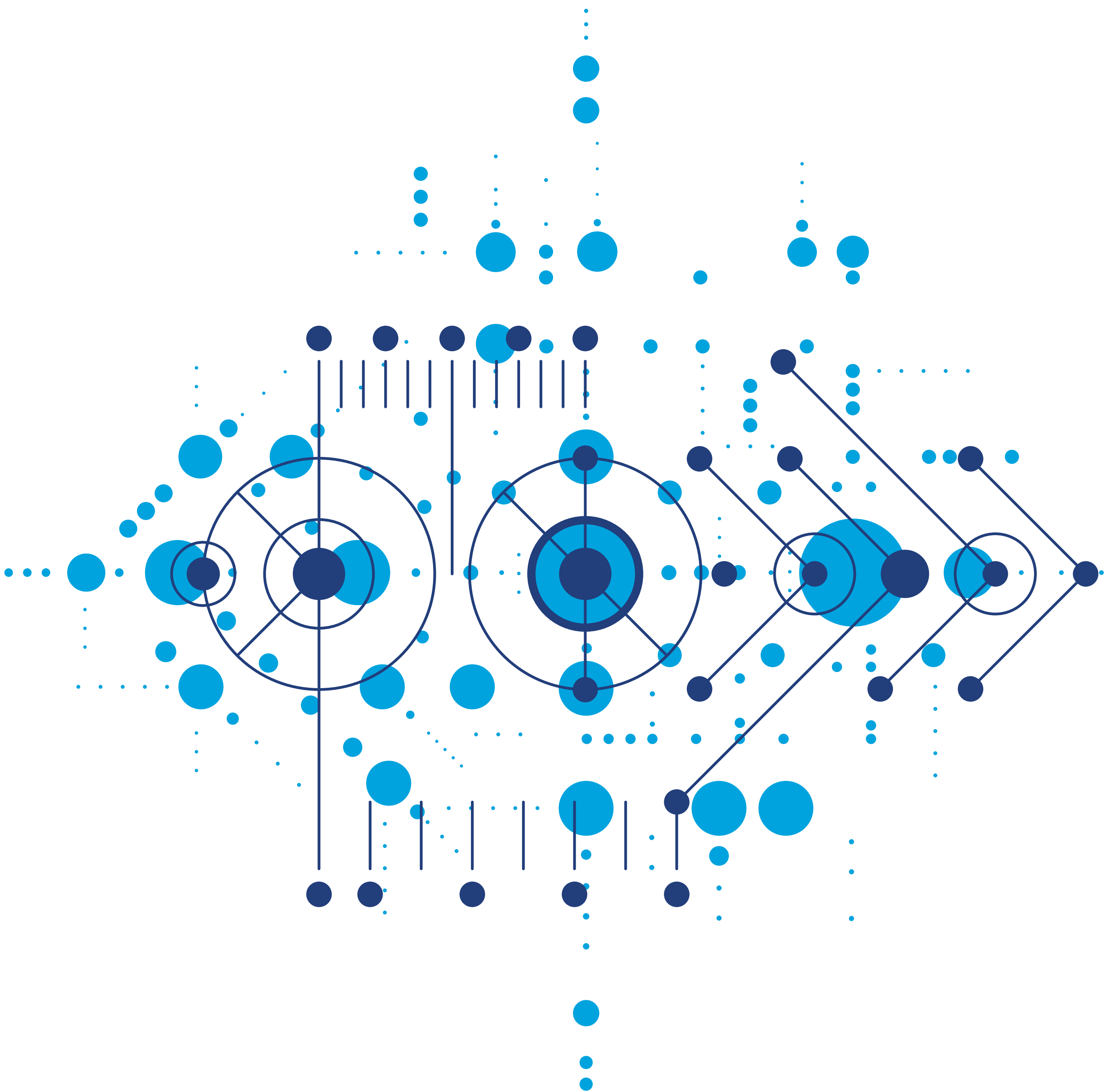
STATE STREET

Institutional Investor and sovereign wealth fund activity during the pandemic: *Reasons for optimism?*



IFSWF
International Forum of Sovereign Wealth Funds

Introduction

During 2020, financial markets proved remarkably resilient to the global pandemic and worst recession observed in a century. In our May 2020 study, Pandemic, No Panic: Evidence from Institutional Investor flows, we examined institutional investor behaviour and sovereign wealth fund activity during the financial and economic crisis precipitated by the Covid-19 pandemic and uncovered signs of caution, selective risk-taking, and rebalancing in the asset allocation and behaviour of these market agents. Institutional investors were underweight risk assets and held elevated levels of cash. They displayed a wide variation in their capital flow decisions and positions across risk assets through the course of the year, but in general started 2020 with positions that performed well last year, e.g., overweight US stocks and technology.

Here, we uncover insights into how these market agents were positioned during the pandemic and highlight some of the key capital flow and reallocation decisions observed from May 2020 to March 2021. The analysis draws on State Street's proprietary indicators of institutional investor flows and holdings, which aggregate the anonymised activity of institutional investors representing more than $38 trillion in assets,[1] and context from members of the International Forum of Sovereign Wealth Funds.

Research methodology

To undertake this project, State Street analysed its dataset of unique indicators that capture aggregated and anonymised capital flows, portfolio positions and behaviour of long-term institutional investors across multiple asset classes, sectors and countries. The indicators capture a diverse group of large global institutional investors, including sovereign wealth funds, collective funds, mutual funds, pension products, insurance products and others. These indicators are derived from security-level transactions, holdings, and borrowings, and are aggregated and anonymised through a robust process to help ensure the preservation of underlying client confidentiality. The indicators provide objective insights into demand and risk sentiment derived from the aggregated activities of long-term institutional investors representing more than $38 trillion in assets under custody and administration at State Street.[2]

To complement this data and provide more colour and context for the quantitative analysis, IFSWF surveyed a sample of seven of its largest members that deploy capital in global markets. These responses were provided on the promise of anonymity. These institutions came from East Asia, West Asia, Australasia, and North America.

1 Source: State Street. As of December 31, 2020.

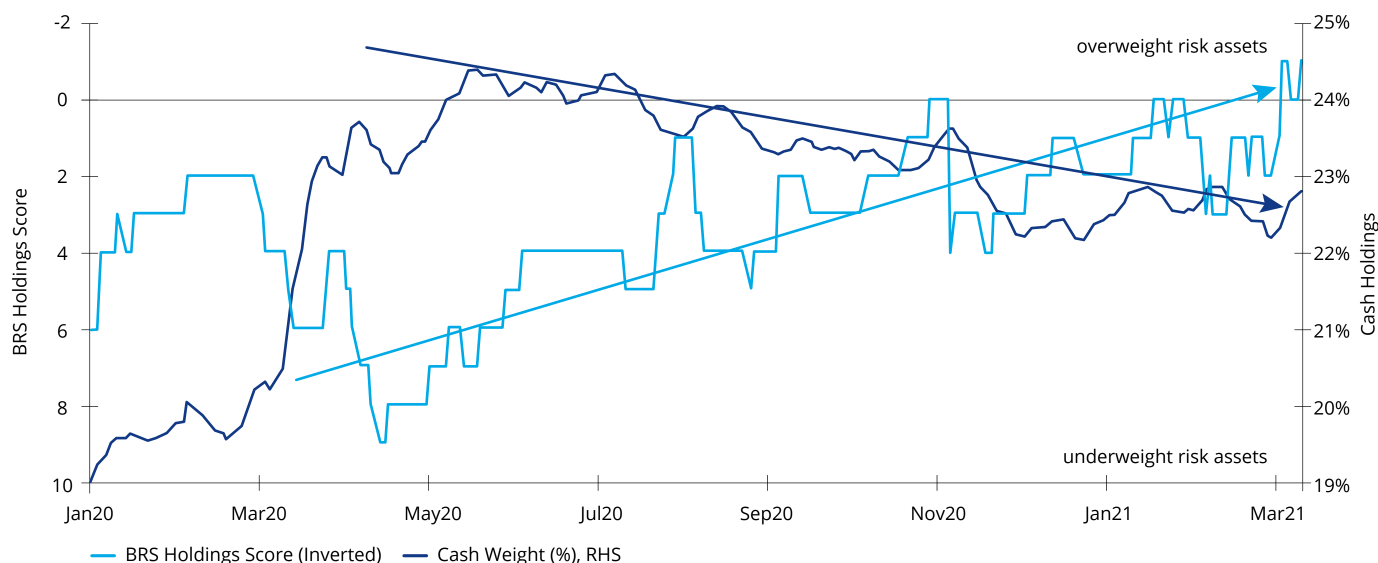
2 Source: State Street. As of December 31, 2020.

Navigating the pandemic

As we showed last year, institutional investor positioning was cautious at the start of 2020. Investors held more defensive positions across asset classes and high levels of cash, which peaked in mid-April. State Street's Behavioural Risk Scorecard (BRS) – an aggregate measure of risk appetite derived from the capital flows and holdings by institutional investors across multiple asset classes and factors[3] – reveals that institutional investors started the year with underweight[4] positions in risky assets, particularly sovereign debt, corporate bonds and foreign exchange markets, while cash levels were at the highest levels observed since the global financial crisis. This was also true of the sovereign wealth funds we spoke to for this project, which reported entering 2020 with "defensive positioning" or a "large overweight to cash and fixed income". Since then, investors have gradually deployed some of their accumulated cash, and reduced fixed income positions to add exposure to risk assets as financial markets rebounded quickly.

As of March 2021, institutional investors, including sovereign wealth funds, had closed their underweight positions to reach a risk-neutral level across asset classes (Figure 1). The data suggests that institutional risk sentiment across asset classes improved broadly during this period, particularly for foreign exchange, commodity-sensitive assets and equity reallocation decisions.

Figure 1: Institutional investor positioning in risk assets and cash holdings



Source: State Street Global Markets. Figure displays the increase in institutional investor portfolio holdings in risk assets across asset classes (summarised by the BRS Holdings score) and reduction in cash holdings in institutional portfolios. As of 9 March 2021.

3 For more information regarding State Street's Behavioural Risk Scorecard, please see Froot, K. Bhargava, R, Cuipa, E and Arabadjis, J (2014), "Multi-Asset Sentiment and Institutional Investor Behavior: A Cross-Asset Perspective", Journal of Portfolio Management, vol. 40, no. 4: 144-156.

4 Underweight (overweight) positions by aggregate institutional investors are defined when holdings excess to an empirical benchmark are below (above) the 50th percentile.

Most of the sovereign wealth funds we spoke to increased their risk exposure in 2020 by adding to their equity allocations. One told us that it had used its "dry powder to aggressively buy global equities in the midst of the March sell-off", and that this had positively contributed to the fund's performance last year. However, there were different approaches to buying equities. For some, this behaviour was simply "rebalancing discipline", while for others it was a case of "taking advantage of opportunities as and when they arose. Specifically, we… bought equities as they became cheaper." Some sovereign wealth funds allocated to additional sectors and ideas that had become more attractive. One took the opportunity to enhance its performance through "investment in REITs [real estate investment trusts] and listed infrastructure where we saw mispricing in the underlying duration exposures", while another increased their allocations to "convertible arbitrage, macro hedge funds, insurance-linked securities [and] growth capital".

However, not all sovereign wealth funds chose to increase their risk exposure. Those with a lower risk appetite chose to maintain the status quo as it appeared to be "resilient to the negative effects of the recent financial turbulence… [as a] large portion of our portfolio is invested in highly liquid and less volatile fixed income instruments", in contrast, this sovereign fund had become "cautious about stock markets… we are not planning to increase our current equity allocation."

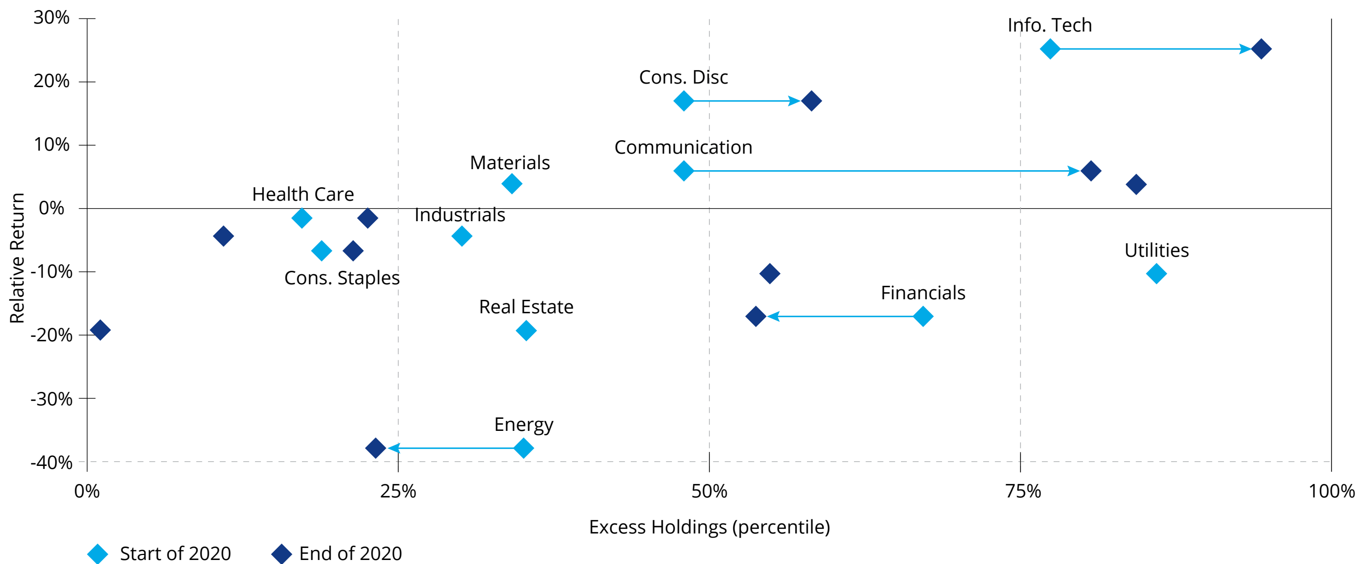
But how did institutional investors perform in their allocation decisions throughout the pandemic?

Institutional investors' portfolios were well-positioned for the pandemic during 2020, because, as one sovereign wealth fund told us it "catalysed and accelerated several structural changes in the global economy and markets" that they had already identified. Consequently, their positions performed well during the pandemic.

For example, at the beginning of 2020, institutional investors were already overweight technology and communication services sectors and built positions in those winning trades in 2020. One sovereign wealth fund told us that this was a key sector for them as "technology has become a real and urgent part of our lives". IFSWF data[5] reveals that sovereign wealth funds invested $7.4 billion across 30 direct investments in public markets in technology and communications in 2020, compared to $2 billion and 22 investments in 2019, and 12 deals worth $1 billion in 2018. Institutional investors were also underweight in sectors, such as energy and financial sectors, which performed poorly during the pandemic (Figure 2). IFSWF data also shows that sovereign wealth funds only invested $1 billion in the energy sector in 2018 and 2019 and that their investments in financial services had been declining since 2017. Both sectors picked up in 2020; energy due to Saudi Arabia's Public Investment Fund (PIF) taking opportunistic positions in energy and financial services companies in the second quarter.

5 The IFSWF data set captures publicly reported direct equity investments by sovereign wealth funds going back to 2015.

Figure 2: Changes in sector holdings by institutional investors during 2020

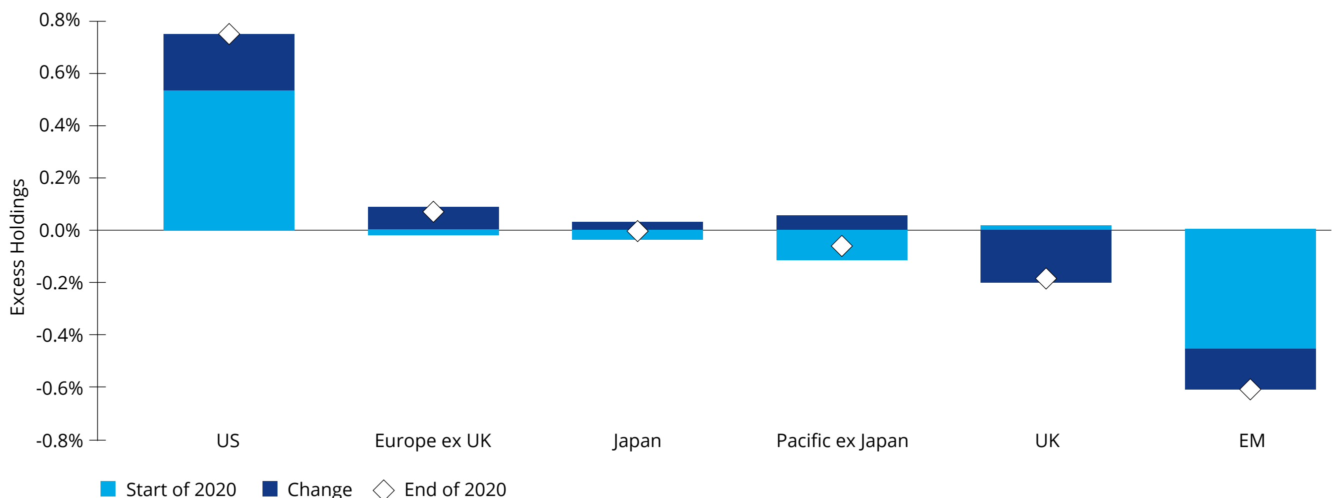


Source: State Street Global Markets, Datastream. Figure displays the historical percentile rank of portfolio holdings by institutional investors in excess of an empirical benchmark and MSCI sector total returns relative to the MSCI AC World Index. Returns denominated in local currency.

As shown in Figure 3, institutional investors also added to their US equity positions in 2020, a trend supported by IFSWF data, which reveals that sovereign wealth funds ramped up investment in US-listed stocks, investing over $16 billion across 46 transactions in 2020 against only $2 billion invested in 28 deals in 2019. This uptick was largely driven by PIF's countercyclical investments in energy, consumer and financial sectors at the peak of the crisis in the second quarter.

Figure 3 also shows institutional investors scaled back their investments in emerging markets. For sovereign wealth funds, it appears this trend was largely confined to listed strategies. For example, IFSWF data suggests that sovereign wealth funds from Asia increased their investments in the region to support local companies and local economies. Figure 3 also suggests that institutional investors withdrew from the UK. However, IFSWF data suggests that there was an uptick in sovereign wealth fund investments in the UK – from $1 billion in 2019 to $4.4 billion in 2020 – almost two-thirds in private markets, as some sovereign wealth funds looked for value in the UK economy, which was hit hard by the pandemic, contracting by 9.9% in 2020.

Figure 3: Changes in country equity allocations by institutional investors



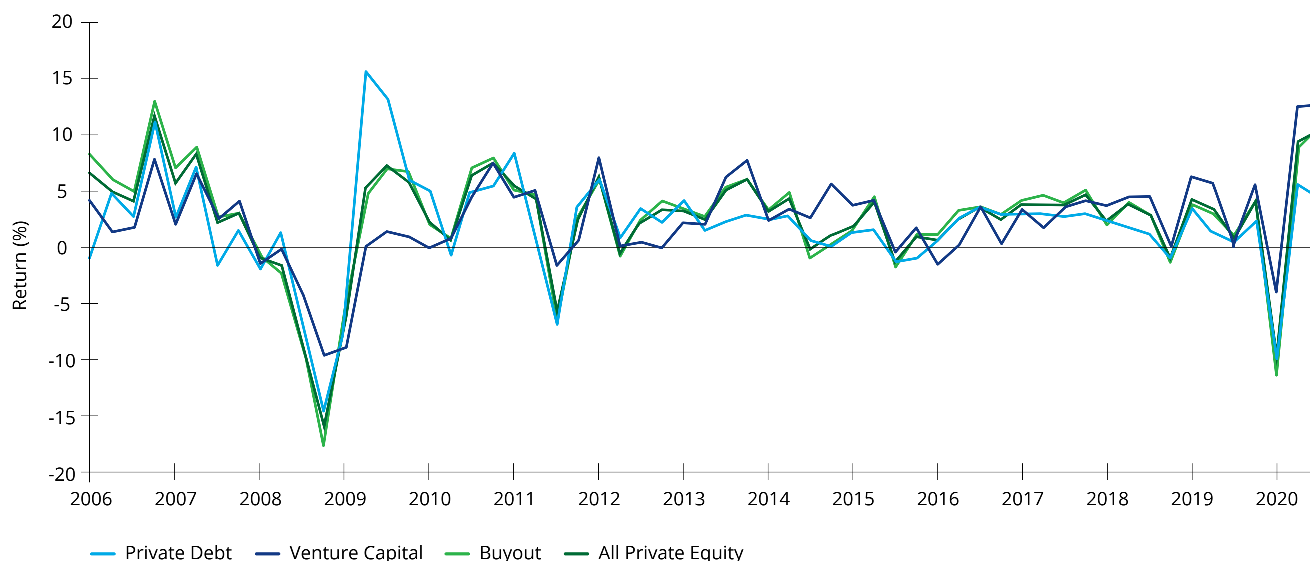
Source: State Street Global Markets. Figure displays the change in portfolio holdings by institutional investors over an empirical benchmark across regions during 2020.

Private asset rebalancing and performance

Institutional investors and sovereign wealth funds have continued to diversify their portfolios by increasing allocations to private assets over the past decade. Several sovereign wealth funds indicated that they provided additional capital injections to some portfolio assets and underlying private market investments – behaviour considered to be a key to success in a downturn according to recent State Street research.[6] One sovereign wealth fund told us that it had invested to ensure "strong cash flows and growth in our portfolio companies" in 2020.

But how did private assets perform during this period and did institutional investors benefit from their rebalancing activity in private markets last year? According to the State Street Private Equity Index – a global benchmark of private equity performance derived from the aggregated and anonymised cash flows of State Street's limited partner (LP) clients who make investments in private equity funds – global private equity returns fell by more than 10% in Q1 2020; the lowest internal rate of return (IRR) observed since the global financial crisis in Q4 2008 and particularly evident in buyouts and private debt. Global private equity returns rebounded rapidly in the subsequent quarters, recording a gain of around 10% in both Q2 2020 and Q3 2020, with venture capital investments posting the strongest performance across strategies during this period (Figure 4). One sovereign wealth fund that said one of its focus areas was in early-stage ventures told us that "private equity had stellar return" for them in 2020. It is perhaps unsurprising, therefore, that December 2020 also witnessed the highest paid-in capital/commitment (PICC) in global private equity since September 2008, and the highest distributions/commitment (DCC) since December 2013 (Figure 5).

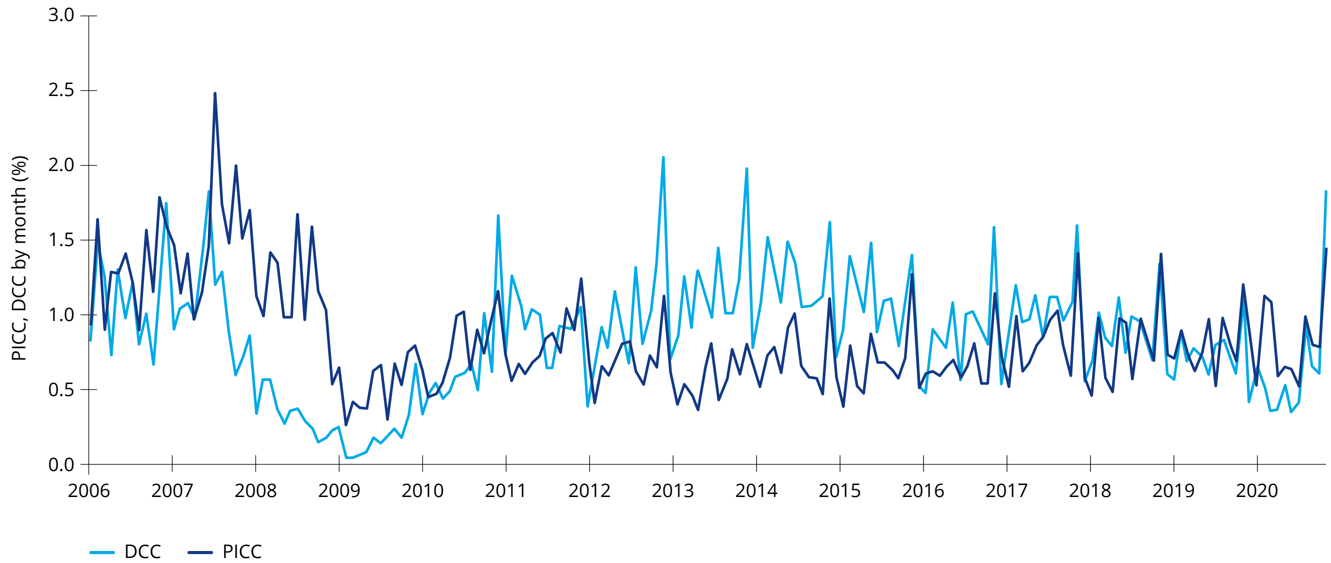
Figure 4: Global Private Equity quarterly returns (%)



Source: State Street Global Markets. Figure displays quarterly returns for Global Private Equity and selected strategies. As of Q3 2020.

6 Josh Lerner, Ann Leamon, Samuel Holt, Private Equity in Troubled Times, State Street "In Practice" Series, April 2020.

Figure 5: Global Private Equity Paid-in-capital and distributions



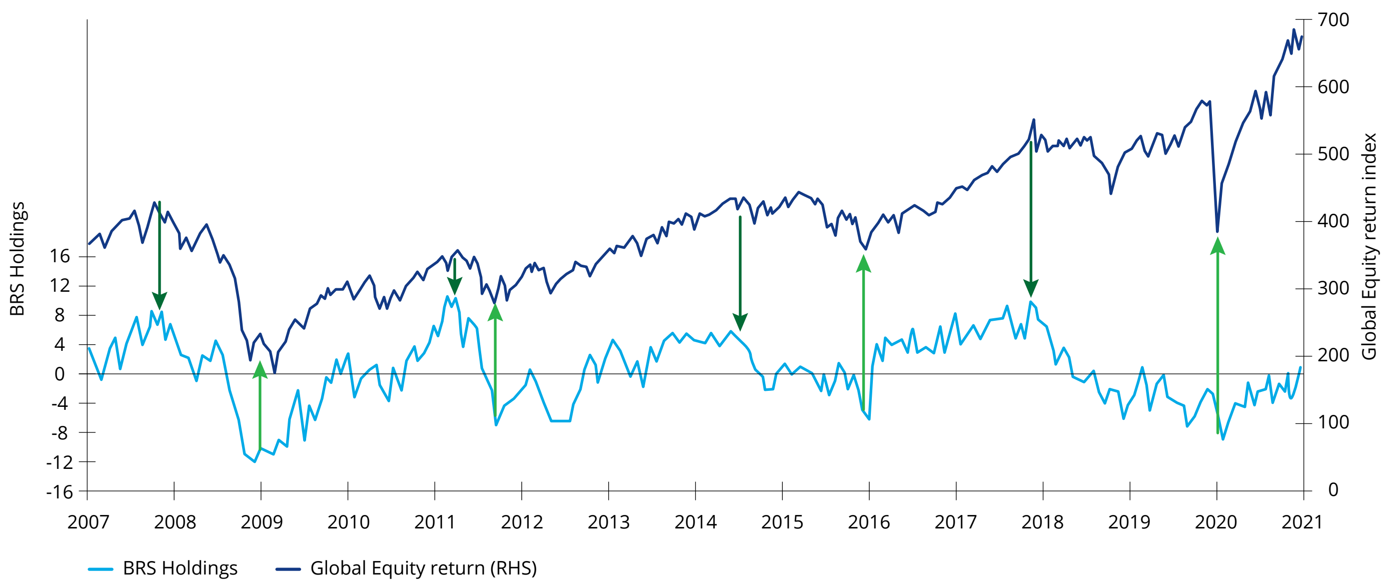
Source: State Street Global Markets. Figure displays monthly paid-in-capital/commitment and distributions/commitment ratios by institutional investors. As of December 2020.

IFSWF data supports this analysis, showing that sovereign wealth fund investment in unlisted companies (excluding fund commitments) more than doubled year on year, from $22.2 billion in 2019 to $50.3 billion in 2020, partly due to sovereign wealth funds supporting their portfolio companies. However, this trend is likely to continue in 2021, as for the sovereign wealth funds we spoke to for this report, private assets were the focus of how they were thinking of deploying their capital this year. Specifically, most were looking at building out their infrastructure and real estate portfolios. One sovereign wealth fund noted that "In a challenging investment environment characterised by well-below average expected real returns from traditional public markets, we may need to consider relying even more on private markets' exposure to achieve our mandate." For another, "We have seen remarkable changes in the investment landscape as a result of the pandemic. We believe our long investment horizon allows us to selectively deploy capital into new opportunities, in particular private equity and real assets."

Investor activity since the outbreak of the pandemic

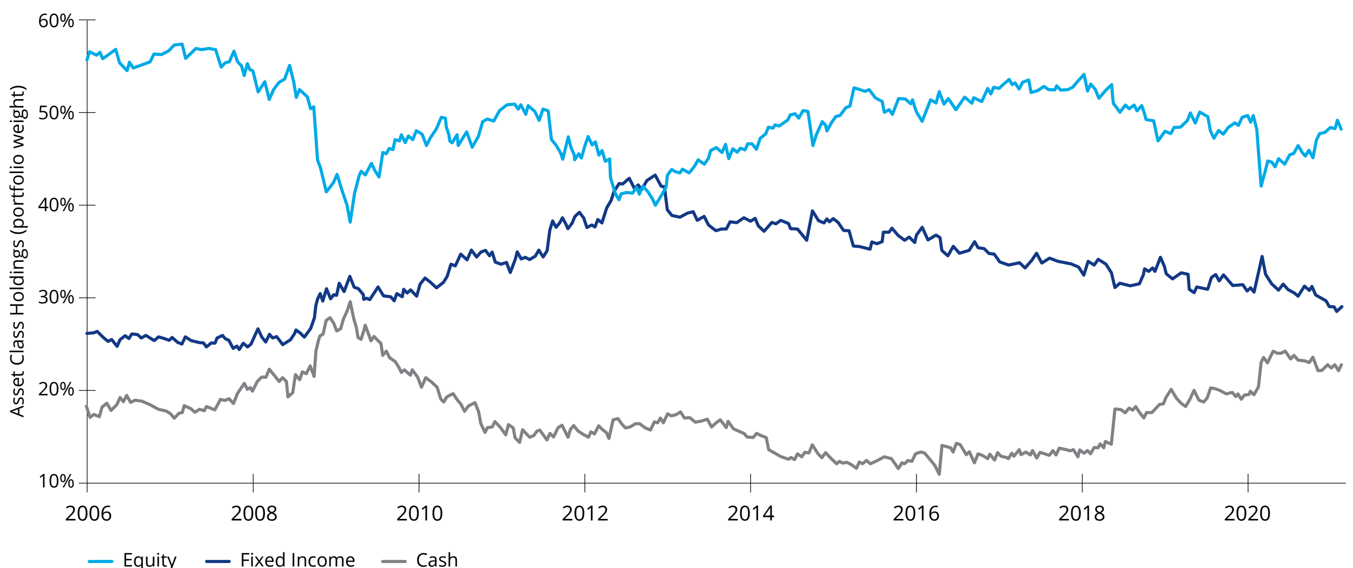
Investors have closed their underweight positions in risky assets in 2020, starting 2021 with a more neutral stance across asset classes (Figure 6). While cash levels remain high and equity positions lower than normal (Figure 7), there is evidence of a sustained rotation from cash and fixed income into equities since July 2020. The lack of positioning risk also illustrates why recent dips in risky assets have been bought quite quickly – a pattern that could continue in 2021 following the large cash positions institutional investors accumulated during 2020, leaving room for further capital deployment and rebalancing towards risk assets.

Figure 6: Institutional investor holdings in risk assets & global equity performance



Source: State Street Global Markets. Figure displays changes in institutional investor portfolio holdings in risk assets across asset classes (summarised by the BRS Holdings score) and global equity performance (summarised by the MSCI AC World Index return). As of 9 March 2021.

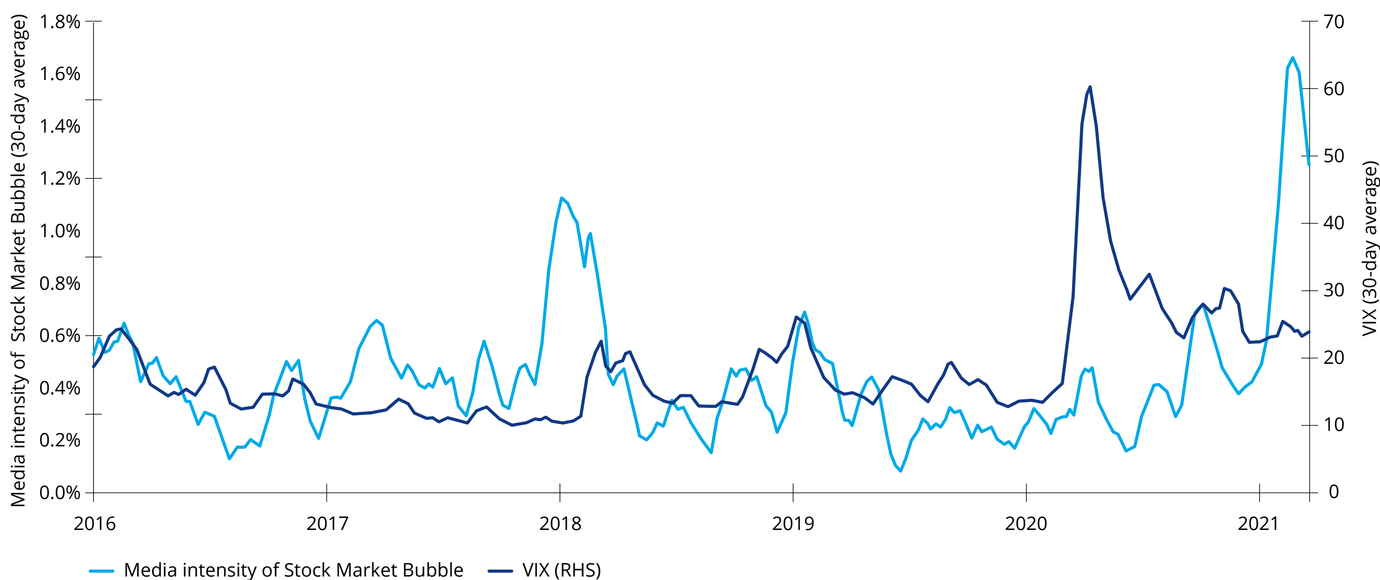
Figure 7: Asset class weights of institutional investors



Source: State Street Global Markets. Figure displays portfolio holdings by institutional investors. As of 9 March 2021.

This raises the question as to whether we are approaching asset bubble territory – a narrative that can be quantified through the lens of the media. Through its partnership with MKT MediaStats, State Street provides daily indicators which quantify the media coverage relating to a wide universe of financial assets, central banks, and market themes by applying algorithms to hundreds of thousands of scraped global digital media articles. While the topic of asset bubbles remains topical and indicates heightened concerns through the lens of the media (Figure 8), we do not see evidence of bubble behaviour, with room for institutional investors to add to positions in risky assets.

Figure 8: Media intensity of "stock market bubble" and volatility



Source: State Street Global Markets, MKT MediaStats. Figure displays the proportion of global digital general media articles about equities that mention Stock Market Bubble and volatility (the VIX Index). As of 11 March 2021.

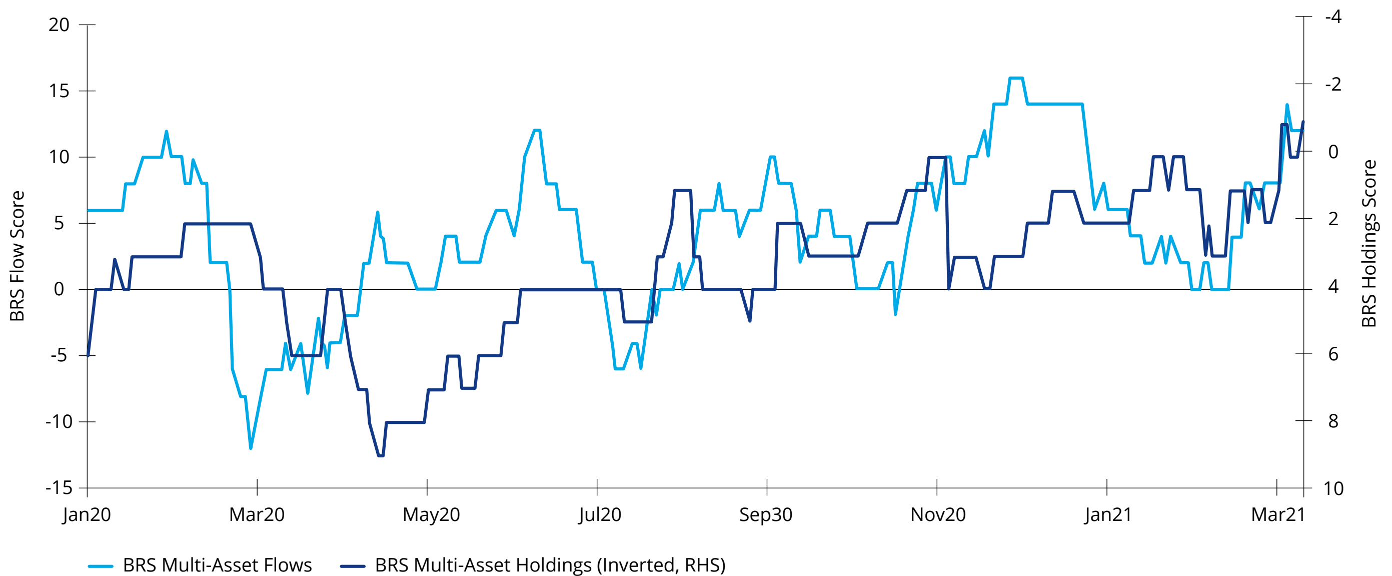
Overall, the sovereign wealth funds we spoke to were not worried about asset bubbles as the "market as a whole, is not yet in a bubble territory". However, they did agree that "portions of the global markets appear to be in or close to what one would consider bubble conditions" and that "financial assets do appear fully priced – to expensive". But, as one IFSWF member told us, "we are not worried about bubbles explicitly given an inability to predict when they burst" or, indeed, as another said, "it remains to be seen what might be of greater systematic concern."

That said, one of the IFSWF members we spoke to did have a concern around the "number of SPAC [special purpose acquisition company] IPOs [initial public offerings], the number of technology companies trading at more than 20 times revenues, the multiples that private equity funds are paying for deals and the proportion of Russell 2000 companies that are unprofitable."

Reasons for optimism?

Institutional investor flows into risk assets have remained positive in 2021 and picked up in February (Figure 9), particularly in equities, commodity-sensitive assets and an aggregate asset allocation adjustment out of fixed income and cash into equities.

Figure 9: Institutional capital flows and holdings across risk assets

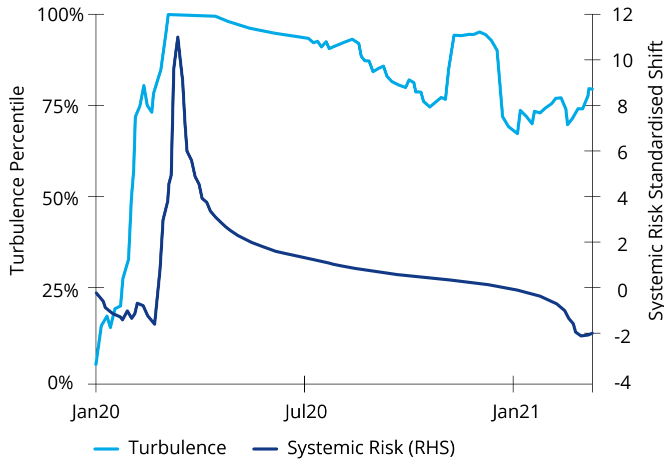


Source: State Street Global Markets. Figure displays changes in institutional investor portfolio flows and holdings in risk assets across asset classes (summarised by the BRS Flows and Holdings score, respectively). As of 9 March 2021

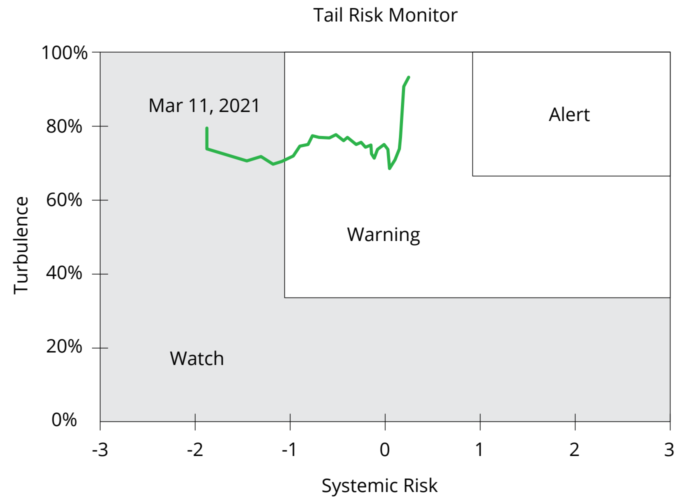
This trend is taking place against a backdrop of a market environment characterised by declining systemic risk and declining financial turbulence in global equities (Figure 10). In 2020, volatility was relatively high, and the markets experienced unusual cross-sector correlations. However, both these characteristics have faded in recent months and risk concentration has continued to decline since the Covid-19-induced spike observed in late February 2020.

Figure 10: Market risk environment

A) Global Equity Turbulence & Systemic Risk



B) Expected risk of left-tail events has receded



Source: State Street Global Markets. As at 11th March 2021. Figure 10A displays the 5-year percentile rank of 30-day average Global Equity Turbulence and the Standardised Shift (1-year z-score) of Global Equity Systemic Risk. Together, these two indicators can be used to estimate the likelihood of left-tail events, as shown in State Street's Tail Risk Monitor (Figure 10B).

Taken together, the current macroeconomic environment, anticipated fiscal stimulus and positioning of institutional investors and sovereign wealth funds present reasons to be optimistic into 2021.

Contributors

About the International Forum of Sovereign Wealth Funds (IFSWF)

The International Forum of Sovereign Wealth Funds (IFSWF) is a global network of sovereign wealth funds (SWFs) established in 2009 to enhance collaboration, promote a deeper understanding of sovereign wealth fund activity, and raise the industry standard for best practice and governance.

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