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Public Pensions and Infrastructure: A Match Made in Heaven

During the State of the Union address, President Trump issued a renewed call for an infrastructure bill. Two days later, the House Committee on Transportation and Infrastructure held its first hearing of the new Congress to address the state of U.S. infrastructure.

Confronting the nation's infrastructure gap is one of the rare bipartisan issues in Washington today. It is a priority for the American public and for elected officials at the federal, state and local levels, all of which make it a likely legislative focus for both the 116th Congress and the administration.

That U.S. infrastructure needs improvement is not news. Any discussion about closing the $2 trillion 10-year investment gap quickly zeros-in on funding — revenue streams in the form of dedicated taxes or user fees — and financing solutions.

While there are perfectly suitable public finance tools, a large pool of untapped available capital resides in the retirement funds of public-sector workers.

In a new, detailed study of the $4.3 trillion U.S. public pension system, we've investigated the infrastructure investments undertaken by the largest public pension systems in the country.

Our findings suggest now might be the perfect time to match pension capital with infrastructure investment needs, creating winners on both ends of the financial chain.

Infrastructure assets have features that are appealing to pension investors. They are long-duration and offer some degree of inflation protection. They are not correlated with the other asset classes, so they offer much-needed diversification.

Best of all, they generate steady cash flows to meet the needs of current retirees. These are among the reasons pension funds have cited when establishing programs to invest in infrastructure, and our analysis bears out most of these benefits.

Still, infrastructure investment programs in big American public pension funds are relatively recent, and they remain small — averaging less than 1 percent of fund assets.

Implicit in public pensions' investment objectives is to accumulate cash flow-generating assets and hold them for a long time. Yet when pension funds invest in infrastructure, they typically invest in private equity-type funds that often have first-rate expertise but seek capital gains, not current income.

The funds usually buy infrastructure assets from other private owners. These investments have generated strong returns in the form of capital gains, benefitting substantially from rising valuations. Infrastructure assets now trade at multiples well in excess of those in other investment classes, such as real estate and private equity.

But these investments don’t generate much in the way of the cash-flows pension funds need to support current retirees. The bottom line is that there has been insufficient investment in infrastructure as an asset class, using the wrong investment vehicles and for the wrong purpose. There are better solutions.

To explore ways in which pension capital might evolve into a financing solution for U.S. public infrastructure, we might look to models that have been successful in other countries.

In Australia, asset recycling is a financing tool that has been used successfully to “repurpose” infrastructure capital. Public-sector agencies sell long-term concession rights on existing infrastructure to investors (including pension funds) and use the proceeds to finance development of new infrastructure.

The public sector retains ownership of the legacy assets, receives cash proceeds to develop new infrastructure and avoids burdening its public finances with more debt. Private investors get a stream of proven cash flows from existing infrastructure over a fixed period of time. The federal government often provides an incentive in the form of a top-up of the proceeds from the concession sale.

True, institutional investors like pension funds are wary of investing in ground-up development. They are properly concerned about cost overruns, delays and unpredictability of revenue streams. But pension systems are uniquely positioned as informed and influential players in regional and local economies.

Just one example: The Quebec pension fund, CDPQ, developed and operates Montreal’s light-rail system and was able to assemble the financial and technical resources and muster the political support to pull it off.

Among the other ways to deal with infrastructure project risk is partnering pension capital with the knowhow of engineering, procurement and construction firms, which have extensive experience in designing and delivering new projects. Dutch pension funds, for example, have invested alongside engineering firms in new road construction projects.

Of course, using pension capital on public works requires strong governance to avoid waste and bloated costs. The presence of private capital can provide necessary transparency and discipline. And there is an argument for investing pension capital locally.

If done right, it can generate economic development, which in turn leads to more jobs and more tax revenues — ultimately favorable to sustainable pension finance. Additionally, when pension funds invest directly in infrastructure, they don’t introduce the political risk of transferring “crown jewels” to private investors.

Most important is to put in place mechanisms that will allow for an improved flow of investable U.S. infrastructure assets. When that becomes evident to pension fund administrators, they will become more comfortable expanding their allocations to this attractive asset class — perhaps to the 5-10 percent levels that are common in Canada.

This will provide hundreds of billions of dollars in incremental financing, which will go a long way to reducing our infrastructure gap.

THE HILL

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