www.pwc.com/sovereignwealthfunds

The taxonomy of Sovereign Investment Funds

May 2015

Click to launch

pwc

SWF's operating in an evolving political environment

The increasing influence and relevance of Sovereign Investors (SIs) is reflected in their total assets under management (AUM), which have increased more than tenfold in the last decade. SIs are an extremely diverse group of investors, varying by income source, legal structure, maturity, and risk appetite. SIs typically take the form of a sovereign wealth fund (SWF) or a pension fund.

Despite their diverse nature, they hold in common what sets them apart from other investor groups and places unique constraints on them: a link to the sovereign and commonality in their ultimate macroeconomic objectives.

A quarter of governments around the world have established and deployed SIs to pursue national goals and encourage strong, stable, and sustainable growth. As a result, SIs operate in a political environment in which objectives may change over time as funds seek to account for changing economic conditions and requirements of their stakeholders.

SIs are often regarded as the ultimate long-term investors – indeed this was a key theme from the 2014 IFSWF annual conference. However, implicit short-term stabilisation activities, an increased role in domestic development for an investor class that has traditionally invested abroad, a lack of defined purpose, and multiple objectives contribute to difficulties in understanding what economic priorities funds are actually trying to address.

This note sets out a framework that will enable funds to review and revise their stated objectives, so that they remain relevant to the current economic priorities of their sovereign stakeholders. This is the first step towards understanding a fund's optimal investment strategy and therefore set up a realistic expectation of its performance.

What are stated objectives?

Based on a review of the stated objectives of 74 SIs*, we have established a framework of macroeconomic objectives, captured in Figure 1 below. These stated objectives are not mutually exclusive, a fund may have multiple or competing objectives from within the framework, but it is comprehensive.

* Our review has been based on SIs that have been most commonly defined as Sovereign Wealth Funds and Sovereign Pension Reserve Funds. It excludes other types of Public Pension Reserve Funds.

Fig 1: Framework of macroeconomic objectives of sovereign investors wealth funds

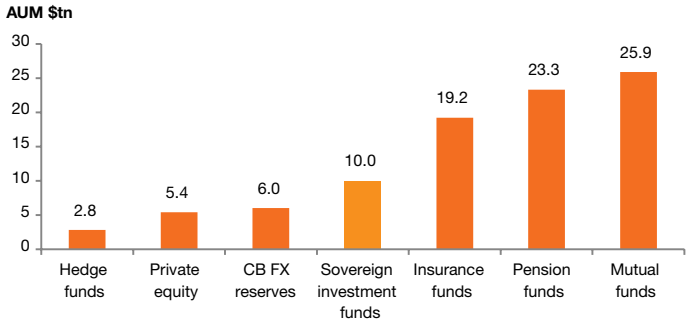
Mission	Objective	Description
Capital maximisation Building a capital base for the growth and preservation of national wealth	Balancing intergenerational wealth	Investing to create intergenerational equity e.g. transforming non-renewable assets into diversified financial assets for future generations.
	Funding future liabilities	Growing and preserving the real value of capital to meet future liabilities, such as contingent liabilities like pensions.
	Investing reserves	Investing excess reserves into potentially higher-yielding assets via financial strategies aiming at higher long-run returns, and reducing the negative carry costs of holding reserves.
Stabilisation Macroeconomic management and economic smoothing	Facilitating fiscal stability	Using counter-cyclical fiscal tools to insulate the economy from internal and/or external shocks, e.g. changes in commodity prices, to smooth consumption.
	Stabilising the exchange rate	Using the fund's resources to balance large capital inflows and outflows in the short-run (which may be caused by commodity price volatility) to prevent asset price bubbles and reduce price volatility.
		Using the fund to manage amount of capital entering the domestic economy over the long run, to ensure the exchange rate is maintained at a level to allow for other export activities, e.g. to prevent Dutch Disease.
Economic development Investment to boost a country's long-run productivity	Investing in hard infrastructure	Domestic development in capital assets, including but not limited to transport, energy, water management and communications.
	Investing in social infrastructure	Domestic development in soft infrastructure: human capital and the institutions that cultivate it. This includes socio-economic projects such as education and health.
	Pursuing industrial policy	Creating a diversified economy in order to reduce dependency on one resource or source of funding. Official, strategic efforts by governments to boost productivity in specific sectors.

Assisting governments in challenging times

Increasing role and prominence

The rapid increase in number and size during the last few years suggests that funds are playing an increasingly important role in macroeconomic management and financial stability for governments; the operations of SIs are closely linked to public finances, monetary policy and external accounts. To put the size of SIs as an investor group in context, SIs are the largest group of Limited Partners in private equity clients, and their AUM is more than the private equity and hedge fund industries combined. AUM increased from $5.5tn in 2007 to $10.0tn in 2013, and could reach $15.3 tn by 2020.

Fig 2: AUM of investor groups in 2013



Why a framework based on macroeconomic objectives?

The SI universe is diverse and complex. Among SI funds, there are differences in investment strategy and beliefs, investment constraints, country-specific circumstances, sources of funding, legal structures, and maturity. All of these will contribute to a fund's performance and therefore, funds with a similar objectives may have different asset allocations and investment strategies. As an IMF study noted: 'asset allocation explains about 90% of the variability of a fund's return over time, but it explains only 40% of variation among funds' returns'. This lack of direct comparability means that it is difficult to benchmark and understand a fund's performance at time when SIs' increasing visibility and relevance is resulting in a simultaneous increase in scrutiny and demand for transparency. Difficulties in measuring performance might arise because conditions are constantly changing (or example, there are often frequent changes in operational rules in response to changes in oil prices), or because SIs are increasingly undertaking activities that would previously have been the responsibility of the government or to the public sector entities; these SIs may find themselves deflected from pursuing objectives (often financial objectives) originally set for them. Such complexities may lead to a disconnect between a fund's objectives and investment strategy, and therefore sub-optimal returns.

The first step towards understanding a fund's optimal investment strategy and therefore realistic expectation of return is to clarify the fund's macroeconomic objectives; their overall role in the economic policy framework should be well understood. This does not mean that a fund can only have one objective. Indeed, most funds have multiple objectives that are not necessarily mutually exclusive. Once the purpose of a fund is understood, an analytical framework can be developed to understand whether a fund's investment strategy is aligned to it's objective, and whether a fund has the capabilities required to carry out this strategy.

Norway case study: The evolution of the GPFG's objectives

Norway's $859bn fund has evolved considerably since its creation in 1990. The Norwegian Government Petroleum Fund (NGPF) was established to smooth the consumption of oil revenue across generations, to pay for the ageing population, and to prevent 'Dutch disease'. In 1998, Norges Bank Investment Management (NBIM)was created in order to diversify NGPF's assets away from traditional asset classes and geographies and maintain its purchasing power. In 2005, the NGPF was reformed and replaced with Government Pension Fund Global (GPFG) in a bid to improve public understanding of the fund's fiscal role, particularly in terms of underwriting Norwegian public pensions (although the GPFG has no explicit liabilities). In recent years, Norway has begun to use the fund more regularly to prop up the economy, fulfilling a short-term stabilisation role. In 2015 it plans to use a record amount to fill the non-oil budget deficit (the government is allowed to use up to 4 per cent a year in its budget). It is evident from this journey that GPFG represents an example of a fund with many priorities, and it is necessary to disentangle these from one another to truly understand the fund's purpose.

Balancing intergenerational wealth	Funding future liabilities	Investing reserves	Facilitating fiscal stability	Stabilising the exchange rate

i Hover on the figures

What are funds actually doing?

The difficulties in balancing economic priorities

Domestic development

The cost of capital is becoming more important for SIs, and investments must be viewed through an opportunity cost lens. Governments are reaching into funds to invest in higher-yielding, domestic opportunities that go beyond financial return. Domestic development activities come in various forms, such as investing in physical or social infrastructure, or pursuing a specific industrial policy. Although a persistent gap in infrastructure financing may leave governments with few alternative options, there is the question of whether SIs – traditionally outward investors –are necessarily the right vehicles for these investments.

Multiple objectives

Some countries have established more than one fund, distinguishable from one another both operationally and in terms of mandate. However, less mature funds may start to blend multiple policy objectives in one fund, which can be problematic: if the weighting of objectives is not clearly defined or understood, the necessary investment strategies associated with each objective may not be executed properly. It can therefore be difficult to determine whether the mix of objectives and subsequent return are appropriate to address a country's economic priorities.

Fig 3: Sub-Saharan Africa's annual infrastructure financing gap

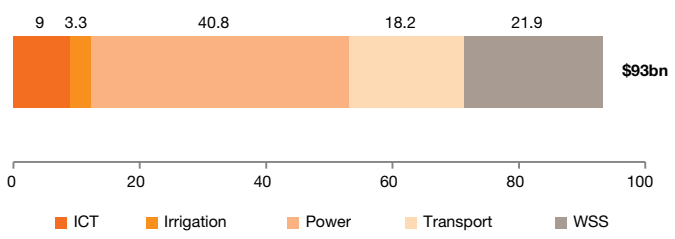
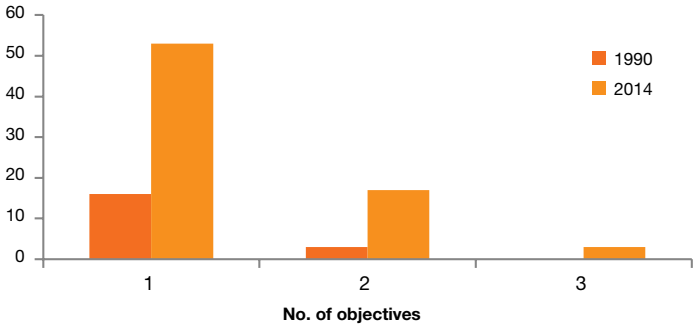
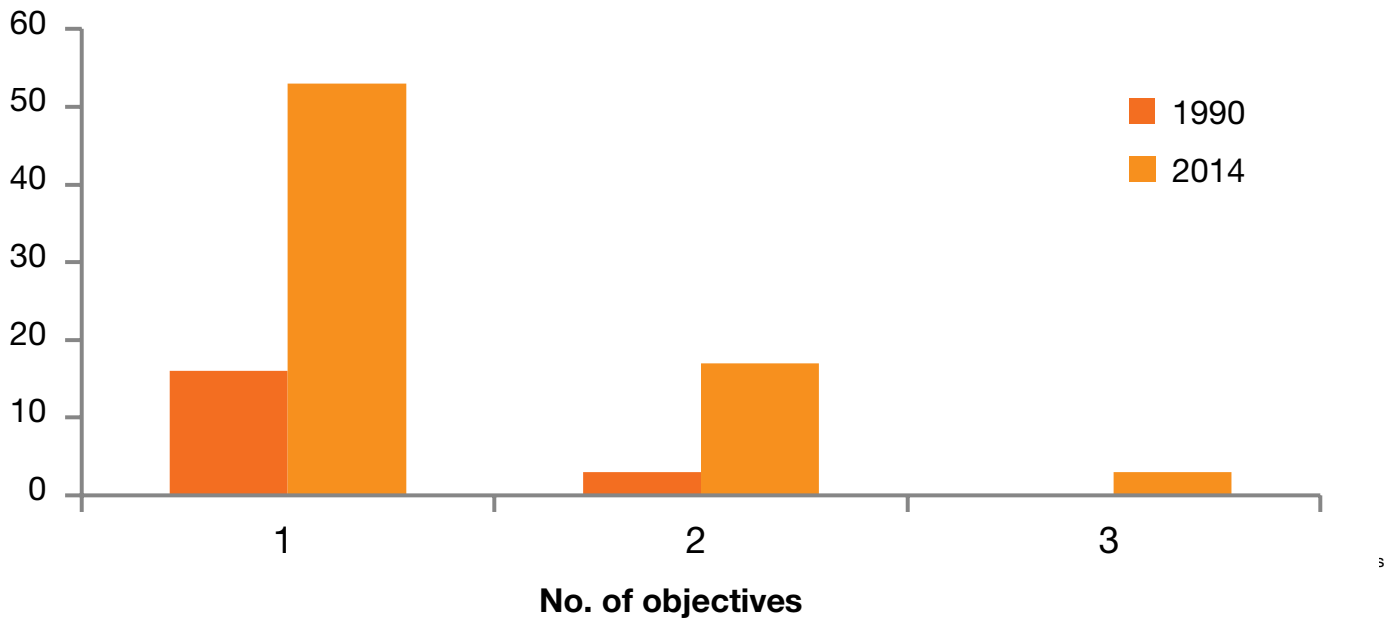


Fig 5: Number of objectives stated by SIs





i *Hover on the figures*

What are funds actually doing?

Box 1: Fast facts – Megatrends and Sovereign Investors*

Demographic and social change

300 million of expected population increase is predicted to come from those aged 60 or more

- The population aged 65 years and over in New Zealand is expected to reach 21 per cent by 2031.
- Globally, there are six Sovereign Pension Reserve Funds at present.

Shift in global economic power

Seven of the world's biggest 12 economics in 2040 will come from emerging markets, the 'E7'

- More than 20% of total SWF AUM is concentrated in China's two funds.
- 80% of SWFs originate from developing or emerging economies.

Rapid urbanisation

1.5 million people are added to the global urban population every week

- 12 SWFs created in Africa for development purposes, with five more expected to be established.
- Half of all funds state that they have an economic development objective, including building physical infrastructure.

Climate change and resource scarcity

50 years of supply left in proven oil reserves

- 90% of funds established since 2005 are financed by surplus revenues from commodity exports.
- Norway could substitute its primary commodity exports with current AUM for more than seven years.

* Facts based on a review of 74 SIs that have been most commonly defined as Sovereign Wealth Funds and Sovereign Pension Reserve Funds. It excludes other types of Public Pension Reserve Funds.

Coming up...

The next in our series of reports looking at strategic issues affecting SIs, will investigate the relationship between a SIs macroeconomic objective, its investment strategy and performance. The report will help to answer the question: how do sovereign stakeholders assess fund performance and determine what 'good' looks like?

These are critical issues that may have implications for the performance of SWFs and their ability to achieve stated objectives, as a disconnect at any point may lead to sub-optimal returns to the beneficiaries of SWFs over the long run. Many of the trends we are seeing in the SWF investment universe require a different investment capability to the traditional bond and equity investment mix that SWFs are deviating from.

Key contacts

Richard Boxshall
richard.boxshall@uk.pwc.com

Charlotte Hacker
charlotte.l.hacker@uk.pwc.com

The PwC Sovereign Investors team brings insight, expertise and specialist knowledge that can help SIs in improving performance.

150511-141316-GN-OS