Real assets:
BRINGING A HOST OF ADVANTAGES TO PENSION FUNDS TODAY

Our panel of experts discuss what real assets can offer pension funds today, which assets are proving most popular and why, and how real assets can assist pensions funds in meeting their ESG objectives

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Chair:

ANDY CHESELDINE
Professional Trustee, CCTL
Before joining Capital Cranfield, Andy acted as an adviser to trustees and employers at Watson Wyatt, Hewitt Bacon & Woodrow and latterly as a partner at LCP. Using his experience of over 30 years in consulting on both DC and DB pension arrangements and liaising with regulators throughout the pension and financial services industry, he is able to use his wide knowledge and understanding for the practical benefit of trustee boards.

Panel:

MARTIN COLLINS
Trustee Director, 2020 Trustees
Martin has worked in pensions for 30 years as a scheme actuary, a derivative structurer, a chief investment officer and as the employer for a £40bn pension scheme. This experience gives him empathy and understanding of the issues an employer faces, as well as the technical skills to be a first-class trustee. His particular strengths are investment and funding strategy and financial risk management. Martin is a regular contributor to the pensions press.

PAUL JAYASINGHA
Global Head of Real Assets, Willis Towers Watson
Paul joined Willis Towers Watson in 1998 and has been involved in manager research since this time. He is a senior investment consultant who heads Willis Towers Watson's real assets research team, which incorporates real estate, infrastructure and natural resources. Paul has previously been a member of Willis Towers Watson's portfolio construction group, which helps to determine the construction of certain client mandates.

CHRISTOPHE MONTCERISIER
Head of Real Estate Debt, BNP Paribas Asset Management

Christophe is head of real estate debt at BNP Paribas Asset Management. Having taken the role in March 2020, he was previously investment director, acting as team deputy head, since joining the company in early 2019 from Société Générale. Christophe has 31 years of industry experience. Prior to Société Générale he was head of business development at GE Capital Real Estate in Paris.

JASPAL PHULL
Senior Vice President, Redington Manager Research team

Jaspal is responsible for manager research and selection across real estate and infrastructure strategies at Redington. Prior to Redington, Jaspal was head of research and strategy for a real estate investment company, where he was involved in the acquisition and disposal of c£500m of commercial and residential real estate. Jaspal has recently assisted London CIV in a manager selection for the LCIV Renewable Infrastructure Fund.

STUART PAWSON
Senior Member, Real Assets Research Team, isio

Stuart is a senior member of isio's real assets research team. He has been at isio, formerly KPMG's UK pensions practice, for 11 years. His responsibilities include coverage of real asset opportunities and manager research, alongside ongoing client management. Stuart often speaks at industry events, and is a regular contributor to the pensions and investment press.

AMARIK UBHI
Global Head of Infrastructure, Mercer Alternatives

Amarik joined Mercer in 2003. He is responsible for overseeing the sourcing, due diligence and monitoring of infrastructure opportunities, and also the construction of portfolios on behalf of Mercer's clients. He is a member of the Infrastructure Investment Committee. Amarik began his career with Mercer as a consultant.

Chair: What are the general themes in the pension space today and how integral are real assets to pension investment?

» **Collins:** The big thing that's changing in the pension space is maturity – all schemes are maturing. Also, one of my clients is a consolidator which is, by its very nature, all about the end game. So there's been a trend towards lower risk assets; more and more credit. Part of the challenge is getting diversification within that universe.

Then, between the different clients, there's a different appetite for illiquidity. If you've got a chance of buy-in or buyout, then you have to be careful, because you're going to have to liquidate. But for those who have a long-term future, like the consolidators, then illiquidity premium is a big play.

» **Jayasingha:** I don't think real assets are integral to all pension investments today. Pension funds can choose to be completely liquid. For a scheme that's looking to buy out, for example, that could be a sensible approach.

On the other hand, if you're a longer-term investor, like a pension fund typically is, why would you want to be completely liquid? You can get an attractive illiquidity premium from real assets; you get advantages around diversification; and you can play attractive thematics in real assets too. That's why they have become integral to many pension schemes.

In terms of how things have evolved over time, over the last five years or so, real assets have been built into solutions that address the challenges pension funds face, liability solutions in particular. Over the next five years, we might see pension funds using real assets to address how they manage climate and carbon exposures within their schemes. Real assets are in fact blessed with having useful climate solutions within their spectrum, particularly within infrastructure. That's how the real assets space is likely to further evolve over time.

» **Montcerisier:** Real assets were not an existing asset class for non-bank investors 25-30 years ago. Today, however, you clearly see it increasing, year on year, in institutional investors' portfolios. One of the reasons is that, as interest rates were declining, and central banks were fighting against inflation, investors have been looking for an investment that provides them with extra yield but limited risk, and diversification was one key objective at a time when bonds were not offering optimum returns.

The other thing is that real assets comprise of a variety of products, ranging from equity to debt, so there is a lot they can offer pension funds.

» **Pawson:** What we like about real assets is the tangible nature of collateral and the contractual nature of returns. We've done a lot with our clients – those that are more mature and at better funding levels – around constructing portfolios with cash-flow driven investing strategies, where the cash raised from investments like real assets – which could be property, infrastructure and timberland, for example – spits off cash-flows that pay pensions. That's why we like them.

The difficulties are around how you plan for that illiquidity in the future life of the scheme. A lot of our mature DB schemes are 10-15 years from end game, and you need to be able to plan and manage the exit from the investments.

» **Phull:** A significant number of our clients are DB pension schemes, so where they are in their "flight path" can impact their ability to invest in real assets. What pension funds are increasingly interested in, however, is what role real assets can play in relation to climate transition as well as from a social perspective – these things are becoming more and more integral in their thinking. Going forward, that's going to have quite a big impact on how people invest as well as why people choose to invest in real assets.

» **Ubhi:** I agree that, on ESG, not only are we seeing interest with respect to climate change, but also the desire to demonstrate some kind of positive social outcome. That is particularly relevant to local authority pension funds, but also certain corporates as well.

On the DC side, we have seen the likes of Nest, for example, issue infrastructure mandates recently. This is also picking up the fact that real assets can play a diversifying, stabilising role within DC plans as well, but again the key is making sure that the structures are correct to allow for sufficient liquidity.

Finally, across different types of clients, the majority are surprised by the ability to take on illiquid exposure. Many pension schemes are conservative and risk averse, but when they actually consider, through modelling and scenario analysis, how much illiquidity they can actually take, versus how much they are currently exposed to, there is, in a lot of cases, some potential upside to allocations to illiquid assets.

Real asset allocations

» Chair: Which real assets are being considered most by pension funds?

» **Montcerisier:** It depends on each individual investor – the way they manage their assets and liabilities, and the time horizon that they have. Investments in alternative real assets are usually illiquid, so you have to have a balance sheet that allows you to invest into relatively illiquid assets. Having said that, real assets comprise of corporate loans, infrastructure equity or loans, real estate equity or loans, and so on – you have a variety of products and each individual product has different characteristics, in terms of the return, investment horizon, liquidity, maturity and so on.

An approach we have taken at BNP Paribas Asset Management is to offer those investors who have not specialised in each individual alternative asset class a mandate whereby we will allocate, as their manager, the percentage that will be put into each asset class, depending on the investor's liability matching.

So, you look at the time horizon of the investments, the maturity that they would be expecting, and then you blend all those categories into one management contract/fund, that is going to manage the mix between the assets.

» **Ubhi:** Data from our clients suggests that the most popular asset classes within real assets have been real estate, particularly core real estate, High Lease to Value (HLV) and infrastructure.

Our last European asset allocation survey suggested that the number of plans with an allocation to core real estate went up from 33% to 39% over the course of the year. Within that context, average allocations are around 7%, and this is across a wide range of different types of pension funds across Europe, of all different shapes and sizes.

Interestingly, that doesn't translate across to the more value-added or opportunistic nature of real estate. That market can sometimes be crudely segmented by vehicle structure, as well: a lot more interesting, the lower risk, open-ended type structures, as compared to the more closed-ended, more private equity like structures.

However, in contrast, in infrastructure, we've seen a general increase in demand, across both open and closed-ended, and across the risk/return spectrum.

» **Phull:** If I look across our client portfolios, allocations in real assets have been typically in UK core property and long lease funds. Even looking from an infrastructure perspective, a lot has been in core type funds, or when you're looking at renewables, much more the operational core side of that.

Where we've seen the most interest over the last eight to 12 months, and where we've been allocating client money the most, is renewable infrastructure. Over the last eight to 12 months, we have seen clients allocate c.£800m in renewable infrastructure. That's across a number of different mandates. That seems to be where the client interest is.

» **Jayasingha:** In terms of strategies being considered today, the contractual cash-flow assets have been talked about. That's been a big beneficiary. Alternative property sectors too, so healthcare, property, sustainable agriculture – these are all areas that we've been involved in with our clients.

I am not sure if it's captured in this space, but we've been big advocates of listed real assets because there are times, such as last year, when you can buy into very high quality real assets on the listed market at big discounts of net asset value. As long as clients can look through the short-term volatility of listed real assets, they offer a wide opportunity set for clients.

Benefits of real assets

» **Chair: How can real assets address pension fund concerns?**

» **Montcerisier:** Firstly, to put it simply, real assets provide a higher return than bonds of similar ratings.

Second, they offer diversification, as compared to public bonds. If you look at the real estate sector, for example, you can buy public bonds issued by listed property companies, but they are going to be mostly retail, maybe some office exposure. You may find some residential exposure, but it's not a very deep market.

So, if you want to truly invest in real estate, private debt is probably a better way than via public bonds.

Yes, public bonds are liquid, and private debt is illiquid, but the scale of the market is very different when it comes to private debt. For example, commercial real estate (CRE) debt has €250 billion origination in Europe per year, so it's a very deep market, much larger than the public bond market, as far as real estate is concerned.

"Real assets provide a higher return than bonds of similar ratings"

» **Ubhi:** The key challenges that pension schemes are facing, and are looking for real assets to solve, are some combination of cash-flow generation, inflation sensitivity, or ideally some form of inflation protection, stability and consistency of return, and also diversification from other asset classes.

Some real assets can help with some of those better than others, but there are also some challenges associated with getting all of those desired outcomes. One of the challenges at the moment is valuation in some parts of the market, particularly the lower risk, lower return end of certain real asset classes, as investors have moved in to try and capture yield and de-risk.

So, investors are struggling to make decisions. They're typically looking to de-risk from equities into other forms of asset classes, but the question is, what do they de-risk into? Notwithstanding the volatility we've seen in equity markets, if equity markets continue to perform so well, that also makes that decision a bit more challenging.

» **Phull:** In terms of the issues which real assets can address, there's the cash-flow generation perspective, and the yield that real assets can now offer. One of the other big aspects is around impact and the fact that you can use infrastructure, for example, to address climate transition, and you're even seeing more offerings now in real estate that can help on that side, as well.

The social impact side of things is also key. There's been a big emphasis on 'E' in ESG, the environmental impact, but more and more investors are also looking towards real estate, particularly the residential sector, as a way of addressing social impact.

» **Pawson:** A key point is ESG, how trustees can navigate sustainability and impact and how they can introduce that into their strategy. Real assets offer a really good opportunity to look at your portfolio and add something that does that job properly.

The spectrum of opportunity is great for pension schemes to be able to dip into and use. There has been a lot of focus on the question of how can we support a decarbonisation of the economy – and renewable infrastructure comes into play here. There's an awful lot of capital that's following this because it is a great asset class that delivers on loads of those metrics, and we're still seeing positive flows into that area, and we expect that to continue.

Social housing is the other area we've started to commit to, in terms of really hitting that 'S' of ESG and really making a change.

There are other concerns around the direction of travel of the funding code – how are you going to meet this long-term return objective that is actually relatively low, compared to where many schemes are now? You also need to do that on a sustainable basis and real assets can offer that, because there's a spectrum of risk/return targets that can operate in real assets. Everything from the high return opportunistic, all the way down to quite low risk such as ground rent/social housing strategies.

» **Jayasingha:** I would argue there are four major challenges that real assets can solve. The key one for a pension fund is paying pensions as they fall due. Within real assets, we're very fortunate of having certain assets that offer that long-term contractual and inflation-linked income. The low yield environment is another challenge that real assets can clearly solve.

Also, uncertainty around inflation is key here – real assets offer strategies that provide both an explicit link to inflation but also an implicit link. That implicit link is really important at a time when governments are changing the rules of the game around measures of inflation. One of the big benefits of real assets is that, over the longer term, you'd expect them to meet an underlying inflation measure over long periods of time. That's key in the current environment, where there's been lots of money printing and changes in measures of inflation.

Finally, as has been noted, real assets can help meet pension fund needs around carbon emissions and demonstrating to their members their positive societal impact.

Drawbacks of real assets

» Chair: What are the obvious drawbacks of some real assets?

» **Montcerisier:** The number one issue is accessing the markets. That's very difficult – you have to have your own network, your own origination capabilities, and that is not a given for all players in the market. The way that can be addressed is by selecting an efficient asset manager, especially in the asset class you are investing in, so that the asset manager will have the network and the capabilities to originate transactions.

Currency is also a potential issue, because hedging currencies can prove very difficult within funds. We tend to focus on funds which will be invested into one single currency. It could be sterling, it could be euro, but it's very difficult to have funds which invest in both currencies, because it is very difficult to hedge. So it's up to the investor to decide whether they want to invest into a euro fund or a sterling fund.

> *"The low yield environment is another challenge that real assets can clearly solve"*

» **Ubhi:** In terms of the drawbacks, the potential valuation challenges in some parts of the market come to mind. To me, that would suggest taking an approach which seeks to build a well-diversified and not just a high quality allocation to real assets. So we're looking at different types of asset classes, but then good portfolio construction, holistically, across the piece.

The associated challenges there are the governance requirements, because these asset classes are more complex than traditional asset classes, and it does take more trustee or investment committee time and resource to get familiar with these asset classes and build an allocation.

One of the other challenges we're seeing is, whilst you have a number of these push factors towards real assets, the big stumbling block can be governance rather than size. Very rarely have I seen the size of a pension scheme be a limiting factor in making an allocation to illiquid assets. It's typically been those discussions around time, effort and resource that is needed.

» **Phull:** On the valuation point, over the last year, as we have been in lockdown, many clients will have been sitting on the side-lines with regards to real estate and infrastructure, partly because of concerns around valuations. You saw that play out in real estate when funds were suspended because of the material uncertainty clauses. There were also concerns around infrastructure assets, although valuations have proved to hold up very well – but there was a concern during that pandemic period as to what would transpire.

» **Pawson:** In terms of drawbacks of real assets, where real assets have really succeeded in the past is bricks and mortar, tangible assets, things that trustees can see and understand. What's helped with our discussions in the past is that you can often go and visit a real asset and see it and know what you're investing in, know how you get paid.

When you start talking about more complex structures, however, or things like carbon credits, then you need to ensure that trustees can follow that narrative and understand what you're investing in.

Some of the liquidity issues and associated costs are also drawbacks, to an extent. We're supportive of the government's objectives around getting DC money flowing into infrastructure. I don't know, however, how they're going to square the circle in terms of management costs. How do you make it accessible for DC investors? At the moment we, as consultants, feel quite constrained with daily liquidity, default charge caps, and so on, so how do you square that circle to get infrastructure into DC?

» **Jayasingha:** In terms of drawbacks, it's interesting to consider how the industry had evolved. It has changed now to a certain extent, but it had evolved to perhaps starting with too high a leverage, too high risk strategies than what clients actually needed – certainly what pension fund clients actually needed.

That has changed somewhat, but that's been one of the drawbacks of the industry, although client engagement has now helped them get to a better point about what solutions work for them.

» **Chair:** As a trustee, how do you bring all of this together?

» **Collins:** With these types of assets, as trustees, you have to remember that there are always specific risks that you need to understand before you commit. Risk in itself is fine – it doesn't mean you can't invest, but you have to have diversification of risk and reward for risk, that's the issue. So how do you do the necessary due diligence to make sure you understand the risks that you are getting into?

For smaller schemes, fiduciary is often the only practical way to do it. Consultants are fantastic, too, so you can lean upon them, but it's important that the Board understands what they're doing.

Another risk is getting adequate diversification – the bigger you are, the easier it is to do this.

In terms of DC, there's a specific risk around liquidity. A lot of these attractive assets aren't easy to price, so you have issues around how you price people coming in and out. It's a shame because, particularly on the ESG side, there are some exciting things that DC investors would like to get into, but there are practical challenges about fairness of pricing before you can use them.

One Covid-related issue I'm concerned about is the change in the use of office space, because commercial property is such a big chunk of our portfolios. People are going into the office less and less. When you're committing to 25 years, to an illiquid asset, that's a concern I have as a trustee.

» **Montcerisier:** Picking up on the point that was made on real estate and the question marks around the liquidity, and the long-term view that you have to take – that is absolutely true. Something we are promoting now is real estate debt. When you invest into real estate debt, you invest into a much more secure asset than when you invest into a property.

You don't get the benefit of the upside on values if the property value increases. However, given the timing we are at right now, where property values have increased significantly over the last decade, is it not worth investing into different asset classes on the same property – the underlying collateral – which provides approximately the same return? Because when you think about it, if you want to buy a prime property, in any large city within Europe, you'd probably buy it on the basis of a cap rate of 3% or just below 3%.

Real estate debt can provide the same kind of return, so if you put aside any capital gain down the road, you have a very compelling investment instrument with a much lower risk because, basically, you lend – depending on whether it's a senior or a junior strategy – 60% of the value of the collateral. So you are very well protected in case values are declining.

Picking up on the point about fewer people using offices – and without getting into detail about the future of real estate and the impact of working from home on office markets and so on – it is important to stress that you have to deal with an asset manager that is very specialised in the asset class you are going to invest in, because you have to take into account all the future trends and try to navigate through the risks that are already on the table.

Real estate debt

» **Chair: Why, in uncertain times with significant structural shifts, are real estate debt investments a good opportunity as an alternative to real estate equities? Why is private real estate debt more attractive than listed real estate debt? What is the outlook for real estate debt?**

» **Collins:** In terms of the preference for real estate debt over equity, as schemes mature, it's a lower risk way to access the same source of alpha. That's the attraction. So, you're more protected as a debt investor against risk than as an equity investor. That's an argument for debt rather than equity.

As an investor, you should always be thinking: what's the best way to get paid for exposure to the same asset class? So valuation comes into it as well.

Often as a trustee, as well, when you're structuring your mandates, you don't want to artificially tie the hands of your manager. For example, if you have a manager that could invest in both, make sure they're able to tell you if they think you're in the wrong one, in terms of valuation. It's very easy to tie their hands in ways to give the wrong outcome.

In terms of private versus listed, private is always harder work, and there's more specific risk, but there's the opportunity for good returns. So again, if you've got the right managers, then private is something to look at.

» **Phull:** Given where we are in the current cycle, it does feel that we are at the top when it comes to property prices so perhaps, from a risk perspective, real estate debt looks very attractive now. We don't know where the economy's going, or what the overall fallout with Covid is going to be, so real estate debt does give you that cushion versus the equity side.

There is a lot of protection there. You have increased covenants and inbuilt protections into the funds. Also there are perhaps good opportunities now, because the banks have been withdrawing from the market and there is a lot of alternative lending (and that has probably even accelerated during this pandemic). That perhaps gives rise to opportunities for certain sectors, such as retail or office development loans – areas that people are concerned about, but probably still have some attractive opportunities. Specialised funds will be able to go into those and get those best opportunities. So, it does look attractive from a number of perspectives.

It does require a lot of specialisation among fund managers. If you are invested in certain positions and you have, for example, a foreclosure on those loans, can the manager then deal with the position that they're going to inherit? You've got to look at the capabilities, depending on where you invest, within the team and within the structure to manage those situations.

» **Ubhi:** The point about debt versus core, core plus equity is an interesting one. We do see that within the infrastructure space, as well. So, for investors that are able to take a more pragmatic, more holistic view of asset classes in their real assets portfolios, that arbitrage between debt and equity at this point in the cycle could be quite interesting, given the relative risk return that's on offer.

The other comment I would make as to why private real estate debt might be more attractive than public real estate debt – and again, this applies to the infrastructure debt space as well – is that the opportunity set is likely to be much larger. So the potential to identify good risk-adjusted opportunities is greater. Also, the ability to bilaterally structure and negotiate transactions, as opposed to transactions that may be larger and more syndicated in public markets, again is another source of potential value-add.

Finally, a lot of the work that we do, as specialists in the space – and trustees and investment committees do as well – is look at the bottom up; the specifics of a particular opportunity, or a particular fund or a particular manager. We also do need to increasingly pay attention to some of these thematic risks. Not to suggest that portfolio construction should be entirely top down, but the shift to working from home, and also what is going on, potentially, within the retail space, needs to be considered – what do these themes mean for particular subsectors?

Similarly, within the infrastructure space, we see the emergence of renewable energy and digitalisation and the move away from supported revenue structures and price mechanisms to merchant pricing: what does that all mean? If you've bought in on the basis of something being the same as it was forever more, but then the world changes, what does that mean for your investment thesis and your investment outlook?

» **Jayasingha:** Firstly, debt can offer some very safe investments, but it could offer less inflation protection than an unlevered exposure to a long lease property investment.

If you take the example of commercial ground rents, we can get pretty attractive terms, long duration, contractual income inflation, that's got explicit inflation linkage, and that can often be a more relevant type of cash-flow generative asset than real estate debt, which is typically much shorter in duration.

The second point is that pensions typically compete with insurance companies in the debt space. Insurance companies like that debt space because it has favourable Solvency II regulations around it and they don't have as much of that competition in the equity space.

So, if you're a pension fund, then there are greater headwinds in the debt space generally. That's not to say there are no opportunities. So, we're positive on the debt space. We'll pick out opportunities there. There has been regulation which has made it less attractive for banks in certain segments of lending, so there's an opportunity for pension funds but, generally, we want to be comparing private real estate debt to other types of bonds, rather than to equity.

We do think that the private debt space can offer less volatile, less reliance on larger issuers who have more negotiation power, so you can get better terms if you're a private debt investor generally.

In the near term, there could be opportunities for transitionary capital there. We talked about offices and how they need money to change and retail needs to change. So there could be opportunities for equity investors in real estate to tap into the debt market, as they transition their properties to something that's more relevant.

» **Pawson:** In terms of setting out what is an attractive asset, you need to define what you're looking for and set the investment objective of that asset. There are roles for both real estate equity and real estate debt in investment portfolios.

Would I say that real estate debt is

better? If you look at some of the portfolios that we've got in real estate debt, the sector allocations and the geographic allocations are actually quite different to what we're investing in, in terms of property equity. So you need to compare apples with apples, and make sure that you understand what you're getting into and what you're buying into.

In that context, a long lease equity portfolio may be a better risk-adjusted return than a five- to 10-year real estate debt fund that has quite high retail exposure.

In terms of private versus listed, our general view is that having private exposure with mostly bilateral negotiated debt is a more attractive position to be in than taking a vanilla piece of debt from the market and just buying your slice. Usually you get better contractual terms, you can put covenant protections in there, and we find that better for most DB schemes. Listed is easier to access, to get in and out of, but you are taking some of that market risk.

In terms of private credit, we expect that there are going to be winners and losers in the asset class over the next five years or so, we like broader private debt mandates that have the opportunity to selectively dip in and out of real estate debt.

» **Montcerisier:** I agree we shouldn't regard this as a competition between debt and equity – they can be quite complementary and debt can offer a way to diversify at a point in the cycle where it may make sense to do so.

As far as real estate is concerned, listed debt is very narrow, in the sense that when you look at the large, listed property companies, it's really retail property companies. You have one large residential in Germany, otherwise it's mostly retail, maybe a little bit office.

If you want to diversify your exposure to something different, such as healthcare assets, or data centres, it's impossible simply to invest into listed debt and do that at the same time, so private debt is the option in that space.

Infrastructure

» **Chair: How has the role of infrastructure in pension portfolios evolved? Are pension funds making the most of infrastructure?**

» **Montcerisier:** Infrastructure is definitely a desired asset class right now, within the alternatives space.

> *"We shouldn't regard this as a competition between debt and equity"*

Infrastructure is usually a longer maturity debt as compared to real estate, and usually, depending on whether you finance brownfield or greenfield, it tends to be longer in terms of drawdown, so the cash-flow profile is different. You don't invest immediately, usually, in infrastructure debt. It takes some time to deploy capital, and it's a longer maturity for the debt.

So, depending on the asset and liability constraints of each individual investor, that has to be taken into account but, having said that, it's a very low risk asset class. You have to look at the pricing of equity, because it's high right now, but if you are in the debt space, it's a great asset class to be in, as a source of diversification.

» **Ubhi:** The role that the asset class plays within portfolios has clearly evolved. It has gone from people not knowing what it was, to establishing its credentials as an asset class in its own right. It's not real estate, it's not private equity, it has its own particular risk/return characteristics, and therefore potentially merits an allocation on a standalone basis.

The roles in which investors are using the asset class within portfolios have also evolved. The first, and I would say most common, use of infrastructure within a portfolio is as a diversifying asset class, as a way of de-risking portfolios, but still providing a long-term source of equity-like return, but ideally at lower volatility and providing genuine diversification within a portfolio from public equities and fixed income.

We have also seen infrastructure broaden out both at the lower and upper ends of the risk/return spectrum. Looking at the lower end of the spectrum first, we have seen lower risk equity strategies in the core, core plus space, incorporating unlevered equity, form part of cash-flow generating type strategies, particularly important to pension scheme investors. Then typically combined with other types of equity in that space, so typically real estate, HLV, et cetera.

Then, if we take a step lower on the ladder, we have junior infrastructure debt, which we've found has been used as part of broader private debt portfolios, maybe as a lower risk form of private debt, asset backed.

Then an area that we haven't seen grow as much as expected is senior secured infrastructure debt as part of a liability matching portfolio. We've seen some of our more sophisticated clients incorporate portfolios, typically on a bespoke basis, into their broader LDI strategies, and do that successfully, but it's not as common as I would have thought it might have become.

Then, at the upper end of the spectrum, the asset class itself is growing and evolving, and within that context the approach that managers are taking within the space has also evolved over time. We're perhaps seeing some unwelcome trends in that regard, in terms of ever-increasing fund sizes and an element of style drift.

Interestingly, one way of potentially capturing that is to think about some of those strategies as being asset-backed private equity, rather than infrastructure. So, if you're looking to diversify your private equity portfolio, can you do that using some of those types of approaches instead?

Then there is the increasing focus on climate change within portfolios. Our asset liability modelling has incorporated a climate change filter, effectively, for a number of years now, providing another perspective on traditional mean variance analysis. Infrastructure is being considered within that context, both as being climate change positive – if you think about renewable energy and energy transition – but also having legacy climate change negative impacts for investors.

If we extend that further into the desire to have more of a positive impact, achieve some kind of social outcome, our experience has been that good investment performance in infrastructure is almost invariably linked to good ESG integration. There is a natural alignment between getting a positive outcome or some form of social good indirectly, through having an infrastructure portfolio that is performing well from an investment perspective.

» **Jayasingha:** In terms of how a pension fund uses infrastructure, it's more buy and hold now. We're seeing far more buy and hold strategies, rather than buying a good quality asset and then selling at an arbitrary date just because their fund is expiring.

There is also an expanding number of sub-asset classes within infrastructure, so tech-enabled infrastructure, for example. The idea that broadband and fibre is seen as a utility now, alongside water and power, highlights this point. This has to of course go alongside a skill-set from the managers that allows them to effectively manage those assets.

Then the idea of infrastructure being used partly as a climate solution is key, so not just renewables, but also battery technology – electricity networks are being seen as needing more capacity, if we're going to move up to greater electrification, as well.

"There is still some reticence about using infrastructure"

» **Pawson:** In terms of the role of infrastructure and how it's evolved, the types of assets are broadening – the area of technology being a prime example. We're all working from home more, so we need greater broadband infrastructure, and that investment is going to need to come from somewhere.

In terms of how fund managers are dealing with infrastructure and building products that meet client needs, this is evolving. There's a much better dialogue about what risk/return target clients need, and how we build a product that delivers that. If you go back 10 to 15 years, everything was PE structured, everything had a 10-year life, it was all centred around IRR, and that ticked the box – and that's just not what clients want. Clients want to be able to see cash-flow come through from the assets to a portfolio that meets their required return. We're building portfolios around that basis and working with managers to develop those solutions.

That's not just in relation to infrastructure. That dialogue and that improvement of working with the management industry is something that's happened over the last 10 to 15 years, and it's really about getting better solutions and better client portfolios.

Are pension funds making the most of infrastructure? I don't think so. There's still some reticence about using the asset class. In terms of understanding what the assets are and how you get paid, that's something that is not understood by many pension scheme trustees.

Our job as consultants is to interpret and help clients on that journey, and build it into portfolios, and we've had some great success in the last few years with putting some new infrastructure mandates in. Renewable energy is one of the ones that there's been a lot of focus on in the last couple of years. That is improving, but there is still a large proportion of pension scheme trustees that are not investing in infrastructure, and they're ignoring a positive, attractive asset class.

» **Phull:** Pension funds have historically been attracted to the stable, Inflation linked cash-flows and diversification that infrastructure provides. Today, it also offers the opportunity to invest in Key themes and global structural trend's that have accelerated due to COVID. You're seeing more funds focusing on mega trends such digitalisation & energy transition as well as demographic changes.

One concern is when you look at funds moving into some of these areas, what is the incremental risk that these funds are now taking on? From our perspective, it's about trying to understand what that risk is and what the client is actually buying into. So the biggest concern is when we see investors moving away from infrastructure into the more private equity realms of investing.

I agree pension funds are probably not making the most of infrastructure, but that's generally down to a lack of understanding. These are complex asset classes. Whether it's renewable infrastructure, whether it's social infrastructure, it can be challenging for a pension fund to understand. Saying that, trustees are becoming more engaged and wanting to understand more, because they've realised that there is a big part that infrastructure across the board can play in their portfolios.

» **Collins:** Infrastructure offers the potential for great returns and diversification, but for trustees it also gives us extra governance challenges. So you must understand the specific risks of the investment and think about your correlation with the rest of the portfolio.

One thing I've always been wary of with infrastructure are inflation-linked returns, because sometimes they're artificially created. I don't like those within infrastructure, because I can hedge that risk precisely and more efficiently with LDI, and sometimes I'm being overcharged for something that's been artificially created. I'm wary of inflation. My message to the management community is, don't try and create a product that solves all my problems. Just give me some great infrastructure at a great price. For me, it's about getting access to a great class of assets that's just not represented in the listed markets.

On the topic of ESG, I'm particularly excited in the UK about the green infrastructure opportunities that are starting to arise. If the government does go with the green revolution it's talking about, there should be a lot more. For me, as an investor, that's about two things. We all want to use the assets we control for good, if we can, but we can't get somebody else to pay for that indulgence. It's got to be at a good price.

This is an area where it could come together, where there's going to be a need for investment, so it can be priced appropriately and you can hit both targets. You can use the assets for good, and get great returns, potentially, for investors.

Also, on ESG, it's introducing a whole range of new risks, because it is getting well priced into assets now, so there's the risk of a pricing hit because something goes wrong, but also then possibly being overpriced, because there's a stampede into them, so it's something to think about.

» **Pawson:** To date, a lot of our discussions with clients on ESG have been about assessing where managers are and how they're managing their long lease assets and dealing with tenants. Clients really do want to see change in portfolios, to be doing ESG well. It's not a tick box exercise.

Where we're really getting traction is looking at impact portfolios or portfolios focusing on sustainability, because clients really see this as a long-term risk. If you've got a long lease, for example, it's 20 plus years. If you've got an infrastructure asset, it's 30 years. Climate transition is going to impact these assets and we need to be aware of those risks.

There's also the opportunity side, in terms of climate transition and making sure that you're an early mover in things like renewables or timberland – making sure you're ready for that transition, and making sure that your scheme is set up for it.

The other thing that I must mention is – and we're working with the Investment Consultants Sustainability Group on this – managers reporting on key metrics and KPIs. How are we actually measuring ESG in portfolios? This is something that all managers need to take on board and improve, and across all asset classes. We need to know what the current impact is, what the current climate emissions are. Clients are already starting to need to report on TCFD, and we're not getting the data from managers. It's a fundamental thing that the management community need to take on board and improve, quickly.

» **Montcerisier:** We take ESG extremely seriously at BNP Paribas Asset Management, and one of the key points effectively is to say: how can we measure the impact we make, be it in relation to infrastructure, real estate, and so on.

We are also encouraged to do so because of this European legislation around SFDR.

We have worked with many third party providers, and we have found the solution to quantify precisely, for each investment we make, the environmental contribution of this investment. We call this the Net Environmental Contribution. That is going to be extremely powerful.

» **Phull:** From a historical perspective, ESG has just been about looking at the risks and trying to manage those risks in relation to the kind of building that you own or you are building.

Going forward, there's a realisation that the best in class buildings, with the best ESG credentials, will hold more value, not just from an environmental perspective, but social, health and wellbeing. These are the buildings that we require, the workforce requires. From a manager perspective, there's a realisation that you can't think about this in five years, because by that time it might be too late. Because once all these issues become factored in, it's going to hit the value of your building, so you've got to address it now. ■