DPG: Good Fund, Reasonable But Premium Valuation

Power Hedge

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One of the most popular investments for retirees and others has long been utilities and to a lesser extent infrastructure firms. This is because these entities tend to be remarkably stable due to the fact that they provide products that are generally considered to be necessities so their customers will generally prioritize paying their utility bills over other more discretionary expenses. In addition, these entities tend to be very low growth entities, so they tend to deliver a high proportion of their returns to investors in the form of dividends. Admittedly though, it can be somewhat difficult to put together a solid and diversified portfolio of these companies. One good option then is to invest in a closed-end funds that focuses on these companies since these funds provide easy access to a diversified portfolio and in many cases can deliver a higher yield than any individual stock in the portfolio.

In this article, we will discuss the Duff & Phelps Utility and Infrastructure Fund (DPG), which is one of the more popular funds in this sector. This may be due to its impressive 9.80% yield. I have discussed this fund before but many months have passed so obviously a great many things have changed. This article will therefore focus specifically on these changes and provide an updated analysis of the fund's finances.

About The Fund

According to the fund's web page, the Duff & Phelps Utility and Infrastructure Fund has the stated objective of producing a high level of total return, which is expected to consist primarily of current income. This is not at all unusual for an equity fund as many of them specifically target total return with an emphasis on current income. It also makes a great deal of sense for a fund investing in utilities and similar assets to place a great deal of emphasis on current income because of the large dividends that companies in these sectors pay out. The fund naturally seeks to achieve its objective by investing in the stocks of utilities and infrastructure firms. It does specifically note that it only invests in dividend-paying companies but most of the companies in these sectors pay dividends so the fund's rule does not exclude very many companies.

The fund does have a broad definition of utility as it includes those companies that most people would define as utilities along with things like telecommunications firms and midstream companies. These account for most of what we see in the fund's portfolio. Here are the largest positions:

Top 10 Holdings[2]

As of 07/31/21 (Unaudited)

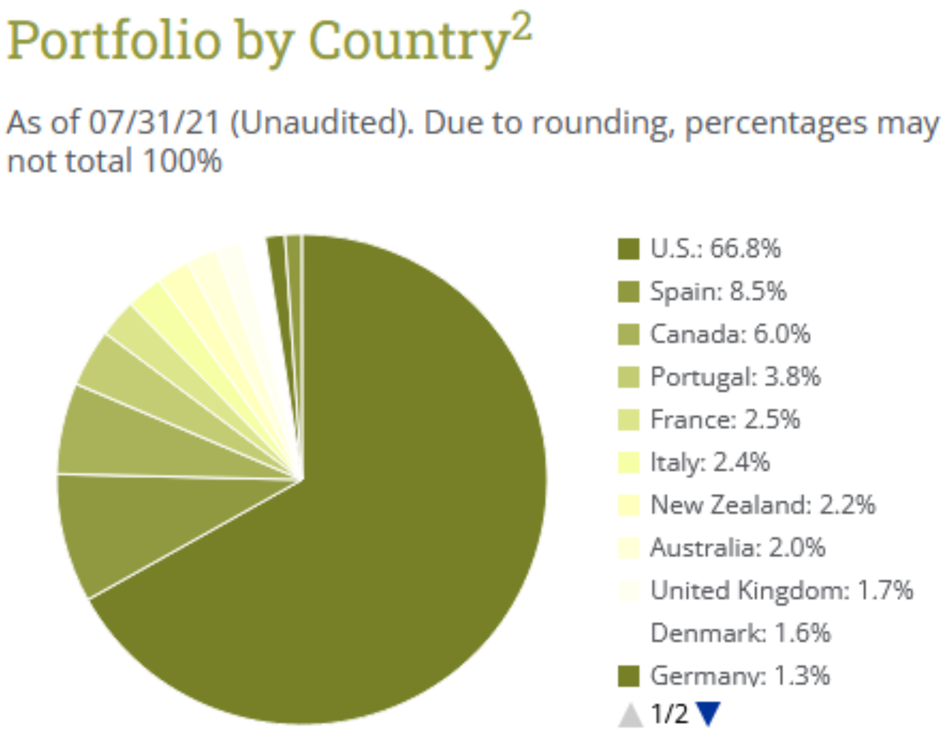
Security Name	Percent
NextEra Energy Inc.	6.1%
Iberdrola SA	4.5%
Enel SPA	3.8%
Enterprise Products Partners LP	3.6%
Norfolk Southern Corp	3.3%
Public Service Entrp Grp Inc.	3.1%
Orsted AS	3.0%
Ameren Corp	3.0%
The Williams Cos Inc.	2.8%
EDP-Energias de Portugal SA	2.8%

Source: Duff & Phelps Investment Management Co.

One of the characteristics of most of these companies is that they enjoy very stable cash flows. This is due to their basic natures. In the case of utilities, people typically prioritize paying their utility bills above anything else apart from food. In the case of midstream firms, they conduct business under long-term contracts that last long enough to allow these companies to weather through any short-term economic disruptions like what we saw last year. Although they did see their market prices decline, several of them were able to maintain their cash flows and distributions. The Williams Companies (WMB) and Enterprise Products Partners (EPD) are in this category.

There are quite a few changes in these positions since the last time that we looked at the fund. For example, The Williams Companies is new to the fund. We also see Norfolk Southern (NSC), Public Service Enterprise Group (PEG) and Ameren Corporation (AEE) added to the portfolio. These replaced companies like Crown Castle International (CCI), Eversource Energy (ES), Dominion Energy (D), and National Grid (NGG). This may all suggest that the fund has a fairly high turnover due to the fairly large number of changes that we see in the portfolio. In fact though, the fund's turnover is only 50.00%, which is incredibly reasonable for an equity fund. We generally like to see a low turnover due to the fact that this helps to keep its expenses down. Generally speaking, the lower the expenses, the more money that is available to make its way through to the shareholders. This is one of the reasons why index funds are so popular. The fund does overall appear to be doing a reasonable job here.

One of the things that we can see is that the fund is a global fund as there are companies all over the world included on this. This is indeed the case but it is still somewhat heavily exposed to the United States:



Source: Duff & Phelps Investment Management Company

The United States accounts for just under a quarter of global gross domestic product and about 40% of global market capitalization. Thus, the fund is overly exposed to the nation based on its actual representation in the global economy. This is certainly not uncommon for a global fund as most of them are overly exposed to the United States. Fortunately though, the fund's exposure to foreign markets does provide the fund's investors with a certain degree of protection against regime risk. *Regime risk* is the risk that a government or some other regional authority will take some action that has an adverse impact on the companies within their borders that we are invested in. We saw a great example of this last year when the incoming Biden Administration unilaterally canceled the permits for the construction of the KeystoneXL pipeline and caused all of the money that was invested by TC Energy (TRP) to be completely wasted. The only way to protect ourselves against this risk is to ensure that only a relatively small proportion of our assets is exposed to any given nation. This fund is certainly doing a reasonably good job of this.

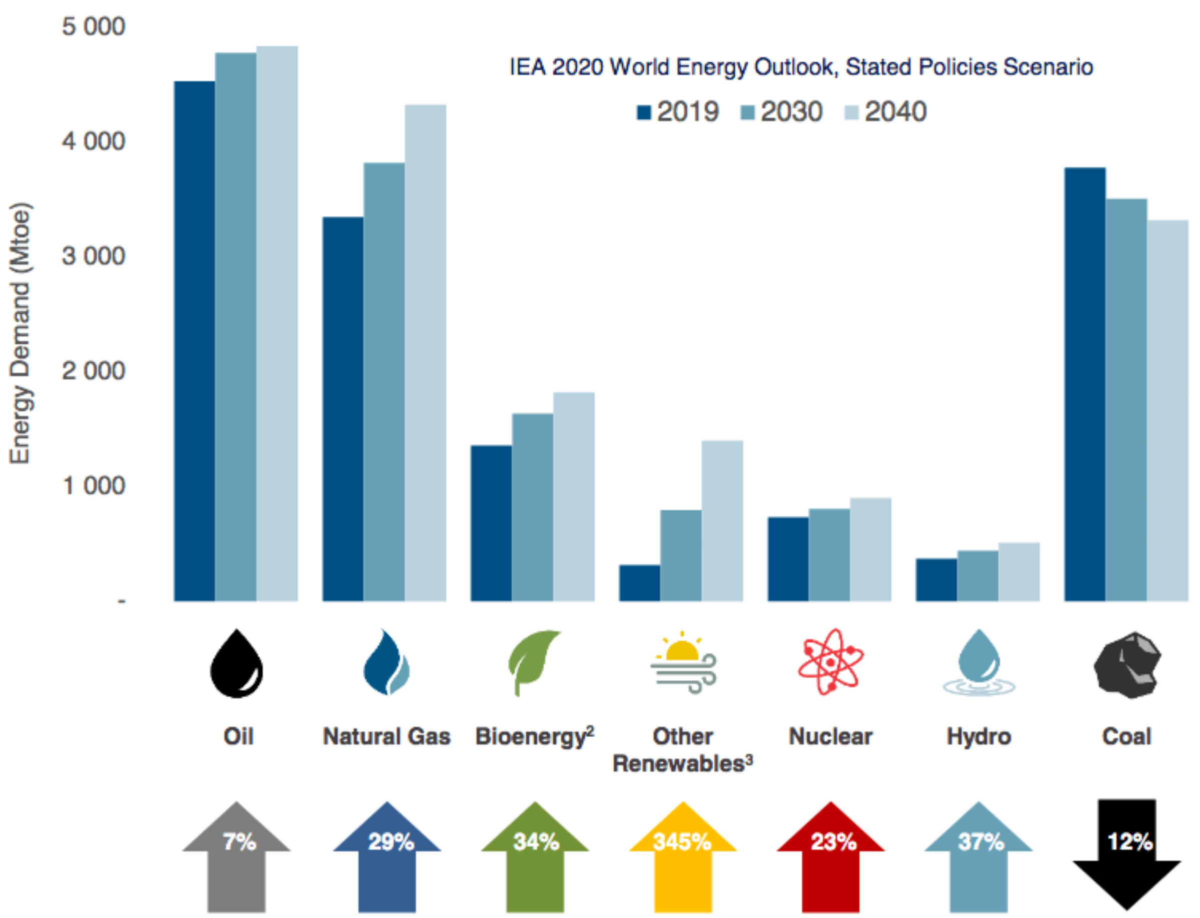
As my regular readers on the topic of closed-end funds are no doubt well aware, I do not generally like to see any position in a fund account for more than 5% of its total assets. This is because this is approximately the point at which an asset begins to expose the fund to idiosyncratic risk. Idiosyncratic, or company-specific, risk is that risk which any asset possesses that is independent of the market as a whole. This is the risk that we aim to eliminate through diversification but if the assets accounts for too much of the portfolio then it will not be completely diversified away. Thus, the concern is that some event may occur that causes the price of a given asset to decline when the market itself does not and if the asset accounts for too much of the fund then it will end up dragging the fund down with it.

As we can see above, there is only one asset that occupies such a high weighting in the portfolio. That company is NextEra Energy, which may be concerning. Although this company has been something of a market darling, it may be somewhat overvalued as I discussed in a previous article. Admittedly, most utility funds have a heavy weighting to this company but investors should still be willing to exposed to the risks of this firm individually before taking a position in the fund.

Fundamentals Of Midstream And Electricity

Infrastructure has been in the news a great deal lately, largely due to the infrastructure package that has been way through the United States Congress. As the name of the fund implies, this one does invest in the companies that provide both American and foreign infrastructure. However, fully 77.7% of the fund's assets are invested in electric utilities and midstream companies so it is most important that we focus on their fundamentals. Fortunately, these fundamentals are quite positive.

The case for midstream companies can be made in the fact that the demand for fossil fuels is rising around the world. This is particularly true for natural gas, which is benefiting from the rising global fears with regard to climate change. As you are no doubt aware, these fears have been leading governments all over the world to impose a variety of incentives and mandates that are meant to reduce the carbon emissions of their respective nations. One of the methods that has been proving popular is to replace old coal-fired power plants with natural gas ones. This is because natural gas burns much cleaner than coal and is more reliable than renewables using today's technologies. The International Energy Agency expects that this will cause the global demand for natural gas to increase by 29% as this trend continues:

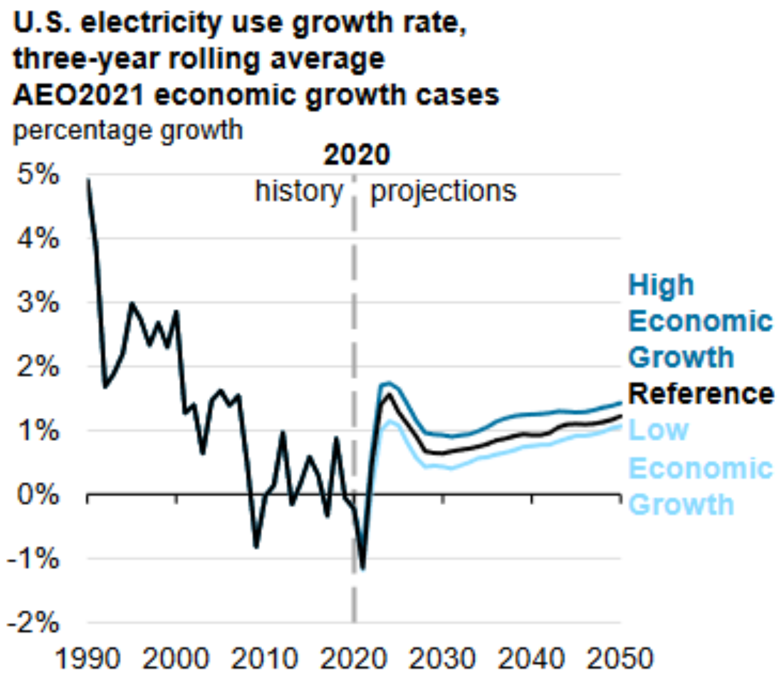


Source: International Energy Agency, Pembina Pipeline

We can also see that the global demand for crude oil is expected to increase over the period. This may be surprising the efforts of the developed nations to move away from the use of crude oil. This demand growth will come from the various developing nations around the world, which are expected to see significant economic growth over the period. As the citizens of these nations begin to enter the middle-class, they will want to enjoy a lifestyle that is closer to what their developed nation peers enjoy. This will require increasing amounts of energy, including that of crude oil. As the populations of these nations exceed those of the developed nations, the growing demand for oil there will more than offset the static to declining demand in the developed nations.

These trends will benefit the nation's midstream companies. This is because the United States is one of the only regions in the world that has the ability to significantly increase its production of fossil fuels due to the wealth of the various resource basins around the nation. It makes sense that the various upstream producers will increase their production in order to profit off of this growing demand. However, someone will need to move the resources away from the basins where they are produced to the markets where they can be sold. This is the business that midstream companies are in so they should see increasing volumes of resources that need to be moved. As these companies make their money based on volumes, this should cause these companies to see growing cash flows.

One of the more popular themes in the media surrounding utilities lately is electrification. This refers to the conversion of things that are traditionally driven by fossil fuels to electricity instead. The most typical things mentioned are transportation (electric cars) and space heating but there are conceivably other things that could be converted as well. This can be expected to significantly increase the demand for electricity and thus the revenues and cash flows of utilities. Unfortunately, the U.S. Energy Information Administration does not expect this trend to play out nearly to the same degree that its proponents do. According to the administration, the American demand for electricity will only grow at a 1-2% rate over the next thirty years:



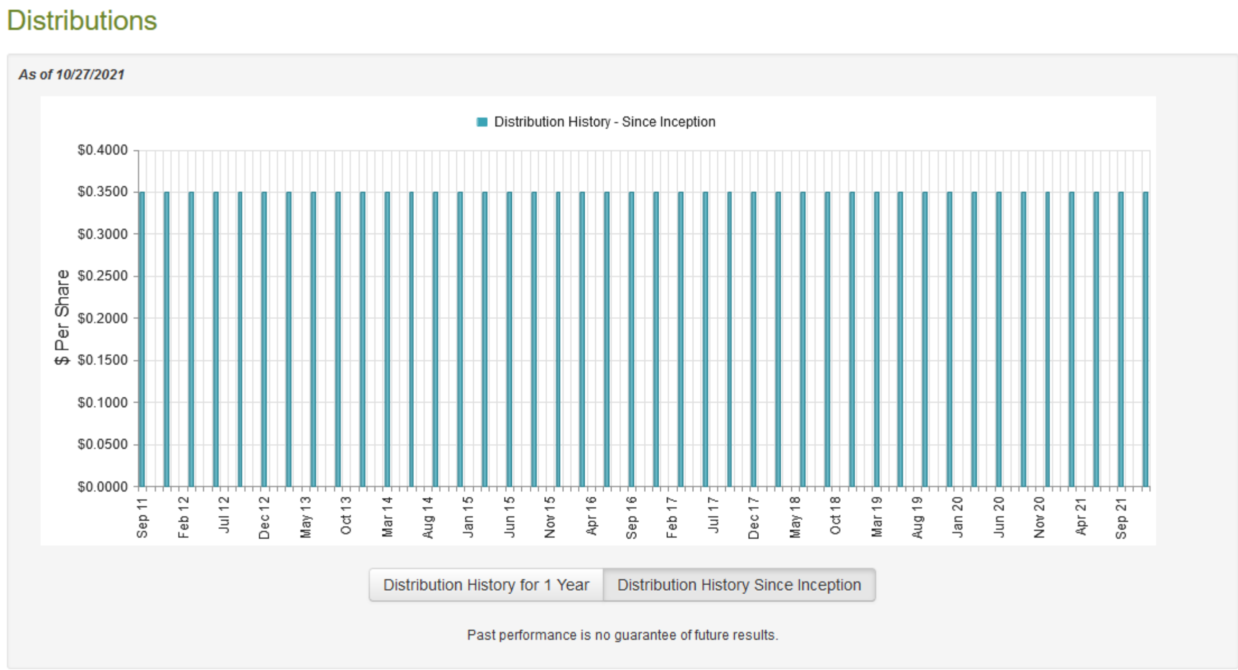
Source: U.S. Energy Information Administration

This is nowhere close to the demand growth that we would see if anything like wide swathes of the economy were to convert from fossil fuels to electricity. With that said though, we should continue to see the electric sector deliver slow and steady growth coupled with reliable dividends, just as it always has.

Distribution Analysis

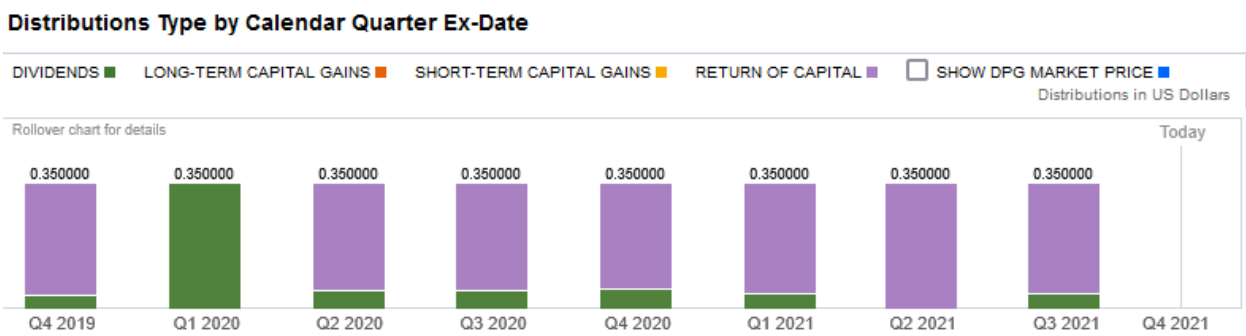
As mentioned in the introduction, the primary objective of the Duff & Phelps Utility and Infrastructure Fund is to provide its investors with a high level of total return, with a specific focus on current income.

As such, we might expect it to pay out a regular distribution to its shareholders. This is indeed the case as the fund currently pays out a distribution of $0.35 per share quarterly ($1.40 per share annually), which gives it a 9.80% yield at the current price. The fund has been remarkably consistent with this distribution over its existence:



Source: CEF Connect

This general consistency will likely endear this fund to investors that are looking for a steady and secure source of income. One thing that may concern some investors though is that a high proportion of these distributions are considered to be return of capital:



Source: Fidelity Investments

The reason why this may be concerning is that a return of capital distribution can be a sign that the fund is returning the investors' own money back to them. This is obviously not sustainable over any sort of extended period. There are however other things that can cause a distribution to be considered return of capital. The most common of these is the distribution of unrealized capital gains. As such, we want to investigate and see how exactly the fund is financing these distributions in order to determine how sustainable they are likely to be.

Unfortunately, we do not have a particularly recent report to consult for this purpose. The fund's most recent financial report corresponds to the six-month period ended April 30, 2021. As such, it will not include any information about the fund's performance over the past several months. With that said though, it will still give us information about how it performed during the midstream recovery and overall strong market in the months following the election.

During this six-month period, the fund received a total of $14,097,849 in dividends from the investments in its portfolio, although $6,263,211 of this was considered return of capital distributions that came from midstream partnerships. As such, the fund's reportable total income was $7,834,638. It paid its expenses out of this amount, leaving it with $1,996,694 available for the shareholders. Once we add back in the income that it got from the partnerships though, it actually had $8,259,905 available for distribution to the shareholders. This number was nowhere close to enough to cover the $26,550,864 that it actually paid out, however.

Fortunately, the fund does have other ways to generate income such as capital gains. It was much more successful at this as it had $13,158,653 in net realized and another $92,192,136 in net unrealized capital gains. Overall then, the fund easily covered its distributions as it saw its net assets increase significantly even after accounting for all of the distributions. It appears that this distribution is likely to be sustainable.

Valuation

As is always the case, it is critical that we do not overpay for any asset in our portfolios. This is because overpaying for any asset is a surefire way to generate a suboptimal return off of that asset. In the case of a closed-end fund like the Duff & Phelps Utility and Infrastructure Fund, the usual way to value it is by looking at the fund's net asset value. The net asset value of a fund is the total current market value of all of the fund's assets minus any outstanding debt. It is therefore the amount that the shareholders would receive if the fund were completely shut down and liquidated.

Ideally, we want to purchase shares of a fund when we can acquire them at a price that is less than the fund's net asset value. That is because such a situation implies that we are acquiring the fund's assets for less than they are actually worth. This is unfortunately not the case here. As of October 27, 2021, the fund had a net asset value of $13.99 per share but actually trades for $14.39 per share. This gives it a premium of 2.86% at the current price. This is quite a bit below the 5.34% premium that the fund has averaged over the past month. Thus, the price does appear to be reasonable even if we are buying it at a price above net asset value.