

Investment Manager's Report

Dear Investor,

I am delighted to write to you as an investor in the Magellan Global Fund (the "Fund" or "Global Fund") for the year ended 30 June 2009.

For the 12 months to 30 June 2009 the net fund return was 7.1%, which exceeded the market benchmark by 23.4%. Since inception of the fund on 1 July 2007, the net fund return has been -5.9% per annum, exceeding the market benchmark by 12.9% per annum. Whilst it is encouraging that the fund's relative performance has been materially better than the market, we are realistic that these statistics are short-term and the absolute performance since inception has been far from satisfactory. Over time we are confident that the fund will achieve our investment objectives of delivering very satisfactory investment returns whilst minimising the risk of a permanent capital loss.

We have often been asked what we regard as very satisfactory investment returns over the medium to long-term. It may be reasonable to expect that equities will achieve returns in the range of 7 - 9% over the long-term and if we are able to beat this market return by a reasonable margin after fees (over a minimum of a five year period) we believe that we will deliver very satisfactory investment returns to investors. We are assembling a portfolio of very high quality (and low business risk) companies that, in our assessment, are likely to deliver investment returns in excess of 7 - 9% per annum over the medium to long-term.

It is important to appreciate that we are not determined to always outperform market benchmarks over short periods of time. Whilst we may implement strategies to mitigate material shorter-term risks, such as our decision in September 2008 to significantly reduce our exposure to financials and our decision to maintain a high cash weighting from inception to March this year, we will not chase short-term returns by buying higher risk investments or investing outside our "circle of competence". We remain focused on the prospects for investments we make over time and we will not knowingly stray from areas in which we believe we have a thorough understanding. I am reminded of the words of John Kenneth Galbraith and Confucius when they said: "One of the greatest pieces of economic wisdom is to know what you do not know" (John Kenneth Galbraith) and "Real knowledge is to know the extent of one's ignorance" (Confucius).

We have received some feedback (principally from consultants) that Magellan's investment philosophy of focusing on very high quality businesses within our three areas of expertise (i.e.. our circle of competence) is too narrow and has the risk of underperforming markets for periods of time. We firmly believe that our investment approach is sound and will deliver attractive, and lower risk investment returns for our investors over the medium to long-term. We are not overly concerned if we underperform some short-term benchmark.

In 1965 Warren Buffett wrote in his letter to investors in the Buffett Partnership: “We derive no comfort because important people, vocal people, or great numbers of people agree with us. Nor do we derive comfort if they don’t. A public opinion poll is no substitute for thought”.

In 2009 Warren Buffett wrote in the Berkshire Hathaway 2008 Annual Report: “Approval, though, is not the goal of investing. In fact, approval is often counter-productive because it sedates the brain and makes it less receptive to new facts or a re-examination of conclusions formed earlier. Beware of the investment activity that produces applause; the great moves are greeted by yawns”.

I believe that objectively understanding our circle of competence gives Magellan a competitive advantage that should translate into attractive and lower risk investment returns over the medium to long-term. I describe our approach to investment research as “inch-wide and mile-deep”.

At the core of our investment philosophy is to invest in a portfolio of outstanding businesses which have very attractive underlying business economics that are protected by long-term sustainable competitive advantages (or in Buffett’s words an “economic moat”) and exhibit a high degree of certainty as to the approximate amount of free cash flow that the business will generate over time. A highly important part of our competence is to understand those matters which are foreseeable with a high degree of certainty and those matters which are not. We simply do not invest in businesses where we do not have the skills to, with reasonable accuracy, predict the amount of free cash flow the business will generate over time.

The British economist John Maynard Keynes said, “It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain”.

Our approach of investing in very high quality, predictable businesses is key, in our view, to minimising the risk of a permanent capital loss.

We know that we will inevitably make investment mistakes and it is important that we objectively recognise any mistakes we make. It is critical that we do not compound errors by letting our emotional reactions justify our prior decisions. Jack Welch said: “Face reality as it is, not as it was or you wish it to be”.

I intend to be candid with our investors regarding our investment mistakes. I have previously written about my decision to invest in Nutrisystem and my failure to sell the Fund’s entire position in Lloyds Banking Group following the collapse of Lehman Brothers. The mistake in relation to Nutrisystem was a misjudgment of mine in understanding the competitive position of the company. The mistake in relation to Lloyds Banking Group was a failure to act decisively when I clearly understood the risks associated with the banking system following the collapse of Lehman Brothers. The Fund retains only small positions in both of these companies. It is my intention to dispose of the position in Nutrisystem and we are evaluating the attractiveness of the investment in Lloyds Banking Group following the merger with HBOS and the bank’s recapitalisation.

In the spirit of candor, I have an additional confession to make regarding my decision to invest in SLM Corporation. The investment in SLM Corporation was sold in October 2008.

SLM Corporation (“**SLM**”) is the leading private sector provider of government guaranteed and non-government guaranteed student loans in the United States. SLM has a significant scale advantage over its private sector competitors and has historically had a very attractive business in originating non-government guaranteed student loans leveraging off its vast infrastructure. SLM’s business model was dependent on the US Department of Education paying the private sector subsidies to originate and service government guaranteed student loans. In undertaking this investment we made three fundamental assumptions: firstly, that investors would continue to buy government guaranteed student loans at tight spreads over treasuries; secondly, that SLM would be able to fund its non-government guaranteed student loans in the capital markets; and thirdly, that the US government would continue to pay subsidies (although we assumed at lower levels) to the private sector to originate and service government guaranteed student loans. Fortunately, following the collapse of Lehman Brothers we sold the investment when it became apparent that there was a substantial risk that any business predominantly reliant on the capital markets may not be able to continue to access funding. Subsequent to the sale of the SLM holding the Obama administration announced that it was no longer going to pay subsidies to the private sector to originate government guaranteed student loans. This effectively put a stake in the heart of the SLM’s business model. There are obvious lessons for investors in assessing the riskiness of investments where a core part of the economics of a business is dependent upon a government subsidy or government policy.

The good news is that the remaining investments in Lloyds Banking Group and Nutrisystem are small, representing approximately 0.5% of the Fund in total.

In our view, when you make mistakes you should avoid seeking to hide the fact by averaging down the cost of the investment. We believe in objectively determining whether a mistake has been made and then dealing with it. As Mae West said: “All discarded lovers should be given a second chance, but with somebody else”.

PORTFOLIO SUMMARY

Magellan Global Fund - as at 30 June 2009			
Nestlé SA	7.2%	Wal-Mart Stores Inc	4.3%
American Express Co	6.8%	US Bancorp	4.2%
Procter & Gamble	6.4%	Coca-Cola Inc	4.2%
Google Inc	6.3%	Unilever NV	3.9%
eBay Inc	6.2%	Tesco Plc	3.9%
McDonalds Corp	5.5%	Reckitt Benckiser	3.4%
Danone	5.4%	Other	9.3%
Pepsico Inc	5.3%	Cash	12.7%
Yum! Brands Inc	5.0%	Total	100.0%

As at 30 June 2009, the Global Fund's portfolio consisted of 25 investments (in comparison with 24 investments at 30 June 2008), and over the same period we decreased our cash weighting from 24% to 12.7%. The top 10 investments represented 58.4% of the portfolio at 30 June 2009 compared with 54.6% at 30 June 2008.

The decrease in cash weighting reflects our view that the risk of financial armageddon occurring has passed and that it is an attractive time to be investing in a carefully selected portfolio of stocks, such as the portfolio held by the Magellan Global Fund. This does not mean that we are saying share markets will not be volatile and may not retest their March 2009 lows. The reality is we do not know what the markets will do over the next 6 to 12 months. We remain focused on the likely investment returns from the portfolio over the next 3 to 5 years and believe purchasing these investments at the current time will produce very satisfactory investment returns over this time horizon.

In the Berkshire Hathaway 2008 Annual Report (released in March 2009) Warren Buffett wrote:

"Clinging to cash equivalents or long-term government bonds at present yields is almost certainly a terrible policy if continued for long. Holders of these instruments, of course, have felt increasingly comfortable – in fact, almost smug – in following this policy as financial turmoil has mounted. They regard their judgment confirmed when they hear commentators proclaim "cash is king", even though that wonderful cash is earning close to nothing and will surely find its purchasing power eroded over time."

The major changes to the Fund's portfolio during the six months from 31 December 2008 have been:

- to substantially reduce the Fund's weighting to cash from 31% to 12.7%;
- to increase the Fund's weighting to financials (from 6% to 13.6%) via a doubling of the weighting in American Express and the purchase of holdings in US Bancorp and Wells Fargo following the release of the Federal Reserve's findings of its stress tests of the 19 largest financial institutions in the United States; and
- the addition of Coca-Cola and Reckitt Benckiser to the portfolio.

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

- Investing in leading multinational non-discretionary consumer franchises which are likely to exhibit mildly accelerating growth over the medium to longer-term due to their ability to capture growth from urbanisation and the emerging middle class in the developing world – key investments include Coca-Cola, Danone, McDonalds, Nestlé, Pepsico, Procter & Gamble, Unilever and Yum! Brands.
- Investing in companies which exhibit strong 'network economics' - key investments are American Express, eBay and Google.
- Investing in the lowest cost, market leading, mass market, non-discretionary retailers – key investments include Tesco and Wal-Mart
- Investing in leading, strongly capitalised, retail focused banking institutions which are likely to emerge from the current financial crisis with even stronger market positions and profitability – key investments include US Bancorp and Wells Fargo & Co.

In our view each of the key investments in our portfolio are outstanding companies, exhibiting high returns on invested capital and possessing 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.

Some observers have commented that the Global Fund is overweight multinational non-discretionary consumer franchises. They comment that this could result in the Fund underperforming a strongly recovering market which may favour more cyclical and discretionary companies. As I stated earlier we will not chase short-term returns by buying higher risk investments or investing outside our “circle of competence”. We are deliberately very overweight in these businesses with approximately 50% of the Fund invested in these companies. We remain cautious regarding the outlook for economic growth in the major developed economies over the next 5-10 years and we strongly believe that these companies are well positioned to prosper almost irrespective of the growth outlook for the developed world. In our view, these companies are very well positioned to benefit from ongoing urbanisation and the very substantial growth in the middle class in the major emerging markets over the next 10, 15 and 30 years. We will not lose any sleep if the fund underperforms some market benchmark for a modest period of time (due to a rebound in stocks in which we will not invest) as we believe that our portfolio of investments will deliver highly satisfactory and lower risk investment returns for our investors over the medium to long-term.

In an interview with Fortune magazine in March 2009 Muhtar Kent, the President and CEO of Coca Cola, said: “Despite the current economic tsunami, what we see is a great future for our business because no matter which way you slice and dice it, between now and 2020 there will be another billion people who will be urbanised, and there’s going to be another billion people joining the middle class. And that translates into a huge opportunity for our beverages”.

MARKET COMMENTARY

It has been an extraordinary year in terms of macroeconomic events:

- On two occasions in 2008 we went to the brink of a complete meltdown of the world’s financial system;
- The world has experienced the sharpest economic downturn since the 1930s; and
- Central banks and Governments have responded with unprecedented monetary and fiscal stimulus.

Chris Mackay (Chairman of Magellan Financial Group Limited and Chief Investment Officer) and I have written on numerous occasions that the global financial crisis was probably the most serious issue which has arisen in financial markets over the past 20 years. The good news, in our view, is that the risk of a “financial armageddon” occurring in the foreseeable future has passed. We are convinced that the major Governments and Central Banks will take whatever action is necessary to prevent the failure of systemically important financial institutions, which will prevent a collapse of the world’s financial system.

There has been considerable commentary in recent months about the emergence of “green shoots” which could suggest an economic recovery is around the corner.

We believe that the economic background surrounding the current situation in most major developed economies is very different to past recessions. The facts on entering this recession are very different and hence the speed of the recovery is likely to be slower than has been observed in the past. The consumer in the developed world has entered this downturn with the highest level of debt relative to income on record due to households in many developed countries living beyond their means over the past 20 years. Consequently, massive global structural savings imbalances have built up and the deleveraging of the consumer and rebalancing of global savings will take years. This is likely, in our view, to result in a prolonged period of slower economic growth in many developed economies. This process is highly likely to impact asset prices (particularly real estate and equities) in the years ahead. A clear picture of the likely level of economic growth over the next 5-10 years is very difficult to predict and will depend on how quickly the deleveraging occurs and the level of offsetting factors such as technology and productivity improvements and, of course, (*sensible*) Government policy.

Governments and Central Banks have responded to the dramatic economic slowdown by flooding the world’s financial markets with liquidity, and by injecting unprecedented levels of monetary and fiscal stimulus. Whilst these policies have assisted in stabilising the short-term economic situation, they will most likely lead to some unpleasant medium-term consequences such as higher taxation, higher interest rates and possibly higher levels of inflation. We do not subscribe to a “free lunch” theory and believe that, whilst many of these policies have been necessary and beneficial in the short-term, they are likely to have repercussions over the next 2-5 years (if not longer).

Unfortunately the “consumption party” of the past 15 years is over and there is likely to be an extended period of structural adjustment. I am reminded of Dorothy in the Wizard of Oz, after her house had been swept away by the tornado, when she said: “I’ve a feeling we’re not in Kansas any more.” Unfortunately we are no longer in “Kansas” and it is likely the developed world will emerge from this downturn with a prolonged period of slow economic growth.

The good news is that the world has not ended, and we are not facing a 1930’s style depression. Structural adjustments will occur over time and the world will emerge with a more sustainable level of economic activity and growth.

I believe that asset allocation will be extremely important during this period of significant structural adjustment. In my view, there is a reasonable likelihood that many investments could deliver low rates of return over this period of adjustment. We believe that the Global Fund has a carefully selected investment portfolio with nearly 50% of the portfolio allocated to global multinational non-discretionary consumer franchises that should benefit from emerging market growth over the years ahead. A number of our other major investments should benefit from a more frugal consumer and other structural shifts that are occurring.

If we do return to “Kansas” and economies rebound without any significant structural adjustments and the current monetary and fiscal policies do not result in any major negative impacts, then most asset classes will do well from their present levels. Of course most investment returns will be better in such an environment, including the returns of the Global Fund. As was the case over the past 15 years (and prior to mid 2007) asset allocation will matter less and relative returns will be less differentiated in such an environment. We would prefer to make investments preparing for a realistic slow growth scenario and gratefully accept higher returns if we return to “Kansas”.

In our view, we have seen signs that the world’s economy and credit markets are stabilising, but we have seen almost no evidence that the world is on the verge of a sharp recovery. We remain very cautious on the outlook for the world’s economy and believe the probability of a quick and sharp turnaround is low. The fact that the world is decelerating less rapidly does not mean economies are about to recover.

The most encouraging signs of a more stable environment relate to parts of the world’s credit markets, particularly around inter-bank funding spreads, the issuance by a number of large financial institutions of non-government guaranteed term debt and the opening of the bond markets for investment grade corporations. I would caution that there are still very important parts of the world’s credit markets, particularly the asset backed securitisation market, that remain closed and banks around the world continue to have many issues to work through.

We are cognisant of the fact that unwinding the current monetary stimulus could result in a sustained period of elevated inflation a number of years out. The risk of inflation in the very near term is unlikely in our view. As a general statement, inflation is not the friend of investors as many asset values are diminished in real terms. We believe the Global Fund’s portfolio is well positioned for a period of higher inflation as the businesses have relatively low levels of capital intensity and have the market power to largely pass through the effects of inflation via higher prices.

KEY STOCK IN FOCUS - NESTLÉ SA

Nestlé is the world’s largest global branded food company. It is headquartered in Switzerland and listed on the Swiss Stock Exchange. It manufactures, markets and sells a range of food products with a focus on nutrition, health and wellness. Nestlé has 25 brands each with sales exceeding CHF 1 Billion per year, including Nestlé (ice-cream, chocolate), Nescafe, Maggi, Friskies and Purina petfood, Nespresso, Nesquik, Milo, Nestlé Pure Life water, Nido and KitKat.

Nestlé manufactures and distributes its products in over 100 countries, with a major presence in all large developed markets and already has leading market positions in the emerging markets across Asia (10% of group sales), Latin America (already 14% of group sales), Eastern & Central Europe (5% of sales) and Africa and the Middle East regions (4% of sales).

Nestlé's very significant scale and vast resources are coupled with a high level of operational excellence. It already has a very deep understanding of major emerging markets and their localised needs.

It also has several other interests. It owns a majority share of Alcon, a leading eyecare company listed in the US, a 30% share of L'Oreal the largest cosmetics and personal care business in the world and two joint ventures: Cereal Partners Worldwide with General Mills and Beverage Partners Worldwide with The Coca-Cola Company.

In 2008 Nestlé generated almost CHF 110 billion in sales and CHF 16 billion in operating profit, as well as recording a CHF 7 billion gain on the sale of a 24.5% interest in Alcon to Novartis. With this deal, the remaining 50% of Alcon owned by Nestlé may be sold to Novartis between January 2010 and July 2011. This would deliver Nestlé another significant profit and cash proceeds of at least CHF 20 billion (>CHF5.75/share) at current exchange rates. This gives Nestlé significant potential optionality to acquire other more strategically aligned businesses and /or return excess capital to shareholders. This would be in addition to the current 3-year plan to return CHF 25 billion of excess cash to shareholders via dividends and share buybacks which is ~80% complete.

As one of the world's largest buyers of many soft commodities, such as milk, coffee and cocoa, Nestlé has forged direct relationships with both industrial suppliers and farmers, giving it surety of supply, a detailed understanding of raw material price trends and global issues which need to be addressed as the world's emerging consumers drive demand for these resources.

Nestlé is an outstandingly well positioned company with high returns on capital, strong cashflow generation, and very long-term competitive advantages. It will continue to benefit from ongoing urbanisation and the very substantial growth in the middle class in the major emerging markets over the next 10, 15, and 30 years. Nestlé's current free cash flow yield is ~7.5%, with a 4% dividend yield and is trading at a large discount to our assessment of the company's long-term value at current prices of ~CHF40 per share.

Yours sincerely,



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