Asset Rotation

- **Norway's pension fund embraces equity risk.**
- **It will only hold bonds in $, € and £; ¥ is out.**
- **Reflects a growing search for liquidity and returns.**
- **Others seek rich returns via structured finance.**

Norges Bank (Central Bank of Norway) and its management of the Norwegian Government Pension Fund has undertaken a major realignment of their investments.

The sovereign wealth fund (world's largest ~ USD 981.4 Billion) was originally established to focus on global sovereign bonds, however, moving forward they are making a tactical allocation shift by increasing their exposure to equities to an initial level of 60%. It is expected that will increase over time.

Risk/Reward profile

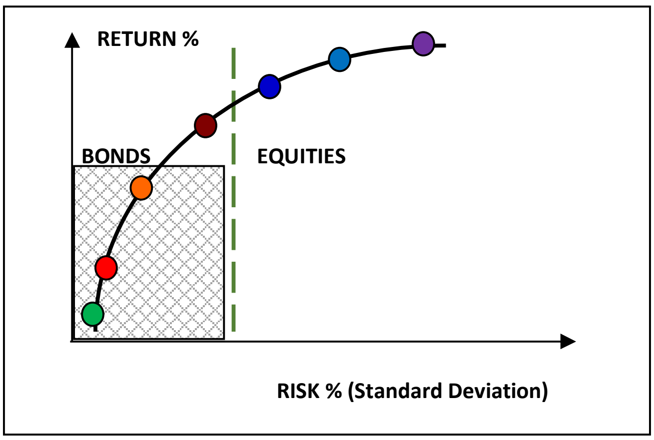
Of course, that means less capital is to be allocated to fixed income bonds and as such they will explicitly focus on the markets where they perceive the greatest liquidity can be obtained. That means the fund will be leaving no less than 23 bond markets and placing their attention on the debt markets denominated in United States Dollars (USD, $), Euro (EUR, €) and Sterling (GBP, £). This includes an exit from all direct emerging market and corporate bonds.

If one looks at Figure 1, it would appear at first glance that the Norwegian reasoning is moving away from the normal position of a sovereign wealth fund that would normally tend to be risk adverse.

Figure 1: Risk/Reward   Source: Spotlight Ideas

KEY: ***Cash***...***Money Market and Government***...
Investment Grade Corporate ...
Emerging Market...***Large Cap Equity*** ...
Mid cap Equity ... ***Small Cap Equity***

Sovereign Wealth Fund Location



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On the contrary, what could be riskier than to be locked into a large holding of an asset where the liquidity has started to evaporate. With bond market volatility almost eliminated by the various formulations of quantitative easing bond prices across can be seen to track along in interesting channels, Figure 2.

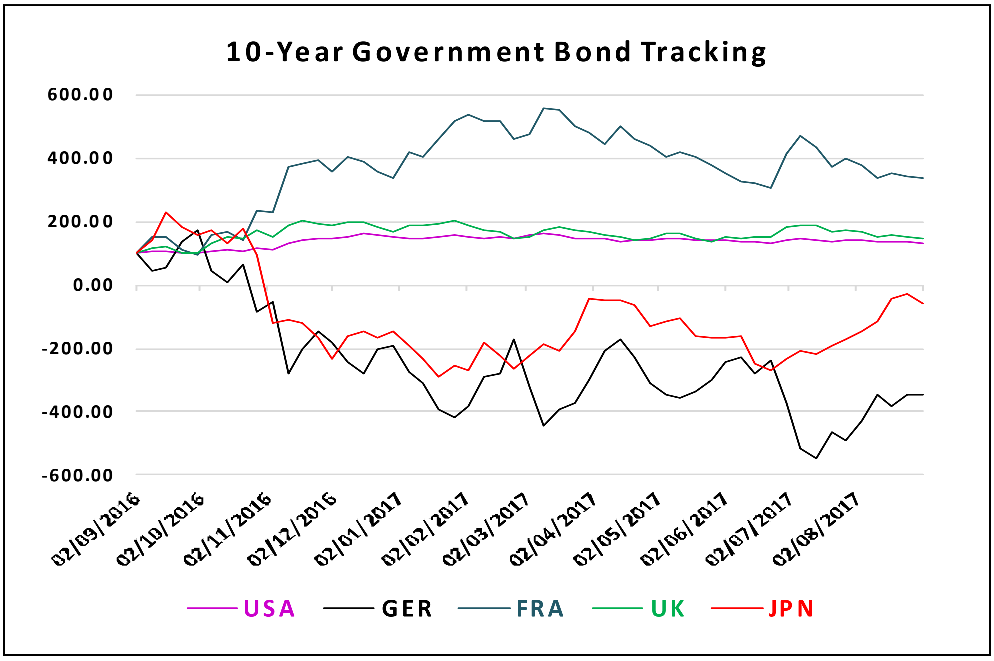

Figure 2: 10-Year Government Bonds, Based at September 2, 2016 =100   Source: Spotlight Indices

What is intriguing from Figure 2 is that there is a good match between Germany and Japan where R^2 is equal to 0.7469 and the UK and US, R^2 = 0.7305. France is the complete outlier thanks to the weak policies of François Hollande and his relatively new successor, Emmanuel Macron.

Consider the paring of the Japanese Government Bond 10-Year and the German 10-Year Bund. These two markets have outperformed the others we illustrate in Figure 2 and yet the Norwegians have decided to liquidate all JGB holdings.

The reason for this is because the two markets offer different risk profiles for the same return. Another critical factor is that the JGB market is less liquid because of the Bank of Japan's bond purchase programme. The Norwegian Fund has concluded that owning JGB's gives no diversification benefit and in the event of a market downturn it could prove difficult to efficiently liquidate holdings, Figure 3.

It would follow then that as the returns from UK Gilts and US Treasuries are closely matched, the two markets are judged to be of sufficient liquidity and depth as to warrant continued exposure.

Gains from diversification

The key to understanding Norges Bank's new rationale and approach is based upon the reality:

"...gains from International diversification are considerable for equities, but moderate for bonds..."

according to the fund in a paper submitted to the Norwegian Finance Ministry outlining the new reasoning that underpins its strategy.

We can support this view as at Spotlight Indices our Developed World Equities have gained 16.74% this year whilst the sector variation rages from -20.76% for Communications to +45.54% for Utilities.

One could maybe feel entitled to ask why stage an exit from all corporate bond exposure? The answer is found in the fact that they now have a yield spread that minimal over the underlying government markets. Why take the risk for such a low return when one can gain corporate exposure in equities?

For example, in Sterling the A3/A-/A- rated Electricitie de France 6.250% May 2028 yields just 35 bps over the 10-Year Gilt. To acquire any valuable spread, one must consider non-investment grade paper that requires one holds paper issued by over-indebted companies that could easily collapse when central banks decide to increase interest rates.

If one looks at Figure 3, it would appear that the Norwegian reasoning is moving to where a risk/reward indifference curve is freed by a lighter constrained optimum of large cap equity exposure IC2 as against the old position at IC1.

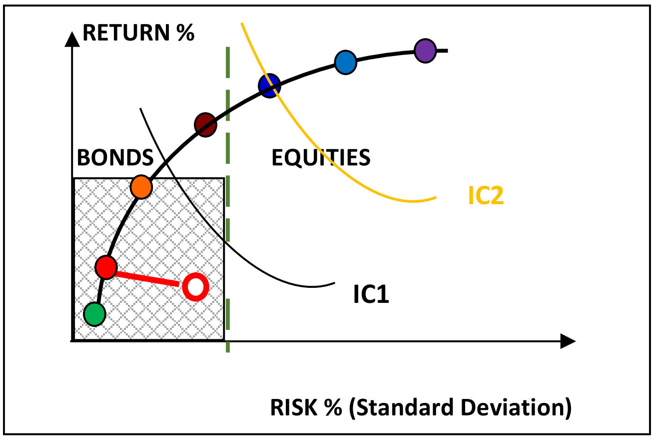

Figure 3: Risk/Reward and New Paradigm
Source: Spotlight Ideas

***KEY:** Cash…Money Market and Government…*
JGB ○… Investment Grade Corporate …
Emerging Market…Large Cap Equity …
Mid cap Equity … Small Cap Equity

In Figure 3 we have drawn the investment indifference curves as not being bowed towards the origin; thus we have not assumed diminishing marginal rate of substitution between return and risk.

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Other investors can look elsewhere

One asset class that was not featured on the risk/reward charts of Figures 1 and 3 was project or structured finance. That is because such arrangements tend not to have the liquidity that a sovereign wealth fund may require and quite often, national governments will have alternative funding offices that engage in such investments, particularly if the project is domestic or at most, locally bi-lateral.

Shrewd managers have often adjusted for risk in capital budgeting. It is accepted that a riskier project is less valuable than a safer one and so as compensation a greater level of return would be required rising in proportion with the level of risk.

A typical starting point is to assess what is the cost of capital that would be required for the project to be activated. This can be used as a benchmark risk-adjusted discount rate for new investments. Therefore, it can be defined as the expected return on a portfolio of all the companies existing securities, i.e. it is the opportunity cost of capital for investment in the firm's assets.

The investment hypothesis is simple: Financial assets (bonds and stocks) have been massively distorted by the asset purchase or quantitative easing (QE) programmes and this has resulted in financial asset inflation seen in low yields and overly optimistic equity prices.

Therefore, there are yield hungry investors that shun traditional low risk instruments as they seek to enhance their yield return by actively engaging in asset rotation...not just active asset management within the same risk domain. In short, they are seeking ways to improve returns and diversification multipliers and "*alternatives*" such as project or structured finance has gained a greater following.

These are complex markets and to engage with confidence any investor ought to have personnel with specific skills and industry knowledge. Only then can an investor be confident about embracing the risks of a structure that take the form of secured senior and subordinated debt, quasi equity, start-up/private finance and equity.

Aircraft to take-off

One current popular activity now is seeking to access the returns derived from real assets such as aircraft leasing.

Aircraft leasing has experienced strong and continued growth for over 40 years, Figure 4, and it is continuing to grow in popularity, accounting for 40% of today's commercial aircraft fleet. It is expected over half of all commercial aircraft will be owned by lessors before the end of the decade.

It is quite feasible to arrange a deal worth USD 500 Million and above where the returns can be 8.0% or more based on a pool of aircraft leased to a leading airline that will offer full aircraft maintenance so providing a predictable residual value at lease end. These can be arrangements between the aircraft manufacturer and airline directly, Figure 5.

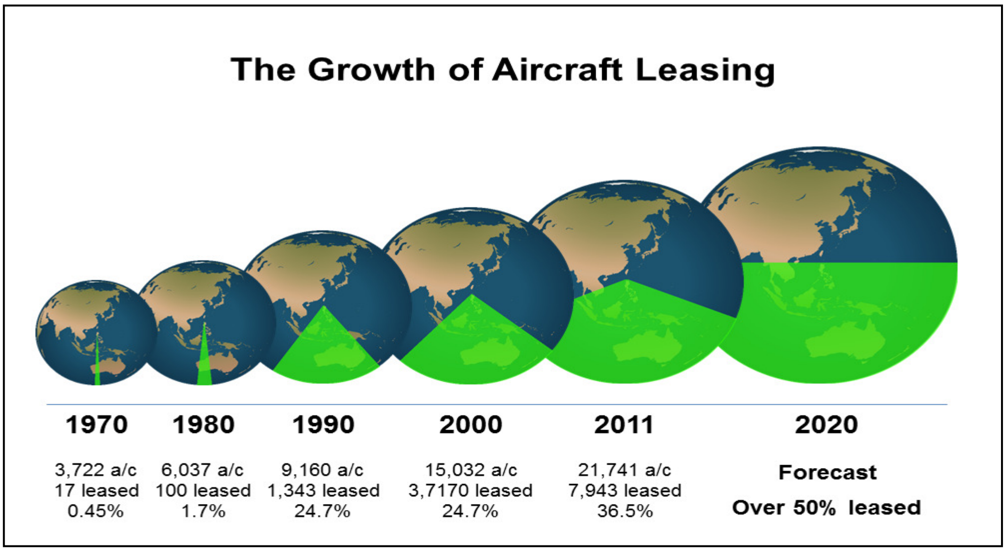

Figure 4: The Growth of Aircraft Leasing Source: Boeing and www.capitalaviation.net

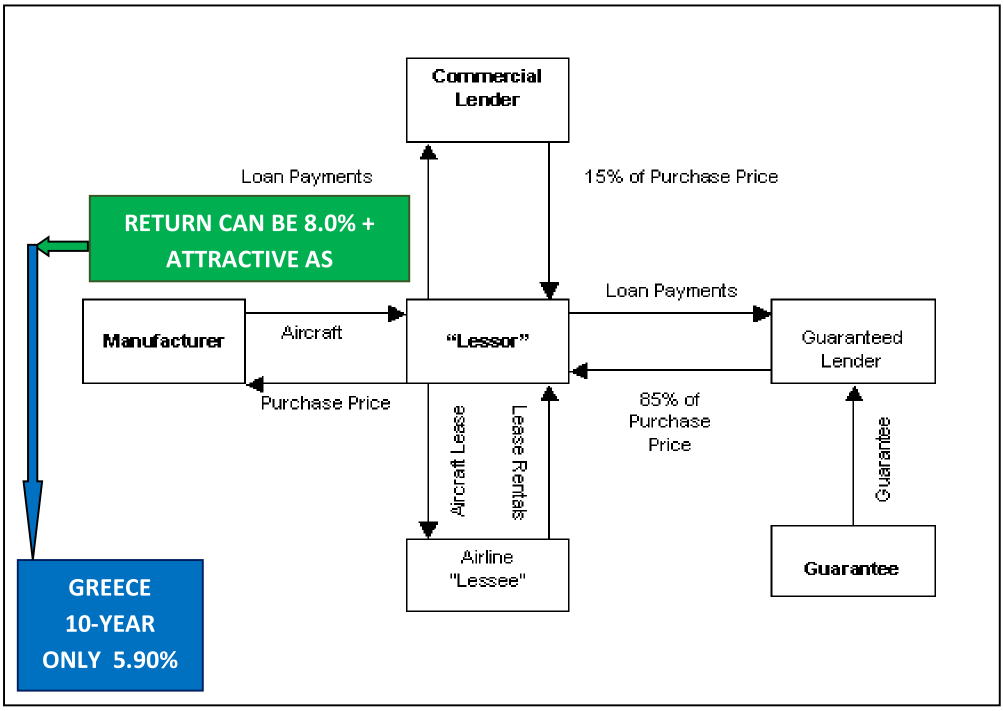

Figure 5: Cash Diagram of Aircraft Leasing Programme Source: Spotlight Ideas

The lessor would normally find a sponsor, e.g. a state-owned airline would look to the government for approximately 85% of the net-net invoice purchase price and the lessor will acquire via a "*Special Purpose Company*" (SPC). In the US, many aircraft deals are financed by the US Export-Import Bank.

The opening for the private investor is in that the SPC typically obtains the balance of the aircraft purchase price from either a commercial financial institution or the airline via a non-refundable advance payment of rent under the lease.

Of course, one should be aware that such deals are complex and created to meet needs that cannot be met from traditional financial instruments available in the markets. As such there is a transfer of risk applied to the securitisation of various financial assets, these include:

Aircraft leases ... Auto-Loans ...Credit Card Receivables ... Movie Finance and once again Mortgages

Such deals have helped provide increased liquidity or funding sources to large cost item markets and can be structured to create enhanced yield returns to buyers of structured products. However, they also come with an elevated level of risk. So, as always, buyers must be awake, alert and aware.

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