First Sentier Investors American Listed Infrastructure
The new US liquid real asset

By Andrew Greenup and Jessica Jouning

Liquid real asset strategies seek to provide investors with high income, low volatility, reduced correlations and improved diversification.

American Listed Infrastructure (ALI) is a new, regionally focused liquid real asset strategy.

The following research paper examines ALI's attributes relative to existing United States-focused liquid real assets: MLPs, REITs and utility funds.

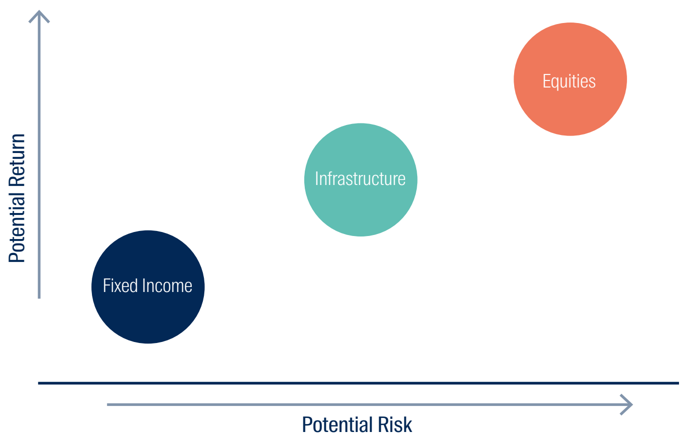
What is American Listed Infrastructure?

American Listed Infrastructure (ALI) is a new, United States (US) focused liquid real asset strategy that seeks to provide investors with inflation protected income and solid capital growth. It comprises a diversified portfolio of essential service infrastructure companies that own assets in the US.

Infrastructure assets provide essential services to the communities they serve. They commonly have defensive characteristics of high barriers to entry, strong pricing power, structural growth and predictable cash flows that foster stable income and total returns over time.

The essential service nature of infrastructure, combined with defensive investment characteristics, means the risk/return profile of infrastructure sits between fixed income and equities.

Asset class risk/return profile comparison



Source: First Sentier Investors

ALI consists of electric, gas and water utilities, cell towers, freight railways, energy infrastructure (oil and natural gas pipelines & storage), waste management, data centers, toll roads and airports.

Each of these infrastructure sub-sectors have different risk/return profiles, as outlined in the following chart.

Infrastructure risk/return profile comparison

Source: First Sentier Investors

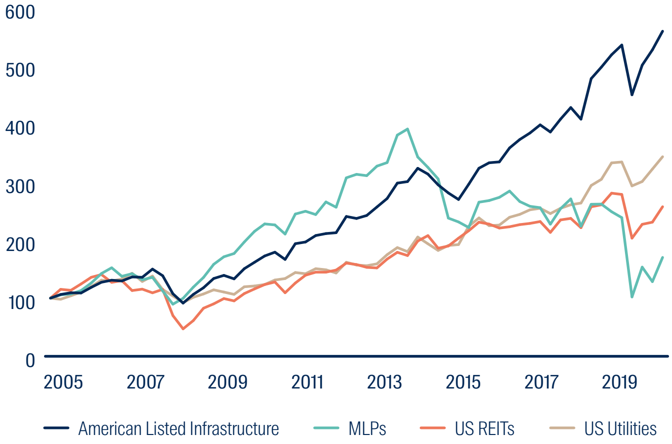
The most stable demand profiles and lowest risk business models (utilities, cell towers, data centers and waste) are at the lower end of the risk/return spectrum. Infrastructure assets with more demand variability and higher GDP sensitive business models (freight rail, airports, energy infrastructure and toll roads) are at the upper end of this spectrum.

Historic risk/return outcomes

Over the 15 years to Dec. 31, 2020[1], ALI[2] has provided strong annualized returns of over 12% to investors—significantly higher than returns for other liquid real assets over the same period. US utilities[3], US Real Estate Investment Trusts (REITs)[4], and Master Limited Partnerships (MLPs)[5] delivered annualized returns of 9%, 7% and 4%, respectively, over the same period.

ALI's superior return performance has been driven by an array of factors including (1) declining interest rates, (2) ability to increase price without destroying demand, (3) structural growth from cell towers, replacement of aged assets and infrastructure enabling changing energy markets, (4) US firms implementing global best practice in freight railroads and renewables, and (5) less prone to business model disruption. In particular, cell tower and freight railway sectors have performed strongly.

American Listed Infrastructure performance vs liquid real assets

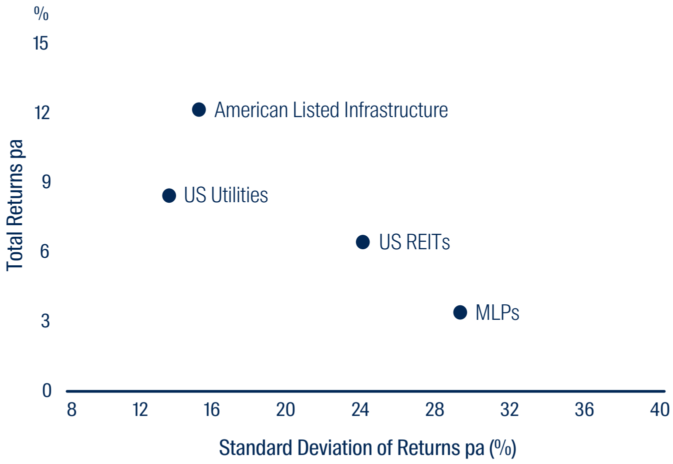


Infrastructure	FTSE USA Core Infrastructure Capped TR Index
Equities	Alerian MLP Total Return Index
US REITs	MSCI US REIT Gross TR Index
US Utilities	Philadelphia Utility TR Index

Source: Bloomberg and First Sentier Investors As at December 31, 2020

ALI's superior return outcomes have been delivered with lower risk (over the 15 years to Dec. 31, 2020, using standard deviation of returns as a proxy for risk). The following chart shows that US utilities had the lowest standard deviation of annualized returns at 13%, followed closely by ALI at 15%. In stark contrast both MLPs and US REITs have exhibited very high levels of standard deviation of annualized returns at 29% and 24% respectively.

US liquid real assets risk and return[6]



Infrastructure	FTSE USA Core Infrastructure Capped TR Index
Real Estate	MSCI US REIT Gross TR Index
Energy	Alerian MLP Total Return Index
US Utilities	Philadelphia Utility TR Index

Source: Bloomberg and First Sentier Investors Quarterly time series from 2006-2020

ALI's lower risk profile has been driven by (1) the stable, essential service nature of the demand for infrastructure services, (2) regulated monopoly or oligopoly businesses providing stability of earnings, (3) high dividend yield backed by prudent payout ratios and robust balance sheets, (4) fair, light handed regulation backed by a robust judicial system, (5) strong governance and alignment of stakeholder interest, and (6) disciplined capital allocation.

Similarities to other liquid real assets

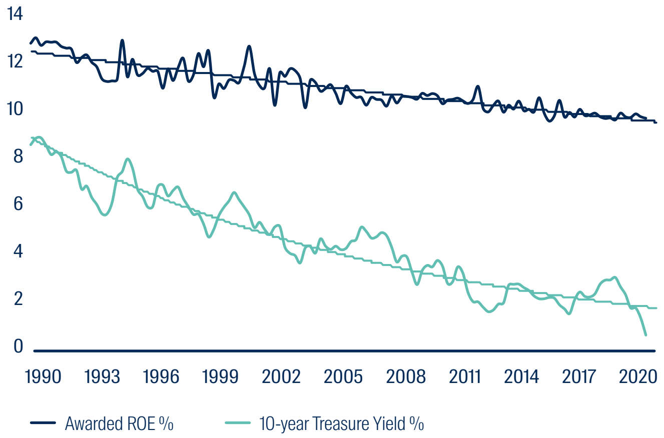
Real assets are tangible physical assets that have an inherent worth. ALI shares many similarities with other liquid real assets including (1) stable earnings profile with limited cyclicality, (2) ability to provide a hedge against inflation, (3) valuations that are sensitive to real interest rates, (4) income producing assets, and (5) low correlations with other asset classes.

The essential service nature of ALI assets—combined with their high barriers to entry and pricing power—result in a relatively stable and defensive earnings profile, with limited economic cyclicality. Accordingly, ALI, along with other liquid real assets, has a low asset beta and is considered a low volatility investment.

The pricing power of ALI and most liquid real assets provides a degree of hedging against inflation. This comes via the ability to increase prices without destroying demand. ALI's pricing power is driven by strong industry structures in freight railways and waste management, contracted price increases in cell towers and regulated returns in utilities (which change with interest rates).

[1] Liquid real asset performance data over 15 years to Dec. 31, 2020. Past performance is not indicative of future performance. Source: Bloomberg.
[2] As represented by the FTSE USA Core Infrastructure Capped Index.
[3] As represented by the Philadelphia Utility Index
[4] As represented by the MSCI US REIT Index
[5] As represented by the Alerian MLP Index
[6] Past performance is not indicative of future performance

US electric utility allowed Return On Equity vs risk free rate

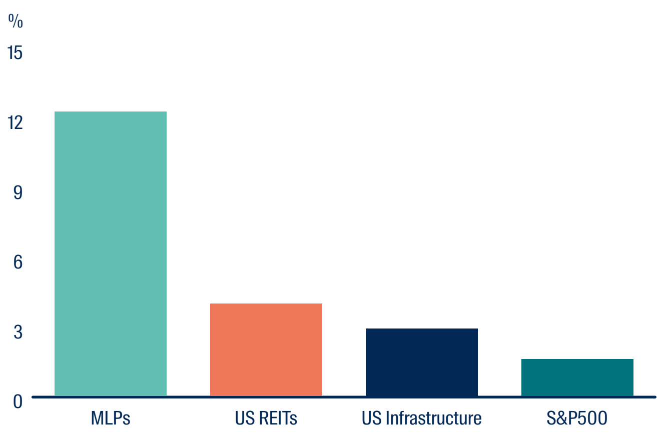


Source: Edison Electric Institute, First Sentier Investors

Low earnings volatility, inflation linked pricing and high levels of financial leverage tend to make the valuations of liquid real assets, including ALI, sensitive to changes in real interest rates. With cash flows from ALI tending to be highly predictable (and inflation a pass-through for many assets), this leaves changes in real interest rates as the biggest variable when valuing infrastructure assets, hence the high sensitivity.

The stable nature of real assets means these assets tend to produce high levels of income for investors. ALI is no different. Over time, the index has delivered a dividend yield of between 3% and 4% annually. And unlike some real asset alternatives, this income has proved to be sustainable over the long term.

American Listed Infrastructure yield vs selected asset classes



Infrastructure	FTSE USA Core Infrastructure Capped TR Index
US REITs	MSCI US REIT Index
MLPs	Alerian MLP Total Return Index
US equities	S&P500 Total Return Index USD

Source: Bloomberg and First Sentier Investors As at December 31, 2020

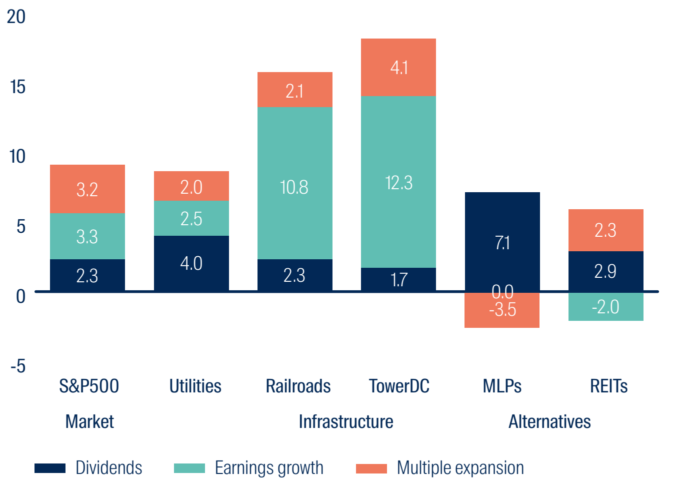
Liquid real assets reduce correlation levels between asset classes within an investment portfolio. ALI's risk return characteristics place it somewhere between fixed income and equities. Over the long term, ALI has historically delivered higher growth than fixed income, with lower risk than equities[7]. This reduced return correlation may help to improve the overall risk return profile of an investment portfolio.

Differences from other liquid real assets

ALI's key differences to the other liquid real assets include (1) higher earnings growth potential, (2) more sustainable dividend profile, and (3) better corporate governance.

The following chart shows that returns from infrastructure companies within ALI's universe have been driven largely by underlying earnings growth and sustainable dividends. In comparison, MLPs and REITs have had minimal earnings growth and - in the case of MLPs - unsustainable dividends.

Total return building blocks 2006 - 2020



Source: Bloomberg and First Sentier Investors
MLP = Alerian MLP Infrastructure Index
REIT = FTSE EPRA NAREIT United States Index

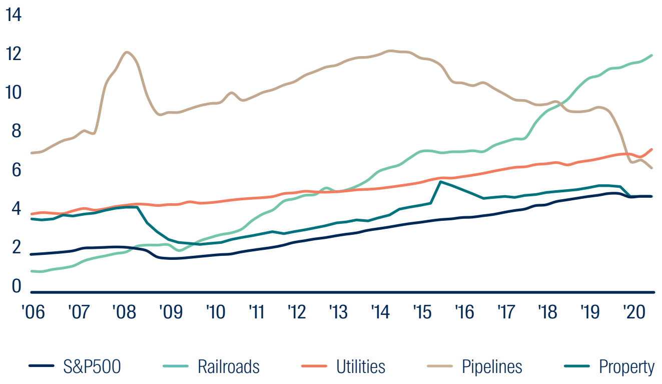
A diversified portfolio of ALI assets should produce higher earnings growth compared with REITs, MLPs or utilities alone. ALI's superior earnings growth is driven by exposure to freight rail companies, cell towers, data centers and waste companies. In addition, the essential service nature of these assets provides a stable demand profile which - when combined with high operating margins - makes earnings less economically sensitive than MLPs or REITs. Further, MLP earnings typically have a portion of commodity price, re-contracting and volume exposure.

While liquid real assets tend to be income producing, financial engineering has seen the sustainability of this income vary from asset to asset. ALI's income tends to be based on sustainable dividend payout ratios of around 65%, backed by robust balance sheets and low earnings risk. MLP dividend payout ratios are typically above 100%, which means the sector has a long history of cutting dividends when businesses come under pressure from commodity price volatility, volume declines or financial market dislocation. REITs must distribute at least 90% of their taxable income to shareholders annually in the form of dividends, which again makes their income more susceptible to economic or financial shocks.

[7] Based on the historical performance of the FTSE USA Core Infrastructure Capped TR Index, the Barclays US Corporate Total Return Value Unhedged index, and the S&P 500 TR Index.

Yield is not income

Annual dividends ($) from $100 invested in 2006



Source: First Sentier Investors, Bloomberg

The essential service—and in some cases regulated monopoly—nature of ALI means that, in general, corporate governance among these companies is held to a higher standard. ALI companies tend to take a measured and balanced view of competing stakeholders including customers, employees, shareholders, regulators and government.

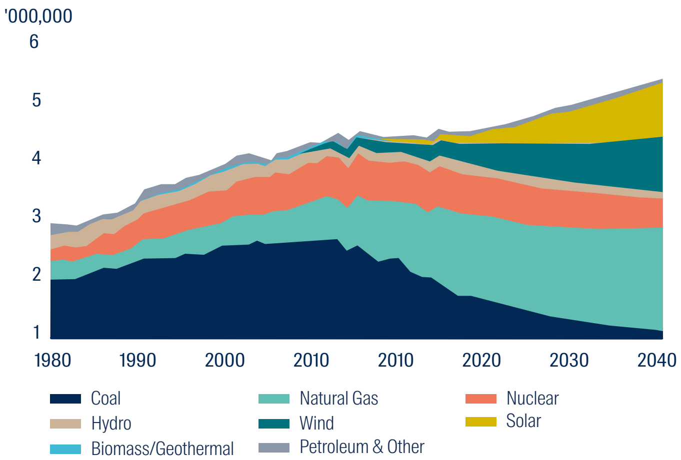
We contrast this with the corporate governance conflicts seen within the MLP space between General Partners (GP) and Limited Partners (LP), which we believe has often led to poor outcomes for LPs.

Structural outlook for liquid real assets

A number of long term structural drivers can affect the underlying asset classes of liquid real assets, both positively and negatively.

The ALI sub-asset class is exposed to the positive structural growth drivers of (1) decarbonization of electricity via renewable energy (utilities), (2) growing data mobility and connectively (cell towers, fiber, small cells, data centers), (3) electrification of transport (utilities), (4) decarbonization of transport (freight railways, utilities), (5) replacement of aged assets (utilities, airports, toll roads), (6) reduction of urban congestion (toll roads), (7) higher air-conditioning demand from climate change (utilities), and (8) increased recycling of waste (waste management).

US electricity output by fuel type (MWhrs)



Source: US Energy Information Administration, First Sentier Investors' forecasts

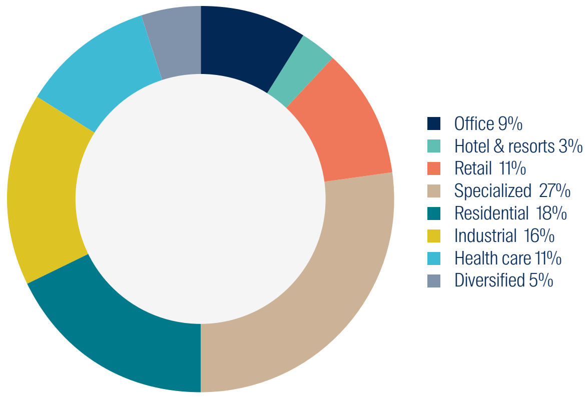
Potential negatives for ALI are (1) reduced demand for oil and natural gas, and subsequent reduced need for pipeline and storage assets supporting it (energy infrastructure), (2) lower natural gas heating from climate change and net zero goals (utilities), and (3) lower landfill waste volumes (waste management).

The MLP sub-asset class is exposed to the transportation and storage of fossil fuels, including oil, natural gas, natural gas liquids (NGLs) and liquefied natural gas (LNG). These fossil fuels already have demand profiles that are below GDP growth rates. Over the next decade, the structural decline for these fossil fuels is expected to accelerate because of (1) improving economics of electrification and (2) increased popular and political support for decarbonization of the economy.

The only modest offset to this structural decline is the globalization of hydrocarbons as North America becomes a larger exporter, which will require capital investment in infrastructure.

The structural drivers of the US REIT sub-asset class are mixed, with positive structural drivers for industrial, data center (included in specialized REITs) and health care property offset by negative structural drivers for retail, office and hotels and resorts.

MSCI US REIT sector split



Source: MSCI US REIT index fact sheet September 2020, First Sentier Investors

The shift to a more digitalized economy is likely to underpin structural growth for industrial property (the Amazon effect) and data center demand. An aging population should also provide a structural growth driver for healthcare property - albeit spending on healthcare in the US at 17% of GDP is already well above the OECD average (9% of GDP)[8] with lower health outcomes.

On the negative side, retail property faces a relentless market share shift to online, which has only accelerated under COVID-19. Office property will likely face a headwind as working from home (WFH) goes mainstream thanks to its success in the COVID-19 era. Hotels and resorts also face structural challenges from the tech-enabled sharing economy (i.e. Airbnb). COVID-19 may also have a longer term impact on residential REITs (typically apartment buildings in large metropolitan areas) if WFH evolves into working from anywhere.

[8] Source: data.oecd.org.

Conclusion

Liquid real assets have attractive characteristics that can improve the overall risk/return outcome of an investment portfolio. ALI is the newest liquid real asset and offers compelling risk/return outcomes with a favorable structural growth outlook relative to existing liquid real assets, such as MLPs, REITs and utilities.

ALI offers an opportunity to improve risk/return outcomes when added to a diversified portfolio of real assets or as a stand-alone diversifier to an overall asset allocation. ALI can provide income greater than traditional fixed income and total return akin to broad equity markets while improving overall portfolio diversification.

First Sentier Investors believes ALI is a compelling strategy for individuals and institutions alike because of the need for increased infrastructure investment in the US and strong demand for income producing, low volatility investments.

ALI is the largest driver of US renewable energy investment

Source: page 55 NextEra Energy 2020 ESG Report