

Five key takeaways from the Sovereign Investment Circle

Sovereign Snapshot



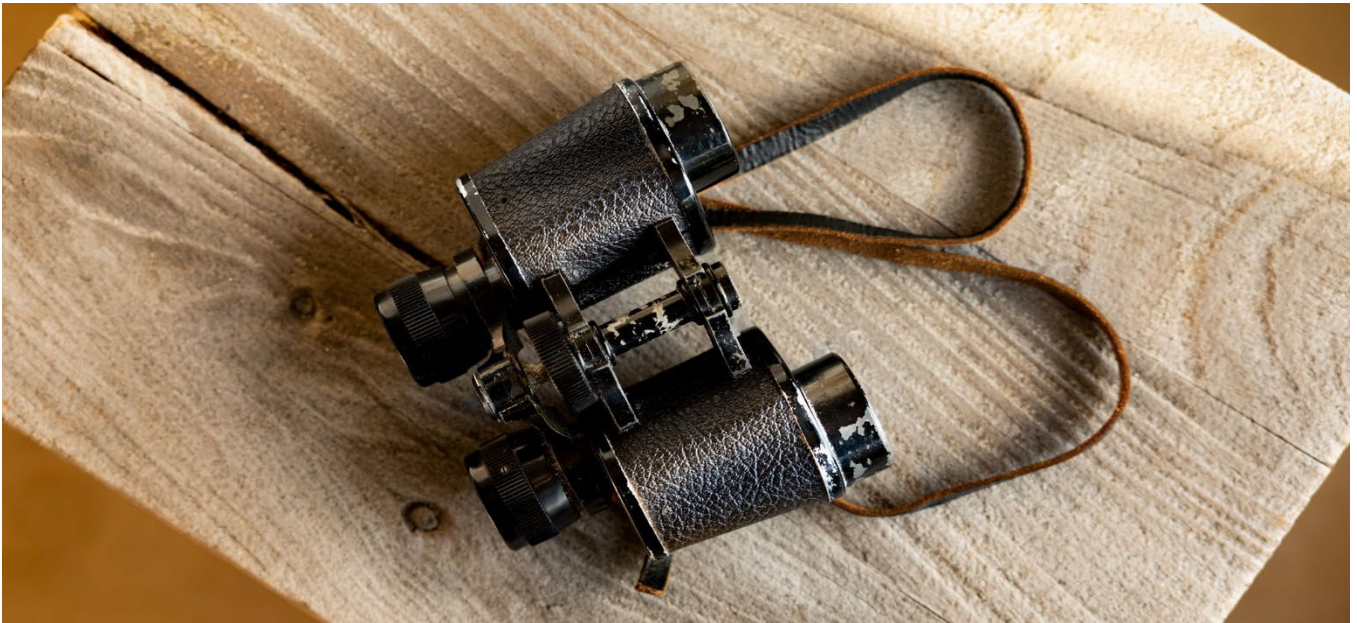


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When the last SIC was held in 2019, SWFs and other long-term investors were focused on the big macro trends shaping the global economy: the rise of China and Asia, political polarization and protectionism in Western countries, sustainability, and digitization. At this year's SIC, the themes addressed were broadly in line with prior years, but a series of events have occurred since then – Covid, the return of inflation, the conflict in Ukraine, and the US/China confrontation have changed how long-term investors look at these macro trends. These geopolitical developments are expected to have significant implications on how sovereign institutions invest in global markets.

In this brief note, we highlight the key takeaways from the conference, which was attended by a range of external academics, SWF officials and internal speakers. The event was held according to Chatham House rules, so no reference or quotes are disclosed (unless permitted by the speakers).



A new paradigm for global investors

We are in a “new paradigm” that according to some event participants has the potential to “reshape the world”. Investors will have to adapt to fulfil their mandate, which is to generate adequate returns to benefit their country. This new paradigm is still evolving and lots of uncertainty remains as to what the “next regime” will look like.

In his opening remarks, Professor Arturo Bris from IMD, UBS’ academic partner for this event, talked about the shift from the “era of uncertainty” to “the era of ignorance”. Many of the shocks that hit the global economy – e.g., Covid and the war in Ukraine – were largely unforeseen. In such an environment, it is difficult for corporate leaders and investors to make long-term plans. Investors need to have processes and capabilities to respond quickly to events; in other words, they need to develop a culture of urgency. In investment terms, this means being more tactical than strategic.

The emerging new paradigm was discussed at length and from a variety of perspectives. From a “physical” standpoint, as outlined by Professor Parag Khanna, a Global Strategy Advisor and Founder of Climate Alpha and FutureMap, the rise of Asia has been a prerequisite of the previous paradigm and will remain key. However, this is not only about China, but also South-East Asia, India, the Middle East, and North

Africa. The “Asian Youth” will be the motor of global growth in the coming decades and countries facing demographic declines will have to tap into this pool of labor to maintain adequate rates of growth. In this respect, the whole question of immigration – a key pillar of globalization – is of paramount importance.

The new paradigm has a geopolitical dimension. Political polarization might have receded within some advanced economies following Covid and the conflict in Ukraine but deglobalization, fragmentation and the China-US confrontation are very powerful trends, and their impact is already visible amongst key economic metrics, such as the re-orientation of trade flows from the technology sector to “friendly” markets.

The new paradigm has an important investment dimension. Many long-term investors are currently updating their investment strategies to deal with the new economic and financial environment. Over the medium to long-term, the revision of their investment strategies will have an impact on key issues such as: a) the ability to generate adequate real returns compared to the past; b) the appropriate split between liquid and illiquid asset classes in SAA; c) the reliance on passive strategies for the core of their portfolios; and d) the management of geopolitical – including sanction risk in investment decisions.



Geopolitics and deglobalization: where are we heading?

The restructuring of global supply chains will affect investments over the next 10 years. In the post-pandemic era, we anticipate that countries will focus on three approaches: reshoring, regionalization, and replication. These strategies will impact countries and corporates in different ways and there will be both winners and losers. This requires a mind shift for strategic investors like SWFs.

The best example of this mind shift was outlined by a participant from a leading Asian SWF in his remarks at the conference. His institution has traditionally focused on megatrends as key drivers of investment decisions, and have recently added geopolitics as an additional layer to their strategy. For instance, as it relates to deglobalization and fragmentation, their strategic investments are now focused on corporates that have access to large domestic markets (export potential is now considered a plus), and the resilience of their international value chains as a secondary factor.

Long-term investors believe that the impact of deglobalization and the US/China confrontation is already being felt, with their investments coming under increasing scrutiny. The regulatory and compliance costs of investment have been on the rise, as recipient countries create barriers to foreign investment and scrutinize acquisitions in sensitive sectors. This trend is expected to continue and could eventually accelerate should the geopolitical situation further deteriorate.

The risk of direct or indirect sanctions being imposed on China has increased in light of the ongoing political debate in the United States. While central banks often think in terms of domestic currency, SWFs turned to the USD as their base currency a long time ago. Some would argue that the weaponization of the US-aligned financial system during the Russia-Ukraine war is one of the most pivotal actions in the post-WWII period. According to some, the USD might have reached its peak – undermining its role as an effective safe haven.



China faces structural headwinds

President Xi wants to reclaim China's status as the world's major economy, reprising its status from the 14th to the 19th century. The 'China Dream' is focused on a new development philosophy (Dual Circulation, Common Prosperity) and Community of Shared Future for Mankind, i.e., the Global Development Initiative and the Global Security Initiative.

One of our panelists noted that China seeks to challenge the US status as an international hegemony but wants to live by the rules internationally. As to whether China catches up to the US economically, much depends on structural reforms, unfavorable demographics, and innovation that has so far lagged behind the US. While China will not wither away, it will not become the biggest economy in the world, according to the panelists, with the country reflecting already-high debt levels.

The interconnectedness between China and the West makes a Cold War 2.0 different to the interplay between the US and Soviet Union, a fact that reduces a calamitous outcome between today's superpowers. That is because total trade

flows are much higher between countries than during the Soviet age. The Soviet Union's total trade flows did not ever rise more than 2% above advanced economies, and yet China's figure currently stands at 16%.

There is growing consensus that Chinese growth is in decline, with the potential to fall close to north of 4% in the future. The confrontation with the US on the technological front is in full swing and has the potential to reduce China's growth rate to about 4%; should it get worse, for instance with the adoption of sanctions, the impact could be much larger over the long term. On the other hand, this trend is also pushing Chinese R&D investments to very high levels which should help to offset some of the negative effects and provide investment opportunities for long-term investors.

There is more pessimism among Chinese entrepreneurs – as evidenced by the flow of funds from wealthy Chinese individuals and family offices into Singapore. This is largely a reflection of higher political risk due to increased centralization and less clear separation between the communist party and the government.



Sustainability as the ‘new norm’

With regards to sustainability, many of the representatives of SWFs discussed how this trend is steadily transforming their organizations due to the integration of ESG in their operations. Most agree that this is a long-term journey and that several milestones need to be met before it can become a fundamental pillar of their investment strategy. Returns remain of paramount importance but sustainability offers some high alpha opportunities, particularly in the alternative asset space.

With regards to the politicization of sustainability in the US, SWFs appear to be focused on implementation. SWFs often engage with their US counterparts and so far, have not detected a slowdown in co-investment opportunities in this area.

The fundamental challenge with ESG integration in the investment process is the lack of available forward-looking data. This is a topic which the panelists addressed, urging for there to be greater disclosure of ESG requirements and a unified approach to tackling sustainability. In terms of opportunities, the main concern is that direct investment opportunities tend to be of the wrong size, meaning that they can span across multiple jurisdictions and fail to provide an appropriate exit.

The opportunities provided by the fast development of the global carbon market were also discussed and some leading SWFs have already taken steps to launch investment strategies in this space.



How are long-term investors adapting?

Return assumptions of 7-8% have been effectively unchanged for 50 years. But the operative environment has changed. Returns are likely to be lower in the future and more risk will have to be taken to achieve them. This has implications for the management of shareholder expectations and return target definition. Many long-term investors express their objectives in terms of “CPI plus” but in the current inflationary environment these targets are difficult to achieve. While these investors are not ready to revise down targets, a debate has begun, and the future path of inflation will determine the direction going forward. What is certain is that capital will have to “sweat” much harder in the future to generate returns comparable to those in the past and there will be an increased emphasis on TAA.

In an increasingly complex and fragmented world, liquidity is at a premium. Will this be the end of the endowment model adopted by many SWFs over the last two decades? Not necessarily, as alternatives are still considered an important asset class for SWFs given their lack of liabilities and high-risk tolerance. However, there will be an adjustment in the share of illiquid asset classes in SAAs in the future.

This adjustment also reflects the higher expected returns in fixed income that are gradually working through asset classes via price adjustments. In the new market paradigm, the role of alternatives will evolve as a means for boosting returns and hedging macro risks such as inflation – private real estate, commodities and natural resources – or the positive

correlation in public markets – hedge funds.

Winning investment strategies that worked well in the previous paradigm might not work in the future. Passive strategies are one example and some of the speakers mentioned the need to have more focus on alpha along 3 strands: a) more granularity within asset classes, moving beyond broad-based bonds and equities; b) more tactical allocations; and c) more focus on the relationship between alpha and beta as opposed to viewing them as substitutes. The combination of alpha and beta will lead to a rethink of the core-satellite investment framework and a revision of the risk budget assigned to individual investment teams.

The move from globalization to fragmentation will lead to more “granularity” at the regional, asset class, and company level. SWFs are adapting to these new realities by adopting a “regional” approach to their investment decisions: this implies that asset allocation will be more fragmented in the future and that regional CIOs will possibly carry more weight than global CIOs in the investment process. Local presence and knowledge of markets will be more important than before as long-term investors will have to gain a much deeper understanding of the economic, financial, and regulatory trends in recipient countries. The new market paradigm also provides some opportunities for long term investors. There is a general consensus that expected returns in fixed income have increased and that this asset class will play a more important role in asset allocation going forward.

While the current focus is on short duration bonds, high grade medium- and long-term bonds' high yields can provide important benefits in terms of hedging macro risks.

In the new geopolitical context there will be countries, sectors and companies that will provide opportunities to generate above-average returns, and we believe that long term investors are well positioned to take advantage of this.

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