THE RISE IN PETRO-DOLLAR INVESTMENTS & SOVEREIGN WEALTH FUNDS (SWFs)

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Facts, Issues, Guidelines: Sovereign Wealth Funds(SWFs)

Presentation

- ***Facts and Definitions - SWFs***
- ***Largest SWFs***
- ***SWFs & Other Entities***
- ***SWFs growth - Main Drivers***
- ***SWFs- Rational Investors or Not?***
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Stylised facts on SWFs, International Reserves

- SWFs have been around since decades, with 3 waves 1970s, 1980s and 2000s: KIA (1953), Temasek (1974), Alaska (1976), ADIA (1976), Alberta (1976); new wave in current decade: QIA (2000), Kazakhstan (2000)

- Two types:
  - Stabilization Funds: address cyclical & revenue smoothing issues
  - Intergenerational Funds: address intergenerational transfer of wealth

Drivers of SWFs

- Strong growth and increase in commodity prices since 2002 leading to large trade & current account surpluses in exporting countries
- ‘Emerging’ market economies have become capital exporters
- Low returns on central bank international reserves
- Increased expansion & integration of international capital markets
- Large, persistent US current deficits:
  - 6% of national income
  - US absorbs some 70% of all net saving by current account surplus countries including China, Japan, Germany and the commodity exporting countries.
  - *“Fundamentally, when a debtor owes the bank a large enough amount, the debt becomes the bank’s problem*.” (K. Rogoff (2007))
- International reserves management policies of surplus countries and SWFs have been major contributors to ‘benign’ international financial conditions and global financial stability: rational, self-interest

Policy issues relating to natural resource countries & commodity exporters

- Natural resources exhaustible:

Risk & Return on Investment Portfolios (source: L. Summers (2007))

- Low real returns on central bank portfolios have created incentives to seek asset diversification and higher returns
- SWF investment strategies similar to pension funds: allocation to fixed income, equities, real estate, PE and related

Annualised risk and return of investment portfolios

1946-2004

Stylised portfolio	Average real return in % p.a.	Annualised standard deviation of return in %	Probability of negative real return for 10Y holding period in %
Typical central-bank portfolio	0.98	1.24	37.0
Typical pension-funds portfolio	5.75	12.45	12.5
All-US-stocks portfolio	7.11	19.37	13.3

Facts & Definitions- Sovereign Wealth Funds

- **Sovereign Wealth Funds (SWFs) are state-owned and operated funds, comprising of financial assets such as stocks, bonds and property. SWFs generally fall into two categories, including commodity funds and or non-commodity funds.**

  - **Commodity funds are established through commodity exports. Commodity based funds are normally from petroleum revenues but not always, as is the case for Chile's US$3.9 billion Copper Stabilization Fund. According to the IMF, the size of SWFs is estimated between $1.5-3.0 trillion.**

  - **Non-Commodity funds are typically established through transfers of assets from official foreign exchange reserves. Global reserves currently stand at roughly $5.6 trillion by surplus countries mainly in Asia with China alone holding $1.2 trillion in reserve assets.**

Facts & Definitions - Sovereign Wealth Funds (SWFs)

- **Most of the current focus regarding SWFs is on the Middle Eastern economies. However, China, Russia, Norway and Singapore all have SWFs.**
- **Typically, the current trend is such that:**
  - **Commodity exporters have chosen SWFs and;**
  - **Asian countries have chosen reserves.**
- **There are exceptions:**
  - **Singapore established the Government of Singapore Investment Corp. in 1981.**
  - **Russia created its oil stabilization fund in 2003, currently standing at US$ 32 billion. Russia has also accumulated the central bank reserve of $430 billion since 2002.**

Largest Sovereign Wealth Funds (SWFs)

Country	Fund Name	Assets (US$bn)	Inception	Origin
U.A.E	Abu-Dhabi Investment Authority	875	1976	Oil
Singapore	Government of Singapore Investment Corp.	330	1981	Non-Commodity
Norway	Government Pension Fund	300	1990	Oil
China	State Foreign Exchange Corp	300	2007	Non-Commodity
Saudi Arabia	Various	300	N/A	Oil
Kuwait	Kuwait Investment Authority	70	1953	Oil
Australia	Australia Future Fund	50	2004	Non-Commodity
Kuwait	Kuwait Investment Authority	70	1953	Oil

Source: Morgan Stanley, March 2007

SWFs & Other Entities

- The distinction between SWFs and other entities such as large corporations needs to be made when it comes to investing internationally.
- SWFs are not the only available tool to invest in foreign entities. Large corporations such as Dubai Ports are also involved in large international investments.
- SWFs are in may ways similar to the large pension funds in G-7 economies who regularly look for and invest at the international level.

SWFs Growth- Main Drivers

- Commodity and especially the oil prices are not the only reason for the growth of SWFs.

- With the US running a current account deficit at 6 percent of national income, foreign nationals have been accumulating US assets at a spectacular rate.

- Foreigners currently hold well over $14 trillion of US assets, more than a 100% of US GDP.

- Currently, the US absorbs roughly 70 percent of all net savings produced by the World's current account surplus countries including China, Japan, Germany and the oil exporting countries.

SWFs – Rational Investors or Not?

- SWFs are integral part of a global financial system. At the recent G-7 Finance Ministers meeting in Washington, the statement praises the role SWFs play for the stability of the global financial system as they are a reliable source of liquidity if the global financial system requires.

- Yet, there are calls for a greater transparency when it comes to SWFs. However, why SWFs be single out when it comes to transparency and regulations? Hedge funds and private equity are more volatile than SWFs and have a far more potential to disturb the global financial system.

- SWFs are not used for irrational investments as the holders of SWFs are fully aware that their national economic and financial future is strongly linked with the global financial system.

SWFs - Next steps

- SWFs are integral part of the global financial system. SWFs look for long term investments and they typically farm out to asset managers to manage their investments. They have no or negative co-relations to the source of their revenue mainly oil.

- SWFs are a national matter with a global reach and influence. That is why it is prevalent to have a constructive discussion on this matter between SWFs holders and the international financial community.

- Western countries and other participants within the global financial system must work with SWFs holders to find a common ground for rules and regulations. If not then there is a danger of financial and investment protectionism which will not be beneficial to the global financial system.