Pandemic, No Panic: Evidence from Institutional Investor flows
Sovereign wealth funds are often referred to as “rainy-day funds”, pools of cash that their government owners can draw upon in times of economic need. It is hard to imagine a rainier day or a greater economic need than the global recession emerging from the Covid-19 pandemic.

Capital markets’ expectations are that the states owning sovereign wealth funds will use these resources to finance the required fiscal stimulus to minimise permanent damage to their domestic economies. In the wake of the pandemic and the oil-price war between the Organisation of Petroleum Exporting Countries (OPEC) and Russia, which saw oil prices plunge to their lowest levels in over a decade, the spotlight has focused on oil-rich countries. Some international organisations have suggested that these sovereign wealth funds would need to offload liquid parts of their portfolios to compensate for lower royalty income on the one hand, and finance higher government spending requirements on the other. Headlines warned of an “asset fire sale”. In April, an official from the International Monetary Fund suggested that “sovereign wealth funds in the Middle East should be used to boost growth”, while the Institute of International Finance had already predicted that the assets managed by Arabian Gulf sovereign wealth funds could decline by $296 billion by the end of 2020, including $80 billion from drawdowns taken by cash-squeezed governments.

So far, so apocalyptic. But do these assertions have any hard data to back them up? To help understand how sovereign wealth funds and long-term institutional investors more generally were reacting to the financial and economic crisis precipitated by the Covid-19 pandemic, the International Forum of Sovereign Wealth Funds (IFSWF) joined forces with State Street, one of the world’s largest global custodians, servicing $32 trillion in assets under custody and administration representing approximately 15% of the world’s tradable assets.

1 Joe Marsh, “Oil-based Sovereign Funds Tipped For Asset Firesale”, Asian Investor, 24 March 2020
2 Davide Barbucia, “IMF Calls For Mideast Sovereign Wealth Funds To Boost Local Economies”, Reuters, 27 April 2020
4 As at 31 March 2020
Research

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 anonymised security-level transactions, holdings, and borrowings, and are aggregated and analysed through a robust process to help ensure the preservation of underlying client confidentiality, providing insights into demand and risk sentiment derived from the aggregated activities of long-term institutional investors.

To complement this data and provide more colour and context for the quantitative analysis, IFSWF surveyed a diverse sample of ten of its members from across the globe. These responses were provided on the promise of anonymity. We asked them whether they had made changes to their asset allocations during the crisis, if they had experienced drawdowns on their assets or been asked to contribute to local projects and the biggest challenges they were currently facing.
Findings

The first point to address, given recent media coverage, is the idea that governments, particularly from oil-rich countries, are drawing on their sovereign wealth funds to finance required public spending to support their economies during the current crisis. Our survey of IFSWF member institutions included both oil funds and those financed from other sources of surpluses. Of the 10 respondents, only two reported that their governments had sought funds. One was an oil fund, one a non-oil fund. Similarly, two respondents reported that they had been requested to support additional government projects since the beginning of the crisis. These responses do not suggest widespread sovereign wealth fund liquidations to support government spending. Indeed, rather than tapping their rainy-day funds, several governments from oil-rich nations from the Arabian Gulf to Kazakhstan have recently borrowed from the international bond markets to cover budget shortfalls.

Neither does State Street research using hard data and estimates reaching as far back as 2002 suggest that such pressures have shaped sovereign wealth funds’ asset allocation. These studies illustrated the longer-term evolution of asset allocation approaches and diversity between sovereign wealth funds. During downturns State Street observed selective risk taking and opportunistic portfolio rebalancing, but no wholesale change in strategic asset allocation. For sovereign wealth funds as a group, the trend has been unequivocal and greatly accelerated since 2008: a systematic expansion of the risk budget and increased exposure to illiquid investments with a longer-time horizon (Figure 1).

While media commentary tends to differentiate between sovereign wealth funds that face liquidity demands from their host sovereign and those unencumbered. However, over the longer-term, State Street data reveals that these differences are limited. For example, when we separate oil and non-oil sovereign wealth funds, the cash and fixed income shares of their total portfolios have largely been identical, hovering around 35% for both groups on average. Given that one would rightly presume that this would be the primary liquidity source in crisis period, we would expect a greater gap. Instead, we have systematically found greater differences between large and small funds, given that scale enables a wider choice of portfolio strategies. This is relevant when looking at broader institutional investor flow data during the Covid-19 crisis, which will be disproportionately shaped by larger investors.

Figure 1: SWF asset allocation evolution

<table>
<thead>
<tr>
<th>Year</th>
<th>Private Markets</th>
<th>Equities</th>
<th>Cash and Fixed Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>12.6%</td>
<td>37.4%</td>
<td>50.0%</td>
</tr>
<tr>
<td>2007</td>
<td>14.8%</td>
<td>39.7%</td>
<td>45.5%</td>
</tr>
<tr>
<td>2012</td>
<td>23.6%</td>
<td>42.0%</td>
<td>34.4%</td>
</tr>
<tr>
<td>2014</td>
<td>23.9%</td>
<td>38.5%</td>
<td>37.6%</td>
</tr>
<tr>
<td>2016</td>
<td>26.6%</td>
<td>39.5%</td>
<td>33.8%</td>
</tr>
<tr>
<td>2018</td>
<td>28.3%</td>
<td>38.5%</td>
<td>31.2%</td>
</tr>
</tbody>
</table>

Asset allocation dislocation: Signs of caution

Institutional investor positioning was not euphoric at the start of 2020, with defensive positions held across asset classes. 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 factors⁵ – reveals that institutional investors started the year underweight⁶ risky assets, particularly in sovereign debt, corporate bond and foreign exchange markets, while cash levels were at the highest levels observed since the global financial crisis (Figure 2).

The sovereign wealth funds surveyed confirmed this position. Several IFSWF members reported that they had already been expanding their liquidity position, overweight cash or underweight equities, in the months leading up to the crisis (from December to February) given high valuations for which it was unclear whether they were supported by earnings or accommodative monetary policy.

However, overall, there was no display of broad-based risk aversion amongst institutional investors. There remains a wide spread in the capital flows and holdings across asset classes (Figure 3), with selective risk taking within equities (e.g. emerging market stocks relative to developed market stocks) and fixed income (e.g. two-year Treasuries relative to 10-year Treasuries) more recently. The risk-off signs State Street observed in the first quarter of 2020 were also less broad based compared to previous crises, such as during the Global Financial Crisis, during which institutional investors displayed more persistent risk aversion in their capital flows across the majority of risk assets.

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⁶ Underweight (overweight) positions by aggregate institutional investors are defined when holdings are below (above) the 50th percentile.
Figure 3: A wide spread of behaviour

Source: State Street Global Markets. Data as at 22 April 2020. Flows are displayed as 5-year percentile ranks of 20-day flows. Holdings are displayed as a 5-year percentile ranks of excess holdings. *Contrarian indicator.
Sticking to the Strategy

According to State Street’s data, institutional investors did not engage in a panicked selling of equities, as they had done in 2008, but rather a more selective approach to risk reduction. In March and April 2020, there was evidence of some regional risk aversion and a general flight to safety towards the US relative to emerging markets and other developed markets (Figure 4A), in addition to inflows into defensive relative to cyclical sectors (Figure 4B). However, broad equity flows remained relatively strong throughout the first four months of 2020 with investors showing signs of rebalancing to maintain aggregate equity exposure despite the market crash and renewed appetite for equities in selective markets (e.g. emerging markets).

Figure 4: Equity flow trends during Covid-19 and the Global Financial Crisis (GFC)

Source: State Street Global Markets. Flows are displayed as 5-year percentile ranks of 20-day flows.

7 Inflows (outflows) are defined when net flows over the prior 20 days are ranked above (below) the 50th percentile.
The sovereign wealth funds surveyed by the IFSWF supported this conclusion, with most of them saying that they had been pursuing a disciplined strategy of selling fixed-income securities to purchase equities and maintain their allocation targets to that asset class. Sovereign wealth funds varied in how they executed this strategy, with some taking a systematic approach of setting specific trigger levels for entering certain equity markets as they rebalanced.

State Street data illustrates the execution of this strategy by institutional investors from the fixed-income perspective, which sold duration with large outflows observed in US Treasuries, high-yield and mortgage-backed securities. Fixed income investors have generally shown signs of liquidation with strong outflows across several sovereign debt markets (Figures 5A & 5B). As sovereign wealth funds and other institutions appear to have completed their rebalancing exercises, heavy fixed income redemptions look to be subsiding (e.g. Germany, France and Canada) and institutional investors have displayed some appetite for risk with inflows into emerging-market fixed income, emerging market foreign exchange and carry.

Figure 5: Fixed Income institutional flows

![Graph A) FI investors are still in liquidation mode](image)

Source: State Street Global Markets. Data through 22 April 2020. 5-year percentile ranks of 20-day flows and excess holdings.

The sovereign wealth funds surveyed noted that rebalancing had been a challenging exercise. One respondent noted a paucity of buyers for fixed-income securities as the fund tried to rebalance in March, remarking that for some high-yield-credit securities there was no bid. As a result, the fund split its rebalancing activity into two tranches, one in March and one in April.

Maintaining the institutional discipline of rebalancing, a lesson sovereign wealth funds have learned since the Global Financial Crisis, has made their stakeholders uncomfortable, particularly given the extreme market conditions of March and April 2020. Consequently, a major challenge for these institutions has been to ensure that their governing bodies understand that this is the right decision in the long term and will benefit performance in the future.
Private market participation remains active

Over the past five years or more, asset owners, including sovereign wealth funds, have been increasing their allocations to private equity, a trend that we have noted in the IFSWF annual review had picked up pace in 2018 and continued into 2019. The move towards unlisted assets has resulted in committed capital to private equity funds reaching an all-time high of $2.5 trillion in December 2019 according to Bain Capital. Fundraising also continued apace. In 2019 alone, investors poured $894 billion into private capital, including private equity, real estate, infrastructure and natural resources.

With more capital committed to private-markets managers, all the sovereign wealth funds surveyed that allocated to unlisted assets told us that one reason they had increased their cash positions was to satisfy capital calls from general partners. They also said that capital calls had continued throughout the turmoil of March and April. Some of those with substantial principal investment and co-investment programmes also noted that they had need to provide additional injections of working capital to some portfolio assets or underlying private-markets fund investments, a key to success in a downturn, according to recent State Street research. None of these institutions reported that this had been a challenge for them or that they were considering defaulting on their capital commitments, which had reportedly been a concern for some GPs.

These findings support recent research from EY, which suggests that with their war chest of committed capital and the experiences of the last financial crisis under their belt, many private equity firms and their co-investing limited partners are prepared to support their portfolio companies through the pandemic and to acquire high-quality assets at attractive valuations, even if these may be slow to adjust during a crisis.

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9 Bain and Company, Global Private Equity Report 2020

10 Josh Lerner, Ann Leamon, Samuel Holt, Private Equity in Troubled Times, State Street “In Practice” Series, April 2020


12 EY, Why Private Equity Can Endure The Next Economic Downturn, March 2020

13 Lerner et al, Private Equity in Troubled Times
**Signs of stabilisation**

Overall, the aggregated capital flows and holdings of institutional investors suggest they did not display widespread risk aversion, but rather selective risk taking and rebalancing flows. Despite significant market price corrections, institutional investors maintained their exposure to equities and have recently expressed greater appetite for risk, supported by a clear stabilisation in aggregate capital flows observed across asset classes (Figure 6).

**Figure 6: Flow signals turn positive**

This conclusion is borne out by the survey responses from IFSWF members. Few are being required to provide capital for their governments and many believe that they are suitably prepared for whatever might happen next in this uncertain environment. The surveyed funds reported that they have formulated countervailing measures to guard against major risks and minimise the impacts of market turbulence on their portfolios. As such, both the quantitative insights into the aggregated and anonymised institutional investor behaviour and qualitative research on sovereign wealth fund activity points to sovereign wealth funds and institutional investors more generally being resilient to current market conditions and maintaining strategic discipline even during severe market volatility and turmoil.
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 SWF activity, and raise the industry standard for best practice and governance.

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