IFSWF

New challenges, private markets
Sovereign wealth funds' changing investment strategies

Subcommittee 2: Investment & Risk Management

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IFSWF
About us

About the International Forum of Sovereign Wealth Funds

The International Forum of Sovereign Wealth Funds (IFSWF) is a voluntary organisation of global sovereign wealth funds committed to working together and strengthening the community through dialogue, research and self-assessment.

IFSWF was formed in 2009 by a group of 23 leading state-owned international investors from around the world. The Forum's initial aim was to maintain an open and stable investment climate by setting and adhering to a set of Generally Accepted Principles and Practices, known as the Santiago Principles, for sovereign wealth funds' institutional governance and risk-management frameworks.

Today, helping members implement the Santiago Principles remains the foundation of the IFSWF's activity. But the Forum now represents a group of more than 30 sovereign wealth funds from all corners of the globe, with a variety of mandates and at various stages in their development. As a result, the Forum's focus has evolved. In addition to encouraging ongoing commitment to the Santiago Principles, the Forum also undertakes research, facilitates peer assistance exercises and holds workshops and seminars to help members enhance their existing investment capabilities. The IFSWF also undertakes to represent its members to the global financial and policy communities.

About Subcommittee 2: Investment and Risk Management

IFSWF's Subcommittee 2 on Investment and Risk Management seeks to provide a consultative forum that can effectively address and discuss matters relating to investment and risk management. The committee is led by Italy's CDP Equity (formerly the Fondo Strategico Italiano). Other members include the Alaska Permanent Fund Corporation, the Alberta Heritage and Trust Fund, Australia's Future Fund, the Korea Investment Corporation, the Kuwait Investment Authority, Morocco's Ithmar Capital, the New Zealand Superannuation Fund, the State General Reserve Fund of the Sultanate of Oman and the Palestine Investment Fund.

The IFSWF is committed to contributing to the development and maintenance of an open and stable investment environment and thereby supporting the guiding objectives underlying the Santiago Principles. Subcommittee 2 acts as a platform for exchanging views and promoting the understanding of best practice in relation to investment and risk management activities within sovereign wealth funds.

Subcommittee 2 works with State Street and Bridgewater Associates with academic support from the Sovereign Investment Lab at Bocconi University in Milan.

The challenges of private markets

In a low-growth, low-yield environment, long-term investors like sovereign wealth funds face greater challenges to make high enough returns to meet their mandates. With bond yields at near-record lows, over $13 trillion of fixed-income securities commanding negative interest rates, and global stock markets looking increasingly volatile or overvalued, many investors, including IFSWF members, are looking to investigate private markets as a way of generating higher long-term returns.

But each investor is different and have different motivations for entering private markets. Allocating to unlisted assets also requires different internal capabilities and a wealth of other governance and system checks and balances to become successful.

In 2016, Subcommittee 2 set out to learn more about how and why eight IFSWF member institutions went about this challenge and the lessons they have drawn from it. To do so, the Subcommittee drew upon the expertise of Professor Josh Lerner, the Jacob H Schiff Professor of Investment Banking at the Harvard Business School, to help bridge the gap between the insights provided by academic research and the practical discussions with sovereign wealth fund investment professionals who manage investment portfolios.

What did we learn about the process of developing in-house private markets teams and the challenges and opportunities it provides?

Capturing illiquidity and inefficiency premia

The sovereign wealth funds that Subcommittee 2 surveyed believed that private markets had the potential to provide higher returns than public markets, particularly given recent stock and bond market performance. They believed that higher returns are driven partly by the illiquidity of private markets, but also because they are less efficient and thus provide the potential to exploit information asymmetries to generate above-average returns.

Nevertheless, even at sovereign wealth funds where private markets investments have performed well, there is still internal debate over whether the premium compensates fully for the illiquidity and other risks, such as lack of transparency and potential loss of capital, that are associated with private-market investing.

Capability is king

Hiring the right people is key to building a successful private-markets capability. “Human capability is the most important part of a successful private-markets investment programme,” said one fund. As many sovereign wealth funds are based outside major financial centres, attracting and retaining talent requires creative solutions and a focus on instilling a sense of culture and purpose. Funds also spoke extensively about the need for enhanced governance and decision-making frameworks to balance the complexity of private markets, as well as strong due diligence frameworks, to enable them to move decisively when opportunities arise.

Words of wisdom

- **Start slow.** “Go into the market step by step. It takes time to build up a good team with the capability to manage private market investments, especially for direct investing.”
- **Do your due diligence.** “In the private-markets you need to commit to understanding your manager and the underlying investments that you have. You can’t sell tomorrow, so you must understand the risks and consequences associated with your investments.”
- **Creatively build and develop your team’s skills** and commitment, especially if you are in a remote location. “There is an importance of ‘stickiness’ in having a team that is around for an extended period. It has to do with what is required to create an organisation where people stick around.”
- **Learn from your successes and failures.** “The most successful investors tend to have a process for institutionalised learning. They go through a structured process of periodic self-examination. This isn’t just about looking at their aggregate returns, but looking at why they chose funds that underperformed and why they passed on funds that ultimately did well.”

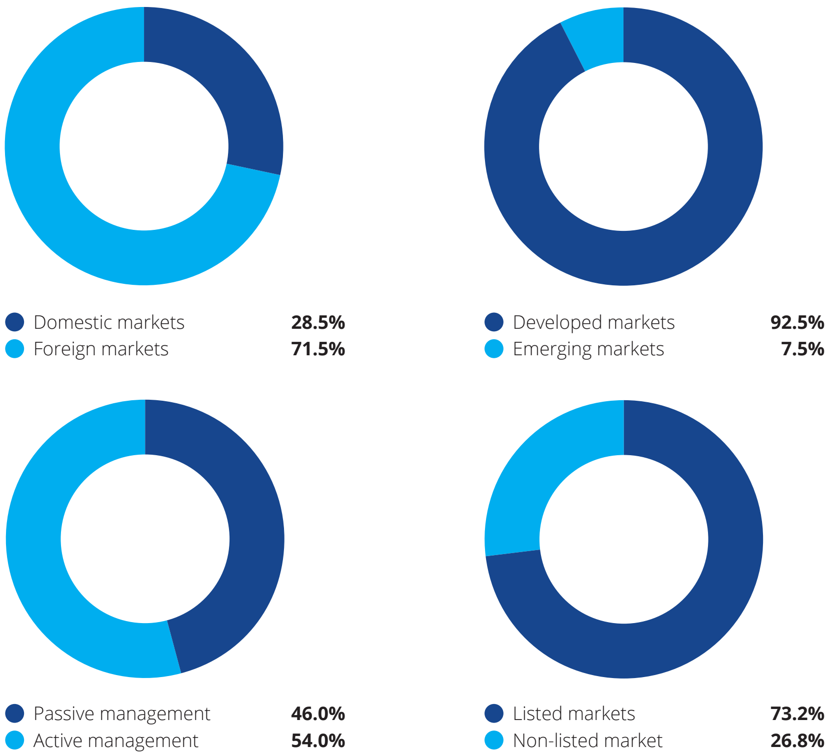
Sovereign wealth funds' evolving asset allocation

The challenges of the current global investment environment have forced investors, sovereign wealth funds among them, to adapt their thinking and reconsider traditional approaches to allocating investments and managing risks. Sovereign wealth funds are an important and growing investor class, comprising one of the world's largest institutional asset pools. They now find themselves on the front lines of new portfolio management challenges.

In 2016, Subcommittee 2 set out to learn more about how and why a diverse group of ten IFSWF member institutions have adapted their portfolio over the past half-decade, the changes they expect to make in the medium term and the organisational adaptations required to facilitate these shifts.

The survey revealed that the funds involved remain primarily allocated to traditional investment categories, and are more heavily weighted to fixed income than equity. That said, the most significant shift in asset allocation has been towards so-called alternative assets. While such investments tend to comprise a relatively small proportion of the surveyed funds' portfolios, they were also the sectors and strategies into which these funds had increased their allocations. Half the funds we surveyed said they had increased their allocations to private equity over the past three to five years, while a third had increased their allocations to real estate. These increases appear to have been funded by drawing down holdings in both government and corporate fixed income.

Sovereign wealth fund asset allocation, July 2016



Source: IFSF survey completed July 2016

The past half-decade has seen a significant shift in our members' portfolio strategies. But as they seek to increase long-term returns and match their assets to their liabilities, it seems that the period of change is coming to an end. Our findings suggest that most of the surveyed funds do not expect to adjust current allocations in the future. Some will continue to gradually increase allocations to infrastructure, real estate, non-listed assets, and emerging markets as they seek to reach desired exposure to these assets. The lack of appetite for further change could be due to uncertainty over the evolution of the capital markets in the future.

While investors view the management of traditional assets as a commodity, they believe that the management of private or alternative assets is an area that requires specialised resources and competencies.

The shift into private markets has also revealed an interesting trend amongst the surveyed members. Sovereign wealth funds appear comfortable outsourcing the management of new asset classes, providing these were in listed markets. However, when adding private-market investments into their portfolio, the funds preferred managing in-house and, to a lesser extent, partnering or cooperating with a third party. The survey results suggest that while these investors view the management of traditional assets as a commodity, they believe that the management of private or alternative assets is an area that requires specialised resources and competencies, needing greater oversight and understanding. Overwhelmingly, however, these sovereign wealth funds chose to add new resources to existing teams, rather than establish new departments to manage new asset classes.

As sovereign wealth funds re-evaluate how they construct portfolios to meet their specific objectives, they also need to rethink how they measure and manage portfolio risk. The analysis undertaken by Subcommittee 2 suggests that assets behave differently depending on whether investors take a short- or long-term view. To strike an effective balance between their short- and long-term objectives, therefore, sovereign wealth funds should account for this divergence when evaluating investment opportunities and forming portfolios.

As sovereign wealth funds learn these lessons against the backdrop of uncertain macroeconomic and market environments, it is likely that their asset allocations evolve more slowly over the coming years.

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