# Reserve managers move to equities

Investment tranche allows for greater risk

by Elliot Hentov in London

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Since 2008, central bank investments have been frequently viewed only in relation to their asset purchases that have been guided by monetary policy. Quantitative easing and a plethora of other asset purchase programmes have expanded the balance sheets of most developed economies' central banks. However, the focus on domestic asset classes has distracted from long-term trends in foreign reserve portfolios.

State Street Global Advisors has identified two clear developments in reserve management: increased exposure to active fixed income at a time when other investors are turning to passive vehicles; and cautious embrace of equities as a new reserve asset class.

Central banks – in their role as investors of reserve portfolios – are cautiously starting to operate much like other investors: investing in riskier assets and searching for higher yield beyond their core bond portfolios. Even if bond yields rise more than forecast, this structural trend will prevail.

In this context, reserve managers are becoming increasingly convinced that equity in passive form has a core role on central bank balance sheets. The immediate effect will be that central banks will contribute to growing overall flows into passive equity products. In the longer term, there will be an evolution of central banks' reserve management.

Between 2003-14, there was unprecedented growth in global foreign reserve holdings. While nominal world GDP grew by 6.2% annually during that period on average, the stock of total foreign reserves grew by 14.3% on average each year, according to the International Monetary Fund. The disparity is partially explained by the commodity boom, higher trend growth in emerging economies and export-led growth resulting in big current account surpluses.

The accumulation of reserves ended in 2014 and stocks have since declined owing to weak growth and capital outflows in emerging markets. Reserves are probably approaching the bottom of the retrenchment and should start to grow again in 2018. Total foreign reserves are expected to reclaim their 2014 high of $12tn by late 2020.

This macro forecast is SSGA's starting point for assessing the investment tranches of global foreign reserves. The investment tranche is the portion that is not designated for external liquidity purposes, but serves primarily national wealth management objectives.

The exact cut-off point within reserves is difficult to define, but the main feature of the investment tranche is that these reserves are liberated from constraints that would apply to conventional foreign reserves. In theory, they can be invested long-term and do not have rigid liquidity requirements.

SSGA estimates that the investment tranche constituted roughly 15% of the total stock of reserves in 2016. Its value is $1.64tn, with the bulk – 80% – held in cash and fixed income products. Given that these funds emerge from a conventional reserve portfolio, and that the core expertise of central banks is in managing fixed income assets, this is to be expected.

At the same time, the question arises as to why the investment tranche (which functions as a long-term investment tool for capital gains purposes) has such large exposure to passive fixed income and cash products. If the investment tranche is designed to produce extra yield in relation to standard bond portfolios, such an allocation seems ineffective.

Things are gradually changing. SSGA research suggests that by 2020 the proportion of central bank investment portfolios in passive fixed income will fall to 38% from 44%. At the same time the share in active fixed income is predicted to grow to 25% from 23% and in passive equities to 20% from 16%. The lower proportion of passive fixed income will stem not from a decline in the nominal size of passive fixed income portfolios, rather from a channelling of reserve portfolio growth into other strategies.

The global investment tranche should reach $1.94tn in 2020. Between 2016-20, more than 75% of future asset growth (new investment assets) is likely to be deployed either in equity or active fixed income strategies. In other words, of the forecast $298bn that SSGA expects to be added to the investment tranche, $228bn is likely to be positioned in those two strategies.

Once reserve managers are comfortable with the new asset classes and the requisite risk management, there is only one direction of travel – to continue to broaden the toolkit and expand further.

Elliot Hentov is Head of Policy & Research, Official Institutions Group, State Street Global Advisors.

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