



Annual Investor Report 2018

Magellan Global Fund
Magellan Global Fund (Hedged)

Dear Investor

While global stocks have set record highs over the past 12 months, we are cautious on the outlook for equity markets and consider that risks are asymmetrical to the downside. Our caution is reflected in the defensive stance of the Magellan Global Fund with cash at 30 June 2018 representing 18% of the portfolio.

Conservative investors sleep well

Some people might consider that having such a large cash holding exposes investors to underperformance if equity markets rise. We have no fear of missing the tail end of an extended bull market. Renowned investor Sir John Templeton was perhaps best known for saying: "Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell." ***In our view, only conservative investors sleep well.*** Implicit in conservative investing is the focus on the conservation of capital. As Warren Buffett has said, there are two rules in investing: 1. Don't lose money. 2. Don't forget the first rule.

At Magellan, we believe in the fiduciary concept of the 'prudent man rule' in managing money for our clients (and ourselves). This rule was conceived in the 19th century when a Massachusetts judge suggested trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

We have often stated that clients should be aware that we will not be overly concerned if we underperform a market benchmark in the short term. Given our approach is to build a portfolio of a small number of outstanding businesses (which, by definition, is substantially different in composition from any broad equity-market index), the probability of this occurring is a near certainty.

All our investments are made in accordance with our investment philosophy; to invest in outstanding businesses that have attractive underlying business economics because they are protected by sustainable long-term competitive advantages or, in Buffett's words, an "economic moat". In our opinion, investing in terrific businesses at appropriate prices is a low-risk investment style and will produce more certain investment returns over time than many other approaches. Buffett wrote in his 1992 letter to shareholders: "Your goal as an investor should be simply to purchase, at a rational price, a part interest in an easily understood business whose earnings are virtually certain to be materially higher 5, 10 and 20 years from now." This test sounds easy, but it is hard to put into practice as there are only a relatively small number of companies in the world whose earnings are almost certain to grow significantly in coming years. We believe that many companies are entering the most disruptive business environment since the start of the industrial revolution. So now it is even harder to find such businesses. We will clearly need to be on our game in the years ahead. Sir Frank Lowy, the founder of Westfield, once gave me some sage advice on the key to being successful: "Be paranoid"; that is, spend more time on thinking about what can go wrong than what will go right.

Our investment objectives are clear. We seek to deliver very satisfactory investment returns (a target average return of above 9% per annum after fees) over the medium to long term while minimising the risk of a permanent capital loss. We are happy to be judged on absolute returns over time and our record at minimising the risk of a permanent capital loss. We recognise that some people are fascinated with comparing investment returns over short periods of time with a share-market index, such as the MSCI World Index. If you look at our returns after fees over three years on a rolling monthly basis, which we think is the minimum time frame you should consider when assessing whether or not a manager is adding value over time, our global equity strategy has outperformed the MSCI World Index consistently since inception; in fact, more than 90% of the time. This places Magellan right at the top of its peer group of global equity managers on the basis of consistency of outperformance.

We feel strongly that people cannot retire on 'relative investment returns'. Only by generating investment returns that exceed the rate of inflation by a reasonable margin will investors meaningfully increase their wealth over time. We are satisfied with the investment results that we have delivered to date.

The following table sets out the compounded yearly investment returns net of fees of the Magellan Global Fund compared with its 9% p.a. (after fees) long-term objective since inception on 1 July 2007, as at 30 June 2018.

Performance of the Magellan Global Fund as at 30 June 2018.*

Annual compound results (%) per annum		
	Magellan Global Fund (net returns - \$A)	Performance objective (9% p.a.)
1 year	16.9	✓
2 years (p.a.)	16.1	✓
3 years (p.a.)	10.4	✓
4 years (p.a.)	14.9	✓
5 years (p.a.)	14.3	✓
6 years (p.a.)	18.2	✓
7 years (p.a.)	18.2	✓
8 years (p.a.)	16.1	✓
9 years (p.a.)	15.9	✓
10 years (p.a.)	14.9	✓
Since inception (% p.a.)	11.6	✓

* 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. Returns denoted in AUD.

in Lloyds Banking Group in September 2008 when we understood the risk to the world's banking system following the collapse of Lehman Brothers. I have made more recent mistakes including a wrong assessment of the risks facing Sanofi's diabetes franchise and misjudging the underlying economic moat of CVS Healthcare, a pharmacy-benefits manager and pharmacy chain in the US. Pleasingly, we quickly faced reality regarding each of these decisions and sold the positions. In 2014, we reinvested in Lloyds following a full recapitalisation of the bank.

The investment mistake that is omitted in this list of where we cut our losses is the decision in 2012 to invest in Tesco, the leading supermarket chain in the UK. At 31 December 2012, the Tesco investment accounted for 6.1% of the portfolio. In 2014, Tesco issued five profit warnings relating to its core UK business and the share price fell by about 50%. The Tesco investment mistake, both the sustainability of the profitability of the UK business and the position sizing, was mine. After the dramatic fall in Tesco's share price, we reviewed Tesco's business prospects and evaluated new CEO, Dave Lewis, and his ability to execute a turnaround of the business. Following this review, we decided to retain the investment. This was counter to our usual modus operandi to exit investment mistakes and clearly against Mae West's dictum. Recently we exited the Tesco investment.

The question is whether or not we made the right decision to retain the Tesco holding for as long as we did. On 31 December 2014, Tesco's share price closed at 1.89 pounds and we recently sold the investment at around 2.43 pounds per share, representing a gain (in British pounds) of about 29% or 7.4% p.a. over the 3½ year period. I note that these returns exclude the adverse impact of the depreciation of the British pound when it was hit by the outcome of the Brexit referendum in June 2016. In hindsight, our decision to retain the Tesco investment over the past 3½ years, while profitable, was marginal at best. There are two lessons here. Firstly, 'turnarounds' are difficult for companies to achieve. The other is that it is usually best to face reality and sell investments when you make mistakes.

The other aspect of capital preservation is to reduce 'downside risk' in periods when markets fall materially – that is to say, to reduce the risk the portfolio might decline as much as, or more than, the market. We seek to construct our investment portfolio with a meaningful margin of safety and with risk characteristics that should enable the portfolio to have materially less downside in the event of a large market correction. Our portfolio is designed to reduce downside risk and aggregation risk (i.e. the risk attached to the aggregation of similar economic, competitive or regulatory risks within a portfolio). We seek

The other side of our investment objective is to minimise the risk of permanent capital loss. This aim can be viewed as lowering the number of investment mistakes that result in permanent investment losses and reducing the downside risk in periods when markets fall materially.

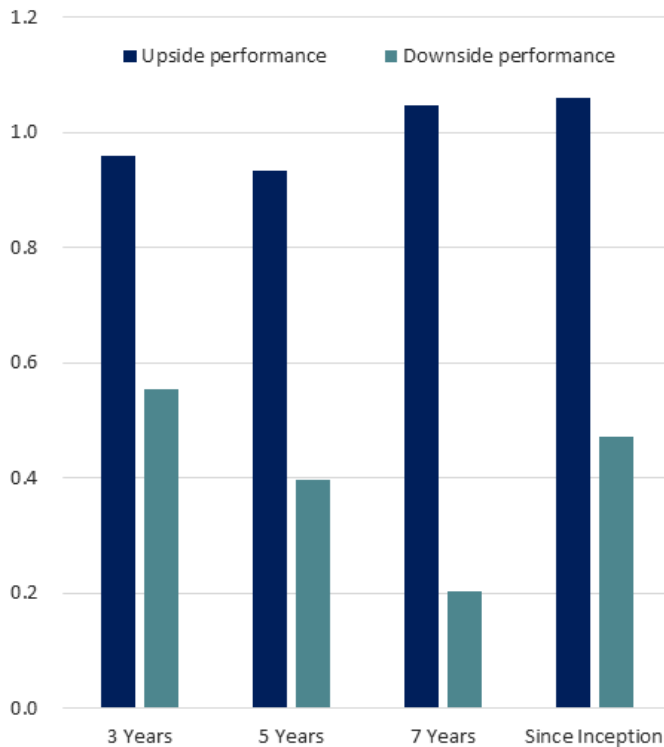
I regard our investment research as 'an inch wide and a mile deep'. We have a large team of talented investment analysts and portfolio managers whose jobs are to undertake detailed fundamental investment research and due diligence on companies and, importantly, to question why our investment case might be wrong. I am proud of the quality of our investment team's research and believe that we have a first-rate 'batting average' in terms of stock selection and minimising our error rate.



In the business of investing, it is inevitable that we will make mistakes. It is important that we face reality when we make mistakes and we do not compound errors by letting emotions justify past decisions. Typically, when we make mistakes we face facts and take our losses. As Mae West said: "All discarded lovers should be given a second chance, but with somebody else." I have made my fair share of investment mistakes since 2007. Early errors included investments in Nutrisystem (a US meal-delivery business for people seeking to lose weight) and SLM (a leading provider of student loans in the US), and a decision not to sell the entire investment

to achieve this in three ways, via: an overall cap on the volatility and downside risk of the portfolio (materially less than the market), combining two sub-portfolios (one consisting of defensive high-quality businesses and another comprising higher-growth or cyclical high-quality businesses), and through our permanent and dynamic risk controls. We believe our approach

Magellan Global Fund's performance in rising and falling markets as at 30 June 2018.



Source: Magellan Asset Management. Magellan Global Fund in US dollars gross of fees relative to MSCI World Net TR Index as 30 June 2018 using rolling three-month returns. Inception date 1 June 2007.

materially reduces the likelihood that our portfolio will fall as much as the stock market in the event of a significant market correction.

I would add one important caveat to our approach: it is almost certain that this built-in 'downside protection' will result in our portfolio lagging a major market rally. We have no concerns that higher risk strategies, such as those heavily weighted to emerging markets or ones holding lower-quality or commodity companies, might outperform our strategy during a bull-market phase of the investment cycle. This is to be expected. We fear some investors are becoming unrealistically obsessed with chasing returns without an appropriate appreciation of the tendency for markets to correct without warning.

The chart to the left sets out the upside and downside performance of our portfolio since inception 11 years ago. The analysis reviews the performance of the market compared with that of our portfolio for all market periods since inception. For example, if in a three-month period the stock market (measured by the MSCI World Index) declined by 5% and our portfolio fell by 2.5% then our portfolio would have a 'downside performance' ratio of 0.5 for this period. We are pleased that our strategy has consistently beaten a falling share market. Since inception, the portfolio has captured about 100% of the upside performance of the market while it has only recorded about 50% of the market's decline.

Market outlook

As noted, we are cautious at present and running a defensive portfolio. This is because we face an extraordinary cocktail of circumstances that skews risks to the downside.

- Asset prices are at, or near, record levels

Prices for sovereign, corporate and high-yield bonds and equities are at, or near, record levels thanks to the ultra-low policy interest rates and the massive quantitative-easing programs of the G3 central banks (the US Federal Reserve, the European Central Bank and the Bank of Japan) over the past decade.

- Central banks have commenced quantitative tightening

In response to the strengthening economic environment, the Federal Reserve is raising the cash rate and has commenced a pre-set program to shrink its balance sheet while the European Central Bank has announced that it will cease its asset-buying program by 31 December 2018. The combined impact of announced balance-sheet activities of the Federal Reserve and the European Central Bank will remove liquidity from global markets, resulting in a reduction in demand for bonds and other assets by these central banks of about US\$1.5 trillion on an annualised basis from October 2017 to the end of December this year. We believe that a change in demand by the central banks of this magnitude is likely to have a meaningful impact on longer-term bond yields by early 2019.

- Late-cycle US fiscal stimulus

In our view, the Federal Reserve's strategy to tighten monetary policy in a smooth and well-foreshadowed manner has been complicated by the large fiscal stimulus being implemented by the Trump administration at the tail end of an extended economic expansion. The tax cuts and additional spending will make a fiscal injection into the US economy of nearly 2% of GDP per annum for the next two years. The US unemployment rate at 4% is near an 18-year low and the US economy has added jobs over the past 93 months, which is the longest such consecutive stretch on record. While there appear to be

powerful longer-term secular forces at work that are likely to result in low inflation over the longer term, there is a significant risk that the size and timing of the US fiscal stimulus could trigger a jump in US inflation, in particular from stronger wages growth, over the next year or two. This could be highly problematic for the Federal Reserve and complicate its efforts to engineer a gradual tightening with a soft landing. We cannot think of a similar combination of circumstances in modern history. The cocktail of circumstances could be explosive. The best hope for investors is that either the US tax cuts and extra spending have limited effects on growth and inflation in coming years or the secular forces that have kept inflation low accelerate to offset any inflationary pressures from the fiscal stimulus.

We assess that there are three possible scenarios for markets over the next 12 to 18 months:

- The first scenario is a continued US economic expansion without triggering a material increase in US wages growth or inflation. In these circumstances, we would expect the Federal Reserve to increase short-term interest rates and to shrink its balance sheet broadly in line with current expectations. In these circumstances, it would be reasonable to expect that over the next, say, 18 months the US cash rate would rise to 3% to 3.5% and the 10-year Treasury yield would increase to about 4%. In this scenario, defensive equity assets, longer-term bonds and emerging-market equities are likely to underperform growth assets and economically cyclical assets, and some commodities are likely to outperform driven by the economic expansion. We would place slightly less than a 50% probability on this scenario.
- The second scenario is where the Federal Reserve is forced to act more swiftly and forcefully than expected to counter inflationary forces. It would be reasonable to assume that US longer-term bond yields could jump suddenly and meaningfully (above 4% compared with 2.86% for the US 10-year Treasury bond at the end of June), which could trigger the biggest slump on world share markets since the global financial crisis. **In our view, a 20% to 30% global stock market correction in the next 12 to 18 months is conceivable.** In these circumstances all equities are likely to be affected. We would put a similar probability on this scenario to the first or, in other words, we don't know which of these two scenarios is more likely.
- The third scenario is where an external event occurs that causes the Federal Reserve and the European Central Bank to reverse course and put on hold any further tightening of monetary policy. We believe that this is most likely to occur in circumstances of a significant event and, therefore, this scenario is likely to be negative for share markets. There is a remote possibility of a 'Goldilocks moment' where the central banks stop their plans to tighten money policy, longer-term bond yields fall and equity markets don't fall or even rise.

During the past year we have monitored several other risks for global stocks:

- Trade tensions between the US and its major trading partners
- Uncertainty in Italy

The past 12 months have seen a dramatic increase in international trade tensions. President Donald Trump has followed through on his demands that the US major trading partners reduce their bilateral trade surpluses and remove what he considers to be 'unfair' trade restrictions such as forced technology transfers and unequal tariffs. As the trade negotiations have involved the threat of tariffs on a large slice of exports to the US from major countries including China, Germany, Canada and Mexico, investors are worried about a slowing in global economic growth.

We believe that the most likely outcome is that negotiations will avert a full-scale trade war, and the US and its major trading partners will eventually agree to new trading arrangements. This view is based on an assessment that President Trump is probably most inclined to do a deal as no country, including the US, would benefit from a full trade war. This appears to be what the market is pricing. However, there is a risk that we and other investors are misreading President Trump's intentions; that he intends to fundamentally rewrite the trading relationships with the US major trading partners, and most importantly with China. This means he will not do a short-term deal until there are fundamental changes that would undermine China's long-term technological strength. China has clearly set out its intention to dominate critical technologies in its 'Made in China 2025' development plan. In these circumstances, the risks of a prolonged and deep trade war are higher than we are assessing. The Trump administration has publicly claimed it would have the upper hand in any tariff war with China given the large trade deficit the US has with China. We think that this view is simplistic and naive. We believe that China will be reluctant to agree to concessions that will hamper its 'Made in China 2025' development plan and Beijing has substantial means at its disposal, including devaluing the renminbi and stimulating the domestic Chinese economy via the banking system, that could counteract the damage of higher US tariffs on exports from China. We note that the trade dispute comes at a time when the economy in China appears to be slowing as the government cracks down on the large shadow banking system and the US Federal Reserve tightens monetary policy. Given the uncertainties, caution is warranted.

The past six months have seen rising investor concern on the outlook for the eurozone. The Italian elections in March that took place amid heightened voter concerns about the economy and immigration proved inconclusive, and it took more than two months for Eurosceptic political parties to form a government. During negotiations to form this coalition,

it was feared that fresh elections might be needed that could usher in a government that intended to exit the euro. The new coalition government has made no moves to exit the euro. It is more focused on confronting EU members on immigration and increasing government expenditure to help the economy in defiance of eurozone rules.

We think that the most likely outcome is ongoing disagreements between Italy and the eurozone but ultimately that Italy will receive some concessions and remain in the eurozone though any stand-offs during negotiations are likely to result in periods of increased market volatility. Domestic political constraints make such stand-offs likely. Greater sharing of the immigration burden is likely to be agreed but be politically difficult for some EU members such as Germany. Given Italy's government debt burden (at about 130% of GDP) and the potential for Italy's debt load to destabilise the eurozone, other euro-using members will be reluctant to allow Italy to substantially increase its budget deficit in the near term in the absence of meaningful microeconomic reforms, which will be politically difficult for Italy. The most likely path to an agreement is a period of increased market volatility (particularly for Italian government bond yields) that will force both sides to reach a compromise.

Portfolio performance and positioning

Notwithstanding our cautionary outlook, we expect that our portfolio of 22 high-quality businesses should generate a satisfactory return over the medium to long term. In a world where the pace of change is accelerating, many traditional industry structures are being redefined and many previously strong businesses are being weakened or displaced. We seek high-quality businesses with long-term competitive advantages that are well positioned for this changing world.

Our portfolio seeks:

- Non-cyclical defensive investments that are resilient to disruption risks and attractively priced when assuming higher interest rates.
- High-growth investments that are likely to be clear winners from change and secular tailwinds over the next five to 10 years.

The core investment themes in our portfolio at 30 June 2018 were:

- Advertising technology-platform companies (Alphabet, the owner of Google, and Facebook) that represented 13% of the portfolio.
- Enterprise-software companies (Microsoft, Oracle and SAP) that comprised 10% of the portfolio. These companies are deeply integrated within the operations of their business customers, which lowers the risk these customers will switch software vendors. They are benefitting from the transformational growth in cloud computing.
- Quick-service restaurant companies (Starbucks, Yum! Brands and McDonald's) that comprised 10% of the portfolio. We view that these companies have unique longer-term competitive advantages that make their businesses defensive and resilient to disruption.
- Payment-platform companies (Visa and Mastercard) that represented 9% of the portfolio. These are classic 'network-effect' business models that connect millions of merchants with billions of cardholders. They are the 'rails' upon which global electronic payment systems run.
- An investment in two of the world's most advantaged retailers (Lowe's and Costco Wholesale) that are largely insulated from the shift to ecommerce. These investments comprised 7% of the portfolio.
- An investment in Apple that represented 5% of the portfolio. We consider that Apple is a highly advantaged consumer-services platform with high consumer loyalty and a long-term opportunity to monetise the one billion Apple devices in use.

Top-10 holdings of the Magellan Global Fund at 30 June 2018.

Security	Weight (%)
Alphabet	6.8
Facebook	6.6
Kraft Heinz	5.4
Visa	5.2
Apple	5.1
Lowe's	5.0
Wells Fargo	4.4
Starbucks	4.2
MasterCard	3.8
Microsoft	3.7
Other	31.4
Cash	18.4
Total	100.0

- An investment in Kraft Heinz that represented 5% of the portfolio. We believe an investment in Kraft Heinz is a long-term partnership with the world's foremost private-equity firm, 3G, which is well placed to consolidate the consumer-staples industry.
- An 18% holding in cash (held in US dollars).

In seeking to minimise our portfolio's exposure to significant global political risks, we are mindful of our geographic exposures. We assess geographic exposure based on the sources of revenue for our investments. Many commentators look to the listing domicile of a stock to assess geographic exposure. They think, for example, that an investment in a US-listed stock creates a US-only exposure. We view this approach as simplistic and disconnected from reality, particularly when assessing a portfolio such as ours that mainly comprises multinationals. The underlying geographic exposure of our portfolio at 30 June 2018 comprised a 45% exposure to the US, 14% to emerging markets, 13% to Western Europe, 10% to the rest of the world, and 18% in cash.

Portfolio performance

Global stocks hit record highs in the 12 months to June 2018 as US companies posted higher-than-expected earnings, the internet giants surged on strong results and upbeat outlooks, the Federal Reserve slowly tightened US monetary policy as flagged, US Congress slashed the corporate tax rate, and the world's major economies grew in unison for the first time in about a decade. Gains were tempered when US President Donald Trump imposed import restrictions that could lead to trade wars with China and the EU, concerns mounted that US inflation might accelerate enough to prompt the Fed to tighten monetary policy more than expected, and worries rose about the regulatory outlook for US technology companies.

The Magellan Global Fund recorded a return after fees of 16.9% for the 12 months, while the Magellan Global Fund (Hedged) recorded a return after fees of 13.1% for the 12 months. The stocks that contributed the most to the portfolio's return included the investments in Visa (+2.2% of the total portfolio return), Apple (+2.1%), Mastercard (+2.0%), Microsoft (+1.8%) and Facebook (+1.8%). Visa rose after its earnings topped analyst expectations for every quarterly reporting period released over 2017 and so far in 2018, aided by outperformance of Visa Europe relative to the expectations held at the time of the acquisition. Apple rose on the strong growth in its services division. Like Visa, Mastercard gained after the payment company revealed that earnings beat estimates due to higher consumer spending, and the company boosted forecasts for 2018. Microsoft rallied after margin expansion in its server software and personal computers businesses drove earnings beyond consensus and guidance. Facebook surged on a view that privacy issues surrounding user data and other regulatory issues wouldn't impede user and advertising growth, which showed strong gains over the period.

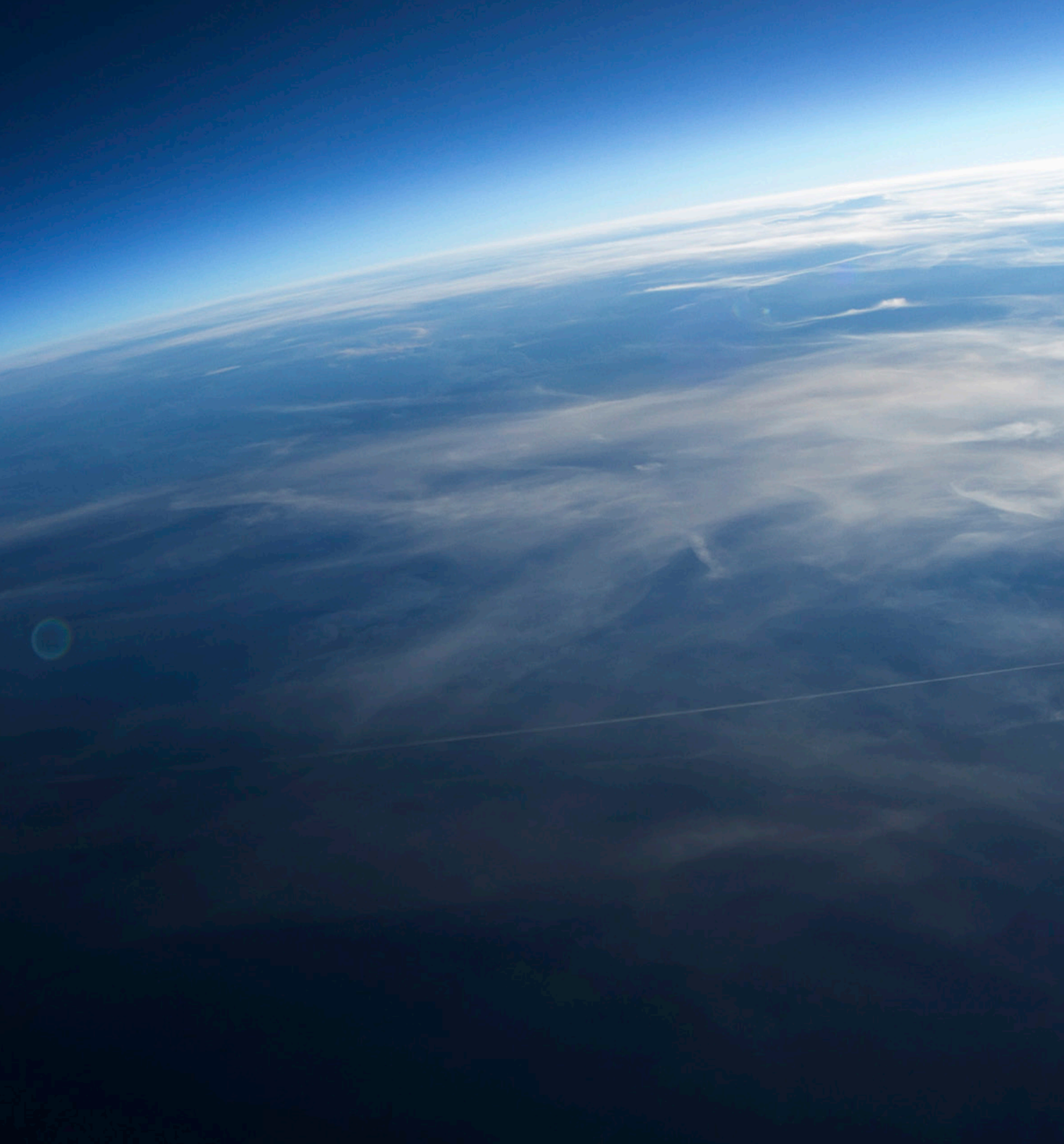
Stocks that detracted from the portfolio's return included the investments in Kraft Heinz (-0.7%), Starbucks (-0.5%) and Sanofi (-0.4%). Kraft Heinz fell as investors discounted the company undertaking a major acquisition, focused on the fact that the company was nearing the end of the cost savings stemming from the merger of Kraft and Heinz in 2015, and revenue growth slowed. Starbucks slid when the coffee chain reduced full-year earnings guidance due to lower same-store sales growth in the US and China and store closures in the US. This news was partially offset by the announcement of a cost-cutting drive and an increase in the company's share-buyback program from US\$15 billion to US\$25 billion. Sanofi fell amid disputes regarding patent protection of its diabetes products and after earnings missed estimates due to pressure on drug prices in the US. We sold the holding in Sanofi during the past 12 months.



Hamish Douglass

Chief Executive Officer and Chief Investment Officer

16 July 2018



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