Magellan Global Fund

Fund Update: 31 March 2014

Key Facts

Portfolio Manager
Hamish Douglass

Structure
Global Equity Fund, $AUD unhedged

Inception date
1 July 2007

Management and Administration Fee[1]
1.35%

Buy/Sell Spread[1]
0.10%/0.10%

Fund Size
AUD $5,244.1 million

Performance Fee[1]
10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (MSCI World Net Total Return Index (AUD)) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

[1]All fees are exclusive of the net effect of GST

AUD Performance[2]

	Fund %	Index %[3]	Excess Return %
1 Month	-3.6	-3.3	-0.3
3 Months	-3.0	-2.3	-0.7
6 Months	10.0	10.3	-0.3
1 Year	30.6	33.9	-3.3
2 Years (p.a.)	25.1	22.0	3.1
3 Years (p.a.)	23.1	14.3	8.8
4 Years (p.a.)	16.7	10.8	5.9
5 Years (p.a.)	17.1	11.7	5.4
Since Inception (p.a.)	10.1	1.5	8.6
Since Inception	91.1	10.5	80.6

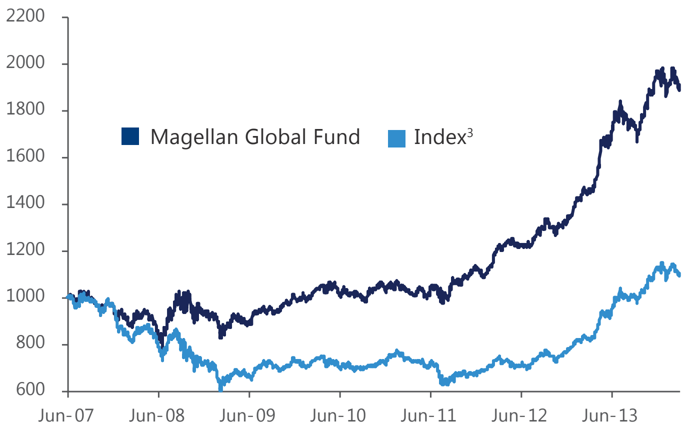
Top 10 Holdings

	Sector	% of Fund
eBay Inc	Information Technology	6.6
Microsoft Corp	Information Technology	6.5
Oracle Corp	Information Technology	6.4
Target Corp	Consumer Discretionary	5.5
DirecTV	Consumer Discretionary	5.1
Visa Inc	Information Technology	4.8
Nestlé SA	Consumer Staples	4.8
Tesco plc	Consumer Staples	4.7
Lowe's Co Inc	Consumer Discretionary	4.6
Yum! Brands Inc	Consumer Discretionary	4.6

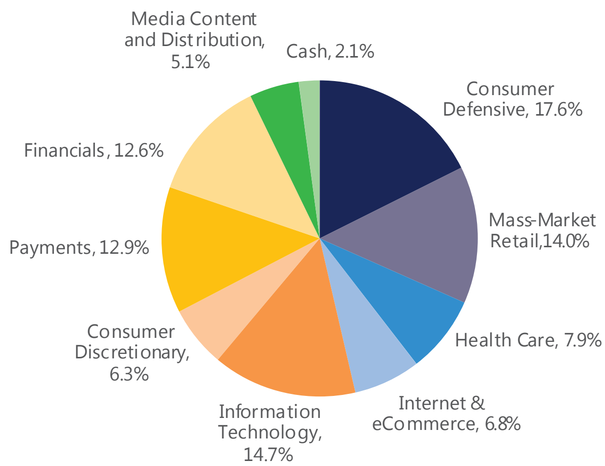
Regional Breakdown

	% of Fund
Multinational	46.8
North America	46.4
United Kingdom	4.7
Australia	0.0
Europe	0.0
Japan	0.0
Asia Ex-Japan	0.0
Cash	2.1
TOTAL	**100**

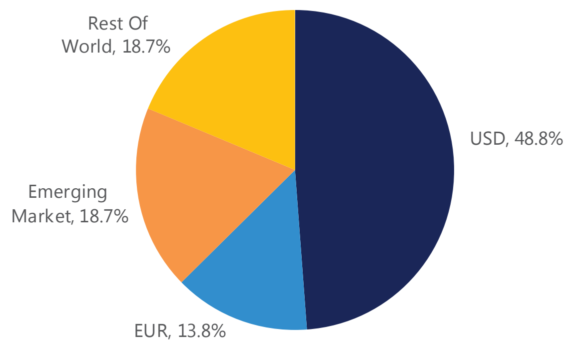
Performance Chart Growth of AUD $1,000[2]



Industry Exposure by Source of Revenues[5]



Geographical Exposure by Source of Revenues[5]



[2]Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Fund Inception 1 July 2007.

[3]MSCI World Net Total Return Index (AUD)

[4]Multinational: Greater than 50% of revenues outside home country.

[5] Calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio.

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MAGELLAN ASSET MANAGEMENT LIMITED

Market Commentary

In the first quarter of 2014, markets struggled for direction amid mixed US employment, consumption and housing data, all of which were likely impacted by adverse weather conditions. Elsewhere, the escalating geopolitical situation in the Ukraine, culminating in Russia's annexation of Crimea, gave rise to near-term uncertainty, while the ECB stressed their capability of undertaking further monetary policy actions, if need be, to combat low Eurozone inflation.

Against this backdrop, global equity markets ended the quarter slightly higher. In regional terms, Europe and North America made modest gains, the latter despite further asset purchase tapering from the Federal Reserve. On the negative, Japan underperformed as its GDP growth slowed and its trade position weakened.

Investors should not be distracted by short-term data trends. In our view, the drivers of US economic growth are gathering strength, justifying the Federal Reserve's moves to end Quantitative Easing and gradually normalise monetary policy. Higher interest rates will be disruptive to markets, particularly those where investors have sought duration and higher yields and, as a result, we continue to consider the unwinding of Quantitative Easing as the single most important factor that will impact markets and economies over the next few years.

Fund Commentary

As at 31 March 2014, the Fund consisted of 28 investments (compared to 27 investments at 31 December 2013). The top ten investments represented 52.9% of the Fund at 31 March 2014, while they represented 52.4% at 31 December 2013.

Over the quarter, the three stocks with the strongest returns in local currency were DirecTV (+10.6%), which showed good margin performance across regions and announced above-consensus guidance, Wells Fargo (+10.2%) which rose on the prospect of higher interest rates, and Microsoft (+10.2%) which saw continued strength in its enterprise businesses as well as the first strategic changes by its new CEO. The three stocks with the weakest local currency returns were Adidas (-15.2%), which indicated that emerging market currency moves would negatively impact performance in 2014 and possibly 2015, Tesco (-11.7%), which suffered a weak Christmas period and may face increased competitive action from its peers, and MasterCard (-10.5%) which disclosed that 2014 revenues would bear the full impact of the loss of its JPMorgan credit card portfolio to Visa (another portfolio stock).

The Fund is fully invested, despite the strong rise in equity markets in 2013, as we believe its holdings have appealing valuations and should deliver attractive returns for investors over the next 3-5 years. The Fund remains positioned to benefit from a strengthening US economy, along with normalisation of interest rates and capital market activity.

Key Stock in Focus - YUM Brands

YUM develops, operates, franchises and licenses a worldwide system of ~38,000 restaurants under the brands of KFC, Pizza Hut and Taco Bell – each respectively a global leader in chicken, pizza and Mexican-style food categories. Units are operated by either the company (about 20%) or independent franchisees or licensees under franchise or license agreements. Franchisees, which range in size from individuals owning just one restaurant to large publicly traded companies, operate the restaurants, invest the capital and pay YUM a royalty based on sales. As measured by system sales, YUM is second to McDonald's globally, but the leader in emerging markets by a sizeable margin.

YUM has established a very significant business in China where it has more than 6,000 restaurants, over 5,000 of which are owned and operated by the company itself. China alone accounted for 40% of YUM's operating profits in its last financial year. YUM is the dominant player in the country and KFC is a top-3 brand with deep customer recognition. In 2013, however, KFC became embroiled in a food safety issue which garnered national headlines and severely impacted both customers' perceptions of the brand and sales. Two of KFC's chicken suppliers were found to have used excessive amounts of antibiotics in late 2012; the public outcry saw KFC's same store sales drop by over 20% initially. As confidence began to be restored in early 2013, an outbreak of Avian Flu again led to consumer concerns around the safety of eating chicken and same store sales fell even further.

YUM moved quickly to address concerns, tighten controls in its supply chain and restore people's trust in the KFC brand. At the same time it stepped up efforts to reduce costs and preserve profits as it managed through the issue. However, the natural operating leverage meant a 23% decline in China profits in 2013 on a 4% decline in system sales. YUM's overall earnings per share dropped by 8.5%, breaking a decade-long run of over 13% compound annual growth.

Importantly from our perspective, we do not believe the YUM China business is permanently impaired. Indeed YUM has continued to invest aggressively in store expansion, adding a further 740 new restaurants in China in 2013, and it sees a long-run opportunity for its store numbers to more than double, or even triple, from here. The business continues to achieve cash paybacks on its investments in China of 3 years or less. While 2013 was a humbling and difficult year for the company, it also brought with it a myriad of learnings. Management grasped the opportunity to build a stronger business on the back of these and, under the strong leadership of CEO David Novak, YUM has built a culture of teamwork and humility. History suggests the company will emerge stronger, wiser, more productive and more innovative; indeed, it has already achieved sustainable cost improvements.

Through 2014, YUM is undertaking a significant campaign to restore KFC brand equity and is moving back on the offense. It is bringing excitement to consumers in China with an all-encompassing campaign that includes a refreshed and expanded menu, new uniforms, expanded digital initiatives and dynamic marketing (including celebrity endorsements). The campaign should see YUM China achieve a 40% rebound in operating profits and the group achieve at least 20% growth in earnings per share. Indeed, YUM China has already witnessed a return to positive same store sales growth and we expect this momentum to continue.

Beyond China, YUM has an unmatched scale in emerging markets, with over 10,000 restaurants, almost twice that of the next largest restaurant company, McDonalds. Already, over half of its operating profits are generated in these faster growing, rapidly-developing countries. One of the most exciting regions for YUM is Asia; clearly in China, but also in countries like India, Indonesia, Malaysia, Thailand, where vast populations are growing in affluence and YUM's KFC and Pizza Hut brands already have high brand recognition and loyalty, and compelling unit economics.

Of course this exposure comes with a different set of risks to other, more developed-market focussed companies. At present some of these markets are experiencing economic downturns, heightened inflation, currency devaluations or various combinations of these factors. Indeed, the persistent strong credit growth in China, without commensurate benefit in GDP growth, is heightening the risks around the latter's sustainability (at historically high levels). We are therefore mindful of these risks in judging YUM Brands' ultimate return prospects, and at what price the investment is good value.

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