

There is much the government could do to make infrastructure investments more attractive for super funds as MICHAEL STRACHAN writes.

There appears to be a widespread belief that infrastructure investment and the long-term investment objectives of superannuation funds are ideally matched, given the typical long duration liabilities of super and long-term, stable cashflows from infrastructure.

While this may be true for some schemes, it may not be valid for others. For instance, a closed defined benefit scheme with a demographic close to retirement age tends to have a shorter term investment horizon and a greater emphasis on liquidity.

The belief is often sustained by the use of the term 'infrastructure' to cover a broad spectrum of assets with vastly differing investment risk and return characteristics. In other words, there is an assumption in some quarters that infrastructure investments should perform in a similar way to investment grade bonds, which are relatively low risk and deliver consistent cashflow.

Consider the range of investments generally classified as 'infrastructure'. They are as diverse as airports and ports, gas pipelines, electricity generators and transmission lines, water utilities, railway tracks, public housing, schools and hospitals, and toll roads. In addition, they can either be "greenfield" projects under development and not yet income-producing, or mature "brownfield" assets with predictable cashflows.

Infrastructure assets all have one thing in common: they are to a greater or lesser extent exposed to the vagaries of public policy and political expediency. Some of the greatest risk associated with the investment performance of these assets is therefore sovereign risk, or change in government priorities and policy settings.

Sovereign should not be underestimated, whether applying to a commercial infrastructure project or a Public Private Partnership, and it is often underpriced in that the adverse impact is often greater than estimated.

Also, governments often keep changing project specifications and scopes during the tender process. This can result in continuously changing project economics and the incursion of additional material costs to the bidders. Governments have also been

known to cancel projects after the tender has closed, again resulting in significant costs to bidders.

Superannuation's investment in any asset class, including infrastructure, must be examined through the prism of what is in the best interests of fund members.

The primary and legal responsibility of super funds (and the fiduciary responsibility of trustees) is to solely invest and manage superannuation benefits prudently for the exclusive purpose of providing members with the best possible retirement benefit. Ultimately, individuals assess the performance of their fund only on the basis of what it delivers to them and, in particular, how well it assists them to save for retirement.

The social argument for the superannuation industry diverting a greater portion of its \$1.2 trillion of investments into infrastructure is, superficially, quite appealing. It certainly could contribute to meeting some of the shortfall in infrastructure funding needs.

But it is not the responsibility of superannuation funds to invest member contributions for the greater good of the community, no matter how important major infrastructure investment may be.

However, subject to a set of principles, infrastructure is an asset class worthy of inclusion in superannuation portfolios.

The first is that infrastructure must deliver an appropriate return relative to the risk of the investment. Given that funds have a large universe of competing investment opportunities across all asset classes, any infrastructure investment must stand "on its merits" in terms of risk-adjusted returns.

Indeed, any investment must meet and be consistent with the risk and return characteristics of the stated investment objectives of the fund.

This may appear obvious, but discussion around infrastructure investment frequently involves other arguments related to government policy, social engineering, corporate citizenship and a host of other considerations that are secondary to the investment analysis and the fiduciary responsibilities of trustees.

While investment outcomes for any

asset class cannot be predicted with any certainty, it is concerning that infrastructure investment is being talked about by some as a reliable and relatively 'low-risk' cash stream for investments funding products like annuities.

Infrastructure investments have traditionally been highly geared – many with up to 80 percent debt funding. With real interest rates trending upwards, it is going to be increasingly hard for funds to achieve the greater than 10 percent per annum return that they should reasonably expect from these assets. This means the opportunity costs of infrastructure investment for fund members, who could invest in other assets more likely to deliver these returns, are also increasing.

Taking these issues into account, the practice of bundling these infrastructure investments under the broad umbrella of 'alternative' investments is inappropriate.

At Equisuper, we have provided greater transparency by having 'Growth Alternatives' and 'Defensive Alternatives' asset classes, which each have their own investment objectives. The Fund's infrastructure investments are allocated to either the Growth or Defensive category depending on their respective risk/return characteristics. This is considered better practice and provides members with a clearer expectation of how various unlisted investments may perform.

The second principle for funds is, where possible, to invest directly in unlisted investments. There are considerable issues for funds that invest in pooled investment vehicles and, if not managed carefully, considerable scope for agency costs. There are also consequences relating to tax efficiency for funds invested in pooled schemes:

- the fund manager typically only purchases infrastructure assets after the investor has committed the cash. While the type of infrastructure assets targeted for investment are broadly described in the Information Memorandum, the actual investments made are solely at the discretion of the fund manager. That is, there may be investments made that are not really optimal from the

superannuation fund's perspective. In contrast, direct investment permits a fund to invest in infrastructure assets that best meets its investment objectives.

- the investment banks and fund managers that promote these schemes generally base their fees as a percentage of the total asset value of the pool. Here, there is potential for conflict of interest. The fund manager can simply build asset values and, therefore, its fee income, by buying assets with little or no regard for the likely performance of those assets. On the other hand, investing funds derive their returns solely from the performance of the assets.
- as assets are bought or sold, any capital losses are retained within the pool or trust, meaning investing funds cannot offset those losses against any capital gains from the fund's other investments. In contrast, superannuation funds investing directly in infrastructure assets can offset any capital losses from such investments against capital gains from elsewhere; thereby, improving the tax efficiency and after tax performance of the fund.

These are just three reasons why smaller funds can benefit from forming partnerships with other super funds in order to directly

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access some of the better quality unlisted investments in which they do not have the capacity to invest alone. This consortium approach is a viable alternative to pooled vehicles and allows the fund to choose assets which best meet its investment objectives.

The third principle for these investments is establishing clear and rigorous protocols. This is where having in-house expertise is relevant. Funds looking at investing directly in unlisted assets should ensure they have people in their internal investment teams with experience in managing money and/or investing in unlisted assets.

To begin with, a fund's internal team must be competent to question the assessment of its asset consultants and other advisers. Many forecasts have proved too bullish. The forecast Internal Rates of Return (IRR) based on an assessment of projected consumer patronage of infrastructure have very often been too high, particularly for toll roads, resulting in real returns being up to 50 percent less than the projected return.

An unquestioning acceptance of advice has unwittingly led many funds into investments where redemptions have been restricted or stopped, some not even offering the opportunity for phased draw downs through the provision of redemption windows. This sort of analysis requires internal team members who are commercially

focused, have hands-on investment experience and knowledge of unlisted asset management. In addition to financial analysis and investment management skills, teams increasingly need to also include personnel with strong accounting, taxation and legal skills.

Finally, it is worth commenting on the appropriate role of government in supporting infrastructure investment by the superannuation sector because, as suggested earlier, politics and government policy settings are perhaps the single greatest and least predictable risk faced by potential infrastructure investors.

Governments could almost turn the belief into reality by underwriting the risk associated with changing political and community priorities, as often occurs with overseas governments' sponsored infrastructure projects. Put simply, this means offering a guaranteed minimum return to investing funds on major infrastructure projects.

This could certainly contribute to making infrastructure investment decisions and returns more akin to those we associate with fixed interest securities. **SF**

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