Future Generation
INVESTMENT & SOCIAL RETURNS

2fold: Take Stock/Investing for Impact podcast

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Magellan Financial Group

CAROLINE GURNEY: 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 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 company to deliver returns for our shareholders while building better futures for young Australians.

So far, we've donated more than $75 million to not-for-profits. And we've been able to do this because of people like Nikki Thomas, portfolio manager at Magellan Financial Group. Like all our fund managers, Nikki charges zero management or performance fees for managing Future Generation's money. This allows us to give 1% of our net assets to Australian not-for-profits. She's in the studio with me today. Nikki, hi. Thank you very much for being here.

NIKKI THOMAS: That's a pleasure, Caroline. It's always lovely to be with you.

CAROLINE GURNEY: Thank you. As we record this, reporting season has got underway in the United States. I'm really interested in what you're seeing there and what are some of the key themes that are emerging for you.

NIKKI THOMAS: It has just got underway. So we're sort of early doors yet. And it's always the banks who lead us out with reporting season in the US. I guess I'd say what we saw from the banks, we're seeing a lot of idiosyncratic risk already.

So different companies in the same sector delivering quite different outcomes. But broadly, I'd say the US, the banking system, suggested things are ok. Loan growth fairly low. The trading books are doing quite well. So, we're seeing a bit of a pickup on M& A, trading activity. So that's coming off real lows.

I would say no real sign of recession, but certainly consumer that has been deteriorating all year. And it's moving from just the low-income consumer in the US, feeling pain to probably increasingly up the economic ladder we're seeing more caution amongst consumers and more value seeking behaviour.

But so far, the results have come in quite well. I think we're looking at earnings growth across the sectors at running at low double digit at the moment and beating expectations. So it's been volatile. But the economic signs coming out of it are quite solid.

CAROLINE GURNEY: That's really pleasing to hear. It's very early in the cycle, as you said. But are you seeing any sort of winners or losers at all?

NIKKI THOMAS: So I'd say it depends how you frame that. When we look at some of the technology stocks, we've just started to see a few report and there are a lot to happen this week and next week.

So far, great results, bad reactions.

So are there winners or losers? You know, they are delivering very good outcomes. But expectations are, particularly around that technology space, are really stretched.

And so it's very hard for these companies to deliver a great result and get a share price benefit from that. Everyone sort of like, oh, that's maybe just good enough, given where share prices have got to.

I think it's going to be a reporting season where we see some more downside risk on share prices, even if the results themselves are actually quite good.

CAROLINE GURNEY: You mentioned that, the US doesn't seem in danger of going into recession. Do you see that for the short term, medium term or long term?

NIKKI THOMAS: It's hard to see too far ahead. But I would just say, you can never rule out a recession, unless of course you are Australia and you can rule one out for 25 years! But, at some point, the US probably sees a recession. It just doesn't feel like it's this financial, this calendar year. So it's hard to see how it would deteriorate that quickly to get us to a recession.

But you could talk about a technical recession. I mean, we definitely could see that in the next 12 months, if real GDP growth dipped negative for a couple of quarters. We saw that in the UK. We saw that in Europe. We saw that in quite a few countries over the last 12 months. But those economies have actually been OK through that. So they're quite shallow in terms of the recessions we've seen.

I don't think you can fully rule it out, but the Fed Put is back in place. So we're going to see rate cuts. We've got inflation coming down. I think the market is increasingly feeling confident that the backstop is back in place. If economic growth deteriorates too quickly, the Fed will be on the cutting front. They'll drop away quantitative tightening; we will get the stimulus that always takes a while. But, you know, people feel reasonably relaxed that the tools are there if things started to deteriorate really badly. But at the moment, it doesn't look that way.

CAROLINE GURNEY: I mean, I do think the rhetoric coming from the Fed is actually it's sort of quite calming in a way. Does the US election factor into your investment decisions?

NIKKI THOMAS: Like everyone, we are fascinated by it. It occupies way too much commentary in markets and conversations in corridors. I approach it by using this framework: “How should I think about the implications of a Democratic Presidency versus a Presidency led by Trump - and whether it could end up being a Republican sweep?”

If you go through the major issues that you need to think about - such as fiscal policy, monetary policy, trade, immigration policies and what would happen with government debt levels - I don't think they're actually massively far apart.

There are nuances that you need to think about when you think about companies and industries, but it’s interesting, as opposed to dramatically game changing for markets. The one thing that has been interesting of late is that the market lent into a ‘Trump win’ trade after the debate. That created a lot of the short-term direction of share prices and noise in the market.

Part of what we saw play out is people are worried that Trump will spend aggressively, and that will be bad for government debt levels. This means people are nervous about the long end of the curve staying high – that is 10 year bonds staying higher, which has meant some of the structural growth companies, like tech, have been pressured.

CAROLINE GURNEY: So we're definitely going to go to tech in a minute. But looking at markets more generally what is your outlook? We have this divide between valuations of small-cap companies and large-cap companies. Where are you seeing opportunities and risks there?

NIKKI THOMAS: So I'm going to diss you for a second because there is always a divide in the market around how companies are valued and whether there is latent value or whether they're fully valued. But I don't think it's significantly along lines of big or small. You can get really cheap small caps. You can get really expensive small caps. You can get really expensive large caps and really cheap large caps when you do your work and understand the fundamentals.

Again, that sort of stuff is narratives that run in markets. And I don't think they're necessarily grounded in fact. But broadly speaking, we deal in the large cap end of the market. So, we don't spend a lot of time looking at smaller cap stocks. We own a few that I would call small cap, but for an Australian, they're, you know, $30 to $50 billion market cap companies, so rather large.

But I would say the things that are driving opportunities for companies over the long term – and thinking about who can take advantage of that is how you make great money investing in markets and not just playing share prices. And so when you think about that, it's the big thematics, digitalization, and of course, this new big wave of the latest thing, artificial intelligence and how that's going to play out.

It's the big capex super cycles around energy transition. It's the shift around the geopolitics that's creating investment into markets, like building foundries to make semiconductor chips in markets that we didn't used to do them in, but because we've decided we need to. It's investing in the infrastructure to support grid transmission of electricity as we move away from fossil fuels and towards electricity. So it's all those big shifts that are going on around us that ultimately create the opportunities, but also the risks with other companies. Some companies are going to be disrupted through that. And that is where we go shopping and looking for opportunities.

CAROLINE GURNEY: So let's look at AI, Artificial Intelligence. How big a game changer is that still and where you invest in that particular narrative? What are the names you're investing in?

NIKKI THOMAS: Yeah. So firstly, I'd break the whole artificial intelligence, generative artificial intelligence, down into two buckets, infrastructure, the enablers of it, and then the adopters, the people who are going to use AI inside their businesses. So let's just deal with them in, two buckets.

If you think about the enablers, they're the picks and shovels of this revolution. So it's the NVIDIAs (NASDAQ: NVDA), it's the Microsofts (NASDAQ: MSFT), it's the Amazons (ASDAQ: AMZN), it's the Googles (NASDAQ: GOOG), it's all of the semiconductor companies. There's a swag of companies, that are all involved in building this infrastructure that will allow AI to happen. And that's where we are today. And that's where the huge amounts of capital are being spent, and all of the excitement is happening. And we're absolutely invested against those. Microsoft and Amazon are our two largest positions, but we've got a lot of exposure to that carefully selected out of the market where we see the best opportunities. So ASML (AMS: ASML) is another one that plays there.

The next bucket is where AI will be put to use. So this is things like Microsoft's Co-pilot. We will hopefully one day have a Co-pilot sitting next to us who will help us do things in our Excel and write our Word documents and whatever it happens to be. But you talk to the companies, I spoke to Salesforce just the other day, and they were saying, you know, it's still experimental.

People love the idea of trying this stuff on. They're giving all these tools to their staff, they're not cutting staff. They're just giving them stuff to play with to figure out.

So we're not yet at the point where the adopters are truly monetizing any of it. It's just a big experiment. And that's where the market's probably got a little bit over at skis, where it's like, super excited… I am too...I think it's going to be amazing. But the investment returns aren't going to be really obvious to us, probably for three or four or five years in that part of the market.

And even with the infrastructure part, to go back to that piece, where we are playing, you know, it's very clear this is an arms race.

They are all going after it. And Sundar put it perfectly just yesterday in the Alphabet call. And he basically said, look, there is a much bigger risk of us underinvesting than the risk we run if we overinvest. So we're all going to overinvest because we don't want to be left out.

And so they hope they're not overinvesting. But if they are, they're actually okay with that because it's fungible. They'll be able to use those investments elsewhere. If they don't go after it, if they underinvest, if they try and preserve their capital and, you know, do bigger buybacks, they're going to be left standing still while everyone else is moving away from them. So it's a fascinating period. And, you know, I think you just got to back these big guys who have the balance sheets, have the deep pockets, have the data sets, that they really do see big opportunity on the other side of this. But we're early doors here.

CAROLINE GURNEY: I think that's a really interesting way to look at it. And I do like what you were just saying in terms of, you know, you have to overinvest to make sure you take advantage of those opportunities. So let's turn to China. We've had long conversations about what you don't do in investing in terms of China. I'm still really interested in your view. Do you think China is investable or is it something you're looking at?

NIKKI THOMAS: We do watch China. I actually even planned a trip to China back in May, which I didn't end up doing because I couldn't get the access I wanted to get. China is really important on the global stage. It's a big economy. You know, it has incredible manufacturing capabilities that's built around a lot of this energy transition. So if you think where the biggest wind, solar, electric batteries, electric vehicle companies are actually in China. So it's really important that we keep watching China and keep understanding what's going on inside of China.

But I think what's been interesting, you know, probably a year ago, maybe we sat down and we kind of said, look, China is a derating asset and we just don't see it as a viable place for us to make the sort of returns that we look to make. In other words, ones that are reasonably risk protected. We don't want to just throw risk around on the hope of making a great return.

We want to do it in great places with opportunity that has protections around capital for our investors. I think the market's increasingly got to where we were at. So the derating in China happened much faster than I would have anticipated. But I think it's because fund managers around the world have gone, you know what, I think I'd rather own India than China. The economic risk is horrible. The political risk is horrible. You don't really have control of your money under the Communist Party. It's fragmenting increasingly away from China and increasingly, you know, Europe and the US are trying to work out how they slow China down and almost hold them back with what's going on. So, we really find it a hard place to think about how you would invest there with any confidence. But there are implications that come from what China does that are important on the global stage.

So, you know, I think - I said I wrote this in commentaries the other day, I think there'll be a lot of Chinese electric vehicles on Australia's roads in the next five years. And that does have implications for the world when you think about some of the things that they are creating really cheap, good product that's going to come out of China and into our markets. And that could be really detrimental for companies that participate in those markets. You know, industries like car industries could be really challenged by what China are doing. So, I'd say China is a bit of a value trap myself.

CAROLINE GURNEY: You mentioned India. Do you invest at all in India?

NIKKI THOMAS: We look. India is really expensive, partly because of this phenomenon, I suspect. And it's really hard to find a competitive advantaged, great high-quality companies. There are a few, but we have not found anything that meets our quality thresholds at a price that looks attractive to us. But again, India, I think, has increased about 10% in the MSCI Emerging Market Index. And China is almost the opposite of that. So, increasingly, people are having to look at India as part of their investment universe. It is becoming more and more relevant. And we will continue to look. There are really clever companies, really, you know, well run companies inside of India.

And they will be increasingly of the scale and liquidity that may make sense for us. So, we're never say never on everything. You know, you shouldn't ever say never, but you just have to be sensible about what you're doing. At the end of the day, this is real people's money.

CAROLINE GURNEY: Absolutely. I really understand that. One of the things we're really fascinated about is how you as a fund manager select a stock. So, can you talk me through your process and a couple of companies that illustrate your process?

NIKKI THOMAS: So, yes, let me talk you through how Magellan think about it. To put it in context, the portfolio tends to be 25 to 30, never actually 30, stocks.

So, it's reasonably concentrated. We like that because we place our bets where we really believe we've got great opportunity to make money. And we're really thoughtful about;

1. What is it we're buying and how good the company is and

2. Are we paying the right price for it. Because there's great companies that get overpriced. So, we don't want to play there either.

The process at its heart is about understanding the competitive advantage and the positioning of a company inside an industry. Firstly, we only look at great industries. So, you probably never see us own a car company because it's just a horrible industry. And it's really hard to make economic returns as a car manufacturer. So, you know, good luck to them. Some of the cars are lovely, but it's really hard place to make money.

So, we'll leave out bad industries. We look at great industries. And then we're looking for businesses that we think will be the winners over time. A simple thing to think about when you think about any industry, typically the market is evolving through digitisation. In other words, as our world increasingly digitalises, the excess, the large amounts of growth in an industry are happening around the companies that are leading the digitisation.

So, a simple example. Retail sales around the world is moving in the direction of e-commerce at about 1% market share a year. So, e-commerce grows faster than retail. So, if we're going to invest into retail, first of all, we want to be investing in the faster growth piece usually. So, we'll be looking at the e-commerce piece, or those that do both.

And then we're saying who's going to be the winners in that? Who is in the best position? What are their competitive advantages? And we think about agency risk, so management, business risk. And we think a lot about reinvestment potential. And what we mean by that is, if a company generates lots of capital and they can return lots of it to us and just invest a bit and get a very high return, that's nirvana. Because you get growth, but they don't use a lot of capital. They give the capital back to shareholders.

So, we love businesses with high reinvestment potential. So, we're very focused on quality, finding the right sort of companies and we leave most of the universe out. There are only about 200 companies that fit into our world with high quality companies.

And then we're looking for the ones that we think look underappreciated, that look undervalued in the market. And we do move the portfolio around quite actively. We're an active manager, but we don't churn the portfolio. We're not chasing the latest short-term gimmicky idea. I can give you an example. We've owned Visa (NYSE: V) and MasterCard (NYSE: MA) for over 15 years. We've owned Yum for over 15 years. Sometimes bigger, sometimes smaller, in terms of position size. But these are winning companies. They're taking share, they deliver great results, and they deal with very limited amounts of capital. So, they’re hard to go past.

So, they're the sorts of businesses that we're always looking for. We love subscription businesses. We love businesses with network effects. Visa and MasterCard fit in that bucket. Netflix (NASDAQ: NFLX) fits in the subscription business model.

CAROLINE GURNEY: I would definitely say that I use Netflix and Visa and MasterCard. Definitely re-occurring customers.

NIKKI THOMAS: I think sometimes people think we're just buying the big things. But big sometimes is deteriorating. They're not the right businesses to be in and they're being disrupted. So, we're always cautious about big doesn't make you beautiful.

If you go back in history, we've owned a lot of Microsoft for quite some time, but Microsoft was a terrible investment for a period of time. And then, actually, probably with Satya Nadella, being an instrumental change in the way that business was run.

But now it's just superbly positioned for where we're headed around AI. The growth in that business will be double digit for years to come. So, I feel like we kind of just make it easy to make money. That's our job. Just find the things that are easy ways to make money.

CAROLINE GURNEY: So, we are obviously incredibly grateful for your involvement in Future Generation. Why do you do it?

NIKKI THOMAS: Well, Caroline, you know the history, as well as I do. But Magellan was approached by Geoff many, many years ago with this idea of how this industry could give back to society and to create a pool of money that could be used to distribute to charities. And Hamish ran Magellan back then, and of course Hamish was all in on an idea like that. So, Magellan were one of the founding partners with this whole Future Generation concept. And one of the big supporters of it.

And Hamish has always been, you know, a big supporter of this style of raising money. So, I inherited the role that I have today, but I inherited it with joy because I work really hard doing what I do every day. And this is a way I can give back, but it allows me to just do it in a way that really maximizes what I do as opposed to me running around trying to help some other charity with spare time that I don't have. So, look, I really enjoy it.

I love interacting with you, of course. I tell my friends to put their money with FGG because it hits a couple of high notes. One, you hopefully get great returns, but two, you get to give some money to charity. So, it's great.

CAROLINE GURNEY: Thank you. Thank you very much. We need really fantastic portfolio managers to manage our money for our shareholders and you are one of those. So, thank you.

NIKKI THOMAS Thanks Caroline. It's a pleasure.

CAROLINE GURNEY: We hope you enjoyed today's episode. Please join the Future Generation family, Australia's first listed investment company to provide investment and social returns. We are proud to have given more than $75 million to Australian not-for-profit organisations. You can be part of this and gain investment returns while contributing to improving the lives of young Australians. For more information please visit our website, www.futuregeninvest.com.au.

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