Understanding Sovereign Wealth Funds

By Victoria Barbary, PhD

It has now become almost impossible to ignore sovereign wealth funds (SWFs). Despite the first SWFs (in Kuwait and what is now Kiribati) being founded in the 1950s, it wasn’t until the mid-2000s that the world took note. The boom in oil prices and world trade endowed a number of emerging economies with vast wealth, which they started deploying actively around the world through a number of new investment vehicles. At the height of the pre-crisis boom, coverage of SWFs became so frenzied that some commentators predicted that total SWF assets under management (AUM) would reach $12 trillion by 2015 and that these coffers would surpass official reserves within five years. Some of the more discreet funds also courted hyperbole; for example, some claimed that the Abu Dhabi Investment Authority’s AUM was in the range of $800 billion and would soon surpass $1 trillion.

Since then, much has been written about SWFs and the losses that they, like most other institutional investors, suffered during the financial crisis. Yet there is little consensus about the definition of a sovereign wealth fund or its objectives. Here I provide a categorization of sovereign investment vehicles, most of which are referred to as “sovereign wealth funds,” based on ownership, funding sources, liability profile (and thus role in economic policy), and investment style. By so doing, I hope to help other stakeholders interact with these funds in appropriate and productive ways, enabling the free flow of capital around the globe.

What is a Sovereign Wealth Fund?

A range of investment vehicles owned by national and sometimes subnational governments are used to invest excess budget surpluses that if managed poorly could cause inflation, Dutch disease, and other macroeconomic threats.

Because each nation’s situation is unique, investment of surpluses needs to be tailored. Some countries such as Venezuela, Iran, or Botswana choose to establish stabilization funds to protect their currencies against excess volatility. Others such as India keep large surpluses in foreign exchange reserves due to the volatility of their income streams and structural deficits. The Japanese perceive that providing for their aging population is their most pressing priority, so they maintain their wealth in large pension funds. Oil-rich nations in the Persian Gulf region invest their oil revenue surpluses abroad to provide for future generations when their oil reserves are depleted.

Budget surpluses generally come from one of three primary sources. The most obvious is income from natural resource rents. This has tended to be hydrocarbon wealth (particularly in the Middle East), but other natural resources such as precious stones and metals, minerals, and “rare-earth” ores might also form the basis for an SWF. The second source is excess reserves built up from persistent trade surpluses. These include the China Investment Corporation (CIC) and the Government of Singapore Investment Corporation (GIC). Finally, SWFs may be formed from government holdings in government-linked companies, for example, Singapore’s Temasek Holdings, Malaysia’s Khazanah Nasional, and the Bahrain Mumtalakat Holding Company.

SWFs have immensely diverse investment strategies, behavior, and asset allocation because the purpose of each is defined by its country’s unique macroeconomic requirements. That said, if we examine their portfolios, SWFs can be loosely grouped into six buckets along a spectrum of financial risk from central banks (which hold the most-liquid and lowest-risk assets) to state-owned enterprises (which have the riskiest and most-illiquid assets).

Central-Bank and Foreign-Exchange Funds

Central-bank and foreign-exchange funds are used for currency stabilization and to control inflation; they are thus highly liquid and managed by the central bank or finance ministry. For example, the Saudi Arabian Monetary Agency (SAMA) has assets of $505.9 billion, nearly 70 percent of which are invested in foreign bonds, with the remainder in cash and gold. Some funds, such as SAMA and China’s State Administration of Foreign Exchange (SAFE), may have riskier investment operations, but these departments only account for a tiny proportion of their funds and primarily are used as a hedge against currency fluctuations. Rarely do these equity holdings make the news, and we have heard very little of them since 2008 when SAMA made headlines bolstering Credit Suisse with $2 billion and SAFE was caught trying to play the Australian banking sector and inadvertently took its stakes in oil companies Total and BP over the reporting limit.

Stabilization Funds

Stabilization funds, such as Chile’s Economic and Social Stabilization Fund, are established to be drawn on at short notice to stabilize a country’s currency at
times of severe macroeconomic shock. Like central-bank funds, therefore, they must be invested in a manner that gives the government owner instant access, rather than maximum return. Consequently, portfolios are liquid and low-risk, consisting of sovereign debt, cash and gold, and potentially high-quality commercial debt such as that of

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First, and primarily in the case of commodity funds, is intergenerational savings. Governments that receive large incomes from a finite resource often choose to invest surpluses to provide for future generations at a time when the income stream will have dried up. The most notable of these funds are the Abu Dhabi Investment Authority (ADIA) and the Kuwait Investment Authority (KIA).

The second purpose for an SWF is to diversify national reserves. As surpluses accrue, they create inflationary and exchange-rate pressures, which may have major implications for economic development in emerging economies. Diversifying national reserves reduces reliance on major currencies and their economies, while providing superior long-term returns to those of traditional low-risk assets such as cash and government bonds for funds that have no immediate liabilities. CIC and GIC are examples of such funds.

The third purpose for an SWF—economic development—traditionally has been confined to those formed from government-linked company portfolios. Temasek and Khazanah have long invested in their domestic economies, looking to develop public companies and ready them for an initial public offering, or to diversify and build capacity in their home economies. Now other countries, for example, the United Arab Emirates and Vietnam, are looking to achieve the same aim, in return for a healthy profit.

The International Forum of Sovereign Wealth Funds, the official representative body of SWFs, formed in 2008 to create a voluntary code of conduct, otherwise known as the “Santiago Principles,” for SWF investment behavior. It defines an SWF thus: “Special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets . . . .” This broad definition, however, encompasses a wide range of organizations from the stabilization funds of Botswana, Chile, and Trinidad and Tobago, as well as more-traditional sovereign wealth funds such as ADIA, GIC, and CIC, as well as funds owned by subnational governments such as the Alaska Permanent Fund.

Domestic Investment and Development Funds

Domestic development funds are prevalent around the world. Some of these funds, like the French Caisse des Dépôts et Consignations or Cassa Depositi e Prestiti in Italy, are old institutions with historic mandates, while others, such as 1Malaysia Development Berhad and Kazakhstan’s Samruk Kazyna, have been formed to accelerate development in emerging economies. These funds create new government-linked companies and joint ventures at home to facilitate economic development, help domestic companies, and manage government holdings in existing government-linked companies. These funds eventually may transition to international investment, like Temasek and Khazanah.

Additionally, there are funds, most notably in the United States, that are owned (usually) by subnational governments and invested for specific purposes. In addition to Alaska’s Permanent Fund, Louisiana has $4.5 billion invested in a series of “trust funds,” Oklahoma has $5 billion invested in “non-pension state funds,” and Texas
has tens of billions in the Permanent Schools Fund and the Permanent University Fund. Each of these funds has a specific state-level funding objective that will aid the economy or society of the state in the future.

State-Owned Enterprises

State-owned enterprises (SOEs), government-linked companies, para-statals—there are any number of terms for companies owned by the government that often undertake operations in infrastructure and strategically important sectors. The highest-profile SOEs in recent years have been national oil companies from emerging markets, such as Saudi Aramco, Russia’s Gazprom, CNPC of China, NIOC of Iran, Venezuela’s PDVSA, Brazil’s Petrobras, and Petronas of Malaysia, which have been dubbed the “new seven sisters” and dominate world oil production. SOEs frequently are confused with sovereign funds. Indeed, attempted purchases by two SOEs in the United States first brought emerging-market sovereign funds to the world’s attention: CNOOC’s attempted acquisition of Unocal and Vietnam’s State Capital Investment Corporation are active in the operations of many of the government-linked companies in which they are stakeholders. Their operations have many parallels to modern private equity firms that actively engage with portfolio companies to add value post-investment. However, as these funds exit their portfolio companies, which both Temasek and Khazanah are doing increasingly, they can increase their investments in financial assets, developing broad-based equity portfolios, and thus transition toward a reserve-diversification fund.

Other funds that have this hybrid role are those from Abu Dhabi, most obviously the Mubadala Development Company. Mubadala’s mandate is to develop and diversify the economy of Abu Dhabi and it thus has extensive operations across many sectors within the emirate. However, it also has a for-profit foreign equity portfolio that it uses to support the investments it makes at home financially. It also undertakes joint ventures with international companies such as GE and Finmeccanica and has bought companies such as SR Technics (aerospace) and John Buck International (property development) for specific projects.

The Qatar Investment Authority (QIA) is also an example of a hybrid model fund. While it is known for its high-profile financial investments abroad, particularly in the United Kingdom, QIA (usually through its wholly owned subsidiary Qatari Diar, a property development and investment company) has undertaken domestic investments to develop the Qatari economy; its largest and most high-profile investment is the $24.4-billion joint venture with Deutsche Bahn to develop the country’s railroad system in 2009. It also invests in agricultural land abroad for food-security purposes through Hassad Food and the Al Gharrara Investment Company.

Dealing with Diversity

Understanding the diversity and heterogeneity of sovereign funds of all types is important as they become an increasingly significant part of the global financial system. The largest government pension and pension reserve funds manage around $3 trillion; sovereign wealth funds (narrowly defined) manage a similar amount—double the global hedge fund industry. As capital dries up in advanced economies and builds up in many emerging markets, ensuring the free flow of capital is vital for both. However, this can be facilitated only by understanding the nature of the institutions involved, their aims, objectives, risk, and liability profiles. This understanding starts at the front line, with those professionals that work with the funds so they can serve their clients well. Recent trends show that SWFs and government pension funds increasingly are investing directly. After sustaining heavy losses during the global financial crisis in their managed portfolios—the $1-billion loss that Goldman Sachs made on the Libyan Investment Authority’s portfolio in 2010 is an extreme case in point—many have reorganized to beef-up in-house capabilities, particularly in the alternatives space and in active fund management. This provides an opportunity for investment consultants who understand the complexities of the landscape into which they are stepping.

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Endnotes

2 These rumors became so pervasive that the ruler of Abu Dhabi, Sheikh Khalifa bin Zayed al-Nahayan, waded into the fray to calm sentiments. When asked whether the value of the funds’ investments abroad exceeded $800 billion, he replied, “The estimations … are exaggerated and they do not reflect the truth and the size of Emirati investments abroad.” See “Abu Dhabi fund worth less than $800bn” (June 28, 2008), available at http://www.tradearabia.com/news/ECO_145802.html.
6 All SWFs with equity portfolios, and many with only fixed-income portfolios, employ asset managers. However, the funds that invest a significant proportion of their portfolios directly often do so through a series of wholly owned subsidiaries that often are registered in low-tax environments such as Mauritius or the Cayman Islands.
8 Other state investment funds in the United States include the Alabama Trust Fund, the Montana Permanent Coal Tax Trust Fund, four different permanent funds jointly managed by New Mexico’s State Investment Council, and the Permanent Wyoming Mineral Trust Fund.