Strategy Update: 31 December 2016

MFG ASSET MANAGEMENT

MFG Global Low Carbon

Key Facts

Portfolio Manager	Domenico Giuliano
Strategy Inception Date	1 October 2016
Total Global Assets[1]	USD $28,610.0 million
Total Strategy Assets	USD $1.0 million

Objectives	Approach
Capital preservation in adverse markets	High conviction (30-50 securities), high quality focus, low turnover
Attractive absolute risk-adjusted returns through the economic cycle	Dual-sleeve portfolio construction with dynamic allocation to cash (max 20%) Relative volatility cap of 0.8^
Deliver carbon intensity less than 1/3 of MSCI World	Integrated ESG analysis with proprietary, multi-dimensional carbon intensity management

USD Performance[2]

	Composite (Gross)	Composite (Net)[3]	MSCI World NTR Index	MSCI World Low Carbon Leaders NTR Index
3 Months (%)	0.3	0.1	1.9	2.0
Since Inception (% p.a.)[4]	0.3	0.1	1.9	2.0

	Composite (Gross)	Composite (Net)[3]	MSCI World NTR Index	MSCI World Low Carbon Leaders NTR Index
2016 (%)*	0.3	0.1	1.9	2.0

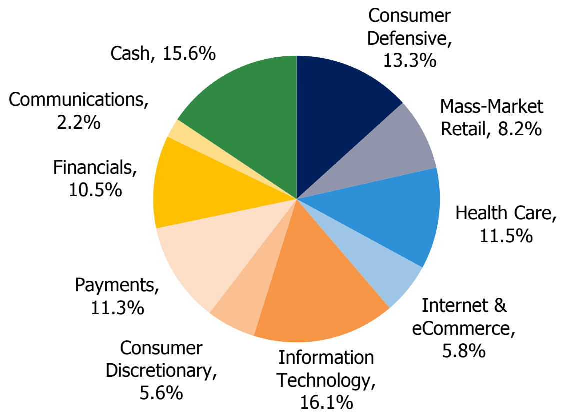
Top 10 Holdings[5]

	Sector	%
Apple Inc	Information Technology	4.3
Alphabet Inc	Internet & eCommerce	4.0
HCA Holdings Inc	Health Care	3.8
Visa Inc	Payments	3.8
Wells Fargo & Co	Financials	3.5
CVS Health Corp	Health Care	3.4
Lowe's Co Inc	Consumer Discretionary	3.4
American Express Co	Payments	3.4
Microsoft Corp	Information Technology	3.3
McDonald's Corp	Consumer Defensive	3.2
	TOTAL:	36.1

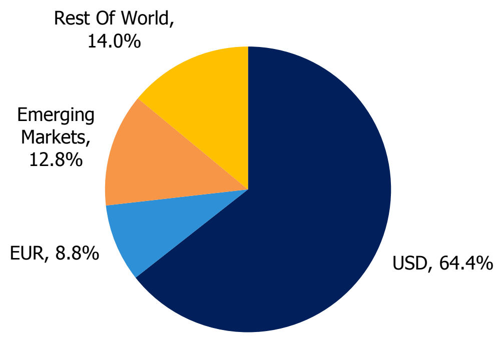
Strategy Fundamentals

	Strategy[5]	Index[4]
Number of Holdings	36	1,654
Energy + Materials Weight (%)	0	12.3
Return on Equity (%)	23	14
P/E Ratio (1 year forward)	16.3	16.3
Interest Cover (times)	11	9
Debt/Equity Ratio (%)	58	52
Active Share (%)	79	n/a
Weighted Average Market Cap (USD million)	125,165	n/a

Industry Exposure by Source of Revenue[5 6]



Geographical Exposure by Source of Revenue[5 6]



[1] Comprised of all Global strategies.
[2] Returns are for the Global Low Carbon Composite and denoted in USD. Performance would vary if returns were denominated in a currency other than USD. Refer to the GIPS Disclosure section at the end of this document for further information.
[3] 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.
[4] The inception date of the Composite and the Index, the MSCI World NTR Index is 01 October 2016.
* Returns are only for part year.
[5] The data is based on a representative portfolio for the strategy. Refer to the end of the document for further information.
[6] Calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio – MFG defined sectors.
^ Weighted average 3-5 year beta against MSCI World NTR Index.

Market Commentary

Equity markets were significantly influenced by political developments during the December quarter, primarily in relation to the US election and the Italian constitutional referendum. The Trump/Republican win pushed US bond yields higher as markets priced in a steeper rate rise trajectory by the Fed and consensus grew that expansionary economic policies will be implemented. Sentiment shifted towards growth-oriented sectors which are perceived beneficiaries of Trump's policy agenda of corporate and individual tax cuts along with increased spending on infrastructure and defence. Against a backdrop of continuing positive trends in key economic indicators, the US equity market continued to perform well and the US dollar appreciated to a 14-year high in December.

The euro weakened for the quarter, while most major European bourses staged a strong rally in December following the Italian constitutional referendum and the European Central Bank's (ECB) decision to extend its quantitative easing program until December 2017, to end the quarter at or near their high point for the year. Despite the nominal gains achieved in European equities, falls in the euro and British pound against the US dollar limited, or in some cases, negated these gains for investors domiciled outside of these currencies.

There was significant dispersion at a sector level for the quarter, with advances led by the financials, industrials, energy and materials sectors which are perceived as beneficiaries of the prospective growth-oriented environment. Energy was the standout sectoral performer, aided by a stabilising oil price and OPECs decision to cut crude oil output for the first time since 2008. Higher growth and inflation expectations have fuelled expectations for interest rate increases and consequently, bond proxies such as utilities, consumer staples and real estate exhibited weakness.

Strategy Commentary

The Strategy returned 0.3% before fees (in US dollar terms) for the December 2016 quarter. This compares with a benchmark return of 1.9%, resulting in a relative performance of -1.6%. As of 31 December 2016, the Strategy held investments in 36 companies. The top ten investments represented 36.1% of the Strategy and the cash position was 15.6% as at 31 December 2016.

During the period, investments in Wells Fargo, American Express and Capital One Financial were among the largest contributors to performance. All three investments are U.S. financials and benefitted primarily from increasing market expectations for US interest rate rises during the quarter, particularly following the US election and expectations that the Trump/Republican administration will implement expansionary policies.

Wells Fargo was the largest contributor to performance for the period. In addition to expectations of higher revenues, resulting from possible higher interest rates, Wells Fargo's share price was depressed at the beginning of the quarter following the cross-selling scandal that broke earlier in September and subsequently recovered.

American Express' share price was propelled higher during the period, resulting in significant outperformance of its main peers in the payments space. The stock received strong support from the market following the release of its third quarter earnings result, with revenue and operational earnings exceeding consensus estimates. The result was achieved despite losing an account with Costco earlier this year, and reflected increases in member spending, high net interest income and card fees. The company's management increased guidance for full-year earnings which bodes well for FY-2017 earnings, particularly in consideration of the company's growth initiatives.

Capital One Financial, a US-based consumer and commercial banking company, also generated strong performance through the quarter. The company's latest earnings result came in ahead of both consensus and our own expectations. The result featured strong loan growth through the period and a slight improvement in net interest margins, while provisioning for credit losses remained adequate.

The main detractors from performance were CVS Health, Facebook and Danone. CVS Health registered a weak performance following its recent earnings update, where management cut its full-year earnings expectations due to contract losses at its retail pharmacy. Novartis' share price reflected weakness in the health care sector associated with the US election and implications for pharmaceuticals. Facebook's share price lagged during the quarter, reflecting concerns around its mis-measurement of user engagement. Notwithstanding this, Facebook reported a better than expected increase in earnings and sales and reported 16% growth in the number of active users. Danone's share price weakness was primarily due to similar weakness seen across consumer staples, as inflation expectations rose, along with a negative revenue guidance adjustment announcement by the company in mid-December.

Investment Update

We remain cautious about the outlook for equity markets over the next few years, given the environment of abnormally low interest rates, historically elevated price-earnings multiples, risks associated with the recapitalisation of the Italian banking system and the continued withdrawal of US monetary policy stimulus. Notwithstanding the current macroeconomic uncertainty, we retain confidence in the quality and long-term outlook for our investments and are comfortable with the Strategy's overall risk profile and construction.

We retain an elevated weight in cash to achieve the desired risk characteristics within the portfolio and continue to apply a consistent approach to selecting high quality companies that are well positioned to deliver satisfactory returns over the long term. Many of these companies are structurally advantaged through their exposure to the following major investment themes that are prevalent within our global equity strategies:

- **Consumer technology platforms**: The leading digital platforms have tremendous opportunities to monetise new services and products (even when they are not the originator). With high switching costs and barriers to entry, their entrenched positions are unlikely to be challenged in the foreseeable future.
- **Enterprise software**: Established enterprise software vendors benefit from their incumbency. They typically operate in concentrated markets with high barriers to entry, network effects, and high switching costs. The shift to cloud computing presents a significant opportunity for leading vendors to expand their addressable markets and win a greater share of total enterprise IT expenditure.

- **Health care and ageing population dynamics**: The health care sector has attractive growth tailwinds due to rising patient volumes, increasing expenditure and large unmet healthcare needs.
- **The move to a cashless society**: There continues to be a strong secular shift from spending via cash and cheque to cashless forms of payments, such a credit cards, debit cards, electronic funds transfer and mobile payments. The explosion of smart and internet connected devices will accelerate this shift on a global basis.

Comments on the Market Environment

Interest rates
The election of Donald Trump as the next President of the United States saw 10-year US Treasury yields increase by approximately 80 basis points (bps), the largest increase since the "taper tantrum" of mid-2013, to around 2.5% - the level at which they traded 12-18 months ago. In response, the trade-weighted US dollar increased around 5%, while interest rate sensitive equities have been re-priced downward. In the month post the election, the S&P500 Financials index increased by around 18%, while bond proxies such as the utilities and consumer staples sectors fell by around 4% and 3%, respectively. Rising bond yields reflect market expectations of reform and fiscal stimulus and the possibility of a faster exit from ultra-stimulatory monetary policies. Notwithstanding recent market moves in interest rates, we believe that asset prices across various asset classes and sectors broadly reflect a reality distorted by extraordinarily accommodative monetary policy, and expect further re-pricings as interest rates normalise.

In our view, there are two phases for interest rates that are relevant to investors. Over the next few years we expect to see rising interest rates, as central banks withdraw their extraordinary monetary policy stimulus. Looking out a further 10 years, rates may then decline as technological disruption, including dramatic advances in artificial intelligence, generate structurally lower inflation pressures.

Normalisation of monetary policy, which is likely to play out over the next few years, brings risks. The issue is whether prevailing asset prices predominantly reflect the current economic reality, or whether they are being significantly distorted by the extraordinary monetary policy (including asset buying) and foreign exchange policies of the G7 central banks[1]. As central bank asset purchases diminish over the coming years there is the potential for material declines in some asset prices.

A key reason that asset prices remain elevated is the ongoing quantitative easing programmes of the ECB, Bank of Japan and Bank of England (approximately US$130 billion per month combined), and the fact that the Fed has not yet started shrinking its balance sheet.

The politics and economics of Europe will likely have a key influence on the direction of global monetary policy and currencies over the next few years. Indeed, several important elections are taking place in the eurozone in 2017, including the Netherlands, France, Germany and possibly Italy. While anti-establishment parties could perform strongly, we believe there is a very low probability of a catastrophic market event where a country leaves the eurozone. Nonetheless, political instability in Europe could lead to a delay in monetary policy normalisation in the US, given the interconnectedness of global capital markets. While we continue to believe that it is more probable than not that the Fed will tighten monetary policy over the next few years, we have moderated our expectations on the extent of the likely rise in longer term bond yields over the next three to five years. It is prudent to remain cautious in this environment.

Longer term, we need to ask what will be the impact of technological disruption on the risk-free rate. Are we going to eventually see massive productivity gains and deflationary forces through huge enhancements in technology, particularly artificial intelligence? How will these changes impact different business models and over the very long term, how will this affect the valuation of assets and interest rates?

Recapitalisation of the Italian banking system
It has been estimated that the Italian banking system is holding around €360 billion of non-performing loans and if banks were required to write down these loans to current market values the Italian banking system could be required to raise at least €20 billion of capital. The issue is that the most vulnerable banks are not able to privately raise capital and while the Italian government has recently created a €20 billion bailout fund for its troubled banks, under European Union (EU) rules both equity and hybrid investors must share the burden of a precautionary recapitalisation. Critically, the hybrid securities, are typically held by retail investors. The risk is thus that a large bail-in of securities owned by retail investors could trigger a widespread depositors run on the Italian banks.

The Italian Government is currently in negotiations with Brussels about the extent of losses that must be forced upon the holders of equity and hybrid securities as part of a recapitalisation of the banking system. The Italian Government is also negotiating the form of compensation scheme designed to mitigate the severity of the required burden sharing by retail investors. There may well be more market volatility ahead, depending on the outcome of these negotiations. Political instability could also complicate the process of finding a resolution to Italy's banking system problems. However, ironically, the defeat of the recent December referendum maintains gridlock in the Italian political system and makes it harder for anti-establishment forces to take Italy out of the eurozone, lowering the probability of this tail risk. We thus continue to consider an exit from the EU by Italy to be a very low probability event.

The election of Trump
We are fairly relaxed about the advent of a Trump administration for our investment portfolio. Trump's economic policies such as tax cuts and spending on infrastructure and defence are broadly stimulatory, so there is likely to be some upward pressure on growth, inflation and interest rates in the medium term, which has been priced by bond markets. However, there are potentially conflicting policy objectives between Trump and Congressional Republicans' who tend to want 'smaller government' and reduced Federal debt, which creates some policy uncertainty. Republican control of the Senate, the House of Representatives and the White House should reduce policy gridlock in Washington DC.

Nonetheless, we expect the near term to bring bouts of elevated market volatility, as markets do not like surprises and there remains great uncertainty on the actual policy platform that Trump, and the majority Republicans in Congress, will seek to enact.

The most material risk from a Trump administration, while low probability in our view, comes from trade and foreign policy. Trump's 'fair-trade' platform focuses on much more favourable outcomes for the US within its free trade agreements and holding China accountable for alleged unfair trade practices. In the event of a low probability 'trade war' scenario, some businesses with operations and/or large markets in China or Mexico could be adversely affected. Apple is one such example.

1 US Federal Reserve, European Central Bank, Bank of Japan, Bank of England, People's Bank of China, Saudi Arabian Monetary Agency, Swiss National Bank.

Global economic update

Our base-case outlook for the next three years assumes a continued recovery in the US with modestly rising inflation, a continued slowdown in China (but not a financial crisis or hard landing) and an improvement in the economic outlook for Europe.

United States
A range of economic indicators show that the US economy continues to recover, albeit with some headwinds.

The US is driven by households, with consumption comprising around 69% of US gross domestic product (GDP). The household sector has been buoyed by strengthening labour markets, rising house prices, lower debt, falling commodity prices, a strengthening US dollar and low interest rates. Average weekly earnings increased by 2.2% over the year to November 2016 and the number of people employed is now 152 million – over five million more than the previous peak in November 2007. Higher goods and services consumption by households is supporting a growing corporate sector and rising corporate profits. As household formation returns to normal, we expect housing starts to grow further to at least 1.3-1.4 million per annum, this being our estimate of normalised demand. Improvements in the household and corporate sectors are flowing through to the banking sector, with total loans and leases outstanding increasing by 7.7% per annum and notably, commercial and industrial loans increasing by 8.8% over the year to November 2016.

The government sector's drag on the economy has abated. The Congressional Budget Office forecasts the federal deficit to remain fairly stable at 2.5-3.0% of GDP over the next few years. While the fiscal policy implications of the incoming Trump administration remain uncertain, additional short term stimulus appears likely.

Although the US economy is facing some headwinds, most are likely to be transitory. Headwinds include the impact of a stronger US dollar and a weaker global economy on trade-exposed industries, a contraction in energy sector activity, and weakness in industries and regions reliant on oil and gas production and investment. Despite the challenge of the rising US dollar, the US is a predominantly domestically driven economy, with a relatively low reliance on exports (which account for approximately 12% of GDP).

Tighter labour markets will lead to faster growth in real wages and potentially lower profit margins for businesses that lack pricing power. Meanwhile, scope remains for further job creation due to underemployment and the cyclically depressed participation rate. The 'U6' unemployment rate, which includes part-time workers who want a full-time job and those marginally attached to the labour force, has been falling steadily since the global financial crisis (GFC) but remains elevated at 9.3%[2]. The U6 has fallen to 8% or lower in previous cycles. Furthermore, the proportion of 25-54-year olds in the labour force has fallen from just over 83% before the crisis, to 81.5% as at November 2016.

Several transitory factors have been keeping inflation below the Fed's 2% target. However, as the oil price bottoms out, the US dollar stabilises and the labour market continues to tighten, wage growth and inflation pressures are likely to normalise. Consistent with previous cycles, this will require the Fed to progressively tighten monetary policy towards the long-run neutral Fed Funds rate, which is probably around 3%.

Overall, we expect the US economy to continue along its path of a steady recovery over the next few years, barring unforeseen events.

Eurozone
Real GDP growth in the eurozone remained modest at around 1.7% p.a. over the year to September 2016. Several periphery economies are continuing on their recovery path. Spain and Ireland's continue to experience steady economic growth, while Greece recorded its highest rate of annual growth since mid-2008 of 1.6% p.a. However, we remain cautious about risks from Italy's ongoing economic malaise, undercapitalised banking system, tight credit conditions and political uncertainty.

The eurozone is likely to continue benefiting from a weaker currency, a stronger US economy, lower commodity prices, and an improvement in borrowing conditions and credit flows in an environment of ultra-low interest rates. However, the pace of eurozone growth is likely to remain modest for the foreseeable future as high levels of government debt, unresolved banking system issues, political uncertainty, and poor demographics hold back the economy.

Labour markets are gradually recovering in the eurozone, although considerable slack remains. Over the year to September 2016, aggregate employment increased by 2.1 million to reach 153.2 million, but remains below the pre-GFC peak of 154.4 million. The aggregate unemployment rate has fallen from 12.1% in June 2013 to 9.8% in October 2016. Although the improvement in eurozone labour markets has been broad-based, Italy's unemployment rate is little changed in the past year and remains elevated at 11.6% in October 2016. While relative wage cost competitiveness of periphery economies is gradually improving, such internal devaluation is proving to be a painful mode of adjustment.

The rise of euro-sceptic political parties in several eurozone countries reflects a long period of adjustment following deep recessions and accompanying high levels of unemployment, which has created difficult policy choices for governments. These parties often threaten an exit from the eurozone (and a dispensing of the euro as currency) and/or debt defaults, which could spark renewed uncertainty in sovereign debt markets. When considering political risks, it is important to distinguish between the nine nations that are members of only the EU, and the 19 nations that are members of both the EU and the eurozone (whose currency is the euro). There is no existing legal mechanism for a country to leave the eurozone, and an exit by a country would be extremely problematic and have far more material systemic implications than a country seeking to leave the EU, such as with Brexit. We place a very low probability on such a scenario.

Nonetheless, the eurozone remains vulnerable to major shocks, such as an escalation of geopolitical tensions with Russia, the election of euro-sceptic parties into government or an Italian banking system crisis. Each of these scenarios could trigger a dramatic uplift in periphery eurozone sovereign bond yields, and would heavily test the resolve and mandate of the ECB.

Overall, we expect a continuing gradual recovery in the eurozone, but remain cautious about material downside risks.

China

While we remain concerned about the medium-term outlook for China, we do not believe that China will have a financial crisis or experience a hard economic landing in the shorter term.

China's rapid economic growth in recent years has been unsustainable. When demand for Chinese manufacturing exports deteriorated in the GFC, China launched the largest credit stimulus in history, fuelling an investment boom that continues today. From 2008-2013, China's state-owned banks issued new credit totalling US$10 trillion, equivalent to the entire US banking system. Although credit growth has slowed, it continues at around 13-15% per annum. The source of credit expansion has recently shifted from companies to households, reflecting policy shifts to support consumption and demand for new home loans from households, which accounted for 73% of all bank lending in Q3 2016. The problem is that GDP benefits from new loans have fallen from around 75 cents per dollar of loan to just 20 cents. Currently, it is estimated that US$1.3 trillion in corporate loans are owed by Chinese companies whose profits aren't sufficient to cover interest payments, which suggests potential problematic bank loans of around 7% of GDP (excluding shadow banking exposures).

Almost half of China's credit growth since the GFC (or around 50% of GDP) may have gone towards financing property market activity. There appears to be approximately four years of excess housing supply in China, comparable to recent property booms in the US, Spain and Ireland. According to the China Household Finance Survey, 22% of urban housing in China is vacant. Meanwhile, vacant floor space on developers' books has increased by around 500% since 2007. Property prices are growing rapidly in Tier 1 cities with supply shortages, however this is not the case in lower-tier cities where most of the excess supply is located.

The potential implications of China's property oversupply are serious. Real estate and related industries account for 20-25% of China's GDP. Fiscal positions are vulnerable, particularly for local governments who have relied on land sales for 35-40% of revenues. A large contraction in China's property construction sector would cause a major slowdown in the economy and perhaps even a recession.

Although economic data out of China is problematic, a range of indicators suggest that China's economy is slowing as the housing oversupply problem broadens. Weakness is most apparent in the industrial space (41% of GDP), a large portion of which is linked to property. Cement production expanded slightly by 1.3% per annum in the last 12 months, compared to 11% growth per annum in the decade prior. Steel production and electricity production grew at a modest pace while freight traffic contracted substantially in the past year. Real trade data also shows that both import and export growth has slowed significantly.

Since 2010 China has contributed around a quarter of total global economic growth, despite its economy only representing around 12% of world GDP. We are cautious about adverse knock-on effects, including currency movements, linked to changing economic fortunes in China. Several commodity exporters such as Russia, Brazil, Australia and Canada have experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. Russia and Brazil have experienced deep recessions. These economies remain vulnerable to the unwinding of commodities-linked domestic credit booms. Other Asian economies with strong trade and financial linkages to China could also be at risk.

The outlook for the Chinese renminbi, which has appreciated around 45% on a real trade-weighted basis since 2005, is uncertain and difficult to predict. While continued RMB depreciation is likely due to capital outflow pressures and rising wages, a large devaluation is less likely. In 2016, China introduced new and tighter capital controls that appeared to temporarily stem capital outflows and stabilise the renminbi. However, in recent months there have been renewed signs of capital outflows, a decline in foreign exchange reserves and a resumption of renminbi depreciation.

Chinese policymakers must carefully manage the credit and property excesses in its economy. If China moves too quickly to address the moral hazard and implicit government guarantees in its financial system, this could lead to a tightening of credit conditions and a pullback in loan demand from the private sector, triggering an economic downturn and possibly a panic in the poorly regulated shadow banking system. On the other hand, if credit stimulus continues unchecked or is ramped up to maintain GDP growth rates, returns to new credit may diminish further and result in material loan losses in the future.

The Chinese leadership appear to be aware of the problems and have the policy tools needed to stabilise the economy. This makes a financial crisis unlikely. Fortunately, most of China's debt is held domestically, which makes it easier for the Government to manage large-scale defaults as it did in the late 1990s. Further monetary stimulus will almost certainly be deployed to reduce interest burdens and ease banks' reserve requirements. Meanwhile, a huge pool of foreign exchange reserves and a large current account surplus make China resilient to external financial shocks.

2 Marginally attached to the labour force are those who currently are neither working nor looking for work, but indicate that they want and are available for a job, and have looked for work sometime in the past 12 months.

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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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For the purpose of complying with GIPS, the Firm is defined as all discretionary portfolios managed by MFG Asset Management.

The Global Low Carbon composite is a concentrated global equity strategy investing in high quality companies (typically 30-50 stocks) with an integrated 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 Equity strategy are to earn superior risk adjusted returns through the business cycle whilst minimising the risk of a permanent capital loss with an integrated ESG strategy with meaningfully lower carbon intensity than broader equity markets. The composite was created in October 2016.

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 list of composites and descriptions, as well as policies for valuing investments, calculating performance, and preparing compliant presentations are available upon request by emailing data@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.