Fund Update: 31 December 2014

Magellan Global Fund

ARSN: 126 366 961

Key Facts

Portfolio Manager	Hamish Douglass
Structure	Global Equity Fund, $AUD unhedged
Inception Date	1 July 2007
Management & Administration Fee[1]	1.35%
Buy/Sell Spread[1]	0.10%/0.10%
Fund Size	AUD $6,790.0 million
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (MSCI World Net Total Return Index (AUD)) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

[1]All fees are exclusive of the net effect of GST

AUD Performance[2]

	Fund (%)	Index (%)[3]	Excess (%)
1 Month	3.8	2.6	1.2
3 Months	11.3	8.0	3.3
6 Months	18.1	14.0	4.1
1 Year	14.5	14.7	-0.2
2 Years (% p.a.)	30.5	29.9	0.6
3 Years (% p.a.)	26.3	24.5	1.8
5 Years (% p.a.)	17.8	12.3	5.5
7 Years (% p.a.)	13.0	4.3	8.7
Since Inception (% p.a.)	11.5	3.5	8.0

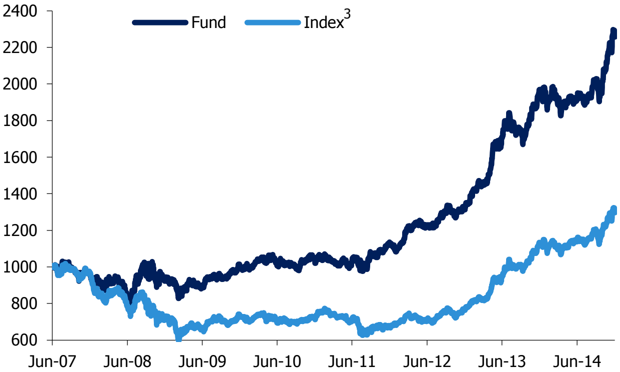
Top 10 Holdings

		% of Fund
eBay Inc	Information Technology	6.0
Microsoft Corp	Information Technology	5.9
Lowe's Co Inc	Consumer Discretionary	5.6
Oracle Corp	Information Technology	5.1
Visa Inc	Information Technology	4.8
Yum! Brands Inc	Consumer Discretionary	4.6
SAP	Information Technology	4.6
Nestlé SA	Consumer Staples	4.5
Target Corp	Consumer Discretionary	4.3
Home Depot Inc	Consumer Discretionary	4.0

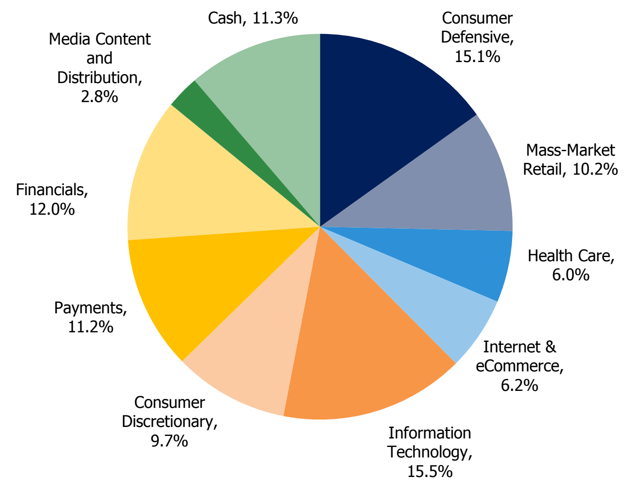
Regional Breakdown

	% of Fund
Multinational[4]	42.4
North America	39.9
United Kingdom	6.4
Australia	0.0
Europe	0.0
Japan	0.0
Asia Ex-Japan	0.0
Cash	11.3
Total	**100**

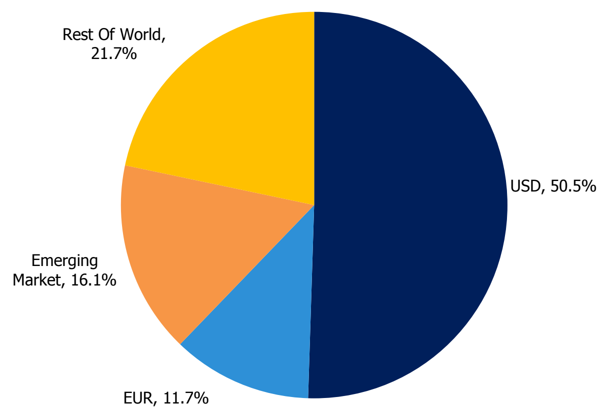
Performance Chart growth of AUD $1,000[2]



Industry Exposure by Source of Revenues[5]



Geographical Exposure by Source of Revenues[5]



[2]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 2007.
[3]MSCI World Net Total Return Index (AUD)
[4]Multinational: Greater than 50% of revenues outside home country.
[5]Calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio – Magellan defined sectors.

Market Commentary

Global equity markets initially suffered declines in the final quarter of 2014, as investors fretted over slowing global growth rates (led by weakness in Europe and China) and disinflationary pressures exacerbated by falling oil prices. However, markets later recovered, buoyed by positive US economic data (in particular, strong employment numbers) and a number of supportive central bank policy actions. The latter included the Bank of Japan's decision to ramp up its quantitative easing programme and various stimulatory measures by the European Central Bank, such as its commencement of asset-backed security and covered bond purchases, its retention of negative deposit rates and its commitment to undertake sovereign QE if necessary.

The Federal Reserve ended its asset purchase programme as the US economy continued to recover, as expected. There remains considerable uncertainty about the future trajectory of US monetary policy. This is highlighted by the large discrepancy between the Federal Open Market Committee's latest projections for the Fed Funds Rate and implied forward market pricing, which poses a downside risk to asset markets should rate increases materially exceed market expectations. This could occur as the labour market strengthens further, credit growth picks up, capacity in the US economy diminishes and core inflation returns to target.

Since the beginning of 2013, we have observed a massive compression in risk premia across multiple asset classes. We believe that there is an elevated probability that this compression will unwind over the next 12 months or so as investors focus on a normalisation of US interest rates. Broadly speaking, market risks are elevated at present due to uncertainty about the trajectory of interest rates in the US, emerging market instability, ongoing sovereign debt challenges in Europe, the slowdown in China and commodity price declines, each of which could trigger material corrections in global credit and equity markets.

Fund Commentary

As of 31 December 2014, the Fund consisted of 26 investments, compared to 27 investments at 30 September 2014. The top ten investments represented 49.3% of the Fund on 31 December 2014, while they represented 48.2% of the Fund on 30 September 2014. The cash position was 11.3% compared with 10.5% at the end of the prior quarter.

Lowe's, the US home-improvement retailer, was the Fund's top contributor over the period. It announced strong results driven by macroeconomic tailwinds such as the continuing recovery of the housing market, an improving employment situation and falling energy prices, as well as better internal execution. Furthermore, its management indicated that they expect an acceleration in operational-expenditure leverage in 2015. Wal-Mart also did well, with its US business achieving positive comparable store sales growth for the first time in seven quarters. This was driven by improved traffic trends (a benefit of a strengthening in the US economy) and the decline in gas prices affording its customers greater disposable income. Likewise, Target was another strong performer, with gains made in its digital and merchandising initiatives helping the company achieve its best traffic trends, again in seven quarters. Target's management also guided investors to improved profitability metrics in the final quarter of 2014, as the business cycles the negative impact of the highly-publicised data breach that occurred in December 2013.

Sanofi was the largest detractor from performance. Its share price fell after the company guided for lower sales of its key drug Lantus, for diabetes, and fired its CEO. We believe that it has guided for the worst case scenario: a price war with Novo Nordisk that is not in the interests of either company. Sanofi still has the best drug in a strong diabetes market, as well as a base of reliable, diverse products across pharmaceuticals, vaccines and consumer and animal health. It also boasts a promising suite of pipeline drugs. For these reasons, we think the market has underestimated its potential to return to growth.

The Fund's investments within the technology sector experienced mixed performance. Google lost ground after coming under increased political pressure in Europe, including a proposal for the company to be broken up. Although we judge this as highly improbable, behavioural change driven by increased regulatory pressure could prove to be a headwind to growth. Conversely, Oracle made gains as continued strong growth in its cloud software business reduced the market's assessment of the competitive threat posed by pure-play cloud software vendors. Elsewhere, the Fund's investments in global payments businesses Visa and MasterCard did well, with both companies reporting stronger-than-expected results that included double-digit payment volume gains and optimistic outlooks, despite fears over the effects of slowing global growth. Furthermore, China's decision to open its domestic payment processing monopoly to external payment networks was also well received.

Key Stock in Focus - SAP

SAP is the fourth largest software vendor in the world. It derives the majority of its earnings from the sale of software applications to enterprises, with its flagship application suite, the SAP Business Suite, running enterprises' core business processes such as payroll, human resources ('HR'), supply chain and financials. SAP leverages its strong position in enterprise applications to sell Business Intelligence software (which is used by companies to analyse data) and various database software products targeted at different use cases.

<u>Entrenched Market Positions</u>
SAP is the incumbent leader in core enterprise applications and Business Intelligence software, especially among large enterprise customers in mature markets. It is difficult for small vendors and non-incumbents to develop software to compete with SAP products, which have been refined over decades and operate across numerous business lines, industries and geographies (with, for example, intricate nuances in tax and regulatory structures). Furthermore, SAP maintains a global network of sales and support personnel and boasts significant software development resources. Its ability to service large enterprise application customers is matched only by Oracle.

In mature markets, many large enterprise customers have remained settled with the same application vendor for decades. This is because the costs inherent in switching enterprise applications are high, owing to investments made by users in customising applications for their needs, as well as the necessity to integrate systems with business processes and test them thoroughly. Additionally, the risk associated with changing systems is heightened by the fact that applications often perform mission-critical functions. As a result, customer attrition is low (SAP says that gross customer attrition averages 1% per annum).

<u>Favourable Business Model</u>
Software support is SAP's most valuable and dependable business, generating almost €9 billion and growing by 11% (excluding currency effects) in 2013. It accounts for 50% of the company's revenue and likely a materially larger portion of its earnings, as SAP's software support earnings margin likely exceeds 80%.

Almost all of SAP's 261,000 customers purchase software support contracts annually, as they are required to do so in order to access important product updates, software patches and technical support services. The recurring nature of SAP's software support revenue helps insulate its financials from adverse economic shocks, while it also allows the company to generate significant excess returns on its relatively small capital base.

<u>Technology Risk</u>
Enterprises have traditionally accessed software by purchasing licenses from software vendors and installing software programs on servers located on their premises. However, the development of the internet and advanced software tools has increasingly enabled enterprises to source software from "cloud" software vendors instead. Enterprises are now able to subscribe to software products hosted in large-scale, off-premise commercial data centres that they access via the internet.

Although cloud computing threatens to reduce the size of the addressable market for new on-premise software licenses, SAP was among the slowest of the legacy technology vendors to address the cloud threat. As a result, market concerns regarding the potential impact of cloud computing on SAP's business have weighed on the stock.

Despite these concerns, a number of factors mitigate the risk posed to SAP by cloud vendors. First, a significant portion of SAP's customers are likely to prefer to retain their SAP applications on premise, either because their applications are mission critical or because the benefit of shifting their applications to the cloud is less apparent. The competitive threat posed by cloud vendors also varies by business line; while Salesforce.com and Workday have rapidly penetrated the respective salesforce automation and HR software markets, there are few cloud-based alternatives to SAP's complex, industry and geography-specific financial and supply chain management software products. In addition, significant switching costs have historically inhibited enterprises' ability to change application vendors. In any case, it is foreseeable that continued demand for on-premise software in emerging markets may support SAP's on-premise license sales, despite the threat posed by cloud-based alternatives.

Notably, SAP has now made its flagship Business Suite applications available via the cloud with subscription pricing, optimised with the company's high-speed HANA database. The value proposition of the cloud Business Suite will continue to improve as SAP simplifies and modernises its application user interface, and as its HANA database product matures. We anticipate that SAP will continue to build out its cloud portfolio over time, offering its existing customers a manageable pathway to the cloud.

<u>Summary</u>
SAP boasts a solid on-premise software business and appears to be making progress transitioning its software assets to the cloud, although continued execution and patience are required. We judge the company to be well placed to deliver attractive returns to shareholders over our investment horizon given its current valuation.