

MAGELLAN SUSTAINABLE FUND (MANAGED FUND) (CHI-X TICKER: MSUF)



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The Magellan Sustainable Fund considers environmental, social and governance factors and implements a proprietary low-carbon framework to invest in outstanding companies at attractive prices while exercising a deep understanding of the macroeconomic environment to manage investment risk. The strategy focuses on risk-adjusted returns rather than benchmark-relative returns. The investment process is designed to generate an unconstrained, concentrated portfolio of 20 to 50 high-quality companies.

PERFORMANCE

Global stocks soared to record highs in the 12 months to June 2021 after government and central bank stimulus helped economies recover from the pandemic, pharmaceutical companies hastened the economic reopenings when they developed vaccines against the virus that causes the illness known as covid-19, the new US administration of President Joe Biden used the unexpected control of Capitol Hill it gained in January after surprise Senate election victories in Georgia to implement more fiscal stimulus, investors decided the Democrats' narrow control of Congress would prevent anti-business measures becoming law, and tech stocks reported earnings that showed how much they have benefited from the shift to online.

The portfolio recorded a return after fees of 10.6% from its inception on 11 December 2020 to 30 June 2021. The stocks that performed best included the investments in Alphabet (+2.9% of the total portfolio return), Microsoft (+2.0%) and Facebook (+1.5%). Alphabet rose after its Google subsidiary's advertising revenue showed a better-than-expected rebound from the coronavirus-triggered slump and the US election outcome and a court ruling in June appeared to reduce the risk of a crackdown on Big Tech that would ensnare Google, which is already under anti-trust scrutiny by the US Department of Justice. Microsoft surged to become the first company after Apple to reach a market cap of US\$2 trillion 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. Facebook climbed enough to record a market cap in excess of US\$1 trillion after earnings beat expectations, the social-media company said its main site has a record 2.9 billion 'active' monthly users, and a US judge in June unexpectedly dismissed two complaints against the social-media giant from the US regulator because the judge said the

Federal Trade Commission failed to prove the company was a monopoly.

The stocks that detracted from performance included the investments in Alibaba Group of China (-1.0%), Lowe's (-0.1%), and US Bancorp (-0.1%). Alibaba declined after the company was forced to suspend the float of its about 33% owned Ant Group after key Alibaba founder Jack Ma criticised financial authorities, and Chinese authorities said they would investigate the company for "suspected monopolistic conduct" amid a broader crackdown on Chinese tech companies. Lowe's declined after investors decided the more than doubling of the home-improvement chain's stock price in the 12 months to March had gone too far. US Bancorp slid because banks lost their appeal as an inflation hedge when investors dismissed faster inflation as a fleeting problem.

OUTLOOK

The global economic upswing appears set to last a couple of years, driven by a record level of monetary and fiscal stimulus as well as a vaccine-driven reopening. However, there are two key risks.

The first is that the supply side of the economy takes much longer to recover than the demand side, leading to inflationary pressures that are larger or more persistent than expected. While we and most central banks expect inflationary pressures to be transitory, a surprise here may force central banks to tighten policy faster than expected, perhaps materially so. The second is a covid-19 mutation that requires replacement vaccines to be developed and distributed, a process that could take three to six months.

Covid-19 has not changed our longer-term economic outlook. The global economy remains structurally low growth and low inflation, resulting in structurally low interest rates. What has changed is a steep rise in government debt and potentially a greater acceptance of central-bank-financed government deficits.

The equity market outlook for the next 18 months is more challenging than usual to predict. The cyclical economic upswing and policy accommodation should support equity returns, but the two economic risks mentioned earlier could trigger a 20% or more decline in equity prices. Another potential trigger is a correction in overvalued pockets of the market such as 'meme' stocks, as this could spread to the broader equity market.

Over the six months to June 30, the cash holding was reduced from 11% to 9%. The reduction was driven by rising equity markets and a decision to invest more in stocks due to the less uncertain outlook.

PORTFOLIO POSITIONING¹

Top-10 holdings at 30 June 2021

Security	Weight (%)
Microsoft Corporation	7.7
Alphabet Inc	7.6
Facebook Inc	6.7
Netflix Inc	4.0
Alibaba Group Holding Ltd	3.9
Reckitt Benckiser Group	3.7
Novartis AG	3.5
Chipotle Mexican Grill Inc	3.5
Unilever PLC	3.3
Yum! Brands Inc	3.3
Total	47.2

We believe our portfolio of 28 high-quality businesses remains well positioned to offer downside protection and to generate satisfactory returns over the medium to long term.

With these objectives in mind, the portfolio has been constructed to account for the cyclical economic recovery underway while considering key nearer-term risks associated with higher-than-expected inflation, an escape mutation and pockets of investor risk-seeking. Portfolio positioning also reflects the longer-term challenges to economies presented by lower structural growth and a likely rise in interest rates over time.

Central to our portfolio construction, now and always, is a gravitation towards high-quality businesses available at attractive prices. It is this approach – a considered and balanced selection of exceptional businesses possessing a competitive moat plus deliberate risk management (including the deliberate assessment of ESG risks) – that provides conviction in the portfolio's ability to satisfy its dual objectives over time.

The past 12 to 18 months provided investors with another visceral reminder of the importance of a long-term orientation and of business quality. By virtue of their competitive advantages, their importance to customers and their robust fiscal positions, high-quality businesses proved resilient through the depths of events last year. As importantly, these businesses have also emerged from the crisis in a more-advantaged position. Given their strength and capabilities, these businesses were able to innovate and adapt while reinvesting for growth through the crisis. Many observed an acceleration in the adoption of their products and services, particularly those with any form of digital

exposure. Some have business units that stand to benefit from further lifting of mobility restrictions. High-quality businesses can weather the inevitable storms, allowing them to capitalise during calmer tides.

Embedded within our definition of business quality is an insistence that a company be on the winning side of disruptive shifts. This exposes the portfolio to businesses that can achieve growth that is less dependent on the underlying strength of the economy. The corollary is that the fundamental results of these businesses, though more attractive over the longer term, can lag companies that benefit from having a purer economic exposure during a strong recovery in the short term but whose performance will be challenged in its absence. Our approach remains to invest in businesses that have a high likelihood of success for decades to come. As always, we evaluate prospective returns in relation to the type and degree of risk we are taking.

The core investment themes in our portfolio at 30 June 2021 were:

- An investment across a range of highly resilient businesses that represented 40% of the portfolio. These businesses primarily offer ballast and downside protection to the portfolio. The fundamental performance of these companies is largely immune to the economic cycle, given their products and services are either essential or in increasing demand. The performance should also be only modestly affected by measures that would likely be required to contain further covid-19 outbreaks. We have been mindful with respect to the form and degree of inflation and interest-rate exposure across these holdings. These investments offer attractive risk-adjusted returns under a wide range of potential economic outcomes. They comprise:
 - Consumer staples at 15% of the portfolio (Nestlé, PepsiCo, Procter & Gamble, Reckitt and Unilever).
 - Regulated utilities in the US, Italy and Spain at 7% of the portfolio (American Water Works, US utility Eversource Energy, Red Eléctrica, which operates Spain's grid, and Terna, which manages Italy's grid).
 - Resilient retailers at 7% of the portfolio (Amazon, Lowe's and Walmart). The Amazon investment also benefits from transformational growth in cloud computing and increasing advertising on its platform.
 - Quick service restaurants at 7% of the portfolio (Chipotle Mexican Grill and Yum! Brands).
 - A diversified healthcare business, Novartis of Switzerland, at 4% of the portfolio.
- Advertising technology-platform companies (Alphabet, the owner of Google, and Facebook) that represented 14% of the portfolio. These companies benefit from the shift in marketing expenditure from traditional media properties to digital platforms.
- Enterprise-software companies (Microsoft and SAP) that comprised 11% of the portfolio. These companies are deeply 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.

- The Chinese consumer (technology-platform companies Alibaba Group and Tencent Holdings) that comprised 7% 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, owning the leading gaming, social media and e-commerce platforms respectively. They are also the two leading cloud-computing and digital-payment businesses in China.
- Companies benefiting from technology-enabled growth (Intercontinental Exchange and Netflix) that accounted for 7% of the portfolio. Netflix is leveraged to the broad shift from pay TV to streaming video on demand, while Intercontinental Exchange’s efforts to digitise the US residential mortgage process complement its resilient exchange business.
- Payment-platform companies (Mastercard and Visa) that represented 5% of the portfolio. These are classic ‘network-effect’ business models that connect millions of

merchants with billions of cardholders. These companies provide the ‘rails’ upon which global electronic payment systems run.

- Companies that benefit from increasing interest rate uncertainty and the possibility of rising inflation comprised 5% of the portfolio (CME Group and US Bancorp).
- A modest 3% exposure to Sydney Airport, a beneficiary of normalising travel behaviours as the impacts of covid-19 abate over the medium term.
- An 9% holding in cash (mostly held in US dollars).¹



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Performance as at 30 June 2021 ²

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	7 years (% p.a.)	10 years (% p.a.)	Since inception (% p.a.)
Magellan Sustainable Fund (Managed Fund) (CXA: MSUF)	-	-	-	-	-	10.6

¹ Portfolio positioning may not sum to 100% due to rounding.

² Returns denoted in AUD. 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). Fund inception date is 11 December 2020 (inclusive).

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