Sovereign wealth fund trends: Implications for alternative managers

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1. Introduction

As the 'savings glut' that has prevailed since the 1980s is ending and the world's demand for investment capital is set to increase significantly over the next several years, if not decades, worldwide savings, however, are unlikely to keep pace. Accordingly, investors in alternative assets will be free to be more selective in assessing investment opportunities and negotiating terms. The largest sovereign wealth funds (SWF), which have been active accumulators and investors of surplus capital, are poised to play an important role in shaping this new era. Alternative investments fund managers seeking commitments from these investors will need to assess a number of important considerations. They will need to consider the supply/demand balance of investment capital, which is shifting in favour of suppliers; providers of investment capital will enjoy a much greater influence over its allocation; larger SWFs are particularly well positioned to benefit from these changes; and concurrently they are assuming the role of marginal capital provider for alternatives. All of these factors suggest several significant considerations for alternative managers.

This paper sets out to highlight current trends and thinking on alternative investments and their appeal to SWFs, taking into account that SWFs have many interests in common and they also have rather different perspectives and long-term goals. It examines the emergence of SWFs from the 1950s onwards and assesses the amount of funds SWFs have at their disposal for investment, compared to the decreasing level of savings globally and in the context of worldwide foreign reserves. The discussion considers: SWFs in the context of changing international capital markets dynamics; the role SWFs will likely play in investing in alternative investment funds; what the implications are for alternative investment managers; and how those managers can formulate the most appropriate approaches in working on long-term basis with SWFs.

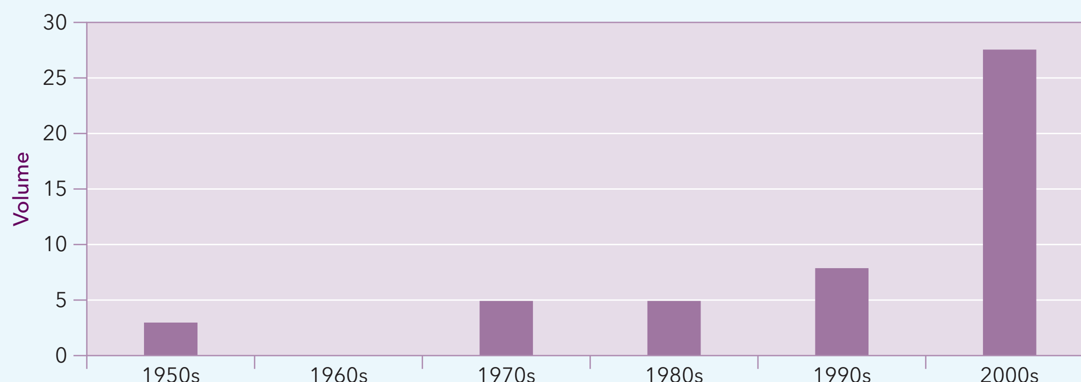
This paper is in part informed by my regular interactions with global sovereign investors, fund managers and associated service providers, and with discussions with my colleagues and their interactions with SWFs. This ongoing dialogue has helped to shape the issues and discussion in this paper.

2. What is a sovereign fund?

SWFs are usually capitalised by current account surpluses – typically from energy exports or a highly competitive manufacturing sector, sometimes assisted by a managed currency – and fuelled in part by sizable regular sovereign contributions. The largest of these represent an important source of new investment capital for alternatives. This is particularly true as it relates to resource-funded SWFs in smaller countries, such as Abu Dhabi, Brunei, Norway and Qatar.

For the first 50 or so years of their existence, SWFs grew at slow rates and generally maintained low

Figure 1: Formation of sovereign wealth funds by volume and decade (1950–2010)



Source: Sovereign Wealth Fund Institute.

public profiles. The first such fund was Kuwait Investment Authority (KIA), which was founded in 1953, eight years before Kuwait gained independence from the UK. The next SWF to be formed was Kiribati's Revenue Equalisation Reserve Fund, which was established in 1956 to manage excess phosphate revenues. After Kiribati's fund was established, no new SWFs were created until Temasek was established by Singapore in 1974. This gradual trend continued until approximately 2000 when sovereign funds began to rapidly assume a position of prominence, in part by simply filling the void left by traditional alternative investors such as large US state pension plans. The influence of sovereign funds has been amplified by their dramatic increase in assets: at the start of 2000, SWF assets under management (AUM) totalled approximately $1 trillion; they grew fourfold to slightly more than $4 trillion by 2010.[1] SWFs look set to continue growing as there is no immediate indication of reduced or halted revenues, which underpin these funds. As Figure 1 shows, the dramatic growth in numbers of SWFs over the past decade mirrors the boom in commodities prices and emerging economies' expanding current account balances. Of the approximately 50 SWFs in existence in late 2011, 28 were founded in the last ten years.

Given that many SWFs are highly opaque, and certain pension funds, central banks and economic development agencies sometimes act as SWFs, observers often have difficulty determining which organisations are true sovereign funds. Accordingly, it is useful to consider a standard definition of SWFs offered by Ashby Monk of Oxford University:[2]

> *". . . government-owned and controlled (directly or indirectly) investment funds that have no outside beneficiaries or liabilities (beyond the government or the citizenry in the abstract) and that invest their assets, either in the short term or long term according to their interests and objectives of the sovereign sponsor."*[3]

Expressed in another way, SWFs are established by governments or with their sanction to promote national goals through the accumulation and investment of national wealth, goals which typically include: husbanding wealth for future contingencies, including exhaustion of natural resources; distributing economic benefits to society, potentially through direct grants or economic development; and stabilising the economy in the event of near-term volatility.

[1] Sovereign Wealth Funds 2011. The City UK Financial Markets Series, April 2011.

[2] Ashby H. B. Monk is a visiting research associate at the School of Geography and the Environment and co-Director of the Oxford SWF Project. His research is on the design and governance of financial institutions, with particular focus on pension funds and sovereign wealth funds.

[3] Monk, Ashby HB (2008). Recasting the Sovereign Wealth Fund Debate: Trust, Legitimacy and Governance. Stanford University – Collaboratory for Research on Global Projects, Working Paper Series. May 1, 2008.

Table 1: Global comparison of foreign reserves and sovereign funds – total and per capita

Country	Foreign reserves (1) ($ billions)	Sovereign fund (2) ($ billions)	Combined ($ billions)	Population (3)	Reserves per capita ($)	SWF per capita ($)	Combined per capita ($)
Brazil	288.6	11.3	299.9	203,429,773	1,419	56	1,474
Russia (4)	479.4	142.5	621.9	138,739,892	3,455	1,027	4,482
India	287.1	–	287.1	1,189,172,906	241	–	241
China (5)	2,876.0	831.0	3,707.0	1,336,718,015	2,152	622	2,773
Brunei (6)	–	30.0	30.0	401,890	–	74,647	74,647
Norway	52.8	556.8	609.6	4,691,849	11,254	118,674	129,927
Singapore	225.7	392.8	618.5	4,740,737	47,609	82,856	130,465
Bahrain	4.5	9.1	13.6	529,446	8,499	17,188	25,687
Kuwait	21.4	296.0	317.4	1,060,000	20,189	279,245	299,434
Oman	13.0	8.2	21.2	2,450,666	5,305	3,346	8,651
Qatar	31.2	85.0	116.2	289,689	107,702	293,418	401,120
Saudi Arabia (7)	445.1	5.3	450.4	20,555,627	21,653	258	21,911
United Arab Emirates (8)	42.8	709.3	752.1	890,000	48,090	796,966	845,056
European Union (9)	1,181.1	61.0	1,242.1	502,957,601	2,348	121	2,470
US (10)	132.4	58.2	190.6	313,232,044	423	186	608
Japan	1,063.0	–	1,063.0	126,475,664	8,405	–	8,405
Rest of world	3,242.8	549.1	3,791.9	3,068,481,527	1,057	179	1,236

(1) CIA Factbook, December 31, 2010 estimate. Reserves of foreign exchange and gold, except for Norway, which is year-end 2009.
(2) Sovereign Wealth Fund Institute, updated June 2010.
(3) CIA Factbook and US State Department, locals only.
(4) National Welfare Fund.
(5) SAFE Investment Company, China Investment Corporation, National Social Security Fund and China-Africa Development Fund.
(6) Brunei's reserves are managed by the Brunei Investment Authority.
(7) Public investment fund. Does not include Saudi Arabia Monetary Authority foreign holdings, which are often counted as foreign reserves.
(8) Abu Dhabi Investment Authority, Investment Corporation of Dubai, International Petroleum Investment Company, Mubadala Development Company and RAK Investment Authority.
(9) Sovereign funds include: Strategic Investment Fund (France) and National Pensions Reserve Fund (Ireland).
(10) Sovereign funds include: Alaska Permanent Fund, New Mexico State Investment Council and Permanent Wyoming Mineral Trust Fund.

Source: See footnotes.

In the context of SWFs, the recent rapid growth of foreign currency reserves merits a mention. At $9.6 trillion, global central bank reserves are larger than the $4.2 trillion of SWF assets known today. While this figure has grown 4.6x from 1999 to 2009, the rate of growth in regions with large SWFs is more striking: 14.3x in the BRIC[4] countries and 13.1x in the Gulf states. These countries may be increasingly tempted to divert some of these monies from low-yielding central bank reserves to higher-return investments in SWFs. This trend is evidenced by recent

4 The BRIC countries are: Brazil, Russia, India and China.

Chinese sovereign contributions to China Investment Corporation (CIC), which illustrates the possibility.

Deeply influenced by the Asian Financial Crisis of the late 1990s, many central banks accumulated extraordinarily large foreign-currency reserves. While this accumulation may have made sense for contingency plans, there is clearly diminishing utility associated with subsequent additions to these ever-growing pools of reserves. The limited impact felt by emerging economies in the wake of the 2008 global financial crisis suggests that the reserves of such countries may now be adequate for their intended purpose, raising the question about what levels are sufficient. If countries holding large foreign-exchange reserves were to ponder this question at length, they would likely consider shifting assets out of sovereign debt and into alternatives.

For China, now the world's second largest economy and a burgeoning investor in the world financial markets, it is possible that, while surpluses are large, over time the country's capital requirements will be larger and international alternatives may be less of a priority. Although it is also possible that in the near term, as the country appears to be reducing its focus on US debt purchases and achieving higher returns on sovereign assets, the appetite for alternatives may remain intact or increase. This is less of a consideration in the sovereign funds of the Gulf states and Norway which are bolstered by revenues from natural-resources, where per capita AUM is quite large and potential domestic claims on sovereign assets are, therefore, relatively small.

Table 1 underscores the degree to which certain countries with large SWFs have large accumulations of investible capital. In the case of countries with a high ratio of investible capital to the population size (for example, Qatar and United Arab Emirates), these accumulated funds are far in excess of current near-term domestic requirements. Therefore, these countries' investing institutions are positioned to disproportionately influence investment capital flows globally.

3. Changing capital markets dynamics

There are two major developments that are likely to affect the global markets for alternative investments: global demand for investment capital will grow significantly over the next several decades and global savings are unlikely to satisfy this increase in demand. These developments are covered in depth by a recent McKinsey Global Institute study and have many long-term implications for the global economy.[5] From the perspective of practitioners working closely with alternative investment managers and investors, these developments are already impacting interactions between SWF investors and alternative managers.

A shift upwards in global demand for investment capital

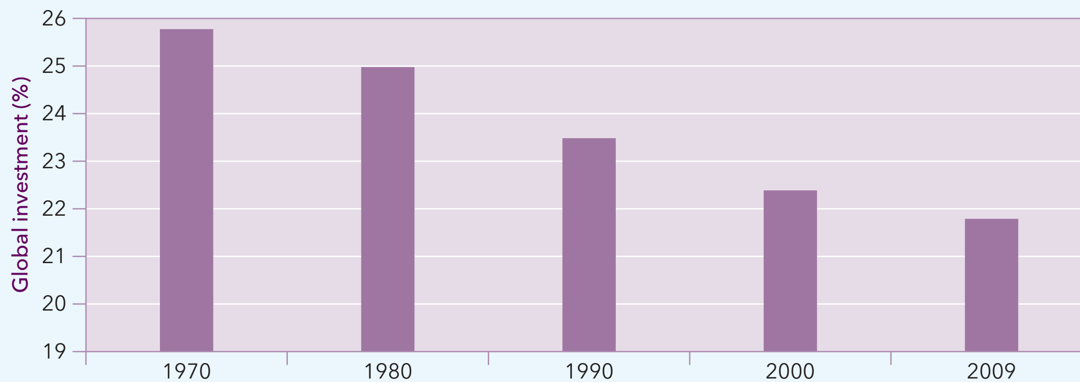
The worldwide imbalance between the supply and demand of investment capital was first termed a 'savings glut' by US Federal Reserve governor Ben Bernanke in 2005.[6] The data suggest that the situation could more accurately be considered an investment drought; the aforementioned recent McKinsey research indicates that savings as a percentage of global GDP has been declining since the 1970s and capital investment has been declining even faster. Global investment has declined from 26.1 percent of GDP in the early 1970s to 21.8 percent in 2009, freeing up a larger portion of GDP for other purposes, including savings (see Figure 2).

In the 1970s, as developed economies were concluding their post-Second World War period of intensive capital investment, today's emerging economies were decades away from emerging. Consider the state of the BRIC countries 40 years ago when these countries were far less developed and required relatively little investment capital. During this period – when developed

[5] Farewell to cheap capital? The implications of long term shifts in global investment and saving. McKinsey Global Institute, December 2010.

[6] The Global Saving Glut and the US Current Account Deficit. Speech by US Federal Reserve Governor Ben Bernanke on March 10, 2005.

Figure 2: Global investment as a % of global GDP



Source: McKinsey Global Institute.

world capital investment declined and developing world demand had yet to take off – a growing gap emerged between the supply of and demand for investment capital. The McKinsey study suggests that if global investment rates had simply remained at their historic average, approximately an additional $20 trillion would have been deployed into capital investments between 1980 and 2008. Looking forward, the study projects that global infrastructure investment in 2030 will be $24 trillion (expressed in constant 2005 dollars), more than double the 2008 figure of $11 trillion.

Today, however, the situation is different as demand for investment capital is increasing and appears likely to persist at elevated levels for decades to come. There are two reasons for this: 1) most significantly, developing countries typically require a much higher investment-to-GDP ratio to sustain high growth rates; and 2) to a lesser degree, many developed countries have deferred infrastructure capital maintenance to the point that significant expenditure will be required to keep these economies competitive.

Emerging markets have low levels of capital stock compared to developed economies. This is significant because growing economies typically require a much higher level of investment compared to GDP to sustain high growth rates, even as GDP is itself growing. From 2000 to 2009, investment as a percentage of GDP grew from 35.2 percent to 48.7 percent in China, and from 23.6 percent to 37.9 percent in India.[7] On the other hand, several developed economies – such as the US – have deferred massive amounts of capital maintenance as is apparent to any traveller who has visits any major airport in the US, but this backlog of infrastructure maintenance is not a tenable situation if a developed economy is to remain competitive. To place this infrastructure backlog into context in the US, a 2009 study issued by the American Society of Civil Engineers projected that the US would need to spend $2.2 trillion just to return existing infrastructure to an acceptable condition.[8]

Savings growth will struggle to match demand

On the other hand, just as global demand for investment capital is gaining momentum, global savings seem likely to have reached a plateau level at best. Savings in mature economies are under pressure from a variety of factors, including declining real wages, increasing healthcare costs and a shrinking ratio of wage earners to retirees. In addition, as developing economies mature, their savings rates typically decline. Improved social safety nets and consumer debt markets reduce pressure on workers to husband

[7] McKinsey, page 26.

[8] Rough road ahead: The economic impact of America's failing transportation infrastructure by 2020, 2009 Report Card for America's Infrastructure, American Society of Civil Engineers.

resources for health costs, retirement and large planned expenditures, such as housing. While this trend has been repeated in the earlier emerging economies such as Japan, South Korea and Taiwan, it is now beginning to take shape in today's emerging economies.

4. SWFs will increasingly shape the alternatives market

Just as demand for capital seems set to increase, many of the institutions that were most active in alternatives are now retreating. As SWFs step into the resulting void, they bring their own set of interests and perspectives:

- Sovereign funds of countries with large current-account surpluses represent a disproportionate flow of new capital.
- US public pensions and endowments, historical mainstays in this area, are pulling back.
- These trends, coupled with a long-term increase in demand for investment capital, position SWFs to shape the future of alternatives.

New 'swing providers' of alternative capital

As the world's demand for investment capital exceeds its willingness and/or capacity to save, providers of marginal investment funds will increasingly influence which opportunities are funded and on which terms.

In capital markets, marginal capital influences the development of products and pricing. SWFs, while small relative to overall global AUM, have a level of freedom far greater than any other group of institutional investors, and this is particularly true of funds located in small countries with large surpluses. Their ability to take large positions with long time horizons is unmatched. By comparison, traditional institutional investors in alternatives are facing several major headwinds that make large-scale alternative investing increasingly challenging:

- Renewed focus on matching the duration of assets and liabilities.
- Uncertain regulatory environment.
- A shift to defined-contribution programmes.
- Revised thinking on alternatives risk.

None of these factors are necessarily unique to traditional investors in alternatives, although they have impacted their appetite for the sector.

Newfound appreciation for duration-matching

Alternatives are characterised by their potential to offer high returns over the long run; however, many investors seemed to forget the 'over the long run' part of the bargain. In the short run, alternatives are volatile and highly illiquid, particularly when investors most need liquidity, which is a relevant consideration given that the average alternative investment encounters at least one cyclical downturn over its lifetime. Endowments, among the most active proponents of alternative investing, had come to rely on investment income for approximately 30 percent to 40 percent of their operating budgets. Whereas such expenditures are predictable, an alternatives portfolio's year-to-year returns are not, which many endowments were painfully reminded following the most recent financial crisis. No matter how well executed, pursuing a strategy that seeks significant exposure to alternatives while generating a regular stream of operating funds is akin to driving without a spare tyre. Alternatives' favourable long-term returns ensure that they will continue to play a role in endowments, though their increasing current liabilities necessitate a moderated approach to investing in the asset class.

New and unclear regulatory obstacles

After the global financial crisis, there has been a growing call for regulation of many areas affecting alternative managers. This urge to regulate has occurred at the state and federal level in the US, in Europe and elsewhere. The likely outcome of these efforts remains unclear, though there are already a number of new obstacles impeding managers from calling on investors and investors from committing to managers. In cases where the outcome of regulatory processes remains unclear, market participants are often electing to forgo the asset class altogether.

A shift to defined-contribution programmes

In many developed markets, especially the US, public pensions are facing calls to transition from

defined-benefit to defined-contribution plans. This is based on the immediate pressure for change emanating from the growing realisation among state and local governments that they are unable to shoulder projected future pension costs. The trend is also driven by an increasingly mobile workforce, as well as by recent and prospective regulatory reforms. The implications for alternatives managers are stark: a programme comprised tens of thousands (or more) of discrete investment accounts is hindered from executing a thoughtful alternatives programme. Public pensions, like corporate pensions before them, will play a more modest role in alternatives.

Reassessment of alternatives risk

From 2000 to 2006, many fund investors were lulled into believing that all alternatives funds produced outsized returns all of the time and that higher risks ensured higher returns, but the resulting increased demand eclipsed the actual supply of capable managers and opportunities. As a result, many subpar or improperly aligned managers that raised funds over this period subsequently exposed their investors to asset bubbles, amplifying losses with liberal leverage. Now, in the post-Lehman period, boards and investment committees are acutely aware that the risks associated with alternative investing can be considerable. As a result, many of the former active investors are now far more hesitant in committing to alternative funds (see timeline in Table 2).

While these developments are significant considerations for traditional investors in alternatives funds, most do not impact SWFs to the same degree, if at all. Near-term claims on SWFs, particularly large funds in small countries, are not comparable to those on most other institutions. SWFs, by their very nature, escape most onerous regulations on alternatives investing. The appetite for alternatives remains intact, though SWFs are rethinking how they obtain that exposure as well as the role of managers, which is addressed later in this paper.

As SWFs grow and as global capital demand grows even more, sovereign funds will increasingly act as the world's 'swing provider' of alternative investment capital. This disproportionate influence will be due to their ample and growing pools of capital, and limited near-term liabilities resulting in longer time horizons that are more compatible with alternative investing. Just as the swing producer of a commodity controls that market, the producers of surplus investment capital will heavily influence the pricing, terms and allocation of alternative investment capital.

Table 2: Significant sources of capital for alternative investment managers (1960s to 2011 and beyond)

1960s to 1980s	1980s to mid 2000s	Mid 2000s to ?
Corporate pensions	Public pensions	Sovereign wealth funds
	Endowments	

Table 3 indicates some of the countries with the largest sovereign funds will have among the largest current account surpluses in the future – much of this will be directed into further sovereign fund investments.

5. Implications for alternative managers

The appeal of alternative investment funds for SWFs will persist for some time as their long-time horizon and access to imperfect markets are well suited to sovereign funds' objectives. However, managers that wish to obtain capital commitments from SWFs should be aware of the ways their perspectives on the sector are evolving. Considering recent investments by SWFs and my own experience as a practitioner, there are three aspects of investing in alternatives that colour SWFs' views on investing in the sector:

- Relationship-building with SWFs is becoming more important, more time-consuming and more competitive.
- Sovereign investors are asking for more control.
- SWF investors are seeking strategies with more exposure to emerging economies.

When managers discover their loyal limited partners are no longer loyal and/or able to invest in their funds, they are increasingly looking beyond traditional relationships in search of large, stable investors including SWFs. However, the task of

Table 3: Current account surplus by region

Country	Population (1)	2010 current account (2) ($ millions)		2011–2015 current account (2) ($ millions)	
		Total	Per capita	Total	Per capita
Brazil	203,429,773	(47,365)	(233)	(401,916)	(1,976)
Russia	138,739,892	71,129	513	265,158	1,911
India	1,189,172,906	(42,807)	(36)	(242,360)	(204)
China	1,336,718,015	305,300	228	2,711,116	2,028
Brunei	401,890	5,573	13,867	37,329	92,884
Norway	4,691,849	51,284	10,930	313,324	66,780
Singapore	4,740,737	49,454	10,432	256,185	54,039
Bahrain	529,446	1,105	2,087	19,960	37,700
Kuwait	1,060,000	36,884	34,796	281,770	265,821
Oman	2,450,666	5,098	2,080	41,654	16,997
Qatar	289,689	32,183	111,095	254,125	877,234
Saudi Arabia	20,555,627	66,841	3,252	401,106	19,513
United Arab Emirates	890,000	21,240	23,865	166,221	186,765
European Union	502,957,601	(23,368)	(46)	103,316	205
US	313,232,044	(470,898)	(1,503)	(1,752,127)	(5,594)
Japan	126,475,664	195,856	1,549	806,697	6,378
Rest of world	3,068,481,527	71,613	23	(250,043)	(81)

(1) CIA Factbook.
(2) IMF World Economic Outlook Database, September 2011.
Source: See footnotes.

connecting with SWFs, already a challenging proposition, can be even more difficult without prior knowledge of their interests and outlooks.

Interactions with SWFs

Relationship-building with SWFs requires more effort – and of a different sort – than many managers may be accustomed to, and it is noteworthy that most of the managers now flocking to SWFs do not receive investment commitments, which is, in part, due to a lack of understanding the audience.

Multiple meetings over several years and potentially multiple fundraises may be necessary for a sovereign fund to become comfortable with a manager and its ability. SWF staff are stretched thinly and with limited resources they cannot act quickly based on an initial meeting. Moreover, SWFs have a heightened level of circumspection in assessing new relationships. Before 2008 many fund managers had demonstrated an erratic interest in sovereign funds, raising questions about commitment levels, and this behaviour had led some SWFs to suspect

that managers considered them unsophisticated investors of last resort. Disappointing strategic investments in western financial firms supported this view, as has the performance of 2006–2007 funds that came to market just as many SWFs were ramping up their exposure to alternatives. It should be no surprise then that SWFs want to get a good sense of a manager and its ability to perform well in advance of considering a commitment.

This approach is very much a test of a manager's long-term interest in a relationship. For groups with long time horizons and sufficient resources, the extra effort can pay large dividends over the long run. On the other hand, managers that visit state SWFs in the Gulf region once every two to three years have found it challenging to establish deep relationships. Accordingly, such managers risk conveying the impression that sovereign investors are not a priority.

Managers with existing SWF investors in their funds must similarly continue to nurture these relationships, particularly when portfolio performance disappoints, and they have to be aware that there is a long queue of general partners waiting to take their place should their SWF investors decide to look elsewhere. SWF investment managers generally appreciate general partners taking the time and effort when they thoughtfully discuss their portfolio performance and how they manage unforeseen events and exploit opportunities; this is part of the required relationship-building process. SWFs recognise and expect that portfolios will face unexpected challenges, but they do not react positively to general partners that not offer regular and proactive updates.

Structuring

SWFs' views about the ideal investor-manager relationship have been heavily influenced by their experiences in the first decade of the 21st century, which was a time for a steep learning curve for SWFs. As relatively recent investors in alternatives, SWFs made many commitments to the largest managers in some of the worst fund vintages in the history of the industry, including the mega-buyouts private equity and real estate funds; it is not surprising therefore that some SWF senior management have been troubled by some funds' performance and fee structures.

While sovereign funds' outlook on manager relations continues to evolve, current thinking among many fund managers encompasses two conflicting views:

1) A newfound confidence in their abilities to select successful direct deals, buttressed by a growing dubiousness about many external managers' ability to do the same.
2) An appreciation that, at least in the near term, there are practical limitations to internally replicating all of the functions of third-party managers.

How SWFs respond is a function of how strongly they believe in each of the two perspectives. In the near term, many large SWFs are implementing organisational changes to facilitate doing more direct deals, while maintaining ties to quality outside managers. Many have established or are establishing internal teams to pursue, evaluate and execute direct deals in real estate, whereas to a lesser degree there is a similar movement to build teams covering infrastructure and private equity.

While there are understandable reasons for wanting to internalise completely investment processes, there are also some practical challenges in this approach. Some accommodation of these challenges seems likely. Replicating the execution role of dozens of private equity and real estate managers requires both large numbers of employees and a highly nimble bureaucracy – often a contradiction in terms. Implementation costs can also be extensive and creating such an organisation takes a great deal of time and focus, which means there is a possible opportunity cost. Moreover, the potential for concentration risk can be magnified when a team's size and capacity direct SWFs to only consider very large direct deals.

Most SWFs recognise these risks and know that some exposure to outside managers can be useful; they would just prefer more favourable structures. Some SWFs prefer approaches that include establishing separate accounts or joint ventures in which the manager's expenses are

funded and in which there are no management fees *per se* and any potential deals require investor sign-off. This arrangement appeals mainly to managers of large-ticket assets, such as real assets. It also appeals to smaller emerging managers that prefer a pool of committed capital which compensates for the loss of management fees and discretion. Another way sovereign funds have gained access to outside management is to make large strategic investments in private companies, from seed-stage ventures to large going-concerns.

These structures are useful as a means to access emerging managers or select private opportunities. However, when applied universally, they may result in a manager-selection process driven by adverse selection. A small portion of top-tier managers – those with a demonstrable track record over various business cycles and acknowledged domain expertise – have been less impacted by the global drop-off in alternatives activity. They remain highly sought after and have the least incentive to heavily negotiate terms. In my recent experience, these managers have had relatively little difficulty in attracting new capital. In addition to some managers being hesitant to unnecessarily cut fees, some are relatively small and would have difficulty digesting the large commitments typically made by SWFs can reap benefits if they are able to find ways to work with these managers which have historically produced outsized risk-adjusted returns over the long term. They also present an opportunity to learn best practices in the industry. Some sovereign funds recognise this and are more flexible in dealing with the highest-performing funds while others have implemented programmes geared towards investing in smaller funds.

At present, SWF thinking on the make-up of an ideal manager relationship is relatively fluid. Some SWFs believe that several if not most managers do not merit discretionary or large fees. Where possible, SWFs are structuring relationships that are far more fee-friendly and offer greater control to them. However, among many sovereign funds, there is a growing appreciation that not all funds are the same – there is a select group of managers that is truly exceptional and whose performance may merit their fees.

Given the evolving outlook of sovereign funds, there are some basic considerations that may be helpful for managers approaching them:

- Some SWFs are reluctant to make large commitments to real assets without more favourable pricing on fees and possibly some discretion. For certain SWFs this sentiment also applies to infrastructure and/or private equity.
- This stance may have slowed down SWFs' ability to deploy capital and/or caused them to focus only on very large deals, introducing tension between the desire to put capital to work and adherence to new standards.
- There is appreciation by some SWFs for smaller and/or top-performing managers that are in great demand and can be a valuable part of their alternatives portfolio.

Interest in emerging markets

Emerging markets hold a large and growing appeal to SWFs. While their large exposure to OECD economies (approximately 75 percent) is unlikely to decline rapidly, the growth in exposure to emerging markets will outpace that to developed economies. This an area of opportunity for both top-tier managers in emerging markets and global managers with large emerging markets exposure. The growing interest in emerging markets is a function of a greater comfort level doing business in these countries, strategic benefits to greater emerging markets exposure, and expected higher real secular growth rates.

Comfort level

As many of the largest SWFs are located in emerging economies they are naturally more familiar with operating in this environment. The Middle East, for example, has traded with India, Africa and Asia for centuries and many SWF staff are drawn from these regions and are comfortable with their ability to ascertain emerging market investment risks and opportunities. Alternatives managers in these regions tend to be younger than their counterparts in developed economies and, as a result, are often more flexible in structuring relationships. This is changing, however, as performing fund managers in popular markets gain a following from Western limited partners.

Finally, while there is regulatory risk in these markets, SWFs' familiarity with the region, coupled with their governments' willingness to advocate for their rights, reduces uncertainty in this area. Such advocacy can be effective as many emerging economies actively court foreign investment and are loath to offend large global investors.

Strategic reasons for emerging markets focus

For Middle East sovereigns there is an added strategic reason to pursue emerging markets: economic growth potential and therefore future capital needs are closely correlated with energy demand. Energy-producing countries have historically cultivated ties with large consumers – growth rates of energy consumption in emerging markets are expected to be strong relative to developed markets.

Potential for higher long-term real returns

SWFs widely believe that secular growth in emerging markets will outpace growth in developed markets. Anticipating a strong relationship between GDP growth and returns, they are seeking greater emerging market exposure. Many energy producers, sponsors of many sovereign funds including the Gulf states and Norway, have serious concerns about inflation. Most of their revenues are denominated in US dollars whereas their expenses are in other currencies, many of which are projected to increase in value relative to the dollar. Increasing emerging market exposure can help mitigate this risk, especially if these currencies adjust upwards.

One aspect not addressed in this paper in detail is the relationship between developed countries and external SWFs, which are usually based in developing countries. In summary, while some actors in developed markets perceive that these institutions are motivated by non-economic (that is, political) considerations, this perception is exaggerated. These arguments rely on generalisations and often do not reflect reality; many of the associated entities are not actually SWFs. Nonetheless, this development can encourage mistrust and resentment by developed economies concerning direct investments made by SWFs, further increasing the relative appeal of emerging markets. This is an important and timely topic, though it is beyond the scope of this paper to fully address the issue other than to acknowledge that these views exist and, therefore, are a real consideration for SWF investors contemplating investing in developed markets.

6. Conclusion

Some general themes emerge in reviewing the global alternatives markets, the changing macroeconomic landscape and activities at the world's largest SWFs.

The shifting balance between supply and demand of capital will accrue to the benefit of those who supply the capital – the investors. In the alternatives area, there have always been relatively few investors and the traditional actors are adopting a more passive role. In this environment, the remaining institutions – mainly large SWFs – will enjoy an influential position in shaping market terms going forward.

SWFs will be faced with practical limitations on their ability to put allocations to work. The funds attempting to completely internalise investment operations may encounter capacity constraints in the near term, reducing their ability to react to market opportunities in a timely fashion. Most SWFs recognise that they need to maintain relationships with outside managers to mitigate this risk. For the time being, however, alternative investment managers and SWFs will continue to have a symbiotic relationship, though the balance of power in this relationship is shifting.

At some sovereign funds, there may be the start of a trend, that is, the division of third-party managers into two distinct groups: 1) those that form large joint ventures with sovereign funds, and 2) specialised managers with strong global support and a demonstrable ability to generate returns over multiple cycles. It is difficult for a manager to play both roles in differing ventures, thus the potential for conflicts abound. For example, managers will need to determine whether SWFs are primarily a source of capital or competition for deals.

For some managers with average or worse returns, or smaller managers, attracting SWF capital may not be practical. SWFs are becoming

increasingly discerning about committing or recommitting to managers that produce lacklustre results. For smaller managers, the time and financial resources to call on these investors are considerable and, in any case, the minimum ticket sizes may be indigestible. A few of the larger SWFs have recently introduced programmes to increase exposure to smaller GPs, which should offer some encouragement to these managers. However, these efforts are limited to a few SWFs and by design are intended to develop relationships with a relatively small number of managers.

This paper is intended to highlight current trends and thinking on alternatives at the largest and most influential sovereign funds. As a one-size-fits-all manual it is inadequate, as any such effort would be: any description of trends among SWFs requires that generalisations be made about a fairly heterogeneous group. This is unfair to the subject. While SWFs have many interests in common (witness the collective effort in drafting the Santiago Principles), they also have rather different perspectives and long-term goals. Hopefully this discussion strikes the right balance.

This paper is in part informed by regular interactions that my colleagues and I have with global sovereign investors, fund managers and associated service providers. In total, we have several hundred such exchanges annually, which include, for example, my own travels to the Gulf region about ten times a year. This collective dialogue has greatly helped refine my thinking about the role of SWFs as well as the broader issues affecting capital markets for alternatives managers. ❖