How Do Sovereign Wealth Funds Invest?
Shift into Private Markets Continues

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From the turn of the millennium onwards, the SWF sector experienced rapid growth in assets under management (AuM), but that has now come to an end. The slowing of organic asset accumulation and the proliferation of new SWFs carries great implications for asset allocation. We are publishing this update to our 2015 article to discuss the changes in the sector over the past two years and to offer several new angles from which the sector can be viewed.

We estimate that in 2002 the total assets of SWFs stood at $790 billion. There were only 21 SWFs, with most of the assets concentrated among a few large SWFs (the top seven held 87% of global SWF AuM); only nine funds were invested in alternatives (referred to in this article as “private markets”) and only two had assets in excess of $100 billion. By the end of 2016, the sector had transformed into a major asset owner group with SWFs managing roughly $6 trillion in assets; 11 funds had more than $100 billion apiece and 30 out of 37 funds had invested in private markets.

These funds have grown in size, sophistication, fiscal importance to their host countries and macroeconomic importance to the global economy. According to our calculations, they own 6.3% of global publicly listed equity. Perhaps more strikingly, their $1.6 trillion private market holdings amount to over 15% of the entire global alternatives market. At the same time, this disproportionately large role of SWFs in private markets is an indicator of limits to future growth. It also explains why vendors of private asset classes have particularly targeted sovereign investors as potential buyers.

Many structural indicators point to the fact that this era of rapid SWF growth is drawing to a close. The oil market — the proceeds from which account for at least a half of all SWF wealth — appears to have been fundamentally reshaped with new spare capacity that could cap a rise in commodity prices. The other large source of sovereign wealth accumulation, namely growth in foreign exchange reserves, also appears to be slowing as many emerging markets move towards consumption-based economic growth and aging populations increase fiscal pressures on SWF owners. In this new environment, many funds are adjusting their policies to focus on internal income generation or accommodating their owners’ fiscal needs.
In 2014–2016, SWF assets grew by a mere 3% annualised, compared to 15% annualised in 2012–2014 (Figure 1). AuM growth in SWFs whose assets had been generated by oil revenues (henceforth “oil funds”) was particularly slow. Despite very favourable financial market conditions, 35% of all SWFs actually experienced a decline in AuM (compared to 10% of SWFs in 2012–2014), indicating that governments made withdrawals from them to finance their fiscal needs. In fact, the proportion of such governments is likely to be higher than 35%, as some funds probably managed to offset fiscal withdrawals with internal income generation. Generally, most SWFs were able to generate greater returns than the borrowing costs of their beneficiary governments, so most governments engaged in a mixture of borrowing and divestment; however, almost none relied on borrowing alone.

The sector has become less dominated by a small number of large funds, as the median AuM grew faster than the average AuM in 2014–2016. Many of the top ten largest funds experienced a slowdown in growth as they adjusted to the new oil price environment, while several Tier 2 funds (i.e. between 10th and 20th in absolute size) made big gains. However, growth has been very uneven. Some medium-sized funds have witnessed erosion — indeed, among the funds with AuM between $10 billion and $100 billion, half have suffered a decline in assets, notably commodity funds from the former Soviet Union and the poorer countries in the Gulf. New entrants to the group have been few and small in size. Moreover, future data may be distorted by a process of consolidation as some Gulf governments merge existing SWFs for idiosyncratic reasons. For example, Mubadala in Abu Dhabi has merged with International Petroleum Investment Company, Sanabil Investments in Saudi Arabia has been incorporated into the Public Investment Fund and Oman is reported to be planning to consolidate all of its SWF vehicles into one.
Despite the considerable slowdown in asset growth, overall asset allocation has only changed incrementally. On an unweighted aggregate basis, private market assets experienced the biggest growth (Figure 3). As a result, the average SWF continued its gradual drift towards private markets at the expense of fixed income (Figure 4). Over the five periods we considered, we saw a gradual reduction in the share of fixed income and an increase in private market allocation, with a more uneven pattern for equities. The big exception was 2012–2014, when the fixed income allocation rebounded, which is explained by several factors outlined in the next section.

Figure 3: Aggregate Asset Allocation of SWFs (US $bn)

Source: SSGA Research, using original data from the Sovereign Wealth Center.

Figure 4: Average Asset Allocation of SWFs (%)

Source: SSGA Research, using original data from the Sovereign Wealth Center.
In the previous study, with data as of the end of 2014, we made two main observations: first, SWFs behave heterogeneously and second, as a group they tend to invest as contrarians. The addition of two extra years of data allows us to refine our conclusions and consider a number of additional aspects of SWFs’ behaviour.

Overall, the heterogeneity in SWFs’ behaviour decreased slightly in 2014–2016 as the increase in allocation to private markets became very uniform (Figure 5). However, within publicly traded asset classes (i.e. fixed income and equities), behaviour actually diverged further. We believe that apart from the diversity of mandates and investment views, a further factor now contributing to SWF heterogeneity in these areas is the difference in the funds’ cash flow patterns, as some funds are still accumulating while others are disbursing to governments.

Given such diversity within SWFs, are there any notable conclusions we can draw about their behaviour as a group? To answer this question, it is worth reviewing the previous period (2012–2014) alongside the current one (2014–2016) and considering what factors drive their decisions.

In 2012–2014, SWF’s behaviour was contrarian to the global asset management industry in two key ways: first, while global asset managers marginally reduced their private market allocations, SWFs increased them (Figure 6); second, while the global asset management industry increased allocation to equities relative to fixed income, the average SWF did the opposite. In 2014-2016, this contrarian behaviour mostly disappeared, but the allocation to private markets increased even further.

We would argue that the shift into fixed income was a transitory phenomenon while the move into private markets was more permanent. In 2014, oil exporter countries suffered a substantial terms-of-trade shock. Both the governments and their SWFs lacked clarity about the future path of oil prices, but at the same time knew that the paths of their fiscal expenditure could only be altered gradually. In anticipation of that, many smaller SWFs of oil exporters de-risked their portfolios and increased their allocations to cash and fixed income, while the asset management industry as a whole dialled risk up as they took advantage of gradually improving market conditions.

Figure 5: Increases and decreases in allocations to asset classes, number of SWFs

Source: SSGA Research, using original data from the Sovereign Wealth Center.
In contrast, the increase in allocation to private markets happened during every time interval we considered. In 2012–2014, larger oil funds as well as non-oil funds increased their allocation to private markets. In 2014–2016, this happened again and the increase among oil funds was larger as, in part, they caught up with non-oil SWFs. While a number of oil SWFs remained in a highly liquid, de-risked state and became a de facto liquidity buffer for their governments, most have realised that the new reality of small or negative inflows increases the onus on them to generate income internally. In a low yield environment, many have increased their asset allocation towards higher-yielding private market assets, in the belief that the asset class matches their needs as long-term investors.

Even in countries which have established separate SWFs dedicated to private investments, the liquid SWFs still allocate a portion of their assets to alternatives. But perhaps more strikingly, the increase in private market allocations happened regardless of the cash flow position of the funds. Generally, we would expect funds with falling AuM to shift out of the riskiest assets and into cash and fixed income. But as Figure 7 shows, funds with falling AuM increased private market exposure by the same amount as funds with growing AuM, the difference being that they supported this increase by reducing the share of public equity to maintain the same allocation to fixed income investments.

Source: SSGA Research, using original data from the Sovereign Wealth Center and Willis Towers Watson.
HOW LONG CAN THESE TRENDS CONTINUE?

The global asset management industry has maintained a relatively flat allocation to alternatives over the past five years at about 14%. By contrast, SWFs now have a 27% aggregate allocation to private markets. For several reasons we believe we are close to the peak as a further increase could hit institutional constraints.

First, while many SWFs were early investors into assets like private equity, the space is more crowded now and there are questions as to whether investors receive an adequate illiquidity premium. Even though the supply of private assets is theoretically almost limitless, the asset management industry sometimes struggles to produce institutionalized vehicles for such investments, which is particularly visible in the area of infrastructure. In the absence of such market vehicles, funds would need to invest directly or in partnership with other asset owners. This would require a corresponding expansion of internal capabilities, including governance and expertise, and many funds may be approaching their institutional limits in this regard.

Second, with a slowdown in inflows, each fund is facing a higher probability of net outflows in any given year, and liquidity management is difficult to conduct with a high share of illiquid investments. The experience of the global financial crisis showed that many endowments (an asset owner type particularly focused on income provision to their beneficiaries) over-allocated to private markets, which made it impossible to rebalance their portfolios quickly enough during a market downturn. Private markets are not a panacea to a low-yield environment and over-allocation to it can lead to portfolio inefficiencies.

Third, a rising interest rate environment will lessen the appeal of higher risk assets for many funds. In this regard, most SWFs are anchored in US dollars so the US interest rate cycle is central to their fixed income decisions. At the time of writing, markets expect at least another 100 basis points rise in the federal funds rate over the next 12 to 18 months, which should boost the attractiveness of bonds for long-term buyers such as SWFs. Even a modest rebound in the appeal of fixed income assets would likely occur at the expense of higher allocations to alternatives.
While SWFs are growing less rapidly than before and some such as oil funds face longer term challenges, they continue to constitute a significant proportion of the global investor universe. As a result, their asset allocation decisions may affect a variety of markets and are worth paying attention to.

Looking ahead, we expect SWFs’ asset allocation to continue to evolve, either in response to changing market conditions or to exogenous factors such as high outflows, which automatically increase the share of alternatives as they are often harder to divest. The asset mix in general, however, could begin to stabilise as fixed income investments do not carry the same opportunity cost they once did and investing in alternatives is hitting institutional limits.

The number and type of SWFs are also likely to change. In recent years, we have seen several smaller funds disappear as independent entities and new funds join the SWF universe. However, we expect large SWFs to continue to be the agenda-setters among asset owners and account for most of the major long-term allocation trends in the coming years.  

1 “Alternatives” is the term used to encompass all asset classes that are not publicly traded, notably referring to private equity, real estate, hedge funds, infrastructure and private debt.
3 All the data hereafter is provided by the Sovereign Wealth Centre unless otherwise stated.
4 As per the Sovereign Wealth Centre, the terms ‘private markets’ and ‘alternatives’ are used interchangeably.
5 We consider the top 37 SWFs with assets in excess of $2 billion.
6 Foreign exchange reserves are assets held by central banks in foreign currencies, used to back their liabilities, conduct monetary policy and intervene in currency markets.
7 The merger only began on 2017 so the data used in the paper reports them separately.
8 We split all assets into three broad categories – (i) cash and fixed income jointly, (ii) (public) equities and (iii) private markets including real estate, commodities, hedge funds, private equity and private credit.
10 The data on the global asset management industry is obtained from ‘The World’s 500 Largest Asset Managers’, October 2017, P&I and Towers Watson.
11 Illiquidity premium – the additional return received by an investor for the additional risk of tying up capital in a less liquid asset.