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Sovereign Wealth Funds: Investing in Transition

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COFIDES, the host of the 2023 IFSWF annual meeting, has commissioned this concept note to outline the key themes that shape the environment in which sovereign wealth funds operate and will be discussed at the meeting. The paper also incorporates a set of questions to stimulate interaction and debate.

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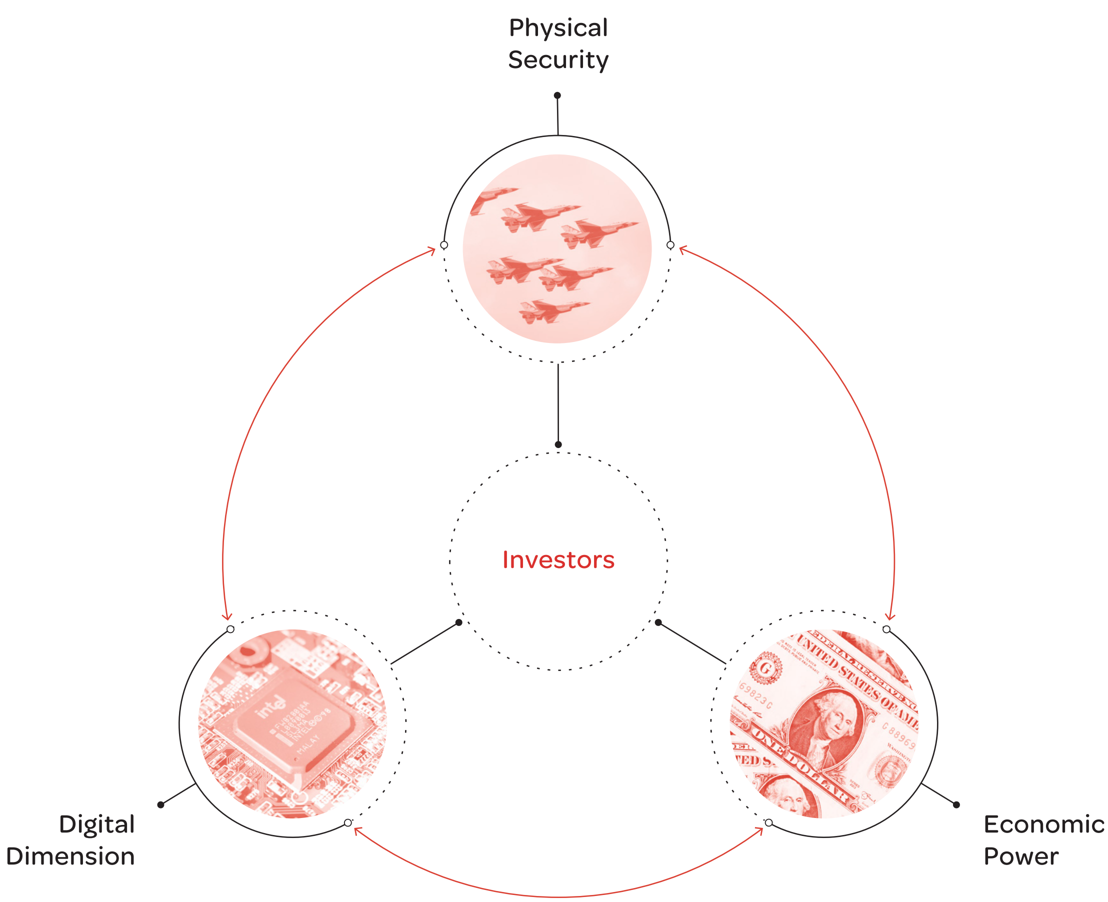
1. Overview

After years of increasing globalisation, international trade, and a benign borrowing environment, investors face an increasingly complex and uncertain investment environment. Geopolitics has become more strained, the post-pandemic inflation spike no longer seems transitory, and the monetary policy response has increased interest rates across the globe.

In this **multidimensional world, investors can consider three different themes. The first dimension is physical security**, in which the United States remains dominant. According to the Stockholm International Peace Research Institute (SIPRI), the U.S. defence spending in 2022 comprised nearly 40% of global military expenditures and even outspends the next ten countries combined. Of course, it can be debated whether modern hybrid threats and defence systems should be considered, but more on this will follow.

The second dimension is economics. Many states share global economic power. The United States economy remains the world's largest, but economic multipolarity and interdependence between countries, regions and blocs is evident. Indeed, economic ties are difficult to break. During times of weak diplomatic relations between the world's two largest economic powers, the US and China, trade between them reached a new high: goods worth almost $700 billion were traded. **While political and diplomatic avenues may experience obstacles, trade in commodities, goods and services still flows.**



Finally, the digital dimension. This third dimension is **not run by governments but by large technology companies.** Through social media, disinformation and conspiracy theories jump from the digital realm to the real world, as seen in the Capitol and Brasilia assaults. The powerful algorithms that can shape the behaviour of millions of world citizens can bring climate, productivity and health improvements, but the same technology may compromise social and political norms. Add artificial intelligence able to perform both basic and complex tasks more efficiently than humans, and you have the answer[1].

Given this new reality, it is important for SWFs to recalibrate their strategies to adapt to these multilayered changes, ensuring their goals remain achievable and aligned with this shifting global paradigm. Identifying and assessing these structural risks and opportunities appears today more relevant than ever.

Thus, in this context, what long-term investors, owned or controlled by governments, fulfilling different missions can do? What to expect from sovereign wealth funds? Let us take a step back and describe the heterogeneity of the SWF industry.

Topics for debate

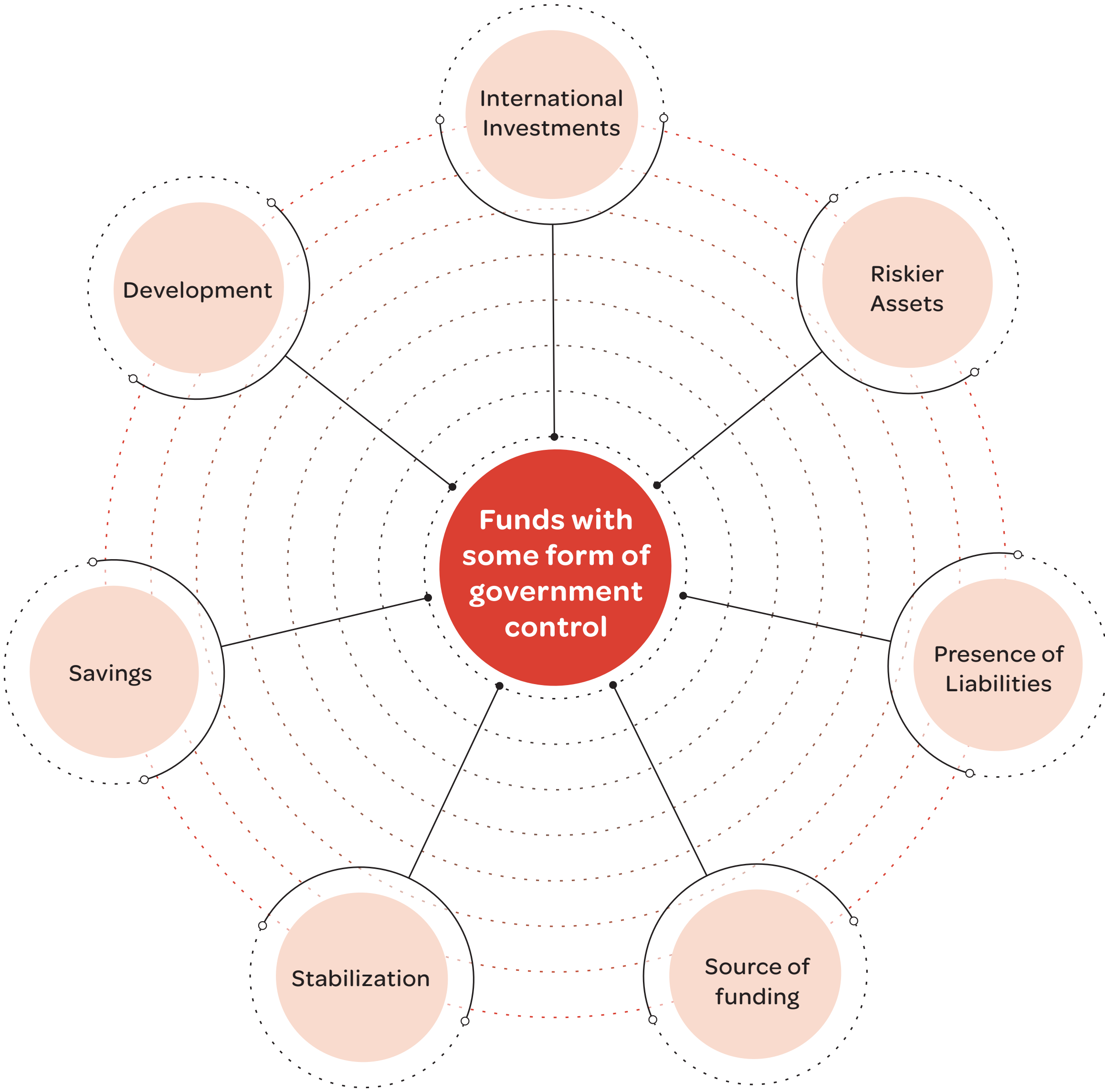
- **How are SWFs adapting their strategies to the current global outlook?**
- **What are the new priorities that SWFs are identifying for their investment strategies?**
- **Given SWFs' varied missions and structures, how can a unified or harmonised approach be developed?**

2. SWF Heterogeneity: Mandates and strategies

Sovereign wealth funds have many definitions. A study run ten years ago was explicitly devoted to analysing the different definitions of sovereign wealth funds (Capapé and Guerrero, 2013). That study concluded that the concept can be explained as an onion. With its multiple layers, only a few of them constitute the concept core: sovereign wealth funds are investment funds with some form of government ownership. The rest of the layers reflect additional elements: international investments, stakes in riskier asset classes (beyond fixed income and cash), liabilities, or how the particular funding source frames investment decisions. Fast forward ten years and 15 years after the signing of the Santiago Principles in October 2008, and sovereign wealth funds have been able to adopt most of these elements. For example, the first definitions of SWFs excluded those whose mandate is to foster the local economy. Now, the nine newest members of the IFSWF focus on domestic economic development: funds from Armenia, Djibouti, Dubai, Egypt, Ethiopia, Gabon, Indonesia, Malta and Mauritius.

Sovereign wealth funds are diverse institutions, and while some still represent what is in the mind of the general public when defining a SWF (commodity-based SWFs with a long-term and international savings mission), the cohort of the new funds admitted to membership at the IFSWF demonstrate the growing relevance of strategic SWFs. **Strategic SWFs explicitly link their portfolio decisions to the strategic national economic priorities.**

1. Of course, along with risks, there are multiple opportunities stemming from the AI revolution, as manifested by the AI-backed venture capital fever of Q1 2023 (most notably OpenAI, behind ChatGPT, the fastest adopted technology ever, which received a $10bn mega-round led by Microsoft).



We can distinguish three high-level sovereign wealth fund mandates: stabilisation, savings, and development. The first group comprises funds that showcase short-term investment strategies, address near-term fiscal requirements, maintain liquidity, and thus are invested largely in fixed-income markets. Saving and pension-reserve funds tend to have a longer-term strategy focused on preserving and transferring national wealth across generations. They can expand allocations to private securities, direct investments and co-investments. Lastly, the strategic investment funds present a mid-to-long-term investment strategy designed to complement national economic development and a clear focus on strategic sectors such as infrastructure, energy and urbanisation. Strategic funds invest heavily in domestic privately-owned companies and projects, support state-owned enterprises leading their sectors or promote efficiency gains that may lead to structured privatisation plans. The mandate is to promote the creation of efficient markets, the attraction of foreign capital, secure jobs, and the enhancement of strategic economic sectors.

Topics for debate

Do you perceive that this classification by mission is still fully applicable, or do you perceive that any new mission might be emerging in the current dynamic context?

What is the role of strategic investment funds in promoting efficient markets, attracting foreign capital, and enhancing strategic economic sectors?

Fifteen years after the Santiago Principles, how do SWFs reconcile financial and economic motivations when investing?

3. What do SWFs have in common? The global challenges and risks

All SWFs, regardless of type, size, age, or source of capital, are implicitly geared towards supporting national economic development (Dixon, Schena, and Capape, 2022). Even those SWFs classified as long-term savings fulfil this wider mission. For instance, the Abu Dhabi Investment Authority, which holds a globally diversified portfolio, has a clear mission "to sustain the long-term prosperity of Abu Dhabi," and its main objective is "to advance the UAE and its citizens." Singapore's GIC also has a similar mission statement, "We are driven by a common purpose – securing Singapore's financial future", as does Australia's Future Fund ("Our purpose is to invest for the benefit of future generations of Australians") or the Kuwait Investment Authority, "enable Kuwait's future generations to face the uncertainties ahead with greater confidence". Supporting the long-run development of the national economy is also included in the mission of stabilisation funds. For instance, Latin American SWFs in Chile, Peru and Colombia have symbolised a prudent macroeconomic management approach and have been instrumental in improving their states' credit ratings and thus reducing the costs of public debt, providing a buffer for extraordinary fiscal efforts in difficult times (like in the pandemic).

Thus, **a common goal across SWF categories is to enhance economic development or domestic economic prosperity**. More SWFs today are taking on a development mandate. However, they need to balance the specific goals of the fund while avoiding overlaps and redundancies in the domestic economy. The original philosophy of the Ireland Strategic Investment Fund on what should be defined as economic impact can serve as the basis for other geographies, a measurable set of criteria to define investment goals, promote economic growth, avoid displacement, and eradicate deadweight losses[2].

Academics are growing concerned about the role larger and influential SWFs can play at home. Past research has shown that the more politicians populate SWFs governing and/or managing echelons, the higher the risks

2. ISIF. 2022. Irish Strategic Investment Fund Self-assessment. IFSWF website. Available at https://www.ifswf.org/assessment/isifs-2022-self-assessment-2022

of inefficient investments (Bernstein, Lerner, Scholar, 2013). Recent history has given us examples of sovereign wealth funds that have suffered a total or partial collapse due to political interference. Yet, the current global landscape marked by decoupling and bloc formation elevates the significance of government roles in securing global value chain access, establishing strategic alliances, and defending against unwanted interference. In this light, strengthening governance structures and alignment with international corporate governance practices gain prominence as mechanisms to mitigate such risks. **The Santiago Principles can be of most use today, given the potential conflicts of interest that arise from the strategic (beyond financial) goals of SWFs.**

Topics for debate

In which way collaboration between SWFs can help them, in your view, to achieve shared goals and face common challenges?

How have you progressed in "educating your stakeholders" about SWF roles, risks, time horizons, and opportunities, especially in the current global landscape?

How can SWF strengthen their governance structures to preserve the most suitable environment for efficient investment decisions? Which measures has your institution adopted or is in the process of adopting that could be, in your opinion, identified as best practices and eventually replicated by other SWFs?

4. Technology and Geopolitics and the New Multidimensional World

Endogenous changes on the technology front are extremely deep. The artificial intelligence revolution is more profound, than the human use of fire or electricity, in words of Sundar Pichai, CEO of Alphabet/Googlee[3]. But **sovereign wealth funds have long understood the relevance of technology. Since 2015, it has been one of the most preferred sectors across funds and geographies.** SWFs have established investment teams, deployed talent close to the best technological hubs, and trained capabilities to approach technology companies directly. Of course, the tech sector can be risky, prone to disruption and fierce competition. Sovereign wealth funds face challenges from a more uncertain and complex investment environment. How economic blocs, international sanctions, and export controls will evolve is of central importance for long-term investors. The complexity of the new network of relationships that incentivises trade and investment in certain industries but discourages it in others offers a complicated picture for long-run managers. Concepts such as near- or friend-shoring are growing as a way of de-risking global value chains. Geography is back after decades of a flat and liquid "world without borders".

Many governments, not only traditionally state-led economies like China, follow an industrial policy approach today. They are financing major schemes. This approach can be a double-edged sword for sovereign wealth funds. This industrial push needs long-term private and patient capital, providing new investment opportunities. Yet, security considerations are leading

3. Fortune, April 2023. "Sundar Pichai: AI is more profound than fire and electricity", available at https://fortune.com/2023/04/17/sundar-pichai-a-i-more-profound-than-fire-electricity/

more governments across the globe to tighten merger control and foreign investment review criteria, which adds a layer of complexity for international investors like SWFs. Moreover, sovereign wealth funds may be included in the screening criteria as government-linked institutions when political and diplomatic tensions between two countries grow. Lastly, strategic SWFs aligning their investment goals with national economic plans will need effective corporate governance structures and leadership as the state coordinates more economic dimensions. In fact, the reliability of its corporate governance allows SWFs to attract international capital (Barbary, Dixon and Schena, 2023). Thus, strategic sovereign wealth funds must carefully define their relationship with their state sponsors ("be relevant but not erratic") to successfully mobilise domestic, regional, international and private capital to achieve its pretended development and prosperity goals.

Topics for debate

Which of the multiple shocks that have affected or are affecting the world economy has impacted your institution's activity more significantly? What did you do?

In which way are SWFs positioned with regard to the increasingly active approach of Governments to promote strategic sectors?

How can SWFs navigate the increasingly complex geopolitical landscape marked by blocs, sanctions, and export controls?

5. Monetary policies: inflation and high interest rates

According to the IMF, global economic growth is likely to decline in 2023 to 3% from 3.5% in 2022. Inflation appears to have peaked at 8.9% globally in 2022, the highest since the 1995 record of 12.6%, but is likely to remain higher than investors had become used to since the global financial crisis of 2007-2008.

Sovereign wealth funds have adapted their investment strategies to deal with this new investment environment. Valuations in asset classes that sovereign wealth funds have traditionally used to drive above-market returns, such as **real estate and unlisted assets, suffered due to rising interest rates and their effect on discounted cash flows.** Simultaneously, **the fixed-income market has regained allure**, with one-year risk-free investments yielding above 5% in certain mature markets.

Local allocation presents a viable option during global economic difficulties, especially if the local economy benefits from favourable conditions. Among G-20 countries, Saudi Arabia recorded the highest annual growth in 2022 (8.7%), followed by India (6.7%), Turkey (5.6%) and Indonesia (5.3%). All of them established strategic domestic SWFs in recent times. Conversely, sovereign wealth funds that only allocate to global markets have "nowhere to hide in times of trouble," in the words of NBIM CEO Nicolai Tangen.

Amid global economic instability, two key investment trends stood out in 2022: a resurgence in real estate and a technology boom. Despite pressure from rising interest rates, real estate attracted significant global investment. Its inflation-linked leases offered a degree of protection, marking it as a strategic long-term investment choice for SWFs. Between January 2022 and March 2023, SWFs funnelled $21.3 billion into real estate, nearly tripling their investment volume compared to the October 2020-December 2021 period.

Meanwhile, the technology sector -particularly, innovative technology and green initiatives- also drew SWF investments. With solid fundamentals underpinning their value, these assets could help decouple financial results from global volatility. The Qatar Investment Authority's CEO, Mansoor Ebrahim Al-Mahmoud, acknowledged inflation as the main topic for the global economy at the World Economic Forum in Davos this year but also mentioned it was an opportunity to reposition QIA's portfolio, noting that there are great opportunities to increase the fund's exposure in the technology market, venture capital, and financial institutions.

Topics for debate

To what extent do you consider that short-term increased volatility in global markets will influence SWFs' investment strategies in the medium and long term?

How does the high inflation-high-interest-rate era affect SWFs' investment decisions and portfolio allocations? What can SWFs do to adapt to this?

Is the current shift towards real estate, technology, and fixed income the right approach in this economic environment, or should SWFs consider other avenues?

6. Managing a transition

A new energy landscape

The global energy landscape is undergoing a significant transformation, driven by the urgent need to transition to cleaner, more sustainable sources of power. Investment in clean energy has steadily increased over the past decade, surpassing fossil fuels for the first time in 2019. The last International Renewable Energy Agency's (IRENA) outlook report underscores the urgency of this transition. It calls for a tripling of annual renewable power additions to 1,000 GW by 2030 to keep the 1.5°C climate target within reach. The report emphasises the need for increased global ambition in renewables deployment, supported by physical infrastructure, policy, and regulations, and highlights the importance of institutional and workforce capabilities. Despite some progress, particularly in the power sector with record additions in global renewable capacity of 300 GW in 2022, the gap between what has been achieved and what is required continues to grow.

SWFs play a key role in this transition, directing capital towards green technologies. Sovereign wealth funds' investment focus has expanded beyond green energy generation resources such as solar, wind, and green/blue hydrogen to include networks and grids, energy storage and management, carbon capture and storage, and manufacturing supply chains. This broader perspective also includes sectors such as electric vehicles, agriculture, sustainability, and recycling, reflecting a more comprehensive approach to the energy transition.

Moreover, SWFs are actively reducing their investments in conventional oil-related industries and are redirecting capital into green technologies. From January 2022 to March 2023, all investments in the energy sector were associated with renewables, with no investments linked to oil and gas[4]. This shift in investment strategy indicates a broader trend towards sustainable energy sources. However, this trend also highlights a new challenge: the influx of capital into renewables has led to increased competition. This implies that SWFs must exhibit increased selectivity due to a narrowing pool of investment options, necessitating a more strategic approach to investment in the renewable sector.

New geographies: The Global South

The three dimensions we used as the theoretical background -defence, economy, and technology- are forging new relationships. But the energy component of the economic layer is accelerating the most. According to the International Energy Agency[5], **if the world reaches net zero by 2050, the growth in demand for selected minerals will generate new tensions.** Lithium demand is expected to grow 40% from the 2020 levels, graphite 25%, cobalt 21%, nickel 18% and rare earths 7%. Besides nickel, whose production is more diversified (led by Indonesia, the Philippines, Russia, and New Caledonia), global production of the rest of these critical minerals belongs to concentrated markets. China leads in two of them: graphite (65%) and rare earths (63%), whereas cobalt production is dominated by the Democratic Republic of the Congo (67%), and lithium is largely dominated by Australia (80%). This may soon reset economic and trade maps, but as of today, coal revenue alone is 10 times larger than the revenue originated by the energy transition minerals combined. **The Global South, with countries like Brazil, Chile, Peru, Morocco, and South Africa, will be part of the new energy superpowers, along with China.**

Sovereign wealth funds may increasingly look to invest in these economies, establishing new vehicles to provide patient capital, play a catalytic or de-risking role, or attract foreign direct investment into these economic future core regions. **Smart long-term financial commitments will be necessary, and SWFs are well suited to occupy that space, easing the inherent risk of immature technologies.** Existing development institutions could play a more active role on this front, too, either transitioning toward an SWF operational framework or co-investing with regional and international long-term investors willing to share the risk and opportunity. Helping countries move upwards on the value-chain ladder is considered at the heart of the strategic SWFs' mission and is of paramount relevance for developing natural-abundant economies. **Latin America and Southeast Asia are good candidate regions to test such a model.** They could be regions that adapt the investment mission, culture and governance structures of existing development agencies and SWFs to collaborate and co-invest in developing those opportunities. A similar trend can be identified in the capital-intensive reconfiguration of global value chains or in the opportunities brought by digitalisation.

A digital revolution

SWFs continue to occupy a significant position in the global landscape despite the market slowdown in 2022 and 2023. During this period, venture capital (VC) activities cooled, with levelled-off deal counts, slowed exits and fundraising, and declining late-stage valuations. Private equity fundraising is also slowing and is on track to fall almost 35% this year compared to 2022. Market volatility has left the sector labouring to raise funds, as investors are already overexposed. Although demand from long-term investors remains strong, there is a lack of investable opportunities, again one of the key roles of strategic SWFs.

However, **the long-term perspective of sovereign wealth funds sets them apart from other institutional investors who have demonstrated caution amid these uncertain market conditions.** SWFs, committed to innovation, sustainability, and returns, remain among the few entities capable of providing stable financing, especially in turbulent market conditions. Their role is crucial in reducing the perceived risk of emerging technologies.

A sector that illustrates this impact is fintech. The sector has been resilient despite broader market conditions, with share prices of newly public entities outpacing the broader market recovery. Several sub-sectors, including

4. IE University and ICEX. *Forthcoming*. 2023 Sovereign Wealth Funds Report. Madrid: IE Center for the Governance of Change. Available at https://www.ie.edu/cgc/research/sovereign-wealth-research/

5. IEA. 2021. The Role of Critical Minerals in Clean Energy Transitions. Paris: IEA. Available at https://www.iea.org/reports/the-role-of-critical-minerals-in-clean-energy-transitions

neobanks, insurtech, proptech, and high-growth payment companies, also show a shift in priorities from growth to profitability. The increased mergers and acquisition activities and the positive EBITDA growth forecasts for 2023 and 2024, particularly for neobanks, brokerages, and even certain crypto businesses, attest to this.

SWFs have consistently invested in information technology, with the sector accounting for 22% of all SWF transactions, totalling $21 billion in 2022. These investments, particularly in regional e-commerce leaders, reflect long-term shifts in global consumer behaviour. Also, new forms of communications, cybersecurity, the Internet of Things and big data remain critical technologies for which long-term investors are well suited.

Healthcare and biotech in a post-pandemic World

Despite the healthcare industry's reputation for counter-cyclicality, the healthcare market has exhibited inconsistent performance in recent years. Data from Pitchbook indicates stocks in medical devices and consumer health sectors aligned with the general market. Conversely, life sciences and diagnostics sectors lagged behind after pandemic-related boosts. The exception to this trend was the hospitals, rehabilitation, and long-term care segment, which thrived despite rising labour costs in 2022. The divergence in stock returns suggests a recalibration of market expectations following the pandemic, with sectors that experienced windfall gains during the pandemic now facing a correction. The medtech sector is expected to face a challenging year in 2023. **Despite the challenges, the healthcare sector continues to offer significant investment opportunities**, driven by the ongoing demand for healthcare services and the increasing role of technology in healthcare delivery. The pandemic has changed how the world looks at healthcare markets.

Sovereign wealth funds demonstrated noteworthy involvement in healthcare investments, especially during the COVID-19 pandemic. Between October 2020 and December 2021, SWFs took part in 83 transactions worth $11 billion. Even in the post-pandemic phase, from January 2022 to March 2023, healthcare was the second most active sector (after technology), and SWFs engaged in 56 transactions, an additional $9.8 billion. Most of these investments targeted the US, the UK, and India, collectively receiving 80% of the funds. This pattern affirms the strategic importance of healthcare to SWFs and its integral role in developed and developing economies.

Private-sector involvement in health systems, particularly that of private equity, generates a debate between the benefits of filling gaps in public health systems and the reputational costs of privatisation processes. Health systems globally face growing pressures both in developed economies and in low-income societies that by prospering will demand better, tech-based and personalised medicine solutions. Private capital and sovereign investors could play a key role in both cases.

Almost every country (both developed and developing) will need to face the same debates in light of the pervasive effects of ageing populations. According to the UN data, in 2050, 80% of older people will be living in low- and middle-income countries. Between 2015 and 2050, the proportion of the world's population over 60 will nearly double from 12% to 22%. These structural shifts come with opportunities. **IMF data highlights an expanding elderly demographic as a unique investment opportunity.** This rise in the elderly population increases demand in sectors such as long-term care but also has impacts in new business models, including travelling, banking, or real estate. Recognising this trend, sophisticated SWFs have been tapping into these profitable investment opportunities in the space for a long time now.

Simultaneously, biotechnology plays a crucial role in addressing the challenges of an ageing society or its ability to fight new diseases, including the growing antimicrobial resistance, which WHO declares as one of the top 10 global public health threats. AI-backed and big data-nurtured biotechnology research will reveal opportunities by exploring new diagnostics, treatments, and drug developments. SWFs could enhance the quality of life for our ageing societies while securing substantial returns.

In conclusion, despite its diverse performance patterns and sector-specific challenges, the healthcare market offers a spectrum of investment opportunities. With a keen eye for strategy, SWFs can navigate this complex landscape and leverage opportunities in sectors driven by demographic shifts and technological advancements. Concurrently, the role of the private sector, including private equity, remains pivotal. Despite criticism, their role is likely to expand, given the limitations of public health services and the need to address system inefficiencies.

Topics for debate

In which way do you perceive that the energy transition and the increasing demand for new raw materials are already leading or might lead to a transformation of SWFs' investment portfolios? Which are, in your view, the main challenges in this regard?

How should Global South economies approach the establishment of a new SWF based on the critical minerals needed for the energy transition?

How are SWFs positioning new healthcare investments in the post-COVID era? In which way have SWFs' medium and long-term investment strategies been adapted in response to the pandemic? When defining your long-term geographic and strategic asset allocation, do you consider other health megatrends?

How are SWF responding to the increasing relevance of artificial intelligence? Do SWFs target specific AI goals for their organizations? How are SWFs trying to capture the benefits of the AI revolution? What is AI's main downside or risk in the eyes of SWFs?

7. The role of SWFs in global finance: De-risking, risk sharing and institutional and financial cooperation

De-risking is now one of the most repeated concepts heard across the SWF community. For many African sovereign wealth funds, de-risking is a key part of their mandate. Acting as an institutional de-risking institution is even more important in today's complex environment. As such, strategic SWFs may use their local and regional expertise to guide foreign investors toward the intricacies of regulation, market research, project preparation, legal underpinnings, management, talent identification, etc. **Strategic funds (both those holding state-owned enterprises and the co-investment SWFs mobilising foreign capital) are creatively finding ways to act as de-risking institutions.**

The concept goes beyond providing guarantees or first-loss tranches to enabling the capacity to move projects forward while mitigating risks. **It links with the capacity of SWFs to act as institutional catalysts, bringing together and cooperating with domestic and international and domestic development agencies and banks, multilateral organizations, foreign private and impact investors, including other sovereign wealth funds.** Without a natural-resource base, certain strategic funds are established as co-investment institutions. Newly established SWFs from

India, Indonesia, or Egypt, have all developed investment attraction mechanisms focused on mobilising foreign investors, particularly other sovereign wealth funds that invest overseas, toward domestic economic objectives. Yet, SWF-SWF co-investments also include developed economies. COFIDES has recently launched FOCO, a co-investment sovereign vehicle to attract foreign investment to Spanish companies operating in strategic sectors, following a European SWF tradition anticipated in France, Italy, or Ireland.

Sovereign wealth funds have evolved substantially since the launch of the Santiago Principles 15 years ago. Today, they have become legitimate financial actors built on the successful governance and institutional experiences of multiple SWFs around the globe. The global economy itself has gone over several cycles since then and is heading towards a different multidimensional world order today. However, the art of investing continues to be a business that is largely reliant on trusting relationships. SWFs have been able to position themselves as effective co-investment partners globally by improving institutional governance and transparency. Following an array of strategies, SWFs co-invest today more and have the capacity to contribute to global financial stability while generating opportunities for current and future generations, reassessing risks, and capturing long-term opportunities in the digital, climate, social and institutional transitions ahead.

Topics for debate

Does your institution actively co-invest with other SWFs? What are the main elements that SWFs evaluate when considering doing so?

In which way do SWFs perceive that financial and/or institutional collaboration with other public or private bilateral or multilateral investors can support their investment goals?

How do SWFs maintain and build trustful relationships with co-investment partners in a rapidly changing global economy? How do SWFs navigate the risks and opportunities presented by digital, climate, social, and institutional transitions?