

INVESTING FOR THE DOUBLE BOTTOM LINE

Ireland's sovereign fund aims for returns *and* economic development

By Nathan Jaye, CFA

The Ireland Strategic Investment Fund (ISIF), launched in December 2014, is the first sovereign wealth fund with a double-bottom-line mandate of achieving both investment returns *and* economic impact. In this interview, Eugene O'Callaghan, director of the fund, and Ronan McCabe, CFA, an ISIF investment manager, jointly respond to questions about the fund's unique position and progress, challenges presented by a double-bottom-line mandate, teaming with co-investors, and the change in mindset necessary to transition from a sovereign wealth fund to a sovereign development fund.

How did ISIF come to be?

The National Pensions Reserve Fund (NPRF) was a classic sovereign wealth fund, saving money for pensions of future Irish generations. This was set up in 2001 to build a pool of money that could be used between the years 2025 and 2055 to help pay for social welfare and public sector pensions in Ireland.

As you know, Ireland experienced severe economic difficulties starting in 2008. The fund had grown to around €24 billion, but over a three-year period beginning in 2009, it became a rainy day fund; €20.7 billion of the fund's assets were used as part of the bailout of the Irish banking system. We had to liquidate substantial assets, most of which were in liquid equities and bonds.

A new government came in to very severe economic problems. Part of what they decided was to use the remaining assets of the NPRF for strategic investment in Ireland. On 21 December 2014, the NPRF was formally closed down, and all of its assets were transferred to the Ireland Strategic Investment Fund. We kicked off then with our new mandate.

What is your double-bottom-line mandate?

Our success is measured both by investment returns *and* economic impact achieved. That's

the double bottom line. Our mandate is to invest on a commercial basis to support economic activity and employment in Ireland. What that means is that every investment must meet both of those criteria. That is extremely challenging.

What does investing on a commercial basis mean? It really means that the investment must have an appropriate expected-risk-adjusted return. We can invest anywhere up and down the risk spectrum, and as long as they are safe investments, we are happy for returns of 1% or 2%. But we also have the flexibility to invest in early-stage venture funds or businesses where (reflecting the higher risk) we might have a target return of 15% or 20%. We can go from safe and secure debt to unsecured debt to project finance, mezzanine finance, working capital finance, all the way through to preferred equity and ordinary equity.

The other element of the bottom line is our economic impact. Every investment we make has to contribute to incremental economic activity in Ireland. We developed an economic impact framework in consultation with public sector economists to help us implement this strategy.

What are the concepts of deadweight, displacement, and additionality within the framework?

We've come up with three key concepts on economic impact. To fuel economic impact, the core attribute we look for is additionality. This is additional economic activity that wouldn't have happened otherwise except for our investment.

For example, if you export products that you didn't export before, this is additional economic activity. If we support a business that's exporting and they export more, that's a clear example of incremental activity. Similarly, if we are engaged in manufacturing—even if the goods are sold domestically—these businesses are open to international competition. If we can make products in Ireland that otherwise would

be bought or produced overseas, that's good as well. That's incremental economic activity for Ireland.

But take a different example: Google's European headquarters is right behind us in Dublin. If we were to buy that building and lease it to Google for 25 years, that would *not* satisfy our mandate, even if we got the building at a cheap price. There would still be the same tenants and the same activity going on in there, so there's no additional economic activity. We look at additionality quite widely. We think about enabling infrastructure. If we invest in infrastructure which will enable the future competitiveness of the economy and growth of GDP, that's good. Where there are infrastructure gaps, we would be looking to help in financing the delivery of those [projects to fill the gaps].

We want to avoid two economic concepts: deadweight and displacement. Financial deadweight is where there are lots of willing investors in a proposition involving a company or a project. There's no point in us participating, because we don't make a difference. If it's going to happen anyway—if there are other willing investors—there's no incremental value from us being involved. That won't satisfy our mandate.

The other constraint has to do with displacement. We want to avoid investing in businesses which would be to the detriment of other Irish businesses. This would be domestic retail- or domestic service-type businesses.

These concepts of seeking additionality and avoiding financial deadweight and displacement, they're the core elements of our economic impact framework. Our opportunity set is dramatically changed from when we were a global investor back at the NPRF.

Do your investments need to be in Irish companies?

Largely and in general, yes, but not necessarily. There are exceptions. We can also fuel economic impact in Ireland by investing outside of Ireland. An example is a transaction we did a few years ago with Silicon Valley Bank, which is a global technology sector bank. We invested US\$50 million in two of their global venture capital funds of funds. As part of the deal, they agreed to lend US\$100 million directly to domestic Irish technology companies. Our investment was outside Ireland, but by virtue of a wider relationship—in this case, Silicon Valley Bank—we were able to generate additional economic activity in Ireland. [The partnership with Silicon Valley Bank began in 2012 when Ireland's sovereign wealth fund was still organized as the NPRF. In May, Silicon Valley Bank pledged to invest an additional US\$100 million in Irish companies over the next five years.]

Our local banks aren't particularly expert in the business models of technology companies. But Silicon Valley Bank is. So we were able to provide financing for indigenous technology companies through Silicon Valley Bank, which wouldn't otherwise have happened.



Eugene O'Callaghan

We've also invested in pan-European private equity funds, where if we committed X into their fund, they would reciprocate by committing to invest 2X in Ireland.

Where do you tend to invest?

It's very broadly based. We have many target investment buckets. These include infrastructure, energy, water, SMEs, venture capital, direct private equity. We also have a food and agriculture sector bucket because Ireland has significant competitive advantage in that sector. We have an innovation/big idea bucket to hopefully achieve something of transformational impact in the medium to longer term. We have high aspirations there.

What are the unique challenges of your mandate?

There are a number of challenges which make our journey quite different from a conventional investment fund. The biggest challenge is the actual mandate itself—the double bottom line.

There is no real precedent for an economic impact mandate for a sovereign fund across the whole economy at this level. All our team comes from conventional investment and



Ronan McCabe, CFA

finance backgrounds. Adapting to the mindset of delivering economic impact has been a challenge to us all. We're a year and a half down the road, and we're definitely getting there. But even though we all accept it, on a day-to-day basis, it has been a significant challenge.

Our size poses another challenge. We have to be fair and consistent in our dealings with all parties. We're a universal investor.

We will own lots of pieces across the Irish economy. As a public sovereign fund, a national fund, we need to make sure that we have processes where anybody who has a reasonable proposal can get a hearing. We've got to be fair and open with everybody.

Thirdly, we have to make sure that we don't become the market. With that scale of money, if we became the market in any particular sector or segment, we run the risk of bidding up the price, using our money to fund two or three different players all of whom are bidding up the price of the same assets against us. This means we have to segment our investments. We will be further segmenting into sub-segments and will try to ensure that when we invest money or allocate money to private equity, the funds are invested directly. Our opportunities need to be very well defined so that we're not competing with ourselves.

More broadly, from a good governance point of view, it's important that our investment decision making be insulated from political influence. The board of the National Treasury Management Agency (NTMA), which has ultimate responsibility for the fund, has six private sector capital market, finance, and business experts. It also includes the NTMA chief executive and the secretaries general of the two government finance ministries.

That board is responsible for the overall strategy for our fund, but all individual decision making is done by an investment committee, which is a subcommittee of the board and comprises purely private sector individuals (our CEO and the two secretaries general are statutorily precluded from being on it). Our team reports to the investment committee and seeks the committee's approval for the things we're looking to do, and that has proven to be very effective.

How are you teaming with co-investors?

We like to have co-investors alongside when possible. It validates the commerciality of what we're doing and means we can get more bang for our buck. We don't need to dedicate quite so much of our resources to make things happen.

The addition of third-party capital has typically multiplied our investment commitments by 2.5 times. The fund is currently €8 billion, and if you gross that up by 2.5 you get €20 billion. That's roughly 10% of the GDP of Ireland. In the US, 10% of GDP would be US\$1.5 trillion. So, in Irish economy terms, this is like having a US\$1.5 trillion investment program in the US, which is obviously very, very big.

How do you transition to a sovereign strategic investment fund?

There are three phases to the transition. The NPRF in its last years implemented a capital preservation strategy, which centered on trying to maintain exposure to real assets. We wanted a lower risk profile. We knew that the fund was going to be transformed into a domestic fund, but we didn't know when.

So we reduced our equity. We made the portfolio more liquid. We managed to sell our private equity very close to par. The conditions for sellers were good at the time—a couple years ago. We used equity put options to give us protection for our public equity investments. This capital preservation strategy was maintained for the first year of the ISIF until we and our investment committee had more clarity on our ongoing strategy.

Currently, the bulk of our €8 billion portfolio (approximately €6 billion) is still invested globally, and a large portion of that is still cash for capital preservation reasons. That global portfolio will be gradually wound down over the next four to six years as the Irish portfolio builds up, and that is where our portfolio transition strategy comes in.

The starting point for the portfolio transition strategy is the cash modeling for the Irish portfolio. We need to make sure that we will have the cash that we need to fund our Irish investments over the next four to six years.

At the same time, we have a return objective, which is mandated in legislation. We have to seek a return that will exceed the cost of Irish government debt, on a rolling five-year basis. The average cost of Irish government debt is about 3.4%. If we add on 20 basis points for our costs and a bit more to get to a round number, we settle on a target portfolio return of 4%. So we can't just cash in our global assets for the next four to six years and earn negative 40 basis points, which is the risk-free rate in the eurozone at the moment.

So, the portfolio transition strategy has three elements to it, one of which, as I said, is cash. The second is short

term (one to three years) and will typically be in bonds. The third element of the strategy is the growth-seeking portfolio. It will include equities, credit, and hedge funds, which would help us achieve 3%–3.5% return overall.

The drawdown is expected to be completed by 2020?

That's an initial estimate. We think it's going to take us four or five years to commit the €8 billion to investment in Ireland. We started in 2015, so it might all be done in five years. Because of the nature of private equity funds—or even credit investments where we approve credit for a construction project—it can take up to two years after our commitment before the money is drawn down. Our global portfolio will gradually deplete from its €6 billion level over a five-to-seven-year period down to nothing as all the investments in Ireland get funded.

How are you building a diversified portfolio without using a CAPM approach?

I would say with extreme difficulty. We're still developing our strategy in this space, because we're still largely exposed globally. As we build our Irish portfolio, we will need to develop a strategy for an Irish portfolio. Given the mandate we've been given, it's not possible for us to diversify away exposure to Ireland. If the Irish economy does really well, we'd expect our fund to do really well. If the Irish economy encounters some headwinds, we would expect that to affect our fund, too.

Within the Irish investment world, we are looking to diversify as much as possible. At a basic level, we will look to be diversified by sector and between debt and equity (and in the capital structure). We will also seek to be diversified by risk category. We have private-market risk. We have private equity- and private credit-type assets. The conventional method of using volatility as a proxy for risk is not going to work here at all. We're developing a more qualitative risk categorization.

We've worked closely over the years with Bridgewater Associates. They have an all-weather framework, which seeks to diversify assets according to those which will do well in high growth and others that would do well in low growth or other economic scenarios such as high and low inflation. We'll be looking to apply this thinking in a very loose way to investing in Ireland.

How does the culture of ISIF fit with the fund's objective?

Everybody who joins the team has to be flexible. They have to understand coming in that there is no job role set in stone. Everyone has to accept that the fund is going to evolve and change shape as we go along. Essentially, we're a start-up business. It's a new business with a new mandate, so people need to be flexible and adaptable—and collaboration is critical. There are hardly any transactions which are the same. We have quite diverse groups of two or three people working on individual deals. We assemble deal teams according to what makes the most sense.

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