INSIGHT

What’s in Store for Sovereign Wealth Funds in the Post-COP26 Era?

One of the climate actions being pushed across the world is to cut fossil fuel use, including gasoline and diesel consumption by cars. Photo credit: ADB.

The global call to accelerate low carbon transition has significant implications for long-term value creation, particularly for funds fueled by oil revenues.

Published: 29 November 2021

Introduction

The COP26 climate talks in Glasgow showed that most of the developing member countries of the Asian Development Bank (ADB) are committed to addressing climate change risks. Participating countries have identified nationally determined contributions (NDCs), and there is a broadly shared intention to limit the rise in global temperatures to below 2°C.

Climate actions include cutting the use of fossil fuels through the transition to zero-emission vehicles. Reducing gasoline and diesel consumption by cars can substantially reduce demand for oil and result in a long-term decline in hydrocarbon prices. For oil and gas exporting countries in the region, such as Azerbaijan and Kazakhstan, this means reduced revenues, which may result in a lower per capita GDP and quickly deplete sovereign reserves accumulated during high oil prices, including reserves accumulated in sovereign wealth funds (SWFs).

The Sovereign Wealth Fund Institute reports that the combined assets of the world’s largest 100 SWFs recently hit a record $9.3 trillion, with SWFs in Azerbaijan and Kazakhstan totaling about $165 billion. The assets managed by the SWFs in the two countries, which are primarily driven by hydrocarbon revenues, currently make up 78% of their combined annual GDP and are significant in terms of the total assets managed by the entire local asset management industry. The assets of the State Oil Fund of the Republic of Azerbaijan are about equal to the country's GDP, while those of Kazakhstan’s National Fund and Samruk-Kazyna are less than the country's total GDP.

These funds achieved significant growth during high oil and gas prices from 2007 to 2014. However, the decline in hydrocarbon prices in the wake of the COVID-19 pandemic and increased pandemic-linked fiscal pressures have led to budget deficits in the oil-rich countries. Governments had to tap their SWFs to offset the deficits, thereby reducing the total amount of assets under management.

Changing the goals and role of regional SWFs

SWFs in Azerbaijan and Kazakhstan were created to achieve one or more of the following long-term goals:

- accumulation of savings for future generations;
- increase in the value of assets in the long term;
- diversification of the economy from overreliance on oil and gas; and
- economic development.

Samruk-Kazyna was created by consolidating state-owned enterprises—to manage and optimize their performance and grow their long-term value.

Subsequently, budget surpluses during high commodity prices were transferred to these funds and allocated to local and international investment vehicles with different asset classes and strategies.

However, against the backdrop of deteriorating current and expected macroeconomic indicators and declining long-term demand for oil and gas, which may ultimately reduce hydrocarbon prices, the role of regional SWFs has become more strategic and important than ever before. They have come to be seen as institutions that support the stabilization of fiscal systems and foreign exchange reserves.

How SWFs prepare for the post-COP26 era

The SWFs in Azerbaijan and Kazakhstan are forced to accept new realities presented by low oil and gas prices over the long term as well as the "post-COP26 era." There are six recent critical trends in the top 10 SWFs’ strategy that may be used as directions for the further development of Azerbaijan and Kazakhstan SWFs:

1. SWFs review their local and international investments, asset classes, and sectoral portfolio risks

to align with their governments' broader economic transformation plans and focus on environmental, social, and governance (ESG) sustainable investment opportunities.

2. The weight of alternative types of investments in investment portfolios is increasing, including real estate, infrastructure assets, private equity funds, and to a lesser extent, private debt and hedge funds. The investment portfolio structure is changed to achieve the absolute return on investment goals and obtain diversification benefits. It is also due to lower yields on fixed-income securities, volatile stock markets, and the SWFs' ability to take long-term investment risks.
3. Emerging markets provide investment opportunities with high returns (and correspondingly high risk) and diversification benefits for funds primarily invested in Europe and North America. As a result, some SWFs are gradually increasing the share of investments in their portfolios in countries with high GDP growth rates, such as Ireland, the People's Republic of China, and Viet Nam.
4. There are various examples of SWFs investing in high-tech companies, local strategic and high-performance sectors (to support national diversification plans), and small and medium-sized enterprises, veering from traditional investments in commodity companies and more familiar sectors, such as real estate and infrastructure.
5. It has become more evident that SWFs have a particular propensity for internal research and asset management to reduce the costs of external investment management and financial advice. This is also due to the SWFs' extensive investment experience, changes in the strategic allocation of assets (in favor of alternative investments), liquidity needs, and losses incurred under specific mandates issued to external managers.

SWFs experiment on and implement new innovative investment models, such as joint ventures with strategic and financial partners, partnerships/alliances with asset managers and financial intermediaries, collective investments and club deals, and more active management of their investments (i.e., passive strategies are under pressure).

What else needs to be done to achieve investment goals in the post-COP26 era?

While these trends provide directions for investment practices that make some economic sense and increase the added value, we also see seven strategic and tactical initiatives that may be decisive factors for achieving the goals of growing the portfolio's value, return on investment, and risk management:

1. **Investment liberalism**. SWFs should be given maximum freedom in controlling and effectively implementing investment strategies fully. It will also help increase the accountability of investment managers. Unexpected requests from governments to withdraw funds from the SWF for the implementation of various fiscal or stabilization initiatives draw the attention of SWF managers toward achieving short-term goals, distracting them from the primary mission of increasing the value of the investment portfolio in the long term. To meet urgent needs, governments may consider tapping debt markets and using alternative funding sources, such as Eurobonds or Sukuk instruments, while market rates are still below historical averages.
2. **Further diversification between different asset classes.** Reallocation of assets can insulate the

SWF portfolio against hydrocarbon price volatility and reduce dependence on oil revenues, provide financial support, and maximize risk-adjusted returns. In a study of the optimal structure of an SWF portfolio published by the Edhec-Risk Institute, a proposed investment model includes the allocation of assets across three blocks or portfolios:

- an equities portfolio focused on achieving high income (assessed using investment risk adjustments);
- portfolio for hedging equity capital risks; and
- portfolio of hedged instruments, focusing on bonds and assets hedged against inflation.

3. **Optimization of anchor assets.** Some SWF assets are defined as "anchors" or strategic, which limits their ability to sell. In this situation, an SWF may consider restructuring them or optimizing their effectiveness by taking a more active role in the management and strategy development of such assets. For those not identified as anchors, the SWF can prepare for an optimal exit strategy through, for example, privatization, sale of shares to strategic partners, and an initial public offering. Empirical evidence suggests that planning for a well-timed disposal can significantly increase an investment's internal rate of return. Samruk-Kazyna continues its work in this direction through a program of privatization and transformation of its portfolio.
4. **Transformation of the business model.** To succeed in a dynamic and competitive environment, SWFs must further improve their human resources and become less bureaucratic and more flexible, ready to respond to sudden economic changes. In addition, the transition to active management, investing in alternative sectors, and the introduction of complex hedging structures require a modernization of the organization of work and appropriate processes, systems, and capabilities as determined by the selected business models.
5. **Development of a culture of meritocracy**. Attract "new blood" and cultivate internal reserves of talent to achieve the best results from implementating new initiatives and using best practices in asset management. Cadres decide everything. Introduce agents of change in the SWF structure; otherwise, it will be challenging to overcome inertia and accept organizational changes. Many of the funds, including Samruk-Kazyna, are already implementing initiatives to develop human resources and attract employees from the world's best organizations.
6. **The strategic role of middle and back-office functions**. Financial and risk management can play the role of a strategic business partner and can be incorporated into investment and performance management processes. The mid and back offices, including operating systems, are no longer seen as cost centers but play an essential role in increasing the added value of the portfolio. The oversight function of these internal departments is also critical. It should be noted that, depending on the level of assets managed by the SWF and the SWF business model, any "noncore" middle and back-office operations may be outsourced to third-party service providers. This helps to focus on the core business, provides access to a larger organization of mid and back-office specialists, mitigates some operational risks, and adds value to the fund.
7. **Technology, robotics, big data management, and analytics**. SWFs will be able to keep up with asset managers and intermediaries through the introduction of modern technologies. The critical question is whether they have the right digital investment management platforms that are secure and scalable. In addition, data management and advanced analytics can provide timely, high-quality, mission-critical information and identify trends that could dramatically improve return on

investment.

Looking ahead, at least in the medium and long term, challenging economic conditions, such as low oil prices, will continue to test the resilience of regional SWFs and challenge their growth dynamics. But those who are ready for change and have the support of stakeholders, especially their governments, will emerge stronger and achieve their goals of profitability, risk reduction, and long-term growth in portfolio value.

Resources

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Asian Development Bank (ADB)

The Asian Development Bank is committed to achieving a prosperous, inclusive, resilient, and sustainable Asia and the Pacific, while sustaining its efforts to eradicate extreme poverty. Established in 1966, it is owned by 68 members—49 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.

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