

When we say
infrastructure we mean



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The case for global infrastructure



More education is necessary on infrastructure, and where exactly it fits into a portfolio. Krystine Lumanta reports.

Infrastructure as an asset class only started to gain some attention maybe five or 10 years ago. However, after demonstrating the benefits of a stable income stream and inflation protection, it's finally come into its own.

Financial planners now recognise infrastructure as an appropriate investment for their clients. But before further allocations are made to these assets, more education about the two infrastructure types - listed and direct (or unlisted) - needs to get out to the marketplace.

Tom McDonald, portfolio analyst at Russell Investments, describes infrastructure as the assets that provide the services essential for a functioning economy, such as energy, transport and water.

"These are all kind of mundane as-

sets," he says.

"But in effect, they're of paramount significance to a given society; and by investing in infrastructure, whether listed or unlisted, you're essentially buying into assets which are designed to improve the standard of living of a given community or society.

"That's the fundamental premise behind infrastructure."

Sarah Shaw, emerging market specialist at AMP Capital Investors, says that the Australian market generally understands infrastructure well after being an earlier adopter of the alternative asset class.

"With any new asset class, it takes time for it to earn a spot in a portfolio allocation decision," she says.

"We took a big step [backwards] in 2009, and that was the result of...a number of collapsed [vehicles] that burnt Australian planners a little bit and Australian investors.

"But what I would point out going

into this cycle is that Australians recognised their problem back then - the ones that have survived have won, cleaned up their balance sheets, they're not borrowing to pay dividends any more and they're being operated as infrastructure assets, as opposed to financial gearing products, today."

Shaw says the goal, therefore, is to make planners comfortable with the asset class and educate them of the differences it has to offer.

"Australia makes up quite a small component of the global infrastructure universe and their relative compatriots were nowhere near the same scenario," she says.

"And if I just take the emerging market universe as an example, they're gearing as a group, and if you consider that they're growing rapidly and investing heavily, they're new to this - it's 25 per cent net debt to market EV [enterprise value]. That's low.

"The developed markets are higher than that, but it's well below what we're seeing in the Australian market, so I think that's somewhere where we have to move the planners a bit more."

McDonald says the asset class is still in its "embryonic" stage and like any new asset class, planners are tentative and sceptical about its validity and strength.

"While there's a good degree of lower correlation with global equities in general, during the GFC you saw listed infrastructure correlations tightened up with equities, meaning that they both fell roughly at the same pace," he says.

"And the same happened to international listed property.

"Advisers look at what happened during the GFC and say they're still susceptible to any downdraft.

"However, if you look at the period following, listed infrastructure has far and away outperformed any developed global equity market.

"A value-oriented, glass-is-half-full kind of view, is to look at the GFC period and see infrastructure assets...as a real asset that has a steady cash-flow stream and will deliver returns, because it's essentially linked to the raw survival needs of a society."

ROLE AND ALLOCATION

In the current environment, with equity markets routinely dropping two to three per cent a day, this makes a compelling investment case.

"It's the alternatives which are literally holding the ground of a portfolio and are truly God's gift to a diversified fund," McDonald says.

"They're definitely doing what they've been intended to do...and effectively make portfolios less prone to violent swings in the market."

Shaw says planners are still figuring out where listed infra-

structure fits into a portfolio, and at the expense of which other asset class an allocation to infrastructure should be made.

"That's something I won't answer. I wouldn't want to dictate to people where they should get their allocation for listed infrastructure," she says.

"Some people take it out of general equities - and you do that to improve the defensiveness of the portfolio. Others would take it out of property allocation, and that would take your portfolio slightly up the risk-return curve.

"You can take it out of direct infrastructure, and that would basically increase your liquidity and your diversification to the asset class.

"And some people take it out of cash, [which] has a nice return, particularly here in Australia; but you can still get a stable yield of four or five per cent out of infrastructure plus growth."

Joseph Brennan, chief investment officer at Vanguard, says the role really depends on an investor's goals, horizon and risk tolerance.

"If you were an investor with a pool of assets that was maybe in a spending phase, less than an accumulation phase, your allocation might be a little higher if you were looking for inflation protection and defensive qualities," he says.

"You would still obviously justify some allocation even if you were in early accumulation phase and had a fairly high risk tolerance, because of the portfolio diversification that it can bring."

The right weighting to infrastructure is also a key consideration for planners, but the small allocation to date confirms its infancy, says McDonald.

"It's a very, very new asset class and by looking at the weightings that listed infrastructure is held in, in balanced or diversified portfolios, it usually only holds about a one, two per cent weighting.

"You can ascertain from that that people are still learning about it," he says.

"At Russell we advocate about two to five per cent in a portfolio and that's roughly what we invest in our diversified funds."

Shaw says it should come down to what's being held in the portfolio and its entire construction, and investing in infrastructure is ultimately a defensive strategy.

"You're trying to get strong defensive earnings with a solid yield and income stream and lower volatility than the broader equity market," she says.

"Now is this going to be your entire defensive allocation? If it was going to be part of a defensive strategy where you have bonds or cash, it could be a small allocation.

"If you're looking for yield, again, it depends whether you've got yield elsewhere."

Regardless of what the decided weighting is, Brennan says it's going to have benefits no matter what.

"It just really would depend on the goal of the particular pool of assets and the risk tolerance of the investor et cetera," he says.

"To place a specific recommendation, that would be [determined] investor by investor, portfolio by portfolio."

McDonald says the rapid growth of emerging markets also provides a compelling case for investing in infrastructure.

"It's not just in infrastructure, it's in equities and in every asset class, they're obviously playing a bigger role in terms of the investible opportunities," he says.

"It's a reflection of their success, their growth rates - like China, Indonesia or the Philippines where they're growing at breakneck rates of eight, nine, 10 per cent per annum - and their market clout, their growing dominance economically, especially considering their developed counterparts who are very much in decline right now."

Justin Lannen, portfolio manager at Macquarie Investment Management, says their funds are only invested in listed infrastructure and that their definition of "global" is across both developed and developing markets.

"We've found what are lots of good infrastructure opportunities in both the developed economies and also some exciting growth infrastructure in developing markets [like] China and Brazil," Lannen says.

He says infrastructure typically has a good dividend yield, particularly in the northern hemisphere.

"We think the dividend yields are sustainable, so the relatively high dividend yields are attractive to a lot of investors in the northern hemisphere because interest rates are so low at the moment.

"When you compare these assets to

the normal companies you see listed on the stock exchange, the income streams of most infrastructure assets tend to be a lot more reliable and predictable.

"A lot of our investors might compare infrastructure to global equities and if you do that, you'll see infrastructure has a much better track record so far and we've seen that in the most recent whack in the market.

"Listed infrastructure [investments] do a lot better in down markets than global equities do."

Unlisted infrastructure investments are subject to revaluations, but according to McDonald, they happen infrequently.

"Unlike an equity product, which is priced every day depending on demand and supply, unlisted assets and unlisted infrastructure [are] valued quarterly or maybe semi-annually," he says.

"This presents an obstacle to providing daily unit pricing because you're not actually sure in the interim periods what's happening to the asset class."

One of the most important issues for investors is liquidity, and unlisted assets pose an impediment on this front. Direct ownership may be subject to a "lock-up period" whereby an asset must be held for a minimum period, usually five, 10 or 15 years.

"So if there's a huge scandal involving that pipeline that you've invested in and you know its value is going to plummet, there's no way of actually divesting before your lock-up period is over," McDonald says.

"That's obviously a rather large disadvantage."

In addition, unlisted assets require huge buying power; therefore a standard portfolio is only able to invest in a handful of infrastructure assets, inhibiting diversification on both a sectorial and geographical basis.

McDonald says this pales in comparison to the diversification that's imported

from listed infrastructure assets.

“As an exaggerated example, an investor can have one dollar and invest [it] in a listed managed fund and effectively have it spread across 50 listed assets; so that illustrates the diversification benefits of the listed side of things.”

OPPORTUNITIES

According to Lannen, going forward, many opportunities are to be found in Chinese infrastructure, particularly transportation.

“Generally speaking, we’re seeing a lot of value in toll roads, particularly in Asia and Europe,” he says.

“Our valuations are telling us that those companies are attractive. We also see opportunities in North American oil and gas infrastructure that’s primarily investing in pipeline.”

Shaw says that although infrastructure is currently an “inefficient asset class”, by taking the time and effort to understand the asset and its cash flow streams, “we can exploit these inefficiencies and make some money”.

She says it’s a mistake for equities investors to assess companies based on a two- or three-year forward price-to-earnings multiple, as it will result in distorted valuations with listed infrastructure companies.

“You’ll totally miss the life of these assets - the maturity of these assets - and it’s a very quick example of where a general equity investor may miss the opportunity of infrastructure if they’re valuing it just on a couple of years’ earnings, particularly since they are capital intensive from the outset.

“For example, if you had a company that owned a toll road [with] a 50-year life and it’s in its second year trading on a [multiple of] 15 times earnings and you compared that to another toll road asset that had five years left of its road, so it’s

a very mature asset, trading at 14 times earnings, which is cheaper?”

Another opportunity Shaw sees is in global positioning, as it provides investor security across major developed markets where regulation is tested, corruption is perceived to be lower and provides a nice, defensive base.

But the biggest opportunity in global listed infrastructure is that it’s a rapidly growing universe.

“We have infrastructure in most developed markets...and taking it a step further to the emerging markets where they lag significantly in infrastructure development, those governments have finally realised that without infrastructure, they’re not going to evolve, so they’re spending copious amounts of money on it,” Shaw says.

The value in real assets lies in their ability to provide an inflation hedge, says McDonald.

“The nature of infrastructure assets, listed or unlisted, is that they’re very much linked to CPI and their respective countries,” he says.

“So if there’s runaway inflation in Australia, you have toll roads for instance, which are mandated to provide an increasing toll revenue at least by CPI. That provides a perfect inflationary hedge.”

RISKS

The biggest risk with infrastructure is the illiquidity disadvantage from unlisted assets, according to Vanguard’s Brennan.

“By investing in a liquid, diversified pool, you definitely mitigate that risk,” he says.

“What you see with unlisted is certainly with investors who are willing to take on illiquidity risk and sort of more greenfield risk, private project finance risk and single-deal risk, those types of things may be appropriate for some investors,

but you do pay the price of a higher risk profile for the potential higher return.

“Probably a lot of [financial planners] aren’t exposing their clients to unlisted infrastructure.”

Lannen says a risk for any listed investment, including Australian and global shares, is the volatility over a short-term period.

“You can invest in unlisted infrastructure and not have that day-to-day volatility,” he says.

McDonald says this is just the nature of being listed on an equity exchange.

“The saying ‘a rising tide lifts all ships’ - the reverse applies when you’ve got a falling tide, it obviously lowers or sinks all ships as well.

“That is, in effect, what occurs.”

There can also be discrepancies between an asset’s underlying value and its listed value. However, Shaw says for an active manager it presents big buying opportunities as it allows them to add alpha by taking advantage of that mispricing.

“These assets are listed securities priced daily, so there is an increased liquidity and volatility in owning a listed infrastructure security,” she says.

“But [if] the market misprices based on a flee to safety or getting out of it altogether, that gives us an opportunity to acquire assets significantly below what their value is.”

KNOW THE FUND, KNOW THE TEAM

Brennan says planners and investors interested in this space need to understand that not all infrastructure investments are created the same.

“There are nuances to really look at regarding which sectors a particular fund invests in, whether they invest in emerging and developed,” he says.

McDonald agrees and says a good managed fund will effectively favour

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companies with strong, stable cash flows and which operate in industries or sectors that have high barriers to entry.

“It’s these sorts of monopolistic assets that will provide very strong returns, so you need a fund that can effectively identify these kinds of assets,” he says.

“But also if you’re looking at active versus passive and you want to apply that to the global listed infrastructure space, a great example of active management in the field of infrastructure is that...you’re able to take action by reducing exposure to a certain sector or geography that has fallen out of favour.

“Infrastructure, as we’ve seen, is very susceptible to natural catastrophes or unforeseen events.”

McDonald says active managers aren’t “held hostage” to their benchmark so they are able to identify opportunities in other listed infrastructure assets that

are not available or part of their benchmark, such as an emerging economy.

A key differentiator between a listed versus a direct infrastructure investment is that listed investors are very focused on the existing management team, according to Shaw. Confidence in the management team’s ability to execute their plan and the history of that execution is something that planners need to be 100 per cent aware of and comfortable with.

“We meet the management, we visit the assets and make sure that they exist, and we meet the guy that’s operating the port and has done for the last 20 years,” Shaw says.

“And that differs from potentially a direct investor because they can buy the asset and change the management team so they don’t [necessarily] care what the management team is like.

“[You] need to assess the teams run-

ning these portfolios: Do they have the global exposure, do they have the global experience, do they have diversified experience?

“Make sure you know what kind of exposure you’re going to get and who’s running your money, as with any portfolio. This is a new asset class so you want people that have been looking at it for many years, you want people that are located in these countries that you’re investing in.”

In the hypothetical case of an asset being tied up with an unforeseen natural disaster, Lannen says there is a checklist of procedures.

“The first thing we’d look at is the level of insurance that the company has in place, and many infrastructure companies do have very large insurance [contracts] to protect the asset,” he says.

“We would also look at the impact on cash flows after the disaster and assess how that is going to impact the current earnings of the business.

“The last thing we’d look at is the impact on the regulatory environment going forward. In Japan there’s a question mark on nuclear generation and whether that’s safe anymore, so obviously the regulation around that is more risky now.” ■

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