

MAGELLAN HIGH CONVICTION FUND



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The Magellan High Conviction Fund is a more concentrated and less constrained version of Magellan's core global strategy. The fund seeks to deliver an attractive risk-adjusted absolute return by investing in eight to 12 of the world's best global stocks. The fund employs an active currency hedging program to reduce the impact of foreign currency exposure when the Australian dollar trades outside its historical range.

PERFORMANCE

Global stocks rose in the 12 months to June 2019 after companies posted higher-than-expected earnings, the US economy expanded briskly without generating inflation, the Federal Reserve indicated it would stop, and possibly reverse, its gradual tightening of US monetary policy, and the European Central Bank said it would "use all the instruments that are in the toolbox" to help the eurozone's weak economy. Gains were capped by concerns global growth might slow, driven by China-US tensions and rising political uncertainty in Europe.

Class A units recorded a return after fees of 13.1% for the 12 months. Class B units returned 13.3% after fees over the same period. The stocks that performed best included the investments in Starbucks (+4.9% of the total portfolio return), Microsoft (+4.0%), Visa (+3.0%) and HCA Healthcare (+2.3%). Starbucks rose after the coffee chain spoke of plans to improve delivery in China, boosted marketing in the US to revive sales growth, posted global sales growth that topped expectations and said it would cut about 5% of the workers at its headquarters. Microsoft gained after releasing earnings results that consistently showed strong growth in cloud revenues. Visa benefited from sustained growth in consumer spending and greater card use in a world going more cashless. HCA rallied after the US hospital chain reported higher-than-expected profits and revenue due to higher patient numbers and an increase in higher-paying procedures.

The only stocks to detract from performance to any extent were Kraft Heinz (-4.7%) and Wells Fargo (-0.1%). Kraft Heinz staged its big tumble in the March quarter after the packaged-goods company wrote down the value of underperforming brands by US\$15.4 billion, reported earnings that fell short of expectations

due to higher costs, and said it was subject to a probe by regulators. Wells Fargo fell as the US bank faced challenges to boost revenue due, in part, to the restrictions regulators have imposed following a series of scandals. We have exited both of these investments.

OUTLOOK

Equity prices rose in the June quarter even though risks remain elevated.

While the likelihood of a deal between China and the US plummeted in May, an agreement to restart talks following the G20 meeting in June raised hopes that the two sides would ultimately settle their differences. This buoyed equity prices, as did central banks signalling their willingness to loosen monetary policy in order to counter risks to growth. But the risk persists that protracted China-US negotiations could undermine global growth so much the deterioration would not be offset by a deal or easier central bank settings.

We see three broad scenarios for equity markets. The first, which we rate about a 50% probability, is that there is no significant increase in US inflation or a sharp slowdown in global growth, with further rate cuts likely. Under this outcome, broad equity indexes would most likely provide satisfactory returns.

In the second scenario (25% probability), global growth slows to a level that forces central banks to respond more aggressively. Needless to say, the more growth slows, the worse it is for equity prices. The final scenario (25% probability) is that interest rates rise on inflation concerns. A spike in interest rates would weigh on the growth outlook and lift risk premiums, potentially triggering a 20% to 30% fall in equity prices.

Performance as at 30 June 2019¹

	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)	7 Years (% p.a.)	10 Years (% p.a.)	Since inception (% p.a.)
Magellan High Conviction Fund (Class A)	13.1	17.6	16.2	–	–	16.2
Magellan High Conviction Fund (Class B)	13.3	–	–	–	–	12.7

¹ 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). Magellan High Conviction Fund (Class A) inception 1 July 2013, Magellan High Conviction Fund (Class B) inception 15 November 2017. Returns denoted in AUD.

Notwithstanding the risks confronting equities, we reduced the cash position in the strategy from 18% to 11% over the 12 months. This reflects our decision to adopt a lower-than-historical interest rate in our valuation models and our view that the probability of the third scenario occurring has fallen over the past six months.

PORTFOLIO POSITIONING

Top-10 holdings at 30 June 2019

Security	Weight (%)
Microsoft	14.6
Facebook	13.1
Alphabet	12.9
Visa	9.3
Apple	8.5
HCA Healthcare	8.4
Starbucks	7.4
LVMH	5.1
SAP	5.1
Berkshire Hathaway	4.9
Total	89.3

Notwithstanding our cautionary outlook, we expect our portfolio of 10 high-quality businesses to generate a satisfactory return over the medium to long term.

Capitalism is brutal. Typically, excess profit opportunities are competed away in short order. Investing in companies unable to defend against capitalism's relentless march is not compatible with our objectives. High-quality businesses, however, are the rare subset of the investment universe because they have an ability to resist the natural forces of capitalism, and sustainably generate excess returns and appreciate in value over the long term. We refer to companies possessing this quality as having an 'economic moat' or sustainable competitive advantage.

In addition to the realities of capitalism, as the pace of technology change around the world accelerates, many traditional industries are facing increasing disruption risks. At the same time, the changing world presents opportunities. The tides of disruption will buoy certain industries and business models while threatening others. And if the world experiences a long-term future of more modest growth and lower inflation, businesses that benefit from enduring, structural tailwinds—those businesses that can generate compounding returns for an extended period—are likely to become increasingly valuable.

Recognising the forces of capitalism, disruption and compounding, we seek to build a portfolio of investments in advantaged and undervalued businesses that will be on the right side of history over the long term.

At 30 June 2019, the portfolio included:

- Advertising technology-platform companies (Alphabet, the owner of Google, and Facebook) that represented 26% of the portfolio. These companies benefit from the shift in marketing expenditure from traditional media properties to digital platforms.
- Enterprise-software companies (Microsoft and SAP) that comprised 20% of the portfolio. These companies are deeply integrated within the operations of their business customers, which lowers the risk these customers will switch software vendors. They are benefiting from the transformational growth in cloud computing.
- Companies exposed to the Chinese consumer (Starbucks and LVMH) that represented 13% of the portfolio. The Chinese middle class is forecast to double in size over the next five to 10 years, with the high-end cohort growing even faster. These companies are benefiting from this expanding consumer class and deriving 50% or more of their future revenue growth from the Chinese consumer.
- An investment in Visa, a payment-platform company, that represented 9% of the portfolio. Visa possesses a classic 'network effect' business model, connecting millions of merchants with billions of cardholders. The company is one of those that provide the 'rails' upon which global electronic payment systems run.
- An investment in Apple that represented 8% of the portfolio. We believe that Apple is a highly advantaged consumer-services platform with high consumer loyalty and a long-term opportunity to monetise the one billion Apple devices in use.
- An investment in HCA Holdings that represented 8% of the portfolio. HCA Healthcare is the leading healthcare provider in the US, benefiting from an ageing population, with about 48,000 beds across its network of roughly 185 hospitals, 120 surgery centres and 250 urgent-care clinics.
- An investment in Berkshire Hathaway that represented 5% of the portfolio. Berkshire Hathaway is the world's leading reinsurance company and has an extensive portfolio of high-quality businesses and listed investments. It offers a defensive economic profile given the strength of its balance sheet, the diversity of its cash flows, and a proven capability of deploying capital in a value-accretive manner during market turbulence.
- An 11% holding in cash, held primarily in US dollars.



Hamish Douglass



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Important Information: Units in the fund(s) referred to herein are issued by Magellan Asset Management Limited (ABN 31 120 593 946, AFS Licence No 304 301). Past performance is not necessarily indicative of future results and no person guarantees the future performance of the fund(s), the amount or timing of any return from the fund(s), or that the investment objectives of the fund(s) will be achieved. This material has been provided for general information purposes and must not be construed as investment advice. It does not take into account the investment objectives, financial situation or particular needs of any particular person. Investors should consider obtaining professional investment advice tailored to their specific circumstances and should read the relevant Product Disclosure Statement (PDS) applicable to the fund(s) prior to making any investment decisions. The PDS for the fund(s) is available at www.magellangroup.com.au or can be obtained by calling 02 9235 4888. Any trademarks, logos, and service marks contained herein may be the registered and unregistered trademarks of their respective owners. Nothing contained herein should be construed as granting by implication, or otherwise, any licence or right to use any trademark displayed without the written permission of the owner. No part of this material may be reproduced or disclosed, in whole or in part, without the prior written consent of Magellan Asset Management Limited.