

Magellan Infrastructure Fund (Unhedged)

ARSN: 164 285 830

Fund Facts

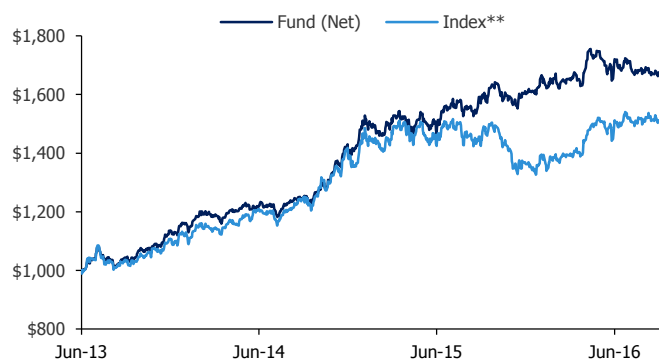
Portfolio Manager	Gerald Stack
Structure	Global Listed Infrastructure Fund (Unhedged)
Inception Date	1 July 2013
Management & Administration Fee ¹	1.05% per annum
Buy/Sell Spread ¹	0.15%/0.15%
Fund Size	AUD \$522.5 million
Distribution Frequency	Six Monthly
Performance Fee ¹	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (S&P Global Infrastructure Index A\$ Unhedged Net Total Return) and the Absolute Return Hurdle (the yield of 10-year Australian Government Bonds). Additionally, the Performance Fees are subject to a high water mark.

¹All fees are inclusive of the net effect of GST

Fund Features

- Benchmark-unaware exposure to global listed infrastructure
- Conservative definition of core infrastructure
- Relatively concentrated portfolio of typically 20 to 40 investments
- Maximum cash position of 20%
- \$10,000 minimum investment amount.

Performance Chart growth of AUD \$1,000*



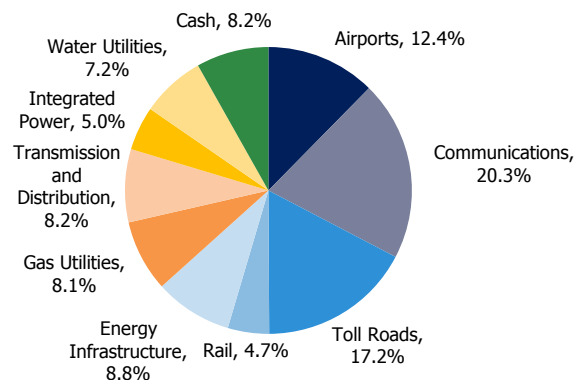
Fund Performance*

	Fund (%)	Index (%)**	Excess (%)
1 Month	0.0	-0.1	0.1
3 Months	-2.6	-0.2	-2.4
6 Months	1.3	7.9	-6.6
1 Year	5.2	4.2	1.0
3 Years (% p.a.)	17.4	13.6	3.8
Since Inception (% p.a.)	17.2	13.5	3.7

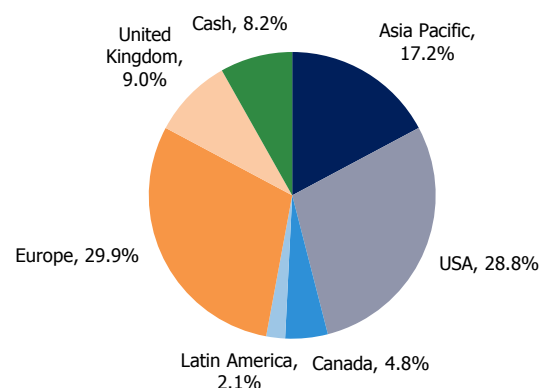
Top 10 Holdings

	Sector	%
Transurban Group	Toll Roads	8.1
Crown Castle International	Communications	6.9
SES S.A.	Communications	6.1
National Grid PLC	Transmission and Distribution	5.0
American Tower Corp	Communications	5.0
Enbridge Inc	Energy Infrastructure	4.8
Sempra Energy	Gas Utilities	4.4
Flughafen Zuerich AG	Airports	4.4
United Utilities Group Plc	Water Utilities	4.0
Vopak NV	Energy Infrastructure	4.0
TOTAL:		52.7

Industry Exposure[#]



Geographical Exposure[#]



* 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 1 July 2013.
 ** S&P Global Infrastructure Index A\$ Unhedged Net Total Return spliced with UBS Developed Infrastructure and Utilities Net Total Return Index (AUD). Note: as the UBS Developed Infrastructure and Utilities Net Total Return Index (AUD) ceased to be published from 31 March 2015, it was replaced by Magellan on 1 January 2015 with the S&P Global Infrastructure Index A\$ Unhedged Net Total Return.
 # The exposures are by domicile of listing.

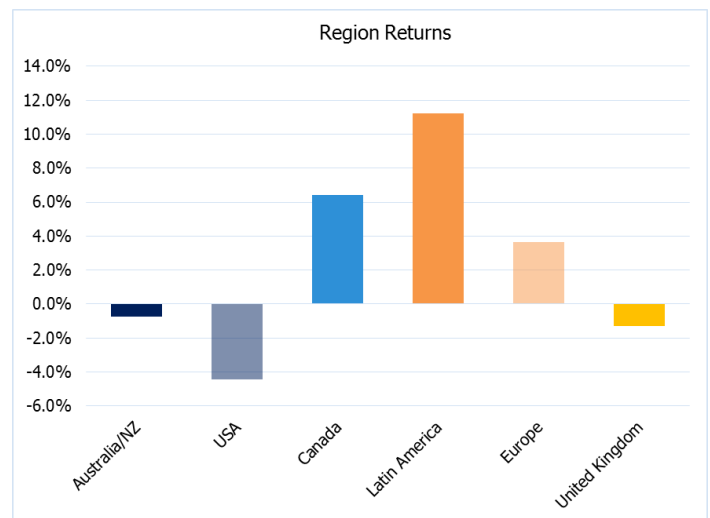
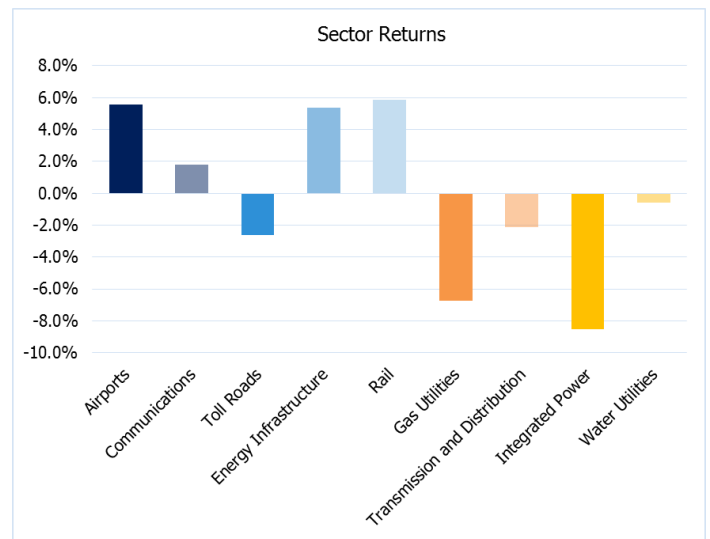
Performance

Over the September 2016 quarter, in Australian dollar terms, the Fund returned -2.6% net of fees. This was 2.4% below the benchmark return of -0.2%. The one-year return for the Fund was +5.2%, 1.0% better than the benchmark return of +4.2%. The Fund also outperformed global equities by 3.0% over the year to 30 September 2016 with the MSCI World Net Total Return Index returning +2.2%. The September quarter saw a continued rebound in stocks that had been heavily sold off in previous quarters. This observation was most prevalent among stocks whose earnings are sensitive to commodity prices and those domiciled in emerging markets, neither of which are considered investable for the Fund. The September quarter saw a continued rebound in stocks that had been heavily sold off in previous quarters. This observation was most prevalent among stocks whose earnings are sensitive to commodity prices and those domiciled in emerging markets, neither of which are considered investable for the Fund.

During the quarter, rail companies were added to the Fund for the first time (further details below). The best performing sectors for the quarter were Rail (weighted average return in local currency of +5.9%), Airports (+5.6%) and Energy Infrastructure (+5.4%). The Fund's exposure to the broader utilities sectors were reduced further during the quarter (see below) and this proved advantageous as they generated negative returns over the period. The Fund's investments in Integrated Power companies declined by a weighted average 8.5% for the quarter, Gas Utilities declined by 6.8%, Transmission & Distribution companies declined by 2.1% and Water Utilities declined by 0.6%. Within the Fund's major holdings, the best performing stocks during the quarter were European satellite company, SES (total shareholder return in local currency of +12.4%), Zurich Airport (+10.2%) and Enbridge (+6.4%).

The performance of the benchmark index was positively impacted by its oil & gas pipelines exposures, which produced an average return of 21.5% (in local currency terms) for the quarter after increasing by 16.4% in the previous quarter. Companies in this sector are excluded from Magellan's investment universe because their earnings are impacted by competition and the price of the commodity they are shipping. Consequently, their share price movements can be volatile and heavily correlated with commodity prices. Examples of companies recovering some of their lost ground over the past year include North American pipeline companies, Kinder Morgan (up 24.3% in the September quarter but still down 13.0% for the year) and The Williams Companies (up 43.0% for the quarter but still down 8.2% for the year). Excluding these companies, the benchmark index return was broadly in line with that of the Fund. A further exception is the benchmark's Competitive Power exposures (not held in the Fund) which were down by an average 3.5% for the quarter.

The Fund's returns for the quarter by sector and region are shown in the following graphs:



Strategy

During the September 2016 quarter the following changes were made to the Fund:

- As previously discussed, we added three US/Canadian rail stocks to the Fund. At the end of the quarter, these totalled 4.5% of the Fund and this is likely to grow modestly in the near future. Magellan has monitored this sector closely over many years and appreciated the attractive duopoly structures that these rail companies operate under. However, we were concerned that a significantly lower oil price might disadvantage rail companies when competing with the trucking industry. Consequently, we have delayed investing in this sector while observing these industry dynamics under a lower oil price environment. A more detailed commentary on the sector can be found later in this report.
- We further reduced our exposure to the broader utilities market in response to continued strength in those markets, particularly for US utilities, and increased our investments in the Communications sector. Utilities now make up 29% of the Fund compared to 35% at the end of the last quarter.
- Consistent with the past 18 months, the cash holding for the Fund remains high at approximately 9%. We expect increased share market volatility associated with any decision by the US Federal Reserve (Fed) to increase interest rates and we want to be able to move quickly to

take advantage of any significant share price weaknesses in quality infrastructure and utility companies, particularly US utilities. As noted in our previous communications to investors, the average debt costs for most US utilities is expected to continue to fall over the next two to three years, regardless of Fed strategy as they will be replacing relatively expensive debt maturing over that period with much cheaper and longer duration debt.

The underlying fundamentals of the markets in which we invest remain sound. Traffic numbers on toll roads in Europe, the US and Australia continue to grow solidly, with particularly strong truck traffic growth in most markets. Passenger numbers through airports are also robust, although terrorism events have impacted a number of European airports. Demand for satellites and other forms of communications infrastructure remains strong and regulators continue to allow satisfactory returns for our utility holdings. While some sectors, particularly US utilities, appear expensive, there are still opportunities to invest in stocks at appropriate values and we remain comfortable that we can meet or exceed our target of generating real returns of 5%-6% over the medium term.

Topic in Focus – Why invest in rail?

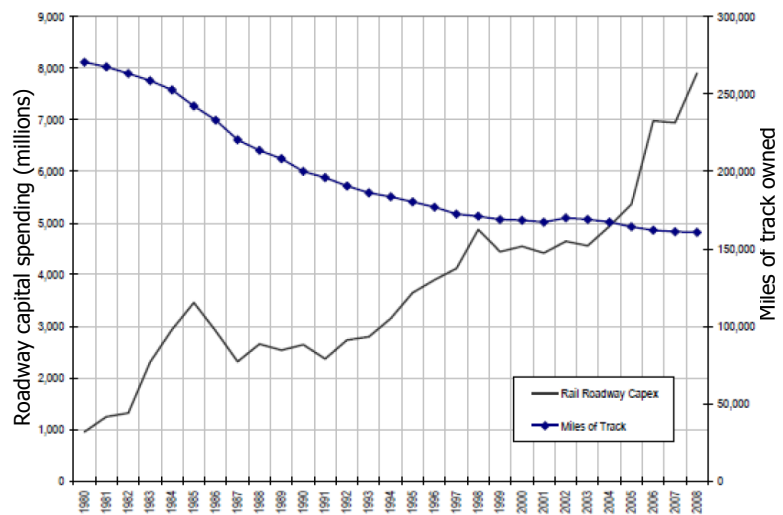
Railroads provide a basic, but critical role for any developed society – they facilitate the connection between producers and consumers of essential goods and support a large section of the economy. The North American rail industry represents one of the world’s oldest and largest collections of transport infrastructure. In this section we provide an insight into the sector and explore the current thesis for investment in North American rail assets.

The US rail industry was once a global leader in rail infrastructure development and innovation, with acclaim for manufacturing world-class locomotives and carriages. In 1934 Budd Manufacturing Co. created the Zephyr, a US diesel-powered train that broke the world speed record. The locomotive traveled from Denver to Chicago at 77 miles per hour and set the US on a course to dominate global rail development. However, over time US rail had become a forsaken sector and failed to keep up with innovations seen elsewhere in Europe and Asia, with aging rolling stock that lacked efficiency compared to competing alternatives in the air and on the roads. The post-World War II era saw the economy make a structural shift away from rail and towards expansion of the US automobile industry.

From an investment perspective, returns from rail operations became uneconomical and by the 1970s, the rail industry’s return on capital averaged just 2%. The majority of railroads in existence were in ruin, with bankrupt railroads accounting for more than 20% of North America’s rail mileage.¹ This led to a number of players exiting the market.

The decline of the rail industry prompted US Congress to reform federal railroad regulation and in 1980, the Staggers Rail Act was established to alter rules around competition, service routes and pricing. The Act was instrumental in reviving the sector and promoting new investment into rail development to help create one of the most cost-effective and productive freight systems in the world.

US rail infrastructure spending vs. miles of track (1980 – 2008)

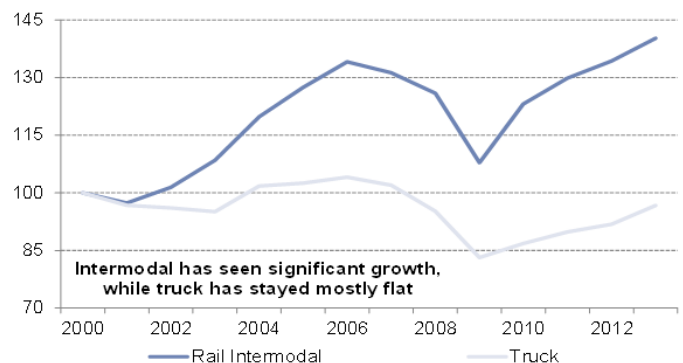


Source: Wolfe Research

Regulation of the industry also resulted in a number of bankruptcies and mergers, taking the number of Class I railroads in the US from about 40 down to five, effectively creating regional duopolies. By 2004, a number of the operating challenges (e.g. labour agreements) abated for the merged entities and they were able to improve operating margins. Since 2004, there has been no real evidence of pricing wars amongst the competing rail roads.

Over the past decade, the North American rail industry has been experiencing somewhat of a renaissance. New investments have been made across the sector to expand capacity, improve transportation efficiency and forge new regional connections. Some railroad operators have established intermodal links – combining rail transportation with road or shipping services to provide freight customers with single end to end solutions. Rail intermodal transport volumes have significantly expanded since the turn of the century.

Intermodal Freight Loadings



Source: Goldman Sachs Global Investment Research, FTR Transport Intelligence. Data is seasonally adjusted (indexed to 2000).

The attractiveness of rail

The synergies between regulatory support, capital investment and operational improvements have contributed to US rail now offering attractive returns on investment. North American rail operators are large corporations that benefit from scale and diversity. One of the largest operators, Union Pacific, operates the world’s largest freight rail yard. The company’s Bailey Yard

in North Platte, Nebraska, covers 2,850 acres and a total length of eight miles, making it three times the size of New York's Central Park. The site is operational 24 hours a day, seven days a week and handles 14,000 rail cars each day that travel across the company's 32,000 route miles.

From agriculture to automotive parts to chemicals and coal, railroads serve practically every industry sector and forms essential infrastructure for communities. The North American rail sector is suitably diverse with an expansive network which is vital for the conveyance of bulk goods. Indeed, about 40% of intercity freight volumes in the US are moved by rail, one of the highest for any developed country.² While the sector is highly capital intensive, there are a number of fundamentally attractive factors for infrastructure investors.

i) Earnings have limited sensitivity to competition

- North American railroads operate within duopoly markets and hence, face limited competitive pressures. Within each of these markets, the main operators have shown discipline in sustaining and growing margins.
- Capital intensity, network effects and right-of-ways create immense barriers to new entrants.
- Rails are typically the only economical solution for shippers, particularly for long haul movements of low value heavy goods such as coal and grains. Trucks are competitive on about 30-35% (on average) of railroad volumes, but their competitive advantage declines as cost inflation for trucks outpaces rails. Issues that drive inflation for trucking companies include rising labour costs, driver shortages, possible limitations on hours of service and growing costs associated with truck safety compliance regulations. Trucking companies have also been less successful in passing through rises in fuel costs.

ii) Earnings have become increasingly less sensitive to commodity price movements

- With fuel costs representing a material component of rail operating costs, operators have been successful in progressively introducing surcharges to facilitate pass-through of changes in fuel costs.

Historically, coal has been a significant component of freight revenues but today, declining demand for fossil fuels and retiring of coal plants has led to coal representing a declining share of total US freight. In our view, this will gradually decrease to a base-line level given that the US maintains a significant reliance on coal-fired energy.

iii) Rail operators benefit from an effective regulatory regime

- Railroad regulation is somewhat light-handed and constructive. Economic regulation of railroad operators is primarily conducted through the United States Surface Transportation Board and in Canada, the Canadian Transport Agency. For US operators, the Staggers Rail Act effectively diluted the regulatory structure, thereby improving economic returns such that only 20-30% of rail volumes are typically subject to freight tariff regulation.

Demand considerations

Economic influences such as variations in global demand for freight-linked commodities, a strong US dollar and energy alternatives have limited growth of freight business in North America in recent years. However, real pricing growth has been evident among some operators, which continues to reflect rail's competitive advantage (cost, capacity constraints and captive customer factors) over alternative modes of transportation. We see minimal signs of price competition amongst the rail group despite the recent soft volume environment.

Rail operators are also well placed to manage capacity as demand changes. An improved focus on operating efficiencies has partly mitigated the effects of the recent volume downturn. But when volumes stabilise and subsequently increase, rail operators have the flexibility to meet the upturn in demand, primarily through adding cars and lengthening train routes. Further gains from technological innovation and future automation provide avenues for additional operational leverage.

An attractive sector in a dependable market

In the prevailing environment, the US economy is continuing to exhibit signs of sustainable recovery and growth in exports, which bodes well for the freight sector. Even in a low growth environment, rail operators have shown the ability to grow earnings. Following a period of increased investment to support intermodal volume growth, improve network performance and meet regulatory requirements, capital investment for rail operators can be expected to ease going forward. Considered together with improved service offerings, this should contribute to strong and stable free cash flow growth, making the sector attractive to infrastructure investors. At current valuations we have seen an attractive entry point to the North American rail sector and will be closely monitoring opportunities in this market.

¹ Source: Magellan Asset Management Limited

² US Department of Transportation - Federal Railroad Administration