MFG ASSET MANAGEMENT

Annual Investor Report 2019

MFG Global Sustainable Strategy

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MFG GLOBAL SUSTAINABLE STRATEGY

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Our Global Sustainable Strategy 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 strategy of 20 to 50 high-quality companies

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 after fees of 13.5% in US dollars for the 12 months. The stocks that performed best included the investments in Starbucks (+2.7% of the total strategy return), HCA Healthcare (+1.7%), Microsoft (+1.5%), Chipotle Mexican Grill (+1.5%) and Yum! Brands (+1.4%). 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. 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. Microsoft gained after releasing earnings results that consistently showed strong growth in cloud revenues. Chipotle climbed after the chain surpassed earnings, sales, margin and traffic forecasts. Yum! Brands rose after same-store sales and profit numbers of the owner of KFC, Pizza Hut and Taco Bell persistently outdid expectations.

Stocks that detracted from performance included the investments in Kraft Heinz (-1.4%), Fresenius Medical Care (-0.7%), CaixaBank (-0.6%), Wells Fargo (-0.5%) and CVS Health (-0.4%). 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. Fresenius slumped after the German-based dialysis company issued two earnings warnings in consecutive months due to emerging-market weakness and a lower percentage of commercial patients in the US. CaixaBank, a Spanish lender that generates higher net interest revenues with higher interest rates, fell when the weakness of the eurozone economy stopped the European Central Bank raising rates and news broke that a legal suit by consumer advocates against Spanish banks regarding mortgage pricing had been elevated to the European Court of Justice. 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, along with expected lower net interest revenues as the Fed's plans to increase interest rates stalled. CVS sagged after rising costs and a weak contribution from its 2015 purchase of nursing-home pharmacy Omnicare led to a big write-down, and talk mounted that one of the few issues where the divided Congress and the White House could agree to act would be on measures to reduce the prices of medicines.

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 Sustainable Strategy (Gross)	**13.5**	-	-	-	-	**13.8**
MFG Global Sustainable Strategy (Net)	**12.6**	-	-	-	-	**12.9**

1 Returns are for the Global Sustainable 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.

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, while the potential exists for further rate cuts. 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. 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.

Due to these risks, the strategy held a high cash holding over 2018-2019. From 18% on 30 June 2018, the cash holding stood at 15% on 30 June 2019.

STRATEGY POSITIONING

Top-10 holdings at 30 June 2019[2]

Security	Weight (%)
Facebook	5.6
Alphabet	5.3
Microsoft	5.0
SAP	4.7
HCA Healthcare	4.7
Visa	4.6
Starbucks	4.4
Oracle	4.2
Reckitt Benckiser	4.2
Mastercard	4.1
Total	**46.8**

The strategy has been constructed with high-quality companies that have long-term sustainable competitive advantages. This positions them strongly to prosper in a world with an increasing pace of disruption. Disruptive technological innovation requires careful review of companies with long-standing historic competitive advantages to determine whether or not these advantages will endure over the coming decade and beyond. Broadly, the strategy comprises investments in:

1. Higher-growth investments that are likely to be clear winners from change and secular tailwinds over the next five to 10 years.
2. Non-cyclical defensive investments that are resilient to disruption risks and are attractively priced.

The strategy remains conservatively positioned, relative to broader markets, to protect capital should equity markets experience a significant decline from the current record levels, perhaps due to an unexpected sharp deterioration in global growth or a reversal in decreasing inflation expectations. On the other hand, if growth remains reasonable with contained inflation expectations the strategy should provide attractive returns. We remain confident that over the longer term the strategy will provide attractive returns and protect capital in adverse markets.

The core investment themes in our strategy have not changed over the course of the past year, although their weightings have, reflecting stock price movements and strategy decisions. These themes at 30 June 2019 were:

- Enterprise-software companies (Microsoft, Oracle and SAP) that comprised 14% 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.
- Healthcare companies (HCA Healthcare, Reckitt Benckiser, Novartis, Fresenius Medical Care and Johnson & Johnson) that represented 14% of the strategy. These companies benefit from ageing populations who spend more on healthcare. Consumers place a high value on trusted brands for health-related products, lowering the risk of disruption.
- Payment-platform companies (Visa, American Express and Mastercard) that represented 13% of the strategy. These are classic network-effect business models that connect millions of merchants with billions of cardholders. They are the 'rails' upon which global electronic payment systems run.
- Advertising technology-platform companies (Alphabet, the owner of Google, and Facebook) that represented 11% of the strategy. These companies benefit from the shift in marketing expenditure from traditional media properties to digital platforms.
- Quick-service restaurant companies (Starbucks, Yum! Brands and Chipotle) that comprised 11% of the strategy. We view that these companies have unique longer-term competitive advantages that make their businesses defensive and resilient to disruption.
- A 15% holding in cash (largely held in US dollars).

Domenico Giuliano

2 Holdings based on a representative portfolio for the strategy..

IMPORTANT INFORMATION:

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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 who do not benefit from double taxation treaties.

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 Sustainable composite is a concentrated global equity strategy investing in high quality companies (typically 20-50 stocks) with an integrated ESG risk assessment process, including a low carbon overlay. 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 Sustainable strategy are to earn superior risk adjusted returns through the business cycle whilst minimising the risk of a permanent capital loss with meaningfully lower carbon intensity than broader equity markets. the composite was created in October 2016. Prior to May 29, 2018 the composite was named the Global Low Carbon Composite. As at 1 February 2019, the composite was redefined to exclude portfolios utilising specific ESG exclusions on societal grounds, in addition to the integrated ESG risk assessment process and low carbon overlay, due to a narrower definition of the ESG universe.

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.