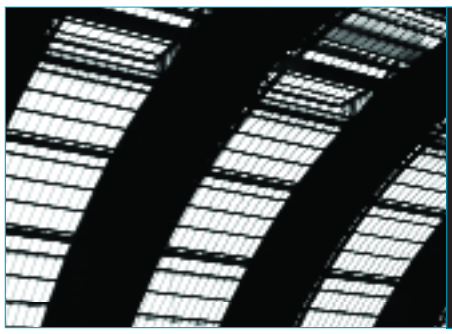
by Michelle Baltazar



Magellan Global Fund

Next generation boutique fund manager Magellan has launched a global fund that aims to beat the market using a Warren Buffet-influenced investment philosophy. Magellan co-founder and fund manager HAMISH DOUGLASS explains how the fund differs from the rest of the pack.

Hamish Douglass

It is not everyday a boutique fund comes to the market with Magellan Fund's pedigree. Before forming the fund, co-founder Hamish Douglass was the joint head of global banking at Deutsche Bank Australasia while fellow founder Chris Mackay was ex-chairman and chief executive of UBS Australasia.

The two of them were behind eight of the top 10 largest M&A transactions ever undertaken in Australia (BHP, Westfield, AMP and Coles Myer, to name a few). In short, when it comes to fund manager skill, both have unparalleled insight to the inner workings of the Australian sharemarket.

But instead of banking on their local know-how, Douglass and Mackay sidestepped Australian shares to launch a fund that invests in global shares.

Global equities specialists have long extolled the virtues of diversifying overseas. But what makes Magellan's global offering different, said Douglass, is the structure of their boutique fund; their multi-dimensional investment strategy; and the make-up of their cornerstone investors (James Packer and his family interests account for the second largest shareholding in Magellan, next only to the stake of Douglass and Mackay).

Next generation boutique

In the early 1990s, Douglass and Mackay made a pact that one day they would form a funds management group for retail investors. But because the idea was some 15 years in incubation, Magellan ended up with more financial firepower than the conventional boutique start-up.

For example, most boutiques start with seed money of less than $10 million and would take at least a year to build a respectable investor base. By contrast, Magellan shot out of the starting line with $100 million from its cornerstone investors ($20 million of which are Douglass' and Mackay's funds) and an impressive 5,000 shareholders (those who bought a stake in the business) on its books in less than nine months.

Crucially, one of the bugbears of boutique fund managers who come from large institutions is that they lose the resources and operations staff who came with their old employer. But because Magellan is well-funded, the group has a high-calibre operations arm that takes the housekeeping load off the portfolio managers and analysts.

The "lollapalooza" effect

In a nutshell, Douglass describes the fund as a very high quality value investor. "Our investment philosophy is key to Magellan. We look to invest in outstanding companies at attractive prices. An outstanding company is one that can produce very high returns on their invested capital and can sustain those returns for a long period of time."

One of their top holdings for example is online auction company eBay. "We look for unique businesses where it's very, very difficult to compete with the business, like eBay. It's very, very difficult to compete against their core auction business. Yahoo tried for six years to set up a free online auctions business whereas eBay charges their users, but Yahoo closed that business three to six weeks ago."

Douglass calls that competitive advantage a "wide economic moat", one of the four legs of their investment philosophy (see illustration). "That economic moat is the protection or sustainable competitive advantages that a business has that protects its high returns on capital, eBay has a sustainable advantage and it earns 175 per cent return on its invested capital."

Douglass also studies a company's potential to continue to re-invest capital, a very important metric which he thinks is often overlooked by investment analysts.

The third criteria is agency risk. "An agency risk is much more than corporate governance, it is the risk of redeployment of free cash flow," he continues, "My background in M&A and advising major corporations gives us a huge insight into management and boardrooms across so many companies in so many years that we understand the psychology of a lot of management, and therefore, we think we can quickly spot management teams and boards who are genuinely focused on delivering real shareholder value, not growing empires."

Finally, the fund also assesses the company's business risks such as cyclicality, operating leverage, financial leverage, regulatory and political environment and profitability on the share price. The fact that he believes the US market is attractive right now is tied to his assessment of the business risks in the region.

Overseas opportunities

"There is a slowdown happening at the US at the moment, what happens when things are slowing down is that the markets overshoot on the downside and don't take into account the real long term economics of the businesses. We're seeing enormous amount of opportunities where, in our view, companies are starting to come well below their long term intrinsic value," said Douglass.

He continues, "People are factoring in a slowdown but then they extrapolate that it's going to go on forever. These things tend to bounce back and we're seeing some very large cap, very high quality businesses in multiples that we haven't seen in ten years, with very high returns on their capital."

And for good measure, the fund has a strong conviction portfolio of 25 to 50 stocks stress tested through the four criteria and against a "margin of safety", the gap between how much the company is fundamentally worth and how much the fund is willing to pay for its share price.

"We are highly risk averse. A fundamental tenet of Magellan is that we want to minimise the risk of permanent loss of capital and the margin of safety is absolutely key to minimising that risk," said Douglass, adding that the fund does not use leverage. "It is up to the individual investor's risk appetite if they want to leverage the fund."

When a company passes Magellan's four-legged investment philosophy, and given a certain margin of safety, you get the "lollapalooza" effect, a term coined by Berkshire Hathaway's Charles Munger. It refers to a company's valuation becoming magnified many times over when a number of independent factors are at work, creating a much more powerful effect than any one of the individual factors alone.

That belief in the "lollapalooza" effect spills over to the way Douglass and Mackay run Magellan. Less than a year since its inception, the group boasts a strong investment team of 13 professionals who owns equity in the company, a well-resourced operations staff, a 5,000-strong shareholder base and a performance-based fee structure that rewards the fund only when they meet demanding performance targets. All that from a pact made 15 years ago. ∎

Figure 1.
Investment philosophy

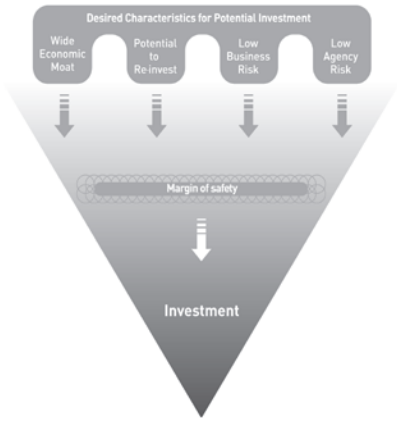


Table 1.
Magellan Global Fund top 10 holdings

Company	% of fund
American Express Company	7.10
eBay Inc	5.90
Yum! Brands Inc	5.40
Nutrisystem Inc	4.80
Abercrombie & Fitch Company	4.20
Wells Fargo & Company	3.80
Lowe's Companies Inc	3.20
Wal-Mart Stores Inc	3.20
Tesco Plc	3.00
Bank of America Corporation	2.80
Harley-Davidson Inc	2.60