Real Assets

Opportunities and Constraints for Sovereign Wealth and Public Pension Funds

With sovereign wealth and public pension funds' investments in real assets set to rise by over US$400billion in the next two years, Marvin Vervaart, Regional Product Manager for Asset Owners and Alan Flanagan, Managing Director, Global Head of Private Markets, explore how both groups compare in their approach to real assets and the constraints they face. They take stock of trends that are re-shaping the global real assets market.

Recent research by BNY Mellon and OMFIF highlighted the speed at which global public investors have grown allocations to real assets since the financial crisis. Real Momentum: Global Public Investors and the Real Assets Market revealed that sovereign wealth and public pension funds have more than doubled their real estate investments since 2009. The growth in allocations to infrastructure has been even more significant; in the same time frame, infrastructure investments rose by 165%.

With strong gains realised from existing investments, the report affirmed that the shift to real assets is here to stay. In the next 12 to 24 months, 70% of global public investors are planning to increase their allocations to infrastructure, against approximately one third for real estate. While sovereign wealth funds have historically carried the shift to real assets, the report emphasised that public pension funds are now more eager to increase their real asset investments.

70%

of global public investors are planning to increase infrastructure allocations in the next 12-24 months, against 32% for real estate

Marvin Vervaart and Alan Flanagan look at how the approaches of both groups compare and the constraints they face. They explore how the global real assets landscape is evolving and where the most attractive opportunities lie.

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Sovereign Wealth Funds

In many ways, sovereign wealth funds already operate at the forefront of real asset investment. Their mandates, which are typically anchored to preserving and growing wealth accrued from a country's natural resources for the benefit of its population, afford them greater flexibility than their public pension fund counterparts. They face fewer restrictions on their investment strategies and can invest over longer time horizons. Many of our sovereign wealth fund clients invest against time horizons of 20 to 50 years. This makes them particularly well-suited to real assets, which are typically illiquid and more complex than traditional assets, and require longer-term investment commitments.

Sovereign wealth funds were earlier adopters of real assets than public pension funds. Over time, they have become more sophisticated. Several of the largest sovereign wealth funds have specialist teams in-house dedicated to real assets. By developing direct investment capabilities, they have been able to bypass some of the challenges and restrictions associated with investing via real asset funds – particularly infrastructure funds. In addition, they have gained greater flexibility with the ability to adjust their investment strategies and tailor their approaches according to the type of project they invest in (value-add, development etc.).

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In recent years, sovereign wealth funds' approach to real assets has shifted. During the sovereign debt crisis, many Middle Eastern and Asian sovereign wealth funds made significant prime real estate purchases in key European cities, where valuations had been hit by the economic downturn, reduced bank lending and capital outflows. Over the last few years, economic recovery in Europe combined with strong competition from other investors has led to substantial rise in valuations, making their risk-return profile less attractive and encouraging sovereign investors to pursue previously overlooked sectors. Amongst the fastest growing sectors are development projects and industrial and logistics assets. These projects are often outside familiar urban areas and require additional knowledge and skills to identify good prospects, undertake the necessary due diligence and add value to the underlying assets.

Today, many sovereign wealth funds continue to chart a more adventurous course in the real assets market. Many are looking to technology infrastructure – from satellite networks to the assets that support artificial intelligence programs – to source new opportunities. Saudi Arabia's Public Investment Fund was recently reported to be contemplating an investment in Tesla. Whether this counts as a real asset investment is another question in itself! What's clear is that sovereign wealth funds, with their deep reserves, immense purchasing power and strong investment appetite, are the driving forces behind many of the newer and more exciting investment trends that are emerging in the real assets space.

Public Pension Funds

Public pension funds have historically operated with a more cautious approach to real asset investment than sovereign wealth funds. With mandates tied to providing a stable income to public sector employees once they retire, they have adopted more conservative investment strategies and invested against shorter time frames to meet ongoing liabilities.

Our research with OMFIF shows that the tide is turning. While public pension funds' average allocations to infrastructure and real estate stand at 2% and 9% respectively, against sovereign wealth funds' 8% and 11%, they are now eager to ramp up their allocations in pursuit of greater returns and against a backdrop of growing familiarity with real asset classes.

> "Having lobbied successfully for greater flexibility, a host of other public pension funds are now appearing on the real assets stage ready to flex their muscles."

Some public pension funds have invested in a range of alternative asset classes, including real assets, for many years via investment funds. Larger public pension funds have developed similar approaches to sovereign wealth funds, established direct investment capabilities. Having lobbied successfully for greater flexibility, a host of other public pension funds are now appearing on the real assets stage ready to flex their muscles. In 2014, the world's largest public pension fund—Japan's Government Pension Investment Fund—authorised for the first time a dedicated alternatives portfolio targeting 5% for real estate, infrastructure and private equity. Recent regulatory changes have allowed the Government Pension Fund of Thailand to invest more in non-domestic real assets, while Sweden's national pension buffer funds can now invest up to 40% in illiquid assets.

> **"Pension funds are keenest to increase their investments in real assets"**

New Frontiers of Real Asset Investment

As sovereign wealth and public pension funds' allocations grow and their preferences evolve, changes continue to unfold in the global real assets market.

Demographic Shifts

Demographic shifts have played a key role in re-shaping the range of real estate and infrastructure projects seeking investment. In mature economies, for example, this has given rise to senior housing investment funds to finance growing demand for retirement accommodation. Similar vehicles are channeling investment into multi-family rental accommodation projects around central business districts, typically favored by millennials with a preference for city living.

Repurposing of Retail, Office and Manufacturing Assets

Escalating appetite for real estate in large European cities is leading investors to seek non-core / non-prime opportunities in mature markets. This is accelerating the repurposing of retail, office and manufacturing assets that are no longer needed for their originally intended purposes in an era of digital commerce, flexible working practices and developments in robotics that are replacing human-centric workspaces.

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Investment Challenges in Developing Markets

In developing markets, risk factors, such as political stability, regulatory clarity and currency volatility, continue to exacerbate the mismatch between supply and demand of real estate and infrastructure investment. This is despite the fact that real asset investment needs are often greatest in these markets which are often facing unprecedented levels of urbanisation. Industry estimates suggest that US$40 trillion will be required globally to build roads, railways, airports and ports over the next two decades.

Sovereign wealth and public pension funds will play an increasingly influential role in the real assets market in the coming years. Public pension funds are catching up with their sovereign counterparts in relation to their desire to harness the benefits real assets have to offer, such as diversification, higher returns and stable income streams. Investors' growing sophistication will have a multitude of impacts on the real assets space—not just in terms of fee pressure and demands for greater transparency, but also in relation to the way real assets are defined. With sovereign wealth and public pension funds poised to ramp up their allocations and a new wave of opportunities emerging, we are at an exciting juncture in the real assets market.

The themes in this blog are explored in our new research report with OMFIF: Real Momentum: Global Public Investors and the Real Assets Market.

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