BROMPTON FUNDS

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# Real Assets:
# Real Income, Real Growth

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"Investing in this low rate environment has become frustrating for most investors as the search for reliable returns has become even more difficult and urgent. We believe that Real Assets equities can help investors capture those elusive investment returns. Real Assets equities are issued by companies operating in the Utilities, Infrastructure and Real Estate sectors (along with select Resources issuers). Real Assets equites have provided investors with long-term outperformance over broad equities, both on an absolute and a risk-adjusted basis, and importantly they have done this while offering attractive and reliable levels of income."

The last several decades have become increasingly challenging for investors seeking income. Yields generally have been declining and volatility has unexpectedly spiked on several occasions. Investing in this low rate environment has become frustrating for most investors as the search for reliable returns has become even more difficult and urgent.

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This high income asset class is a welcome anomaly today. Forty years ago in the early 1980's, it would have been hard to predict that income could ever be in short supply, with government rates of all terms peaking in the mid-to-high teens. Since then, interest rates and borrowing costs have steadily trended lower. With interest rates across the term structure now hovering near 0%, the long decline in interest rates seems to be playing out in an extreme way. Our view is that low interest rates will continue to be a challenge for an extended period. This is a dilemma for investors as yields across most asset classes have also compressed, making it difficult to find acceptable yield without taking on meaningful credit or term risk. Real Assets equities can be an important part of the solution to this dilemma.

The story doesn't end here for Real Assets companies. They are unique in that they not only exhibit defensive/income characteristics, but they also give investors exposure to secular global growth themes which we expect to continue to be a powerful contributor to returns for Real Assets companies for decades.

In this paper, we discuss the defensive features of Real Assets equities, along with the trajectory of interest rates over the past several decades and why we think low rates are here to stay for the foreseeable future. There are global growth themes that should provide a tailwind to long-term returns for Real Assets equites and we outline how Real Assets equities can help investors navigate this environment.

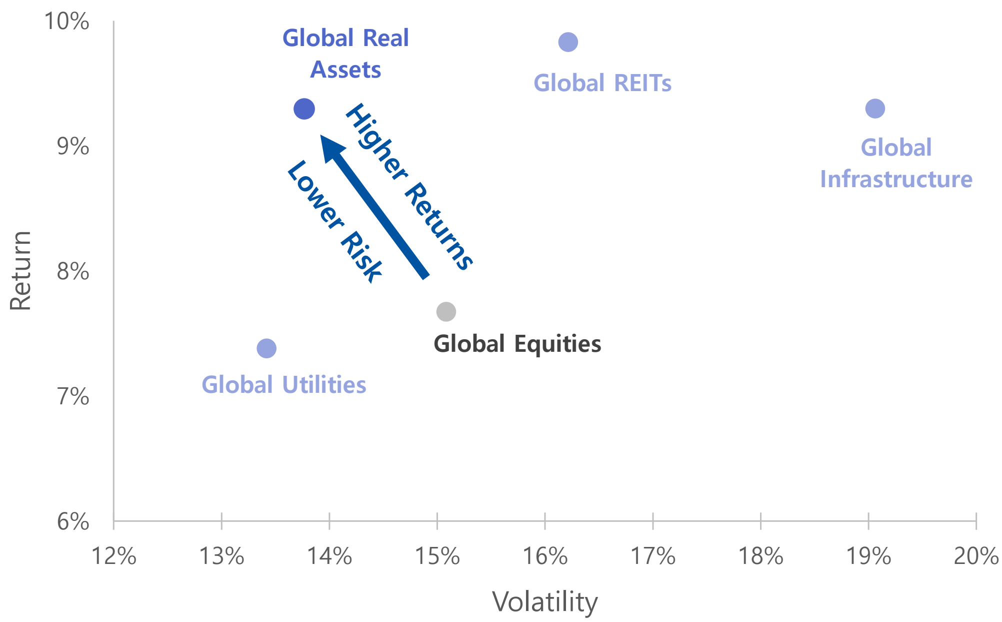
## Real Assets Outperformance

Companies in the Infrastructure, Real Estate, Utilities, and Resources sectors can be categorized as Real Assets issuers. Although these companies operate in a number of different sectors, these businesses generally rely on unique physical assets.

Many companies own and operate tangible assets. The differentiator for Real Assets issuers is the highly significant initial investment that would be required to replicate a Real Asset. Examples of Real Assets include power plants, pipelines, real estate, rail systems and telecom networks, to name a few.

Real Assets issuers operate in a variety of economic sectors, providing diversification. Each Real Asset subsector is exposed to different factors affecting returns, which results in reduced correlations between the various sub-sectors. This has been an important contributor to attractive long-term risk-adjusted returns. The various Real Assets categories have provided investors with comparable or better long-term absolute performance than broad global equities, but on a diversified basis, Real Assets have provided better risk-adjusted returns than each individual Real Assets category. The chart below demonstrates how Global Real Assets have delivered higher returns than global equities over a 30 year period, with less volatility.

**Higher Returns with Lower Risk[1]**




## Defensive Characteristics

Real Assets companies are defensive in nature due to the common focus on the operation of valuable physical assets. They typically have "wide-moat" business models with minimal competition and highly visible revenue streams. Although the initial investment to build or acquire real assets can be very high, ongoing maintenance capital expenditure and operating expenses are typically low, allowing many Real Assets issuers to enjoy high free cash flows and pay out high dividends. This has contributed to solid long-term risk-adjusted performance for investors.

Real Assets companies offer the following characteristics to varying degrees, which make them desirable as defensive investments:

**High barriers to entry:** Real Assets companies usually require large initial capital investments. This limits potential competitors and creates natural monopolies or oligopolies, enhancing profitability. For instance, there are only three Tower REITs in the U.S. and there are only seven Class I Railroads in Canada and the U.S. combined.

**Government support:** Infrastructure or Utilities projects tend to be government supported and are often considered the backbone of any economy. Construction projects such as water and transportation networks may have municipal, provincial/state, and/or federal funding support. Strong government support in our view decreases the risk profile of Real Assets companies.

**Resilient in economic downturns:** Real Assets companies offer essential services through the economic cycle. Services like water, electricity, and waste collection are necessary even during an economic downturn, providing investors with reliable returns.

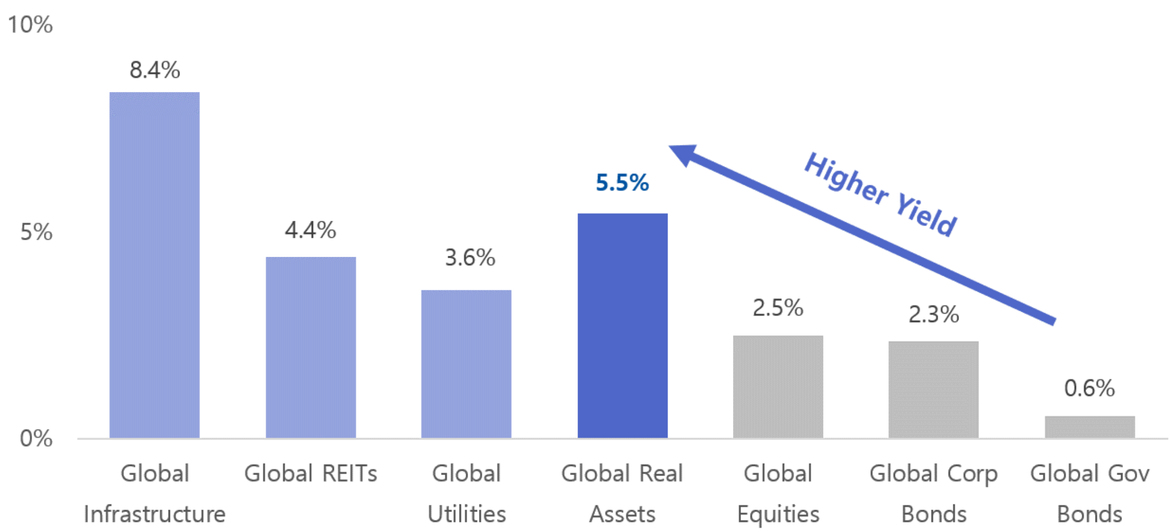
**Clear revenue visibility:** Infrastructure, Utility and REIT operators tend to have long-term contracts or regulatory returns in place. Some operators, especially in the Utilities segment, have return-on-equity levels which are set by regulators. In contrast to many other companies whose revenues depend on a more typical but more uncertain best-efforts approach to generating revenues through ongoing sales of goods and services, Real Assets companies tend to enjoy stable, recurring, lower-risk revenue streams through long-term contracts or regulations.

**Attractive income:** Once a major investment to build the Real Asset is made, subsequent operating costs and capital expenditures tend to be relatively low, which translates into higher free cash flows, profits, and ultimately stable and attractive dividends for Real Assets operators.

## The Importance of Income

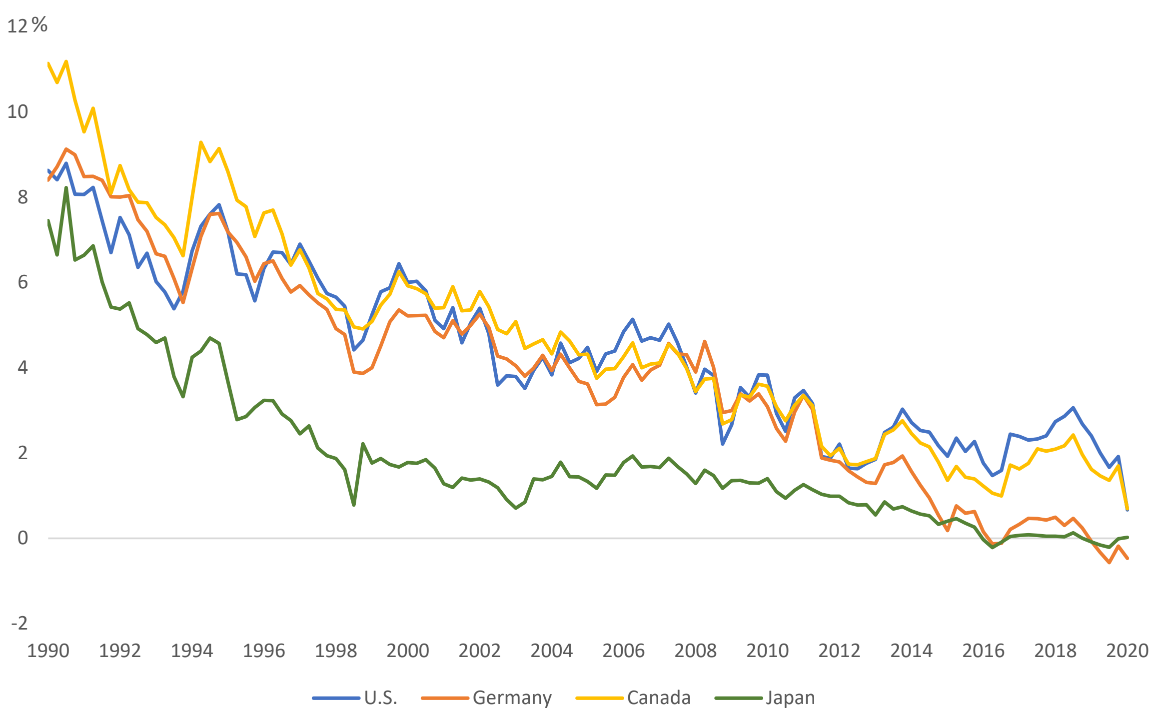
The attractive income available from Real Assets equities has become an especially compelling feature for investors, given a global market where income has become increasingly scarce. The following chart compares dividend yields available from various Real Assets subsectors and a diversified holding in Real Assets equities, with global equities, global corporate bonds, and global government bonds.

### Global Asset Yields – Apr. 30, 2020[2]




Sovereign/government bond yields are the basis for local yield levels in any investment market, and the long-term trend for sovereign yields is down strongly. This is a worldwide phenomenon as noted below with long-term nominal interest rates trending down over the last 30 years for most developed nations, including the U.S., Germany, Japan and Canada.

### 10-Year Government Bond Yields[3]



When bond yields trade at low levels, many income-oriented investors struggle to earn a return on investment that is sufficient to meet their investment goals. At current levels, long-term sovereign bond yields in many parts of the world are below the rate of inflation in those countries. In fact, persistently low inflation and the demand for safety have pushed many investors to buy negative yielding debt over the last 6 years. The amount of negative yielding debt globally grew exponentially from US$1 trillion in 2015 to around US$12 trillion in 2020.

There are several pieces of evidence to suggest interest rates will remain low for the foreseeable future. First, an aging demographic implies a “lower-for-longer” interest rate environment. In countries like Japan, Germany and most of the European Union, where population growth has stalled, there is an abundance of capital held by older generations, effectively creating a “borrowers market”, where younger people, who are more prone to borrow, are outnumbered by older generations, who have built up larger pools of savings. In a “borrower’s market”, interest rates need to decline in order to reach an equilibrium between supply and demand for income investments, or at least remain low to encourage more borrowing and to discourage saving.

Second, corporate savings, as measured by aggregate cash and marketable securities held by non-financial corporations, have grown at a steady pace and totaled US$4 Trillion in the U.S. as of the end of 2017. The higher propensity to save at both the corporate and the individual level supports persistently low interest rates going forward.

Third, policies such as quantitative easing, suppress the long end of the yield curve as central banks purchase medium and long term debt instruments to enhance market liquidity. Policy makers are also inclined to keep interest rates at levels lower than the equilibrium suggests, especially during times of economic stagnation. Lastly, the rate of economic growth has slowed due to lower trend productivity, especially in developed nations. Economic theory suggests slower trend growth translates into lower long-term interest rates.

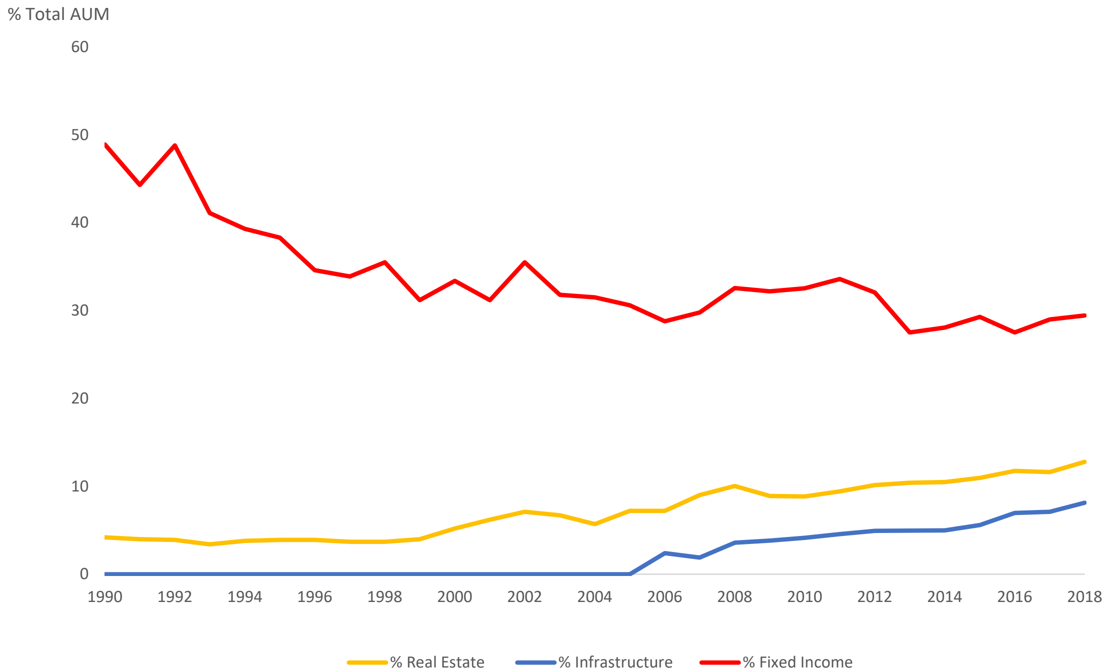
Finally, many of the same generational issues seen in Europe are also playing out in North America, and we believe this will help to keep interest rates low for the forseeable future. The Baby Boom generation (56-74 years of age in 2020) and Generation X (40-55 years old in 2020) are approaching or are in retirement age. Combined with the older Silent Generation, these demographic cohorts control the lion’s share of household wealth; as they continue to push into retirement years and their income needs continue to expand, we expect to see these cohorts allocate higher portions of household wealth to income-producing investments.

## Declining Interest Rates and the Real Assets Advantage

Real Assets companies receive significant benefits from lower interest rates. As the name implies, they are asset-heavy and require large initial capital investments. Due to their stable cash flows, Real Assets companies are able to employ higher leverage compared to companies in other sectors. When interest rates decline as they have for decades, Real Assets companies often can refinance at lower rates. As borrowers, Real Assets companies are beneficiaries of significant cost savings due to declining debt-servicing requirements, compared to companies in asset-light sectors.

Fixed income investors are lenders in global markets, and they are disadvantaged by declining global interest rates. How are investors responding to a market lacking in income opportunities? We take the institutional market as an important bellwether. Real Assets equities have been the investment of choice for Canada pension plans in recent years, as this class of professional investor has moved decisively to reallocate away from ever-lower-yielding fixed income holdings, into Real Estate and Infrastructure equity investments.

## Asset Allocation to Real Estate and Infrastructure[4]




In our view, North American retail investors would be wise to take a cue from institutional investors. Real Assets equities are well-positioned to attract interest from investors seeking higher income than is available from traditional fixed income instruments. While we caution retail investors that Real Assets equities are NOT bonds, we propose there is an increasingly significant place for Real Assets equities in retail investor portfolios as an income-enhancing investment. But the story doesn't end there, as Real Assets can that also provides growth benefits.

## Strong Growth Potential

Along with their defensive features, Real Assets companies can also be growth investments. There are a number of major long-term growth themes that are playing out in the world today, that can benefit well-positioned Real Asset companies.

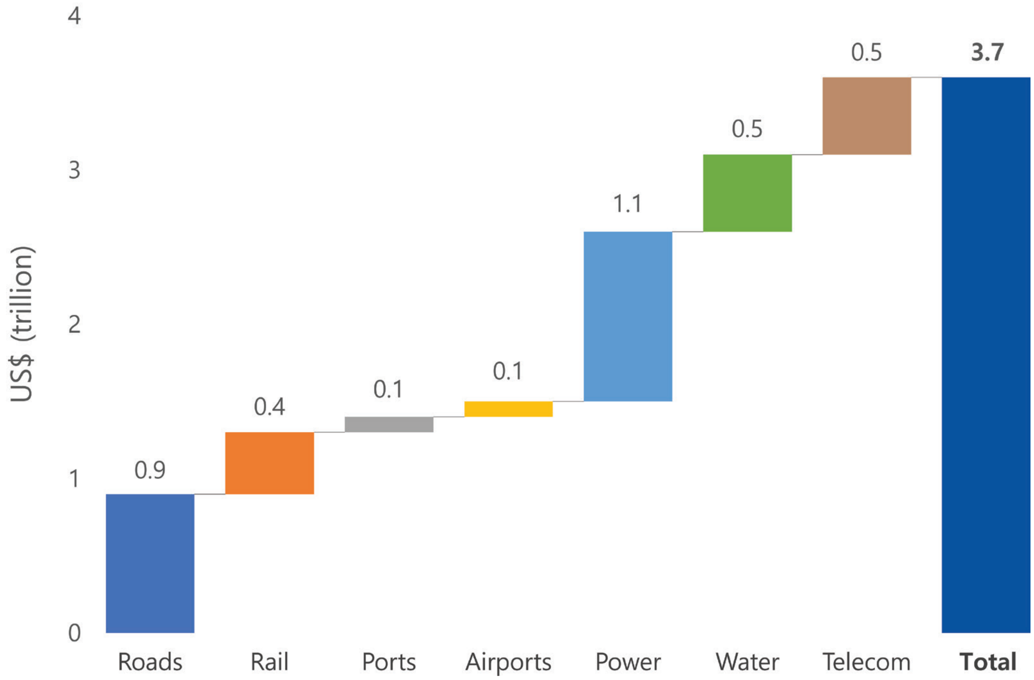
The key global growth themes that in our view will positively impact Real Assets companies are:

**Aging population and growing demand for income investments:** As discussed earlier in this paper, the oldest generations (the Silent Generation, the Baby Boom, and Generation X) control most net household wealth, currently over 90% in the U.S. As the proportion of retirees in these three major cohorts grow, demand for income investments is expected to increase substantially. As the income generation capacity of Real Assets issuers becomes more widely recognized, this should have a positive effect on Real Assets equity prices.

**"Government outsourcing of public infrastructure":** The world has extensive infrastructure needs, and with recent pressure on global defecits due to the COVID-19 pandemic, we expect governments around the world to re-focus on investment in Infrastructure as a partial means to address stimulus for global economies. In order to offset the financial burden, we project that governments will continue to expand partnerships with Real Asset companies to fund, construct, and operate public infrastructure Real Assets.

McKinsey estimates (pre-pandemic) that, through to 2035, global governments need to invest US$3.7 trillion per annum to meet global demand for Infrastructure whereby US$5.7 trillion is unfunded though to 2035. This represents a large opportunity for Real Assets companies to partner with governments worldwide and to capture and create value

**Annual Global Infrastructure Spending Need, US$tn (2017-2035)[5]**




**Urbanization:** The global urbanization trend continues to fuel demand for key infrastructure, including railroads, toll roads, airports, housing and data infrastructure. Asia is a key area of growth as it is urbanizing faster than any other region in the world. Over 60% of the world's population is in Asia, but currently only approximately 50% of the Asian population lives in urban areas. This is expected to grow to 70% over the next 30 years. Continued demand for infrastructure due to the urbanization trend is expected to provide significant global growth opportunities for Real Assets companies.

**Hyper-connectivity:** Businesses and governments around the globe are undergoing a digital transformation. The migration to 5G technology, the ongoing digitization of businesses in the retail and service sectors, and ongoing adoption of cloud computing will require more digital infrastructure, such as cell towers, data centers and fiber networks. Telecommunication players, Tower REITs and Data Center REITs are natural beneficiaries of this growth trend. COVID-19 has accelerated the pace of digital adoption.

**Environmental, Social, and Governance (ESG) trends:** ESG investing has gained popularity over the past decade. Many Utilities companies are ESG-oriented as they become increasingly focused on adopting renewable energy over the use of traditional fossil fuels. The European Commission (EC) has recently reiterated its strong commitment to the Green Deal as a key pillar of a European economic recovery following ongoing virus-related lockdowns. Specifically, as part of a broader effort to deploy €1 trillion of investments in climate policies by 2030, the EC aims to approve a budget in excess of €500 billion this year to be invested between 2021 and 2027. Goldman Sachs estimates that net zero emissions investments in renewables and the power grid could amount to €2.6 trillion by 2050, or €80 billion per annum. Most importantly, with improving technology and drop in costs, alternative energy can now compete with fossil fuels without subsidies. This could drive double-digit compound annual growth rates for Real Assets issuers through to 2030. In North America, there are also many ESG-related commitments at the state/provincial level that we expect will be additive to total returns in the Utilities sector.

## Real Assets: An Attractive Income and Growth Solution

With interest rates likely to stay lower for longer, investors would be well-served to re-evaluate their investment portfolios, with the objectives of meeting income goals and maximizing risk-adjusted returns. Real Assets equities including Utilities, Real Estate and Infrastructure provide defensive qualities, and as borrowers they benefit from a lower-for-longer interest rate environment. Real Assets companies also tend to offer better yields than global equities generally and many fixed income investments, making them ideal for income-oriented investors. When we also consider the secular global growth themes that Real Assets issuers participate in, the combination of defensive income and strong growth potential presents a compelling investment thesis for most investors.

## Brompton's Approach

Brompton Global Real Assets Dividend ETF (BREA) is an actively managed ETF investing in Global Real Assets companies in the Real Estate, Utilities, Infrastructure and Resources sectors. BREA is uniquely designed to capture the broadest universe of opportunities in the Real Asset space and to focus on the key secular income and growth themes discussed in this paper. BREA provides investors with high monthly distribution and the opportunity for capital appreciation. The Portfolio Managers also have discretion to write covered calls on the portfolio holdings. We use an active approach to call writing in order to enhance monthly income while further reducing portfolio volatility.

[1]*Source: Datastream, for the 30 year period ending April 30, 2020. Global Equities: Developed Markets-Datastream Market Index; Global Infrastructure: Developed Markets-Datastream Pipelines Index; Global REITs: Developed Markets-Datastream Real Estate Investment Trusts Index; Global Utilities: Developed Markets-Datastream Utilities Index; Global Real Assets represents an equal-weighted blend of Global Pipelines, Global REITs, and Global Utilities.*

[2] *Source: Refinitiv Datastream, as at 2020-04-30. Global Equities represents Developed Markets-Datastream Market Index; Global Infrastructure represents Developed Markets-Datastream Pipelines Index; Global REITs represents Developed Markets-Datastream Real Estate Investment Trusts Index; Global Utilities represents Developed Markets-Datastream Utilities Index; Global Corporate Bonds represents Bloomberg Barclays Global Aggregate - Corporate Bond Index; Global Government Bonds represents Bloomberg Barclays Global Aggregate - Government Bond Index. Global Real Assets represents an equal-weighted blend of Global Pipelines, Global REITs, and Global Utilities.*

[3]*Source: Bloomberg.*

[4] *Source: Brompton Funds, Pension Investment Association of Canada. https://www.piacweb.org/publications/asset-mix-report.html.*

[5] *Source: McKinsey Global Institute, "Bridging Infrastructure Gaps; Has the World Made Progress?", October 2017.*



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