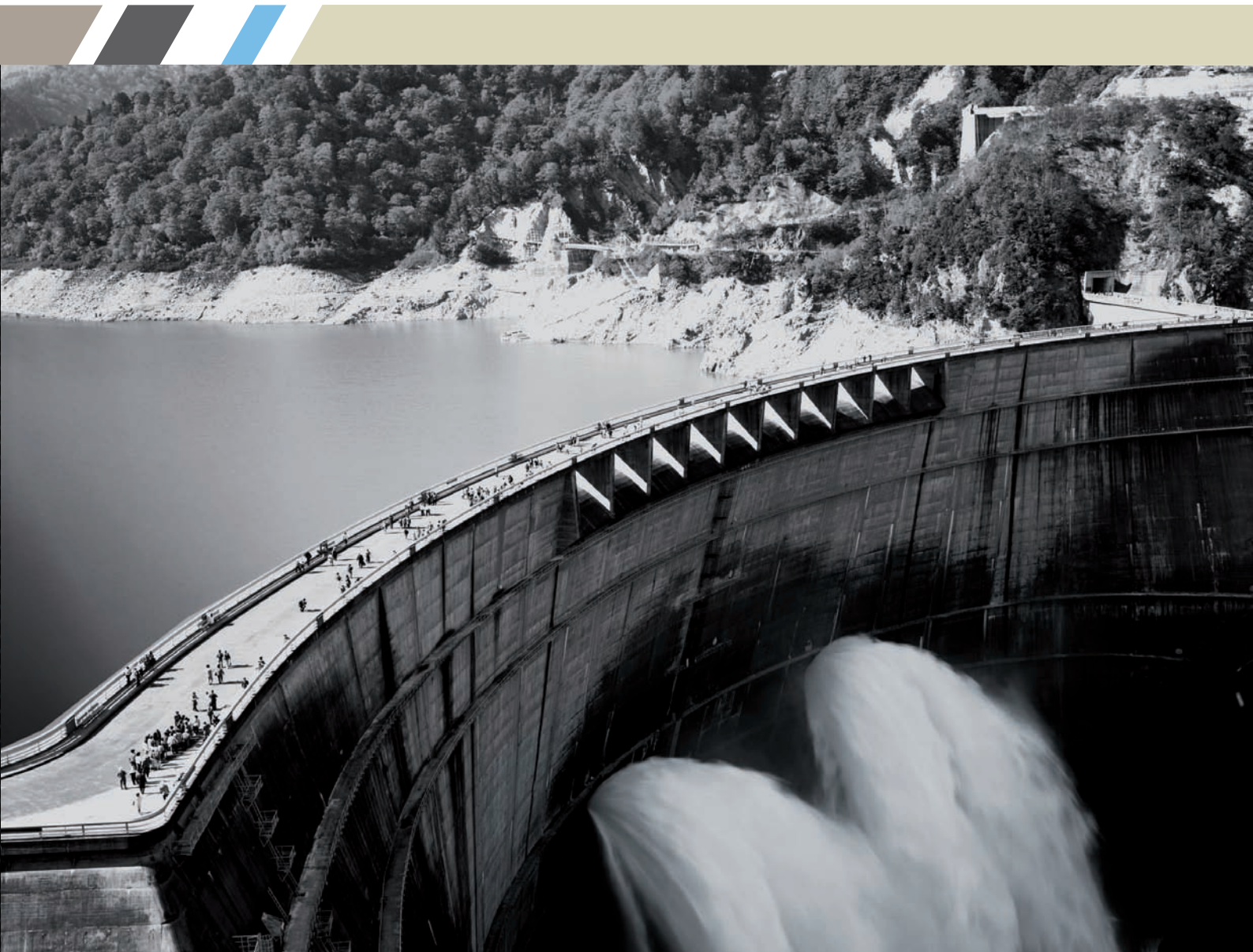


Russell OpenWorld®

Listed infrastructure investing



Laying the foundations for growth by investing in Infrastructure

DEFENSIVE IN NATURE, INFRASTRUCTURE INVESTMENTS CAN IMPROVE THE DIVERSIFICATION OF ANY PORTFOLIO AND OFFER A HIGH STABLE INCOME WHICH IS, IN MANY CASES, LINKED TO INFLATION.

Infrastructure assets include toll roads, airports, utilities and pipelines. Often viewed as the “old economy”, these assets typically operate in less competitive environments where high barriers to entry, pricing power and predictable cash flows enhance their appeal in a challenging investment environment.

The Russell OpenWorld® fund range includes a series of thematic funds that focus on areas expected to experience sustained growth due to increased demand for basic products and services like food, commodities, energy and transportation. One such area is listed infrastructure.

Investment opportunities within the asset class are enormous with funding requirements likely to run into trillions of dollars, with a significant share financed privately. The trend for governments around the world to embrace the financing of public infrastructure by the private sector is creating vast opportunities for investors to address funding shortfalls and to support economic development in both developed and developing economies.

This may mean a focus on the renewal of transportation networks in the US, or on privatisation programmes in faster-growing economies such as India.

Defining infrastructure

We define infrastructure investment as being investment in assets that provide sustainable services that are essential for a functioning economy. The services provided are typically monopolistic or quasi-monopolistic in nature as a result of geography or regulation. Demand for these services is often inelastic to price changes and these investments can therefore provide predictable and sustainable cashflows.

Most infrastructure assets are grouped into the following sectors:

- › **Energy** – Power generation, transmission, distribution, renewable energy, pipelines, storage;
- › **Water** – Water and waste-water networks, sewerage facilities, desalination plants;
- › **Transport** – Ports, rail, airports, roads, bridges, parking, mass transit, waterways;
- › **Communication** – Cable networks, telecom lines, towers, satellites; and
- › **Social** – Hospitals, prisons, schools, stadia, courts, social housing.

The benefits of investing in infrastructure

In volatile and challenging market conditions, the long duration of infrastructure investments - typically 20 to 50 years, and potentially even longer – can offer greater stability in an uncertain world

Portfolio allocations to infrastructure are increasing, with investors enticed by the asset class' elongated investment horizon. The natural life cycle of infrastructure assets are very long, making them an attractive alternative to government bonds in terms of liability matching. A further appeal is revenue streams often have regulated price increase mechanisms that explicitly consider the rate of inflation.

The Organisation for Economic Co-operation and Development estimates that around \$40 trillion of investment in new and existing infrastructure will be required globally between now and 2030.

Why listed infrastructure?

Where previously unlisted or direct infrastructure investment was the domain of larger institutional investors, the nascent global listed market has given a broader range of investors' easier access to this burgeoning asset class.

Listed infrastructure comprises a universe of publicly traded securities issued by companies that own and/or operate infrastructure assets. These companies generate steady cash flows derived from tangible, long-lived assets with semi-monopolistic pricing power – a function of the high fixed costs and, by extension the high barriers to entry associated with infrastructure construction.

Listed vehicles offer much greater liquidity and transparency, and have lower management fees, than private or direct equity investments.

Diversification across regions and sectors may be more easily effected as investors are not obliged to concentrate their allocations in a handful of large assets.

Companies often have a lower level of leverage than their unlisted counterparts, and feature a straightforward tax structure.

Listed infrastructure securities tend to be high-yielding, generating stable income streams guaranteed by lengthy fixed-term contracts, often backed by a government, meaning the asset class possesses bond-like qualities, but offers the potential for higher capital gains.

Listed vehicles tend to invest in more mature assets relative to unlisted vehicles, and have less

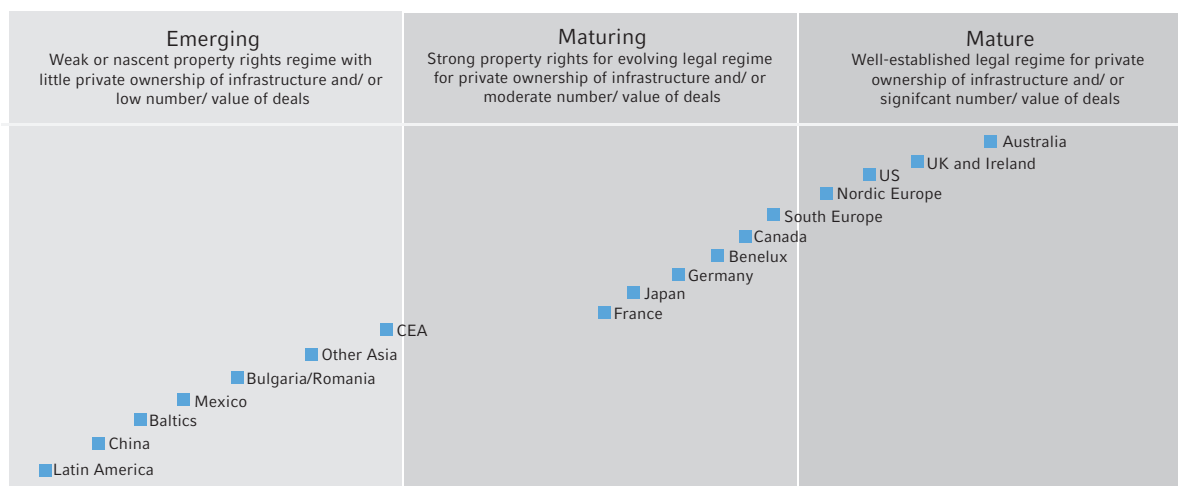
access to "greenfield" sites, which are generally more risky. The advantages of investing in listed infrastructure are partially offset by a higher correlation to broader equities, a higher level of volatility relative to unlisted assets and reduced access to "greenfield" investments.

What's driving infrastructure growth?

Owning part of one of the world's first fully electronic toll roads in Melbourne, the Chicago Midway Airport or a local water utility may sound like an unusual investment, but these types of assets continue to gain increasing traction as an attractive avenue for the placement of new capital.

Already firmly established in Australia, Europe and Canada, infrastructure as an asset class is growing rapidly elsewhere. Developing countries are crying out for high levels of investment in the infrastructure they need to support their growing economies and expanding, wealthier populations. At the same time, in the developed world, existing infrastructure is now beginning to falter after long periods of underinvestment.

Upgrading the emerging world's infrastructure is likely to be one of the themes dominating global investment in the next few years. Emerging market spending is booming as populations are growing and urbanising. This is straining existing infrastructure resources and leading to acute demand for electricity, water and sanitation. Despite recent falls in commodity prices, strong economic growth has granted resource-rich governments' significant capital to dedicate towards infrastructure investment.



Source: RREEF Research, Thomson Financial, April 2006 and Euromoney, March 2006

Among the key drivers from which companies operating in related industries will profit are:

Key drivers	Description
Increasing population	Growing and increasingly wealthy population requires additional housing and power supply, public transport, clean water, healthcare and education.
Power generation	Global population growth is such that electricity consumption is expected to double by 2030 - while newsflow on harmful carbon emissions, oil price volatility and concerns over the security of energy supply have led to an upsurge in interest in the alternative and renewable energy sectors.
Climate change	Improved long-distance infrastructure is essential, not only for the more efficient provision of energy, but for bringing on-line the large-scale, but potentially remote, renewable energy resources such as solar and wind. Climate change represents both a challenge and an opportunity to emerging market development.
Limited supply	Roads, airports and pipelines can only operate up to a fixed maximum capacity, beyond which extra assets are required. As emerging markets develop, the economy's focus typically turns to ensuring that the transport infrastructure is sufficiently robust to support this growth, with motorway projects invariably targeted at the outset.
Financing shift	The private sector will be assuming a greater share of the funding and construction responsibility as governments worldwide come under increasing fiscal constraints, particularly in the developed world. Governments in Australia, Europe, Canada, and, to a degree, the US have already embraced the private sector and this trend looks set to accelerate. For example, the Energy Policy Act of 2005 actively encourages US utility companies to boost spending to enhance transmission and distribution infrastructure in an effort to alleviate the strain on the nation's ailing electrical grid.
The petrodollar	In the Middle East, the flow of petrodollars is driving a huge amount of investment, with an estimated \$2.4 trillion in construction projects, many of a civil nature, either underway or in development. The recent decline in oil prices has not diminished the desire for development, with Saudi Arabia alone estimating that it will be spending up to \$1 trillion on the development of six new "mega-cities" ¹ . Similarly, in Russia natural resource revenues flowing from the country's deep oil and natural gas resources look set to be funnelled into diverse infrastructure projects, including improving access to the Black Sea resort of Sochi in time for the 2014 Winter Olympics. ²
Asian expansion	As Asia's "tiger" economies continue to develop, their demands for infrastructure will increase markedly. The Asian Development Bank concluded that developing economies in East Asia will need to spend an estimated total of \$165bn per year between 2006-2010 in certain infrastructure sectors, namely electricity, telecommunications, major inter-urban roads, rail routes, water and sanitation. This excludes additional spending on urban roads, mass transit, ports, airports, bridges and waterways so the opportunity set is vast. ³
The credit crunch	The global financial crisis and the resulting unprecedented volatility in financial and credit markets may also spark renewed public sector funding on a huge scale. With the US sliding into recession, there is every possibility that the clamour for imposition of the "New Deal" style programmes first seen in the depression of the early 1930's will grow, with one of the key demands being increased spending on the country's crumbling infrastructure. As with the earlier incarnation there are already calls for the government to pump funds into roads, bridges and railways to create new jobs and spending power that will be ploughed back into the economy. Spending on roads, bridges and passenger rail routes amounts to just 0.6% of GDP, compared to China's 9% and the European Union's 3.5%. The American Society of Civil Engineers estimates that \$1.6 trillion is needed over 5 years to bring US infrastructure to good condition. In this sense, the US could very well be described as an emerging infrastructure market. The Australian government has already announced its intentions to fast-track plans to unlock a \$15.5bn infrastructure building fund to boost the economy amid the global financial crisis.

Sources: ¹Middle Eastern Economic Digest, 2006, ²Reuters, September 2007, ³Tito Yepes, Expenditure on Infrastructure in East Asia Region, 2006-2010.

What are the risks?

Leverage is an integral part of infrastructure investing, as by extension, is **interest rate** risk. There is always the possibility that an upswing in interest rates could dent the profitability of a project. The flipside, however, is that the asset class should do well when credit conditions tighten, as lenders are attracted to the stability of its cashflows.

Like all asset classes, infrastructure could experience some negativity from a **liquidity drought**, but we believe any downturn should be less severe than that experienced by lower quality debtors. This helps make infrastructure a truly defensive play. It has been one of the only sectors to enjoy continued access to credit in recent months and it has largely escaped any pressure to de-leverage.

The public necessity of infrastructure assets ensures that provider behaviour is heavily scrutinised and therefore subject to regulatory and governmental supervision. This opens the possibility of **political and regulatory risk**. The latter is potentially of the most import to investors, who have to be able to rely on the deals they have agreed being enforced.

Legal and regulatory risks can be acute with any **emerging market exposures**, where legal systems may be less well developed, and there is the danger of arbitrary changes to laws governing foreign investments. Frequent changes of government, such as those witnessed in Thailand in 2008, may also mean that a deal gets overturned. Variations in bureaucratic requirements, resource availability and technological limitations should also be taken into account.

Finally, **merger and acquisition (M&A) activity** also represents a potential risk, whereby attractive infrastructure assets become increasingly viable takeover targets. M&A activity could potentially dilute the pure infrastructure exposure, exposing investors to other sectors, additional debt burden and new management.

So it's clear that infrastructure is not a risk-free play. We believe however, that the positives far outweigh the negatives, with infrastructure assets providing predictable, long-term inflation-linked revenues. Infrastructure investing offers exposure to returns that have a relatively low correlation to the broader equity, bond and property markets over the longer term and can deliver relatively high returns in a less volatile, less risky manner.

Risks

Interest rate risk – significant levels of gearing used to finance

Political/Regulatory risk – potential abuse of governments' intervention especially in emerging markets

M&A Risk – Infrastructure assets are attractive takeover targets – potential contamination with other business loosing the 'pure' infrastructure play

Benefits

Improves the diversification of your portfolio – moderate correlation with equities (similar to bonds?)

Defensive nature provided by a high stable income

Partial inflation hedge – infrastructure asset revenues are often fully or partially linked to the inflation

Significant niche premium – inefficiencies are above average offering high alpha potential

Manager selection in infrastructure

We believe that inefficiencies within the listed infrastructure market are still above-average for an asset class, creating scope for value added from good active managers to broaden their activities. The universe of managers specialising in infrastructure investment remains relatively small. Very few asset managers define their business around such a narrow theme, but we have identified several characteristics that we believe can give a manager a competitive advantage in this area:

Exclusivity. With such a broad range of specific issues relating to infrastructure, we believe that firms dedicated to the pursuit of listed infrastructure securities may have a particular advantage over managers who include infrastructure as part of a broader approach. This should enable our preferred manager to hire and retain superior staff in what is still a niche market.

Expertise. The ability to identify undervalued infrastructure securities requires a detailed understanding of infrastructure cashflows, gearing, regulatory issues and economic/demographic growth. It sounds simple, but a good understanding of what is, and what is not infrastructure is also essential. We prefer firms who understand the dilution of an infrastructure play that may enter a portfolio via stock which possesses "infrastructure exposure" but is not a true infrastructure asset.

Experience. We favour managers who are able to offer a truly in-depth and broad assessment of the potential stock universe and opportunity set. We aim to select a manager that is distinguishable by its deep investment team, its extensive experience in investing in listed and unlisted infrastructure, and in financial markets generally. Some previous direct infrastructure experience will also provide additional informational advantages.

With new stocks coming onto the market with such regularity, we prefer a manager that has the ability to expand its reach to focus its detailed research on the widest range of companies possible. We prefer a manager that can offer a fully global proposition, accessing both mature and emerging markets.

CONCLUSION

Infrastructure assets offer the potential for attractive returns, low volatility, diversification, high income, long duration and, in time, plentiful capacity. Investments of this nature has been around for a long time, but the listed market is an attractive new area, and is likely to become mainstream in the next 10 years.

Russell believes that there is a strong case for integrating infrastructure investing into our clients' portfolios. Listed infrastructure is a relatively new investment strategy, but one which is fundamentally sound, with a rapidly evolving, and ever-increasing opportunity set.

Based on our manager research, and given the continued expansion in the potential investment universe, we favour using a fully global approach to infrastructure investing. We prefer a manager who can offer our investors the broadest possible access to this burgeoning asset class, be it through investing in more mature assets in the developed world or by seeking out suitable "greenfield" sites in emerging markets.

We believe that superior results can be achieved by investing through a carefully researched and experienced manager, specialising in infrastructure, and able to offer competitive advantage through its compelling proposition and outstanding expertise.

Through Russell OpenWorld®, investors can access this exciting investment opportunity with confidence.

For more information:

Call:
+44 20 7024 6000

Visit:
www.openworldinvesting.com



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