Fund Update: 30 June 2016

Magellan High Conviction Fund

ARSN: 164 285 947

Fund Facts

Portfolio Manager	Hamish Douglass
Structure	Global Equity Fund
Inception Date	1 July 2013
Management & Administration Fee[1]	1.50% per annum
Buy/Sell Spread[1]	0.10%/0.10%
Fund Size	AUD $277.9 million
Distribution Frequency	Annually at 30 June
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.

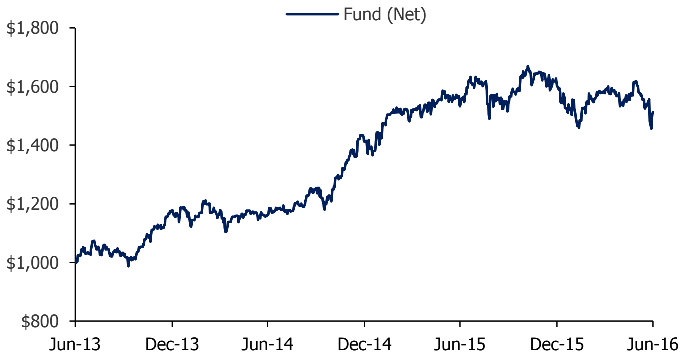
[1]All fees are inclusive of the net effect of GST

Fund Features

- Unconstrained, long-only, highly concentrated
- High quality global equity strategy
- High individual stock exposure – 8 to 12 stocks
- Ability to actively hedge currency exposures†
- Maximum cash position of 50%
- $10,000 minimum initial investment.

† Currently 40% hedged to AUD

Performance Chart growth of AUD $1,000**



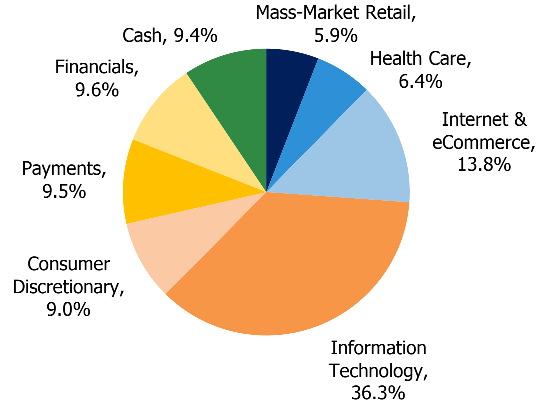
Fund Performance*

	Magellan High Conviction Fund (%)	Magellan Global Fund (%)
3 Months	-4.1	-0.2
6 Months	-5.6	-5.0
1 Year	-1.3	-0.1
3 Years (% p.a.)	14.8	13.1
Since Inception (% p.a.)	14.8	

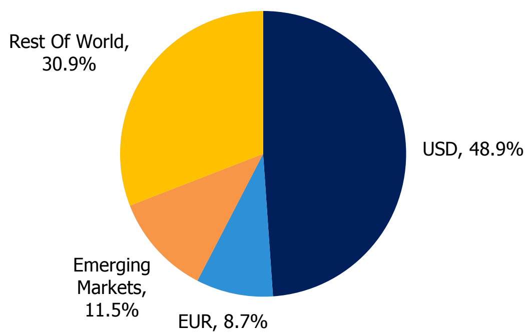
Top 5 Holdings

In alphabetical order	GICS Sector
Alphabet Inc Class C	Information Technology
Apple Inc	Information Technology
Lowe's Co Inc	Consumer Discretionary
Microsoft Corp	Information Technology
Visa Inc	Information Technology

Industry Exposure by Source of Revenues#



Geographical Exposure by Source of Revenues#



** The Fund is currently exercising its ability to hedge some of the capital component of the foreign currency exposure of the Fund arising from investments in overseas markets back to Australian dollars.
* 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. Returns denoted in AUD.
# Calculated on a look through basis based on underlying estimated revenue exposure of individual companies held within the portfolio - Magellan defined sectors.

Market Commentary

The June quarter commenced with a continuation of improving investor sentiment that began in the latter stages of March. Risk concerns abated as key commodity prices stabilised, in particular oil, together with a tempering of concerns over China's economic well-being. Major central banks retained their extraordinary monetary policy settings, in line with market expectations. Throughout June investors became preoccupied with the impending UK referendum to exit the European Union. The surprise Brexit vote result had a material impact on equity markets, effectively erasing most of the quarter's gains as capital flows moved back to a "risk-off" mode.

UK and European equity markets oscillated dramatically during June amid growing contemplation over the many implications of a Brexit event. The ensuing political uncertainty and potential impact on business and consumer confidence led to major selloffs across the key markets. The market volatility overshadowed more positive underlying signals on the region's prospects, with inflation turning positive and gross domestic product (GDP) data for the euro area indicating a positive trend. Following the Brexit vote, both the European Central Bank and Bank of England stood ready to provide additional policy support to ensure financial stability.

The US economy continued to lead the developed world on a trend of stability through most of the quarter, backed by a fairly muted quarterly corporate earnings season and the market reducing its assessed probability of a June interest rate hike by the US Federal Reserve. Weaker than expected labour market data (only an estimated 38,000 jobs created in May compared to an average of 210,000 per month over the past year) and a fairly moderate expansion in US GDP supported the case for pushing interest rate hike expectations out beyond the mid-year period. Inflation indicators remained benign while the Brexit vote acted to firm expectations of the 'lower for longer' mantra remaining in play.

Mixed signals for equity market investors through the period has seen the share prices of many high quality companies experience sharp corrections, reflecting the often indiscriminate selling seen at times in markets when there's a perception of elevated risks. In times of heightened market volatility, investors need to calmly separate the volatility in share prices from the fundamentals of a company, which may be largely unchanged. Over time, the fundamentals determine the ability of a company to generate shareholder returns. In our view, the recent volatility in markets overstate the risks for the companies we are invested in.

Fund Commentary

As of 30 June 2016, the Fund consisted of investments in 12 companies, the same number of companies held as at 31 March 2016. The top five investments represented 48.3% of the Fund on 30 June 2016, while they represented 46.8% of the Fund on 31 March 2016. The cash position has decreased to 9.4% as at 30 June 2016 from 11.0% at the end of March.

The Fund's performance fell short of the benchmark this quarter, with a number of portfolio stocks succumbing to broader market weakness. The largest contributors to returns over the quarter within the major holdings were Lowe's, and Intel Corp. Lowe's delivered strong gains following the release of its Q1 earnings result. The company reported a strong 7.5% rise in same store sales over the prior corresponding period, ahead of consensus expectations. Home improvement retailers have enjoyed rising sales on the back of buoyant conditions in the US housing market and reflecting this dynamic, the company upgraded its guidance for full year earnings to US$4.11 from US$4.00 per share.

Two of the major detractors from performance were positions in Apple and Microsoft. Microsoft weakened in April after reporting a decline in quarterly earnings. The company reported growth in revenues across its key business lines for the March quarter, although these were at levels which were generally below market expectations. Weaker earnings within the company's Productivity and Business Processes segment impacted the result, while weaker results in emerging markets and slower than anticipated technology replacement activity among its major customers limited revenue growth. Microsoft's stock price partially recovered from the earlier decline, after announcing the sale of its entry-level phone business and more significantly, announcing the acquisition of LinkedIn for US$26.2 billion.

Apple fell following the release of quarterly results. Revenue, earnings and guidance for the next quarter came in below market expectations. Apple's recent year-on-year sales trends have been weak relative to the prior period when the company experienced the highly successful iPhone 6/6+ launch. Later in the quarter, rumours continued to surface around weakness in the iPhone supply chain (the market was trying to project the impact on Apple's future sales from orders and commentary from its suppliers) which continued to weigh on sentiment. The iPhone installed base continues to grow, while its popularity and engagement remains high. At the current share price, Apple is inexpensive even without further installed base growth.

Lloyds Banking Group was a significant detractor from performance this quarter, largely due to the Brexit outcome which had a pronounced impact on many UK-focused companies. The exact economic impact of the Brexit vote will remain unclear for some time and downward pressure is likely to remain on interest rates with heightened risks for the British pound. Lloyds is well placed to meet these challenges, reflecting its significant restructuring post the financial crisis into a retail focused bank with a simple, relatively low risk, business model. Following the recent sell-off, Lloyds' is trading at a material discount to our assessment of its long-term intrinsic value, notwithstanding its near-term challenges and the lower earnings outlook resulting from the likely slowdown in UK economic activity.

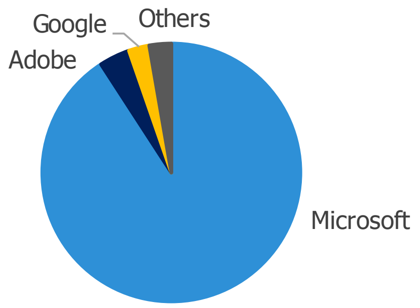
Key Stock in Focus - Microsoft

Microsoft is the largest software vendor globally by revenue, with more than US$90 billion in sales in FY15. The majority of its earnings are attributable to software sold to businesses, including (in order of magnitude) its Office productivity suite, data centre products and Windows. In aggregate, we estimate that approximately 80% of Microsoft's earnings are sourced from business customers. Microsoft is strategically advantaged in business software, and has considerable growth opportunities.

Productivity

Microsoft Office has more than 90% market share of productivity software globally, having withstood competition from vendors of alternative products (often given away for free) for decades. Office is delivered as an integrated suite, with little competition from vendors of point solutions. Users are required to purchase Office to maintain high-fidelity access to their legacy Office files, and to seamlessly collaborate and share Office files with colleagues and external parties. Third-party developers have created add-ons integrated with Office, and have few incentives to develop products compatible with other solutions with smaller user bases. Further, Office users are typically reluctant to learn to use different productivity applications.

Office suites market share, 2015



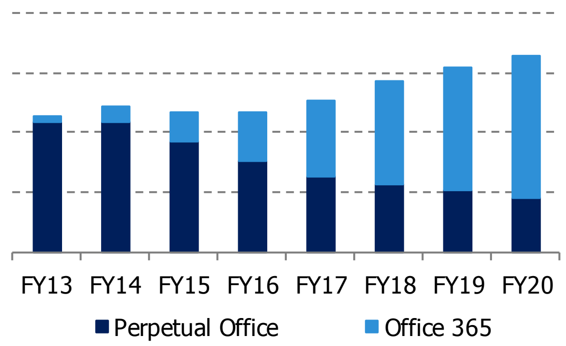
Source: Gartner.

Microsoft is extending its lead in productivity software to the cloud, offering Office 365 subscriptions on all platforms (Windows, iOS and Android). Cloud delivery enables new functionality to be offered, such as cloud file storage accessible from any device, and tools facilitating improved collaboration. Office 365 customers have access to Microsoft's most up-to-date functionality, with no requirement to buy and install new Office releases. From the customer's perspective, Office 365 offers improved functionality, while lowering implementation, management and security costs.

Office 365 has also become a powerful productivity platform, enabling simple deployment of new and premium functionality, as well as ease of collaboration and data-sharing across users. For example, as at October 2015, one-third of Microsoft's 60 million active Office 365 customers were using its premium Information Protection features, following the limited success of the licensed version of this functionality. New features from acquired companies can be quickly sold and deployed to Microsoft's rapidly expanding user base. Office 365 better utilises organisational data as part of Microsoft's Office Graph, which connects users and relevant documents, conversations and people. Office Graph is being used by Microsoft and third-party application developers to build new productivity functionality. For example, its Delve feature analyses Office Graph with advanced machine learning to proactively surface documents and suggested connections based on a user's current work and calendar. Office's competitive position is likely to be further enhanced by the recent acquisition of LinkedIn and the proprietary business user data managed by it.

Microsoft's installed base of Office customers continues to grow. The company has stated that Office 365 customers have a higher lifetime value than customers that have traditionally purchased perpetual licences for its products on-premise. As shown to the right, while the shift to subscription pricing has negatively impacted Microsoft's recent financials, we expect it to benefit materially from the shift to Office 365 in the medium term. With more than 1.2 billion existing Office users globally, Microsoft's opportunity in productivity software is significant.

Microsoft office revenue

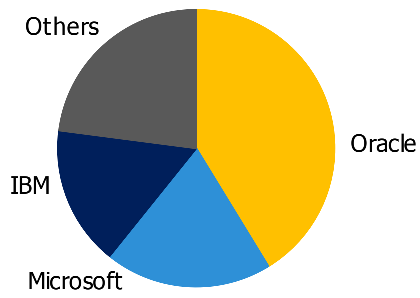


Source: Company reports, Magellan Asset Management Limited estimates.

Data centre and cloud

We estimate that the majority of Microsoft's server software revenue is attributable to its Windows Server operating system and its SQL Server database. Windows Server is the leading server operating system by revenue globally, according to IT market research firm, Gartner. As shown to the right, SQL Server is the second largest database software product, behind the Oracle database, globally.

Database market share, 2015



Source: Gartner.

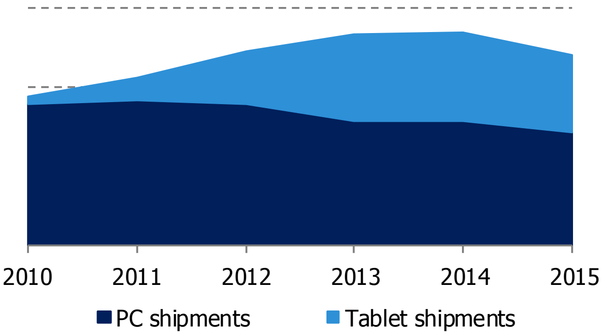
The server operating system and database software markets are relatively concentrated, with structural barriers to entry and switching costs. An established ecosystem of third-party applications has formed around Windows Server and SQL Server, generating a network effect that entrenches incumbent vendors. That is, application developers have few incentives to integrate their software with non-incumbent products, while users are attracted to server software platforms with the broadest range of compatible software applications. In addition, Microsoft's server software products tend to form part of the plumbing of enterprise software systems and perform mission-critical functions, rendering them difficult to replace, with material inherent transition risk.

Microsoft's incumbent on-premise server software business is complemented by its hyper-scale public cloud, Azure. The shift to public cloud computing is among the most significant transitions to have affected the enterprise technology market in the past two decades. Gartner predicts that the market for cloud infrastructure and platform services will grow from $22 billion in 2015 to $80 billion by 2020. Azure is second only to Amazon's AWS, and grew 120% in constant-currency in Microsoft's most recent quarter. Azure has been designed to offer Microsoft's existing customers a more manageable pathway to the cloud than competitors' solutions, and is highly integrated with Microsoft's on-premise server products, providing a hybrid solution that its major competitors are unable to offer.

Windows

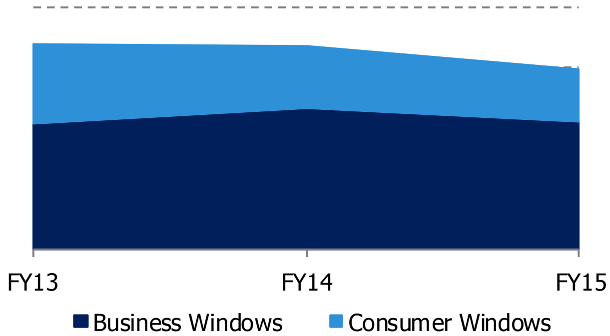
While Windows dominates the PC market, Microsoft was famously unable to capitalise on its position when addressing the rapidly growing smartphone and tablet markets, ceding them to Google's Android and Apple's iOS. There are now more than twice as many smartphones and tablets in use than PCs, according to Gartner. As mobile devices have cannibalised PC sales and users have replaced PCs less frequently, PC shipments and sales of Windows have contracted. As shown below, we estimate that consumer Windows revenue has been most heavily impacted by these effects, while business Windows revenue has been more stable. Businesses have continued to rely on Windows and the millions of Windows applications developed over the past 30 years.

Global PC & tablet shipments



Source: Gartner.

Windows revenue by customer



Source: Company reports, Magellan Asset Management Limited estimates.

However, Microsoft is making progress restructuring consumer Windows to address structural challenges. Its latest Windows release, Windows 10, has been adopted at a faster pace than any of its previous operating system releases, with more than 270 million active devices running Windows 10 as at April 2016. Microsoft is executing its stated strategy of increasingly monetising its Windows platform indirectly via peripheral services such as the Windows App Store, sales of content, PC and Xbox games, and its Bing search engine. Bing broke even on a stand-alone basis in FY16, having incurred billions of dollars of losses over the prior decade. However, those investments produced Microsoft's hyperscale cloud infrastructure and improved its capabilities in machine learning. Microsoft is now in a strong position in the global race for increasingly useful artificial intelligence, and is likely second only to Google. These capabilities should yield considerable value for businesses, consumers and Microsoft.

Summary

We expect Microsoft's highly valuable and growing business software platforms, particularly Office and Azure, to drive long-term revenue and earnings growth, and significant shareholder returns. At prevailing share price levels, we consider Microsoft an attractive investment.