# Sovereign Wealth Funds: Finding the Right Model

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# Disclaimer

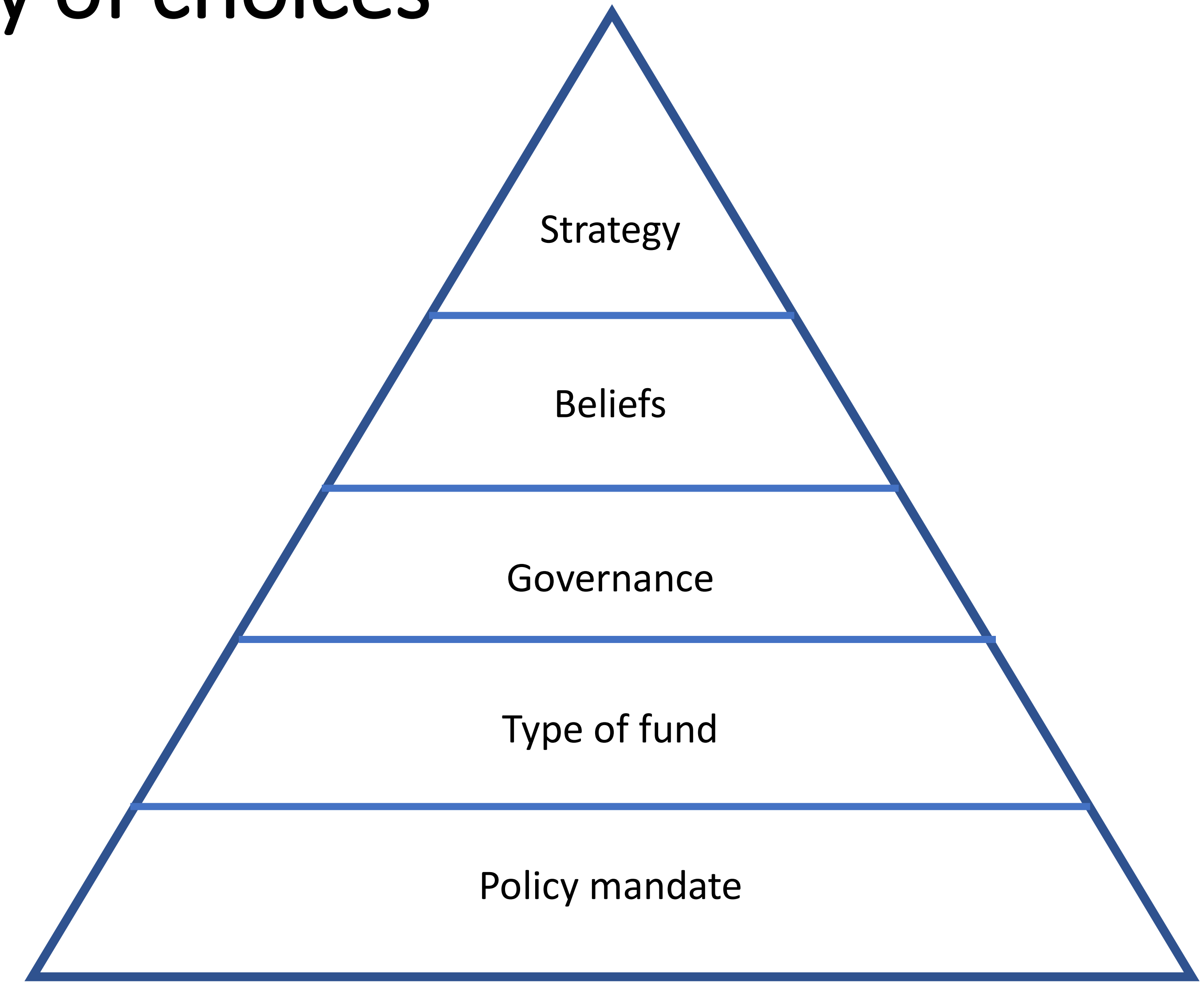
This presentation has been prepared based on the author's 20 years of experience researching and working with Sovereign Wealth Funds. As such, the views and opinions contained herein are solely those of the author, and do not represent the views and opinions of any organization with which the author is currently affiliated or has been affiliated in the past.

# Agenda

- Revisiting the SWF fundamentals
  - The hierarchy of choices
  - Five types of policy mandates
  - Three types of SWFs
- Sovereign Development Funds
  - Three reasons to focus on SDFs
  - The evolution of SDFs
  - Features, advantages, challenges
- Some preliminary suggestions for NDFI

# SWF fundamentals

# Hierarchy of choices



# Five policy mandates

- **Macroeconomic risk management**
  - Volatile and unpredictable revenue stream (fiscal risks)
  - Limited absorptive capacity (inflation risks)
  - ‘Dutch disease’ (currency risks)

- **Equitable commodity wealth distribution**
  - Transforming a non-renewable resource into a financial endowment
  - Maintaining inter-generational equity

- **Pre-fund long-term pension liability gaps**
  - Increase savings in preparation for future pension and welfare costs
  - Improve fiscal sustainability and debt ratings

- **Improve long-term returns on foreign exchange reserves**
  - Mitigate the costs of holding excess FX reserves
  - Improve fiscal sustainability, access critical markets and industries

- **Accelerate domestic economic development**
  - Improve efficiency and profitability of government holdings
  - Catalyze foreign direct investments (FDI) to raise productivity

# Five policy mandates

# Three SWF types

- **Macroeconomic risk management**
  - Volatile and unpredictable revenue stream (fiscal risks)
  - Limited absorptive capacity (inflation risks)
  - 'Dutch disease' (currency risks)

**Stabilization fund**

- **Equitable commodity wealth distribution**
  - Transforming a non-renewable resource into a financial endowment
  - Maintaining inter-generational equity
- **Pre-fund long-term pension liability gaps**
  - Increase savings in preparation for future pension and welfare costs
  - Improve fiscal sustainability and debt ratings
- **Improve long-term returns on foreign exchange reserves**
  - Mitigate the costs of holding excess FX reserves
  - Improve fiscal sustainability, access critical markets and industries

**Endowment fund**

- **Accelerate domestic economic development**
  - Improve efficiency and profitability of government holdings
  - Catalyze foreign direct investments (FDI) to raise productivity

**Development fund**

# Different SWF types manage money differently

- Stabilization fund = preserving wealth (100% foreign assets)
  - Often managed by the central bank FX reserve management team
  - Focus on safety, liquidity, and only then marginal active return
  - Investment grade fixed income, currencies
- Endowment fund = growing wealth (90%+ foreign assets)
  - Typically managed by a dedicated team of portfolio managers
  - Focus on maximising and compounding risk-adjusted long-term returns
  - Broadest possible spectrum of asset classes and strategies
- Development fund = creating wealth (90%+ domestic assets)
  - Typically managed by a dedicated team of corporate finance professionals
  - Focus on risk-adjusted returns from developing and growing local economy
  - Private and public equity and debt of local businesses and local projects

# Impact of SWF type on investment strategy

| | Stabilization Fund | Endowment Fund | Development Fund |
|---|---|---|---|
| **Investment Horizon** | Short-term (1-3 years) | Long-term (10+ years) | Long-term (10+ years) |
| **Target Return** | Nominal return | Real return | Real return |
| **Risk Assets** | 0-10% weight<br>Public equity, developed markets | 60-80% weight<br>Public and private equity, emerging markets, alternatives | 80-100% weight<br>Public and private equity, infrastructure, property |
| **Target Liquidity** | High | Medium | Low |
| **Investment Style Bias** | Capital preservation | Counter-cyclical | Counter-cyclical |

# Sovereign Development Funds

# Three reasons to focus on SDFs

- The Iran experience
  - In terms of policy mandate and SWF type, SDF is the closest comparator
  - Iran has good economic relations with multiple countries with SDFs
  - All SDFs are different, there is room for mutual learning and collaboration

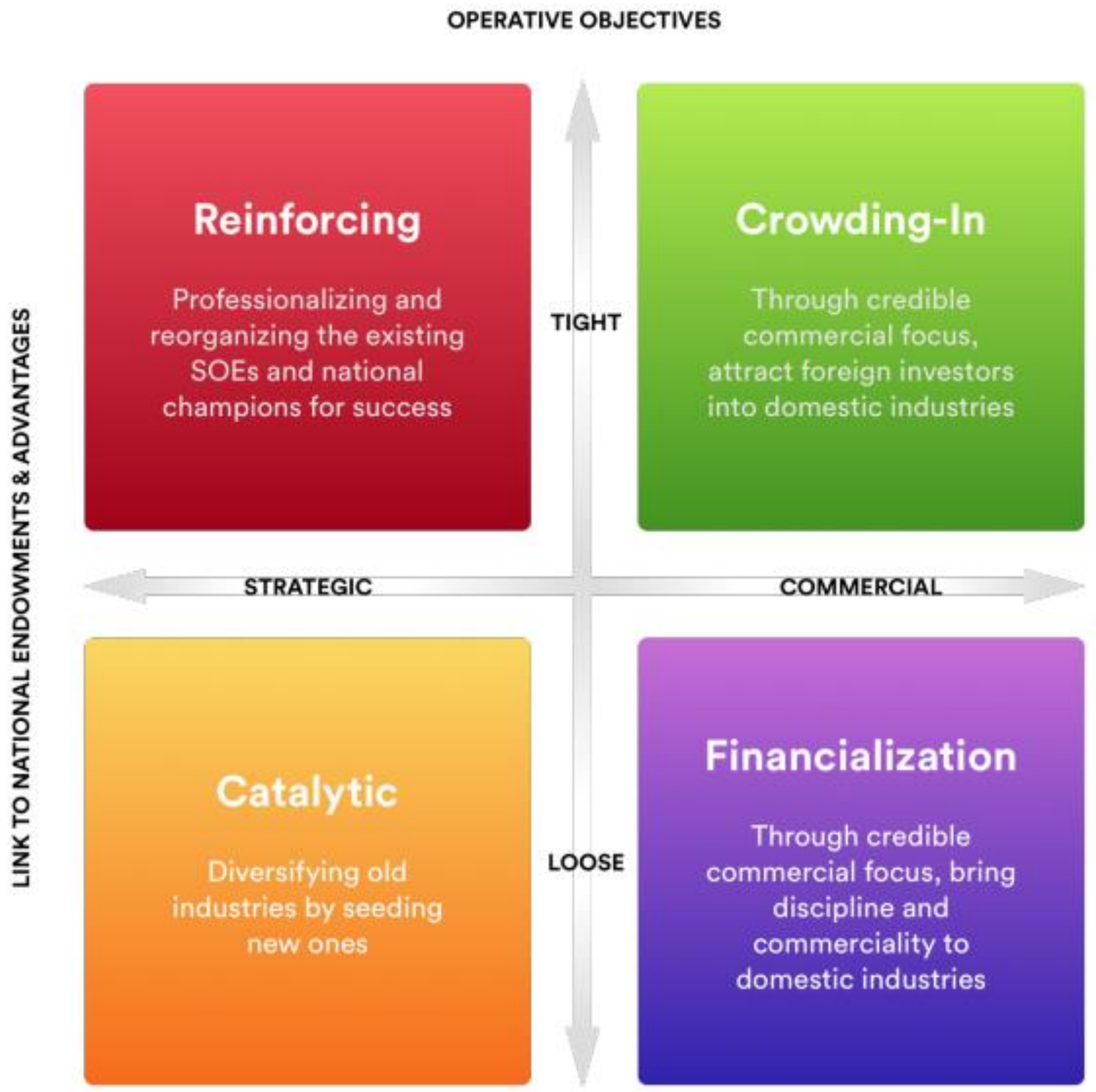
- The evolution of the SWF landscape and new trends
  - SDFs dominate in terms of newly created SWFs
  - SDFs are more naturally predisposed towards collaboration with other SDFs

- Geopolitical and geo-economic developments
  - SDFs by their nature and design are more resilient to geopolitical shocks
  - There are plenty of potential SDF partners in friendly and neutral countries

# The evolution of SDFs

- On a global scale, SDFs are a relatively recent phenomenon
  - Temasek of Singapore (1974) and Khazanah of Malaysia (1994) pioneered this approach
  - However, most SDFs were established during the last 20 years
  - Historically, there are two separate strands of SDF evolution, which are now merging
- Strand #1: Improving management of state-owned assets
  - Separate the government’s role as a market participant and a rule-setter / regulator
  - Improve efficiency through rationalization, professionalization, commercialization
  - Focus on better fiscal outcomes and long-term development objectives
- Strand #2: Catalyzing foreign direct investments (FDI)
  - Diversify the economy, create quality jobs and globally competitive national companies
  - Use high-quality FDI to scale up capital investment and achieve financial discipline
  - Focus on collaboration and partnerships with both public and private sector players

# The evolution of SDFs: a broader typology




Source: Clark and Monk (2017)

# Features, advantages, challenges

- Unique features of SDFs
  - Double bottom line automatically built into the mandate
  - Focus on local, often untraded securities and/or stakes in large projects and properties
  - Direct strategic investment with an active hands-on role (e.g., board representation)
  - A concentrated portfolio of predominantly equity, infrastructure, and property

- Comparative advantages of SDFs
  - Proprietary knowledge and understanding of local opportunities
  - Privileged access to local opportunities
  - Trusted relationships with local and foreign entities
  - ‘License to innovate’ (no readily available off-the-shelf products and solutions)

- Main challenges of SDFs
  - No pre-existing and universally accepted models, frameworks, rules, or solutions
  - Double bottom line (choosing and balancing objectives, benchmarking, KPIs)
  - Concentrated and illiquid portfolio, limited options for risk mitigation
  - Few, if any, options to outsource to external managers
  - Limited access to expertise and talent

# The two most important SDF functions

- Function #1: The equity investment arm of the government
  - Technically, SDFs have the flexibility to invest anywhere in the capital structure
  - However, there are often other entities who can provide debt and mezzanine financing
  - Acting as a policy-driven, long-term equity investor is unique to SDFs
- Function #2: The centre of investment network of the country
  - Proactively catalyze investments from all sources for the benefit of the local economy
  - Scale investment capital to many multiples of SDF’s original allocation
  - Explore ways to de-risk local investment opportunities for potential partners

# Some suggestions for NDFI

# Seek opportunities on multiple dimensions

- Review and reassess
  - Critically review and assess accumulated experience: What has worked and what hasn't?
  - Consider bringing in an independent and experienced third-party consultant
  - Review case studies of peer SDFs (e.g., Singapore, Malaysia, Abu Dhabi, Russia, India, Kazakhstan)
  - Focus on two functions: *Equity investment arm of the government* and *Centre of investment network*
- Collaborations and co-investments
  - Develop and nurture bilateral relations with other SDF nations, including joint funds
  - Consider establishing and sponsoring multilateral SDF frameworks
  - Potential platforms: Belt & Road Initiative; Eurasian Economic Union; BRICS; SCO
  - Maybe there is room for an International Forum of Sovereign Development Funds (IFSDF)?
- Prioritise the private sector
  - Seek out and engage with existing private sector players currently active in Iran
  - Consider proactively reaching out to foreign private sector players with interest in Iran
  - Make sure to understand their objectives, needs, and constraints
  - Be flexible in your engagement formats