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INSIGHT

Building retirement savings while preserving community trust

In the investment community, we deal with myriad risks every day and they frame our decisions. In many cases, however, it's only when an investment goes wrong that its risks are revealed and articulated. If an investment makes a poor return or if there is a major financial crisis, the community wants answers and eventually the risks that were being taken come to light. These become "learning moments" for the community as people come to understand more about what institutional investors are doing with their money.

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INFRASTRUCTURE INSIGHT

It's at these times of crisis that end investors become much better able to describe what their expectations and standards are when it comes to investment.

In the case of the global financial crisis of 2007/2008, pension fund members were understandably outraged when it was revealed that sub-prime mortgages had been packaged and on-sold as if they had much greater value than they did. Members of the community had an underlying expectation that financial products would be sold in a transparent way. Just because end investors don't articulate or necessarily think about their own expectations or standards doesn't mean institutional investors shouldn't be anticipating them.

The community's role in infrastructure investments

For institutional investors who invest in essential community infrastructure assets, there is a dual responsibility to end-investors as well as the community.

Global infrastructure investors – who in many cases also assume responsibility for the day-to-day management of infrastructure assets – need to consider and manage risks in multiple communities and jurisdictions. We believe being able to understand and anticipate the community's implicit expectations about how they should invest in and manage community infrastructure assets is key to enabling them to make

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Photo: Anglian Water, UK

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the investments successful and to maintaining their social licence to operate. It's essential for infrastructure investors to earn and maintain community trust.

Why invest in community infrastructure?

It appears pension funds across the globe are increasingly investing in illiquid, unlisted asset classes, such as infrastructure and real estate. Fund members have generally made substantial gains from the illiquidity premium of these assets.

Pension funds are typically well placed to sustain investments in illiquid investments such as infrastructure, as members' long investment horizons are well-matched with infrastructure assets' long investment life cycles. We believe pension funds can also act as responsible, long term stewards of infrastructure assets.

Infrastructure investing carries a dual responsibility

Pension capital is currently funding critical community infrastructure such as toll roads, ports, airports, railway stations and pipelines in the UK, Europe, Australia, the Americas and parts of Asia. These infrastructure assets are not only owned by millions of pension fund members across the world, but are utilised by millions of members of the public every day. Institutional investors in these assets need to remain mindful of their fiduciary responsibility and also of the community trust that is vested in them as a consequence of owning and managing critical community resources.

Given this dual responsibility, infrastructure investors need to stay up to date with the sentiments of pension fund members as well as members of the public who use these infrastructure assets – and they need to be aware of member sentiment now as well as their likely sentiment in future years. This is to help ensure the assets can provide their intended essential services well and meet the always-evolving expectations and standards of the wider community.

Holding and maintaining assets for generations

Asset management is fundamental to a responsible infrastructure investment process. Maximising the return to members while maximising benefit to the community necessarily entails continuous investment in an asset. Indeed, an infrastructure asset often needs to be maintained and improved over decades.

This requires a systematic approach, and an ongoing programme of activities that seeks to protect, enhance and exceed the target returns of infrastructure assets. For example, in order to share best practice and lead improvements in safety, equipment, technology and systems in our toll road assets, at IFM Investors we recently established and conducted a Toll Road Summit, which brought together the talent and leadership of all our toll road portfolio company investments.

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Photo: Anglian Water, UK

Look for a full picture of the risks

Understanding risk is key in the infrastructure asset management process. Managing a major community infrastructure asset necessarily involves understanding all the risks facing that business, such as climate, reputation risk, labour issues, supply chain issues, demographic shifts, health and safety risks, workforce management issues, geopolitical and government policy risks, to name a few. All these risks need to be managed to maintain a healthy business while remaining aligned with community standards and expectations.

For example, how does an investor meet expectations about managing climate risk? Using climate scenarios (e.g. a two degrees scenario) can assist an investor in conducting a high level risk assessment of their infrastructure assets, to help them understand potential climate change impacts on industry sectors and the assets themselves. Ideally, such an analysis would also cover transition risks stemming from changes in policy, law, markets, technology and prices, and physical risks stemming from the direct impact of climate change on our physical environment. Improvement plans can then be developed for assets where material risks and/or improvement opportunities exist.

Leverage is another risk to be mindful of in infrastructure investment. To help mitigate credit risks, investors should take a conservative approach to leverage at the company level in their portfolios. They should not use leverage that would jeopardise the long-term viability of an asset and they should seek to ensure that their assets' capital structures remain sustainable in a variety of economic and industry environments.

Risk is present throughout the economy and every institution within it. We believe pension funds that invest in infrastructure have a responsibility to engage with members and communities in order to be mindful of risks, to anticipate them and to manage them. This approach should assist in the optimising of investment returns, and in earning the ongoing trust of members and the people who use their infrastructure assets every day.

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