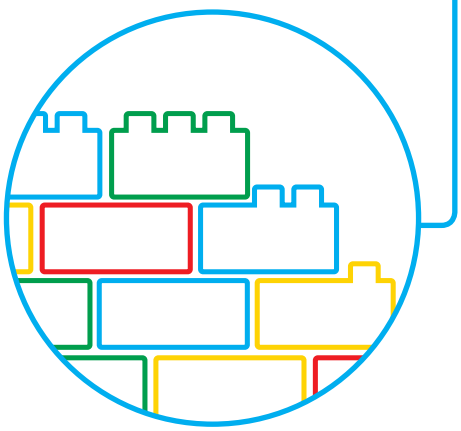
The building blocks of the Mixed Investment Funds

Infrastructure is all around us; roads, railways, pipelines and pylons. These are the physical assets that allow an economy to function effectively. They allow people to move domestically and internationally and allow services such as water, electricity, gas and telecoms to be delivered to consumers. Given their essential nature to every day economic activity, the cashflow generated by these assets is quite predictable and stable, making it an attractive proposition for investors.



Infrastructure assets are generally characterised by long economic lives, often in excess of 20 years, with little risk of redundancy. Infrastructure companies often operate in a monopoly structure due to high barriers to entry such as construction costs and geographic barriers. Due to these factors, infrastructure assets are often regulated. This further enhances cashflow predictability and prevents the abuse of dominant positions. However, this does introduce political and regulatory risk as a key and often unpredictable risk to infrastructure investments. In the UK, for example, re-nationalisation of some infrastructure assets and its investment implications is often discussed in political circles.

WHAT DOES THE GLOBAL LISTED INFRASTRUCTURE MARKET LOOK LIKE?

Listed infrastructure companies can broadly be split into four groupings:

- **Utilities** – Water, gas and electricity distribution like National Grid and Severn Trent in the UK
- **Transport** – Airports, sea ports, rail networks, toll roads, tunnels and bridges such as Sydney Airports and the Canadian National Railway
- **Energy pipelines** – Oil and gas transportation pipelines, mainly in North America, such as Kinder Morgan carrying oil from oil wells to refining and storage facilities
- **Communications** – Broadcast towers, cable networks, telecoms networks, satellite operators like Cellnex, the main provider of wireless communications in Europe

While these all may fall under the umbrella term 'infrastructure', there are some important differences to consider. Infrastructure is assumed to be sensitive to interest rates as their dependable cashflows allow them to be highly levered, but there is variation at the sector level. As an example, electric utilities are more sensitive to interest rates due to their bond-like cashflows, high dividend yields and their typically higher leverage. Conversely, railways typically have less leverage and are therefore less sensitive to interest rate changes.

Reasons to invest
1. Attractive risk-adjusted returns, complementing a diversified portfolio
2. Reliable, inflation-linked returns
3. Low correlation to traditional asset classes
4. Stable and attractive yields
5. Defensive characteristics

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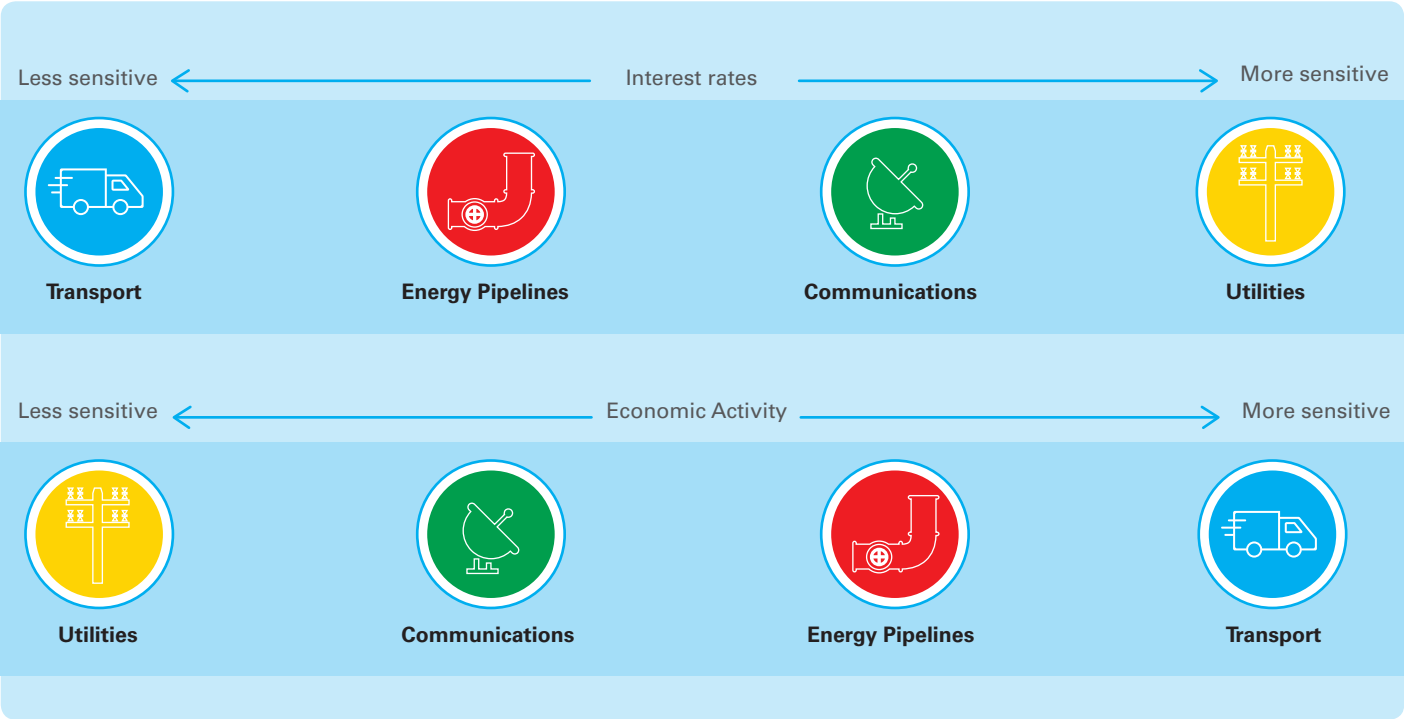
Figure 1: Sector sensitivity to interest rates and economic cycle



Source: LGIM, for illustrative purposes only

While infrastructure assets overall are said to have a low sensitivity to economic activity, there are still variations at the sector level which can have a direct link to performance. For example, airports are more sensitive to economic activity as they are linked to global trade and business and leisure travel, a link which is still present, but less prevalent for rail and toll roads which generally have a base level of users through the economic cycle. At the least sensitive end of the spectrum, utilities benefit from almost constant demand no matter the economic conditions.

FIVE REASONS TO INVEST IN GLOBAL LISTED INFRASTRUCTURE

1. Attractive risk-adjusted returns, complementing a diversified portfolio

The stable and predictable cashflows of infrastructure assets have resulted in a lower volatility of returns than equities in other sectors. Since the inception of the FTSE Global Core Infrastructure Index in 2005, it has had lower volatility and superior returns than global equities with a less severe maximum drawdown.

	Global Equities	Global Listed Infrastructure
Annualised Return	9.4%	11.0%
Volatility	13.5%	11.4%
Max Drawdown	-33.6%	-14.5%
Beta to Equities	1.00	0.60

Source: LGIM. Bloomberg L.P. Global Equities represented by the FTSE All-World Total Return Index unhedged in GBP, Global Listed Infrastructure represented by the FTSE Global Core Listed Infrastructure Total Return Index unhedged in GBP. Data from 31/12/2005 to 31/12/2017.

2. Reliable, inflation-linked returns

Guarding against rising inflation is often a key concern for investors. Through regulation, many infrastructure companies such as toll road or railway providers are allowed to increase prices as inflation rises. This offers investors inflation protection in the case of rising inflation. Figure 2 shows the relative performance of listed infrastructure against global equities in different inflation environments and demonstrates that the infrastructure assets have performed much better than equities in high inflation environments.

3. Diversified investment with a low correlation to traditional asset classes

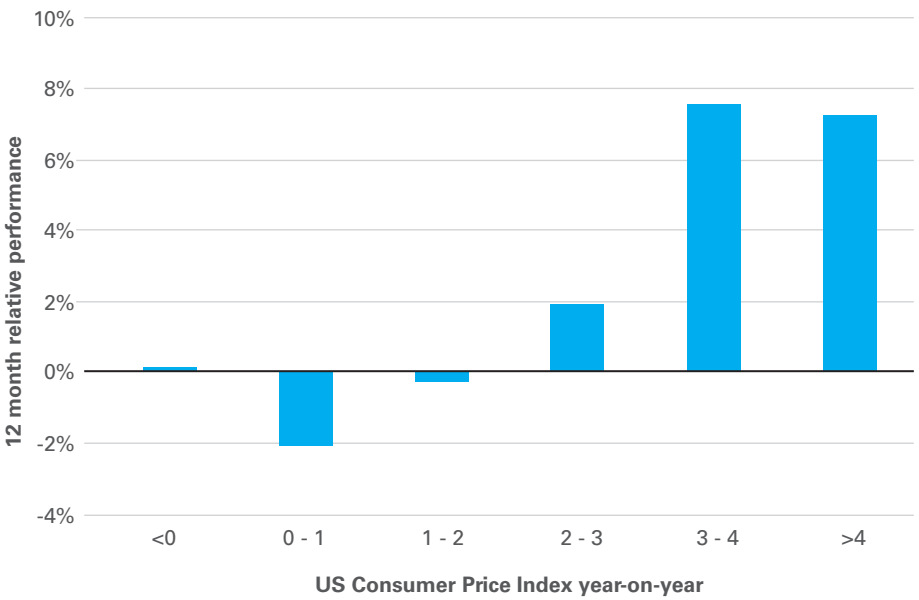
The global listed infrastructure asset class contains over 200 different holdings from over 30 countries around the world including developed and emerging markets. While utilities represent approximately half of the asset class, other sectors as mentioned above including transport, energy pipelines and communications are also represented.

To see how different investments behave relative to each other, we look at how correlated they are. Investments with a correlation of 1 move up and down in tandem, if the correlation is -1 they move perfectly in opposite directions, anything close to 0 means the performance of the investments is not really related to each other. Infrastructure has showed only a modest correlation to the broader equities market over the long term and a low correlation to bonds, meaning that the asset class could potentially help further diversify a multi asset portfolio.

4. Stable and attractive yields

Due to the high cashflow generation of infrastructure assets, they have typically been able to pay an attractive dividend yield relative to broader equities. Over the last decade, the dividend yield on listed infrastructure has been around 0.6% higher than that of the broader equities market.

Figure 2: Relative performance of infrastructure vs equities at different inflation levels



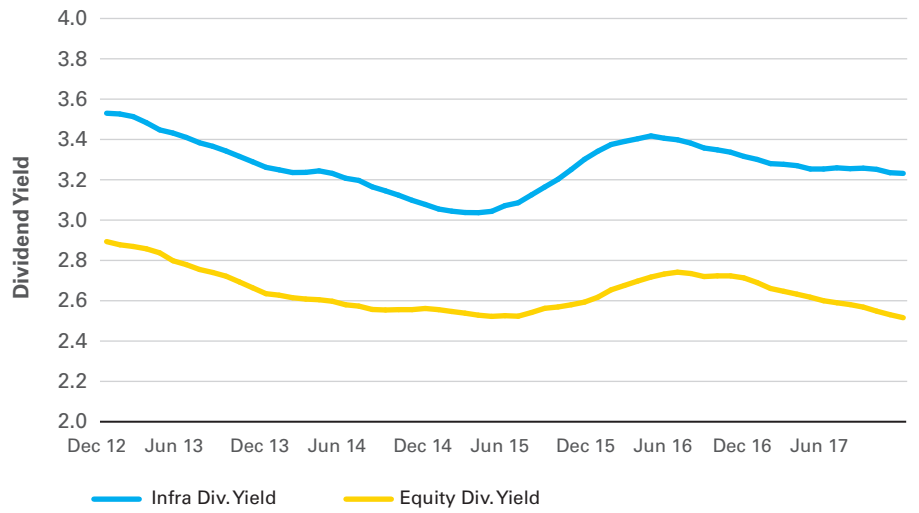
Source: LGIM. Bloomberg L.P. Using US Consumer Price Index year-on-year. Global Equities represented by the FTSE All-World Total Return Index unhedged in GBP, Global Listed Infrastructure represented by the FTSE Global Core Listed Infrastructure Total Return Index unhedged in GBP. Data from 31/12/2005 to 31/12/2017.

Figure 3: Low or modest correlation with other assets

	Infrastructure	Equities	Credit	Government Bonds
Infrastructure		0.68	0.55	0.05
Equities	0.68		0.42	-0.04
Credit	0.55	0.42		0.56
Government Bonds	0.05	-0.04	0.56	

Source: LGIM. Bloomberg L.P. Global Equities represented by the FTSE All-World Total Return Index unhedged in GBP, Global Listed Infrastructure represented by the FTSE Global Core Listed Infrastructure Total Return Index unhedged in GBP. Credit represented by the Bloomberg Global Aggregate Credit Index and Government Bonds by the Bloomberg Global Aggregate Treasuries Index. Data from 31/12/2005 to 31/12/2017.

Figure 4: A dividend yield above global equities

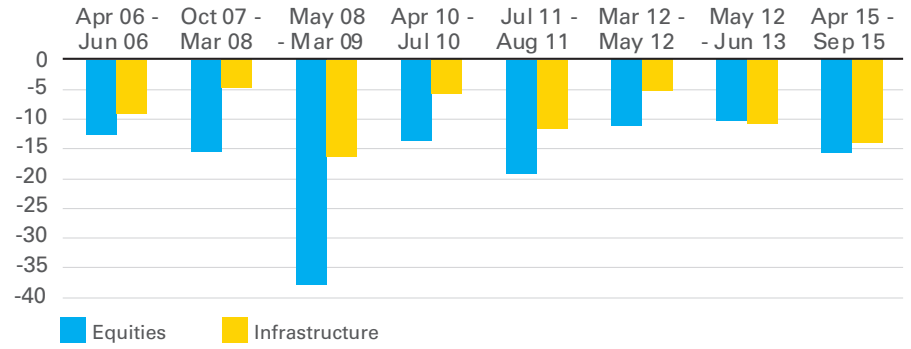


Source: LGIM. Bloomberg L.P. Global Equities represented by the FTSE All-World Total Return Index unhedged in GBP, Global Listed Infrastructure represented by the FTSE Global Core Listed Infrastructure Total Return Index unhedged in GBP. Data from 31/12/2011 to 31/12/2017.

5. Defensive characteristics

As infrastructure assets are less sensitive to changes in economic activity, returns have historically been less volatile and shown smaller reactions to market dips than broad equities. Looking at events where equities sold off by more than 10%, it is evident that infrastructure tends to display smaller drawdowns. Only on one occasion since 2016 was the drawdown of infrastructure worse than that of equities, in 2012/13.

Figure 5: Infrastructure and equity drawdowns during periods of market stress



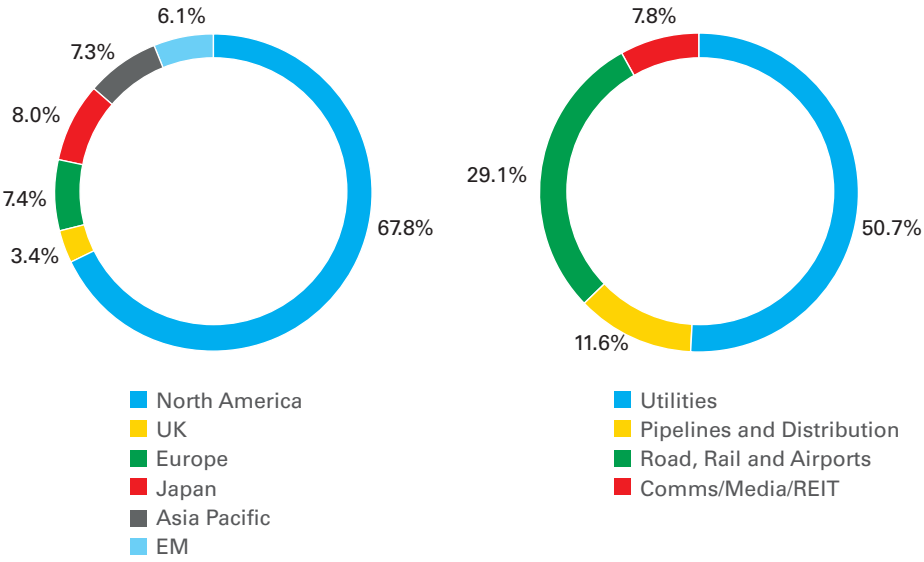
Source: LGIM. Bloomberg L.P. Global Equities represented by the FTSE All-World Total Return Index unhedged in GBP, Global Listed Infrastructure represented by the FTSE Global Core Listed Infrastructure Total Return Index unhedged in GBP. Data from 31/12/2005 to 31/12/2017.

HOW DO WE INVEST IN GLOBAL LISTED INFRASTRUCTURE?

Historically, the Mixed Investment Funds have invested in global listed infrastructure through a third party exchange traded fund (ETF). However, Legal & General will launch its own index tracking fund early in 2018 which we will invest in going forward. Both the ETF and the new unit trust follow the same index so the exposure to the underlying infrastructure companies will not change. The benefit is that we will reduce the costs incurred within the Mixed Investment Funds, a saving that will be directly passed on to our investors though a reduction of the ongoing charges figure (OCF). While this may only represent a few basis points, all savings boost performance over the longer term.

The underlying index to the fund will be the FTSE Core Global Listed Infrastructure index, the composition of which is shown in Figure 6.

Figure 6: Regional and Sector Allocations



As at 28 February 2018.

AN ASSET CLASS THAT DELIVERS

Global listed infrastructure is an asset class which offers many benefits including the potential for inflation-linked income and a modest correlation with many other asset classes. Historically, infrastructure has delivered a higher return than global equities in periods of high inflation and suffered less of a drawdown in times of market stress. With stable demand and predictable cashflows, this is an asset class that we consider to be an attractive addition to multi-asset portfolios.