Global Infrastructure Funds

By Sam Campbell

Investment strategies adopted by endowments and foundations are the precursor to trends in the retail market. According to a January 2014 report by the Commonfund Institute entitled “Alternatives Reality: What to Expect from Future Allocations,” the endowment model has led to substantially higher allocations to alternative investment strategies including hedge funds, private real estate, private equity, venture capital, and other less liquid (or illiquid) strategies (Sedlacek 2014). We are seeing this trend unfolding in the retail arena today with the burgeoning array of liquid alternative mutual fund offerings. The largest educational endowments allocate, on average, more than one-half of their portfolios to alternative investment strategies. Even pension funds have reallocated assets to alternatives with the goal of boosting investment performance and dampening volatility. To quote (Sedlacek 2014, 21):

Perpetual and other long-term asset pools such as endowments and foundations and pension funds have not been able to maintain purchasing power over the last generation by simply allocating to a basic mix of passively managed equities and bonds. Active management of long-only strategies will only bridge part of the gap. As such, we believe that significant allocations to alternative strategies—thoughtfully constructed, with top-tier managers—are necessary to preserve intergenerational equity and thus fulfill the long-term missions and obligations of institutional investors.

The concept of inflation protection and the maintenance of purchasing power are equally applicable for retail investors who also will need to maintain buying capacity in their retirement years. Asset classes included in the alternatives bucket serve specific purposes—growth, deflation hedge, inflation hedge, and diversification/uncorrelated alpha. Alternatives such as core real estate, natural resources/timber, and infrastructure serve principally as inflation hedges in portfolios. In this article, we consider the role of a global infrastructure fund in an investor’s portfolio.

Global Infrastructure Fund: Definition and Role
A global infrastructure fund seeks to provide long-term growth of capital and current income through investments in equity securities, including common stocks and preferred stocks, of listed infrastructure companies. By the nature of their underlying investments, global infrastructure funds, which invest in both developed and emerging markets, offer steady, defensible return streams, provide potential inflation hedges, and may reduce long-term portfolio volatility.

Maintaining purchasing power in retirement is a top goal for investors who must manage their own expenses in retirement (much like a liability-driven investment strategy). Even modest inflation can substantially erode purchasing power over time, so investments with the potential to mitigate the deleterious effects of inflation play an important role. An investment in an equity-driven global infrastructure fund is able to provide a potential inflation hedge as well as a higher level of income than typically available from most equity investments, attractive risk-adjusted returns, lower volatility, and diversification via low correlation with other asset classes.

Diverse Infrastructure Investments
A typical global infrastructure fund may hold investments in categories such as electric and gas utilities, highways and railroad tracks, marine ports, oil and gas storage, and transportation, railroads, telecommunication services, government outsourcing (e.g., prisons), and water utilities. The fund may be able to invest across the capital spectrum and likely will be diversified to control security, sector, country, and currency risks. Precisely because it is a global fund, the investment manager may follow both a top-down and bottom-up strategy in country and security selection because either/both types of risk will affect performance.

Attributes of Global Infrastructure Investments
Although infrastructure is considered an alternative investment, it has emerged as a differentiated asset class precisely because of its unique attributes. At the highest level, infrastructure investments are needs-based and are geared specifically to facilitate more efficient functioning of economies—whether at the municipal, state, or country level—in order to foster economic growth. Infrastructure investments share the following attributes:

Consistent demand. Demand for essential assets and services remains consistent regardless of price or economic conditions. In short, monopolistic.

High barriers to entry. Infrastructure investments typically are made for capital-intensive projects, which limit the pool of potential developers/operators with the requisite deep pockets.

Stable cash flows. Infrastructure investments typically have long-term contracts. After a development is completed and the intense capital expenditures are concluded, spending generally drops to low and
predictable levels and typically is focused on maintenance. Beginning at this point, the investment produces consistent cash flows and higher margins.

**Inflation.** Infrastructure investments provide a two-pronged inflation advantage. Inflation increases the cost to replace existing tangible assets, and the long-term contracts frequently have revenue or fee increases tied to inflation.

**Highly regulated environment.** Infrastructure investments are highly regulated to ensure fair pricing given the unconstrained demand (e.g., for water or electricity), which provides another barrier to entry.

**Demand for Infrastructure Investments**

Regardless of geography, infrastructure is the underlying foundation for continuing economic growth and well-being. Regarding the magnitude of the infrastructure investment crisis, it is estimated that modernizing and expanding the global infrastructure will require $57 trillion between 2013 and 2030 (McKinsey & Company 2013). The two pivotal questions tied to infrastructure investments are who pays and how do we pay (Urban Land Institute and Ernst & Young 2013). Increasingly the answer is that the private sector (including sovereign wealth funds, institutional investors, and now mutual funds) will assist in providing the requisite capital and replace or complement direct government investment, which is waning due to increasing fiscal restraints.

In the most-developed countries, infrastructure spending will be directed principally at decr ipt or crumbling infrastructure. The American Society of Civil Engineers, which annually provides a report card of the United States’ infrastructure, gave no higher than a B grade (to solid waste) in its 2013 report about the United States. The preponderance of the infrastructure was rated D, and included dams, drinking water, hazardous waste, levees, wastewater, aviation, inland waterways, roads, and transit. A barely passing grade of C/C+ was awarded to bridges, ports, rail, and public parks and recreation. The quality of our infrastructure may be the ultimate go/no go decision as we strive to retain—or garner—a global competitive advantage.

As we look internationally, the drivers for such investments are less about repairs than about satisfying brand-new infrastructure needs. Look no further than the continued population shift to urban areas in less-developed countries. This influx of people underscores the need for substantial investments to (among other things) limit pollution, deliver sufficient supplies of potable water and power, offer multi-modal mass transit, provide communications connectivity, and limit greenhouse gases. Absent infrastructure investments, economic development will be constrained.

**More about Infrastructure Funds … and a Caution**

Global infrastructure funds typically are benchmarked to the S&P Global Infrastructure Index, a market-cap-weighted index that provides “liquid and tradable exposure to 75 companies from around the world that represent the listed infrastructure universe.”

As demonstrated in table 1, investors looking for market-matching equity fund returns (whether domestic or international) should not consider an infrastructure fund as the appropriate vehicle. Over all three periods, the performance of the S&P Global Infrastructure Index lagged the other two broad measures. Moreover, infrastructure investments should not be thought of in traditional asset allocation terms—as traditional equity investments or for current income. For example:

- The nature of the underlying holdings in an infrastructure fund provides some protection from business and economic cycles that is not available to typical equities. In other words, infrastructure funds have greater total return worth in down markets.
- Because infrastructure funds offer income-generating potential, they furnish an alternative for yield-starved investors. While current income is a benefit of infrastructure funds, they are not income funds per se.
- Given their relatively short track records, it is unclear how infrastructure investments will perform in a higher (or rising) interest-rate environment. Will they behave like equity funds or bond funds (with price depreciation) given their underlying debt?

**Infrastructure funds are specifically designed for total-return investors seeking an inflation hedge and the added benefits of portfolio diversification and an overall dampening of volatility.**

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### References


Table 1: S&P Global Infrastructure Index Performance

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<tr>
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<th>1 Year</th>
<th>3 Years (Annualized)</th>
<th>5 Years (Annualized)</th>
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<tbody>
<tr>
<td>S&amp;P Global Infrastructure Index</td>
<td>12.99%</td>
<td>8.02%</td>
<td>12.76%</td>
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<tr>
<td>S&amp;P 500</td>
<td>26.81%</td>
<td>14.90%</td>
<td>19.25%</td>
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<tr>
<td>S&amp;P Global 1200*</td>
<td>21.15%</td>
<td>10.77%</td>
<td>16.98%</td>
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* The S&P Global 1200 captures “…approximately 70% of global market capitalization … constructed as a composite of 7 headline indices….”

All data are for periods ending January 17, 2014.

Source: US.SPindices.com