MAGELLAN
EXPERTS IN GLOBAL INVESTING

Annual Investor Report 2017

Magellan Infrastructure Fund
Magellan Infrastructure Fund (Unhedged)
Magellan Infrastructure Fund (Currency Hedged)(Managed Fund) (ASX:MICH)

Dear investor,

I am pleased to write to you, an investor in the Magellan Infrastructure Fund.

For the 12 months to 30 June 2017, the Fund delivered an 8.62% net return to investors (including reinvested dividends). This was 3.81% less than the benchmark return of 12.43%. In July 2017, the Fund paid a distribution of 10.23 cents per unit, which boosted the distributions paid to investors in the Fund for 2016-17 to 11.28 cents per unit.

For the 12 months to June 30, the Magellan Infrastructure Fund (Unhedged) recorded a net return of 5.20%, whereas its unhedged benchmark returned 8.46%. The Magellan Infrastructure Fund (Currency Hedged) (Managed Fund) (ASX:MICH) posted a net return of 8.70% since its inception on 19 July 2016, while its hedged benchmark returned 10.44% over that time.

Portfolio strategy

Our investment philosophy has not changed since we launched the strategy in mid-2007. We seek to build a portfolio of outstanding infrastructure and utility companies. We aim to invest in these companies at prices that deliver attractive risk-adjusted returns over a three- to five-year period.

Infrastructure assets generally produce reliable earnings when providing essential services to the community. Over time, the predictable earnings or cash-flow streams derived from infrastructure assets are expected to deliver income and capital growth for investors.

Where our strategy is different is that we apply a stricter definition to what qualifies as infrastructure. We believe that a key reason why investors invest in infrastructure is that they seek the reliable returns that are associated with the asset class. To ensure we achieve this key objective we limit our investment universe to stocks that provide investors with predictable, through-the-cycle, inflation-linked returns. This means that we exclude infrastructure stocks whose earnings are exposed to competition, sovereign risk and changes in commodity prices.

The universe of infrastructure assets that we consider for the strategy mainly comprises two sectors:

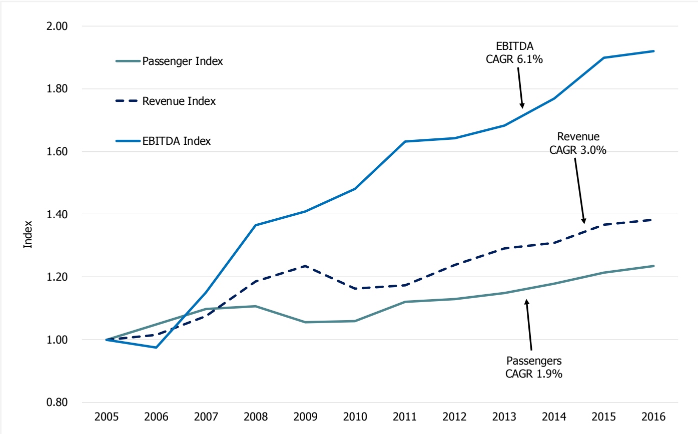
- Regulated utilities, which includes energy and water utilities. We estimate that utilities comprise about 60% of the potential investment universe for the strategy. Utilities are typically regulated by a government-sponsored entity. Such regulation requires the utility to efficiently provide an essential service while allowing the utility to earn a fair rate of return on the capital it has invested.

- Infrastructure, which includes airports, ports, railroads, toll roads, communications assets and energy infrastructure (oil and gas pipelines). Regulation of infrastructure companies is generally less intensive than for utilities and allows companies to benefit from a greater number of people using their services. As economies develop and become more interdependent, we expect aviation, shipping and vehicle traffic to increase, as will demand for communications and energy.

Utilities and infrastructure companies provide essential services, while facing limited, if any, competition. Because the services are indispensable, the prices charged can be adjusted with limited impact on demand. As a consequence, earnings are more reliable than those for a typical industrial company and generally enjoy inherent protection against inflation. Consider it the triumph of cash flow, as the following examples show.

Aeroports de Paris (ADP) owns the major airports in Paris. Over the past decade, aviation has been subject to demand shocks that include the global financial crisis and terrorist strikes, and ADP has not been immune. The chart, however, shows that the company's underlying financial performance has progressed in a reliable manner. The combination of long-term passenger growth at ADP's airports, price increases for ADP's services and cost-saving measures has led to measured but consistent growth in cash flows and earnings (as measured by earnings before interest depreciation and amortisation or EBITDA).

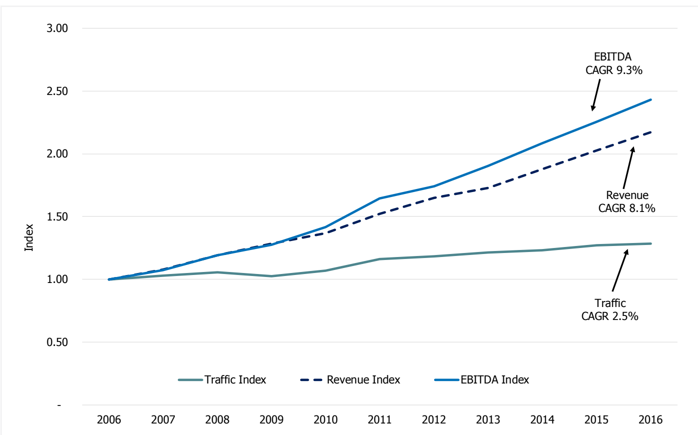
Chart 1: ADP – Passenger, revenue, EBITDA (2005-15).



Source: Aeroports de Paris, Magellan analysis.

CityLink in Melbourne is the original asset for which Transurban was founded in 1995 to develop and operate. Traffic on the road has grown at a modest but consistent rate over time. When combined with toll increases and stable operating costs, this cash flow or revenue growth has led to reliable and consistent EBITDA growth over time. Just as for ADP, the vital nature of the service delivers for investors over time.

Chart 2: CityLink – Traffic, revenue, EBITDA (2006-16).



Source: Transurban, Magellan analysis.

With infrastructure assets, the stability of earnings is influenced by competitive positioning and numerous risks. Key risks we consider are:

- Sovereign risk – We avoid countries where political decisions that undermine the contractual position or potential earnings of a company can be made easily. We only invest in countries where the judicial system and law are sound, so that contractual positions can be enforced as required.
- Regulatory risk – We avoid regulatory jurisdictions where regulatory processes are opaque or applied inconsistently.
- Commodity-price risk – We seek to avoid businesses whose earnings are meaningfully exposed to the price of the product they transport. Many pipeline businesses in the US, for example, are excluded from our universe for this reason.
- Leverage risk – We avoid businesses with excessive debt or that might struggle to pay their interest bills.

Portfolio review for 2016-17

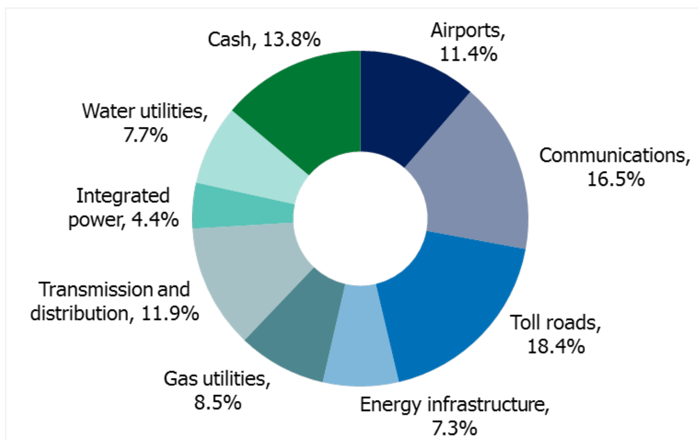
Changes in interest rates during the past 12 months affected the performance of the strategy over the period. In the first half of fiscal 2017, an increase in prevailing 10-year US government bond yields subdued the strategy's returns. Performance improved in the second half of the fiscal year when investors refocused on the reliability of the earnings and cash flows that infrastructure companies and regulated utilities generate.

At 30 June 2017, the portfolio consisted of 31 investments compared with 29 investments a year earlier. The top-10 investments represented 45% of the portfolio at 30 June 2017, compared with 49% a year earlier.

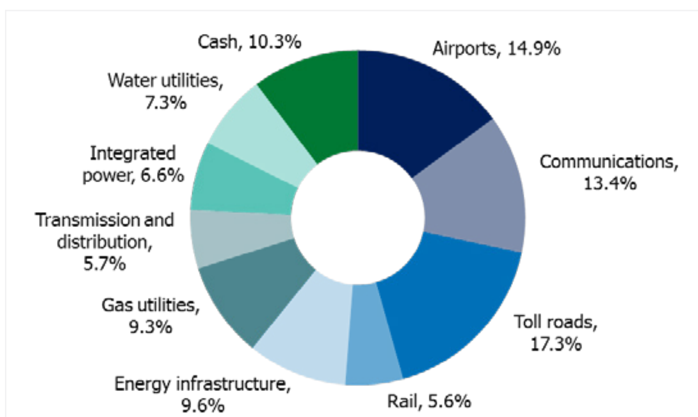
The strategy held approximately 10% in cash on 30 June 2017, compared with 13.8% a year earlier. The decision to hold a large part of the portfolio in cash reflects a view that accommodative monetary policy of recent years has affected global asset prices and that any unwinding of this policy could lead to a rapid repricing of assets. We expect to invest the bulk of our cash holding over the medium term.

The composition of the portfolio by sector at 30 June 2016 and 2017 was:

Portfolio by sector at 30 June 2016



Portfolio by sector at 30 June 2017



The key changes to the portfolio over the year are a reduced allocation to utilities and a corresponding increase in the allocation to infrastructure. The major increases to infrastructure included adding rail investments and increasing the holding to airports.

The easy global monetary conditions of recent years have boosted regulated utility stocks. It is our assessment that regulated utilities in the better-performing economies of the world, effectively the most-defensive infrastructure investment opportunities, have become expensive compared with opportunities available in the infrastructure sector. We have, accordingly, reduced the portfolio's allocation to regulated utilities in the US and the UK and increased the portfolio's exposure to infrastructure stocks.

Railroads are considered infrastructure because they provide a basic and essential role by connecting the producers and consumers. From agriculture to automotive parts to chemicals and coal, railroads serve practically every industry and form essential infrastructure for communities.

Key factors that make US rail companies attractive include:

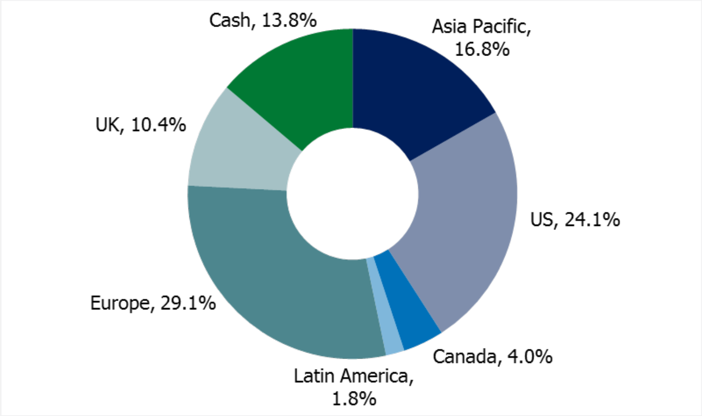
- Earnings have limited sensitivity to competition – North American railroad companies operate within duopoly markets, which means competitive pressures are limited. Within each market, the main operators have shown the discipline needed to expand margins. Capital intensity, network effects and right-of-ways create barriers to new entrants. Rail is typically the only economical option for shippers, particularly when hauling low-value heavy goods such as minerals and grains.

- Earnings have become less sensitive to commodity prices – As fuel costs represent a large portion of rail operating costs, operators have introduced surcharges to pass-through changes in fuel costs.

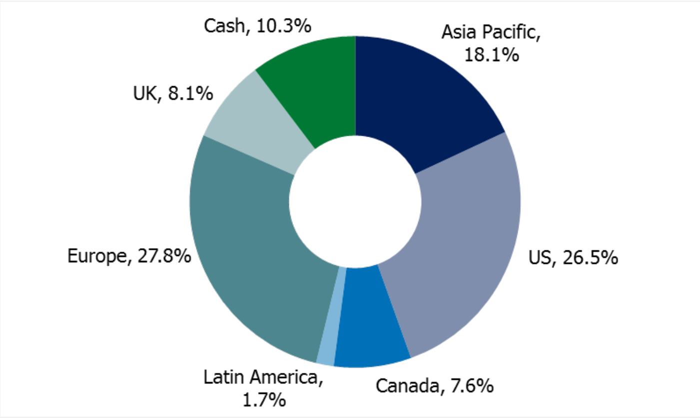
- Rail operators benefit from an effective regulatory regime – Regulation is light and constructive.

The composition of the portfolio by geography at 30 June 2016 and 30 June 2017 was:

Portfolio by region at 30 June 2016



Portfolio by region at 30 June 2017



While we have increased the share of the portfolio invested in North America, we remain underweight relative to our potential investment universe. The bulk of the available listed infrastructure investment opportunities in North America are regulated utilities and, as outlined earlier, it is our assessment that utilities are less attractive than opportunities in the infrastructure sector.

The strategy's top-performing stocks for the year to June 2017 were generally infrastructure companies rather than utilities and included:

- US rail companies CSX and Norfolk Southern, which operate in an effective duopoly and benefited from expectation that operational efficiencies would improve.

- Satellite companies SES and Eutelsat, which experienced something of a recovery after their respective share prices fell dramatically in the prior year. While neither company's share price has fully recovered, their financial results have stabilised.

- Airport companies ADP and Flughafen Zuerich, which enjoyed passenger growth. While the terrorist attacks that occurred in Paris in 2015 and 2016 reduced French tourist traffic in 2016 and lowered passenger numbers at ADP's airports in Paris – Charles de Gaulle Airport and Orly Airport – these numbers have rebounded.

- Italian toll-road operator SIAS, which benefited from more traffic and improved investor sentiment.

The strategy's worst-performing stocks included UK utilities National Grid and United Utilities and energy infrastructure companies Enbridge of the US and Koninklijke Vopak of the Netherlands.

- The UK utilities performed strongly but they were viewed by investors as havens in the final weeks of fiscal 2016 amid the uncertainty created by the UK vote to leave the EU. While operating performance has been solid for both companies in the past year, the gains in share price in the prior 12 months led to subdued performance over the past fiscal year. We still assess the companies to be attractive investments.

- Enbridge and Vopak provide infrastructure to the energy industry. Enbridge essentially transports oil and gas across North America while Vopak stores oil and chemicals around the world.

Outlook

We expect global monetary conditions to become less accommodative in coming years, which means long-term interest rates are likely to rise. There are two key areas we focus on when we assess what higher interest rates could mean for infrastructure stocks:

- The impact on the businesses – We are confident that the businesses that meet our investment-grade infrastructure criteria are well placed to meet our expectations over the medium term even if interest rates rise.
- Impact on valuations and on debt and equity markets – An increase in interest rates can be expected to lead to higher debt costs and higher long-term discount rates. Our forecasts and valuations for the businesses in which we have invested take these factors into account. The history of financial markets, however, indicates that higher interest rates will increase uncertainty. Stocks that are regarded as 'defensive', including infrastructure and utilities, are often shunned when interest rates increase because investors switch to higher-growth sectors. It is our experience, however, that provided these businesses have solid fundamentals, their stock prices will revert to a longer-term trend that reflects their earnings profiles.

Notwithstanding volatility on equity markets, we expect the underlying earnings of infrastructure and utility companies in our restricted universe to remain reliable and predictable. Ultimately, the value of the companies in our portfolio reflect the future cash flows they are expected to generate and the risks associated with those revenue flows. We believe that investment markets are pricing in higher, more 'normal' levels of interest rates. This means that if interest rates increase over the medium term, we can expect the impact on asset prices to be somewhat muted because investors have already allowed for some increase in rates.

Even allowing for the resilient nature of the stocks held in the portfolio, we expect to see volatility in equity markets, particularly if US interest rates rise as we expect. We are confident, however, that any increase in interest rates will fail to hamper the financial performance of the stocks in the portfolio.

Overall in terms of our outlook, we believe that infrastructure assets, with their reliable earnings that are protected to a degree from inflation, are an attractive, long-term investment proposition. The predictable nature of their earnings compared with those offered by other asset classes means that infrastructure assets offer diversification benefits. In uncertain times, the reliable financial performance of infrastructure stocks makes them particularly attractive. An investment in listed infrastructure can be expected to reward patient investors.

Yours sincerely,

Gerald Stack

Portfolio Manager

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