Midyear Outlook: Infrastructure, MLPs and the CEF Market

Summary:

- Infrastructure equities and closed-end funds (in general) both present an attractive investment opportunity
- Within infrastructure, MLPs look especially attractive as many are working to simplify their structures, lower leverage, and higher distribution coverage, factors that should help to improve governance and long-term returns for the asset class
- MLP and Energy Infrastructure closed-end funds are sectors with strong relative value as their underlying assets have strong fundamentals and we believe the funds are at compelling valuations with discounts wider than their historical averages
- Given the current market environment, we are finding more value broadly in equity over fixed-income closed-end funds
- Many closed-end funds continue to trade at a discount, which offers an attractive buying opportunity for both equity and select fixed-income funds

The following Q&A recaps the conversation that originally took place as part of a podcast series. In this discussion, the Closed-End Fund Association checks in with two Cohen & Steers' experts for a mid-year review of the MLP, infrastructure and CEF markets. Special guests Doug Bond and Bob Becker are both portfolio managers who have decades of investment experience in their respective asset classes.

Bob Becker

Doug Bond

Libby Hastert

LH: **Good afternoon, and welcome back to the CEFA podcast. I'm Libby Hastert, and today we're convening for a midyear outlook with some added discussion around MLPs and infrastructure. Today's speakers, Doug Bond and Robert Becker, join us from Cohen & Steers. Both Doug and Robert, who we'll call Bob, are experts in their respective areas. Before we get started, let's get to know them a little better. Doug, today you serve as executive vice president and portfolio manager for Cohen & Steers' Closed-End Opportunity Fund, along with a few other closed-end fund-centric portfolios. How did you land in this niche market sector, Doug?**

DB: Libby, before joining Cohen & Steers in 2004, I spent 23 years working at Merrill Lynch. The last 12 years of that time at Merrill Lynch, I headed up Merrill Lynch's closed-end fund origination effort, which gave me a window into many, many different closed-end fund ideas and the due diligence process associated with closed-end fund launches. I was involved in all of the IPOs that Merrill Lynch launched in the closed-end fund market on behalf of a variety of different investment managers before I got to Cohen & Steers in 2004 to do what I do today, which is selecting closed-end funds for closed-end fund portfolios that I manage.

LH: **Thanks, Doug. Bob, you're senior vice president and portfolio manager for Cohen & Steers' infrastructure portfolios including those that focus on master limited partnerships. Can you tell us your history and how it lends itself to this role?**

BB: Sure, Libby, I'd be happy to. I've been investing in infrastructure for about 23 years. I started out in some research positions at places like Scudder and Salomon Smith Barney. From there, I went to Franklin Templeton where I was a PM for their utility fund before coming to Cohen & Steers in 2003. We launched the strategy in 2004 and now manage over $6 billion in infrastructure and midstream portfolios.

LH: **All right, thanks for the background information. Now that we've gotten to know each other a little bit better, I'd like to jump right in. Doug, can you speak to us about the 2018 midyear outlook? So far, 2018 has been a much tougher market than 2017. Beginning on the fixed-income side, the Fed looks like they will continue to raise interest rates, trimming their balance sheets. How do you position fixed income, that portion of your portfolio, as they continue this trend for the foreseeable future? Doug?**

DB: In a few words, Libby, the fixed-income part of the portfolio we position very, very carefully. Generally speaking, we're underweight fixed-income closed-end funds relative to equity funds, and our focus in the areas that we are investing in is on relative value. It's hard to find a lot of undervalued parts of the broad, taxable fixed-income marketplaces as the hunt for yield and the chase for yield has extended itself. The background of a rising short-term interest rate for funds that have leverage in their capital structure, as most of the fixed-income funds in the closed-end fund market do, creates the tough earnings picture. Real carefully we're picking our spots, but generally speaking underweight the fixed-income funds.

LH: **Along the same line, Doug, raising rates can impact leveraged closed-end funds, as we all know, because of the higher borrowing cost. Have you seen much of an impact to this point? What are your expectations over the next 12 to 18 months?**

DB: We think that the rising borrowing cost for closed-end funds is going to continue to challenge many of the funds' earning power. There are some sectors of the closed-end fund market like the senior loan funds where the assets reprice as short-term interest rates rise, so they have a little bit better ability to defend in this environment of rising Fed fund rates that we expect to see over the next 12 to 18 months.

Broadly speaking, in both taxable fixed-income closed-end funds and municipal fixed-income closed-end funds, we've seen lots of dividend reductions in 2017 and 2018. We expect that to continue as a headwind to how those funds can perform over the next 12 to 18 months. We do think there is some value in municipal bond-focused closed-end funds where the discounts have gotten very, very wide to their long-term averages on a tactical basis.

LH: **Thanks, Doug. If we look outside of the US, emerging markets have had some difficulty, as well as developing markets. They've also faced some macroeconomic and political uncertainty. Does this present a longer-term opportunity for US investors, at least in certain markets, or is it really too soon to tell?**

DB: We wish we could tell you that we have crystal ball, Libby, and know exactly what's going to unfold over the next year or two years in terms of emerging markets. To us, we actually come down on the side that for US investors, this pullback in emerging markets that's occurred and unfolded in 2018 we think represents a longer-term investment opportunity. If you think about it in the context of longer-term return, you go back 30 years and both the S&P 500 and emerging markets indices on the equity side have compounded returns for investors in excess of 10% per annum. If you go back just the last 10 years, the S&P 500 has compounded at about 11%, and the emerging market equity indices have compounded at less than 3%. With emerging market closed-end fund discounts north of 11% and, generally, US-focused domestic equity closed-end funds selling on average at discounts less than 3%, we think there's good relative value in the emerging market equity funds. We would pick those over emerging market debt funds if we were going to be willing to take the risk of emerging markets.

LH: **Thanks, Doug. You manage a pretty broadly diversified portfolio of both closed-end funds and ETFs. How are you positioning your sector allocation for the second half of the year? Do you have main concerns, and are there any interesting opportunities?**

DB: I think in terms of concerns, we probably share some that many investors focused on the financial markets are thinking about or talking about. Trade has been a big topic this year. Rising short-term and longer-term interest rates and the prospect of perhaps an accelerating inflation picture are probably most top of mind in terms of investment concerns. In terms of our overall positioning, it's broadly consistent with the macro view, which we've had for at least the last several years, which in an environment of gradually improving and steady economic growth and rising short-term rates, equity-focused closed-end funds tend to do better than fixed income-focused closed-end funds. That's where we have our portfolios overweight. Within that, on a sector basis, we're looking for asset classes and parts of the equity closed-end fund market that we think offer better relative value.

We mentioned emerging market equity funds. We like those. We also find MLP energy infrastructure-focused closed-end funds attractive not only because their discounts to net asset value are wider than their long-term average, but more importantly because, as Bob will probably detail in his comments, we think there's great relative value in the underlying asset class. We're encouraged that private equity investors are acquiring midstream energy companies at prices in excess of where they're trading at in the public market. Beyond that, we find certain healthcare-focused closed-end funds attractive. We also favor the financial sector. Within fixed income, I mentioned it earlier, we like the relative value and what we think is a nice tactical opportunity in municipal closed-end funds. On average, muni funds trade at about a 4% discount to net asset value if you go back over a 20-year period. Today, you can find many muni-focused closed-end funds trading at discounts to NAV in excess of 10%. We think those offer good total return opportunity over the next 12 months.

LH: Thanks, Doug. Bob, Doug touched on this, but if we could talk MLPs. Energy price volatility and structural changes within the sector have caused some disappointing performance for MLPs in recent periods, but how is the sector positioned? Are there valuations providing investors with an interesting opportunity going forward? What are your thoughts on the MLP space?

BB: Sure, Libby. First, I should note that we invest in a midstream energy universe that goes beyond MLPs. Midstream businesses are actually increasingly leading the MLP structure, often electing a corporate wrapper. In fact, since January 2016, the number of MLPs has dropped from over 120 to under 90. We've seen tens of billions of dollars created in the midstream corporate wrapper over the last couple of years, but regardless of the structure or the wrapper, all of these businesses either gather, process, store, or transport energy commodities. For those companies that are remaining MLPs, we're seeing an evolution to a much better, more stable business model focused on improving governance and long-term returns and not just short-term distribution growth. This recent trend has been for MLPs to simplify their structure, lower leverage, and have higher distribution coverage -- all very positive in our view. We think the sector is well positioned going forward and also that the valuations are attractive if you look at metrics such as enterprise value relative to EBITDA, a good measure of cashflow. Also, its spreads versus corporate, the sector looks attractive.

LH: Thanks, Bob. Infrastructure is interesting as global requirements for it and its investments are significant. How are listed companies positioned to take advantage of this, and are their fundamentals attractive?

BB: You're right, Libby. There are massive infrastructure investments needed globally. There's been a steady decline in investment in the developed markets. If you look at metrics such as infrastructure investment relative to GDP, it's been on a steady downtrend for decades. You may have also seen the American Society of Civil Engineers' report card on US infrastructure. We're getting failing grades. There's definitely a big need to invest, and listed companies are going to be part of that investment. Then also you have different trends in emerging markets where trends such as urbanization and a rising middle class are leading to a big need to invest in infrastructure.

BB: An important component of all this is that private sector capital is essential as government balance sheets are stretched. We think listed fundamentals are strong, and they're well positioned to make investments and achieve attractive growth, especially since their balance sheets are in good shape after a period of deleveraging.

LH: Given the large required infrastructure investments that have been debated in the public, are valuations in the listed infrastructure space attractive?

BB: We think the valuations are attractive. The group is trading in line with long-term average valuation metrics, but the growth outlook is better than it's been historically. On a cashflow multiple basis, the group's trading at around 11 times versus a long-term average of around 10.5 times. However, the premium to global equities has declined materially. Infrastructure now trades at a 10% premium to the broader equity market, whereas that premium was about 40% seven years ago. There's also a lot of support because of what's happening in the private infrastructure markets. There's been a lot of money raised for investment amongst private funds. There's now about $160 billion on the sidelines waiting to be invested. This is going to provide a lot of support for listed valuations because these private funds are buying assets from listed companies and listed companies themselves for premiums that vary anywhere from 50% to 100% above prevailing market values.

LH: How do you see investors best positioning MLP and infrastructure closed-end funds in their portfolios?

BB: We definitely think they belong in a portfolio. You have good diversification benefits. You have attractive growth and income and good underlying fundamentals. I'll have to defer to Doug on which closed-end funds look the best. I think he's saying he sees better value in the MLP funds.

LH: All right. Any final remarks for our listeners?

BB: I've been investing in infrastructure for a couple decades now, and I can honestly say the fundamentals are very attractive. It's one of the most exciting times to be looking at the space.

LH: Doug, any remarks on your end?

DB: The mantra that we've always embraced in the world of closed-end funds is that there is always a sale available, a sale going on in the closed-end fund market. There are many groups offering attractive relative value today in both the equity and the fixed-income parts of the closed-end fund market. On any given day, you can find great values that meet your risk objectives and asset allocation needs in the closed-end fund market.

LH: Thank you both for making time today. I think you've given us a lot to think about.

Announcer: Thank you for joining us. We hope you will stop by again for news on this ever-changing space. Until next time, connect with us on Twitter at @CEFAssociation, or by searching for the Closed-End Fund Association on LinkedIn and YouTube.