MFG ASSET MANAGEMENT

Strategy Update: 30 June 2021

# MFG Global Equity (USD)

| Portfolio Managers | Strategy Inception Date | Total Strategy Assets | Total Global Assets [1] |
|---|---|---|---|
| Lead Portfolio Manager: Hamish Douglass<br>Co-Portfolio Manager: Arvid Streimann | 1 July 2007 | USD $48,756.9 million | USD $64,119.7 million |

| Objective | Approach |
|---|---|
| Capital preservation in adverse markets<br>Pre-fee return of 10%p.a. through the economic cycle | High conviction (20-40 securities), high quality focus<br>Dual-sleeve portfolio construction with dynamic allocation to cash (typically between 0% - 20%)<br>Combined Risk Ratio cap of 0.8^ |

| Strategy Fundamentals[2] | Strategy |
|---|---|
| Number of Holdings | 24 |
| Return on Equity | 30 |
| P/E Ratio (1 year forward) | 26.1 |
| Interest Cover | 16 |
| Debt/Equity Ratio | 73 |
| Active Share | 88 |
| Weighted Average Market Cap (USD million) | 484,761 |

| Top 10 Holdings[2] | Sector[2] | % |
|---|---|---|
| Microsoft Corporation | Information Technology | 7.8 |
| Alphabet Inc | Internet & eCommerce | 6.8 |
| Facebook Inc | Internet & eCommerce | 6.4 |
| Starbucks Corporation | Restaurants | 5.3 |
| Netflix Inc | Internet & eCommerce | 4.8 |
| Alibaba Group Holding Ltd | Internet & eCommerce | 4.8 |
| Visa Inc | Payments | 4.6 |
| Tencent Holdings Ltd | Internet & eCommerce | 4.5 |
| SAP SE | Information Technology | 4.3 |
| Yum! Brands Inc | Restaurants | 4.1 |
| | TOTAL: | 53.4 |

| 3 Year rolling returns[3] (measured monthly) | 1 Year | 3 Years | 5 Years | Since Inception |
|---|---|---|---|---|
| **Against MSCI World NTR Index** | | | | |
| No of observations | 12 | 36 | 60 | 133 |
| Average excess return (% p.a.) (Gross) | 3.3 | 3.9 | 3.3 | 6.1 |
| Average excess return (% p.a.) (Net) | 2.4 | 3.0 | 2.4 | 5.2 |
| Outperformance consistency (Gross) | 100% | 100% | 100% | 100% |
| Outperformance consistency (Net) | 83% | 94% | 97% | 98% |

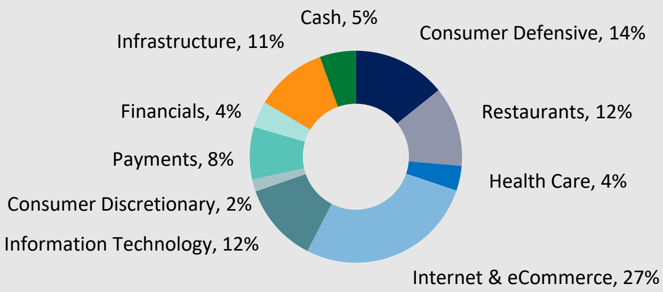
| Capital Preservation Measures[4] | 3 Years | 5 Years | 10 Years | Since Inception |
|---|---|---|---|---|
| **Adverse Markets** | | | | |
| No of observations | 8 | 12 | 30 | 48 |
| Outperformance consistency | 100% | 92% | 97% | 94% |
| Average return – Strategy | -3.9% | -3.2% | -1.7% | -3.8% |
| Average return – Benchmark | -8.2% | -6.1% | -5.6% | -8.1% |
| Down Market Capture | 0.5 | 0.5 | 0.3 | 0.5 |
| **Drawdown** | | | | |
| Maximum Drawdown - Strategy | -15.3% | -15.3% | -15.3% | -36.0% |
| Maximum Drawdown - Index | -21.1% | -21.1% | -21.1% | -54.0% |

| Performance[5] | 3 Months (%) | 1 Year (%) | 3 Years (% p.a.) | 5 Years (% p.a.) | 10 Years (% p.a.) | Since Inception (% p.a.) |
|---|---|---|---|---|---|---|
| Composite (Gross) | 6.8 | 22.4 | 15.4 | 16.2 | 14.4 | 12.7 |
| Composite (Net) | 6.6 | 21.4 | 14.4 | 15.3 | 13.5 | 11.8 |
| MSCI World NTR Index | 7.7 | 39.0 | 15.0 | 14.8 | 10.7 | 6.7 |
| Excess (Gross) | -0.9 | -16.6 | 0.4 | 1.4 | 3.7 | 6.0 |
| MSCI World Qual. Mix NTR Index | 10.7 | 37.4 | 20.5 | 18.5 | 14.0 | 10.5 |
| MSCI Min. Vol. NTR Index | 5.8 | 18.5 | 10.0 | 8.5 | 9.7 | 6.8 |

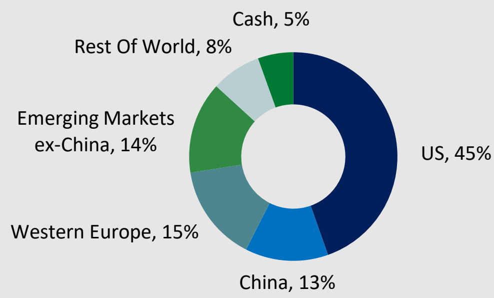
| Annual Performance[5] (%) | CYTD | 2020 | 2019 | 2018 | 2017 | 2016 | 2015 | 2014 | 2013 | 2012 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Composite (Gross) | 9.3 | 11.2 | 29.7 | 0.4 | 25.2 | 4.7 | 4.2 | 6.6 | 30.8 | 21.6 | 11.9 |
| Composite (Net) | 8.8 | 10.3 | 28.7 | -0.4 | 24.2 | 3.9 | 3.4 | 5.7 | 29.8 | 20.7 | 11.0 |
| MSCI World NTR Index | 13.0 | 15.9 | 27.7 | -8.7 | 22.4 | 7.5 | -0.9 | 4.9 | 26.7 | 15.8 | -5.5 |
| Excess (Gross) | -3.7 | -4.7 | 2.0 | 9.1 | 2.8 | -2.8 | 5.1 | 1.7 | 4.1 | 5.8 | 17.4 |
| MSCI World Qual. Mix NTR Index | 13.9 | 22.2 | 36.1 | -5.5 | 26.0 | 4.6 | 3.7 | 8.4 | 27.1 | 13.0 | 3.8 |
| MSCI Min. Vol. NTR Index | 7.1 | 2.6 | 23.2 | -2.0 | 17.3 | 7.5 | 5.2 | 11.4 | 18.6 | 8.1 | 7.3 |

| Supplementary Statistical Measures[6] | 3 Years | 5 Years | 10 Years | Since Inception |
|---|---|---|---|---|
| Turnover | 23.4% | 19.1% | 15.9% | 13.2% |
| Beta | 0.7 | 0.7 | 0.7 | 0.7 |
| Tracking Error (% p.a.) | 8.1% | 6.6% | 6.4% | 6.7% |
| Standard Deviation – Strategy | 13.4% | 11.4% | 11.0% | 13.2% |
| Information Ratio | 0.0 | 0.2 | 0.6 | 0.9 |

**Sector Exposure[2]**




**Geographical Exposure[2]**




[1] Comprised of all Global Strategies.
[2] The data is based on a representative portfolio for the strategy. Sectors are internally defined. Geographical exposure is calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio. Exposures may not sum to 100% due to rounding. +The Index is the MSCI World NTR Index. Refer to the Important Notice below for further information.
[3] Rolling 3-year returns are calculated and rolled monthly for the duration of each period shown. The average excess return is then calculated for each period, with the outperformance consistency indicating the percentage of positive excess returns.
[4] Capital preservation measures are calculated before fees and in USD. An adverse market is defined as a negative 3-month return for the MSCI World NTR Index (USD), rolled monthly, whilst drawdown is based on rolling monthly returns.
[5] 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 below 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.
[6] Supplementary Statistical Measures Beta, Tracking Error and Information Ratio are calculated in USD using the MSCI World NTR Index.
^ Combined risk ratio is a measure of relative beta and relative drawdown to MSCI World NTR USD Index. Please contact MFGAM should you wish for further details on the calculation.



**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 brands 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.

## Market Commentary

Global stocks soared to record highs as they rose for the ninth quarter in 10 during the three months to June after investors backed that vaccines and more government spending would drive economies, dismissed an acceleration in inflation as transitory, and thus believed statements from central banks they would keep monetary policy loose. During the quarter, 10 of the 11 sectors rose in US-dollar terms. Information technology (+12%) climbed the most on healthy earnings while utilities (-0.7%) declined on concerns that longer-term bond yields might rise. The Morgan Stanley Capital International World Index surged 7.7% in US dollars.

US stocks gained as companies, especially tech ones and the banks, reported healthy earnings reports for the first quarter, the administration of President Joe Biden announced plans for another US$4 trillion in spending (that Congress is still to approve), consumers spent as they grew in confidence, and, by the White House count, 67% of adults have received one vaccine dose. Reports, however, on inflation provoked spasmodic caution. Consumer inflation rose 5.0% in the 12 months to May, the fastest pace since 2008, while producer prices surged 6.6% in the year to May. These reports fanned talk the US Federal Reserve might rethink its loose monetary policy. A Fed survey of its policymakers show they had brought forward their expectations of when they would sanction a higher US cash rate. They (as represented by their median forecast) now expect to approve two increases in the cash rate from close to 0% by the end of 2023. The S&P 500 rallied 8.2%.

European stocks rose as countries relaxed pandemic restrictions as vaccine programs rolled out and the European Central Bank said it would keep aggressive monetary stimulus in place, though gains were limited by news that an ever-more debt-heavy eurozone economy is contracting. A report showed the eurozone economy shrank 0.3% in the March quarter, which followed a contraction of 0.6% in the December quarter. Another report showed government debt stood at 98% of eurozone GDP at the end of December. The Euro Stoxx 50 Index rose 3.7%.

Japan's Nikkei 225 Index defied the global trend and fell 1.3% after a resurgence in covid-19 infections extended restrictions and a report said the economy shrank 1.0% in the first quarter. China's CSI 300 Index rose 3.5% as a release showed the economy expanded a record 18.3% in the March quarter from a year earlier. Australia's S&P/ASX 200 Accumulation Index gained 8.3% after the major banks reported upbeat results, energy and material prices climbed (iron ore prices reached record highs), the federal government's budget for 2021-22 came with more stimulus, and a report showed the economy expanded 1.8% in the March quarter, to be larger than before the pandemic. The MSCI Emerging Markets Index increased 4.4% in US dollars on signs the world economy is recovering even as covid-19 ravaged emerging countries especially India.

## Strategy Commentary

The strategy recorded a positive return for the quarter. The biggest contributors were the investments in Alphabet, Microsoft and Facebook. Alphabet rallied after the parent of Google reported that rising spending on digital ads boosted first-quarter sales to US$55.3 billion, a higher-than-expected rise of 34% from a year earlier. Microsoft rose as rising demand for PCs, gaming consoles, and digital services delivered over the cloud boosted the software giant's first-quarter sales by a higher-than-expected 19% to US$41.7 billion. As well, in April, Microsoft agreed to buy speech-recognition firm Nuance Communications for US$19.7 billion, to expand the services it can offer business customers. Facebook surged after first-quarter sales smashed expectations to rise 48% to US$26.2 billion as advertisers sought access to the social media platform's 2.9 billion users and a US judge unexpectedly dismissed two complaints against the social-media giant from the US regulator because the judge said the Federal Trade Commission failed to prove the company was a monopoly.

The biggest detractors were the investments in Eversource Energy of the US, Tencent of China and WEC Energy of the US. Eversource Energy fell after the Connecticut Public Utility Regulatory Authority slammed the utility that through subsidiaries offers electricity, natural gas and water services for its preparation for and response to Tropical Storm Isaias that hit in 2020. In a politically charged decision, the authority found that Eversource did not satisfy relevant performance standards, ordered an indefinite reduction of 90 basis points to subsidiary Connecticut Light & Power's authorised return on equity, ordered the opening of a regulatory docket to consider issuing civil penalties against the subsidiary and foreshadowed the disallowance of certain costs that the authority asserts were imprudently incurred were Eversource to seek recovery. Eversource has indicated it will appeal these findings. Tencent fell as the Chinese government stepped up regulatory scrutiny of the country's largest technology stocks. WEC Energy, which provides electricity and gas across four Midwest states, slid on concerns that utilities were most vulnerable to any rise in interest rates.

In relative terms, the portfolio underperformed the benchmark over the quarter. This reflected a modest outperformance of cyclical stocks over defensive stocks, on average, within the index. Uncertainty around the Chinese regulatory outlook weighed on Chinese technology platforms, while the portfolio's utility holdings were hampered by a company-specific regulatory decree and the threat of higher interest rates in the medium term.

*Index movements and stock contributors/detractors are based in local currency terms unless stated otherwise.*

## Stock story: PepsiCo

The Super Bowl is the most watched television program in the US each year. One of the products to feature during the 2021 final, where a 30-second advertising slot fetched about US$5.5 million, was the Mountain Dew drink owned by PepsiCo.

PepsiCo generates about half of its revenue from its famous beverage brands, including Mountain Dew, Gatorade, Tropicana, SodaStream and Pepsi-Cola, but they account for only about one-third of the company's profits.

The 110 million or so Americans watching the US football game were probably munching on the products of PepsiCo's most prized asset. This is the savoury snacks business that generates the remaining 50% of the company's revenue, amounting to US$70.4 billion in fiscal 2020. Thanks to the business's best-in-class operating margins, snacks amount to two-thirds of the company's profits. The division that includes brands like Cheetos, Doritos, Lay's and Ruffles and the breakfast-oriented Quakers enjoys about 65% market share in the US, underscoring its dominance.

These salty treats did especially well during the covid-19 pandemic, as even the healthiest among us turned to comfort food when locked up. Before covid-19, PepsiCo's snacks business had delivered consistent sales growth over the previous decade, thanks to the shift to 'on the go' lifestyles and a trend away from three 'square' meals per day. Although PepsiCo's soft drinks division offers lower growth, it is still a valuable asset that plays alongside Coca-Cola in a branded duopoly with rational competitive dynamics.

The brand equity of PepsiCo's product range is central to the investment case. The company's true edges here are in innovation and marketing, attributes that are often more important than price in determining market share. The company's scale and dominance, particularly in the US, puts it in a strong negotiating position vis-à-vis fragmented retail outlets. This gives it strong pricing power and a secure route to market.

Another key advantage is PepsiCo's distribution system. Unlike competitors that rely on retailers to place their products on the shelves, PepsiCo operates an extensive direct-to-store delivery system in the US, using a truck fleet numbering in the thousands (and one that is larger than that of the US Postal Service). This system gives PepsiCo control of product freshness, presentation, marketing and merchandising at the point of sale. It also enables the swift rollout of new products, and helps to minimise out-of-stocks on high-turnover items. Replicating this expensive infrastructure and expertise would be near-impossible for smaller rivals, which gives PepsiCo an enduring competitive advantage.

Investors are also attracted to PepsiCo's defensive qualities. In a world where macroeconomic and geopolitical uncertainty is palpable, PepsiCo offers time-tested earnings streams. Consumer staples companies such as PepsiCo have often outperformed the broader market during past periods of upheaval. After a brief initial hit from the pandemic, PepsiCo shares have recovered to reach record highs. We are confident the company's promising earnings and profit growth will generate superior returns for investors for a while yet.

PepsiCo faces challenges, of course. There are many substitutes for the company's products and consumers are always keen to experiment. The rise of retailer-led 'private label' strategies, e-commerce and 'guerrilla marketing' tactics has threatened the power of big brands. The sugar and salt content in PepsiCo's products mean sales are vulnerable to a shift to healthier eating or government taxes to encourage the same.

In our view, the company's overall advantages are meaningful enough to overcome these challenges and disruption risks. We think PepsiCo will generate attractive investment returns for years to come, while proving a safer investment in falling markets.

**A quack solution**

PepsiCo's history starts in 1898 when Caleb Bradham, an entrepreneur from New Bern, North Carolina, created Pepsi-Cola and offered the soft drink to customers within his pharmacy, claiming it cured dyspepsia and indigestion.

Bradham obviously knew he had something popular to sell because in 1903 he registered the Pepsi trademark. Taking inspiration from the Coca-Cola Company, Bradham developed a bottling franchise system. By World War I, 300 bottlers had joined the franchise. After the war, Bradham stockpiled sugar to safeguard against rising costs, but in 1920 sugar prices plunged, forcing him into bankruptcy in 1923.

Pepsi existed on the brink of ruin under various owners until Loft Candy bought it in 1931. Its sales improved in 1933 when during the Great Depression it doubled the size of its bottles to 12 ounces (0.35 litres) without raising the price from 5 US cents.

A pivotal moment in the founding of the modern PepsiCo came in 1965 when the CEOs of Pepsi-Cola and Frito-Lay envisaged what they called "a marriage made in heaven"; namely, creating a single company that offered salty snacks and one of the US's most popular cola drinks.

Nowadays, consumers across the world enjoy PepsiCo products more than one billion times each day. In addition to its North American operations, which account for about 60% of revenue, PepsiCo has four international divisions. Each of these divisions has a distinct history and way of doing business. The dominance and prominence of the products, however, whether on store shelves or when advertised during popular TV shows, is the same the world over.

*Sources: Company website, Bloomberg, Dunn & Bradstreet.*