Listed infrastructure overview

How is listed infrastructure coping in an environment of rising inflation and volatility?

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- Inflation forecasts have increased dramatically during the past year, and investors' expectations are shifting from thinking that inflation would be transitory to believing that it will become entrenched
- With interest rates on the rise, infrastructure, which has traditionally been seen as a "bond proxy" type of asset with cashflows highly sensitive to movements in interest rates, may not be the first port of call for investors
- However, we believe listed infrastructure merits a closer look not only because many of the companies within the asset class have cashflows that are linked to inflation, but also due to its role in the transition to a world of net-zero carbon emissions and as a potential beneficiary of other long-term structural trends, such as digital connectivity and demographics

The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Surging prices

What a difference a year makes. If in the spring of 2021, consumer price increases were considered a temporary phenomenon and not much to worry about, this year it is hard to ignore the pinch of the rise in the cost of living. Indeed, in April 2021, economists polled by Reuters were forecasting inflation for 2022 at a little over 2% in the US and at around 1.5% for the eurozone. Currently, those forecasts have been hiked to almost 7% for the US and almost 6% for the eurozone.

Rising inflation has hurt stockmarkets as well, in particular so-called "growth" plays, as illustrated by the steep decline into bearish territory (defined as a fall of more than 20% from the peak) of the tech-heavy Nasdaq Composite index in April. As inflation expectations seem to slowly shift from transitory to entrenched, investors are searching for assets that could potentially withstand better than others the corrosive effect of generalised price rises.

Historically, investing in infrastructure has sometimes provided shelter from inflation. For example, long-term data from 31 December 2002 to 31 March 2021 analysed by S&P Dow Jones Indices in a report last year[1] shows the Dow Jones Brookfield Global Infrastructure Index and the S&P Global Infrastructure Index outperformed the S&P Global Broad Market Index by an average year-on-year return of 3.1% and 2.4%, respectively, in high-inflation months. In low-inflation months, the Dow Jones Brookfield Global Infrastructure Index slightly outperformed the S&P Global Broad Market Index, while the S&P Global Infrastructure Index underperformed. Investors should note that past performance is not a guide to future performance.

The Dow Jones Brookfield Global Infrastructure Index seeks to measure the performance of pure-play infrastructure companies from anywhere in the world, and covers all sectors of the infrastructure market. The S&P Global Infrastructure Index is designed to track 75 companies from around the world chosen to represent the listed infrastructure industry, while maintaining liquidity and tradability. The index includes three distinct infrastructure clusters: energy, transportation, and utilities, in order to create diversification. The S&P Global Broad Market Index includes more than 14,000 stocks from 25 developed and 24 emerging markets.

Inflation hedge?

One reason why infrastructure can potentially be seen as an inflation hedge is that many of the income streams coming from these assets are linked to inflation. Contracts may stipulate that regular payments such as royalties should be linked to some measure of inflation or, in other cases, inflation-linked payments may be mandated by law – such as in the case of toll roads in some countries.

Of course, rising inflation also means rising interest rates, which are likely to affect infrastructure assets because of

[1] https://www.spglobal.com/spdji/en/documents/research/research-approaches-to-benchmarking-listed-infrastructure.pdf

Figure 1: MSCI ACWI Utilities vs MSCI ACWI

Past performance is not a guide to future performance.

Source: Bloomberg as at 31 December 2021. Rebased to 100 at January 2000.

the consequent increase in the rate at which their cashflows are discounted. When calculating the value of an asset based purely on its cashflows, the higher the discount rate for these cashflows, the lower the asset's value. However, this issue is not confined only to infrastructure assets; it affects virtually all companies' valuations.

To illustrate this point, while some investors consider utilities – an important sub-segment of infrastructure investing – to be highly sensitive to changes in interest rates due to their bond-proxy nature (as they offer regular cash payments rather like bonds' regular interest rate payments), over the past 20 years (spanning different interest rate environments) utilities have outperformed the broader equity market (see Figure 1).

In our view, that is partly due to the compounding of the healthy dividends that have tended to be paid in the sector, but also because utilities are increasingly seen as being at the heart of the transition to a renewable energy solution.

Something else to keep in mind is that real interest rates – adjusted for inflation – are still deep in negative territory. Some market observers are saying that central banks are likely to keep real interest rates negative for as long as possible, because this helps reduce debt burdens for both the public and the private sector.

Volatility on the rise

Another issue that is currently worrying investors is volatility. The VIX Volatility Index, also known as the "fear index", climbed to a year-high of 36.45 on 7 March and although it has come down since then, it was still trading around 33 in the last week of April, compared to 17 at the end of December 2021 and 18.6 at the end of April 2021.

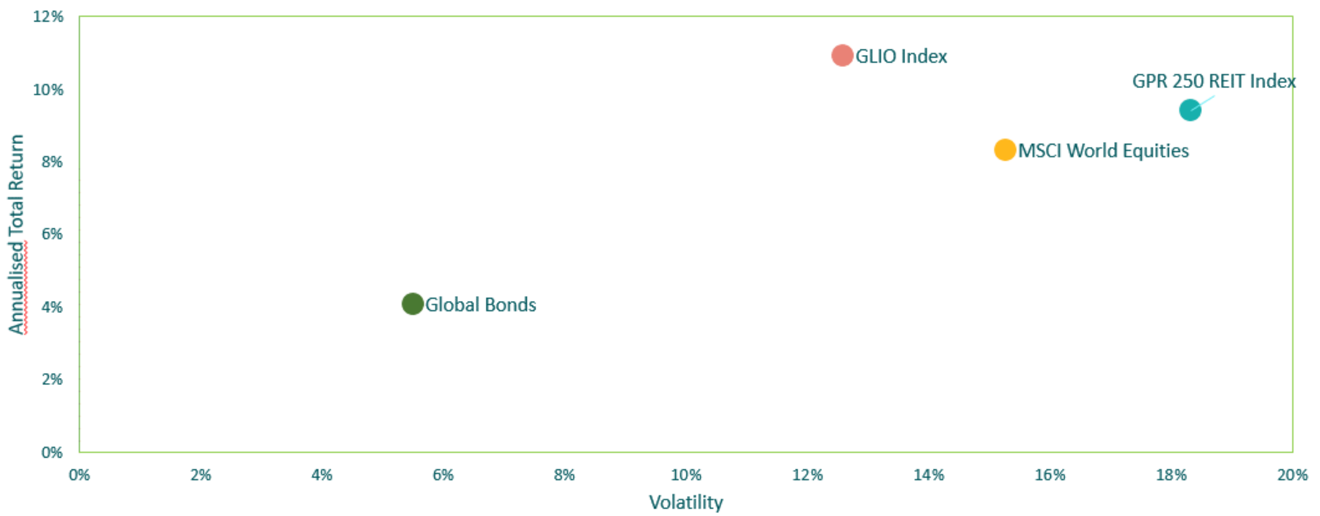
Russia's war on Ukraine, besides the immense human tragedy that it is causing, is the major factor behind the spike in volatility on financial markets.

The risk of over-dependence on Russian gas has been brought into sharp relief, not only because it is a politicised commodity controlled by an unpredictable regime, but also because the gas is transported through pipeline networks in eastern Europe. The spike in global natural gas prices after Russia cut supplies to Poland and Bulgaria in late April following their refusal to pay Russia in roubles is just one example of how the Kremlin's political decisions can deeply influence the wider global markets.

Infrastructure has historically offered some shelter from volatility. Data from the Global Listed Infrastructure Organisation (GLIO) – an organisation that raises investor awareness for the asset class through research, education, events and promotion – shows that listed infrastructure has delivered higher returns with lower volatility in the past two decades than global stocks or real estate. Global bonds, of course, experienced much lower volatility than listed infrastructure assets, but they also delivered much lower returns (see Figure 2).

One reason why listed infrastructure generally displays lower volatility than the wider market could be the higher degree of earnings predictability of companies within this asset class compared with general equities and even REITs. This facilitates more accurate valuation assessment, even during uncertainty.

Figure 2: Asset classes risk/return profiles – 20 years

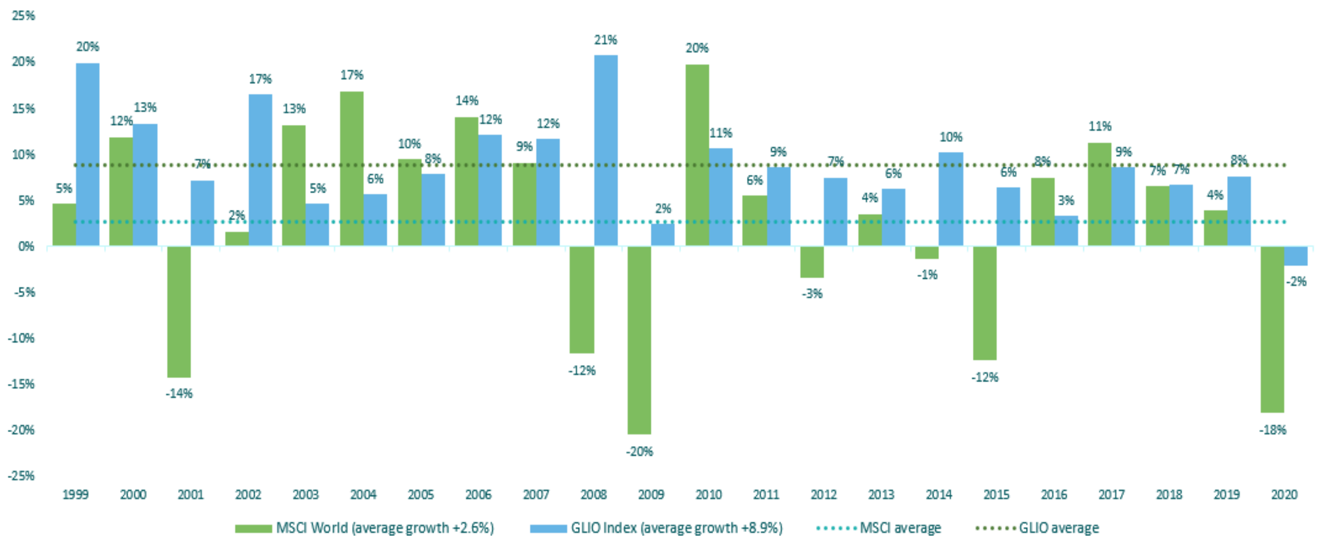


Past performance is not a guide to future performance.

The GLIO Index is a free-float weighted index that tracks the performance of the leading and most liquid infrastructure companies worldwide.

Source: Global Listed Infrastructure Organisation (GLIO), as at 31 March 2022.

Figure 3: Year-on-year EBITDA growth: GLIO Index vs global equities



Past performance is not a guide to future performance.

Source: Global Listed Infrastructure Organisation (GLIO) as at 31 December 2020, most recently available data.

A pre-pandemic comparison of the evolution of earnings before interest, tax, depreciation and amortisation (EBITDA) for the GLIO Index versus global equities shows that infrastructure earnings have held up better in the two decades before the COVID-19 pandemic than those of global companies in general (see Figure 3).

Recovery from the COVID-19 pandemic will most likely require big investment in the asset class globally. In fact, governments around the world have already announced various plans to invest in infrastructure to help support the global economy after the COVID-19 pandemic. In the US a US$1.2 trillion programme aims to repair, modernise and

expand America's crumbling infrastructure. The European Union has embraced the green agenda and is looking to promote renewable energy and clean transport.

Transition to 'net zero' carbon emissions

With environmental, social and governance (ESG) issues becoming more relevant for investors and portfolio managers alike, infrastructure assets such as those helping the transition to renewable energy are gaining in prominence. To reach "net zero" carbon emissions by 2050, US$50 trillion in investment will be required, according to estimates by Morgan Stanley[2]. Even if we assume that only a part of these investments will end up being implemented, there is a potentially long-duration opportunity that infrastructure investors could look to capitalise on, considering how essential infrastructure is to decarbonisation.

The infrastructure sector facilitates the transition to a net zero carbon world through the deployment of cleaner forms of generating energy, as well as the reduction or capture of existing carbon emissions. Infrastructure companies that use renewable fuels or transition ones such as natural gas, and those that already develop future fuels such as hydrogen, play a crucial role in the transition, in our view.

These policies may represent a favourable backdrop for the asset class, but they are not the only reason for our optimism. We also think that besides renewable energy, listed infrastructure is a potential beneficiary of other long-term structural trends, such as digital connectivity and demographics – powerful themes, which we believe will endure for many decades to come. In this environment, we are extremely optimistic about the long-term opportunities in listed infrastructure.

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[2] https://www.morganstanley.com/ideas/investing-in-decarbonization