

**DARIUSZ URBAN**

---

## **Sovereign Wealth Funds – new players on global financial markets**

### **Abstract**

*The objective of this paper is analysis of Sovereign Wealth Funds, which are becoming increasingly important players in the international monetary and financial system. Those funds are attracting growing attention not only due to last investment activities in brand-name global firms, but also due to lack of transparency and information about themselves. The article consists of two part. In the first part of the paper based on the latest literature the author presents definitions of Sovereign Wealth Funds and main factors responsible for the rise and growth of those funds. The second part of the paper deals with investment characteristics made by the largest of them. The main conclusion of this paper is that empirical analysis do not prove the thesis that investment made by SWF`s has a political background. The latest available data suggest that those funds avoid investing in sensitive sectors like defense, aerospace, high technology and transportation.*

### **1. Introduction**

SWF`s are a symbol of global economics and rebalancing of power in financial markets. Their emergence is not only controversial because of the fear of politically induced investments but also because they symbolize a much bigger and deeper phenomenon that is reshaping the world`s economy and finance. Since the early 2000`s emerging markets are for the first time running current account surpluses and exporting capital to the rest of the world. Emerging markets have become key players in the global economy (OECD 2008, p.1). SWF`s represent also a new way of thinking about government

investments. Many governments replace conservative holdings of government bonds with higher risk/ higher return investment in equities or corporate acquisitions. The reason for these changes in allocations seems to be clear; reserve-rich countries are seeking the higher returns and greater diversification associated with investing (Gilson and Milhaupt 2008, p.1347-1348). SWF`s arise as by-product of countries current account surpluses and accumulating net foreign assets in circumstances where governments retain control of foreign assets. (Eizenman and Glick 2007, p.1).

The controversy over SWF`s results from interaction of two different conceptions of the role of government in economy. One of them is “state capitalism” and the other one “market capitalism”. In the market capitalism developed in advanced economies, individual company is the unit whose value is maximized. According to WTO and UE rules government subsidies and preferences are designed to prevent government from shifting the level of profit maximization from the company to the state. For countries with market capitalism a belief that free trade and competition increase national wealth is the object of faith. However in state capitalism countries like China, the country is the unit whose value need to be maximized and government is the way to achieve that. It is a kind of new mercantile capitalism, where government acting through SWF`s attempts to ensure that company-level behavior results in higher country-level social, economic and political benefits(Gilson and Milhaupt 2008, p.1346).

SWF`s have changed the patterns of global investments because of economic reasons rather than changes in international relations or foreign policy. Until recently government surpluses were conservatively invested mainly in U.S. treasury securities and other national government bonds. (Gilson and Milhaupt 2008, p.1347).

## **2. Definitions**

Sovereign Wealth Funds defy attempts at straightforward definition. In essence, they are equity investment vehicles established by and under the control of sovereign states. SWFs are sovereign investment vehicles that are not central banks, monetary authorities in charge of foreign reserves, or national pension funds, unless they are financed by commodities exports (Gilson and Milhaupt 2008, p.1354).

According to other approach definition of SWF`s can have broadest and narrower character. In first of them SWF`s are government-owned or government - control assets. Narrower definition may exclude purely domestic assets, foreign exchange reserves, assets owned or controlled subnational governmental units, government financial or nonfinancial corporations and government pension funds (Truman 2008, p.1).

Sovereign Wealth Funds are also defined as public investment agencies, which manage part of the foreign assets of the national states. Although there is no one commonly accepted definition, according to the European Central Bank (Beck and Fidora 2008, p.6), three elements can be identified that are general to these funds; state ownership, very limited explicit liabilities and management separated from official foreign exchange reserves. This point of view seems to be shared also by others authors (Miracky et al 2008, p.11).

According to International Monetary Fund (IMF 2008, p.5) five types of Sovereign Wealth Funds (SWFs) can be distinguished based on their main objective:

1. Stabilization funds, where the primary objective is to insulate the economy and the budget against commodity price swings;
2. Savings funds for future generations, which aim to convert nonrenewable assets into a more diversified portfolio of assets and mitigate the effects of Dutch disease;
3. Reserve investment corporations established to increase the return on reserves whose assets are often still counted as reserve assets;
4. Development funds, which promote industrial policies that might raise a country`s potential output growth and help fund socio-economic projects;
5. Contingent pension reserve funds, which provide for contingent unspecified pension liabilities on the government`s sheet.

It is difficult to arrive at more precise definition due to diversity among these funds. SWF`s are one form of cross-border investment utilized by governments. The following table details all the forms of them.

**Table 1. Types of governmental investment vehicle.**

Official Reserves / Central Bank	Sovereign Funds			State Owned Enterprises
	Pension Funds	Domestic Sovereign Funds	Sovereign Wealth Funds	
External assets for directly financing international payment imbalances	Investment vehicle to meet government's future pension obligations	Investment vehicle to encourage domestic economic development	Investment vehicle funded by foreign exchange assets	Companies where the state has significant control
Highly liquid often OECD government bonds	Funded and denominated in local currency	Funded and denominated in local currency	Managed separately from official reserves Typically have a higher tolerance for risk	May make investments in foreign assets
Examples				
Federal Reserve (US) Bank of England (UK) SAMA (Saudi Arabia)	Government Pension Fund (Norway) GIC (Singapore)	Khazanah Nasional (Malaysia)	ADIA, Mubadala (Abu Dhabi) Temasek, GIC (Singapore) Istithmar, DIFC (Dubai) CIC (China) SAMA (Saudi Arabia)	CNOOC (China) Gazprom (Russia) SABIC (Saudi Arabia)

Source: Miracky W., Dyer D., Fisher D., Goldner T., Legarde L., Piedrahita V., (2008), Assessing the Risk, The behaviors of sovereign wealth funds in the global economy, Monitor Company Group, p.15.

There are number of driving forces responsible for the rise and growth of SWF's (Lyons G. 2007, p. 120). First of them is the movement in oil and other commodity prices. Petrodollars and revenues generated by the recent boom in commodity prices are the main source of income for sixteen of the largest twenty two funds. The second is the growth of foreign exchange reserves, especially Asian central banks reserves, accounted for two-third of total global currency reserves. The third factor is investment performance and returns achieved by the funds due to fund management, asset allocations and strategic investment. The fourth group of factors is discretionary factors, which can be understood as government's wish to finance these funds. Another purpose of SWF's especially in resource-rich countries is accumulation of savings for next generations before its natural and non-renewable resources will be exhausted.

These funds are not new phenomenon in global economy. First Sovereign Wealth Fund was established in 1950's on Kiribati, a Pacific island nation, in order to manage its phosphate deposits revenues (guano). Table 2 gives more detail information about twenty the largest funds. Unfortunately due to lack of precise data calculations about their assets are approximated.

**Table 2. The world's largest Sovereign Wealth Funds**

Country	Fund	Assets in USD billion	Foreign investment	Equity investment
Oil exporters		1240-2220		
UAE	Abu Dhabi Investment Council	400-800	high	high
Norway	Government Pension Fund – Global	373	high	medium
Saudi Arabia	SAMA	300	high	low
Kuwait	Kuwait Investment Authority	213	high	high
UAE	Investment Corporation of Dubai	20-80	high	high
Qatar	Qatar Investment Authority	20-60	high	high
Libya	Libya Investment Authority	20-60	high	high
Brunei	Brunei Investment Authority	10-50	high	high
Norway	Government Pension Fund-Norway	~20	low	medium
Russia	Future Generation Fund	~24	high	high
Kazakhstan	National Oil Fund	22	high	low
Malaysia	Khazanah Nasional Berhad	~18	low	high
East Asia		~585		
China	China Investment Corporation	~200	high	high
Singapore	Government Investment Company	~130	high	high
Hong Kong	Exchange Fund Investment Portfolio	~112	high	low
Singapore	Temasek Holdings	~108	medium	high
Korea	Korea Investment Corporation	~20	high	high
Taiwan	National Stabilisation Fund	~15	low	high
Others		~138		
Australia	Government Future Fund	~49	medium	medium
United States	Alaska Permanent Fund	~38	medium	medium
United States	Permanent University FUnd	~20	medium	medium
United States	New Mexico State Investment	~16	medium	medium
Canada	Alberta Heritage	~15	medium	medium
Total		1963-2943		

Notes: figures are only rough approximations. “High” and “low” refers to shares above two –thirds and one-third, respectively.

Source: Beck and Fidora, 2008 The impact of Sovereign Wealth Funds on Global Financial Markets, ECB, Occasional Paper Series No.91, p.10.

A large number of these funds were formed during the 70`s, due to rising oil prices. The same situation is happening since 2000`s, where many new funds such as for example: Taiwan National Stabilization Fund (2000), Stabilization Fund of Russian Federation (2003), Qatar Investment Authority (2005), Dubai International Financial Center Investment (2006), China Investment Company (2007) has been established. According to Sovereign Wealth Fund Institute total size of those funds is estimated at 3,778 trillion of USD. These funds probably will grow quickly, and surpass official global foreign currency reserves. Morgan Stanley Research Global estimates that situation for year 2011, but it was before oil prices began to fall down and slow down in economy begins (Morgan Stanley 2007, p.2).

But it is not the size and growth rate of these funds that has recently prompted attentions; it is the lack of transparency or secrecy of the funds, in particular concern about the strategic intention some of the funds. SWF`s as a group are less transparent relative to more regulated institutional investors such as mutual funds and pension funds. Some of them are very transparent; Norway, Temasek, Alberta, Malaysia, Azerbaijan, for example. These funds provide clear and detailed information about size, returns and portfolio composition. Others like UAE, China, Kuwait, Qatar, Brunei, Venezuela, Taiwan have very low level of transparency. Another concern with SWF`s activities is the potential for abuse of informational disparities. Because of government connections and possibilities of using data collected through national intelligence services such a funds can have particular informational advantages that may not be available to others investors or even to company insiders. Another apprehension about SWF`s is that current financial globalization has reached the point where the sheer size of foreign savings may distort economic incentives of investment. These may include supporting domestic firms, buying controlling positions in foreign firms with proprietary knowledge, or increasing control of financial and tangible assets abroad. It may led to proliferation of capital controls and financial protectionism. (Eizenman and Glick 2007, p.2).

On the other hand there is not difficult to identify positive effects of those funds on global markets. They have long investment horizons and generally have no commercial liabilities and because of that they are likely to face less pressure than most private investors to reduce the size or increase of liquidity of their investments. SWFs may stabilize markets and play role of key investors in times of market stress. The second advantage is that due to SWF`s investments governments can improve allocation of resources, of course only if these investments are based on economic criteria. Investing in equities may also help emerging markets to integrate into global financial system. (Gieve 2008, p.199). For countries having surplus of foreign exchange inflow, investing through

SWF's gives an opportunity to sterilize this capital and to avoid prize bubbles higher inflation. However for countries with deficit, SWF's investment activity may imply, that foreign governments might stop financing other's countries deficit and transfer through SWF's the money they have to higher return investment (Heyward 2008, p.21).

### **3. Investment strategy and performance**

In recent months many companies all around the world have experienced influence (in a positive way) of those funds. Citygroup, Berkleys, Morgan Stanley, Merrill Lynch are only a few examples where SWF's have invested approximately 60 billions USD since may 2007 and meltdown in subprime mortgage market (Gilson and Milhaupt 2008, p.1349). SWF's have made number of high-profile acquisitions in recent months. The following table detail the twenty the largest ones in period 2007 -1Q2008. Because of absence of verifiable public data concerning transactions made by SWF's, it has been a lots of myths and misunderstanding about their investment activity. One of the most comprehensive data base about transactions made by SWF's was prepared by Monitor Group (Miracky et al 2008).

**Table 3. SWF`s major cross-border equity investment**

Sovereign wealth fund	Acquired company	Transaction value	
		in USD billion	in % of firm value
GIC of Singapore	USB	9,8	8,6
Abu Dhabi Investment Council	Citigroup	7,6	4,9
GIC of Singapore	Citigroup	6,9	4,4
Investment Corporation of Dubai	MGM Mirage	5,1	9,5
China Investment Company	Morgan Stanley	5,0	9,9
Temasek (Singapore)	Merril Lynch	5,0	11,3
Qatar Investment Authority	Sainsbury	3,7	25,0
KIA (Kuwait)	Merril Lynch	3,4	7,0
China Development Bank	Barclays	3,0	3,1
China Investment Company	Blackstone	3,0	10,0
Investment Corporation of Dubai	London Stock Exchange	3,0	28,0
Temasek (Singapore)	China Eastern Air	2,8	8,3
SAFE (China)	Total	2,8	1,6
SAFE (China)	British Petroleum	2,0	1,0
KIC (Korea)	Merril Lynch	2,0	4,3
Temasek (Singapore)	Barclays	2,0	1,8
Qatar Investment Authority	London Stock Exchange	2,0	20,0
Temasek (Singapore)	Standard Chartered	2,0	5,4
Undisclosed "Middle East investor"	UBS	1,8	1,6
Abu Dhabi Investment Council	Carlyle Group	1,4	7,5

Notes: Period 2007 -1Q2008.

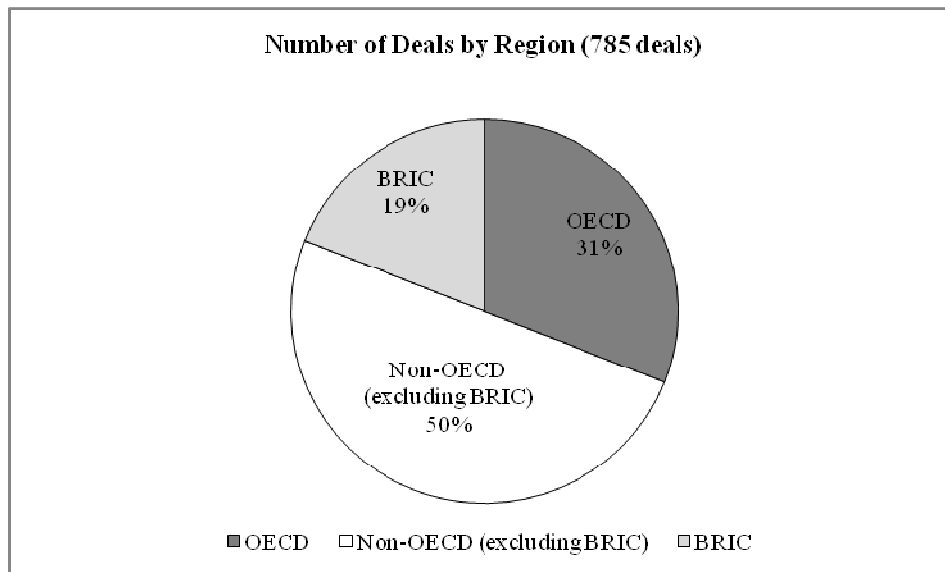
Source: ECB 2008 The impact of Sovereign Wealth Funds on Global Financial Markets, Occasional Paper Series No.91, p.11.

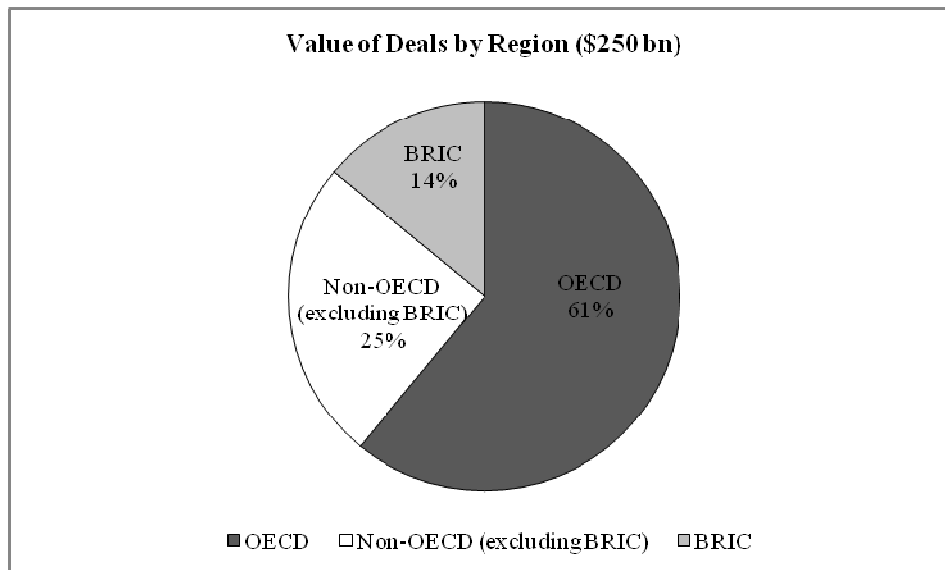


It contains information about 1181 transactions involving 25 funds from 1975 to March 2008. The authors point out that SWF's do not act as a group and there are significant differences in their investment strategy that make it difficult to generalize about them. Following graphs detail investment by geographical destination, sectors and stakes acquired.

The majority of SWF's investment is focused on OECD countries and will continue to be, because they have highly liquid markets and diversity across asset classes. Measured by value of transaction 61% of them have occurred in OECD countries. OECD countries are the main investment destination for the large funds such as Abu Dhabi Investment Council, KIA, China Investment Company and GIC of Singapore. Measured by number of transactions these deals represent only 31% of total, which can suggest that SWF's keen on investment in non-OECD countries but they place smaller sum in such a transactions.

**Graph 1. Geographical destination of SWF investment**

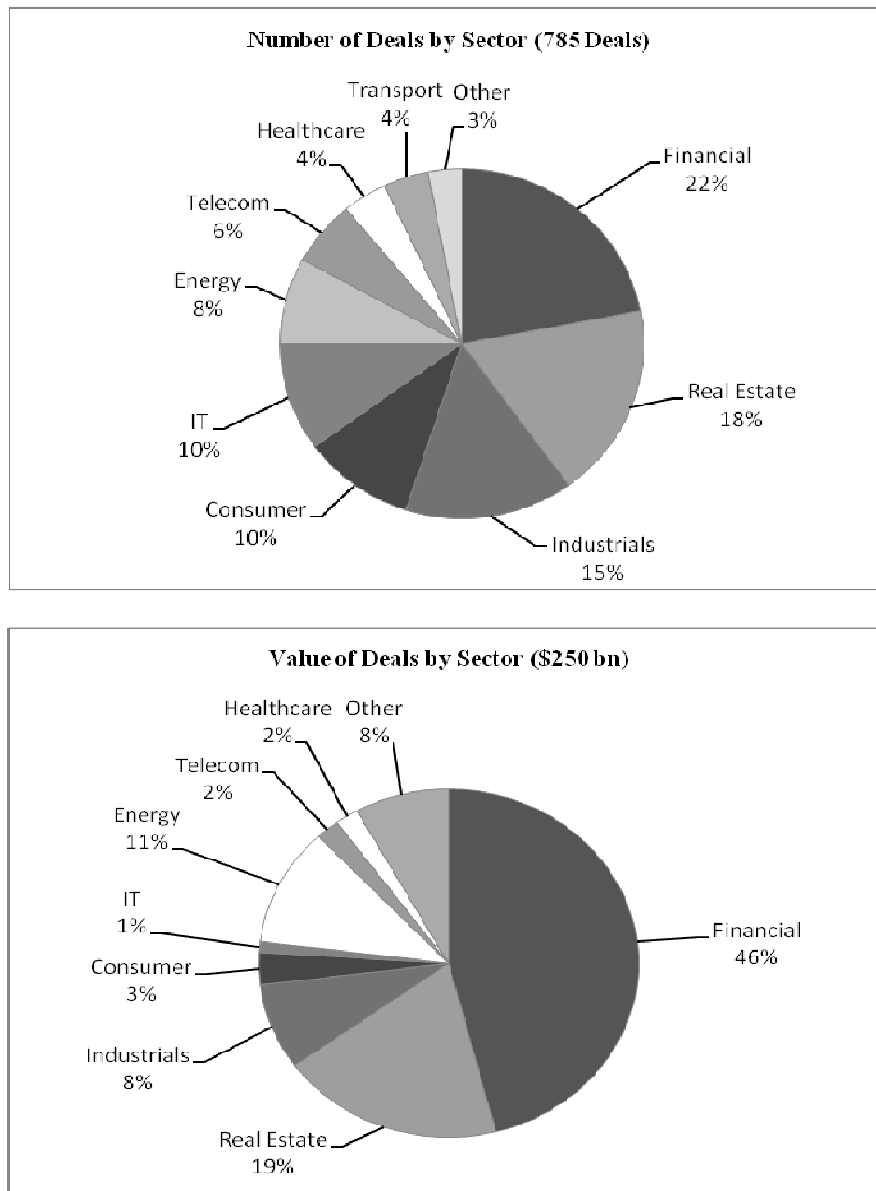




Notes: BRIC= Brazil, Russia, India, China.

Source: Miracky W. et al., (2008), Assessing the Risk, The behaviors of sovereign wealth funds in the global economy, Monitor Company Group, p.37.

Data presented on Graph 2 suggest that investments made by SWF's are relatively diversified by sectors measured by numbers of deals, and concentrated in financials according to value of transactions (46%). On the next places are investments in real estate, industrials, energy and IT. Investments in defense, aerospace, high technology and transportation is less than one percent of deals according to collected data base. That may suggest that SWF's avoid investment in sensitive sectors and industries. One can come to conclusion that these funds are not politically induced.

**Graph 2. SWF's transactions in sectors by numbers and value**

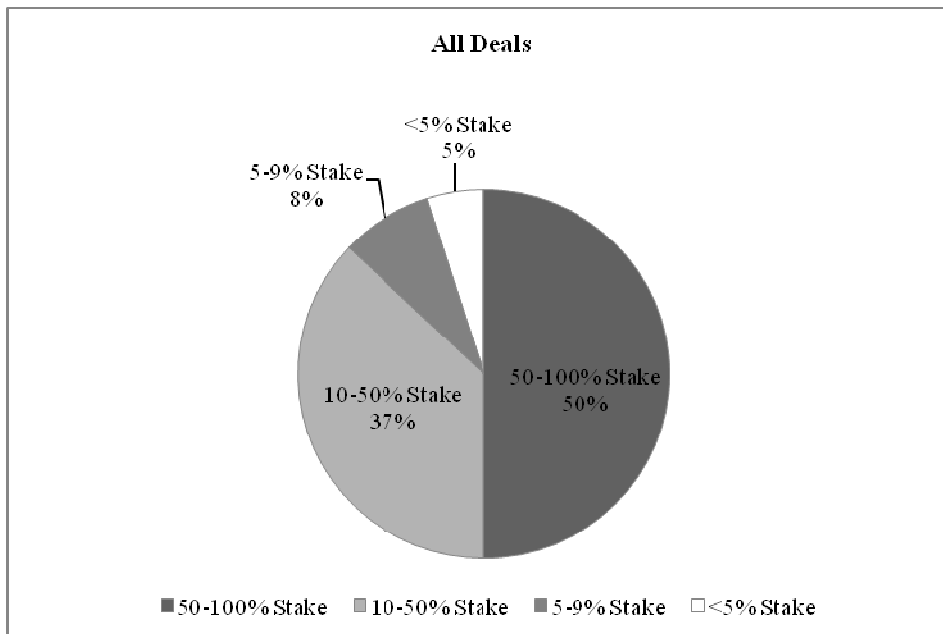
Source: Miracky W. et al., (2008), Assessing the Risk, The behaviors of sovereign wealth funds in the global economy, Monitor Company Group, p.40.

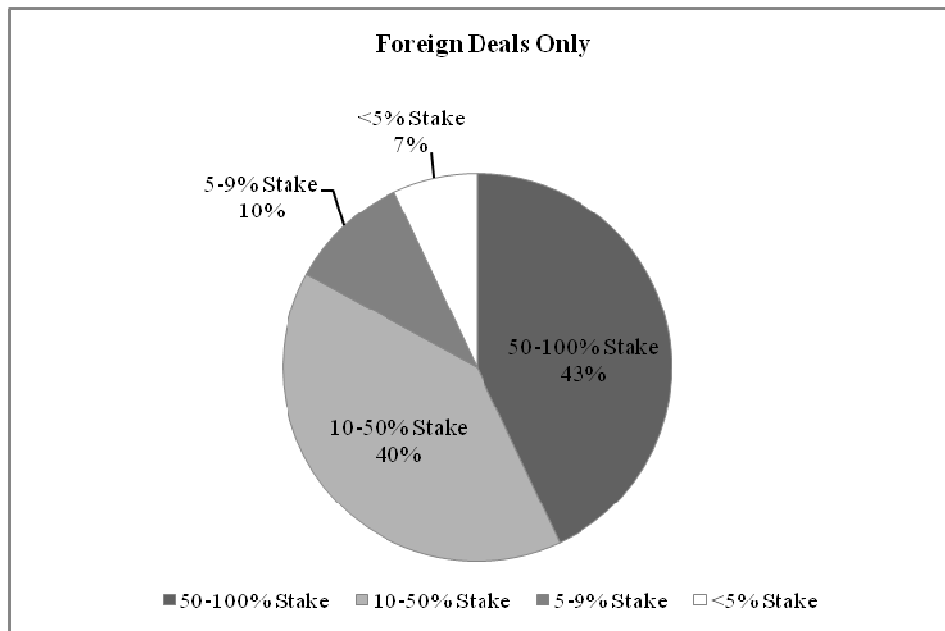
Investing mainly in finance sectors may have several reasons. First is that bank and financial institutions are generally attractive to global investors. Second, investing in financial institutions provides some SWF's with opportunity to buy preferential access to high quality investment opportunities. Third reason is the current situation on financial markets, which allow them to make deals with brand-name global institutions, such as banks, insurance companies etc. on attractive terms.

Information indicated on Graph 3 suggests that half of equity transactions made by SWF's involve controlling stakes. These controlling-stakes deals in OECD are not made in sensitive sectors, mentioned previously. It is probably due to willingness to avoid acquisitions in controversial sectors. Only 4% of financial services transactions made in OECD market resulted in controlling stakes.

Graph 4 presents information about recent growth of Sovereign Wealth Funds. Quick growth of activity of those funds from 2005 can be seen especially in value of transactions, which is almost double every next year. Although due to financial crisis this situation will not probably happen in present year. With oil prices being under 60USD per barrel level, many of Sovereign Wealth Funds may have not enough fuel to feed as rapid growth as before.

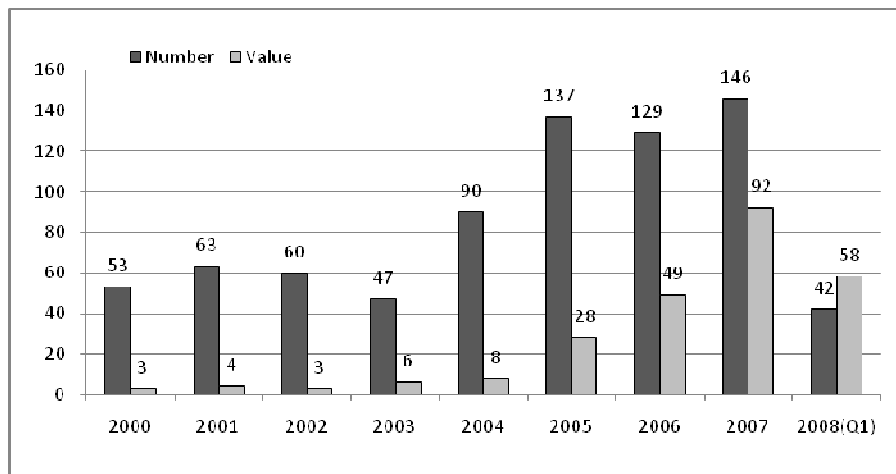
**Graph 3. Stake acquired by SWF's**





Source: Miracky W. et al., (2008), Assessing the Risk, The behaviors of sovereign wealth funds in the global economy, Monitor Company Group, p.45.

**Graph 4. Sovereign Wealth Funds transactions made since 2000**



Source: Miracky W. et al., (2008), Assessing the Risk, The behaviors of sovereign wealth funds in the global economy, Monitor Company Group, p.46.

#### 4. Conclusion

Sovereign Wealth Funds are becoming more and more important actors on global financial markets. Their existence is visible especially during last financial crisis, when they invest their resources into brand-name global institutions, becoming white-knights investors for some of them. They induce a lot of controversy because of governmental control, lack of information and transparency. Sovereign Wealth Funds represent new way of thinking about state investment and rebalancing power in international financial markets. The main conclusion of this paper is that empirical analysis do not prove the thesis that investment made by SWF's has a political background. The latest available data suggest that those funds avoid investing in sensitive (from state point of view) sectors like defense, aerospace, high technology and transportation.

#### References

- Beck R., Fidora M., (2008), *The impact of Sovereign Wealth Funds on Global Financial Markets*, ECB, Occasional Paper Series No.91
- Eizenman J., Glick R. (2007), *Sovereign Wealth Funds: Stumbling Blocks or Stepping Stones to Financial Globalization?*, FRBSF Economic Letter, Number 2007-38
- Gieve J., (2008), *Sovereign Wealth Funds and Global Imbalances*, Bank of England
- Gilson R.J., Milhaupt C.J. (2008), *Sovereign Wealth Funds and Corporate Governance: A Minimalist Response to the New Mercantilism*, 'Stanford Law Review', Vol.60
- Heyward P. (2008), *Sovereign Wealth Fund Investment in US Financial Institutions: Too Much or Not Enough?*, 'Banking & Financial Services Policy Report', Volume 27, Number 5
- International Monetary Fund, (2008), *Sovereign Wealth Funds – A Work Agenda*
- Lyons G. (2007), *State capitalism- The rise of Sovereign Wealth Funds*, 'Journal of Management Research', Volume 7, Number 3
- Miracky W., Dyer D., Fisher D., Goldner T., Legarde L., Piedrahita V., (2008), *Assessing the Risk, The behaviors of sovereign wealth funds in the global economy*, Monitor Company Group
- Morgan Stanley (2007), *How Big Could Sovereign Wealth Funds be by 2015?*, Morgan Stanley Research Global
- OECD, (2008), *Sovereign Developments Funds*, OECD Development Centre Policy Insights, No. 58
- Truman E.M., (2008), *The Rise of Sovereign Wealth Funds: Impact on US Foreign Policy and Economic Interests*, Peterson Institute for International Economics, Washington, DC