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ABN: 32 121 977 884

27 October 2016

ASX Limited  
ASX Market Announcements Office  
Exchange Centre  
20 Bridge Street  
SYDNEY NSW 2000

**Magellan Flagship Fund Limited  
2016 Annual General Meeting**

In accordance with ASX Listing Rule 3.13.3, please find attached a copy of the Chairman's Address and the Managing Director/Portfolio Manager's Comments.

Yours faithfully,

A handwritten signature in blue ink, appearing to be 'G. Stirton', written over a horizontal line.

**Geoffrey Stirton  
Company Secretary**

## **Important Notice**

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## **Chairman's Address Magellan Flagship Fund Limited 2016 Annual General Meeting Thursday, 27 October 2016**

MFF recorded a net loss after tax of \$9.9 million for the year ended 30 June 2016 (compared with a net profit after tax of \$187.1 million for the previous year).

MFF's balance sheet is strong. As at 30 June 2016 the \$786.4 million Total Equity comprised Retained Profits of \$259.9 million and Contributed Equity of \$526.5 million. Investments were \$1004.4 million and Borrowings \$107.9 million. MFF has substantial deferred tax liabilities (approximately \$108.4 million as at 30 June 2016) which reflect more than \$340 million of net unrealized gains compared with the cost of our investments. Current tax incurred was again below 1c per share.

MFF uses "mark to market" accounting for both investments and foreign exchange. Thus MFF's profit and loss starts each new financial year at zero, based off the market values at the end of the previous financial year. Hence significant fluctuations in reported year to year results are inevitable.

The 2015/16 result represents a decline after expenses and tax of approximately 1.25% based on our net assets. Negative marks to market on some of our investments modestly exceeded positive marks to market, and the benefits from currency movements were far smaller than in the previous year, and actually were negative in the second six months.

Quality businesses, valuation and risk controls continue to be key metrics for MFF's portfolio management. MFF's primary focus is to seek out investments in advantaged

companies at attractive prices. In the higher markets in recent years this has been much harder, and MFF has been very patient with both buying and selling.

Your Board and management have also overlaid risk controls including borrowing and position size limits. Your Board considers that MFF's high risk standards and investment processes continue to be well maintained. Your Board also remains pleased with Mr Mackay's focus as Portfolio Manager.

Your Board is updated regularly by the Portfolio Manager on his assessment of the risks and potential upside for the holdings, and potential holdings. We remain very pleased with the composition of the portfolio. We continue to caution against elevated investor expectations. Risks associated with the sustained low interest rates and higher asset prices continue.

#### Dividends

The Directors have declared a fully franked dividend of 1 cent per share, to be paid in November 2016. Imputation credits of approximately \$3.8 m as at 30 June 2016 allow us to fully frank the dividend. The Directors' continued preference is for a regular six monthly dividend at 1 cent per share, subject to corporate, legal and regulatory considerations, with continued operation of the Dividend Reinvestment Plan (at zero discount to the applicable market price). Although we note and respect the desire of some shareholders for higher dividends, we also note that MFF's retained funds continue to be put to good use with strong medium term returns.

#### Capital Structure

A bonus issue of options was undertaken in October 2012 on a 1:3 basis to shareholders and the bonus options are quoted on the ASX (Code: MFFO). The adjusted exercise price of the options is \$0.9964 and the expiry date is 31 October 2017. As at 30 June 2016 approximately 75.6 million options were unexercised.

We do not currently have any plans to raise additional new capital or otherwise alter MFF's overall capital structure. MFF has liquid investments, debt markets remain favourable and the MFF 2017 options are nearer their expiry date. Capital structure can be reviewed promptly if circumstances change, for example if a general fall in markets leads to far more attractive investment opportunities and the most sensible funding is not sale of existing investments, or additional use of MFF's borrowing capacity.

Your Board favours the possible benefits of greater scale but only if this is in shareholders overall interests. Your Board seeks to ensure that shareholders have equal opportunity to participate in entitlements or bonus option issues, and to realise market value for their entitlements and options.

The Portfolio Manager maintains a search for significant investments which might provide MFF with a meaningful flow of income, but market prices for these type of investments are unfavourable compared with the benefits of MFF's portfolio, including its liquidity aspects.

### Service Arrangements

The key operating subsidiary of Magellan Financial Group was originally the manager of MFF, and since 2013 has provided research and other services as MFF's key service provider. Your Board has agreed to extend the arrangements on financial terms including a fixed fee arrangement for 3 years from 31 December 2016, comprising base fees of \$4 million per annum and possible performance fees of \$1 million per annum.

### On-market Share Buy-back

Shareholders benefitted from the share buybacks we conducted in recent years at prices well below recent prices. It did not make sense to buy back shares in the past 12 months and so no shares were bought under the ongoing buyback authorisation.

MFF provides regular, very high levels of transparency about MFF, our portfolio, decisions made, prospects and risks in addition to detailed statutory information so that investors can make informed decisions about their investments. In addition to the Annual and half yearly reports, we release detailed figures each week including pre and post-tax figures, details of adjustments for exercise of the MFF options, updates in relation to the portfolio holdings, as well as extensive monthly commentaries.

MFF's processes continue to target strong medium term investment performance and for this to translate into share price performance over time. We note that notwithstanding MFF's repeated cautionary statements about elevated investor expectations, the share price raced ahead at the end of Calendar 2015 when the AUD was lower, and this has contributed to the lower share price this calendar year.

We welcome the questions we have received during the year and those specifically for the meeting. We will seek to address many in the formal comments and in Q+A, as well as questions from the floor and the phones.

An important question from a shareholder asked whether MFF non-executive directors take part of their fees in shares to align with shareholders. In the case of MFF the alignment is very strong: all the Directors have large shareholdings (multiples of their fees) that they have held for the long term and have increased during their time on the Board. These shares have all been paid for from our own resources on the same terms as other shareholders, and the Company has not incurred any outlay on Board or Executive share or option plans.

I now invite Chris Mackay to make some remarks and we look forward to your questions.

**Richard Warburton AO LVO**  
**Chairman**

**Comments from Chris Mackay  
Managing Director and Portfolio Manager  
Magellan Flagship Fund Limited 2016 Annual General Meeting  
Thursday, 27 October 2016**

In addition to discussing MFF, its performance, current position and outlook, diving down into the portfolio, its construction, currency and interest rate decisions, I will touch on an overview of current market conditions given the context of unprecedented easy global monetary policies, low and negative interest rates.

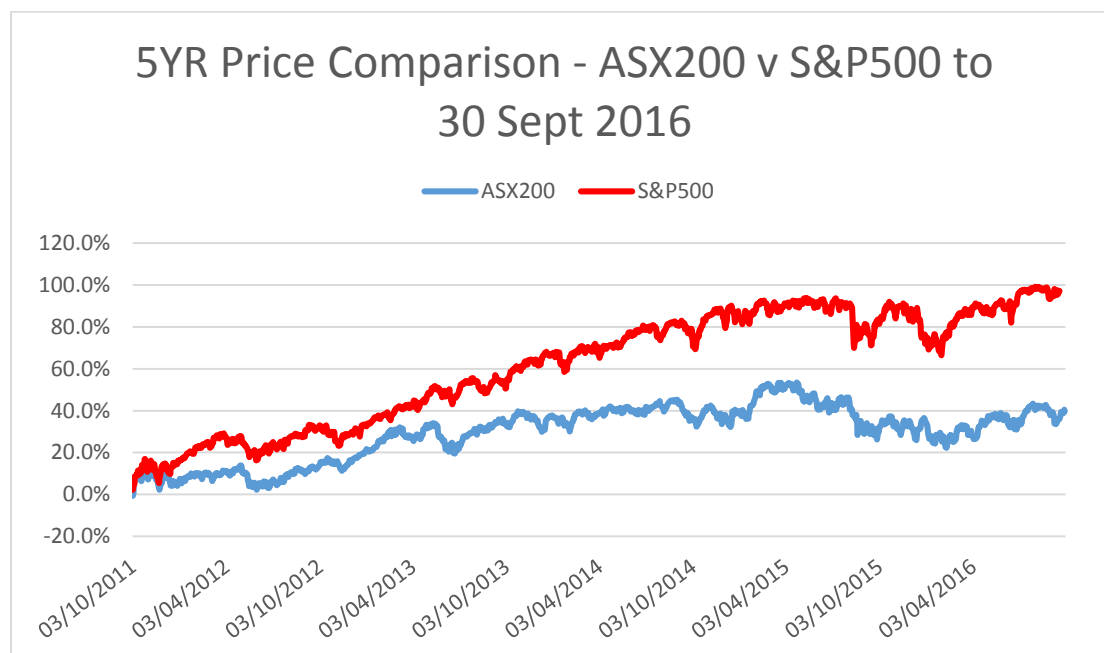
We have also received a number of questions during the year and specifically for the meeting, thank you. Whilst some are addressed in the prepared remarks, we will answer others in the Q+A session, and we will leave plenty of time for follow up, for questions and comment from the floor and from the phones.

MFF continues to be invested in a portfolio of extremely high quality companies which have favourable medium term prospects and well above average prospects that their advantages are sustainable; overall those advantages continued to improve in the year, with widespread market share gains converting into cashflows and they should produce strong cashflows for many years.

Our core mandate is to buy quality companies when they are out of favour (and hopefully relatively inexpensive) and to hold them whilst valuations and risk assessments remain favourable, subject to overall opportunity cost assessments in relation to the portfolio. We also seek deep value/higher growth situations with appropriate risk/reward balances.

Our processes and risk controls require ongoing patience and objectivity. Investments in equities require sufficient potential returns given their ranking below fixed and variable business costs such as wages and rent, and below debt securities. A majority of all businesses have declined in value over the medium to longer term, and this is logical given the nature of market capitalism. Probabilities of favourable outcomes may rise if objective focus is price disciplined, and upon a group of likely business winners over the medium term.

On the screen we are showing 5 year graphs of the S+P 500 index (the leading US equity index) as well the S+P/ASX 200 (the leading Australian equity index). These graphs provide some context for MFF, markets, risks and where we are today, although of course the story is more complex (value and interest rates for example).



The investment performance of MFF over that period (after costs and taxes) compares favourably with the indices, and other alternatives. Objectively, it was difficult not to achieve sizeable gains in the strongly rising equity markets post Crisis, and also for MFF not to outperform in most years when our portfolio excluded the areas most impacted. In considering this period note that most risk management processes from excellent experienced investors were not rewarded, whereas we benefitted materially from our currency position, particularly in 2014/15.

As value investors we require market prices for equities to be 'wrong' from time to time, and to either buy or sell accordingly. Some investors might argue that prices were 'right' at all points along the graphs on the screen. We consider that the data reflect fluctuations well beyond what might objectively be rational economically (even for these indices, which contain hundreds of securities). Businesses and markets are impacted by context, and markets correlate and overshoot.

Turning to the present: we continue to consider that prices for our portfolio are broadly satisfactory in current circumstances. Specifically, as at financial year end, we commented "(f)ollowing the market declines in the last month of the financial year (which accelerated after the UK Brexit vote), we are moderately more positive about valuations than we were a year ago". Our short term figures and some official data released this financial year have been modestly positive and, overall, the latest earnings results have been received positively, including for the US bank financials. Currency has been a headwind.

During the last year we preferred to be largely invested, with moderate borrowings, in a portfolio focused on business advantaged, liquid securities. As we have done for a number of years, we tended to buy on downward moves. In the year our buys

exceeded our sales by more than 11 to 1. Risks lessened of an immediate spike in key interest rates, which may have caused a sustained downward move in equity prices for our portfolio. We feel that the likely returns compare favourably with cash, and that the medium to longer term return probabilities compare sensibly with current alternatives (having regard to risks/opportunity costs).

The graphs also show that rises in large capitalization indices were more likely than falls across the period. However, a majority of investors did not benefit from market level gains in this period, perhaps as investors fear losses particularly whilst previous traumatic losses are in memory. The graphs also invite questions of asset allocation. Investors could easily have sat in cash for this period and their capital would likely have been secure, but the cumulative after tax returns would likely have been well below 10%.

We are asked shareholder questions along the lines of the media/other experts who say the market must crash so what are you doing about it? Unless the price volatility gives us opportunity or objective risks require action, we avoid attempts to discern patterns in unpredictable and emotional short term movements and volatility [eg around events], as a focus on business and fundamentals is less risky over time.

Most investors have forgotten what they worried about at the start of the period as pretty much all the original investor worries that were overcome, one by one, with the US election obviously still to come, and the markets mostly kept rising. The old worries were replaced by new worries. Intelligent shareholders are worried shareholders, but investing temperament is different. Actually we perceive there are fewer questions/comments like this compared with the lead up to past meetings [which coincided with some downward spikes in the graphs]. Investors appear somewhat more confident, and some of the big asset allocators are making noises about having to increase equity exposures to meet return targets.

We have discussed momentum investing and the growing popularity of index investing and ETFs which have momentum underpinnings in our releases in recent years. Some who have been risk averse are being lured by the pyrrhic victory of lower costs, the psychic illusion of 'not making a mistake' as everyone is doing it, and buying index funds, usually with the stated goal of being a long term investor.

Going forward, if asset prices again rise in the short term, as is customary towards the latter stages of most bullish markets, most investors will feel good about the gains they are seeing, and there will likely be some economic multiplier effects and scope to block out memories of previous losses. However more confident, index and yield chasing investors mean higher prices, more risks and lower medium to longer term aggregate returns, even though momentum is as likely as not to keep prices rising for a period.

Whilst we typically bought equities in market downturns in the period covered by the graphs, obviously this will not always be sensible. As prices rise, risks rise and rational return expectations fall, although we argued that potential returns coming out of the Crisis were exceptional. Future returns may remain favourable compared with other alternatives.

Another question we have been asked is when assessing investments, what allowance is made for the impact of franking credits payable by Australian companies versus global (foreign) companies which cannot pay franked dividends? We prefer franked dividends by the mathematical value of the franking credits and domestic tax saving. Qualitatively we also consider investor preference for franking and for dividends, and its context for managements' capital allocations. However, particularly in the low rate environment, many investors put considerable emphasis on dividends and hence yield based investments typically are [more] highly priced, and reaching for yield, whether fully franked or not, may not protect capital. Over the period of the chart it would have been less profitable investing in an ASX index portfolio than a US index portfolio even adjusted for franking benefits.

Sensible capital allocation, including dividend policy, is important for our portfolio companies (alongside sustainable economic advantages, whether the companies can reinvest their capital at high rates of return, business quality, growth, value and comparison with price as factors which may offer some safety of capital). Dividends received by MFF last year of \$17 million were up 60% are seen in the context of unrealized gains of over \$340 million at year end.

On the screen we are showing the largest investments (above A \$1m) as at 14 October 2016 (as percentages of investment assets).

Holding	%	Holding	%
Visa	12.7	Lloyds Banking Group	3.0
MasterCard	10.3	Bank of New York Mellon	2.5
Home Depot	10.0	Microsoft	2.2
Lowe's	9.7	State Street	1.6
Bank of America	8.3	Qualcomm	1.1
Wells Fargo	8.3	Schroders	0.9
HCA Holdings	7.3	CapitaLand	0.4
US Bancorp	5.6	Singapore Technologies	0.3
CVS Health	4.5	Fraport	0.3
JP Morgan Chase	3.9	SIA Engineering	0.2
BlackRock	3.5	Axalta Coating Systems	0.1
S&P Global	3.1		

In addition we have 3 Canadian investments, another in Asia and one in Europe below that level.

We feel that some of our companies are likely to continue to demonstrate at least moderate growth for at least the medium term. We are delighted with the excellent recent business performances and prospects of almost all of our major holdings, despite a number of disappointments in recent years (eg cross selling in banking and higher contract labour costs in healthcare).

Whether our portfolio prices are broadly satisfactory in the current market environment requires comparison with alternatives. Purchasers of short term Government securities accept zero or negative interest rates, and 10 year US Government Bonds yield approximately 1.8% (up from 1.3%) and hence buyers and traders in that market can



only return 1.8% p.a. nominal , less costs, in aggregate for the next decade. If/when US and global rates rise back to 2, 3 or 4% or higher is important for financial stability as well as markets.

Interestingly, many professional investors have only moderately adjusted downwards their estimates of discount rates for future returns from equities; outside of so called 'safe haven' investments. The loss aversion sentiment preference mentioned above has been very strong for regulators, advisers, intermediaries and many investors. These are reflected in more than US\$50 trillion remaining in cash or similar according to BlackRock's recent estimate.

Whether profits and growth are sustainable and what is reflected in market prices are key judgement areas in current markets; many investors have continued with optimistic future earnings forecasts and various companies appear to us to be over earning, some are under earning with decent probabilities of sustainable increases.

We have found very few new opportunities to buy in recent years and none that we have regarded as compelling. MFF continues with its focused approach which carries portfolio concentration risks.

MFF's proportion invested in global multinationals remains lower than in previous years; we would increase this level and exposures to emerging markets and other sectors if/when we find the right opportunities. Although diversifying widely for its own sake would have cost our shareholders in recent years, we will continue to adjust exposures and portfolio construction (having regard to market prices, business characteristics and risks). Credit based financials fell further out of favour with investors in the 12 months and they continue to be prominent in the portfolio. Although we will not dismiss genuine 'deep value' opportunities, buying lower quality securities late in a market cycle does not reliably create value and certainly not in aggregate; many investors making lots of money inevitably become less focused on risks.

The graphs shown earlier obviously do not overlay economic, company specific information or trends in technology or society. For example more individuals are aware that governments and the employers will not meet their retirement needs and they have to handle their own investments.

Many key measures of economic conditions in the US and elsewhere are stronger than press and commentators acknowledge. Low rates of credit defaults, increased employment and wages, increased population, increased trade, rising asset markets, increased lending and spending... there is much that is not right, but better than widely perceived aggregate figures translate into solid corporate earnings prospects, and many of our portfolio companies are doing better than the economies in which they operate. The services sectors, where we and most modern capital is allocated, may not be represented adequately in the structure of official economic data (which was constructed when manufacturing was more important), and services are more economically stable, and have higher growth with less price deflation.

As part of our portfolio and market risk management, we have concentrated in securities with high levels of liquidity and previously cleaned out most marginal, illiquid and relatively expensive holdings from the portfolio. Our recent low portfolio turnover (about 1.5% last year) has been an outcome rather than a target, and it may sensibly improve our risk/reward tradeoff to increase the portfolio turnover by sales into a rising market cycle. Although we are concentrated in securities that we feel will be more

valuable in 5 and 10 years, obviously there will be periods of market declines and declines for individual securities, and it is inevitable that from time to time we will sell some of our larger holdings in order to build capacity for future opportunities. MFF's opportunity cost is high when selling high quality existing investments thereby incurring tax on accrued gains, in order to buy replacement investments. However, periodic extended downward pressures are usually far more severe than can be perceived during the upturn.

Our assets comprise international equities, and we have not hedged the currency exposures. We believe that this profile offers some benefits given our perception of the medium term fundamental dynamics around the AUD, even at 30th June rates. Possible risk mitigation also remains an important consideration for MFF's currency positions. Currency movements are a primary transmission mechanism for risk adjustments in the world economy, with GBP and Turkish Lira being recent examples. Of course, this AUD currency position may add to MFF's risks, for example this year China has again undertaken a major stimulus to restart their economy and the AUD has risen in Calendar 2016. Our recent moderate reduction of MFF's USD exposure in part reflected recent USD strength, the China stimulus and the prospects of increased infrastructure spending in developed economies.

We will address questions about interest rates further in Q+A, and note our comments on page 19 of the Annual Report on the ongoing debates on inflation, deflation and interest rates (with deflation in the ascendency until very recently). Our positions in banks would have benefitted if interest rates had increased, but year-end consensus had moved closer to lower forever, or at least much longer.

I thank my fellow Directors who continue to provide very insightful judgement, counsel and leadership.

We also congratulate MFG, our key service provider and partner, on its success and on reaching 10 years and thank our MFG teams on the service, support, kindness and friendship they give us. The Board and I want to publicly acknowledge and thank Nerida Campbell, who not only was instrumental from inception as MFG's original CFO and COO, but who has been very valuable for MFF over many years. Some of you might know that Nerida and Stuart Nelson were MFG's first employees in a serviced office but very few are aware that Nerida was instrumental in framing our key risk parameter of trying to avoid permanent capital loss.

Another shareholder question asks what is MFF's policy on selection of ethical investments and environmental considerations? MFF takes into account these matters in assessing companies, well beyond the strength of the societal license that a company might enjoy. Interested shareholders and investors should also reach out to MFG as its macro-economic and investor teams are prominent on these issues which they review in detail for investments, and some material is on the website and contained in ASX releases.

Finally, MFF shareholders and others interested in investment processes are encouraged to review the video on the website of MFG's recent investor briefings. This is an important piece of work, which has already been commended widely, as it deals with accelerating technological changes, their wide ranging societal impacts and investment implications.

I will hand back to the Chairman and we would be happy to address the written and other questions.

**Chris Mackay**  
**Managing Director and Portfolio Manager**