

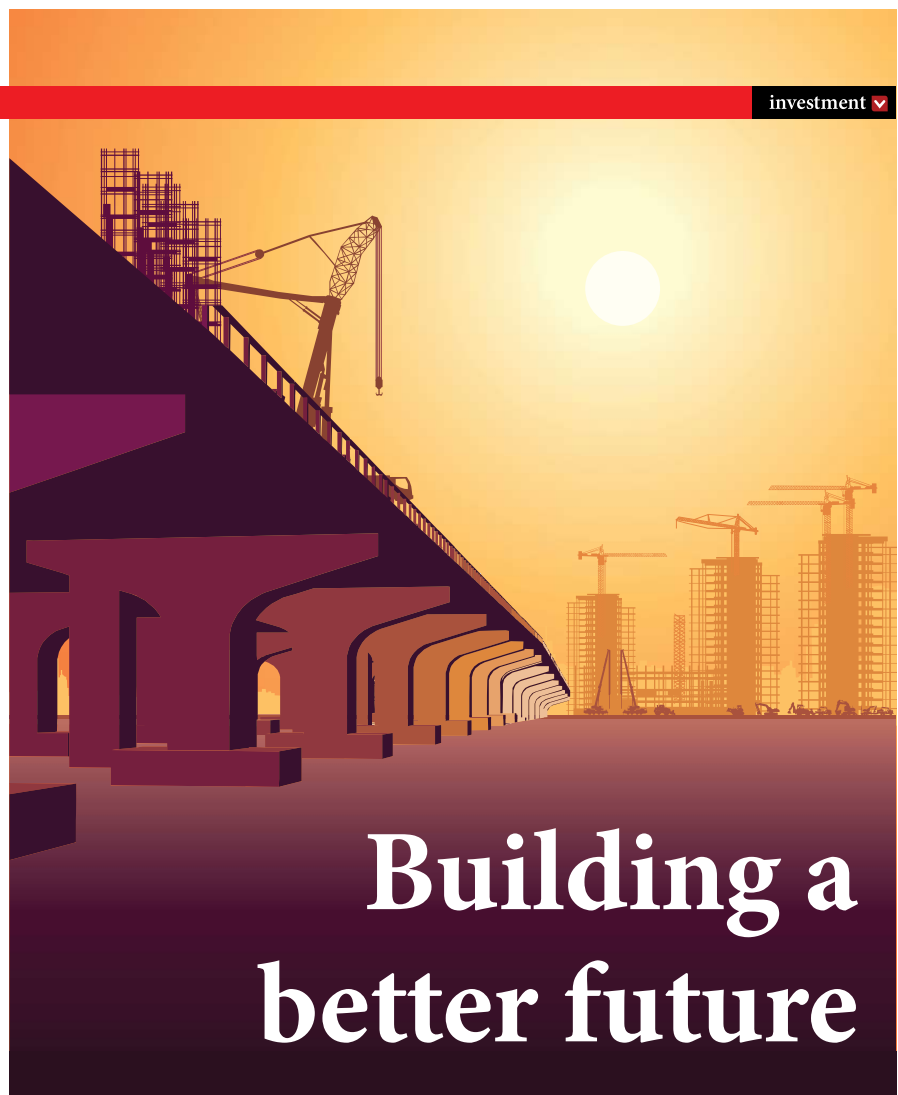
Build, build, build. This was the Prime Minister's recent message to the country, as he announced a 'new deal' designed to put infrastructure and jobs at the heart of the UK economy. The deal includes an additional £5 billion of capital investment projects and social infrastructure, with £1.5 billion directed towards hospital maintenance and a further £1 billion towards school rebuilding. However, for many institutional investors, such as pension schemes, infrastructure is not a new opportunity but a long-standing feature of their portfolios, and their commitment to this asset has not waned, even throughout the crisis.

Macquarie Infrastructure Debt Investment Solutions (MIDIS), for instance, recently raised £2.7 billion, predominantly from UK corporate pension schemes, local authority pension schemes and insurance companies, to support its UK infrastructure debt strategy. MIDIS associate director, James Lumb, states that many of the "more sophisticated pension schemes" in the UK have been allocating to infrastructure for a number of years, due to "high-quality, stable cashflows".

A recent report from the Social Market Foundation highlighted pension superfunds as "the key" to solving the UK's infrastructure funding "mega-gap", estimated to be as much as £1 trillion. Whilst a second report by Legal & General (L&G) argued that there could be as much as £190 million in pension money ready to be directed towards UK infrastructure over the next decade.

It seems there is still much more the pensions industry can do to support British infrastructure, especially amid the ongoing pandemic. Of course, no matter how socially worthwhile an investment may be, pension scheme trustees must remember to consider the economic arguments.

Making a difference or making returns?
Nest investment analyst, Jess Menelon,



Building a better future

Summary

- Infrastructure investments have long been an aspect of pension fund investing, but access issues persist around social infrastructure.
- They can hold environmental and social value, but are also well matched for pension scheme liabilities and have fared well throughout the pandemic.
- The government must engage with the industry to ensure pension schemes can access infrastructure investments effectively and direct capital where needed.

✓ As the government highlights infrastructure as key to the UK's post-Covid recovery, Sophie Smith explores what this could mean for pension schemes and what role they can play in 'building back better'

however, says that it is "clear" that when chosen and managed carefully, infrastructure investments can offer "stable, long-term inflation-correlated returns, even in difficult market conditions". She explains that the pension scheme, of which the youngest member is just 16 years old, is a long-term investor, and can be patient with members' savings, allowing them to

benefit from illiquidity premiums often associated with these types of equity investments.

The financial benefit of infrastructure investing can also be seen in the defined benefit (DB) space, with a spokesperson for the Pensions Insurance Corporation (PIC) describing infrastructure investments as "socially-useful capitalism at its best", emphasising that these types

of investments “naturally align” with the aim of paying pensions.

L&G head of investment solutions, Sumit Mehta, says the reason for this, is that they provide long-dated, fixed-income style returns with attractive risk-adjusted yields.

“It needn’t involve a trade off between protecting pensioners or benefitting society,” he insists. “Instead there is a virtuous circle, where older savers are funding the infrastructure that supports communities, jobs and growth for the next generation, to provide the economic returns to support pension payments.”

Lumb adds that social infrastructure investments and financial returns actually go “hand in hand”, stating that if an investment is not socially useful, it is likely that there will be concerns about being able to finance it in the long term.

Access denied

Aviva Investors managing director, infrastructure, Darryl Murphy, agrees that infrastructure can work from an asset/liability-matching perspective, emphasising, however, that pension schemes, which tend to be more yield focused, may approach infrastructure investment differently than some insurers, typically focusing more on equity, rather than debt space. The reason for that, he explains, is that they like the strong asset liability matching characteristics of infrastructure, but that there are key differences in terms of the rates of return available in the equity space compared to debt. Insurers also benefit from capital treatment under Solvency II, unlike pension schemes.

Murphy stresses, however, that pension funds historically have had “reasonably limited” access to social infrastructure, as this tends to be publicly funded. He notes that investing in debt in housing associations (HAs) could be one route of access, which also holds strong social importance. Although, more broadly, he says smaller schemes that want to invest, but have no capability,

tend to invest through a pooled fund as a route to the asset.

The Lothian Pension Fund (LPF) also highlights the costs of legal execution and due diligence as prohibitive for small-pot investors. Lumb, however, argues that “familiarity with institutional capital as a funding source” is growing and creating new opportunities for institutional investors.

Even where access is improved, Murphy warns that “if you’re going to invest directly, you need a fairly material level of capital”. However, Mehta highlights the potential scale accessible through the pension risk transfer (PRT) market and the aggregation of pension scheme assets. This has allowed insurers, such as PIC, to step up to the plate in the DB space. But with no equivalent in DC, many schemes have suffered limited access to the asset due to size restraints.

Clara Pensions director of policy and communications, Richard Williams, highlights the emergence of pension superfunds as a potential answer to this, stressing that consolidation can make pensions safer, and that benefits of scale can also benefit the broader economy.

“Consolidation gives schemes the capacity and capabilities to invest in assets such as infrastructure. However, the right role for infrastructure assets will depend on sufficient assets of the right quality and right risk profile being available,” he adds.

This increasing trend towards de-risking, across both DB and DC, has seen rapid growth across the PRT market. This can lead to issues around availability of opportunities, although equally, according to PIC, it can lead to an increased need to source debt investments in secure, long-term investments like infrastructure.

PIC highlights debt financing for social HAs as an example of this, explaining that HA clients are seeking to build long-term relationships with lenders. Without these relationships, the firm warns that many development plans

would need to be cancelled or scaled back, as “government funding alone is not nearly enough”.

HAs are not the only sector that could benefit from additional funding, as Lumb highlights that both public-sector balance sheets and banks will be facing pressure from a funding and capital perspective. He emphasises, however, that the UK still has the potential to “unlock deep domestic pools of pension capital” to finance long-term infrastructure needs.

Lumb adds that in this “lower for longer rate environment”, many investors will be very focused on returns, noting that the potential for superior risk-adjusted returns through infrastructure debt could encourage more investors into the asset class as an alternative to government and corporate bonds traditionally invested in.

Built to last?

A new study by the Foresight Group has revealed that over half (54 per cent) of financial intermediaries believe that infrastructure is seeing the biggest surge in investor demand across all asset classes in response to Covid-19, more than twice the number choosing equities (20 per cent) or fixed income (19 per cent).

However, Mehta highlights that the pandemic has presented some “short-term headwinds”, with the transportation sector particularly hard hit by the pandemic, stressing that the disruption of global supply chains will also affect construction timelines for infrastructure “across the board”.

On the other hand, RPMI Railpen and Wrenbridge recently announced that they had secured planning consent for a warehouse development in Waltham Cross, London. This will not only deliver jobs for the borough of Broxbourne, but was also one of the first virtual planning committees held since lockdown.

Murphy adds that the majority of infrastructure has “fared well during Covid”, noting that whilst the volatility throughout the crisis had been a “test

on the sector”, the asset has proven its “resilience and demonstrated itself to be a long-term defensive investment”.

The benefits of infrastructure within a portfolio can also be seen in the LPF, which noted in its recent financial report for 2019/20 that its infrastructure portfolio includes “essential critical assets” that benefit from contracted or regulated income streams, expected to largely insulate the portfolio from “material adverse financial impacts derived from Covid-19”.

Mehta notes that more broadly, the crisis has demonstrated the importance of infrastructure to the UK economy, predicting that it will “remain a critical component of strategy and an ideal class for backing liabilities” for pension funds. The LPF, meanwhile, argues that this could also see a re-rating of low volatile essential infrastructure assets.

Building back better

Murphy adds that whilst it is encouraging to see infrastructure as a “key pillar” in plans to rebuild the UK economy, the government announcement, which will see billions of pounds directed towards

social infrastructure investments, has suggested a preference for private capital to be focused on consumer-funded assets, rather than support improvements to social infrastructure and transport; further restricting pension scheme access to the social infrastructure space.

Achieving a net-zero future, however, is a “significant challenge” that will likely offer an opportunity for private investment to demonstrate its long-term value, Murphy stresses. Indeed, in the government’s summer economic update, Chancellor Rishi Sunak emphasised that this would be a “green recovery”, with concern for the environment at its heart.

“This means that the infrastructure opportunity in the UK is heavily focused on the energy transition,” Murphy explains, adding that whilst infrastructure is not akin to impact investing, it should still be viewed as a similar win/win.

“Infrastructure investments work from a financial point of view, from a risk and return point of view, and they’re also very ESG positive; that’s why they are attractive to pension schemes,” he says.

Equally, Lumb notes that a step up

in focus on ESG by pension schemes has also led to a “strong and growing interest in sustainable infrastructure”.

“The renewable energy sector was the initial beneficiary of this trend,” he explains, clarifying that appetite for social infrastructure has increased as investors have become more familiar with the sector and the “essential role” it plays.

The LPF also highlights pension schemes as key in providing “green and sustainable infrastructure for all”, with around 17 per cent of its own infrastructure portfolio already invested in renewable energy. At the PLSA Investment Conference earlier this year, Pensions Minister Guy Opperman also highlighted low-carbon infrastructure projects as a climate-related opportunity.

However, Mehta states: “To effectively harness the potential of infrastructure investments, pension schemes will need to carefully assess sector selection, thoroughly test the quality of underlying cashflows and devise the most optimal framework for collaboration with government, in light of the expected increase in fiscal deficits.”

Speaking at an industry webinar in June, the Department for Work and Pensions (DWP) director of private pensions and arm’s length bodies, Pete Searle, emphasised that the department was looking to talk with “people in the system” to find out what the blockages were, and what the government needs to do to remove them. Infrastructure investments then seem like a potential win/win/win for the pensions industry, the broader economy, and environmental objectives. Considering the growing scale in the pensions industry, and campaigns such as the newly-launched Make My Money Matter [*see p45*], bringing renewed member attention to where investments sit, it seems likely this trend will continue to grow. But only if the government and industry are ready to work together.

✎ Written by Sophie Smith

