MFG Global Equities

Key Facts

Portfolio Manager	Hamish Douglass
Strategy Inception Date	1 July 2007
Total Global Equity Assets[1]	USD $23,838.4 million
Total Strategy Assets	USD $20,809.0 million

USD Gross Performance[2]

	Composite	MSCI World NTR	MSCI World Qual. Mix NTR	MSCI World Min. Vol. NTR
3 Months (%)	1.4	0.3	-0.4	-1.6
6 Months (%)	3.7	2.6	2.1	2.1
1 Year (%)	7.4	1.4	3.3	6.3
3 Years (% p.a.)	16.9	14.3	13.4	11.5
5 Years (% p.a.)	19.4	13.1	13.4	12.8
Since Inception[4] (% p.a.)	12.4	3.2	4.7	4.7

	Composite	MSCI World NTR	MSCI World Qual. Mix NTR	MSCI World Min. Vol. NTR
2007* (%)	0.0	-0.1	1.0	1.0
2008 (%)	-21.6	-40.7	-35.4	-29.7
2009 (%)	39.4	30.0	27.7	16.4
2010 (%)	18.3	11.8	11.4	12.0
2011 (%)	11.9	-5.5	0.7	7.3
2012 (%)	21.6	15.8	13.0	8.1
2013 (%)	30.8	26.7	24.5	18.6
2014 (%)	6.6	4.9	7.3	11.4
2015 CYTD (%)	3.7	2.6	2.1	2.1

Top 10 Holdings

	GICS Sector	%
eBay Inc	Information Technology	7.6
Microsoft Corp	Information Technology	7.1
Yum! Brands Inc	Consumer Discretionary	5.5
Lowe's Co Inc	Consumer Discretionary	5.3
Visa Inc	Information Technology	4.8
IBM Corp	Information Technology	4.8
Intel Corp	Information Technology	4.2
Lloyds Banking Group	Financials	4.1
Home Depot Inc	Consumer Discretionary	4.1
Tesco PLC	Consumer Staples	4.1
	TOTAL	51.6

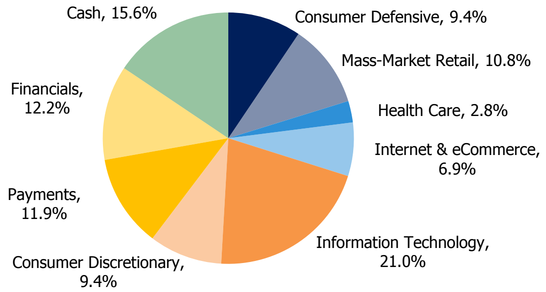
Strategy Fundamentals

	Strategy[6]	Index[4]
Number of Holdings	25	1,645
Return on Equity	22	14
P/E Ratio (1 year forward)	16.2	16.1
Interest Cover	23	10
Debt/Equity Ratio	29	46
Active Share	84	n/a
Weighted Average Market Cap (USD million)	113,221	n/a

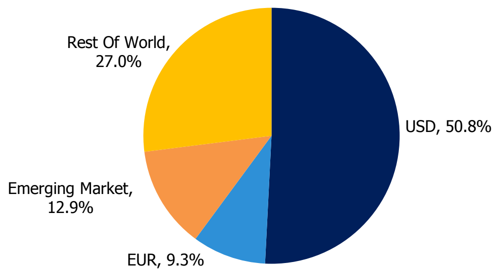
USD Risk Measures[2]

Risk Measures	3 Years	5 Years	Since Inception[3]
Upside Capture	1.1	0.9	0.9
Downside Capture	0.8	0.4	0.5
Beta	0.9	0.7	0.7
Information Ratio	0.7	1.0	1.2
Tracking Error (% p.a.)	3.8%	6.4%	7.5%
Standard Deviation - Strategy	8.6%	10.3%	14.2%
Standard Deviation - Index	8.6%	13.2%	17.4%
Worst Drawdown - Strategy	-4.3%	-7.0%	-36.0%
Worst Drawdown - Index	-3.7%	-19.6%	-54.0%
Turnover[6] p.a.	27.1%	22.1%	17.7%

Industry Exposure by Source of Revenues[5]



Geographical Exposure by Source of Revenues[5]



[1] Comprised of all Global Equity strategies.
[2] Returns and risk measures are for the Global Equity Composite and denoted in USD. Refer to the end of the document for further information.
[3] The inception date of the Strategy is 1 July 2007.
[4] The inception date of the Composite and the Index, the MSCI World Net Total return in USD is 1 July 2007.
[5] Calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio – MFG defined sectors.
[6] The data is based on a representative portfolio for the strategy. Refer to end of document for further information.
* Returns are only for part year.

Market Commentary

Global equity markets were dominated by cautious sentiment. European and US markets moved sideways for most of the quarter before dropping in late June, reflecting the escalation of the Greek sovereign debt crisis once again and uncertainty on the timing of the first interest rate increase by the Federal Reserve ("Fed"). Meanwhile, speculation on an equity bubble in China persists. Chinese stocks reached all-time highs early in June before plunging nearly 20% in the last week of the quarter.

In Europe, economic growth remains weak (~1% real GDP growth since March 2014). QE appears to be reducing deflationary risks and the Eurozone is benefitting from a weaker currency, a stronger US economy, lower oil prices and a gradual improvement in credit conditions. Despite this, high debt levels, political and economic impediments as well as the sovereign debt crisis in Greece will likely continue to dampen any meaningful recovery. Greece recently defaulted on a €1.6b payment due to the IMF and was forced to impose severe capital controls on its banks after its bailout package expired at the end of June. Greece and the Eurozone countries reached agreement (subject to parliamentary approval) on a new bailout deal to keep its banks solvent and avoid an exit from the Eurozone. The terms of the new bailout deal are harsh and do not yet address the sustainability of Greece's debt burden. In our view, the Greek sovereign debt crisis has not been solved with this new bailout, but the near term 'Grexit' risks appear to have been averted. In China, economic growth continues to slow. While significant policy effort is focused on positive reform to capital flows and access, as well as internationalisation efforts, risks remains centred on the property market and shadow banking system.

In the United States, recent data generally suggests an ongoing economic strengthening, though some indicators remain weak partly reflecting transitory issues around weather and the West Coast ports dispute. Further, capital investment was affected by the fall in oil prices and reduced investments in this sector.

Today, we believe there is a great disagreement as to where US monetary policy is headed over the next few years. The Fed is anticipating a normalisation of the US economy and higher interest rates, whereas the market is pricing secular stagnation with prolonged low inflation and economic growth (and lower interest rates). If the Fed is right, this could lead to a major market correction translating into material losses for investors. As a consequence, we remain focused on prudent portfolio construction and have increased the cash weighting of the Strategy to approximately 15%. This should act as a partial hedge against equity market volatility should interest rates increase.

Strategy Commentary

As of 30 June 2015, the Strategy consisted of investments in 24 companies, compared to 26 investments at 31 March 2015. The top ten investments represented 51.6% of the Strategy on 30 June 2015, while they represented 50.6% of the Strategy on 31 March 2015. The cash position was 15.6% compared with 13.9% at the end of the prior quarter.

YUM! Brands was the Strategy's top contributor over the quarter. The company reported better than expected earnings for the first quarter of 2015. KFC is getting traction from its brand renewal efforts while Taco Bell is demonstrating continued strong execution. In addition, the stock jumped after well regarded activist investors disclosed a material position in the company. It also benefited from market speculation on a possible spin-off of its China business. Microsoft was another strong performer after the company announced results exceeding market expectations. Microsoft's software and cloud businesses continue to grow strongly and it will likely retain pole position in the software industry post cloud transition.

Lloyds reported strong Q1 earnings of £1.6 billion, 8% ahead of consensus driven by a higher net interest margin. At the same time, management upgraded its guidance for 2015 as it anticipates stronger capital generation and lower credit costs. In addition, political risk was alleviated with the election win by the conservatives. Lloyds' efforts to return to a simple banking model and refocus on its UK retail business are starting to bear fruit. Likewise in the financials, State Street contributed positively to performance as did payment processing companies eBay (via Paypal) and MasterCard.

Lowe's, the US home improvement company was the largest detractor after its first quarter earnings fell short of estimates (70 cents a share versus 74 cents). Despite the recent noise, we expect the company to continue to benefit from the US housing market recovery in the medium term. Elsewhere, Tesco's share price was down over the quarter after the UK retailer reported a historic loss of £6.4 billion (including £6.6 billion of one-offs.

Key Stock in Focus - IBM

IBM is the largest enterprise technology provider in the world, generating approximately $93 billion of revenue in 2014. It is among the largest vendors of datacentre hardware in the world, it is the third largest software vendor globally, and the largest Information Technology ("IT") services vendor. 90% of its earnings are sourced from software and services (48% and 40% of earnings, respectively), with the remainder of its earnings attributable to hardware, and a complementary financing business. However, whilst only a small portion of IBM's earnings are directly attributable to hardware, we estimate that a material portion of its software and services earnings are related to mainframe computers.

Favourable industry structure

Many of the market segments in which IBM competes are characterized by significant barriers to entry and switching costs that have historically allowed incumbent vendors to generate returns in excess of their cost of capital. However, IBM is differentiated from other incumbent IT vendors by its monopoly in mainframes in particular.

Mainframes are proprietary, large-scale computers, bundled with IBM software, which have handled many enterprises' most mission-critical workloads since the early 1950s. According to IBM, 70% of the world's business data is managed by mainframe computers. It says that 71% of Fortune 500 companies run IBM mainframes, including 92 of the top 100 banks globally, 10 of the 10 largest insurers, 6 of the top 10 global retailers, and 23 of the 25 largest airlines globally.

Mainframe is effectively a monopoly business for IBM, with significant barriers to entry, because IBM has refined and integrated mainframe hardware and software over decades. While alternative server and software technologies have been developed since mainframes were introduced in the early 1950s, they have struggled to match the reliability, availability, and security of the mainframe.

Mainframe switching costs are also high. Legacy mainframe applications were typically written for specific compatibility with the mainframe platform. Enterprises that are interested in migrating workloads from mainframes to another server architecture may be required to rewrite complex mainframe software, in which they have made significant investments over decades. Mainframe migrations may be multi-billion dollar undertakings. In addition, mainframes typically support only the most mission-critical workloads; non-core processes that could economically be shifted from mainframes to cheaper servers were migrated in the 1990s and early 2000s. There is material transition risk inherent in migrating these mission-critical workloads.

IBM's non-mainframe software and services businesses also benefit from the existence of barriers to entry and switching costs. For example, IBM's middleware software products are part of the plumbing of enterprise IT systems, and are typically integrated with other software programs, rendering them difficult and costly to replace. Similarly, IBM has a distinct advantage competing for large IT outsourcing contracts, according to which it operates datacentres for large enterprise clients. These engagements typically have a multi-year term, and tend to be sticky.

Defensive business model

A significant portion of IBM's revenue and earnings is recurring in nature. IBM says that 70% of software revenue is annuity-based, and attributable to recurring mainframe software and support contracts. Similarly, a material portion of IBM's services revenue is sourced from multi-year outsourcing contracts. In aggregate, IBM says that approximately 60% of its revenue, and 75% of its segmental pre-tax profit is recurring in nature. Its financials are consequently relatively insulated from adverse shocks.

Risks and valuation

With a material portion of its earnings tied to legacy technologies, IBM is exposed to technology risk. IBM's Power server business is contracting, owing to the shift to the cloud and competition from commodity servers. Its software business is also contracting, which it says is attributable to its decision to grant customers increased "flexibility" in how they deploy its software products. It faces secular challenges in services, owing to customers' desire to break-up large outsourcing contracts among multiple vendors, and deploy workloads in the cloud. Its stock is broadly out of favour with the market.

However, IBM is making progress restructuring its business, divesting low value businesses such as its commodity server business, and focusing instead on its "strategic imperatives", including cloud, analytics, mobile, and social. Its strategic imperatives accounted for 27% of its revenue in 2014, and grew at an average rate of 19-20% between 2010 and 2014. While we do not anticipate that IBM's growth will reaccelerate, we believe that its businesses is of a high quality, and that investors are being more than fairly compensated for technology risk at the current share price.

IMPORTANT NOTICE