

## MAGELLAN HIGH CONVICTION STRATEGY

The Magellan High Conviction Strategy seeks to deliver an attractive risk-adjusted absolute return over the long term by investing, at an attractive price, in a concentrated portfolio of high-quality businesses.



**Chris Wheldon,**  
Portfolio Manager



**Michael Poulsen,**  
Portfolio Manager  
(Effective 1 July 2022)

### PERFORMANCE

Global stocks fell over the 12 months to June after Russia's invasion of Ukraine clouded the global economic outlook and boosted energy and food prices, central banks tightened monetary policies to tame inflation at decade highs, higher interest rates prompted talk the US economy was headed for recession, China added to worries about shortages and inflation by locking down cities to enforce a policy of zero covid-19, and key companies reported disappointing earnings.

- The **High Conviction Class A** units recorded a return after fees of minus 23.3%<sup>1</sup> for the 12 months.
- The **High Conviction Class B** units returned minus 22.9%<sup>1</sup> after fees over the same period.
- The **High Conviction Trust (ASX:MHHT)** recorded a return after fees of minus 23.3%<sup>1</sup> for the 12 months.

Within the underlying portfolio, the stocks that detracted most over the 12 months were the investments in Netflix (-6.0 percentage points of the total portfolio return in Australian dollar (AUD) terms), Alibaba Group (-3.9 pts) and Meta Platforms (-3.4 pts). Netflix fell after the streaming service said it expected subscriber growth to slow and profit margins to narrow. Alibaba dropped after the Chinese tech company announced sales figures that disappointed and Chinese regulators cracked down on local technology companies. Meta tumbled after the owner of Facebook offered weak revenue forecasts due to Apple privacy restrictions inhibiting the reach and effectiveness of online ads, its Facebook site suffered its first drop in regular users due to the popularity among the young of TikTok, and the company faced a public-relations blow and possible legal difficulties after a former employee exposed issues at the social-media company and that it was losing younger audiences.

The stocks that contributed over the 12 months were the investments in Microsoft (+0.8 pts) and Yum! Brands (+0.3 pts). Microsoft rose after the software giant reported profit and revenue increases that showed how much it had benefited from the shift to online during the

pandemic. Yum! Brands surged on the ability of its chains such as KFC, Pizza Hut and Taco Bell to pass on higher input costs, an advantage in a time of high inflation.

### OUTLOOK

Over the past 12 to 18 months, companies have confronted a complex and fast-changing environment characterised by health and economic policies that were unprecedented and geographically distinct that led to whipsawing consumer behaviour, resurgent inflation, supply-chain fragility, and capital markets that oscillated between accommodative and restrictive. Some companies benefited enormously from the pandemic while other businesses stalled. There is confusion among investors arising from where these trends are reversing and where short-term revenue and other indicators poorly reflect the long-term prospects of these businesses.

During this period, by virtue of their competitive advantages and their importance to customers, high-quality businesses proved resilient. Many adapted and prospered given their ability and attitude to innovate and invest for future growth. Others were appropriately defensive while social and economic restrictions crimped their business but survived given their robust capital footing.

As the period reminds us, high-quality businesses can weather the inevitable storms and often emerge stronger relative to frailer peers, which allows them to capitalise during calmer times. This reflection is instructive as we know that further challenges always lie in wait.

The past few years also remind us of the futility regarding equity market and macroeconomic projections. Reflecting on recent events, how could the lesson not be one of humility with respect to the developments that may confront us?

We recognise the seemingly mounting headwinds to global economic growth. Having overseen a period of extreme policy accommodation that temporarily suspended the economic cycle, and having observed signs of excess more recently, policy makers are moving in a direction that not only seeks to

normalise conditions but one that may need to correct for these excesses.

The paradox confronting genuinely long-term investors is that periods such as these, characterised by rising cyclical and geopolitical concerns, are appealing in so far as they result in lower asset prices and more disciplined investor behaviour. For owners of high-quality assets with a multi-year horizon, lower prices improve the probabilities of favourable risk-adjusted outcomes, while greater capital-market discipline typically favours profitable and well-resourced incumbents.

Instead of opining on the direction of global economic growth or interest rates, our focus remains on partial ownership of a select few outstanding companies that we believe collectively offer a high probability of performing in line with our investment objectives.

## PORTFOLIO POSITIONING<sup>2</sup>

### Holdings at 30 June 2022

| Security                      | Weight (%)   |
|-------------------------------|--------------|
| Microsoft Corporation         | 12.0         |
| Alphabet Inc                  | 11.5         |
| Visa Inc                      | 10.4         |
| Amazon.com Inc                | 9.1          |
| SAP SE                        | 8.8          |
| Yum! Brands Inc               | 8.8          |
| Intercontinental Exchange Inc | 8.3          |
| Safran SA                     | 5.9          |
| Meta Platforms Inc            | 3.4          |
| Netflix Inc                   | 3.3          |
| Cash                          | 18.4         |
| <b>Total</b>                  | <b>100.0</b> |

We believe our portfolio of 10 high-quality businesses remains well positioned to generate attractive compound risk-adjusted returns over the medium to long term.

With this objective in mind, the portfolio has been constructed to provide investors with a concentrated exposure to advantaged businesses purchased at attractive prices and positioned to benefit from secular growth tailwinds. It is this approach – a considered yet concentrated selection of quality businesses possessing a competitive moat, expansive market opportunities, and appealing fundamental prospects, plus deliberate risk management – that provides conviction in the portfolio's ability to achieve its objective over time.

Embedded within our definition of business quality is an insistence that a company be on the winning side of disruptive shifts. This exposes the portfolio to businesses that can achieve growth that is less dependent on the strength of the economy, often because these businesses are gaining share, and relevance, of their large markets in spite of the economic cycle. Our approach remains to invest in businesses that have a high likelihood of fundamental success for decades to come. As always, we evaluate prospective returns in relation to the type and degree of risk we are taking.

The core investment themes in our portfolio at 30 June 2022 were:

- Enterprise-software companies (Microsoft and SAP) that comprised 21% 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, and often driving, the transformational growth in cloud computing.
- Companies benefiting from technology-enabled growth (Amazon, Intercontinental Exchange, and Netflix) that accounted for 21% of the portfolio. Amazon, like Microsoft and SAP, stands to benefit from the growth in cloud computing while also leveraging its leading ecommerce platform to pursue growth across the digital advertising, streaming media, and logistics industries. Intercontinental Exchange's efforts to digitise the US residential mortgage process complement its resilient exchange and data services businesses. Netflix is poised to gain from the shift in pay TV audiences to streaming video on demand.
- Advertising technology-platform companies (Alphabet, the owner of Google, and Meta Platforms, formerly Facebook) that comprised 15% of the portfolio. These companies benefit from the shift in marketing expenditure from traditional media properties to digital platforms.
- A payment-platform company (Visa) that represented 10% of the portfolio. Visa possesses a classic 'network-effect' business model that connects millions of merchants with billions of cardholders. It provides the 'rails' upon which global electronic payment systems run.
- A quick-service restaurant company (Yum! Brands) that represented 9% of the portfolio. The geographic and brand diversity of Yum! Brands, in addition to its franchised model and the non-discretionary nature of its meals, makes the business defensive and resilient to disruption.
- A commercial aerospace company (Safran) that represented 6% of the portfolio. Safran is one of the world's largest commercial aircraft engine and equipment suppliers and has a dominant position in highly concentrated product markets that it typically monetises through sales of spare parts over the multi-decade life of aircraft programs.
- An 18% holding in cash, held primarily in US dollars.

A fuller description of our investment approach, including some recent notable changes, can be read in the appended letter



Chris Wheldon



Michael Poulsen

### Performance as at 30 June 2022<sup>1</sup>

|   | 1 year<br>(%) | 3 years<br>(% p.a.) | 5 years<br>(% p.a.) | 7 years<br>(% p.a.) | 10 years<br>(% p.a.) | Since<br>inception<br>(% p.a.) |
|---|---------------|---------------------|---------------------|---------------------|----------------------|--------------------------------|
| Magellan High Conviction Fund<br>(Class A)    | <b>-23.3</b>  | <b>-1.5</b>         | <b>5.1</b>          | <b>6.3</b>          | -                    | <b>10.0</b>                    |
| Magellan High Conviction Fund<br>(Class B)    | <b>-22.9</b>  | <b>-1.3</b>         | -                   | -                   | -                    | <b>3.4</b>                     |
| Magellan High Conviction Trust<br>(ASX: MHHT) | <b>-23.3</b>  | -                   | -                   | -                   | -                    | <b>-2.3</b>                    |

<sup>1</sup> Returns denoted in AUD. 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 date is 1 July 2013 (inclusive), Magellan High Conviction Fund (Class B) inception date is 15 November 2017 (inclusive) and Magellan High Conviction Trust inception date is 11 October 2019 (inclusive).

<sup>2</sup> Portfolio positioning may not sum to 100% due to rounding. Based on the Magellan High Conviction Fund

# RECENT UPDATE – MAGELLAN HIGH CONVICTION FUND AND MAGELLAN HIGH CONVICTION TRUST

- Addition to the portfolio management team

- Update to portfolio holdings range and minimum market capitalisation

- Unchanged objective to deliver attractive risk-adjusted absolute returns to investors over the medium to long term

Dear Investor,

As you may have read, we recently updated the portfolio management of the Magellan High Conviction Fund (“Fund”) and Magellan High Conviction Trust (“Trust”).

Effective from 1 July 2022, we made the following changes that we believe enhance our ability to deliver the shared objective of the Fund and the Trust, being attractive risk-adjusted absolute returns to investors over the medium to long term.

## Strengthening of Portfolio Management Team

We are delighted to announce that Michael Poulsen was added as co-portfolio manager of the Fund and the Trust, joining Chris Wheldon. Michael has served as a key member of Magellan’s investment team since 2012, working across sector teams and investment strategies. Chris Mackay will continue to perform an oversight role.

## Increase in Portfolio Flexibility

The portfolio holdings range of the Fund and the Trust was increased modestly from 8-12 to 10-20 and will remain weighted towards Magellan’s highest conviction ideas. The increase reflects our desire to:

- Invest in high-quality businesses having a smaller market capitalisation;
- Increase position sizing flexibility and portfolio balance;
- Improve risk management and the diversification of common exposures; and
- Enhance our ability to respond to corporate actions undertaken by portfolio companies.

## Expansion of Investment Universe

Having more extensively reviewed the universe of high-quality smaller businesses and having established a dedicated team to appraise these opportunities, the minimum market capitalisation constraint for inclusion in the Fund and the Trust was reduced from US\$5 billion to US\$3 billion. We anticipate that over time there will be highly attractive investment opportunities from these smaller companies that are often less actively researched by market participants than larger companies, and by definition, have a longer runway to compound.

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Critically, we would like to reiterate what has not changed.

The most important constant remains our responsibility to you as fiduciaries and stewards of your savings. We take this responsibility seriously, guided by Warren Buffett’s first rule of investing (“don’t lose money”) and have aligned our interests with yours by investing alongside you.

The Fund’s and the Trust’s objective will remain: to achieve attractive risk-adjusted returns over the medium to long term. Directed by the discipline of risk-adjusted opportunity cost, we aspire to the highest level of compounding achievable over the longest possible time – our investment runway is measured in decades. We will assess the performance of the Fund’s and the Trust’s holdings through the lens of long-term operating results rather than short-term share price movements.

The Fund’s and the Trust’s investment philosophy remains grounded in the pursuit of risk-adjusted absolute returns – not unadjusted or relative returns – with a long-term orientation and deep fundamental research. We will continue to apply this inch-wide-mile-deep mindset to a deliberately constrained universe of outstanding companies that we consider possess the means to sustainably exploit competitive advantages. Our role then is to construct a concentrated portfolio of these high-quality companies, purchased at attractive prices relative to their conservatively assessed intrinsic value, while being mindful of the various types and degrees of risk in the Fund’s and the Trust’s portfolio. We recognise that exceptional risk-adjusted compounding opportunities are rare and, consequently, the Fund and the Trust each retain the ability and inclination to lean in, subject to appropriate constraints, when these investments present themselves. Avoiding the residual mediocre opportunities aligns with the Fund’s and the Trust’s concentrated and patient nature. Coming full circle, this process will continue to be executed in pursuit of the shared objective of the Fund and the Trust.

Our approach and attitude remains bottom-up, fundamental, and informed by the view that high-quality and well-run companies exposed to growth tailwinds and purchased at sensible prices provide the highest odds of weathering the inevitable market and macroeconomic storms that are certain to confront us. We will experience age-old economic and market fluctuations. We also know we’ll confront new, unthinkable developments over the years ahead that can’t be studied in any history book. Worst-case scenarios are not bound by historic precedent. Environmental flux, surprises and periodic headwinds are features of the system, yet despite the assurance of their occurrence we can’t know when or where they’ll

strike, and nor will we attempt to 'time' their arrival. We will seek to understand what could happen but not predict what will happen regarding these unknowable future developments, and we'll view the inevitable swings in Mr Market's mood as providing a fertile environment for opportunity, not risk, and otherwise as a distraction.

There are very few great businesses, and even fewer opportunities to purchase them at attractive prices. Those rare occasions that equity markets provide to transact at prices that differ meaningfully from fair value will often be associated with excessive optimism or pessimism. Periods of volatility that create clear disparity between price and value offer an advantage available to equity market investors. But the cost of this service is fear, doubt, uncertainty, and regret. A meaningful decline in prices typically requires widespread concern and turmoil. Yet lower prices increase prospective risk-adjusted returns, all else equal, which is why investors view all historic drawdowns as opportunities despite being concerned by future market declines. Therefore, purchase activity should be highest in a climate when this very activity seems most ill-conceived. The opposite is also true, and investors risk being tempted into complacency just when they need to be most prudent.

We must also regularly squint through the immediate and absorbing thing to observe the slow and uneven, but relentless and often overlooked, progress that characterises economic and equity market outcomes over the long term. The longer one's investment horizon, the greater the asymmetry and odds of favourable outcomes become for equity market investors. With the probabilities of attractive risk-adjusted returns stacked in favour of long-term investors, the tailwind of economic and equity market gains over time should be exploited, not forgone. Rather than a source of protection, attempts at market timing would risk underperforming our objective.

Instead of attempting to predict the unpredictable, our focus will remain directed towards each company's customer relevance, competitive advantage and direction, market opportunity, reinvestment profile, adaptability, management capability and alignment, capital position, and business- and industry-specific risks, knowing that only a very small percentage of companies will account for the vast majority of economic gains over time. We'll favour businesses prioritising long-term resiliency and durability over short-term efficiency and optimisation. Deliberate, disciplined, repeated, and retested insistence on these qualities offer a degree of protection against unforeseeable risks. Amidst constant attention-seeking headlines and noise, our bias will be towards inactivity when informed by an assessment that the likely range of fundamental outcomes remains consistent with our objective. Activity does not correlate with performance. Sustained compounding requires patience and where patience is deserved, we will seek to reward it.

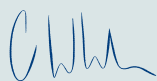
Despite these attempts to keep the odds tilted in our favour, business outcomes are inherently uncertain. Chance and randomness abound. And all companies eventually succumb to competitive and disruptive forces. Each of these factors mean mistakes are inevitable. Yet, in addition to patience, compounding demands the avoidance of large losses, so we must be vigilant to both the likelihood of loss and its consequences, in addition to any added outcome from bad luck. In turn, this requires humility, a focus on process over outcomes, probabilistic thinking with an active pursuit of disconfirming evidence and diverse views, insistence on a margin of safety, guarding against extrapolation, a willingness to admit ignorance and pass on most opportunities, a disregard for sunk costs, imagination of failure, a strict adherence to disqualifying features, an open-minded and dispassionate attitude towards ever-changing fundamental circumstances and prospects, and ready idea destruction and acknowledgement of mistakes, each necessitating a corrective reallocation of portfolio capital towards superior opportunities. If change is constant then we must be flexible and continuously realign with reality to benefit from it, not stubbornly resist it.

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We intend to communicate with you as partners, and as owners of businesses rather than as renters of stocks. When we make mistakes, we will discuss them candidly. We will continue to disclose the portfolio's five largest holdings in the monthly factsheets, plus the full portfolio each quarter with a lag. Expect our commentary to centre on business fundamentals rather than market prognostications. However, understanding the impairment to clear and unencumbered thought that follows any public commentary, we will be careful and balanced in our communication.

By revisiting some foundational views in this letter, we hope you have sufficient information to determine whether the Fund or the Trust – each focused on long-term compounding of fundamental value through the concentrated ownership of exceptional businesses – is aligned with your investment approach and time horizon.

Should you wish to discuss any of the contents of this letter, please reach out to us directly, or contact your Magellan representative.



**Chris Wheldon**  
Portfolio Manager



**Michael Poulsen**  
Portfolio Manager

## IMPORTANT INFORMATION

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