Fund Update: 30 September 2014

MAGELLAN ASSET MANAGEMENT LIMITED

Magellan Global Fund

ARSN: 126 366 961

Key Facts

Portfolio Manager	Hamish Douglass
Structure	Global Equity Fund, $AUD unhedged
Inception Date	1 July 2007
Management & Administration Fee[1]	1.35%
Buy/Sell Spread[1]	0.10%/0.10%
Fund Size	AUD $5,974.4 million
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (MSCI World Net Total Return Index (AUD)) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

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

AUD Performance[2]

	Fund (%)	Index (%)[3]	Excess (%)
1 Month	5.4	4.0	1.4
3 Months	6.1	5.5	0.6
6 Months	6.1	8.7	-2.6
1 Year	16.7	19.9	-3.2
2 Years (% p.a.)	25.2	26.6	-1.4
3 Years (% p.a.)	24.1	22.1	2.0
5 Years (% p.a.)	16.6	11.1	5.5
7 Years (% p.a.)	10.9	2.9	8.0
Since Inception (% p.a.)	10.2	2.6	7.6

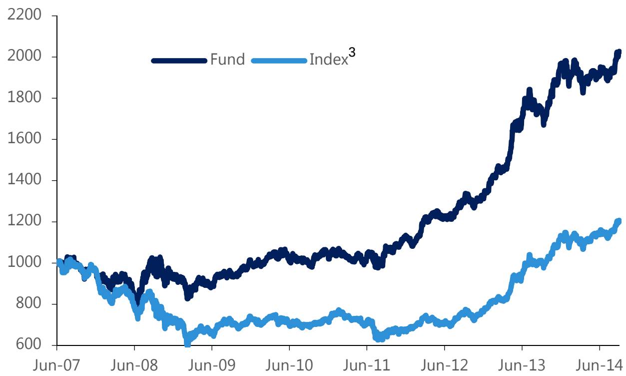
Top 10 Holdings

		% of Fund
eBay Inc	Information Technology	5.9
Microsoft Corp	Information Technology	5.6
Wal-Mart Stores Inc	Consumer Staples	5.3
Yum! Brands Inc	Consumer Discretionary	4.7
Nestlé SA	Consumer Staples	4.7
Target Corp	Consumer Discretionary	4.6
Lowe's Co Inc	Consumer Discretionary	4.5
Oracle Corp	Information Technology	4.5
Sanofi-Aventis	Health Care	4.3
Visa Inc	Information Technology	4.1

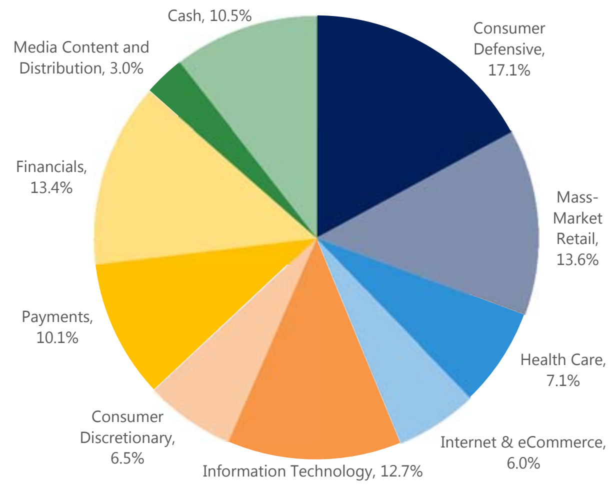
Regional Breakdown

	% of Fund
Multinational[4]	42.1
North America	40.6
United Kingdom	6.8
Australia	0.0
Europe	0.0
Japan	0.0
Asia Ex-Japan	0.0
Cash	10.5
Total	**100**

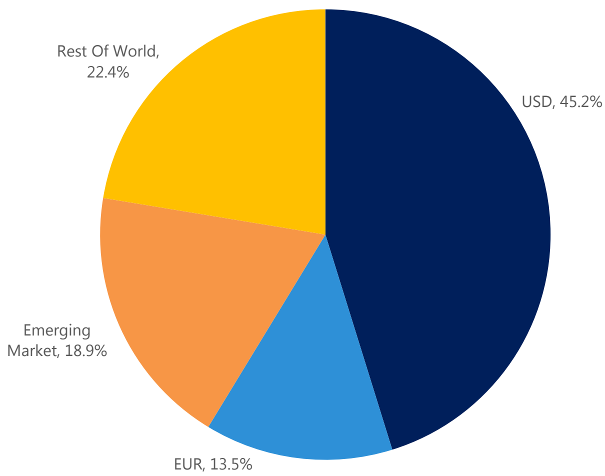
Performance Chart growth of AUD $1,000[2]



Industry Exposure by Source of Revenues[5]



Geographical Exposure by Source of Revenues[5]



[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 2007.
[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 – Magellan defined sectors.

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 27 investments (compared to 28 investments at 30 June 2014). The top ten investments represented 48.2% of the Fund at 30 September 2014, while they represented 51.2% at 30 June 2014.

During the quarter to 30 September 2014, eBay, Microsoft, Lowe's and Target all contributed strongly to performance, further assisted by USD strength. Microsoft's cloud products drove strong performance in its core enterprise business. eBay continued to recover from its data breach and provide solid operating metrics. Its shares jumped on 30 September after announcing plans to spin off PayPal, its online payments business. Lowe's 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.

Yum! Brands and Adidas were small detractors in the quarter. Yum! Brands fell on health and safety concerns relating to one of its meat suppliers in China, while Adidas declined due to concerns over its exposure to Russia, weakness in its golf business and rising marketing costs.

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.

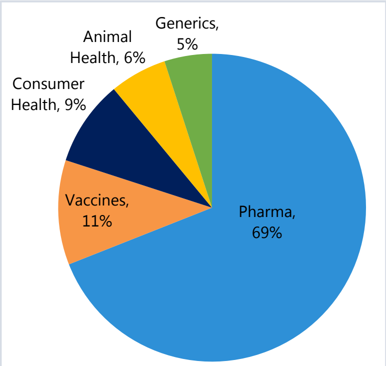
The Fund remains positioned to benefit from a strengthening US economy, along with normalisation of interest rates and capital market activity.

Key Stock in Focus

SANOFI

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, despite 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.