Fund Update: 31 March 2015

Magellan High Conviction Fund

ARSN: 164 285 947

Key Facts

Portfolio Manager	Hamish Douglass
Structure	Global Equity Fund, $AUD
Inception Date	1 July 2013
Management & Administration Fee[1]	1.50%
Buy/Sell Spread[1]	0.10%/0.10%
Fund Size	AUD $234.2 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

AUD Performance[2]

	Magellan High Conviction Fund (%)	Magellan Global Fund (%)
1 Month	0.0	0.6
3 Months	7.2	9.1
6 Months	20.7	21.5
1 Year	29.4	28.8
Since Inception (% p.a.)	26.7	

Regional Breakdown

	% of Fund
Multinational[4]	32.7
North America	45.1
United Kingdom	12.8
Australia	0.0
Europe	0.0
Japan	0.0
Asia Ex-Japan	0.0
Cash	9.4
Total	**100**

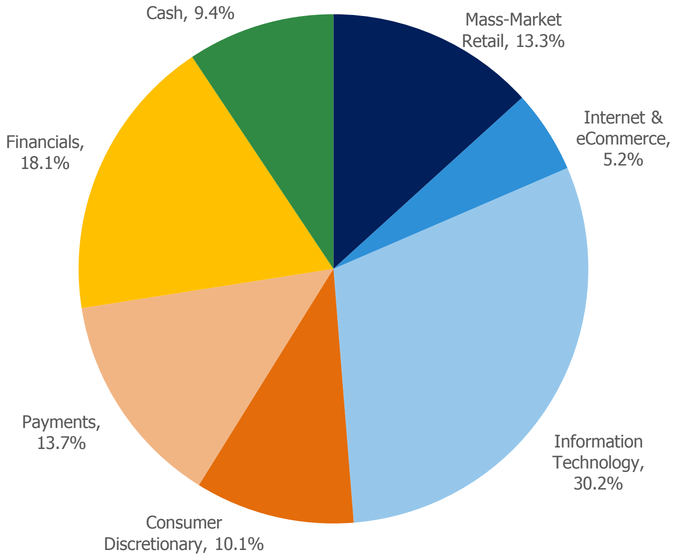
Key Features

- 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

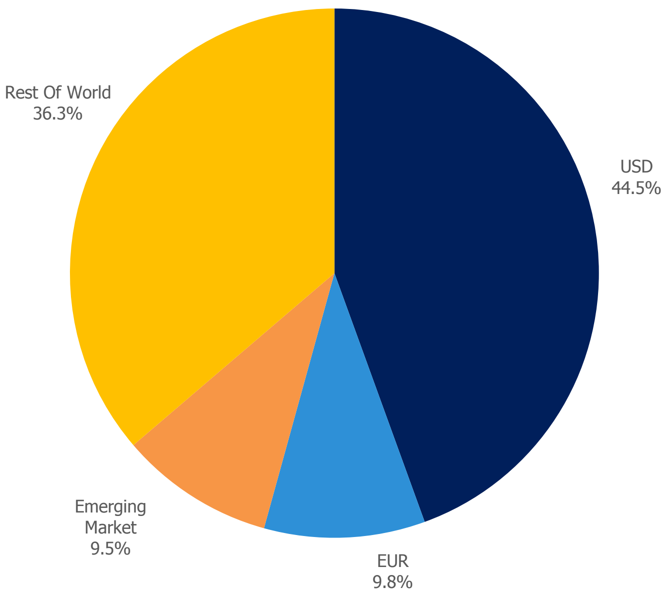
Top Five Holdings

In alphabetical order	
eBay Inc	Information Technology
IBM Corp	Information Technology
Lowe's Co Inc	Consumer Discretionary
Microsoft Corp	Information Technology
Visa Inc	Information Technology

Industry Exposure by Source of Revenue[5]



Geographical Exposure by Source of Revenue[5]



[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 estimated revenue exposure of individual companies held within the portfolio - Magellan defined sectors.

Market Commentary

Over the quarter, global equity markets initially moved sideways as investors remained cautious over slowing global economic outlook. Markets later recovered, supported by the European Central Bank (ECB)'s announcement that it will expand its quantitative easing (QE) programme in an attempt to act against deflationary pressure and boost growth. Euro QE commenced in October last year with the purchase of asset-backed securities (ABS) and covered bonds and will now include the purchase of €1.1 trillion of public and private assets, predominantly government bonds and will run for 19 months from March 2015, or until "a sustained adjustment in the path of inflation" is achieved towards the ECB's inflation target of just below 2%.

The US economy continues to strengthen as labour market conditions improved and the housing market recovery persists. However, recent data disappointed. Retail sales growth and consumption were lower than expected despite a number of positive tailwinds such as lower oil prices, continued low interest rates, jobs growth, higher consumer confidence and a strong currency. This appears to be the result of a cautious consumer more inclined to save rather than structural weakness in the US economy or an impending turn in the US business cycle. Elsewhere, China's economy experienced its slowest growth quarter in almost a decade. Retail sales and industrial production were weak, however, the deteriorating property market and increasing debt levels remain major concerns to growth prospects.

We continue to believe that there is an elevated probability that the massive compression of risk premia observed in recent years will unwind over the next 12 months or so as investors focus on a normalisation of US interest rates. As a consequence, we remain focused on a prudent portfolio construction likely to exhibit substantially less downside risk than the market in the event that global markets deteriorate materially.

Fund Commentary

As of 31 March 2015, the Fund consisted of 12 investments, compared to 12 investments at 31 December 2014. The top five investments represented 48.8% of the Fund on 31 March 2015, while they represented 43.1% of the Fund on 31 December 2014. The cash position was 9.4% compared with 10.2% at the end of the prior quarter.

Tesco was the Fund's top contributor as the share price recovered from its fall last year. The company's new CEO announced a number of meaningful steps to strengthen the company's balance sheet and turnaround its core UK business. This includes appointing advisers to evaluate a sale of its data analytics business (Dunnhumby), a reduction in capital expenditure of more than 50%, a rationalisation of overhead costs, an intention to close its pension scheme and it also reduced its final dividend to zero.

US home-improvement retailer Lowe's also released strong results which were driven by macroeconomic tailwinds, such as strength in the housing and employment markets, and falling energy prices, as well as improving internal execution. Furthermore, the company's management indicated that they expect further acceleration in operational expenditure leverage in 2015. Target also performed well supported by improved traffic trends.

Microsoft's results disappointed, revealing the scale of the positive impact on revenue and earnings of last year's Windows XP end of life, which drove PC sales, and associated Windows 7/8 and Office. Along with currency headwinds, this lead to a negative market overreaction. In the short term, earnings were also weighed on by the transition to its cloud software, which Microsoft grew at over 100% to a $5.5b revenue run rate, making it the largest global cloud software vendor. Despite the recent noise, Microsoft's commercial businesses continue to grow strongly, and consumer businesses are benefitting from a fresh growth strategy.

Key Stock in Focus – Lowe's

Lowe's is the World's second largest home improvement retailer with 1,840 stores (including 74 Orchard Supply branded stores) and $56bn in sales. In 2014, the company earned $2.6 billion in operating profit and returned $4.7 billion to shareholders by way of dividends ($0.8bn) and share repurchases ($3.9 billion). Founded in 1921, Lowe's remains a US centric business despite selected international expansion into Canada, Mexico and Australia. The company caters to homeowners, renters and professional customers selling a wide range of products for maintenance, repair, lawn and garden, remodelling and decorating. It also provides a number of installation, repair and project-related services. Lowe's is differentiating itself from competitors through offering better customer experiences and has successfully created a unique market position as the "project authority" to support customers not only with product but also design inspiration, information and service required to improve their homes.

<u>Market Structure</u>

Lowe's operates in a highly attractive industry. Based on Lowe's broader market definition, the addressable market is worth $690 billion and, we estimate that the combined U.S. market share of Lowe's and Home Depot, its larger competitor, is approximately 20%. Home Depot had sales of $83 billion in 2014. To put this in perspective, the third largest industry competitor has sales of less than $5 billion. The U.S. home improvement retail market operates as a rational, highly-profitable duopoly and both Home Depot and Lowe's strengthened their competitive positions post the 2009 recession as weaker competitors exited the industry.

<u>Strategy</u>

Lowe's has three key strategies:

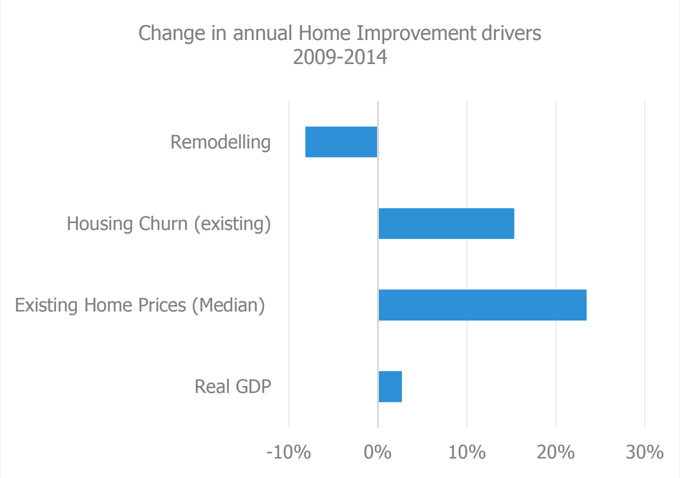
- Driving profitable share gains in the core US business
- Adapting to a changing home improvement landscape
- Generating long-term profitable growth and substantial returns for shareholders

Key to Lowe's market share gains is expanding its network of project specialists to support customer home improvement projects. Recognising you have to "go where the customer is going" Lowe's continues to increase its relevance and enhance the customer experience through an omni-channel retailing capability. Enhancements in 2015 include a website upgrade, new CRM tools and order management software.
Adapting to a changing market environment, Lowe's is planning to add high return stores in under-penetrated markets in US metro and urban areas. It will use the Orchard Supply brand and format as well as a new specifically designed and assorted "city centre" format. Lowe's continues to evaluate high-potential international markets to broaden its customer reach.

Lowe's has set robust three year growth and return targets, which we expect will be exceeded. During this period, Lowe's expects annual sales growth of 4.5% to 5.0% per annum, EBIT margins to expand by 250 basis points and reach 11% by 2017 and net income to grow by 15% per year. Allowing for the impact of share repurchases, the company anticipates its EPS to increase at an average 21% per annum.

<u>U.S Housing Market</u>

Home Depot and Lowe's note their respective financial performance depends significantly on the housing, residential construction and home improvement markets. US home building and house sales made a comeback in 2012 after three years of decline. Similarly, house prices also rebounded in 2012. In the following charts, the difference in annual growth rates in 2014 compared to 2009 is shown for the major drivers of activity in the home improvement retailing segment. Increased US housing activity has had a significant impact on volume through the Home Improvement retailers with 2014 sales approximately 20%-25% higher than in 2009.



Source: JCHS, BEA, NAR,NABH

The increased volume in Lowe's business is illustrated by higher real GDP growth and housing churn (existing home sales) compared to 2009. Existing (median) home prices are also higher and a leading indicator of activity around new home construction, churn and remodelling. Rising house prices provided relief to homeowners owing more on their mortgages than their house was worth. Today, the number of underwater homeowners is around 5.4 million homes compared to over 10 million at its peak in 2011.

Interestingly, the remodelling market activity rebounded from 2011 lows, however, it is still around 8% below 2007 levels. Likewise, housing activity has not returned to previous peaks and it is expected to increase over the next few years. The home improvement segment should drive near term volume growth, as the ageing housing stock requires preventative maintenance and discretionary remodelling demand increases with a stronger economy.

Investment Case

Despite a significant improvement in housing activity and Lowe's sales levels in the last two years, our investment case remains unchanged. A sustained recovery in US housing activity, complemented with a growing level of home improvement investments will support further growth in sales for Lowe's. We believe this to be greater than the company's target for 2017. We anticipate traditional retail sales productivity will drive operating margin expansion, again, greater than the company's guidance. Finally, Lowe's maintains a highly value-accretive capital allocation program. With rollout of 30 new stores per year (or approximately 0.5%), capital expenditure of $1.2 billion per annum is relatively modest. Free cash flow generation therefore continues to substantially support share buybacks (Lowe's plans to buyback $3.8bn in 2015) and dividends. Critically, Lowe's is repurchasing shares that are trading at a discount to our assessed intrinsic value.

Lowe's provides a direct exposure to a continuing recovery in the housing and home improvement market in the United States. Importantly, it does so in a structured and stable duopoly market, where the risk of new entrants is low. Lowe's and Home Depot have created unique business models whereby they are leveraging a predominantly consumer orientated large format, big box, retail brand with a professional business allowing them to generate large returns.