Post-pandemic shift: Evidence from institutional-investor and sovereign wealth fund-activity
Introduction

Institutional investor behaviour and sovereign wealth fund activity proved remarkably resilient in the brief recession during the COVID-19 pandemic. Institutional investors had already started 2020 holding portfolio cash at their highest levels since the 2008-09 financial crisis. Sovereign wealth funds ended 2019 in risk-off mode, having deployed the least amount of capital into direct investments since 2015: only $35.9 billion – 17% less than the previous year. Having accumulated plenty of cash to weather the storm, institutional investors and sovereign wealth funds deployed some of this capital and reduced fixed income positions to add exposure to risk assets taking advantage of depressed prices before financial markets rebounded and institutional risk sentiment improved during the period up to March 2021.

Since then, State Street’s indicator of systemic risk for global equity markets – which captures the proportion of market returns explained by a fixed number of statistical factors through time – reveals that markets have become more robust with a broader set of factors influencing stock markets over the past year. Similarly, the State Street MediaStats Thematic Indicators – which capture the negative intensity of global news coverage pertaining to specified themes – reveal that while COVID-19 had been the most prominent media narrative over the preceding year, inflation and international conflict themes have become more important determinants of market performance over recent months, presenting new multi-faceted challenges for investors.

In this report, we uncover insights into how institutional investors and sovereign wealth funds implemented their capital flow and portfolio reallocation decisions over the past year as market conditions evolved, powered by State Street’s proprietary indicators of institutional investor flows and holdings derived from the anonymised and aggregated activity of institutional investors representing more than $43 trillion in assets1. This data is contextualised by input from members of the International Forum of Sovereign Wealth Funds (IFSWF).

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1 Source: State Street. As of December 31, 2021.
Research methodology

State Street analysed its dataset of unique indicators that capture aggregated and anonymised capital flows, portfolio positions and the 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 $43 trillion in assets under custody and administration at State Street.

To complement this data and provide more colour and context for the quantitative analysis, the IFSWF asked some of its largest members that deploy capital in global markets for some insights into their asset allocation strategies over the last year. These responses were provided with the promise of anonymity. These institutions came from Central Asia, East Asia, West Asia, Australasia, and North America.
New challenges on the horizon

As economies around the world emerged from the shadow cast by the COVID-19 pandemic, investors are faced with new risks. Today, risk assets are re-pricing due to international conflict, inflation, and central bank policy responses (Figure 1).

Figure 1: Media coverage intensity of COVID-19 and international conflicts

Global equity markets have become less concentrated since the outset of the pandemic. Having previously reached an all-time high during March 2020, State Street’s measure of systemic risk (i.e. fragility) for global equity markets has since declined and remained low over the past year, currently standing close to the lowest levels observed over the prior year. However, market turbulence has increased due to the conflict between Russia and Ukraine, reaching the highest levels since the start of the pandemic in March 2020 (Figure 2).
Meanwhile, inflationary pressures have spread across global markets, initially fuelled by supply-side disruptions induced by COVID-19 and more recently by higher food, commodity and oil prices from geopolitical uncertainty, compounded by decade-old accommodative monetary and fiscal policies, with no signs of inflationary pressures stalling in the short-to-medium term. The State Street PriceStats measures of online price inflation have shown a steady rise in prices globally since the start of the pandemic in March 2020 (Figure 3). Indeed, the United States, United Kingdom, Eurozone, and emerging markets are now observing record inflation pressures over the past decade, with some at multi-decade levels.

**Figure 3: Monthly global online price inflation**

A) Monthly global online price inflation

B) Annual global food, fuel online price inflation

Source: State Street Global Markets, PriceStats. This figure displays the increase in global online price inflation since 2020. As of 15 March 2022.
Institutional investor activity: Signs of caution

Following a period of opportunistic rebalancing and selective risk-taking during 2020, the past year has seen institutional investors moving toward assets and markets considered to be less risky. State Street’s Behavioural Risk Scorecard Multi-Asset Flow & Holdings scores (Figure 4) – an aggregate measure of risk appetite derived from the capital flows and holdings by institutional investors across multiple asset classes and factors – turned negative in early February 2022 and reached its lowest in two years. The risk aversion evidenced by institutional investors through their capital flow decisions has also become more broad-based, with evidence of risk-off behaviour manifesting across investors’ equity, fixed income, foreign exchange and asset allocation decisions over recent months.

Figure 4: Institutional capital flows and holdings across risk assets

Institutional investors’ asset allocation decisions suggest that they are no longer adding to their equity exposure – which they had been doing since Q1 2020 – and are instead adding to their fixed-income and cash balances. Among sovereign wealth funds, the sentiment was the same. “The portfolio continues to be positioned with a neutral risk setting and around the middle of the range we would normally expect,” said Raphael Arndt, CEO of Australia’s Future Fund on 1 February 2022. “However, we have taken some risk off, particularly in the listed equities programme, given the run-up in prices and our view is that risk is likely to be less well-rewarded in future,” he commented in the Future Fund’s December 2021 portfolio update.
The strong capital outflows from emerging markets – the largest level of selling observed over the previous five years – have been matched by robust demand for stocks in developed markets. Within sectors, institutional investors continue to show a strong preference for defensive sectors such as consumer staples and utilities, which is unsurprising as volatility has risen in response to military actions in Eastern Europe. However, cyclical flows have also started to recover recently. Energy, materials, discretionary and industrials are all seeing inflows, while the financial sector has observed strong capital outflows. That said, most sovereign wealth funds are taking the long view and sometimes a contrarian stance. For example, one IFSWF member increased its emerging-market equity positions as the value/price gap widened, as emerging-market equity was cheaper than it was six months ago relative to its fair value estimates.

Figure 5: Asset class weights of institutional investors

![Image of Asset class weights of institutional investors]

Source: State Street Global Markets. This figure displays portfolio holdings by institutional investors. As of 15 March 2022.

Figure 6: Equity market institutional capital flow

A) Developed- and Emerging-market

B) Cycicals, defensive and financial sector flows

![Image of Equity market institutional capital flow]

In fixed income, heightened geopolitical risk has seen capital outflows from emerging-market sovereign debt, while high-quality, developed-market sovereign bonds are maintaining stable capital inflows despite rising domestic inflationary pressures. Euro- and US-dollar-denominated corporate credit have also seen outflows, driven by a challenging combination of rising rates, high inflation and slower growth, tapering of quantitative easing from global central banks, and potential ripples from Russian sanctions. One beneficiary of the credit uncertainty and rising inflation pressures is the US Treasury Inflation-Protected Security (TIPS) market, where we have observed renewed appetite by institutional investors.

In foreign exchange, institutional investors have acted on currency sensitivity to developing international conflicts. Investors have replaced exposure to currencies with negative exposure to international conflict with currencies that have shown a more positive exposure to the theme, leading to outflows from currencies within close proximity to Russia and Ukraine, and inflows into currencies that are geographically more disconnected from the conflict (Figure 8). This pattern has the potential to continue, with investor positioning remaining close to neutral territory despite recent moves.
Private market participation remains active

Building on the strong interest in the previous year, 2021 is on course to set the highest private equity fundraising on record, according to State Street's Private Equity Index data. With data from the first three quarters of 2021 available, buyout and venture capital funds have surpassed the capital raising high-water marks of 2020, while fundraising in private debt has slowed in 2021 compared to 2020. Across regions, funds domiciled outside of the US and Europe continued their strong pace of fundraising, surpassing the amount raised in the whole of 2020 by more than 20% in the first three quarters. US funds are approaching the same amount raised in 2020, while European funds have maintained the same fundraising pace as they did the previous year.

Figure 9: Fundraising in private equity

Some sovereign funds noted an increased allocation to private markets for three reasons. First, they have long-term strategic asset allocation targets for private markets and are still building their private markets portfolio. Second, private markets can work as a diversifier in sovereign wealth funds’ portfolios due to idiosyncratic opportunities, various risk-return spectrums and asymmetric information. Third, some sovereign wealth funds are adding illiquidity premiums by allocating to private markets as they have long-term investment horizons.

In terms of cash flow activity, during 2021 net cash flow for global buyouts, venture capital and private debt strategies recovered rapidly towards their pre-Covid levels. The improving net cash flow trend was driven by increasing investment activities coupled with a higher level of cash flow distributed to investors. Both the quarterly Distribution over Committed Capital (DCC) and quarterly Paid-in Capital over Committed Capital (PICC) measures posted their highest levels observed since 2013, according to State Street’s private equity data. Indeed, several IFSWF members thought that there were more private equity firms on the road fundraising than there were those exiting their portfolio companies and returning cash to investors.
Conclusion: Institutional investors have adjusted positions to face new risks

A broader set of factors are now driving financial markets, which present institutional investors with new challenges and risks. International conflict and rising inflationary pressures now dominate the key market narratives against a backdrop of high global equity market turbulence but low systemic risk, with global equity market returns becoming driven by a wider set of factors. The evidence from institutional investors and the sovereign wealth fund community suggests that investors have responded to these new challenges. By rotating out of emerging-market to developed-market equities, shifting into defensive sectors, and reducing foreign exchange exposure to countries sensitive to international conflict, investors have adjusted their portfolio positions in response to the new challenges that lie ahead.
Contributors

About the International Forum of Sovereign Wealth Funds (IFSWF)

The International Forum of Sovereign Wealth Funds (IF) is a global network of sovereign wealth funds 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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