Magellan High Conviction Fund

Fund Update: 31 December 2013

Key Facts

Portfolio Manager
Hamish Douglass

Structure
Global Equity Fund, $AUD

Inception date
1 July 2013

Management and Administration Fee[1]
1.50%

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

Size
AUD $106.4 million

Performance Fee[1]
10.0% of the excess return of the units of the Fund above the Absolute Return performance hurdle (10% per annum). Additionally, the Performance Fees are subject to a high water mark.

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

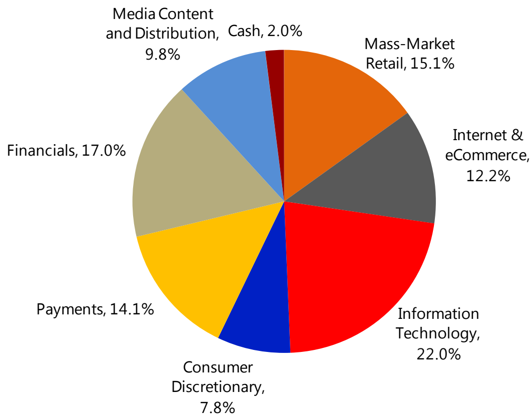
Key Features

- Unconstrained, highly concentrated
- High quality global equity strategy
- High individual stock exposures - 8 to 12 stocks
- Ability to actively hedge currency exposures
- Maximum cash position of 50%
- $100,000 minimum initial investment

AUD Performance[2]

	Composite %	Index %[3]	Excess Return %
1 Month	5.2	4.3	0.9
3 Months	15.1	12.9	2.2
6 months	17.7	19.5	-1.8
Since Inception	17.7	19.5	-1.8

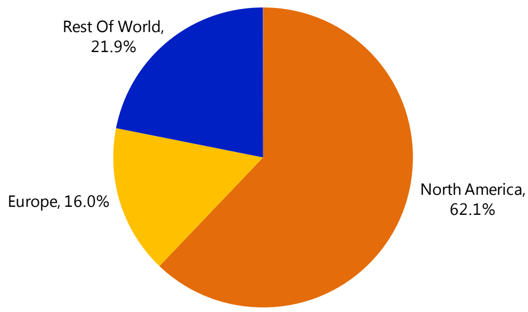
Industry Exposure by Source of Revenues[5]



Portfolio in Alphabetical Order

	Sector
Bank New York Mellon	Financials
DirecTV	Consumer Discretionary
eBay Inc	Information Technology
Lowe's	Consumer Discretionary
Microsoft Corp	Information Technology
Oracle	Information Technology
Target Corp	Consumer Discretionary
Tesco Plc	Consumer Staples
Visa Inc	Information Technology
Wells Fargo	Financials

Geographical Exposure by Source of Revenues[5]



Regional Breakdown

	%
Multinational[4]	26.3
North America	63.9
United Kingdom	7.8
Australia	0.0
Europe	0.0
Japan	0.0
Asia Ex-Japan	0.0
Cash	2.0
TOTAL	**100**

[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 2013.

[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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Market Commentary

While there are signs that Europe's economic situation is stabilising, we remain highly skeptical that the region is on the verge of a sustained and meaningful recovery. The positive indicators include:

- The Eurozone running a substantial current account surplus, approximately 2% of GDP.
- Industrial production growing marginally on an annual basis, having recently ended two years of contraction.
- Manufacturing and service PMIs indicating modest expansion since August, with large cross-country variations.
- Relative unit labour costs having fallen materially in Portugal, Ireland, Greece and Spain during the past five years.
- Bank lending surveys indicating looser credit conditions for firms and consumer credit were expected in Q4 2013.

The indicators against a near-term cyclical recovery include:

- The Eurozone banking system remains under-capitalised. There is a long way to go to establish a comprehensive European Banking Union.
- Portugal, Ireland, Italy, Spain, Greece and France remain fiscally stretched.
- Unemployment remains above 10% in Ireland, Italy and France, above 15% in Portugal and above 25% in Greece and Spain.
- Weak price growth and falling inflation expectations have increased the risk of deflation.

We continue to believe that many European countries face a prolonged period of sub-par economic growth due to the combined effects of fiscal austerity by governments and deleveraging of bank balance sheets and households.

There are encouraging signs that the US is undergoing a modest to accelerating economic recovery. Key indicators of this recovery include:

- Non-farm payrolls that have increased by 193,000 per month, on average, over the three months to 30 November (which is equivalent to new job creation of 2.3 million per annum).
- The unemployment rate falling to 7.0% in November from 7.6% in June.
- Continuing falls in the total number of unemployed people.
- Mortgage debt rising 0.2% in the third quarter of 2013, the first increase since the first quarter of 2008.
- Average weekly earnings increasing 2.3% in the year to November.
- November, annualised automotive sales of >15 million in 2013, the highest since 2007.
- A continuing recovery in house prices.
- A turn in housing starts from a post-GFC low of 478,000 starts in April 2009 to 1,091,000 in November 2013.

A recent paper by the Philadelphia Fed argues that the increase in non-participation since the financial crisis was primarily due to three factors: an increase in retirements since 2010, a steady increase in disability and a sharp increase in other reasons for non-participation, including discouraged workers who gave up looking for work. These factors also offer a partial explanation for the fall in the employment to population ratio, which has improved only marginally from its 2010 low of 58.2% of 16+ year olds to 58.6% in November 2013, after peaking at 63.4% in 2006.

In our view, in the absence of a material negative shock, it is likely that the US economy will experience accelerating economic growth over the next 12 to 24 months.

Fund Commentary

As at 31 December 2013, the Fund consisted of 11 investments (compared to 11 investments at 30 June 2013). The top five investments represented 52.8% of the Fund at 31 December 2013.

The Fund remains fully invested despite the strong rise in equity markets over the past twelve months. We believe that its holdings remain attractively valued and should deliver attractive returns to investors over the next 3-5 years

Over the six months to 31 December 2013, the three stocks with the strongest returns in local currency were Oracle (+27.4%), Google (+26.3%) and Bank New York Mellon (+22.7%) and the stocks with the weakest returns were Tesco (+0.8%), eBay (+3.2%) and Yum! Brands (+3.6%). On an absolute basis, the three largest stock contributors, in local currency, were Oracle, Google and Bank New York Mellon which added +2.8%, +2.3% and +2.3%, respectively. There were no detractors from absolute performance over the period in local currency terms.

Key Stock in Focus - DirecTV

DirecTV is the largest pay TV distributor in the world, with a total of 37 million subscribers across the US and Latin America. The company operates almost purely as a TV distributor, with virtually no in-house content production.

DirecTV currently derives around 75% of its earnings from the US, where it is the second-largest pay TV provider, with 20% market share. The US market is very mature, with 87% of households subscribing to pay TV.

<u>TV viewing demand</u>

TV viewing is the most popular form of entertainment. In 2012, the average American watched over five hours of traditional (linear) TV per day. Despite the development of many competing forms of entertainment, such as video games, social networks, YouTube and Netflix (to name just a few), time spent watching linear TV has continued to increase.

Pay TV subscribers are very sticky. Although pay TV distributors have increased consumer prices above the rate of inflation every year for decades, even during the recent US consumer recession, this has never resulted in annual net subscriber losses for the industry.

<u>Pay TV competition & DirecTV's Competitive Advantage</u>

DirecTV's competitive advantage is derived from the lower capital cost per subscriber associated with satellite TV distribution compared to competing wireline pay TV distributors (cable and telco). This advantage has allowed DirecTV to win market share by offering superior packages with more channels of a higher signal quality (e.g. high-definition versus standard-definition), without charging a premium price (pay TV distributors offer broadly the same content). At the same time, its lower-cost network capacity has enabled the business to generate an average 72% pre-tax return on tangible capital over the last five years, while the two largest cable providers, Comcast and Time Warner Cable, have earned only 15% and 13% average returns, respectively, over the same period.

Going forward, the increased adoption of high-definition (HD), and the development of ultra-HD, will drive the need for distribution systems to increase their capacity. Importantly, this means that DirecTV's competitive advantage will be maintained. The lowest spec version of ultra-HD (4k) requires roughly four times the capacity of HD (using the same compression technology).

<u>Key Threats</u>

There are a number of potential threats to DirecTV' s investment case, although we believe the current share price over emphasises these risks. The most significant threat to DirecTV's economic moat is the potential for a broad deployment of fibre-to-the-home networks, which would have significantly higher capacity than existing cable and satellite systems. However, we believe that the capital costs associated with building out such a network would be prohibitively high for a rational investor. We therefore judge the likelihood of a broad fibre upgrade in the US, at least in the medium term, to be low.

DirecTV's operating and financial performance has been very strong, generating EBITDA growth of 40% per annum over the last decade and repurchasing more than 60% of its share capital since it began its buyback program in 2006. We believe its market leading competitive positions will continue to drive strong returns and more than outweigh the near-term macroeconomic risks in Latin America.

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