Sovereign Wealth Funds Face the Winds of Change

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EXECUTIVE SUMMARY

Sovereign wealth funds (SWFs) face a dilemma as their domestic priorities and global financial markets evolve. On one hand, their capital reserves have grown to their highest level ever. On the other hand, the governments of many funds' home countries face growing demands for spending to meet domestic needs including social safety nets, investment in housing and infrastructure, programs to confront structural youth unemployment and rising import bills. This is increasingly focusing attention on the question of portfolio versus development needs when it comes to setting strategic policy for many of these funds. At the same time, the long, gradual unwind from fixed income securities has started for many funds, but the opportunities for reallocating across equities or other asset classes are not obvious. Risk premia for emerging market assets may shrink in the future as large emerging markets such as China seek more stable growth paths. The structural rally in commodities that began in 2004 shows signs of having ended and geopolitical tensions are adding their own uncertainties to the investment landscape. Better understanding the challenges these funds are facing helps us identify the trends we are likely to see over the next three to five years and possible shifts in their strategic policies. This in turn should provide important insights into the implications for investment flows, product innovation and the advisory business of the asset management industry. The following discussion looks at what we think are the major challenges facing SWFs.

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Sovereign Wealth Funds (SWFs)[1] by design try to set their investment policies for the long haul. At the same time, the dramatic changes occurring in capital markets as the global economy recovers from the financial crisis have dictated that SWFs at least attempt to invest more opportunistically. This need for opportunism has largely been driven by the tenuous dislocations across most of the liquid as well as some of the illiquid asset classes. As the end of U.S. monetary policy accommodation approaches, with its implications for fixed income and risk, some of these funds face a series of challenges. These include balancing domestic spending needs against the need to invest capital to generate return; rethinking allocations to "safe" fixed income areas as they evolve from sources of risk-free return to return-free risk; and reconciling the need to invest offshore with the need to shore up domestic investment. In this note, we try to forecast the more persistent trends that may emerge as these investors confront these challenges.

As always with sovereign institutions, we need to be careful in drawing broad inferences. Sovereign wealth funds vary enough in shape, size, objective and investment horizon to resist typecasting, despite the asset management industry's tendency to treat them as a monolithic whole for convenience sake. Notwithstanding their differences, SWFs have three things in common: they often hold large pools of captive capital, they safeguard wealth for future generations and they seek long-term returns. Their actions are the focus of those who observe investment flows and these funds often set investment trends. Some of these trends are not obvious or are disguised with elements of transitory or behavioral incentives. This is because SWFs face a variety of unique circumstances and hence tend to be less transparent than other institutional investors.

This note tries to be as broad and forward-looking as possible in identifying nascent trends in SWFs' investment behavior that could become more well-defined. These trends might have repercussions for investment policy among other kinds of institutional investors and certainly will have implications for product development across the asset management industry. They will also be the focus of policy makers who shape the financial landscape for the magnets of capital.[2]

TREND 1: BETA DOESN'T COME IN A SINGLE PACKAGE: MANAGING BETA MORE EFFICIENTLY

The hunt for elusive alpha will continue, but the financial crisis taught SWFs that harnessing alpha can be costly. The cost comes with rewards, but it correlates tenuously with overall market performance. Painful fees, capacity constraints and damaging tail risk are the realities of outsourcing, and manager selection is neither a science nor an art than can be precisely replicated across alternative asset classes, geographies and liquidity profiles.

Sovereign wealth funds have become more skeptical about the reliability of manager alpha and the ease with which it can be acquired. In response, they are considering the benefits of in-house management as they seek ways to acquire alpha more efficiently, reliably and cheaply. The question is whether there is a way to reproduce manager alpha. While alpha by definition needs to be uncorrelated risk, history shows that no single source of return remains dominated by pure alpha across all phases of the market cycle.

1 Sovereign Wealth Funds (SWFs) are an important but established class of risk-taking institutional investors. These state investment vehicles have existed for many decades, but accelerated growth in the mid-2000s resulted in two dozen funds controlling $3 trillion in assets (GAO 2008). Estimates of their size currently vary from (USD) $5 to $7 trillion in stated assets.

2 A good introduction to the various investment objectives and how they differ across the SWF universe is available in P. Kunzel, Y. Lu, I. Petrova, and J. Pihlman (2011), "Investment Objectives of Sovereign Wealth Funds–A Shifting Paradigm," *IMF Working Paper WP 11/19* (Washington: International Monetary Fund).

Faced with the challenges involved in generating consistent alpha, investors are increasingly interested in managing, enhancing and augmenting beta exposures with some definition of style, risk management and factor exposure. Investment managers have responded to this interest by developing "smart" or "alternative" beta strategies.

While investors have so far sought smart beta in equities (since equities dominate risk budgets), SWFs are also increasingly interested in using smart beta strategies across other liquid asset classes. Beta is by definition cheaper than alpha, so those who manage it are unlikely to demand anything like the fees charged for alpha. Beta can also be risk-controlled with a robust risk management oversight framework. It can be pivoted toward styles specified by an investor, such as low volatility, growth and value to mention a few and it has greater capacity than dedicated alpha strategies.[3]

Repositioning SWF portfolios more toward beta risk than alpha risk may increase. While many smart beta strategies have been confined to equities, increased interest from SWFs could fuel demand for this style of exposure and catalyze the development of diversified smart beta strategies across liquid asset classes.

Smart beta strategies also merit meaningful consideration in terms of asset allocation exposure across factors. One growing concern among global investors is a potential acceleration of inflation and its impact on overall portfolio performance. Smart beta strategies may be applied across stocks that are sensitive to inflationary shocks. Such strategies could also be designed to work in higher real interest rate environments. They can also be oriented, for example, towards stocks that weather global demand shocks, and stocks that are aligned with investors' views on growth or value.

Another growing concern for investors is the eventual end of financial accommodation policies by central banks and the implications for aggregate market volatility. Smart beta strategies designed to mitigate exposure to stocks with higher than average volatility are an increasingly popular response to those concerns. In many respects these strategies try to marry the economic environment or cycle to asset performance and increase the investor's ability to customize the strategy to reflect their investment preferences.

Investment Implications: Repositioning SWF portfolios more toward beta risk than alpha risk may increase. While many smart beta strategies have been confined to equities, increased interest from SWFs could fuel demand for this style of exposure and catalyze the development of diversified smart beta strategies across liquid asset classes.

TREND 2: INVESTING ACROSS RISK FACTORS, NOT ASSET CLASSES OR PRECONCEIVED DIVERSIFICATION PRECEPTS

Institutional investment practice continues to evolve. The global financial crisis showed the limits of traditional diversification. Portfolios that investors assumed were diversified and allocated across uncorrelated asset classes in fact contained additional risk from alternative asset class exposures. For example, adding investment grade credit to a portfolio with allocations to equities and bonds did not really increase diversification. Investment grade credit has growth, duration and term premiums, and many portfolios already held other asset classes with the same sources of risk. Adding investment grade credit, as many investors did, duplicated the sources of risk already in the portfolio. This was difficult to detect and only came to light during periods of elevated beta, when such portfolios suffered drawdowns.

A number of SWFs are now shifting their asset allocation philosophies to account explicitly or implicitly for macroeconomic or financial factors. Variations in asset return patterns show a fair degree of consistency across macroeconomic regimes, phases of the business cycle and cycles of central bank easing or tightening. Imperfect knowledge of future and even present regimes could well be shown to

3 To understand the variety of nuances and characteristics of "smart" or "alternative" beta strategies, as well as how these strategies are constructed through the combination of different style choices, see N. Amenc, F. Goltz and A. Lodh (2012), "Choose Your Betas: Benchmarking Alternative Equity Index Strategies", *Journal of Portfolio Management*, 39(1), Fall.

enhance return and mitigate risk over the longer term.[4] Because the importance of macroeconomic conditions tends to vary over time, investment practitioners should use information sets that distinguish asset return performance across cyclical, regime or long-run trend-based factors.

Traditional asset allocation overlooks the fact that metrics often assumed to aid our various allocations, such as long-run or equilibrium forecasts of asset returns and their volatilities and correlations with other asset returns, are done in a static, single-time forecast. Traditional asset allocation also assumes that means and variances of returns don't vary over time. Investing with the aid of frameworks that take these oversights into account is not fool-proof, but it provides investors of large pools of capital with additional market foresight and, at times, insurance to take on risk.

For strategic asset allocation, SWFs should think in terms of risk factors and risk premia rather than conventional asset class silos, which are bundles of risk factors.

To invest based on factors, funds need to make several changes to their previous practices. First, they must recognize that strategic investors can exploit anomalies due to dislocations in alternative market phases but with an opportunistic objective. Second, they must realize that regime-based investing may require a nimble or flexible investment board or committee. Finally, they must recognize that this approach also adds discipline to manage downside risk more robustly.

Investment Implications: For strategic asset allocation, SWFs should think in terms of risk factors and risk premia rather than conventional asset class silos, which are bundles of risk factors. To reduce the risk of path dependency, these funds should make room to absorb short-term risk in a more opportunistic fashion in order to avoid the risks that most other investors pay significant premiums to mitigate. Investing across factors, whether within a regime-oriented framework or not, should offer more opportunistic ways to exploit risk premia across various assets. Using this approach should also shorten strategic investors' horizons. Adopting a factor-based approach does not imply that SWFs transform themselves into tactical investors; rather demand for assets will likely vary within sleeves of their portfolios. They will also likely increase the attention they pay to the global macro cycle, demographic forecasts and policy shifts, with a focus on how these forces may influence asset performance and risk. Funds using this approach currently consider inflation, rising interest rates, global growth, volatility (both financial and fundamental) and thematic factors, especially those related to international and emerging market equity. The solution will most likely take the form of a bundle of various asset classes, all of which are sensitive to the factors that the investor cares about.

TREND 3: REASSESSING THE ROLE OF FIXED INCOME WITHIN THE SWF PORTFOLIO

While signs from markets, economic indicators and policymakers indicate that real interest rates will rise in the future, the exit from fixed income assets may not be as easy or smooth as some investors might expect. Allocations to fixed income serve a variety of objectives for SWFs, beyond simply providing diversification for risk assets. Several funds use fixed income for downside risk management and the asset class's relatively low risk and conservative return can be viewed as a cost of guarding against tail risk. Most SWF and institutional investors increased their large fixed income allocations following the global financial crisis. Despite recent underperformance, many of these allocations remain in place, although their viability is now being reviewed.

Commodity-based SWFs often use fixed income assets as a hedge for commodities due to their low correlation to that asset class. Whether this hedging strategy works in reality is a separate and debatable question.

4 To consider an objective framework for understanding the linkages of asset return patterns and macroeconomic regimes, as well as how they can be mapped to asset allocation and portfolio design, see: Investment Strategy and Solutions Group (2011), "Great Expectations: Regime-Based Asset Allocation Seeks High Return, Lower Drawdown", *ISSG White Paper*, BNY Mellon. This is a proprietary asset allocation model created by the ISSG. It considers asset returns in the context of regimes created by underlying changes in growth and inflation expectations.

Funds that deal specifically with pension liabilities and social security obligations use fixed income allocations for functional reasons, and fixed income will likely remain a large and permanent component of their portfolios.

Regardless of the purpose of their fixed income allocations, SWFs are now making a more concerted effort to diversify their existing pools of fixed income assets across a greater variety of sectors. They are also considering their exposure to more sensible benchmarks and reassessing their return expectations, even if returns may be negative. Investors using fixed income to dampen equity tail risk could view negative returns as a cost of obtaining protection.

Investment Implications: The fixed income asset class will no doubt evolve as SWFs look for alternative diversification methods, regardless of their appetites, objectives and ultimate allocations. Fixed income exposure will almost certainly take non-traditional forms across GDP-weights, profit shares and debt ratios instead of cap-weighted benchmarks. Another development is the use of thematic fixed income exposures which align more closely with funds' policy objectives.

The evolution in emerging market-domiciled assets implies muted returns and a higher incidence of tail risk for SWFs, but also a greater smorgasbord of returns across themes that will continue to drive differentiation in EM risk premia.

TREND 4: FULFILLING DOMESTIC DESIRES AND IMPLICATIONS FOR EMERGING MARKET INVESTING

Domestic objectives have a price, and satisfying them frequently conflicts with the objectives of preserving capital, managing risk and earning stable returns to grow a capital base to meet the needs of future generations. From one perspective, SWFs' investment behavior can be understood as reflecting sectoral, geographic and demographic trends which they map across their portfolios, resulting in allocations they believe can deliver risk-adjusted financial returns. While this view may explain part of how SWFs allocate their portfolios, it may not be a complete explanation. Another view holds that SWFs' development needs drive their investment preferences in terms of asset class exposures.

Development needs may cause these funds to make more domestic and regional investments and more concentrated allocations that align with longer-term planning needs. Considering both return-oriented investment objectives and development needs provides a fairly broad spectrum of the appetite for certain asset classes, and hence the aggregate demand for such asset classes and their flows going forward. It is no surprise that development needs have historically been important parts of the investment policy objectives of larger funds, predominantly in Asia and the Middle East, and are becoming even more so.

This is where the question of the future of emerging market-domiciled assets enters the picture. Despite the growing differentiation in emerging market equities and debt, managers of captive capital increasingly believe that EM returns will not be driven by as wide a variety of factors in the future as they have been for much of the last two decades. They have a number of reasons for this belief, not least being that the major drivers of past returns are likely to have less and even possibly no impact on future returns. China has already started its transition toward what its government hopes will be slower, more stable growth. Emerging markets' trade surpluses are declining, which will likely prove to be a headwind. Maintaining growth with even larger imports will also pose a challenge. Commodity prices are likely to stabilize, and emerging markets will also likely feel the impact of a relatively tighter financial environment.

Investment Implications: The evolution in emerging market-domiciled assets implies muted returns and a higher incidence of tail risk for SWFs, but also a greater smorgasbord of returns across themes that will continue to drive differentiation in EM risk premia. SWFs should consider basing their exposure to EM equity or debt on thematic factors, rather than regions, countries or sectors. This may well lead SWFs to increase their opportunistic exposure to EM equity and debt markets as they try to harness drivers they believe will enhance sources of long-term EM returns.

The experience of a number of SWFs, especially those with commodity-based exposures, revealed the misalignment between the funds' asset allocation practices and their overall balance sheet objectives.

TREND 5: MINDING YOUR LIABILITIES: INVESTING WITH REFERENCE TO A CONTINGENT LIABILITY POLICY

In the universe of institutional investors, the behaviors and practices of endowments and foundations are perhaps most similar to those of SWFs. Both have multiple horizons, can afford to take risks over long horizons and can comfortably maintain large allocations to illiquid assets. Endowments and foundations realized too late in the spring of 2009 that their liabilities were not just operational expenses but also included capital calls on their illiquid investments. When liquidity was scarce, managers demanded capital for pre-committed illiquid investments. While the responses of individual endowments and foundations differed, the lesson learned from their experience also applies to SWFs. Most SWFs have accumulated capital from revenue derived from either commodity exports or balance of payments surpluses. These SWFs have liabilities in the form of expenditures as well as in the unreliability of their revenue sources. Petroleum funds are a very vivid example. Oil prices fluctuate and as oil importers invest in alternative energy sources, oil funds' dependency on oil-based revenues becomes a source of tangible concern.

This concern can provoke two responses. One response is to partition the fund. This partitioning has already taken place in several Asian countries that have established "investment corporations" distinct from their central banks. The investment objectives of each of these entities are deliberately different. While the central bank focuses on liquidity and security issues, the investment corporation concentrates on growing the pool of capital through exposure to risk instruments, both with a strategic and more recently, a growing opportunistic objective. The partitioning could be aligned to purely investment/risk objectives. The other response relates to asset allocation and the role of alternative investments. SWFs are realizing that the lesson from the financial crisis is that alternatives should be understood according to their asset-specific characteristics, rather than as a homogenous asset class.

The experience of a number of SWFs, especially those with commodity-based exposures, revealed the misalignment between the funds' asset allocation practices and their overall balance sheet objectives. Oil prices and government revenues proved to be highly correlated with their portfolios' inherent risk profiles. But quite apart from capital calls on illiquid assets, a number of "unexpected liquidity calls" forced some funds to liquidate undervalued risk assets in order to rescue domestic financial entities, buffer domestic recapitalizations and finance economic stimulus policies. These forced asset sales exposed the issue of "contingent liabilities" and the unintended consequences of asset allocation policies that lacked the underlying spending and revenue generators of many of the developing countries where SWFs are domiciled.

Some larger funds are dealing with contingent liabilities by implementing frameworks whereby part of the portfolio is free to adopt such risks, if those risks are uncorrelated with the underlying spending and revenue positions of these economies. This is not a trivial issue. The partitioning of portfolios must be based on a set of objective metrics. The goal is to have two or three portfolios each designed with alternative objectives, as well as with a slightly more dynamic approach whereby capital is transferred to more risk-oriented portfolios as it accumulates. This approach simultaneously resolves three concerns: the overall size of the funds (using "reserve adequacy metrics"), the optimal partitioning of the portfolios across each of the objective needs and the asset allocation within each bucket. The portfolio with the lowest risk profile typically will be allocated to the most liquid, least risky assets; while the riskiest portfolio is allocated to illiquid, hard assets. This leaves the transition portfolio as the most "managed" portfolio, which is exposed to a diversified basket of typically liquid risk assets.[5]

5 As we possibly enter a new paradigm for the fixed income asset class, several sovereign institutions continue to review their assets within a liability context and the suitability of traditional investment frameworks and asset allocation models. Motivations include factors ranging from domestic fiscal challenges to a more robust institutional structure to growing their asset pool. For a broader discussion by a panel of investment professionals of these and related issues, see: "Global Reset: Rethinking Investment Approaches for Sovereign Institutions," *Viewpoint*, BNY Mellon, September 2012.

Sovereign wealth funds are evolving, with far-reaching implications and consequences for global investment and the asset management industry in particular.

Investment Implications: While the adoption of contingent liability frameworks may give rise to increased demand for the entire spectrum of risk assets, two asset classes for which demand is likely to grow are worth highlighting. One is long-maturation, high yield and high quality assets. The other is assets that generate sustainable returns, but are matched to contingent liabilities. These include infrastructure, direct real estate (both core and opportunistic especially across emerging markets) and real assets linked to inflation. In the middle, equity risk will likely be managed more frugally with respect to fees. This is where alternative or "smart-beta" strategies will be the harbingers of longer-term income streams.

TREND 6: DESIGNING AND IMPLEMENTING MORE FLEXIBLE GOVERNANCE MODELS

While a major shift in SWF governance has not yet occurred, shifting capital markets, policy doctrines and emerging domestic contingencies will likely require funds to adopt more flexible and adaptable operating and governance models.[6] This will take time, but perhaps the dilemma that SWFs now face will incite some urgency. It is difficult, of course, to generalize about the flexibility of fund governance. Some SWFs have already become nimble and created room as well as appetite for transparency, state-of- the-art risk management and autonomy for the investment committee including the chief risk officer to take appropriate, active risk. Nothing suggests that SWFs will or should reduce their strategic investment principles. They ought to have the longest horizons of all investors. Developing the ability to enter and exit asset classes on an opportunistic basis will be a big change for them, but it will both enhance as well as complement their mandates to act on their development agendas.

LOOKING AHEAD

Sovereign wealth funds are evolving, with far-reaching implications and consequences for global investment and the asset management industry in particular. Their ballooning levels of capital, extensive mandates and stark investment policy differences compared with other institutional investors are certainly unique characteristics. But so are the ways in which they pursue their objectives and meet their demands and responsibilities. Their investment policy is so important because their "sovereign" nature distinguishes them from other kinds of institutional investors. Their *sovereign* objectives result in distinctive portfolio allocations and results that potentially differ from those of other investors. These funds face challenges as well as opportunities to pursue more adaptable policies to address this potential new paradigm.

We have identified the changes we expect that will have important implications for how these funds shape their strategic policy, including dramatic shifts in capital markets, domestic challenges and accumulated reserves. The way SWFs address these challenges could have meaningful implications for the way that they invest, what they expect from the active asset management industry and the demand for strategy and product innovation given their outsized capacity to outsource. Focusing on returns alone will not address the entirety of their challenges. It is therefore necessary for asset managers to understand the scale of these challenges and design solutions and frameworks that enable SWFs to change, deploy and monitor risk in ways they have not been accustomed to.[7]

6 For an analytical approach to understanding some stylized facts regarding governance models adopted by SWFs, see Aizenman, J. and R. Glick (2009), "Sovereign Wealth Funds: Stylized Facts about Their Determinants and Governance," *International Finance*, 2009, 12, 3, pp. 351-386.

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