Strategy Update: 31 March 2017

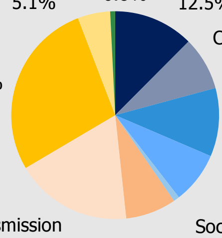
MFG Core Infrastructure (USD)

Portfolio Manager	Strategy Inception Date	Total Strategy Assets	Total Infrastructure Assets[1]
Gerald Stack	18 January 2012	USD $3,079.7 million	USD $5,534.2 million

Objective	Approach
Capital preservation in adverse markets	Diversified rules-based portfolio applying our proprietary infrastructure classification
Pre-fee return of CPI plus 5%p.a. through the economic cycle	Highly defensive, inflation-linked exposure
	Benchmark unaware

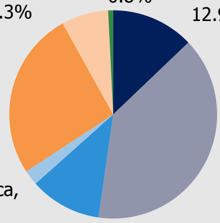
Top 10 Holdings[2]	Sector	%
National Grid PLC	Transmission and Distribution	3.0
Aena SA	Airports	3.0
Atlantia SpA	Toll Roads	3.0
Enbridge Inc	Energy Infrastructure	2.9
Transurban Group	Toll Roads	2.9
TransCanada Corp	Energy Infrastructure	2.9
Power Assets Holdings	Integrated Power	2.9
Abertis Infraestructuras	Toll Roads	2.6
Snam Rete Gas SpA	Gas Utilities	2.5
Fortis Inc	Transmission and Distribution	2.2
	TOTAL:	27.9

Sector Exposure[2]



USD 5 Year Risk Measures[4]	Against Benchmark[5]	Against Global Equities
Upside Capture	1.0	0.8
Downside Capture	0.7	0.4
Beta	0.9	0.6
Correlation	0.9	0.6

Geographical Exposure[2]



Cumulative Performance[3]	3 Months	1 Year	3 Years (p.a.)	5 Years (p.a.)	Since Inception (p.a.)
Composite (Gross)	**8.4**	**4.7**	**8.1**	**11.5**	**12.1**
Composite (Net)	**8.2**	**4.0**	**7.3**	**10.7**	**11.3**
Global Infrastructure Benchmark	7.8	10.7	3.9	7.3	7.7
Excess (Gross)	0.6	-6.0	4.2	4.2	4.4
MSCI World NTR Index	6.4	14.8	5.5	9.4	10.8

Annual Performance[3]	CYTD	2016	2015	2014	2013	2012*
Composite (Gross)	**8.4**	**7.2**	**-0.1**	**17.4**	**14.0**	**16.4**
Composite (Net)	**8.2**	**6.5**	**-0.8**	**16.6**	**13.2**	**15.6**
Global Infrastructure Benchmark	7.8	11.4	-12.2	14.1	14.4	7.0
Excess (Gross)	0.6	-4.2	12.1	3.3	-0.4	9.4
MSCI World NTR Index	6.4	7.5	-0.9	4.9	26.7	13.0

1 Comprised of all Infrastructure Strategies.
2 The data is based on a representative portfolio for the strategy. Refer to the end of the document for further information. Sectors are internally defined. Geographical exposure is by domicile of listing.
3 Returns are for the Core Infrastructure Composite and denoted in USD. Performance would vary if returns were denominated in a currency other than USD. Refer to the GIPS Disclosure section below for further information. 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 Risk measures are for the Core Infrastructure Composite before fees. The Global Equity Index is the MSCI World NTR Index.
5 The Benchmark or Global Infrastructure benchmark is comprised of the following: from inception to 31 December 2014 the benchmark is UBS Developed Infrastructure & Utilities NTR Index and from 1 January 2015 onwards, the benchmark is the S&P Global Infrastructure NTR Index. Note: the UBS Developed Infrastructure and Utilities NTR Index ceased to be published from 31 March 2015, replaced on 1 January 2015 with the S&P Global Infrastructure NTR Index.
* Returns are only for part year.

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The Global Infrastructure Benchmark is comprised of the following: from inception to 31 December 2014 the benchmark is UBS Developed Infrastructure & Utilities Index Net Total Return and from 1 January 2015 the benchmark is S&P Global Infrastructure Net Total Return Index. The benchmark changed because UBS discontinued their index series.
The UBS Developed Infrastructure & Utilities Index Net Total Return 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 S&P Global Infrastructure Net Total Return Index 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.

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Magellan Asset Management Limited, doing business as MFG Asset Management in jurisdictions outside Australia and New Zealand, (MFG Asset Management) 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 MFG Asset Management.

The Global Core Infrastructure composite is a global strategy investing in strictly defined or "pure" infrastructure companies (typically 80-120). The filtered investment universe is comprised of stocks that 1. generate reliable income streams, 2. benefit from inflation protection and 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 composite was created in February 2012.

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.

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Market Commentary

Global infrastructure stocks outperformed global stocks during the March quarter when they rose for the fourth quarter in the past five. Global infrastructure funds outperformed after investors decided their decline over the December quarter in reaction to higher interest rates was overdone.

Global stocks, as measured by the MSCI World Index in USD, rose for a fourth consecutive quarter during the first three months of 2017 as US companies posted higher-than-expected earnings, President Donald Trump's pro-growth policies fanned optimism about the US economy and mainstream parties held off populists in the elections in the Netherlands. The S&P 500 Index and the Stoxx Europe Index each rose 5.5% over the quarter.

Global infrastructure stocks did even better to more than overturn their decline in the December quarter. Infrastructure stocks fell in the three months to December 31 after Trump's shock election victory sparked a jump in US bond yields on talk that his pro-growth agenda would boost the US economy. Infrastructure stocks are vulnerable in the short term to surges in interest rates because higher rates reduce their allure as so-called bond proxies. These are the stocks that are sought when interest rates are so low investors seek other securities with similar haven qualities to bonds.

A levelling in interest rates over the March quarter and views that infrastructure bonds are more immune to changes in interest rates over the longer term helped infrastructure stocks.

Strategy Commentary

The portfolio recorded a positive return for the quarter while outperforming its benchmark.

Over the quarter, investments in integrated power, airports and toll roads contributed to returns while holdings in energy infrastructure and gas contributed little. On a geographical split, investments in the US and Europe contributed to returns while holdings in Asian stocks contributed little.

Over the quarter, OHL México, Fraport of Germany, American Tower and Transurban were among the best performing investments in the portfolio.

OHL México rallied 29.4% on a report that its parent intends to delist the company that invests in transport infrastructure. Fraport rose 18.1% after the airport operator said it expects passenger numbers at Frankfurt airport to rise 2% to 4% this year, and at least two analysts upgraded recommendations on the stock. American Tower gained 15.0% after it boosted 2017 earnings guidance on an expected US$100 million gain in revenue and increased its quarterly distribution to 62 US cents a unit. Transurban jumped 13.1% after the toll-road operator lifted fiscal 2017 guidance on strong traffic, reported 11% revenue growth for the first-half of fiscal 2017 and signed a A$460 million deal to extend a freeway in Virginia.

Over the quarter, investments in SCANA, Koninklijke Vopak of the Netherlands and Enbridge of Canada were among the negative performers in the portfolio.

SCANA fell 10.1% after Moody's Investors Service lowered the company's outlook to "negative" due to concerns that trouble surrounding the company SCANA contracted to install two nuclear reactors in the US will boost the cost of the projects. Vopak tumbled 8.9% after the tank terminal operator said 2017 earnings won't exceed 2016's profit ex-items of 822 million euros. Enbridge lost 0.5% after the oil pipeline network operator reported lower-than-expected adjusted earnings of 56 Canadian cents a share in the fourth quarter.

During the quarter, four securities were added to the portfolio. These included three North American regulated utilities and a communication tower operator. Two of the utilities were included because they now meet our rule that an investment must derive at least 75% of its earnings from what we define as infrastructure, while the third was added following an assessment post its IPO in 2015. The tower operator was included because it was finally converted to a REIT structure. One US regulated utility was removed from the portfolio after it was taken over.

Unless indicated, indices and stock price movements reflect changes in local currency.

Topic in Focus – Why infrastructure stocks can withstand higher interest rates

The shock election of Donald Trump as US president sparked excitement that his pro-growth policies would reinvigorate the US economy. Talk these policies would be accompanied by faster inflation boosted US long-term interest rates by about 50 basis points over November. While Trump inspired a 14% rally in US equity markets that month, global infrastructure stocks fell 4% (as global equities overall rose 1.4%) because they were lumped among bond-proxy stocks that are considered to be vulnerable to higher rates.[1]

The term bond proxy is often used to describe any security with bond-like features that benefited in recent years when low or even below-zero bond yields tied to ultra-loose monetary policies forced investors to look elsewhere for higher-yielding but still-dependable returns. Many turned to the safest of stocks including infrastructure stocks. After all, a primary characteristic of the infrastructure asset class is that the regulatory frameworks governing essential services generally ensure fair and predictable returns for owners.

The outlook is for tighter monetary conditions and higher bond rates. The Federal Reserve has raised the cash rate three times in the past 16 months because the US economy is progressing towards full employment. Recent evidence suggests that the global economy is picking up and seems to be winning its battle against deflation. This prospect of higher bond rates is prompting concerns that infrastructure stocks are set to underperform.

If interest rates were to jump then history suggests that infrastructure stocks would be likely to lag. But experience has been that this is a short-term phenomenon. Over the longer term, the relationship between infrastructure assets and interest rates is muted – whether rates are rising or falling. Interest rates have less sway on infrastructure stocks than many might think because these businesses are generally insulated from the business cycle. If interest rates were to rise, infrastructure stocks would be likely to recover quickly in relative terms, the more so because higher interest rates are already factored into infrastructure valuations.

Infrastructure stocks are certainly more sensitive to interest rates these days than the energy, materials and consumerdiscretionary stocks that aren't classed as 'yield plays'. Circumstances could be such that infrastructure stocks could underperform. An unexpectedly large surge in interest rates would be one such circumstance. If rates rise modestly as expected, investors can be confident the embedded valuations and the protected nature of their earnings mean that infrastructure stocks are well placed to ride out the increase.

Split analysis

Higher interest rates have two distinct impacts on a portfolio of global infrastructure stocks such as those in our strategy, which can largely be divided into regulated utilities and transport stocks. First, higher interest rates can affect the financial performance of businesses. But the nature of how infrastructure is regulated makes this less of an issue with such stocks.

Regulators of utilities around the world typically set prices for water, electricity or energy services to allow the utility company to earn a 'fair' return on the equity invested – a return on equity in the range of 9% to 10% is typical. If an increase in interest rates or in some other variable cost threatens profitability then utilities are able to increase their prices so that they can maintain their return on equity. The essential nature of their services means that higher prices don't reduce demand and dent revenue. All up, higher interest rates pose limited or no burden for regulated utilities.

With infrastructure companies such as airports and toll roads regulators focus on the prices companies charge rather than their returns. Most of these companies have contracts that adjust charges for inflation. When the CPI rises, for example, up go tolls on privately owned roads. Transport companies are thus protected from higher interest rates when, as would be the case now, the increase in interest rates would reflect a pickup in inflation.

As an aside, many infrastructure companies are now well protected from higher rates because they have taken advantage of low interest rates over the past five years to lock in cheap debt for long periods. Atlantia, for instance, which controls much of the Italian motorway system, in January sold 750 million euros worth of bonds with an eight-year maturity at a rate of just 1.63% p.a.

The other side to an increase in interest rates is what it means for valuations. We view the value of any investment as reflecting two factors: the expected cash flows the asset will generate and the risks associated with those cash flows. Under this approach, investors account for risks by discounting the expected cash flows at a rate that reflects the risks. An increase in interest rates will increase the discount rate and reduce the value of expected cash flows, reducing the value of the investment. Hence, the assumptions investors make about interest rates has a direct impact upon valuation.

As a consequence of the ultra-loose monetary policies of recent years, 10-year US government bonds are trading well below average historical levels – the yield ranged from 2.31% to 2.63% over the first three months of 2017. Our analysis suggests that infrastructure stocks today are priced on expectations that the US 10-year government bond yield will rise to about 4%. As such, while we would expect to see some short-term underperformance if US long-term yields were to rise, we wouldn't expect longer-term valuations to be threatened by a 10-year US government bond yield that remained below 4%.

If US 10-year Treasury yields were to increase significantly beyond 4%, infrastructure stocks would most likely come under pressure. The yield on US 10-year Treasuries on March 31, however, was 2.39%. That means that valuations today are factoring in a 1.61-percentage-point increase in the rate in coming years. Infrastructure stocks thus appear well insulated against any modest rise in interest rates sparked by Trump or some other factor.

[1] Benchmarks used are the S&P 500 Index in US dollars for US stocks, the MSCI World Index TR in US dollars for global stocks, the S&P Global Infrastructure Index TR in US dollars for global infrastructure stocks and Bloomberg 10-year government generic bond for 10-year US Treasury yields, which rose 52 basis points over November.