ifm investors

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Infrastructure, an asset class for all seasons

The role of infrastructure in institutional portfolios will continue to be a prominent theme for asset allocators in 2023, along with the increasing engagement within the investment community on how to manage the 'S' – or social factors – within ESG.

by Luba Nikulina

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INFRASTRUCTURE INSIGHT

The job of asset allocators is never easy, but the recent macro environment has been particularly challenging given correlated weakness in equity and bond markets. Increasing interest rates around the world and the impact they have had on valuations across most asset classes have proven difficult for 60:40 style investors and this has been reflected in negative returns.

To us, this again highlights the strategic importance of the infrastructure asset class for asset allocators, given its resilience through economic cycles and its effectiveness as an inflation hedge. We believe the infrastructure asset class has a role to play as a foundation portfolio asset class aimed at securing diversified, less volatile, low correlation long-term returns.

In addition to its defensive and diversifying characteristics, infrastructure also has a strong growth momentum behind it. A few meaningful macro trends are contributing, such as ageing and underinvested infrastructure in the developed world and the requirement for a significant ramp-up in emerging markets infrastructure. And most importantly, the urgent need to decarbonise the global economy, but in a prudent way that allows countries to preserve their energy security. This requires enormous investments in the traditional and emerging infrastructure ecosystem around the world.

In addition to these environmental demands, the integration of social factors (which are the 'S' in ESG) in infrastructure investments is also going to be topical in 2023. It is a theme that is attracting increasing attention because complete integration of ESG considerations depends on the 'S' being measured and managed as comprehensively as the 'E' and the 'G'.

A challenging macro environment for asset allocators

Looking back, the investment environment in the decade leading up to the pandemic was relatively favourable given strong global growth, widespread disinflationary pressures, generous monetary stimulus from central banks through low interest rates and quantitative easing, and

governments providing further fiscal stimulus in response to pandemic-induced lockdowns. Asset allocators could stay invested in equities for growth and use bonds and derivatives for protection. Relatively high valuations in listed markets also prompted significant growth in private markets as investors sought to sustain performance with the added benefit of increased diversification.

But in 2022, everything changed. Inflation that was initially deemed transitory suddenly became persistent and pervasive. Post-pandemic supply chain disruptions, prolonged lockdowns in China and the massive energy, commodity and food price shocks caused by Russia's invasion of Ukraine combined to force central banks into a very aggressive monetary policy tightening cycle that is not yet over. The rising tide of global liquidity that 'floated all boats' is in the process of receding rapidly.

The combination of accelerating inflation, rising interest rates, and slowing economic activity has been very challenging for asset allocators for several reasons:

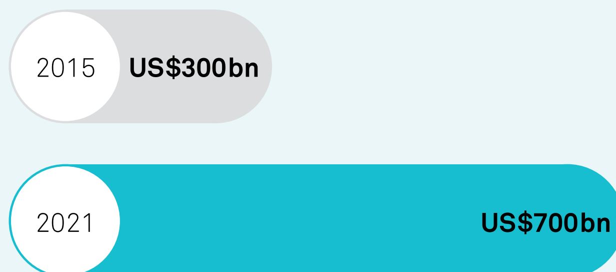
- Bonds are traditionally viewed as defensive assets, but yields have risen sharply, causing significant falls in value. These value moves in US and UK government bonds were modelled as a less than once-in-100-years event. Real returns (inflation adjusted) in bond markets were still negative at the time of writing, although asset allocators are increasingly seeing value in some segments of the credit markets in expectation of the resurgence of yield generating fixed income and credit strategies.
- Equity markets have also been weak, but this adjustment was mostly a reflection of the rise in the discount rate in 2022, and it is only in the most recent earnings cycle that negative growth expectations have started coming through. The only certainty about the equity markets in 2023 is continued volatility and uncertainty.
- Current market pricing suggests that investors expect inflation to come under control in 2023 and that this will be achieved with only a small slowdown in GDP and a quick return of earnings growth. Whilst this would be a welcome outcome, it would be historically unprecedented, and economists are currently more pessimistic, with Bloomberg survey data suggesting the probability of a global recession is currently around 66%[1]. Instability in the global banking sector only adds to the list of economic risks going forward. Taming the level of inflation that is currently evident in the US and Europe without some material economic cost is, in our view, unlikely.

This has been a "nowhere to hide" environment for asset allocators. The weakness in asset values has also increased the importance of searching for resilience, inflation linkage but also true alpha in alternative markets.

The opportunity in infrastructure

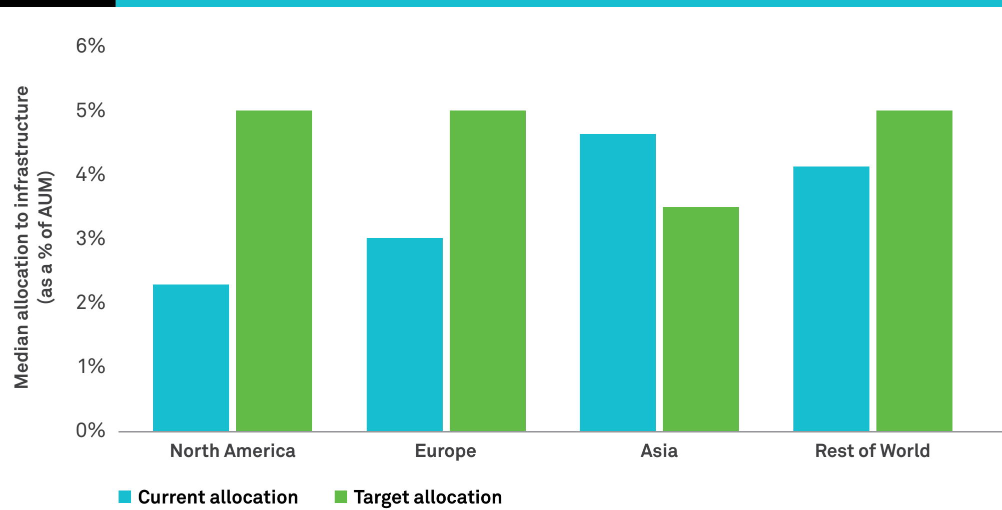
From an asset allocator's perspective, interest in the infrastructure asset class has grown significantly in recent years

Allocations to externally managed infrastructure by institutional investors have grown from around US$300bn to over US$700bn over the six years to 2021.[2]



[1] Based on Bloomberg's survey of economists, GDP-weighted US, UK, AU. NZ, CA, EZ, JP, KO, SE, NO
[2] McKinsey's Global Growth Cube database

FIGURE 1 INVESTORS' MEDIAN CURRENT AND TARGET ALLOCATION TO INFRASTRUCTURE BY LOCATION



Source: Preqin Global Report 2023: Infrastructure. Survey data as at November 2022.

as investors have sought private market investments to generate attractive returns given relatively high listed market valuations.

In the current challenging market environment, we expect this growth trend to continue for several reasons:

- The resilience of infrastructure to macro swings – Contracted pricing links to inflation and inelastic demand for their services make many infrastructure assets quite resilient to economic downturns. This is discussed in detail in an article later in this Report titled *Infrastructure remains resilient despite macro challenges*, and it suggests that infrastructure could continue to outperform other assets classes in 2023, providing potentially attractive returns.
- Investors generally remain underweight – Our research suggests that pension funds and other institutional investors, in aggregate, remain underweight the infrastructure asset class relative to their long-term targets. This is supported by data from Preqin as detailed in Figure 1. While the current discrepancy between public and private valuations has led many investors to be over-allocated to private markets, it is clearly a temporary phenomenon. Once valuations adjust closer to their fundamental values, we believe infrastructure has plenty of potential for additional allocations, particularly given its expected resilience to cyclical downturns. Many institutional investors still do not have a separate allocation to infrastructure, so there is also the potential for new allocations to the sector as private markets continue to expand in future. We believe that over time, infrastructure will become as ubiquitous as commercial property in a truly well-diversified asset allocator's portfolio. We also believe there is an opportunity for global investors to build allocations to private markets, to the extent that their liquidity allows, as the foundation assets of portfolios long-term.

The growing importance of the 'E' plus 'S' in infrastructure

Over the last decade, the importance of the 'E' (environmental factors within ESG) in infrastructure investing has become virtually indisputable for asset allocators. Climate change has come to the fore and should be considered as both a risk and an opportunity. In fact, we believe it is a significant opportunity for infrastructure investors.

Another more recent broad trend which is significant for both asset allocators and infrastructure is the increasing engagement within the investment community on how to manage the 'S' – or social factors – within ESG. As with the 'E' and the 'G', there is a growing awareness that social factors and social system settings carry investment risks and opportunities for companies and investors.

Social factors that are particularly relevant to infrastructure investors, include:

- Organisational workforce practices, especially labour rights and health and safety

- Supply chains and modern slavery
- Inequality across income, wealth, and opportunity
- Inclusion and diversity.

Social factors can impact companies' reputations and financial performance, and this is why we believe the consideration of social factors is intrinsic to the fulfilment of fiduciary obligations in the investment context.

The advantage of unlisted infrastructure is that it sits in the private markets sphere where investors like IFM can have the most direct influence on social factors, as they own or part-own the infrastructure assets in their portfolios. This provides a level of influence over corporate strategy that is usually much higher than in listed markets.

At IFM we have an active program to integrate consideration of the 'S' factors across our listed and unlisted asset portfolios and our commitment to consider social factors is anchored in deep social dialogue, in line with OECD guidelines. IFM's views on two major social themes – health & safety and inclusion & diversity - are discussed in more detail in separate articles that feature later in this report – *The constant quest for greater safety across infrastructure assets and I&D maturity and infrastructure assets*.

One of the biggest challenges that investors face is the lack of common metrics and reliable data with which to measure social factors and impacts.

As institutional investors become more sophisticated in understanding the risks and opportunities associated with social factors, it is likely that there will also be a growing need for more precise measurement of the impact these factors can have on investments and portfolios. One of the biggest challenges that investors face is the lack of common metrics and reliable data with which to measure social factors and impacts. The UK's recently announced Taskforce on Social Factors established by the Department for Work and Pensions is an attempt to improve this lack of data availability and we expect more action on this globally in the year ahead.

By working as a collective, with a view to maximising long-term returns for members, we believe institutional investors have an opportunity to develop a range of meaningful metrics which will help all investors to better identify the risks and opportunities associated with social factors. This would also support an industry-wide prioritisation and management of the systemic challenges that are so material to long-term investment performance.

An asset class for all seasons

The year ahead is likely to pose a host of new challenges for asset allocators as markets navigate tight monetary policy and the possibility of a global recession looms. But asset allocators are increasingly recognising the important role that Infrastructure can play in institutional portfolios given its historical track record of relatively stable long-term returns and resilience to cyclical downturns[3]. We expect this to continue to be a key theme in 2023 given increasing infrastructure investment opportunities arising from the transition to net zero and underweight investors seeking to increase their infrastructure exposure.

There is also a growing recognition that managing social factors is part of an investor's fiduciary duty given the potential risks they pose to reputation and financial returns. We expect this to gain momentum within infrastructure markets given the direct influence that institutional asset managers can have over the corporate strategy employed at portfolio companies.

[3] Past performance does not guarantee future returns.

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