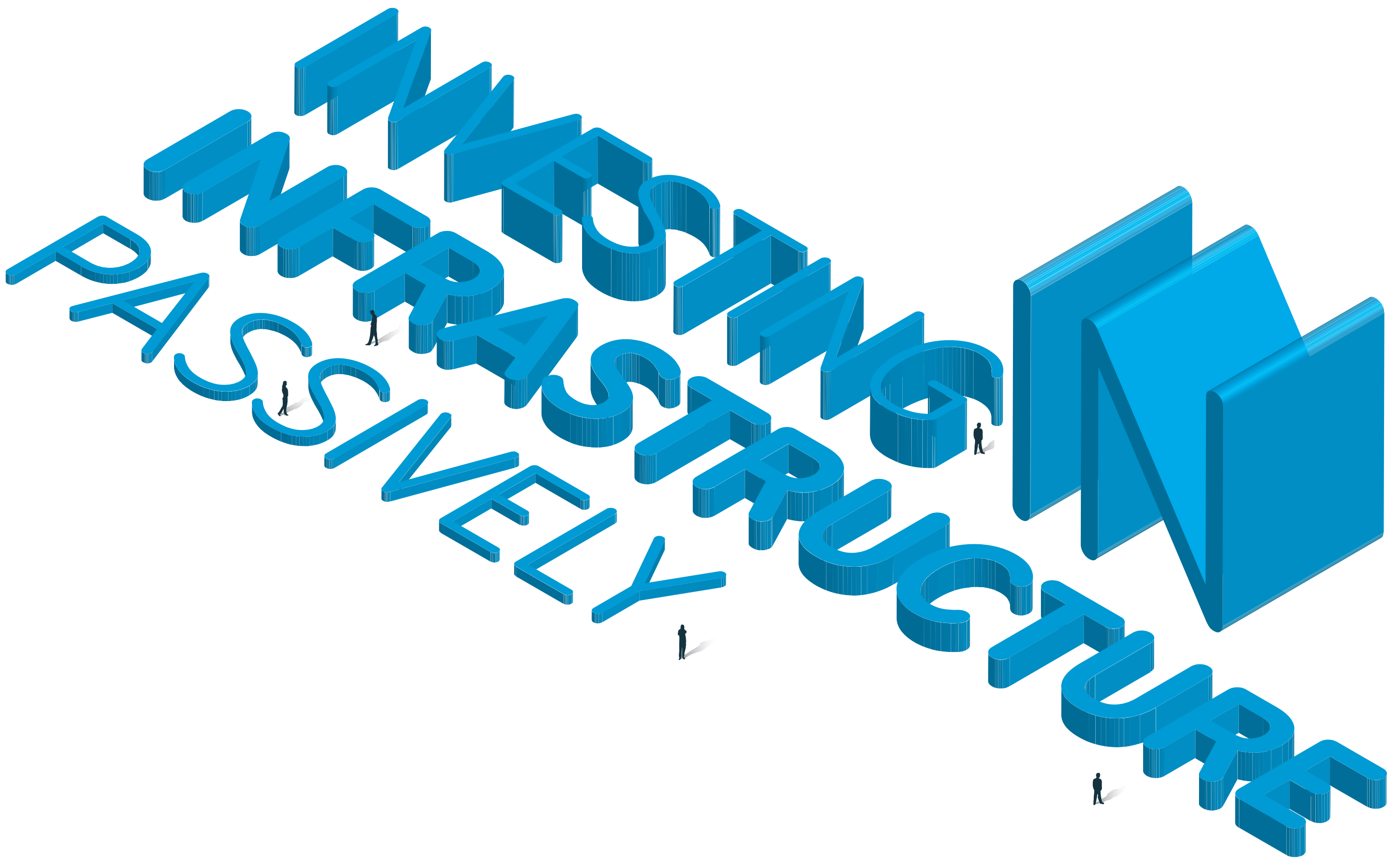
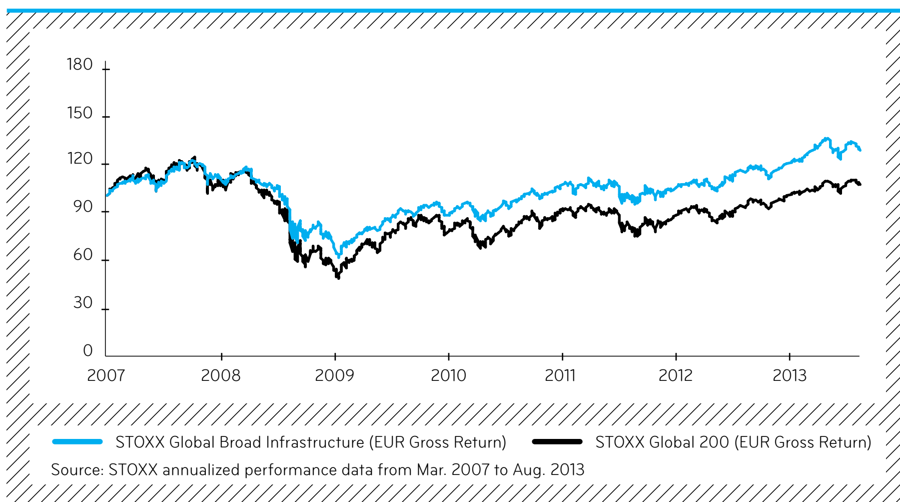


**CHRISTOPHER HUEMMER**
FlexShares

A BOTTOM-UP CLASSIFICATION OF THE SECTOR IS MORE REFINED THAN THE TRADITIONAL TOP-DOWN DELINEATION

**STOXX GLOBAL BROAD INFRASTRUCTURE INDEX HAS HIGHER RETURN COMPARED TO BENCHMARK**




Source: STOXX annualized performance data from Mar. 2007 to Aug. 2013

STOXX Ltd. introduced the STOXX Global Broad Infrastructure Diversified Index in September. In a season when neither bonds nor equities, it seems, can be trusted, some investors say infrastructure provides protection during all kinds of weather.

STOXX Pulse talked to Christopher Huemmer, senior investment strategist at Northern Trust's FlexShares ETF unit, about investing in infrastructure through an index fund and what investors should look out for in this sector, which is challenging to classify.

**WHEN IT COMES TO CRAFTING AN INFRASTRUCTURE INVESTMENT STRATEGY (THROUGH AN INDEX FUND) WHAT ARE THE MAIN CRITERIA INVESTORS SHOULD LOOK FOR?**

Investors have three different ways to access infrastructure investing: direct investment in the actual infrastructure asset, through a private equity deal or via listed equity. We feel that listed equity is the preferable approach for most investors because it delivers the desired investment thesis while also providing liquidity and transparency not readily available from the other options.

Using an index fund to invest in listed infrastructure adds incremental benefits, such as a robust diversification of holdings across several variables. In addition to geographic diversification (global-focus preferred), this might include diversifying the type of revenue stream. Practically, this can be accomplished by seeking breadth across multiple sub-sectors within different infrastructure asset sleeves.

Finally, it is important to focus on actual infrastructure ownership through these equity holdings to ensure direct access to the revenue stream derived from these assets. This will offset some of the increased correlation that listed infrastructure has to the stock market.

IT IS OFTEN SAID THAT INFRASTRUCTURE INVESTMENTS ARE A HEDGE AGAINST INFLATION, WHAT ARE YOUR VIEWS ON THAT?

We do not think inflation risk can be managed with a singular product solution. Inflation needs to be addressed across near-term, intermediate-term and long-term time horizons (20+ years). Traditionally infrastructure assets have been viewed as a long-term inflation hedge, along with real estate and common stock. Some legacy sub-components of infrastructure, e.g. utilities and energy, have generated historical returns that clearly demonstrate their effectiveness as a longer-term inflation hedge. Other sub-components, such as government outsourcing companies, are too new to have a long enough track record to prove their worth.

However, several facts lead us to believe that the newer sub-components of infrastructure may also serve as effective hedges against long-term inflation. Firstly, the regulated pricing of many infrastructure assets tend to raise fees with inflation. Whether a direct or shadow pass-through of CPI, many cash flows from equity infrastructure investments provide investors with protection in most inflationary environments. Secondly, as equity-based investments, they should benefit from the inherent inflation protection of the global stock market.

WHAT ARE THE DIFFERENT WAYS OF DEFINING AND CATEGORIZING THE INFRASTRUCTURE SECTOR, IS ONE BETTER THAN THE OTHER OR DOES EACH HAVE ITS STRENGTHS AND WEAKNESSES? IS THERE ANY PARTICULAR DEFINITION YOU PREFER?

Most global infrastructure strategies give investors access to utilities and energy companies and the vast majority of those strategies also include some exposure to transportation infrastructure. While these are the traditional building blocks generally thought of as ‘infrastructure,’ another segment gaining traction is communications assets such as wireline, fiber-optic cable and satellite owners. In the ‘Information Age’ new areas of communications – such as wireless towers and data centers – have broadened the scope of the communications supersector.

The newest area of infrastructure is government outsourcing or social infrastructure. As governments across the globe trim budgets and look to more effectively manage the services they provide, public-private partnerships have become an increasingly popular solution to fill the gap between public needs and budget limitations. The operational management of post offices, hospitals and other public services may be outsourced to private entities on long-term contracts but the assets are still owned by the governmental entities. For investors, exposure to these newer types of infrastructure investments helps diversify away from the legacy supersectors, thereby improving risk mitigation.

However, the broadening definition of the infrastructure supersectors is only one way equity-based strategies differentiate from one another. Another way is by how these supersectors are defined. Traditionally, a top-down sorting approach has been used where sector codes delineate infrastructure companies from the rest of the equity market. This is an inexact science that can include or exclude companies based on an overly broad or subjective sector-classification system. In our opinion, a bottom-up approach is more refined as companies are sorted and selected based on either their actual ownership of infrastructure assets, or the revenues derived from these assets. A bottom-up process allows a qualifying company to be included in a diversified portfolio of infrastructure assets regardless of its equity sector classification.

WHAT IS THE UNDERLYING RATIONALE BEHIND AN INVESTMENT IN THE INFRASTRUCTURE SECTOR? WHICH CHARACTERISTICS, E.G. RISK RETURN CHARACTERISTICS, DISTINGUISH INFRASTRUCTURE FROM THE OVERALL EQUITY MARKET?

We view infrastructure as a risk-mitigating tool within a portfolio framework. The asset class offers diversification benefits along with several other attractive investment qualities. In general, infrastructure strategies tend to be defensive in nature and can provide protection in down markets. Additionally, these companies typically provide stable cash flows that can be useful to investors desiring income generation. Finally, because their regulated revenue streams are tied to various economic metrics, these strategies tend to offer some level of protection in both inflationary as well as in rising interest rate environments.«