5 SWFs and the ascent of emerging-market economies

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Well before the outbreak of the recent financial crisis, the global economic focus was shifting from mature advanced economies (ie, the north) to fast-growing emerging-market economies (the south). The crisis originating in the advanced economies, it has had a disproportionately larger impact on them, while recovery remains fragile and uncertain. In the south, on the other hand, recovery has been stronger and has taken a firm hold. In short, although the global crisis did not initiate the shift of global economic power from the north to the south, it accelerated and gave further momentum to the shift.

The rapid growth of assets held by sovereign wealth funds (SWFs), primarily from the south, is an important example of this north-to-south shift. That is, the increasing prominence and resources of the SWFs are symptomatic of a global rebalancing in economic standing and represent one of the key channels through which this phenomenon is taking shape. Currently, SWF assets under management (AUM) are estimated to be in excess of $4.1 trillion[1] and are projected to grow to some $10 trillion in the coming decade.

The growing prominence of SWFs over the last few years, and especially their high-profile acquisitions of corporate stakes, was met with dismay in certain policy circles and reflected in western media with thinly veiled nationalistic and protectionist overtones, disguised as security concerns or risks of foreign political influence. Due to their sheer collective size and alleged non-commercial, geopolitical motives, concerns were expressed that the activities of SWFs could pose a risk to global financial stability. The adverse rhetoric in the aftermath of the financial crisis – and especially since the demise of Lehman Brothers – waned as the need to recapitalise the banking and financial sector and support cash-strapped enterprises became a crucial issue. The "barbarians at the gates" turned into a cornerstone of financial and economic stability in a matter of weeks, becoming a welcome source of

capital, and strengthening the weak balance sheets of systemically important financial institutions.

Gradually, the media hysteria prompted by the activities of SWFs gave rise to a more thoughtful approach, driven by a host of academic research and policy papers. The prevailing view now argues that SWFs constitute a class of asset management institutions often with extended investment horizons and low-to-medium risk tolerance, but whose core behaviour does not differ fundamentally from standard industry practices (for example, those adopted by pension funds or endowment funds). In fact, looking at their track record, it is difficult to discern deviation away from purely financial objectives or to claim that they have been pursuing ulterior objectives.[2]

It is now widely recognised that SWFs perform a stabilising function for global markets, because in general they display a propensity to concentrate on long horizons, rather than being driven by the spasmodic emphasis on quarterly reports that besets even private equity funds. It is rare to find asset managers in the private sector whose time frame extends beyond five years, while typically even the more forward-looking private funds target an exit within two to three years.

Globalisation, the rise of the south and the motivation for establishing a SWF

The north-to-south shift has resulted from a greater access to new technology, differences in demographic patterns, faster communications, freer trade, capital flows, advances in logistics – that is, the process known as "globalisation". Few expected that globalisation would so disrupt and rearrange the economic landscape, propelling emerging markets to become the primary engine of global growth. Since 2002, emerging markets contributed two-thirds of this global growth. In 2009, the takeovers of northern companies by southern companies amounted to $105 billion, surpassing takeovers in the other direction – which reached an estimated $74.2 billion.

However, globalisation has not proceeded smoothly. On the contrary, as it became more established, massive capitals inflows (often in search of quick gains), poor supervision and loose fiscal policies disrupted the macroeconomic framework in several emerging markets. This process led to a series of crises that ravaged the world economy – from Mexico in

1994 to Argentina in 2002, and with Russia, Turkey, Thailand, South Korea, Indonesia, Malaysia and others in between. In the painful aftermath of these crises, the authorities in many emerging countries adopted a more prudent fiscal and monetary policy mix, and started accumulating foreign exchange reserves as self-insurance. The emergence and rapid growth of surplus reserves in the south led gradually to more active reserve management.

A basic question arises at this point: is it wise to invest export revenues abroad rather than fund domestic projects and entitlement schemes? To help answer that, contrast two almost opposite examples, Russia and the United Arab Emirates (UAE). Russia has yet to emerge as a fully functioning market economy, and investors decry the corruption and poor governance that besets the economy and mars public investments. As a result, despite a wide range of urgent domestic investment requirements, even Russian SWFs prefer to invest abroad resources that would be more desirably used to raise the living standards of the domestic population.

The UAE, by contrast, is a tiny, mostly barren country with less than a million citizens. Its governments, notably the emirates of Dubai and Abu Dhabi, and followed by Ajman and Ras Al Khaimah, have launched a massive programme of infrastructure building and transformation of the economy in areas such as financial services, tourism, transport services and petrochemicals over the last decade. After a while, this expansion ran into all kinds of bottlenecks in terms of housing scarcity, labour and raw materials shortages, and economic pressures, and similar observations can be made for other Gulf Cooperation Countries (GCC). In essence, the oil revenues are already fully utilised at home, while the size of the domestic economy does not allow for further growth acceleration.

Another motivation for setting up a government-owned investment fund is linked to the stabilisation of fiscal revenues. In other words, the investment vehicle is used to accrue funds at times when commodity prices are high and to use savings when they drop, to smooth the effects of cyclical swings on macroeconomic stability or public policy programmes.

Therefore, the rationale for setting up SWFs could be either a poor domestic investment climate or the lack of absorption capacity. Small countries such as the UAE, Kuwait and Qatar – but also the likes of Norway, South Korea and Singapore, which have already attained a high per capita income – are better off transferring wealth to future generations. At the opposite end of the spectrum, countries such as Russia, Venezuela and Libya, would be better off

channelling more of their export earnings into developing their domestic economies after liberalising their business environment. In between, small, open economies such as Chile and Australia are wise to use a sovereign investment vehicle as a stabilisation policy tool.

Governance, mandates, objectives and conflicts

Good governance principles suggest that an SWF should be given a clear mandate, with an explanation provided if the mandate changes. Lack of clarity on mandates and objectives can become disruptive and negatively impact investment returns. At the most fundamental level, institutions will need clear overall guidance from their governing bodies, so that SWF managers can allocate assets in the pursuit of forward-looking, long-term goals anchored by solid cash, liquidity, and counterparty and collateral management.

In practice, however, mandates are too vaguely worded to provide meaningful operational criteria for investment. This is highlighted by the recent literature on SWFs, which argues that they are not a homogeneous group of asset managers, as they might have widely different mandates, adopt diverse investment styles (passive, active, opportunistic), and therefore it would be misleading to group them together. Further, objectives could change if circumstances and priorities also change.

In general, the objectives of state-owned investment funds can be defined in two ways.

- *Long-term savings maximisation and wealth preservation*: investments are made with the sole objective of achieving financial returns, typically investing in a global diversified portfolio.
- *National economic objectives*: they can be either domestic investments or government revenues stabilisation. Under this heading, one could also list ensuring food security for those countries that import the bulk of their agricultural commodities.

In reality, the majority of SWFs are given an ambiguous mandate that allows them to adapt to circumstances. Recently, for example, the SWFs of countries such as Kuwait, Qatar, Russia, China, Kazakhstan and Ireland have been asked to support domestic financial institutions, their national Treasury and sometimes even the stock markets.[3]

There is compelling evidence that, at least in the Middle East, SWFs have not been used to pursue domestic political goals even when the second description would have been justified and acceptable. Most GCC countries have emphasised the need to diversify their economies away from hydrocarbon extraction and towards services and manufacturing, and eventually moving toward more knowledge-based economies. However, with the notable exception of Mubadala, SWFs have not been overly active in this developmental/diversification role.

Another dimension that is relevant when talking of SWF objectives is the evaluation of performance. Here the ground is rather shaky, because benchmarking is not an exact science and SWFs, as was argued above, do not constitute a homogeneous investor class. Nevertheless, it would be an important exercise for the management and board of an SWF to devise a yardstick for a couple of reasons: it would clarify the objectives of the investment strategy in terms of time frame, expected returns and appetite for risk, and it would concentrate attention on the risks that the decision-makers are willing to bear. For example at one extreme, the State Oil Fund of the Republic of Azerbaijan has a mandate to maintain a low-risk profile, hence it invests almost exclusively in government bonds (although their asset allocation conditions are currently under review, and it is expected the portfolio exposure will be broadened later in 2011). By contrast, Singapore's Temasek covers a broad set of asset classes, including listed and non-listed companies and spanning a number of sectors with a wide geographical diversification (although centered on Asia).

For a diversified equity fund or balanced portfolio of listed securities, it is relatively straightforward to design a benchmark using existing market indexes, which would in practice be a measure of opportunity cost. An alternative approach would be the use of an absolute return benchmark, for example, a prefixed mark-up over a money market yield, such as five-year US Treasuries.

For funds with a preference for non-listed companies, the evaluation is beset by more subjective assessments and, during a bear market, the performances would be negatively affected by the difficulty to liquidate investment. In other words, returns might be lumpy, meager in the initial years, and questionable due to lack of accounting standards, and therefore much tougher to assess in comparison with, say, mutual or pension funds. This kind of predicament also affects venture capital and private equity funds, and is not unique to SWFs. However, there exist indexes that have been developed by specialised firms

such as Venture Economics and Prequin. S&P has also developed the Listed Private Equity Index, which offers an alternative approach based on the market valuation of investors in non-liquid assets.

Finally, it is important to remember that the function of SWFs, especially those funded by natural resources proceeds, can be seen as transferring underground wealth into overground wealth. This function can be performed through investments in financial assets, in physical assets or in human capital. Investment in listed or non-listed companies, and in corporate or government bonds, are obviously a natural choice, but not necessarily the most appropriate in the long run. For funds that target long horizons, it is desirable to finance long gestation projects such as infrastructure through the financial markets by issuing debt securities that match the maturity of the project and which tend to deliver above-average returns to patient investors. In the same vein, investments in innovative technology and research-intensive ventures would be a more suitable choice for the long run, especially for countries that are trying to diversify their economies into high-value-added sectors.

A new international financial architecture and the transformation of SWFs

SWF are an atypical class of asset managers: due to their long-term focus they can neglect short-term fluctuations, take up illiquid investments and avoid paying hefty liquidity premiums (eg, by hoarding government bonds). What role could SWFs play in the new environment emerging from the aftermath of the financial crisis (or, as it has become popularly named, the "new normal")? To answer this question, let us try to envision the evolution of global financial architecture over the first half of this century.

This chapter has already highlighted the emergence of a multipolar global economic system, with the emerging markets accounting for an increasing portion of world output. This rebalancing of the real economy was accompanied by a shift in global financial geography. In 2001, the US accounted for 50% of total world equity market cap, while the emerging markets accounted for a meager 9%, see table opposite. Fast forward to end 2010, when the share of US had dramatically declined to 31% and the emerging markets had jumped to 30%. Even more stunning is the combined performance of Brazil, Russia, India and China (Bric), which increased more than eightfold between 1999 and 2010, while the share of the rest of the emerging markets doubled.

This restructuring of the financial markets framework is bound to intensify. Until the near meltdown of 2008, the financial system hinged on a "hub-and-spoke" arrangement. New York and London were the hubs, with virtually all major financial transactions being carried out with the involvement of a financial institution from one or both of these centres.

While this prominence was justified when the US and the British Empire were net capital exporters and therefore played a key role in the allocation of their own savings to the rest of the world, it now appears a vestige of the past. With the emergence of a multipolar world, financial architecture is evolving into a spider web system with numerous interconnected international financial centres across the globe, that have the capital market depth and regulatory sophistication to absorb excess capital from their own regions, as well as from elsewhere. Besides, as the recent crisis demonstrated, the enormous concentration of systemic risk in just one or two financial hubs is inherently unstable and tends to generate volatile and sizeable capital waves, exacerbating contagion and herd behaviour.

Table 5.1 Share of world stock market capitalisation, 1999–2010 (%)

	1999	2000	01	02	03	04	05	06	07	08	09	10(E)
World market cap	100	100	100	100	100	100	100	100	100	100	100	100
United States	46	47	50	47	45	43	39	36	31	33	31	31
Rest of developed	46	45	41	42	44	44	44	44	41	41	41	39
Emerging markets	8	8	9	11	12	13	16	20	28	26	28	30
Bric	2	3	3	3	4	4	6	9	17	15	17	17
Rest of emerging	6	5	6	7	7	9	11	10	11	11	11	12
of which GCC	0.3	0.3	0.4	0.9	0.9	1.3	2.5	1.3	1.7	2	1	1

Source: Standard and Poor's.

Given their growing size, SWFs have also gained political clout, and the financial means and interest to develop linkages among (so far) peripheral financial centres – and therefore bypass New York and London. They are building the necessary capabilities to conduct business outside the beaten path or channels that have prevailed up to now. A trend is already discernible; sizeable deals between emerging markets that, until recently, would have been

arranged through a major financial centre, now take place through direct links. China, with its huge current account surplus and accumulated net foreign assets, is at the forefront of this new wave, but other areas, including the GCC and the prominent example of the Dubai International Financial Centre (DIFC), are increasingly stepping outside the traditional limits. The foreign direct investments among emerging markets, which in the jargon of policy makers are called south–south flows, are booming and dislocating traditional north–south capital flows.

Links are often forged away from the limelight. For example, a consortium of nine SWFs – including Singapore's GIC, China's CIC and the Abu Dhabi Investment Council – invested $1.8 billion in fresh capital into BTG Pactual, an independent Brazilian investment bank spun off from UBS. Pactual's chief, Andre Esteves, remarked that the deal is "a sign of a new financial order" and marks the biggest-ever SWF commitment in Brazil as part of a portfolio reallocation away from Western assets and towards emerging markets. Chinese companies invested $30 billion in Latin America in 2010, a 150% increase over the past year, and amounting to a third of the total of China's foreign investments. Another $14 billion went to Brazil. It was therefore only natural to build a financial outpost with the aim of extending Pactual's reach beyond the Brazilian borders and reconnecting with some of the clients it lost when it severed ties with UBS. This effort is likely to be directed at Mexico, Colombia, Chile and Peru.

With the Asian emerging economies enjoying a quick rebound from the crisis (unlike the mature economies), a web-like financial structure of connected regional financial centres will help to strengthen, but the speed of change depends on many factors. One of the most important is the creation of liquid and deep local currency money and debt markets in these regional financial centres. Having both deep and liquid fixed income security markets represents the best source of funds and liquidity for governments, public companies, agencies and financial institutions. Their functioning is paramount for the efficiency and stability of financial intermediation, and also provides a boost to economic growth. However, apart from a handful of emerging countries, the establishment of such markets remains an elusive goal, thereby underscoring an element of fragility in several nodes of the new financial architecture. In this respect, it is imperative to intensify the preparation for a single currency among the GCC countries, which would become the fourth or fifth most important currency in the world and pave the way for a capital market of primary importance in emerging markets, resilient to crisis due to its link to energy commodity exports and accumulated wealth in the Arabian Peninsula.

In the evolution towards the new normal, it is also likely that SWFs will make headway in their shift from being purely passive investors into more active shareholders that take an interest in companies in which they have acquired a stake. It is already becoming more common for SWFs to request a seat on the board and take a more active role. The past model based on a hands-off approach has too often led to suboptimal performance. Instead, SWFs are emphasising the implementation of solid governance principles and a timely flow of information.

SWFs also need to learn key lessons from the financial crisis in terms of the role of corporate governance in the investment process, specifically relating to board competency, risk management, management remuneration structures, adequacy of internal controls and processes, and implementation of good governance practices. When making investment decisions, key considerations need to be adequately addressed, such as "What are the competence, quality and experience of the board members at a time of crisis?", "How effective is the board?" and "How sound is the risk management function?"

Indeed the counterpart to further SWF activism and more dynamic investment choices is improved risk management. The crisis shattered the traditional risk management approach based on value-at-risk (VaR) and other simplistic data-driven models. The new environment requires a holistic risk management framework encompassing the analysis of multiple scenarios. Specifically, SWFs should supplement conventional asset class diversification, rotation themes and currency exposure with better macroeconomic research and intelligence, and organise the cost-effective management of tail risks (which are likely to become more frequent). The new normal will imply a more uncertain landscape with tremendous challenges coming from areas such as the sustainability of fiscal policy and the build-up of public debt in the US and OECD economies, the restructuring of the European sovereigns, the demographic decline in mature economies, inflationary pressure, the redrawing of geopolitical maps (North Africa and the Mediterranean is only the latest hotspot) and the reformatting of global monetary and financial architecture.

Only with superior analytical tools and human resources dedicated to navigation in uncharted waters will SWFs be able to identify the differences between technical and fundamental factors over the long run. The key is not avoiding risk, but understanding the changing pattern and sources of risk, and recognising when it has materialised. This requires spatial outreach, research prowess and adaptability to a fast-changing environment,

sophisticated vision and unconventional valuation models. Communication to the public will increasingly be recognised as vital to ensuring public support in good and bad times.

Such functions pervade all investment decisions, but cannot be built instantly. They require the establishment of a "culture" through relentless efforts to establish good governance, improved procedures, implementation of successful models and intellectual firepower.

Conclusions

The label "sovereign wealth funds" has come to denote a wide array of financial vehicles whose common feature is public ownership, but whose purposes, investment strategies and *modus operandi* vary widely. This chapter has argued that their growth is part of a broader trend of economic rebalancing between developed economies and emerging markets. Given the shift in global economic and financial geography, the latter classification of nations stands as out of touch with reality. A number of important emerging economies have now fully emerged and actually overtaken some of those classified as developed, in terms of per capita income, future prospects and overall risk (Brazil is a good example of this).

The tide of capital flows towards emerging markets with limited domestic resources and shallow capital markets that has been witnessed over the last 25 years constituted the fuel for this rebalancing, along with sound macroeconomic policies in the emerging economies, high saving rates and the dividend of demographics. Given the lessons of the Asian crisis, most emerging markets accumulated international reserves as a buffer against international contagion and spillover effects. The emergence of SWFs is a reflection of the growing ascendancy of these economies.

SWFs also hold substantial resources that are bound to swell further over the next few years, although as a group their weight in financial markets remains small compared to advanced economy institutional investors and other asset managers. However, collectively, emerging markets are spearheading a novel trend in the financial markets – namely, the emergence of players that manage public funds to be preserved for future generations. For many countries they also represent a key element of the macroeconomic policy mix, because they hold a cache of funds that can be deployed in emergencies and crises, or for attenuating the effects of cyclical downturns. In this respect, it is notable that for some GCC countries the revenues from the foreign assets held by SWFs

are on a par, or at least of the same order of magnitude, as the revenues from oil and gas exports.

One of the outcomes of the international financial crisis is a re-orientation of SWFs towards domestic economic policy concerns. Increasingly – at least for the GCC countries – SWFs are likely to adopt investment strategies consistent with the fundamental factors that drive domestic economic growth, primarily demographics, infrastructure and technological advances, which could also prove instrumental in the diversification of those economies too reliant on commodity exports. In this dynamic new environment, SWFs will become increasingly important builders of a new international financial architecture.

The views, analysis and opinions expressed in this chapter are those of the authors and should not be considered or construed to imply official policy or views of their respective institutions.

Notes

1. However, SWFs make up less than one eighth of global pension assets, less than one twelfth of global investment funds and insurance assets and only 3% of bank assets worldwide.
2. A notable piece of research (S. Bernstein, J. Lerner and A. Schoar, "The Investment Strategies of Sovereign Wealth Funds," Harvard Business School working paper 09-112, April, 2009) on 2,662 investments by 29 SWFs between 1984 and 2007 highlights that they have been primarily engaged in trend chasing. Likewise, another paper (R. Avendaño and J. Santiso, "Are Sovereign Wealth Funds' Investments Politically Biased? A Comparison with Mutual Funds," OECD Development Centre working paper 283, December 2009) scrutinised the activity of SWFs, concluding that "The fear that sovereigns with political motivations use their financial power to secure large stakes in Western companies is shown to be unfounded." To reach this conclusion, the authors used mutual funds' investments as a benchmark for evaluating whether the portfolio choice of SWFs exhibited unusual traits.
3. The Irish National Pension Reserve Fund (NPRF) offers a notorious example here. In its statutory mandate set in 2001, funds from the NPRF could not be used before 2025 to sustain the commitments of Ireland's social welfare and public service pensions system until 2055. In the face of the collapse of its banking system, the Irish government was forced to scrap the rule in 2009 and used 7 billion euro – ie, all cash balances and part of sovereign bond holdings (to rebalance asset allocation, 2.7 billion euro of equities were later switched into fixed income securities) – to recapitalise their banks. A further 3.7 billion euro was used in November 2010 for another bail-out. Essentially, the NPRF was ravaged to pay for the excesses of the banks.