Global Listed Infrastructure Sector Wrap-Up

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Executive Summary

Morningstar has completed qualitative research assessments of eight global listed infrastructure investment strategies. This Sector Wrap-Up provides an overview of our key observations and a summary of our Morningstar Analyst Ratings.™

Our wrap concentrates on two issues preoccupying the thoughts of many investors and their advisers – inflation and income. We begin by examining arguments both for and against global listed infrastructure's ability to endure bouts of inflationary pressure. Many managers have used the inflation angle when promoting their strategies, and there are some fundamental reasons for expecting this to hold true. However, these arguments aren't foolproof, and empirical evidence gathered from academic research is far from overwhelming. While it's important to refrain from simply allocating to the sector on the basis of concerns over inflation, for those preoccupied by this prospect we believe a strategy with a very conservative definition of infrastructure is more likely to meet their needs.

We then move onto how well global listed infrastructure meets the needs of income-focused investors. At the underlying company level, the sector has delivered relatively steady dividend yields exceeding other equity sectors – in line with expectations. These yields can change over time, however, and their decline from 2009 – 12 is indicative of the sector's rising valuation. External factors such as currency hedge gains and losses and fund flows may also affect the stability of the actual distribution paid to unitholders. Listed infrastructure managers have acted to address these issues, but even so, investors assessing this sector in the context of meeting an income need should be aware of its potential shortcomings.

We conclude with our usual overview of the rationale for the changes to our Analyst Ratings, and those we designated Morningstar Medallists.

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Can Infrastructure Tame Inflation?

The infrastructure sector is often touted for its defensive characteristics. Our last Infrastructure Sector Wrap-Up, published in September 2012, proved that funds in this sector have indeed held up somewhat better than diversified equity funds in bear markets. That data, however, was dominated by the impact of the global financial crisis because the strategies' track records are only about five to seven years long. The GFC was a debt-driven shock to the global economy, but future shocks could have any number of causes and stocks could react differently than they did from 2007 - 2009. Some advisers may fear that adverse inflation will be the next global economic shock. Infrastructure managers generally maintain that the sector can withstand an inflationary episode. They have some reasonable justifications, but we think that argument should be viewed with a healthy dose of scepticism.

Fund managers often cite a few fundamental reasons for why listed infrastructure should perform better than other shares amid high inflation. These arguments are generally sound but, as explained below, each has potential flaws.

Superior Ability to Pass Higher Costs Through to Consumers

Two characteristics support the notion that infrastructure firms can pass on inflationary cost pressures. The first is that they often operate as monopolies, or near-monopolies, which affords them a high degree of pricing power. In many cities, for example, there is only one company that transmits electricity because there is only one set of transmission lines. Such monopolies don't enjoy endless power to set prices, of course. At least in developed economies, they are regulated by a government body. Regulators typically have considerable leeway to impose price caps or otherwise restrict the firm's pricing power.

Regulation actually facilitates the second characteristic: regular price increases linked to inflation. In some sectors, including utilities and toll roads, the prices charged by infrastructure operators are established in contracts agreed to by the firm and the regulator. These contracts often allow for periodic price increases in line with some measure of inflation. However, this doesn't necessarily guarantee that the firms and their shareholders will be perfectly hedged against inflation. The contracted price increases could easily lag the onset of inflation, and the inflation metric used could be an imperfect measure of the cost increases the company experiences. Plus, some managers are concerned that the cocktail of political pressure, stretched fiscal balance sheets and the perception that some infrastructure companies are earning excessive profits may lead to less favourable regulatory arrangements.

Low Variable Input Costs

Infrastructure assets typically cost significant amounts of money, but once they're up and running, they often require minimal ongoing cash outlays. For example, now that toll roads can charge consumers electronically, ongoing costs basically consist of occasional road repairs or upgrades. Theoretically, that leaves little room for their cost structure to be impacted by inflation. It would be dangerous, however, to apply this to all the stocks typically categorised as infrastructure. For example, some utilities found in infrastructure indexes generate a portion of their revenue through electricity generation, which requires that part of the business to continually buy commodities and such commodities are very exposed to a variety of external factors, including inflation.

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Essential Services

Infrastructure assets typically perform society's vital functions, such as distributing water and building roads. Demand for such essential services tends to be relatively inelastic. People continue paying for them, even during economically stressful times, because they can't live without them. This gives infrastructure stocks an advantage over most other types of firms because demand shouldn't falter if they need to raise prices. Many infrastructure firms do experience volume dips, though. For example, air traffic decreases when ticket prices go up and container traffic falls when global growth slows, potentially diminishing the revenues generated by airport and seaport operators, respectively.

These arguments don't address other key inflation-related risks faced by infrastructure stocks. Infrastructure firms tend to be more highly geared than the average company because they must make significant investments to develop the assets. Their relatively protected revenues typically afford them favourable costs of debt. But inflation naturally pushes interest rates up, which may force infrastructure firms looking to refinance their debt to pay higher interest costs. As mentioned above, they may be able to pass some of that onto consumers, but it would be a mistake to assume that all can recuperate those costs entirely. Additionally, infrastructure stocks are naturally vulnerable to the same equity market risks that plague all stocks. In particular, when interest rates rise, the discount rates used to value stocks also rise, naturally pushing their present value down.

The Evidence

The empirical evidence on this issue uncovered by academic research is less than compelling. Academic studies, including a 2012 paper by Maximilian Rödel and Christoph Rothballer published in the *Journal of Alternative Investments*, have generally failed to find any statistically significant evidence of infrastructure stocks outperforming other equities during periods of high inflation. Some studies suggested that American and British utilities fared relatively well, but later studies didn't confirm the findings. However, Rödel and Rothballer went further than their predecessors by trying to separate the infrastructure universe into sectors with high and low pricing power, and found that those sectors with the strongest pricing power may be better able to withstand inflation.

Like the arguments described above, however, these results should be taken with a pinch of salt. The data sets used in the studies aren't necessarily robust, in large part because inflation has generally been benign for the past 20 years, leaving few obvious periods for infrastructure stocks to prove their hedging abilities. Data on infrastructure stock returns stretching back further than 20 years is limited and difficult to string together because the widely used infrastructure benchmarks commenced in the 1990s or later. Even if there were robust data, however, predicting how the stocks will react to future inflationary scenarios is difficult. Inflation has many different causes and related economic environments, which all impact the costs and revenues of various sectors in different ways, and it's extremely tricky to isolate the impact of inflation from the various other economic variables in play.

The Point

Advisers and investors with significant concerns about the impact of potential inflation clearly shouldn't rely solely on infrastructure for all the protection they seek. But the fundamental arguments in favour of the sector's hedging potential do have merit, especially compared to equity-related alternatives. Many look to real estate investment trusts (REITs) because the rental income they generate adjusts to inflation relatively easily. That argument depends heavily on the property's lease structure though, and many leases are long-term in nature or may otherwise be somewhat insensitive to inflation. The stocks of gold miners can be similarly flawed as an inflation hedge because their prices can be heavily impacted by the market's opinion of management's execution or development prospects. Besides, the relationship between gold bullion prices and inflation is somewhat tenuous.

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So while we think advisers and investors should refrain from allocating to infrastructure based solely on inflation fears, we think relative defensiveness in that scenario could be part of the investment thesis. Those that are significantly concerned should consider a manager with the most conservative definition of infrastructure. **Vanguard Global Infrastructure** 16242 is the strictest strategy we cover. It only invests in regulated utilities, utilities focused on water or electricity distribution, and toll roads – sectors that have the soundest inflation protections. **Magellan Infrastructure** 15700 invests around half the portfolio in utilities with no commodity price exposure and thoroughly avoids competitive or regulatory risks in the other half. Similarly, **Lazard Global Listed Infrastructure** 13457 only invests in a subsector it calls "preferred infrastructure". Qualifying stocks must have monopoly-like characteristics, an explicit or implicit link to inflation in their service contracts, and sustainable levels of financial leverage.

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Infrastructure and Income

Meeting income needs is a commonly-cited goal for investors and their advisers. It's an understandable and yet increasingly tricky objective, given falling term deposit rates and historically low sovereign bond yields for many developed countries. Some may consider global listed infrastructure to be part of a potential solution to this conundrum. So, let's see how well it fits the bill. The estimated dividend yield of the companies held in these portfolios is our first stop.

Yields at the Underlying Company Level

During 2012, dividend yields typically hovered between 3.0 – 4.0% for the funds we cover. This is higher than global equities and global listed property, as represented by the MSCI World ex Australia and FTSE EPRA/NAREIT Indices respectively. Vanguard's 4.44% yield at 31 December 2012 was noticeably above peers – we consider this a function of its explicit preference for higher-yielding securities when constructing the portfolio. It's worth noting that this dividend yield calculation may understate company distributions earned by fund managers, as it omits actions like share buy-backs.

Table 1: Global Listed Infrastructure Strategies – Historical Dividend Yields, 2008 - 12

Fund Manager/Strategy	Ticker	31-Dec-08	31-Dec-09	31-Dec-10	31-Dec-11	31-Dec-12
AMP	18347	N.Ap.	N.Ap.	N.Ap.	N.Ap.	3.05
CFS Wholesale	15889	5.02	3.97	4.73	4.05	3.83
CFS FirstChoice	15003	N.Ap.	6.05	4.95	4.24	3.15
Lazard	13457	7.50	8.86	4.44	3.59	3.09
Macquarie	13287	6.70	8.10	4.10	4.83	3.52
Magellan	15700	9.70	4.03	4.51	3.97	3.31
RARE	14651	6.68	4.34	5.44	5.21	2.65
Vanguard	16242	4.62	6.19	5.00	4.62	4.44
S&P Global Infrastructure NR Hdg AUD	N.Ap.	N.Ap.	N.Ap.	N.Ap.	4.07	4.12
MSCI World Ex Australia NR AUD	N.Ap.	4.54	3.05	2.62	2.76	2.71
FTSE EPRA/NAREIT Dv TR Hdg AUD	N.Ap.	N.Ap.	7.49	3.63	3.76	2.65

Source: Morningstar Direct™

Table 1 highlights one key point – global listed infrastructure has become more expensive. The sector's falling dividend yield and thinning spread above global equities reflects investor enthusiasm for higher-yielding assets. Such securities were especially in vogue during 2012. But this all neglects capital growth, and total return. These falling yields have translated into higher total returns for investors in these strategies as shown in the following Figure 1.

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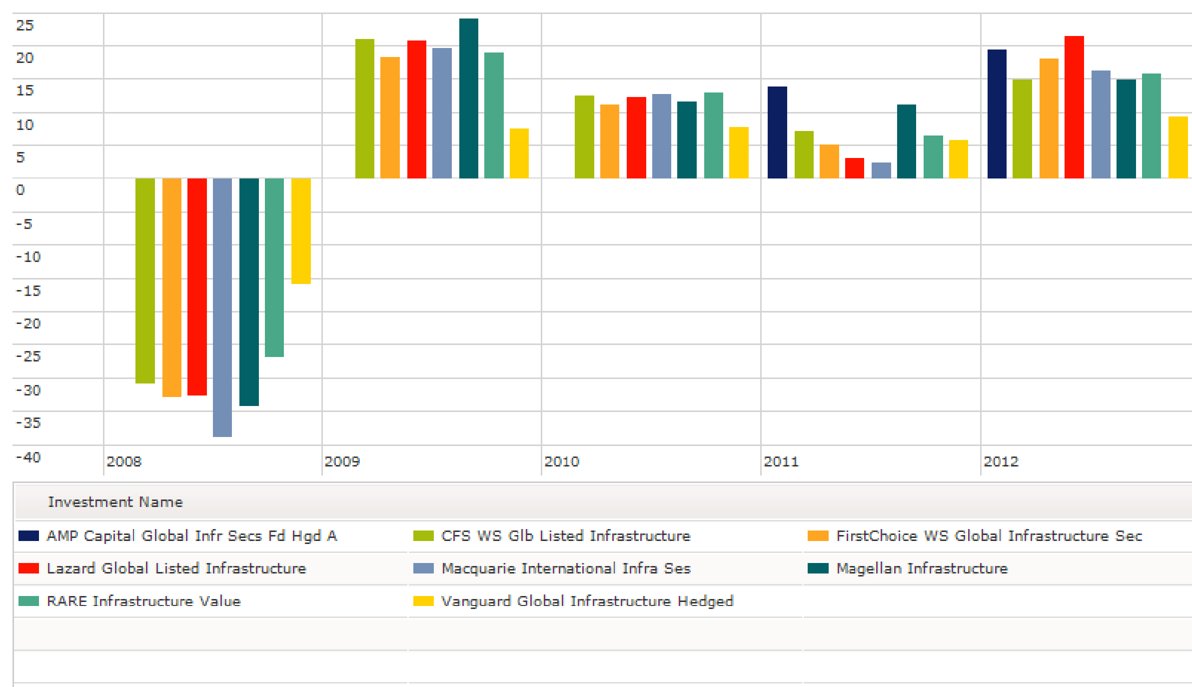
Figure 1: Global Listed Infrastructure Strategies – Annual Calendar Year Returns, 2008 - 12



Source: Morningstar Direct™

The total returns in Figure 1 bear little resemblance to the underlying dividend yield of the companies held. Double digit annual gains (and losses) were far more common than not during 2008 – 13. Dividend yields were closer to 3.0 – 8.0% over this span. Changing growth expectations and sentiment can greatly influence valuations. The changing perception of how much investors are willing to pay for this dividend stream can easily overwhelm its apparent stability.

Complicating Factors

At the underlying stock level, rising valuation multiples leave us cautious about expecting a repeat of the sector's historic appreciation. These companies need to keep growing faster than what investors expect to sustain further upward revaluations, and remember that they tend to exhibit relatively stable and predictable operations. Plus, there's always the potential for cost overruns, unfavourable regulatory decisions or large capital expenditure programs to affect shareholder distributions. Even if the sector meets growth expectations, investors may not be so amenable to a 3.0 – 4.0% yield if they became more optimistic about the global economy's outlook. Determining an appropriate valuation is highly subjective, and trying to second-guess the market is extremely difficult. A total return viewpoint that looks beyond headline yields enables investors to grasp the full picture as valuations fluctuate.

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We also need to examine practical aspects to the income global listed infrastructure can actually deliver to unitholders. Table 2 outlines the distribution frequency to unitholders.

Table 2: Global Listed Infrastructure Strategies – Income Distribution Frequency Periods

Fund Manager/Strategy	Ticker	Distribution Frequency
AMP	18347	Quarterly
CFS Wholesale	15889	Semi Annually
CFS FirstChoice	15003	Semi Annually
Lazard	13457	Quarterly
Macquarie	13287	Quarterly
Magellan	15700	Semi Annually
RARE	14651	Quarterly
Vanguard	16242	Quarterly

Source: Morningstar Direct™

Most of these vehicles distribute income quarterly. Magellan and the pair of CFS strategies pay semi-annually, the former switching from annual distributions in December 2012. This change is indicative of the renewed attention from fund managers to provide a regular income. Among sectors where income is often a key consideration, most Australian listed property and fixed interest strategies we cover distribute quarterly, with semi-annual payments more common for global listed property. A handful of fixed interest funds distribute monthly, but overall, global listed infrastructure is comparable to these other sectors. One small caveat is that distribution frequencies may differ for funds sold through platforms or wrap structures.

This is just the starting point. As outlined in previous Sector Wraps, while global listed infrastructure companies can deliver relatively steady dividends, this won't always translate into consistent income distributions paid to unit trust investors. A fund's income distribution should converge toward its underlying dividend yield over time (barring significant realised capital gains and losses), but there may be some sudden and large bumps along the way.

The industry-standard practice of currency hedging can periodically disrupt income distributions when the A$ falls sharply. This was starkly evident in 2009 – several strategies failed to pay an income return, despite relatively steady dividend yields on their underlying portfolios. Claims that the A$ is overvalued, at least compared to the US$, may make this especially pertinent. It's not an insurmountable obstacle, though, as **Macquarie International Infrastructure Securities** 13287 and **CFS Wholesale Global Listed Infrastructure** 15889 have both made a Taxation of Financial Arrangements hedging election enabling them to account for currency hedging gains and losses through the capital rather than the income account. This should minimise the effects of currency fluctuations on income distributions. These firms are yet to face a sharply declining A$ to test how this change works in practice, however.

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Table 3: Global Listed Infrastructure Strategies – Historical Income Distributions, 2008 - 12

Fund Manager/Strategy	Ticker	31-Dec-08 %	31-Dec-09 %	31-Dec-10 %	31-Dec-11 %	31-Dec-12 %
AMP	18347	N.Ap.	N.Ap.	N.Ap.	15.42	2.72
CFS Wholesale	15889	6.26	0.28	3.80	9.03	3.92
CFS FirstChoice	15003	4.75	---	6.27	2.85	3.07
Lazard	13457	1.46	---	1.76	12.40	6.35
Macquarie	13287	10.47	---	7.75	15.35	3.42
Magellan	15700	4.52	5.42	12.56	9.25	3.83
RARE	14651	7.10	4.37	5.07	10.99	4.54
Vanguard	16242	8.95	---	16.78	18.25	3.54

Source: Morningstar Direct™

Speaking of 2009, Magellan and **RARE Infrastructure Value** 14651 stood out for actually distributing income. This leads us to the next factor – fund flows. Magellan and RARE had large inflows that bulked up their assets base, and allowed the pair to earn more dividends to offset the currency hedge losses. However, inflows may complicate income returns in other situations. A fund that has a large inflow just prior to paying a distribution may face paying a lower percentage distribution yield to unitholders. For instance, it may collect dividends in January, receive heavy inflows during February and pay its regular distribution in March – thus diluting the yield unitholders receive because these dividends are spread over a larger investor base. Funds that distribute less frequently may be more at risk as there's a greater window of time to grow after receiving its dividends.

Outflows may also pose difficulties. Managers facing significant redemptions may have to liquidate portions of their portfolios and realise capital gains. These would be accounted for as an income return, often a very outsized one, and may be particularly unfriendly from a tax perspective.

Managers have safeguards to reduce the effect of fund flows on distributions, however. CFS Wholesale Global Listed Infrastructure has a trigger whereby it can make a special distribution if it receives applications or redemptions beyond 2.50% of the fund's net asset value. Vanguard has a similar mechanism – when redemptions hit 5.0% it can isolate the tax impacts from capital gains to the withdrawing investor and avoid spill over effects onto remaining unitholders. And when it comes to large inflows around scheduled distributions, managers can discuss whether an incoming investor is prepared to defer their investment until after this distribution. On the whole, we're yet to see any clear instances of inflows or outflows materially affecting the funds we cover, besides the aforementioned situation with RARE and Magellan in 2009.

These issues are not exclusive to this sector and part and parcel of the Australian unit trust structure. It's just an unfortunate reality that the actions of fellow unitholders can disrupt or accelerate income returns.

As such, all investors, income-focused or not, should continue to ask themselves the same basic questions: what am I trying to achieve with a global listed infrastructure investment, and how does it fit within my broader portfolio. The Australian unit trust structure creates additional complexities for investors seeking income, and global listed infrastructure is not immune to these challenges. But in truth, no perfect solutions exist. The sector has broadly generated an above-average dividend yield through different market circumstances, and over time this should materialise in the income distributions paid. Pleasingly, fund managers have been on the front foot here too, trying to better cater for this market desire, whether that's increasing distribution frequency or making a Taxation of Financial Arrangements hedging election. Even so, keep in mind that external factors may affect the consistency of these distributions, both in size and timing.

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Changes to Morningstar Analyst Ratings

We take a medium- to long-term outlook when determining qualitative recommendations. Our views about the merits of investment strategies move over time on the basis of manager-specific factors such as investment team composition, changes to investment process, and our degree of relative conviction.

In this review we did not make any changes to our Morningstar Analyst Ratings™. We initiated new coverage on one strategy, **AMP Capital Global Infrastructure Securities** 18347, at Neutral. This strategy possesses likeable features, notably a firm emphasis on quality when building the portfolio and some experienced personnel. Nonetheless, it has not been tested over a meaningful period in its current form since AMP Capital ended its joint venture with Brookfield Investment Management, while we harbour some concerns about turnover that can at times reach high levels.

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Changes to Morningstar Analyst Ratings

Investment strategies with Morningstar Analyst Ratings™ of Gold, Silver, or Bronze carry the tag Morningstar Medallists. These are the strategies that in our opinion truly stand out, and share common traits including a capable and stable team, robust processes, and an ability to deliver in a variety of market conditions.

We designated four of the eight global listed infrastructure strategies we assessed Morningstar Medallists (Table 4 below). Two attained an Analyst Rating of Silver, and we designated a further two Bronze. M

Table 4: Morningstar Medallists – Global Listed Infrastructure Strategies

Ticker	Fund Manager/Strategy	Morningstar Analyst Rating™
15700	Magellan Infrastructure	Silver
14651	RARE Infrastructure Value	Silver
15889	Colonial First State Global Listed Infrastructure	Bronze
16242	Vanguard Global Infrastructure	Bronze

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Appendix 1: Basic Data

Fund Manager/Strategy	Ticker	Morningstar Analyst Rating™	Morningstar Analyst	Start Date	Flagship Fund Assets A$m	Assets Date	ICR %pa
AMP Capital Global Infrastructure Securities	18347	Neutral	Tim Wong, CFA	30-Apr-10	17.37	28-Feb-13	0.85
Colonial First State FirstChoice Global Infrastructure	15003	Neutral	Kathryn Young	29-Mar-06	21.15	28-Feb-13	1.23
Colonial First State Global Listed Infrastructure	15889	Bronze	Kathryn Young	1-Jun-07	216.66	28-Feb-13	1.22
Lazard Global Listed Infrastructure	13457	Neutral	Kathryn Young	4-Oct-05	570.12	11-Apr-13	0.98
Macquarie International Infrastructure Securities	13287	Neutral	Tim Wong, CFA	29-Sep-05	429.51	31-Mar-13	1.03
Magellan Infrastructure	15700	Silver	Tim Wong, CFA	1-Jul-07	370.32	31-Mar-13	1.06
RARE Global Infrastructure	14651	Silver	Tim Wong, CFA	1-Aug-06	780.47	28-Feb-13	1.03
Vanguard Global Infrastructure	16242	Bronze	Kathryn Young	27-Nov-07	230.58	28-Feb-13	0.52

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Appendix 2: Portfolio Characteristics

Fund Manager/Strategy	Benchmark	No. Stocks	Max. Weight %	Min. Weight %	Expd Tracking Error %pa	Expd Turnover %pa
AMP Capital Global Infrastructure Securities	Dow Jones Brookfield Global Infrastructure Index A$ Hedged	35 – 45	Index +6.0	Zero	2.0 – 5.0	50.0 – 70.0
Colonial First State FirstChoice Global Infrastructure	UBS Global Infrastructure & Utilities 50/50 Index	N.Ap.	N.Ap.	N.Ap.	3.0 – 6.0	30.0
Colonial First State Global Listed Infrastructure	UBS Global Infrastructure & Utilities 50/50 Index	30 – 50	10.0	Zero	Not targeted	25.0 – 30.0
Lazard Global Listed Infrastructure	Consumer Price Index + 5.0%	25 – 50	15.0	Zero	Not targeted	40.0 – 60.0
Macquarie International Infrastructure Securities	S&P Global Infrastructure Index (Net Total Return $A Hedged)	30 – 60	7.0	Zero	Not targeted	30.0 – 40.0
Magellan Infrastructure	UBS Developed Infrastructure & Utilities Net TR Index ($A Hedged)	20 – 40	20.0	Zero	N.Ap.	10.0 – 20.0
RARE Global Infrastructure	OECD G7 Inflation Index + 5.50%	30 – 60	6.0	Zero	Not targeted	35.0
Vanguard Global Infrastructure	Customised index based on UBS Global Infrastructure and Utilities Index	115 – 130	6.0	0.10	Up to 1.0	10.0 – 20.0

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Appendix 3: People

Fund Manager/Strategy	Lead Manager(s)	Appointed	Years Exp	Team Size	Avg Yrs Experience	Avg Yrs Tenure
AMP Capital Global Infrastructure Securities	Tim Humphreys	2012	16	6	13	2
Colonial First State FirstChoice Global Infrastructure	Scott Tully	2006	23	7	15	6
Colonial First State Global Listed Infrastructure	Peter Meany	2007	16	7	12	4
Lazard Global Listed Infrastructure	Warryn Robertson, John Mulquiney, Matt Landy, Bertrand Cliquet	2005, 2007, 2011, 2011	20, 15, 17, 13	5	16	8
Macquarie International Infrastructure Securities	Brad Frishberg, Jonathon Ong, Anthony Felton	2010, 2012, 2012	23, 19, 14	8	16	6
Magellan Infrastructure	Gerald Stack	2007	18	6	11	3
RARE Global Infrastructure	Richard Elmslie, Nick Langley	2006, 2006	22, 14	13	2	3
Vanguard Global Infrastructure	Angus McLeod	2009	15	2	11	8

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