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STATE OF THE PENSION FUND INDUSTRY

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Pension Funds Infrastructure Investments – Who Benefits?

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The contentious issue surrounding infrastructure development investing for pension funds is the question – is it the role of the private sector, pension funds in particular, to develop infrastructure? Is this not instead the sole responsibility of the government of the day? Further, is it not that pension funds' first responsibility is to their members?

Trustees have a fiduciary duty to only invest in assets where the reward is market-related and the risk acceptable. With that fundamental legal requirement, and in the backdrop of a highly taxed environment such as ours, it becomes particularly difficult to justify why the private sector should be expected to play an active role in infrastructural development.

Infrastructure projects include power generation plants and transmission grids, toll roads, railway lines, bridges, road and airports, hospitals, education facilities, communication towers, and many other such amenities. But who, in the bigger scheme of things, actually stands to benefit from investments in such developments?

There is an argument to be made that, where they invest in infrastructure, workers will be able to retire in well-developed communities. They will also be able to witness, and derive satisfaction from, the fruits of their own investments. Even where they are not blessed enough to live that long to enjoy the fruits, their children will, and so will generations that come after them.

In Swahili, they have a profound ancient proverb, "We do not own this land, but we owe it to our children." – maybe, the same can be extended to infrastructure as well. At its very core, infrastructure investment is not just a financial investment, it is a source of hope, and a significant part of its yield is a better future.

Wide Fiscus Funding Gap

While we dislike excessive taxes, if the private sector does not play its part as the situation we currently find ourselves in demands, then the government will simply be forced to introduce more taxes to fund any infrastructural projects required, no matter how unpopular that move could be. Of course, there is a reason we dislike taxes – there is no guarantee that once in government hands the collected revenue will go towards its intended objectives. Other than creating another tempting “cookie jar”, even where the government has all the right intentions, there is bound to be a lot of spillages in the delivery system. It will cost more in the hands of the government than the private sector – it is just the nature of how governments operate.

Importantly, private sector infrastructural development will lighten the burden on the fiscus – allowing the government purse to focus more on other more critical priorities – for instance, social welfare. As if to acknowledge that, we have seen the Ministry of Finance bringing to being, and supporting, a prescribed assets status regime that is designed to promote infrastructure funding by pension funds. Workers are best advised to embrace these gestures of good will and build the infrastructure themselves. The same dollar under government’s control generally produces less than the same dollar in private control – meaning, workers would have to be taxed a lot more for the same result.

Even if the government had the political will, it just lacks the financial capability. There is a huge funding gap which seems to keep widening as our old infrastructure stock becomes due for replacement or refurbishment. This is before we even start talking about any new additions to the inventory. Funding from multilateral development agencies and other donor funding is unlikely to fully fill this gap.

“Two-in-One” Investment

Infrastructure, as an asset class, has both the capital growth and income generation attributes – just the right combination for long term investing. Only very few other asset classes have those characteristics in combination – certainly not listed equities or conventional bonds. The growth is also in real terms. In the absence of inflation-linked bonds, and with a listed equity space struggling to beat inflation, this is a much-needed quality. In fact, infrastructure gives investors the equities-bonds characteristics in one asset class – a “two-in-one” type of investment. That is also what direct property has always been believed to be able to do, but in a post COVID-19 environment the fortunes of property investment are facing significant headwinds.

Worthy emphasizing further that infrastructure investment is a direct investment into the economy as opposed to simply investing in the secondary listed equities space with no immediate and direct benefit to the real economy. Studies have gone as far as to quantify the relationship between infrastructure investment and economic growth: a percentage point increase in potential GDP growth requires investing 1% of GDP in infrastructure.

Upfront Challenges

While the benefits of infrastructure investments to the already converted could be obvious, there are pertinent challenges with the asset class. The one that comes to mind immediately, in our case, is just the absence of bankable projects into which capital could be deployed. The few that are there are mostly at the conceptualization stage. The World Bank classifies these as Greenfields investments. They are extremely risky – probably more so in our case due to a lack of a well-developed infrastructural investment ecosystem. Boards of Trustees, exercising the duty of care and utmost good faith, are well-understood to exercise ultra-caution with Greenfields investments. Risks associated with the development stage of any infrastructure are not generally the types of risks that pension fund members are open to, for instance, risks of poor workmanship resulting in the project being condemned before it is commissioned.

Brownfields investments, which are one notch above Greenfields, are less risky as they involve investing in additional funding requirements for projects that are already operating. They have very little in terms of construction risks prone to Greenfields investments.

The least risky of them all are the Secondary Stage investments. Their name is of course self-explanatory, they carry relatively less risk, and not surprisingly, their returns are also relatively lower.

With Greenfields, which make up the bulk of what we will have at the outset, there is also the issue around lock-in periods while the project is underway. This could be quite long – a power station, for instance, could take as long as 15 – 20 years to build. Very few pension funds would be able to wait that long before starting to receive an income and with no option to disinvest. Then there is also the liquidity challenge even where the project is up and running. There is no guarantee that, as an investor, a pension fund will be able to find a willing buyer at a fair price when it wants to exit the position.

Industry Fragmented

In a Defined Contribution environment, it matters much at what value are pension fund assets reported. Those are the values based on which members' benefits will be determined. With infrastructure investments, especially where the sector is yet to fully develop, as in our case, any such values are likely to be highly subjective. At any point in time thus, some members will benefit at the expense of others, leading to an unfair and unintended redistribution of wealth.

Closely related to these concerns are issues around the indivisibility of infrastructure due to the massiveness and scale of the individual investments. This is especially so for small-medium-sized pension funds, of which we have quite a good dominance of them. So, while the push for infrastructure investments could be all good and well, a lot of retirement fund members would be closed out of the opportunities it presents. What we need first are two things, firstly, a well-designed infrastructure investment system, and secondly, a robust consolidation of the retirement fund sector. The latter speaks to a need that we have highlighted in our previous papers – consolidation of the pension fund industry into umbrella funds.

Too Much Public Influence

Absence of a known track record and related benchmarks are also a concerning challenge – Trustees cannot just invest members' money on the basis of promises that such very long-term investments will be able to generate good returns. With no track records, Trustees will be acting in a way that could potentially be considered as failing on the duty of care if they are to just pile up members' money into infrastructure investments. This is especially so considering that we currently do not have that much deep competence levels for analysing infrastructure investments amongst our Trustees. So, there will be a lot of reliance on consultants who, if not properly vetted and scrutinized, could make recommendations based on their own self-interests.

Furthermore, while good returns in real terms are theoretically possible, there is no guarantee that all projects will generate the returns claimed in the proposals. Infrastructure development, just like any business that is anchored on an idea, carries a significant risk of failing on its construction path, on completion, or in execution. For such a long-term investment, Trustees will be best advised to exercise maximum caution.

To successfully address some of these issues, the government will need to play a strategic role beyond that of just setting the regulatory framework and supervisory oversight. It will need to also get down and dirty and be a part to every project in a commercially meaningful way. Public-Private-Partnerships will be a significant part of the solution to this.

Of course, if the private sector is going to heavily invest in infrastructure, they will require a commitment from government for policy consistency. Based on experience, that consistency cannot necessarily be taken for granted – a serious concern for any investor, but more so for investors in such very long-term projects. Worse-still, by its very nature, whether publicly or privately funded, infrastructure will always attract a lot of political influence – either in the project development phase, or at the time of rendering services. Policy consistency is therefore critical to reduce political risk on long term infrastructure projects. It cannot only be promised but must be seen to be practiced.

There are also no guarantees that if you build it, they will use it. South Africa today is grappling with the possibility of completely writing off its Johannesburg e-Toll System. This could permanently wipe out several billions of investments that went into it. How the investors of that project will be compensated will certainly be a popular case study for legal scholars for years to come. No doubt, it is certainly a case that is going to keep their courts busy for quite some time.

Very Little Diversification

In a fast-paced world we live in today, tastes and behaviour change over time. A much-needed infrastructure today might be obsolete by the time it is completed in say 15 years' time. Starting to build a coal-powered power station today could fall victim, upon its completion in 2035, to the net-zero commitments of the government.

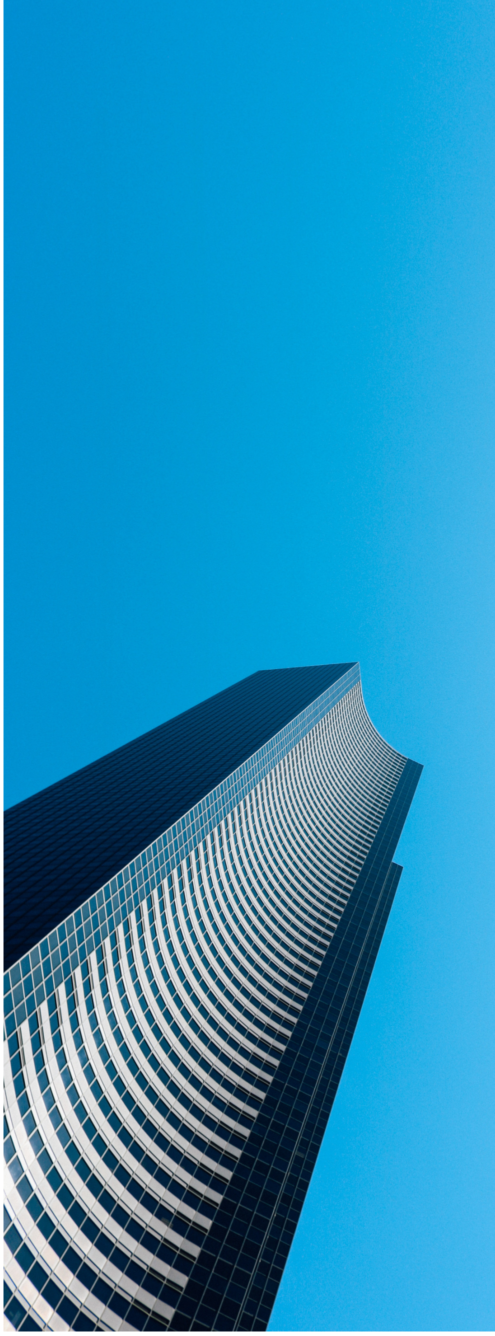
Even where there is no issue around changes in behaviour, infrastructure investing is just fraught with risks only a few investors can take, least so pension funds. Think of all the stadiums South Africa built ahead of the 2010 soccer world cup. They are now all mostly lying ideal, and it is said they cost more to maintain when they are not in use than when they are in use – and the taxpayer is having to suffer heavily as a result. Never mind how much financial pain investors are having to endure on these yesteryear's national prides that are today's national white elephants.

The absence of an already well-developed infrastructure sector manifests itself in many different challenges. Where there aren't many projects, it is difficult to create a well-diversified infrastructure portfolio, a basic requirement for any portfolio construction exercise. Those funds that choose to tap into the returns of the sector will find their investments overly exposed to only a few projects. At an industry level, this will have an immediate impact of pushing up the prices of those few viable projects – thus dampening down prospects of good future returns for the investors. An ideal system would be one where there are immediately available multitudes of infrastructure projects at different levels of development. We do not have that currently, and we will not have that at the outset.

Conclusion

In a market devoid of bonds, and with a shrinking stock exchange, infrastructure investments could be the saviour. With the overwhelming need today for diversification, lowly-correlated investments, stable income, and inflation-beating returns, infrastructure investments are an ideal consideration for portfolio optimization. The challenges at hand are not fundamental but rather structural and with the right intervention from the government, at a policy and strategic level, they can be addressed. Trustees should brace themselves and be actively looking out for infrastructure investment opportunities. Other markets are further down the road as what used to be called alternatives is steadily, but increasingly, becoming mainstream. Canada and Australia are at the front of the curve on this, and here closer to home, South Africa is ramping up its allowable limit to infrastructure investments for pension funds to a whopping 55%.

Making government decisions and policy positions less confusing, less ambiguous, more predictable, and speedier is not just logical, it is critical to the future of the infrastructure sector — and by extension, similarly to our country. On their part, pension funds may need to establish a not-for-profit infrastructure fund manager which they jointly own and is tasked with the management of a pool of assets drawn from all the participating schemes via an open-ended funds arrangement. In successfully doing so, two of the government's public policy problems could be addressed simultaneously. These are of course, firstly, that of many pensions failing to deliver comfortable retirement to members due to, among other things, inadequate investment returns. The second one being that, not only do we need a new stock of infrastructural developments for the modern economy, the old ones are also long overdue for refurbishment and replacement.



Our monthly publication is aimed at inviting conversations from like-minded individuals with a view to engaging in forward-thinking-led discussions on how we can collectively improve the state of our industry.

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