

"A Huge Advantage"

BEING "BUILT DIFFERENTLY" MAKES SOVEREIGN WEALTH FUNDS MISUNDERSTOOD BUT ALSO MAKES THEM MORE INNOVATIVE, SAYS SCOTT KALB

By Nathan Jaye, CFA

With more than 90 funds managing US\$9 trillion, sovereign wealth funds (SWFs) are among the world's largest and most innovative investors. They're also among the most widely misunderstood, according to Scott Kalb, executive

director of Sovereign Investor Institute and formerly the chief investment officer of Korea Investment Corporation. Whereas many people believe SWFs are driven by political aims, he points out that the primary purpose of SWFs "is actually to protect capital from political influences." In this interview with *CFA Institute Magazine*, Kalb explains inaccurate perceptions regarding sovereign wealth funds, the new collaborative models for SWF investment, how falling oil and commodity prices are affecting these funds, and why sovereign funds are uniquely "built" for innovation.

was indexed, and the managers could leave it alone. How many people did you need to run a portfolio like that? The answer is: not many.

Things are different today. It's been more than 60 years since modern portfolio theory was introduced, and markets have evolved; market theory has evolved. There are many new asset classes and strategies. It's been proven that portfolio diversification is extremely important, but older traditional funds just aren't built to take advantage of the many diversifiers on offer today. Some have evolved, but many are locked in dogmatic governance structures. Their structures can't change because they [conventional structures] are accepted as "less risky" or "the traditional way to go."

What's the consequence of older governance structures?

In many situations, it's tragic: Firms can't engage in new asset classes or hire more people. These funds will go to the board or state legislature and they'll say, "Let me hire 10 people. It'll cost us a million dollars, but we can save \$25 million in fees." The state legislature says, "What are you, crazy? You're going to spend a million dollars? Not on my watch." Or say a traditional fund wants to introduce new alternative asset classes. They don't have the resources internally, so they have to outsource it. If they outsource it, it becomes very expensive. They end up with an internal argument like, "Let's not do these things, because it's expensive to outsource and we can't do it efficiently because of the constraints of our governance structure."

So, sovereign funds have more flexible structures?

SWFs are not built simply to be outsourcing institutions. They're mandated to be developing expertise in all kinds of different investment strategies and to become a repository of knowledge. This gives them a better opportunity to diversify their investments. It also gives them a better opportunity to manage risk and to be more efficient overall.

SOVEREIGN FUNDS ALSO HAVE A MANDATE TO DEVELOP THEIR CAPABILITY, WHEREAS IN MANY OF THE CLASSIC PENSION FUNDS, THERE'S NO SUCH MANDATE. IN FACT, THEY'RE OFTEN INHIBITED FROM DOING SO.

KEY POINTS

Compared with institutional investors, the mandate of sovereign wealth funds (SWFs) "gives them a better opportunity to diversify their investments" and a greater ability to innovate.

SWFs have experienced massive growth of assets in recent years, but "if this challenging economic environment continues for another two or three years, then all bets are off."

Misunderstandings about SWFs and suspicions of their aims pose problems.

How are SWFs different from other institutional investors?

Sovereign funds are built differently. They have more scale, more assets, and more internal resources than classic institutional investors. Average assets under management (AUM) are \$100 billion for sovereign wealth funds [and \$150 billion for sovereign pension funds]. The average head count is about 200 people. Sovereign funds also have a mandate to develop their capability, whereas in many of the classic pension funds, there's no such mandate. In fact, they're often inhibited from doing so.

The institutional side of capital markets was built around pension funds and insurance companies. These funds were built in a "kinder, gentler" time and today are structurally challenged. If you take the top 200 pension funds in the US, the average asset size is about \$20 billion, which is small compared to sovereign wealth funds. The average head count is about 10 or 12 investment professionals.

So the size, scale, and resources are smaller than SWFs. Classic institutional firms were built during a time when a well-diversified portfolio had 60% in equities, 40% in bonds,

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Scott Kalb spoke at the 68th CFA Institute Annual Conference held last year in Frankfurt, Germany.

So if you have large, scalable assets and large internal resources—and you’ve got a mandate to develop your expertise and capability—then why would you invest in the same old way [as smaller institutions that have fewer resources and smaller scale]?

The sovereign funds are asking, “Is there a better way to do things? Why do we need to pay very, very high fees? Why do we have constructs where we outsource and have less control over risk? Why do we have to benchmark public market investments and then be subjected to crazy market volatility?”

How are sovereign funds innovating?

They are trying lots of things. Some are setting up specialized subsidiary companies or joint ventures. They may find a real estate or infrastructure firm and say, “Let’s team up. You are the operating partner, and we’ll provide the capital. We’ll give you a couple billion dollars, and in return we’re going to share the upside.”

Or they might go to a multi-asset management firm like Blackstone and say, “Okay, we’re going to give you \$2 billion to manage across a lot of asset classes. But in return for that, we want lower fees and some optionality. We want to have a first look at a bunch of different investment

opportunities.” In some cases, they’re becoming their own exit strategy. They invest in a private equity fund, and at the end of the life of the fund, they can buy out the assets.

Are SWFs capturing a liquidity premium?

Sovereign funds have a long-term horizon. That’s a huge advantage. Everyone talks of being a long-term investor. But long-term investing is really a function of your balance sheet strength. If you’ve got a huge check you need to write every year (relative to your assets), you can’t really be a long-term investor; you can’t afford to have a big “drawdown” in your portfolio. The fund could be threatened. So you have to be more cautious about how you invest.

Generally, sovereign funds don’t have big liability streams. They can afford to invest with a 10- or 20-year horizon and not worry if they go down in the short run, because they don’t need the liquidity. These guys are perfectly built to invest in illiquid alternative strategies and to harvest liquidity premiums. They are increasingly adding more and more to their non-traditional assets because they can capture premium there.

How are economic conditions and commodity prices affecting SWFs?

Commodity and oil prices are down by more than 50%, and half of the sovereign wealth funds are in commodity-based economies. These funds—for example, the Saudi Arabian Monetary Agency, the Oman Investment Fund, or the Nigeria Sovereign Investment Authority (NISA)—are being hit. They’re not seeing as much money going into their funds, and in some cases, rules are being triggered and money is coming out. That’s very unusual. We haven’t seen that since the Global Financial Crisis.

Then you have the sovereign funds based in economies that use trade as an engine for growth, like the China Investment Corporation or the Korea Investment Corporation. A lot of these funds are in Asia, and we’re seeing a big slowdown in demand for goods produced by these countries, so foreign exchange reserve growth is slowing. It’s going to be interesting to see how the funds respond. So far, I haven’t seen any real change in the way they allocate, but the pace of investment has definitely slowed.

Sovereign fund assets have been growing by about \$500 billion a year. We are well below this level now, but overall we still see inflows. If this challenging economic environment continues for another two or three years, then all bets are off and we’ll have to see if flows stop and reverse course.

What’s the connection to reserve growth?

The explosive growth in sovereign wealth funds in trade-based economies is connected with robust growth of foreign exchange reserves. Here’s a simple way to look at it: A company will sell its goods overseas—its handsets or automobiles—and bring back dollars or other foreign currency, sometimes amounting to hundreds of billions of dollars. These companies can’t just go to the bank on the corner and exchange billions of dollars for local currency. If they did, the exchange rate would appreciate through the roof.

So the central bank intervenes. It prints local currency, opens a window, and it buys the dollars for cash from the companies. Foreign exchange reserves are thus created and, during the boom years of the 2000s, reserves expanded rapidly. Something similar happened for commodity-based nations when commodity prices increased dramatically.

After printing local currency and buying the dollars for cash, the central bank may have allowed too much local currency into circulation, leading potentially to exchange rate declines, so it then issues monetary stabilization bonds to soak up excess liquidity. They have to pay interest on those bonds, usually higher than the rate they receive on their dollar assets. Maybe they're paying 4% and they're only making 1% on their dollar assets. This means they lose money on the spread.

Having a strong base of reserves is important. But too much of a good thing can be painful. In the case of China, GDP is about \$10 trillion, and their reserves grew to around \$5 trillion, an enormous amount both in absolute terms and relative to the economy. Let's suppose you're losing 3% on the spread and you've got \$5 trillion in reserves. That's \$150 billion a year you might be losing—an insane amount.

Eventually, this led to pressure to create sovereign wealth funds, in order to take out excess reserves and manage them with a bit more risk to seek higher returns than those generated by traditional foreign exchange reserve management practices at central banks.

You've described a new model for SWF investment. You call it the collaborative (or re-intermediation) model.

The new model is about having like-minded institutions teaming up, engaging in joint ventures and forming different partnerships than we've seen in the past. In 2012, approximately 45% of all SWF direct investments were collaborative, and I think that percentage is growing. They're also collaborating with external managers. For example, Abu Dhabi Investment Authority (ADIA) and British Columbia Investment Management Corporation collaborated with Macquarie to buy Open Grid Europe [a gas distributor] in 2012.

Enormous amounts of capital are involved here. Sovereign funds have been spending an average of \$50 billion a year on direct investing for the past 10 years. Qatar Investment Authority has built an 11% stake in Tiffany & Co. It's not that sovereign funds are saying, "We want to do everything ourselves," but rather, "We want to do some things ourselves and others with partners, and we want to work with our partners on a different footing rather than being locked into an old format."

What are some misperceptions about SWFs?

Many people think SWFs are politically motivated. People think, "Governments are setting these up for strategic purposes. They want to get involved in foreign industries." But the reality is very different. The idea behind establishing an SWF is actually to protect capital from political influences. SWFs are usually established by an assembly or parliament,

and the assets are ring-fenced—off-limits except in emergency situations when specific rules are triggered (for example, when a country's balance of payments goes negative by 20% over a two-month period). The idea is to take the assets out of the hands of politicians and reserve them for a specific purpose.

These misperceptions often lead to protectionist barriers. In the US, it is okay for an SWF to invest into a third-party fund and pay fees to a US manager who may buy an asset (like a port), but it's not okay for the SWF to invest in that port directly. In the United States, we have highly developed municipal markets and strong public equity markets, but we're not very open to foreign private equity financing of our assets. We could use it. Our infrastructure is falling apart. We're now ranked around 25th in the world according to the World Economic Forum, down from second in 2002. I think we should be figuring out how to work with capital instead of being so suspicious of it.

So, SWFs can help mitigate corruption?

That's one of the ideas. We'll see how effective it turns out to be. One of the earliest sovereign wealth funds was set up in France (Caisse des Dépôts et Consignations) in 1816 by King Louis XVIII to safeguard public funds and civil servants' pension funds. The government was worried that Napoleon might return and squander the national treasury on his war agenda. They ring-fenced an amount of money to keep it safe. Today, the Caisse is an enormous fund with about €300 billion in assets.

Nigeria set up NISA in 2011. It was a very difficult endeavor; many governors in different states didn't want it. Nigeria produces oil, and when oil is above a certain price level, a percentage of it goes into the sovereign wealth fund. NISA actually has a very interesting structure, with three distinct funds inside the SWF: one for long-term savings, one for development, and one for budget stabilization. A portion of the inflows is allocated to each of these funds.

In Alaska, I'm not saying there was corruption, but there was a kind of slippage. When oil was first discovered, about a billion dollars went into the treasury, and it kind of disappeared over two to three years. So the state set up the Alaska Permanent Fund in 1976 to better safeguard the income to be generated by the forthcoming pipeline. I believe 25 cents on every dollar of oil went into the fund, and it has paid out dividends over the years to its citizens greater than the amount of capital it has taken in.

You can still get some shenanigans, but by and large what you're trying to do is protect capital from the political process and keep it safe for the benefit of the people.

What are the five traditional types of SWFs?

The classic one is the long-term savings fund for the future generations of a country—like the one I managed in [South] Korea, or ADIA, or Singapore's GIC (Government Investment Corporation).

Another type is a budget stabilization fund. When commodity prices are high, money goes in, and when commodity prices are low, money goes out—to stabilize the budget. That’s what you have in Chile. This is not a return-oriented fund. It holds money and keeps it safe, depending on the needs of the government.

The third kind of fund is a super-reserve fund generally managed inside central banks. They are usually geared toward making returns to offset the costs and enhance returns of running traditional reserve management programs. Hong Kong Monetary Authority is a good example.

The fourth type is the development funds, and their purpose is to develop the domestic economy. They make investments in an effort to induce foreign technology, manufacturing capability, and outside capital to help with the development of domestic industry. Khazanah Nasional Berhad in Malaysia, the Irish Strategic Investment Fund, and the Fondo Strategico Italiano are good examples.

Finally, you have sovereign wealth funds that are pension funds. You might ask, “What’s the difference between a pension-fund-type sovereign wealth fund and a sovereign pension fund?” The difference is the liability stream. With a sovereign wealth fund, the liability stream goes to the government and then the government deploys the capital on behalf of the people. For example, the New Zealand Superannuation Fund (NZSF) was set up to provide a guarantee for the pension system. With a sovereign pension fund, the liability stream flows directly to the constituents of the fund.

Which funds are leading innovation?

The Canadian funds are a model of innovation. There’s the CPP (Canada Pension Plan) Investment Board, which is not a sovereign fund but a government pension fund. The Ontario Teachers’ Pension Plan also is a leader. They both have robust governance structures and the trust and confidence of their stakeholders, without which it’s very difficult to do anything innovative. These funds are very advanced and are leading the charge.

In the United Arab Emirates, ADIA and the Abu Dhabi Investment Council both are doing innovative things. In Oceania, the NZSF is smaller (\$30 billion) but “perfectly formed,” as they like to say. The head of New Zealand Super [Adrian Orr] is now the chair of the International Forum of Sovereign Wealth Funds and has great vision. The Australian Government Future Fund does a great job, too. In Singapore, the GIC and Temasek have been implementing progressive investment policies for years. In Malaysia, Khazanah has become a model for development funds.

In Denmark, you have the ATP, which is a terrific \$100 billion fund and extremely well run. You have the AP funds in Sweden. In the Netherlands, there’s PGGM and APG, with assets of more than \$400 billion. These funds are very advanced in how they invest. An exception might be the Norwegians, who have one of the largest SWFs

in the world but have adopted and adhered to a very old investment model. The Norwegian Government Pension Fund Global is 60/40 in equities and bonds, mostly benchmarked with very tight tracking-error bands and almost no exposure to alternative or illiquid investments. They’ve been trying to add real estate, but it’s still a tiny portion of their overall portfolio.

Why does the Norwegian Government Pension Fund get so much attention?

Because they are so big! Actually, they’re very advanced in some ways. They have a high degree of transparency, so the public can see exactly what’s going on. They mark their assets to market every minute. People love that kind of stuff. They also are very advanced in terms of their policies on ESG (environmental, social, and governance) and social responsibility. But their investment style is based on a very traditional model that is rooted in indexing and passive management. At their inception (1990), that was the easiest strategy for them to put in place, but once these things are put in place, it’s difficult to change them.

THE CANADIAN FUNDS ARE A MODEL OF INNOVATION. THESE FUNDS ARE VERY ADVANCED AND ARE LEADING THE CHARGE.

What did you learn from your experience managing the Korea fund?

I must have been one of the only foreigners running another country’s sovereign wealth fund. You get a strong sense of the complexities of doing public service. These funds are managing huge assets, but the employees are not getting paid investment banker type salaries. They’re public servants. In some cases, they are well paid, but that’s pretty rare; in most cases, they are paid like public servants.

What’s the role of Sovereign Investor Institute (SII)?

We’re part of Institutional Investor [Institute], which provides a neutral platform and strong brand with rigorous intellectual credibility. At SII, we work with government funds around the world. About 290 government fund delegates from 140 funds and 60 countries were part of SII last year. We have face-to-face meetings at roundtables held around the world, where we can address important investment issues of the day, exchange ideas, and work on ways to collaborate. It’s hard to manage sovereign wealth sitting in isolation. You’ve got to get into the community and see what other funds are doing. Otherwise, everybody’s just re-creating the wheel.

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“Sovereign Wealth Funds in the Global Capital Markets,” CFA Institute webcast (28 April 2015) [www.cfainstitute.org]

“The Industrial Organization of the Global Asset Management Business,” Research Foundation of CFA Institute (November 2015) [www.cfapubs.org]