MAGELLAN
ASSET MANAGEMENT LIMITED

YEARLY INVESTOR REPORT

30 JUNE 2012

Magellan Global Fund

Dear Investor,

I am delighted to write to you as an investor in the Magellan Global Fund ("Fund") for the 12 months ended 30 June 2012.

Over the year, the Fund has returned 18.3% net of fees. The 12 month return exceeded the Fund's benchmark by 19.0%. Over the past 2, 3, 4 and 5 years the Fund has returned 10.1%, 11.4%, 10.3% and 4.1% per annum respectively. The Fund has exceeded the benchmark by 10.7% per annum over the past 5 years.

As we have stated many times, 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, after fees, 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 12 months. The major event driving short term markets has been the European sovereign debt crisis. Notwithstanding the volatility and uncertainty, the Fund remained fully invested during the past 12 months with cash at 30 June of 5.1%.

We continue to consider the risk of a systemic financial system meltdown as a result of the current European sovereign debt crisis as low. We continue to hold this view notwithstanding dramatically higher credit default swap costs for certain European sovereign debt, soaring sovereign bond yields, an undercapitalised European banking system and credit rating downgrades for both banks and sovereigns.

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 letters, 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 excesses 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.

The extraordinary policy responses in recent years, particularly by the Federal Reserve and ECB, have 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". These policy settings will not last indefinitely and we consider the portfolio is well positioned for the eventual correction.

We believe it is critical to understand common human cognitive or psychological biases that often lead to poor decisions and investment mistakes. Cognitive biases are "hard wired" and we are all liable to take shortcuts, oversimplify complex decisions and be overconfident in our decision-making ability. Included in the Appendix to this letter is a reprint of a section of the June 2010 Investor Letter in which I outlined five key cognitive biases. In the following section I have included five additional cognitive biases that I believe are important to understand in order to improve one's decision making framework:

1. Hindsight bias

Hindsight bias is a tendency to see beneficial past events as predictable and bad events as not predictable. In recent years we have read many explanations for poor investment performance blaming the unpredictability and volatility of markets. In our view some of the explanations are as credible as a school child complaining to the teacher that "the dog ate my homework". Whilst we have made mistakes we will not blame our mistakes on so called unpredictable events. In fact, not a single mistake we have made over the past five years could be attributed to an unpredictable event or market volatility but rather to errors of judgment. We have always sought to candidly outline our investment mistakes in our Investor Letters (including our investments in SLM, Lloyds Banking Group and Nutrisystem) and will continue to do so in the future. I probably should add at this point that I believe we were somewhat lucky in September 2008 when we decided to sell our major investments in financials. At that moment their share prices were near all-time record levels immediately following the collapse of Lehman Brothers. The market was materially mispricing the macroeconomic risk and we were able to act. This was in no way predictable. We were focused on avoiding risk and in doing so, received a free kick.

In our view, hindsight bias is a dangerous state of mind as it clouds your objectivity in assessing past investment decisions and inhibits your ability to learn from past mistakes. In order to reduce hindsight bias we spend significant time upfront setting out in writing the investment case for each stock, including our estimated return. This makes it more difficult to "re-write" our investment history with the benefit of hindsight. We do this both for individual stock investments and macroeconomic calls.

2. Bandwagon effect (or groupthink)

Bandwagon effect, or groupthink, describes gaining comfort in something because many other people do (or believe) the same. Warren Buffett tells a story about the oil prospector who dies and is in a large crowd of other oil prospectors who are all waiting at the gates of heaven. All of a sudden the crowd disperses. Saint Peter asks the oil prospector why the crowd dispersed. The oil prospector said it was simple: "I shouted oil discovered in hell." Saint Peter asks the oil prospector why he would like to be let into heaven. After thinking for a while the oil prospector says, "I think I will go and join my colleagues as there may be some truth in that rumour after all."

In our view, to be a successful investor, you must be able to analyse and think independently. Speculative bubbles are typically the result of groupthink and herd mentality. We find no comfort in the fact that other people are doing certain things or whether people agree with us. At the end of the day we will be right or wrong because our analysis and judgement is either right or wrong.

In avoiding the pitfalls of the bandwagon effect I am reminded of the Robert Frost poem, "The Road Not Taken", where he writes:

"Two roads diverged in a wood and I,
I took the one less travelled by,
And that has made all the difference."

While we don't seek to be contrarian, we have no hesitation in taking "the road less travelled" if that is what our analysis concludes.

3. Restraint bias

Restraint bias is the tendency to overestimate one's ability to show restraint in the face of temptation. This is most often associated with eating disorders. Most people are wired to be "greedy" and want more of a good thing or a "sure winner". For many people, money is the ultimate temptation. The issue for many investors is how to properly size an investment when they believe they have identified a "sure winner". In our opinion, many investors have come unstuck by overindulging in their "best investment ideas". Many seasoned investors loaded up on financials during 2007 and 2008 in the belief that they became more and more compelling as their share prices fell. In our opinion, "sure thing" investments are exceptionally rare and many investments are very sensitive to changes in assumptions, particularly macroeconomic assumptions.

In order to overcome our natural tendency to buy more and more of our best ideas we hardwire into our process restraints or risk controls that place maximum limitations on stocks and combinations of stocks which we consider to carry aggregation risk. The benefit of risk controls to mitigate the human greed tendency is well captured by the quote from Oscar Wilde: "I can resist everything except temptation".

4. Neglect of probability

Humans tend to completely ignore, or over or underestimate, probability in decision making. Most people are inclined to oversimplify and assume a single point estimate when making investment decisions. The reality is that the outcome an investor has in mind is their best or most probable estimate. Around this outcome is a distribution of possible outcomes, known as the distribution curve. The shape of the distribution curve of possible valuation outcomes can vary dramatically depending on the nature and competitive strength of an individual business. Businesses which are more mature, less subject to economic cycles and have particularly strong competitive positions (examples would include Coca-Cola and Nestlé) tend to have a tighter distribution of valuation outcomes than businesses that are less mature or more subject to economic cycles or are more subject to competitive forces. Examples in our portfolio would include Wells Fargo, eBay and Google. In our portfolio construction process we distinguish between the different types of businesses to account for the different risks or probabilities of outcomes.

Another error investors make is overestimating or mispricing the risk of very low probability events. That does not mean that "black swan events" cannot happen but overcompensating for very low probability events can be costly for investors. We seek to mitigate the risk of "black swan events" by including in the portfolio a meaningful proportion of businesses (purchased at appropriate prices) where we believe the distribution curve of valuation outcomes is particularly tight. We term these businesses as high quality long cycle businesses. We believe the risk of a permanent capital loss from a "black swan event" in this part of the portfolio is low. If we have real insight that the probability of a "black swan event" is materially increasing and the pricing is attractive to reduce this risk, we will have no hesitation in making a material change to the portfolio, particularly our holdings of shorter cycle businesses. The issue for investors is assessing when the probability of such an event is materially increasing. It is usually not correlated with the amount of press or market coverage on a particular event. Warren Buffett recently said in an interview (7 May 2012, CNBC): "The worst mistake you can make in stocks is to buy or sell stocks based on current headlines".

For example, it is our view that the risk of a financial Armageddon event due to the European sovereign debt crisis has actually decreased this year primarily due to the liquidity provided to European banks by the ECB last December and again in February this year. Notwithstanding this reduction in risk the financial media has been in near hysteria about the increasing chance of the collapse of the Euro in the near term.

5. Anchoring bias

Anchoring bias is the tendency to rely too heavily, or anchor on a past reference or one piece of information when making a decision. There have been many academic studies undertaken on the power of anchoring on decision making. Studies typically get people to focus on a totally random number, like their year of birth or age, before being asked to assign a value to something. The studies show that people are influenced in their answer, or anchored, to the random number that they have focused on prior to being asked the question.

From an investment perspective, one obvious anchor is the recent share price. Many people base their investment decisions on the current share price relative to its trading history. In fact, there is an entire investment school of thought (called Technical Analysis, an amusing term in itself) that bases investing on charting share prices. Unfortunately where a share price has been in the past presents no information as to whether a stock is cheap or expensive. We base our investment decisions on whether the share price is trading at a discount to our assessment of intrinsic value and we have no regard as to where the share price has been in the past. We also have little regard to the prevailing share price in deciding to invest the time to research a new investment opportunity. We know share prices continually change and we want to have a range of well researched investment opportunities so that we can act on an informed basis when prices move below our assessment of intrinsic value.

PORTFOLIO SUMMARY

Magellan Global Fund - as at 30 June 2012			
eBay	6.9%	Tesco Plc	4.5%
Novartis	6.1%	Visa Inc	4.5%
Lowe's	6.0%	American Express	4.3%
Google Inc	5.9%		
Danone	4.8%	Other	42.8%
Wal-Mart Stores	4.6%	Cash	5.1%
Wells Fargo	4.6%	TOTAL	100%

As at 30 June 2012, the Fund's portfolio consisted of 24 investments (in comparison with 23 investments at 30 June 2011). The top 10 investments represented 52.1% of the portfolio at 30 June 2012 compared with 58.4% at 30 June 2011.

The cash weighting of 5.1% at 30 June 2012 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 valuations are currently not stretched and we believe the portfolio should continue to deliver attractive returns for investors over time.

Over the 12 months to 30 June 2012, the three stocks with the strongest returns in local currency were Home Depot (50.3%), Visa (47.9%) and MasterCard (43.0%) and the stocks with the weakest returns were Tesco (-19.1%), Danone (-2.2%) and L'Oréal (-2.6%). On an absolute basis the three largest stock contributors in local currency were eBay, Visa and Lowe's, which added 2.2%, 2.0% and 1.7% respectively and the biggest detractor was Tesco (-0.23%).

The following table sets out some key statistics for the Fund's Portfolio as at 30 June 2012:

Average market capitalisation (US$ billion)	105
Number of stocks	24
Average daily liquidity (US$ million)	473
PE – 1 year forward*	13.5
Beta*	0.77
Average return on equity*	27%
Concentration of top 10 Investments	52.1%

*Magellan estimates

There have been very few major changes to the Fund's portfolio during the past 12 months. The material changes have been an increase in the weighting of investments in Lowe's, Tesco, Walmart 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 31.7% of the portfolio in multinational consumer franchises which have on average approximately 40% of their sales revenue generated from emerging markets. The five largest investments in multinational consumer franchises at 30 June 2012 were Danone, Kraft, Nestlé, 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 2012, the Fund had approximately 15.9% of the portfolio invested in the payments space 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 2012 were eBay and Google, which represented approximately 9.3% of the Fund's portfolio.
- **US housing.** A recovery in new housing construction should drive a strong cyclical recovery in companies exposed to the US housing market 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 15.6% of the Fund's portfolio at 30 June 2012.

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 12 months.

MARKET COMMENTARY

Europe

In recent months, the failed first round of Greek elections spooked markets as investors held the view that there was an increasing probability that Greece would leave the Eurozone which could trigger a disorderly default scenario. With this uncertainty, sovereign bond yields increased in Spain and Italy and there has been focus on the solvency of Spain and the Spanish banking system. It is not surprising that markets have been volatile, as investors headed to the "safety" of German Bunds, US Treasuries and the US dollar. This was predictable in our view.

The meeting of EU leaders on 28 June announced a number of measures that are aimed at breaking the negative feedback loop between individual country's banks and sovereign debt, the issue of subordination of private sector debt to bailout funds provided by the EU and the first step towards an EU banking union. Importantly, the EU leaders announced that they have agreed to refinance Spanish banks with an injection of up to €100 billion to be lent directly by the European Stability Mechanism (ESM) rather than via a loan to the Spanish government, which would increase Spanish government debt. This should assist in breaking the negative feedback loop between the level of sovereign debt and the solvency of the banking system. The immediate market reaction was not surprising, equities and commodities rallied, German bunds and US Treasuries fell and the US dollar fell.

In our view it is likely that investors will become concerned that these measures have not solved the fundamental issues and Spanish and Italian bond yields will again start rising. The markets will focus on the fact that the bailout mechanisms are not large enough to bailout Spain, let alone Italy.

Additionally, in our view the German government strongly believes that the only way for the Euro to survive is for a closer integration of Europe. This is what Merkel refers to as a policy of "more Europe". Merkel appears to be pursuing Helmut Kohl's original vision of an integrated Europe, together with a monetary union. Germany is pursuing closer fiscal integration (more direct controls over government budgets) and a banking union. Even for Germany, political integration is an impossible objective. With closer integration, it is likely that Germany would permit a more traditional central bank role for the ECB, including acting as the lender of last resort to governments and possibly some form of mutualisation of European sovereign debt. Unfortunately this process is politically extremely difficult (including treaty change and referendums) and will take a number of years to achieve. We also believe that Germany considers that the only environment in which this change will be possible is an environment of fear and uncertainty. It is interesting that the French government has championed the concept of a banking union, as they have been historically the main opponents of further European integration. Many believe that Merkel is losing the battle and has been rolled by France, Italy and Spain in recent discussions. Contrary to this view, we believe Merkel has them exactly where she wants them. They are all moving in the direction of closer integration.

It is highly unlikely that Germany will support policies in the short term that will remove market pressure until greater integration is achieved. It is therefore likely that the environment of uncertainty could persist for a number of years. This will make financial markets difficult and uncertain. We are expecting this and it does not worry us.

We believe the tail risk probability of a European sovereign and financial system meltdown is low. In the event that financial markets get ahead of the German plans to integrate Europe, and the risk of a meltdown materially increases, we believe Germany will have no hesitation in evoking the safety mechanisms. These would most likely involve the ECB printing an unlimited amount of money to monetise sovereign debt. This could either involve the ECB purchasing government bonds of troubled countries in the secondary market or granting the ESM, or a subsidiary of the ESM, a banking licence which would enable the ESM to access the ECB's unlimited funding capacity. The ESM would then be in a position to purchase an "unlimited" quantity of government bonds. Many parties have been urging Germany to allow this to happen immediately. Some people have interpreted Germany's response of "nein" as a lack of understanding of the severity of the issues. We believe that Germany completely understands the issues, but believe if they allow this today, pressure would be removed and there is no chance of finding a lasting solution and a closer integration of Europe.

In assessing whether it is likely that the ECB will print money in the event of a severe sovereign liquidity crisis, it is important to look at the actions taken by the ECB in late 2011 and early 2012 when the European banking system was facing a dangerous liquidity squeeze. The ECB offered European banks an unlimited amount of 3 year loans at an interest cost of 1%. In total, the ECB "printed" €1 trillion of new money. This policy, supported by the Bundesbank, has materially reduced the liquidity risk of the entire European banking system. We believe Germany will support the ECB acting in an unlimited way in the event of a sovereign liquidity crisis.

We continue to believe that many European countries face a prolonged period (possibly 5-7 years) 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 Letter 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

Nothing has fundamentally changed in our views on the US economy over the past 12 months. There are signs that the US is undergoing a modest economic recovery. We believe that there is unlikely to be a meaningful reduction in the unemployment rate in the short term until housing construction reverts to more normalised levels, which we consider will take another 2 to 3 years. When this happens, we believe the US economy will recover significantly. We have a number of investments in our portfolio that are strongly leveraged to a recovery in US housing starts, including investments in Lowe's, Home Depot, Wells Fargo and US Bancorp.

China

China's economic growth over the past three 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 lead 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 engineering a relatively soft landing with slowing economic growth, albeit at healthy levels.

TESCO

Tesco is the UK's largest retailer, and third largest globally with annual sales of £72 billion.

Tesco is largely a UK centric grocery retailer comprising approximately 2/3 of operating earnings. The UK grocery sector is competitive, and is dominated by 4 retailers, Tesco, Sainsbury, Morrison, and ASDA (owned by Wal-Mart). Tesco has a 30% share of UK sales, two times larger than its nearest competitor. Over time the company had been expanding into the non-food market through hypermarkets, and retailing services operations. Tesco today sells grocery, clothing and hardlines (electrical, homewares, entertainment, toys, books etc) across hypermarket, supermarket, petrol station, convenience store and online formats. Importantly, Tesco has the largest UK store network with approximately 3,000 stores, including approximately 1,500 convenience stores.

The Tesco brand is well known and trusted, with its private label brands comprising 50-55% if sales. The Tesco Value and Finest products are themselves >£1bn brands in the UK. Tesco is known and evidenced as being an excellent retailer with the highest store sales productivity in the world. Tesco also has a world class customer insight process and loyalty scheme in Clubcard.

Tesco has also developed a significant international grocery presence across Europe and Asia over the past 12 years. It now holds #1 or #2 positions in Ireland, Korea, Thailand, Poland and Malaysia. International operations comprise 1/3 of revenues and over half of revenue growth.

Tesco has recently launched a 'building a better Tesco' plan in the UK to address some long standing issues and industry trends in the UK, exacerbated by the difficult consumer environment. This plan entails:

1) UK margins are being reset to address foot traffic (including increased staff and service levels, improved store look and feel, some price investment and better quality private label products);

2) Change in roll out plans, materially reducing new space growth;

3) A continued push on convenience; and

4) A continued push on multi-channel or online sales, utilising its existing scale, logistics and store network to deliver superior fulfillment for online orders.

Most significant here is the reduced space growth and capital expenditure plan which is strategically sensible and a fundamental shift in Tesco's strategy toward return on invested capital (ROIC). This change will yield a material step up in cash generation by Tesco (Refer Chart 1), which will be directed toward dividends (supporting the 5% current yield), as well as increased share buybacks (Refer Chart 2).

Chart 1

The pullback in new space will improve free cash generation

Free Cash Flow/Net Profit (LHS) New UK square footage (RHS)

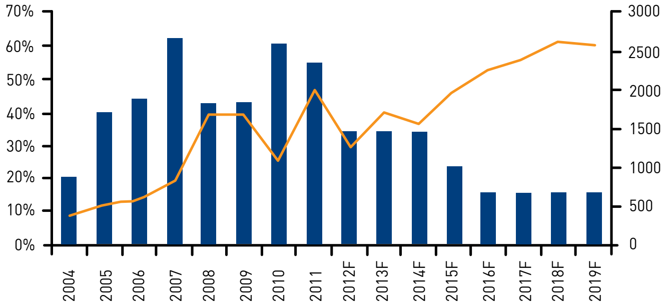
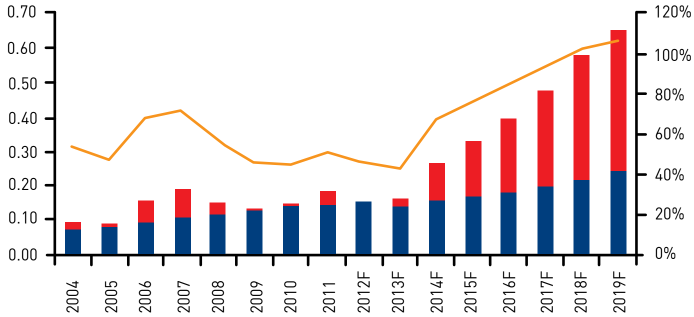


Chart 2

...which will enable increased returns to shareholders

Dividend per share Buyback per share Total Payout (RHS)



We do expect Tesco to continue to invest in new space, but for this to be concentrated on smaller local stores (reflecting consumer preferences), as well as online fulfillment capacity. International growth will also be centered on smaller formats, continuing to build scale in these markets where formal grocery retailing is still developing.

Yours sincerely,

Hamish Douglass
Portfolio Manager
Magellan Global Fund
July 2012

APPENDIX – COGNITIVE BIASES IN INVESTING FROM JUNE 2010

In order to be a successful investor over the long term, we believe it is critical to understand, and hopefully overcome, common human cognitive or psychological biases that often lead to poor decisions and investment mistakes. Cognitive biases are "hard wired" and we are all liable to take shortcuts, oversimplify complex decisions and be overconfident in our decision making process. Understanding our cognitive biases can lead to better decision making which is fundamental, in our view, to lowering risk and improving investment returns over time. I have outlined below five key cognitive biases that can lead to poor investment decisions:

1. Confirmation bias

Confirmation bias is the natural human tendency to seek or emphasise information that is confirmatory of an existing conclusion or hypothesis. In our view confirmation bias is a major reason for investment mistakes as investors are often overconfident as they keep getting data that appears to confirm the decisions they have made. This overconfidence can result in a false sense that nothing is likely to go wrong which increases the risk of being completely blindsided when something does go wrong.

In order to minimise the risk of confirmation bias we attempt to challenge the status quo and seek information that causes us to question our investment thesis. In fact, we are always seeking to "invert" the investment case to critically analyse why we might be wrong. We continuously revisit our investment case and challenge our assumptions. It is much more important to ask oneself "why you are wrong than why you are right". Charlie Munger, the Vice Chairman of Berkshire Hathaway and Warren Buffett's business partner, said: "We all are learning, modifying, or destroying ideas all the time. Rapid destruction of your ideas when the time is right is one of the most valuable qualities you can acquire. You must force yourself to consider arguments on the other side".

In our view, the strength of many of history's most accomplished scientists and mathematicians has been their ability to overcome their confirmation bias and to see all sides of a problem. Carl Jacobi, the famous 19th century mathematician, said: "Invert, always invert".

2. Information bias

Information bias is the tendency to evaluate information even when it is useless in understanding a problem or issue. The key in investing is to see the "wood from the trees" and to carefully evaluate information that is relevant to making a more informed investment decision and to discard (and hopefully ignore) irrelevant information. Investors are bombarded with completely useless information everyday, from financial commentators, newspapers and stockbrokers, and it is difficult to filter through it to focus on information that is relevant. In our view, daily share price or market movements usually contain no information that is relevant to an investor that is concerned about the medium-term prospects for an investment, yet there are entire news shows and financial columns dedicated to evaluating share price movements on a moment by moment basis. In many instances investors will make investment decisions to buy or sell an investment on the basis of short-term movements in the share price. This can cause investors to sell wonderful investments due to the fact that the share price has fallen and to buy into bad investments on the basis that the share price has risen.

In general, investors would make superior investment decisions if they completely ignored daily share price movements and focused on the medium-term prospects for the underlying investment and looked at the price in comparison to those prospects. By ignoring daily commentary regarding share prices, investors would overcome a dangerous source of information bias in the investment decision making process.

3. Loss aversion/endowment effect

Loss aversion is peoples' tendency to strongly prefer avoiding losses than obtaining gains. Closely related to loss aversion is the endowment effect where people place a higher value on a good that they own than on identical good that they do not own. Loss aversion/endowment effect can lead to very poor and irrational investment decisions whereby investors refuse to sell loss making investments in the hope of making their money back.

The loss aversion tendency breaks one of the cardinal rules of economics; the measurement of opportunity cost. To be a successful investor over time you must be able to properly measure opportunity cost and not be anchored to past investment decisions due to the inbuilt human tendency to avoid losses. Investors who become anchored due to loss aversion will pass on mouth watering investment opportunities in order to retain an existing loss making investment in the hope of making their money back.

In our view, all past decisions are sunk costs and a decision to retain or sell an existing investment must be measured against its opportunity cost. In order to increase our focus on measuring opportunity cost we run the Magellan Global Fund like a "football team" where we have the ability to put about 25 players onto the paddock at any one time. This forces us to focus on the opportunity cost of retaining an existing investment versus making a new investment in the portfolio. We believe many investors would make superior investment decisions if they constrained the number of investments in their portfolios as they would be forced to measure opportunity cost and make choices between investments. Warren Buffett often gives the illustration that investors would achieve superior investment results over the long-term if they had an imaginary "punch card" with space for only 20 holes and every time they made an investment during their lifetime they had to punch the card. In Buffett's view, this would force investors to think very carefully about the investment, including the risks, which would lead to more informed investment decisions.

4. Incentive caused bias

Incentive caused bias is the power that rewards or incentives can have on human behaviour, often causing folly. The sub-prime housing crisis in the United States is a classic case study in incentive caused bias. Notwithstanding that financiers knew that they were lending money to borrowers with appalling credit histories, and in many cases people with no incomes or jobs and limited assets ("NINJA" loans), an entire industry, with intelligent people, was built on lending to such people.

How did this happen on such a massive scale? We believe the answer can be found in the effect of incentives. At virtually every level of the value chain there were incentives in place to encourage people to participate. The developers had strong incentive to construct new houses, the mortgage brokers had strong incentive to find people to take out mortgages, the investment banks had strong incentive to pay mortgage brokers to originate loans so that they could package and securitise these loans to sell to investors, the ratings agencies had strong incentive to give AAA ratings to mortgage securities in order to generate fees, and banks had strong incentive to buy these AAA rated mortgage securities as they required little capital and produced enormous, leveraged profits.

Warren Buffett said: "Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behaviour akin to that of Cinderella at the ball. They know that overstaying the festivities — that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future — will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands."

One of the key factors we focus on in making investment decisions is our evaluation of agency risk. We evaluate the incentives and rewards systems in place to assess whether they are likely to encourage management to make rational long-term decisions. We prefer companies that have incentive schemes that focus management on the downside as well as the upside and encourage management to return excess cash to shareholders. For instance, executive compensation that is overly skewed towards share option schemes can encourage behaviour that is contrary to the long-term interests of shareholders, such as retention of earnings above those that can be usefully reinvested into the business.

5. Oversimplification tendency

In seeking to understand complex matters humans tend to want clear simple explanations. Unfortunately some matters are inherently complex or uncertain and do not lend themselves to simple explanations. In fact, some matters are so uncertain that it is simply not possible to see the future with any clarity. In our view, many investment mistakes are made when people oversimplify uncertain or complex matters.

Albert Einstein said: "Make things as simple as possible, but no more simple".
A key to successful investing is to stay within your "circle of competence". A key part of our "circle of competence" is to concentrate our investments in areas that exhibit a high degree of predictability and to be wary of areas that are highly complex and/or highly uncertain. We believe that forecasting the volume growth for Colgate-Palmolive, Coca- Cola or Procter & Gamble is relatively foreseeable over the next 10 years and is well within our circle of competence.

Investing in financials is far more complex and we are disciplined to try to ensure we do not overly simplify the inherent complexity of a major financial institution. If we cannot understand the complexity of a financial institution we simply will not invest, no matter how compelling the "simplified" investment case may appear. Notwithstanding that our investment team has over 50 years combined experience in analysing financial institutions, there are many institutions that we believe are simply too difficult to assess.

In our view the majority of the investment mistakes we have made can in large part be attributed to our cognitive biases, where we have fallen susceptible to confirmation bias, have oversimplified a complex problem or strayed outside our circle of competence. Unfortunately these cognitive biases are "hard wired" and we will make mistakes in the future. Our aim is to have systems and processes in place in order to minimise the number of mistakes we will inevitably make due to our cognitive biases.

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