CAPITAL ECONOMICS

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The rise of ESG and infrastructure as an alternative asset class

Headwinds to equity and bond markets in near-term leave investors looking for alternate opportunities

We expect the next ten years to be generally less rewarding for investors in conventional assets than the last ten. (See our piece on the outlook for long term real interest rates for further details.) This will leave investors looking towards alternative asset classes, including infrastructure, where returns may be more promising.

Price pressures have been building this year, and we suspect that a potential legacy of the pandemic will be an institutional slide towards tolerating higher rates of inflation. However, we do not think that inflation will climb to rates that will be damaging for economic growth, or that it will be accompanied by meaningfully tighter monetary policy. So, in our view, markets will not falter in the way that they did during some periods of higher inflation in the past. That being said, slightly higher inflation and gradually rising policy interest rates will weigh on fixed-income returns, while higher bond yields will likely be a headwind for the valuation of equities in the years ahead. We think that the returns from most risky assets from here will be far less impressive than they have been since the spring of last year. That reflects not only our view that bond yields will climb further, but also that we see limited room for global growth to surprise on the upside. As such, future gains in corporate earnings growth are now largely discounted. Additionally, valuations already appear fairly stretched in many cases.

While the economic backdrop over the coming years may be less supportive for more traditional assets than in the past, there are still a wealth of opportunities to be had. The recent global market turmoil has seen a rebalancing of many asset manager's portfolios away from listed equities and a greater willingness to examine alternative asset classes in the search for enhanced diversification and yield. One such class is infrastructure.

Infrastructure investment opportunities abound on the back of post-pandemic recovery plans

Infrastructure assets offer a number of attractive investment characteristics. Driven by longer-term factors like demographics and often providing essential services, infrastructure investments can better weather short-term challenges and often show durability even through times of economic turbulence. Additionally, infrastructure assets in certain sectors, like toll roads and utilities, have revenues linked to inflation through regulation, concession agreements or contracts. They can therefore provide some hedge against inflation.

COVID-19 has highlighted the critical importance of things like reliable connectivity and internet access, as well as accessible health care facilities. The pandemic has also created a legacy of higher rates of home and hybrid working and accelerated the online shift of retail. Considerable amounts of investment in infrastructure are needed to respond to this "new normal". Much of this investment will be focussed on digital technologies, such as data centres, fibre-to-the premises and satellite internet. And supply chains will need to be more resilient to minimise disruptions, further necessitating the need for new infrastructure. Indeed, government policies to revitalise economies post-COVID have been heavily focused on infrastructure as a central component of their recovery plans, given the effectiveness of this type of spending in delivering economic stimulus. Governments have historically footed much of the bill.
Yet with public debt-to-GDP ratios reaching multi-decade highs and government balance sheets strained, there is an increasingly important role for the private sector to help fund major infrastructure projects. As such, the opportunities for infrastructure investors is strong.

Infrastructure investment is not only being used to support post-pandemic recoveries, but to help diversify economies away from their dependence on fossil fuels and towards greener and more environmentally sustainable technologies. Governments around the world have made ambitious commitments to cut greenhouse gas emissions over the next 30 years. And the COP6 summit at the end of October may accelerate action towards the goals of the 2015 Paris Agreement. Infrastructure has a key role to play in helping nations achieve their climate targets, with government policy measures geared towards developing transport, electricity and home heating projects, among other areas.

ESG considerations are becoming an increasingly important component of infrastructure investing

At the same time as investors are seeking alternative assets to invest in, there is an increasing movement to consider environmental, social and governance (ESG) principles in investment decisions. A recent survey by Natixis Investment Managers in 2021 found, for example, that the number of professional investors adopting ESG has grown by 18% since 2018. And by 2020, an estimated US$40.5 trillion, or over one third of all professionally managed assets, were subject to ESG criteria according to research firm Opimas.

While the practice of ESG investing dates back to the 1960s, when investors focused on ethical or moral considerations (e.g. excluding particular industries, like tobacco, from their portfolios), the field has since expanded to consider financial relevance as well. Based on our discussions with a number of infrastructure investors, understanding a company's core strategy, business ethics, supply chain management, customer privacy, employee diversity and ecological impacts is increasingly important for infrastructure investment. These investors see ESG considerations as helpful in creating long-term value as well as an aid to mitigate long-term risk.

ESG considerations have the potential to accelerate diversification into renewable energy and technology, as companies manage their climate risk. There has been increased pressure on infrastructure investors, for example, to decline funding for carbon-intensive projects such as coal. The challenge at the moment is making sure that the increasingly high ESG expectations of investors are being met while at the same time not compromising returns.

The environmental aspect of ESG investing typically receives the most attention, as its metrics are more readily quantifiable and comparable. Social and governance metrics can be more challenging to measure due to their more qualitative nature. While firms that provide benchmarks for investors to integrate ESG considerations into their investment processes have made progress in recent years devising indices that better capture "S" and "G" performance, there is no industry-wide benchmark that most investors would agree on.

Nevertheless, the latter two ESG components can play an important role in infrastructure investing. The longer-term nature of infrastructure lends itself well to social and governance considerations, due to the essential services these investments are often providing to the community. And in some countries, such as England, social value is now a formal part of the assessment process for public tenders. It is likely that social values will be something that investors have to consider more in the future.

Different regions around the world offer a range of infrastructure investment opportunities

Governments around the world are ramping up infrastructure investment, although there is some variation between regions in the type of projects being prioritised.

With the European Union being a leader in global efforts to tackle climate change, the heart of the region's infrastructure investments are focused on moving from a high-carbon to low-carbon economy. While Eastern Europe is also active in renewables investment and is emerging as a leader in solar energy investment, the focus is on connectivity across the region. Large-scale infrastructure projects are currently underway in the rail and roads sectors to strengthen integration and enhance interconnectivity between East and West. Asian countries are focussing on green and digital technologies. Singapore has recently completed construction of one of the world's largest floating solar farms. Over the coming 25 years, the facility will make the island nation one of the few countries in the world to have a 100% green waterworks system. Japan, prone to some of the world's strongest earthquakes and tropical storms, has adopted a plan to spend US$144 billion over the next five years for disaster-proof infrastructure. Indonesia is seeing great interest in the development of smart cities. And via its Belt and Road Initiative, China is operating the largest infrastructure and trade project in the world.

With strong economic and population growth prospects and a sizeable infrastructure gap to be filled, the African continent is abounding with infrastructure opportunities. Kenya is emerging as a FinTech and software development hub and there is strong demand in the region for building data centres. The Middle East is focussing on diversification. While the oil and gas sector will remain an important part of the Gulf economy for many years to come, there is a push within the region to diversify away from fossil fuels. Indeed, Saudi Arabia is aiming to generate half its electricity from gas and renewables by 2030.

And the Americas are pushing the boundaries with digital connectivity and clean energy, with particular urgency given to fortifying investment in social infrastructure, like hospitals. One of the largest stimulus packages of its kind comes from the United States, via President Joe Biden's "America Jobs Plan". This package sets aside considerable funding for transportation infrastructure, including investment in electric vehicles. It would also impose gradually tighter restrictions on the use of fossil fuels to generate electricity, with the aim of making that sector carbon neutral by 2035. In South America, investment is building into developing satellite technology to help address the lack of digital coverage in more rural areas. There has also been a drive within the region's important mining industry towards embracing renewable energy procurement, including the use of green hydrogen.

In summary, the economic backdrop over the coming years may not be as supportive for conventional assets as it has been over the last decade. This leaves investors looking away from their more traditional, financial-focussed assets and towards alternative investments. Infrastructure offers opportunities ranging from roads and hospitals to digital technologies, renewable energy and smart cities; opportunities that can also meet the growing interest in ESG investing.

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