First State Investments

Colonial First State
Global Asset Management

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Investing in a low growth environment.

The Investment Report.

Unlisted Infrastructure

Time to shine

For starters, unlisted infrastructure plays a valuable defensive role in most institutional portfolios. Hence, a low-growth environment is precisely when this asset class is expected to shine.

The risk-return profile implied by the current and foreseeable macroeconomic environment is one with limited upside, but with the potential for large capital losses from 'black swan' events. This is not dissimilar to the risk-return profile of a typical regulated utility, where returns are capped by the regulator and where tail-risk events may exist on the downside.

There is a strong argument, therefore, that the performance of a well-managed core infrastructure portfolio should not be vastly different in a low-growth macro environment.

From a cyclical perspective, demand for essential services provided by water utilities and other regulated assets should remain resilient in the context of an economic downturn. In other words, these assets are 'low-beta' in nature.

However, the illiquid and long-term nature of unlisted infrastructure means that investors have the freedom to look through the economic cycle, and through short-term market noise.

This means focusing on the inexorable upward march of gross domestic product (GDP) per capita levels in a developing economy rather than the swings and roundabouts of year-on-year GDP growth. It means focusing on the step-change in renewables generation capacity rather than fluctuations in oil prices. It means assessing the permanent increase in propensity for international air travel from a newly-created Asian middle class rather than shorter term changes in an airport's passenger mix due to currency ebbs and flows.

Accordingly, we do not believe the current low growth environment warrants a change of strategy. Importantly, this includes avoiding the sort of 'style drift' that is currently being observed from other participants in the infrastructure market, who are looking to chase returns by moving higher up the risk curve into 'quasi-infrastructure' assets. Our experience over two decades suggests that this path has many potential pitfalls – foremost of which is the strong likelihood that these assets will not deliver the same defensive attributes as 'core' infrastructure assets.

Instead, there are three keys to investment in the current macro environment. One, maintaining an unwavering focus on tail-risk management. Two, focusing on sectors with structural tailwinds. Three, delivering returns through alpha. Let us deal with each of these in turn.

Risk management is perhaps not the most obvious way to deal with a low-growth environment, but it is important to understand this in the context of an unlisted infrastructure portfolio. A typical portfolio might have anywhere from 8 to 12 assets, which is far less diversified than a portfolio of listed securities, which might have hundreds of holdings. Risk management, therefore, is primarily about avoiding deleterious capital losses within the portfolio as much as possible.

One way of achieving this is by requiring strong governance to ensure an appropriate level of control over the portfolio assets. We typically have Board representation on our investee companies – in many cases owning 100% of the business. This acts as a tail-risk mitigant by allowing us to proactively steer management away from 'short-termism' or other value-destroying ventures.

Instead, we seek to ensure that long-term risks and opportunities, such as environmental, social and governance (ESG) factors are embedded in company strategy.

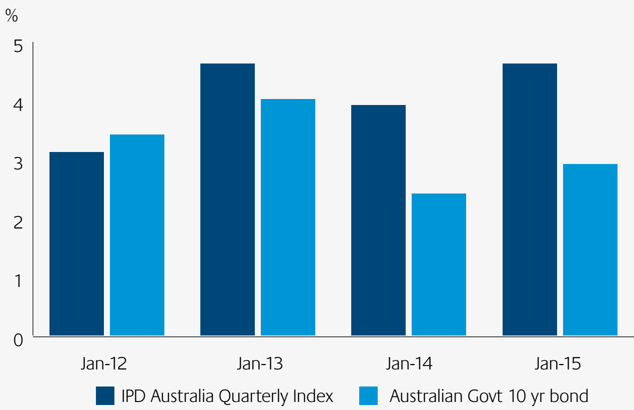
The second key is to ride tailwinds, not battle headwinds. Warren Buffett famously advised to 'only buy something that you'd be perfectly happy to hold if the market shut down for 10 years.' A similar logic applies to infrastructure assets, several of which exist in sectors undergoing structural change and transformation. These include generation (renewables displacing fossil fuel), rail (set to gain modal share as carbon pricing is widely adopted), ports (increased globalisation and trade), and toll roads (ongoing urbanisation). These structural growth trends will continue to unfold even in an environment of low overall growth. They also highlight why infrastructure is often described as a 'solution' for governments seeking to promote economic growth.

The third source of outperformance is delivering alpha via active asset management. In investment parlance, 'alpha' is uncorrelated with 'beta'. This roughly translates to the notion that manager 'skill' is (or should be) independent of prevailing market conditions. This is certainly true when it comes to managing infrastructure assets. Regardless of whether the broader economy is robust or sluggish, our asset managers are constantly seeking to implement initiatives in investee companies that either enhance revenue or trim costs – both of which add to profitability, and hence returns.

Two examples are the A$1.4 billion new parallel runway at Brisbane Airport, which is not expected to be operational until 2020; and the range of innovative projects Electricity North West (UK) has received funding for under the regulator's Low Carbon Networks Fund. Both are examples of initiatives where the ultimate payoff will be realised in years to come – with no indication of what the prevailing macroeconomic climate will be. These initiatives are also typical of our approach in managing assets with a wide range of stakeholders, often with competing interests.

Finally, no discussion of the implications of a low-growth environment for infrastructure would be complete without addressing the elephant in the room – the current 'lower for longer' interest rate environment. In an attempt to stave off the onset of economic stagnation following the global financial crisis, global monetary authorities have engineered the current environment of low government bond yields. Infrastructure yields therefore look relatively appealing to liability-driven institutional investors such as defined-benefit pensions funds and insurers as the chart below demonstrates.

Chart 1: Infrastructure yields look attractive relative to government bonds



Source: Bloomberg as at 21 Sep 2016.

This, coupled with the relative scarcity of high-quality infrastructure assets, has contributed to return compression.

This intense interest in infrastructure arguably creates more difficulties for investors than the weak macroeconomic environment itself (which, conversely, can be positive for investors insofar as fiscally-burdened governments seek to privatise assets and promote infrastructure spending). One potential solution for astute investors is to allocate capital to existing funds, which provide some insulation from aggressive bidding for 'trophy' assets while minimising execution and 'blind pool' risk.

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