Magellan – In The Know: Episode 19

Has the party run out of punch? 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 any 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.

Arvid Streimann (00:29):

Just remember that one of the Fed's mandate is to keep inflation under control. They've also started to talk about shrinking the balance sheet, a process that we would call quantitative tightening. Now, there is an issue here, Jen, and one knows, not even the central banks themselves, no one knows exactly what shrinking the balance sheet will do to the economy or even to the financial markets.

Host (00:50):

That's Arvid Streimann, Magellan's head of macro and co-portfolio manager, global strategies, speaking to Jennifer Herbert about the unpredictable times we find ourselves in. Welcome to Magellan-In The Know.

Host (01:08):

In this episode, Arvid is joined by portfolio manager, Elissa Di Marco, and investment analyst, Adrian Lu, to discuss what could impact markets in 2022. Hosted by Magellan's key account manager, Jennifer Herbert, they discuss supply chain challenges, the labour market, and resulting inflation and interest rates, as well as issues as diverse as cyber security, globalisation, and the state of the technology and payments industries. But first here's a warm welcome from Jennifer.

Jennifer Herbert (01:42):

Welcome to Magellan-In The Know. This is our 19th episode, and as always, we thank all our listeners for taking time to join us. This episode is the second part of our look at sectors and stocks in our global portfolios.

Jennifer Herbert (01:55):

In the January episode, I spoke to three senior members of Magellan's investment team covering everything from stock market price behaviour to China, and inflation. We had a particular focus on the franchises, tech, and financial sectors. Today, we're going to build on that conversation and discuss further macro considerations and their relevance to the enterprise software and payment sectors.

Jennifer Herbert (02:17):

The investment team at Magellan is 35 strong, which allows us to employ what we call inch-wide, mile-deep stock analysis. We're tremendously proud of our investment talent, and I'm thrilled to be able to showcase another three senior members of that team today. The speakers have collectively over 50 years of investing experience. So by way of introduction, in the studio, we're joined by Arvid Streimann, our head of macro and co-portfolio manager on the global fund. Welcome, Arvid. It's great to see you.

Arvid Streimann (02:46):

Well, thanks Jen. It's great to be back in front of the mic.

Jennifer Herbert (02:49):

We also have Elissa Di Marco, our payments company analyst and portfolio manager on the MFG Core ESG Fund. Welcome Elissa.

Elissa Di Marco (02:56):

Thanks Jen. Great to be chatting to you as always.

Jennifer Herbert (02:59):

And finally last, but certainly not least, we have Adrian Lu, our enterprise software and semiconductors analyst. Welcome to you too, Adrian.

Adrian Lu (03:08):

Thanks Jen. I'm looking forward to another exciting discussion.

Jennifer Herbert (03:12):

So we discussed the huge rally of 2021 in the last episode. In contrast, 2022 has started quite differently. Key equity indexes are soft and the hot air definitely feels like it's coming out of the market. Arvid, from a macro perspective, what do you see as the key reasons for this current softness across the board?

Arvid Streimann (03:31):

Well, thanks Jen. It's certainly been a volatile time and I think the first thing here to realise is that expectations are always priced into markets. So if you're trying to think of why markets have moved, it's really a case of expectations having changed. And I would say that the main area where expectations have changed since the start of the year is for inflation and interest rates and some things that we've talked about a lot in the past.

Arvid Streimann (03:54):

Now, both inflation interest rates, as you know, they're linked. And the two latest inflation reports out of the US have been higher than what people have expected and now the market is now assuming a faster increase in interest rates. And in particular, the bond market now sees the Fed at around one and three quarter percent by the end of this year. And if you rewind back to the start of this year, it was around half of that. So you can see how much things have changed.

Arvid Streimann (04:20):

But that's not all Jen, the Fed is also beginning to talk about shrinking their balance sheet, which you can think of as a reduction in liquidity, or maybe even the amount of punch at the party. Now, the second area I'd say here, where expectations of change is around Ukraine. It's really been in the news and people I would say, have increased their probability and what they're thinking the probability of military action.

Arvid Streimann (04:42):

Now getting back to the Fed, now that's the main issue, I'll talk a little bit about that, the record amount of stimulus from the Fed, but also the government. I think you've got to think about the government as well. That's very predictably resulted in some, what we would call very high valuations in some parts of the equity market. I think most people can see that.

Arvid Streimann (04:58):

Now to be clear, I don't think it's everywhere, but I think that there are parts of the market, the equity market, and maybe even assets more generally, where if you look at the valuations, they're very high by historical standards. Now, we've all seen interest rate cycles before and you often see these lower quality type investments do quite well when interest rates are low. And then when you get through the cycle, it often reverses when interest rates start to go back up again. And you know what? So much so that this backup that in some cases, these lower quality investments, they give all of their gains back. So it's really interesting times.

Arvid Streimann (05:34):

Now, whether or not what it's going to happen here depends on inflation and we will see what happens. But let me say that this continued market weakness, the things that you reference that's happening in January, Jen, that's just one potential scenario from here for that to continue.

Jennifer Herbert (05:49):

Adrian, two of the key stocks you cover in the portfolio are Microsoft, which is currently our largest holding and SAP, which is also in the top 10 holdings. Now Microsoft had a strong 2021 and both companies are experiencing a softer 2022 so far. With regards to the points that Arvid has highlighted, how do they apply to these enterprise software companies?

Adrian Lu (06:11):

Well, Arvid spoke about rising rate expectations and we've seen the impact of that on valuations in the tech sector, and that includes with Microsoft and SAP, who've traded down since the start of the year at a level not too dissimilar from the NASDAQ. And just more broadly, we've seen compression in valuations across the software space to varying degrees, depending on the cohort or companies that you're looking at.

Adrian Lu (06:35):

Mind you, it's not all just to do with rates. So there were some software companies outside of our portfolio that had terrific growth during the pandemic, but have really had to temper growth expectations coming out of it. But in terms of inflation, look, these enterprise software companies have generally good pricing power, so they're pretty well protected there.

Adrian Lu (06:57):

Now from an individual stock perspective, Microsoft's been pretty much an execution machine. These guys printed another remarkable quarter in January where the only real headwind was something that affected everyone and completely out of Microsoft's control and that was the hardware shortages in the supply chain, which I'd love to talk about later if we get a chance. But there's decent growth expectations priced into Microsoft. You saw that in the fairly muted share price reaction after this great result and it's not going to be immune if there's waning sentiment in the market. But I think Microsoft's still priced attractively and we're comfortable with our holding in the company.

Jennifer Herbert (07:35):

And what about SAP?

Adrian Lu (07:37):

Our investment thesis on SAP's a little different to Microsoft, and I'd characterise SAP as being at a much earlier stage of a business model transition. The other thing is, unlike Microsoft, the market isn't yet pricing in the successful outcome. So we're really backing the company's ability to pivot what is a very dominant position in back office enterprise software to the cloud, not too dissimilar to when we backed Microsoft's early cloud pivot years ago. And given that I think SAP's share price performance over the next couple of years is going to be largely dictated by the traction in this new strategy, and so far it's shown strong momentum in winning new deals and we're continuing to watch its margin profile.

Jennifer Herbert (08:24):

Elissa, it's different in your world. In contrast to the MSCI index, Visa and MasterCard underperformed last year, but both seem to be doing better in 2022. Why did they not have the 2021 tailwinds that many other companies experienced and why are they doing well now? What has caused the turnaround?

Elissa Di Marco (08:43):

You're absolutely spot on there, Jen. So in 2021, there was a lot of noise and uncertainty in the payment space. As most of you listening, you would've experienced, we had continued lockdowns and border closures globally, which then reduced our ability to travel and spend on entertainment. So this was really quite a big headwind for Visa and MasterCard.

Elissa Di Marco (09:04):

But in addition to that, there was also regulatory uncertainty, there was commentary from the largest eCommerce retailer, Amazon on the acceptance of Visa credit cards, and then there was also uncertainty from expansion of payment options, or which you could also think of as competition. So when we look at these events, they compounded and it led to Visa and MasterCard being oversold last year. However, at the tail of 2021, and then the start of 2022, we've seen that the payment companies, that they've started to recover from this under performance.

Elissa Di Marco (09:36):

So what actually caused this turnaround? So governments importantly, they've kept borders open as Omicron has taken over. Amazon, it also stepped away from blocking Visa cards and the competition fears were allayed as Visa and MasterCard payment volumes, they hit record highs in the fourth quarter. So when you put all of these points together, the market has regained confidence in the payment sector.

Elissa Di Marco (10:02):

But I suppose just summing up here, despite what happened last year, we remain confident in the investment thesis of Visa and MasterCard. They're very high quality businesses with sustainable growth and they have meaningful tailwinds.

Arvid Streimann (10:17):

So let me just jump in here quickly, just to give some perspective. In order for us to deliver attractive returns to our investors, we have to look for companies that are going to grow at strong rates for a long period of time. And you can think of that in some sense as companies that are going to grow faster than GDP. And companies like Visa and MasterCard, which Elissa just talked about, they fit the bill here and they really compound their earnings over time.

Jennifer Herbert (10:40):

Yes, the power of compounding, we do talk about that a lot at Magellan. Okay, let's move on now. I'd like to spend some time talking about supply chain issues.

Jennifer Herbert (10:49):

Now supply chain issues are affecting almost all businesses as we attempt to navigate our way out of the pandemic and there's plenty of noise around computer chips. I had no idea that a computer chip was integral in so many things, for example, the electrics in cars, smart phones, and a broad range of appliances, and that's just to name a few. Who would've thought that this tiny piece of hardware could cause such headaches on a global scale? Adrian, please enlighten us on why there's been such a shortage and the repercussions for product manufacturers and why it's taking so long for supply to meet demand.

Adrian Lu (11:22):

It's a real interesting one, Jen. And I have to say, when your parents are asking you about chips, you know it's really become front and centre, and it just reminds you, as you said, how critical these little pieces of silicon are across so many things we rely on every single day.

Adrian Lu (11:39):

What's important to realise about chip manufacturing is it's really complex and it's really capital intensive. There's a long lead time to build factory capacity, we're talking years here, and then the chips themselves take months to actually fabricate. And that really puts this shortage in context, because with the onset of the pandemic, you had companies reducing orders for chips and their own inventory because they were bracing for a prolonged demand contraction. I'm talking about companies that make end products like automobiles and capital equipment and smartphones and appliances. So in response, you had the chip makers reducing their capacity plans.

Adrian Lu (12:21):

And then a few months into lockdown, what they saw instead was a surge in demand for products and suddenly you needed more devices for hybrid working and learning, data centres needed more capacity to support accelerated IT demand, people had more savings to spend on goods, and factories just needed more equipment to make more stuff. So you get this step up in demand for chips happening all at once that chip makers really just weren't ready for and would need a couple of years lead time just to catch up on.

Adrian Lu (12:50):

And then of course this whole thing's been exacerbated by lockdowns impacting factory operations and logistics, but it's something we could start to see normalise later this year, if not early next year, as far as chips go.

Jennifer Herbert (13:03):

Yeah, the impact's been really huge, you just have to look at the car market. The reduced supply of new cars has made car prices quite ridiculous. And then the knock on effect is that people can't afford to buy a new car, but rather hang onto their old one, which affects supply in the secondhand car market, and the issue goes on. Arvid, do you have anything that you want to add here regarding supply chain issues? How long do you think that they're going to last?

Arvid Streimann (13:26):

Well, Jen, when we're thinking about supply chains, here's how I think about it. So the first thing I'd say is that there are many different things that you can buy, and so that means there any different supply chains, there's not just one single supply chain. And for sure, more and more things have semi-chips in them and many things don't, or at least for now. And some of those things without chips where there have been some supply issues, things like timber, chicken, rapid antigen tests, and of course, toilet paper and maybe even puppies when COVID first hit. There were a shortage of both, if you remember.

Arvid Streimann (13:56):

Now, because there are so many of these supply chains, how fast things recover depends on how or what needs to be done to get supply back online, or maybe just even increase. Now, Adrian was talking about semiconductor factories, and Adrian, how long do they take to build again?

Adrian Lu (14:13):

It varies on a few things like the type of chips you're building. So if you're adding tools to an existing fab or building an advanced Greenfield fab, which can take anywhere between three to five years to build.

Arvid Streimann (14:24):

Yeah, so that's a long time I would say, because people want to buy these things right now. But on the other hand, things like timber, you can increase supply there pretty quickly. Maybe you just need a couple of workers in the factory. And speaking of workers, I'd say this touches on one of the big issues, which is the worker shortage. I'm sure we've all noticed this. And I think there's a couple of points here that are really important on the labour market.

Arvid Streimann ([14:46]()):

Now the first is when we're thinking about COVID, obviously, and I think we all felt this, it was pretty hard to get into the office or to the workplace and it really stopped people getting to work. Now, hopefully this sorts itself over time. We've got the vaccines now and maybe more importantly, I think we're all feeling this as well, the fact is that many people just want to get back to normal. So in terms of that COVID effect on getting to work, I'm optimistic that we through the most of that.

Arvid Streimann ([15:11]()):

But the second thing is more interesting and I think that that is that a number of people who want to work has actually fallen. Now, some people may have decided to retire early, lucky them. And some people have said, look, I've got different life priorities after what we've gone through in COVID, and maybe they just want to spend some time with their families, and I'm sure we all do. But you know what? At the end of the day, there's less workers around and some of this change will be permanent. And what I mean by permanent is that realistically wages aren't going to rise to the amount required to get those folks back into the labour market.

Arvid Streimann ([15:43]()):

There are actually companies that are pulling back their opening hours because they can't find staff, which is just amazing. Now, when you think about this and you say, well, how do you fix this labour shortage? And there really is only one way in the short term and that's immigration, because if you think about it, if you're going to take the natural way to produce more workers, it takes about 18 years or so and I don't think we can really wait that long.

Arvid Streimann ([16:05]()):

Now, when it comes to immigration, look, I think that it eventually comes back so long as there's not more mutations that keep the borders closed. Now that's not a guarantee because it's very hard to predict where these mutations will end up with any conviction at all. But I think that's the key unknown in terms of getting those workers back into the office and the labour market sorted out again.

Jennifer Herbert ([16:25]()):

Look, it's certainly a challenging situation. And these supply chain issues have clearly been a very significant contributor to inflation as you'd expect. Things are really starting to heat up in this area as we're seeing some really worrying numbers come through. Where are we at? What's the Fed doing?

Arvid Streimann ([16:41]()):

Yeah. Well, supply chains have certainly contributed to inflation and I'd say then the higher interest rates that we're talking about right now are a direct consequence of that. But you just talked about the Fed, Jen.

Just remember that one of the Fed's mandate is to keep inflation under control, so there's pressure on the Fed there to do something. And I also think that Joe Biden would also love to see inflation come down because he's copping, politically, flack for this. And so maybe that influences the Fed to some extent as well.

Arvid Streimann (17:07):

But you ask what the Fed's doing. Well, I think they've done a pretty good job. They've communicated very carefully what they want do and that's starting to increase the fed funds rate. Of course, they haven't done it as we speak right now, but they are planning, or at least signalling they're going to do it shortly.

Arvid Streimann (17:21):

The other thing is that they've also started to talk about shrinking the balance sheet, a process that we would call quantitative tightening. Now there is an issue here, Jen, and no one knows, not even the central banks themselves, no one knows exactly what shrinking the balance sheet will do to the economy or even to the financial markets and that's because no one has completely done it before.

Arvid Streimann (17:42):

So when the Fed starts doing it, it's going to be a riskier than usual point in time from some economic perspective. And you know what? Who knows what markets are going to do and how they're going to react to that uncertainty. But one thing I'm pretty sure of is that I think it's unlikely that they are going to see it as a positive event.

Jennifer Herbert (18:01):

Okay. So would you say that this has already been factored into share prices?

Arvid Streimann (18:05):

I'd say that what's been factored into share prices right now are current expectations around interest rates and inflation, but these can change very quickly, we saw that in January. And you know what? They probably will change, because as you know, Jen, in financial markets, nothing really stands still for very long at all. So, when the Fed starts to increase the fed funds rate, this is going to slow economic growth, that's what it's designed to do. And what that means is that the growth outlet becomes less certain.

Arvid Streimann (18:32):

Now remember that the Federal Reserve's latest dot plots, this is a report they put out, they say that the long run fed funds rate is estimated to be around two and a half percent, that's their guess. And I think more or less what they are saying there is that's the neutral rate, two and a half percent. When you start to get around two and a half percent on the federal funds rate, that's when the fed funds rate starts to really stop supporting growth.

Arvid Streimann (18:55):

Now, if the Fed is right and this is the neutral rate, let's just assume that, then the closer that expectations and rates get to two and a half percent, then the more the growth outlook begins to look more uncertain, or perhaps we're going to say here, less certain. And so when we look forward, there you go, I think there's a couple of potential sources of uncertainty there, the first one being, what happens when the balance sheet starts to shrink? And secondly, what happens when rates start to approach that neutral zone?

Arvid Streimann (19:22):

Now that's one of many potential risks for markets that may not be priced in, that risk that markets have another continuation of what happened in January. Now I'm not saying that this is definitely going to occur. I think you've got to keep an open mind here, but that's a scenario that is more likely than usual. And just for completeness, I'd say that there is another scenario here which is the opposite, which is interest rate expectations have gone too far and inflation actually comes off faster than what people think. I don't think you can rule that out of your viewfinder and let's see what happens.

Arvid Streimann (19:51):

But as I said, I think we're in a period of heightened uncertainty on interest rates right now. What's happened in Ukraine's compounding that uncertainty. And you know what, Jen? I'm going to ask you a question here, what do you think is the most common trigger for share market corrections? What do you think?

Jennifer Herbert (20:05):

I'd have to say higher interest rates.

Arvid Streimann (20:07):

Yeah, and you'd be spot on, Jen. We've looked at that and past 120 years that is the number one reason for market corrections. And we've been watching interest rates very closely as a firm. We've been very careful not to be too exposed to stocks that would be most impacted if interest rates rise. Also, increased our cash a little bit because what happened in January. We did that ahead of January because what happened in January was reasonably predictive as far as these things go.

Jennifer Herbert (20:31):

Look, it's probably worth mentioning here that we do actually have a couple of stocks in the portfolio, which should in theory be net beneficiary should rates rise, and these include the payments companies. Elissa, perhaps you could flesh this out for us.

Elissa Di Marco (20:44):

Yeah. Absolutely, Jen. So as Arvid's been talking to, the exposure and impact of inflation risk, it varies by company and then also the sub-industry that they're part of. But when we're thinking about payments, the majority of the revenues for the payment networks, they're actually linked to the payment volumes so that they clip a fee as a percentage of the spending that goes through the card networks. So higher prices that come through from inflation mean that Visa and MasterCard actually will generate higher revenues. So assuming that this higher inflation doesn't then lead to a contraction in economic growth, then the greater inflation, it indicates that Visa and MasterCard will be net beneficiaries. So they actually add a sort of inflation protection to the portfolio.

Jennifer Herbert (21:30):

Okay. So it's nice that the payment companies are somewhat protected from inflation, unlike the lion's share of companies in the MSCI index, but they obviously have other threats that are keeping them on their toes. The first word that comes to my mind when I think of Visa and MasterCard is competition. The continued transition to a cashless society is of course a very favourable tailwind, but there seems to be so many new buy now, pay later, or funky payment systems popping up. Are they a fad or a real threat to Visa and MasterCard? Sorry, Elissa, there's quite a bit to unpack there.

Elissa Di Marco (22:04):

No, that's all right, Jen, happy to talk through some of the points there that you were just asking about. So there are longer term disruptive threats to Visa and MasterCard that are essentially driven by technology, but it's the timing of this potential disruption that is uncertain. So I might just take a moment here to explain why the timing is actually uncertain.

Elissa Di Marco (22:25):

So typically when we're thinking about disruption and how it occurs, it would, firstly, either occur because there's a superior technology to the existing. So our tech expert, Adrian, no doubt he could talk to us for a whole episode on this, but think of how we've shifted to cloud computing and how it's disrupted on premise computing. The second element for disruption is that a disruptor is actually trying to solve a problem. So when you're solving a problem, it would then lead to strong adoption. So think about how quickly we've had musical video streaming be adopted versus buying or renting content.

Elissa Di Marco (23:01):

You're probably asking now, well, how does this actually relate to the payments ecosystem? So when we think through the payments ecosystem in developed countries like Australia and the United States, so for consumer payments, the technology is somewhat seamless. So transactions online or at the point of sale, they're approved instantly. Consumers have fraud protections and payments are integrated into online and mobile banking. What is the consumer problem that the disruptors are actually trying to solve here? And in fact, when we're thinking about it, the problem that is trying to be solved here is that we're just creating more competition within the payment space.

Elissa Di Marco (23:40):

So given all of this put together, the path and the speed of disruption is really unclear. So with the path unclear, there is competition emerging. Now I could speak for the rest of the episode on this, but I'll just mention three areas of competition that we think about here internally.

Elissa Di Marco (23:58):

So the first one is one that you mentioned, Jen, which is buy now, pay later. And this is for example, Afterpay or Klarna. They're brands that you've probably heard about over the past few years. So in buy now, pay later, they're attempting to reshape credit payments. So they're giving consumers the option to buy now and repay in instalments. So buy now, pay later has been quite popular with the millennials and it now accounts for around 2% of global eCommerce.

Elissa Di Marco (24:25):

But the buy now pay later networks, they face extensive competition from within the buy now, pay later sector, but also from established payments players. And then there are challenges to building that network effect, which is something that we know and love about the payment networks. And Visa and MasterCard, they've been nurturing their networks for several decades now.

Elissa Di Marco (24:49):

The second area of competition that I think we should touch on here is cryptocurrencies. So there are over 8,000 cryptocurrencies globally. However, there are challenges for these currencies to be the backbone of global commerce. So firstly, it's on speed. Now I think this is a stat that many will be baffled by, but Visa processes more than 65,000 transactions per second, whereas Bitcoin is estimated at less than 10 transactions per second. So we really need the strength of your Visa and MasterCards for global commerce.

Elissa Di Marco (25:23):

And then with respect to crypto, there's also concerns about the stability in the value of cryptocurrencies and then there's also risks around money laundering. So there's many things to consider about with respect to cryptocurrency being a really viable avenue of competition.

Elissa Di Marco (25:37):

And then the final area I wanted to touch on is real time payments. So this is the threat that we're actually most concerned about here at Magellan. So real time payments, it's the ability to transact instantly. Now there's significant investment coming from central banks globally and they're trying to build out these new networks to initially send money between accounts. Now, if they're able to turn that new payment rail into a consumer payment rail, then this would be direct competition to Visa and MasterCard. Now it's still early days with respect to real time payments, but it's an area that we are monitoring really closely.

Elissa Di Marco (26:16):

So we spent a lot of time talking about risks, which is really important in how we protect on the downside here at Magellan, but I think it's also really important to talk about the tailwinds behind the payment networks. So Visa and MasterCard are beneficiaries of the transition to the cashless society, but also as we transition our spending to eCommerce. They're also benefiting from reopening as borders remain open at the moment. And as we mentioned before, they're an inflation hedge.

Jennifer Herbert (26:43):

That's fantastic. Thanks, Elissa. Now it's a bit of a topic change, but I'd like to turn to cyber security, something that's relevant for almost all businesses worldwide. This topic actually does genuinely worry me as there are some pretty sophisticated and fast moving hackers out there who I have no doubt would be happy to help themselves to my private data, let alone my bank account. They may find both rather underwhelming mind you, but I still have no desire to share. So Adrian, you're at the forefront of this issue, what cyber security risks are real out there for enterprise software companies?

Adrian Lu (27:15):

It's a great question, Jen, because cyber security's one of the biggest challenges facing all companies across our portfolio and across the economy, frankly. It's an issue that spans well beyond the tech companies that I look at. And it's quite frightening to see how incredibly sophisticated cyber crimes become. The types of attackers we see span the gamut of profiles. You've got really well resourced syndicates out there being run like large enterprises and it's lucrative business.

Adrian Lu (27:47):

They're also really innovative. We talked about software as a service, well, there's a thing called ransomware as a service, which is based on the same concept except with a subtle difference of being illegal. But we also see nation state attackers where the motives are maybe more to do with espionage or destabilisation rather than financially driven.

Adrian Lu (28:08):

Now, as we're becoming more digital as an economy, it also brings more complexity, which means more potential points of security vulnerability. And the more digital products we rely on, the more attack surfaces that provides for bad actors to try and exploit. And what I've come to learn is that most companies actually don't have security postures that are adequately keeping up with the adoption of digital tech and that's why we keep hearing about all these exploits and data breaches.

Jennifer Herbert (28:37):

So it sounds like this could be a real opportunity for software companies.

Adrian Lu (28:41):

It really is, and we're seeing tremendous innovation happening. And even though we're not directly invested in any pure play cyber security businesses, we do have exposure through Microsoft who generated $15 billion in security revenue over the past year, which believe it or not makes it the world's largest security software vendor by revenue. I'd probably just add that public cloud computing has some positive exposure to the security thematic, and that includes the likes of Google Cloud and Amazon.

Jennifer Herbert (29:13):

And Elissa, cyber security must be an issue for Visa and MasterCard, it's not just moms and dads and people like me on the one side that they need to protect, but also the banks on the other side. What do they have in place to mitigate these risks?

Elissa Di Marco (29:26):

Yeah, you're absolutely right, Jen. So similar to Microsoft, Visa and MasterCard have security at the forefront of their operations as it's a key risk if there was a breach.

Adrian Lu (29:39):

That's such a great point, Elissa, and it's a real testament they've so far managed to avoid serious hacks or data breaches.

Elissa Di Marco (29:43):

Yeah, you're absolutely right, Adrian. And for this reason, it's that Visa and MasterCard are prioritising the security of their network. So they are the largest payment networks globally and the functioning of Visa and MasterCard is essential for global commerce and the safety of the banks, but also for Visa and MasterCard's key customers. So just talking through a few of these.

Elissa Di Marco (30:06):

So firstly on consumer protection. So Visa and MasterCard, they invest heavily to protect the security of card users, that's us consumers. So for example, they have chargebacks which allow consumers to challenge a fraudulent transaction and to get a refund. They also developed tokenization. So this is where they substitute sensitive information for characters that then need to be decoded. So this is protecting our card details and hence our card balances and our identity.

Elissa Di Marco (30:37):

And then the third thing they do for consumers is on the analytics side. So they analyse location and spending patterns when approving transactions. This is just another element to improve the security. And then finally is their focus on security for banks. So banks are Visa and MasterCard's key customers. They have many products that they offer to banks to protect from cyber security and to protect customers. And then Visa and MasterCard actually generate revenues from the sale of these products to the banks.

Jennifer Herbert (31:09):

And while I have you, Elissa, cross border travel is opening up, which is really exciting for all of us. Visa and MasterCard are also huge beneficiaries, can you explain why?

Elissa Di Marco (31:20):

Your right, Jen. It is very exciting from a personal note. I know that many of us have been yearning to travel again, given the borders have been closed these past years. But there's not just been pent up demand for those on the call today, but there's pent up demand across most consumers. And when you couple that pent up demand with healthier balance sheet and then the confidence that the borders will remain open, it's created a really positive environment for the return to travel and entertainment.

Elissa Di Marco (31:48):

But why is that then a tailwind for Visa and MasterCard? So we typically pay with our cards for experiences, so things like restaurants and travel. So with the barriers to travel and entertainment nearing normal, and then that pent up demand, we're seeing consumers rush back to experiences. So this is really positive for Visa and MasterCard, especially when it's a cross border transaction, because these are higher margin and they're a higher ticket size.

Jennifer Herbert (32:16):

Well, that's excellent news for Visa and MasterCard and a good excuse for the four of us to go travelling, if we want to support our portfolio stocks. Arvid, question for you, globalisation or de-globalisation? What are your thoughts on this thematic as the world opens up again?

Arvid Streimann (32:33):

Well, Jen, globalisation, well, it's been a very powerful trend in the past 30 years, so it's a very good question. Now, if you think about globalisation, I think most people think of all the cheap stuff you can now buy, which is made overseas. But I'd also remind people that it's not just price, there's also variety. There's a lot more stuff that you can buy and it's just been amazing.

Arvid Streimann (32:52):

So, people like us and other people around the world, we've really benefited from this. If you think about it, if you've got the same amount of income, you can buy so many more different things and you've really benefited from that. But there's more to it than that. So if you look on the other side of the coin, there are all those workers in the Far East, in China, all through ASEAN who have more employment opportunities and I'd say higher wages as well than they otherwise would've.

Arvid Streimann (33:17):

Now, if you think about those big cities in China, you see all these big cities on the TV, they're there for a reason, because those people in China and all those other countries, they benefited from globalisation as well. But when we're thinking about globalisation, I think there's always pressures for globalisation to slow or maybe even to go into reverse. I think that's always been the case and I think there's a few things that are driving this right at this very moment.

Arvid Streimann (33:40):

And the first one I would say here is that countries really don't want to rely on their rival countries. So Adrian was talking about semiconductors, we can also think about medicines, vaccines, rare earth minerals, but a lot of these types of things, they are often built or maybe mined in other countries. And this issue that I'm talking about, you can see this right now with the US and China, neither country wants to rely on the other one because that other country might actually just decide to stop exporting to them, which obviously wouldn't be a good thing.

Arvid Streimann (34:11):

Now, similarly, countries not only don't want to rely on their rivals, but they also don't want to help their rivals. And I think once again, you can think of this in the context of the US-China relationship. The US has started making it hard for China to get their hands on these semiconductor chips that Adrian was talking about. And Adrian, how long does it take for China to become self-sufficient here? It could take a long time, I imagine.

Adrian Lu (34:33):

Yeah, it's an interesting one, Arvid. This is one that really takes up a lot of my focus. Semiconductors, they're seen as such a critical industry for competitiveness and national security, and China's been investing so heavily into closing that gap, but it's extremely difficult. They're probably about five years behind in advanced chip making, but that gap is really hard to close.

Arvid Streimann (34:55):

Yeah, so it's real interesting because the US isn't trying to help them close that gap obviously. The last thing I'd say here is there's always been voters of domestic politics and the politicians are sensitive to what voters feel. And we know that manufacturing workers were upset and they had the belief that manufacturing jobs were moved overseas and offshore. So they don't like globalisation and there is a real political feedback loop there.

Arvid Streimann (35:19):

So what happens to international trade, Jen, you're asking about out that, it depends on the benefits of trade versus those issues that I was talking about. Now, governments will decide whether to trade is a net benefit or not, and they'll decide and act accordingly. I doubt there's going to be wholesale decoupling, but there's always going to be puts and takes around that.

Jennifer Herbert (35:38):

Okay, we've covered a lot of topics today, including supply chain issues, inflation, cyber security, and globalisation. Let's wrap up with a final question for each of you on what lies ahead for 2022 and beyond. Elissa, what opportunities do you see for the payments networks over the longer term and how will this convert into shareholder returns?

Elissa Di Marco (36:00):

When we're thinking about the payment networks long term growth model, it's a combination of economic growth, the digitization of transactions that we spoke about earlier, and also their new product development. So when you add all this together, the networks can sustainably grow faster than the economy, and this is what Arvid had touched on earlier. This allows Visa and MasterCard to compound their earnings over time.

Elissa Di Marco (36:23):

So firstly on economic growth, economic growth, it's tied to consumer spending, which allows Visa and MasterCard to grow their revenues. Secondly, we mentioned was the digitization of transactions. So Visa and MasterCard, they will continue to benefit from the global transition from cash to digital transactions. The pandemic actually accelerated this trend and we view that it has actually had a permanent impact on how consumers transact. So Visa and MasterCard, they're not just investing in consumer payments, but they're also investing in the digitization of non-consumer transactions. This will be new flows for Visa and MasterCard as they try and digitise payments from government disbursements, but also businesses.

Elissa Di Marco (37:09):

And then the final growth engine that we were mentioning is new products. So while Visa and MasterCard, they're known primarily for allowing consumers to transact virtually instantly in a secure manner, creating that positive customer experience, there's actually a lot of add-on services that they're selling to merchants, but also to banks to enable those transactions. So there's significant opportunity in our opinion for Visa and MasterCard in selling products related to cyber security like we touched on before in digital identities, fraud and analytics.

Elissa Di Marco (37:44):

Now, I suppose just bringing everything together here, and it's really key for why we like Visa and MasterCard, it's that strength of their network. They're able to take these new products and these new customer flows and they're able to quickly deploy them across their global network. [inaudible 00:38:02] characteristics of a network effect, it's very expensive and it's time consuming to replicate by its competitors.

Jennifer Herbert (38:10):

Adrian, what are some of the opportunities that you think will be relevant to our existing or future software investments?

Adrian Lu (38:17):

A lot of innovation happening here. I'll highlight two or three other areas where there's imminent opportunity that's already starting to be monetized today. So I won't talk about the metaverse, I just wanted an excuse to drop the word, so I'm happy now.

Adrian Lu (38:33):

But a significant opportunity we see is in industry or vertical specific enterprise software. And for a long time, what we had was software vendors focusing on more horizontal or general purposed software that spanned across industries and then it was up to customers within each of those industries to either customise or augment that software to suit their industry specific needs, or in the worst case, having to adapt their whole internal process just to fit around the software rather than making the software work for them.

Adrian Lu (39:10):

And software vendors are now realising the opportunity in specialisation to solve problems for customers with industry specific needs to capture more value. So there's a lot of activity in this space. Elissa spoke about some of the digital innovations by Visa and MasterCard in payments and these are the exact sort of things that software platforms can help to enable.

Adrian Lu (39:34):

And there's a related area, but also a very interesting one, which is in process automation and application development, which is an area where software companies can provide enterprises with the platforms to very efficiently build out their own software, to serve their customers better, or to differentiate their business operations without requiring armies of consultants or software developers, who as we know are in really short supply.

Adrian Lu (40:02):

And maybe I'll just throw in a last one. There's a lot of exciting things going on in big data. We're generating staggering amounts of data at exponential rates across a multitude of systems and sources. And there can be a lot of value in connecting that seemingly disparate data and generating insights that might otherwise have been trapped. So interesting innovations happening in this space, Jen, that leverage cloud computing and artificial intelligence. And this is an area that organisations everywhere are recognising as strategically important, including many of those in our investment universe.

Jennifer Herbert (40:39):

Finally, Arvid, we've talked a lot about current issues, interest rates and inflation, but what are some of the potential issues into the medium term?

Arvid Streimann (40:48):

Well, Jen, once we get through COVID and all of these issues that it's triggered, it seems as though we might be back at the same point where we were before COVID. And I know that sounds strange, but hang with me here. The point that we were at was low growth, low inflation, low interest rate world. And you'll say to me, well, what's really different? And I'd say, well, there are always going to be some differences, and let me just talk about a couple of these as some closing thoughts.

Arvid Streimann (41:12):

Now, the first one, and this is probably the most obvious one is that we are in a world where government debt levels are much higher than they were before, I think we all know that. And that's because governments have more or less borrowed a lot of money and given it straight over to households. And that means that household balance sheets are in great shape, but the flip side is that government balance sheets aren't. You can think of it that way.

Arvid Streimann (41:33):

But is that a good or a bad thing? And I think that people have some different views on this, but I would make one point, and that point is that in some sort of equilibrium, you probably want whoever has the best ability to fund their deficits, either because they've got the lowest borrowing rate or the best access to credit, you want them to be the ones who have the most pressing demand for borrowing. Now I think that the world is in that situation with governments because they actually have the best access to capital. Now that's obviously a gross oversimplification, but in some sense, I think things could be a lot worse.

Arvid Streimann (42:06):

The last thing I'd say here, Jen, is that many people were wondering whether quantitative easing, which is that expansion into central bank balance sheets, many people were wondering whether that quantitative easing would actually work. And you know what? It probably worked, but I think the more powerful thing to say here is that it didn't fail.

Arvid Streimann (42:23):

And when I look forward, I wonder whether a politician somewhere one day is going to say something like this, they're going to say, you know what? We printed that money when we needed to and it didn't really cause any problems. And by the way, I'd really like to get some extra money for my little pet project here, or maybe I want to give it to that voter over there. You know what? No worries, I'm just going to print off some money again.

Arvid Streimann (42:45):

And that's the thing, Jen, what we have been through may have actually increased the likelihood of further quantitative easing in the future, which may mean that the risks or maybe the uncertainties that surround quantitative easing have actually risen in the median to longer term.

Jennifer Herbert (43:01):

Thank you, Arvid, plenty to think about. I'd like to say a big thank you to all of our speakers today, Arvid, Elissa, and Adrian. 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. We've hit over 200,000 downloads recently and continue to get great feedback, so thank you. I hope you enjoyed today's session.

Jennifer Herbert (43:24):

If you'd like to hear more from across our investment team, please head over to the Magellan website to access our biannual short video series, The Magellan Minutes. The most recent episode was released last week. Stay safe, everyone, and see you next time.

Host (43:38):

That was Magellan's key account manager, Jennifer Herbert, who was joined by Magellan head of macro and portfolio manager, Arvid Streimann, portfolio manager, Elissa Di Marco, and investment analyst, Adrian Lu. 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, where you can also sign up to receive our regular investment insights programme. Thanks for listening.