

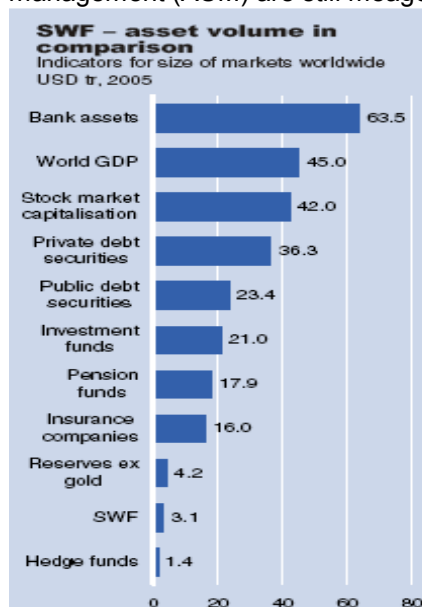
Sovereign Wealth Funds

The global financial arena is abuzz with a new phenomenon, that of Sovereign Wealth Funds (SWF). In short, a SWF is a fund owned by a government, and is composed of numerous types of financial assets, be they stocks, bonds, currency deposits, foreign exchange reserves or Special Drawing Rights (SDR) with the IMF.

Country	Fund name	Assets (\$bn)
UAE	Abu Dhabi Invst Authority	875
Singapore	Govt of Singapore Invst Corp	330
Singapore	Temasek Holdings	100
Saudi Arabia	Various	300
China	China Investment	300
Norway	Govt Pension Fund-Global	300
Australia	Future Fund	40
Russia	Stabilisation Fund	32
Brunei	Brunei Invst Authority	30
South Korea	Korea Invst Corp	20
Malaysia	Khazanah Nasional BHD	18

Source: Morgan Stanley & Financial Times

SWFs are big money, as one can see from the table above. It comes as no surprise that the Gulf countries should have a huge corpus of assets. Owning the world's most sought after natural resource, coupled with sky-high prices, these oil producing countries are probably having their best run in recent history. Further, a recent report by Deutsche Bank shows that a majority of the SWFs are from OPEC and other oil producing nations. At the same time, the assets under management (AUM) are still meager when other investment funds are concerned.



Source: Deutsche Bank

SWFs can serve as a stabilization fund, and can help protect an economy, to an extent, in times of a crisis. I had said earlier that oil producing nations are currently going through a boom phase. But what if the price of oil in the international market falls suddenly. If not all of a sudden, what if it falls by, say 30% over a period of 3 years? Since most gulf countries are dependent solely on oil revenues, it would be a rude shock for them. In such a case, the fund can act as a stabilizing agent, and cushion the economy to an extent.

The second purpose of a SWF is diversification and return maximization. Gulf countries do not want to be dependent only on oil for their revenues. China and India do not want to hold only US dollars. Dollar denominated returns have been at all time low levels. In such cases, it makes perfect economic sense to invest idle or low-yielding financial assets of a nation in profitable investments, which give a much higher return than that obtained from holding foreign reserves (which are largely comprised of US Dollars for most countries). A landmark case is the recent Blackstone deal, wherein the Chinese government, through its investment arm (China Investment Corporation) bought a 10% stake in the private equity firm.

The management of SWFs differs from fund to fund. As in the case of an individual, SWFs too have a risk-return trade-off. They have an added responsibility though, since the money they are managing belongs to the state, or the public. SWFs thus need to strike a very careful balance between generating returns on funds, managing them effectively, and meeting the social objective of investing safely. This is further complicated by the fact that central bankers have a duty to not only safeguard public money, but also to provide them with a higher rate of return! Thus the need arises to strike a careful balance.

But do all nations with SWFs have the competence to manage such funds? Well, even if they do not, there is still a way out; a Fund of Funds! This concept already exists in capital markets, where certain mutual funds invest in a portfolio of other mutual funds. This trend has caught on in the SWF scenario too. Norway, for instance, has become a fund manager of sorts for other SWFs. The reason why it has stood out is because of two reasons; its investment strategies and transparency. Unlike other SWFs, Norway religiously discloses its portfolios and returns every fiscal year. This is similar to the concept of outsourcing. One has the resources, but not necessarily the competence. So, outsource your resources to someone who possesses the competence and both parties eventually stand to gain.

Logic and rationality prevail in a utopian world. Unfortunately, this is not the case in the world we live in. While one may justify a SWF on the basis of its economic logic, the industry has been mired in controversy. The reason being that unlike private investment funds, the stake holder in a SWF is a government, and not an individual. This may seem to be trivial, but is not really so. The French may not object to a Chinese buying property or setting up a business in France. But will it sit back quietly if the China Investment Corporation makes a bid for Total, or for Charles De'Gaulle Airport?

It is this very nature of SWFs that make host governments skeptical about their motives. To be fair, you can't hold any one party responsible for creating this mutual distrust. On the one hand, I feel the Europeans are too wary of Islam, Chinese and Asians in general. There is a growing concern among many European nations that their "national champions" may one day be acquired by these funds. This was made public in a recent statement by Joaquin Almunia, EU commissioner for economic and monetary affairs, who aired concerns over the motives of such funds. There are also reports of Germany and France drawing up legislations at both a domestic and international level (G7), which will in effect keep a tab on such funds. It may even initiate the EU to impose capital controls on such funds.

A second concern is regarding financial market stability. We know the problems caused by hedge funds, in terms of inducing volatility. Hedge funds are difficult to contain and regulate, thus not only can they boost the stock market buy buying heavily, but can also square off their positions any time and create a glut in capital markets. This is what makes them very risky. Analysts fear

that since SWFs now have larger AUM than hedge funds, they are equally capable of creating instability in financial markets.

I personally do not subscribe to this view. Firstly, the risk appetite of SWFs is far lower than that of hedge funds and other private investor, the reason is as I have mentioned above. SWFs have an added responsibility of managing people's money, and they are unlikely to take the risk a private investor would. It is also unlikely that a SWF would want to be termed as a "destabilizing fund", since it can have an adverse effect on the country's overall sovereign rating, and is likely to dis-incentivise potential investors. Secondly, all human beings are driven by self interest, and given an opportunity, any human would desire to turn the tide in his favor. Then why marginalize SWFs? A myriad of factors can cause instability in financial markets. As we in the Indian scenario know, even individuals can create stock market crashes. Risk is a critical component of financial markets. Risk can not be done away with, but one can hedge against it. Instead of holding individuals or certain funds responsible for creating instability, I feel a better way would be to implement safeguards and self-regulating systems. Criticizing SWFs on this count is a bit unfair.

But at the same time, governments have been known to "bribe" host governments by striking deals or committing investments in return for favors, concessions or access to natural resources. For instance, it is well known now that china is investing heavily in Africa and Latin America, in return for possession of key natural resources. It is believed that over 650 Chinese state companies have invested in Africa in strategic sectors such as oil and minerals. For instance, China National Offshore Oil Corporation (CNOOC) recently struck a USD 2.3 bn deal with the Nigerian government, for investments in oil and gas exploration. Readers may also recollect the attempt by Dubai Ports World to acquire a stake in P&O Steam Navigation Company, which ultimately did not work out.

To sum up, SWFs are here to stay, and the AUM under them will grow. However, strategic investment is not only about AUM. How one goes about it is also important. Most SWFs today follow no system of financial disclosure. No one knows what China Investment Corporations portfolio is. No one knows what its key financials are. Such secrecy will only cause more opposition from western states. Transparency and mutual trust, as always, make things easier for both parties in any transaction. SWFs would also find it prudent to professionally manage their funds, by either de-politicizing the process (why should the King's nephew necessarily be at the helm of the fund?) or by outsourcing it to parties who have the necessary competence in the field, as I mentioned the case of Norway, or maybe some other private equity firm.