MAGELLAN INFRASTRUCTURE FUND (CURRENCY HEDGED) (MICH)

Gerald Stack, Head of Investments and Head of Infrastructure

The Magellan Infrastructure Fund (Currency Hedged)(Managed Fund) is an ASX-listed fund (ASX:MICH) that seeks to provide efficient access to the stable returns offered by infrastructure and utility stocks, while protecting capital in adverse markets. Infrastructure and utility stocks that will help achieve these aims generally have strong underlying financial performance over the medium to long term, which is expected to translate into reliable, inflation-linked returns. The Fund typically holds between 20 and 40 stocks.

PERFORMANCE

Global stocks rose in the 12 months to June 2019 after companies posted higher-than-expected earnings, the US economy expanded briskly without generating inflation, the Federal Reserve indicated it would stop, and possibly reverse, its gradual tightening of US monetary policy, and the European Central Bank said it would "use all the instruments that are in the toolbox" to help the eurozone's weak economy. Gains were capped by concerns global growth might slow, driven by China-US tensions and rising political uncertainty in Europe.

The portfolio recorded a return after fees of 16.6% for the 12 months. The stocks that contributed over the 12 months included the investments in Transurban (+2.2% of the total portfolio return) and the US-based companies Crown Castle International (+1.5%), Eversource Energy (+1.5%), American Tower (+1.4%) and Atmos Energy (+1.4%).

Transurban rose when investors turned to longer-duration assets as the Reserve Bank of Australia indicated it would cut the cash rate to help Australia's slowing economy. Crown Castle surged after the US cell-tower operator reported higher-than-expected earnings and boosted full-year guidance and after reports Dish, the US pay TV operator, was in talks to acquire some of the assets of Sprint and T-Mobile in order to establish itself as a fourth carrier in the event that the merger between Sprint and T-Mobile merger is approved. Eversource gained after the power utility announced operating revenue for the third quarter that beat estimates and management indicated that it would increase capital expenditure guidance for the full-year result. American Tower, which is judged another winner from the potential Dish entry to the market, jumped after the owner of wireless communications towers raised guidance for fiscal 2019 and reported higher-than-expected earnings and sales figures. Atmos Energy rallied as investors backed a gas utility that, due to increased investments to replace its ageing pipelines, is expected to enjoy high earnings growth for a utility for an extended period.

The stocks that detracted over the 12 months were Atlantia of Italy (-1.4%), Groupe ADP of France (-0.7%), United Utilities of the UK (-0.1%), Zurich Airport (-0.1%) and Severn Trent of the UK (-0.04%).

Atlantia declined following the collapse of a bridge in Genoa that was a tolled section of the A10 motorway operated under a concession contract by Autostrade per l'Italia, an 88% owned subsidiary of Atlantia of Italy and its largest asset. ADP fell after France's constitutional court suspended the further sale of the government's 50.6% stake in the operator of Paris's airports ahead of a possible referendum on any sale proposed by political parties opposing the sale. United Utilities and Severn Trent declined on concerns that the opposition Labour Party has promised to nationalise key utilities and only pay prices below their prevailing market capitalisations on the stock market. Zurich Airport fell after revealing steps announced by Switzerland's regulator to reduce the allowed return of its aeronautical revenue business by more than what was anticipated by the market.

OUTLOOK

In our view, the likely time frame and trajectory of interest rate movements have shifted to a 'lower for longer' scenario where we see the balance of probabilities in the near term for

Performance as at 30 June 2019[1]

	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)	7 Years (% p.a.)	10 Years (% p.a.)	Since inception (% p.a.)
Magellan Infrastructure Fund (Currency Hedged) (MICH)	**16.6**	–	–	–	–	**10.9**

1 Calculations are based on the monthly ASX released net asset value with distributions reinvested, after ongoing fees and expenses but excluding individual tax, member fees and entry fees (if applicable). Fund inception date 19 July 2016. Returns denoted in AUD.

rates to stay low or indeed be cut further before rising in the medium term. We have previously focused on the risks posed by a material increase in rates and we see a risk of inflation leading to an increase in interest rates. However, in the current outlook, the probability of this risk has reduced.

Irrespective of the macro-economic outlook, we expect the underlying earnings of infrastructure and utility companies in our conservative universe to remain reliable and predictable. Ultimately, the values of the companies in our portfolio reflect the future cash flows they are expected to generate, and the risks associated with those revenue flows. Even allowing for the resilient nature of the stocks held in the portfolio, if interest rates rise, we expect to see volatility in equity markets. We are confident, however, that any increase in interest rates will fail to hamper the financial performance of the stocks in the portfolio for the foreseeable future.

We believe that infrastructure assets, with their reliable earnings that are protected to a degree from inflation, are an attractive, long-term investment proposition. The predictable nature of their earnings compared with those offered by other asset classes means that infrastructure assets offer diversification benefits. In uncertain times, the reliable financial performance of infrastructure stocks makes them particularly attractive. An investment in listed infrastructure can be expected to reward patient investors.

PORTFOLIO POSITIONING

Top-10 holdings at 30 June 2019

Security	Weight (%)
Transurban	**6.2**
Atmos Energy	**5.9**
Aena	**5.3**
Enbridge	**4.9**
Xcel Energy	**4.9**
Groupe ADP	**4.7**
Atlas Arteria	**4.4**
Sempra Energy	**4.3**
Eversource Energy	**4.0**
Crown Castle International	**3.7**
Total	**48.3**

At 30 June 2019, the portfolio consisted of 31 investments compared with 29 investments a year earlier. The 10 biggest investments represented 48% of the portfolio at 30 June 2019.

The portfolio held 5.2% in cash on 30 June 2019, down about 3% from 12 months prior. We had previously held an elevated cash holding to reflect a view that the accommodative monetary policy of recent years had boosted global asset prices and that the unwinding of this policy could lead to a repricing of assets. However, as central banks around the world have indicated a willingness to ease monetary policy again, and as there are increasing headwinds to global growth, we are less concerned about rising interest rates than we were.

The key changes to the portfolio over the year were a 12% increase in the allocation to utility segments as share prices fell from what we felt were elevated levels, funded by a reduction in the level of cash and a reduction in the allocations to the communications infrastructure and toll roads segments. Within utilities, we have increased the allocation to integrated power and gas utilities while we have reduced exposure to the water utility segment.

The reduction in the allocation to the water segment reflects our concerns over sovereign risk in the UK; specifically, the policy of the opposition Labour Party to nationalise these utilities at significantly less than market value.

In the toll road segment, the largest change was the removal of Italian toll road company Atlantia from the portfolio. Following the collapse of the Morandi Bridge in August 2018, the government commenced a process that could lead to it revoking the single concession that governs all of Autostrade per l'Italia's toll road network in Italy. Our consultation with different legal experts indicated that if the government proceeded with revoking the toll road concession, it would be required to provide compensation to Autostrade per l'Italia based on market value (albeit the timing and value of the compensation would be inherently uncertain). However, if Autostrade per l'Italia were to be found to have been grossly negligent or even criminal, then the discussion on compensation would change and the company's claim on compensation could be effectively zero. Given these risks, we assessed that the range of likely outcomes was too wide to be consistent with one of our key investment objectives—capital preservation.

In terms of geographic allocation, while we have increased the share of the portfolio invested in North America over the course of the year, we remain underweight relative to our universe as the bulk of the available opportunities in North America are regulated utilities, many of which are less attractive than other opportunities. We also remain underweight the UK given the issues with UK utilities described above.

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