MAGELLAN
FLAGSHIP FUND LIMITED

Magellan Flagship Fund Limited
ABN 32 121 977 844

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2 June 2011

Company Announcements Office
Australian Securities Exchange Limited
Level 4, Exchange Centre
20 Bridge Street
Sydney NSW 2000

Dear Sir/Madam,

MAGELLAN FLAGSHIP FUND LIMITED

MONTHLY NTA FOR MAY 2011
Q&A ON MARKETS, PORTFOLIO AND OUTLOOK

Please see attached the Magellan Flagship Fund Limited ("MFF") monthly NTA for May 2011 and a Q&A on Markets, Portfolio and Outlook with Chris Mackay.

For additional information please contact

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Yours sincerely,

Nerida Campbell
Company Secretary

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Magellan Flagship Fund Limited ("MFF")
Net Tangible Assets ("NTA") per share for May 2011

MFF advises that its monthly and weekly NTA per share as at 31 May 2011 was $0.769 excluding net deferred tax assets[1] of $0.081. These figures are unaudited.

Slightly more than half of the companies in MFF's portfolio reached 52 week or multi year highs during May reflecting recent positive investor sentiment towards these companies. However, overall market sentiment weakened, market volatility rose and aggregate global equity prices were flat or declined modestly for the month. The businesses of the MFF portfolio companies continue to perform well and we believe that their share prices remain attractive, but most are not the "mouth watering" bargains they were when sentiment was worst. Most of their earnings and share prices are actually at or above pre crisis levels and the businesses have strengthened materially. Modest reversal of the AUD translation also assisted in May.

Changes in the MFF portfolio were higher than for most months (about 3% of the portfolio). We again reduced some holdings in our consumer companies to free resources for other current and future opportunities. We increased some existing holdings, such as Google, Visa and China Mobile, including during the market sell offs towards month end. As MFF does not receive regular operating cashflows, insurance float or new investor inflows, it needs to sell investments to take advantage of price declines, perceived better prospects in other investments, manage risks or to buy back MFF shares. Our perception of "opportunity cost" was behind the activity in May.

Quarterly results announcements were light this month. Wal-Mart and Lowes each produced solid results and continue to improve their competitive positions, in the context of declining disposable incomes (post utility and similar charges) and the continuing weakness in US housing. Wal-Mart is continuing on a solid expansion programme, both inside and outside the US, with approval received to enter Africa. In contrast Lowes has scaled back its US expansion programme. Both generate significant cashflow, are buying back shares and increasing dividends but have not benefitted from the recovery in wealthy customer spending unlike our largest holding, American Express. Updates from other companies included McDonald's noting the benefits from the Chinese government development of transport hubs and networks (Yum! and our other consumer goods companies with strong presences in China also benefit).

We are particularly positive about the terms of the portfolio's exposure to some likely winners from the rise of emerging market consumers and in online activity (including mobility and payments). Our companies are better placed than most to deal with economic risks such as further increases in taxation and adverse regulation which we expect. Margins for our companies are high by historical standards and input prices are rising and we are cautious about growth assumptions.

We continue to have considerable concerns about economies in the short and longer term, including inflation, overcapacity and stagflation. These considerations are inputs into our decisions about bottom up analysis of individual businesses and industries, portfolio composition and currencies, including the AUD position. Much market nervousness continues to be factored into market prices and cash weightings/savings rates are well above pre crisis levels (and may go higher). A recent Economist survey/poll found consensus expectations across more than 2/3 of the countries/regions surveyed were for inflation to increase and economic growth to slow in 2011, but for economic growth to rebound in 2012. We believe that market consensus is unlikely to occur.

The US policies including easy/zero cost money and 10%+ Federal budget deficits have contributed to MFF's currency headwinds, but have benefitted the economic performances of most of our holdings. The timing and implications of the inevitable (forced or voluntary) reversal of these policies remains very unpredictable, and we have been overoptimistic on this in the recent past. Our current view is that US policies and the weak housing cycle remain significant risks, but the US has retained many of the competitive advantages which made it the most attractive global business location. Current decisions matter, and insightful leadership, considerable resilience and character are required from this generation. The US must adjust policies to market requirements after the end of QE2 and this has considerable challenges to avoid ongoing USD weakness without damaging economic recovery.

MFF's direct exposure to Australian companies remains negligible. Our currency position remains unhedged although risks remain that this will continue to detract from performance. The underpinnings of the strong AUD are narrowing around ongoing Chinese stimulus such as public housing and the capital expenditure mining supply response, while other underpinnings such as domestic property, Chinese property and exports moderate. We are mindful of factors which may well continue to push the AUD higher including the market momentum, record forward capital expenditure projects in the mining sector, recent Central Bank buying of the AUD, interest rate differentials, ongoing Chinese government stimulus and insufficient Chinese curbs on property/inflation.

It is apparent from multiple data that the extent of the Chinese stimulus is unprecedented. The 10 million public housing units that the government is planning to have constructed in 2011 is almost 20x the current run rate for US housing starts. In the key Australian export commodities, China represents more than 50% of consumption. China has recently reversed its policies from market based activity in favour of greater Government direction and state owned enterprise activity and this has buoyed current economic figures and smoothed a lot of pressures as, for example, export markets and business confidence collapsed in the Crisis.

Stagflation has previously been very damaging for Australia. Policy decisions are now becoming more difficult whether or not the rebalancing of commodity supply and demand is rapid or delayed (as it was by the financial crisis). Stagflation may already be apparent in recent Australian data including the budget, labour cost, productivity and interest rate pressures, the March Quarter figures of 3.3% p.a. inflation and a decline of 1.2% in real GDP (QOQ; +1% for 12 months), although the figures include considerable one off pressures such as the floods and cyclone impacts.

Oil is another major risk. The policy response has been lacking in recent years with the largest user countries not doing much to encourage lower oil usage and substitution or to mitigate supply risks. Depletion of oil is an obvious future potential market failure as supply is measured in the decades rather than the centuries for other commodities (even where "temporary" transport related bottlenecks and strong building/infrastructure demand have elevated current equilibrium prices). Oil consumption has relatively low price elasticity particularly in developed markets such as the US and developing country usage is increasing particularly with sales of new motor cars in China. Sustained damaging high oil prices are a real risk if current price signals/policies are inadequate to encourage the necessary innovation and scale development to be ready when supply of and demand for oil moves from a "reasonably" priced equilibrium.

The European crises continue. We expect the EU countries to experience low growth over the next few years. Problems in the periphery are moving steadily from liquidity to solvency and are spreading well beyond Greece. In time, the ECB itself may require recapitalisation. Banks are pressured by capital requirements, weak economies and government involvement and are cautious about extending credit. The problems are distracting Europe from making necessary economic reforms (for example, in labour competitiveness) and increases in direct and indirect taxes are also likely. European governments are losing popularity, even if Europe is able to "kick the can down the road" to avert near term default.

We continue to hold no direct exposure to EU based companies, other than small holdings in Unilever and Tesco. In addition to the EU specific issues, many EU based multinationals are not the most attractive in terms of current returns on investment and global potential. We also continue to avoid European financial institutions, including because of the region's ongoing risks of financial contagion. Our direct exposure to Japanese companies also remains at zero.

As the world has become wealthier, the discretionary components of GDP are increasing (for many Governments under fiscal pressure "discretionary" includes deferral of expenditure that was previously characterised as necessary maintenance). Hence, confidence is an increasingly important variable for actual economic results but it is much harder for businesspeople, economists and Governments to predict than more traditional variables. Policy makers are also struggling with the increasingly uneven impacts of the costs and benefits of globalisation and technology. The best businesses have clearer goals in seeking to benefit from these developments and in mitigating the risks.

Changes in key conditions are inevitable for Australia, including commodity supply/demand responses and property prices reverting to longer term averages. Recent collapses in economies such as Ireland and Spain from growth to extreme adversity reflect the risks of changes in key conditions. In contrast Chile was far better prepared to respond to the financial crisis and earthquake.

About 85% of MFF's total investment assets by market value are in global multinationals (being entities that generate 50% or more of their revenue and/or have material operations in 15 or more countries outside the domicile of their primary securities exchange), with the balance being predominantly North American focused and about 6% being China focussed. The revenue and earnings split for the multinationals average almost 40% USA, slightly less than 30% Europe about 1/3 ROW. The emerging markets proportion of underlying revenue and earnings continues to rise.

As at 31 May 2011, MFF had net borrowings of approximately 18.7% of total investment assets. The borrowings are almost entirely denominated in AUD, with a small amount in Euros.

Key currency rates for AUD as at 31 May 2011 rates which were 1.066 (USD), 0.7412 (EUR). 0.6474 (GBP) and 0.9088 (CHF) compared with the 30 April 2011 rates were 1.094 (USD), 0.7376 (EUR), 0.6561 (GBP) and 0.9504 (CHF).

Yours faithfully,

Chris Mackay
Chief Investment Officer

Nerida Campbell
Company Secretary

2 June 2011

[1] Deferred tax assets less deferred tax liabilities.

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Level 7
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2 June 2011

MFF Q&A on Markets, Portfolio and Outlook

Chris Mackay (Chief Investment Officer)

Question: Are you worried about the consumer, particularly with rising oil and utility prices and unemployment in many markets?

Answer: Yes. We use conservative growth assumptions and in all cases the first protections are a low purchase price for an advantaged quality company relative to our perception of value. We like to buy when other investors are very pessimistic, for example in relation to near term economic conditions. We prefer the lowest cost manufacturers and distributors of products or services that combine resilient usage, exposure to developing markets, pricing power, brand differentiation and are immune to technological change or are assisted by it.

Question: But is there a risk that consumers simply go on strike and save more?

Answer: Yes. We are seeing wealthier consumers save more of their incomes and hence US bank deposits are at record levels although interest rates are almost zero. Our companies have generally exhibited sales resilience and are using their scale advantages on R+D, innovation, distribution and marketing to gain profitable market share. There have been shifts in consumption where, for example, American Express has returned to record card spending amongst wealthier consumers and a return of corporate spending, but Wal-Mart has had 2 years of same store sales declines in the US as its lower income consumers feel far more pressure. Detail is important, for example price comparisons between at home meals (fresh or packaged) against quick service restaurants moved in favour of McDonald's in the latest recession. Not all of Nestle's competitors have been able to respond in the packaged category and Wal-Mart has picked up market share in fresh and packaged as price matters for most consumers.

Companies can launch global products far more broadly than in the past. For example, Procter & Gamble's Gillette launched the Pro Fusion razor in competition with the global #2's largest ever product launch last year. P&G are winning this product battle but actually underestimated the global demand and experienced supply disruptions. Notwithstanding the constraints on consumers, some products are going "viral" with wide global acceptance, particularly in technology and some serious business value is accruing to the winners.

Question: How do you think about technology?

Answer: Technology is increasingly important, including when price matters, such as in online sales and price comparators such as Google. Growth markets and market leadership are insufficient. For example, mobile devices have experienced explosive growth and we looked quite closely at Nokia a few years ago. Nokia had been the absolute market leader with lowest cost and greatest innovation but has lost market share firstly to Apple and then to Android (Google). We prefer the networks of an advertiser such as Google or payments companies to businesses which rely primarily on device sales or sales of other consumer durables. We look for network effects in sizable global markets, including in technology. Technology is more difficult than regular consumer sectors because changes are more profound and leadership usually less defined and more transient. There are parallels as, for example, the China motor car market is growing strongly but is highly competitive.

<u>Question:</u> Are you worried about further Government interference in the banking sector and weakness in demand for loans?

<u>Answer:</u> Yes. Governments have important roles to play and getting capital structures and regulation right are important. Loan demand is currently weak and we believe that it will remain weak for most lending sectors for some time. Sectors such as housing will likely be weak and/or dangerous for lenders for some time in many jurisdictions. Hence bank share prices have been much weaker relative to earnings and assets than previously.

We believe that the strongest banks can provide the best customer offerings and use scale and other benefits to be lower risk institutions for customers and society more broadly. They have moved a long way from the pre crisis conduct of the industry as a whole. We aim to be very selective. We want lending banks with the lowest cost of funds and with sticky deposits that cover their loan books, with sustainable net interest margins, limited dependence upon wholesale markets for funding and "sticky" customers with multiple products with the bank. These banks' mix of assets will give them scope to respond better to excessively intrusive regulation than the competition. Demographics also matter, as do overall economic conditions, obviously.

<u>Question:</u> How confident are you that the Chinese government will allow your foreign owned capitalistic companies to survive and thrive?

<u>Answer:</u> A strong economy is vital for China to achieve its current goals. Some US hedge funds are commenting adversely about Chinese housing and uneconomic lending, amongst other China related risks. Our view is nuanced. On most matters we don't have a strong view, for example when the growth in fixed asset expenditure will slow. Our core expectation is that Chinese consumption expenditure is likely to continue growing at a decent rate or above for a sustained period. Timing and changes in the slowdown in building activity, property prices, lending or Government spending go to magnitude. Our assessment is that the Chinese Government's decision to have 10 million low cost housing units built in 2011 was both to avoid a near term economic slowdown and to partially address housing unaffordability issues.

The Chinese government is central to everything in China and has had unprecedented success in rapidly lifting living standards for its people. In any business in any country there are risks of government interference and we try to factor that into our assessments. We feel that most of our companies have interacted well with Chinese local and central governments over many years. Having said that we prefer companies that have major exposures to more than one country and we factor in concentration risks in our assessments. China Mobile and Yum! Brands are the two companies with the highest proportion of activities in China.

<u>Question:</u> Why does China Mobile trade on such low multiples of earnings and cashflows?

<u>Answer:</u> This is hard to answer. It is a function of markets and we expect that one day it will pass (China Mobile was a true market darling not so many years ago and, on many measures, its business is better now). We recognise that China Mobile has its own set of risks, including that it is controlled by Government and it operates in a regulated industry with significant capital requirements and technology changes. There are risks in how they deploy the $40 billion+ of cash on balance sheet and $30 billion per annum of operating cashflow. China Mobile is developing add on products for its over 600million customers, and is a leader in 4G technology, but the telco space is competitive and its 3G positioning has been less attractive than Unicom in particular. The share owning culture in China is in early stages and has been marked by volatility as locals, HK investors and foreigners enter and leave.

<u>Question:</u> How long will it be before inflation is a major problem in the US? How about stagflation?

<u>Answer:</u> Despite the high level of overcapacity in most industries and in most markets, including in the US, inflation is inevitable if monetary and fiscal policies remain loose for an extended period. At the very least, global markets will continue to force down the USD and force up the prices of commodities and other inputs and this will lead to employees, service providers and owners that have pricing power raising their prices. If the US has excellent leadership and policy responses, inflation will not become a problem.

At the moment $1trillion+ "created" through easy policy is still sitting on the Federal Reserve's balance sheet because banks have not lent it out. It only requires a small proportion of these bank deposits to enter the mainstream economy to be inflationary, assuming "normal" economic multipliers.

In assessing companies for investment, we have a focus on companies which are able to put up prices to meet input cost rises but which are not forced to slash them during downturns. Our companies are raising prices at the moment in response to commodity and other input cost increases.

As to stagflation, it is possible if there is sustained policy failure in the US like in the '70s. It is more difficult now than in the '70s because China is increasing wages rapidly and hence its exports will become more expensive and it will move from being an exporter of deflation to inflation. Stagflation is actually more likely in Australia than in the US given relative cost competitiveness/productivity across most activities, the ongoing wage rises across the public and private sectors, and Australia's narrower economic base. It is also far more likely that manufacturing (in particular) and services will return to the US (than return to Australia) to shorten supply lines if manufacturing costs continue to rise.

Question: What have been your recent economic concerns?

Answer: The following comes from the April NTA announcement and summarises some of the recent issues. Numerous other points are raised in the May NTA announcement released concurrently with this release.

Key concerns relate to margins (particularly as commodity and other input costs rise), weak consumer spending power (which is squeezed further by elevated unemployment and rising fuel and utility costs) and rising Government regulation, taxation and intervention pressuring both business and consumers (for example via higher utility prices).

Inflation is returning in many markets but, outside of emerging markets such as Brazil and China, with massive Government stimulus programmes adding to the economic momentum, the recovery is not broad based. Our companies are exceptionally well placed in this environment with limited capital expenditure requirements (Australian readers see the contrast with significant cost blow outs in capital budgets for major resource, renewables, infrastructure and other projects). Many of our companies are implementing price increases to offset input price rises whilst maintaining scale and other advantages as lowest cost operators. Our companies maintain exposure to long term growth via demographics (emerging market consumers and urbanisation), the movement to electronic payments and network effect benefits.

We remain concerned about European sovereign and bank debt and continue to expect some rescheduling. If the oil price remains elevated this is also a particular negative and oil remains vulnerable to supply shocks. The Japanese disasters are having more near term impact on GDP than Kobe, in part because supply chains are more integrated. We continue to believe that the Japanese disasters are unlikely to have a prolonged material negative impact on global GDP but we believe that markets will likely focus on Japanese Government funding pressures in due course. We are watching the Chinese efforts to rein in inflation, transition from the unprecedented stimulus (including fiscal, money supply and debt funded railway and other infrastructure) and respond to the high level of housing investment (which has per capita housing building at multiples of the peaks reached during the bubbles elsewhere).

True returns on capital in many sectors in China remain poor and pressured by commodity and other input price inflation (including wages). Corporate and Local Government Dependant Entity (eg many developers) results are vulnerable if interest rates cease to be subsidised at below market rates. Many Government Owned Enterprises (eg the railway entities that have debt funded the most rapid and largest railway expansion in history) benefit from low price long dated bullet payment borrowings (which are carried at cost on lender balance sheets) but we have not seen the implied Government guarantees aggregated in official figures.

We continue to reduce our very small exposure to Australia as large parts of the economy are developing many of the characteristics of stagflation and fiscal pressures. We continue to expect that commodity prices will adjust when supply and demand rebalance with major new project expansion and associated transport improvements (for example Chinese railways to transport coal).