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Utility shares a good option

Relatively low level of risk can bring peace of mind for many

INVESTORS are set to flock to infrastructure and utility stocks this year, seeking relatively stable income in a still volatile global market, according to NZ Funds Management.

Utility shares such as water, electricity and energy stocks have relatively stable earnings predictability, as well as built-in inflation protection because of their ability to raise prices quickly in periods of high inflation.

NZ Funds Management chief investment officer, Michael Lang, says consumer demand for utility services often protect the stock against crisis.

"Utilities are a compelling investment opportunity for sensible, conservative investors," Mr Lang says. "They have a relatively low level of risk as they sell essential services in markets with limited competition and frequently have regulated prices."

Mr Lang says each time New Zealand is faced with the prospect of blackouts, the nation struggles to curb demand.

During the worst hydro-lakes crisis of 1992, a combination of cold showers and cuts by major power users such as Comalco resulted in only a modest 15 to 20 per cent reduction in electricity usage.

"Tough economic times also have a limited impact on the demand for electricity," Mr Lang says. "In the middle of one of the most severe global economic crises in decades, New Zealand households did not hesitate to turn on their electric heaters. Power companies have reported double digit growth in the demand for power from residential consumers."

Conservative investors are not just attracted to utilities because of stable demand. Utilities also operate in an environment of limited competition, and the networks to deliver water, gas and electricity are very expensive to build and maintain, making duplication extremely inefficient.

Normally, customers can simply switch suppliers, use an alternative product or avoid consuming the product. But for utilities this is almost impossible, and therefore utilities can raise prices with limited impact on demand.

This monopoly or predatory pricing benefits the company at the cost of its customers and so governments use pricing regulation (or at least the threat of this regulation) to remove the opportunity to exploit customers.

"The mention of regulation often puts cold shivers up the spines of investors," Mr Lang says. "But the effect of regulation on utilities is very different. Pricing regulation places maximum caps on the price a utility company can charge.

"Once the regulatory framework is set up, the future pricing is relatively easy to predict, especially when compared with an average company," he says.

The adjacent table shows the performance of utilities in periods of high inflation — an important indicator for investors wishing to beat the eroding effect of inflation.

Mr Lang says utilities had returns that were greater than the rate of inflation in five of the six periods.

"This is a good batting average, especially when compared with cash which is a measure of bank deposit returns, or the sharemarket as a whole. Cash had greater returns in three cases, while all types of shares taken together only beat inflation twice."

Mr Lang says to gain sufficient diversity, investors need to look offshore for their utility investments as there are very few listed utility companies in New Zealand.

UTILITIES STRIKE IN INFLATIONARY TIMES

Period	Inflation	Utilities
Aug 1940 - Jul 1943	7.8%	14.8% (above inflation)
Jul 1945 - Oct 1948	9.6%	14.5% (above inflation)
Jan 1950 - Nov 1951	6.6%	22.9% (above inflation)
Dec 1968 - Jun 1970	6.1%	-14.6% (below inflation)
Aug 1972 - Jul 1982	8.9%	10.3% (above inflation)
Sep 1989 - Dec 1990	5.6%	5.7% (above inflation)
Total	**219.9%**	**301.1%**

Source: Bloomberg