MAGELLAN ASSET MANAGEMENT LIMITED

ANNUAL INVESTOR REPORT

30 JUNE 2013

Magellan Infrastructure Fund

Dear Investor,

I am pleased to write to you as an investor in the Magellan Infrastructure Fund (the 'Fund') for the year ended 30 June 2013.

During the year, the Magellan Infrastructure Fund (the Fund) showed a positive return of 17.7%, exceeding the market benchmark (the UBS Developed Infrastructure & Utilities Net TR Index) by 3.3%. These returns, on both an absolute and relative basis are pleasing, but we remind investors that infrastructure, properly defined, is a low-risk asset class that should provide investors with CPI + 4-5% per annum returns over the long term. Infrastructure assets were oversold during the global financial crisis, and returns over the last three years (Fund 19.2% p.a., Index 12.1% p.a.) reflect the market re-focusing on the attractive, conservative, fundamentals of the asset class.

Our underlying investment philosophy has not changed since we launched the Fund in mid 2007. We seek to buy and hold an investment portfolio of what we regard as outstanding infrastructure companies. We aim to invest in infrastructure and utility companies that possess attractive fundamentals at prices that enable the Fund to achieve superior risk adjusted returns over a 3 to 5 year period.

PORTFOLIO STRATEGY

Generally, infrastructure assets are natural monopolies that provide an essential service to the community. Over time the stable, reliable earnings of infrastructure assets are expected to lead to a combination of income and capital growth for investors.

The universe of infrastructure assets that we consider for the Fund is made up of 2 main sectors:

- **Utilities,** including both regulated energy utilities and regulated water utilities. We estimate that utilities comprise more than 75% of the potential universe for the Fund. Utilities are typically regulated by a government sponsored entity. Such regulation requires the utility to efficiently provide an essential service to the community and, in return, permits the utility to earn a fair rate of return on the capital it has invested in its operations. As the utility provides a basic necessity, e.g. energy or water, there is minimal fluctuation in demanded volumes in response to the economic cycle and the price charged for the utility service can be adjusted with limited impact upon demanded volumes. As a result, the earnings of regulated utilities have been and are expected to continue to be stable irrespective of economic conditions; and

- **Infrastructure,** which includes airports, ports, toll roads and communications infrastructure. Regulation of infrastructure companies is generally less intensive than for utilities and allows companies to accrue the benefits of volume growth i.e. the returns of infrastructure companies are linked to growth in passengers, vehicles or containers. As economies develop, grow and become more inter-dependent, we expect the underlying level of aviation, shipping and vehicle traffic to increase. As a result, the revenues and earnings derived by infrastructure assets are expected to grow.

Both utilities and infrastructure companies provide an essential service while facing limited (if any) competition, and, because the service is essential, the price charged for the service can be adjusted with limited impact upon demanded volumes. As a consequence, earnings are more reliable than those for a typical industrial company.

PORTFOLIO SUMMARY

As at 30 June 2013, the Fund's portfolio consisted of 29 investments (in comparison with 29 investments at 30 June 2012). The top ten investments represented 51.5% of the portfolio at 30 June 2013 compared with 47.8% at 30 June 2012.

The Fund's investment portfolio has been constructed to reflect the most attractive investment opportunities that meet our qualitative criteria whilst also minimising the risk of capital loss. Accordingly, portfolio exposures can be expected to change over time to reflect the ebb and flow of market prices for companies that meet our qualitative criteria.

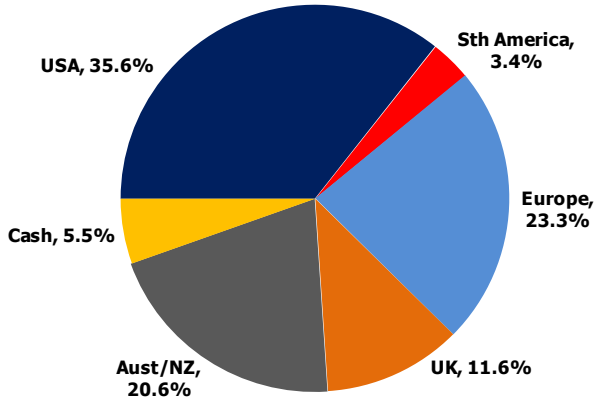
The composition of the Fund by sector at 30 June 2012 and 30 June 2013 was as follows.

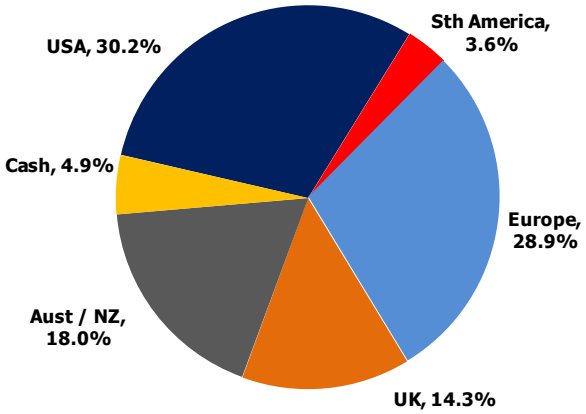
	Portfolio Weight (%)	
	30 June 2012	30 June 2013
Toll Roads	13.4%	13.7%
Airports	15.0%	14.9%
Ports	2.8%	2.5%
Communications	6.0%	8.4%
Energy Utilities	41.6%	35.8%
Water Utilities	15.7%	19.7%
Cash	5.5%	4.9%

The major sector changes to portfolio composition during the period were a reduction in exposure to energy utilities offset by an increase in the weighting of water utilities and communications infrastructure assets.

The composition of the portfolio by geography at 30 June 2012 and 30 June 2013 was as follows:

30 June 2012	30 June 2013





The major changes to geographic exposures were an increase in the weightings to Europe and the United Kingdom offset by a reduction in the weightings to the USA and to Australia.

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 in the "chase for yield". Accordingly, we have reduced the exposure to regulated utilities in the USA and infrastructure assets in Australia, and increased our exposure to airports and communications infrastructure in Europe.

Airports:

Economic conditions remain subdued in much of Europe and we remain cautious about the economic outlook for the region. Notwithstanding this, it is our assessment that the price at which a number of the airport investment opportunities are currently trading effectively capitalises current economic conditions for an extended period.

Given the continued pressure for increasing aviation travel as a result of continued growth in global wealth per capita, most notably through the increasing disposable wealth of the rising middle class in emerging economies, falling real cost of aviation (due to technological development, the increasing market share of low cost carriers and the progressive reduction in regulatory barriers to international travel) we believe the long run outlook for European airports is more positive than the outlook inferred by current prices.

Communications Infrastructure:

The most profitable part of the satellite industry is TV broadcasting. To be considered infrastructure, Magellan believes that an asset must provide an essential service and we believe that TV broadcasting satisfies this definition. As an illustration, despite costing the average US household over $80 per month, pay TV subscriptions actually increased over the worst financial crisis since the Great Depression. That is, US pay TV households increased from 95 million in 2006 to 100m in 2012, and the subscription cost rose over the same period.

For TV broadcasters, satellite distribution of TV is the lowest cost method of reaching a mass audience over a wide area – lower than hundreds of towers or cable networks. In fact, these two methods often use satellites as an efficient means of transmitting TV signals to disparate towers and cable networks. Satellites have also historically provided greater capacity to deliver more channels of higher quality to users, i.e. high definition channels use four times the signal capacity of standard definition channels. Demand for satellite services grows with the number of channels offered and the quality of those channels, offset by improved compression technology, i.e. fitting more channels into a given amount of signal.

By way of example, satellite owner SES has grown recurring revenue by over 4% p.a. for the last 5 years. We expect this modest growth to continue. However, SES is also well placed to accelerate its growth with strong positions in nascent satellite TV markets in Latin America, Africa and Asia, where pay TV penetration is currently low yet demand is high, and land-based transmission infrastructure is limited.

We believe that the incumbent satellite operators, including SES, will profit from this growth as they are protected by barriers to new entrants and switching costs for existing broadcasters.

- There is a physical limit on the number of satellites that can be used for TV broadcasting to a geographic area without causing interference with each other. Therefore, satellites occupy "slots" that are at least two degrees apart, i.e. a maximum of 180 slots around the globe can be used for satellite TV. Above major population centres, valuable slots are already being used by existing satellite operators, giving them a perpetual lease on this valuable space real estate. Given the interference issues, it is almost inconceivable that a new operator would be able to access an orbital slot above major population centres.

- In Europe alone, 85 million households access their TV from a satellite dish pointing directly at the orbital slots of SES or those of competing provider Eutelsat. Should a broadcaster or Direct to Home (DTH) platform using these satellites wish to change the alternative satellite provider, it must factor in the cost of physically moving all of its customers' satellite dishes to point to a different orbital slot. Relative to the modest cost of satellite distribution, this rarely, if ever, makes sense. A new DTH platform is also best served to use incumbent satellite operators as this gives them immediate access to a large existing user base.

- Broadcasters typically enter 10-15 year contracts with satellite providers. The weighted average remaining contract life across SES's entire business is currently 8.6 years, and represents over 4 years of 2012 revenue.

SES has generated over 25% return on tangible capital each and every year over the last 5 years, illustrative of the barriers to entry and switching costs in the satellite TV industry. These characteristics also mean that the incumbent satellite operators exhibit low earnings volatility, demonstrated during the GFC, when SES's lowest recurring revenue growth was +1.7%.

Risk of Rising Interest Rates:

The most recent quarter has witnessed an increase in underlying interest rates as investment markets turned their focus to the prospect the Fed will end its quantitative easing programme (QE) in the next couple of

years. We expect interest rates to continue to rise over the medium term (Hamish Douglass has written about the potential outcomes from the end of QE in his most recent investor letter for the Magellan Global Fund). Increasing interest rates represent a challenge for infrastructure, as it does for all investment classes. While prevailing interest rates have been well below historical averages since the GFC, 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 that interest rates rise above a more "normal" level.

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 the utility provides reliable, efficient service and invests for the future and 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 so an increase in interest rates should lead to an increase in the approved rate of return so that the utility continues to be able to earn a fair return. However, the 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 infrastructure service 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 then, where the infrastructure asset is partially funded by debt, the cost of the debt can be expected to rise (with a lag if the debt interest costs are hedged) and so reduce the returns available to investors.

ISSUE IN FOCUS

Opportunities for Infrastructure Investors from US Shale Gas Development

The story of natural gas in the U.S over the last decade has been a remarkable one. In 2005, natural gas was trading at nearly double today's level as the market reflected tightening supply markets. Today, the natural gas market looks markedly different – prices declined sharply in response to significant increases in production. These increases were effectively made possible by the "shale revolution" – new technology that allowed producers to unlock vast known quantities of natural gas at relatively low cost.

So what is Natural Gas Shale?

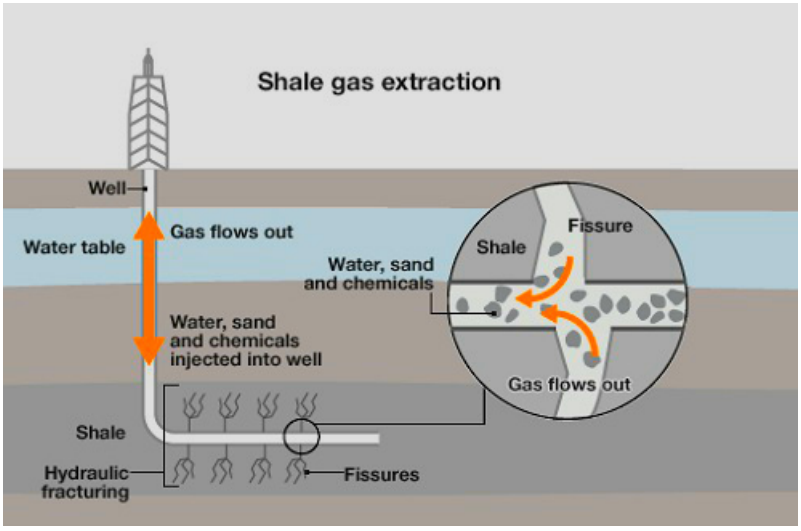
In simple terms, shale gas is natural gas found in very fine-grained sedimentary rock (shale). The natural gas is tightly trapped in small spaces within the impermeable shale formation, and essentially requires breaking of the shale formations – or fracturing – to make extraction possible. In the past, accessing shale gas wasn't feasible as doing so proved to be both difficult and uneconomical. But that was until more recently when producers developed hydraulic fracturing.

What is Hydraulic Fracturing?

Hydraulic fracturing, or often referred to as "fracking", is the process of pumping large amounts of fluid down a well thousands of metres (typically 6,000-10,000 metres) below ground. The pressure this creates causes the shale rock to crack. The fluid, consisting mostly of water and sand, then flows into the cracks. As the pumping pressure eases, the water disperses and leaves the sand to keep the cracks open which allows the trapped natural gas to flow up the well.

Directional drilling has also played a critical role in fracking (see Exhibit 1 on next page). As no formation is ever similar, directional drilling allows the producer to access non-vertical shale formations, as well as increasing access to a particular reservoir (thereby increasing well efficiency and recovery rates).

Exhibit 1: Hydraulic Fracturing

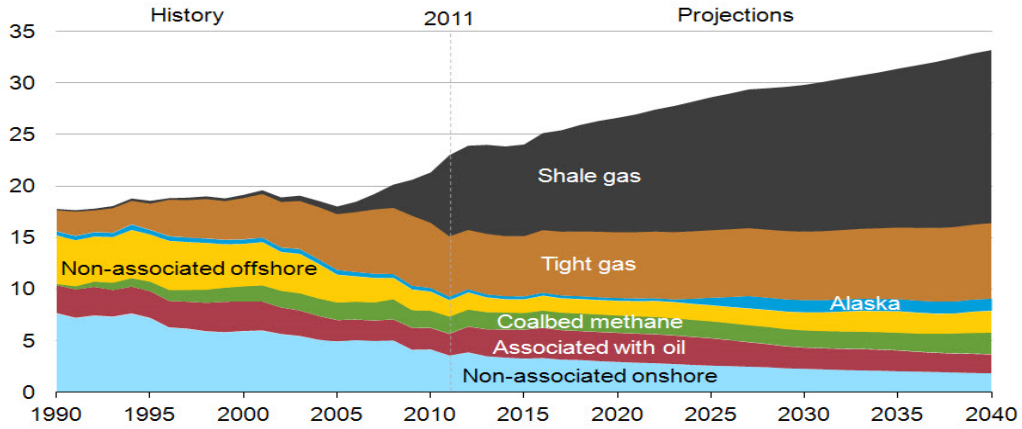


Source: Timera Energy

Why is it a big deal?

The impact of the shale gas revolution has been immense on several fronts. From a supply perspective, the U.S. has virtually become natural gas independent overnight. According to the U.S. Energy Information Administration's latest projection (Exhibit 2, below), shale gas is expected to drive much of the domestic production increase from 23 trillion cubic feet in 2011 to 33.1 trillion cubic feet in 2040 – a 44% increase.

Exhibit 2: U.S. Dry Natural Gas Production



Source: U.S. Energy Information Administration, Annual Energy Outlook 2013 Early Release

The demand response to the increased supply has been equally impressive, particularly in power generation, where the availability of natural gas (in addition to increasing emission standards) has provided the impetus for coal-fired generation retirements. Based on the estimates of the U.S. Energy Information Administration, approximately 9% of total coal-fired generation capacity will be retired by 2016.

Increased demand for natural gas should also come from: growing industrial demand (e.g. fertilizer and petrochemical producers); increased U.S. manufacturing; and growth in natural gas powered vehicles. Liquefied Natural Gas (LNG) is also expected to weigh on demand going forward, with more than a dozen LNG facilities awaiting licences to export to non-Free Trade Agreement countries.

What Does This Mean for Infrastructure Investors?
Magellan expects the energy infrastructure space to be a primary beneficiary of natural gas shale production. Historically, the natural gas pipeline network in the U.S. was designed to serve the major production markets in the Gulf Coast and the key Northeast consuming region. However, new shale developments in Texas, the Rockies, Mid-Continent and Appalachia, have resulted in a need for new and/or additional energy infrastructure such as pipelines.

In its most recent study, the Interstate Natural Gas Association of America (INGAA) estimated that US$251 billion (in real 2010 dollars) in capital investment would be needed in the period to 2035 to meet the infrastructure requirements for increasing shale gas production in North America. And the majority of that capital (approximately US$200 billion) would be required for midstream infrastructure (e.g. transmission and gathering pipelines). More importantly, Magellan expects most of these capital investments to be pursued by listed infrastructure companies.

Exhibit 3: INGAA Projected Infrastructure Investments (in US$bn, real 2010)

	2011-2020	2011-2035
Natural Gas Infrastructure	$98.1	$205.2
Natural Gas Liquids Infrastructure	$12.3	$14.5
Crude Oil Infrastructure	$19.6	$31.4

Source: INGAA

Magellan also expects other less-obvious infrastructure sectors to benefit from shale development. For example, increased natural gas production in the Marcellus Shale in the North East of the USA has allowed American Water Works (NYSE: AWK) to become a key provider of water resources used in the production process while also extending service to new residential customers – all of which are conducted under regulated terms. AWK's presence in the Marcellus Shale has also eliminated the need for thousands of water delivery trucks, benefitting both natural gas producers and other stakeholders.

We believe that the shale revolution clearly provides a number of opportunities for investors and stakeholders. For the Magellan Infrastructure Fund, the opportunity set around the shale phenomenon remains geared toward assets that meet Magellan's definition of infrastructure, specifically those assets with (among other things):

- High regulation;
- Inelastic demand;
- Low competition;
- Limited commodity price exposure; and
- High degree of inflation protection.

In this regard, the Fund remains focused on natural gas transmission and distribution assets that can service these new sources of supply. Ultimately, Magellan believes this approach will provide the Fund with not only stable and predictable returns, but also an attractive element of growth.
Magellan believes that infrastructure assets, with requisite earnings reliability and a linkage of earnings to inflation offer an attractive, long-term investment proposition. 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 3 to 5 year timeframe.

Yours sincerely,

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July 2013

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