

Investment Manager's Report

Dear Investor

I am delighted to write to you as an investor in the Magellan Global Fund.

For the 6 months to 31 December 2009 the net Fund return was 12.34%, which exceeded the market benchmark by 2.47%. Since inception of the Fund on 1 July 2007, the net fund return has been -0.44% which has exceeded the market benchmark by 26.95%. Whilst we are satisfied that the Global Fund has preserved investors' capital during this extremely difficult period, we are mindful that the absolute return remains below our objective of delivering above our target 9% per annum over the medium to long term. We remain confident that over time our investment strategy is likely to deliver satisfactory investment returns whilst minimising the risk of a permanent capital loss.

It is important for investors to appreciate that we are in the business of "investment" and not "speculation". To be in the business of "investment" is to have a mindset that you are buying an entitlement to a share of the cash flows that a business will produce over time. Our investment horizon is the medium to long term, as it is only over this time frame that an investor can share in the cash flow generation of a business. Conversely, "speculation" involves trading in anticipation that a share price will move upwards or downwards over a short time horizon, typically less than 12 months. A speculator's portfolio will typically have high turnover whereas an investor's portfolio should exhibit relatively low turnover as individual investments will usually be held for the medium to long term.

In the 2008 annual investor letter I quoted John Bogle, founder of The Vanguard Group, who said in a speech to a conference of Financial Planners:

"Investing to me, is all about the long-term ownership of businesses, focused on the gradual accretion in intrinsic value that is derived from the ability of our corporations to produce the goods and services that our consumers and savers demand, to compete effectively, to thrive on the entrepreneurship, and to capitalise on change, adding value to our society..."

"Speculation is just the opposite. It represents the short term, not long term, holding of financial instruments, not businesses, focused (usually) on the belief that their prices, as distinct from their intrinsic values, will rise."

When making an investment decision we are assessing 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 cashflows. This represents our estimate of the intrinsic value of the business. We then seek to make investments when we believe that the share is trading at a discount to our assessment of the business's intrinsic value. We do not make decisions on the basis of where a company's share price will move over the short term. I am reminded of the words of Warren Buffett when he wrote: "I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years."

As an investor in the Global Fund you should be aware that we will not be overly concerned if we underperform some short term performance benchmark. Given our approach outlined above, the probability of this occurring is a near certainty. We simply will not make investment decisions designed to outperform the

market on a short term basis. All our investments will be made strictly in accordance with our investment philosophy and with our objectives of delivering very satisfactory investments returns (i.e. a target above 9% per annum) over the medium to long term whilst minimising the risk of a permanent capital loss.

We firmly believe that if we are approximately correct as to how much free cash flow a business will generate over time, and we make an investment in the business at an appropriate discount to our assessment of intrinsic value, then it is likely that over time the investment will generate a satisfactory investment return.

Whilst the investment process appears straightforward; in our view it is very difficult (if not impossible) to accurately estimate the free cash flow that many businesses will generate over time. The reality is that there is a wide range of potential outcomes for many businesses and therefore it is difficult to accurately estimate their intrinsic values. There are many variables that come into play when you are trying to forecast the future, for example changes in market share, selling prices, input prices, the potential for emergence of new competitors, the potential for emergence of new technologies or products etc. I am reminded of the advice of Thomas Rowe Price: "No one can see ahead three years, let alone five or ten. Competition, new inventions – all kinds of things – can change the situation in twelve months."

The core of our investment philosophy is to invest in outstanding businesses that have very attractive underlying business economics which are protected by sustainable long term competitive advantages, or in Buffett's words an "economic moat". We believe that it is easier to assess the intrinsic value for outstanding businesses as they are more resilient to change and their future cash flows tend to be more predictable. In our view, investing in outstanding businesses at appropriate prices is lower risk and will produce more certain investment returns over time than many other investment approaches. In our view the light really went on for Warren Buffett (with guidance from Charlie Munger, his business partner) and Phil Fisher, author of *Common Stock and Uncommon Profits* (1958) and *Conservative Investors Sleep Well* (1975)), when he determined "It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price."

We consider each of the key investments in our portfolio to be outstanding companies with strong competitive advantages which will protect their fundamental business economics for many years to come.

PORTFOLIO SUMMARY

Magellan Global Fund - as at 31 December 2009			
eBay	7.93%	Macquarie Infrastructure Group	4.60%
McDonald's	6.69%	PepsiCo	4.56%
Yum! Brands	6.65%	Coca-Cola	4.50%
Procter & Gamble	6.52%	Tesco	4.18%
Wells Fargo	6.05%	Wal-Mart	3.90%
Nestlé	5.52%	Google Inc	3.87%
US Bancorp	5.16%	Other	16.31%
Kraft Foods	4.85%	Cash	4.01%
American Express	4.71%	Total	100%

As at 31 December 2009 the Global Fund's portfolio consisted of 23 investments (in comparison with 25 investments at 30 June 2009) and over the same period we decreased our cash weighting from 12.67% to 4.01%. The top 10 investments represented 58.67% of the portfolio at 31 December 2009 compared with 58.36% at 30 June 2009.

The continued decrease in cash weighting from 12.67% to 4.01% is consistent with our view that the risk of financial Armageddon has passed and it is an attractive time to be investing in a carefully selected portfolio of stocks. We continue to believe that the Global Fund's portfolio of investments is well placed to deliver very satisfactory investment returns over the next 3 to 5 years whilst minimising the risk of a permanent capital loss.

The major changes to the Fund's portfolio during the six months from 30 June 2009 have been:

- the introduction of three new investments (including the investment in Kraft);
- an increase in weighting towards selected infrastructure stocks – most notably the holding in Macquarie Infrastructure Group;
- an increase in the weighting in Wells Fargo; and
- a reduction in the holding in Reckitt Benckiser.

As part of our constant appraisal of the relative attractiveness of available investment opportunities, we have continued to improve the quality of our portfolio over the past six months (particularly with the sales of the positions in Lloyds Banking Group and Nutrisystem) and we are currently very comfortable with the entire portfolio. I normally detail investment mistakes that I feel I have made over the period. Fortunately, and possibly due to the more benign market conditions, I am happy to report that there are no glaring faults to report over the past six months. There are, of course, things I could have done better over the past six months, like maintaining the weightings in both American Express and Google as their share prices rose. Unfortunately, it is a virtual certainty that I will make mistakes in the future, and there could well be mistakes in the current portfolio of which I am unaware. When I become aware of any errors of judgement I will continue to candidly report these to you.

We continue to hold approximately 50% of the Fund's portfolio in multinational consumer franchises that generate at least 20-25% of their sales revenue from emerging markets and have a very low exposure to cyclical, or consumer discretionary, businesses. We remain cautious about the outlook for economic growth in the major developed economies over the next 5-10 years and we strongly believe that these companies are well positioned to prosper, almost irrespective of the growth outlook for the developed world. In our view these companies are very well positioned to benefit from ongoing urbanisation and the very substantial growth in the middle class in the major emerging markets over the next 10, 15 and 30 years.

The portfolio remains highly concentrated towards the four key investment themes on which we are focused:

- Investing in leading multi-national, non-discretionary consumer franchises which are likely to exhibit mildly accelerating growth over the medium to longer term due to their ability to capture growth from urbanisation and the strongly growing middle class in the emerging markets – key investments include McDonald's, Yum! Brands, Procter & Gamble, Nestle, Pepsico, Kraft Foods and Coca-Cola.
- Investing in companies which exhibit strong "network economics" – key investments include eBay, American Express and Google.
- Investing in leading, retail-focused banking institutions that exhibit significant capital strength which are likely to emerge from the financial crisis with even stronger market positions and profitability – key investments include Wells Fargo and US Bancorp.
- Investing in the low cost, market leading, mass market, non-discretionary retailers – key investments include Wal-Mart and Tesco.

Investors may be interested in the rationale for investing in Macquarie Infrastructure Group (“MIG”) as it does not neatly fit with the investment themes outlined above. Firstly, and importantly, infrastructure is clearly within our investment team’s “circle of competence”. We have an outstanding infrastructure investment team lead by Gerald Stack and Dennis Eagar. Secondly, we view MIG as a highly attractive and undervalued investment opportunity. MIG is currently in the process of undertaking a demerger to split into two separately listed infrastructure companies – Intoll and Macquarie Atlas Roads. The Global Fund is particularly attracted to Intoll as it will own two highly attractive toll road assets: 25% of the M7 toll road in Sydney; and 30% of the 407 ETR toll road in Toronto, Canada. In the view of our infrastructure team, the 407 ETR toll road is probably the most attractive infrastructure asset in the world and Intoll’s equity stake will represent 80-90% of the intrinsic value of Intoll. The 407 ETR toll road concession agreement gives the concessionaire the right to increase tolls at their sole discretion for the duration of the remaining 89 years of the concession). This truly is a unique asset which effectively exhibits the pricing power of an unregulated monopoly as it is only subject to competition from a highly congested freeway. Importantly, post the demerger Intoll will be internally managed and relatively conservatively financed for the nature of the assets. Macquarie Atlas Roads is more complicated and holds less attractive assets, however at the Global Fund’s entry price into MIG we do not believe that we paid any value for this investment.

MARKET COMMENTARY

There continues to be considerable debate on the shape of the economic recovery in the major economies around the world. In our view, the factual situation is different in many economies and it is difficult to generalise of how a “global recovery” is likely to unfold. We continue to believe that the economic background surrounding the current situation in many developed economies is very different to past recessions (particularly the level of household debt) and hence the duration of the ultimate recovery is likely to be longer than in the past.

A recent paper by The McKinsey Global Institute titled *Debt and deleveraging: The global credit crisis and its economic consequences* (January 2010) concluded:

“We find that leverage remains very high in at least ten sectors of five major economies – Canada, Spain, South Korea, the United States, and the United Kingdom. While we cannot say for certain whether these sectors will deleverage, we do know that nearly every significant financial crisis in the post-World War II period was followed by a lengthy and painful period of deleveraging. These episodes lasted on average six to seven years, with total debt as a percentage of GDP declining by roughly 25%. GDP contracted in the initial years of deleveraging but rebounded in the later years. If history is a guide, therefore, we would expect a significant period of deleveraging to come, which will dampen GDP growth.”

The McKinsey paper also concluded that the deleveraging process may start later and take longer than historical situations would suggest. They comment:

“Most of the past episodes involved one economy or a few relatively small economies following a national or regional crisis. Today, however, the crisis is global in scale, affecting the world’s biggest economies, many of which are still in recession or experiencing very tepid growth. It is difficult to see how all the affected economies could simultaneously deleverage by boosting net exports, as many have done in the past.”

“Moreover, rising government debt may delay the start of deleveraging. Government debt is projected to increase sharply in Spain, the United Kingdom, and the United States. This could more than offset any deleveraging by the private sector, and thus delay the point at which an entire economy’s debt to GDP declines.”

In our view, over the next 12 months the United States, and a number of other major developed economies, are likely to report accelerating economic growth which will lead many to the conclusion that the United States and other companies are experiencing a typical “V” shaped economic recovery and that the “deleveraging story” is a myth in economists’ imaginations. We remain very cautious around the sustainability of a strong recovery in the United States as the recovery is likely to be largely supported by the continued massive fiscal and monetary stimulus being injected into the economy.

We regularly review the state of the US Federal Reserve’s Balance sheet to ascertain the extent of quantitative easing and whether the resultant increase in the money supply has found its way into the economy. Of particular interest is the size of the Federal Reserve’s Balance Sheet which has grown from around US\$940 billion in August 2008 to around US\$2.275 trillion in January 2010. Also reserves balances (or deposits) held with the Federal Reserve from US banks have increased from US\$11 billion to US\$994 billion over the same period. The increase in the size of the Federal Reserve’s balance sheet largely reflects the purchase of US treasuries and mortgage backed securities under the quantitative easing program. It is particularly noteworthy that the increase in the money supply from the quantitative easing program has largely been put on deposit with the Federal Reserve. As the economy starts to pick up it is likely that banks will start to withdraw these reserve balances and inject the money into the economy via the extension of credit. It is interesting that over the last month the reserve balances actually fell by around US\$130 billion, which is the first time they have fallen since the Federal Reserve commenced its quantitative easing program. In our view the most probable outcome is that the US economy will accelerate in the short term as this money finds its way into the economy. In fact, given the quantum of the reserve balances it is possible that the US economy could actually accelerate faster than current near-term economic forecasts predict.

It is highly likely if the US economy starts to pick up this stimulus will need to be withdrawn. In our view when the Federal Reserve commences its “exit strategy” both short term and long term interest rates will be pushed up which will act to slow an economic recovery. We continue to believe that it is likely (although not certain) that highly leveraged economies (like the US and the UK) which have been severely impacted by the financial crisis will deleverage, resulting in subdued economic growth for an extended period of time. We hold this view notwithstanding the likelihood that economic growth will accelerate over the next 12 months.

Although we remain cautious about the economic outlook we remain of the view that it is an excellent time to be investing in a portfolio of carefully selected companies. We believe that the Global Fund portfolio is well placed to prosper if deleveraging takes hold in a number of major economies and will do somewhat better if it does not occur.

Interestingly, we have a more positive outlook for Australia over the short to medium term as we do not believe that the financial crisis had a severe enough impact on the economy, and on household psychology, to cause deleveraging at this stage. Nor has the Reserve Bank engaged in quantitative easing which will need to be reversed. We do note however, that the Australian consumer is also highly leveraged and at some point in the future this leverage will need to reduce.

KEY STOCK IN FOCUS

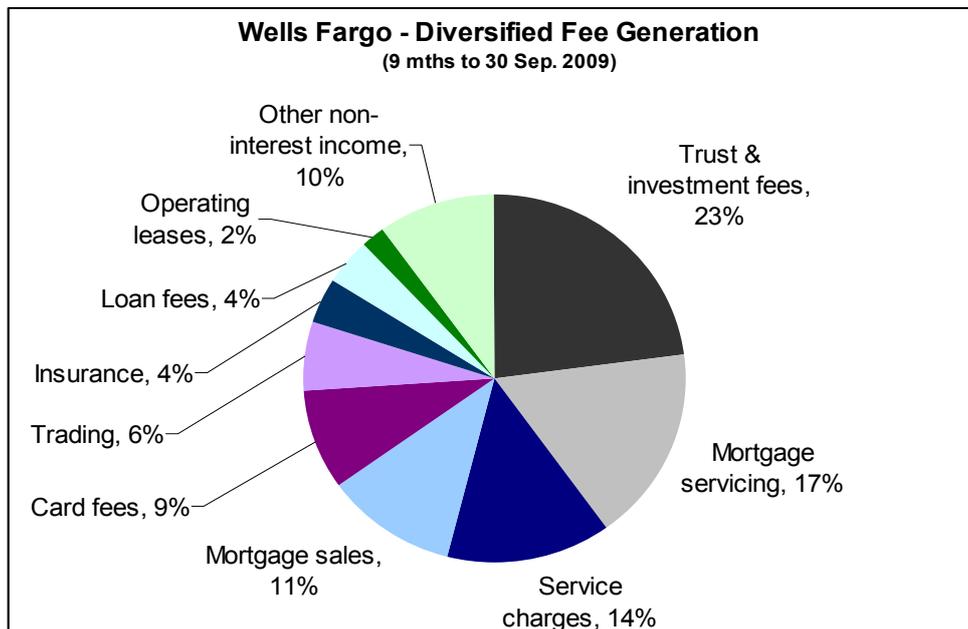
WELLS FARGO

Wells Fargo has the United States’ leading bank distribution network serving one in three US households through more than 6,650 branches across 39 states and 12,350 ATMs. The bank also has America’s

second largest deposit base, with around \$800 billion in deposits. Wells Fargo was founded in 1852 in San Francisco to support businesses in the California gold rush. Wells Fargo has undergone two large transformations in recent history. The merger with Norwest in 1998 deepened and expanded the bank's franchise across the West and Midwestern United States, as well as greatly strengthening Wells Fargo's consumer-oriented sales culture. The recent acquisition of Wachovia brings Wells Fargo a very strong retail bank franchise in East and South Eastern United States as well as national capital markets and wealth management businesses.

One of the significant attractions of Wells Fargo is the diversity of its revenue streams, with over 80+ businesses within the banking and financial services spectrum. Further, Wells Fargo has leading market shares in higher-growth states and leading product positions. It has the #1 deposit market share in 44% of the 39 states in which it operates and a top 3 deposit share in 93% of those 39 states. It is also a leader in a number of areas including; the largest number of mortgage stores (2,200) in America; the largest mortgage producer; the leading lender to small business; largest bank-owned insurance broker. Wells Fargo is the number 2 bank in the following businesses; deposits; issuer of debit cards; full-service brokerage provider; family wealth provider.

The leading franchise positions of many of its businesses provide Wells Fargo with its economic moat. In particular, Wells Fargo's success in cross-selling products to both its retail and corporate customers help to enmesh customers within its well-regarded product offering, providing a steady stream of recurring revenues. For example, Wells Fargo's retail household customers own 6 products, on average, compared to an average of 2 products for most financial institutions. Wells Fargo's very strong deposit franchise also provides it with access to low cost funding, which help support its margins and provide resilience in adverse funding markets.



The financial strength of Wells Fargo has been reinforced by capital raisings of \$33bn since November 2008 and the full redemption of preferred shares ("TARP") mandatorily issued to the US Treasury. Risks from credit losses remain, with losses anticipated to continue to increase as the recession and high levels of unemployment result in higher loan defaults. However, the stability of Wells Fargo's diverse revenue streams is expected to cover likely losses as well as contribute to capital strength.

Historically, Wells Fargo has achieved 15% compound annual growth in pre-tax pre-provision earnings in the 10 years to 2008, along with consistent 15% dividend growth since 1989 until 2008. Wells Fargo's 5

year average return on equity has been 18%, compared to the peer average of 13%. Management expects the Wachovia acquisition to provide a return on invested capital of greater than 20%.

Wells Fargo is the leading retail and small business oriented bank in the United States. It has superior positions in higher growth states. The diversity and security of its revenue streams, together with the integration of Wachovia and normalization of credit losses, will continue to provide GDP+ earnings growth.

Yours sincerely



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