Strategy Update: 30 September 2016

# Magellan Select Infrastructure

## Key Facts

| | |
|---|---|
| Portfolio Manager | Gerald Stack & Dennis Eagar |
| Strategy Inception Date | 1 July 2007 |
| Total Infrastructure Assets[1] | AUD $6,942.9 million |
| Total Strategy Assets | AUD $2,743.4 million |

## AUD Hedged Performance[2]

| | Composite (Gross) | Composite (Net)[3] | Index[4] | Excess Return |
|---|---|---|---|---|
| 3 Months | 0.2 | 0.0 | 2.6 | -2.4 |
| 6 Months | 3.1 | 2.7 | 8.8 | -5.7 |
| 1 Year | 16.0 | 15.1 | 14.0 | 2.0 |
| 3 Years (% p.a.) | 17.7 | 16.8 | 11.7 | 6.0 |
| 5 Years (% p.a.) | 17.8 | 16.9 | 12.8 | 5.0 |
| 7 Years (% p.a.) | 17.0 | 16.1 | 10.5 | 6.5 |
| Since Inception (% p.a.) | 9.7 | 8.8 | 5.4 | 4.3 |

| | Composite (Gross) | Composite (Net)[3] | Index[4] | Excess Return |
|---|---|---|---|---|
| 2007 (%)* | 2.7 | 2.3 | 6.5 | -3.7 |
| 2008 | -33.4 | -33.9 | -27.5 | -5.8 |
| 2009 | 25.5 | 24.5 | 10.0 | 15.5 |
| 2010 | 13.0 | 12.1 | 5.7 | 7.3 |
| 2011 | 12.4 | 11.5 | 4.7 | 7.7 |
| 2012 | 16.8 | 15.9 | 9.1 | 7.7 |
| 2013 | 19.1 | 18.2 | 18.5 | 0.7 |
| 2014 | 24.0 | 23.0 | 22.9 | 1.1 |
| 2015 | 12.6 | 11.7 | -5.4 | 18.0 |
| 2016 (CYTD) | 10.7 | 10.0 | 15.4 | -4.8 |

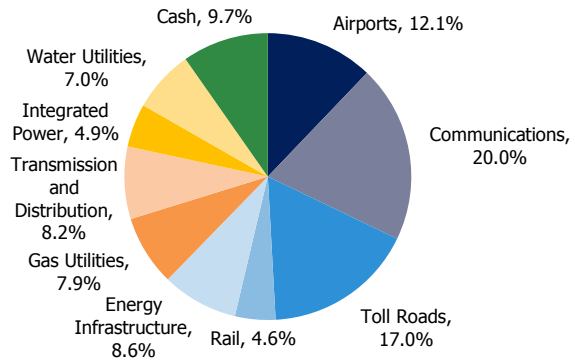
## AUD Hedged 5 Year Risk Measures[2]

| | Against Benchmark[4] | Against Global Equities[5] |
|---|---|---|
| Upside Capture | 1.0 | 0.6 |
| Downside Capture | 0.4 | -0.2 |
| Beta | 0.6 | 0.3 |
| Correlation | 0.8 | 0.4 |

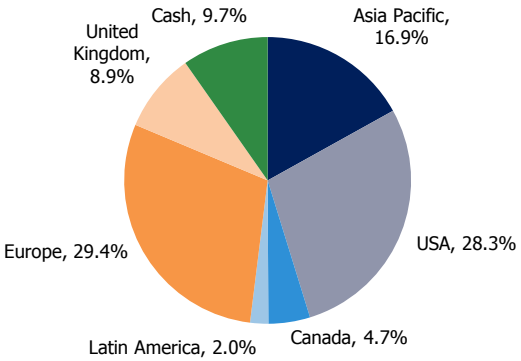
## Top 10 Holdings[6]

| | Sector | % |
|---|---|---|
| Transurban Group | Toll Roads | 8.0 |
| Crown Castle International | Communications | 6.8 |
| SES S.A. | Communications | 6.0 |
| National Grid PLC | Transmission and Distribution | 5.0 |
| American Tower Corp | Communications | 4.9 |
| Enbridge Inc | Energy Infrastructure | 4.7 |
| Sempra Energy | Gas Utilities | 4.3 |
| Flughafen Zuerich AG | Airports | 4.3 |
| United Utilities Group Plc | Water Utilities | 3.9 |
| Vopak NV | Energy Infrastructure | 3.9 |
| | TOTAL: | 51.8 |

## Industry Exposure[6]




## Geographical Exposure[6]




1 Comprised of all Infrastructure strategies.
2 Returns are for the Global Select Infrastructure Hedged in AUD Composite and denoted in AUD. Performance would vary if returns were denominated in a currency other than AUD. Refer to the GIPS Disclosure section at the end of this document for further information.
3 Composite (Net) returns are net of fees charged to clients and have been reduced by the amount of the highest fee charged to any client employing that strategy during the period under consideration. Actual fees may vary depending on, among other things, the applicable fee schedule and portfolio size. Fees are available upon request.
4 S&P Global Infrastructure Index Net Total Return (hedged to AUD) 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 on 1 January 2015 with the S&P Global Infrastructure Index Net Total Return (hedged to AUD).
* Returns are only for part year.
5 Risk measures are for the Global Select Infrastructure Composite (hedged to AUD). The Global Equity Index is the MSCI World Net Total Return (AUD Hedged).
6 Representative portfolio. The exposures are by domicile of listing.

## Performance

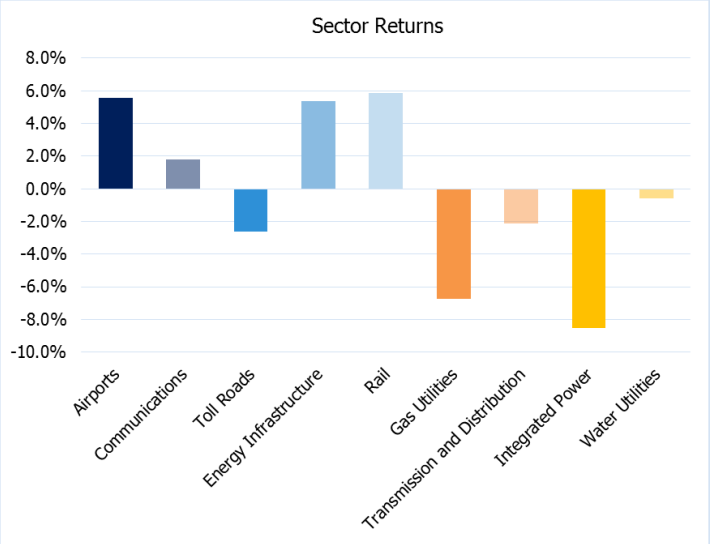
Over the September 2016 quarter, in Australian dollar hedged terms, the Strategy returned +0.2% before fees. This was 2.4% below the benchmark return of +2.6%. The one year return to 30 September 2016 for the Strategy was +16.0%, 2.0% better than the benchmark return of 14.0%. The Strategy also outperformed global equities by 4.2% over the year to 30 September 2016 with the MSCI World Net Total Return Index (AUD hedged) returning +11.8%.

The September quarter saw a continued rebound in stocks that had been heavily sold off in previous quarters. This observation was most prevalent among stocks whose earnings are sensitive to commodity prices and those domiciled in emerging markets, neither of which are considered investable for the Strategy.

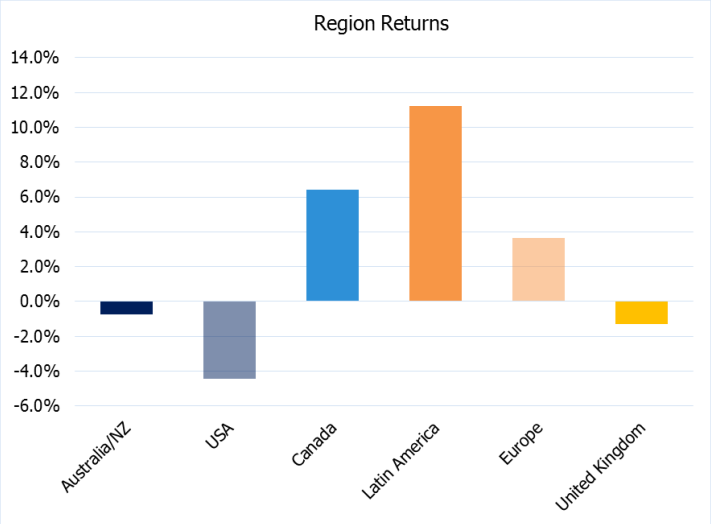
During the quarter, rail companies were added to the Strategy for the first time (further details below). The best performing sectors for the quarter were Rail (weighted average return in local currency of +5.9%), Airports (+5.6%) and Energy Infrastructure (+5.4%). The Strategy's exposure to the broader utilities sectors were reduced further during the quarter (see below) and this proved advantageous as they generated negative returns over the period. The Strategy's investments in Integrated Power companies declined by a weighted average 8.5% for the quarter, Gas Utilities declined by 6.8%, Transmission & Distribution companies declined by 2.1% and Water Utilities declined by 0.6%. Within the Strategy's major holdings, the best performing stocks during the quarter were European satellite company, SES (total shareholder return in local currency of +12.4%), Zurich Airport (+10.2%) and Enbridge (+6.4%).

The performance of the benchmark index was positively impacted by its oil & gas pipelines exposures, which produced an average return of 21.5% (in local currency terms) for the quarter after increasing by 16.4% in the previous quarter. Companies in this sector are excluded from Magellan's investment universe because their earnings are impacted by competition and the price of the commodity they are shipping. Consequently, their share price movements can be volatile and heavily correlated with commodity prices. Examples of companies recovering some of their lost ground over the past year include North American pipeline companies, Kinder Morgan (up 24.3% in the September quarter but still down 13.0% for the year) and The Williams Companies (up 43.0% for the quarter but still down 8.2% for the year). Excluding these companies, the benchmark index return was broadly in line with that of the Strategy. A further exception is the benchmark's Competitive Power exposures (not held in the Strategy) which were down by an average 3.5% for the quarter.

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




Source: Magellan Asset Management Limited.




Source: Magellan Asset Management Limited.

## Strategy

During the September 2016 quarter the following changes were made to the Strategy:

- As previously discussed, we added three US/Canadian rail stocks to the Strategy. At the end of the quarter, these totalled 4.6% of the Strategy and this is likely to grow modestly in the near future. Magellan has monitored this sector closely over many years and appreciated the attractive duopoly structures that these rail companies operate under. However, we were concerned that a significantly lower oil price might disadvantage rail companies when competing with the trucking industry. Consequently, we have delayed investing in this sector while observing these industry dynamics under a lower oil price environment. A more detailed commentary on the sector can be found later in this report.

- We further reduced our exposure to the broader utilities market in response to continued strength in those markets, particularly for US utilities, and increased our investments in the Communications sector. Utilities now make up 28% of the Strategy compared to 35% at the end of the last quarter.

- Consistent with the past 18 months, the cash holding for the Strategy remains high at approximately 9%. We expect

increased share market volatility associated with any decision by the US Federal Reserve (Fed) to increase interest rates and we want to be able to move quickly to take advantage of any significant share price weaknesses in quality infrastructure and utility companies, particularly US utilities. As noted in our previous communications to investors, the average debt costs for most US utilities is expected to continue to fall over the next two to three years, regardless of Fed strategy as they will be replacing relatively expensive debt maturing over that period with much cheaper and longer duration debt.

The underlying fundamentals of the markets in which we invest remain sound. Traffic numbers on toll roads in Europe, the US and Australia continue to grow solidly, with particularly strong truck traffic growth in most markets. Passenger numbers through airports are also robust, although terrorism events have impacted a number of European airports. Demand for satellites and other forms of communications infrastructure remains strong and regulators continue to allow satisfactory returns for our utility holdings. While some sectors, particularly US utilities, appear expensive, there are still opportunities to invest in stocks at appropriate values and we remain comfortable that we can meet or exceed our target of generating real returns of 5%-6% over the medium term.

## Topic in Focus – Why invest in rail?

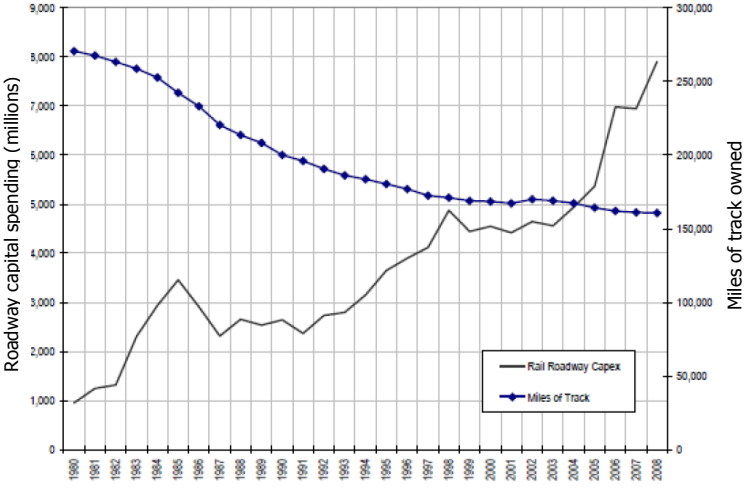
Railroads provide a basic, but critical role for any developed society – they facilitate the connection between producers and consumers of essential goods and support a large section of the economy. The North American rail industry represents one of the world's oldest and largest collections of transport infrastructure. In this section we provide an insight into the sector and explore the current thesis for investment in North American rail assets.

The US rail industry was once a global leader in rail infrastructure development and innovation, with acclaim for manufacturing world-class locomotives and carriages. In 1934 Budd Manufacturing Co. created the Zephyr, a US diesel-powered train that broke the world speed record. The locomotive travelled from Denver to Chicago at 77 miles per hour and set the US on a course to dominate global rail development. However, over time US rail had become a forsaken sector and failed to keep up with innovations seen elsewhere in Europe and Asia, with aging rolling stock that lacked efficiency compared to competing alternatives in the air and on the roads. The post-World War II era saw the economy make a structural shift away from rail and towards expansion of the US automobile industry.

From an investment perspective, returns from rail operations became uneconomical and by the 1970s, the rail industry's return on capital averaged just 2%. The majority of railroads in existence were in ruin, with bankrupt railroads accounting for more than 20% of North America's rail mileage[1]. This led to a number of players exiting the market.

The decline of the rail industry prompted US Congress to reform federal railroad regulation and in 1980, the Staggers Rail Act was established to alter rules around competition, service routes and pricing. The Act was instrumental in reviving the sector and promoting new investment into rail development to help create one of the most cost-effective and productive freight systems in the world.

**US rail infrastructure spending vs. miles of track (1980 – 2008)**

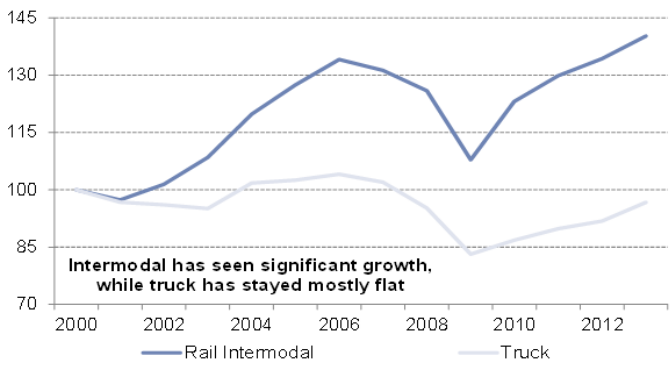



Source: Wolfe Research

Regulation of the industry also resulted in a number of bankruptcies and mergers, taking the number of Class I railroads in the US from about 40 down to five, effectively creating regional duopolies. By 2004, a number of the operating challenges (e.g. labour agreements) abated for the merged entities and they were able to improve operating margins. Since 2004, there has been no real evidence of pricing wars amongst the competing rail roads.

Over the past decade, the North American rail industry has been experiencing somewhat of a renaissance. New investments have been made across the sector to expand capacity, improve transportation efficiency and forge new regional connections. Some railroad operators have established intermodal links – combining rail transportation with road or shipping services to provide freight customers with single end to end solutions. Rail intermodal transport volumes have significantly expanded since the turn of the century.

**Intermodal Freight Loadings**




Source: Goldman Sachs Global Investment Research, FTR Transport Intelligence. Data is seasonally adjusted (indexed to 2000).

### The attractiveness of rail

The synergies between regulatory support, capital investment and operational improvements have contributed to US rail now offering attractive returns on investment. North American rail operators are large corporations that benefit from scale and diversity. One of the largest operators, Union Pacific, operates the world's largest freight rail yard. The company's Bailey Yard in North Platte, Nebraska, covers 2,850 acres and a total length

of eight miles, making it three times the size of New York's Central Park. The site is operational 24 hours a day, seven days a week and handles 14,000 rail cars each day that travel across the company's 32,000 route miles.

From agriculture to automotive parts to chemicals and coal, railroads serve practically every industry sector and forms essential infrastructure for communities. The North American rail sector is suitably diverse with an expansive network which is vital for the conveyance of bulk goods. Indeed, about 40% of intercity freight volumes in the US are moved by rail, one of the highest for any developed country[2]. While the sector is highly capital intensive, there are a number of fundamentally attractive factors for infrastructure investors.

**i) Earnings have limited sensitivity to competition**

- North American railroads operate within duopoly markets and hence, face limited competitive pressures. Within each of these markets, the main operators have shown discipline in sustaining and growing margins.
- Capital intensity, network effects and right-of-ways create immense barriers to new entrants.
- Rails are typically the only economical solution for shippers, particularly for long haul movements of low value heavy goods such as coal and grains. Trucks are competitive on about 30-35% (on average) of railroad volumes, but their competitive advantage declines as cost inflation for trucks outpaces rails. Issues that drive inflation for trucking companies include rising labour costs, driver shortages, possible limitations on hours of service and growing costs associated with truck safety compliance regulations. Trucking companies have also been less successful in passing through rises in fuel costs.

**ii) Earnings have become increasingly less sensitive to commodity price movements**

- With fuel costs representing a material component of rail operating costs, operators have been successful in progressively introducing surcharges to facilitate pass-through of changes in fuel costs.

  Historically, coal has been a significant component of freight revenues but today, declining demand for fossil fuels and retiring of coal plants has led to coal representing a declining share of total US freight. In our view, this will gradually decrease to a base-line level given that the US maintains a significant reliance on coal-fired energy.

**iii) Rail operators benefit from an effective regulatory regime**

- Railroad regulation is somewhat light-handed and constructive. Economic regulation of railroad operators is primarily conducted through the United States Surface Transportation Board and in Canada, the Canadian Transport Agency. For US operators, the Staggers Rail Act effectively diluted the regulatory structure, thereby improving economic returns such that only 20-30% of rail volumes are typically subject to freight tariff regulation.

**Demand considerations**

Economic influences such as variations in global demand for freight-linked commodities, a strong US dollar and energy alternatives have limited growth of freight business in North America in recent years. However, real pricing growth has been evident among some operators, which continues to reflect rail's competitive advantage (cost, capacity constraints and captive customer factors) over alternative modes of transportation. We see minimal signs of price competition amongst the rail group despite the recent soft volume environment.

Rail operators are also well placed to manage capacity as demand changes. An improved focus on operating efficiencies has partly mitigated the effects of the recent volume downturn. But when volumes stabilise and subsequently increase, rail operators have the flexibility to meet the upturn in demand, primarily through adding cars and lengthening train routes. Further gains from technological innovation and future automation provide avenues for additional operational leverage.

**An attractive sector in a dependable market**

In the prevailing environment, the US economy is continuing to exhibit signs of sustainable recovery and growth in exports, which bodes well for the freight sector. Even in a low growth environment, rail operators have shown the ability to grow earnings. Following a period of increased investment to support intermodal volume growth, improve network performance and meet regulatory requirements, capital investment for rail operators can be expected to ease going forward. Considered together with improved service offerings, this should contribute to strong and stable free cash flow growth, making the sector attractive to infrastructure investors. At current valuations we have seen an attractive entry point to the North American rail sector and will be closely monitoring opportunities in this market.

[1] Source: Magellan Asset Management Limited

[2] US Department of Transportation - Federal Railroad Administration

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The UBS Developed Infrastructure & Utilities Index Net Total Return ($A Hedged) 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.
The S&P Global Infrastructure Net Total Return Index (AUD Hedged) is a market capitalisation weighted index that is designed to track 75 companies from around the world diversified across three infrastructure sectors energy, transportation and utilities. 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.

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The Global Select Infrastructure composite is a concentrated global strategy investing in strictly defined or "pure" infrastructure companies, (typically 20-40). The filtered investment universe is comprised of stocks that 1. generate reliable income streams 2. benefit from inflation protection and 3. have an appropriate capital structure. The investment objective of the strategy is to minimise the risk of permanent capital loss; and achieve superior risk adjusted investment returns over the medium to long-term. The portfolios are hedged to Australian dollars with Forward contracts. The composite was created in December 2011.

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.