Why listed infrastructure is an investment foundation

By Jason Beddow, Argo Global Listed Infrastructure

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Lower-volatility global infrastructure companies add defensive element to portfolios.

Equity market investors have had a wild ride in recent times, with major global share indices plunging in the latter part of 2018 before staging a strong recovery in the new calendar year. These turbulent conditions have turned investors' attention towards less volatile investments to reduce the market sensitivity of their portfolios.

Attracted by resilient cash flows, many investors have sought refuge in global listed infrastructure companies. With a lower correlation (relationship) to broader equities and historically low volatility, the asset class offers a "defensive layer" for investment portfolios while still offering excellent long-term growth prospects.

For Australian investors heavily exposed to domestic equities, infrastructure also provides the significant benefit of global diversification.

Downside protection and upside capture
Fears of a global economic slowdown, as well as tightening credit conditions and growing US/China trade tensions, weighed heavily on investor sentiment towards the end of 2018. In response, the MSCI World Index fell sharply, ending the volatile December quarter down -11.0 per cent in Australia-dollar terms.

Domestic equities fared only slightly better, falling -8.2% over the same period. Amidst the market turmoil, markets shifted from cyclical growth stocks towards more defensive assets.

In this environment, global infrastructure stocks significantly outperformed broader global equities. Over the three months to 31 December 2018, the benchmark FTSE Global Core Infrastructure 50/50 Index rose +0.1 per cent exceeding the MSCI World Index return by a remarkable +11.1 per cent.

In addition, as markets rebounded in 2019 when investors' appetite for risk returned, global listed infrastructure stocks posted a solid performance (up +13.9 per cent), only slightly trailing the broader global share market (up +16.5 per cent) in the first four months of the year.

These performance figures confirm the infrastructure asset class's ability to provide downside protection and upside capture.

This means, in a falling market, global listed infrastructure shares tend to fall by less than broader equities (downside protection) and, in a rising market, they can capture some, if not all, of the broader equity market's gains (upside capture).

Understanding global listed infrastructure
To understand the resilience of global infrastructure stocks, it is important to appreciate their underlying assets and fundamental characteristics.

Infrastructure assets are the real or "hard" assets critical to economic growth and the functioning of society.

This diverse group of assets falls into four broad categories:

- transportation (toll roads, ports, railways and airports);
- midstream energy (including pipelines and storage);
- utilities (including gas, electricity and water);
- communications (such as wireless communication towers and satellites).

Although infrastructure assets cover a broad range of industries, they have several shared features:

- **Stable and predictable cash flows**: The essential service nature of infrastructure assets means demand is reasonably inelastic. This generates stable and predictable cash flows, even in economic downturns.
- **High barriers to entry**: Infrastructure assets are costly to build and difficult to replace. This reduces competition and creates monopolistic market positions and pricing power.
- **Long-life assets**: As infrastructure assets are typically built to last 30 to 50 years plus, they provide long-term investment income.
- **Inflation-linked pricing**: Asset regulators generally take inflation into account when setting asset-pricing structures. This means that as inflation rises, asset operators are often permitted to increase user fees.

These common characteristics translate into steady, long-term income streams through various economic cycles.

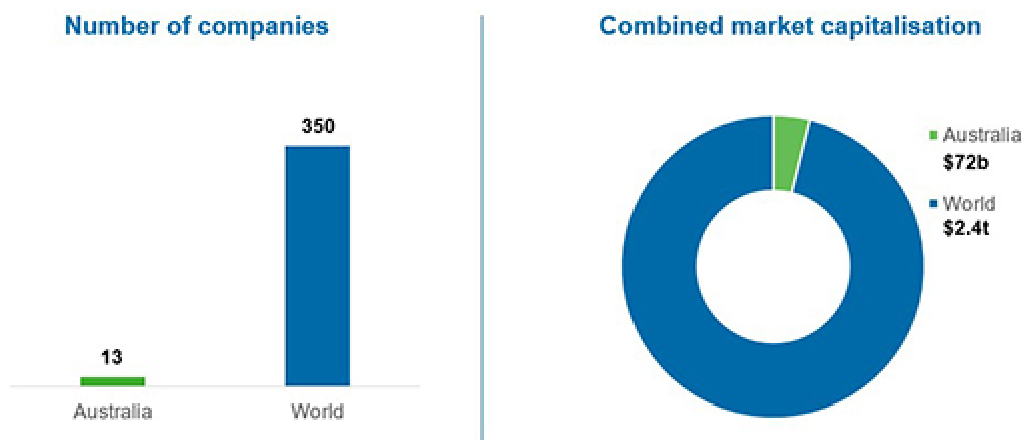
Listed versus unlisted infrastructure
Listed infrastructure companies own the same sort of assets as private, unlisted infrastructure owners, but with the added benefits of being exchange-traded stocks, such as transparency and daily pricing. This "equity wrapper" also provides considerable liquidity benefits when contrasted with direct infrastructure investments, which typically require large capital outlays, have long "lock-up" periods and often lack secondary markets.

The liquidity of global listed infrastructure companies ensures flexibility to quickly and easily adjust positions as opportunities arise and conditions change.

Offshore opportunities
Australia's listed infrastructure sector is mature and limited to about a dozen ASX-listed stocks, predominantly focused on toll roads, utilities and airports.

Furthermore, the three largest Australian infrastructure stocks account for approximately 60 per cent of the US$72 billion domestic-listed infrastructure universe.

In contrast, globally there are around 350 listed "pure play" infrastructure companies, across 16 countries. The combined market capitalisation of these stocks is approximately US$2.4 trillion, roughly double the size of Australia's entire share market.



Source: Argo

In addition to being large and liquid, the global listed infrastructure universe includes assets not accessible directly through the ASX, such as communication towers, satellites and water utilities. Investors can also access assets with much greater scale than their Australian counterparts. For example, Spain's listed airport operator, AENA, has 263 million passengers a year. In comparison, Australia's busiest airport, Sydney Airport, sees just 44 million passengers annually.

New listed infrastructure opportunities continue to arise as cash-strapped governments globally are turning to the private sector to fund much-needed infrastructure. There have been around 50 infrastructure Initial Public Offerings globally in the last four years.

Another general difference between Australian and global listed infrastructure companies is their growth and yield profiles. Consistent with other global equities, overseas infrastructure stocks typically have lower yields than their Australian counterparts. However, many global infrastructure stocks have far greater growth prospects than

Australian infrastructure shares, which tend to operate in mature environments.

Mitigating risks
Because infrastructure assets play an essential economic and social role, they are often heavily regulated, making them susceptible to the prevailing political climate. However, heavily-indebted governments worldwide need to provide an accommodating regulatory environment as their reliance on private-sector infrastructure investment increases.

As infrastructure assets are capital-intensive, they can also be sensitive to interest-rate movements, although sensitivity varies across subsectors. Infrastructure assets typically react negatively when interest rates rise. However, historical data shows that after this initial impact, infrastructure companies recover as investors again focus on fundamentals.

As with all investments, portfolio diversification helps mitigate a range of risks. The vast and highly liquid nature of the global listed infrastructure universe allows investors to easily construct a diverse and flexible portfolio.

An active investment approach is critical to ensuring a listed infrastructure portfolio is regularly adjusted to reduce exposure to varying country and company risks.

A specialist infrastructure portfolio manager with in-depth knowledge and on-the-ground insights into the regulatory and economic environment of individual countries and assets across the large infrastructure universe helps identify and mitigate market-specific risks.

Solid fundamentals
Structural, rather than cyclical, factors are driving the continued and increasing need for infrastructure investment, including compelling demographic trends and historic underinvestment. McKinsey Global Institute estimates that to meet expected global economic and population growth, US$3.7 trillion needs to be invested in infrastructure every year until 2035. With stretched balance sheets, governments around the world are turning to the private sector to meet funding shortfalls.

Despite the need for infrastructure investment, supply is not keeping pace with investor demand. There remains a scarcity of quality infrastructure assets worldwide and private-sector capital earmarked for investment in infrastructure has reached a record US$180 billion.

This pent-up private-sector demand is leading institutional investors to buy listed infrastructure companies to gain exposure to the underlying assets, often at stretched valuations, pushing listed infrastructure share prices higher.

Outlook
Despite the prospect of slowing global economic growth, the outlook for global listed infrastructure is positive. Supportive industry fundamentals, strong demand and record levels of private capital sitting on the sidelines point to the ongoing resilience of the asset class.

Offering investors defensive qualities and exposure to a diversified portfolio of assets, in terms of geographies and asset types, global listed infrastructure represents an attractive investment opportunity with excellent long-term growth potential. For Australian investors with investment portfolios that tend to be weighted towards domestic equities, the asset class is particularly compelling.

About the author

Jason Beddow is managing director of Argo Global Listed Infrastructure Company. Argo Global Listed Infrastructure (ASX: ALI) is Australia's only specialist, global listed infrastructure LIC. Investors can simply buy ALI shares through a sharebroker, as they would any other ASX-listed company. For more insights into global listed infrastructure and to subscribe for regular email updates, visit here.

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