KEYNOTE INTERVIEW

The case for diversification

A global pandemic and now rising inflation have reinforced the importance of portfolio theory, says Northleaf managing director and head of infrastructure Jamie Storrow

Q Why is diversification so important?

Diversification from an investment perspective is predominantly grounded in portfolio theory. Investors benefit from a variety of exposures to different asset classes and a variety of macro and micro exposures in order to reduce risk. In the context of infrastructure, that means accessing a good mix of asset types to ensure you have inflation protection, economic benefits and defensive characteristics in a variety of scenarios.

Q What are the different parameters by which an investor can achieve diversification in an infrastructure portfolio?

In the most general sense, there is geographic, sectoral and investment size diversification. Within these categories, various strategies drive different risk and return targets. For example, a conservative investor might wish to pursue a large-cap, low-risk OECD super-core or core strategy, which is going to lead them to certain mature asset types, whereas an investor looking for higher returns, and therefore more willing to take additional risk, might choose a regional mid-cap core-plus or value-add strategy.

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Q How was the importance of diversification highlighted through the pandemic?

At the beginning of the pandemic, volumes dropped dramatically in a way not seen in the modern era. Airport volumes were down 90 percent. Traffic on some roads was down 50 percent. Container volumes through ports dropped. Commodity prices and upstream activity also fell, with oil prices dropping below $20 per barrel. The pandemic had a material impact on many assets almost overnight.

But at the same time, many other assets were unaffected. For example, a contracted wind farm relies on strong winds and the performance of its generation equipment, so is largely insulated from a global pandemic. A diversified infrastructure portfolio during the pandemic meant that while some parts of an investor's portfolio were impacted, others were not. Having that balance was critical, because if an investor's portfolio was dominated by volume-linked or economically sensitive assets during covid, then returns and valuations would have been significantly impacted.

Q Did the pandemic reveal some generalist managers to be less diversified than they purported to be?

The pandemic seemingly impacted all funds in some way, but with varying degrees of materiality. Funds with high concentration of transportation assets likely fared the worst. Funds with exposure to commodity volumes suffered. Certain construction assets were also materially impacted, as the pandemic resulted in long wait times for the delivery of equipment and challenges getting labour on site. It was difficult for any asset to be completely immune.

Nonetheless, most funds appear to have fared well coming out of the pandemic. We saw very few bankruptcies across the industry and as a result, we are not seeing many pandemic-related distressed sales. While covid remains a concern, economies are moving on, and I would say that the industry did quite well, given the seriousness of the situation overall.

Q Will diversification prove equally important in this new economic environment?

Diversification is important in all environments. Currently, inflation is one of the most topical macroeconomic factors. We are seeing accelerated cost inflation affecting goods and labour, which will impact some investments more than others. For a mature investment where the business plan is substantially complete, while the asset might experience operating cost pressures, it may be protected by inflation-linked revenues.

However, developers of various types, for example, are struggling in some cases with rising equipment costs, supply delays and the availability of labour. It is proving difficult for these developers to bring projects in on a timeline and cost that they had anticipated. You don't want to have all your eggs in

"The infrastructure industry is very broad and many subsectors are not sizeable enough for a standalone fund to specialise"

Q As a generalist manager, with the full spectrum of relative value available to you, are there sectors or geographies that you are particularly focusing on right now?

The three main sectors that we focus on are energy transition and renewables; communications; and concessions, transportation and other contracted infrastructure, in OECD countries. In the US, we are active across all three areas, as it is our largest investable jurisdiction. The US market is also highly fragmented, and fragmentation is an attribute that really benefits mid-market managers.

In Canada, Australia and Western Europe, however, we are more targeted. In Europe, for example, we are less active in renewables and more active in communications and the broader energy transition sector. In Australia and New Zealand, we are not active in transportation, but are active in communications and with certain renewables projects. It very much depends on the country, but the US offers the broadest range of investment opportunities for us currently.

one basket, which is why diversifying your risk is important.

Q While the pandemic and now high inflation appear to be endorsing the importance of diversification, we are also seeing an increase in specialist managers. Is that counterintuitive?

I don't think this is a counterintuitive situation. As an investor, you have the choice of diversification as a key tool, as well as the opportunity to allocate your capital across both generalist and specialist funds. Investing all your capital in a single strategy can be very risky. The lack of diversification increases exposure to particular events. As a result, there is certainly room for both generalist and specialist managers.

At Northleaf, we define ourselves as more of a generalist mid-market manager, and we have found our strategy to be effective because certain subsectors and geographies tend to fall in and out of favour. If we were purely focused on a single subsector in a single country, for example, our investment pipeline would face many more binary risks. Being active in a broader range of jurisdictions and industries gives us the opportunity to move around and find the best relative value.

Q What are you seeing in terms of investors' evolving understanding of diversification?

I think investors are starting to appreciate the need for diversification. For example, for a mid-to-large pension plan, their most common route to gaining exposure to the funds world will often begin with the larger managers – those firms with an established track record and well-resourced teams. They then often start to move down in size into the mid-market, typically with generalist managers. A tertiary step might then be to add specialist managers, perhaps those focused on renewables, communications or development, or particular jurisdictions such as Latin America or Asia.

> *"There is certainly room for both generalist and specialist managers"*

That path – from large-cap to the mid-market and then the inclusion of specialists – is probably the most common trajectory that we see.

Q A specialist would argue that they have deeper industry knowledge and relationships than a generalist targeting the same sector. How would you respond to that?

I don't think deep industry knowledge is only limited to specialists in every strategy or subsector. For example, a renewable power development specialist in a particular country may benefit from certain advantages in that location and sector. But extend that to other countries, or to more mature assets or to other areas of the energy transition, and limitations to a specialist manager may appear.

More importantly, the infrastructure industry is very broad and many subsectors are not sizeable enough for a standalone fund to specialise. For example, we are active in security infrastructure. It is not a huge sector, but it is one where we are building expertise. While it would be extremely difficult to build a specialist security infrastructure fund, as a generalist fund, we are able to efficiently access the sector.

Similarly, we are involved with various forms of tank storage. Again, it would be very difficult to build an international tank storage fund. There simply isn't an adequate volume of transactions available in that market. But as generalists, it is still a very interesting area for us.

Q Do you believe we will see some specialists morph into generalists?

In the early days of the industry, there were many funds focused on PPPs and PFIs, for example, which is now a quiet sector in most countries. Those firms have since evolved into diversified managers. So, that path from specialist to generalist is a well-trodden one.

It is also worth noting that these areas of specialisation often have a limited timeline. A couple of decades ago, you saw certain managers specialise in regulated utility acquisition; these types of funds don't exist anymore as the returns just aren't there, and the manager would have had to transition their pipeline out of that space over time. So, while there is room for specialisation, I don't think it is realistic for specialist strategies to have a multi-decade lifespan without at least some degree of adaptation.

Q How do you see the infrastructure manager landscape evolving?

I think that we will continue to see new entrants and the majority of the new funds will be specialists. There is still room for new players in the energy transition and communications sectors, in particular. But launching a traditional, diversified strategy is only going to get more difficult, given the proliferation of managers we have seen in recent years.

However, infrastructure remains an evolving industry. It is possible to start out as an energy transition manager, for example, and then add additional sectors with your second or third vintage – so long as you have the necessary track record and reputation. It is an evolution between vintages that we have often seen in the past and we expect to continue to see in the future. ■