MarketWatch

Market upheaval forcing many sovereign-wealth funds to adapt

By Sue Chang
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An earlier version of this report misidentified one of the sources of the benchmarks used to evaluate Norway's Government Pension Fund Global as Investment Property Databank rather than MSCI, which bought IPD in 2012.

As representatives of dozens of the world's sovereign-wealth funds gather at Milan's posh Hotel Principe di Savoia this week for their annual conference, they will have more than networking on their minds.

The ending of a commodities bull market and the uncertainty created by China's economic slowdown have prompted the massive funds to reassess a fast-changing global landscape. Assets managed by sovereign-wealth funds grew more than 20% annually between 2011 and 2014, in large part because of higher oil prices.

But with oil falling lately—and, perhaps, poised to fall further—experts say the funds will be forced not only to review their investments but also take on greater risk to sustain yields.

"It is a new era," said Massimiliano Castelli, head of strategy of global sovereign markets at UBS Global Asset Management. Sovereign-wealth funds, he said, "will have to adapt to this new environment and work harder to achieve the return expectations of their stakeholders."

Some see sovereign-wealth fund returns slowing after strong run

The multibillion-dollar government-owned funds known as sovereign-wealth funds have enjoyed a strong run of results in recent years. But that growth could slow—perhaps to around 7% a year over the next half-decade, according to Castelli.

Kuwait Investment Authority, the world's oldest sovereign-wealth fund, is spending millions on a new headquarters.

Some funds have responded nimbly to the volatile financial environment. The New Zealand Superannuation Fund, with about $22 billion in assets under management, reported returns of 14.6% for the fiscal year ended June 30, according to Patrick Schena, co-head of SovereigNET at the Fletcher School at Tufts University.

The guardians, as the fund's managers are known, are adroit when it comes to moving away from existing positions for other opportunities, according to Schena. The fund's strategy "combines a disciplined approach to asset allocation via-a-vis their policy benchmark with a regiment of 'strategic tilting' to take tactical advantage of opportunities resulting from shifts in asset values and market volatility," he said.

Other funds have been less successful. Norway's Government Pension Fund Global—the world's largest sovereign-wealth fund, with about $895 billion under management—reported a 0.9% decline in returns in the second quarter, the first quarterly drop in three years, mainly due to bond investment losses.

The fund's market value fell by 115 billion kroner ($17.38 billion) during the second quarter to 6.85 trillion kroner ($1.04 trillion). Thomas Sevang, head of communications and external relations at Norges Bank Investment Management, which manages Norway's Government Pension Fund Global, declined to answer questions about fund strategy.

GPFG's stock, bond and real-estate investments are benchmarked against indexes from FTSE Russell, Barclays and MSCI. In an email, Sevang said the fund's performance tracks its benchmarks, "as we are broadly invested across all markets."

Many funds are especially sensitive to commodities fluctuations

Sovereign-wealth funds are typically financed by surpluses in a country's balance of payments, foreign exchange reserves, and commodity exports. Of the approximately 70 sovereign-wealth funds in operation, slightly more than half are funded by oil receipts, with the aim of providing their countries an alternate source of revenue when oil resources are depleted.

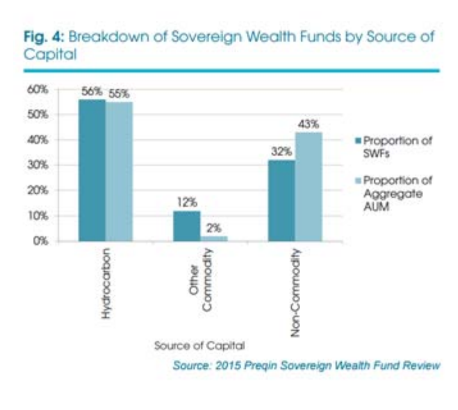
That makes them particularly sensitive to commodities fluctuations, observers say. About half of the sovereign-wealth funds that reported a decline in assets under management since 2013 derive their capital from hydrocarbon, according to alternative assets data provider Preqin.

Table 1: Sovereign Wealth Funds, Assets Under Management

Country	Fund Name	Inception Year	Source of Funds	AUM 2014 (US$BN)
Norway	Government Pension Fund – Global	1990	Commodity (Oil & Gas)	895.09
China	China Investment Corporation	2007	Trade Surplus	652.74
UAE-Abu Dhabi	Abu Dhabi Investment Authority	1976	Commodity (Oil & Gas)	773.00
Kuwait	Kuwait Investment Authority	1953	Commodity (Oil & Gas)	548.00
Singapore	Government of Singapore Investment Corporation	1981	Trade Surplus	320.00
Russia	National Wealth Fund and Reserve Fund	2008	Commodity (Oil & Gas)	152.74
Singapore	Temasek Holdings	1974	Trade Surplus	167.20
China	National Social Security Fund	2000	Trade Surplus	197.91
Qatar	Qatar Investment Authority	2005	Commodity (Oil & Gas)	256.00
Australia	Australian Future Fund	2006	Non-Commodity	93.82
UAE - Dubai	Investment Corporation of Dubai	2006	Commodity (Oil & Gas)	70.00
Libya	Libyan Investment Authority	2006	Commodity (Oil & Gas)	66.00
UAE-Abu Dhabi	International Petroleum Investment Company	1984	Commodity (Oil & Gas)	68.39
UAE-Abu Dhabi	Mubadala Development Company PJSC	2002	Commodity (Oil & Gas)	66.32
Kazakhstan	Kazakhstan National Fund	2000	Commodity (Oil & Gas)	77.00
Republic of Korea	Korea Investment Corporation	2005	Government-Linked Firms	72.00
Malaysia	Khazanah Nasional Berhard	1993	Government-Linked Firms	41.18
Brunei	Brunei Investment Agency	1983	Commodity (Oil & Gas)	40.00
Azerbaijan	State Oil Fund of Azerbaijan	1999	Commodity (Oil & Gas)	34.93
Ireland	Ireland Strategic Investment Fund	[illegible]	[illegible]	[illegible]
New Zealand	New Zealand Superannuation Fund	2001	Non-Commodity	21.67

Sovereign Investment Lab

The largest sovereign-wealth funds in the world.

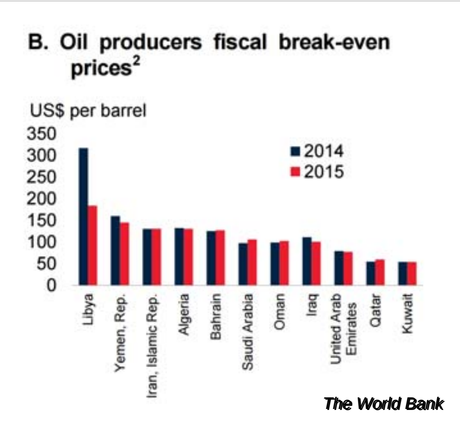


"For funds that are resource-based—particularly oil—dramatic drops in price will affect the rate and scale of their future accumulation of new assets, while potentially requiring assets sales or outflows to fund possible fiscal deficits," said Schena.

Brent crude LCOX5, +1.95% the international benchmark, is currently trading near $48 a barrel, down about 50% over the past 12 months. Earlier this month, Goldman Sachs cut its forecast for Brent crude to $49.50 in 2016 from $62 previously, warning that it could fall as low as $20 a barrel on the back of a supply glut.

Read: Oil unlikely to return to $100 a barrel for years

The International Monetary Fund in May said countries including Saudi Arabia, Kuwait, and Qatar won't be able to balance their budgets if oil falls to $60 a barrel. That level was breached less than two months later, and it quickly fell even further.



In Russia, where oil and natural gas accounted for some 68% of its exports in 2013, the fiscal break-even point is $107 a barrel, according to Citi Research. Brent hasn't seen that level in more than a year, and the impact of falling oil prices, as well as Western economic sanctions in connection with the conflict in Ukraine, has been so severe that Russia was forced to withdraw some $20 billion from its National Wealth Fund and Reserve Fund to prop up its economy.

"For now, Russia is an isolated case, but it might be a herald of things to come," said Bernardo Bortolotti, director of the Sovereign Investment Lab at Bocconi University in Milan. Lower oil prices are likely to force "painful fiscal adjustment across the board in the Gulf."

Tumbling oil prices aside, sovereign-wealth funds operated by oil producing states also carry the burden of serving as "rainy day" funds for when oil resources are exhausted.Oman's sovereign-wealth fund, for example, invested in a solar energy company in 2014, according to Selina Sy, a senior manager at Preqin.

"The slump in oil prices has been something of a canary in a coal mine with regard to this outlook that we call the new normal," said Bortolotti.

Some funds are shifting allocations to riskier deals

Sovereign-wealth funds are also shifting their allocations in favor of larger and riskier equity deals and "experimenting with new investment models more akin to private equity and venture capital," he noted. And others are taking on more assertive, if not activist, investment approaches.

South Korea's Korea Investment Corp. recently campaigned to strip Bank of America Corp.'s BAC, +0.99% Chief Executive Brian Moynihan of his chairman's role on disappointment over the bank's stock performance, The Wall Street Journal reported. Shares of Bank of America rose 2.6% since January 2010 when Moynihan took office, compared with the S&P 500's SPX, +0.78% 70% surge; he survived the vote to retain the dual title.

The global equities rout triggered by the selloff in the Chinese stock market is also hurting sovereign-wealth funds, according to analysts. (Timely data on sovereign-wealth fund performance isn't widely available to the public.)

One sovereign-wealth fund may be feeling the pinch more than others: the China Investment Corporation. CIC, the second-largest fund in the world with $652.7 billion in assets under management, is often tasked to buy Chinese stocks, particularly during times of market instability. That, experts, say, will likely hurt returns in the short term.

China's fund "is no stranger to acquiring shares of domestic equities," said Schena. "In the recent case, to the extent that Central Huijin has acquired shares, including shares in ETFs, as Chinese markets have continued to decline, near-term performance will logically suffer."

A return to 2008 strategies may boost funds now

This isn't the first rough patch sovereign-wealth funds have encountered: The U.S.-sparked financial crisis in 2008 is another notable case. Many funds were able to weather that storm by making countercyclical bets and hunting for bargains, which may not have offset losses but sped up a recovery in portfolio values, according to Schena.

“A few of them, the smartest, tilted their tactical allocation in favor of equity when prices collapsed and gained stellar returns when markets normalized,” Bortolotti said, citing the Norwegian fund as an example.

Michel Meert, PWC’s director of the investment advisory team in London, said sovereign-wealth funds are well-positioned to seek long-term strategies that allow them to avoid a “herd mentality.”

“Sovereigns go further by incorporating long-term trends in their investment thinking, adopting a more contrarian approach and having a greater focus on rebalancing,” he said in a report published earlier this year. Such an approach is not only beneficial for the funds but helps to stabilize financial markets, according to Meert.

He singled out Temasek Holdings, Singapore’s wealth fund with $167 billion under management, for exemplifying this philosophy. For the fiscal year ended March, the fund reported returns of 19.2%.

The key to success, according to Meert, is to stick with an investment even when short-term performance doesn't live up to expectations, which Temasek does. “It is a struggle to translate investment strategy into action but they are very clear about their long-term themes and what they want to achieve,” he told MarketWatch.

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