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## **MAGELLAN HIGH CONVICTION TRUST (ASX: MHH)**

### **Magellan Global Markets and Portfolio Positioning Update**

We are pleased to provide the enclosed global markets and portfolio positioning updates.

The audio broadcast recorded on 1 April 2020 with Hamish Douglass is available here: <https://www.magellangroup.com.au/insights/>. The key talking points from the Q&A section of the audio broadcast are also enclosed.

*Authorised by*

Marcia Venegas | Company Secretary

**Magellan Asset Management Limited**  
**as responsible entity for**  
**Magellan High Conviction Trust**

### **About the Magellan High Conviction Trust**

The Trust invests in a global equities portfolio of Magellan's highest conviction ideas and aims to deliver investors a cash distribution yield of 3% per annum. The Trust's portfolio will comprise between 8 to 12 stocks at any one time but will also have some exposure to cash. The investment objective of the Trust is to achieve attractive risk-adjusted returns over the medium to long-term. The Trust may also manage its foreign currency exposure arising from investments in overseas markets.

## The output gap, policy responses and consumers hold the key to the outlook

As the world battles with the covid-19 pandemic, our assessment of the economic and investment implications depends upon three fundamental issues. These are the duration of the output gap, the policy responses to mitigate the output gap, and whether or not the crisis will result in fundamental and lasting changes in consumer behaviour. Let's take each issue in turn.

### Issue 1: The duration of the output gap

The output gap is the lost economic output a country will experience during a period in which the economy is effectively shut down. The longer the output gap, the deeper the economic damage. The duration of the output gap will largely depend on the effectiveness of the health response taken by governments.

There are two health responses that are being pursued. One is a hard suppression strategy, where authorities implement a total shutdown of the economy for, say, six to eight weeks. This is likely to be the most effective strategy to minimise the duration of the output gap. Following a period of total shutdown, growth in new cases should be near zero. Officials should be able to reopen the economy provided they have strong testing, contact tracing and monitoring to stop the spread of new cases. For many countries, this might prove to be hard to do comprehensively and effectively. External borders would have to remain closed to stop imported cases. China appears to be on this path.

The other strategy is a mitigation strategy where authorities implement a controlled social-distancing strategy and keep parts of the economy open as long as possible. This is likely to lengthen the duration of the output gap compared with a hard-suppression strategy.

Many countries are now pursuing courses in between these two bookends.

Our best guess is that the duration of the output gap ranges from two months to six months depending on the effectiveness of the various health responses. Based on the measures being pursued by various countries, we would put China at the low end of this range, the US and Australia in the middle and many emerging markets at the other end.

The one area that could shorten the output gap is an effective therapeutic being found that reduced the mortality rate in the most severe cases. This would enable countries to reopen with less fear. We would be surprised if an effective therapeutic could be found and scaled globally within six months. There is enormous work being undertaken on testing therapeutics with trials underway with little red tape. We note Johnson & Johnson has announced it will commence trialling a vaccine in September. At best, it would only be available for small-scale deployment in early 2021. This is unlikely to truncate the duration of the output gap.

### Issue 2: The policy response

The policy responses cover those by central banks and governments. Central banks appear to be taking two courses. The first is to reduce interest rates as far as practicable; that is, making money effectively free. The other is to ensure the financial system has sufficient liquidity to ensure it doesn't freeze. We are seeing massive injections of liquidity by central banks via a scaling up of quantitative easing, providing liquidity-

support facilities to businesses, liquidity support to other central banks (currency swaps) and liquidity to critical areas of the economy such as the repo markets and money-market funds.

We have been impressed with the actions taken by the major central banks to date; they are acting nimbly, and with scale and speed. They appear to be winning the fight to head off a liquidity crisis, and will tailor responses as issues emerge. At the same time, some difficult issues haven't yet been addressed that are likely to put further strains on the financial system. One unresolved issue is the support to be given to sub-investment-grade companies that have borrowed in the high-yield and leverage-loan markets. Another area to be resolved is what happens when many companies have their credit ratings downgraded from investment grade to sub-investment grade. Solving these issues is difficult and might require a co-ordinated response from governments and central banks.

With fiscal policy, we are seeing governments implement four possible packages of fiscal responses. One is to compensate all businesses for 100% of their lost revenue. This would keep balance sheets intact and enable businesses to pay all their employees and key suppliers; for example, landlords, lenders and so on. Businesses could furlough workers and restart when the economy reopens. In this instance, there would be a limited rise in unemployment, despite a hit to GDP, and activity would resume when the economy reopens. The output gap would be transferred to governments and to central-bank balance sheets via quantitative easing. This would be a V-shaped economic recovery. Singapore and Denmark come closest to adopting this strategy.

The second strategy is to compensate businesses for some of their revenue loss and allow them to meet permitted expenses such as wages, interest on loans, rent and utilities. Employees would be furloughed. The US has a program to lend up to US\$10 million to companies employing fewer than 500 people. Under this strategy, a large part of the output gap would be transferred to governments and central-bank balance sheets and the remainder would be shared by society. This would save many businesses and enable them to restart. This combined with an effective mitigation strategy would be the best chance of a U-shaped economic recovery. Germany is following this strategy.

The third strategy is to compensate workers for 70% to 100% of lost wages (typically capped at the median wage). This strategy preserves personal balance sheets, but not businesses that have to manage fixed costs. The issue here is that, outside of wages, the remainder of the output gap would fall on businesses, landlords, utilities and banks. This is also likely to hit property prices. Even if many businesses survive, they would emerge with additional debt or balance sheets that were damaged. This would impede their ability to invest and employ as many people as before. They would cut costs to survive even when the economy restarted. This strategy would head off the most dire of economic outcomes but it is unlikely to prevent a deep and prolonged recession and a significant jump in unemployment. Many western governments are pursuing this strategy. These governments might well provide additional fiscal support to preserve businesses' balance sheets that could be expected to support a stronger economic recovery.

The last strategy is zero compensation. A country loses 17% to 50% of annual output (depending on the duration of the blow to the economy). Many businesses would not survive, particularly small businesses. The property market would crash. Banks would face severe losses. This is the depression scenario. Fortunately, almost no developed country is following this strategy. We fear many emerging markets will not have effective mitigation strategies and be unable to fill a meaningful part of the output gap. We are particularly concerned about Africa, Latin America, India and emerging countries in Southeast Asia.

### **Issue 3: Changes in consumer behaviour**

In thinking about the economic and investment implications, investors need to assess the effect that the health and economic crisis is likely to have on consumer behaviour. This will determine the speed of any economic recovery and create winners and losers in a relative sense.

We know that significant events such as the Great Depression of the 1930s and the world wars had lasting effects on behaviour; so too will today's crisis. There are areas such as the cruise industry where there is likely to be a lasting effect on consumer behaviour. It is possible that the travel industry will experience

a fundamental and lasting reduction in demand. Retirees will probably not travel overseas like they did previously. Businesses might determine much business travel is inefficient and discretionary and that meetings can be held just as effectively via video conference.

Other questions investors must ask themselves include: Will there be a fundamental shift in consumption patterns? Will people dine out in restaurants less frequently? Will there be less conspicuous consumption? Will people change their hygiene habits enough to lead to higher demand for cleaning and hygiene products? Will there be a change to how people work? Will this lead to increased demand for software like video conferencing? What will happen to the savings rate? Will people delay renovations to their homes?

The extent of change in consumer behaviour will depend upon many factors. These include the duration of the output gap, the effectiveness of the policy response and the speed and shape of the economic recovery.

## **Conclusion**

The situation remains fluid. It is difficult to predict how the next two to 12 months will play out.

We think there is a range of outcomes for the economic recovery, from a V-shaped recovery (a fleeting recession) to a U-shaped recovery (a mild recession), a prolonged and deep recession and, at the pessimistic end, a depression. We believe that for many major economies a V-shaped recovery and a depression appear the least likely scenarios. Outside of a few countries, a recession (a U-shaped recovery) to a deep and prolonged recession appear the most likely outcomes at this point in time. The good news is that governments and central banks are calibrating their responses to attempt to mitigate the economic fallout.

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## Q&A with Hamish Douglass

Hamish Douglass, the Chairman and CIO at Magellan, talks about what market reaction to covid-19 surprised him, why the portfolio has withstood the market ructions, what makes Estée Lauder and LVMH sound investments still and why inflation is not an immediate threat despite the massive fiscal and monetary stimulus.

### **Q: Are you surprised by the turbulence covid-19 unleashed on financial markets?**

**A:** The extreme market volatility on stock markets didn't surprise us as it was correlated to bleak news headlines and the uncertainty those created. Different types of stocks performed as expected. Non-discretionary retailers such as supermarket chains performed well, as did consumer staples, business software companies and telecoms. At the opposite end, travel, oil and gas producers, banks, discretionary retailers and property trusts struggled as logic dictated.

But some events surprised us. Saudi Arabia's dispute with Russia over oil prices was unexpected. The bond market surprised us when yields edged higher as did the extended selling of some utilities. We would have expected that government bonds and utilities would have performed better due to their defensive qualities. In the rush for cash, however, cash-like assets were sold to meet liquidity needs. That was somewhat counterintuitive during a flight to safety.

### **Q: What is your best risk-management tool during a crisis such as today's?**

**A:** Our most important risk-management tool is our portfolio construction. We design a portfolio to deal with the unexpected. This is probably as close as you can get to a 'black swan' event even though, along with a terrorist or bioterrorist event, we have often cited a pandemic as a risk.

Despite the fact that we were close to fully invested when covid-19 struck, our portfolio has proved resilient because we apply conservative risk controls (such as a 0.8 cap on the combined risk ratio) when we build the portfolio and we invest only in quality companies.

As events unfolded, we reduced the risk ratio of the portfolio. So far, we can say we are pleased with the way the portfolio has reacted to the most extreme event we have seen in our careers.

### **Q: The portfolio includes consumer-discretionary companies such as Estée Lauder from the US and LVMH from France. Do you think consumer behaviour will change after the crisis and are these luxury companies still good investments heading into a recession?**

**A:** We certainly expect the crisis to change consumer behaviour but it is too early to tell how much. How consumers react will depend on the depth and the length of this crisis and how economies recover.

The perspective from which to view Estée Lauder and LVMH is that these stocks amount to only a moderate proportion of the portfolio as we have reduced their positions in recent weeks. That said, and while these companies offer luxury goods that might be less sought after than before, Estée Lauder and LVMH are outstanding companies with outstanding brands and they hold the advantage that about 33% of their sales come from Chinese consumers. We are confident that China will emerge relatively well from this crisis. At the right price, we'd be happy to increase our positions in these investments.

## **Q: What are the long-term implications of these unprecedented levels of monetary easing and fiscal spending underway? What is the risk of higher inflation or other pressures emerging?**

**A:** Our initial assessment is that inflation is unlikely to be an issue for many developed economies for many years. We're likely to come out of this with a substantial and lasting shock to demand. Therefore, the world is likely to have substantial excess capacity, which points to few inflationary pressures emerging for a long while. It could, however, be a different outcome for some emerging markets.

The other issue we are thinking about is the debt burdens that many countries are incurring when combating the virus (and remember that some countries in Europe had high debt burdens before the crisis). The problem is that these debt burdens could put substantial upward pressure on long-term interest rates. Investors might worry about the solvency of some countries. The only way to overcome an increase in longer-term interest rates is effectively to transfer the debt burdens to central banks via quantitative easing and maybe by specifically targeting longer-term interest rates as Japan has done.

We are thinking too about portfolio positioning in terms of where we want to be exposed and which currencies we want to be in and which ones we wish to avoid. We are aware that these debt burdens could once again place significant pressures on the eurozone and on the euro. That means we might prefer investments in the US, Switzerland, Denmark, the UK, Singapore and possibly Australia.

We are wary of emerging-market currencies. We have limited exposure to emerging markets outside of China but we still could take action to further reduce this risk.

## **Q: While it is not necessarily an issue just yet, what might inspire you to deploy some of your cash holdings and move out of defensive stocks?**

**A:** I'm glad you phrased that this is not an issue for today because we are not thinking of moving out of cash at the moment. We need to better assess how this crisis is likely to play out. We need to assess how deep and long the recession might be and whether or not central banks are across all the issues around financial stability. History doesn't provide a good reference point for anyone on what might happen next. You can't just say that stocks will rebound because that's what happened after 2008 and through 2009. That would be a misjudgment of this situation.

We are especially mindful that risks might emerge in the financial system. These risks include high-yield credit and what might happen when companies get downgraded from investment grade to sub-investment grade. Another is that there is likely to be further pressure on the capital of banks and insurance companies. Before we took the portfolio to a less-defensive position we would want to see how these risks develop and how regulators, governments and central banks might address them if they were to become threats.

In the meantime, we will stay focused on preserving the capital of our investors. As Warren Buffett has said: "To finish first, you must first finish." That said, we should remind people that we have about 85% of the portfolio invested in global equities and our portfolio is positioned to do well if the economic recovery is better overall than investors envisage.

## **Q: What long-term changes might covid-19 prompt for the world in terms of supply chains coming back home and how might this influence your future portfolio construction?**

**A:** We've heard a lot about supply chains heading home but we think this is a misplaced notion. Moving all supply chains onshore doesn't necessarily mitigate the pandemic risk. By definition, a pandemic is a global event and it might turn out that China is one of the best places to have manufacturing located because China could be one of the first countries to get their manufacturing working again.

The reaction we are more likely to see is the onshoring of warehousing. There will be more stock held in supply chains. The crisis has exposed the fragility of just-in-time supply chains because they had no flexibility when production shut down. Another consequence is that we will have the onshoring of strategic industries such as medical supplies.

From the portfolio point of view, we want to make sure we capture the additional cost of strengthening supply chains in our company models. We need to think about whether or not companies have the pricing power to recoup these costs, which would see them preserve their margins. This might be hard for many companies if we have subdued demand during an extended recession.

### **Q: Which industries do you think won't bounce back from the virus crisis and which ones might do well?**

**A:** Even though many companies are likely to have materially lower earnings for an extended period, there will be winners and losers. The winners will be those companies with resilient business models such as supermarkets. People are bound to be more conscious of hygiene, which would benefit companies that produce hygiene products. There is likely to be a permanent increase in the demand for software, especially business software. We're all on video conferencing today. This is of benefit to Microsoft. Digital entertainment platforms should benefit as should utilities and consumer staples because their demand should hold up. With interest rates so low, these stocks could end up on favourable valuations.

Some industries certainly appear to be in trouble. Cruise lines, travel companies, airlines, oil and gas producers, some mining companies and certain property investments face challenges, as could financial investments such as banks and insurance companies where the strength of balance sheets is so important.

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## Magellan High Conviction Trust (MHH)

### Portfolio positioning (as at 31 March 2020)

We have taken action to increase the defensiveness of the Magellan High Conviction Trust portfolio and have increased the cash in the strategy from about 5% to 25%. We have been surgical in selling down positions that we feel are more exposed in this environment. All cash is held in US dollars.

We believe the Magellan High Conviction Trust portfolio has numerous advantages to weather this situation. These include:

- We have about 61% of our portfolio in 4 companies and cash that are likely to prove resilient through the shutdown and during a subsequent economic downturn;
  - Cash is at 25% (held in US dollars);
  - Our investments in enterprise software companies (Microsoft of the US and SAP of Germany) and our Chinese platform technology companies (Alibaba and Tencent) are likely to be resilient in this environment. These investments represent 36% of our portfolio;
- We have 19% of the portfolio in two technology investments with more cyclical exposure (Alphabet and Facebook). While economic activity and advertising will decline, we think this downturn could prove an accelerant to their business models. These companies are additionally well positioned to weather the downturn due to their financial strength;
- We have 7% of the portfolio in a leading payment platform (Visa). While demand will be hit by the economic downturn, we consider Visa to possess strong long-term prospects and well positioned to weather the downturn due to its financial strength;
- We have 6% of the portfolio in a luxury company (Estée Lauder). The demand for this company's products is inherently more discretionary in nature and the blow to its businesses will depend upon the depth of the economic downturn. We note that Estée Lauder owns some of the world's strongest brands, retains a solid balance sheet and benefits from sourcing about 33% of sales from Chinese consumers. We think China is one of the best-placed economies to recover from this situation;
- We have 6% of the portfolio in a quick-service restaurant company (Starbucks). This business faces a challenging situation during the next two to six months due to the social-distancing measures being implemented around the world. We note that their drive-throughs and delivery remain open in many markets. Post the health crisis, we believe Starbucks should recover strongly and will likely prove to be resilient to an economic downturn;
- We have reduced the currency hedge to around 26% of the portfolio.

We are monitoring the strength of the balance sheet of each company in our portfolio and, in particular, the ability of our companies to withstand an extended economic slump. However, none of the businesses in the portfolio currently have meaningful financial leverage.

Importantly, our High Conviction portfolio holds no investments across industries that are the most vulnerable to this crisis. The portfolio does not hold any banks, energy companies, airlines, travel-related companies or property trusts. The portfolio has no direct exposure to emerging markets, other than China. We estimate our indirect exposure to emerging markets, excluding China, represents 9% of the portfolio.

This is a complex, fast-moving and unprecedented situation and we will continue to manage the portfolio to protect capital of investors. As Warren Buffett has said: "To finish first, you must first finish."

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