Global Equities

Despite varying economic cycles, equity markets have achieved impressive gains. Our global equity Portfolio Managers Arvid Streimann, Nikki Thomas and Alan Pullen offer valuable insights into the drivers of these gains and how they are positioning the portfolios to take advantage of emerging growth patterns and industry trends.

It is with great pleasure we share some perspectives with you as an investor in either the Magellan Global Fund or Magellan High Conviction Fund.

We have again witnessed impressive gains in global equities (MSCI World Index), with returns of ~20% for the second consecutive year. These equity market gains over the past two years have been driven initially by low starting prices and increasingly by strengthening revenue and profit growth. In mid-2022, quality companies were trading at substantial discounts to our estimate of their intrinsic value due to concerns at the time about rising interest rates and a potential recession. The improving fundamentals often have been led by initiatives to take advantage of technological innovation, particularly Artificial Intelligence (AI) and generative AI. Additionally, there is significant opportunity as the world endeavours to meet net zero emissions targets. These structural changes have led to new patterns of growth and changing trends across many industries, and it is uncovering the winners which helps us position your portfolio to capture strong returns.

Equity markets continued to deliver even as tight monetary policy has been used to bring down inflation and in most regions achieved now falling inflation without significant negative impacts on economic growth. There is variation in outcomes, evident in markets and currencies, with regions now at different points in their economic cycles. For instance, in the last 12 months the MSCI World Index rose 20.2% in USD, while the Nasdaq (USD), S&P 500 (USD) and EURO STOXX 600 (EUR) rose 28.6%, 22.7% and 10.7% respectively. China's CSI 300 (CNY) fell by 9.9%, while the Nikkei 225 rose 19.3% in JPY, versus 7.0% in USD as the Yen has weakened materially to an 38 year low of 160. The ASX200 (in AUD) delivered 12.1% return.

These varying outcomes reflect several factors, including:

- Interest rate rises had varying impacts on businesses and consumers (and therefore economies) reflecting different sensitivities based on borrowing habits such as fixed versus variable mortgages, or levels of indebtedness.
- Diverse domestic industry structures allowed for more or less pricing power or inflation stickiness for local companies.
- Different starting points were dictated by the relative scale of covid-related support by governments.

As we look ahead, we believe the factors below will be highly influential in how companies perform:

- The consumer.
- China's place in the world.
- Costs and relative cost competitiveness.
- Capital investment flows.

The consumer

The consumer remains the largest component of economic growth in almost all countries around the world (over 70% in Australia and the US), and so analysing the outlook and state of the consumer is key. While industries have largely (but not totally) worked off the bumps, both up and down, resulting from the pandemic period, there seem to be some areas of lasting impact.

The consumer in the US

In the US, excess savings have been drawn down, while rate increases weighed first on those at the lowest rung on the economic ladder. This weakness in consumption is gradually moving up the ladder as economic growth and unemployment both move slowly (and fairly modestly) in a less positive direction.

Higher rates have, in general, slowed demand more rapidly outside the US...

This reflects the slow shift to higher mortgage rates – very slow, given the 30-year fixed nature of most US mortgage lending. US unemployment hit 4% in May from a low of 3.4% in early 2023, while economic growth in real terms is around 2.9% annualised (1.4% QOQ). Nominal economic growth is probably more useful in this context (we live in a nominal world) and this growth has deteriorated moderately from over 7% in early 2023 to 5.4% in the March 2024 quarter. On the positive side of the ledger, wealthier consumers are benefiting from solid housing price growth (above 6% YOY), the boost in equity values (S&P 500 up 18% YOY) and high short-term interest rates on savings (>5%). While many discretionary spending categories have been reverting from a boom post Covid, 'experiences' have continued to show strength, evident in strong and resilient spending in travel-related categories. Combined with the strong USD, travel spending has been impactful for related segments in Europe, Japan and other regions. Overall, it appears US consumption is still mellowing yet is supported by household net worth at historic highs, up 9.2% in the past year. Competitive pricing is firmly back in retail, grocery, restaurants, even airfares, as lower prices get passed through to consumers as businesses compete for volumes.

The consumer outside the US

Higher rates have, in general, slowed demand more rapidly outside the US due to much shorter-term (and therefore more variable) borrowings. In Australia, most mortgages are variable or fixed for two years or less and so rate changes rapidly hit people's debt-servicing costs. In Europe, costs of food and energy have dropped sharply back, and the ECB executed its first policy rate cut in June to 3.75%, while wages and real household incomes are in good shape today, after several countries saw a dip into a weak recession. There is potential for a consumer upturn in Europe, albeit modest, if politics don't unnerve citizens too much. We hope some of you may be planning an exciting visit to the Paris Olympics and a European summer!

China's place in the world

China is evolving economically and has become more cost-competitive in industries key for the transition to net zero emissions. We are not invested directly in Chinese stocks but the shifts in this economy have global ramifications. We have seen Chinese consumers continue to exhibit low confidence and a desire to save given their asset base is particularly dominated by the housing market, which has fallen in value due to a popping of its housing bubble. This low confidence has made the domestic consumption market relatively unattractive and we have minimal exposure to it, thereby avoiding the notable weakness of once-great companies like Nike, Starbucks and Estée Lauder. Elsewhere, Chinese entrepreneurs and state-owned companies, supported by an enormous local market and need, have invested significantly to build capacity and capability in newer technologies. From wind, solar, electric batteries and electrical components to electric vehicles, these technologies will be crucial for a net zero future. China has become a very significant and cost-competitive player and is once more relying heavily on exports for growth.

We see a future where Chinese electric vehicles will dominate the roads of countries like Australia where there is no local car industry to protect. As the cost of smaller and more efficient electric vehicles becomes compelling, it will drive one important part of the electrification shift needed to decarbonise the world. In a recent trip to Silicon Valley and Europe, I (Nikki) heard about the rising competition many companies see from scaled Chinese players with capacity built for its huge domestic market that are now looking at export opportunities. We expect the playing field for such industries will change, products will commoditise, and a European loss of market share alongside potential margin pressure will result. We avoid commodity-linked sectors and weak industries but highlight this as a risk for global investors who are participating in some of these industries; the growth rates look exciting yet may not deliver good investor returns.

We have also witnessed a shift among global investors away from viewing China as the huge opportunity it once was as the political, geopolitical and economic backdrop has become significantly more difficult with no sign of a reversal. We surmise this is one of several reasons for a shift in focus towards India and Japan in the search for opportunities for investable companies. While at Magellan we have also turned more attention to such other markets, our high bar for liquidity, quality, scale and deep competitive advantages makes the threshold for inclusion in our investable universe high. We will remain attentive as regional diversification is a good portfolio discipline, though we view our portfolio through a revenue exposure lens rather than the home listing to more accurately reflect the portfolio's economic diversification.

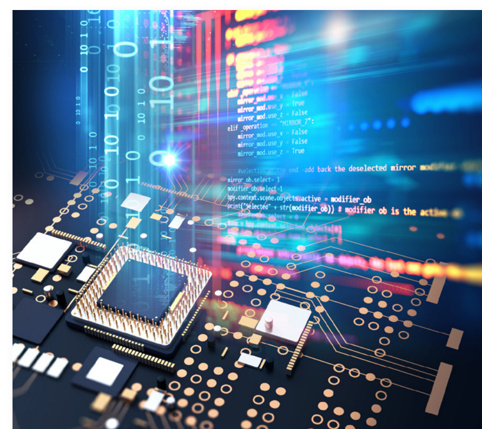
Innovative companies typically lead their industries in change and thereby unlock opportunities to grow

Capital investment flows

Significant capital investments have been prevalent as corporates and governments pursue the goals of reducing carbon emissions and the opportunities in technological innovation. There are multi-billions of dollars of capital flowing to expand and geographically shift the semiconductor industry and to build and fit out data centres in support of AI innovation and electrification. The scale of spending by many, including our portfolio companies – Microsoft, Amazon, Alphabet and Meta – and governments (Chips Act, Green Deal, etc) is extraordinary and driving a rebound in activity of many industries.

Beware the naysayers – in periods of major leaps forward, there are always some who will argue it's not real, it's not significant or it's overhyped. Hype is difficult to measure and certainly expectations on the timing of opportunity have a history of getting ahead of reality in the early innings of a major shift. However, the spending and investment to drive this new era are real and many major companies can see enormous benefits to be realised by enabling new technology. As for governments, elections (announced or held) in recent months – and likely up to the US's November 2024 election – are creating short-term volatility. The volatility reflects concerns or excitement about policy revisions that would influence industry trends or profits (tax changes, oil vs renewable support, healthcare policies). For the most part, this is noise and trying to speculate on post-election outcomes is not value-accretive for long-term investors. Good companies adapt.

Our approach remains to 'stand on the shoulders of giants' and capitalise on this opportunity to deliver wealth creation for our investors over the long term. This approach ensures we stay true to our philosophy while being very thoughtful with how we allocate our risk budget. The 'Magnificent Seven' leadership is symptomatic of the shifts, with these companies typically well-placed to commercialise the opportunity. While much is made of the narrow leadership, this is actually typical in markets throughout history. Since 2000, about 1% of companies have accounted for 40% of overall returns. Such statistics can be found throughout much of history and support our concentrated, conviction investing style.



The other overarching themes in focus when choosing our investee companies are innovation and execution. Innovative companies typically lead their industries in change and thereby unlock opportunities to grow. Finding strong, capable management teams who ensure good execution, attention to returns on capital and good people management, with appropriately aligned incentives, also helps us separate the wheat from the chaff inside industries we like. Time and again we have seen good companies become great while others lose their way; good leadership in a CEO and senior executive team is a significant, deterministic factor.

Investing for the long-term

During strongly rising markets, recency bias, a cognitive bias that results in investors extrapolating the recent past, can result in investors becoming less focused on potential risks. At such times it is important to remain disciplined, and Magellan's investment process remains focused on delivering long-term returns. This process involves numerous steps, with our philosophy underpinned by three core principles: a long-term focus, a commitment to investing in quality businesses, and a disciplined approach to intrinsic valuation.

There are many different types of participants in markets – from speculators to traders to longer-term investors – and many different investing styles. We work to avoid short-termism and take a long-term view of the opportunities presented by prices in markets. We ask ourselves: Will this company be larger, more profitable, and positioned to deliver strong shareholder returns sustainably? By focusing on a company's long-term prospects, we can avoid the noise of short-term market movements and invest in businesses poised for sustainable success.

Not all companies are created equal. We believe in focusing our investments on a select group of high-quality businesses. This involves a rigorous process of identifying companies that possess sustainable competitive advantages and low business risks, among other factors. As Buffet says: *"Time is the friend of the wonderful company, the enemy of the mediocre."* The market, on average, structurally undervalues quality companies due to its short-term focus. Not only do quality companies deliver compounding returns over long time frames, but they also limit risk within the portfolio as they tend to be relatively resilient in market downturns.

Over the long term, good absolute returns should be supported by continued profit and cash flow growth...

Intrinsic value is the true underlying worth of a business, independent of its current market price. Passive investment, where investors simply mirror a basket of exposure or an index irrespective of the underlying valuation of the companies, or speculation by small speculators who can be drawn to currently trending stocks, do not reference true fundamental values. Certainly, the recent performances of "meme" stocks such as GameStop and the strong performance of stocks undertaking stock splits – which increase the intrinsic value of a business by precisely zero – are indicative of market participants who pay little heed to intrinsic value. The market is inefficient in pricing long-term value creation, and this mispricing creates the potential for significant capital appreciation as the market recognises the true value of these companies over time. As Benjamin Graham, the father of value investing, put it more eloquently: *"In the short run, the market is a voting machine but in the long run, it is a weighing machine."*

Outlook for markets

Looking ahead, we expect good opportunity for us to find compelling investments for our investors. Over the long term, good absolute returns should be supported by continued profit and cash flow growth, while policy rate settings may slowly become less stringent. In the coming year we anticipate the US economy to continue to slow gradually, while tight job markets and deglobalisation are likely to reduce deflation risks. US long-term (10-year) interest rates are likely to remain range-bound around current 4% levels, and we believe the balance of risks for long-term bond yields in most markets is slightly tilted to the downside. The economic data and company commentary reveal that US consumption growth is slowing, led by lower- and middle-income households feeling the pinch from sustained high interest rates and cost-of-living pressures.

Returns will likely be higher than we expect if inflationary pressures subside without a deterioration in the growth outlook. However, faster globalisation and higher immigration look unlikely, while rapid productivity improvements are more likely to unfold in the medium to longer term.

Returns will be less if inflationary pressures re-emerge or there is a material deterioration in the growth outlook. Higher inflationary pressures are more likely should Trump win the US election this year, while a worsened growth outlook will most likely be driven by the lagged impact of higher interest rates, such as a sharp fall in property prices or sovereign debt strains.

We remain disciplined in adhering to our core principles and process and so believe the funds should continue to deliver attractive long-term returns. Fuelled by curiosity, we continue to work hard to take care of your wealth and aim to grow its value over time.

Thank you for the trust you place in us.

Yours sincerely,

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