MAGELLAN
EXPERTS IN GLOBAL INVESTING

Annual Investor Report 2018

Magellan High Conviction Fund

www.magellangroup.com.au

Dear investor,

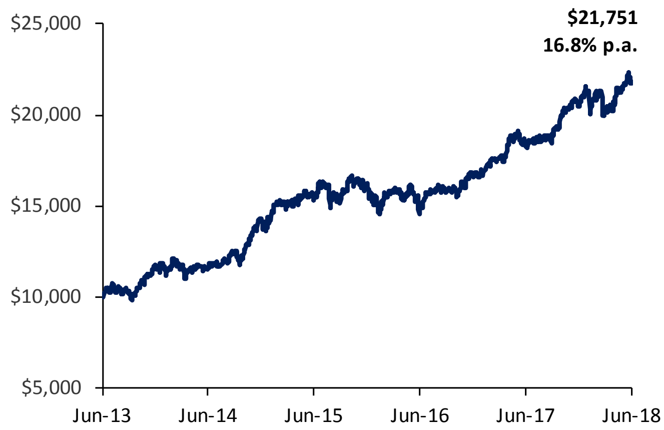
We are delighted to write to you on the fifth anniversary of the launch of the Magellan High Conviction Fund. If you had invested A$10,000 in the Fund on 1 July 2013, it would have grown to A$21,751 (including reinvested distributions) by 30 June 2018, a return of 16.8% p.a. net of fees and expenses.

The following table sets out the investment results of the Magellan High Conviction Fund since its inception in 2013.

Yearly results to June 30 since inception in Australian dollars after fees and expenses.*

Yearly results to June 30	Magellan High Conviction Fund (%)
2013-14	16.2
2014-15	31.9
2015-16	-1.3
2016-17	20.8
2017-18	19.0
Since inception (% p.a.)	16.8

Growth of A$10,000 invested in the Magellan High Conviction Fund over the five years to 30 June 2018.*



* 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.

Five years is the briefest amount of time that we would consider appropriate to judge the performance of a highly concentrated, unconstrained equity fund. We view the return achieved since the Fund's inception as satisfactory, and above our long-term objective. Please note that this performance was achieved during a period of sustained price appreciation across various asset classes.

Reflections

At this five-year mark, we want to offer insight into our investment principles, process and decision-making to help you assess the Fund's performance and better understand its objectives.

The Fund's investment principles recognise that superior risk-adjusted returns are available to investors who compound capital at satisfactory levels over long periods of time. The power of compound returns is well understood. However, most investors allocate capital in a manner that makes this outcome improbable. The Magellan High Conviction Fund seeks to be different.

The Fund takes a very long-term approach, always keeping capital preservation front of mind, but understanding that short-term price volatility is to be embraced and exploited opportunistically. The Fund invests in eight to 12 outstanding companies at prices that represent a discount to our assessment of intrinsic value. This degree of concentration, the select nature of the investable universe and constant valuation discipline results in the Fund bearing no resemblance to equity indices or the vast majority of peers. Constraints on the Fund are limited, allowing for real flexibility, objectivity and differentiation. Finally, the Fund focuses on risk-adjusted absolute returns rather than benchmark-relative returns. It is the compound rate of absolute returns that we achieve for investors over the longer term that matters.

The Magellan High Conviction Fund leverages Magellan's investment process, which integrates three key disciplines:

- Intensive bottom-up business and industry analysis to identify, value and monitor high-quality companies;
- Broad and detailed macroeconomic insights to manage exposure to aggregation and economic risks; and
- Rigorous portfolio construction and risk discipline. This includes hedging some, or all, of the Fund's foreign currency exposure.

Our investment research is best described as 'an inch wide and a mile deep'. We have a large team of talented investment analysts and portfolio managers whose jobs are to undertake detailed fundamental investment research and due diligence on companies and, importantly, to question why our investment case might be wrong. We are proud of the quality of the research of our investment team and believe that we have a first-rate 'batting average' in terms of stock selection and minimising our error rate.

Our philosophy and investment process are designed to increase the probabilities of disciplined, patient and rational decision-making in the pursuit of attractive risk-adjusted returns over time for the Fund's investors. The outcome is an unconstrained, highly concentrated portfolio of Magellan's highest-conviction ideas; a portfolio that necessarily looks and behaves differently from broader equity indices and most peers.

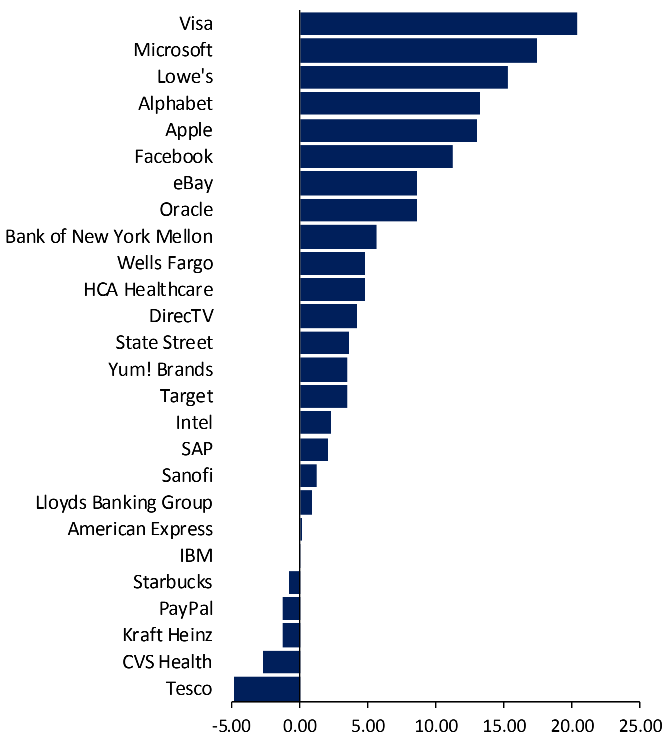
Some people might wonder if a portfolio of eight to 12 investments is too concentrated. Consider yourself having some unencumbered capital to invest. You approach a trusted adviser who suggests you invest in 10 unrelated local businesses, well understood by the investor, having dominant market positions and favourable prospects, run by able managers, and available at a reasonable price. You are advised to monitor the fundamental performance of these businesses over time. This is sensible and reasonable counsel, and most investors would not consider this portfolio as having excess concentration. However, when presented with an expansive investable universe of liquid securities whose prices change by the second, many investors feel the need to deviate from this concentrated investment approach. We think this is a mistake. As long-term investors, we believe the periodic diversion of business price and intrinsic value is advantageous to investors in the Fund.

The number of positions required to reduce the level of diversifiable risk in equity portfolios has been debated for decades. A 1968 paper by Evans and Archer was the first study to evaluate the reduction in portfolio risk as portfolio size increased. With standard deviation as a risk measure, the authors show that, on average, eight to 10 stocks are sufficient to achieve most of the benefits of diversification.

US investor Howard Marks once said that investment success is a function of being "different and better". We adapt his statement to suggest that success is a function of being different and right. We've established the case for the Fund's differentiation. But has our decision-making been 'right'? There are several ways to consider this.

The first way is to look at total returns. Since inception to 30 June 2018, the Magellan High Conviction Fund has delivered a compound annual growth rate of 16.8%. Over the same period, the Magellan Global Fund produced an annualised return of 14.3%. (Both figures include reinvested distributions and are net of fees and expenses.) The High Conviction Fund's annualised return exceeded return of our core Global Equity strategy (the Magellan Global Fund), which we regard as the best benchmark against which to judge the performance of the High Conviction Fund as it represents a concentrated portfolio of our 'best ideas'.

Magellan High Conviction Fund contribution to returns of stocks since inception to 30 June 2018 (%).*



* Inception date is 1 July 2013. In Australian dollars.

Another way to access our decision-making is to review our 'batting average'. In addition to the 11 holdings at 30 June 2018, the Fund has invested in 15 other businesses since inception. Of these 26 positions, 20 have delivered positive contributions (totalling 144%) to the Fund's total returns over this period. Of the six investments that detracted from returns since inception, two (Kraft Heinz and Starbucks) are current portfolio holdings. Realised investments that delivered negative results include Tesco (-4.9% of the total return of the fund), CVS Health (-2.7%), PayPal (-1.3%) and IBM (-0.1%). In the case of the first two investments, we misjudged the underlying economic moat of these businesses. Pleasingly, we quickly faced reality regarding each of these decisions and sold the positions. PayPal is recorded as a detractor but was spun out of eBay in July 2015 and held by the Fund for three months. The Fund held a position in eBay at inception and the combined eBay and PayPal positions delivered a considerable positive contribution to the Fund's returns.

The top five contributors to returns since inception include Visa (+20.3%), Microsoft (+17.4%), Lowe's (+15.3%), Alphabet (+13.3%) and Apple (+13.0%). Aside from Microsoft, all remain holdings in the Fund at 30 June 2018. It is interesting to note that the contribution from any of the Fund's five largest contributors over the past five years more than offset the losses from all detracting investments.

Reflecting on the past five years, we are pleased with the risk-adjusted returns earned for investors, while recognising the Fund's youth and the buoyant backdrop. The process to which we adhere has delivered favourable results to date. Future mistakes are inevitable, though we constantly seek to minimise their frequency and severity. It is important that we face reality when we make mistakes and we do not compound errors by letting emotions justify past decisions. Typically, when we make mistakes we face facts and take our losses. As Mae West said: "All discarded lovers should be given a second chance, but with somebody else." We will always be candid with you when we make mistakes.

Conservative investors sleep well

While global stocks have set record highs over the past 12 months, we are cautious on the outlook for equity markets and consider that risks are asymmetrical to the downside. Our caution is reflected by the fact that cash represented 18.4% of the portfolio at 30 June 2018.

Some people might consider that having such a large cash holding exposes investors to relative underperformance if equity markets rise. We have no fear of missing the tail end of an extended bull market. Renowned investor Sir John Templeton was perhaps best known for saying: "Bull markets are born on pessimism, grown on scepticism, mature on optimism and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell." ***In our view, only conservative investors sleep well.*** Implicit in conservative investing is the focus on the conservation of capital. As Warren Buffett has said, there are two rules in investing: 1. Don't lose money. 2. Don't forget the first rule.

At Magellan, we believe in the fiduciary concept of the 'prudent man rule' in managing money for our clients (and ourselves). This rule was conceived in the 19th century when a Massachusetts judge suggested trustees should "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

We have often stated that clients should be aware that we will not be overly concerned if we underperform a market benchmark in the short term. Given our approach is to build a portfolio of a small number of outstanding businesses (which, by definition, is substantially different in composition from any broad equity-market index), the probability of this occurring is a near certainty.

All our investments are made in accordance with our investment principles; to invest in outstanding businesses that have attractive underlying business economics because they are protected by sustainable long-term competitive advantages or, in Buffett's words, an "economic moat". In our opinion, investing in outstanding businesses at appropriate prices is a low-risk investment style and will produce more certain investment returns over time than many other investment approaches. Buffett wrote in his 1992 letter to shareholders: "Your goal as an investor should be simply to purchase, at a rational price, a part interest in an easily understood business whose earnings are virtually certain to be materially higher 5, 10 and 20 years from now." This test sounds easy but it is hard to put into practice as there are only a relatively small number of companies in the world whose earnings are almost certain to grow significantly in coming years. We would argue that many companies are entering the most disruptive business environment since the start of the industrial revolution so it is now even harder to find such businesses. We will clearly need to be on our game in the years ahead. Sir Frank Lowy, the founder of Westfield, once gave me some sage advice on the key to being successful: "Be paranoid"; that is, spend more time on thinking about what can go wrong than what will go right.

Our investment objectives are clear. We seek to deliver very satisfactory investment returns (a target average return of above 10% per annum after fees and expenses) over the medium to long term while minimising the risk of a permanent capital loss. We are happy to be judged on the absolute returns of our strategy over time, and our record at minimising the risk of a permanent capital loss. We recognise that some people are fascinated with comparing investment returns over short periods of time with a share-market index, such as the MSCI World Index. However, we feel strongly that people cannot retire on 'relative investment returns'. Only by generating investment returns that exceed the rate of inflation by a reasonable margin will investors meaningfully increase their wealth over time.

Market outlook

As noted, cash represented 18.4% of the portfolio at 30 June 2018. This caution is because we face an extraordinary cocktail of circumstances that skews risks to the downside.

- Asset prices are at, or near, record levels

Prices for sovereign, corporate and high-yield bonds and equities are at, or near, record levels thanks to the ultra-low policy interest rates and the massive quantitative-easing programs of the G3 central banks (the US Federal Reserve, the European Central Bank and the Bank of Japan) over the past decade.

- Central banks have commenced quantitative tightening

In response to the strengthening economic environment, the Federal Reserve is raising the cash rate and has commenced a pre-set program to shrink its balance sheet while the European Central Bank has announced that it will cease its asset-buying program by 31 December 2018. The combined impact of announced balance-sheet activities of the Federal Reserve and the European Central Bank will remove liquidity from global markets, resulting in a reduction in demand for bonds and other assets by these central banks of about US$1.5 trillion on an annualised basis from October 2017 to the end of December this year. We believe that a change in demand by the central banks of this magnitude is likely to have a meaningful impact on longer-term bond yields by early 2019.

- Late-cycle US fiscal stimulus

In our view, the Federal Reserve's strategy to tighten monetary policy in a smooth and well-foreshadowed manner has been complicated by the large fiscal stimulus being implemented by the Trump administration at the tail end of an extended economic expansion. The tax cuts and additional spending will make a fiscal injection into the US economy of nearly 2% of GDP per annum for the next two years. The US unemployment rate at 4% is near an 18-year low and the US economy has added jobs over the past 93 months, which is the longest such consecutive stretch on record. While there appear to be powerful longer-term secular forces at work that are likely to result in low inflation over the longer term, there is a significant risk that the size and timing of the US fiscal stimulus could trigger a jump in US inflation, in particular from stronger wages growth, over the next year or two. This could be highly problematic for the Federal Reserve and complicate its efforts to engineer a gradual tightening with a soft landing. We cannot think of a similar combination of circumstances in modern history. The cocktail of circumstances could be explosive. The best hope for investors is that either the US tax cuts and extra spending have limited effects on growth and inflation in coming years or the secular forces that have kept inflation low accelerate to offset any inflationary pressures from the fiscal stimulus.

We assess that there are three possible scenarios for markets over the next 12 to 18 months:

- <u>The first scenario is a continued US economic expansion without triggering a material increase in US wages growth or inflation.</u> In these circumstances, we would expect the Federal Reserve to increase short-term interest rates and to shrink its balance sheet broadly in line with current expectations. In these circumstances, it would be reasonable to expect that over the next, say, 18 months the US cash rate would rise to 3% to 3.5% and the 10-year Treasury yield would increase to about 4%. In this scenario, defensive equity assets, longer-term bonds and emerging-market equities are likely to underperform growth assets and economically cyclical assets, and some commodities are likely to outperform driven by the economic expansion. We would place slightly less than a 50% probability on this scenario.

- <u>The second scenario is where the Federal Reserve is forced to act more swiftly and forcefully than expected to counter inflationary forces.</u> It would be reasonable to assume that US longer-term bond yields could jump suddenly and meaningfully (above 4% compared with 2.86% for the US 10-year Treasury bond at the end of June), which could trigger the biggest slump on world share markets since the global financial crisis. **In our view, a 20% to 30% global stock market correction in the next 12 to 18 months is conceivable.** In these circumstances all equities are likely to be affected. We would put a similar probability on this scenario to the first or, in other words, we don't know which of these two scenarios is more likely.

- <u>The third scenario is where an external event occurs that causes the Federal Reserve and the European Central Bank to reverse course and put on hold any further tightening of monetary policy.</u> We believe that this is most likely to occur in circumstances of a significant event and, therefore, this scenario is likely to be negative for share markets. There is a remote possibility of a 'Goldilocks moment' where the central banks stop their plans to tighten money policy, longer-term bond yields fall and equity markets don't fall or even rise.

During the past year we have monitored several other risks for global stocks:

- Trade tensions between the US and its major trading partners
- Uncertainty in Italy

The past 12 months have seen a dramatic increase in international trade tensions. President Donald Trump has followed through on his demands that the US major trading partners reduce their bilateral trade surpluses and remove what he considers to be 'unfair' trade restrictions such as forced technology transfers and unequal tariffs. As the trade negotiations have involved the threat of tariffs on a large slice of exports to the US from major countries including China, Germany, Canada and Mexico, investors are worried about a slowing in global economic growth.

We believe that the most likely outcome is that negotiations will avert a full-scale trade war, and the US and its major trading partners will eventually agree to new trading arrangements. This view is based on an assessment that President Trump is probably most inclined to do a deal as no country, including the US, would benefit from a full trade war. This appears to be what the market is pricing. However, there is a risk that we and other investors are misreading President Trump's intentions; that he intends to fundamentally rewrite the trading relationships with the US major trading partners, and most importantly with China. This means he will not do a short-term deal until there are fundamental changes that would undermine China's long-term technological strength. China has clearly set out its intention to dominate critical technologies in its 'Made in China 2025' development plan. In these circumstances, the risks of a prolonged and deep trade war are higher than we are assessing. The Trump administration has publicly claimed it would have the upper hand in any tariff war with China given the large trade deficit the US has with China. We think that this view is simplistic and naïve. We believe that China will be reluctant to agree to concessions that will hamper its 'Made in China 2025' development plan and Beijing has substantial means at its disposal, including devaluing the renminbi and stimulating the domestic Chinese economy via the banking system, that could counteract the damage of higher US tariffs on exports from China. We note that the trade dispute comes at a time when the economy in China appears to be slowing as the government cracks down on the large shadow banking system and the US Federal Reserve tightens monetary policy. Given the uncertainties, caution is warranted.

The past six months have seen rising investor concern on the outlook for the eurozone. The Italian elections in March that took place amid heightened voter concerns about the economy and immigration proved inconclusive, and it took more than two months for Eurosceptic political parties to form a government. During negotiations to form this coalition, it was feared that fresh elections might be needed that could usher in a government that intended to exit the euro. The new coalition government has made no moves to exit the euro. It is more focused on confronting EU members on immigration and increasing government expenditure to help the economy in defiance of eurozone rules.

We think that the most likely outcome is ongoing disagreements between Italy and the eurozone but ultimately that Italy will receive some concessions and remain in the eurozone though any stand-offs during negotiations are likely to result in periods of increased market volatility. Domestic political constraints make such stand-offs likely. Greater sharing of the immigration burden is likely to be agreed but be politically difficult for some EU members such as Germany. Given Italy's government debt burden (at about 130% of GDP) and the potential for Italy's debt load to destabilise the eurozone, other euro-using members will be reluctant to allow Italy to substantially increase its budget deficit in the near term in the absence of meaningful microeconomic reforms, which will be politically difficult for Italy. The most likely path to an agreement is a period of increased market volatility (particularly for Italian government bond yields) that will force both sides to reach a compromise.

Portfolio positioning

Notwithstanding our cautionary outlook, we expect that our portfolio of 11 high-quality businesses should generate a satisfactory return over the medium to long term. In a world where the pace of change is accelerating, many traditional industry structures are being redefined and many previously strong businesses are being weakened or displaced. We seek high-quality businesses with long-term competitive advantages that are well positioned for this changing world.

Our portfolio seeks:

- High-growth investments that are likely to be clear winners from change and secular tailwinds over the next five to 10 years; and
- Investments that are resilient to disruption risks and attractively priced when assuming higher interest rates.

At 30 June 2018, the portfolio included:

- Advertising technology-platform companies (Facebook and Alphabet, the owner of Google) that represented 25% of the portfolio.
- Quick-service restaurant companies (Starbucks and Yum! Brands) that formed 11% of the portfolio. We view that these companies have unique longer-term competitive advantages that make their businesses defensive and resilient to disruption.

Top holdings of the Magellan High Conviction Fund at 30 June 2018.

Security	Weight (%)
Facebook	12.5
Alphabet	12.5
Kraft Heinz	9.2
Visa	7.8
Lowe's	6.3
Apple	6.3
Yum! Brands	5.9
Wells Fargo	5.4
Starbucks	5.4
HCA Healthcare	5.2
Oracle	5.1
Cash	18.4
Total	**100.0**

- An investment in Kraft Heinz that represented 9% of the portfolio. We believe an investment in Kraft Heinz is a long-term partnership with the world's foremost private-equity firm, 3G, which is well placed to consolidate the consumer-staples industry.
- A payment-platform company (Visa) that represented 8% of the portfolio. Visa possesses a classic 'network-effect' business model, connecting millions of merchants with billions of cardholders. The company provides the 'rails' upon which global electronic payment systems run.
- An investment in one of the world's most advantaged retailers (Lowe's), which is largely insulated from the shift to ecommerce. This investment comprised 6% of the portfolio.
- An investment in Apple that represented 6% of the portfolio. We believe that Apple is a highly advantaged consumer-services platform with high consumer loyalty and a long-term opportunity to monetise the one billion Apple devices in use.
- An investment in Wells Fargo that represented 5% of the portfolio. Wells Fargo is a leading banking franchise in the US, serving one-third of US households, which should benefit from rising US interest rates.
- An investment in HCA Healthcare that represented 5% of the portfolio. HCA Healthcare is the leading healthcare provider in the US with about 47,000 beds across its network of roughly 170 hospitals, 120 surgery centres and 250 urgent-care clinics.
- An enterprise-software company (Oracle) that comprised 5% of the portfolio. Oracle's products are deeply integrated within the operations of its business customers, which lowers the risk these customers will switch software vendors.

In seeking to minimise our portfolio's exposure to significant global political risks, we are mindful of our geographic exposures. We assess geographic exposure based on the sources of revenue for our investments. Many commentators look to the listing domicile of a stock to assess geographic exposure. They think, for example, that an investment in a US-listed stock creates a US-only exposure. We view this approach as simplistic and disconnected from reality, particularly when assessing a portfolio such as ours that mainly comprises multinationals. The underlying geographic exposure of our portfolio at 30 June 2018 comprised a 49% exposure to the US, 14% to emerging markets, 12% to Western Europe, 7% to the rest of the world, and 18% in cash.

Portfolio performance

Global stocks hit record highs in the 12 months to June 2018 as US companies posted higher-than-expected earnings, the internet giants surged on strong results and upbeat outlooks, the Federal Reserve slowly tightened US monetary policy as flagged, US Congress slashed the corporate tax rate, and the world's major economies grew in unison for the first time in about a decade. Gains were tempered when US President Donald Trump imposed import restrictions that could lead to trade wars with China and the EU, concerns mounted that US inflation might accelerate enough to prompt the Fed to tighten monetary policy more than expected, and worries rose about the regulatory outlook for US technology companies.

The portfolio recorded a return after fees of 19.0% for the 12 months. The stocks that contributed the most to the portfolio's performance included the investments in Visa (+4.3%), Facebook (+4.0%), Alphabet (+3.6%), Apple (+3.5%) and HCA Healthcare (+2.4%). Visa rose after its earnings topped analyst expectations for every quarterly reporting period released over 2017 and so far in 2018, aided by outperformance of Visa Europe relative to the expectations held at the time of the acquisition. Facebook surged on a view that privacy issues surrounding user data and other regulatory issues wouldn't impede user and advertising growth, which showed steady gains over the period. Alphabet rose after the company's large global advertising businesses (Search, YouTube, programmatic) grew revenue in excess of 20% and its non-advertising businesses (primarily Play Store, Google Cloud Platform and hardware like the Pixel and Google Home) generated even stronger growth. Apple rose on the strong growth in its services division. HCA Healthcare rallied on a robust operating performance that included more patient admissions and higher acuity cases and the company, with all its revenue sourced in the US, benefitted from lower US corporate taxes.

Stocks that had a negative contribution to the portfolio's return included the investments in Starbucks (-0.7%), Kraft Heinz (-0.6%) and Oracle (-0.5%). Starbucks slid when the coffee chain reduced full-year earnings guidance due to lower same-store sales growth in the US and China and US store closures. This news was partially offset by the announcement of a cost-cutting drive and an increase in the company's share-buyback program from US$15 billion to US$25 billion. Kraft Heinz fell as investors discounted the company undertaking a major acquisition, focused on the fact that the company was nearing the end of the cost savings stemming from the merger of Kraft and Heinz in 2015, and revenue growth slowed. Oracle fell due to slowing cloud revenue growth in fiscal 2018 and because the company reduced financial disclosures relating to its cloud business.

Hamish Douglass

Chief Executive Officer, Chief Investment Officer
and Lead Portfolio Manager

Chris Wheldon

Portfolio Manager

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Magellan Asset Management Limited

ABN 31 120 593 946, AFS Licence No. 304 301

MLC Centre, Level 36

19 Martin Place, Sydney NSW 2000 Australia

+61 2 9235 4888

info@magellangroup.com.au

www.magellangroup.com.au

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