

# National Adviser Briefing September 2015

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# Magellan Financial Group

As at 31 July 2015

- Sydney-based global equity investment boutique established in 2006
- Over \$38 billion in assets under management
- Principals, Directors and staff own over 25% of company and are invested alongside their clients
  - Over \$200 million of principal and staff investment into client strategies
- ASX-listed company with 93 staff
  - Investment Team: 31 members (28 PMs/analysts and 3 traders)
- MGE and MHG: ASX quoted (over \$300 million FUM)

# Agenda

## **SECTION 1:**

The Great Compression

## **SECTION 2:**

China's economy at risk

## **SECTION 3:**

So what does this mean?

## **SECTION 4:**

So what are we doing about it?

## **SECTION 5:**

Portfolio update

## **SECTION 6:**

Risk and return

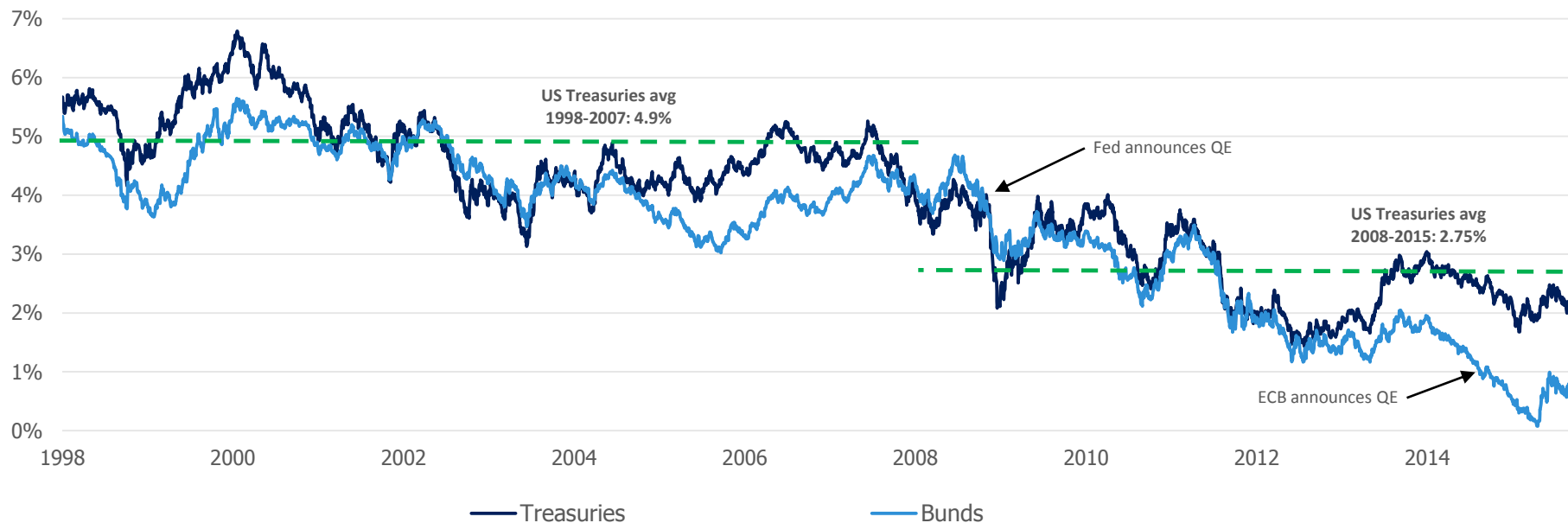
The background of the slide is a dark blue grid filled with various financial data visualizations. These include line graphs, bar charts, pie charts, and a world map. The text is overlaid on this background.

# SECTION 01: The Great Compression

# Recent Compression of Risk Premia

# Government bond yields are near record lows

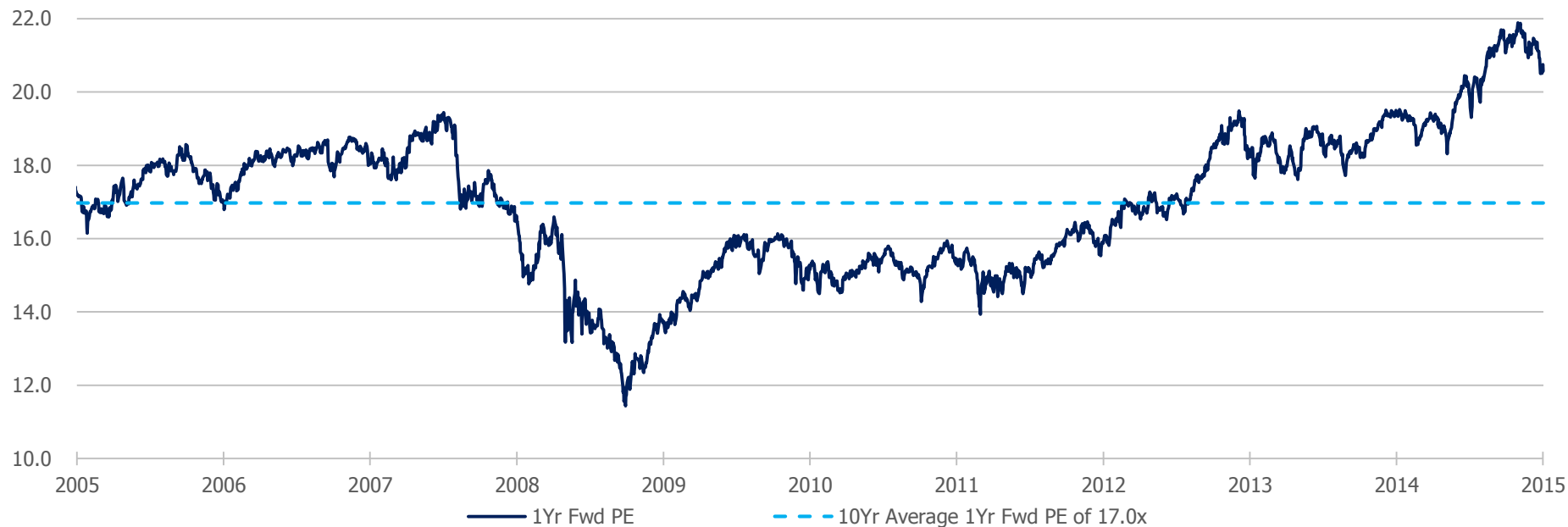
## 10 year US Treasury and German Bund yields



Source: Thomson Reuters; Magellan Asset Management Limited.  
Note: Data as at 2/09/15

# 'Expensive defensives' signal risk compression

European/US Consumer Staples PE multiple (1 year forward)



Source: Bloomberg

Note: Data as at 12/6/15



# What happened in 1994?

# US Treasury yields rose sharply

## 10 year US Treasury yields



## 5 year US Treasury yields



Source: Thomson Reuters; Magellan Asset Management Limited.

# It was a 'double whammy' for Australian bonds

## Australian 10 year government bond yields

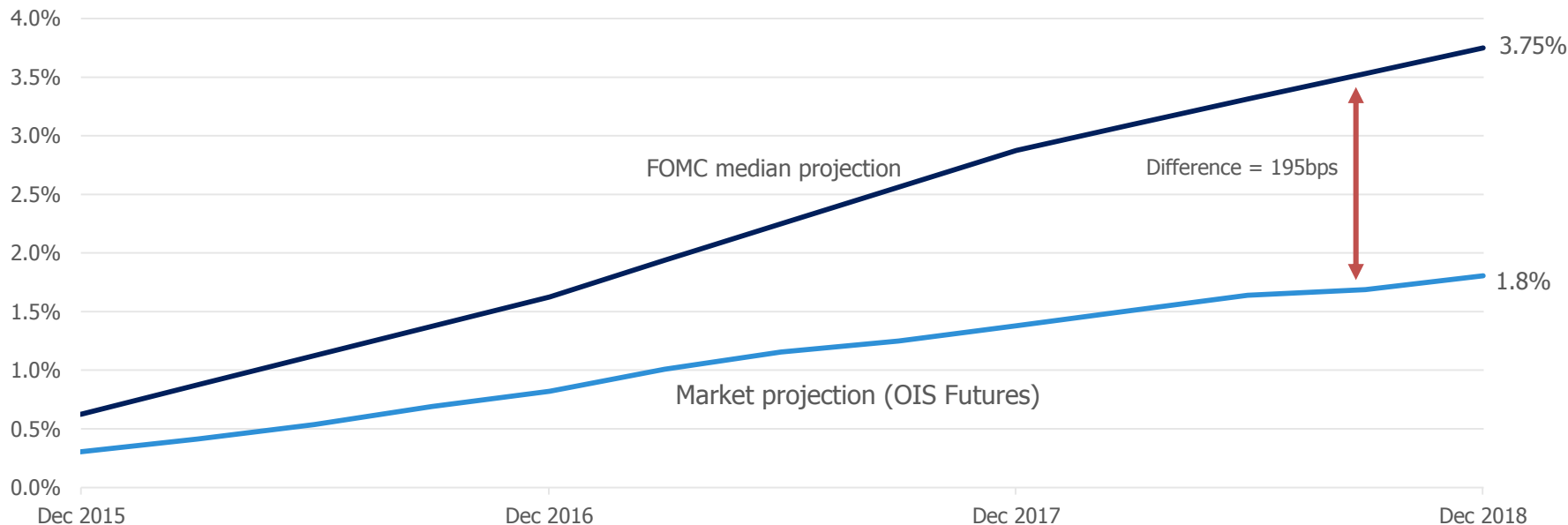


Source: Thomson Reuters; Magellan Asset Management Limited.

# The Great Disagreement

# Market rate expectations are well below the Fed

Market v FOMC median projections for the Fed Funds rate



Source: Federal Reserve; Bloomberg; Magellan Asset Management Limited.

Note: FOMC estimates are from June 17, 2015.

Market estimates are from September 2, 2015. Long run FOMC median projection is assumed to be 2018.

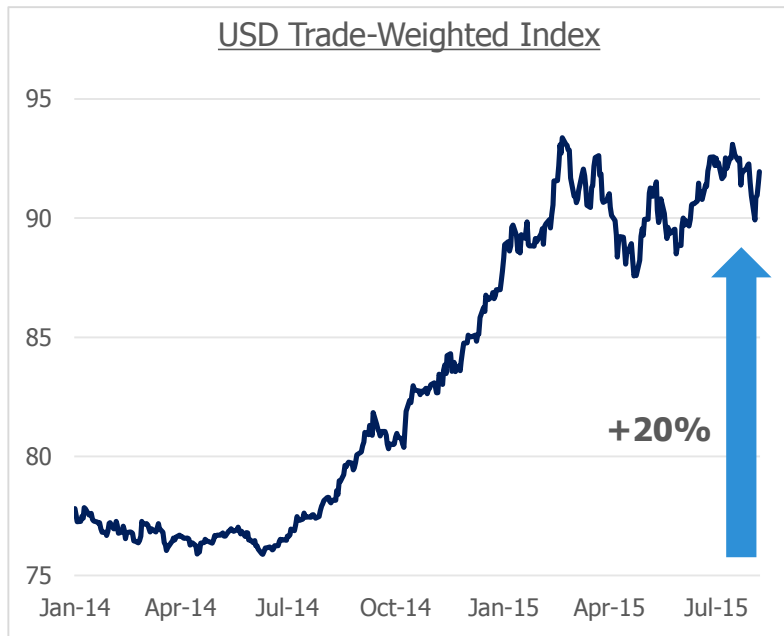
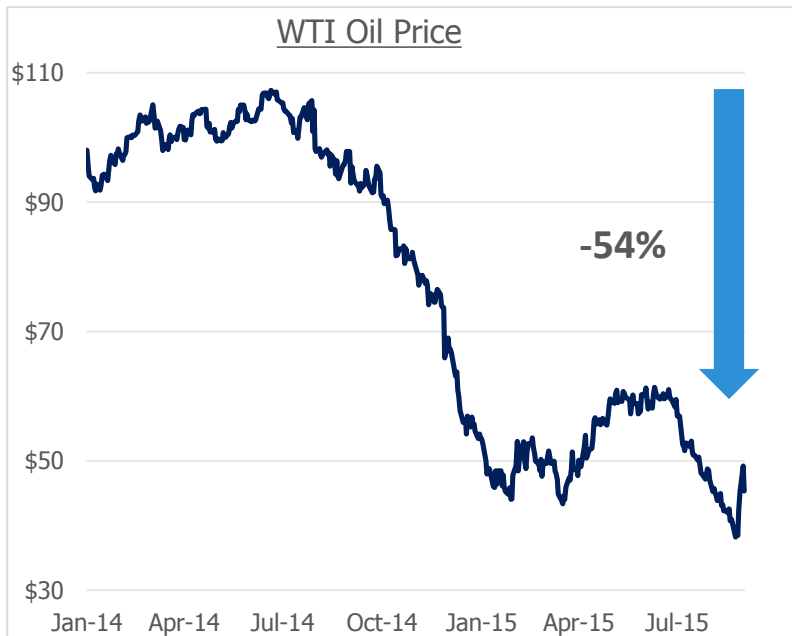
# The US economy is growing at a moderate pace – with some headwinds

Indicator	Latest	1 year ago	
Unemployment	<b>5.1%</b>	6.2%	↓
GDP	<b>2.7%</b>	2.6%	↔
House starts	<b>1.2m</b>	1.1m	↑
Bank loans & leases (y-o-y growth)	<b>7.3%</b>	6.5%	↑
Retail sales ex autos (y-o-y growth)	<b>4.2%</b>	2.8%	↑
CPI	<b>0.2%</b>	2.0%	↓
CPI (ex food and energy)	<b>1.8%</b>	1.9%	↔
Industrial production (y-o-y growth)	<b>1.3%</b>	4.8%	↓

Note: Data as at 2/9/15

Source: Federal Reserve; Bureau of Labour Statistics; Dept. of Commerce; ISM; US Census Bureau; Bloomberg; US Treasury

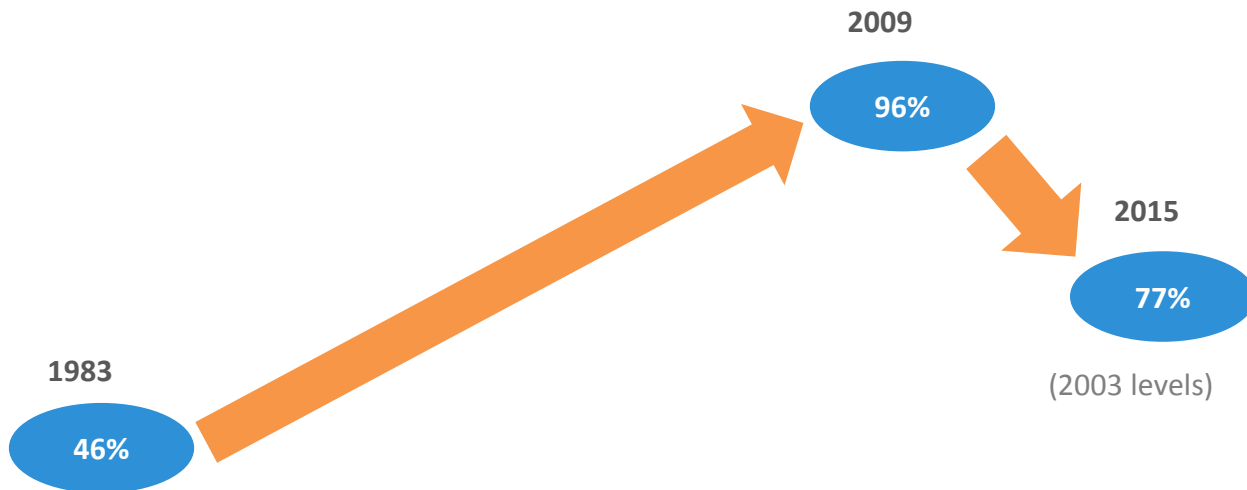
# Deflationary forces



Data as at 2/09/15. Changes since Jan 2014.  
Source: Thomson Reuters; Federal Reserve; Magellan Asset Management Limited.

# Deleveraging has freed up household wallets

## US Household Debt to GDP (%)



Source: US Federal Reserve; Bureau of Economic Analysis; Magellan Asset Management Limited.  
Source: Thomson Reuters; Magellan Asset Management Limited.



# Concluding observations

1. Perfect storm leading to low interest rates
2. US economy continues its steady growth
3. Deflationary forces in the US are likely to be transitory
4. US rates likely to normalise higher than the market is pricing
5. 1994 highlights that increasing US interest rates can lead to even larger increases in rates in other credit markets
6. Rate increase likely to be very gradual.

The background is a dark blue collage of various financial data visualizations. It includes several pie charts of different sizes, line graphs with fluctuating lines, and bar charts. A world map is visible in the lower right quadrant. The overall aesthetic is professional and data-driven.

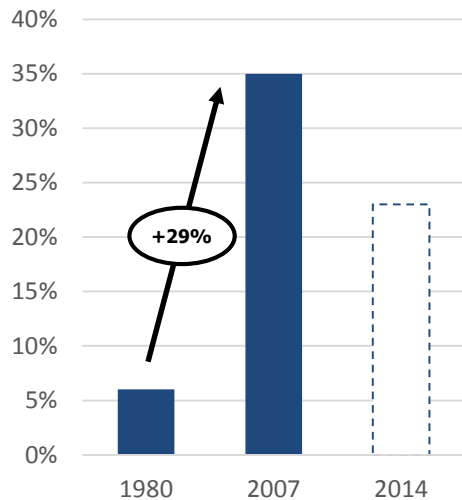
SECTION 02:

# China's Economy at Risk

# Three stages of China's development

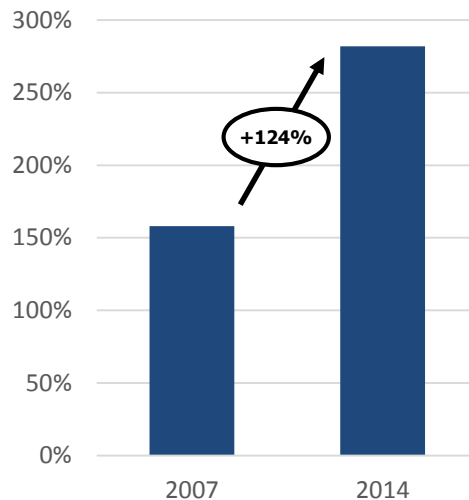
## Export led phase

### Exports (% of GDP)



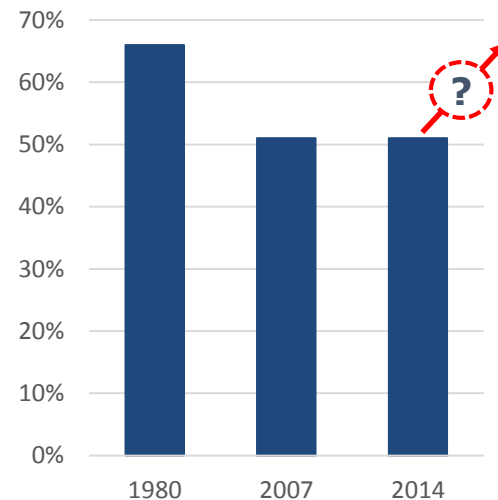
## Credit-fuelled investment phase

### Credit (% of GDP)



## Consumption/reform phase?

### Consumption (% of GDP)



Source: World Bank; McKinsey; National Bureau of Statistics

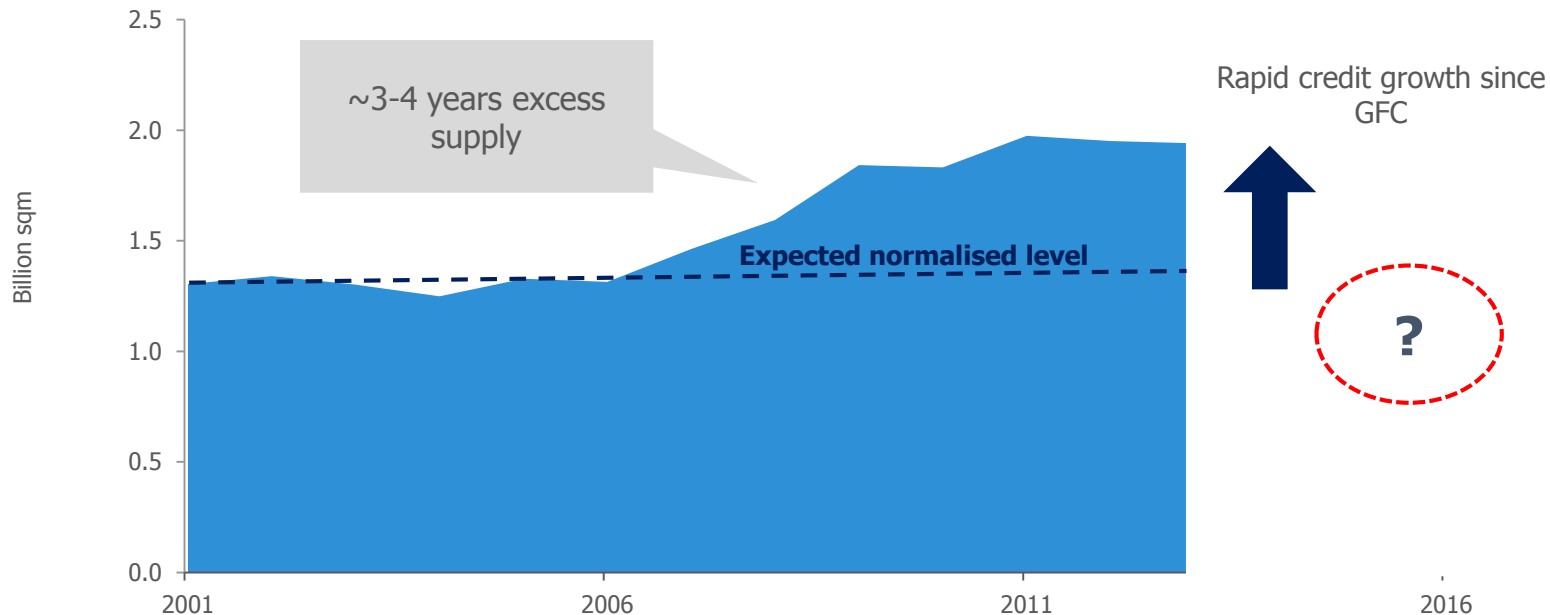
# China's economy is slowing

Average growth p.a.	2000-2008	2009-2013	Latest
Real GDP	9%	9%	7%
Credit*	14%	19%	16%
Steel production	15%	11%	-4%
Electricity production	11%	12%	1%
Cement production	11%	11%	-5%
Urban housing completions	9%	10%	-14%

\*Financial institution RMB loans

# Housing completions in China have exploded

Residential floor space completed



Source: National Bureau of Statistics; Magellan Asset Management Limited.

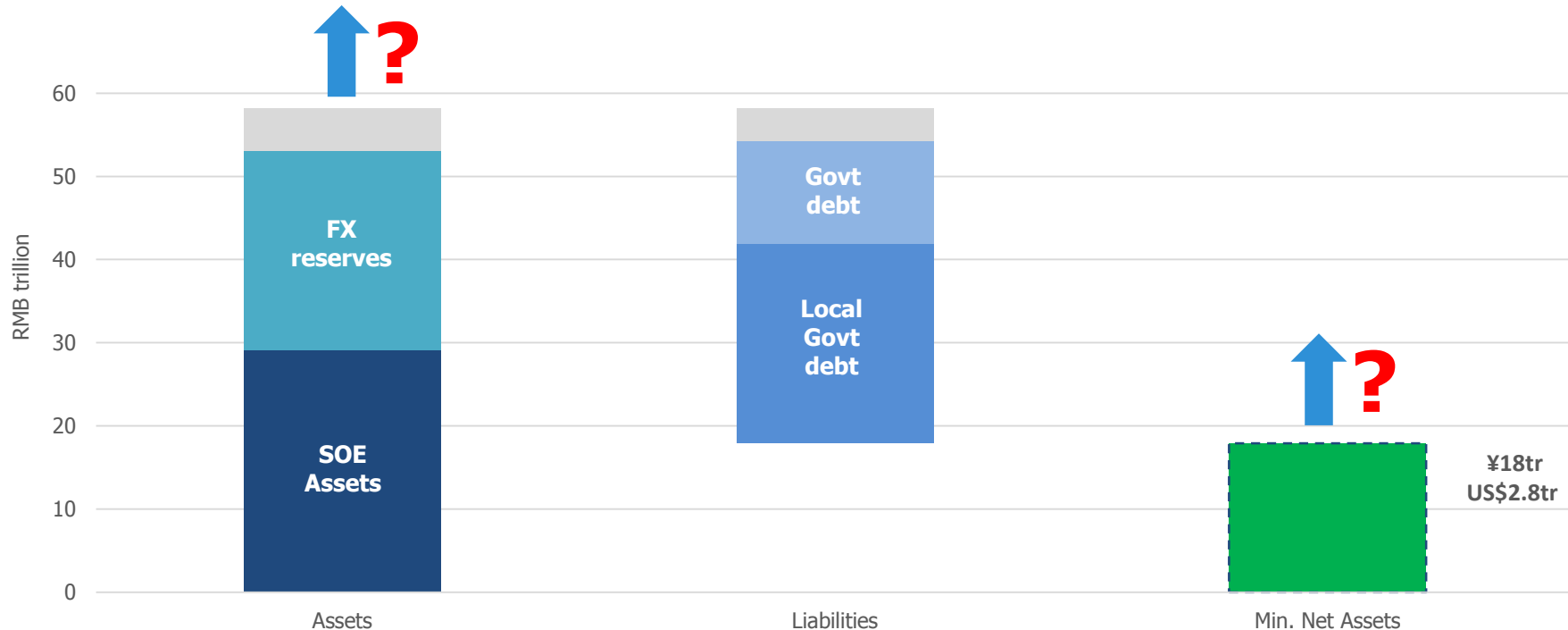
# Housing excesses take years to normalise

	Excess supply	% fall	Years to normalise
U.S.	4 years	75%	8
Spain	3 years	98%	7 - ?
Ireland	5.5 years	90%	7 - ?
China	3-4 years	?	?

Source: Magellan Asset Management Limited.

Note: Assumes demand based on long run household formation plus housing stock replacement rate of 0.25% p.a.

# China's government has a strong balance sheet

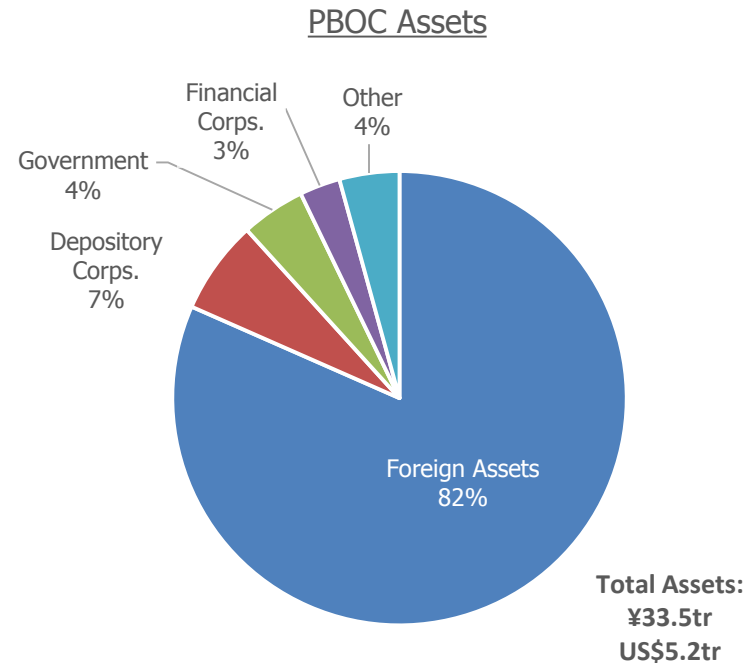
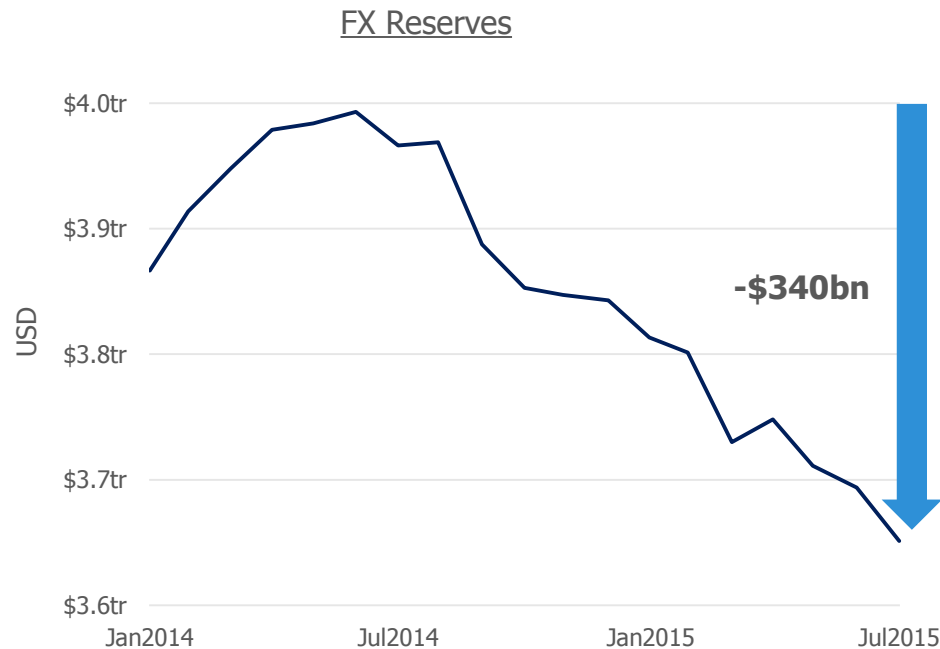


Source: Morgan Stanley, Bloomberg, China National Audit Office, Magellan Asset Management Limited.

Note: Non-financial SOE assets and liabilities only. Excludes land reserve and non-operational entity assets.

Data from 2014. SOE assets are net assets, including market value equity of government interest in top 4 listed banks.

# China's FX reserves have been falling



Source: PBoC, Bloomberg

Data from July 2015. Change from peak in June 2014.

Foreign Assets includes FX reserves, gold and other foreign assets.



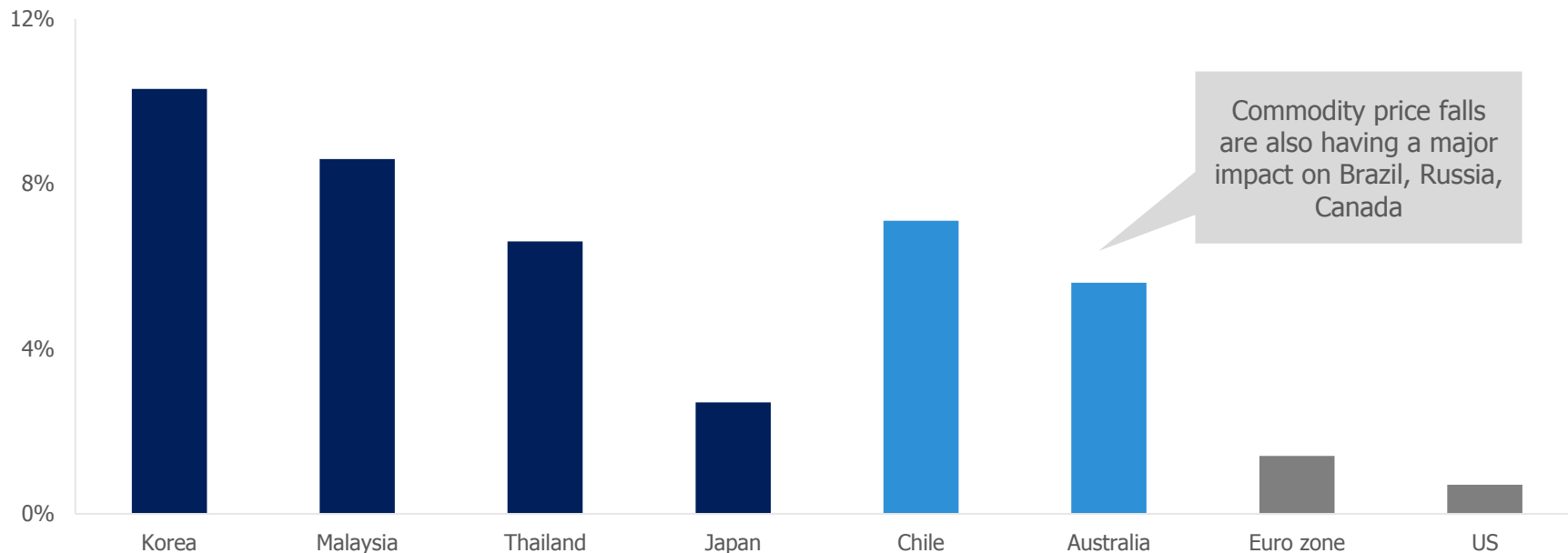
# China has policy options... but there are limits

- China has a very strong balance sheet and has capacity to support economy, banks and employment
  - Multiplier from fiscal monetary spending has dramatically reduced
  - PBOC releasing FX reserves to support economy and offset capital flight
- Substantial room to reduce interest rates and bank reserve requirements
- An export lead recovery is unlikely
  - A large scale devaluation of the RMB would be counter-productive
- A further credit fuelled property expansion is unlikely
- Economy needs to transition/reform to support domestic consumption

A continued slowdown is a near certainty but a hard landing is unlikely

# Asian and commodity economies are most at risk

Exports to China as a % of GDP



Source: IMF, Magellan Asset Management Limited.



SECTION 03:

So what does this mean?

# So what does this mean?

1. US and China moving in opposite directions
2. China's slowing economy is likely to lead to a change in policy
3. China is likely to continue to sell FX reserves (i.e. US Treasuries) and buy domestic assets to support economy
4. A large RMB devaluation is unlikely
5. Need to watch emerging market vulnerability

Are the two largest holders of US Treasuries (PBOC and Fed) about to become sellers?

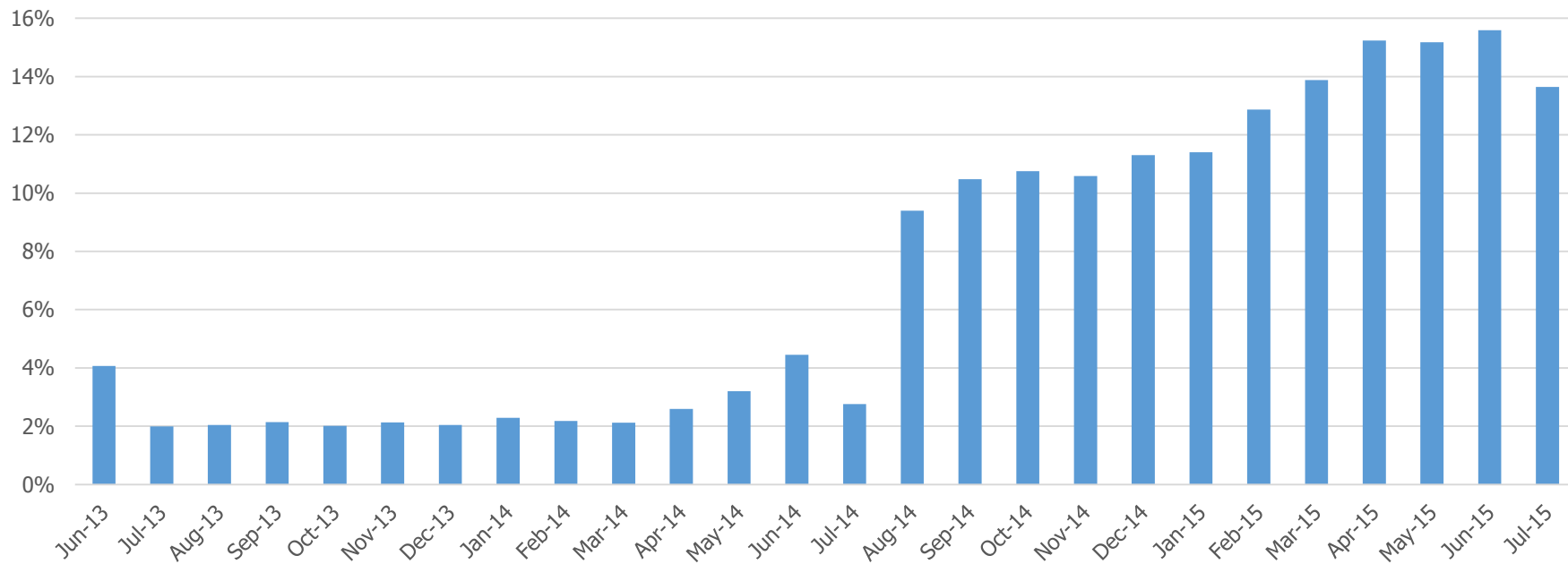
Prudent to reduce risk



SECTION 04:

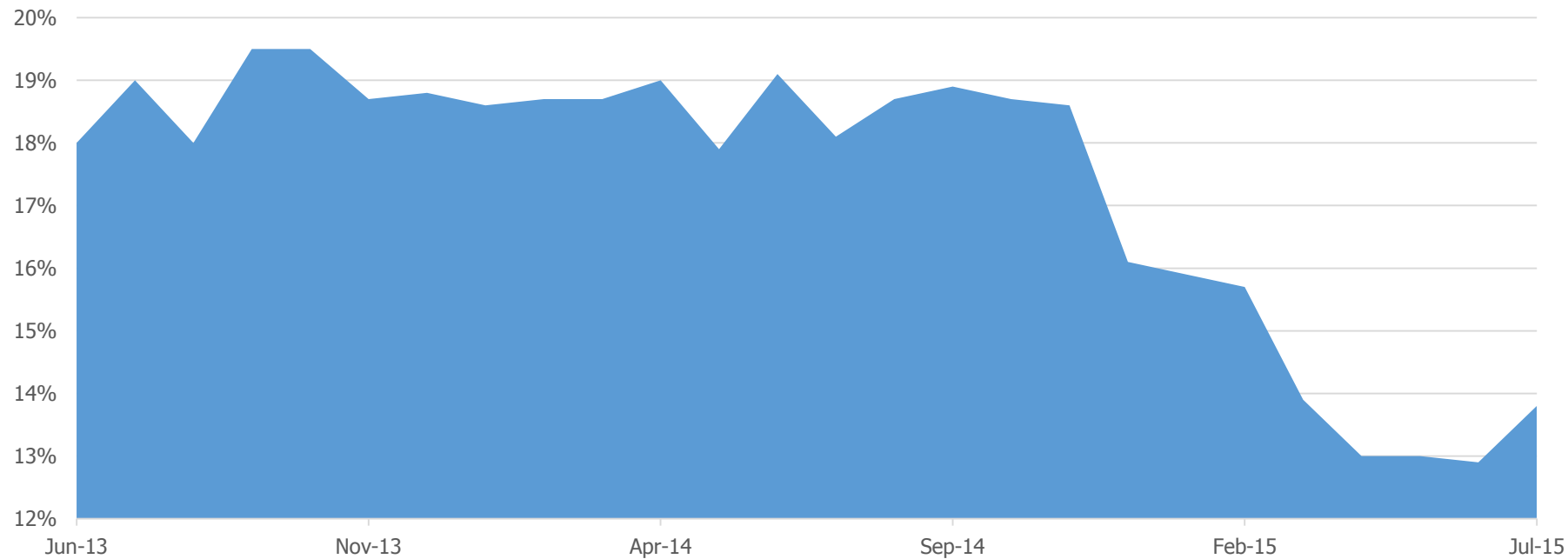
# What are we doing about it?

# Increased cash weighting



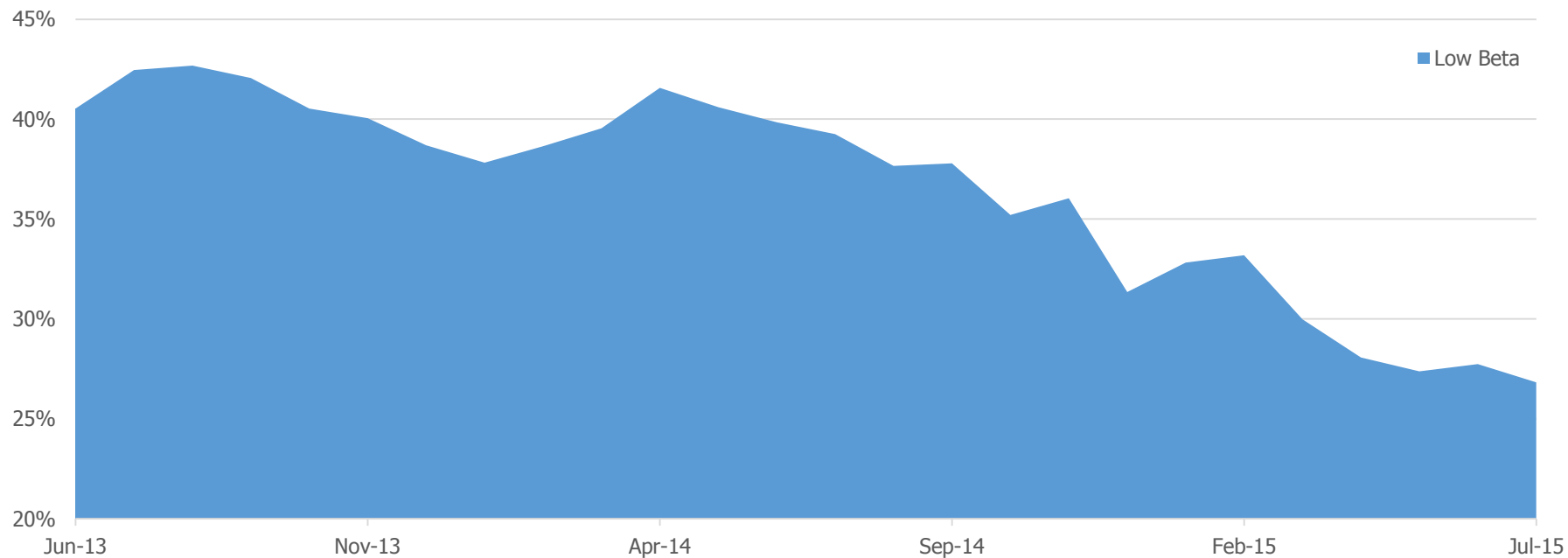
Source: Magellan Asset Management Limited.

# Reduced Emerging Market Exposure



Source: Magellan Asset Management Limited.

# Reduced exposure to expensive defensives



Source: Magellan Asset Management Limited



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# SECTION 05: Portfolio Update

# Magellan Global Fund

## Investment Objectives

Minimise the risk of permanent capital loss

Target 9% p.a. return through business cycle

# Key Investment Themes

As at 31 July 2015

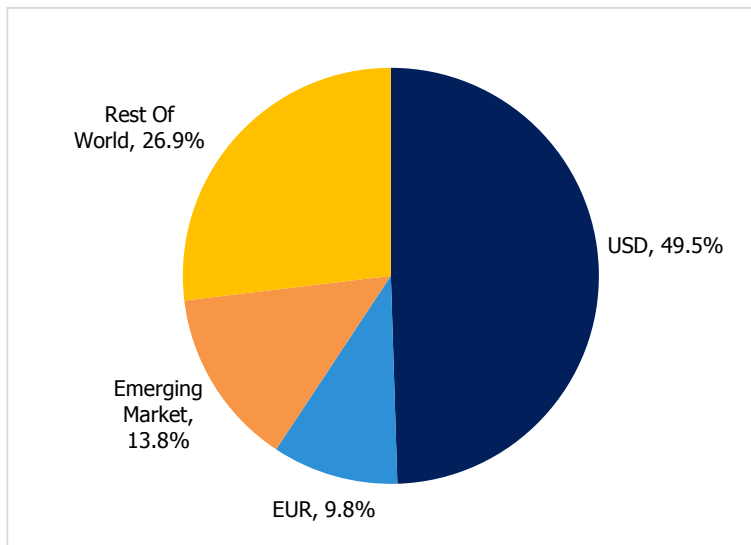
Technology/Software (19.2%)	 Microsoft  IBM  intel  ORACLE  SAP
Cashless Society (13.7%)	 PayPal  VISA  MasterCard  AMERICAN EXPRESS
US Housing Recovery (12.0%)	 LOWE'S  THE HOME DEPOT
Emerging Market Consumer (8.8%)	 Yum!  Nestlé  Unilever
Rising US Interest Rates (8.0%)	 BNY MELLON  STATE STREET  WELLS FARGO
Internet/eCommerce (7.6%)	 ebay  Google

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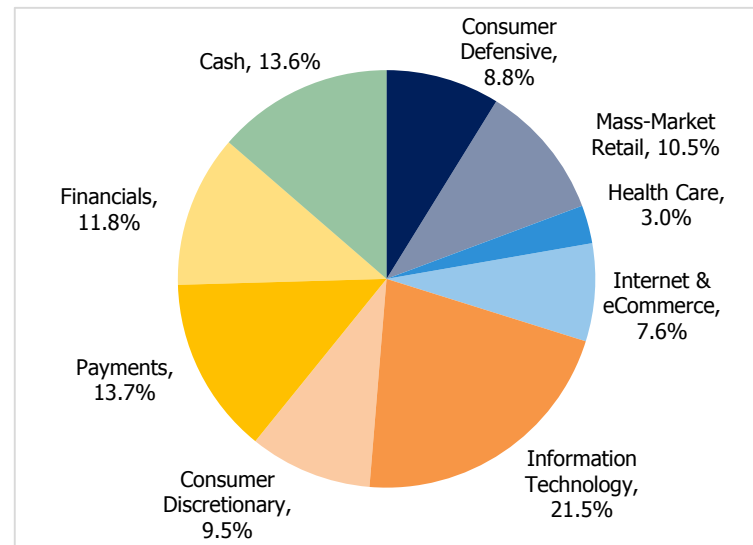
# Portfolio Exposures

As at 31 July 2015

## Geographical Exposure



## Sector Exposure



Source: Magellan Asset Management Limited. Magellan Global Fund data.

Calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio – Magellan defined sectors.

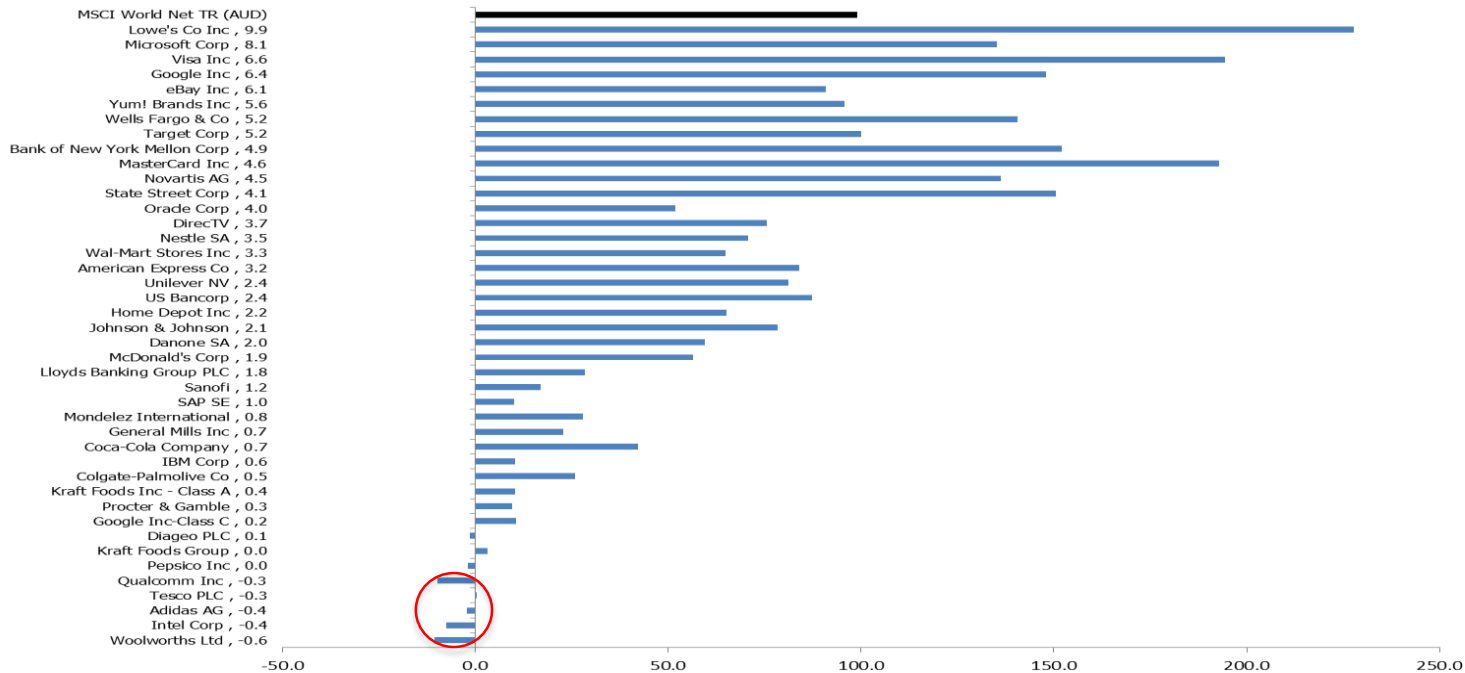
# Changes to sector weights

Sector Weights (%)	31-Jul-13	31-Jul-14	31-Jul-15	
Information Technology	12.6	12.8	21.5	↑
Payments	11.4	11.3	13.7	↑
Financials	15.5	14.5	11.8	↓
Mass-Market Retail	13.2	16	10.5	↓
Consumer Discretionary	7.5	7.1	9.5	↑
Consumer Defensive	19.7	16.6	8.8	↓
Internet & eCommerce	8.5	6.7	7.6	↑
Health Care	9.6	6.7	2.9	↓
Media Content and Distribution		5.6		
Cash	2.0	2.8	13.6	↑

Source: Magellan Asset Management Limited.

# Batting average

Contributors to Return (AUD), 3 years to 30 June 2015



Source: Magellan Asset Management Limited  
Index is MSCI World Net Total Return Index (AUD)

# Portfolio additions and deletions last two years

## Additions



## Deletions



Source: Magellan Asset Management Limited, as at 31 July 2015.

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# BEWARE OF QUANTITATIVE TIGHTENING



# Q&A

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# SECTION 06: Risk and Return

# Consistent returns with low risk

## Global Equity Strategy: eVestment Global Large Cap Equity

Percentile Rank	Total Return (Percentile)	Beta (Percentile)	Downside Avoidance (Percentile)
3 years	23 <sup>rd</sup>	20 <sup>th</sup>	24 <sup>th</sup>
5 years	1 <sup>st</sup>	5 <sup>th</sup>	2 <sup>nd</sup>
7 years	1 <sup>st</sup>	9 <sup>th</sup>	1 <sup>st</sup>

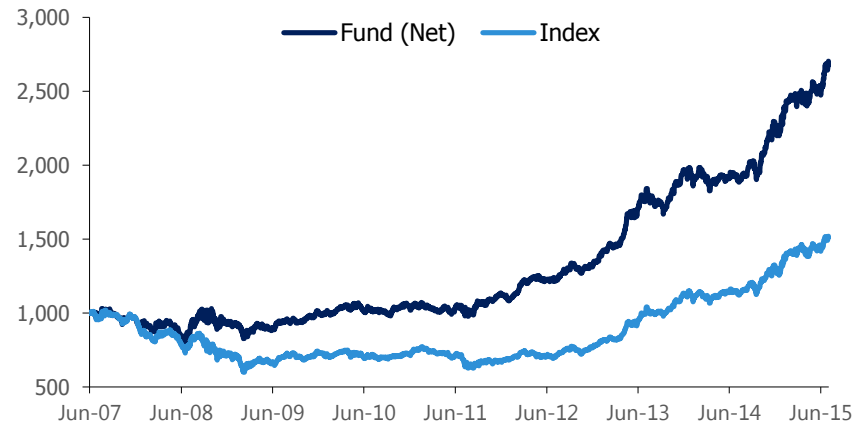
Source: eVestment, periods ending 30 June 2015

The eVestment Global Large Cap Equity peer group presented contains 325, 276, and 236 observations for 3, 5, and 7 years respectively. Magellan's comparative portfolio in this survey is the Magellan Global Equity Composite before fees.

# Magellan Global Fund Performance

AUD net performance as at 31 July 2015

(% p.a.)	Magellan Global Fund	MSCI World Net Total Return Index	Excess Return
One year	<b>40.4</b>	32.8	7.6
Three years	<b>29.9</b>	29.0	0.9
Five years	<b>21.5</b>	16.5	5.0
Seven years	<b>17.5</b>	9.8	7.7
Since Inception	<b>12.9</b>	5.2	7.7



Fund inception 1 July 2007. Performance shown is after fees. Index is MSCI World Net Total Return Index (AUD).

Source: Magellan Asset Management Ltd, MSCI