Magellan Infrastructure Fund

Fund Update: 31 March 2014

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.

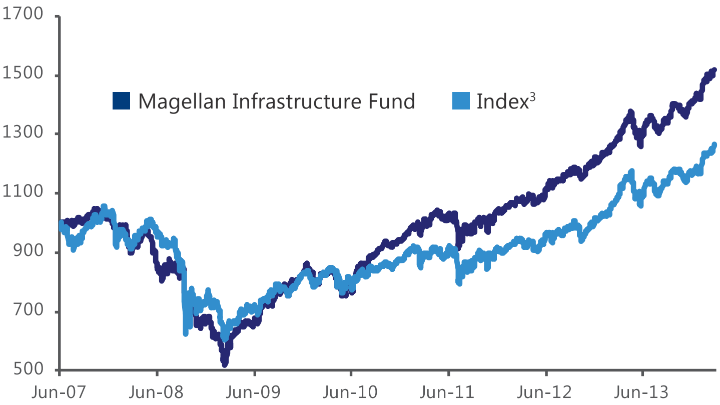
Buy/Sell Spread[1]
0.15%/0.15%

Fund Size
AUD $601.9 million

Performance Fee[1]
10.0% of the excess return of the Units of the Fund above 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

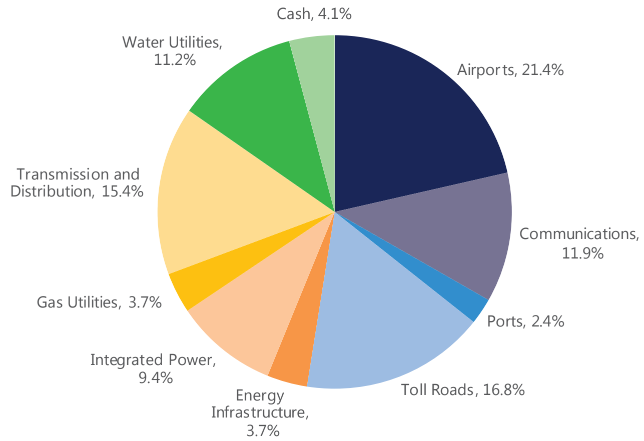
Performance Chart Growth of AUD $1,000[2]



Performance[2]

	Fund %	Index %[3]	Excess Return %
1 Month	1.5	2.4	-0.9
3 Months	7.6	7.5	0.1
6 Months	13.3	11.5	1.8
1 Year	17.8	16.3	1.5
2 Years (p.a.)	18.6	16.1	2.5
3 Years (p.a.)	14.8	12.5	2.3
4 Years (p.a.)	16.4	11.1	5.3
5 Years (p.a.)	19.8	14.4	5.4
Since Inception (p.a.)	6.4	3.6	2.8
Since Inception	51.8	26.7	25.1

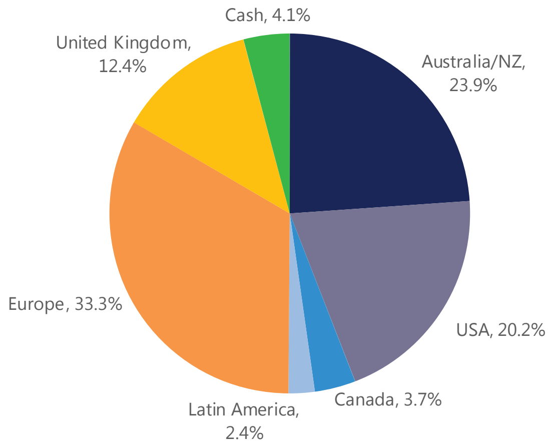
Industry Breakdown



Top 10 Holdings

	Sector	% of Fund
Transurban Group	Toll Roads	8.4
National Grid	Transmission and Distribution	7.0
Atlantia	Toll Roads	6.1
Fraport	Airports	6.1
SES	Communications	6.0
Auckland Airport	Airports	5.2
Sydney Airport	Airports	5.1
Zurich Airport	Airports	5.0
Enbridge	Energy Infrastructure	3.7
Spark Infrastructure	Transmission and Distribution	3.5

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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Performance

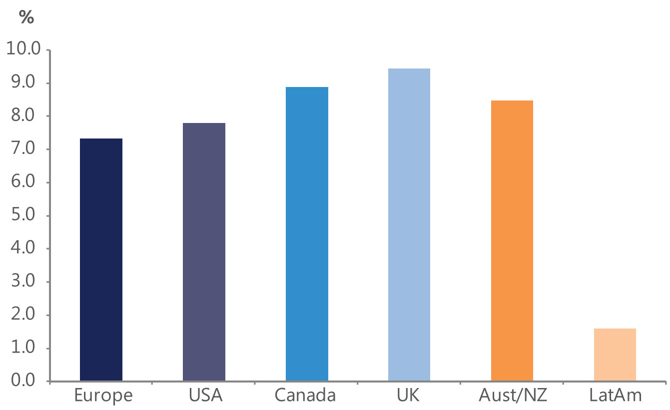
During the March 2014 quarter, the Magellan Infrastructure Fund (MIF) generated a return after fees of +7.6%, marginally better than the benchmark UBS Infrastructure & Utilities Index. This brought the 1 year return for MIF to 17.8% and the five year return to 19.8% per annum, 5.4% better per annum than the benchmark index.

A key feature of the approach used by Magellan in managing MIF is the way we define the universe of potential investments for the fund. Magellan has adopted a conservative definition of the universe of listed infrastructure investments. We did so because we believe that is the appropriate risk management strategy to provide investors with their desired outcome, i.e. returns that have low correlation with other asset classes and the economic cycle but with inherent inflation linkages. Over the medium term, we expect this universe will generate returns in excess of inflation of approximately 5% to 6% pa.

As we have discussed previously, one area where Magellan's approach to defining the investable universe is clearly evident is in the electricity generation sector where Magellan excludes any stock that has a material, i.e. more than 25% of earnings, exposure to unregulated power generation. We do so because we believe the earnings of such companies can be significantly impacted by the economic cycle and, therefore, likely to be strongly correlated to the performance of broader equity markets. Separately, we also exclude the Japanese regulated electricity utilities from the investable universe because we believe that the regulatory regime in Japan does not provide investors with an appropriate protection in all market conditions. As discussed below, the relative performance of MIF during the March 2014 quarter was influenced by both these asset classes.

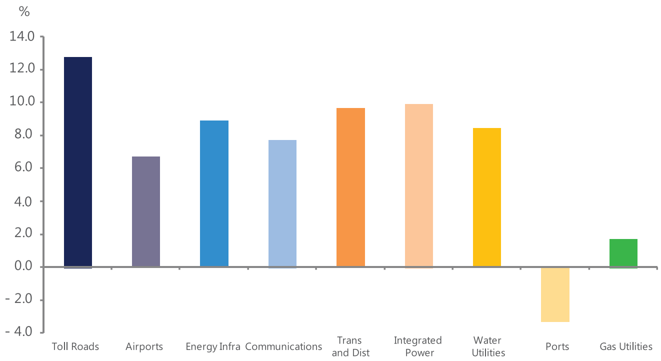
On a regional basis, returns during the quarter were solid across all the exposures except the small Latin American holding (a Chilean water utility) as highlighted in the following graph.

Figure 1: Regional Returns, March Quarter 2014



Returns from the sector exposures were also excellent across all the sectors except Ports where the Ukraine crisis had a material impact on the fund's two European port holdings.

Figure 2: Sector Returns, March Quarter 2014



The best performing stocks during the quarter included Italian toll road company SIAS, which generated a Total Shareholder Return (TSR) of 21.0%, US electricity transmission company ITC (TSR of 17.4%), UK water company United Utilities (+17.3%), European satellite company SES (+15.2%) and another Italian toll road company Atlantia (+14.4%). The only meaningful detractors from performance for the quarter were Dutch oil & chemical tank storage company Vopak (TSR of -4.7%) and US gas utility Southwest Gas (-3.8%) which had seen very strong share price growth in previous quarters.

In regard to stocks excluded from the Magellan defined listed infrastructure investment universe but included in commonly used benchmarks, two distinct trends were observed during the quarter. Firstly, stocks significantly exposed to unregulated power generation generally performed strongly during the quarter. Examples included Italian utility Enel SpA (TSR of +29.4% for the quarter), Electricidade de Portugal SA (+26.3%), US utilities Exelon (+23.8%) and Edison International (+23.1%) and French utility GDF Suez (+16.2%). These stocks have been very unhappy places to invest in previous years, e.g. Exelon's TSR for the 3 years ended 31 December 2013 was -23.3% while GDF Suez's was -19.6%. In contrast to the strong performance of the market generally, Japanese stocks again performed very poorly generating an average TSR of -6.5% for the quarter. Japanese electricity utilities were particularly poor including Hokkaido Electric Power (TSR of -27.9%), Tokyo Electric Power (-19.5%) and Kansai Electric Power (-12.4%).

Portfolio

During the quarter only one change was made to the constituent stocks in MIF being the inclusion of US company Crown Castle International (CCI). CCI owns networks of towers in the USA & Australia that are primarily involved in the rebroadcasting of mobile telephony. It has recently transitioned into a REIT structure, a defining catalyst for Magellan to include the stock in MIF. The inclusion of CCI meant there were 31 stocks in MIF at the end of March 2014.

During the quarter the weighting of the strategies across sectors and regions did not change materially. Utility stocks were approximately 40% of the portfolio while the European exposures made up 35% of the strategy of which 24% were in northern European stocks.

Magellan's Views on Regulation

Regulated utilities often get a pretty 'boring' wrap, namely that their reliable, but not exactly 'mouth-watering', returns mean that the asset class is treated somewhere between a bond and a typical equity asset. We hold no major issues with this broad view of regulated assets on the risk and return spectrum. However, as you look around the world, we see huge differences in the quality of the regulation and the resultant risk and return of this 'bond-proxy'. In our view, such a high level view of regulated utilities is disingenuous and overlooks the significant differences in the risks associated with different regimes.

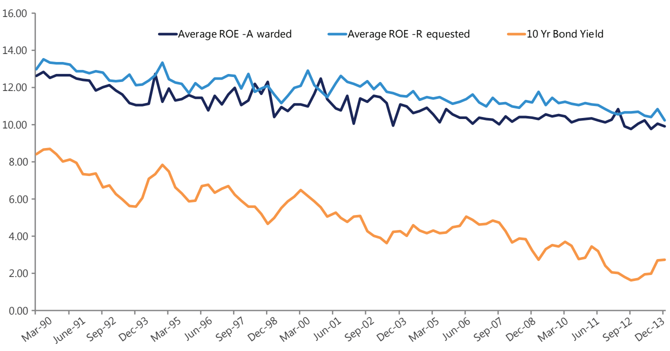
In our investment analysis process, we spend a lot of time trying to understand the dynamics of risk and return in the various regulatory regimes. In our thinking, the keys to a good regulatory regime come down to the fairness of the financial returns allowed by the regulator, the consistency of the rules for determining allowed returns, the transparency of the regulatory framework and the governance process.

Fairness of Financial Returns

Acceptable returns are what most investors seek from regulated utilities (along with low risk). The returns don't have to be astronomical, but they do need to be in the right ball-park. In fact, returns that are too high are likely to create risks down the road as 'over-earning' will likely get corrected at some point in the future.

To provide some context to the discussion, we highlight two regulatory regimes where returns have been adequate over a number of years. Firstly, the USA, which we note has had a reasonably consistent level of returns handed down by the 52 State and Federal regulatory commissions. These have provided an average return on equity of 10% or more over three decades, trending higher at times of high interest rates. Investors can be confident that, through the cycle, the majority of assets in this region will have an opportunity to generate acceptable returns.

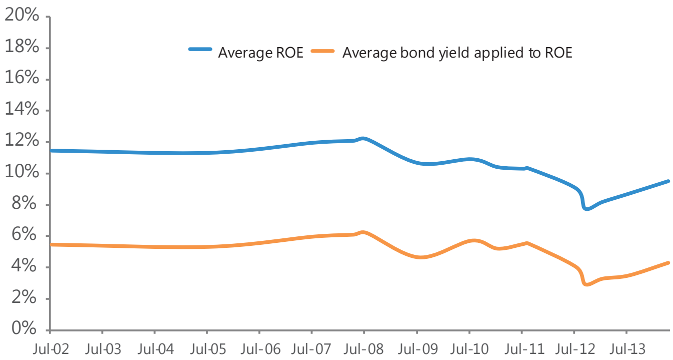
Figure 3: Regulatory Awards in the US



Source: Regulatory Research Associates and Edison Electric Institute

As we now turn to Australia which, as a newer regulatory regime has less history, we note that the returns approved by the regulator have been attractive, but have seen significant declines in the post-GFC period. While, in our view, the allowed financial returns are pushing the lower bounds of a 'fair-return', the decline is due to the decline in the bond yield (which weighs heavily in setting returns in the Australian regulatory regime). In the fullness of time, we have confidence that the risk spread (between the government bond yield and utility returns) will remain intact and that normalising of bond yields to historic averages will be fully reflected in allowed regulatory returns.

Figure 4: Allowed ROEs for Australian Regulated Utilities



Source: Australian Energy Regulator, Magellan Group

When comparing the outcomes of the two regions, it's clear that the USA returns have been more stable through time. This in part reflects the preference of the US regulators to provide more stable returns that don't move as much with the prevailing level of bond rates. We normally have a preference for stable returns, provided the absolute level is fair given the underlying risks.

Predictability

The attraction of investing in regulated utilities is the predictability of their earnings. This requires the regulatory regime to be both consistent and transparent.

Consistency of approach is important. We prefer to invest in regulatory regimes that offer us reliability in both the rules and the application in decisions. Clearly, in an asset that is designed to offer reliable returns, the need for consistency ranks highly. We seek situations where we believe we have a high probability of estimating where regulated returns are likely to move over time. In the above examples of the USA and Australia, we have a high conviction of where returns are likely to trend over time due to the consistency of the regulatory approach.

Consistency also comes through in the length that applies to setting regulatory returns. Regimes such as the UK now offer fairly long-regulatory cycles of 5-8 years providing confidence on the profile of long-term regulated returns.

In order for us to feel comfortable about an investment in regulated utilities, we need to at least have an understanding of the regulatory system and how returns are derived. This means that, even if returns are consistent, we also need to have an understanding of how returns are set.

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As discussed above, in our view, Japan is an example of a region where electric utility regulation has been difficult to understand. We view the regulatory regime as opaque and have struggled to get a clear and firm understanding of the mechanics used to derive energy prices and financial returns to investors. For this (and other concerns on regulation), we have avoided investments in Japan.

Governance

By definition, the regulated utilities that we invest in supply essential services. From a demand point of view, this is an attractive asset class, as demand is relatively stable throughout the economic cycle. However, a risk for investors is that essential services can become a political 'hot-potato' (Who doesn't recall hearing a politician saying that they will reduce power prices if elected?). This normally happens at the worst time - right after you have spent money on infrastructure and need to increase tariffs to pay for it.

For us, the key to managing this risk is the framework under which regulation occurs, i.e. the institutions involved in regulation. Firstly, we have a strong preference for regulator independence. Ideally the regulator is a separate body from the government, with a clear mandate setting out its power and obligations to stakeholders. Regimes such the UK, Italy, Australia and the USA tend to provide greater confidence that the political process won't see our investments become political footballs.

While regulator independence is first on our list when looking at governance, obviously it's only as good as the regulator. Hence, we prefer regimes where the regulator isn't "judge, jury and executioner", i.e. there is sufficient separation of power. We find a good example of this is the Australian regulatory framework, where there is a high degree of responsible governing. The 'rules' for regulation are set by a body whose job is to create regulations from the national laws. These laws represent a common set of legislation across both state and Federal levels, making change for politics sake much less likely. The national regulator then applies the rules, and if the utilities disagree there is a separate appeals body. This is good governance, with regulatory independence, a separation of powers between the rule makers, the people who implement them and the appeals process. This framework gives us confidence that there are sufficient protections in place to allow a fair process to occur.

Outlook and Strategy

The MIF seeks to provide investors with attractive risk-adjusted returns from the infrastructure asset class. It does this by investing in a portfolio of listed infrastructure companies that meet Magellan's strict definition of infrastructure at discounts to their assessed intrinsic values. We expect that the MIF should provide investors with real returns of approximately 5% to 6% over the longer term.

We believe that infrastructure assets, with requisite earnings reliability and a linkage of earnings to inflation, offer attractive, long-term investment propositions. 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 standard asset classes and offer investors valuable diversification when included in an 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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