Allianz Global Investors

Infrastructure debt: A natural fit for LDI investors seeking to hedge liabilities

Institutional investors in need of long-duration assets for liability-driven investing (LDI) strategies should consider allocations to infrastructure debt, an asset class whose unique characteristics make it well suited for asset-liability matching, and whose limited exposure to economic and market fluctuations should make it less susceptible to volatility caused by the COVID-19 crisis.

For institutional investors, hedging liabilities has become particularly challenging in light of: (a) the limited supply and increasing concentration of U.S. long-duration investment-grade credit; (b) increased volatility after the COVID-19 pandemic due to future earnings uncertainty; and (c) the long-lasting impact of U.S. corporate debt downgrades within LDI benchmarks, especially in light of the pandemic. While there is no one-size-fits-all solution to these thorny issues, the growing importance and availability of infrastructure debt as an asset class presents an opportunity to address some of these concerns.

Core infrastructure bonds typically finance monopolistic, critical assets, such as electricity transmission and distribution, solar and wind farms, toll roads, rail networks, and midstream energy projects. For the sake of comparison, infrastructure debt best resembles investment-grade, long-duration, corporate regulated utility bonds.

For many institutional investors, infrastructure debt is a relatively new option. The asset class was long dominated by banks, which controlled 80 percent or more of the market. However, tougher capital requirements for longer-tenor debt under Basel III have caused many banks to loosen their grip on this market for longer-dated debt, creating opportunities for institutions. Insurance companies were among the first institutions to enter the market. However, a wider cohort of investors — especially corporate defined-benefit plans that are increasing liability-hedging allocations — can benefit from expanded allocations to the asset class.

Infrastructure debt is designed to offer investors superior credit quality compared with traditional corporate debt, with historically lower defaults. An analysis of Moody's Investors Service data reveals BBB-rated core infrastructure debt had cumulative default rates between 1983 and 2018 that are less than half of comparable non-financial corporate debt and is even lower than A-rated corporate debt. Over a 10-year period, infrastructure debt experienced loss rates of about half those of other non-financial corporate issuers **(Exhibit 1).**

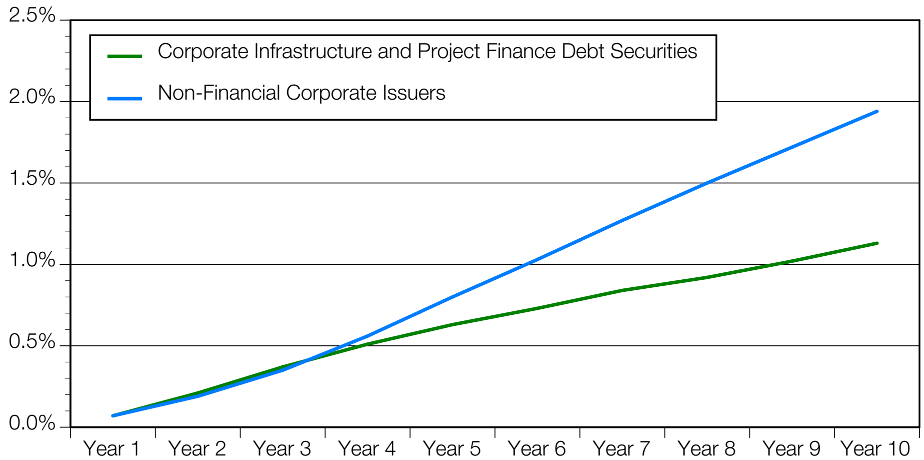
Historically, infrastructure debt also has experienced fewer downgrades than similar corporate bonds — a characteristic that could prove increasingly valuable in portfolios as the consequences of the pandemic continue to play out in the global economy. According to Moody's, over a 10-year period the average one-year rating volatility for corporate infrastructure and project finance securities was about one-third lower than for corporates. Meanwhile, infrastructure debt typically exhibits a high correlation to corporate debt and U.S. Treasuries returns, allowing it to be used as a substitute for some portion of those assets, thereby increasing portfolio diversification.

In addition to the benefits of diversification, credit-quality improvement and protection from downgrade headwinds, infrastructure debt has the ability to enhance portfolio yields — a critical consideration for all institutions in today's rate environment. Historically, investors have experienced a BBB-like spread for an asset that is equivalent in credit quality to a class A or better asset. The asset class aims for a yield pickup of 40 basis points to 60 basis points over comparable corporate debt, the service of which is backed up by stable cashflows. Investors can further enhance their return potential and add regional diversification through deals in investment-grade countries in Latin America, particularly Chile, Peru, Mexico and Colombia. Such high-quality investments in the region can fit within a core fixed-income allocation, helping to boost returns at comparable levels of risk to similarly rated U.S. credits and comparable levels of default.

Of course, in the midst of the COVID-19 crisis, investors must assess every investment in the context of unprecedented levels of market volatility. In that respect, there is every reason to expect that infrastructure debt should hold up to the turbulence better than comparative corporate credit. Core infrastructure bonds finance physical assets that come with decades of contracted or regulated cashflows generated by projects that operate under stringent government oversight. These projects are less tied to the economic cycle compared with typical corporate businesses because they operate based upon revenue models that are highly stable with little sensitivity to the economic cycle. Whatever happens, over the longer term, electricity will still be transmitted over distribution lines to homes, factories and offices, and people will continue to travel on toll roads and trains. As a result, infrastructure

Exhibit 1: Over time, infrastructure has suffered about half the credit loss rates of corporates

Average Baa-rated credit loss rates, 1983–2018



As of August 2019.
Source: Moody's Investors Service
Past performance is not indicative of future results.

debt has historically been more resilient in times of economic stress.

As with any investment, infrastructure debt has some idiosyncratic risks and challenges, such as access, liquidity and political risk. Investors have several ways to address these risks. Access to infrastructure debt deals can be improved by investing alongside a large asset manager that can, as a result of its size, gain access to a pool of deals that most investors could not access alone. (Large asset managers also often can obtain the best terms and covenants.) Concerns about liquidity can be somewhat mitigated by investing via an open-ended, commingled vehicle. Such vehicles typically lock up investments for a specified number of early years while initial funds are deployed, after which investors have an annual liquidity window during which they can redeem their investment and when new investors can join.

Currency and political risk in infrastructure debt can be managed through careful asset selection. For example, industries in Latin American energy, power and other sectors often have U.S. dollar cashflows and, therefore, prefer borrowing in dollars, eliminating currency risk for U.S. institutions. Political risk can be mitigated by only investing in the highest-profile infrastructure projects — such as regulated companies and projects — in countries with a long-standing track record of respecting foreign investment and the rule of law.

Institutional investors that use these techniques to deploy infrastructure debt in a portfolio as part of a core fixed-income allocation can create a natural hedge to their liabilities. Because the asset class has powerful inherent traits to mitigate a potential unexpected deterioration of the plan's funding status, infrastructure debt can be a natural fit for insurance companies and pension plans using LDI strategies, especially at a time of economic stress, when traditional corporate-bond quality was already on the decline and appears at risk of further deterioration.

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CORPORATE OVERVIEW

Allianz Global Investors, or AllianzGI, is a leading active asset manager with over 780 investment professionals in 25 offices worldwide and managing $560 billion in assets for individuals, families and institutions. AllianzGI offers its clients a wide range of actively managed strategies and solutions across the risk/return spectrum and has established expertise in equities, fixed-income, multi-asset and alternative investments.

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