

## Magellan – In The Know: Episode 18

### Prudence in Volatile Times: A panel discussion with senior members of Magellan's investment team

**Announcement** ([00:00](#)):

The information contained in this podcast is for general information purposes and does not constitute investment advice. You should seek investment advice tailored to your circumstances before making an investment decision.

**Host** ([00:14](#)):

This is In The Know, a monthly investment podcast brought to you by Magellan Asset Management, experts in global investing. We bring you timely, unique and thought provoking insights to help you make sense of today's investment landscape.

**Alan Pullen** ([00:29](#)):

It's not surprising that we have seen an increase in inflation, but I think it's been a lot bigger than everybody anticipated. Obviously we get 7% reading in the US, much higher than anybody would've thought a year ago, nobody would've predicted that.

**Host** ([00:44](#)):

That's Alan Pullen, Magellan's head of financials outlining how the spectre of inflation emerged in 2021 and how it looks certain to put pressure on interest rates in 2022. Welcome to Magellan In The Know, in this special edition of our podcast, Alan is joined by his colleagues, Head of Technology, Communications and Media, Ryan Joyce and Co-Head of Franchises, Hannah Dickinson. They're Hosted by Magellan's Key Account Manager, Jennifer Herbert, for a discussion about the current volatile investment landscape, the challenges of investing in China and the inflationary economic outlook. But first here's a warm new year welcome from Jennifer.

**Jennifer Herbert** ([01:28](#)):

Thanks to everyone for joining us for the first episode of In The Know for 2022. We hope you all had a relaxing and safe Christmas break with loved ones and a brace for another interesting year ahead. Who would've thought that two years after the onset of COVID, we'd still have so much uncertainty and so many restrictions whether mandated or self-imposed isolations, we're certainly not through the woods yet, but if you're an eternal optimist like myself, you'll be planning for a better year this year than the last.

**Jennifer Herbert** ([01:57](#)):

I'd like to take this opportunity to thank all of our listeners, your support has been tremendous, and we've just ticked over 190,000 downloads since we launched in August, 2020. We're delighted that the podcast is so well received and are very excited about the fascinating lineup of guests we have in store for you in 2022. In this episode, I'm thrilled to be joined by three key members of the Magellan investment team. The investment team is the backbone of what we do here at Magellan.



**Jennifer Herbert** ([02:27](#)):

And it's great to get them out of the engine room and in with us here today as guest speakers on the podcast. By way of introduction, the three portfolio managers we have with us today are firstly, Ryan Joyce, our Head of Technology, Communications and Media. Welcome Ryan, it great to see you.

**Ryan Joyce** ([02:45](#)):

Thanks, Jen.

**Jennifer Herbert** ([02:46](#)):

We also have Hannah Dickinson, our Co-Head of Franchises. Welcome Hannah and thanks for joining us.

**Hannah Dickinson** ([02:52](#)):

Thanks, Jen.

**Jennifer Herbert** ([02:53](#)):

And finally last, but certainly not least, we have Al Pullen, our Head of Financials. Welcome you too, Al.

**Alan Pullen** ([02:59](#)):

Great to be here.

**Jennifer Herbert** ([03:01](#)):

Today we'll be digging deep into key sectors of focus in the portfolio and discussing thematic that shaped last year and those that will continue to be influential into 2022. Perhaps we should start by reflecting back on 2021 and the extraordinary year that it was. Global stocks soared to record highs. And in fact, the S&P Index was up almost 27%. The tech stocks now portfolio ex China did especially well over the first 11 months of 2021. Ryan, perhaps you can talk us through the strength in the tech sector over that period,

**Ryan Joyce** ([03:38](#)):

2020 and most of 2021 was really something of a perfect storm for the share prices of technology and high growth stocks more broadly. And we saw that in the NASDAQ, which was up around 70% over those two years. In my view, there were really two key dynamics at play over that period. First is you had this massive change in the behaviour of consumers and businesses that resulted in a lot of tech companies in particular reporting higher than normal levels of revenue growth, as well as above normal profit margins.

**Ryan Joyce** ([04:11](#)):

And in a lot of cases that was being extrapolated into the future and increasing what people were willing to pay for them. Second, you had an increase in speculative behaviour or willingness to pay for future growth, more broadly driven by the combination of lower rates, the stimulus programmes, people being unable to spend money on going out and travelling as well as a creation of baskets of things like COVID winners or other thematic like the metaverse that often had no reference to value or future cash flows.

**Ryan Joyce** ([04:41](#)):

And just to highlight that speculative behaviour, we saw VC funding in 2021 was over 600 billion. And that compares with a bit under 300 billion in 2019. And in the US there were around a thousand IPOs in

2021. And that compares with just a couple hundred on average, over the past 20 years. And both of those can really be thought of as insiders selling parts of their business and what they think are pretty attractive valuations.

**Ryan Joyce (05:07):**

Now in the later parts of 2021, we did begin to see their behaviour of consumers and businesses start to normalise. And some of that speculation come out of the market and that's resulted in some fairly brutal stock moves as the markets built in more realistic growth forecast and pay more attention, I would say to the long term earnings power of those businesses. And just to highlight some of those moves, we've seen Zoom fall from over \$500 to \$160 a share. Peloton fall from one \$160 to \$30 a share. Pinterest from \$85 to \$31. And we saw DocuSign fall from \$310 to \$130 a share including down 40% in a single day. It has become a bit more mixed.

**Jennifer Herbert (05:48):**

Yeah, we definitely did see profits being taken last December and also early this year. And this followed a lot of noise around the market about tech being broadly overvalued. What's your take on the sector from here?

**Ryan Joyce (06:00):**

As you mentioned, we have seen a bit of a correction, but in my view that does remain a fair amount of speculation in the market for high growth businesses and these so-called COVID winners. And while some of the businesses will deliver on those high expectations, I expect a lot of companies will also disappoint as that behaviour continues to normalise. And for that to result in some more of those large negative moves like the one I've mentioned, and hopefully some of those moves end up being a bit overdone and do provide some interesting opportunities for us. Importantly I would add that while full by historical standards, we think valuations of portfolio stocks like Microsoft and Alphabet and Meta and Netflix are quite reasonable when taking a medium to long term view and also less subject to that rebasing of expectations. Although you could obviously see some volatility there in the near term also.

**Jennifer Herbert (06:50):**

Hannah, I'd like to turn to franchises now and talk specifically about the quick service restaurants. We have a number of these now portfolio including McDonald's, Starbucks and Yum! Brands, which of course owns Pizza Hut, Taco Bell and KFC. We saw great resilience and adaptability from these businesses during the first wave of COVID. But the issues feel quite different during the second wave, why do you think that is?

**Hannah Dickinson (07:14):**

Well, most countries have moved from a zero tolerance strategy to more of a living with COVID strategy as vaccination rates have increased. During the first wave back in 2020, quick service restaurants closed their doors and sales plummeted across the world. But this time they're staying open and that comes with its own set of challenges, consumers still want their cheeseburger or their oat latte, but in some cases there aren't enough staff members to serve them at the counter because the whole team is isolating or there's a shortage of core ingredients because of congested shipping and trucking routes. I think the pandemic has really exposed the interconnectedness of global supply chains and the fragility of them. These are complex global systems that usually operate in the background unnoticed, but they seem to be buckling under the pressure.

**Jennifer Herbert (08:06):**

Well, this is definitely something that we've all felt directly. I mean, all you need to do is look at the supermarket shelf to see the effects of the supply chain issues. During the first wave, it was a demand story with the shelves clearing due to panic buying, while this time it seems to be a supply issue with not enough workers to get their produce from vine to supermarket shelf, it's really quite extraordinary. Hannah, what are the quick service restaurants doing in response to these supply chain issues?

**Hannah Dickinson (08:32):**

Yeah, I'd say that this latest wave of the virus has exacerbated some of the pressures that were already bubbling away. But I think we have to take a step back and remember that these global restaurant chains are really adept at navigating through volatility, even in a pre COVID world, they were dealing with different operational challenges every day. And the big companies like McDonald's or Yum! are really advantaged in terms of procurement power and digital or drive through capabilities. These challenging times can actually be a chance for them to gain share over smaller competitors.

**Hannah Dickinson (09:07):**

The labour shortage has been particularly interesting to me, as we've seen an evolution in the way companies are thinking about it and managing it. You would've heard of the great resignation and it has certainly hit the hospitality and leisure sector hard. There are stats that over one million workers or 8% of the workforce still haven't returned to the industry since February, 2020. It initially looked like a temporary issue related to stimulus payments and unemployment benefits. But it's clear now that there are many more factors that are preventing restaurant workers from returning to work.

**Hannah Dickinson (09:45):**

It could be lack of reliable childcare or just difficult working conditions or new options like becoming a delivery driver for Amazon. Companies are starting to make some longer term strategic investments in people and wages. If we take Starbucks as an example, it has always put its workers first and strives to be an employer of choice. At the beginning of the pandemic before any government support measures were announced, Starbucks was one of the first companies to commit to paying its workers while stores were closed.

**Hannah Dickinson (10:20):**

Then in October, 2021, Starbucks announced that it would be increasing its average hourly wage in the US to \$17 an hour, which is about 20% above the national average wage of \$14 an hour. We're fully supportive of that decision because it means they'll be ready and able to ramp up capacity when they need to. And we're not too concerned about the margin impact for Starbucks because they have the pricing power to offset it in the medium term. Most people will continue buying their daily cappuccino when the price goes up from \$4 to \$4.20.

**Jennifer Herbert (10:56):**

Al, the financial sector in 2021, it had a very strong year with the sector up over 30% on the year, and the traditional banks while coming off a low base did particularly well, why was that?

**Alan Pullen (11:08):**

Yeah, Jen, that's right. Financials do tend to be quite economically sensitive. They react to what's happening in the underlying economy. And of course we saw a pretty strong rebound last year, coming off that really low week year, the year before, because of the initial impacts of the pandemic. Most financials did pretty well, insurers, exchanges, credit rating agencies, all posted solid gains for the year. And as you mentioned, banks did particularly well. The household sector was particularly strong last year. We had stimulated payments. We saw about the strength in employment, anybody who wanted a job could get a job last year. And that means everybody was paying off their debts. Banks remarkably saw record low credit costs last year, a big recovery and profitability, and that was reflected in their strong share price performance for the year.

**Jennifer Herbert (11:58):**

Would you say there's still further upside in the banks, and if so, is it an opportunity that we are looking at?

**Alan Pullen (12:04):**

Well, a lot of the good news is now in the price and with credit costs likely to inevitably normalise at some point, that's going to prove a headwind for banks over the medium term. Having said that, they do benefit from higher rate increases. If we see rates increasing as we expect, that'll be some benefit to their net interest revenue. We continue to monitor the sector to see if there is an opportunity there to take some exposure.

**Alan Pullen (12:31):**

But the problem is that if we get too many rate rises, if the fed finds themselves behind the curve on inflation, that actually starts to impact sentiment and economic activity. And we get those credit costs coming up much more quickly than people will currently expect. It's really a mixed outlook for banks at this stage. And given we've still got these longer term threats, disruptive threats from big tech companies from FinTech still impacting the sector's long term outlook. It's really a challenging risk reward in the space at this point and we're sitting on the sidelines.

**Jennifer Herbert (13:05):**

Great. Thank you, Al. And look, I'd like to turn to China now. China was a huge focus for the world throughout 2021, and will continue to be so going forward. We have direct exposure through Alibaba and indirect exposure through some of our franchise positions. Let's start by focusing on our direct exposure through our investment in Alibaba, which of course is domiciled in China. Ryan, Alibaba has been a real headache for investors over the last couple of years. We've seen the pulling of the Ant IPO, the disappearance of Jack Ma, antitrust fines, as well as other government intervention. They held an Investor Day recently, did anything new or interesting come out of that?

**Ryan Joyce (13:47):**

Yeah, absolutely. In addition to those factors you mentioned, another headwind for Alibaba has been increased competition in e-commerce as smaller competitors have entered this space with a bit of a different angle or a different consumer proposition, whether that's live streaming, whether it's offering more value orientated goods that are delivered direct from manufacturers or community group buying. And then those competitors have also been spending heavily on sales and marketing to grow GMV and really try and establish themselves as a platform.

**Ryan Joyce** ([14:19](#)):

And so Alibaba's been responding to those challenges in various ways, but the Investor Day was really an opportunity for it to provide insight into the strategic nature of those investments beyond just kind of matching them in terms of spending on sales and marketing. And I thought management did a good job of explaining the investments it's making in creating a multi app portfolio, including more value orientated apps like Taobao deals, and also offering different fulfilment models that suit the different needs of consumers, but which require significant upfront investments in its supply chain.

**Ryan Joyce** ([14:52](#)):

Now, while those investments will continue to weigh on earnings, the upside in our view is that they'll enable Alibaba to continue to serve the breadth of the Chinese population rather than conceding portions of the market to competitors. Management also highlighted some additional disclosures. The company will start providing going forward, that includes for its China local services business Ele.me, and its Southeast Asian e-commerce business, Lazada. Now both of these businesses are loss making today, but we do think they have meaningful standalone value. And hopefully these disclosures combined with a willingness to take on some external capital or even IPO, some of them will see that value reflected at some point.

**Ryan Joyce** ([15:34](#)):

Now offsetting some of those incremental positive takeaways, we are seeing economic weakness in China in the past few months, and that's being driven by a combination of the regulatory actions, including in the property sector, as well as ongoing COVID lockdowns and inflation and unsurprising that's impacting retail sales and particularly more discretionary categories like apparel where Alibaba is quite strong, so that's something we're also mindful of.

**Jennifer Herbert** ([16:01](#)):

Well, I have no doubt that analysts are welcoming increased disclosure from the company. As we weigh up the opportunities and the risks associated with Alibaba, is clear that we still want to be investors in the business. What is it that we believe Alibaba has to offer over the longer term?

**Ryan Joyce** ([16:17](#)):

At a high level I would say that notwithstanding those near term headwinds, we've talked about, we do remain believers in China's long term economic growth and the related growth in consumer spending that comes with that. And as the dominant e-commerce company in China, Alibaba's well positioned to benefit from that growth as well as that continued shift in purchases online. On top of that, Alibaba's favourably exposed to another mega trend in cloud computing where it's the clear market leader in China in terms of market share and capabilities.

**Ryan Joyce** ([16:48](#)):

And then while we might prefer it, wasn't the case. We do think it's incredibly cheap at the moment, given the near term company regulatory and macro issues it's facing, Alibaba's trading at around 15 times Ford earnings, and that includes no contribution from its cloud business. It includes significant upfront investments in commerce that should moderate over time. And it includes significant losses from the likes of Ele.me and Lazada, which we spoke about, so it looks very attractive.

**Jennifer Herbert** ([17:18](#)):

Hannah, a number of our franchise stocks also have Chinese exposure, but it's quite different as the companies we own are domiciled outside of China. What are the risks that we need to manage with regard to our indirect Chinese exposure?

**Hannah Dickinson (17:32):**

We do own a number of companies and Western consumer brands that operate in China, so they're exposed to the same macro drivers as Alibaba, but things do look different when we drill down to the sub sector level. Interestingly, some of the competition type headwinds that Alibaba is facing would actually be tailwinds for consumer brands because it means they can advertise and distribute their products across different platforms and target consumers across new cities or demographics. And over time we could see the total cost of marketing come down, which would help their margins.

**Hannah Dickinson (18:04):**

In terms of risks, China's zero COVID policy will be an ongoing challenge for companies over the next year or so. Today there are at least 20 million people or about 1.5% of the population in lockdown across the country, so that will have a direct impact on restaurants and retail spending, but it will also prolong some of the supply chain pressures that we are seeing at a global level.

**Hannah Dickinson (18:27):**

There are a couple of other longer term risks that we are thinking about. One is the ageing of the population and another is the party's common prosperity agenda. Common prosperity really envisages a reshaping of society's wealth distribution from a pyramid to an olive. When the agenda was first articulated in August last year, we questioned whether it was signalling a fundamental shift in the party's attitude towards economic growth consumption and the accumulation of wealth.

**Hannah Dickinson (18:59):**

But the messaging from officials has softened in recent months, which has given us some comfort that the policy changes won't be too damaging for consumer brands. In fact, I think it could be a real positive for companies like Starbucks and Yum! that cater to the emerging middle class rather than the ultra wealthy.

**Jennifer Herbert (19:17):**

I think we all agree that China does offer compelling investment opportunities, putting risks aside for the moment. But what about the country's slowing GDP, does this change our appetite for investment?

**Hannah Dickinson (19:29):**

Our strategy has always been focused on companies with structural growth tailwinds that will compound over time rather than ones that are overly reliant on cyclical drivers. If we take coffee as an example, in the US, the average consumer drinks 330 cups of coffee per year, so nearly one a day. But in China, that number is less than 10 per a year. If we look at store density, Starbucks has just over 15,000 stores for a population of 300 million in the US. Whereas in China, it has less than 5,000 stores for 1.4 billion people. We think there's a clear runway for growth in the demand for coffee, but also in the number of Starbucks stores. And I'd also point out that the pace of the store rollout is something that is within the company's control, so it gives the growth algorithm a degree of predictability that we quite like.

**Jennifer Herbert (20:22):**

Thanks, Hannah. Let's now move on to what is possibly considered to be the biggest elephant in the room, and that's inflation. AI, you did touch on this earlier, but I'm keen to dig deeper on the subject. Inflation has now reached a 39 year high in the US, with the fed reacting by tapering its asset purchases. It's also accelerated worldwide and sparked much debate and speculation around whether the inflation is going to be transitory or structural, and whether it will result in a significant rise in interest rates. This could have huge ramifications for markets. AI, as an ex central banker, I know that you are always thinking about inflation. What are your thoughts on the current outlook? And should we be concerned?

**Alan Pullen (21:05):**

Yeah, Jen, this is the big question in financial markets at the moment. And as an ex central banker, as you say, always thinking about inflation and particularly now it's just such an interesting time for global central bankers. We kind of think that the initial impetus for this inflation is largely transitory in nature. When we think about what happened last year or during the pandemic in the US, we had these massive stimulus payments going into people's bank accounts. This is the old fashioned helicopter money that Ben Bernanke was talking about years ago in theory, we actually got it happening during the crisis.

**Alan Pullen (21:43):**

We had the fed doing quantitative easing and fiscal policy, dropping money directly into people's bank accounts effectively. And we saw a 40% increase in the money supply in the US over the period of the pandemic. That's a huge increase in money supply. If we go back to famous economists such as Milton Friedman, he said, "Inflation is always and everywhere a monetary phenomenon." We could have expected that to put some pressure onto the inflation rate, but we had so much disruption on the other side to economic activity, we weren't sure how much.

**Alan Pullen (22:18):**

Then you combine that impact with what's been happening in terms of the supply chain disruption. And we saw Hannah talk about what we're seeing with our companies in terms of supply chains and the global nature of those supply chains being disrupted, that's put a lot of pressure onto input pricing as well. We see oil prices up, and it's not surprising that we have seen an increase in inflation. But I think it's been a lot bigger than everybody anticipated. Obviously we get 7% percent reading in the US, much higher than anybody would've thought a year ago. Nobody would've predicted that.

**Alan Pullen (22:55):**

Where to from here? Well, those two impacts that were the initial trigger for the inflation, they are moderating. We're not seeing the stimulus payments being repeated in the US. The supply chain is slowly, slowly going to get fixed as work has come back into the system after having COVID or having a full immunity from their vaccinations. Those two impacts should moderate, but what we worry about now is that that inflation that was seen becomes embedded within expectations, that people's wages demands start going up to reflect the inflation that they've seen.

**Alan Pullen (23:31):**

And that's what central banks are really worried about, that that transitory nature of those initial shocks becomes embedded in expectations. And we see more inflation going forward as wages go up. It's a fascinating time. We should be worried. The fed is clearly behind the curve here. When I was working at the reserve bank 20 years ago, if you had told me that inflation would be at 7% and the policy interest rate would be at almost zero, I would've said, "That's impossible. There's no way that could happen." Yet that's exactly the situation we find ourselves in today.



**Alan Pullen (24:06):**

The fed is behind the curve, we know they're going to start raising rates. They might have to move faster than people expect if we do not see inflation starting to come down. It should come down from here. As we said, some of those impacts that started to cause it will fade going forward, but there is a real risk here that we see the fed tightening more than expected and that their tightening has a significant impact on economic activity and markets.

**Alan Pullen (24:32):**

We've done work here in the macro team on what triggers bigger draw downs in markets historically. And the number one trigger historically for market draw downs is central bank tightening. It's clearly a period of elevated risk for markets, for asset valuations and for economic activity, so something we've got to have to continue to monitor really, really closely. And yes, we should be concerned.

**Jennifer Herbert (24:56):**

Very interesting times. Hannah, I'm interested in your perspective here. Are we concerned about inflation with regards to our franchises holdings, which stocks in the portfolio would be well placed should we see this rising rates?

**Hannah Dickinson (25:10):**

It's certainly the topic [inaudible 00:25:11] and it's proving more persistent than companies originally expected. Most consumer companies are seeing pressure or they're still seeing pressure across their cost base from raw materials and packaging to labour and logistics. I mean the cost to ship a container from China to the US has increased tenfold since the start of the pandemic.

**Hannah Dickinson (25:31):**

I think a real sign of the times was when the discount retailer Dollar Tree raised its prices for the first time in 35 years, from a dollar to a \$1.25. The best antidote to inflation is pricing power. The companies that are well positioned are the ones that have a demonstrated track record of raising prices and protecting their gross margins over time. But there are other levers they can pull outside of simply raising prices, like they could introduce new innovative products at premium price points or adjust the package formats and sizes to improve the revenue per unit.

**Hannah Dickinson (26:07):**

We generally avoid companies that are playing in ultra competitive categories like yoghurt or categories where consumers don't have strong brand preferences like rice or milk. At times like these, those are the areas where brands face a real trade off between raising prices and maintaining sales volumes. Inflation will end up hitting their bottom line.

**Hannah Dickinson (26:30):**

Aside from categories, business models are also important to consider. If we take Yum! And McDonald's as examples, they operate under what's called a franchised business model, which means that the restaurants themselves are run by independent franchisees. Those franchisees have a typical restaurant P&L, so you can imagine they earn revenue every time someone buys a cheeseburger and they have costs like labour and beef. But as the franchisors Yum! and McDonald's earn their income by taking a royalty fee on restaurants sales rather than restaurant profits.

**Hannah Dickinson** ([27:06](#)):

The beauty of that model is that when restaurants push through menu price increases to cover the cost of higher wages and raw materials, it increases the royalty fees that McDonald's and Yum! are earning, but their cost line isn't going up by the same amount. That's what we call positive operating leverage. And it means that these companies can be net beneficiaries of a bit of inflation, which I think is something that is often underappreciated by the market.

**Jennifer Herbert** ([27:32](#)):

Well, I think that's good to hear, and it does give us some comfort on how our franchise stocks would fare in a rising rate environment. Now, Ryan, I imagine the tech stocks could be vulnerable to inflation and rising rates as they sit more on the growth end of the spectrum. How are you thinking about inflation risk?

**Ryan Joyce** ([27:50](#)):

At a high level you are right in that the valuation of assets whose forecast cash flows are longer duration or more backend weighted are more sensitive to higher rates, keeping all levels equal. And technology companies that are expected to grow very strongly and which in many cases may not be generating any cash flows for the next few years due to heavy upfront investments certainly fall into that bucket and have been most impacted by the increase in yields we've seen so far.

**Ryan Joyce** ([28:17](#)):

Now that said while entire sectors can get caught up in the short term as portfolios are repositioned. As Hannah mentioned, it's important to consider the implications and exposures on a stock by stock basis. And so if you think about Alphabet or Facebook, which are two of the larger positions in the portfolio, they are obviously growth businesses, but they're advertising based business models also offers some protection against inflation in that if the price of the goods and services that they're advertising go up, the price that merchants will be willing to pay for the ads for that should also go up assuming there's no issues on the demand side. So they don't have to go out and get price increases to offset inflation.

**Ryan Joyce** ([28:57](#)):

And Hannah also talked about pricing power. Microsoft and Netflix, two other large positions in the portfolio are good examples of businesses with strong pricing power. In August last year, Microsoft, for example, announced that it was going to increase prices for its Office 365 subscription by 10% to 25%. And that will come into effect in March 22, which the timing has turned out quite well. And you're not going to see anybody switch off that subscription as a result of those price increases.

**Ryan Joyce** ([29:27](#)):

Similarly, Netflix just recently announced that it would increase prices in the US and Canada by a bit over 10%. And again, we expect to see very little churn there given the value of the service. Now, Amazon's a bit of a different one, but also very interesting in that while it is experiencing a lot of inflation and supply chain disruption in its retail business at the moment, it is actually choosing to eat a lot of that in the short term to further increase customer loyalty and ultimately build long term value.

**Ryan Joyce** ([29:58](#)):

And Amazon because of its history of really putting the consumer first and conditioning its investors to think long term is one of the few companies in the world that's afforded the luxury by markets to do that rather than needing to protect its near term earnings through price increases. Amazon is really treating this inflation and supply chain disruption as an opportunity. While as our mentioned rising rates are certainly a headwind to valuations and a risk to economic activity. If we see significant tightening, we do feel the tech stocks in the portfolio relatively well positioned to protect their real earnings power.

**Jennifer Herbert (30:35):**

Thanks Ryan. Now, I do want to move on from inflation, but before I do, I have a less specific question for you AI, but one that certainly interests me. The current love affair that the market has with cryptocurrency is probably being fueled by the fact that interest rates have been so low for so long, making it hard to get decent returns from fixed income and term deposits, et cetera. If we do see a significant increase in inflation and a subsequent increase in interest rates, do you think we'll see investors less enamoured with cryptocurrencies and perhaps even find a renewed interest in old school banking practises again?

**Alan Pullen (31:10):**

Yeah, that's an interesting question, Jen. It's hard to be definitive. Ryan mentioned that higher rates increase at discount rate that you apply to future cash flows, lowering the value of an asset. But of course, Bitcoin doesn't actually have any cash flows. You never expect to see cash coming out of it. Theoretically it's not impacted, it's a purely speculative investment. It only depends if you can consider it an investment, it only depends on what other people are willing to pay for it at any point in time. It's more what will happen to sentiment I think over time.

**Alan Pullen (31:44):**

And yes, true as the rates of return on alternative investments such as term deposits, where you are right, it's been hard to get any return on these safer assets and people have reached for risk. So as you get a return on those safer assets again, that certainly could impact demand at the margin for some of these more speculative investments. But really I think it comes down to sentiment. And if we do see increasing rates impacting sentiment of asset markets more generally, that could certainly have a negative impact on Bitcoin and the more speculative end of the investment universe, but it's very hard to be definitive.

**Jennifer Herbert (32:23):**

Yes, it's going to be so interesting to watch that space. I do agree that part of the allure is excitement and momentum of cryptocurrency, so let's see how it plays out over the longer term. Now I'd like to direct one more question to each of you before we wrap up. AI, while I have you, I might just direct the first question your way. One diversified financial stock we hold in the portfolio, which we're very excited about is Intercontinental Exchange or ICE. And pleasingly it's had a very strong last quarter in 2021. To welcome, we attribute the recent share price strength, and do we believe we'll see further upside?

**Alan Pullen (32:59):**

Yeah. Just as a quick reminder, ICE has a number of business lines. It predominantly earns its money from its futures exchanges, trading things like oil derivatives, energy derivatives, emissions, as well as agricultural derivatives and financial related derivatives, such as interest rates, but they also have a really attractive growth platform digitising the mortgage market in the US, offering their technology to

do digital mortgages, which are still quite paper based and analogue as well as providing data to fixed income and other financial markets data is the new oil as they say.

**Alan Pullen (33:36):**

We think it's really well placed within those segments. And last year they had a really strong finish to the year and it really just reflected the strength in the underlying performance of the business. We saw some volatility in energy prices and that benefited the use of their markets, where people go to hedge that risk or speculate on those markets. That was really strong, we saw really good adoption of their environmental products as well. People trade emissions there to help manage their emissions, zero emissions outlook, as well as natural gas is becoming a much bigger part of that market as a really important transition fuel as we move to a zero carbon economy. That was all really good.

**Alan Pullen (34:19):**

We also saw strong adoption of their digital mortgage technology. We are seeing a slowing in refinancings in the US as interest rates increase and less people refinance their mortgage. But we're seeing much greater adoption of their technology over time. It really just reflected a strong underlying performance of the business and looking forward we still think it's well placed over the long term. It's pretty inexpensive on a Ford PE of 26 times. It's very capital light, so that translates into a free cashflow yield of around 4% at current prices. And we expect it to grow in the order of 10% a year going forward. It's a really attractive return Outlook and one we're pretty confident of.

**Jennifer Herbert (35:03):**

I've been hearing a lot about decentralised finance, which is the offering of financial instruments that don't rely on intermediaries, such as exchanges or banks. Instead, it uses smart contracts on a blockchain. Do you see this as being a threat to ICE?

**Alan Pullen (35:16):**

DeFi is interesting. DeFi is what the cool kids are calling it, Jen. And it's still in its infancy. It has numerous issues around the technology, around driving adoption, around regulatory impacts to be sure. However, the proponents do say that it has a potential to displace the significant parts of the traditional financial system with these decentralised kind of smart contracts and other systems. As I said, it's very, very early days and we'll have to wait and see centralised counterparties play a number of roles.

**Alan Pullen (35:51):**

But one area I do think there's a potential role to play is where really they're just doing the back office plumbing. They don't offer any service except making the transaction smooth and efficient. We call it the clearing and settlement kind of part of a transaction. And when you do say a foreign exchange transfer, put it into some money from here to the UK, they're actually a huge number or a large number of finance institutions that sit behind that, just to make sure that money gets there in the right way.

**Alan Pullen (36:22):**

And it's pretty old fashioned and relatively inefficient. Potentially that's something like DeFi where you're just doing that clearing and settlement piece could have a role to play. With ICE in particular, people have said it could impact exchanges. And certainly for perhaps a stock exchange where the clearing and settlement really just means you get the ownership of the share when you make a trade. DeFi could have a role to play there, getting you dividends, really it's just making sure the money goes from A to B.

**Alan Pullen (36:51):**

It's quite different though in the case of ICE. Yes, they have clearing houses that fulfil those functions, but they're also really a risk management tool. Trading futures, when you have a position there, you actually have to have a margin or you have to lodge it with a clearing house. And that margin manages the risk of that open position. And it makes sense to have it centralised because if say you long a gold future and short a silver future, you only have to hold the margin to cover the difference price between the two.

**Alan Pullen (37:20):**

It actually makes a lot of sense to be centralised. The exchange needs to monitor all those open risks and it's much, much more a risk management tool, not just a simple plumbing kind of clearing and settlement tool. It's a minimal risk to the likes of ICE, but an interesting space to watch nonetheless.

**Jennifer Herbert (37:39):**

Thanks, Al. Well, I'll be calling it DeFi from now on so I can be one of the cool kids. Thanks for the tip. Ryan, a final question for you. Facebook recently announced a name change to Meta. What do you think are the reasons behind the change? I mean, why would the company do that when Facebook is such a household name?

**Ryan Joyce (37:57):**

Sure, it's a good question and I think your question is actually part of the answer. Now we're obviously speculating a little bit to the true motives here, but I think there's two main reasons. The first is signalling that Meta is more than just Facebook. Obviously we're all familiar with Instagram, that's a very material part of the business and also growing much faster. WhatsApp has billions of users that it doesn't monetize yet.

**Ryan Joyce (38:23):**

And the company is investing very heavily in its vision of the Metaverse and that's obviously included in its name and that includes things like AR, VR. It has the Oculus VR headsets. It's introduced or released the Ray-Ban Stories recently and it sees a significant long term opportunity there. And when I say investing heavily in that area, I'm referring to its recent disclosure that it'll incur around 10 billion in operating losses in its Facebook reality lab segment in 2022, which is where a lot of that investment is being captured.

**Ryan Joyce (38:55):**

Now, the second reason which I referred to earlier is actually trying to create some separation from the constant stream of criticism and negative press that's directed at the Facebook app in particular. I think management prefer not to have that criticism attached to the parent company, kind of attached to the employees and negatively impact their morale or the ability to recruit good talent in what is a competitive environment. And also not to attach to whatever new products they launch in the future, including those related to the Metaverse. Now, whether a simple name change can actually achieve those things, it's hard to say, but it also doesn't cost them a lot. So from that perspective it's worth a go.

**Jennifer Herbert (39:35):**

Okay, Hannah, let's wrap up today by getting the crystal ball out and looking at the world of franchises. What excites you and what concerns you going into 2022? Are we generally positioned well for these scenarios?

**Hannah Dickinson (39:48):**

If the start of the year is anything to go by, I think what we might see is a lot more volatility in markets than we saw in 2021. As AI talked about, there's a lot of worry about inflation and how severe or swift the Fed's response will be. But even if I had a crystal ball on those questions, there are still so many second order effects that could really move markets around. For example, you have to consider the forces of market psychology, everything hinges on expectations and what's priced in today.

**Hannah Dickinson (40:19):**

We could easily see periods where stock prices become divorced from fundamentals. And that might sound like a bit of a scary playground, but I think what excites me is the buying opportunities that it could present, particularly when it comes to some of those high quality compounding companies that we've had on our wishlist for some time. And by high quality, I mean, companies with pricing power that will be able to navigate those supply chain pressures, companies with sustainable competitive advantages, companies with resilient business models that are not facing meaningful, disruptive threats. And I think the portfolio of companies that we have today definitely meets that criteria. And hopefully there's a chance to either add to those positions or consider some new ones.

**Jennifer Herbert (41:04):**

Well, they do say that volatility provides opportunity. And 2022 certainly could be a big year for both of those things. I think we might be running out of time, so I'd like to say a big thank you to all of our speakers today, Hannah, Ryan, and AI, it's been an absolute pleasure speaking with each of you, and thank you to you the listener for supporting our podcast In The Know. I hope you enjoyed the session.

**Jennifer Herbert (41:26):**

And for those of you who'd like to hear more from our investment team, I'd like to direct you to a series of short video interviews we produce bi-annually called the Magellan Minutes, where we interview individual members of our investment team and discuss topical issues as we did today. The next series will be out mid-February and you can find it on our website. We'd love for you to join us, stay safe everyone, and see you next time.

**Host (41:49):**

That was Magellan's Key Account Manager, Jennifer Herbert, joined by Magellan's Head of Technology, Communications and Media, Ryan Joyce, Co-Head of Franchises, Hannah Dickinson, and Head of Financials, Alan Pullen. We trust you've enjoyed this episode of Magellan, In The Know. Join us in a month's time for the next episode. For more information on upcoming episodes, visit [magellangroup.com.au/podcast](http://magellangroup.com.au/podcast), where you can also sign up to receive a regular investment insights programme. Thanks for listening.