How Do Sovereign Wealth Funds Invest? Less and Less Contrarian

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Introduction

This is an update to our bi-annual report on the investment trends among Sovereign Wealth Funds (SWFs), highlighting the following key trends in 2016–2018.

- Overall asset allocation has essentially stabilized, with only a marginal further re-allocation to private markets; the number of SWFs has shrunk due to mergers.
- While oil funds continue to have a markedly higher average allocation to alternatives than non-oil funds, we observe that the fund size has become a more important predictor of asset allocation than the fund origin.
- The changes in SWFs’ average asset allocation have reached full synchronization with the global asset management industry, indicating the maturing of SWFs as an institutional segment.
- In the next two years, we expect some further consolidation and a stable overall asset allocation, unless a significant market downturn causes a systematic change.
Sovereign Wealth Funds (SWFs) are a prominent and diverse group of global asset owners. They represent unencumbered fiscal resources of the host governments, invested under a range of different mandates. In this study, we considered 35 largest SWFs, located in 26 different jurisdictions, which have assets above $5 billion as of year-end 2018.

Compared to our previous study released in early 2018, there are two major changes to the sample. First, three major Abu Dhabi—based SWFs — Mubadala, Abu Dhabi Investment Council (ADIC) and International Petroleum Investment Company (IPIC) — have merged into one under Mubadala’s umbrella. We have merged them in the historical data, to have a consistent view of the changes in asset allocation. Second, we have now included Saudi Arabia’s Public Investment Fund (PIF) for both 2018 and 2016 and treat it as a successor entity to the much smaller Sanabil. Furthermore, we continue to exclude a number of entities referring to themselves as SWFs but de-facto constituting government holding companies. While several SWFs have a holding company legacy or segment (Temasek, Khazanah), we believe that an SWF should have some liquid and/or some non-domestic investment to be viewed as a relevant global capital markets player.

The resultant sample are collectively worth $6,830 billion, having grown by annualized 5.5% since 2016. Just over half of the assets (51%) belong to the 19 SWFs which originated from oil, while the other 16 were sourced either from other commodities (including natural gas) or from excess foreign-exchange reserves unrelated to specific commodity exports. Hereafter, they are correspondingly referred to as ‘oil SWFs’ and ‘non-oil SWFs’. As in the preceding two-year period, non-oil SWFs had a slightly higher growth rate (Figure 1) and were responsible for the overall acceleration in the sector’s growth. A few of the large oil SWFs are still reducing their balance sheets to help their host government with fiscal problems, while non-oil SWFs are focusing on internal revenue generation and more efficient use of existing resources.

Collectively, SWFs continue to hold significant weight and influence in global markets. We estimate that the 35 SWFs in our sample hold 6.8% of global listed equity market; furthermore, on a very conservative assumption that a quarter of SWF’s alternatives portfolio is in private equity funds or deals, they appear to be holding 14% of the global private equity market.

![Figure 1: Sovereign Wealth Fund Growth](source: SWFC, State Street Global Macro Policy Research, based on 35 largest SWFs.)
Our reports track asset allocation across three very broad asset classes: cash and fixed income, public equities and alternatives/private markets. Between 2016 and 2018, the most remarkable observation is how little it has changed. The average SWF moved 1.7% of their assets into private markets, funded by a 1.1% reduction in public equities and a 0.6% reduction in cash and fixed income (Figures 2 and 3). On the face of it, this amounts to a slight risk-on mood with a further expansion of illiquid assets. If we exclude two SWFs which have gone through a major strategy review, the changes become near-negligible.

Source: SWFC, State Street Global Macro Policy Research, based on 35 largest SWFs; allocations may not add to 100% due to rounding.

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Only four out of the 35 SWFs (mostly very small ones) have ‘cashed in’ on their growth assets to a significant extent, by adding 3% or more to the cash and fixed income layer. In contrast, seven made a significant ‘deployment’ by cutting cash and fixed income by 3% or more. The average fund has a third of assets in fixed income, but fixed income represents only 26% of the aggregate assets, as smaller funds tend to be more liquid (more on this in the next section).

Listed equity remained the largest asset class, both on average and in aggregate. In fact, for those SWFs which are wary of private markets, it is the main growth asset, with eight of the 35 funds having an allocation of above 50% and four funds — above 60%. In this regard, the significant market downturn in late 2018 may be affecting figures, perhaps depressing those SWFs’ growth rates. Moreover, in case some of them did not re-balance their portfolios by the end of the year, it is possible that the aggregate amount of listed equity is artificially low, as markets rebounded in 2019.

The allocation to private markets continues to grow, but at a slower rate than before. The bulk of 2016–2018 growth was created by two SWFs, others being somewhat more cautious. Two other large SWFs have re-allocated back to public from private equity, presumably after exiting some PE investments from older vintages, but this was offset by many other SWFs adding small amounts. If we only consider SWFs who ‘specialize’ in private markets (>40%), they made almost no changes at all, meaning there is no reason to suspect a systemic change in attitude toward the asset class.

Another way to look at SWF’s moves is to count the increased and decreased asset allocations, as shown in Figure 4. Here, too, the picture is almost flat, in contrast to preceding periods; importantly, the chart indicates that that the appetite for increasing private investments is beginning to wane.

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**Figure 4**

Increases and Decreases in Allocations to Asset Classes

![Figure 4 image]

Source: SWFC, State Street Global Macro Policy Research, based on 35 largest SWFs.
The investment policy of each of the 35 SWFs in our sample has evolved under a unique set of circumstances, determined by age or the size of the institution. Another factor is the underlying source of SWF wealth. Oil is a particularly volatile commodity and many oil-based economies accumulated wealth relatively quickly; non-oil wealth either comes from commodities which are less volatile but also less likely to generate abnormal profits; or from foreign exchange reserves accumulated over very long periods. The geography of the two categories is also distinct, with the former relatively concentrated in the MENA region and latter being somewhat dispersed with a bias to Asia.

Earlier in the decade, it seemed that the greater underlying fiscal uncertainty caused oil funds to behave distinctly from non-oil ones, for example, by increasing allocations to fixed income in 2012–2014. However, we have found that post the 2014 oil price shock, oil SWFs have either dwindled or re-adjusted to the new reality, and their investment behaviour somewhat converged with the non-oil ones. Instead, we find that the size of the SWFs is an increasingly important factor.

If we interpret the share of fixed income as an indication of the SWF’s risk aversion, we note that oil SWFs started out as more risk-averse, as the mandates and the horizons of the funds were still evolving. The difference eroded by 2012 and resurfaced slightly in 2014, as some oil funds cashed out in preparation for fiscal drains (Figure 5). In 2018, it shrunk virtually to zero, both for the average fund and for the aggregate assets of SWFs in either category. In contrast, smaller funds (<$50bn) have materially higher shares of fixed income (38% vs 29%); moreover, the gap between small oil funds and large oil funds and between small and large non-oil funds is also similar. It appears that large funds have fewer liquidity constraints and try to utilize their size to improve net-of-fees returns in both public and private equity markets. In contrast, funds which we consider ‘small’ only account for 4.3% of SWF assets, and their average size of $18 bn is not that different from large corporate pension plans or other private sector asset owners.
However, with regard to the attitude to private markets, the fund origin still appears to play a role. While the allocation to alternatives is on an upward trend for all fund categories, oil SWFs appear to have a consistent lead. In other words, the average oil SWF allocates 6% more to private assets than a non-oil one. However, if we look at the aggregate of all oil SWFs, the total share of private markets is only 20% — against 38% in the aggregate assets of non-oil SWFs. The explanation lies in the fact that oil funds are more likely to have allocations at the extremes: a quarter of oil SWFs allocate more than half of their assets into private markets, while a third allocate less than 10%.

Figure 6
Allocation to Fixed Income By Fund Source and By Fund Size

Source: SWFC, State Street Global Macro Policy Research, based on 35 largest SWFs.

Figure 7
Allocation to Private Markets By Fund Source and By Fund Size

Source: SWFC, State Street Global Macro Policy Research, based on 35 largest SWFs.
In our earlier research, we often described SWFs as contrarians — entities whose behavior is inconsistent or often opposite to the broader asset owner universe. We used Willis Towers Watson’ annual study on the world’s largest 500 asset managers as the benchmark (see Figure 9). Until recently, the ‘contrarian’ designation was well-grounded: in 2012–2014, SWFs (mostly oil ones) de-risked on fiscal uncertainty even as other asset owners heavily moved into equities, and in 2014–2016, SWFs ramped up illiquid exposures just as the overall universe stayed put. However, in 2016–2018, SWF asset allocation changes have largely mirrored the global asset management industry; in other words, the SWF universe appears to be less contrarian and perhaps offers less swing demand that has been so prevalent in previous downturns.

How can we interpret this? One simple explanation may be that as SWFs grow larger, there is less room to be contrarian; however, the aggregate scale of SWFs has been of comparable magnitude since 2014. Another interpretation could be that as soon as their mandates and strategies settled, so did their strategic asset allocations, and the changes thus represent mere tactical moves, which in turn could be similar to non-SWF institutions.
In our third bi-annual study of sovereign wealth funds, we observed very few significant changes in asset allocations. Most funds merely extended or trimmed some position tactically but retained the same strategic direction. While the sector continued to grow, most of the growth was organically generated. Finally, the tactical asset allocation moves were similar to the broader financial industry.

This is not to say that SWFs stopped being unique. Among the top asset owners in the world, they are unique in having no specific liabilities, which contributes to them having the highest allocation to alternatives of all key asset owner types. Several individual sovereign wealth funds have the biggest listed equity portfolios in the world, five of them holding more than half a percent of global market each.

In the next two years, we expect asset allocations to remain stable, with some individual funds making occasional changes. There could also be pressure for further consolidation of SWFs, although governments with a single large SWF may, in contrast, consider the model with a separate entity focused on illiquid investments. The growth of private markets and the shrinking of public markets, described in our recent report, may put further pressure of SWFs to increase private market allocations, but it is important to remember that SWFs were partly responsible for that trend in the first place.

Could things change more significantly during a global downturn? The previous one was followed by rapid asset accumulation, and SWFs promptly utilized the new cash for buying opportunities in both public and private markets. To continue to do so after next one, they would have to consciously increase their allocations to those asset classes, which would require a significant relaxation of risk tolerance. Moreover, they would be cautious of placing additional funds into the private markets if faced with extended holding periods of their existing commitments. Hence, even a significant market downturn may not, by itself, shift asset allocations beyond tactical moves.

Most importantly, SWFs have gained importance in the broader fiscal framework of their host governments, and the changes in their assets are increasingly considered alongside the broader fiscal framework; consequently, big changes in SWFs would occur if and when these frameworks are reviewed, which is ultimately a broader policy issue.
In this study, we use the terms ‘alternatives’ and ‘private markets’ interchangeably to denote all asset classes which cannot be categorized as cash, fixed income or equity, such as real estate, private equity, private debt and commodities.


In 2016, PIF’s role was still evolving and we excluded it from the study.

Sovereign Wealth Centre.

Dodard, F., A. Le and A. Roy (2018) ‘What is the Portfolio of Assets Held by the World?’

ibid.; the exact number is hard to compute as some of the SWF’s private investments are done on an ad-hoc basis and by-pass the private equity industry.

We merge cash and fixed income in our study as short-term fixed income has quasi-cash properties and it is not always possible to separate them in the original reporting.


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