Future Generation and 2Fold: Take Stock

Caroline Gurney and Nikki Thomas

I'd like to begin by acknowledging the Traditional Owners of the land on which we meet today and recognise their continuing connection to lands, waters, and communities. We pay our respects to Elders past and present.

CAROLINE GURNEY: Hello and welcome to Take Stock, a new Podcast by Future Generation. In this series we get a backstage pass into the minds of leading Fund Managers, and work out how and why they make the stock choices they do. I'm Caroline Gurney, CEO of Future Generation. We're Australia's first listed investment group to deliver both social and investment returns. And that's all thanks to the managers we're going to be talking to. So far Future Generation has donated more than $75 million to not-for-profits that improves the lives of young Australians. And we can do this because of people like Nikki Thomas and Magellan Financial Group. They charge zero management or performance fees to our shareholders for managing Future Generation's money. Nikki is in the studio today. Welcome Nikki.

NIKKI THOMAS: Thanks Caroline.

CAROLINE GURNEY: You have more than 20 years' experience in financial markets and have been recognised for bringing global equities to Australia. So Nikki, what are the biggest trends that have emerged out of the recent reporting season? Perhaps if we can go through what's happened recently and then we can ask you some more personal questions.

NIKKI THOMAS: Yeah, sure. So I guess we're just at the tail end of reporting season. I think if there were topics that continue to be front of mind as companies report, the shift around artificial intelligence and generative AI remains front and centre and we're seeing some very strong results for the enabling companies, things like Amazon and Microsoft clearly are evidenced, even though we're a long way from the kick off really on this. The commercialisation of AI is still well in the future but we can see it coming. And there was a lot of talk around that. I guess the energy transition and the work that's going on there. It has been interesting to watch. I would say that the piece that jumped out at me this reporting season is one of the things we've been saying to people and that is that there's going to be large amounts of money that will pursue this but there won't be good returns for everybody on the back of it. And that's actually become evident in some of the results we've seen. So there's been quite a lot of significant write downs by companies involved in renewables and there will be difficulties as we go through this process. So that's been an interesting piece of the puzzle I think as we've gone through reporting season. And you've seen similar things around electric vehicles which as the competition heats up a lot of the large OEMs are finding it really difficult to compete in that electrical vehicle space which China's done so well. So you know not all good news I guess. Weakness in Europe and China's been evident. And I guess the question marks around how big the impact of interest increases will have on consumers around the world continue to I guess try to be addressed. People are still unclear as to how bad that's going to get but we're seeing different levels of pain across markets.

CAROLINE GURNEY: You know this year has been really tough. I mean we can't hide from that. But what are you looking forward to next year? What's your market outlook?

NIKKI THOMAS: I always struggle with a market outlook because I don't really think about the whole market and I can't tell you where the market's going to go overall. What we do is think about what the key parameters are and what we're trying to do always is look within the market to find where the best opportunities are, where we can make great returns for our investors, in a way that doesn't take too much risk. So we spend a lot of time inside the market looking at where the opportunities are, where things are changing. Trying to be live to the data at all times. I think markets are probably going to continue to give us good and bad and we could continue to see volatility as we work through what are very significant transitions ahead of us for the word.

CAROLINE GURNEY: So we recently had our Future Generation Summit which you spoke at. And you gave Netflix as a stock tip. Magellan and you you've sort of gone hot and cold on this over sort of the past few years. So I'm really interested in what is the investment case for Netflix and other streaming models and I'm interested because I watch so much Netflix, and I love it, but you know is it something we should be investing in?

NIKKI THOMAS: Yes it's an interesting one Caroline. And you say we've blown hot and cold. I hear you. The reality is the share price has blown pretty hot and cold. So first you've got to deal what is the business and then you've got to think about what the stock is and what you're getting with the stock and where you are in the lifecycle of this business. So I think our view on the company hasn't really changed much over the last five years. This is a business that was really early lifecycle. It's maturing. And we have always been very positive on the outlook for streaming and the opportunity ahead of Netflix and we believe they have a very good management team. If you go back to 2022 you had a stock that was expensive. It didn't have a lot of free cash flow. In fact it hadn't started to deliver any free cash flow at that point. So the lifecycle point at which it was at was still quite early. There was a lot of potential growth ahead, but then they uncovered the issues they had around password sharing. And they'd always said they weren't going to do an ad supported streaming model, and then they changed that. So last year for Netflix was a pretty big year in terms of them having to rethink their strategy, and address the issues around how they were going to grow but grow profitably and deliver cash flows. We'd had the stock in the portfolio. I'd obviously came back to Magellan at that time.

Duration stocks at that point were definitely not the place to be as interest rates rose so we took it out of the portfolio and said at the time this is going to continue to be a Magellan stock, we're going to continue to cover it, we think there's about 12 months for them to get this strategy sorted out, they've got a deal with password sharing, they've got a deal with implementing an ad supported model, so let's watch that and we'll see where they get to but let's not bet the house on something that we just don't know quite how it's going to play out. So we have been watching and doing the work and the team have been fantastic in uncovering the data points that we needed to understand, and we put it back into the portfolio more recently. And that's really because we're seeing now that that execution is working, that this is a business that is back on and got its mojo. Free cash flow generations gone from none, literally negative, to the market thought four, we were kind of thinking five or six billion of free cash flow. It's a big turnaround. They're now guiding to numbers better than that. So we've seen a really significant shift. And I think as we look at it today you've got a business that is the dominant player and will continue to be probably the leading player in streaming. Streaming will continue to take share of entertainment so linear TV will continue to lose share to this industry. And then Netflix have the ability to leverage a fixed cost base. So you get double digit top line growth, and you should get massive margin expansion as we go out over the next five or so years. So 20% margins could be 40% margins. So we see a business growing over 20% per annum with a positive free cash flow yield. It looks exactly the sort of business that Magellan should have in its portfolio so we're pretty super excited about where that'll be.

CAROLINE GURNEY: Excellent. So if you don't mind if we can go back to the US. You were very optimistic on the US. And why is that?

NIKKI THOMAS: There's something quite special about the US, Australia has a bit of this as well, and that is that there's a couple of things that are really obvious when you look at the way the US economy and markets work, and that is that it really believes in innovation and entrepreneurship and it takes a very shareholder friendly approach to capital allocation. And so you often find, and if you look at the big successful companies in the world, they've also been brought up in the US. They've made their way out of the US market and that's because the structures, the governance, the way people are rewarded for innovation, the entrepreneurial spirit, is always alive and well in the US. So, you think about all the big magnificent seven. If you think about what's happening around just electric vehicles for instance. You know, vehicles has been an industry dominated by European companies, and yet where did the company from that changed everything? The US, Tesla. So I just think it's a really phenomenal place for companies to grow and become big players on the world stage. And so it kind of falls out of our research to be honest. We don't look at the US and go oh we'll just find our ideas there. But as we look at the best ideas and the best opportunities for us and we're always thinking about very high quality companies who are superbly positioned so we're very, very focused on just a select group of businesses around the world, it's amazing how often they are in the US.

CAROLINE GURNEY: So I'd now really like to go back to your portfolio in terms of what you do. I'm really interested in terms of how does a stock get into your portfolio, and perhaps you could actually explain the process to us?

NIKKI THOMAS: I've got to be careful not to talk too much when I start talking about process. So I guess the Magellan process starts with thinking about what sort of company makes sense for our style of investing. And that is where-

CAROLINE GURNEY: And what's your style of investing?

NIKKI THOMAS: So we're very much around high quality concentrated businesses that we believe will compound returns for the long term. So we're looking for an absolute return focus. We're not trying to just beat markets. And indeed we will wear underperformers relative to the market if we're convicted that the businesses that we're in ultimately will pay off. So looking at a relative performance number is something that is deeply ingrained in most portfolio managers but it's a bit of anathema to the Magellan process. And so we have to be very conscious of that. We are very much focused on those absolute returns out of high quality sustainably advantaged businesses. It goes to risk. If you buy those sorts of companies you're actually always taking a lot less risk. And our mindset is this is money that is real people's savings. And we want to protect that money. And so taking less risk while delivering them compound returns that are going to create wealth fast is just the right way to go about it. So when I think about how does a stock get in the Magellan portfolio. Firstly, we only select from a select group of companies. So we screen the world. We cover the ones that jump out at us as having competitive advantages. And that ultimately lands in an investible universe. It's only about 200 stocks. Not the 1,650 that are out there. So we've tightly defined what it is we think's investable. And then it's about portfolio construction. It's about risk. It's about vectors of growth opportunity. It's about not paying too much for stocks. And so all of these pieces have to brought together to build a portfolio that again doesn't lean too heavily on just one thing to deliver the returns. We're thinking about portfolio effect, in other words diversification, but not door-esification.

CAROLINE GURNEY: [laugh] it's always good to quote Buffet. Nikki there's an art to portfolio construction. I mean I think it's incredibly complicated and to do it well is something that we need our fund managers to do. Tell me about how you do it?

NIKKI THOMAS: I think the thing I always to the team is let's stay live to the data. So we're always testing ourselves with the things we own, and then also things that we're looking at that maybe we're thinking about owning. And we're thinking about what's going to happen in the future. Ultimately that's what investing is, predicting the future. And we're trying to work out how we can extract a better than 10% return over the next three years in a way that doesn't take too much risk and is balanced in terms of portfolio construction. And so the stock ideas, there's sometimes businesses out there, stocks out there, that we can see handsome returns in, but we won't own them. And it's because they don't make sense in the portfolio. They don't add something to the portfolio. So you don't have to have or you have to avoid FOMO. You can't wish you could own all of these things because we won't, we will have a concentrated portfolio. Similarly you may have a stock that you had a real belief around the investment case, and the data changes, the facts emerge that make your investment thesis look incorrect. You'll never know if it was incorrect until time goes by but you have to ultimately make decisions. And I think that is the bit that people often misunderstand with portfolio management. There's lots and lots of analysis and the team are obviously really important in us doing that analysis well. But the role of the portfolio manager is to make decisions. And decision making takes courage. And you have to just back your view sometimes and believe that this is going to work and all of the data and all of the science and all of the analysis cannot tell you absolutely what the future looks like so that's where you have to keep thinking about the balance of risk.

CAROLINE GURNEY: So I like the question in terms of you know obviously it's incredibly data driven. Is it art or science?

NIKKI THOMAS: It's definitely both. There's a piece of this that we will look for data points, we will look for trend analysis. It's the piece that analysts lean on most across the world and it's why COVID made things so challenging for investors. When trends get broken so dramatically by something like a pandemic it makes it really hard to understand where you're going to end up on the other side of that. So trend analysis and thus data analysis, the analytics of how things are changing in industries, trying to piece together all of the jigsaw pieces, to give you a picture of what the future looks like is a really important part of what we do and there is a level of science there. There's a level of quantifying the trends and the data points that we can gather. But ultimately there's, if it was just science none of us would exist, there would be no ability to do things differently or to add value because the data would just make it all work. So that's I guess the piece where the art comes in and part of that is around portfolio construction in my view. It's about putting together a portfolio that works as a portfolio and isn't just a, I use the term, a punters club. You know we're not just picking a few stocks and throwing them out there. We're thinking about portfolio effect.

CAROLINE GURNEY: And I suppose I sort of listen to how people construct their portfolio, and it's actually incredibly difficult isn't it. Like I mean I talk to a number of fund managers and I think the amount of work that must go into that construction is amazing really because you've got to look at the universe of stocks and you've got to work out exactly what's going to work together. Is that often gut instinct as well or is that purely sort of data driven?

NIKKI THOMAS: If gut instinct is experience, then I'd say yes there's an element of that. And you lean on your experience. You also lean on other people's experience. So I read, and anybody who manages money I think reads prolifically, because you want to find all of the pieces that you can that will help you make the right decision so. And sometimes they're journalists.

You know it might be The Financial Times that has an interesting piece that you think oh that's changed my opinion on something, or The Wall Street Journal. Bloomberg I obviously use an enormous amount as do most people who do this. But then it's people who work in markets. Its sales people and researchers at broking houses. It can be podcasts that I listen to. And-

CAROLINE GURNEY: What podcasts do you listen to? Besides ours obviously. [laugh]

NIKKI THOMAS: So there's a couple, well I can just talk to one I was listening to yesterday which is left of centre but it's the Paul Taylor Podcast. It's actually about, he's a psychologist psychiatrist kind of fellow, so it's often around health and science around that stuff, but it just brings a different perspective around things. He was talking about neuroscience with someone yesterday that I was listening to. I like the All In Podcast. So that's venture capitalists. They're hilarious. They swear a bit. They talk too much. But they bring perspectives that I don't get in the market. So it is about finding different places to get perspectives. You know we will talk to independent experts who've worked in industries. We will talk to people who are experts on macroeconomics. As you know we have advisors who are ex-CIA so they bring us an incredibly useful lens around what goes on in Washington and thinking by the US around geopolitical events.

CAROLINE GURNEY: Actually I listened to one that was very good the idea that you put forward in terms of what was happening in the Middle East. It was really fascinating to get that.

NIKKI THOMAS: That's why I do this job because it's always fascinating.

Level 26, Governor Phillip Tower, 1 Farrer Place, Sydney NSW 2000
Future Generation Australia Limited ABN 97 063 935 553
Future Generation Global Limited ABN 52 606 110 838
W. futuregeninvest.com.au
T. +61 2 9247 9202

CAROLINE GURNEY: So I'm going to take us back to some of my list of questions. I'm interested in what was the first stock pick that you ever made and where is it now?

NIKKI THOMAS: So I knew you were going to ask me this question so I actually thought about it. So I can't tell you what my first stock pick was when I was an Aussie stockbroker because it's just, I can't remember. But I can remember my first stock pick when I started covering global equities. So that was at Magellan. We put the stock into the global portfolio when we launched the fund in July of 2007. The company's name is Young Brands. So anybody who's been following Magellan knows Young Brands. It is still in the portfolio. I did a bit of digging because I had no idea, but at the time we put it in the stock was trading at the equivalent today of around $15.00. So there's been stock splits and so forth across the last 15 years. So the $15.00 has turned into about $125.00. So it's up about eightfold.

CAROLINE GURNEY: Pretty good. So I suppose the question what do you know now that you wish you'd known then? Mind you with that stock pick that was yeah that was pretty good.

NIKKI THOMAS: It jumped off the page at me to be honest. After having covered Australian equities as a broker mostly for a long period of time and I started looking at international companies and some of these phenomenal US based companies I felt like I'd been missing something really important when I started looking because I found these incredible companies that are just at global scale that you don't get in Australia. What do I wish I knew then that I know now? I wish I'd known how much Australian property was going to rocket in value.

CAROLINE GURNEY: Don't we all [laugh]. Yeah that's definitely a good point. Definitely. So maybe we should go to like what do you see that investors get wrong? Like we speak to a lot of retail investors and I'm just really interested in what you see that they might be getting wrong. Or what do they get right?

NIKKI THOMAS: Yeah I think look I think people always do their best when they're trying to manage money and some people are obviously managing their own money and they want to look after it. I think there's a couple of things I'd say that are areas to be cautious if you're trying to do this for yourself. One is to truly understand risk. And I think it's hard to truly understand risk if you're doing this as not your main game. It's a part-time gig ultimately for people who are just trying to manage some of their own money. The other thing that I think is really hard to deal with is that with shares you get to see stock prices every single day. So if you're investing in property you don't get to see the price every day. You sort of know vaguely what a house is worth and it feels like it'll be the same in six months, or maybe you think it's going to going to go up in six months, but you know it's not something that's literally visible to you every single day and I think the hardest thing for investors who aren't professionals and are doing this as something they're trying to learn how to do is that they think share prices are giving them real information. All it is giving you is the price opportunity. So when share prices fall ten or rise ten percent, and they do that a lot these days, they may not be conveying anything material in terms of the underlying intrinsic value of that business. And so it's really hard to separate those two. So I think people, and it's really hard to fight that bias to be ah the stock's fallen ten percent, ah things are broken, or its risen ten percent I knew I was right. It's a really difficult piece of the puzzle in not stepping away from share prices. And when we started Magellan we gave nobody in the investment team, so none of us had access to share prices. You could go and find it somewhere. But most people start with a Bloomberg terminal and the prices are visible in front of you every day. But we did that on purpose. The analysts were not given that because we weren't asking them to decide about a share price, we're asking them to build a understanding of a company and decide what that company was worth and looking at daily share prices wasn't going to help them do that well. And so I think that is often the hardest thing for people who are learning this game to step away from the noise of the market.

CAROLINE GURNEY: And they certainly are noisy aren't they. I mean obviously since you re-joined Magellan what have you done differently with your fund?

NIKKI THOMAS: I think the first thing we did, we haven't done a lot differently to be clear, genuinely the process at Magellan put in place back in 2007 which I was part of building is still there tried and true and still doing what it should be doing. But we did you know Chris and I both came back and we both looked at the portfolio, and we looked at areas where we were uncomfortable with the positioning based on the macro environment that we were facing into, which was one of clearly raising interest rates and of course then a war kicked off. And so we repositioned. And one of the things, and Chris was very much of the same view, China was risky. And these companies so Alibaba in particular was one that was in the portfolio still truly looked undervalued. Still looks undervalued. It wasn't going to be a business that we felt the risk profile was right. And it was one of those tough decisions that needed to be made. So stepping away from the China story that had been a wonderful tailwind for Magellan's portfolio for years and accepting that the China situation had changed and that we just needed to accept that it was time to move on was a really important piece I think for us, to get out of the way of the noise of what was going on there and re-establish some trust I guess in terms of investors who were hurting. You know the portfolio performance hadn't been terrible but the relative performance had been. And so people were losing confidence that the process was working. So there were a few changes like that. Taking some of these long duration stocks out of the portfolio. Not because the businesses were broke but because they were going to be sailing into a big headwind of a de-rating market. You know they were decisions that just needed to be made at the time. So to be honest it was really about just repositioning the portfolio. Changing the way we invest didn't happen. So that was really all that I would say we did differently.

CAROLINE GURNEY: And you're still not into China at all are you?

NIKKI THOMAS: No. No look I think there's always money to make even in a market like China. So absolutely I'm not critical of people who get inside of the Chinese market and can find opportunities there. You know I wish them well. I look at the issues, the macro issues that I think China have ahead of them, the liquidity. It looks like a liquidity trap. The lack of confidence around consumers. The deterioration in the real estate market. The lack of fiscal multiplier for spending by the government. I find it very hard to have conviction about the longer term opportunity of buying into that China story. So I think there will be people who will make money. But we have thirty stocks or less in our portfolio. There's just better, easier ways to make money for our investors.

CAROLINE GURNEY: Well we are very grateful that you manage our money, our shareholder money. Why do you do it? Why do you invest our shareholder money?

NIKKI THOMAS: I guess, I always feel like a bit of a girl when I say this stuff, but I genuinely care about the people on the other side. So I do this because I want people's hard earned savings to turn into a pot of gold. I want to help people make money by investing. And so I genuinely do it because I want a great outcome. There's two sets of people I care about most in this process and why I'm at Magellan, one is the people that at work at Magellan, and you know I want to help them, I want to help this business grow and get back to the great business that it was, and the other piece is the investors on the other side of that. You know the people who've trusted us with their savings I absolutely want them to be justified in that trust and to give them a great outcome. So that's why I go to work.

CAROLINE GURNEY: Well thank you. I love the Future Generation model because you're giving hope to our future generations, but also you're making sure that people have a healthy retirement and they have a good savings pool. So it's really important that we have fund managers like you to manage our money. So thank you. I've really enjoyed this chat. Thank you very much for your time. I look forward to speaking to you again.

NIKKI THOMAS: Thanks Caroline. It's lovely to be here. And it always lovely to be involved in a project like Future Generation. You know what you do I think, and the ability for us to contribute to the outcomes that Future Generation have had, has been really rewarding.

CAROLINE GURNEY: Please join the Future Generation family, Australia's first listed investment company to provide investment and social returns. We have given more than $75 million to Australian not-for-profit organisations, something we and our shareholders are incredibly proud of. Be part of this and gain investment returns while contributing to improving the lives of young Australians. For more information about Future Generation visit the website www.futuregeninvest.com.au. Thank you.

[end]