Institutional infrastructure investing: Australia versus Canada

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Australia and Canada are the two leading countries in terms of institutional infrastructure investing. Australian pension funds have been pioneers in the field since the early 1990s, when their financial industry invented 'infrastructure as an asset class'. Large Canadian pension plans spearheaded *direct* investments in infrastructure over the last decade. Today, these two countries have the highest asset allocation dedicated to infrastructure by pension funds across the globe, i.e. about 5 per cent (Fig. 1), against a global average of still only roughly 1 per cent.

Lessons can be learned from the experience in these countries. The recent OECD working paper[1] looks at factors such as infrastructure policies, the pension system, investment strategies and governance of pension funds.

Commonalties and differences

With pension assets of about US$1.5tn each, Australia and Canada rank in places 4 and 5 in global comparison, behind the USA, Japan and the UK. Both countries were, with the UK, early adopters of public-private-partnerships (PPP). There are more commonalties between the two countries, in particular a trust-based pension system, the absence of restrictive investment and solvency regulation, and a relatively stable political environment.

There are also some marked differences. Australia's infrastructure industry started with a bang of large-scale privatizations in the 1990, while Canada is still largely abstaining from privatizations. Canada has a well-functioning project bond market while Australia has not. The occupational pension systems are at the opposite ends of the spectrum: voluntary defined benefit (DB) in Canada and compulsory defined contribution (DC) in Australia.

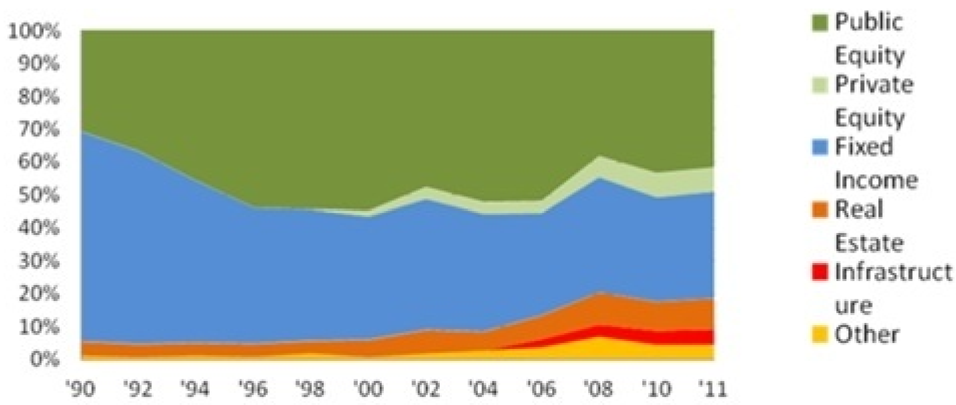
Key factors contributing to Australia's growth story are:

- The coincident privatization of public assets by the Government and the introduction of a compulsory superannuation system in the early 1990s.
- The continued growth of pension assets on the back of economic growth and favourable demographic trends.

- The emergence of financial intermediaries such as investment banks and asset managers that fuelled the private investment boom in infrastructure.
- The belief of trustee boards, especially of industry-wide pension plans, in infrastructure as a useful asset class for a core range of DC (default and other) investment options.

Canada's infrastructure growth story is mainly driven by the asset allocation policies of larger public pension funds. It could be summed up by two paradoxes. First, Canada's pension funds are major infrastructure investors in the global context, but most of the capital goes overseas, given the near abstinence of the country from large-scale privatizations of public infrastructure assets. Second, Canada has a well-functioning PPP model, and yet, pension funds are not major investors in it. A key reason for this is the small 'ticket size' because PPP projects often are too small, highly leveraged with an equity share of less than 20 per cent.

Figure 1: Asset mix of Canadian pension funds



Source: PIAC (asset mix of plans of sponsor organizations represented by members)

Different pension systems and investment vehicles

One of the main findings is simply that substantial infrastructure investments are possible in very different pension system. It is often assumed that DC has prohibitive features for bulky, less liquid investments because of the large number of small individual accounts and the requirement of daily or weekly fund valuations. In fact, Australian members can switch funds easily and short-term. And yet, perhaps paradoxically, Australia's industry-wide DC superannuation funds have produced a remarkable infrastructure investment history. Among the contributing factors one can list positive net cash flows into superannuation funds, the use of default funds, and a wide-spread political and trustee commitment.

Illiquidity is often seen a hurdle also for mature and underfunded DB schemes. Here the 'maple revolutionaries' (The Economist) of Canada found their own way. While pension funds have been 'de-risking' at the expense of listed equities, they were not forced into bonds by regulators (as, e.g., in some European places) but have diversified into alternative assets (estimated at 23 per cent).

Especially real estate and infrastructure are used not only to diversify portfolios better but also for their long-term yield characteristics in liability-driven investing (LDI).

A second takeaway from the two countries is that infrastructure investment vehicles can evolve and adjust according to investors' needs. In Australia, initially listed infrastructure funds were most popular. These days, pension funds prefer outsourced, open-ended infrastructure funds, or 'aligned asset managers', at comparatively low cost (the 'new Australian model'). In contrast, the 'Canadian model' of infrastructure investing is about *direct* investing with in-house staff, aiming for better control and lower cost of investment.

Investor scale and resources

A third crucial feature is the importance of pension plans' size when investing in less liquid assets. Both countries have a highly fragmented pension scene. Private, unlisted infrastructure investing is primarily driven by large-scale funds - some of them with allocations of 10 per cent or more - while smaller funds mostly invest little to nothing (Table 1).

Table 1: Top 10 Australian Funds: Infrastructure Allocation

	Fund	Market Segment	Fund Size (USD$b)	Conservative Option (30/70)	Default Option ** (70/30)
1	Future Fund	Sovereign	73.0	5.2% *	n/a
2	AustralianSuper	Industry Fund	43.0	9.0%	14.0%
3	QSuper	Government	32.4	3.1%	6.2%
4	State Super (NSW)	Government	32.0	5.1%*	13.8%*
5	First State Superannuation Scheme	Industry Fund	31.2	17.0%	3.5%*
6	UniSuper	Industry	29.0	0.0%	5.0%
7	Retail Employees Superannuation Trust	Industry Fund	20.4	4.0%	6.0%
8	Australian Reward Investment Alliance	Government	19.8	not available	13.8%*
9	HESTA Super Fund	Industry Fund	18.3	6.0%	10.0%
10	Sunsuper	Industry Fund	18.3	4.0%	5.0%

Source: AMP Capital

Fourth, asset owners need adequate resources, especially when investing directly: governance, management, operational, legal. Some Canadian plans admit that their own estimates of time and other inputs were too optimistic at the outset. Smaller pension funds traditionally invest via external funds although a number of them are now trying to co-invest alongside larger ones. There is much talk about different models of investment alliances and syndication.

Lessons for investors

In terms of the actual performance, the experience has been mixed to fairly positive in both countries so far, but varies considerably across investors. Unfortunately, the data is still surprisingly poor. Many assets and products more or less produce the expected income and return profile. However, there have been disappointments during and after the financial crisis, and those can weigh heavily in highly concentrated portfolios.

Investors learnt some lessons learnt the hard way:

- overly optimistic demand projections and overvaluation of assets during the boom years (especially in the mid-2000s)
- poor risk assessment (e.g. demand risk of transport assets) and risk management (e.g. excessive leverage)
- market volatility of *listed* infrastructure funds (the 'old Australian model')
- governance and fee issues with infrastructure funds
- pitfalls in investing in less-known overseas jurisdictions.

Lessons for policy makers

Important lessons can be learnt not only by investors but also policy makers. Governments in many countries would like to push more private capital into *new* (preferably domestic) infrastructure projects. However, most insurance companies and pension funds are mainly interested (or able) to invest in low-risk, operating assets. Therefore, the idea of 'asset recycling' is popular in Australia, i.e. the sale of old public assets to finance new projects.

In recent years, both countries have tried to increase the efforts in infrastructure spending and in private financing, and have also been consulting investors and the infrastructure industry more. In Australia, a vast proportion of PPP projects initially consisted of large transport items, in particular urban toll roads and tunnels. There is a reform process is underway to identify weaknesses and to 'retune' the PPP model.

PPP and project bonds

After closing some high profile projects in the early 1990s, Canada had been stagnating in the use of PPP. But the PPP market has been steadily growing since the mid-2000s in the healthcare, road and justice systems and also the water sector. The Canadian PPP process is characterized as comparatively clear and competitive. Despite closing some high profile projects in the early 1990s, Canada generally has lagged behind in the past in the use of PPPs.

So far, the focus of Australian and Canadian pension funds has been primarily on equity. Although the interest on debt is rising, there is no such urgency for long-term investors to substitute banks as perceived in Europe. Canadian banks provide infrastructure loans relatively short term, up to a maximum of 7 years or so. Project bonds play a much bigger role in North America. In Canada, insurance companies have been involved in long-term debt for decades. Canadian infrastructure bonds tend to be investment grade; contrary to Europe and Australia, monoline insurers never played a role in Canada. Governments in other regions need to realize that such project bond markets cannot be jump-started overnight.

Global market, global competition

From the outset, infrastructure has been a global asset class with surprisingly little home bias. Canadian pension plans had to find big infrastructure tickets in Europe or elsewhere from the beginning. Australia's pension funds increasingly need to seek opportunities overseas. At the same time, their experienced infrastructure investment industry can export their services in other regions. Eight out of the top 20 global infrastructure managers are Australia-based.

However, political and regulatory stability are paramount for the attraction of international capitals. Investors express increasing concerns about the supply side, such as inconsistent infrastructure policies, the lack of a suitable project pipeline, retroactive changes of rules and regulations, especially in the energy sector.

Following the examples of institutional investors in these two countries, the demand for infrastructure assets is potentially very high. Many countries are these days competing for private capital, often with attractive sweeteners. For investors, however, it will remain difficult on their path to bypass the traps of political opportunism and cyclical overvaluation of infrastructure assets.

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[1] *Inderst, G. and Della Croce, R. (2013), "Pension Fund Investment in Infrastructure: A Comparison Between Australia and Canada", OECD Working Papers on Finance, Insurance and Private Pensions, No. 32, OECD Publishing. (Available here.)*