MAGELLAN HIGH CONVICTION FUND

Hamish Douglass, Chairman and Chief Investment Officer

Chris Wheldon, Portfolio Manager

The Magellan High Conviction Fund is a more concentrated and less constrained version of Magellan's core global strategy. The portfolio seeks to deliver an attractive risk-adjusted absolute return by investing in eight to 12 of the world's best global stocks. The portfolio employs an active currency hedging program to reduce the impact of foreign currency exposure when the Australian dollar trades outside its historical range.

PERFORMANCE

Global stocks rose in the 12 months to June 2020 after huge fiscal and monetary stimulus just offset the damage from the coronavirus to economic activity, company profits and investor confidence. Over the last three months of 2019-2020, stocks recovered from post-virus lows after an ebbing in infection rates in developed countries allowed governments to ease restrictions on everyday life, even though the economic hit from the virus was so stark that the US entered its first recession in nearly 11 years.

Both the Class A and Class B units recorded a return after fees of 6.1% for the 12 months. The stocks that performed best included the investments in Microsoft (+5.5% of the total portfolio return), Alphabet (+3.6%) and Apple (+2.8%). Microsoft surged to a record high over the period after its cloud business helped the software giant beat earnings and revenue forecasts and then held up relatively well when covid-19 hit because it was judged a stock that would benefit from greater online activity. Alphabet, the owner of Google, gained as it reported higher earnings over the 12 months and as online advertising held up better than expected during the pandemic. Apple gained after the company boosted sales forecasts, citing the popularity of the latest iPhone 11, new services such as Apple TV+ and items such as AirPods, and trade tensions between China and the US fell short of Beijing placing tariffs on iPhones.

The stocks that detracted from performance included the investments in Yum! Brands (-1.5%) and Starbucks (-0.5%). Yum! Brands fell after posting downbeat earnings and after its KFC, Pizza Hut and Taco Bell outlets were closed when countries ordered lockdowns or restrictions on restaurants to stop the transmission of the virus. Starbucks fell after an announcement in August that a higher tax rate and fewer buybacks would result in 2020 earnings-per-share growth below its long-term target of at least 10% and after its outlets were closed when countries ordered lockdowns or restrictions on restaurants to stop the transmission of the virus.

OUTLOOK

The outlooks for the economy and equity markets remain uncertain. Key will be the pace of economic reopening and policymaker responses. We continue to see four scenarios.

The best scenario is a V-shaped recovery; a fleeting recession. This would require a quick and successful reopening supported by policymakers, with most furloughed workers returning to their pre-pandemic hours. This scenario still appears relatively unlikely.

The worst scenario is a depression, where reopening is very slow and there is a policy error, hurting employment and output. This would be the worst outcome for markets but also appears relatively unlikely.

Performance as at 30 June 2020 [1]

	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)	7 Years (% p.a.)	10 Years (% p.a.)	Since inception (% p.a.)
Magellan High Conviction Fund (Class A)	**6.1**	**12.6**	**11.2**	**14.7**	**-**	**14.7**
Magellan High Conviction Fund (Class B)	**6.1**	**-**	**-**	**-**	**-**	**10.1**

1 Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Magellan High Conviction Fund (Class A) inception 1 July 2013 (inclusive), Magellan High Conviction Fund (Class B) inception 15 November 2017 (inclusive). Returns denoted in AUD.

The two middle scenarios are a U-shaped recovery from a recession and a prolonged and deep recession. The downturn that occurred after the global financial recession lay between these two scenarios. It is still challenging to definitively predict if the current downturn will be more or less severe than the recession of 2008-2009.

Due to our cautious economic outlook and the risks confronting equities, we boosted the cash holding from 11% to 23% of the portfolio over the 12 months.

PORTFOLIO POSITIONING[2]

Holdings at 30 June 2020

Security	Weight (%)
Microsoft Corporation	**13.7**
Alibaba Group Holding Ltd	**13.6**
Tencent Holdings Ltd	**9.4**
Alphabet Inc	**8.5**
Facebook Inc - Class A Shares	**7.8**
Starbucks Corporation	**7.3**
SAP SE	**5.9**
Visa Inc	**5.7**
Estee Lauder - Class A Shares	**5.0**
Total	**76.9**

Notwithstanding our cautious outlook, we believe our portfolio of nine high-quality businesses will generate a satisfactory return over the medium to long term.

We have positioned our portfolio cautiously by holding a substantial amount of cash and by investing in businesses that should be largely resilient, or even beneficiaries, in the current environment.

Over the long term, we believe that investing in a concentrated portfolio of high-quality businesses, our best ideas, purchased at reasonable prices will generate attractive returns and prove resilient in times of economic uncertainty. Near-term portfolio resiliency is provided by the balance sheet strength and advantaged competitive positions of our holdings, which we expect to remain highly profitable through the economic cycle given the necessity or desirability of their offering. Longer-term portfolio returns will be supported by the favourable industry and geographic positioning of our holdings, recognising that each company's advantages provide conviction that it will benefit disproportionately from these enduring growth tailwinds and, critically, see this growth translated into rising shareholder value over time. As always, we evaluate these prospective returns in relation to the type and degree of risk we are taking.

The core investment themes in our portfolio at 30 June 2020 were:

- The Chinese-consumer-related stocks (technology-platform companies Alibaba and Tencent and consumer companies Estée Lauder of the US and Starbucks) that comprised 35% of the portfolio. The Chinese middle class is forecast to double in size over the next five to 10 years with the high-end cohort growing even faster. Alibaba and Tencent are structural winners in the Chinese economy as they own the leading ecommerce and gaming/social media platforms respectively. They are also the leading cloud-computing and digital-payment businesses in China. The consumer businesses have strong brands and are well placed to benefit as China's middle- and upper-classes expand.
- Enterprise-software companies (Microsoft and SAP of Germany) that comprised 20% of the portfolio. These companies are integrated within the operations of their business customers, which lowers the risk these customers will switch software vendors. They are benefiting from the transformational growth in cloud computing, which is likely to become even more popular in the coming years.
- Advertising technology-platform companies (Alphabet, the owner of Google, and Facebook) that represented 16% of the portfolio. These companies benefit from the shift in marketing expenditure from traditional media properties to digital platforms.
- A payment-platform company (Visa) that represented 6% of the portfolio. Visa possesses a classic 'network effect' business model that connects millions of merchants with billions of cardholders. They provide the 'rails' upon which global electronic payment systems run.
- A 23% holding in cash, held primarily in US dollars.

Hamish Douglass **Chris Wheldon**

2 Portfolio positioning may not sum to 100% due to rounding.

IMPORTANT INFORMATION