MAGELLAN
EXPERTS IN GLOBAL INVESTING

Q&A:

WITH HAMISH DOUGLASS

Hamish Douglass, the Chairman and CIO at Magellan, talks about the global strategy's performance over the past 12 months, tells how he assesses the regulatory risk tech stocks face, and explains why the recent US stimulus package won't prove inflationary and why the market outlook is so uncertain.

Q1. The past 12 months have been a rollercoaster on share markets. Stocks dived when the pandemic struck and then rallied on news of vaccines such that November was the best month in nearly 46 years. How has the strategy fared over this time?

The past 12 months was an extraordinary time on stock markets. To understand what happened with markets and the strategy, it's best to split the period into three chapters. The first is when the pandemic arrived in many countries in early March and stocks crashed over the next month. These weeks were true crisis management. Defensive businesses such as McDonald's, Starbucks and Yum! Brands that easily withstood the ructions of the global financial crisis in 2008-09 were forced to shut outlets all over the world. Suddenly, we had to evaluate the balance sheets of some of the most defensive businesses in the world where these companies had no revenue yet needed to meet their lending repayments. In a recession, the revenue of quick-service restaurants and café chains might drop 5%. Yet here their revenue dived 85%. Normally when markets crash, we wouldn't think of selling stocks and going to cash. Normally we'd say; where should we invest? But 12 months ago, we were analysing the debt obligations of many businesses and also our exposure to emerging markets because we wanted to remove these risks from the portfolio. We tell investors that we seek to preserve their capital. And that's why we adopted the defensive mentality we did. The strategy performed well during this initial phase when markets plunged.

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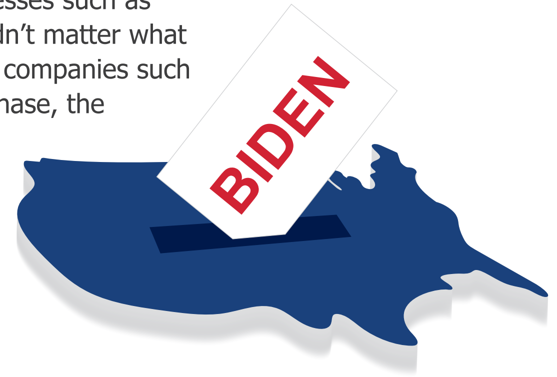
The second chapter covers the bottom of the market from April to October, over which time extreme monetary and fiscal stimulus supported many businesses and asset prices. Governments worldwide stepped in with job-keeper programs while central banks dramatically eased monetary policy. They cut interest rates,

conducted massive asset purchasing, provided emergency liquidity and offered innovative credit-like facilities. The global economy steadied. There was still huge uncertainty about the course of the virus but the risk of bankruptcy disappeared for many businesses. During these months, we deployed cash cautiously by investing in highly defensive businesses such as utilities, and businesses such as SAP that have idiosyncratic risk. It really didn't matter what might happen with the pandemic in terms of the outlook for US utilities and companies such as Crown Castle International that owns communication towers. Over this phase, the strategy performed solidly.



The third chapter started in early November and was as dramatic as the first. The announcement of the very strong vaccines trial results on November 9 and the election of Joe Biden as US president led to a massive increase in the risk appetite of investors and support for more cyclical investments. The strategy has underperformed during the extremely strong cyclically driven rally from early November through to March.

Q2. Your strategy entails a defensive bucket of stocks that's lower risk than world equity markets. How do you assess your portfolio management since markets roared from early November?

"Our strategy runs less risk than the market and we were never going to outperform the strongest market recovery in decades"

In hindsight, the time to act was before November because there's no use reacting once the cyclical horse has bolted. The question is why we missed the cyclical recovery. We spent a lot of time in September and October evaluating more cyclical investments such as Wells Fargo and travel-related investments such as Booking.com, Amadeus, Safran, Marriott and American Express. We decided at that time to retain investments in long-term structural growth business such as Microsoft rather than switch investments into businesses that may do better in the short term from a strong economic recovery. This was in part due to our lack of conviction on the likely outcome of the vaccine trials and the downside risk if the trials failed. All the cyclically exposed companies we evaluated have rallied strongly since the vaccines were announced in early November. In hindsight, we were too cautious.

We think it's important that people understand our global equity strategy is an inherently defensive strategy. Our strategy runs less risk than the market and we were never going to outperform the strongest market recovery in decades. This is a reason why our strategy has performed so strongly in down markets. About half our portfolio is always invested in defensive businesses such as consumer staples, utility-like businesses and cash. The market has rallied more than 20% since November 1. Defensive quality assets have effectively gone nowhere in that period and this has been the major reason why our strategy has lagged equity markets since early November.

Q3. The strategy owns the big tech platforms from China and the US. Regulators are looking at these businesses. How do you view this risk?

"Even a US$2 billion or US$3 billion fine is not a big blow to these companies…"

First, I would say that the regulatory risk for each of these companies is real and is not unique to China. There are anti-trust investigations underway in the US against Alphabet, Amazon, Apple and Facebook; early in April this year, Chinese regulators settled their anti-trust case with Alibaba. When we view this risk, we think about the likely actions that regulators might take. We think their penalties will most likely be fines and behavioural undertaking on business practices. But even a US$2 billion or US$3 billion fine is not a big blow to these companies because their revenues are huge numbers.

The bigger problem would be if regulators forced structural changes on these companies. We think about what structural changes could happen, how they might hit the economics of these businesses and how that would affect the share price. For the most part, the regulatory risk is already priced into the share prices of these companies whereas the share price doesn't always fully reflect the expansion opportunities that await these companies.

Q4. The Biden administration is implementing or plans to implement about US$4 trillion in fiscal stimulus. Any concerns about this?

First of all, we need to split this amount into a near-term stimulus plan of US$1.9 trillion and another US$2 trillion of spending on infrastructure over eight years that is to be largely paid for by higher taxes. Long-term plans funded by higher taxes are unlikely to prove inflationary. So the inflation risk is largely contained to the recently passed stimulus package that is funded by borrowing.

If inflation were to rise and the Federal Reserve reacted by raising interest rates that would be a problem for stock markets. What's our view of this risk? Our view is that the package is unlikely to trigger a permanent rise in inflation to troubling levels that forces the Fed to abruptly raise rates. This is a one-off stimulus program and some of the money will be saved. Our expectation is that US inflation will rise in the short term but it is then likely to recede when the spending burst has passed. What people need to understand is that the structural demographic and technological forces behind low inflation are likely to prove to be entrenched.

Q5. What's your outlook for share markets?

The next 18 months will be hard to pick. The 50-50 probability is that today's strong market conditions continue. This view is based on vaccine rollouts reopening economies that are still enjoying huge fiscal and monetary stimulus. The major assumption here is that the Fed sees no reason to tighten monetary policy.

On the other hand, foreseeable risks exist that could easily result in a 20% market correction – this is what makes the next 18 months so difficult to predict. One of the risks is the virus keeps mutating. Evidence is emerging that mutations are compromising the vaccines. If the virus were to mutate in a way that rendered vaccines ineffective, the imminent economic recovery that everybody's expecting could be materially delayed.

Another risk is that pockets of the market at the moment appear to be speculative bubbles. You can easily tally about US$5 trillion of assets, from cryptocurrencies to Tesla, that are not underpinned by any fundamental earnings. They're speculation. And if these bubbles were to unravel, that could drag down a wider range of investments.

It's inevitable that some of these bubbles will deflate. They could go on for five years or they could unwind in three months. No one knows. Thus it's credible to envisage scenarios where markets remain strong. When there's all this euphoria around, however, a dose of reality and some caution is probably warranted.

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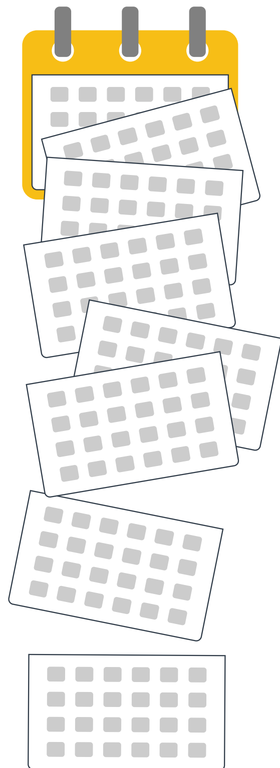
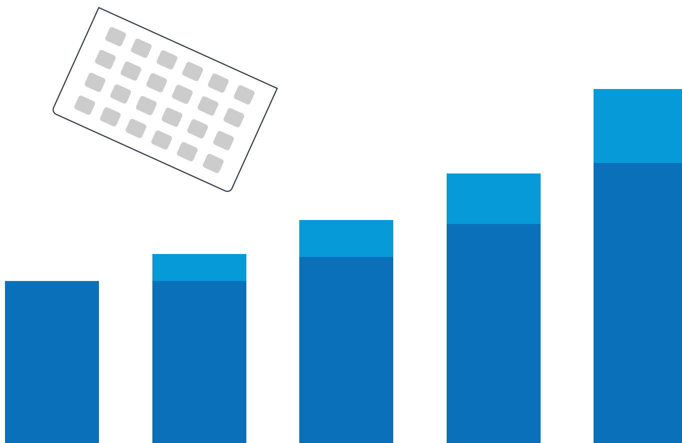


Q6. Given your outlook, what's the one piece of advice you would give investors?

People need to distinguish between investment and speculation. There is an enormous amount of speculation occurring. Many people have made enormous amounts of money in the past 12 months from speculating. Speculators in Bitcoin are not thinking about what cash flows will do over time. But that's what investors do. They try to identify businesses that have assured cash flows in coming years so they can earn compounded returns as time goes by.

Looking at things in short time frames such as over three or four months is misleading when it comes to evaluating great businesses that compound over time. We bought Microsoft shares at US$28 in 2014. The shares cost about US$260 today. Whether Microsoft went up 20% in the past three or four months is irrelevant in compounding terms over the long term.

Our strategy is first about investing in great businesses that will compound the capital of our investors over the long term. Second, the strategy tries to do this while taking on less risk than the market. We think that's what investing is all about. Warren Buffett often says to finish first, you must first finish. People who are just following others into fads might not finish. My advice is to think as an investor, not as a speculator.



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