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SOVEREIGN WEALTH FUND ANNUAL REPORT 2011

A Brave New World For Sovereign Wealth Funds

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THE GROWTH OF SWFS IS DRIVEN BY ECONOMIC FUNDAMENTALS

Since the start of the new millennium, economic and financial power has been draining away from mature advanced economies towards fast-growing emerging markets. A growing number of developing countries, thanks to rapid economic growth and the correlated increase in international trade and investment flows, have significantly raised their shares of global income, trade and foreign investment. Much of the growth was concentrated in manufacturing and industry as these economies moved out of traditional agriculture. As a direct consequence, there was an acceleration of growth in demand for raw materials, natural resources and commodities such as metals and energy which are inputs for manufacturing and industry. This upward shift in demand led to a surge in commodity prices, including energy and food. The two giants', China and India, combined share of global oil demand increased from nine percent in 2002 to about 15 percent in 2011. Emerging market economies (EMEs) have also become more urbanised, with young and rapidly growing populations moving to job opportunities in the cities. In turn, rapid urbanisation – as exemplified by China's massive city building – has driven increased investment on infrastructure, including on public utilities, transport, and health and educational and housing. In turn, greater infrastructure investment has increased demand for raw materials, metals and other commodities, driving up their prices. Thus, high economic growth, changing production structures and growing urbanisation in EMEs are major contributory factors to higher commodity prices, more than offsetting slower growth and the effects of the financial crisis in the United States and Western Europe. Importantly, the shift in global economic and financial geography towards EMEs and Asia is not a temporary phenomenon. EMEs are expected to grow at two to three times the rate of advanced economies over the coming decade. It is a secular trend implying a permanent shift in income and wealth in favour of EMEs, which along with high saving rates implies a growing accumulation of claims of EMEs against mature, advanced economies.

COMMODITY-BASED SWFS ARE DOMINANT AND SWFS ARE HERE TO STAY

In turn, the strong rise in the prices of commodities led to large surpluses in the current accounts of commodity exporters leading to an accumulation of international reserves. The financial resources available to commodity-based sovereign wealth funds (SWFs) boomed. Assets managed by SWFs (broadly defined) grew from about \$1.2 trillion in 2002 to \$4.8 trillion at end-2011, and are projected to be some \$5.4 trillion by end-2012, with commodity-based SWFs representing some 58 percent of the total. Note that the share of commodity-based SWFs has declined from 77 percent of the total in 2002, largely on account of China's strong accumulation of foreign assets and creation of the China Investment Corporation in 2007. According to a 2012 Preqin analysis,[1] almost three quarters of all SWFs are based in either Middle Eastern or Asian countries and they are mostly funded by natural resources, in particular oil and gas. But a growing number of EME governments have been establishing SWFs funded by strong market fundamentals for commodities and associated surplus revenues, with some 60 percent of SWFs being established since

1 Preqin (2012), *Sovereign Wealth Fund Review*, Preqin, London

SWFs are rebalancing the portfolios towards emerging markets, and alternative investments.

2000, and 30 being established between 2006 and 2010. For example, Nigeria, Africa's top oil producer, established a SWF in 2011 with an initial capital of $1 billion to help the country save for the future, invest in strategic infrastructure projects in Africa's most populous nation and act as a "buffer" against volatile oil prices. Given the economic fundamentals favouring EMEs we can expect SWFs and related public investment funds to play a growing role in a changed global financial architecture. Already, as at end-2011 SWF assets under management at $4.8 trillion exceeds the combined total managed by private equity and hedge funds of $4.4 trillion.

GREAT FINANCIAL CRISIS AND GREAT CONTRACTION HAVE CHANGED SWF INVESTMENT STRATEGIES

The great financial crisis starting in 2008 and the ensuing "great contraction" have led to three shifts in the investment strategies of most SWFs. First, SWFs are moving away from investment in mature advanced economies towards the better prospects of EMEs. A corollary is that SWFs are eschewing exclusive reliance on the services of asset managers in traditional centres like New York and London and building their own investment management capacity, a move justified by the growth in their assets. Second, SWFs are playing a growing role in financing economic development in their domestic and linked economies. This is a move away from traditional portfolio investment for risk diversification purposes. This is particularly true in the GCC countries and other oil exporters where governments have sought to allay the perceived threats and vulnerabilities of the "Arab Spring" by using the resources of their SWFs. Finally, SWFs are diversifying investments away from traditional market securities towards direct investment and alternative assets including renewable energy, land, real estate and other investments. Consequently, SWFs are increasingly undertaking more active management of their assets.

SWFs played a major stabilising role in the great financial crisis contributing to the bailout of American and European financial institutions during the financial tsunami of 2007-08 and the bailout of their domestic banking sectors in early 2009. Indeed, over the period 2008-2010 SWFs invested some $112 billion in financial services.[2] However, the great financial crisis has led to a reassessment of the risks and returns to investment in advanced economies. A combination of capital losses on investments, higher perceived risks, including unexpected governance and regulatory risks, of investments in advanced economy financial markets and the prospect of low returns on financial asset investments and specifically government securities – a favourite asset of SWFs – resulting from historically unprecedented loose monetary policies implemented in Western economies, led to a re-evaluation of traditional SWF investment strategies.

SWFS PORTFOLIOS ARE SHIFTING TO EMES, REAL ESTATE AND ALTERNATIVE INVESTMENTS

The investment portfolios of SWFs are being rebalanced from advanced economies in favour of the higher expected return investments of EMEs, as well as into alternative asset classes. There is also a trend shift away from portfolio to direct investment strategies, including private equity and real assets. A growing number of SWFs are investing in private equity (about 55 percent) and in real estate (51 percent) a favoured asset of Middle East investors, infrastructure (47 percent) and hedge funds (37 percent).[3] Moreover governments and SWFs are also investing in agricultural land, both as a real hedge and as security for the long-term, strategic supply of food. Indeed, a near universal "land grab" is currently underway driven by demographics. Absent major catastrophes or radical policies (such as China's one child policy), the global population is expected to

2 The CityUK (2012), *Sovereign Wealth Funds*, CityUK, London.

3 Preqin, *Sovereign Wealth Fund Review*

double by 2050, potentially outpacing the growth of exploitable, arable land.[4] The population to land ratio is rising. Growing EME populations, increased urbanisation, growing middle classes with changing consumption patterns, climate change, and the demand for biofuels and rising input costs are putting pressure on limited land resources. By contrast, it is more uncertain whether the countervailing factors of technological innovation, bio-genetics, and the emergence of new frontiers (new Northern lands resulting from climate change, sea-based agriculture) will mitigate or offset the risks and consequences of higher population density.

These economic and ecological fundamentals are driving SWFs, pension funds and other long-term institutional and "patient investors" towards the energy sector, land, commodities, and associated processing industries and economies. Indeed, the investment drive into Africa is based on these fundamentals.

But the energy rush is not all about hydrocarbons; the focus is increasingly on renewable energy sources. A number of SWFs now incorporate environmental, corporate social responsibility and corporate governance (ESG) criteria in designing their investment strategies and in the choice of securities and investments. SWFs from both Asia and the Middle East have recently invested over $2 billion into non-hydrocarbon energy sources. Singapore's Temasek Holdings has invested $47.8 million in biofuels; Abu Dhabi's Mubadala Development Company is investing some $360 million in the Shams Solar energy plant, while the Norwegian Government Pension Fund–Global increased the size of its environmental investments to $4.7 billion. The bulk of these investments are in EMEs.

This wider diversification in investment portfolios is made possible by the growing ability of EMEs to acquire and host new technologies and innovate. For SWFs, it means new opportunities to diversify portfolios beyond advanced economy securities.

4 Arezki, Rabah; Klaus, Deininger; and Harris, Selod (2012), "Global Land Rush", *Finance & Development*, 49 (1).

Even though SWFs' initial forays into the renewable energy sector are currently fragmented, they could become more systemically important and game changers in since they benefit from long investment horizons. They are in a position to accept lower short- and medium-term returns for strategic gains later. Investment in clean technology would also allow developing economies, many of them owners of SWFs, to facilitate the transfer of technology and know-how needed to build the advanced infrastructure of the twenty-first century, rather than follow unsustainable growth and consumption patterns based on hydrocarbon intensive consumption and production. Investing in clean energy and technology is a long-term business, and SWFs have a comparative advantage to invest in this sector, as they are intrinsically "patient investors". After all, a major objective of SWFs is to manage and preserve resources for future generations.

SWFS ARE LIKELY TO CHANGE MARKET RISK-RETURN OUTLOOKS

As the world's economic and financial geography increasingly shift towards EMEs, they will become the dominant savers and investors. Increasingly, given current governance structures in EMEs, capital flows and investments will be directed, allocated and managed by EME state-owned enterprises and SWFs with their idiosyncratic investment strategies, attitudes to risk and investment horizons. Intriguingly, we may be heading for a world dominated by a new class of investors with a longer-term view of return and risk, which may contribute to reducing volatility in financial markets and a focus on the role of the banking and financial markets in financing infrastructure and economic and social development. This would be a major transformation from the current pattern of investment short-termism and an orientation towards financial sector securities and investments that have become increasingly divorced from real economic activity.