



EXPERTINSIGHT

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How real assets can help protect against inflation

Higher costs of both energy and food have contributed to a significant increase in inflation all around the world. Notably, this process was well underway even before the Russian invasion of Ukraine and is by no means limited to these two sectors. Annual inflation rates of 9% in the US and over 10% in the UK are the highest in 40 years¹. Price increases are widespread, with supply chain interruptions and a Northern Hemisphere heatwave making a bad situation even worse.

This period of high inflation, low growth and rising interest rates has been especially painful for investors. In H1 2022 and for the first time in over 50

years, a more than 20% decline in equity markets² worldwide was accompanied by a near double-digit percentage loss in bonds.

A European investor who had placed his or her funds in the continent's supposedly safest securities – ten-year German government bonds – would have suffered a 12% drop in the first six months of the year. Meantime, a traditional 60/40 balanced stock/bond portfolio saw its value fall almost one-fifth³.

The scale of value destruction is quite staggering. Total world stock market capitalisation tumbled by 23.6 trillion

dollars whilst global outstanding debt market value fell by 8.1 trillion dollars⁴.

Looking across this generally bleak investment landscape, there were nonetheless a few bright spots. Most obvious were energy and commodities. Natural gas rose 64%, Brent Crude oil by 52% and wheat by 20%; pushing the CRB commodities index up by 30% in just six months⁵.

Elsewhere, the performance of infrastructure assets also catches the eye. There are a number of infrastructure indices, which aim to measure the performance of listed infrastructure companies. They vary in size and scope and some are specific to individual geographies or sectors.

There are three main global infrastructure indices, each with different methodologies and sampling but all of them backed by well-respected investment industry practitioners. In H1 2022, these three main indices - Stoxx, S&P and MSCI - delivered returns of 7.0%, 3.2% and 0.5% respectively; an impressive feat in a challenging macro environment. Adding infrastructure assets to the investment portfolio would have increased absolute returns and lowered volatility; exactly what the textbooks and financial literature would suggest.

Infrastructure covers a wide range of assets across many sectors. Within transport, it encompasses roads, ports, railways, pipelines, tunnels and airports. It includes power transmission and generation - whether conventional or renewable - ground-based or orbital telecommunications, data centres, water supply, sanitation and waste management and can include housing, education, prison, stadiums and healthcare facilities.

As investors seek to shelter their traditional equity and bond portfolios from the shrinking real value of their dividend income streams, and from higher Central Bank interest rates, we believe real assets can continue to be more resilient and offer genuine diversification benefits.

Infrastructure investment shares some characteristics with other asset classes but

is generally distinct from them. There is, for example, the potential for capital appreciation driven by operational efficiencies or for refinancing, which characterises both private and listed equity. There is the long-term cash flow predictability which infrastructure shares with fixed income and the potential for inflation-linked returns on a tangible asset, which together underpin the attractions of real estate.

The risk/return profile of infrastructure investment varies according to the specific attributes of each asset, and to whether it is listed on a regulated Stock Exchange or is a private, unlisted security. While listed assets are valued daily by the stock market, unlisted assets are based on their net tangible value using discount rates and cash flows adjusted to reflect the current consensus view of economic conditions and asset-specific drivers.

Recent innovations such as the investment trust, we at ThomasLloyd, listed on the London Stock Exchange in December 2021, are solving the problem of delivering long-term assets with daily liquidity and the highest regulatory and reporting standards. This makes the asset class investable for a much wider group of retail and institutional investors who might previously have been unable or unwilling to commit funds to a vehicle with a lengthy lock-in period or one for which liquidity was not readily available.

For the rest of this year and into 2023, consumers everywhere are facing higher food and energy prices at the same time as higher debt service costs on their home loans. With wage growth still much lower than inflation, falling real incomes are hitting household consumption and will surely hit business investment too. It is a very challenging macro background.

Having proved their worth during a period of global wealth destruction, we expect that real assets will be increasingly attractive to investors, offering some degree of inflation protection whilst generating positive, visible cash flows over a long operational life.

Infrastructure as an asset class is doing exactly what investment theory says it should.



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Sources

¹ Bloomberg

² Bloomberg, ThomasLloyd calculations

³ Bloomberg, ThomasLloyd calculations

⁴ Bloomberg, ThomasLloyd calculation

⁵ Bloomberg, ThomasLloyd calculations

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