Fund Update: 31 March 2021

MAGELLAN
EXPERTS IN GLOBAL INVESTING

Magellan Infrastructure Fund

ARSN: 126 367 226

Fund Facts

Portfolio Manager	Gerald Stack
Structure	Global Listed Infrastructure Fund, A$ Hedged
Inception Date	1 July 2007
Management Fee[1]	1.06% per annum
Buy/Sell Spread[1]	0.15%/0.15%
Fund Size	AUD $2,629.9 million
Distribution Frequency	Semi-annually
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (S&P Global Infrastructure Net Total Return Index (A$ Hedged)) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

[1]All fees are inclusive of the net effect of GST

3 Year rolling returns* (measured monthly)

Against the Index**	Last 12 Months	Last 36 Months	Last 60 Months	Since Inception (130 Months)
Average excess return (% p.a.)	4.0	3.2	3.6	4.1
Outperformance consistency	100%	94%	97%	96%

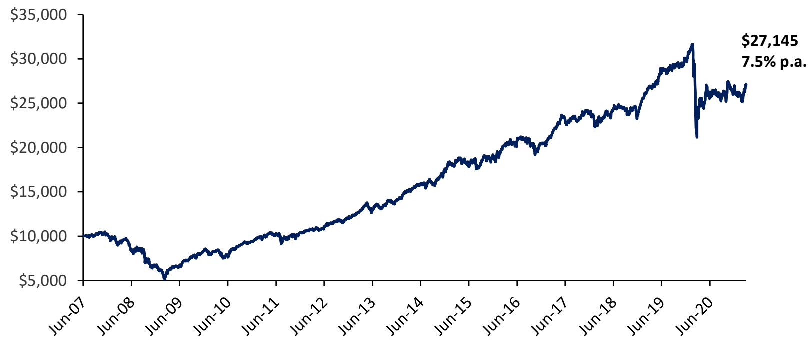
Fund Performance* (as at 31 March 2021)

	Fund (%)	Index (%)**	Excess (%)
1 Month	8.0	5.6	2.4
3 Months	2.8	4.1	-1.3
1 Year	12.4	27.4	-15.0
3 Years (p.a.)	5.3	4.5	0.8
5 Years (p.a.)	5.9	5.7	0.2
10 Years (p.a.)	10.5	8.0	2.5
Since Inception (p.a.)	7.5	5.1	2.4

Fund Risk Measures^

	Last 36 Months	Last 60 Months	Since Inception*
Upside Capture	0.5	0.5	0.6
Downside Capture	0.5	0.5	0.4

Performance Chart growth of AUD $10,000*



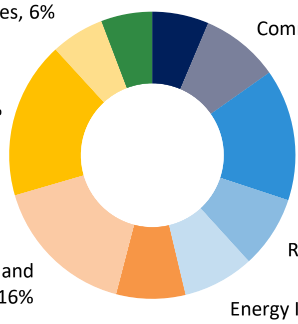
Fund Features

- Benchmark-unaware exposure to global listed infrastructure
- Conservative definition of core infrastructure
- Relatively concentrated portfolio of typically 20 to 40 investments
- Seeks to substantially hedge the capital component of the foreign currency exposure back to Australian dollars
- Typical cash exposure between 0% - 20%
- $10,000 minimum investment amount.

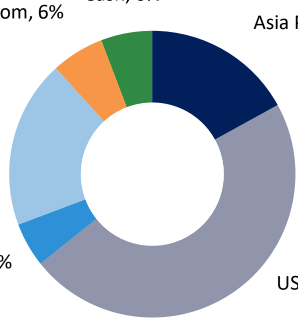
Top 10 Holdings

	Sector#	%
Transurban Group	Toll Roads	6.5
Atmos Energy Corporation	Gas Utilities	5.2
Enbridge Inc	Energy Infrastructure	5.0
Sempra Energy	Integrated Power	4.7
Vinci SA	Toll Roads	4.5
Crown Castle International	Communications	4.4
Eversource Energy	Transmission and Distribution	4.4
American Tower Corporation	Communications	4.4
Xcel Energy Inc	Integrated Power	3.9
Aena SME SA	Airports	3.9
	TOTAL:	46.9

Sector Exposure#



Geographical Exposure#



^ Risk measures are calculated after fees. Upside/downside capture shows if a fund has outperformed the global market during periods of market strength and weakness, and if so, by how much. The MSCI World Net Total Return Index (A$ Hedged) has been used as the representative of the global market to calculate this risk measure.
# Sectors are internally defined. Geographical exposures are by domicile of listing. Cash exposure includes profit/loss on currency hedging. Exposures may not sum to 100% due to rounding.
* Calculations are based on exit price with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable) Fund Inception is 1 July 2007.
** The index is the S&P Global Infrastructure Net Total Return Index (A$ Hedged) spliced with UBS Developed Infrastructure and Utilities Net Total Return Index (A$ Hedged). Note: as the UBS Developed Infrastructure and Utilities Net Total Return Index ($A hedged) ceased to be published from 31 May 2015, it was replaced by Magellan on 1 January 2015 with the S&P Global Infrastructure Net Total Return Index (A$ Hedged).

Fund Commentary

In absolute terms, the portfolio recorded a positive return over the quarter. The key driver of investment performance for the portfolio during the quarter was investors' expectations for inflation and interest rates.

In January and February, the portfolio recorded a negative return, reflecting concerns from investors about potential increases in inflation and consequent increases in prevailing bond rates. The potential increases in inflation and bond rates particularly affected the share prices for regulated utilities, which make up close to 50% of the investment portfolio. Given the regulatory process, whereby increases in inflation and interest rates are typically passed through to consumers, the earnings of regulated utilities should be largely insulated from increases in inflation and bond rates. However, a rise in interest rates can lead to an increase in the discount rate applied by investors, leading to a reduction in value if there is no offsetting increase in cash flows.

In March, comments from central-bank officials, suggesting any increase in inflation was likely to be transient rather than structural, appeared to mollify the concerns of investors about inflation. The share price performance of regulated utilities did well during the month as a result, increasing in local currency terms by an average of approximately 10%. The upshot was the portfolio outperformed for the month.

Our view of regulated utilities during the quarter did not change. We assess utilities as offering reliable, predictable earnings and able to digest moderate inflation and interest rate increases through the regulatory process.

Investments that contributed the most to investment performance in the quarter included Enbridge of Canada, ASTM of Italy and Crown Castle International of the US. Enbridge benefited as President Joe Biden issued an executive order revoking the presidential permit for Keystone XL, a pipeline that was being developed between Canada and the US, increasing Canadian producer reliance on Enbridge's system as well as benefiting from the increase in oil prices – even though changes in the oil price have little immediate effect on their revenues. ASTM, formerly Autostrada Torino-Milano, jumped when a consortium comprising its majority shareholder launched a tender offer to acquire 100% of the listed equity of the business. Crown Castle gained on a robust fiscal 2020 result and as management offered encouraging volume growth forecasts for fiscal 2021.

Stocks that detracted the most included the investments in Red Eléctrica, Atlas Arteria and Koninklijke Vopak. Red Eléctrica, which manages Spain's electricity transmission grid, fell after the utility provided a disappointing forward investment outlook. Atlas Arteria, which manages toll roads in Europe and the US, fell as the Australian-based company indicated the concession extension on its main asset, APRR, was unlikely before French elections next year, and as the Virginia legislature passed a bill that looks to increase the regulatory burden on Dulles Greenway. Vopak declined, even after the Netherlands-based company posted a solid fiscal 2020 result, due to the questionable complexity of a "one-off" item in Malaysia, and some unclear and tentative guidance on fiscal 2021 earnings.

In relative terms, the portfolio underperformed the benchmark index over the quarter. This was due largely to oil prices jumping 20% over the three months. This boosted the oil-price-sensitive stocks that we exclude from our investable universe given the volatility in underlying earnings that comes from commodity-price sensitivity.

Stock Story: National Grid

nationalgrid

In April 2020, thunderstorms capable of triggering tornadoes swept through the east coast of the US. Fierce gusts pounded New York City and the surrounding region and many areas suffered blackouts after falling branches snapped powerlines. Amid covid-19 restrictions, out hurried the local employees from a UK-based company. In no time, its 200,000 customers across New York, Rhode Island and Massachusetts had their power restored.

The company that once again showed its mettle at operations was National Grid, one of the world's largest publicly listed utilities focused on transmission and distribution of electricity and gas. National Grid's core business is that it owns and operates regulated electricity and gas infrastructure in the UK and the northeast US. More specifically, National Grid combines a UK electricity transmission business (34% of fiscal 2020 operating profit), a UK gas transmission arm (12%), a US regulated utility business (47%) and National Grid Ventures (7%), where sit an assortment of other assets.

The electricity and gas networks of National Grid, which earned revenue of 16 billion pounds in fiscal 2020, extend a long way. In the UK, the company has 7,212 kilometres (4,481 miles) of overhead electricity lines, 2,239 kilometres of underground electricity cables and 7,630 kilometres of high-pressure gas pipes. In the US, National Grid boasts 14,659 kilometres of overhead electricity transmission lines, 169 kilometres of underground electricity transmission cables and 57,425 kilometres of gas pipelines.

The company, which was formed in 1990 as part of the privatisation of the electricity industry in England and Wales (and listed in 1995), focuses too on renewables. In the US, National Grid, for instance, has connected more than 200 Megawatts of rooftop solar for 27,000 customers and aims to boost the output of wind and solar energy projects to more than 2.4 Gigawatts in coming years.

National Grid's appeal to investors is that the utility aims to be a low-risk business that generates shareholder value through dividends and a higher share price – just what the fund is looking for. To understand how National Grid operates, it's best to understand what utilities are and how that drives the way they are regulated.

The distinctive feature of utilities is that they are monopolies in their local areas because most of their customers generally have no alternative source of the essential service the utility provides. Because privately owned utilities do not face competition, they are subject to economic regulation that seeks to replicate competition in terms of prices for consumers. Regulators typically set relatively fair prices for consumers based on their estimates of a utility's operating costs and capital expenditure. Regulators thus settle on a fair return on the capital spending a utility has undertaken to fulfil its role. The way, therefore, for a utility to increase gross earnings is to spend more on approved capital works.

As expected from a well-managed utility, National Grid has delivered robust and predictable returns for investors in recent years – a weighted average return on equity of 12.4% in fiscal 2020 no less. And it's likely to achieve its target to deliver asset growth of between 5% and 7% in coming years (after achieving 9% growth in fiscal 2020) as approved capital works expand, especially in the US where regulators are allowing for higher utility returns on investment.

The main reason electricity utilities in the UK and the US are expected to find significant opportunities for capital investment is that these countries are shifting towards 'net zero' emissions. A key plank of the transition to this climate-change-mitigation target is the increased electrification of the economy – think electric vehicles – which will require substantial investment in the electricity grid.

To gain more exposure to this theme, National Grid recently spent 14 billion pounds to acquire Western Power Distribution, which is the UK's largest electricity distribution network and a supplier that plugs into National Grid's transmission network. As well, National Grid's UK gas transmission business is well placed to play a central role in the move towards increased penetration of hydrogen in the economy, another key plank in the transition to a net-zero economy. National Grid is a leader in the testing and development of the use of a hydrogen as an alternative source of clean energy.

National Grid Ventures is another promising asset. The arm includes the ownership and operation of electricity interconnectors (key infrastructure for the UK economy), a US renewable-energy-development business, a UK electricity-metering business and a business redeveloping excess company-owned property for residential housing. While National Grid Ventures accounts for less than 10% of company earnings today, its contribution is expected to swell over the next five years as its assets deliver. All up, National Grid is primed to deliver what we want from stocks in our portfolio – steady income and some capital growth.

To be sure, National Grid, as do all utilities, faces risks, especially regulatory and political ones. Political risks were especially apparent when the UK Labour Party under Jeremy Corbyn had a policy to nationalise utilities at below-market prices – and nearly all of National Grid's UK assets were targeted. Every time Labour rose in the opinion polls in recent years, utility shares sank. But that risk vanished when Labour lost badly in the 2019 elections and Corbyn went as leader. The regulatory risk is that officials can make adverse decisions at any time though none such appear to be looming for National Grid. The company paid a 60% premium for Western Power (over its regulated asset base) so it needs to better manage these assets to ensure a worthwhile return. The takeover has boosted National Grid's debt beyond industry norms (to a debt-to-capital ratio of 70% and above the common ceiling of 60%), even allowing for the imminent sales of its Rhode Island power operations in the US and the future sales of a stake in its UK gas transmission business. Cyber threats are an emerging menace for utilities these days, but any damage is usually only temporary. Renewables are a threat as well as an opportunity for the company. If enough households, for instance, were to install solar panels and the ability of batteries to store power were to improve, demand for grid electricity might slide.

But not that many people are likely to disconnect from the grid. National Grid appears to be entering a phase where it can command a steady growth in earnings as electricity demand rises, even allowing for the odd storm, real and metaphorical.

Sources: Company website, Bloomberg, Dunn & Bradstreet.