November 21, 2019

Centre Funds Insight – Winter 2019/20 Market Review & Outlook – Global Infrastructure

Global listed infrastructure securities remain a compelling investment option, characterized by high dividend yields, stable cash flows, and attractive risk-adjusted performance, while offering a long-term hedge against inflation. Despite significant funding gaps for infrastructure in developed markets, and the years of debate about replacing outdated backbone systems, infrastructure investment has declined as a share of GDP (Gross Domestic Product) in more than half of the G20 economies since the global financial crisis. Years of underinvestment in critical areas such as transportation, water treatment, and power grids could erode future growth potential and productivity. Municipalities are now focusing efforts on connecting institutional investors with projects that need their capital as well as creating an expanded role for public-private partnerships and tax and other incentives to undertake infrastructure investment. We believe the majority of the infrastructure funding gap will likely be financed by the private sector, creating significant opportunities within publicly traded global listed infrastructure assets, especially in the Telecom and more innovative areas where the intellectual capital resides. Infrastructure is also a defensive asset class because of the characteristics of the underlying assets owned by many global listed infrastructure companies including: 1) inelastic demand due to the essential nature of the assets used in everyday life; 2) high barriers to entry due to the critical and often irreplaceable nature of the assets; and 3) contractual revenue streams that offer inflation protection in many cases. Conventional wisdom holds that you invest in bonds for yield and equities for capital appreciation. While this might be true historically, with 10-Year Treasury yields collapsing (to 1.5% from 3.2%) over the past 9 months, infrastructure related stocks now offer the best of both. Currently, the S&P 500 Index's dividend yield of 1.9% supersedes Treasury yields and, from a sector perspective, Infrastructure related sectors such as Telecom (4.6%), Energy (3.9%), and Utilities (3.0%) are all well above the market. The Infrastructure Fund has an underlying yield of approximately 4.0% as of September 30, 2019. The combination of continued underperformance of limited partnership structured energy equities and improved free cash flow for some companies has begun to drive investor interest in the sustainability of increasingly attractive dividend yields in the infrastructure related sectors.

We remain upbeat on global telecom, cable and communications infrastructure industries. Wireless carriers are accelerating the pace of their 5G deployments and expect to have mostly national coverage by mid-2020, as 5G enabled handsets become more widely available. AT&T committed to nationwide 5G by mid-2020 and Verizon noted that it has launched 5G service in nine cities and is on track to meet its goal of deploying 5G in 30 cities by the end of 2019. Based on our conversations with telecom industry experts, companies are making major upgrades in their access networks, upgrading to the latest Wi-Fi protocols to increase network capacity and 5G to support Internet of Things (IoT) specific use cases. Furthermore, changing network management to cloud-based approaches are required to keep up with the rapid pace of change. In our opinion, 5G represents a meaningful opportunity for incremental growth at the U.S. wireless carriers, something which the industry has lacked. Over the last decade (2008-2018), wireless industry service revenue has only grown at a 1% per annum. This is despite the proliferation of smartphones and LTE networks, which have enabled unlimited broadband usage in customers' hands anywhere they go. We believe much of the incremental economic benefits from LTE likely accrued to the platforms/services built atop these networks (Uber, YouTube/Google, Amazon, etc.), as well as smartphone manufacturers (Apple). Looking forward, we believe operators are intent on better monetizing their investments in newer 5G networks/infrastructure, taking a greater slice of the revenue pie/opportunity 5G presents. While the Communications Infrastructure companies (primarily Towers and Fiber) are key beneficiaries from 5G as well, this group has benefitted from a very healthy demand (and carrier capex) backdrop in recent years (as carriers competed on network quality to win share). So, 5G may represent more of a continuation catalyst to sustain very healthy growth; however, we believe 5G is far more significant as a potential incremental tailwind for the carriers and have positioned the Fund accordingly. Today, the U.S. wireless industry generates approximately $235B in total annual revenue. While it is very difficult to predict (and single out) what unique 5G revenues there may be, the numbers appear staggering, as the sum of the incremental revenue opportunities nearly equals the U.S. wireless market today. The ability to set up massive IoT networks poses one of the more compelling 5G enterprise use cases, in our view, as it offers big cost savings in a broad range of settings. 5G can support up to 300 times the number of devices per cell vs. 4G, paving the way for dense IoT device networks. Data research firm IDC expects 5G connected IoT devices to rise to $22.3 billion in 2025 from $8.6 billion in 2019. Longer term scope for Industrial IoT to drive incremental telco total addressable market (TAM) and infrastructure vendor revenues is impressive. The Industrial IoT use case envisages the use of 5G technology to connect machines and processes, benefiting not only from higher speeds but crucial for better latency (responsiveness), facilitating real time feedback loops, and high reliability/security. We see Industrial IoT offering scope to boost the incremental telco TAM, given the potential to open new customer opportunities and various potential use cases. Applications in Industrial IoT can be divided into two categories: mission critical and massive IoT. Ericsson stated that potentially 10 million industrial sites and 3 million warehouses globally can be connected by using 5G network.

The U.S. Utilities sector is underpinned by a higher than broad market dividend yield, or more than 100 basis points above the current U.S. 2-year Treasury yield. U.S. Utilities stock prices gained substantially during 2019 thus far, making it the best performing S&P 500 subsector, as defensive groups have been outperforming amid increasing trade tensions and sliding bond yields. However, with a price to earnings multiple (PE) of 23.5 and a forward PE of 19.2, the group can be considered expensive on this basis when compared to history and the overall S&P 500 Index, which is at 19.6 and 17.0, respectively. Despite historically high trading multiples, we view the Utilities sector backdrop as still positive given bond yields have dropped sharply and earnings growth has picked up for the sector with expectations for medium-term earnings per share (EPS) growth close to a decade high, and in-line with the market for the first time since the financial crisis of 2008. We are constructive about water utilities given their regulatory support, scarcity value, and favorable backdrop for capital spending and industry consolidation. During market volatility, we think the water related companies could be a preferred investment given the clarity on the regulatory environment, long-term capital investment visibility, and a more dedicated investor base over time. U.S. water utilities are broken down into municipal systems and investor-owned utilities. Municipal systems are owned and operated by local governments and account for the majority of community water systems, according to the EPA (Environmental Protection Agency). There are approximately nine publicly traded investor-owned water utilities (including American Water Works, owned by the Fund) which are concentrated in areas with favorable regulatory environments. Regulated water utilities drive earnings growth, in part, by making capital investments to improve their service territory. These investments are then incorporated into a company's rate base, which contributes to earnings growth during rate cases. The highly fragmented and capital-constrained water industry provides growth opportunities through accretive acquisitions. The water industry is highly fragmented with roughly forty-nine thousand community water systems (significantly higher than electric or gas utilities). Additionally, headline risk (Flint, Michigan or Newark, New Jersey for example) can foster consolidation from municipalities that do not want the risk associated with failing systems. Lastly, constructive regulatory environments allow utilities to recoup infrastructure investments more quickly and efficiently, and limit the difference between authorized and earned returns on equity. A growing number of states have recognized the importance of consistent investment in system infrastructure and therefore have implemented regulatory policies to incent investor-owned utilities to invest in their infrastructure. While we believe valuation is admittedly high for the group, we think a premium multiple is warranted due to strong fundamental growth drivers which are not tied to the global macro environment.

Oil and natural gas bankruptcies this year are coming at the fastest clip since 2016, reflecting mounting distress in the Permian basin. Also, the massive California wildfires have resulted in PG&E Corp. proposing a restructuring plan that calls for more than $14 billion in equity commitments, while giving no clear picture of what its liabilities may be. The total capital-spending budget of the aggregate S&P 500 Utilities sector will likely further expand through 2020, counter to the consensus view for a 3% drop, in our view. Most analysts will likely increase capital expenditure estimates after fourth quarter earnings calls, when companies update their spending plans. The Utility sector's 2020 EPS growth may accelerate as the one-time effect caused by the recent U.S. tax overhaul fades and the rate base expands at a faster pace. Consensus EPS for 2020 reflects an almost 6% gain vs. less than 2% for 2019. However, a lower corporate tax rate creates excess deferred-income tax liabilities that must be returned to customers, posing a drag on Utilities' cash flows. Many Utilities have issued additional equity in 2018-19 to mitigate these adverse effects and defend their credit ratings. Utilities Edison International and NextEra may post the highest growth rates, of about 13% and 9%, respectively, among the 25 or so regulated electric and gas Utilities this year. Lastly, weather indicating warm temperatures should set the stage for a strong finale to a remarkably supportive cooling season following the hottest summer on record over the last 50 years.

After a record-breaking rally in oil prices following the early September 2019 drone attacks on key oil infrastructure in Saudi Arabia, we see the recent retracement in prices as warranted. Despite the large initial disruption to oil production, the Kingdom’s latest guidance is that production should recover to nearly full capacity soon, and that inventory destocking will limit the impact on export volumes. But even if the outage proves more prolonged than projected, we think the global oil market has enough resources to balance lost Saudi barrels even without a release from the Strategic Petroleum Reserves (SPR) of OECD (Organization for Economic Co-operation and Development) countries. With this in mind, we think current Brent spot crude oil prices in the mid $60 per barrel (bbl.) range are close to fair value. In general, we maintain a more positive bias on midstream related companies relative to other parts of energy, but concerns remain, especially on those with exposure to Marcellus/Utica gas producers or natural gas focused (NGLs). With additional pipelines expected to come online, we see the Permian Basin as oversupplied. We expect the surplus to continue largely due to several projects taking service through 2020 and 2021. While the stock prices of refiners have performed well in the last three months, we see this as fundamentally justified by three recent market dynamics. First, we project higher diesel margins and improved heavy crude differentials from current tight levels. Second, we see large capitalization companies as well positioned to return capital to shareholders through dividend growth and share repurchases. Third, there has been increased investor focus on the value of the non-refining segments embedded within the refiners. The recent Dallas Federal Reserve Energy Survey struck a pessimistic tone ahead of capital budget season, which highlighted that most energy companies in the Eleventh Federal Reserve District expect the U.S. rig count to continue sliding lower, with only 2% of executives identifying a potential bottom as of mid-September. The bearish outlook is not surprising in the face of recent commodity price volatility and abysmal equity market performance. On that note, the survey indicated that limited access to capital and credit (20%) and increased investor pressure to generate free cash flow (13%) have clearly emerged as the second and third biggest constraints to growth, trailing the usual suspect of low or volatile commodity prices (42%). That said, dovish interest rate policies, self-funding business models and robust growth programs continue to provide us with a bullish view on the energy infrastructure space, particularly pipelines. In the Fund, we maintain our large cap preference due to diversified footprints, strong financial positions and ability to self-fund. While crude has remained above $50/bbl., natural gas and NGL prices are more challenged, creating another concern for midstream entities. We remain cautious on Northeast natural gas focused assets. Abundant natural gas and renewables expansion remain key themes in the Energy sector heading into 2020. Investors remain focused on gas growth in the Bakken/Permian Basin with positive implications on Permian pipeline project owners, particularly Fund owned Kinder Morgan.

We believe the Fund will perform relatively well with exposure to favorable areas of the world's equity markets. Also, undervalued international infrastructure-related stocks with strong balance sheets and free cash flows, solid dividend yields, and cyclically depressed profits are poised to outperform in our opinion. The Fund is positioned by targeting energy, telecom, industrials, and other undervalued areas of globally listed infrastructure industries and sub-sectors. The combination of low embedded growth and a robust stream of income payments effectively lowers the duration of the portfolio and, if interest rates rise, this will help protect against a broader based contraction in valuation multiples. Lastly, the Fund's unique exposure to next-generation global infrastructure adjacencies, including public cloud deployments, data center monitoring, cybersecurity, and IIoT (Industrial Internet of Things) is a key differentiator against legacy managed infrastructure portfolios, which overlook these powerful trends within the industry.

James A. Abate, MBA, CFA, CPA
Fund Manager – Centre Global Infrastructure Fund
Managing Director & Chief Investment Officer
Centre Asset Management, LLC

James A. Abate, MBA, CPA, CFA, is the Chief Investment Officer of Centre Asset Management, LLC, and the portfolio manager of the firm's Global Infrastructure Strategy. He also serves as the firm's Managing Director and as the President and Trustee of the Centre Funds. Prior to founding Centre Asset Management, LLC, Mr. Abate was U.S. Investment Director, North America, for GAM. Prior to GAM, Mr. Abate served as Managing Director & Fund Manager/Head of U.S. Active Equity at Credit Suisse Asset Management responsible for its U.S. Select Equity Strategy and stable of Global Sector Funds. While at GAM and Credit Suisse, Mr. Abate achieved Standard & Poor's Funds Research AAA rating, has received numerous "Category King" mentions in The Wall Street Journal, as well as multiyear Investment Week award nominations. Prior to transitioning to asset management, he was a Manager in Price Waterhouse's Valuation/Corporate Finance Group and served as a commissioned officer in the U.S. Army and Reserves, achieving the rank of Captain. Mr. Abate holds a BS in accounting from Fairleigh Dickinson University and an MBA in finance from St. John's University, and is a visiting Adjunct Professor in the graduate and honors academic programs at the Zicklin School of Business, Baruch College. Mr. Abate is a contributing author to several John Wiley published books: Applied Equity Valuation, Focus on Value, Short Selling, and The Theory and Practice of Investment Management; his article writings have appeared in The Journal of Portfolio Management, Investment Week, FT Investment Adviser, The Wall Street Journal, Mergers & Acquisitions and other various publications; and other writings — with Professor J. Grant, Ph.D. — on EVA, or economic value added approach to security analysis have been adopted by the CFA Institute candidate study programs. Mr. Abate is a former member of the editorial advisory board of The Journal of Portfolio Management.

About The Fund

The Centre Global Infrastructure Fund is for investors seeking to potentially benefit from a renewed focus on infrastructure spending but wish to have liquidity in publicly traded investments in developed global markets rather than illiquid private investments. The Fund pursues a bottom-up, active management approach and invests in what we deem the most attractive infrastructure-related companies from the United States and developed international economies. Also, the Fund seeks to balance its exposures to where the weights of the Telecommunication, Utilities, Energy, Transportation, and Social Infrastructure industries are broadly represented.

The Fund offers several key differentiators from broad global equity indexes and other funds, including: 1) historically, the MSCI World Infrastructure Index has generated a dividend yield greater than the yield on conventional core equity indices like the MSCI World Index; 2) the Fund historically pays distributions of dividend and interest income monthly rather than annually; 3) hard assets like infrastructure tend to retain their "real" value through the long-term; 4) historically, infrastructure indices' volatility is lower than on conventional equity indices like the MSCI World Index; and 5) many infrastructure companies in which the Fund may invest have assets, concession agreements or other contracts that link their pricing or revenues to inflation.

In identifying companies with sustainable pricing power, the Fund seeks investments that exhibit high barriers to entry in their segments and that create positive externalities in their regions. The Fund also focuses on companies with lower volatility, such as toll roads, power stations, hospitals and schools. Also, by targeting high EVA growth companies, the Fund narrows its focus to high quality infrastructure-related companies that make, in the view of the Fund's investment adviser ("Centre", "we", or the "Adviser"), wise capital allocation decisions. Through the Adviser's "bottoms-up" analysis, we seek to avoid investing Fund assets in companies that we believe destroy shareholder wealth by either "empire building" or under-investment. Additionally, our stock-selection approach includes standardizing accounting across countries, which facilitates cross-border comparisons among potential investments, including U.S. and non-U.S. companies. From a portfolio management perspective, the Fund while bottom-up in research its focus is able make active strategic and tactical investments across sectors and regions based on opportunities the Adviser sees in the market.

Definitions and References

1. The price to earnings ratio (P/E multiple) is the ratio for valuing a company that measures its current share price relative to its per-share earnings. The price to earnings ratio is also sometimes known as the price multiple or the earnings multiple.
2. The Internet of Things refers to a network comprised of physical objects capable of gathering and sharing electronic information. The Internet of Things includes a wide variety of "smart" devices, from industrial machines that transmit data about the production process to sensors that track information about the human body. The goal behind the Internet of Things is to have devices that self report in real time, improving efficiency and bringing important information to the surface more quickly than a system depending on human intervention.
3. Capital expenditure (capex) are funds used by a company to acquire, upgrade, and maintain physical assets such as property, industrial buildings, or equipment. Capex is often used to undertake new projects or investments by the firm. This type of financial outlay is also made by companies to maintain or increase the scope of their operations.
4. The S&P 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies by market value. The index is widely regarded as the best single gauge of large-cap U.S. equities.
5. A dividend yield is a financial ratio that indicates how much a company pays out in dividends each year relative to its share price. Dividend yield is represented as a percentage and can be calculated by dividing the dollar value of dividends paid in a given year per share of stock held by the dollar value of one share of stock.
6. Economic Value Added (EVA) is an estimate of a firm's economic profit - the value created in excess of the required return of the company's investors (shareholders and debt holders). Quite simply, EVA is the profit earned by the firm less the cost of financing the firm's capital. The idea is that value is created when the return on the firm's economic capital employed is greater than the cost of that capital. EVA® is a registered service mark of EVA Dimensions LLC.

Disclosures

Investors should consider the investment objectives, risks, charges and expenses of the Funds carefully before investing.

To obtain a prospectus containing this and other information, please call 1-855-298 4236 or download the file from www.centrefunds.com. Read the prospectus carefully before you invest.

There is no assurance that this investment philosophy will consistently lead to successful investing. An Investment in the Funds involves risk, including loss of principal. The Fund is subject to risks including undervalued securities risk, portfolio turnover risk (which may result in tax consequences), and political/economic risk. Funds focusing on a single sector may experience greater price volatility.

Credit Risk – Risk that the issuer of a debt security will fail to repay principal and interest on the security when due, and that there could be a decline or perception of a decline the credit quality of a security.

Foreign and Emerging Market Securities Risk – The Fund's investments in foreign and emerging markets could expose the Fund to foreign exchange rate risk, lax insider trading restrictions, lack of liquidity, difficulty raising capital, poor corporate governance, increased chance of bankruptcy, political risk, and limited historical information to draw proper correlations between events and returns.

Infrastructure-Related Company Investment Risk – The Fund's investments in infrastructure-related companies will expose the Fund, and make it more susceptible, to adverse economic or regulatory occurrences affecting those companies. Infrastructure-related companies may be subject to a variety of factors that, individually or collectively, may adversely affect their business or operations.
Diversification does not eliminate the risk of experiencing investment losses.

The statements and opinions expressed are those of James A. Abate as of the date of this report. All information is historical and not indicative of future results and subject to change. Reader should not assume that an investment in the securities mentioned was or would be profitable in the future. This information is not a recommendation to buy or sell. Past performance does not guarantee future results.

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The content of this document is part of the Centre Funds annual report covering the twelve-month period ending September 30, 2019.

Top 10 Holdings – As of 9/30/2019 (subject to change)

AT&T, Inc. 8.3%
Verizon Communications, Inc. 7.5%
Enbridge, Inc. 5.6%
TC Energy Corp. 3.8%
Kinder Morgan, Inc. 3.3%
NextEra Energy, Inc. 2.7%
HCA Healthcare, Inc. 2.6%
ONEOK, Inc. 2.4%
The Williams Cos., Inc. 2.3%
Enel Americas SA 2.1%

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