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Reviewing your Equities Approach:
Do Domicile & Index Weights Matter?

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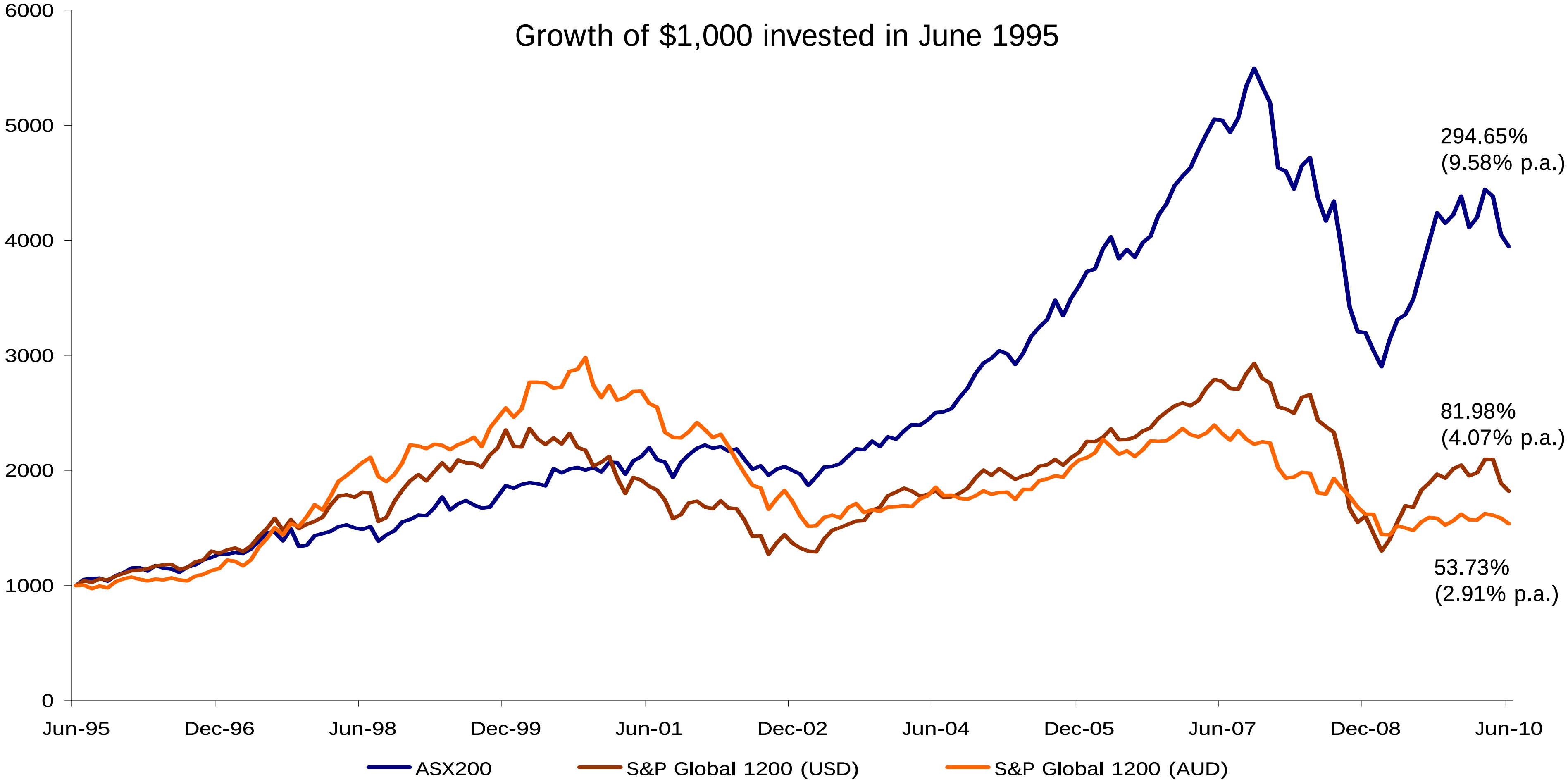
MAGELLAN
ASSET MANAGEMENT LIMITED

Agenda

- Performance and composition of global equity markets
- Why has the Australian market outperformed?
- The inflation/deflation debate
- Factor consideration in portfolio construction

What we know (1)

Australian equities have significantly outperformed over the last 15 years



Source: Bloomberg

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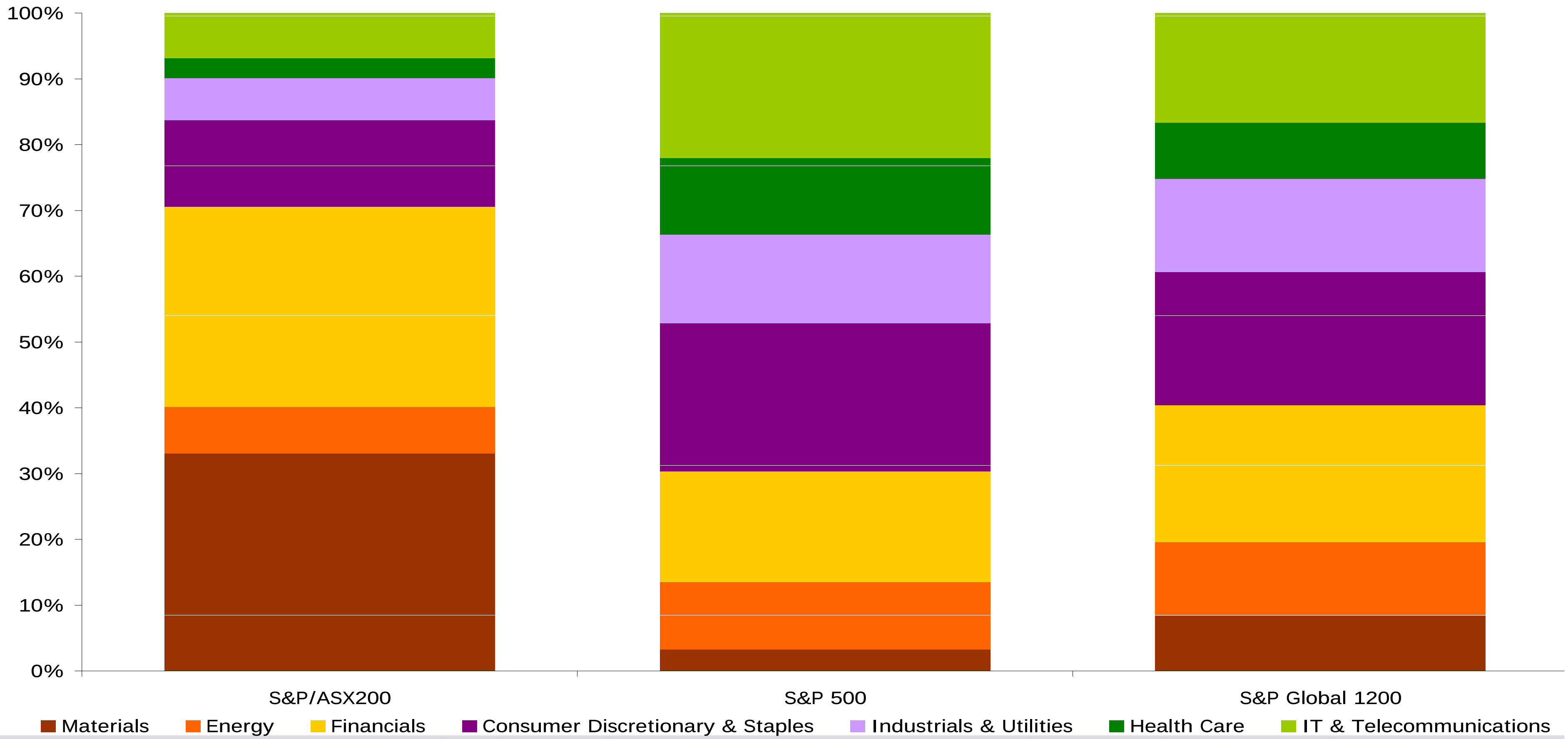
What we know (2)

Australian equities have a significant sector bias vs global equities...

Sector weights as at 30 June 2010



Source: Bloomberg

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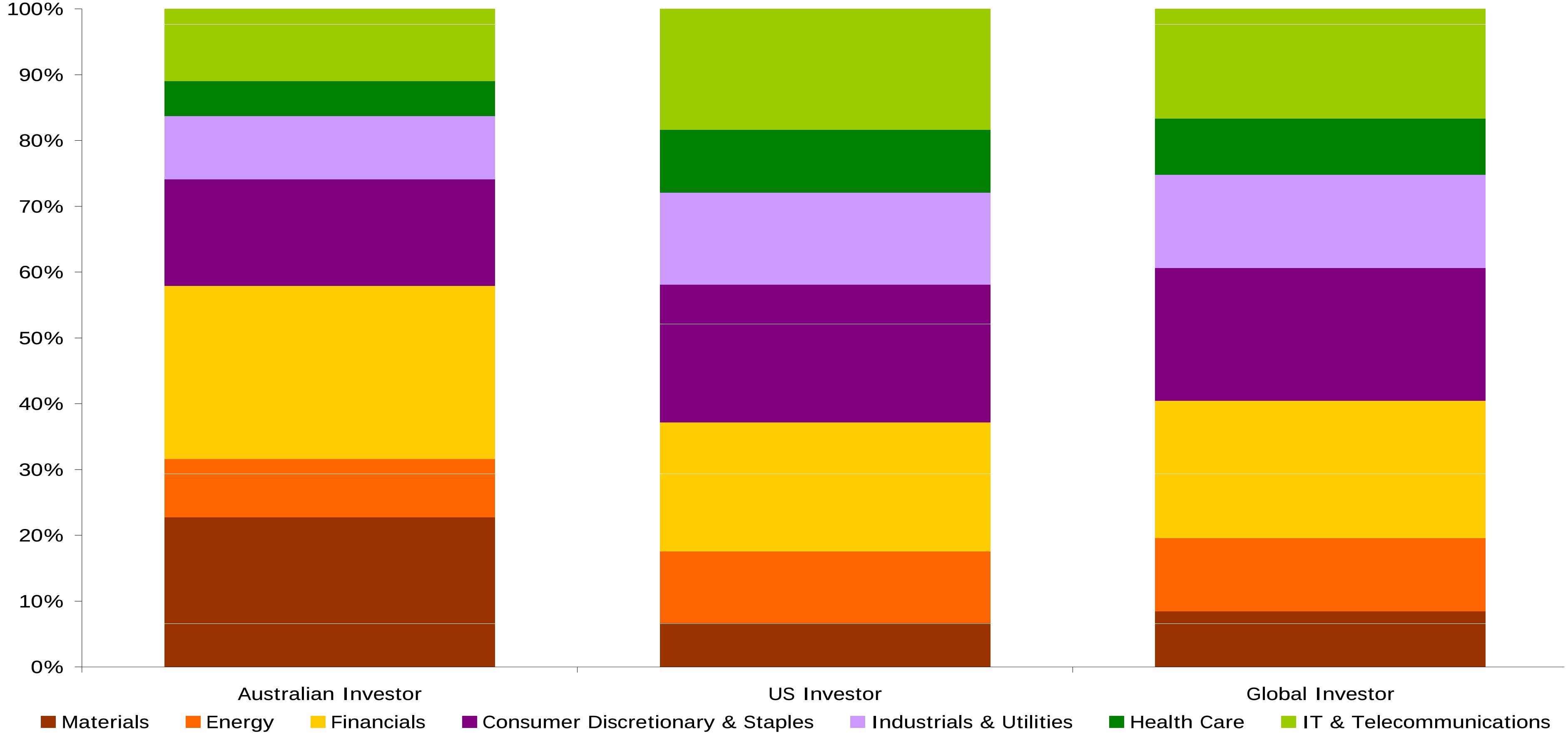
Typical global diversification barely moves the needle

Combined Sector weights as at 30 June 2010



Combined weights are 60% local market/40% global market excluding local securities

Source: Bloomberg

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Why has the Australian market outperformed?

Explaining Australia's Outperformance

- Is the 'lucky country' systematically destined for superior performance, or are there other factors at play?

- Stated another way, do country effects (unique to Australia) or sector effects (not unique to Australia) dominate relative returns?

- This is an extremely important question for investors when determining their asset allocation

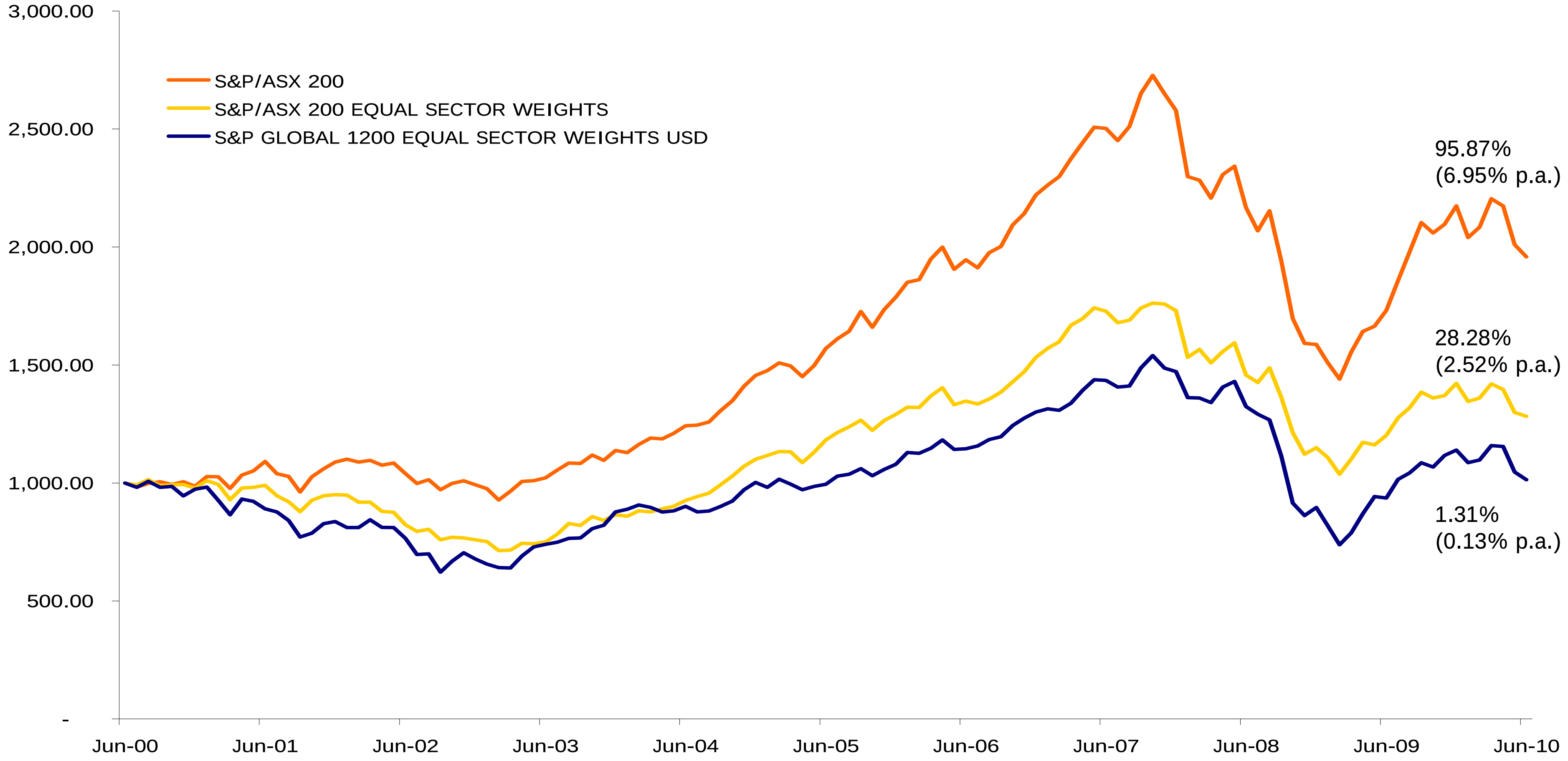
Explaining Australia's Outperformance

Removing sector effects

- To remove the impact of sector effects, we compare published benchmark returns with the returns that would be generated when monthly re-weighted equally to each of the ten GICS® sectors over the last ten years. Importantly this period:
    - Eliminates much of the impact of the 'TMT bubble" which would cause the sector effect to be overstated
    - Incorporates two global recessions thus a range of economic cycles
    - Captures the significant global market integration that has taken place in recent years, particularly through the 1990's (rendering older data redundant)

Explaining Australia's Outperformance

Removing sector effects – impact on total return from Australian equities



Source: Bloomberg

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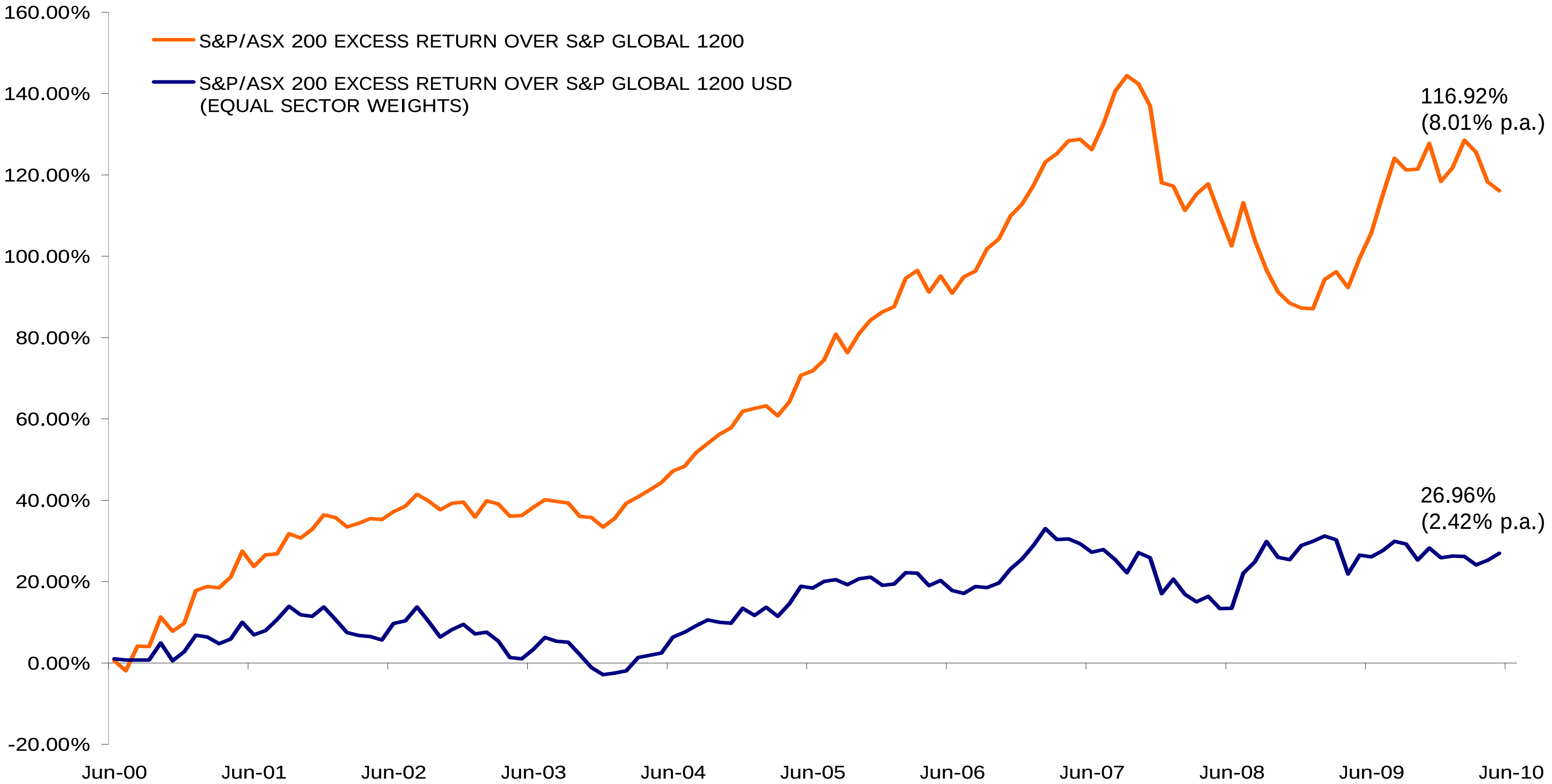
Explaining Australia's Outperformance

Removing sector effects – impact on excess returns



Source: Bloomberg

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Explaining Australia's Outperformance

Removing sector effects

- This analysis illustrates the equally-weighted sector effect has accounted for 70% of total returns of the S&P/ASX200 over the last ten years; and

- 77% of excess returns over the S&P Global 1200 over the same period

Explaining Australia's Outperformance

Removing sector effects

- By adjusting weights to reflect the historic sector bias of the Australian market against the S&P Global 1200*:
  - Total return drops further to 13.33% (or 1.26% per annum)
  - Excess returns drop by a similar amount to the equal-weighted methodology, dropping from 116.12% (8.01% p.a.) to 40.06% (3.43% p.a.)

- This analysis illustrates that the Australian sector bias vs the S&P Global 12000 has accounted for 79% of total returns and 65% of excess returns over the period of the S&P/ASX 200.

* By applying S&P Global 1200 monthly weights to S&P/ASX 200.

For all periods up to December 2004, sector weights used for the S&P Global 1200 are as at December 2004 as earlier data is not available.

Explaining Australia's Outperformance

Removing sector effects

- Whilst the country effect has been a positive contributor (accounting for approximately 20-35% of both excess and total returns over period), clearly the sector effect has dominated given Australia's significant skew to the resources and financials sector

- The concern for investors should be will this positive sector contribution continue *ad infinitum*? If not, what is the appropriate action to take given its dominance?

- This requires <u>forward looking</u> asset allocation considering portfolio factor exposure, rather than simple domestic/international splits

Practically building forward-looking portfolios

Factor exposures that need consideration

- The fallout from escalating Sovereign debt
- The deleveraging of the household sector
- The increased capital requirements of the financial system via Basle III
- The asset-intensive nature of China's recent economic growth
- The movement of economic power from the developed world to the developing world
- Inflation or deflation?

Inflation v deflation

The inflation/deflation debate

- Enormous countervailing forces at work
- The deflationary debate is primarily a developed world issue
- Enormous inflationary pressures in the emerging world (China, India, Russia, Brazil, etc)
- Numerous developed countries with inflationary pressures (Australia, NZ, Denmark, Norway, Switzerland)
- The deflationary debate is primarily focused on major Northern Hemisphere economies (US, UK, France, Japan, Spain, Italy etc)

The inflation/deflation debate

Potential sources of deflationary pressures

1. Persistent excess productive capacity
2. Prolonged period of sub-par economic growth due to:
   - Consumer deleveraging
   - Government fiscal austerity measures
3. Structurally high and persistent unemployment
4. Prolonged low interest rates
5. Falling house prices
6. Embedded expectations of deflationary pressures

The inflation/deflation debate

Medium term sources of inflationary pressures

1. Rising food and energy prices
2. Effects of global warming
3. Expansion of the money supply from quantitative easing
4. Central bank exit strategies
5. Imported price inflation due to inflationary pressures in emerging markets
6. Rising long term interest rates
7. Increased regulatory intervention
8. Increased taxation

The inflation/deflation debate

US 10 Year Nominal Government Bond Yields are historically low

Source: Bloomberg

The inflation/deflation debate

Magellan's View

- Deflationary pressures are non-existent in emerging markets and in economies such as Australia
- In our view short term deflationary pressures in the US and Europe are likely to be overwhelmed by inflationary pressures in the medium term
- Investors should be concerned about:
  - Anaemic economic growth for the foreseeable future
  - Rising long term bond rates
  - Rising inflation in the medium term
- Stagflation may be a more realistic risk than deflation in the medium term

Conclusions

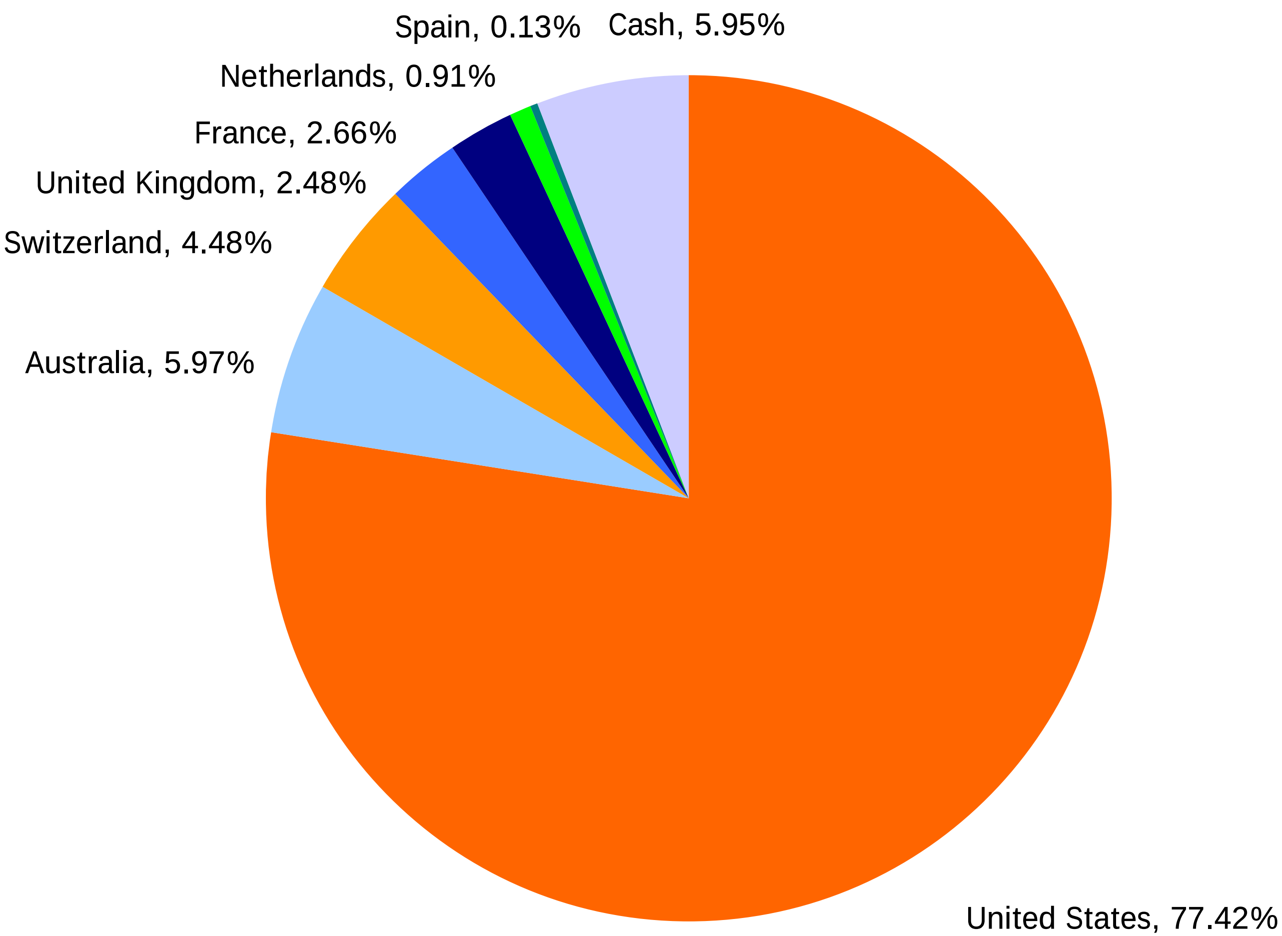
- Factor diversification is vitally important – the factor exposures of the Australian market have been the dominant drivers of performance over the last decade
- Portfolio construction is a composite of factor exposures, and these need to be explicitly considered in the context of forward-looking investor expectations
- The simplistic approach of using historical mean-variance to allocate between domestic and international equities is fundamentally weak and need to be revisited, and this weakness is particularly pronounced for Australian investors.
- Is supplementing Australian equities with an international index (or index-like) allocation likely to provide any material diversification benefit?

Factor consideration in practice

Magellan Global Fund

Factor Consideration in Practice

Magellan Global Fund – Geographical Lens



Portfolio weights as at 30 June 2010

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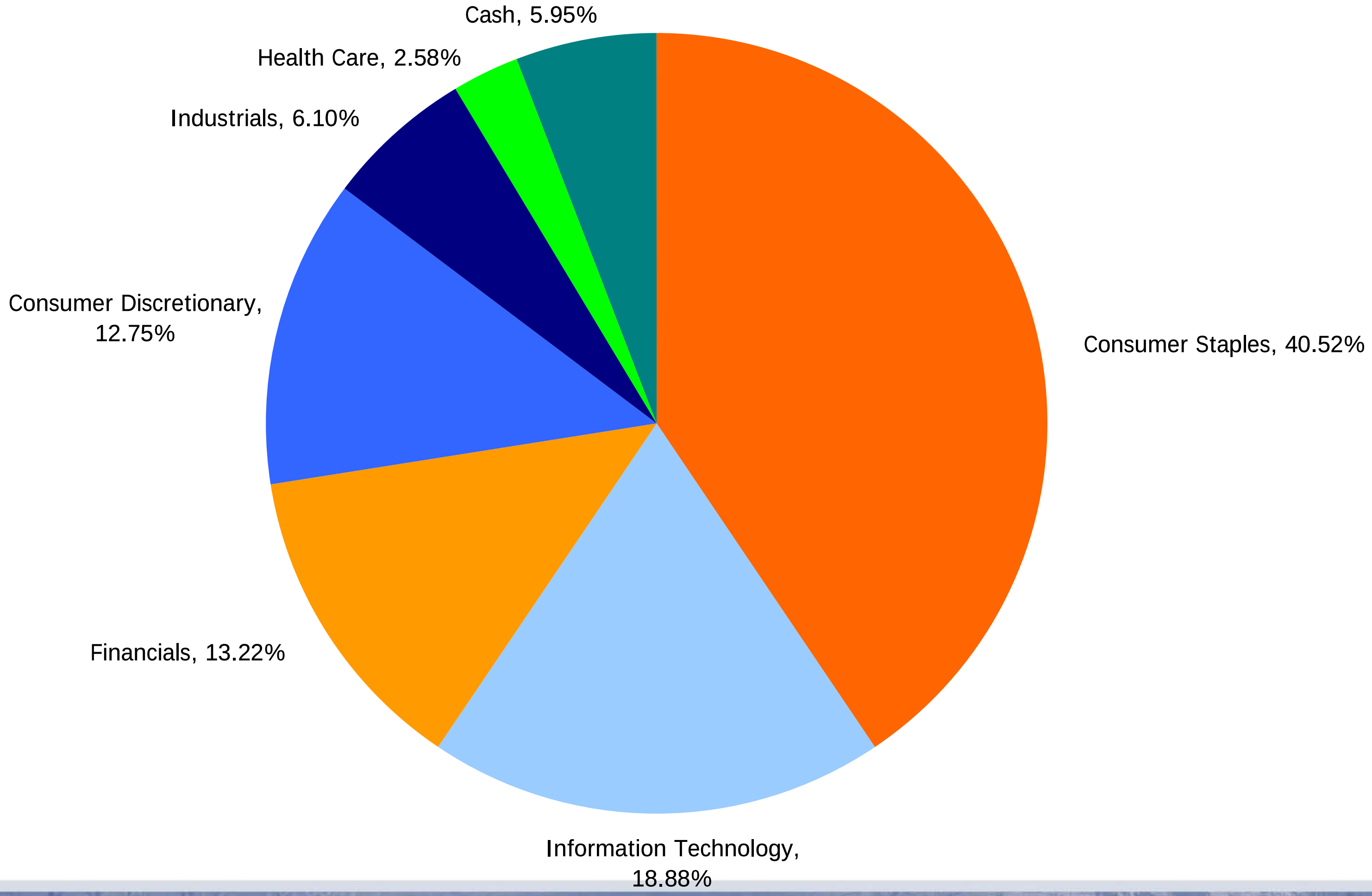
Factor Consideration in Practice

Magellan Global Fund – GICS® Lens



Portfolio weights as at 30 June 2010

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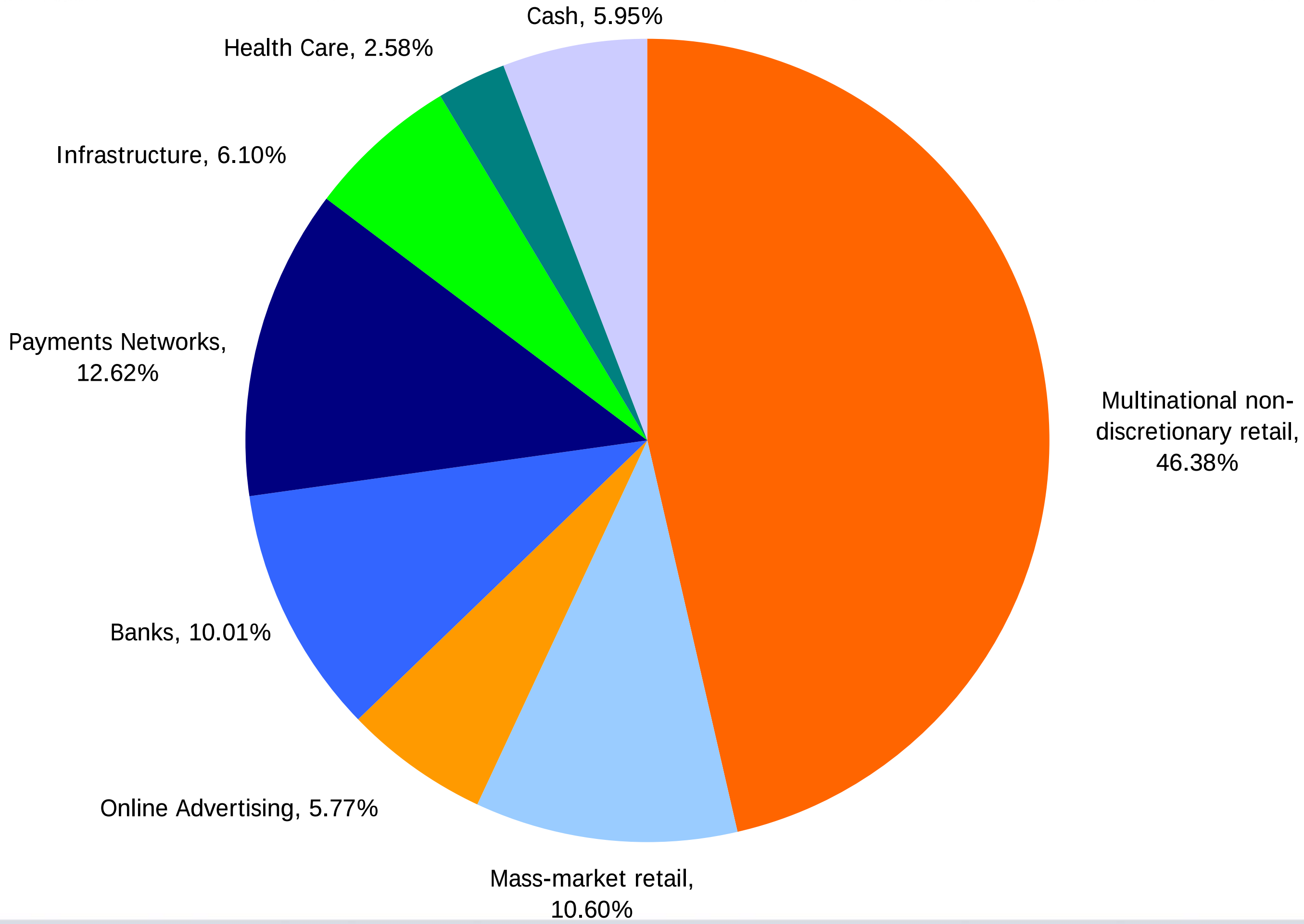
Factor Consideration in Practice

Magellan Global Fund – Portfolio Manager Lens



Portfolio weights as at 30 June 2010

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