Global Infrastructure Investing:
New Asset Class or Fad?

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With their high returns and low correlations to other major indices over the past five years, investments in global infrastructure—toll roads, airports, utilities and the like—are attracting attention from financial advisors and new products from fund providers. But will such impressive performance continue? And, if you buy the case for this kind of investing, how should you evaluate the funds vying for your attention?

The Case for Global Infrastructure Investing

"You can get attractive returns without adding volatility to a portfolio." That's how Jay Rosenberg, lead manager of First American's Global Infrastructure Fund, sums up the appeal of global infrastructure investing. The historical data support Rosenberg's assertion. Global infrastructure's returns, as represented by the S&P Global Infrastructure Index, have outdistanced those of the major asset classes for the past three-year and five-year periods, according to First American Funds.

Performance of Various Asset Classes as of 3/31/2008

		Performance as of 3/31/2008		
Asset Class	**Index**	**1-Year**	**3-year**	**5-Year**
Infrastructure	**Global Infrastructure –** S&P Global Infrastructure Index	5.87	21.00	27.12
U.S. Markets	**U.S. Equity –** S&P 500 Index	-5.08	5.85	11.32
	U.S. Fixed Income – Lehman Brothers Aggregate Bond Index	7.67	5.48	4.58
	U.S. Real Estate – FTSE NAREIT Equity REIT Index	-17.37	11.69	18.34
International Markets	**International Equity –** MSCI EAFE Index	-2.27	13.79	21.90
	International Fixed Income – Lehman Brothers Global Aggregate (ex. U.S.) Index	21.69	7.67	9.48
	International Real Estate – Citigroup BMI Global REIT Index	-18.19	15.72	26.33

Source: First American Funds, based on data from Morningstar

The index is also largely uncorrelated to major U.S. and global asset classes.

Correlation to Major U.S. Asset Classes

	Global Infrastructure	S&P 500	Lehman Aggregate	U.S. REIT
S&P Global Infrastructure Index	1.00			
S&P 500 Index	0.62	1.00		
Lehman Brothers Aggregate Bond Index	0.13	-0.30	1.00	
FTSE NAREIT Equity REIT Index	0.46	0.43	0.08	1.00

Correlation to Major Global Asset Classes

	Global Infrastructure	MSCI EAFE	Lehman Global Agg.	Global REIT
S&P Global Infrastructure Index	1.00			
MSCI EAFE Index	0.80	1.00		
Lehman Brothers Global Agg. ex. U.S. Index	0.41	0.18	1.00	
S&P/Citigroup BMI Global REIT Index	0.57	0.50	0.26	1.00

[7] Mark A. Weisdorf, "Infrastructure: A Growing Real Return Asset Class," CFA Institute, 2007

Source: First American Funds

As Rosenberg puts it, "This is likely to behave differently than anything else in your portfolio."

Harold Evensky, president of wealth management firm Evensky & Katz, agrees the data is appealing, but he wonders if such performance is sustainable. "Is this just a hot market?" he asks.

Rosenberg believes global infrastructure is up to the challenge. He suggests it could perform relatively better in the current weakening environment because global infrastructure investments shine in periods of slowing growth and rising inflation. Rosenberg says, "I expect infrastructure—because of its stable cash flows across economic cycles—will exhibit even lower volatility relative to other asset classes over time."

These stable cash flows are one of the key attributes of global infrastructure companies. A 2007 study by the Pension Consulting Alliance found a number of other factors that favor infrastructure investing:

- Long Life Assets – Infrastructure employs capital intensive assets with 25 to 99 year concession agreements.
- Inflation Protection – Revenues are typically linked to the CPI
- Monopoly or Quasi-Monopoly – High barriers to entry, due to scale and capital cost, create effective entry barriers and diminish competitive threats
- Low Correlation – Returns which are uncorrelated to major indices provides portfolio diversification and low beta
- Inelastic Demand – Predictable demand with little volatility makes these investments less susceptible to economic downturns
- Limited Commodity Risk – Limited exposure to commodity pricing reduces volatility
- Insensitive to Changes in Technology – Low risk of redundancy or technology obsolescence decreases overall investment risk

These characteristics will contribute to good performance in a challenging economy.

Infrastructure expenditures are forecast to be 2.5% of global GDP over the next two decades, according to an OECD study ("Infrastructure to 2030: Mapping Policy for Electricity, Water, and Transport"). That number increases to 3.5% with the inclusion of electricity generation and other energy-related infrastructure. The percentage will rise further as the world population grows and becomes more urban, requiring more utilities, transportation, communication, and social services—the major categories of infrastructure—in emerging markets. Developed nations also offer opportunities because they are turning to private companies to renew their aging infrastructure.

Infrastructure Investing Options for Advisors

Infrastructure investing was pioneered in the early 1990s, when the Australian bank Macquarie partnered with the government to invest in transportation infrastructure. In what became known as the Macquarie model, the bank raised funds from institutional investors on a world-wide basis and deployed them through public-private partnerships (PPPs) to fund infrastructure projects. Such funding was especially popular for towns and local governments that were facing budgetary constraints. The Macquarie model embodied substantial leverage, and many of their funds are now facing performance pressure due to the credit crisis. Institutional investors worldwide remain very active in infrastructure investing, with an estimated $50 billion in new funds brought to the global market in 2006 and 2007.

Today, advisors can employ a limited number of ETFs and actively managed mutual funds that target infrastructure investing. These offer the advantages of access by ordinary investors and greater diversification, and they put your money to work on day one.

S&P's Global Infrastructure Index is the benchmark for infrastructure funds. It is a market cap weighted index consisting of 75 holdings, 60 in developed markets and 15 in emerging markets. S&P targets the index to be 20% energy, 40% transportation, and 40% utilities upon rebalancing. This index is tracked by Barclay's iShare ETF IGF, which was introduced in December 2007.

The other infrastructure index is the Macquarie Global Infrastructure Index (MGII), which consists of 100 holdings without any geographical constraints, although all companies come from developed or advanced emerging markets. It is essentially the 100 largest firms with at least 50% of revenue derived from infrastructure, weighted by market cap based on their weightings in the FTSE Global Equity Series All Cap Index. This index is tracked by the MQ Global Infrastructure Total Return ETF MGU which was introduced in August of 2005.

Four mutual funds offer broad-based infrastructure products, in addition to these two ETFs.

					Sector Weightings				
Fund	Symbol	Expense Ratio (A Shares)	Avg. Market Cap ($ Mill)	P/E Ratio (prospective)	Business Services	Energy	Utilities	Telecom	Inception
iShares S&P Global Infrastructure Index	IGF	0.48	15,463	13.8%	34.77%	17.97%	44.16%		12/1/2007
MQ Global Infrastructure Tot Ret	MGU	1.54	4,794	N/A	34.97%	25.14%	34.40%		8/25/08
DWS RREEF Global Infrastructure A	TOLLX	N/A							6/1/2008
First American Global Infrastructure A	FGIAX	1.25	7,696	16.4%	33.26%	22.15%	38.43%		12/1/2007
Kensington Global Infrastructure	KGIAX	1.49	14,694	13.4%	34.03%	20.00%	33.15%		6/29/2007
Phoenix Global Infrastructure	PGUAX	1.19	30,546	15.2%		7.24%	67.17%	25.59%	See note

Note: PGUAX recently converted from a utilities fund to an infrastructure fund.
Data obtained from Morningstar, September, 2008

Active versus Passive Management

But even if you're sold on the idea of a global infrastructure fund, questions remain. For instance, should you go with an actively-managed or an index investment?

First American believes in an active approach that:

- Includes more sectors than the S&P Global Infrastructure Index
- Can anticipate trends forming in the market
- Can avoid pitfalls from geopolitical and regulatory risks

The S&P Global Infrastructure Index is flawed, Rosenberg says, because its sectors and industries are too narrowly construed – it also includes some companies that don't exhibit infrastructure characteristics (such as those identified above by Pension Consulting Alliance). The First American Global Infrastructure Fund's universe expands those sectors by investing in airports, logistics, ports, and toll roads in the transportation sector as well as alternative energy and water, electric utilities, pipelines, gas, and waste management in the utilities/energy sector. It also adds social infrastructure industries—prisons, hospitals, and other community facilities— and expands the category of "alternative assets/other" – such as communications towers. First American's additions are based on whether the industry offers infrastructure's abovementioned key attributes.

The advantages of adding sectors, described in First American's *Redefining Global Infrastructure* white paper, include:

- Exposure to investments that might otherwise be available only to private equity investors
- Exposure to sectors overlooked because of small size or recent emergence
- Less emphasis on sectors, such as electric and integrated utilities, that already have high exposure

As for anticipating trends and reducing geopolitical and regulatory risks, Rosenberg cites his fund's underweightings in toll roads (5.9% of the fund vs. 18.0% of S&P's index as of June 30) and airports (5.0% vs. 8.1%), two areas that have suffered during recent economic troubles. He's investing in ports that emphasize commodities rather than more economically sensitive consumer goods. On the geopolitical front, the First American fund invests in one-third more countries than the index.

Indicative of its strategic underweighting of overexposed sectors, the fund's electric utilities holdings totaled only 21.5% of the fund vs. 37.1% of the S&P index as of June 30 (although total utility exposure is roughly equal to that of the index), a disparity in weightings that is the single greatest between the fund and the index.

But Evensky is not convinced that First American's sector weighting will add value. "Where's their background knowledge that would tell me that their 10% bet against electric utilities is the right thing?" he asks.

Implications for Advisors

Evensky voices the central concern with global infrastructure: does it constitute a distinct asset class that worth adding to a portfolio? Proponents of infrastructure investing argue that it should be. But Evensky says a more reasonable approach is treating infrastructure investing as a distinct sector, alongside financials, energy, etc. Infrastructure can also be viewed as discrete components with a multi-sector composition.

A diversified portfolio will have significant exposure to infrastructure assets; the question is how meaningfully to tilt the portfolio toward these assets, and whether that can be accomplished by the funds above. Jay Rosenberg points out that his portfolio has significantly less overlap with global indices than the S&P Global Infrastructure Index.

Advisors will want to consider a target allocation in the 2.5-3.5% range, consistent with the role infrastructure plays in global GDP.

The above funds present measurably different exposures to infrastructure investing. Most have significant non-US exposure and hence carry currency risk. When reviewing the performance of these funds over the last 12 to 18 months, advisors should assess the gains from currency movements versus the underlying securities. An international bias may be desirable, as infrastructure investing, particularly in emerging markets, is likely to offer substantial opportunities in the coming decade. The OECD study cited above forecasts non-US infrastructure investing to outpace US spending by 58%, justifying a higher allocation to non-US assets.

Advisors should assess the following risks in these funds, and when considering infrastructure investing in general:

- Infrastructure investing is a relatively new discipline. Do the fund managers have the necessary experience to evaluate securities in the global marketplace in this field?

- Infrastructure investing is gaining popularity. Are the underlying securities fairly valued, or are new investors driving up prices?
- Privatization of public assets must gain public acceptance, at least in the US, and faces regulatory and political challenges that will vary by state.
- Regulatory factors can impose unpredictable and negative pressures on prices. An economic slowdown can lead to surplus capacity.
- Privately funded infrastructure projects may face challenges from organized labor, resulting in concessions, delays, and unforeseen obstacles.
- Asset control typically resides with the public sector, and private companies may not be able to implement desired pricing and growth targets.
- Outside the US, infrastructure assets are subject to sovereign risk and the possibility of being nationalized.
- Despite the claim that infrastructure assets are insulated from commodity prices, some assets will be subject to fuel supplies, which may not be available at reasonable prices.

Evensky plans to further study this area. “It might make an interesting tactical investment,” he says. With global inflation on the rise, advisors will want to carefully evaluate infrastructure investing.

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