

# Magellan High Conviction Fund

## Fund Update: 30 June 2014

### Key Facts

Portfolio Manager Hamish Douglass	Management and Administration Fee <sup>1</sup> 1.50% p.a.
Structure Global Equity Fund, \$AUD	Buy/Sell Spread <sup>1</sup> 0.10%/0.10%
Inception date 1 July 2013	Fund Size AUD \$129.5 million
Performance Fee <sup>1</sup> 10.0% of the excess return of the units of the Fund above the Absolute Return performance hurdle (10% per annum). Additionally, the Performance Fees are subject to a high water mark.	
<sup>1</sup> All fees are exclusive of the net effect of GST	

### Regional Breakdown

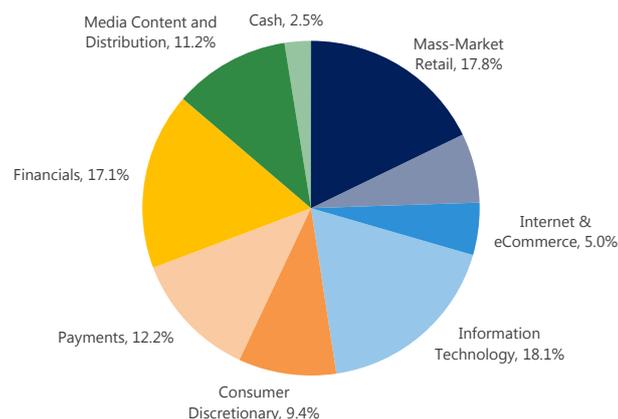
	%
Multinational	24.0
North America	64.0
United Kingdom	9.5
Australia	0.0
Europe	0.0
Japan	0.0
Asia Ex-Japan	0.0
Cash	2.5
<b>TOTAL</b>	<b>100</b>

### AUD Performance<sup>2</sup>

For comparison purposes only

	Magellan High Conviction Fund %	Magellan Global Fund %
1 Month	-0.7	-0.9
3 Months	-0.7	0.0
6 Months	-1.3	-3.0
1 Year	16.2	11.7
Since Inception	16.2	

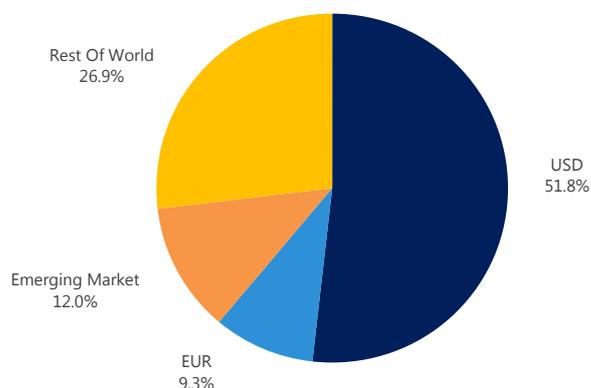
### Industry Exposure by Source of Revenues<sup>5</sup>



### Top Five Holdings in Alphabetical Order

	Industry Sector
DirectTV	Consumer Discretionary
eBay Inc	Information Technology
Lowe's Co Inc	Consumer Discretionary
Microsoft Corp	Information Technology
Tesco PLC	Consumer Staples

### Geographical Exposure by Source of Revenues<sup>5</sup>



### Key Features

- Unconstrained, highly concentrated
- High quality global equity strategy
- High individual stock exposures - 8 to 12 stocks
- Ability to actively hedge currency exposures
- Maximum cash position of 50%
- \$100,000 minimum initial investment

<sup>2</sup>Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Fund Inception 1 July 2013.

<sup>3</sup>MSCI World Net Total Return Index (AUD)

<sup>4</sup>Multinational: Greater than 50% of revenues outside home country.

<sup>5</sup>Calculated on a look through basis based on underlying estimated revenue exposure of individual companies held within the portfolio - Magellan defined sectors.

[www.magellangroup.com.au](http://www.magellangroup.com.au)

Important Information: Units in the Magellan High Conviction (Fund) are issued by Magellan Asset Management Limited (ABN 31 120 593 946, AFS Licence No 304 301). Past performance is not necessarily indicative of future results and no person guarantees the future performance of the Fund, the amount or timing of any return from it, or that it will achieve its investment objective. This material has been provided for general information purposes and must not be construed as investment advice. This material has been prepared without taking into account the investment objectives, financial situation or particular needs of any particular person. Investors should consider obtaining professional investment advice tailored to their specific circumstances and should read the relevant Product Disclosure Statement (PDS) prior to making any investment decisions. The PDS is available at [www.magellangroup.com.au](http://www.magellangroup.com.au) or can be obtained by calling 02 8114 1888.



## Market Commentary

During the second quarter of 2014, the Federal Reserve continued to normalise US monetary policy amid expanding economic activity and an improving employment situation. Conversely, the ECB took further steps to support the Eurozone, which continues to suffer from below-target inflation. These include a number of measures to boost bank lending, including the introduction of negative interest rates on funds deposited with the ECB, as well as the decision to halt sterilisation of bond purchases undertaken as part of its Securities Market Programme (SMP), an action which has been judged by some as a potential pre-cursor to a US-style quantitative easing programme.

In our view, the drivers of US economic growth continue to gather strength, justifying the Federal Reserve's moves to normalise monetary policy. We continue to consider the unwinding of Quantitative Easing as the single most important factor that will impact markets and economies over the next few years. Higher interest rates will be disruptive to markets, particularly those where investors have sought duration and higher yields. We note that the rally in US and European government bonds over the past 6 months (when economic data would have suggested that the opposite might have been expected) may, in part, be due to the Bank of Japan's \$600 billion (per annum) quantitative easing programme encouraging Japanese banks, insurers and pension funds to sell Japanese government bonds and invest in other assets, including foreign sovereign bonds.

In China, the property downturn continued with little sign that the government is ready to relax general controls imposed on the market towards the end of 2013. In our opinion, it remains possible that China's economy could experience a significant slowdown as a combined result of market forces and the government's continuing efforts to address the structural oversupply inherent within its housing market. The rapid rate of credit expansion experienced by China in recent years, and its role in funding the property developers, adds further to economic risk. We continue to monitor the situation closely.

### Key Stock in Focus:



eBay has two global businesses – Marketplaces (ebay.com) and PayPal. In 2013, these businesses facilitated over US\$200 billion in commerce, representing approximately 2% of total global retail sales. On these sales, eBay generated US\$16 billion in revenue and operating income of US\$3.4 billion.

#### Marketplaces (52% of revenue and 67% of operating income)

Marketplaces is a leading global e-commerce marketplace, with over 60% of its gross sales generated outside the US. eBay facilitated over US\$75 billion of Gross Merchandise Sales (GMV) in 2013. With 140 million active users, Marketplaces provides significant value to online merchants seeking customers, with only Amazon.com having a similar scale.

Marketplaces' initial success was as an auction site in the early days of e-commerce. Increasing full-service online competition from Amazon resulted in stagnant growth from 2008 to 2010. Since then, eBay's management has successfully repositioned the company, using listing fees, search ranking and other tools to encourage sellers to improve service. By 2013, 70% of Marketplace's sales were at a fixed price and over 50% included free shipping. Although auctions and vehicle sales have continued to fall, total Marketplaces gross sales grew by over 10% p.a. between 2010 and 2013.

#### PayPal (41% of revenue and 31% of operating income)

PayPal is the leading global online wallet, with over 148 million active accounts in over 190 countries and 25 currencies. It allows consumers to purchase online with convenience and security by entering their financial information only once (and never divulging it to merchants). It offers small merchants an inexpensive means of accepting payments and reduces shopping cart abandonment by streamlining transactions.

PayPal is a member of a select group of global method of payment providers, including Visa, MasterCard and American Express. Significant barriers to entry mean that it would be very difficult even for large tech companies like Google, Apple and Amazon to enter the payments market.

Over the last three years, PayPal has experienced well over 20% compound growth in revenue and profit. The business is highly scalable and we expect operating margins to expand materially as this growth continues and the company completes the build out of its global payment infrastructure. Current margins are 24%, compared to Visa and Mastercard's margins of 50-60%.

## Fund Commentary

As at 30 June 2014, the Fund consisted of 11 investments (compared to 11 investments at 31 March 2014). The top five investments represented 50.7% of the Fund at 30 June 2014, while they represented 52.5% at 31 March 2014.

The Fund's top contributor was DirecTV, which rose strongly after receiving a takeover approach from US telecoms giant AT&T. Other strong performers included Bank of New York Mellon and Wells Fargo, which benefitted from expectations of rising interest rates, as well as European pharmaceutical Sanofi-Aventis.

Conversely, eBay was among the Fund's largest detractors, suffering a confluence of headwinds including a data breach, a change in Google's search algorithm adversely affecting its positioning within internet search results, slowing (but still strong) retail sales growth and the resignation of PayPal's CEO. We judge these issues of limited materiality to eBay's investment case over the longer term. Also, Target's results were negatively affected by continued losses in its Canadian business, which is suffering from execution errors, while its US business was held back by the lingering impact of the data breach, as well as an economic environment that remains constrained for the portion of its customers on lower incomes. We are aware of Target's short-term headwinds and continue to believe that the company is likely to surmount these over the next 3 years. Other weak performers during the period included global payments processor Visa and US enterprise software vendor Oracle.

The Fund is fully invested, despite the strong rise in equity markets over the past 12 months, as we believe its holdings have appealing valuations and should deliver attractive returns for investors over the next 3-5 years. It remains positioned to benefit from a strengthening US economy, along with normalisation of interest rates and capital market activity.

### The Omni-Channel Opportunity

The dramatic growth in smartphones and tablets, coupled with ubiquitous wireless connectivity, has changed the way that people use the internet and expanded the addressable market for internet companies. As a result, eBay users can access its services more frequently and with greater convenience. PayPal is also useful on smartphones, as few people want to enter their credit card information on a small touch-based device. These benefits have contributed to the rapid growth of eBay's businesses on mobile devices. In 2013, mobile commerce volume already represented 16% of eBay's total volume, or US\$33b.

Smartphones are quickly bridging the gap between what was previously perceived to be two separate retail channels: online, where eBay's businesses were confined, and offline, creating a single, ubiquitous merchant-customer relationship, known as omni-channel. As the leading third-party internet-enabled facilitator of commerce and payments, this creates enormous opportunities for eBay to expand its market beyond e-commerce, and to increase the number and quality of services that it offers.

Many traditional retailers continue to struggle due to the secular shift to e-commerce, with these struggles compounded by increasing competition from Amazon. Amazon's success is in part derived from its convenience and superior ability to successfully make use of customer data. However, eBay's businesses are well positioned to partner with traditional offline retailers, providing them with the means to fight back:

- Leveraging store assets: eBay can display a local retailer's inventory online (on its websites and apps) and give customers the choice of delivery or pick up in-store.
- Levelling the data playing field and more: PayPal is increasing its presence offline at the point of sale in the US. PayPal encourages customers to identify themselves to merchants to receive special treatment, increasing a merchant's visibility into its customers' behaviours, its ability to reward loyalty, personalise the experience and drive sales.

PayPal is in the early stages of its strategy of achieving ubiquity online (on and off eBay), at the retail point of sale and within apps consumers use to conduct transactions (e.g. Uber). In 2013, PayPal was used for 73% of eBay gross sales, 11% of online transactions off-eBay, and currently 0% of transactions offline. The opportunity is immense.

We believe that eBay is currently attractively priced and there is potentially enormous upside should Marketplaces and PayPal successfully execute their omni-channel strategies.

#### Sydney Head Office

Level 7, 1 Castlereagh  
Street Sydney NSW 2000  
Telephone: 02 8114 1888  
Facsimile: 02 8114 1800

#### Melbourne

Suite 103, 1 Queens Road  
Melbourne Vic 3004  
Telephone: 03 9863 9746  
Facsimile: 03 9863 9741

#### Brisbane

Level 22, 127 Creek St  
Brisbane Qld 4000  
Telephone: 07 3218 2122

#### New Zealand

Level 4, 17 Albert Street  
Auckland City,  
New Zealand  
Telephone: +64 9 215 1531



**MAGELLAN**  
ASSET MANAGEMENT LIMITED