Elston

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Elston Insights

Infrastructure: a reliable diversifier

- Infrastructure roll-out & renewal underpins modern economies
- Income streams are inflation-protected
- Infrastructure has both bond- and equity-like characteristics

Key drivers of infrastructure investments

The infrastructure sector is the fabric that underpins the modern economy: transport (roads, railways, airports, bridges), utilities (water supply, power grids, gas networks, electricity generation), and social (hospitals, schools). Investment into infrastructure themes can be driven by changing demographics, technological developments and environmental concerns. Current examples include increased demand for education by a rising global population, a greater need for healthcare services thanks to increased longevity, a transforming energy landscape as part of the transition to renewables and changing consumption habits for example the switch to e-commerce and the consequent requirement for warehousing.

US goes large on infrastructure

The US Inflation Reduction Act is the largest commitment ever made by the US to reduce carbon emissions, support climate solutions and advance sustainable technology. It is labelled "inflation reduction" to move the economy away from structural fossil fuel dependency which was a key driver of inflation in 2022.

The target is to provide $161bn over Clean Electricity Tax credits, $40bn to support air pollution reduction, transportation and infrastructure, $37bn in clean energy, $37bn in clean manufacturing, $35bn in conservation and rural development, $36bn in clean fuel and vehicle tax credits, and $27bn in building efficiency and electrification[1].

As well as supporting the economy, the Inflation Reduction Act is a huge support for the clean energy infrastructure sector that are enabling climate solutions and the transition toe net zero.

So large is the stimulus is that China, the EU and the UK are all thinking how best to respond to support (and protect) their own domestic clean energy industries in face of this material support for US clean energy industry.

[1] Blackrock: *The Inflation Reduction Act* August 2022

The benefits of an allocation to infrastructure

Traditional infrastructure companies (such as toll roads and power grids) have both equity-like and bond-like characteristics. The bond like characteristic is the inflation-adjusted income stream that is received as a tariff. The equity-like characteristic is the capital value of the project once constructed and de-risked if sold on to another owner. For this reason infrastructure is seen as a diversifier, and is less dependent on the economic cycle than say property which can be left vacant. Traditional infrastructure is currently attractive as an inflation-hedge.

Clean energy infrastructure companies are beneficiaries of government and private sector investment to enable the transition to net zero and also have (or will have) steady tariff-based income streams. Clean energy is currently attractive owing to the structural secular investment trend.

Infrastructure exposure can provide much-needed diversification within a wider portfolio. Generally, the infrastructure sector is less cyclical and therefore less volatile than other alternative asset classes.

It is in times of economic stress that the 'essential' nature of infrastructure becomes attractive, and traditionally – as a sector - it has held up better than straightforward equity indices. Moreover the opportunity for inflation-linked yield is significant. Infrastructure tariffs will typically have a mechanical inflation protection built into their contracts, meaning that investor income is not eroded. As part of a portfolio, infrastructure – the hard assets providing an essential service to the economy – can protect investors in both recessionary and inflationary periods.

Options for implementation

Infrastructure investment attracts long-term capital (e.g. from pension funds) but this is either direct or through institutional funds with investment thresholds that exclude access for retail investors.

There are also a number of ways that retail investors can gain exposure to infrastructure themes as part of a wider portfolio.

- Actively managed infrastructure OEICs: a manager selects listed infrastructure equities and bonds.
- Index-tracking infrastructure OEICs/ETFs: a fund/ETF tracks an index of listed infrastructure equities and/or infrastructure bonds.
- Investment Trusts: a manager selects listed infrastructure equities and bonds, but can also participate in direct infrastructure projects and hold unlisted securities. Premium/discount to an Investment Trust's NAV may vary depending on relative demand for its shares and may add a layer of performance complexity when managing a position.
- Long-Term Asset Fund (LTAF): a new type of fund a vehicle authorised by the FCA in 2021 that allows professional and retail investors access to illiquid assets with up to 50% in unlisted assets, and borrowing of up to 30% of net assets, with monthly redemptions after 90-day notice period.

Whereas the fund format (OEIC, ETF, IT, LTAF) determines the accessibility of the strategy, the selection of underlying holdings is the key determinant of investment outcomes.

In our view, the transparency, diversification and efficiency of of index-based exposures is attractive when considering this sector.

Summary

The infrastructure universe offers an array of attractive opportunities across sectors and regions, so are not exclusive to private markets. And while investment in infrastructure is intrinsically aligned with a longer-term approach, investors using daily dealing, transparent funds do not have to forego liquidity or regular price transparency as is the case in private markets. Deciding on risk-return potential, liquidity horizon and quality of underlying assets remains key in selecting both the fund format and the fund manager.

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