



Economic Letter

Sovereign Wealth Funds Allow Countries to Invest for More Than the Long Term

by Alex Musatov and Josh Zorsky

► Some experts question the investment motives, while others regard sovereign wealth funds as a helpful source of capital and even a vehicle for socially responsible investment.

Sovereign wealth funds (SWFs), more than any other institutional investment, operate in an environment of wealth, geopolitics, trade imbalances, sophisticated financial bets and limited, if any, transparency. These giants are alternately regarded with fearful anxiety, as during a Dubai fund's failed acquisition of key U.S. ports, and with respectful gratitude, such as immediately following a \$60 billion infusion of much-needed capital into struggling Western banks in 2009.

Some experts question the investment motives, while others regard SWFs as a helpful source of capital and even a vehicle for socially responsible investment. Both camps agree that the funds' rapid growth (*Chart 1*) has secured their place among globally influential investors.

Although SWFs have existed under various names since the 1950s, they lack a universal definition—the term “sovereign wealth fund” was first coined in 2005. They can best be distinguished by the attributes setting them apart from other state-sponsored investors, such as some pension funds, domestic investment and development funds, and state-owned enterprises. SWFs are institutions operated directly by a sovereign govern-

ment, distinct from foreign exchange reserves, and managed independently of other state financial and political institutions. They have no explicit liabilities and invest globally in a diverse set of financial and real assets.

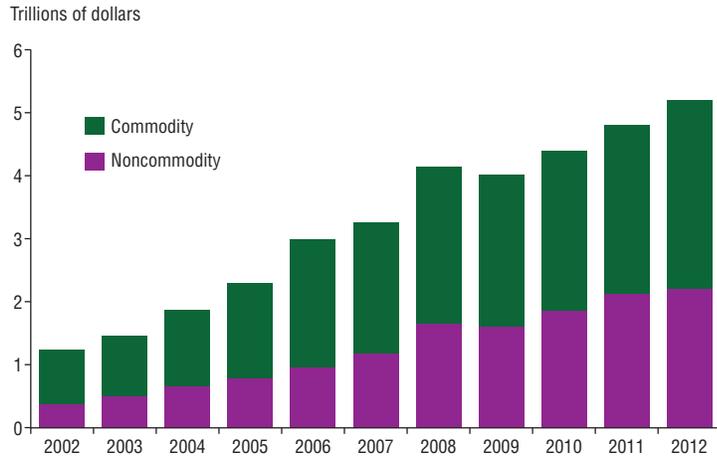
In general, SWFs are governmental savings accounts funded by a combination of fiscal surpluses and balance-of-payments surpluses, often attributable to commodity exports. SWFs over the past decade have become important players in global capital markets even as opacity and strong links to geopolitical powers warrant ongoing scrutiny. SWFs' assets surpassed \$5 trillion in 2012 (*Chart 2*), and their size now exceeds that of private equity and hedge funds combined. Changes in SWF investment appetite—be it for securities or direct foreign investment—can materially impact asset prices and foreign exchange rates.¹

Sovereign Funds Emerge

Mineral export revenues supplied funding for almost two-thirds of the total assets held by SWFs as of earlier this year, with the remaining third mainly the product of general export surpluses.²

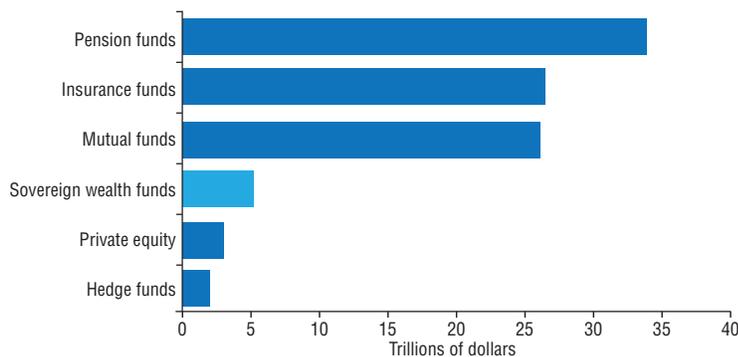
The Kuwait Investment Authority, established in 1953, is considered the oldest SWE.³ Its mission “is to achieve long-

Chart 1 Sovereign Wealth Funds' Assets Under Management Steadily Increasing



SOURCE: Sovereign Wealth Fund Institute.

Chart 2 Global Assets Under Management at Year-End 2012



SOURCE: TheCityUK.

term investment returns on the financial reserves of the State of Kuwait, providing an alternative to oil reserves.⁴ To accomplish this, Kuwait directs 10 percent of all state-generated oil proceeds into a “rainy day” fund, converting a finite, nonrenewable resource into a diversified portfolio.

Commodity price booms and persistent current account surpluses—positive balances from the global trade of goods and services—have fueled the growth of SWFs. The 1970s witnessed the formation of Abu Dhabi Investment Authority, Singapore’s Temasek Holdings, Alberta’s Heritage Fund and Oman’s State General

Reserve Fund. Some governments (for example, China and Abu Dhabi) formed multiple SWFs with distinct objectives. Twenty SWFs opened between 2000 and 2008, a period when nominal oil prices rose 400 percent. Thirty of today’s 50 largest SWFs were formed after 2000, with new funds from Nigeria, Italy, Papua New Guinea, Mongolia, Brazil and Angola entering in the past two years.

Differing SWF Strategies

Despite a similarity of funding sources, SWFs have evolved into heterogeneous entities with diverse modern hold-

ings rivaling those of private institutional investors. Categorizing their objectives and strategies has become increasingly difficult. The International Monetary Fund (IMF) has created three general groupings of SWFs, but it is common for a fund to be a hybrid of types or to change over time.

The most conservative type is the stabilization fund, which tries to protect the domestic economy from trade revenue fluctuations. These SWFs construct their portfolios specifically to offset commodity price exposures and, therefore, invest heavily in developed markets, where they purchase highly rated fixed-income securities (typically bonds) and publicly traded equity. Because the investment horizon is long-term, stabilization funds purchase assets with long durations and extended payback periods. Examples of these traditional SWFs include Russia’s Stabilization Fund and Kazakhstan’s National Oil Fund (*Table 1*).

The second type is the savings fund, like the one Kuwait established in 1953. These funds convert current wealth from a nonrenewable natural resource (usually oil and gas) into a diversified portfolio of financial assets for the benefit of future generations. Savings funds typically have an even longer investment horizon than stabilization funds and can therefore tolerate a greater amount of risk. Savings funds commit larger proportions of their portfolios to illiquid assets such as private equity, real estate and infrastructure projects.⁵ Funds that follow this model include the Abu Dhabi Investment Authority, Government Investment Corp. of Singapore and China Investment Corp.

The final fund type is the reserve investment corporation, which strives to reduce the opportunity cost of holding excess foreign reserves by pursuing investments with higher returns. These funds typically have the most-aggressive risk profile and are the most secretive. It is not uncommon for reserve investment corporations to go beyond alternative investments and to take direct equity stakes in firms and use borrowed funds to leverage their investments. Funds that follow this model are Singapore’s Temasek Holdings, the Qatar Investment Authority and Abu Dhabi’s Mubadala Development Co.

Potentially Stabilizing Force

Steady funding, long-term perspective and flexible investment mandates allow SWFs to provide unique benefits to the global financial markets. They are important providers of capital during times of volatility and key investors in extremely long-term infrastructure projects and even socially conscious undertakings that private markets may be reluctant to fund.

Because of their deep pockets and few binding liabilities, SWFs can afford to make quick, opportunistic investments when more-constrained investors cannot, improving market liquidity. For example, they undertook supportive investments during the U.S. subprime mortgage crisis. Throughout the 2007–09 turmoil, while many investors withdrew from volatile financial markets, SWFs were countercyclical providers of capital and took bolstering stakes in struggling financial institutions (*Table 2*).⁶

SWFs additionally benefit the global economy through their substantial (and growing) investment in infrastructure projects. As of July 2013, 61 percent of SWFs were actively invested in infrastructure—both domestically and internationally.⁷ Some funds consider development of domestic infrastructure as part of their explicit mandate, but the main reason is the natural match between SWFs' perpetual lifespan and the long-term nature of infrastructure investments.

Finally, SWFs can afford to invest in experimental, socially responsible ventures that have not yet attracted private capital. A subsidiary of Abu Dhabi's Mubadala Development is constructing Masdar City, the world's first zero-carbon, zero-waste, car-free ecosystem. The city in the United Arab Emirates is designed to cover 2.3 square miles, rely entirely on renewable energy sources and support a population of 50,000. Only SWFs are suited to back such a project, with its 15-year construction schedule and estimated \$20 billion final cost.

Geopolitics and Wealth

SWFs' emergence as globally significant sources of capital has not been without criticism, mostly focusing on their close ties with governments and their secretiveness. Critics fear that noncom-

mercial goals enter into SWF decision-making. Compounding this concern, some of the largest SWFs reside in countries with weak legal environments, and SWF investments have grown fastest in nondemocratic regimes. In addition, some of the funds, including ones from Russia and Dubai, have suffered significant business setbacks.⁸

Policymakers may perceive countries as directing their SWFs to secure strategic stakes in sectors abroad. Of particular concern are instances where SWFs wish to invest in projects that involve other countries' natural resource industries, military firms or other politically sensitive sectors where an investment could yield previously unobtainable intelligence.

When U.S. banks received significant SWF capital injections during the financial crisis, several congressional committees—including the Senate Banking Committee, Senate Foreign Relations Committee, House Financial Services Committee, House Foreign Affairs Committee and the Joint Economic Committee—held hearings.

This was not the first instance of SWFs drawing intense public and media attention. An escalating national security debate arose when DP World—a company owned by the government of Dubai—acquired the management contracts of multiple major U.S. ports. Although initially cleared through official channels, the deal stalled when members of

Table 1 Prominent Sovereign Wealth Funds by Category

Fund category	Fund name	Year established	Assets (billions of dollars)	Source of capital
Stabilization fund	Kazakhstan National Oil Fund	2000	58	Oil
	Russian Stabilization Fund	2004	n.a.	Oil
Savings fund	Abu Dhabi Investment Authority	1976	627	Oil
	China Investment Corp.	2007	482	Noncommodity
	Government Investment Corp. of Singapore	1981	248	Noncommodity
Reserve investment corporation	Temasek Holdings (Singapore)	1974	158	Noncommodity
	Qatar Investment Authority	2005	100	Oil
	Abu Dhabi Mubadala Development Co.	2002	48	Oil

SOURCE: Sovereign Wealth Fund Institute.

Table 2 Largest SWF Investments in Western Financial Institutions During 2007–09 Financial Crisis

Target	Sovereign wealth fund(s)	U.S. dollars (billions)	Percent stake
Citigroup	ADIA and GIC	17.5	10.9
Merrill Lynch	Temasek (Singapore), KIA, Korea	10.4	20.3
UBS	GIC	9.8	8.6
Barclays	QIA, Temasek	5.5	9.5
Morgan Stanley	CIC	5.0	9.9
Blackstone	CIC	3.0	10.0
Standard Chartered	Temasek	2.0	5.4
UBS	SAMA Foreign Holdings	1.8	2.0
Carlyle Group	ADIA	1.4	7.5

NOTE: ADIA = Abu Dhabi Investment Authority; GIC = Government Investment Corp. of Singapore; KIA = Kuwait Investment Authority; QIA = Qatar Investment Authority; CIC = China Investment Corp.; SAMA = Saudi Arabian Monetary Agency.

SOURCES: Bloomberg; Sovereign Wealth Fund Institute.

Congress questioned the transfer of strategic port leases to a foreign government holding company. DP World eventually sold the leases to a unit of American International Group. A similar outcry in 2005 stopped a bid by CNOOC of China to buy a controlling stake in Unocal, a U.S. oil firm.

Concerns about investment goals are not limited to Western countries. In 2006, Singapore's Temasek purchased from the family of the Thai prime minister a firm controlling Thai military space satellites. The transaction led to political unrest in Thailand and eventually the government's ouster.

Toward Transparency

The lack of a supranational regulatory body to oversee SWF activities is another concern. No regulations or disclosure requirements mandate the funds to divulge their holdings, investment strategies or even their size. This lack of transparency is mostly due to the variety of the funds' domiciles, legal structures and governing bodies. Some SWFs operate as independent corporate entities, while others exist merely as departments or operating groups within a ministry of finance.

In a move that recognized the force and staying power of SWFs in global capital markets, the IMF established the International Working Group of Sovereign Wealth Funds, which in 2008 drafted a set of generally accepted principles and self-regulatory practices known as the "Santiago Principles."

They include 24 general guidelines underpinned by four objectives: maintenance of a stable global financial system, compliance with all applicable disclosure requirements, investment on an economic basis and establishment of transparent governance. The principles remain the only global effort to preside over SWFs and to increase financial market understanding of their operations.

The Next Chapter

Unconstrained by many limitations facing more-conventional asset managers, SWFs have evolved into a heterogeneous class of important, dynamic global investors. They regularly deploy substantial amounts of capital across public and private capital markets worldwide. The funds have a formidable global financial market presence and operate largely outside any comprehensive regulatory oversight. Bridging the worlds of international politics and high finance, SWFs require ongoing analysis so policymakers can better understand the funds and the implications of their investment decisions.

Musatov is an alternative investments specialist and Zorsky is a financial industry analyst in the Financial Industry Studies Department of the Federal Reserve Bank of Dallas.

Notes

¹ A recent example of a large SWF direct foreign investment is China Investment Corp.'s £245 million purchase of Deutsche Bank's London headquarters.

² "Sovereign Wealth Funds," Financial Markets Series, TheCityUK, March 2013.

³ In 1854, Texas established the Texas Permanent School Fund, a \$2 million endowment dedicated expressly to the benefit of public schools. While not technically a SWF, the endowment is the oldest surviving institution with similar attributes.

⁴ Available at www.kia.gov.kw/En/About_KIA/Mission_Principles/Pages/default.aspx.

⁵ "2012 Sovereign Wealth Fund Review," Preqin Investor Services. Available at www.preqin.com/item/2012-preqin-sovereign-wealth-fund-review/1/4985.

⁶ "Global Macro Issues: Navigating the Long Run," Deutsche Bank Special Report, Feb. 21, 2012.

⁷ "Sovereign Wealth Funds Investing in Infrastructure," by Paul Bishop, Preqin (blog), July 2, 2013, www.preqin.com/blog/101/6921/sovereign-fund-infrastructure.

⁸ Sovereign Investment Lab, Bocconi University, Milan, Italy; "Democracy Index 2011: Democracy Under Stress," Economist Intelligence Unit, December 2011.

DALLAS FED



Economic Letter

is published by the Federal Reserve Bank of Dallas. The views expressed are those of the authors and should not be attributed to the Federal Reserve Bank of Dallas or the Federal Reserve System.

Articles may be reprinted on the condition that the source is credited and a copy is provided to the Research Department of the Federal Reserve Bank of Dallas.

Economic Letter is available on the Dallas Fed website, www.dallasfed.org.

Federal Reserve Bank of Dallas
2200 N. Pearl St., Dallas, TX 75201

Mine Yücel, Senior Vice President and Director of Research
E. Ann Worthy, Senior Vice President, Banking Supervision
Anthony Murphy, Executive Editor
Michael Weiss, Editor
Jennifer Afflerbach, Associate Editor
Ellah Piña, Graphic Designer

