Maximizing Returns & Diversifying risk in Countries with Small, Thin or Poorly Developed Capital Markets

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Pensions Core Course

Road Map

- Broad overview of current state of foreign investments by pension funds
- Select pension funds case studies:
  - **Case Study 1**: South Africa's experience with the role of currency in risk diversification of foreign investments
  - **Case Study 2:** Namibia's experience with regulatory reforms to bring foreign assets on-shore for private market development and economic impact
  - **Case Study 3:** Pacific Island States' pension funds experience with addressing regulatory, policy and technical constraints to stimulate cross-border co-investment in regional infrastructure

Key Reasons for Investing Off-Shore: Theory and Practice

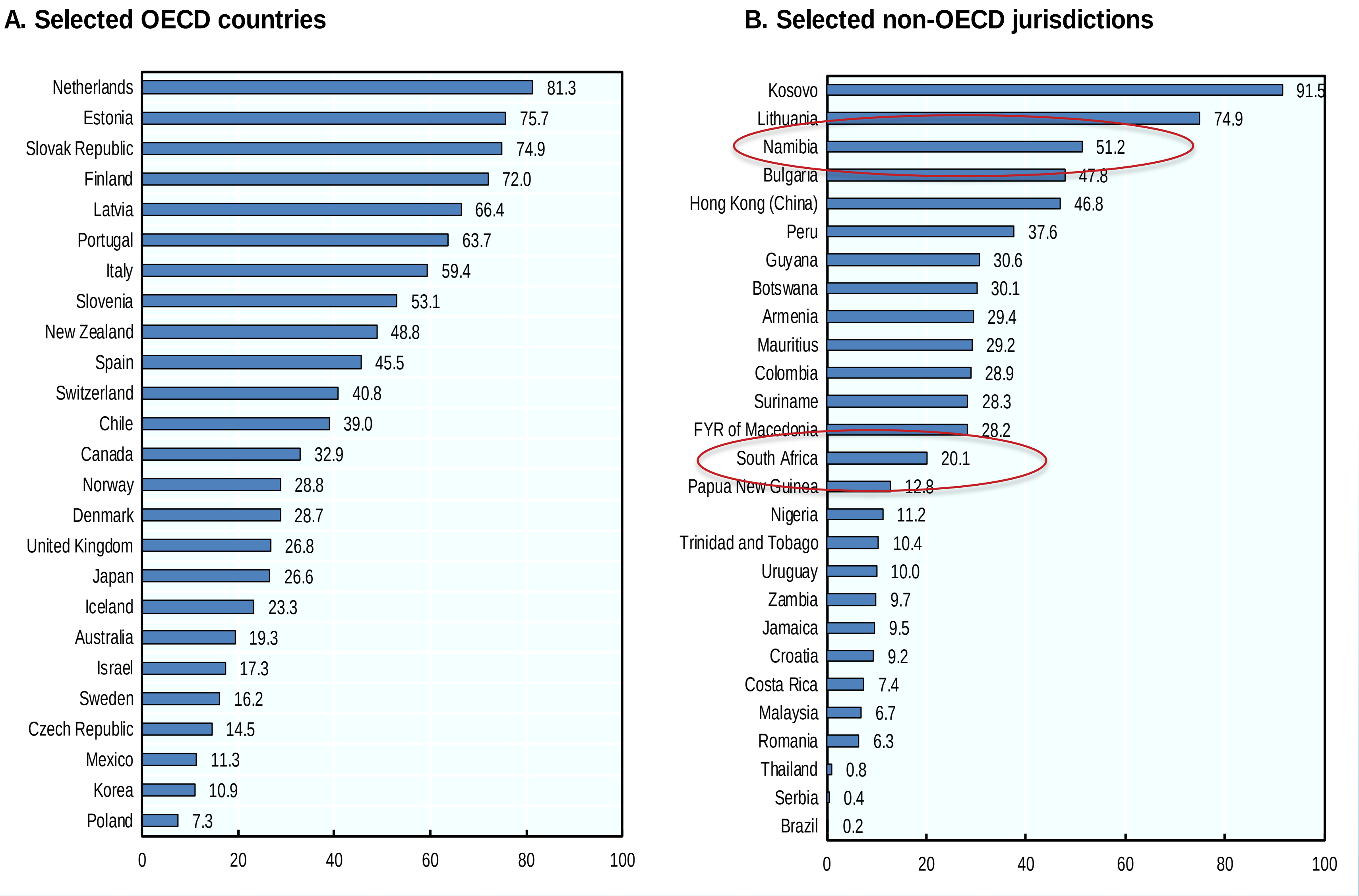
- Hypothesis: investing abroad broadens investment opportunities and allows for greater portfolio diversification
- However, in practice most pension funds are subject to home bias
- There are a number of barriers and risks faced by pension funds to investing abroad
- Investments abroad are mostly directed to select (mostly developed) markets: US, EU and neighboring countries (i.e. regional bias)

Different Regulatory Environments Across Countries

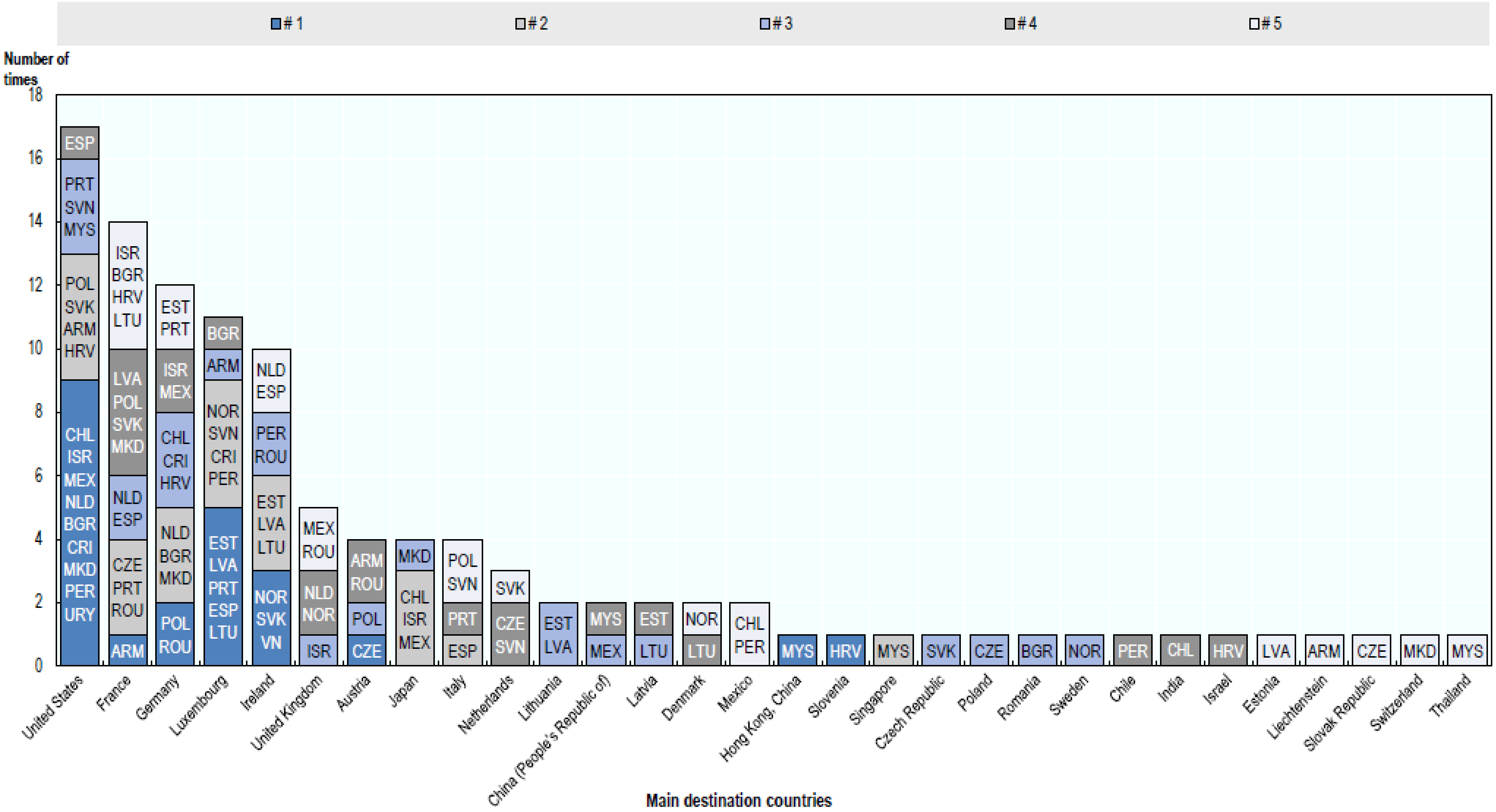
Countries	Global investment limit in foreign assets
Australia	• No limit.
Belgium	• No limit.
Brazil	• 10%; • Real estate, Private investment funds and loans are not allowed; • Bonds, retail investment funds and bank deposits are allowed only through local retail investments in foreign assets; • Direct equity investments are limited to Brazilian Depositary Receipts (BDR) and to stocks listed in the MERCOSUR capital markets; • Indirect equity investments are allowed through local retail investments with foreign assets.
Canada	• No limit.
Czech Republic	• No limit.
Chile	• Joint limit for all funds: 80%; • 100%; 90%; 75%; 45%; and 35% for funds A, B, C, D and E, respectively.
Colombia	• No specific limit for each type of investment; • Maximum limit: 40% (Fund A and D), 60% (Fund B), 70% (Fund C); • Additional requirements apply in equity, bond, retail and private investment funds.
Denmark	• No limit for OECD countries.
Germany	• No limit; where certain legal risks can arise, must be kept at prudent level.
Finland	• 10% for non–OECD countries - Voluntary pension plans; • 20% for non–OECD countries - Statutory pension plans.
Hong Kong	• At least 30% in HKD denominated investment.
Ireland	• No limit.
Italy	• Securities (debts and equities) issued by non-OECD residents: 5%; • 0% if not traded on regulated markets.
Japan	• No limit.
Luxembourg	• No limit.
Mexico	• Max 20% regardless of asset classes; • Additional asset classes requirement applies.
Netherlands	• No limit.
Norway	• No limit.
Peru	• 42%.
Poland	• OPF: MAX 10% in 2014; 20% since 2015; 30% since 2016; • EPF: MAX 30% in foreign currency.
Portugal	• 30% limit on investment in a different currency from that in which responsibilities are denominated. 15% limit for investment in assets not traded in an EU or OECD regulated market. For PPR pension funds, the limit is 10%.
South Korea	• 30% - 70%.
Spain	• No limit.
Sweden	• No limit.
Switzerland	• Max 30% in foreign currency (hedging allowed), could be extended if under prudent management.
United Kingdom	• No limit.
United States	• No general limit. Some limit on equity, real estate and bonds.

Sources: PwC Market Research Centre, national associations and the OECD.

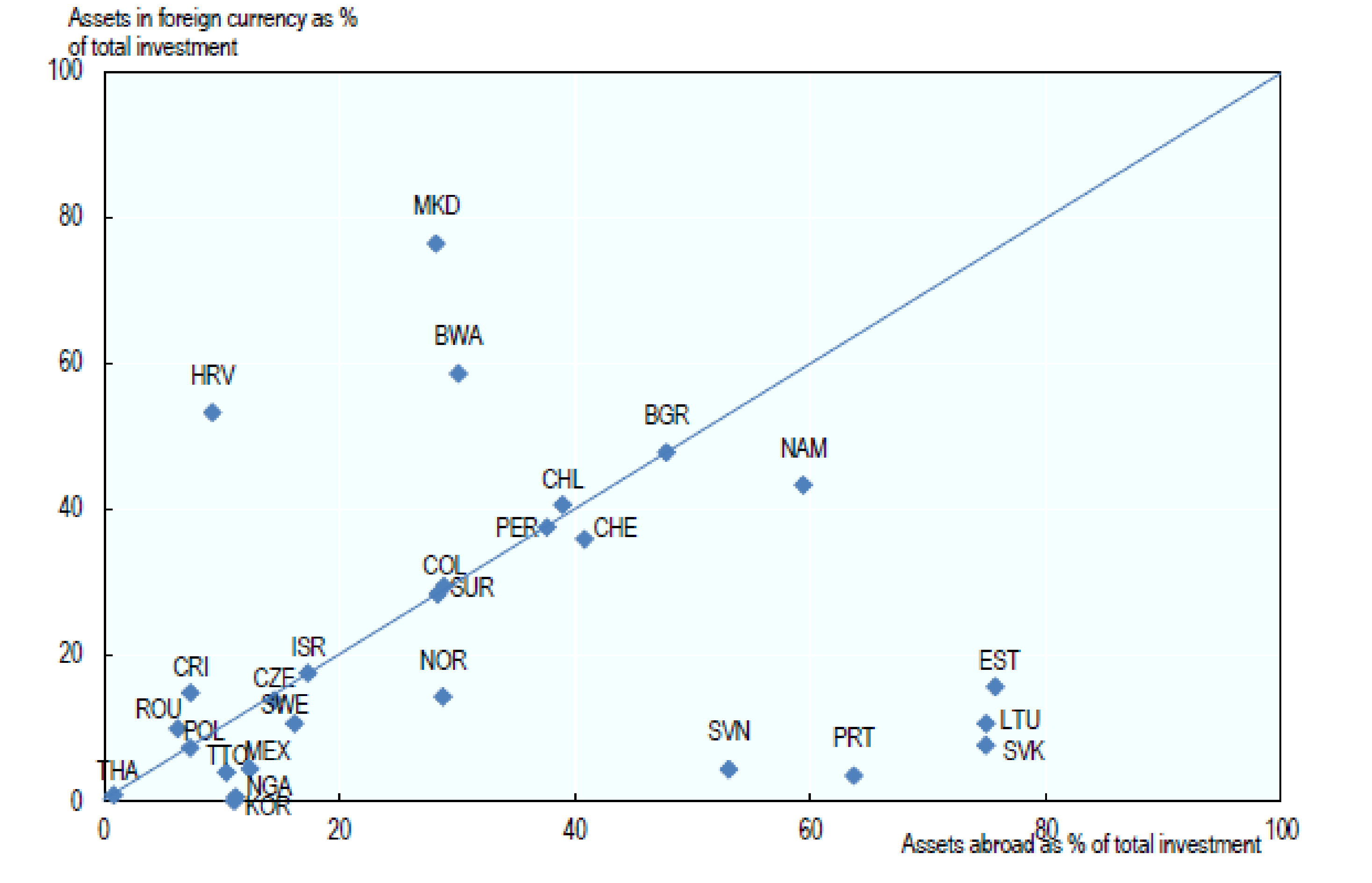
Diverse Profile of Foreign Investments by Pension Funds (OECD, 2016)



DMs are the Main Destination of Foreign Investments (OECD, 2016)



Managing Currency is Seen as One of Key Issues (OECD, 2016)



Case Study 1: South African GEPF – Largest Pension Fund in Africa

- The Government Employees Pension Fund (GEPF) is Africa's largest pension fund with more than 1.82 trillion Rand (121 billion USD). It is a defined benefit pension fund for public sector employees in South Africa. Currently there are more than 1.2 million active members and more than 450,000 pensioners and beneficiaries
- Given the size of the fund compared to the South African economy (GEPF assets represents about 33% of the annual GDP) there is a strong rationale for GEPF to seek to diversify part of their assets beyond the local economy
- As of 2018, the GEPF exposure to global bonds and stocks was still rather low (5%) and their are in the process to seek to increase that in the coming years
- The purpose of the analytical work presented in the following slides was to see if there was a benefit from expanding exposure to developed market assets on an unhedged basis

Case Study 1: Currency exposure - Background

- International assets represent a bundle of local market exposure and foreign currency exposure. From the perspective of the investor, the return (and risk) on international assets can be decomposed into a local asset return and a currency return

- The **size of the currency risk** undertaken depends on:

  - ✓ The frame of reference – the 'neutral' currency of the fund (the neutral numeraire). It could be the domestic currency of the investor or a different mix

  - ✓ The strategic asset allocation and any deviations from that in the actual portfolio

  - ✓ The use of hedging strategies

- The decision on how to manage it depends on:

  - ✓ The underlying investment framework (asset only vs. asset/liability)

  - ✓ Investor views on the value of taking currency risk on strategic and/or tactical basis

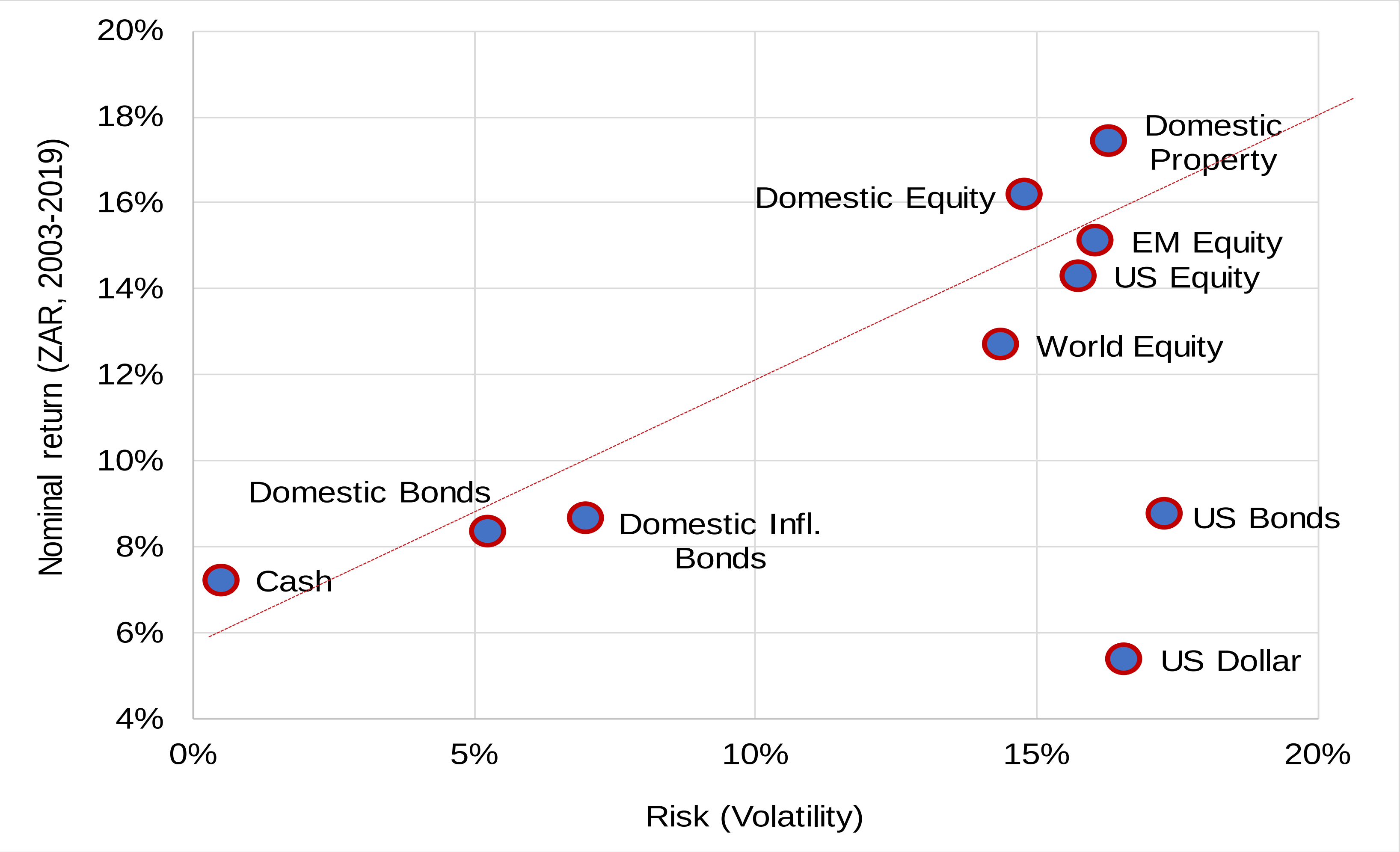
Case Study 1: Currency exposure and Equity Risk

- Typically developed market currency risk provides significant diversification benefits for a investment portfolio denominated in an emerging market currency

Source: Bloomberg, World Bank Treasury calculations

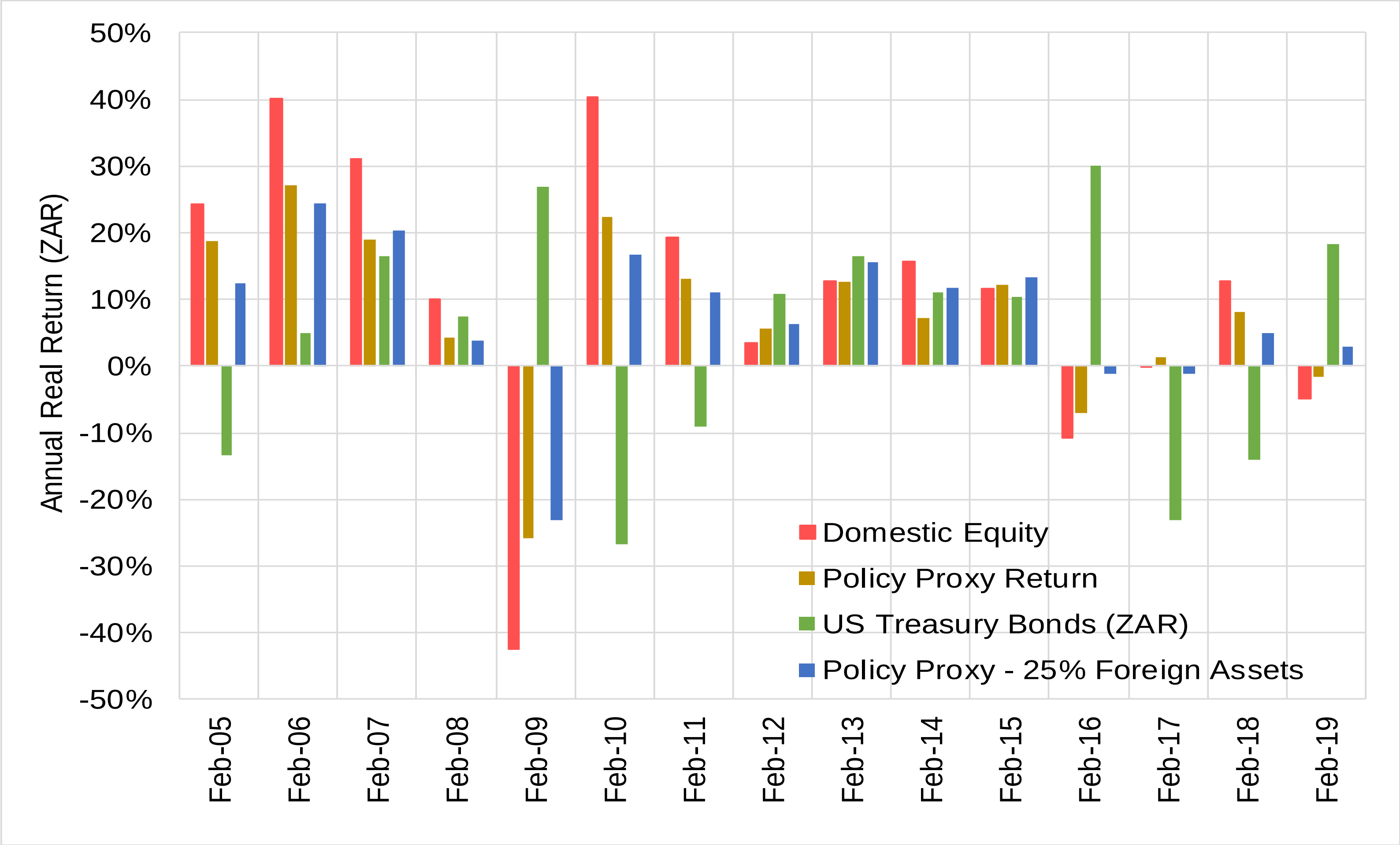
Case Study 1: Asset Classes – Risk/Return Trade-off

Historical Risk/Return Trade-off (ZAR, 2003 – 2019)



Case Study 1: Diversification Through Foreign Assets

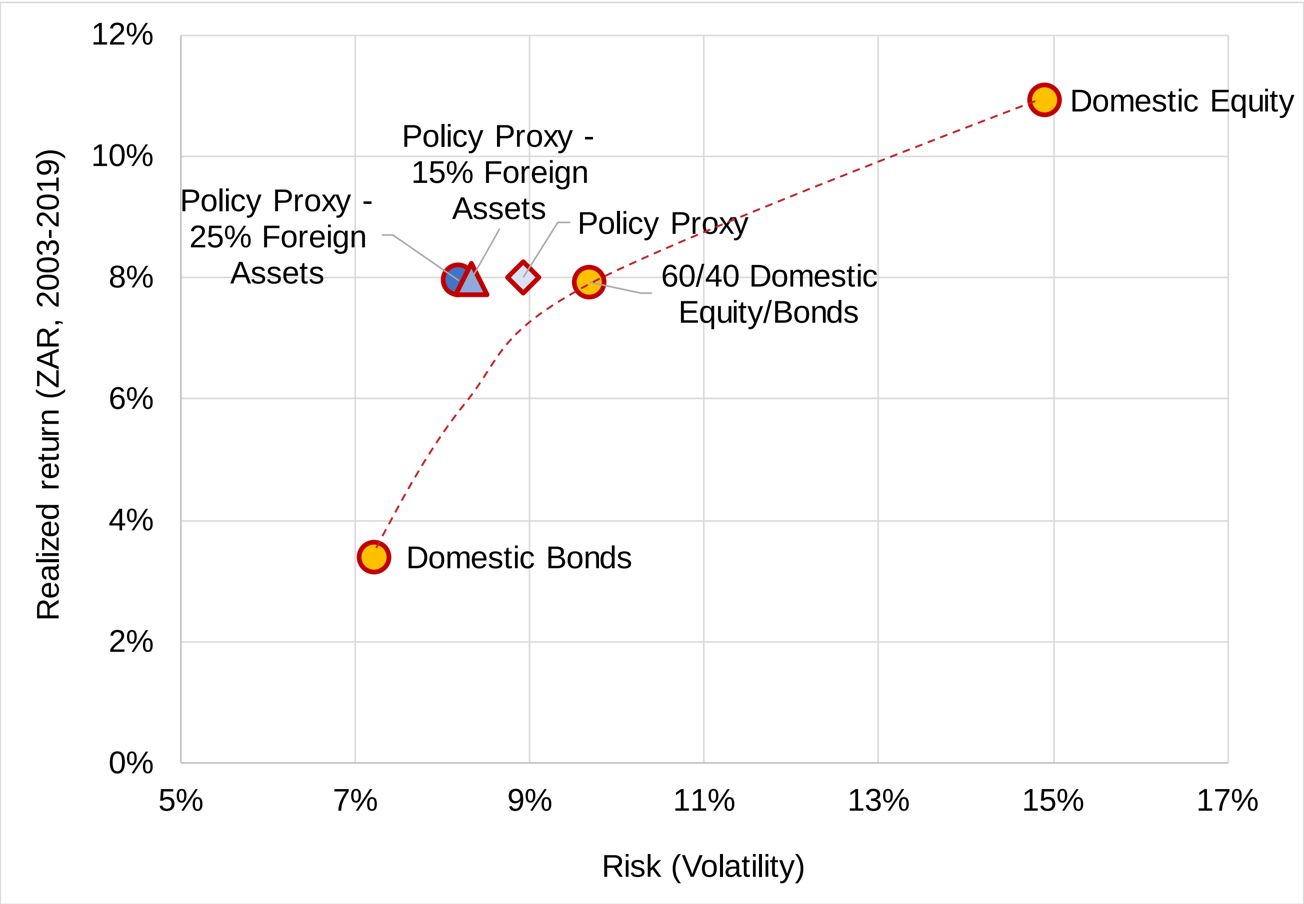
Annual real returns various portfolios (2003-2019, ZAR)



Source: Bloomberg, World Bank Treasury calculations

Case Study 1: Potential Benefits of Foreign Diversification

Historical Risk/Return Profile – Alternative Portfolios

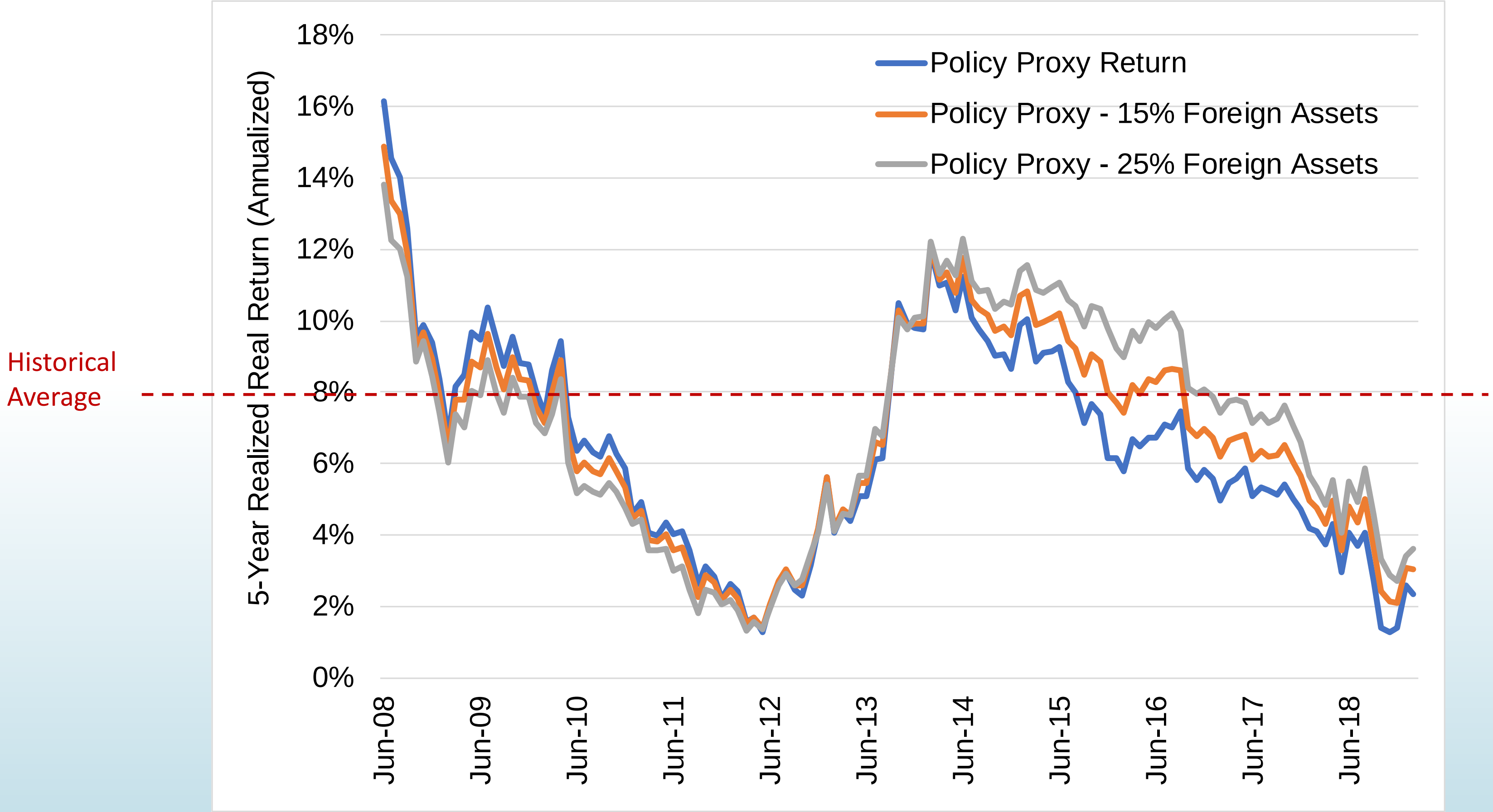


Policy Proxy – 15% and 25% Foreign Assets - includes proportional exposure to US equity and Treasury markets on unhedged basis

Source: Bloomberg, World Bank Treasury calculations

Case Study 1: Foreign Asset Boost Local Returns in Downturn

5-year Realized Real Return – Alternative Portfolios

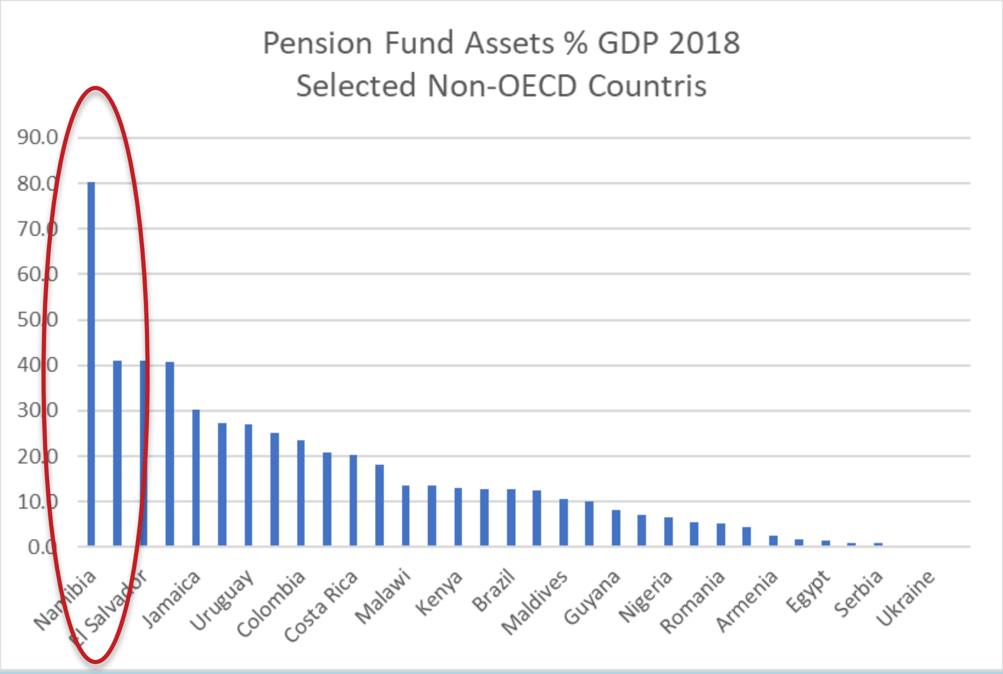


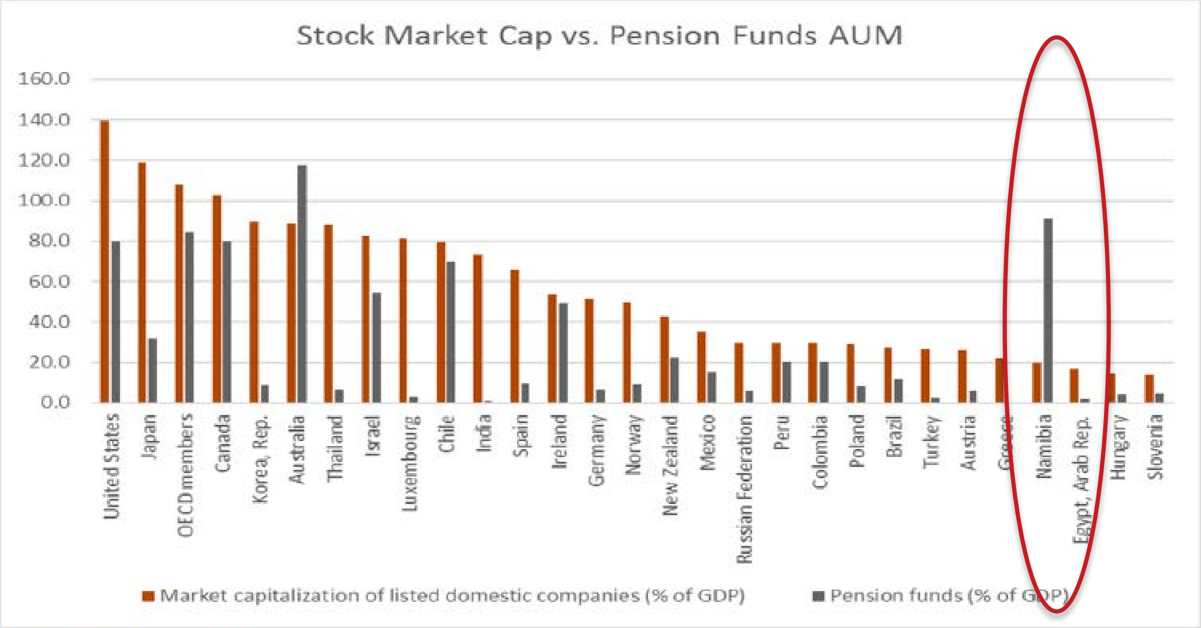
Policy Proxy – 15% and 25% Foreign Assets - includes proportional exposure to US equity and Treasury markets on unhedged basis

Source: Bloomberg, World Bank Treasury calculations

Case Study 2: Large Pool of Pension Assets Compared to National Economy and Public Markets

- Namibian capital markets (stock and bond) were illiquid and lacking in the number and types of available instruments
- Supported by relatively liberal regulation, Namibian institutional investors invested off-shore in search of sufficient market depth and breadth to achieve its investment and diversification objectives, and for liquidity management
- This was seen by policy makers as a significant capital outflow, which was put to work in other countries, with Namibia only benefiting from the investment returns on its assets





Source: World Bank and OECD Databases.

Case Study 2: Political Economy of Large Pension Assets in EMs

- Increased political pressures globally and EMs in particular for pension funds (that have accumulated significant assets) to make them work for the domestic economy
- In EMs with underdeveloped capital markets policy priority is capital market development
- In Namibia:
  - ✓ It was viewed that it was difficult to attract foreign investors if domestic institutions invest in other jurisdictions
  - ✓ Focusing on developing private market: public market was dominated by South African joint listed companies: while the NSX is 10 times GDP, there are only 8 Namibian-only equities accounting for 1.85% of the market capitalization
  - ✓ Increasing the stock of publicly tradable assets through the sale and realization of private investments to supports domestic capital market development

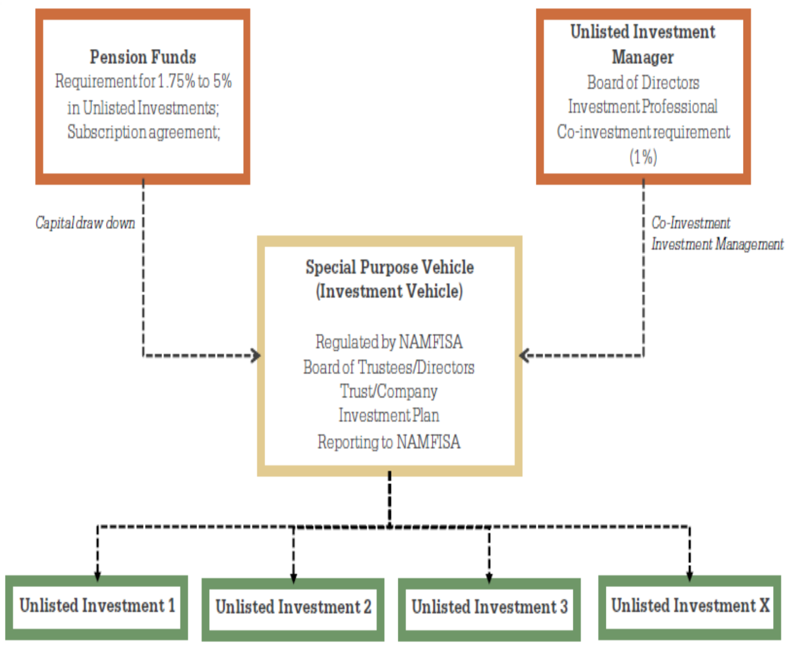
Case Study 2: Painful Legacy of Losses by Namibia's Largest Pension Fund (GIPF) over 1996-2010

- In 1996 GIPF undertook of direct investing in Namibian companies its Development Capital Portfolio (DCP)
- GIPF's objectives were to promote socio-economic development and empowerment of Namibians through financing of development projects and to assist previously disadvantaged Namibians to enter the main stream of economic activity along-side achieving investment returns
- GIPF allocated approximately N$611 million (US$~50million) to the DCP and invested directly into various Namibian companies with little or no intermediation
- By 2006 the DCP experienced losses on some of its investment and it was liquidated in 2010

Case Study 2: Namibian Policy Response

- Identified problems
  - ✓ Lack of understanding of alternative assets
  - ✓ Lack of due-diligence and process
  - ✓ Lack of active management
  - ✓ Poor governance
  - ✓ Perception of “friendship” investment and corruption
- Policy response
  - ✓ Develop a system to address the identified problems
  - ✓ Formalize and regulate the alternative asset market
  - ✓ Where possible address problems of illiquidity and valuation

Case Study 2: Key Features of Regulation 29



- Pension funds must invest in unlisted investments through

an SPV prohibiting pension funds from directly investing in unlisted investment managers

- An SPV must be either a public or private company or a Trust and

having its investment plan and directors approved by NAMFISA

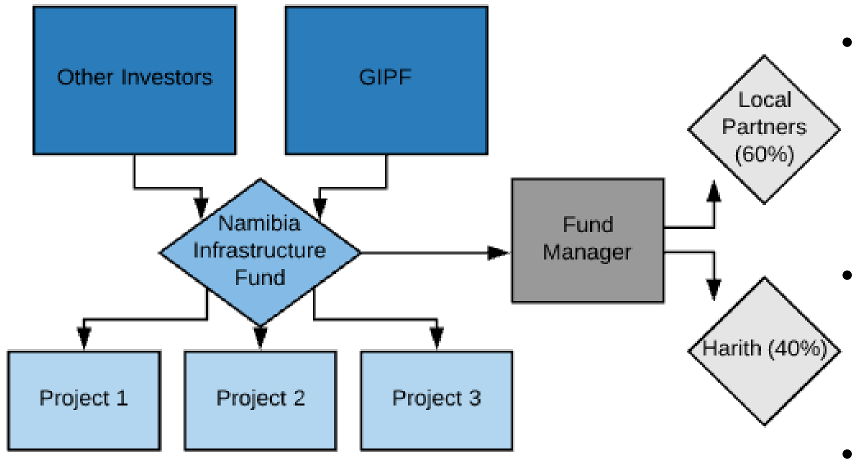
- An SPV must enter into a Management Agreement with the unlisted investment manager

- To establish independence in investment decision making, the regulation provides that unlisted investment managers cannot be a trustee or a principal officer of a pension fund

- To have “skin in the game” the regulation also requires unlisted investment managers to co-invest a minimum of 1% of the contributed capital of investors in any SPV

- SPVs are required to report to NAMFISA every six months and submit audited financial statements within 180 days after the end of its financial year according to IFRS.

Case Study 2: Example of Ino Harith Capital for Direct Infrastructure Investments



- The Fund. The GIPF of Namibia has championed the establishment of the Namibian Infrastructure Fund referred to as the "NIF". NIF is a dedicated Namibia focused Infrastructure Fund. The fund strictly adheres to ESG principles. The fund currently has N$780 million committed capital from GIPF.

- Governance Structure. The legal entity is Bewind Trust registered with NAMFISA (15/SPV/15). The Board of Trustees represents the interests of investors. Investment Committee, Audit and Risk Committee, and Conflicts Committee are sub-committees of the Board on key governance issues.

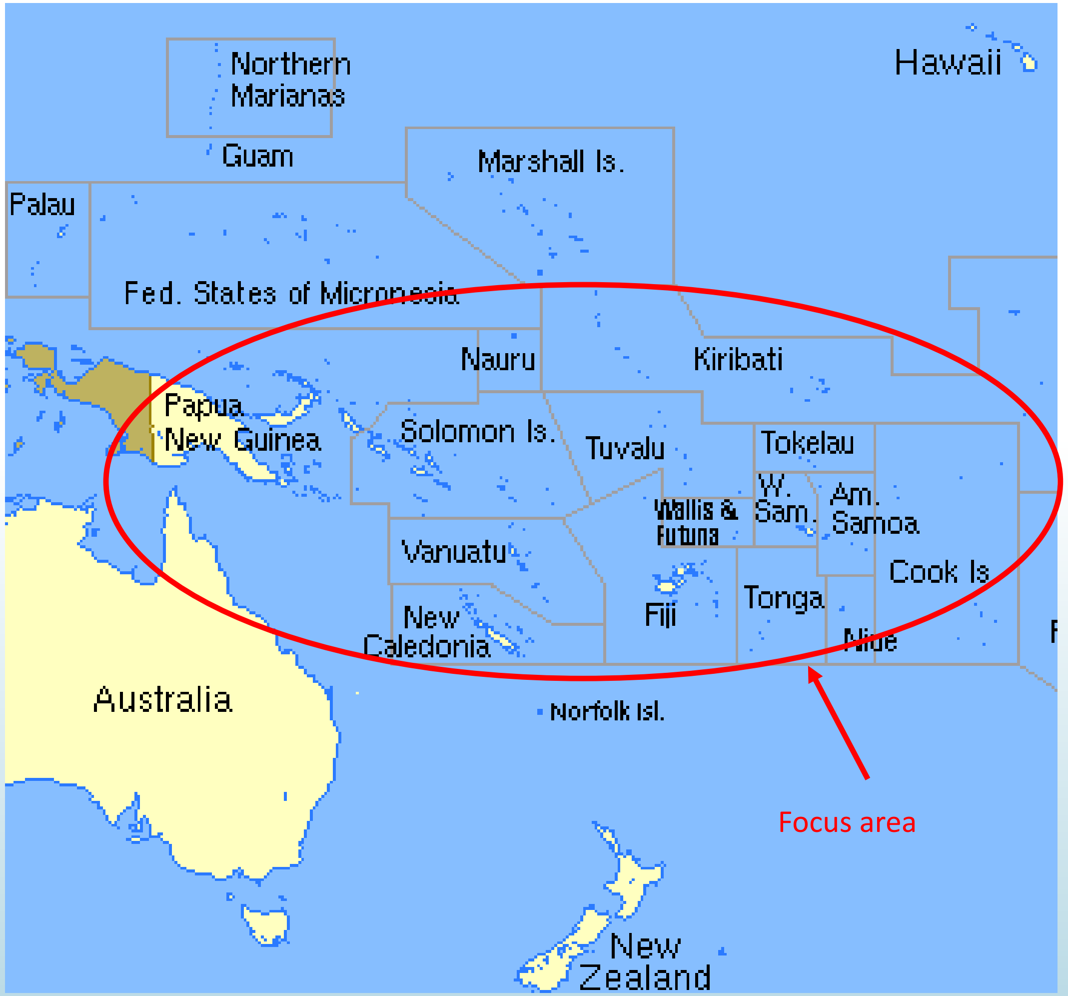
- The Fund Objective. To realize superior financial returns through income from, and capital appreciation of infrastructure investments made in portfolio companies across Namibia.

- The Fund Investment Strategy. The 12-year closed equity and mezzanine fund invests in commercially viable infrastructure projects in Namibia in local currency across a diverse range of infrastructure assets in energy, ICT, transport and logistics, health, municipal services, water and sanitation sectors. The fund assumes significant minority investor position in projects. The fund targets about 15-20 deals/assets. Equity investments range between N$15 million and N$56 million. The fund's target IRR of 15% with the hurdle rate of 9.75%. The fund's management fee is 2.5% per annum with the incentive fee of 20% net of the hurdle rate.

Case Study 2: Lessons Learnt for Development of Private Market in EMs: Evolutionary Process

- Domestic investment should be undertaken within fiduciary role of pension funds
  - ✓ for policy makers to reconcile potential tension between fiduciary responsibility of pension funds to its members and targeting broader social and economic benefits
- Develop appropriate investment structures
  - ✓ appropriate structures will depend on the country's market development objectives and current market circumstances
  - ✓ investment structures should be flexible enough to fit with local market circumstances and evolve over time as the local market develops and market participants are becoming more experienced
- Appropriate level of regulation
  - ✓ There different level of regulation of alternative investment vehicles and their managers internationally depending on the nature of investments and the policies makers and regulators' objectives
- Development of a project pipeline
  - ✓ Creation of a viable project pipeline is essential for the development of the domestic alternative asset class
- Communication and development of skills for market participants

Case Study 3: Pacific Island States – Heterogeneous Group of Small States and Territories



- Geographically isolated - small population across a large ocean area
- Small economies dominated by remittances, tourism, fisheries & agriculture (subsistence farming)
- High import dependency / minimal export markets
- Extreme vulnerability to climate change
- Populations generally low in capacity

Case Study 3: Undeveloped Capital Markets and Financial System

- Banking sector limited in scale and competition
  - Potential withdrawal by offshore / regional banks
  - High margin spreads but small bank books
  - Domestic banks with low capitalization provide limited product offering
- Undeveloped capital markets / Illiquid exchanges
  - Risk transfer mechanisms not price effective
  - Stock exchanges in PNG & Fiji only but trade turnover low
- Size of institutional funds critical to economies
- Provident (pension) funds filling gaps holding broad exposures
  - Acting as substitutes for other market failures
  - Direct equity, member loans, system liquidity providers

Fund	% GNI[1]
Kiribati sovereign wealth fund	345
Tuvalu Trust Fund	190
Tuvalu National Provident Fund	68
Cook Islands Superannuation	67
Fiji National Provident Fund	52
Kiribati National Provident Fund	31
Samoa National Provident Fund	30

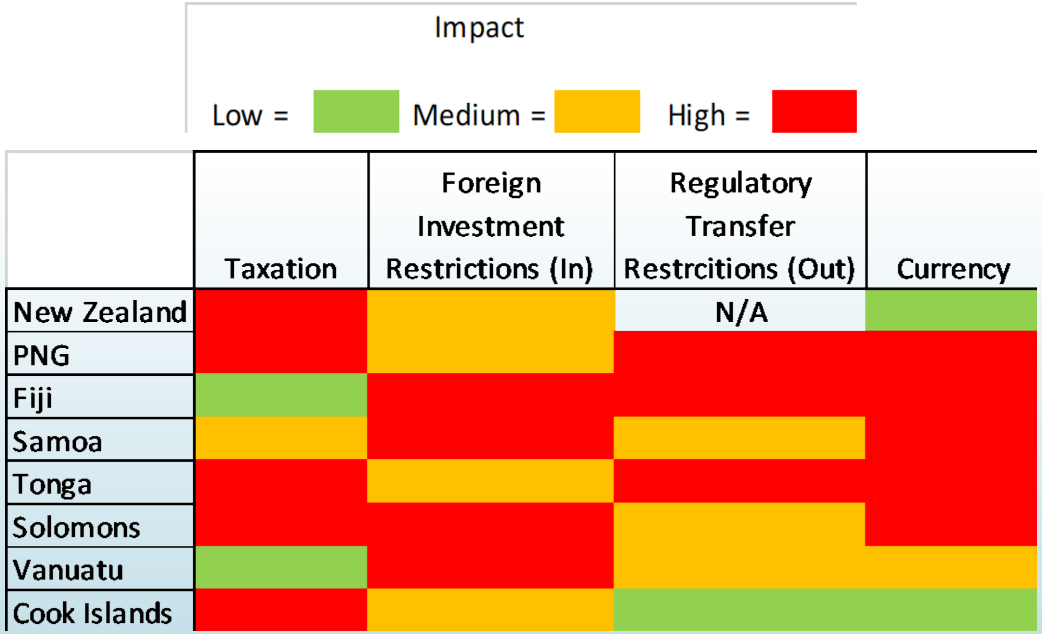
1: Indicative % of GNI

Case Study 3: Investment Environnent - Unique Regional Challenges

- Environment for asset owners requires navigation of issues common for developing countries and unique to the Pacific context:
  - Challenging national governance context given small populations and regional legacies
  - Strong sovereign allegiances and different perspectives due to historical legacies
  - Fiduciary obligations jeopardized through undue influence
  - Regulatory and policy constraints imposed on cross-border capital transfers
  - Concentration risk is particularly significant given the smallness of economies
  - Complexity in risk management of domestic currencies
  - Availability and retention of human resource capabilities
  - Access to quality financial services given small absolute size of funds and their geographic remoteness from financial centers

Case Study 3: Addressing Constraints through Network of Pension Funds

- Formed and incorporated a network of regional funds (pension, sovereign & trust) – Pacific Islands Investment Forum (PIIF) - to collaborate and build capability for commercial co-investment: 11 Pacific Nations and 18 Funds
- Network's investment pool at USD8.6 billion versus shortfall on Pacific infrastructure funding of USD45 billion over the next 12 years[2]
- Mobilize institutional funds to address funding shortfalls for regional benefit
  - Facilitates necessary infrastructure and investment to the benefit of Pacific communities
  - Investment returns retained in the Pacific
- Appetite for cross-border investment is clear but regulatory and policy constraints in jurisdictions require resolution by various policy and decision makers



2: Asian Development Bank estimation

Case Study 3: PIIF Members' Priority Areas

Priority of PIIF members preferences towards governance and tax offers a strong base in developing a platform offering sustainable and value-added outcomes for funds

Issues
1. Strong governance
2. Tax efficiency
3. Legal structure
4. Operating model
5. Efficiency in foreign investment restrictions/limits
6. Currency of the platform
7. Domicile of the platform

Case Study 3: Project objectives – Develop co-investment function

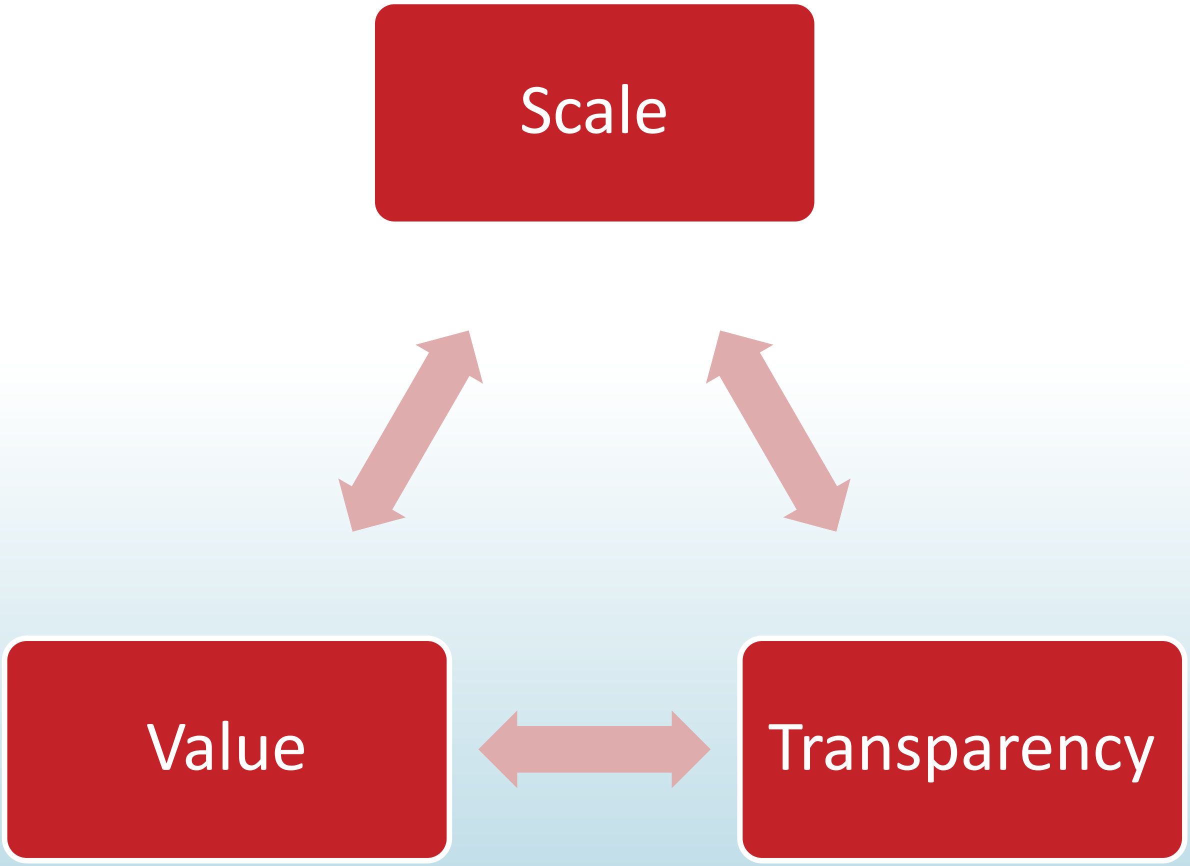
- Project's overall objective:

  Develop a cross-border investment function that facilitates efficient investment and capital transfers into multiple assets by multiple funds consistent the their fiduciary responsibilities

- To achieve the broader objective, project will follow a number of key steps :
  - Objective 1: Address government and regulatory constraints imposed in development of an investment platform
  - Objective 2: Utilizing global expertise and best fit practice, identify (an) investment structure(s) that's 'fit for purpose' to the needs and realities of Pacific funds
  - Objective 3: Develop guidelines and facilitate support functions to operationalize the preferred investment platform

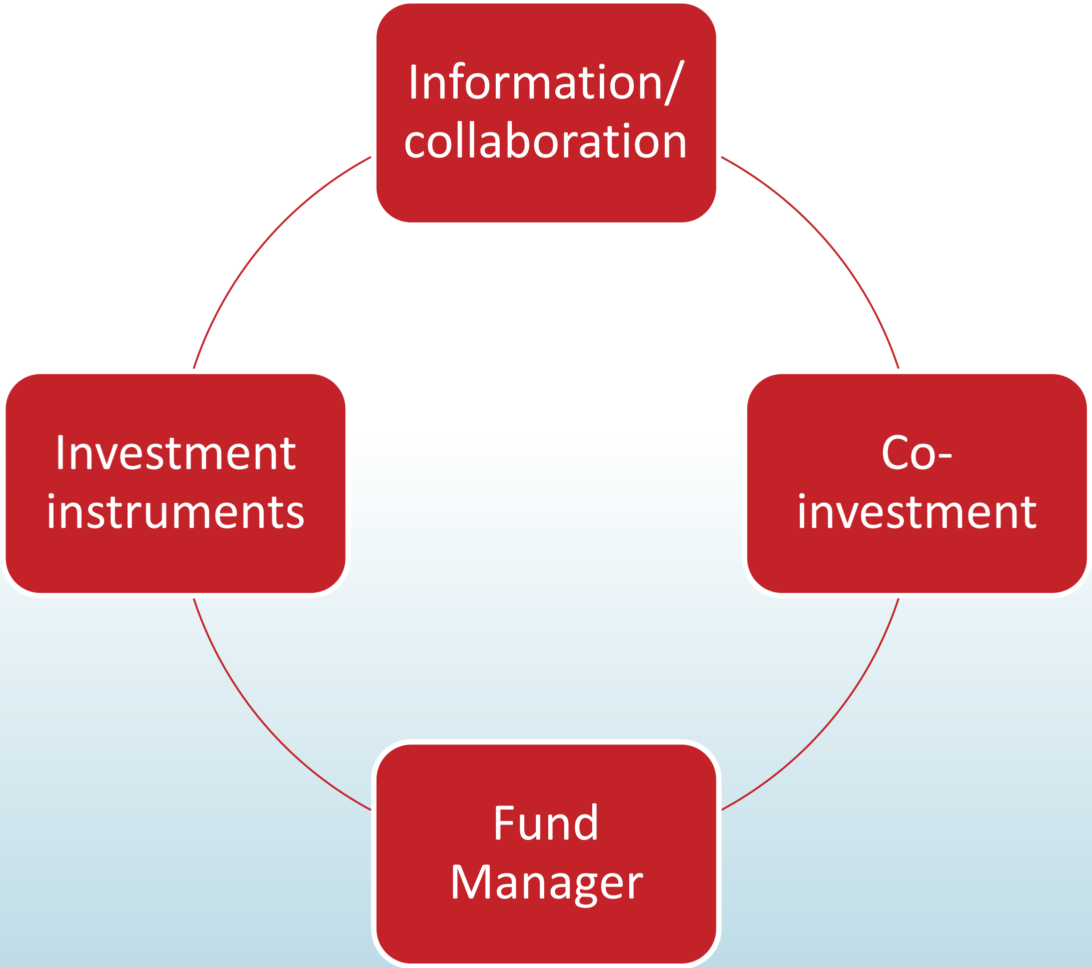
Case Study 3: International Experience – Drivers of Action

- All about alignment of interests
- Creates necessary scale
- Shares costs
- Evidence of credible source of long term, local currency financing
- Attract partnerships with foreign capital
- Develop local markets and technical capacity
- Shows regulatory / policy changes needed



Case Study 3: International Experience – Different Models for Cooperation

- Information / Collaboration platform
- Co-investment platforms
- Establish joint-owned fund manager
- Investment instrument
  - Unit trust
  - Partnership structure (GP/LP)
  - Insurance company model



Case Study 3: International Experience - Lessons Learnt

- Need champion – 1 or 2 key/ well placed individuals to drive the initiative
- Keep moving forward – go in small steps / build to keep sufficient core group on board
- Focus on governance
    - Alignment -strategy / fees etc.
    - Balance of involvement vs. liability
    - How get members out + in
    - How recycle capital
- Focus at start and build over time (sector/ geography/ instrument)
- Use existing / external capacity and build over time
- Work with policy makers and regulators from start

Case Study 3: Opportunity for Pacific Region

- New models being developed across EM –lessons / models for Pacific Funds
- Starting with advantages over other regions
  - Public funds already have scale
  - Leading global infrastructure investors in the region
  - MDB/ donor support
- Global trends opportunity for Pacific Region
  - International investors looking for new opportunities
  - Want to see local involvement
  - Initiative has already generated lots of interest
- Pension funds are working together and engage with regional governments and partners:
  - Pipeline – long-term and demonstration transaction
  - Development of capital markets and new instruments
  - Potential blending

Thank you!