Magellan High Conviction Strategy Update

Video Transcript (May 2020)

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Mark Burgess:

Welcome everyone to today's dedicated high conviction update, designed to give investors a greater focus on the high conviction strategy's recent performance, as well as an outlook going forward. My name is Mark Burgess and joining me today is portfolio manager for the high conviction strategy, Chris Wheldon. Welcome Chris.

Chris Wheldon:

Hi Mark.

Mark Burgess:

Chris. I think a perfect place to start would be to remind everyone exactly what it is you're trying to achieve in the management of the high conviction strategy.

Chris Wheldon:

Well, first of all, we should highlight some of the commonalities between high conviction and our other portfolios at Magellan. High conviction adheres to the same investment philosophy and the same process, it's supported by the same investment team, and Hamish Douglas is the lead portfolio manager. So in those respects it's actually quite similar to our other portfolios, but there are three notable differences. First of all, as the name might suggest, it's a very concentrated portfolio. It's our 8 to 12 best investment ideas. And that means in this portfolio, we can expose clients to some really high quality businesses. Businesses that have long enduring tailwinds behind them that provide that compounding opportunity, and we get to be very disciplined around trying to find a very attractive price with these investments.

Chris Wheldon:

Secondly, we've relaxed some of the constraints to provide a bit more flexibility in the strategy. First of all, we can take cash up to 50% of this portfolio. Likewise, we can be a little bit more offensive in this portfolio compared to some of our other ones, and we've opened up the universe to include very high quality mid cap businesses for the high conviction strategy. And the third area of difference is that we've embedded an active currency hedging program within the high conviction strategy. So you put those things together, Magellan's investment DNA very much infused in this portfolio, the 8 to 12 best ideas, the limited constraints and more flexibility, and the active currency hedge, and Mark, what we're trying to do is to provide high and attractive absolute returns to investors over the medium to long term. But, and of course there's always a but, what we always want to be very transparent and upfront with investors about is the idea that they're trading off that potential for higher longterm returns, with the elevated likelihood of some shorter term volatility, just given the more concentrated nature of this portfolio. Now that doesn't bother us necessarily at all, but it's something we want to be very transparent about that clients should consider that.

Mark Burgess:

Well, speaking of short term volatility, COVID-19 has certainly seen some wild gyrations in the market since February this year. What changes have you made to the portfolio since the beginning of this pandemic?

Chris Wheldon:

Well, it's worth highlighting, Mark, but we actually didn't do anything in the portfolio in the months of December last year and in January and February of this year. And I think over time, investors should expect that pretty low level of turnover, given we're trying to expose investors to those wonderful businesses over the long term. But it is true that in March we recognized the implications associated with coronavirus and we shifted to a much more defensive posture across our portfolios at Magellan, including our high conviction fund. And that meant that during the first quarter we exited two positions, we exited Yum! Brands and we exited LVMH. Yum! Brands was really around some short term question marks around their balance sheet and funding profile. And LVMH was just recognizing that in this environment that just didn't have the same attractive investment profile. Now Tencent was a business that we actually entered during the first quarter and attached to the email that's going out with this video, we've got some commentary around our views on that business and that investment. So please have a look at that.

Chris Wheldon:

And then finally we were trimming some of the other positions within the portfolio during the first quarter, and we were most active in trimming those businesses that had the highest degree of economic sensitivity.

Mark Burgess:

So how would you characterize the makeup of the strategy at the end of the first quarter?

Chris Wheldon:

Let's start with cash. So cash increased from about 5% of the portfolio at the end of February to about mid to high 20% levels at the end of March. So a very meaningful increase in cash during the first quarter. There was another 35% of the portfolio at the end of March in four businesses, Microsoft, SAP, Alibaba, and Tencent. And we expect all four of those businesses to be incredibly resilient during this initial shutdown period, but also in the recessionary period that we expect will follow. And pleasingly, that view has been supported by the first quarter results from these companies so far. Take Microsoft as an example, this is a very, very large business already, a trillion dollar plus market cap, but just in the first quarter of this year, it grew revenues year on year at mid teen levels and its operating profits grew by nearly 30%, which just speaks to the resiliency and the quality of these sort of businesses.

Chris Wheldon:

Now there's another 6% of the portfolio in Starbucks, and Starbucks, we think, remains a very attractive business over the long term. That business will open 500 or so units in China this year. Again, notwithstanding the environment, over one new cafe open in China per day this year is quite breathtaking. And we think Starbucks is a business that will be very resilient to the economic downturn, but we separate it just because we recognize it is acutely exposed to this initial shutdown period. We think it will survive this period, but we just wanted to call out that it's probably got some bumpy quarters ahead of it, but it will remain a very defensive business in the economic downturn and very attractive over the longterm. So there you've got 70% of the portfolio in five very high quality businesses and businesses with good resiliency to an economic downturn and in cash. It's a very high quality and defensive core to the portfolio.

Chris Wheldon:

And then there's another 30% of the fund invested across four businesses, Alphabet, Facebook, Visa, and Estee Lauder. And we recognize these businesses are more cyclical and they're going to have some challenging short term headwinds ahead of them. Importantly, though, we recognize the quality of these businesses and the industries in which they operate will recover and will grow over time. We expect digital advertising will continue to take share of total advertising and digital payments will continue to take share of total payments over time. And just as importantly, for these businesses that do have that high cyclicality, the balance sheets of these businesses are incredibly healthy, which allows them, first of all, to survive this downturn, but also potentially to do some really attractive things and to emerge stronger and take advantage of the opportunities that may emerge through this downturn. So those businesses we recognize they might have a bumpy couple of quarters or years potentially ahead of them, but we think they remain incredibly well positioned for the long term.

Mark Burgess:

Okay, great. So we've touched on the cash. We've touched on the equity side of the portfolio, but as you mentioned from the outset, one of the features of this strategy is the fact that it can actively hedge the currency. Can you talk through both the impact of this as well as your current hedging position?

Chris Wheldon:

Yeah, that's a really important question, and it's something else that we did in March to add to the defensiveness of the portfolio. Investors may have seen that we disclosed, as at the end of February, the portfolio is about 54% hedged and that dropped to about 26% hedged as at the end of March. Now that reduction in the hedge level isn't as dramatic as it sounds, because you recall I mentioned earlier that we increased cash by about 20 to 25% in March, and we don't hedge cash and we've never hedged cash. [inaudible 00:08:14] account for most of the reduction in that hedge level. And the balance of the reduction was because we shifted our range modestly lower, just recognizing the very uncertain economic environment that we're in and also recognizing the pro cyclical nature of the Australian dollar over time. So we thought it was appropriate that we're shifting to a more defensive posture in the portfolio by increasing cash and reducing cyclical equity exposures, we should be consistent and add that additional layer of downside protection by reducing the hedge levels.

Mark Burgess:

Okay. So as we sit here today, you've got approximately 25% of the portfolio in US dollar cash. What might it take for you to deploy some of that cash in the market, given that we've already had a rebound of sorts? What are the signs you're looking for?

Chris Wheldon:

We always see there's two risks in investing. There's the risk of losing money, which is fairly obvious. And then there's the risk of missed opportunities. You rightly mentioned we've got a pretty meaningful cash allocation at the moment that will allow us to take advantage of those opportunities when we see them. Sitting here today, though, we still have quite a cautious view on the macro environment. There is still, in our minds, a very high degree of uncertainty and a very wide range of potential outcomes as it relates to the health, the economic, the policy aspects of this crisis. Further to that, adding to that uncertainty is our view that prevailing prices for most equities don't appear that attractive at the moment. Prices for most equities don't seem to allow for a lot of potentially bad news or bad outcomes. So you marry those ideas of a very uncertain macro environment with prevailing price levels, and it just seems to us that risks here at the moment seems skewed to the downside.

Chris Wheldon:

So to answer your question a bit more directly, Mark, I think probably one of two things needs to happen. We'd have to feel like there's a dramatic reduction in the risk associated with the macro backdrop, or we'd feel that prevailing prices offered a more attractive investment profile. Until one of those two things happens or both of those things potentially happen. I expect we'll retain that defensive posture that we've got at the moment. A different way of answering that question that might be more useful is highlighting the work we're doing on the opportunities today and the opportunities we hope to find over time. We're searching for those incredibly high quality durable businesses, operating in attractive and growing industries. We'll be very insistent as always on a big margin of safety and trying to acquire those businesses at a very undervalued price. And then we're going to seek to own those businesses for the longterm to allow the compounding of those businesses that had those wonderful economics to compound for clients over the long term.

Mark Burgess:

Thanks Chris. Now, before we go, are there any last thoughts that you'd like to leave with us today?

Chris Wheldon:

Well, maybe, Mark, I could just try and tie a few of those ideas that we've discussed together and stress again, that we have no idea in the short term what's going to happen with market prices or with macro developments, but importantly, we've built the high conviction process and we've built the high conviction portfolio to allow for a very high degree of flexibility and responsiveness within our universe of incredibly high quality businesses at Magellan. And in the meantime, I think investors could recognize that in this portfolio they have a very meaningful allocation to cash at the moment, which provides a lot of defensiveness, but a lot of optionality as well. We have a meaningful amount of cash to deploy and we'll deploy it in some concentrated investments in super high quality businesses when we think that's appropriate to do so. And in the meantime, the rest of the portfolio is made up of some incredibly durable, high quality, profitable, defensive businesses that we think over time will thrive and will compound for investors over the long term.

Mark Burgess:

Pertinent final thoughts. Thanks, Chris. And thank you for your time today. As Chris mentioned earlier, there is some supporting material attached to this update email, including the Tencent stock story, the latest research reports, as well as of course the April fund fact sheet. And as always, please feel free to share this with clients and colleagues as you see fit. Thanks again, and stay safe.