Building momentum

After years of publicity, DB schemes are increasing their allocations to infrastructure. Alastair O'Dell reports

Infrastructure investment has evolved substantially during its decade-long path to becoming an established option for defined benefit (DB) pensions schemes.

The Investment Association's (IA) 2018 survey stated DB investment is becoming "more prominent" and expected it to be a "key growth area in the coming year". IA asset manager members increased their holdings from £29 billion to £40 billion during 2017.

Infrastructure provides an illiquidity premium, extra returns for long-term commitment. Assets typically provide contract-based fixed or inflation-linked cashflows, used to match liabilities.

Pensions Infrastructure Platform (PiP) chief executive, Paula Burgess, says: "Investment-grade debt, as well as core and core-plus equity assets, have a low sensitivity to GDP and little or no market risk."

Public infrastructure

LGPS infrastructure investment has been gaining momentum since 2011, when the Treasury set a £20 billion target for public projects that would raise allocations from 1-10 per cent. The creation of eight pools complicated matters and GLIL Infrastructure only recently emerged as the leading platform *[see boxout].*

Government initiatives tend be greenfield projects that include construction risk, while many investors seek stable and predictable cashflows. USS head of real assets, Gavin Merchant, says: "This leads them to focus more on brownfield assets, which are already well developed and have a track record."

One notable exception is the Thames Tideway project. The government provided guarantees against low-likelihood but high-impact risks for the major construction project. "This was an excellent example of how public-private collaboration resulted in a good basis for both," adds Burgess.

Scheme maturity is increasingly a barrier for closed schemes. "The Osborne-inspired overexcitement was probably borne of the misconception that DB schemes have very long-term liabilities," says PTL managing director Richard Butcher. "While local authority schemes remain open, the vast majority of private ones are closed and their time horizon limited. They will not be building roads and holding them for 100 years."

Illiquidity premium

The success of infrastructure has brought pressure on returns. "Over recent years, as more investors identified the benefits, more capital has been invested," says Merchant. "This has created significant additional demand and contributed to increasing market values. We have seen returns compress across the entire capital structure."

Merchant adds that USS has still been able to originate and execute attractive investments by "focusing on where we have something unique to offer on a transaction".

Greater Manchester Pension Fund assistant director, Paddy Dowdall, notes that in just a few years the anticipated returns from airport equity has fallen from around 15-9 per cent. "The compression of returns, across all asset classes, means that the focus on fees becomes more important," he says.

It's wise to pause at times of high prices and tight rates of return, according to Burgess. "Opportunities can still be found, especially if there is willingness to invest time in building relationships and understanding particular sectors."

Risk versus return

Asset prices have been skewed by the specific demands of different types of investor. In particular, insurance companies have competed hard for investment-grade debt as it provides favourable Solvency II capital treatment.

Pension funds therefore have a relative advantage in junior debt, according to Schroders alternatives director, Claire Smith: "We see a good opportunity."

The spread over investment-grade tranches is around 3 per cent with expected losses increasing just 30bps, according to Smith citing Moody's 36-year dataset. "The increase in expected returns is 10 times the increase in expected losses. The junior market is less well known and there are fewer participants," she adds.

Junior debt, typically BB-rated, is issued by corporations large enough to tranche debt, including utilities and airports. It also often results from the consolidation of project finance.

Schroders' strategy is to lend to core, stable borrowers on a secured subordinated basis, one step up the risk spectrum, and on a senior secured basis to companies that do not quite provide stable cashflows – both for a maximum of 10 years. "As long as the risks are adequately explained to clients, there are opportunities in senior secured infra-like companies," adds Smith.

In Europe, banks aren't as active in the junior space. Smith says: "We originate the opportunities directly with the sponsors, which requires internal underwriting and structuring. The smaller pool of capital chasing these opportunities means the rewards are very good."

Butcher adds: "*[Lower-rated debt]* is fine as long as it matches your risk profile, if you are willing to accept additional risk for additional return. We are in a lower-for-longer environment, for all asset classes, so there is little room for manoeuvre."

Alignment

Private markets are less transparent than public ones so nothing should be taken on trust or, as Burgess puts, it "the basis of trust is the alignment of interest".

The £64 billion USS has the scale to support an internal team that is completely aligned with its 400,000 members. CEM Benchmarking found the team saved £61 million on its DB section's 2017 investments.

However, most UK pension schemes are not of sufficient size to directly invest hundreds of millions of pounds and contribute to governance, perhaps taking a board seat, and therefore need to invest in pooled funds.

Equity mandates typically include carried interest – but this can incentivise the manager to sell even if the scheme wants to remain invested. Burgess warns that incentives should not encourage the manager to deploy capital quickly, encourage risk taking or prematurely sell assets to crystallise payments.

Debt does not have the carried interest problem as contacts naturally end but Smith agrees that "alignment is definitely an important issue". Schroders overcame it by creating an AIFM-regulated joint venture for its infrastructure business – its teams take stakes that cannot be sold for 10 years. "The platform's growth depends on fund performance and reinvestment, which incentivises the team to grow the platform in a stable and low risk way."

ESG

Infrastructure is particularly suitable for environmental, social and governance (ESG) investment, given strategies' long-term commitment and high concentration.

USS has a five-person responsible investment team; ESG is fully integrated into its processes and it uses its board positions to ensure ESG is considered appropriately. "For example, resilience to physical climate change is thoroughly assessed, particularly with regard to infrastructure," says Merchant. "Several of the scheme's direct infrastructure holdings have produced detailed climate scenario models as part of their resilience planning."

All GLIL funds have very clear policies for their listed assets and it is in the process of making replicating that for private assets. Dowdall says: "In many cases we want to have more direct involvement in the ownership of the underlying assets. One of the advantages of a direct platform is that you can improve governance."

Schroders applies a scorecard approach with 13 of its 48 criteria dedicated to ESG. It conducts its own research into issues from carbon emissions to workplace accidents and the effect on local communities.

Case study: GLIL Infrastructure

The Greater Manchester Pension Fund and the LPFA set up GLIL Infrastructure in 2015 and other LGPS funds have since joined. "We had a desire to disintermediate managers and invest in UK infrastructure directly," says Dowdall.

The founding LGPS schemes had grown increasingly uncomfortable with "high fees and ownership cycles" linked to the interests of the manager. "The manager aims to make a profit between buying and selling, but this incurs transaction costs and pension funds would like to hold them in perpetuity.

"We wanted a vehicle that would reduce the fees and let us control our destiny – and influence the governance of infrastructure assets from an ESG perspective. Local authority pension funds have a wider interest in society."

GLIL has commitments totalling £1.8 billion with £1 billion already invested. In 2018 GLIL restructured to become a regulated alternative investment fund, so it can admit limited partners. Entrants to the open-ended fund take stakes in existing and future investments.

"We are trying to build a UK asset owner investment platform that compares with similar ones in Canada and Australia. There is potential for growth from the existing partners and there is very much a desire to work with other LGPS pools."

Written by Alastair O'Dell, a freelance journalist

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