

1. The Aurora Sovereign Wealth Fund (ASWF) of the fictional country Eldoria is a state-owned investment vehicle established to invest the country's surplus oil revenues. ASWF manages USD 700 billion in assets and is focused on diversifying Eldoria's wealth away from reliance on the country's natural resources. A sizable portion of the fund's portfolio is allocated to alternative investments, particularly in direct infrastructure projects, private equity (PE), and private debt.

ASWF's core investments include:

- Direct infrastructure investments: ASWF owns stakes in Eldoria's national highway system, a fiber-optic broadband network across Southeast Asia, and renewable energy assets in wind and solar power in South America.
- Infrastructure funds: ASWF has invested in several global infrastructure funds that hold assets in airports, utility grids, and water management systems across Europe, North America, and Oceania.
- Private equity: ASWF holds direct investments in health care technology startups within Eldoria and participates in established PE co-investments in clean energy companies, biotechnology firms, and logistics networks in Asia.
- Private debt: ASWF has substantial allocations to private debt funds focused on real estate and small-to-medium enterprises (SMEs) in emerging markets. It also engages in co-investments in real estate-backed private debt in North America.

ASWF aims to balance the high returns offered by alternative assets with Eldoria's goals of long-term financial stability and economic growth. However, the high concentration in these alternative investments presents unique financial and nonfinancial risks that require careful management.

Question 1 of 4

Identify two financial risk exposures in the Aurora Sovereign Wealth Fund's portfolio strategy.

Discuss how these risks might impact ASWF's objectives of growing Eldoria's wealth in a prudent manner.

Explanation:

Model Answer

Identify

Liquidity risk

Valuation risk

Interest rate risk

Discuss

- Liquidity risk: ASWF's alternative investments are largely illiquid since assets like those in the national highway system or fiber-optic networks are challenging to sell quickly without accepting a potential discount. Limited liquidity could impede ASWF's flexibility to adjust its portfolio in response to sudden economic changes or fund withdrawals; this is a crucial consideration given the fund's role in supporting Eldoria's economy.
- Valuation risk: Illiquid investments, such as PE in clean energy companies or debt co-investments in real estate, often lack frequent market pricing, which increases the difficulty of accurately valuing them. When the valuations are overstated, ASWF will receive less money than anticipated from selling the assets should it attempt to liquidate or if real economic downturns have impacted the assets' worth.
- Interest rate risk: With significant exposure to private debt in SMEs, rising interest rates could lower the value of ASWF's fixed-income portfolio and make refinancing a challenge for debt-laden companies, potentially impacting ASWF's returns.

Any two of these responses is sufficient; only your first two responses will be graded.

Further Explanation

ASWF's focus on alternative investments across infrastructure, PE, and private debt presents significant financial risk exposures. These exposures must be managed to protect Eldoria's economic interests and the fund's objectives of ensuring that wealth is shared across generations; therefore, the growth of wealth must be tempered with prudent investing.

Scoring Guideline:

1 point for naming two financial risks

1 point for each explanation of how the risk impacts ASWF's objectives (2 points total)

3 points total

LOS - Analyze and evaluate the financial and non-financial risk exposures in the portfolio strategy of an institutional investor.

Discuss *one* method specific to ASWF's portfolio that the fund employs to manage the risks associated with its long-term direct investments, particularly in infrastructure and private equity.

Identify and **discuss** *one* new method ASWF could adopt to enhance its risk management framework.

Provide a specific example from ASWF's portfolio that could apply to the new method identified.

Explanation:

Model Answer

Discuss and provide examples

ASWF actively manages risks associated with its long-term investments through established strategies, but the fund could also adopt additional measures to further strengthen its risk management framework.

Existing risk management strategies

Diversification across regions and sectors:

- ASWF reduces concentration risk by diversifying its investments across geographical regions and sectors. For instance:
 - Direct infrastructure investments include Eldoria's national highway system, Southeast Asia's fiber-optic network, and renewable energy projects in South America.
 - Complementary allocations to infrastructure funds expose ASWF to airports, utility grids, and water systems in developed markets.
- This diversification minimizes reliance on any single asset class, region, or political environment, thus mitigating systemic and idiosyncratic risks.

Strategic partnerships and co-investments:

- ASWF leverages partnerships to share risks and access specialized expertise. For example:
 - Co-investment along with established PE firms in clean-energy companies reduces operational risks by capitalizing on partners' expertise in regulatory compliance and project management.

- Collaboration with experienced operators in biotechnology firms and logistics networks enhances due diligence and mitigates execution risks.

Any one of these responses is sufficient; only your first response will be graded.

Proposed additional strategies

Dynamic stress testing:

- Regular stress testing of ASWF's portfolio under extreme scenarios—such as sharp interest rate increases, prolonged market downturns, or geopolitical instability—can provide insights into potential vulnerabilities.
- **Example:** Assessing the impact of a currency crisis on the fiber-optic network investment in Southeast Asia would enable preemptive hedging measures.

Enhanced ESG integration:

- ASWF could expand its ESG oversight by adopting impact metrics to assess the ESG outcomes of projects.
- **Example:** Implementing carbon reduction targets for renewable energy projects in South America would align with global sustainability standards, reducing regulatory and reputational risks.

Long-term currency hedging:

- Mitigate risks associated with the depreciation of local currencies, particularly in the case of Southeast Asia's fiber-optic network.
- **Example:** For investments in emerging markets, ASWF could explore long-dated forward contracts or options to manage currency volatility over extended investment horizons.

Any one of these responses is sufficient; only your first response will be graded.

Scoring Guideline:

1 point for naming *one* example of a current method *and one* example of a proposed method

2 points total for discussing the *two* methods provided

3 points total

LOS - Discuss various methods to manage the risks that arise on long-term direct investments of an institutional investor.

Identify the type of sovereign wealth fund that ASWF most appropriately exemplifies from the choices listed below.

(Budget Stabilization Fund, Savings Fund, Development Fund)

Justify your answer. For the type of sovereign wealth fund named, include a brief description of its typical asset allocation.

Explanation:

Model Answer

Identify

Savings Fund

Justify

Savings funds are established to convert proceeds from the sale of nonrenewable natural resources into long-term wealth through diversified financial portfolios. Since the mission of savings funds is to transfer wealth to future generations after the depletion of natural resources, the funds' liabilities are inherently long-term. These funds often have explicit objectives, such as achieving real returns or adhering to specific spending policies.

Given their long-term horizons, savings funds typically invest in risky and illiquid assets, such as speculative equities and alternative investments, while avoiding assets that are highly correlated with the nonrenewable resources they aim to diversify away from. The low liquidity needs of savings funds align with their focus on growing wealth for future generations and are comparable to the liquidity requirements of endowments and foundations.

Further Explanation

A savings fund's liquidity needs may evolve when natural resource reserves are depleted. At that point, governments may begin withdrawing from the fund to support budgetary requirements. The primary objective of savings funds is to preserve purchasing power in perpetuity.

Scoring Guideline:

1 point for identifying the type of sovereign wealth fund

2 points for describing the typical asset allocation of the fund named

3 points total