The Rationale behind Magellan's Definition of the Investable Infrastructure Universe

BACKGROUND

Magellan believes infrastructure investors seek a high degree of confidence that their wealth will grow and be protected. However, the commonly used definition of infrastructure focuses only on whether the asset provides an essential service. We believe delivery of essential services alone is not sufficient to meet an investor's objectives in infrastructure. To this end, Magellan includes in its investment universe only companies whose services are essential to communities and where earnings are expected to be predictable. In practice, this means the companies in Magellan's investment universe have limited exposure to variables outside the companies' control which means the earnings generated by Magellan's investment universe are generally highly reliable, providing confidence that the long-term returns to investors are similarly reliable.

Magellan excludes from its investable universe a range of companies that other investors routinely include. This is due to both the predictability of earnings and risk profile of these companies. Most notably, Magellan excludes companies whose earnings are directly affected by oil prices. This exclusion means the investment performance of Magellan's infrastructure strategy should benefit from a tailwind when oil prices are declining and will face a headwind when oil prices are rising.

MAGELLAN'S DEFINITION OF INFRASTRUCTURE

No single definition of infrastructure has gained widespread acceptance among investors. Most investors have adopted a version of "infrastructure assets are assets that provide services that are essential to the efficient functioning of their communities". This definition essentially defines infrastructure by reference to the physical characteristics of the asset – does the asset provide an essential service? Most investors, as well as the commonly used benchmarks for listed infrastructure securities, use a version of this rationale.

Magellan takes a different approach. Magellan believes that a key reason investors invest in infrastructure as a separate and distinct asset class is because they seek the diversification and the benefits that come from an asset class where the long-term investment returns are reliable. In essence, investing in infrastructure provides investors with a high degree of confidence that they will grow their wealth through time – albeit that an investment in infrastructure is unlikely to make investors rich quickly.

Magellan has defined infrastructure by reference to its risk and return characteristics – the reliable earnings we expect – rather than to its physical characteristics. Magellan defines investable infrastructure assets as assets that meet two criteria:

i. they are essential assets; and

ii. their earnings are unlikely to differ from expectations due to day-to-day factors outside of their control.

The second leg of this definition means Magellan excludes from its defined universe any companies whose earnings are directly affected by external factors such as competition, sovereign risk and commodity prices.

The demand for the essential services provided by infrastructure assets – power, water, transport – are all highly predictable over the long term compared to the demand for most other goods and services. It also means the economic cycle is likely to have a more muted impact on demand for these services. In essence, people don't tend to switch off electricity as a first step to resolving economic difficulties.

In addition, Magellan's defined infrastructure assets face limited, if any, competition, and the pricing of infrastructure services is typically linked to inflation through regulation or contract. Hence, investment in infrastructure assets that meet these criteria – provide an essential service, face minimal competition and with pricing either regulated or subject to long-term contracts – will be in companies that can be expected to generate predictable long-term earnings, which should lead to reliable long-term investment returns.

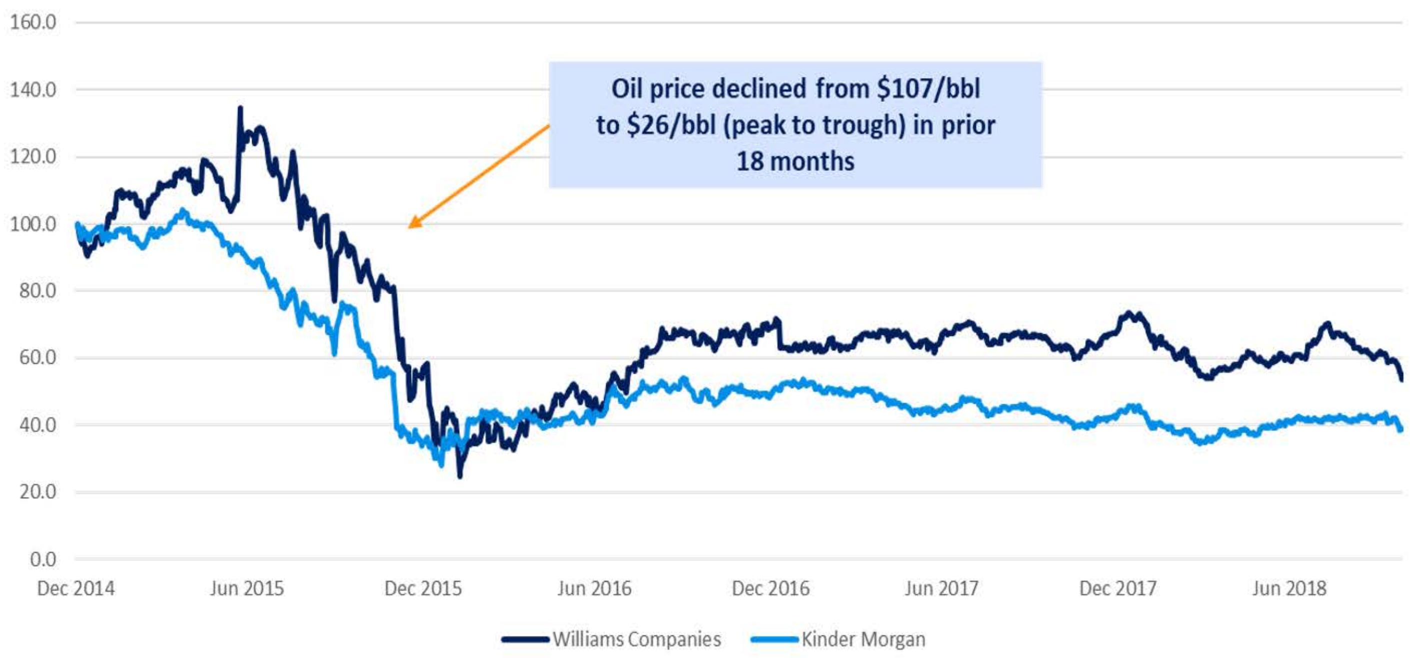
IMPACT OF OIL PRICES ON RELATIVE INVESTMENT RETURNS

As noted above, Magellan excludes assets if their earnings are directly affected by changes in commodity prices such as oil prices. There are some essential assets involved in the transport or storage of oil or gas that are commonly referred to as energy infrastructure. Magellan has observed that the earnings for many energy infrastructure assets are directly affected by changes in the price of the underlying commodity. Given future changes in oil and gas prices are extremely difficult to predict, this implies that for those assets where earnings are directly affected by oil prices the long-term investment returns for such assets are unpredictable. This is why Magellan excludes assets where earnings are directly affected by oil prices from its investment opportunity set.

The following chart shows the change in the share prices of two large US energy infrastructure companies – Kinder Morgan and Williams Companies – following a significant decrease in oil and gas prices. These companies are highly regarded energy infrastructure companies of significant size. Over approximately 18 months to 2014/15 the oil price fell from US$107/barrel to US$26/barrel. As the impacts of the decline in oil prices on company profitability became apparent, so the share prices of the two companies also suffered a significant decline.

The below example shows it is difficult to invest in energy infrastructure companies with confidence about long-term earnings and hence about long-term value.

Kinder Morgan and Williams Companies – Share Price from December 2014 to September 2018



Source: Bloomberg

As Magellan's infrastructure strategy excludes companies whose earnings are sensitive to changes in commodity prices, the investment performance of Magellan's infrastructure strategy should benefit from a tailwind when oil prices are declining and will face a headwind when oil prices are rising. The following chart demonstrates the impact of oil prices on relative investment performance of Magellan's infrastructure investment strategies over the period 2014 to 2023.

The table shows that over the periods when oil prices were declining – from July 2014 to January 2016 and from July 2018 to April 2020 – Magellan's infrastructure investment strategy outperformed the infrastructure benchmark and the Alerian MLP Index. However, in the periods when oil prices have been increasing, Magellan's infrastructure investment strategy has underperformed the infrastructure benchmark and the Alerian MLP Index.

Whilst the exclusion of companies where earnings are sensitive to commodity prices leads to structural divergence from the benchmark, we believe this approach is in accordance with investors' expectations for infrastructure investment. Over time this approach mitigates the uncertainties associated with commodity market fluctuations, providing a greater level of confidence that the assets within the Magellan infrastructure investment strategy can be expected to generate predictable long-term earnings and reliable long-term investment returns.

Impact of Changes in Oil Prices from 2014 to 2023 on the performance of Magellan Infrastructure, S&P Global Infrastructure Index, Alerian MLP Index[1] and MSCI World Index

Date Range	WTI Crude USD	Magellan Infrastructure Fund	S&P Global Infrastructure NTR Index (A$ Hedged)	Alerian MLP Index USD	MSCI World NTR Index (A$ Hedged)+
July 2014 - January 2016	-68.1%	22.5%	0.7%	-46.0%	3.5%
February 2016 - June 2018	120.6%	25.5%	28.7%	23.6%	41.6%
July 2018 - April 2020	-74.6	3.9%	-8.2%	-39.8%	0.4%
May 2020 - September 2023	381.9%	6.6%	25.3%	146.3%	44.1%

Source: Bloomberg. +All MSCI data used is the property of MSCI. No use or distribution without written consent. Data provided "as is" without any warranties. MSCI and its affiliates assume no liability for or in connection with the data. Please see complete disclaimer in www.magellangroup.com.au/funds/benchmark-information/.

[1] The Alerian MLP Index is an index that measures the investment performance of US-listed Master Limited Partnerships, which is made up of listed energy infrastructure companies.

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