The Rise of Sovereign Wealth Funds: New Investment Strategies

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1. Beyond Strategic Asset Allocation

LONG HORIZON INVESTING
## Long Horizon Investing

### ADVANTAGES OF A SOVEREIGN WEALTH FUND

<table>
<thead>
<tr>
<th>Average Institutional Investor</th>
<th>Sovereign Fund</th>
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</thead>
<tbody>
<tr>
<td>• Shorter or truncated horizon</td>
<td>• Long Horizon</td>
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<tr>
<td>• Limited, possibly declining, liquidity</td>
<td>• Ample Liquidity</td>
</tr>
<tr>
<td>• Time varying risk profile – staff/leadership, customers, governance, liquidity</td>
<td>• Stable Risk Aversion</td>
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<td></td>
<td>• Other potential factors – governance, tax, cost, intellectual property</td>
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</table>
Portfolio Construction Comparison

SAA VS. REFERENCE PORTFOLIO

Traditional Strategic Asset Allocation

Reference Portfolio

What?
A low cost, passive, easily tracked, listed investment portfolio.

Why?
Fewer assumptions, greater certainty.

Source: Illustrative Purposes Only for Typical Growth Mandate
Reference Portfolio Concept

“The CPP Reference Portfolio … portfolio of publicly traded securities that could be readily implemented using a low cost passive investment program.“

“will earn capital market returns over the long term”

“equilibrium concept”

“reflects the amount of risk that Government is prepared for the GIC to take in its long-term investment strategies”

Example Reference Portfolios

Source: CPPIB, GIC, NZSF, UTAM.
Portfolio Construction Comparison

Traditional Strategic Asset Allocation
Reference Portfolio
Actual, Target or Policy Portfolio

- Cash
- Fixed Income
- Equities
- Alternatives
- Real Estate

Source: Illustrative Purposes Only for Typical Growth Mandate
Making it work in practice

• Importance of long term asset class returns.

• Need strong belief in mean reversion.

• Well defined liquidity parameters
  – Belief that the underlying risks of the portfolio not correlated; or
  – Sufficient liquidity that correlated drawdowns are survivable.

• Strong governance mechanism.

• Ideally an independent business unit that allows for critical thinkers away from traditional asset classes and the market model.
2. Case Example in Risk Arbitrage
UNBUNDLING A HEDGE FUND STRATEGY
AND TARGET ALPHA
Evolution of Hedge Funds

THE OLD VS. THE NEW

High idiosyncratic risk that’s different

Unconstrained, high absolute return seeking

High leverage, high fees – 2/20

Correlations? We’ll make so much who cares!

Becoming more systematic

Target cash+ return

Can still be high leverage, fees falling

Purportedly uncorrelated return stream
What is Merger Arbitrage?

EXAMPLE: OFFER OF $28 BY VARIAN MEDICAL FOR SIRTEX

1. Merger Arbitrage buys post-announcement deals

2. Investors may short the acquirer or the market or not at all

3. A premium is derived from a discount to the offer price

Source: Bloomberg
What could possibly go wrong?

WHAT’S ON THE LABEL …

Win/Loss
No. Months Positive/Negative Jan-98 to Mar-18

ρ = 42%
β < 0.2

Cancelled vs. Completed Deals
Russell 3000 (2001-17)

Source: Bloomberg, Big Mountain Capital

Source: S&P IQ
Skewness and Downmarket Beta

WHAT YOU’RE REALLY PAID FOR …

Normal Market Distribution
(Actual vs. Assumed Returns)

Negative Skew & Left Tail Risk
HFRX Merger Arbitrage (Jan-98 to Mar-18)

Source: Big Mountain Capital, Bloomberg
Merger Arbitrage Return Behaviour

KNOW WHAT YOU’RE BUYING

<table>
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<tr>
<th>Model Type</th>
<th>R²</th>
<th>IR*</th>
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</thead>
<tbody>
<tr>
<td>Single Factor (CAPM)</td>
<td>18%</td>
<td>1.0</td>
</tr>
<tr>
<td>Two Factor Model</td>
<td>24%</td>
<td>0.8</td>
</tr>
<tr>
<td>Multi-Factor Model</td>
<td>&gt;40%</td>
<td>0.4</td>
</tr>
</tbody>
</table>

*IR (Information Ratio Gross of Fees)

Source: Big Mountain Capital
Notes: Fees set at alpha for illustrative purposes only
Alternative Implementation

INVESTMENT STRATEGY UNBUNDLING THE ALPHA

Building Blocks of Expected Returns
(Illustrative Only, Not to Scale)

- Target the “alpha”
- Available to most investors

Implementation Strategy

- Hire a manager - anybody willing to pay fees can do this
- Replicate with combination of credit and option selling – requires liquidity and some skill
- Target the alpha – systematic program to capture excess for volatility and liquidity premium and alpha signals – takes liquidity / long horizon / skill / data

Source: Big Mountain Capital
Notes: Fees set at alpha for illustrative purposes only
Applications

INVESTMENT STRATEGIES

- Re-Conststituted Premia
- Hedge Funds
- Asset allocation (e.g. Risk Parity)
- Alternatives e.g. Royalties
- Dynamic asset allocation
- Alt/Smart Beta
- Active index huggers
Summary

• Horizon is not an aspiration, it is your state of being.

• Long horizon provides greater degrees of freedom and some advantages but ultimately same talent pool.

• Increasing availability of data, ETFs and swaps creates target alpha opportunities.

• Disaggregation of returns is a useful discipline for everyone but hard to implement in practice. At least it helps you to know what you’re paying for.
Thank you for attending today’s talk

ARE YOU INTERESTED IN OUR UPCOMING TALKS?
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The rise of sovereign wealth funds (SWFs) has created an investor class with some particular attributes not available to the average investor. Chief amongst these is a truly long term horizon and strong liquidity profile in addition to tax and cost advantages. This has seen the development of alternative forms of portfolio construction and investment strategy designed to best use these endowments. This workshop will discuss:

- The move away from Strategic Asset Allocation at some of these SWFs;
- An alternative approach to developing investment strategy; and
- Discuss a case example of how a traditional hedge fund strategy might be unbundled.

Video Link Used: https://www.youtube.com/watch?v=brTVoslt-hA
Pros and Cons in Practice

- Anchoring & relative value thinking – *hugging the benchmark*.

- Pervasiveness of market model.

- Does it allow for true risk neutral investors ~ NPV concept to your portfolio?

- Implementation mismatch and manager selection.

- Need personnel or unit that allows for independent critical thinkers away from traditional asset classes and the market model.