THE IMPORTANCE of remaining rational

Hamish Douglass,
Chief Investment Officer and Lead Portfolio Manager – Global Equities

> "Especially when others are gripped by emotion."

A common question from investors is: "What's your outlook for the next 12 months?" My honest answer these days is: "I don't know." That's because the world confronts its most complex set of economic circumstances for at least 30 years. Charlie Munger, Vice Chairman of Berkshire Hathaway, said at the company's recent annual general meeting: *"If you are not a little confused by what's going on, you don't understand it."* I admit it is a little confusing and this may not be helpful if you would like clear advice. But it is not the time to be overconfident. As the great economist John Kenneth Galbraith said: "One of the greatest pieces of economic wisdom is to know what you don't know." If you hear other investors expressing strong opinions at the moment, it probably means they are either in 'marketing mode' or they are unaware of today's complexities. Our view is that the coming 12 months could see either further gains on share markets or a major correction. Judging which outcome is more likely is difficult, if not impossible.

The case for continued robust market conditions is convincing. Economies are likely to grow, strongly driven by vaccines allowing economies to reopen, unprecedented fiscal expenditure and aggressive monetary policy (zero interest rates and substantial buying of government and other debt). The scale of government spending and central-bank asset buying is historic and breathtaking. In the US in 2020 and 2021, the government is forecast to tally a fiscal deficit of US$6.1 trillion, or 14% of GDP per annum. The Federal Reserve bought US$3.6 trillion of government debt and mortgage-backed securities from 1 March 2020 until June 2021 and still pledges to buy at least US$120 billion of debt each month.

The problem is that the case for a major correction in stock markets (20% or more) in the next 12 months is also convincing. A slump could be triggered by rising interest rates in response to inflation, a mutation of the covid-19 virus that eludes vaccines, a panic in emerging markets sparked by rising interest rates and a stronger US dollar, a spate of corporate debt downgrades and defaults due to rising interest rates, or the bursting of asset bubbles.

It is interesting that few people appear to be focused on major risks that are evident and 'hiding in plain sight'. It is foreseeable that any of these risks could trigger a major correction, yet almost zero risk is priced into markets, market risk measures are benign and few people appear concerned. This may be due to the euphoria associated with the reopening of the world's economies. Or it could be the manifestation of our personal experiences as we emerge from covid-19 and maybe a 'fear of missing out' when everyone seems to be making easy money.

We have seen similar situations where markets are priced for perfection and know it often ends abruptly and badly. We are not smart enough to leave a great party at one minute to midnight, just before things turn to pumpkin and mice. It is even harder to judge when to leave a party where the clocks have no hands. We are custodians of your money and we will never reach for risk due to a fear of missing out. Our job is to remain rational, make fact-based analytical decisions, and not get caught up with what other people are saying or doing. In 1965, Warren Buffett wrote in his letter to investors in the Buffett Partnership: "We derive no comfort because important people, vocal people, or a great number of people agree with us. Nor do we derive comfort if they don't. A public opinion poll is no substitute for thought."

We know we will inevitably make investment mistakes and it is important that we objectively recognise mistakes. In the past year, two mistakes stand out.

"Our focus, as always, was on wanting to protect our investors from the risk had the vaccine trials failed."

The first was Alibaba Group. After initially outperforming after we invested, Alibaba's share price fell when the Ant initial public offering was pulled in November 2020 after Alibaba founder Jack Ma criticised Chinese regulators. While we never thought Ma would act so counter to his interests, I made a risk-management mistake in allowing our holding in Alibaba to grow via a higher share price to more than 8% of the portfolio. There are times when we hold such conviction in a position that such an allocation is entirely sensible, but the main reason I didn't trim the Alibaba holding prior to the Ant IPO was because reducing our holding might have diminished the chance of securing a decent allocation in the listing. At the same time, Alibaba was performing strongly from an operational perspective and we assessed the stock to be undervalued. The plan at the time was to gain a holding in Ant before trimming the Alibaba holding to a more moderately sized position. In hindsight, this was a mistake and was likely due to overconfidence and confirmation bias. Since then, we have trimmed our holding in Alibaba, notwithstanding our positive view on the prospects of the business and our assessment still that the company is undervalued. To avoid making the same error again, we have instituted risk controls that set a maximum position size for Chinese companies and certain other technology companies.

The second mistake of the past 12 months was being too cautious prior to the announcements about vaccine trials results that were released in November 2020. Our focus, as always, was on wanting to protect our investors from the risk had the vaccine trials failed. Thus, we did not place enough importance on the opportunity that would arise from successful trial results. Our combined risk ratio cap (which is discussed below) makes it expensive from a risk-budgeting perspective to place a meaningful proportion of the portfolio in cyclical stocks such as banks, industrials and travel-related companies. We knew the trial results were coming and prior to November 2020 we evaluated numerous more pro-cyclical opportunities (that have all done well since). But for various reasons I decided not to invest in these cyclicals and the portfolio entered November last year with limited cyclical exposure. In hindsight, this was a mistake. However, we will not chase the market after that horse has bolted.

We are happy with the underlying operating performance of each company in the portfolio (and, in most cases, their operating performance through the pandemic has been exceptional). We judge that the portfolio is well positioned to prosper over the next three to five years, almost irrespective of how events play out in the short term.

We have two fundamental investment objectives for the Global Fund:

- To achieve superior risk-adjusted investment returns (our objective is to achieve a minimum average return of 9% per annum after fees over the medium to long term); and
- To minimise the risk of a permanent capital loss.

If we achieve these objectives over time, we hope you will be happy. The concept of minimising the risk of a permanent capital loss is integral to how we manage your money. In our view, investors in recent years have become unrealistically obsessed with chasing returns without appreciating the risk that they could lose their capital. We believe in the 'prudent man' rule in managing money for our clients. This rule was developed in the 19th century when a Massachusetts judge suggested trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested".

Our investment philosophy is to build a relatively concentrated portfolio of outstanding companies – ones that possess sustainable competitive advantages – and to purchase securities in these businesses when their share prices are attractive compared with our assessment of their intrinsic value. We believe buying a concentrated portfolio of high-quality companies purchased at appealing prices will deliver investors superior risk-adjusted

investment returns over the medium to long term while minimising the risk of a permanent capital loss. We will never make investment decisions to outperform the equity market in the short term. We believe our skill is judging where a business's earnings will be in three, five and ten years and not how a company's share price will perform relative to the equity market in the short term.

In 2009, I wrote: "As an investor in the Global Fund, you should be aware that we will not be overly concerned if we underperform some short-term performance benchmark. Given our approach, the probability of this occurring is a near certainty. We simply will not make investment decisions designed to outperform the market on a short-term basis. All our investments will be made strictly in accordance with our investment philosophy and objectives of delivering very satisfactory investment returns (i.e. a target above 9% per annum) over the medium to long term while minimising the risk of a permanent capital loss."

Our track record is that our Global fund has consistently achieved our investment objectives over the past 14 years. Since inception on 1 July 2007, the fund has delivered a return of 11.9% per annum in Australian dollars after fees, meaningfully exceeding our return objective of 9% per annum. If you had invested A$10,000 in the fund on 1 July 2007 it would have grown to A$48,343 by 30 June 2021 (including reinvested dividends). As a comparison, if you had invested in an MSCI World Index over the same period, your investment would have grown only to about A$28,165 a return that equates to 7.7% per annum.

Our investment results have been achieved with meaningfully lower risk of capital losses compared with the index. In terms of downside participation (measuring how the fund performs versus the index during market decline), our Global Fund has suffered 45% of the market's decline since inception, measured on a three-month rolling basis. This has, in part, been due to our cap on the amount of risk we allow the Global Fund to take. We call this cap the 'combined risk ratio'. It incorporates share price volatility and how a company's share price performs in adverse market conditions. We set a maximum risk cap for the portfolio at 80% of the combined volatility and stock 'downside risk' compared with the world equity market. This capping of risk has shown its worth over time. Unsurprisingly, this risk cap has been a significant constraint on the fund over the past year when higher-risk cyclical stocks boomed on news of successful vaccine trial results. We believe our conservative approach of capping risk and investing in a concentrated portfolio of high-quality companies that have been purchased at attractive prices is prudent and is likely to continue to deliver superior returns with lower risk over time.

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Our fund is often compared with the return of global equity markets (measured usually against the MSCI World Index) over short periods. It is important to appreciate that the composition of our portfolio is nothing like that of the general stock market. We typically only hold about 25 investments whereas the MSCI World Index comprises about 1,600 companies. The MSCI World Index includes companies from all sectors of the economy. But our fund will only invest in outstanding companies, does not invest in certain sectors such as mining and oil and gas, and, importantly, incorporates the risk cap that is integral to capital preservation. In the short term, you should thus expect our portfolio to sometimes materially outperform and underperform the index. Our investment style means we would generally expect in the short term to outperform falling markets if there is a material market downturn and underperform a very strong equity market rally.

While we judge the Global Fund's return over time predominantly against our after-fee return objective of 9% per annum and its performance in falling markets, it is relevant to judge the performance of the fund against the MSCI World Index over a reasonable time frame. A standard industry benchmark is to measure returns versus the market on a three-year rolling basis, measured monthly. Since the fund's inception in mid-2007, there have been 133 months of three-year returns. We are satisfied that our Global Fund has delivered an average three-year return of 14.4% per annum in Australian dollars after fees over these 133 monthly periods, which has outperformed the MSCI World Index by 4.2%

per annum on average over the same three-year periods. The Global Fund has outperformed the MSCI World Index on a three-year rolling basis 88% of the time, or 117 months out of 133. In the 16 months when the fund underperformed the MSCI World Index, it delivered an average annual return of 12.3% in Australian dollars after fees and underperformed the index by 0.4% per annum on average. In fact, the worst three-year return relative to the MSCI World Index was in June 2016 when the fund recorded a three-year return of 13.1% per annum in Australian dollars after fees, which lagged the MSCI World Index by only 1.5% per annum.

“We have recently taken action to make the Global Equity portfolio more resilient to inflationary pressures and higher interest rates.”

Now to the major risks that appear to be hiding in plain sight. There is considerable debate and uncertainty on whether inflation will re-emerge as a threat and whether central banks will be forced to tighten monetary policy. It is clear that the reopening of economies and pent-up demand fuelled by expansive fiscal and monetary policies are resulting in constraints along supply chains and in labour markets. This has placed upward pressure on various goods and services such as building materials, certain commodities and transportation costs. It is likely these inflationary pressures will persist for some time. The big question is whether these pressures will prove to be transitory – that is to say, disappear once supply chains normalise – or lead to more permanent inflationary pressures. Most central bankers say they think inflationary pressures will subside next year and they feel comfortable with their loose monetary policies. While we agree that this is the more likely outcome, we don’t think people should be complacent about inflation risks. There is a meaningful risk that we may enter a period of inflation that troubles markets. Even if you believe that inflationary pressures are more likely to be temporary, the most important question to ask is what happens if inflation pressures are not temporary. If central banks were forced to tighten monetary policy by reducing, or ending, asset purchases and increasing interest rates, we could witness a major correction in equity and other asset markets. We have recently taken action to make the Global Equity portfolio more resilient to inflationary pressures and higher interest rates. If this outcome were to eventuate, we assess that the portfolio would prove more resilient than equity markets in general.

Other risks hiding in plain sight include some worrying asset price bubbles. It would be fair to say that we are witnessing one of the most extreme delusions in modern history, measured by the breadth of participation and size. This delusion has some powerful attributes: cult-like behaviour, rebellion against authorities, gambling, break-out technology, a fear of missing out and the madness of crowds. You have probably guessed that the prime example of bubbles are cryptocurrencies with Bitcoin being the pin-up. To put Bitcoin into context, if it were a listed company it would be the seventh or eighth most valuable company in the world (depending on the day).

Devoted followers accuse doubters of not understanding blockchain or the role of cryptocurrencies. Calling out a cult is not popular, particularly when people are making ‘easy’ money. But in times of cult-like behaviour, the most important thing is to stay rational and not be afraid of being unpopular with the crowd.

CRYPTO GOLD

Perhaps the best way to show how weird all this is to imagine if someone were to create crypto gold.

Imagine this journey starts via a proposal to launch a gold exchange-traded fund backed by one metric tonne of gold (35,274 ounces). At market prices, the assets of the new gold ETF are worth US$65 million. The gold ETF has one million units on issue so the initial price per unit is US$65, which should move in line with the gold price. The new gold ETF is named GOLDCOIN and listed on a reputable stock exchange. There is nothing revolutionary about GOLDCOIN other than it offers an easy way for investors to trade in gold.

A genius colleague, Hideyoshi Son (excellent, virtuous, good and respectable), proposes some enhancements to GOLDCOIN:

- The total amount of gold in the ETF is fixed at one metric tonne;
- The total maximum number of units that can be issued is capped at 20 million units (rising from one million to a maximum of 20 million over time); and
- New units are issued to people who solve a complex mathematical riddle.

On review, we run into a problem: that the rules of the reputable stock exchange ban the issuing of units to new investors for no consideration. Not to be deterred, Hideyoshi Son says we need to create a mechanism to trade our product outside the system so we won't be constrained by stock exchange rules or, for that matter, laws or regulations. He suggests that units in GOLDCOIN be recorded on a new fully distributed ledger known as the blockchain. This form of ledger changes everything, he argues. Most importantly, a blockchain ledger gives reliable proof of ownership but also total privacy – no one can find out who owns units in GOLDCOIN. Our new product is outside the constraints of the current system and doesn't have to comply with any anti-money-laundering laws, exchange rules, consumer-protection laws, etc. This provides GOLDCOIN with an enormous potential market.

We launch GOLDCOIN on the new blockchain but things don't go as planned. Each time we issue a unit to a person who solves the riddle, the value of a unit of GOLDCOIN falls. We are so stupid. Obviously when we create units for no consideration the value per unit falls. In fact, once the total number of units reaches the maximum 20 million allowed, the value of GOLDCOIN will fall by 95% on a per-unit basis.

Hideyoshi Son sees the flaw in our product. The problem, he says, is that the asset backing of GOLDCOIN is fixed at one metric tonne of gold. The solution, I suggest, is to increase the asset backing up to a maximum 20 metric tonnes of gold, in line with the maximum number of units we can issue. If we do this, each unit will always be backed by 0.035 ounces of gold. We now have the perfect product, a digital form of gold where each unit is always backed by the same quantity of gold, that can be traded anonymously on the blockchain outside of the reach of authorities.

Hideyoshi Son says so far so good but we need to do something more radical. He says the proposal to fully back the product with gold won't work under the magic he is proposing where crypto mining and the solving of a complex riddle lead us to create another unit of GOLDCOIN. He says if additional units are backed by gold, and paid for, then no one will be motivated to solve the riddle. He says the solving of a complex problem and setting a maximum limit on the total number of units that can be issued is essential to the psychology behind the illusion. He says to solve the problem of dilution resulting from issuing new units we need to remove the physical gold underpinning the value of GOLDCOIN. By removing any tangible asset backing from our product there can be no dilution when issuing new units – you cannot dilute something that has no value. He argues that people can be convinced that GOLDCOIN, with a capped number of units to be issued, is a new form of digital gold. Sceptical me asked: "How can something that is imaginary, with no tangible value, be more valuable than our original product backed by one metric tonne of gold?"

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Hideyoshi Son, a master of human psychology, says we have the perfect circumstances to create an illusion, one that defies the laws of economics and logic:

- Post the financial crisis of 2008-09 and the recent pandemic, millions of people are worried that the world's major currencies are being debased by excessive 'money printing' by central banks. He says placing a cap on the maximum number of units of GOLDCOIN that can be issued plays into these fears. He has inverted the law of dilution to a law of scarcity;
- Removing any tangible value from our product removes any anchoring bias around its actual value;
- The fact that ownership is untraceable, and the fact that it can be traded, makes units the ultimate medium of exchange for illicit activity;
- The riddle-solving (or mining as it was to become known) to win a newly created unit and the dazzle of the blockchain give our product mystical properties;
- Social media, with the right clickbait, will fuel unconstrained and widespread promotion of our product – no need to worry about legal constraints such as laws that

demand a prospectus. He is most excited by a platform called TikTok due to its ability to attract a generation of first-time speculators. He guesses that as the price is driven up, more and more speculators will get on board. The mainstream media will become infatuated, thus giving GOLDCOIN legitimacy; and

- As momentum grows, more people will be attracted to this unregulated system of easy money. Entrepreneurial people will offer services such as exchanges and crypto wallets.

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Hand it to Hideyoshi Son, a true genius. He has created the illusion of scarcity and hence value from something that has no intrinsic worth. Our product, he argues, will become the world's greatest Ponzi scheme. Some call his scheme a new digital currency or even crypto gold – highly amusing given that there is no gold backing our product.

The above illustration clearly is absurd and defies logic. But this imaginary product has attributes that are similar to those of Bitcoin. In our opinion, it is virtually certain that, in time, cryptocurrencies that are not backed by assets or by a central bank will become worthless. It is concerning, but not surprising, that regulators have not put in place appropriate regulations and consumer protections. They should. Cryptocurrencies are operating outside the system, which enables their use for money laundering, terrorism, ransom, cybercrime and other illegal activity. It is inevitable that the regulators will catch up, and the day of reckoning may be approaching sooner than people expect. It is likely that this will end in tears for many people.

That said, while we are sceptical about the value of today's cryptocurrencies, we believe in blockchain technology and think it will have profound implications and disrupt many industries. We expect that most central banks in time will issue digital currencies and private asset-backed cryptocurrencies (or stable coins) will enter more common use. With the explosion of government debt following the pandemic amid the money printing of central banks, the case for a gold-backed cryptocurrency grows by the day. Maybe there is some truth in GOLDCOIN after all.

Hamish Douglass
Chief Investment Officer and Lead Portfolio Manager – Global Equities

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