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International Forum of Sovereign Wealth Funds

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Internal vs External Management: A False Dichotomy

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Introduction

Sovereign wealth funds and other institutional investors have been debating the merits of insourcing or outsourcing important investment decisions for the last decade. Despite a well-established trend towards insourcing over the past five years, according to the 2020 Invesco Global Sovereign Report, many state-owned investors and central banks are planning to increase their engagement with external managers across all asset classes over the next three years. This includes sovereign investors reversing previous moves towards insourcing, with some noting that the anticipated benefits had been harder to realise than expected, leaving them unable to justify an increase in associated costs, particularly in more complex asset classes such as real estate and private equity.

Against this backdrop, sovereign wealth funds are constantly asking questions about how best to harness the expertise of managers to complement their internal capabilities while ensuring that investment implementation is coordinated with their investment strategy, governance structures and corporate culture. In April 2021, the International Forum of Sovereign Wealth Funds (IFSWF) brought together Wendy Norris, Deputy CIO for Private Markets at Australia's Future Fund, Marcus Frampton, CIO at the Alaska Permanent Fund and Paul O'Brien, Trustee and member of the Investment Committee at the Wyoming Retirement System for a Chatham House Rule discussion on the challenges of making the right decisions of how and where to use external managers, particularly in private markets.

Many mid-sized sovereign wealth funds (those with assets of between $50 billion and $200 billion) have adopted a hybrid investment management model, using external managers for more complex or challenging tasks, such as deal origination and the day-to-day management of an asset, but retain a level of oversight of the process that enables them to ensure alignment of interests and strategy

Even those sovereign wealth funds with relatively extensive co-investment programmes in private markets do not normally source or structure direct investments but let the external manager do so.

For asset owners with limited resources in terms of staff, it makes sense to have the internal capability to choose the asset managers with which they work, even in those asset classes such as hedge funds, or private equity where gatekeepers and advisors can provide the function. Apart from the cost savings, this approach gives the asset owner more control and by keeping external managers close to the issues that the asset owner is trying to solve, it also maintains alignment.

Sovereign wealth funds that insource the management of their assets have to take a spectrum of decisions: from picking an objective, an asset allocation, risk budget, all the way through security selection. Even more importantly, they need to be careful not to create an internal clash of cultures. Yet these sovereign wealth funds also need to retain a capable investment team that can follow an external manager along the path of co-investing if, and when needed. These considerations are important both in public markets – when investment managers will be generating ideas and studying the best factors for the asset allocator – and in private markets – where portfolio managers will be selecting best in class private equity managers and selecting co-investment opportunities.

"Despite a well-established trend towards insourcing, many state-owned investors are planning to increase their engagement with external managers across all asset classes"

[1] Please see the full report on the Invesco website: https://www.invesco.com/igsams/en/home.html

Asset Classes & Co-Investments

Investing in Infrastructure

In private markets, some sovereign wealth funds use external managers to originate deals, even when they have some capability to do so. This approach keeps the investment team focused on managing the assets rather than sourcing and bidding for new deals. To do so, however, requires a close relationship with the asset manager and an internal team with the skills to make the investment decision on any transaction brought by the external managers. For example, sovereign wealth funds that have an infrastructure programme hold the shares directly and will be part of consortia with other strategic investors. When investing through infrastructure funds, if a sovereign wealth fund is one of the largest limited partners (LPs) in that fund it has greater influence over the general partner (GP). It is also important to make sure that the internal team is skilled enough to engage in due diligence in real-time and to make sure that the sovereign wealth fund's internal procedures and systems and investment committees are responsive to that transaction timetable when offered co-investments by the GP.

Private Equity and Venture Capital

It is more difficult to have such a deep level of interaction in private equity. Given the scale of sovereign wealth funds, they are always trying to balance how to make investments that are worth the time and energy and gain exposure to parts of the market that are harder to access at large scale. Some sovereign wealth funds have brought manager selection in-house starting from investing through fund of funds, at least for large buyouts. In venture capital, even sovereign wealth funds struggle, at times, to get access to top-quartile performing managers, consequently, the best way to access these investments can be a mix of funds of funds and direct allocations. Some sovereign wealth funds have a small handful of external managers with whom they have deep relationships with whom they co-invest as their portfolio companies grow from early-stage to growth.

Public Markets

Many mid-sized sovereign wealth funds insource much of their equity and fixed-income management. Over the past five years, it has become common for sovereign wealth funds to adopt a factor investing approach, using external managers in public markets. However, they often remain involved in actively selecting benchmarks and developing ideas with the external managers on better indices to improve outcomes and alignment with the mandate.

Co-investments

Sovereign wealth funds use a range of co-investments structures. The easiest, and least involved, is for them to access a syndicated deal after the sponsor has already finished the due diligence and is no longer competing with other bidders for the asset. In this arrangement, inexperienced LPs can start co-investing and are not thrown into the deep end; most of the private equity managers will work with the LPs on the syndicated co-investments almost like a fiduciary manager. Sovereign wealth funds can then interact with the sponsor before the transaction has been tied up on an exclusive basis.

As sovereign wealth funds gain in sophistication, they may choose to join their GPs earlier in the transaction process, taking part in the decision-making process rather than just accepting the syndicated deal. For example, it will receive the memos, the consultant reports and make other decisions alongside the GP. The next step in sophistication is co-underwriting. In this case, the size of the LP's cheque is a significant driver, as it must be a large enough proportion of the total deal equity to give the sovereign wealth fund a material interest in the asset. In this situation, the investment is considered more akin to a direct investment. Consequently, the sovereign wealth fund takes on greater responsibility in the deal, with the sponsor looking to it for input, on issues such as pricing.

The final step is when a sovereign fund or other asset owner leads a transaction: the big leap. Many sovereign wealth funds are getting to this point, but most are not quite there yet as they lack experience and depth of staff. Moreover, sovereign wealth funds usually have a different culture from private equity managers, not only in terms of commitment but also remuneration. As a result, leading a transaction may not always be either possible or desirable for sovereign wealth funds seeking to align their people's interests across the organisation. However, while most sovereign wealth funds are not at the stage of regularly acting in a lead role on direct private market transactions, several of the larger SWFs do pursue these opportunities quite successfully.

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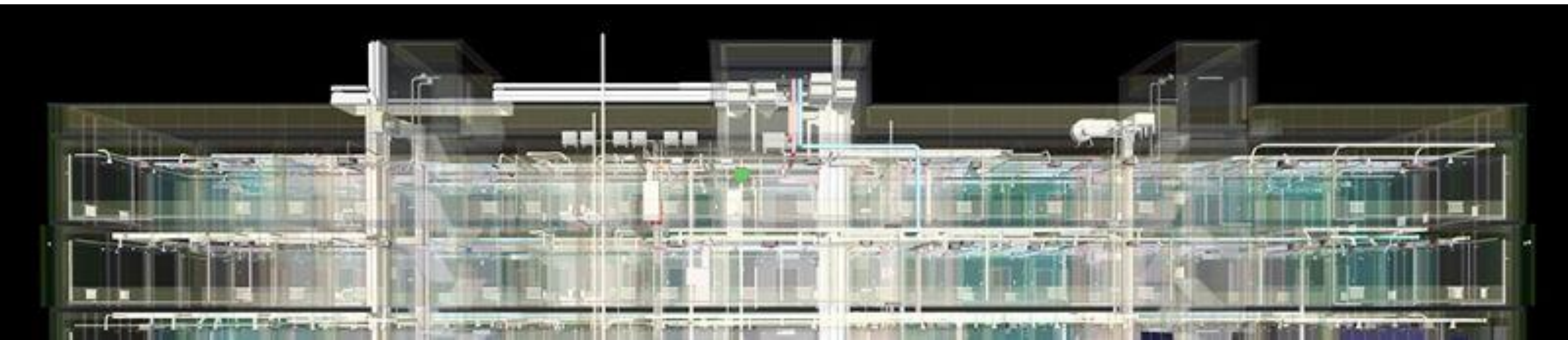

Working Together Successfully

It is not only about the fees

For sovereign wealth funds, co-investing is not only about saving money on fees, but also about gaining control of the investment process, particularly in infrastructure or in real estate where the investor has direct control over the shares. It is also beneficial from a portfolio construction point of view, as the asset owner can decide which assets match its risk profile and diversification needs.

Sovereign wealth funds can take on the majority of the risk management, capability and portfolio construction benefits of internal management by co-investing with partners, but without the need to be the leading investor in consortia bidding on assets. That said, in some asset classes, such as infrastructure, the Canadian model of direct investing and managing the asset directly rather than via a GP may be beneficial. This is because that the sovereign wealth funds could keep the asset for 50 to 60 years rather than the seven or eight normally mandated when investing with a GP.

Culture across teams is important

Many sovereign wealth funds find it beneficial to create a culture across the whole investment team in terms of remuneration and incentives. However, it is difficult to keep the balance between the skill sets that it takes to be really successful when investing in an individual asset class and the whole portfolio outcome. Consequently, some sovereign wealth funds have decided not to hire a big team of direct private equity executives as it would not only be competing with GPs, but could also create a fragmentation of objectives, as the sovereign fund would have to match (or better) private-equity compensation. Instead, sovereign wealth funds often prefer to hire professionals that are skilled enough to engage with the GP in a sophisticated manner, but not so far as they would be wishing that they were on the other side of the fence. This process also helps the fund to build a cadre of experienced professionals to serve in other institutions, both public and private.

What can external managers improve?

Not everything is perfect in the relationship with external managers. For example, in real estate, sovereign wealth funds can struggle to keep incentives aligned between them and their manager, although some asset owners use a separate account manager to address some of the challenges of this relationship, such as fees and short duration. As a result, some sovereign wealth funds manage the properties internally, particularly when the asset is a core property with one tenant as it is relatively straightforward to manage it, even with just one member of staff overlooking the assets.

On the other hand, several sovereign wealth funds are frustrated by private equity continuation funds, when a private equity fund will hold an asset and at the end of the fund life will sell to a continuation vehicle, as they would rather see a clear exit to the initial investment, with a true market valuation. There could be a conflict of interest between the GP eager to pass the hurdle rate to get carry interest and the LP on the valuation of the continuation portfolio.

> ***"Some sovereign wealth funds have decided not to hire a team of direct private equity executives. Instead, they often prefer to hire professionals that are skilled enough to engage with the GP, but not wish they were on the other side of the fence."***

Enabling Collaboration

Tech is important

Another organisational challenge when moving from an outsourcing model to a hybrid model is the need to have a holistic approach to accounting and performance systems. Investors now require greater transparency from their managers. Ten years ago, most LPs would have been happy with a one-page statement from their GP, they now need to see the performance of the individual investments within the fund, know how much of their lines of credit at the fund level have been used, and they want to know how the internal rate of return is calculated on a transaction level. However, data management and risk platforms are still catching up. In terms of portfolio management software, one chief investment officer described a leading technology solution as “getting a dial on the public side and then the private side is a bit of a blind spot.” Even though there is good private markets software available it is difficult to supply good data, as you generally start with different data types.

These systems are often expensive to purchase, but investors also need to employ people to enter and interpret the data, which adds to costs. Although there are many new AI technologies, many still rely on human data entry and personnel manually scraping data from PDFs and inputting it into the software. Sovereign wealth funds have to consider that in a hybrid or a completely insourced model, data is at the very core of the system and this is perhaps the most difficult part, often overlooked by new entrants.

Governance

Regarding the difficult topic of governance investing in private markets, there can be a conflict between the need for speed when co-investing and the need for oversight from a proper investment committee board, which may meet monthly. It is important that trustees, or board members, know when and how they are delegating investment decisions to staff as opposed to running them through a committee or the board. This is true even in public markets. For example, if an investor has an internal fixed income programme and some internal equity programmes it needs to know how to track its risk limits and then the portfolio managers have almost full discretion and they will be accountable for their performance against the benchmark.

Regarding co-investments in private markets, it is important to ensure that the sovereign fund has enough responsiveness in the overall operation not to miss a deadline as private equity firms and other co-investors will not make allowances for slow governance processes. Consequently, sovereign wealth funds that are more involved in deal-making need to develop processes that are nimble enough to meet both the speed and oversight requirements. One sovereign fund mentioned that their asset review committee might make three times in one month and then it might not meet for longer, it just depends on what's happening in the transaction universe.

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Looking Forward

The next ten years

Looking at the challenges for the next ten years, most market observers believe that prospective returns on most asset classes likely will be lower and market risk and volatility may be higher than the past ten years. Consequently, some sovereign wealth funds will need to simplify their businesses and return to becoming owners of good investments rather than juggling many different managers and many different asset classes. At the same time, those sovereign funds with scale may need to assess the Canadian model and try to insource more direct investments in private markets.

Conclusion

The choice between internal and external management is a false dichotomy: There is a spectrum of intermediate points that better match a sovereign wealth fund's goals and capabilities. Many government investors are engaging more deeply with asset managers, treating them as partners. Perhaps this is a result of some sovereign investors reversing previous moves towards insourcing, but it is also the case of more mid-sized sovereign wealth funds finding a good balance with the hybrid model.

A more engaged approach with external managers still provides sovereign wealth funds with all internal management's benefits of better risk management, capability and portfolio construction by co-investing with partners, but without the need to be the lead investor. That said, in some asset classes, such as infrastructure, the Canadian model of direct investing and managing the asset directly rather than via a GP may be beneficial, if those sovereign funds with adequate resources can manage the conflicts and cultural issues arising from a deal-making team and the other investment teams.

As many investors progress along the path of the hybrid model, technology and up-to-date systems become ever-more important. Management and performance monitoring systems can be expensive to purchase and maintain, as investors need to employ people to set the systems and interpret the data. In a hybrid model, data is central to monitoring the performance of investments and they must understand how to harness its power.

In short, the relationships between sovereign wealth funds and their managers remains central. However, over time, it will become closer as sovereign wealth funds continue to expand their investment universe and embrace new strategies to generate returns in the low-interest-rate environment.

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