Manager selection and the broader role of listed infrastructure

By Julien **Barral** &
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'Silo' investment planning misses the reality that there's no one-size-fits-all in the infrastructure debate.

For pension funds and other large investors currently seeking global listed infrastructure managers or considering such an investment, three questions are frequently high on the agenda, based on bfinance's recent experience as an investment consultant focusing on strategy and manager selection:

- How does this fit within my broader portfolio, alongside existing investments in sectors such as unlisted infrastructure, listed equities and real estate?
- Does listed infrastructure currently offer more attractive valuations or better entry points than unlisted infrastructure?
- And, last but not least, what are the differences between the 50 global listed infrastructure funds[1] that are now available to institutional clients – a list which has grown by approximately 20% during the past three years?

Such questions have been thrown into even sharper focus by views from some quarters on listed infrastructure over the past 12 months. The points at the heart of the debate are not new: the high correlation between listed infrastructure and listed equity has long been well understood by investors, as is the case with REITs. Yet noisy critique has made it more important for allocators to enunciate a coherent case for listed infrastructure in their portfolios, and implement those investments in a way that is beyond reproach.

Vocal critics of listed versus unlisted infrastructure, while entirely right on a number of key issues, overlook several fundamental points. Firstly, the arguments are somewhat reliant on the concept of asset class silos, which is increasingly outdated among sophisticated asset owners. Most investments in any portfolio are either 'equity' (in that they represent >

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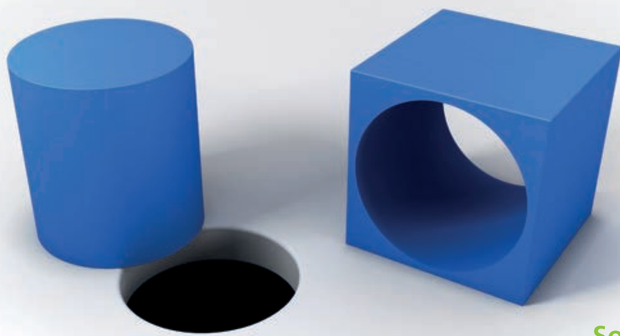
1 Source: List of dedicated Global Listed Infrastructure managers under the GLIO AUM coverage.

an ownership stake, whether the entity is listed or not) or 'debt'; even then, the lines between the risk exposures of defensive equity investments (including core infrastructure) and riskier lending activities are blurred. *#FakeSilos* can be administratively and conceptually useful, but they can also be dangerous.

Secondly, they may overstate the diversification characteristics of illiquid assets based on their less frequent valuation and their artificial resistance to NAV markdowns – forms of *#FakeDiversification* which many investors now seek to look beyond.



Thirdly, the criticisms understate certain important realities about the infrastructure market today. Those realities are now driving greater appetite for listed infrastructure and REITs among bfinance clients who are seeking to build broad, robust, well-diversified portfolios. This article explores some of those dynamics which are driving listed infrastructure demand and outlines bfinance's approach to manager selection in the sector.

Geographical Bias

The balance of listed and unlisted infrastructure – in essence, the question of whether a company that we might define as having an 'infrastructure' focus happens to be unlisted or listed – varies hugely based on geographical region.

A focus on unlisted infrastructure will leave global investors somewhat underexposed to infrastructure in the US, the home of a large number of publicly traded utilities and telecom infrastructure companies, and over-exposed to Europe and the UK. Listed infrastructure produces quite a different pattern: the indices tend to give 40-60% US exposure, with Canada as the second largest country. Among the managers, the average is currently 38% with a few above 50%. Global listed infrastructure indices and funds also tend to feature significant exposure to Australia – a region where both unlisted and listed infrastructure vehicles have thrived.

Interestingly, for those seeking listed infrastructure managers, these geographical quirks also contribute to substantial differences in personnel expertise among today's listed infrastructure teams. Australian funds often feature staff from the unlisted infrastructure sector, while US-based teams are more likely to have strong REITs background. These not only produce distinct cultures but also quite different approaches to issues such as portfolio construction and assessing valuations. Team background and expertise is, incidentally, one of the core elements in the framework that bfinance uses to rate prospective managers for our investor clients.

So What Counts?

Critics of listed infrastructure often point to the inclusion of stocks in listed infrastructure portfolios that they do not believe should fall under the 'infrastructure' label, such as service companies.

Indeed, the main listed infrastructure benchmarks differ considerably in terms of sector exposure. Some funds, particularly the older group, benchmark against the S&P listed infrastructure index, which is quite narrow (75 stocks globally) and utilities-heavy. Other funds use the broader Dow Jones Brookfield (DJBGI) index (over 100 stocks), which focuses more on companies' exposure to infrastructure in terms of underlying revenues, or the larger-still FTSE index (approximately 200 companies worldwide).

The majority of listed infrastructure managers have beaten their chosen benchmarks in recent years, but closer scrutiny of performance is essential. Much of the outperformance has been the result of exposure to equities beyond the listed infrastructure benchmark used: many funds have off-benchmark exposures of 20-30%; for others the figure is as high as 60%. It could be argued, perhaps, that the S&P index has been somewhat easier to beat in recent years than the DJBGI index. A minority of managers do not use an infrastructure equity benchmark at all, but instead opt for an absolute return or inflation + x% target.

Yet the "What counts as infrastructure?" question has also been immensely relevant on the unlisted side of the fence. The last few years have seen unlisted infrastructure managers widening the scope of the sector to include assets that simply would not have fallen within their remit before, such as data storage centers. We have also seen an increasing emphasis on the 'value-added' end of the spectrum, which can produce portfolios with higher correlation to equities and more vulnerability to economic cycles, especially for GDP-sensitive assets.

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Interestingly, most listed infrastructure funds routinely seek to exclude commodity-sensitive stocks, based on our latest manager research, although DJBGI has more weight in Gas and the S&P more in Electric. Furthermore, listed infrastructure funds appear to be heavier on utilities than many of their unlisted fund counterparts – a conventional infrastructure sector by anyone's definition.

Expensive Times

With record levels of fundraising in unlisted infrastructure and high levels of dry powder chasing deals, the illiquidity premium that investors seek through private investments has been greatly eroded.[2]

2 See: "Dude, Where's my illiquidity Premium?" article on page 17

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Unlisted infrastructure funds are also deploying investments more slowly, taking up to five years to draw down capital, creating a substantial cash drag which is detracting from investors' returns. Fund-of-funds can take even longer, with managers committing to funds of different vintages.

In such an environment, listed infrastructure can offer the opportunity to improve returns through arbitrage between the two sectors, and a far more rapid means of generating exposure. In addition, exposure to what Benjamin Graham called the "daily voting machine" of stock markets can provide opportunities to snap up assets at a discount, as seen recently in the UK when infrastructure stocks declined in value following comments by the opposition Labour Party around renationalization of assets.

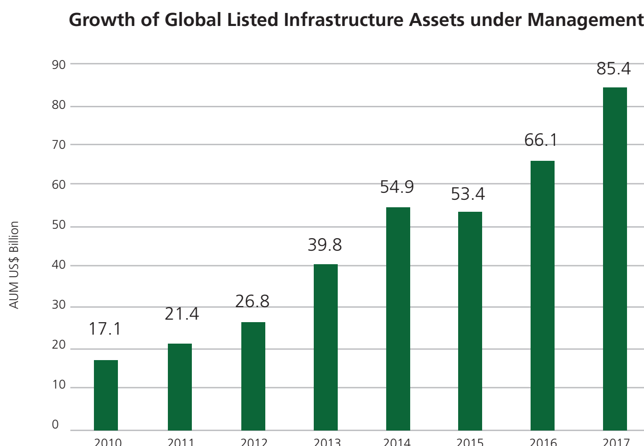
Manager Selection Philosophy

Black-and-white verdicts on sectors or strategies always risk missing the mark one way or another. The strategy or manager that suits one investor's portfolio structure and needs won't suit another.

For this reason, bfinance insists on a highly customised approach with each investor client: there are no 'buy-lists' or generalized manager/fund ratings, all relevant managers can take part in any search at no cost, and the scoring is specific to the client's needs. For example, where the investor is happy to consider managers with shorter track records, bfinance's process allows for newer entrants to compete on a level playing field.

In addition, we urge clients to consider the widest possible universe of options

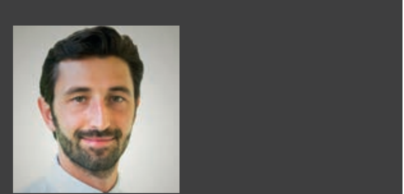
Growth of Global Listed Infrastructure Assets under Management



Source: evestment & GLIO

Of course, along with the expense of getting into these assets, investors must also consider the expense of getting into these funds. The lower cost of listed infrastructure funds – 40-100bps versus a minimum of 100bps on the unlisted side – should also be borne in mind.

for their implementation needs: if an investor is undecided about which strategies would suit their objectives in the present market climate, a fresh approach to a broad range of manager and fund types can provide clarity from the bottom-up. The importance of considering the full spectrum was outlined in the recent paper *Rethinking Real Assets* (March 2018). Investors in unlisted infrastructure (and, presumably, public equities) should also interrogate whether listed infrastructure, infrastructure debt, non-infrastructure real assets (such as agriculture) and more could be suitable for their needs.



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