INSTITUTIONAL INVESTING IN INFRASTRUCTURE

MENU

FIRSTavenue. A leading global advisory and capital placement business

PUBLICATIONS

INFRASTRUCTURE

MAY 1, 2018: VOL. 11, NUMBER 5

Success benchmarked: Initial forays into infrastructure investment benchmarks are producing results

BY ANDREA ZANDER

The appetite among prominent global investors for investments in infrastructure is growing, and it is helping to drive growth in infrastructure investments across the globe. The Global Infrastructure Hub and Oxford Economics estimate that governments across the world will need to spend more than $94 trillion by 2040 to keep pace with profound economic and demographic changes.

In responding to the demand, the world's biggest pension funds, insurers and sovereign wealth funds have increased allocations to infrastructure investments as they search for yield, seek to diversify portfolios and add liability-matching assets to their portfolios.

Approximately 60 percent of these investors expect to increase allocations to infrastructure and renewables, according to BlackRock's "2018 Global Institutional Rebalancing Survey," which surveyed 224 global

institutional investors. And more than $200 billion has been raised by specialist global infrastructure funds since 2006 with allocations made by pension funds and other direct investors, according to PricewaterhouseCoopers.

As institutional demand for infrastructure investments increases, so has the need for more effective and adequate benchmarks. Crucial requirements for indices to help investors are insights into the performance and risk of the asset class; however, efforts to create independent, third-party indices have lagged the rush to invest.

"Without adequate performance benchmarks infrastructure investors have found it challenging to make investments in infrastructure," says Sarah Tame, associated director, EDHEC Infrastructure Institute–Singapore (EDHEC*infra*).

Three-quarters of industry representatives indicated they would use an infrastructure investment benchmark to understand how assets are performing, according to EDHEC*infra,* which surveyed 200 infrastructure investors, asset owners and bankers. A fifth of respondents, who collectively own more than 10 percent of global assets under management in the sector, noted they would use a benchmark to determine asset allocations.

In a 2016 EDHEC*infra* and the Global Infrastructure Hub survey, more than half of the respondents declared they did not trust the valuations reported by infrastructure asset managers. In addition, 94 percent of respondents said useful benchmarks currently do not exist.

"The key to improving indexes for directly held assets like infrastructure is to increase the number of contributors who submit assets each quarter," says James Harkness, executive director, MSCI. "As the MSCI Real Estate Indexes have demonstrated, there are tremendous benefits to owners of real assets who contribute data, including: improved transparency of investment performance on a relative basis, detailed relative investment performance analytics, and timely updates on shifts in market trends."

Firms such as EDHEC*infra* and MSCI are aiming to fill this void.

EDHEC*infra* is currently building a large, representative database of infrastructure investments in the world, and by 2020, the EDHEC*infra* Global 1000 Unlisted Infrastructure Index will track 40 major markets.

"Using unique asset pricing technology, we are able to compute the metrics that investors and regulators need to understand private infrastructure in a multi-asset class context," says Tame. "We are one of the first to measure the risk and risk-adjusted return of private infrastructure investment, an essential performance metric for investors and regulators."

MSCI provides two infrastructure benchmarks, the MSCI Global Quarterly Infrastructure Asset Index and the MSCI Australia Quarterly Unlisted Infrastructure Index. MSCI and its index advisory committee, which consists of representatives from the owners of direct infrastructure, created its own data collection template. The template is populated each quarter by owners of direct infrastructure, and consists of valuation, accounting (costs and revenue) and asset characteristics. MSCI follows a set of data submission, calculation, verification and sign-off processes to ensure its data quality.

"Benchmarks are desirable to allow investors to compare and contrast the performance of fund managers and/or particular subsectors and assets," says Danny Latham, partner with the infrastructure team at First State Investments. "Any benchmark is only as good as the data that underpins it. A good reference point is how the real estate indexes developed such as the NCREIF."

Improving the indices will help investors define infrastructure as a distinct asset class and will be a catalyst for more investment, new investment products, better diversification and better long-term investment solutions for pension plans, insurers and other institutional investors. Policymakers have widely supported the creation

of transparent and impartial benchmarks stating that they will help to make infrastructure an asset class that is attractive to a broader investor community.

"It is important to note that the relevance of any infrastructure benchmark will be highly dependent on the investment objectives that the investor is seeking to achieve with their capital," says Matina Papathanasiou, deputy head of global infrastructure with QIC Global Infrastructure. "In this regard, investors may make an allocation to infrastructure for growth or for defensive characteristics — the relevant benchmark would vary in these situations as the target risk-return profile will be very different."

It's all relative

Perfecting infrastructure benchmarking comes with a number of challenges. Infrastructure as a sector is not homogenous enough to accurately do a side-by-side comparison or a comparison for any single asset against an index. Even within the same subsector, infrastructure assets often have completely different value drivers and risk profiles. For example, two seaports may have very different risk-return profiles depending on the nature of their pricing model and the macroeconomic factors they are exposed to due to the nature of their throughput and the trade and geographies they are exposed to, Papathanasiou explains.

Infrastructure can be assessed and evaluated through different lenses.

From a wider macro perspective, infrastructure is the backbone of society that enables the efficient movement of people and products and services.

From an investment perspective, infrastructure has an important role in building a well-diversified investment portfolio to meet the liabilities of investors. The particular objectives of investors, whether they be alpha generation or more defensive in nature with a yield focus, will determine where investors play along the infrastructure risk-return spectrum.

Core and core-plus infrastructure is defensive in nature with inflation correlation and relatively strong stable cash yields. Those investment characteristics provide a good match for meeting the wage inflation and long-duration liabilities of pension funds. They also provide an enhanced substitute for fixed interest in the portfolios of insurance companies, Latham says.

"Investing in infrastructure as an asset class necessitates valuation-based indexes to help investors and owners align their investment strategy with the actual performance of their assets in a relative context," says Harkness. "For example, the performance of a portfolio compared to an absolute-return benchmark will not demonstrate how the portfolio has scored compared to its peers. Institutional investors believe that more assets are needed in the index and more owners need to participate by contributing data each quarter because investment performance transparency is what makes indexes important."

Managing expectations

Some investors are comfortable with the current benchmarks and make successful investments by allocating to third-party managers with teams that determine and evaluate each investment.

"We develop our return expectations based on an in-depth understanding of the risk-return profile of each individual asset we look at," says Papathanasiou. "This requires deconstructing value chains at the asset level and understanding the asset's unique economic relationships at the macro level."

Investors can take different approaches to investing in infrastructure, and managers can help them do this. Some of these strategies take a sector-centric approach to origination, investment and asset management, with several teams focused on sectors such as transportation, energy, and utilities or P3s across multiple geographies. This enables investment managers to develop deep sector knowledge, which can be applied to

origination and ongoing asset management that helps drive returns for investors, Papathanasiou explains. “We also undertake deep-dive research into long-term trends through our series of red papers.”

She adds, “This strategic research supplements our thinking in terms of thematic investing.”

Other strategies can be more narrow; for example, a strategy exclusively focused on brownfield assets in a few sectors in developed markets. At the moment, it probably is the case that these more narrow strategies are better reflected in third-party indices because the indices are relatively sparsely populated with investments and those are often in developed markets. A strategy that is similarly narrow could be a good reflection of a particular index.

The bottom line

Institutional investors have been steadily increasing their exposure to infrastructure investment during the past decade as they search for yield, seek to diversify their portfolios and find a better asset/liability match. But it is difficult to categorize infrastructure adequately as there is currently no objective and reliable benchmark that can help to fully understand the risk and volatility of infrastructure investments. Without a standard reference for infrastructure investment performance, infrastructure can be off-putting for some investors.

Benchmarks aim to allow investors to properly measure the risk-adjusted returns of infrastructure, as well as provide an objective measure of third-party managers, which can help define and establish infrastructure as an asset class by creating transparency and efficiency in infrastructure investment. At the moment, and perhaps indefinitely, investors will have to accept or adopt less-than-perfect benchmarks. However, with more time and data, these tools will become more useful. And other investors, meanwhile, have developed infrastructure performance measures created by internal research teams to help understand these investments.

If investors are able to properly measure the risk-adjusted return of infrastructure, it opens up the decision about where to invest and, as a result, more capital will flow through to much-needed infrastructure investments.

Andrea Zander is editor, *Institutional Real Estate Newsline,* with **Institutional Real Estate, Inc.**