MFG Global Sustainable (USD)

MFG ASSET MANAGEMENT

AS AT 31 MARCH 2023

PORTFOLIO MANAGER | **DOMENICO GIULIANO**

INVESTMENT PHILOSOPHY

To invest in outstanding companies at attractive prices, while exercising a deep understanding of the macroeconomic environment to manage investment risk.

OBJECTIVES

Seek to achieve attractive risk-adjusted returns over the medium to long term while reducing the risk of permanent capital loss.

Am to deliver carbon intensity less than 1/3 of MSCI World Index.

PORTFOLIO CONSTRUCTION

High conviction (20 - 50 securities), high quality focus.

Portfolio construction with dynamic allocation to cash (typical exposure between 0% - 20%).

Combined Risk Ratio cap of 0.8^.

Integrated ESG with proprietary, multidimensional carbon emissions management.

MAGELLAN GLOBAL SUSTAINABLE (USD)

TOTAL STRATEGY ASSETS	TOTAL GLOBAL SUSTAINABLE ASSETS[1]	INCEPTION DATE
USD $292.4 million	USD $292.4 million	1 October 2016

USD PERFORMANCE[2]

	3 Months (%)	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)	Since Inception (% p.a.)	OUTPERFORMANCE CONSISTENCY*
Composite (Gross)	11.8	-4.9	10.0	7.3	8.7	40%
Composite (Net)	11.6	-5.6	9.1	6.4	7.8	40%
MSCI World NTR Index[+]	7.7	-7.0	16.4	8.0	9.6	
Excess (Gross)	4.1	2.1	-6.4	-0.7	-0.9	
MSCI World Low Carbon NTR Index[+]	7.5	-7.8	16.0	7.9	9.4	

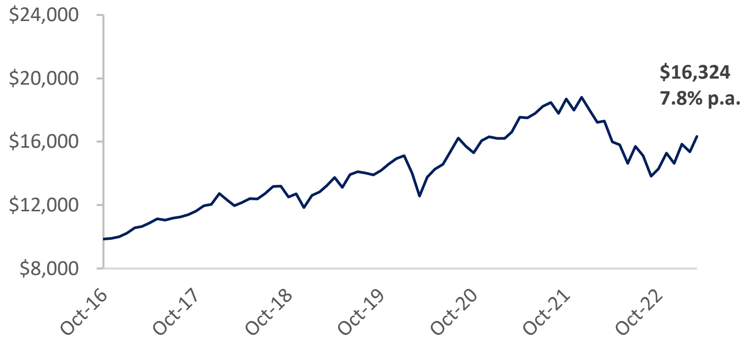
CALENDAR YEAR RETURNS[2]	CYTD (%)	2022 (%)	2021 (%)	2020 (%)	2019 (%)	2018 (%)	2017 (%)	2016 (%)**
Composite (Gross)	11.8	-21.6	16.3	10.1	27.2	-1.0	21.4	0.3
Composite (Net)	11.6	-22.2	15.3	9.2	26.2	-1.8	20.4	0.1
MSCI World NTR Index[+]	7.7	-18.1	21.8	15.9	27.7	-8.7	22.4	1.9
Excess (Gross)	4.1	-3.5	-5.5	-5.8	-0.5	7.7	-1.0	-1.6
MSCI World Low Carbon NTR Index[+]	7.5	-18.8	21.5	16.5	28.5	-8.9	22.2	1.4

Past performance does not predict future returns.

STRATEGY FUNDAMENTALS[3]

Number of Holdings	26
Carbon Intensity (CO_2t/US$1m revenues)	Strategy: 20 Index[+]: 129
Return on Equity (Trailing 1 year)	28
P/E Ratio (1 year forward)	23
Interest Cover (EBIT/interest expense)	17
Weighted Average Market Cap (USD million)	477,375

PERFORMANCE CHART GROWTH OF USD $10,000 (NET)[2]



Past performance does not predict future returns.

[1] Comprised of all Global Sustainable strategies.
[2] 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 below for further information. Strategy inception is 1 October 2016. 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.
[3] Strategy Fundamentals are based on a representative portfolio in the strategy.
^ Combined risk ratio is a measure of relative beta and relative drawdown to MSCI World NTR USD Index. Please contact MFG Asset Management should you wish for further details on the calculation.
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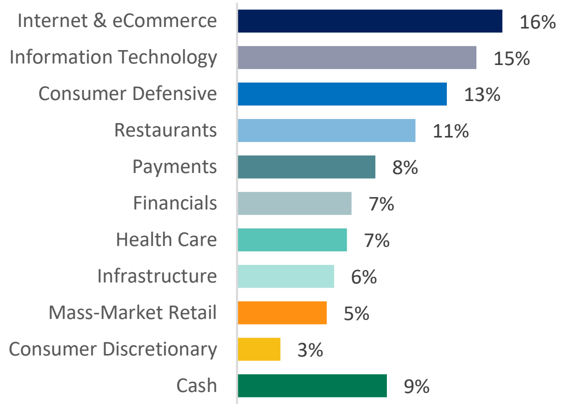
[*] Outperformance consistency indicates the percentage of positive excess returns for rolling 3 year returns since inception.
[**]Part year return.

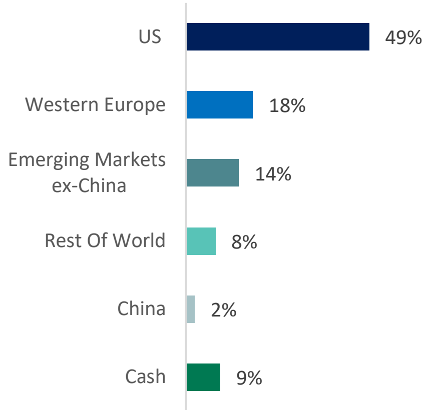
TOP 10 HOLDINGS[4]

STOCK	SECTOR	%
Microsoft Corporation	Information Technology	7.6
Alphabet Inc	Internet & eCommerce	6.5
Meta Platforms Inc	Internet & eCommerce	5.7
Yum! Brands Inc	Restaurants	4.9
Chipotle Mexican Grill Inc	Restaurants	4.2
SAP SE	Information Technology	4.2
Amazon.com Inc	Internet & eCommerce	4.1
Novartis AG	Health Care	3.9
Unilever Plc	Consumer Defensive	3.9
US Bancorp	Financials	3.6
	TOTAL:	48.6

SECTOR EXPOSURE BY SOURCE OF REVENUE[4]



GEOGRAPHICAL EXPOSURE BY SOURCE OF REVENUE[4]



[4] The data is based on a representative portfolio in the strategy. Sectors are internally defined. Geographical exposure is calculated on a look through basis on underlying revenue exposure of individual companies held within the portfolio. Exposures may not sum to 100% due to rounding.

Market Commentary

The 2023 year has started with global equities rising in the first quarter across all major markets, although the rally is narrow. The MSCI World NTR Index rose 7.7% in USD and 9.1% in AUD, with two key developments – the public launch of "ChatGPT", software that makes certain artificial intelligence (AI) capabilities available to the public and businesses, and a banking crisis that started in the US and then spread to Europe. On the economic front, there continued to be low unemployment, solid personal income growth and a softening of inflation across the developed world. In local currency terms, 8 of the 11 industry sectors rose with the information technology (+21.0%), communication services (+17.9%) and consumer discretionary (+16.1%) sectors performing the best. Falls were led by the energy sector (–3.8%), financials (-1.9%) and health care (-1.9%) as commodity prices fell and a banking crisis saw several banks fail and major steps taken by regulators to curtail banking system risks.

The S&P 500 Index rose 7.0% in the first quarter of 2023. The US Federal Reserve raised the cash target rate a further 50bp to a 4.75% to 5% target range in two 25bp increments, slowing its pace of increase. With interest rates rising by 450bp since the start of this tightening cycle a year ago, the impact on slowing inflation and slowing economic growth is starting to become more apparent, though recent data on US economic growth has remained resilient and ahead of expectations. One unexpected effect of the sharp move higher in interest rates was the collapse of California-based Silicon Valley Bank, whose balance sheet deteriorated to levels requiring recapitalisation, as higher rates resulted in large unrealised losses on its large portfolio of US Treasuries. This squeeze on SVB's capital strength led to a loss in confidence by customers, provoking a run on its deposits that forced its regulator to step in. The crisis escalated across other smaller US banks, which had disproportionate exposure to the crypto sector, and then to Credit Suisse in Europe. Regulators then responded decisively to avert a systemic crisis by providing liquidity to banks on very generous terms and encouraging major banks to intervene to help reduce stresses in the system.

The Euro Stoxx 50 rose 13.7% this quarter to be just shy of the high of January 2022. This has occurred despite the ongoing war in Ukraine, still elevated, albeit improving, levels of inflation across Europe, ongoing interest rate increases by the European Central Bank and the bank sector stresses noted above. Ordered by regulators, UBS acquired Credit Suisse in March, given its pending collapse.

Across the Asian region, Japan's Nikkei 225 Index rose 7.5%, Australia's S&P/ASX 200 Accumulation Index gained 3.5%, China's CSI 300 Index rose 4.6% and the MSCI Emerging Markets Index added 3.5% in US dollars. Japan has a new Bank of Japan Governor, Kazuo Ueda, and his policy decisions, particularly the shift away from Yield Curve Control, will be closely watched given implications for global money flows. China continues its committed, albeit chaotic, reopening and cut the Reserve Requirement Ratio for its banks in March to help with efforts to revitalise economic growth. Geopolitical tensions between China and the US were again evident during the quarter, including the cancelling of a visit by the US Secretary of State to Beijing and coordinated widening of restrictions on the export of advanced semiconductor machinery to China.

Developments in Sustainability

During the quarter investors and regulators intensified their scrutiny of companies' transparency and disclosure on sustainability risks and opportunities. The UK's Competition and Markets Authority (CMA) announced that it will expand its efforts to address greenwashing, examining the green claims made by companies marketing items including food, drink and homecare products. Similarly, Australia's competition authority, the ACCC, announced an investigation following a review of companies' websites for misleading sustainability claims. Company disclosure requirements on broader ESG issues is being lifted with the Taskforce on Nature-related Financial Disclosures (TNFD) further honing its draft framework for nature-related risk management and disclosure.

The northern hemisphere's main Annual General Meeting and proxy-voting season has commenced. Issues detailed in company reports and shareholder proposals demonstrate increasing investor focus on environment, social and governance matters. Per the last few years, there is a focus on diversity, equity and inclusion, shareholder rights and board structure.

Strategy Commentary

The strategy performed strongly over the quarter, with the top three contributors being Meta Platforms, Microsoft and Salesforce. Meta outperformed in the quarter following announcements relating to significant cost cuts. Given the recent spending spree related to the metaverse, the cost conscience strategy was well taken. Meta intends to become a faster, leaner and more technical company in the future. Microsoft performed well with the broader tech sector and was further lifted by market buzz surrounding the public release of ChatGPT, an artificial intelligence chatbot released by the company OpenAI. Microsoft increased its stake in OpenAI through a multi-year, multi-billion-dollar investment and has been incorporating OpenAI's technology into its products including Bing, Azure, and Microsoft 365. ChatGPT's capabilities can also be integrated into other firms' services, perhaps creating a new tech platform network effect that could be material to Microsoft's revenues in the medium term. Salesforce fell out of favour during last year's tech de-rate as the market lost confidence in the long-term margin potential of the company and became impatient with management's lack of historical track-record for driving profitability. During the quarter, Salesforce announced significant cost-out initiatives and a committed share repurchase program that restored the market's confidence in Salesforce's profitability potential and indicated a shift in management's focus towards profitable growth and investor-friendly capital allocation.

The three largest detractors from performance over the quarter were US Bancorp, Dollar General and Procter & Gamble. The largest detractor in the quarter was US Bancorp (USB), which fell 16% over the quarter as loss of confidence in the banking system fuelled panic in the sector. As the fifth-largest US bank, USB is well positioned as further industry consolidation seems likely and we assess it is materially undervalued post the sector-wide sell-off. Dollar General underperformed following downgrades to company guidance due to challenges for low-income consumers and strategic investments. Procter & Gamble underperformed as the market overestimated the speed at which the recent commodities deflation would benefit operating margin. Instead, management are restoring brand reinvestments and prioritising the long-term health of the business. We expect margins to return to more normal levels over the medium term.

Outlook

High levels of inflation appear to be slowing down, especially in the goods part of the measure. However, wages inflation continues to warrant close attention, as it is a strong contributor to elevated levels of inflation in the large services sectors of advanced economies. Central banks have been vocal in their determination to retain their restrictive stances until credible evidence emerges that inflation is being reined in, so while there remains uncertainty on the duration of higher levels of interest rates, there is greater market confidence in the levels at which they peak. This means it is likely the market's repricing of the level of long-term interest rates is mostly done and the levels of the benchmark US 10-year bond appear to be settling into a range around the high 3% mark. Therefore, over coming quarters we expect the primary cause for movements in stock prices will be from the earnings prospects of individual companies and the path of their cash flows (rather than the discount rate applied to those cash flows).

This uncertainty on the duration of elevated rates and the real possibility that central banks are willing to tip economies into recession, if that is necessary to steadfastly reduce inflation, cause us to retain our cautious portfolio stance with our 9.2% holding in cash and defensive tilt. The start of 2023 sees growing earnings risks in parts of the market for the coming year and we expect share prices to respond to these risks. The coming reporting season may result in stock price volatility that provides opportunities for capital to be redeployed into higher risk-adjusted returns. A significant proportion of Magellan's high-quality universe has attractive medium-term return prospects. The Magellan Global Sustainable portfolio retains the quality and diversity and the longer-term prospects we seek for our companies. We believe these are advantaged companies with excellent business track records, skilled management and disciplined capital management, and this gives us confidence that the strategy will be able to achieve its return objectives over the medium term.

Stock Story

(Elisa Di Marco - Portfolio Manager)

Mastercard is one of the most recognisable brands in the world. You may know Mastercard as the card in your wallet that can be used at merchants globally, or perhaps it's from their memorable multi-decade 'priceless' marketing campaign. The network's global penetration of nearly 100m merchants and 3.1 billion cards creates a seamless and ubiquitous payments experience that is 'priceless' to network participants, which makes it extremely valuable to shareholders.

Since Mastercard was formed in 1966 the network has been part of the payments revolution. Mastercard along with peers Visa, American Express and, more recently, PayPal have been transforming payments, and commerce more broadly. We've moved from the confines of paying in cash and cheque and signing to having ready access to credit and digital cash (debit) to swiping to tapping, e-commerce, mobile payments, digital wallets and real-time payments. The innovation has been remarkable, and beneficial, to consumers, merchants, governments, and shareholders.

Over the last decade Mastercard's payment volumes, merchant network and card reach have more than doubled. This growth has generated attractive 15% annual compounded returns for shareholders. The consistency and strength of the business are due to several layers:

1) <u>Business quality</u> – Payment companies enjoy the strong protections of the network effect that links consumers, merchants and banks – where each additional user boosts the benefits of the network for all users. It is extraordinarily difficult to launch and grow to scale a global network, creating high barriers to entry, and therefore making the businesses of Mastercard and its three peers resilient to aspiring competitors. These network characteristics allow Mastercard to generate high-quality, consistent earnings that continue to compound for shareholders.

2) <u>Structural tailwinds</u> – Mastercard benefits from multi-pronged structural growth tailwinds over several decades. First was the convenience and security of using cards over cash and cheque. This physical convenience then morphed into digital payments convenience on desktop computers and mobile. Digital convenience was turbocharged by the necessity of fast and secure digital payments that underpin the e-commerce revolution. These tailwinds persist globally and are further supported by nascent tailwinds from growth in business and government digital payment processes. All of these tailwinds have been supported by ongoing innovation from Mastercard, their peers, and technology companies.

3) Strength in strategic capital allocation – Mastercard has been a master capital allocator over the past decades. The business in 2012 generated ~90% of revenue from payments and 10% from related services. In FY22, Mastercard generated 20% of its revenue from related services. The transition in revenue mix is due to organic investment and thoughtful acquisitions and is critical to the long-term sustainability of Mastercard's revenues, and to maintaining its strengths in business quality. The acquisition of the company 'Dynamic Yield' is a great example of how Mastercard acquired capabilities in AI and deployed them within its suite of loyalty capabilities across its network.

4) Business model – The bulk of Mastercard's revenue is earned as a percentage of the payment dollars or number of transactions made across its network. These dollars and transactions are mostly related to personal consumption expenditures. Importantly, these revenues are not directly dependent on credit quality for credit card transactions or interest rates on loans. However, the business model does experience cyclicality, with a strong consumer beneficial to revenues and a weaker consumer leading to slower growth. In the post-covid era, this business model proved highly favourable since a large portion of revenue is earned on the value of goods and services transacted, and therefore benefits from higher rates of inflation. This very attractive revenue model is complemented by an expense base that consistently increases at a lower rate than revenues, leading to steady increases in margins over time.

5) Financial inclusion – Mastercard is a socially aware company, prioritising financial inclusion for underbanked members of societies. To date, Mastercard, across 94 countries, has brought more than 675 million people into the digital economy, 18 million female-led businesses and more than 10 million small and medium-sized enterprises. Mastercard has achieved this through investment in communities, non-traditional partners and industry groups, assisting with technology and new solutions. This investment is valuable for the poor and unbanked, lifting them from a dangerous and rapacious informal financial system and into the modern, efficient, and safeguarded financial system. Importantly, this investment grows Mastercard's end market for decades to come.

The attractive dynamics of the payments industry continue to attract investment from competitors. However, to take market share from the four incumbents, any newcomer to the global payments business would need consumers and merchants to simultaneously accept its card, have banks/financial institutions to issue the cards and be connected to the merchant's bank/financial institution. To achieve that, the entrant would need to achieve mass awareness, offer a simple means of payment, have ubiquitous technology, have positive consumer appeal (for example, fraud protections or associated rewards programs), be trusted (even though the issuing bank bears the risk of theft and fraud), meet regulatory requirements in every country in which it wished to operate, and fulfil arduous customer and merchant servicing needs. With these elevated barriers to entry, we've seen mixed attempts to drive competition:

- Thus far the barriers to entry have been too challenging for many well-funded fintech and technology companies outside of China. Apple, Meta, Alphabet and Samsung have all stepped into payments, but they are leveraging the payment companies' infrastructure. Likewise, buy-now-pay-later and remittance companies rely on the incumbents. Cryptocurrencies are no threat either because payments this way are, so far, too slow and insecure to take market share and they face major regulatory impediments. Their volatile prices are another risk to adoption.

- Central banks, however, have different motivations. Their policy goals typically include safeguarding their domestic payments system, competition and efficiency (i.e., lower cost) in payment mechanisms. They have recognised the possible threats posed by American-owned payments networks on their policy goals. This has led many of them to support domestically owned real-time payment systems, which enable transfer of funds from one bank account to another within seconds at very low cost. These could pose competitive threats to Mastercard, particularly its debit business. However, while investment in real-time payments isn't new, it is extremely complex to develop and drive adoption. As a result, there has been mixed success globally. This year is somewhat of a milestone, with the U.S. Federal Reserve launching FedNow, its real-time payments network that has been more than five years in the making. While this is a milestone, in its initial form it is not targeting consumer payments. It will take many years for the Fed to be connected to the thousands of U.S. banking institutions, to have a comparable consumer offering and have a comparable proposition for financial institutions. Connecting FedNow to payments globally will be an even bigger hurdle. With less than 10% of Mastercard's revenue estimated to be linked to domestic debit transactions, this risk is likely to be manageable in the near term.

Mastercard faces risks beyond that of consumer spending levels and government investment in payments infrastructure. One risk is excessive regulation as governments move to protect privacy and competition. Evidence of this includes ongoing investigations from the Department of Justice into anti-competitive practices, regulation of interchange rates and developing countries regulating how banks interact with global networks.

But let's not forget, these watchful eyes from regulators and competitors are driven by the strength in business quality and the necessity of an efficient payments system. Mastercard's relentless focus on its network reach and capabilities has been priceless for consumers in its network, and extremely valuable to shareholders. While Mastercard will need to continue to invest in its network, we're confident that shareholders will continue to benefit from Mastercard's high-quality business model.

Source: Mastercard website

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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.

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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 and specific ESG exclusions on societal grounds related to either material manufacturing or retail exposures to Tobacco, Alcohol, Gambling, Controversial Weapons, Civilian Firearms, Adult Entertainment and other activities that Magellan may specify from time to time. 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 specific ESG exclusions and a meaningfully lower carbon intensity than broader equity markets. The composite name was changed from Global ESG to Global Sustainable on 1 November 2020 following the restructure of our Global Sustainable product offerings into two distinct strategies, one with additional ESG exclusions and one without. The Global Sustainable strategy does apply additional ESG exclusions.

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.

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USD is the currency used to calculate performance.