Future Generation: Investment Insights

Caroline Gurney and Nikki Thomas

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CAROLINE GURNEY: Hello, and welcome to Future Generation Investment Insights. I'm Caroline Gurney, CEO of Future Generation. Today I'm joined by Nikki Thomas, who is the Global Portfolio Manager for Magellan. Magellan manages around 10% of Future Generation Global (ASX: FGG) funds for us, and they do that on a pro bono basis for which we're incredibly grateful. This means they don't charge any management or performance fees to our shareholders. Nikki, welcome. Thank you very much for your ongoing support and for also spending some time with us to really talk to our shareholders about what your outlook is and what's happening at Magellan, because everybody wants to know about all of our fund managers. Nikki has a long history of Magellan. She was one of the earliest hires by Chris Mackay and Hamish Douglass after they set up Magellan in 2006. She left the firm in 2017 and was brought back again in February this year. So Nikki, first off, what our shareholders really want to know is, what's your current market outlook and how you're you positioning your portfolio to deal with that?

NIKKI THOMAS: Thanks Caroline. So I guess the market outlook at the moment is pretty complicated, but I would say there's two things that are really important as you think about investing that will ultimately deliver what comes through in share markets. One is what's happening in the company, front earnings growth, cash flow growth, and how that's playing out relative to market expectations. And the second is obviously the tricky one right now is the interest rate setting, the discount rate that you use. There's a bit of a dichotomy because actually in the U.S. growth is amazing. Economic growth in the U.S. at the moment's running nominally, GDP's at about 9%. Households are in great shape. Balance sheets are good. Credit growth is strong and there's also support for good earnings growth for a good number of businesses. But as rates go higher, obviously that's a challenge for asset prices. So that's the trade-off that we're constantly working through, and it means you need to be very carefully positioned inside the markets to make sure you're capturing the earnings growth and you're not selling into a headwind of what's happening around rates. There's no doubt when you're thinking about the earnings piece and how companies are positioned, it is very complex, and we are at real turning points in some areas. China's going into a slowdown. Europe is probably going into recession. We've got a war going on there. U.S. obviously very good. So again, you've got to be looking

under the hood of markets to really understand where the opportunities are and to be positioning the portfolio for the best outcome.

CAROLINE GURNEY: Can I just ask you one quick question? Obviously, there's a lot of people out there that believe that U.S. is going to go into recession. What are your thoughts on that?

NIKKI THOMAS: I debate whether a lot of people think that. I think the odds at the moment are running at 15 to 20% expected recession. You never know if it's going to happen, really at some point if there'll be a recession. So the issue is timing, quantum in terms of is it a moderate recession? Is it a deep recession? Does it happen in 2023? Does it happen in 2026? Right now, I would say recession is a low probability event for the next 12 months. The yield curve has not inverted at the three to 10 or the two to 10. So there's no leading indicator there. And as we've talked about, there's an enormous thought of money sitting on consumer balance sheets, banks are in great shape, corporates are in good shape. The issue that I guess people are grappling with is the most important thing to watch right now is inflation. Whatever happens with inflation will ultimately determine what happens with central bank interest rate settings. And if inflation stays very hot, they will stay very aggressive and it will be those sorts of things that will ultimately trigger either a recession or the market being volatile in expecting a recession.

CAROLINE GURNEY: Thank you. That was a great explanation for our shareholders. So Magellan, it is this incredible success story in Australia. Standing start in 2006 as I mentioned before, you've got funds under management of over $50 billion. It's a diverse, it's a very deep client base and a team of more than 100 people, which is actually incredible. And I don't think that's really been told in terms of the number of investment professionals you actually have that have worked here for many years. You were there from the very beginning, which is incredibly exciting to have seen that whole journey. Can you perhaps go through some of the early chapters, how it was started with Chris and Hamish, and why you decided to join them then, because that was a risk really.

NIKKI THOMAS: Yeah. I think it was a risk, but it was an exciting risk. So if I go back to those very early days, Chris and Hamish were pretty famous in Australia.

CAROLINE GURNEY: They were, weren't they?

NIKKI THOMAS: Big investment bankers. And they had a shared passion to begin investing.

They'd been doing it on the side. It was interesting because they wanted to do it in a way that they could create a big, bold future. And to do that, they decided to list so that they had a really strong balance sheet supporting that vision to create a really amazing company. Typically, a fund manager lists because they're trying to find an exit strategy. These guys listed because they wanted to build something amazing. So they always had a vision for something that was going to be big, global, and done extremely well. And I think that's an important understanding because that is what they built. There's a degree of excellence around everything that Magellan puts its hand to. And that was a cultural piece from the very beginning that came from the founders. So why did I join? I got an opportunity to do global equities in Australia. My husband was never going to leave Australia, so it was a unique opportunity. I sat down with Chris and Hamish and they explained to me what they saw as their vision and the way they would invest, that spoke to me, that's my style of investing. So it seemed like a good thing to do. I guess if I look at my career over time, I haven't been frightened to take risks. So it was a risk, but it was a very good risk, even though it had some very challenging times.

CAROLINE GURNEY: So you left five years ago now. And in a way, it was doing amazingly well. And that was another risk to go and do something else. So what made you return? What made you think right now is the time and I know I can make a real difference?

NIKKI THOMAS: I think the latter bit has come later, but to be honest...

CAROLINE GURNEY: We can always make a difference.

NIKKI THOMAS: Well, you always hope you can make a difference. I think it was just a very unique opportunity. When I left, I left because I didn't feel I was skipping to work anymore. And I needed to find a new path and do something that was a new challenge. And I enjoyed doing that. The opportunity came to me really out of left field. Hamish and I were sharing Christmas emails. I was not working at the time and wondering what it was I might do and unable to disconnect properly from markets because it is my passion. So I'd managed to get a couple of brokers to keep sending me research. And I was watching Bloomberg every day. My husband always thinks it's hilarious, drinking my coffee, watching my Bloomberg. So I was annoying him a little bit on some stocks he held in my Christmas emails. Why do you have this? And I think you should do that. And bless him, he engaged. We've always had a wonderful relationship like that. And I think that ultimately just led to him going, Nikki, I'd love to have you back. And I said to my

husband, what do you reckon? And he was like, "It's in your DNA". Truthfully. I just thought, wow, you know what? I feel like this is going to be really fun. I love working with both Chris and Hamish. And so it was just an opportunity to do something that I'm really passionate about in a way that I thought I could actually bring something to the table at Magellan, and it felt like the right thing to do.

CAROLINE GURNEY: Hamish isn't here, so how's your working relationship with Chris? Because obviously you mentioned Hamish, but Chris was doing something different within Magellan. So how's that now?

NIKKI THOMAS: Well, not even within Magellan, Chris has been running the original seed capital that was raised when Magellan first listed. And while he sits here and has been a part of the fabric of Magellan, he has been doing something separate up until February when we both came back. I worked with Chris in the early days so I know him. He is an absolute delight to work with. I am so privileged because you have two of the smartest minds in investing and I have got to work with both of them. I have enormous respect for Chris and his capability. He is very good at what he does. He's kind, he's caring, he's driven. He built something phenomenal when he was at UBS, as you know. And he brings that caliber back to the table at Magellan. So I feel very privileged.

CAROLINE GURNEY: It would be remiss for me not to ask. I mean, obviously Magellan's been in the press a lot. Well, I would say probably more so in the past year. And you've obviously got criticism, not you per se. So would you mind giving our shareholders what's the insider's view of the company and what are you bringing to the company now and how do you see things going forward?

NIKKI THOMAS: It's a really good question because I think the press has no comprehension of actually what's going on inside Magellan and what this business really is inside. And that's created a lot of pain for people, both inside Magellan and obviously as shareholders of Magellan because some of the criticism has been personal and also unfounded. But there's no doubt, some of the criticism was justified by some mistakes in the way things were done for a period of time. So we own that, we accept it and we learn from it. And I think that's been an important piece for Magellan that you must accept if you make mistakes, learn from them and do things better. But really when you sit here as an insider, there are over 130 people in this organization.

If I broke them into buckets, there's an investment group. There's a distribution group who take care of the clients. And there's an operational group who do all of the hard work that again, protects clients and looks after clients. So this is so focused on creating great outcomes for clients and that is deeply embedded in the culture of the organization. These are kind, genuine, hardworking people, who come to work every day to try and make a difference for the client. So I came back partly because these people have always been my friends and I wanted to come back and help them through and be a part of this. The day I first walked back into the office, I had more hugs, particularly post-COVID, than I've had in a very long time. And I think part of what I bring is a positivity and an enthusiasm for the future. Some skills that I can bring back to Magellan and an understanding of the culture and the people here. And hopefully we'll make a real difference going forward. I have real faith in the future of Magellan and what this group of people can achieve over the next 10 years.

CAROLINE GURNEY: So let's look at the performance then because I think that segues very well into that. Are there some of the investments that obviously haven't delivered as well as you thought they would, and what are you doing about that and where are you going now?

NIKKI THOMAS: It's a great question. And of course, every portfolio always will have some mistakes in it. And those mistakes aren't necessarily that you just got it completely wrong, that you were stupid. Actually, what can happen is facts change a lot sometimes and you just have to be live to that and recognizing when facts are changing, you sometimes aren't in the right place for how the world is evolving. So the world is always evolving. You must be live to that challenge and continually reassessing what you've got. And we look back in history, Magellan had a period that in 2021 delivered about 20% growth in the portfolio. Most people go, woohoo, 20%, happy with that. But of course, the market was red hot on the back of fiscal and monetary stimulus and economic growth. So it didn't do as well as the market. And so that's been a criticism levied. But it's always structured to probably never keep up as well in very hot markets. The other important piece of the puzzle when Magellan thinks about delivering compound returns over time, you mightn't get the highs. You definitely don't want to get the lows. You just want to work through the middle of that and keep growing wealth. And that's the ambition. That's what the process and philosophy are grounded around. And so there's been a couple of stocks that I would say the investment cases broke.

CAROLINE GURNEY: And which ones are they?

NIKKI THOMAS: So one in particular, Alibaba (HKG: 9988) was a large position in the portfolio a couple of years ago, maybe the beginning of last year, and things really have changed. I don't think there's many people out there who don't say, Alibaba's an amazing company. People still believe that, but the problem is that competition has escalated dramatically, encouraged by the government. The government has changed the rules of the game materially. More recently, they've implemented a zero-COVID policy that is unending at the moment, because they're looking towards election in November. And so they want to keep everybody safe and they don't have the vaccines that we have. So there is some very significant headwinds for China's economic growth, as well as for investors around regulatory risk and the centralization of control that's coming through inside China. And I think that's a really significant change of facts. When China joined the World Trade Organisation (WTO), most world investors believed that China was on a very positive pathway in our direction, to a more democratic society and freer capital markets. And in fact, we've gone the other direction. And so right now, geopolitics are adding to the complications with difficulties in relation to what's going on in Russia and how that might play out. So Alibaba was definitely a position in the portfolio that hurt. It has been exited. It's not in the portfolio today. We cannot see the case for why you own that today, relative to a lot of other better opportunities. I'm not going to tell you the share price won't be higher in three years. I genuinely don't know if it'll be higher or lower. I just know that that isn't the best place for us to have money invested when we can look at other opportunities that have a very clear path to us making lots of money.

CAROLINE GURNEY: Have you made a lot of other changes in the portfolio?

NIKKI THOMAS: We're always making adjustments, that's our job. And I think it's important to put a framework around that. Chris and I started at the beginning of February. Since that time inflation data has accelerated way beyond anyone's expectations. A war has broken out in Europe and significant sanctions have been levied, which has created a very different investment case around commodities and energy because of sanctions and the issues that are resulting from the war. The Fed, because of inflation, have become very aggressive around interest rates. And of course we've seen a very significant shift in the bond market. So almost everywhere you look, risk premiums are changing from a long period of shrinking to probably expanding again, geopolitics have got even more complicated. There's a lot of changes in direction that's been going on just in the last two to three months. And so we clearly have to reflect that in the portfolio, in that if the world's changing a lot, should we be making adjustments?

And so we have. But to be clear, making change can be very valuable and only influence 10 or 15% of the portfolio. We have a vast majority of the portfolio that are exactly the sort of businesses you'd expect Magellan to own, and that we will continue to own, and we expect to continue to deliver outstanding results. Microsoft (NASDAQ: MSFT) just delivered another cracking result. And this is an enormous business growing above 20% per annum. I mean, phenomenal company. Visa (NYSE: V) and Mastercard (NYSE: MA) - so we were about to get the Mastercard result, but Visa, up 5% on the back of the result, it's a reopening trade. We'd lean forward on a couple of these opportunities because we felt like there was an underappreciated upside in some of these businesses, but that is a winning franchise and will be for a long time. And right now, we think they're still actually looking very cheap, because people have been too cautious on the COVID impacts and how that will play out as we go forward. So under the hood, there's a lot going on, I guess, because there should be, but at its heart, it's still very much the portfolio you would expect to see.

CAROLINE GURNEY: As I said before, you manage 10% of our Future Generation Global portfolio and you do that pro bono. So we are incredibly grateful, but I always like to end on why are you telling your investors to keep their money with you? And why is Future Generation - What should we be telling our shareholders?

NIKKI THOMAS: Why? Well, I guess when markets are tricky and often people see a little bit of a share price deterioration and things going down, you have to remain true to the fact that over time, the best thing for you to do is to stay invested. Don't panic because you see a 5% loss or a 10% loss in the short term, as long as what you're investing in, you can have conviction around. And that's our part of the job, I guess. We invest in extremely high-quality businesses that are competitively advantaged. We seek secular growth tailwinds for those businesses. So we don't just buy a great business that's... Ford's (NYSE: F) a great business. Maybe it has some tailwinds, we'll see, but it's not Microsoft or Alphabet (NASDAQ: GOOGL). So we're selective around that, where we can see above the economic growth story, really strong growth to come through. And then we have to be very measured around not paying too much. And that's been really important right now because of the rate cycle that we're in. As rates go higher, particularly in thinking about asset prices, what you should focus on is; are you getting near-term strong cash flows as well as growth? If you've just got growth, but no cash flows and you think those cash flows are going to come in 10 years' time, those businesses will not be attractive in this environment. So it's about the duration of the cash flows and leaning in on those amazing businesses to generate very

high cash flows right now and also have growth. That's what we do so well. We also protect to the downside. We don't get caught up in the noise of markets and we position defensively so that when you get gyrations, the portfolio is resilient. So if there was a time that you should look forward with confidence on what Magellan can deliver to investors, I think it's now.

CAROLINE GURNEY: Excellent. Thank you very much, Nikki for your time.

NIKKI THOMAS: It's a pleasure.

CAROLINE GURNEY: We really appreciate it.

NIKKI THOMAS: Nice to meet you. Thank you.

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