HALF YEARLY INVESTOR REPORT
31 DECEMBER 2013
Magellan High Conviction Fund

Dear Investor,

I am delighted to write to you as an investor in the Magellan High Conviction Fund (the 'Fund') for the six months ended 31 December 2013.

Over the period and since its inception on 1 July 2013, the Fund returned 17.7% net of fees. Our High Conviction Strategy (since inception on 1 January 2013) has returned 51.3%, net of fees.

In general, equity markets have been strong over the past twelve months. This is reflected in the performance of the MSCI World Net Total Return Index in US Dollars, which has risen by 26.7%. Stock markets have been supported by strong flows into equity funds on the back of a recovering US economy, a stabilising environment in Europe, positive data out of China and the short-term positive impact of Abenomics in Japan. Since June, however, investors have become increasingly focused on the implications of the US Federal Reserve (the 'Fed') ending its quantitative easing programme ('QE'). This is evident in US 10-year Treasury yields, which have risen from 2.2% to 3.0% from 31 May to 31 December 2013, and in certain major currency movements. The Australian dollar, Indian rupee and Brazilian real, for instance, have depreciated against the US dollar by 6.7%, 8.6%, and 9.4%, respectively. We note that most equity strategies, including our own, appear to be doing well in this environment; a rising tide lifts most boats.

We do not manage the Fund against short-term performance metrics, and it is inevitable that it will underperform markets from time to time. The Fund's net return of 17.7% for the past six months underperformed the MSCI World Net Total Return Index AUD by 1.8%. This is of little relevance or concern to us.

We are happy to be judged on the absolute returns of our strategy over time. We feel strongly that people cannot retire on "relative investment returns"; only by generating investment returns that exceed the rate of inflation (ideally by a satisfactory margin) will investors increase their wealth over time.

We have no way of assessing how a company's share price will perform against an index over a short period of time. We are far more interested in where a company's share price may be in 3 to 5 years' time than where it may be in six months' time. In the short term, the stock market predominately reacts to the most recent information, both positive and negative, which can lead to large fluctuations in share prices that are often unrelated to the underlying value of a business. In the long term, however, share prices should broadly track the underlying intrinsic values of the business. This is what Benjamin Graham was referring to when he said: "In the short term the market is a voting machine and in the long term it is a weighing machine".

The concept of minimising the risk of a permanent capital loss is also integral to how we manage money. We believe that this central concept differentiates us from many of our competitors in the funds management industry. For many, risk is effectively measured as the danger of falling short of, or varying too far from, the benchmark or index, rather than the risk of losing capital for investors.

At Magellan, there are fundamental building blocks reducing risk and protecting capital:

1. Focus on quality companies. The core of our investment philosophy is to identify and invest in a portfolio of quality companies that have very attractive underlying business economics protected by durable competitive advantages (or in Warren Buffett's words, "economic moats"). Businesses that have these characteristics are far less likely to disappoint over time and, therefore, a focus on quality companies should produce fewer investment mistakes than would be made by investing in a portfolio selected randomly from all the companies listed on global stock exchanges. Our approach of investing in high-quality businesses is a key building block to minimising the risk of a permanent capital loss.

2. Incorporate a margin of safety. Stated simply, a margin of safety is the difference between the intrinsic value of a company on a per share basis and its current share price. We look at margin of safety through two lenses:
    - The first method is to estimate how much free cash flow a business is likely to generate over time. We then discount these cash flows, at an appropriate discount rate, to determine the present value of those cash flows. This represents our best estimate of the Intrinsic Value of the business. While the discounted cash flow process appears straightforward, it is difficult (if not impossible) to accurately estimate the free cash flow that businesses will generate over time. There are many variables that come into play when you are trying to forecast the future of businesses, for example changes in market shares, product innovation, selling prices, input prices, rates of inflation, interest rates, competitors, taxation, regulation, technologies, etc. Relatively small changes in assumptions, when projected out over many years, can significantly move estimates of intrinsic value. The reality is that there is a wide range of potential outcomes and it is therefore difficult to accurately estimate the Intrinsic Value of a company. However, we believe it is easier to assess the intrinsic value of a high-quality company than an average one. As Warren Buffett said: "Time is the friend of the wonderful company, the enemy of the mediocre," and "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price".

    - The second method is to estimate the Total Return (i.e. share price appreciation and dividends) that an investment is likely to generate over the next three years. We then compare our forecast Total Return with our pre-fees investment hurdle of a minimum of 10% per annum. The higher the expected Total Return above our investment hurdle, the greater the margin of safety.

3. Invest within your circle of competence. We believe that objectively understanding our circle of competence gives us a competitive advantage and should translate into better investment decisions and, therefore, lower-risk returns over time. I have previously described our approach to investment research as "inch-wide and mile deep". Some people have suggested that we are missing opportunities by not expanding our research coverage into new areas or reducing our minimum market capitalisation requirement for companies that we research. While there are many good investment opportunities outside our "circle of competence", or among smaller-capitalisation companies, I believe there is a substantial disadvantage that would accrue from trying to "focus" on too many things. I often describe an investor that tries to be an expert on everything as being like a "fly in bottle," i.e. moving around continuously but making no progress. I am extremely proud of the focus, depth and rigor of our industry and company research. We have a world-class team of 20 analysts across our core research areas of franchises, financials, food & beverage, healthcare, technology, infrastructure and macroeconomics.

4. Understand opportunity cost. Economists define opportunity cost as the cost of an alternative foregone to pursue a course of action. In our view, few investors properly consider opportunity cost when deciding to make an investment. An investment opportunity looked at in isolation can often look attractive. For example, let's assume that we are considering an investment that is priced at a discount of 15% to our assessment of Intrinsic Value and has a forecast 3-year Total Return of 12% per annum. Prima facie, this would appear to be an attractive investment considering our investment objectives. At its simplest, our opportunity cost is the next best alternative, which is buying a slice of the existing Fund. If our existing Fund was priced at a discount of more than 15% to intrinsic value and offered a Total Return of greater than 12% per annum then it would be dilutive to expected returns to undertake the new investment, notwithstanding it meets our return objectives. A proper assessment of opportunity cost does not only take into account the expected return but also risk. In assessing an investment opportunity, we look at what the investment will do to the Fund's expected return, quality attributes, aggregation risk, volatility, currency exposure and concentration. Only by properly assessing a multitude of factors is one able to assess the opportunity cost of undertaking a course of action. Often the best course of action is to invest in what you already own.

We continue to view the major current investment risk as what will happen when the Fed ends QE. The endgame for QE presents a risk for equity and other asset markets (particularly currency and bond/credit markets) due to the likely redistribution of global money flows and rising bond yields.

The critical issue is that there are now in excess of US$2.4 trillion of excess banking reserves on deposit at the Fed. This represents 14% of US gross domestic product and 17% of total US bank assets. To mitigate the potentially adverse effects of these excess reserves on inflation, the Fed would either have to substantially reduce their size or neutralise their impact. While the Fed has a number of tools at its disposal, there is no good historical precedent that can guide investors (or the Fed itself) as to what will happen to markets as QE unwinds. As I outlined in my last investor letter, there are three principal policies the Fed could implement to reduce or neutralise these excess reserves:

1. Increase the interest rate payable on excess reserves.
2. Sell longer-term Treasuries or mortgage backed securities in the open market.
3. Raise the reserve requirement.

We continue to believe that there are two main scenarios that could play out:

1. An orderly unwinding of QE. This scenario is predicated on a steady, but not sharp, US economic recovery with a gradual increase in the demand for credit. Against this backdrop, it is likely that the Fed could gradually reduce excess banking reserves by employing a combination of policies without any real threat of materially higher inflation expectations. Under this scenario, we would expect US short-term interest rates to rise to around 2-3% and the US 10-year Treasury yield to rise to around 4.5%-5.5% over the next one-and-a-half to two-and-a-half years. We would expect elevated market volatility and potentially some dramatic re-pricing of certain asset classes as this unfolds. We view this as the most likely scenario and one that does not overly concern us from an investment perspective.

2. A disorderly unwinding of QE. This scenario could be triggered by a sharp US economic recovery, coupled with a strong demand for credit. Such a scenario could be driven by a strong improvement in US house prices and a significant increase in demand for consumer credit, such as home equity loans. Under this scenario, longer-dated bond yields could start increasing rapidly as the markets lose confidence in the Fed's ability to exit QE in an orderly manner. In this environment, it is not unthinkable that US 10-Year Treasury yields could hit 8-10% over the next one-and-a-half to two-and-a-half years. We note that US 10-year bonds peaked at over 8% in the last bond market crisis in 1994.

   The good news, in this scenario, is that highly-elevated US Treasury yields are unlikely to prevail for an extended period. The Fed is likely to take strong action against any inflationary threat and it is likely global investors, banks and central banks would be attracted "like bees to a honey pot" to US 10-year Treasuries yielding 8-10%. As buyers enter the market the yields would fall to more normal levels.

   The bad news is that a rapid rise in the US 10-Year Treasury yield to 8-10% is likely to cause massive market dislocations and increase global systemic risk. We could see large and rapid falls in asset prices, major moves in currency markets and massive global monetary flows. Furthermore, liquidity could be rapidly withdrawn from certain emerging markets, possibly triggering an event similar to the 1997 Asian crisis. We consider the following major emerging markets to be particularly vulnerable to this style scenario: Turkey, South Africa, India and Indonesia. These countries are vulnerable due to a combination of budget and current account deficits, significant foreign debt exposures (especially short term and foreign currency debt), significant growth of domestic credit, and modest foreign currency reserves. Other countries to watch include Brazil and Mexico.

   We also believe that a rapid rise in longer-term US interest rates is highly likely to drive up longer-term interest rates around the world. This could place enormous pressure on certain European countries and could re-ignite the Euro crisis (we estimate the total sovereign debt funding requirement for the next two years for Portugal, Ireland, Italy, Greece and Spain is approximately €1.4 trillion). We consider that Portugal, Italy and Spain appear to be the most vulnerable European countries, each with annual funding requirements of around 20% of GDP. A crisis that affected multiple Eurozone countries would be beyond the capacity of the European Stability Mechanism, which only has existing available lending capacity of approximately €260 billion. This could force the European Central Bank ('ECB') to intervene in certain European sovereign bond markets, possibly on a massive scale, and would test the veracity of both the ECB's Outright Monetary Transactions policy and the political will of Eurozone members.

   Overall, we assess the risk of a disorderly unwinding of QE to be a "fat tail," or low-probability, scenario. Unfortunately, as we have repeated on many occasions, low probability does not mean zero probability.

We feel comfortable with the Fund's overall risk profile and construction, and believe it is likely to exhibit substantially less downside risk than the market in the event that a disorderly unwinding of QE occurs or another tail event strikes.

PORTFOLIO SUMMARY

Magellan High Conviction Fund - as at 31 December 2013	
Top 10 Holdings (Alphabetical Order)	**Sector**
Bank New York Mellon	Financials
DirecTV	Consumer Discretionary
eBay Inc	Information Technology
Lowe's	Consumer Discretionary
Microsoft Corp	Information Technology
Oracle	Information Technology
Target Corp	Consumer Discretionary
Tesco Plc	Consumer Staples
Visa Inc	Information Technology
Wells Fargo	Financials

As at 31 December 2013, the Fund consisted of 11 investments, with the top five investments representing 52.8% of the Fund at 31 December 2013.

The Fund remains fully invested despite the strong rise in equity markets over the past twelve months. We believe that its holdings remain attractively valued and should deliver attractive returns to investors over the next 3-5 years.

Over the six months to 31 December 2013, the three stocks with the strongest returns in local currency were Oracle (+27.4%), Google (+26.3%) and Bank New York Mellon (+22.7%) and the stocks with the weakest returns were Tesco (+0.8%), eBay (+3.2%) and Yum! Brands (+3.6%). On an absolute basis, the three largest stock contributors, in local currency, were Oracle, Google and Bank New York Mellon which added +2.8%, +2.3% and +2.3%, respectively. There were no detractors from absolute performance over the period in local currency terms.

The table below sets out some key statistics for the Fund's Portfolio as at 31 December 2013:

Average market capitalisation (US$ billion)	155
Average daily liquidity (US$ million)	649
Number of stocks	11
PE - 1 Year forward*	14.7x
Average return on equity (%)*	21.3
Beta*	0.88

*Magellan Asset Management Limited estimates

MARKET COMMENTARY

Europe

While there are signs that Europe's economic situation is stabilising, we remain highly skeptical that the region is on the verge of a sustained and meaningful recovery. The positive indicators include:

- The Eurozone running a substantial current account surplus, approximately 2% of GDP. Importantly each of Portugal, Ireland, Greece and Spain are now running current account surpluses.
- Industrial production growing marginally on an annual basis, having recently ended two years of contraction, although the experience of individual countries varies widely. We note that industrial production contracted

in France and dropped materially in Germany in October.
- Purchasing Managers' Indices (PMIs) for manufacturing and services indicating
- Relative unit labour costs having fallen materially in Portugal, Ireland, Greece and Spain during the past five years.
- Bank lending surveys indicating looser credit conditions for firms and consumer credit were expected in Q4 2013.

The indicators against a near-term cyclical recovery include:
- The Eurozone banking system remains under-capitalised. In the absence of Government-led recapitalisations, the most realistic way to recapitalise banks is via further balance sheet deleveraging.
- Notwithstanding recent announcements, there is a long way to go to establish a comprehensive European Banking Union.
- Portugal, Ireland, Italy, Spain, Greece and France remain fiscally stretched, with high levels of government debt and ongoing budget deficits.
- Unemployment remains above 10% in Ireland, Italy and France, above 15% in Portugal and above 25% in Greece and Spain.
- Weak price growth and falling inflation expectations have increased the risk of deflation. This could be a major problem for certain Eurozone economies that are reliant on nominal GDP growth and inflation to reduce their very large debt burdens.

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 deleveraging of bank balance sheets and households. We are cautious that Europe remains vulnerable to major external shocks. The near-term risk is a dramatic uplift in European sovereign bond yields, potentially triggered by a disorderly unwinding of QE in the US. This scenario would heavily test the resolve of the ECB to intervene in the sovereign bond markets of troubled EU countries in an unlimited way. We are also guarded on the resolve of European governments to step in to save banks that may fail in such a scenario and, therefore, remain cautious about holding investments leveraged to a European cyclical recovery at this point in the economic cycle.

United States

There are encouraging signs that the US is undergoing a modest to accelerating economic recovery. Key indicators of this recovery include:
- Non-farm payrolls that have increased by 173,000 per month, on average, over the four months to 31 December (which is equivalent to new job creation of 2.1 million per annum). Since the bottom of the recession in December 2009, approximately 6.6 million jobs (net) have been created in the US. The total number of people employed in the US is now only 2.0 million below the all-time high of around 147 million in November 2007.
- The unemployment rate falling to 6.7% in December from 7.5% in June. This compares with the peak unemployment rate of 10% in 2009.
- Continuing falls in the total number of unemployed people. At the end of December 2013 there were 10.4 million unemployed people compared to a peak of 15.4 million in October 2009.
- Mortgage debt rising 0.2% in the third quarter of 2013, the first increase since the first quarter of 2008.
- Average weekly earnings increasing 1.5% in the year to December (and are now 9.4% higher than in December 2009).
- Annualised automotive sales of >15 million in 2013, the highest since 2007.
- A continuing recovery in house prices. The S&P/Case-Shiller 20-City Composite Home Price Index is up 13.6% over the twelve months to 31 October 2013.
- A turn in housing starts from a post-GFC low of 478,000 starts in April 2009 to 1,091,000 in November 2013. We believe it is inevitable that housing starts will revert to more normal levels (around 1.3 million to 1.4 million per annum, close to the average since 1959) over the next one-and-a-half to two years. This will provide a significant further boost to the US economy and overall employment levels.

Some economists believe that the declining labour-force participation rate indicates that the unemployment situation is far worse than headline figures suggest. While it is true that the participation rate has decreased since 2007 (62.8% versus 66.0%), due in part to the economic downturn, it is important to understand that it has been declining since 2000 (from a peak of 67.3%) as a result of the aging demographics of the US population. Based on the decline in the participation rate of 0.2% per annum from 2000 to 2007, it would be reasonable to expect the participation rate may have reduced from around 66% in 2007 to around 64.8% in 2013 due to demographic trends.

Furthermore, a recent paper by the Philadelphia Fed argues that the increase in non-participation since the financial crisis was primarily due to three factors: an increase in retirements since 2010, a steady increase in disability rates and a sharp increase in other reasons for non-participation, including discouraged workers who gave up looking for work. These factors also offer a partial explanation for the fall in the employment to population ratio, which has improved only marginally from its 2010 low of 58.2% of 16+ year olds to 58.6% in December 2013, after peaking at 63.4% in 2006.

In our view, in the absence of a material negative shock, it is likely that the US economy will experience accelerating economic growth over the next 12 to 24 months. We note that there is likely to be a substantially reduced fiscal drag on economic growth in 2014 compared to 2013. Economists estimate government expenditure cuts and payroll tax increases decreased GDP growth by 1.5%-2.0% in 2013 and is expected to decrease GDP growth by 0.5% in 2014. We believe that with the budget deficit falling faster than expected (currently at around 3.6% of GDP), there is reducing pressure on Congress to force further near-term expenditure cuts. We note the recent bipartisan agreement on the US budget for the next two years, which will moderate some of the effects of recent budget cuts. In our view, it is likely that the US economy will accelerate in 2014, with risks on the upside.

China

In November, at the conclusion of the 3rd Plenum, the new Chinese Leadership announced a major reform package. Key reforms include:

- The deregulation of most state-controlled industries (including banking) to allow private businesses to enter, greater market access for foreign investors in service industries and the relaxation of pricing controls over resources such as natural gas and water.
- Financial system reforms including:
    - Acceleration of renminbi internationalisation and the opening of China's capital account.
    - Liberalisation of interest rates.
    - Establishing a bank deposit insurance scheme.
    - Bond market reforms, including the development of a municipal bond market, and the establishment of a more market-driven government bond yield curve.
    - IPO reform.
- Relaxation of the one child policy for parents who are only children.
- Improvements to social security/pensions, including raising the dividend payout ratio for State Owned Enterprises to 30% by 2020 (from 5-15% currently) and the transfer of shares in State Owned Enterprises to a consolidated pension fund.
- Ending the restrictive household registration system (hukou) in small cities, helping to increase workforce mobility and speed up urbanisation.
- Granting farmers greater property rights.

Notwithstanding the potential benefits of this important reform package, we believe that the days of 10%+ GDP growth are over. We also believe that the new leadership team is content with a lower but healthy rate of economic growth. The dramatic increase in total credit outstanding to around 200% of GDP over the past four years means that it would be highly dangerous to continue to pursue a credit fuelled growth model moving forward. Importantly, we believe that the systemic risk issues for China are relatively low as it has a closed capital account, net foreign assets and significant resources at its disposal to address issues at the local government level or in the banking or shadow banking system. Although risks in the housing market are cause for some concern, we believe that in the absence of rapid financial system liberalisation housing will continue to be an important store of value for Chinese savers and a beneficiary of China's ongoing urbanisation drive.

KEY STOCK IN FOCUS

DirecTV

DirecTV is the largest pay TV distributor in the world, with a total of 37 million subscribers across the US and Latin America. The company operates almost purely as a TV distributor, with virtually no in-house content production.

DirecTV currently derives around 75% of its earnings from the US, where it is the second-largest pay TV provider, with 20% market share. The US market is very mature, with 87% of households subscribing to pay TV.

The company's market position in Latin America is stronger than it is in the US. In Brazil, it is the number-two provider, with 31% market share and has won around 35% of new market subscribers over the last three years. In Spanish-speaking South America (PanAmericana), DirecTV has 25% market share, significantly ahead of the second placed provider (Argentinean Cablevision with 16%). DirecTV has won around 50% of new market subscribers across the PanAmericana region over the last three years. At the end of 2012, pay TV penetration was 27% in Brazil and 41% in PanAmericana, leaving these markets with significant growth potential.

<u>TV viewing demand</u>

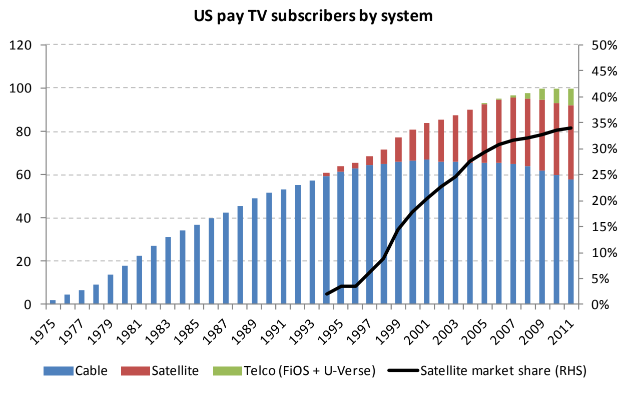
TV viewing is the most popular form of entertainment. In 2012, the average American watched over five hours of traditional (linear) TV per day. Despite the development of many competing forms of entertainment, such as video games, social networks, YouTube and Netflix (to name just a few), time spent watching linear TV has continued to increase.

Pay TV subscribers are very sticky. Although pay TV distributors have increased consumer prices above the rate of inflation every year for decades, even during the recent US consumer recession, this has never resulted in annual net subscriber losses for the industry.

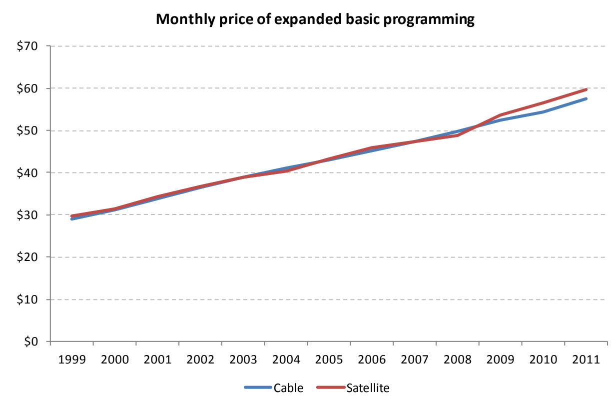
Approximately 50% of the programming costs for pay TV distributors are for sports programming, 96% of which is viewed live. A significant proportion of non-sports programming costs are for premium networks (15%), first-run hit shows on standard networks and news, all of which are predominately watched live. Live TV is ideally suited to satellite distribution because it is a same-to-all distribution method which, by its nature, implies that all viewers watch the same show at the same time.

<u>Pay TV competition & DirecTV's Competitive Advantage</u>

DirecTV's competitive advantage is derived from the lower capital cost per subscriber associated with satellite TV distribution compared to competing wireline pay TV distributors (cable and telco). This advantage has allowed DirecTV to win market share by offering superior packages with more channels of a higher signal quality (e.g. high-definition versus standard-definition), without charging a premium price (pay TV distributors offer broadly the same content). At the same time, its lower-cost network capacity has enabled the business to generate an average 72% pre-tax return on tangible capital over the last five years, while the two largest cable providers, Comcast and Time Warner Cable, have earned only 15% and 13% average returns, respectively, over the same period.



Source: DirecTV, NCTA



Source: FCC "Report on Cable Industry Prices" 2001-2011

Going forward, the increased adoption of high-definition (HD), and the development of ultra-HD, will drive the need for distribution systems to increase their capacity. Importantly, this means that DirecTV's competitive advantage will be maintained. The lowest spec version of ultra-HD (4k) requires roughly four times the capacity of HD (using the same compression technology).

Key Threats

There are a number of potential threats to DirecTV's investment case, although we believe the current share price over emphasises these risks.

The most significant threat to DirecTV's economic moat is the potential for a broad deployment of fibre-to-the-home networks, which would have significantly higher capacity than existing cable and satellite systems. However, we believe that the capital costs associated with building out such a network would be prohibitively high for a rational investor. We therefore judge the likelihood of a broad fibre upgrade in the US, at least in the medium term, to be low.

In the case of internet TV, the largest distributor, Netflix, currently delivers only 4.4% of the viewing hours of pay TV, yet it represents 33% of peak time internet traffic (despite only using lower-quality signals). Internet TV would require a massive increase in internet capacity if it were to have the ability to challenge existing pay-TV distributors; however, cable companies are the largest providers of high-speed internet in the US and they are not incentivised to facilitate the expansion of internet TV with cheap, high-capacity internet.

DirecTV also faces potential risks from rising programming costs. We consider the balance of power between distributors and content providers to be relatively even, particularly for large distributors like DirecTV who use their size to negotiate more favourable programming rates. Furthermore, it is in the interest of both distributors and content providers to avoid programming black-outs as both parties face significant financial losses if they occur.

Investment thesis

DirecTV's operating and financial performance has been very strong, generating EBITDA growth of 40% per annum over the last decade and repurchasing more than 60% of its share capital since it began its buyback program in 2006. We believe its market leading competitive positions will continue to drive strong returns and more than outweigh the near-term macroeconomic risks in Latin America.

Yours sincerely,

Hamish Douglass
Lead Portfolio Manager
Magellan High Conviction Fund
January 2014

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