3. EXTERNAL MANAGERS

KNOWLEDGE IS KEY AS RESERVES MANAGERS LEAN ON THEIR ADVISERS

Deep relationships mean external managers can help their clients navigate short-term market challenges as well as long-term strategic shifts. By Julian Jacobs.

WHAT a difference a year makes. In the 2021 OMFIF survey of central banks, reserves managers revealed that accessing complex asset classes was the main reason for employing external managers. As central banks sought to diversify into higher yielding products, such as credit or equities, paid for advisers played a crucial role in helping them add new products to their portfolios and manage associated risks.

Twelve months later the world has changed, with the return of inflation and rising geopolitical concerns. Many investors have switched into capital preservation mode (see Chapter 2). Diversification and knowledge transfer are now the most important part of the external/reserves manager relationship. Benchmarking performance is of growing importance (see Figure 1).

This chapter summarises key findings from our survey of 73 central banks as well as our interviews with external managers from Amundi, BNY Mellon, BNP Paribas, BlackRock, State Street Global Advisors, Neuberger Berman and UBS Asset Management. Our findings suggest that external managers are becoming a growing part of central banks' strategies, helping abet knowledge transfer, particularly at institutions in the global south, many of which have more scarce internal resources. External managers are thus a key part of the broader movement towards diversification, which is marked by growing interest in new asset classes, including exchange-traded funds.

DIVERSIFICATION IN A VOLATILE WORLD

External managers can assist central banks by helping improve their diversification. The chief reasons for central bank reserves diversification are to preserve capital, reduce risk volatility and increase returns. Figure 1 shows that 76% of reserves managers in 2022 cited diversification as a reason that they employ external managers, up from 69% in 2021. And this emphasis on diversification may grow in response to current uncertainty. As Jahangir Aka, head of official institutions at Neuberger Berman, points out, 'Volatility is a big driver for movement towards external managers, since the diversification of instruments is greater than ever, and some central banks lack resources.'

Aka spoke to a crucial point about the way central banks are using external managers in such a difficult period for the global financial system. Many central bank reserves managers are dealing with their first experience of taking losses in a long time. Massimiliano Castelli, head of strategy for global sovereign markets at UBS Asset Management, notes that central bank losses right now dwarf those 'experienced even in 2008' largely as a result of negative returns in fixed income. So far, central banks have adopted a wait and see approach in the light of the strong returns experienced over the last few years.

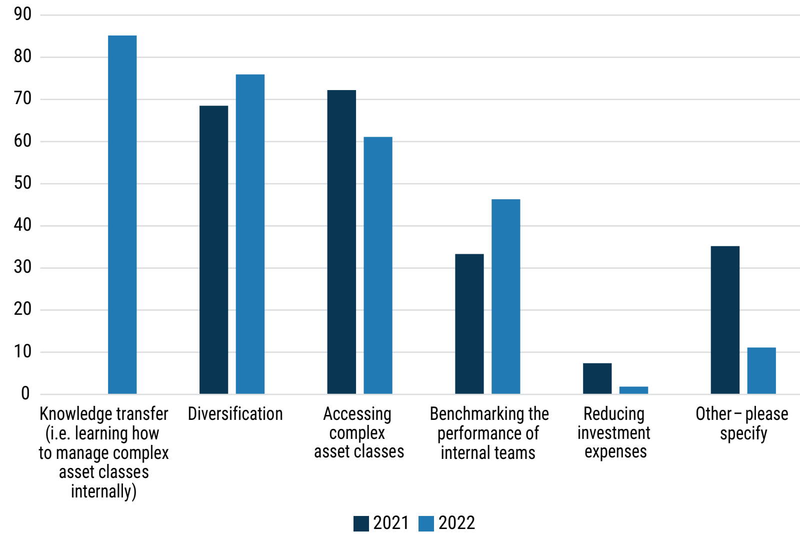
External managers offer the opportunity to not only reduce losses, but also to become more active investors. The growing orientation of reserves managers towards equity markets and real estate, for instance, is a good example of how central banks are, as Castelli said, diversifying and in doing so becoming 'more similar to pension funds'.

The importance of external managers in diversifying and accessing other asset classes is highlighted in Figure 2. Although the use of external managers is highest for government and corporate bonds, these results should be contextualised. First, the World Bank's reserve advisory and management partnership may well be considered external management by many central banks, which inflates the figures for government bonds in particular. And second, as Johanna Lasker, chief executive officer for North America at BNP Paribas Asset Management, pointed out, 'If you think of a classic [central bank] portfolio, it's still mostly government bonds, with a small allocation to equity, if any.' Indeed, the 27%

1. CENTRAL BANKS USE EXTERNAL MANAGERS FOR KNOWLEDGE TRANSFER AND DIVERSIFICATION

For which of the following reasons do you employ external managers? Share of respondents, %

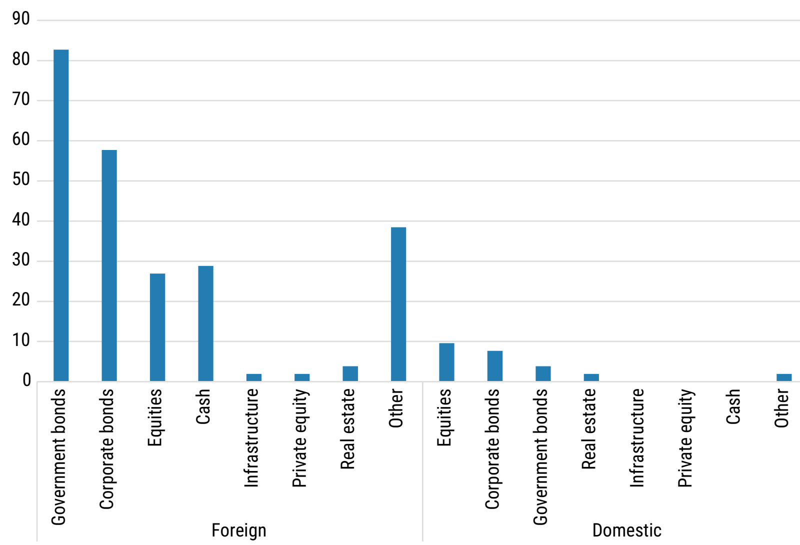
Note: Knowledge transfer not included as an option in 2021.



Source: OMFIF GPI survey 2021-22

2. EXTERNAL MANAGERS USED IN DIVERSITY OF ASSET CLASSES

For which of the following reasons do you employ external managers? Share of respondents, %



Source: OMFIF GPI survey 2022

76%

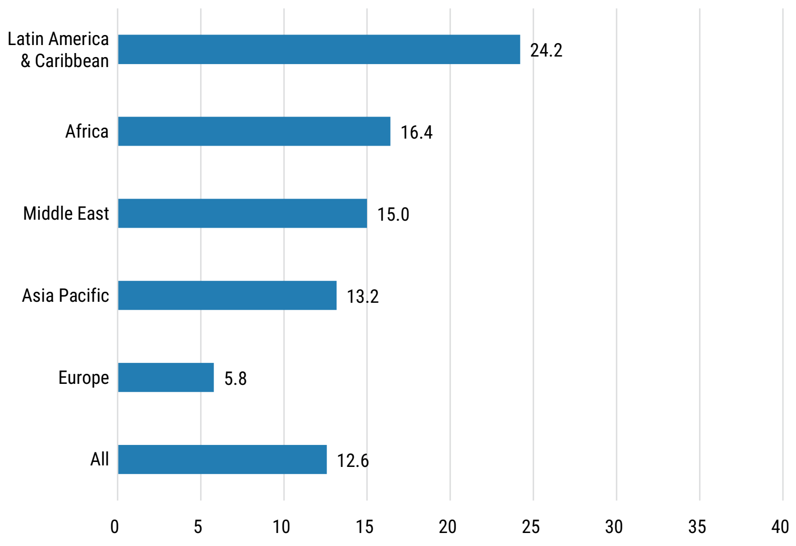
Three-quarters of reserves managers who turned to external managers did so to aid diversification

18%

Nearly one-fifth of reserves managers find moving into ETFs appealing

3. EXTERNAL MANAGERS RESPONSIBLE FOR AVERAGE 13% OF CENTRAL BANK ASSETS UNDER MANAGEMENT

What percentage of your assets under management is managed by external managers? Average response, %



Source: OMFIF GPI survey 2022

usage of external managers for equities and 38% for 'other' (e.g. supranationals and mortgage-backed securities) is high relative to the average equity allocation of a central bank reserves portfolio.

This indicates a particular emphasis in central bank usage of external managers on equity. Moreover, if we studied the percentage of central bank equities that are handled by external managers, we might see a more complete picture of the role external managers play in supporting central banks' behaviour in equity markets. As Isabelle Mateos y Lago, global head of the official institutions group at BlackRock, remarked, 'In our experience, central banks are more likely to turn to external asset managers when they diversify into new asset classes; when it comes to equity allocations, which according to our research only about one-third of central banks in 2019 were allowed to invest their reserves in, the GPI survey share of 27% recourse to external managers suggests it is the overwhelmingly dominant practice.'

THE IMPORTANCE OF KNOWLEDGE TRANSFER

Beyond the growing significance of external managers to central banks' diversification efforts, they are used by many central banks as part of 'knowledge transfer' – 85% of central bank survey respondents cited this. The point here is for reserves managers to utilise the deep institutional knowledge, flexibility and understanding of new financial instruments, portfolio management techniques and operating models that asset managers and private financial institutions possess.

The importance of passing on such institutional knowledge is particularly pronounced for central banks with fewer resources. This explains the higher rates of external manager usage in the global south. External managers are responsible for 13% of assets under management for all central banks in our survey (Figure 3). Yet this number is larger for Latin America (24%), Africa (16%) and the Middle East (15%). External managers, by contrast, handle 6% of assets under management in Europe. In total, this comes out to an estimated $410bn of survey respondents' assets handled by external managers and average fees of 0.05% (or five basis points) of central bank assets under management among respondents.

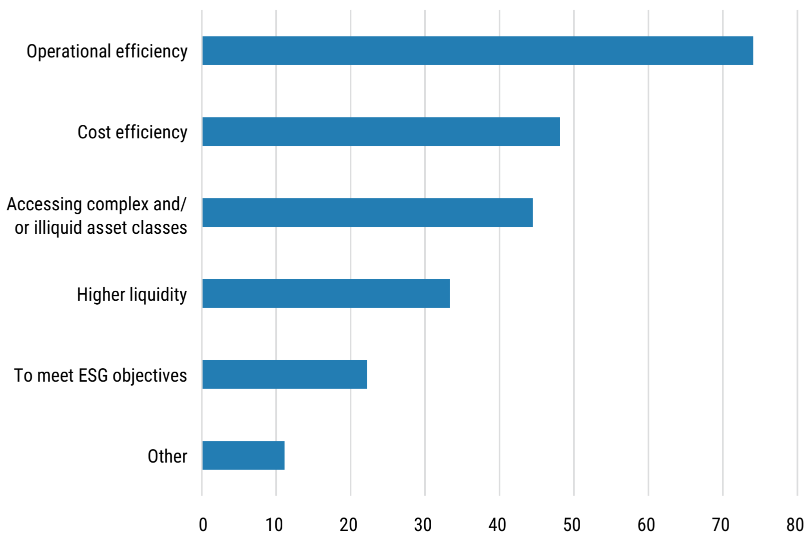
Xavier van den Brande, segment head for asset owners, Europe at BNY Mellon, explained that central banks 'expect to learn more about asset classes by working with external managers… [and the] diversification away from fixed income means some global south central banks will benefit from using external managers.' As a consequence, some central banks not only view external managers as a helpful way to diversify, but, perhaps more importantly, as a tool to learn about markets, financial instruments, data and complex asset classes.

Knowledge transfer tends to be tailored to central bank needs. Aka of Neuberger Berman explained that 'We have training that is bespoke for them, including training them on a more holistic view of how to manage money… and if there is a specific area, we help with that too.' Eric Dussoubs, head of institutional clients coverage at Amundi, discusses how, in particular, the institutional knowledge of external managers around 'regulation, complexity and data' are areas where central banks ask for support.

This element is likely to grow in importance for

4. ETFs USED PRIMARILY FOR OPERATIONAL EFFICIENCY

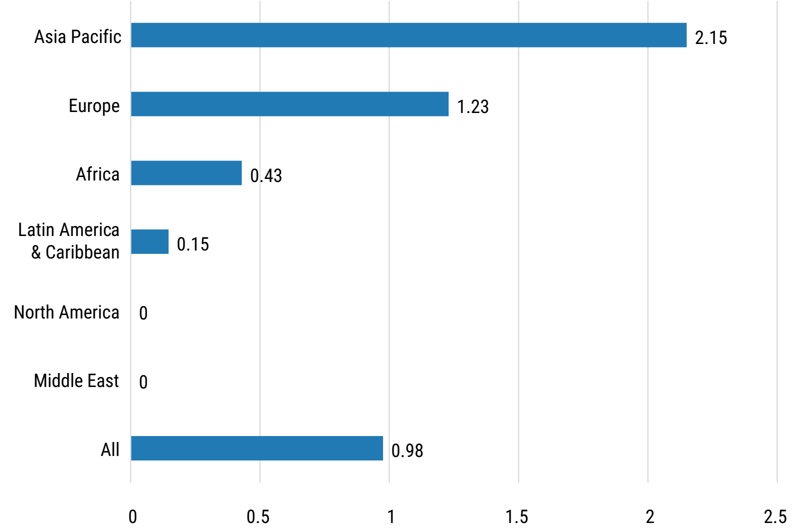
What share of your portfolio is held in the form of ETFs? Average response, %



Source: OMFIF GPI survey 2022

5. ALLOCATIONS TO ETFs AVERAGE 1% OF CENTRAL BANK PORTFOLIO; HIGHEST IN ASIA

For which of the following purposes do you use ETFs? Select all that apply. Share of respondents, %



Source: OMFIF GPI survey 2022

central banks, given the increasing digitalisation and complexity of the financial sector as well as the role of sophisticated data science analyses. Lasker said that there is a 'need among central banks to understand artificial intelligence and data science, and now digital currencies as well.' Regardless of whether this knowledge transfer induces changes to a reserves manager's portfolio, the need for central banks to employ external managers to better understand the changing dynamics of a digital financial system may continue to grow.

THE ROLE OF ETFs AND EQUITY MARKETS

The drive for diversification is not borne out in the level of ETF and equity usage by central banks. Figure 5 shows that an average of 1% of central bank portfolios are invested in ETFs. Such a small allocation is notable given that ETFs should, in theory, represent a particularly attractive vehicle for central banks to enter equity markets. The share of portfolios allocated to ETFs is highest in Asia at 2%.

These low levels of ETF usage may be changing, however. As Brande at BNY Mellon commented, 'ETFs are an obvious choice for central banks without sufficient internal expertise because they are a low-cost way to get exposure' to equity markets. This promises more diversification, making portfolios more resilient across different economic and financial conditions. And although, as Castelli said, central banks with equity exposures are seeing losses in the range of 6% to 8%, he predicts that the diversification trend will continue. Figure 4 shows the main reasons central banks gave for using ETFs within their portfolios. Chief among them were operational efficiency (74%), cost efficiency (48%) and access to complex and/or illiquid asset classes (44%).

Figure 6 highlights the planned movement of ETF holdings by central banks over the next 12-24 months. The results suggest that, even in an environment with significant uncertainty in equity markets, the prospect of moving into ETFs remains appealing to nearly one-fifth of reserves managers.

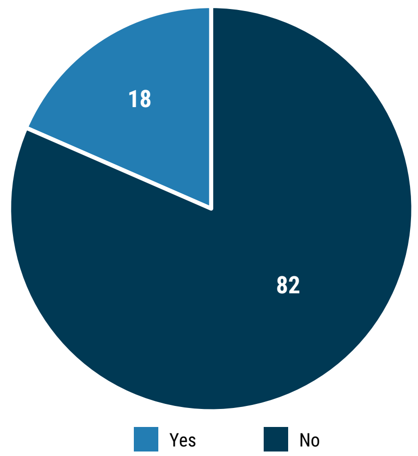
GROWING OPPORTUNITY AMID RISING UNCERTAINTY

Our findings from surveying central bank reserves managers and interviewing external managers offer a window into both the uncertainty of the current macro environment and the opportunity some central banks see for the future. Geopolitical crises, inflationary shocks and prospects for recession are posing considerable challenges for reserves managers. With many reserves managers grappling with the most significant losses they have seen in their career, many central banks have slowed their movement of capital. And yet, the growing use of external managers for diversification (Figure 1) indicates a possible openness to new asset classes. This is made clear by the role these managers play as part of knowledge transfer and in helping central banks understand new markets.

Such developments point to trends in central bank reserves management that may outlast the shock of the current geopolitical and inflation crises. Indeed, as the movement towards ETFs indicates, there is a growing focus among reserves managers on diversifying their portfolios and becoming more innovative in their investment strategies. With this comes the prospect of higher returns, but also greater risk. •

6. 18% OF CENTRAL BANKS PLAN TO INCREASE ETF HOLDINGS

Do you plan to increase the share of your portfolio held in the form of ETFs in the next 12-24 months? Share of respondents, %



Source: OMFIF GPI survey 2022