MFG ASSET MANAGEMENT

Annual Investor Report 2019

MFG Global Equity Strategy

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MFG GLOBAL EQUITY STRATEGY

Our Global Equity Strategy is a core holding that invests in the world's best 20 to 40 global stocks. The fund aims to deliver 10% p.a. over the economic cycle while reducing the risk of permanent capital loss. The hedged version of the strategy aims to protect returns from currency movements.

Hamish Douglass, Chairman and Chief Investment Officer

PERFORMANCE

Global stocks rose in the 12 months to June 2019 after companies posted higher-than-expected earnings, the US economy expanded briskly without generating inflation, the Federal Reserve indicated it would stop, and possibly reverse, its gradual tightening of US monetary policy, and the European Central Bank said it would "use all the instruments that are in the toolbox" to help the eurozone's weak economy. Gains were capped by concerns global growth might slow, driven by China-US tensions and rising political uncertainty in Europe.

The strategy recorded a gross return of 15.8% for the 12 months in US dollars. The stocks that performed best included the investments in Starbucks (+3.3% of the total strategy return), Microsoft (+2.1%), Visa (+1.7%), Yum! Brands (+1.4%), Mastercard (+1.3%) and HCA Healthcare (+1.2%). Starbucks rose after the coffee chain spoke of plans to improve delivery in China, boosted marketing in the US to revive sales growth, posted global sales growth that topped expectations and said it would cut about 5% of the workers at its headquarters. Microsoft gained after releasing earnings results that consistently showed strong growth in cloud revenues. Visa and Mastercard benefited from sustained growth in consumer spending and greater card use in a world going more cashless. Yum! Brands rose after same-store sales and profit numbers of the owner of KFC, Pizza Hut and Taco Bell persistently outdid expectations. HCA rallied after the US hospital chain reported higher-than-expected profits and revenue due to higher patient numbers and an increase in higher-paying procedures.

The stocks that detracted most performance were Kraft Heinz (-3.0%) and Wells Fargo (-0.5%). Kraft Heinz staged its big tumble in the March quarter after the packaged-goods company wrote down the value of underperforming brands by US$15.4 billion, reported earnings that fell short of expectations due to higher costs, and said it was subject to a probe by regulators. Wells Fargo fell as the US bank faced challenges to boost revenue due, in part, to the restrictions regulators have imposed following a series of scandals. We have exited Kraft Heinz and Wells Fargo.

OUTLOOK

Equity prices rose in the June quarter even though risks remain elevated.

While the likelihood of a deal between China and the US plummeted in May, an agreement to restart talks following the G20 meeting in June raised hopes that the two sides would ultimately settle their differences. This buoyed equity prices, as did central banks signalling their willingness to loosen monetary policy in order to counter risks to growth. But the risk persists that protracted China-US negotiations could undermine global growth so much the deterioration would not be offset by a deal or easier central bank settings.

We see three broad scenarios for equity markets. The first, which we rate about a 50% probability, is that there is no significant increase in US inflation or a sharp slowdown in global growth, with further rate cuts likely. Under this outcome, broad equity indexes would most likely provide satisfactory returns.

In the second scenario (25% probability), global growth slows to a level that forces central banks to respond more aggressively. Needless to say, the more growth slows, the worse it is for equity prices.

Performance as at 30 June 2019[1]

Performance (USD)[1]	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)	7 Years (% p.a.)	10 Years (% p.a.)	Since inception (% p.a.)
MFG Global Equity Strategy (Gross)	15.8	16.9	11.0	14.0	16.5	12.2
MFG Global Equity Strategy (Net)	14.9	16.0	10.2	13.1	15.6	11.3

1 Returns are for the Global Equity Composite and denoted in USD. Performance would vary if returns were denominated in a currency other than USD. Refer to the GIPS Disclosure section for further information. Composite (Net) returns are net of fees charged to clients and have been reduced by the amount of the highest fee charged to any client employing that strategy during the period under consideration. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Fees are available upon request.

The final scenario (25% probability) is that interest rates rise on inflation concerns. A spike in interest rates would weigh on the growth outlook and lift risk premiums, potentially triggering a 20% to 30% fall in equity prices.

Notwithstanding the risks confronting equities, we reduced the cash position in the strategy from 18% to 8% over the 12 months, allocating that cash primarily to 'defensive' stocks. This reflects our decision to adopt a lower-than-historical interest rate in our valuation models and our view that the probability of the third scenario occurring has fallen over the past six months.

STRATEGY POSITIONING

Top-10 holdings at 30 June 2019 [2]

Security	Weight (%)
Microsoft	7.3
Facebook	6.7
Visa	5.9
Starbucks	5.8
Alphabet	5.7
Apple	5.4
HCA Healthcare	4.6
SAP	4.5
Mastercard	4.4
Novartis	4.0
Total	**54.3**

Notwithstanding our cautionary outlook, we expect our strategy of 27 high-quality businesses to generate a satisfactory return over the medium to long term.

Capitalism is brutal. Typically, excess profit opportunities are competed away in short order. Investing in companies unable to defend against capitalism's relentless march is not compatible with our objectives. High-quality businesses, however, are the rare subset of the investment universe because they have an ability to resist the natural forces of capitalism, and sustainably generate excess returns and appreciate in value over the long term. We refer to companies possessing this quality as having an 'economic moat' or sustainable competitive advantage.

In addition to the realities of capitalism, as the pace of technology change around the world accelerates, many traditional industries are facing increasing disruption risks. At the same time, the changing world presents opportunities. The tides of disruption will buoy certain industries and business models while threatening others. And if the world experiences a long-term future of more modest growth and lower inflation, businesses that benefit from enduring, structural tailwinds – those businesses that can generate compounding returns for an extended period – are likely to become increasingly valuable.

Recognising the forces of capitalism, disruption and compounding, we seek to build a strategy of investments in advantaged and undervalued businesses that will be on the right side of history over the long term.

The core investment themes in our strategy at 30 June 2019 were:

- Enterprise-software companies (Microsoft, Oracle and SAP) that comprised 16% of the strategy. These companies are deeply integrated within the operations of their business customers, which lowers the risk these customers will switch software vendors. They are benefiting from the transformational growth in cloud computing.
- Payment-platform companies (Visa, Mastercard and American Express) that represented 13% of the strategy. These are classic 'network effect' business models that connect millions of merchants with billions of cardholders. These companies provide the 'rails' upon which global electronic payment systems run.
- Advertising technology-platform companies (Alphabet, the owner of Google, and Facebook) that represented 12% of the strategy. These companies benefit from the shift in marketing expenditure from traditional media properties to digital platforms.
- Healthcare companies (HCA Healthcare, Novartis and Reckitt Benckiser) that represented 12% of the strategy. These companies benefit from ageing populations that spend more on healthcare. Consumers place a high value on trusted brands for health-related products, lowering the risk of disruption.
- The Chinese consumer (Starbucks and others) that comprised 9% of the strategy. The Chinese middle class is forecast to double in size over the next five to 10 years with the high-end cohort growing even faster. These companies are benefiting from this expanding consumer class and deriving 50% or more of their future revenue growth from the Chinese consumer.
- An investment in Apple that represented 5% of the strategy. We believe that Apple is a highly advantaged consumer-services platform with high consumer loyalty and a long-term opportunity to monetise the one billion Apple devices in use.
- An 8% holding in cash (held in US dollars).

Hamish Douglass

2 Holdings based on a representative portfolio for the strategy.

IMPORTANT INFORMATION:

This material is being furnished to you to provide summary information regarding Magellan Asset Management Limited trading as MFG Asset Management ('Magellan') and an investment fund or investment strategy managed by MFG Asset Management ('Strategy'). No distribution of this material will be made in any jurisdiction where such distribution is not authorised or is unlawful. This material does not constitute, and may not be used for the purpose of, an offer or solicitation in any jurisdiction or in any circumstances in which such an offer or solicitation is unlawful or not authorized or in which the person making such offer or solicitation is not qualified to do so. This material is not intended to constitute advertising or advice of any kind and you should not construe the contents of this material as legal, tax, investment or other advice.

The investment program of the Strategy presented herein is speculative and may involve a high degree of risk. The Strategy is not intended as a complete investment program and is suitable only for sophisticated investors who can bear the risk of loss. The Strategy may lack diversification, which can increase the risk of loss to investors. The Strategy's performance may be volatile. The past performance of the Strategy is not necessarily indicative of future results and no person guarantees the performance of the Strategy or the amount or timing of any return from it. There can be no assurance that the Strategy will achieve any targeted returns, that asset allocations will be met or that the Strategy will be able to implement its investment Strategy or achieve its investment objective. The management fees, incentive fees and allocation and other expenses of the Strategy will reduce trading profits, if any, or increase losses. The Strategy will have limited liquidity, no secondary market for interests in the Strategy is expected to develop and there are restrictions on an investor's ability to withdraw and transfer interests in the Strategy. In making an investment decision, you must rely on your own examination of any offering documents relating to the Strategy.

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The MSCI World Index (Net) is a free-float adjusted market capitalization weighted index that is designed to measure the equity performance of 24 developed markets. Index results assume the reinvestment of all distributions of capital gain and net investment income using a tax rate applicable to non-resident institutional investors.

GLOBAL INVESTMENT PERFORMANCE STANDARDS (GIPS®) DISCLOSURE

Magellan Asset Management Limited, doing business as MFG Asset Management in jurisdictions outside Australia and New Zealand, (MFG Asset Management) claims compliance with the Global Investment Performance Standards (GIPS ®.)

For the purpose of complying with GIPS, the Firm is defined as all discretionary portfolios managed by MFG Asset Management, excluding portfolios managed by subsidiaries operating as distinct business entities. MFG Asset Management is a wholly-owned subsidiary of the publicly listed company Magellan Financial Group Limited. MFG Asset Management is based in Sydney, Australia. Total Firm assets is defined as all assets managed by MFG Asset Management, excluding assets managed by subsidiaries operating as distinct business entities.

The Global Equity composite is a concentrated global equity strategy investing in high quality companies (typically 20-40 stocks). High quality companies are those companies that have sustainable competitive advantages which translate into returns on capital materially in excess of their cost of capital for a sustained period of time. The investment objectives of the Global Equity strategy are to earn superior risk adjusted returns through the business cycle whilst minimising the risk of a permanent capital loss. The composite was created in December 2011.

To achieve investment objectives, the composite may also use derivative financial instruments including, but not limited to, options, swaps, futures and forwards. Derivatives are subject to the risk of changes in the market price of the underlying securities instruments, and the risk of the loss due to changes in interest rates. The use of certain derivatives may have a leveraging effect, which may increase the volatility of the composite and may reduce its returns.

A copy of the composite's GIPS compliant presentation and/or the firm's list of composite descriptions are available upon request by emailing client.reporting@ magellangroup.com.au

The representative portfolio is an account in the composite that closely reflects the portfolio management style of the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio may differ from those of the composite and of the other accounts in the composite. Information regarding the representative portfolio and the other accounts in the composite is available upon request.

USD is the currency used to calculate performance.