Theoretical and Applied Economics
Volume XXI (2014), No. 2(591), pp. 7-18

Sovereign wealth funds, catalyzers for global financial markets

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Abstract. *In this paper we briefly present the impact of sovereign wealth funds on the global financial markets, the advantages they offer and the concerns they have generated lately. Sovereign wealth funds have emerged as important players in global financial markets and their stability. Although they are controlled by state, they seek to activate in the markets in the same as private investors, showing significant impact on listed companies they invest. Despite of their important presence in global financial markets, little is known about their asset allocation. Significant concerns have been expressed about SWFs limited transparency being suspected to follow other factors besides risk adjusted returns. We believe that SWFs should present clearer governance standards and more transparency in order to ensure a catalyst role for the global financial imbalances. The essential role of authorities relies on implementing an agreement on a set of regulations, standards and best practices for the sovereign wealth funds.*

Keywords: sovereign wealth funds, official reserves, voting rights, financial regulation, asset allocation, benchmark, portfolio diversification.

JEL Classification: F01, F65, G11, G18, O16, P16.
REL Classification: 10A, 10I.

Introduction

Sovereign wealth funds are vast pool investments on behalf of governments with budgetary surpluses or funded by foreign currency reserves, that invest globally through systematic diversification across multiple currencies and asset classes for higher risk adjusted returns. They are typically active investors industries covering financial services, logistics, transportation, healthcare, transportation, real estate, telecom & media, engineering, IT, energy and real estate. Most of the funds are financed budgetary surpluses, mineral royalties, natural resources royalties, budget transfers, privatizations revenues, taxes, luxury goods, alcohol and cigarettes excises or transfers of assets from official foreign reserves (non-commodities sovereign funds). Over the last decades, they have become more visible and in global financial markets and focus on responsible investing in the context of maximizing the wealth creation.

According to their aims, there are various types of sovereign funds: budget stabilization funds, saving and wealth sharing across generation through diversification, pension reserve funds, reserve investment funds (reducing the negative carry cost of holding reserves) and strategic development sovereign wealth funds in order to allocate resources to priority projects according to the national economic, social and political goals. They do not engage in macroeconomic policies with the exception of transfers received from or to the budget or central banks' reserves for exceptional needs (tied to the source of the funds), or in order to stabilize local strategic businesses.

Benefits

Establishing a sovereign wealth fund by a state represents an evidence of government will **for implementing a sustainable long term economic strategy**. This type of funds plays many roles in sustaining the wealth of a nation over the long term, through:

- Protecting the national wealth through long term vision over investments transcending micro and macroeconomic cycles;
- Saving for the future generation's wealth fare and preparing provisions for "rainy days";
- Diversifying the economies of the countries that depend on limited raw material exports;
- Obtaining a better risk adjusted return over the long term than the conventional way of investing the budget surpluses and the national foreign reserves;

- Sustaining national businesses that activate in strategic sectors and industries (agribusiness, energy, real estate, national defense, etc.);
- Funding distressed financial institutions in order to prevent financial systemic risks;
- Proactive role in sustaining national key infrastructure project developments.
- Reducing the volatility of government revenues (including fiscal revenue stabilization);
- Helping central banks to sterilize the surplus of liquidity;
- Countering the macro economic cycles and build up diversified portfolios of savings for future generations' wealth fare, especially for countries that depend on limited raw material exports that wish to diversify their economies. It may be a good strategy for export countries of nonrenewable resources to build up provision in preparation for a "rainy day".

Comparing to other forms of asset management, sovereign funds are highly liquid, with very limited constraints in managing assets. They are long term investors (less sensitive to market conditions than most of the institutional investors) with relatively high risk appetite, highly diversified in searching for higher yields in order to increase the wealth of the state over the following generations. They use little or no debt and typically invest in various asset classes from all over the world: from sovereign and corporate bonds to emerging market equities, high yield corporate bonds, commodities, structured products and derivatives, private equity, real estate and other alternative investments like art, hedge funds and precious metals.

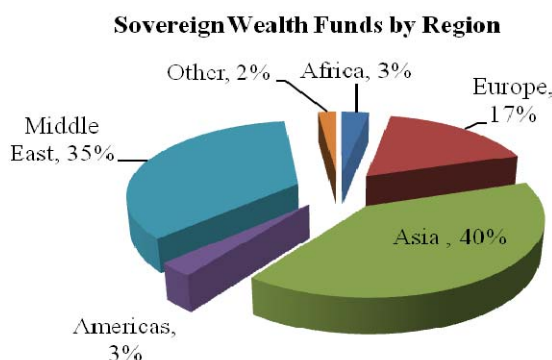
Taking in consideration the source of funds, sovereign wealth funds may be Commodity Funds, financed by sale of commodities and established for budget stabilization and wealth sharing across generations and Non Commodity Funds funded by the excess of assets from national foreign exchange reserves and privatization processes in order to realize its functions mentioned above.

Although the very first fund was established in 1854 (Texas Permanent School Fund), sovereign funds' inceptions started with 1950s (Kuwait 1953, New Mexico 1958), and the dramatically increase in size, number and structure has started over the last 20 years. According to SWF Institute, the total market size in September 2013 was almost US$ 6 trillion, from mostly US$500 billion in the early 1990s raising them into some of the most important participants in global financial markets attracting attention by policy makers, traders and international community (Mezzacapo, 2009).

Since 2005 more than 40 sovereign wealth funds have been created, due to the rising commodity prices for the last years. From the beginning of 2008 until the end of 2012 the assets under management of sovereign wealth funds grew by over 59%.

Some of the largest sovereign funds have their origins in countries like China, United Arab Emirates, Norway, Saudi Arabia, Singapore, Kuwait, Hong Kong, Russia, Qatar, Australia, USA, Iran, Libya and other countries. There are some countries that have more than one SWF (China, UAE, Saudi Arabia, USA, Kazakhstan, Russia).

The holdings are quite concentrated, with the top sovereign funds accounting about 70% of the total assets. More than half of them represent countries with significant export amounts of natural resources. Currently more than 30 countries have set up their own investment funds and about a dozen have expressed an interest in establishing one. The rapid rise in price of the major commodities as the result of excess liquidity nurtured by lax global monetary policies, exports of China and other East Asian Countries over the past decade, increased US dollars cash reserves from exports or privatization proceeds. Commodities SWFs' aim stands on reducing the country natural resources dependency for the future generations through global diversification of wealth over the long term. Sovereign funds have limited or no liabilities, allowing them to pursue different medium and long term investment strategies, diversifying assets (foreign investments) and taking higher risks.



Their holdings may seem significant but they are not huge in the context of the total value of traded securities and GDP of the most developed countries, however may be large enough related to the size of their countries (Norway) or the size of some emerging markets.

In the following pages, there are mentioned the first 12 largest sovereign funds according to the value of assets held under management[(1)]:

- **Government Pension Fund Global (Norway)** – with over US$ 803.9 billion funded in 1990 as a fiscal policy tool to support the country's long term petroleum revenue. The funds are invested abroad in international equity, fixed income and real estate markets (in about 70 countries, including the emerging and frontier markets excluding Norway), to avoid overheating the national economy and obtain the highest possible risk adjusted return over the long term. The fund has generated an annual return of 5.49% between 1998 and the end of the third quarter of 2013 and after management costs and inflation, the average real annual return was 3.41%. The guidelines for strategic allocations are set to hold 60 percent of its assets in equities, 35 percent to 40% in fixed income and as much as 5 percent in real estate. The fund's market value in the third quarter of 2013 was over 4,7trillion NOK with equity investment market value of almost 3 billion kroner and the total accumulated return since 1996 exceeds 1.5 billion NOK. The projecting for the size of the fund by 2020 is to exceed 6.8 billion NOK. The Norwegian parliament has set the framework and the Norges Bank Investment Management (central bank's asset management division) has the operational and risk management tasks of the fund on behalf of the Ministry of Finance. The fund's investments are measured against benchmark indices for different asset classes, and the ownership strategies promote good corporate governance standards and encourage issuers to improve their social and environmental standards, safeguarding shareholders rights and ensuring an equitable distribution of the profits. Norway's sovereign wealth fund represents the global hallmark in terms of disclosure standards.
- **SAMA Foreign Holdings** represent the sovereign wealth funds managed by the Saudi Arabian Monetary Agency the central bank of the Kingdom of Saudi Arabia. The fund was established in 1952 from a significant portion of surplus oil revenues. The funds invest typically in low risk assets and according to SWF Institute it is estimated to have reached over US$ 670 billion assets under management in 2013.
- **Abu Dhabi Investment Authority (ADIA)** – with over US$ 627 billion, established in 1976 to invest funds on behalf of the Government to make available the necessary financial resources to secure and maintain the future welfare of the Emirate through sustained long term financial returns. ADIA's assets are not classified as international reserves. The fund involves in looking for strategies beyond individual economic cycles, capturing secular trends to general long-term sustainable returns, without seeking an active role in the management of the companies in which it invests. The fund's portfolio consists of quoted equities, fixed income and treasury instruments, real estate and infrastructure, private equities and other alternative investments. Is not involved and has no matter to do with the spending requirements of the Government of the Emirate of Abu Dhabi.

- **China Investment Corporation**, established in 2007 as a non-commodity sovereign wealth fund (through issuing special treasury bonds), has reached more than US$ 570 billion assets under management. The fund's stated mission is to manage long term risk and maximize financial return on overseas investment portfolio, consisted of equity, fixed income and alternative assets in both developed and emerging markets.
- **SAFE Investment Company** established in 1997 as a non-commodity sovereign wealth fund is responsible for managing China's foreign exchange reserves. According to SWF Institute, the fund reached more than US$ 567 billion in 2013.
- **Kuwait Investment Authority (KIA)** established as commodity (oil) sovereign wealth funds (General Reserve Fund – GRF 1953 and the Future Generation Fund – FGF 1976) that have reached approximately US$ 386 billion by the third quarter of 2013 and has one of the main aims to achieve a rate of return on its investment that, on a three year rolling average exceeds it composite benchmarks. KIA ensures that the state transfers on an annual basis 10% of the oil revenue into the FGF.
- **Hong Kong Monetary Authority's Exchange Fund** created in 1993 as a non-commodity fund acts as a stabilizer and invests primarily in its local exchange (Hang Seng) and in the local currency and monetary markets to support the HKD exchange rate. The Exchange fund it is consisted in three parts: Backing Portfolio (providing the full backing monetary base for HKMA), Investment Portfolio invested in fixed income and equity markets to preserve the value and long –term purchasing power of the assets and a strategic Portfolio in some key financial local institutions to maintain Hong Kong as a key international financial center. By the end of the third quarter of 2013, the Exchange fund has reached more than US$ 320 billion.
- **Government of Singapore Investment Corporation (GIC Private Limited)** manages the non-commodity funds created in 1981, funds that have reached more than US$ 285 billion by the end of the third quarter 2013. The aim of the funds is to enhance long-term returns through broad portfolio diversification: private equity, real estate, inflation linked bonds, nominal bonds & cash, developed and emerging market equities and alternative investments.
- **Temasek** incorporated in 1974 represent an investment company based in Singapore with over US$ 215 billion dollars in assets under management by the end of the first quarter of 2013. As the years progressed the underlying exposure progressed to 58% to mature economies and 42% to growth regions into various sectors and industries like energy, resources, consumer, transportations, industrials, real estate, telecom, media, IT and financial services.

- **Qatar Investment Authority (QIA)** established in 2005 manages the country's commodity sovereign fund, accumulated from the budget revenue surpluses, in order to strengthen the country's economy through a diversified portfolio into new domestic and international asset classes. According to SWF Institute, QIA's managed fund has reached over US$ 115 billion dollars.
- Other sovereign funds with assets under management comprising less than US$ 100 billion each may be over 30 other sovereign funds from Australia, Russia, Kazakhstan, Algeria, Dubai, Libya, South Korea, Iran, several states from USA (Texas, Alaska, New Mexico), Brunei, Malaysia, Ireland, Iraq, Canada, Chile, Oman, Bahrain, Peru, Botswana, Brazil, Saudi Arabia, United Arab Emirates, Nigeria, Palestine, and many others.

Business models

The legal basis and form under sovereign funds are established varies from country to country although the constitutive legislation is publically available. They have limited or no debts have any pending explicit liabilities, except for certain derivatives, to deliver long term sustainable risk adjusted returns through diversified investments effective management of the entrusted funds. Most of them disclose information limited to institutional and legal framework, accumulated returns, and brief asset allocation and performance description, excepting the Norway's SWF reports, that represents the global hallmark in terms of disclosure standards. Although the governance arrangements differs much from one state to another, the operational independence is mostly assured, while requiring regular financial reports disclosure and performance accountability to the Parliament, Ministry of Finance and the Central Bank. Some of them are managed by a separate entity owned by the government; some are managed by a specific asset management division of the central bank, on behalf of the Finance Minister's given mandate (Norway's Fund) or by one or more private asset managers.

Most of the funds mitigate operational risk through clears segregation of responsibilities (front, middle and back-offices), internal and external audit functions, compliance units, conflict of interests policies, corporate governance codes, reporting standards, investment strategies, rigorous codes of conducts for employees, operational guidelines, business recovery and continuity back-up procedures and facilities.

Some of the funds report performance according to a benchmark with specific investment policies (with risk, asset allocations and sectors restraints), some have

goals in terms of absolute return or others have larger investment possibilities without a specific return objective but to seek long term sustainable financial returns). The most frequent risk management measures and methods are the credit ratings issued by specific agencies, value at risk models, tracking errors, concentration analysis, factor exposure, stress tests, asset and currency weights, rigorous individual exposures management and broad portfolio diversification.

The owner of the fund (usually the government through the ministry of finance) is responsible for setting up the general investment policy (investment universe, exclusion list and asset allocation), in order to ensure consistent risk management, and greater accountability for the chosen investment strategy. The investment policy should formulate specific definitions, objectives, parameters, measures and methods related to various aspects like: risk assessing and tolerance, investment horizon, asset classes allocation, regions and currency allocation, benchmark and the active risk limits for deviating from the policy benchmark, risk budget and investment performance appraisal.

On the other hand, the fund management responsibilities may consist proposing capital market assumptions, implementing the strategy and managing the portfolios (directly or not through external managers), measuring risk adjusted performance and reporting to the owner and 3rd parties.

Investment strategies vary from traditional (equities and bonds) to more advanced like real estate, commodities, hedge funds other alternative investments with general constraints over investments classes, regions, currencies and instruments. The investment horizon, asset and currency composition, performance benchmarks, risk tolerance, asset and liability management differs widely according to the SWF's aims (stabilization, savings, pensions, reserve or development funds). The fixed incomes investments are allocated in a certain percentage according to the issuer (sovereign or corporate bonds), credit rating, currency, region and country. The equity investments may also be spread globally to capture significant risk adjusted returns through adaptive market exposure strategies, sector and market timing strategies.

Due to their global investments, sovereign wealth funds are exposed to various risks: market risk, credit risk, disclosure risks, agency risks, governance risks, reputation risks, political risks, liquidity risks, operational risks, credit risks and many others. That is the reason why these funds need to have a strong risk management culture, risk policies and procedures related to risk identification, measurements, monitoring, auditing and reporting. Reporting and transparency are crucial elements for performing fund governance. Although few funds provide full disclosure (mostly Norway's fund), transparency may contribute to

legitimacy, foster trust, gain commercial advantage and nurture reputation. Transparence is crucial to maintain legitimacy among the citizens of the country as well as for the credibility among international partners.

SWFs potential impact on listed companies, banking sector and on global financial markets

SWFs play an important role in global financial stability. Due to their massive buying power, SWFs are closely linked to public finances, monetary policies and external accounts. Furthermore, they emerge a positive impact on share values listed on stock exchanges. SWFs buying power enable them to act as stabilizing urge and a significant source of liquidity in global financial markets and a genuine institutional customer for the banking sector.

Banks may contribute to the success of the funds through various services provided: financial accounting of asset portfolios, benchmarks, investment market data and analysis, proxy voting agent, market risks assessments, portfolio measurement, external asset management services, transaction settlements with counterparties, custody and clearing of securities and trading technical support. On the other hand, sovereign funds could be the "saver of last resort" for the banks. During the latest crisis some SWFs have helped in recapitalization of many US and European distressed financial institutions (UBS, Citi, Morgan Stanley, Barclays, London Stock Exchange and Merrill Lynch) by purchasing minority stakes and acting as passive institutional shareholders. In absence of SWFs capital fund, probably de deterioration of the financial institutions mentioned above would probably have proven even worse. Buying distressed financial institutions stakes certifies their long term business sustainability and a back-up certificate for recapitalization in case of future financial distressed conditions.

A close coordination with macroeconomic policies and public sector finances is essential in order to flourish their macro stabilization role. They also help in loosening up global imbalances, due to emerging process of low yielding excess reserves of central banks into higher yielding emerging markets assets, since SWFs are considered to be less liquidity oriented and less risk adverse. Their behavior is expected to generate an increasing demand for risky assets and declining investments and low yielding sovereign securities.

On the other hand, there are some critics due to the possible conflict of interest among the rest of the shareholders and the eventually incentives to take exclusive advantages of their positions (benefits not shared with the minority shareholders).

Higher concentrated ownership should reflect a higher profitability through closer monitoring only if other related costs due to the risk of "asset striping" and risk of exploitation disfavoring the rest of the shareholders do not overweigh the benefits or improved monitoring.

In order to develop a consistent reputation, the owner could regulate a set of responsible investment practices, including here the exercise of ownership rights, the observation and exclusion of companies. Defining and implementing ownership strategies are crucial for the reputation of a sovereign wealth fund. One of the most transparent funds, Norway's SWF seeks to promote good corporate governance standards and encourage businesses that improve social and environmental standards, focusing on six strategic areas of ownership activities: equal treatment of shareholders, shareholder influence and board accountability, well-functioning, legitimate and efficient markets, children's rights, water management and environmental management.

Concerns

The confusing limits between private and public investors, limited transparency and the high level of buying power concentration have raised concerns among US and European politicians that the funds may be gaining political advantage and alleviating global tensions. There are some countries where government ownership has long been suspected. Western nations worry about the security implications on foreign relations, because of the risk of being used as instruments for capital account protectionism and gaining important positions in key global industries and companies ensuring technology, knowhow about natural resources, gaining economic and geopolitical advantage leaving triggering security implications for the host countries. In capitalism, shareholders act to maximize the value of their shares but public investments may have adverse impact on corporate governance efficiency triggering geopolitical implications and conflict of interests among shareholders. Public investments are not always driven by risk adjusted profit maximization but simply could be for geopolitical, and security and strategic interest to extract or implement certain technologies, or gain influence for their eventually hidden political agendas. A countermeasure in maintaining control over important and politically sensitive industries (national security interest industries) could be the "golden share" instrument (retaining effective veto power related to takeovers for assets in so called national strategic sectors).

Regulatory intervention

The lack of periodic and reliable information (except of Norway's' fund) has made global authorities to set up a voluntary "best practices" code for SWFs related to transparency, governance and fund organization because nowadays their practices vary widely (Norway's fund being a model of such transparency, but others publish very little information or none). The idea is to reduce their "opacity", so their investments may not let them be used geopolitical strategies implementation instruments like encouraging capital account protectionism, through choosing which country or company to invest, disrupting the financial markets flow or making them less efficient.

Transparence plays a major role in keeping the confidence in the markets; limited transparency allows "market abuse" and "insider trading" practices, undermining market confidence and raising systemic risks. SWFs need to diversify their holdings based on trust and transparence striving to improve efficiency in financial markets. Disclosing their voting records and policies helps market participant to avoid unwelcome surprises and certifies that funds militate against political interference and respect their investment policies supporting markets efficiency. In inefficient markets the prices are not optimal due to the abnormal losses and gains realized by participants. Since the party benefiting from inefficiency may not have much incentive to change things, market alone cannot lead to efficient outcomes and regulatory intervention may be welcomed if SWFs would not offer transparency through voluntary means (Mezzacapo, 2009, p. 41).

Conclusion

As a concluding remark, we believe that exaggerating the risk of investments realized by Sovereign funds may not be fair – because such investments have a vital role in providing liquidity to global markets and in generating wealth for the receiving markets and for future generations' citizens of the home countries. Authorities should take constructive approaches to ease concerns over some eventual political pursues or instruments of foreign policy objectives and showing progress over some issues like governance, transparency fund organization. Disclosures about investment philosophies and strategies in the annual reports would be a sound step. All this may contribute over the reassuring and building confidence for markets, investors and authorities.

Our further research will be towards the opportunity, the benefits and costs of establishing a Romanian sovereign fund for the national economy and for the long term social welfare.

Note

[1] Estimates offered by SWF Institute – November 2013.

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