MAGELLAN
EXPERTS IN GLOBAL INVESTING

Fund Update: 31 March 2021

Magellan Global Fund (Hedged)

ARSN: 164 285 661

Fund Facts

Portfolio Manager	Lead Portfolio Manager: Hamish Douglass Co-Portfolio Manager: Arvid Streimann
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 $1,624.3 million
Distribution Frequency	Semi-annually
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (MSCI World Net Total Return Index (A$ 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.

[1]All fees are inclusive of the net effect of GST

3 Year rolling returns* (measured monthly)

Against the Index**	Last 12 Months	Last 36 Months	Since Inception (58 Months)
Average excess return (% p.a.)	2.8	2.2	1.3
Outperformance consistency	83%	86%	72%

Fund Performance* (as at 31 March 2021)

	Fund (%)	Index (%)**	Excess (%)
1 Month	3.8	4.2	-0.4
3 Months	2.8	6.1	-3.3
1 Year	27.4	48.4	-21.0
3 Years (p.a.)	11.7	12.0	-0.3
5 Years (p.a.)	12.0	13.1	-1.1
Since Inception (p.a.)	11.5	12.4	-0.9

Capital Preservation Measures^

Adverse Markets	Last 36 Months	Last 60 Months	Since Inception
No of observations	11	12	19
Outperformance consistency	91%	92%	95%
Down Market Capture	0.6	0.6	0.6

Performance Chart growth of AUD $10,000*

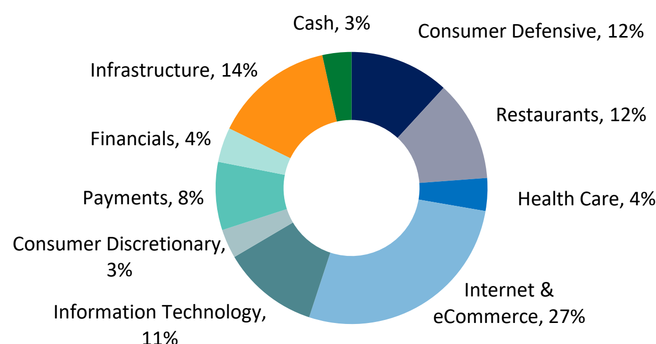
Fund Features

- 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.

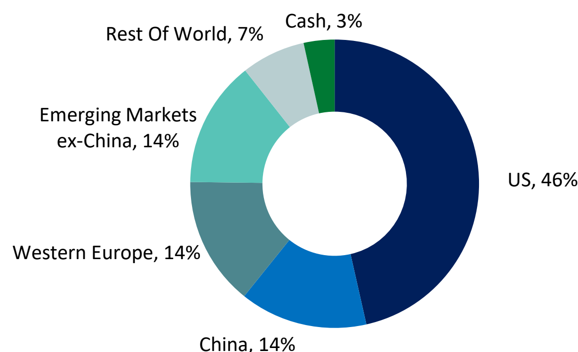
Top 10 Holdings

	Sector#	%
Microsoft Corporation	Information Technology	7.4
Alphabet Inc	Internet & eCommerce	6.9
Facebook Inc - Class A Shares	Internet & eCommerce	5.9
Starbucks Corporation	Restaurants	5.6
Alibaba Group Holding Ltd	Internet & eCommerce	5.1
Tencent Holdings Ltd	Internet & eCommerce	5.1
Visa Inc	Payments	4.5
Netflix Inc	Internet & eCommerce	4.4
Reckitt Benckiser Group	Consumer Defensive	4.3
Pepsico Inc	Consumer Defensive	4.2
	TOTAL:	53.4

Sector Exposure by Source of Revenue#



Geographical Exposure by Source of Revenue#



^ Capital preservation measures are calculated after fees. An adverse market is defined as a negative 3 month return for the MSCI World Net Total Return Index (A$ Hedged), rolled monthly. 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.
* 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. ** The index is the MSCI World Net Total Return Index (A$ hedged).

Market Commentary

Global stocks reached record highs as they rose for the eighth quarter in nine for the three months to March after the vaccine rollout intensified, US President Joe Biden capitalised on the Democrat's surprise control of Congress to launch massive fiscal stimulus, the Federal Reserve reiterated it would keep interest rates low, encouraging reports emerged on the US economy, and investors welcomed Italy's new prime minister. Gains were capped as US bond yields rose on concerns that the fiscal stimulus could revive US inflation and a third wave of covid-19 infections swept through Europe. During the quarter, 10 of the 11 sectors rose in US dollars. Energy (+22%) climbed most while consumer staples fell (-0.6%). The Morgan Stanley Capital International World Index climbed 4.9% in US dollars and 6.3% in Australian currency over the quarter.

US stocks gained as the White House count showed 37% of Americans had received one vaccine dose by quarter end and Democrat control of Capitol Hill allowed Biden to force a US$1.9 trillion bill through Congress that, at 9% of GDP, will boost the budget shortfall for fiscal 2021 to 18% of output. The Democratic party gained control of the Senate after winning the two seats in Georgia that went to a special election (by-election) on January 6. The result tied the Senate 50-50 but new Vice President Kamala Harris's tie-breaking vote gives the party control of the upper chamber to go with its control of the House of Representatives and the White House. In other political news, outgoing president Donald Trump was impeached and acquitted for a record second time. The House in January impeached Trump for helping to incite a mob that breached congress during a protest on January 6 against the election result. The Senate in February acting as an impeachment court acquitted Trump when it failed to gain the required two-thirds majority, though seven Republicans were among the 57 who voted for a guilty verdict while 43 senators voted not guilty. The Fed soothed concerns about bond yields rising on inflation concerns. Fed Chair Jay Powell testified to Congress that the US's recovery is "far from complete" and that the central bank intends to keep interest rates at levels that support employment growth while concerns about inflation remain low. In economic news, the US economy grew at a (revised) annualised speed of 4.3% in the last three months of 2020. The March quarter was marked by individual investors on Reddit and Robinhood bidding up selected stocks that heightened concerns of a stock bubble and the liquidation of Archegos Capital Management's leveraged bets that hurt selected stocks and its banking counterparties. The S&P 500 Index rose 5.8%.

European stocks rallied after the vaccine rollout gained enough pace, the European Central Bank loosened monetary policy even more and Mario Draghi won parliamentary backing to become Italy's next prime minister. Draghi, the former president of the European Central Bank, accepted a mandate from the Italian President Sergio Mattarella to lead the eurozone's third-largest economy after Italy's 66th post-war government collapsed. The European Central Bank officials spoke to calm investors about the risk from rising bond yields as it stepped up the pace of bond-buying to arrest the rise in borrowing costs. This offset the damage from a third wave of infections that forced fresh restrictions across Europe. An economic report showed the eurozone GDP fell a revised 0.7% for the fourth quarter. The Euro Stoxx 50 Index jumped 10.3%.

In other markets, Japan's Nikkei 225 Index rallied 6.3% after the Diet approved a record budget worth 106.6 trillion yen (US$976 billion) for the fiscal year starting on April 1 and a report showed the economy expanded a revised 2.8% in the fourth quarter. China's CSI 300 Index slid 3.1% as Chinese interest rates rose and the government set a modest growth rate of above 6% for 2021. The S&P/ASX 200 Accumulation Index added 4.3% as company earnings for the period ending December 31 exceeded expectations, the jobless rate fell below 6% and a report showed the economy expanded a higher-than-expected 3.1% in the December quarter. The MSCI Emerging Markets Index edged up 1.9% in US dollars on the better outlook for the world economy.

Fund Commentary

The portfolio recorded a positive return for the quarter in absolute terms. The biggest contributors were the investments in Alphabet, Tencent Holdings and Microsoft. Alphabet rallied 18% after its 23% surge in revenue for the fourth quarter that was driven by Search and YouTube advertising beat expectations. Tencent gained 8.2% after it was among the Chinese stocks that the Trump administration spared from its 'blacklist' of Chinese stocks. Microsoft added 6.2% after fourth-quarter sales advanced a higher-than-expected 17% on pandemic-driven demand for video games and cloud resources.

The biggest detractors were the investments in Netflix, PepsiCo and SAP. Netflix lost 3.5% as risk-taking investors rotated from streaming to legacy media companies. PepsiCo fell 3.8% as further restrictions on out-of-home activity were implemented, especially in Europe. SAP declined 2.6% as investors baulked at its shift to a cloud-based subscription model (rather than relying on selling licences).

In relative terms, the strategy underperformed over the quarter. While the portfolio performed strongly during the pandemic up to the end of October, it has lagged the benchmark since November for three main reasons.

The first was, to conform with portfolio risk controls (a combined risk-ratio cap of 0.8%), about half of the portfolio was invested in cash and defensive equities such as utilities, consumer staples and defensive healthcare. This portion of the portfolio has delivered lagging returns compared with the benchmark (but not noticeably against defensive stocks overall), highlighting the unusually strong preference among investors for riskier investments. The flipside is that these stocks are at their cheapest in many years, giving us comfort about future portfolio returns.

The second reason for the underperformance was the stock-specific issues faced by companies such as Alibaba. Despite their volatile stock prices, we remain comfortable with holding our investments and we see a high likelihood of them delivering attractive returns over our horizon of three to five years. The third reason was our underweight exposure to cyclical equities. We are more attracted to defensive equity valuations compared with those of cyclicals.

Stock contributors/detractors are based in local currency terms unless stated otherwise.

Stock story: Netflix

NETFLIX

Competition under the capitalist system in theory works something like this. An entrepreneur has a bright idea. That leads to a business making, or promising to make, excess profits on the capital invested. Others see the riches to be made. They set up rival companies. The extra competition reduces the prices consumers pay. Profits decline, even for the pioneering business. The loss-makers fold while the industry survivors eke out their cost of capital.

Let's see how the theory applies to the on-demand-video or streaming industry. The pioneer for watching TV shows and movies over the internet in a personalised way is Netflix. In 1997, Reed Hastings and Marc Randolf founded the company in the US as a movie-rental service, where people ordered DVDs via the Netflix website that were then posted out. The company listed in 2002 and successfully saw off a challenge from Blockbuster. Recognising that streaming was the future of video distribution, in early 2007 Netflix introduced its Watch Now product as part of its DVD subscription that allowed people to choose from about 1,000 movies they could watch instantly on their PCs.

What a great idea. By 2012, Netflix had expanded its catalogue of streamed content significantly and amassed sufficient viewership to begin its inevitable transition towards original content. Netflix's first original series, *House of Cards,* was a huge hit. By 2016, Netflix's streaming service was available globally (ex-China) as Hastings moved rapidly to take advantage of a "competitive window that will be open only temporarily". One year later, Netflix cracked 100 million subscribers of whom more than 50% came from outside the US, won its first Oscar (for a documentary) and released its first feature film.

There was always competition in a broader sense for the streaming services of Netflix (which still operates the legacy DVD and Blu-ray disc hiring business). The company was always competing with linear free-to-air and cable TV for people's viewing time and early on Amazon, Walmart-owned Vudu, and Hulu, owned by a consortium of media companies, offered rival streaming products. More recently, however, the Hollywood studios arrived. Long concerned with cannibalising existing revenue streams, they responded belatedly by launching streaming services.

WarnerMedia, NBCUniversal, ViacomCBS and Disney arrived with immense backlogs of content, the money to create more, and huge marketing budgets to try to convince households to add their service to the emerging streaming bundle. A critical early move of Hollywood was to reclaim their most popular content such as the *Friends* series. In just over a year, Disney's iconic content has seen it attract more than 90 million Disney+ subscribers worldwide, complementing its nearly 40 million Hulu subscribers in the US over which it has control following its 2019 acquisition of 21st Century Fox. WarnerMedia's HBOMax has over 40 million subscribers. Although Netflix's 204 million subscribers worldwide as at the end of 2020 still provides it with 'scale' advantage, the competitive set in streaming is broadening.

With this increase in competition, is Netflix destined to be a business grafting out its cost of capital? We don't think so. The streaming industry comes with characteristics that when combined with Netflix's bespoke advantages are likely to ensure the company can earn bumper returns on capital for the foreseeable future.

The most notable features of streaming are its popularity and the scalability of content spend. Industry leaders including Netflix are likely eventually to sign up hundreds of millions more households around the globe. As they do so, a portion of the incremental revenue will be reinvested in expanding their content offering, improving the value of the service while concurrently creating ever-growing barriers to new entrants.

Another benefit of these economies of scale is that streaming services are relatively cheaply priced (especially compared with the fees and commitments for pay TV). That means most households will be able to afford two or more streaming subscriptions (reducing direct competition between providers), can easily absorb increases in fees and are likely to hang onto the services they now consider necessities if economic times get tougher. Netflix is well positioned to be one of the services most people pick.

That leads to Netflix's bespoke pluses. Netflix's early-mover advantage has allowed the company to build the reputation as the must-have basic offering that, while innovative, is easy to understand and use. People are likely to subscribe to Netflix and then line up one or two other services that complement Netflix's increasingly broad and deep offering of films, documentaries and series. Given the aforementioned scale advantages, dislodging Netflix from this position will be incredibly difficult.

Another advantage Netflix has is that it has operated in most countries for at least five years, well ahead of its peers. Netflix has thus gained a fair assessment of what people from Brazil to Japan to Germany want to watch, how they interact with the service, and the most efficient way to attract new subscribers. Another benefit from this early global start is that Netflix has a pipeline of local original content that differentiates its service and positions it well to meet local-content requirements that may emerge.

Netflix's positioning as one of the must-haves that dominate the industry gives it 'pricing power'. This term describes Netflix's ability to boost revenue by raising its prices because higher prices won't cost it customers. Even after the Hollywood competition arrived in 2020, Netflix increased the price of its most popular US plan for the second time in two years, raising it US$1 to US$14 a month, and raised prices by a similar amount in many other markets. We think the emerging industry structure and the value of Netflix's service mean this will persist for an extended period. It all makes for a stock that is well positioned to deliver attractive returns for investors willing to take a long-term view.

To be sure, while Netflix is nicely positioned, execution still matters. In an industry where low switching costs create the potential for churn, Netflix will need to spend its growing content budget wisely to maintain strong engagement and attract new segments of the market while avoiding controversy. The threat emerging from streaming aggregators – including smart TV manufacturers, Roku and Amazon's FireTV that are looking to become the starting point of household viewing sessions and participate in the rapid growth in video streaming – also needs to be managed carefully. Netflix's challenge to match the record subscriber additions in 2020 due to pandemic-induced lockdowns could create pressure from investors focused on near-term performance rather than the journey ahead.

While the entry of Hollywood has intensified near-term competition in streaming, the flipside is that there are unlikely to be many more other entrants into this flourishing industry. Netflix's ability to withstand the Hollywood push indicates it will thrive in coming years in an industry better explained by theories on oligopolies rather than those on perfect competition.

Sources: Company website, Bloomberg, Dunn & Bradstreet.

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