MAGELLAN ASSET MANAGEMENT LIMITED

ANNUAL INVESTOR REPORT

30 JUNE 2011

Magellan Global Fund

Investment Manager's Report

DEAR INVESTOR,

I am delighted to write to you as an investor in the Magellan Global Fund ("Fund").

Over the year to 30 June 2011, the Fund has returned 2.5% net of fees. This was broadly in line with the Fund's benchmark. Over the past 2 and 3 years the Fund has returned 8.1% per annum and 7.7% per annum respectively.

The three stocks with the strongest returns in local currency were eBay (65%), Mastercard (51%) and Yum! Brands (44%) and the stocks with the weakest returns were Nestle (4%), Unilever (4%) and Procter and Gamble (9%). On an absolute basis the three largest stock contributors in local currency were eBay, Yum! Brands and Coca Cola, which added 4.7%, 2.9% and 2.3% respectively and the biggest detractor was Johnson and Johnson (-0.50%).

It is important for investors to appreciate that the Fund is not only exposed to the performance of the individual companies in which it invests. It is also exposed to currency movements, as the Fund is unhedged and the Australian dollar is effectively a reporting currency only. Since 1 July 2010 the Australian dollar has appreciated by around 27%. The AUD:USD exchange rate of $1.07 at 30 June 2011 is close to its highest level since the Australian dollar was floated in 1983. The nearest functional currency for the Global Fund is the US dollar. In US dollar terms, the net fund return was 30% for the 12 months to 30 June 2011 and since inception the net fund return was 29%, or 6.6% per annum. We believe that the underlying investment performance of the Global Fund has been satisfactory over the past 12 months and since inception on 1 July 2007.

The Fund effectively does not hedge any of its investments. We understand that exchange rates, and particularly the Australian dollar, are highly volatile. In our view an unhedged portfolio of international investments provides both diversification and likely downside protection in weak markets. Whilst we understand the factors driving the current strength in the Australian dollar, including the very strong terms of trade driven by Chinese commodity demand, the strong interest rate differentials between Australian interest rates and interest rates in other major countries and the effects of US quantitative easing, we believe that many of these factors will reverse over coming years.

The reality is that Australia has historically, and is likely to continue to run over the medium term, a large current account deficit. As the net investment balance continues to grow, an increasing proportion of Australia's national income will be paid to foreign investors in the form of interest and dividends. Our continued dependence on foreigners to finance our economy is likely to lead to a weaker rather than stronger Australian dollar over the medium to longer term. This is one of the reasons why we are relaxed in not hedging the Australian dollar at the currently high levels. I should note that Australia gets substantial benefits from foreign investment in terms of job creation and stronger underlying economic growth.

We know that there are some investors who are not happy with holding international investments on an unhedged basis. For this reason we intend to launch a fully hedged version of the Magellan Global Fund within the next 6 to 12 months.

As we look forward, it is highly probable that inflationary pressures will be increasing in most economies, with Japan being the likely exception. In our view, the major driver of increased global inflation will be the increasing standard of living in emerging markets. As countries such as China, Brazil, Turkey, Indonesia, Mexico and India continue to forge ahead it is likely that commodities (most likely food and energy prices) will rise in real terms as demand growth outstrips any offsetting productivity gains. Probably the most important driver of inflationary pressures in developed countries will be increasing prices of imported consumer goods sourced from countries such as China. It is our hypothesis that we have reached an inflection point in the globalisation story. Historically, globalisation has resulted in massive global productivity gains and deflationary pressures to the prices of imported consumer goods. As China's economy continues to evolve and moves away from the fixed asset investment/export growth model towards a domestically driven consumer economy, we believe that imported consumer goods in developing countries will begin an inflationary cycle. We believe it is unlikely that there are sufficient productivity gains either within China or from mass sourcing of goods from other countries to offset these inflationary pressures.

The world has become highly dependent upon cheap goods sourced from countries such as China. The Wall Street Journal recently had an article that said China supplies 78% of the footwear imported into the US; 71% of the ties; 55% of the gloves; roughly 50% of dresses and baby clothing and 90% of house slippers.

So why should inflation, even a modest rise in inflation, be a concern for investors? The answer is that inflation erodes the purchasing power of money and real returns to investors. Over time the purchasing power of a dollar depreciates in line with the nominal rate of inflation. For example, over a ten year period the purchasing power of a dollar depreciates by 18 % at a 2% p.a. inflation rate, by 32% at a 4% p.a. inflation rate and by 44% at a 6% p.a. inflation rate. In order for investors to increase their wealth in real terms the after tax rate of return on an investment must exceed the inflation rate. The following table sets out the effect of inflation on real rates of return over a ten year period, assuming an investor has a tax rate of 30% and investments earn a nominal rate of return of 8% per annum:

Effect of Inflation on Real Returns:

Inflation (%p.a)	Annual Return Pre-tax - Nominal	10 Year Return After Tax - Nominal	10 Year Return After Tax - Real*
2.0%	8.0%	72.44%	50.54%
4.0%	8.0%	72.44%	24.42%
6.0%	8.0%	72.44%	-6.64%

* Net of inflation

This example illustrates that an increase in inflation from 2% p.a. to 4% p.a. decreases the real total return (i.e. after the allowing for the decrease in purchasing power due to inflation) over 10 years from 50.5% to 24.4% and an increase in the inflation rate to 6% p.a. would result in a negative total real return over the period.

In order for investors to be protected from the effects of higher inflation they should seek investments that ideally have the following characteristics:

- Pricing power;
- Ability to maintain or increase volumes. This is particularly challenging as the rate of real economic growth and activity usually slows as inflation rises; and
- Low capital intensity. As inflation increases companies will usually need to spend materially more than the accounting depreciation charge to replace plant and equipment and more to reinvest in receivables and inventory. This means that the economic earnings (i.e. after capital expenditure and changes in working capital) will tend to be materially lower than accounting earnings for capital intensive businesses.

In our view there are few equity investments that have these characteristics. A classic example would be a monopoly essential toll road with a concession deed that allows the owner to increase tolls at least in line with inflation. Many commentators have stated that investments in commodity producers are a good hedge against inflation. We disagree. In our opinion commodity businesses tend to be highly capital intensive and as inflation increases, volumes usually fall.

We believe the Fund has the vast majority of its portfolio in investments with strong characteristics to protect it against a rise in inflation.

Magellan Global Fund Investments with Inflation Protection Characteristics

	Pricing Power	Volume resilience	Low capital intensity	Examples
Consumer staples	✓	✓	✓	Coca-Cola, Colgate, Procter & Gamble, Nestle, McDonalds
Payment networks	✓	✓	✓	American Express, Visa, Mastercard, PayPal
Internet/ e-commerce	✓	✓	✓	eBay, Google

In our view the Fund is full of easily understood businesses whose economic earnings (i.e. after inflation) are virtually certain to be materially higher five, ten and twenty years from now.

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PORTFOLIO SUMMARY

Magellan Global Fund - as at 30 June 2011*			
eBay	8.69%	Unilever	4.64%
Google	7.46%	American Express	4.50%
Yum! Brands	6.22%	L'Oreal	4.35%
Nestle	6.15%	Kraft Foods	4.35%
Wells Fargo	6.07%	Visa	4.33%
Coca-Cola	5.07%		
McDonald's	4.77%	Other	17.23%
Lowe's	4.70%	Cash	2.17%
US Bancorp	4.66%		
Procter & Gamble	4.64%	Total	100%

* Ex Distribution

As at 30 June 2011, the Global Fund's portfolio consisted of 23 investments (in comparison with 25 investments at 30 June 2010). The top 10 investments represented 58.4% of the portfolio at 30 June 2011 compared with 58.6% at 30 June 2010.

The continued decrease in cash weighting from 4.7% to 2.2% over the past 12 months 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, a move to a cashless society and e-commerce.

The major changes to the Fund's portfolio during the past 12 months have been:

- Investments in companies leveraged to a recovery in US housing starts. Over the past 12 months the Fund has made investments in Lowe's and Home Depot, home improvement retailers based in the United States. We consider that both of these companies are attractively priced and should provide attractive returns to investors over the next 3-4 years;
- An increase in the Fund's weighting to the payments industry due to greater certainty regarding the regulatory environment in the United States (including increased exposure to eBay (which owns PayPal), American Express, Visa and Mastercard).
- An investment in L'Oreal the world's leading cosmetics company; and
- The sale of the Fund's investments in infrastructure companies, including Ferrovial, Intoll (via acceptance of a takeover offer), Transurban and ConnectEast.

The Fund's current portfolio is exposed to the following major investment themes:

- Emerging market consumption growth via investments in multinational consumer franchises. The Fund has approximately 48% 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 30 June 2011 were Yum! Brands, Nestle, Coca-Cola, McDonalds and Procter & Gamble.

- 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 a 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 30 June 2011, the Fund has approximately 17% of the portfolio invested in the payments 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 30 June 2011 were eBay and Google, which represented approximately 16% of the Fund's portfolio. We have set out a summary of the investment case for eBay at the end of this report.
- US housing. A recovery in new housing starts 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. These investments represented approximately 7% of the Fund's portfolio at 30 June 2011. I have set out some observations on the US housing market in the Market Commentary section below.

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

MARKET COMMENTARY

I outlined in the 2010 Magellan Global Fund Annual Investor Report the following:

- We observed that many major Northern Hemisphere developed economies are entering a prolonged period of structural adjustment where households deleverage and governments are forced to undertake substantial fiscal adjustments in order to ensure the level of government debt is sustainable. This is highly likely to lead to a period of sub-par economic growth in many developed world nations.

2011 update

We continue to hold this view.

In the 2010 Annual Investor Report I also outlined the following:

- We were optimistic that the recent European bailout packages for EU member states, and the decision to put in place a permanent EU liquidity facility, substantially reduced the risk of a sovereign default of a European nation at a time when the banking system remains fragile. We were very conscious that there continues to be considerable sovereign and financial stress in Europe and there is a reasonable likelihood that a few EU nations will need to undertake some form of debt restructure in the future. We stated that the current liquidity issues are manageable provided the major European nations retain the political will to see it through.

2011 update

There continues to be considerable sovereign debt stress in a numerous EU member states, most notably Greece, Ireland and Portugal.

The major risk is that an uncontrolled sovereign default occurs in Greece which could set off a chain of events resulting in a domino of defaults in other nations and a European banking crisis. In our view the probability of this event occurring is currently low, however the risk is increasing.

In relation to Greece, the current path of "kicking the can down the road" is at best delaying the inevitable or at worst keeping Europe in a perpetual state of flux and increasing the risk of an uncontrolled Greek sovereign debt default at some point in the future.

The time has come for a definitive solution to the Greek sovereign debt crisis. Any solution must address the following objectives: minimising contagion risk; strong ongoing incentives for Greece to pursue fiscal sustainability and economic reform; and minimising the cost of the bailout to EU taxpayers and the IMF.

A solution could have the following three key elements: Greek bank depositor protection; a full recapitalisation of Greek banks; and a definitive restructuring of Greek sovereign debt to sustainable levels. It is time for Europe to face up to the realities of the situation and put in place a definitive solution for Greece.

Unfortunately, it is probably going to take at least 12 months or so before the European Central Bank and other regulators accept that a more definitive restructure plan needs to be put in place to end the perpetual state of uncertainty.

We are continuing to monitor this situation very closely and are prepared to act quickly should our assessment of the likelihood of an uncontrolled Greek sovereign default increase materially.

In the 2010 Annual Investor Report I made the following comments:

- We stated that the United States is likely to report accelerating economic growth over the next 12 months. We said that the announcement by the Federal Reserve that they will extend its quantitative easing programme to purchase an additional US$600 billion of bonds and the agreement to extend the Bush tax cuts for two years and to introduce a payroll tax holiday will further stimulate the US economy in the short term.

2011 update

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.

KEY STOCK IN FOCUS - eBay

eBay owns two global businesses – eBay Marketplaces and PayPal.

eBay Marketplaces (ebay.com) is a leading e-commerce marketplace in many countries around the world including the US, Australia, UK, Germany and Korea. Over US$60 billion was sold through eBay Marketplaces in 2010, which would rank it as one of the world's top 10 retailers. With over 95 million active users, eBay Marketplaces provides significant value to online merchants seeking customers, with only Amazon.com coming close to matching their scale.

eBay's growth has slowed in recent years as new online consumers favoured full service online retailers like Amazon. To re-accelerate growth, eBay Marketplaces has shifted its pricing to focus its sellers on offering superior service and free shipping, while improving the experience on ebay.com by investing heavily in its search algorithm as well as website functionality and mobile apps. eBay Marketplaces has seen early success from its efforts with the number of active accounts and sold volumes re-accelerating. It is already growing faster than e-commerce in the UK and Australia.

PayPal is the leading global online wallet. It allows consumers to purchase online with convenience and security by entering their financial information only once and then never divulging this information to any merchant. It also allows small merchants an inexpensive way of accepting payments, and reduces shopping cart abandonment by consumers as a purchase requires only username and password entry. PayPal connects its customers and merchants in 190 markets via 15,000 banks and 57 financial networks.

PayPal has over 100 million active users and has recently been growing at 2 million users per month. PayPal has now achieved critical mass and has overcome the difficulty of any new payments system of attracting enough merchants to make it useful for consumers and having sufficient consumers to make merchants want to use it – by initially piggybacking off the success of eBay Marketplaces and its millions of customers and merchants. By 2010, however, eBay represented just 39% of PayPal's rapidly growing transaction volume as it continues to extend across merchants "off-eBay". Between 2005 and 2010, PayPal's "off-eBay" merchant volume grew at 50% p.a to over US$55 billion in 2010.

PayPal also has many other significant growth opportunities:

- PayPal is seeking to be used as payment for non-retail transactions, including utilities and rent.
- PayPal was the first payment platform to open up to third party developers to be integrated into mobile applications and for micropayments, collectively a US$200 billion market and growing rapidly.
- BillMeLater, which PayPal acquired in 2009, provides transactional credit at the point of sale and has recently been integrated into the PayPal wallet in the US. This allows PayPal to offer credit to its users at a lower cost than credit cards. Users benefit from access to credit while merchants benefit due to less shopping cart abandonment.
- PayPal is testing the use of PayPal at the point of sale (POS). The POS transaction market is estimated to be US$8 trillion. PayPal claim that they are being pulled offline by some large US merchants who want more access to customer data and understand PayPal's potential to be used to steer payments at the point of sale to store cards which not only increases data collection, but also reduces the fees that merchants pay to credit card companies. The potential upside for PayPal being available at POS of sale is enormous, however we caution it is very early days and there are many obstacles to large success.

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 21% compared to Visa and Mastercard at around 50 - 60%.

We believe that eBay is currently attractively priced and there is potentially enormous upside should PayPal develop into a widely adopted electronic wallet in both the online and offline worlds.

Yours sincerely

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