MAGELLAN
ASSET MANAGEMENT LIMITED

HALF YEARLY INVESTOR REPORT
31 DECEMBER 2011
Magellan Global Fund

Dear Investor,

I am delighted to write to you as an investor in the Magellan Global Fund ("Fund") for the 6 months ended 31 December 2011.

Over the 6 months to 31 December 2011, the Fund has returned 8.2% net of fees and for the 12 months the net Fund return was 9.8%. The 12 month return exceeded the Fund's benchmark by 15.4%. Over the past 2, 3 and 4 years the Fund has returned 6.0% per annum, 6.2% per annum and 3.9% per annum respectively.

It is important for investors to appreciate that notwithstanding the strong performance of the Fund compared to global stock market indices over the past 4 years, we do not manage the Fund against short term performance metrics and it is inevitable the Fund will underperform markets at some point in the future. We aim (not guarantee) to produce absolute returns of a minimum of 9% per annum through the business cycle whilst minimising the risk of a permanent capital loss. We will continue to focus on these objectives and will not chase short term performance.

We have seen volatile and difficult investment markets over the past six months. The major event driving short term market moves has been the European sovereign debt crisis. Notwithstanding the volatility and uncertainty, the Fund remained fully invested during the past 6 months with cash at 31 December 2011 of 3.3%. In contrast in September 2008, in the immediate aftermath of the collapse of Lehman Brothers, we increased the cash weighting of the Fund to 31% (at 31/12/08) and decreased the Fund's exposure to financials to 5.4%. In the December 2008 Investor Report we commented:

"The decision to substantially reduce the Fund's exposure to financials was made following the collapse of Lehman Brothers on 15 September 2008. In the days following the collapse of Lehman Brothers the global commercial paper market froze, which resulted in the complete seizure of the interbank funding market. This was a 1 in a 100 year event that nearly led to the collapse of the world's banking system. In our view, the freezing of the interbank funding market and the subsequent loss of depositor confidence substantially altered the risk profile of banking institutions. It was for this reason that we decided to effectively exit the bank investments in the Global Fund."

You may be interested why we remained fully invested over the past 6 months in contrast to the action we took in 2008. The principal reason is we consider the risk of a systemic financial system meltdown as a result of the European sovereign debt crisis is substantially less than the risk following the collapse of Lehman Brothers. We have held this view notwithstanding dramatically increasing credit default swap costs for certain European sovereign debt, soaring sovereign bond yields, an undercapitalised banking system, credit rating downgrades and failure of governments to put in place a comprehensive solution. Whilst not wanting to underplay the seriousness of the situation in Europe, we believe the lessons of the collapse of Lehman Brothers are fresh in central bankers and policy maker's minds and it is likely that they will continue to pursue policies to head off a systemic meltdown. The most critical short term policies are:

- The ECB and other central banks have put in place, and we believe will continue to put in place, facilities to ensure the banking system has access to sufficient liquidity to meet their funding requirements. In December the ECB offered European banks €498 billion of 3 year funding. The ECB will offer another unlimited tranche of 3 year funding in February. This aggressive policy action has dramatically reduced near term liquidity risk for the European banking system and has improved liquidity and reduced yields for Italian, Spanish and French sovereign debt.
- The European Union and IMF are likely to continue to provide sufficient funding to head off an uncontrolled default of a sovereign state, most notably Greece and Portugal.

Whilst we anticipated that financial markets would be volatile we considered it was not prudent in the current circumstances to move to a material cash weighting. In our view such a strategy could have proved costly to investors as investments would be sold during a period of pessimism and uncertainty only to be bought at higher prices as the outlook became clearer. Whilst we consider the risk of a financial Armageddon event to be low the probability is not zero. As we have commented in prior Investor Reports we believe that a key lesson from the global financial crisis is that prudent portfolio construction is critical for reducing risk, and particularly important in the circumstances that a"tail event" strikes. The key to prudent portfolio construction is to ensure an investment portfolio does not have a high level of aggregation risk (i.e. the risk attached to similar economic, competitive or regulatory forces) and avoiding or minimising exposure to speculative excess or bubbles. We feel comfortable with the overall risk profile and construction of the Fund's portfolio and believe it is likely to exhibit substantially less downside risk than the market in the event that the situation in Europe deteriorates materially.

We believe the extraordinary policy responses in recent years, particularly by the Federal Reserve and ECB, has fuelled a number of current bubbles and distortions in certain asset markets, most notably foreign exchange and bond markets. It is inevitable that these distortions will unwind at some point and there is a reasonable chance that bond prices and foreign exchange markets could adjust very rapidly. The longer these policy responses are held in place the more complacent investors are likely to become believing that this environment is the"new normal". We do not believe that these policy settings will last indefinitely and believe the portfolio is well positioned for the eventual correction.

PORTFOLIO SUMMARY

Magellan Global Fund - as at 31 December 2011			
Google	7.56%	Visa	4.55%
eBay	6.97%	US Bancorp	4.52%
Lowe's	6.55%	Nestle	4.40%
Yum! Brands	6.00%		
Danone	5.04%	Other	41.42%
Wells Fargo	4.87%	Cash	3.27%
Novartis	4.83%	TOTAL	100%

As at 31 December 2011, the Fund's portfolio consisted of 24 investments (in comparison with 23 investments at 30 June 2011). The top 10 investments represented 55.3% of the portfolio at 31 December 2011 compared with 58.4% at 30 June 2011.

The cash weighting of 3.3% at 31 December 2011 is consistent with our view that it remains an attractive time to be investing in a carefully selected portfolio of stocks. The portfolio is well balanced and exposed to themes, such as emerging markets consumption growth, the move to a cashless society and e-commerce.

Over the 6 months to 31 December 2011 the three stocks with the strongest returns in local currency were Google (28%), MasterCard (24%) and Visa (21%) and the stocks with the weakest returns were eBay (-6%), American Express (-8%) and L'Oreal (-10%). On an absolute basis the three largest stock contributors in local currency were Google, Visa and MasterCard, which added 1.95%, 0.91% and 0.91% respectively and the biggest detractor was eBay (-0.44%).

The following table sets out some key statistics for the Fund's Portfolio as at 31 December 2011:

Average market capitalisation (US$ billion)	97
Number of stocks	24
Average daily liquidity (US$ million)	504
PE – 1 year forward*	14.2
Beta*	0.8
Average return on equity*	21%
Concentration of top 10 Investments	55.3%

*Magellan estimates

There have been very few major changes to the Fund's portfolio during the past 6 months. The material changes have been an increase in the weighting of investments in Lowe's and Danone and a new investment in Novartis, a diversified global healthcare company based in Switzerland.

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

- Emerging market consumption growth via investments in multinational consumer franchises. The Fund has approximately 43% of the portfolio in multinational consumer franchises which have on average approximately 40% of their sales revenue from emerging markets. The five largest investments in multinational consumer franchises at 31 December 2011 were Yum! Brands, Danone, Nestle, Procter & Gamble and Unilever.
- 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 mobile phones 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. The companies are typically highly attractive with strong network effects, low capital intensity, high barriers to entry and high returns on capital. As at 31 December 2011, the Fund had approximately 16% of the portfolio invested in the payments sector through exposure to companies such as PayPal (via eBay), American Express, Visa and MasterCard.
- Internet/e-commerce. There are a number of internet enabled businesses that have very attractive investment characteristics with increasing competitive advantages. The Fund's internet investments at 31 December 2011 were eBay and Google, which represented approximately 15% of the Fund's portfolio.
- US housing. A recovery in new housing construction should drive a strong cyclical recovery in companies exposed to US housing and also provide a strong boost to the overall economy. Our major exposure to the US housing market is via our exposure to the home improvement retailers, Lowe's and Home Depot, and the domestic US banks, Wells Fargo and US Bancorp. These investments represented approximately 19% of the Fund's portfolio at 31 December 2011.

I normally detail investment mistakes that I feel we have made over the period. Fortunately, there are no glaring mistakes that have had materially negative consequences over the past 6 months.

MARKET COMMENTARY

- Europe

As stated above we consider the risk of a financial Armageddon event resulting from the European sovereign debt crisis is low. We estimate the total sovereign funding requirement, i.e. maturing government bonds and budget deficits, for the PIIGS countries (Portugal, Ireland, Italy, Greece and Spain) at around €638 billion for 2012 and €365 billion for 2013. Italy and Spain represent around 84% of the total PIIGS funding requirement over the next 2 years. The recent action by the ECB in providing €498 billion of 3 year funding to European banks, together with another round of unlimited 3 year funding to be offered in February, has dramatically reduced the funding risk for both banks and solvent European nations (i.e. Spain and Italy) that were at the risk of being locked out of funding markets. In the last 6 weeks the sovereign yields of Spain and Italy have fallen materially and both nations have successfully issued bonds at lower rates than previously.

The situation in Greece and Portugal has continued to deteriorate and they are highly unlikely to be able to remain solvent in the absence of support from the EU and the IMF. We estimate the total sovereign funding requirement for Greece and Portugal at around €130 billion over 2012-2013. Given that the actions of the ECB have substantially reduced the risk of the liquidity risks spreading to Spain and Italy, we consider that the existing resources of the EU bailout facilities and the IMF are sufficient to handle the funding requirements of both Greece and Portugal. Whilst the situation facing both Greece and Portugal is dire, we believe that both the EU and IMF are highly likely to continue to provide funding to ensure there is not an uncontrolled default which could trigger a banking crisis in Europe. Of course both countries need to be put on a sustainable financial footing which will require a substantial write down of Greek debt, large budgetary cuts and economic reform in both countries.

We continue to believe that many European countries face a prolonged period of sub-par economic growth (and in many instances recessions) due to the combined effects of fiscal austerity by Governments, deleveraging of bank balance sheets and household deleveraging.

- US

In the June 2011 Investor Report we stated:

"Notwithstanding the enormous monetary and fiscal stimulus, the US economy has grown less vigorously than we expected during the past 12 months. Part of this may be attributable to ongoing uncertainties such as the sovereign debt issues in Europe and the global supply distribution due to the Japanese earthquake. However, the likely major reasons for the slower rate of growth are that household deleveraging has most likely offset the benefits of fiscal stimulus and the unemployment situation is unlikely to materially improve until housing construction recovers.

In our view it is inevitable that US housing construction will recover over time to a level where new housing starts approximate the rate of household formation plus natural attrition of housing stock. We estimate the equilibrium rate of housing starts at around 1.5 million units per annum. This can only occur when the current level of excess housing stock is depleted. The good news is that current housing construction is running at around 550,000 to 600,000 units per annum. Based on our estimate of the current level of excess housing and pent up demand for household formation we believe it will take around 3 years for the US housing construction market to recover. This recovery should drive down the unemployment rate and provide a strong boost to the overall economy.

We are also fairly relaxed about the US fiscal position and the level of US government debt. We believe that the US has numerous fiscal choices to reduce its budget deficit to sustainable levels over the next three years and there is little chance that the US will default on its obligations or that the US dollar will lose its"reserve currency" status for the foreseeable future. We believe that this issue is unlikely to be fully addressed until after the next Presidential election in November 2012."

Update

There are encouraging signs that the US is undergoing a modest economic recovery. We continue to believe that there is unlikely to be a meaningful reduction in the unemployment rate until housing construction reverts to more normalised levels, which we consider will take another 2 to 3 years.

- China

China's economic growth over the past 3 years has been aided by an enormous stimulus programme, focused on fixed asset investment by local governments. It is highly likely that a meaningful portion of the investment has been directed towards unproductive and uneconomic assets. This has been funded by Chinese banks lending to local government off balance sheet financing entities, as local governments are not permitted to borrow directly. It is estimated that local government debt now sits at 40-50% of GDP. If you add Central Government debt at around 20% of GDP, China's government debt as a percentage of GDP is catching the US, UK and Germany. Clearly a policy of continuing to drive GDP growth via the build up of off balance sheet local government debt is unsustainable. The investment boom and expansion of credit has led to rampant property markets and inflationary pressures. Some market participants have stated that they believe that the policies of recent years will result in a hard economic landing, with massive loan write offs and a property crash. We believe this scenario is unlikely as we believe the Chinese authorities have the tools available to absorb bad loans and curb further speculation. We agree with many economists that China is likely to experience a relatively soft landing with slowing economic growth, albeit at healthy levels, over the next few years.

We have been asked about the impact a slowdown in China would have on the Fund and particularly on Yum! Brands. We believe it is necessary to focus on the difference between slowing GDP growth and the shift in drivers of GDP growth. The 12th Five Year Plan is aimed at improving income equality, lifting domestic consumption as a proportion of GDP and rebalancing China's economic growth model. China has stated that it wants to double the minimum wage over the next 5 years, improve safety nets and provide affordable housing as part of the economic transition. It is highly likely that a soft landing combined with deliberate policies to rebalance will result in lower growth in fixed asset investment over the next five years. We do not believe that this will be a material issue for companies in the portfolio and most notably Yum! Brands. It is the rise of consumer purchasing power and the growing middle class which is the meaningful driver of revenue growth for businesses like Yum! Brands. Of course, businesses must be able to pass through the effects of rising wages on cost inflation. We continue to believe that Yum! Brands is well positioned to prosper from a growing Chinese middle class almost irrespective of the rate of GDP growth over the next few years.

- Middle East

The increasing tensions over Iran's nuclear programme has the potential to cause a severe disruption to the world's oil supply. If this resulted in a prolonged period of dramatically higher oil prices it could be the catalyst for another global recession at a time when many governments are too fiscally stretched to respond. Iran recently threatened to shut down the Strait of Hormuz in response to EU sanctions. We do not know whether such an action would be effective as it is likely that the West would respond to keep the Strait open. We also do not know whether Israel and the West are likely to make a pre-emptive strike against Iran in an attempt to stop Iran obtaining a nuclear weapons capability. This is a classic"known unknown" where we can clearly see the risk but it is virtually impossible to handicap the probabilities of potential outcomes. We believe that the Fund is conservatively positioned and is likely to exhibit materially lower downside risk in the event that this situation severely disrupts the World's oil supply.

KEY STOCK IN FOCUS

GOOGLE

Google is the dominant search engine in the World. We estimate it generates 80% of global search revenues.

Google earns the bulk of its revenue from advertisers that pay when a user clicks on paid advertisements (blue text link) which appear next to the non-paid links on Google's search results page. Search advertising has proven to be very valuable as it presents customised advertisements only to individual users who are already showing commercial intent described by the search term they are typing (e.g. ads for cars are displayed when a user searches for "Toyota Corolla") This compares to TV advertising, where a single ad is shown to millions of passive viewers, a small share of whom may be interested, but at a time when they are typically showing no intent to buy.

Another benefit of search over traditional advertising is that it is highly measurable – advertisers can easily track the amount they spend on search against the online sales delivered. Google allows anyone to advertise against any word, competing in an auction for top placement. This measurability coupled with the auction process means that search terms are valued to ensure that the advertiser will make a good return on its expenditure and that Google keeps a meaningful slice of the value it creates. For example in 2011 the search term"self employed health insurance"cost advertisers US$43.39 per click, while "unemployment benefits" cost US$1.37 per click.

This has been an incredibly successful business model. By 2010, in little over 10 years of existence, search advertising had grown to over US$35b in global revenues, 8% of the global media advertising market, compared to newspaper advertising which is 20%. The lion's share of this revenue flowed to Google.

But this growth is far from finished. Firstly, penetration of existing developed markets will continue. According to the IAB, in 2010 the UK had the highest penetration of search at 17% of total advertising, compared to 7% in the US indicative of significant growth left in the US. Second, Google will benefit from growth in major emerging markets where it is already dominant such as India, where less than 10% of the population currently uses the internet. Finally, search is expanding beyond the desktop computer, particularly to mobile devices (tablets and smartphones). There are two major benefits to mobile search – firstly the proliferation of devices leads to many more searches, many of which are complementary to desktop searches. Mobile internet access is particularly valuable in emerging markets where almost everyone has a mobile phone but few have access to a desktop computer. Secondly, people always have their mobile devices with them, so mobile search can have immediate commercial intent, which is very valuable to advertisers, particularly local businesses like restaurants and bars. In the US, Google has estimated that already 30% of restaurant searches are performed on mobile devices. Hastening the growth of mobile search and ensuring that the lion's share of revenue continues to flow to Google explains its investment in the Android mobile operating system which it provides free to handset manufacturers. After releasing Android in 2009, Android had been activated on 250 million smartphones by December 2011, making it the leading mobile operating system globally.

Barriers to competitive entry are very high due to internet search's fixed costs. To deliver relevant results in milliseconds, search engines use complex algorithms chewing through immense amounts of constantly evolving internet data from trillions of websites which is stored in massive data centres situated throughout the world to limit latency. Potential competitors must incur research and infrastructure costs irrespective of revenues, which are driven by the amount of users, who typically use a search engine habitually. For example Microsoft's Bing, the second largest search engine in the US with about 30% search query share (including Yahoo's volume) made an operating loss of approximately US$2.5 billion in the year to June 2011. Despite offering broadly comparable search results, few users switched from Google, even when Bing offered users cash to use their search engine for e-commerce. As a result advertisers spent far less on Bing advertising than their search query share would suggest. Conversely, Google benefits handsomely from economies of scale, generating US$10b in free cash flow in 2011. Google had US$40b in net cash by the end of 2011.

Google is leveraging its success in search by investing in adjacent areas which are already huge businesses:

- YouTube represents about half of all of the internet video watched in developed markets and is beginning to compete for the US$180b TV advertising market as users watch increasing amount of video content online. Google is attempting to bring the customisation, automation, targeting and measurability of search to video advertising.
- Online display advertising, a US$25b market, dominated by portals (e.g. Yahoo!) and social networks (e.g. Facebook). This is already a US$5b business for Google (including YouTube).
- Google Apps is a cloud-based competitor to Microsoft Office. Google Apps leverages off Google's extensive global data centre infrastructure to deliver email and productivity applications to businesses.

Despite an entrenched market position and huge growth opportunities the market price undervalues Google because of several fears including government regulation, competition from vertical search engines, competition from Facebook, patent litigation, and lack of clarity in respect to Google's intentions regarding its large and growing cash balance. While we do not discount these concerns, we believe their potential impact is limited.

Yours sincerely,

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