MFG Select Infrastructure

Key Facts

Portfolio Manager	Gerald Stack
Strategy Inception Date	2 May 2013
Total Infrastructure Assets[1]	USD $5,071.3 million
Total Strategy Assets	USD $2,045.3 million

Objectives	Approach
Capital preservation in adverse markets	Concentrated 20-40 stock portfolio applying MFG Asset Management's proprietary infrastructure classification
Pre-fee return of CPI plus 5-6%p.a. through the economic cycle	Valuation driven benchmark-unaware strategy Highly defensive, inflation-linked exposure

USD Performance[2]

	Composite (Gross)	Composite (Net)[3]	Index[4]	Excess Return
3 Months	-6.1	-6.2	-4.3	-1.8
6 Months	-5.7	-6.0	-1.8	-3.9
1 Year	4.4	3.6	11.4	-7.0
3 Years (% p.a.)	7.4	6.5	3.8	3.6
Since Inception (% p.a.)	7.3	6.4	3.3	4.0

	Composite (Gross)	Composite (Net)[3]	Index[4]	Excess Return
2013 (%)*	4.6	4.0	0.9	3.7
2014	14.1	13.2	14.1	0.0
2015	3.9	3.1	-12.2	16.1
2016	4.4	3.6	11.4	-7.0

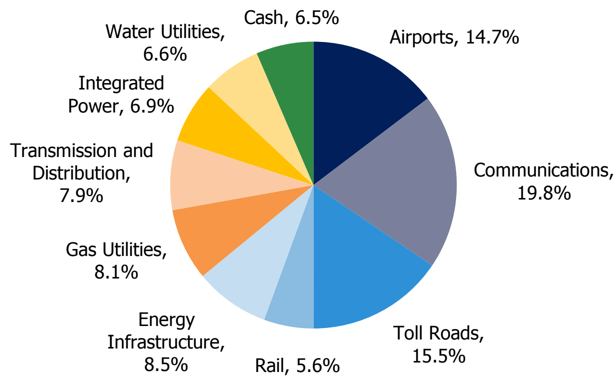
USD 3 Year Risk Measures[5]

	Against Benchmark[4]	Against Global Equities[5]
Upside Capture	0.9	0.6
Downside Capture	0.7	0.3
Beta	0.8	0.5
Correlation	0.9	0.6

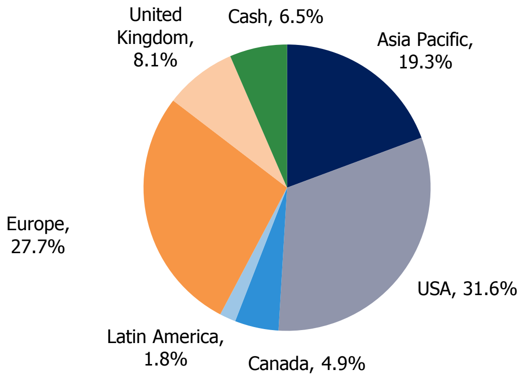
Top 10 Holdings[6]

	Sector	%
Transurban Group	Toll Roads	7.4
Crown Castle International	Communications	6.7
SES S.A.	Communications	5.8
American Tower Corp	Communications	5.0
Enbridge Inc	Energy Infrastructure	4.9
National Grid PLC	Transmission and Distribution	4.5
Sempra Energy	Gas Utilities	4.4
Flughafen Zuerich AG	Airports	4.3
Eversource Energy	Integrated Power	3.9
United Utilities Group Plc	Water Utilities	3.7
	TOTAL:	50.6

Industry Exposure[6]



Geographical Exposure[6]



[1] Comprised of all Infrastructure strategies.
[2] Returns are for the Global Select 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 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 spliced with UBS Developed Infrastructure and Utilities Net Total Return Index. Note: as the UBS Developed Infrastructure and Utilities Net Total Return Index 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.
* Returns are only for part year.
[5] Risk measures are for the Global Select Infrastructure Composite. The Global Equity Index is the MSCI World Net Total Return.
[6] Representative portfolio. The exposures are by domicile of listing.

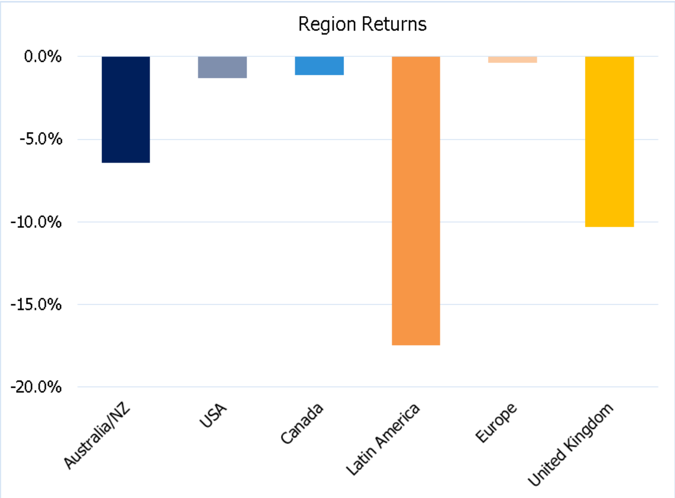
Performance

During the December 2016 quarter, in US dollar terms, the Strategy returned -6.1% before fees. This was 1.8% below the benchmark return of -4.3%. The one-year return for the Strategy was +4.4%. This was 7.0% below the benchmark return of +11.4%.

There were two key drivers of the Strategy's performance during the quarter – the increase in oil prices and long term interest rates and their impact on sentiment towards infrastructure and utilities (and other defensive sectors). This topic is explored in more detail in the following section of this report which seeks to explain how the application of our proprietary definition of infrastructure has impacted investment returns in the most recent quarter and, more broadly, over recent years.

Performance by Region

The following graph shows the returns for the Strategy by region for the quarter in local currency terms.



The Strategy's performance exhibited weakness in the major regions during the quarter, with material declines experienced by investments domiciled in the UK and Australian/New Zealand. In our view, with the exception of the one stock held in Latin America, which was impacted by potential regulatory changes, the performance does not reflect changes to the underlying financial or operating performance of the companies concerned; rather, the performance reflects the impact of broader macroeconomic sentiment.

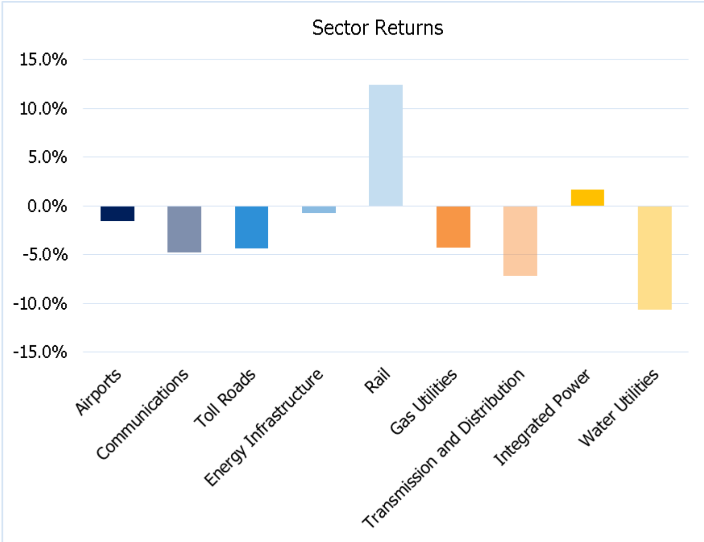
The December quarter saw a notable increase in long-term interest rates in the US, UK and Australia as investment markets regained some confidence that monetary conditions would tighten. The election of Donald Trump to the US presidency has spurred those markets even further on the perception that a Trump administration would be good for economic growth. As we have discussed in previous updates, the companies held within the Strategy are typically viewed as interest rate sensitive by investment markets and the increase in long-term interest rates has led to broad-based share price declines for infrastructure and utilities stocks over the December quarter.

We acknowledge that the value of the assets held in the Strategy are sensitive to *real* interest rates. However, to the extent that a potential increase in inflation leads to an increase in prevailing interest rates, almost all the stocks in the Strategy have either the express (e.g. CPI toll increases) or implied (e.g. regulated utility returns) ability to pass through inflation to customers, thereby preserving the real value of the asset cash flows. Accordingly, it is our assessment that an increase in inflation does not have a significant impact upon the value of the investment portfolio for the Strategy.

We expect that the stocks in the Strategy will continue to benefit from earnings growth over the next two to three years and that, over the medium term, this will be reflected in the share prices of those stocks. However, we acknowledge that there will be periods of volatility as investment markets swing between enthusiasm for growth stocks and other periods where defensive stocks find favour on the realisation that risks are building up in financial markets.

Performance by Sector

The following graph shows the returns for the Strategy by sector for the quarter in local currency terms. The data highlights the sell-off of most sectors in the infrastructure and utility universe, contrasted by the positive performance of the more economically sensitive rail stocks which were added to the portfolio at the start of the quarter.



Investment Update

At 31 December 2016, the Strategy comprised 33 stocks, with approximately 64% invested in infrastructure segments (toll roads, airports, communications infrastructure, energy infrastructure and rail), 30% in regulated utilities and approximately 6% held in cash.

The weighting of infrastructure stocks in the Strategy increased slightly during the quarter by approximately 2% by the end of December. Additional exposure to airports (2.7%) and rail (1.1%) was somewhat offset by a reduction in the exposure to toll roads. The increase was funded through use of cash. The allocation to regulated utilities, energy and water was broadly in line with the position at the end of September 2016.

Minor increases in the exposure to North America and Australia/New Zealand were offset by reductions in the weight to Europe, the UK and cash holdings.

We note that the Strategy held the highest level of cash since inception earlier in the year and we have progressively reduced that position in recent months as the sell-off in stocks that we view favourably provided buying opportunities. We expect to continue this trend through 2017.

Topic in Focus – Validating our Definition of Infrastructure

Our approach to building an infrastructure portfolio relies on our conservative definition of what constitutes an infrastructure asset. By defining infrastructure in this manner, we exclude a number of companies from our infrastructure investment universe that are commonly included in infrastructure benchmarks and indices. For an asset to be included in our universe it must:

- Provide a service that is essential to the efficient functioning of a community and therefore exhibit reliable demand;
- Generate cash flows that have little or no exposure to exogenous risk factors such as sovereign risk, competitive pressures or commodity prices; and
- Meet specific requirements in relation to gearing.

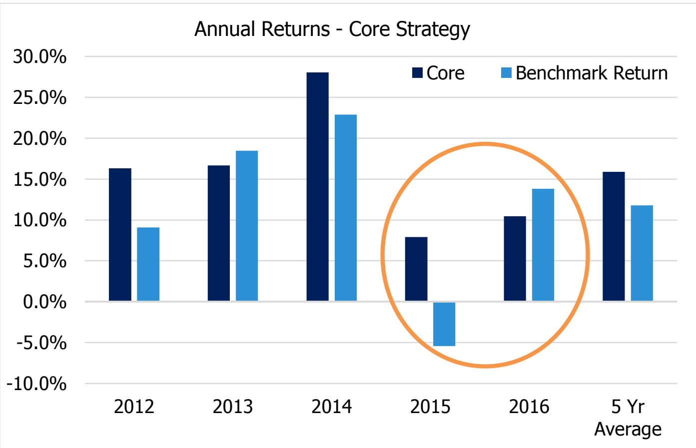
This approach has served investors well since we started running infrastructure portfolios. That said, over the past two years, the *relative* performance of our infrastructure strategies has been impacted by large variations in commodity prices – one of the key variables that we aim to avoid exposure to.

The following discussion utilises the before fee returns of the Global Core Infrastructure Composite Hedged in Australian dollars as a representative for the MFG Select Infrastructure Strategy to demonstrate the benefits of applying our definition of infrastructure. The benchmark is the S&P Global Infrastructure NTR Index (hedged to AUD) spliced with UBS Developed Infrastructure and Utilities Net Total Return Index (hedged to AUD) prior to 1 January 2015.

While we appreciate that investors use comparisons against infrastructure benchmarks to make assessments on relative returns, it is noteworthy to emphasise that our approach takes no consideration of the constituency of infrastructure benchmarks for the reasons outlined above.

The problems with following commodities

The following graph shows the performance of the Core Strategy against the benchmark for each of the past five years.



In 2015, our approach delivered returns that were significantly ahead of the benchmark, which actually lost value. As we have discussed previously, the relative outperformance of the Core Strategy was significantly influenced by our conservative definition of the listed infrastructure investable universe and, in particular, the avoidance of stocks whose earnings were materially impacted by commodity prices. The performance during 2015 also clearly demonstrated the downside protection inherent within the Core Strategy.

The key driver of outperformance in 2015 and the subsequent underperformance in 2016 has been the contrasting impact of falling oil prices in 2015 compared to increasing oil prices in 2016.

	WTI Crude Oil Price (US$)	S&P Global Infra. Net Total Return Index (A$ Hedged)	MSCI World Net Total Return Index (A$ Hedged)	Core Strategy Return (A$ Hedged)
Jan 2010 – Aug 2010	-9.4%	-0.9%	-3.6%	7.2%
Sept 2010 – April 2011	58.4%	15.8%	25.4%	17.1%
May 2011 – Sept 2011	**-30.5%**	-9.0%	**-16.1%**	0.4%
Oct 2011 – Feb 2012	35.2%	12.2%	19.0%	8.3%
Mar 2012 – June 2014*	-1.6%	46.4%	52.1%	54.2%
July 2014 – Jan 2016*	**-68.1%**	-0.6%	3.5%	22.3%
Feb 2016 – Dec 2016	59.8%	13.8%	16.7%	7.9%

Source: Bloomberg. *Returns for periods greater than one year are cumulative.

For instance, some of the worst performing stocks in the benchmark in 2015 included oil and gas pipeline companies such as those listed below, with total shareholder returns quoted in local currency terms:

- Targa Resources (-73.4%), a company engaged in midstream oil and gas services;
- Kinder Morgan Inc. (-62.8%), North America's largest oil and gas storage and transmission company (as well as the second largest oil producer in Texas); and
- ONEOK Inc. (-47.4%), a company with interests in natural gas pipelines, gathering and processing.

In line with our philosophical approach to clearly defining infrastructure, the Core Strategy's investment process excludes companies whose earnings are assessed as being sensitive to oil prices. As a result of this conservative approach, the Core Strategy is likely to outperform in periods where oil prices are falling and this was a key reason for the Core Strategy's outperformance in 2015.

In 2016, the oil price staged a significant rebound, rising by 40% for the year which led to a consequent recovery in share prices of these commodity price sensitive companies. Consequently, in 2016:

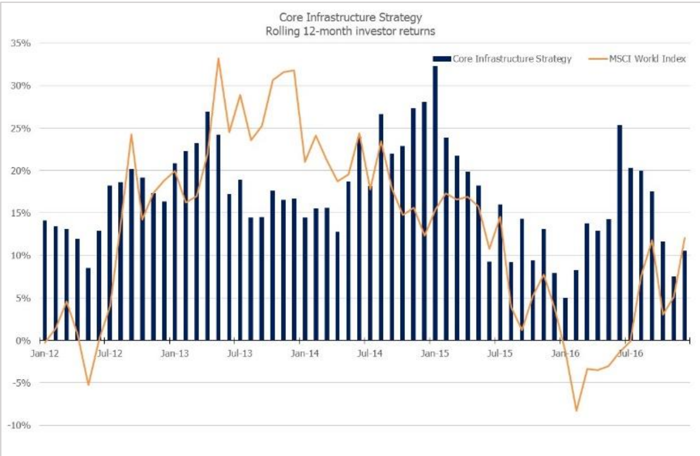
- Targa Resources returned +130.5%, although its share price remains 39% below where it started in 2015;
- Kinder Morgan Inc., returned 42.7% but its share price remains 47% below its starting point in 2015; and
- ONEOK Inc. delivered a return of +149.4%, while its share price is 31% above the level at the start of 2015.

Note that the returns quoted above are expressed as total shareholder returns in local currency terms.

Hence, the benchmark's outperformance of the Core Strategy in 2016 can be largely attributed to the stock price rebounds of companies that were heavily sold down in 2015. As such, the exclusion of such companies from our defined investment universe is a key reason for the Core Strategy's underperformance in 2016 and particularly for the December quarter. Despite the lower positive return achieved in 2016, the Core Strategy has maintained strong outperformance of the benchmark over two years to 31 December 2016.

Lower variability in returns from infrastructure

Notwithstanding the shorter term commodity related impact discussed above, the Core Strategy's performance over the longer term highlights the value that has been generated through the application of our conservative definition of infrastructure. As the graph below highlights, the Core Strategy's variability of returns has been significantly less than global equities.



The impact of excess volatility

There are essentially two key aspects involved in managing money – the absolute level of investment returns that a strategy is able to generate and the level of risk taken to generate those underlying investment returns. Excessive volatility can exert a detrimental impact on a strategy's ability to achieve its target investment return over the longer term due to the compounding nature of investment returns. Consider the example of a $100 investment in a company that extracts and sells crude oil. If the investment results in a 50% fall in value through a period where the oil price collapses like it did between 2014 and 2015, all else being equal, the initial investment would now be worth $50. To recover the 50% loss in value, the investment would actually need to generate a return of 100%. This drawdown effect can have a material impact on long term returns from an asset. This principle has relevance for the Core Strategy's rationale of not investing in infrastructure stocks that are cyclical in nature or linked to variability in commodity prices.

The importance of definition

We believe that infrastructure assets, with requisite earnings reliability and a linkage of earnings to inflation offer an attractive, long-term investment proposition. Over time, the universe of opportunities in infrastructure has expanded, along with the range of asset types that the broader market has called infrastructure. Applying a disciplined, clearly defined set of parameters to capture the desired characteristics of infrastructure, namely, long term stable cash flows from assets with extensive life spans, protection through effective regulation and close linkages to inflation, provides a solid framework for generating attractive, stable returns over the long term.

Furthermore, given the predictable nature of earnings and the structural linkage of those earnings to inflation, the investment returns generated by infrastructure assets are different from traditional asset classes and offer investors valuable diversification when included in an investment portfolio.

Outlook for infrastructure

Notwithstanding the resilient nature of the operating and financial performance of the companies that the Core Strategy invests in, as mentioned in our previous updates, we expect to experience volatility in equity markets, particularly as interest rates start to rise in the US. However, we are confident that any increase in interest rates will be gradual and therefore have a minimal negative impact on the underlying operating and financial performance of the companies held in the investment portfolio.

In the current uncertain economic and investment climate, the reliable financial performance of infrastructure investments makes them particularly attractive and an investment in listed infrastructure can be expected to reward patient investors with a three to five year timeframe.

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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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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.

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.