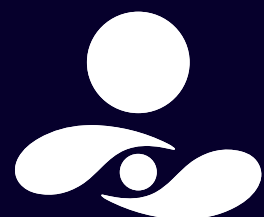




BAKU 2022
IFSWF
14TH ANNUAL MEETING

Mobilising Capital in a World of Change: Lessons From Baku

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STATE OIL FUND OF THE
REPUBLIC OF AZERBAIJAN

Coming together for the first time in person since 2019, the International Forum of Sovereign Wealth Funds held its annual meeting between 14 and 17 November 2022 in Baku, Azerbaijan, hosted by the State Oil Fund of the Republic of Azerbaijan (SOFAZ).

With its eclectic architecture, from modern skyscrapers to centuries-old mosques, to imposing structures of the Soviet period and the grand Parisian-style mansions built by the oil barons in the late 19th century, Baku is enlivened by its unique style of jazz that mixes the ancient musical tradition known as mugham. The city's history and geography at the crossroads of East and West provided a powerful backdrop to the many challenges that sovereign wealth funds face in the current economic and geopolitical environment.

Investors now face numerous and often intersecting challenges. Not since the global financial crisis have sovereign wealth funds faced such a difficult market environment. Inflation is at highs not seen for decades, and economic growth prospects are still dampened by ongoing pandemic-induced disruptions to supply chains and tight labour markets. The scaling back of central bank quantitative easing has put downward pressure on equity markets, and the debt sustainability of companies and many emerging market economies are starting to take centre stage.

If many of these risks can be quantified and managed, they are set against the uncertainties of increasing geopolitical tensions. Scrutiny of foreign investment is on the rise through more expansive investment screening mechanisms, and economic sanctions are increasingly used against rivals in place of military conflict. The globalisation we have come to know over the last three decades is no longer, with a possibly fractured and less open global economy on the horizon.

But also on the horizon are global challenges that necessarily require working together. The theme of this year's annual meeting was Mobilising Capital for Change. This theme reflects the recognition that the world economy is undergoing important changes, adding challenges to how and where sovereign wealth funds invest. But the idea also represents the opportunity sovereign wealth funds have to effect change by mobilising capital at home and abroad.

As capital markets and institutional investors everywhere face evermore calls to support more sustainable and inclusive forms of capitalism and development, sovereign wealth funds are increasingly recognising and developing their roles and contributions to local and global markets. For many new sovereign wealth funds with a domestic development mandate, catalysing economic change and driving greater opportunities for their economies and citizens is a fundamental measure of how they invest. Investing with purely financial motives (a single bottom line) has become a thing of the past. It is not that SWFs are less focused on commercial returns – SWFs are still profit-seeking – but there is a growing recognition among this group of investors that risks and opportunities are increasingly complex. They must consider a wider set of issues in their long-term investment decisions.

In the next three sections, we reflect on the discussions held at the annual meeting. The interpretations herein are our own and do not necessarily reflect those of the International Forum of Sovereign Wealth Funds or its member institutions.

Section 1: Long-term Investing in a Geopolitical World

Against the unprecedented backdrop of pandemic-induced economic disruption, conflict in Europe, and rising geopolitical tensions, we were reminded in Baku of the challenges capital allocators face when market functions and capital flows are strained. In the current context, the discussions accentuated the link between macroeconomic pressures and deepening geopolitical conflict. Attendees emphasised that uncertainty and associated risks impact daily operations, the execution of investment strategies, and engagement with stakeholders. Moreover, rising geopolitical tensions, particularly when elevated to the level of military and economic interventions, necessarily have direct consequences for both investment returns and operating performance, not least in the form of competition for capital and higher capital costs.

As sovereign wealth funds exchanged views on the global economy and its prospects in Baku, three interrelated factors surfaced:

- 1. The scale and velocity of the current economic downturn**
- 2. The immediacy of changing conditions**
- 3. The synchronicity of policy actions**

Compared to past recessions, the recent impact on economic activity has been sharp, reflected in declines in consumer confidence, economic growth, and equity prices across all three major global growth engines: the United States, the Eurozone, and China. Accompanied by an equally intense rise in inflation, they have prompted synchronous policy actions by central banks targeting interest rates to mitigate the effects of rising prices.

The impacts of the slowdown have been accentuated by the direct and indirect disruptions to commodity and financial markets resulting from the conflict in Eastern Europe, as well as the residual, and potentially recurrent, effects of Covid-19 on global supply chains, particularly those emanating from China. The implications of energy and food security for both developed and emerging economies were also evident in conversations. The fragmentation of global trade and investment, and disruptions to financial networks, also raise questions about the effects of persistent geopolitical tensions on market access, either through the imposition of hard barriers to foreign investment or fostering a market environment that increases the costs of cross-border investment.

While the discrete causes and eventual consequences of the current turmoil will continue to be deliberated, three prescriptive themes emerged from the Baku proceedings:

- **Prepare**
- **Partner**
- **Perform**

Weaving these themes together is the need to be forward-leaning and proactive. Similarly, calls to extend and strengthen partnerships were premised on the notion that opportunities to improve communications and knowledge-sharing would help mitigate investment and operational risks, including those resulting from market access. Lastly, although economic and geopolitical tensions accentuate short-term volatility, longer-term investment horizons afford sovereign investors some capacity to minimise resulting disruptions while focusing on driving long-term returns to owner-shareholders.

Section 2: Stakeholder Capitalism and Long-term Investing

If longer investment horizons allow sovereign investors flexibility in managing near-term market and asset exposures, they nevertheless present sovereign wealth funds, as long-term investors, with equally pressing systemic risks. These are intractable and manifest over long periods: climate change, the low-carbon transition, the rapid and deleterious effects of pandemics, and social inequality. Finally, these risks have tangible operating and investment consequences. Importantly, many sovereign investors' scale and market breadth complicate their ability as so-called universal owners to simply "opt out" of assets and markets that are especially vulnerable to these risks.

For sovereign asset owners, stakeholder capitalism, with its attention to the requirements of all stakeholders, can help align the management of systemic risks with long-term value creation. Thus, the integration of an ESG lens into their investment decisions surfaced in multiple sessions of the meetings, variously in the context of resilience or sustainability. There were four recurrent themes:

- 1. Gaps in the availability of quality climate disclosure data;**
- 2. the relatively less attention paid to social risk factors;**
- 3. the need to assess environmental, social, and governance risks more holistically rather than as discretely siloed; and finally,**
- 4. governance informed by the role of asset owners in standard setting and regulatory oversight.**

The low-carbon transition drew particular attention as a consensus emerged that persistent data quality and consistency issues hampered informed decision-making across the investment lifecycle. Data shortcomings were seen as especially acute in private markets, where sovereign wealth funds own approximately 16% of private equity assets.¹ The higher concentration of ownership in private markets was acknowledged as offering greater opportunity for meaningful engagement with portfolio companies and managers to promote broader and more consistent climate disclosure. These extended to fostering cooperation between portfolio companies to address common challenges in the low-carbon transition. As David Crofts, Executive Director of Enterprise Risk Management at Mubadala, reflected: "It was encouraging to hear the common view that engagement with partners to promote improved disclosure and action was key to delivering more impact in the future."

¹ [Harmonising Climate Data for Private Markets Executive Brief, One Planet Sovereign Wealth Funds](#)



During the meetings, the IFSWF released a focused study on member experience and practice of integrating the so-called “S”, or social pillar, into investment decision processes. The study revealed that while the mandates of some sovereign wealth funds (sovereign development funds, for example) may be aligned with a national economic and social agenda, most have only recently begun to consider social factors as investment criteria. The study’s release was accompanied by frank and open discussions acknowledging the complications of integrating social factors into the investment process, including limitations imposed by context, data design and quality, and, more broadly, materiality. In the context of governance applied to environmental justice, they also highlighted a key takeaway: the importance of evaluating ESG criteria – and a wider concept of sustainability – in an integrated and holistic fashion.

Stepping back momentarily from the operational details afforded sovereign wealth funds brief self-reflection on the potential impacts of greenwashing and their role in standard setting and regulatory engagement. Has sovereign wealth funds’ sustainability performance improved vis-à-vis the past, the market, or some long-term, external target? Selecting a performance benchmark compatible with a fund’s discrete sustainability strategy was considered critical to aligning manager and stakeholder interests while advancing shareholder engagement. In this context, the idea of engagement by asset owners was extended to include the role of regulators and other third-party market participants.

Section 3: Development and Governance

Most new sovereign wealth funds, many of whom seek IFSWF membership, are sovereign development or strategic investment funds from developing economies. These funds have mandates to catalyse development by mobilising foreign capital for local investment. This dynamic cohort of sovereign investors was widely represented in Baku, including the host country's new investment holding company. Together they offered rich perspectives across a range of experiences and challenges, including mandates, capacity, engagement with the private sector, additionality, independence, and, not least, governance.

Sovereign development or strategic investment funds are primarily domestic investors whose mandates generally support national development objectives, such as diversification. They are also long-term investors, sometimes with multiple mandates that include mobilising strategic foreign investment or managing state assets to enhance their performance and possibly advance their privatisation.

For sovereign development funds, the goal of mobilising capital, which was central to the Baku meetings, implies a local fund will function as an “anchor partner” to derisk foreign capital and serve as a channel or conduit for foreign investment in national projects. Sovereign development funds can accomplish this by leveraging strategic national assets while narrowing institutional shortcomings and promoting conditions conducive to economic, social, and political stability.

The goal of managing and ultimately monetising state assets can be especially challenging where the state is the dominant shareholder and employer. Investors with such mandates must proceed carefully to avoid crowding out and suppressing an emerging private sector. Suppose a fund's mandate includes managing local state enterprises with the intent to privatise them. In that case, it must do so without prejudice to both private interests and the social fabric of the country. This strategy requires development or strategic funds to balance their investment approaches with managing the capacity constraints of the local private sector.

The performance of development or strategic funds thus necessarily extends beyond strictly financial returns to include contributions that drive additional benefit to the broader economy and civil society. In other words, they may manage a so-called “double-bottom line”, which often includes supporting a discrete agenda that aims to ensure that foreign capital deployed domestically is invested sustainably. As Papa Demba Diallo, the CEO of the FONSI, the sovereign fund of Senegal, remarked succinctly: “The role of the corporation is not to make profit, but to make impact. The role of profit is to make impacts last.”

Ultimately the success of development funds will rest on their ability to meet the key performance goals set for them by their owners. For many, this includes multiplying the impact of a limited base of local capital with that of foreign institutional investors, who see their local partner as a strong, professional counterparty that enjoys government support and whose legitimacy rests on strong governance and its capacity to make independent investment decisions.

As noted, in recent years, the expansion of IFSWF membership, and the rise in membership applications, have reflected the significant growth in development fund creation. The Santiago Principles, and the associated self-assessment process, offer development funds a robust governance framework to build partnerships with foreign capital to deliver on their mandates.

Looking forward to Madrid

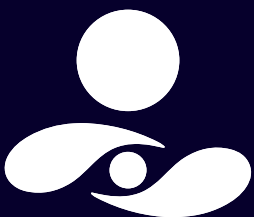
In 2023, the IFSWF will hold its annual meeting in Spain's vibrant capital, Madrid. There, members will be treated to sites, sounds and tastes as eclectic and steeped in world history as in Baku. The organising theme of the Madrid meeting has yet to be defined, but the rich conversations and professional dialogue of Baku will undoubtedly carry forward.

From our vantage point in the final days of 2022, the economic and geopolitical tensions that informed the Baku meeting show little sign of moderating. Notwithstanding, we can, with greater certainty, suggest that globalisation and the broader global political order have changed fundamentally. If the COVID-19 pandemic shares the blame for recent economic dislocations, deepening protectionism and restrictive "national security" policies will hinder, rather than facilitate, a return to robust global growth and an expansion of strong international trade and investment. Hope rests in the clear recognition that fracturing the global economy comes with costs few will be willing to bear.

In the wake of the proceedings in Baku, we can also say with confidence that the ESG movement has moved from being a niche strategy to being widely represented in the investment programmes of global asset owners and institutional managers. Despite growing criticism of and legislative threats to ESG investing, particularly in the United States, sustainable finance is integral to long-term, focused and inclusive capitalism. Consequently, it must continue to inform the investment decisions of investors who are obliged to manage the risks of universal portfolios with a long-term view. While so many – particularly new – funds invest with development mandates, all sovereign wealth funds invest with purpose, which challenges sovereign owners and managers to reconsider the question, "how do external changes affect our portfolio?" and instead resolve, "how does our portfolio drive change?"



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