Magellan Sustainable Fund (Managed Fund)

TICKER: MSUF | APIR: MGE4669AU | ARSN: 645 516 187

AS AT 31 DECEMBER 2023

PORTFOLIO MANAGER ALAN PULLEN

INVESTMENT PHILOSOPHY

To invest in outstanding companies at attractive prices within a framework that considers environmental, social and governance risks and delivers very low carbon exposure, while exercising a deep understanding of the macroeconomic environment to manage investment risk.

OBJECTIVES

To achieve attractive risk-adjusted returns over the medium to long-term while reducing the risk of permanent capital loss. This incorporates consideration of environmental, social and governance risks and the application of a proprietary low carbon framework.

PORTFOLIO CONSTRUCTION

High conviction (20 - 50 securities), with high quality focus. Integration of ESG screens and risk assessment together with a proprietary low carbon framework overlay.

Typical cash and cash equivalents exposure between 0 - 20%.

INVESTMENT RISKS

All investments carry risk. While it is not possible to identify every risk relevant to an investment in the fund, we have provided details of risks in the Product Disclosure Statement. You can view the PDS for the fund on Magellan's website www.magellangroup.com.au.

ENVIRONMENTAL, SOCIAL, GOVERNANCE AND LOW CARBON

The fund excludes companies whose activities, as assessed by Magellan, may have wide-ranging detrimental impacts on society. These exclusions encompass companies with material exposures to the production of tobacco products, gambling, as well as companies involved in the production of alcohol, adult entertainment and handguns. Materiality is normally assessed as greater than 10% of a company's revenues exposed to the exclusionary activity. Revenues are sourced from MSCI ESG Manager.

Companies are reviewed for the materiality of their exposures to environmental, social and governance issues, with assessments incorporated into our perspectives on business risks.

We overlay our proprietary low carbon framework to deliver a portfolio with meaningfully lower carbon intensity than broader equity markets.

MAGELLAN SUSTAINABLE FUND (MANAGED FUND): KEY PORTFOLIO INFORMATION

TICKER	FUND SIZE	BUY/SELL SPREAD[1]	MANAGEMENT AND PERFORMANCE FEES[2]	INCEPTION DATE
MSUF	AUD $7.7 million	0.07% / 0.07%	1.37% p.a. and performance fee of 10% of dual hurdle excess return^	11 December 2020

^ 10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (MSCI World NTR Index (AUD)) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

PERFORMANCE[3]

	1 MONTH (%)	3 MONTHS (%)	6 MONTHS (%)	1 YEAR (%)	3 YEARS (% p.a.)	Since Inception (% p.a.)
MSUF	1.3	7.5	6.7	29.5	9.5	8.9
MSCI World NTR Index (AUD)*	1.9	5.4	4.9	23.0	11.8	11.4
Excess	-0.6	2.1	1.8	6.5	-2.3	-2.5

CALENDAR YEAR RETURNS	2023 (%)	2022 (%)	2021 (%)	2020 (part year)
MSUF	29.5	-17.1	22.3	-1.2
MSCI World NTR Index (AUD)*	23.0	-12.2	29.3	-0.3
Excess	6.5	-4.9	-7.0	-0.9

Past performance is not a reliable indicator of future performance.

PERFORMANCE CHART GROWTH OF AUD $10,000[3]

31 December 2023#	FUND	INDEX*
CARBON INTENSITY (CO_2T/US$1M REVENUE)	28	106

Carbon intensity data available on a quarterly basis. Certain information ©2023 MSCI ESG Research LLC. Reproduced by permission. The Fund's carbon intensity score is calculated using MSCI data. In a limited number of circumstances, where data is not available or Magellan deems it appropriate, manual adjustments are made to the MSCI carbon intensity score for certain investments held by the fund.

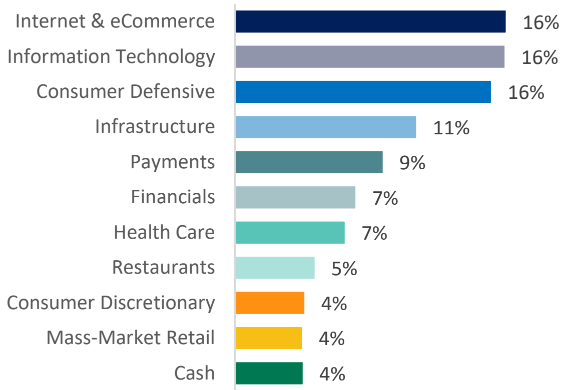
Past performance is not a reliable indicator of future performance.

[1] Only applicable to investors who apply for units directly with the Responsible Entity.
[2] Transaction costs may also apply – refer to the Product Disclosure Statement. All fees are inclusive of the net effect of GST.
[3] 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.
* MSCI World Net Total Return Index (AUD). All MSCI data used is the property of MSCI. No use or distribution without written consent. Data provided "as is" without any warranties. MSCI and its affiliates assume no liability for or in connection with the data. Please see complete disclaimer in www.magellangroup.com.au/funds/benchmark-information/

TOP 10 HOLDINGS

STOCK	SECTOR[4]	%
Microsoft Corporation	Information Technology	7.4
Alphabet Inc	Internet & eCommerce	7.1
Nestlé SA	Consumer Defensive	7.0
Meta Platforms Inc	Internet & eCommerce	4.8
Amazon.com Inc	Internet & eCommerce	4.6
Intercontinental Exchange Inc	Financials	4.3
Booking Holdings Inc	Consumer Discretionary	4.3
Dollar General Corporation	Mass-Market Retail	4.1
Eversource Energy	Infrastructure	4.0
MasterCard Inc	Payments	4.0
	TOTAL:	**51.7**

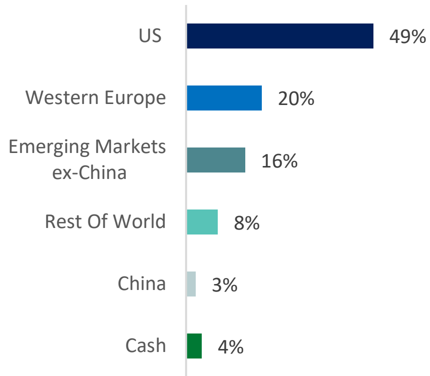
SECTOR EXPOSURE BY SOURCE OF REVENUE[4]



TOP CONTRIBUTORS/DETRACTORS 1 YEAR[5]

TOP 3 CONTRIBUTORS	CONTRIBUTION TO RETURN (%)
Meta Platforms Inc	6.4
Microsoft Corporation	3.8
Alphabet	3.7
TOP 3 DETRACTORS	**CONTRIBUTION TO RETURN (%)**
Dollar General Corporation	-1.5
Eversource Energy	-0.6
Coca-Cola Company	-0.1

GEOGRAPHICAL EXPOSURE BY SOURCE OF REVENUE[4]



[4] 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.
[5] 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 December quarter saw strong global equities returns with the MSCI World Index rising 11.4% in USD terms, driven by lower bond yields. The Information Technology sector led these gains (up 16.9%), followed by Industrials (11.4%) and Financials (11.2%), with these sectors sensitive to interest rate movements and the economic outlook. The Energy sector declined 5.5% as oil prices fell in the quarter. The S&P 500 rose 11.2%, MSCI Emerging Markets Index (7.4%) and Euro Stoxx 600 (6.4%). In contrast, China's CSI 300 Index fell 7.0%.

The main driver of equity returns in the quarter was a large fall in bond yields. US 10-year Treasury yields fell 70bp to 3.9%, German 10-year Bunds declined 80bp to 2.0% and Japanese 10-year JGBs declined 10bp to 0.6%. These were a response to easing inflationary pressures, with annualised US inflation in the three months to November running at 2% compared with 5.5% just six months earlier. Notably, this development led the Federal Reserve to suggest in December that its policy rate may be "at or near its peak". The tailwind to equity returns from lower interest rates was reinforced by a slightly improved profit outlook, with the gradual slowdown in global growth not hurting profit growth as much as many had feared earlier in the year.

The Chinese growth outlook remains challenged as the country digests its real estate bubble. Poor consumer, business and investor confidence are stiff headwinds to growth and will take time to improve in the absence of economic stimulus. While the Chinese government appears so far to be more focussed on internal security rather than growth, there have been some signs of minor pro-growth policies. These growth headwinds are reducing geopolitical risk in East Asia as the Chinese government focuses more on domestic issues.

Fund Commentary

The portfolio delivered strong returns over the quarter, both in absolute terms and relative to the MSCI World Index. Key contributors to performance included American Tower, Microsoft and US Bancorp. American Tower performed strongly on a solid 3Q23 result and as yields on long-dated US government debt moderated as inflation concerns eased. Microsoft delivered a strong quarterly result driven by commercial cloud momentum, unexpected Windows growth in a stabilising PC environment, gross margin expansion, and operating leverage. Azure performance provided encouraging early evidence of Microsoft's ability to monetise the AI opportunity despite cloud spending headwinds. US Bancorp benefited from the improved outlook for the US economy, which eased fears of significant credit losses. In addition, lower long-term interest rates should reduce losses on the bank's securities holdings, benefiting their balance sheet.

Detractors for the quarter included Nestlé, Novartis and Reckitt. Nestlé reported a disappointing third-quarter result owing to an IT integration issue in its vitamins, minerals and supplements division. The issue is expected to be resolved in early 2024, causing six months of earnings impact. Sector rotation into higher beta stocks also caused the staples index as a whole to underperform. Novartis underperformed due to sector rotation towards more economically sensitive stocks. There is no change to our investment thesis, and we remain positive on Novartis's drug pipeline potential post the company's recent investor day. Reckitt's third-quarter volume performance disappointed investors and increased risk that volume growth will be delayed and FY24 organic growth might be lower than expectations. The stock's attractive valuation adequately reflects near-term headwinds.

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

Developments in Sustainability

The annual United Nations conference on climate change, COP28, reignited pivotal discussions on global climate strategy. While we saw nearly every country agree to a 'transition away from fossil fuels', there was no agreement on timing or approach. The lack of global unity, however, has not deterred some nations from driving climate action at the national level. For example, the French government has implemented strict rules that force and incentivise households to address emissions. Overall, the mixed global stage regarding policy makes our commitment to the Net Zero Asset Manager Initiative and ongoing engagement with companies exposed to the transition critical to ensuring companies are resilient and working towards their own net zero targets aligned with limiting warming to 1.5C. We outline our climate strategy and our stewardship efforts more broadly in our 2023 Stewardship - Proxy and Engagement Review.

During the quarter, the United Nations Principles for Responsible Investment (UNPRI), the global organisation responsible for spurring and driving best practice in Responsible Investment including ESG integration, released the 2023 survey results. Happily, Magellan scored above peers in ESG integration, policy governance and oversight. We are pleased with this result, a reflection of our continued focus to enhance ESG risk management and investment opportunities.

Outlook

Following the rally in late 2023, markets enter 2024 relatively fully valued. The market continues to price in a Goldilocks scenario, with central banks tapping the brakes sufficiently to bring inflation under control, but not so much as to trigger a deep recession. The credibility of this position has been aided by the Federal Reserve's recent comments suggesting that US interest rate rises are complete. However, economic forecasting is notoriously error prone, and while we view the base case of a soft landing as reasonable, we are mindful that a more adverse outcome is certainly possible. At current market valuations there is little room for such an error, and consequently we continue to position the portfolio conservatively.

With market returns unlikely to benefit materially from higher valuations given current above-average levels, we anticipate returns are more likely to be driven by earnings growth. Our companies remain well placed to deliver solid earnings growth in the years ahead, reflecting their high quality, strong free cash flow generation, and the benefit of long-term structural tailwinds such as AI adoption.

Stock Story: Yum!

(Emma Henderson – Investment Analyst)

Behind the success of the world's most famous quick-service chicken restaurant, the world's second-largest pizza chain and the US's leading Mexican-style franchise sits Yum! Brands. With over 55,000 restaurants across more than 155 countries and territories, Yum! Brands is the world's largest restaurant company by number of restaurants and second only to McDonald's in total restaurant sales.

The iconic KFC, Pizza Hut and Taco Bell brands were originally brought together under consumer goods giant PepsiCo in the 1970s and 1980s as part of a series of acquisitions to diversify its business away from beverages. In 1997, PepsiCo announced it would be narrowing its focus back to its core beverages and snacks businesses and its fast-food unit would be spun off into an independent public company, ultimately named Yum! Brands.

Over the last 25 years, Yum! Brands has grown its global restaurant base by over 25,000 restaurants and has transformed from a US-centric company to a truly global business. It has also shifted its business model from owning and operating a portion of its restaurants to running an almost entirely franchised model, driving dual benefits of reduced risk and accelerated growth for shareholders.

Today, over 98% of KFC, Pizza Hut and Taco Bell outlets are operated by franchisee and licensee partners who deploy their own capital to open and operate restaurant outlets. These partners in turn pay Yum! Brands a royalty fee of approximately 5% of restaurant sales. In 2022, KFC, Pizza Hut and Taco Bell stores around the world generated US$60 billion in total system sales, resulting in US$3 billion in franchise revenue for Yum! Brands and contributing 90% of the company's earnings. Franchise fee revenue is a high-margin, capital-light earnings stream that is insulated from labour and commodity costs increases. The accessible price point and strong value-for-money nature of fast food add to the predictability of this attractive earnings stream throughout economic cycles.

By geography, approximately half of Yum! Brands' franchise revenue is now generated in international markets, including approximately 30% in fast-growing emerging markets like China, India, Southeast Asia and Latin America. While we have seen various misses from Yum! Brands and peers when trying to export US brands internationally, both KFC and Pizza Hut concepts have proven to have strong global appeal, with chicken and pizza products easily customised for local market tastes and preferences. Mexican-style Taco Bell, which is an outstanding business in its home US market, has proven harder to replicate internationally but is beginning to make inroads in markets like Spain, India, the UK, and China.

Despite significant growth and value creation delivered over the past few decades, there remains an exciting growth runway ahead for Yum! Brands, particularly in emerging markets where penetration of its brands remains low, consumer incomes are rising, and the existing restaurant landscape is highly fragmented and unsophisticated. Yum! Brands is targeting global system sales growth of 7% p.a. underpinned by new store growth of approximately 5% p.a. and modest growth in existing store sales through menu and marketing initiatives. The company has been running ahead of this net new store growth target, with over 100 countries contributing to global store growth of closer to 6% in recent years. Highly attractive payback periods on new stores and a more sophisticated and better-capitalised franchisee base relative to peers should prove key advantages to sustaining development in a higher interest rate environment.

Yum! Brands' growth will also be increasingly powered by digital and technology. The company has spent the last few years investing heavily in areas like customer analytics, digital ordering, loyalty programs and back-of-house restaurant technologies, which will be shared across its global system to drive better customer experiences, sales performance and franchisee profitability. One of many examples is the company's acquisition of Dragontail Systems in 2021 for approximately US$70 million. Dragontail is an AI-based technology that automates and optimises multiple Pizza Hut processes, from preparing the pizzas to dispatching product to delivery drivers and enabling customer tracking. In an increasingly digital world, we expect economies of scale on largely fixed-cost technology investments, as well as consumer data advantages from operating over 55,000 restaurants, to become increasingly important competitive differentiators relative to smaller restaurant players in the highly fragmented US$900 billion limited services restaurants industry.

Yum! Brands has a strong track record of ensuring its brands remain culturally relevant and loved. However, to ensure its brands can continue to grow sustainably, it will be important to manage food quality and nutrition risks as consumer preferences evolve, social risks as a large global employer and environmental risks as a large procurer of global agricultural and packaging products.

Yum! Brands remains a cornerstone of the Magellan Global portfolios, generating sustainable and defensive cash flows for investors.

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