Infrastructure as a True Portfolio Diversifier

Stockholm (HedgeNordic) – Investors searching for genuine diversification may need to venture out beyond traditional assets to more alternative asset classes such as infrastructure. Infrastructure describes the physical assets providing essential services to our modern world, including, among others, water, electricity, transportation and communication. These assets represent the skeleton holding up of a well-functioning economy and society.

Low business risk and high dividend payments endow infrastructure investments. But with direct investments in toll roads, airports and other unlisted infrastructure assets out of reach for most investors, publicly-listed companies that own or operate infrastructure assets – may represent an attractive avenue for exposure to this growing asset class.

In an environment of low yields, investing in listed infrastructure can be an attractive source of returns for income-focused investors, which partly explains the growing investor demand for this asset class. "In the current environment where we have zero interest rates, fundamentally-sound infrastructure businesses that are still yielding between three to four percent are attractive to investors," says Pekka Niemelä *(pictured),* the portfolio manager of three infrastructure funds at Finnish asset manager United Bankers. "More and more institutional and private investors are looking for stable, yield-generating investments and there is a general trend towards this type of investments, whether they are real estate or infrastructure investments."

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"Fixed-income investments have been an important allocation in the portfolios of many income-seeking investors such as large institutions, but investors are currently getting nothing from investing in fixed income," points out Niemelä. As a result, "there is a fundamental interest in all kinds of businesses offering dividend yields or some cash component in returns," he continues. "The main forces and drivers of the growing demand for infrastructure investments stems from what is happening in general economies, namely slow growth and very low interest rates."

Impact of COVID-19 on Infrastructure

The coronavirus pandemic has shaken up economies around the globe, leaving its mark on infrastructure sectors too, predominantly on GDP-correlated assets such as airports, ports and toll roads. Other infrastructure segments such as water utilities, electric utilities, renewables, or telecom infrastructure have seen less of an impact from the pandemic. "Given the current level of disruption among businesses and business models further enhanced by the pandemic, investors really appreciate infrastructure businesses that are less prone to disruption," highlights Niemelä. However, Niemelä considers that "businesses in the infrastructure sphere have been more susceptible to changing consumer behaviors, which have longer-lasting implications, rather than short-term pandemic-driven interruptions."

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Whereas the coronavirus-induced market turmoil in March impacted most listed equities with roughly the same intensity, the pace of recovery has varied across different segments. “If we look at what happened in March, almost all companies and industries came down when the pandemic-related shock hit the markets, and then gradually different industries have been recovering from that first shock,” says Niemelä. “Looking at the infrastructure side, different industries have performed differently, too,” he points out.

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Traditional segments such as water and electricity utilities are back up to the pre-Covid levels. “The core utilities have performed as expected even under very difficult circumstances,” says Niemelä. “These are businesses with business models that are not easily disrupted,” he emphasizes. “The consumers have been able to pay electricity bills, and the companies have paid their dividends to investors. The shock was more about the way the market reacted, and share prices have gradually been picking up.”

User-based transportation infrastructure assets have been most impacted due to the coronavirus pandemic, most notably airports, toll roads and ports. “If we look at the other end of the performance spectrum, we can see that, for example, airports are one of the worst-hit areas in the infrastructure space,” says Niemelä. “There are some sectors such as airports that will need a year or two to be back to where we started the year.” Whereas Niemelä acknowledges that “the recovery won’t be that fast,” he considers that “the recovery could be faster than people expect.”

United Bankers’ Expertise

Instead of playing the “stock picking and market timing” game, Pekka Niemelä predominantly relies on a buy-and-hold approach to build well-diversified portfolios for the three infrastructure funds at United Bankers. Niemelä mostly focuses on monopoly-like infrastructure businesses, which “leaves not that much room for stock picking,” he argues. “Our approach is more about diversification, building and maintaining portfolios that are diversified across geographies, sectors, and companies,” says Niemelä.

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One common characteristic of all holdings across the three UB infrastructure funds is the focus on near-monopoly infrastructure. “Not all infrastructure businesses are regulated, but we focus on finding natural monopolies,” says Niemelä. “The competition is limited for these types of businesses and, therefore, the pressures on profitability and business volumes are less than in normal competitive markets.” The focus, therefore, is on traditional utilities such as water, gas and electricity, as well as toll roads, airports, and ports. “These are the core of our universe.”

As the UB infrastructure funds avoid a benchmark-hugging approach, Niemelä chooses sector weights to build portfolios with attractive risk-return profiles. “Whereas water utilities are a really small slice of the total infrastructure markets, we like the profile of water utilities very much and we have maintained a much bigger share of water utilities in our portfolio compared to respective benchmarks,” says Niemelä. “Water utilities are known for being the least risky part of the market.”

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United Bankers currently managers three infrastructure focused-funds: UB Infra, which invests in OECD countries; UN EM Infra, which invests in emerging markets; and UB EM Frontier Real Assets, which makes investments in both infrastructure and real estate assets. The geographic focus shapes the risk-return profile of the UB infrastructure funds. “Investing in emerging markets is associated with more risk,” acknowledges Niemelä. “OECD countries exhibit low growth prospects and thereby low growth expectations, whereas companies in emerging markets enjoyed higher growth rates and had higher growth expectations reflected in valuations, so valuations in emerging markets came down more sharply during the pandemic.” Over longer periods of time, emerging market-focused vehicles are expected to perform more strongly than developed market-focused funds due to higher growth rates.

Since launching in early 2006, UN EM Infra delivered an annualized return of 6.3 percent through the end of October this year. Going forward, Niemelä expects that 50 percent of the return will come from dividends, contributing between three to four percent annually. “Then there a small capital appreciation on top of that, so we anticipate a six to seven percent return range going forward, which is what we actually managed to achieve over the years.”

Runway for Growth

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Infrastructure and listed infrastructure in particular “is still a young asset class,” according to Niemelä. “But we proved that the performance of the asset class can be consistent, that the risk level is lower than in the general stock market and the returns are competitive,” he continues. “It can give some reassurance for investors that these infrastructure companies can deliver attractive returns over long-term despite going through difficult periods.” More importantly, the infrastructure asset class has a “bright future in both developed and emerging markets, as the need for infrastructure investments is huge.”