AN ACTIVE 2016 FOR SOVEREIGN WEALTH FUNDS

GLOBAL TRENDS POINT TO A MORE VOLATILE YEAR—AND PLENTY OF OPPORTUNITIES FOR ACTIVE MANAGERS

After a brief trend toward passive investing, sovereign wealth funds (SWFs) appear to be embracing a more active investing style. As large state-controlled investment funds, SWFs control over $6.3 trillion worth of assets with $927 billion added between 2013 and 2015.¹ Before 2007, active management was the rule for many of these funds—until the upheavals of the global financial crisis resulted in many SWFs moving away from active management and instead opting for passive equity strategies. More recently, the pendulum has swung in the other direction. SWFs are once again concerned with looking for growth, not just maintaining their reserves — and they’re increasingly looking for active fund managers to help them do so.

Over the past few quarters, SWFs have been pulling money out of low-fee index equity products while at the same time showing an increasing appetite for more actively managed products, as Peter Laurelli, head of research at eVestment, told the Financial Times.² Given the current state of the global economy, 2016 looks like a strong year for SWFs to move in a more active direction.

RISING INTEREST RATES CREATE OPPORTUNITIES

After years of near-zero interest rates, the United States is once again facing a rising rate environment. In December, the U.S. Federal Reserve (Fed) raised the federal funds rate for the first time in nearly a decade. Janet Yellen, Chair of the U.S. Federal Reserve, has indicated that the Fed plans to keep raising short-term rates—albeit at a measured pace—about one percentage point a year for the next three years.

If history is any lesson, this shift in Fed policy promises to shake up the financial landscape. Rising rates tend to have a dampening effect on the market, creating an environment that’s traditionally favorable to active managers, who are able to more effectively seek out opportunities. When rates rise, investors tend to see lower correlations and higher stock valuation dispersion. During periods when the market doesn’t move as a unit, active managers can benefit by looking for idiosyncrasies in the market in order to add value. Historically, rising interest rates in the U.S. have also tended to result in volatility in fixed income and private markets, as seen in the early weeks of 2016.


 Stocks are represented by S&P 500 Index. Bonds are represented by Barclays Aggregate Bond Index.
Source: FactSet, 2/29/16

Taking a look at these past trends should inspire investors—including SWFs and other institutional investors—to reconsider their investment strategy. History shows that when rates rise, active managers beat their benchmarks. In years when rates moved higher, active managers beat an S&P 500 Index fund by 1.5 points on average.³ In other words, rising rates provide yet another impetus for SWFs to move toward a more active approach.

WEAK OIL PRICES MAKE STABILITY A PRIORITY

Plunging commodity prices—most notably the sharp decline in oil prices—are another factor that’s shaking up the global economy. The price of a barrel of oil plunged more than 70 percent between June 2014 and February 2016. That’s the steepest downturn for the oil industry in decades. This shake-up in the oil and gas industry is being felt throughout the global economy. Its ripples are having a particularly strong effect on SWFs, about half of which are commodity-based.

EXHIBIT 2: DECLINE OF OIL PRICES (FEBRUARY 2014 – FEBRUARY 2016)

Source: FactSet, 2/29/16

The steep declines in oil prices—and the subsequent slowdown in accumulation of assets—may inspire SWFs in oil-dependent countries to retreat to a passive investment strategy. But during periods of uncertainty, a passive approach poses its own risks: Commodity-dependent SWFs may have more of a pressing need to produce returns since their reserves are hurt by lower oil prices. In such a situation, passive investing may not represent a prudent investment strategy. By contrast, active strategies can provide higher-than-average returns during periods of market divergence, which is exactly what such funds may be seeking now.

Furthermore, uncertainty about the future of oil prices has been blamed for some of the volatility in the market—the volatility that creates fertile ground for active managers. Some larger SWFs in the Middle East and Asia, such as the Abu Dhabi Investment Authority (ADIA), have been increasingly relying on in-house experts to manage their investments. That is an easier proposition when funds are following a passive index replicating strategy, as ADIA does for about 55 percent of its assets. It’s harder to do, however, with active management—which is more of an art than a science.

But opting for an active investment approach doesn’t mean throwing caution to the wind—quite the opposite, actually. SWFs feeling the crunch from plummeting oil prices may benefit from an investment strategy that prioritizes stability, particularly if 2016 turns out to be as volatile a year as many experts are predicting. That may mean boosting exposure to more developed, stable markets such as the United States.

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4 Bloomberg.com, Brent crude index as of February 11, 2016.
VOLATILITY UNDERLINES THE NEED FOR DIVERSIFICATION

Apart from a sharp stock market decline in August, 2015 was notable for its lack of volatility, despite the serious slowdown in the Chinese economy and plunging commodity prices. This relatively calm market environment may have led some investors to get complacent. If so, they’ll likely be shaken up soon: Experts are predicting a volatile year for the markets in 2016. In the early months of the year, several major volatility indexes already have increased sharply.6

EXHIBIT 3: VIX INDEX (FEBRUARY 2006 – FEBRUARY 2016)

Source: FactSet, 2/29/16

Volatility isn’t necessarily a bad thing, though it does tend to cause investors anxiety. After all, opportunities arise during periods of market turbulence. However, investors relying on passive strategies risk tend to be troubled when the market makes lots of moves. That holds true for those SWFs that have been recently following a more passive path, as they risk not meeting their internal benchmarks during periods of volatility and divergent returns. Once again, signs point to active management, as market volatility is historically highly correlated with excess returns from active managers.

In a volatile environment, investors will find it difficult to meet their goals by simply investing in the market as a whole. With a bumpy year ahead, SWFs need tailored strategies that suit their particular situation. These strategies can turn a bumpy market into an opportunity. For example, many non-commodity-based SWFs, including the Korea Investment Corporation and the Government of Singapore Investment Corporation, have a large exposure to Asia. Instability in China makes this a risky position in 2016; these non-commodity-based funds may consider moving away from emerging markets to minimize potential issues surrounding investor concerns over China’s slowing economy.

Newer SWFs are in a slightly different position and may need to tweak their strategy accordingly. Over the past decade, about 40 new SWFs have been created. These younger funds are similar to new investors, in that their first priority should be creating a solid foundation—something that’s tricky to do during a period of volatility. In 2016, that might mean moving away from emerging market equities. Instead, embracing U.S. equities and fixed income would be key for new SWFs.

STAYING AHEAD OF THE GAME

If there’s one thing that can be expected from 2016, it’s the unexpected. The economic trends that sent tremors through the global economy last year, from uncertainty in China to collapsing commodity prices, are likely to be felt even more strongly in the months to come. While a passive investment strategy may have made SWFs and other investors feel comfortable during a long bull market notable for its low volatility, those days are nearing their end. During periods of market divergence, a passive strategy puts these funds at the mercy of market forces. As investors look to take advantage of the opportunities presented by a diverging financial system, it looks like SWFs will once again be aiming to stay active.
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IMPORTANT INFORMATION

Barclays Aggregate Bond Index is an unmanaged index of U.S. bonds, which includes reinvestment of any earnings and is widely used to measure the overall performance of the U.S. bond market.

CBOE Volatility Index (VIX) shows the market’s expectation of 30-day volatility, a measure of market risk and is often referred to as the “investor fear gauge.”

A sovereign wealth fund (SWF) consists of pools of money derived from a country’s reserves, which are set aside for investment purposes that will benefit the country’s economy and citizens. The funding for an SWF comes from central bank reserves that accumulate as a result of budget and trade surpluses, and from revenue generated from the exports of natural resources.

Standard & Poor’s 500 Index is an unmanaged index of 500 selected common large capitalization stocks (most of which are listed on the New York Stock Exchange) that is often used as a measure of the U.S. stock market. Investors cannot invest directly in an index.

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