Magellan High Conviction Trust (Managed Fund)

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

AS AT 30 JUNE 2024

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 $454.5 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.

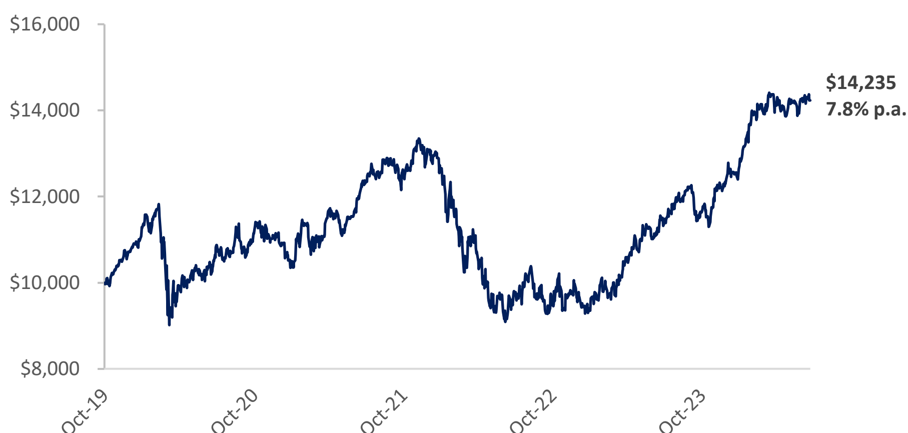
PERFORMANCE[3]

	1 MONTH (%)	3 MONTHS (%)	1 YEAR (%)	3 YEARS (% p.a.)	Since Inception (% p.a.)
MHHT	1.9	-1.0	23.2	5.2	7.8

CALENDAR YEAR RETURNS	CYTD (%)	2023 (%)	2022 (%)	2021 (%)	2020 (%)	2019 (part year)
MHHT	13.4	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]



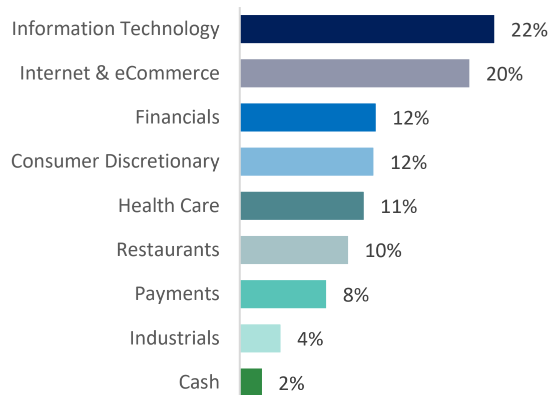
Past performance is not a reliable indicator of future performance.

TRUST CHARACTERISTICS[4]

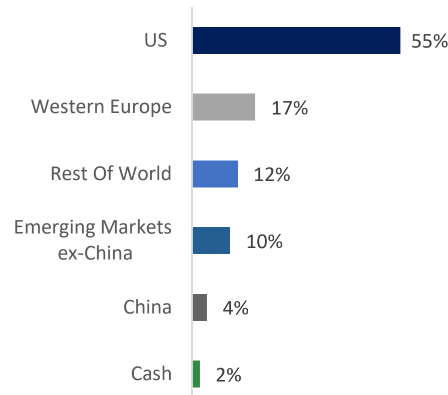
3-YEAR	AVERAGE	HIGH	LOW
Cash Weight	4.5%	18.7%	1.1%
Number of Stocks	13	16	10
Hedging Weight	0.3%	10.1%	0.0%

[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 (%)
Amazon.com Inc	4.1
Booking Holdings Inc	3.7
Microsoft Corporation	3.2
TOP 3 DETRACTORS	**CONTRIBUTION TO RETURN (%)**
Ulta Beauty Inc	-1.4
WEC Energy Group Inc	-0.5
Diageo Plc	-0.5

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

3 months

During the June quarter the MSCI World Index gained 2.6% in USD and 0.3% in AUD. Markets globally diverged with returns being driven by two distinct themes: 1) central banks and governments balancing a slowing of inflation with economic data prints and gauging the right level for interest rates, and 2) continued optimism around the building of infrastructure (chips, data centres) for Generative Artificial Intelligence. Companies that are well positioned to benefit from these new growth opportunities performed well while companies more at risk if demand growth slows too much were weaker. Consequentially, Information Technology (+11.4%) and Communication Services (+8.1%) were by far the strongest sectors in the June quarter, while economic sensitives gave back some of the first quarter gains, with Materials (-3.5%), Consumer Discretionary (-2.3%), Industrials (-2.2%), Energy (-1.3%) and Financials (-0.4%) all lower.

The huge investments, an arms race, to build capacity and capability in Artificial Intelligence rolled on this quarter and share prices followed. US markets were strongest regionally, given it is the home to most major technology companies, with the Nasdaq Composite up 8.3%, followed by the S&P 500 index up 3.9%. Decoupling trends further accelerated as the US imposed tariffs on China's electric vehicles and further limited China's access to semiconductor-related equipment. The US election in November 2024 is filling much column space, but we do not see many areas of truly material policy differences. Most, including us, see Trump's more likely policies as broadly more positive for US corporates and thus equity investors.

AAfter a 20% gain in the March quarter, Japan's Nikkei 225 index dipped 2% in the June quarter. In March the Bank of Japan raised rates from –0.1% to a range of 0.0%-0.1%, the first rise in 17 years and its first move out of negative rates in eight years. The bank hopes to protect the Yen from further devaluation and cool its above-target 2.8% inflation. Unions have successfully been bargaining for higher wages.

Europe's Euro Stoxx 600 index was broadly flat in the quarter, down by 0.2%. President Macron called a snap election in France, causing a sharp sell-off in French bonds and stocks on concerns of a right-wing government gaining control. Europe's recovery is in its early stages with the euro area and UK growth turning positive and disinflation bringing inflation to 2.5% in the EU and 2% in the UK – good news for policy makers. Indeed, the ECB cut its policy rate by 25bp in June. The EU and UK unemployment rates were 6% and 4.4% respectively in May 2024. The German 10-year Bunds rose to 2.5% from lows of just under 2% in December 2023.

Australia’s ASX 200 was down 1.1%.

In China the CSI 300 index fell 3.3% as policy support remained modest. Economic activity was led by improving exports while the consumer remains cautious, preferring to save rather than spend. May data showed retail sales rose 3.7% year on year, exports rose 7.6% year on year and the USD–CNY remains above 7.2. The Third Plenum begins on July 15 where China's government lays out its long-term growth target.

12 months

The MSCI World Index rose strongly this past year, by 20.2% in USD and 19.8% in AUD, fuelled by the significant investments being made to unlock the productivity and growth opportunities that will be enabled by AI and Generative Artificial Intelligence. At the same time, economic growth has held up well, particularly in the US, despite tight monetary policy around the world to bring inflation back down to acceptable levels of closer to 2%. This reflected an improving outlook in many cyclical sectors as both fiscal policy and strong corporate spending have driven growth.

All sectors rose in local currency terms, with Information Technology (+38.8%) and Communication Services (+38.2%) clear beneficiaries of the strengthening growth anticipated from AI, followed by Financials (+25.0%), Industrials (+17.7%) and Energy (+16.4%) revealing the expectations of cyclical recovery. The weakest sectors were Consumer Staples (+2.8%) and Utilities (+5.7%).

The S&P 500 index (USD) added 22.7% and the Nasdaq gained 28.9% in the year to end June 2024. The top five S&P 500 stocks are Microsoft, Apple, Nvidia, Alphabet and Amazon and the impressive performance has rested largely on these stocks. All are important players in driving technological innovation. The Federal Reserve has kept rates at 5.5% in seven consecutive meetings, with the last 25 basis points hike in July 2023. The consumer price index measured inflation at 3.3% in the 12 months to May – down from 4.1% a year earlier – while the Core PCE (which the Fed focuses on) resumed slowing in May (after three stable months at 2.8%) hitting 2.6%. The 10-year US Treasury yield finished the year at 4.4%.

Europe's Euro Stoxx 600 index (EUR) rose 10.7% for the year. After weakening up to October 2023, markets turned as it became clearer that disinflation was taking hold and the growth slowdown would not become a significant economic downturn. Food and energy prices, which had been particularly painful for Europeans, fell back quickly while household wealth is improving modestly. Household disposable incomes are rising at ~5.8% with employee compensation rising at a similar rate. European Union and China trade relations became increasingly difficult over the past year, and this could have profound impacts on multinationals operating across both jurisdictions. Tariffs on Chinese EVs and other measures seem likely as the EU tries to derisk its economy and supply chains

Japanese shares had another strong year, as the Nikkei 225 index advanced 19.3% in Yen (7% in USD). The Japanese share market has benefited from improved corporate governance, a weak Yen benefiting exporters (such as its car industry) and changes in regulations on investment accounts that have also boosted share purchases. In March 2023, the Tokyo Stock Exchange (TSE) requested companies to take "action to implement management that is conscious of the cost of capital and stock price”. The evidence of changes is increasingly widespread and has been a material factor in boosting shareholder returns in Japan.

China's CSI 300 index fell 9.9% over the year, though has been closer to flat in the past six months. China's growth outlook has stabilised as exports are picking up to fill the gap being left by weak domestic consumption. This is tied to poor consumer confidence, as much household wealth remains tied to real estate where prices continue to fall as the market digests oversupply.

Australia's ASX 200 (AUD) ended the year up 12.1% after a strong first half with a relatively stable currency at around 66c. Australia's economic growth has remained positive but weak, while population growth is strong (up 2.5% as last measured in December 2023 principally due to net migration) and inflation is easing, slowly. Unemployment is low and labour markets tight, so wage inflation is holding at around 4%.

Fund Commentary

3 months

After a strong start to the year, the portfolio fell back by 1% in the June quarter, a disappointing result. Our holdings in Alphabet (up 20.6%) and Booking (up 9.4%), alongside Amazon, Microsoft, Chipotle and ASML, were our large contributors. All of these continue to deliver on our thesis, with Alphabet's rally reflecting a growing confidence amongst investors in its ability to navigate the evolving world that Gen AI will bring. We have written on each of the others in recent quarters and their stories remain unchanged.

The disappointment came from two holdings: Ulta Beauty, which fell 26.7% in the quarter, so it alone took 1.4% off the portfolio return, and Salesforce, which fell 14.6% over the quarter, albeit even more at the peak. Ulta entered the portfolio in the June quarter. Ulta is a specialty chain of approximately 1,400 beauty stores in the US, selling skin, hair, make-up and body care products. The company added a further 500 stores inside Target over the past year, bringing its Ulta Target locations to 800. Ulta has built an engaged loyalty program with 43 million members, which is also leveraged by suppliers for advertising services. Early in the quarter Ulta highlighted the impact the expansion of Sephora (which has added 900 shops within Kohls) was having on its business, causing revenues to grow more slowly than anticipated. Ulta later reported 1Q24 results and downgraded full-year earnings expectations owing to these share losses in prestige beauty. While the company retained its share of mass market beauty sales, growth in the mass category is slower than in prestige. With the overall beauty category cycling a period of exceptional growth last year and the economic data revealing a US consumer that is increasingly restraining their spending, discretionary retailers have been under pressure and Ulta has not been immune. We have retained our holding as the pricing of the stock is now heavily discounting the risk. We continue to view the business as well positioned and so likely to come through the short-term weakness in results in good shape. Ulta is holding its Capital Markets Day in October, updating medium-term plans and strategies we expect will allay some of the fears around the business's outlook.

Salesforce reported strong 1Q24 results that did not disappoint. But the company added some caution to its expectations on growth for the 2024 year. There was also a general concern that enterprise software names were seeing a slower return to strong growth trends as corporate IT managers are trying to figure out what is needed to take advantage of the newer AI opportunity and thus potentially delaying some IT budget spend. After a sharp selloff, Salesforce (CRM US) has bounced back in recent weeks alongside other structural growth names.

With policy rates likely to have peaked in most if not all parts of the world and inflation normalising to low single-digit levels, equities and structural growth opportunities may benefit as central banks adjust policy settings lower. The outlook for earnings growth and returns on capital remain the key focus, as the driving force in markets over time. More recent data point to a weakening consumer in the US, likely a delayed impact of the rise in interest rates that has slowed demand already in other markets. This does make us more cautious on the earnings outlooks for discretionary spending, albeit many share prices have adjusted lower in anticipation. Beyond this near-term uncertainty, it is the long-term total addressable market opportunities alongside advantaged competitive positions we believe are evident for many of our holdings that are back in focus for investors.

12 months

For the year to end June 2024, the strategy delivered a 23% (AUD) return. Our large holdings in Amazon, Booking, ASML, Microsoft and Alphabet all rose strongly over the year, from 32% for Microsoft to 56% for ASML. Each of these was held at between 6% and 10% of the portfolio.

Amazon and Microsoft are well-situated as Cloud transition re-accelerates over the next year. With Generative AI being the major technological innovation that is emerging, we believe both companies are superbly positioned to capitalise on this in the years ahead and benefit from being both enablers and adopters. With the need for deep pockets and large data sets for commercialisation of Gen AI, we believe the large cloud platforms (AWS inside Amazon; Azure within Microsoft; GCP within Alphabet) are well positioned to capitalise. We anticipate strength in Google Cloud and delivery on cost savings during 2024 will be important for Alphabet as it confronts the innovations that will likely see it cede some share in search advertising (from over 90% today). Search advertising is likely to be a good growth industry and benefit from a cycle upturn and election year, so we do not see share loss as likely to lower its advertising revenues overall. We will keep monitoring to assess the speed of change across these vectors for Alphabet.

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We remain of the view that global travel and spending on experiences is a 'better than GDP growth' industry. Consumers are continuing to spend in this discretionary category and Booking's loyalty program now sees ~50% of its guests come directly to it for travel needs. Booking continues to fine-tune its offerings to expand in experiences and in home stays (where Airbnb remains dominant) as well as enticing customers via gradated benefits that increase notably the more you use Booking.

One stock – Ulta Beauty, that we acquired in the June quarter – fell more than 10% while in the portfolio. While the timing of our purchase has proven to be wrong, the long-term investment case is intact. Ulta is a capable beauty retailer with a strong presence in the US market and loyal following. We did not appreciate that the US expansion of LVMH's own specialty chain, Sephora, was taking longer to garner market share and thus the impact to Ulta lasting longer. Major beauty supplier L'Oréal also recently pulled back its expectations for beauty market growth from 5% to 4%, weighing on the sector. At current prices we believe Ulta is still attractive, and its longer-term prospects undervalued.

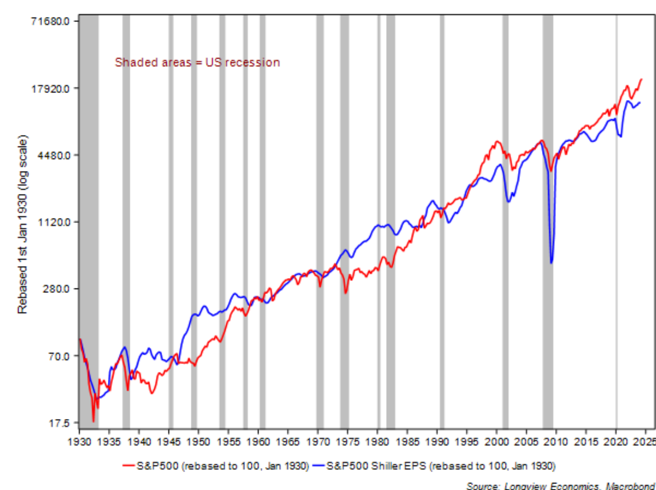
Index movements and stock contributors/detractors are based in local currency terms unless stated otherwise.

Outlook

As we look to the years ahead, we see a good backdrop for global equities and for the portfolio of companies we hold. In conclusion, we see the interest rate backdrop as reasonably benign and potentially a positive; earnings outlooks as positive for investors, and no evidence at present of rising geopolitical or financial shocks that would drive a need to be on alert.

Growth in earnings

Over the very long term the stock market is all about earnings growth. That is, over the very long term the multiple placed on expected earnings growth will wax and wane around an average level. Earnings are the driving force of the stock market.



US S&P 500 & EPS (rebased to 100 in Jan 1930, log scale)

Over shorter horizons, the multiple placed on a company's earnings or cash flows will significantly influence returns. Barring short-term pullbacks of ~5-10%, markets tend to trend higher along with earnings, except in a cyclical bear market. Causes of these bear markets are usually one or a combination of three factors: a recession, tight money, or a shock (such as an oil price shock or banking crisis). We see none of these as likely in the coming year (though shocks are called shocks because we do not foresee them!)

Interest rates

We continue to expect US 10-year Treasuries to trade within a 50bp range either side of 4% and to stay similarly flattish in Europe with the balance of risks for these yields tending to the downside. Policy (cash) rates, in most major developed economies, should begin or continue to be cut as inflation slows. Elsewhere Japan has finally moved its cash rates above zero to 0.1%.

Growth in economies

European consumers should sustain some improvement ahead though productivity in Europe remains low – always a headwind to performance. The US consumer is showing signs of weariness, especially at the lower end of incomes, though with equities and housing prices still up comfortably year on year, household wealth is up 9% and overall spending should be ok. Fiscal policy in the US was a big driver of economic growth in calendar 2023 but this is no longer a driver. Investments in technology and supporting industries look likely to sustain a solid, if slightly slower, US economic growth path with nominal US GDP growth currently above 5%. Any material slowing is likely to be met with Fed policy rate cuts and we do not anticipate a recession any time soon. China has retained a 5% GDP growth goal though this may be revised in July at the Third Plenum. With weak housing, low inflation, an ageing population, low consumption expenditure and recent deterioration in industrial production, exports growth will be critical. China's large investments in value-added manufacturing have resulted in significant capacity and cost-competitiveness so more protectionist policies elsewhere, like tariffs, seem likely. The issue of Taiwan and its independence from China remains unresolved and potential for flare-ups is high.

Sovereign debt

Government deficits are apparent in most countries around the world today and are often raised with us as points of concern. Concerns on the levels of public debt have, at times, led to a sharp repricing of debt and equities. Elections that shift governments to parties more likely to spend recklessly bring short-term event risk; e.g. Liz Truss's UK and the current concerns over Le Pen's showing in France. In the US, neither party seems particularly worried about budget deficits and government debt to GDP is currently around 124%. For context, the ratio is 262% in Japan, ~30% in Australia and ~80% in Europe's EU and in China. We do not see the primary deficit in the US as sufficient to cause risk premiums to blow out for now; solving it will require a period of strong economic growth or tax rate increases down the road.

The next leap forward

The advances in AI and Gen AI are not yet apparent in the revenues or earnings of ~95% of companies and for now, the ramifications are really only showing up in huge capital

spending on semiconductor chips and data centres to enable its use. However, innovation is evident and the potential for meaningful change in time is likely to be unlocked as companies and governments invest to capture the opportunity and protect the value of unique data. We own meaningful stakes in the companies we believe can lead in the digitalisation shift including AI and deliver market-leading growth and returns.

We anticipate our portfolio companies can keep delivering better-than-expected results over time and are yielding high and growing cash flows from their operations today. Innovation alongside execution excellence is at the heart of the companies we own as we believe these factors position them to succeed and outgrow their respective industries.

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