

Why UK pension funds should consider infrastructure

David Morley discusses why infrastructure provides the answer to some of the challenges facing trustees and their advisers.

How can you best explain rising interest in infrastructure from UK pension schemes?

Trustees and their advisers in the UK pensions industry face some key challenges. Falling interest rates, rising longevity assumptions and nervous equity markets all put pressure on funding levels. Any one of these factors could have a significant impact. Over recent months they have come along together. Trustees and their advisers are searching for answers and there are a number of reasons why this search sometimes focuses on infrastructure.

The first of these is diversification. An investment strategy which targets multiple sources of uncorrelated returns is one of the best ways for a pensions scheme to manage risk at a total portfolio level. Infrastructure projects and the returns they generate tend to be lowly correlated with the traditional investments that pension schemes have historically relied on. For this reason they can be an attractive diversifier of risk.

Over the last fifteen years or so the private sector has become closely involved in large scale public sector infrastructure projects. With concession-based projects in the UK this might mean the private sector taking on board the responsibility for designing, building, financing and operating an asset while the government will normally maintain overall control.

In the UK concession-based infrastructure projects are generally either PFI (Private Finance Initiative) or PPP (Public Private Partnership). The regulatory framework in the UK within which these projects operate insulates them to an extent from some of the risks associated with operating large infrastructure projects. For instance, pricing controls can be written in to service contracts and in many cases, the operational revenues are quite predictable. As a result concession-based infrastructure projects can be strong cash generators and can deliver stable inflation-protected returns, which pensions schemes can use as part of their inflation matching strategy.

Finally they can be very low risk. In the UK, where the Government is generally the counterparty to projects of this kind, there has never been a default on an infrastructure concession.

Why are pension schemes well-placed to benefit?

In general traditional infrastructure investments are long term investments with long term benefits. However it is also true that they might require long term commitment from investors. Some concession-based infrastructure projects might have life-spans of 30 years or more and they can be generating strong, stable index-linked returns over very lengthy periods.

This puts some pension schemes at a real advantage. Pension schemes generally do not need to maintain immediate access to their funds. This means they are perfectly placed to access the additional premium which less liquid assets can deliver. Many pension schemes are aware of this benefit and have already made allocations to

other less liquid assets such as credit. The illiquidity premium available from certain carefully chosen infrastructure investments means that these opportunities have the potential to become more and more popular among pensions schemes.

What does the market look like in the UK?

Infrastructure refers to the facilities, services and installations which help an economy to function. PPP and PFI opportunities are focused on social, transportation and environmental areas. In these areas the Government is often keen to maintain overall control of infrastructure projects, while harnessing the skill and expertise in the private sector to deliver improvements.

What are the main challenges and risks associated with infrastructure investments?

Managing the cash flows or maintenance of a project over the long term is a skill. Through effective active management of infrastructure projects it is possible for experienced managers to add more value to deals. And investors need the guidance of an experienced hand if you want to access the opportunity at the right price.

Combining strong cash generation with negligible counterparty risk and the risk/return profile of such investment opportunities is very attractive. When you combine these features with the classic defensive investment characteristics that infrastructure opportunities can be blessed with, and it is easy to see how they have become attractive for some pension schemes trying to fulfil their commitments in uncertain times.

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