Frontier MFG Global Sustainable Fund
Institutional Class (FMSGX), Service Class (FMSRX)
Sub-advised by MFG Asset Management – Sydney, AU

FRONTIER FUNDS

Quarterly Commentary, March 31, 2024

Global equity markets posted strong returns in the quarter ending March 31st. The sectors with the largest gains were Communication Services (up 13.7%), followed by Information Technology (12.8%) and Financials (12.0%), while the laggards were Utilities (down 2.2%), Consumer Staples (-4.8%) and Materials (-5.6%).

The main drivers of these strong returns were improved earnings outlooks and sentiment. U.S. economic data released during the quarter were stronger than expected, though not strong enough to suggest that a broad-based reacceleration in inflation was likely. Earnings results for the December quarter released in the March quarter led to sizeable earnings upgrades. Overall, this dataflow saw investors reduce the number of quarter percentage point Federal Reserve rate cuts they expect by the end of 2024 from six to three, while also pushing up the U.S. 10-year Treasury yield by 30bp to 4.2%.

In Europe, several countries including Germany, Finland, the UK and Ireland entered a technical recession by posting two consecutive quarters of negative GDP growth for the second half of 2023. The 10-year German government bond yield increased 30bp to 2.3%, a move broadly in line with movements in global sovereign bond yields.

In Japan, the Bank of Japan ended its negative interest policy that had been in place since 2016. Japanese equity returns have benefited from corporate governance changes that promote returns and a return of inflation, which boosts nominal growth rates. The yield on Japanese 10-year government bonds rose 10bp to end the quarter at 0.7%. While the Chinese authorities are also attempting to improve corporate profitability, we believe that relatively low trading multiples in China are justified by permanent political and governance risks and the more difficult economic backdrop in the medium term.

The Fund delivered strong absolute performance in the quarter, albeit slightly below market returns, reflecting conservative positioning. Key contributors for the quarter included Meta Platforms, SAP and TSMC. Meta reported a solid 4Q23 result and provided much-stronger-than-expected 1Q24 revenue guidance, benefiting from strong user engagement trends, broad-based improvements in advertiser demand and strong traction of its Reels and AI ad performance products. Market conviction in Meta's AI-related growth opportunities and improved management focus on cost discipline and shareholder returns continues to build. SAP reported a solid Q4 result with accelerating cloud growth and an implicit raise of its mid-term 2025 EBIT and FCF guide. It also announced a €2b restructuring program as it reinvests in AI capabilities for its products and internal operations. Overall, the result supported SAP's cloud growth thesis and we remain positive on the momentum and resilience of core ERP. TSMC delivered a modest Q4 beat on what the company described as recovering from a bottoming-out and provided strong FY24 revenue growth guidance in the low to mid-20s in USD, implying FY24 revenue 6.5% ahead of our estimates at the midpoint. The guidance increased investor confidence on demand recovery and comported with ASML's bookings strength.

Key detractors in the quarter included Reckitt, American Tower and UnitedHealth Group. Reckitt was affected by weaker-than-expected sales volumes in the 4Q result as well as an unexpected accounting issue in its Middle East business. It was further affected by a jury verdict over an outstanding lawsuit awarding $60 million to a plaintiff citing U.S. infant formula manufacturers failed to communicate elevated risks of infants developing necrotizing enterocolitis when fed preterm infant formula under the care of neonatologists in hospital. Both the ruling against Reckitt as well as the magnitude of the award were unexpected. The market reaction to these events suggests much of the future obligation from similar product liability lawsuits is in the price. American Tower underperformed on higher U.S. interest rates, to which it is particularly sensitive given fixed escalators and higher leverage. For UnitedHealth Group the upcoming U.S. elections are affecting the regulatory backdrop for U.S. managed care organizations, with lower-than-expected reimbursement decisions and anti-trust investigations announced in the quarter. In addition, the company was affected by a cyber security breach. We view these issues as short term and transitory, with plan re-pricing and re-designs as well as operating expense savings as key offsets.

In March 2024, the EU AI Act was approved by the European Parliament. This is a significant piece of regulation to mitigate the social and human rights risks of AI. The use cases of AI are categorized and restricted according to whether they pose an unacceptable, high or low risk to human safety and fundamental rights. It is important for technology providers and AI users to adhere to this regulation as penalties can include bans and fines. In February 2024, MFG Asset Management signed the 2024 Investor statement on Ethical AI. As a new member of the Collective Impact Coalition (CIC) for Ethical AI, we are happy to share that the CIC for 2024 has been launched. The main Global Annual General Meeting (AGM) season commenced in March. Similar to 2023 we continue to see an increase in sustainability-related shareholder proposals. The proposals are focused on shareholder rights, and the management of material risks ranging from health and wellness to climate, diversity and human rights.

That markets continued rally in Q1 was partly justified by solid fundamentals, with strong earnings for many of our companies and the macroeconomic backdrop largely stable. Nonetheless, valuations remain full and downside risks are evident in the shorter term should earnings or the macroeconomic backdrop deteriorate. Indeed, indicators suggest inflation may remain higher than target levels, prompting the Federal Reserve to delay anticipated rate cuts even further. At current market valuations there is little room for such an outcome, and we continue to position the portfolio conservatively.

Over the long term, we consider that our companies remain well placed to deliver solid earnings growth in the years ahead, reflecting their high quality, strong free cash flow generation, and the benefit of long-term structural tailwinds such as AI adoption.

Index movements and stock contributors/detractors are based in local currency terms unless stated otherwise. U.S. GDP statistics come from the U.S. Department of Commerce, while U.S. employment and inflation statistics are published by the U.S. Department of Labour. EU economic statistics come from Eurostat. UK statistics are released by the Office for National Statistics.