Sovereign wealth funds continue to capture attention as a result of their ever-growing assets under management (AUM) and corresponding influence on global financial markets. Despite the decline in commodity & oil prices and the global volatility seen over the past year, which has reduced the capital available to some sovereign wealth funds, AUM of these investors reached $6.51tn in March 2016 (Fig. 1). This is over double the AUM held in 2008 ($3.07tn), the year Preqin launched its first Sovereign Wealth Fund Review.

Relative to other institutional investors, sovereign wealth funds typically have a greater tolerance for the illiquidity inherent in private equity investments, allowing many sovereign wealth funds to build private equity allocations that may not be feasible for other investor types. This is due to sovereign wealth funds’ preference for returns, in order to increase capital reserves for future generations. These unique investors have been steadily increasing their share of capital invested in private equity and remain an important source of capital for the asset class. Fig. 2 shows that private equity has seen greater participation from sovereign wealth funds over the past year, illustrative of the increasing sophistication of these institutions in constructing their investment portfolios and the attraction of the asset class to deliver their investment objectives.

As shown in Fig. 3, over half (55%) of sovereign wealth funds are known to invest in private equity, representing an eight percentage point increase from the proportion seen last year. Thirty-eight percent of sovereign wealth funds exclude private equity from their investment strategy, often due to liquidity prioritization or anticipation of a period of economic stress. Chile-based Economic and Social Stabilization Fund, for example, does not invest in the asset class as it does not provide the liquidity needed to meet the requirements of its mandates.

Sovereign Wealth Funds Investing in Private Equity

Alastair Hannah and Selina Sy provide an insight into this secretive and exclusive subset of the investor community, based on data from Preqin’s recently launched 2016 Preqin Sovereign Wealth Fund Review.

Fig. 1: Aggregate Sovereign Wealth Funds Assets under Management ($tn), December 2008 - March 2016

Fig. 2: Proportion of Sovereign Wealth Funds Investing in Each Asset Class, 2014 - 2016

Assets under Management

Larger sovereign wealth funds are more likely to allocate to the asset class than their smaller counterparts (Fig. 4). While only 20% of the smallest sovereign wealth funds (with total assets under $1bn) invest in private equity, rates of participation in the asset class increase steadily alongside AUM, reaching 100% for sovereign wealth funds with total assets of $100-249bn.

*Please note that Preqin has only been collecting private debt information since 2014 and natural resources data since 2015.
However, this rate declines to 89% for those with total assets of $250bn or more. Norway-based Government Pension Fund Global, for example, is the largest sovereign wealth fund in the world and does not invest in private equity due to restrictions imposed by the Government of Norway. Instead, its portfolio is allocated to investments in public markets and real estate.

Location

Fig. 5 shows that sovereign wealth funds investing in private equity are based across the globe. Middle East- and Asia-based sovereign wealth funds continue to constitute the largest proportions of investors in private equity within this pool, accounting for 33% and 29% of funds respectively. While this is primarily due to the large numbers of sovereign wealth funds based in these regions, this also illustrates the large appetite such investors have for the asset class and the vast amounts of capital allocated to private equity by these investors. Sovereign wealth funds based in North America, Europe and Africa also invest in private equity, representing 14%, 10% and 10% respectively of all sovereign wealth funds investing in the asset class. Currently, no sovereign wealth funds located in Latin America & Caribbean invest in private equity; however, Fondo de Ahorro de Panamá has reported that it will consider investing in the asset class once its total assets exceed 4% of Panama’s GDP.

Strategy Preferences

Buyout funds remain the most preferred private equity strategy among sovereign wealth funds, with 72% of sovereign wealth funds investing in such funds (Fig. 6). The larger size of buyout funds makes them attractive to sovereign wealth funds, as it allows them to put large amounts of capital to work, while venture capital funds (which draw capital from 65% of sovereign wealth funds) allow for the nurture of domestic enterprise and support the economic development initiatives of the fund. Commitments to venture capital funds are a significant component of BpiFrance’s investment strategy, with known commitments to Europe-focused venture capital vehicles, Fonds Européen des Matériaux and CapAgro Innovation.

Co-Investments and Separate Accounts

Due to their size, many sovereign wealth funds look to alternative routes to the traditional commingled fund model to gain access to the asset class in a bid

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Sovereign Wealth Funds Investing in Private Equity

for lower fees and greater transparency. Nearly half (47%) of sovereign wealth funds investing in private equity are inclined to invest alongside fund managers in co-investment arrangements. Attractive benefits for co-investors include portfolio diversification, exposure to quality private equity assets, the ability to evaluate the risk/return profile of an investment (that is not necessarily available in traditional fund investments), better transparency and mitigation of the J-curve effect as capital is deployed faster.

Separate accounts provide sovereign wealth funds with a number of advantages, offering enhanced transparency in being the sole investor of a fund, having greater control over terms and conditions and the ability to gain exposure to a bespoke product to achieve investment objectives. Alaska Permanent Fund Corporation (APFC) is one such fund that prefers private equity investment through separate account structures; APFC will also co-invest alongside fund managers and invest in fund of funds vehicles.

Regional Preferences

Europe is the most attractive region for sovereign wealth funds gaining exposure to private equity, with 79% investing in the region (Fig. 7). Appetite for Europe-focused private equity opportunities remains ahead of that for North America-focused investment (for which 65% of sovereign wealth funds have indicated a preference). Both Europe and North America accommodate some of the world’s largest and most established private equity fund managers and are the most mature private equity markets globally, thus offering a wide range of attractive strategies and opportunities for investors.

Despite containing some of the largest sovereign wealth funds, just over half of sovereign wealth funds target private equity in the MENA region, trailing emerging markets (for which 60% of sovereign wealth funds have a preference). However, it is worth noting that some sovereign wealth funds in the MENA region pursue direct private equity investment to support domestic, social and economic initiatives.

Outlook

Private equity investment offers diversification within overall investment portfolios, potentially generating substantial returns over the long term without the short-term volatility seen in public markets. Sovereign wealth funds are contributing a growing proportion of total institutional investor capital to private equity, increasing from 9% in January 2013 to 17% in January 2016, suggesting an expanding influence within the asset class. From the perspective of fund managers, securing capital from sovereign wealth funds is an increasingly competitive endeavour, with such investors looking for the best opportunities to deploy capital, showing a healthy appetite for the asset class to achieve their investment objectives.

Data Source:
The 2016 Preqin Sovereign Wealth Fund Review is our largest and most comprehensive review of sovereign wealth funds and their investment activity yet, featuring detailed profiles for 74 sovereign wealth funds worldwide.

For more information, or to order your copy, please visit: www.preqin.com/swf
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