Invesco Global Sovereign Asset Management Study 2014

This study is not intended for members of the public or retail investors.
Full audience information is available inside the front cover.

Welcome

As co-chairs of Invesco's Sovereign Investor Group, we are delighted to share with you our second report on the sovereign asset management industry. Our study covers sovereign wealth funds, government pension funds and central banks from around the world.

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

For Asia Pacific:
Alex Prout
Managing Director
Head of Institutional Sales, Asia Pacific
alex.prout@invesco.com
+852 3128 6866

This year we have expanded our study to include interviews with 52 sovereign investors including greater coverage of leading state pension funds and central banks with meaningful investment portfolios.

We have again worked with independent strategy consultants NMG to deliver an objective view of the industry based predominantly on face-to-face interviews with either chief investment officers or strategy unit executives. In our 2013 report we developed a framework which grouped sovereigns into four objective-based categories. We use this classification throughout this year's report to draw out important themes both between and within related groups.

We discuss the growth in exposure to alternatives and emerging markets and the dynamic between strategic and tactical asset allocation.

We have specifically examined liability sovereigns this year (better known as government pension funds) and define a unique group of partial liability sovereigns, which have longer time horizons, higher target returns and greater risk asset exposure than conventional defined benefit and defined contribution sovereigns. Our third theme sets out a 3-phase model for analysing the evolution of liquidity (central banks) and investment sovereigns. We note that growing sovereign assets over the past decade has supported a gradual reduction in liquidity objectives relative to investment objectives.

We conclude the report by analysing sovereign collaboration, benchmarking and capability. Sovereign investors are collaborating more often and more strategically whilst working hard to manage the people and talent challenges we identified last year.

We hope that the key themes in this report deliver unique, evidence-based findings for the industry. We believe that the sovereign investor universe is fascinating, complex and fast moving and we hope our frameworks and key themes translate complexity into digestible insight for readers.

Summary of key themes

1. **Strategic and tactical asset allocation**
   Strategic asset allocation appears to be more influential than tactical asset allocation. Sovereigns have increased allocations to alternatives and exposure to emerging markets, and anticipate doing the same in 2014, despite an underlying preference for developed markets.
2. **Liability sovereigns and segmentation**
   Partial liability sovereign pension funds are not responsible for all scheme liabilities so they have longer term horizons and higher target returns than conventional defined benefit and defined contribution sovereigns.
3. **The evolution of liquidity and investment sovereign investors**
   We have validated our sovereign framework and set out a 3-phase model for analysing the evolution of liquidity and investment sovereigns.
4. **Sovereign benchmarking, performance and capability**
   Sovereign benchmarking is increasing and funds are working hard to manage priorities such as people and talent. Invesco Sovereign Confidence Index seeks to monitor performance and key capabilities over time.

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Visit the study webpage to view more content on this year's themes

Strategic and tactical asset allocation

Strategic asset allocation appears to be more influential than tactical asset allocation. Sovereigns have increased allocations to alternatives and exposure to emerging markets, and anticipate doing the same in 2014, despite an underlying preference for developed markets.

Growth in alternatives is driven by strategic asset allocation targets and high levels of new funding

In our 2013 report we highlighted a shift in asset allocation towards alternative investments by many sovereign investors. Sovereigns were seeking diversification, noting the volatility of equities, yield compression in treasuries and greater correlation between equities and corporate bonds due to quantitative easing. This year we observed similar demand for alternatives in 2013, with 51% increasing new exposure to real estate relative to the portfolio and 29% increasing new exposure to private equity relative to the portfolio on a net respondent view[1] basis. Furthermore, all of the major alternative asset classes (real estate, private equity, infrastructure, hedge funds and commodities) were projected to increase on a net respondent view basis when sovereigns compared their forecasted asset placements for 2014 with their 2013 actuals.

51%

Percentage of sovereigns, on a net respondent view basis, increasing exposure to real estate in 2013.

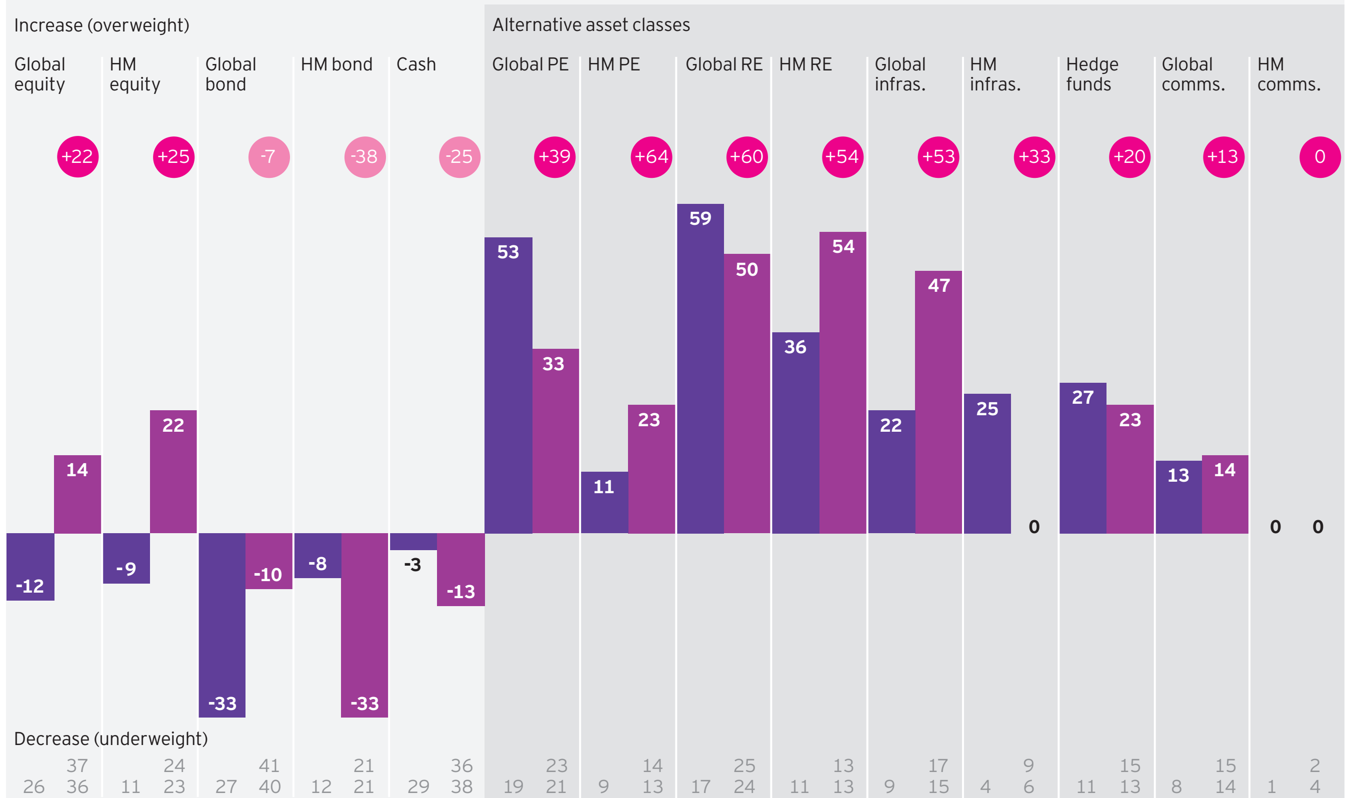
29%

Increase in new exposure to private equity relative to the portfolio on a net respondent view basis.

Strategic asset allocation is defined as an investment strategy that involves setting target allocations for various asset classes while tactical asset allocation is defined as an active portfolio strategy that rebalances the percentage of assets held in various categories in order to take advantage of market pricing anomalies or strong market sectors.

Fig 1. Net respondent view[1] of demand for different asset classes (2012 and 2013 allocations are relative to the total portfolio and 2014 estimated allocations are relative to 2013 allocations) (%)

● 2014 estimated allocations relative to 2013
■ 2013 actual allocations relative to total portfolio
■ 2012 actual allocations relative to total portfolio



[1] Net respondent view is the % increase citations less % decrease citations. Note: 2012 and 2013 data captures the demand for asset classes relative to the total portfolio; 2014 data captures the estimated demand for asset classes relative to new assets placed in 2013. PE = Private equity, RE = Real estate, Infras. = Infrastructure, Comms. = Commodities. Samples shown in grey.

The three-year trend including 2014 estimates in increasing alternative allocations appears to be structural, driven by strategic asset allocation, rather than a short term shift due to tactical allocations. This is supported by three observations:

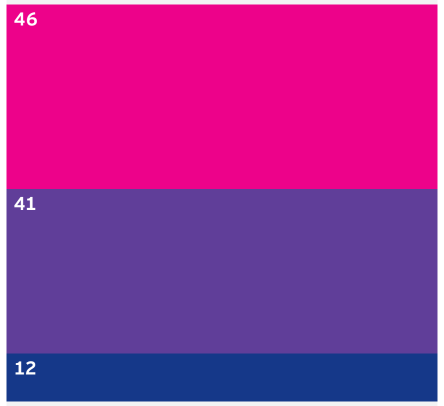
- First, many respondents explained that they remained underweight in alternatives relative to their strategic asset allocation targets. These sovereigns were typically large (greater than US$50bn in assets) who had increased their target allocations for alternatives in the last five years and had yet to reach these targets.
- Second, many sovereigns (46% in figure 2a) estimated an increase in new funding this year compared to last year, driven by increasing country surpluses and strong support from government for their sovereign funds (figure 2b). Some of these investors explained that large increases in assets encouraged more strategic asset allocation placements because prioritising tactical asset allocation would breach the asset allocations boundaries.
- Third, the increase in alternative exposure took place during a period where their reported yields underperformed targets. Sovereign investors cited an average return from alternatives of 7% in 2013 compared to a target of 8%. In contrast sovereign reported returns from equities in 2013 were greater than 10% versus a target of 7%. This underperformance of alternatives suggests that increasing alternative exposure is unlikely to be driven by a tactical asset allocation strategy to boost short-term returns.

Within alternatives, we also noted a trend to increase global infrastructure allocations. Figure 1 shows that in 2013 on a net respondent view basis 47% of sovereigns increased global infrastructure exposure compared to 22% in 2012. Furthermore this figure was 53% when forecasting future global infrastructure placements in 2014 compared to 2013.

According to respondents, the demand for infrastructure was driven by three factors. First, there was recognition that yields were falling in real estate as global demand (particularly for developed market real estate) continues to grow. Second, there was a strong belief that the size and long-term nature of infrastructure investments matched sovereign objectives and capabilities. And finally, there was broad consensus that the risk-adjusted returns were likely to remain attractive. We also noted debate amongst sovereigns on the value of a separate infrastructure allocation. Some investors have infrastructure targets while others felt that the large one-off investment values and limited availability of opportunities meant infrastructure should sit within a broader alternatives category.

Fig 2a. Sovereign investor view of future funding levels relative to last year's new funding (%) 41

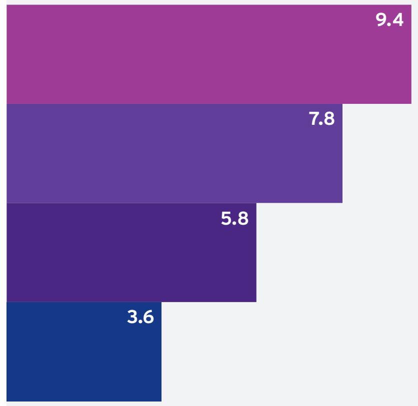
Increase
Stay the same
Decrease



Sample shown in grey (2014).
Note: Total is only 99% due to percentage rounding.

Fig 2b. Average importance[1] of key drivers of sovereign investor funding levels

Government decisions 28
Government spending 23
Commodity prices 24
Political stability 18



[1]Importance rated on a score from 1 to 10 where 10 = most important. Samples shown in grey.

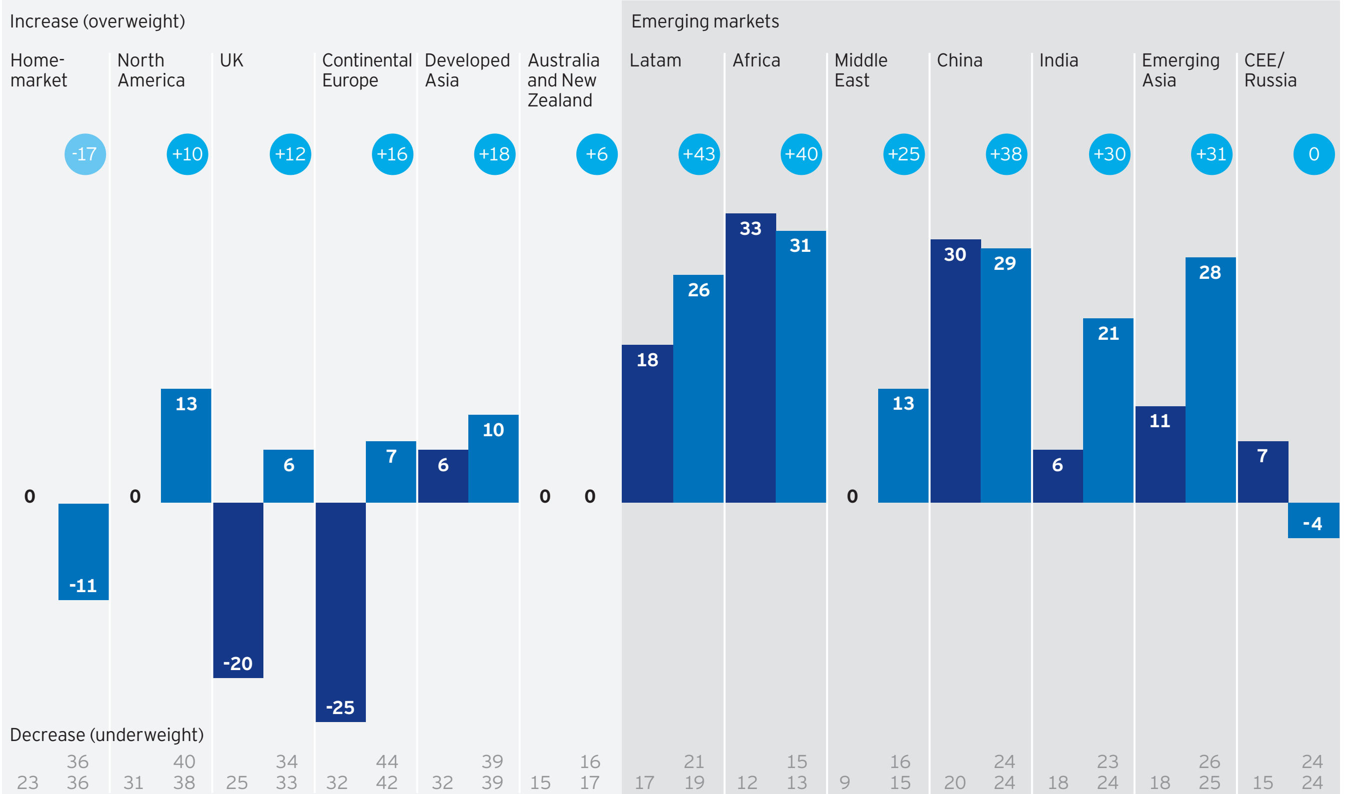
Growth in emerging market allocations for new assets but a preference for developed markets remains

Our analysis of geographic allocations points to a second trend driven by strategic allocation targets. We observed last year that on average sovereigns were investing more new money in emerging markets relative to their total portfolio. This year the same trend has emerged with allocations to Africa, Latin America, China, India and emerging Asia all increasing in 2013 relative to the portfolio on a net respondent view basis. Furthermore, many sovereign investors expect allocations to these regions to increase again in 2014 relative to 2013 (figure 3). These sovereigns explained that they are underweight in emerging markets relative to their strategic asset allocation targets. The fact that emerging market equities underperformed developed market equities during 2013 did not offset this long-term structural trend to emerging markets.

"Many sovereign investors expect allocations to these regions (Africa, Latin America, China, India and emerging Asia) to increase again in 2014 relative to 2013."

Fig 3. Net respondent view[1] of demand for different geographic regions (2012 and 2013 allocations are relative to the total portfolio and 2014 estimated allocations are relative to 2013 allocations) (%)

2014 estimated allocations relative to 2013
2013 actual allocations relative to total portfolio
2012 actual allocations relative to total portfolio



[1]Net respondent view is the % increase citations less % decrease citations. Note: 2012 and 2013 data captures the demand for asset classes relative to the total portfolio; 2014 data captures the estimated demand for asset classes relative to new assets placed in 2013. CEE = Central and Eastern Europe. Samples shown in grey.

While the major trend in geographic allocation is a strategic shift to emerging markets, there are also more tactical, region-specific trends. For example, we note that allocations to Central Eastern Europe and Russia have declined on a net respondent view basis in 2013 due to the crisis in Ukraine.

Increasing allocations to emerging markets takes place in the context of a strong historical preference for developed markets. Even after excluding home-market allocations from sovereigns based in developed markets, 56% of the average sovereign investor portfolio is in developed markets. Sovereigns are attracted by the depth, stability and diversification benefits of developed markets, with this diversification benefit being particularly important for sovereign investors based in emerging or frontier markets. While emerging market allocations are expected to increase from current levels, many sovereigns expect they will remain underweight emerging markets on a GDP-weighted basis. Figure 4 shows the top-10 economies in the world based on GDP in 2013 rated by pure economic performance, private sector opportunity and sovereign investor attractiveness.

The results confirm a strong underlying preference for developed markets. The average economic performance ratings for developed and emerging markets are comparable, however the opportunities for private sector investors are perceived to be higher for developed markets but lower for emerging markets.

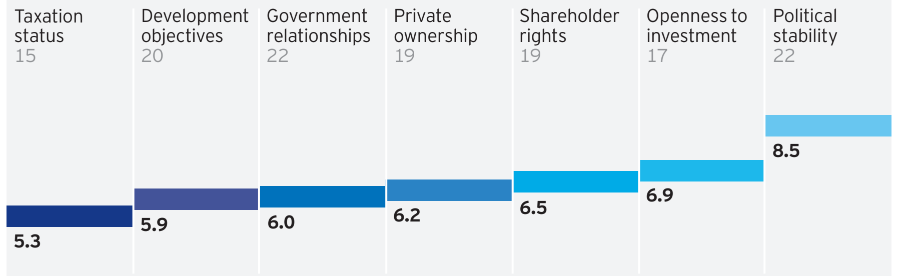
There is also significant variation in sovereign investor attractiveness scores across these economies rising from 4.7 (Russia) to 7.4 (UK). These scores show both positive and negative correlations to the private sector opportunity scores: for example sovereign investor attractiveness scores are lower relative to private sector opportunity in the US, but higher for the UK.

Figure 5 highlights that the most important factor in determining sovereign geographic allocations is political stability followed by the openness of a country to sovereign investment, strength of shareholder rights, level of private ownership and government relationships. The secondary factors such as openness, shareholder rights and government relationships help to explain the differences in sovereign attractiveness for markets of comparable political stability.

56%

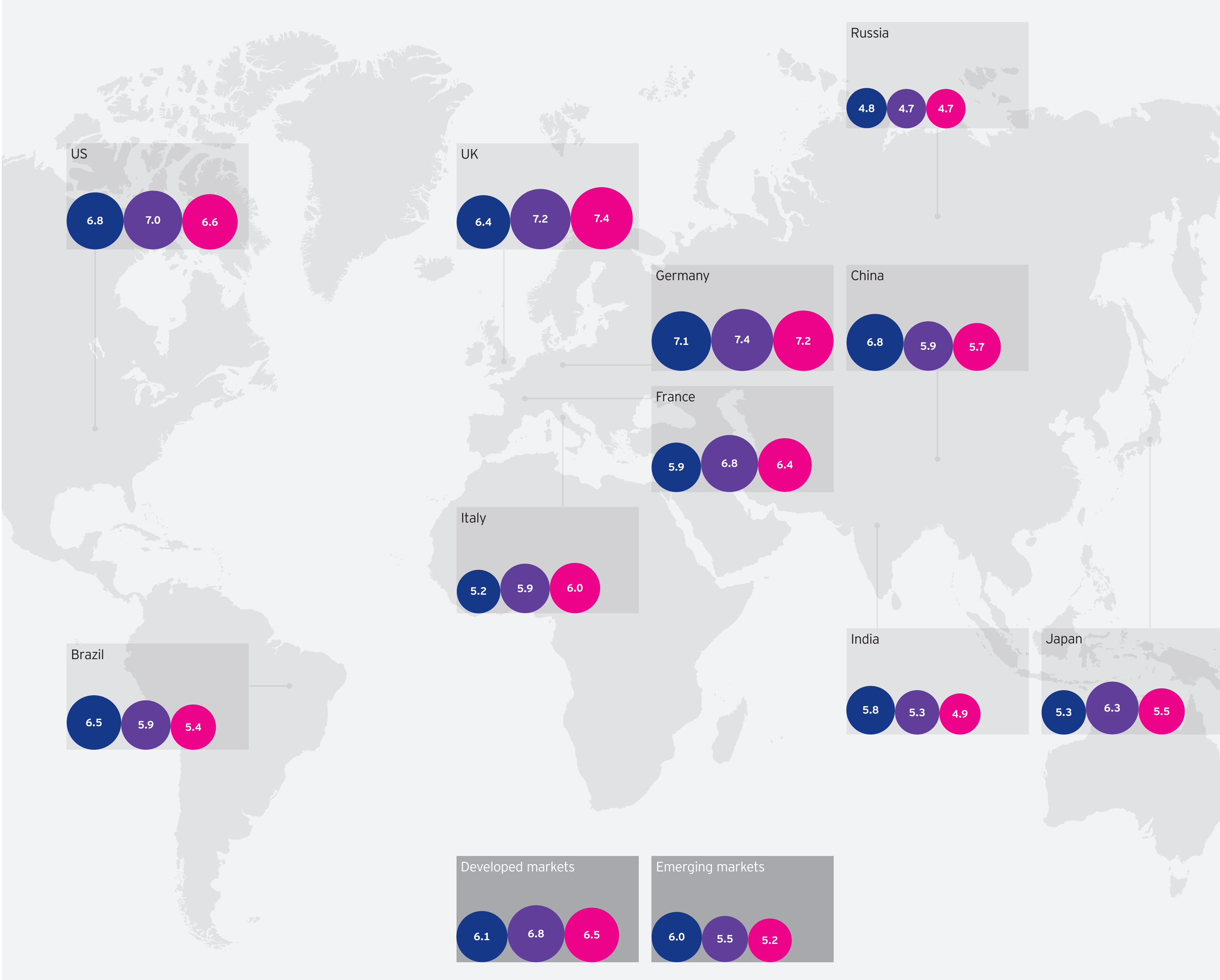
Average allocations to developed markets across sovereign investor portfolios.

Fig 5. Average importance[1] of factors driving geographic allocations for sovereign investors



[1]Importance rated on a score from 1 to 10 where 10 = most important. Samples shown in grey.

Fig 4. Average sovereign investor rating for economic performance, private sector opportunity and attractiveness for a sovereign investor for the top-10 economies based on GDP in 2013 26



[1]Rated on a score from 1 to 10 where 10 is the highest score. 'Developed markets' average is an equally weighted average across Germany, US, UK, France, Japan and Italy; 'Emerging markets' average is an equally weighted average across China, Brazil, India and Russia. Source: 'International Monetary Fund 2013'. Sample shown in grey (2014).

"On a net respondent view basis 11% of sovereigns reduced allocations to their home-market."

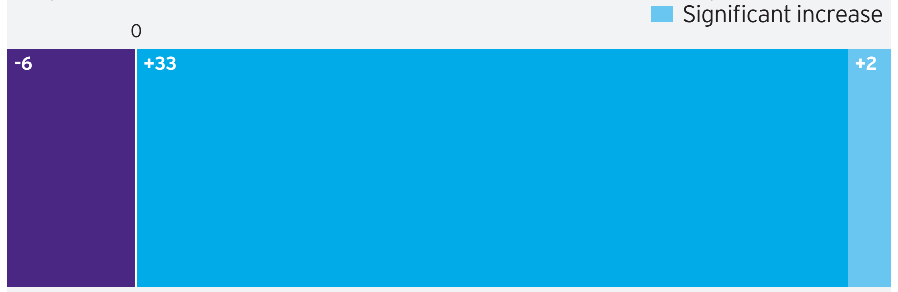
Increasing risk appetite and reducing home-market bias

For every investor increasing their allocation to alternatives or emerging markets there must be a reduction in another category. Last year we observed that respondents increasing their new asset placements in alternatives in 2012 (relative to the total portfolio) typically cited a decrease in equities or global fixed income. Similarly respondents increasing their new asset placements in emerging markets typically referenced a decrease in developed markets.

In 2013 these dynamics were different. Respondents increasing new assets in alternatives typically cited a decrease in home-market fixed income or cash rather than global fixed income or equities. We note that home-market and global equity allocations increased on a net respondent view basis (figure 1). This observation may be linked to increasing risk appetite and time horizons across sovereign investors in our study. Figure 6 shows an average increase in target return since 2013 and figure 7 shows an average lengthening of time horizons which are typically consistent with increasing exposure to risk assets like equities.

Respondents increasing new assets in emerging markets in 2013 typically referenced a decrease in home-market allocations rather than developed markets. On a net respondent view basis 11% of sovereigns reduced allocations to their home-market (figure 3) in 2013. This trend is important because home-market allocations account for a significant percentage of the total portfolio (42% on average across all sovereign investors in 2013). It suggests that sovereign investors could continue to increase exposure to both emerging and developed markets at the same time if home-market allocations continue to decrease.

Fig 6. Analysis of change in sovereign investor target return between 2013 and 2014 (%) 49

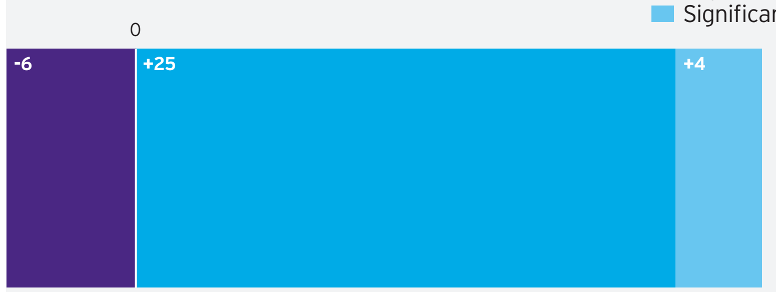


[1]Net respondent view is the % increase citations less % decrease citations. Sample shown in grey.

+29%

Increase, on a net respondent view[1] basis, of sovereign investor target return between 2013 and 2014.

Fig 7. Analysis of change in sovereign investor time horizon between 2013 and 2014 (%) 51



[1]Net respondent view is the % increase citations less % decrease citations. Sample shown in grey.

+23%

Increase, on a net respondent view[1] basis, of sovereign investor time horizon between 2013 and 2014.

Liability sovereigns and segmentation

Partial liability sovereign pension funds are not responsible for all scheme liabilities so they have longer term horizons and higher target returns than conventional defined benefit and defined contribution sovereigns.

A framework for classifying liability sovereigns

Last year we analysed development sovereigns in a specific theme exploring the importance of different development objectives and the willingness of these investors to sacrifice investment returns to meet development needs. This year we have developed a theme focused on liability sovereigns, also known to the industry as sovereign pension funds.

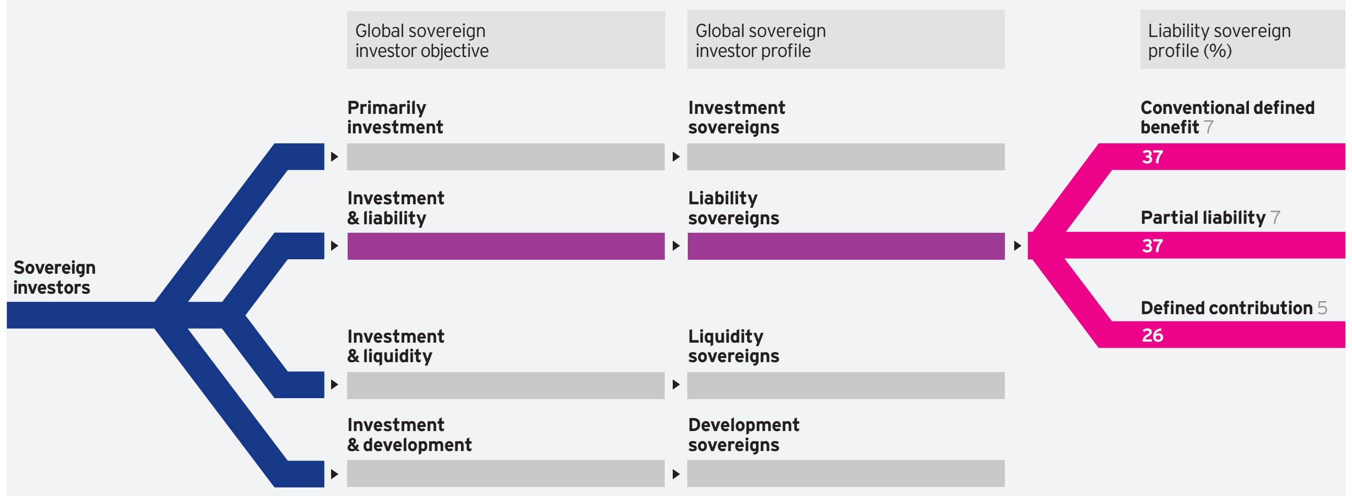
In the private sector there are two main types of pension fund: defined benefit and defined contribution schemes. Private sector defined benefit schemes are expected to manage all of their liabilities via assets in their fund and generally target a funding ratio (assets minus liabilities) of 100%. However, this is not the case for all liability sovereigns. We classify three types of liability sovereign: defined contribution (DC), conventional defined benefit (DB) and partial liability. This year our study included 19 liability sovereigns of which five were DC, seven were conventional DB and seven were partial liability DB schemes (figure 8).

Many defined benefit liability sovereigns are 'partial liability' and therefore are not responsible for all of the scheme liabilities. For example, the assets might cover some of the liabilities and the remainder is paid by the government on a pay-as-you-go basis from tax or commodity revenues. In some cases the government pays all the annual income requirements and in these cases the primary focus of the sovereign pension fund is on investment returns.

19

This year our study included 19 liability sovereigns of which five were DC, seven were conventional DB and seven were partial liability DB schemes.

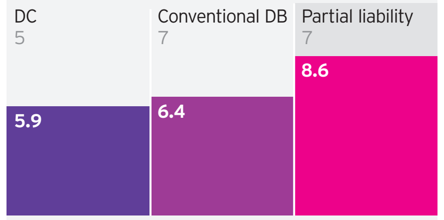
Fig 8. Sample and segmentation of liability sovereigns within Invesco's sovereign investor framework



Samples shown in grey.

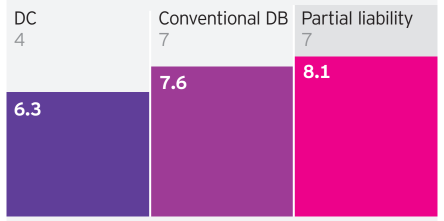
As we have explained, partial liability sovereigns are unique because investment objectives are more important and liability objectives are less important relative to other liability sovereigns. As a result, they have longer time horizons and higher target returns and exposure to risk assets. Figure 9a shows that partial liability sovereigns have an average time horizon of 8.6 years, more than two years longer than conventional DB and DC sovereigns. These investors also target a 50 basis point premium (figure 9b) and allocate over 10% more to equities than their defined benefit peers (figure 10).

Fig 9a. Average time horizon[1] for DC, conventional DB and partial liability sovereigns (years)



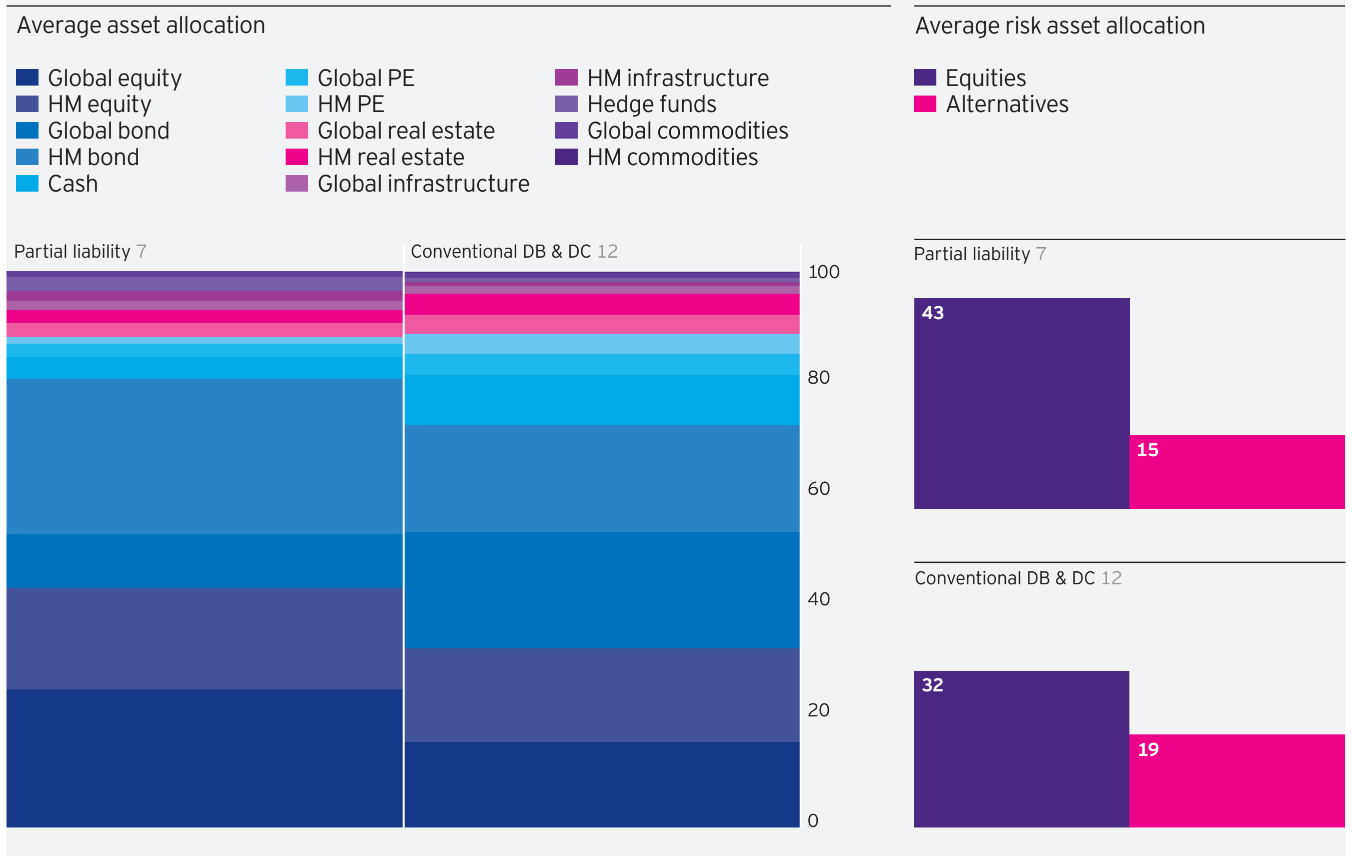
[1]Average calculated as weighted mid-point between time horizon categories. Samples shown in grey.

Fig 9b. Average target return[1] for DC, conventional DB and partial liability sovereigns (%)



[1]Average calculated as weighted mid-point between target return categories. Samples shown in grey.

Fig 10. Average asset allocation and risk asset exposure for conventional DB and DC versus partial liability sovereigns (%)



Average allocations across segments, results not weighted by funds under management. Equities include global equity, home-market equity; alternatives includes hedge funds, global and home-market (HM) private equity (global PE and HM PE), real estate, commodities and infrastructure. Samples shown in grey.

There are two ways income requirements are met where a country has a partial liability sovereign. In the first option (option 1 in figure 11a) income payments are a combination of payments from the liability sovereign and the government. In the second option the government pays all the income and the liability sovereign has no income requirements. Many respondents were aware that while they were currently partial liability sovereigns the government may top-up their assets to bring their funding level close to 100% and pass the income payment responsibilities to the sovereign. This would transition the partial liability sovereign into a conventional DB sovereign as shown in figure 11b. You would expect this change to result in a reduction in time horizon and target return given greater focus on more liquid, income-generating assets.

You could argue that further government top-ups and migration to conventional DB sovereigns will reduce time horizons and target returns over time. However, many respondents expected new partial liability sovereigns where governments pay all the income to be set up around the world, so the direction of future investment preferences is unclear.

100%

Many respondents were aware that while they were currently partial liability sovereigns the government may top-up their assets to bring their funding level close to 100% and pass the income payment responsibilities to the sovereign.

Fig 11a. Schematic of partial liability assets, liabilities and income payment options
For illustrative purposes only

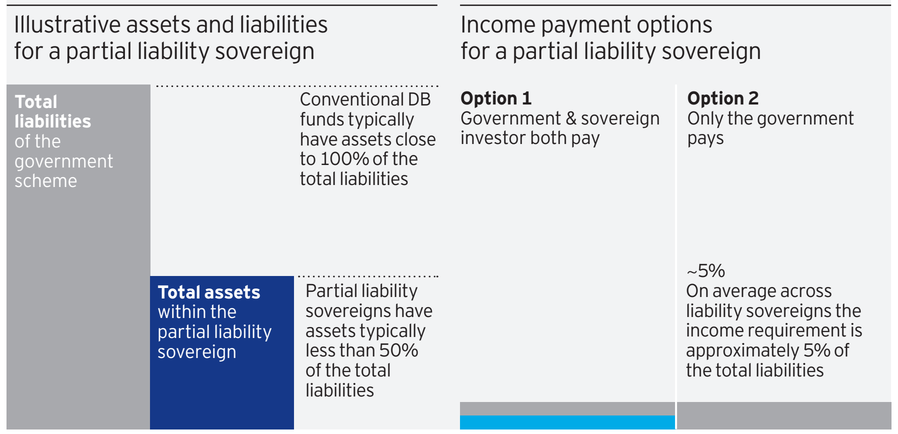
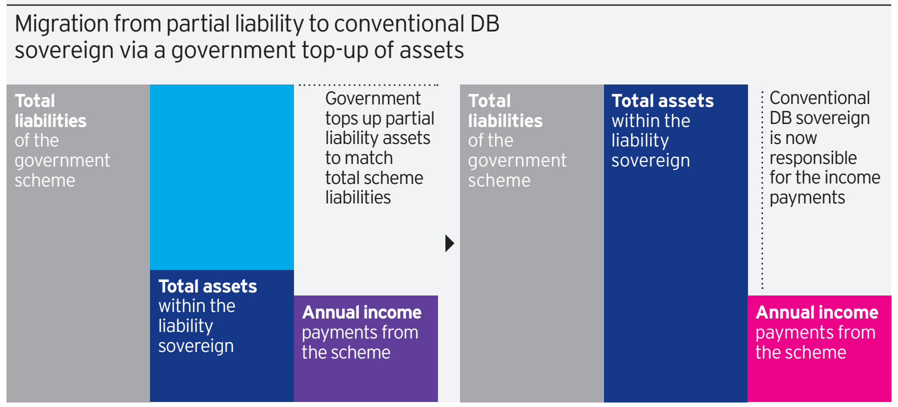


Fig 11b. Schematic of the potential migration from partial liability to conventional DB



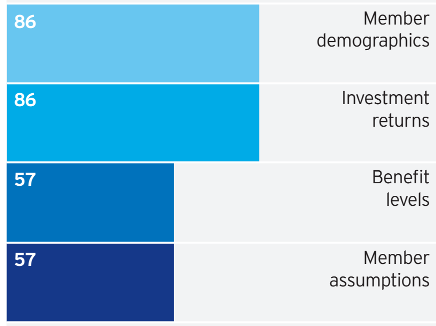
Limited correlation between demographics and investment preferences
The demographics of a private sector pension scheme are important to funding, time horizon, risk appetite and liability requirements of the fund. The same principles apply to sovereigns with defined benefit schemes who cite member demographics (rather than returns or benefits) as the key factor in calculating scheme liabilities (figure 12).

Given the size and coverage of government schemes, the member demographics should map relatively well to country demographics. As a result you would expect that liability sovereigns in emerging markets with younger demographics (i.e. where more members are in the accumulation phase) would have longer time horizons, higher target return and greater exposure to risk assets compared to those in developed markets.

However, our results show limited correlation to country demographics. We split liability sovereigns into 'young' (Africa, Latin America, Middle East and emerging Asia) and 'mature' (Europe, ANZ and developed Asia) demographics. The results show that each segment has the same time horizon of seven years and target returns are within one percentage point.

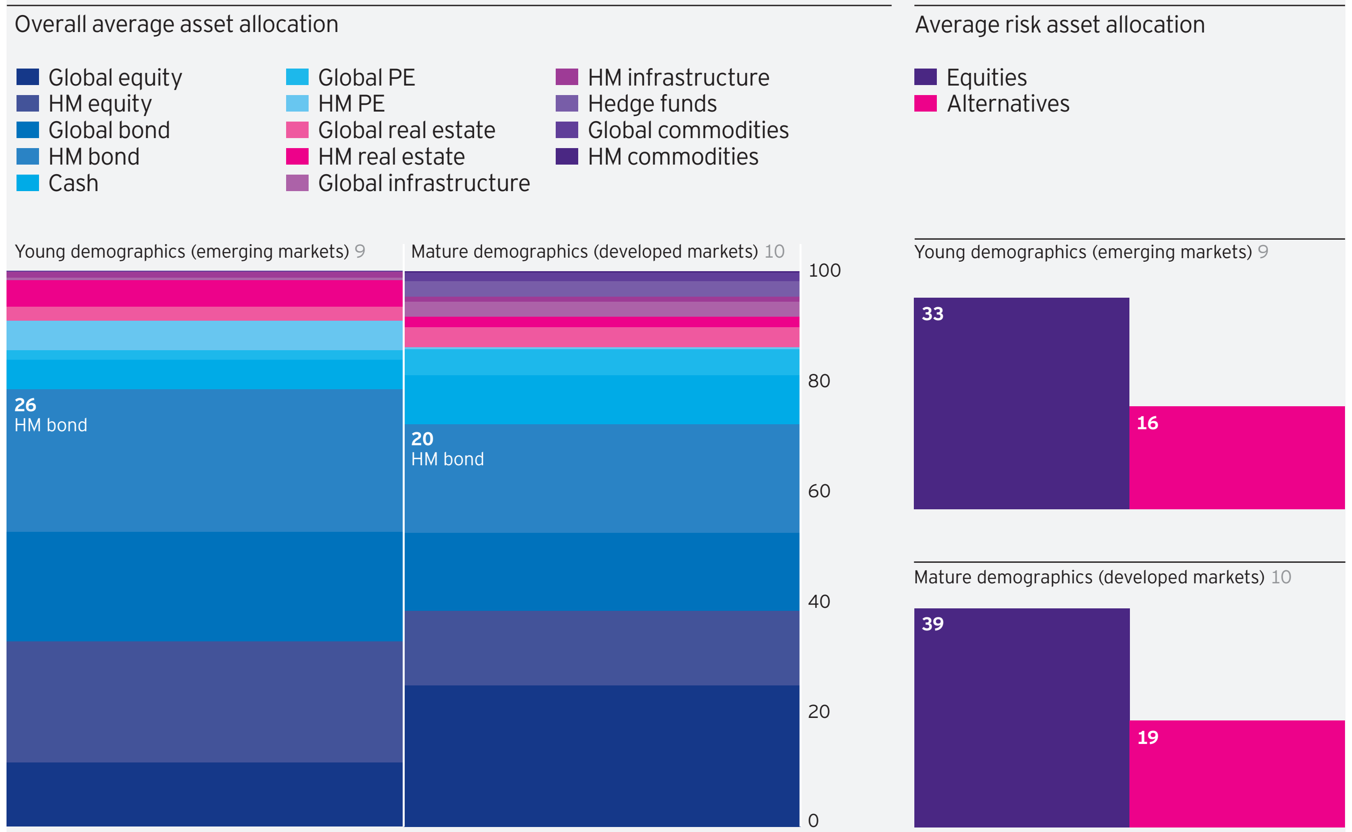
We believe this limited correlation is driven by three factors. First, there are more partial liability funds in the mature demographic segment and we have seen that partial liability funds have longer time horizons and higher risk asset exposure. Second, liability sovereigns in emerging markets are more conservative in their asset allocation and some of these investors have restrictions on international exposure, equity allocations or the use of alternatives in their mandates. Third, liability sovereigns in emerging markets are well placed to access higher yields from local fixed income than their developed market peers and this reduces their need to invest in risk assets to meet target returns. The third point is evidenced by home-market bond allocations of 26% amongst emerging market pension funds in figure 13 compared to 20% for their developed market peers.

Fig 12. Key factors in calculating pension scheme liabilities for conventional DB and partial liability sovereigns (%) 7

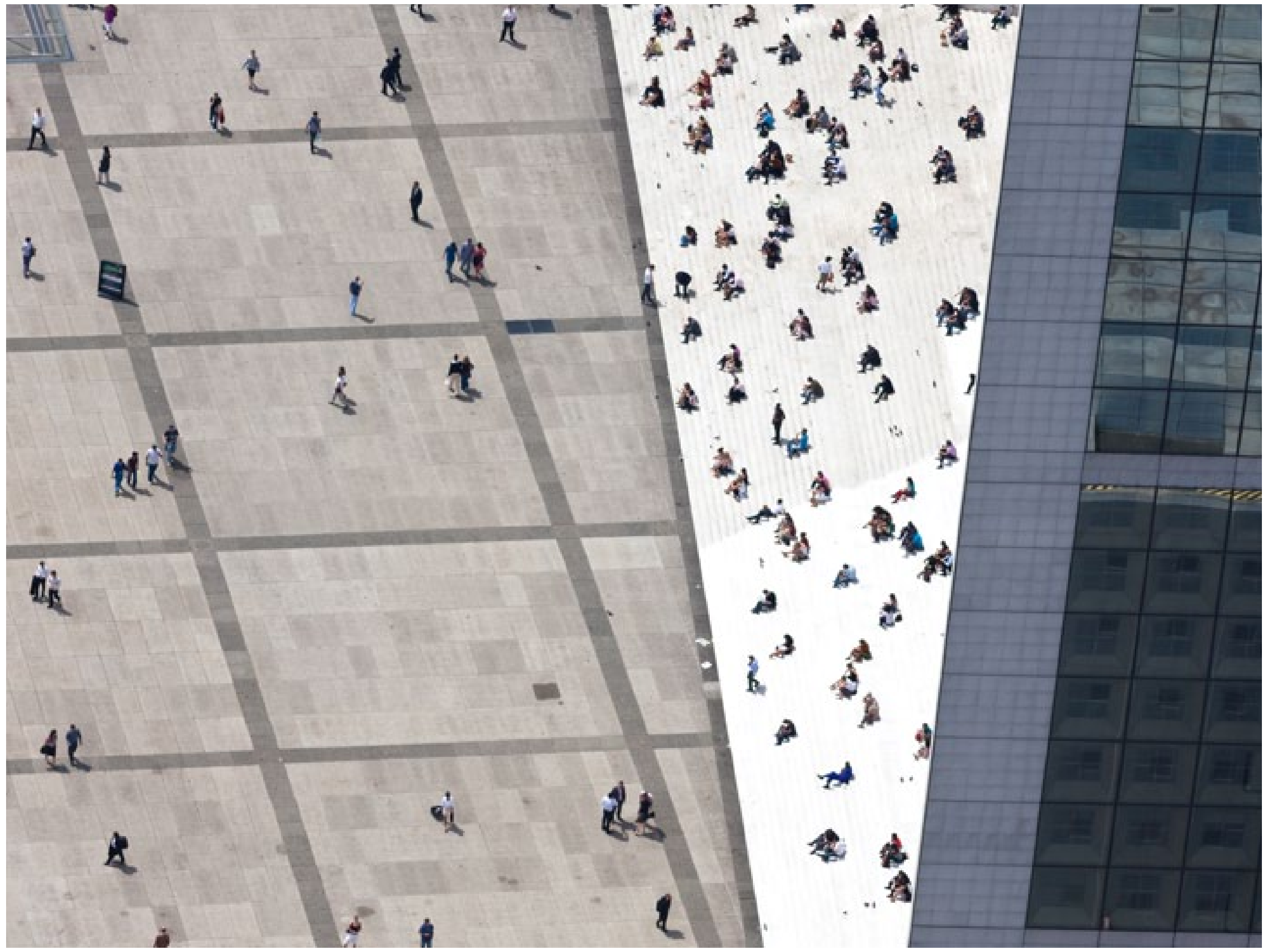


Note: %s based on number of citations / number of respondents. Membership assumptions include new members, contribution levels. Benefit levels include retirement date and inflation.
Sample shown in grey (2014).

Fig 13. Average asset allocation and risk asset exposure for young (emerging market) and mature (developed market) demographics (%)



Average allocations across segments, results not weighted by funds under management. Equities includes global equity, home-market equity (HM equity); alternatives includes hedge funds, global and home-market private equity (HM PE), real estate (RE), commodities and infrastructure. Samples shown in grey.



Strong global growth outlook for liability sovereigns
We have previously highlighted the growth potential of sovereign pension funds in the Middle East based on net contribution increases as well as investment returns. This finding remains valid on a global basis. More than 80% of liability sovereigns in our study are in a demographic growth phase where member contributions exceed member payments, with new annual contributions accounting for 7% on average compared to 4% on average for payments. Furthermore, the average scheme in a demographic growth phase expects net inflow to continue for the next seven years.

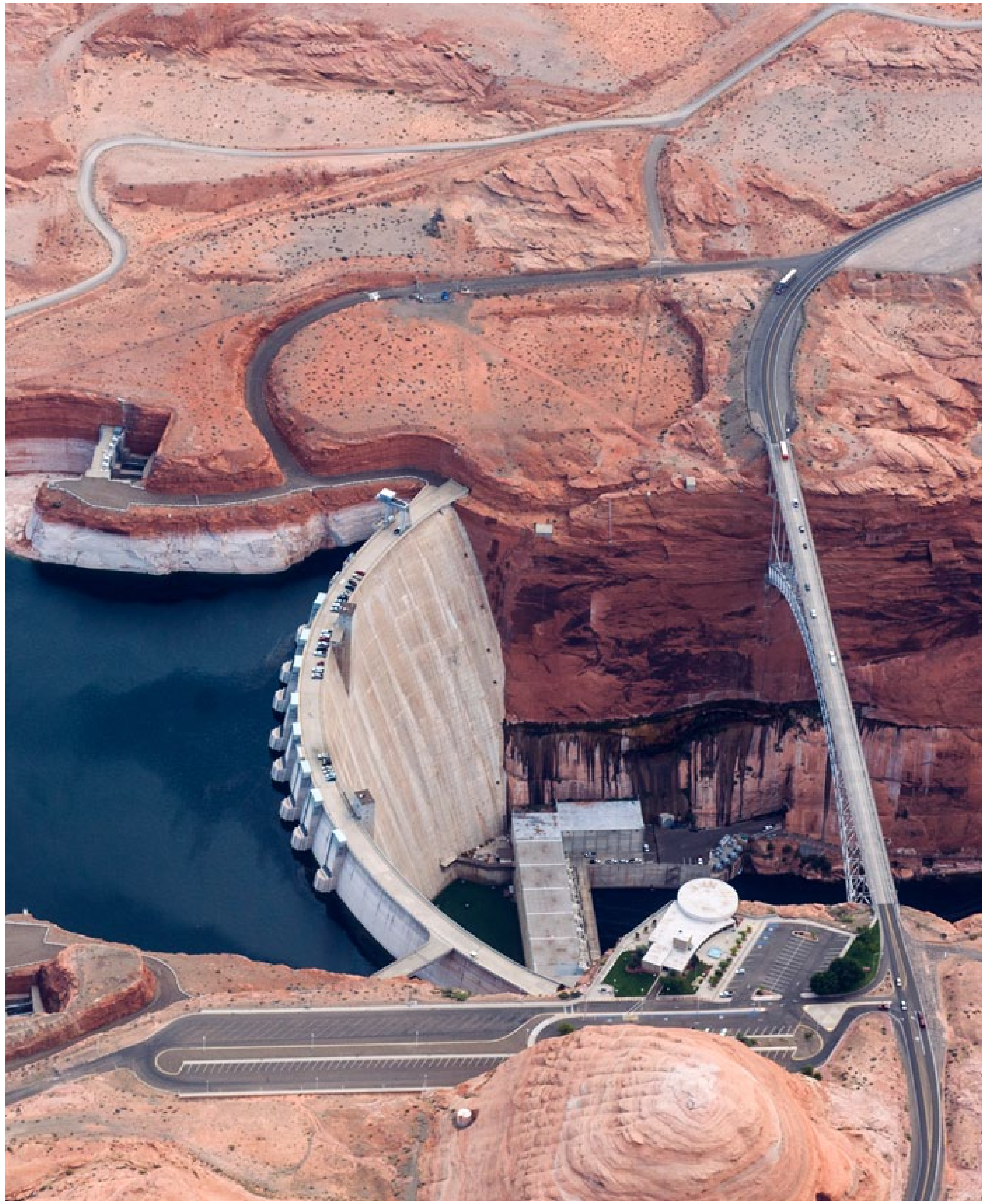
For demographic growth to continue after seven years, the industry may need governments to create new schemes. Fortunately, many respondents predicted this trend so even the long-term outlook for this segment of sovereign investors could be positive.

7%

More than 80% of liability sovereigns in our study are in a demographic growth phase where member contributions exceed member payments, with new annual contributions accounting for 7% on average compared to 4% on average for payments.

The evolution of liquidity and investment sovereign investors

We have validated our sovereign framework and set out a 3-phase model for analysing the evolution of liquidity and investment sovereigns.



Validation of Invesco's sovereign framework

In last year's report we proposed a sovereign framework which highlighted the importance of objective. We hypothesised that objectives have more influence on investment behaviour than organisational structure, size of fund, age of fund or location for all sovereign investors. We therefore defined four profiles: investment, liquidity, liability and development sovereigns. Our framework has been well received by the industry and we have probed further into the importance of different objectives this year. Figure 14 shows the citations and importance of each objective split by our sovereign investor profiles. The results show that while most sovereigns have more than one objective, allocating them to a single profile based on the importance of each objective is relatively straightforward.

For investment sovereigns (often named future funds by the industry), investment is the primary objective with an average importance score of 9.4 out of 10 (figure 14). A small number of these sovereigns also have liquidity, liability or development objectives but these are of secondary importance, scoring less than 7 out of 10 on average. We have completed the same analysis of primary and secondary objectives for liquidity sovereigns (where liquidity objectives score 9.4 out of 10 on average for importance) and for development sovereigns (where development objectives score 9.8 out of 10 on average). The analysis is more complex for sovereign pension funds (liability sovereigns) where investment and liability objectives are broadly equal in importance. This supports the segmentation of pensions in the previous theme which highlights that investment objectives have greater relative importance for partial liability funds than for conventional defined benefit or defined contribution funds.

Fig 14. Objective citations and average importance for different sovereign investor profiles in 2014

[1] Importance rated on a score from 1 to 10 where 10 = most important. Samples shown in grey.

An evolutionary pathway for liquidity sovereigns?

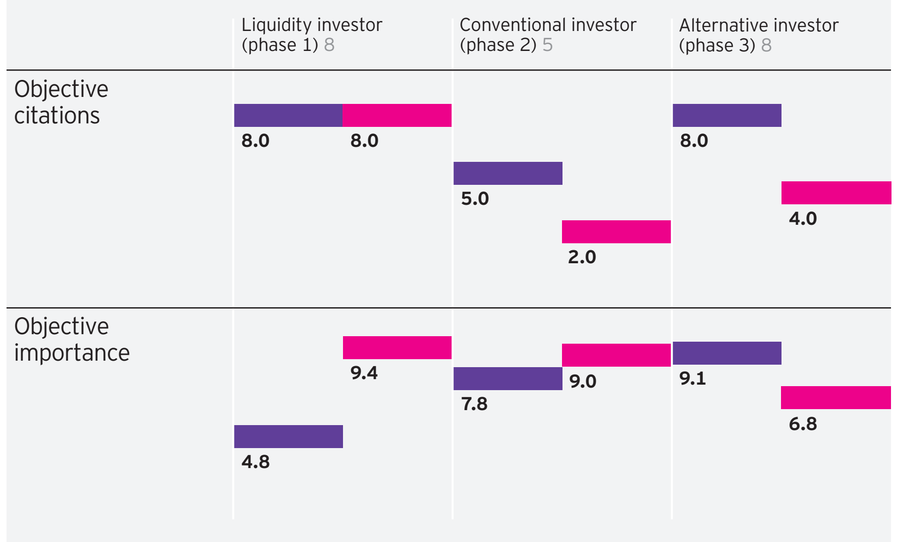
We have been confident in classifying sovereigns but we have not previously forecast the direction of evolution. We are conscious that sovereigns have unique history, context and decision making structures and are heavily influenced by a range of uncertain external factors. This year we will set out a 3 phased evolutionary model for this specific group of sovereign investors.

Within the liquidity and investment sovereign segments there appears to be a level of structural evolution, from liquidity portfolios concentrated on fixed income to investment portfolios with more complex risk assets over time.

We define liquidity sovereigns in the first phase as 'liquidity investors' who are primarily invested in low-risk cash and fixed income instruments for liquidity with assets typically bought in-house or via the central bank. These investors are different to conventional central bank reserve funds because they also seek returns via higher risk fixed income or equities from a small part of their portfolios usually measured on an inflation plus basis.

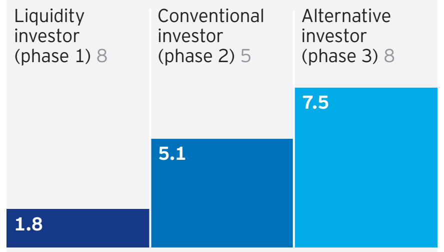
Phase 2 sovereigns are defined as 'conventional investors' and place more emphasis on investment returns than phase 1 liquidity sovereigns (figure 15). Conventional investors score the importance of investment objectives at 7.8 on average out of 10 compared to 4.8 out of 10 for liquidity investors. Phase 2 conventional investors have higher equity exposure and adopt a conventional asset allocation approach to benchmarking their portfolio. While conventional investors may also manage low-risk assets in-house, they place on average 24% of their assets with external managers.

Fig 15. Citations and average importance[1] of liquidity and investment objectives by phase



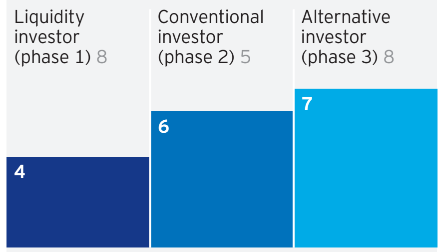
[1] Importance rated on a score from 1 to 10 where 10 = most important. Samples shown in grey.

Fig 16a. Average[1] time horizon by phase (years)



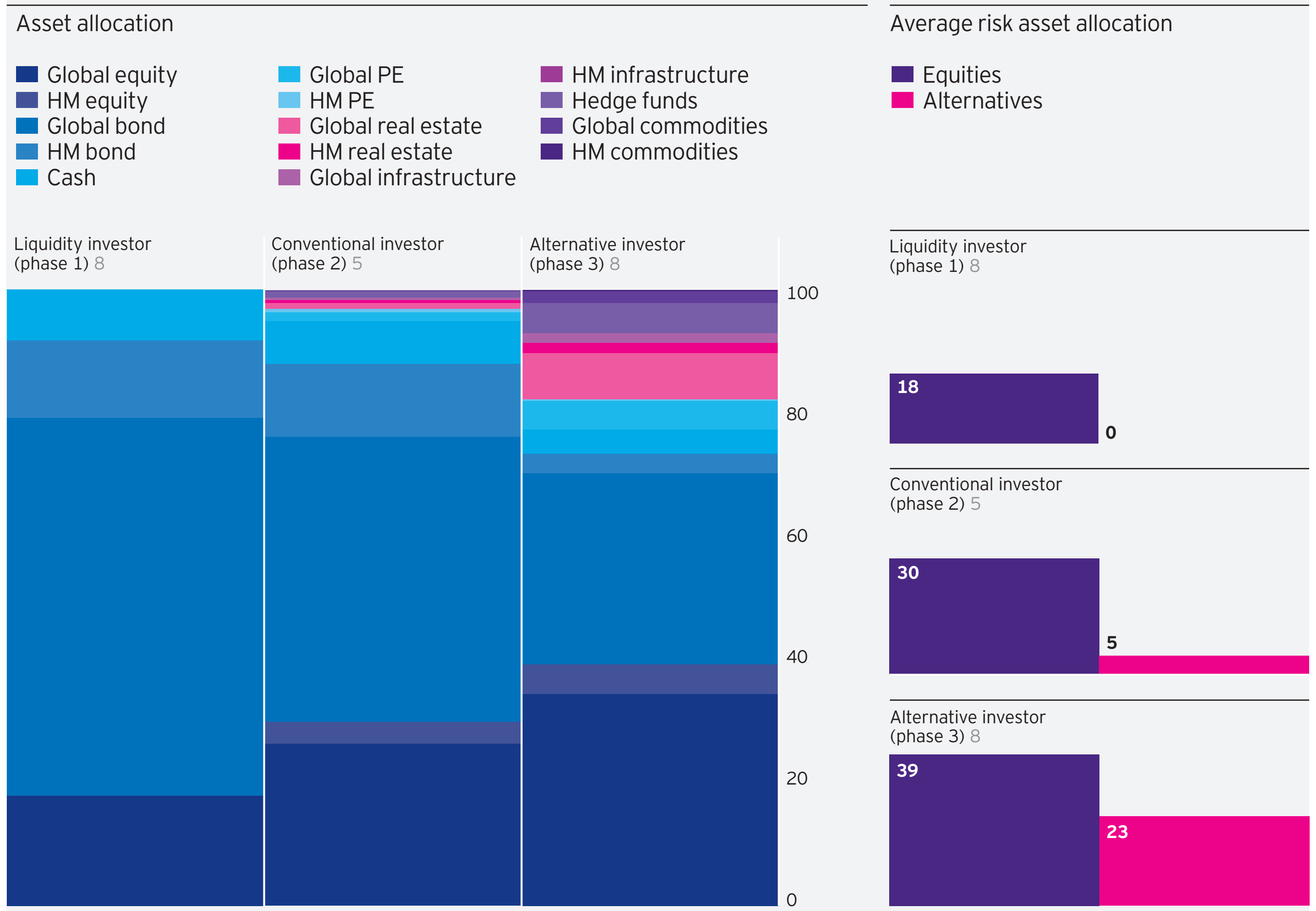
[1] Average calculated as weighted mid-point between time horizon categories. Samples shown in grey.

Fig 16b. Average[1] target return by phase (%)



[1] Average calculated as weighted mid-point between target return categories. Samples shown in grey.

Fig 17. Average asset allocation and risk assets exposure by phase (%)



Average allocations across segments, results not weighted by funds under management. Equities include global equity, home-market equity (HM equity); alternatives includes hedge funds, global and home-market private equity (global PE and HM PE), real estate (RE), commodities and infrastructure. Samples shown in grey.

We have labelled phase 3 sovereigns as 'alternative investors' who prioritise investment returns and have sought to diversify their portfolio by allocating more than 10% of their portfolio to alternative assets. While alternative investors do have liquidity objectives, the importance of these liquidity objectives is lower, at 6.8 out of 10 on average compared to 9.0 out of 10 on average for conventional investors (figure 15). As a result alternative investors can take longer time horizons than conventional investors (figure 16a) and more aggressively target liquidity premiums from alternative assets like real estate, private equity and infrastructure (figures 16b and 17).

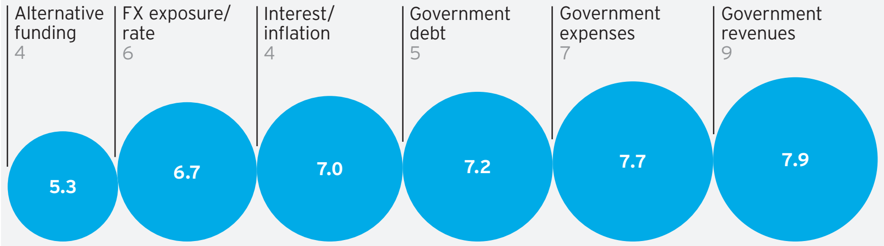
> "Conventional investors score the importance of investment objectives at 7.8 on average out of 10 compared to 4.8 out of 10 for liquidity investors."

Past evolution as a possible guide to the future?
The evolution from liquidity investors in phase 1 to alternative investors in phase 3 has been driven by increasing country reserves in markets with sovereign investors over the last decade. The growth in reserves has driven asset growth and reduced the relative importance of liquidity (versus investment) because there are more assets to cover downside liquidity scenarios. Liquidity sovereigns expect a worst case scenario (an estimated 1 in 30 year occurrence) to require on average 36% of their assets to be liquid. This percentage is consistent with the percentage of their assets which could be liquidated within 24 hours. Looking at their asset allocation of the remaining 64% of the portfolio, some respondents believe there is scope to reduce the level of liquidity and increase risk asset exposure while still maintaining a conservative approach which prioritises liquidity over investment.

However while this theoretical argument stands, we would note that the development of the worst case liquidity scenario is not an exact science. Figure 18a sets out the key variables to determine the worst case scenario (such as government revenues, expenses and debt). These variables are easy to calculate but hard to forecast under different scenarios. Figure 18b shows that the key factors driving these scenarios are linked to the local and global economy. Political instability and natural disasters are also important and these factors are particularly hard to predict.

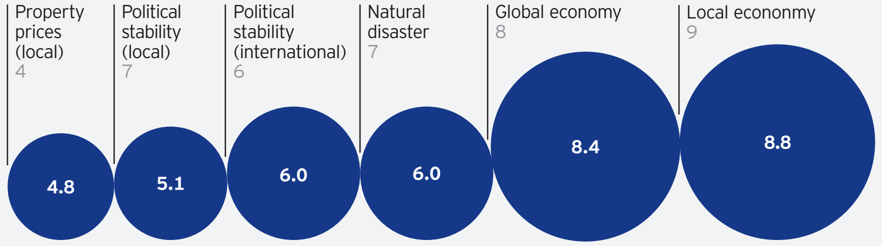
Liquidity sovereigns expect a worst case scenario (1 in 30 year occurrence) to require on average 36% of their assets to be liquid. This percentage is consistent with the percentage of their assets which could be liquidated within 24 hours.

Fig 18a. Relative importance[1] of key variables for calculating the worst case liquidity scenario for a sovereign investor



[1] Importance of variables rated on a score from 1 to 10 where 10 = most important. Samples shown in grey.

Fig 18b. Relative importance[1] of key factors driving the worst case liquidity scenario for a sovereign investor



[1] Importance of variables rated on a score from 1 to 10 where 10 = most important. Samples shown in grey.

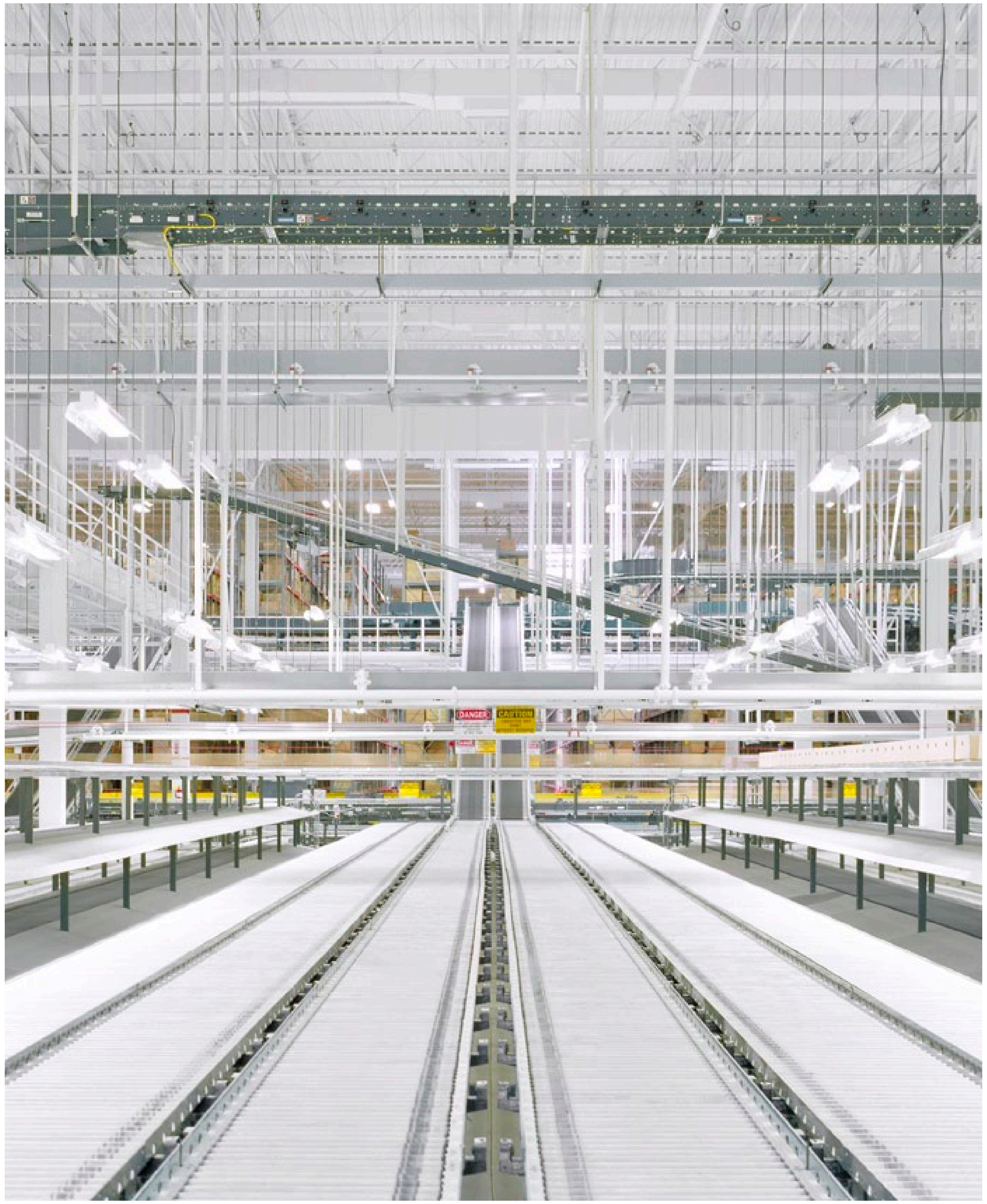
What are the alternatives to our evolutionary model?
There is also no guarantee that funding growth from country surpluses will continue over the next decade. If commodity prices fall or government spending increases rapidly then surpluses may turn to deficits. If funding drops and withdrawals are made then the remaining assets will need to re-focus on liquidity. Under this scenario, the sovereign evolution pathway we have set out would likely reverse. You would see phase 2 conventional investors retreating to phase 1 liquidity investors as observed amongst certain European central banks following the eurozone crisis.

There is also a risk that surpluses are used for non-investment objectives. For example, governments may decide to reallocate investment-focused assets to other objectives such as the creation of a development sovereign or a pension fund to cover unmatched liabilities. A few years ago we cited a trend towards development sovereigns in the Middle East, with some sovereigns changing from investment to development objectives and other development sovereigns receiving more funding than their equivalent investment sovereign.

While these alternative pathways exist, we feel the evolution from liquidity to investment most accurately captures the majority of structural sovereign evolution over the last decade. It also captures the basecase scenario for future evolution for the existing liquidity sovereigns in our study. If you take the current sovereigns in Latin America, a number would classify themselves as phase 1 liquidity investors seeking to expand beyond a liquidity focus and develop a longer term investment portfolio.

Sovereign benchmarking, performance and capability

Sovereign benchmarking is increasing and funds are working hard to manage priorities such as people and talent. Invesco Sovereign Confidence Index seeks to monitor performance and key capabilities over time.



Benchmarking and collaboration are increasing

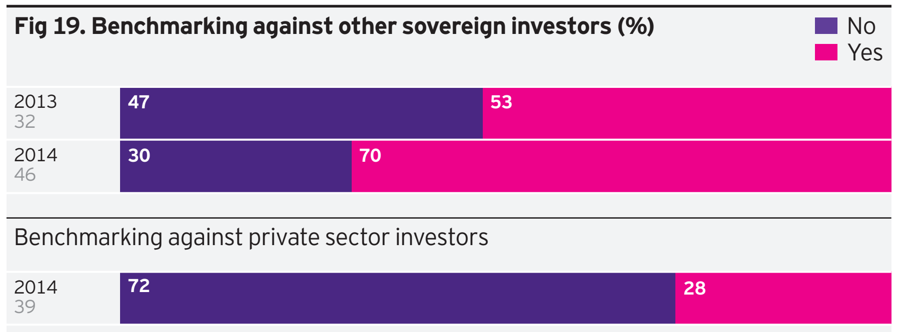
We noted last year that historically there has been limited interaction between sovereigns. Furthermore most existing relationships are based on convenience (between sovereigns located in the same market or region) rather than strategic relationships between sovereigns with similar objectives and challenges.

Our discussions this year reported that 70% of respondents conducted some form of benchmarking against other sovereign funds this year compared to 53% last year (figure 19). This increase was primarily attributed to growing awareness, collaboration and transparency amongst sovereigns. As we noted last year, most benchmarking remains a simple desktop research exercise, comparing actual returns supplemented by informal discussions between executives.

Figure 20 validates these findings but shows that some sovereigns are undertaking formal benchmarking focused on internal metrics. There was certainly a growing desire to identify and make contact with sovereign investors on a global basis with comparable objectives. In addition to greater sovereign interaction, there is also growing desire to benchmark against private sector organisations. This year 28% of respondents cited a private sector organisation as a benchmark (figure 19) and we expect this figure to increase from this level in future years.

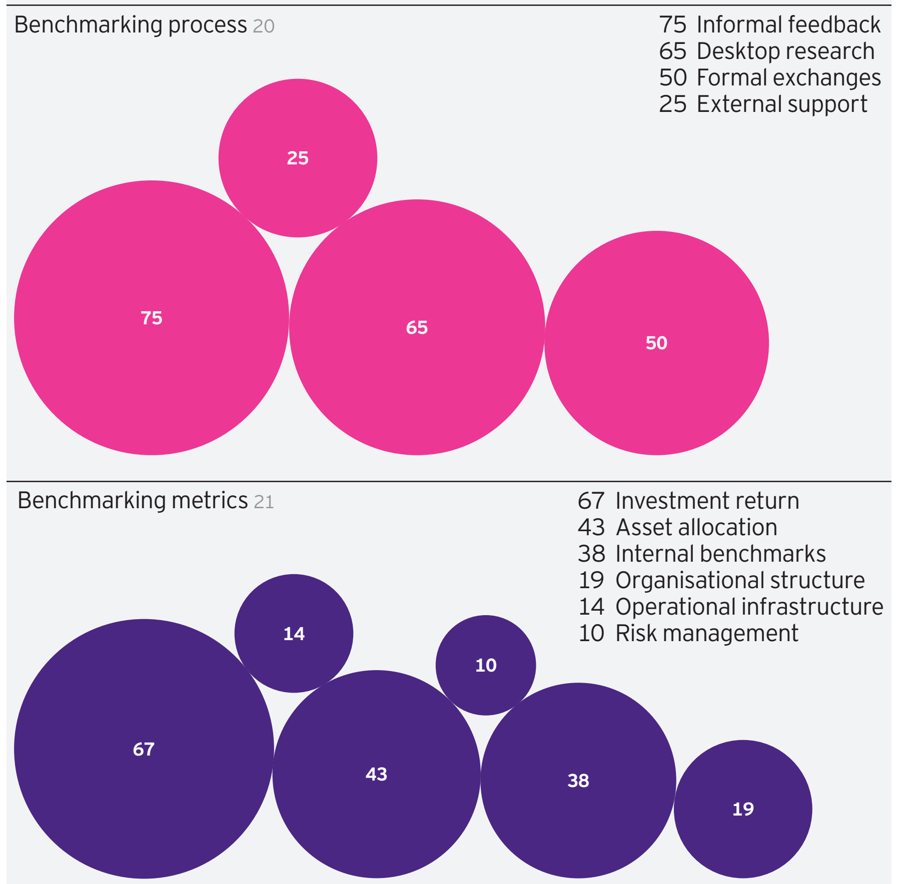
The regional anomaly to this trend was Latin America where sovereign benchmarking reduced slightly year-on-year. Where benchmarking took place there was a strong focus on regional sovereigns at a similar scale and phase of development rather than international peers and best practice. Respondents planned to increase risk asset exposure so it is probable that sovereigns will conduct more extensive global benchmarking over time.

Fig 19. Benchmarking against other sovereign investors (%)



Samples shown in grey.

Fig 20. Number of citations for different benchmarking processes and metrics (%)



Note: % based on number of respondents. Samples shown in grey (2014).

Ongoing focus on people and talent and other structural factors like size
Last year more sovereign investors cited people and talent as the key development area. Development sovereigns and those in developed markets identified the greatest people and talent challenges but the issue was almost universal given the structural challenges for sovereigns when competing for top talent with private sector institutions. This year we can quantify these challenges. On average only 20% of sovereigns feel they are able to match private sector remuneration and 9% believe packages are equivalent, leaving the majority with a challenge in terms of absolute remuneration or the ability to construct long-term incentive schemes (figure 21a).

Our analysis suggests that these challenges are particularly acute for smaller sovereigns with above-average allocations to risk assets or above-average allocations to internal asset management. Key recruitment and retention challenges were most prevalent in strategy units (with a focus on asset allocation, risk and benchmarks), followed by the manager selection process or underlying asset management (figure 21b). However, this result does not adjust for sovereigns who do not manage assets in-house: where sovereigns have made a decision to manage assets in-house, asset management (rather than strategy or asset allocation) is often the key focus for people and talent.

Our year-on-year analysis and qualitative feedback suggest that the challenges around people and talent are reducing. Last year 37% of respondents cited people and talent as a challenge compared to 31% this year (figure 22). Respondents explained that they are more comfortable articulating their non-financial points of differentiation and are improving or expanding their partnerships with third parties for training and secondments.

Fig 21b. Sovereign investor view of areas of key recruitment challenges (%) 37

Sample shown in grey (2014).

Fig 21a. Sovereign investor view of their remuneration versus the private sector (%) 35

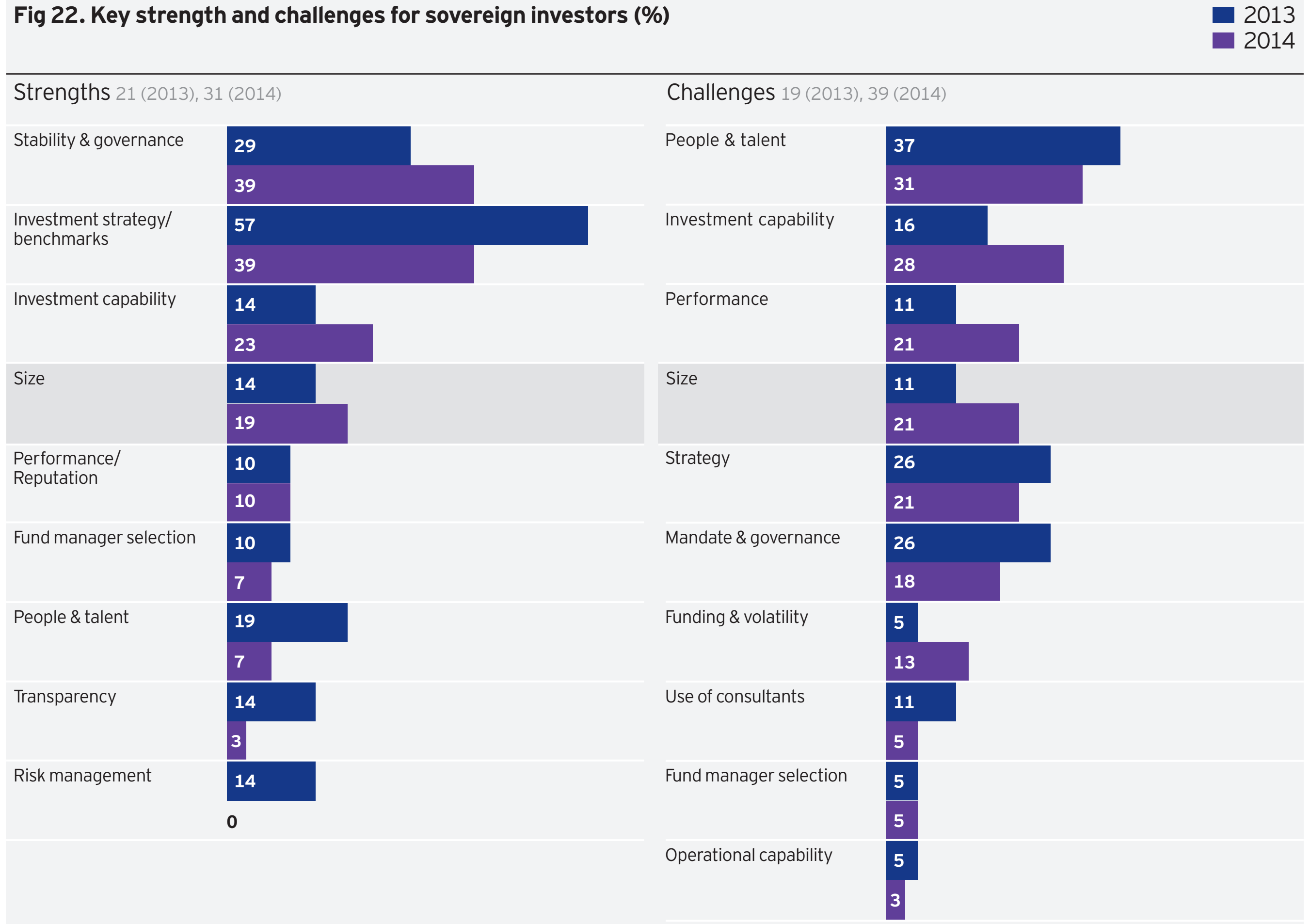
Sample shown in grey (2014).

"On average only 20% of sovereigns are able to match private sector remuneration and 9% believe packages are equivalent, leaving the majority with a challenge in terms of absolute remuneration or the ability to construct long-term incentive schemes."

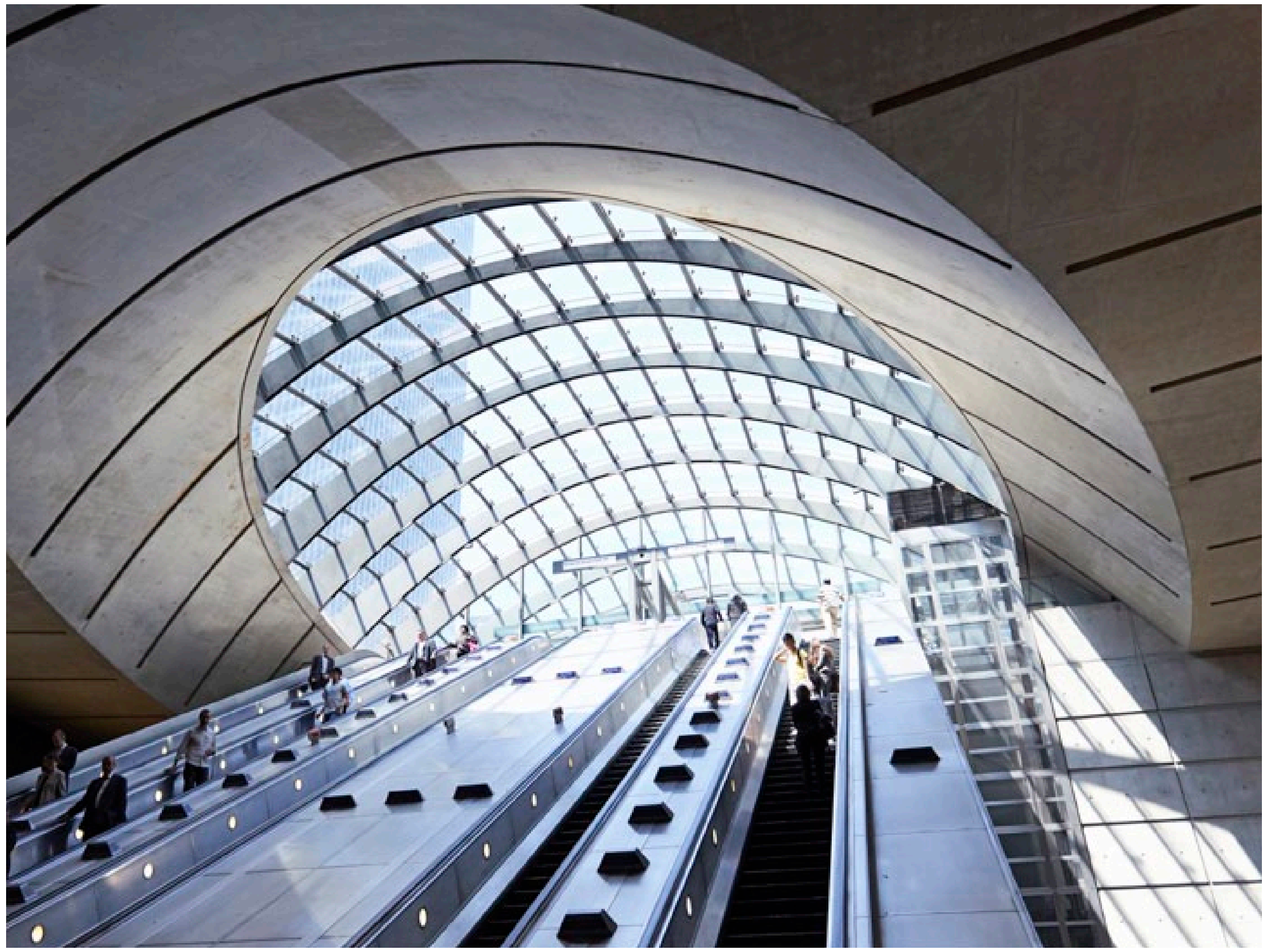
This year we note that discussions on people and talent often followed on to a discussion on the size of the fund. Across all sovereign investors, stability and governance is viewed as the greatest strength while people and talent is the primary challenge (figure 22). However if you analyse the results for sovereigns with greater than $100 billion, 'size of fund' is cited as the greatest strength and also as the greatest challenge.

Size helps attract and retain talent: sovereigns invest globally and offer employees a global view of investment management and access to the full spectrum of global experts. Few private sector asset owners can match this global perspective and level of accessibility. Furthermore, sovereign size ensures competitive pricing across all asset classes. However there are challenges to size. In theme 1 we highlighted that strategic asset allocation appears more influential than tactical asset allocation. This dynamic is acute amongst the largest sovereign investors placing large volumes of new assets. Tactical behaviour would move the market and many strategy units are challenged by their inability to sufficiently exploit short-term investment opportunities. Similar challenges exist in manager selection. Individual asset managers struggle to absorb sovereign capacity so sovereign investors place similar mandates with multiple managers, challenging outperformance and driving sovereigns towards indexing strategies.

Fig 22. Key strength and challenges for sovereign investors (%)



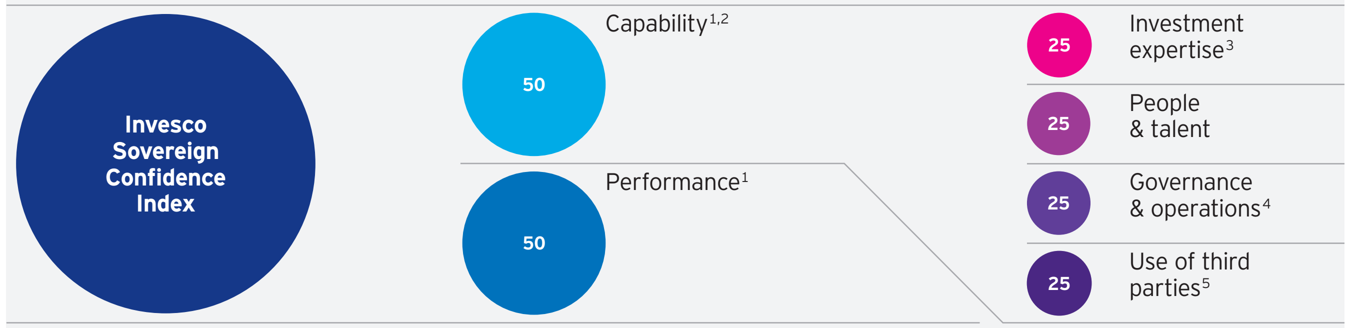
Note: Percentages based on number of citations / number of respondents. Samples shown in grey.



The Invesco Sovereign Confidence Index will aim to track sovereign perceptions of performance and capability each year
Our global sovereign studies detail key themes in the industry and as part of this process our sovereign confidence index will monitor ongoing perceptions of performance and capability on a consistent basis. Our sovereign index proposes a range of sub-indices to monitor perceptions of performance and capability on an annual basis. Our core index applies an equal weighting to historic annual performance and capability where capability consists of four components: investment expertise, people and talent, governance and operations and the use of third parties (asset managers and consultants). A schematic of the core index and underlying indices is set out in figure 23. Some of these capabilities are built up from multiple underlying factors: for example investment expertise includes ratings for asset allocation, risk management and investment benchmarks.

Our core index, in figure 24, generates an aggregate average score of 7.5 out of 10 across the sample, with averages of 7.9 for investment sovereigns, 6.8 for development sovereigns, 7.3 for liability sovereigns and 8.0 for liquidity sovereigns. We will also report on performance and underlying capability indices separately to help explain the underlying drivers of the overall index performance.

Fig 23. Schematic of the core sovereign index and underlying indices and weightings (%)



[1] Performance and capability rated on a score from 1 to 10 where 10 = highest. [2] Average across capabilities where the importance and performance scores are greater than or equal to 6; average based on a 25% weighting across investment expertise, people & talent, governance & operations and use of 3rd parties. [3] Includes investment strategy/benchmarks, asset allocation, investment risk management and internal asset management. [4] Includes governance, transparency, operational capability and investment reporting. [5] Includes fund manager selection and use of consultants.

"Our sovereign index proposes a range of sub-indices to monitor perceptions of performance and capability on an annual basis."

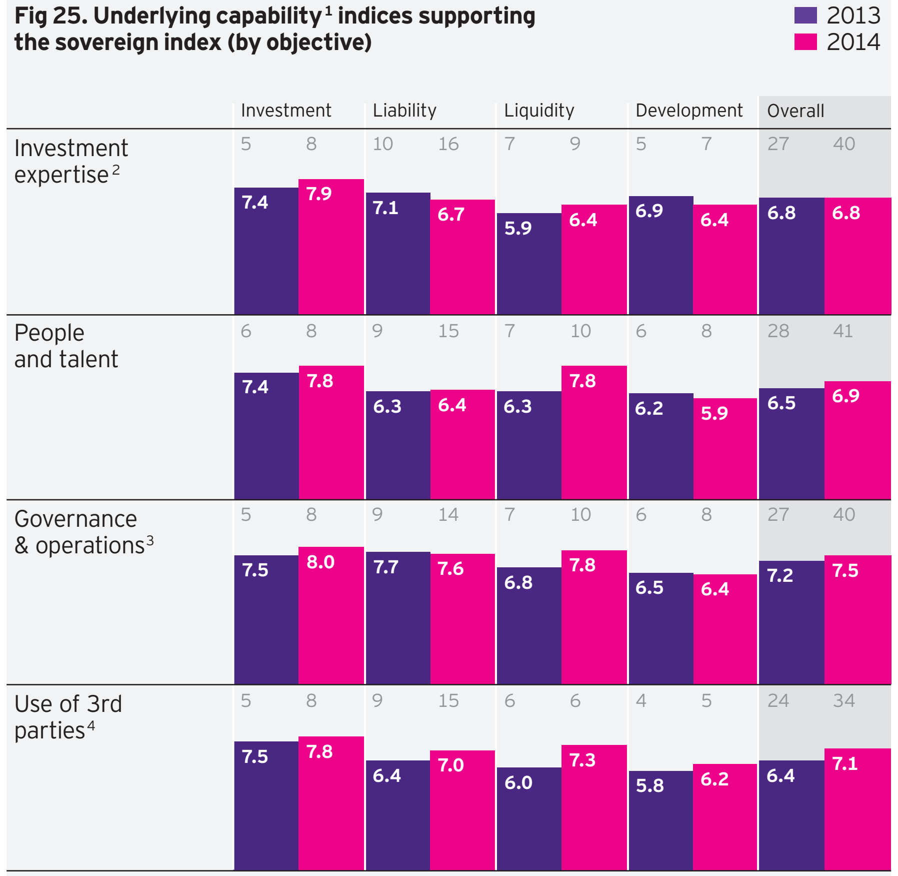
Fig 24. The Invesco Sovereign Confidence Index and underlying capability and performance metrics

[1] Performance rated on a score from 1 to 10 where 10 = highest performance. [2] Capability rated on a score from 1 to 10 where 10 = highest capability. Average across all capabilities except strategic investments and internal PE where the importance and performance scores are greater than or equal to 6. Invesco Sovereign Confidence Index – average of 'performance' and 'capability'. Samples shown in grey.

Our index highlights confidence in short-term performance but some concerns over the longer term
The last year was positive for short-term sovereign investment returns. Typical asset allocations meant that higher returns from developed market equities outweighed any underperformance from emerging market equities or fixed income. As a result investment sovereigns were positive overall, rating their annual performance in 2013 and their perceived capability to deliver future returns close to 8 out of 10 on average (figure 24).

However, the index highlights some areas of lower confidence and supports the key themes in our report. Liquidity sovereigns scored themselves highly for delivering on liquidity objectives in 2013 but lower, on average, for overall capability at 7.5 out of 10 given potential evolution from liquidity investors to conventional investors (theme 3). In line with our theme last year, development sovereigns are least confident scoring 7.4 out of 10 on average for 2013 performance and 6.2 for capability as they continue to identify gaps in direct strategic investing which defines these sovereigns. The potential concern that partial liability sovereigns may take on all the liabilities and income payments (theme 2) is evidenced by a significant drop in capability versus performance for liability sovereigns. Finally, the focus on people and talent reported last year and the investment in this capability this year are evidenced by the low but improving average rating for people and talent across the study. We will seek feedback from the industry on our confidence indices and consider ways to improve the insight from these sovereign indices in the future.

Fig 25. Underlying capability[1] indices supporting the sovereign index (by objective)



[1]Capability rated on a score from 1 to 10 where 10 = highest capability. [2]Includes investment strategy/benchmarks, asset allocation, investment risk management and internal asset management. [3]Includes governance, transparency, operational capability and investment reporting. [4]Includes fund manager selection and use of consultants. Samples shown in grey.

7.5/10

Liquidity sovereigns scored themselves highly for delivering on liquidity objectives in 2013 but lower, on average, for overall capability at 7.5 out of 10.

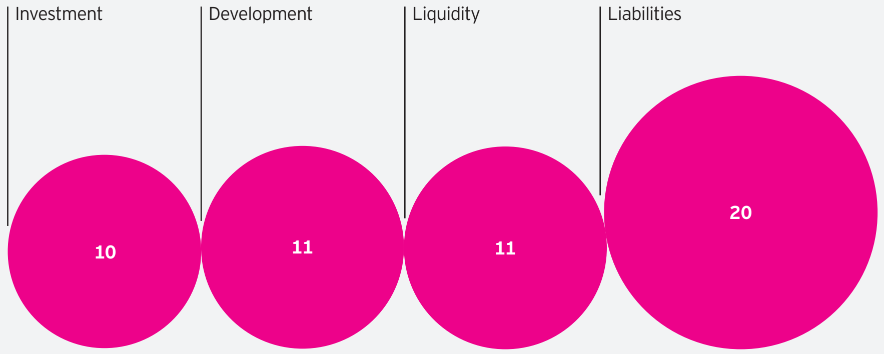
Appendix

Sample & 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

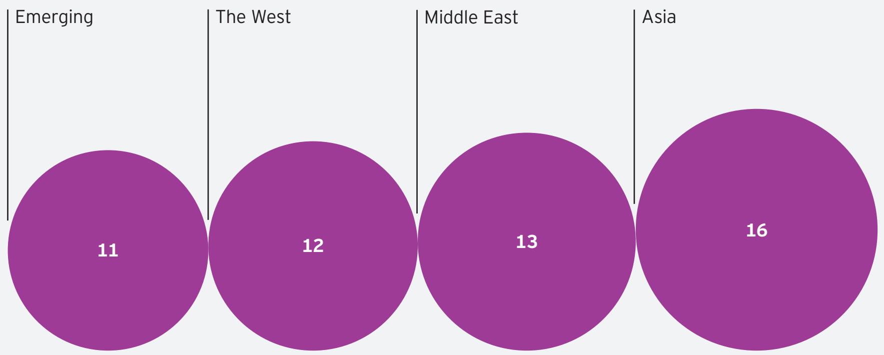
In 2014 we conducted interviews with 52 different sovereign investors compared to 38 in 2013, with significant increases in our coverage of liability sovereigns and of Asia and the Middle East regions. Throughout the report we present 2014 results based on the 52 interviews and 2013 results based on 38 interviews. However we have also validated our findings using 'common cohort' analysis of the 31 interviews conducted with the same firms in both years. The breakdown of the 2014 interview sample split by three core segmentation parameters (sovereign investor profile, region and size of FUM) is displayed in figures 26 to 28.

Fig 26. Sample overview by sovereign investor objective 52



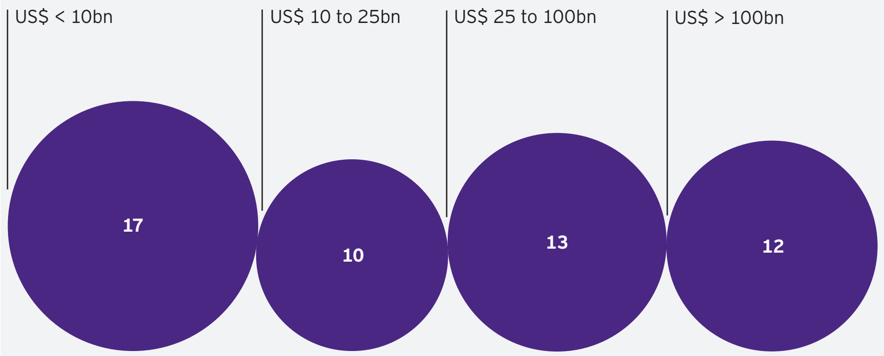
Sample shown in grey.

Fig 27. Sample overview by region 52



Sample shown in grey.

Fig 28. Sample overview by size of FUM 52



Sample shown in grey.

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

For Asia Pacific:
Alex Prout, Managing Director
Head of Institutional Sales, Asia Pacific
alex.prout@invesco.com
+852 3128 6866

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