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INFORMATION PAPER 8: MANAGEMENT OF PACIFIC SOVEREIGN WEALTH FUNDS

Purpose and Summary

Purpose

In response to a 2019 FEMM’s request “to undertake a regional analysis on the comparison of the governance, portfolio management and returns of national trust funds, this paper summarises the key findings from the comparison study. It also provides commentary on COVID’s impact on global financial markets and on performance of long-term investment portfolios.

Summary

Pacific funds’ investment outcomes have been quite diverse since their inceptions, and our proposed benchmarking approach helped illuminate the key factors that led to differences in outcomes.

The most significant factor explaining the differences in investment outcomes was the Pacific funds’ investment policies that their respective Boards pursued in achieving their investment objectives. The Pacific funds followed two different approaches with diverging outcomes.: While the traditional *Strategic Asset Allocation* approach delivered long-term value to funds, *Objective Based Asset Allocation* strategy, fell far short of expectations.

Another contributing factor to the returns difference was the Pacific funds’ different approaches to the implementation of their investment strategies and the fees paid to external asset managers. Passive low costs strategies delivered value, while complex expensive strategic underperformed the market and peers.

COVID had short-term impact on funds’ portfolio values at the onset of the pandemic, but global markets recovered in 2020 and portfolios with higher allocation to riskier assets were compensated for the short-term volatility.

A. Overview/Summary

At the 2019 Forum Economic Ministers Meeting (FEMM), Ministers called for improved transparency of the Pacific trust funds' management practices and investment results as a way to foster their improved management going forward: "Forum recognizes the need to undertake regional analysis on the comparison of the governance, portfolio management and returns of national trust funds" and tasked the World Bank to undertake this study. The original Pacific trust fund comparison was prepared in March 2020 at the onset of the global COVID-19 pandemic.

2. This paper summarises the key findings from the comparison study and provides commentary on COVID's impact on global financial market and on performance of long-term investment portfolios.

B. Discussion

3. The objective of this comparative study is to inform policy and decision makers governing these funds, on the impact of their investment governance decisions on the performance of the funds over the medium to long term. This comparative analysis covers five national trust funds and a sovereign wealth fund from the following countries: the Federated States of Micronesia (FSM), the Republic of Kiribati (Kiribati), the Republic of Nauru (Nauru), the Republic of the Marshall Islands (RMI) and Tuvalu as presented in Table 1. The five funds selected for the study are designed as perpetual funds with a common objective of balancing distribution of their income for today's spending while preserving equity across generations. While seen as heterogenous within the Pacific community, from the perspective of publicly managed funds globally, these funds share commonality of their fundamental nature and similarity of their investment approaches providing a sound basis for comparing these funds with each other.

4. Based on the data provided by the funds as of the end of 2019, Figure 1 presents 3- and 5-year returns net of fees¹ and Figure 2 presents fees paid to external managers.² To understand the key factors that contributed to observed differences in Pacific Funds investment outcomes over the period, we evaluated the funds' investment choices along the following parameters. First, we assessed the funds' specific investment strategy decisions against other potential investment strategy choices consistent with their investment authorisations and measure their impact on funds' long-term wealth. Secondly, we reviewed the impact of the funds' decisions with regards to the implementation of their investment policy, notably in relation to the level of active management given to the external fund managers and whether it added value net of cost to funds over time.

5. As evidenced on Figure 1, Pacific funds' investment outcomes have been quite diverse, and our proposed benchmarking approach helped illuminate the key factors that led to differences in outcomes. While direct comparison of the Pacific funds' investment returns is challenging due to the funds' different reporting periods and granularity of the available data, our approach of using reference portfolios calibrated to specific markets and risk levels allows us to infer the implicit investment benchmarks pursued by each funds' in their investment approach and to compare them to the available investment alternatives specific to the funds.³

¹ It is not clear what costs are excluded by different funds, as asset management costs comprise number of categories (see next footnote).

² Total investment management costs include costs of advice, custody, external fund management, internal management and operations, and governance (payments to committee members and travel). As total investment costs are only available from FSM and RMI funds, we are able to present only the costs of external fund management across the Pacific funds included in this study.

³ One of the reasons for the lack of comparative analysis across these Pacific funds has been cited as the Fund's different currencies. We deal with the issue of currencies through the selection of appropriate reference portfolios tailored to each fund circumstances. We also note that fundamentally the different base currency for these funds is not an issue as the investment portfolios of the considered funds are globally diversified.

Figure 1. Pacific Funds 3- and 5- year Net Returns⁴

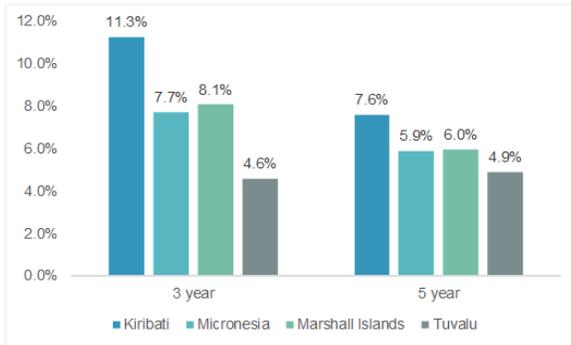
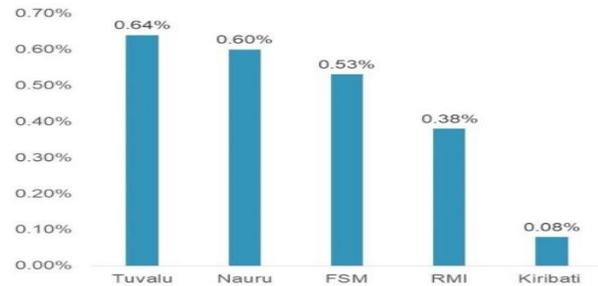


Figure 2. Pacific External Funds Management Costs, 2019



6. The most significant factor explaining the differences in investment outcomes was the Pacific funds’ investment policies that their respective Boards pursued in achieving their investment objectives. The Pacific funds followed two different approaches: a traditional Strategic Asset Allocation (SAA) approach pursued by Kiribati, FSM and RMI and an Objective Based Asset Allocation (OBAA) strategy in the case of Tuvalu. In the traditional SAA approach, the Boards expressed their tolerance for the overall level of risk through an asset allocation mix that was translated into an investment benchmark. In contrast, in the OBAA strategy, which TTF implemented in 2012, the decision on asset allocation was delegated from the Board to the asset managers with the view that the managers were in a better position to anticipate the market movements to deliver superior returns vs. if the Board pursued the traditional asset allocation approach.

7. As summarised in Tables 1, 2 and 3, OBAA returns since inception are comparable to a conservative portfolio and are materially lower than comparable returns of its regional peers, which have delivered returns in line with balanced or growth investment strategies. In fact, if TTF Board had set a simple and easy to implement benchmark of 50% Global Equities and 50% Global Investment Grade Fixed income it would have delivered 10.6% returns vs. OBAA strategy’s 6.1 % since inception. Thus, our analysis revealed that implicit benchmark for the OBAA strategy is a highly conservative investment strategy that the TTF Board could have been pursued by implementing a passive portfolio, e.g. AUD Morningstar Conservative Index⁵ or 80% Fixed Income/20% Global Equity, for a fraction of the cost, as discussed later in the paper. In contrast, the returns of the funds of FSM, RMI and Kiribati pursued an explicit investment growth strategy and these funds implicit benchmarks were in line with having 50%-80% growth assets.

⁴ Tuvalu, Micronesia, and Marshall Islands as of September 30, 2019. Kiribati as of November 30, 2019. Return and other data come from each fund’s respective data and/or reporting sources, including custodian reports, annual reports or other investment management reports. We are not in the position to ensure the accuracy of the data from these reports. However, our benchmarking against reference portfolio constructed from publicly available market indices over respective investment horizons provides satisfactory validation that the return data is representative of the funds’ investment approaches.

⁵ Annex B provides specific details about Morningstar indices that are constructed for different level of risk tolerance and comprise Australian and Global asset classes including cash, fixed income, public equity and listed and unlisted property.

Table 1. TTF's Investment Returns vs Alternatives⁶ vs **Table 2. RERF's Investment Returns vs Alternatives⁷**

	3 year	5 year	Inception (April 2012)
TTF - Tuvalu	4.6%	4.9%	6.1%
AUD Morningstar - Conservative	4.8%	5.1%	5.8%
AUD Morningstar - Moderate	6.1%	6.2%	7.0%
AUD Morningstar - Balanced	8.4%	8.1%	9.1%
AUD Morningstar - Growth	10.0%	9.2%	10.7%
AUD Morningstar - Aggressive	12.0%	10.8%	12.4%
AUD Global Equities 50%/ Fixed Income 50%	9.3%	9.0%	10.6%

	3 year	5 year	Inception (June 1995)
RERF - Kiribati	11.3%	7.6%	6.0%
AUD Morningstar - Conservative	5.5%	4.8%	6.5%
AUD Morningstar - Moderate	6.9%	6.0%	6.8%
AUD Morningstar - Balanced	9.3%	7.9%	7.5%
AUD Morningstar - Growth	11.0%	9.2%	7.8%
AUD Morningstar - Aggressive	13.0%	10.8%	8.0%
AUD Global Equities 50%/ Fixed Income 50%	10.0%	8.7%	7.5%

Table 3. FSM and RMI TF Investment Returns vs. Alternatives⁸

	3 year	5 year	FSM Inception (Sept 2004)	RMI Inception (Oct 2005)
FSM - Micronesia	7.7%	5.9%	5.5%	
RMI - Marshall Islands	8.1%	6.0%		6.0%
USD Diversified Risk 20%	4.8%	4.9%	5.3%	5.0%
USD Diversified Risk 40%	6.0%	5.5%	6.0%	5.6%
USD Diversified Risk 60%	7.0%	6.2%	6.6%	6.1%
USD Diversified Risk 80%	8.1%	6.8%	7.2%	6.4%
USD Global Equities 50%/ Fixed Income 50%	7.1%	5.8%	6.1%	5.7%

8. Another contributing factor to the returns difference was the Pacific funds' different approaches to the implementation of their investment strategies. All examined funds experienced underperformance by their asset managers, which in some cases underperformed their respective benchmarks significantly (e.g. Tuvalu) or suffered outright default (e.g. Kiribati). The level of underperformance was directly related to the level of the investment mandate's complexity and/or degree of allowable active risk. More complex or active mandates require significant in-house skills to implement and monitor on the ongoing basis. As a result of these experiences and in line with trends globally, the Pacific funds in our study, with the exception of Tuvalu, have either moved entirely to passive mandates (e.g. Kiribati) or have been reducing the overall level of active risk for the total portfolios (e.g. FSM and RMI). The level of complexity of the investment mandates is also the main factors explaining the differences in investment costs. For Tuvalu, Nauru, FSM and RMI their higher fees are reflective of their investment in alternative asset classes and/or higher complexity mandates, while Kiribati's low costs reflects fully passive mandates. Furthermore, Kiribati was able to further reduce its managers fees through a competitive RFP process. This is a standard market practice globally, which we believe would bring value to Pacific funds in general.

9. The analysed returns of the Pacific funds were collected before onset of the COVID pandemic, which had significant impact on global markets. In the three weeks from 19 February the US and global stocks dropped by over 30%. It represents the fastest decline of that magnitude ever and long-term investors, including Pacific funds, witnessed a significant drop in the market value of their portfolios as a result. As of May 2021, however, not only those losses were recovered, the risky asset classes have rebounded strongly with portfolios with higher allocation to risky assets were compensated for the short-term volatility experienced during the early stage of the pandemic. Table 4 presents returns of various asset classes across different regions as of May 3, 2021. 2020 was the best performance year for the vast majority of asset classes and the last 12 have seen significant rebound for the stocks across both developed and developing markets and for emerging market debt.

⁶ Differences in reporting cycle dates for the Pacific finds and their different base currencies are the reason for differences in returns of reference portfolios across Tables ES.2, ES.3 and ES.4. Pacific Funds returns are net of fees, while reference portfolios returns are based on index returns. Implementation of reference portfolios could range between several basis points for passive index replication strategies to 30 bps as assumed by NZ Superannuation fund for its reference portfolio.

⁷ Same comment as footnote 6.

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Asset Classes		12 months	2020	3 years	5 years	10 years
Equity (Stocks)	World	49.5%	16.5%	14.5%	14.6%	10.5%
	Europe	44.4%	5.9%	6.9%	9.3%	5.4%
	China	39.1%	29.7%	9.4%	16.7%	7.5%
	Emerging Markets (EM)	50.5%	18.7%	8.2%	12.9%	4.0%
	Frontier Markets	39.8%	1.7%	2.3%	7.7%	4.5%
Fixed Income (Bonds)	Global	0.2%	5.6%	4.6%	3.3%	3.9%
	US Aggregate	-0.2%	7.5%	5.2%	3.2%	3.4%
	G7-hedged (USD)	-2.1%	5.3%	3.9%	2.7%	3.6%
	EM Debt Hard Currency	12.1%	6.5%	5.6%	5.1%	5.5%
	EM Debt Local Currency	9.6%	5.3%	2.8%	3.7%	1.8%

10. Thus, the long-term investors that have stayed the course during COVID have benefited from exposure to risky assets and taking the long view on their investments. As New Zealand’s Superannuation Fund’s 2020 Annual report stated: **“Our key takeaway is that it is a fool’s errand to try to precisely time the economic cycle and the markets”**.

11. Key takeaways for the Pacific funds from this benchmarking study are consistent with best global practices for long-term investors:

- (i) To ensure long-term sustainability of Pacific funds, the investment strategy should reflect the fund’s **investment purpose and long term nature**, which should have in place a well-defined investment governance framework to ensure the strategy is formalised, implemented and monitored in line with global best practices.
- (ii) Investment benchmark, representing replicable strategic asset allocation based on the investment policy, typically accounts for **80 to 90% of the returns** and risk of the portfolio and **trying to time the market movements does not work over investment horizons**.
- (iii) More complex investment approaches and mandates require more sophisticated governance and ongoing efforts to oversee and manage them. Boards should ensure they have the required time, inclination and knowledge to oversee such mandates, which are their **fiduciary responsibility**.
- (iv) **Outsourcing is no substitute for accountability**: Boards have a fiduciary responsibility to the fund’s beneficiaries and are ultimately responsible for investment decisions, including those that are outsourced. As such, they need to ensure ownership of the risks that are being delegated, and ensure robust processes are followed to select and monitor service providers in line with the fund’s needs.
- (v) **High-quality governance of the investment process is critical to long-term success of investment funds**. Statutory governance, i.e. clearly defined rules and investment parameters should be well articulated to provide clarity and accountability to manage the funds. Operational governance, i.e. quality of day to day decision-making and the process of exercising fiduciary responsibility, will directly impact the financial results of the funds. The periodic review of the frameworks should be undertaken by impartial and independent parties to ensure that investment parameters evolve with evolving context.

C. Next Steps

12. Given the importance of Pacific funds to some FEMM members, the management and investment of these funds should be regularly assessed, and best practices and lessons learnt be made available to them to enhance and improve their investment results.

World Bank/Pacific Islands Forum Secretariat
10 June 2021