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Investing in infrastructure

The loose monetary policy measures employed since the Great Financial Crisis and the huge stimulus injections that governments have applied to cope with the pandemic this year have seen financial markets flooded with cash, which has pushed up equity valuations and left more than $17 trillion of bonds with negative yields.

This has raised the concern that returns from traditional asset classes have become more and more challenged and led many to question the viability of the traditional 'Balanced' portfolio of 60% stocks and 40% bonds.

Given we are in the festive season and it is traditionally a time for resolutions to be made, perhaps investors' thoughts should turn to 'New Year – New Portfolio'. It may be time to incorporate a greater long-term allocation to alternative assets, including commodities, hedge/absolute return funds, property, private equity and infrastructure. These are assets that historically have been 'optional' on the menu of investment opportunities but may well become a staple ingredient within a well-balanced portfolio structure.

Real assets

Infrastructure investing is of particular interest, given that it provides investors with exposure to 'real' physical assets such as schools, hospitals, roads, bridges and renewable energy (including wind farm installations and solar arrays). Historically, this investment has been available only to large institutional investors and pension fund managers happy to allocate capital for the very long term and accept the trade-off between the stable return profile offered by real assets and their lack of short-term liquidity.

However, there is now a range of structures – open-ended and closed-ended funds – offering all investors the opportunity to access underlying assets that have in many cases proved their resilience, given they often underpin much of the economic and social infrastructure of society.

In basic terms, the owners of infrastructure assets receive an income stream based upon either the simple availability of the asset over a given period ('availability-based revenue') or the level of usage of the asset ('demand-based revenue').

Toll roads and rail are examples of assets in the latter class that have had a challenging time in 2020 due to rolling lockdowns and reduced consumer activity. Schools, prisons, hospitals and renewable power generators are assets that have been generating a stable income from governments or government-backed agencies irrespective

of the macroeconomic backdrop. It is this stability in income – often index-linked and contracted over periods that run as long as 20 years – that helps underpin the value of these assets to investors.

Returns

The level of disclosure provided within the publicly available infrastructure fund universe means it is relatively easy for investors to compare and contrast the potential returns from assets and decide how best to allocate portfolio capital for the future.

Open-ended and closed-ended infrastructure funds offer attractive income yields that can be as high as 6%. They have a proven long-term track record in generating additional capital growth for investors. When compared with a yield to maturity on the UK 10-year Gilt of 0.3% and the 30-year Gilt of 0.9%, the underlying attraction of infrastructure funds is very clear – particularly in an environment where income itself is hard to come by.

Sustainability

The focus on ESG and the global progression towards net-zero carbon emissions are additional, policy-led tailwinds that should ensure infrastructure investment remains on an investor's radar for many years to come. Global ESG equity funds saw an inflow of $3.8bn in the last week of October – the 42nd week of inflows this year – and we are seeing almost weekly announcements from governments regarding their own 'green' initiatives.

In the UK we are looking to 'Build Back Better', including investment in EV charging infrastructure and renewable energy projects to achieve net zero by 2050. Further afield, the Australian government granted 'major project' status in October to a $36bn renewable energy initiative that aims to build the world's biggest power station and export green hydrogen from Western Australia to Asia and Europe.

Liquidity

The usual warnings should be borne in mind by investors. Underlying infrastructure assets are long-term by their very nature, so there is not a ready market to buy and sell them on a daily basis as we have with company shares and other tradeable securities.

There are, however, a range of open-ended (OEIC) and closed-ended (investment trust) vehicles that provide retail investors with an economic interest in the underlying projects that are owned within each structure. These provide daily liquidity and a generally high level of transparency and have appropriate levels of regulatory oversight. But one only has to consider the recent closing of property funds (at times of market stress) to understand that holding long-term assets within a daily traded open-ended structure can sometimes lead to liquidity mismatches when all investors are running for the same door – and we know this imbalance can often take time to correct.

Investment trusts, on the other hand, are unable to 'close', but the share price can trade at a premium or discount to the value of the underlying assets – and at times of market stress investors have often had to accept substantial discounts being applied to share prices in order to be able to exit and move on.

Diversification

Diversification within infrastructure exposure is important in terms of both geography and the underlying asset type. This helps to manage future regulatory and technology risk and to ensure that investments in this area continue to act as stabilisers within a multi-asset portfolio, smoothing the future total return achieved.

At James Hambro & Partners we currently favour a mix of both open-ended and closed-ended structures. We have a distinct international bias within all our funds and a particular leaning towards North American markets, where deal flow has been greater in recent years. Underlying asset exposure includes transport and health assets, renewable energy projects and economic infrastructure debt, all of which combine to provide attractive income yields ranging from 4-6% and the potential for future capital growth.

Spending guidance from authorities worldwide reflects the importance of infrastructure assets in improving everyday life. It also reflects their historical ability to boost economies. Chosen carefully and with an eye on valuations, these investments can play a similarly positive role within portfolios.