MFG ASSET MANAGEMENT

Annual Investor Report 2018

MFG Asset Management Core Infrastructure Strategy

Dear Investor

I am pleased to write to you, an investor in our Core Infrastructure strategy. For the 12 months to 30 June 2018, the strategy delivered a gross return of 1.6% in US dollars (+0.9% net of fees)[1] to investors. This was 0.7% above the benchmark return of 0.9%.

Portfolio strategy

Our investment philosophy has not changed since we launched the strategy in 2009. We seek to build a diversified portfolio of outstanding infrastructure and utility companies that deliver reliable returns through the economic cycle.

The types of assets in which the strategy invests are generally natural monopolies that provide an essential service to the community. Infrastructure assets offer investors protection against inflation because their earnings generally have some direct linkage to inflation. Over time, the stable revenue 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 want to 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 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.

A key feature of the portfolio-construction process for our Core Infrastructure strategy is the application of what we call "the 75% rule". This relates to those companies whose assets are a mixture of assets that we classify as infrastructure and those assets that do not meet our strict requirements. In those circumstances, we require at least, and on a consistent basis, 75% of the company's earnings to be derived from the assets that meet our definitional requirement before it can be included in the Core portfolio.

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.

With infrastructure assets, the stability of earnings is influenced by the strength of competitive positioning of the asset and the exposure of the asset to key 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 invest only 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.

[1] 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.

Portfolio review 2017-2018

At 30 June 2018, the strategy consisted of 85 investments compared with 87 investments a year earlier. Over the past 12 months, four stocks were added to the strategy and six were removed.

The four stocks added were as follows.

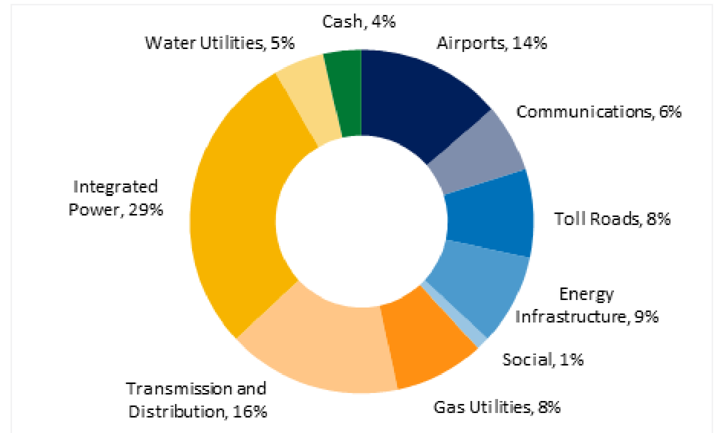
- REN of Portugal was added after the credit rating of Portugal was upgraded by several credit rating houses to investment grade. We have long considered REN's assets as attractive but had waited for confirmation of the improving macro environment.
- North American utility company Evergy was added following the merger of Westar Energy and Great Plains Energy. (Both companies were previously included in the strategy.)
- Canadian Utilities was added after confirmation that the assets and ownership structure had the requisite risk profile for inclusion.
- John Laing Infrastructure Fund was added following a review of the earnings composition of the business.

The six stocks removed were as follows.

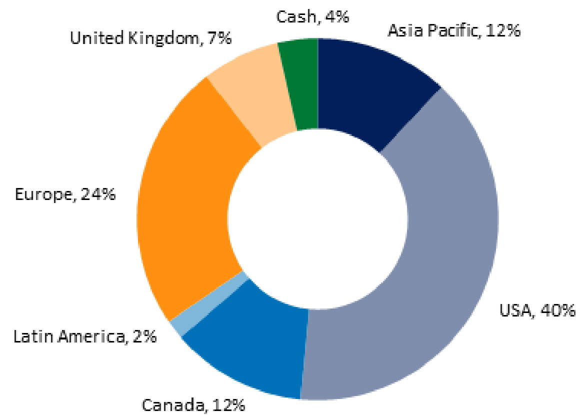
- Abertis Infraestructuras was removed following a share tender offer from German contractor Hochtief.
- Great Plains Energy and Westar Energy were removed after the companies were combined into the newly formed Evergy discussed above.
- OHL Mexico was removed after a share tender offer saw its free-float drop below acceptable levels.
- Two European satellite operators, Eutelsat and SES, were removed due to concerns about their ability to deliver the reliable returns we expect from our investments. Our infrastructure definition requires that a limited share of a company's earnings be subject to competition. The earnings of satellite companies have historically been dominated by their satellite TV businesses where the satellite company broadcasts the TV signal for TV operators. When we initially invested in the satellite companies, we were attracted to the stable and predictable cash flows generated by the satellite TV business as demand for paid TV has historically been highly resilient to the economic cycle and is subject to limited competition between operators. However, the competitive dynamics in the non-TV part of the operators' businesses has been higher than anticipated. It is our assessment that, because of the advancement of communications technology, a material component of the earnings of the satellite companies is subject to competition and, therefore, the companies no longer met our definition of infrastructure.

By the end of the period, the strategy held the following regional and geographic exposures.

Sector exposure – 30 June 2018



Geographic exposure – 30 June 2018



Investment performance

Headwinds encountered over the past 12 months meant that returns for the period were below what we would consider a reasonable return from the strategy. None of these factors alters our longer-term expectations for the strategy's ability to deliver a 5% real return to investors.

Over the period, a general market rotation away from low-risk utilities hampered investment performance. The primary cause of this was that the gradual tightening of monetary conditions led to an increase in bond yields and the market values of regulated utilities are often perceived to be sensitive to movements in interest rates. Because of this, eight of the bottom 10 performers in the strategy were utilities (and the bottom five were from this category). In aggregate, the utility holdings of the strategy were minor detractors from performance.

UK utilities were again in the bottom quartile of stocks in the strategy due to not only the theme discussed above, but also, impending updates to regulated determinations and the threat of nationalisation. The process to determine regulated earnings for the UK water utilities will shortly heat up when OFWAT, the UK water regulator, issues a draft determination in early 2019 for the five years to 2026. It is expected that the allowed earnings for the utilities will decline compared with recent history due to the low level of prevailing interest rates.

In addition to the uncertainties associated with the regulatory cycle, the Labour opposition party in the UK has stated that, if elected, it would nationalise key utilities at a price the Labour party considered appropriate rather than a price considered appropriate by investment convention or precedent. Both issues led to concerns about the reliability of future earnings to be derived from the UK regulated energy and water utilities.

Key contributors

The strategy's top-performing stocks for the year to June 2018 were mixed between infrastructure and utility stocks. However, interestingly, several of the best-performing companies over the period were those that could be described as having some potential or actual corporate interest. The major contributors were:

- Airport company ADP (formerly Aéroports de Paris), which benefitted from a combination of steady passenger growth and news that the French government is readying to sell its 50.6% stake in the airport operator. It is believed that there are a number of companies and unlisted infrastructure funds that would be keen to acquire the interest of the French government in the belief that the operations of this company can be enhanced. Such an outcome could result in either a takeover offer to remaining shareholders or an improvement in underlying financial performance from which existing shareholders would benefit.

- Getlink (formerly known as Eurotunnel), which recorded steady traffic growth and healthy financial performance. However, the stock benefitted from the acquisition by Italian toll road company Atlantia of a 15.5% stake in the company. We note that the rise in Getlink was in spite of the uncertainty surrounding the nature of the UK's impending separation from the EU. Any major disruption to trade between the UK and Europe could affect Getlink's revenue as more than £140 billion of goods pass through the tunnel each year.

- US utility company Avista, which rose after Canada's Hydro One launched a takeover offer for the company.

- Abertis Infraestructuras, which benefitted from a bidding war between German contractor Hochtief and Italian toll-road operator Atlantia that was concluded when the pair teamed up as a part of a restructured transaction.

- Australian pipeline operator APA, which received an unsolicited proposal from the Hong Kong-based CKI consortium.

Outlook

We expect global monetary conditions to become less accommodative in coming years, which means that 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 as 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. 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 rise 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 reflects the future cash flows they are expected to generate and the risks associated with those revenue flows. We believe that investment markets are already 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 as global interest rates rise. We are confident, however, that any increase in interest rates will have a minimal impact on 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

26 July 2018

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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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GLOBAL INVESTMENT PERFORMANCE STANDARDS (GIPS®) DISCLOSURE

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.

Gross composite returns (includes the reinvestment of dividends and capital gain distributions), are net of transaction costs, withholding taxes and direct expenses, but before management fees, custody and other indirect expenses. Net composite returns are prepared by subtracting from the monthly gross returns one-twelfth of the maximum applicable to institutional investors (0.70% p.a.). 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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