Magellan High Conviction Fund

Fund Update: 30 September 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 $75.2 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

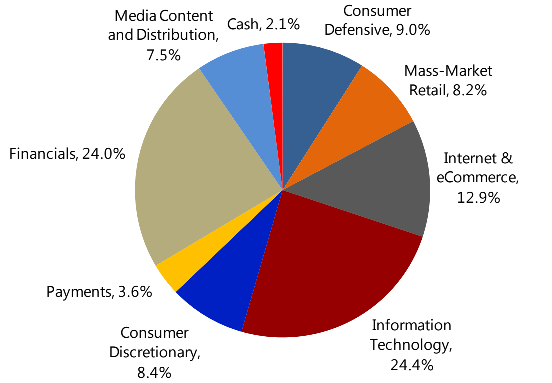
Key Features

- 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	-2.2	0.0	-2.2
3 Months	2.3	5.9	-3.6
Since Inception	2.3	5.9	-3.6

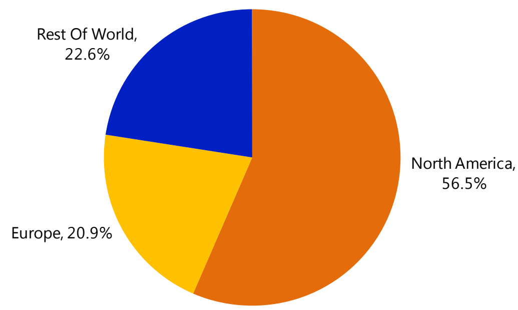
Industry Exposure by Source of Revenues[5]



Portfolio in Alphabetical Order

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

Geographical Exposure by Source of Revenues[5]



Regional Breakdown

	%
Multinational[4]	25.5
North America	64.2
United Kingdom	8.2
Australia	0.0
Europe	0.0
Japan	0.0
Asia Ex-Japan	0.0
Cash	2.1
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

Global equity markets were strong in the third quarter of 2013 as a number of central banks committed to maintaining loose monetary policies. In the US, in particular, a sharp rise in mortgage rates, the low labour participation rate and concerns over the drag on growth resulting from political wrangling over the country's debt limit caused the Federal Reserve to postpone plans to 'taper' its asset purchases. Ben Bernanke, the FOMC Chairman, subsequently emphasised that tapering would be dependent on the strength of the economy and that there was no set timetable for the removal of supportive policy measures.

Although US monetary policy was among the dominant factors driving markets over the period, a number of significant developments also occurred in other regions. Both the Eurozone and Japan saw their growth rates improve, the former emerging from a long period of recession and the latter seemingly benefitting from the aggressive Abenomics policies implemented almost one year prior. Europe also benefitted from the re-election of German Chancellor Angela Merkel, in what was considered, in some respects, an endorsement of her pro-European policies. Meanwhile, China's economic data was encouraging, giving some indication that the country's growth rate may be stabilising after consecutive years of deceleration.

Despite these developments, 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 the deleveraging of both bank balance sheets and households. A major near-term risk for Europe would be a dramatic uplift in European sovereign bond yields (particularly in Spain or Italy) which could accompany a disorderly unwinding of quantitative easing in the US.

Key Stock in Focus - Oracle

Oracle is the world's largest provider of database software. Its flagship product is the Oracle Relational Database Management System ('RDBMS'), a software product used by businesses to manage data. Oracle also operates a substantial middleware and enterprise software applications business, and currently small hardware and services businesses.

The characteristics of the database software industry are highly attractive. The database market is very highly concentrated (Oracle has around 50% market share by revenues), owing to network effects, high barriers to entry and high switching costs favouring the three incumbents. Vendors earn annuity revenue streams and high returns on capital. Oracle is able to claim that all of the Fortune 100 companies are its customers.

Oracle's core business model is very attractive. It has a massive installed base of customers that purchase software license update and product support contracts annually. In the last financial year, Oracle generated US$17 billion in revenue from software license update and product support fees, growing 6% over the prior year and accounting for nearly 50% of revenues and 75% of segmental earnings. Due to high switching costs, Oracle enjoys low customer attrition and substantial pricing power, typically increasing annual software license update and product support fees by CPI plus 1-2%. This level of pricing power is extremely rare in any industry. It is also a beneficiary of the explosion in data generated by the internet and a proliferation of mobile and other devices capable of collecting information, as its software pricing model is related to the amount of data processed. This is a remarkable annuity style business.

Over time, Oracle's revenue will continue to benefit from pricing escalators and growth in data and users of deployed software. However, as Oracle is nearly fully penetrated among large, multinational enterprises, in order to grow more quickly, it will be required to further build out its software portfolio organically or via acquisitions, cross-sell its various software products to existing clients, and target smaller customers with its cloud software. While Oracle faces some nimble and able competitors in the cloud applications market (such as Salesforce.com), we consider that IT departments generally prefer to source core enterprise software from a single vendor simplifying integration, which favours Oracle. We also expect Oracle will increasingly sell the hardware which it has optimised to run its software. This hardware, which Oracle calls Engineered Systems, has achieved strong growth since its release in 2008, but this has been masked by a rapidly declining commodity hardware business that Oracle acquired with Sun Microsystems in 2009.

Risks

Sheer growth in the volume of data and speed of analysis required is encouraging the development of new database solutions that have the potential to both accelerate and cannibalise demand for existing relational databases. One example is Hadoop, which is a non-relational, open-source version of Google's early internal database systems.

While non-traditional database management systems like Hadoop are able to efficiently analyse vast amounts of unstructured data, we believe that RDBMSs will likely remain the dominant systems supporting the vast majority of day-to-day transactions and structured data analytics needs. In any case, Oracle offers its own non-traditional database products and bridging software to enable enterprises to convert unstructured data into a relational format for analysis and management decision making. Therefore, while we acknowledge the potential risk posed by non-traditional database systems, it is insufficient to materially affect our assessment of Oracle's economic moat.

In-memory databases are also considered a threat to Oracle's database business. SAP has recently launched an in-memory database product (HANA) which offers substantially increased processing speed, in comparison to standard RDBMSs, at the substantial cost of rewriting all existing applications as well as considerably more expensive hardware. In response, Oracle has launched its own in-memory product, which it claims is substantially cheaper, runs all existing applications, and is faster than HANA. While it is difficult to substantiate Oracle's claims until the product is released, we are confident that HANA is less of a threat to Oracle's business than the market assumes.

Cloud-computing will continue to disrupt the traditional on-premise enterprise software business model. However, we believe that Oracle is well placed to navigate this risk, as it has produced a database product (Oracle Database 12c) and a suite of applications (Oracle Fusion apps) designed specifically for the cloud.

Valuation

We consider that Oracle represents a compelling value proposition at present. It is trading on a historical non-GAAP PE multiple of less than 13x, and a free cash flow yield of in excess of 8.5%. Oracle also has a strong track record of returning its free cash flow to shareholders. Last financial year it bought back approximately 5% of its issued capital and paid a healthy dividend. We believe that the reason it is trading on such attractive terms is due to the market's uncertainty about the impact of alternative databases on its core database business, and its ability to win in the enterprise applications market.

Sydney Head Office
Level 7, 1 Castlereagh Street Sydney NSW 2000
Telephone: 02 8114 1888
Facsimile: 02 8114 1800

Melbourne
Suite 103, 1 Queens Road
Melbourne Vic 3004
Telephone: 03 9863 9746
Facsimile: 03 9863 9741

Brisbane
Level 22, 127 Creek St
Brisbane Qld 4000
Telephone: 07 3218 2122

New Zealand
Level 4, 17 Albert Street
Auckland City,
New Zealand
Telephone: +64 9 215 1531

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