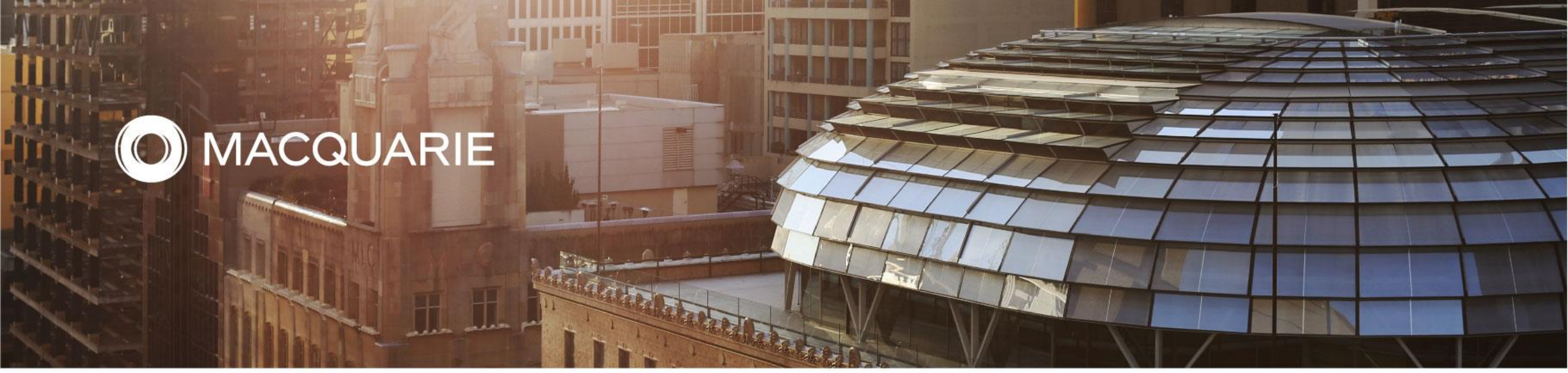


Investment Strategy Update #110

Infrastructure: Our preferred Real Asset exposure

- Infrastructure (patronage assets) is our preferred real asset exposure. Inflation and growth concerns have increased the cyclical appeal of infrastructure versus traditional assets but structurally the supports for including infrastructure within a balanced portfolio are the primary reason. We would use any near-term weakness to add to real asset exposures.

- We like the risk adjusted return outlook for infrastructure where we expect yields of 4-5% and total returns of 8-10% through the cycle. While current market conditions are raising short-term appeal (particularly against equities), infrastructure is a long duration asset with pricing power, stable earnings and distributions and strong structural demand tailwinds. This is an asset to own now and when current market concerns (such as inflation and rising interest rates) decline.

- Within a balanced portfolio we would allocate up to 5% in real assets. We think investors can look towards infrastructure to provide the following key benefits:

  1. Infrastructure can help hedge against inflation given inflation linked pricing of cashflows for many infrastructure assets.

  2. Infrastructure is relatively defensive given high visibility of future earnings due to the contractual nature of cashflows.

  3. Unlisted infrastructure has low volatility can improve the overall risk-return profile for diversified portfolios.

  4. Infrastructure currently offers a yield pick-up on other assets by as much as 2.4% versus global equities and 2.8% versus global bonds. In addition, stable cash flows mean higher distribution certainty.

  5. Longer-term structural supports such as the need to upgrade the world's infrastructure over the next few decades.

- Within infrastructure we like 'patronage' assets (such as airports and toll roads) that benefit from reopening as well as 'regulated' assets (such as utilities) with defensive cashflow streams hedged against inflation.

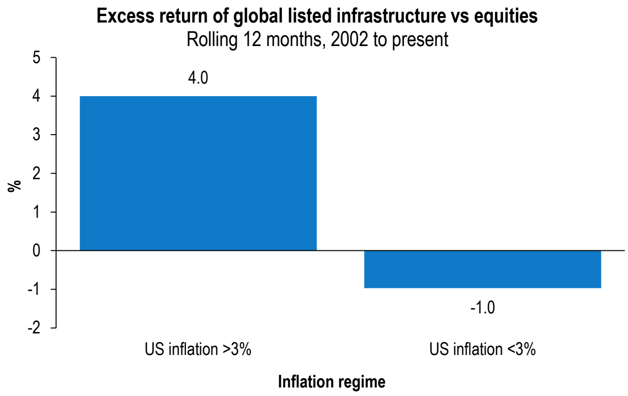
The absolute & relative return outlook for infrastructure is positive

We are positive on the return outlook (8-10%) for infrastructure and believe adding an allocation (5%) to infrastructure would benefit a diversified portfolio for the following reasons:

#1 Infrastructure can help hedge against inflation

Inflation has been the number one issue vexing markets with headline inflation accelerating to levels not seen since the early 1980s. While global inflation looks like it is peaking, it is expected to take a number of years before it is back within central bank target levels. As a result, markets may be stuck with inflation levels that are higher than those experienced for many years.

Infrastructure outperforms equities during inflation periods



Source: Factset, MWM Research, August 2022

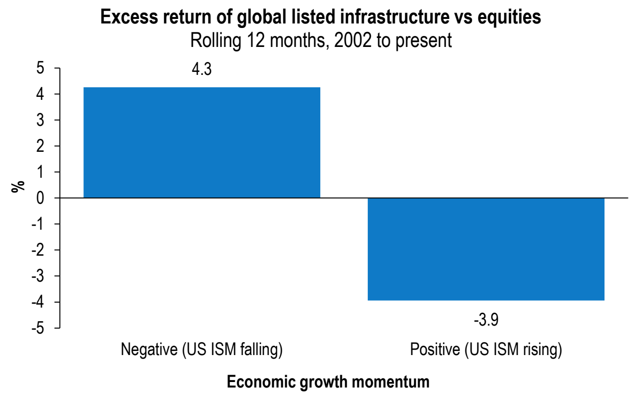
Infrastructure assets can help hedge against inflation either explicitly because cash flows are directly linked to CPI or implicitly because often monopoly positions allow a degree of pricing power. This is borne out by historical performance where Infrastructure has outperformed equities during elevated inflation periods.

#2 Infrastructure is defensive vs. growth assets

Central banks have not finished raising rates and Macquarie expect ongoing policy tightening to eventually slow economic growth and raise unemployment, with recessions the base case in the US, UK and Europe. A slowing business cycle will mean corporate earnings (and dividend) growth is likely to come under downward pressure.

Infrastructure assets are more defensive than equities, as the contracted nature of their cashflows (for regulated assets) or low demand elasticity (for non-regulated but 'monopolistic-type' assets) means infrastructure cashflows are able to better withstand economic weakness that would translate into earnings weakness.

Infrastructure outperforms equities during economic weakness



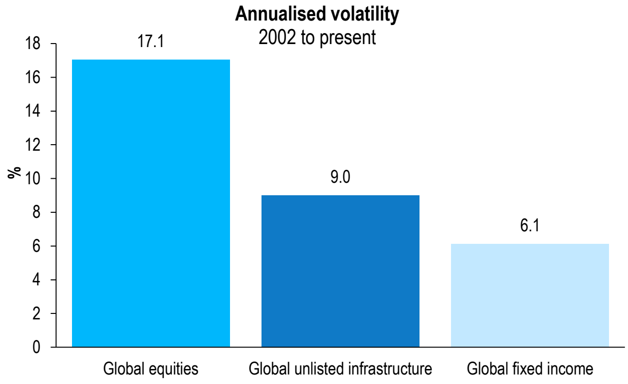
Source: Factset, MWM Research, August 2022

#3 Unlisted infrastructure has low volatility

Uncertainty around the economic outlook is expected to keep financial market volatility (across both bonds and equities) higher than we saw prior to the global pandemic period. Unlisted infrastructure can provide a 'dampening' effect on overall portfolio volatility via its lower volatility and lower correlation with other traditional asset classes, improving the overall risk-return profile for diversified portfolios.

Volatility of returns for unlisted infrastructure has historically been very low, because cashflows are generally less sensitive to the business cycle and given the lag in their valuation cycle, which means they don't have the mark-to-market volatility of listed equities (or if they do, it doesn't tend to be as extreme). This also means that the returns of unlisted infrastructure have a low correlation with other traditional asset classes.

Unlisted infrastructure volatility is lower than for 'growth' assets

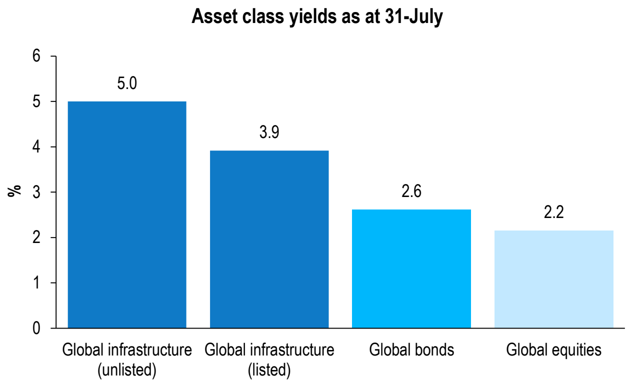


Source: Factset, MWM Research, August 2022

#4 Infrastructure offers yield pick-up

Both listed and unlisted infrastructure currently offers yields well in excess of that available for both global equities and fixed income. Furthermore, given the defensive/low volatility nature of infrastructure cashflows, its yield is likely that distributions are more secure than those on global equities which are more exposed to economic fluctuations.

Infrastructure offers attractive and more secure yields



Source: Factset, MWM Research, August 2022

#5 Longer-term structural supports are a key attraction for portfolio inclusion

Our preference for infrastructure has always been centred around multiple long-term structural supports and we think the current backdrop where most assets have been discounted (both listed and listed) provides an opportune time to add to portfolio positions. We don't think short term cyclical risks are impacting the longer-term structural drivers that underpin this asset class including:

- Upgrading the world's infrastructure will be a dominant theme over the next 20 years. McKinsey estimates that almost $4 trillion per annum will need to be spent on infrastructure by the year 2035 to keep pace with projected GDP growth. Furthermore, with governments already heavily indebted, much of the financing of this will have to come from private capital.

- Exposure to ESG: The growing demand for sustainable investments will see a strong multi-decade tailwind for infrastructure as investors increasingly support asset managers with ESG objectives.

Why hold infrastructure if the economic backdrop improves?

Some investors think that allocating towards infrastructure during the current market turmoil is a short-term defensive play and that this raises the risk of underperformance once cyclical pressures (inflation, rates and growth) begin to normalize. We do not agree.

Infrastructure does have a lower beta than equities and so will go through a period of underperformance if risk assets bounce – this should be well understood. However, risk assets bounce back because they tend to be oversold and/or because valuations are normalizing. After the bounce, returns are driven by the strength of the earnings recovery and by how far valuations can expand.

We think the medium-term outlook will be one characterized by inflation and interest rates being higher than they were throughout the prior cycle and with economic growth slightly lower as a result. Against this backdrop we think risk-adjusted returns for infrastructure will look more appealing than they did prior to the latest inflation scare and/or the global pandemic.

How to play infrastructure

In a high inflation and weakening economic environment, ‘regulated’ assets (such as utilities) with defensive cashflows explicitly linked to inflation would generally be preferred over ‘patronage’ assets, which are more dependent on customer demand.

However, some ‘patronage’ assets that were hard-hit by lockdowns and border closures are still receiving a boost as activity levels normalize. Consequently, we would still recommend exposure to selected patronage assets (such as airports and toll roads), in addition to regulated assets (such as utilities).

Macquarie WM Investment Strategy Team

Investment Strategy Update #110 was finalised on 8 August 2022.

Recommendation definitions (Macquarie Australia/New Zealand)

Outperform – return >3% in excess of benchmark return

Neutral – return within 3% of benchmark return

Underperform – return >3% below benchmark return