

MFG GLOBAL SUSTAINABLE STRATEGY



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The MFG Global Sustainable Strategy 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.

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 strategy recorded a gross return of minus 17.1% in US dollars for the 12 months. The stocks that detracted the most over the 12 months were the investments in Meta Platforms (-3.2 percentage points of the total portfolio return), Netflix (-3.1 pts) and China's Alibaba Group (-2.2 pts). 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. Netflix fell after the streaming service said it expected subscriber growth to slow and profit margins to narrow. 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 penetration was underestimated, and therefore the potential market size available to 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 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 (+0.6 pts), Chipotle Mexican Grill (+0.5 pts) and Lowe's (+0.5 pts). 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

Top-10 holdings at 30 June 2022¹

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 thematic 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.



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Performance (USD) as at 30 June 2022²

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	7 years (% p.a.)	10 years (% p.a.)	Since inception (% p.a.)
MFG Global Sustainable Composite (Gross)	-17.1	2.5	6.6	-	-	7.7
MFG Global Sustainable Composite (Net)	-17.7	1.7	5.8	-	-	6.9
9% p.a. Objective Excess (Gross)	-26.1	-6.5	-2.4	-	-	-1.3

Capital Preservation Measures³

Adverse Markets	Last 36 months	Last 60 months	Since inception 67 months
No. of observations	12	19	19
Outperformance consistency (Gross)	42%	63%	63%
Down Market Capture Ratio	1.0	0.8	0.8

1 Holdings based on a representative portfolio for the strategy. Portfolio positioning may not sum to 100% due to rounding.

2 Returns are for the Global Sustainable Composite and denoted in USD. Performance would vary if returns were denominated in a currency other than USD. Inception date is 1 October 2016. Composite (Net) returns are net of fees charged to clients and have been reduced by the amount of the highest fee charged to any client employing that strategy during the period under consideration. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Fees are available upon request. Refer to the GIPS Disclosure section below for further information.

3 Capital preservation measures are calculated based on the Global Sustainable Composite before fees in USD. An Adverse Market is defined as a negative 3-month return for the MSCI World NTR Index (USD)⁺, rolled monthly. The Down Market Capture Ratio shows if a fund has outperformed a benchmark during periods of market weakness, and if so, by how much. Inception date is 1 October 2016 (inclusive).

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The MSCI World Index (Net) is a free-float adjusted market capitalization weighted index that is designed to measure the equity performance of 24 developed markets. Index results assume the reinvestment of all distributions of capital gain and net investment income using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties.

GLOBAL INVESTMENT PERFORMANCE STANDARDS (GIPS®) DISCLOSURE

Magellan Asset Management Limited, doing business as MFG Asset Management in jurisdictions outside Australia and New Zealand, (MFG Asset Management) claims compliance with the Global Investment Performance Standards (GIPS®).

For the purpose of complying with GIPS, the Firm is defined as all discretionary portfolios managed by MFG Asset Management, excluding brands managed by subsidiaries operating as distinct business entities. MFG Asset Management is a wholly-owned subsidiary of the publicly listed company Magellan Financial Group Limited. MFG Asset Management is based in Sydney, Australia. Total Firm assets is defined as all assets managed by MFG Asset Management, excluding assets managed by subsidiaries operating as distinct business entities.

The Global Sustainable composite is a concentrated global equity strategy investing in high quality companies (typically 20-50 stocks) with an integrated ESG risk assessment process, including a low carbon overlay and specific ESG exclusions on societal grounds related to either material manufacturing or retail exposures to Tobacco, Alcohol, Gambling, Controversial Weapons, Civilian Firearms, Adult Entertainment and other activities that Magellan may specify from time to time. High quality companies are those companies that have sustainable competitive advantages which translate into returns on capital materially in excess of their cost of capital for a sustained period of time. The investment objectives of the Global Sustainable strategy are to earn superior risk adjusted returns through the business cycle whilst minimising the risk of a permanent capital loss with specific ESG exclusions and a meaningfully lower carbon intensity than broader equity markets. The composite name was changed from Global ESG to Global Sustainable on 1 November 2020 following the restructure of our Global Sustainable product offerings into two distinct strategies, one with additional ESG exclusions and one without. The Global Sustainable strategy does apply additional ESG exclusions.

To achieve investment objectives, the composite may also use derivative financial instruments including, but not limited to, options, swaps, futures and forwards. Derivatives are subject to the risk of changes in the market price of the underlying securities instruments, and the risk of the loss due to changes in interest rates. The use of certain derivatives may have a leveraging effect, which may increase the volatility of the composite and may reduce its returns.

A copy of the composite's GIPS compliant presentation and/or the firm's list of composite descriptions are available upon request by emailing client.reporting@magellangroup.com.au

The representative portfolio is an account in the composite that closely reflects the portfolio management style of the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio may differ from those of the composite and of the other accounts in the composite. The representative portfolio for the Global Sustainable strategy changed on 1 November 2020 following the removal of the additional ESG exclusions from the previous representative portfolio. Information regarding the representative portfolio and the other accounts in the composite is available upon request.

USD is the currency used to calculate performance.