Global Listed Infrastructure Separately Managed Accounts as an Inflation Hedge

By Michael Underhill and Susan Dambekaln

What is Global Listed Infrastructure?
Infrastructure assets represent a broad mix of the large-scale public systems, services, and facilities of a country or region that are necessary for economic activity to function. Some examples of infrastructure include power generation and transmission, water supplies and waste-water treatment, public transportation, rail, roads, bridges, tunnels, ports, airports, telecommunications, and basic social services such as schools and hospitals. The global listed infrastructure market represents a market value of roughly $1.79 trillion of outstanding securities, according to S&P’s most recent listing of infrastructure assets (S&P Listed Infrastructure Assets – A Primer 2009).

Infrastructure has emerged as a differentiated asset class that provides unique investment characteristics. Infrastructure assets provide necessary goods or services to society and have monopolistic positions with high entry barriers for competitors. Hence infrastructure assets tend to be highly regulated, which results in investments with distinct qualities.

Infrastructure assets typically are expensive to build and usually are built to have long and useful lives. The demand for the output from these assets tends to be inelastic given the scarcity of the resource offered. With the pricing power that results from market position, revenue growth from these assets typically is limited by regulators to the rate of inflation. These factors result in infrastructure investments being able to offer long-term stable cash flows that have the potential for inflation hedging.

Infrastructure investments also exhibit a hybrid nature combining fixed income cash flows with capital gains. They behave somewhat like bonds by providing stable cash flows. Because these assets can be improved and expanded, their principal value can grow over time. The best opportunity for capital gains comes from investments involving development risk or monopoly businesses.

Infrastructure investments offer a variety of risk-and-return profiles. Infrastructure investments range from low-risk regulated assets to moderate-risk loosely regulated entities such as energy production. The assets offer varying amounts of inflation protection and different levels of vulnerability to economic cycles. It is important to note that while these assets all are considered the same asset class, not all of them exhibit the same risk-and-return behavior.

What is the Infrastructure Opportunity?
Global demographic trends are driving the need for infrastructure construction in the world’s developing economies. China and India have shifted from agrarian to industrial, urban societies. These countries require new, modern infrastructure in order to facilitate expansion of industry, urbanization of their economies, and manage the effects of continued population growth and an expanding middle class.

In the developed markets, basic infrastructure was constructed in the mid-1900s and now is old and dilapidated. The percent of gross domestic product spent on infrastructure in most developed economies has been declining for decades, leaving a crumbling legacy. This entire supply of old infrastructure needs to be repaired or replaced.

In the United States’ crumbling infrastructure has been well-documented over the past few years. U.S. infrastructure currently holds an average grade of “D” (see table 1).

But U.S. funding levels as a share of all federal expenditures are exactly the same as more than 20 years ago, and the supply of capital for projects is dwarfed by the demand for infrastructure. This demand is driven by aging facilities as well as population growth, urbanizations, and economic and political climate.

Over the years, the U.S. government has pushed responsibility for growth and upkeep of the nation’s infrastructure onto the states. The states have been unable to meet the capital requirements of this task. The recent economic downturn has reduced all of the usual sources of revenue for states. Real estate...
taxes, income taxes, and sales taxes all have declined precisely when the need for capital is greatest. By law states are prohibited from incurring budget deficits, so they are unable to generate capital for essential infrastructure improvements. Some now are courting private investors in order to fill budget gaps. Recent federal government stimulus focused on infrastructure also has directly benefited this sector in the near term.

For investors, global listed infrastructure provides another “club” in the golf bag and alternative access to a dynamic market opportunity. The liquidity and transparency of listed infrastructure are attractive in today’s opaque investment environment, and so is its ability to generate income and total return in a volatile economy.

**Benefits of Global Listed Infrastructure Investments**

Investors who responded to a recent survey conducted by Capital Innovations Institute in July 2011 listed the following as the top attributes of an attractive investment:

- Diversification
- Liquidity
- Reasonable fees
- Valuation and daily market pricing
- Transparent corporate governance
- Active management and value creation

Global listed infrastructure can provide these attributes in a straightforward framework, which positively differentiates it from many other complex, unlisted (private equity type) investments.

**Diversification.** Any investment strategy has a series of risk-and-return elements. Global listed infrastructure permits investors to diversify across sectors, which may help to ameliorate some of the risks inherent in infrastructure. These risks include regulatory risk, demand risk, and interest rate or refinancing risk. Diversification across regulatory sectors, physical assets, currency exposure, and political risks (country or region) helps investors construct portfolios that achieve desired risk-return profiles or risk-budgeting processes. This can be achieved in a global diversified portfolio of holdings.

**Large investment universe that provides liquidity.** Investors may access investment vehicles, separately managed accounts, and mutual funds, all of which have liquidity that is unavailable in direct project finance deals. This liquidity feature allows investors to easily put money to work and trim global listed infrastructure exposure to maintain asset allocation models.

**Reasonable fees.** Investment portfolio fees challenge investors and portfolio managers alike when it comes to investment performance. Listed infrastructure transaction fees typically are lower than private infrastructure transaction fees. An actively managed portfolio of global listed infrastructure investments at institutional pricing can be more attractive than buying the benchmark and paying active management fees.

**Valuation and daily market pricing.** Unlisted infrastructure valuations are performed by an independent auditor or administrator. But because listed securities are exchange-traded and market-priced, global listed infrastructure investors enjoy price and valuation transparency.

**Transparent governance.** Listed companies are subject to examination by regulatory authorities, governments, investor advocacy groups such as UNPRI/UN Global Compact, labor unions, and the media. Listed companies have increased focus on social issues, the environment, and governance.

**Active management.** The value proposition behind active investments in global listed infrastructure securities can be seen in the composition of frequently used benchmarks. The Macquarie Global Infrastructure Benchmark consists almost entirely of global listed utilities companies (approximately 90 percent). The S&P Global Infrastructure Benchmark is more diversified and consists of utilities companies (40 percent), transportation companies (40 percent), and energy companies (20 percent). Active portfolio management in the global listed infrastructure sector provides the ability to generate significant returns while avoiding unwanted sector concentration in the benchmark. Additionally, stock market volatility has risen, creating a greater dispersion of returns among individual stocks and expanding the scope for active managers to distinguish themselves from a benchmark.

**Risks and Rewards**

Research presented at the 2011 GAIM USA Conference by Jerry Stevens, PhD, senior consultant and economist for Vantage Consulting Group, reveals how selective use of well-defined segments within real asset classes enhances the overall portfolio risk-and-return profile beyond what can be achieved with more-traditional combinations of broad asset classes.

Investing in global listed infrastructure allows investors to add income and further diversify portfolios, and thereby improve overall long-term performance. Investors add an asset class that is relatively uncorrelated to the aggregate portfolio (see table 2). If history is an indicator, stock market recoveries have come in relatively short bursts and outperformance has occurred in a select number of sectors; infrastructure has been one of these sectors. As markets continue to rebound from lows, global listed infrastructure is well-positioned to capitalize for investors.

Historically, infrastructure stocks typically have experienced annual dividend yields of 5.15 percent while traditional stocks have yielded 4.37 percent, and bonds have produced 4.29 percent. These yields and growth potential make infrastructure stocks attractive during economic booms and busts, particularly compared with the long-term performance characteristics of common stocks and bonds (see table 2).
Investment Outlook

Global growth dynamics continue to drive investment in infrastructure worldwide. Population centers in Latin America, China, and India are experiencing growth in infrastructure investment over multiple sectors including regulated utilities, transportation, and social infrastructure. This infrastructure investment growth is necessary for these regions to accommodate burgeoning populations (see table 3).

In contrast, the United States and Europe have different demographic trends. The developed countries need to rebuild existing infrastructure, so these countries will focus on investment in “brownfield” (existing infrastructure) and “rehabilitative brownfield.” Emerging market countries need to build infrastructure from the ground up; their focus is “greenfield” projects.

Economic concerns regarding short-term deflation and long-term, worldwide inflation are persistent. Exposure to a diversified pool of infrastructure securities can be beneficial to investors in both scenarios (see figure 1). Post-credit crisis, short-term deflation has proven a pervasive determinant, creating a difficult market in which to operate or invest. Falling consumer prices and excessive market volatility have further hindered investors. The market as a whole is volatile, offering opportunity for either outperformance or underperformance.

Investors now face a common predicament: How do they position themselves for this swing in inflation without tactically reallocating too much? In response to this challenge, institutional investors, investment consultants, and retail investors are committing double-digit percentages of their portfolios to four specific asset classes: equities, natural resources, real estate, and global listed infrastructure securities. These asset classes will act as hedges against increasing prices or inflation over the next 3–5 years.

Banking woes in Western Europe, combined with spillover from Eastern European financial institutions, are causing sovereign-debt problems in several European countries. Therefore we continue to focus on North American investment opportunities, with a bias toward companies with a global footprint. These are the companies that have the ability to hedge currency risk and negotiate long-term contracts that generate inelastic revenue streams for our institutional investors.

During this period of increased volatility, investors are struggling to find reliable asset classes that offer potential for dependable, long-lasting performance and short-term liquidity. Thus, security selection will remain critical. Infrastructure, however, offers inelastic demand, stable cash flows, and protection from inflation. Who said sewage is not sexy?

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**TABLE 2: INFRASTRUCTURE STOCKS PROVIDE RETURN ENHANCEMENT TO STOCK AND BOND PORTFOLIOS**

<table>
<thead>
<tr>
<th></th>
<th>Bonds</th>
<th>Common Stocks</th>
<th>Infrastructure Stocks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annualized returns</td>
<td>6.52%</td>
<td>0.83%</td>
<td>10.86%</td>
</tr>
<tr>
<td>Annualized volatility</td>
<td>5.89%</td>
<td>15.31%</td>
<td>12.95%</td>
</tr>
<tr>
<td>Infrastructure Correlations</td>
<td>36.44%</td>
<td>45.53%</td>
<td></td>
</tr>
</tbody>
</table>


**TABLE 3: POPULATION GROWTH**

<table>
<thead>
<tr>
<th>Age</th>
<th>China</th>
<th>India</th>
<th>Mexico</th>
<th>Western Europe</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>0–19</td>
<td>30.9%</td>
<td>41.3%</td>
<td>41.0%</td>
<td>22.6%</td>
<td>27.7%</td>
</tr>
<tr>
<td>20–39</td>
<td>33.5%</td>
<td>32.2%</td>
<td>32.7%</td>
<td>26.6%</td>
<td>27.6%</td>
</tr>
<tr>
<td>40–59</td>
<td>24.8%</td>
<td>18.9%</td>
<td>18.1%</td>
<td>28.7%</td>
<td>27.9%</td>
</tr>
<tr>
<td>60+</td>
<td>10.8%</td>
<td>7.65</td>
<td>8.2%</td>
<td>22.1%</td>
<td>16.8%</td>
</tr>
</tbody>
</table>


**FIGURE 1: WORLDWIDE INFLATIONARY ENVIRONMENT**

Rising Inflationary Environment
- Equities
- Natural Resources
- Real Estate
- Infrastructure

Falling Inflationary Environment
- Bonds
- Real Estate
- Infrastructure
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