Strategy Update: 30 June 2016

MFG ASSET MANAGEMENT

MFG Global Equities

Key Facts

Portfolio Manager	Hamish Douglass
Strategy Inception Date	1 July 2007
Total Global Equity Assets[1]	USD $25,109.9 million
Total Strategy Assets	USD $22,176.3 million

USD Performance[2]

	Composite (Gross)	Composite (Net)[3]	MSCI World NTR Index	MSCI World Qual. Mix NTR	MSCI Min. Vol. NTR
3 Months (%)	-3.1	-3.3	1.0	1.4	5.1
6 Months (%)	-2.1	-2.5	0.7	3.8	11.5
1 Year (%)	-1.6	-2.4	-2.8	3.2	14.8
3 Years (% p.a.)	7.3	6.4	6.9	8.9	12.1
5 Years (% p.a.)	12.7	11.8	6.6	8.5	10.9
7 Years (% p.a.)	16.3	15.4	10.3	11.5	12.8
Since Inception (% p.a.)[4]	10.7	9.8	2.5	4.5	5.8

	Composite (Gross)	Composite (Net)[3]	MSCI World NTR Index	MSCI World Qual. Mix NTR	MSCI Min. Vol. NTR
2007 (%)*	0.0	-0.4	-0.1	1.0	1.0
2008 (%)	-21.6	-22.3	-40.7	-35.4	-29.7
2009 (%)	39.4	38.3	30.0	27.7	16.4
2010 (%)	18.3	17.4	11.8	11.4	12.0
2011 (%)	11.9	11.0	-5.5	0.7	7.3
2012 (%)	21.6	20.7	15.8	13.0	8.1
2013 (%)	30.8	29.8	26.7	24.5	18.6
2014 (%)	6.6	5.7	4.9	7.3	11.4
2015 (%)	4.2	3.4	-0.9	1.6	5.2
2016 CYTD (%)	-2.1	-2.5	0.7	3.8	11.5

Top 10 Holdings[6]

	GICS Sector	%
Apple Inc	Information Technology	5.9
Microsoft Corp	Information Technology	5.5
Visa Inc	Information Technology	4.8
Yum! Brands Inc	Consumer Discretionary	4.7
Alphabet Inc	Information Technology	4.7
Oracle Corp	Information Technology	4.5
Lowe's Co Inc	Consumer Discretionary	4.4
Intel Corp	Information Technology	4.1
eBay Inc	Information Technology	4.0
CVS Health Corp	Consumer Staples	4.0
	TOTAL:	46.6

1 Comprised of all Global Equity strategies.
2 Returns and risk measures are for the Global Equity Composite and denoted in USD. Performance would vary if returns were denominated in a currency other than USD. Refer to the GIPS Disclosure section at the end of this document for further information.
3 Performance figures are net of fees charged to clients and have been reduced by the amount of the highest fee charged to any client employing that strategy during the period under consideration. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Fees are available upon request.
4 The inception date of the Composite and the Index, the MSCI World Net Total Return Index is 01 July 2007.
* Returns are only for part year.
5 The data is based on a representative portfolio for the strategy. Refer to end of document for further information.
6 Calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio – MFG Asset Management defined sectors.

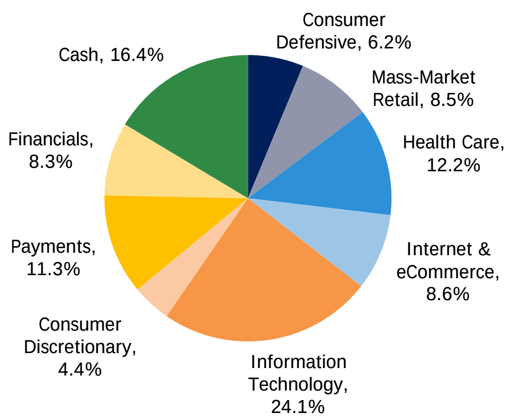
Strategy Fundamentals

	Strategy[5]	Index[4]
Number of Holdings	25	1,645
Return on Equity	21	13
P/E Ratio (1 year forward)	14.7	15.8
Interest Cover	15	10
Debt/Equity Ratio	14	51
Active Share	82	n/a
Weighted Average Market Cap (USD million)	144,024	n/a

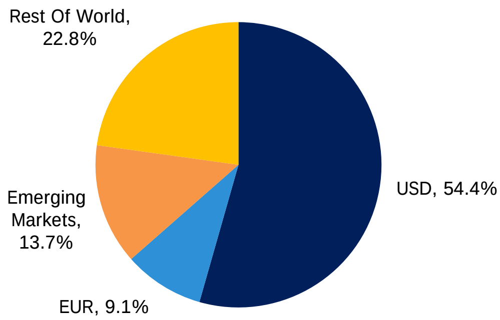
USD Risk Measures[2]

Risk Measures	3 Years	5 Years	Since Inception[4]
Upside Capture	0.9	1.0	0.9
Downside Capture	0.9	0.6	0.6
Beta	0.8	0.7	0.7
Information Ratio	0.1	1.0	1.1
Tracking Error (% p.a.)	4.4%	6.0%	7.3%
Standard Deviation – Strategy	10.5%	10.6%	14.1%
Standard Deviation – Index	11.5%	13.1%	17.2%
Worst Drawdown – Strategy	-7.3%	-7.3%	-36.0%
Worst Drawdown – Index	-12.0%	-16.6%	-54.0%
Turnover[5]	27.3%	21.9%	16.6%

Industry Exposure by Source of Revenue[6]



Geographical Exposure by Source of Revenue[6]



Market Commentary

The June quarter commenced with a continuation of improving investor sentiment that began in the latter stages of March. Risk concerns abated as key commodity prices stabilised, in particular oil, together with a tempering of concerns over China's economic well-being. Major central banks retained their extraordinary monetary policy settings, in line with market expectations. Throughout June investors became preoccupied with the impending UK referendum to exit the European Union. The surprise Brexit vote result had a material impact on equity markets, effectively erasing most of the quarter's gains as capital flows moved back to a "risk-off" mode.

UK and European equity markets oscillated dramatically during June amid growing contemplation over the many implications of a Brexit event. The ensuing political uncertainty and potential impact on business and consumer confidence led to major selloffs across the key markets. The market volatility overshadowed more positive underlying signals on the region's prospects, with inflation turning positive and gross domestic product (GDP) data for the euro area indicating a positive trend. Following the Brexit vote, both the European Central Bank and Bank of England stood ready to provide additional policy support to ensure financial stability.

The US economy continued to lead the developed world on a trend of stability through most of the quarter, backed by a fairly muted quarterly corporate earnings season and the market reducing its assessed probability of a June interest rate hike by the US Federal Reserve. Weaker than expected labour market data (only an estimated 38,000 jobs created in May compared to an average of 210,000 per month over the past year) and a fairly moderate expansion in US GDP supported the case for pushing interest rate hike expectations out beyond the mid-year period. Inflation indicators remained benign while the Brexit vote acted to firm expectations of the 'lower for longer' mantra remaining in play.

Mixed signals for equity market investors through the period has seen the share prices of many high quality companies experience sharp corrections, reflecting the often indiscriminate selling seen at times in markets when there's a perception of elevated risks. In times of heightened market volatility, investors need to calmly separate the volatility in share prices from the fundamentals of a company, which may be largely unchanged. Over time, the fundamentals determine the ability of a company to generate shareholder returns. In our view, the recent volatility in markets overstate the risks for the companies we are invested in.

Strategy Commentary

As of 30 June 2016, the Strategy consisted of investments in 24 companies, compared with 25 companies held as at 31 March 2016. The top ten investments represented 46.6% of the Strategy on 30 June 2016, while they represented 45.6% of the Strategy on 31 March 2016. The cash position has increased to 16.4% as at 30 June 2016 from 15.3% at the end of March.

The Strategy's performance fell short of the benchmark this quarter, with a number of portfolio stocks succumbing to broader market weakness. The largest contributors to returns over the quarter within the major holdings were Lowe's, YUM! Brands and Intel Corp. Lowe's delivered strong gains following the release of its Q1 earnings result. The company reported a strong 7.5% rise in same store sales over the prior corresponding period, ahead of consensus expectations. Home improvement retailers have enjoyed rising sales on the back of buoyant conditions in the US housing market and reflecting this dynamic, the company upgraded its guidance for full year earnings to US$4.11 from US$4.00 per share.

YUM! Brands, the global operator of fast food brands KFC, Pizza Hut and Taco Bell, continued to perform well this quarter after announcing another strong earnings result, highlighted by strong same-store sales in China. The company also reiterated that it is on track for the demerger of its businesses in China later this year. Meanwhile, Intel Corp weakened through the first half before recovering along with advances in banking and technology sectors.

Two of the major detractors from performance were positions in Apple and Microsoft. Microsoft weakened in April after reporting a decline in quarterly earnings. The company reported growth in revenues across its key business lines for the March quarter, although these were at levels which were generally below market expectations. Weaker earnings within the company's Productivity and Business Processes segment impacted the result, while weaker results in emerging markets and slower than anticipated technology replacement activity among its major customers limited revenue growth. Microsoft's stock price partially recovered from the earlier decline, after announcing the sale of its entry-level phone business and more significantly, announcing the acquisition of LinkedIn for US$26.2 billion.

Apple fell following the release of quarterly results. Revenue, earnings and guidance for the next quarter came in below market expectations. Apple's recent year-on-year sales trends have been weak relative to the prior period when the company experienced the highly successful iPhone 6/6+ launch. Later in the quarter, rumours continued to surface around weakness in the iPhone supply chain (the market was trying to project the impact on Apple's future sales from orders and commentary from its suppliers) which continued to weigh on sentiment. The iPhone installed base continues to grow, while its popularity and engagement remains high. At the current share price, Apple is inexpensive even without further installed base growth.

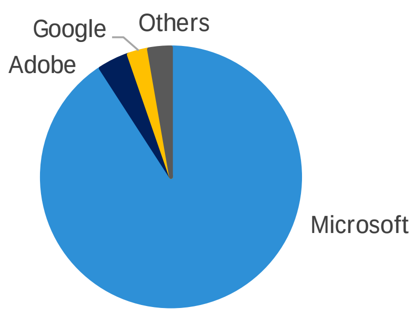
Lloyds Banking Group was a significant detractor from performance this quarter, largely due to the Brexit outcome which had a pronounced impact on many UK-focused companies. The exact economic impact of the Brexit vote will remain unclear for some time and downward pressure is likely to remain on interest rates with heightened risks for the British pound. Lloyds is well placed to meet these challenges, reflecting its significant restructuring post the financial crisis into a retail focused bank with a simple, relatively low risk, business model. Following the recent sell-off, Lloyds' is trading at a material discount to our assessment of its long-term intrinsic value, notwithstanding its near-term challenges and the lower earnings outlook resulting from the likely slowdown in UK economic activity.

Microsoft is the largest software vendor globally by revenue, with more than US$90 billion in sales in FY15. The majority of its earnings are attributable to software sold to businesses, including (in order of magnitude) its Office productivity suite, data centre products and Windows. In aggregate, we estimate that approximately 80% of Microsoft's earnings are sourced from business customers. Microsoft is strategically advantaged in business software, and has considerable growth opportunities.

Productivity

Microsoft Office has more than 90% market share of productivity software globally, having withstood competition from vendors of alternative products (often given away for free) for decades. Office is delivered as an integrated suite, with little competition from vendors of point solutions. Users are required to purchase Office to maintain high-fidelity access to their legacy Office files, and to seamlessly collaborate and share Office files with colleagues and external parties. Third-party developers have created add-ons integrated with Office, and have few incentives to develop products compatible with other solutions with smaller user bases. Further, Office users are typically reluctant to learn to use different productivity applications.

Office suites market share, 2015



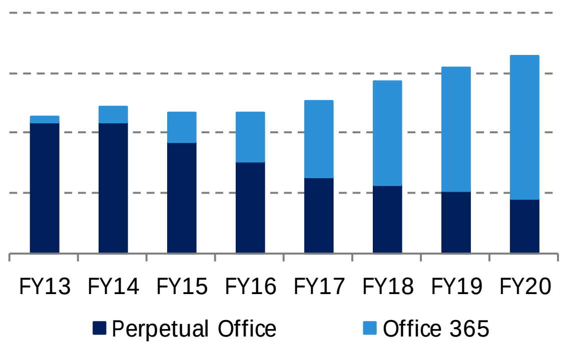
Source: Gartner.

Microsoft is extending its lead in productivity software to the cloud, offering Office 365 subscriptions on all platforms (Windows, iOS and Android). Cloud delivery enables new functionality to be offered, such as cloud file storage accessible from any device, and tools facilitating improved collaboration. Office 365 customers have access to Microsoft's most up-to-date functionality, with no requirement to buy and install new Office releases. From the customer's perspective, Office 365 offers improved functionality, while lowering implementation, management and security costs.

Office 365 has also become a powerful productivity platform, enabling simple deployment of new and premium functionality, as well as ease of collaboration and data-sharing across users. For example, as at October 2015, one-third of Microsoft's 60 million active Office 365 customers were using its premium Information Protection features, following the limited success of the licensed version of this functionality. New features from acquired companies can be quickly sold and deployed to Microsoft's rapidly expanding user base. Office 365 better utilises organisational data as part of Microsoft's Office Graph, which connects users and relevant documents, conversations and people. Office Graph is being used by Microsoft and third-party application developers to build new productivity functionality. For example, its Delve feature analyses Office Graph with advanced machine learning to proactively surface documents and suggested connections based on a user's current work and calendar. Office's competitive position is likely to be further enhanced by the recent acquisition of LinkedIn and the proprietary business user data managed by it.

Microsoft's installed base of Office customers continues to grow. The company has stated that Office 365 customers have a higher lifetime value than customers that have traditionally purchased perpetual licences for its products on-premise. As shown to the right, while the shift to subscription pricing has negatively impacted Microsoft's recent financials, we expect it to benefit materially from the shift to Office 365 in the medium term. With more than 1.2 billion existing Office users globally, Microsoft's opportunity in productivity software is significant.

Microsoft office revenue

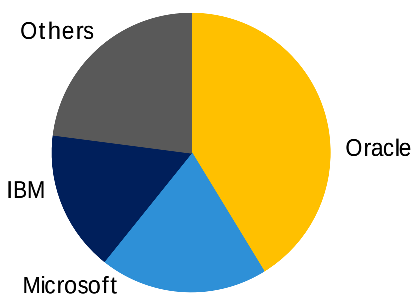


Source: Company reports, MFG Asset Management estimates.

Data centre and cloud

We estimate that the majority of Microsoft's server software revenue is attributable to its Windows Server operating system and its SQL Server database. Windows Server is the leading server operating system by revenue globally, according to IT market research firm, Gartner. As shown to the right, SQL Server is the second largest database software product, behind the Oracle database, globally.

Database market share, 2015



Source: Gartner.

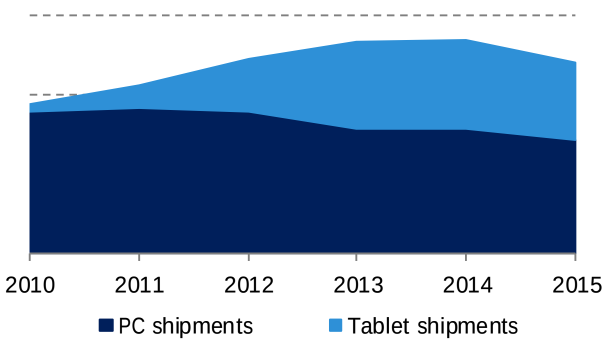
The server operating system and database software markets are relatively concentrated, with structural barriers to entry and switching costs. An established ecosystem of third-party applications has formed around Windows Server and SQL Server, generating a network effect that entrenches incumbent vendors. That is, application developers have few incentives to integrate their software with non-incumbent products, while users are attracted to server software platforms with the broadest range of compatible software applications. In addition, Microsoft's server software products tend to form part of the plumbing of enterprise software systems and perform mission-critical functions, rendering them difficult to replace, with material inherent transition risk.

Microsoft's incumbent on-premise server software business is complemented by its hyper-scale public cloud, Azure. The shift to public cloud computing is among the most significant transitions to have affected the enterprise technology market in the past two decades. Gartner predicts that the market for cloud infrastructure and platform services will grow from $22 billion in 2015 to $80 billion by 2020. Azure is second only to Amazon's AWS, and grew 120% in constant-currency in Microsoft's most recent quarter. Azure has been designed to offer Microsoft's existing customers a more manageable pathway to the cloud than competitors' solutions, and is highly integrated with Microsoft's on-premise server products, providing a hybrid solution that its major competitors are unable to offer.

Windows

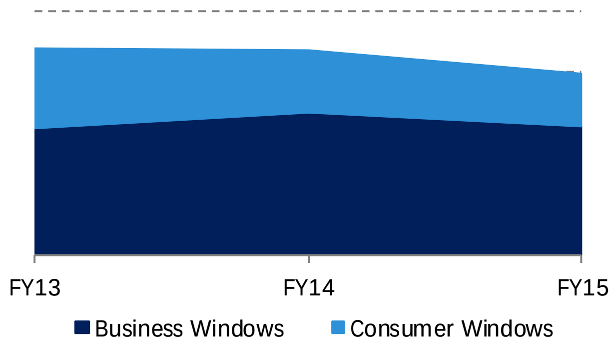
While Windows dominates the PC market, Microsoft was famously unable to capitalise on its position when addressing the rapidly growing smartphone and tablet markets, ceding them to Google's Android and Apple's iOS. There are now more than twice as many smartphones and tablets in use than PCs, according to Gartner. As mobile devices have cannibalised PC sales and users have replaced PCs less frequently, PC shipments and sales of Windows have contracted. As shown below, we estimate that consumer Windows revenue has been most heavily impacted by these effects, while business Windows revenue has been more stable. Businesses have continued to rely on Windows and the millions of Windows applications developed over the past 30 years.

Global PC & tablet shipments



Source: Gartner.

Windows revenue by customer



Source: Company reports, MFG Asset Management estimates.

However, Microsoft is making progress restructuring consumer Windows to address structural challenges. Its latest Windows release, Windows 10, has been adopted at a faster pace than any of its previous operating system releases, with more than 270 million active devices running Windows 10 as at April 2016. Microsoft is executing its stated strategy of increasingly monetising its Windows platform indirectly via peripheral services such as the Windows App Store, sales of content, PC and Xbox games, and its Bing search engine. Bing broke even on a stand-alone basis in FY16, having incurred billions of dollars of losses over the prior decade. However, those investments produced Microsoft's hyperscale cloud infrastructure and improved its capabilities in machine learning. Microsoft is now in a strong position in the global race for increasingly useful artificial intelligence, and is likely second only to Google. These capabilities should yield considerable value for businesses, consumers and Microsoft.

Summary

We expect Microsoft's highly valuable and growing business software platforms, particularly Office and Azure, to drive long-term revenue and earnings growth, and significant shareholder returns. At prevailing share price levels, we consider Microsoft an attractive investment.

IMPORTANT NOTICE

The MSCI World Index (Net) is a free-float adjusted market capitalization weighted index that is designed to measure the equity performance of 24 developed markets. Index results assume the reinvestment of all distributions of capital gain and net investment income using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties.

GLOBAL INVESTMENT PERFORMANCE STANDARDS (GIPS®) DISCLOSURE

Magellan Asset Management Limited, doing business as MFG Asset Management in jurisdictions outside Australia and New Zealand, (MFG Asset Management) claims compliance with the Global Investment Performance Standards (GIPS ®)

For the purpose of complying with GIPS, the Firm is defined as all discretionary portfolios managed by MFG Asset Management.

The Global Equity composite is a concentrated global equity strategy investing in high quality companies (typically 20-40 stocks). High quality companies are those companies that have sustainable competitive advantages which translate into returns on capital materially in excess of their cost of capital for a sustained period of time. The investment objectives of the Global Equity strategy are to earn superior risk adjusted returns through the business cycle whilst minimising the risk of a permanent capital loss. The composite was created in December 2011.

To achieve investment objectives, the composite may also use derivative financial instruments including, but not limited to, options, swaps, futures and forwards. Derivatives are subject to the risk of changes in the market price of the underlying securities instruments, and the risk of the loss due to changes in interest rates. The use of certain derivatives may have a leveraging effect, which may increase the volatility of the composite and may reduce its returns.

Gross composite returns (includes the reinvestment of dividends and capital gain distributions), are net of transaction costs, withholding taxes and direct expenses, but before management fees, custody and other indirect expenses. Net composite returns are prepared by subtracting from the monthly gross returns one-twelfth of the maximum applicable to institutional investors (0.80% p.a.). A list of composites and descriptions, as well as policies for valuing investments, calculating performance, and preparing compliant presentations are available upon request by emailing data@magellangroup.com.au

The representative portfolio is an account in the composite that closely reflects the portfolio management style of the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio may differ from those of the composite and of the other accounts in the composite. Information regarding the representative portfolio and the other accounts in the composite is available upon request.