MAGELLAN
ASSET MANAGEMENT LIMITED

Annual Investor Report

Magellan Global | June 2015

- Magellan Global Fund
- Magellan Global Fund (Hedged)
- Magellan Global Equities Fund (ASX:MGE)

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I am delighted to write to you as an investor in the Magellan Global Fund (the 'Global Fund' or the 'Fund') for the 12 months ended 30 June 2015.

Over the past 12 month period, the Global Fund returned 29.5%, in Australian dollar terms after fees. Over the past 3 and 5 years, it has returned 26.4% and 19.6% per annum, respectively as seen in figure 1. It has returned 12.0% per annum since its inception (1 July 2007). We believe that the Fund's investment returns have been more than satisfactory, having exceeded our longer-term objective of 9% per annum after fees. We feel strongly that people cannot retire on "relative investment returns"; only by generating investment returns that exceed the rate of inflation (ideally by a satisfactory margin) will investors increase their wealth. As such, we are happy to be judged by the Fund's absolute returns over time.

On 1 July 2013, we launched a hedged[1] version of the Fund. Over the past 1 year and 2 years, the Magellan Global Fund (Hedged) returned 12.5% and 13.8% respectively per annum.

On 2 March 2015, we launched

Figure 1: Performance to 30 June 2015 in AUD after fees:

Yearly Results (Financial Years)	Magellan Global Fund (%)	MSCI World Net Total Return Index AUD (%)[1]	Difference (%)
2007/08	-17.2	-21.0	3.8
2008/09	7.1	-16.3	23.4
2009/10	13.9	5.5	8.4
2010/11	2.5	3.0	-0.5
2011/12	18.2	-0.8	19.0
2012/13	39.7	32.8	6.9
2013/14	11.7	20.3	-8.6
2014/2015	29.5	24.6	4.9
Annual compound results (% per annum)			
1 Year	29.5	24.6	4.9
3 Year	26.4	25.8	0.6
5 Year	19.6	15.2	4.4
Since inception (1 July 2007)	12.0	4.5	7.5

[1]Hedged to movements in the Australian dollar, relative to the currencies of stocks' domiciles.

the Magellan Global Equities Fund (ASX:MGE), an ASX quoted version of the Fund. Since inception, the Magellan Global Equities Fund has returned 0.3% after fees.

Both these funds adopt an identical investment management discipline to the Magellan Global Fund. They share the same investment strategy, portfolio constituents, investment manager and principal investment objectives.

In August 2014, I wrote to investors with an update letter titled "The Great Compression" and in April 2015 wrote a follow-up titled "The Great Disagreement", a copy of which is set out as an attachment to this investor letter. These updates outline our view on the risks associated with the massive compression in risk premia we have seen in markets over the past few years and the potential for these risk premia to unwind as the US Federal Reserve ("Fed") increases interest rates.

Today, there is a "Great Disagreement" as to where US monetary policy (and hence US interest rates) is headed over the next three years or so. In one corner is the Fed, which is anticipating a normalisation of the US economy and US monetary policy (and hence higher interest rates). In the other corner is "the market" which is effectively pricing secular stagnation with prolonged low inflation and economic growth (and hence lower interest rates). I believe it is unusual to see such a fundamental and large disagreement between the market and policy setters.

In our view, if the Fed is right, many assets are currently mispriced and a normalisation of US monetary policy could lead to material losses for investors. At the end of April, the cash weighting of the Magellan Global Fund, the Magellan Global Fund (Hedged) and the Magellan Global Equities Fund (ASX quoted), was increased to approximately 15%. This increases the defensiveness of our portfolio and should act as a partial hedge to increasing interest rates.

Being an Investor

In December 2009 I wrote that "we are in the business of investment and not speculation". To be in the business of "investment" is to have a mindset that when purchasing shares on stock markets, you are buying an entitlement to a share of the cash flows that a business will produce over time. Your job as an investor is to assess (if you can) the likely cash flows a business will generate over its lifetime, discount these cash flows back to the present value (at an appropriate discount rate) and determine whether you are likely to generate an acceptable rate of return via buying a share in the business at the prevailing share price. Conversely, speculation involves trading in anticipation that a share price will move upwards or downwards over a short time horizon, typically less than 12 months.

In 2008, John Bogle, founder of The Vanguard Group, said in a speech to a conference of Financial Planners:
"Investing to me, is all about the long-term ownership of businesses, focussed 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 capitalise 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, focussed (usually) on the belief that their prices, as distinct from their intrinsic values, will rise."

Warren Buffett neatly summarised the difference between investing and speculation when he said: "Investment is an activity of forecasting the yield on assets over the life of the asset. Speculation is the activity of forecasting the psychology of the market."

Mark Twain waxed on the dangers of speculation when he said: "There are two times in a man's life when he should not speculate; when he can't afford it, and when he can."

In our view, any true investor should aim to generate a satisfactory return on capital over time while minimising the risk of a permanent capital loss.

While investing appears easy, very few people maintain outstanding investment records over the long term. I have spent considerable time thinking about the attributes of successful investors that I admire, and aspire to, and have set out my observations below:

Incorporate a margin of safety

Benjamin Graham who co-authored Security Analysis (1934) and authored The Intelligent Investor (1949) coined the phrase "Margin of Safety". Graham's margin of safety is the difference between a stock's price and its intrinsic value. In theory, the further a stock's price is below its intrinsic value, the greater the margin of safety against future uncertainty. I believe the concept of margin of safety to be one of the most important principles for investors.

Seth Klarman, founder of Baupost said: "A margin of safety is necessary because valuation is an imprecise art, the future is unpredictable, and investors are human and do make mistakes. It is adherence to the concept of a margin of safety that best distinguishes value investors from all others, who are not as concerned about loss."

Invest within your circle of competence

I believe that if an investor can objectively understand the limits of their circle of competence and focus their expertise within that circle they will develop a competitive advantage which should translate into better investment decisions. The most outstanding investment records have been built by people who specialise, develop a deep understanding and stay within their circle of competence. While there are many good investment opportunities outside one's circle of competence, there is a substantial disadvantage in attempting to become an expert in too many things. I have described investors who try to be experts at everything to be like a "fly in a bottle", i.e. moving around continuously but making no progress. I am reminded of this by the words of John Kenneth Galbraith when he said: "One of the greatest pieces of economic wisdom is to know what you do not know" and those of Confucius: "Real knowledge is to know the extent of one's ignorance".

Charlie Munger, the Vice Chairman of Berkshire Hathaway and Warren Buffett's business partner, said: "The game of investing is one of making better predictions about the future than other people. How are you going to do that? One way is to limit your tries to areas of competence. If you try to predict the future of everything, you attempt too much. You're going to fail through lack of specialisation."

Be prepared to walk away

Unfortunately our inbuilt biases (bias of sunk costs and loss aversion tendency) make it difficult for investors to walk away from investment opportunities or sell investments when something has gone wrong. The inability to ignore sunk costs can lead to irrational decisions, particularly if an investor has spent considerable time (and money) researching a potential opportunity. An investment firm with multiple analysts may make an investment in order to reward the effort put into the research and to avoid the analyst feeling they have wasted their time. If the due diligence does not support an investment case or does not demonstrate a sufficient margin of safety (adjusted for risk), then the investor must be prepared to walk away and wait patiently.

In addition, people's loss aversion tendency is to strongly prefer avoiding losses rather than obtaining gains. This can lead to poor and irrational investment decisions whereby investors refuse to sell loss making investments in the hope of making their money back. I believe that good investors pay no attention to the purchase price of an investment in deciding the rational course of action regarding whether or not to hold or sell. The rational investor will consider their best estimate of the likely return on the investment on a forward looking basis and compare that return to the next best alternative use of the capital.

Do not overly diversify

In our view, very few investors have achieved outstanding long term investment records by holding a widely diversified investment portfolio. By definition, additional stocks dilute the contribution to future returns of the best investment ideas within the portfolio. While a portfolio not correlated to single factor risk is important, it is not necessary to overly diversify by the number of investments to adequately manage risk.

Warren Buffett said on diversification: "Diversification is a protection against ignorance. It makes very little sense for those who know what they are doing" and Charlie Munger said: "The academics have done a terrible disservice to intelligent investors by glorifying the idea of diversification. Because I just think the whole concept is literally almost insane. It emphasises feeling good about not having your investment results depart very much from average investment results. "

Focus on the batting average

I have observed that long term outstanding investment track records are built upon good "batting averages" rather than a few "out of the ball park" decisions. To develop an outstanding batting average, it is far more important to minimise the inevitable investment mistakes than be obsessed with trying to find the 10x investment winners. Many investors are very happy to talk about their investment winners but very few talk about their error rate. Charlie Munger commented: "It's a good habit to trumpet your failures and be quiet about your successes."

However, maintaining an outstanding batting average is extremely difficult. It requires time, focus, discipline, patience, extensive investment due diligence and the ability to forgo opportunities. At Magellan, we are obsessive with the rigour of our investment research, which I have often described as "inch wide and mile deep". Extensive investment due diligence and staying within your circle of competence is critical to achieving a low error rate and improving the investment batting average. We note that very few tennis players have won the US Open or Wimbledon with a high unforced error rate.

Have a medium term investment horizon

The vast majority of investment managers increase the degree of difficulty of producing superior long term returns by focusing on a short term investment horizon. It is our view that the "institutional imperative" of beating the market benchmark over short periods (quarterly or yearly) is counter-productive. A short term investment focus often rules out many mispriced investments on the fear that they will underperform the market in the short term.

I believe investors with a longer term investment horizon have a significant and easy advantage over investors with short term perspectives. At Magellan, we do not regard the short-term performance of an investment as important. We base our decisions on the rate of return we assess an investment will earn over the next three to five years. In doing so, we do not get caught up with a false precision as to timing. Warren Buffett said: "I have no idea on timing. It's easier to tell what will happen than when it will happen." When we have a high conviction as to "what will happen", we are prepared to invest and wait.

Think in terms of probabilities and not in single point estimates

While the investment process appears straightforward, it is very difficult (if not impossible) to accurately estimate the free cash flow that many businesses will generate over time. In reality, there is a wide range of potential outcomes making it difficult to determine a single point estimate of intrinsic value. It is therefore important for investors to think in terms of probability. However, most investors are attracted by the simplicity of assuming a single point estimate. The reality is that the outcome an investor has in mind is their best or most probable estimate. However, there is a distribution of potential outcomes around this outcome known as the distribution curve. The shape of the distribution curve can vary dramatically depending on the nature and competitive strengths of an individual business. More mature businesses, less subject to economic cycles have particularly strong competitive positions (Nestlé would be an example) and tend to have a tighter distribution of valuation outcomes compared to less mature businesses (like technology and biotechnology companies), or those subject to economic cycles (such as banks), or those subject to significant competitive forces.

Challenge your own ideas (invert the problem)

In our view, confirmation bias is one of the primary causes of investment mistakes. Indeed, investors often seek or rely upon information which confirms the decisions they have made and they become overconfident. Instead, good investors should seek to challenge the status quo and find information that disproves their investment thesis, minimising the risk of confirmation bias. It is much more important to ask yourself why you are wrong than why you are right. Charlie Munger 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." He also said "Invert, always invert: Turn a situation or problem upside down. Look at it backward. What happens if all our plans go wrong? Where don't we want to go, and how do you get there? Instead of looking for success, make a list of how to fail instead – through sloth, envy, resentment, self-pity, entitlement, all the mental habits of self-defeat. Avoid these qualities and you will succeed. Tell me where I'm going to die, that is, so I don't go there."

Do the analysis and think independently

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."

It is also important to understand that being contrarian does not make you a good investor. Many investors have caught "falling swords" by seeking to be contrarian when other investors are panicking. We undertake extensive analysis before making a contrarian investment call in order to avoid catching the falling sword. Our investment returns over time will depend on whether our analysis of the economics and competitive positioning of a business is correct. 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."

Investment temperament (controlling your biases)

In our view, inherent tendencies gives humans the wrong wiring to be successful investors. A great investor will be obsessed about analysing the facts, will always be rational in deciding a course of action, will understand the limitations of their own knowledge, will continuously challenge their best ideas and will remain completely unemotional in their decision making notwithstanding the environment they are in. Numerous successful investors study behavioural economics to understand (and try to counteract) common human cognitive or psychological biases that can lead to poor decision making. Cognitive biases are "hard wired" as we are all liable to take short cuts, over simplify complex problems and be overconfident in our decision making ability. I have previously written about 10 cognitive biases that I think are important to understand as an investor; confirmation bias, information bias, loss aversion, incentive caused bias, oversimplification tendency, hindsight bias, groupthink, restraint bias, neglect of probability and anchoring bias (see June 2012 investor letter).

Training investors to remain unemotional in their decision-making is almost impossible. Evolution did not have investing in mind when designing the biology of the human body. In times of extreme stress (like during a market crash) our brain causes the adrenal gland to release the adrenaline hormone that leads our heart rate and blood pressure to increase. If we were still cavemen about to be attacked by a wild animal, the release of adrenaline would no doubt have enormous benefits. However, as an investor you need to remain extremely calm and rational during times of immense stress and you do not want your body to release adrenaline. With this in mind, it is unsurprising that few investors are able to take advantage of periods of extreme market pessimism. Conversely, during extended bull market environments, the human brain will likely release endorphins as investors watch ever increasing share prices and perceived prosperity. It is probably unsurprising that numerous well known investors train themselves in stress management techniques such as yoga and meditation.

Warren Buffett famously said: "I will tell you the secret to being rich on Wall Street. You try to be greedy when others are fearful and try to be fearful when others are greedy."

Understand opportunity cost

Economists define opportunity cost as the cost of an alternative foregone to pursue a course of action. In our view, few investors properly consider opportunity cost when deciding to make an investment. An investment opportunity looked at in isolation can often look attractive. A proper assessment of opportunity cost takes into account both the expected return and risk in comparison to the next best alternative. In assessing an investment opportunity we look at what the investment will do to the portfolio's expected return, quality attributes, volatility risk, and currency exposure and if it shares underlying business risks with other portfolio holdings. Only by properly assessing a multitude of factors is one able to assess the opportunity cost of undertaking a course of action. Often, the best course of action is to invest in what you already own.

I have often drawn the analogy that we consider our portfolio to be like a football team. Our portfolio consists of around 25 players and each player has a role to play in winning the game. Some stocks play a defensive role and some play an offensive role. We seek to place the best players in each position and when considering a new investment we ask ourselves which player (or stock) are we prepared to replace it with. By doing so, we are actively assessing the opportunity cost of new investments.

Charlie Munger said: "Everything is based on opportunity costs. Academia has done a terrible disservice: they teach in one sentence in first-year economics about opportunity costs, but that's it. In life, if opportunity A is better than B, and you have only one opportunity, you do A. There's no one-size-fits-all. If you're really wise and fortunate, you get to be like Berkshire. We have high opportunity costs. We always have something we like and can buy more of, so that's what we compare everything to."

I end with another (and final) quote from Charlie Munger that I think well summarises the qualities of a good investor:

"Preparation. Discipline. Patience. Decisiveness".

Portfolio Summary

On 30 June 2015, the Magellan Global Fund held investments in 24 companies (compared to 28 at 30 June 2014). The top 10 investments represented 51.6% of the Fund, while they represented 51.2% at 30 June 2014 as seen in Figure 2.

Over the past 12 months, we have made the following material changes to the Fund:

- In April, we increased the cash weighting of the Fund to approximately 15% (from 10%).
- We added new positions in Home Depot, IBM, Intel, Lloyds Banking Group, Qualcomm, and Woolworths.
- We exited the positions in Adidas, Coca Cola, Danone, Diageo, DirecTV, Johnson and Johnson, McDonalds, US Bancorp, Walmart and Novartis.

Over the 12 months to 30 June 2015, the three investments with the strongest returns in local currency were Target (44.5%), Lowe's (41.4%) and Visa (28.3%) while the investments with the weakest returns were Tesco (-24.7%), American Express (-17.0%) and Google (-7.7%). On an absolute basis, the three largest contributors, in local currency, were Lowe's, Target and eBay which added +1.9%, +1.8% and +1.2%, respectively. Conversely, the three bottom contributors were Tesco, Google and American Express which detracted -1.4%, -0.2% and -0.1%, respectively.

Figure 2 - Source: Magellan Asset Management Limited

Magellan Global Fund as at 30 June 2015 (%)			
eBay Inc	7.6	Lloyds Banking Group	4.1
Microsoft Corp	7.1	Home Depot	4.1
Yum! Brands Inc	5.5	Tesco	4.1
Lowe's Co Inc	5.3		
Visa Inc	4.8	Other	32.8
IBM Corp	4.8	Cash	15.6
Intel Corp	4.2	**TOTAL**	**100.0**

The table below sets out some key statistics for the Fund's portfolio as at 30 June 2015:

Average market capitalisation (US$ billion)	139
Average daily liquidity (US$ million)	534
Number of companies	24
Concentration of top 10 Investments (%)	51.6
PE – 1 year forward[2]	16.2x
Average return on equity (%)[2]	22.4
Beta[2]	0.76

[2]Magellan Asset Management Limited estimates

Equity markets have become more challenging and value has become harder to find as share prices have continued to rise. While nothing is certain in investing, we predict that the next three years will be challenging for equities as they battle the headwind of rising long-term US interest rates.

We feel comfortable with the Fund's overall risk profile and construction. We believe it is likely to deliver satisfactory returns over the next investment cycle, while it is also likely to exhibit below-benchmark downside risk in the event that there is a major downturn in markets.

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

- **Technology/software:** We believe that entrenched global software companies boast enormous competitive advantages and exhibit attractive investment characteristics. On 30 June 2015, 21.0% of the Fund was invested in the technology/software companies Microsoft, Oracle, SAP, IBM, Qualcomm and Intel.

• **The move to a cashless society:** There continues to be a strong secular shift from spending via cash and cheque to cashless forms of payments such as credit cards, debit cards, electronic funds transfer and mobile payments. In our opinion, the explosion of smart and internet-connected, mobile devices will accelerate this shift on a global basis. We believe that there are only a limited number of companies that are well positioned to directly benefit from this structural shift. These companies are typically highly attractive, with strong network effects, low capital intensity, high barriers to market entry and high returns on capital. On 30 June 2015, approximately 11.9% of the Fund was invested in the payments space through exposure to companies such as PayPal (via eBay) Visa and MasterCard.

• **US housing:** A recovery in new housing construction, together with investment in existing housing stock, should drive a strong cyclical recovery in companies exposed to the US housing market, while providing a boost to the overall economy. Our major exposure to this theme is via holdings in Lowe's and Home Depot, the home improvement retailers, as well as our investment in Wells Fargo. These investments represented approximately 11.9% of the Fund at 30 June 2015.

• **Emerging market consumption growth:** The Fund gains its exposure via investments in multinational consumer franchises. Approximately 9.4% of the Fund is invested in multinational consumer franchises, which generate around 40% of their revenue in emerging markets. On 30 June 2015, the Fund's three largest investments in multinational consumer franchises were Yum! Brands, Nestle and Unilever.

• **US interest rates:** In our view, it is likely that US short and long-term interest rates will "normalise" over the next two to three years as the US economy recovers. We own three US financial institutions that are likely to benefit from the increase in US interest rates: Wells Fargo, Bank of New York Mellon and State Street. These investments represented approximately 8.1% of the Fund on 30 June 2015.

Macroeconomic Commentary

Our views on the world's largest economic zones have not altered materially since my last investor letter (December 2014). China's growth continues to slow, with risks centred on the property market and shadow banking system. The United States' economic recovery continues, while the Eurozone remains in a structural and political muddle, which is hindering sustainable economic growth. The prospect of "Abenomics" solving Japan's intractable problems appears as uncertain as ever. Finally, emerging markets and commodities-linked economies face a period of heightened uncertainty as China slows and the Federal Reserve moves towards normalising interest rates.

United States

A range of economic indicators show that the US economy continues to improve. The household sector is buoyed by strengthening labour markets, rising house prices, and low interest rates. Average weekly earnings increased by 2.3% over the year to May 2015 and the number of people employed is now 149 million, 2.2 million more than the previous peak in November 2007. The household sector is supporting a growing corporate sector, with higher goods and services consumption. This includes a significant pick up in housing starts to 1.0 million per year in May 2014, up from less than 0.5 million in April 2009. Indeed, as household formation increases we expect housing starts to grow further to around 1.3-1.4 million per annum, this being our estimate of normalised demand. The improvements in the household and corporate sectors are flowing through to the banking sector, with total loans and leases outstanding increasing by 7.6% per annum and, notably, commercial and industrial loans increasing by 12.5% over the year.

Meanwhile, the government sector's drag on the economy has abated. The Congressional Budget Office forecasts the federal deficit to remain fairly stable over the next few years.

Weakness in reported economic indicators in the first quarter of 2015 were largely due to transitory factors in our view. The West Coast ports dispute, severe winter weather, investment weakness in oil-linked industries and seasonal problems with data all likely affected quarter-on-quarter readings for the US economy produced by the Bureau of Economic Analysis (BEA). Over the year to March 2015, the BEA reports that personal consumption grew 3.4%, disposable income increased 3.2%, investment increased 7.9%, and exports grew 3.4%, which we see as positive signs for the US economy. Consumers remain cautious, though, as indicated by savings rates (including a muted consumption response to falling oil prices) and ongoing household deleveraging.

Recent strength in the US dollar may also be having an adverse impact on the internationally exposed part of the US economy, and some of this weakness could continue for a few years. The real effective trade-weighted US dollar exchange rate is moderately elevated. However, US wages remain highly competitive and energy costs very low compared to global peers, and household consumption is likely to be boosted by lower prices of imports. In addition, the US is a predominantly domestically-driven economy, with a relatively low reliance on exports (which account for approximately 13% of GDP).

We expect consumption growth to strengthen as the US labour market continues to recover. Considerable scope remains for further job creation in our view due to the prevalence of underemployment and the cyclically depressed participation rate. The 'U6' unemployment rate, which includes part time workers who want a full time job and those marginally attached to the labour force, remains elevated at 10.8%[3]. The U6 has fallen to 8% or lower in previous cycles. Furthermore, the proportion of 15-64 year olds in the labour force has fallen from just over 75% before the crisis, to under 73% as at April 2015.

We consider that the US economy will continue along its path of a steady and solid recovery over the next few years, barring unforseen events.

Eurozone

Real GDP growth in the Eurozone remains weak (around 1% p.a. in aggregate since March 2014). The periphery economies of Spain and Ireland have recorded relatively solid growth, having stabilised after deep recessions, while Greece's economic contraction resumed in the six months to March 2015. The Eurozone as a whole is likely to benefit from a weaker currency, a stronger US economy, lower oil prices, and a gradual improvement in credit conditions. However, we believe growth is likely to remain subdued for the foreseeable future as high levels of government debt, and political and economic impediments hold back any meaningful, sustained recovery.

In January, the ECB announced the expansion of its quantitative easing (QE) programme, involving the purchase of €1.1 trillion of assets (€60 billion per month), predominantly government bonds, paid for with money 'printed' by the ECB. The programme will run until September 2016, or until "a sustained adjustment in the path of inflation" is achieved towards the ECB's target of just below 2% inflation. QE is intended to help stimulate economic growth and put a floor under deflationary forces, by placing downward pressure on interest rates with an ancillary benefit of a devaluation of the Euro. However, we are sceptical about the direct economic stimulus from QE as the prevailing interest rates in the Eurozone were already low and the transmission mechanism via lending is likely to be weak. Eurozone core inflation remains low but has recently recovered to 0.9% p.a., despite the dramatic fall in the oil price over the past year.

There are tentative signs that labour markets have stabilised in the Eurozone. Aggregate employment increased 1.6 million to 150.3 million from June 2013 to March 2015, but remains below the pre-GFC peak of 154.4 million. Meanwhile, the aggregate unemployment rate has fallen from 12.1% in June 2013 to 11.1% in April 2015. Over the past year unemployment has fallen in Germany, Portugal, Ireland, Greece and Spain, while it has risen in France and has been little changed in Italy.

The difficult policy choices facing governments, as well as the long period of recessionary environments and accompanying high levels of unemployment, have supported the rise of Eurosceptic political parties in a number of Eurozone countries. These parties often threaten an exit from the Eurozone (and a dispensing of the euro as currency) and/or debt defaults, which could spark renewed uncertainty in sovereign debt markets.

Following the election of the Eurosceptic Syriza government in January, the sovereign debt crisis in Greece is once again threatening to develop into a broader contagion. Greece defaulted on a €1.6b payment due to the IMF and was forced to impose severe capital controls on its banks after its bailout package expired at the end of June. At the date of this letter Greece and the Eurozone countries reached agreement (subject to parliamentary approval) on a new bailout deal to keep its banks solvent and avoid an exit from the Eurozone. The terms of the new bailout deal are harsh and do not yet address the sustainability of Greece's debt burden. In our view the Greek sovereign debt crisis has not been solved with this new bailout, but the near term 'Grexit' risks appear to have been averted.

While economic conditions appear to have stabilised, we continue to believe that many Eurozone countries face a prolonged period of sub-par economic growth, due to the combined effects of high government debt, private sector debt levels and unfavourable long term demographics.

The Eurozone remains vulnerable to major shocks, such as an escalation of the Russia/Ukraine crisis, the election of Eurosceptic parties or a disorderly unwinding of QE in the US. Each of these scenarios could trigger a dramatic uplift in Eurozone sovereign bond yields and would heavily test the resolve and mandate of the ECB.

China

We remain concerned about the short to medium-term economic outlook for China, with evident risks in its property market and shadow banking system. A range of indicators suggest that China's economy is slowing, perhaps somewhat more than official figures imply. Furthermore, domestic economic weakness in China is starting to flow through to asset markets around the world (particularly commodity and currency markets).

There are a number of indicators that suggest a broad-based slowdown is underway. National house prices fell 6% in the year to May 2015, while urban housing completions are down 16% so far in 2015. The evidence of a slowing business sector includes electricity consumption growth of only 2% over the year to May 2015, compared to 8% per annum in 2012 and 2013. Steel production, auto sales and rail freight traffic growth have also slowed significantly (or are contracting).

Weak trade-growth data shows that exports and imports are both contracting. Some of the weakness in imports may be due to falling

[3]Marginally attached to the labour force are those who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the past 12 months.

commodities prices, but the figures are also likely to reflect domestic demand weakness. Slowing export growth could be due to a weak global economy and/or the early stages of competitiveness problems associated with an appreciating renminbi and rising wages. However we note that Chinese trade data should be treated with caution as it can be volatile and may be affected by illicit capital flows disguised as trade flows.

The massive oversupply in China's housing market has started to feed through to a range of other linked sectors in the economy, as millions of homes lie vacant. According to the China Household Finance Survey, 22% of urban housing in China is vacant. We believe that there may be approximately three to four years of excess housing supply, comparable to recent property booms in the US, Spain and Ireland. Almost half of China's sizeable credit growth since the GFC (or around 50% of GDP) may have gone towards financing property market activity.

The potential implications of China's property oversupply are serious. Real estate and related industries account for 20-25% of China's GDP, while the housing sector directly represents approximately 10% of GDP (approximately 50% more than a comparative US measure pre 2007). Fiscal positions are vulnerable, particularly local governments, who have relied on land sales for 35-40% of revenues. A large contraction in China's property construction sector would cause a major slowdown in the economy and perhaps even a recession.

Since 2010, China is estimated to have directly contributed around a quarter of total global economic growth, despite its economy only representing around 12% of world GDP. We are cautious about the prospect of adverse knock-on effects, including currency movements, linked to changing economic fortunes in China. A number of commodity exporters such as Russia, Brazil, Australia and Canada have experienced material depreciations in their currencies against the US dollar as commodity prices have fallen. In some cases these economies may also be vulnerable to the unwinding of commodities-linked domestic credit booms.

The outlook for the Chinese renminbi, which has appreciated 53% on a real trade-weighted basis since 2005, is uncertain and difficult to predict. Domestic economic weakness has led to an intensification of capital outflows from China, and forced the People's Bank of China (PBOC) to sell foreign currency reserves to keep the renminbi's peg to the US dollar intact. As countries cannot simultaneously have a fixed exchange rate, an open capital account and operate independent monetary policy – a concept known as the 'impossible trinity' – China faces some difficult policy choices. On the one hand the PBOC may want the renminbi to depreciate to provide support to its domestic industry and to enable the PBOC to more aggressively cut interest rates, while on the other hand, a strong renminbi, effectively pegged to the USD, may be strategically important from a geopolitical perspective.

The good news is that the Chinese authorities are aware of the problems within China's economy and appear to be taking steps to slow credit growth and manage the housing market correction. Furthermore, almost all of China's debt is held domestically, which makes it easier for the government to manage large-scale defaults as it did in the late 1990s. The differences this time are that much of the credit growth has occurred in the poorly-regulated shadow banking system, and it could prove more challenging for the government to bail out this part of the financial system. Furthermore, although the Chinese government has substantial resources at its disposal, it still may not be able to prevent a sharp slowdown in growth, or a recession, if the returns on incremental spending and investment are sufficiently low.

Stock in Focus:

IBM

IBM is the largest enterprise technology provider in the world, generating approximately $93 billion of revenue in 2014. It is among the largest vendors of datacentre hardware in the world, it is the third largest software vendor globally, and the largest Information Technology ("IT") services vendor. Approximately 90% of its earnings are sourced from software and services (48% and 40% of earnings, respectively), with the remainder of its earnings attributable to hardware, and a complementary financing business. However, whilst only a small portion of IBM's earnings are directly attributable to hardware, we estimate that a material portion of its software and services earnings are related to mainframe computers.

Favourable industry structure

Many of the market segments in which IBM competes are characterised by significant barriers to entry and switching costs that have historically allowed incumbent vendors to generate returns in excess of their cost of capital. However, IBM is differentiated from other incumbent IT vendors by its monopoly in mainframes in particular.

Mainframes are proprietary, large-scale computers, bundled with IBM software, which have handled many enterprises' most mission-critical workloads since the early 1950s. According to IBM, 70% of the world's business data is managed by mainframe computers. It says that 71% of Fortune 500 companies run IBM mainframes, including 92 of the top 100 banks globally, 10 of the 10 largest insurers, 6 of the top 10 global retailers, and 23 of the 25 largest airlines globally.

Mainframe is effectively a monopoly business for IBM, with significant barriers to entry, because IBM has refined and integrated mainframe hardware and software over decades. While alternative server and software technologies have been developed since mainframes were introduced in the early 1950s, they have struggled to match the reliability, availability, and security of the mainframe.

Mainframe switching costs are also high. Legacy mainframe applications were typically written for specific compatibility with the mainframe platform. Enterprises that are interested in migrating workloads from mainframes to another server architecture may be required to rewrite complex mainframe software, in which they have made significant investments over decades. Mainframe migrations may be multi-billion dollar undertakings. In addition, mainframes typically support only the most mission-critical workloads; non-core processes that could economically be shifted from mainframes to cheaper servers were migrated in the 1990s and early 2000s. There is material transition risk inherent in migrating these mission-critical workloads.

IBM's non-mainframe software and services businesses also benefit from the existence of barriers to entry and switching costs. For example, IBM's middleware software products are part of the plumbing of enterprise IT systems, and are typically integrated with other software programs, rendering them difficult and costly to replace. Similarly, IBM has a distinct advantage competing for large IT outsourcing contracts, according to which it operates datacentres for large enterprise clients. These engagements typically have a multi-year term, and tend to be sticky.

Defensive business model

A significant portion of IBM's revenue and earnings is recurring in nature. IBM says that 70% of software revenue is annuity-based, and attributable to recurring mainframe software and support contracts. Similarly, a material portion of IBM's services revenue is sourced from multi-year outsourcing contracts. In aggregate, IBM says that approximately 60% of its revenue, and 75% of its segmental pre-tax profit is recurring in nature. Its financials are consequently relatively insulated from adverse shocks.

Risks and valuation

With a material portion of its earnings tied to legacy technologies, IBM is exposed to technology risk. IBM's Power server business is contracting, owing to the shift to the cloud and competition from commodity servers. Its software business is also contracting, which it says is attributable to its decision to grant customers increased "flexibility" in how they deploy its software products. It faces secular challenges in services, owing to customers' desire to break-up large outsourcing contracts among multiple vendors, and deploy workloads in the cloud. Its stock is broadly out of favour with the market.

However, IBM is making progress restructuring its business, divesting low value businesses such as its commodity server business, and focusing instead on its "strategic imperatives", including cloud, analytics, mobile, and social. Its strategic imperatives accounted for 27% of its revenue in 2014, and grew at an average rate of 19-20% between 2010 and 2014. While we do not anticipate that IBM's growth will reaccelerate, we believe that its businesses is of a high quality, and that investors are being more than fairly compensated for technology risk at the current share price.

Hamish Douglass
Chief Executive Officer, Chief Investment Officer and Lead Portfolio Manager

14 July 2015

The Great Disagreement

An Important Update | April 2015

In August 2014 we wrote a piece titled "The Great Compression" regarding the risks associated with the massive compression in risk premia[4] and the potential effects of the US Federal Reserve ("the Fed") starting to increase US interest rates in 2015. We also informed investors that we had increased the cash weighting of our Global Equity Strategy to approximately 10% as a partial risk mitigation.

Since we wrote to investors in August 2014 the oil price has collapsed, the European Central Bank has commenced a large scale sovereign QE programme, the US dollar has appreciated materially, China's economy has slowed and risk premia across equity and credit markets have continued to compress. Today there is a "Great Disagreement" as to where US monetary policy (and hence US interest rates) is headed over the next three years or so. In one corner is the Fed which is anticipating a normalisation of the US economy and US monetary policy (and hence higher interest rates) over the next three years or so. In the other corner is "the market" which is effectively pricing secular stagnation with prolonged lower inflation and growth (and hence lower interest rates). In our view it is unusual to see such a fundamental and important disagreement between the market and policy setters. In our view, if the Fed is right, many assets are mispriced at the moment and a normalisation of US monetary policy could lead to material losses for investors.

The scale of this disagreement is staggering. At present, the market's forecast of overnight index swaps are pricing the Fed Funds Rate (FFR) at 1.7% by the end of 2017. This compares to the median forecast for the FFR by each Federal Reserve member at 3-3.25%. The gap between the market's and the Fed's forecast of short term interest rates in 2017 is almost 1.5%. The gap is even wider when you compare longer run forecasts of short term interest rates. Worryingly, we believe that this translates into a large gap between the long term risk free interest rate assumed by equity investors and the implied long term risk free interest rate assumed by the Fed. As an illustration of the implications of this divergence, the difference between the value of 30 year bonds yielding 3.5% and 5.0% is approximately 25%. If long term rates rise more than the market expects, there could be a similarly adverse impact on equity valuations.

While we do not rule out the possibility of secular stagnation in the US, we believe that many of the near term economic forces (such as the collapse in the oil price) will prove to be transitory and the most likely outcome is that the Fed will need to neutralise monetary policy over the next three years or so. This will result in materially higher US interest rates than the market is currently anticipating. Many investors have cited the current low inflation environment as a reason to doubt the necessity for the Fed to raise interest rates to levels anywhere near pre-crisis levels. However, as the oil price and the US dollar stabilise, and as wages growth returns, inflation is likely to head back towards the Fed's target of 2%. We do not expect a break-out in US inflation; we believe normalising inflationary pressures, diminishing labour market slack and the size of the Fed's balance sheet (over US$4.5 trillion in assets) will force the Fed to normalise monetary policy over the course of the next three years.

We believe that the economic events of the last eight months or so (the dramatic fall in oil prices, the appreciation of the US dollar, falling Chinese growth, some poor economic data in the US in recent months) have clouded investors' judgment and increased confirmation bias regarding the case for secular stagnation. We would also add that there appears to be anchoring bias associated with such a prolonged period of low interest rates which makes a normalisation of monetary policy

[4]The difference between the expected return on a security or portfolio and the benchmark "riskless" rate of interest is often termed its risk premium. Underlying the terminology is the notion that investors should receive a premium for bearing risk.

in the US almost seem radical and implausible. We regard the current market environment as anything but normal. Yields and spreads across a range of credit markets are at or near historic extremes. We have witnessed a number of high quality corporates issue debt at negative interest rates, and many European sovereigns (including Switzerland, Denmark, Germany, the Netherlands and Belgium) are experiencing negative yields on debt of up to five years to maturity. Investors are now effectively paying European governments or certain corporates to borrow money. Furthermore, spreads between German Bunds and US Treasuries are at their highest levels since before the reunification of Germany. As investors we find this unprecedented and somewhat confronting.

As a consequence of a further compression in risk premia (i.e. asset prices have continued to rise) since August last year we have, over the past two months, increased the cash weighting in our Global Equity Strategy from 10% to 15%. The cash weighting increases the defensiveness of our portfolio and should act as a partial hedge to increasing US interest rates.

The experience of 1994 highlights that risk premia can adjust rapidly, even in a non-recessionary environment. Countries like Australia, and many others, could potentially encounter a 'double whammy' situation where rising US Treasury yields and widening spreads cause a sharp spike in yields. This is exactly what happened to Australian government 10-year bonds in 1994 when yields rose over 350 basis points from February to December. Over this period the price of an Australian government 10-year bond fell by approximately 21%. US corporate high yield (5 to 7 year) credit markets also suffered large valuation losses, with yields spiking 485 basis points over the same period.

It is critical that we ask ourselves the reasons we may be wrong.

The first and most plausible reason is the proponents of the secular stagnation theory turn out to be right. If nominal growth in the US is meaningfully lower than we, and the Fed, anticipate in the medium term, then it may be appropriate for the Fed to run monetary policy targeting materially lower interest rates. If US inflation runs closer to 1% in the longer term, as opposed to 2% as currently anticipated by Fed members, then it may be appropriate to run monetary policy with interest rates closer to the market's current expectations. While we do not believe this is the most likely outcome we cannot totally discount the possibility of secular stagnation in the US over the medium term.

The second, and in our view less plausible, argument for lower US interest rates is the effect of exceptionally low European and Japanese bond yields on the demand for US Treasuries. For as long as European and Japanese bond yields are at exceptionally low levels (maybe due to central bank demand as a result of QE or weak economic fundamentals) then investors will sell bonds in countries like Germany, France and Japan and buy US Treasuries. Therefore, this demand from large foreign buyers for US Treasuries will keep US longer term interest rates low, irrespective of US economic fundamentals or what monetary policy the Fed attempts to implement. In our view this is a rather simplistic view of how markets and central banks work and is akin to believing in the "tooth fairy". In our view market participants will only sell bonds in Europe or Japan to buy bonds in the US on the basis that they expect to make a profit from the apparent interest rate arbitrage.

So let's examine one way this argument breaks down under a likely set of future circumstances and a possible Fed response. Let's fast forward a few years. Growth in the US has now normalised, US inflation is running at around 2%, US unemployment is below 5%, US wages growth is above the rate of inflation and the Fed's balance sheet remains exceptionally inflated at around US$4.5 trillion. In light of this economic data the Fed has raised the short term interest rate to 3.75%-4.0%. However, the 10 year US Treasury yield is sitting at around 3.5% because of all of the selling of bonds in Germany, France and Japan and buying of US Treasuries. The Fed would be confronted with an inverted yield curve which many economists would argue is too accommodative for the economic circumstances. In order to avert a disaster in the future the Fed reaches the conclusion that longer dated US Treasuries should be at a higher yield to remove monetary accommodation. Confronted with this economic reality the Fed decides to issue the following statement:

"Over recent years the FOMC has responded to the improving economic situation by increasing the Federal Funds Rate from a target rate of 0-0.25% in 2015 to the current target rate of 3.75%-4.0%. The unemployment rate and inflation expectations are now at or above levels consistent with the Fed's mandate of full employment and price stability. The FOMC is concerned that market yields on longer dated Treasuries remain exceptionally low and could fuel expansion inconsistent with the Fed's mandate. The Fed considers a more neutral policy setting would be to have the 10 year Treasury yield closer to longer term averages, which would imply a positively sloped yield curve. If market prices do not adjust within a reasonable period the FOMC will revisit the composition of its holding of US Treasuries and may consider a reverse twist operation[5] or outright sales from its portfolio."

In light of such a statement it is unlikely market participants would continue to buy US Treasuries at exceptionally low rates given the Fed would have almost guaranteed investors that they would lose money, since they would

[5]A reverse twist operation would sell long-dated US Treasuries and buy short-dated US Treasuries, causing a steepening of the yield curve.

be confronted by the possibility of sustained and heavy selling of US Treasuries by the Fed. We therefore believe the US economy will be the driver of future interest rates and not external factors like arbitrage driven demand.

The key question is not when the Fed commences raising interest rates, but by how much they will increase rates in the next few years and what will normalisation look like. Where US monetary policy is heading is an economic question and not a question of apparent market demand for US Treasuries. We have confidence that the US Fed will react appropriately to the economic circumstances prevailing in the future and set monetary policy accordingly.

It would appear that many investors are presently very confident in their ability to "get off the merry-go-round" before the music stops. Most investors clearly understand that the Fed will commence increasing US interest rates shortly however it would appear that many investors aware of the potential risks of rising US interest rates feel confident in their ability to ride this wave right to the shore. As I stated in the update last August investing is a long-term endeavour and we believe it is appropriate to risk giving up some short-term return in order to protect our clients' capital. As Warren Buffett has often reminded investors "To finish first you must first finish". It may turn out that we are right to be cautious but that we are too early in reducing our equity risk in the portfolio. Indeed it could be argued that we moved too early in reducing risk in August last year. We have no interest in being "Cinderella" at this ball, staying too late and thus risk everything turning to pumpkin and mice.

Of course, there is a possibility that the US may be in secular stagnation and long-term bond yields do not rise to the levels we anticipate, and markets remain benign or even strong. In such a scenario, the decision to increase our cash weighting will be a drag on short-term performance. However, the cost of taking out this additional insurance is likely to be small, and the Global Equity Strategy will remain 85% invested in high quality global equities. Indeed under such a scenario this remaining 85% of invested capital may well deliver even better returns to our investors than our current expectations. Even if we are wrong in our judgment that US monetary policy will normalise over the next three years it does not lead to the conclusion that it is wrong to take out some insurance for "the Great Disagreement". No one could be 100% certain about the case for secular stagnation and these extraordinarily low rates prevailing. We believe it is better to be prudent, given the current set of facts, than be complacent.

Hamish Douglass
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30 April 2015

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