Magellan Infrastructure Fund

Fund Update: 31 December 2013

Key Facts

Portfolio Manager
Gerald Stack

Structure
Infrastructure Fund, $A hedged

Inception date
1 July 2007

Management and Administration Fee [1]
1.05% p.a.

Buy/Sell Spread[1]
0.15%/0.15%

Fund Size
AUD $542.7 million

Performance Fee[1]
10.0% of excess return over the higher of the Index Relative hurdle (UBS Developed Infrastructure and Utilities Net Total Return Index (hedged to AUD)) 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 exclusive of the net effect of GST

Performance[2]

	Fund %	Index %[3]	Excess Return %
1 Month	1.7	1.4	0.3
3 Months	5.2	3.7	1.5
6 Months	8.5	7.7	0.8
1 Year	17.8	18.5	-0.7
2 Years (p.a.)	16.4	13.7	2.7
3 Years (p.a.)	14.7	10.6	4.1
4 Years (p.a.)	13.9	9.3	4.6
5 Years (p.a.)	15.9	9.5	6.4
Since Inception (p.a.)	5.4	3.0	2.4
Since Inception	41.0	21.3	19.4

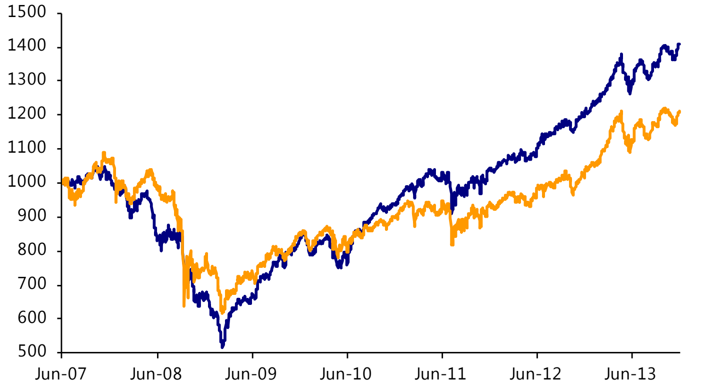
Top 10 Holdings

	Sector	% of Fund
Transurban Group	Toll Roads	9.0
Fraport	Airports	7.3
Atlantia	Toll Roads	6.7
National Grid	Transmission and Distribution	6.5
SES	Communications	6.0
Zurich Airport	Airports	5.3
Auckland Airport	Airports	5.3
Enbridge	Energy Infrastructure	4.0
Sydney Airport	Airports	3.3
Spark Infrastructure	Transmission and Distribution	3.2

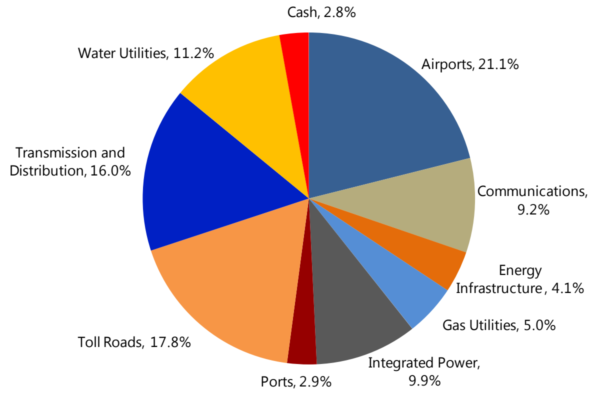
Regional Breakdown[4]

	% of Fund
North America	26.4
Europe ex-UK	32.7
United Kingdom	14.0
Developed Asia	0.2
Emerging Markets	4.2
Australia	14.2
New Zealand	5.3
Other	0.2
Cash	2.8
Total	**100**

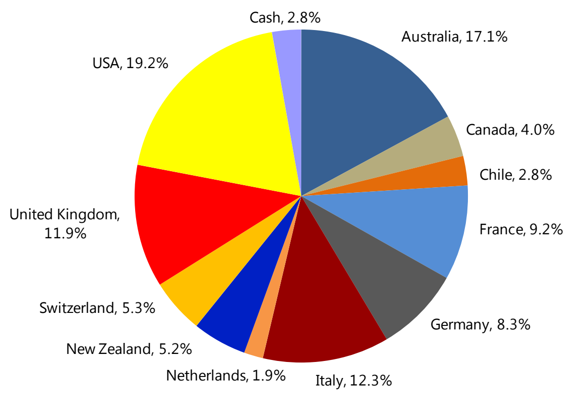
Performance Chart Growth of AUD $1,000[2]



Industry Breakdown



Country Exposure by domicile of listing[5]



[2]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 2007.

[3]UBS Developed Infrastructure and Utilities Net Total Return Index (hedged to AUD)

[4]Calculated on a domicile of asset basis

[5]The exposures are by domicile of listing. It is the Fund's intention to substantially hedge the capital component of the foreign currency exposure of the Fund arising from investments in overseas markets back to Australian Dollars.

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MFG MAGELLAN ASSET MANAGEMENT LIMITED

Fund Commentary

As at 31 December 2013, the Fund consisted of 30 stocks (compared to 29 stocks at 30 June 2013). The top ten investments represented 56.5% of the Fund at 31 December 2013 compared with 51.5% at 30 June 2013.

In January 2014, the Fund paid a distribution of 0.9 cents per unit in respect of the six months ended 31 December 2013. The Unhedged version of the Fund did not pay a distribution in respect of this six month period but is expected to pay a distribution in respect of future half years.

The major sector changes to portfolio composition during the period were a reduction in exposure to US utilities offset by an increase in the weighting of European transport infrastructure stocks. Over the course of the year we have found utilities in the better performing economies of the world (effectively the most defensive infrastructure investment opportunities) to have become progressively more expensive relative to other opportunities in the infrastructure investment universe. Accordingly, we have reduced the exposure to regulated utilities in the USA, and increased our exposure to airports and toll roads in Europe.

The last 12 months have witnessed the share-price recoveries of the utilities and infrastructure sectors that are often included in broader market definitions of infrastructure investment universe, but are outside the universe of stocks that we consider investment grade. These sectors, European integrated utilities with significant exposure to unregulated power generation and Japanese electric utilities, have been poor investments in previous years reflecting their inability through this period to generate reliable earnings.

The Risk of Increasing Interest Rates

In our view, the major risk currently faced by infrastructure and other asset classes is the impact on global money flows and bond yields as a result of the end of the quantitative easing programme (QE) run by the US Federal Reserve (Fed).

The past six months has witnessed a broad increase in underlying interest rates as investment markets have turned their focus to the prospect the Fed will end QE in the next couple of years. We expect interest rates to continue to rise over the medium term. Increasing interest rates represent a challenge for all investment classes and, whilst better placed than many asset classes, infrastructure is not immune from these risks. While prevailing interest rates have been well below historical averages since the global financial crisis, we do not believe that long-term infrastructure investors made their investment decisions during the period based on prevailing interest rates, but on a higher, more historically normal level of interest rates. As a consequence while increasing interest rates represent a risk for investors in infrastructure assets, we believe that the risk over the medium to long term is not that interest rates rise from present levels, but rather that they rise materially above "normal" levels.

The risks posed by an increase in interest rates are somewhat different for utilities as compared to infrastructure assets.

- **Utilities:** Utilities operate under a compact with their communities under which they provide reliable, efficient services while investing for the future. In return, the utility is able to earn a fair return on the capital invested in its operations. Utilities are not able to exploit their natural monopoly power but are protected from the fluctuations of the economic cycle and from changes in variables outside their control, such as interest rates. Ultimately, the key determinant of the level of returns generated by regulated utilities is the return approved by the utilities' regulator and, therefore, an increase in interest rates should lead to an increase in the approved rate of return, ensuring that the utility continues to be able to earn a fair return. However, a utility can suffer because of mismatches and lags between the increase in interest rates and the subsequent increase in the approved regulatory return. Regulatory rates of return have been sticky as interest rates have declined and we expect that there will also be stickiness as interest rates rise.

- **Infrastructure:** Infrastructure assets typically have an ability to pass through the effects of inflation through the price of the service provided; e.g. tolls on a toll road are normally linked to inflation. However, where an increase in interest rates is not accompanied by an increase in inflation, the cost of the debt can be expected to rise (with a lag if the debt interest costs are hedged), reducing the returns available to investors.

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