

The Tipping Point: SWF as Agents of Change

Prepared by

Scott E. Kalb

Executive Director, Sovereign investor Institute

CEO, KLTi Advisors

Former CIO and Deputy CEO, Korea Investment Corporation

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Small Country, Poor Resources



Land Use:

Arable Land	19%
Permanent Crops	2%
Permanent Pastures	1%
Forests and Woodland	65%
Rivers and Lakes	10%
Other	13%

Population 50m

Natural resource endowment poor

South Korea – My Experience

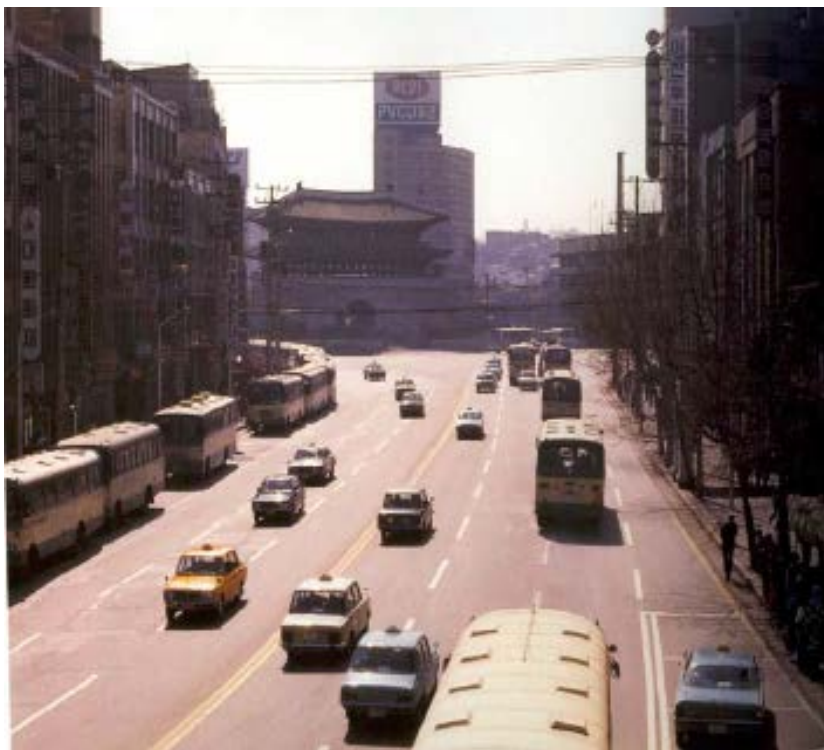


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Seoul: 1960 – life after the war



Seoul scenes: 1978



Namdaemun (South Gate) Road
(Photo by US Ambassador Stephens)



Namdaemun (South Gate) Market

Same Places Today



**Namdaemun (South Gate) Road
(Photo by US Ambassador Stephens)**



Namdaemun (South Gate) Market

Euljiro, one of Seoul's main roads, before



Euljiro today



Me, before and after



In 1978, Korean clothes and red hair



In 2009, suit and tie, no more red hair

Korea – before and after

In the space of one generation (1978-2012), Korea transforms:

- Per capita GDP from \$700 to \$24,000.
- From large debtor to creditor nation
- From one of the smallest economies to 12th largest in GDP
- Negligible reserves to 6th largest
- Minimal exports to 9th largest exporting country
- Lowest graduation rate among OECD nations to highest.

The Tipping Point: Why and How Sovereign Wealth Funds are Changing the Game



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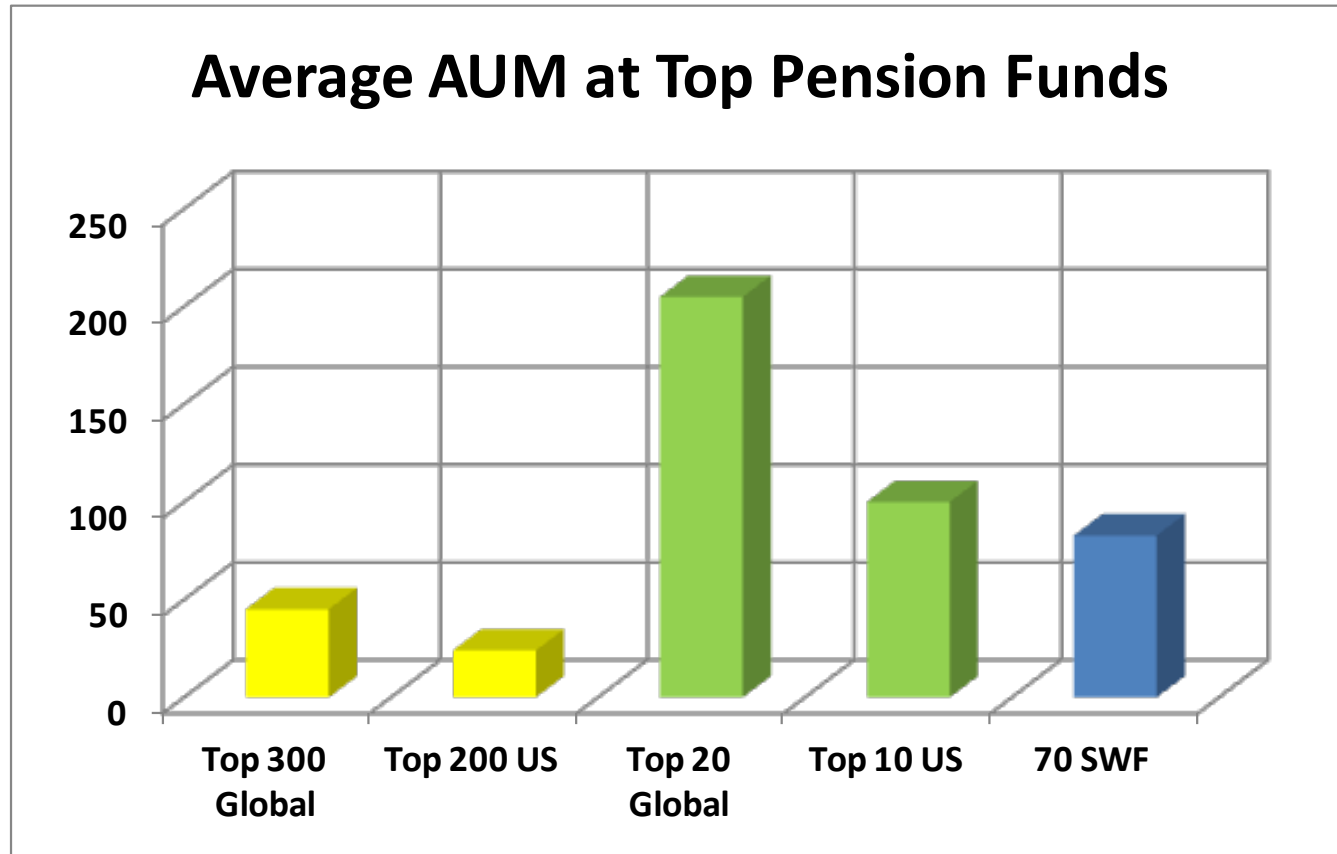
SWF: Newly forming, large AUM, growing and ambitious

AUM of Top 70 SWF	
Year	USD Trillion
2010	4.4
2011	4.8
2012	5.2
2013 August	5.8

Formation of Top 70 SWF		
Period	No.	Pct.
Last 15 years	54	77%
Since 2005	34	49%

Source: Sovereign Wealth Fund institute

Only top traditional institutions can match SWF in scale



Sources: Towers Watson, Pension and Investments, SWF Institute

Some reasons why SWF leading to “Tipping Point”

- New phenomena: 50% formed in last 8 years, 75% since 2000.
- Powerful force: controlling \$6 trillion in AUM and growing.
- Bigger scale: avg. AUM \$90bn, head count 200.
- Long-term investment horizon: few liabilities relative to AUM.
- Risk Appetite: liquidity is not risk, capture Illiquidity premium.
- Mandate. Build internal capability. In-source.

SWF “Tipping Point” also based in two paradox

1. There is no such thing as a free lunch.” Or is there?
2. The secret to successful investing is to be counter-cyclical, to buy when prices are down and sell when they are up. Yet in practice why is this so hard to do?

Paradox 1: There is a free lunch - diversification

DIVERSIFICATION improves risk adjusted returns at no cost

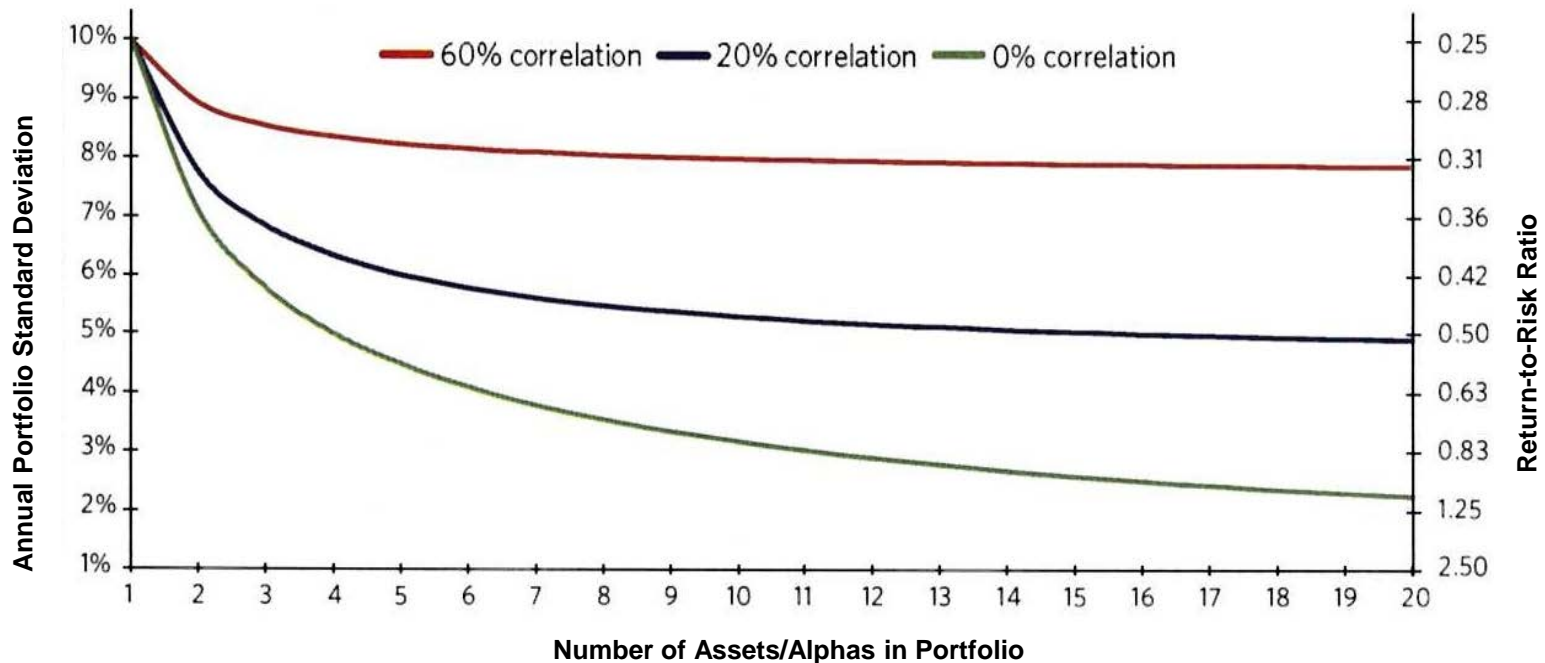
Equity-Bond Risk Adjusted Returns, 1926 - 2010

	Avg. Annual Return Compounded (%)	Sharpe Ratio RFR = 0
S&P 500 Composite Index Equities	6.53	0.2744
US Long-term Government Bonds	2.42	0.3115
50:50 Equity/Bond Portfolio	4.97	0.4244

Sources: Ibbotson Data; University of Washington Endowment, KIC

The convexity of diversification

The more un-correlated return streams in the portfolio, the better.



Source: Bridgewater

Paradox 2: Volatility defeats common sense investing

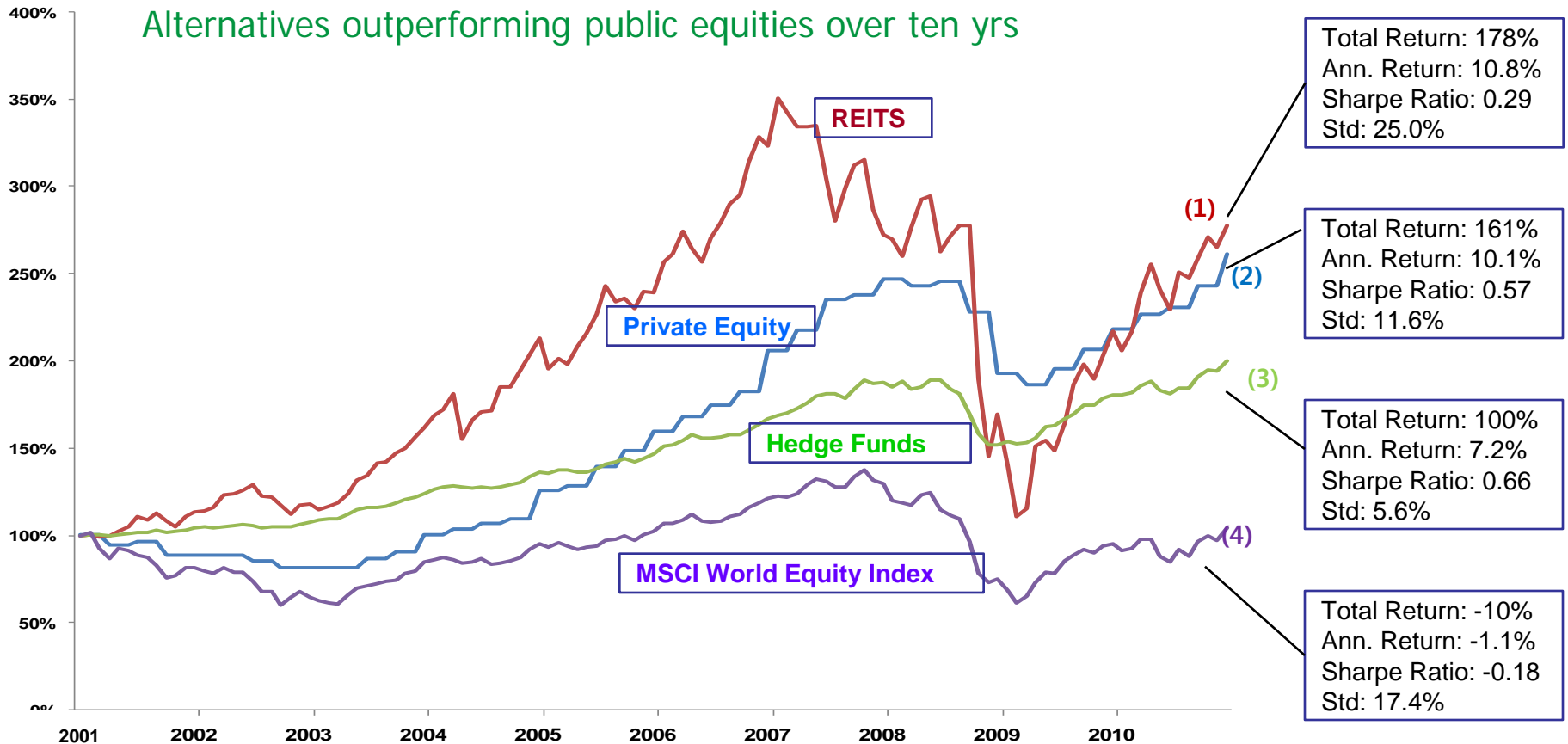
Volatility in public markets leads to pro-cyclical pressures. Alternatives have no daily mark to market pricing pressures. They are illiquid but offer superior returns in exchange.

Comparative Returns of Private Equity and Public Equity

	1 Year	3 Years	5 Years	10 Years
US Private Equity Index	13.8%	7.3%	8.1%	11.6%
S&P 500 Composite Index	1.1%	1.2%	-1.2%	2.8%

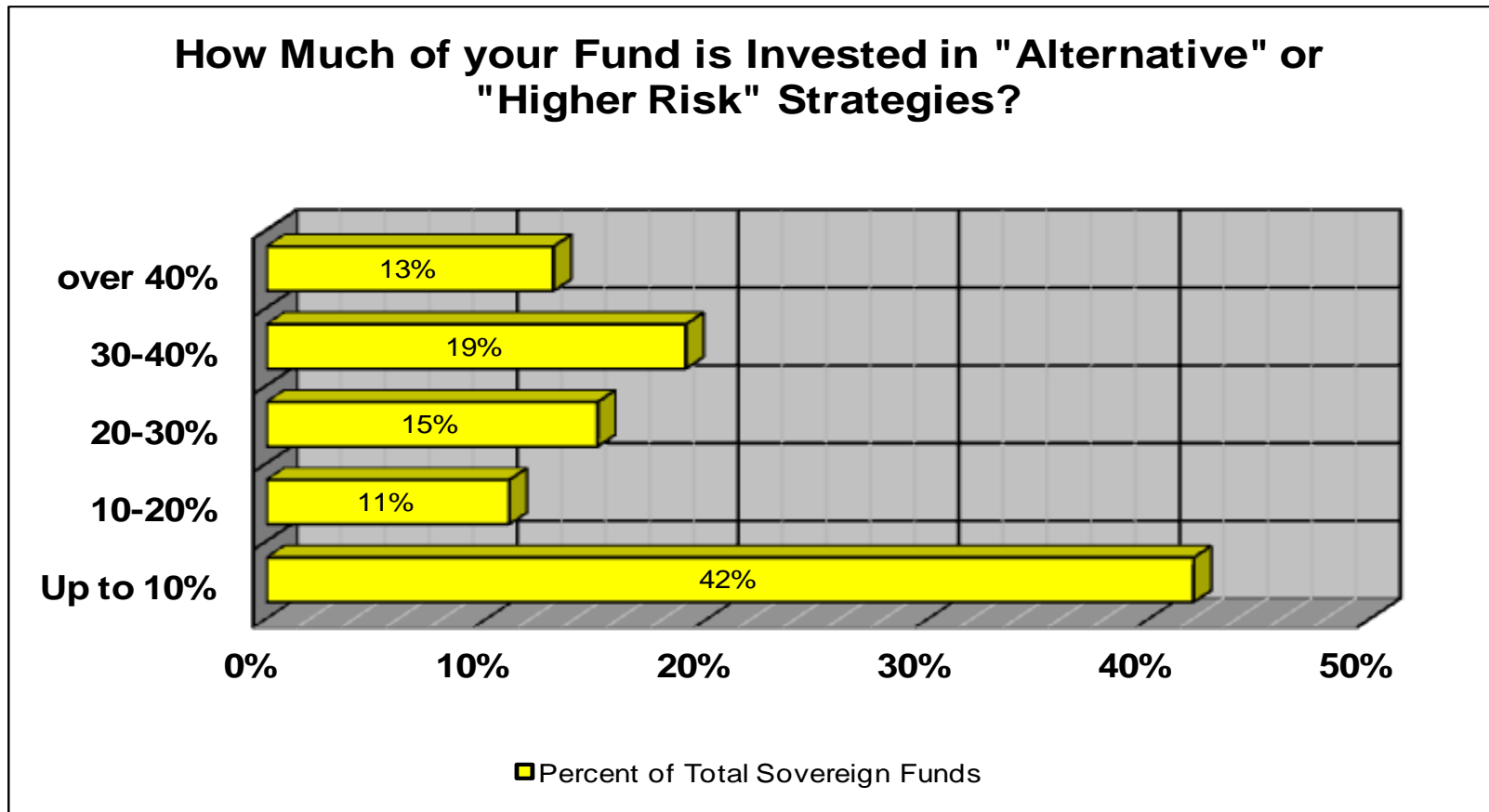
Source: Cambridge Associates LLC US Private Equity Index, Cambridge Assoc. analysis. Period ending Sep 2011

SWF are built to collect and harvest illiquidity premium



- (1) Performance from Jan. 2011 to Dec. 2010. Assume a risk free rate of 3% per annum over the period
- (2) Data based on US NAREIT index, Prequin US Private Equity Index, HFRI Composite Hedge Fund Index, MSCI All Country World Equity Index
- (3) Performance calculated using monthly returns except for **the private equity index**, which is based on quarterly returns.

Allocations to alternative strategies high and growing



Source: Sovereign Investor Institute, Asked in May 2013 of 97 sovereign funds (risk assets include emerging markets, hedge funds, private equity, real estate, infrastructure, commodities)

Sample of government fund allocations to alternatives

Allocation to non-public strategies up to 39% from 34% one year ago

Select Sovereign Funds Asset Allocation

Asset Class	GIC (3/12)	CIC (12/11)	CPP (12/11)	OTPP* (12/11)	Australia Future (9/12)	Wellcome Trust (12/11)	Alaska Perm (11/12)	OMERS (12/11)	Avg.
Local Market Public Equity	0%	0%	8%	9%	11%	41%	14%	7%	
Int Public Equity	Developed Market	25%	21%	31%	18%		31%	18%	
	Emerging Market		6%		5%				
Total EQ	45%	25%	34%	26%	34%	41%	45%	25%	34%
Fixed Income	Developed Market	21%	33%	56%	19%	0%	20%	33%	
	Emerging Market		17%	19%					
Total FI	17%	21%	33%	37%	19%	0%	20%	33%	22%
Private Equity	11%	43%	15%	12%	6%	28%	10%	14%	
Real Estate / Infrastructure / SI	13%		16%	32%	12%	11%	11%	29%	
Hedge Fund	3%		0%	12%	18%	17%	14%	0%	
Total Private Markets	27%	43%	32%	38%	36%	56%	35%	42%	39%
Cash & Others (CMD)	11%	11%	1%	0%	11%	3%	1%	0%	5%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%

*Note: 1. Data from Annual reports. 2. OTPP uses about 35% leverage and this explains why individual assets do not add up to totals

Problem is alternatives can be expensive to access

Performance and management fees = 300-400bps.

Portfolio construction costs = 200-300bps.

Total cost = 5-6% per year.

A 5% annual return gap results in a 13-fold difference in end-of-horizon wealth after 50 years.

This kind of difference cannot be ignored by investors with a long-term horizon.

High fees lead to social and political problems

Metrick and Yasuda (2010) calculated the average net present value of typical payment received per partner per PE fund.

They found that for venture funds, the average payment is US\$ 17 million; for buyout funds, US\$ 33 million.

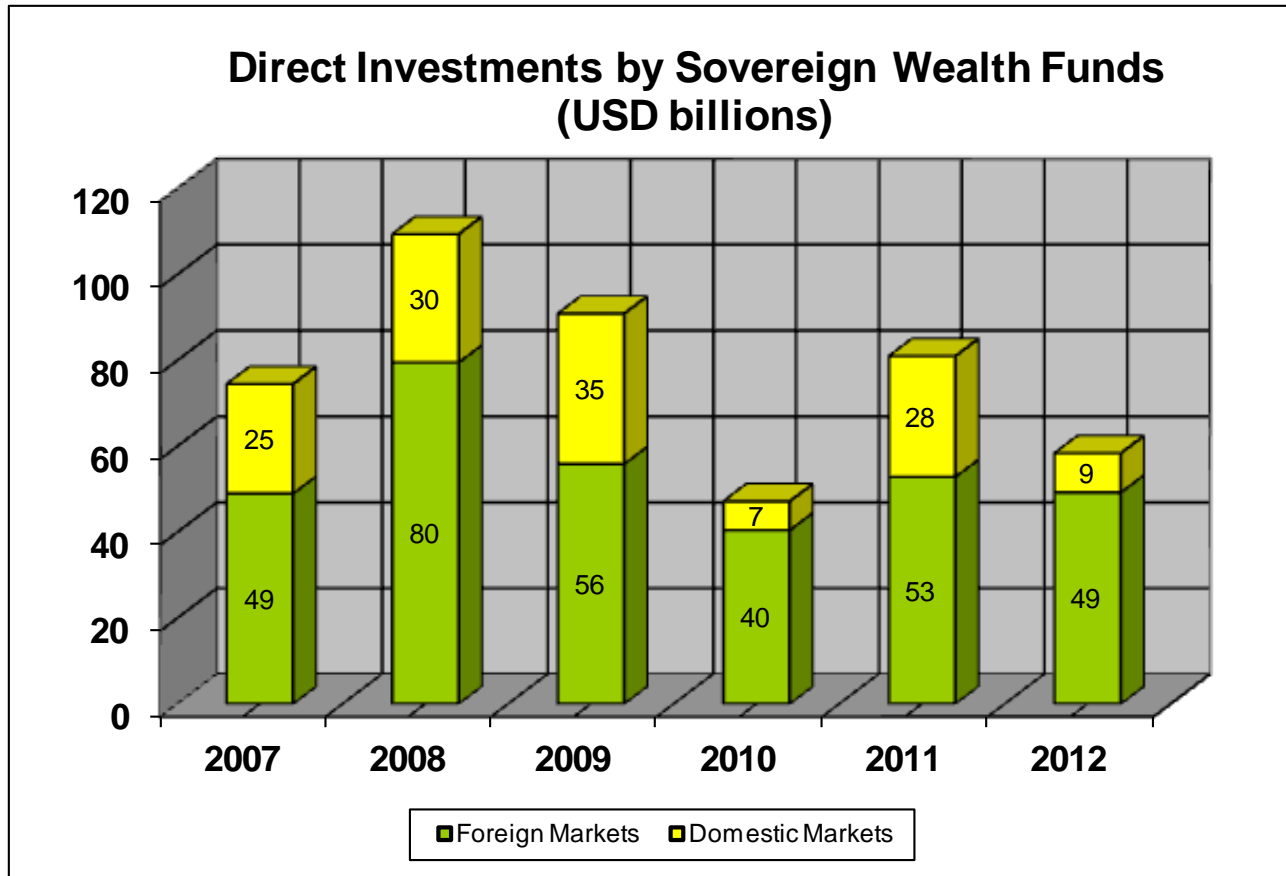
These payments represent a huge wealth transfer from the portfolio to the general partners.

Not the job of asset allocators to make GPs rich

Leading SWF to change the rules of the game

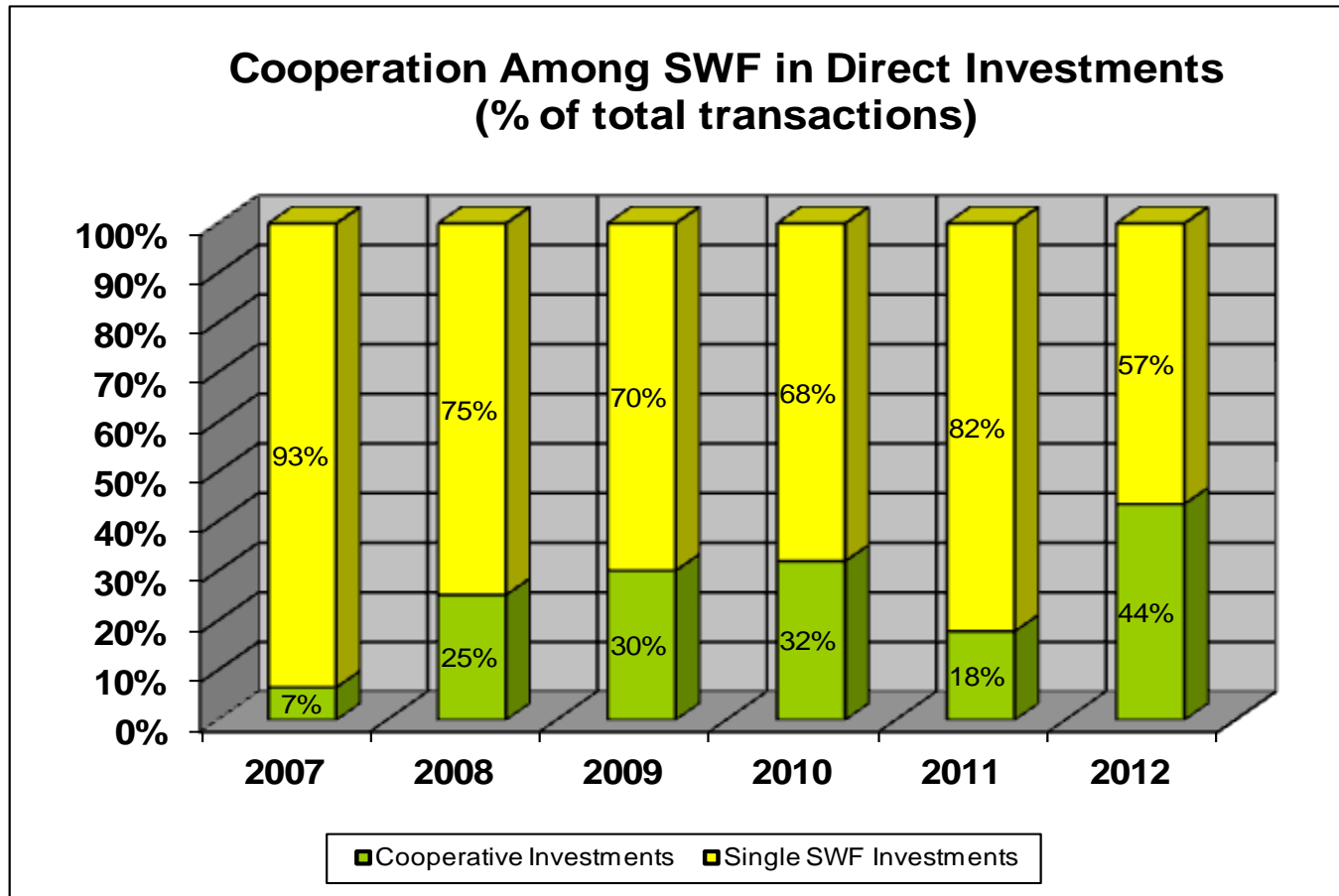
- **Taking control: using new models for better alignment, terms of investment, control and risk-adjusted returns.**
- Direct investment programs – lower costs, better returns
- Cooperation with other sovereign funds – network, lower costs
- Co-investment programs – dollar for dollar, acquiring skills
- Taking stakes in select managers – leverage relationships
- Buyouts – acquiring assets directly from asset managers
- Sponsoring new fund models – lower fees, better alignment
- Separate mandates – using scale to drive terms

Direct investing across borders about \$50bn per annum



Source: Sovereign Investment Lab, Paolo Baffi Centre, Universita Bocconi

Over 40% of direct investing is cooperative



Source: Sovereign Investment Lab, Paolo Baffi Centre, Universita Bocconi

Why are SWF going direct?

Professor Josh Lerner (HBS) publishes a seminal paper in August 2013 showing the IRR from seven direct investment programs beat PE fund benchmark returns by 700 basis points.

They have the mandate, capacity, scale and resources to do so.

Examples of new models, the “Tipping Point”

- Co-investment – GIC and Highstar buy GWF energy in US. ADIA, BCIMC team up with Macquarie to buy stake in gas distributor Open Grid Europe for over \$3 billion.
- Direct investing – QIA buys 11% stake in Tiffany. GPFG buys \$4.5 billion of European real estate.
- Cooperation with like-minded institutions – GPFG and TIAA CREF team up for five office properties in US valued at \$1.2bn. Khazanah and Temasek form M+S Pte. Ltd to develop properties in Singapore and Iskandar.
- Buyouts – CPP buys \$650mn in assets from Behrman Capital. GIC tenders for five US resort properties from Paulson for \$1.5 billion.

Examples of new models, the “Tipping Point”

- Taking stakes in GPs – CVC sells 10% stake to three SWF.
- Working directly with companies – Total sells 4% stake to QIA and CIC for \$6.3 billion.
- Sponsoring new funds – Atlas Partners; IFC Infra, ALAC
- Separate mandates – Teacher’s Retirement System of Texas (TRS) gives \$3bn mandates to KKR, Apollo, gets better terms

Sovereign Funds and Fixed Income Risk



Stocks outperform bonds over time with more risk

<u>U.S. Equity/ U.S. Bond Ratio</u>	Average Annual Compound Return (%) <u>1926-1980</u>		Average Annual Compound Return (%) <u>1926- 5/2010</u>	
		Sharpe Ratio RF= (0) <u>1926-1980</u>		Sharpe Ratio RF= (0) <u>1926-5/2010</u>
0/100 (Bonds only)	0.10	0.0152	2.42	0.3115
10/90	0.90	0.1362	3.01	0.3541
20/80	1.67	0.2285	3.55	0.4099
30/70	2.40	0.2810	4.07	0.4372
40/60	3.09	0.3050	4.54	0.4382
50/50	3.73	0.3121	4.97	0.4244
60/40	4.34	0.3113	5.37	0.4041
70/30	4.90	0.3053	5.72	0.3803
80/20	5.42	0.2968	6.03	0.3564
90/10	5.90	0.2871	6.30	0.3333
100/0 (Equities only)	6.33	0.2762	6.53	0.2744
CPI	3.0		2.3	

Bonds: US long-term government bond total return. Equity: US S&P500 total return. Higher bond weighting (50%-70%) for period including last thirty shows better Sharpe Ratio. Higher equity weighting (50%-70%) for period not including last thirty years shows higher Sharpe Ratio.

Sources: Ibbotson Data, University of Washington Endowment Office, KIC

Three extraordinary decades for bond returns...

Decade by Decade Average Real Returns in US\$

Decade	Comment	Equity	FI
1950s	Post war restructuring	18.0%	-0.3%
1960s	Soviet Reform, Flower Power, Vietnam War, Civil Rights Movement	5.4%	0.7%
1970s	USD crash, OPEC	0.8%	1.5%
1980s	Asian Decade, China Rising, Supply-side Economics	13.5%	6.5%
1990s	Fall of Berlin Wall, Tech Boom, Japan Bust	7.9%	6.7%
2000s	Two Asset Bubbles Burst, China again	-1.6%	5.3%

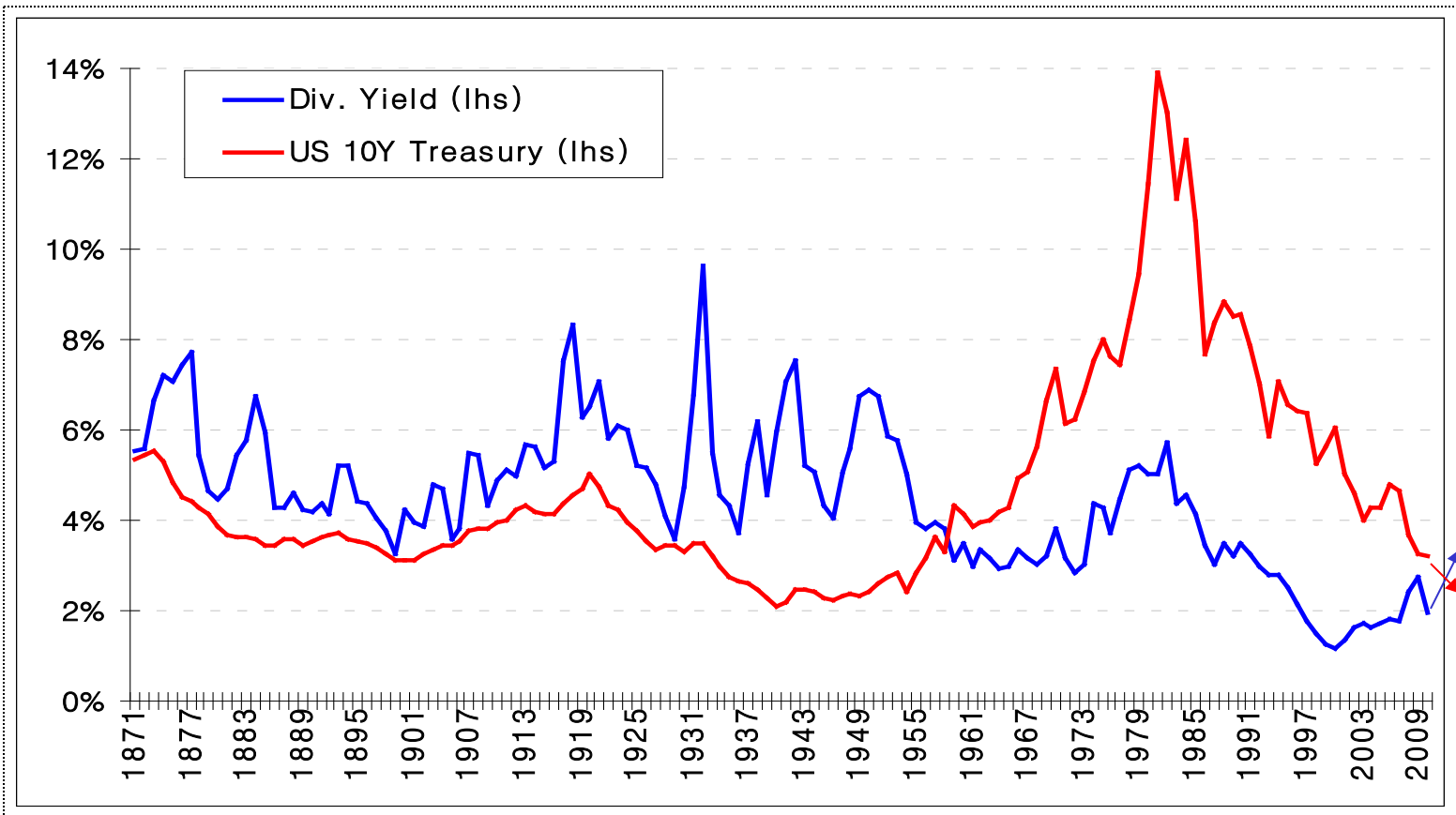
...but after a 30-year rally in yields, where do we go now?



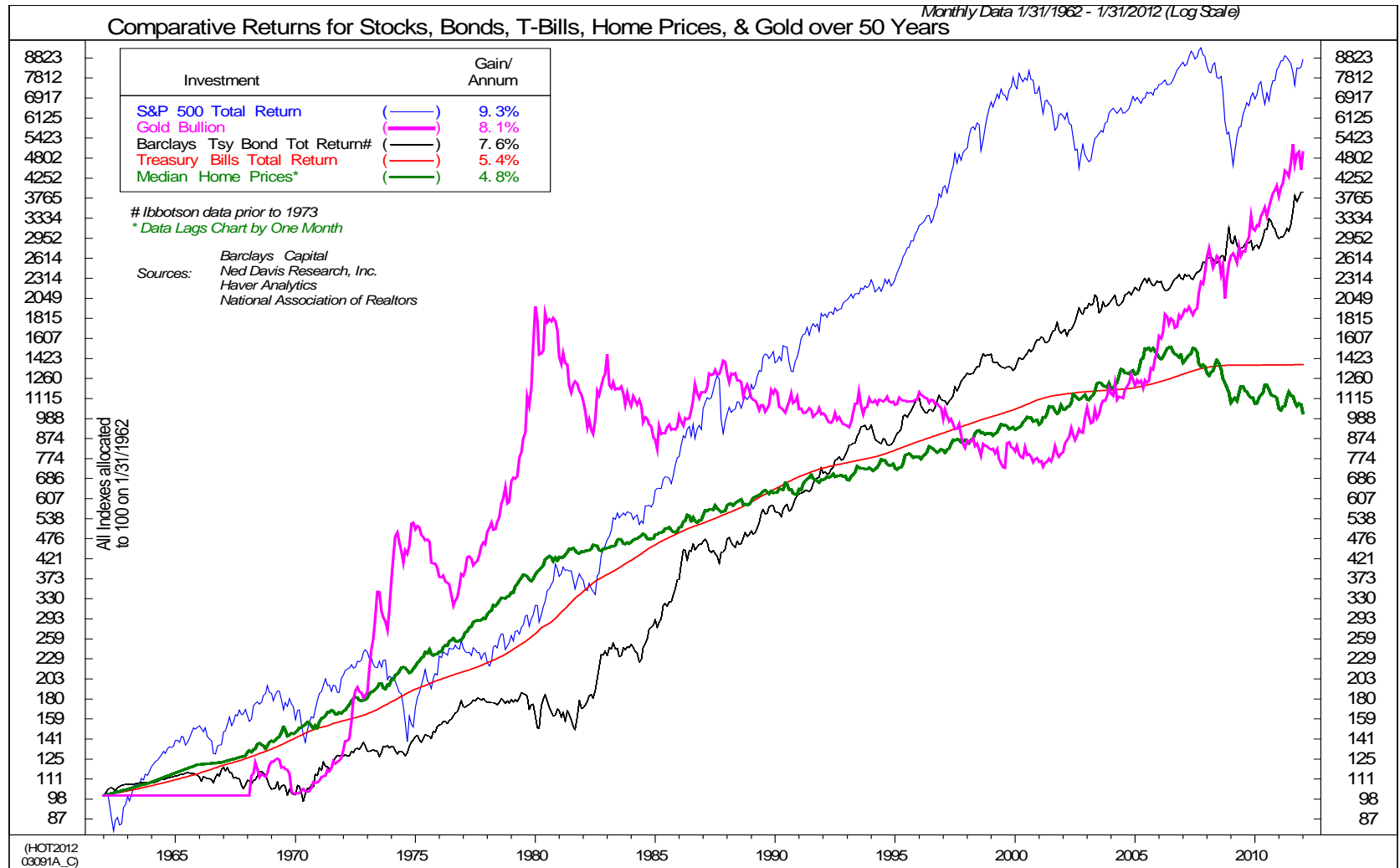
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Stock dividend yield attractive relative to bond yield

Stock dividend yield attractive relative to bond yields, back at 1960 levels, but were cheap relative to bonds during 1871-1960!



Every asset has it's time - stocks, bonds, cash, R/E, gold



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