Fund Update: 31 March 2016

Magellan Infrastructure Fund

ARSN: 126 367 226

Fund Facts

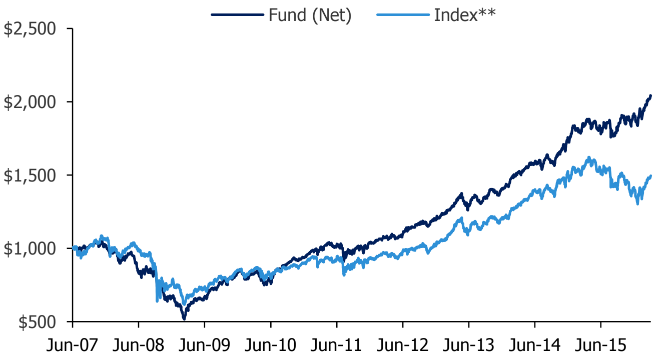
Portfolio Manager	Gerald Stack
Structure	Global Listed Infrastructure Fund, $AUD Hedged
Inception Date	1 July 2007
Management & Administration Fee[1]	1.05% per annum
Buy/Sell Spread[1]	0.15%/0.15%
Fund Size	AUD $960.7 million
Performance Fee[1]	10.0% of the excess return of the units of the Fund above the higher of the Index Relative Hurdle (S&P Global Infrastructure Index A$ Hedged 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 exclusive of the net effect of GST

Fund Features

- Offers investors a pure, benchmark-unaware exposure to global listed infrastructure
- Conservative definition of core infrastructure: invests in companies that generate over 75% of their earnings from the ownership of infrastructure assets
- Relatively concentrated portfolio of typically 20 to 40 investments
- Seeks to substantially hedge the capital component of the foreign currency exposure of the Fund arising from investments in overseas markets back to Australian dollars
- Maximum cash position of 20%
- $20,000 minimum investment amount.

Performance Chart growth of AUD $1,000*



Fund Performance*

	Fund (%)	Index (%)**	Excess (%)
1 Month (%)	4.1	5.5	-1.4
3 Months (%)	6.9	6.1	0.8
6 Months (%)	11.5	4.7	6.8
1 Year (%)	11.3	-3.9	15.2
3 Years (% p.a.)	16.6	10.1	6.5
5 Years (% p.a.)	15.2	10.3	4.9
7 Years (% p.a.)	18.7	12.2	6.5
Since Inception (% p.a.)	8.5	4.7	3.8

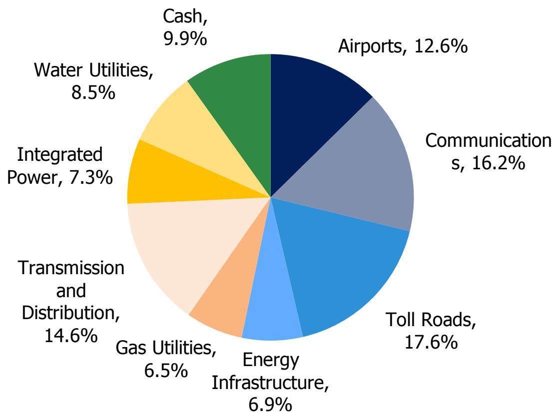
Fund Risk Measures^

	5 Years	Since Inception*
Upside Capture	0.6	0.7
Downside Capture	0.0	0.4

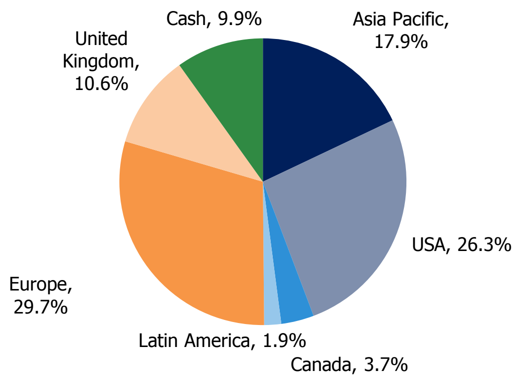
Top 10 Holdings

	Sector	%
Transurban Group	Toll Roads	9.2
National Grid PLC	Transmission and Distribution	6.0
Crown Castle International	Communications	6.0
Atlantia SpA	Toll Roads	5.0
ITC Holdings Corp	Transmission and Distribution	4.6
SES S.A.	Communications	4.5
Flughafen Zeurich AG	Airports	4.0
Enbridge Inc	Energy Infrastructure	3.7
Eutelsat Communications	Communications	3.2
Vopak NV	Energy Infrastructure	3.2
	TOTAL:	49.4

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 2007.
** S&P Global Infrastructure Index A$ Hedged Net spliced with UBS Developed Infrastructure and Utilities Net Total Return Index (hedged to AUD). Note: as the UBS Developed Infrastructure and Utilities Net Total Return Index (hedged to 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$ Hedged Net Total Return.
^ Upside/downside capture shows if a fund has outperformed the global market during periods of market strength and weakness, and if so, by how much. The MSCI World Net Total Return Index AUD Hedged has been used as the representative of the global market to calculate this risk measure.
# The exposures are by domicile of listing.

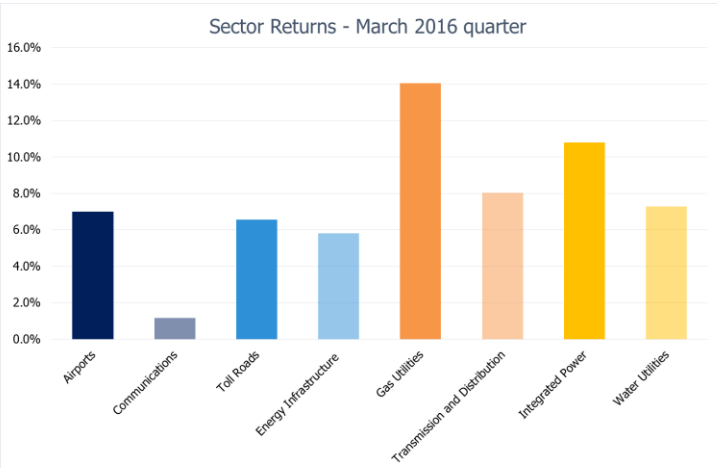
Performance

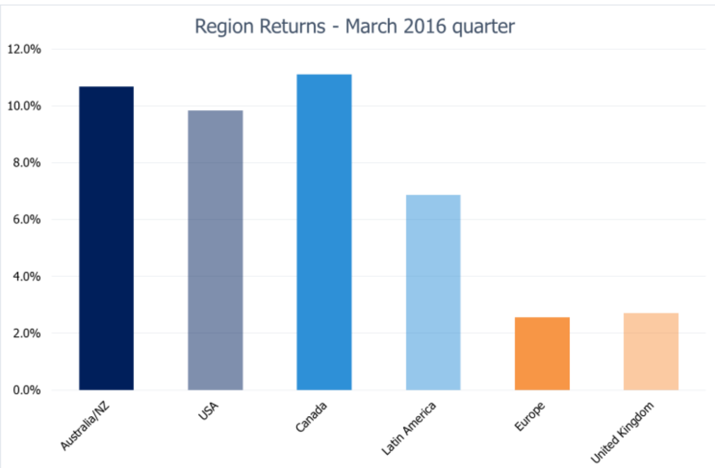
Over the March 2016 quarter, in Australian dollar terms, the Fund returned +6.9% net of fees. This was 0.8% better than the benchmark of 6.1%. The 1 year return to 31 March 2016 for the Fund was +11.3%, 15.2% better than the benchmark return of -3.9%. The Fund also outperformed global equities by 14.6% over the year to 31 March 2016 with the MSCI World NTR (AUD hedged) Index returning -3.3%.

The March 2016 quarter saw very strong share price performance by US utilities offset by weak performance by European and UK infrastructure & utility stocks. The best performing stocks held by the Fund during the quarter (in local currency terms) included Australian toll road company, Macquarie Atlas Roads, with a Total Shareholder Return (TSR) of +20.2%, US utilities Atmos Energy (+18.5%), WEC Energy Group (+18.1%), Westar Energy Inc (+18.0%) and XCEL Energy Inc (+17.4%). The worst performing stocks in the portfolio during the quarter were German airport company, Fraport (-9.6%), Italian toll road companies, SIAS (-8.2%) and Atlantia (-0.5%), and UK water utility United Utilities (-1.3%).

There was significant variability in the returns for the quarter for stocks that Magellan excludes from its investable universe. On the positive side, US competitive power generation companies were up more than 16% while US/Canadian rail companies were up over 5%. In contrast, Japanese rail companies were down an average 13%, as were Japanese regulated electricity utilities. Chinese infrastructure stocks were also down around 13%, European competitive power generation companies were down an average 5% and US oil & gas pipeline MLP's were down more than 4%.

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





Topic in Focus – Crude Awakening for MLPs

Investing in assets linked to oil and gas has been a volatile, yet rewarding experience for many investors over the past decade. The general ascension of the United States in the production stakes has provided a platform for expanding investment in the sector. Master Limited Partnerships have been at the centre of this proliferation, delivering investors tax-advantaged income streams through investments in energy and natural resources sectors. But the downward trend in energy prices that has taken hold since mid-2014 has dragged the MLP sector down with it and in the process, exposed the vulnerabilities of this unique corporate structure.

Investing in the energy sector can take many forms and can be channeled through a range of investment vehicles, from investments in private equity, listed corporations and structured debt through to purpose-built funds. Among the alternatives, the MLP structure has proven popular among asset managers, institutions and individual investors.

The MLP structure evolved through laws passed by US Congress in the mid-1980s. The US Government had a clear incentive to develop a framework for greater self-sufficiency for its energy needs and to reduce the external risks to its own economy. This structure sought to improve the economic viability for companies operating within the oil and gas industry through the incorporation of income pass-through provisions and tax deferral features.

Development of the structure led to a widespread uptake by owners and operators of US energy infrastructure such as natural gas and crude oil pipelines, storage terminals, natural gas processing plants, LNG import and export facilities and other mid-stream operations.

The sector has grown from only a handful of companies in the early 1990's to over 100 MLPs operating largely within the oil and gas sector, representing approximately US$500 billion in market value[1]. MLPs operating mid-stream assets represent 82% of that total market capitalisation, although only 19 of these MLPs hold an Investment Grade credit rating[2].

Testing times for MLPs

Historically, MLPs as an asset class have offered investors:

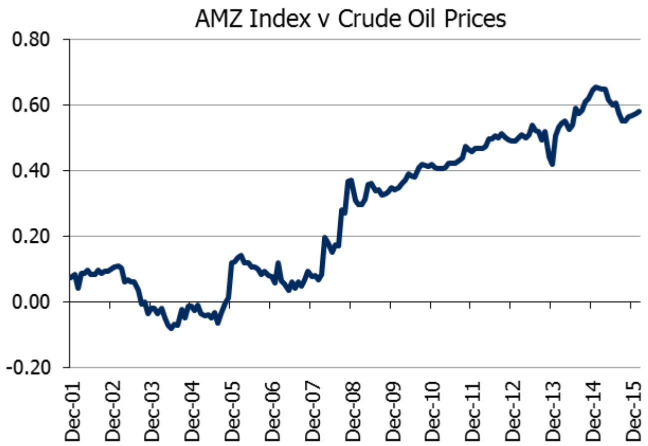
1. Reliable cash flows – primarily from fee-based volumes, typically with inflation-linked tariffs
2. Low correlation to commodity prices
3. Growth potential – stemming from technological improvements like shale gas and oil extraction

While these investment characteristics have been sustained through generally stable operating conditions for the sector, in more recent times we have seen these characteristics break down.

The capitulation of energy prices since mid-2014 has seen an increase in the correlation of MLPs to energy prices which has reduced the degree of differentiation from other corporate-based investments in the oil and gas sector.

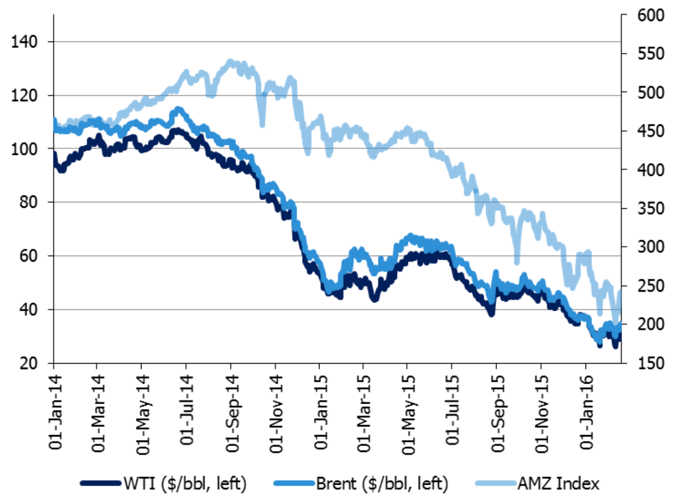
Figure 1 shows that the long term correlation between MLPs and commodity prices has been historically low, but today MLPs exhibit a greater link to movements in commodity prices – particularly crude oil. This correlation has risen from close to zero in 2005 to 0.6 in 2015. Magellan Asset Management suspects that this may be a function of the changing risks in the MLP space, which we highlight later in this report. Critically, the increased sensitivity to crude oil prices has seen some operators experience negative returns while others have delivered declining yields.

Figure 1: Rising correlation of MLPs to commodity prices



Source: Alerian, Bloomberg, Magellan Asset Management Limited

Figure 2: MLPs following energy prices



Source: Alerian, Bloomberg, Magellan Asset Management Limited

A combination of greater energy infrastructure capacity (i.e. competition), depressed energy prices and highly levered balance sheets now present a key challenge for MLPs. Notwithstanding the recent partial recovery in commodity prices, investors need to consider the flow-on effects, particularly in the scenario of a protracted period of low crude oil prices. Likely implications for MLPs include:

1. Distribution cuts to fund future growth or reset to more sustainable levels at the expense of future growth;
2. Tighter access to capital market funding; and
3. Asset value write-downs (thereby adding further strain to credit metrics).

More importantly, the impact of depressed commodity prices has become increasingly apparent within capital expenditure budgets, which we see invariably hindering future cash flow growth.

The sustained decline in energy prices has had a pronounced impact on MLP distribution yields and distribution coverage ratios are likely in decline. This trend is prevalent in the distributions for energy limited partnership closed-end funds (CEF), whereby 14 of the 26 CEFs in the category announced distribution cuts between December 2015 and February 2016[3].

Figure 3: Significant Distribution Cuts

			Amount			
Fund name	**Ticker**	**Frequency**	**Current ($)**	**Previous ($)**	**Change (%)**	**Pay date**
Goldman Sachs MLP and Energy R	GER	Quarterly	0.16	0.34	-52.24	2/29/16
Goldman Sachs MLP Income Opps	GMZ	Quarterly	0.21	0.35	-39.13	2/29/16
Clearbridge American Energy MLP	CBA	Quarterly	0.20	0.31	-34.43	2/29/16
Kayne Anderson Energy Total Return	KYE	Quarterly	0.33	0.49	-32.65	1/15/16
Clearbridge Energy MLP TR Fund	CTR	Quarterly	0.29	0.36	-19.44	2/26/16
Clearbridge Energy MLP	CEM	Quarterly	0.36	0.44	-19.32	2/26/16
Clearbridge Energy MLP Opps	EMO	Quarterly	0.32	0.40	-18.99-	2/26/16
Kayne Anderson MLP	KYN	Quarterly	0.55	0.66	-16.67	1/15/16
Nuveen All Cap Energy MLP Opps	JMLP	Quarterly	0.29	0.34	-15.20	2/16/16
Salient Midstream & MLP Fund	SMM	Quarterly	0.33	0.37	-11.92	2/29/16
Kayne Anderson Midstream Energy	KMF	Quarterly	0.45	0.51	-11.76	1/15/16
Tortoise Pipeline & Energy	TTP	Quarterly	0.41	0.45	-9.44	2/29/16
Kayne Anderson Energy Dev Co.	KED	Quarterly	0.48	0.53	-9.43	1/15/16
Tortoise Power & Energy Infrast.	TPZ	Monthly	0.13	0.14	-9.09	3/31/16

Source: Morningstar, data as of 28 February 2016.

Peeling back the layers of risk

The dynamics for MLPs are changing and we believe there are now a deeper level of risks which investors need to be cognisant of including (but not limited to):

Increased competition: There has been a considerable buildout in the North American energy infrastructure space over the past decade. Between 2009 and 2014, US companies added nearly 14,000 miles of crude oil pipeline, representing an increase of 26%[4]. In a weak environment for commodity prices, we have seen re-contracting to competitors where contract tenures have shortened (by 50% in some cases) and other commercial terms renegotiated increasingly in the customer's favour.

In addition, competition potentially increases exposure to lower creditworthy counterparties. Magellan suspects this may have played a part in a Plains All American customer defaulting on a long-term contract, which represented 10% of a major pipeline's capacity.

Increased balance sheet risk: MLPs may be pressured to offer higher payouts and distribution growth to attract cheaper capital which in turn is used to fund new and higher return projects. Lower income levels can lead to asset sales or capital draw down and consequently, higher leverage ratios (>4.0x Debt/EBITDA) which is ultimately unsustainable. We saw this in 2014 when Boardwalk Partners became overly geared, contributing to its distribution being reduced by 81%.

Weak governance: Under the MLPs General Partner (GP)/Limited Partner (LP) structure, the GP is retained on behalf of the LP's to operate the MLP on their behalf. This structure highlights two weaknesses:

1. LP's have restricted voting rights or say on management, compensation and mergers/acquisitions; and
2. GPs are incentivised to acquire assets and take on more debt which may not be sustainable.

A confluence of lower commodity prices, declining income, high distribution expectations and balance sheet misalignment create a clear set of risks for MLP investors.

Purer forms of infrastructure yield more favourable characteristics

These observations warrant a reassessment of the fundamental investment proposition underlying MLPs. We believe that investors typically seek investments in listed infrastructure for their attractive investment characteristics in terms of:

1. Stable, inflation-linked cash flows;
2. Long term contracts typically backed by government regulation;
3. Low correlation with equities and other asset classes; and
4. A stable operating environment through significant natural barriers to competition.

These traits may have prevailed to some degree among the MLP universe historically, but now is the time to reassess these prospects. Magellan continues to consider and utilise exposures to the Energy sector via mid-stream and down-stream operators within the listed infrastructure sector, and we believe that these areas better exhibit the desired characteristics of stable income than the current income distribution profile of the MLP space.

[1] Source: Master Limited Partnerships Association, August 2015
[2] Source: Alerian
[3] Morningstar, "MLPocalypse Averted for Now", March 2016
[4] Wall Street Journal, "Energy Pipeline Boom Ebbs", 9 September 2015