



Letter from Hamed bin Zayed Al Nahyan

Managing Director

ADIA marked an important milestone in its history in 2016, taking time across the organisation to reflect on 40 years of investing successfully and fulfilling its mission on behalf of the Government of Abu Dhabi.

Since its creation in 1976, ADIA has transformed from a small investment fund using a single floor of rented office space in Abu Dhabi to become a thriving and influential player in global financial markets. It has done so by prudently adhering to the original vision of its founders, while demonstrating a willingness to always question conventional wisdom and navigate its own path.

In addition to our many achievements over the decades, we have, of course, faced obstacles along the way. But these experiences have made ADIA stronger, providing an opportunity to fine tune practices and ensure we are correctly positioned to confront the challenges and identify the opportunities of the future.

A key pillar of ADIA's success since its creation has been its commitment to objective self-reflection, as a driver of renewal and necessary change. It is this trait that has spurred much of the change within ADIA over the years, and has allowed us to generate consistent returns through multiple market cycles.

2016 was no exception to this, from both an organisational and investment perspective.

On the former, ADIA intensified its efforts to improve productivity and reduce complexity across the institution, while closely monitoring and measuring progress. Resulting initiatives were then prioritised through their inclusion in ADIA's annual department-planning process.

In another significant development, ADIA last year took the decision to open an office in Hong Kong, our first in the Territory and a symbol of our long-term commitment to Asia and confidence in its continued growth. ADIA Hong Kong, which is led by a Chief Representative supported by research professionals, serves as a platform for ADIA to broaden and deepen its network of relationships and identify new opportunities in China – where we have invested for more than 25 years – as well as other Asian markets.

It marks the latest example of our drive in recent years to further develop ADIA's internal research and analysis capabilities, while deepening relationships and building local knowledge in the key global markets where we invest.

In addition to bringing ADIA closer to its key local contacts and investments, the new Hong Kong office will seek to identify new avenues for cooperation and growth in one of the fastest developing regions in the world.

As in previous years, 2016 was also marked by continued evolution on the investment front.

At ADIA, investment strategy always begins with a clearly defined appetite for risk. Last year, we further refined the process for calibrating risk appetite by formalising our Reference Portfolio, a hypothetical blend of publicly traded securities with fixed weightings. This acts as a starting point for ADIA's Strategic Portfolio, which aims to outperform the Reference Portfolio by diversifying across more than two dozen asset classes and sub-categories, while maintaining ADIA's risk profile.

Within our investment departments, we continued to expand our universe of investable asset classes and geographies, and deploy internal teams to proactively identify and originate attractive opportunities. We also took advantage of cyclically attractive valuations in some asset types to recycle capital into areas that we feel offer more attractive risk-return characteristics over the long term. This will likely continue selectively in the year ahead as asset prices approach levels last achieved during the market peak a decade ago.

In our Private Equities Department, there was continued momentum towards increasing our exposure to direct private equity transactions, alongside our partners, and broadening our focus in the rapidly developing Asian private equity markets, particularly China and India.

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It also sought out opportunities in the structured equity space, as a means of diversifying and reducing overall risk in the portfolio.

The Alternative Investments Department saw positive results from its decision in 2015 to expand its investment universe to allow co-investments in “special situations” and in smaller, younger managers with capacity constraints. The Department also launched a new Emerging Opportunities mandate to invest in asset types that fall outside the remit of ADIA's other investment departments. Internally staffed, the new mandate is due to become active this year, with a view to adding new and differentiated return streams and diversification to ADIA as a whole.

In Infrastructure, meanwhile, ADIA continued to build its portfolio of assets in the renewable energy field with a significant investment in Greenko, a leading developer of wind, hydro and solar energy based in India and elsewhere, as well as adding to its portfolio in its other focus areas including energy more broadly, transport and utilities.

When viewed as a whole, ADIA ended 2016 on a positive note, with performance underpinned by respectable gains in global markets despite considerable headwinds from political events throughout the year.

ADIA's 20-year and 30-year annualised rates of return were 6.1% and 6.9% respectively in 2016. As in 2015, these figures were impacted by the exclusion of strong returns in the mid-1980s and 1990s from the rolling averages, although ADIA's real rates of return remain consistent with historical levels.

From a headcount perspective, 2016 was mostly a year of consolidation although we continued to hire selectively in key areas and to fill positions as a result of natural attrition.

One area of focus was ADIA Global Research, which appointed a Head of Economic Analysis and a Head of Energy Analysis, among other key hires, as part of its build out of key specialisations. ADIA Global Research was created in 2014 as part of ADIA's strategy to expand its internal analytical and research capabilities to support management in their decision making. A central pillar within ADIA's integrated research community, it has responsibility for producing economic, political and energy-focused research, while also seeking to cultivate external networks and participate in global dialogue on significant issues.

Also active in 2016 was the Fixed Income & Treasury Department, which appointed a Head of Active Internal Fixed Income, and the Internal Equities Department, which selectively recruited across a number of portfolios.

As we enter our fifth decade, it is important to look back at all that has been accomplished and feel a sense of respect and pride in the achievements of so many. ADIA has come a long way since its modest beginnings, but we remain steadfast in our commitment to fulfilling ADIA's mission responsibly, and with a steady hand, despite the economic or market backdrop.

The role that ADIA performs in securing the future prosperity of Abu Dhabi is becoming ever more relevant as the Emirate prepares for a future that is less dependent on its traditional sources of income. By remaining prudent and disciplined, and by drawing on the knowledge and experience built over 40 years, we will ensure that Abu Dhabi continues to prosper.

Review of 2016

Capital markets delivered solid returns to investors in 2016, with global equity indices returning close to 9% in U.S. dollar terms and government bonds largely delivering their coupon, albeit negative in some cases. Seen through the eyes of a long-term investor, in general, realised volatility was low, economic growth was steady and markets mostly held their nerve in the face of unexpected and complex external factors.

The year 2016 will surely be remembered most for political events, especially the vote in the United Kingdom to leave the European Union and the outcome of the U.S. presidential election.



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Markets were influenced by the strong rebounds in prices of energy and other commodities, a more general acceleration in inflation, and the continued resilience of the U.S. dollar. The move in inflation could prove to be another durable legacy of 2016, as it potentially signalled a turn away from the deflation fears that had been stubbornly prevalent since the global financial crisis.

In addition, last year likely marked a major turning point in economic policies. This began with aggressive efforts by the European Central Bank and the Bank of Japan to push short-term interest rates further below zero and to ramp up the pace of expansion of their balance sheets. While these measures were successful in lowering bond yields, they seemed to deliver little improvement in spending and led to increased stress on banks, pension funds and insurance companies, all of whom are dependent on interest income. By the second half of the year the climate of opinion in policy circles had shifted: further reliance on extraordinary monetary policies was in doubt, while fiscal stimulus was viewed more favourably.

Markets delivered a swift verdict on the implications of this shift. In the middle of 2016 bond yields were near record lows, largely negative in Europe and Japan, and equity markets were sluggish. Concerns about policy paralysis and secular stagnation dominated thinking. The tone was markedly different in the second half of the year, as worries about deflation were chased away by more upbeat visions of what policy could accomplish. Pessimism gave way to realisation that confidence could improve, and bring with it investment and improved growth.

Outlook

One of the strongest sentiments coming out of 2016 is that the world is changing. Politics, policies and economic drivers are expected to be very different in the decade ahead than in recent experience. We would not disagree, although we would stress that the major events of 2016 were not entirely unexpected. They were the result of pressures that had been building for some time, and that are likely to persist.

At ADIA we know that change is inevitable and should be seen as an opportunity for the long-term investor. Remaining focused on the longer term allows us to position our assets to favour geographies and asset classes that stand to benefit from the new reality, and to limit our exposure to emerging risks that are not well compensated.

One clear trend today is an evolution in the economic relations among countries. While this is often viewed as a pause or decline in "globalisation" the reality is far richer and more complex. The global exchange of ideas, people, goods, services, and capital has never been greater, nor has the prosperity brought by these exchanges. Attention to the human element of globalisation has increased, along with awareness of issues such as inequality. This is appropriate and in our opinion likely to put international norms of trade relations and capital flows on a sounder footing. Risks of protectionist policies have increased, but we also note staunch defences of free trade amongst the global community. We continue to view openness to trade and capital flows as beneficial and expect this perspective to be an effective counter to efforts to rebuild barriers.

The continued importance of economic globalisation will require new approaches to investing. The shifting balance between traditional developed economies and the "emerging" economies has passed its tipping point. Economic growth in the decade ahead will be dominated by the emerging world. We expect that over two-thirds of the growth in global GDP over the coming ten years will come from those emerging economies; with roughly half coming from China and India alone. A key challenge for ADIA and other global investors is how to access this growth, and we welcome efforts in many of these countries to improve the openness and functioning of capital markets.

The most exciting trends on the horizon involve innovation and new business models. New technologies such as 3-D printing, big data analytics, and biotechnology are opening up a new landscape of more customised production. This transition favours businesses that can embrace flexibility, connection to the customer, and continuous learning. Importantly, this evolution in business models applies to both countries and companies. It was with this in mind that ADIA chose to focus its annual Global Investment Forum in 2016 on "*The Fourth Industrial Revolution: How technology and automation will impact the investment landscape*".

As we seek to look into what the future holds, it is clear that economic development will be different in the decade ahead. Rather than favouring scale and resource endowments it will favour emphasis on education and an ability to foster entrepreneurship.

With the strong relationships that ADIA has built over the past 40 years, and by remaining open to change and innovation, I am confident that the organisation is strongly positioned to capitalise on these emerging trends.

Hamed bin Zayed Al Nahyan
Managing Director

2016 Key Initiatives

- ADIA opened its first office in Hong Kong, a symbol of our long-term commitment to Asia and confidence in its continued growth.
- ADIA formalised the Reference Portfolio, a hypothetical blend of publicly traded securities with fixed weightings which is used as a starting point for our Strategic Portfolio.
- Private Equities continued to increase its exposure to direct private equity transactions, alongside our partners.
- Selective senior appointments were made in Global Research, Fixed Income, Operations and Central Dealing.
- A new Emerging Opportunities mandate was launched by Alternative Investments to invest in asset types that fall outside the remit of ADIA's other investment departments.