Building for the long term

Sandra Haurant explores the role infrastructure plays in pension scheme portfolios, amid the government's push for increased investment in UK plc

Summary

- Pensions and infrastructure tend to be a good fit; the former needs long-term, stable places to invest, the other needs long-term, stable investors.
- Governments (including the UK's) are actively encouraging pension funds to invest in infrastructure projects.
- Direct investment in infrastructure gives pensions a say in governance – a vital part of ESG strategies.
- Infrastructure also opens the door to investment in environmentally responsible projects (renewable energy, for example), which will help schemes (and governments) meet their sustainability goals.

Solid foundations

Investment in infrastructure has a reputation for providing reliable returns with relatively low levels of risk. Indeed, the assets associated with infrastructure investment have generally tended to be solid in a very literal sense. Railways, airports, toll roads and telecommunication networks, essentially the structures that enable people to go about their lives, are all elements that form the foundations of infrastructure investment. But investment in these assets isn't limited to the solid structures themselves; it can also include the companies that use and manage them.

Of course, infrastructure assets evolve in line with changing lifestyles and priorities. What counts as vital infrastructure changes over time. Today, electric vehicle charging, battery storage and many other 'new' essentials, with potentially very different characteristics to the old guard, form an integral part of infrastructure. So as the field broadens, what role does infrastructure play in pension fund investment?

Evolution in infrastructure

The change in underlying assets is only part of the evolution, says WTW head of global infrastructure research, So Yeun Lim: "Infrastructure as an asset class has evolved significantly since it has emerged as a separate asset class to private equity, although it is still a small percentage of a total pension portfolio compared to other listed asset classes or even some of its other illiquid counterparts like real estate."

However, while change is constant, there is a certain stability to be found here. "Whilst the types of assets included in infrastructure have changed, partly as a result of energy transition and digitalisation, its underlying characteristics have not changed," Lim says. "Infrastructure assets have strong inflation linkages in terms of income generation capabilities, and sticky revenue base as a result of its services being essential to the customers; two characteristics that are very important to pension funds."

Indeed, pension funds and infrastructure investment have long been a suitable fit in many ways, according to JTC Group senior director, fund and corporate services, Simon Gordon. "There are a lot of alignments between pension funds and infrastructure," says Gordon. "Particularly in low interest rate environments, where pension funds were looking for risk levels close to cash, infrastructure provided that along with reasonable returns. And with links to inflation, it's an area that offers a hedge over the long term."

A good match in theory, then; so it makes sense that, according to a study published by GLIL Infrastructure, 65 per cent of UK pension fund leaders are expecting to increase their investment in UK infrastructure during the next 12 months.

Investing in UK Plc

Investing in infrastructure allows pension schemes to invest in the very heart of a country and its day-to-day activities – and GLIL's survey, which polled a group of 300 local government pension leaders in the UK across both DB and DC, showed that there is an appetite for investment in the UK. Asked about the main drivers for the shift towards investing in UK infrastructure – beyond their fiduciary responsibility to members, of course – 39 per cent cited supporting the UK. The news will be cheering for Chancellor Jeremy Hunt, who launched the Mansion House Compact last year and has repeatedly pushed for increased UK investment from pensions.

Indeed, according to IFM Investors head of infrastructure – Europe, Deepa Bharadwaj, the Mansion House reforms are a potential win-win, and have "paved the way for a greater allocation to infrastructure, across multiple pensions systems in the UK."

For Bharadwaj, the reforms will help to "unlock access to direct infrastructure, which in turn will enable savers to achieve greater returns and retirement outcome, whilst also creating tangible community benefits." And, she says: "Direct infrastructure can also act as a form of productive finance in this way. We are already seeing increased engagement from pensions investors following the Mansion House reforms."

Ways into infrastructure

There is, it seems, a healthy appetite for these assets among pension schemes, then – but what is the best way to access infrastructure investment? Lim says: "The majority of infrastructure assets lie in the unlisted asset class, but some do use listed infrastructure as part of total portfolio construction."

Indeed, for Bharadwaj, recent history has demonstrated the potential limitation of investment through certain listed products which, when push came to shove, were unable to provide the liquidity that was required. "The 2022 gilts crisis exposed vulnerabilities in the closed-end fund model typically adopted by infrastructure investment providers," she says.

Of course, the contrasting needs of DC and DB schemes lead to differing approaches to infrastructure. With most DB schemes closed to new members and navigating their endgame, infrastructure investment decisions are necessarily made on a case-by-case basis. "As an inflation and interest rate-sensitive asset class, infrastructure can help sponsors offset their exposure to these risks, whilst generating cash inflows that can contribute to overall funding levels," Bharadwaj says.

For DC, the landscape looks different. "Direct infrastructure investment supplements a more traditional portfolio composition by offering high returns, with built-in resilience to inflationary conditions and low correlation to other asset classes," Bharadwaj says. "As such, we are seeing infrastructure playing an important role in the long-term asset funds (LTAFs) that are emerging across the market."

The importance of ESG

While their first priority is looking for ways to provide the necessary returns to meet their commitments to members, environment, social and governance obligations of pensions are a vital part of decision-making for pension schemes. And infrastructure has an important role to play here, too.

Arguably, infrastructure helps pensions to both contribute and benefit from renewable energy and other environmentally progressive projects. "Some of infrastructure assets are helping with the decarbonisation goal of many countries, including clean energy generation, and electrification of transport and heat," Lim says.

According to the GLIL report, 70 per cent of pension fund leaders surveyed believed infrastructure investment should prioritise the energy transition, while 96 per cent said they will be focusing investments on infrastructure in areas such as battery storage, hydrogen, and carbon capture usage and storage.

And, says Bharadwaj, feedback from pension investors suggests that direct infrastructure investment "helps them to align with their own principles". She adds: "Direct infrastructure investment is a powerful tool for decarbonising the global economy, but it's a process that will require long-term commitment and diligence from asset owners to meet the aims of the Paris Climate agreement.

"In addition to creating new green infrastructure projects, transitioning existing infrastructure is crucial for meeting carbon reduction targets, as about half of the infrastructure needed to achieve this by 2050 is already in place or planned," says Bharadwaj.

But it's not just the 'E' in ESG that counts, of course. "Different infrastructure investments will align with the E, the S or the G, of ESG," says Gordon. "This is a way in which they can balance their portfolios to make sure they meet their goals."

The approach must be holistic, says Bharadwaj: "Infrastructure investment […] must consider universal factors such as health and safety, supply chain issues, modern slavery, and general workforce conditions. As illustrated by the DWP's Taskforce on Social Factors – in which IFM has been closely involved – this is an aspect of infrastructure investment which aligns with pension fund ethos." After all, direct investment gives asset owners, such as pensions, a louder voice in the running of organisations.

This is reflected in the GLIL report, too. It showed that 34 per cent of professionals cited supporting local communities as a main incentive for investment in this area. And, as Lim says, infrastructure can, at least in theory, deliver on this: "As infrastructure assets are location-specific, it is also important for the infrastructure asset operators to demonstrate strong linkages with communities for social impact as well."

So, with governments keen to harness pension power, and pension funds looking for suitable, stable, investments that can underpin their obligations, it looks as though the future of infrastructure and the pensions industry may be intertwined for some time to come.

Written by Sandra Haurant, a freelance journalist