

MFG Select Infrastructure

Strategy Update: 31 March 2014

Portfolio Manager

Dennis Eagar/Gerald Stack

Inception date

1 July 2007

Total Infrastructure Assets¹

USD \$3,745.9 million / GBP £2,246.9 million

Composite Size²

USD \$557.9 million / GBP £334.6 million

AUD Hedged Gross Performance²

	Composite %	Index % ³	Excess Return %
1 Month	1.5	2.4	-0.9
3 Months	7.9	7.5	0.4
6 Months	13.9	11.5	2.4
1 Year	19.1	16.3	2.8
2 Years (% p.a.)	20.2	16.1	4.1
3 Years (% p.a.)	16.2	12.5	3.7
4 Years (% p.a.)	17.8	11.1	6.7
5 Years (% p.a.)	21.2	14.4	6.8
Since Inception (% p.a.)	7.6	3.6	4.0
Since Inception	63.8	26.7	37.1

AUD Hedged Gross Performance - Calendar Year²

	Composite %	Index % ³	Excess Return %
2007 (part year)	2.7	3.4	-0.7
2008	-33.4	-27.5	-5.9
2009	25.5	10.0	15.5
2010	13.0	5.7	7.3
2011	12.4	4.7	7.7
2012	16.8	9.1	7.7
2013	19.1	18.5	0.6

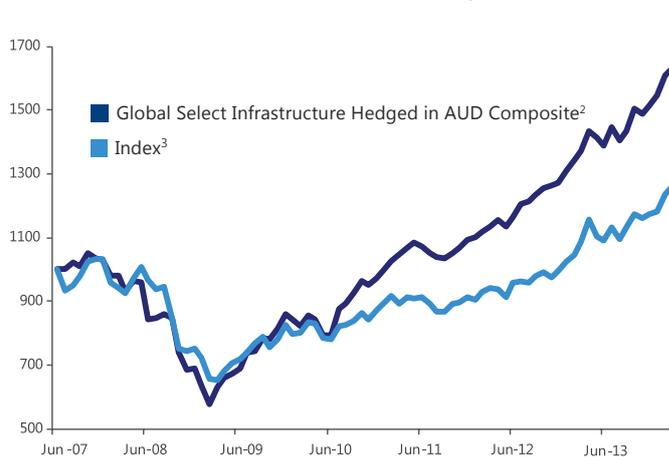
AUD Hedged Risk Measures Since Inception²

Upside Capture	0.9
Downside Capture	0.7
Beta	0.8
Information Ratio (% p.a.)	0.4
Tracking Error (% p.a.)	9.5%
Worst Drawdown - Fund	-45.6%
Worst Drawdown - Index	-37.4%

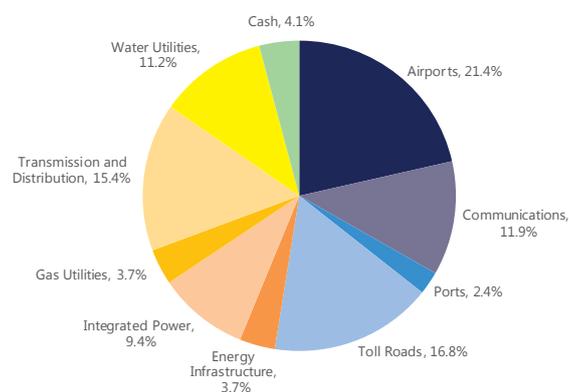
Top 10 Holdings⁴

	Sector	% of Strategy
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

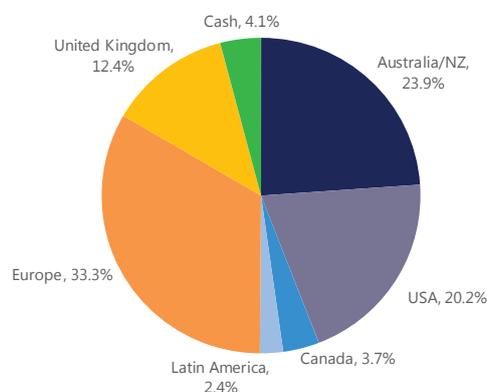
Performance Chart Growth of AUD \$1,000



Industry Exposure⁴



Geographical Exposure⁴



¹ Comprised of the total Firm Infrastructure assets, comprising the Select Infrastructure strategy and Core Infrastructure strategy.

² Returns and risk measures are for the Select Infrastructure Hedged in AUD Composite. *Refer overleaf for further information.

³ Index: UBS Developed Infrastructure & Utilities Net Total Return Index (Hedged to AUD) Source: UBS

⁴ Representative Portfolio. ^Refer overleaf for further information.

Performance

During the March 2014 quarter, the MFG Select Infrastructure strategy (the Strategy) generated a return before fees of 7.9%, marginally better than the benchmark UBS Infrastructure & Utilities Index. This brought the 1 year return for the Strategy to 19.1%, 2.8% better per annum than the benchmark index.

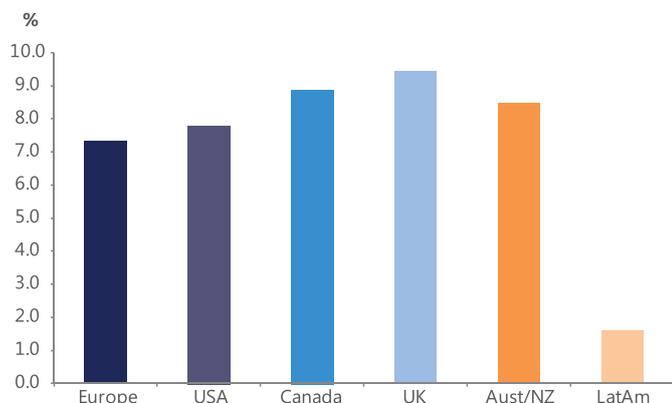
During the quarter, the sector exposures of the Strategy remained relatively stable with approximately 60% of the Strategy invested in infrastructure stocks, e.g. toll roads, airports, ports and communications assets while 40% was invested in energy and water utilities.

A key feature of the approach used by Magellan in managing the Strategy is the way we define the universe of potential investments for the Strategy. 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 real returns 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 the Strategy during the March 2014 quarter was influenced by both these asset classes.

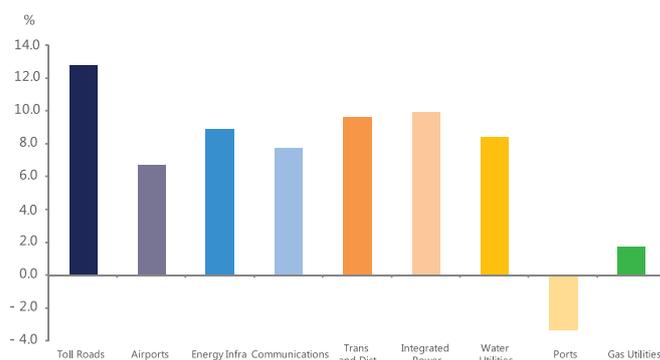
On a regional basis, returns during the quarter were solid across all the Strategy's exposures except the small Latin American holding (a Chilean water utility) as highlighted in the following graph.

Figure 1: Regional Returns, March Quarter 2014



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

Figure 2: Sector Returns, March Quarter 2014



The best performing stocks in the Strategy 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 the Strategy 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 the strategy. The inclusion of CCI meant there were 31 stocks in the Strategy at the end of March 2014.

During the quarter the weighting of the Strategy's exposures 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 the 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.

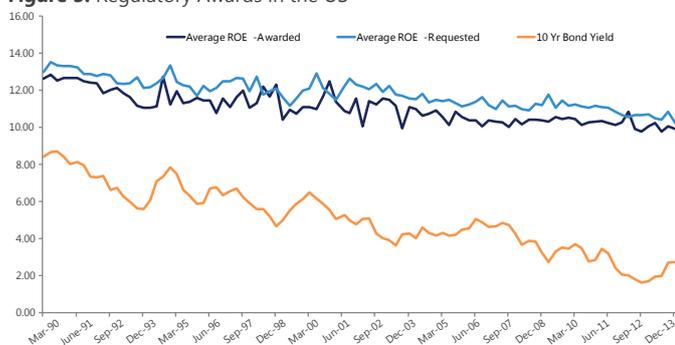
In our investment analysis process, we spend a lot of time trying to understand the dynamics of risk and return in the various regulatory regimes. In our thinking, the keys to a good regulatory regime come down to the fairness of the financial returns allowed by the regulator, the consistency of the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

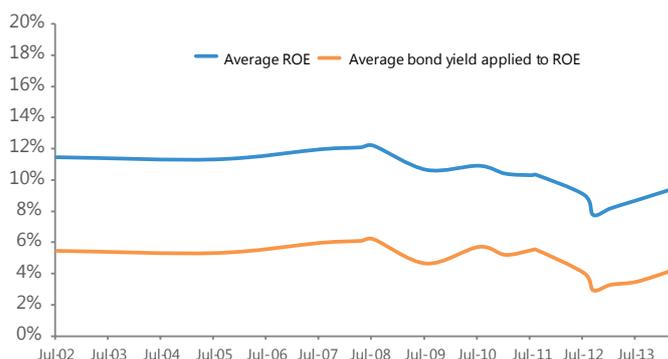
Figure 3: Regulatory Awards in the US



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 Asset Management Limited

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.

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 as 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 Strategy 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 Strategy 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.

IMPORTANT NOTICE

This document is being furnished to you to provide summary information regarding Magellan Asset Management Limited trading as MFG Asset Management ('MFGAM') and an investment fund or investment strategy managed by MFGAM ('Fund'). This document is strictly confidential and is being provided to you solely for your information and must not be copied, reproduced, published, distributed, disclosed or passed to any other person at any time without the prior written consent of MFGAM. No distribution of this document will be made in any jurisdiction where such distribution is not authorised or is unlawful. This document is not intended to constitute advertising or advice of any kind and you should not construe the contents of this document as legal, tax, investment or other advice.

The investment program of the Fund presented herein is speculative and may involve a high degree of risk. The Fund is not intended as a complete investment program and is suitable only for sophisticated investors who can bear the risk of loss. The Fund may lack diversification, which can increase the risk of loss to investors. The Fund's performance may be volatile. The past performance of the Fund is not necessarily indicative of future results and no person guarantees the performance of the Fund or the amount or timing of any return from it. There can be no assurance that the Fund will achieve any targeted returns, that asset allocations will be met or that the Fund will be able to implement its investment strategy or achieve its investment objective. The management fees, incentive fees and allocation and other expenses of the Fund will reduce trading profits, if any, or increase losses. The Fund will have limited liquidity, no secondary market for interests in the Fund is expected to develop and there are restrictions on an investor's ability to withdraw and transfer interests in the Fund. In making an investment decision, you must rely on your own examination of any offering documents relating to the Fund.

No representation or warranty, express or implied, is made with respect to the correctness, accuracy, reasonableness or completeness of any of the information contained in this document. This information is subject to change at any time and no person has any responsibility to update any of the information provided in this document. MFGAM will not be responsible or liable for any losses, whether direct, indirect or consequential, including loss of profits, damages, costs, claims or expenses, relating to or arising from your use or reliance upon any part of the information contained in this document including trading losses, loss of opportunity or incidental or punitive damages.

Performance is compared to the UBS Developed Infrastructure & Utilities Index Net Total Return (Hedged to AUD) which is a market capitalisation weighted index that is designed to measure the equity performance of listed Infrastructure and Utility stocks. Index results assume the reinvestment of all distributions of capital gain and net investment income using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. The index is hedged to Australian dollars.

United Kingdom - This document does not constitute an offer or inducement to engage in an investment activity under the provisions of the Financial Services and Markets Act 2000 (FSMA). This document does not form part of any offer or invitation to purchase, sell or subscribe for, or any solicitation of any such offer to purchase, sell or subscribe for, any shares, units or other type of investment product or service. This document or any part of it, or the fact of its distribution, is for background purposes only. This document has not been approved by a person authorised under the FSMA and its distribution in the United Kingdom and is only being made to persons in circumstances that will not constitute a financial promotion for the purposes of section 21 of the FSMA as a result of an exemption contained in the FSMA 2000 (Financial Promotion) Order 2005 as set out below. This document is exempt from the restrictions in the FSMA as it is to be strictly communicated only to investment professionals as defined in Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (FPO).

United States of America - This document is not intended as an offer or solicitation for the purchase or sale of any securities, financial instrument or product or to provide financial services. It is not the intention of MFGAM to create legal relations on the basis of information provided herein.

GIPS® DISCLOSURE

MFGAM claims compliance with the Global Investment Performance Standards (GIPS®). For the purpose of complying with GIPS, the Firm is defined as all discretionary portfolios managed by MFGAM. The Magellan Select Infrastructure composite is a global strategy investing in strictly defined pure infrastructure companies (typically 20-40). The composite is hedged to Australian dollars with forward contracts. To achieve investment objectives, the composite may also use derivative financial instruments including, but not limited to, options, swaps, futures and forwards. Derivatives are subject to the risk of changes in the market price of the underlying securities instruments, and the risk of the loss due to changes in interest rates. The use of certain derivatives may have a leveraging effect, which may increase the volatility of the composite and may reduce its returns. A list of composites and descriptions, as well as policies for valuing investments, calculating performance, and preparing compliant presentations are available upon request by emailing data@magellangroup.com.au

^ The representative portfolio is an account in the composite that closely reflects the portfolio management style of the strategy. Performance is not a consideration in the selection of the representative portfolio. The characteristics of the representative portfolio may differ from those of the composite and of the other accounts in the composite. Information regarding the representative portfolio and the other accounts in the composite is available upon request. Industry and Geographical Exposures are calculated on a look through basis based on underlying revenue exposure of individual companies held within the portfolio