

Dear Investor,

I am delighted to write to you as an investor in the Magellan Global Fund (the 'Fund') for the six months ended 31 December 2012.

Over the six months, the Fund returned 8.3% net of fees. Over the past 1, 3 and 5 years the Fund returned 18.3%, 10.0% and 6.7% per annum net of fees, respectively. This compares with our return objective of 9% per annum net of fees. The Fund has exceeded the benchmark by 11.1% per annum over the past five years.

As we have stated many times, we do not manage the Fund against short-term performance metrics and it is inevitable the Fund will underperform markets at some point in the future. We aim (not guarantee) to produce absolute returns of a minimum of 9% per annum, after fees, through the business cycle whilst minimising the risk of a permanent capital loss. We will continue to focus on these objectives and will not chase short-term performance.

We have seen more stable investment markets over the past six months. In our view the major contributing factor to the more stable market environment was the commitment by the ECB President, Mario Draghi, to preserve the euro. On 26 July he stated in a speech in London: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." This commitment was followed up on 6 September with announcement by the ECB of the Outright Monetary Transactions Programme or the "OMT". Under the OMT the ECB will buy an unlimited amount of sovereign bonds (with a maturity of less than three years) of any EU country with a distressed sovereign debt market. A country must apply for help from the European Stability Mechanism and agree to any fiscal conditions applied. In our view these commitments by the ECB have further reduced the possibility of a major financial meltdown scenario in Europe.

Whilst we continue to consider the risk of a financial Armageddon event to be low, the probability is not zero. As we have commented in previous investor letters, we believe that a key lesson from the global financial crisis is that prudent portfolio construction is critical for reducing risk, and particularly important in the circumstances that a "tail event" strikes. The key to prudent portfolio construction is to ensure an investment portfolio does not have a high level of aggregation risk (i.e. the risk attached to similar economic, competitive or regulatory forces) and avoiding or minimising exposure to speculative excesses or bubbles. We feel comfortable with the overall risk profile and construction of the Fund's portfolio and believe it is likely to exhibit substantially less downside risk than the market in the event that the situation in Europe deteriorates materially or another unexpected event emerges.

I have been often asked why we believe our strategy will deliver good returns for investors over the medium term. In simple terms, I believe our strategy has two fundamental advantages. These advantages are:

- a focus on quality companies; and
- an investment horizon which is not focussed on the next quarter or next twelve months, but rather a focus on what the investment is likely to earn over the next three to five years.

A focus on quality companies

The core of our investment philosophy is to invest in a portfolio of quality businesses which have very attractive underlying business economics that are protected by long-term sustainable competitive advantages (or in Warren Buffett's words an "economic moat") and exhibit a high degree of certainty as to the approximate amount of free cash flow that the business will generate over time. Businesses that have these characteristics are far less likely to disappoint over time and are inherently easier to value than lower quality businesses. Focussing on quality companies should produce far fewer investment mistakes than investing in a portfolio

selected from all companies listed on global stock exchanges. It is investment mistakes that destroy long-term returns. In our view a focus on quality companies reduces risk and is likely to reduce the frequency of investment mistakes over time.

As Warren Buffett has said: "Time is the friend of the wonderful company, the enemy of the mediocre" and also "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

We are very happy to have as the core of our portfolio a selection of very high quality companies, purchased at fair prices, which we believe should produce low risk satisfactory investment returns over time. We then seek to add to this core portfolio a selection of other high quality companies, possibly facing some short-term headwinds, which are trading at a material discount to our assessment of intrinsic value.

A medium-term investment horizon

It is our belief that the short-term investment horizon of the vast majority of investment managers increases the degree of difficulty of producing superior longer-term risk adjusted returns. The "institutional imperative" of beating the market or 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.

We believe our investment time horizon of three to five years gives us a significant, and easy, advantage over many other investment managers. We simply do not care if an investment could underperform the market over the next twelve months. We base our decisions on the rate of return we believe the investment will deliver the next three to five years. Importantly, 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". If we have a high conviction as to "what will happen" we are prepared to invest then wait.

In early 2011, we made a significant investment in two US home improvement retailers, Lowe's and Home Depot, based on our analysis that the US housing market was very likely to improve over the next three to five years. At the time we made these investments, US housing construction starts were at a 60-year low, the US was going through the last fiscal cliff debate and many were fearful of a financial collapse in Europe. It would not have been unreasonable to conclude that the stock prices of Lowe's and Home Depot would underperform in the short term. We had no idea how their share prices would move in the short term. From our perspective these were perfect investment opportunities. We considered it was very likely that these investments would generate very satisfactory returns over a three to five year time period, irrespective of how their share prices would move in the short term. We are pleased that these stocks have performed very well over our holding period.

PORTFOLIO SUMMARY

Magellan Global Fund - as at 31 December 2012			
Google	6.6%	McDonald's	4.5%
Novartis	6.2%	Visa	4.4%
Tesco	6.1%	Wal-Mart	4.4%
Lowe's	5.6%		
Yum! Brands	5.3%	Other	45.1%
Danone	4.7%	Cash	2.7%
eBay	4.5%	TOTAL	100%

As at 31 December 2012, the Fund's portfolio consisted of 24 investments (in comparison with 24 investments at 30 June 2012). The top ten investments represented 52.2% of the portfolio at 31 December 2012 compared with 52.1% at 30 June 2012.

The cash weighting of 2.7% at 31 December 2012 is consistent with our view that it remains an attractive time to be investing in a carefully selected portfolio of stocks. The portfolio is well balanced, valuations are currently not stretched and we believe the portfolio should continue to deliver attractive returns for investors over time.

Over the twelve months to 31 December 2012, the three stocks with the strongest returns in local currency were eBay (+68.1%), Visa (+50.5%) and Lowe's (+42.9%), and the stocks with the weakest returns were Tesco (-12.3%), McDonald's (-9.3%) and General Mills (+3.3%). On an absolute basis the three largest stock contributors in local currency were eBay, Lowe's and Visa, which added +3.7%, +2.5% and +1.9%, respectively, and the biggest detractor was McDonald's (-0.4%).

The following table sets out some key statistics for the Fund's Portfolio as at 31 December 2012:

Average market capitalisation (US\$ billion)	90
Number of stocks	24
Average daily liquidity (US\$ million)	\$550 million
PE – 1 year forward*	14.6x
Beta*	0.79
Average return on equity*	29%
Concentration of top 10 Investments	52.2%

*Magellan estimates

There have been a few major changes to the Fund's portfolio during the past six months. The material changes have been a new investment in General Mills, the addition of global custody banks, Bank of New York Mellon and State Street (refer US interest rate discussion below), an increase in the weighting of investments in Yum! Brands and Tesco and a decrease in the weighting of eBay, Unilever, and Lowe's.

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

- **Emerging market consumption growth** via investments in multinational consumer franchises. The Fund has approximately 27% of the portfolio in multinational consumer franchises which have on average approximately 40% of their sales revenue generated from emerging markets. The five largest investments in multinational consumer franchises at 31 December 2012 were Danone, Yum! Brands, McDonalds, Nestle and Mondelez International (the multinational packaged foods company which spun off from Kraft in October 2012).
- **US interest rates.** It is our view that it is likely that US short and long-term interest rates will "normalise" over the next three to five years as the US economy recovers. This will be as a result of the US Federal Reserve lifting the Federal Deposit Rate and the Federal Reserve firstly ceasing its quantitative easing programme and then taking steps to shrink (or sterilise) its balance sheet which is likely to have a material impact on longer-term bond yields. We own four US financial institutions which are likely to benefit from the change in US interest rates, Wells Fargo, US Bank Corp, Bank of New York Mellon and State Street. These investments represented approximately 14% of the Fund's portfolio at 31 December 2012.
- **A move to a cashless society.** There continues to be a strong secular shift from spending via cash and cheque to cashless forms of payments such as credit cards, debit cards, electronic funds transfer and mobile payments. In our opinion, the explosion of smart mobile phones will accelerate this shift on a global basis. We believe that there are only a limited number of companies that are well positioned to benefit from this structural shift. The companies are typically highly attractive with strong network effects, low capital intensity, high barriers to entry and high returns on capital. As at 31 December 2012, the Fund had approximately 14% of the portfolio invested in the payments space through exposure to companies such as PayPal (via eBay), American Express, Visa and Mastercard.
- **US housing.** A recovery in new housing construction should drive a strong cyclical recovery in companies exposed to the US housing market and also provide a strong boost to the overall economy. Our major

exposure to the US housing market is via our exposure to the home improvement retailer, Lowe's, and the domestic US banks, Wells Fargo and US Bancorp. These investments represented approximately 13% of the Fund's portfolio at 31 December 2012.

- **Internet/e-commerce.** There are a number of internet enabled businesses that have very attractive investment characteristics with increasing competitive advantages. The Fund's internet investments at 31 December 2012 were eBay and Google, which represented approximately 11% of the Fund's portfolio.

I normally detail investment mistakes that I feel we have made over the period. Fortunately, there are no glaring mistakes that have had materially negative consequences over the past six months.

MARKET COMMENTARY

Europe

In June 2012 we stated: "We believe the tail risk probability of a European sovereign and financial system meltdown is low. In the event that financial markets get ahead of the German plans to integrate Europe, and the risk of a meltdown materially increases, we believe Germany will have no hesitation in evoking the safety mechanisms. These would most likely involve the ECB printing an unlimited amount of money to monetise sovereign debt."

As noted previously, since June the ECB has taken substantive action with Mario Draghi's "Whatever it takes" statement in July and the announcement of the OMT in September, which has further reduced the probability of a European sovereign and financial system meltdown. Since 30 June 2012, the yields on Spanish and Italian 10 year bonds have fallen from 6.29% and 5.81% to 4.87% and 4.13%, respectively (as at 11 January 2013).

There has also been some progress on the EU Banking Union, which was first announced in June. In December the EU Finance Ministers announced that the ECB will take responsibility for banks that have at least €30 billion in assets or make up more than 20% of their country's GDP or operate in at least two countries. In our view, an effective framework for regulation of EU banks is critical to break the negative feedback loop between individual countries and their banking systems. To be effective, the Banking Union will need to have consistent capital and liquidity rules, a wind up mechanism (likely to involve the mandatory "bail in" of creditors) and an EU deposit insurance scheme. This is a complex task and requires the foregoing of a certain degree of sovereignty.

In our view, many of the world's banks are still in denial about how determined global regulators are to dramatically strengthen capital and liquidity rules. Their aim is to make it prohibitively expensive for deposit-taking banks to undertake certain activities. This is designed to reduce the need for tax payers to become the guarantors of last resort to failing large deposit-taking financial institutions. There is a push by certain regulators to introduce a meaningful minimum leverage ratio (i.e. total tangible equity to total tangible assets). A number as high as 10% has been suggested by certain regulators. This would have dramatic consequences for many large banks.

Moving into 2013, we are closely watching the unfolding political processes in both Germany and Italy. In our view, Angela Merkel and Mario Monti have been absolutely critical in steering Europe through this complex and difficult period.

A destabilising election in Italy could push up Italian bond rates to a level where the ECB is forced to intervene. This would really test the resolve of the ECB, particularly as a new Italian government may be unwilling to sign up to an EU-sanctioned austerity programme. An unlimited bond buying programme involving a country the size of Italy would put significant pressure on the relationship between the ECB and the Bundesbank. We continue to believe Germany will support the ECB's acting in an unlimited way in the event of a true sovereign liquidity crisis.

The elections in Germany could also have a very important bearing on financial markets next year and possibly on the ongoing stability of Europe. It would appear at the present time that Merkel appears to be in a strong

political position. The reality is that it is unlikely that substantive further progress will be made, such as a write down of the official sector's holding of Greek government bonds or more substantive moves towards a Banking Union, until after the German elections.

We continue to believe that many European countries face a prolonged period (possibly five to seven years) of sub-par economic growth (and in many instances recessions) due to the combined effects of fiscal austerity by Governments, deleveraging of bank balance sheets and household deleveraging.

United States

Nothing has fundamentally changed in our views on the US economy over the past six months. The meaningful events that have happened over the period include:

- the announcement by the Federal Reserve in September of QE3, which involves the purchase by the Federal Reserve of US\$40 billion per month of mortgage-backed securities. The purpose of QE3 is to reduce the longer-term mortgage rate to enable households to refinance mortgages at lower rates;
- the announcement by the Federal Reserve in December of the intention to buy \$US45 billion per month of longer-dated treasuries and an intention to keep the Federal Funds rate at an exceptionally low level until the US unemployment rate is below 6.5%, provided forward inflation expectations are no more than 2.5%. This is the first time in recent times that the Federal Reserve has explicitly tied short-term interest rates to a specific level of unemployment;
- the re-election of Barack Obama as President, and;
- the last-minute agreement to avert the fiscal cliff by increasing tax rates for wealthier Americans and extending the Bush-era tax rates for the middle class. The agreement also involved the expiry of the temporary payroll tax cuts and pushed out the date for automatic expenditure cuts. Unfortunately, this agreement has not ended the political uncertainty. By 1 March 2013, automatic spending cuts are due to take effect, which could place the US economy in recession in the absence of an agreement not to implement the automatic cuts which will require an agreement on longer-term revenue measures and expenditure cuts. In addition, by 31 March the US Congress will again need to lift the US federal government debt ceiling (ie the maximum amount the US government can borrow). Whilst we believe these issues will continue to result in political uncertainty and likely market volatility, we remain relaxed that the US has substantial flexibility to address these issues over the medium term.

I have stated on a number of occasions that the extraordinary policy responses in recent years, particularly by the Federal Reserve and ECB, have fuelled a number of current bubbles and distortions in certain asset markets, most notably foreign exchange and bond markets. It is inevitable that these distortions will unwind at some point, and there is a reasonable chance that bond prices and foreign exchange markets could adjust very rapidly. The longer these policy responses are held in place, the more complacent investors are likely to become, believing that this environment is the "new normal." These policy settings will not last indefinitely, and we consider the portfolio is well positioned for the eventual correction.

It is our view that there is a very high likelihood that US interest rates (both short-term and long-term) will be materially higher in three to four years. This will be as a result of the Federal Reserve having to lift the Federal Reserve Rate (or the short-term deposit rate) to more neutral levels as the economy recovers and the need to take action to prevent inflation implications resulting from the extraordinary amount of quantitative easing undertaken by the Federal Reserve. It is our view that the market will push up longer-term interest rates materially as the Federal Reserve seeks to unwind its current policy measures. As noted previously, we have approximately 14% of the portfolio invested in four US-based banks, Wells Fargo, US Bancorp, Bank of New York Mellon and State Street, that we believe will benefit from higher US interest rates.

There continue to be signs that the US is undergoing a modest economic recovery. We believe that there is unlikely to be a meaningful reduction in the unemployment rate in the short term until housing construction reverts to more normalised levels, which we consider will take another two to three years. When this happens, we believe the US economy will recover significantly.

China

We continue to believe that China is engineering a relatively soft landing with slowing economic growth, albeit at healthy levels. The major event in the past six months has been the appointment of the new leadership team in China headed by Xi Jinping (President) and Li Keqiang (Premier). It would appear that the new leadership team will continue to focus on economic reform and a gradual opening up of the economy.

China also appears to be moving away from the credit-fuelled development model and a more balanced approach of economic growth based on increasing domestic demand. Importantly, Mr Li recently emphasised at the annual Central Economic Work Conference the need to continue to promote urbanisation as the most important driver of domestic demand. We understand, China is looking at a land reform plan that will increase payments to farmers for land seized for urban development.

We believe it is unlikely that the government will again embark on a massive stimulus programme to increase the level of fixed asset investment to drive up the rate of economic growth. China appears content with the lower but healthy rate of economic growth.

KEY STOCK IN FOCUS

McDonald's Corporation

McDonald's is the world's biggest fast food chain, with more than 34,500 restaurants. Over 80% of these restaurants are operated by others, often entrepreneurs, under franchise or licence agreements with the company operating the balance. The business is managed in distinct geographic regions. The US and European segments account for about 43% and 37% of operating profits, respectively, while the Asia Pacific, Middle East, and Africa markets produce another 19%. Latin America and Canada (less corporate costs) account for the balance. Its most important profit markets are the US, France, the UK, Germany, Russia, Australia and Japan.

Since 2003, McDonald's has experienced a renaissance as it has re-energised its operations, focussing on maximising the sales from its existing stores and thus improving returns on its capital, rather than emphasising the rollout of new stores. The results of its efforts have been superb. As an example, sales per US store have risen from US\$1.6 million to US\$2.5 million and returns on invested capital across the group have almost doubled from 12.7% to 23.5% between 2003 and 2011. Some of the most significant factors behind this were the expansion of breakfast and McCafe, the extension of the menu to offer a much broader array of items and proteins, longer trading hours to 24 hours, addition of drive-thrus where possible and the upgrading and modernising of stores.

McDonald's has a wide economic moat. It has a significant scale advantage over any other player, owns much of its real estate, which is positioned in prime locations, and has phenomenal worldwide brand recognition.

In 2012, the company, its franchisees, and affiliates should generate roughly US\$88 billion of systemwide sales globally, from ~US\$50 billion in 2004. This compares to about US\$43 billion in YUM! Brand's systems sales (across three brands), US\$15 billion by Burger King (and Hungry Jack's) and an estimated US\$18 billion by Subway. Its size gives it buying power when negotiating with suppliers of food and paper inputs and also provides incredible advertising muscle. McDonald's significantly outspends all other competing brands, from KFC, Subway, Burger King and the numerous small players in the US. The economics of its scale also means McDonald's can sell its food products at prices which represent compelling value when consumers search for reliable, convenient eating options.

Over many decades, McDonald's has sought to own the best sites in any city or town and securing these highly valuable prime sites for the long term. Thus, McDonald's also makes a significant portion of its income from rental incomes from these sites which are often operated by its franchisees. It also ensures McDonald's has a high degree of control over its brand and the way franchisees operate under its umbrella. While we acknowledge the ownership of property has a dampening effect on the return on invested capital, the property ownership is a core long-term strategic benefit, and we are confident McDonald's has no intention of divesting its property for short-term gain. It also means McDonald's receives annuity-like cash flow streams of rent,

service fees and royalties which will continue long after many assets are fully depreciated.

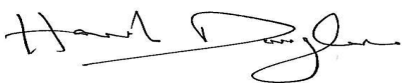
The McDonald's brand speaks for itself. It consistently rates as a top ten global brand in major brand value surveys such as Interbrand. Importantly, we believe the shift in strategic focus since 2003 has served to strengthen the brand and rebuild consumer perceptions. Some of the important facets to the brand include its substantially uniform menu across the world, the value proposition relative to other options, its speed of service, the high level of consistency of taste and service offering and its ubiquitous presence. The dramatic lift in choice (depth of menu range) is further enhancing the brand while being a key driver of its market share gains and above average growth in sales.

Internationally, McDonald's adapts its menu to reflect the tastes and preferences of the local population. Some of McDonald's menu items developed exclusively for the local population include Bubur Ayam McD (Malaysia), McAloo Tikki (India), McArabia (Egypt), McMollete (Mexico), McPollo (Chile), McKroket (The Netherlands), McTurco (Turkey), McLaks (Norway), Shaka Shaka Chicken (Singapore), Koroke Burger (Japan), and so on.

Due to its perceived image as a restaurant chain serving mass produced and unhealthy food, it is often criticised for promoting obesity. Thus it is trying to change its image by using more natural/healthy ingredients, displaying the calorie content, expanding choice and portion sizes, advertising that emphasises the freshness of raw materials and remodeling restaurants to make them look upscale in order to attract more health-conscious consumers. Its immense success and acceptance in France is testament to what can be achieved under the McDonald's brand.

After growing at very healthy rates right through the global financial crisis, mainly through an ability to deliver strong growth in sales per store, coupled with some modest growth in store numbers, 2012 has seen the business slow. There have been various causes, including reinvigorated competitors in the important US market, less benefit from continual asset upgrades in Europe (which are largely now completed), alongside a consumer weakened by austerity, low food inflation, Japan and Australia's economic weakness and a material foreign exchange translation headwind as it reports foreign earnings in US dollars. Its long-term financial targets are for average annual system-wide sales and revenue growth of 3% to 5%, respectively; average annual operating income growth of 6% to 7%, and; annual returns on incremental invested capital in the high teens. These targets exclude the impact of foreign currency translation. It is delivering outcomes in excess of these targets, and we believe the recent period of weaker results has opened up the gap between the current stock price and long-term value.

Yours sincerely,



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