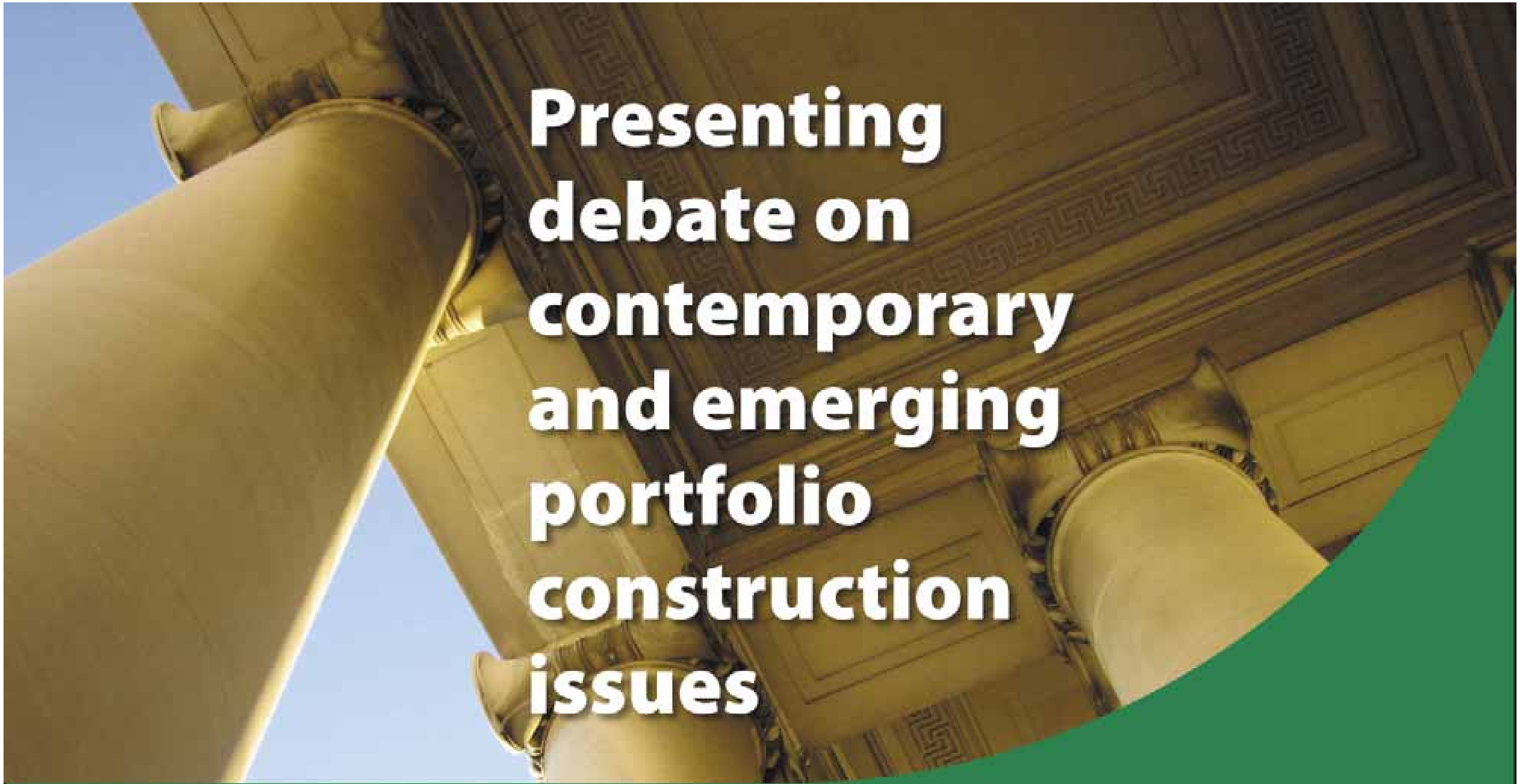


portfolio construction

CONFERENCE

15 & 16 August 2007 | AJC Convention Centre, Randwick, Sydney

Concentrated portfolios – why less is more

Hamish Douglass, Chairman – Magellan Financial Group

Presentation to PortfolioConstruction Conference 2007

MAGELLAN ASSET MANAGEMENT LIMITED

Disclaimer

Units in a Magellan Fund are issued by Magellan Asset Management (ABN 31 120 593 946, AFSL 304301). Before making an investment decision in relation to a Magellan Fund, investors should obtain and read the Product Disclosure Statement for the Funds dated 23 July 2007 which can be obtained from Magellan's website at www.magellangroup.com.au.

Any general advice about the Funds in this presentation have been prepared without taking into account your personal objectives, financial situation or needs. You should consider the appropriateness of the information having regard to your personal circumstances.

About Magellan Financial Group

- Magellan Financial Group was formed in 2006
- ASX listed with a market capitalisation of over $170 million
- Sydney based specialist investment manager with global focus
- 26 staff members including 13 investment professionals

Agenda

- The Case for Concentrated Portfolios
- Historical & Statistical Evidence
- Investing when the odds are in your favour
- Diversification – How many stocks is enough?
- Portfolio construction considerations

The Case For Concentrated Portfolios

- Good capital allocation is simply allocating capital to the most attractive investment opportunities

- To maximise returns investors should:
  - Find opportunities where they have an analytical edge
  - Allocate a material amount of capital in such opportunities

- Most fund managers tend to allocate too little capital to opportunities where they really have an analytical edge

Statistical Evidence
Concentrated Managers – United States

Fund Manager	Fund Inception	No of stocks*	% Top 10*	Fund return since inception (% p.a.)	S&P 500 since fund inception (% p.a.)
Sequoia	15/07/1970	22	77.2%	15.6%	11.8%
Clipper	29/02/1984	20	73.0%	14.5%	13.0%
Oakmark Select	11/01/1996	20	62.0%	18.0%	N/A
Legg Mason Growth Trust	17/04/1995	25	54.4%	11.6%	11.1%
Longleaf Partners Funds	8/04/1987	23	53.2%	14.2%	10.6%
Weitz Value	9/05/1986	33	49.7%	13.3%	N/A
Legg Mason Value Trust	16/04/1982	41	45.0%	15.9%	13.7%
Tweedy Brown Value	8/12/1983	41	44.0%	10.9%	11.0%
Third Avenue Value Fund	1/11/1990	100+	37.5%	16.6%	N/A

All performance data is as at 30/06/2006 other than Sequoia and Longleaf Partners (31/03/2007) and Third Avenue Value (31/07/2007). Performance data provided by individual managers. Benchmark performance since inception for Oakmark Select, Weitz Value and Third Avenue Value was not provided by the manager

Statistical Evidence

Morningstar Study January 1992 – December 2006

- Most concentrated 25% of funds in each category no riskier than average as measured by standard deviation

- When concentrated funds were also bottom quartile in terms of trading frequency the subgroup exhibited lower volatility than average in 76% of rolling 1, 3, 5 and 10 year periods.

- Index relative R-Squared results meaningfully lower than less concentrated peers (Vanguard Explorer = 97, Oakmark Select = 66)
  - ⇨ *"more likely to dance to the beat of their own drummer"*

- Concentrated funds performed better in weak markets of 2000, 2001 and 2002
  - ⇨ *"More tempered downside"*

Source: Dolan, K (2007) A 40 Stock Portfolio: Not Just for the Bold Types. Published at morningstar.com.

Statistical Evidence
Hagstrom/Lamm-Tennant Study

- 12,000 portfolios randomly selected from 1,200 companies in the United States, with varying degrees of concentration
- Performance assessed over a 10 year period

No of stocks	Best return (% p.a.)	Worst return (% p.a.)
15	26.6	4.4
50	19.1	8.6
100	18.3	10.0
250	16.0	11.4

The potential for outperformance in a concentrated portfolio is greater, provided you have skill

Source: Hagstrom, R (1999) The Warren Buffett Portfolio
Returns calculated 1987 – 1996.

Investing when the odds are in your favour
The Kelly Formula

Case Study

Fact 1: You are a card counter with a 10% edge over the casino
(i.e. you have a 55% chance of winning, the casino has a 45% chance)

Fact 2: The payoff if you win is $1 profit

How much of your bank roll should you invest?

- If you bet too little, you miss out on a great opportunity
- If you bet too much, you could lose all of your capital

Investing when the odds are in your favour

The Kelly Formula cont…

Kelly Formula:

$$\frac{\text{Expected Return}}{\text{Payoff when you win}} = \text{fraction of your bankroll that should be invested}$$

In this case:

Expected return (edge)	=	\$0.10
Payoff	=	\$1.00
Fraction to bet	=	10%

Placing 2% into such an investment is clearly a wasted opportunity.

A word from the experts…

There should be adequate though not excessive diversification. This might mean a minimum of ten different issues and a maximum of about thirty

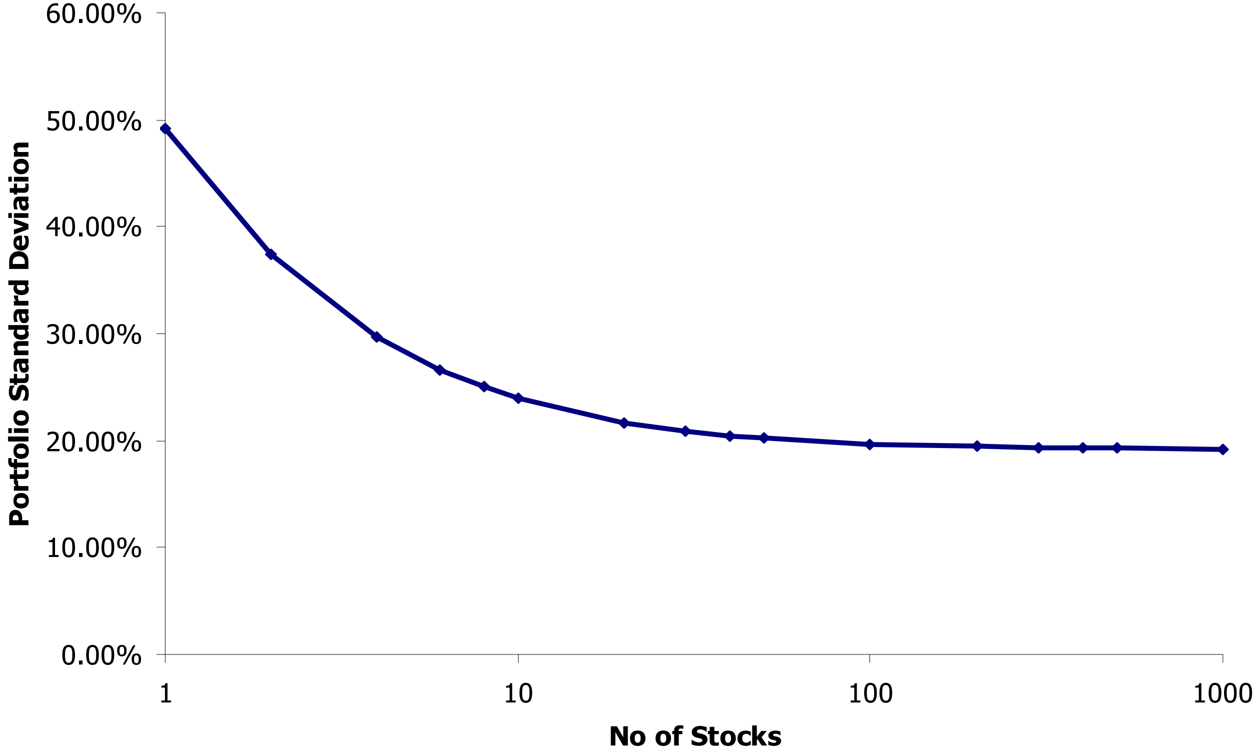
Benjamin Graham

The wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don't. It's just that simple.

Charlie Munger

Diversification

How many stocks is enough?



Immaterial diversification benefit when randomly selected portfolio exceeds 15 – 20 stocks

Portfolios of up to 1,000 randomly selected stocks in the Russell 1000.
Source: Statman, J (1987) "How many stocks in a Diversified Portfolio" Journal of Financial and Quantitative Analysis

Diversification
How many stocks is enough?

- A randomly selected equally weighted portfolio of 15-20 stocks should achieve diversification similar to the index
- Active fund managers do not randomly select or equally weight investments
- We consider that an appropriately structured portfolio of 25-50 stocks will achieve sufficient diversification
- Assessment of underlying business correlation is key in diversifying a concentrated portfolio

eBay

Three unique businesses

- eBay Marketplaces – world's leading online auction platform
- Pay Pal – world's leading secure online payments business
- Skype – world's leading VOIP communications network

Each business exhibits powerful network effects with widening economic moats

eBay
Marketplaces

- 244 million registered users and 83 million active users
- #1 e-commerce brand with 98% aided brand awareness
- Approximately US$55bn in GMV making eBay one of the world’s top 10 retailers
- 900,000 people make their living from eBay
- Highly attractive economics:
  - toll road with no inventory and limited fixed assets
  - maturing but strong revenue growth (23% in Q1 07)
- Developing other businesses (Shopping.com, Rent.com, Classified advertising)
- Maturing active user growth

eBay
Pay Pal

- 153 million users (Amex has 82 million cardholders)
- Attractive to merchants:
  - Pay Pal typically saves merchants 10 bpts to 300 bpts
  - can be set up by a merchant in a few minutes
- Attractive to buyers
  - easy to set up
  - fast – transactions take a few seconds
  - secure
- Highly attractive economics
- Very substantial growth opportunities with powerful network effects at work

eBay
Skype

- 220 million users
- Network effect created by free Skype to Skype community
- Powerful monetisation model yet to be realised
  - Skype out minutes
  - Value added services (telephone number, voicemail)
  - On-line money transfer
  - Advertising revenue via pay per call lead generation
  - eBay integration
  - Pay Pal integration

eBay

Attractive economics

- Return on tangible capital >60%
- Free cash generation in excess of reported profit (US$1.7bn v US$1.5bn in 2006)
- Implemented share buyback
- 2007 PE circa 26 times based on current guidance
- 2008 PE circa 21 times based on our forecast
- Priced on a 5% free cash flow yield with strong growth outlook in each business

0.14% of MSCI World

The planner's dilemma

- Typically 3 managers to achieve sufficient manager diversification
- Median international manager holds 134 stocks (van Eyk) and themselves are managing benchmark risk
- Total portfolio of 402 stocks, or 360 stocks if you assume assume 10% commonality
  - ⇨ average position size less than 0.3%
- Does this lay a foundation for excess returns?

Solutions

1. Index the entire portfolio – and forfeit any value you may add by manager selection

   Buffett: [While efficient market theorists] "*observ[ed] correctly that the market was frequently efficient, they went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day*"

2. Invest into a pool of concentrated equity managers and thus eliminate risks of overdiversification – *providing the greatest opportunity for excess return, whilst having a low probability of over-diversification*

3. Attain your beta via an index manager or multi-manager portfolio and your alpha via a portfolio of concentrated equity managers – *providing low cost market exposure whilst allowing alpha to be driven into the overall portfolio*

Focus in Practice

Magellan Global Fund Top 10 Holdings as at 31 July 2007

Company	Portfolio Holding
eBay Inc	7.85%
Yum! Brands Inc	7.13%
American Express Company	6.79%
Abercrombie & Fitch Company	4.23%
Wal-Mart Stores Inc	4.19%
Nutrisystem Inc	4.01%
Tesco Plc	3.98%
Wells Fargo & Company	3.79%
Bank of America Corporation	3.78%
Harley-Davidson Inc	3.44%

The final word…

We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort level he must feel with its economic characteristics before buying into it. In stating this opinion, we define risk, using dictionary terms, as "the possibility of loss or injury"

Warren Buffett

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