MAGELLAN ASSET MANAGEMENT LIMITED

ANNUAL INVESTOR REPORT

30 JUNE 2008

Magellan Global Fund

Investment Manager's Report

DEAR INVESTOR

I am delighted to write to you as an investor in the Magellan Global Fund for the 12 months ended 30 June 2008.

For the 12 months to 30 June 2008 the net fund return was -17.2%, compared with the market benchmark [MSCI World Net Total Return Index $A] of – 21.0%. Whilst the short term absolute return levels of both the fund and the market benchmark are clearly disappointing they should not be that relevant for an investor with any sensible investment horizon. For example, at 31 May 2008 the net fund return since inception [1 July 2007] was -7.5% after fees compared with the market benchmark of -12.4%. These are clearly very volatile market conditions and short term market movements often reflect the mood of the market rather than the increase or decrease in the long term intrinsic value of a business. John Bogle, Founder of The Vanguard Group, wrote in his *Little Book of Common Sense Investing* that "the stock market is a giant distraction from the business of investing."

The market often provides us with excellent investment opportunities to buy or sell at prices significantly different from our assessment of the intrinsic value of underlying businesses. In chapter 8 of the *The Intelligent Investor*, Benjamin Graham introduced the concept of "Mr Market". Mr Market is an obliging business partner who every day is prepared to tell you what your interest in a business is worth and is prepared to buy or sell you an additional interest on that basis. Sometimes he quotes you very reasonable prices based on the business prospects and developments as you know them. Often, Mr Market is unpredictable and temperamental and quotes you ridiculously high or low prices.

Additionally Graham wrote: "Basically price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."

We agree entirely with Messrs Bogle and Graham that for most investors the daily quotation of stock prices are a giant distraction and can lead people to make entirely incorrect investment decisions. As Warren Buffett has stated on numerous occasions "the market is there to serve you not instruct you". We remain entirely focused on analyzing the underlying results and economics of businesses in which we seek to invest in and virtually ignore daily share price movements unless we are interested in making purchasing or selling decisions.

In a recent speech (June 2, 2008) to a conference of Financial Planners in Florida John Bogle said:

"Investing to me, is all about the long-term ownership of businesses, focused on the gradual accretion in intrinsic value that is derived from the ability of our corporations to produce the goods and services that our consumers and savers demand, to compete effectively, to thrive on the entrepreneurship, and to capitalize on change, adding value to our society." ...

"Speculation is just the opposite. It represents the *short*-term- not *long*-term – holding of financial instruments, not businesses, focused (usually) on the belief that their prices, as distinct from their intrinsic values, will rise".

At Magellan we are clearly focused on the business of investing and not speculating on short term price movements.

I wrote in the December 2007 Half Yearly Report that we remain focused on assembling a portfolio of what we regard to be outstanding companies, and during times of market volatility, we are often provided with opportunities to buy these outstanding companies at lower valuations. We aim to purchase securities when we believe that the investment will deliver very satisfactory returns for our investors over a 3 to 5 year timeframe. We are far more interested where a company's share price is likely to be in 5 years time than where it may be in 6 or 12 months time.

Notwithstanding the short term adverse share price movements for many of the companies in which the Fund has invested, there has been no material change to our assessment of the underlying intrinsic values of these companies and we believe that each of these companies will deliver very satisfactory returns over a 3 to 5 year period.

In fact we have been selectively making investments throughout June as pessimism moved to a mood of fear and panic. Sir John Templeton who recently died at the age of 95 was perhaps best known for saying: "Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."

We are very conscious that many investors have caught "falling swords" by making contrarian investment calls simply on the basis that it must be a good time to buy when others are panicking. We generally take a very cautious stance, and undertake extensive investment analysis, in order to seek to avoid the "falling swords". Our investment returns over time will depend on whether our analysis about the economics and competitive position of a business is correct and not on short term share price movements. Benjamin Graham stated: "You are neither right nor wrong because the crowd disagrees with you. You are right because your data and reasoning are right."

We fundamentally believe that over time a business' share price should broadly track its underlying intrinsic value. This is what Graham was referring to when he pointed out: "in the short run the market is a voting machine ... (but) in the long term it is a weighing machine"

At Magellan we have two fundamental investment objectives:

- To achieve superior risk adjusted investment returns; and
- To minimise the risk of a permanent capital loss for our investors.

The concept of minimising the risk of a permanent capital loss is integral to our philosophy of how we manage money. We believe that this central concept is different to many in the funds management industry. For many, risk is effectively measured as the danger of falling short of the benchmark, rather than the risk of losing capital for investors. In my view investors in recent years have become unrealistically obsessed with chasing returns without any real appreciation of the risk of losing their capital.

At Magellan we believe in the "prudent man rule" in managing money for our clients (and ourselves). The "prudent man rule" was developed in the 19th century when a Massachusetts judge suggested trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

In order to achieve our investment objectives our investment philosophy is to buy a relatively concentrated portfolio of outstanding companies from around the world, and to purchase securities in these businesses when their share prices are attractive compared to our assessment of their underlying intrinsic value. We believe buying a concentrated portfolio of outstanding companies at attractive prices will deliver investors superior risk adjusted returns over a 3 to 5 year time horizon, whilst minimising the risk of permanent capital loss.

In chapter 20 of *The Intelligent Investor*, Benjamin Graham introduced the concept of "Margin of Safety" which he refers to as the central concept of investment. The concept of "Margin of Safety" is central to our investment philosophy and our desire to minimize the risk of permanent capital loss.

I have set out in the attachment to this Annual Investor Report Magellan's *Investment Philosophy* which should give you a greater appreciation of the characteristics of companies in which we are seeking to invest.

PORTFOLIO SUMMARY

Magellan Global Fund - Top 10 Investments as at 30 June 2008	
American Express Company	8.3%
Nestle	6.5%
Tesco plc	6.2%
Wal-Mart Stores Inc	6.2%
Yum Brands Inc	5.6%
eBay Inc	5.4%
Lloyds TSB Group plc	5.1%
Pepsico Inc	4.5%
Wells Fargo & Co	3.4%
Procter & Gamble Company	3.4%

As at 30 June 2008 the Global Fund portfolio consisted of 24 investments (up from 21 at 31 December 2007), over the same period we decreased our cash weighting from 32% to 24%. The major new portfolio additions since 31 December were investments in Lloyds TSB Group (made in June) and Procter & Gamble (made in May). We sold down our position in Abercrombie & Fitch due to our view on the deteriorating discretionary consumer environment in the US.

There are four key investment themes on which we are focused:

- Investing in companies which exhibit strong 'network economics': - key investments are American Express and eBay
- Investing in lowest cost, market leading, non-discretionary retailers – key investments include Tesco and Wal-Mart
- Investing in leading global fast moving consumer good (FMCG) companies which are likely to exhibit mildly accelerating growth over the medium to longer term due to their ability to capture growth from the emerging middle class in the developing world – key investments include Nestle, Yum Brands, Pepsico and Procter & Gamble
- Investing in leading, strongly capitalized retail focused banking institutions which are likely to emerge from the current financial crisis with even stronger market positions and profitability – key investments include Lloyds TSB and Well Fargo & Co.

In our view each of the key investments in our portfolio are outstanding companies, exhibiting high returns on invested capital and possess strong competitive advantages which will protect their fundamental business economics for many years to come.

Most importantly, we believe that each of these investments have been purchased at material discounts to our assessment of their intrinsic values and will deliver very satisfactory investment returns over a 3 to 5 year horizon.

It would be a fair observation that the Fund has a significant portion (23% at 30 June) of the portfolio in financials in the midst of a financial crisis. Whilst we purchased the majority of these positions in August last year, prior to the real emergence of the credit crisis, we have continued to selectively purchase financials at price levels we consider to be compelling.

In fact our most recent major recent addition to the portfolio was an investment in Lloyds TSB in June. Given that Lloyds TSB is our most significant recent purchase, and it has been purchased in the midst of a financial crisis, I thought it was appropriate to briefly outline our investment case as our Key Stock in Focus (please refer later section in this report). I would also encourage you to read the summary on our investment case for American Express which was set out in the December 2007 Half Yearly report on the Global Fund which is available on our web site www.magellangroup.com.au. It is important that investors understand the investment case for American Express as it is the Fund's largest position and has been the largest single negative contributor to the

Fund's performance over the past 12 months. We maintain a high conviction that American Express is a unique high returning business that will deliver very satisfactory investment returns for investors with any sensible investment horizon.

Overall I am extremely satisfied with the Global Fund's investment portfolio and the likelihood of delivering very satisfactory investment returns over a 3 to 5 year period.

I have, in my view, made one major investment blunder over the past year. I purchased for the Fund an investment in Nutrisystem Inc which has subsequently lost 80% of its market value. In fact this has been the second largest negative contributor to the Fund's performance over the past 12 months.

Nutrisystem is a weight loss company that direct markets portion controlled prepared meals. At the time of the initial investment we believed that the business had outstanding business economics (with returns on invested capital above 100%), high cash generation, low financial risk (the company had net cash and no debt) and strong growth prospects operating in an attractive industry. We also believed that the market pricing was attractive as the business was trading at around 18x forward earnings after tax.

We (and you should read "I") underestimated the competitive dynamics of the weight loss industry. In August 2007 a new weight loss pill (Alli) was released in the US by GlaxoSmithKline with a massive marketing campaign. This directly affected the cost effectiveness of Nutrisystem's direct marketing expenditure leading to a shortfall in the expected number of new customers signing up for Nutrisystem's weight loss programme. As a result the market dramatically de-rated the shares of Nutrisystem with the P/E ratio dropping from around 18x to 5x (2007 earnings). Notwithstanding my error in judgment on the competitive dynamics of this business, I have elected not to sell the investment at the current price. The business remains highly profitable and cash generative and there is a very low likelihood of an insolvency issue in my view. At the end of the first quarter 2008 the company commenced paying a dividend and continued a very strong share buyback programme (in the first quarter of 2008 the company repurchased nearly 10% of its outstanding shares) yet maintained a very strong net cash position with no debt outstanding.

This is clearly not a business that fits with our philosophy of investing in outstanding businesses with strong and sustainable competitive advantages. It is now the Fund's smallest investment (at 0.6% of the portfolio) and thus will not have any meaningful impact on the Fund's performance moving forward, however is trading at a very significant margin of safety. I will continue to monitor the situation closely and intend to exit the investment at a sensible price relative to the realistic prospects for the business.

MARKET COMMENTARY

I wrote in the December 2007 Half Yearly report that the global credit crisis is probably the most serious issue that has arisen in financial markets in the past 20 years. The global credit crisis virtually froze the interbank funding market, the asset backed securitization market, the auction rate securities market in the US and has resulted in massive write offs by financial institutions around the world.

Following the bail out of Bear Stearns in March this year and evidenced again by the swift actions of the US Treasury to stabilize the government sponsored mortgage companies in the US (Freddie Mac and Fannie Mae) in July we believe the risk of a series of events which could occur and trigger an unprecedented meltdown in financial markets has materially reduced. In our view, the actions of the US Federal Reserve and the US Treasury clearly indicate that they (and other central banks around the world) will take whatever action is necessary to prevent an uncontrollable melt-down in financial markets. This does not mean that there will not be serious on going implications resulting from the global credit crisis – there will be. There is likely to be more failures of financial institutions around the world. In our view, institutions that will fail are unlikely to threaten the stability of the financial system, but will cause investors in these institutions to suffer significant losses and the failures will contribute to the current very negative sentiment in financial markets and cause ongoing volatility for investors.

We remain very cautious on the outlook for the world economy and believe that financial markets will remain very volatile over the next 6-12 months. In our view there are two major economic factors which are likely to result in a synchronized global slowdown:

- The effect of deleveraging of the financial system on asset prices and global consumption; and
- The effect of rapidly rising commodity prices on inflation expectations around the world.

DELEVERAGING OF THE FINANCIAL SYSTEM

The credit crisis has resulted in a significant curtailment in the availability and pricing of credit in the global financial system. Prior to August 2007 there was virtually an unlimited supply of capital to support borrowings around the world. Much of this unlimited supply of capital was dependent on banks, investment banks and non-bank financial institutions being able to package and securitize loans and sell these securities to investors around the world.

Since August 2007 the market for securitized assets has effectively closed which has had a dramatic effect on the availability of credit. A large number of non-bank financial institutions which relied on securitization markets for their funding have either gone out of business or are effectively closed for new business. In addition, many banking institutions which relied on the securitization markets to "distribute" loans which they "originated" have had to curtail their lending activities to those loans which they have sufficient capital to hold on their balance sheets.

In addition, the capacity of banks and investment banks to take additional assets on their balance sheets has been constrained due to the massive write offs they have taken and they have been required to provided funding to many of the structured vehicles they created to hold off balance sheet loans.

In our view the economic consequence of this deleveraging of the financial system will be a global economic slowdown, which is already evident in many countries. Economic activity around the world is very much dependent on the capacity of consumers to buy goods and services. Consumers in developed nations (particularly in countries like Australia, the United States and the UK) have become highly dependent on their capacity to borrow to maintain their rate of expenditure. Their capacity to borrow in recent years has been enhanced by high house prices and the free availability of credit. With falling assets prices (and particularly house prices) in many developed countries and the curtailment of credit will, in our view, directly impact consumers' ability to spend which is highly likely to slow the rate of global economic growth.

The extent and duration of the economic effects of this deleveraging is difficult to predict. We are, however, confident that over time the financial system will recapitalize and investor appetite for traditional style securitized assets will re-emerge which will set the foundations for vibrant credit markets and renewed economic growth.

INCREASING INFLATION EXPECTATIONS

The rising level of inflation in virtually every country around the world (and particularly developing nations), primarily driven by high commodity prices (most notably oil and food) has the potential to force central bankers around the world to take meaningful action to raise interest rates to ensure that inflation does not become embedded via a wage and price spiral.

In a speech to US Congress on 15 July 2008 the Chairman of the US Federal Reserve, Ben Bernanke said:

"Moreover, the currently high level of inflation, if sustained, might lead the public to revise up its expectations for longer term inflation. If that were to occur, and those revised price expectations were to become embedded in the domestic wage- and price – setting process, we could see an unwelcome rise in actual inflation over the longer term. A critical responsibility of monetary policy makers is to prevent that process from taking hold."

The current economic situation of slowing economic growth and rising inflation expectation is a particularly difficult paradigm for central banks.

My best evaluation at this point is that if commodity prices ease over the next 6 months then it is likely that the world economies will slow with a relatively soft landing as central banks will have the capacity to implement policies to stimulate growth. If commodity prices do not ease and inflation expectations continue to increase I believe that central bankers will be left with little choice other than to meaningfully increase interest rates which is likely to result in a sharp slow down (read recession) in most developed economies. Under any scenario it is difficult to envisage a scenario over the next 12 months that does not include a synchronized global slowdown.

The good news for investors is that these are exactly the economic times when investments can be purchased at prices that are likely to produce outsized returns over a medium term investment horizon. It is very difficult to predict exactly how economic events will play out over the next 12 months and when markets will bottom, however we are confident that investing in outstanding businesses at times of extreme pessimism will produce highly satisfactory investment returns for patient investors.

KEY STOCK IN FOCUS

LLOYDS TSB GROUP

Recently, we have been taken advantage of the indiscriminate treatment of UK financial stocks by the "Mr Market", by purchasing a holding in what we consider to be one of the world's leading retail banks, Lloyds TSB ("Lloyds"). Since the beginning of the year, the average share price of Lloyds TSB's larger competitors have declined by 56%; in a similar vein Lloyds TSB's share price has declined by 42%. Lloyds exhibits very different risk and business characteristics to its peers and the markets have tarred Lloyds with the same brush that is being applied to its riskier and less-focused competitors.

Lloyds is one of five large retail banks in the UK and has a leading market share position in retail transaction accounts (at approximately 20%). This provides Lloyds with a large and sticky deposit base and forms the key banking product from which to cross-sell other financial products to customers. Lloyds is the UK leader in new bank customer acquisition and credit card issuance. Lloyds also owns Scottish Widows, which is one of the largest five life insurers and asset managers in the UK.

In our view there are four fundamental pillars that support and differentiate Lloyds TSB's business:

- Capital strength

Lloyds TSB is also one of only three banks in the world that carries a Aaa credit rating from Moody's. Lloyds TSB bank is strongly capitalised with a Tier 1 ratio of 8.1% and total capital of 11.0% (as at December 2007). The Scottish Widows subsidiary is very strongly capitalised, with its risk capital margin covered many times over by available capital within the life company. This strength is recognised in capital markets, where Lloyds TSB has been able to access funding at peer leading rates throughout this period of dislocation.

- Risk profile

Lloyds TSB's focus on its core domestic retail and small to medium business banking franchises means that it has had very little exposure to sub-prime and other risky assets during this market dislocation. Lloyds has been careful to focus on quality of growth, rather than quantity. By way of example, Lloyds has maintained strict underwriting standards resulting in an average loan to value (LTV) ratio on the entire mortgage book of 44% and average LTVs on new mortgages of 65%. Further, the average LTV on commercial loans is 62%. These ratios suggest that the probability of loss on property collateralised loans will remain very low, even with a severe decline in property markets. In the life operations, Lloyds has also been diligent in reducing the risks within the business. The life product mix has rapidly shifted from capital guaranteed-type products towards unit-linked type products. This has reduced both the investment risk to shareholders and capital intensity of the life operations.

- Retail deposit base

Lloyds TSB has one of the lowest loan to deposit ratios amongst the UK banks, at 130%. This sticky funding provides the bedrock of Lloyds TSB's liquidity strength and is a source of competitive advantage compared to its peers. Lloyds TSB does need to access wholesale markets for funding beyond its deposit base. It has been able to access cost-effecting wholesale funding because of its capital strength and low risk profile, as described above. Further, the retail deposit base provides a relationship platform with customers, which can then be used to facilitate cross-sales of credit cards, mortgages, investment and insurance products.

- Consumer focused scalable business

Lloyds TSB strategy centres on growing its retail and small to medium business banking franchises, primarily through organic growth. These businesses are scalable and generate high returns. This is evidenced by the low cost to income ratio of 49% and return on equity of 25.2% in 2007. These excellent metrics were achieved without resorting to riskier strategies, or the originate-to-distribute models adopted by peers. Lloyds does undertake corporate banking, but this is mostly client driven. Unlike peers, it does not generally invest shareholders' capital in principal positions. This means that material adverse "surprise" events are unlikely.

One of the most cited criticisms of Lloyds is its perceived capital weakness by some observers. This perception arises because the capital of its Scottish Widows life business is currently included within the bank's Tier 1 capital calculation and post 2012 Lloyds will be require to deduct this from Tier 1 capital, potentially requiring a capital raising. Our investment team has undertaken detailed analysis of Lloyds and Scottish Widows capital positions and we are comfortable that a capital raising will not be required to meet this change.

The most significant risk that we see facing Lloyds TSB in the near term is the uncertainty in the UK economic environment and the potential for increasing credit write-offs. Our analysis indicates that Lloyds has a conservative lending book and its strong capital position should enable it to withstand a deteriorating credit cycle, (notably Lloyds increased its dividend for the first time in five years in February 2008).

Our purchases to date have been at a forward P/E ratio of approximately 5 times and approximately an 11% dividend yield. Though we do not claim to have picked the bottom of the market in financials, we believe that price we paid for the investment in Lloyds is at a very significant discount to its underlying intrinsic value and there is a very high likelihood that the investment will produce very satisfactory returns over a 3 to 5 year period.

Yours sincerely,

Hamish M Douglass
Portfolio Manager
Magellan Global Fund
July 2008

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Magellan Asset Management

OUR INVESTMENT PHILOSOPHY

MAGELLAN
ASSET MANAGEMENT LIMITED

Investment Objectives

The Magellan Funds have two principal Investment Objectives:

- to achieve superior risk adjusted investment returns over the medium to long-term; and
- to minimise the risk of permanent capital loss.

Investment Philosophy

Our Investment Philosophy is simple to state. We aim to find outstanding companies at attractive prices. We consider outstanding companies to be those that have sustainable competitive advantages which translate into returns on capital materially in excess of their cost of capital for a sustained period of time. While we are extremely focused on fundamental business value, we are not typical "value" investors. Securities that appear undervalued on the basis of a low price to earnings multiple or a price to book multiple will often prove to be poor investments if the underlying business is fundamentally weak and exhibits poor returns on capital. We will buy companies that have both low and higher price to earnings and price to book multiples provided that the business is outstanding and the shares are trading at an appropriate discount to our assessment of intrinsic value.

An outstanding company will usually have some or (ideally) all of the following characteristics:

WIDE ECONOMIC MOAT

An economic moat refers to the protection around an economic franchise which enables a company to earn returns materially in excess of the cost of capital for a sustained period of time.

Outstanding companies are unusual as capitalism is very efficient at competing away excess returns, in most cases. A company's economic moat will usually be a function of some form of sustainable competitive advantage.

A strong indicator as to whether a company possesses an economic moat is the historical returns on capital (both including and excluding intangible assets) it has achieved. If a company has earned returns materially above the cost of its capital for a sustained period, it is a good indication that a company may have an economic moat. In some cases, a company may be developing a strong economic moat, but its historical returns on capital are low reflecting the investment in building a business with long-term sustainable competitive advantages. The key lesson is that historical returns on capital do not necessarily indicate whether a business has a wide economic moat and it is critical to fully understand the competitive advantages and threats which protect and threaten a company's economic franchise.

Identification of companies with wide economic moats involves consideration and assessment of the barriers to entry, the risks of substitutes, the negotiating power of buyers and suppliers to a company and intensity of rivalry amongst competitors.

The following are illustrations of sustained competitive advantages:

- Where it is very expensive for consumers to shift from the incumbent provider (that is, where there is a low threat of substitutes) because of, for example, cost, inconvenience and/or regulatory restrictions.
- Where the leading market participant has material economies of scale which gives it a significant cost advantage over competitors or new entrants.
- Where the business has a strong and unique brand name or is protected by long-term intellectual property rights such as copyright, patents, trademarks and/or regulatory approvals.
- Where a company has a very strong network (ideally monopoly or proprietary). For example, where it is the vital intermediary between buyers and sellers, a market maker or even a ring road that tolls workers and businesses use as they move people and goods. We are particularly interested in networks where access, pricing and volume are subject to market forces and are not regulated in a materially adverse manner.
- Where the use of psychological imperatives (such as, safety, exclusivity and quality) drives customer loyalty and enables companies to charge a premium for their products or services.

Each of these sustained competitive advantages is relatively unusual and it is particularly valuable where a strong competitive advantage prevails over a long period of time. Market-based monopolies and proprietary networks can provide the strongest and most sustainable competitive advantages, but are extraordinarily rare.

RE-INVESTMENT POTENTIAL

We seek companies that have a moderate to high potential to continue to re-invest capital into the business at high incremental returns.

We believe that conventional investment analysis fails to properly assess the potential of a business to deploy material amounts of additional capital into the business at attractive rates of return. This is a fundamental driver of value over time.

The most attractive types of companies are either:

- Companies with wide economic moats which can continue to grow materially with very limited additional capital. These companies will exhibit rising returns on capital employed. These types of businesses are extraordinarily rare and extremely valuable.
- Companies with wide economic moats which have opportunities to deploy material amounts of capital into the business at high incremental rates of return. Examples include a strong retail franchise with substantial roll-out opportunity, or a retail banking or financial services franchise that can continue to grow its lending activities at attractive margins.

These types of businesses are rare and can be very valuable "compounding machines". It is more usual to find businesses with wide economic moats which can only deploy very modest amounts of capital and exhibit modest growth potential. These businesses, while attractive, are less likely to be "compounding machines" than those with material high return re-investment opportunities.

We are therefore very focused on assessing a company's ability to continue to re-invest free cash flow at high rates of return. It is factors such as, store roll out potential, global expansion potential, the size of the market and market share potential, and market growth rates, which will drive this re-investment potential.

We judge re-investment potential as low, medium or high depending on the level of re-investment over the medium term as a percentage of net income, and the rate of return expected to be achieved.

LOW BUSINESS RISKS

The purpose of assessing business risk is to determine the predictability of cash flow and earnings projections. Businesses which are difficult to predict or could exhibit large variations in cash flows and earnings have high inherent business risk.

We assess business risk taking into account factors such as cyclicality, operating leverage, operating margin, financial leverage, competitive strength, regulatory and political environment and profitability.

We assign each company a risk assessment: low, medium and high. This is not an attempt to measure the volatility of the shares, but rather the predictability and strength of the underlying business.

LOW AGENCY RISK

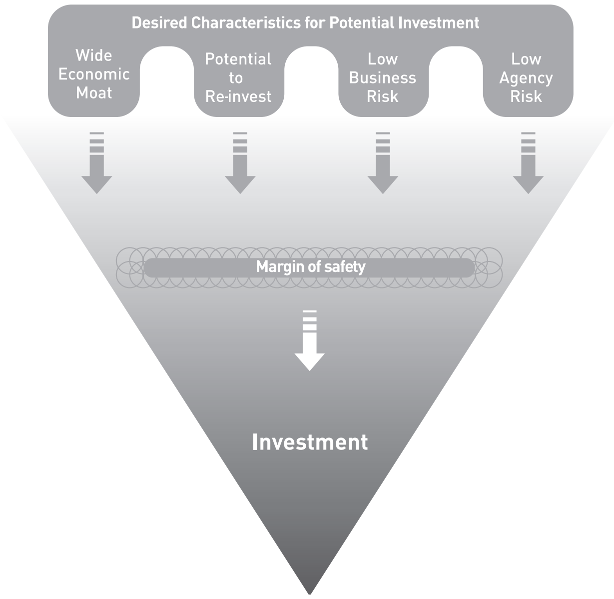
We term the risk surrounding the deployment of the free cash flow generated by a business as 'agency risk'.

A fundamental assumption inherent in a standard discounted cash flow valuation (**DCF**) is that free cash flows are returned to shareholders or are re-invested at the cost of capital. The reality is that this assumption is often flawed as free cash flow is often not returned to shareholders but, rather, cash is re-invested by companies at returns below the cost of capital. In these cases, businesses can end up being worth substantially less than implied by a DCF analysis. We term the risk surrounding the deployment of the free cash flow generated by a business as "agency risk".

A company which can deploy a substantial amount of free cash flow back into the business at attractive returns for a sustained period of time will almost certainly carry lower agency risk than a company which has limited opportunities to re-invest capital at attractive returns, unless the company is explicit about returning excess cash flow to shareholders via dividends and/or share buy-backs.

In assessing agency risk, we look at factors, including the structure and level of incentives offered to senior management, the level of share ownership by senior management and directors, the track record of management in pursuing acquisitions, the desire of management to grow their empire and the track record of management and the Board in acting in a shareholder friendly manner, including returning free cash flow to shareholders via share buy-backs and/or dividends.

The assessment criteria we apply in evaluating potential investments are depicted in the diagram below.



An ideal investment will normally have a number of combined favourable attributes operating together which would illustrate what Charlie Munger of Berkshire Hathaway describes as a "Lollapalooza" effect (which is a term for factors which will reinforce and greatly amplify each other).

MARGIN OF SAFETY

We will only purchase an investment when there is a sufficient "margin of safety". The margin of safety is the discount we require before buying shares of a company. The bigger the assessed discount, the wider is our margin of safety.

The available margin of safety, we believe, is driven, in part, by prevailing market psychology. While not a driver of a company's quality or intrinsic value, the markets can have a profound, albeit rarely long-term, effect on the pricing of a company's shares. When short-term issues or concerns are worrying investors or other factors are resulting in excess enthusiasm (that is, irrational exuberance), shares will often be mis-priced relative to intrinsic value. While our process can make us appear to be out of step with trends, investing contrary to consensus thinking has the potential to provide investment opportunities. Understanding where current market sentiment lies and assessing the company within the context of whether the concern or excitement is being appropriately priced, is an important step in investing.

There are some exceptional businesses where the "Lollapalooza" effect is truly at work and the moat is so wide and the risks are so low that we will invest with a very modest margin of safety. It is more usual to find companies which do not have all the reinforcing factors at play which results in a higher level of risk and requires a higher margin of safety.

Portfolio Construction

Magellan Global Fund seeks to have sufficient diversification so the portfolio is not overly correlated to a single company or industry specific or macroeconomic risks. In theory, if a portfolio is fully diversified the portfolio would only be subject to market risk. Academic research supports the conclusion that a randomly selected equally weighted portfolio of approximately 25 to 50 investments will achieve similar diversification to investing in the entire market index. While Magellan Global Fund will hold 25 to 50 investments, the portfolio will neither be equally weighted nor randomly selected.

We do not randomly select companies to invest in but, rather, undertake extensive research in order to identify outstanding companies and then weight the portfolio towards our highest conviction ideas. It would be inconsistent with our Investment Philosophy to fully diversify the portfolio, by randomly selecting and equally weighting investments or significantly increasing the number of investments in the portfolio, as this would reduce an investor's exposure to the most compelling ideas and is likely to lead to market-based investment returns.

We believe that an appropriately structured portfolio of 25 to 50 investments will achieve sufficient diversification to ensure the portfolio is not overly correlated to a single company, industry specific or macroeconomic risks. The most important factor in achieving sufficient diversification within the portfolio is assessing how individual investments are correlated with each other. In assessing individual investment correlation, our primary methodology is to undertake an assessment of fundamental business characteristics of each company in the portfolio. We also review historical share price correlations.

We have a three-tier classification process for approved investment opportunities. This process reflects the Portfolio Manager's quantitative and qualitative assessment of the relative attractiveness of approved investment opportunities. We utilise a proprietary ranking tool called Magellan Conviction Scoring Matrix which ranks companies based on quantitative and qualitative factors consistent with our Investment Philosophy. This process is a critical part of weighting the portfolio towards the highest conviction ideas.

It is anticipated that the portfolio will comprise 25 to 50 individual investments with the following general guidelines:

- 5-10 "Tier I" investments each comprising 5% to 10% of the portfolio at the time of the initial investment. These investments will exhibit high quality characteristics and will be trading at a large discount to our assessment of their intrinsic value.
- 10-20 "Tier II" investments each comprising 2% to 5% of the portfolio at the time of the initial investment. These investments will typically exhibit characteristics similar to Tier I investments, but will be slightly less attractive on one or two metrics.
- 10-20 "Tier III" investments each comprising less than 2% of the portfolio at the time of the initial investment. These investments will often be trading at a smaller discount to intrinsic values than Tier I and Tier II positions or will be trading at large discounts to intrinsic value, but will have less attractive investment attributes than Tier I and Tier II positions. Importantly, Tier III positions will often provide attractive diversification benefits for the portfolio.

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