Embracing the opportunities

Building the future

Welcome to the second publication in our *Embracing the opportunities* series, focusing on why and how DC schemes can access infrastructure

You will have heard about the UK government's "Build Back Better" growth plan, which requires significant investment in infrastructure. In this publication, we explore whether infrastructure is an asset class DC schemes should explore, and, if so, how investment can be implemented in practice.

In the first publication in our series, we established why those responsible for DC schemes should explore opportunities in illiquid investments to improve retirement outcomes for members. We also dispelled some of the myths associated with investing in less liquid assets.

What is infrastructure?

Infrastructure is commonly defined as the facilities and essential services required for the effective functioning of modern economies. Examples of infrastructure assets include schools, hospitals, airports and power generation assets. Infrastructure is an asset class of considerable diversity; this makes it challenging to evaluate specific opportunities but also underpins the asset class' diversification potential.

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Within the diverse opportunity set, there are a range of investment opportunities with different risk and return characteristics. We have summarised how the universe can be segmented, with examples and typical returns to expect in the table below:

Segment	Example	Typical Return %pa
Core	Operational solar farm in Western Europe backed by long-term power purchase agreement ("PPA") with large industrial end user	4-6%, mostly income
Core-Plus	Australian airport where revenues vary with passenger numbers	7-10%, mostly income
Value-Add	Underutilised toll road that requires significant capital expenditure	10-15%, capital gain and income
Opportunistic	Offshore wind farm in an emerging country which in early stages of development	15%+, mostly capital gain

Why invest in infrastructure?

Return potential

After costs and charges, the potential returns from the asset class are attractive for long-term investors such as DC schemes, albeit high quality managers are needed to navigate a complex universe. In addition, underlying income and the value of infrastructure assets is heavily linked to inflation. These features are attractive to DC schemes looking to deliver good long-term returns above inflation, with the aim of providing good retirement outcomes for members.

Diversification

Infrastructure has demonstrated a significantly different return stream to traditional equities and bonds. This means there are opportunities to improve diversification within portfolios whilst maintaining or potentially improving longer-term return expectations.

Impact

By definition, infrastructure investing means investing for the future. This means there is the potential for each £ invested to have a positive impact on the world around us. With many pension schemes putting in place longer-term goals to address climate change, infrastructure may be an attractive asset class to explore to progress towards interim climate targets (e.g. climate solutions). DC schemes within the scope of the TCFD requirements will need to put in place appropriate climate metrics and targets – infrastructure investment could be part of the solution to make positive progress relative to these. It's not just about environmental impact, infrastructure investments can contribute positively to society too. For example, infrastructure projects provide jobs and the opportunity to develop skills needed for the future and a more sustainable world.

Generating a positive impact on the world around us by investing in tangible infrastructure projects also provides opportunities to engage DC savers – we think savers will respond positively to news that their money is being used not just to generate good returns, but to do good in the world.

Government support

Governments in many countries are showing greater awareness of the socio-economic costs of sluggish productivity growth and wealth inequalities and the role high quality infrastructure can play in addressing them. A big reason for the increased demand is that governments have poor finances, especially post-pandemic, so need private capital to invest in infrastructure. The Build Back Better and Levelling-Up policies in the US and UK, for example, suggest a greater appetite to take concrete action. At the same time, the pandemic and heightened geopolitical risks have highlighted the need for more resilient supply chains which will also involve increased investment in infrastructure. The single most important source of demand for new infrastructure though is likely to be decarbonisation; meeting the net zero challenge will involve massive investment across many segments of the infrastructure market from power generation to carbon capture and storage.

In the UK, for example, the government's net zero strategy calls for £695-825bn of public and private sector capital to be mobilised over the period 2022-35 (£45-55bn per annum), much of which will be invested in enabling infrastructure (see chart below) [1]. Similar projections were provided by the UK's National Infrastructure Commission in its first infrastructure assessment report.

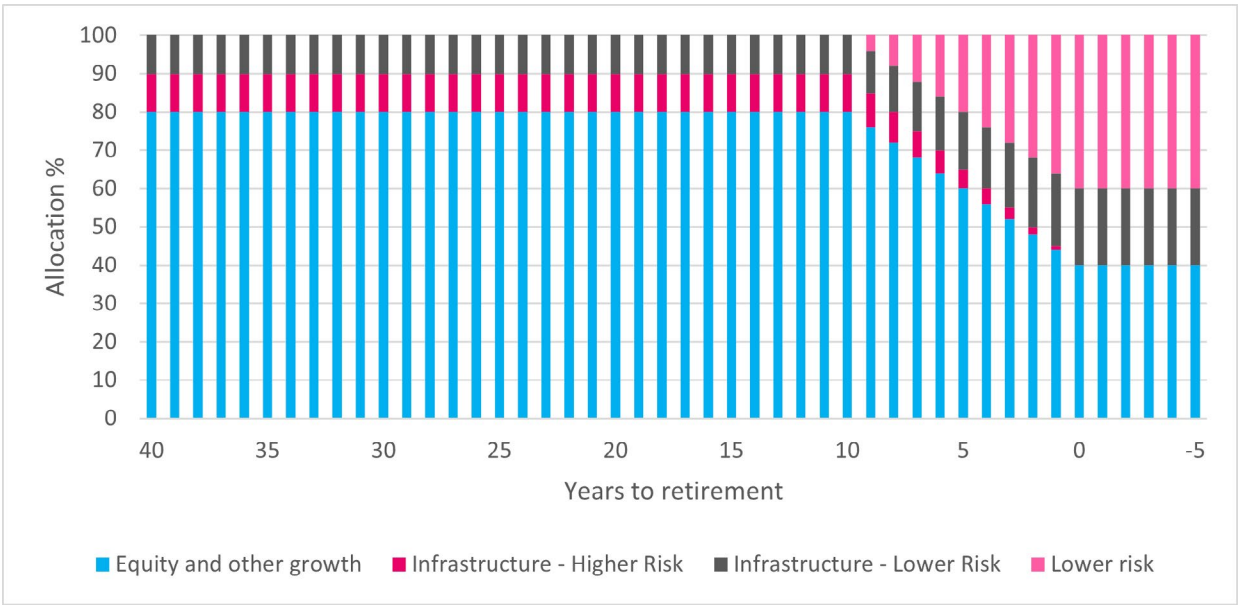
We think there is potential for more than £100bn of DC assets to be committed to infrastructure investments by the end of this decade, reflecting growth in the size of DC schemes.

What is the potential role in DC strategies?

In our previous publication we set out some high-level views on how different illiquid investments could be used to improve retirement outcomes for DC savers. Indeed, we showed that infrastructure has a potential role to play throughout the savings journey.

DC savers can afford to take more risk in the earlier stages of their savings journey, provided this risk is expected to be rewarded over the longer-term. We think the more higher risk infrastructure investment have a role to play in the earlier stages, providing opportunities to enhance long-term returns. Closer to retirement, savers still need adequate returns but managing risk becomes increasingly important. The more income-oriented (and lower risk) core and core-plus opportunities having a role to play here. With a significant proportion of returns provided by income, the value of DC savers' assets will be less sensitive to shorter-term price fluctuations. Indeed, these characteristics are also likely to be attractive for retirement portfolios where capital (and inflation) protection becomes even more important. We illustrate below:

[1] Net Zero Strategy; Build Back Greener, HM Government, October 2021



A sensible (cautious) return expectation from infrastructure is in the range 4-8% per annum (after fees). At this level, infrastructure has the potential to improve retirement outcomes for DC savers by up to 20% depending on allocation size. However, with allocations to some of the higher risk opportunities, there is further potential to enhance long-term returns and retirement outcomes.

How can infrastructure be implemented in DC schemes?

We think blended funds are now an essential feature for future proofing your DC scheme's investment strategy. This means you can make changes to the underlying asset allocation, without creating onerous consultation and reporting requirements each time a change is made. This will be increasingly important as the ability for DC schemes to access more sophisticated asset classes and fund structures improves.

Managing liquidity

One of the key concerns when investing in illiquid assets is managing liquidity. For infrastructure investing, a long-term time horizon is critical as underlying capital deployed within funds may be locked away for 10 or more years. Infrastructure investments can also take a number of years to 'ramp-up'. In other words, it can take time for asset managers to navigate the complex infrastructure universe and put your capital to work. This period is typically around 3 years, but it can take longer.

The long-term capital commitment should not be an immediate concern for DC schemes given savers' very long time-horizons. Indeed, there is an alignment of interests in terms of time horizon and corresponding opportunities. A key risk is facilitating cashflow, particularly during periods of market stress. In practice, cashflow would be fulfilled using liquid assets. This can be achieved using blended funds, provided the platform provider has sufficient capabilities. We have provided a worked example below for how this could work in practice.

Worked example: 20% allocation to infrastructure within a Blended Growth Fund.

In this example (for simplicity), we have assumed a 20% allocation to infrastructure alongside an 80% allocation to listed global equity funds. These assets are implemented within a blend – this means savers invest in the top-level blended fund, and experience returns in line with this. In the table below we illustrate the potential impact on the allocation of the blend due to different market and cash outflow stresses. In all of these scenarios, cashflow for DC savers is assumed to be fulfilled from the liquid equity components.

Equity/infra allocation	Stable equity markets	20% fall in equity markets	40% fall in equity markets
Cashflow neutral	80/20	76/24	71/29
20% net cash	75/25	69/31	58/42
40% net cash outflow	67/33	55/45	29/71

In order to facilitate cashflows from a blend of liquid and illiquid assets, it is necessary to implement a tolerance range around the central allocations. A tolerance of broadly +/-10-10% is reasonable whilst maintaining strategic integrity (i.e. similar long-term risk/return characteristics). In the example above, the blended fund could survive significant market and cashflow stresses whilst maintaining strategic integrity.

During the ramp-up phase for investment, listed infrastructure could be used as liquid 'dry powder'. This asset class will tend to demonstrate more price volatility in the short-term (similar to equity markets) but longer-term returns more correlated with infrastructure, albeit with lower returns. Our preference is to deploy capital to 'pure' illiquid infrastructure investments, but we recognise the potential for listed infrastructure to diversify return sources relative to traditional equity markets and hold capital during the ramp-up phase of investment.

This does require a platform provider to be willing and able to implement this form of cashflow management. Our experience suggests that not all platform providers are equipped in this way, so we suggest this is an area for immediate development to support DC schemes for the future.

Although we have included scenarios with significant cash outflows from a growth fund, in practice this scenario is only likely to materialise if a scheme, or large participant, was to transfer to another arrangement.

This risk can be managed. In our previous publication, we suggested that all DC Master Trusts should accept incoming transfers of illiquid assets as a requirement of authorisation. In this way, the likelihood of such a significant cash outflow is reduced to near zero. An alternative (already used in the DC industry) is to put in place contractual terms with the appointed fund manager to provide for re-assignment of ownership in the event of bulk transfer.

In practice, DC schemes are heavily cashflow positive, with net cashflows representing between 10% and 15% of total assets. Although we have explored stressed cashflow scenarios, we don't believe these are likely to materialise in practice (provided there is adoption of one or both of the measures described above).

So, what are the main take-aways?

As we've demonstrated, there are significant opportunities in infrastructure investments which could lead to improved outcomes for members.

There is also the opportunity for pension schemes to integrate their climate and wider sustainability goals in line with the broader portfolio. Here are some initial steps you can take:

Educate

When receiving training on illiquid investing more generally, seek specific guidance on infrastructure investment. This should cover risk and return characteristics as well as social and environmental impacts.

Engage

Engage with your pension provider and advisors to understand how you may be able to access infrastructure investment opportunities. Platform capabilities will be key – is your platform provider up to scratch? This is a key engagement area to drive support for DC schemes well into the future.

Review

As part of your next review of your investment strategy, explore how infrastructure and other illiquid assets can be used to improve outcomes for your members. As part of your next provider review, attribute a weighting to platform capability, given lack of functionality could stifle your ability to deliver good outcomes for your members over the long-term.

Implement

If you identify opportunities to improve outcomes, you should take action to capture these for the benefit of your members. Work with your provider and advisors to develop plans to introduce allocations to infrastructure and illiquid assets over a reasonable time period.

Communicate

Share positive stories about the action you are taking to improve outcomes with your members. Infrastructure investments have strong potential to create engaging stories about how your members' money is being used to build a more sustainable future.

Illiquid investments: embracing the opportunities

Look out for further publications in our illiquid investments for DC schemes series. If you have any questions on the subject in the meantime, please get in touch:

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