MAGELLAN
FLAGSHIP FUND LIMITED

Magellan Flagship Fund Limited
ABN 32 121 977 844

Level 7, 1 Castlereagh Street,
Sydney NSW 2000 AUSTRALIA

General: +61 2 8114 1888
Facsimile: +61 2 8114 1800
Website: www.magellangroup.com.au

8 February 2011

Company Announcements Office
Australian Securities Exchange Limited
Level 4, Exchange Centre
20 Bridge Street
Sydney NSW 2000

Dear Sir/Madam,

CONDENSED FINANCIAL REPORT
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

Magellan Flagship Fund Limited (**MFF**) hereby lodges:

1. Appendix 4D Statement for the half year ended 31 December 2010;

2. Condensed Financial Report for the half year ended 31 December 2010; and

3. Half Yearly Investor Report.

Yours sincerely,

Leo Quintana
Legal Counsel and Company Secretary

Appendix 4D
Magellan Flagship Fund Limited
Half Year Report Ended 31 December 2010

Details of Reporting Periods

Current:	1 July 2010 to 31 December 2010
Comparative:	1 July 2009 to 31 December 2009

Results for Announcement to the Market	**Change from the Comparative Period* $'000**	**31 Dec 2010 $'000**
Total investment income / (loss) *("revenue from ordinary activities")*	Down by 50,338 to	(3,516)
Net operating profit / (loss) after income tax *("Profit / (loss) from ordinary activities after tax attributable to members" and "Net profit / (loss) for the period attributable to members"*	Down by 35,959 to	(5,238)

*The percentage changes from the previous comparative period 31 December 2009 are not meaningful.

Dividends

The Company does not propose to pay any dividend for the half year ended 31 December 2010.

Net tangible assets per share

31/12/2010.	$0.74 excluding net deferred tax assets of $0.090
31/12/2009.	$0.76 excluding net deferred tax assets of $0.085

Commentary on Results

The Company recorded a net loss after income tax for the half year ended 31 December 2010 of $5.24 million (2009: profit $30.72 million) principally as a result of the impact of exchange rate movements more than offsetting net increases in the market prices of the Company's investments.

The Company's net tangible assets (NTA) per share (excluding deferred tax assets) at 31 December 2010 was $0.74 (30 June 2010: $0.76). The NTA per share (including deferred tax assets) at 31 December 2010 was $0.83 (30 June 2010: $0.84). Overall, net increases in the market value of the portfolio in base currencies benefitted the Company by about $0.14 per share, offset by net movements in foreign exchange in the period of approximately $0.16 per share. These increases and decreases are largely unrealised. The AUD rose approximately 21.4% against the USD over the six months.

Directors remain pleased with the Company's portfolio of excellent companies. In aggregate, the businesses of the Company's portfolio companies continue to perform strongly and improve their competitive advantages. Further details are included in the Investment Manager's Report.

The Company continued its on market buyback during the six months and acquired approximately 4.48 million shares at an average price of approximately $0.63 per share. Further details of the buyback are provided in note 8 to the financial statements.

Financial Report

The Company's independent auditor Ernst & Young has completed a review of the Company's 31 December 2010 Condensed Financial Report on which this report is based and has provided an unqualified review report. A copy of the Company's Financial Report inclusive of the review report is attached.

MAGELLAN FLAGSHIP FUND LIMITED

ABN 32 121 977 884

CONDENSED FINANCIAL REPORT

FOR THE HALF YEAR ENDED 31 DECEMBER 2010

MAGELLAN FLAGSHIP FUND LIMITED

FINANCIAL REPORT
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

Contents	Page

DIRECTORS' REPORT
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

The Directors of Magellan Flagship Fund Limited (the "Company") submit their report in respect of the half year ended 31 December 2010.

Directors
The following persons were Directors of the Company during the half year and up to the date of this report unless otherwise noted.

Name	Directorship	Appointed
Richard Warburton AO	Chairman & Independent Non-executive Director.	19 October 2006
John Ballard	Independent Non-executive Director.	19 October 2006
Andy Hogendijk	Independent Non-executive Director.	19 October 2006
Chris Mackay	Non-executive Director.	29 September 2006
Hamish Douglass	Non-executive Director.	29 September 2006

Chris Mackay is the Chairman and Chief Investment Officer and Hamish Douglass is the Managing Director and Chief Executive Officer of Magellan Financial Group (ASX Code: MFG), the parent company of the Investment Manager for the Company.

Review of Results and Operations
The Company recorded a net loss after income tax for the half year ended 31 December 2010 of $5.24 million (2009: profit $30.72 million) principally as a result of the impact of exchange rate movements more than offsetting net increases in the market prices of the Company's investments.

The Company's net tangible assets (NTA) per share (excluding deferred tax assets) at 31 December 2010 was $0.74 (30 June 2010: $0.76). The NTA per share (including deferred tax assets) at 31 December 2010 was $0.83 (30 June 2010: $0.84). Overall, net increases in the market value of the portfolio in base currencies benefitted the Company by about $0.14 per share, offset by net movements in foreign exchange in the period of approximately $0.16 per share. These increases and decreases are largely unrealised. The AUD rose approximately 21.4% against the USD over the six months.

Directors remain pleased with the Company's portfolio of excellent companies. In aggregate, the businesses of the Company's portfolio companies continue to perform strongly and improve their competitive advantages. Further details are included in the Investment Manager's Report.

The Company continued its on market buyback during the six months and acquired approximately 4.48 million shares at an average price of approximately $0.63 per share. Further details of the buyback are provided in note 8 to the financial statements.

Dividends
Since the end of the half year, the Directors have not recommended the payment of any dividend.

Likely Developments and Expected Result of Operations
The Company's investment portfolio is concentrated in securities in high quality businesses and this focus will continue. Refer to the Investment Manager's Report for a more detailed discussion.

DIRECTORS' REPORT
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

Events Subsequent to the end of the Half Year
The Company reports its Net Tangible Assets (NTA) per share to the Australian Securities Exchange each week. In the latest release on 8 February 2011 the Company advised that the NTA per share as at 4 February 2011 was $0.76 excluding deferred tax assets of $0.08 ($0.74 as at 31 December 2010 excluding deferred tax assets of $0.09).

Since the end of the half year, the Directors are not aware of any other matter or circumstance not otherwise dealt with in this report or financial statements that has significantly or may significantly affect the operations of the Company, the result of those operations or the state of affairs of the Company in subsequent financial periods.

Rounding Off of Amounts
The Company is an entity to which the Australian Securities & Investments Commission's Class Order 98/0100 (as amended) applies and as a consequence amounts in the Directors' Report and financial statements have been rounded off to the nearest thousand dollars in accordance with that Class Order, unless otherwise indicated.

Auditors' Independence Declaration
A copy of the Auditors' Independence Declaration as required under section 307C of the Corporations Act 2001 is set out on page 3.

This report is made in accordance with a resolution of the Directors.

Richard Warburton AO

Chairman

Sydney
8 February 2011

AUDITOR'S INDEPENDENCE DECLARATION

ERNST & YOUNG

Ernst & Young Centre
680 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
www.ey.com/au

Auditor's Independence Declaration to the Directors of Magellan Flagship Fund Limited

In relation to our review of the financial report of Magellan Flagship Fund Limited for the half-year ended 31 December 2010, to the best of my knowledge and belief, there have been no contraventions of the auditor independence requirements of the *Corporations Act 2001* or any applicable code of professional conduct.

Ernst & Young

Ernst & Young

R Da Silva

Rita Da Silva
Partner
Sydney
8 February 2011

STATEMENT OF COMPREHENSIVE INCOME
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

	Note	31 December 2010 $ '000	31 December 2009 $ '000
Investment income			
Dividend income		2,423	2,435
Interest income		17	1
Net change in fair value of investments		(4,602)	43,423
Net (losses) / (gains) on foreign currency borrowings		(1,396)	867
Net gains on foreign exchange contracts		42	96
Total investment (loss) / income		**(3,516)**	**46,822**
Expenses			
Management fees		1,646	1,609
Finance costs – interest expense		2,054	1,071
Directors' fees		111	111
Auditors' remuneration		23	22
Transaction costs		19	14
Registry fees		29	27
Fund administration fees		27	26
ASX listing, clearing and settlement fees		25	24
Other expenses		32	31
Total expenses		**3,966**	**2,935**
(Loss) / profit before income tax		**(7,482)**	**43,887**
Income tax benefit / (expense)	2(a)	2,244	(13,166)
Net (loss) / profit after income tax		**(5,238)**	**30,721**
Total comprehensive (loss) / income for the period		**(5,238)**	**30,721**
Basic (loss) / earnings per share (cents per share)		**(1.50)**	**8.59**
Diluted (loss) / earnings per share (cents per share)		**(1.50)**	**8.59**

The notes on pages 8 to 12 are an integral part of these condensed financial statements

STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 2010

	Note	31 December 2010 $ '000	30 June 2010 $ '000
Current assets			
Cash and cash equivalents		52	67
Investments at market value	3	323,880	334,761
Receivables		1,526	4,292
Prepayments		53	12
Total current assets		**325,511**	**339,132**
Non-current assets			
Deferred tax assets	2(b)	31,444	28,852
Total non-current assets		**31,444**	**28,852**
Total assets		**356,955**	**367,984**
Current liabilities			
Borrowings	7	67,018	69,977
Payables		860	868
Total current liabilities		**67,878**	**70,845**
Total liabilities		**67,878**	**70,845**
Net assets		**289,077**	**297,139**
Equity			
Contributed equity		357,089	359,913
Accumulated loss		(68,012)	(62,774)
Total equity		**289,077**	**297,139**

The notes on pages 8 to 12 are an integral part of these condensed financial statements

STATEMENT OF CHANGES IN EQUITY
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

	Note	31 December 2010 $ '000	31 December 2009 $ '000
Contributed equity			
Balance at beginning of the half year		359,913	366,822
Shares acquired under buy-back	8	(2,822)	(6,836)
Transaction costs on share buy-back		(3)	(13)
Transaction costs on share buy-back – tax effect		1	4
Balance at end of the half year		**357,089**	**359,977**
Accumulated loss			
Balance at beginning of the half year		(62,774)	(93,872)
Net (loss) / profit after income tax		(5,238)	30,721
Balance at end of the half year		**(68,012)**	**(63,151)**
Total equity		**289,077**	**296,826**

The notes on pages 8 to 12 are an integral part of these condensed financial statements

STATEMENT OF CASH FLOWS
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

	31 December 2010 $ '000	31 December 2009 $ '000
Cash flows from operating activities		
Dividends received	2,753	2,401
Interest received	17	1
Payments for purchase of investments	(27,803)	(24,359)
Proceeds from sale of investments	36,141	12,987
Net foreign exchange gains	42	96
Management fees paid	(1,660)	(1,496)
Other expenses paid	(272)	(345)
Net cash inflow / (outflow) from operating activities	**9,218**	**(10,715)**
Cash flows from financing activities		
Net (repayment) / proceeds of borrowings	(4,354)	18,654
Interest paid	(2,054)	(1,071)
Payment for shares under buy-back	(2,822)	(6,873)
Payment of share buy-back costs	(3)	(14)
Net cash outflow from financing activities	**9,233**	**10,696**
Net decrease in cash and cash equivalents	(15)	(19)
Cash and cash equivalents at the beginning of the half year	67	54
Cash and cash equivalents at the end of the half year	**52**	**35**

The notes on pages 8 to 12 are an integral part of these condensed financial statements

NOTES TO THE FINANCIAL STATEMENTS
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

1. Summary of Significant Accounting Policies

(a) Basis of Preparation
This general purpose condensed financial report for the half year ended 31 December 2010 has been prepared in accordance with AASB 134: *Interim Financial Reporting*, and the *Corporations Act 2001*.

The financial report is presented in Australian dollars and all values are rounded to the nearest thousand dollars ($'000) unless otherwise stated under the option available to the Company under ASIC Class Order 98/0100. The Company is an entity to which the class order applies.

The half year financial report does not include all the notes of the type normally included in the annual financial report and therefore cannot be expected to provide as full an understanding of the financial performance, financial position and financing and investing activities of the Company, as the annual financial report. Accordingly, it is recommended that this report be read in conjunction with the annual report for the year ended 30 June 2010, and any public announcements made by Magellan Flagship Fund Limited during the half year ended 31 December 2010 in accordance with the continuous disclosure requirements of the *ASX Listing Rules*.

(b) Statement of Compliance
The financial report complies with Australian Accounting Standards applicable to interim reporting as issued by the Australian Accounting Standards Board and International Financial Reporting Standards (IFRS) applicable to interim reporting as issued by the International Accounting Standard Board.

(c) New Accounting Standards and Interpretations
The accounting polices applied by the Company in this interim financial period are the same as those applied by the Company for the year ended 30 June 2010.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

2. Income Tax

	31 December 2010 $ '000	31 December 2009 $ '000
(a) The income tax (expense) / benefit attributable to the financial year differs from the prima facie amount payable on the operating profit / (loss). The difference is reconciled as follows:		
(Loss) / profit before income tax expense	(7,482)	43,887
Prima facie income tax benefit / (expense) on the operating profit / (loss) at 30%	2,244	(13,166)
	2,244	**(13,166)**

(b) Deferred tax asset relates to the following:	31 December 2010 $ '000	30 June 2010 $ '000
Tax losses carried forward	2,934	2,007
Capital losses carried forward	13,185	11,609
Costs associated with the issue / buy-back of shares	195	385
Unrealised loss on investments	13,713	13,911
Allowable tax credits	1,466	1,120
Other temporary differences	(49)	(180)
	31,444	**28,852**

3. Investments at Market Value

	Domicile of Principal Exchange Listing	31 December 2010 $ '000	30 June 2010 $ '000
American Express *	United States	57,298	64,209
Yum! Brands Inc *	United States	39,520	38,177
Nestlé SA *	Switzerland	36,108	38,071
eBay Inc *	United States	29,424	25,171
Coca-Cola *	United States	24,315	18,749
Wells Fargo & Co	United States	17,934	11,502
Google Inc *	United States	16,164	14,168
McDonald's Corp*	United States	16,069	16,731
Wal-Mart Stores Inc *	United States	12,423	28,437

NOTES TO THE FINANCIAL STATEMENTS
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

3. Investments at Market Value (continued)

	Domicile of Principal Exchange Listing	31 December 2010 $ '000	30 June 2010 $ '000
Procter & Gamble *	United States	10,570	12,652
Pepsico *	United States	9,668	16,574
US Bancorp *	Unites States	9,614	4,513
Colgate-Palmolive Co *	United States	6,598	7,376
Visa Inc *	United States	6,282	5,226
Bank of America Corp	United States	5,839	6,353
Lowe's Co Inc	United States	4,583	4,524
Tesco Plc*	United Kingdom	4,519	8,715
China Mobile	Hong Kong	4,433	-
Johnson & Johnson *	United States	2,466	2,856
China Telecom	Hong Kong	2,299	-
Total top 20 holdings		**316,126**	**324,004**
Other companies		7,754	10,757
Total listed securities		**323,880**	**334,761**

* Entities that generate 50% or more of their revenue and / or have material operations in 15 or more countries outside of the country of domicile of their primary securities exchange

The following table illustrates changes in Australian dollar exchange rates against the following currencies (London 4.00pm rates):

	31 December 2010 $	30 June 2010 $
United States Dollar	1.0251	0.8446
Eurodollar	0.7641	0.6896
British Pound	0.6547	0.5646
Swiss Franc	0.9554	0.9108
Hong Kong Dollar	7.9684	6.5774

NOTES TO THE FINANCIAL STATEMENTS
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

4. Statement of Net Asset Value

	31 December 2010	30 June 2010
Reconciliation of Net Asset Value with that Reported to the ASX		
Net Asset Value per Balance Sheet **- $'000**	289,077	297,139
Divided by:		
Number of shares on issue	349,348,689	353,826,037
Net Asset Value – cents per share	**83**	**84**
Net Asset Value – ASX - cents per share	**83**	**84**

The above Net Asset Value is inclusive of net deferred tax assets

5. Contingent Assets, Liabilities and Commitments for Expenditure
No contingent assets or liabilities exist as at 31 December 2010 (30 June 2010: nil).

The Company has no commitments for uncalled share capital on investments (30 June 2010: nil).

6. Segment Information
While the Company operates from Australia only (the geographical segment), it has global investment exposures due to its investments in many truly multinational entities and specific exposure to some countries from investments in other entities that generate revenues and operate predominantly within those countries.

The geographical locations are determined by the nature of the investment entity's business:

- International Companies are defined by the Company as being entities that generate 50% or more of their revenue and / or have material operations in 15 or more countries outside of the country of domicile of their primary securities exchange
- Entities that do not meet the Company's definition of International Companies are categorised by the country or region from which they predominantly operate in and derive their revenue from.

Note 3 provides further domicile information.

7. Borrowings
During the half year ended 31 December 2010 the Company continued to be provided with a borrowing facility by Merrill Lynch International (Australia) Limited (MLIA), a wholly owned subsidiary of Bank of America. The facility is associated with the International Prime Brokerage Agreements (IPBA) entered into by the Company and Merrill Lynch International (MLI). The Company has granted MLI a fixed charge over the Company's right, title and interest in the assets held in custody with MLI, as security for the performance of its obligations under the IPBA. The credit quality of Bank of America /Merrill Lynch's senior debt is rated by Standard & Poor's as being A and by Moody's as being A2.

NOTES TO THE FINANCIAL STATEMENTS
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

7. Borrowings (continued)
As at 31 December 2010 the borrowing facility, repayable on demand, was $67.0 million (30 June 2010: $70.0 million). In the unlikely event that Merrill Lynch required repayment upon short notice, the Directors are confident that the borrowings could be refinanced via an alternative lender or the borrowings could be repaid via settlement proceeds from the sale of part of the Company's investment portfolio, having regard to the high quality and liquidity of the Company's investments.

Under the Company's borrowing policy, total borrowings by the Company on the date of any acquisition of additional securities must not exceed 20% of the Company's investments at market value. MLIA may lend up to a multiple well above the Company's own borrowing limits, having regard to the high quality and liquidity of the Company's investments.

8. Share buy-back
The Company completed an on-market share buy-back of 20 million shares at a total cost of approximately $11.2 million on 30 July 2009. On 26 August 2009, the Company announced a further on-market share buy-back programme of 20 million shares. At 31 December 2010 the Company had bought back approximately 28.7 million shares under these programmes.

During the six month period to 31 December 2010, the Company acquired 4,447,348 shares for consideration of $2.82 million, reducing shares on issue to 349,348,689. Shares bought back by the Company are cancelled on settlement.

9. Events Subsequent to Reporting Date
The Company reports its Net Tangible Assets (NTA) per share to the Australian Securities Exchange each week. In the latest release on 8 February 2011 the Company advised that the NTA per share as at 4 February 2011 was $0.76 excluding deferred tax assets of $0.08 ($0.74 as at 31 December 2010 excluding deferred tax assets of $0.09).

No other significant events have occurred since the end of the reporting year which would impact the Balance Sheet of the Company as at 31 December 2010 or the results for the half year ended on that date.

10. Dividends
Since the end of the half year, the Directors have not recommended the payment of any dividend and there were no dividends paid or payable during the half year ended 31 December 2010 (2009: $nil). The Company's franking credit balance as at 31 December 2010 was $388,277.

DIRECTOR'S DECLARATION
FOR THE HALF YEAR ENDED 31 DECEMBER 2010

In accordance with a resolution by the directors of Magellan Flagship Fund Limited I state that, in the opinion of the Directors,

(a) the financial statements and notes of the Company are in accordance with the *Corporations Act 2001*, including:

(i) giving a true and fair view of the financial position of the Company as at 31 December 2010 and of its performance for the half year ended on that date; and

(ii) Complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*.

(b) there are reasonable grounds to believe that the Company will be able to pay its debts as and when they become due and payable.

On behalf of the Board,

R.J.E. Warburton

Richard Warburton AO
Chairman

Sydney
8 February 2011

INDEPENDENT REVIEW REPORT

ERNST & YOUNG

Ernst & Young Centre
680 George Street
Sydney NSW 2000 Australia
GPO Box 2646 Sydney NSW 2001

Tel: +61 2 9248 5555
Fax: +61 2 9248 5959
www.ey.com/au

To the members of Magellan Flagship Fund Limited

Report on the Condensed Half-Year Financial Report

We have reviewed the accompanying half-year financial report of Magellan Flagship Fund Limited, which comprises the statement of financial position as at 31 December 2010, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the half-year ended on that date, notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration.

Directors' Responsibility for the Half-Year Financial Report

The directors of the company are responsible for the preparation of the half-year financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001*. The directors are also responsible for such internal controls that the directors determine are necessary to enable the preparation of the condensed half-year financial report that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express a conclusion on the half-year financial report based on our review. We conducted our review in accordance with Auditing Standard on Review Engagements ASRE 2410 *Review of Interim and other Financial Reports Performed by the Independent Auditor of the Entity*, in order to state whether, on the basis of the procedures described, we have become aware of any matter that makes us believe that the financial report is not in accordance with the *Corporations Act 2001* including: giving a true and fair view of the company's financial position as at 31 December 2010 and its performance for the half-year ended on that date; and complying with Accounting Standard AASB 134 *Interim Financial Reporting*, the *Corporations Regulations 2001*. As the auditor of Magellan Flagship Fund Limited, ASRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial report.

A review of a half-year financial report consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Independence

In conducting our review, we have complied with the independence requirements of the *Corporations Act 2001*. We have given to the directors of the company a written Auditor's Independence Declaration, a copy of which is attached to the Directors' Report.

INDEPENDENT REVIEW REPORT

ERNST & YOUNG

2

Conclusion

Based on our review, which is not an audit, we have not become aware of any matter that makes us believe that the half-year financial report of Magellan Flagship Fund Limited is not in accordance with the *Corporations Act 2001*, including:

a. giving a true and fair view of the company's financial position as at 31 December 2010 and of its performance for half-year ended on that date; and

b. complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*.

Ernst & Young

Ernst & Young

R Da Silva

Rita Da Silva
Partner
Sydney
8 February 2011

CORPORATE DIRECTORY

Directors
Richard Warburton AO
John Ballard
Andy Hogendijk
Chris Mackay
Hamish Douglass

Company Secretaries
Leo Quintana
Nerida Campbell

Registered Office
Level 7, 1 Castlereagh Street
Sydney NSW 2000
Telephone: +61 2 8114 1888
Email: info@magellangroup.com.au
Fax: +61 2 8114 1800

Investment Manager
Magellan Asset Management Limited
Level 7, 1 Castlereagh Street
Sydney NSW 2000
Telephone: +61 2 8114 1888
Email: info@magellangroup.com.au
Fax: +61 2 8114 1800

Auditor
Ernst & Young
680 George Street
Sydney NSW 2000

Share Registrar
Registries Limited
Level 7, 207 Kent Street
Sydney NSW 2000
Telephone: +61 2 9290 9600
Fax: +61 2 9279 0664
Email: registries@registries.com.au

MAGELLAN FLAGSHIP FUND LIMITED

Half Yearly Investor Report
31 December 2010
Magellan Flagship Fund Limited

Dear Shareholder,

The portfolio's appreciation in the latest six months was more than offset by the negative impact on MFF's reported results of the appreciation in the Australian Dollar, as all movements in market prices of currencies and securities are reported through the income statements. The net portfolio appreciation of approximately 14 cents per share was exceeded by a negative currency impact of approximately 16 cents per share. These figures are predominantly unrealised. The AUD rose approximately 21.36% against the USD over the six months to $1.0251 at balance date, with a 6.88% rise in December.

There was modest turnover in the portfolio and we remained fully invested in the six months, as we felt that:

- valuations were not stretched;
- underlying company performances remained strong and competitive advantages continued to strengthen for our portfolio companies;
- alternative, better, risk adjusted opportunities were not obvious;
- portfolio balance remained satisfactory in the prevailing markets, with exposure to the emerging market consumers, wealthier consumers and the corporate sector recoveries and to the modest but steady US recovery, each on attractive risk adjusted terms; and
- borrowing costs were low on an absolute basis and compared with possible returns.

In deciding to remain fully invested, we also felt that the AUD would be likely to again be a buffer in the event of a sharp fall in equity prices (which did not occur), as the AUD was broadly moving upwards and downwards in tandem with equity prices.

Our portfolio's largest and growing category of exposure is to profitable multinationals with leading market shares in consumer products/services in emerging markets, as well as in the slower growing, more established countries. In many cases we have the #1 (and profitable) category position in the major emerging markets. Our category "winners" have made significant capital, brand, product and management commitments over many years seeking scale profitability and sustainable competitive advantages. Scale is an advantage, as hundreds of millions or billions of dollars are required to develop the key emerging markets, as is skilled experienced management. Market leadership demands capital and management investments in brands, product innovation, distribution, low costs, price, regulatory responses and marketing.

Consumer spending is growing at or above 10% per annum in various of these categories in the largest emerging markets, with favourable longer term outlooks underpinned by rising living standards and urbanisation. We believe that favourable secular trends are likely to continue for many years, although there will be numerous challenges, such as inflation (which we discuss below). China, for example, is likely to move from US$4,000 per head GDP to at least US$10,000 per head and the Chinese consumer market is likely to exceed US$5 trillion.

It is possible that the world concurrently has both excessive inflation and deflation in different countries and sectors. The most efficient global leading companies with considerable localised exposure to the fiscally strongest emerging markets are relatively well placed in most foreseeable economic conditions. MFF's portfolio is focused upon high return on invested capital companies with well above average in built shields against both inflation and deflation.

An immediate market risk is that the December conditions of rising commodity prices and rising AUD continue to impact MFF via the currency translation, the impact on margins of rising input prices, inflation subduing consumer spending and the impact on relative investment multiples if investors move heavily to chase other asset classes.

The business performances of MFF's portfolio companies remains strong, with few exceptions. Three of MFF's four largest shareholdings have reported their Q4 2010 results and Nestlé's results for the half are expected to be released later in February (these results will reflect the final $28 billion component of the $41+ billion sale of Alcon which was acquired by Nestlé for $280 million in 1977).

eBay continues to make profitable progress, particularly as its PayPal division grew payments volume 26% YOY for the quarter and had 94.4 million customers they class as active.

Yum! Brands had its 8th consecutive year of double digit earnings per share growth. Yum! now earns a majority of its earnings outside the US with a focus upon emerging markets. The Chinese division was established in 1987 and finished 2010 with 3,906 restaurants and achieved profits of $755 million (+27%) for the year. The international division (ex China) had 14,281 restaurants at year end (and profits of $589 million) as it reached critical mass in markets such as India (where Q4 YOY sales grew 39%).

Yum! illustrates the broader points made above. It has been in China since 1987 and is now in 650 cities. Yum! has end to end control over distribution, production, menu, advertising, real estate development and training in a vast country. It is funding the opening of more than one restaurant per day whilst earning world class margins and returns on investment, returning cash to shareholders and increasing both its current lead over local competitors and the likelihood of achieving further growth over coming decades. Whilst the inflationary impacts of increased commodity inputs and their expected 15% wage rises for 2011 will impact margins, they will use scale benefits and have already taken some price increases. They also benefit as Chinese wages rise generally and increase consumer purchasing power.

American Express reported Q4 earnings per share increased by 47% and annual earnings rose by more than 100% to a reported $3.35 per share (various adjustments and normalisations may be made to the figures by analysts…our Head of Financials Dom Guiliano "normalises" these earnings upwards somewhat, but others may normalise downwards). The results reflect spending volumes above pre Crisis levels and loan loss figures far better than any other major participant and at historically low levels, offset by reduced lending as card members borrowed far less and Amex tightened its exposures. Amex traded in early 2009 at less than 3x its earnings after tax for 2010 despite being an advantaged, relatively easy to understand business, currently earning more than 25% annually on its equity. It was one of many very high quality companies that traded at a low percentage of true value in the panic.

Amex has invested heavily in service, rewards, buyer protection and merchant relationships to improve its value proposition for individual and corporate members and merchants. A key indicator is member spending and it clearly reflects that Amex is taking market share and that affluent spending has recovered more quickly (Amex might benefit in 2011 if corporate spending also recovers). Amex's quarterly member spend increased by 15% to $197.7 billion for the quarter and to $713.3 billion for the year. Amex's quarterly card member spend has approximately tripled from $68.3 billion in Q1 2000, despite severely adverse events such as 9/11 and the financial Crisis. Amex's share price did not rise in tandem with the business improvement in 2010 and regulatory issues and control of expenses are concerns for investors.

The Company's holdings with a market value of A$2.5 million or greater (which represent about 97% of the portfolio value) as at 31 December 2010 were:

Holding	$million	Holding	$million
American Express	57.3	PepsiCo	9.7
Yum! Brands	39.5	US Bancorp	9.6
Nestlé	36.1	Colgate-Palmolive	6.6
eBay	29.4	Visa	6.3
Coca-Cola	24.3	Bank of America	5.8
Wells Fargo	17.9	Lowe's	4.6
Google	16.2	Tesco	4.5
McDonald's	16.1	China Mobile	4.4
Wal-Mart	12.4	Johnson & Johnson	2.5
Procter & Gamble	10.6		

MFF increased its exposure to high quality financials during the 6 months. This is the most economically sensitive part of our portfolio and most vulnerable to an economic relapse but a key beneficiary of economic recovery. Our strong financials, such as Wells Fargo and US Bancorp have low cost, relatively sticky deposits which match their loan books. They have relatively modest requirements for wholesale funding in the global debt markets. The rises in longer term bond rates in recent months are expected to benefit them, unless inflation goes out of control. The damaging effects of uncertain and changeable regulations remain a negative impact, but we are positive about this category of our holdings even though their market prices are much higher than in early 2009.

All of the largest holdings for the past few years continue to be held with modest reweightings, including a reduction in the staples retailers Wal-Mart and Tesco as well as in snackfood and drinks company PepsiCo and other food companies. We felt that valuations for the MFF companies generally remained attractive during the period and hence there was no substantial selling.

Small positions were also commenced in China Mobile and China Telecom which are Hong Kong listed Chinese state controlled enterprises with significant exposure to the Chinese consumer and, as far as these matters can be ascertained, regulatory regimes and valuations that are not unfavourable. Last Wednesday on the eve of Chinese New Year, China Mobile network users were doing their little bit to help MFF with Beijing users sending 770 million text messages (+13% YOY), Shanghai users 920 million (+20% YOY) and messages were up 23% in Guangdong Province for the day. China Mobile added 61.7 million net new subscribers in calendar 2010.

About 90% of MFF's total investment assets by market value continue to be 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 a majority of the balance being predominantly North American focused and almost 3% being China focussed. The revenue and earnings split for the multinationals average about 40% USA, slightly less than 30% Europe and slightly more than 30% ROW. The emerging markets proportion of underlying revenue and earnings continues to rise.

Although share prices have risen strongly since the March 2009 lows, MFF's portfolio valuation retains a sizable 'Margin of Safety' (Value). Share prices were abnormally low in the panicked conditions at the end of 2008 and in early 2009, when we moved to be fully invested. We have continued to be almost fully invested and we believe that valuations remain attractive in terms of their foreseeable future cashflow generation. However, a continuation of extremely loose fiscal and monetary policies in the US and China (and loose lending in China) are creating further risks including asset bubbles and commodity price pressures.

We will not repeat the extensive discussions about the portfolio, individual companies and economic, political and market issues from recent years. Various of the concerns and opportunities highlighted in the discussions are playing out. For example, we discussed the regulatory failure in the US and Europe surrounding financials, and this is now widely acknowledged, even by legislators and regulators. Unfortunately, the responses generally are piecemeal, politically driven, misdirected in part and not yet adequate. Hopes for systemic financial soundness under stressed conditions now depend principally on the Basel 3 implementation of capital and liquidity requirements (which is subject to fierce lobbying efforts targeting populists). The Australian response must balance some of the challenges in competition and margins against regulatory soundness. The US response failed even to address the greatest failure and structural weakness, being the roles of Fannie Mae and Freddie Mac, and related issues.

An economy growing as strongly and successfully as China's escapes the same scrutiny on its accounts as Greece. Maintaining a high growth rate is by no means assured as the laws of large numbers apply. Structural adjustments should occur, such as increasing the proportion of consumption and, as China builds out its infrastructure, the level of capital intensity will fall. The increase in power and activity of the state owned enterprises compared with the entrepreneurial sector in recent years, which reverses the previous trend, is inconsistent with some of the goals of structural adjustment, but enabled a rapid and effective stimulus response during the Crisis.

The willingness of the Chinese Government and regulators to continue fiscal and monetary stimulus and to encourage loan growth has resulted in an unprecedented Keynesian type expansion. It is unsustainable to have fixed asset investments at 75% of GDP funded by fiscal deficits, loose monetary policy, fixed exchange rates and rapid lending growth. Investors and businesspeople should watch closely whether China continues with the rapid growth in infrastructure spending as the Crisis response effectively brought forward about 18-24 months of projects.

They should also watch the efforts of Chinese authorities to manage the recapitalisation of their banking system given the state directed 50% lending growth over the past 24 months which was so instrumental in maintaining the very strong economy. China's earlier growth spurts included problem loans, bank recapitalisations, poor regulatory oversight and accounting practices that hid rather than illuminated. History has a very high probability of repeating itself in relation to recent loans turning bad and much depends upon the regulatory responses. Unfortunately, the early signs are not good and the potential problem grows larger as bankers, Government officials and borrowers continue to "game" the system with millions of vacant apartments and debt funded social infrastructure projects.

China recently rolled over the repayment of the bad debts from more than 10 years ago with repayments not required from the banks for another decade or more. The funding of the state's portion of the latest recapitalisation of the Banks (where the state holds about 75% of the shares) coincided with significant bond issues by the state owned shareholders (where the Banks themselves and other state owned enterprises are the largest bondholders/ financiers).

The full emergence of the European debt crisis contributed to a further subduing of the developed world recovery in mid 2010 and it impacted consumer and business confidence. Implications have included continuing unsustainably loose US fiscal and monetary policy, a rapid re-emergence of commodity price inflation and capital flows, a slow US housing and employment recovery and record low US corporate loan utilisation (US Banks have held more than $1 trillion on deposit with the US Federal Reserve earning almost zero for well over 12 months). Concerns about the European debt crisis might also have factored into the limited, "too late too loose" response by Chinese authorities to their emerging inflationary problem, which is now picking up real momentum.

Whilst US growth and confidence appear to be returning, we continue to believe that overall market and economic conditions remain unsettled and some risks are not being addressed. Issues to watch include input price inflation, particularly from commodity price rises and rising costs in China, European Sovereign debts, further official tightening to reduce Chinese inflation, Government/regulatory actions including their impact on confidence and fluctuating capital flows in the context of low official interest rates.

Last year we argued that “Given the likely return of inflation in a world of broad overcapacity (which is deflationary), it will be more important than ever to have strongly advantaged businesses and management teams that have successfully navigated crises over the decades”. This scenario is playing out. Chinese exported deflation for the last two decades and this is reversing, with implications for the developed world as well as emerging markets.

We intend to maintain our unhedged currency position in prevailing market conditions. Although the various fiscal and monetary stimulus packages, particularly out of the US, have damaged market sentiment for its currency (and hence reduced the value of the USD against many other currencies and made future weakness likely) we believe that the Australian situation is vulnerable to reversal. The AUD rose strongly in the latest 6 months and particularly in December, despite weak economic growth figures (0.2% GDP growth for the September Quarter, with similar poor numbers also possible for the December and March Quarters). Current growth is below the US and European levels and Australian inflation is above each, despite perceptions to the contrary and the huge commodity price benefits. More importantly, iron ore (the largest export) and metallurgical coal supply and demand will inevitably rebalance.

We expect a leveraged impact from at least a partial reversal in the improved terms of trade, particularly as Australia has already benefitted by over $100 billion from the Chinese Keynesian stimulus during the Crisis which has brought forward over a $trillion of infrastructure and other capital spending. The timing of, and the trigger for, any reversal is unclear. For example, projects to expand resource supply were deferred during the Crisis but now appear to be progressing in many parts of the world.

The impacts of crowding out increased during 2010 and will rise again with the ongoing stimulus spending and post disaster rebuilding. As well as manufacturing relocations, there is emerging evidence of service sector relocations away from Australia and pressure on service exporters such as the education sector to maintain competitiveness. The funding requirements associated with the $781 billion of net foreign liabilities (which the RBA expects to rise, despite the record terms of trade) and well above trend house prices may weigh on the market when it assesses any retracement, but not in current conditions.

It is inevitable that supply and demand will rebalance in the major resource markets which are most relevant for Australia as there are hundreds of years of supply and easy “super profits” from supplying commodity products at multiples of the cost of production.

In summary the MFF companies are in good shape, market prices for our portfolio are higher but not of themselves key risks, macro events are increasing near term prices and activity but also medium term economic risks. Longer term trends including demographics continue to favour our high quality companies.

Yours faithfully,

Chris Mackay
Chief Investment Officer
8 February 2011