Summary

- An increasing number of pension funds recognise the central importance of infrastructure investments in ESG strategies.
- A useful approach for funds is to develop understanding of critical ESG issues in infrastructure portfolios and establish long-term strategies to influence their investment and management strategies.
- Pension fund investors should clearly and regularly communicate their ESG priorities and data requirements to infrastructure funds and asset managers.
- ESG Management Systems like ISO 14001 can be useful tools.
- Observers expect to see more sustainable and ESG impact strategies across the board, and infrastructure is well-placed to deliver in this area.

Infrastructure: Incorporating ESG

Abigail Williams explores how pension funds are incorporating ESG into their infrastructure investment considerations

A growing number of pension fund investors now recognise the central importance of infrastructure investments in ESG strategies. So, how best can fund managers incorporate ESG considerations into their infrastructure investment decisions? And what trends and developments can we expect in this area in the coming years?

Long-term strategies

According to GRESB director of infrastructure, Joss Blamire, pension funds should initially understand what the critical ESG issues are for their infrastructure portfolios and set long-term strategies around what impacts they want to have in order to influence their investment and management strategies.

"Thankfully, infrastructure managers are increasingly realising that producing clear and detailed ESG disclosures and reports gives them a competitive advantage when seeking investment from ESG-conscious investors," he adds.

GLIL Investment Committee member, Patricia Rodrigues Jenner, observes that infrastructure is an asset class with "inherent ESG credentials" as it provides services for communities and creates value for society.

"Currently, many early-stage infrastructure assets with ESG potential have an unacceptably high-risk profile for pension fund investors as they do not yet offer stable returns for members. But with continued government prioritisation and early investment, hopefully in time the availability of ESG assets suitable for pension funds will increase," she adds.

Management system

If the objective is to have a strong, balanced ESG positioning, UBS Asset Management, Real Estate & Private Markets' head of infrastructure research and strategy, Declan O'Brien, says, then the principles of an ESG Management System like ISO 14001 are "useful, robust and systematic".

Here, the first place to start is undertaking an appropriate ESG materiality assessment, based on sector, as a way to prioritise the most significant potential ESG impacts and opportunities, for example, SASB or GRESB Infrastructure, says O'Brien.

"Ideally, stakeholder interests and priorities will also be considered in the materiality mapping stage. Based on this, appropriate policy approaches, KPIs and targets should be set. The next stage … is to ensure alignment with relevant ESG regulation, and have appropriate risk management controls and processes in place.

"Monitoring, measurement, and reporting results is also crucial and routine ESG audits are good practice. Active stakeholder engagement is required, as well as understanding and implementing ESG improvement programmes, with the aim of ongoing continual improvement," he adds.

Transition scenarios

For Redington head of stewardship and sustainable investment strategy, Paul Lee, climate change is the key ESG issue for infrastructure investment because, by its nature, all infrastructure is exposed to physical climate change risks.

"As long-term illiquid investments in physical objects that often cover significant tracts of land, infrastructure can face the full force of the additional extremes of nature caused by our overheating planet. Infrastructure investments that are not built to withstand these future extremes may not last the time period that is expected of

them," he says.

Lee also observes that some infrastructure assets, specifically roads and airports, face significant transition risks in various climate scenarios as travel may become less favoured.

"Considering these potential impacts when making long-term illiquid investments is vital. In contrast, other infrastructure assets will be heavily favoured in most transition scenarios. Clearly that's true of renewables, but rail is also likely to fall into these categories. While the pricing of some renewables assets is becoming unattractive, our current research in the space indicates that there are opportunities, including include smart grid technologies, power storage and hydrogen opportunities, which still have beneficial risk/return characteristics," he says.

"Most infrastructure is also challenged with regard to climate because cement and concrete is by its nature significantly carbon intensive. Given that much infrastructure investment currently relies on new builds and the heavy use of concrete, this is a major issue. Unless new technologies emerge, the very creation of many infrastructure investments will have a significant carbon footprint. This may make some less attractive to investors seeking to deliver a net-zero agenda," he adds.

Progressive policy

According to O'Brien, infrastructure can often be perceived as an esoteric asset class, where each asset contributes to ESG in a different way. For example, at a regional airport, recurring carbon emissions are clearly high, but the economic and social aspects could also be locally important – meaning there would be a vast impact on the livelihoods of rural economies, employment and innovation if the airport was starved of capital and closed.

"In such cases, a progressive ESG policy could improve the assets in the areas that you can control, as well as carefully managing relations with local communities who may be impacted by noise. One key component would be to compile a carbon footprint … so that you can understand what is driving emissions. However, this will only get you so far with 'E' focused investors, given that the nature of the asset will mean it is a high carbon emitter," he says.

Whether it be for an asset or a fund, O'Brien stresses that the key challenge is collecting and interpreting data. Within infrastructure, this is "least challenging when you are the majority owner of an asset and can collect the data at source" – but "the further you are away from the ownership of the asset, the more difficult it is to collect the data required to assess its ESG credentials, and in turn, drive change in its ESG performance".

Future trends

Bfinance senior director, infrastructure, Anish Butani, reports a growing trend amongst investors and managers around making a tangible impact when allocating to infrastructure.

From the investment side, O'Brien expects to see more sustainable and impact strategies across the board, and believes infrastructure is well-placed to deliver on these.

"We expect more specialised funds, for example, focusing on investing solely in 'sustainable' infrastructure assets like energy transition assets. We also expect to see more multi-asset sustainable strategies where a fund will invest in sustainable assets across private markets in order to create scale and diversification," he says.

"Another key trend is data, in terms of its availability, quality, and the dynamic analysis of it. With the huge focus on greenwashing and for regulation such as SFDR, data is front and centre for ESG investing and is only going to become more so. Investors that commit to understanding data now, and focus on asking for the right data, as well as managers who invest into sourcing and providing quality data, are going to be able to keep up with the shift," he adds.

O'Brien also points out that climate risk analysis and reporting is becoming increasingly important, and is arguably the largest evolving area for ESG strategies.

"Investors are still transitioning. Many are still comparing sustainable funds with traditional funds, so returns are still the predominant consideration. If it is green and generates a high alpha, then everyone is happy. We're starting to see this status quo shifting, where investors have an impact bucket, meaning that a fund will only be considered if it meets the impact criteria. The investor will then choose the best risk/reward fund within the universe of impact funds rather than within the wider investment universe. This fits well with the multi-asset sustainable thesis as impact begins to get its own allocation," he adds.

Blamire also points to an ever-increasing recognition of the value of making progress in key ESG aspects to make infrastructure more sustainable for the future, prompting an increase in demand for more reporting from investors, asset managers, governments and wider society in general.

"This is leading to increased pressure for reporting to be standardised and mandatory much in the same way as financial reporting has been over the last century. However, ESG reporting is still maturing so there is still work to ensure that any mandatory requirements also meet the diverse needs of investors and reflect real world ESG impacts of infrastructure investments," he adds.

Written by Abigail Williams, a freelance journalist

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