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 $278.4 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.

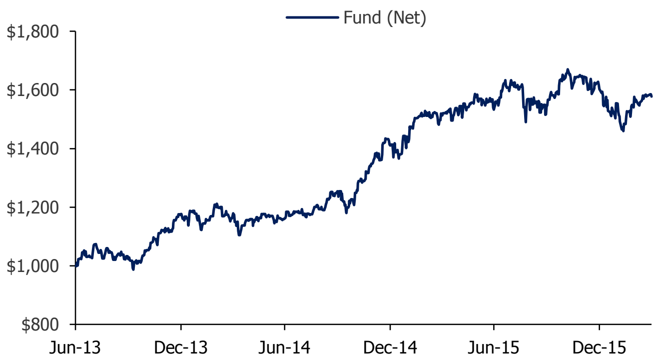
[1]All fees are exclusive of the net effect of GST

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%
- $100,000 minimum initial investment.

† Currently 37% hedged to AUD

Performance Chart growth of AUD $1,000**



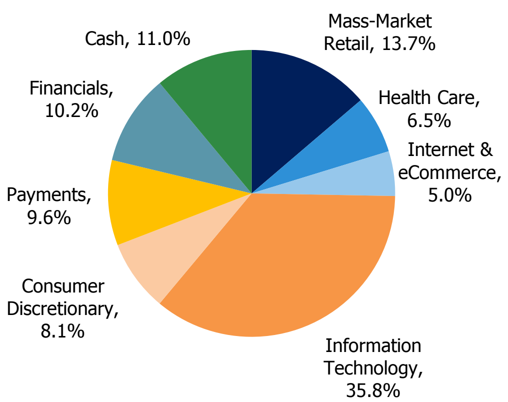
Fund Performance*

	Magellan High Conviction Fund (%)	Magellan Global Fund (%)
1 Month	2.4	-1.9
3 Months	-1.6	-4.8
6 Months	2.1	-4.2
1 Year	4.3	0.6
Since Inception (% p.a.)	18.0	

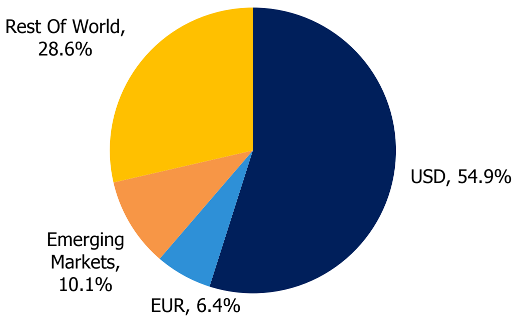
Top 5 Holdings

In alphabetical order	GICS Sector
Apple Inc	Information Technology
Intel Corp	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 March quarter saw volatile conditions persist in global equity markets amid further signs of emerging weakness for the global economy. Markets sold off heavily in January in reaction to heightened concerns over China's growth and the extent to which weakness in key domestic activity indicators may translate to the other major economies. Crude oil prices also plunged to their lowest level since 2004, as investors puzzled through possible weaker demand and continued concerns of oversupply by large oil producing countries, and associated geopolitics. The oil price subsequently recovered, as did global equity markets to end the quarter closer to levels at the end of 2015.

European markets were led lower by these offshore developments and on speculation over whether the European Central Bank (ECB) will take action to ease monetary settings – moves that had been flagged in the preceding months. The ECB delivered its latest injection of stimulus at its March meeting, announcing a further cut to the overnight cash rate to -0.4% and announced a new series of targeted longer-term refinancing operations (TLTRO II), each with a maturity of four years, aiming to provide cheaper financing to certain investments. The ECB also announced an expansion of its monthly asset purchases program to €80 billion. Equity markets responded favourably to the announcements, while the UK's stock market received a boost following a strong rebound in key commodity prices.

In the US, market observers were preoccupied with the US Federal Reserve's (Fed) path to interest rate normalisation. Amid growing concerns over China and the likely impact on domestic settings, equity markets sold off and acted to alert the Fed. Later in the quarter, Janet Yellen sought to clarify thinking around the future trajectory of interest rates, indicating the need to see a sustained development of domestic labour market, business and consumer health. Data released during the quarter provided evidence of buoyant conditions in the labour market, with US Non-Farm Payrolls continuing to expand and the unemployment rate remained stable at 5%. Statistics on lending to the private sector also showed continued growth, although retail sales (ex-automobiles) have moderated in recent months. While these indicators provide some comfort, Yellen cited concerns over depressed inflation, falling earnings expectations and foreign growth forecasts and placated markets with a message that the Fed is more inclined to be late in raising rates rather than being too early. US Treasury yields weakened further following the speech, while the S&P500 moved higher to end the quarter in a marginally stronger position.

Macroeconomic developments are likely to remain at the forefront of concerns for equity markets, suggesting that the future influence of central bank policy actions will periodically dominate sentiment. Policy makers are acutely aware of the sensitivity to interest rates, constrained fiscal conditions and the unwelcomed prospect of deflationary pressures, hence the lower for longer mantra is likely to dominate opinion. With risks to the global economy balanced between an uncertain slow-down trajectory for China and Emerging Markets, stabilising Europe and a growing U.S., we retain a cautious approach in terms of where to prudently place capital.

Fund Commentary

As of 31 March 2016, the Fund comprised of investments in 12 companies, consistent with the number held as at 31 December 2015. The top five investments represented 46.8% of the Fund on 31 March 2016, compared with 48.5% of the Fund as at 31 December 2015. The cash position of the Fund on 31 March 2016 was 11.0%, while the cash level on 31 December 2015 was 10.5%.

The Fund's performance this quarter was negatively impacted by its major holdings in the information technology sector, through positions in Intel, Microsoft and Visa. Intel declined through the first half of the quarter before recovering most of its losses. The stock's decline was reflective of weakness in the IT sector more broadly amid the general rotation back to more defensive sectors. Intel's fourth quarter earnings result was weaker than expected, after being impacted by a stronger US dollar and still soft demand for personal computers.

Visa gave back some of its gains from the prior quarter and generally followed the broader trend in equity markets. The company's alignment with discretionary spending and associated transactional business was not in favour amid the trend towards more defensive equities. However, the company's third quarter earnings disclosed that spending volumes growth continued at the same pace on prior quarters and management affirmed their operational flexibility to deliver earnings outcomes, notwithstanding the possibility of more difficult trading conditions over the remainder of their financial year. Accordingly, the stock recovered much of its earlier losses by the end of March.

Microsoft's share price followed a similar trajectory to Visa, recovering from declines in January to register a flat return for the quarter. The company's latest quarterly earnings release saw the stock jumped 6% after it beat consensus estimates, supported by 11% revenue growth from intelligent cloud services and strong performance within its commercial software focused business segment. Performance in these areas offset declines from personal computing revenues. Microsoft's software products dominate their categories and its strong market position is likely to support its earnings in the near term.

Key Stock in Focus - Apple

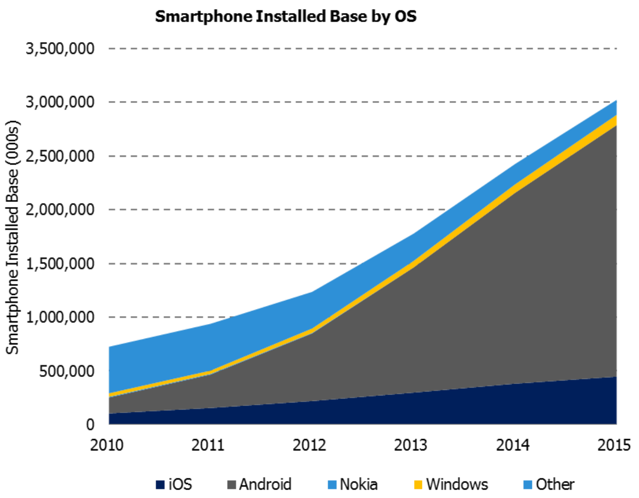
Apple is amongst the largest companies in the world. The company enjoys strong brand recognition globally and extensive market penetration for its flagship products, most notably the iPhone. While speculation around the success of Apple Watch, Apple TV, iPad, or even the likelihood of an Apple Car often captures headlines, we estimate that iPhone and iPhone-related services represented around 70% of Apple's revenue and 80% of Apple's gross margin in FY15. Despite its relatively high price, there is strong demand for the iPhone in both developed and emerging markets, with China now contributing 24% of Apple's total revenue.

Apple's growth has been driven through its position as a consumer hardware vendor. There are few, if any, examples of consumer hardware vendors which have endured over the long term as the products have typically commoditised over time. However, having built a powerful, enduring ecosystem, we view Apple today as a leading mobile platform and services company with sales of its devices reflecting effectively a "subscription" payment to access its platform and services.

Apple displays several attractive investment characteristics which support our longer term outlook for the company.

Global digital platform

Along with Windows and Android, Apple's iOS is one of the major global digital platforms. There are only two main mobile platforms globally – Apple's iOS and Google's Android – which is unlikely to change in the foreseeable future. Almost all consumer software and services will be developed for these two platforms and the vast majority of digitally connected people will connect via one of the two. Importantly, while iOS is not the leading mobile platform by users, it currently dominates use among premium phones and the highest-spending consumer demographic, which is particularly valuable.



Source: Gartner

Mobile devices are increasingly central to people's lives, with a 2015 Deloitte study finding that the average American checks his or her phone 46 times per day. Being the mobile platform owner provides Apple with tremendous optionality in terms of new devices and services such as Apple Pay (payments), HealthKit (health wearables) and HomeKit (home network connectivity). Even though it is very difficult to estimate the impact of these on Apple's consolidated earnings given the immense profitability of the iPhone, more iOS devices and services make the platform increasingly valuable and make switching harder, thereby lowering iPhone churn and helping to cross sell other Apple devices.

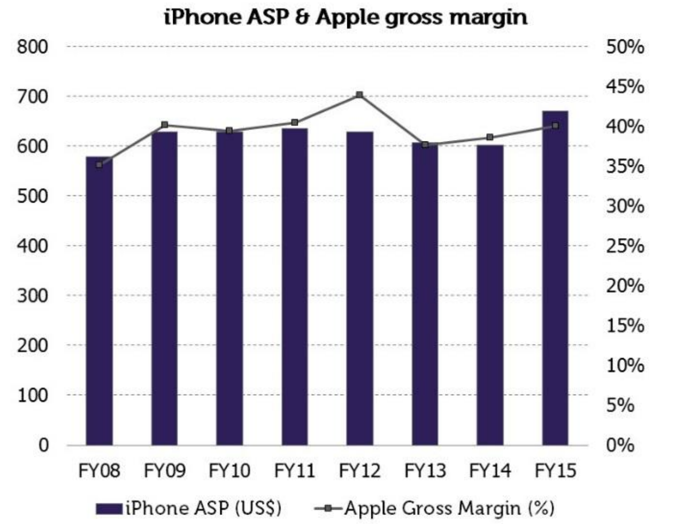
Increasingly annuity-like revenues

iPhone sales are becoming more annuity-like. As the installed base of iPhone users has grown, Apple's dependence on winning new users has diminished. User satisfaction among iPhone users is typically very high and thus renewal rates are also high. We expect sales of new devices to existing users will represent a significant majority of iPhone revenues going forward.

Little exposure to typical hardware commoditisation

During the rapid expansion in the smartphone market over the past decade, we held concerns that these devices would face commoditisation similar to that seen historically in the PC market. Apple has achieved impressive growth as a consumer hardware vendor, but our cautious approach to date has been prompted by the tumultuous history of the mobile phone vendor market structure, with market leadership rapidly changing hands in recent history - consider prior leaders - Motorola, Sony Ericsson, Nokia, Blackberry and HTC.

Our initial concerns were three-fold: (i) the relatively high price of the iPhone, (ii) the continual functional improvements of lower-priced Android phones, and (iii) greater phone price transparency as carriers moved away from subsidies (by explicitly listing the monthly cost of the phone rather than recovering the cost of the phone via service fees). Despite these issues, Apple has continued to grow sales of iPhones and increase average prices at high margins. In 2015, release of the large-screened (and more expensive) iPhones resulted in volumes increasing by 37%, average selling prices rising by 10% and Apple increased its aggregate gross margin. These results displayed little evidence of price sensitivity among existing and new users.



Source: Magellan Asset Management Limited, Apple Inc.

We believe this resilience in iPhone prices and Apple's margins will continue due to the iPhone's premium positioning, the iOS ecosystem and very high user retention. The latter will be driven by brand loyalty and user preference, as well as the switching costs associated with user reluctance to learn a new interface, desires to maintain access to iOS-only apps (e.g. Facetime) and services (e.g. photo collection in iCloud), and preserving the integration benefits of multiple Apple devices (e.g. iPhone and Apple TV).

Growth opportunity

At the end of 2015, smartphones represented an installed base of approximately three billion phones globally and are expected to reach 4.7 billion in 2020[1]. While smartphones now enjoy very high penetration rates among high-value device user groups, much of the market's growth will come from low-value device users. We see Apple's growth being generated from:

- **Growing share of high value device segment**. Android switchers to iPhone have risen to record levels since release of the large-screened iPhones.
- **Growth in high value device users**. Emerging markets now contribute 34% of Apple's total revenue and the company is seeing rapid growth in the proportion of the population able to afford an iPhone. While there is some caution around global consumer weakness in the short term, the expanding middle class globally is expected to benefit Apple over the long term.
- **iPhone addressable market expansion**. Apple's recent decision to lower the cost of its entry level iPhone demonstrates Apple's increased focus on expanding its market.

Earnings prospects

In the lead up to the December 2015 and March 2016 quarterly results, market fears rose around anaemic iPhone 6S sales volume growth trends as it cycled strong iPhone 6 sales in the prior corresponding period. This was exacerbated by elevated concerns around China's growth. While it is likely that iPhone sales in the March quarter will be below the prior corresponding period, this quarterly growth number belies the strong underlying long term growth prospects. Our view of Apple's long-term prospects is framed by its pricing power, brand strength, installed base size, replacement cycles and optionality. At prevailing market pricing, we consider Apple to be an attractive investment.

[1] Source: Gartner, 24 March, 2016