Magellan High Conviction Trust (Managed Fund)

TICKER: MHHT | APIR: MGE1055AU | ARSN: 634 789 754

MAGELLAN ASSET MANAGEMENT

AS AT 31 DECEMBER 2023

PORTFOLIO MANAGERS NIKKI THOMAS, CFA AND ALAN PULLEN

INVESTMENT OBJECTIVE AND PHILOSOPHY

Objectives: To achieve attractive risk-adjusted returns over the medium to long-term.

Aims to deliver 10% p.a. net of fees over the economic cycle.

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

PORTFOLIO CONSTRUCTION

A concentrated portfolio of 10-20 high quality companies meaningfully diversified in risk exposure and correlations seeking to achieve strong risk-adjusted, not benchmark-relative returns.

Cash and cash equivalents exposure between 0 - 50%.

The trust may, from time to time, hedge some or all of the capital component of the foreign currency exposure of the trust arising from investments in overseas markets back to Australian Dollars.

INVESTMENT RISKS

All investments carry risk. While it is not possible to identify every risk relevant to an investment in the trust, we have provided details of risks in the relevant Product Disclosure Statement or offer document. You can view the PDS for the trust on Magellan's website www.magellangroup.com.au

MAGELLAN HIGH CONVICTION TRUST (MANAGED FUND): KEY PORTFOLIO INFORMATION

TICKER	TRUST SIZE	BUY/SELL SPREAD[1]	MANAGEMENT AND PERFORMANCE FEES[2]	INCEPTION DATE
MHHT	AUD $438.5 million	0.07% / 0.07%	1.50% p.a. and performance fee of 10% of excess return^	11 October 2019

^ 10.0% of the excess return of the Trust above the Absolute Return Performance Hurdle of 10% per annum. Additionally, Performance Fees are subject to a high water mark.

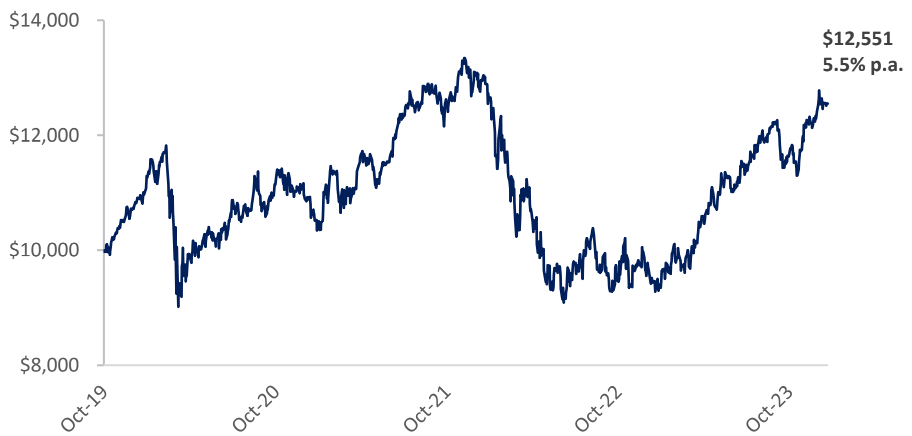
PERFORMANCE[3]

	1 MONTH (%)	3 MONTHS (%)	1 YEAR (%)	3 YEARS (% p.a.)	Since Inception (% p.a.)
MHHT	2.9	9.7	34.6	5.7	5.5

CALENDAR YEAR RETURNS	2023 (%)	2022 (%)	2021 (%)	2020 (%)	2019 (part year)
MHHT	34.6	-27.7	21.2	-1.6	8.2

Past performance is not a reliable indicator of future performance.

PERFORMANCE CHART GROWTH OF AUD $10,000[3]



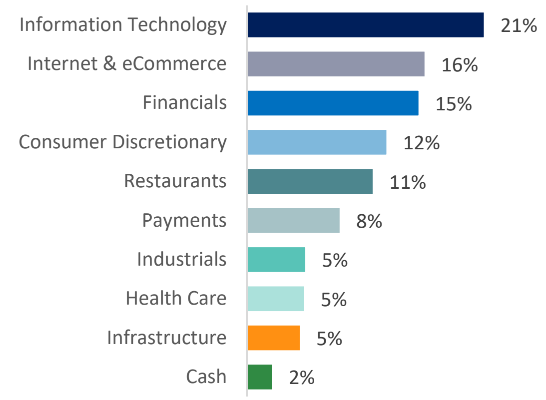
Past performance is not a reliable indicator of future performance.

TRUST CHARACTERISTICS[4]

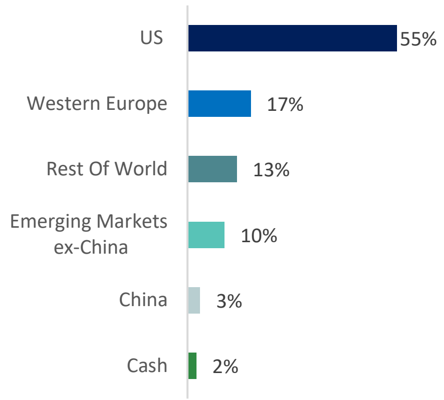
3-YEAR	AVERAGE	HIGH	LOW
Cash Weight	5.1%	18.7%	1.1%
Number of Stocks	12	15	10
Hedging Weight	0.3%	10.1%	0.0%

[1] Only applicable to investors applying for units and withdrawing units directly with the Responsible Entity.
[2] Transaction costs may also apply – refer to the Product Disclosure Statement. All fees are inclusive of the net effect of GST.
[3] Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Returns denoted in AUD.
[4] 3-year average cash weight and hedging ratio are calculated using month end values over the period.

SECTOR EXPOSURE BY SOURCE OF REVENUE[5]



GEOGRAPHIC EXPOSURE BY SOURCE OF REVENUE[5]



TOP CONTRIBUTORS/DETRACTORS 1 YEAR[6]

TOP 3 CONTRIBUTORS	CONTRIBUTION TO RETURN (%)
Microsoft Corporation	5.6
Booking Holdings Inc	5.4
Amazon.com Inc	5.3
TOP 3 DETRACTORS	**CONTRIBUTION TO RETURN (%)**
Alibaba	-0.6
WEC Energy Group Inc	-0.4
Diageo Plc	-0.3

TOP 5 HOLDINGS (ALPHABETICAL ORDER)

STOCK	SECTOR[5]
Amazon.com Inc	Internet & eCommerce
Booking Holdings Inc	Consumer Discretionary
Intercontinental Exchange Inc	Financials
Microsoft Corporation	Information Technology
Visa Inc	Payments

[5] 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.
[6] Shows how much the stock has contributed to the trust's gross return for the period in AUD. Excludes non-disclosed positions established in the latest quarter.

Market Commentary

The December quarter saw strong global equities returns with the MSCI World Index rising 11.4% in USD and 5.4% in AUD, driven by lower bond yields. The Information Technology sector led these gains (up 16.9%), followed by Industrials (11.4%) and Financials (11.2%), with these sectors sensitive to interest rate movements and the economic outlook. The Energy sector declined 5.5% as oil prices fell in the quarter. The S&P 500 rose 11.2%, outpacing the S&P/ASX 200 Accumulation Index (8.4%), MSCI Emerging Markets Index (7.4%) and Euro Stoxx 600 (6.4%). In contrast, China's CSI 300 Index fell 7.0%.

The main driver of equity returns in the quarter was a large fall in bond yields. US 10-year Treasury yields fell 70bp to 3.9%, German 10-year Bunds declined 80bp to 2.0% and Japanese 10-year JGBs declined 10bp to 0.6%. These were a response to easing inflationary pressures, with annualised US inflation in the three months to November running at 2% compared with 5.5% just six months earlier. Notably, this development led the Federal Reserve to suggest in December that its policy rate may be "at or near its peak". The tailwind to equity returns from lower interest rates was reinforced by a slightly improved profit outlook, with the gradual slowdown in global growth not hurting profit growth as much as many had feared earlier in the year.

The Chinese growth outlook remains challenged as the country digests its real estate bubble. Poor consumer, business and investor confidence are stiff headwinds to growth and will take time to improve in the absence of economic stimulus. While the Chinese government appears so far to be more focused on internal security rather than growth, there have been some signs of minor pro-growth policies. These growth headwinds are reducing geopolitical risk in East Asia as the Chinese government focuses more on domestic issues.

Fund Commentary

The Magellan High Conviction portfolio performed strongly in the December quarter. All of our 15 holdings rose, with the top contributors up between 17% and 30% in the quarter. Positive contributions were led by Microsoft and Amazon, followed by Intercontinental Exchange (ICE), Salesforce and Chipotle Mexican Grill. The moves reflect both rising expectations as AI opportunities are considered and a shift in sentiment around higher-growth investments as policy interest rates are seen to be at peak (and falling in 2024). Microsoft delivered a strong fiscal Q1 result driven by commercial cloud momentum, unexpectedly good Windows growth in a stabilising PC environment, gross margin expansion, and operating leverage. Azure performance provided encouraging early evidence of Microsoft's ability to monetise the AI opportunity, and abating cloud spending headwinds. Amazon reported a strong 3Q23 result. AWS growth stabilised in 3Q23 vs the prior quarter and management indicated growth would inflect in 4Q23/F24 as optimisation efforts reduce and digital transformation programs resume. ICE has experienced strong derivatives volumes, reflecting volatility in energy prices and interest rates, while the company has now completed its Black Knight acquisition and a fall back in US mortgage rates bodes well for origination volumes, which will benefit the group. Salesforce continues to deliver strong revenue growth and rapidly improving profitability as it manages costs more rigorously. Chipotle is executing superbly, extracting share gains to drive revenue growth and expanding margins as cost inflation, particularly wages, is well managed.

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

Outlook

2023 ended strongly as markets almost everywhere (OK, not China) rallied. Breadth expanded beyond the few stocks that led 2023 strength and financials caught some interest as a benign US economic backdrop became a more consensus view. We are seeing recessions in Europe, clear weakness in China and still some small risk of a brief period of economic weakness in the US even though in late 2023 US growth accelerated. Without a notable slowdown in its economy, accompanied by deteriorating employment conditions or a concern that deflation could be ahead, we doubt the US Federal Reserve will feel compelled to cut its policy rates too quickly. We expect US 10-year Treasuries at around 4% for a while yet and quantitative tightening to continue even as inflation further comes back to levels seen as acceptable to central banks around the world. This is no longer a major headwind for equity markets and indeed likely becomes a tailwind during 2024. September Federal Reserve projections (rates, GDP growth, unemployment) were all revised to reflect a sustainably stronger economic outlook, and nothing thus far has contradicted this.

In many respects the world looks to be in good shape economically. Measures of Consumer Sentiment show gloominess amongst Americans, but this seems somewhat at odds with prospects and perhaps is a function of social media's negative lens. We continue to see remarkable progress in many areas and excellent opportunities within markets and we encourage a longer-term and disciplined approach by investors.

Areas of consternation largely reflect some level of dysfunction politically and geopolitically – migrant crises, Israel/Hamas, income inequality and high government debt – and we can add to that regular weather calamities. Yet in the US economic growth (real) has accelerated and is likely to be close to 3% in 4Q23 vs 0.7% a year ago. Unemployment has been below 4% for the longest period since the 1960s and the participation rate amongst 18- to 64-year-olds is the best it's been since 2009. With falling inflation, real wages are up and wealth drivers of housing and share markets mean household net worth is up strongly.

Prospects for corporate earnings and cash flows mean an exciting backdrop for long-term investors. New projects are being undertaken as the trends of digitisation, decarbonisation and deglobalisation gain momentum. US non-residential construction spend is strong and has one of the highest growth multipliers (estimated at 3x) of any industry. Even if interest rates do not fall materially, we believe opportunities outweigh the risks within equity markets.

Stepping to the portfolio positioning, we are clearly positive on the opportunity to deliver wealth creation in global equities. We believe that there are boundless opportunities in front of us for our superbly managed companies with strong competitive advantages to deliver exceptional earnings and cash flow growth in coming years. There may be some share price bumps along the way as bond yields fluctuate and sector rotations within markets affect prices through flows, but we are confident in valuation upside for the portfolio. Strong earnings mitigate rate volatility risk over a longer time horizon and so the portfolio is tilted towards those companies we believe can keep delivering better-than-expected results through time and are yielding high cash flows from their operations even today. Innovation alongside execution excellence is at the heart of many of the companies we own – Microsoft, Amazon, Intercontinental Exchange, Salesforce and Chipotle Mexican Grill, among myriad others, discuss with us the innovations that place them at the forefront of their industries.

We continue to work hard to position for strong future performance by selecting compelling uncorrelated exposures via companies that not only have strong competitive advantages but that we believe can also deliver resilient cash flows and exciting growth. We believe that the portfolio has the potential to deliver our clients strong double-digit returns over coming years as we focus exposures in strong, extremely well-capitalised and advantaged companies that can benefit from the changing shape of economies and industries. We thank you for the trust you place in us.

Stock Story: Yum!

(Emma Henderson – Investment Analyst)

Behind the success of the world's most famous quick-service chicken restaurant, the world's second-largest pizza chain and the US's leading Mexican-style franchise sits Yum! Brands. With over 55,000 restaurants across more than 155 countries and territories, Yum! Brands is the world's largest restaurant company by number of restaurants and second only to McDonald's in total restaurant sales.

The iconic KFC, Pizza Hut and Taco Bell brands were originally brought together under consumer goods giant PepsiCo in the 1970s and 1980s as part of a series of acquisitions to diversify its business away from beverages. In 1997, PepsiCo announced it would be narrowing its focus back to its core beverages and snacks businesses and its fast-food unit would be spun off into an independent public company, ultimately named Yum! Brands.

Over the last 25 years, Yum! Brands has grown its global restaurant base by over 25,000 restaurants and has transformed from a US-centric company to a truly global business. It has also shifted its business model from owning and operating a portion of its restaurants to running an almost entirely franchised model, driving dual benefits of reduced risk and accelerated growth for shareholders.

Today, over 98% of KFC, Pizza Hut and Taco Bell outlets are operated by franchisee and licensee partners who deploy their own capital to open and operate restaurant outlets. These partners in turn pay Yum! Brands a royalty fee of approximately 5% of restaurant sales. In 2022, KFC, Pizza Hut and Taco Bell stores around the world generated US$60 billion in total system sales, resulting in US$3 billion in franchise revenue for Yum! Brands and contributing 90% of the company's earnings. Franchise fee revenue is a high-margin, capital-light earnings stream that is insulated from labour and commodity costs increases. The accessible price point and strong value-for-money nature of fast food add to the predictability of this attractive earnings stream throughout economic cycles.

By geography, approximately half of Yum! Brands' franchise revenue is now generated in international markets, including approximately 30% in fast-growing emerging markets like China, India, Southeast Asia and Latin America. While we have seen various misses from Yum! Brands and peers when trying to export US brands internationally, both KFC and Pizza Hut concepts have proven to have strong global appeal, with chicken and pizza products easily customised for local market tastes and preferences. Mexican-style Taco Bell, which is an outstanding business in its home US market, has proven harder to replicate internationally but is beginning to make inroads in markets like Spain, India, the UK, and China.

Despite significant growth and value creation delivered over the past few decades, there remains an exciting growth runway ahead for Yum! Brands, particularly in emerging markets where penetration of its brands remains low, consumer incomes are rising, and the existing restaurant landscape is highly fragmented and unsophisticated. Yum! Brands is targeting global system sales growth of 7% p.a. underpinned by new store growth of approximately 5% p.a. and modest growth in existing store sales through menu and marketing initiatives. The company has been running ahead of this net new store growth target, with over 100 countries contributing to global store growth of closer to 6% in recent years. Highly attractive payback periods on new stores and a more sophisticated and better-capitalised franchisee base relative to peers should prove key advantages to sustaining development in a higher interest rate environment.

Yum! Brands' growth will also be increasingly powered by digital and technology. The company has spent the last few years investing heavily in areas like customer analytics, digital ordering, loyalty programs and back-of-house restaurant technologies, which will be shared across its global system to drive better customer experiences, sales performance and franchisee profitability. One of many examples is the company's acquisition of Dragontail Systems in 2021 for approximately US$70 million. Dragontail is an AI-based technology that automates and optimises multiple Pizza Hut processes, from preparing the pizzas to dispatching product to delivery drivers and enabling customer tracking. In an increasingly digital world, we expect economies of scale on largely fixed-cost technology investments, as well as consumer data advantages from operating over 55,000 restaurants, to become increasingly important competitive differentiators relative to smaller restaurant players in the highly fragmented US$900 billion limited services restaurants industry.

Yum! Brands has a strong track record of ensuring its brands remain culturally relevant and loved. However, to ensure its brands can continue to grow sustainably, it will be important to manage food quality and nutrition risks as consumer preferences evolve, social risks as a large global employer and environmental risks as a large procurer of global agricultural and packaging products.

Yum! Brands remains a cornerstone of the Magellan Global portfolios, generating sustainable and defensive cash flows for investors.