

Institutional Investing in Infrastructure

At the Top of the List

Listed Infrastructure Managers Make Their Case

by Drew Campbell

Listed infrastructure managers have had a more difficult time than their private equity counterparts convincing plan sponsors their strategies are worth a commitment. While listed infrastructure has a lot to offer, many investors are still learning about the strategy and seem to want more information about performance expectations and how the market is defined before committing capital.

All investors want a degree of certainty about how an investment will perform before handing over their capital to a manager, and plan sponsors — stewards of employee retirement assets — tend to want more assurances than most. When investment managers and consultants in the United States proposed infrastructure investment — long-lived assets with consistent stable cash flows — it looked like a perfect fit. Plan sponsors could match these long-term cash flows to their schedule of retirement benefit payouts.

The ramp up, however, has been slower than some anticipated. The recent financial market collapse is partly responsible, and with a new and complex asset class such as infrastructure and plan sponsors' cautious nature, it's understandable that these investors are not jumping in with more gusto.

What might be more difficult to understand, at least to someone looking from the outside in, is why more plan sponsors have not chose publicly listed infrastructure as a first step into the asset class. Logic would suggest that for several reasons listed infrastructure makes sense for a new investor: The threshold for a commitment is typically lower than a private equity vehicle — sometimes as low as \$5 million to \$10 million versus up to \$100 million for private investments. A wealth of information comes with listed products traded on regulated exchanges, offering investment staff the ability to understand the differences in utilities regulation between regions or which markets are toll road friendly and any number of topics across the range of infrastructure assets.

"There are very different regulatory environments and different risks that are analyzed and underwritten," says Craig Noble, portfolio manager with Brookfield Investment Management. "A listed investor also can get insight into things as basic as the valuation similarities or differences for the private space and the listed space. That is helpful information when a plan sponsor is considering investment directly or in a fund just to know what some of the comps are in a pure set in each sector."

Listed strategies also offer investors diversification

across sectors and geographies and can make reaching a target allocation easier because of the highly liquid nature of public markets; commitments to private vehicles, on the other hand, can sometimes take years to be fully invested.

"A listed strategy adds diversity that a lot of plan sponsors can't get if they are buying directly into an infrastructure asset because the investor may only end up buying one asset or a share of one asset," says Connie Luecke, senior vice president of Duff & Phelps Investment Management Co. and co-manager of the Virtus Global Infrastructure Fund with senior vice president Randle Smith.

And investors planning to take their infrastructure program global also can do so relatively quickly with listed products.

"We recently spoke with a plan sponsor that recognized it would take too long to get global exposure if they were to invest solely in private vehicles," says Steve Dunn, director of institutional marketing with Cohen & Steers. "They went with a listed strategy now and plan to partially draw down the listed investments over time while building up a private portfolio."

So, listed infrastructure would seem to be a good way to move into this new asset class and get familiar with the market, but "actually, pension funds globally have tended to initially focus on investment in unlisted infrastructure with the growth in listed infrastructure funds being a more recent occurrence," says Andrew Greenup, portfolio manager, global listed infrastructure securities with First State Investments.

There are several reasons for this, including a concerted effort by investment managers to market infrastructure as a private investment — plan sponsors are deluged with information about these opportunities and listed infrastructure managers have to break through this in order to get their stories heard.

"It's true, infrastructure in the U.S. market has been marketed as a private equity investment, but during the past 12 months as people have homed in on their risk profiles and grasp how illiquid investments affect their portfolio, we have been seeing a pick up in RFPs and RFIs for listed infrastructure," says Dunn. "Some are looking for data and information while others are making decisions to allocate to listed infrastructure."

THE LISTED INFRASTRUCTURE STRATEGY

Beyond the problem of being heard, there has been criticism leveled at the strategy itself. A top complaint is that

listed infrastructure is too closely correlated with the general equity markets.

“Our strategy exhibited a higher correlation during the global financial crisis than it has shown over the four years we have been managing money,” says Warryn Robertson, portfolio manager of the Lazard Global Listed Infrastructure Fund. “This crisis was unique. We entered an economic downturn through a financial crisis, and the question of leverage and debt was at the forefront of every investor’s concerns. Rightly or wrongly, infrastructure was perceived to have high exposure to leverage, more than was the case. During the panic investors wanted to increase cash holdings, and they sold across the board, including infrastructure, and so correlations with the general markets picked up.”

By some estimates the correlation between listed infrastructure and the general equity markets reached as

had a conversation with us, they will review their portfolio and find their true infrastructure exposure. They have some utilities, some in the transportations bucket, some in the communications bucket, but it is not classified as infrastructure.”

Listed infrastructure managers make the case that active management focused on the right sectors of the market will add value and is worth an allocation. But because the market is so new, it has bumped up against a chicken and egg issue — until there is long-term performance history the long-term value of listed infrastructure can’t be known.

However, as time passes and more performance history accumulates, data is published that validates what managers believe about listed infrastructure securities. According to *Infrastructure and Strategic Asset Allocation: Is Infrastructure an Asset Class?*,

about five years, it can be a challenge to get investors comfortable with an investment.

“As an investor you have to ask yourself what are you looking for infrastructure to provide,” says Dunn. “Private investments are illiquid and you can be locked up eight years to 10 years, or you can get comfortable with market volatility and daily pricing. The benefits of listed infrastructure include liquidity and diversification, transparency and more modest capital commitments. It’s a trade off.”

Managers say investing in listed infrastructure is analogous to listed investments in the commercial real estate market. Both real estate and infrastructure generate considerable cash flows. Similar to direct infrastructure, direct commercial real estate investments are illiquid, they tend to require larger commitments of capital, and investment holding periods are relatively long. REITs and other listed real estate securities, on the other hand, are highly liquid, capital requirements are lower, and it’s relatively fast and cheap to develop global real estate exposure. In real estate markets, many investors end up allocating to both direct and listed strategies, something managers anticipate also will happen in the infrastructure market.

The expectation for returns among managers is that similar to real estate securities, focused active management in certain infrastructure sectors can generate excess value over a benchmark for investors.

“What we have seen on the real estate side is that managers tend to be able to beat the benchmark much more frequently and with a higher degree of consistency than managers in general equities strategies,” says Noble. “That is because of the focus a dedicated real estate manager has, and we expect this to be the case on the infrastructure side as well.”

According to a January report by the National Association of Real Estate Investment Trusts (NAREIT), REITs outperformed the general equity markets during the past 10 years by roughly 10 percent. “I would take that a step further to say that REIT managers’ ability to beat the REIT index is impressive when you compare that to say a global equity manager trying to beat their benchmark,” says Noble.

Listed infrastructure securities are one product for plan sponsors to consider. The market is maturing, and to be successful investment managers and data providers will need to continue to refine their products.

high as 70 percent to 80 percent during the past two to three years.

“Yes, these companies have higher leverage, but they also have high margins,” Robertson continues. “In their defense, from 2007 to 2009 listed infrastructure companies raised \$80 billion to \$85 billion and a lot of this was because of their high margins, which tells me bankers felt their risk was much lower than the markets perceived.”

Robertson also points out that Lazard’s listed infrastructure portfolios have an average correlation to global equities of 50 percent.

The correlation with the general equities markets is an issue because most investors already have a general equities allocation, and the perception is that making an allocation to listed infrastructure could be redundant.

“It’s a valid question because there is infrastructure exposure in a global equity strategy,” says Noble. “Sometimes after a plan sponsor has

a January 2009 report sponsored by FAF Advisors and authored by Thomas Idzorek, CIO and director of research, and Christopher Armstrong, senior consultant, with consultant Ibbotson Associates, listed infrastructure investment can add value for investors: “Despite our initial concerns regarding the use of listed infrastructure indices to proxy the unique infrastructure asset class, we found empirically that the various listed infrastructure asset class proxies seem to offer a unique investment opportunity,” write Idzorek and Armstrong. “We also believe a number of investors will choose to gain exposure to infrastructure using the best available implementation vehicle, listed infrastructure stocks, just as they have used REITs to gain exposure to real estate.”

INFRASTRUCTURE AND COMMERCIAL REAL ESTATE

Because active management in listed infrastructure is so new and performance track records date back only

“That is our expectation for the infrastructure space as well.”

DEFINING THE MARKET

Another issue listed infrastructure is wrestling with is how a portfolio is built — is it primarily utilities and transportation, or should communications infrastructure be included? Do unregulated companies belong in a portfolio, and what is the role of social infrastructure? The components of the strategy have been around for decades, but their grouping under the infrastructure umbrella is new.

Asset manager Duff & Phelps launched its global infrastructure product five years ago, expanding an existing global utilities and communications product to include the transportation sector.

“When we looked at transitioning from a global utility product to a global infrastructure product, we really looked at how institutional investors approach infrastructure, and that is how we built our fund — to invest in the owners and operators of those assets,” says Luecke of Duff & Phelps. “For example, we don’t invest in the construction companies. They build infrastructure, but they don’t own the assets. A construction firm’s revenues are variable, they are not regulated, they don’t have inflation protection, and they don’t have long-term contracts. We felt that was an important distinction to maintain the integrity of infrastructure as an asset class,” Luecke says.

Lazard Asset Management, which has been managing listed infrastructure accounts for clients for four years, looks for what it calls “preferred infrastructure assets,” a distinction it says gets at the heart of what makes infrastructure *infrastructure*.

“It is not merchant power, and it is much more than utilities,” says Robertson. “We own companies with monopolies, inflation-hedging characteristics, regulated utilities for example — gas, water, electricity — toll roads and airports. We don’t invest in merchant power because they have to compete in the market — their pricing is determined by commodity price cycles, which invites excess volatility. We don’t invest in construction companies because they are linked to commodity cycles, and we buy the airport owner, not the airplanes that use the runways and terminals.”

So why should a plan sponsor peel away these particular sectors from global equities and place them under an infrastructure umbrella?

“What it comes down to is the stability and the growth of the underlying cash flows,” says Noble. “What you are getting are the characteristics that infrastructure investors are after — the long-term stable cash flows, high barriers to entry, high risk-adjusted returns and good growth because so much infrastructure needs to be replaced or built.”

TRACKING PERFORMANCE

The early infrastructure indices such as the UBS Infrastructure and Utilities Index and the FTSE/Macquarie Global Infrastructure Index are heavy on utilities and include subsectors

6). What does seem to be happening is that the benchmarks and products in the market are increasingly aligning with investors’ wishes.

“The character of the benchmarking universe is evolving,” says Dunn. “The early benchmarks — UBS and Macquarie/FTSE — were heavily weighted to utilities and included merchant power. It also used to be that most transportation assets were in government hands and could not be accessed, but that has changed over time and now investors can access more of those assets. Benchmarks are being refined to be more attractive to investors’ requirements. There has been a narrowing of the universe to focus on companies that deliver exposure to owners and operators of infrastructure assets and the investment

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such as merchant power, lending to the complaint that listed infrastructure benchmarks have not done enough to differentiate the market from general equities performance.

“We believe asset allocators should adopt a relatively narrow definition of the infrastructure asset class for strategic asset allocation purposes that centers on unique infrastructure,” note Idzorek and Armstrong with Ibbotson. “While there are no indices that directly measure what we are calling unique infrastructure, there are several relatively new indices or benchmarks designed to track the performance of the increasing number of infrastructure-related investment products.”

The differences between the several indices benchmarking infrastructure can be wide; for example, some are full of utilities, and others are not (see “Infrastructure Indices,” on page

characteristics investors want.”

In conjunction with Dow Jones, Brookfield Investment Management launched the Dow Jones/Brookfield Infrastructure indices in 2008. “Our approach is very much pure play infrastructure, and that is one of the reasons we teamed up with Dow Jones to develop the benchmark,” says Noble. “We like the capital-intensive companies that are the owners of the assets as opposed to the companies that built the assets or the materials company that make the cement that goes into the road. That is not our focus. Our focus is the toll road itself or the pipeline or the electricity transmission grid or the water distribution and treatment facility. It is those asset-rich companies that have high barriers to entry, that grow over the long term more or less in line with GDP, and more or less in line with inflation or more than

INFRASTRUCTURE INDICES

■ **Dow Jones–Brookfield Global Infrastructure Index:** a free float–adjusted, market capitalization–weighted index designed to track the performance of global listed infrastructure. The index was started in 2008 and has a back-filled history to 2003.

■ **Macquarie Global Infrastructure Index:** a free float–adjusted, market capitalization–weighted index designed to track the performance of global listed infrastructure. The index was started in 2006 and has a back-filled history to 2000.

■ **MSCI All Country World Infrastructure Sector Capped Index:** a free float–adjusted, market capitalization–weighted index designed to track the performance of global listed infrastructure. This index is a modified version of the standard infrastructure index that caps communication and utility sectors at 33 percent and applies the remaining 33 percent to pipelines, transportation and social sectors. The index was started in 2008 and has a back-filled history to 1999.

■ **S&P Global Infrastructure Index:** a free float–adjusted, market capitalization–weighted index designed to track the performance of global listed infrastructure. The index uses a modified market capitalization–weighting scheme designed to reduce single stock concentrations, and balances exposures across what they identify as two macro infrastructure clusters: a utilities/transportation cluster and an energy cluster. The index was started in 2007 and has a back-filled history to 2001.

■ **UBS Global Infrastructure & Utilities Index:** a free float–adjusted, market capitalization–weighted index designed to track the performance of global listed infrastructure. The index was started in 2006 and has a back-filled history to 1990. It is divided into several sub-components including:

■ **UBS Global Infrastructure Index:** a free float–adjusted, market capitalization–weighted index designed to track the performance of non-utility-related global listed infrastructure (transportation and communication).

■ **UBS Global Utilities Index:** a free float–adjusted, market–capitalization weighted index designed to track the performance of global utility companies (excluding subsector generation utilities).

■ **UBS Global 50/50 Infrastructure & Utilities Index:** a free float–adjusted, market capitalization–weighted index designed to track the performance of 100 global infrastructure-related securities, split evenly between utilities and infrastructure. The index was started in 2006 and has a back-filled history to 1995.

Industry Exposures

Industry Composition	Dow Jones Brookfield	Macquarie	MSCI ACWI Sector Capped	S&P	UBS Global 50/50 Infrastructure & Utilities	UBS Global Infrastructure & Utilities
Pipelines	27	6	15	26	3	6*
Utilities	36	89	33	38	48	85*
Communication	22	2	33	0	19	3
Transportation	22	3	15	36	29	5
Social	0	0	4	0	0	0
Diversified	4	0	0	0	1	0

Sources: Dow Jones, FTSE, Ibbotson Associates, MSCI, S&P, UBS

*Estimate

inflation, and which provide that good inflation hedge.”

CONCLUSION

Listed infrastructure securities are one product for plan sponsors to consider. The market is maturing, and to be competitive investment managers and data providers will need to continue to refine their products. The question of whether listed infrastructure securities track the general equities market too closely is out there, and managers will have to continue to show the market that these products do in fact deserve to be managed separately from a general equities strategy. ❖

Drew Campbell is senior editor of *Institutional Investing in Infrastructure*.

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Risks. Investing in any equity market presents risks. The risks of investing in infrastructure securities typically include: (i) government regulation of rates charged to customers, (ii) restrictions on operations and increased costs and delays associated with compliance with, and changes in, environmental and other regulations, (iii) increased competition from other service providers and (iv) technological innovations that may render existing plants, equipment or other products obsolete. Foreign securities also involve special risks, including currency fluctuations, lower liquidity, political and economic uncertainties and differences in accounting and disclosure standards. Some international securities may comprise small and medium-sized companies, which can be more susceptible to price volatility and illiquidity than larger companies.

RPF is Request for Proposal; RFI is Request for Information; GDP is Gross Domestic Product