing of such a reacceleration will determine if central banks feel compelled to add yet another rate rise into the mix. If this improved economic growth can happen, then there would be no need for rate cuts. Indeed, even as inflation trends to more acceptable levels, we expect the central banks will not want to risk restoking this by cutting rates. With the market pricing 60bp of rate cuts in 2024, the ongoing risk is these are not necessary and interest rates, across the entire yield curve, stay at higher (many of us with longer historical perspective may say 'more normal') levels.

Returning to the credit market issue of large unrealised losses, this is the financial risk vector we continue to watch. If any bank breaks rank, a repeat of March 2023 – liquidity runs and financial stress – is likely. It is difficult to see such a risk before it emerges, so we are avoiding banks and holding more cash given our capital protection goal. It is unclear if a prolonged period of higher bond yields will cause instabilities due to the large unrealised losses in the financial system. We would put this as a low-probability but high-impact event

for stock markets. The resulting rapid tightening of financial conditions would make a case for slower growth, less inflationary risk and thus (the silver lining) lower rates as central banks adjust and cut rates.

We are more cautious about the growth outlook for Europe where recessionary conditions have already emerged, though if China were to provide sufficient support to improve the growth trajectory for its economy, Europe should benefit. These factors will be important for foreign exchange rates and whether the US dollar can sustain recent strength.

Stepping to the portfolio positioning, we are clearly broadly positive on growth assets and are happy to be investing in global equities. We believe that there are boundless opportunities in front of us for our superbly managed companies with strong competitive advantages to deliver exceptional earnings and cash flow growth in coming years. In the very near term, it is possible markets may still need to adjust to a sustainably higher rate environment. The portfolio is thus tilted towards those companies we believe can keep delivering better-than-expected results through time and are yielding high cash flows from their operations even today. Unless underlying investment cases change materially for the worse, we intend to lean into short-term price weakness given these companies remain our highest conviction ideas.

We anticipate that some volatility in markets may accompany us over the next few months as share prices continue to adapt to the evolving interest rate environment and reshaping of economic growth. Risk is not volatility. We work diligently to assess the real risks that face our portfolio companies and will continue to hold the line on our absolute return objective.

## Stock Story: Brookfield

(James MacDonald – Investment Analyst)

# Brookfield

Chances are you have come across Brookfield before. Perhaps your home is powered by a Brookfield wind and solar farm. Your phone might be connected to a Brookfield telecommunications tower or your computer to a Brookfield data centre. Your shoes may have been imported via a Brookfield port, in a shipping container leased from a Brookfield company. Your car could be one in three globally using a Brookfield-backed Clarios battery, or maybe it was purchased from a car dealership running on Brookfield-owned CDK software. Perhaps you have worked in a signature Brookfield Place office precinct in one of the major global financial centres. Brookfield might also manage some of your retirement savings on behalf of your superannuation fund.

Everywhere you look, Brookfield has a presence. The Canadian financial giant owns and operates almost US\$900 billion of mostly infrastructure and real estate assets globally on behalf of its clients and shareholders. With backing from some of the world's largest pension and sovereign wealth funds, Brookfield has its eyes on opportunities to invest its ~US\$80 billion cash pile in a digitalising, deglobalising and decarbonising world.

Tracing its origins to the 1899 formation of the São Paulo Tramway, Light and Power Company, a Brazilian electricity utility, Brookfield, in its various forms, has always sought to own, develop and operate critical infrastructure projects and real estate assets. After decades of investing its own capital, Brookfield opened its doors to external investors in the early 2000s, repurposing as Brookfield Asset Management, now one of the largest global alternative asset managers with real estate, infrastructure, private equity and private credit asset capabilities, the latter in partnership with Howard Mark's Oaktree.

Brookfield forecasts it will bring in US\$150 billion on behalf of its clients in 2023, which it will invest across three themes underpinning its strategies. The first is the increasing digitalisation of the global economy. Brookfield has invested in

data centres to power the shift to “the cloud”, telecommunications towers to power the growth of 5G, and fibre-optic cables to speed up internet connections. The second theme, deglobalisation, has seen Brookfield invest in projects and businesses exposed to the reshoring of manufacturing, with recent investments including a US\$15 billion contribution to fund a new Intel® semiconductor fabrication plant in Arizona and US\$13 billion for Triton International, the world's largest lessor of freight containers. Last, in decarbonisation, Brookfield is putting money to work to reduce emissions, bidding for Australia's Origin Energy with a commitment to spend a further US\$20 billion on new renewable energy projects in Australia.

Brookfield generates profits in several ways. Most significant are the fees earned by managing client assets at Brookfield Asset Management, which grows as more investors commit money to its investment vehicles. Historically, Brookfield invested on behalf of large pension and sovereign wealth funds in North America but now has its eyes on larger pools of capital in Asia and the Middle East, the insurance sector and among retail investors, all of which typically have low exposure to alternative investments. The second way Brookfield makes money is by owning ~US\$53 billion of infrastructure, renewable and real estate assets, which typically generate steady cash flows. Last, in recent years, it has built a North American insurance business focused on annuity-life products, known as Brookfield Reinsurance. These three earnings streams, housed with Brookfield Corporation (BN:NYSE, BN:TSX), generate consistent cash flow, which is then redeployed back into opportunities to continue the compounding. Key to it all is a long track record of exceptional investment performance for clients and shareholders.

Now, over a century since Brookfield began and the future remains bright. The expertise it has built from owning and operating hundreds of businesses is in high demand as the world tackles problems from climate change to inflation and rising interest rates. With a network of businesses, global banking relationships and deep pools of flexible capital, Brookfield has positioned itself as a partner of choice for those in need of capital – and there are plenty.

*Source: Brookfield, Sentio, Magellan*

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