FINANCIAL STANDARD GUIDE TO INFRASTRUCTURE

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NUCLEUS GLOBAL INVESTORS

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Editor
Michelle Baltazar
michelle.baltazar@financialstandard.com.au

Writer
John Kavanagh
john@thesheet.com

Research
Andrew Keevers
andrew.keevers@rainmaker.com.au

Publisher
Christopher Page
christopher.page@rainmaker.com.au

Production Manager & Designer
Kym-Maree Apps
kym-maree.apps@financialstandard.com.au

Level 2, 151 Clarence Street, Sydney NSW 2000
Phone: 02 8234 7500 Fax: 02 8234 7599

www.financialstandard.com.au
www.rainmaker.com.au

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S&P reports that money invested in these funds has risen from $200 million in 2006 to more than $2 billion today.

INDUSTRY SNAPSHOT

TO TALK OF INFRASTRUCTURE as a new asset class is, at first sight, odd. Governments around the world have been handing over the task of building and managing power stations, water storage and distribution, roads and telecommunications networks to the private sector for years. Large institutional investors have been backers of this privatisation process for just as long. In addition, there are many infrastructure companies listed on the world's stock exchanges.

What is new is the emergence of a group of managed funds, sold to retail investors through platforms or product disclosure statements that invest in listed infrastructure companies around the world.

According to Standard & Poor's, there were two listed infrastructure funds operating in the Australian market in 2006. They were Lazard Asset Management's Lazard Global Listed Infrastructure Fund and the Macquarie International Infrastructure Securities Fund.

A year later, two more managers entered the market. RARE Infrastructure Ltd launched the RARE Series Value Fund and RARE Series Emerging Markets Fund. UBS Global Asset Management launched the UBS Global Infrastructure Securities Fund.

By early 2008 the number of listed infrastructure funds had risen to seven, with the addition of the Magellan Infrastructure Fund, the Colonial First State Global Listed Infrastructure Fund and the BGI Infrastructure Fund.

New funds are appearing all the time. A boutique manager, Nucleus Global Investors, launched the Nucleus Global Infrastructure Fund in mid-2008.

S&P reports that money invested in these funds has risen from $200 million in 2006 to more than $2 billion today. That strong increase reflects investor demand for the type of returns these funds can offer – consistent, inflation-linked yields derived from long-term assets whose performance tends to remain consistent through the different phases of the economic cycle.

All the funds construct their portfolios from a global universe of stocks and all but one have a bottom-up stock-picking investment style.

While listed and unlisted infrastructure assets are not fully immune to market corrections, such as the one in September 2008, their earnings are more stable than other asset classes. This report explores why infrastructure's mix of defensive and growth characteristics appeal to investors in bull and bear markets.

TYPES OF INFRASTRUCTURE ASSETS

ASSETS THAT AN INVESTOR WOULD EXPECT TO FIND in an infrastructure portfolio include airports, communications infrastructure, electricity generation, transmission and distribution, marine ports, airports, toll roads, water facilities, pipelines and railroads.

Infrastructure assets provide essential services. They are the building blocks of modern economies. One feature of such assets is that demand for them remains consistent throughout the economic cycle and they produce steady returns. When times are tough people still use water, gas, electricity and roads to get to work.

This is the characteristic that makes infrastructure a defensive asset in an investment portfolio. An investment in infrastructure has a lower risk profile than an investment in equities.

An important characteristic of infrastructure companies is that they are owners of monopoly or quasi-monopoly assets. There are a limited number of providers because the assets cannot be replicated easily. There is usually only one toll road connecting parts of a city, one major airport and one water supplier.

Because of this monopoly position, infrastructure assets tend to be regulated. Prices are set by government, they tend to rise in line with inflation and a rate of return is often guaranteed.

There are usually high barriers to entry in the markets in which infrastructure assets operate, which means that it is very difficult for competitors to take business away from established operators.

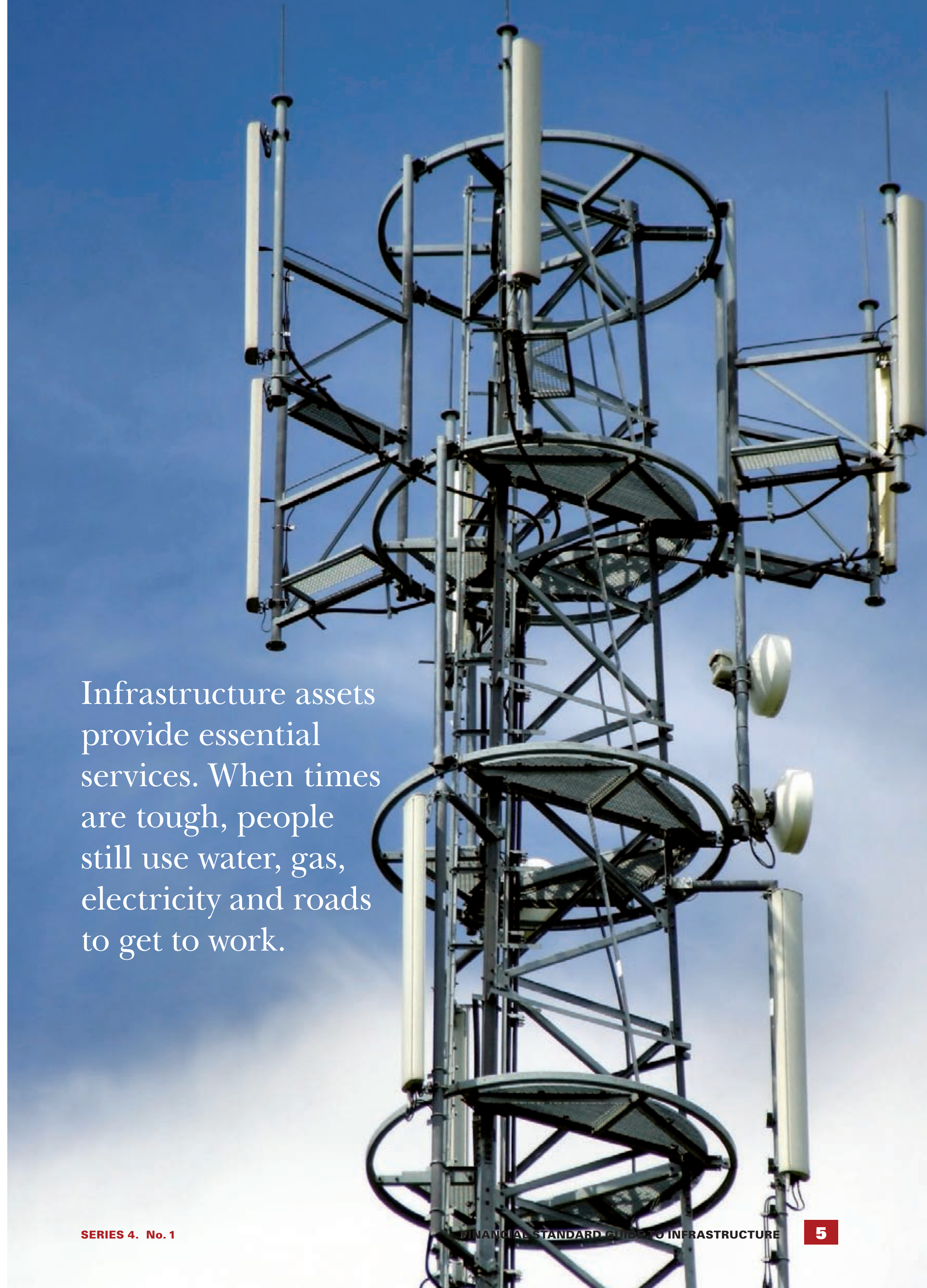
Operating in regulated markets where competition is limited, infrastructure assets are able to produce stable returns. Fund managers agree that an infrastructure portfolio should pay a dividend yield of four to six per cent a year and a total return of around 10 per cent. Volatility is lower than a normal equity investment and the risk of loss is low.

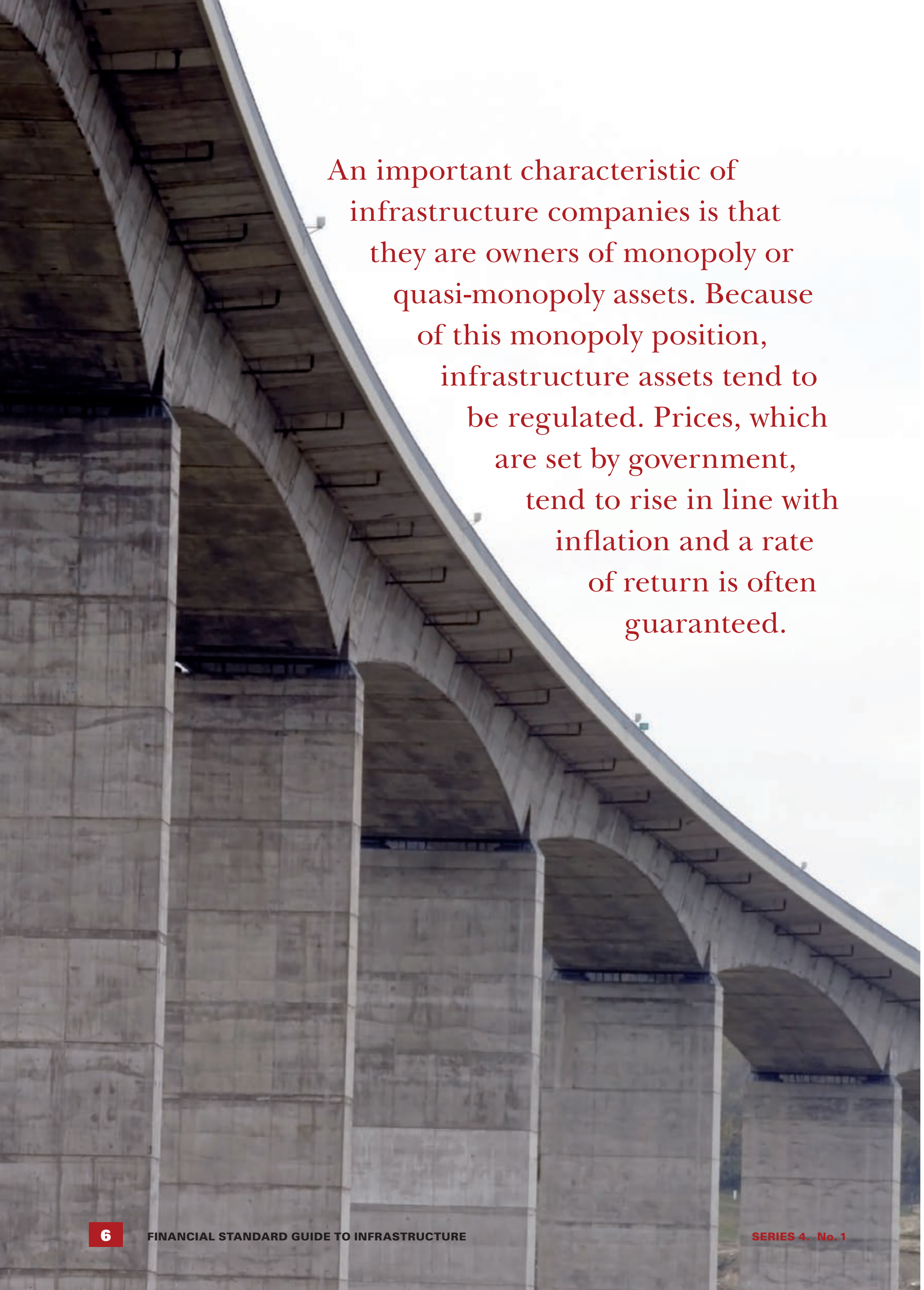
The low volatility and low risk of loss are functions of the characteristics of the assets – long life assets providing essential services in regulated markets, with regulated pricing.

The World Bank forecasts that US$4 trillion will be invested in infrastructure in the next five years, double that of the last five years.

The consultant Booz Allen predicts that over the next 25 years the US will need US$6 trillion of investment in water, electricity and roads. For western Europe, Booz Allen predicts the figure is US$9 trillion

According to Citigroup research, China has spent more in the past five years on infrastructure than in the past 50 years. The country is planning US$2 trillion in investment on railways, 97 new airports and 16,000 new highways.





An important characteristic of infrastructure companies is that they are owners of monopoly or quasi-monopoly assets. Because of this monopoly position, infrastructure assets tend to be regulated. Prices, which are set by government, tend to rise in line with inflation and a rate of return is often guaranteed.

Increasingly, the money for investment in infrastructure comes from the private sector – superannuation funds, private equity funds and private investors. Citigroup says that US$87 billion has been allocated to global infrastructure by private equity funds.

The infrastructure asset class is usually divided into two sub-classes – infrastructure and utilities. Infrastructure includes toll roads, communications infrastructure, ports and airports. Utilities include power generation, transmission and distribution and water.

The two groups are classified separately because they have different risk and return characteristics. Different fund managers have a preference for one over the other.

BEWARE INFRASTRUCTURE ASSET CREEP

As demand for investment in infrastructure grows, some investment banks and fund managers are casting the net wider as they look for assets to offer investors. Some commentators believe the net is being cast too wide – a process that has become known as asset creep.

RARE Infrastructure senior portfolio manager, Nick Langley, says investors should take care to check a fund manager's mandate before committing their money.

"We have seen funds that offer timber plantations, aged care facilities, logistics parks. The boundary between property and infrastructure is often blurred," says Langley.

He adds it would be possible to make a case for adding any of these assets to an infrastructure portfolio but argues that they fail the test based on the profile of their returns. "With timber there is no cash flow along the way and you have no idea what the market price will be at the end.

"Aged care would struggle to meet the definition of infrastructure because there are no barriers to entry into that industry and therefore operators have no pricing power."

Lazard Asset management portfolio manager, Warryn Robertson, says: "There is a US infrastructure fund that has an investment in a home builder. Another invests in the credit card company Visa, arguing that it is some kind of payment infrastructure asset.

"You have to come back to the original philosophy of these things. You are investing in assets that will give you a particular return. You are looking for a bond-like return that keeps pace with inflation, low risk of capital loss and the capacity for growth in earnings over time through ongoing investment.

"Assets that produce those returns are long-life assets in monopolistic markets and with regulated pricing."

BENEFITS OF INVESTING: LISTED VS UNLISTED

ONE OF THE BIG DEBATES IN INVESTMENT MANAGEMENT over the past year has been about the most appropriate structure for investing in infrastructure. Investors can put their money directly into an unlisted fund or company, a listed fund or company, or invest in a managed fund that holds a portfolio of listed infrastructure assets.

The case against listed investment, either direct or though a managed portfolio, is that it introduces market risk into an asset class that is usually characterised as having defensive risk and return features and stable cash flows. If the underlying asset performs in the same way, whether it is listed or unlisted, why introduce unwanted volatility through a listed holding?

Another argument is that investment banks promoting listed infrastructure vehicles have structured them with too much debt, high fees, complicated business models and unfair management arrangements with related parties.

On the other side of the debate investors in listed vehicles argue that listed infrastructure assets provide liquidity, diversification, access to a wider range of assets and markets, and the opportunity to buy undervalued assets.

On the question of volatility, listed infrastructure fund managers say an investor adding infrastructure to their portfolios should have a medium to long term return horizon and should be prepared to ride out short term volatility.

Lazard Asset Management infrastructure portfolio manager Warryn Robertson says: “The flip side of volatility is the opportunity you get as an equity manager to buy mispriced assets.”

In a study of listed infrastructure assets published early in 2008 Standard & Poor’s concluded: “The listed market provides access to the infrastructure sector and offers the liquidity of the stock market. However, investors also take on market risk, as the value and return of an investment may fluctuate significantly over short periods of time due to the regular re-pricing of the stock exchange.

“Over the long term, characteristics have historically been in line with the unlisted infrastructure sector.”

S&P also found that historical correlations between infrastructure companies and the broad ASX and MSCI stock indices were low over the longer term.

Stocks in the sector index, the UBS global infrastructure and utilities total return index, produced an average return of around 14 per cent a year over the five years to the end of June 2008. That return compares to the 16 per cent average annual increase in the S&P/ASX 200 accumulation index over the same period.

However, the ASX 200 has standard deviation of 11 per cent, compared to the 9.5 per cent standard deviation of the UBS index. What the figures show is an equity-like return with low volatility.

Many financial planners consider infrastructure funds as a source of diversification away from listed property funds. The standard deviation of the S&P/ASX 200 property accumulation index over the five years to June 2008 was close to 15 per cent.

The managed investment research group Lonsec has done some analysis of the correlation between listed infrastructure and other assets. Over a five year period to the end of June 2008, the UBS global infrastructure and utilities total return index had a 46 per cent correlation to the MSCI global equity index, a 23 per cent correlation to the global property index and a four per cent correlation to the global bond index. These correlations are not high.

Nucleus Global Investors’ portfolio manager, Brian Ingham, says “The reason for the low correlation is the type of assets we are talking about. Infrastructure assets are long-life assets, usually operating in a regulated monopoly and with some pricing power.”

Ingham says listed infrastructure funds will suffer losses during bear markets, such as the one which overtook global equity markets in 2008, but the volatility will be less. Because infrastructure stocks operate in regulated markets and have earnings certainty they will be among the first stocks taken up by risk-averse investors as markets recover.

The global listed infrastructure market boasts over 200 large liquid infrastructure and utilities stocks, and the market is growing.

RARE Infrastructure investment director and senior portfolio manager, Richard Elmslie, says: “In 1989 when I started working in this area in the United Kingdom the total market capitalisation of the listed infrastructure and utility stocks was about $100 billion. Most of the stocks were US gas producers and electricity generator.

“By 1996, the capitalisation of the top 200 stocks in the sector had hit $400 billion. Today it is $2.6 trillion. There has been very strong growth in the listed sector as a result of organic growth and ongoing privatisation. That growth presents investors with great opportunities.”

As to the argument that the listed infrastructure sector is dominated by investment banks over-gearing their assets and taking big fees, the fund managers say that is a uniquely Australian phenomenon. All the listed infrastructure fund managers reviewed by Standard & Poor’s have global mandates and show a strong preference for assets with low gearing.

INFRASTRUCTURE AS A MAINSTREAM ASSET CLASS

Sponsored statement

Nick Langley, senior portfolio manager, RARE Infrastructure

Nick Langley
RARE Infrastructure

INFRASTRUCTURE HAS BECOME a mainstream asset class. The development of a significant listed market, some US$2.5 trillion globally or roughly twice the size of the Australian market, means the ability to invest in these attractive assets is within the reach of all investors.

Infrastructure companies generally include regulated utilities and user-pays assets, such as toll roads, airports, and ports. These companies exhibit defensive characteristics because they tend to be less exposed to business cycles. They often have inflation linked returns; toll roads and regulated utilities generally have their tariffs adjusted by an inflation factor each year. These are long term assets and, as such, are attractive investments for core portfolio holdings.

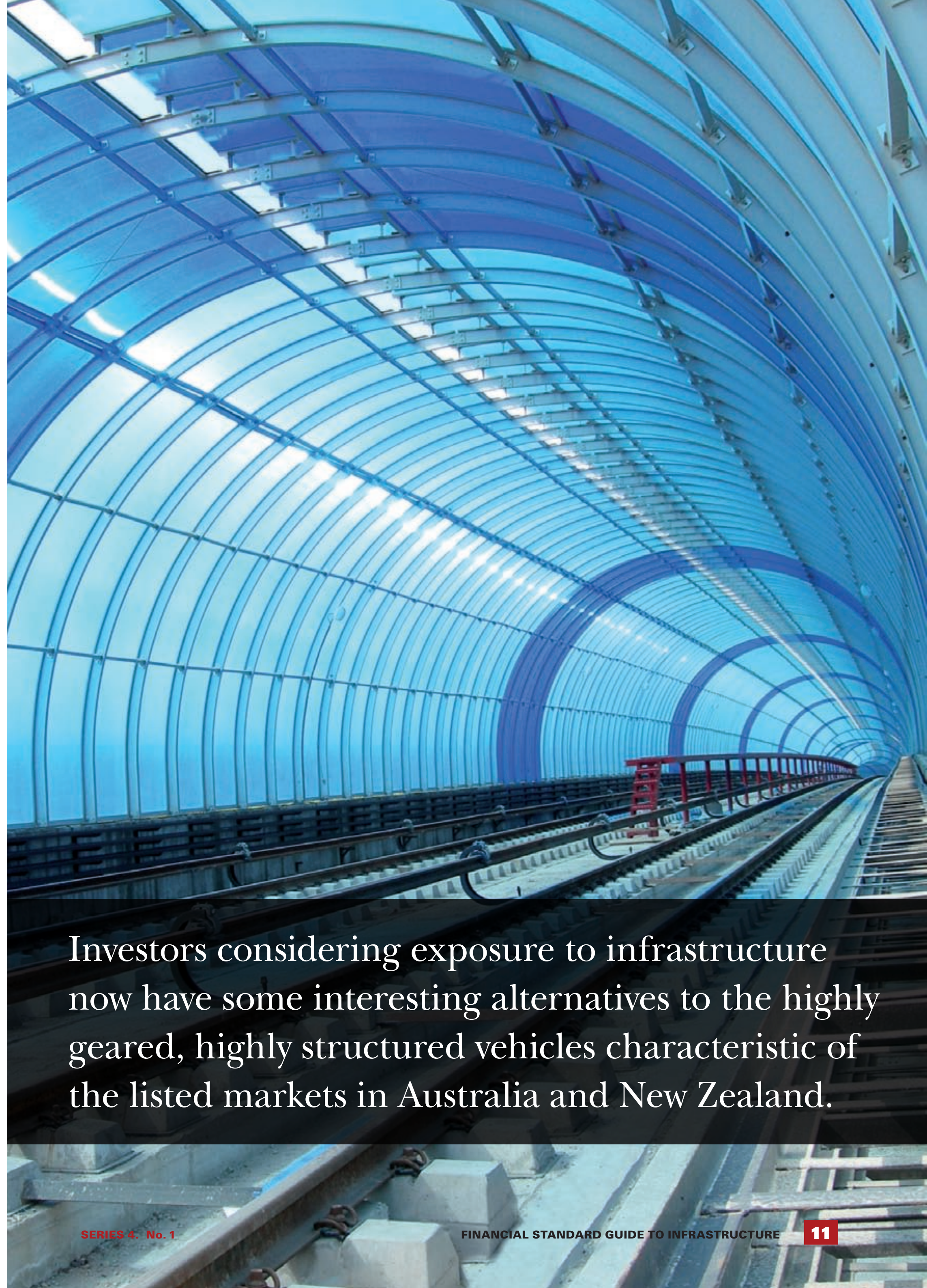
Investors considering exposure to infrastructure now have some interesting alternatives to the highly geared, highly structured vehicles characteristic of the listed markets in Australia and New Zealand. A number of local fund managers, such as RARE Infrastructure (RARE), are offering funds exposed to overseas utility and infrastructure companies.

There are some important differences between these overseas companies and the local variants including the gearing versus yield equation, the sustainability of the funding structures, and the organic growth embedded in these companies.

Local utility and infrastructure entities tend to be highly structured “stapled security” vehicles designed to carry “optimum” debt levels and pay out a significant proportion of the post-financing cash flows.

Overseas companies tend to be simpler corporate structures that distribute based on a payout ratio and carry far more conservative debt levels. This gives rise to the gearing versus yield equation. On average, the gearing of Australian and New Zealand vehicles (utilities 61 per cent, infrastructure 47 per cent) are significantly higher than the gearing of European (utilities 29 per cent, infrastructure 29 per cent) and North American (utilities 38 per cent, infrastructure 16 per cent) companies.

However, the yields of Australian and New Zealand vehicles (on average utilities 9.7 per cent, infrastructure 8.8 per cent) are significantly higher than overseas companies (on average ranging from 2.2 per cent to 4.4 per cent).



Investors considering exposure to infrastructure now have some interesting alternatives to the highly geared, highly structured vehicles characteristic of the listed markets in Australia and New Zealand.

While the higher yields may seem attractive in the short term, they come with a significant increase in financial risk, which as recent markets have demonstrated can cause significant capital losses as risk appetites and premia change.

Given the long term nature of the underlying infrastructure assets, it is important that companies consider the sustainability of their funding and capital structures.

A review of the most recent year of distributions shows that, on average, Australian and New Zealand vehicles tended to pay out a much greater proportion of their operating cash flows as distributions (utilities: 205 per cent, infrastructure: 90 per cent). A score of less than 100 per cent indicates that more distributions were paid than actual operating cash flow, the syndrome of borrowing to make distribution payments. By contrast, overseas companies scored much higher (on average, 253 per cent to 347 per cent) indicating more sustainable long term capital structures and greater financial flexibility.

RARE's investment team researches companies in both developed and emerging markets and pays particular attention to the organic growth profiles of the companies considered for investment. RARE believes that investment in organic growth tends to be far less risky than growth by acquisition because the investment takes place within or adjacent to existing networks or regulatory frameworks.

In addition, no premium for control or assessment of operational synergies is required both of which add risk to acquisitions.

A review of RARE's forecast compound annual earnings growth (measured by earnings before interest, tax, depreciation and amortization or EBITDA) over the next three years shows the Australian and New Zealand vehicles with generally lower growth (on average utilities 4.7 per cent, infrastructure 6.3 per cent) than overseas companies (on average, 6.1 per cent to 8.6 per cent). A number of industry participants expect that these growth rates will increase significantly with in excess of US$20 trillion to be spent on global infrastructure projects over the next twenty years.

RARE (which means Risk Adjusted Returns to Equity) believes in the active management of listed infrastructure assets to achieve superior medium to long term returns and attractive risk/return characteristics. Buying these assets in a listed form provides the benefit of liquidity and the ability to construct a diversified portfolio.

RARE's flagship product, the RARE Infrastructure Value Fund, invests between 75 per cent and 100 per cent in developed markets and up to 25 per cent into emerging markets and has returned 12.2 per cent pa since its November 2006 inception, as at 31 May 2008.

WHAT MAKES A GOOD INFRASTRUCTURE INVESTMENT

WHEN LAZARD ASSET MANAGEMENT portfolio manager Warryn Robertson sits down to review the infrastructure market he starts with the 400 stocks, capitalised at US$3 trillion, listed on markets in North America, Europe, Asia and Australasia.

The stocks in this opportunity set are electrical, gas and water utilities, pipeline companies, airport and toll road operators, railways and marine port businesses.

Lazard only looks for long-duration assets that will deliver inflation-linked return with low risk of capital loss, and that opportunity set of 400 is quickly whittled down to an investable universe of just over 230 stocks.

Some of the initial filtering at that point includes minimum market capitalisation, ownership structure (the operating company must own the asset) and preferred markets.

Robertson says: "Not all infrastructure assets will deliver the investment characteristics we are looking for. To provide revenue certainty there must be stable demand, monopolistic characteristics, regulated inflation-linked pricing and long-term contracts.

"To ensure profitability the asset must have high operating margins, sustainable gearing and an appropriate cost structure."

"And when we look at the longevity of the asset we prefer assets in markets where the economy and the legal system are well developed."

After those criteria have been applied, the number of stocks still available for consideration comes down to about 150. Stocks are then measured against a qualitative risk ranking that covers demand volatility, competition, operating margin, cost and gearing.

Out of the 80 or so stocks left the manager applies some portfolio construction rules around stock weightings, sector and geographic diversification and liquidity to come up with a portfolio of 25 to 50 stocks.

Robertson says he has a preference for mature assets. "We like to get them at the cash cow stage of their life," he said.

RARE Infrastructure senior portfolio manager Nick Langley says his group screens a universe of 1200 global stocks for long-dated assets, predictable cash flows, asset ownership, monopoly characteristics, attractive yields with inflation hedges and low volatility of earnings.

At the next stage RARE researches 200 to 250 stocks, focusing on liquidity, financial strength and valuation. In the final detailed research of 80 to 120 companies RARE looks at the quality of management and corporate governance, the regulatory environment and the cash flows. The portfolio is made up of 30 to 60 stocks.

THE GEARING DEBATE

Lazard applies a gearing screen to infrastructure, ranking those companies with debt to assets of more than 60 per cent as highly geared. The only highly geared stocks that have made it into the portfolio are Australian ones.

Robertson says, "We don't rule a highly geared stock out automatically. We look at whether the cash flows are robust, at the duration of the debt and its make-up. We assess the risk.

"High gearing is used to pay higher dividends. Our view on this is that the level of dividends doesn't affect the value of the equity. Paying higher dividends than can be currently sustained by free cash flow is an accounting sleight of hand used to give comfort to retail investors looking for stability.

"It can be something of a misrepresentation but makes no difference to the professional investor who does proper work on the company."

Nucleus Global Investors does not have any investments in Australia because it does not support the highly geared model that has prevailed in this market in recent years.

Nucleus portfolio manager Brian Ingham says: "Thirty to 50 per cent gearing is our range. The highly geared business models are not sustainable."

The stocks in RARE Infrastructure's Value Fund have average gearing (net debt to enterprise value) of 36 per cent. Portfolio manager Nick Langley says gearing is one of the parameters in the screening process.

Nucleus Global Investors portfolio manager Brian Ingham says: "Good infrastructure companies can be defined as companies where the owner is also the operator of the asset and does not employ an external manager, and where investor needs are aligned with operating management."

Nucleus starts narrowing its investable universe by picking only from the 250 stocks in the UBS global infrastructure and utilities index. It then applies a number of screens to get down to about 150 stocks. Infrastructure assets must be in OECD countries, market capitalisation must be greater then US$400 million, accounts must be transparent, and the return profile must be stipulated by a regulator.

To get the number of stocks down to around 80, Nucleus looks are price-earnings ratios, price to cash flow, dividend yield and so on. To get to the 40 or 50 securities in the portfolio it then looks more closely at the regulatory regime in which the asset operates, sovereign risk, the quality of the board and management.

Nucleus aims to beat the Australian inflation rate by 6 per cent a year. That equates to a total return of 10 per cent or more a year. The majority of Nucleus holdings are in the US and Europe. It does not have any Asian or Australian holdings.

THE BENCHMARK DEBATE

There are infrastructure benchmarks covering the local and global markets but they are not universally supported.

Lazard does not use a benchmark. It has a target return of inflation plus five per cent over a rolling five-year period.

Nucleus Global Investors aims to outperform the UBS global utilities and infrastructure index by one to three per cent a year over a rolling five year period.

RARE Infrastructure is an absolute return manager that targets a return ahead of the G7 economies' rate of inflation plus five per cent.

Managers believe they can produce returns of anywhere between eight and 12 per cent a year, with low volatility.

China has spent more in the past five years on infrastructure than in the past 50 years. The country is planning US$2 trillion in investment on railways, 97 new airports and 16,000 new highways.

THE NEXT FRONTIER

ONE OF THE MOST HOTLY DEBATED TOPICS among infrastructure fund managers is whether it is appropriate to invest in infrastructure assets in emerging markets. Supporters of emerging markets like the exposure to fast growing economies, while those who keep away do so because of the risk.

RARE Infrastructure is a strong supporter of emerging markets. It has 20 per cent of its RARE Series Value Fund allocated to emerging markets and also offers the RARE Series Emerging Markets Fund.

RARE senior portfolio manager Nick Langley says the group looks at factors such as the regulatory environment and the predictability of cash flows when it does its qualitative scoring of stocks and it factors sovereign risk into its cost of equity assumptions.

What the group likes about infrastructure assets in emerging markets is the exposure they give the fund to strong economic growth.

RARE senior portfolio manager Richard Elmslie says: "We have an investment in the Spanish toll road operator Cintra, which has 11 per cent of its assets in Chile. We have an investment in a Hong Kong-based Chinese toll road operator.

"As Chinese GDP grows car ownership will go through the roof. Portfolio performance improves with the addition of these companies because emerging market economies are growing rapidly. The stocks can be volatile but we are looking at a three to five year investment horizon."

Lazard Asset Management has no emerging markets stocks in its infrastructure portfolio. Lazard portfolio manager Warryn Roberston says: "We exclude emerging markets stocks. There is an issue with the risk return trade-off. We believe that the profile is higher risk."

Nucleus Global's Ingham says: "We stick to assets in OECD markets because we get better transparency and liquidity.

"We want to be able to move in and out of a stock quickly. We want to be able to analyse it and be confident about the value we put on it.

"Anyway, there are lots of opportunities in developed economies. We ask ourselves whether we will get any extra bang for our buck taking the extra risk, and we don't think we will."

Fund managers point to Europe, where the European Union has been encouraging member countries to upgrade infrastructure using private sector participation.

A NEW INVESTMENT HORIZON: PREFERRED INFRASTRUCTURE

Sponsored statement

Warryn Robertson, portfolio manager, Lazard Asset Management

Warryn Robertson
Lazard Asset Management

INFRASTRUCTURE ASSETS are some of the essential building blocks within the structure of the modern economy. They enable the delivery of some of the fundamental services that are essential to the operation of a modern community or society. They also present investors in some select cases, with very attractive investment opportunities. Among such assets are tollroads, energy and water transmission and distribution utilities, airports, railways, ports and communications towers.

Listed infrastructure is a separate and distinct asset class that is growing rapidly, due to an increasing shortfall of public investment in infrastructure. Its management requires specialist knowledge, but offers attractive liability matching characteristics for long-term investors.

Many investors in the past have had sub-optimal allocations to infrastructure, due to the high costs of access and the difficulties in diversifying exposures. The global listed infrastructure markets are now of a size similar to the Australian Stock Exchange and are expected to grow much more rapidly. This offers the potential to invest in infrastructure at lower costs, with greater liquidity and within a well-diversified portfolio spread across geographies, assets, regulatory regimes, and political risks.

While the infrastructure sector is relatively immature globally (Australia's, for example, is more advanced than those of many other regions), already some leading international pension funds allocate up to 10 per cent of their portfolio to infrastructure. At Lazard, we believe that there is a convincing case for allocating some part of an investment portfolio specifically to infrastructure assets.

We do not believe that all infrastructure assets are equal. Only a select group of the world's infrastructure assets actually offer the attractive characteristics we look for. We have identified these characteristics as longevity of the assets, lower risk of capital loss and inflation-linked revenues and it is companies that possess these characteristics that are most likely to deliver desirable investment returns.

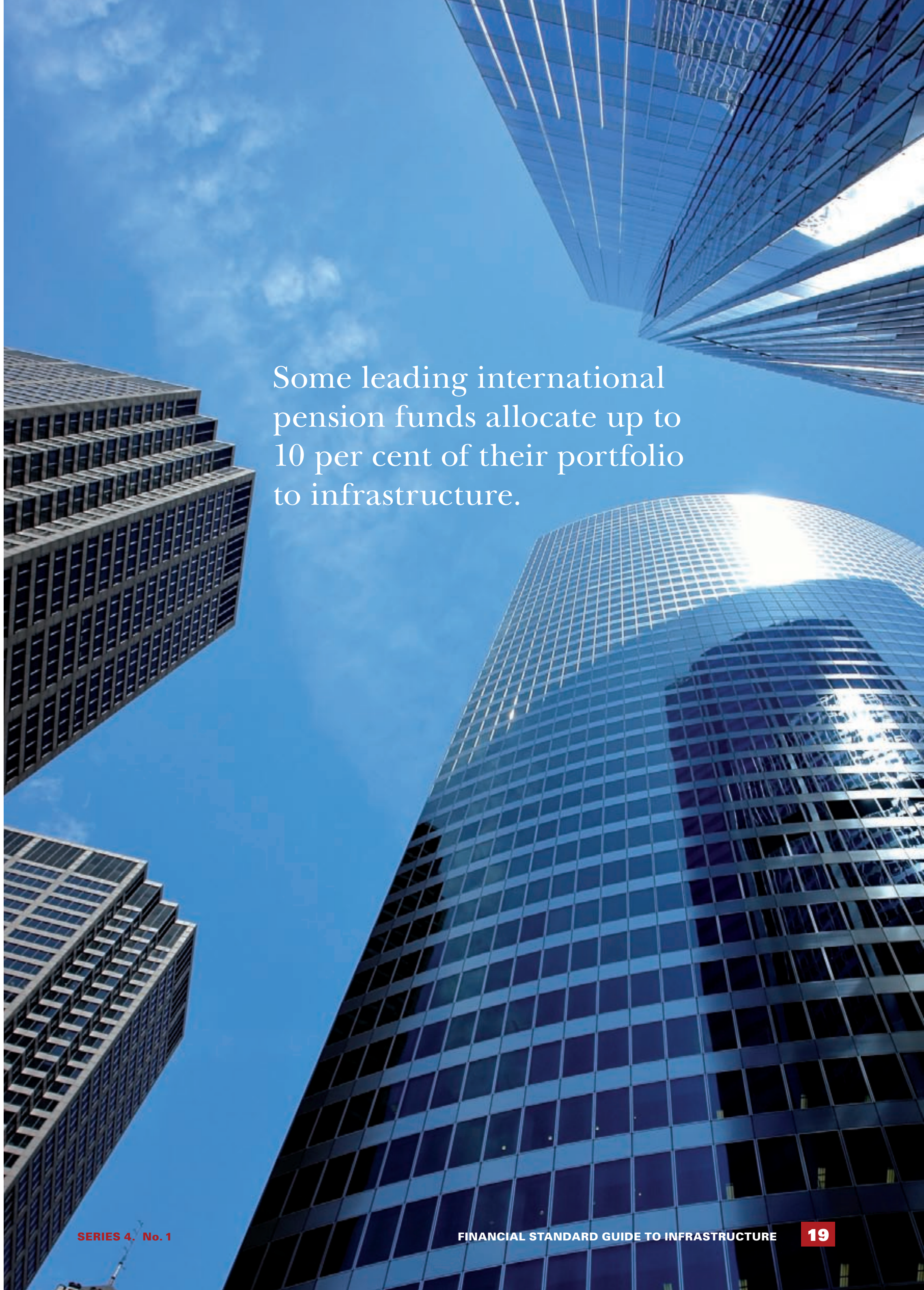
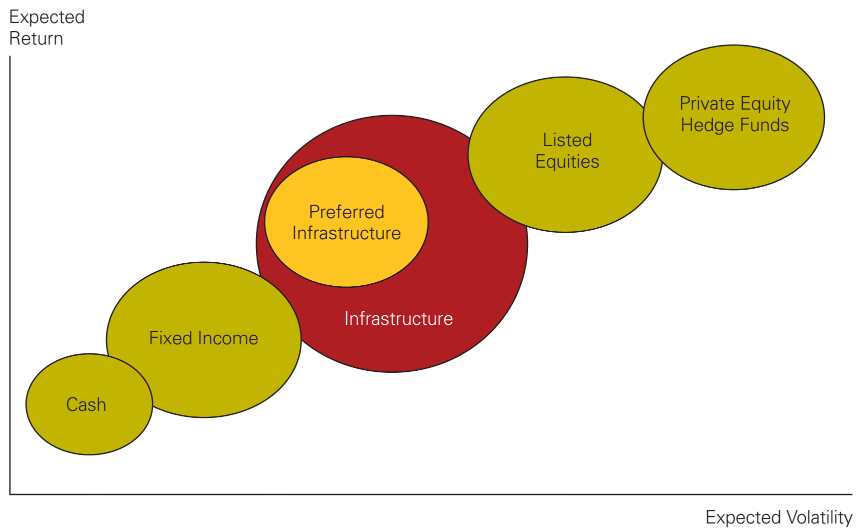


Figure 1: Expected risk and return



We screen the wider infrastructure universe for such companies and from them construct what we call our preferred infrastructure universe. The appropriate place on the risk/return spectrum for preferred infrastructure is between equities and bonds. Other managers, either listed or unlisted may approach the asset class differently and actually offer a higher return objective but we believe that this can ultimately only be achieved by taking on higher risk.

Where should investors look for attractive, preferred infrastructure opportunities? At Lazard we invest globally for the greater pool of opportunities, liquidity and diversification that global investing offers. Importantly, we generally do not invest in emerging markets infrastructure assets. This is because the greatest risk to infrastructure investors is political risk, which involves considerations of regime change, asset repatriation and the strength of contract law. Given the greater political risk that exists in emerging markets and our low risk preferred infrastructure approach, we chose to generally exclude emerging markets. Preferred infrastructure investments are also mostly modern infrastructure assets that are mature with proven demand and that deliver revenue certainty. In comparison, an investment in emerging market infrastructure assets is often an investment in the development and construction of the essential service where the creation of demand is vital. This is not to say that investments in these assets cannot be successful but both these considerations (political and lifecycle) present a completely different risk and return proposition to our preferred infrastructure approach.

So who should invest in listed infrastructure? In our experience, investors have tended to use the strategy:

- As a higher yielding substitute for index linked bonds to immunise long-term real liabilities;
- To diversify their unlisted infrastructure portfolio;
- To get set in the infrastructure market quickly, with diversification and/or less ongoing internal due diligence and lower headline risk than direct investment; and
- As an "alternative" investment at the lower end of the risk spectrum.

Lazard's global listed infrastructure strategy is a long only, valuation driven investment discipline that targets long-term, inflation-linked investment returns with volatility between bonds and general equities.

Lazard aims to achieve, or exceed, its investment objective of inflation (as measured by CPI) +5 per cent per annum, over rolling five-year periods, by constructing a portfolio of typically 25 to 50 preferred infrastructure securities that are diversified across a variety of infrastructure sectors and countries. The strategy is passively hedged to the Australian Dollar to ensure currency volatility does not influence the desired risk and return profile.

We manage around $3 billion* in this strategy for pension, superannuation and corporate investors in Australia, the US, the UK, Canada, Japan and Scandinavia. In Australia, our strategy is available to wholesale investors directly via the Lazard Global Listed Infrastructure Fund or to retail investors via platforms such as BT Wrap.

* As at 30 June 2008

COST OF INVESTMENT

LISTED INFRASTRUCTURE FUNDS have fee structures similar to standard managed investment products, although a number of them also charge performance fees.

Management fees range from 0.9 per cent to 1.3 per cent. Transaction fees of 0.25 per cent apply in many cases. This range applies to funds offered by Lazard, Macquarie, RARE, BGI, Nucleus, UBS, Colonial First State and Magellan.

When performance fees apply, they are usually around 10 per cent. The most common performance benchmark is an Australian or international inflation figure plus a margin of five or six per cent.

Some managers apply a high water mark to their performance fees, which means that performance fees cannot reduce net returns below benchmark.

In other words, if the payment of the performance fee would result in the net return falling below the benchmark, the performance fee will be adjusted so that the net return remains at the benchmark level.

TAX & COMPLIANCE

FROM A TAX AND LEGAL POINT OF VIEW, listed infrastructure funds operate in the way as any other regulated unit trust.

As long as the fund distributes all gains to investors, the fund pays no tax. Tax on interest, dividend income, other income and capital gains is payable by the investor.

One thing to note is that listed infrastructure funds hold most, in some cases all, of their assets offshore. Consequently, the volume of franked dividend will be small.

All the standard compliance rules applying to managed investment apply. December 2008 is the deadline for reporting entities covered by anti-money laundering rules to operate customer identification, verification and due diligence systems and processes.

SAMPLE PORTFOLIO

WHAT COMPANIES GO INTO LISTED INFRASTRUCTURE PORTFOLIOS?
Three fund managers give an insight into how they pick stocks.

Drax – The Nucleus Global Listed Infrastructure Fund has invested in Drax Power Ltd, the owner of the largest coal-fired power station in the UK.

Nucleus portfolio manager Brian Ingham says Drax came onto his radar because its stock price had been penalised because of investors' concerns about its use of coal.

Ingham says, "Our view was that the penalty the company was paying for using a fuel that was seen to be dirty was too great. Our view on emission controls is that the change will be gradual."

After doing a discounted cash flow to work out what the Drax shares were worth, the Nucleus team arranged a conference call with management in the UK. After that discussion Ingham's team fine-tuned its model and came up with a recommendation to buy the stock.

Red Electrica de Espana – This Madrid-based power company was the biggest holding in the Lazard Global Listed Infrastructure Fund at the end of June 2008, making up 8.1 per cent of the portfolio.

Lazard was attracted to the company because it had a monopoly on electricity transmission throughout Spain. The company has a regulated, long-term pricing structure that allows it to keep pace with inflation.

Lazard portfolio manager Warryn Robertson says one of the differences between infrastructure companies in Europe and North America, compared to those in Australia, is that they usually retain some of their earnings to use for investment in business growth. Australian infrastructure companies tend to pay out all their earnings as distributions.

Red Electrica has plans to double its asset base and has forecast dividend growth of 15 per cent a year over the next five years.

Cintra – The European toll road operator Cintra Concesiones de Infrae is the biggest holding in the RARE Infrastructure Value Fund, making up 7.3 per cent of the portfolio.

Part of the appeal of the stock is that it combines an established portfolio of assets in Europe with a growing presence in an emerging market, Chile.

RARE senior portfolio manager Richard Elmslie says, "Assets in Chile make up 11 per cent of its business. We like our portfolio to have the bulk of its investment in mature assets but about 18 per cent of our assets are in emerging markets.

"That gives the fund exposure to high GDP growth that comes from emerging markets. Throughput on toll roads depends on that country's GDP and the revenue is linked to that country's inflation rate."

THE CASE FOR GLOBAL LISTED INFRASTRUCTURE AND UTILITIES

Sponsored statement

Brian Ingham, portfolio manager and principal, Nucleus Global Investors Pty Limited

Brian Ingham
Nucleus Global Investors Pty Limited

IT IS VITAL TO DRAW A DISTINCTION between the global listed infrastructure and utilities sector and the Australian infrastructure and utilities sector. For the 12 months ended 30 June 2008, the S&P ASX 200 Utilities Index fell by 31.6 per cent. This is an extremely poor outcome for a sector that has been marketed to investors as defensive.

The main differences between the Australian and global infrastructure and utilities investments are:

1. Australian listed investments tend to be more geared: Australia has the lowest interest coverage ratios and the highest gearing ratios of any country in the global index. During a time of interest rate volatility, this has had very negative effects on the Australian investments.
2. Australia has a larger percentage investments in infrastructure companies than utilities companies compared to the global index.

   In Australia, 37 per cent of the index consists of infrastructure companies and 63 per cent of utilities companies. In the UBS global infrastructure and utilities index, eight per cent are infrastructure companies, and 92 per cent are utilities companies. By virtue of the regulatory framework in which most utilities companies operate, they are less vulnerable to economic shocks and input cost increases.
3. Australia has a larger percentage of externally managed entities.

The existence of the external manager model in many Australian investments is a crucial component for investors to understand. The external manager model for infrastructure is where a sponsoring manager – usually but not always an investment bank – acquires assets and then on-sells them into a separate fund or listed entity but retains management rights. In recent years, investment banks aggressively grew assets in the listed infrastructure funds.

In these investment vehicles it is in the external manager's interest to build the total asset pool to the largest possible size. This allows the external manager to generate ever larger transaction and management fees. The fee regime reached ludicrous levels in the 2006 financial year when one investment bank took a fee out of one of its listed vehicles that was equivalent to 116 per cent of the total group revenue for the year.

The management fees for these vehicles operate on the basis of the total assets controlled by the vehicle. External managers aggressively used debt funding to increase the total asset pool and, thereby, their fees. To appease investors, most of these vehicles paid high levels of distributions. However, the distributions were not from profits but out of capital reserves. In the long term, this proposition is not sustainable and, with the shakeout in global credit markets, investors have realised that the structure operates to the greater benefit of the external manager at the expense of the investor.

In the Australian component of the global index, 64 per cent of companies are "externally managed". From a global perspective, only two per cent of the investments in the UBS Global Infrastructure and Utilities Index are externally managed and these basically represent the Australian component of the index.

The Australian model is very different from the companies in the UBS Global Infrastructure and Utilities Index. Most companies are run by operators, not external managers. They have not overpaid for assets, have not over borrowed and have been able to pay sustainable dividends from the operating cash flows. This has led to markedly different performance and provides investors with the unique risk and return characteristics that are so attractive.

The example below demonstrates the risk and return benefit (see Figure 1) of incorporating global listed infrastructure in a typical growth-oriented balanced fund.

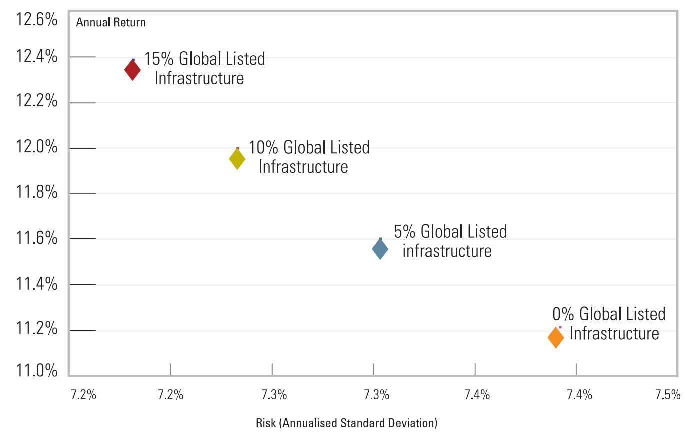
In the five years to June 2008, a typical growth-oriented balanced fund which had a 15 per cent allocation in global listed infrastructure would have returned at least one per cent more over five years than a comparable fund with no investments in the sector. At the same time, the risk was lower.

Figure 1 identifies the benefit, while Table 1 identifies the asset allocation used to generate these outcomes.

Table 1. Asset allocation scenarios of a typical growth-oriented balanced fund

Asset class	Asset Allocation			
Australian shares	40%	40%	40%	40%
International shares	25%	25%	20%	15%
Australian listed property	15%	10%	10%	10%
Cash	5%	5%	5%	5%
Global listed infrastructure	0%	5%	10%	15%
Total	100%	100%	100%	100%

Figure 1. Risk versus return profile of a growth-oriented balanced fund with varying degrees of global listed infrastructure investments (5 year period ending 30 Jun-08)

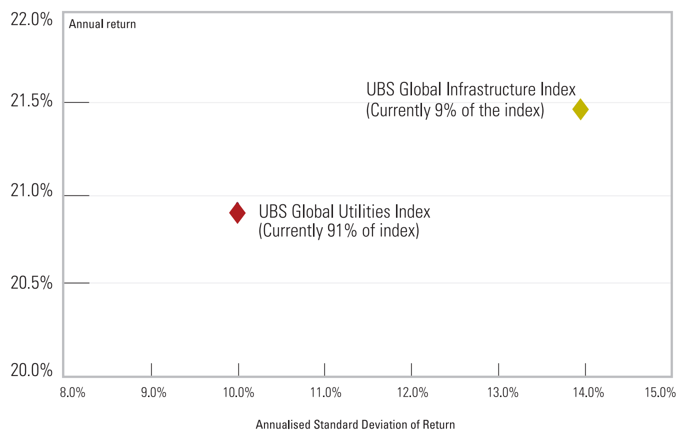


These findings are driven by using the returns generated by the major global index for listed infrastructure and utilities investments, the UBS Global Infrastructure and Utilities Index. This is the key index which most asset consultants and sophisticated investors have used to frame their view on global listed infrastructure and utilities.

To ensure that investors achieve the risk and return profile offered by the index, it is important to understand the index composition and to identify what has generated its unique return profile.

The index is made up of 85–95 per cent utilities companies with the balance being other infrastructure investments. None of these assets are listed in emerging markets. All are listed in OECD countries. Given their weighting, it is unsurprising that the utilities companies are the determinants of the index's risk and return profile. Figure 2 identifies the risk and return profile of the utilities and infrastructure sections of the index over the last five years.

Figure 2. Risk and return profile of the benchmark indices (5 year period ending 31 Aug-08)



This shows that while returns are quite similar (20.9 per cent utilities and 21.4 per cent infrastructure), the risk associated with each index is significantly different (10.1 per cent utilities versus 14.0 per cent infrastructure).

In other words, as an investor, it is not a very efficient use of your risk budget to increase your annualised volatility by 4 per cent while only increasing your return by 0.5 per cent.

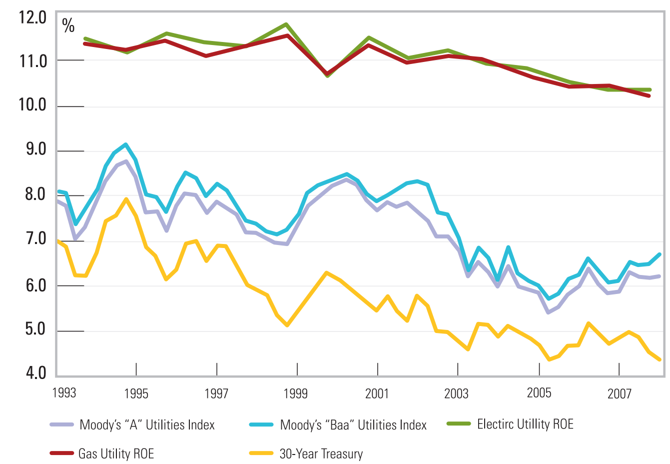
The unavoidable conclusion from this is that any investor hoping to achieve the risk and return profile offered by the sector must address, first and foremost, the utilities sector.

At Nucleus, we have undertaken extensive research to identify the core investment attractions of the utilities sector. Among these are:

- A significant proportion of the assets are regulated.
- These companies have maximum allowable returns that can be generated from their assets and maximum gearing level that the regulator will allow to ensure corporate stability in the sector.

- The returns are sufficient to encourage investment in the industry but not so excessive as to allow customers to be charged monopoly rents by the asset owners. These regulatory regimes tend to be very stable and some have not changed for 20 years or more.

Figure 3. Historical utility ROEs vs long-term bond yields
Yields: electric and gas utility ROEs vs Moody's daily long-term utilities bond yield averages



Source: *Moody's Investor Service and RRA/SNL*
Note: Moody's Long-Term Corporate Bond Yield Averages, including those for Utilities, are derived from pricing data on a regularly replenished population of nearly 100 seasoned corporate bonds in the US market, each with current outstandings over $100 million. The bonds have maturities as close as possible to 30 years; they are dropped from the list if their remaining life falls below 20 years, if they are susceptible to redemption, or if their ratings change. All yields are yield-to-maturity calculated on a semi-annual basis.

In Figure 3 (Source: National Grid General Investor Pack Summer 2008), the top two lines represent the returns on equity that have been generated out of gas and electric utilities over the last 15 years. The stability of these returns is in stark contrast to the volatility of typical equity investments.

In conclusion, the low volatility and correlations of returns from the global listed infrastructure and utilities sector have been driven by returns out of the utilities sector. These are generally, large, quasi-monopolistic assets with inelastic revenues and an ability to pass on their cost increases to consumers. As such, they tend to be regulated and provide stable returns with low volatility, which are exactly the characteristics that investors want when they invest in this area.

EASY GUIDE

A comparison of:

- **global listed infrastructure vs domestic listed infrastructure**
- **listed vs unlisted assets**
- **developed markets vs emerging markets**

FEATURE	DOMESTIC	GLOBAL
	Highly structured, often stapled	Simple companies
	Highly geared, with interest rate hedging	Lower gearing, combination fixed/floating debt
	Higher yields	Lower yields
	Distributions often funded partially from borrowings	Greater operating cash flows

	LISTED	UNLISTED
	Greater liquidity	Less liquidity
	Greater volatility	Lower volatility
	Generally lower fees	Generally higher fees
	Greater diversity	Less diversity
	Faster "getting set"	Can take longer to get set

	DEVELOPED MARKETS	EMERGING MARKETS
	Greater liquidity	Less liquidity
	Greater broker/analyst coverage	Less broker/analyst coverage
	Lower GDP growth	Generally higher GDP growth
	Generally more established operating/regulatory environments	Often less robust/untested regulatory environments

GLOSSARY

Correlation	The strength of a linear relationship between two variables. In investing, highly correlated assets tend to move together in response to changes in market and economic conditions. Adding assets with low correlation to existing assets in a portfolio improves diversification.
External manager model	Some infrastructure assets are operated by external managers, often investment banks. This approach has been criticised for adding to the cost and complexity of the investment.
Inflation-linked	Revenue is linked to inflation. In many infrastructure contracts the government or regulator allows the operator to increase prices on tolls in line with changes in the cost of living.
Infrastructure	The physical assets that society requires to facilitate its orderly operation. These come under the headings of transport, energy, water, communications and social.
Liquidity	Publicly traded assets, such as trusts and companies whose securities are listed on stock exchanges, provide investors with the ability to enter and exit the investment relatively easily.
Mark to market	A valuation method where, at the end of each trading day, security holders re-price their assets in line with the market value. Listed assets immediately reflect current valuations on their securities. Unlisted assets are re-valued on a periodic basis.
Regulatory risk	Many infrastructure companies operate in regulated markets. There is a risk that the actions of a regulator or the intervention of government will adversely affect the revenue of the business and therefore the price of the stock.
Utilities	A sub-class of infrastructure assets that includes power, water, sewerage and communications facilities.
Volatility	The extent of fluctuation of security prices, interest rates, exchange rates and so on. It is usually calculated by measuring standard deviation, which is the degree of variation of returns around the mean return. Increasing levels of dispersion around the mean lead to higher standard deviation, indicating a higher level of risk.

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