MAGELLAN
ASSET MANAGEMENT LIMITED

Annual Investor Report

Magellan Global Fund | June 2014

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I am delighted to write to you as an investor in the Magellan Global Fund (the 'Global Fund' or the 'Fund') for the 12 months ended 30 June 2014. Over the period, the Global Fund returned 11.7%, net of fees. Over the past 3 and 5 years, it has returned 22.7% and 16.6% per annum, respectively. The Fund has exceeded the MSCI World Net Total Return Index AUD by 5.1% per annum over the past 5 years, but has underperformed it by -8.6% over the past 12 months. We note that since inception (on 1 July 2007), the Global Fund has delivered an investment return of 9.7% per annum, which is above our longer-term objective (9% net of fees), whereas the MSCI World Net Total Return Index AUD has produced a return of 1.9% per annum. We have no way of assessing how a company's share price will perform against an index over short time periods; we are far more interested in where a company's share price may be in 3 to 5 years than where it may be in 6 months.

On 1 July 2013, we launched a hedged version of the Fund. For the year ending 30 June 2014, the Magellan Global Fund (Hedged) returned 15.2%, net of fees.

Figure 1: Performance to 30 June 2014:

Yearly Results (Financial Years)	Global Fund (%)	MSCI World Net Total Return Index AUD (%)[1]	Difference (%)
2007/08	-17.2	-21.0	3.8
2008/09	7.1	-16.3	23.4
2009/10	13.9	5.5	8.4
2010/11	2.5	3.0	-0.5
2011/12	18.2	-0.8	19.0
2012/13	39.7	32.8	6.9
2013/14	11.7	20.3	-8.6
Annual compound results (% per annum)			
1 Year	11.7	20.3	-8.6
3 Year	22.7	16.6	6.1
5 Year	16.6	11.5	5.1
Since inception (1 July 2007)	9.7	1.9	7.8

[1]This is an index produced by MSCI Inc. that aims to capture large- and mid-cap representation across 23 Developed Markets countries. The index covers approximately 85% of the free float-adjusted market capitalisation in each country. The index is presented here showing returns in Australian Dollars.

We feel strongly that people cannot retire on "relative investment returns"; only by generating investment returns that exceed the rate of inflation (ideally by a satisfactory margin) will investors increase their wealth over time. As such, we are happy to be judged on the absolute returns of our strategy over time.

In general, equity markets have been strong over the past 12 months. This is reflected in the performance of the MSCI World Net Total Return Index in US Dollars, which has risen by 24.0%. The current investment environment is extraordinary. Many world equities indices ended June at or near all-time record highs, the 10-year bond yields of Spanish, Irish and Italian government debt closed below 2.85%, credit default swaps on major banks are now below 2007 levels and the European Central Bank has recently reduced the interest rate on deposits by banks to minus 0.1%.

We continue to see capital flows that are distorting markets and causing asset prices and currencies to diverge from underlying economic trends. The enormous US$600 billion per annum quantitative easing (QE) being undertaken by the Bank of Japan, as part of Prime Minister Abe's economic plan, is encouraging Japanese banks, insurers and pension funds to sell Japanese government bonds and invest in other assets, including foreign sovereign bonds. This may, in part, explain the rally in US and European government bonds over the past 6 months (as well as the strong Australian dollar), when economic data would have suggested that the opposite might have been expected. We also note recent reports that China's State Administration of Foreign Exchange, which manages China's vast foreign exchange reserves, has become the world's largest public sector equity investor; elsewhere, numerous other central banks have also increased their exposure to equity markets.

Against this backdrop, we would expect our global equity strategy to lag general equity market indices. Despite this, we will not chase momentum and will always have a conservative, defensive bias built into our portfolio. As Warren Buffett has often said, "To finish first you must first finish."

It is a little surreal that equity market volatility and other risk measures appear benign as we edge closer to a cycle of increasing long-term interest rates, with the US Federal Reserve and the Bank of England ending their QE programmes and China appearing to be entering a period of lower growth. While we are not predicting a major downturn in equity markets (in the absence of a major global event), they have become more challenging and value has become harder to find as share prices have continued to rise. While nothing is certain in investing, we predict that the next 3 years will be challenging for equities as they battle the headwind of rising long-term interest rates.

We feel comfortable with the Fund's overall risk profile and construction. We believe it is likely to deliver more-than satisfactory returns over the next investment cycle and exhibit below-benchmark downside risk in the event that there is a major downturn in markets.

Corporate Governance
Board and executive pay

As you would expect, we take a proactive role in matters of corporate governance relating to our investee companies. We are focused on 3 principal areas relating to board and executive compensation where we believe shareholder value can be enhanced:

1. **Separation of the roles of CEO and Chairman**

It is still common practice, for US-based companies in particular, to combine the roles of CEO and Chairman. In our view, combining the roles of CEO and Chairman places too much power in the hands of a single individual. As Chairman and CEO, an individual has substantial influence in appointing and shaping the makeup of a company's board. In contrast, where the roles of CEO and Chairman are separate, the influence of each individual over the composition of the board is greatly reduced. A board is established to provide a separation of powers between the governance and the executive management functions of a company. Combining the roles of CEO (the executive powers) and Chairman (the governance powers) undermines the proper separation of these functions. We do not accept that a Lead Independent Director function overcomes the issue, as in many instances the combined Chairman / CEO would have had very substantial influence in selecting each of the independent directors, including the Lead Independent Director. We also note that it is usual for the Chairman to set / agree the agenda for board meetings and that combining the roles risks removing an important check mechanism on management.

2. **Aligning executive option and share schemes with the interests of shareholders**

We do not have an issue with rewarding senior executives well, provided that share-based performance pay is earned. Pay for performance is our motto. In our view, too many companies have pay practices that hand out substantial rewards for mediocre performance and place too little risk on their executives.

Executive option schemes

We are opposed to the majority of option-based executive incentive schemes as we do not believe that they are properly aligned with the interests of shareholders. A typical option scheme usually has:

- A strike price based on the share price at the time the options are granted.
- A vesting period, usually between 2 and 4 years.
- An expiry period of up to 10 years from the date of grant.
- No performance hurdle which must be achieved before the option can be exercised.

The following example describes how generous executive option schemes can be. Let's assume the value of such an option is assessed to be worth between 25% and 30% of a company's current share price, which means the executive is leveraged 3 to 4 times against the increase in the share price over time. Let's also assume the share price increases by 3% per annum over the next 10 years, meaning that it would rise by around 30% over 10 years. Under these circumstances, the executive would receive between 90% to 120% of the original assessed value of the options upon exercising after 10 years, while shareholders would have barely kept up with inflation. In our view, the level of payout to the executive is unjustified and is clearly a misalignment of interests with shareholders. Even a modest 5% compound annual growth in the share price would deliver the executive a return of around 200% to 250% of the original assessed grant value at the end of 10 years.

In order to align an option scheme with shareholders, it is necessary to include a meaningful performance hurdle that must be satisfied before an option can be exercised. A performance hurdle could be structured around a minimum compound increase in the share price, or around relative share-price performance measured against an appropriate peer group of companies.

Another potential conflict of interest stemming from large option-based incentive schemes relates to the determination of appropriate dividend/ capital return policies for companies. The retention of earnings will usually increase the value of options in a company over time, whereas the payment of dividends will reduce their value. It isn't entirely surprising that companies with the largest option-based incentive schemes often do not pay dividends or undertake share buy-backs.

Under current disclosure / accounting rules the true economic cost of executive option plans is hidden from shareholders. Companies are required to disclose the upfront issue value of options as part of compensation, but not the actual realised value received by executives upon exercise.

Furthermore, the upfront "assessed" issue value of options rarely reflects their true underlying market value. In assessing the issue value of options, companies need to make a number of important assumptions including in relation to the expected term until option exercise, expected dividend yield, risk-free rate and implied share price volatility. Unfortunately, many companies utilise assumptions that reduce their value for reporting purposes; for example, a reduction in the expected term of an option reduces its accounting value (by understating expected term, the upfront value of options awarded to senior executives is also understated). We often see companies assuming the expected term of a 10-year option is only 5 to 6 years. While this assumption may have some validity for an entire population of grantees, it is usually incorrect for a CEO or senior executive as individuals in these roles rarely leave voluntarily in cases where they would forgo unvested options.

It is even more horrifying that companies issuing large amounts of options often persist with excluding their upfront issue cost when presenting underlying earnings. We think that these companies should replace "underlying earnings" with "lying earnings" to more appropriately reflect the information they are encouraging investors to focus on. Whom do they think pays for the cost of executive options - the "tooth fairy"? We have even seen instances where companies have reduced the strike price of options when the share price has fallen – this is hardly an alignment of management and shareholder interests. Do we need to say any more about the unfairness of option schemes to shareholders?

It isn't surprising that senior executives at some companies strongly support option schemes. Such schemes are usually one directional, long-term leveraged share price plays, without the constraint of performance hurdles. In addition, they often disguise the windfall gains delivered to executives.

Performance-based restricted stock schemes

In our view, a better way of rewarding executives and aligning executive pay with shareholder interests is via the establishment of performance-based restricted stock schemes. These vest shares in line with a pre-determined distribution schedule in the event that appropriate performance hurdles are satisfied. We are encouraged that:

- A number of companies have recently replaced option schemes with restricted stock schemes:
- Nearly 50% of our portfolio companies do not have executive option schemes.
- Virtually all of our portfolio companies have adopted restricted stock schemes.
- 70% of our portfolio companies have performance hurdles that apply to their restricted stock schemes.

When evaluating executive compensation arrangements, we closely examine these schemes' performance hurdles to ensure that they properly align management and shareholder interests. Unfortunately, there are numerous schemes that purport to restrict the payment of stock incentives subject to performance hurdles that, on closer reading, entitle executives to between 50% and 75% of the restricted stock even if none of the performance metrics are achieved. In our view, executives at major listed companies are paid substantial sums and if they fail to deliver they should not receive any performance-based restricted stock compensation.

Accounting practices relating to restricted stock plans also leave much to be desired. Companies are required to account for the value of restricted stock in the income statement, on the issue date and based on an assumed level of "target vesting", which is often 100% of the amount of restricted stock issued. However, actual vesting amounts usually range between 0% and 300% of the amount of restricted stock issued. The problem is that if a company sets mediocre performance hurdles to achieve the "target vesting" level, then the value that is reflected in the income statement is often understated, while the actual value an executive realises upon vesting is rarely set out in a company's remuneration report. Furthermore, the treatment of restricted stock in remuneration reports is varied; some companies report the upfront assessed issued value of restricted stock, while others report the value of restricted stock upon vesting.

In our view, there is very little incentive for companies to fully reflect the true economic cost of stock-based compensation in either the income statement or remuneration report. Reflecting the true economic cost would reduce reported earnings and increase reported remuneration, therefore risking confrontation with shareholders on executive pay. Corporate governance would be improved if companies were required to do the following when accounting for the value of stock-based compensation:

- In the year of grant, reflect the fair value of such compensation in the income statement and remuneration report.
- Each year, reflect the change in fair value of stock-based compensation granted in previous years in the income statement and remuneration report. Only by including the change in the fair value of stock-based compensation will the full cost be reflected over time.

I am sure we would see a substantial change in executive remuneration practices if the full cost of stock-based schemes was more transparently reflected in earnings and reported to shareholders.

We are more than happy for strongly-performing executives to be very well rewarded for outstanding performance, provided there is real downside for sub-par performance and that the full cost of compensation is transparently disclosed to shareholders.

3. Minimising the dilutive impact of executive option and share schemes

We believe that option-based incentive schemes are a highly-dilutive method of rewarding executives, from a shareholder's perspective. The reason is that an option, when issued, is worth only a fraction of the underlying share price. If an option is assessed to be worth 25% of the current share price, if exercised the company needs to potentially issue shares worth 4 times the initial dollar value of the options. Companies can seek to neutralise the impact of options by buying back an equivalent number of shares when they are exercised; however, the share price at time of exercise is usually significantly higher than the exercise price, meaning that the company needs to outlay significantly more cash to buy back the equivalent number of shares than is received from the exercise of the options. The major advantage of restricted stock plans, in comparison, is that they are less dilutive for shareholders than option-based schemes.

We like to see companies adopt maximum limits regarding net per-annum issuance in relation to option and share-based schemes, as well as establishing maximum limits of options and restricted stock that can be outstanding at any point in time (as a percentage of the issued capital). Regarding the latter, we think a 5% limit is appropriate for most companies. Additionally, for companies that do not need to raise capital, we would like to see more programmes that undertake offsetting share buy-backs to neutralise the dilutive impact of executive share and option schemes at the time of grant.

We have analysed the corporate governance of the 28 companies in the Global Fund at 30 June 2014 and have made assessments regarding the following key questions:

- How many portfolio companies have a separate Chairman and CEO? (63%)
- How many portfolio companies have issued options to executives with no performance hurdle? (48%)
- How many portfolio companies have restricted stock schemes? (96%)
- How many restricted stock schemes allow some vesting if performance hurdles are not achieved? (35%)
- Percentage of portfolio companies with more than 5% of issued capital in options and restricted stock. (15%)

While it is encouraging that more than 60% of our portfolio companies have a separate Chairman and CEO, and that less than 50% of our portfolio companies have option plans without performance hurdles, on the other hand, it is concerning that almost 50% of portfolio companies have option plans with no performance hurdles and 35% have restricted stock plans that can vest (in part) if performance hurdles are not achieved. Probably the most telling figure is that only 39% have what we would regard as good corporate governance in relation to the separation of the roles of Chairman and CEO, combined with properly-aligned executive equity compensation schemes. We believe that shareholders would be better served if companies adopted the following key corporate governance principles relating to board composition and executive compensation:

- Separation of the role of Chairman and CEO.
- Elimination of executive option plans, or adoption of option plans that have appropriate performance hurdles that must be satisfied for options to vest.
- Adoption of restricted stock plans with appropriate performance hurdles and zero vesting if minimum levels of performance are not achieved.
- Restricting the maximum amount that can be outstanding under executive option and restricted stock schemes to no more than 5% of issued capital.

Portfolio Summary

As at 30 June 2014, the Fund consisted of 28 companies (compared to 25 investments at 30 June 2013). The top 10 investments represented 51.2% of the Fund, while they represented 51.0% at 30 June 2013.

The Fund remains fully invested, despite the strong rise in equity markets over the past 12 months. We believe that its holdings remain attractively valued and should deliver attractive returns to investors over the next 3 to 5 years.

Over the past 12 months, we have made the following major changes to the portfolio:

- We added a new position in global beverages giant Diageo, enterprise software vendor SAP and European pharmaceutical Sanofi-Aventis.
- In September 2013 we also made a new investment in DirecTV, the world's largest pay television company by subscriber numbers. Our initial purchase price was around $60 per share. In May 2014, AT&T made a cash and share takeover offer which valued DirecTV at $95 per share. The transaction is subject to regulatory and shareholder approval and, assuming AT&T receives the necessary approvals, is anticipated to close in around 12 months. DirecTV is currently trading at around $85 per share, reflecting the transaction uncertainty and time to completion. We have decided to retain our holding at the current share price (30 June 2014), as we will earn a return of around 12% if the transaction proceeds, while we will feel comfortable owning DirecTV at the current price in 12 months if the transaction does not proceed. We feel the risk / reward is superior to available alternative uses of the sale proceeds that could be sale proceeds that could be generated from exiting our DirecTV holding.
- We exited the holding in Colgate-Palmolive and reduced the positions in Google, American Express, McDonald's and Johnson & Johnson.
- We increased the positions in Nestle, Visa, Target and Tesco.

Over the 12 months to 30 June 2014, the 3 stocks with the strongest returns in local currency were DirecTV (+43.3%), Bank of NY Mellon (+35.8%) and Oracle Corp (+33.2%), while the stocks with the weakest returns were Target Corp (-13.9%), Tesco PLC (-10.4%) and Adidas AG (-9.9%). On an absolute basis, the 3 largest stock contributors, in local currency, were Oracle Corp, DirecTV and Microsoft Corp which added +1.9%, +1.7% and +1.6%, respectively. Conversely, the three bottom contributors were Target Corp, Tesco PLC and Adidas AG which detracted -0.7%, -0.6% and -0.2%, respectively.

The table below sets out some key statistics for the Fund's portfolio as at 30 June 2014:

Average market capitalisation (US$ billion)	143
Average daily liquidity (US$ million)	451
Number of companies	28
Concentration of top 10 Investments (%)	51.2
PE – 1 year forward[2]	15.7x
Average return on equity (%)[2]	19.6
Beta[2]	0.77

[2]Magellan Asset Management Limited estimates

It is worthwhile commenting that 3 of our top 10 investments (eBay, Target and Tesco) have materially lagged rising world markets over the past 12 months. eBay's share price has fallen by -3.2%, Target's has fallen by -15.8% and Tesco's has fallen by -14.2%; in comparison the MSCI Price Index in USD has risen by 21.6%.

We are not concerned about the relative share-price performance of these companies over a period of 12 months. eBay has been one of the Fund's strongest performers over the last 3-5 years and we believe that it will again be a strong performer over the next 3-5 years. In our opinion, eBay's payments business, PayPal, has some of the best prospects of any large business over the next decade. We judge our investment in eBay to be fundamentally attractive at the current share price and have included a summary of its investment case in the Key Stock in Focus section at the end of this letter.

Both Target and Tesco face significant short-term headwinds. We have spent substantial time undertaking further due diligence on both companies and consider that each are likely to overcome their respective headwinds over the next 3 years. We are realistic that the management teams of each of these companies have much to do to fix key operational issues in the short term and that it is unlikely that either company's share price will improve materially over the next 12 months. However, as stated previously, we have no way of assessing how a company's share price will perform over a short period of time; we are far more interested in where a company's share price may be in 3 to 5 years time than where it may be in 6 months time. Should these companies fix their current operational issues, as we expect, their share prices will likely move materially higher and we believe that each are likely to deliver very attractive returns for their investors over a 3 year timeframe. We would, however, caution our investors that each of these investments is exposed to material execution and competitive risks and there is a chance that they will not deliver the returns we are envisaging. Importantly, while the upside is not assured, we consider that each of Target and Tesco has limited downside risk at current share prices.

In the current market, where share prices are generally high and finding value is difficult, it is not surprising that we perceive the more attractive investment opportunities to be in companies facing difficult short-term business issues.

Magellan Global Fund as at 30 June 2014 (%)			
Microsoft Corp	6.3	Visa Inc	4.4
Lowe's Co Inc	5.8	Nestlé SA	4.2
eBay Inc	5.7	Oracle Corp	4.2
DirecTV	5.4		
Tesco PLC	5.4	Other	44.4
Target Corp	5.1	Cash	4.4
Yum! Brand Inc	4.6	**TOTAL**	**100.0**

The Fund continues to be exposed to the following major investment themes:

- **Emerging market consumption growth:** via investments in multinational consumer franchises. Approximately 17.6% of the Fund is invested in multinational consumer franchises, which generate around 40% of their revenue in emerging markets. On 30 June 2014, the Fund's 5 largest investments in multinational consumer franchises were Yum! Brands, Nestle, Danone, McDonald's and Unilever.

- **US interest rates**: In our view, it is likely that US short- and long-term interest rates will "normalise" over the next 2 years as the US economy recovers. This will occur as a result of the US Federal Reserve ending its QE programme and then taking steps to shrink (or sterilise) its balance sheet, as well as the normal monetary policy action of lifting the federal funds rate. We own 4 US financial institutions that are likely to benefit from the increase in US interest rates: Wells Fargo, US Bancorp, Bank of New York Mellon and State Street. These investments represented approximately 12.8% of the Fund on 30 June 2014.

- **A 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 as credit cards, debit cards, electronic funds transfer and mobile payments. In our opinion, the explosion of smart, or internet-connected, mobile devices will accelerate this shift on a global basis. We believe that there are only a limited number of companies that are well positioned to benefit from this structural shift. These companies are typically highly attractive, with strong network effects, low capital intensity, high barriers to market entry and high returns on capital. On 30 June 2014, approximately 11.9% of the Fund was invested in the payments space through exposure to companies such as PayPal (via eBay), American Express, Visa and MasterCard.

- **US housing:** A recovery in new housing construction, together with investment in existing housing stock, should drive a strong cyclical recovery in companies exposed to the US housing market, while providing a boost to the overall economy. Our major exposure to this theme is via our holding in Lowe's, the home improvement retailer, as well as our investments in domestic US banks, Wells Fargo and US Bancorp. These investments represented approximately 12.5% of the Fund on 30 June 2014.

- **Technology/software:** We believe that entrenched global software companies boast enormous competitive advantages and exhibit attractive investment characteristics. On 30 June 2014, 12.1% of the Fund was invested in the technology/software companies Microsoft, Oracle and SAP.

- **Internet/e-commerce:** There are a number of internet-enabled businesses that are experiencing increasing competitive advantages and showing very attractive investment characteristics. On 30 June 2014, the Fund's internet investments, eBay and Google, represented approximately 6.3% of the Strategy.

I normally detail investment mistakes that I feel we have made over the period. Fortunately, there are no glaring mistakes that have had material negative consequences over the past 12 months.

Market Commentary

China

We are becoming increasingly concerned about the short- to medium-term economic outlook for China, based on growing risks in its property market and shadow banking system.

In the past eight years, annual residential floor space completed has shot up by almost 50% (to 1.9 billion square metres in 2013), while urbanisation and population growth rates have remained relatively steady. We believe this may have created approximately 3 to 4 years of excess housing supply in China, comparable to recent property booms in the US, Spain and Ireland. Housing construction in those countries fell by between 75% and 98% when the booms ended, causing deep recessions and financial crises.

There are severe geographic mismatches between housing supply and demand in China; some Tier 1 and 2 cities suffer from housing shortages, while Tier 3 and 4 cities are believed to hold most of the excess supply. Meanwhile, many of the migrant workers moving to cities are unable to afford to buy new houses at current market prices. Most of China's excess housing supply is thought to be vacant stock held by private investors, with the remainder sitting on the books of real estate developers, many of whom are highly indebted. As a result, falls in investor demand and prices could have a devastating impact on the industry.

The risks associated with a shift in property market sentiment are serious. Property development is now a large part of the Chinese economy, directly contributing around 9% of GDP (and more still indirectly), while around 60% of Chinese household wealth is held in property. In addition, 40% of local government revenue is thought to come from land sales. The International Monetary Fund (IMF) estimates that China's fiscal deficit would be 10% of GDP if land sales and market financing of local government debt were excluded.

We believe the Chinese government must attempt to manage an orderly contraction of the property sector and accept slower GDP growth in order to avoid a major recession further down the road. We believe the probability of a Chinese recession resulting from a major property market contraction has increased. The good news is that the authorities appear to be well aware of the risks and are taking steps to cool the market.

The ramp up in property development has been fuelled by an explosion in credit over the past 5 years. Over this period, the ratio of credit to GDP has increased from 128% to 217% in China, with much of this credit creation occurring in the shadow banking system. China's shadow banking system is comprised of many unregulated financial intermediaries that provide capital to Chinese private and state-owned enterprises, local government financing vehicles (LGFVs), property developers and other entities. Within this system, loans are often packaged and sold as deposit-like products to investors hoping for higher rates of return than are available in a Chinese bank account, such as trusts and wealth management products (WMPs). Investors are generally unaware of the credit risks attached to these opaque financial instruments and assume that they will be supported by the government in the event of a default. In addition, loan collateral is often of questionable value and most WMPs have short-term maturities, which could assist in propagating a systemic liquidity event if investors start to demand their money back. Indeed, a recent run on a rural Chinese bank may be a pre-cursor of what is to come in China's shadow banking system.

Of course, China is no stranger to financial crises; in the late 1990s, non-performing loans (NPLs) at Chinese banks rose to well over 20% of total loans before government-backed asset management companies took over the debt to recapitalise the banking system. Reported NPLs of Chinese banks are currently very low, but are highly likely to be understated. On a more positive note, almost all of China's debt is held domestically and the capital account remains relatively closed, which makes it easier for the government to manage large scale defaults. However, the difference this time might be that much of the credit growth has occurred in the poorly regulated shadow banking system and the government may not have the resources to bail out this part of the financial system.

Although we remain optimistic about China's long-term economic future, the excesses in its property market and credit system appear unsustainable. We believe a slowdown in China is inevitable and it is possible that we could see a recession if we get a panic in the property or shadow banking sectors. This would have major effects on countries with trade and financial links to China. Commodity exporters such as Australia, Canada and Brazil would be especially vulnerable, as would economies in Asia, Japan and possibly also Germany. Financial links between Chinese banks and Hong Kong or Singapore could be channels for the international transmission of a Chinese financial shock, while capital repatriation by Chinese investors could hit property markets in Canada, Australia, the UK and Hong Kong.

Many investors assume that China's vast pool of foreign exchange reserves effectively inoculates it against domestic financial crises. Although this assumption may have some merit, we think that there are some practical issues which may limit the use of these reserves in addressing domestic economic instability:

- Chinese foreign exchange reserves have been built up as a result of the country's massive trade surplus and the People's Bank of China's (PBOC) management of the renminbi through foreign exchange intervention. In order to stop the currency from appreciating materially, the PBOC has printed new renminbi that it exchanges for export revenue earned by Chinese companies in foreign currency. The policy of printing new renminbi to exchange for foreign currency revenue keeps the exchange rate low by meeting excess demand for renminbi at a below-equilibrium exchange rate. The foreign currency that the PBOC receives becomes China's foreign exchange reserves. These reserves now amount to 42% of the country's GDP.
- The renminbi that is created enters the Chinese banking system and adds to the money base. To offset the potentially inflationary impact of this newly created currency, the central bank 'sterilises' the funds by issuing government securities, sucking the currency out of the system in the traditional way, or by raising bank reserve requirements (forcing the banks to hold extra reserves).
- The foreign exchange reserve asset is therefore offset by a domestic liability (the bonds issued or reserve deposits). There is no net asset created.
- All other things being equal, if China was to convert large amounts of foreign reserves back into renminbi (to recapitalise the banks or for other domestic purposes), this would put significant upward pressure on the exchange rate, which would likely be undesirable.

These practical limitations could be mitigated, to some extent, by relaxing foreign exchange controls to allow capital to flow out of China or by directly offering foreign currency assets for sale to Chinese investors. This would enable the PBOC to convert some of its foreign exchange reserves into renminbi without adversely affecting the currency. Although this may appear sensible policy at face value, a sudden and meaningful relaxation of foreign exchange controls could trigger a collapse in domestic asset prices as people attempt to sell assets to get their money out of the country.

It is also possible that the government could transfer some of its foreign exchange reserves to banks without exchanging it back into renminbi, as they did in the last round of recapitalisations. The banking system would then appear to be better capitalised, although if these banks actually tried to exchange these foreign exchange reserves back into renminbi (to match renminbi-denominated liabilities) they would run into the same issues described above.

Overall, while we believe the Chinese government has substantial resources to offset potential financial system instability, the use of foreign exchange reserves for domestic purposes faces some practical limitations.

We believe that now is a time to be cautious about exposures to China given the adjustment process that is currently underway.

United States

Notwithstanding the weak GDP growth in the first quarter of 2014, which many attributed to the very harsh winter, there are encouraging signs that the United States is undergoing a modest economic recovery that is likely to accelerate in the years ahead. Key indicators of this recovery include:

- Non-farm payrolls that have increased by 231,000 per month, on average, over the 6 months to 30 June 2014 (which is equivalent to new job creation of 2.8 million per annum). Since the bottom of the recession in December 2009, approximately 8.2 million jobs (net) have been created in the US. The total number of people employed in the US is now only 0.4 million below the all-time high of around 147 million in November 2007.
- The unemployment rate falling to 6.1% in June from 6.7% in December. This compares with a peak unemployment rate of 10% in 2009.
- Continuing falls in the total number of unemployed people. At the end of June 2014 there were 9.5 million unemployed people compared to a peak of 15.4 million in October 2009.
- Average weekly earnings increasing 2% in the year to June. Average weekly earnings are now 11% higher than in December 2009.
- Annualised automotive sales of greater than 16.5 million in the 3 months to June 2014, the highest since 2007.
- A continuing recovery in house prices. The S&P / Case Shiller 20-City Composite Home Price Index rose 10.8% over the 12 months to 30 April 2014.
- A recovery in housing starts from a low of 478,000 starts in April 2009 to 1,001,000 in May 2014. Despite this improvement, there has been reluctance by banks to write mortgages to lower income households to sell to Government Sponsored Enterprises, due to fear that they will be forced to repurchase these mortgages

in the future. This has been a significant headwind to a more rapid recovery in housing starts. The good news is that US regulators are working with banks to provide much greater clarity on rules for loans to be put back to banks. We consider that creating regulatory certainty regarding repurchase risk for conforming mortgages is critical to drive a continued recovery in the US housing market and believe it likely that housing starts will revert to more normal levels (around 1.3 million to 1.4 million per annum, which is close to the average since 1959 and a fair approximation of normalised demand) over the next 2 years. This will provide a significant further boost to the US economy and overall employment levels.

In our view, it is likely that the US economy will experience accelerating economic growth over the next 12 to 24 months, in the absence of a material negative shock. Weak growth in the first quarter of 2014 was materially affected by adverse weather, leading to large reported falls in inventories and net exports. We expect this weakness to have been transitory. We note that there is likely to be a substantially reduced fiscal drag on economic growth in 2014 compared to 2013. Economists estimate government expenditure cuts and payroll tax increases decreased GDP growth by 1.5% to 2.0% in 2013, while they are expected to decrease GDP growth by only 0.5% in 2014. We also believe that the pressure on Congress to force further near-term expenditure cuts is reducing as the federal budget deficit is falling faster than expected (currently at around 2.9% of GDP).

Europe

While the Eurozone has returned to growth in aggregate, performance varies widely by country and we remain sceptical that the region is on the verge of a sustained and meaningful recovery. The positive indicators include:

- The Eurozone returning to positive economic growth over the past 6 months, although we note that periphery economies such as Portugal, Ireland, Greece and Italy contracted in the first quarter of 2014.
- The Eurozone running a substantial current account surplus, approximately 2.6% of GDP. Importantly each of Ireland, Greece, Spain and Italy are running current account surpluses.
- Industrial production growing on an annual basis, overall and in the majority of countries. We note that industrial production contracted in France in the year to April 2014, while it grew in Germany.
- Relative unit labour costs having fallen materially in Portugal, Ireland, Greece and Spain during the past 5 years.
- Bank lending surveys indicating marginally looser credit conditions for firms and consumers were expected in Q2 2014, while demand for credit is picking up. Credit creation should be assisted by the ECB's recent shift from zero to negative deposit rates and a new round of targeted long-term refinancing operations (TLTROs) to encourage private sector lending by banks.
- The unemployment rate has fallen from its peak of 12% in 2013 to 11.6% in May 2014, led by improvements in periphery countries.
- Construction output, retail sales, employment and investment have returned to growth.

Indicators suggesting a weak recovery include:

- That the Eurozone banking system remains undercapitalised. In the absence of forced recapitalisations, the most realistic way to recapitalise banks is via further balance sheet deleveraging. This has continued in 2014, albeit at a slower pace than in previous years.
- Notwithstanding recent developments, there is a long way to go to establish a comprehensive European Banking Union.
- Portugal, Ireland, Italy, Spain, Greece and France remain fiscally stretched, with high levels of government debt and ongoing budget deficits.
- Weak price growth and falling inflation expectations have increased the risk of deflation. This could be a major problem for certain Eurozone economies that are reliant on nominal growth and inflation to reduce their very large debt burdens.

The European Central Bank (ECB) is aware of these risks. In June it announced a range of measures to provide additional stimulus to Eurozone economies as mentioned above. The most important measures included reducing the rate that the ECB pays on banks' deposits to minus 0.1% to encourage lending, as well as a commitment to provide up to €1 trillion of TLTROs from 2014 to 2016 in order to enable banks to borrow at ultra-cheap rates to lend to the non-financial private sector (excluding mortgages). The ECB also took its first step towards adopting QE by ending its weekly sterilisation of government bonds purchased under the Securities Markets Programme. Further, it indicated that it is looking at a form of QE where it purchases non-government asset backed securities. Despite this, a cloud continues to hang over the bank's policy to purchase unlimited amounts of distressed sovereign debt, with the German Constitutional Court reserving the right to rule unfavourably in the future. The case has passed on to the European Court of Justice for now.

We continue to believe that many European countries face a prolonged period of sub-par economic growth due to the combined effects of fiscal austerity by governments and deleveraging of bank balance sheets, and by households. We are cautious that Europe remains vulnerable to major external shocks. At present, the governance arrangements in the Eurozone are complex and are conducive to policy paralysis rather than decisive action and reform. The near-term risk is a dramatic uplift in European sovereign bond yields, potentially triggered by a disorderly unwinding of QE in the US. This scenario would heavily test the resolve and mandate of the ECB to intervene in the sovereign bond markets of troubled EU countries in an unlimited way. We are also guarded on the resolve, and capacity, of European governments to step in to save banks that may fail in such a scenario and, therefore, remain cautious about holding investments leveraged to a European cyclical recovery at this point.

Stock in Focus:

ebay inc™

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

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 would rank among the world's top 10 retailers, having facilitated over US$75 billion of Gross Merchandise Volumes (GMV) in 2013. With 140 million active users, Marketplaces provides significant value to online merchants seeking customers, with only Amazon 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. While auctions and vehicle sales have continued to fall, total Marketplace's 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 more than 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 this information to merchants. It offers small merchants a convenient means of accepting payments and reduces shopping cart abandonment by streamlining the transaction. Over the last 3 years, PayPal has experienced well over 20% compound growth in revenue and operating profit.

PayPal is a member of a select group of global payment providers, including Visa, MasterCard and American Express. We consider that it is difficult for large tech companies like Google, Apple and Amazon to achieve material success in the payments market due to the chicken-and-egg problem of building scale on both the merchant and consumer side, the difficulty of providing sufficient product differentiation to encourage behavioural change, and high fraud and loss risks.

PayPal is highly scalable. As strong growth continues and PayPal completes the build out of its global payment infrastructure, we expect that, over time, operating margins will expand materially. Current margins are 24%, compared to Visa and MasterCard's margins of 50 to 60%.

The Omni-Channel Opportunity

The dramatic growth in smart-phones and tablets, coupled with ubiquitous wireless connectivity, has changed the way that people use the internet and expanded the addressable market for internet companies. On the most basic level, eBay benefits from growth in mobile connectivity, as its users can access its services more frequently and with greater convenience. PayPal is especially useful on smart-phones, 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$33 billion.

Furthermore, smart-phones are much more than just another screen to access the internet. They are personal, location-aware, always on, immediate and socially-enabled. These devices are quickly bridging the gap between what was previously perceived to be 2 separate retail channels: online 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 increase the number and quality of services that it offers. eBay has estimated that the global retail market is $10 trillion in size, of which $1 trillion is e-commerce related and $4 trillion is mobile-enabled (that is, commerce that is transacted in the physical world but can be completed online; for example, paying for a Starbucks coffee in-store using its mobile app linked to a credit card).

In this environment, eBay's businesses are well positioned to become partners of traditional offline retailers. Many traditional retailers continue to struggle due to the secular shift to e-commerce, with these struggles compounded by increasing competition from Amazon:

- **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. A customer may find in-store pick-up more convenient than 2-day shipping and this is a service that Amazon's distributed warehouses cannot offer. In some cities, eBay now offers customers the choice of 1-hour delivery for $5.
- **Levelling the data playing field and more:** In the US, PayPal is increasing its presence offline at the point of sale, with Home Depot and Jamba Juice among the early adopters. PayPal encourages customers to identify themselves to merchants in order to receive special treatment. This increases a merchant's visibility into its customers' behaviour and improves its ability to reward loyalty, personalise the shopping experience and drive sales. Such special treatment includes ordering ahead and skipping the queue, in-store / in-aisle merchandising, loyalty schemes and faster payment (e.g. pay without the waiter). Merchants may also use PayPal to encourage consumers to use their own store cards, which have lower fees than Visa / MasterCard / American Express cards and can facilitate the collection of greater levels of customer data.

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's gross sales and 11% of online transactions off-eBay, but it is currently used for virtually of offline transactions - 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.

Yours sincerely,

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