Invesco Global Sovereign Asset Management Study 2013

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Summary of key themes

1 Global sovereign investor segmentation
Segmenting global sovereign investors using a multi-parameter approach assists in the understanding of government investment objectives.

2 Development sovereigns
Development sovereigns exhibit unique characteristics given their role in fostering growth in the private sector through direct strategic investing.

3 Alternative investing
An increased allocation to alternatives is a widespread trend and can be linked to the use of sophisticated benchmarking strategies.

4 Home-market bias
Changes in geographical allocations and home-market bias are driven by expected future economic growth and potential returns.

5 People and talent
A key focus for sovereign investors is the development and retention of people.

6 Sovereign collaboration
The development of strategic partnerships and collaboration between sovereign investors.

Welcome

As co-chairs of Invesco's Global Sovereign Group, we are delighted to share with you our first report on the sovereign asset management industry worldwide. We have worked with independent strategy consultants NMG to produce a report based on a total of 43 face-to-face interviews with executives, within 37 global sovereign investors.

Sovereign investors have received a higher profile in recent years as they have grown both in size and number. Indeed their role, since the financial crisis, as active investors in Western institutions and their attractiveness for government projects, have brought them further attention.

What's clear is that sovereign investors are likely to take on a major role in shaping the global economy moving forward. With this in mind we've sought to provide unique evidence-based insight on their investment objectives and behaviours across a wide range of topics.

We have developed a framework which aims to group the universe of sovereign investors into four objective-based categories. Throughout the report we use this as one of the key parameters to differentiate sovereigns and understand the key drivers of strategy.

Building on our analysis of development sovereigns from our Middle East study, we explore the dynamics of these investors on a global scale. In addition we discuss the potential for alternative investing by sovereigns and delve further into the concept of home-market bias. We also begin to develop insights about the importance of people within sovereigns through discussions about individual capabilities; and we conclude our report by examining the extent of collaboration amongst sovereigns.

We hope that our first report provides you with a unique insight into these increasingly pivotal state-owned investors. Please do contact one of us if you would like to discuss any of the findings in more detail.

For EMEA and Americas
Nick Tolchard
Head of Invesco Middle East
nick.tolchard@invesco.com
+44 (0)1491 417010

For Asia Pacific
Desmond Ng
CEO, Invesco Greater China
desmond.ng@invesco.com
+852 3128 6129

Nick Tolchard

Desmond Ng

igsams. invesco.com
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Key study regions

- Asia
- Australia
- New Zealand
- US
- Latin America
- Europe
- Africa
- Middle East

1 Global sovereign investor segmentation

Segmenting global sovereign investors using a multi-parameter approach assists in the understanding of government investment objectives.

In our study we define sovereign investors as state-owned investors. This definition is deliberately broad in scope, including standalone Sovereign Wealth Funds (SWFs), state pension funds, Central Banks and government ministries. This scope is important to develop a holistic view of sovereign investors and demonstrate that sovereign entity structure does not correlate directly to underlying investment objectives. For Central Banks, we identify a sub-set of institutions with longer time horizons and a level of equity exposure in their portfolios.

Most analysis of sovereign investors concludes that every sovereign is different. While this is the logical conclusion when you consider that there are so many different parameters influencing behaviour, it makes it difficult to draw out important themes within related groups. In this report, we set out the case for a multi-parameter segmentation model, supported by a strong evidence base across all regions and types of sovereign investor.

In figure 1 we set out a list of 10 factors which sovereign investors cited as key parameters influencing behaviour. We have used respondent feedback to rate each factor on its importance in influencing sovereign investor strategy. Overall, our analysis and respondent feedback suggest that sovereign investor objective is the most important parameter for assessing sovereign strategy followed by region and then by size of fund.

In our discussions with sovereign investors, the history and context of each sovereign is a logical start-point to assess strategy and behaviours. However we have discounted history and context as a key parameter influencing strategy because:

1 It is hard to classify political and economic events into mutually exclusive and collectively exhaustive categories. For example, some events are regional (e.g. Arab Spring in the Middle East) and others are global (e.g. the Global Financial Crisis) so individual sovereigns are influenced by multiple events in different ways.
2 Events create sovereigns or change sovereign investor strategies but do not explain strategy. For example, the Asian Crisis facilitated the set-up of sovereigns in Asia and the Arab Spring caused a shift from investment to development objectives, but neither can explain the underlying portfolio, participation and competitive strategies of different sovereigns.

"We set out the case for a multi-parameter segmentation model supported by a strong evidence base across all regions and types of sovereign investor."

Our study and segmentation models seek to understand the following components of sovereign investor strategy:

Overall strategy
What do sovereign investors want to achieve? How do they measure success and what benchmarks do they use?

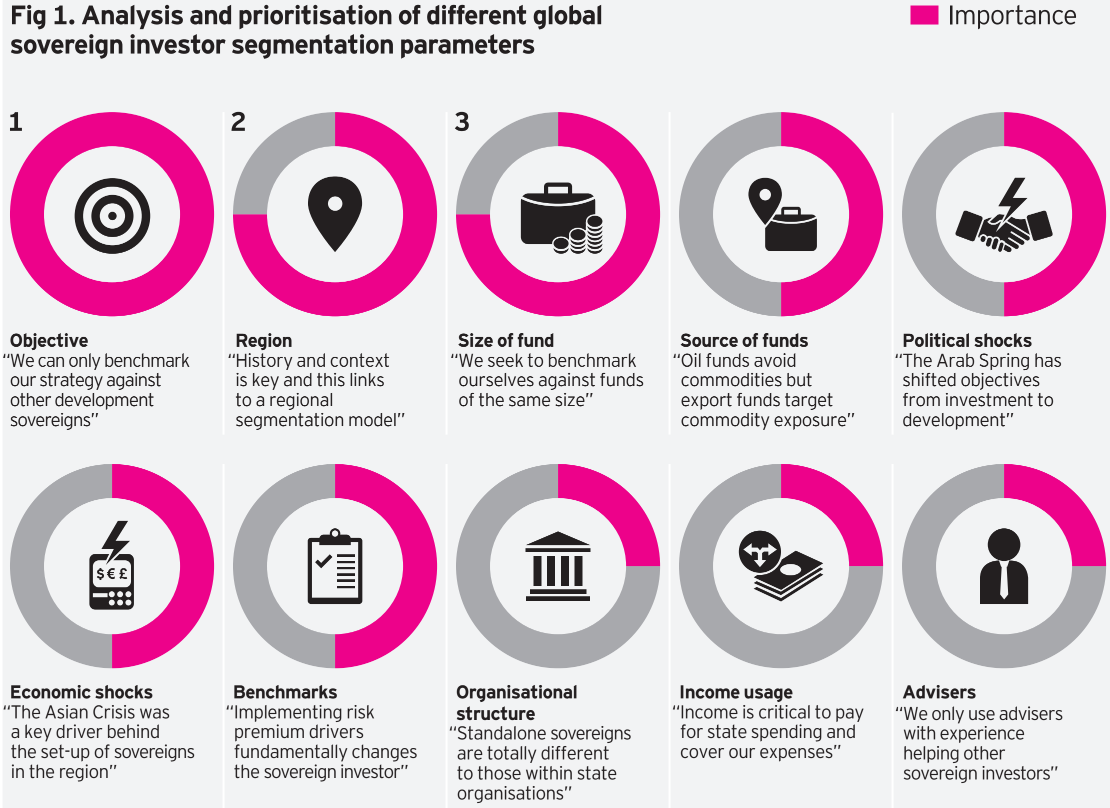
Portfolio strategy
Where do sovereign investors invest? Which geographies, asset classes and products?

Participation strategy
How do sovereign investors invest? Where do they participate along the value chain and which asset classes are managed internally and externally?

Competitive strategy
How do sovereign investors benchmark their performance and how do they differentiate (from other sovereign investors and other institutional investors)?

Organisational strategy
How do sovereign investors organise their business to deliver their portfolio, participation and competitive strategies?

Fig 1. Analysis and prioritisation of different global sovereign investor segmentation parameters



1 Global sovereign investor segmentation

Regional segmentation

Many respondents cited regional differences and we have divided the market into four key regions: the West (Europe, Australia and New Zealand [ANZ] and North America), Asia, the Middle East and Emerging markets. There are cultural similarities between the West, the Middle East and Asia which may influence strategy. There is also strong overlap between region and key parameters such as age of sovereign investor and source of funds. For example the Middle East sovereigns set up shortly after independence and the discovery of oil, while the Asian sovereigns emerged following the Asian Crisis and export-led growth. We have defined the fourth region as Emerging markets because it covers emerging economies which have recently set up sovereigns, including Latin America and Africa.

Size of fund segmentation

Size of fund was also seen as important: it influences all components of strategy. For example, larger sovereign investors struggle to invest in small, illiquid asset classes but are more able to invest in in-house capabilities which require scale efficiencies. Our sovereign investor sample is easily split into four categories based on total assets under management as shown in figure 2.

Sovereign investor objective segmentation

Based on respondent feedback, the most important parameter influencing sovereign investor strategy is the investment objective. In our 2012 and 2013 Middle East Asset Management Studies we distinguished between pure investment and development objectives and developed a framework which classified investment sovereigns into diversification vehicles and asset managers, and development sovereigns into development agencies and policy supporters.

Fig 2. Sample by different sovereign investor segmentations: objective, region, size

Sample size: Figures shown in circles.

Market division for regional segmentation

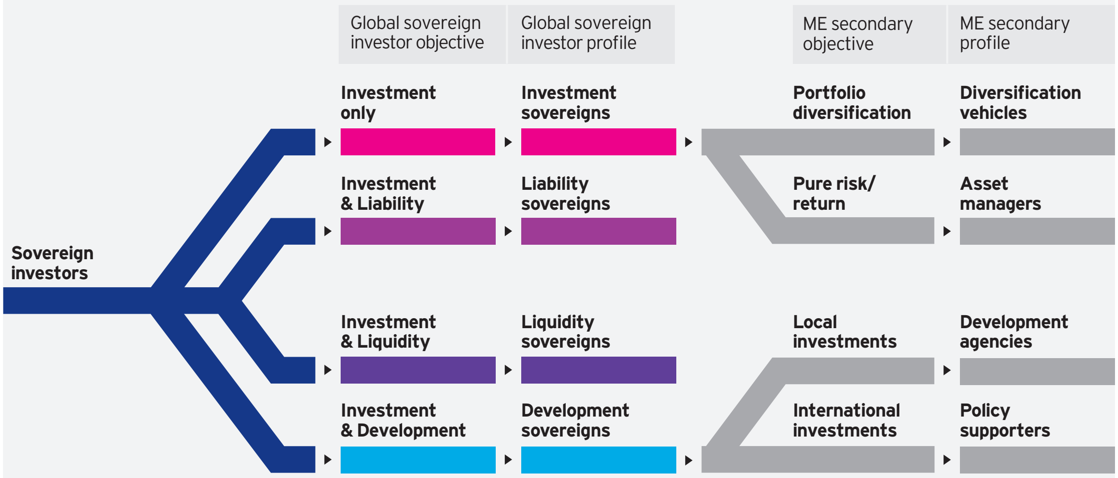
The West

Asia

Middle East

Emerging markets

Fig 3. Comparison of Invesco's global and Middle East sovereign investor frameworks



However, the Middle East framework falls short on a global basis. A number of sovereigns in Latin America and Africa are managed by Central Banks or government entities and have liquidity (or stabilisation) objectives alongside investment objectives. Liquidity objectives could include maintaining currency stability or assisting in the stabilisation of budget shortfalls. As a result, we have developed a separate category called liquidity sovereigns for sovereign investors with both investment and liquidity objectives.

In Western markets the primary sovereign investors are state pension funds. Many of these funds do not have the same defined liabilities as private sector pension funds because they fund a small percentage of the overall liability. However in all cases these sovereign investors have some form of defined or undefined income requirement. We define these funds as liability sovereigns with investment and liability objectives.

In figure 3, we present Invesco's global sovereign investor framework by sovereign investor objective and we highlight the evolution from our Middle East (ME) model. In figure 2, we set out three core segmentation parameters and demonstrate that the sample splits into four different categories for each parameter.

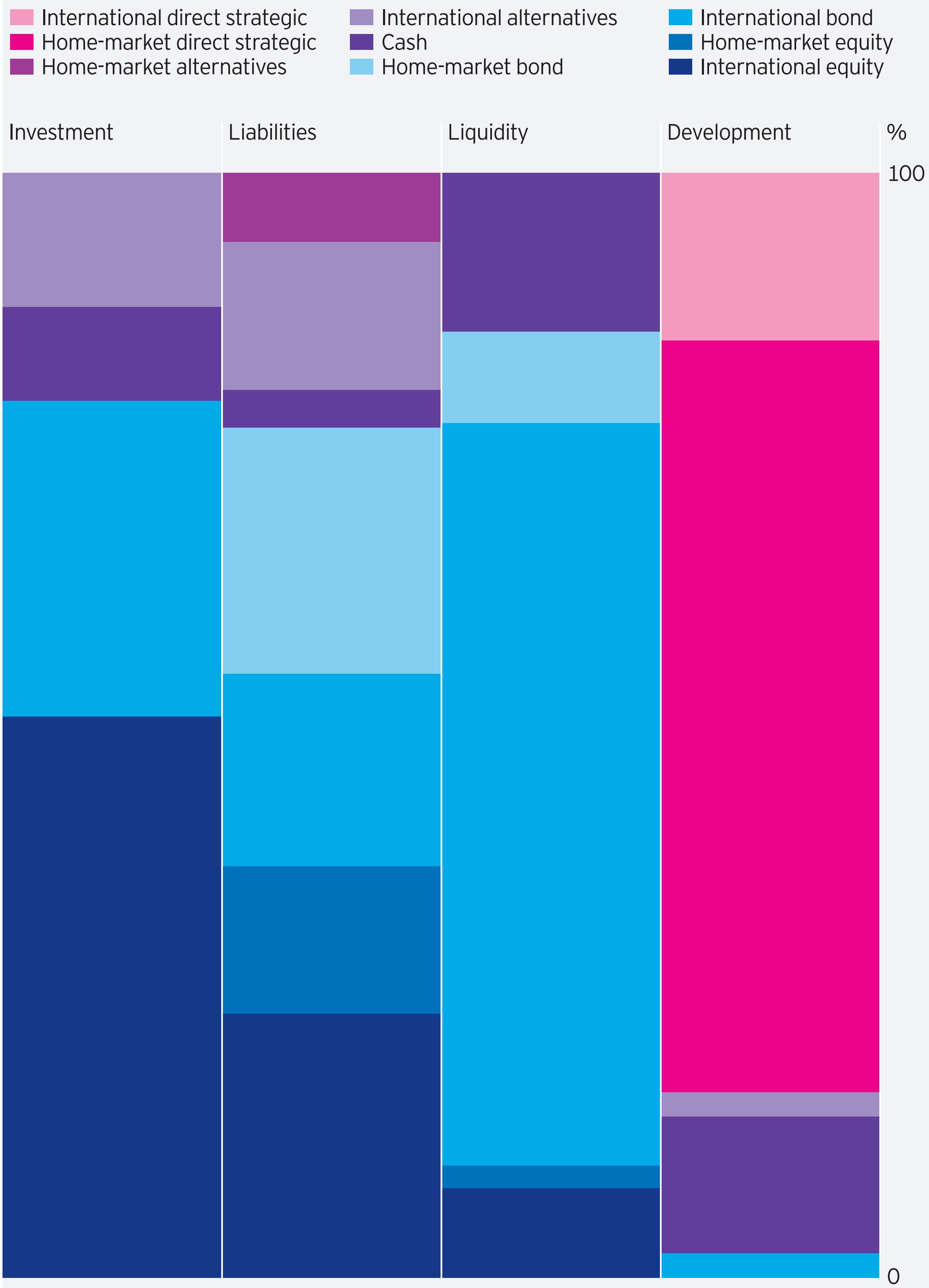
"However, the Middle East framework falls short on a global basis. A number of sovereigns in Latin America and Africa are managed by Central Banks or government entities and have liquidity (or stabilisation) objectives alongside investment objectives."

We can support the hypothesis that sovereign investor objective is the key parameter by analysing asset allocations by objective in figure 4. Investment sovereigns have a bias to international equities, liability sovereigns invest across asset classes, liquidity sovereigns focus on fixed income and development sovereigns adopt a non-conventional investment approach, (as discussed further in theme 2).

This analysis highlights some differences but does not explain why they arise. In the remainder of the report we will explain the key similarities and differences in sovereign investor strategy by considering our three primary segmentation models and the following topics:
– Development sovereigns and direct strategic investing
– How significant could the shift to alternatives be within sovereign investors?
– Geographic allocations and the drivers of home-market bias in sovereign investing
– The importance of people within sovereign investor organisations
– Increasing levels of collaboration between sovereign investors.

"Investment sovereigns have a bias to international equities, liability sovereigns invest across asset classes, liquidity sovereigns focus on fixed income and development sovereigns adopt a non-conventional investment approach."

Fig 4. Total asset allocations by sovereign investor objective (%)



Average allocations across segments, results not weighted by FUM.
Note: 'Direct strategic' investments are defined in further detail in theme 2.
Sample size: Investment (7), Liabilities (12), Liquidity (10), Development (9).

2 Development sovereigns

Development sovereigns exhibit unique characteristics given their role in fostering growth in the private sector through direct strategic investing.

"The primary objective for development sovereigns is to support the development of their country by providing a commercially minded state investment partner for private sector (typically international) firms."

The primary objective for development sovereigns is to support the development of their country by providing a commercially minded state investment partner for private sector (typically international) firms. To achieve this, development sovereigns seek partnerships which deliver a commercial return (for them and their partners) and promote economic growth, employment and skills development in their own country.

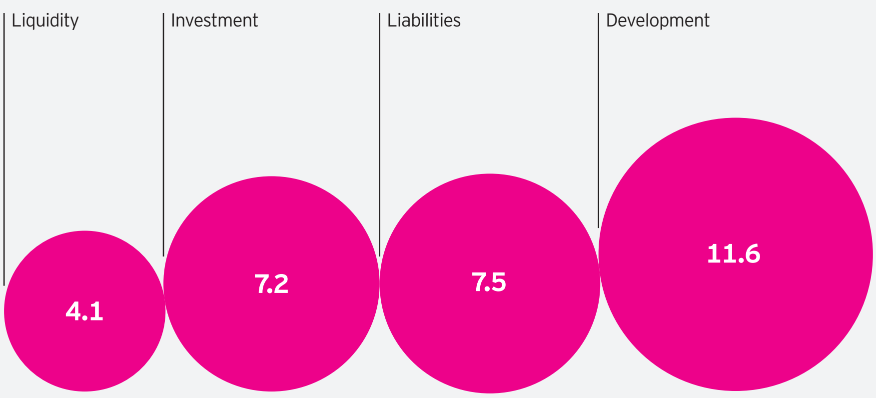
A key difference between development and non-development sovereigns is risk appetite (measured as target return). The results in figure 5 demonstrate the difference in annual target returns. Investment, liability and liquidity sovereigns all have single-digit average annual target returns, compared to 11.6% for development sovereigns. However, there are more strategic differences than target return. We will provide a structured analysis of development sovereigns, starting with their objectives and benchmarks before considering portfolio, participation, competitive and organisational strategy in turn.

Development sovereigns assess their performance against investment hurdle rates (target returns) and specific development (or socio-economic) benefits. It is appropriate to refer to these socio-economic benefits as benchmarks, although they are very different to investment strategy benchmarks that we discuss in theme 3.

11.6%

Investment, liability and liquidity sovereigns all have single-digit average annual target returns compared to 11.6% for development sovereigns

Fig 5. Average annual target return (%) by sovereign investor objective



Average calculated as weighted mid-point between target return categories.
Sample size: Liquidity (10), Investment (7), Liabilities (12), Development (9).

Figure 6 shows the socio-economic benchmarks used by development sovereigns and the corresponding importance of the three key measures: GDP, jobs and skills transfer. In aggregate, job creation was the most important socio-economic benefit with a score of 6.4 out of 10. You can also observe a wide range of benchmarks such as middle market wage growth and private sector investment which are specific to individual sovereigns.

We observe that investment hurdle rates (target returns) and development benchmarks vary by country and region depending on the sovereign's ability to deliver commercial outcomes for partners and the importance of different development benchmarks. When you consider sovereign investors on a global basis respondents in the Middle East and Western markets were quick to identify Asian development sovereigns as the leaders in this field in terms of performance, track record and capability. Figure 7 shows the variance in target return by development sovereign (defined as the difference between target return and the lowest acceptable return for projects with the highest socio-economic benefits) and highlights the differences across the regions. You can observe Asian sovereigns are the most commercial and the least willing to accept lower returns in order to meet their objectives, with 3% being the largest variance between target return and the lowest acceptable return for any Asian sovereign. In contrast, Middle East sovereigns are willing (often in exceptional circumstances) to sacrifice return to execute a partnership and a variance of 10% was observed for two separate sovereign investors.

Development objectives have important implications for all other components of sovereign investor strategy. An emphasis on local partnerships indicates a portfolio strategy with a strong home-market bias and a competitive strategy linked to knowledge of the local business environment. But how would you describe investments in terms of asset class, product and participation strategy (defined in this case as the sovereign's appetite to invest directly or use third-parties)?

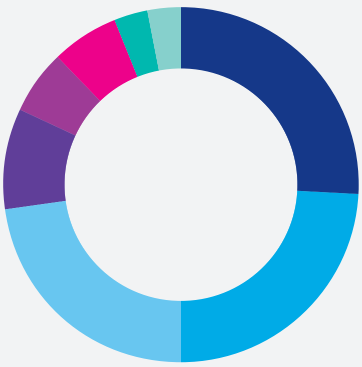
6.4

In aggregate, job creation was the most important socio-economic benefit with a score of 6.4 out of 10

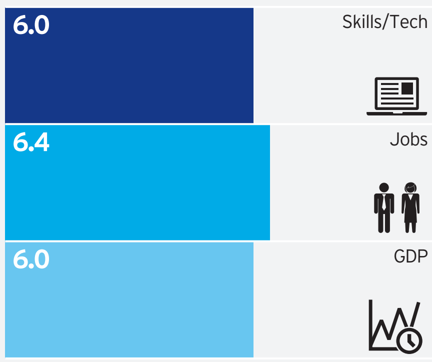
Fig 6. Range (%) and importance of different development benchmarks

Skills/Tech	26	Economic diversification	6
Jobs	24	Middle market wages	6
GDP	23	Capital markets	3
Private investment	9	Energy supply	3

Citations



Importance[1]



[1]Importance rated on a score from 1 to 10 where 10 = most important.
Sample size: Citations (9), Importance: Skills/Tech (9), Jobs (8), GDP (8).

"Asian sovereigns are the most commercial and the least willing to accept lower returns in order to meet their objectives."

We have previously classified (in the Invesco Middle East Asset Management Study 2013) the majority of development sovereign investments as local equity or private equity investments. However in this study we have adopted a separate term to differentiate these investments from other sovereign investor profiles. Creating a separate category is useful because it avoids high allocations to private equity across the total sovereign investor sample. It should also prevent large year-on-year changes in allocations to local equity versus private equity which may occur if a development sovereign invests primarily in local (listed) equity in one year and then invests primarily in local private equity the next year.

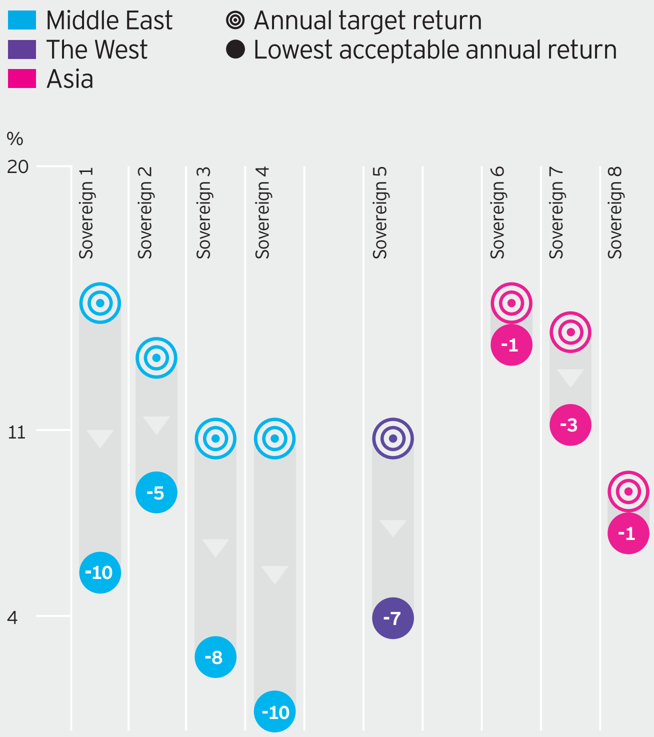
For these reasons, we use the term 'direct strategic investing' to refer to any investment made by a development sovereign with development objectives. 'Direct' captures the active nature of the investment in terms of how the investment is made (direct not via funds) and the active management of these stakes required to deliver the desired development outcomes. 'Strategic' explains portfolio strategy in more detail: development sovereigns identify industries where they believe the country can build competitive advantage (e.g. petro-chemicals or tourism) and then seek partnerships with private sector firms in these sectors.

In figure 8, we have presented our high-level analysis of portfolio strategy (asset allocation and geographic allocation) and participation strategy (in-house versus external management) for development sovereigns. The emphasis on local markets is consistent with socio-economic objectives but we also observe that some development sovereigns target international markets as a way of acquiring or deploying skills or building relationships with international partners. We also note that the majority of investments which are not classified as direct strategic investments are allocated to cash. The high allocations to cash are consistent with a deal-driven approach: development sovereigns need large cash holdings to move quickly and take advantage of any potential partnerships.

Definition of direct strategic investing

For the purpose of this report we define direct strategic investing as any investment made by a development sovereign with development objectives. In most cases, these investments will seek to promote GDP or jobs within a country or skill transfers to a country via partnerships with private sector firms

Fig 7. Annual target returns (and variance) for each development sovereign (%)



The figures in the circles represent the variance between the annual target return and the lowest acceptable annual return.
Sample size: 8.

Fig 8. Analysis of portfolio and participation strategy for development sovereigns (%)

Average allocations across segments, results not weighted by FUM.
Sample size: 9.

The implications of development sovereign portfolio and participation strategy for organisational strategy and competitive strategy are significant. Development sovereigns need to organise around sectors rather than asset classes or risk premium drivers as per non-development sovereigns. Often there will be a high-level split between service, retail and manufacturing and then a more granular segmentation by specific industry.

To analyse the impact on competitive strategy, we turn to the analysis in figure 9. We have presented key capabilities cited by development sovereigns, and the respondent's view of their current performance for each capability. Where importance exceeds performance we define the difference as the capability 'gap' and where performance exceeds importance we define the difference as a capability 'asset'. The largest gaps exist for 'direct strategic investing', followed by 'people and talent'. 'Risk management' and 'use of consultants' have smaller capability gaps.

Many of these sovereign investors are in the early phases of development. The gaps they cited within their investment process are supported by the results for 'direct strategic investing' in figure 9. Respondents articulated a three-step process for a development sovereign to execute direct strategic investments.

Respondents expected gaps in the deal execution process to be filled by independent business consultants (not asset consultants) and we highlight the importance of using consultants in figure 9. However sovereign investors expected on-going strategy development and the process for managing investments to be run in-house, and most new sovereigns planned significant investment in staff with expertise in these areas.

In summary, development sovereigns are of particular interest because respondents expect a number of new development sovereigns to set up in the future. The concept has been well established in Asia but only recently replicated in the Middle East and Europe. Because more countries in different regions plan to set up funds, development sovereigns could become a global phenomenon. We believe there could be an investment case for every country (irrespective of region or development phase) to set up a development sovereign to facilitate private investment via a commercially minded state investment vehicle.

The three-step process

1

Strategy development: identification of strategic industries where the country can build competitive advantage

2

Deal execution: analysis and completion of specific partnership opportunities with private companies in each sector

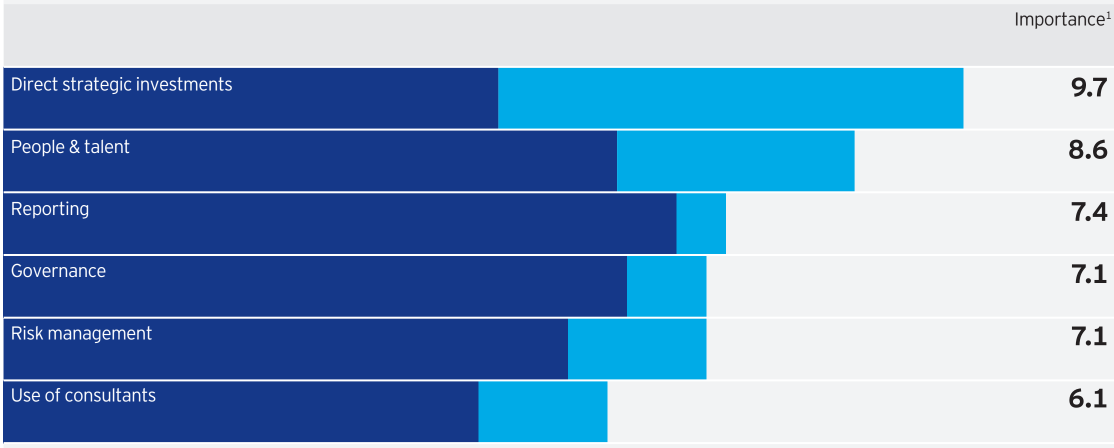
3

Management: on-going management of partnership investments usually via Board representation

> "We believe there could be an investment case for every country (irrespective of region or development phase) to set up a development sovereign."

Fig 9. Analysis of the key development sovereign capabilities (importance and performance)

Capability performance
Capability gap



[1]Importance and strength rated on a score from 1 to 10 where 10 = most important.
Capability gap is calculated as the difference between capability importance and capability performance.
Sample size: Direct strategic investments (3), People & talent (7), Reporting (8), Governance (8), Risk management (8), Use of consultants (8).

3 Alternative investing

An increased allocation to alternatives is a widespread trend and can be linked to the use of sophisticated benchmarking strategies.

The recent growth in allocations to alternatives within sovereign and institutional investor segments in the last 12 to 24 months has been well documented. In this theme we will consider investment strategy benchmarks, future allocations to individual asset classes and the key drivers of growth to assess how significant the shift to alternatives could be in the future. We will focus our analysis on investment, liability and liquidity sovereigns. Development sovereigns are excluded because we recognise that they have different investment strategies which can obscure trends within other sovereign investor profiles.

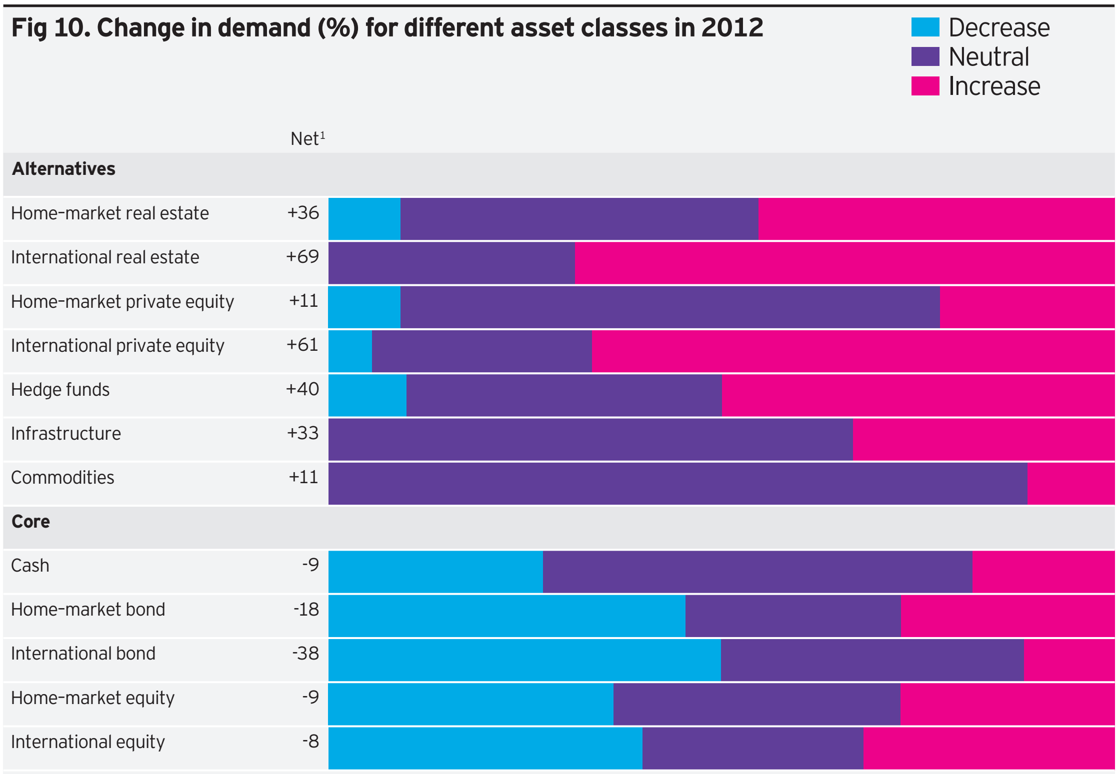
Figure 10 shows the change in demand for individual asset classes across non-development sovereigns and validates the overall trend towards alternatives (defined as private equity, real estate, infrastructure, hedge funds and commodities) and away from core asset classes (defined as equities, bonds and cash). For example, 69% of sovereign investors cited growth in international real estate and 61% cited growth in international private equity in the last 12 months relative to their total portfolio.

This trend was justified by considering the attractiveness of traditional asset classes. Respondents observed high volatility in equities and market-wide dissatisfaction with the risk/return profile of equity investing. Furthermore, a low interest rate environment challenges fixed income returns and encourages sovereign investors to consider alternative asset classes for growth. Analysis of sovereign investor target returns by asset class also supports the shift to alternatives. Figure 11 sets out expected target returns for each asset class and shows that respondents expect the highest returns from alternatives, as well as additional diversification benefits.

69%

Percentage of sovereign investors that cited growth in international real estate in the last 12 months relative to their total portfolio

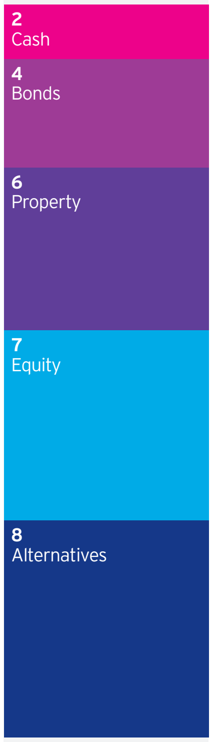
Fig 10. Change in demand (%) for different asset classes in 2012



[1]Net respondent view is the % increase citations less % decrease citations. Analysis shown for non-development sovereigns only.
Sample size: Home-market real estate (11), International real estate (16), Home-market private equity (9), International private equity (18), Hedge funds (10), Infrastructure (10), Commodities (9), Cash (22), Home-market bond (11), International bond (26), Home-market equity (11), International equity (25).

"Respondents observed high volatility in equities and market-wide dissatisfaction with the risk/return profile of equity investing."

Fig 11. Average expected annual target returns (%) for different asset classes



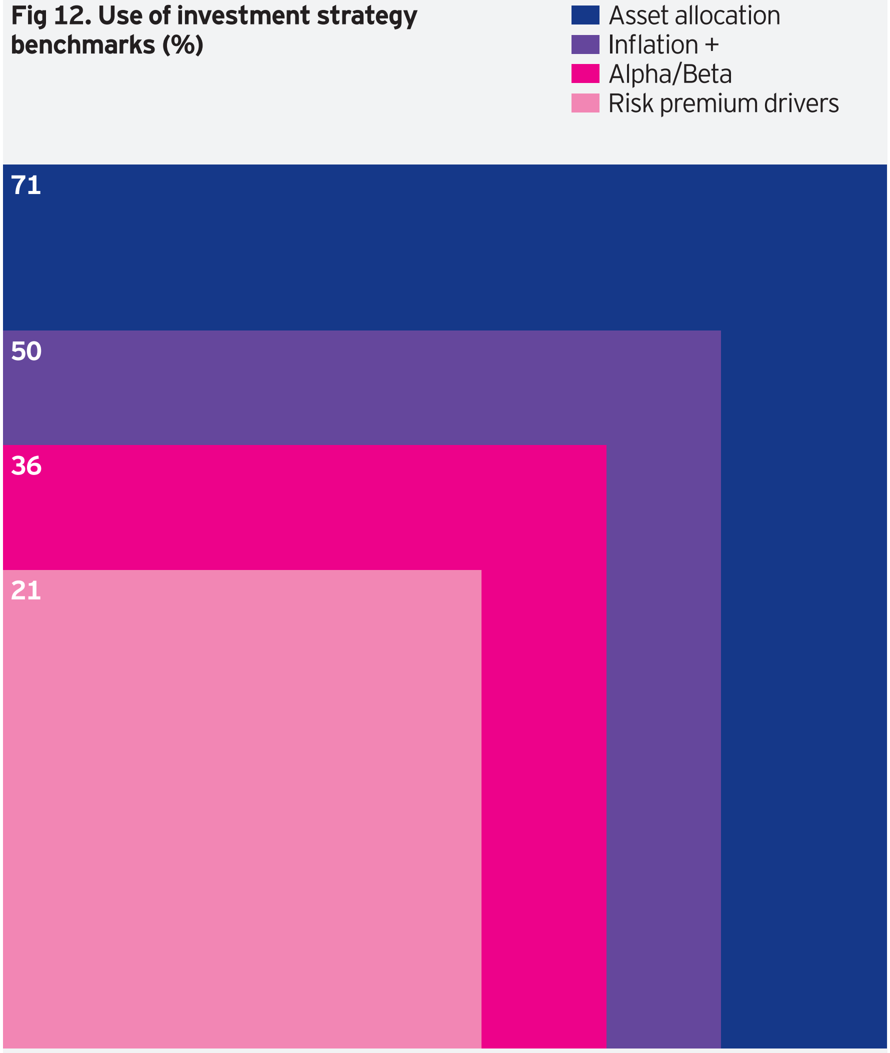
Analysis shown for non-development sovereigns only. Sample size: Cash (10), Bonds (10), Property (8), Equity (10), Alternatives (8).

However, many respondents believed that there were more structural, longer term reasons for increasing alternative allocations linked to changes in investment strategy. Figure 12 shows the use of different investment strategy benchmarks across sovereign investors in our study. We note that asset allocation benchmarks dominate in terms of usage, but many respondents cite increasing emphasis on an alpha/beta approach, inflation plus targets and risk premium drivers.

Risk premium drivers were of particular interest across the sample, even where sovereign investors did not use specific risk premium benchmarks. In total, 21% of sovereign investors used risk premium drivers but only a small group of Western liability sovereigns had fully adopted risk premium drivers as their primary benchmark. Where sovereign investors adopt risk premium drivers such as growth, inflation, credit and liquidity, they have higher allocations to alternatives. This is because alternative assets are often perceived as a way to achieve exposure to many of these drivers, such as property for liquidity and commodities for inflation. Respondents expect more sovereign investors to implement a risk premium approach and, as a result, one would expect allocations to alternatives to increase further.

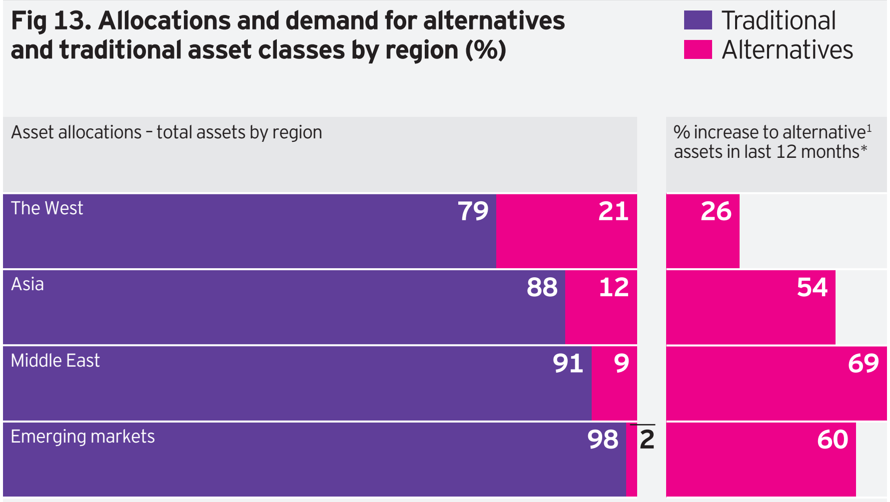
Definition of risk premium drivers
For the purpose of this report we define a risk premium driver approach as an investment strategy which benchmarks the portfolio against risk premium such as growth, inflation and liquidity

Fig 12. Use of investment strategy benchmarks (%)



Percentages based on number of respondents. Excludes 'Other'.
Analysis shown for non-development sovereigns only.
Sample size: 28.

Fig 13. Allocations and demand for alternatives and traditional asset classes by region (%)



[1]Alternative includes international and local private equity, real estate, hedge funds, infrastructure and commodities. Average allocations across segments, results not weighted by FUM. *Net respondent view. Analysis shown for non-development sovereigns only.
Sample size: The West (10), Asia (6), Middle East (4), Emerging markets (9).

21%

Percentage of all portfolio assets non-development Western sovereigns allocate to alternatives

Analysis of alternative asset portfolios and new placements by region also highlights the potential growth in demand for alternatives. Figure 13 shows that non-development Western sovereigns allocate 21% of all portfolio assets to alternatives (including property) while those across Asia, the Middle East and Emerging markets have much lower allocations to alternatives. However, more Asian and Middle Eastern sovereigns have increased new allocations to alternatives and anecdotal feedback suggests that some of these sovereign investors are contemplating a move to alternative programmes more aligned to Western peers. When you consider that the vast majority of sovereign investor assets are managed by sovereigns in Asia and the Middle East, the growth in sovereign alternative investments could be substantial.

Analysis by region works well in highlighting differences in alternative exposures, but analysis by sovereign investor objective or size of fund provides further details on alternative preferences. Positive attitudes to alternatives are broadly consistent between investment and liability sovereigns but liquidity sovereigns are less positive. Many liquidity sovereigns are in the process of increasing equity allocations from a low base and need to develop a decent track record in equities before gaining confidence and Board support for an alternatives programme. Looking at the impact of size, many of the largest sovereigns are struggling to meet asset allocation targets for alternatives. This is because increasing exposure to real estate, infrastructure or private equity by a percentage point in the portfolio translates into extremely large increases in new investment allocations. Many of the largest sovereigns in Asia and Middle East predict it could take years rather than months to reach the existing targets, and these targets remain lower than the benchmarks adopted by many Western sovereigns.

"Where sovereign investors adopt risk premium drivers such as growth, inflation, credit and liquidity, they have higher allocations to alternatives."

Overall these findings indicate that the outlook for investment providers specialising in alternatives could be positive. However, as demand for alternatives grows, we observe a preference for in-house and co-investment structures rather than investment via funds, and our global analysis validates this finding. For example, 21% of private equity assets are currently placed in co-investment structures, compared to a target (future) allocation of 27%.

Figure 14 shows the change in demand (in 2012) for in-house versus external management for different asset classes split into home-market and international regions. For traditional asset classes, sovereigns appear to be comfortable with their current balance of internal and external investing. However, for alternative investments there is demand to manage more in-house. International alternatives show the strongest demand, with a net respondent view of 36% supporting more in-house investing. For home-market alternative investments, the trend towards internal management is much weaker as home-market investments in property, infrastructure and private equity are already predominantly managed internally. Sovereigns have brought these investments in-house because it is easier to build knowledge and investment expertise in their home-market.

In conclusion, there are both temporary and structural factors driving the growth of alternatives for sovereign investors and the structural factors make this theme particularly important. For the asset management industry, this presents an opportunity to export its international capabilities even if providers are forced to manage a difficult trade-off between volume and margin as demand for co-investment and internal investment increases.

Definition of private equity models

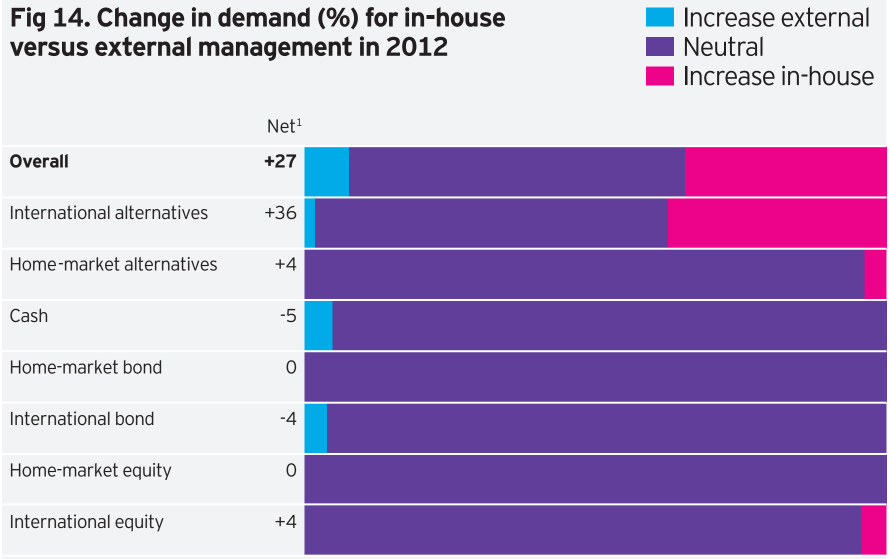
There are three high-level models for private equity investing:

1
Investment into private equity funds

2
Co-investment alongside private equity funds

3
Direct investment independent from other private equity investors

Fig 14. Change in demand (%) for in-house versus external management in 2012



[1]Net respondent view is the % increase citations less % decrease citations.
Analysis shown for non-development sovereigns only.
Sample size: Overall (26), International alternatives (19), Home-market alternatives (10), Cash (21), Home-market bond (10), International bond (26), Home-market equity (10), International equity (23).

"Many of the largest sovereigns are struggling to meet asset allocation targets for alternatives."

Preference for in-house and co-investment structures

21%

Current allocation of private equity assets placed in co-investment structures

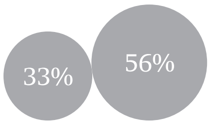
27%

Target (future) allocation of private equity assets for co-investment

4 Home-market bias

Changes in geographical allocations and home-market bias are driven by expected future economic growth and potential returns.

The size and scope of geographic allocations by sovereign investors can have a meaningful impact on economic growth, capital markets and the asset management community. Their role in supporting governments and key private sector institutions during the Global Financial Crisis (GFC) and the polarised view of different governments towards the attractiveness of sovereign investor investment are of particular interest. In this theme we will consider the drivers of geographic exposures at a portfolio level and for new asset placements across our sovereign investor segments.



US allocations account for 33% of all assets and in total developed markets account for 56%

At a portfolio level, geographic allocations are concentrated towards the United States (US) and other developed markets, particularly compared to a GDP-weighted index. US allocations account for 33% of all assets and in total developed markets (defined as US, Canada, Europe ex-Central Eastern Europe (CEE), Japan and ANZ) account for 56%. Respondent feedback suggests that these allocations are driven by two factors:

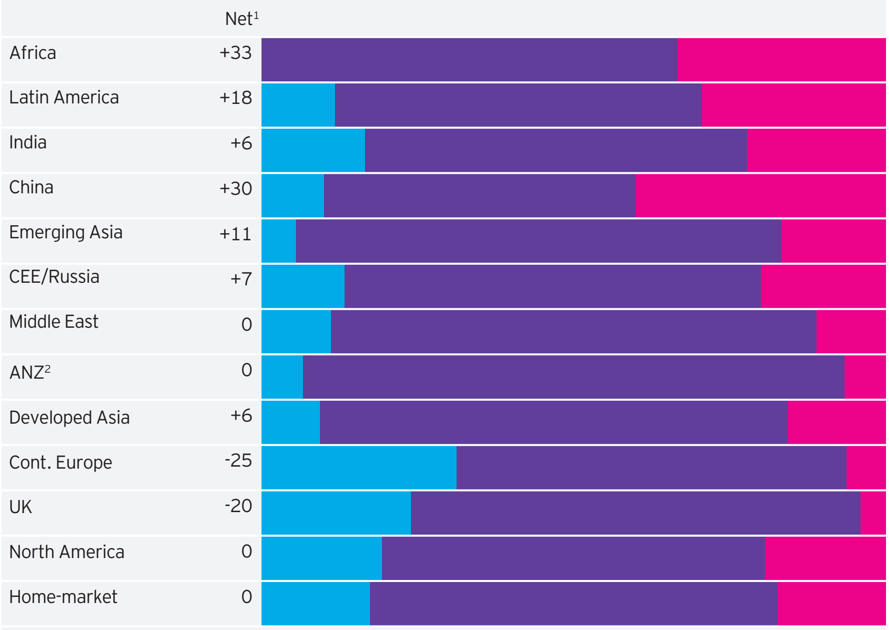
1. A strong bias to the US for liquid investments such as Treasuries due to the United States' role as the world's reserve currency and as the currency peg for some countries.
2. A broader bias towards developed markets due to a relatively conservative risk appetite, a lack of capacity in emerging markets and an ability to achieve emerging market equity exposure via developed market stocks.

This portfolio-level context is important. Although overall portfolios remain strongly oriented towards developed markets, sovereign investors cite a significant increase in new emerging market placements relative to their total portfolio, notably for China and Africa (figure 15). Many sovereign investors also explained that they would need many years of above-average allocations to emerging markets to reach a GDP-weighted exposure, even after allowing for indirect exposure via international stocks. The primary driver for increasing emerging market exposure was the desire to maintain and improve portfolio diversification, re-balancing the portfolio towards GDP and future drivers of economic growth. This also explains why allocations to North America, ANZ and Developed Asia in figure 15 were neutral on a net respondent view basis while allocations to the UK and Continental Europe (where economies have been struggling most) were negative on the same basis.

"The primary driver for increasing emerging market exposure was the desire to maintain and improve portfolio diversification, re-balancing the portfolio towards GDP and future drivers of economic growth."

Fig 15. Change in demand (%) in geographic allocations in 2012

Decrease
Neutral
Increase



[1]Net respondent view is the % increase citations less % decrease citations.
[2]ANZ includes Australia and New Zealand.
Sample size: Africa (12), Latin America (17), India (18), China (20), Emerging Asia (18), CEE/Russia (15), Middle East (9), ANZ (15), Developed Asia (32), Cont. Europe (32), UK (25), North America (31), Home-market (23).

One important feature of our analysis by region is that we split out home-market allocations as a separate category. This is important because the size of home-market allocations varies significantly by sovereign and can obscure trends in international allocations. Across retail and institutional markets, we consider the concept of home-market bias of particular interest to the asset management industry for two main reasons:

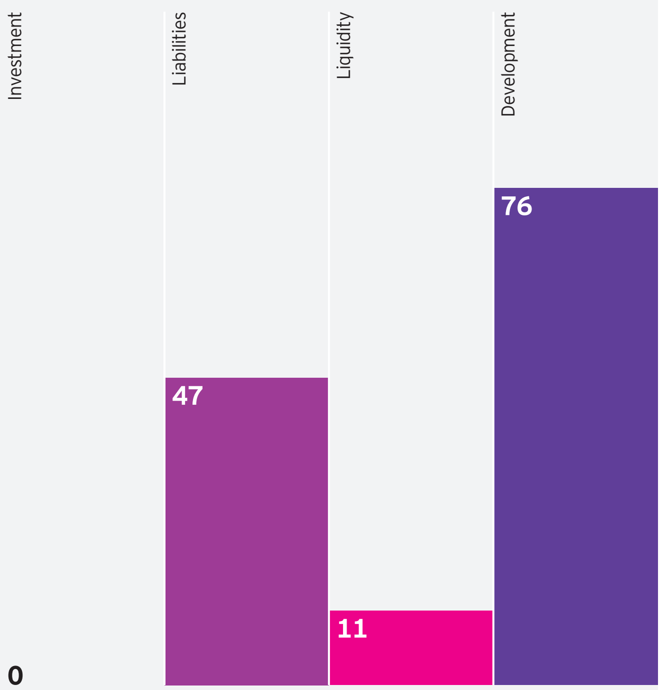
1. Variation and volatility: different retail and institutional investor segments have varying strategies for home-market investing and allocations are highly dependent on macro factors such as interest rates and currencies which vary considerably year-on-year.
2. Contestability: the dynamic between local and international investment influences the contestable market for asset managers and this is particularly true in key sovereign investor markets where few international players have local asset management capability.

We define 'home-market bias' as excess allocations to the home-market compared to a peer group or global benchmark. However, because many sovereigns are located in markets with very limited or zero allocations within international indices, we have decided to adopt a straightforward approach and focus primarily on home-market allocations, as well as home-market bias.

There are major differences in home-market allocations for each sovereign investor profile, as illustrated in figures 16 and 17, and these differences further validate the use of sovereign investor objective as a segmentation parameter. We observe that development and investment sovereigns are at opposite ends of the spectrum, with extremely high allocations to home-markets for development sovereigns and very limited (or zero) home-market allocations for investment sovereigns. We explained development sovereign behaviour in theme 2 and noted that development objectives naturally focus funds on local or home-market investments. Limited (or zero) home-market allocations by investment sovereigns can be explained by their desire to diversify and preserve investments for future generations. Some investment sovereigns explicitly restrict local investments within their mandate and governments create different sovereign investors with objectives focused on their home-market.

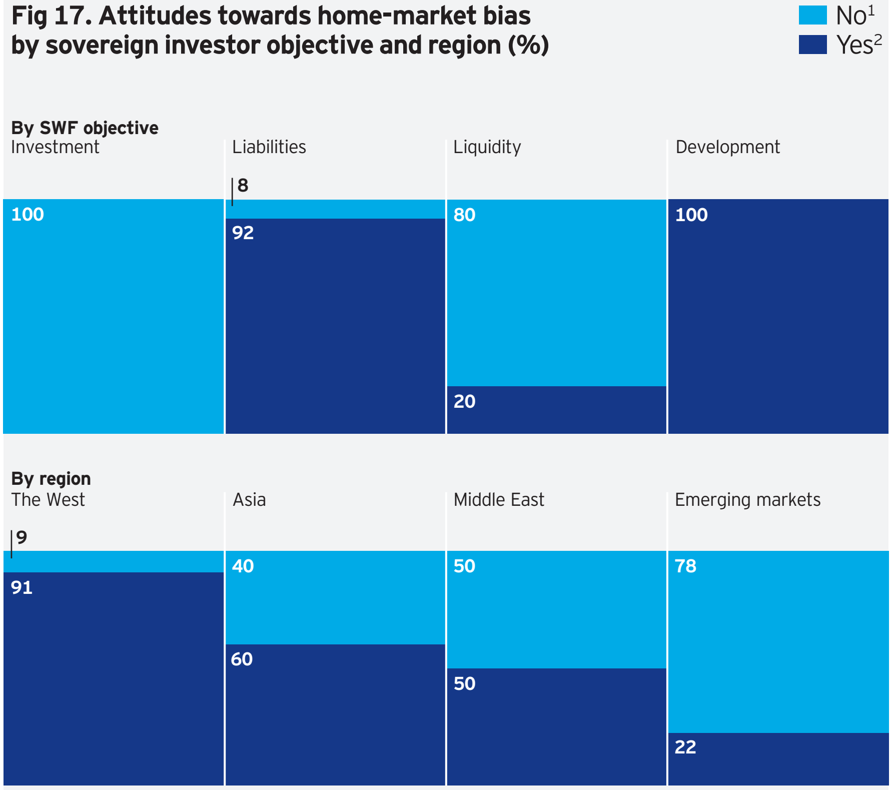
"Development and investment sovereigns are at opposite ends of the spectrum, with extremely high allocations to home-markets for development sovereigns and very limited (or zero) home-market allocations for investment sovereigns."

Fig 16. Total home-market asset allocations by sovereign investor objective (%)



Sample size: Investment (7), Liabilities (12), Liquidity (10), Development (9).

Fig 17. Attitudes towards home-market bias by sovereign investor objective and region (%)



[1]No – we allocate fewer assets to home-market (than the global MSCI).
[2]Yes – we allocate more assets to our home-market (than the global MSCI).
Sample size: By SWF objective: Investment (7), Liabilities (12), Liquidity (10), Development (9);
By region: The West (11), Asia (10), Middle East (8), Emerging markets (9).

"Liquidity and liability sovereigns sit between investment and development sovereigns, with 11% and 47% respectively allocated to home-markets."

Liquidity and liability sovereigns sit between investment and development sovereigns, with 11% and 47% respectively allocated to home-markets. Relatively low allocations for liquidity sovereigns are consistent with their stabilisation objectives: in the event of a crisis, highly liquid foreign assets could be used to support the exchange rate and stimulate demand in the economy. Most of the Latin American liquidity sovereigns framed this discussion by citing Dutch Disease. This theory suggests that increasing domestic revenues from natural resources (or foreign aid or any other surge in foreign investment) strengthens the local currency and thus reduces the competitiveness of exports. Because Latin American governments are concerned by Dutch Disease, they plan to divert excess revenues from major natural resource discoveries towards international investments via sovereign investors. This prevents the currency strengthening which could damage exports and potentially increase unemployment in the manufacturing sector.

Home-market allocations for liability sovereigns were the most polarised and most complex to explain. Relatively high allocations to home-markets are consistent with the desire to match liabilities denominated in local currency but this was not the only factor. Figure 18 shows the drivers of home-market bias and links citations to different sovereign investor objectives. The graphic shows that liability sovereigns cite asset liability management (ALM) and currency, competitive advantage and shareholder protection as key drivers.

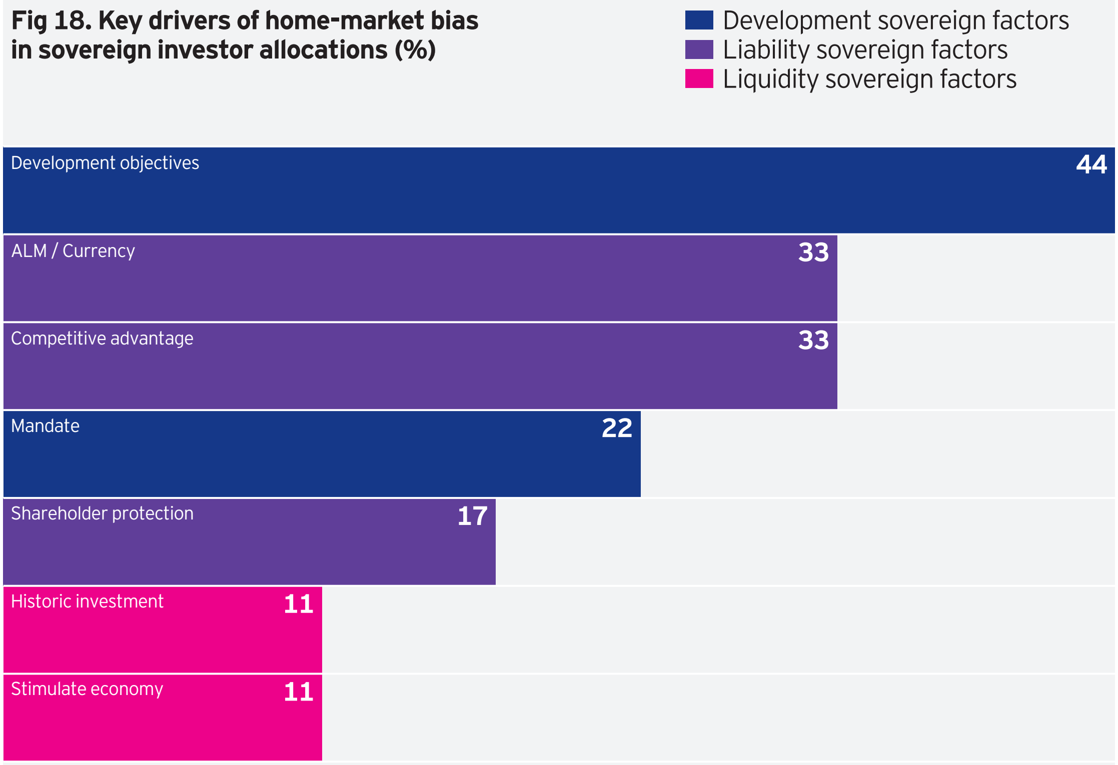
Competitive advantage is the ability to differentiate from other investors and as a result outperform on investment returns. Many liability sovereigns stated local market knowledge, track record and scale as reasons why they are able to outperform in their home-market. Nordic sovereigns in particular cited shareholder protection as a key driver of home-market allocations. These sovereigns felt disclosure and corporate governance amongst locally listed firms were superior to firms listed in international markets. This feedback was not restricted to emerging market indices where high-profile risks such as nationalisation are greatest. Nordic sovereigns also cited risks to shareholder rights when they invested in multi-nationals via established stockmarkets in the US and Europe.

In summary, home-market bias for development, investment and liquidity sovereigns is intuitive once you define the sovereign investor profile and objective. However, home-market bias for liability sovereigns is harder to predict and more complex to explain. The fact that the perceived quality of shareholder protection on different stockmarkets drives home-market bias is a key finding with important implications. It suggests that future changes in shareholder protection regulation could have a significant impact on sovereign investor allocations and, as a result, on global capital flow.

44%

Percentage of respondents that cited development objectives as the key driver of home-market bias in sovereign investor allocations

Fig 18. Key drivers of home-market bias in sovereign investor allocations (%)



Percentages based on number of respondents.
Sample size: 18.

"Because Latin American governments are concerned by Dutch Disease, they plan to divert excess revenues from major natural resource discoveries towards international investments via sovereign investors."

5 People and talent

A key focus for sovereign investors is the development and retention of people.

In our preparatory discussions with sovereign investors there was significant demand to understand internal capability across their peer group. In this theme we present a high-level picture of the importance attributed to different internal capabilities and of sovereign investor perceptions regarding their own performance for each capability. As we evolve the study each year, we will aim to provide more granular and informative benchmarking on an individual basis to sovereign investors.

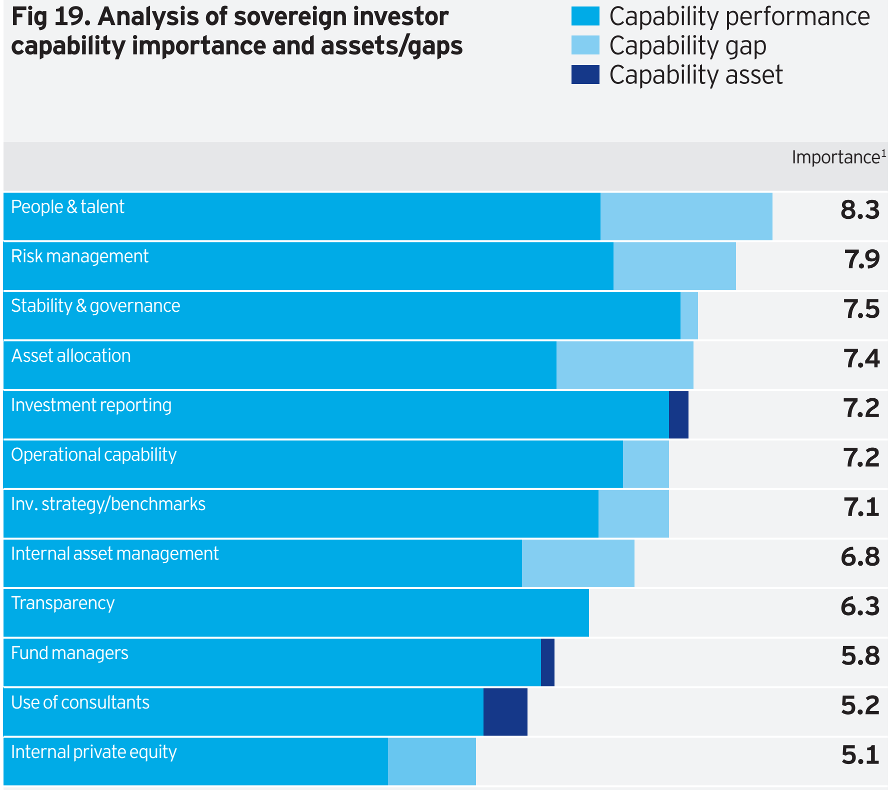
Figure 19 sets out the importance and perceived performance of sovereign investors against 12 different internal capabilities. Where importance exceeds performance we define the difference as the capability 'gap' and where performance exceeds importance we define the difference as a capability 'asset'.

Across the study, respondents cited people and talent as the most important attribute for the success of their sovereign. Furthermore, sovereign investors rated themselves lower on performance than importance, suggesting that people and talent is perceived as a key capability gap. This finding is supported by direct sovereign investor feedback on their key development areas in figure 20, which shows that 37% of sovereign investors cited people and talent as a key area for development. Returning to figure 19, the remaining gaps suggest that some key functions such as risk management, asset allocation, investment strategy and internal asset management may face challenges attracting and retaining the best staff.

37%

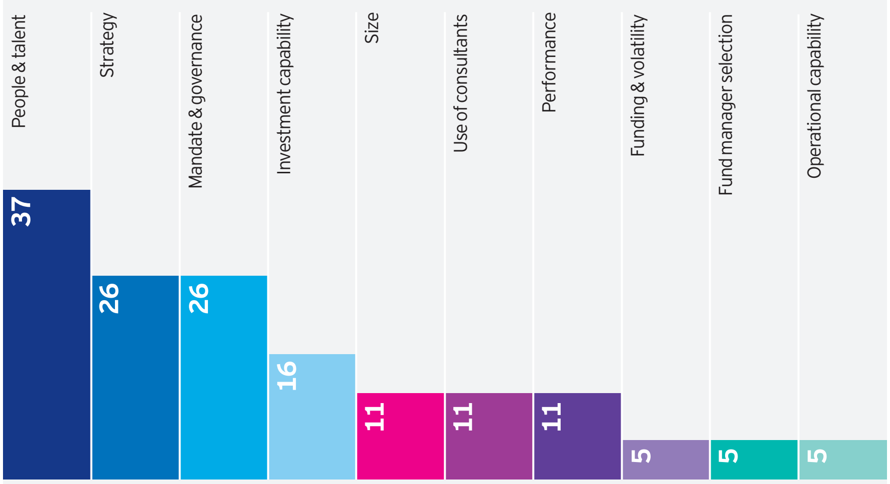
Percentage of sovereign that investors cited people and talent as a key area for development

Fig 19. Analysis of sovereign investor capability importance and assets/gaps



[1]Importance and strength rated on a score from 1 to 10 where 10 = most important.
Sample size: Capability importance (32), Capability performance (29).

Fig 20. Specific feedback on sovereign investor key development areas (%)



Percentages based on number of respondents.
Sample size: 19.

"Respondents cited people and talent as the most important attribute for the success of their sovereign."

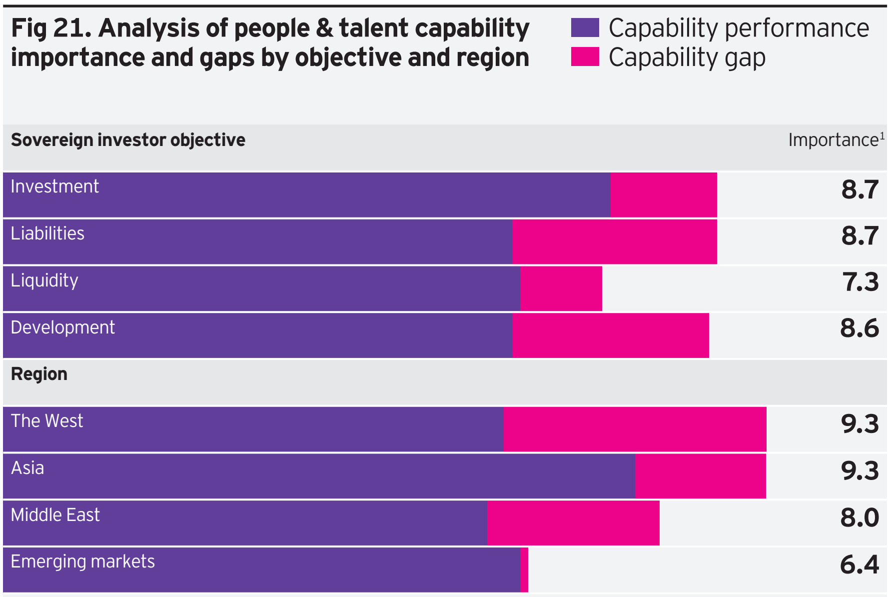
So why do sovereign investors feel that 'people and talent' is an area for development? Respondents highlighted a number of factors but most mentioned remuneration and pay constraints relative to the private sector, or a general shortage of skilled individuals for key functions such as risk management and investment strategy. The responses varied by sovereign investor and by function. In markets with existing investment management expertise in the private sector, the primary issue was competition. In markets with a less developed private sector or for functions where sovereign investors were unique or market leading, the issue was attracting, retaining or growing talent.

These findings are supported by the segmentation analysis of capability importance and gaps by sovereign investor objective and by region in figure 21. There are challenges and opportunities to develop people and talent across all sovereign investor profiles and regions. However, it was interesting to note that while Emerging market sovereigns required investment professionals to support strategy development, many of these sovereigns cited governance and mandate, track record or size as more important challenges.

In fact the greatest gaps for people and talent were observed for liability sovereigns in Western markets and for development sovereigns in the Middle East. We covered development sovereign needs in theme 2 so will focus here on the people and talent challenges for liability sovereigns in Western markets. Our discussions indicate two reasons why Western sovereigns face challenges linked to people and talent:

1. Competition from the private sector is more challenging in Western markets. Greater competition is linked to more established private sector investment management industries and tougher public sector pay constraints. The lack of flexibility on remuneration can be linked to high levels of disclosure on executive pay in annual reports and intense scrutiny from politicians and electorates.
2. Western sovereigns have the greatest need for top investment professionals because on average they do more in-house asset management and this requires individuals who can outperform external fund managers. Furthermore, executives felt that high levels of disclosure around performance, especially during a sustained period of market volatility, puts more pressure on Western sovereigns to develop more innovative investment strategies (such as risk premium drivers) and to increase exposure to alternatives.

Fig 21. Analysis of people & talent capability importance and gaps by objective and region



[1]Importance and strength rated on a score from 1 to 10 where 10 = most important. Capability gap is calculated as the difference between capability importance and capability performance.
Sample size: Investment (6), Liabilities (9), Liquidity (8), Development (7), The West (7), Asia (8), Middle East (8), Emerging markets (7).

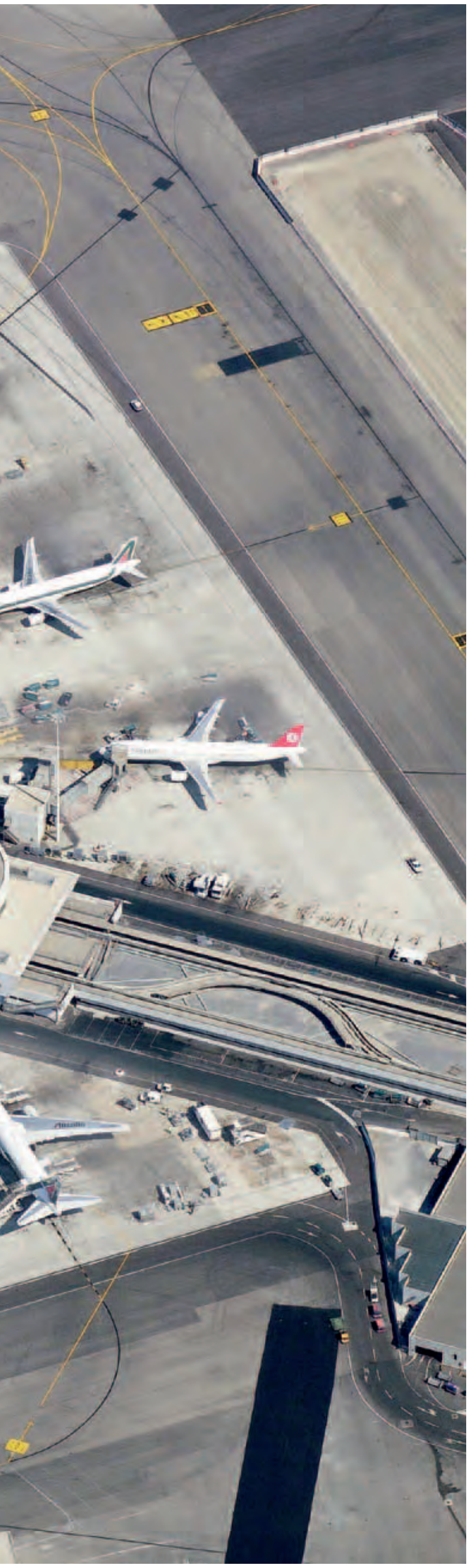
> "While Emerging market sovereigns required investment professionals to support strategy development, many of these funds cited governance and mandate, track record or size as more important challenges."

In summary, human capital is a key point for all sovereign investors as they seek to grow capabilities within their organisations. However the combination of tough pay constraints, high levels of scrutiny on costs and the need to attract and retain top investment professionals from a small global talent pool make it especially difficult for Western sovereigns.

These findings present opportunities and challenges for the investment management industry. The opportunity is the significant demand from sovereigns for investment management expertise via more strategic relationships which may help develop their people and talent. The challenge is how asset consultants and investment managers can deliver these services in a more commercially viable way.

6 Sovereign collaboration

The development of strategic partnerships and collaboration between sovereign investors.

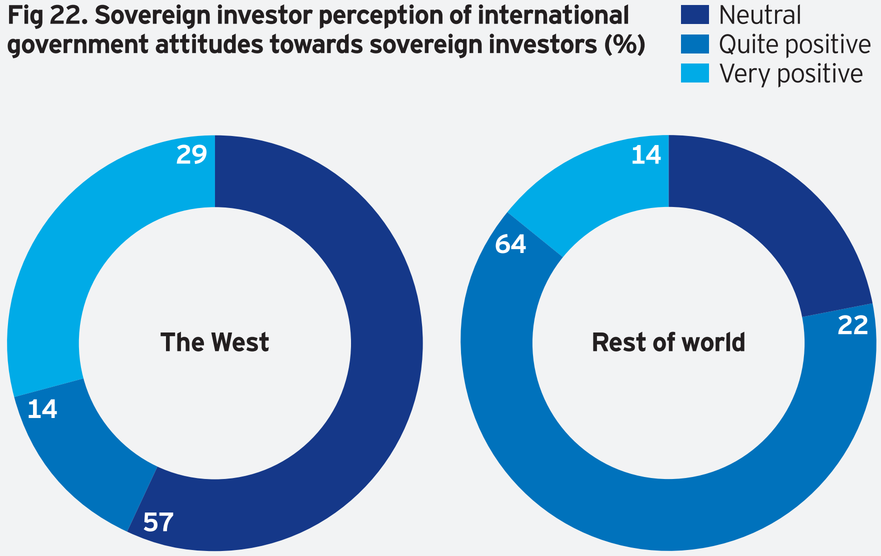


In our recent discussions with sovereign investors, the concept of collaboration was a hot topic. Historically there has been limited interaction between sovereigns. Where there are close relationships, this is typically between sovereign investors in the same country for the following reasons:

- Some sovereign investors were formed via the transfer of assets from another sovereign investor in the same country
- There has been overlap in objectives and co-investment between sovereign investors in the same country
- Disclosure by sovereign investors has been limited, making it hard to build trust and develop formal long-distance relationships.

However our discussions indicate that most sovereign investors believe interactions and collaboration between sovereign investors will increase over time. In figure 22 we show respondent views on international government attitudes towards sovereign investors, and highlight the differences between Western sovereigns and the remaining sovereigns. Most Western sovereigns believe governments are neutral to sovereigns while those in other parts of the world believe governments are quite positive towards sovereigns. Critically, many sovereign investors felt that positive perceptions of government attitudes gave them the confidence to collaborate.

Fig 22. Sovereign investor perception of international government attitudes towards sovereign investors (%)



Rest of world includes Asia, Emerging markets and the Middle East.
Sample size: LHS (7), RHS (14).

Our discussions highlighted that sovereign investors expected to increase interactions with other sovereign investors with comparable objectives rather than with funds in the same market or region. We believe geography will lessen in importance as legacy ties fade and the overlap in objectives between sovereign investors in the same market lessens. We expect investor objective will increase in importance as levels of transparency increase (enabling executives from different regions to talk more openly about strategy and investment) and as new funds emerge creating a larger pool with the same strategy and objective.

Nearly all sovereign investors conducted some form of desktop research on other sovereign investors and met with executives from other sovereign investors at industry events, consistent with Stage 1. Figure 23 shows that just over 50% have adopted some form of benchmarking against sovereign peers, consistent with the second stage of collaboration.

However, there was limited science behind the development of the peer group. There are no stand-out sovereign investors used as a global benchmark by other sovereigns. Some quoted local or neighbouring sovereigns, some quoted sovereigns of a similar size and others quoted sovereigns with high levels of disclosure. Very few actively sought out the global leaders with comparable objectives to their own. This is demonstrated in figure 24, where you can see the wide range of different sovereign investors cited as benchmarks.

A four-stage process

Our discussions with sovereign investors suggest that the process of sovereign collaboration will be slow and incremental. We define four stages of increasing collaboration between sovereign investors:

1

Desktop research on sovereign investor peers or ad hoc face-to-face meetings at seminars and conferences

2

Formal or semi-formal benchmarking of the organisation or investment performance against a peer group of sovereign investors

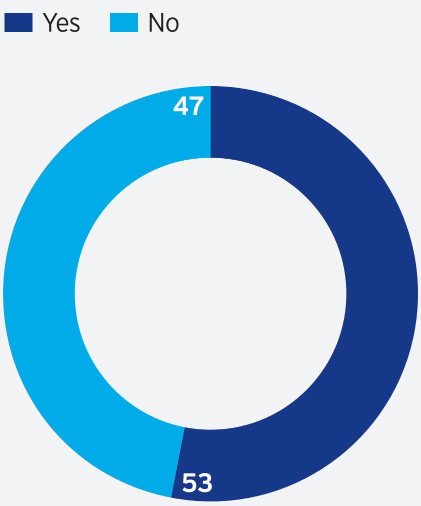
3

One-off or longer term partnerships for co-investment on deals or asset classes

4

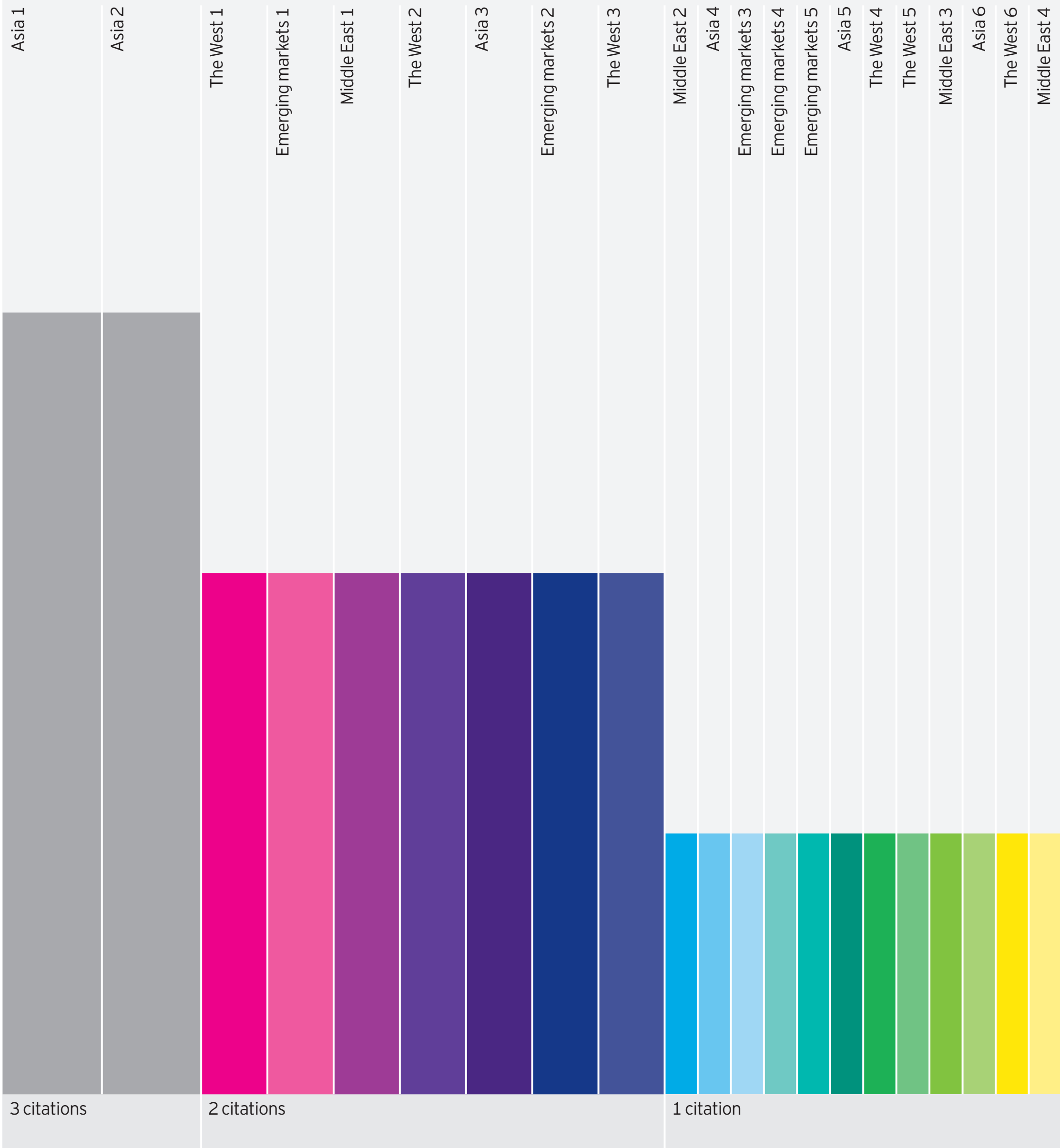
Formal strategic partnerships including the exchange of knowledge or people between sovereign investors

Fig 23. Current benchmarking trends amongst sovereign investors (%)



Sample size: 32.

Fig 24. Range of sovereign investors cited as benchmarks



Sample size: 15 (2013).

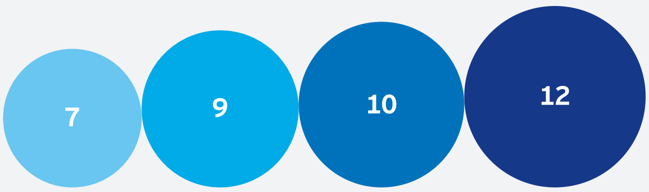
Based on our qualitative notes we estimate that around a quarter of sovereign investors had Stage 3 interactions, partnering with sovereigns for some form of co-investing. For development sovereigns, partnerships were typically linked to large regional development projects; for investment sovereigns, partnerships were typically linked to a specific asset or sub-asset class within commodities where sovereigns have shared expertise. Stage 3 was seen by respondents as an important milestone where sovereign investors move from informal benchmarking to active or formal collaboration. Many respondents expected active collaboration to increase rapidly between specific sovereign investors and predicted that a large number of new co-investment deals would take place in the next 12 to 18 months.

We observed few genuine Stage 4 strategic partnerships between sovereign investors although some sovereigns saw these partnerships as the logical end-point. As inter-sovereign investor trust develops, disclosure increases and more expertise is built in-house by sovereigns, we believe that more strategic partnerships between sovereign investors with comparable objectives are inevitable.

"We believe geography will reduce in importance as legacy ties fade and the overlap in objectives between sovereign investors in the same market lessens."

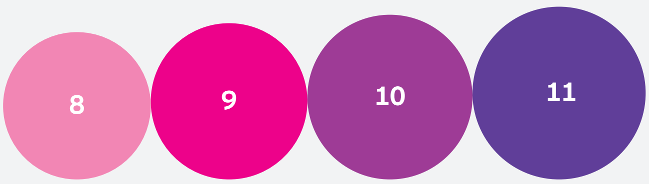
Appendix

Fig 25. Sample overview by objective



Sample size: 38.

Fig 26. Sample overview by region



Sample size: 38.

Fig 27. Sample overview by size of fund

Sample size: 38.

Sample and methodology

The fieldwork for this study was conducted by NMG's Strategy Consulting practice. Invesco chose to engage a specialist independent firm to ensure high-quality objective results. Key components of the methodology include:

- A focus on the key decision makers within sovereign investors, conducting interviews using experienced consultants and offering market insights rather than financial incentives
- In-depth (typically 1 hour) face-to-face interviews using a structured questionnaire to ensure quantitative as well as qualitative analytics were collected
- Analysis capturing investment preferences as well as actual investment allocations, with a bias toward actual allocations over stated preferences
- Results interpreted by NMG's strategy team with relevant consulting experience in the global asset management sector.

In this report we conducted interviews with 37 individual sovereign investors, which resulted in 38 separate data points. Discussions with one particular sovereign investor resulted in two separate data points as the interview was conducted with different entities, both of which held some responsibility for the fund. Additional 'contributor' interviews were also completed with six sovereign investors. Although these interviews are not included as part of the total sample of 38, they helped to validate some of the core results.

Throughout the report, many of the themes and insights are focused around three core segmentation parameters (described in detail in theme 1). The sovereign investor sample spreads across four different categories for each parameter as shown in figures 25 to 27.

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For EMEA and Americas
Nick Tolchard
Head of Invesco Middle East
nick.tolchard@invesco.com
+44 (0)1491 417010

For Asia Pacific
Desmond Ng
CEO, Invesco Greater China
desmond.ng@invesco.com
+852 3128 6129

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