Product Assessment

Zenith Investment Partners Pty Ltd

Highly Recommended
Recommended
Approved
Not Approved
Redeem

Magellan Global Fund

30 Sep 2007

Zenith regards Magellan Asset Management as one of the highest quality start-up boutique funds management businesses we have reviewed in recent years. As such despite the Global Fund's relative infancy (launched in July 2007), it offers an excellent opportunity to get in at the "ground level" and warrants immediate inclusion as a "best of breed" candidate within its asset class.

Magellan's co-founders Hamish Douglass (ex Deutsche) and Chris Mackay (ex UBS) are highly credentialed, well connected and experienced investment professionals who exhibit an intimate understanding of financial markets and valuation. They have pulled together a solid investment team (14 in total) from multiple sources with the exception of infrastructure where the three member team moved en masse (all ex Capital Partners).

The Manager's investment style is best described as a "value orientation with a quality overlay". Magellan is almost "Buffet like" in its philosophy with a "margin of safety" sought on its intrinsic valuation which models discounted cash flow (DCF) using a weighted cost of capital methodology. Capital preservation is also a strong underlying theme found throughout the process given the Manager's focus on quality.

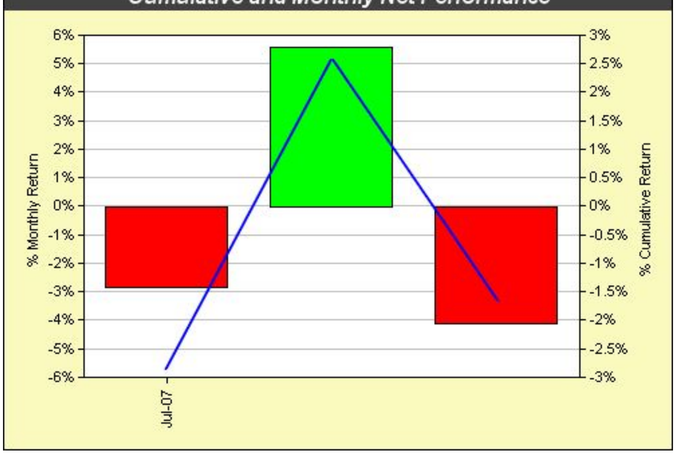
An approach of investing only in its "circle of competence" which narrows its investment universe to 65% of MSCI constituent stocks (4,000 stocks), is rated highly by Zenith as it ensures a focused and disciplined investment approach. Depth of investment due diligence is excellent with Magellan's extensive modelling regarded as one of its key drawcards relative to competitors. Portfolio construction is robust and strongly intertwined with the stock selection mechanism which ensures an appropriate risk management framework is maintained while still giving portfolio manager discretion (Hamish Douglass).

The Fund itself is concentrated (25-50 securities), agnostic to benchmark and absolute return focused (can hold significant cash during adverse market conditions). The portfolio's neutral position is to be unhedged, except for in extreme circumstances, and portfolio turnover is expected to be low (<25% p.a.).

Overall the Magellan Global Fund has been rated RECOMMENDED and endorsed as a candidate for client portfolios particularly when blended with a global growth style orientated product or with an allocation to global resources, real estate or small companies, which is not a focus under its "circle of competence" approach.

Key Features	***Description***
APIR Code	MGE0001AU
Asset Class	International Shares
Sub-Asset Class	Global (Unhedged)
Investment Style	Value
Benchmark	MSCI World ex Aust $A
Recommended Investment Timeframe	5 + years
Chairman, PM of Magellan Global Fund	Hamish Douglass
Investment Team Size	14

Cumulative and Monthly Net Performance



Performance Analysis

Performance Statistics	***Since Inception***	***3 Mths (%)***
Performance - Fund	-1.66	-1.66
Performance - Benchmark	-2.11	-2.11

Inception Date: Jul 2007

As at 30 September 2007 the Fund held 20 stocks, which is under its targeted range of 25 to 50 securities but it is still in the process of being invested. The total equity position accounted for 65.4% of the portfolio with 34.6% in cash. This cash weighting is higher than what we would normally expect to see as a result of the Fund still being in its infancy yet to be fully invested (launched July 2007). Furthermore the Manager's view is that a 25%+ risk still exists of a significant credit related event impacting on equity markets.

The Fund's top five positions as at 30 September include eBay Inc (online auction site), Yum Brands Inc (world's largest restaurant company - KFC, Pizza Hut etc), American Express Company (financial services), Abercrombie & Fitch Co (US-based lifestyle & apparel company) and Tesco (UK-based international grocery and general merchandising chain).

Investment Personnel

Name	Title	Time with Manager
Hamish Douglass	Chairman, PM of Magellan Global Fund	1 Yr(s)
Chris Mackay	Deputy Chairman / Chief Investment Officer	1 Yr(s)
Gerald Stack	Portfolio Manager	9 Mth(s)
Dennis Eager	Senior Analyst	9 Mth(s)
Alex Hone	Analyst	9 Mth(s)
Jacqueline Fernley	Sector Head - Consumer & Retail	9 Mth(s)
Dan Ellis	Analyst	8 Mth(s)
Nikki Thomas	Senior Analyst	9 Mth(s)
Michael Young	Analyst	8 Mth(s)
Domenico Giuliano	Sector Head - Financial Services	9 Mth(s)
Vihari Ross	Analyst	6 Mth(s)
Henry Pennington	Analyst	1 Yr(s)
Michael Leonard	Analyst	9 Mth(s)
Chris Wheldon	Analyst	0 Mth(s)

Fund Manager - Background

Magellan Asset Management was incorporated in July 2006 and is a wholly owned subsidiary of the ASX-listed, Magellan Financial Group (MFG). The Group achieved listing through a recapitalisation of the Pengana Hedgefunds Group but has no connection or link to this previous entity. Magellan is the brainchild of co-founders and key principals, Chris Mackay (ex CEO UBS Australasia) and Hamish Douglass (ex Co-Head Global Banking at Deutsche Bank), both of whom come from investment banking / advisory backgrounds. Interests associated with these individuals control approximately 20% of the equity in MFG.

As a new corporate entity, Magellan is still establishing itself in the wholesale and retail markets, having seeded its two unlisted managed funds, the Magellan Infrastructure Fund and Magellan Global Fund with $5 million and $15 million respectively.

Investment Team

The Magellan Investment team focuses on its "circle of competence" which it regards as the financial services, consumer & retail and infrastructure sectors. These sectors make up approximately 65% of the MSCI World index and accordingly 11 of the 14 investment professionals are split into these sector teams. All members of the investment team are Sydney-based with the exception of Michael Leonard (New York) who tends to be a resource used across the entire group.

The Financial services team comprises three individuals, Domenico Giuliano, Vihari Ross and Henry Pennington. The team is head by Giuliano, who joined Magellan from Morgan Stanley where he was Executive Director responsible for insurance sector coverage for the Asia-Pacific region. Prior to this he was a consultant for six years at Tilinghast-Towers Perrin predominantly involved in merger and acquisition (M&A) and valuation work. Other members of the financial services team include a "mid tier" analyst (Ross - 5 years Ausbil) and a junior analyst (Pennington - ex stockbroker E.L & C Baillieu).

The Consumer & Retail team comprises five investment professionals, headed by Jacqueline Fernley. Prior to joining Magellan Fernley was with Suncorp Investment Management (a style neutral manager) as a Senior Equities Analyst / Portfolio Manager. Her experience also spans roles at Credit Suisse First Boston, PricewaterhouseCoopers and Wilson HTM where she has been responsible for small companies and the consumer, commercial services, capital goods, transport and infrastructure sectors. Other members of the consumer & retail team include Nikki Thomas (15 years institutional stock broking - BT, Deutsche), Dan Ellis (8 years - Wesfarmers & Gresham Private Equity), Michael Young (5 years - Macquarie Bank) and Chris Wheldon (3 years - Farallon Capital).

The Infrastructure team comprises three investment professionals, Gerald Stack, Dennis Eagar and Alex Hone, all of whom worked together previously at Capital Partners and collectively joined Magellan in 2006. In Zenith's opinion Stack and Eagar have been pioneers of rigorous and independent research in the infrastructure sector domestically and have considerable depth of experience and expertise in their field.

With the exception of the Infrastructure team, Magellan has pulled in expertise from multiple sources which while giving it diversification of background, skill sets and ideas, means that the Magellan global equity team in its entirety is an unknown quantity and yet to prove its capability. With 10 years average industry experience within both the consumer & retail and infrastructure teams, this is regarded as a key strength. Having originally attracted Heath Behnecke (ex Perennial) to the financial services team, his departure prior to formal commencement is regarded as a loss as his inclusion in the team would have added to overall team experience. Overall Zenith rates the investment team as solid although with the majority of the investment professional coming from a domestic background we would prefer to see some additional global equity experience and capabilities. The Financial services sector team could also be further bolstered although in this sector Douglass and Mackay have significant wealth of experience and expertise.

The 14 person Magellan investment team meets daily for a morning meeting while the Investment Committee meets on a fortnightly basis (or more frequently as deemed necessary). Sector team heads (Giuliano, Fernley and Stack) bring forward stock ideas before a detailed due diligence report to the Investment Committee before a formal vote takes place on whether it is an eligible investment. If a majority vote is attained, portfolio managers are able to invest. Hamish Douglass is the portfolio manager for the Magellan Global Fund while Chris Mackay is portfolio manager for the ASX-listed Magellan Flagship Fund.

While this is Mackay and Douglass's first foray into funds management, both individuals are highly credentialed having previous roles as Chairman, CEO and Head of Investment Banking, UBS Australasia and as Co-head Global Banking, Deutsche Bank Australia & New Zealand respectively. Their long involvement in M&A activity and corporate advisory work means they have been involved in some of Australia's largest corporate transactions which stand them in good stead in terms of experience and expertise. In Zenith's view their ability to source, assess and value attractive investment opportunities is unquestionable, whether they can manage a portfolio is the unknown although their strong risk management focus gives us confidence that despite their infancy as a funds management house they will deliver on their objectives.

Investment Process

Magellan's investment philosophy is simple - "find outstanding companies at attractive prices". Outstanding companies are those which exhibit sustainable competitive advantages and can deliver returns on capital materially in excess of their cost of capital.

The other key tenet is a belief that investment markets are not always efficient and don't always price the future earnings potential of a business. This creates the ability to identify investment opportunities through deep, detailed and rigorous investment research. Magellan believes identifying companies with a robust franchise (cashflow generation through economic cycles) protects against unexpected events. While these events may create short term setbacks, they shouldn't dissipate the underlying value of the franchise.

Security Selection

The Magellan investment process starts with an investment universe of approximately 4,000 stocks. These include all companies with a market capitalisation in excess of $US 500 million and which fall into one of the three "circle of competence" sectors - financial services, consumer & retail and infrastructure. Magellan's approach of focusing on their strengths rather than seeking to cover the entire market where they may not have a competitive advantage is in Zenith's opinion fundamentally sound.

A fundamental screen on the investment universe narrows the field down to approximately 1,000 stocks worthy of further investigation. This high level screen will cull opportunities principally on an assessment of a companies "economic moat" and return on capital (ROC). Economic moat refers to the protection around a company's economic franchise (i.e. sustainable competitive advantages) which in Magellan's opinion will allow them to earn returns materially in excess of the cost of capital. Identification of companies with wide economic moats involves consideration and assessment of the barriers to entry, the risks of substitutes, the negotiating power of buyers and suppliers to a company and intensity of rivalry amongst competitors. Return on capital seeks to identify companies which have moderate to high potential to continue to re-invest capital into business at high incremental returns. Magellan believes conventional analysis fails to properly asses the ability of a business to deploy material amounts of additional capital into the business at attractive rates of return. Those which do so are rare and regarded as "compounding machines" which have often executed correctly store roll out, global expansion and market growth. Other factors which will contribute at this culling stage are an assessment of quality (i.e. Russian financial institutions), OECD domicile and the attractiveness of the sub-sector (i.e. competitive power generation).

More detailed assessment on the four qualitative criteria in the investment process reduces the 1,000 stock universe down to approximately 600 companies. While at the screening stage much of the focus is on economic moat and re-investment potential (ROC), at this stage the relative attractiveness of investment opportunities are also considered relative to business risks (i.e. predictability of future cash flows and earnings) and agency risk (i.e. risks associated with redeployment of free cash flow). Each of the four qualitative factors is assessed as follows:

- Economic moat - none, narrow or wide (scored out of 20);
- Reinvestment potential - low, medium or high (scored out of 10);
- Business risks - low, medium or high (scored out of 10); and
- Agency risk - low, medium or high (scored out of 10).

The scoring of the qualitative factors tends to occur in increments of 5 to avoid over analysis or debate with questionably material impact. This process forces analysts to be decisive and in Zenith's opinion is a strong feature of the process.

Discussion within the sector teams and with the CIO and Portfolio Manager reduces this universe further with full due diligence expected to be completed on 400 stocks. At the time of our review Magellan had completed financial modelling on 120 stocks and full due diligence on approximately 65 stocks.

The valuation component of the due diligence focuses on assessing intrinsic value primarily arrived at through the use of a three stage DCF using a weighted average cost of capital (WACC) methodology. The duration of the DCF model is determined by the economic moat of the business to ensure this is inline with the durability of the company's competitive advantage. For example, a company with a wide economic moat will typically have DCF analysis undertaken over 25-30 years. While a DCF of this potential time duration would normally cause some concerns with regard to forecast risk, Zenith is comfortable that through Magellan's detailed due diligence, the fading of ROC to cost of capital over the horizon period and use of a consistent terminal growth rate addresses these issues. On any valuation Magellan is looking for a sufficient "margin of safety" (MOS) or share price discount to intrinsic value. Valuation is expressed as a MOS score out of 40 where a minimum requirement is a 10% discount to intrinsic value. In their due diligence analysts also score "optionality" out of 10, which seeks to capture any factors or attributes which cannot be incorporated the valuation model.

Overall the investment process deployed by the Magellan global equity team is regarded as robust and backed by in-depth modelling and solid qualitative assessment. The use of a consistent template and standard market assumptions "across the board" ensures ease of peer review and adds rigour to the overall process.

Portfolio Construction

The first step in the portfolio construction process is the Investment Committee (IC), which meets weekly and comprises 6 voting members - Chris Mackay (CIO), Hamish Douglass (Portfolio Manager), Gerald Stack (Head of Infrastructure team), Jacqueline Fernley (Head of Consumer & Retail team), Dom Giuliano (Head of Financial Services team) and Matthew Webb (Distribution). All other members of the investment team are also invited to attend along with Brett Cairns as an external director representative of MFG.

The IC formally appraises and votes on all stocks, which must be deemed investment grade to be eligible for investment by a portfolio manager. A majority vote must be attained with Chris Mackay as chairman having the casting vote. At the time of our review the IC had approved 60 securities as eligible investments.

Ultimately the portfolio will seek to include high quality companies trading at a significant discount to intrinsic value. To achieve this goal one of the tools used is Magellan's Conviction scoring Matrix which rates each stock out of 100 with a 50% weight given to qualitative measures and a 50% weight applied to valuation. In Zenith's opinion the scoring matrix adds rigour and discipline to the overall process while still maintaining flexibility without over engineering the inputs.

The scoring process produces a list of stocks which are ranked and used by the portfolio manager in building the portfolio, which will comprise of 25-50 investments. Stocks generally fall into one of the following three buckets:

- *Tier I Investment* - high quality companies with large margins of safety, portfolio will typically comprise 5-10 of these stocks with each position being a 5% to 10% weight;
- *Tier II Investment* - companies slightly less attractive on one or two metrics to Tier I, portfolio will typically comprise 10-20 of these stocks with each position being a 2% to 5% weight; and
- *Tier III Investment* - stocks less attractive than Tier 1 or Tier II but still warrant inclusion in portfolio. Often provide diversification benefits for the portfolio which can hold 10-20 of these stocks, portfolio unlikely to hold a position size under 1%.

The portfolio will at times actively allocate to cash and can hold up to a maximum cash weighting of 50% (at time of review cash stood at 35%). A key driver of Magellan's current cash weighting is a belief that there is still a +25% chance of another significant credit related event impacting on equity markets and as such it is envisaged the fund will hold a significant weighting in cash over the next 6 months. Zenith expects the portfolio to have a large to mega market capitalisation bias as a consequence of its investment style (i.e. attracted to well established, impregnable businesses with sustained competitive advantages). Portfolio turnover is estimated at 20% per annum over a full market cycle.

Magellan's philosophy on portfolio construction is that opportunity cost of capital sets the agenda with all investment ideas having to compete for a piece of the capital allocation. As such its sell discipline will typically occur under the following scenarios:

- Value of a company materially exceeds assessment of intrinsic value (i.e. 30%-50% typically);
- Underlying fundamentals of business franchise materially weaken;
- Directors or management behave against shareholder interest;
- Company underperforms expectations or business economics of company have been misjudged; and
- Prudent sell down occurs for risk management purposes.

Magellan makes all sell judgements at the prevailing share price but as a long term investor will tend not to exit a stock based on a single poor quarterly earnings announcement unless the underlying fundamentals have deteriorated.

The Manager is agnostic to benchmark with no requirement to holding sectors and / or companies based on index composition. Magellan's aim is to own a portfolio of stocks actively chosen on long term value and as such portfolio turnover is expected to be low (<25% p.a.).

Overall Zenith rates Magellan's portfolio construction process highly given it is robust, disciplined and strongly intertwined with its stock selection mechanism.

Risk Management

The primary means by which risk is managed at Magellan is through the depth and quality of the investment due diligence process. The qualitative assessment also formally scores each of agency risk and business risk.

At the portfolio level the following risk limits are in place:

- Limit on exposure to a single security within portfolio (max 10% at cost);
- Limit on exposure to a securities issued capital (max 10%);
- Limit on exposure to a single security within portfolio with market cap of less than $US 500 million (max 20%);
- Limit on total exposure to non-OECD markets (max. 20%);
- Limit on borrowings (max 20% of gross asst value of Fund);
- Naked short selling not permitted; and
- Limit on cash holding (max 50%, expected to be well below this once fully invested and conditions favourable).

Risks of the Fund

Zenith has identified the following key risks associated with the Fund although this is not meant to be an exhaustive list of all risks:

- *Business risk* - Magellan is a start-up funds management outfit and while the key principals (Chris Mackay & Hamish Douglass) are well credentialed and the firm in a strong financial position (+$100m liquid assets as at 30 June 2007), it is in its infancy and largely an unknown quantity;
- *Key man risk* - Chris Mackay and Hamish Douglass are regarded as critical investment personnel and any event which caused either of these individuals to depart would have an immediate impact. We do however believe the risk of a departure is low at the principal level with them owning approximately 20% combined equity in the business;
- *Interest rate risk* - the Fund may borrow for liquidity purposes up to a maximum 20% of its gross asset value which may be impacted upon through interest rate moves;
- *Market Capitalisation risk* - the Fund is expected to have a large to mega market capitalisation bias as a consequence of its investment style (i.e. attracted to well established, impregnable business with sustained competitive advantages). If these sectors underperform it will likely have a detrimental impact on the Fund;
- *Sector risk* - through the Manager's focus on its "circle of competence" it will tend to only invest in the financial services, consumer & retail and infrastructure sectors. While these sectors comprise approximately 65% of the constituent stocks in the MSCI World index, the portfolio will have limited exposure to the economic drivers of the real estate and resource sectors;

- *Currency risk* - the Fund's neutral position is to be unhedged and it will tend to only hedge in extreme circumstances. An appeciating $A will hurt performance while a depreciating $A will enhance returns;
- *Diversification risk* - Magellan typically run high conviction portfolios, in the case of the Global Fund 25-50 stocks. This is more concentrated than many of its peers and as a consequence a higher degree of stock specific and overall diversification risk may exist;
- *Market risk* - while the Manager's investment style, which is best described as a "value orientation with a quality overlay", will offer solid defensive capabilities, any downturn in global equity markets will have a direct impact on the fortunes of this Fund; and
- *Manager risk* - if Magellan fails to deliver on its stated return objective of achieving superior risk adjusted investment returns over the medium to long term and minimising risk of permanent capital loss.

Applications of the Fund

The Magellan Global Fund is regarded as an "up and coming" manager that now needs to "put some runs on the board", in terms of sustained performance. While its key personnel (Hamish Douglass & Chris Mackay) come highly credentialed and experienced from an investment banking perspective, neither have run nor managed global equity portfolios or a funds management business. To this end Zenith regards the Fund as a suitable candidate for those investors willing to get in "at the ground level" on a new boutique which is yet to prove itself but has solid pedigree and organisational backing.

The Manager's underlying investment style will suit those investors seeking a high conviction fund with a more concentrated portfolio relative to some mainstream peers (25-50 stocks). As you would expect from a Manager with a value style and quality orientation, portfolio turnover is expected to be relatively low (circa 20% p.a.). In Zenith's opinion the Fund would typically best blend with a global growth focused product or an allocation to global resources, global real estate or global small companies which is not its focus under this Fund's "circle of competence" approach.

Fees

While many mainstream global equity products typically have a base management fee structure only, the performance fee structure on this Fund is regarded as fair and reasonable. The two pronged performance benchmark approach means that Magellan must beat both an absolute (Australian Government 10 year bond yield) and relative (MSCI World Index Net $A) hurdle before being paid a 10% excess performance on the relative index. The Performance fee is also subject to a high water mark. In circumstances where the index relative hurdle is negative, Magellan Asset Management will only be entitled to a Performance Fee of each Unit's excess return above zero.

The Management fee on this Fund is 1.26% p.a. while Administration fees are estimated at 0.10% p.a.

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