Infrastructure debt – a way to access the infrastructure illiquidity premium for funds with net outflows

A common driver of returns for strong performing funds in 2015-16 was high allocations to illiquid assets. That is, property and infrastructure and to a lesser extent private equity.

A common feature of these assets are very long investment horizons (often decades), high transactions costs and low liquidity. It is simply not practical – returns would be outweighed by transactions costs – to invest in these types of assets on a short term basis.

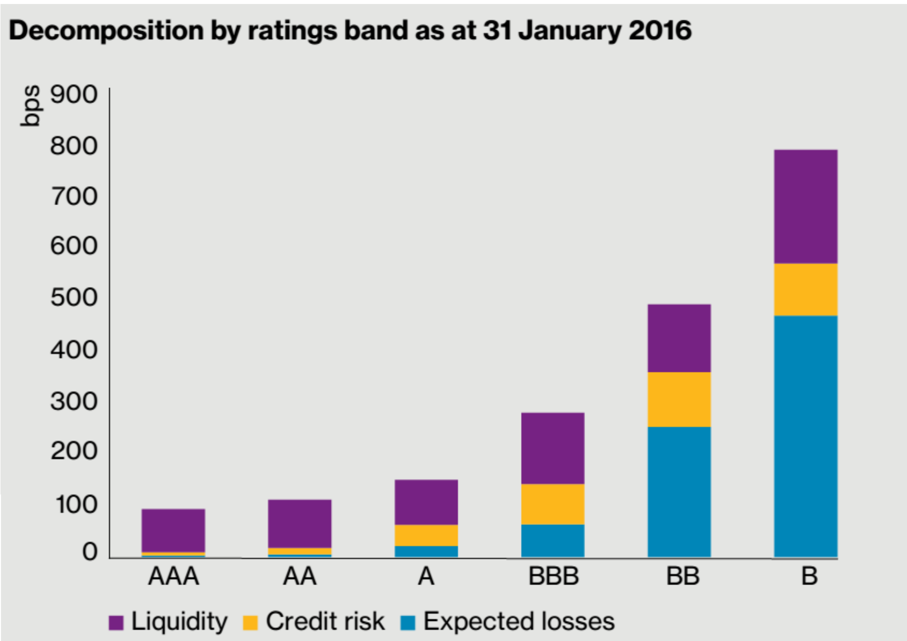
While returns of these assets have been very attractive recently (as they have benefited disproportionately from the fall in bond rates and the hunt for yield) they present real challenges for funds (or member investment choices within funds) that have a shorter time horizon or have weak (or negative) net member inflows. For these funds, liquidity and investment horizon constraints can severely limit the capacity to invest in these asset classes (and, hence, participate in the recent run of strong returns).

Debt investments provide a way of capturing some of these investment characteristics – most notably the liquidity premium – for constrained investors. In particular:

1. debt portfolios can be structured – through their maturity profile - to directly address time horizon/liquidity constraints; and
2. debt investments can provide meaningful liquidity premiums.

<u>Debt portfolios can have their maturity profile aligned with investment horizon/liquidity constraints.</u> For funds or investment choices that have a specific investment horizon, debt maturities can be aligned with this horizon. For funds with net outflows, maturities can be laddered to deliver matching liquidity. This highlights a fundamental feature of debt investments – maturity provides an automatic exit and liquidity. This allows investors to 'program in' the liquidity characteristics they want through the appropriate selection of portfolio maturities.

<u>Non-government debt investments often provide substantial liquidity premiums.</u> For debt investments it is possible to decompose the spread above sovereign debt into a return for underlying credit risk (both actual losses and the volatility around the average level of loss) and liquidity. For example – Willis Towers Watson provides one example of this approach in their article Understanding and measuring the illiquidity risk premium (May 2016). The chart below shows the split between credit and liquidity risk premium for US corporate debt by credit rating.



Source: Willis Towers Watson May 2016

The chart shows the liquidity premiums are substantial component of returns across the rating spectrum. However, particularly for investment grade debt (BBB rated debt and above) the liquidity premium represents more than half of the excess return.

For infrastructure debt – which tends to be focused in the A/BBB rating band – and which benefits from lower volatility, lower defaults and higher recoveries – the proportion of returns attributable to illiquidity will be even higher.

This is not suggesting that debt portfolios can (or should) deliver the double digit returns that infrastructure/property has enjoyed over the last couple years. However, properly structured debt portfolios can be an effective way of harvesting a material liquidity premium – even for investors with time horizon/weak inflow constraints.