

Magellan Sustainable Fund (Managed Fund)



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

AS AT 30 SEPTEMBER 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 \$7.3 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.

PERFORMANCE³

	1 MONTH (%)	3 MONTHS (%)	6 MONTHS (%)	1 YEAR (%)	2 YEARS (% p.a.)	Since Inception (% p.a.)
MSUF	-4.4	-0.8	7.1	20.7	2.4	6.9
MSCI World NTR Index (AUD)*	-4.0	-0.4	7.0	21.5	4.7	10.4
Excess	-0.4	-0.4	0.1	-0.8	-2.3	-3.5

CALENDAR YEAR RETURNS	CYTD (%)	2022 (%)	2021 (%)	2020 (part year)
MSUF	20.5	-17.1	22.3	-1.2
MSCI World NTR Index (AUD)*	16.7	-12.2	29.3	-0.3
Excess	3.8	-4.9	-7.0	-0.9

Past performance is not a reliable indicator of future performance.

PERFORMANCE CHART GROWTH OF AUD \$10,000³



30 September 2023 [#]	FUND	INDEX*
CARBON INTENSITY (CO ₂ T/US\$1M REVENUE)	27	113

[#] 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.

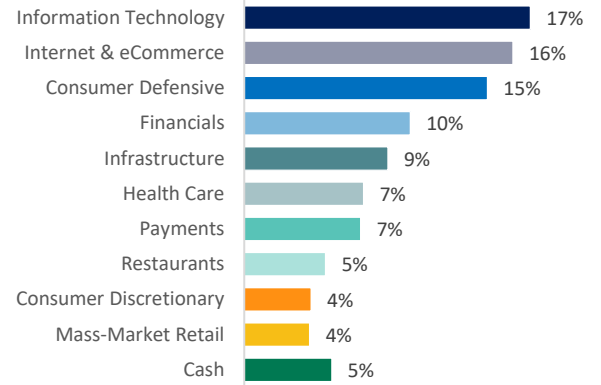
³ Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Returns denoted in AUD.

* 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	7.0
Nestlé SA	Consumer Defensive	5.8
Meta Platforms Inc	Internet & eCommerce	4.8
Amazon.com Inc	Internet & eCommerce	4.5
Novartis AG	Health Care	4.3
MasterCard Inc	Payments	4.2
SAP SE	Information Technology	4.2
Booking Holdings Inc	Consumer Discretionary	4.1
Intercontinental Exchange Inc	Financials	4.0
TOTAL:		50.3

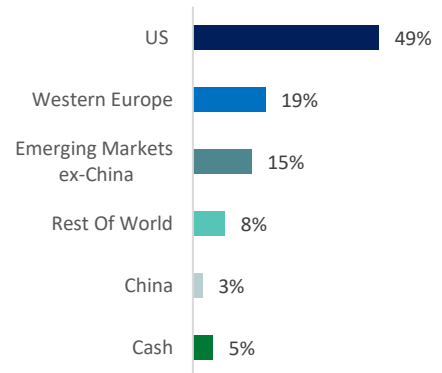
SECTOR EXPOSURE BY SOURCE OF REVENUE⁴



TOP CONTRIBUTORS/DETRACTORS 1 YEAR⁵

TOP 3 CONTRIBUTORS	CONTRIBUTION TO RETURN (%)
Meta Platforms Inc	4.9
Microsoft Corporation	2.5
SAP SE	2.3
TOP 3 DETRACTORS	CONTRIBUTION TO RETURN (%)
Dollar General Corporation	-2.1
PayPal Holdings Inc	-0.7
Eversource Energy	-0.6

GEOGRAPHICAL EXPOSURE BY SOURCE OF REVENUE⁴



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 September quarter saw listed shares fall with the MSCI World Index declining 3.5% in USD and 0.4% in AUD as oil prices rose, the US dollar rose and 10-year government bond yields, used by investors as a “risk free” benchmark, increased materially. Gains were evident in the Energy sector (+12.5%), as oil rose almost 30% to a peak just before month end, with Communication Services (+2.0%) and Financials (+0.4%) the other gainers. Sectors typically more sensitive to higher real rates – Utilities (-8.2%), Real Estate (-6.5%) and Information Technology (-5.8%) – led declines. In local currencies, the S&P 500 and Nasdaq Composite indices fell 3.6% and 4.1% respectively, Europe’s STOXX 600 declined 2.5% and China’s CSI 300 fell 4.0%. Japan’s Nikkei 225 bucked the trend to rise 5.6% as the Yen fell.

This was a quarter of a meaningful and unusual shift in long-term bonds, bringing commentary comparing it to 2007. The 10-year US Treasury bond yield rose 80bp to around 4.6%, a level last seen in 2007. This large move seemed to have reflected a variety of factors and it is hard to distil which of them are transient: some are due to ongoing economic resilience despite the large monetary tightening of the past year; others are likely due to large Treasury issuance, ongoing quantitative tightening and falling holdings by foreign investors. That is, some of it is supply/demand imbalance; some is a realisation that the neutral rate may be higher than during the last 10+ years. The latter may also be behind similar moves in Europe’s German Bunds and Japan’s government bonds, while in markets like Australia and the UK, economic resilience is less clear.

On the inflation front, data supported the trend for falling prices in most areas, with oil the obvious exception. In the US, annual core consumer price inflation adjusted to exclude volatile food and energy prices was 4.3% in August, the lowest annual rate in almost two years. In the 12 months to September, German core inflation was 4.6%, down from the annual rate of 5.5% recorded a month earlier.

China dropped its zero-covid policies late in 2022 but the economic rebound has been far less than seen in most developed economies. Policy to stimulate the economy has been incremental and relatively small in scale while weak consumer and business confidence has seen a propensity to caution on spending. Political events – the disappearance and subsequent removal of the Foreign Minister and Defence Minister and the purging of Xi loyalists soon after the National People’s Congress where they had been promoted by Xi – add to the uncertainty.

Developments in Sustainability

Climate change was centre stage during the quarter, following extreme weather events and elevated average temperatures during the Northern Hemisphere summer. We continue to monitor the risks and opportunities related to climate via engagement and through industry body participation. Magellan is a member of the Investor Group on Climate Change (IGCC), with IGCC hosting its annual summit during the quarter. The focus of the seminars was the risks and opportunities related to climate, including regenerative agriculture and renewables, and the importance of active engagement to drive investment.

During the quarter, Magellan finalised its Net Zero Asset Manager initiative (NZAMi) targets. These targets are now publicly available ([link](#)). We are thrilled to have made this formal commitment of managing climate risk within our portfolios.

Fund Commentary

The Fund delivered a negative return for the quarter.

Microsoft, Yum! Brands and Dollar General were key detractors. Microsoft delivered a solid quarterly result, but guidance fell somewhat short of more optimistic market expectations of an inflection in growth for their public cloud business, Azure, as we lap the optimisation cycle. The Yum! Brands share price has been affected by broader weakness in consumer defensive stocks and concerns regarding a stalled economic recovery in China. This is despite a strong 2Q23 result that included accelerating store roll-out activity and strong momentum in other international markets. Dollar General posted a disappointing 2Q23 result and a significant downgrade to full-year guidance. Its same-store sales trends have deteriorated over the year due to executional missteps and macro pressures affecting low-income consumers. We believe the company now needs to reinvest into markdowns and labour hours, which will pressure margins. We have attempted to determine whether we were wrong on the quality of Dollar General or whether the significant share price decline offers an attractive opportunity. The answer is probably a bit of both; the company’s executional issues suggest it was previously over-earning due to pandemic-related tailwinds. Nonetheless, we do not believe the model is broken and at current valuations we consider that the company can play a valuable role within the portfolio.

In contrast, key contributors included Alphabet, Booking and Meta. For Alphabet, concerns about Search disruption from AI / ChatGPT continued to ease as they effectively demonstrated their own advancements in the field. The company also reported solid results demonstrating stable trends in advertising and continued cost control. Booking reported a strong second-quarter result where it demonstrated continued progress on direct bookings, performance marketing efficiencies, and North American market share. Growth and sentiment were also bolstered by resilient travel demand in Europe. Meta’s share price has benefited from improved market sentiment towards the broader digital advertising market and an increased appreciation of the payoff of heavy investments in AI across user engagement, advertiser returns and overall monetisation.

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

Outlook

We remain cautious about the economic outlook; while inflationary pressures are beginning to ease, the inflation rate remains elevated and central banks around the world continue to increase policy rates. The market appears to be largely pricing 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. To be fair, the consumer has, to date, proven relatively resilient, buffered by excess savings built up during covid. Our base case remains that inflation is brought back under control with only a mild recession. However, monetary policy works with long and variable lags, making such precision by central banks difficult to achieve. There remains a risk that the economy experiences a deeper-than-anticipated recession as savings buffers are exhausted and consumers and businesses cut spending. Indeed, if inflation proves stubbornly high, central banks may be forced to raise rates further than anticipated, ultimately forcing the recessionary outcome above.

We have confidence that, should major economies enter a recession in the coming 12 months, the portfolio is well positioned. We seek to build downside protection into the portfolio construction process, and we consider the companies held in the strategy to be high quality. Notwithstanding potential macroeconomic risks, our view is that the portfolio companies are generally performing well, growing revenue and earnings at attractive rates and generating significant levels of free cash flow.

Stock Story: Microsoft

(Adrian Lu – Investment Analyst)



Microsoft is the largest enterprise software vendor in the world. The company founded in 1975 has a broad suite of product offerings, with diversified exposure across many industry verticals. Microsoft is one of the three dominant providers of large-scale public cloud computing outside China and is a market leader in office productivity tools, infrastructure software and PC operating systems. While Microsoft has a strong presence across commercial and consumer markets, it generates most of its sales from commercial customers.

Enterprises around the world are still at the early stages of a multi-year shift towards adapting, modernising and infusing their businesses with digital innovations – often described as digital transformation. Microsoft is positioned as a key beneficiary of this disruptive trend thanks to its commercial cloud businesses, including Microsoft Azure.

Azure is competitively advantaged with its hyperscale infrastructure footprint, breadth of capabilities and enormous R&D engine supporting rapid innovation cycles. These characteristics are incredibly difficult to replicate. Microsoft is able to leverage these capabilities across its broader portfolio, as a flywheel to commercialise innovations such as artificial intelligence (AI). AI has seen tremendous progress in recent years and has the potential to further accelerate innovation and productivity. Microsoft has moved rapidly to integrate and roll out new AI features and products to capture this opportunity from Azure through to business applications and productivity software.

Within office productivity software, Office 365 and Teams expand the addressable market through innovations like Copilot AI, expanded use cases in collaboration, new users such as front-line workers, and deeper opportunities in verticals like healthcare and retail. Microsoft's opportunities span other areas including analytics, application development, and business applications like customer insights and enterprise resource planning. Its enterprise incumbency and its status as a trusted partner enable the company to cross-sell its product portfolio and deliver a suite of integrated solutions to customers.

While the cloud opportunity is astounding, a significant part of Microsoft's business is still derived from its traditional on-premises software. Microsoft's Server products, including Windows Server and SQL Server, continue to offer the traditional perpetual licensing software model. However, these are not pure on-premises businesses, as they can also be deployed in the cloud or as part of hybrid landscapes, and therefore ought not to be viewed in isolation from Azure. In other words, we view these businesses as likely to remain resilient. Similarly, Windows, the world's dominant PC operating system, offers flexible deployment options from on-premises to the cloud.

In summary, we believe Microsoft possesses strong moat characteristics in an industry at the early stages of a substantial growth opportunity. Digital technology-led disruption is accelerating and Microsoft is at the frontier.

IMPORTANT INFORMATION

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