

Investing in Financials

The evolving landscape of the global financial sector



Investing in the global financial sector means investing in companies such as banks, insurers, payment networks, asset management companies, and stock exchanges. These companies play an important role in the global economy by facilitating transactions, managing risk, and providing capital for businesses and consumers. The demand for financial services typically increases as economies grow and develop.

Why invest in financials?

The financials sector is constantly evolving, with the rise of technology, data analytics and digital transformation playing an important role in reshaping this industry. The utilisation of unique and extensive datasets enables financial institutions to improve the customer experience, better price for risk, and create new products. While technology enables new entrants, incumbent businesses can often benefit from their established reputations, extensive customer bases, diversified revenue streams and a long history of regulatory compliance.

Financials – Growth through economic cycles

This sector is highly sensitive to economic cycles, interest rates and regulatory oversight. Not all companies meet the requirements for inclusion in the Magellan investment universe. Thorough research is undertaken to identify the unique attributes of a company that enable it to generate sustainable attractive returns over the longer-term. Some of the industries in the Magellan investment universe include:

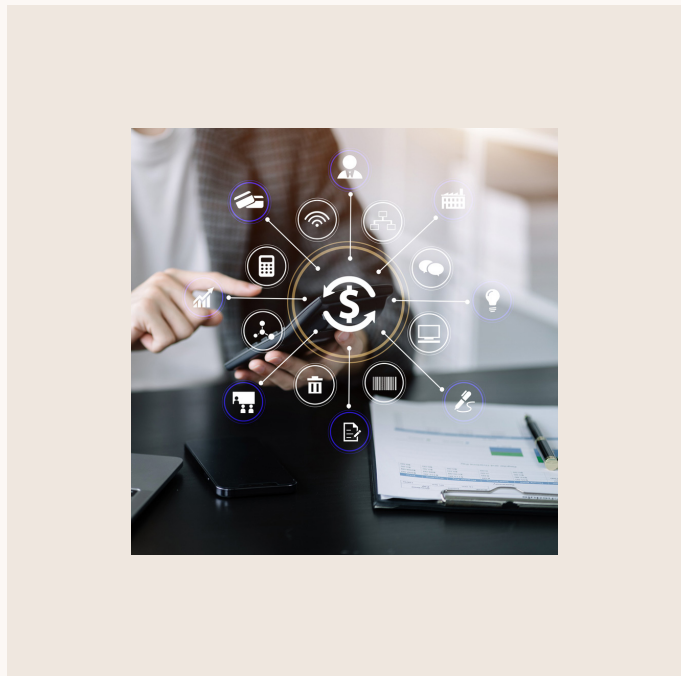
“Technology and data analytics are reshaping the financial sector.”

Payments

Payment companies provide a range of functions from payment networks to payment processing and other payments services or infrastructure. These companies are typically technology companies that are providing services to merchants and banks, with fewer companies working directly with consumers.

Payment networks are the most valuable part of the industry. These networks connect billions of consumers to millions of merchants and thousands of banks globally. This is done within seconds, with a focus on security and user experience. Replicating these networks is challenging and costly.

Payment networks generate revenue from each transaction that uses the network, as well as value-added services that enhance the user and client experience. Given the importance of payment networks for global commerce, regulation is the most material risk.



Diversified financial services

Diversified financial services companies typically provide a wide range of financial products and services, such as exchanges, credit ratings, data analytics and asset management. These companies often provide essential services, that can generate sustainable and attractive cash flows when operating within a consolidated industry structure. Similar to payment networks, given many of these companies provide essential services, regulatory risk can be elevated.

The revenue models differ across each of the subsegments. In common, however, is fees are typically generated on a volume basis. Exchanges, for example, generate revenue from trading volumes, asset managers from AUM, and credit rating agencies from bond issuance and ratings monitoring.

Banks

By providing essential services such as lending and deposit taking, banks play an important role in the economy. These services are highly regulated given the risk they pose to the economy and consumers. As a result, banks must hold meaningful levels of capital and maintain robust risk management practices, to provide protection during economic downturns.

Banks generated revenue through interest from loans, fees for services and investment income from various financial activities. Offsetting this is the interest expense and cost of bad loans. Given this backdrop, banks with higher levels of retail deposits and mortgage lending are viewed as lower-risk banks with the most reliable returns.

A bank's competitive advantage typically arises from scaled operations, and a consolidated industry. These features combined with a lower-risk retail-focused bank give investors greater certainty in the bank's ability to protect and grow earnings into the future.

In depth research, macro analysis on consumer health and interest rates, and ongoing monitoring of the financial health, risk management and strategic vision of the bank are important to identify the opportunities that investing in banks may present.

Insurance

Insurance companies generate revenue through premiums paid by policyholders, which they then invest to generate returns. This business model can provide a steady income stream, making insurance companies relatively resilient to economic fluctuations. The demand for insurance products, including life, health, property, and casualty insurance, tends to remain stable, as these products are commonly utilised by consumers.

Insurance companies manage risk through sophisticated actuarial models. These models determine policy pricing and reserves to cover potential claims. Actuarial models are based on statistical assumptions that from time to time can lead to losses, likely driven by the higher frequency or higher severity of the insured event; for example, weather-related events. These instances can lead to losses in a particular year, which are then recovered via higher prices in subsequent years.

Scaled insurance companies that have diverse operations, and offer a range of products across different markets are favoured. These attributes diversify risk and enhance financial stability.



What are the risks?

This sector can be highly sensitive to economic cycles, interest rates and regulatory changes. For example, interest rate fluctuations can significantly affect the profitability of banks and insurers. Additionally, regulatory changes in different countries can affect the operations and profitability of financial firms. Market volatility can have a negative impact on these companies, affecting asset prices and investment returns. Innovation and adoption of technology are critical within financial services. Cybersecurity and fraud pose significant risks to financial institutions.

How do financial companies fit into a portfolio?

Financial companies can be used within the portfolio to take advantage of 1) mispricing related to a market cycle; for example, banks or insurers; or 2) to gain exposure to a structural tailwind such as cash digitalisation or increasing alternative asset exposure. Payment networks and exchanges have often featured in our portfolios given the exposure to sustainable long-term growth, pricing power and attractive industries.

Examples of listed global financial companies



Visa is the largest global payment network – the total volume of payments over Visa’s network in 2023 reached US\$12.5 trillion. Across the globe, Visa connects 4.2 billion cardholders across more than 200 countries, at around 85 million merchant locations and over 16,000 financial institutions.



Mastercard is the world’s second-largest global payment network, with the total volume of payments across its network reaching US\$8.2 trillion in 2023. Mastercard’s operations span more than 210 countries, while about 25% of revenue comes from developing markets.



Intercontinental Exchange, Inc. operates key global exchanges and clearing houses for financial, energy, agricultural and other products as well as providing mortgage technology, data and listing services.



Brookfield Corporation is one of the world’s largest alternative investment management companies with over US\$500b in fee-bearing capital across infrastructure, real estate, renewables, private credit and private equity. Brookfield also has significant direct investments in these asset classes, and a large annuities business.

As at December 2024

What sets our approach apart?

There are thousands of companies listed on world exchanges. However, at Magellan we regard our eligible universe of potential investments to be only about 200 companies. These are the companies we believe to be of sufficient quality to consider for investment, companies in which we have a high degree of certainty in their ability to protect and grow earnings into the future. This requires rigorous fundamental research into the economics of the company and a deep understanding of the company’s strategic direction and the industry in which it operates.

At Magellan, this focus on quality companies represents the core of our investment philosophy and goes directly to achieving our investment objectives for our investors.



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