Green Infrastructure Fund

Q2 2023 Commentary

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PERFORMANCE

	3 Months	6 months	ITD*
Fund Performance (B Class)	-6.3%	-10.2%	-5.6%
IA Infrastructure	-2.9%	-4.6%	-6.8%
Sector Quartile	4	4	2

Source: Morningstar. Figures compared on a Bid to Bid basis with Net Income Reinvested. *Inception: 28 September 2022

MARKET REVIEW

While the first part of 2023 was challenging for infrastructure, share prices remained somewhat resilient until May when they dropped as UK inflation surprised on the upside and caused many investors to reposition portfolios in anticipation of further rate rises. When rate rises materialised in June in the form of a 0.5% rise from the Bank of England, green infrastructure share prices sold off further. The prevailing narrative was that investors were questioning the benefit of taking risk by owning infrastructure assets when they could get similar yields without risk by owning government debt. If this was the motivating factor, it would seem the market was failing to take into account that the government debt offering similar yields to infrastructure did not offer inflation-linkage, while infrastructure generally does.

PERFORMANCE & ACTIVITY

Since launch in September 2022, the fund has generally delivered relatively stable capital returns while harvesting inflation-correlated income to fund its dividend – up until the market upheavals that took place in May, after which share prices declined more steeply. Over the quarter, energy generation companies, such as Bluefield Solar Income Fund and Foresight Solar Fund fell most sharply as the UK power price curve continued to decline. It should be mentioned that many of our investments, particularly in the solar area, have significant exposure to long term power price fixes and are therefore less badly affected by near-term power price moves than suggested by recent share price movements. On the positive side, our complementary asset investments softened the overall drawdown, with, for example, Target Healthcare REIT delivering positive returns over the period after it reported its net tangible assets rose 0.4% over Q1, primarily driven by a like-for-like valuation uplift from inflation-linked rent reviews. Amongst other noteworthy outperformers this quarter was the wind turbine installation vessel business Cadeler, which managed to deliver positive performance over the quarter after securing a contract to install twenty-six 11 MW wind turbines at the Aflandshage wind farm in Denmark at a record day rate of more than €375,000, and announcing an intended business combination with its competitor Eneti.

Green infrastructure assets generally underperformed more conventional, less environmentally friendly infrastructure assets due more, we believe, to shorter-term financial positives for the less green assets than negatives for green assets. For example, airports feature heavily in less environmentally friendly infrastructure portfolios, and these have been benefitting from global passenger traffic continuing to recover post the pandemic, and declining jet fuel prices. We believe the resilience of less sustainable infrastructure investment is grounded in shorter-term factors, whereas sustainable infrastructure benefits from structural trends that we would expect to persist for decades, as the world adjusts to a net zero future.

Two noteworthy transactions took place over the period under review. The sale of our position in US Solar Fund, and the purchase of an Aaa-rated supranational green bond from the International Finance Corporation. The US Solar Fund share price was until recently underpinned by that the company was undergoing a strategic review and considering bids for the company.

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US Solar Fund announced this quarter that it had failed to secure any bids that were not at a significant discount to NAV, hanging a question mark over the accuracy of its NAV. These events ultimately triggered a review of the position, and we determined that the risks had come to outweigh the benefits of the investment and decided to sell out. A new position was initiated in an Aaa-rated supranational green bond from International Finance Corporation (IFC), which is part of the World Bank Group. The bond matures before the end of the year, and was bought below par value and at a yield to maturity above the long term inflation-based target yield of the fund. The IFC focuses on encouraging private enterprise in developing countries, and the proceeds of this green bond were earmarked for investments in renewable energy, energy efficiency, and other areas that reduce greenhouse emissions. The IFC is owned by 186 member states, with the US being its largest shareholder with a 20% voting share. Although we have conservatively allocated this investment to the complementary assets portion of the fund, we nevertheless see it as an investment that is highly suited to our investment strategy, giving us a low-risk way of gaining exposure to core green infrastructure in emerging markets.

We continue to see potential for rising income distributions from the fund based on prospective yields in the portfolio.

News relating to positive environmental outcomes from our holdings over the period under review included the following:

- The UK's first deep geothermal energy plant in 37 years, funded in part by GCP Infrastructure Investment, became operational, harnessing heat from the Earth's core to supply the Eden Project's new nursery Growing Point, as well as its related offices.
- Atrato Onsite Energy announced in its interim results that it had committed £69m into four new solar PV plants with a total capacity of 80MW.
- The EU parliament voted overwhelmingly in favour of reforming the EU Emissions Trading System so that the supply of the kind of EU Allowances we hold in the fund is set to decrease faster than previously anticipated, with permitted emissions set to drop 62% from 2005 to 2030 as opposed to the previous target of 43%, supporting the carbon price and incentivising more rapid decarbonisation.

OUTLOOK

Many infrastructure companies, especially in the UK-listed investment trust space, are now trading at discounts to NAV not seen in a decade or so of trading history, at a time when the demand for renewable energy solutions is increasing as the world struggles to meet its net zero ambitions over the next couple of decades. If investors believe interest rates will stay elevated for longer but inflation will come down rapidly, it might make sense for infrastructure assets to suffer from increased interest rate expectations, but, given that rate expectations have been rising off the back of stubbornly high inflation, this does not seem reasonable. We believe that, on average, our holdings not only benefit from rising inflation in isolation but that this benefit is sufficient to overcome the negative effect of rising risk-free rates in a scenario where risk-free rates rise in lockstep with inflation. While recent mark-to-market declines in share prices have been uncomfortable, the actual assets that underpin our investments in listed green infrastructure seem to be continuing to do what we would expect them to do – broadly maintain capital (as per stable NAVs) while delivering inflation-mitigating income from investment in assets with positive environmental outcomes.

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