Annual Investor Report

Select Infrastructure Strategy | June 2015

Gerald Stack
Head of Investments and Portfolio Manager
Magellan Infrastructure Fund

Dear Investor

I am pleased to write to you as an investor in the Magellan Select Infrastructure Strategy (the 'Strategy') for the year ended 30 June 2015.

During the 12 months to 30 June 2015, the Strategy delivered a 14.0% return hedged in Australian dollars and before fees. This was 6.5% better than the benchmark[1] return of 7.5%.

Our underlying investment philosophy has not changed since we launched the Strategy 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 Strategy to achieve attractive risk adjusted returns over a three to five 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 Strategy is made up of two main sectors:

Utilities, including both regulated Energy Utilities and Regulated Water Utilities. We estimate that utilities comprise more than 60% of the potential investment universe for the Strategy. 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, earn a fair rate of return on the capital it has invested; and

Infrastructure, which includes Airports, Ports, Toll Roads, Communications Assets and Energy Infrastructure (oil & gas pipelines). Regulation of infrastructure companies is generally less intensive than for Utilities and allows companies to accrue the benefits of volume growth. As economies develop, grow and become more inter-dependent, we expect the underlying levels of aviation, shipping and vehicle traffic to increase as will demand for all forms of communications and energy.

Both utility 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 demand volumes. As a consequence, earnings are more reliable than those for a typical industrial company and generally enjoy inherent inflation protection.

[1] The Global Infrastructure benchmark is comprised of the following: from inception to 31 December 2014 the benchmark is UBS Developed Infrastructure & Utilities NTR Index hedged to AUD and from 1 January 2015 onwards, the benchmark is the S&P Global Infrastructure NTR Index hedged to AUD.

Portfolio Summary

The Strategy's investment portfolio has been constructed to reflect the most attractive investment opportunities that meet our qualitative criteria while also minimising the risk of permanent capital loss. As at 30 June 2015, the Strategy's portfolio consisted of 28 investments (in comparison with 30 investments at 30 June 2014). The top ten investments represented 57.6% of the portfolio at 30 June 2015 compared with 58.2% a year previously.

The Strategy also held approximately 10% in cash as at 30 June 2015, up from approximately 3% a year ago. The decision to hold such a material part of the portfolio in cash (which mirrors a similar strategy adopted by the Magellan Global Strategy) reflects Magellan's view that markets will become increasingly volatile as we move closer to the US Federal Reserve increasing interest rates and as the crisis in Greece unfolds. This level of cash will allow us to move quickly to take advantage of buying opportunities that may consequently arise. Indeed, we took advantage of the selloff in the last two days of the financial year to increase our holding in one of the Strategy's key stocks.

The composition of the Strategy by sector at 30 June 2013, 2014 & 2015 was as seen in figure 1.

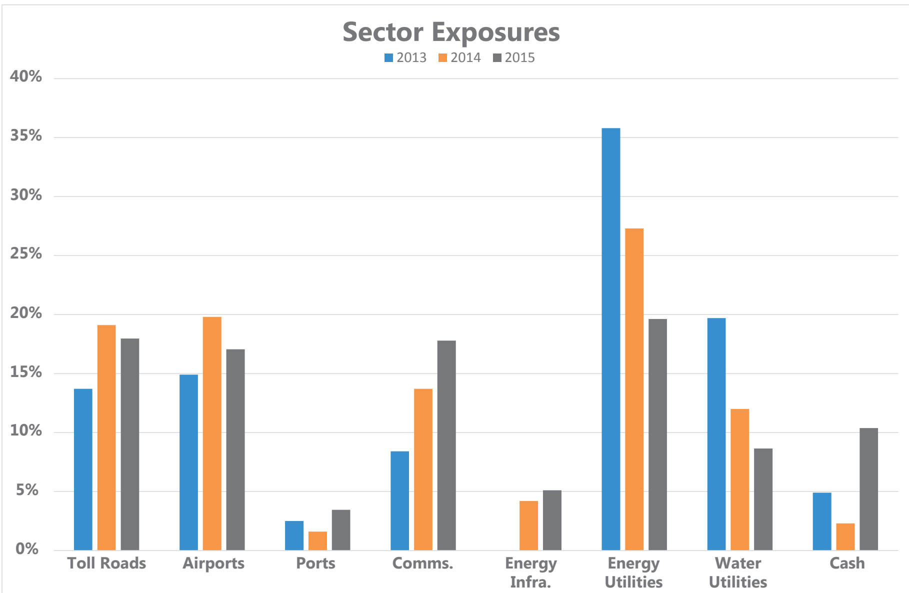
Over the course of the year, we have found utilities in the better performing economies of the world, effectively the most defensive infrastructure investment opportunities, to have become progressively more expensive. Accordingly, we have reduced the Strategy's exposure to Regulated Utilities in the US and UK and increased the Strategy's exposure to Communications Infrastructure stocks and also increased our cash holding. The three Communications sector exposures included two European satellite companies owning perpetual rights to the key geostationary positions for satellites broadcasting television directly to homes throughout Europe and a company that owns more than 40,000 towers for the rebroadcasting of mobile phone telephony in the US.

You will note the marked reduction in utilities over the last two years (28% today compared with 56% at 30 June 2013). This reflects utilities becoming expensive relative to other investment opportunities over the period with US utilities, in particular, exhibiting markedly higher prices as a result of the increased appetite for their defensive nature and relatively high yield. The reduction in the utilities weight despite our expectation of increased volatility reflects our view that the greatest risk to markets is rising US interest rates (and thus a decline in pricing), rather than a cyclical macro-driven downturn (and thus a decline in earnings). Notwithstanding this, we do envisage that increases in Treasury yields will cause volatility in the prices of some utilities (as they did in the 'taper tantrum' of 2013) at which point we will appraise their relative attractiveness and potentially seek to reintroduce them to the portfolio.

This move in portfolio exposures to utilities proved beneficial as the average return from Utility stocks held in the Strategy during Full Year 2015 was only 2.7% compared to 17.4% for non-utility stocks.

The composition of the portfolio by geography at 30 June 2014 and 30 June 2015 was as seen in figure 2.

Figure 1: Composition of the Strategy by Sector.



Source: Magellan Asset Management Limited

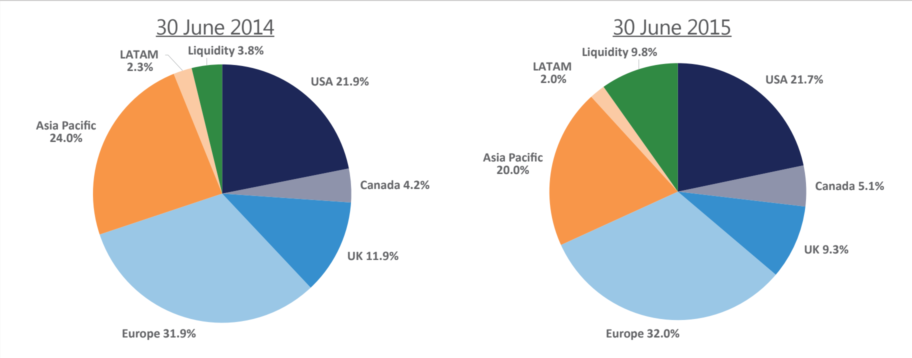
The top performing stocks in the Strategy during the year were Zurich Airport (which delivered a Total Shareholder Return (TSR) of 35.2%), Auckland Airport (TSR of 32.7%), Australian Toll Road company Transurban, which was also the Strategy's largest holding during the year, (TSR of 31.8%), oil & chemical tank storage company Vopak (TSR of 29.1%) and Sydney Airport (TSR of 24.0%). Nine of the ten worst performing stocks in the portfolio were US Utilities, although only three delivered negative returns for the year.

A Reflection on the Last Five Years

As we have discussed in previous investor letters, there is no universally agreed definition of what is or is not an infrastructure asset. Therefore, every manager needs to define their investment universe as the first step in building a portfolio. Magellan uses what most asset consultants and research houses judge to be the most conservative definition of the term infrastructure of all listed infrastructure managers globally. Magellan refers to the universe of stocks meeting our definition as the Magellan Core Infrastructure Index.

Over the last 5 years, the Magellan Core Infrastructure Index returned 18.4%

Figure 2: Composition of the Strategy by Geography.



Source: Magellan Asset Management Limited

per annum before fees (compared to a before fee return from the Magellan Select Infrastructure Strategy of 19.8% per annum). The following graph shows returns by sector over this period (which we calculate by taking the average local currency return of the stocks in that sector). The key observations to be made from this data are:

• As we would expect, the returns from the Utility sectors were more consistent than the non-Utility sectors

• The higher returning non-Utility sectors were led by the Airports sector which returned 25% pa over the period.

The next graph shows returns by region. Clearly, the Latin American returns, which are primarily driven by four Mexican airport companies, were outstanding while the Asia Pacific stocks also performed very strongly (note that we only include developed markets in the Asia Pacific region). It is worth noting that, despite the ongoing economic problems in Europe, stocks from that region performed in line with the US, UK and Canada.

In terms of individual stock performance:

• The best performing stock was Mexican airport company OMAB with a TSR of 38.5%;

• 5 of the 6 best performing stocks were airports;

• Pleasingly, only one stock of the 86 stocks in the strategy delivered a negative return over the five year period.

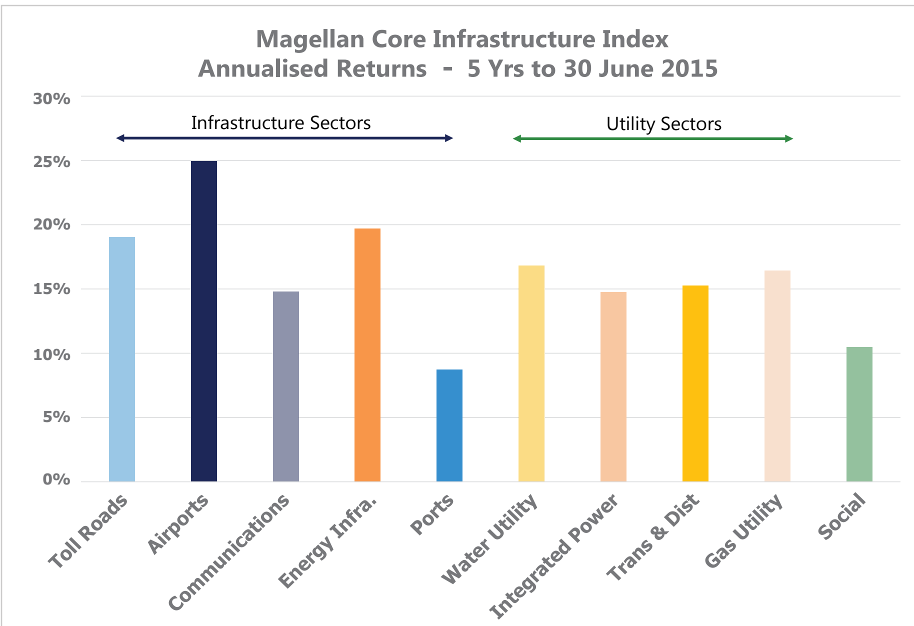
Finally, one of the key reasons that investors choose to include global listed infrastructure in their asset allocation is to diversify their exposures from global equity markets. One of the key criteria used to measure how effective an investment is at risk reduction and diversification is called 'Downside Capture'. This measures how the investment performs when equity markets go down. An analysis of performance over the five years to 30 June 2015 shows that the Magellan Core Infrastructure index's downside capture ratio was -0.1 (and indeed the Strategy achieved the same result). This means that, on average, the index delivers investors a positive return when global equity markets fall.

Outlook

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 within a three to five year timeframe.

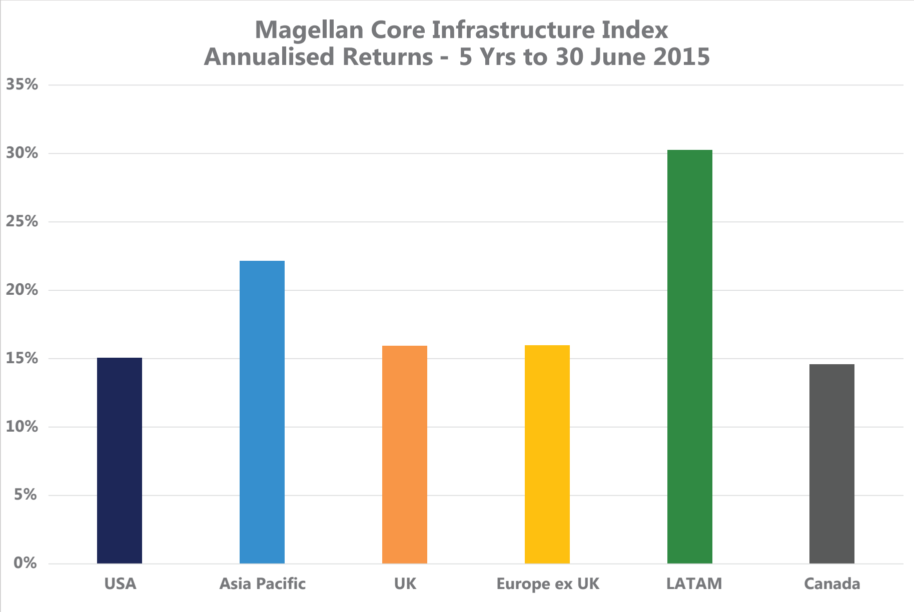
Notwithstanding the resilient nature of the stocks held in the Strategy, as mentioned in our March 2015 newsletter, we expect to see increasing volatility in equity markets as interest rates start to rise in the US. We are, however, very confident that any increase in interest rates will have minimal negative impact on the actual financial performance of the stocks in the portfolio.

Figure 3: Magellan Core Infrastructure Index by Sector.



Source: Magellan Asset Management Limited

Figure 4: Magellan Core Infrastructure Index by Geography.



Source: Magellan Asset Management Limited

As is clear from much of the content of this letter, Magellan has a conservative approach to the management of this Strategy. This will not change regardless of market conditions as we strongly believe such a defensive posture reflects the role infrastructure should play in any portfolio. This may mean that we will under-perform the benchmark if markets rise strongly, an outcome that would not cause us a moment's discomfort.

Yours sincerely

Gerald Stack
Head of Investments and Portfolio Manager (Infrastructure)

Contact Details

Magellan Asset Management Limited ABN 31 120 593 946, AFS Licence No. 304301
Level 7, 1 Castlereagh Street, Sydney, NSW 2000 Australia.
www.magellangroup.com.au

+61 2 8114 1888

info@magellangroup.com.au