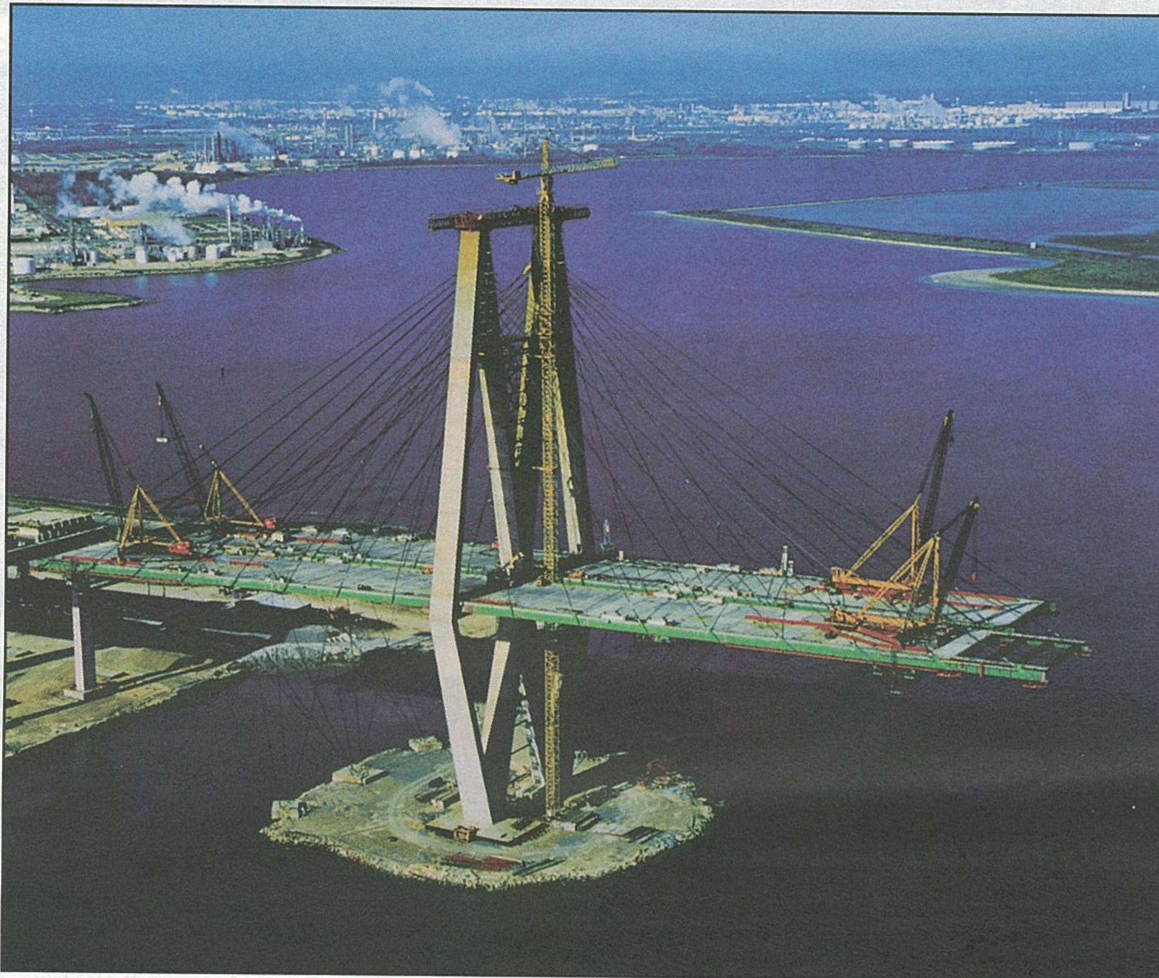
Infra funds fail to bridge the gap

It looked like it could be the perfect pairing but pension schemes are fearful of commitment to infrastructure funds, writes Mark Cobley



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Pension plans and infrastructure: it looks like a match made in heaven. Yet since the onset of the credit crunch three years ago, investment has plunged.

UK chancellor George Osborne is pondering plans to mobilise pension scheme billions into public projects to create growth, but investors seem reluctant to put money into existing or new private funds. This was the hot topic at a conference organised this month by the Organisation for Economic Co-operation and Development and the World Pensions Council, a Paris-based think tank.

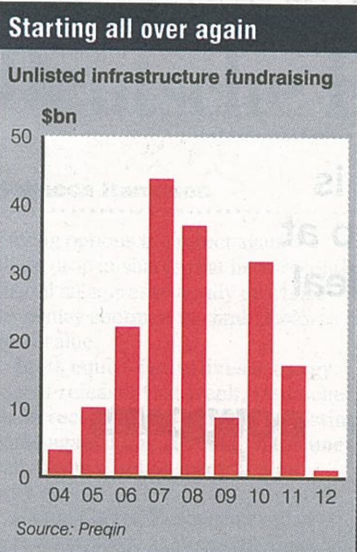
Nicolas Firzli, managing director of the World Pensions Council, said: "One of the reasons we organised this conference was to look at why some large pension funds aren't acting as long-term investors as much as they could, and why they are not investing more in assets like infrastructure, as well as emerging markets and commodities."

According to analyst Preqin, $174.3bn has been raised by banks and managers for private infrastructure funds since the start of 2004, and pension funds are by far the leading investors. Yet the OECD estimates in the next 20 years, there will be a worldwide need for as much as $30 trillion of infrastructure investment.

The Danish public pension fund ATP, itself a big investor in infrastructure, estimates that even with heroic assumptions this gap will remain. Ulrik Dan Weuder, the fund's head of infrastructure investment, told the OECD conference: "Potential demand from pension funds is probably not as large as you think it is.

"If we assume pension funds put 5%-10% of their money into alternatives, and up to half of that could be used for infrastructure, this would mean that in theory, $1 trillion to $2 trillion is available from pension funds for infrastructure – far short of what is needed. Nevertheless, we are a source of capital," he said.

Starting all over again



Source: Preqin

Fundraising hiatus

The investment case is well-rehearsed. The long-dated, inflation-linked income that infrastructure projects tend to generate suits pension funds' needs. But the credit crunch curtailed fundraising, which plunged 80% from $44bn in 2007 to $8.7bn in 2009. Banks and fund managers are hoping demand recovers. There are indications it might, according to Preqin.

Elliot Bradbrook, manager of infrastructure data at Preqin, said: "Fundraising will be quite difficult. The market rebounded strongly after 2009, but the primary reason was that when the crisis was passed, the funds that had been on the road pre-crisis finished off their fundraising.

"Sixteen billion dollars was raised in 2011, which looks like a big drop-off – half as much as 2010. But last year's funds were targeting fresh capital from investors, suggesting the interest is still there. 2010 was a little bit deceptive; the industry has almost had to start again."

> ***Funds need local partners to invest in infrastructure... partners that know the political environment***
>
> Eric Hayoun, CDC Infrastructure

Preqin says its figures do not include direct investments by very large pension funds which handle their own infrastructure programmes. There are several of these worldwide, including ATP, and Canadian giants like Ontario Teachers and Ontario Municipal Employees. These megafunds have shown an increased willingness to go it alone in recent years, but only a handful can match the global reach of an investment bank. So they are teaming up, too.

Eric Hayoun, a financial director at CDC Infrastructure, which is part of the French development bank Caisse des Dépôts, said at the conference: "We think that pension funds need local partners to invest in infrastructure; you need to have a partner that knows very well the political environment in the country. It so happens that in France the CDC is negotiating such a co-investment initiative with international investors."

The liquidity trap

Despite the appeal of infrastructure investments, many of the largest funds have yet to invest. Some fear long-term policy trends may ultimately endanger the future of private infrastructure funding. In most developed countries, collective defined-benefit pension plans are being replaced by individual defined-contribution accounts. Members are granted investment choice, and are able to move their money around at a moment's notice. This means funds have to be liquid – not tied up for years in infrastructure projects.

Stefan Lundbergh, head of innovation centre at APG and a board member at AP4, the fourth Swedish national pension fund, said: "The pensions industry will change from an institutional business run by social partners, to a retail business. If you look at infrastructure it's typically an institutional product not a retail product. In the long term, assets will be shifting towards retail DC products, and so the source of private investment for infra projects will diminish."

Australia might offer a way forward. The country's A$1.3 trillion (€1.1 trillion) pensions industry is mostly defined contribution, but about a quarter is accounted for by industry-wide plans that have the scale and positive cashflow needed to invest in illiquid infrastructure assets.

According to Brett Himbury, chief executive of Australian infrastructure manager Industry Funds Management, which looks after US$30bn of Australian pension funds' money: "This means we buy for the very long term, we are not looking to flip assets in seven years. We always try to partner with investors who have certainty over their cashflow and a similar long-term focus."

IFM is able to run open-ended funds. These contrast with the closed-ended private equity-style funds that have traditionally dominated private infrastructure investment and have a defined lifespan of seven to 10 years.

World Bank: pick managers with care

Mark Cobley

The World Bank has made market-beating returns on private equity investments in emerging markets by backing local partners, not western financiers, it says.

Its portfolio has made a 22.2% average return between January 2000 and June last year, compared with 19.8% for the top quartile of Cambridge Associates' emerging-markets private equity index; and 12.8% for the MSCI Emerging Markets index.

David Wilton, chief investment officer of the International Finance Corporation, the investment arm of the World Bank, says the performance was achieved by picking the right private equity partners.

About four-fifths of its $3bn portfolio is managed by its in-house team, and a fifth invested through third-party funds.

Wilton said the number of these funds had dramatically expanded: "Ten years ago, only the Brics [Brazil, Russia, India and China] and South Africa could support single-country funds. Today the opportunity is much broader."

Speaking at a recent conference run by the Organisation for Economic Co-operation and Development, Wilton pointed to figures showing there are now about 20 countries that fit the bill, plus many more that could provide dealflow for a regional fund.

He said that as an investor, the IFC had been intrigued when it ran analysis of its returns to establish its sources of profit. There was a wide dispersion, he said, with the top 10% of the funds in which IFC invested returning 46% on average, while the bottom 10% lost 38.3%.

Wilton said: "We invest in a lot of newly launched funds with first-time managers, so at first we looked to see if that explained the difference. But it didn't; the rates of return for first-time managers was exactly the same. Then we looked at our exposure to 'frontier' markets. It turned out the frontier markets actually did better than the others.

"In fact, we found that it really is all about the quality of the general partners [the private-equity fund managers]. The top 10% of funds by returns had an average due diligence score of 97%; the bottom 10% by returns scored only 17% on quality."

Wilton said that in emerging markets, it is especially important to make sure your private-equity managers have the right set of skills.

He said: "In most of these markets there is not much leverage available, so the skills of investment and merchant banking are not very much use.

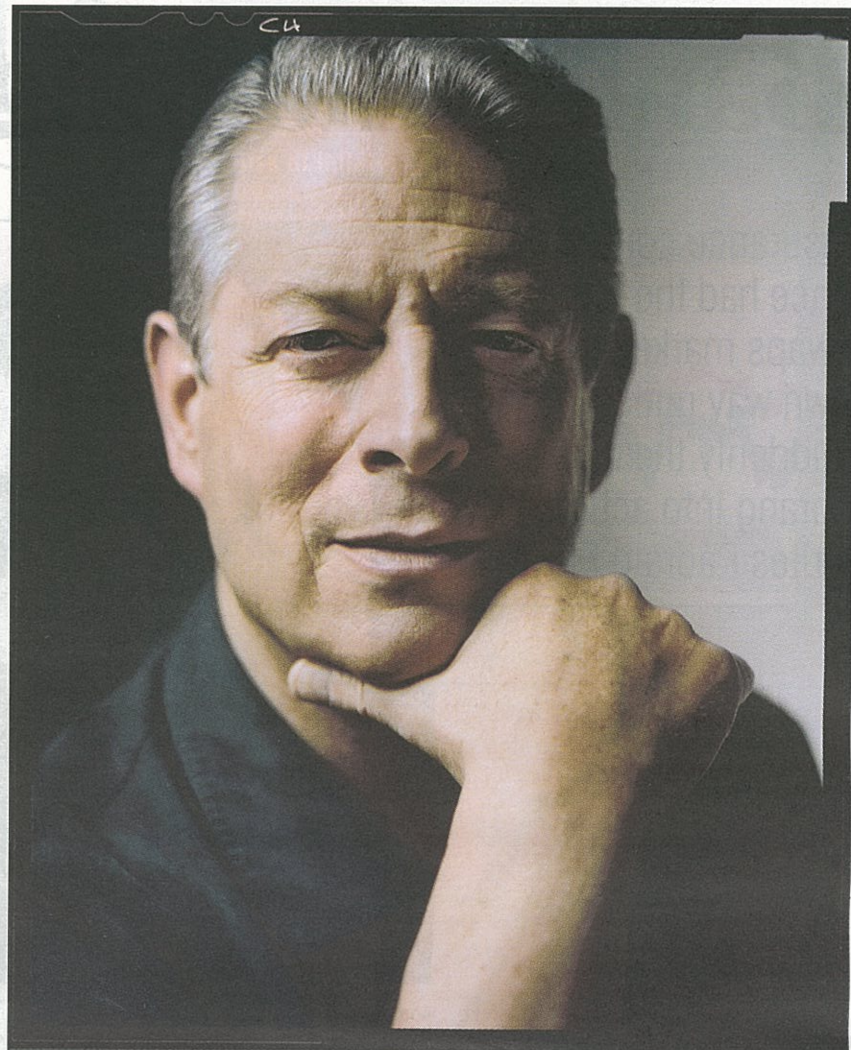
"The sort of GP we want is one with people who have actually run companies, who have had operational experience, and who are local; people with corporate operational backgrounds, entrepreneurs or management consultants.

"In the Nineties, we backed investment bankers who set up funds; they had great access, got a seat on the board. But when the entrepreneur who founded the business wanted to sell up, the minority shareholders got treated quite badly. The companies found ways to minimise the share of the profits they gave to investors.

"Whereas, if you pick private-equity managers who have operational backgrounds, who can help the entrepreneurs day-to-day, these GPs are seen as partners, and no-one cheats a partner."

Blood and Gore call time on investor complacency

Former US vice-president and his business partner want to tip capitalism over the edge for good, writes William Hutchings



It is the only moment in a 60-minute interview when Al Gore, the affable former US vice-president and winner of the 2007 Nobel peace prize, seems annoyed.

The man who narrowly lost the 2000 US presidential election has found an analogy between the impact of climate change and the sub-prime mortgage crisis. The sub-prime crisis happened because mortgage-backed securities were priced on the assumption that borrowers could repay their mortgage loans. When it turned out they couldn't, the price of MBS plummeted.

In Gore's view, asset prices are incorrectly priced now – mostly, overvalued – because the market is ignoring the impact of climate change. He said: "Prices are based on the assumption that it is OK that there's 90 million tonnes of carbon being pumped into the earth's atmosphere every day."

This is the point at which his demeanour darkens. Pointing with his right index finger, he chops the air, twice, to emphasise his objection: "It is not. It is not OK."

He has hit his stride: "People have been encouraged to think it's all right, or they feel unsure of the figures. Liars for hire have published papers saying there's no problem, or reports that doubt the judgment of the scientific community. But every scientific study shows climate change is real."

If Gore is right, asset values will tumble. He said: "When will these assets be repriced? We don't know, but it is likely to be within the timeframe of long-term investors.

"And the effect will be big. We have trillions of dollars of assets that are flagrantly mispriced. Investors need to think about the prices they're giving them."

Sustainable capitalism

This variation on Gore's favourite issue is the most controversial of a set of demands, recommendations and suggestions just published by him and David Blood, the former chief executive of Goldman Sachs Asset Management, with whom he went into business nine years ago.

The pair, who together founded asset manager Generation Investment Management in 2003 and 2004, have called on companies, investors, governments and civil society to re-engage in a dialogue on long-term investment issues. They have published their views in a white paper, Sustainable Capitalism.

As well as the call on investors to quantify the risk of climate change, the points they raise include a recommendation for companies to give extra shares to long-term investors; a proposed end to chief executives giving quarterly guidance to equity analysts; the creation of a new investment consultancy focusing on sustainable investment; a selective integration of financial and environmental, social and governance reporting; and the deferment of compensation payments until the period when the long-term results of decisions are realised.

Gore, in a dark blue blazer with three gold buttons on the sleeve, white shirt and blue tie, comes over the video link looking well, despite the fact that it's five o'clock in the morning in New York, where he is calling from. He should be at a disadvantage to Blood, in the firm's London office, but there's no sign of it: "We've been up for hours," Gore said.

Alignment of interests

The pair want to give a shove to a global movement that has got stuck. Blood said: "When we started Generation, it was based on the notion that there wasn't enough long-term investment. There were a lot of voices saying something about it, investors with $30 trillion signed up to the UN Principles of Responsible Investment, there was momentum. We felt that we were at a point of inflection. Then all of a sudden it stopped. If anything, it's gone backwards."

They are not making this up. Last month, Aviva Investors, a UK asset manager that has been in the vanguard of responsible investment, announced a reduction in its efforts on this front because, in the words of Aviva Investors' chief executive, Alain Dromer: "We don't see the business coming in. These are themes that do not particularly generate any revenues."

Blood and Gore have a vested interest in the cause: Generation was set up to focus on sustainable investment. But their firm's financial statements do not suggest it needs a boost. Profits for the UK arm of the business rose 56% to £49m for the year ended December 2010, and it has $7bn of assets under management, according to the most recent accounts filed at Companies House. Blood said Generation's investment strategy had done better, "by a fair margin since inception", than its target of outperforming its benchmark by an average of three percentage points a year over rolling three-year periods.

Moreover, when pressed, they are less hardline than their headline recommendations may imply.

Take their suggestion that companies reward shareholders for maintaining their positions in the company. Their paper says: "We propose that companies issue loyalty-driven securities that are only paid to investors who have held stock for more than three years."

In person, they acknowledge that this proposal, which has been made before in various forms, is no panacea – it might make change at companies more difficult, for example. They emphasise that they do not have all the answers, and that everything in the paper is intended to promote further discussion; at the same time, they want action, which means specific steps.

Gore, who reckons businesses typically take seven to 10 years to realise the value of their actions, while average shareholding periods have fallen from seven years in the 1970s to seven months now, said: "The mismatch is obvious. Loyalty-driven securities is a specific proposal we put forward for discussion to improve that alignment."

Wake-up call

Likewise, they know it's controversial to call for the creation of an independent investment consultancy focused on sustainable investment products and sustainable asset allocation. This is an initiative Generation cannot back itself, for fear of falling foul of conflict-of-interest issues. Governmental backing would draw accusations of unfairness from the consulting industry. And if investors wanted more of it, consultants would already be increasing their efforts in this area.

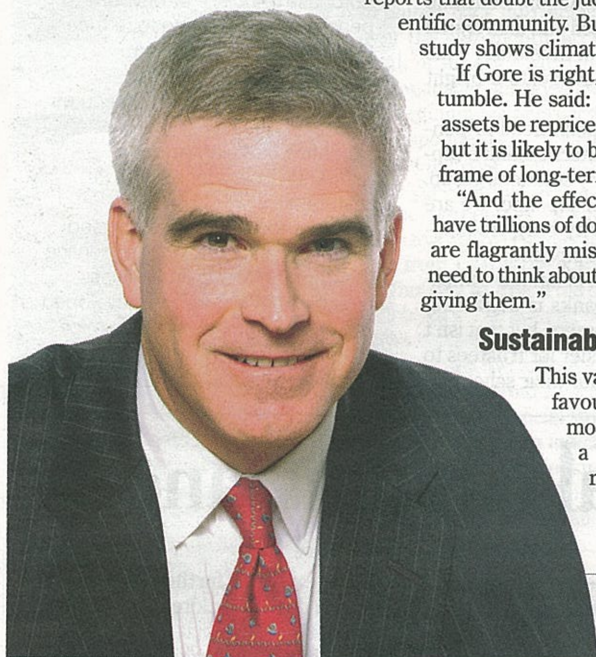
A consultant focused on sustainability issues within a mainstream investment consulting firm said he was sympathetic to the view that consultants were not doing enough, or not doing a good enough job, of advising institutional investors on sustainability issues. But, from his point of view, the trouble is that investors don't want it that much.

The consultant said: "The biggest part of the problem is that it's not high enough up pension schemes' agendas. If demand isn't apparent for something, you won't get anyone offering it."

This, however, puts a finger right on the heart of what Blood and Gore want to achieve. They want sustainability, in its broadest sense, to move from the periphery of investors' view to the centre. In this regard, it is right in line with attempts to promote long-term investment, epitomised in the UK by the forthcoming Kay Review and internationally by the Organisation for Economic Cooperation and Development, which this month announced its own review into short-termism.

From this point of view, the item at the top of their agenda – the call for investors to work into asset valuations the risk of environmental change, water scarcity, poverty, disease, economic inequality, migration and urbanisation – is simply one of a range of points that are all intended to get investors re-thinking their fundamental investment views. Blood and Gore fear that investors, just like the banks that blithely ramped up their leverage in the mid-2000s, are turning a blind eye to real risks.

Gore, statesmanlike, tempers his warnings with a ray of hope, however. He said: "We may be closer to a tipping point than many imagine. The problems of capitalism as currently formed are so much more obvious, and problems arising from the build-up of carbon dioxide, for example, are so much more in view, that people are beginning to connect the dots. The two views [on short-termism in capitalism, and the impact of environmental change] are close to converging. We're hoping to accelerate the transition towards a sustainable capitalism."



Partners: Blood (left) and Gore (above) have published a white paper, Sustainable Capitalism

Five easy pieces...

Al Gore and David Blood have recommended five key actions for immediate adoption, which they say will bring sustainability issues into the mainstream of capitalism by 2020.

- Identify and incorporate risks from stranded assets [those whose value is highly sensitive to issues such as climate change]
- Mandate integrated reporting
- End the default practice of issuing quarterly earnings guidance
- Align compensation structures with long-term sustainable performance
- Encourage long-term investing with loyalty-driven securities

...and five not-so-easy pieces

The founders of Generation Investment Management also believe there are five broader ideas that merit support and attention.

- Reinforce sustainability as a fiduciary issue
- Create advisory services for sustainable asset management
- Expand the range and depth of sustainable investment products
- Reconsider the appropriate definition of growth beyond GDP
- Integrate sustainability into business education at all levels

The white paper is available at http://www.efinancialnews.com/story/2012-02-16/al-gore-david-blood-take-aim-at-short-termist-investors