Critical success factors

Underpinning the right investment strategy

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In a lower return world, the focus is on capital preservation, investment performance, performance measurement (financial as well as socio-economic measures) and the investment decision making process.

Almost all Sovereign Funds are driving towards better internal transparency and governance, accountability and performance measurement. The overall investment appraisal framework plays an important role in ensuring that the Sovereign Fund's strategic objectives are achieved and that the acquisition process is supported by rigorous, robust financial analysis. This will help Sovereign Funds to satisfy their fundamental aims, including capital preservation, value creation and furthering the national agenda, if relevant.

The investment appraisal framework is a fundamental part of a Sovereign Fund's operations and this can, and should, be continually reviewed to identify areas for improvement. The cause for deals proving successful or unsuccessful can, in a large part, be tracked back to the original investment and the quality of the decision-making and level of challenge arising from the investment appraisal framework.

While these themes focus on investments in unlisted equity and alternative assets such as real estate and infrastructure, the broad principles and themes are relevant to global investors across asset classes.

The fundamental questions being asked

- What is the strategy? How is the strategy reflected in the investment process?
- What is the risk appetite? How is risk measured in each investment and across the portfolio?
- Is there sufficient rigour and independent challenge in the investment process?
- How is value generated and realised? How is this measured and monitored?
- How often is the value realisation strategy for each investment assessed?
- How is the strategy reflected in management's incentive programmes?

Investment Appraisal Framework – critical success factors

1. Strategy	*2. Decision-making process*	*3. Post-investment management*	*4. Measurement*
Setting the risk return appetite and benchmark returns	*Understanding value and realisation strategies*	*Ensuring successful post-investment management of assets and aligning incentives to strategy*	*Defining, measuring and understanding returns*
The strategy should dictate the risk appetite and targeted returns, both of which should be defined and reflected throughout the investment process.	A clear understanding is required of value drivers, key sensitivities, value creation and realisation strategies for each investment. These should be tracked as part of regular post-investment reviews.	Active tracking and delivery on value creation and risks identified in the investment process. In addition, incentivisation plans should be aligned to achieving the long term objectives of the Sovereign Fund.	It is critical to clearly define and track financial and socioeconomic returns (if applicable) using measures appropriate to each asset but with broad consistency across investments, to allow for robust internal and external communications of returns.

Internal Governance, Transparency and Accountability

So what is a 'best in class' investment appraisal framework?

Each Sovereign Fund is different – with its own characteristics, objectives and culture – there is no 'one-size fits all' investment appraisal framework for appraising investment opportunities and managing post-investment value creation. However, by looking at good practices across the spectrum of investor class from Private Equity ('PE') through to International Financial Institutions ('IFIs'), there are a number of success factors that underpin a robust investment appraisal framework from defining the investment strategy through to monitoring the performance of assets.

This is especially relevant as Sovereign Funds look to doing more direct investments or to invest alongside other funds given the appeal of co-investment in terms of returns and risk management.

The other key aspect is the ability to get access to opportunities that are not available to others, which has been a feature of the PE success over the recent past.

By applying these good practices across the investment cycle, Sovereign Funds, and any global investor, can refine and improve existing processes as well as tackle challenges in new areas such as non-financial performance measures.

Ultimately, a robust investment appraisal framework will help to achieve the benefits of enhanced returns through:

- increased rigour, independent challenge and continuous improvement in the investment process (including the identification of gaps between an Sovereign Fund's current process and market practice);
- effective and efficient procedures for managing and measuring investments post-deal;
- stronger risk management at both the fund and portfolio level; and greater transparency to key stakeholders.

It is critical for Sovereign Funds to review and improve their framework on a continual basis to ensure that investments are being made with the appropriate rigour, challenge and skill thereby maximising the potential for capital preservation and ultimately value creation. The key is to ensure that only the best investments are selected, that the impact of new investments for the Sovereign Fund is fully understood and to have robust processes that are aligned to the strategic objectives of the fund.

Good governance and transparency in the investment appraisal framework are key to achieving success.

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