MFG Global Equity

Key Facts

Portfolio Manager	Hamish Douglass
Strategy Inception Date	1 July 2007
Total Global Assets[1]	USD $28,610.0 million
Total Strategy Assets	USD $24,518.8 million

Objective	Approach
Capital preservation in adverse markets	High conviction (20-40 securities), high quality focus
Pre-fee return of 10% p.a. through the economic cycle	Dual-sleeve portfolio construction with dynamic allocation to cash (max 20%)
	Relative volatility cap of 0.8^

USD Performance[2]

	Composite (Gross)	Composite (Net)[3]	MSCI World NTR Index	MSCI World Qual. Mix NTR	MSCI Min. Vol. NTR
3 Months (%)	0.7	0.5	1.9	0.6	-2.7
6 Months (%)	7.0	6.5	6.8	4.0	-3.6
1 Year (%)	4.7	3.9	7.5	7.9	7.5
3 Years (% p.a.)	5.2	4.3	3.8	5.6	8.0
5 Years (% p.a.)	13.1	12.2	10.4	10.6	10.0
7 Years (% p.a.)	13.7	12.8	8.2	9.3	9.9
Since Inception (% p.a.)[4]	10.9	10.0	3.1	4.7	5.1

	Composite (Gross)	Composite (Net)[3]	MSCI World NTR Index	MSCI World Qual. Mix NTR	MSCI Min. Vol. NTR
2007 (%)*	0.0	-0.4	-0.1	1.0	1.0
2008 (%)	-21.6	-22.3	-40.7	-35.4	-29.7
2009 (%)	39.4	38.3	30.0	27.7	16.4
2010 (%)	18.3	17.4	11.8	11.4	12.0
2011 (%)	11.9	11.0	-5.5	0.7	7.3
2012 (%)	21.6	20.7	15.8	13.0	8.1
2013 (%)	30.8	29.8	26.7	24.5	18.6
2014 (%)	6.6	5.7	4.9	7.3	11.4
2015 (%)	4.2	3.4	-0.9	1.6	5.2
2016 (%)	4.7	3.9	7.5	7.9	7.5

Top 10 Holdings[5]

	Sector	%
Apple Inc	Information Technology	6.6
Alphabet Inc	Internet & eCommerce	4.9
Visa Inc	Payments	4.8
Lowe's Co Inc	Consumer Discretionary	4.7
Microsoft Corp	Information Technology	4.6
Wells Fargo & Co	Financials	4.6
eBay Inc	Internet & eCommerce	3.8
CVS Health Corp	Health Care	3.7
McDonald's Corp	Consumer Defensive	3.5
Oracle Corp	Information Technology	3.5
	TOTAL:	44.7

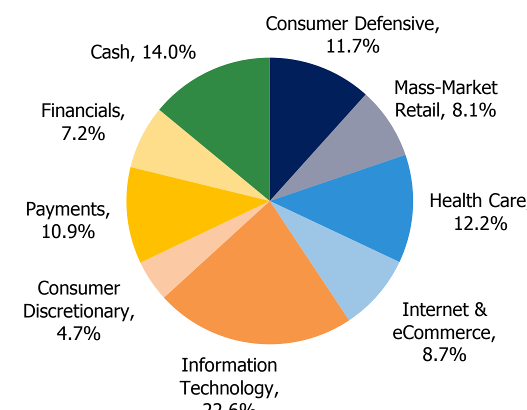
Strategy Fundamentals

	Strategy[5]	Index[4]
Number of Holdings	27	1,654
Return on Equity	23	14
P/E Ratio (1 year forward)	16.1	16.3
Interest Cover	18	9
Debt/Equity Ratio	24	52
Active Share	82	n/a
Weighted Average Market Cap (USD million)	171,693	n/a

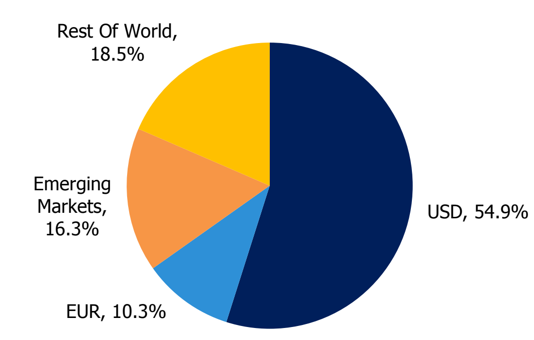
USD Risk Measures

Risk Measures	3 Years	5 Years	Since Inception[4]
Upside Capture	0.9	1.0	0.9
Downside Capture	0.8	0.7	0.6
Beta	0.9	0.8	0.7
Information Ratio	0.3	0.5	1.1
Tracking Error (% p.a.)	4.2%	5.0%	7.1%
Standard Deviation – Strategy	10.2%	9.8%	13.8%
Standard Deviation – Index	10.9%	11.1%	16.8%
Worst Drawdown – Strategy	-7.3%	-7.3%	-36.0%
Worst Drawdown – Index	-12.0%	-12.0%	-54.0%
Turnover[5]	27.7%	22.0%	16.2%

Industry Exposure by Source of Revenue[5 6]



Geographical Exposure by Source of Revenue[5 6]



[1] Comprised of all Global strategies.
[2] Returns are for the Global Equity Composite and denoted in USD. Performance would vary if returns were denominated in a currency other than USD. Refer to the GIPS Disclosure section at the end of this document for further information.
[3] Composite (Net) returns are net of fees charged to clients and have been reduced by the amount of the highest fee charged to any client employing that strategy during the period under consideration. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Fees are available upon request.
[4] The inception date of the Composite and the Index, the MSCI World NTR Index is 01 July 2007.
* Returns are only for part year.
[5] The data is based on a representative portfolio for the strategy. Refer to the end of the document for further information.
[6] Calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio – MFG Asset Management defined sectors.
^ Weighted average 3-5 year beta against MSCI World NTR Index.

Market Commentary

The December quarter commenced with divergent performance across the major equity markets in October in response to US corporate earnings data, currency fluctuations and increasing market expectations of a December interest rate hike by the US Federal Reserve (Fed). Equity markets were also significantly influenced by political developments during the period, primarily in relation to the US election and the Italian constitutional referendum. The Trump/Republican win pushed US bond yields higher as markets priced in a steeper rate rise trajectory by the Fed and consensus grew that expansionary economic policies will be implemented. Sentiment shifted towards growth-oriented sectors which are perceived beneficiaries of Trump's policy agenda of corporate and individual tax cuts along with increased spending on infrastructure and defence. Against a backdrop of continuing positive trends in key economic indicators, the US equity market continued to perform well and the US dollar appreciated to a 14-year high in December.

The euro weakened for the quarter, while most major European bourses staged a strong rally following the Italian constitutional referendum in early December to end the quarter at or near their high point for the year. Italy's stock market was the best performer of this group, rising by more than 20% over the quarter, however earlier losses preceding the fourth quarter meant the Italian market finished 2016 largely unchanged from the beginning of the year. Concerns have been escalating over the country's banking system, which has amassed large concentrations of non-performing loans, discussed in detail below. In December the Italian Government announced a €20 billion bailout fund to support the banking system. Despite the nominal gains achieved in European equities, falls in the euro and British pound against the US dollar limited, or in some cases, negated these gains for investors domiciled outside of these currencies.

There was significant dispersion at a sector level for the quarter, with advances led by the financials, industrials, energy and materials sectors which are perceived as beneficiaries of the prospective growth-oriented environment. Energy was the standout sectoral performer, aided by a stabilising oil price and OPECs decision to cut crude oil output for the first time since 2008. Higher growth and inflation expectations have fuelled expectations for interest rate increases and consequently, bond proxies such as utilities, consumer staples and real estate exhibited weakness.

Strategy Commentary

As of 31 December 2016, the Strategy held investments in 26 companies, compared with 25 companies held as at 30 September 2016. The top ten investments represented 44.7% of the Strategy on 31 December 2016, while they represented 47.7% of the Strategy as at 30 September 2016. The cash position has declined to 14.0% as at 31 December 2016 from 15.9% at the end of September.

During the period, investments in Wells Fargo, Microsoft, Apple and Target were among the largest contributors to performance.

Wells Fargo was the largest contributor to performance for the period. Wells Fargo's share price benefitted primarily from increasing market expectations for US interest rate rises during the quarter, particularly following the US election and expectations that the Trump/Republican administration will implement expansionary policies. Higher interest rates will improve Wells Fargo's revenue outlook. Additionally, Wells Fargo's share price was depressed at the beginning of the quarter following the cross-selling scandal that broke earlier in September.

Microsoft has continued to perform well following another strong earnings result which exceeded its guidance targets and consensus estimates. The result featured continued revenue growth within its Productivity and Intelligent Cloud businesses with only a modest contraction in revenues from its Personal Computing segment. Microsoft continued to register gains in December, reflecting support for the technology sector. Apple was another key contributor after the stock posted strong gains through the second half of the period. Apple's latest quarterly earnings result was overshadowed by a 9% fall in quarterly sales, which was broadly in line with guidance. However, the company reported continued growth in its installed base of users and positive indications from its upgrade programs following the recent release of the iPhone 7 and 7 Plus phones.

Target's share price rallied following a stronger than anticipated earnings result, with earnings per share 26% higher than consensus estimates. The result featured strong growth in digital sales and positive observations on traffic trends which has remained a key focus for management, along with efforts to position the grocery business to drive medium-term growth.

The main detractors from performance were eBay, CVS Health and Novartis. eBay's share price declined following the release of its latest earnings result, despite being ahead of consensus expectations. The company is continuing to invest to improve its platform and drive future gross merchandise value (GMV) growth. The multi-year timeframe required for the additional spending means benefits to the business will take longer to accrue. CVS Health registered a weak performance following its recent earnings update, where management cut its full-year earnings expectations due to volume losses at its retail pharmacy. Novartis' share price reflected weakness in the health care sector associated with the US election and implications for pharmaceuticals.

Investment strategy update

We remain cautious about the outlook for equity markets over the next few years, given the environment of abnormally low interest rates, historically elevated price-earnings multiples, risks associated with the recapitalisation of the Italian banking system and the continued withdrawal of US monetary policy stimulus. Notwithstanding the current macroeconomic uncertainty, we retain confidence in the quality and long-term outlook for our investments and are comfortable with the Strategy's overall risk profile and construction.

Consistent with the stance held over the past two years, we retain a large weight in cash to preserve capital and continue to apply a consistent approach to selecting high quality companies that are well positioned to deliver satisfactory returns over the long term. Many of these companies are structurally advantaged through their exposure to the following major investment themes that are prevalent within our global equity strategies:

- **Consumer technology platforms**: The leading digital platforms have tremendous opportunities to monetise new services and products (even when they are not the originator). With high switching costs and barriers to entry, their entrenched positions are unlikely to be challenged in the foreseeable future.
- **Enterprise software**: Established enterprise software vendors benefit from their incumbency. They typically operate in concentrated markets with high barriers to entry, network effects, and high switching costs. The shift to cloud computing presents a significant opportunity for leading vendors to expand their addressable markets and win a greater share of total enterprise IT expenditure.
- **Health care and ageing population dynamics**: The health care sector has attractive growth tailwinds due to rising patient volumes, increasing expenditure and large unmet healthcare needs.
- **The move to a cashless society**: There continues to be a strong secular shift from spending via cash and cheque to cashless forms of payments, such a credit cards, debit cards, electronic funds transfer and mobile payments. The explosion of smart and internet connected devices will accelerate this shift on a global basis.

Market risk update

Interest rates

Since the election of Donald Trump as the next President of the United States, 10-year US Treasury yields have increased approximately 70 basis points (bps), the largest increase since the "taper tantrum" of mid-2013, to around 2.5% - the level at which they traded 12-18 months ago. In response, the trade-weighted US dollar increased around 5%, while interest rate sensitive equities have been re-priced. In the month post the election, the S&P500 Financials index increased by around 18%, while bond proxies such as the utilities and consumer staples sectors fell by around 4% and 3%, respectively. Rising bond yields reflect market expectations of reform and fiscal stimulus and a hastened exit from ultra-stimulatory monetary policies. Notwithstanding recent market moves in interest rates, we continue to believe that asset prices broadly reflect a distorted reality, and expect further re-pricings as interest rates normalise.

In our view there are two phases for interest rates that are relevant to investors. Over the next five years we expect to see rising interest rates, as central banks withdraw their extraordinary monetary policy stimulus. Looking out a further 10 years, rates may decline again as technological disruption, including dramatic advances in artificial intelligence, generate structurally lower inflation pressures.

We have previously written about the dangers of quantitative tightening, which is likely to play out over the next five years. The issue is whether asset prices predominantly reflect the current economic reality, or whether they are being significantly distorted by the extraordinary monetary policy (including asset buying) and foreign exchange policies of the G7 central banks[1]. As central bank asset purchases diminish over the coming years there is the potential for material declines in some asset prices.

A key reason that asset prices remain elevated is the ongoing quantitative easing programmes of the European Central Bank (ECB), Bank of Japan and Bank of England (approximately US$130 billion per month combined), and the fact that the Fed has not yet started shrinking its balance sheet.

The politics and economics of Europe will likely have a key influence on the direction of global monetary policy and currencies over the next few years. Indeed, a number of important elections are taking place in the eurozone in 2017, including France, Germany and possibly also Italy. While anti-establishment parties could perform strongly, we believe there is a very low probability of a catastrophic market event where a country leaves the eurozone. Nonetheless, political instability in Europe could lead to a delay in monetary policy normalisation in the US, given the interconnectedness of global capital markets.

There are some commentators who believe that the central banks will need to implement even more aggressive forms of monetary policy, such as the monetisation of government debt or a helicopter drop[2] of printed money in order to induce inflation. Such policies are almost certain to create inflation via the devaluation of money. If such policies were to be implemented, interest rates would almost certainly need to rise in response to rising inflation. While we are unable to handicap whether central banks will go down this path (although we do not believe it is likely in the US or Europe), we would caution investors about the medium-term impact on asset prices of such action. Initially, investors may react euphorically to more monetary stimulus; however, asset prices will eventually react to the prospects of rising inflation and interest rates. While we continue to believe that it is more probable than not that the Fed will tighten monetary policy over the next few years, we have moderated our expectations on the extent of the likely rise in longer term bond yields over the next three to five years. It is prudent to remain cautious in this environment.

Longer term, we need to ask what will be the impact of technological disruption on the risk free rate. Are we going to eventually see massive productivity gains and deflationary forces through huge enhancements in technology, particularly artificial intelligence? How will these changes impact different business models and over the very long term, how will this affect the valuation of assets and interest rates?

Recapitalisation of the Italian banking system

It has been estimated that the Italian banking system is holding around €360 billion of non-performing loans and if banks were required to write down these loans to current market values the Italian banking system could be required to raise up to €40 billion of new capital. The issue is that the most vulnerable banks are not able to raise new capital and while the Italian government has recently created a €20 billion bailout fund for its troubled banks, under European Union (EU) rules they are not able to provide financial assistance unless a bank's shareholders and creditors bear losses equivalent to 8% of the bank's liabilities. Critically, the junior debt, which is first in line to be "bailed-in" is largely held by retail investors. The risk is thus that a large bail-in of retail bonds could trigger a widespread depositors run on the Italian banks.

The Italian Government is currently in negotiations with Brussels about the extent of losses that must be forced upon the holders of junior debt as part of a recapitalisation of the banking system, involving aid from the Italian Government. There may well be more market volatility ahead, depending on the outcome of these negotiations. The resignation of Prime Minister Matteo Renzi in the aftermath of the failed constitutional referendum could complicate the process of finding a resolution to Italy's banking system problems, with the possibility of an early election and increasing power for anti-establishment parties such as the Five Star Movement leading to further political instability. However ironically, the defeat of

the referendum reinforces gridlock in the Italian political system and makes it harder for anti-establishment forces to take Italy out of the Eurozone, lowering the probability of this tail risk. We thus continue to consider an exit from the EU by Italy to be a very low probability event.

The election of Trump
We are fairly relaxed about the advent of a Trump administration for our investment portfolio. Trump's economic policies such as tax cuts and spending on infrastructure and defence are broadly stimulatory, so there is likely to be some upward pressure on growth, inflation and interest rates in the medium term, which has been priced by bond markets. However, there are potentially conflicting policy objectives between Trump and Congressional Republicans' who tend to want 'smaller government' and reduced Federal debt, which creates some policy uncertainty. Republican control of the Senate, the House of Representatives and the White House should reduce policy gridlock in Washington DC.

Nonetheless, we expect the near term to bring bouts of elevated market volatility, as markets do not like surprises and there remains great uncertainty on the actual policy platform that Trump, and the majority Republicans in Congress, will seek to enact.

The most material risk from a Trump administration, while low probability in our view, comes from trade and foreign policy. Trump's 'fair-trade' platform focuses on much more favourable outcomes for the US within its free trade agreements and holding China accountable for alleged unfair trade practices. In the event of a low probability 'trade war' scenario, some businesses with operations and/or large markets in China or Mexico could be adversely affected. Apple is one such example.

As we stated heading into the election, and have discussed at length, we continue to believe that there are other macro issues which are more important than the US election for markets and our portfolio, including:

- Risks associated with monetary policy and the massive distortions in fixed income markets caused by central banks
- European political risks, particularly the rise of euro-sceptic parties, and the Italian banking system
- China's financial system risks

[1] US Federal Reserve, European Central Bank, Bank of Japan, Bank of England, People's Bank of China, Saudi Arabian Monetary Agency, Swiss National Bank.
[2] A term coined by Milton Friedman in 1969 that describes the printing of money by a central bank, which is then distributed to households to spend as they wish. This would stimulate aggregate demand, as well as debase the currency, since there would be more money chasing the same goods and services.

Global economic update

Our views on the world's largest economic zones have not changed materially since our last update. Our base-case outlook for the next three years assumes a continued recovery in the US with modestly rising inflation, a continued slowdown in China (but not a financial crisis or hard landing) and an improvement in the economic outlook for Europe.

United States
A range of economic indicators show that the US economy continues to recover, albeit with some headwinds.

The US is driven by households, with consumption comprising around 69% of US gross domestic product (GDP). The household sector has been buoyed by strengthening labour markets, rising house prices, lower debt, falling commodity prices, a strengthening US dollar and low interest rates. Average weekly earnings increased by 2.2% over the year to November 2016 and the number of people employed is now 152 million – over five million more than the previous peak in November 2007. Higher goods and services consumption by households is supporting a growing corporate sector and rising corporate profits. As household formation returns to normal, we expect housing starts to grow further to at least 1.3-1.4 million per annum, this being our estimate of normalised demand. Improvements in the household and corporate sectors are flowing through to the banking sector, with total loans and leases outstanding increasing by 7.7% per annum and notably, commercial and industrial loans increasing by 8.8% over the year to November 2016.

The government sector's drag on the economy has abated. The Congressional Budget Office forecasts the federal deficit to remain fairly stable at 2.5-3.0% of GDP over the next few years. While the fiscal policy implications of the incoming Trump administration remain uncertain, additional short term stimulus appears likely.

Although the US economy is facing some headwinds, most are likely to be transitory. Headwinds include the impact of a stronger US dollar and a weaker global economy on trade-exposed industries, a contraction in energy sector activity, and weakness in industries and regions reliant on oil and gas production and investment. Despite the challenge of the rising US dollar, the US is a predominantly domestically driven economy, with a relatively low reliance on exports (which account for approximately 12% of GDP).

Tighter labour markets will lead to faster growth in real wages and potentially lower profit margins for businesses that lack pricing power. Meanwhile, scope remains for further job creation due to underemployment and the cyclically depressed participation rate. The 'U6' unemployment rate, which includes part-time workers who want a full-time job and those marginally attached to the labour force, has been falling steadily since the global financial crisis (GFC) but remains elevated at 9.3%[3]. The U6 has fallen to 8% or lower in previous cycles. Furthermore, the proportion of 25-54-year olds in the labour force has fallen from just over 83% before the crisis, to 81.5% as at November 2016.

Several transitory factors have been keeping inflation below the Fed's 2% target. However, as the oil price bottoms out, the US dollar stabilises and the labour market continues to tighten, wage growth and inflation pressures are likely to normalise. Consistent with previous cycles, this will require the Fed to progressively tighten monetary policy towards the long-run neutral Fed Funds rate, which is probably around 3%.

Overall, we expect the US economy to continue along its path of a steady recovery over the next few years, barring unforeseen events.

Eurozone
Real GDP growth in the eurozone remained modest at around 1.7% p.a. over the year to September 2016. A number of the periphery economies are continuing on their recovery path. Spain and Ireland's annual growth rates remained strong at 3.2% and 6.6% p.a. respectively, while Greece recorded its highest rate of annual growth since mid-2008 of 1.6% p.a. However, we remain cautious about risks from Italy's ongoing

economic malaise, undercapitalised banking system, tightening credit conditions and political uncertainty.

The eurozone as a whole is likely to continue benefiting from a weaker currency, a stronger US economy, lower commodity prices, and an improvement in borrowing conditions and credit flows in an environment of ultra-low interest rates. However, the pace of eurozone growth is likely to remain modest for the foreseeable future as high levels of government debt, unresolved banking system issues, political uncertainty, and poor demographics hold back the economy.

Labour markets are gradually recovering in the eurozone, although considerable slack remains. Over the year to September 2016, aggregate employment increased by 2.1 million to reach 153.2 million, but remains below the pre-GFC peak of 154.4 million. The aggregate unemployment rate has fallen from 12.1% in June 2013 to 9.8% in October 2016. Although the improvement in Eurozone labour markets has been broad-based, Italy's unemployment rate is little changed in the past year and remains elevated at 11.6% in October 2016. While relative wage cost competitiveness of periphery economies is gradually improving, such internal devaluation is proving to be a painful mode of adjustment.

The rise of euro-sceptic political parties in a number of eurozone countries reflects a long period of adjustment following deep recessions and accompanying high levels of unemployment, which has created difficult policy choices for governments. These parties often threaten an exit from the eurozone (and a dispensing of the euro as currency) and/or debt defaults, which could spark renewed uncertainty in sovereign debt markets. When considering political risks, it is important to distinguish between the nine nations that are members of only the EU, and the 19 nations that are members of both the EU and the eurozone (whose currency is the euro). There is no existing legal mechanism for a country to leave the eurozone, and an exit by a country would be extremely problematic and have far more material systemic implications than a country seeking to leave the EU, such as with Brexit. We place a very low probability on such a scenario.

Nonetheless, the eurozone remains vulnerable to major shocks, such as an escalation of geopolitical tensions with Russia, the election of euro-sceptic parties into government or an Italian banking system crisis. Each of these scenarios could trigger a dramatic uplift in periphery eurozone sovereign bond yields, and would heavily test the resolve and mandate of the ECB.

Overall, we expect a continuing gradual recovery in the eurozone, but remain cautious about material downside risks.

China

While we remain concerned about the short- to medium-term outlook for China, we do not believe that China is about to have a financial crisis or experience a hard economic landing.

China's rapid economic growth in recent years has been unsustainable. When demand for Chinese manufacturing exports deteriorated in the GFC, China launched the largest credit stimulus in history, fuelling an investment boom that continues today. From 2008-2013, China's state-owned banks issued new credit totalling US$10 trillion, equivalent to the entire US banking system. Although credit growth has slowed, it continues at around 13-15% per annum. The source of credit expansion has recently shifted from companies to households, reflecting policy shifts to support consumption and demand for new home loans from households, which accounted for 73% of all bank lending in Q3 2016. The problem is that GDP benefits from new loans have fallen from around 75 cents per dollar of loan to just 20 cents. Currently, it is estimated that US$1.3 trillion in corporate loans are owed by Chinese companies whose profits aren't sufficient to cover interest payments, which suggests potential bank losses of around 7% of GDP (excluding shadow banking exposures).

Almost half of China's credit growth since the GFC (or around 50% of GDP) may have gone towards financing property market activity. There appears to be approximately four years of excess housing supply in China, comparable to recent property booms in the US, Spain and Ireland. According to the China Household Finance Survey, 22% of urban housing in China is vacant. Meanwhile, vacant floor space on developers' books has increased by around 500% since 2007. Property prices are growing rapidly in Tier 1 cities with supply shortages, however this is not the case in lower-tier cities where most of the excess supply is located.

The potential implications of China's property oversupply are serious. Real estate and related industries account for 20-25% of China's GDP. Fiscal positions are vulnerable, particularly for local governments who have relied on land sales for 35-40% of revenues. A large contraction in China's property construction sector would cause a major slowdown in the economy and perhaps even a recession.

Although economic data out of China is problematic, a range of indicators suggest that China's economy is slowing as the housing oversupply problem broadens. Weakness is most apparent in the industrial space (41% of GDP), a large portion of which is linked to property. Cement production expanded slightly by 1.3% per annum in the last 12 months, compared to 11% growth per annum in the decade prior. Steel production and electricity production grew at a modest pace while freight traffic contracted substantially in the past year. Although industrial sector data showed signs of improvement in early 2016, we believe this is due to a temporary credit impulse by the Chinese Government and households speculating on the property market. Real trade data also shows that both import and export growth has slowed significantly.

Since 2010 China has contributed around a quarter of total global economic growth, despite its economy only representing around 12% of world GDP. We are cautious about adverse knock-on effects, including currency movements, linked to changing economic fortunes in China. A number of commodity exporters such as Russia, Brazil, Australia and Canada have experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. Russia and Brazil have experienced deep recessions. These economies may still be vulnerable to the unwinding of commodities-linked domestic credit booms. Other Asian economies with strong trade and financial linkages to China could also be at risk.

The outlook for the Chinese renminbi, which has appreciated around 45% on a real trade-weighted basis since 2005, is uncertain and difficult to predict. While continued RMB depreciation is likely due to capital outflow pressures and rising wages, a large devaluation is less likely. In 2016, China introduced new and tighter capital controls that appeared to temporarily stem capital outflows and stabilise the renminbi. However, in recent months there have been renewed signs of capital outflows, a decline in foreign exchange reserves and a resumption of renminbi depreciation.

Chinese policymakers must carefully manage the credit and property excesses in its economy. If China moves too quickly to address the moral hazard and implicit government guarantees in its financial system, this could lead to a tightening of credit conditions and a pullback in loan demand from the private sector, triggering an economic downturn and possibly a panic in the poorly regulated shadow banking system. On the other hand, if credit stimulus continues unchecked or is ramped up to maintain GDP growth rates, returns to new credit may diminish further and result in material loan losses in the future.

The Chinese leadership appear to be aware of the problems and have the policy tools needed to stabilise the economy. This makes a financial crisis unlikely. Fortunately, most of China's debt is held domestically, which makes it easier for the Government to manage large-scale defaults as it did in the late 1990s. Further monetary stimulus will almost certainly be deployed to reduce interest burdens and ease banks' reserve requirements. Meanwhile, a huge pool of foreign exchange reserves and a large current account surplus make China resilient to external financial shocks.

[3] Marginally attached to the labour force are those who currently are neither working nor looking for work, but indicate that they want and are available for a job, and have looked for work sometime in the past 12 months.

Key Stock in Focus - Yum! Brands Inc.

Yum! Brands develops, operates, franchises and licenses a worldwide system of nearly 43,000 restaurants under the brands of KFC, Pizza Hut and Taco Bell – each respectively a global leader in chicken, pizza and Mexican-style food categories. Yum! Brands has been a strong performer within the restaurants and leisure industry in recent years, delivering double-digit growth in core operating profits while expanding its number of restaurants by over 2,000 each year. KFC represents the largest of these businesses, accounting for nearly half of the group's operating profit.

Yum! Brands – business profile

Number of outlets	15,449	16,063	6,407
Number of countries/ territories	125	95	21

Yum! Brands was formed in 1997, initially under the name of Tricon Global Restaurants, Inc. which was spun out of PepsiCo's fast food division later that year. In 2002 the company changed its name to Yum! Brands and set the company on a path of international expansion. The following decade saw significant growth, expanding its KFC and Pizza Hut operations in emerging markets with a particular focus on China. Yum! Brands is the dominant quick service restaurant (QSR) operator in the country and KFC is a leading brand with deep customer recognition. The opportunity in China is immense and Yum! Brands executed superbly under strong local leadership, garnering itself a significant lead in this market and building an incredible operation with over 5,000 restaurants that generated operating profits of over US$1 billion in China alone by 2012. This was without precedent for a western consumer company. In the years since then, the Group's China operation had a difficult period as food safety issues inside China heavily impacted restaurant sales and the company is still rebuilding from this setback.

In November 2016, YUM undertook a transformative move, separating its operation in China into a new listed entity, Yum China Holdings Ltd (NYSE: YUMC) and distributing these shares to Yum! Brands' shareholders. Shares are held in these two companies in the Strategy; the parent franchisor Yum! Brands (YUM), with a market capitalisation of approximately US$23 billion, and YUMC, its China franchisee, with an approximate US$10 billion market capitalisation.

The new company, YUMC, has exclusive rights to KFC, Pizza Hut and Taco Bell brands in Mainland China and pays YUM a royalty of 3% of restaurant sales for their use and for access to the global know-how, innovation and marketing/ brand support. YUMC also owns the local restaurant brands Little Sheep and East Dawning, which diversify YUMC's restaurant offering to localised cuisines though they remain immaterial at present. Little Sheep operates a hot pot meals concept throughout its 255 outlets and East Dawning represents a Chinese food QSR category offering.

Today YUMC operates over 7,300 restaurants in 1,100 cities and employs over 400,000 people in China. YUMC has commenced in a very strong capital position, holding almost US$1 billion in net cash to self-fund strong ongoing expansion plans. The long-term aim remains to triple its restaurant count in China. We are focussing hereafter on the parent company, YUM.

Are two companies better than one?

While in our view, the underlying fundamental value of YUM is unchanged irrespective of whether it trades as one company or two, we believe the transaction will prove to be extremely positive for shareholders as we move forward. It achieves two things: it separates two quite different investments, allowing investors to choose that which suits their strategy; and it focuses the management teams on the specific opportunity for each business. In the case of YUM, management will now dedicate immense focus on building up and sustaining the three brands and supporting its franchisees in taking these brands to the world's consuming class. This focus finds its expression in strong marketing, advertising, product development and innovation, driven by consumer insights with menus adapted for local cultures.

From a financial perspective, the separation sees Yum! Brands become an asset light, high returning global franchisor of these brands. Thus, the sales generated by franchised stores are recorded by the franchisee and YUM's revenues reflect a royalty stream on those sales. Similarly, the operating costs of the restaurants, and capital investment in building and renovating stores, is borne by franchisees. YUM's cost base reflects a support network of people who work with franchisees to create excitement and customer engagement in the brands, helping to drive sales. The outcome is a company with low earnings volatility, low operational risk, high returns (as it needs little capital itself) and a growth opportunity that extends beyond the decade. For perspective, YUM sees room to grow each of its brands three-fold; to approach 60,000 KFC restaurants,

50,000 Pizza Hut outlets and 20,000 Taco Bells. (McDonalds has over 36,000 restaurants globally today).

When we consider that YUM has already established itself as the global leader in emerging markets, yet its penetration in these economies is multiples less than that of mature markets like Australia and the US, the global store rollout opportunity is immense. For instance, in China, despite having a more than a 2:1 lead over the next largest restaurant chain (McDonalds), KFC has four restaurants per million people. In Australia, this number is 45 restaurants per million people. Chinese household wealth has grown at 10% p.a. for the past decade and government policy is aggressively focussed on continuing to lift wealth levels and opportunity for its people. Retail sales are growing at over 10% p.a. Similar examples of expansion opportunity exist for these brands in Malaysia, Thailand, Indonesia, Russia, India and many other regional markets.

We are not ignoring the risks around execution, but we note that by separating Yum! Brands into a China business and a parent franchisor, Yum! Brands' risk profile has improved. If YUMC suffers ongoing volatility in sales at its KFC and Pizza Hut stores, this no longer has a material impact on the parent's operating income. The changed risk profile has also meant that Yum! Brands could access debt markets over the past year and has aggressively geared up its balance sheet to a target of 5x net debt/EBITDA while lowering its average debt cost. This level of leverage is consistent with similar heavily franchised peers and YUM passed these proceeds through to shareholders via aggressive share repurchase activity.

Over the next five years, YUM expects to achieve strong growth as it hones its consumer insight driven marketing and works with franchisees to take its brands to more and more consumers. It aims to compound the size of its system at a rate of 7% p.a. (through new and existing units), own just 2% of its estate with the rest operated by franchisees, and almost double its earnings per share (EPS). EPS will be driven by both strong earnings and reducing the share count via repurchases as it holds leverage and returns over 100% of free cash flow to shareholders. Ultimately, with an ongoing progressive dividend, YUM anticipates delivering an annual return of 15% p.a. However, our internal expectations are tempered by foreign currency translation, the risks around execution of the strategy and timeframe for improving the brand positioning in some core markets. Thus, we are slightly more reticent on the pace of sales growth in existing stores in many markets, especially where consumers are still somewhat challenged and/or inflation is very benign. Even so, we believe YUM is a uniquely advantaged investment opportunity.

Leading player with strong credentials

YUM already has an impressive track record of growing its store base around the world. The Yum! Brands system opens an average of six restaurants per day and the company has amassed considerable experience through global expansion of the KFC and Pizza Hut brands. This experience is expected to be drawn upon to facilitate international growth for Taco Bell which is still largely a US-based restaurant chain.

From an investment perspective, YUM is advantageously positioned from several perspectives. Its significant presence within markets that feature favourable demographics and rising consumption trends supports our view of YUM's wide economic moat. The opportunities to expand its restaurants around the world with minimal capital investment represents world class reinvestment potential, another key criteria for our investments. YUM has been represented in the Magellan Global Equities strategy since 2007 and we remain favourably disposed to the company's future growth prospects.

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