Fund Update: 31 December 2016

MAGELLAN ASSET MANAGEMENT LIMITED

Magellan Infrastructure Fund (Unhedged)

ARSN: 164 285 830

Fund Facts

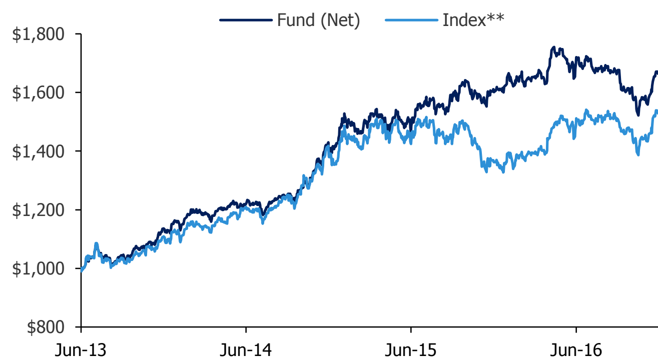
Portfolio Manager	Gerald Stack
Structure	Global Listed Infrastructure Fund (Unhedged)
Inception Date	1 July 2013
Management & Administration Fee[1]	1.05% per annum
Buy/Sell Spread[1]	0.15%/0.15%
Fund Size	AUD $554.0 million
Distribution Frequency	Six Monthly
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (S&P Global Infrastructure Index A$ 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.

[1]All 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*



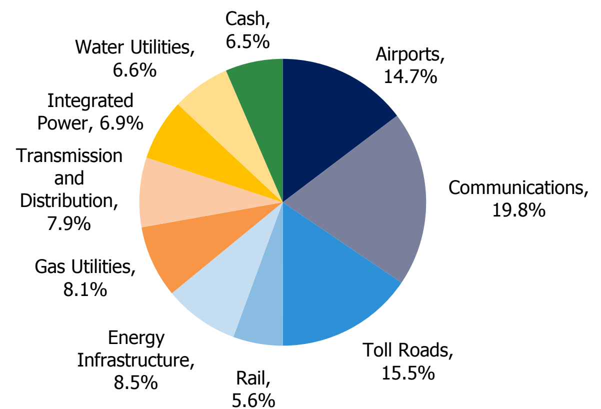
Fund Performance*

	Fund (%)	Index (%)**	Excess (%)
1 Month	4.5	4.9	-0.4
3 Months	-1.0	1.2	-2.2
6 Months	-3.5	0.9	-4.4
1 Year	3.7	12.0	-8.3
3 Years (% p.a.)	13.6	11.3	2.3
Since Inception (% p.a.)	15.6	12.8	2.8

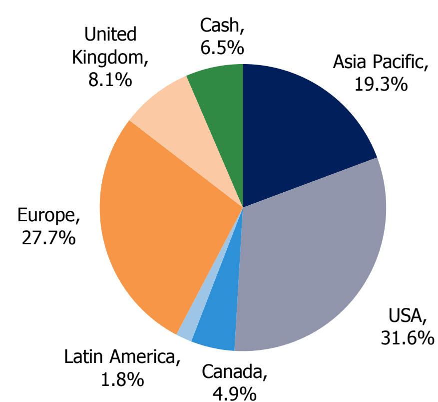
Top 10 Holdings

	Sector	%
Transurban Group	Toll Roads	7.4
Crown Castle International	Communications	6.7
SES S.A.	Communications	5.8
American Tower Corp	Communications	5.0
Enbridge Inc	Energy Infrastructure	4.9
National Grid PLC	Transmission and Distribution	4.5
Sempra Energy	Gas Utilities	4.4
Flughafen Zuerich AG	Airports	4.3
Eversource Energy	Integrated Power	3.9
United Utilities Group Plc	Water Utilities	3.7
	TOTAL:	50.6

Sector 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.

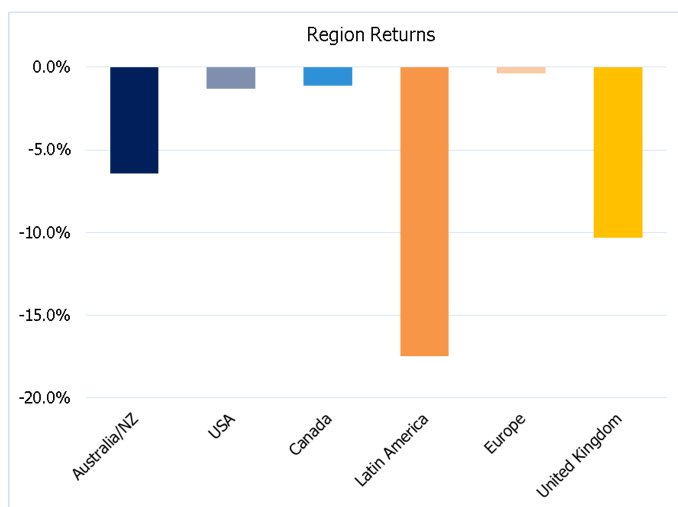
Performance

During the December 2016 quarter, the Fund returned -1.0% after fees, in Australian dollar terms, which was 2.2% lower than the benchmark return of 1.2%. The one year return for the Fund was +3.7% which was 8.3% below the benchmark return of 12.0%.

There were two key drivers of the Fund's performance during the quarter – the increase in oil prices and long term interest rates and their impact on sentiment towards infrastructure and utilities (and other defensive sectors). This topic is explored in more detail in the following section of this report which seeks to explain how the application of our proprietary definition of infrastructure has impacted investment returns in the most recent quarter and, more broadly, over recent years.

Performance by Region

The following graph shows the returns for the Fund by region for the quarter in local currency terms.



The Fund's performance exhibited weakness in the major regions during the quarter, with material declines experienced by investments domiciled in the UK and Australian/New Zealand. In our view, with the exception of the one stock held in Latin America, which was impacted by potential regulatory changes, the performance does not reflect changes to the underlying financial or operating performance of the companies concerned; rather, the performance reflects the impact of broader macroeconomic sentiment.

The December quarter saw a notable increase in long-term interest rates in the US, UK and Australia as investment markets regained some confidence that monetary conditions would tighten. The election of Donald Trump to the US presidency has spurred those markets even further on the perception that a Trump administration would be good for economic growth. As we have discussed in previous updates, the companies held within the Fund are typically viewed as interest rate sensitive by investment markets and the increase in long-term interest rates has led to broad-based share price declines for infrastructure and utilities stocks over the most recent quarter.

We acknowledge that the value of the assets held in the Fund are sensitive to *real* interest rates. However, to the extent that a potential increase in inflation leads to an increase in prevailing interest rates, almost all the stocks in the Fund have either the express (e.g. CPI toll increases) or implied (e.g. regulated utility returns) ability to pass through inflation to customers, thereby preserving the real value of the asset cash flows. Accordingly, it is our assessment that an increase in inflation does not have a significant impact upon the value of the investment portfolio for the Fund.

We expect that the stocks in the Fund will continue to benefit from earnings growth over the next two to three years and that, over the medium term, this will be reflected in the share prices of those stocks. However, we acknowledge that there will be periods of volatility as investment markets swing between enthusiasm for growth stocks and other periods where defensive stocks find favour on the realisation that risks are building up in financial markets.

Performance by Sector

The following graph shows the returns for the Fund by sector for the quarter in local currency terms. The data highlights the sell-off of most sectors in the infrastructure and utility universe, contrasted by the positive performance of the more economically sensitive rail stocks which were added to the portfolio at the start of the quarter.

Investment Update

At 31 December 2016, the Fund comprised 33 stocks, with approximately 64% invested in infrastructure segments (toll roads, airports, communications infrastructure, energy infrastructure and rail), 30% in regulated utilities and approximately 6% held in cash.

The weighting of infrastructure stocks in the Fund increased slightly during the quarter by approximately 2% by the end of December. Additional exposure to airports (2.7%) and rail (1.1%) was somewhat offset by a reduction in the exposure to toll roads. The increase was funded through use of cash. The allocation to regulated utilities, energy and water was broadly in line with the position at the end of September.

Minor increases in the exposure to North America and Australia/New Zealand were offset by reductions in the weight to Europe, the UK and cash holdings.

We note that the Fund held the highest level of cash since inception earlier in the year and we have progressively reduced that position in recent months as the sell-off in stocks that we view favourably provided buying opportunities. We expect to continue this trend through 2017.

Topic in Focus – Validating our Definition of Infrastructure

The following discussion utilises the before fee returns of the Magellan Infrastructure Fund, which is the Australian dollar hedged version of the Fund, (referred to hereafter as "the Strategy") to demonstrate the benefits of applying our definition of infrastructure. The benchmark is the S&P Global Infrastructure NTR Index (hedged to AUD) spliced with UBS Developed Infrastructure and Utilities Net Total Return Index (hedged to AUD) prior to 1 January 2015.

Our approach to building an infrastructure portfolio relies on our conservative definition of what constitutes an infrastructure asset. By defining infrastructure in this manner, we exclude a number of companies from our infrastructure investment universe that are commonly included in infrastructure benchmarks and indices. For an asset to be included in our universe it must:

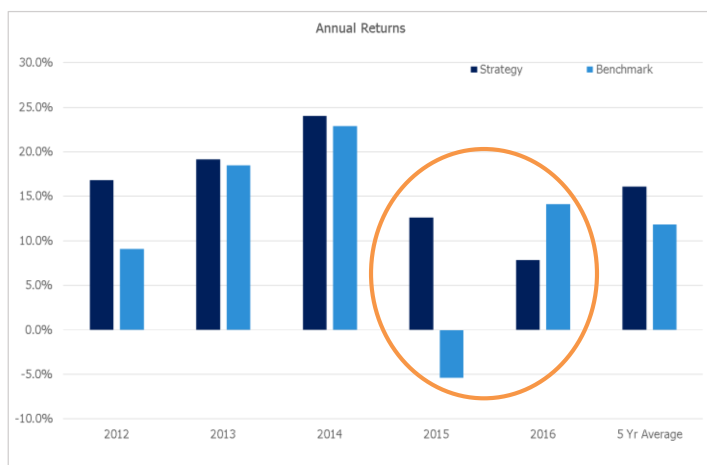
- Provide a service that is essential to the efficient functioning of a community and therefore exhibit reliable demand;
- Generate cash flows that have little or no exposure to exogenous risk factors such as sovereign risk, competitive pressures or commodity prices; and
- Meet specific requirements in relation to gearing.

This approach has served investors well since we started running infrastructure portfolios. That said, over the past two years, the *relative* performance of our infrastructure strategies has been impacted by large variations in commodity prices – one of the key variables that we aim to avoid exposure to.

While we appreciate that investors use comparisons against infrastructure benchmarks to make assessments on relative returns, it is noteworthy to emphasise that our approach takes no consideration of the constituency of infrastructure benchmarks for the reasons outlined above.

The problems with following commodities

The following graph shows the performance of the Strategy against the benchmark for each of the past five years.



In 2015, our approach delivered returns that were significantly ahead of the benchmark, which actually lost value. As we have discussed previously, the relative outperformance of the Strategy was significantly influenced by our conservative definition of the listed infrastructure investable universe and, in particular, the avoidance of stocks whose earnings were materially impacted by commodity prices. The performance during 2015 also clearly demonstrated the downside protection inherent within the Strategy.

The key driver of outperformance in 2015 and the subsequent underperformance in 2016 has been the contrasting impact of falling oil prices in 2015 compared to increasing oil prices in 2016. In 2015 the oil price fell by approximately 31% which had a major impact on the share prices of many stocks in the benchmark. For instance, some of the worst performing stocks in the benchmark in 2015 included oil and gas pipeline companies such as those listed below, with total shareholder returns quoted in local currency terms:

- Targa Resources (-73.4%), a company engaged in midstream oil and gas services;
- Kinder Morgan Inc. (-62.8%), North America's largest oil and gas storage and transmission company (as well as the second largest oil producer in Texas); and
- ONEOK Inc. (-47.4%), a company with interests in natural gas pipelines, gathering and processing.

In line with our philosophical approach to clearly defining infrastructure, the Strategy's investment process excludes companies whose earnings are assessed as being sensitive to oil prices. As a result of this conservative approach, the Strategy is likely to outperform in periods where oil prices are falling and this was a key reason for the Strategy's outperformance in 2015.

In 2016, the oil price staged a significant rebound, rising by 40% for the year which led to a consequent recovery in share prices of these commodity price sensitive companies. Consequently, in 2016:

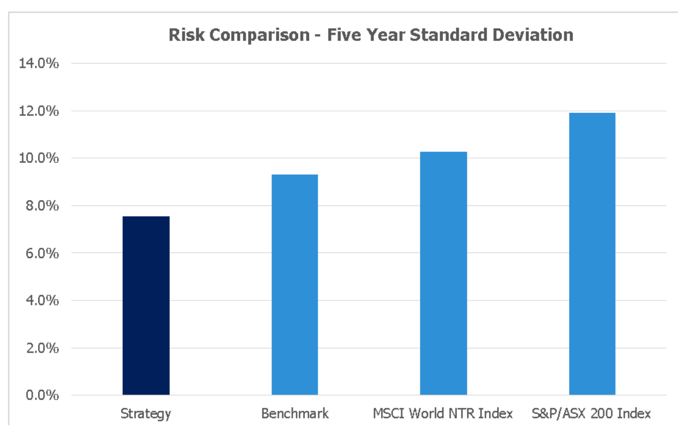
- Targa Resources returned +130.5%, although its share price remains 39% below where it started in 2015;
- Kinder Morgan Inc., returned 42.7% but its share price remains 47% below its starting point in 2015; and
- ONEOK Inc. delivered a return of +149.4%, while its share price is 31% above the level at the start of 2015.

Note that the returns quoted above are expressed as total shareholder returns in local currency terms.

Hence, the benchmark's outperformance of the Strategy in 2016 can be largely attributed to the stock price rebounds of companies that were heavily sold down in 2015. As such, the exclusion of such companies from our defined investment universe is a key reason for the Strategy's underperformance in 2016 and particularly for the December quarter. Despite the lower positive return achieved in 2016, the Strategy has maintained strong outperformance of the benchmark over two years to 31 December 2016.

Lower variability in returns from infrastructure

Notwithstanding the shorter term commodity related impact discussed above, the Strategy's performance over the longer term highlights the value that has been generated through the application of our conservative definition of infrastructure. One key observation is the inherent reduction in the volatility of returns from the Strategy compared to global equities, Australian equities and the Strategy's benchmark, which is highlighted in the chart below.



The impact of excess volatility

There are essentially two key aspects involved in managing money – the absolute level of investment returns that a strategy is able to generate and the level of risk taken to generate those underlying investment returns. Excessive volatility can exert a detrimental impact on a strategy's ability to achieve its target investment return over the longer term due to the compounding nature of investment returns. Consider the example of a $100 investment in a company that extracts and sells crude oil. If the investment results in a 50% fall in value through a period where the oil price collapses like it did between 2014 and 2015, all else being equal, the initial investment would now be worth $50. To recover the 50% loss in value, the investment would actually need to generate a return of 100%. This drawdown effect can have a material impact on long term returns from an asset. This principle has relevance for the Strategy's rationale of not investing in infrastructure stocks that are cyclical in nature or linked to variability in commodity prices.

The importance of definition

We believe that infrastructure assets, with requisite earnings reliability and a linkage of earnings to inflation offer an attractive, long-term investment proposition. Over time, the universe of opportunities in infrastructure has expanded, along with the range of asset types that the broader market has called infrastructure. Applying a disciplined, clearly defined set of parameters to capture the desired characteristics of infrastructure, namely, long term stable cash flows from assets with extensive life spans, protection through effective regulation and close linkages to inflation, provides a solid framework for generating attractive, stable returns over the long term.

Furthermore, given the predictable nature of earnings and the structural linkage of those earnings to inflation, the investment returns generated by infrastructure assets are different from traditional asset classes and offer investors valuable diversification when included in an investment portfolio.

Outlook for infrastructure

Notwithstanding the resilient nature of the operating and financial performance of the companies that the Strategy invests in, as mentioned in our previous updates, we expect to experience volatility in equity markets, particularly as interest rates start to rise in the US. However, we are confident that any increase in interest rates will be gradual and therefore have a minimal negative impact on the underlying operating and financial performance of the companies held in the investment portfolio.

In the current uncertain economic and investment climate, the reliable financial performance of infrastructure investments makes them particularly attractive and an investment in listed infrastructure can be expected to reward patient investors with a three to five year timeframe.

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