

FEBRUARY 2010

Investors are set to flock to infrastructure and utility stocks in 2010, seeking relatively stable income in a still volatile global market, according to New Zealand 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' CIO, Michael Lang says consumer demand for utility services often protect the stock against crisis. "Utilities are a compelling investment opportunity for sensible, conservative investors," 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."

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," 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 with most utilities competing with only a handful of other companies providing the same service. Limited competition further reduces the risk of utilities as an investment.

One explanation for the limited competition that utilities face is the unique infrastructure they use to deliver water, gas and electricity. "These networks are very expensive to build and maintain, making duplication extremely inefficient," Lang says.

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," 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. Arguably, this removes upside. But in its place is certainty. Once the regulatory framework is set up, the future pricing is relatively easy to predict, especially when compared with an average company."

The Government may also be forced to set up incentive programs to encourage the companies that own these assets to accelerate their capital expenditure programs. A common way to incentivise these companies is to allow greater returns on new infrastructure spending. In other words, these companies have the opportunity to squeeze additional returns above their normal regulated returns.

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

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.

Lang says the most important thing to note from the table is that 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 share market as a whole. Cash had greater returns in three cases, while all types of shares taken together only beat inflation twice"

But Lang observed that this was before tax which can be up to 30% for cash, but is usually significantly lower

for shares. For example New Zealand shares accessed through a managed PIE fund attract little or no tax, while international shares accessed in the same way usually only attract a 5% tax on the value of assets invested. Either way, when you combine the superior inflation beating characteristics of listed utilities with the highly tax effective PIE tax regime Lang believes long term investors are onto a winner.

However, 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. Investors should adopt a passive “utilities index” orientated approach to investing, as opposed to active stock pickers portfolio. “The potential for an active manager to skew the portfolio towards unregulated utilities, utilities with energy ‘upside’ or utilities with operations in emerging markets, is unattractive because it puts a utilities stable earnings growth and attractive dividend yield at risk”

Lang notes that the investment appeal of this sector can be improved by carefully designing a capital protected investment strategy. This protects investors’ capital when fear grips the market and all types of listed shares suffer, irrespective of their long run merits. “For utility investors this type of approach will ensure capital stability and rapid earnings and dividend growth in an environment of rising inflation,” Lang says.

For further information please contact:



Michael Lang Ph: 09 377 2277
Chief Investment Officer
New Zealand Funds Management

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