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MEMORANDUM

Infrastructure Investing

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Investment Concept: The growth of emerging market economies and increasing evidence of the decaying infrastructure within developed countries has created a need for investment estimated at $40-50 trillion over the next 25-30 years. It will be impossible to fund an effort of this magnitude through the public sector alone, especially when the fiscal budgets of most governments are already stressed by social programs and prospects of increasing spending needs in response to aging demographics. As a result private sector investing has stepped in to fill the need, creating attractive investment opportunities that, to date, have yielded above average returns with reasonable risks and appealing diversification attributes.

Background: Infrastructure is broadly defined as the basic facilities, equipment and installations needed for the functioning of a system or organization. Cohen & Steers identifies several broad infrastructure categories including: Transportation, Energy, Utilities and Communications. Other definitions also include a category of Social Infrastructure that embodies such assets as hospitals, schools, prisons, etc. The essential characteristics of infrastructure projects are that they include long-lived assets, high barriers to entry, a monopolistic structure and inelastic demand pattern. As a result these assets/projects have the potential to generate stable growth and income over long periods of time. Further, the revenues of many projects contain an inflation-linked component.

The underlying drivers to demand for infrastructure investing include world-wide GDP growth and population growth, but infrastructure needs will be influenced as well by social and demographic patterns, e.g., urbanizations within emerging market economies, and by political will and public opinion.

While revenues, or cash flow yields, are the essential component of the revenue return, these revenues are netted against capital, financial and operational costs. Infrastructure funds managers seek to add value by investing in only the most attractive assets/projects, utilizing skillful financing decisions, and achieving operational efficiencies.

Risks: As a relatively new asset class with little historic data, there is still much to be learned about the nature of infrastructure investing. That being said, it is safe to say that there is no reason to believe infrastructure investing is a free lunch. Risks include political and regulatory risks, financial leverage, interest rate risk, valuation risk, illiquidity risk, event risk, business/operational risk, long-tail risk, and foreign exchange risk for global projects.

Historical Experience: While there are only limited historical data on infrastructure investing any risks, ex-post estimated returns show both high total returns and lower standard deviations on infrastructure investments relative to US and non-US stocks with correlation coefficients approximating 0.40-0.60. These data, however, are likely to have been influenced by the newness of the asset class and therefore the higher returns earned by early participants in the strategy. Several observers suggest that the magnitude of recent growth in infrastructure investing has created an investment bubble, the result of a foreign feeding frenzy in the US market with simply too much money chasing too few projects. They cite the evidence of high prices recently paid for a number of specific projects.

Vehicles: To date most private investments in infrastructure have been made through limited partnerships that typically purchase projects (e.g., toll roads, airports, water utilities, wind farms, etc) directly from the public sector). The best known name in this regard is the Macquarie Group, an Australian bank. Other players include Babcock & Brown, Cintra, Goldman, Morgan Stanley and Transurban. These groups create large institutional funds requiring very large financial commitments from participants. Very few commingled vehicles are available in which a small investor can take a stake. More recently, however, new vehicles are becoming available; Cohen & Steers and others are offering mutual funds that invest in stocks of companies whose products and services are expected to benefit from infrastructure demand. These are likely to act more like sector funds, participating in the economics of infrastructure investing, but still closely correlated to the general equity markets. ETF and closed-end fund structures are likely be available shortly as well.

Strategic Recommendation: There is an investment postulate that an abundance of demand covers a multitude of sins, i.e., that having in place a prolonged and assured revenue source has a high correlation with company and investment success. This appears to be the case with investing in infrastructure. The demand for investments of this type will only grow, and to sustain the supply of capital required to meet demand for projects will require that deals offer fair/attractive returns on investment. Nevertheless, the risks surrounding investments of this type are material. Therefore other basic principles of investing apply as well; that is, hire good, proven managers with a clear, unifying investment philosophy and disciplined process, diversify holdings, and invest for the long term.