MAGELLAN
EXPERTS IN GLOBAL INVESTING

INReview 2022

THE WORLD
confronts an unusual number of difficulties

Arvid Streimann, PM
Magellan's Global Strategy

Nikki Thomas, PM
Magellan's Global Strategy

Efforts underway to resolve them will favour quality companies.

So far 2022 has been unusual for the number and magnitude of events that have taken place. The shifting to the endemic stage of the first pandemic in a century, the largest invasion in Europe since World War II, and the first 75-basis-point increase in the US policy interest rate since 1994 are just three of significance. Layering on to that is an escalating climate crisis and inflation at highs not seen in decades. Many of the issues are inter-related, the result of significant imbalances in supply and demand across many markets. These are difficult times for investors across asset classes, as governments and central banks attempt to reach a steadier path.

What is driving share prices and how do we protect wealth during such times? We outline what we believe are the issues of most significance to the global economic outlook and to global equity returns.

Let's start with inflation. US inflation is hovering around four-decade highs and is unlikely to slow sharply any time soon. European and Australian inflation, among others, are too at unusual highs. The excesses of fiscal and monetary policies implemented to deal with forced economic shutdowns to save lives during the pandemic have fuelled huge demand for goods and, more recently, services. Those same shutdowns also led to significant lost supply, and supply-chain disruptions. Add in a war in Europe, which led to sanctions and loss of access to commodities, especially energy, and supply disruptions have been exacerbated. Further fuel to the inflation-inducing imbalances comes from the climate crisis. Bushfires, droughts, floods, rising sea levels, water shortages et al are causing widespread destruction in cities and to productive land. The cost is not just lives lost, but a persistent rebuilding that strains resources and more disruption to food supplies.

"Further fuel to the inflation-inducing imbalances comes from the climate crisis."

When you stimulate demand with close-to-free money but have limitations on supply, prices will soar. History shows out-of-control inflation damages livelihoods and so there is an 'unconditional' approach to reduce inflation to acceptable levels. To do this, most major central banks are tightening monetary policies by raising interest rates and reducing financial liquidity via quantitative tightening. Central banks are moving away from stimulatory levels set during the pandemic that with hindsight were too loose because they transferred huge sums to consumers and created excessive demand. The problem is that monetary policy cannot easily quell inflation driven by impediments to supply; its effect will be to reduce demand. Today's inflation is driven by both. The risk in attempting to slow inflation with a tool that only reduces demand-led price increases is that rates might be increased to a level that triggers a recession.

Signs have already emerged that tighter monetary policies in the major economies (except Japan) are dampening demand as intended, but they are yet to slow inflation. The difficulty surrounding monetary policy is that tightening of financial conditions will invariably hurt economic growth but calibrating this is imprecise. Central bankers are seeking to engineer a gentle slowing in growth – a 'soft landing' – while taming inflation. Given the mandate central banks have, it is almost impossible not to expect inflation to be brought down to acceptable levels, let's say low single digits. But we do not expect this to happen quickly even in the absence of further shocks (such as more sanctions against Russia, supply cuts of energy in Europe, or sustained lockdowns in China with its zero-covid policy).

"With inflation still accelerating, the risks of a bleak outcome remain large."

This brings us to the ultimate question for investors. How bad will the demand destruction need to be for this to be achieved? Does it mean a gentle economic slowing with a few low- or no-growth quarters; or does it require a sizeable recession in all or many major economies to kill off inflation? For now, with inflation still accelerating, the risks of a bleak outcome remain large. While the extent to which growth slows is debatable, we know from history that slower (or negative) growth leads to conflict over resources. Eurozone members are bound to fight over how high interest rates should go (Germany high versus Italy stay low). Creditor nations are likely to argue with debtor nations over income transfers needed to support economies in any downturn. They are likely to clash over any program the European Central Bank devises to help hold down bond yields of key indebted nations (Germany not needed, Italy yes please). European harmony and collaboration are likely to be tested yet again.

Emerging countries as well as China are hurt by higher US interest rates as a stronger US dollar makes it more costly to meet US-dollar-denominated debt repayments. On top of that, emerging countries face their separate challenges. China's pursuit of a zero-covid policy and resulting lockdowns, as well as a struggling housing sector that is the store of wealth for many Chinese, mean the government must add economic support via looser monetary and fiscal policies. While we expect Beijing will stimulate its economy in a restrained manner and note some encouraging Chinese vaccine developments, we see China's economic and political risk as elevated as President Xi Jinping seeks to cement his grip on power.

So, how do we navigate the uncertain and unbalanced world to protect capital? We remain focused on investing in only high-quality companies that can cope with the challenges the world faces. We are seeking companies that we expect to be resilient during the tightening of financial conditions and those that can benefit from such conditions. This means companies that are protected from rising and high inflation or indeed can benefit from high prices. In terms of the portfolio, a world of rising interest rates has prompted us to scale back our holdings of energy utilities that had risen on their bond-proxy allure when rates were low. We avoid growth (but not cash-generating) companies that are susceptible as valuations are deflated by higher discount rates and we exited those similarly vulnerable due to low cash generation now. Our concerns about China prompted us to exit Chinese-domiciled stocks. We added banks that are likely to enjoy higher margins as interest rates return to more normal levels. We have added high-quality defensive companies with pricing power and minimal commodity and labour-related cost pressures.

The second issue likely to determine the fate of economies and investment markets is that inequality seems to be reaching its political limits. A pushback against inequality has driven many policy changes of late in countries from China to the US that act against investment returns. In the US, for example, the backlash against inequality has led to higher minimum wages, the rising influence of business-unfriendly progressives within the ruling Democratic Party, instructions for the Federal Reserve to take account of people on lower income and minorities when conducting monetary policy, and more onus on companies to justify their social licence (a bigger risk in the age of smart phones and social media). Beijing's drive to improve 'common prosperity' by eliminating poverty and social inequality is another example. The risk for equity investors is that any lowering of the corporate profit share of national income will weigh on overall equity returns. Rising social-licence risks contributed to our decision to reduce our holding in Meta Platforms (formerly Facebook).

The third issue confounding the economic outlook and financial markets is that geopolitics has become more unstable. Russia's invasion of Ukraine in February is a pivotal event because it is fanning a decoupling of the West and its competitors (foremost China) due to concerns about national, health, economic and energy security. The invasion is likely to cause rifts in Europe's 'security architecture' because countries nearer to Russia are seeking to help Kyiv while Western Europe is more aware of the economic costs of doing so. The risk now is that Europe will trigger a downturn to break its reliance on Russian energy. This could herald another financial crisis as threatening as the one from 2008 to 2012 – another risk spurring our caution on Europe.

Among the last things Europe or elsewhere needs is another energy upheaval. But the world intends to pivot from Russian hydrocarbons towards Gulf energy sources. The risk is that global economic security could be used as a bargaining chip in Iran's nuclear negotiations or become a vulnerability for the West if Iran were to retaliate to any attack.

In Asia, Taiwan remains a flashpoint. Economic interdependence and nuclear weapons reduce the likelihood of a Chinese invasion of what Beijing regards as a renegade province. But economic cooperation is being eroded by the decoupling of China and the West. Expect standoffs or 'incidents' involving Taiwan. But as Russia's invasion of Ukraine showed, large military deployments take time to organise and can be observed. A lack of surprise could deter a Chinese invasion.

The investment implication of heightened geopolitical risks is that benefits of globalisation are reduced. That means slower economic growth and stalled increases in living standards. Unhappy voters reinforce the risks around inequality because people might support populists promising to redistribute income and wealth to the masses. Some companies might be caught up in such political developments.

The fourth issue holding sway over economies and investment markets is the energy transition to renewables and to electrification. This is of paramount importance to us as citizens as well as for our fiduciary responsibility as we aim to strengthen our portfolio returns by analysing the implication of the changes needed. Much is yet to happen, and government policy, regulatory frameworks, reporting requirements and corporate strategies are in flux as the world navigates its way to Net Zero. Implications will be far-reaching and will present outsized opportunities and outsized risks as new economic models and new technologies arise. Huge addressable markets will be created and destroyed and vast sums of capital will be spent to find solutions to our deteriorating climate. So we are enhancing our understanding of the changing competitive landscape, and return prospects of companies exposed.

"The investment implication of heightened geopolitical risks is that benefits of globalisation are reduced."

What then is the central economic case stemming from tightening monetary policy, fiscal contraction, efforts to address inequality, ongoing global political tensions and steps to mitigate climate change? The global and US economies are already slowing quickly, asset prices (equities, bonds, property) are either deflated or no longer rising, while price inflation is remaining doggedly high. But herein lies the silver lining. As demand destruction continues, technology and innovation deliver productivity, labour markets benefit from renewed international flows and some other supply disruptions unlock, we believe there is a good prospect that inflation drops back to 3% or so. Signs of this will add confidence back to financial markets and companies. Whether it happens quickly enough to allow major economies to avoid recession remains difficult to gauge. Even with the engineering of conditions by central banks today, the cycle lives on.

THIS TOO SHALL PASS

What might this central economic case mean for global share markets? Equity markets have declined from record highs in January because investors have brought forward their expectations of when, and increased their assessment of at what height, central banks' policy rates will peak.

> "The dominant driver of equity market returns is likely shifting from interest rates to earnings."

Assuming no more shocks, the dominant driver of equity market returns is likely shifting from interest rates to earnings; in particular, downgrades to earnings expectations. This is a natural sequence when higher rates slow economies.

Earnings estimates for S&P 500 countries have been resilient so far this calendar year with this number especially buoyed by the booming energy sector and any company benefiting from rising commodity prices. European earnings could be susceptible to downgrades; Chinese earnings expectations have already been downgraded. We expect more downward pressure on earnings outlooks through the balance of this year as companies review guidance. Broad capitulation of negative earnings revisions is normally a prerequisite for a bottoming in equity markets.

As such, the global portfolio is holding a cash level moderately higher than usual. We will seek to use this money to buy high-quality companies at great prices as we navigate the volatility induced by the uncertain backdrop. We remain confident that the portfolio is positioned to benefit from longer-term investment thematics and secular growth tailwinds to above-GDP growth in many segments of industry. These include digitalisation trends across our lives – in payments, in enterprise processes, in advertising, entertaining and retail spending – as well as the energy transition and electrification and rising usage of data analytics via increased computation speeds. We are working to ensure our investors benefit from today's inflationary pulse and the return to more-normal social engagement and community activity, including travel.

While the visibility of daily share prices makes volatility appear risky and uncomfortable, proper due diligence and concentrated investment in high-conviction opportunities are the ways we take advantage of the opportunity this brings for strong future returns. We do not invest in overtly risky market segments such as unprofitable emerging companies or commodity-linked companies.

This quality-focused portfolio, aligned to the opportunities presented by the macroeconomic backdrop, has generally stood the strategy and our clients in good stead. We will persist with the robust process behind our absolute-return, lower-risk objectives and we remain focused on seeking to deliver outstanding performance over the economic cycle to you, our valued clients.

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"IN CONVERSATION"

with Nikki Thomas and Arvid Streimann

Finding opportunities for growth in global equities

Arvid Streimann, PM
Magellan's Global Strategy

Nikki Thomas, PM
Magellan's Global Strategy

Nikki Thomas has returned to Magellan as Global Portfolio Manager at a crucial juncture for global shares. She joined Arvid Streimann, Head of Macro and co-Portfolio Manager of the Global Equity Strategy, to talk to Head of Strategy, Asset Management, Matthew Webb. They discussed how to identify opportunities for growth in a macroeconomic environment dominated by inflation and rising interest rates.

Matthew: Nikki, you and Arvid have been working together closely on the portfolio for six months now. How has it been going?

Nikki: It's wonderful being back at Magellan. Arvid and I worked together when I was Head of Research, and we have complementary skills. There has been good input from Arvid into the process to help with stock selection and consideration of macroeconomic issues.

Arvid: Complementary is a great way to describe our relationship. Nikki has a significant amount of experience looking at stocks and markets and, while I'm a stock analyst at heart, I spend most of my time looking at risk and macro. Bringing those things together is really important – more so, given what's been going on in the world right now.

Matthew: Have there been many changes to the investment team?

Nikki: The existing team is made up of about 30 analysts who have been doing great work with Magellan for a long time and continue to engage in deep research that sits behind the Magellan philosophy and process.

We're engaging with them every day, digging through different stocks and issues confronting the markets right now. They're supporting new and different ways to position properly for volatility across global markets. The experience of our investment team is a great asset for us.

Matthew: What about your experience with Magellan co-founder Hamish Douglass who has returned to the firm in a consultancy role?

Nikki: We're looking forward to that – I think it's a real win-win. He understands how Magellan invests and I'm looking forward to being able to tap into the mind behind the strategy to enhance our offering going forward. He'll be a wonderful addition back into the team.

Matthew: Arvid, I'll ask you a few questions about the macroeconomic environment and then we'll turn to Nikki for the impact on the portfolio. The last 12 months have been a tale of two halves – the "growth at any price" mentality ended in December. But while markets overall have fallen, energy indices have rallied by 50%. Are energy companies going to be a good investment?

Arvid: It has certainly been an unusual year. When we look at companies, we have an intense focus on quality. For our strategy, pricing power is almost a prerequisite for a company to be considered a quality investment opportunity. That isn't generally found in the energy industry.

Take the oil industry, for example. Generally, oil producers don't have the pricing power that OPEC has. There are also many government restrictions and regulations that can limit pricing changes. Because of this, energy industry companies don't have the level of quality that we look for.

Oil markets are a good example of the cyclicality of the industry. Oil prices are more than $100 a barrel now. Just two years ago, in some places oil prices were actually negative. You had to pay people to take oil off your hands.

While energy industry returns are up almost 50% in the last six months, it's an aberration. Over the last 10 years, the sector has only generated returns of around 5% per year – including the 50% returns from the past six months. Looking to the future of energy prices, while they're relatively high at the moment, I don't think they're going to continue to increase at this pace. When they level off, the energy sector is probably going to underperform the broader market.

Matthew: How have quality companies performed in the bear market?

Arvid: Quality companies tend to be defensive, which means they provide reliable earning streams. They have low leverage and high returns on capital. So, it's fairly unusual to see quality companies underperforming in a bear market.

"The chance of recession will go up even more if rates continue to increase."

I think the biggest consideration about why has to do with higher interest rates. Growth-focused quality companies tend to have profits further into the future than most other companies. That means their valuations are more sensitive to higher interest rates, which have gone up significantly this year. While we still consider these quality companies, this mechanical link between interest rate hikes and valuation has dragged down the overall quality index.

The question now is, "where are interest rates going to go?" Looking at the 10-year bond yield in America, which is probably the key interest rate here, the Federal Reserve has already told people that it is going to raise rates to a level that is going to start constraining activity. If they did more than that, people in the bond market would say that growth is already going to be constrained.

I think the chance of recession will go up even more if rates continue to increase. But as recession risk rises, yields on the 10-year bond may come down; think of it as an average of interest rates over the next decade.

The point is that it is getting harder for the 10-year bond yield to go up materially from where it is right now. And so, the drag from higher rates on the performance of quality companies is unlikely to be as strong as it has been so far this year.

Matthew: How should investors think about geopolitical risks like the war between Russia and Ukraine and interest rate increases, as well as new considerations about inflation or stagflation?

Arvid: While there is a lot going on in the markets right now, there is a normal sequence of events that we're seeing. The first step is higher inflation that causes the second step, which is central banks raising interest rates to keep inflation under control. This is when investor sentiment starts to weaken, which I think we've already seen. In the third step, higher interest rates start to do their work and reduce economic growth and profit growth. This is where I think we are right now as people are reducing their expectations.

This slowing in growth is going to make it hard for bond yields to move higher. I think the market is going to perform in a very similar manner to the sequence I just described. In the first six months of the year, the rise in interest rates was the dominant reason why returns were negative. At this time investors were focused on what companies and sectors were most sensitive to interest rates.

"The companies that will hold up the best in this environment are quality companies with defensive or more reliable earnings."

Looking forward, we're expecting an environment with slowing economic and profit growth. I think investors are going to start focusing not on interest rate sensitivities but earning resiliency. The companies that will hold up the best in this environment are quality companies with defensive or more reliable earnings. While they have been hit in some places by higher interest rates, I think they'll do a lot better in the future.

If you can find a quality company that has a strong, long-run industry thematic, then you've got a real winner. They're the type of companies that we're looking for.

Matthew: Nikki, how are you incorporating these broader macro trends in the portfolio?

Nikki: Broadly speaking, we're looking for the things that are working right now. We want to have pricing power. We want to have protection from inflation and, if we can get it, to be able to leverage inflation. That means we're looking for companies that can make more money on the back of inflation.

We want to stay with the high-quality options that Magellan is known for, finding businesses that we think will outgrow GDP year in, year out for the next decade.

We're confident in the companies that we have in our portfolio, which is very concentrated – it's only ever 20-30 stocks. We have high representation from businesses like Visa and Mastercard, which are largely inflation protected and, in fact, leverage inflation.

Strong exposure to Microsoft and Alphabet – both with strong tailwinds around enterprise software, global digitalisation and digital advertising – provide a strong base.

We've also leaned on reliable earnings generators like McDonald's and Yum! Brands that clip the ticket on top-line sales that come from franchise operators. They don't get the headwinds of commodity costs to the same degree as a typical restaurant chain. We believe these brands will perform well and will be resilient if we go into a period where economic growth is challenged.

They're the sort of companies that we're looking for and leaning on in this difficult market. We're starting to see some opportunities appear where the market's oversold and we find brands that have strong tailwinds, in our opinion. We're looking for opportunities like these in these difficult markets.

"We're starting to see some opportunities appear where the market's oversold."

Matthew: What are some of these new opportunities?

Nikki: Some of them are new and some are stocks that have been reintroduced to the portfolio that have history with Magellan. Stocks like Diageo, the world's largest spirits manufacturer. It is very leveraged to the end of lockdowns and reopenings happening around the world. Its last results saw a 20% organic growth in its business; that's an example of an economically resilient business that has extraordinary pricing power.

Others may be new, like ASML, the leading supplier to the semiconductor industry. It's probably the least-known monopoly in the world. When you think about the growth in semiconductors in this digitalised world – everything from your dishwasher and fridge to your phone and car are all connected – you need semiconductors for that. This is a business we had an opportunity to pick up and put into the portfolio.

Another one is Chipotle Mexican Grill, a high-quality Mexican food chain with store roll-out opportunity giving it at least 8% to 10% per annum growth for the next decade due to an efficient operating model. Restaurant margins are very strong and returns on capital as they roll out these stores are extraordinarily good. It's a classic Magellan-type of investment, but we've been able to start acquiring this at what we believe are bargain basement prices.

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"IN CONVERSATION"

with Leon Panetta

Today's challenges will shape the 21st century

Leon Panetta, Former Secretary of Defense and CIA director

Leon Panetta has had a remarkable career, having been US Secretary of Defense, Director of the CIA, White House Chief of Staff and a Congressman representing California. Secretary Panetta joined Portfolio Manager and Head of Macro Arvid Streimann to discuss some critical global issues.

Q: There's a lot going on in the world today. The rise of a superpower in China, the war between Russia and Ukraine, and increasing partisanship. How uncertain do you think the world is today?

A: I think we're looking at a world that is both very dangerous and at a pivotal moment that could tell us a great deal about what the future holds in the 21st century.

In many ways, what happens in Ukraine will tell us a great deal about the future. I've never seen NATO more unified than it has been in confronting Russia and supporting Ukraine. If that combination of courage and bravery on the part of Ukrainians, plus the support of the United States and our allies – if that can come together and the result is a defeated or weakened Russian President Vladimir Putin and Russia, I think that will go out as a message to others like China, North Korea, Iran, and terrorists.

I think it can also tell us a great deal about whether or not democracies can sustain themselves in a way that can really give them the ability to strengthen and develop in the 21st century – as opposed to autocracies.

Q: That gives an interesting sense of perspective. In investing, we look at the world with uncertainty and say, "there's a reason to be worried." How worried are you about the conflict in Ukraine?

A: If you think about World War I, it set the power struggle for the 20th century. What ultimately happened was a failure of efforts to try to find peace in the world that led to World War II and the US confrontation with the Soviet Union. That table was set as the result of what happened in World War I. I look at the war in Ukraine as having that same impact in terms of setting the table for what happens in the 21st century.

I see three potential outcomes now that we're seeing a war of attrition develop. If it's a long war of attrition, that may play into Putin's hands because I think he's trying to wear down the United States and our allies and Ukraine. The longer this war goes on, the more concern there is about the unity and whether you can really hold these countries together. So, I think probably the worst result would be a long war of attrition.

The second possibility is a negotiated settlement of some kind. My concern is that this could have happened a long time ago if Putin wanted it to happen. I think he wants to gain more territory and more leverage. I think he's concerned that unless they're able to hit back, Russia somehow will lose face and be viewed as a loser.

The third is that it escalates and somebody makes the wrong kind of decision and suddenly we find Russia using either gas or chemical warfare or some kind of battlefield nuclear weapon. If that happens, one of the worst consequences is it could very well lead to World War III.

> **"The key right now is for the United States and our allies to maintain unity."**

My view is that the key right now is for the United States and our allies to maintain unity, maintain that dedication to supporting Ukraine. I think Ukraine President Volodymyr Zelensky is right, if he could bring this war to some kind of conclusion by the end of this year, then I think we could get a good result in the sense that Russia, no matter what they may maintain, will be viewed as having lost and Putin will have been weakened.

Q: There are also questions as to Putin's goals. I think the most common answer to that question is that he wants security for the Russian motherland – is that actually what he wants?

A: I have to go back to, as director of the CIA, the basic intelligence on Putin is that he's KGB. That's what his background is. That's where he comes from. I think having been in the intelligence arena for a long time, he's paranoid. He's very suspicious of the United States. I think his principal goal is to undermine the United States as well as other democracies. He has a czarist approach to Russia, to regain lost territories and rebuild the empire of Russia as it was.

If Ukraine can manage the capability of pushing the Russians back at a time when I think the Russian forces are depleted, then I think Putin has a very tough decision to make – does he face a total loss on the battlefield, or does he try to negotiate and at least gain some face in the end? The only way to get Putin there is through the use of effective force.

CHINA RISE AS A SUPERPOWER

Q: The rise of China as an economic superpower comes from a consumer desire for cheaper goods. But it's coming at a cost and we're starting to see some fractures in the relationship between China and America. How do you see it panning out over time?

A: China is a strong economy and we've developed relationships in terms of trade. If you're going to deal with Chinese President Xi Jinping, you'd better do it from strength, not from weakness. If Xi reads weakness on the part of the United States or our allies, then he'll try to take advantage of it. That's what he's done to date. When the US pulled out of the Trans-Pacific Partnership (TPP), Xi immediately went into those countries and tried to take advantage of that.

It's important that the US has a strong alliance in the Pacific, both economically and in terms of security. The US, Australia, South Korea, Japan, India, the Quad, the ASEAN countries ought to come together in a strong alliance, similar to the way the US and NATO came together.

China will look at that alliance and realise that they don't have much of a choice but to try to reach out if they want to maintain their economy and where they want to go in the future.

I go back to conversations that I had with President Xi when I was Secretary of Defense. Normally in those meetings, both sides get their talking points out, say what they're supposed to say, but it doesn't really accomplish a hell of a lot. With Xi, there were no talking points. He basically sat down and was very frank and direct with me because we had just made the pivot to the Pacific in our defence policy and he raised concerns about that. He said, "What are you doing pivoting to the Pacific?" And I told him, "Look, we're a Pacific power, just like you're a Pacific power. And we have an interest in the Pacific, just like you have an interest in the Pacific and very frankly, there are areas where we could work together. Areas like dealing with North Korea and their problems. Like dealing with trade, dealing with disaster assistance. You're a Pacific power, we're a Pacific power, it would be much better if we were working together to do that." And he reacted to that and said, basically, "You're right. To a large extent, that would be a better path to peace and prosperity than having a confrontation."

I think that Xi is much more pragmatic about what steps need to be taken to ensure that China has a strong economy and moves forward in the future. I don't think it requires a confrontation of some kind or a crisis in the way Russia did. You can offer China the opportunity to resolve some of these issues, whether it's technology, space, cyber, or other areas where we have to have a dialogue and figure out where we're going.

At the same time, you have to make it very clear that China cannot advance their interest in the South China Sea, that they cannot show any kind of aggression towards Taiwan, that what happened in Hong Kong is unacceptable in terms of what happens in Taiwan. I really do think you could have a positive dialogue, but it has to be from strength, not from weakness.

It makes sense for us in the Pacific to try to develop a strategy for how we can work together, to try to make sure that the islands and other areas in the Pacific know that if they really want to develop their economy, if they really want to develop their security, if they really want to develop their country, they are much better off working with us than working with China.

GROWING PARTISANSHIP

Q: When people talk about China, many say China's foreign policy is an extension of its domestic policy. Maybe you could say that for other countries as well. Is the increase in US domestic partisanship a powerful influence on geopolitics?

A: It's an important issue that can tell us a lot about whether or not the United States can be a world leader. To be a world leader, the US has to show that it can govern its democracy at home.

If you want to look at threats to our national security, the biggest threat is the dysfunction in Washington. The partisanship and polarisation that often interferes with the ability of the country to come together to deal with major issues confronting our country.

There are going to be challenges in a free society. There are going to be differences. But, ultimately a democracy has to be able to govern and deal with the major issues.

There are signs that, despite polarisation and disruptions as a result of what happened on January 6th 2021, there is a willingness to work together. You've seen it on infrastructure, on Ukraine, on gun control. Political leaders were able to come together and compromise.

"To be a world leader, the US has to show that it can govern its democracy at home."

It's going to require leadership. In a democracy, we govern either by leadership or by crisis. If leadership is there and willing to take the risk associated with leadership – and make no mistake about it, whether in business or politics, if you're going to lead, you've got to take risks. If you're willing to take those risks, then I think we can contain crises in the future. If leadership is not there, then we'll govern by crisis. And that's when our democracy really weakens itself. The price you pay is the loss of the trust of the American people in our system of governing.

Ultimately, I have to place my trust in the American people that regardless of the politics, regardless of the loudmouths, regardless of the demagogues who often appear in politics, I think when you look at the country itself, whether it's a red state or a blue state, there are common values that are represented. Having a good job. Raising a family. Educating kids, providing healthcare for themselves or their family. The rule of law. It's ultimately those values that show up at election time and I see the American people willing to be the ultimate check in our democracy.

IMPORTANT INFORMATION

MAGELLAN
EXPERTS IN GLOBAL INVESTING

INReview 2022

ENGAGING
for long-term value creation

Dom Giuliano,
Deputy CIO, Head of
ESG and Portfolio
Manager

It’s the best way to force companies to change for the better.

An essential ingredient in the pantry of the long-term environmental, social and governance, or ESG, investor is the ability and willingness to pragmatically engage with a company. Engaging with a company on material risks and opportunities can provide improvements that enhance value to stakeholders. Sometimes those outcomes can be quantified in monetary terms, but more frequently the outcomes are non-monetary but nonetheless important. Desired engagement outcomes, for instance, might be a reduction in the risk of political interference, enhanced brand perception among customers, or improved sustainability of the societies in which the company conducts its business. In our view, achieving such outcomes requires a pragmatic perspective from investors in recognition that companies operate in complex environments.

‘Engagement’ simply describes the process of conversing with a company with a view to influencing it to achieve specific outcomes. ‘Conversing’ could be interacting with relevant board members, senior management, other officials of the company, or advisers to the company. The form of interactions span meetings through to formal letters. ‘Specific outcomes’ refer to desired strategies or actions from the company; for example, climate-risk strategies or specific employee diversity goals.

Ultimately, an investor’s power to engage stems from voting rights that attach to their share ownership. These voting rights are exercised in the ‘proxy voting’ process, which can result in significant change, including the appointment of new directors and auditors, and approval of specific proposals. Naturally, the size of an investor’s ownership in a company has a proportional impact on voting rights and, therefore, influence. Collaborating with other like-minded investors can help increase the pressure on a company for a specific outcome.

It’s worth noting some of the most non-ESG companies escape this type of engagement because ESG investors often have specific exclusion requirements from such businesses. Many (including us) choose not to invest in tobacco manufacturers. These sorts of exclusions are sensible because a tobacco manufacturer can’t help being other than a purveyor of tobacco products. No level of engagement would prompt them to stop selling packaged nicotine.

> **“Collaborating with other like-minded investors can help increase the pressure on a company.”**

For many other types of business, ESG investors are happy with the products and services but seek to engage for changes that enhance opportunities and reduce risks. Most, say, are content with the business of supplying electricity to homes and businesses; however, sometimes concerns arise that some of these businesses are not properly planning for decarbonisation and climate-related risks.

In these instances, we believe it rational for investors to invest in these businesses and then seek to engage for specific outcomes that improve management of climate-related risks. These investors have the voting power to agitate for improvements and then reap the longer-term rewards of those improvements. Merely divesting those businesses results in no voice with which to engage a company to improve their practices. In these instances, no investment means no impact.

"Our engagement goal is to recognise our stewardship responsibilities of being custodians of our investors' capital over the long term."

This perspective, however, does not obviate the rational investment decision to divest a company that chooses not to engage on material risks, or pretends to engage but doesn't make genuine changes, which may then expose the longer-term investor to significant risks.

The explosion of interest in 'sustainability' and 'ESG' considerations in investing has led to a growing number of shareholder proposals being submitted for voting at annual general meetings.[1] Yet many of these shareholder proposals are immaterial to the company, relate to issues already being managed, or are even detrimental to the interests of long-term shareholders. Indeed, this year's proxy voting season (April to June, mostly for US and European companies) has seen the number of shareholder proposals increase by 40% from 2021 for the companies that we vote upon (those stocks we manage on behalf of our clients).

We assess each of these proposals on behalf of our investors. We do not outsource this important responsibility. For each proposal, we assess whether the issue at hand is material to the company, or perhaps to the company's industry, and whether the company is already managing the issue appropriately. If the proposal has merit, we will generally vote for it, while opening a conversation with the company about the issue to express our perspectives and what a desirable outcome might look like. In our assessment of materiality, we do consider how much time and effort is involved in meeting the demands of the proposal and the likely degree of management, or board, distraction involved. Managements should be busy creating value for long-term investors and not be distracted by immaterial matters.

In conclusion, our engagement goal is to recognise our stewardship responsibilities of being custodians of our investors' capital over the long term. This recognition steers us to engagement that improves the management of material risks and opportunities of our investee companies, and not merely box-tick issues that are topical but not material to a company. Properly doing this requires thoughtful and pragmatic consideration of complexities companies and societies face.

1 "A shareholder proposal is a recommendation or requirement that a company or its board of directors take a particular action, which is submitted by a shareholder for consideration at a meeting of the company's shareholders." – Thomson Reuters

IMPORTANT INFORMATION

GLOBALISATION

is morphing into something less

Michael Collins
Investment Specialist

'Geoeconomics' is fanning an inward turn that produces some winners but mostly losers.

Tennis staged its first 'open' tournament in 1968, when the British Hard Courts were staged at Bournemouth. The open tag meant professionals were welcome to play in national tournaments including Grand Slams, which until then were restricted to amateurs. For more than five decades, prestigious tennis tournaments welcomed players from any country. [1]

No more. This year's Wimbledon has banned players from Belarus and Russia. Their offence? Russia attacked Ukraine, and Belarus was a base for some of the Russian invaders. While no one will call it the Wimbledon Almost-Open, the fracturing in the global nature of sport competitions reminds how the era of hyperglobalisation is over. Hindering the movement across borders of commodities, components, culture, goods, ideas, money, people and services appears an irreversible trend for the foreseeable future.

The most recent impetus is that war between Russia and Ukraine has elevated a strategy known as geoeconomics, [2] when economic and financial tools are used to promote national political goals. About 30 Western countries are choking Russia with the most draconian financial sanctions and export controls ever imposed on a leading power. The freezing of half of Russia's foreign-exchange reserves is such a breach of trust and property rights it portends an unfixable tear in the US-dollar-dominated global financial system. [3] As too are moves to cut Russian commercial banks from the US (SWIFT) payments system and to confiscate the assets of Russian individuals connected to power. Europe's move away from Russian hydrocarbons shows how free trade only happens when the world feels secure.

The pandemic was the previous setback to globalisation because it showed that producing essential goods far away from where they are needed is too risky, no matter the cost savings from cheap labour. Washington has no intention, for instance, of allowing China to remain the source of 50% of US penicillin imports. [4]

> **"The era of hyperglobalisation is over."**

An initial impediment in advanced countries for the globalisation that occurred from the 1980s was the cultural pushback against the loss of local political accountability, and the political reaction from those who lost jobs as manufacturing shifted abroad. The winners were the billion-plus people in emerging countries who soared out of poverty. [5] These countries, foremost China, expanded in political muscle. Beijing's flexing, often in norm-breaking ways (Hong Kong, for example) counts as another blow to globalisation because it provoked fear, mistrust and retaliation.

The post-hyperglobalisation era too will come with winners and losers and economic and political consequences. Winners will include emerging countries close to, and friendly with, Western powers. Countries such as Mexico stand to gain from any 'near-shoring', or 'regionalisation', of production. [6] US allies stand to gain from "friend-shoring", as US Treasury Secretary Janet Yellen described strengthening links among countries that (mostly) share liberal values. [7] An example is the new US-led Asia Pacific Economic Framework that groups 13 (anti-China) allies. [8] Other victors will include Western businesses producing essential items deserving of tariffs and subsidies. Unworthy winners will be companies of lesser offerings that are talented at 'rent seeking'. This term describes when businesses manipulate policymakers to boost their profits. Losers will include emerging countries that missed out on investment that would have created local jobs and wealth. A notable loser might be China as it becomes more estranged from the West, even if Western adversaries enjoy cheaper commodities and energy from Russia. [9]

"The economic consequences of 'slowbalisation' are faster inflation (at least initially) and slower growth."

Other also-rans will be multinationals that seek customers across the globe and companies that were prepared to have production arrangements that spanned the world. The 'splinternet' will be starker as governments block access, protect local data and toughen cybersecurity. For consumers, production 'misallocated' to higher-cost locations, steeper tariffs and rent seeking (price gouging) spell lower living standards.

The economic consequences of 'slowbalisation' [10] are faster inflation (at least initially) and slower growth. [11] Emerging countries will miss out on know-how and an opportunity to build wealth through exporting. Barriers preventing investment in emerging countries, however, could give workers in advanced countries greater bargaining power. As the global pool of labour deglobalises, Western workers might achieve a greater share of national incomes, which after four decades of hyperglobalisation fell to record lows. [12]

While inequality might decline, there might be less wealth to fight over because profits might be lower in a more-fenced world.

Returns on capital might be reduced because protectionism will inhibit economies of scale. Companies will carry larger inventories as just-in-time production has proved vulnerable to transport delays and much else. Reduced profits spell lower corporate tax takes.

Hindered capital flows suggest investors might have to stomach lower returns. Governments, especially in the emerging world, might need to pay higher interest rates to woo bond investors. Slowing economies would make it harder for governments to trim debt-to-GDP ratios. If less competition leads to less innovation, reduced productivity would mean lower living standards and reduced long-term investment returns.

Politically the world is likely to split into "distinct economic blocs with different ideologies, political systems, technology standards, cross-border payment and trade systems and reserve currencies", as IMF Chief Economist Pierre-Oliver Gourinchas, sees it. [13] One US-led group will favour a rules-based order among themselves. The other China-led bunch will group authoritarian countries extolling a power-based world and possibly democracies such as India, Indonesia and South Africa that hang back from a rules-based global system. The Chinese-US "lose-lose tech war" [14] will create a schism across tech platforms and 'data sovereignty', [15] and will mean less innovation. The IMF estimates that 'technology fragmentation' will cost smaller countries that straddle multiple tech hubs 5% of their GDP. [16]

A split world means less international cooperation on global challenges such as climate change, pandemic responses and resolving food shortages. In any emergency, which grouping could save a crisis-hit G-zero world, as the G-20 did in 2008 by standardising the response? [17] Not the WTO. [18] Nor a hyperpolarised US. In a fragmenting world, more military spending might be required, which ties up resources (though often spurs innovation). In emerging countries, hunger and lower living standards might lead to uprisings and defaults.

Within countries, globalists will battle patriots for political power. One destabilising by-product of stronger national identity politics is that it tends to fan secessionist movements, especially when nationalities absorbed into countries such as the Catalonians in Spain have such distinctive identities.

What might remain the same? The US currency is bound to stay the world's reserve currency because it lacks a credible rival, even as US opponents seek alternatives.

To be determined? The cleverness of policymakers. The West would best avoid a permanent stand-off against a rival bloc, in what would be 'the clash of civilisations' that Samuel Huntington warned of in 1996.[19] Advanced countries, through an empowered IMF, might need to rejig the international financial system for a multipolar world to better support emerging countries.[20] But even if policymakers prove sound, the era of inefficient globalisation heralds a poorer future than otherwise. Perhaps people might feel more secure.

Now for the qualifications. Globalisation always proceeded at different speeds and security considerations were never ignored.[21] Globalisation is so layered it's hard to generalise about its direction or pace. It's debatable too whether the end of hyperglobalisation is a form of deglobalisation or another type of globalisation. More the latter because trade flows are exceeding IMF pre-pandemic forecasts,[22] China-US trade reached a record in 2021,[23] and authoritarian governments still apply export-led economic models. Note too that any retreat from the recent pace of globalisation has natural limits, as does the China-US split. Too much is intertwined and too many vested interests favour the status quo. Short of China invading Taiwan, the West would be reluctant to incur the costs of suddenly isolating China, while Beijing has an interest in preserving, rather than snapping, ties with the US. The internet might make people feel they are as tied to a globalised world as before.

People and businesses will be connected but not like they were. Their state of mind has turned away from the hyperglobalisation that, for all its drawbacks, enriched the world. A more-stunted form of globalisation points to less prosperous times. Even winning Wimbledon will be tainted.

CEMENTED STATUS

The Asian financial crisis of 1997-1998 contained lessons for the region. One was the need to assemble foreign-exchange reserves to protect currencies against adverse capital flows if need be. By 2014, China's symbol of success was that it had amassed a record US$4.0 trillion of foreign reserves, the bulk in US-dollar-denominated securities.[24]

By all reports, China was stunned earlier this year when Washington weaponised the US dollar against Russia after it invaded Ukraine, even though the US had so acted against Afghanistan, Cuba, Iran, North Korea and Venezuela. Russia's central bank could defend the rouble only by raising interest rates to 20% and thereby crush Russia's economy.

The greater the damage to Russia, the greater the incentive for US opponents to explore ways to shift foreign-exchange reserves away from US-dollar-denominated assets. Included in such efforts are Beijing's drive to internationalise the yuan and build a cross-border yuan payments system.[25]

But it would be hard for rivals to dethrone the US dollar as the world's reserve currency.[26] At the end of 2021, 59% of global currency reserves of US$12.9 trillion were denominated in US dollars (even if that's down from 72% in 1999 when the euro appeared). At year end of last year, the next favoured currency was the euro at 21%, the yen at 5.6%, UK sterling at 4.8% and the renminbi at 2.8%.[27]

"It would be hard for rivals to dethrone the US dollar as the world's reserve currency."

The US dollar has peerless status because the currency of the world's largest economy is the world's medium of exchange and unit of account and US securities are the global financial haven. US capital markets are deep and liquid. Investors trust the rule of law and other infrastructure such as an independent central bank that gives them confidence US-dollar-denominated securities will hold their value.

Away from currencies, options for diversifying away from the US dollar include crypto currencies, commodities, namely gold, and a global fiat money such as the IMF's special drawing rights. But crypto currencies including so-called stable coins are unstable – Bitcoin (not a stable coin) fell more than 70% since it peaked last year to June. They have no intrinsic value, are awkward to trade and the amount on issue is small. The market worth of cryptos on June 20 was US$1.2 trillion, just 9% of global forex reserves. [28] Gold is awkward to trade physically, needs to be stored and its price gyrates. The IMF's rights would be stillborn as a reserve option.

As for currency rivals to the greenback, the euro is stymied because the lack of a eurozone government limits the sale of the needed securities. A bigger problem is the eurozone monetary union lacks the political, fiscal and banking union a currency union needs to endure. This means the euro's future is not assured.

Other Western currencies such as the Swiss franc and the yen lack the security issuance to be substitutes for the US dollar. These countries are part of the West's sanctions on Russia. They aren't out to undermine the West's ability to torment Russia.

The yuan, and its digital equivalent, is not a threat to the US dollar because China's currency lacks the backing of a trusted democratic government and rule of law. Beijing restricts China's capital account, the country's financial markets are underdeveloped and Beijing does not want to lose the control over the economy it would forgo if the yuan were market set. China, which sells sovereign bonds denominated in US dollars, is too dependent on the US-dollar-based global financial system to flee from it. [29]

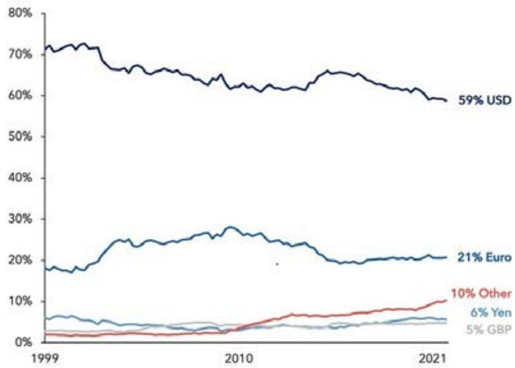
"China's currency lacks the backing of a trusted democratic government and rule of law."

Over time, however, China could widen use of the yuan among the emerging countries that are its closest and biggest trading partners. The US could undermine the reserve power of its dollar by allowing inflation to get out of control, running massive fiscal deficits that boosted Washington's debt to uncomfortable levels, or if social cohesion broke down.

But the yuan's chance of deposing the US dollar in the foreseeable future, even in a split world? About the same as Russians or Belarusians competing under their nationalities had of winning this year's Wimbledon.

Michael Collins
Investment Specialist

Currency composition of foreign exchange reserves since 1999 (IMF. June 2022)



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IMPORTANT INFORMATION

Nikki Thomas, CFA
Portfolio Manager

Arvid Streimann, CFA
Head of Macro and
Portfolio Manager

MAGELLAN GLOBAL FUNDS

The Magellan Global Funds invest in the world's best 20 to 40 global stocks. The strategy aims to deliver 9% p.a. over the economic cycle while reducing the risk of permanent capital loss.

PERFORMANCE

Global stocks fell over the 12 months to June after Russia's invasion of Ukraine clouded the global economic outlook and boosted energy and food prices, central banks tightened monetary policies to tame inflation at decade highs, higher interest rates prompted talk the US economy was headed for recession, and China added to worries about shortages and inflation by locking down cities to enforce a policy of zero covid-19.

- The **Magellan Global Fund (Open Class) (ASX:MGOC)** recorded a return after fees of minus 11.8%[1] for the 12 months.
- **Magellan Global Fund (Closed Class) (ASX:MGF)** recorded a return after fees of minus 10.6%[1] for the 12 months.
- The **Magellan Global Fund (Hedged)** recorded a return after fees of minus 18.2%[2] for the 12 months.
- The **Magellan Global Equities Fund (Currency Hedged) (Managed Fund) (ASX:MHG)** recorded a return after fees of minus 18.1%[2] for the 12 months.

Within the underlying global portfolio, the stocks that detracted the most over the 12 months were the investments in China's Alibaba Group (-2.7 percentage points of the total portfolio return in Australian dollar (AUD) terms), Netflix (-2.3 ppts) and Meta Platforms (-1.9 ppts). Alibaba dropped after the Chinese tech company announced sales figures that disappointed and Chinese regulators cracked down on local technology companies. Netflix fell after the streaming service said it expected subscriber growth to slow and profit margins to narrow. Meta tumbled after the owner of Facebook offered weak revenue forecasts due to Apple privacy restrictions inhibiting the reach and effectiveness of online ads, its Facebook site suffered its first drop in regular users due to the popularity among the young of TikTok, and the company faced a public-relations blow and possible legal difficulties after a former employee exposed issues at the social-media company and that it was losing younger audiences.

The stocks that contributed the most over the 12 months were the investments in PepsiCo (+0.8 ppts), McDonald's (+0.5 ppts) and Procter & Gamble (+0.5 ppts). PepsiCo gained after the drinks and snacks company raised its forecast for full-year earnings and announced profit and revenue numbers that beat expectations. McDonald's too benefited from the ability of its franchisees to raise prices to absorb higher input costs. Procter & Gamble was another to enjoy the boost quality consumer staples received for their ability to protect margins in times of high inflation.

OUTLOOK

In the past 12 months, inflation pressures have proven to be more persistent than expected, leading central banks to increase the size and pace of their monetary tightenings. While this is likely to result in a slow peak in inflation, the trade off to the growth backdrop remains highly uncertain. We see three risks to this outlook.

The first risk is that consumer expectations of inflation become unhinged, triggering a wage-price cycle. This would prompt central banks to conduct more rate increases, which would put more downward pressure on economic growth. The second risk is an unexpected supply- or demand-side shock that worsens the outlooks for growth and inflation. There might be, for instance, a disruption to energy supplies or a loosening or tightening in fiscal-policy settings. The third risk is that economic growth slows more quickly or more significantly than expected yet central banks keep raising rates for too long or take them too high.

We are cautious about the outlook for equity market returns as we navigate the uncertainties and risks surrounding inflation and on June 30 held a cash balance of 9%. As economies slow, we expect overall earnings forecasts to be reduced and many companies to revise lower their outlook statements. Until the peak in interest rates and the likely path of growth become clearer, uncertainty will likely prolong volatility in stock markets.

PORTFOLIO POSITIONING[3]

Top-10 holdings at 30 June 2022

Security	Weight (%)
Microsoft Corporation	7.8
Visa Inc	6.0
Alphabet Inc	5.6
Mastercard Inc	5.1
McDonald's Corporation	4.5
Yum! Brands Inc	4.3
Novartis AG	4.3
Reckitt Benckiser Group	4.0
Intercontinental Exchange Inc	3.9
Nestlé SA	3.6
Total	**49.1**

We believe our concentrated, high-conviction portfolio of 30 high-quality companies is positioned to deliver on our objective to create wealth for clients over the long term.

It is our conviction that high-quality companies will provide investors with the most reliable returns over the medium to long term. To be sure, returns from quality companies may lag over some short time frames, especially if investors are infatuated with mesmerising profitability forecasts that have a low probability of occurring in the medium to long term. History, however, has repeatedly shown that these periods are aberrations that are punctured when investor sentiment inevitably normalises. Indeed, this is what has happened over the past 12 months; investor risk appetite eventually deteriorated.

One of the strongest signs of a quality company – in fact, almost a prerequisite – is pricing power. With the surge in inflation over the past 12 months or so, companies with pricing power have proven their value to investors because they have swiftly passed on higher costs to customers and thereby protected their profit margins. This advantage is compounded when companies sell something that their customers are reluctant, or unable, to do without when prices rise. Over the past 12 months, companies with these characteristics have performed comparatively well owing to their 'defensive' nature. Our investments with these characteristics include:

- Consumer staples such as the UK-listed Reckitt Benckiser, Nestlé, PepsiCo and Procter & Gamble.
- Restaurant companies such as McDonald's, Yum! Brands (owner of KFC, Pizza Hut and Taco Bell) and Chipotle Mexican Grill that are enjoying an added boost to revenue and profit growth from new stores.
- Leading alcoholic spirits, luxury and beauty companies Diageo, L'Oréal and LVMH that have consistently displayed pricing power thanks to superb management of their large portfolio of prized brands and their low exposure to rising commodity costs.
- US utilities Eversource Energy, WEC Energy and Xcel Energy alongside telecommunications infrastructure provider Crown Castle International of the US that offer predictable cash flows thanks to regulation and strong growth in mobile data consumption respectively.
- Novartis, one of the world's largest and most diversified drugmakers. The medicine sales of the Switzerland-based group are relatively immune from the economic cycle

In the medium to long term, quality companies that are exposed to powerful and lasting thematics are rare and valuable. The portfolio's investment in such quality stocks includes:

- Leading western 'hyperscale' cloud providers that are part of Microsoft, Alphabet and Amazon. The shift to the public cloud is a long-duration thematic that we expect to grow about 20% p.a. to 2030. These companies are well placed because of their technological leadership and economies of scale.
- Enterprise software companies (Microsoft and SAP) that boost company productivity. Both are well positioned even as economic growth slows as companies look to operate more efficiently.
- Payments companies Visa and Mastercard that are leveraged to the cash-to-cashless transition that was turbocharged during the pandemic. Moreover, they benefit from faster inflation (by clipping the ticket on the value of personal consumption expenditures) and the reopening of international borders, which boosts their revenue from high-margin cross-border transactions.
- Companies leveraged to digital advertising (Alphabet, owner of Google, and Meta Platforms, owner of Facebook, Instagram and WhatsApp) that have privileged positions in the industry and offer customers compelling returns on their advertising spending. Moreover, their scalable business models mean they enjoy high profit margins.
- Companies benefiting as economies reopen such as those exposed to international travel (European-listed Amadeus IT, LVMH and Safran) and people socialising outside of home (Diageo, the world's largest distiller).
- Companies in industries where strong demand looks set to continue into the medium term. ASML is an essential part of the global semiconductor chip market that is forecast to grow by 7% p.a. and become a US$1 trillion industry by 2030. The Netherlands-based company has a near monopoly in manufacturing advanced lithography machines that build the world's most advanced and miniaturised chips. Home-improvement retailer Lowe's is benefiting from the thriving US residential property market, where household formation rates are outstripping homebuilding. HCA Healthcare is a leading US hospital operator with an exceptional record of operational excellence that is benefiting from the need for healthcare and medical procedures in an ageing US society.
- A company that provides essential financial markets infrastructure, Intercontinental Exchange, which operates some of the largest futures and equities marketplaces and has a leading position in the sprawling mortgage-technology market.

Nikki Thomas **Arvid Streimann**

Unhedged Performance as at 30 June 2022[1]

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	7 years (% p.a.)	10 years (% p.a.)	Since inception (% p.a.)
Magellan Global Fund (Open Class) (Managed Fund) (ASX: MGOC)	**-11.8**	**2.1**	**8.4**	**8.1**	**13.3**	**10.2**
9% p.a. objective excess	**-20.8**	**-6.9**	**-0.6**	**-0.9**	**4.3**	**1.2**
Magellan Global Fund (Closed Class) (ASX: MGF)	**-10.6**	-	-	-	-	**-2.5**
9% p.a. objective excess	**-19.6**	-	-	-	-	**-11.5**

Capital Preservation Measures[4]

Adverse Markets	Last 36 months	Last 60 months	Since inception 178 months
No. of observations	**9**	**16**	**58**
Outperformance consistency	**56%**	**63%**	**72%**
Down Market Capture Ratio	**0.8**	**0.7**	**0.5**

Hedged Performance as at 30 June 2022[2]

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	7 years (% p.a.)	10 years (% p.a.)	Since inception (% p.a.)
Magellan Global Fund (Hedged)	**-18.2**	**0.7**	**5.6**	**6.6**	-	**8.1**
9% p.a. objective excess	**-27.2**	**-8.3**	**-3.4**	**-2.4**	-	**-0.9**
Magellan Global Equities Fund (Currency Hedged) (Managed Fund) (ASX: MHG)	**-18.1**	**0.9**	**5.8**	-	-	**6.2**
9% p.a. objective excess	**-27.1**	**-8.1**	**-3.2**	-	-	**-2.8**

Capital Preservation Measures[5]

Adverse Markets	Last 36 months	Last 60 months	Since inception 106 months
No. of observations	**12**	**19**	**23**
Outperformance consistency	**50%**	**63%**	**70%**
Down Market Capture Ratio	**0.9**	**0.8**	**0.8**

1 Returns denoted in AUD. Open Class fund 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). Closed Class calculations are based on net asset values with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Open Class inception date is 1 July 2007 (inclusive). Closed Class inception date is 30 November 2020 (inclusive).

2 Returns denoted in AUD. Unlisted fund 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). Active ETF calculations are based on net asset values with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable).Magellan Global Fund (Hedged) inception date is 1 July 2013 (inclusive), Magellan Global Equities Fund (Currency Hedged) inception date is 4 August 2015 (inclusive).

3 Based on Magellan Global Fund, weights may not sum to total due to rounding.

4 Based on Magellan Global Fund (Open Class). Capital preservation measures are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). An Adverse Market is defined as a negative 3-month return for the MSCI World NTR Index (AUD), rolled monthly. The Down Market Capture Ratio shows if a fund has outperformed a benchmark during periods of market weakness, and if so, by how much. Fund Inception date is 1 July 2007 (inclusive).

5 Based on Magellan Global Fund (Hedged). Capital preservation measures are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). An Adverse Market is defined as a negative 3-month return for the MSCI World NTR Index (AUD Hedged), rolled monthly. The Down Market Capture Ratio shows if a fund has outperformed a benchmark during periods of market weakness, and if so, by how much. Fund Inception date is 1 July 2013.

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MAGELLAN HIGH CONVICTION STRATEGY

Chris Wheldon,
Portfolio Manager

Michael Poulsen,
Portfolio Manager
(Effective 1 July 2022)

The Magellan High Conviction Strategy seeks to deliver an attractive risk-adjusted absolute return over the long term by investing, at an attractive price, in a concentrated portfolio of high-quality businesses.

PERFORMANCE

Global stocks fell over the 12 months to June after Russia's invasion of Ukraine clouded the global economic outlook and boosted energy and food prices, central banks tightened monetary policies to tame inflation at decade highs, higher interest rates prompted talk the US economy was headed for recession, China added to worries about shortages and inflation by locking down cities to enforce a policy of zero covid-19, and key companies reported disappointing earnings.

- The **High Conviction Class A** units recorded a return after fees of minus 23.3%[1] for the 12 months.
- The **High Conviction Class B** units returned minus 22.9%[1] after fees over the same period.
- The **High Conviction Trust (ASX:MHHT)** recorded a return after fees of minus 23.3%[1] for the 12 months.

Within the underlying portfolio, the stocks that detracted most over the 12 months were the investments in Netflix (-6.0 percentage points of the total portfolio return in Australian dollar (AUD) terms), Alibaba Group (-3.9 ppts) and Meta Platforms (-3.4 ppts). Netflix fell after the streaming service said it expected subscriber growth to slow and profit margins to narrow. Alibaba dropped after the Chinese tech company announced sales figures that disappointed and Chinese regulators cracked down on local technology companies. Meta tumbled after the owner of Facebook offered weak revenue forecasts due to Apple privacy restrictions inhibiting the reach and effectiveness of online ads, its Facebook site suffered its first drop in regular users due to the popularity among the young of TikTok, and the company faced a public-relations blow and possible legal difficulties after a former employee exposed issues at the social-media company and that it was losing younger audiences.

The stocks that contributed over the 12 months were the investments in Microsoft (+0.8 ppts) and Yum! Brands (+0.3 ppts). Microsoft rose after the software giant reported profit and revenue increases that showed how much it had benefited from the shift to online during the pandemic. Yum! Brands surged on the ability of its chains such as KFC, Pizza Hut and Taco Bell to pass on higher input costs, an advantage in a time of high inflation.

OUTLOOK

Over the past 12 to 18 months, companies have confronted a complex and fast-changing environment characterised by health and economic policies that were unprecedented and geographically distinct that led to whipsawing consumer behaviour, resurgent inflation, supply-chain fragility, and capital markets that oscillated between accommodative and restrictive. Some companies benefited enormously from the pandemic while other businesses stalled. There is confusion among investors arising from where these trends are reversing and where short-term revenue and other indicators poorly reflect the long-term prospects of these businesses.

During this period, by virtue of their competitive advantages and their importance to customers, high-quality businesses proved resilient. Many adapted and prospered given their ability and attitude to innovate and invest for future growth. Others were appropriately defensive while social and economic restrictions crimped their business but survived given their robust capital footing.

As the period reminds us, high-quality businesses can weather the inevitable storms and often emerge stronger relative to frailer peers, which allows them to capitalise during calmer times. This reflection is instructive as we know that further challenges always lie in wait.

The past few years also remind us of the futility regarding equity market and macroeconomic projections. Reflecting on recent events, how could the lesson not be one of humility with respect to the developments that may confront us?

We recognise the seemingly mounting headwinds to global economic growth. Having overseen a period of extreme policy accommodation that temporarily suspended the economic cycle, and having observed signs of excess more recently, policy makers are moving in a direction that not only seeks to normalise conditions but one that may need to correct for these excesses.

The paradox confronting genuinely long-term investors is that periods such as these, characterised by rising cyclical and geopolitical concerns, are appealing in so far as they result in lower asset prices and more disciplined investor behaviour. For owners of high-quality assets with a multi-year horizon, lower prices improve the probabilities of favourable risk-adjusted outcomes, while greater capital-market discipline typically favours profitable and well-resourced incumbents.

Instead of opining on the direction of global economic growth or interest rates, our focus remains on partial ownership of a select few outstanding companies that we believe collectively offer a high probability of performing in line with our investment objectives.

PORTFOLIO POSITIONING[2]

Holdings at 30 June 2022

Security	Weight (%)
Microsoft Corporation	12.0
Alphabet Inc	11.5
Visa Inc	10.4
Amazon.com Inc	9.1
SAP SE	8.8
Yum! Brands Inc	8.8
Intercontinental Exchange Inc	8.3
Safran SA	5.9
Meta Platforms Inc	3.4
Netflix Inc	3.3
Cash	18.4
Total	**100.0**

We believe our portfolio of 10 high-quality businesses remains well positioned to generate attractive compound risk-adjusted returns over the medium to long term.

With this objective in mind, the portfolio has been constructed to provide investors with a concentrated exposure to advantaged businesses purchased at attractive prices and positioned to benefit from secular growth tailwinds. It is this approach – a considered yet concentrated selection of quality businesses possessing a competitive moat, expansive market opportunities, and appealing fundamental prospects, plus deliberate risk management – that provides conviction in the portfolio's ability to achieve its objective over time.

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 strength of the economy, often because these businesses are gaining share, and relevance, of their large markets in spite of the economic cycle. Our approach remains to invest in businesses that have a high likelihood of fundamental 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 2022 were:

- Enterprise-software companies (Microsoft and SAP) that comprised 21% 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, and often driving, the transformational growth in cloud computing.
- Companies benefiting from technology-enabled growth (Amazon, Intercontinental Exchange, and Netflix) that accounted for 21% of the portfolio. Amazon, like Microsoft and SAP, stands to benefit from the growth in cloud computing while also leveraging its leading ecommerce platform to pursue growth across the digital advertising, streaming media, and logistics industries. Intercontinental Exchange's efforts to digitise the US residential mortgage process complement its resilient exchange and data services businesses. Netflix is poised to gain from the shift in pay TV audiences to streaming video on demand.
- Advertising technology-platform companies (Alphabet, the owner of Google, and Meta Platforms, formerly Facebook) that comprised 15% 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 10% of the portfolio. Visa possesses a classic 'network-effect' business model that connects millions of merchants with billions of cardholders. It provides the 'rails' upon which global electronic payment systems run.
- A quick-service restaurant company (Yum! Brands) that represented 9% of the portfolio. The geographic and brand diversity of Yum! Brands, in addition to its franchised model and the non-discretionary nature of its meals, makes the business defensive and resilient to disruption.
- A commercial aerospace company (Safran) that represented 6% of the portfolio. Safran is one of the world's largest commercial aircraft engine and equipment suppliers and has a dominant position in highly concentrated product markets that it typically monetises through sales of spare parts over the multi-decade life of aircraft programs.
- An 18% holding in cash, held primarily in US dollars.

A fuller description of our investment approach, including some recent notable changes, can be read in the appended letter

Chris Wheldon

Michael Poulsen

Performance as at 30 June 2022[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)	-23.3	-1.5	5.1	6.3	-	10.0
Magellan High Conviction Fund (Class B)	-22.9	-1.3	-	-	-	3.4
Magellan High Conviction Trust (ASX: MHHT)	-23.3	-	-	-	-	-2.3

1 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). Magellan High Conviction Fund (Class A) inception date is 1 July 2013 (inclusive), Magellan High Conviction Fund (Class B) inception date is 15 November 2017 (inclusive) and Magellan High Conviction Trust inception date is 11 October 2019 (inclusive).

2 Portfolio positioning may not sum to 100% due to rounding. Based on the Magellan High Conviction Fund

RECENT UPDATE – MAGELLAN HIGH CONVICTION FUND AND MAGELLAN HIGH CONVICTION TRUST

- Addition to the portfolio management team

- Update to portfolio holdings range and minimum market capitalisation

- Unchanged objective to deliver attractive risk-adjusted absolute returns to investors over the medium to long term

Dear Investor,

As you may have read, we recently updated the portfolio management of the Magellan High Conviction Fund ("Fund") and Magellan High Conviction Trust ("Trust").

Effective from 1 July 2022, we made the following changes that we believe enhance our ability to deliver the shared objective of the Fund and the Trust, being attractive risk-adjusted absolute returns to investors over the medium to long term.

Strengthening of Portfolio Management Team

We are delighted to announce that Michael Poulsen was added as co-portfolio manager of the Fund and the Trust, joining Chris Wheldon. Michael has served as a key member of Magellan's investment team since 2012, working across sector teams and investment strategies. Chris Mackay will continue to perform an oversight role.

Increase in Portfolio Flexibility

The portfolio holdings range of the Fund and the Trust was increased modestly from 8-12 to 10-20 and will remain weighted towards Magellan's highest conviction ideas. The increase reflects our desire to:

- Invest in high-quality businesses having a smaller market capitalisation;
- Increase position sizing flexibility and portfolio balance;
- Improve risk management and the diversification of common exposures; and
- Enhance our ability to respond to corporate actions undertaken by portfolio companies.

Expansion of Investment Universe

Having more extensively reviewed the universe of high-quality smaller businesses and having established a dedicated team to appraise these opportunities, the minimum market capitalisation constraint for inclusion in the Fund and the Trust was reduced from US$5 billion to US$3 billion. We anticipate that over time there will be highly attractive investment opportunities from these smaller companies that are often less actively researched by market participants than larger companies, and by definition, have a longer runway to compound.

Critically, we would like to reiterate what has not changed.

The most important constant remains our responsibility to you as fiduciaries and stewards of your savings. We take this responsibility seriously, guided by Warren Buffett's first rule of investing ("don't lose money") and have aligned our interests with yours by investing alongside you.

The Fund's and the Trust's objective will remain: to achieve attractive risk-adjusted returns over the medium to long term. Directed by the discipline of risk-adjusted opportunity cost, we aspire to the highest level of compounding achievable over the longest possible time – our investment runway is measured in decades. We will assess the performance of the Fund's and the Trust's holdings through the lens of long-term operating results rather than short-term share price movements.

The Fund's and the Trust's investment philosophy remains grounded in the pursuit of risk-adjusted absolute returns – not unadjusted or relative returns – with a long-term orientation and deep fundamental research. We will continue to apply this inch-wide-mile-deep mindset to a deliberately constrained universe of outstanding companies that we consider possess the means to sustainably exploit competitive advantages. Our role then is to construct a concentrated portfolio of these high-quality companies, purchased at attractive prices relative to their conservatively assessed intrinsic value, while being mindful of the various types and degrees of risk in the Fund's and the Trust's portfolio. We recognise that exceptional risk-adjusted compounding opportunities are rare and, consequently, the Fund and the Trust each retain the ability and inclination to lean in, subject to appropriate constraints, when these investments present themselves. Avoiding the residual mediocre opportunities aligns with the Fund's and the Trust's concentrated and patient nature. Coming full circle, this process will continue to be executed in pursuit of the shared objective of the Fund and the Trust.

Our approach and attitude remains bottom-up, fundamental, and informed by the view that high-quality and well-run companies exposed to growth tailwinds and purchased at sensible prices provide the highest odds of weathering the inevitable market and macroeconomic storms that are certain to confront us. We will experience age-old economic and market fluctuations. We also know we'll confront new, unthinkable developments over the years ahead that can't be studied in any history book. Worst-case scenarios are not bound by historic precedent. Environmental flux, surprises and periodic headwinds are features of the system, yet despite the assurance of their occurrence we can't know when or where they'll strike, and nor will we attempt to 'time' their arrival. We will seek to understand what could happen but not predict what will happen regarding these unknowable future developments, and we'll view the inevitable swings in Mr Market's mood as providing a fertile environment for opportunity, not risk, and otherwise as a distraction.

There are very few great businesses, and even fewer opportunities to purchase them at attractive prices. Those rare occasions that equity markets provide to transact at prices that differ meaningfully from fair value will often be associated with excessive optimism or pessimism. Periods of volatility that create clear disparity between price and value offer an advantage available to equity market investors. But the cost of this service is fear, doubt, uncertainty, and regret. A meaningful decline in prices typically requires widespread concern and turmoil. Yet lower prices increase prospective risk-adjusted returns, all else equal, which is why investors view all historic drawdowns as opportunities despite being concerned by future market declines. Therefore, purchase activity should be highest in a climate when this very activity seems most ill-conceived. The opposite is also true, and investors risk being tempted into complacency just when they need to be most prudent.

We must also regularly squint through the immediate and absorbing thing to observe the slow and uneven, but relentless and often overlooked, progress that characterises economic and equity market outcomes over the long term. The longer one's investment horizon, the greater the asymmetry and odds of favourable outcomes become for equity market investors. With the probabilities of attractive risk-adjusted returns stacked in favour of long-term investors, the tailwind of economic and equity market gains over time should be exploited, not forgone. Rather than a source of protection, attempts at market timing would risk underperforming our objective.

Instead of attempting to predict the unpredictable, our focus will remain directed towards each company's customer relevance, competitive advantage and direction, market opportunity, reinvestment profile, adaptability, management capability and alignment, capital position, and business- and industry-specific risks, knowing that only a very small percentage of companies will account for the vast majority of economic gains over time. We'll favour businesses prioritising long-term resiliency and durability over short-term efficiency and optimisation. Deliberate, disciplined, repeated, and retested insistence on these qualities offer a degree of protection against unforeseeable risks. Amidst constant attention-seeking headlines and noise, our bias will be towards inactivity when informed by an assessment that the likely range of fundamental outcomes remains consistent with our objective. Activity does not correlate with performance. Sustained compounding requires patience and where patience is deserved, we will seek to reward it.

Despite these attempts to keep the odds tilted in our favour, business outcomes are inherently uncertain. Chance and randomness abound. And all companies eventually succumb to competitive and disruptive forces. Each of these factors mean mistakes are inevitable. Yet, in addition to patience, compounding demands the avoidance of large losses, so we must be vigilant to both the likelihood of loss and its consequences, in addition to any added outcome from bad luck. In turn, this requires humility, a focus on process over outcomes, probabilistic thinking with an active pursuit of disconfirming evidence and diverse views, insistence on a margin of safety, guarding against extrapolation, a willingness to admit ignorance and pass on most opportunities, a disregard for sunk costs, imagination of failure, a strict adherence to disqualifying features, an open-minded and dispassionate attitude towards ever-changing fundamental circumstances and prospects, and ready idea destruction and acknowledgement of mistakes, each necessitating a corrective reallocation of portfolio capital towards superior opportunities. If change is constant then we must be flexible and continuously realign with reality to benefit from it, not stubbornly resist it.

We intend to communicate with you as partners, and as owners of businesses rather than as renters of stocks. When we make mistakes, we will discuss them candidly. We will continue to disclose the portfolio's five largest holdings in the monthly factsheets, plus the full portfolio each quarter with a lag. Expect our commentary to centre on business fundamentals rather than market prognostications. However, understanding the impairment to clear and unencumbered thought that follows any public commentary, we will be careful and balanced in our communication.

By revisiting some foundational views in this letter, we hope you have sufficient information to determine whether the Fund or the Trust – each focused on long-term compounding of fundamental value through the concentrated ownership of exceptional businesses – is aligned with your investment approach and time horizon.

Should you wish to discuss any of the contents of this letter, please reach out to us directly, or contact your Magellan representative.

Chris Wheldon
Portfolio Manager

Michael Poulsen
Portfolio Manager

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MAGELLAN INFRASTRUCTURE STRATEGY

The strategy seeks to provide efficient access to the stable returns offered by infrastructure and utility stocks while protecting capital in adverse markets by investing in infrastructure companies that provide essential services and generate predictable long-term earnings. Infrastructure and utility stocks that will help achieve these aims generally have strong underlying financial performance over the medium to long term, which is expected to translate into reliable, inflation-linked returns. The strategy typically holds between 20 and 40 stocks. The unhedged version of the strategy makes no attempt to protect returns from currency movements.

Gerald Stack,
Head of Investments and Head of Infrastructure

PERFORMANCE

Global stocks fell over the 12 months to June after Russia's invasion of Ukraine clouded the global economic outlook and boosted energy and food prices, central banks tightened monetary policies to tame inflation at decade highs, higher interest rates prompted talk the US economy was headed for recession, and China added to worries about shortages and inflation by locking down cities to enforce a policy of zero covid-19.

- The Magellan Infrastructure Fund recorded a return after fees of 6.6%[1] for the 12 months.
- The Magellan Infrastructure Fund (Currency Hedged) (Managed Fund) recorded a return after fees of 6.5%[1] for the 12 months.
- The Magellan Infrastructure Fund (Unhedged) recorded a return after fees of 10.7%[2] for the 12 months.

Within the underlying global portfolio, the companies that contributed were the investments in Sempra Energy of the US (+1.2 percentage points of the total portfolio return in Australian Dollar (AUD) terms), Atlantia of Italy (+1.1 ppts) and WEC Energy Corp of the US (+0.9 ppts). Sempra Energy rose after investors assessed that one fall-out of the Russia-Ukraine war is faster growth for the energy infrastructure's North American LNG export business. Atlantia surged after the Benetton family, the largest shareholder in the motorway and airport infrastructure company with a 33% stake, announced a takeover of 23 euros a share to take the company private. WEC Energy jumped after the company that supplies electricity and gas to Midwestern states announced first-quarter earnings that beat expectations thanks to strong demand for gas during winter and growth in its 'rate base'.

The companies that detracted the most were the investments in Aena of Spain (-0.7 ppts), Royal Vopak of the Netherlands (-0.4 ppts) and Vinci of France (-0.4 ppts). Aena tumbled as covid-19 variants disrupted travel and the world's largest airport operator reported disappointing earnings due to higher energy prices. Vopak slid as the storage operator's earnings reports disappointed, occupancy rates in its terminals fell and the 'backwardation' in oil markets (when the spot price is higher than the futures price) stirred uncertainty. Vinci fell as investors expressed concern that an economic downturn and soaring fuel prices could hamper the company's toll road and construction businesses.

POSITIONING AND OUTLOOK

The strategy has invested in a portfolio of listed infrastructure companies that the investment team considers to be high quality and that are expected to generate reliable long-term earnings that ultimately lead to reliable investment returns.

In addition to reliable underlying earnings, the portfolio is exposed to structural growth that could potentially enhance returns to investors:

- The transition of the global economy to net-zero emissions will require significant investment in electricity transmission and distribution that will enable regulated electricity utilities to grow their assets and earnings.
- Strong growth in the volume of data flowing across communications networks will require additional investment in communications infrastructure.
- Growth in economies will lead to increased road and aviation traffic that can be expected to increase revenues and earnings for toll roads and airports.

The past 12 months have seen central banks tighten monetary policy with consequent increases in prevailing bond yields leading to increased market volatility. Notwithstanding turbulence in equity markets, we expect that underlying earnings of infrastructure and utilities companies in our defined investable universe should prove reliable. These reliable earnings provide confidence that a portfolio of high-quality infrastructure companies will deliver the investment performance we expect.

Top-10 holdings at 30 June 2022[3]

Security	Weight (%)
Transurban Group	8.1
Vinci SA	6.1
Dominion Energy Inc	5.1
United Utilities Group Plc	4.6
Sempra Energy	4.5
American Tower Corporation	4.5
Crown Castle International	4.1
Atlantia SpA	4.1
Atlas Arteria	3.8
Eversource Energy	3.8
Total	**48.7**

PORTFOLIO STRATEGY

Our investment philosophy has not changed since we launched the strategy in 2007. We seek to build a portfolio of outstanding infrastructure and utility companies that generate the predictable long-term earnings with predictable earnings being the bedrock of reliable long-term investment returns for infrastructure investors.

The types of infrastructure assets in which the strategy invests are generally natural monopolies that provide an essential service to the community. We exclude infrastructure companies whose earnings are exposed to competition, sovereign risk and changes in commodity prices, with the aim of limiting our investment universe to stocks that provide investors with predictable, through-the-cycle, inflation-linked returns. Infrastructure assets offer investors protection from inflation because their real earnings are generally protected in various ways.

The universe of infrastructure assets that we consider for the strategy mainly comprises two sectors:

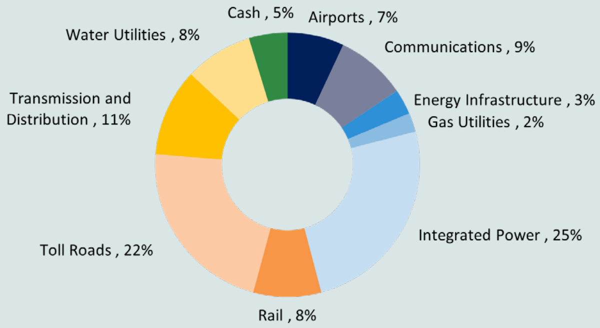
- **Regulated utilities**, which includes energy and water utilities. We estimate that utilities comprise about 60% of the potential investment universe for the strategy. Utilities are typically regulated by a government-sponsored entity. Such regulation requires the utility to efficiently provide an essential service while allowing the utility to earn a fair rate of return on the capital it has invested.
- **Infrastructure**, which includes airports, ports, railroads, toll roads, communications assets and energy infrastructure (oil and gas pipelines). Typically, infrastructure companies are involved in the transport of people, goods or data. Regulation of infrastructure companies is generally less intensive than for utilities and allows companies to benefit from growth in the use of the infrastructure offered. As economies and technology develop, we expect the volume of aviation, shipping, rail and vehicle traffic to increase, along with demand for data transported through communications networks.

Utilities and infrastructure companies provide essential services while facing limited, if any, competition. Because the services are indispensable, the prices charged can be adjusted with limited impact on demand. As a consequence, earnings are more reliable than those for a typical industrial company and generally enjoy inherent protection against inflation. Over time, the stable revenue or cash-flow streams derived from infrastructure assets are expected to deliver income and capital growth for investors.

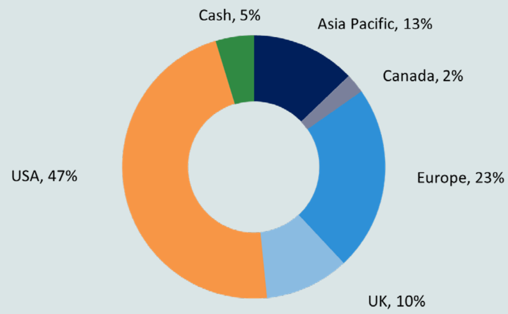
Over the 15 years we have been managing infrastructure investments, we have faced many periods of investment market uncertainty. Ultimately, we believe the use of a conservatively defined infrastructure investment universe has meant that the long-term earnings derived by the companies that we invest in have grown in a predictable manner and this has led to reliable long-term wealth accumulation for investors.

PORTFOLIO OUTLOOK

Sector Exposure[4]



Geographical Exposure[4]



As the chart above shows, at the end of June 2022 the portfolio was composed of approximately equal investment in infrastructure and utilities and a small allocation to cash. While the generation of reliable long-term earnings is a key characteristic of these investments, some sectors that the portfolio has invested in enjoy attractive long-term structural growth.

The **regulated electricity utilities** in the portfolio (categorised as 'integrated power' and 'transmission and distribution' in the chart above) typically operate within regulatory frameworks that protect their earnings against increases in fuel and purchased power costs. In most instances, regulatory mechanisms also moderate the sensitivity of earnings to changes in customers' consumption of electricity. Reflecting these supportive regulatory settings, almost all the electricity utilities in the portfolio reported 2021 calendar-year financial results that were in line with or ahead of guidance issued at the beginning of the year, notwithstanding the impact of sharp rises in wholesale energy prices, and the ongoing effects of the pandemic.

We expect the transition to a net-zero economy to require sustained high levels of investment, leading to attractive rates of earnings growth for our regulated electricity utilities for a generation. Electrification of end-use consumption lies at the heart of policymaker plans to achieve net-zero emissions, while the International Renewable Energy Agency projects the contribution of electricity to total energy consumption will increase from 19% in 2019 to 50% in 2050.[5] A meaningful portion of the remaining demand for energy in a net-zero economy is expected to be met by green hydrogen and advanced biofuels synthesised in grid-connected electrolysers, and 'power-to-x' facilities that use renewable electricity as an input to production, further accentuating the contribution of electricity infrastructure. Having regard to the critical role electricity utilities play towards a net-zero economy, investors can be confident that significant network investment is likely to attract regulatory support.

The International Energy Agency (IEA) estimates that global renewable generating capacity will need to triple over the period to 2030 and increase nine-fold over the period to 2050 if the world is to achieve net-zero emissions by mid-century.[6] The IEA further projects that investments in electricity grids will triple to 2030, remaining at elevated levels until 2050.[7] In the US, Princeton University estimates that the transition to a net-zero emissions economy will require investments in new wind and solar capacity of US$3.4 billion to $6.2 trillion and in new transmission capacity of US$2.5 billion to $3.7 trillion.[8] Electricity distribution networks to support the electrification of transportation will require further significant investment. Under the regulatory construct, these investments boost the earnings potential of our electricity utilities, presenting investors with an opportunity to compound attractive risk-adjusted investment returns for a generation.

Water utilities are among the most defensive assets in the infrastructure investment universe. Stable underlying demand for water and wastewater services confers on the earnings of these companies a high degree of predictability. The replacement of ageing pipes and water treatment plants coupled with efforts to enhance the resilience of networks against the impacts of climate change support expectations of predictable growth in earnings well into the future.

Gas utilities operate within regulatory constructs that protect their earnings against increases in volatile natural gas prices. In many instances, these businesses also benefit from weather-normalisation clauses and revenue-decoupling mechanisms that moderate the sensitivity of earnings to changes in customer consumption. As a consequence of this favourable treatment, the gas utilities in the strategy delivered robust financial results during 2021, sharp rises in gas prices and the ongoing impact of the pandemic.

The significant investment required to replace ageing cast iron, bare steel and vintage plastic pipe within gas distribution networks supports attractive earnings growth rates for many gas utilities. We expect the space heating loads that dominate demand for gas to prove resilient to electrification in the regions where we invest, reflecting the superior economics and technical properties of gas-fired heating relative to electric heat pumps.

The **communications infrastructure** assets in the portfolio generate highly defensive earnings streams. Leases over communications tower assets are typically struck with an initial term of five to 10 years, provide for multiple renewal terms, and limit the termination rights of tenants. Moreover, lease agreements ordinarily embed rent escalation clauses, with rents typically escalating at a rate of about 3% p.a. in the US and at prevailing inflation rates in international markets.

With mobile data consumption expected to grow at rates in excess of 25% p.a. in key international markets over the next five years,[9] communication infrastructure companies in the portfolio are poised to benefit from strong tenancy growth as wireless carriers add cell sites to deliver adequate network coverage. Having regard to the operating leverage inherent in the tower companies' business models, this revenue growth is expected to yield outsized growth in earnings and cash flow.

The **toll-road** companies in the strategy are among the most structurally advantaged infrastructure assets in the world. Congestion on alternative routes implies that these assets face limited competition and capture a disproportionate share of incremental growth in traffic. Moreover, concession agreements typically provide for tolls to escalate at CPI or fixed nominal rates above CPI, preserving the real value of cash flows in an inflationary environment. As the covid-19 health crisis has abated, restrictions on movement have eased, supporting a rapid recovery in traffic volumes. The traffic levels for most of the toll roads we follow are now back above pre-pandemic levels, demonstrating the robust underlying demand for the efficient transportation that these essential assets provide.

While the global health crisis still weighs heavily on the results of our **airport** investments, easing pandemic restrictions have seen the recovery in aviation activity gather momentum over recent months. For the month of April (the most recently available data), the International Air Transportation Association (IATA) reported that global passenger demand remained about 37% below its 2019 level, with international demand operating at about 57% of its pre-pandemic level.[10] Encouraged by the efficacy of vaccines, IATA's most recent projections call for world aviation activity to exceed 2019 levels in 2023, while major airports are guiding to a recovery to 2019 passenger volumes between 2023 and 2027.

North American **railroads** provide a basic and essential service to the freight industry by transporting freight across North America. From agriculture and automotive parts to chemicals and coal, railroads serve practically every industry. Rail is typically the most economical option for long-distance shippers, particularly when hauling low-value heavy goods such as minerals and grains.

North American railroad companies operate within duopoly markets, which means competitive pressures are limited. Within each market, the main operators have shown the discipline needed to expand margins while capital intensity, network effects and rights of way create barriers to new entrants.

Railroads have demonstrated an ability to more than account for inflation through pricing power. Railroads face light economic regulation that allows railroad operators to charge rates that support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation while attempting to maintain sufficient levels of market-based competition. Arguably, this framework has provided railroads with greater discretion around the rates they charge customers and thus, the ability to more than account for inflation.

Key risks for railroads include regulation and economic sensitivity. As is often the case in infrastructure, economic regulation is present but the regulation has historically been light handed and constructive. Rail companies are exposed to potential fluctuations in the volume of goods transported due to changing economic conditions but long-term underlying demand can be expected to grow with the economy.

Over the long term, we expect rail companies to benefit from modest volume growth and progressive improvement in operating efficiency. Improvements in operating efficiency are expected due to the adoption of 'precision scheduled railroading' initiatives. These initiatives have been implemented across the railroad industry over the past 20 years, leading to structural cost efficiencies and consequent improvements in profitability. These improvements are expected to continue.

The **energy infrastructure** companies in the strategy generate earnings by storing and transporting crude oil, natural gas and chemicals in their network of storage terminals and pipelines. The selective group of storage and pipeline assets that meet our strict definition of infrastructure derive the bulk of their earnings under long-term take-or-pay arrangements or from assets that are subject to economic regulation. Critically, these arrangements immunise earnings against the movements in commodity prices that erode the reliability of cash flows from most oil and gas pipelines. Moreover, while our energy infrastructure investments often bear some volume risk on their regulated assets, the advantaged producing regions and demand centres that these pipelines and storage assets serve have historically supported consistently high levels of use.

While the transition to a global economy that is less reliant on fossil fuels may challenge energy infrastructure companies in the long term, we expect their reliable earnings to be fundamentally undisturbed for at least the next 15 years. While most major auto manufacturers have signalled their intent to discontinue the sale of internal combustion engine passenger vehicles between 2030 and 2035, the existing fleet will support demand for crude oil well beyond this period. Indeed, Bloomberg New Energy Finance forecasts that there will still be more than 900 million fossil-fuel-powered vehicles on the road in 2040, representing more than half of the global fleet.[11] We expect demand from power generation and space heating to lend similar resilience to natural gas transportation assets.

Having regard to the advantaged characteristics and favourable prospects of the companies in the portfolio, we remain confident that the strategy will meet its objectives of delivering attractive risk-adjusted investment returns over the long term and protecting capital in adverse markets.

IMPACT OF INFLATION AND INTEREST RATES ON INFRASTRUCTURE INVESTMENTS

The emergence of inflation and withdrawal of ultra-accommodative monetary policy settings marked a paradigm shift in global markets during the last twelve months. Consequent increases in prevailing bond yields have led to increased investment market volatility. There are two key areas we focus on when considering interest rates:

1. **The impact on the businesses in which we invest**: We remain confident that the businesses that meet our investment-grade infrastructure criteria are well placed to meet our investment expectations through a period of elevated inflation and rising interest rates; and
2. **Impact on valuations and on debt and equity markets:** An increase in interest rates can be expected to lead to a higher cost of debt and an increase in long-term discount rates. We observe that stocks that are regarded as 'defensive,' a term that covers infrastructure businesses and utilities, are often subject to negative sentiment during periods when interest rates rise. Nevertheless, it is our experience that, provided the fundamentals of the businesses we are invested in remain robust, their stock prices will ultimately resume their former trajectory of growth. As the famous investor Benjamin Graham noted, in the long run the stock market is a cash flow weighing machine and what matters is underlying business performance rather than short-run prospects.

Notwithstanding equity market volatility, we expect that underlying earnings of infrastructure and utilities companies in our defined investable universe should be robust and reflect solid growth. Ultimately the value of the companies in our investment portfolio reflects the future cash flows they are expected to generate and the risks associated with those cash flows.

OUTLOOK

We think that infrastructure assets, with requisite earnings reliability and a linkage of earnings to inflation, offer an attractive long-term investment proposition. Furthermore, given the predictable nature of earnings and the structural linkage of those earnings to inflation, the investment returns generated by infrastructure assets are different from standard asset classes and offer investors valuable diversification when included in an investment portfolio. In the current uncertain economic and investment climate, the reliable financial performance of infrastructure investments makes them particularly attractive. We believe, an investment in listed infrastructure can be expected to reward patient investors within a three- to five-year time frame.

Notwithstanding the resilient nature of the stocks held in the portfolio, we expect to see volatility in equity markets, particularly when interest rates change. We are, however, confident that any increase in interest rates will have minimal drag on the underlying financial performance of the companies in the portfolio.

Gerald Stack

Hedged Performance as at 30 June 2022[1]

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	7 years (% p.a.)	10 years (% p.a.)	Since inception (% p.a.)
Magellan Infrastructure Fund	6.6	1.5	5.5	7.6	10.4	7.5
Magellan Infrastructure Fund (Currency Hedged) (Managed Fund) (ASX: MICH)	6.5	1.7	5.6	-	-	6.2

Capital Preservation Measures[12]

Adverse Markets	Last 36 months	Last 60 months	Since inception 180 months
No. of observations	14	19	63
Outperformance consistency	64%	68%	73%
Down Market Capture Ratio	0.6	0.5	0.4

Unhedged Performance as at 30 June 2022[2]

	1 year (%)	3 years (% p.a.)	5 years (% p.a.)	7 years (% p.a.)	10 years (% p.a.)	Since inception (% p.a.)
Magellan Infrastructure Fund (Unhedged)	10.7	2.0	6.9	8.1	-	10.8

Capital Preservation Measures[13]

Adverse Markets	Last 36 months	Last 60 months	Since inception 108 months
No of observations	15	23	41
Outperformance consistency	60%	61%	61%
Down Market Capture Ratio	0.8	0.5	0.5

1 Returns denoted in AUD. Unlisted fund 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). Active ETF calculations are based on net asset values with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Magellan Infrastructure Fund inception 1 July 2007 (inclusive), Magellan Infrastructure Fund (Currency Hedged) inception date is 19 July 2016 (inclusive).
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 1 July 2013 (inclusive).
3 Based on Magellan Infrastructure Fund. Weights may not sum to total due to rounding.
4 Based on Magellan Infrastructure Fund. Sectors are internally defined. Geographical exposures are by domicile of listing. Cash exposure includes profit/loss on currency hedging. Exposures may not sum to 100% due to rounding.
5 International Renewable Energy Agency, Energy Transitions Outlook 20222: 1.5°C Pathway, March 2022.
6 International Energy Agency, Net Zero by 2050: A Roadmap for the Global Energy Sector, May 2021.
7 International Energy Agency, Net Zero by 2050: A Roadmap for the Global Energy Sector, May 2021.
8 Princeton University, Net-Zero America: Potential Pathways, Infrastructure, and Impacts, December 2020.
9 Ericsson Mobility Report, November 2020.
10 International Air Transportation Association, Air Passenger Market Analysis, April 2022.
11 BloombergNEF, Electric Vehicle Outlook 2021, June 2020.
12 Based on Magellan Infrastructure Fund. Capital preservation measures are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). An Adverse Market is defined as a negative monthly return for the MSCI World NTR Index (A$ Hedged). The Down Market Capture Ratio shows if a fund has outperformed a benchmark during periods of market weakness, and if so, by how much. Fund Inception date is 1 July 2007 (inclusive).
13 Capital preservation measures are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). An Adverse Market is defined as a negative 3-month return for the MSCI World NTR Index, rolled monthly. The Down Market Capture Ratio shows if a fund has outperformed a benchmark during periods of market weakness, and if so, by how much. Fund Inception date is 1 July 2013 (inclusive).

IMPORTANT INFORMATION

MAGELLAN SUSTAINABLE FUND (MANAGED FUND) (CXA: MSUF)

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.

Dom Giuliano,
Head of ESG/Portfolio Manager

PERFORMANCE

Global stocks fell over the 12 months to June after Russia's invasion of Ukraine clouded the global economic outlook and boosted energy and food prices, central banks tightened monetary policies to tame inflation at decade highs, higher interest rates prompted talk the US economy was headed for recession, and China added to worries about shortages and inflation by locking down cities to enforce a policy of zero covid-19.

The Magellan Sustainable Fund (Managed Fund) (CXA:MSUF) recorded a return after fees of minus 17.4%[1] for the 12 months. The stocks that detracted the most over the 12 months were the investments in Netflix (-3.2 percentage points of the total portfolio return in Australian dollars), Meta Platforms (-3.0 ppts), and China's Alibaba Group (-2.3 ppts). Netflix fell after the streaming service said it expected subscriber growth to slow and profit margins to narrow. Meta tumbled after the owner of Facebook offered weak revenue forecasts due to Apple privacy restrictions inhibiting the reach and effectiveness of online ads, its Facebook site suffered its first drop in regular users due to the popularity among the young of TikTok, and the company faced a public-relations blow and possible legal difficulties after a former employee exposed issues at the social-media company and that it was losing younger audiences. Alibaba dropped after the Chinese tech company announced sales figures that disappointed and Chinese regulators cracked down on local technology companies.

Of these three largest detractors, Netflix and Alibaba can be considered investment mistakes. For Netflix, there were two key errors. First, the impact of the elevated and sustained level of competition from other streaming platforms was underestimated. Second, the level of likely market penetration was underestimated, and therefore the potential market addressable by Netflix was overestimated. For Alibaba, the position sizing was overly large within the portfolio given the degree of regulatory risks facing facets of Alibaba's businesses. Both these mistakes have resulted in permanent erosion of invested capital. Meta Platforms is different in that the range of innovation, revenue and earnings outcomes remain wide, notwithstanding the pressures facing the business in the shorter term. Meta's management does have significant scope to meet its challenges, whether from TikTok, Apple's restrictions or its investment in innovation.

The stocks that contributed the most over the 12 months included the investments in Sydney Airport (+0.8 ppts), Chipotle Mexican Grill (+0.8 ppts) and Lowe's (+0.7 ppts). Sydney Airport jumped following a A$24 billion takeover offer from a consortium led by the infrastructure manager IFM. Chipotle surged after the US fast-food chain reported 'beats' on quarterly sales during the year and the company increased its long-term restaurant goal to 7,000 in North America, up from 6,000. Lowe's gained as a jump in home improvements amid a housing boom helped the company report higher-than-expected earnings.

OUTLOOK

In the past 12 months, inflation pressures have proven to be more persistent than expected, leading central banks to increase the size and pace of their monetary tightenings. While this is likely to result in a slow peak in inflation and a 'soft' landing, we see three risks to this outlook.

The first risk is that consumer expectations of inflation become unhinged, triggering a wage-price cycle. This would prompt central banks to conduct more rate increases, which would put more downward pressure on economic growth. The second risk is an unexpected supply- or demand-side shock that worsens the outlooks for growth and inflation. There might be, for instance, a disruption to energy supplies or a loosening or tightening in fiscal-policy settings. The third risk is that central banks fail to see that economic growth has slowed enough to rein in inflation and they keep raising rates and slow the economy too much.

We are cautious about the outlook for equity market returns over the next 18 or so months and on June 30 held a cash balance of 12%. As economies slow, we expect equity returns to be increasingly driven by a softening in earnings expectations rather than higher interest rates. Until the peak in interest rates and the likely path of growth become clearer, uncertainty will weigh on equity valuations.

PORTFOLIO POSITIONING[1]

Top-10 holdings at 30 June 2022

Security	Weight (%)
Alphabet Inc	7.7
Microsoft Corporation	7.5
Visa Inc	4.9
Mastercard Inc	4.7
Yum! Brands Inc	4.1
Novartis AG	4.1
Unilever PLC	3.8
Meta Platforms Inc	3.8
Reckitt Benckiser Group	3.8
Nestlé SA	3.7
Total	**48.1**

We think our portfolio of 27 high-quality companies is positioned to deliver on our investment objectives.

It is our conviction that high-quality companies will provide investors with the most reliable returns over the medium to long term. To be sure, returns from quality companies may lag over some short time frames, especially if investors are infatuated with mesmerising profitability forecasts that have a low probability of occurring in the medium to long term. History, however, has repeatedly shown that these periods are aberrations that are punctured when investor sentiment inevitably normalises. Indeed, this is what has happened over the past 12 months; investor risk appetite deteriorated.

One of the strongest signs of a quality company – in fact, almost a prerequisite – is pricing power. With the surge in inflation over the past 12 months or so, companies with pricing power have proven their value to investors because they have swiftly passed on higher costs to customers and thereby protected their profit margins. This advantage is compounded when companies sell something that their customers are reluctant, or unable, to do without when prices rise. Over the past 12 months, companies with these characteristics have performed comparatively well owing to their 'defensive' nature. Our investments with these characteristics include:

- Consumer staples such as Nestlé, Procter & Gamble, Unilever and Reckitt.
- Restaurant companies such as Chipotle Mexican Grill, McDonald's and Yum! Brands (owner of KFC, Pizza Hut and Taco Bell) that are enjoying an added boost to revenue and profit growth from new stores.
- Utilities Eversource Energy from the US and Red Eléctrica of Spain that offer predictable cash flows thanks to regulation. While not regulated in the same way as utilities, Verisign's monopoly business of managing domain names '.com' and '.net' provides significant revenue stability.
- Novartis, one of the world's largest and most diversified drugmakers. The medicine sales of the Switzerland-based group are relatively immune from the economic cycle.
- Well-positioned mass-market retailers such as Walmart are increasingly successful vendors with economies of scale across physical and digital commerce. The retailer's strong grocery offer and growth prospects in digital are expected to provide stable revenues through the economic cycle.

In the medium to long term, quality companies that are exposed to powerful and lasting thematics are rare and valuable. The portfolio's investment in quality stocks comprises:

- Companies leveraged to digital advertising (Alphabet, owner of Google, and Meta Platforms) that have privileged positions in the industry and offer companies compelling returns on their advertising spending. Moreover, their scalable business models mean they enjoy high profit margins.
- Leading western 'hyperscale' cloud providers that are part of Alphabet, Amazon and Microsoft. The shift to the public cloud is a long-duration thematic that we expect to grow about 20% p.a. to 2030. These companies are well placed because of their technological leadership and economies of scale.
- Enterprise software companies (Microsoft, Salesforce and SAP) that boost company productivity. These companies are well positioned if economic growth slows and companies look to operate more efficiently.
- Payments companies Mastercard, PayPal and Visa that are leveraged to the cash-to-cashless transition that was turbocharged during the pandemic. Moreover, they benefit from faster inflation (by clipping the ticket on the value of personal consumption expenditures) and the reopening of international borders, which boosts their revenue from high-margin cross-border transactions.
- Companies benefiting as economies reopen such as those exposed to increased travel (airport groups Aena of Spain and Fraport of Germany) and vacation (Booking Holdings, one of the world's largest online travel platforms).
- Banks as they are one of the few potential beneficiaries of higher interest rates. US Bancorp is poised to see its net interest margins rise as central banks increase key interest rates. However, a harder landing scenario could pose nearer-term cyclical risks from higher loan losses.
- Companies benefiting from technology-enabled growth (Intercontinental Exchange and Netflix). Intercontinental Exchange of the US provides essential financial markets infrastructure and operates some of the largest futures and equities marketplaces and has a leading position in the sprawling mortgage-technology market. Netflix is leveraged to the broad shift from pay TV to streaming video on demand.

Dom Giuliano

Performance as at 30 June 2022 [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)	**-10.4**	**-**	**-**	**-**	**-**	**-0.6**

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).

IMPORTANT INFORMATION

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