Half Yearly Investor Report
31 December 2011
Magellan Flagship Fund Limited

Dear Shareholder,

Overview

Over the last six months, MFF's pre-tax NTA per share rose from $0.762 to $0.820. The portfolio outperformed the difficult markets and the AUD fell approximately 4.3% against the USD during the period. The gains were approximately 2/3 currency, 1/3 base currency equity values.

MFF has remained largely fully invested because:

- we consider that equity prices for our portfolio companies remain below our assessment of value and that high quality equities are a safer investment than alternative asset classes;

- European politicians, and most recently the ECB, have committed to take all steps necessary to avert an uncontrolled economic disaster at this time. We perceive that they have the tools available and the will to do so, albeit at significant cost and with considerable longer term risks, including uneven austerity burdens exacerbating unfairness and inequality, future inflation risks and low near term economic growth rates; and

- we perceive that many US companies particularly leading multinationals are in very strong business and financial positions, that despite various policy missteps the Federal Reserve's overall policy response to the crisis is likely to be broadly vindicated and US economic resilience gives political leaders scope to improve materially its fiscal position to a sustainable level consistent with modest overall economic growth.

MFF also continues to be structurally "short AUD" because (in summary):

- we believe that the medium term structural risks remain materially to the downside for the AUD; and

- this position helps MFF remain fully invested in quality equities as it provides a meaningful hedge against market volatility and, more importantly, against the risks of extreme events (Iran, North Korea and Europe risks for example).

The tradeoffs between attractive valuations, relative security of quality companies and macroeconomic risks will continue to move rapidly. The "medicine" of low or zero interest rates and huge fiscal deficits (in some countries) helps some "patients" for some time but consequences include heightened overall risk as indebtedness rises, and distorted trade, markets and asset prices.

Portfolio

Portfolio turnover remained low over the six months. Modest additions included Google, Wells Fargo, China Mobile, Visa, MasterCard and US Bancorp. Reductions included Nestle, Connect East (takeover), Tesco, McDonald's, Colgate-Palmolive and Coca-Cola.

The buyback continued and approximately 2.95 million shares were bought back over the 6 months at an average price of approximately 64 cents per share.

Various high quality consumer companies are far closer to our perception of their underlying values, as their share prices have been appreciating ahead of their (strong) business performance. In contrast, most credit based financials remain out of favour and the best financials are inexpensive, in the absence of further major macro event(s).

The Company's holdings with a market value of A$2 million or greater (which represent about 99% of the portfolio value) as at 30 December 2011 were:

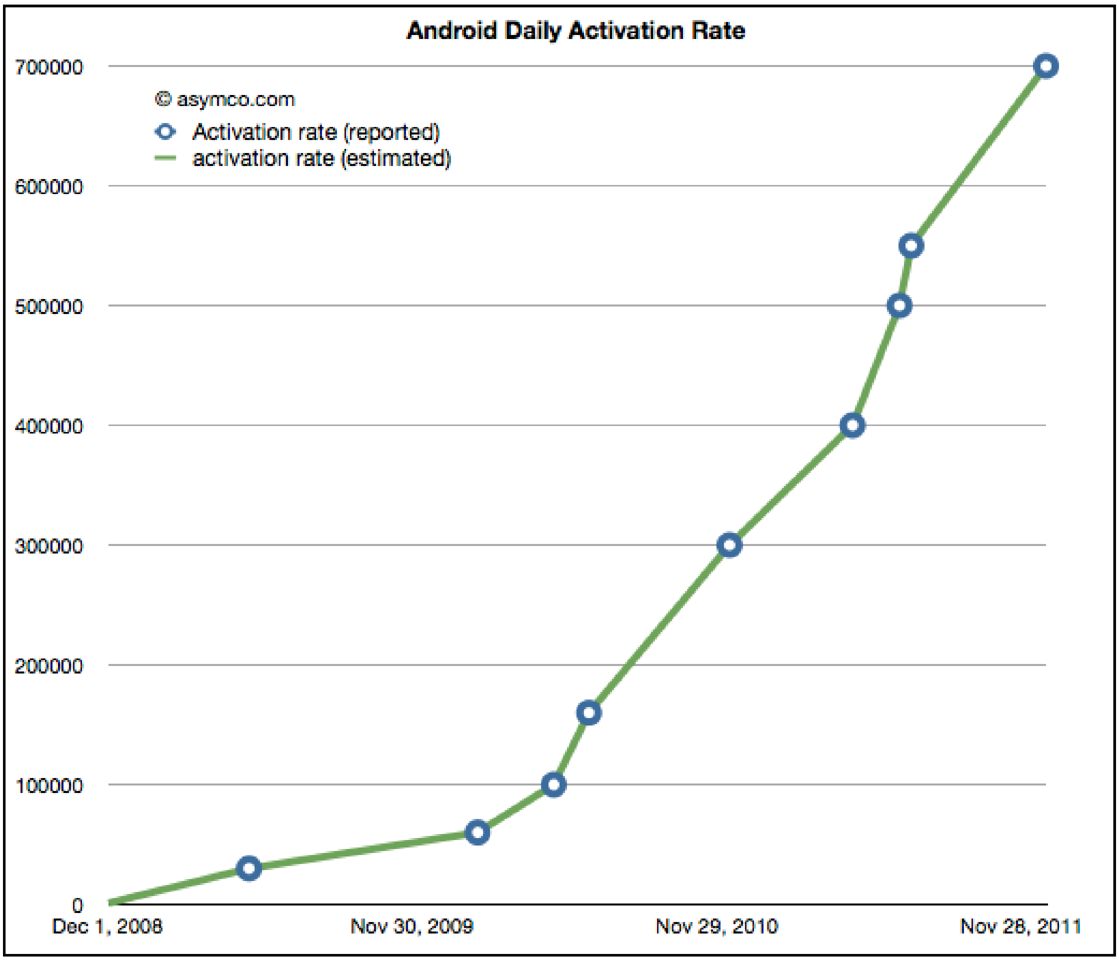
Holding	**$million**	**Holding**	**$million**
American Express	62.8	Visa	16.2
Yum! Brands	48.7	McDonald's	15.6
eBay	32.1	US Bancorp	11.2
Google	30.8	Procter & Gamble	11.0
Coca-Cola	24.1	Wal-Mart	7.2
China Mobile	22.1	MasterCard	5.9
Wells Fargo	18.2	Lowe's	2.7
Nestlé	17.6	Bank of America	2.4

The businesses in the MFF portfolio are outstanding and are performing well in the ongoing difficult economic conditions. There has been little cause to make major portfolio changes. Most portfolio changes of this and prior periods were made because of relative share price/value movements. In a very few cases we have also been concerned about management strategy, changes in customer behaviour or risks of sustained competitive pressures/market share losses.

In portfolio terms, credit based financials were the weakest performers in 2011 and outstanding consumer companies the strongest (McDonald's was the best performer in the Dow Jones Industrials Average and Bank of America the worst in 2011).

More importantly, in terms of business progress, we are pleased with our main financials. MFF's 3 main credit exposed financials (American Express, Wells Fargo and US Bancorp) continued to increase revenue and profitability, in contrast to many financials and despite the economic, regulatory and competitive challenges. 2011 earnings per share for each were above previous pre crisis highs. Investors remain cautious about investing in financials and share prices remain low relative to earnings. Bank of America's share price recovered a little in January as results showed progress in bolstering capital and its underlying businesses have earnings power, but poor previous decisions (particularly about acquisitions) continue to damage the Bank.

We are likely to need to be somewhat opportunistic in these market conditions. Some share prices are likely to react positively to the fiscal and monetary stimulus, and momentum may drive them beyond our assessment of underlying value. However, out of favour companies and sectors perceived to be risky or under (temporary) business/earnings or regulatory clouds, may offer far better value. For example, in January we added to Google as its shares were marked down by about 10% despite strong results (including 25% revenue growth). The graph below is of the growth in activations of Google's Android mobile operating system, the monetisation of which was only modestly reflected in Google's $10.5 billion revenue last quarter.



Source: Asymco

Macro and Markets Discussion

Sovereign debt and risks continue to increase. Debt levels are unsustainable and increasingly incompatible with a return to stable growth in many countries. The Chinese housing market is crucial, both as a driver of economic activity but also as another barometer. Almost all major regions/countries have greater macro challenges in 2012 than in 2011, including Europe, Japan, India and Brazil.

Stronger fiscal and balance of payments countries include Singapore and Hong Kong, which differentiate from the Euro entitlement view of the world that most Governments are following. The recent Hong Kong Budget lowered taxes further, handed back money to residents from the large surplus including a decision to waive public-housing rents for two months. Professor Rogoff, the expert on crises based on Government indebtedness, says that such crises lead to slower recoveries than cyclical recessions. He says that history tells investors to ignore what Governments say and instead concentrate on the incentives which drive their behaviours. We feel that there are very few true safe havens when politicians are under pressure.

The US economic figures are benefitting from the ongoing monetary and fiscal stimulus. This is benefitting equity investors via higher corporate profitability and via investors moving funds from zero/low interest rate investments.

Macroeconomic concerns are ongoing into 2012. The ECB intervened to provide emergency liquidity to European banks and this helped to avert disasters at both Government and Bank levels, at this time. This intervention was necessary to again give Euro leaders more time to seek to address the fiscal, structural and other fundamental issues in relation to the Greek and Portuguese rescues, and for the EU more broadly.

The ECB continues to monetise Government and Bank liabilities and this may encourage private sector involvement in the 2012 bailouts, subject to agreement on loss sharing arrangements. Europe may now have scope to defer its hardest decisions for this year, although uncertainty remains as Greece and Portugal are unresolved and EU leaders are frustrated with the ongoing Greek negotiations to avoid the consequences of a disorderly default.

The IMF's funding base is inadequate to fund a full scale rescue of even a middle sized developed economy. The ECB "printing money" by injecting liquidity to defer or avoid a solvency crisis for the Banks and Governments is a key component of avoiding disorderly defaults. Political risks include opposition to the risks of hyper inflation (which had devastating consequences last century) and the ECB's single mandate to maintain price stability (which it sees as inflation rates of below, but close to, 2% over the medium term).

Central Banks, such as the ECB are heavily geared compared with most institutions. The ECB would probably have negative net worth if forced to mark to market its assets at private sector prices and/or if forced to take private sector write downs on its holding of peripheral debt. The ECB's capital is in the process of being increased to 10.76 billion Euros and its funding requirements are multiples larger (the ECB's February LTRO programme itself is estimated at €1 trillion and December's was half of this). Liability for losses amongst member country banks and/or remedial policy actions will likely be problematical if significant write downs are required. The latest (2010) ECB Annual Report showed €170 million profit from an asset base exceeding €163 billion and net assets of €5 billion.

Note that the ECB's weekly published figures also consolidate the 17 individual central banks, (i.e. not a legal entity). They show much higher gearing (an asset base of almost €2,700 billion post the LTRO). Some of the consolidated balance sheets will be the responsibility of the individual national central banks, and some exposures are shared under the Euro treaties. Germany (27%) and France (20%) are the largest contributors. Tension rises as the stronger nations do not want liability for losses arising from the ECB buying debts of weaker sovereigns and Banks. The transcript of Mr. Draghi's latest press conference is reflective of Professor Rogoff's warnings based on similar crises responses over the centuries.

In the US, the political cycle also makes deferral of substantive action most likely, and hopefully less confidence sapping regulation is passed in 2012 than in recent years. Increased US activity and confidence is finally occurring after 4 years of record low interest rates and over $5 trillion of borrowed Federal Government stimulus. Although Japan had its first trade deficit in 30 years, its population fell for the fifth year in a row and Government waste continues to accrue, the tipping point for a funding crisis has not yet been reached. Amongst much complexity in China, policy makers have the levers with which to restimulate if the current slowdown becomes too risky for them.

Ultimately, excessive debts are only brought down to manageable levels by some or all of growth, trade, inflation, forbearance or default. The investment consequences (not to mention the geopolitical and societal consequences) vary dramatically with different policies (and factors such as business and consumer confidence). Obviously, populations in austerity affected countries are protesting and removing Governments.

Currency and more Macroeconomics

The currency headwinds continue, as the AUD's strength has been sustained. We regularly review whether to reverse MFF's currency position but have decided not to do so, in the absence of a change in circumstances. Our perception is that the AUD is materially overpriced and the main factors underpinning its strength are being reversed or will very likely be reversed.

Although there are plausible circumstances for the AUD strength to continue for some time, the likelihood of circumstances causing a substantial reversal is high in our view and we intend to remain patient. We have also wanted to be close to fully invested in high quality equities where we had high confidence that they were inexpensive and the "short AUD" position has given MFF considerable protection in periods of negative equity markets (such as the last 6 months) given the current correlation between "risk assets". MFF also is likely to benefit somewhat from this position in the event of a major geopolitical or markets disruption.

There are numerous influences upon a currency's market movements, and its relative underlying value such as relative interest rates, yield carry trades, commodity prices/terms of trade, business investment, fiscal and financial stability. Currently, a number of policy directed sovereign funds, central banks and governments are buying Australian bonds for the carry trade and hence the AUD has remained strong despite other economic indicators such as the Baltic Dry Index of bulk shipping costs collapsing (to 25 year lows).

Two important factors for the AUD (particularly as it is a non reserve currency) are fixed asset investment / steel production in China (which drives demand for Australia's key exports of iron ore and coking coal) and Australia's net foreign liabilities, and these will be discussed briefly.

Our expectation is that the growth rate in China's fixed asset investment and steel production will slow materially. The supply of iron ore and coking coal will increase. If supply rises and demand flattens prices will fall, other things being equal. Despite material differences in grades, it is unusual for true commodities to sell at multiples of their cost of production for sustained periods, given typical supply/demand dynamics. As almost all contracts for these commodities, and LNG (which is also experiencing a surge in investment and supply to meet rising demand) have prices set at the time of supply, their revenues fluctuate materially.

In considering demand, China purchases more than half of these commodities and drives marginal demand levels, and its consumption is driven by construction, particularly residential construction. Construction in China approximately doubled from 2004 to 2008, in an unprecedentedly rapid build out. At the time, Chinese authorities regarded investment as being an unsustainably high proportion of GDP. However, Chinese construction has approximately tripled from 2009 to 2011, as the Chinese authorities reacted to the Global Financial Crisis with trillions of dollars of direct and indirect stimulus targeted at fixed asset investment (construction data source: UBS January 2012 presentation).

Concurrently, various resource expansion projects were deferred or abandoned in the financial crisis. Hence, the key commodity prices for fixed assets, and Australia's terms of trade, have risen to higher record levels.

In the absence of policy action, Chinese construction will fall because housing sales and prices are falling (the HK listed Chinese developers are reporting huge YOY revenue falls: Guangzhou R&F January sales declined 45% MOM and 57% YOY: Macquarie Equities Report, 2 February 2012). Current policy includes stimulus for public housing (36 million over 5 years i.e. far more in public housing than the total build in the US in all of its bubble years) but this appears to be insufficient to keep construction growth at recent rates if private housing constructions drops from its bubble levels.

Although the Chinese Government has capacity to restimulate its economy if housing and exports slow too far, it has far less scope than in 2008/9 and it is now far more concerned about the property bubble and about distorting effects such as inflation and the subsidy from savers receiving low fixed deposit rates.

The annual benefit to the Australian economy of the Chinese demand may be about $250 billion, depending on the measurement of the direct and indirect flows (i.e. a reasonable estimate may be 15-20% of GDP). If China experiences a hard landing (which we are not predicting), or when its economic growth rate inevitably slows, or it succeeds in its policy makers' aims of reducing the proportion of fixed asset investment and thus steel intensity, the impact on Australia's commodity exports will be material.

Australia's foreign liabilities position has been highlighted by analysts as a vulnerability for decades (most recently, Fitch placed the banks on credit watch because of wholesale funding reliance), whilst low foreign liabilities are a reason why Japan has not yet suffered Europe's fate despite higher debt levels. In 1986 the then Treasurer Paul Keating warned of the danger of becoming a banana republic. In 2000 he cautioned of "the consequences of this growing weight of foreign liabilities" and that "the debt and liabilities may well go supercritical" (see Chapter 14 of PJ Keating "After Words"), and he warned against complacency to this vulnerability.

In recent years Australia's net foreign liabilities have risen materially despite record terms of trade, favourable underlying budgetary and economic conditions, some recent increases in private savings and translation benefits from the strong currency. In June 2003 the official ABS estimate of foreign liabilities was $443.9 billion and the latest figures (September 2011) after rises every year show $848.3 billion (which the ABS estimates at 58.5% of GDP). As at 31/12/99 net foreign liabilities were $381.5 billion. The GDP figures were $621.0 billion (99/00), $1045.6 billion (02/03) and $1320.1 billion (10/11) (Source: ABS).

Whilst a proportion of the extra net borrowings/liabilities have been for productive purposes that will earn more than the cost over the life of the project, much has been used for an unsustainable increase in housing construction, its price appreciation and related consumption (which is now slowing). One of Mr Keating's key points is increased vulnerability when commodities face a sustained downturn. Recently, the "hollowing out" of the non-resource sectors of the economy is accelerating, as service and manufacturing activities relocate. This narrowing of activity was feared in previous decades and increases the vulnerability to adverse fluctuations in the terms of trade.

Government budgetary positions are a component of net foreign liabilities. Australian State Governments, in particular, are under fiscal pressure to meet recurrent and infrastructure spending demand (and they lack effective taxing powers, as their GST allocations face additional recurrent expenditure). The recent MYEFO State and Federal Government reviews showed that Government sector debt is forecast to continue its rapid rise over the next 3 years (even before the impact of any shift of spending from the Federal level to the States).

The level of net foreign liabilities help explain why Australia's Balance of Payments persists in a sizable deficit despite the record terms of trade and export volumes. It may also help explain why Treasury has been firm in advising the Federal Government about tightening fiscal deficits (which is a key policy point in Mr Keating's book).

Market confidence can evaporate quickly, as shown by Italian and other European bond yields moving rapidly in late 2011 from acceptable to prohibitive levels when perceptions changed about the sustainability of fiscal and external balances. Remedial action should occur in advance of circumstances deteriorating, but that is very difficult to achieve politically, and is rarely accompanied by popular support.

Europe and the UK illustrate the difficulties, as well as the early stage consequences, of forced austerity. Australians are accustomed to the benefits of the resources boom, of increasing house prices and indebtedness, and of increasing Government payments. Mr Keating didn't underestimate the difficulties, or the consequences of failure. Complaints about the relatively mild Federal budget tightening last May to reduce the $50+ billion deficits to $22 billion, contributed to its revision to $37 billion in November, and the deficit for the first 3 months to September had already reached $23 billion.

Loss aversion theory helps explain the resistance of voters to the removal of payments and benefits as they weigh far higher the pain of the loss than potential future broad economic gains. The austerity measures in the UK after their fiscal position deteriorated rapidly illustrates the compounding negative impacts upon social cohesion, economic activity and business confidence that Mr Keating warned about.

It is obviously not certain that any of these figures will move unfavourably to dangerous levels. However, there will be future crises. Correlations are high during crises and the levels of vulnerability are higher than broadly perceived. Even absent a crisis, the AUD is trading well above longer term averages and mean reversion is more likely than not.

Global multinationals and borrowings/cash summary

Almost 85% of MFF's total investment assets by market value continue to be held 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 7% being China focussed. The revenue and earnings split for the multinationals average almost 40% USA, about 25% Europe and about 1/3 ROW. The emerging markets' proportion of underlying revenue and earnings continues to rise and direct exposure to Europe and Japan remains low.

As at 30 December 2011, MFF had net borrowings of approximately 14.0% of total investment assets. Most of the borrowings are in AUD with small amounts in Euro, Swiss Francs and Sterling. Cash balances continue to be held in a mix of US Dollars, Singapore Dollars and Hong Kong Dollars. Refer to the earlier comments regarding Singapore and Hong Kong.

Yours faithfully,

Chris Mackay

Chris Mackay
Director
9 February 2012