Different animals to deal with

Strategic investment funds offer interesting co-investment opportunities but have their own rules and incentives, according to Georg Inderst

Strategic Investment Funds **Briefing**

A new breed of funds has emerged on the global investment scene: strategic investment funds (SIF). These are state-run funds that combine financial objectives with wider development considerations for the national economy and society. They should also help mobilise more private capital for investment finance, not least from institutional investors.

Therefore, it is useful to learn more about SIFs – or strategic development funds (SDF), as they are often also called. Why they are different from traditional sovereign wealth funds (SWFs)? What are their priorities? What are the implications for other investors?

Some SIFs/SDFs have been in existence for a long time, especially in emerging markets. Prominent examples are Singapore's Temasek (established in 1974) and Malaysia's Khazanah Nasional (1993). More recent initiatives include the Nigeria Infrastructure Fund, a sub-fund of the SWF (2012), FONSIS in Senegal (2012) and a range of other countries.

In the new wave of SIF creation, funds are typically set up in countries with weak public budgets to find alternative ways of strengthening the economy. In Europe, several SIFs were born out of the 2007-09 financial crisis and the eurozone's stagnation:

- French Fonds Stratégique d'Investissement (FSI).
- Italian Fondo Strategico Italiano (FSI).
- Ireland Strategic Investment Fund (ISIF)
- European Fund for Strategic Investments (EFSI).

So far, public attention has focused mainly on the activities of large SWFs, especially from the Middle East and East Asia, which own over 70% of the $7trn (€6.3trn) SWF global assets. Such classic SWFs are well-funded by revenues from natural resources or other export surpluses. Their main objectives are macroeconomic stabilisation and/or savings for future generations. Also, they invest primarily internationally, given the lack of investment opportunities and diversification at home, or for more strategic policy reasons.

In contrast, SIFs/SDFs have a clear domestic focus. Most target investments in key industries, such as infrastructure and innovation, or give support to small and medium-sized enterprises (SME). There are differences in the genesis and sourcing of SIFs.

Of lesser interest here is a first group of traditional, commodity-driven SWFs with some sort of additional domestic goal – for example, in Russia, Kazakhstan or Abu Dhabi.

Secondly, in some countries, governments transfer state-owned enterprises (SOEs) to a fund, aiming for better corporate management or privatisation. In a third group, the source ►

of equity is social security and pension funds.

Singapore's Temasek, for example, was initially mandated to manage a portfolio of SOEs and domestic investments on a commercial basis. It has since turned increasingly into a globally oriented SWF but it still has a domestic allocation of about 30% of the portfolio. The Malaysian Khazanah is asked to restructure government-linked companies and undertake new investments. Over 80% of assets are still in the country, mainly in finance, media and communications, utilities, IT and transportation.

The CDP Quebec (1965) and South Africa's PIC (1911) are rare examples of a public pension fund manager with an explicit mandate to contribute to the domestic economy. The Government Pension Fund Norway (ex National Insurance Scheme Fund, 1967) is constrained to locally listed companies.

The key elements of SIFs are:

- state ownership;
- domestic investment (fully or predominately);
- catalysing private capital ('crowding in') – multiple objectives.

SIFs tend to have double bottom line (that is a target beyond financial performance) or even multiple targets including:

- economic growth, employment;
- social progress (for example, housing, health and education facilities);
- development of strategic industries (for example, transport, energy, technology, resources);
- green, sustainable, climate change investments;
- capital market development;
- competitiveness, external trade.

The new European SIFs are driven by a redirection of economic policy towards higher involvement of private investors – this against the background of chronic public underinvestment and ailing loan markets. However, it is not easy for such funds to achieve significant scale.

The French FSI was created in 2008 as a SWF to support innovative smaller companies with equity in turbulent times. It comprised €14bn of minority stakes held by the French state, plus €6bn of cash injection. Run by the CDC, a public investment group, it held participations in hundreds of smaller companies before being merged into Bpifrance in 2013. The Italian FSI (€4bn) was designed in 2001 to provide capital to companies 'of national interest'. The main owner, the public investment bank CDP, has set up joint ventures with Kuwaiti and Qatari SWFs.

The EFSI initiative itself, announced in 2014 as part of the European Commission's Investment Plan for Europe, is not really a fund but a €16bn guarantee from the EU budget to increase the volume of (higher risk) projects supported by the European Investment Bank and the European Investment Fund. It is expected to attract private investment with a multiplier effect of 15 to 20.

The Irish ISIF is an interesting case, given its size; the discretionary portfolio of €8bn is equivalent to about 4% of GDP. It has as a dual mandate of financial returns and support of economic activity and employment. It was sourced through a transfer of roughly one third of the National Pension Reserve Fund (NPRF) assets. The rest went into the rescue of two major Irish banks.

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Ireland has been explicit about the main parameters for the fund:

- **Double bottom line.** Risk-adjusted investment returns and economic impact in Ireland. NPRF's mostly global, listed asset portfolio is being shifted into strategic domestic assets.
- **Unrestricted investment strategy.** ISIF can use the full range of investment instruments, including private equity. The portfolio benchmark is a rate of return greater than the cost of government debt. It will invest via other funds, directly, and via co-investments.
- **Economic impact.** 80% of the portfolio should over time go to 'high economic impact' investments. The fund focuses on 10 sectors such as food and agriculture, real estate, infrastructure, energy including renewables, emerging technologies and smaller companies. ISIF is required to regularly assess and report on the impact of the fund.

About 5% of assets are invested in infrastructure. It co-operates with the Dutch pension fund PGGM in the N11 public private partnership (PPP) road project, with debt financing from the EIB. In the NTR onshore wind farm portfolio, ISIF is co-invested alongside Strathclyde Pension Fund, Legal & General and other institutions.

Overall, state-run funds all start with the best intentions but face heavy challenges, in particular the risk of political interference, the vagaries of electoral cycles and the tendency to bureaucratisation. This can lead to misallocation of resources or even fund raids. Issues can be even more pronounced for SIFs, given their concentration on domestic markets, such as:

- potentially conflicting multiple objectives;
- the definition and evaluation of the socioeconomic impact;
- the balance of commercial and social returns in individual projects;
- lobbyism by particular companies, industries and regions;
- market distortion and uncompetitive behaviour.

Good governance is paramount, in particular independent boards and commercially-focused management. The question remains whether the usual governance principles are sufficient. Transparency is key, especially since SIFs are to a large extent outside the usual supervisory regimes for institutional investors. On a global perspective, the experience of SIFs has, so far, been mixed.

The involvement of international investors may act as a good discipline. Co-investing is not new to experienced SIFs like Temasek. In future, SIFs can certainly offer more interesting co-operation opportunities for pension funds and other institutional investors. As public funds, they may provide additional projects, local knowledge and, in the best case, also some sort of reassurance. But it needs to be recognised that SIFs are all different animals – with their own rules and incentives.

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