

# Annual Investor Report 2018

## MFG Asset Management Select Infrastructure Strategy

Dear Investor

I am pleased to write to you, an investor in the MFG Asset Management Select Infrastructure Strategy.

For the 12 months to 30 June 2018, the Strategy delivered a gross return of 6.8% in US dollars (+5.9% net of fees) to investors. This was 5.9% above the benchmark return of 0.9%.

### 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 and utility assets generally produce reliable earnings when providing essential services to the community. Over time, the predictable earnings or cash-flow streams derived from these 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 (a term often used here to include utilities). We believe that a key reason why investors invest in infrastructure is that they are seeking 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 returns over an economic cycle. 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 generated by infrastructure companies are more reliable than those for a typical industrial company and generally enjoy inherent protection against inflation. We believe that over the long term the share prices of the companies in which we invest will reflect the underlying earnings and cash flows. The reliability of the long-term earnings generated by infrastructure assets gives us confidence that investment returns will be reliable.

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 undermine the contractual position or potential earnings of a company. 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 for this reason.
- Leverage risk – We avoid businesses with excessive debt or ones that might struggle to pay their interest bills.

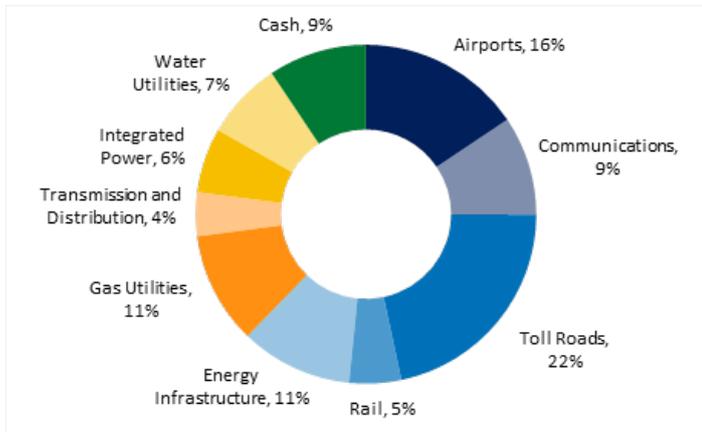
## Portfolio review for 2017-18

At 30 June 2018, the portfolio consisted of 29 investments compared with 31 investments a year earlier. The 10 biggest investments represented 48% of the portfolio at 30 June 2018 compared with 46% a year earlier.

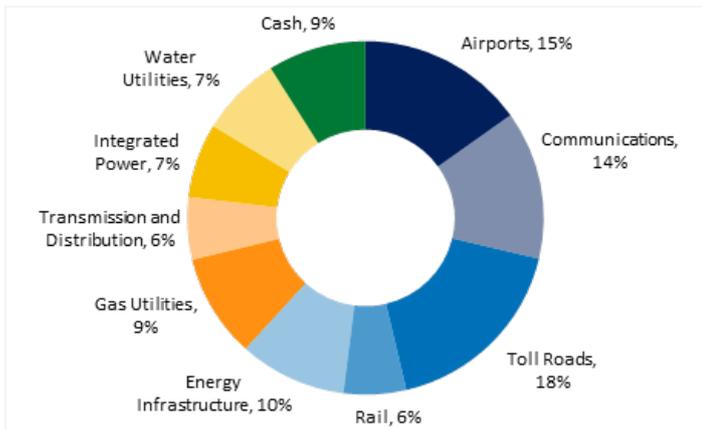
The strategy held approximately 9.4% in cash on 30 June 2018, about the same level as a year earlier. The decision to hold such a large cash holding reflects a view that accommodative monetary policy of recent years has boosted global asset prices and that the unwinding of this policy could lead to a 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 2017 and 2018 was:

### Portfolio by sector as at 30 June 2018



### Portfolio by sector as at 30 June 2017



The key changes to the portfolio over the year are a small increase in the allocation to infrastructure segments (the blue and grey segments in the pie chart above) offset by a small reduction in the level of cash. Within the infrastructure allocation, we have increased the allocation to toll roads and airports and reduced the allocation to communications infrastructure.

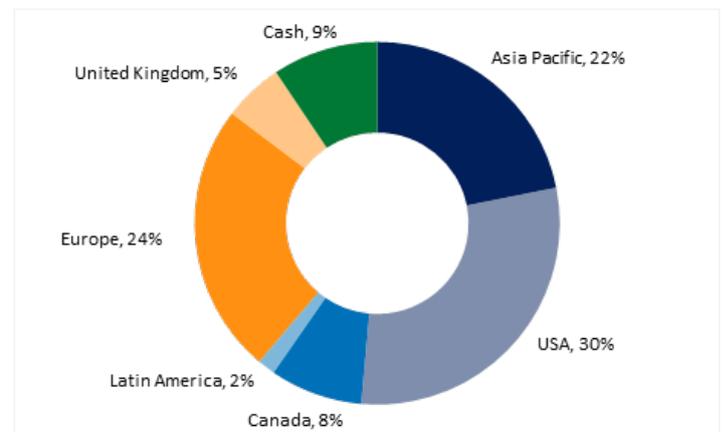
The reduction in the allocation to communications reflects our decision to exclude satellite companies from our universe. Our infrastructure definition requires that a limited share of the earnings derived from the asset should be subject to competition. The earnings of satellite companies have

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 attractive cash flows generated by the satellite TV businesses 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, due to advancements in communications technology, a material component of the earnings of the satellite companies is now subject to competition. As a consequence, we sold two satellite companies during the year – SES and Eutelsat.

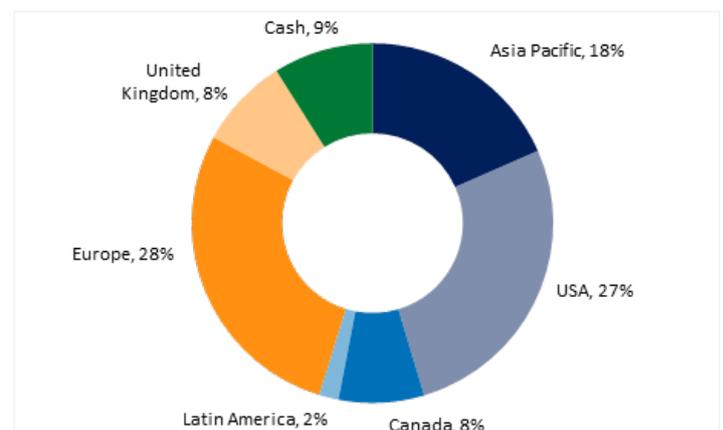
We have maintained the allocation to regulated utilities at about 30% of the portfolio. As we have noted in previous years, the easy global monetary conditions of recent years have boosted the share prices of regulated utility stocks. It has been our assessment that regulated utilities in the better-performing economies of the world, effectively the most-defensive infrastructure investment opportunities, were less attractive investments compared with opportunities available elsewhere in the infrastructure investment universe.

The composition of the portfolio by geography at 30 June 2017 and 30 June 2018 was:

### Portfolio by region as at 30 June 2018



### Portfolio by region as at 30 June 2017



While we have increased the share of the portfolio invested in North America over the course of the year, we remain underweight relative to our universe. The bulk of the available

opportunities in North America are regulated utilities and, as outlined earlier, we judge that utilities are somewhat less attractive than other opportunities.

### Contributors

The strategy's best-performing stocks for the year to June 2018 were generally infrastructure companies rather than utilities. Buoyant economies helped toll roads, airports and communications companies to grow traffic, passenger and data volumes. Notwithstanding higher interest rates, this was sufficient to generate attractive investment returns, particularly for those companies insulated from political issues. The companies that performed best included:

- Airport operator ADP (formerly Aeroports De Paris), which benefitted from steady passenger growth and news that the French government is readying to sell its 50.6% stake in the company. It is believed a number of companies and unlisted infrastructure funds 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 a takeover offer to remaining shareholders or an improvement in underlying financial performance that would benefit existing shareholders.
- North American rail companies Canadian Pacific and Union Pacific, which benefitted from lower US corporate taxes, steady operational performance and expectations that operational efficiencies will continue to improve.
- Italian toll road operator SIAS, which delivered strong performance over the year, reflecting improvements to regulatory agreements and transparency to investors. The company finalised an agreement with the Italian government that will lead to toll increases on a number of its roads and it signed a new agreement for a concession in northern Italy. Further, the company improved the transparency of its structure through the sale of non-core assets and the release of a plan that helped clarify the company's outlook.
- Getlink (formerly known as Eurotunnel), which recorded steady traffic growth and healthy financial performance. The share price benefitted when Italian toll-road company Atlantia bought 15.5% of the company.

We note that the strong share-price performance of Getlink was in spite of the uncertainty surrounding the nature of the UK's impending separation from the EU. The terms of the UK departure are unknown and any major disruption to trade between the UK and Europe could affect Getlink's revenue as more than 140 billion pounds worth of goods pass through the tunnel.

- Atlas Arteria (formally Macquarie Atlas Roads), which enjoyed strong traffic growth from its key asset, French toll road APRR. This was more than enough to compensate for an underperforming Dulles Greenway in the US, which was hampered by improvements on competing routes as well as construction work in the corridor. Another contributing factor was the falling Australian dollar, which boosted cash flows in the reporting currency (Australian dollars). Finally, the

company internalised the management from Macquarie on favourable terms, which will result in reduced fee leakage and increased cash flow over time.

### Detractors

The strategy's worst-performing stocks included Italian utilities Terna, SNAM and Italgas, North American energy infrastructure company Enbridge, the US regulated utility sector generally and UK regulated utilities.

- Italian-domiciled infrastructure companies faced political uncertainty, which hurt the outlook for toll road and utility companies held in the portfolio. The uncertainty hit the share prices of Italian regulated utilities, including electricity-transmission company Terna, gas-transmission company SNAM and gas-distribution company Italgas, which all recorded negative returns for the year. While Italy formed a left-right populist government under Prime Minister Giuseppe Conte in June about three months after inconclusive elections, political uncertainty soared in May when the country veered towards a fresh poll during negotiations among parties to form government that could have been an unofficial vote on the country's use of the euro.

While the Italian businesses in which the portfolio invests are strong businesses, any potential changes to Italy's connectedness to the EU institutional settings, no matter how unlikely, create uncertainty for these investments. The underlying financial performance for each of the Italian regulated utilities was strong and the outlook remains positive. Furthermore, these businesses are natural monopolies that provide essential services with management teams that MFG Asset Management regards as efficient and effective.

- Enbridge, which provides infrastructure in the form of pipelines that transport oil and gas across North America, faced adverse regulatory decisions. Key issues for Enbridge included the potential reduced earnings due to a revised policy statement from the Federal Energy Regulatory Commission regarding tax treatment for master limited partnerships (MLPs). While Enbridge is not an MLP, it owns interests in a number of related company MLPs. (The regulator announced that the tax-friendly MLP structure popular with pipeline firms would no longer be able to recover an income tax allowance in certain pipeline service contracts reducing its taxable income.)
- US-domiciled regulated utilities faced tighter monetary conditions. Higher 10-year US government bond yields acted as something of a headwind for the returns of these companies compared with the strategy's investments in infrastructure companies.
- UK regulated utilities faced challenges from impending updates to regulated determinations and the potential threat of nationalisation. The process to determine regulated earnings for the UK water utilities will shortly heat up. OFWAT, the UK water regulator, in early 2019 will issue a draft determination for the period 2021 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 said 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.

## 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 conservative 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.

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

## IMPORTANT NOTICE

This material is being furnished to you to provide summary information regarding Magellan Asset Management Limited 'doing business as'/'trading as' MFG Asset Management ('MFG Asset Management') and an investment fund or investment strategy managed by MFG Asset Management ('Strategy'). No distribution of this material will be made in any jurisdiction where such distribution is not authorised or is unlawful. This material is not intended to constitute advertising or advice of any kind and you should not construe the contents of this material as legal, tax, investment or other advice.

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

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 material. This information is subject to change at any time and no person has any responsibility to update any of the information provided in this material. MFG Asset Management 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 material including trading losses, loss of opportunity or incidental or punitive damages.

This material 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 MFG Asset Management. Any trademarks, logos, and service marks contained herein may be the registered and unregistered trademarks of their respective owners. Nothing contained herein should be construed as granting by implication, or otherwise, any licence or right to use any trademark displayed without the written permission of the owner.

United Kingdom - This material 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 material 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 material or any part of it, or the fact of its distribution, is for background purposes only. This material 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 material 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 material 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 MFG Asset Management to create legal relations on the basis of information provided herein. Where performance figures are shown net of fees charged to clients, the performance has been reduced by the amount of the highest fee charged to any client employing that particular 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 and also may be found in Part II of MFG Asset Management's Form ADV.

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.

## 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 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 composite was created in May 2013.

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 (0.80% 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](mailto: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.

MFGSIUSDIL43281

## MFG Asset Management

ABN 31 120 593 946, AFS Licence No. 304 301

MLC Centre, Level 36

19 Martin Place, Sydney NSW 2000 Australia

+61 2 9235 4888

[info@magellangroup.com.au](mailto:info@magellangroup.com.au)

[www.mfgam.com.au](http://www.mfgam.com.au)