SOVEREIGN WEALTH FUNDS – THE ACTIVITY AND ITS CONSEQUENCES FOR THE GLOBAL ECONOMY

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ABSTRACT

The paper aims at discussing the idea of Sovereign Wealth Funds, the range of their activity, as well as its consequences for the global financial stability. The author shows that these funds invest in different sectors of the economy and their assets, according to the predictions, are still supposed to grow in the future. Therefore, the role of SWFs in the economy is and will be more and more important. If one additionally takes into consideration that they influence the financial stability both in a positive and in a negative way and that there are not unified standards on investment strategies, governance of these institutions as well as transparency issues, it raises the need to control them globally and to create suitable law regulations.

JEL classification: E01, N3

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INTRODUCTION

The purpose of the paper is to pay attention to Sovereign Wealth Funds whose assets under management are big enough to threaten the stability of global financial markets. The author argues that these funds invest in different sectors of the economy and their assets, according to the predictions, are still supposed to grow in the future. Therefore their role in the economy is and will be more and more important. It suggests that these institutions should be controlled globally.

1. THE IDEA AND THE SIZE OF SOVEREIGN WEALTH FUNDS

There is no generally accepted definition of Sovereign Wealth Funds. For example the US Treasury has defined them as government investment vehicles funded by foreign exchange assets, and managed separately from official reserves (Kimmitt, 2008: 62-71). International Monetary Fund treats sovereign wealth funds as special investment funds created or owned by governments to hold foreign assets for long term purposes. It also divides them into two groups: the sources of sovereign wealth, and their policy objectives (Global Financial Stability Report, 2007: 45). European Central Bank defines sovereign wealth funds as public investment agencies which manage part of the (foreign) assets of national states and gives the following specific features of SWFs (Beck & Fidora, 2008: 6):

- are state owned,
- have no or very limited explicit liabilities,
- are managed separately from official,
- foreign exchange reserves.

At the end of 2008 Deutsche Bank reported that Sovereign Wealth Funds' assets under management are equal to 3,6 trillion[1] dollars and predicted their further growth of 15% per year, which according to Deutsche Bank will bring the industry to 5 trillion dollars in 2010 and 10 trillion dollars by 2015 (Kern, 2008: 63). These data are impressing and at the same time, one should be aware that the funds in question should be taken under scrutiny in order to prevent their owners from using them as the economic or political force against other countries and their institutions lacking liquidity during a financial crisis.

At present there are about 40 Sovereign Wealth Funds, half of which have been established since 2000. Their assets under management are equal to 2 – 3 trillion dollars (McCormick, 2008). The International Monetary Fund instead predicts that assets under management of Sovereign Wealth Funds' will reach 12 trillion dollars by 2012, which is an even bigger amount (Global Financial Stability Report, 2007: 45). According to Miles and Jen (2007), by 2022 SWFs will reach almost 9% of global assets. By contrast, the total value of foreign reserves is currently 5.1 trillion dollars (Gomes, 2008: 4).

Unfortunately, there is no one reliable source of data on Sovereign Wealth Funds. Different sources give various numbers concerning assets managed by these subjects as well as investments conducted by them. However, there has been some research on Sovereign Wealth Funds that helps to understand the core of their activity. For instance, Bernstein, Lerner and Schoar (2009) identified 2662 investments between 1984 and 2007 by SWFs, including acquisitions, venture capital

[1] Twelve zeros. Please note that some countries call it a billion.

and private equity investments, as well as structured minority purchases in public entities. They examined the propensity of funds to invest domestically, the equity price levels at the time of their investments, the changes in equity prices after their investments, and the size of the acquired stakes and found several interesting patterns in the data (Bernstein et al., 2009: 3-4):

- SWFs are more likely to invest at home when domestic equity prices are higher, and more likely to invest abroad when foreign prices are higher.
- On average, funds invest at significantly lower price-earnings (P/E) ratios when investing at home and higher P/E levels outside. This result is mainly driven by Asian and Mid- Eastern funds, while the opposite holds for Western funds.
- Asian groups and, to a somewhat lesser extent, Middle Eastern SWFs, see the industry P/E ratios of their home investments drop in the year after the investment, while they see a positive change in the year after their investments abroad.
- SWFs where politicians are involved in governance have a much greater likelihood of investing at home, while those relying upon external managers display a lower likelihood.
- Once we control for the differing propensity to invest domestically, SWFs with external managers tend to invest in lower P/E industries, while those with politicians involved in the governance process invest in higher P/E industries.
- Investments by SWFs with the involvement of external managers tend to be associated a more positive change in industry P/E in the year after the deal, while for funds where politicians are involved, the trend goes the other way round.

Moreover, according to Miracky and Bortolotti (2008: 54) Sovereign Wealth Funds have invested more new capital into the world's financial institutions recently than any other single entity except the United States government. It means that their role in the global economy is significant and can not be ignored.

Table 1 depicts 10 Sovereign Wealth Funds that have the highest amount of assets under management. The biggest fund is Abu Dhabi Investment Authority with assets of 875 billion dollars, the second big is Government of Singapore Investment Co. possessing assets equal to 330 billion dollars, whereas the third big is Government Pension Fund of Norway having assets of 300 billion dollars. As far as the transparency of the funds is concerned, data presented in table 2 show that most of them has medium or low transparency. It puts the global economy under the risk that these funds will put the global financial stability in danger. Besides, the autonomy of SWFs is low or medium, which means that they have been created to serve the country which is its owner.

Table 1 Top 10 Sovereign Wealth Funds by assets under management

Sovereign Wealth Funds	Assets under management (bn USD)	Transparency	Autonomy
Abu Dhabi Investment Authority	875	Low	Medium
Government of Singapore Investment Co.	330	Medium	Medium
Government Pension Fund of Norway	300	High	Medium
Kuwait Investment Authority	250	Low	Low
China Investment Corporation	200	Low	Low
Temasek Holdings	159	High	High
Qatar Investment Authority	50	Low	Low
Alaska Permanent Fund	40	Medium	Medium
Australian Government Future Fund	40	Medium	Medium
Libyan Investment Authority	40	Low	Low

Source: Langford, Garcia & Lerman (2008: 2)

What's interesting, according to E. Truman, the list of the leading sovereign funds is a little bit different than the one presented above (see table 2). These differences show that the world of Sovereign Wealth Funds is not transparent. However, it can also be interpreted that the periods taken into consideration when preparing a list were different as one source comes from 2008 and another one from 2007. Anyway, if we take into consideration that one list gives the value of assets as one quantity and another gives the range of values for some funds, it proves of the fact that the market of Sovereign Wealth Funds is not a transparent one and there is no unified accounting and documentation. It is necessary that one creates the international law (including accounting standards) on the activity of Sovereign Wealth Funds.

Table 2 Leading Sovereign Wealth Funds.

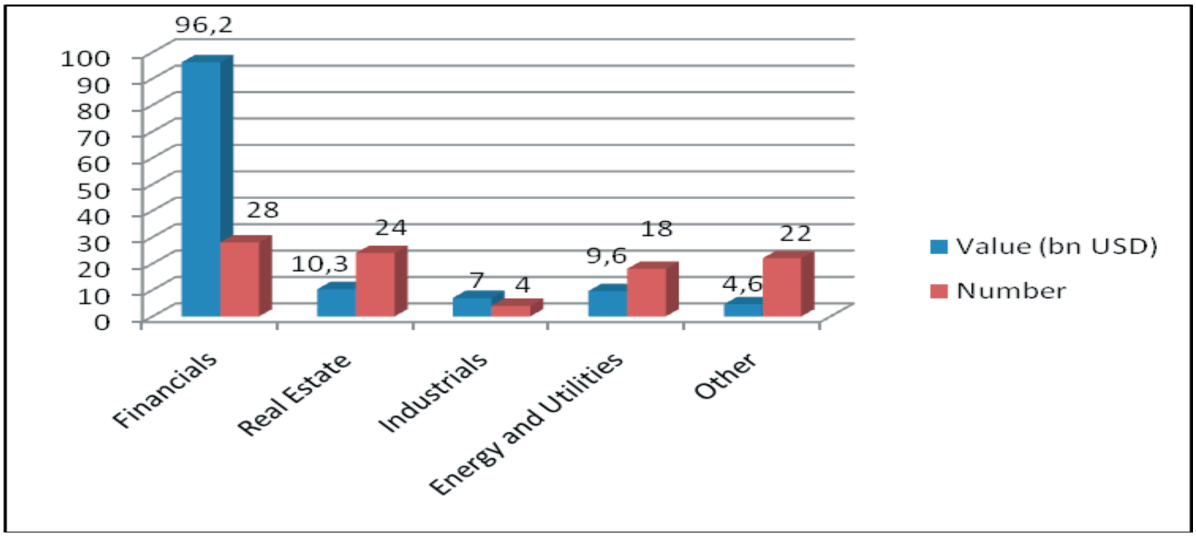
Country	Funds	Size ($ Billion)	Year Created
United Arab Emirates	Abu Dhabi Investment Authority (ADIA)	500 - 875	1976
Singapore	Government of Singapore Investment Corporation (GIC)	100 - 330	1981
Norway	Government Pension Fund Global (GPFG)	308	1990
China	China Investment Corporation, Ltd. (CIC)	200	2007
Kuwait	Future Generations Fund	174	1976
Russia	Stabilization Fund for the Russian Federation	122	2004
Singapore	Temasek Holdings	108	1974

Source: Truman (2007: 1)

2. SECTORAL INVESTMENT STRUCTURE

SWFs invest in different sectors of the economy. Their owner's aim is to preserve the capital or to generate positive rates of return. Institutions that use them most of all need them to provide additional liquidity in the times of financial distress. As data depicted in chart 1 show, the sector where the highest amount and value of investments are made is the financial sector where 96,2 billion dollars were invested in 2008 (for examples see also table 3). The second best was the real estate sector with the value of 10,3 billion dollars invested in it (for some examples see table 4 as well), whereas the third best was the energy and utilities sector with the investment value equal to 9,6 billion dollars.

Chart 1. Value and number of SWF Investments by Target Sector in 2008



Source: Miracky & Bortolotti (2009: 13, 17)

Calculations made by the author using data depicted in chart 1 show that the biggest transactions are conducted in the financial sector where the average transaction value is 3,43 billion dollars. The second sector as far as the value of transactions is concerned is the industrial one where the average value of the transaction is equal to 1,75 billion dollars. The third is energy and utilities with the average transaction value of 0,53 billion dollars. The fourth sector is real estate (0,43 billion dollars) whereas the last place belongs to other, not specified sector (0,21 billion dollars).

Table 3. Examples of SWFs investments in financial institutions in 2008.

Date announced	SWF	Target	Target country	Amount invested (mil dollars)
Styczeń 2008	Korean Investment	Citigroup	USA	3000
Styczeń 2008	Korean Investment	Merril Lynch	USA	2400
Grudzień 2008	Temasek Holdings	Merril Lynch	USA	4400
Grudzień 2008	China Investment Corp.	Morgan Stanley	USA	5000
Grudzień 2008	Government of Singapore	UBS	Szwajcaria	9750
Listopad 2008	Abu Dhabi (ADIA)	Citigroup	USA	7600
Wrzesień 2008	Mubadala (UAE)	Carlyle Group	USA	1350

Source: based on Langford, Garcia & Lerman (2008: 3)

As it was emphasized above, real estate is the second major part of Sovereign Wealth Funds' portfolios. Both in the case of the financial and the real estate sector they mainly invest in the USA (see table 3 and 4 again). One of the reasons according to the author is probably a well-developed, liquid and competitive financial market.

Table 4 Examples of SWF Investments in Real Estate in 2008.

Sovereign Wealth Funds	Target	Country	Investment ($ Value USD mil or % Stake)	Type	Date
Mubadala Development	Kor Hotel Group	USA	50%	Hotel	September 2008
Dubai World	MGM Mirage	USA	20%	Hotel	August 2008
Kuwait Investment Authority, JV with Boston Properties	125 West 55th St., N.Y.	USA	444%	Office	August 2008
Kuwait Investment Authority, JV with Boston Properties	2 Grand Central Tower, N.Y.	USA	427,9%	Office	August 2008
Kuwai Investment Authority, JV with Boston Properties	540 Madison Avenue, N.Y.	USA	277,1%	Office	August 2008
Dubai Investment Group, JV Kennedy-Wilson	Avalon Bay	USA	81,2%	Apartament	June 2008
Abu Dhabi Investment Authority	Chrysler Building	USA	800%	Office	June 2008
Boston Property, Meraas Capital, Kuwait Inv. Authority and Qatar Inv. Authority, Goldman Sachs	NY General Motors Building	USA	2800%	Office	June 2008
Nakheel Co PJSC (Dubai)	Fountainbleau Resorts	USA	375%	Hotel	April 2008
Mubadala Development	John Buck Co.	USA	24,9%	Real Estate	March 2008
Kuwait Investment Authority	Willis Building	UK	582%	Office	March 2008
Dubai World	MGM Mirage Inc./ City Center Holdings	USA	2700%	Hotel	February 2008

Source: Langford, Garcia & Lerman (2008: 4)

It is worth emphasizing that Sovereign Wealth Funds invest not only in unpublic undertakings, but also in public companies. If one analyses the largest SWFs investments in listed stocks (see table 5), it can be concluded that one fund only (Abu Dhabi Investment Authority) managed to generate a positive rate of return in the examined period which was from the inception of the investment to 27.03.2009. If one also takes into consideration that generated losses were extremely large (starting from about 49% ending with more than 90% of capital invested), in general these largest investments must be assessed as unsuccessful.

Table 5 Details of the largest SWF investments in listed stocks.

Acquiror name	Target name	Investment date	Value of investment (mil USD)	Value 27/03/2009 (mil USD)	Holding period return. Inception to 27/03/2009	Gain or loss (mil USD)
Government of Singapore Investment Corporation (GIC)	UBS	8/2/2008	14400,00	4339,16	-69,87%	-10060,84
Government of Singapore Investment Corporation (GIC)	UBS	10/12/2007	9760,42	2121,06	-78,27%	-7639,36
Abu Dhabi Investment Authority	Citigroup Inc.	27/11/2007	7500,00	684,87	-90,87%	-6815,13
Government of Singapore Investment Corporation (GIC)	Citigroup Inc	15/1/2008	6880,00	2370,00	-65,55%	-4510,00
Abu Dhabi Investment Authority (ADIA)	PrimeWest Energy Trust of Canada	7/9/2007	5000,00	5371,40	7,43%	371,40
China Investment Corporation	Morgan Stanley	19/12/2007	5000,00	2545,13	-49,10%	-2454,87

Source: Miracky & Bortolotti (2008: 57)

3. THE IMPACT OF SOVEREIGN WEALTH FUNDS ON THE GLOBAL FINANCIAL MARKETS

One of the biggest advantages of SWFs is that they are a source of liquidity which makes the market more stable. In the times of unstable economic situation they can help institutions sustain their activity or even survive. From the point of view of the whole economy they offer possibilities of risk sharing in the market. By providing the economy with financial means when certain participants of the economic process need it, they contribute to managing capital in the macro sphere. Apart from positive effects on the economy, the literature presents many concerns regarding the Sovereign Wealth Funds. Thanks to mainly long term investment policy, they stabilize the market and prevent it from structural imbalances. Besides, what's important, their investment strategies are not as risky as those of hedge funds because they do not use as much leverage as the latter do. It cannot be denied that injections of capital made by SWFs during the last financial crisis have proved that they are a significant tool in fighting against financial destabilization.

Moving on to drawbacks, the most important of them is the lack of transparency (some examples have already been discussed in the earlier paragraphs), which means that they cannot be fully controlled globally and what results from it, they might be used as a tool of political or economic dominance. For more effects of SWFs on international financial stability see table 6.

Table 6 Potential stabilizing and destabilizing effects on international financial stability

Potential stabilizing effects	Potential destabilizing effects
Macroeconomic management of capital flows	Potential to trigger herding behavior
Portfolio diversification and risk sharing	Lack of transparency may cause short-term volatility
Address long-term structural issues	Risk of financial protectionism due to non-commercial investment motivations
Provision of liquidity	
Long-term investment strategy	Monitoring and agency problems
Gradual unwinding of global imbalances	Disorderly unwinding of global imbalances

Source: Gomes (2008: 2)

As far as the destabilizing effect of Sovereign Wealth Funds on financial markets is concerned, T. Sun and H. Hesse have examined financial stability issues that arise from the increased presence of Sovereign Wealth Funds in global financial markets by assessing whether and how stock markets react to the announcements of investments and divestments to firms by SWFs using a case study approach. On the basis of 166 publicly traceable events collected on investments and divestments by major SWFs during the period from 1990 to 2009, the paper evaluates the short-term financial impact of SWFs on selected public equity markets in which they invest. The impact is analyzed on different sectors (financial and nonfinancial), actions (buy and sell), market types (developed and emerging markets), and level of corporate governance (high and low score). Results, based on these 166 events, show that there was no significant destabilizing effect of SWFs on equity markets (Sun & Hesse, 2009: 1-17).

Another concern relates to the question of whether such funds might distort asset prices through non-commercially motivated purchases or sales of securities

(Beck & Fidora, 2008: 7). The greater transparency of these institutions would surely help to limit those threats.

Another research that is worth paying attention to is the one done by J. Kotler and L. Ugur. Thus, after having analyzed 163 sovereign wealth funds investment announcements between 1982 - 2008, they concluded that the market reactions were positive (Kotter & Ugur, 2008). Similar findings can be found in Dewenter, Han and Malatesta who on the basis of 196 acquisitions and 47 divestitures proved that there were positive market reactions to acquisitions and negative reactions to divestitures (Dewenter, Han & Malatesta, 2009).

Another concern is connected with investment strategies of Sovereign Wealth Funds. As European Central Bank emphasizes, Sovereign Wealth Funds have been investing governments' foreign assets for decades. However, it is only in recent times that such funds have emerged as managers of large "excess reserves" and other foreign assets. A transfer of sizeable amounts of traditional foreign exchange reserves to these investment vehicles may have an impact on the global financial landscape since such funds are likely to pursue an investment strategy that differs considerably from that of central banks (Beck & Fidora, 2008: 24).

The above mentioned research and data prove that Sovereign Wealth Funds influence the economy in various ways and suggests that they must be taken under scrutiny. It is more and more often stressed that some steps must be taken to put them under control. According to E. Truman, the international standard on government cross-border investments by Sovereign Wealth Funds and other entities should cover at least the following four topics (Truman, 2007: 7-8):

- *Objectives and Investment Strategy.* The standard should establish the presumption that the international investment activities of governments are based on clearly stated policy objectives, including how the funds are incorporated into the investment mechanism (or entity), how earnings and/or principal should be spent or redeployed, what types of assets are included in portfolios, how the assets should be managed, where the responsibilities for their management lie, what investment and risk-management strategies should be followed, and how these elements can be changed. At the same time, it makes no economic or political sense to think that an investment strategy should be etched in stone although principles of sound public policy suggest that it should not be modified frequently or capriciously.

- *Governance.* The standard should set out clearly the role of the government and the managers of the investment mechanism, what entity sets the policies, how those policies are executed, and the accountability arrangements. To the extent that the international investment mechanism is making anything other than passive investments in financial assets (deposits, notes, bonds, and non-voting shares), guidelines for corporate governance should be enunciated and followed. Responsibility for ensuring compliance with those guidelines should be clearly established. In some countries, there may also be a desire to have guidelines or a process to deal with ethical issues, for example, types of activities or circumstances in which investments should not be made, as has been done for Norway's Government Pension Fund–Global.
- *Transparency.* The operations of the investment mechanisms should be as transparent as possible. Transparency promotes horizontal accountability among the interested parties and stakeholders (domestic and international) as well as vertical accountability within the policy process. In practice, transparency should involve at least annual reports and preferably quarterly reports. It would be desirable to have substantial quantitative disclosure about investment strategies, outcomes, and the nature and location of actual investments. It would also be desirable to subject the activities of investment mechanisms to published, independent audits.
- *Behavior.* Depending on the type of mechanism, its size, and the scope of its activities, it would be desirable to establish behavioral guidelines with respect to its management. For example, the behavioral guidelines might cover the scale and rapidity with which the entity adjusts its portfolio. They might also create the presumption of consultation with the relevant countries with respect to the allocation among assets denominated in different currencies or located in different countries.

The above mentioned steps would help to limit threats against financial destabilization and allow to control the activity of these subjects on a wider scale. They could be treated as money reserves both for governments and other institutions which need to take advantage of such exceptional financial means in a certain unpredictable situation that may take place on the financial market.

CONCLUSION

To sum up, there is no one opinion in the literature concerning advantages and disadvantages of Sovereign Wealth Funds to the global economy. The only undesputable fact is that their investments are present in different sectors of the economy and their role is significant.

If one additionally takes into consideration that they can be a money lender of the last resort during the financial market turbulences leading to the lack of liquidity in the market, it can be concluded that it is worth developing and preserving this kind of subjects despite of many threats to the economy and financial system itself. However, this process should be followed by the development of suitable regulations, which will result in a better control of Sovereign Wealth Funds' activity. Greater transparency of these subjects is what action taken by governments should aim at. It would not only contribute to financial stability but also lower chances of using them as a tool in a political or economic "battle".

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