Portfolio Resilience with Infrastructure Assets

Prepared by: Affin Hwang Asset Management

With little overlap against traditional asset classes, infrastructure assets provide an additional source of diversification to investors by virtue of its regulated and long-term contractual nature. Anchored by secular trends such as increasing urbanisation and decarbonisation, the sector is also poised to see an uplift in infrastructure spending that will propel growth.

In our latest Fundamental Flash, **Charles Hamieh**, Portfolio Manager of ClearBridge Investments shares his insights on infrastructure investing and outlook for the sector.

Charles Hamieh
Portfolio Manager of ClearBridge Investments

Questions

1 Global infrastructure spending is projected to rebound strongly in 2022 as countries like the US embark on aggressive fiscal stimulus to boost recovery in their respective economies. Is an infrastructure boom underway and what will drive infra spending?

We are on the cusp of a significant opportunity in listed infrastructure. The infrastructure sector has extraordinary public policy support. In the near term, as economies are stimulated to recover from the global pandemic and in the medium to longer-term, infrastructure plays an important role in decarbonising and mitigate the effects of climate change. As such, this boom in infrastructure investment will be a multi-decade phenomenon.

For one, infrastructure has been subject to underinvestment in recent decades, and its essential service nature leaves

little choice but to invest in its upkeep. U.S. infrastructure, for example, recently received a D+ from the American Society of Civil Engineers. In emerging markets especially we're seeing a nascent middle class and whole economies dependent on new infrastructure to get them to their next stage of growth. Climate change is also increasingly top of mind, and utilities especially will be critical in the energy transition as we move to decarbonise the global economy.

2

Post-pandemic, sustainability has been brought to the forefront of various governments' agendas who are looking to meet net zero targets and address climate change. Do you see any opportunities for sustainable infrastructure with this renewed green push?

Investment in infrastructure will be at the forefront of government efforts to address climate change. While public policy will play a significant role in funding lower-emission infrastructure, we expect governments will rely on the private sector and listed companies, in particular, to fund many initiatives.

Commitments to be net-zero by 2050 in Europe and many U.S. and Australian states, for example, will push investments in renewable electricity generation. The International Energy Agency's baseline case for the capital required in energy networks was recently $1.3 trillion needed annually on a global basis for the next 20 years, and $1.7 trillion in the sustainable scenario in which we meet the U.N.'s climate change target of 1.5%–2% of warming. Much of this spending will be on networks, transmission and distribution that will be concerned with changing the way we use electricity, gas and other energy grids. This will mean growth in the underlying asset base for infrastructure companies and regulators, providing attractive returns to equity holders to help fund that growth.

Addressing climate change also means repairing and upgrading water infrastructure. For example, the U.S. loses 7,000 Olympic-sized swimming pools of water every day from leaking pipes and burst water mains. Bringing water infrastructure up to standard will require a massive amount of capital.

3

Walk us through the investment process employed by ClearBridge in identifying opportunities in the infrastructure sector. How are stocks selected and what criteria are used before they are included in the portfolio's holdings?

Key to our philosophy is to take a long-dated private markets approach to assessing infrastructure assets and execute our views in listed markets. We have a benchmark-unaware investment approach that looks for long-term inflation-linked capital growth over an economic cycle with a focus on providing a reliable income. We do this by investing in a range of listed infrastructure securities across a number of infrastructure subsectors such as gas, electricity, renewables and water utilities, toll roads, airports, ports, rail and communications spread across geographic regions in both developed and emerging markets.

The investment process is mainly bottom-up. We build a proprietary investment universe of the most liquid, highest-quality, infrastructure companies globally that generate a sufficient level and quality of dividend yield. By high quality, we mean the expected predictability of future cash flows assessed with reference to the sovereign risks, regulatory environment, pricing transparency and volume predictability of the underlying assets and its operating environment.

We apply a valuation approach with excess return as the key metric from this group of high-quality companies. This is the difference between a company's expected return (before and after inflation) and its real required return, which considers its real cost of equity, its liquidity and its sustainability, which we price. These bottom-up risk/return characteristics account for about 80% of our portfolio construction, with macro factors and sector and region considerations accounting for the other 20%. The result is an appropriately diversified portfolio of 30–60 listed infrastructure securities.

4 With surging inflation on investors' minds today, what role can infrastructure assets play in a portfolio in terms of returns and yield?

Infrastructure provides an inflation hedge for portfolios. While regulation in different countries globally has various technical differences, they are essentially designed to protect the return utilities receive for capital investment against macroeconomic changes, including inflation. As such, rising inflation will rarely compromise the total return and yield outcomes of companies.

More specifically, as it relates to regulated utilities, rising inflation will have little impact on valuations, as inflation can be directly or indirectly passed through to customers.

Transport infrastructure is no different – think of the impact of inflation on Toll Roads. Rights to operate toll roads are typically granted under a concession that defines the parameters under which the toll road may operate, and in most cases, stipulates how toll prices may be increased. As a result, toll price increases are linked to inflation. So, user-pays assets typically see cash flows increase if there is a cyclical upswing in growth and inflation, with increasing valuations more than offsetting the impact of a rising cost of capital.

5 As we enter the new year, what's your broad outlook for markets and the investment strategy ahead? Any country/sector preferences?

Infrastructure looks well-positioned for 2022. Let's look quickly across infrastructure sectors. Utilities have trailed amid sharp cyclical rallies in 2021, but they tend to do better once the path of rate hikes becomes more certain, which we expect in 2022. Transportation should see a strong start to the year as growth returns and supply chain constraints ease. Continued negative real rates and high growth driven by 5G buildouts are bullish for communications infrastructure. Renewables had a poor 2021 until the runup to COP26 as focus returned to the enormous policy support for renewable energy: ongoing focus on reducing emissions should help the sector carry strength into 2022. Energy infrastructure benefits from further growth in production activity and higher equilibrium oil prices, and its role in nascent green hydrogen and carbon sequestration activities.

We have a base case of slowing growth and higher inflation, and our playbook for infrastructure portfolios broadly is to watch for a transition from growth orientation, in which we prefer higher exposure to economically sensitive user-pays infrastructure and lower utility weightings, to a more defensive positioning as growth fades and utility underperformance unwinds. In the base case, this will be a measured process throughout 2022, though we have an alternate view in which this transition will be accelerated. We'll look for defensive growth exposure through communications and high-growth utilities, including renewables, and we'll look to ensure strong inflation correlation with utility positions, including the use of midstream pipelines that would benefit from a structural change in the view of long-term equilibrium energy prices.

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