An overview and analysis of the Ireland Strategic Investment Fund

PBO Publication 7 of 2019

Introduction

The Ireland Strategic Investment Fund (ISIF or “the Fund”) is an Irish sovereign development fund administered by the National Treasury Management Agency (NTMA). The Fund has a statutory mandate to invest on a commercial basis, in a manner that supports economic activity and employment in Ireland. The ISIF was established in 2014 and consists of a combined portfolio of €20.5 billion (as at end-2017).

The Fund was formed from the remaining assets of the National Pensions Reserve Fund (NPRF). The NPRF was established in 2001 to meet the future public sector pension liabilities of the State, and was sourced via an annual Exchequer transfer of 1% of Gross National Product. During the financial crisis, approximately €20.7 billion was invested in Irish banks from the NPRF, leaving approximately €22.1 billion with which to establish the ISIF.

The ISIF’s Discretionary Portfolio has generated an annualised return of 1.8% per annum since end-2014 (0.8% for the Global Portfolio, and 7.0% for the Irish Portfolio). Preliminary results for 2018 indicate a loss on the Discretionary Portfolio of -1.1% (driven by a loss of -3.1% on the Global Portfolio, while the Irish Portfolio generated a return of 4.7%).

The ISIF reports that €7.5 billion has been committed by co-investors, bringing the total capital commitment in Ireland between ISIF funds and co-investors to €11.6 billion, as of end-2018. Separately, the Rainy Day Fund (RDF) will be capitalised with €1.5 billion from the ISIF’s “excess funds.” An additional €2 billion has also been allocated to address other Government priorities.

This Note aims to provide Members with an overview of the ISIF, including its structure and investment strategy. It further analyses the performance of the Fund and raises certain key issues for the consideration of Members.

Key issues

• The ISIF targets a return of 4% per annum on a five year rolling basis, incorporating fund management costs and an excess margin in addition to the cost of Government debt. Based on modelling by the PBO, the ISIF’s annual return for 2019 must be 13.4% for this target to be met at end-2019 (five years since the Fund’s inception). However, the ISIF have stated that they believe this target is achievable over the long-term.

• The Fund has a statutory obligation to meet the annual interest cost of general Government debt (averaged over five years) over the long term. Estimates of the interest cost for 2018 and 2019 suggest a five-year average of 2.87% by end-2019. Modelling by the PBO indicates a required return for the Fund in 2019 of 7.3%, for this target to be met at end-2019 (five years since the Fund’s inception).

• The Fund’s global transition strategy requires the Global Portfolio to be held in low-risk (and low return) cash or near-cash assets to maintain capital and liquidity for investment in Ireland. This may be worth re-examining in the context of a low interest environment and an Irish economy at risk of overheating, particularly given the relatively weak performance of the portfolio (which experienced a loss of -3.1% in 2018).

• The ISIF targets an absolute return, and does not appear to assess performance relative to a benchmark portfolio. Measurement relative to a benchmark portfolio allows for an assessment of the portfolio manager’s value-added, and is common in assessing the performance of standard large institutional funds.

• In terms of regional impact and development, approximately 69% of ISIF capital has been committed to Leinster (53% to Dublin). This is broadly in line with regional Gross Value Added generated in Ireland.

1 An earlier draft of this Note was shared with the ISIF. We are grateful for their feedback, some of which was incorporated into this final version of the Note.

2 National Treasury Management Agency, Annual Report and Accounts 2017. The 2018 report was unavailable at the time of publication.
The ISIF was established on a statutory basis in December 2014, on foot of an agreement in the Programme for Government 2011-2016, setting out that the remaining funds of the National Pension Reserve Fund (NPRF) should “be invested ... on the basis of obtaining a return on investment that does not impact the Government Balance Sheet.”

The NPRF was a sovereign wealth fund established to help meet the future pension liabilities of the State. During the financial and fiscal crisis in 2009, the NPRF was used to help recapitalise Irish banks (namely Allied Irish Bank and Bank of Ireland). The remaining assets of the NPRF were transferred to the ISIF upon the establishment of the Fund.

The ISIF consists of two main portfolios. A Discretionary Portfolio of €8.7 billion and a Directed Portfolio of €11.8 billion, for a total combined portfolio of €20.5 billion (at end-2017). The Fund’s key statutory requirements in terms of its investment priorities are:

- Investments must be made on a commercial basis and in a way that supports economic activity and employment in the State;
- The NTMA must consider the rates of return on the Fund’s investments having regard to the level of risk of the underlying assets; and,
- The NTMA must seek a rate of return on the portfolio that, over the long-term, is greater than the average annual interest cost of general Government debt (currently averaging an estimated 3% since the Fund’s inception). Specifically, the ISIF’s returns are assessed as a five year rolling average annualised return.

The ISIF operates under a “double bottom line mandate” wherein investments need to support economic activity and employment in Ireland, while generating investment returns. In this way, the Fund differs to other large institutional funds, in that the sole concern is not with generating a return on investment.

The organisational structure of the Fund is laid out in Figure 1 below. As shown, the Fund is divided into a Discretionary Portfolio and a Directed Portfolio.

**Figure 1: Structure of the ISIF**

The Directed Portfolio consists of investments made under the direction of the Minister for Finance that are deemed to be in the public interest (likewise, the Minister can direct a sale of assets held in the Directed Portfolio, allowing for the transfer of any funds raised from this sale to the Exchequer). Specifically, the Directed Portfolio contains shares in Allied Irish Bank (valued at €10.5 billion) and Bank of Ireland (valued at €1.1 billion), with additional lending committed to the Strategic Banking Corporation of Ireland (at €215 million), bringing the total size of the portfolio to €11.8 billion.

The Discretionary Portfolio contains investments both in Ireland (the “Irish Portfolio”) and abroad (the “Global Portfolio”). As of end-2017, the ISIF had committed

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3 National Treasury Management Agency (Amendment) Act 2014.
4 National Treasury Management Agency, Annual Report and Accounts 2017. The 2018 report was unavailable at the time of publication.
5 AIB underwent an IPO (Initial Public Offering of shares) in June 2017, raising proceeds of €3.43bn which were subsequently transferred to the Exchequer.
6 These valuations are as of end-2017.
€3.3 billion across its Irish Portfolio (of which, €2.2 billion had been drawn down) with an additional €6.5 billion held in the Global Portfolio, since inception. In 2016, the ISIF implemented a transition strategy for its Global Portfolio, aimed at positioning the portfolio as a conservatively managed portfolio with a view to maintaining liquidity to ensure the availability of funds for investing in Ireland. 8

The Government is not permitted to make withdrawals from the Discretionary Portfolio before 2025. Beyond 2025, the ISIF can make a dividend payment of up to 4% per annum to the Exchequer. However, the Minister can direct that an asset from the Directed Portfolio is disposed of, and that the proceeds from the sale be transferred to the Exchequer.

The Fund is a signatory of the UN Principles for Responsible Investment, which believe that environmental, social and governance issues should be considered as part of the investment process, as these issues can impact on long term investment returns. The Fund also belongs to the International Forum of Sovereign Wealth Funds, and is committed to the Santiago Principles (generally accepted principles of good governance and risk management for Sovereign Wealth Funds).

### Sovereign Wealth Funds

A Sovereign Wealth Fund (SWF) is a state-owned investment fund that invests national savings with the intention of generating a return for the State. These funds can be based on surplus revenue from commodity exports such as oil (as in Saudi Arabia and Norway) or minerals (as in Botswana and Chile), and SWFs have grown in size in line with rising commodity prices. 9 Alternatively, SWFs can be non-commodity based (as in Brazil and Ireland). International examples of SWFs include the New Zealand Superannuation Fund ($22.7 billion), BPIFrance ($68.35 billion) and the Government Pension Fund of Norway ($1.06 trillion). 10

SWFs differ from private wealth funds in that they are State held rather than privately owned, and must act in the interest of the State writ large. In this way, SWFs generally have strict, legally mandated investment criteria and are less flexible than privately held funds. 11 Generally, regulation will govern how different SWFs may be used and managed, with these rules varying between countries.

As an example, the ISIF is required through legislation (Fossil Fuel Divestment Act 2018) to divest from direct investment in companies involved in the extraction, exploration and refinement of fossil fuels, with total relevant holdings of approximately €65 million. 12 Norway's pension fund is financed via surplus rents from the country's petroleum industry, and invests primarily in international equity markets and real-estate, with a 3% cap on the amount of funds which can be drawn down by government annually. 13

In contrast, the ISIF acts as a Strategic Development Sovereign Wealth Fund or a Sovereign Development Fund. It is mandated to invest, on a commercial basis, and in a way that develops and supports Irish industry and employment. Investments made as part of the Discretionary Portfolio are independently evaluated and executed by the NTMA, and the Fund’s assets are not available for Government for annual expenditure.

#### Interaction with the Rainy Day Fund

The Rainy Day Fund 14 (RDF), upon establishment, will be capitalised with €1.5 billion from the ISIF. Specifically, the legislation governing the RDF was published as the National Surplus (Reserve Fund for Exceptional Contingencies) Bill 2018, and includes an amendment to the ISIF’s governing Act to provide for an allocation to the RDF from the ISIF not exceeding €2 billion.

The Regulatory Impact Assessment (RIA) published alongside the RDF legislation considered an amendment to the ISIF’s mandate as an alternative to establishing a separate Rainy Day Fund. This would involve ring-fencing a portion of the ISIF’s funds as cash or near cash holdings for use in the event of an economic shock. The RIA also notes that this would further help to mitigate

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7 €4.1 billion as of end-2018.
8 National Treasury Management Agency, Annual Report and Accounts 2017. The 2018 report was unavailable at the time of publication.
9 The International Forum of Sovereign Wealth Funds, 27 November 2018.
10 The Sovereign Wealth Fund Institute, November 27 2018.
11 The International Forum of Sovereign Wealth Funds, 27 November 2018.
12 Approximate amount confirmed via correspondence with the NTMA in December 2018.
the risk of ISIF investments contributing to economic overheating (or indeed, to the crowding out of other private investors). However, the RIA notes that there are certain legislative and technical challenges to this approach.

A review of the ISIF by the Department of Finance (published alongside Budget 2019) identifies €3 billion of ISIF funds that it proposes for reallocation to alternative Government priorities (including €1.5 billion in seed capital for the RDF). This €3 billion includes €2 billion of “excess funds” identified by ISIF for reallocation (through “capital recycling”). The Department’s review notes that the ISIF can meet its investment objectives through capital recycling “without having to fully deploy the entirety of its funds” due to higher levels of co-investment and observed cash-flow patterns. It further notes that the proposed change to not invest all of the ISIF’s Discretionary Portfolio will require a statutory change to the ISIF’s governing Act.

The RDF is intended to act as an emergency fund for the State to help mitigate the adverse effects of severe economic shocks. The Minister for Finance has also indicated that the RDF will help to reduce the risk associated with “windfall receipts” for certain taxes (namely Corporation Tax), with the intention that these receipts would be transferred to the RDF rather than be used to fund permanent increases in expenditure. The RDF is designed to be used only in the event of an economic shock (unlike the ISIF, which is designed to be invested in support of Irish industry and employment), and will be held in readily available or accessible cash or near cash investments. This is intended to allow the RDF to be readily drawn from in the event of an economic shock. Conversely, the ISIF, as a Sovereign Wealth Fund, has a long-term investment horizon in respect of investments made in Ireland.

<table>
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<tr>
<th>Investment strategy</th>
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The ISIF invests on the basis of a long-term investment horizon, and provides performance updates across its portfolios. While quarterly update reports were provided up until Q2 2017, these have been superseded by biannual reports. Under its dual mandate, the ISIF aims to achieve both investment returns and economic impact.

The ISIF Investment Strategy (2015) included the following core financial and economic objectives:

- Target an overall medium-term return in excess of the annual interest cost of general Government debt (currently averaging 3% since the Fund’s inception);
- Specifically, the ISIF targets a return on its Discretionary Portfolio of 4% per annum, incorporating fund management costs;
- Across its investments, the ISIF aims to bring additionality (or value-added) while avoiding displacement and deadweight (i.e. the crowding out of private funds).

As part of the 2015 investment strategy, the ISIF targeted a “broad based” portfolio across different sectors, regions, investment types and asset classes, and aimed to generate economic value-added in the form of turnover, profit, net exports, capital expenditure and employment. The ISIF also seeks to fill investment gaps and enable transactions that would not be otherwise easily completed. It seeks co-investors to ensure the commerciality of its investments and to better leverage the economic impact of its funds.

As noted previously, the ISIF’s Global Portfolio functions as a conservatively managed liquidity preserve for suitable investments in Ireland. However (and as noted in the RIA accompanying the National Surplus (Reserve Fund for Exceptional Contingencies) Bill 2018), continual investment by the ISIF in Ireland could risk displacing private sector investment and may contribute to overheating pressures in the economy. It may be worth re-examining if the requirement for the Global Portfolio to be held in low-risk and low-return cash or

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15 The NTMA notes that a deadweight assessment is carried out on all transactions that it undertakes, in an attempt to prevent this crowding out.
17 In addition to the €2 billion identified by ISIF, the review identifies an additional €980 million (€530 million in AIB dividends and €450 million in Irish Water funding).
18 The NTMA have indicated that this €2 billion in excess funds will come from the Global Portfolio.
19 Capital recycling involves divesting (selling) from current investments and reallocating the proceeds.
20 Budget 2019 – Economic and Fiscal Outlook, October 2018.
21 See the Ireland Strategic Investment Fund H1 2018 Update, July 2018.
22 Rolling annualised return over five years.
23 The Ireland Strategic Investment Fund Investment Strategy, 2015.
near-cash assets is appropriate, in the context of a low interest environment and an economy already at risk of overheating, particularly given the performance of the portfolio, which has reported a loss (of -3.1%) for 2018. In this context, an alternative strategy might involve investing the Global Portfolio over a longer-term horizon, targeting a suitable return, rather than focusing on low-return but liquid assets.

Against the backdrop of a recovering economy, the Minister for Finance announced in July 2018 that the ISIF would be refocused to better address certain key challenges facing the State. These include:

- Supporting indigenous industry and regional development;
- Mitigating the adverse impacts of Brexit and climate change; and,
- Issues relating to housing supply.

The reallocation of funding to capitalise the RDF was cited as part of this refocusing of the ISIF’s investment strategy. These changes follow the Department of Finance’s review of the ISIF (as previously discussed), which was completed in 2017 and published alongside Budget 2019.

In February 2019, the ISIF published its Investment Strategy 2.0. In addition to the €3.5 billion allocated for existing Government priorities (e.g. the Rainy Day Fund), the plan commits to a €3 billion 5 year investment programme that prioritises:

- Regional development;
- Housing;
- Indigenous businesses;
- Climate;
- Brexit; and,
- National initiatives.

The preliminary 2018 results indicate an overall loss of -1.1% in the Discretionary Portfolio, driven by a loss of -3.1% in the Global Portfolio, with a gain of 4.7% in the Irish Portfolio. These results also indicate that the Fund has generated an annualised return of 1.8% per annum (€576 million) since inception in December 2014; the Global Portfolio has gained 0.8% (€225 million), while the Irish Portfolio has gained 7.0% (€351 million).

As previously discussed, the relatively weak performance of the Global Portfolio could potentially be explained by the ISIF’s global transition strategy, implemented in 2016, that aims at investing the Global Portfolio in a conservative way to preserve capital for investment in Ireland. It aims to reduce the risk of a loss in capital in the event of a market decline, and to maintain liquidity for Irish-based investments that would ultimately form part of the Irish Portfolio.

The NTMA Annual Report and Accounts for 2017 (the latest release for which this level of information is provided) indicates that approximately 58.6% (or €3.8 billion) of the Global Portfolio is held in cash or near-cash investments (see Table 1 below). These assets tend to provide a lower level of return and are relatively safe or low risk investments (the NTMA have indicated that the Global Portfolio has a low correlation with global markets and a lower volatility relative to equity markets). In addition, the commitment to invest in cash or near-cash alternatives limits the scope for risk diversification across different asset classes.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Share of Portfolio</th>
<th>€m</th>
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<tbody>
<tr>
<td>Quoted Equity</td>
<td>11.8%</td>
<td>769</td>
</tr>
<tr>
<td>Absolute Return Funds</td>
<td>28.6%</td>
<td>1,870</td>
</tr>
<tr>
<td>Legacy Global Real Estate and Private Equity</td>
<td>1.0%</td>
<td>65</td>
</tr>
<tr>
<td>Bonds and Debt</td>
<td>48.9%</td>
<td>3,192</td>
</tr>
<tr>
<td>Cash</td>
<td>9.7%</td>
<td>632</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>6,528</strong></td>
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Ireland Strategic Investment Fund 2018 Update, February 2018.
The annual performance of the ISIF’s Discretionary and Directed Portfolios (until end-2017) can be seen in Table 2, while the Fund’s quarterly performance since inception is shown in Figures 2 and 3. As shown, the ISIF’s Discretionary Portfolio has been improving in performance over time, while the performance of the Directed Portfolio is considerably more volatile.

The improving performance of the Discretionary Portfolio could potentially be explained by the increased deployment of capital in Ireland, and the move away from the investments held in the Global Portfolio, which have a lower return potential. The planned reallocation of the ISIF’s capital will continue to reduce the size of the Global Portfolio.

The Fund targets a return (annualised average over five years) on the Discretionary Portfolio of 4%. Based on modelling by the PBO, this means that the annual return for 2019 must reach 13.4% for the target return to be met at end-2019. The Fund is required to meet (over the long term), at a minimum, the annual interest cost of general Government debt (averaged over five years). Estimates of the interest cost for 2018 and 2019 suggest a five-year average of 2.87% at end-2019. Modelling by the PBO suggests a required return for the Fund in 2019 of 7.3%, if this minimum target is to be met at end-2019.

However, the ISIF have indicated that they believe this target is achievable over the long-term, based on the continued reallocation of capital away from the Global Portfolio, the expected reductions in the cost of Government debt, and the maturity of assets held in the Irish portfolio.28

Table 2 - Annual returns of ISIF portfolios

<table>
<thead>
<tr>
<th>Year</th>
<th>Discretionary Portfolio</th>
<th>Directed Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>1.1%</td>
<td>18.6%</td>
</tr>
<tr>
<td>2016</td>
<td>2.9%</td>
<td>-7.9%</td>
</tr>
<tr>
<td>2017</td>
<td>4.3%</td>
<td>19.9%</td>
</tr>
<tr>
<td>2018</td>
<td>-1.1%</td>
<td>-</td>
</tr>
</tbody>
</table>

Notes. Returns refer to annual returns in each year, and are taken from the NTMA Annual Report and Accounts for each year. The 2018 return on the Discretionary Portfolio is taken from Ireland Strategic Investment Fund 2018 Update, February 2018.

It should be noted that the ISIF measures performance relative to an absolute return; it does not refer to an underlying benchmark. However, an absolute return target may be achieved due to a strong performance in the financial markets in which the underlying assets are traded. The use of benchmarks is common in assessing the performance of standard large institutional funds, as measurement relative to a benchmark allows for an assessment of the value-added by the portfolio manager, beyond the performance of the market at large.29

Figure 2 - Quarterly returns since inception (in December 2014) for the Discretionary Portfolio

Notes. Q2 2017 is the latest quarterly performance release. Returns are expressed in annual terms.

Figure 3 - Quarterly returns since inception (in December 2014) for the Directed Portfolio

Notes. Q2 2017 is the latest quarterly performance release. Returns are expressed in annual terms. In December 2015, AIB converted ISIF’s preference shares, resulting in the receipt of €1.9 billion in cash and 155 billion in ordinary shares.

28 Based on correspondence between the ISIF and the PBO, and the ISIF Investment Strategy 2.0, February 2018.

29 The Santiago Principles (Principle 23) refer to measuring and reporting performance relative to benchmarks. However, the NTMA have argued that the dual mandate of the Irish Portfolio is not comparable to common institutional funds, and therefore state that the cost of Government debt is an appropriate benchmark return for the Fund.
The composition of the ISIF’s Irish Portfolio, in terms of the sectors invested in (or that capital has been committed to) is detailed in Table 3. Approximately one-fifth of the portfolio is committed to Small and Medium Enterprise (19.19%) and Real Estate (20.48%), with other substantial commitments to Venture Capital projects (15.13%).

In addition, the ISIF reports that €7.5 billion has been committed by co-investors, bringing the total committed capital between ISIF funds and co-investors to €11.6 billion, as of end-June 2018 (2.8 times ISIF’s own capital commitment of €4.1 billion).

Table 3 - Allocation of Irish Portfolio, end-2018

<table>
<thead>
<tr>
<th>Sector</th>
<th>Share of Portfolio</th>
<th>€m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small and Medium Enterprise</td>
<td>19.19%</td>
<td>789</td>
</tr>
<tr>
<td>Real Estate</td>
<td>20.48%</td>
<td>842</td>
</tr>
<tr>
<td>Venture Capital</td>
<td>15.13%</td>
<td>622</td>
</tr>
<tr>
<td>Water</td>
<td>10.95%</td>
<td>450</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>9.63%</td>
<td>396</td>
</tr>
<tr>
<td>Direct Equity</td>
<td>5.79%</td>
<td>238</td>
</tr>
<tr>
<td>Food &amp; Agriculture</td>
<td>5.01%</td>
<td>206</td>
</tr>
<tr>
<td>Energy</td>
<td>5.84%</td>
<td>240</td>
</tr>
<tr>
<td>Other</td>
<td>4.67%</td>
<td>192</td>
</tr>
<tr>
<td>Innovation</td>
<td>3.31%</td>
<td>136</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>4,111</strong></td>
</tr>
</tbody>
</table>


**Economic impact**

In its latest release, the ISIF reports several metrics that aim to capture the economic impact of the investments in its Irish Portfolio as of end-June 2018. These include:

- 29,682 in additional jobs;
- €500 million in Gross Value Added (GVA);
- €1 billion in turnover;
- €474 million in wages; and,
- €258 million in exports.

In addition to the above metrics, the ISIF also captures more qualitative metrics that cannot be consolidated at the fund level due to their sector specific nature. These include, for example:

- The number of new housing units delivered;
- The amount in Mega Watts of renewable energy; and,
- The diversification of the SME financing landscape to enhance the resilience of Irish SME’s.

The regional distribution of ISIF funds, as well as the distribution of supported employment and Gross Value Added is shown in Figure 4, overleaf. Dublin has received the most in ISIF funding (and likewise has seen the greatest number of jobs and the largest Gross Value Added). Including Dublin, Leinster has received 69% of all ISIF funding (with 70% of associated jobs and 68% of Gross Value Added). This is broadly in line with Gross Value Added generated on a regional basis (Dublin and Leinster account for 64% of total Gross Value Added in Ireland).

However, this represents a substantial concentration of the Fund’s capital, and in July 2018 the Minister for Finance listed regional development as a priority area in refocusing the ISIF’s funding. The ISIF 2.0 Investment Strategy commits to prioritising regional development (targeting €500 - €750 million of commercial investment into the Regions over five years).


31 Ibid.
Conclusion

This Note provided an overview of the ISIF, in terms of the structure of the Fund, its investment strategy, and the performance and evolution of the Fund over time. It further raised certain key issues for the consideration of Members.

Notes. Figures correct as of end-June 2018. 'ISIF Capital' refers to the amount of ISIF funding committed to the region, 'Jobs' refers to the number of jobs supported via ISIF investments and 'Gross Value Added' captures the earnings of those employed. These figures are based on data supplied to ISIF by the underlying investees.

Source: based on data from the Ireland Strategic Investment Fund 2018 Update, February 2018.