TD Asset Management

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Beyond Stocks and Bonds

The benefits of looking outside the box for investment portfolios

In the current low growth/interest rate environment, portfolios that broaden investments beyond standard exposures and asset classes may capitalize on better diversification and returns required for most investors to meet their long-term goals. As a result, TD Asset Management Inc. (TDAM) continues to stress the importance of thinking outside of the traditional fixed income and equity box to access a greater variety of exposures and factors in order to improve the risk and return profile of investment portfolios.

The emergence of Infrastructure

One way of accomplishing this is by adding listed Infrastructure to a portfolio. As an asset class, listed infrastructure can provide several strategic benefits to investors over a full market cycle including steady income generation, increased diversification and access to a growing market.

One of the challenges with the infrastructure asset class is the subjectivity around the definition of what qualifies as “infrastructure”. At TDAM, we define infrastructure as the essential assets a society requires for the economy to function properly.

These essential assets include traditional physical infrastructure such as roads, airports, water and electricity along with recent non-physical digital infrastructure such as payment infrastructure platforms. These assets provide the backbone of a healthy and modern society, and as such, share some common qualities and attributes. They tend to have long useful lives (e.g. toll roads), contracted cashflows and are operated by companies in quasi-monopolistic markets with high barriers to entry.

Historically, due to the cost and importance of infrastructure, governments have been the central investors in the industry. Consequently, they typically owned and operated much of the critical infrastructure, such as ports, water supply and airports. However, as the global population rose from 2.5 billion in 1950 to 7.7 billion in 2020*, maintaining existing infrastructure, in addition to building new infrastructure for the growing population, became an extremely costly endeavor. As a result, over the past few decades, governments have been gradually utilizing the private sector as a source of capital to finance these societal needs. Today, private ownership and operation of critical infrastructure such as electrical utilities, railroads and cellular towers is the norm.

What is Listed Infrastructure?

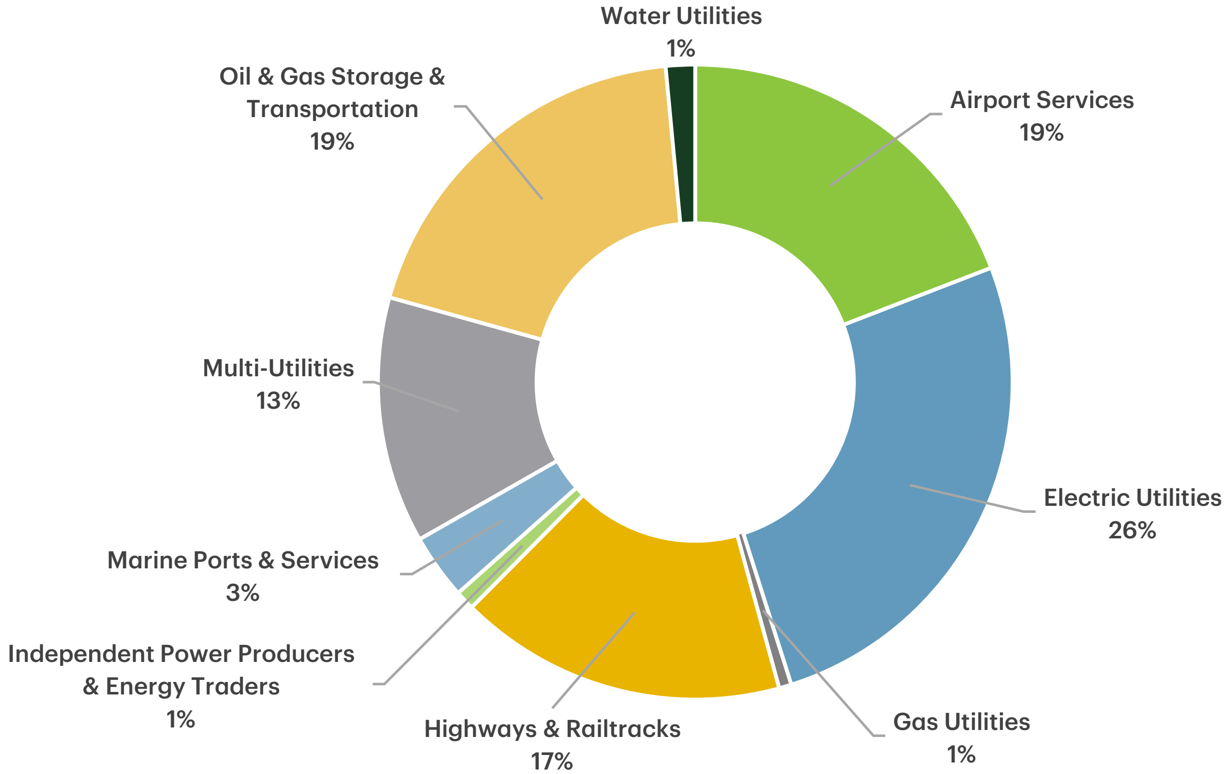
Listed infrastructure is the term used to describe publicly-traded companies that generate the majority of their cashflows from owning and/or operating infrastructure assets. An example of such a company would be NextEra Energy who is one of the largest providers of power and electricity in North America. The company owns and operates a variety of power assets such as natural gas power plants, wind farms and solar farms to provide energy to homes, businesses and communities across the U.S. and Canada.

Listed infrastructure is still a relatively new asset class. However, due to the rise in privatization of the industry, there has been a swift increase in both the number and size of publicly-traded infrastructure companies worldwide. Nowadays, publicly listed infrastructure companies can be found throughout the economy, providing investors with a wealth of opportunities to invest in the growing sector.

The different types of Infrastructure

Infrastructure is a broad term. As an asset class, infrastructure encompasses investments in the essential networks and services that are necessary for the proper functioning of global economies. As such, the industry does encompass a wide variety of subsectors and industries which possess some key defining characteristics such as high barriers to entry, inelastic demand, long life duration and inflation sensitivity. These subcategories are illustrated in figure 1 below.

Figure 1 - Sub-categories of the S&P Global Infrastructure Index



Source: FactSet. S&P Global Infra Sub-Categories. As of August 31, 2020.

At TDAM, we approach infrastructure a little differently. We have divided the industry into two subsectors - traditional infrastructure and new generation/digital economy infrastructure. Traditional infrastructure or “bricks and mortar” infrastructure typically captures physical assets. This includes the large physical networks necessary for the functioning of a modern industrial nation such as transportation infrastructure (i.e., airports, railroads, roads, and ports) and commodity infrastructure (water, oil, natural gas, and electricity).

New generation or “future” infrastructure are classified as assets that provide a societal foundation that are delivered online, not physically. Examples of this can include payment infrastructure platforms (i.e. Visa and Mastercard), stock exchanges (i.e. ICE) or specialized management software infrastructure (i.e. ADP).

Investor benefits

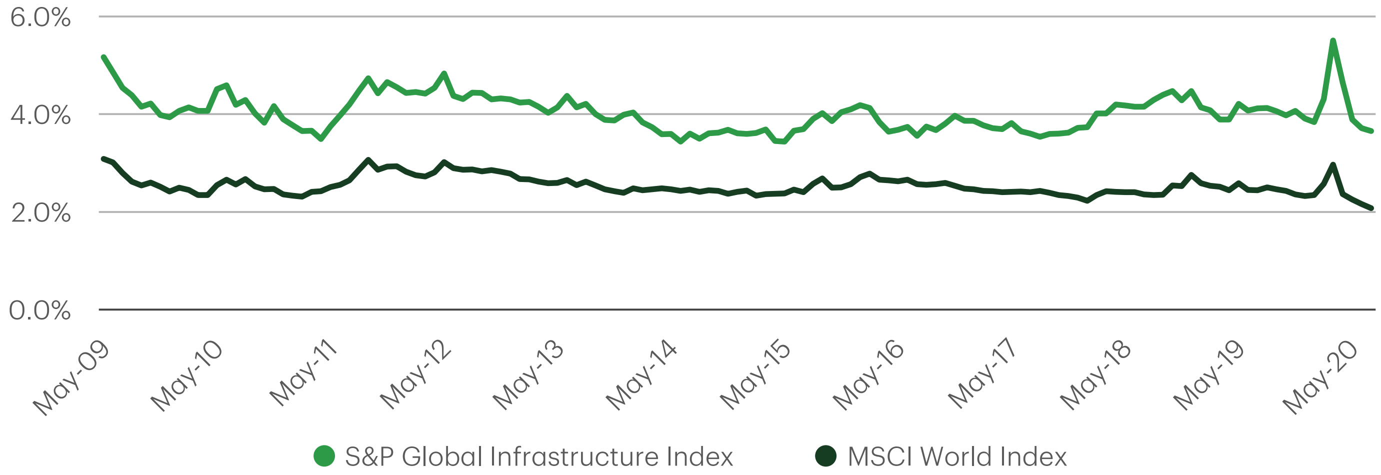
Over the last two decades, investor enthusiasm for listed infrastructure has grown. This is due to the compelling characteristics of the asset class and the strategic benefits it provides to a traditional portfolio over a full market cycle. These benefits include:

Stable and predictable cashflows - One of the key attributes shared between infrastructure categories is that their cashflows are typically supported by contractual arrangements, providing consistency and predictability across differing economic environments.

Let's take the example of a wind turbine which has an expected useful life of +25 years. During the lifetime of the asset, it will generate electricity which will be sold under long-term contracts called Power Purchase Agreements (PPAs). These PPAs set out the length of the contract, payment terms and the eventual termination date. Usually, the agreement will also have embedded price escalators which are linked to the annual rise of inflation. This allows for the turbine to generate secure inflation adjusted cashflows well into the life of the asset.

The ability to generate these stable and predictable long-term cashflows translates to steady and attractive dividend yields in excess of the broader equity market (figure 2). For investors with a preference for income and a more defensive investment during times of market volatility, listed infrastructure may be a welcomed addition to their portfolio.

Figure 2 - Dividend Yield since May 2009



Source: Factset. As of July 31, 2020.

Diversification - As listed infrastructure securities trade on the public stock markets, they are not immune to systematic risk, or broader market events that cause stock prices to fluctuate. We can see this in figure 3 below where the correlation between the broader equity market and public infrastructure increased during the Great Financial Crisis ("GFC"). However, as infrastructure is a unique asset class with inherent structural differences, over the long term, the asset class exhibits a relatively low correlation with the broader equity and fixed income markets. We can see evidence of that from figure 3, as correlation begins to fall dramatically during the periods following the GFC.

Figure 3 – 5-Year Rolling Correlation of S&P Global Infrastructure Index to broader fixed income and equity

Source: Factset. As of July 31, 2020.

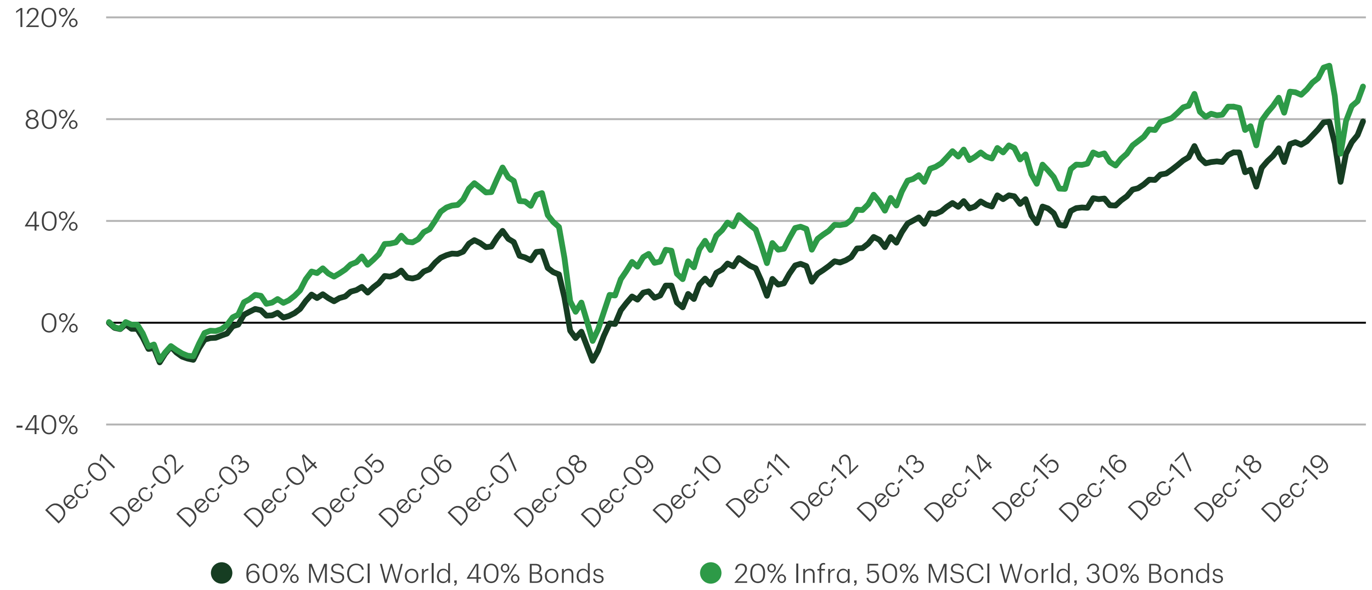
Infrastructure offers relatively low correlation to traditional equity and fixed income, given the contracted revenues. Additionally, listed infrastructure companies offer diversification through a large opportunity set of companies both geographically and by sector. Diversification is particularly important during economic shocks and changes in human behavior such as the COVID-19 pandemic.

Various sectors and geographies were impacted by the pandemic in many ways, with uncontracted transportation assets such as airports and toll roads for example taking larger write-downs, while demand for communications and internet infrastructure increased the value of those assets. The same can be said in terms of geographical diversification of infrastructure where some jurisdictions were impacted more than others. Therefore, having the increased diversification that listed infrastructure offers, across both geographies and sectors, can be a very powerful diversification tool for an investor's portfolio.

Enhanced portfolio returns - Global listed infrastructure assets tend to complement other common investment portfolio holdings. The relatively low correlation with other asset classes along with the attractive return profile driven by stable dividends means the inclusion of the asset class in a typical 60/40 portfolio can enhance risk adjusted returns and help drive the portfolio closer to the optimal asset mix.

In figure 4 below, we compare the cumulative returns of a 60/40 global equity/global bond portfolio, with a portfolio that includes a 20% allocation to global listed infrastructure, funded from both the global equity and global bond allocation. Since December 2001, the addition of a 20% allocation to infrastructure would have significantly improved the portfolio's return profile.

Figure 4 – Cumulative Returns Comparison



Source: Factset. As of July 31, 2020

Access to growing industries - Infrastructure is not just a defensive asset class. With global population forecast to hit 10.9 billion by 2100, the growth in long-term society trends such as urbanization, global trade and renewable energy will likely intensify.

As governments remain reluctant to participate in infrastructure, the reliance on private capital will increase. This suggests a very healthy supply of attractive projects for listed companies in various growing regions and sectors. This would allow investors to participate in growing markets and continue to drive demand for global listed infrastructure as an asset class.

Gaining access through ETFs

Not all infrastructure is created equal, and with several different investment options available, choosing the right infrastructure investment can be challenging. Detailed due diligence on individual companies can be onerous while performance across the industry can vary widely due to macroeconomic trends and industry regulations.

As a result, listed Infrastructure Exchange Traded Funds (ETFs) have become an increasingly popular method for investors to gain exposure to the industry while at the same time diversifying across geographies, sectors and removing single stock risk. Infrastructure ETFs have been available in Canada since 2008 and, consistent with traditional ETFs, provide a low-cost, liquid and transparent investment product to access the industry.

Passive vs. Active Infrastructure ETFs?

Infrastructure ETFs are a specialized niche that represents a popular market segment and an attractive market opportunity. However, most ETFs in the space offer an inefficient approach by using a passive indexed or a rules-based investment method. These passively managed products offer no active investment management and as such, generally attempt to mirror the returns of an underlying index or benchmark.

In recent years, the emergence of actively managed ETFs has presented a second option for investors in the space. These funds, in contrast to passively managed ETFs, have dedicated portfolio managers who strive for improved risk-adjusted returns by making independent investment decisions. These funds generally have a greater ability to identify and select high quality stocks and, in turn, a greater potential to outperform over the long term.

TD Active Global Infrastructure Equity ETF (TINF)

In order to strive for the best risk return profile that will be accretive to a client's portfolio, it is critical that thorough due diligence and portfolio management be completed by a team that has extensive experience in this space. This is where we believe that the TD Active Global Infrastructure Equity ETF (TINF) may be a great tool for investors.

TINF is an actively managed, globally diversified Infrastructure ETF solution that leverages TDAM's infrastructure investment expertise and focuses on providing total return with lower volatility. The strategy's dedicated portfolio managers employ a rigorous three-step investment process that utilizes quantitative screens, qualitative analysis and most uniquely, team-based decision making to select between 40-60 of the highest quality names across both traditional and new generation infrastructure. This flexibility helps the PMs to deliver on their core objective of providing a regular source of income through the investments in core infrastructure while also enabling them to participate in the future of where infrastructure investments are heading.

In contrast to other passively managed Infrastructure ETFs, our approach is designed to outperform our benchmark (S&P Global Infrastructure Index CAD) over the long term while helping to ensuring we focus on delivering a total return for clients, where they receive consistent income combined with capital appreciation potential.

Expertise

Bringing Infrastructure inside the box

In today's challenging investment environment, investors are continuously searching for investment options outside of the traditional equity and fixed income box. Listed infrastructure, due to its potential for high dividends, inflation protection and diversification, can be a beneficial addition to a portfolio for investors seeking to improve risk-adjusted returns. The TINF ETF can be an excellent way to tap into the space by providing exposure to the highest quality globally diversified infrastructure securities that generate stable and growing cashflows with the added liquidity of an ETF wrapper.

Globally Diversified

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*Pew Research Center. World's population is projected to nearly stop growing by the end of the century. June 17 , 2019. https://www.pewresearch.org/fact-tank/2019/06/17/worlds-population-is-projected-to-nearly-stop-growing-by-the-end-of-the-century/

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