

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 \$150.0 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.

¹All fees are exclusive of the net effect of GST

AUD Performance²

	Magellan High Conviction Fund (%)	Magellan Global Fund (%)
1 Month	5.1	5.4
3 Months	7.9	6.1
6 Months	7.2	6.1
1 Year	22.5	16.7
Since Inception (% p.a.)	19.8	10.2

Regional Breakdown

	% of Fund
Multinational ⁴	24.1
North America	52.6
United Kingdom	13.8
Australia	0.0
Europe	0.0
Japan	0.0
Asia Ex-Japan	0.0
Cash	9.5
Total	100

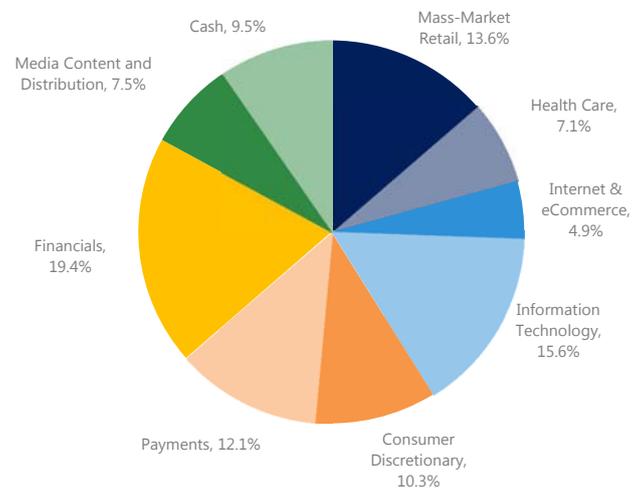
Key Features

- 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

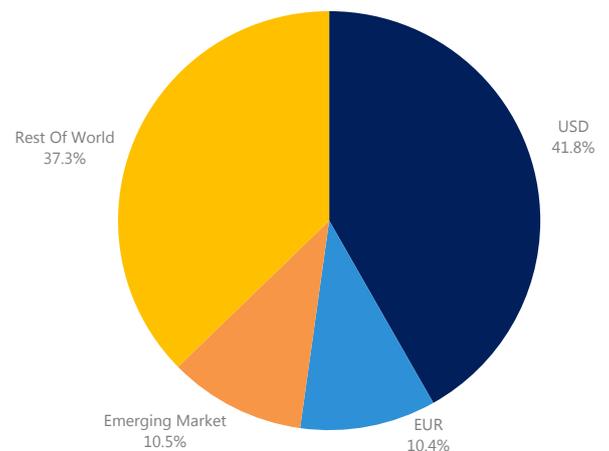
Top Five Holdings

In alphabetical order	
eBay Inc	Information Technology
Lloyds Banking Group	Financials
Lowe's Co Inc	Consumer Discretionary
Microsoft Corp	Information Technology
Target Corp	Consumer Discretionary

Industry Exposure by Source of Revenue⁵



Geographical Exposure by Source of Revenue⁵



²Calculations 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.

³MSCI World Net Total Return Index (AUD)

⁴Multinational: 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.

Important Information: Units in the Magellan High Conviction Fund (Fund) are issued by Magellan Asset Management Limited (ABN 31 120 593 946, AFS Licence No 304 301). Past performance is not necessarily indicative of future results and no person guarantees the future performance of the Fund, the amount or timing of any return from it, or that it will achieve its investment objective. This material has been provided for general information purposes and must not be construed as investment advice. This material has been prepared without taking into account the investment objectives, financial situation or particular needs of any particular person. Investors should consider obtaining professional investment advice tailored to their specific circumstances and should read the relevant Product Disclosure Statement (PDS) prior to making any investment decisions. The PDS is available at www.magellangroup.com.au or can be obtained by calling 02 8114 1888.

Market Commentary

The US Federal Reserve continued to taper its bond purchases during the third quarter of 2014, amid greater-than-anticipated improvement in the US labour market (and despite lingering concerns over stagnant wage growth). Meanwhile, Eurozone inflation slowed further. In response, the ECB has recently announced its intent to increase the size of its balance sheet by around €800bn through two mechanisms. First, it will provide ultra-cheap funding to banks to then on-lend to the private sector and, second, it will purchase private sector securities. As the latter will be financed by money creation, it essentially amounts to small-scale Quantitative Easing.

There has been a massive compression in risk premia across multiple asset classes over the last 18 months. Within equity markets, one manifestation of this has been the underperformance of lower-volatility, high-quality stocks. We consider this a warning sign and believe there is an elevated probability of the risk compression unwinding over the next year or so, as investors focus on normalising US interest rates. As such, we continue to consider the unwinding of Quantitative Easing as the single most important factor that will impact markets and economies over the next few years.

Furthermore, it remains possible that China's economy could experience a significant slowdown as a combined result of market forces and the government's continuing efforts to address the structural oversupply inherent within its housing market. The rapid rate of credit expansion experienced by China in recent years, and its role in funding fixed asset investment and property developers, adds further risk to the situation.

Fund Commentary

As at 30 September 2014, the Fund consisted of 12 investments (compared to 11 investments at 30 June 2014). The top five investments represented 44.2% of the Fund at 30 September 2014, while they represented 50.7% at 30 June 2014.

During the period, Microsoft was among the Fund's top contributors as the growth of its cloud products drove strong performance in its core enterprise business. eBay also performed well as it continued to recover from its data breach and provide solid operating metrics. The company also saw its shares jump on the last day of the quarter after announcing plans to spin off PayPal, its online payments business.

Lowes's also did well as the recovery in US housing continued, while a number of the company's recent initiatives are also bearing fruit, including an increased focus on Pro and online sales, payroll investment, general expense discipline and assortment and pricing resets. Furthermore, the company's recent results benefited from a recovery in seasonal sales that were lost to bad weather earlier in the year. Likewise, Target rose after nearer-term sales trends signalled improvement while cost-optimisation initiatives gained traction. Additionally, insights from the new CEO on his views and likely initiatives have been well received.

Tesco was the Fund's only large detractor, as the company announced in July a change of CEO and reduced profit guidance for this year in July and again in late August. Then on 22 September it revealed an internal investigation into its own accounting practices, which remains an outstanding issue.

We consider that there is an elevated probability that the massive compression in risk premia that has occurred across multiple asset classes over the last 18 months will unwind over the next 12 months or so, as the US Federal Reserve ends Quantitative Easing and investors focus on a normalisation of US interest rates. As a result, we made the decision to raise the Fund's cash (US dollar) weighting to increase its defensiveness during the period. Within equity markets, one manifestation of the compression in risk premia has been the underperformance of lower-volatility, high-quality stocks and the outperformance of higher-beta stocks. We took this skew into account in determining which areas of the portfolio to liquidate in order to increase the cash exposure. As of the end of the period, this decision has been beneficial to the Fund's performance.

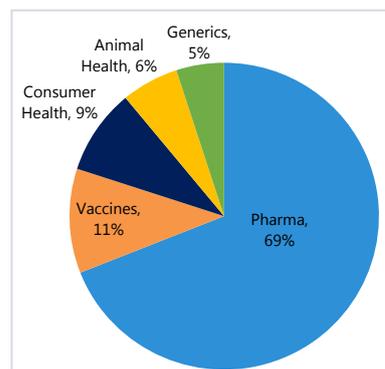
The Fund remains positioned to benefit from a strengthening US economy, along with normalisation of interest rates and capital market activity.

Key Stock in Focus



Sanofi is the world's fifth-largest pharmaceutical company by market capitalization. In recent years, the company has passed through a major patent cliff that exposed 31% of its sales to generic competition. As these patents expired, management took the opportunity to reposition the business towards areas that could provide stable and sustainable revenue and earnings growth. This involved increasing exposure to the emerging markets, diabetes solutions, vaccines, consumer health, animal health, the treatment of rare diseases and other innovative products. To date, these initiatives have led Sanofi to complete numerous acquisitions and in-licensing agreements. As a result, the company's revenue streams have become more diversified, while dependence on individual products has been reduced.

Figure 1: Sanofi Aventis sales by segment



Investment Case

We look for certain key features when picking healthcare stocks. First, a company's ability to sustain historic returns on invested capital which, in the case of pharma, is achieved by either leveraging a broad-reaching sales force to launch new and competitive medicines at minimal incremental cost, or by using scale to attract smaller biotech/pharma

companies as licensing partners. Second, we look for companies with high earnings visibility, low business risk and low economic sensitivity. This often means that the company has a broad portfolio of marketed products, combined with a deep pipeline of drugs in the later stage of clinical development that supports, but is not relied upon, as a key source of growth. Drug development is a hit or miss game and, as such, to rely on the pipeline for future growth reduces earnings visibility and increases risk. We believe Sanofi meets each of these criteria.

Since emerging from a major patent cliff in September 2013, a number of one-off events hampered margin recovery and led to conservative management projections for 2014. While we had ultimately expected margins to improve as these one-offs cycled out or were resolved, we were somewhat surprised at the speed of the recovery during the second quarter of 2014. We expect margins will continue to improve in the second half of the year and into 2015, driven by product launches, productivity initiatives and positive product mix effect.

While earnings visibility has improved, the market remains somewhat cautious over the sustainability of the company's market-leading insulin franchise for diabetics, Lantus, given its upcoming patent expiry in 2015. There are three reasons why we believe these concerns are overdone. First, the company is preparing to release a reformulated product, which it plans to accompany with new, complementary combination drugs that generic producers will not initially be able to match. Second, franchises of this scale require significant sales and manufacturing capabilities that take time to build up and, thirdly, the operational track records of generic drug companies that have come in to compete with similar franchises post patent expiration are littered with delays (which could mean competition is slower to materialize than investors expect).

Outside of pharmaceuticals, Sanofi is the market leader in vaccines and companion animal health. It is because of these leading market positions that Sanofi is staying its course of a diversified asset base, amidst the recent industry moves to divest underperforming or subscale businesses.

Unlike pharmaceuticals, the highly-concentrated vaccine market exhibits very low generic risk due to high barriers to entry. In this area, Sanofi is leading in the race to develop the first-ever vaccine for Dengue Fever (the second most widespread tropical disease after malaria). Following successful completion of a clinical trial, this vaccine could easily reach blockbuster status by the end of the decade, if it is accepted onto immunisation programs in Latin America and Asia. Animal health's benefit is that it is defensive; it has a longer lifecycle than pharma despite generic competition, the average age of compounds in its product portfolio exceeds 30 years.