Fund Update: 30 June 2018

Magellan High Conviction Fund

ARSN: 164 285 947

Fund Facts

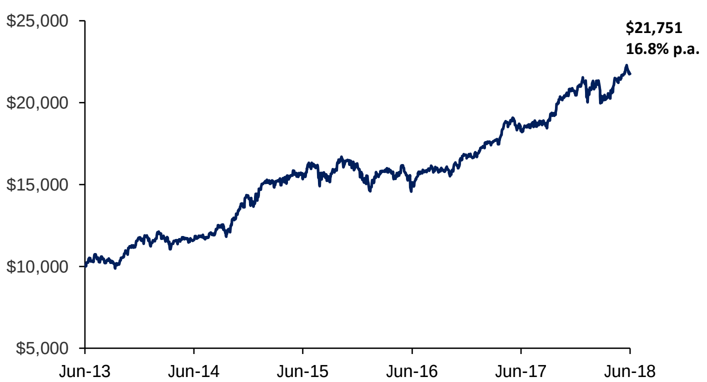
Portfolio Manager	Hamish Douglass
Structure	Global Equity Fund
Inception Date	Magellan High Conviction Fund: 1 July 2013 Magellan High Conviction Fund Class B: 15 November 2017
Management & Administration Fee[1]	Magellan High Conviction Fund: 1.50% per annum Magellan High Conviction Fund Class B: 0.78% per annum
Buy/Sell Spread[1]	0.10%/0.10%
Fund Size[2]	AUD $543.9 million
Distribution Frequency	Annually at 30 June
Performance Fee[1]	Magellan High Conviction Fund: 10.0% of the excess return of the units of the Fund above the Absolute Return performance hurdle (10% per annum). Magellan High Conviction Fund Class B: 20% of the excess return of Class B Units above the Absolute Return performance hurdle (10% per annum). The performance fee for Class B Units is subject to a cap of 2.22% per annum. Performance fees are subject to a high water mark.

[1]All fees are inclusive of the net effect of GST
[2]Includes High Conviction Fund and High Conviction Fund Class B units.

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, currently 42% hedged to AUD[†]
- Maximum cash position of 50%
- Magellan High Conviction Fund $10,000 minimum initial investment; Magellan High Conviction Fund Class B $100,000 minimum initial investment

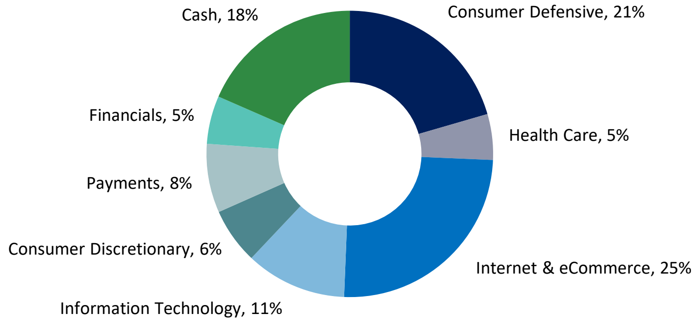
Performance Chart growth of AUD $10,000*



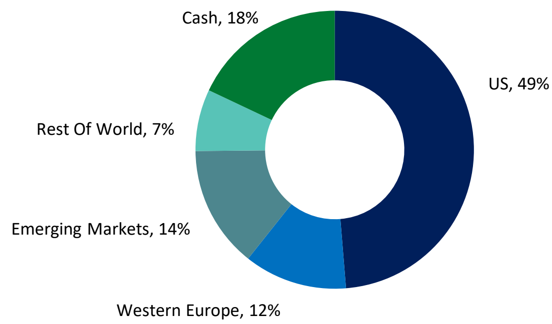
Top 5 Holdings

In alphabetical order	Sector#
Alphabet Inc	Internet & eCommerce
Facebook Inc-A	Internet & eCommerce
Kraft Heinz Co	Consumer Defensive
Lowe's Co Inc	Consumer Discretionary
Visa Inc	Payments

Sector Exposure by Source of Revenue#



Geographical Exposure by Source of Revenue#



Fund Performance*

	Magellan High Conviction Fund (%)	Magellan High Conviction Fund Class B^ (%)	Magellan Global Fund (%)
1 Month	1.3	1.4	2.8
3 Months	6.7	7.1	7.4
6 Months	6.3	6.0	8.1
1 Year	19.0		16.9
3 Years (% p.a.)	12.4		10.4
5 Years (% p.a.)	16.8		14.3
Since Inception (% p.a.)	16.8	7.1	

^ The Nov '17 Class B return calculation has been corrected by +0.10%, the impact of this change is reflected in the since inception return.
† 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. Magellan High Conviction Class B inception 15 November 2017. Returns denoted in AUD.
# Sectors are internally defined. Geographical exposure is calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio.

Market Commentary

Global stocks rose over the June quarter, to mark their eighth gain in the past nine quarters, after companies posted higher-than-expected earnings, especially the US internet giants, the US economy headed towards its 10th year of expansion, the Federal Reserve only tightened monetary policy as expected, Italy formed a workable coalition that said it wanted to stay with the euro, and Japan's central bank promised to keep up monetary stimulus. Gains were capped when US President Donald Trump imposed import restrictions that could lead to trade wars with the EU and China.

US stocks rose on buoyant company and economic news. Financial research and data company FactSet said that about 80% of companies announced earnings per share above mean estimates, the highest rate since FactSet began tracking this measure in 2008. In economic news, the Fed, as expected, in June raised the cash rate by 25 basis points to between 1.75% and 2%, the seventh rate increase since the onset of the global financial crisis. The central bank once again signalled four rate increases would be made over 2018, implying another two before the end of the year. A report showed a Fed gauge of inflation, the core personal consumption expenditure price index, rose 2% in the 12 months to May, the first time it has hit the Fed's price target since 2011. Reports pointed to the US economy expanding briskly in the June quarter, by when the economy would have completed nine years without recession. Among highlights, the jobless rate fell to an 18-year low of 3.8% in May, while retail sales grew 0.8% over the same month, their biggest gain in six months.

European stocks gained after a left-right populist coalition took control of Italy in May after elections in March (even if it is Eurosceptic), moderate Socialist Pedro Sanchez was installed as prime minister in Spain after Mariano Rajoy lost a vote of no confidence over a corruption scandal, and inflation reached the European Central Bank target of 2%, which justified the central bank's decision to end its asset-buying program by year end. Stocks fell steadily from mid-April highs as concerns about a trade war with the US mounted and Angela Merkel's coalition in Germany threatened to break apart over immigration policy.

Japanese stocks rose after the Bank of Japan said it would persist with monetary stimulus, reports on employment and manufacturing showed the economy might rebound from a contraction in the first quarter and the country was judged insulated from any trade wars. Chinese stocks plunged on concerns about the growing clash with the US on trade and on signs the economy is slowing. Emerging markets struggled as tighter US monetary policy boosted the US dollar and Argentina negotiated an IMF rescue.

Fund Commentary

The portfolio recorded a positive return for the quarter. Stocks that performed best included the investments in Facebook, Alphabet and Visa. Facebook surged on a view that privacy issues surrounding user data wouldn't impede user and advertising growth, which showed gains in the first-quarter earnings report released in late May. Alphabet gained after its 26% increase in revenue for the first quarter beat estimates as Google's advertising revenue expanded at close to a similar pace. Visa gained after higher consumer spending helped the payments company post higher-than-expected revenue growth of 11.5% and 30% earnings growth for the first quarter, which prompted it to boost guidance for fiscal 2018.

Stocks that lagged included the investments in Starbucks and Yum! Brands. Starbucks declined after disappointing sales growth in the US prompted the coffee chain to reduce outlets in its home market, sales growth in China disappointed and Moody's Investors Services downgraded the company's debt rating by one notch to Baa1 due to an increase in borrowing. Yum! Brands slid after the owner of KFC and Pizza Hut reported first-quarter comparable sales that missed estimates due to discounting across the fast-food industry.

Key Stock in Focus – Lowes

Lowes - A new shareholder is driving a challenge to The Home Depot's No. 1 ranking in the US home-improvement market.

In 1946, Carl Buchan was the part owner of a hardware store in North Carolina. Anticipating a post-World War II housing boom, Buchan envisaged creating a hardware chain, so he bought out his brother-in-law. More than 70 years later, his efforts have culminated in Lowe's, the US's second-largest chain of home-improvement and hardware stores.

Buchan and his successors have done much right in the past seven decades to create a retailer with 2,154 stores across North America that in fiscal 2017 recorded a net profit of US$3.7 billion from US$68.6 billion in sales.

Recent times have been buoyant for Lowe's and other housing-related businesses. The nine-year expansion of the US economy and the interrelated recovery in housing have buoyed a retail segment that has proved relatively insulated from internet disruption.

Convenience is a big reason why the industry is internet-proof. A large number of stores in close proximity to much of the population service people when they need advice on technical products. The shopping mission often includes bulky goods or urgent purchases that are best done in person. Costly consumables and DIY projects require product selection and planning, both easier done in store. On top of that, demand has been strong for home-related professionals who prefer to buy in store rather than on the internet.

The favourable environment has helped Lowe's boost revenue by 20% over the past three years though this performance of late has been more sluggish, particularly in the first quarter of 2018. The company's share price climbed 37% over the past calendar three years.

Lowe's, however, has an overarching problem in terms of its operational performance. The company isn't judged as well run as the No. 1 home-improvement company. The Home Depot, based in Atlanta, which recorded a net profit of US$8.8 billion on sales of US$100.9 billion in fiscal 2017, is better at retail basics. Home Depot attracts more people to its stores. The company converts more of those who enter into customers. It entices those supporters to spend more as a proportion of their household budgets. It turns a greater portion of revenue into profits. Home Depot has boosted its same-store revenue for nine consecutive years and the share price has climbed more than Lowe's in recent years; it rose 83% over the past three calendar years – more than double the gain in Lowe's. Lowe's challenge has long been how to stop being overshadowed by Home Depot.

Enter DE Shaw, a New York-based hedge fund. In January this year, Shaw announced it had spent US$1 billion to buy about 1% of Lowe's and it would use this shareholding to shake up the company. Shaw quickly engineered the appointment of three new directors to the board of Lowe's. One of the new directors is David Batchelder, co-founder of Relational Investors, who when on the board of Home Depot, a decade ago helped turn around that company. In April, Shaw aided the search to replace departing Lowe's CEO Robert Niblock, who had spent 13 years in the role. And in May a new CEO, Marvin Ellison, who led retailer JC Penny from 2015 and who worked in senior roles at Home Depot for 12 years, was appointed. Investors can expect to be well rewarded if the new management can make Lowe's as honed as Home Depot. Management is confident that better execution of retail basics means Lowe's can.

To others, Home Depot has some advantages over Lowe's that will hobble Lowe's efforts to match its bigger rival. One hurdle is that Home Depot had a 15-year head start in placing large 'box' stores in the best locations in the best cities – and in the homeware and hardware segments, location amounts to a local monopoly. Other challenges for Lowe's include that housing-dependent businesses are hostage to macroeconomics. Any slowing in the economy and housing and all housing-related industries tend to struggle. The internet will always remain a potential threat.

But Lowe's under fresh guidance could surmount these challenges or be better placed to cope during any economic and housing downturn. Company insiders estimate that better online offerings, a more appropriate product offering, an enhanced customer experience, and superior servicing of builders and other professionals could reap an extra US$8 billion in revenue each year for Lowe's while costs could be reduced by some US$1 billion, especially by making its supply chain more efficient. Confidence that Lowe's can revamp itself is growing, even though the loss of customer traffic and other structural problems won't be easy to overcome. Evidence? 'Activist' investment firm, William Ackman's Pershing Square Capital Management, in May revealed it had bought US$1 billion worth of Lowe's shares.

Beyond the US

Lowe's became the US's – and the world's – second-largest home-related retailer by offering low prices and one-stop shopping. The company's margin is based on 'everyday low costs' in its supply chain, allowing it to offer profitable 'everyday low prices' to people who buy its products and services for home improvement, home décor, home maintenance, home repair, and remodelling and maintenance of commercial buildings.

Lowe's large-format stores host about 40,000 items over 214 million square feet (19.9 million square metres) of floor space that cater to the 'do it yourself' and 'do it for me' customers. The latter are professionals who cater for older and time-poor households whom Lowe's target via the LowesForPros.com website.

While it will always face competition from Home Depot, Lowe's is protected against other formidable competitors because it operates in a structured and stable duopoly market. Home Depot and Lowe's control about 24% of the market. The cheaper sources of supplies based on such buying power mean they can undercut smaller competitors. The pair's size alone gives them much bargaining power with suppliers.

Lowe's, which was listed in 1961, has a presence in Canada (since 2007) and Mexico (since 2010). For now, though, it's whether or not the company can meet basic goals such as getting more people into its US stores that will determine how fast goes the expansion that Buchan initiated seven decades ago.

Sources: Company filings and website.