Feb 3 2017 at 11:00 PM | Updated Feb 3 2017 at 11:00 PM

Donald Trump may push up rates but infrastructure stocks will still deliver

Regulated utilities such as toll roads have revenues linked to inflation, although there can be a time lag. **afr**

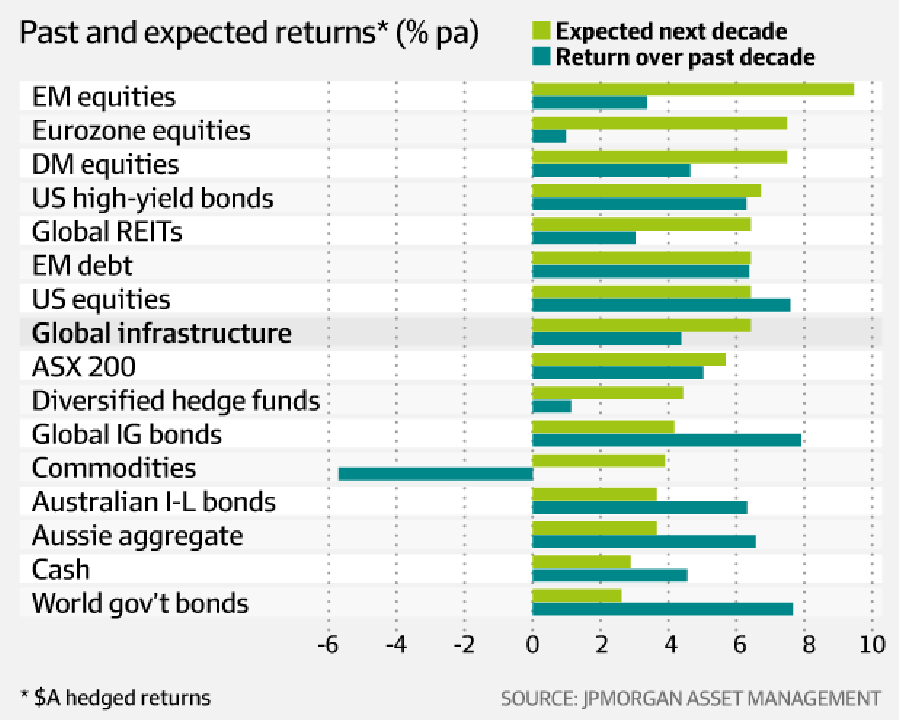
by **Chris Wright**

When interest rates finally started rising again in the US after many years of dormancy, received wisdom had it that this was bad news for infrastructure stocks after a great run. The election of President Donald Trump, which is expected to lead to an acceleration in rate hikes, cemented the view. But is it that simple?

The usual view of infrastructure works like this. In times of low interest rates, when yield is hard to find, infrastructure performs exceptionally well.

It generates a steady return, is largely recession-proof (since people still use toll roads and electricity even in tough times) and looks particularly strong when cash and bonds are hardly paying anything.

Following the same argument through, once interest rates start rising and cash and bonds start paying out more then, relatively speaking, infrastructure has less to offer; moreover, many infrastructure companies have a lot of debt, which costs them more to service.



"The market moves on that story fairly readily," says Andrew Buchan, financial planner at HLB Mann Judd in Brisbane.

"The general theme is that rising rates are not good for infrastructure, so whenever it looks like rates will rise the brokers are on the phone saying: get out of Sydney Airports and Transurban."

But the case for infrastructure as an investment class remains robust.

"One of the key arguments for investing in infrastructure is the reliable earnings profile," says Gerald Stack, head of infrastructure at Magellan Asset Management, and portfolio manager for the Magellan Infrastructure Fund.

"It doesn't matter if it is good times or bad economically. If you are investing in infrastructure – by which I don't mean things that are called infrastructure for the hell of it, but assets that provide a service essential to the efficient functioning of a community – then you have reliable demand and reliable returns over time.

"That doesn't change irrespective of who is president in which jurisdiction."

Valuation question

So the question is not whether infrastructure will cease to function as an investment, but whether valuations of listed infrastructure will change during rising interest rate cycles, and how the businesses themselves are affected.

Stack argues that businesses generally come out OK. "The bulk of these assets have revenues linked to inflation through regulation," he says, citing Transurban as an example. "Inflation feeds directly to the revenue line through toll escalation."

Regulated utilities, be they toll roads or power stations, go back to regulators from time to time to make their case about where their prices should be. "Similarly, that system allows interest rates to pass through too. As a regulated utility, you are protected from that."

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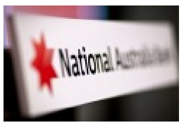
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They're not completely protected, because there is a lag. "Utility companies get a new allowed return every time they go to their regulator," says Nick Langley, co-CEO and co-CIO of fund manager RARE Infrastructure, "and that return is linked to current bond yields.

So they have a hedge against movements in interest rates. But where they are exposed is in the short term, between now and the next time they visit their regulator. That's why you see these companies sell off as people worry about increasing bond yields."

That, though, is a fairly brief period of adjustment. "The message I'm trying to get across is that businesses are insulated and rising rates are inconsequential," says Stack.

That does depend on how much debt the utility in question has, since it naturally gets harder to service debt with higher interest rates, just as it gets harder to pay your mortgage.

But most major infrastructure companies have used the low rate environment of the last few years to extend the maturity of their debt often five to 10 years ahead.

Instead, the bigger issue is valuation. To put it another way, if people think infrastructure is vulnerable to interest rate movements, then they will sell, and the whole thing becomes self-fulfilling.

"Because infrastructure is widely held to be interest-rate sensitive, as and when investment markets convince themselves that rates are about to rise you tend to see some sticker shock," says Stack.

"Investors sell long-duration assets, real estate, infrastructure and high quality equities. You only need to look at the last quarter to see that going on. Subsequently, you see valuations rise back to something approaching their levels prior to that."

Taper tantrum

Before the Trump election, the clearest example of this pattern was the "taper tantrum" in 2013, when then-Federal Reserve chief Ben Bernanke gave markets the impression that interest rates were about to rise (which they didn't, or not immediately).

The mere expectation of this happening caused long-dated assets and anything in emerging markets to sell down, and infrastructure stocks sold off by five to 10 per cent.

Within six to 12 weeks, depending on the location, most had gone back to where they had started from. A similar thing is already happening with infrastructure now: Transurban plunged on the US election but at the time of writing is at more or less the same level it was in early November (though well below its July 29 high).

Sydney Airports plunged too, but was way ahead of its pre-election level six weeks later, before retreating again at the start of this year.

For a good fund manager, volatility like this creates opportunity. "Our view is the market will oversell, and create a great opportunity for investors to take a position in utilities," says Langley.

At this point, it is useful to distinguish between different types of infrastructure, and the difference between infrastructure and utilities, because they can behave in slightly different ways and not everybody agrees on what constitutes an infrastructure asset.

"The infrastructure we talk about at Magellan is big on reliable earnings," says Stack. First of all, they strip out anything where earnings are influenced by commodity prices and by competition, which would include power generation unless it's tightly regulated.

If risk levels like political or sovereign uncertainty are too high to stop the underlying earnings being reliable, then that's out too. In practice, that leaves them with what they call infrastructure (toll roads, airports, ports, communication infrastructure assets, and US rail freight), and what they call utilities (energy, water, and the distribution and transmission of gas and electricity).

This distinction is important, because Langley at Rare Infrastructure believes at a time like this, the two sides of the asset class diverge. Where Stack talks of sticker shock, Langley talks of a sugar rush: he says initially when rates start rising, markets infer it to be positive for the economy, and so infrastructure goes up, while utilities go down.

"If you are looking for steady returns out of infrastructure, that's the point when you should take a contrary view and rotate into more defensive liquidity," meaning utilities. So where are we in that process? "We believe that we will still be in the sugar rush until some time in the first half."

Another element in the mix is the fact that a Trump presidency, if he sticks to policy, should mean a lot of spending on US infrastructure (although one of the pleasing ironies of his insistence on building a border wall with Mexico is that it will chiefly benefit Mexican construction companies).

"Trump wants to spend big on infrastructure, and with those levels of debt he will have to turn to private listed operators," says Buchan.

Opportunities with volatility

So there is a contradiction at work: a Trump presidency means steeper rates which is bad for infrastructure, but big spending on infrastructure which is obviously better for the asset class. In any event, Buchan believes "rates are going to go up slowly. I don't think these things are going to be hammered. They may be volatile stocks, but with opportunities."

Stack says Magellan hasn't seen net outflows despite the news flow. And nobody is really talking about abandoning the asset class. "We are sticking with infrastructure as an asset, but not adding to our allocations at present," says Paul Moran, financial planner and founder of Moran Howlett. "The recent rally has allowed us to take some profits by simply re-balancing to neutral rates."

Moran says that rising rates will have a short-term impact on infrastructure asset pricing, "primarily because they have been used as a bond proxy during the low rate period". As bonds start to deliver a return, investors may switch back into them and out of infrastructure.

But "while the rate cycle has certainly turned, the general levels of indebtedness – both government and consumer – mean it is unlikely that rates will rise quickly to a point where infrastructure becomes unappealing".

To Moran, the other advantage of infrastructure is that "it provides a somewhat inflation-protected income stream, unlike bonds which generally are not inflation-protected – even inflation-linked bonds typically sacrifice some interest to provide some inflation protection.

"We think that we need to be careful of infrastructure that is loaded with debt, as rising interest rates could well have a double effect of lower net yields as well as the bond effect, but there seems to be enough options around both direct and indirect to meet our modest allocation to this sector."

Among the direct options, he mentions Transurban, Sydney Airports, APA Group and Spark Infrastructure; among indirect, the VanEck Vectors FTSE Global Infrastructure ETF (known by its stock code, IFRA).

So where does one find value? Generally for Magellan, the split is about 60-40 in favour of utilities, but right now Stack says he sees the best opportunities in infrastructure, and in particular European infrastructure, where the perception of risk is pushing values down.

Long-term cash flow

Magellan is stridently global in its outlook – the AFR tracks Stack down in Los Angeles – but Transurban remains its biggest holding, at about 8 per cent of the portfolio today. "It remains an asset we like," Stack says.

"We like the long duration nature of these cash flows, we expect traffic to continue to grow on Australian motorways over a long period of time, and the fixed nature of the operating cost structure means we will continue to see solid growth in cash flows." Other key holdings include airports, from Sydney to Auckland to Europe.

RARE has a strong exposure into growth-oriented infrastructure in the US, such as rail companies, wireless tower businesses and high growth gas utilities.

"We don't take commodity exposure in the portfolio, but we do take companies with exposure to the increasing natural gas theme, as well as LNG out of the US," says Langley. He expects to build positions in more defensive US utilities later in the year as they show weakness.

What return can you expect from infrastructure? The stocks have had a great run. According to Morningstar, the best five-year return from a global infrastructure fund available in Australia up to December 31 was an annualised 19.36 per cent per year, from Lazard Global Listed Infrastructure; products from AMP, BT and Colonial First State all topped 15 per cent, and no product with a five-year track record in Morningstar's universe managed less than 8.43 per cent.

Even in the more difficult last 12 months, Maple-Brown Abbott's Global Listed Infrastructure fund returned 16.98 per cent. Returns like that are going to be hard to find in the short term, but infrastructure is a long-term play.

"When you look at average listed and unlisted returns after fees, it's been in the 8-9 per cent range over the last 10 years," says Langley. RARE aims for G7 inflation plus 5.5 per cent over rolling five-year periods.

Assessing that return requires you to consider what other asset classes might provide over the same timeframe.

Rates might be rising but yield is still highly prized. While Australia boasts one of the best markets in the world for dividends from blue chips, the outlook for many of them – particularly banks – is uncertain. In a JP Morgan Asset Management report setting out expected returns (in Australian dollars) in the decade ahead (2017 long-term capital market assumptions, issued in October 2016), global infrastructure ranks a place ahead of the ASX 200.

Aside from actively managed funds, infrastructure can be bought through passive vehicles, including Vanguard's Global Infrastructure Index Fund, and through the Van Eck ETF mentioned by Moran earlier.

Most planners believe that there is a place for infrastructure in a portfolio. Buchan puts it in a bucket he calls real assets, into which real estate also goes. "Sydney Airports looks more like a Westfield than anything else," he says. "Except instead of a car park out the front, it's got a runway."

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