Fund Update: 30 September 2015

Magellan High Conviction Fund

ARSN: 164 285 947

Fund Facts

Portfolio Manager	Hamish Douglass
Structure	Global Equity Fund, $AUD unhedged
Inception Date	1 July 2013
Management & Administration Fee[1]	1.50%
Buy/Sell Spread[1]	0.10%/0.10%
Fund Size	AUD $256.7 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.

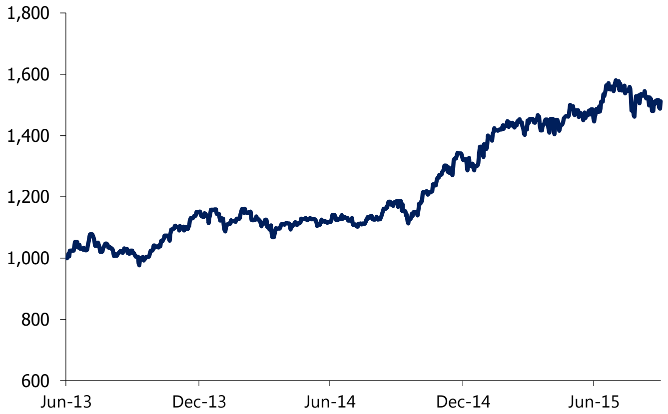
[1]All fees are exclusive of the net effect of GST

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 62% hedged to AUD[2]

Performance Chart growth of AUD $1,000[3]



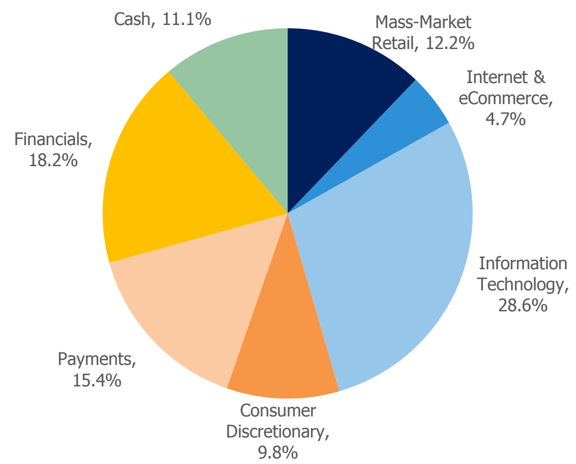
Fund Performance[2]

	Magellan High Conviction Fund (%)	Magellan Global Fund (%)
1 Month	-1.6	-1.3
3 Months	0.8	4.5
6 Months	2.1	5.0
1 Year	23.2	27.5
2 Years (% p.a.)	22.9	22.0
Since Inception (% p.a.)	21.3	

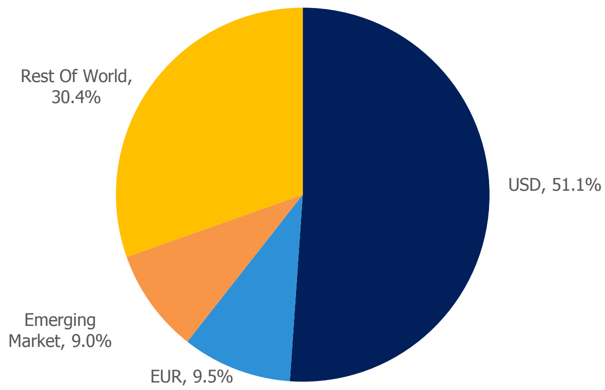
Top 5 Holdings

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

Industry Exposure by Source of Revenues[4]



Geographical Exposure by Source of Revenues[4]



[2]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.

[3]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.

[4]Calculated on a look through basis based on underlying estimated revenue exposure of individual companies held within the portfolio - Magellan defined sectors.

Market Commentary

Global equity markets have been dominated by much volatility for most of the quarter, dropping sharply late August, seemingly as a result of China allowing a fall in its currency versus the US dollar of about two percent over three days. This, together with the sharp falls in Chinese equity markets since June and associated government interventions in markets, sparked speculation that the Chinese economy might be slowing faster than previously thought and resulted in a global sell off, sending equity markets around the world to their lowest levels in seven months in just one day.

In Europe, signs that a recovery might be on its way remain choppy. Economic growth remains patchy despite stimulus from the European Central Bank's Quantitative Easing programme. Indeed, the effects of a low currency, interest rates and falling energy prices were partly counteracted by the escalation of the Greek debt crisis once again. After the expiry of its second bailout programme, reaching an acceptable and sustainable deal between the European Leaders and the anti-austerity Greek government was problematic. Nevertheless, Spain and Ireland, which implemented reforms post their bailout programmes, are growing at a healthier rate and unemployment is reducing across the Eurozone.

The strengthening of the US economy persists. Recent data is showing continued positive signs that a recovery is under way. Consumer spending and the housing market have held up relatively well despite the softening of the global economy exacerbated by uncertainties in China. The labour market was surprisingly strong, however, inflation fell short of expectations, leading the Federal Reserve to defer the first interest rate hike.

We continue to believe that the uncertainties as to where US monetary policy is headed over the next few years is the most important factor that could lead to a major market correction translating into material losses for investors. As a result, we remain focused on prudent portfolio construction with a cash weighting of approximately 10% which will act as a partial hedge should interest rates increase.

Fund Commentary

As of 30 September 2015, the Fund consisted of investments in 12 companies, compared to 12 investments at 30 June 2015. The top five investments represented 47.9% of the Fund on 30 September 2015, while they represented 48.2% of the Fund on 30 June 2015. The cash position was 11.1% compared with 10.6% at the end of the prior quarter.

The performance of our technology holdings was generally mixed. Microsoft was amongst the major contributors. Despite incurring a record loss due to the $7.5 billion write off of Nokia, Microsoft's results exceeded market expectations. Microsoft's software and cloud businesses continue to grow strongly. Elsewhere, weak PC demand and currency headwinds continue to be a drag on Intel's share price. IBM's share price underperformed the broader market and detracted from performance this quarter.

Visa posted increased earnings compared to last year, exceeding market expectations. Management also confirmed a potential purchase of Visa Europe (currently owned by European banks), which boosted the share price to a record high in July. Lowe's also contributed positively to performance. The US home improvement company continues to benefit from the US housing market recovery.

Key Stock in Focus – Lloyds Banking Group

Lloyds Banking Group is a leading financial institution in the United Kingdom. The Group serves more than 30 million customers and is the UK's leading provider of current accounts, savings, personal loans, credit cards, and mortgages. Lloyds has a multi-brand strategy, offering banking services in England and Wales through the Lloyds Bank brand and in Scotland through the Bank of Scotland brand. In addition, the Group includes the UK's leading "challenger bank" Halifax and the insurance, investments and pensions provider Scottish Widows. The Group was formed in 2009 when Lloyds TSB acquired HBOS, owner of Halifax and the Bank of Scotland.

A Six Year Transformation

The UK banking industry was significantly impacted by the Global Financial Crisis. Household leverage was high, some banks had relatively risky offshore operations, and many banks held too little capital and were overly reliant on wholesale funding, much of it short-term. When wholesale funding markets largely closed in late 2008 and early 2009 there were real doubts about the ability some large UK banks to continue operating as going concerns, most notably RBS and HBOS.

The UK Government and the Bank of England were forced to intervene to stabilise the financial system, including approving the sale of HBOS to Lloyds and forcing all large banks to raise equity, either privately or through a government injection. The newly formed Lloyds Banking Group was not unscathed by the turmoil, with the Government emerging with a 43% stake in the company.

Following the crisis Lloyds set about transforming its operations:

- Higher risk businesses have been either sold or wound down. Many of these businesses were acquired as part of the HBOS acquisition and were located offshore where the bank had little competitive advantage. In total Lloyds exited more than 20 countries and now derives approximately 95% of revenue from the attractive UK market.
- Capital levels have more than doubled.
- Wholesale funding has declined from a peak of more than £320 billion to approximately £120bn, the majority of which is long-term. The bank's Loan to Deposit ratio, which measures lending relative to deposit funding, has fallen from more than 170% to 110%.

We judge that Lloyds' management, under the leadership of CEO António Horta Osório, are effectively executing their strategy of transforming the company into a relatively low risk, customer focused, UK retail bank. In light of the operational improvement the UK government has commenced selling its stake in the bank, which has fallen to less than 12%. The government is likely to complete its sell down in 2016, recently announcing plans for a retail offer of part of its remaining stake. In addition, following a five year hiatus, Lloyds resumed paying dividends earlier this year.

Favourable Industry Structure

The domestic UK banking market is large and structurally attractive. There are roughly £2 trillion of loans and deposits outstanding in the system. Notwithstanding the large size of the market, it is relatively concentrated, with the top six financial institutions having a market share of more than 80%. Lloyds is the dominant bank in the retail market, accounting for almost a quarter of loans and deposits, a market share approximately 10% larger than its closest peer.

There are high barriers to entry in retail banking. Banking involves significant economies of scale, with large banks able to spread information technology, regulatory, and distribution costs over a larger customer base, allowing them to price competitively. In addition, customer switching tends to be quite low, with a study by Ofcom (the UK communications regulator) finding that only 21% of customers have ever changed their main banking relationship. In particular, older customers, who are valuable as they tend to have higher deposit balances, rarely switch. The combination of economies of scale and low customer switching makes it difficult for potential competitors to significantly encroach on established market leaders.

There is a reasonable level of competition between the major banks, though it is rational and tends to focus on non-price factors. This reflects the economics of banking; all large banks have a significant existing book of business (outstanding loans and deposits). Consequently, if a bank were to compete aggressively on price it would be likely to result in a significant decline in the bank's own profitability as its existing book of business reprices. In addition, due to low customer switching, any offsetting market share gains are likely to be limited. In any event, as an oligopoly, competitors would be expected to eventually respond, further limiting incentives to compete aggressively on price. These economic forces tend to result in rational competition amongst the large banks.

The economic forces highlighted amount to an economic moat, which allows the large UK banks to generate strong returns on their domestic retail banking operations. Lloyds is the most exposed to this business, reflecting its leading market share and lack of significant offshore or investment banking operations, which tend to be less profitable.

Risks and Valuation

UK banks are exposed to political and regulatory risk. Regulatory requirements have been increasing for banks around the world and the UK is no exception. While much of the new regulatory regime is in place, some rules are still to be finalised. In addition, tax changes have impacted near-term profitability and there is an outstanding competition review focusing on current accounts and small business banking. Nonetheless, the political environment appears to stabilising, reflecting the recent election of a majority government, and we judge Lloyds well placed to meet any additional requirements given its strong capital position.

UK banks have also been impacted by significant fines and redress costs for financial misconduct. By far the most material issue for Lloyds has been Payment Protection Insurance (PPI) redress costs.

Many PPI insurance policies were found to have been mis-sold to customers (policies were not appropriate to their circumstances or simply not needed) and the banks have been forced to pay redress costs to affected customers. For Lloyds, these costs has totalled more than £13 billion over the past four years. The impact of these costs has, to a degree, masked the significant improvement in Lloyds' underlying profitability over the period. Lloyds now appears to be through the bulk of PPI payments, with the regulator recently announcing they will consult on the implementation of a deadline for PPI complaints, though further financial misconduct costs cannot be ruled out.

In addition, banks are always impacted by the performance of the economy within which they operate. In this case the UK appears relatively well placed compared to many parts of the world, with steady economic growth and an unemployment rate of just 5.5%, providing a solid economic backdrop for Lloyds.

Lloyds Banking Group's valuation is attractive, with the bank trading on a price to forward earnings ratio of less than ten times. We judge the bank likely to deliver strong returns over the next few years.

Summary

While it has been a tough period for Lloyds and the UK bank sector more generally, the future is looking more promising. The economy is performing well and the banking system has largely addressed its imbalances. The market is an attractive oligopoly, with Lloyds enjoying a very strong market position. Consequently, we are expecting a significant improvement in reported profits going forward. The bank trades on an attractive valuation and is forecast to deliver solid returns to shareholders over our investment horizon.