M&G (Lux) Global Listed Infrastructure Fund

Opportunities and threats in a post-lockdown world

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FOR INVESTMENT PROFESSIONALS ONLY

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This note covers the topics discussed by Alex Araujo, manager of the M&G (Lux) Global Listed Infrastructure Fund, during his webcast on 9 June 2020.

Please note, past performance is not a guide to future performance. The value and income from the fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise. There is no guarantee that the fund will achieve its objective and you may get back less than you originally invested.

Summary

- The period of market volatility in March presented some attractive buying opportunities, in our view; we have been more active than usual in our portfolio management and established four new holdings in utilities.
- The reliable, growing dividends from utilities have strengthened the fund's income stream.
- Fiscal stimulus may provide a favourable tailwind as governments increase infrastructure spending to revive the economy.

Philosophy and approach

Infrastructure holds an important place in the fabric of modern society, serving as the backbone of the world economy through good times and bad. As such, we believe that the stable and growing cashflows generated by the asset class across the vagaries of the economic cycle have an equally important part to play in investors' portfolios over the long term.

Focus on listed companies with physical assets

Our strategy invests in listed infrastructure, with a clear focus on asset-backed businesses in the belief that physical assets provide a barrier to entry. We do not invest in private companies; we only invest in listed companies which benefit from the liquidity inherent to publicly traded equities. By doing so we have tremendous flexibility in our portfolio and our investible universe to take advantage of opportunities presented by market events, such as the indiscriminate sell-off we experienced in March. We will continue to act on these types of opportunities.

We invest in critical infrastructure with physical backing, where the assets are long-life in nature. This long-term aspect is captured in concession businesses, which can generate stable and growing cashflows over several decades, as well as royalty companies, which provide the ultimate in long-term cashflow streams because the cashflows from their physical landholdings are so long term that they run into perpetuity.

Focus on dividend growth

We are resolutely focused on dividend growth in the belief that the asset class provides a broad range of opportunities for long-term growth, from the inflation-linking in certain sectors to the powerful thematic trends driving digital infrastructure. Dividend growth is key to the fund's objective of providing a rising income stream. In that context, the fund's yield is an outcome of our stock selection. Listed infrastructure typically offers a yield premium to global equities and the fund is currently offering a **gross** yield of just under 4%, compared to the MSCI ACWI Index's 2.3% (Source: MSCI Inc., 29 May 2020), but this is very much an outcome. Our income priority is to grow the fund's distribution for our clients.

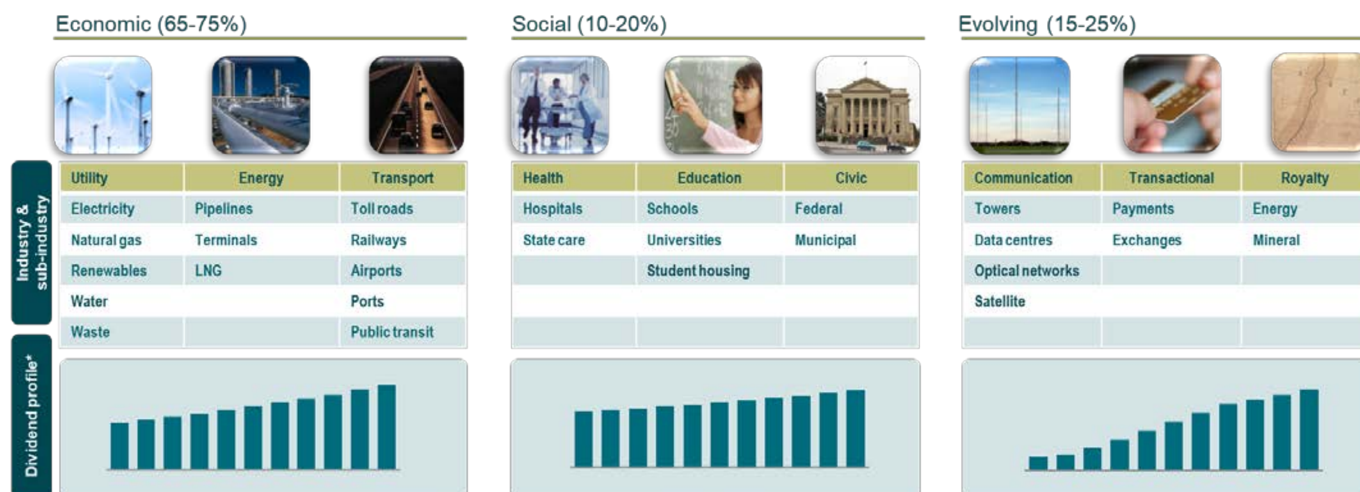
A modern approach to listed infrastructure

Infrastructure is expanding rapidly beyond the traditional realm of utilities, energy pipelines and transport – sectors commonly known as 'economic' infrastructure. In order to capture the full breadth of the asset class and the qualities it has to offer in its entirety, we invest in three distinct categories: 'economic', 'social' and 'evolving' infrastructure. (See Figure 1, overleaf.)

'Economic' infrastructure accounts for the largest part of the portfolio with a typical weighting of 65-75%, but we also invest in the more defensive 'social' infrastructure, which covers facilities in the health, education and civic domain. The 'social' segment typically accounts for 10-20% of the portfolio. 'Evolving' infrastructure, our third and final category, adds a unique profile. The long-term growth opportunities from communications infrastructure, transactional and royalty companies inject a new dimension to an asset class more commonly associated with stability.

Figure 1. Philosophy and approach

Our definition of listed infrastructure: bringing the asset class to the modern age



Source: M&G, 2020. *Expected annual dividend increase, for illustrative purposes only.

'Evolving' infrastructure is expected to range between 15% and 25% of the portfolio.

Creating a balanced portfolio from these three infrastructure classes provides a diversified exposure to an asset class with compelling characteristics.

Performance update

The M&G (Lux) Global Listed Infrastructure Fund is the best performer in its Morningstar peer group since the fund's launch in October 2017 and over one year. The fund has delivered positive returns in both time periods and outperformed global equities. The fund has performed broadly in line with the MSCI ACWI Net Return Index so far in 2020 to date.

The fund participated in the market recovery in April and May. Energy infrastructure and transport, which weighed on the fund's performance in March, led the rebound. The decision to add to selected holdings during the market downturn was swiftly rewarded. Utilities also added value, helped by the contribution of new holdings.

The fund has benefited from diversified sources of performance during the market upturn. Communications infrastructure, which generated a positive return during the sell-off, extended its gains. The importance of digital infrastructure became very apparent during lockdown as millions of people were forced to work remotely and entertain themselves at home. Social infrastructure, which showed resilience in extreme market conditions, also made a positive contribution.

Six-month, one year and since launch performance

	6 months (%)	1-year (% pa)	Since launch on 5 Oct 2017 (% pa)
Fund	-6.5	5.7	8.1
Benchmark	-6.8	5.6	5.6
Morningstar Equity Infrastucture Sector	-9.4	-2.5	1.8
Quartile (Percentile)	2 (35)	1 (1)	1 (1)

Year-to-date and 5-year performance

	YTD (%)	2019 (% pa)	2018 (% pa)	2017 (% pa)	2016 (% pa)	2015 (% pa)
Fund	-8.6	36.7	-1.7	n/a	n/a	n/a
Benchmark	-8.3	28.9	-4.4	9.5	11.7	9.3

Past performance is not a guide to future performance.

Benchmark = MSCI ACWI Net Return Index

The benchmark is a comparator against which the fund's performance can be measured. It is a net return index which includes dividends after the deduction of withholding taxes. The index has been chosen as the fund's benchmark as it best reflects the scope of the fund's investment policy. The benchmark is used solely to measure the fund's performance and does not constrain the fund's portfolio construction.

The fund is actively managed. The investment manager has complete freedom in choosing which investments to buy, hold and sell in the fund. The fund's holdings may deviate significantly from the benchmark's constituents.

Benchmark is Gross Return prior to 01 October 2018 and Net Return after this date.

Source: Morningstar, Inc., as at 31 May 2020, EUR Class A Acc, income reinvested, price-to-price basis. Benchmark returns stated in EUR terms.

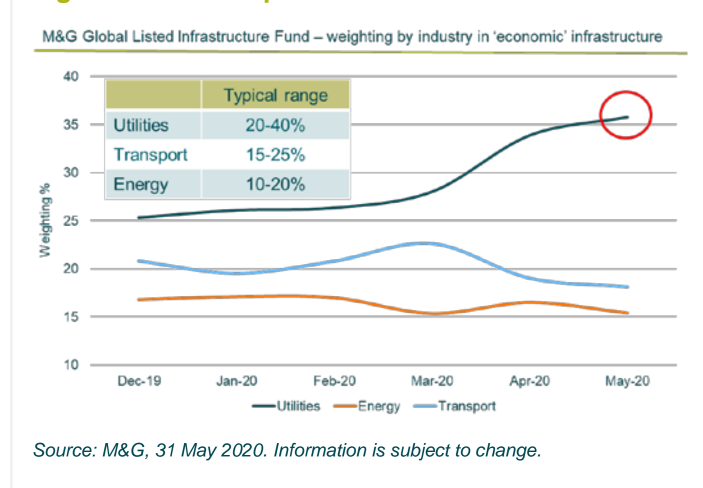
The fund can be exposed to different currencies. Movements in currency exchange rates may adversely affect the value of your investment.

Portfolio activity

The fund is usually managed as a low turnover, buy-and-hold strategy, but the indiscriminate selling in March created buying opportunities for long-life infrastructure assets which are critical for the smooth functioning of modern society, while delivering reliable revenue and cashflow growth. We were more active than usual during the period of market volatility to take advantage of attractive entry points.

We capitalised on relative value in utilities and bought four new holdings in the sector: **NextEra Energy Partners** (US) and **A2A** (Italy) in March followed by **ContourGlobal** (UK) and **China Gas Holdings** (Hong Kong-listed) in April. We have been tracking these companies for many years, but the valuations were out of reach until the recent market downturn presented the buying opportunity we were waiting for. All four stocks have added value since purchase with share price gains of 30% or more. The fund's utilities weighting rose to the highest since inception at just over 35%.

Figure 2. Utilities – increased exposure to the highest since inception



Source: M&G, 31 May 2020. Information is subject to change.

The fund's exposure to energy infrastructure and transport was scaled back after they performed strongly in the market rebound. The weightings in communications and social infrastructure were also reduced, having performed well across the market's ups and downs.

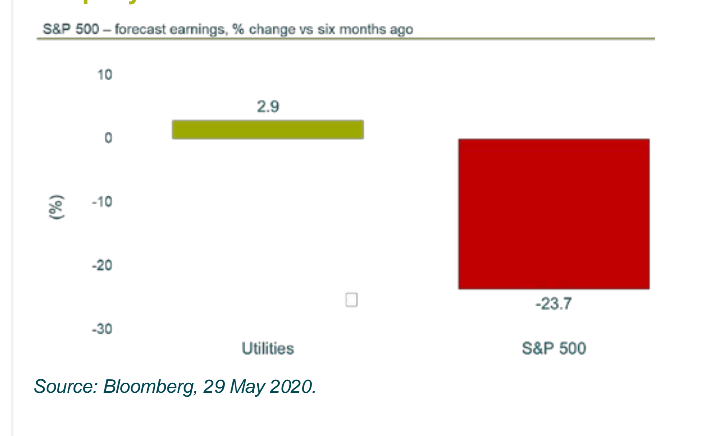
Please note, the fund holds a small number of investments, and therefore a fall in the value of a single investment may have a greater impact than if it held a larger number of investments.

Dividends

In an environment where dividends are under pressure across the market, utilities is one area where we can confidently expect growth in earnings, cashflows and ultimately dividends. The unique resilience of utilities, a core part of our strategy, has helped to improve the reliability of the fund's income stream. The sector provides a bastion of strength against a backdrop of economic uncertainty and continues to demonstrate solid fundamentals. Utilities has been the only sector in the US to see positive earnings revisions when forecasts for the S&P 500 have been downgraded by almost 25%. We also believe the progress in operating performance should lead to solid share price performance from the businesses in which we are invested.

Airports, by contrast, have faced a difficult operating environment as the world entered lockdown and international travel came to a grinding halt. The fund's look-through exposure to airports is limited to about 5%. Dividends from airport companies are under pressure in the short term, with **Sydney Airport** and **Flughafen Zurich** temporarily suspending their payments, but we continue to have conviction in the long-term attractions of their strategic assets. We also take comfort from both companies' commitment to reinstate the dividend as soon as possible. **Vinci** and **Ferrovial** also have airports businesses, but we are optimistic about the prospects for their toll-road assets which are well placed for a recovery in traffic volumes, in our view, given the behavioural changes we are already seeing in a post-lockdown world.

Figure 3. Utilities – sector earnings have been uniquely resilient



Source: Bloomberg, 29 May 2020.

We have no intention of selling out of these airports-exposed holdings on a tactical basis. Our long-term perspective has been rewarded with strong share price performance during the market rally.

The fund has not been immune to dividend cuts elsewhere, but the number of cases has been less than we expected given the severity of the economic climate. It is also to energy infrastructure and transport important to consider the circumstances behind each company. **PrairieSky Royalty's** dividend cut was a cautionary measure for a company with a strong balance sheet, which was seeking greater financial flexibility in response to the energy sector's extreme uncertainty. **Unite Group**, the UK's leading provider of student accommodation, chose to cancel its final dividend after taking the decision not to charge students returning home for the rest of the academic year or overseas students who were required to stay. We believe that the company took the right course of action to deliver on its social responsibility, while preserving its long-term reputation. Both companies remain committed to long-term dividend growth.

The four companies which have cut or suspended their dividends have been exceptions rather than the rule and we continue to see the majority of the fund's holdings deliver

solid growth. Utilities have accounted for most of the dividend increases (**Enel** and **NextEra Energy Partners** were among six utilities reporting double-digit growth), but we have seen higher dividends from elsewhere in 'economic' infrastructure, including **ONEOK** in energy and **CSX** in transportation. We also saw continued growth from 'social' and 'evolving' infrastructure, with **SDCL Energy Efficiency Income Trust** (+10%) and **American Tower** (+20%) leading their respective categories. We remain fully committed to the fund's objective of growing the income stream for our clients.

Outlook

Governments around the world have announced huge fiscal stimulus packages in response to Covid-19, including higher spending on infrastructure, which may provide a favourable backdrop. Our long-term approach is not reliant on fiscal expansion continuing or government initiatives having an immediate impact on economic growth, but we are also conscious that this type of dynamic that can drive strong performance for listed infrastructure.

We are seeing more anecdotal evidence to support this emerging theme. In the US, the New Jersey Turnpike Authority announced a 36% toll hike to help fund $24 billion in capital projects for its highways over the next 15 to 20 years. In an election year where the need for infrastructure spending is one of the few areas that Republicans and Democrats agree upon, we watch with keen interest for similar developments in other states. In Europe, the Spanish government is considering the privatisation of motorways under the toll road model to ensure their maintenance and longevity in light of strained government finances. We have also seen infrastructure contracts being awarded to companies such as Vinci, which we own, for a project associated with the public transit system in Paris. These are important developments for the asset class.

Europe's economic rescue package also stood out for its green agenda, with the issue of sustainability central to the recovery plan. 'Next Generation EU' has a clear policy of promoting renewable energy and clean transport, as well as the renovation and efficiency of buildings and infrastructure to support a more circular economy. Digital infrastructure is another area receiving more investment as Europe strives to improve connectivity in a digital age, with the rapid deployment of 5G networks high on the priority list. Germany's proposal followed a similar vein, with €50 billion earmarked for climate change, innovation and digitisation. Companies exposed to these structural growth trends can prosper to the benefit of its stakeholders, which include employees, shareholders and broader society.

Fiscal stimulus is likely to remain a topical issue until the global economy is on a firmer footing, but it is also important not to lose sight of the fact that listed infrastructure is a beneficiary of powerful trends which are likely to be more enduring. Thematic tailwinds such as renewable energy, clean transportation and digital connectivity are likely to persist for many decades to come. We continue to invest with a long-term view and remain as excited as ever about the long-term growth opportunities in listed infrastructure.

Figure 4. Powerful long-term themes
An asset class driven by multi-decade trends

Source: M&G, 2020.

Questions & answers

We are seeing an increasing number of dividend cuts driven by political reasons. How do you handle those?

A couple of dividend suspensions in the fund were politically motivated. I would highlight Flughafen Zurich which, in our mind, did not need to cut the dividend, but given the bailout of airlines which were primary customers of the airport, it was difficult to be seen as passing on those subsidies to its shareholders in the form of dividends. The company has therefore temporarily suspended the dividend, but I expect that it will very capably reinstate the dividend at an appropriate time. The language around Sydney Airport's

dividend suspension was similar in the sense that it was the right thing to do. We understand the reasons for the actions taken and we will assess the outcome for these airport companies as the situation develops.

Unite Group's dividend cut was also the right thing to do, in our view, after the student accommodation provider decided to forgo revenue despite contractual rights to rent. PrairieSky Royalty's cut was a prudent measure reflecting the new realities of the energy sector, not in any way reflecting balance sheet strain as the company carries zero debt. Both companies remain committed to long-term dividend growth.

In general, we would look to sell a stock if the company had no intention of reinstating the dividend or returning to a path of dividend growth, but none of these holdings fall into that category.

Why is the exposure to 'social' infrastructure so low?

We entered the difficult period in markets with a healthy weighting in 'social' infrastructure, but because these holdings performed so well, they actually funded the increased exposure to other areas. It was really a matter of rotating capital based on relative value. In times of extreme stress and uncertainty, 'social' infrastructure tends to do quite well, the shares re-rate and the valuations extend. When that happens, this category provides a good source of funds to invest in more attractively valued parts of the market. We have not sold any holdings outright and we continue to own the same names, but we have simply reduced the weightings to fund other opportunities and take advantage of a relative valuation gap. We have nothing against 'social' infrastructure, they are critical businesses and should the shares de-rate we would be happy to increase the exposure once again.

Cash levels are reasonably low ahead of a second-quarter reporting season, which may present buying opportunities. How do you see the situation?

The cash position is governed by our philosophy that we want to be fully invested in listed infrastructure for the long term. The cash position, which has been around 1% of the fund on average since inception, gives us the flexibility to manage flows and take advantage of opportunities in the market, but cash is not the only source of liquidity. This is a diversified fund, and the three categories and the various sectors of infrastructure don't necessarily move in the same direction at the same time, so we will use capital rotation out of the better-performing names to fund new opportunities. It's always nice to have liquidity available, but we had no trouble, even with a 1% cash position, adding four new names in March and April. Staying fully invested in listed infrastructure is, in our mind, the best way to serve our clients.

How do you reconcile the recent market rally with the reality of a recession?

The rally has been broad based, with some sectors that probably deserve to be valued as they are, while others do not, and it is incumbent on active managers to assess these relative valuations. I go back to my earlier point about utilities delivering reliable earnings and this is an area where we have increased exposure significantly. We do have economic exposure in the portfolio through transportation and energy infrastructure, for example, but we as active managers are trying to pick stocks with solidity in the earnings and cashflow streams. Of course, there will be volatility and we will see what the reporting season brings, but we focus our attention on asset-backed businesses generating reliable and growing cashflows over the long term and we manage a concentrated portfolio of 40-50 names. We currently have 45. We are being selective. The reporting season could lead to another episode of volatility, but that could present us with another opportunity to take advantage of attractive prices given our long-term investment horizon.

If the result of monetary and fiscal stimulus is inflation, which parts of the portfolio are set to benefit?

This strategy is focused on growth. We are investing in growing cashflows and growing dividends, and in many cases, whether directly or indirectly, the cashflows and revenue streams are linked to inflation. What we want to see for this strategy is a growing economy with gently rising inflation – gently rising inflation which drives pricing and returns. We welcome inflation. I am often asked about the strategy's sensitivity to bond yields and of course we will be exposed to short-term volatility in bond markets, but gently rising inflation benefits us over the long term because we are focused on growth. If we were just focused on delivering a high yield, we would be in a very different position.

How has the portfolio been affected by the lockdown and the unwinding of the lockdown?

The major impact of the lockdown was in 'economic' infrastructure, where the use of transportation infrastructure effectively came to a halt. There was a knee-jerk reaction in the market which we used to our advantage with our long-term investment horizon. Energy infrastructure was another area under pressure. The OPEC supply shock added to a challenging backdrop created by a collapse in demand for hydrocarbons. Utility businesses, by contrast, were highly reliable and consistent throughout the difficult period.

As we come out of lockdown, however, we are already seeing a significant rebound in transportation infrastructure including airports in anticipation of people starting to fly again. Energy infrastructure has experienced a similar rebound. As lockdown eases, I would expect 'economic' infrastructure businesses to bounce back.

'Social' infrastructure was very stable and consistent through the lockdown, similar to the utilities sector, so I would expect this category to underperform as we come out of lockdown, although the need for hospital infrastructure is very clear. There are structural growth opportunities in this segment and we maintain our exposure, albeit at the lower end of our typical allocation range.

In ‘evolving’ infrastructure, here has been a lot of excitement about communications infrastructure during lockdown given the obvious need for digital infrastructure, whether it’s mobile infrastructure, broadband or data centres, but this is not just about lockdown. This is a structural growth opportunity and we are absolutely bullish on this. Transactional infrastructure took a bit of a step back during lockdown just on the payments infrastructure side, but that is rebounding quickly, as are the royalty businesses. This is why we have the flexibility to invest across the three categories and the various sectors to take advantage of opportunities from a timing point of view when equities come under pressure and we are able to take advantage of the rebound.

How would a second wave of Covid-19 affect the portfolio?

In ‘economic’ infrastructure, transportation businesses would face difficulties once again and potentially energy infrastructure businesses. During March these stocks came under significant pressure, but we added selectively and aggressively in some cases to holdings we had confidence in. On the rebound, the re-rating of these equity values took the weights of these sectors to quite high levels. What we have been doing is to manage those exposures and bring them back so that if we were to see another wave we would have some protection. Our much higher utilities exposure, while generating reliable dividend income, also provides a defensive backdrop.

I don’t want to underplay the benefit that volatility can bring. We are a long-term minded investment strategy so if the market in its panic wants to de-rate equity values excessively, we will take advantage. It’s a matter of position sizing and having the appropriate sector weight should we face another wave of volatility.

How do you approach ESG?

ESG has been integrated in the investment process from day one, so we have been doing it all along. The latest crisis has underscored the importance of ESG, particularly the governance aspect as we have to make sure that companies are being governed appropriately, that decisions about dividends are appropriate for stakeholders, the social element has come to the fore with multiple stakeholders being considered. Unite Group was a perfect example of that, where we feel that the company did the right thing for its customers, for the business and for stakeholders outside of shareholders. Our ESG process is driven by an assessment of the sustainability of the assets of listed infrastructure businesses. We cannot afford our companies to lose their social license to operate or their assets to become stranded. These are concerns that come to the fore in the midst of an economic crisis, so these assessments are absolutely critical. We do our own research and we do make use of external agencies in assessing the ESG credentials of businesses, but ultimately we do our own work and don’t necessarily follow to the letter what the external agencies tell us. We take our own views and we have been rewarded for having contrarian views. It’s absolutely critical, it’s all focused on sustainability of assets and cashflows which we expect to grow over time so that we can receive higher dividends which we can distribute to our investors.

M&G
June 2020

Please note that the fund invests mainly in company shares and is therefore likely to experience larger price fluctuations than funds that invest in bonds and/or cash.

Further risks associated with this fund can be found in the fund’s Key Investor Information Document.

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