

Magellan – In The Know: Episode 46

Lessons learnt from investing in essential services.



Announcement (00:00):

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Host (00:14):

This is In The Know, a monthly investment podcast brought to you by Magellan Asset Management.

Gerald Stack (00:20):

I think that example gives a pretty powerful showing about what infrastructure brings to the table. We go back to March 2020, passenger numbers globally down 98.5%, earnings down accordingly. For many of these companies, their earnings went negative in the airport space, and yet three years later, the model that you had in place, the forecasts you had in place were within 5% of where that company's ended up. It goes to how structurally sound long-term demand is for these services.

Host (00:48):

That's Magellan head of infrastructure, Gerald Stack, explaining how the reliability of infrastructure assets, despite occasional short-term impacts continue to benefit from reliable long-term demand. Welcome to Magellan-In The Know. In this episode, Gerald Stack, head of Magellan infrastructure and portfolio managers, Ben McVicar and Ofer Karliner discuss their experience in investing in infrastructure and why essential services provide a great opportunity to grow wealth reliably over the medium to long-term. It's a great discussion about the lessons learned and opportunities this sector offers. First, here's a warm welcome from Gerald Stack.

Gerald Stack (01:36):

Welcome. Today we've got three of the portfolio managers from our infrastructure investment team. We're going to talk a little bit about some of the lessons we've learned in infrastructure. The three of us have collectively got around about 60 years worth of investment experience in the infrastructure field. So, we're going to talk about some of the things that we've come across over time, both problems and solutions, and hopefully that'll be something of interest to people. Now by way of introduction, I'm joined with me today by Ben McVicar.

Ben McVicar (02:01):

Good to be here.

Gerald Stack (02:02):

Ben's been working in infrastructure for about 15 years, so he's a pretty boring guy. I've also got Ofer Karliner here.

Ofer Karliner (02:07):

Hi Gerald.

Gerald Stack (02:09):

Ofer's been in infrastructure for about 25 years. So, he's a little bit more boring than Ben, and myself, Gerald Stack, I've been in infrastructure for a little over 30 years, so I'm the most boring of the three of us.

(02:17):

So, with that as an introduction, we're going to talk a little bit about infrastructure. Now, first of all, I want to talk about really what is infrastructure and how we think about it, and then we're going to talk a little bit about the framework in terms of what we look for in attractive assets and the experiences we've had over time. So firstly, what is infrastructure? Infrastructure are assets that provide essential services. Typically, it's the provision of energy, the provision of water, and the provision of transport. So, these are services that communities rely upon, that they're essential for the efficient functioning of communities. Because these services are essential, the demand for them is incredibly reliable and predictable over the long term. That's not to say that there won't be short-term influences on the demand levels for these assets, but over the long run, the demand for these services is highly reliable and predictable.

(03:04):

Because of that, you end up with very distinct financial characteristics for these assets. So, first of all, the nature of infrastructure, big upfront capital expenditure, you build a big piece of typically, ugly capital expenditure, a lot of money out the door in the short run. But over the long run, these long series of cash flows mean that as an investor you can be pretty confident about growing your wealth over the long term. So, if you think about the major assets that we invest in, firstly there's utilities, electricity, gas, water. They very much meet that criteria. They're big capital expenditure to build these assets, the poles and wires for electricity, the pipes for gas, water, dams, and pipes, again. It's a lot of money spent day one and the asset owner is expecting a long series of very reliable cash flows over into the future.

(03:50):

Now these assets are typically monopolies, so monopolies providing an essential service that can be potentially hazardous for consumers. So as a result, these assets are normally regulated by governments, and that economic regulation means it is struck on a basis whereby the utility undertakes to invest for the future, invest lots of money in those facilities and in return they get a fair return on that capital, so very reliable returns. Then we've got things like toll roads and airports and toll roads and airports, it's typically price that gets regulated rather than earnings. So the think about the toll on a toll road, which grows with inflation on a regular basis, similarly with airports, but what you are exposed to as an investor in those assets is that over the long run you can expect patronage, traffic on a road or passengers through an airport to grow at a very reliable predictable rate over the long term, and hence you get very reliable returns, so those financial characteristics.

(04:42):

The big massive capital expenditure upfront and therefore cash out the door as an investor followed by a long series of very reliable, predictable cash flows, that's the essence of what we're investing in. It goes in some respect to the things that we're going to talk about today, and they are that we're going to talk about a range of different investment lessons we've come across, but they all have a theme that's common to them, and that theme is the capitalisation of a short-term problem or opportunity into share price. So what do we mean by that? All companies, infrastructure companies, while they may face very long-term reliable earnings in the short term, things can go wrong or they can go particularly right.

Given the expected reliability of earnings, we quite often find that that short-term variability can be capitalised into a long-term share price reaction.

(05:26):

So if we think about that, a short-term risk or a short-term reduction in earnings can lead to a pretty significant impact on share price and vice versa, a short-term opportunity can lead to a significant appreciation in share price and that might not be actually justified. That leads itself to a range of different opportunities. We've seen these sorts of opportunities across the different sectors that we've invested over time. We've all come across these sorts of situations. We've got examples across electricity. We've got examples through the GFC with debt levels and what that's meant for companies. We've got examples from the pandemic, indeed, there's examples today in the UK water space, and we're going to talk a little bit about those. So with that, maybe perhaps, Ben, you'll give us a bit of background of some of the things that you've seen over time?

Ben McVicar (06:11):

Yeah, certainly. When you told me about the topic for this one, certainly the thing that came immediately to my mind was one of the ones I recall covering the stock before I joined Magellan, and I know you had been invested in it in the fund, but before I joined. This was a company, Spark Infrastructure, and this would've been going back when I started covering this company. It would've been 2010 timeframe. This business is a, it's now been taken off market by KKR, but for a long time, it very much fit the bill of what you're just describing there. This was a business that had regulated earnings.

(06:45):

It had operations in Victoria and South Australia. It was a regulated utility, it had incredibly reliable earnings. But the problem this company had back then was you would just come to a situation where a lot of these companies had a balance sheet that made sense probably pre-GFC. But when you then rolled the camera to the post-GFC era, these guys were suddenly way too levered. I recall when I first started following this company, the discussion was very much around how are they going to get through these current balance sheet issues? It was very clear this company was cheap. I remember it was probably trading on a look through sustainable basis something on the order of 17, 18% free cash flow yield, which let's be honest, the amount of risk you're taking in a utility like that company spark infrastructure, that is a huge deal to get.

Gerald Stack (07:30):

Yeah, that's a massive number, and it signifies that there's a problem.

Ben McVicar (07:33):

Yeah, and I also recall the dividend yield was probably in excess of 10%.

Gerald Stack (07:37):

Yeah, there you go.

Ben McVicar (07:38):

I actually remember the AFR ran an article at the time saying generally, 10% plus dividend yields are not a great indicator for sustainability of yield. But the problem they were basically facing was that they had a balance sheet that was a little bit too loaded. Then in addition to that, they had what I think the market then was perceiving as a big problem, but I actually thought it was a big opportunity, which was

that this company had a boatload of CapEx coming through. They were growing their regulated asset base probably by 8% per annum, 9% per annum back then. It happened for a few reasons. One is you had to refurbish the grid and there was also a need and refresh the grid, but a lot of the regulators from the late '90s, there'd been a bunch of reliability problems, and they were trying to clean that up. You really saw that ongoing need for CapEx in the system to fix that, so you had this huge growth in this business.

(08:26):

The problem they had is when you've got to deleverage and you've got to fund a huge growth pipeline, that's not a great situation from a short-term balance sheet perspective. But when you think about that short-term issue, all they really had to do was get through that period and all they did in the end was they had to raise some capital. I remember the market at the time was pretty upset, they had raised capital at a dollar a share and the company had promised they weren't going to do that, but they went out and did that. But notwithstanding that they had to do that, there was a bit of dilution, but when you started at a 17, 18% current yield, you can do a bit of dilution and still have a lot of value on the table.

(08:58):

Then in addition to that, all that to do is overfund future CapEx with equity, and they did that. Slowly what we saw with this business is that they, as a long-term investor, the CapEx is a great problem because for every dollar they're spending, typically, the market values that dollar of CapEx, not at one times that you spend, but at 1.2, 1.3, 1.4 times so you're creating value. So not only do you have a lot of value on the table today, but there's a lot of value being created, so all I had to do is get through that. I recall doing the math at the time, it was something like compounded grade of equity rate base, something about 14, 15% per annum, so there's huge value. You could just ride through that period.

(09:33):

To me, when you brought up the topic of this, that was very much the thing that came to my mind was that, this is a great example and for me, a really important lesson in this space that sometimes these short-term issues when you have the starting premise of this space is that you're investing in high quality, really reliable businesses. You have these short-term issues. They don't tend to sink the ship, they just become gate issues you've got to get through. So that was a business I thought was just had a lot of long-term value, but the market was very myopically focused there around to me what looked like a relatively short-term mission. It felt uncomfortable, but it was caused by a quality problem. They were growing too fast effectively for what they were at the time, but it was, I think, a great situation long term, and it worked out very well in the end, as I recall.

Ofer Karliner (10:17):

That sounds pretty similar to US Utilities at the moment, bad CapEx they're facing. Obviously, you see a huge tailwind of CapEx for these guys from the energy transition. These guys are not that heavily levered by global standards or by historical standards, yet people will look at them and go, "Well, they've got to fund massive CapEx," when I say massive, what's it? The Princeton study has, was it 5.9 to \$9.8 trillion to be spent on generation transmission? That's not even clean distribution over the period to 2050. It's huge amount of money to be spent. People look at it as a problem, we see it as a massive opportunity.

Gerald Stack (10:48):

I think that's a key theme, a key thing that makes infrastructure different. As we've touched on as we started on here, the nature of infrastructure is you build a big piece of capital equipment, lot of CapEx out the door. That's actually a good thing for infrastructure investors. You're providing an essential service in something like a monopoly setting. It's the CapEx that gives you the right to charge for that. So

that's actually how you earn. So for many investors when they hear CapEx, they get a bit scared by that. Our eyes tend to light up a bit when we hear CapEx.

Ofer Karliner (11:14):

Particularly for regulated utilities because you get effectively guaranteed return on that. It's a very low risk way of growing cash flows and growing the business overall, and so we quite like that.

Gerald Stack (11:24):

So yeah, I think that's a really good example. In the GFC, what we found that there were a number of companies that got into problems around gearing levels. The nature of infrastructure, again, is as we've touched on a few times now, a lot of capital expenditure involved and hence given the reliability of earnings coming out the other side of that, what we typically find is these businesses have a fair amount of debt in their capital structure, and on average, you're probably looking at 50% debt, 50% equity, which is much higher than an average business, but reflects the underlying reliability of those earnings. Of course, if you've got a high level of debt in your capital structure and you come up against a credit crisis as we did in the GFC, well, that exposes you to potentially to some risks, and we certainly found that in the GFC.

(12:01):

There were certainly a number of companies that found themselves on the wrong side of investors' expectations in terms of what the rise in interest rates, that the shortfall of available of debt capital, they found themselves on the wrong side of investors' views about these things. Macquarie Communications Infrastructure Fund is, I think, a really good example of that. The nature of communications infrastructure is it's essentially vertical real estate. You build big towers and you hang pieces of equipment off those towers and you lease space on your tower to those telecom operators or TV operators for those pieces of equipment, so very reliable business model over time. But if you found yourself with high levels of debt at the wrong time in the middle of the GFC, then you got punished for that and MCIF, that's exactly what happened to them.

(12:44):

It is common with a number of the situations where we see this sort of thing happening, unlisted infrastructure investors scooped in and took out that company. They understood the nature of these earnings were very strong over the long-term, and that what MCIF faced really was a short-term issue. We've seen this again and again in infrastructure that where there's a short-term issue that gets capitalised into a price reduction in the share price, that knowledgeable infrastructure investors with deep pockets and they tend to be unlisted infrastructure investors have been willing to come in and take out some of those opportunities and take them private. In the Australian marketplace, if we were to go back 15 years ago, there would've been somewhere between 10 and 20 infrastructure companies listed on the Australian Stock Exchange. Today I think we're down to three or four. So those companies have gone into private hands and they've gone into private hands because of that thematic. MCIF's a really good example of that, but it wasn't the only one.

Ofer Karliner (13:38):

Yeah, we saw Sydney Airport taken out in 2021. Now obviously COVID had a big impact on all the airports. Obviously, air travel went to virtually zero in 2020 as countries shut borders, even domestic borders. Obviously, in Australia, we couldn't travel between the states for quite a period. By 2021, we had a vaccine. We saw a path to borders reopening, border was with New Zealand. It wasn't feasible to keep global borders shut forever, yet, the market was pricing in a very, very slow recovery in traffic to get to the high five share price it was trading at. You had to be very bearish on the recovery. Owners of

Sydney Airport at the time, Gerald looked back at my model, Sydney Airport came up with their results a few weeks ago. I think I was off by six 7% from the EBITDA number they put out.

Ben McVicar (14:26):

I call that a big missing infrastructure by [inaudible 00:14:28]

Ofer Karliner (14:28):

Yeah, it's two years, two years...until the model. But the thing, we weren't going to get everything right. So the nature of the way traffic came back was slightly different. So Chinese passengers were slower to come back and their spend rates are a bit lower. But broadly speaking, the trends have all been correct, as in we've recovered to almost full traffic around the world. I think February, we're back to the same level of traffic. Where in 2019, the real handbrakes have been around fleet availability. There's not enough planes out there at the moment. We're still behind the 2019 level fleet numbers, and they expect to be normalised by about this year.

(15:00):

But ongoing production issues at Boeing, et cetera, plus retirement of older planes has caused some problems. But by and large, when markets opened up, people want to travel and they took the opportunity as soon as things opened up to get back on board and travel, and we saw that, if you look back at September 11, people were never going to travel again. Sure enough, within a few months, traffic was back on trend. In SARS, people were never going to go to Hong Kong again, took a few months, people were back travelling to Hong Kong and nothing happened. To assume that there were going to be a very, very slow recovery or permanent, very significant reduction in traffic didn't make sense to us.

Gerald Stack (15:33):

But let's just go back over that a minute, because I think that example gives a pretty powerful showing about what infrastructure brings to the table. We go back to March 2020 passenger numbers globally down 98 1/2%, earnings down accordingly. For many of these companies, their earnings went negative in the airport space, and yet, three years later, the model that you had in place, the forecasts you had in place were within 5% of where that company's ended up. It goes to how structurally sound long-term demand is for these services. In the short term, yeah, pandemics can happen. Let's hope it doesn't happen again in a hurry, but these things can happen. But we can be very, very confident that the demand for aviation, the demand for toll roads, for traffic, the demand for water and energy will remain very robust over time.

(16:17):

Indeed, the demand for energy and water pretty much remained on par with expectations throughout the entire pandemic period. Clearly to the extent that governments weren't allowing or requiring people to quarantine in their homes and therefore weren't allowing people to move around either by aviation or indeed through cars, then yeah, traffic levels were down, but those numbers have come back. They have come back very quickly. In the case of airports, I dare say that really, they've come back much more quickly than we had originally expected across the board. I think you can invest in these sorts of assets with a high degree of confidence that you will grow your wealth over time, notwithstanding the fact that you might face some short-term issues. It's those short-term issues to the extent they get capitalised into share price, they're nothing other than a massive opportunity, I think, for investors.

Ofer Karliner (16:58):

Yeah, I agree. Yeah, just want to touch that. You mentioned before, talk about the GFC and some of the problems that some of the companies had. I think a lot of that also came down to some of the incentives that we saw. So a lot of these companies had externally managed models where effectively the external manager was rewarded based on the size of their asset base. So they were incentivized rather than focusing on long-term returns on trying to... greater the number of assets they had, and that created a situation where debt levels are too high. They were paying too much for assets. A lot of those models have been cleaned out effectively, and what we have now is long-term asset owners, and that's a lot struck a more structurally sound investment philosophy.

(17:33):

If you're buying and holding the asset for a long period of time, you're going to make sure you're paying a reasonable price for it and would not just on the externally managed model, we saw on the unlisted market too where we saw a number of toll roads go bankrupt, going to administration in Australia and globally, in fact, across the tunnel, Lane Cove Tunnel, that bridge connects here or SR 125 in San Diego, there's an incentive there for the investment banks to sponsor the deals, to actually win the deals. You'd have three or four investment banks sponsoring different consortiums, and you got paid a success fee if you won as an investment bank. Those could be hundreds of millions of dollars potentially. So you're incentivised to push traffic forecasts to the absolute limit.

(18:11):

I'm not going to get into the technical details of things like reveal versus state of preference, all that stuff nerdy that we like here, but to the extent that there's nothing left on the table effectively, you had no margin for error. What we saw again and again was these traffic forecasts being pushed right to the edge because the incentives were to do so. We spent a lot of time here looking at the incentives of management. I used to run the training from a quarry analyst on the Southside when I was there, or part of it. When the first lesson always says is open up the REM report and look what management incentivized to do because that's what they're going to do? Incentives drive behaviour. It's the reason we put such a high weight on agency risk in our modelling. So we have quality scores for all our stocks and 48 of 150 relates to management because getting that wrong and management incentives wrong can have a material impact on the outcomes you receive as an investor.

Gerald Stack (18:57):

Yeah, no question. This theme of things going wrong on the short term, but being capitalised into a long-term price, it's something that remains obvious even today. We're seeing it, I would argue at the moment in the water space, in the UK water space.

Ben McVicar (19:09):

Yeah, absolutely. I think that there's a tonne of examples I can think about in this area as well, and we see it, some of your points before about the airports has got me thinking about this as well, which is we often see this thematic as these short-term issues just being capitalised out. It's amazing as well when you look at things as predictable as electric utilities. These are businesses that have been around for 100 plus years. We are continuing to see these businesses get these thematics that pop up and people expect these businesses that have been operating as they do for such a long period of time, but all of a sudden you'll see... I recall early on in my career, the discussion for those companies back then was the death spiral of the grid. We were going to see all of these electric utilities become effectively worthless because what we were going to do is every single household and business was going to have solar rooftop on the top and a battery, and all of a sudden the thesis was, "I'm not going to need a grid anymore."

(19:58):

Of course, I think everyone's sitting here today in 2024 realises that's complete make belief. That's not happening. But it's amazing that you see that. Now I'd say the thematic we're seeing, and I think this is we're having that sense of the short term versus the long term is so important in our space because even today we're seeing the AI excitement coming our way, which is amazing that the AI excitement has gone so far across the value chain we're now hitting the electric companies. But the regulated utilities, the thesis is all of a sudden you're getting some growth in electricity in the grid, and that's going to fundamentally make these growth companies. The reality is that's what these companies have been to us since we've been investing in them. They've always had a growth element and a real growth component to them, and I think the UK, you mentioned the UK is another example that came to your mind.

(20:41):

I think that's a great example of this. It's a space that we spent a lot of time looking at recently. We think there's interesting opportunity in this space, but, again, it's been driven by the valuation opportunities being driven and coming about by short-term issues in our view. So in this case, you've got a set of regulated water companies, very benign, predictable businesses, but then you've got a major player in the market unrelated to the listed players that we look at. You've got Thames Water. They're a quarter of the market in the UK for customers, and they're going through serious issues at the moment, but these are all separate franchise utilities with their own service territory. Thames Water's got obviously, as we all know, they've got their very serious balance sheet issues. They've got very poor operating performance metrics. The stats on that, as a reminder, Thames Water has got something like 80% debt to regulated asset value at the moment.

(21:30):

They're a quarter of the population and their regulated return on equity for the first few years of the current regulatory period is something anaemic like 1.9%. So it's absolutely tiny. Compare that to the ones we look at, they're earning very healthy rates of return. If Thames Water is 80% levied or geared, you're going to be looking at 60% or less for the companies we look at. But the market has, again, said, "Okay, you've got this problem with Thames water, the government must look at therefore the rest of the sector and try to penalise." But it's clearly from our point of view, you go, "These are essential service companies," as you said, right in the opener, these are essential service companies. So from our perspective, this looks like a great opportunity because these are good operators.

(22:09):

If anything, they've actually got opportunity at the moment because they're getting more topics thrown at them to fix some of the sector service quality issues. By the way, their stats are great, but this gives them an opportunity to continue to greater asset base. Again, that's the growth engine here for these businesses. So you get to mentioned opportunities, and from a value point of view, all of this risk blowing up in the sector has meant that we're seeing these companies trade down to levels that you only really see a handful of times in the utility space that there are times last year they were trading at close to one times regulated capital value, which is not that typical for us. So you can get some interesting opportunities that come out if you are able to look through these short-term issues and project into the long-term what you've seen happen for the decades in the past.

Gerald Stack (22:48):

Yeah, I think again, it's another good example of exactly what we've been talking about, short-term issues. In this case, not even the company's short-term issues, we're talking Severn Trent and United Utilities. It's someone else's issue, and it's being portrayed as their potential problem. It absolutely shouldn't be their problem, but they have to deal with the social licence issues, but they're top quartile performers. They've been strong financial performers over a long period of time, and we think that

they've got a long pathway of value accretive capital expenditure in front of them, which we've touched on already, is the key thing that drives value for infrastructure companies in the long run. So they're in a particularly fantastic spot we would think, but the share price is not necessarily reflecting that.

(23:26):

So what we've seen, whether it goes back to the GFC around gearing, around startup traffic levels with Connect East, if it goes to the pandemic with Sydney Airport or indeed with the UK waters today, these are each examples of problems that are short term in nature, but are getting capitalised, in other words, treated like they're a long-term problem for these companies. That's the essence of where we see opportunity in the space. In broad terms, when we're looking for attractive investment opportunities, we're looking for really one of two things, well, the bulk of our opportunities are one of two things. The first is duration arbitrage, what we call duration arbitrage. The second is what we would call valuation anomalies. Duration arbitrage is where we find an asset that is going to grow its earnings for structural reasons over long periods of time into the future.

(24:10):

So if you think about a toll road, particularly an urban toll road in an environment where you've got population growth, you've got the toll road because the free roads are full. We're not of the view that you tend to build toll roads just for the hell of it. You build them because the free roads are full and the government doesn't want to pay for the new road. So to the extent that you're getting population growth, that population growth is going to lead ultimately to traffic growth. In the catchment and given the free roads are full, you can expect the toll road to get the bulk of that growth so that therefore, you're getting growth in traffic with a higher degree of confidence over a long period of time, on top of which you're getting inflation indexation on your tolls, and you've probably got a pretty stable cost structure.

(24:45):

So you can expect earnings growth for structural reasons over long periods of time. Airports are not a dissimilar situation. With the airports, there's a strong link between growing GDP per capita, in particular, the growth of the middle class and growth in passenger numbers over time. We've seen passenger numbers grow across airports around the world at something like two times GDP for about the last 50 years. That's a structural thematic that we can be confident in overtime. So you get this long-term structural growth in those cash flows. We really like those opportunities, and that's a big pot for us to go shopping in when we are investing in our funds.

(25:19):

The other opportunity set, as I touched on, is what we would broadly call as valuation anomalies, and that's really where the valuation gets divorced from the share price or the share price gets divorced from the valuation. Typically, because of the short-term issues, the short-term issues, they get capitalised as long-term issues. They can be one of a myriad of different types of short-term issues, but we tend to find the same impact at the long run. As we've touched on, there have been opportunities 20 years ago. There have been opportunities 15 years ago. There have been opportunities five years ago, and there are opportunities today in this space, and this is a key thematic for us in the infrastructure space. So thanks for joining us today. Thanks to Ofer and to Ben for being part of the podcast.

Ofer Karliner (25:56):

Thank you.

Ben McVicar (25:57):

Thank you.

Gerald Stack (25:58):

If there's any questions out there, we'd encourage you to get in touch with our business development managers in each of the states. Thank you.

Host (26:05):

That was Magellan head of infrastructure, Gerald Stack in conversation with portfolio managers, Ben McVicar and Ofer Karliner. We trust you've enjoyed this episode. For more information on previous episodes, visit magellangroup.com.au/podcast where you can also sign up to receive our regular investment insights programme. Thanks for listening.

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