MAGELLAN SUSTAINABLE FUND (MANAGED FUND) (CXA: MSUF)

The Magellan Sustainable Fund considers environmental, social and governance factors and implements a proprietary low-carbon framework to invest in outstanding companies at attractive prices while exercising a deep understanding of the macroeconomic environment to manage investment risk. The strategy focuses on risk-adjusted returns rather than benchmark-relative returns. The investment process is designed to generate an unconstrained, concentrated portfolio of 20 to 50 high-quality companies.

Dom Giuliano,
Head of ESG/Portfolio Manager

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, and China added to worries about shortages and inflation by locking down cities to enforce a policy of zero covid-19.

The Magellan Sustainable Fund (Managed Fund) (CXA:MSUF) recorded a return after fees of minus 17.4%[1] for the 12 months. The stocks that detracted the most over the 12 months were the investments in Netflix (-3.2 percentage points of the total portfolio return in Australian dollars), Meta Platforms (-3.0 ppts), and China's Alibaba Group (-2.3 ppts). Netflix fell after the streaming service said it expected subscriber growth to slow and profit margins to narrow. 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. Alibaba dropped after the Chinese tech company announced sales figures that disappointed and Chinese regulators cracked down on local technology companies.

Of these three largest detractors, Netflix and Alibaba can be considered investment mistakes. For Netflix, there were two key errors. First, the impact of the elevated and sustained level of competition from other streaming platforms was underestimated. Second, the level of likely market penetration was underestimated, and therefore the potential market addressable by Netflix was overestimated. For Alibaba, the position sizing was overly large within the portfolio given the degree of regulatory risks facing facets of Alibaba's businesses. Both these mistakes have resulted in permanent erosion of invested capital. Meta Platforms is different in that the range of innovation, revenue and earnings outcomes remain wide, notwithstanding the pressures facing the business in the shorter term. Meta's management does have significant scope to meet its challenges, whether from TikTok, Apple's restrictions or its investment in innovation.

The stocks that contributed the most over the 12 months included the investments in Sydney Airport (+0.8 ppts), Chipotle Mexican Grill (+0.8 ppts) and Lowe's (+0.7 ppts). Sydney Airport jumped following a A$24 billion takeover offer from a consortium led by the infrastructure manager IFM. Chipotle surged after the US fast-food chain reported 'beats' on quarterly sales during the year and the company increased its long-term restaurant goal to 7,000 in North America, up from 6,000. Lowe's gained as a jump in home improvements amid a housing boom helped the company report higher-than-expected earnings.

OUTLOOK

In the past 12 months, inflation pressures have proven to be more persistent than expected, leading central banks to increase the size and pace of their monetary tightenings. While this is likely to result in a slow peak in inflation and a 'soft' landing, we see three risks to this outlook.

The first risk is that consumer expectations of inflation become unhinged, triggering a wage-price cycle. This would prompt central banks to conduct more rate increases, which would put more downward pressure on economic growth. The second risk is an unexpected supply- or demand-side shock that worsens the outlooks for growth and inflation. There might be, for instance, a disruption to energy supplies or a loosening or tightening in fiscal-policy settings. The third risk is that central banks fail to see that economic growth has slowed enough to rein in inflation and they keep raising rates and slow the economy too much.

We are cautious about the outlook for equity market returns over the next 18 or so months and on June 30 held a cash balance of 12%. As economies slow, we expect equity returns to be increasingly driven by a softening in earnings expectations rather than higher interest rates. Until the peak in interest rates and the likely path of growth become clearer, uncertainty will weigh on equity valuations.

PORTFOLIO POSITIONING[1]

Top-10 holdings at 30 June 2022

Security	Weight (%)
Alphabet Inc	7.7
Microsoft Corporation	7.5
Visa Inc	4.9
Mastercard Inc	4.7
Yum! Brands Inc	4.1
Novartis AG	4.1
Unilever PLC	3.8
Meta Platforms Inc	3.8
Reckitt Benckiser Group	3.8
Nestlé SA	3.7
Total	**48.1**

We think our portfolio of 27 high-quality companies is positioned to deliver on our investment objectives.

It is our conviction that high-quality companies will provide investors with the most reliable returns over the medium to long term. To be sure, returns from quality companies may lag over some short time frames, especially if investors are infatuated with mesmerising profitability forecasts that have a low probability of occurring in the medium to long term. History, however, has repeatedly shown that these periods are aberrations that are punctured when investor sentiment inevitably normalises. Indeed, this is what has happened over the past 12 months; investor risk appetite deteriorated.

One of the strongest signs of a quality company – in fact, almost a prerequisite – is pricing power. With the surge in inflation over the past 12 months or so, companies with pricing power have proven their value to investors because they have swiftly passed on higher costs to customers and thereby protected their profit margins. This advantage is compounded when companies sell something that their customers are reluctant, or unable, to do without when prices rise. Over the past 12 months, companies with these characteristics have performed comparatively well owing to their 'defensive' nature. Our investments with these characteristics include:

- Consumer staples such as Nestlé, Procter & Gamble, Unilever and Reckitt.
- Restaurant companies such as Chipotle Mexican Grill, McDonald's and Yum! Brands (owner of KFC, Pizza Hut and Taco Bell) that are enjoying an added boost to revenue and profit growth from new stores.
- Utilities Eversource Energy from the US and Red Eléctrica of Spain that offer predictable cash flows thanks to regulation. While not regulated in the same way as utilities, Verisign's monopoly business of managing domain names '.com' and '.net' provides significant revenue stability.
- Novartis, one of the world's largest and most diversified drugmakers. The medicine sales of the Switzerland-based group are relatively immune from the economic cycle.
- Well-positioned mass-market retailers such as Walmart are increasingly successful vendors with economies of scale across physical and digital commerce. The retailer's strong grocery offer and growth prospects in digital are expected to provide stable revenues through the economic cycle.

In the medium to long term, quality companies that are exposed to powerful and lasting thematics are rare and valuable. The portfolio's investment in quality stocks comprises:

- Companies leveraged to digital advertising (Alphabet, owner of Google, and Meta Platforms) that have privileged positions in the industry and offer companies compelling returns on their advertising spending. Moreover, their scalable business models mean they enjoy high profit margins.
- Leading western 'hyperscale' cloud providers that are part of Alphabet, Amazon and Microsoft. The shift to the public cloud is a long-duration thematic that we expect to grow about 20% p.a. to 2030. These companies are well placed because of their technological leadership and economies of scale.
- Enterprise software companies (Microsoft, Salesforce and SAP) that boost company productivity. These companies are well positioned if economic growth slows and companies look to operate more efficiently.
- Payments companies Mastercard, PayPal and Visa that are leveraged to the cash-to-cashless transition that was turbocharged during the pandemic. Moreover, they benefit from faster inflation (by clipping the ticket on the value of personal consumption expenditures) and the reopening of international borders, which boosts their revenue from high-margin cross-border transactions.
- Companies benefiting as economies reopen such as those exposed to increased travel (airport groups Aena of Spain and Fraport of Germany) and vacation (Booking Holdings, one of the world's largest online travel platforms).
- Banks as they are one of the few potential beneficiaries of higher interest rates. US Bancorp is poised to see its net interest margins rise as central banks increase key interest rates. However, a harder landing scenario could pose nearer-term cyclical risks from higher loan losses.
- Companies benefiting from technology-enabled growth (Intercontinental Exchange and Netflix). Intercontinental Exchange of the US provides essential financial markets infrastructure and operates some of the largest futures and equities marketplaces and has a leading position in the sprawling mortgage-technology market. Netflix is leveraged to the broad shift from pay TV to streaming video on demand.

Dom Giuliano

Performance as at 30 June 2022[2]

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	7 years (% p.a.)	10 years (% p.a.)	Since inception (% p.a.)
Magellan Sustainable Fund (Managed Fund) (CXA: MSUF)	-10.4	-	-	-	-	-0.6

1 Portfolio positioning may not sum to 100% due to rounding.
2 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). Fund inception date is 11 December 2020 (inclusive).

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