An Introduction to Infrastructure Investing:

Infrastructure is a component of real assets investing, which also includes real estate and natural resources private market strategies. While real estate has remained a relatively consistent exposure for institutional investors at about 12%, infrastructure has grown substantially over the last 15 years to now be approximately 5% of institutional private markets capitalization.[1] Demand for infrastructure has continued to grow, especially more recently against higher inflation and a less certain macroeconomic backdrop. While this growth is impressive, it's important to consider both the potential risks and rewards before allocating capital to infrastructure investments. Let's explore infrastructure and why private market investors may want to incorporate the strategy into their portfolios.

What Is Infrastructure Investing?

Infrastructure is a real assets investment strategy that focuses on the tangible assets involved in the distribution of people, goods and resources. Infrastructure investing provides financing to build, purchase or upgrade tangible assets that provide essential services in two key categories: 1) Economic assets such as airports, power plants and cell towers, and 2) Social assets such as hospitals, schools and parks. These assets have potential inflation protection qualities and typically provide long-term value with regular cash flow. For the purposes of private market investments, we focus on economic infrastructure assets.

WHAT YOU SHOULD KNOW:

- Infrastructure focuses on tangible assets which provide essential services and whose value is derived from their utility. Infrastructure can be divided into types: social infrastructure such as hospitals, schools and public parks, and economic infrastructure such as toll roads, data centers, power generation facilities and ports, to name a few.
- Social infrastructure is typically funded through the public via tax revenue, while economic infrastructure is typically funded by private investors.
- Infrastructure assets may provide investors with unique return characteristics including downside protection, yield as a component of total return, hedges against inflation, relatively low volatility, and returns which are not correlated to other traditional asset classes such as stock, bonds, and even private equity.

[1]Hamilton Lane Cobalt data – June 30, 2023.

What Are the Benefits of Investing in Infrastructure?

Infrastructure assets are an integral part of the functioning of society and the support of large-scale commerce. Since they are essential services which are in constant demand, infrastructure investments may provide unique investment characteristics to investors, including:

- **Yield as a Component of Return:** Infrastructure assets may generate income or yield, generally via recurring revenue generated by the infrastructure asset itself. The level of yield may depend on the investment strategy implemented. For example, core investments have historically featured yield prominently in total returns while appreciation has featured more prominently in non-core strategies.
- **Downside Protection:** Downside protection may be provided by long-term, contracted cash flow, as well as by the value of the physical asset itself.
- **Inflation Hedge:** Infrastructure assets can provide a potential hedge against inflation given exposure to a physical asset whose replacement cost rises as costs rise, and whose contracts may include built-in, periodic inflation escalators based on metrics such as the Consumer Price Index (CPI) or Producer Price Index (PPI) in the U.S. and Harmonised Index of Consumer Prices (HICP) in the U.K.
- **Non-Correlated Returns:** Infrastructure assets have historically shown low correlation to traditional asset classes such as stocks and bonds and even other types of real assets.

Given these characteristics, infrastructure has the potential to improve overall portfolio performance. This is the case when it is added as a standalone exposure and when infrastructure is added to a broader, existing real assets portfolio. Since each sub-strategy (such as real estate or natural resources) has a low correlation to one another, the potential for positive portfolio performance is enhanced. With each sub-strategy driving potential returns in its own way, the co-movement of returns (or the correlation of two or more entities) is limited. As a result, infrastructure may offset some downside risks in a broader private markets portfolio.

What Are the Risks of Investing in Infrastructure?

Infrastructure assets are considered to be generally stable assets, but it is important to understand their unique set of risks given their size and relative importance to societies and industries. Risks can exist at both the macroeconomic level as well as at the asset level. Because of this, investors should consider the full range of risks as part of their due diligence efforts. Some risks include, but are not limited to:

- **Political, Regulatory and Reputational Risk:** Because of their role in the economy, large infrastructure investments can at times receive a lot of attention from customers, voters, elected officials, regulators and the press.
- **Operational Risk:** Infrastructure investments require industry-specific knowledge and operational expertise. Given the individual nature of each infrastructure investment, this knowledge may not be easily replicated from one investment to another, even in the same sector or geography.
- **Environmental Risk:** Environmental issues can pose substantial risks for infrastructure investments. Real or perceived threats to the environment can significantly alter public opinion on the merits of private infrastructure investments.
- **Commodity Risk:** The performance of certain infrastructure investments may be tied to commodity prices, particularly within the energy and power sectors, which are sensitive to economic changes.
- **Merchant Risk:** The asset intensive nature of infrastructure assets means that they carry heavy fixed costs, and assets without long-term contracted cash flows may be impacted by short-term fluctuations in the demand and prices for their services, such as power production.

It’s important to note that these risks are general in nature and may vary depending on the specific infrastructure project or investment. Diversifying investments across different types of infrastructure projects or geographic regions may help mitigate risks and enhance the overall risk / return profile.

Where Does Infrastructure Fit into a Portfolio?

Infrastructure investments are worth considering for investors exploring alternatives. Why? Infrastructure investments may provide regular cash flow, inflation protection and uncorrelated returns in a broader private markets portfolio. Additionally, infrastructure assets like data centers or power plants may provide more stable, long-term yield than rate-sensitive assets, like private credit, in uncertain macroeconomic environments. While individual sub-strategies have varied return characteristics, together, they may benefit the total return of portfolios across different economic conditions. For investors looking to diversify their portfolios with historically uncorrelated alternative assets, which have the potential to provide risk-adjusted returns, infrastructure investments may provide the counterbalance that they seek.

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