

SOVEREIGN WEALTH FUNDS: CHALLENGES AND OPPORTUNITIES

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Sovereign wealth funds (SWFs) have been around since the 1950s, but it is only in the last several years that they have become a household name — at least in some households. Starting out modestly as either central banks or government investment offices, today these institutions are among the largest and most powerful investors in the world. Collectively they manage approximately \$3 trillion across global markets, a number that is widely expected to climb throughout the next decade.

The Kuwait Investment Office, founded in London in 1953 — long before Kuwait became an independent state — is generally credited with being the first SWF. The Kuwait Investment Agency (KIA), now its parent organization, is actually one of the more transparent of these organizations, and, with some \$250 billion in assets, it is one of the largest. However, perhaps the largest institutional investor in the world is ADIA (Abu Dhabi Investment Authority), with an estimated \$400-\$500 billion in assets under management.¹ Across the Gulf Cooperation Council (GCC), SWF assets at the end of 2009 were believed to be in the \$1.5 trillion

range, representing about half the world-wide total.² For comparative purposes, this is about twice the entire hedge-fund industry's worth, though only one-sixth that of global pension funds.³

In analyzing these institutions, it may be useful to start at the beginning: to focus on the question of how and on what basis these organizations are funded. Though this is in many ways the most important policy issue regarding the deployment of the Gulf countries' financial resources, it is one in which the SWFs rarely participate, as it is generally made at a political level above them.

Imagine for a minute that you are a Saudi or Kuwaiti decision maker. You have three primary choices as to where to allocate your oil revenues to maximize your return on investment. From a purely economic point of view, it might well make sense to invest 100 percent of your money overseas and create a pure rentier state, where the citizens live off the income and you spend minimal amounts on infrastructure or the domestic economy. In fact, many years ago at the Federal Reserve, we did a study that essentially concluded that the Gulf states would be better off invest-

TYPES OF SOVEREIGN WEALTH FUNDS

	Central Bank	Long Term Investors	Domestic Synergy
Examples	SAMA	ADIA, KIA, QIA	Mubadala Dubai Investment
Characteristics	Conservative Risk averse Indigenous workforce	Specialist Risk-oriented Dependent on ex-pats	Domestic focus More entrepreneurial
Methodology	Excluding FX reserves — 3 rd party-managed	Primarily external managers	Internally managed joint-ventures
Investment Strategy	Bond-oriented	Primarily equities and alternative investments	Direct investments

ing all the oil money overseas and keeping their population in palatial splendor in the Dorchester Hotel in London. Of course, politically this would be completely unacceptable in a modern nation-state.

Alternatively, you could prime the pump and pour money into the pockets of the population without worrying too much about how it is spent. This approach has the added benefit of creating a very positive economic environment and perhaps co-opting political opposition, but it does little for long-term development prospects.

Finally, you could devote the bulk of your resources to development by putting funds into both physical infrastructure and human resources. This would presumably maximize your return on investment over time, but there would be substantial lags and uncertainties, and in the short term, the benefits would not be very visible.

In practice, of course, regional decision makers have followed a combination of these three strategies. However, the saving route, which leads to funding for the SWFs, has generally been a residual,

once policymakers have satisfied the other needs of the state. As a result, the SWFs are relegated to a subservient role in which they have relatively little say in terms of policy but, of course, a great deal of say regarding how these sums are invested. While this may insulate them from the politics of the decision-making process, it removes them from participating in defining the broad terms of their investment mandates and usually forces them to focus on foreign investments, ignoring the possibility of adding value in terms of national economic goals.

II

A number of SWFs started life as central banks, but over time they have morphed into different types of entities. While it is tempting to see this as an evolutionary process, all of the chosen models have strengths and weaknesses. In a number of cases, governments have chosen to separate the function of central bank from that of long-term investor, while in others they have remained integrated. Gradually, some of the GCC countries are starting to move

towards a third model in which specialist entities are created to focus on domestic objectives, but this trend remains in its infancy. Although there are some cautionary examples, such as Dubai's recent forays into real estate, there is potential synergy and value added if the SWFs invest some of their assets domestically as opposed to keeping them primarily overseas.

III

To paraphrase Dickens, the combination of the effects of the recent economic upheaval on the region and the region's effect on the upheaval over the last few years has been a tale of two markets. The first few years were the best of all times for SWFs. They were followed by some of the worst.

While the West suffered immensely from the great recession, imagine that the price of your main commodity fell by 75 percent after many years in which consumption and absorptive capacity had increased at a heady rate. To take a specific example, GCC hydrocarbon revenues fell from an estimated \$577 billion in 2008 to \$342 billion in 2009. At the same time, their current-account surplus fell from \$260 billion to \$40 billion.⁴ Not surprisingly, domestic equity markets in the Gulf followed suit, falling by an average of close to 70 percent.

It is important to recognize that this is not the first time the region has gone through a boom-and-bust cycle. In the eighties, Saudi revenues fell from 368 billion Saudi riyals in 1981 to SR74 billion in 1986, causing huge drops in the standard of living, with concomitant political fallout.⁵ The primary difference this time was that the central banks and SWFs in the region had ample cash on hand and were smart enough to use it countercyclically to buffer the blow, spending vast sums

to keep government expenditures up and protect the banks from the worst of the economic slowdown.

They were also in a position to help the West, which only several years ago had rebuffed Dubai in its efforts to buy U.S.-based assets. We suddenly had the ironic image of the senior Senator from New York, one of a number who took the lead on blocking Dubai Ports from investing in the United States, soliciting neighboring Abu Dhabi to invest into financially strapped U.S. financial institutions whose demise might have caused a number of his constituents to lose their jobs. Role reversal, and surely a sign of the changing economic balance of power between Washington and the Gulf.

IV

Briefly examining the asset-allocation strategies of the SWFs provides evidence that their objectives are not very different from those of other long-term investors like pension funds and endowments, which they closely resemble. They invest in a diversified mix of cash, bonds and alternatives spread over a wide geographic area. Allocations are to some extent influenced by perceptions of political risk that have recently caused movement away from the United States — historically seen as the most *laissez faire* and safe environment for investors from the Gulf — towards Europe and Asia, which have traditionally been thought of as more resistant to foreign investment. Yet, despite the push-back after Dubai Ports, monies have continued to flow to the United States, which benefits from being the deepest and most liquid capital market in the world, though there can be little doubt that the scrutiny imposed by Congress has caused concern in some quarters. Still, U.S. government

debt remains the single largest beneficiary of these inflows, which have been helpful in financing America's recent budget and current-account deficits.

While one suspects there will always be a political element in the overseas investment policies of SWFs, it appears to be considerably less than that of some other big institutional investors, such as the California Public Employees Retirement System (CALPERS), which is known for trying to impose its political agenda on the companies it invests in. However, in both cases, these organizations are generally dominated by commercial considerations and profit, not politics.

By far the most politically sensitive area for the funds is direct investments, particularly if there is an element of control involved. Though direct foreign investments account for only a small portion of most SWFs' strategies (they are primarily portfolio investors), some of the most significant direct investments have gone into financial institutions. This has been facilitated by their needs and the fact that SWFs often deal directly with the banks and therefore know the people and the environment well. The list is long and includes, among others, Citibank, Morgan Stanley and the Carlyle Group. Collectively, Western financial institutions have received an estimated \$40 billion from the GCC funds over the past several years. This has been of enormous value to them in weathering the recent financial storm.

However, in few cases have the SWFs exercised a substantial degree of management control or demanded board seats from the companies. This is partly due to the thinness of domestic staff, caused by the limited supply of qualified locals, as well as the difficulty of recruiting and retaining them. According to a recent Risk-

Metrics study,⁶ even at the KIA, the ratio of assets to staff is estimated to be \$2.6 billion per employee. At the Qatar Investment Authority it is \$550 million for every professional, surely not enough manpower to actively manage their investments, and no doubt one of the reasons that many of the funds remain dependent on foreigners and external advisers to manage their assets. In most cases, these external advisers are not part of the fabric of the institutions they serve and generally play the role of hired gun with little buy-in or commitment to the country's broader agenda.

Part of the issue also revolves around transparency or the lack thereof. Despite numerous efforts by the United Nations and the OECD (Organization for Economic Cooperation and Development) — culminating in the Santiago Principles, in which the signatories pledged themselves to a greater degree of disclosure and openness — in practice, there has been relatively little implementation of the concept. While it is welcome news that ADIA has recently released an annual report providing some details on its holdings, SWFs have generally remained opaque, with little information filtering out on the scope of their investment strategies.

This has implications in two ways. From a Western point of view, it does little to remove the fear of the unknown among regulators and politicians, and it feeds the antagonism of those who may already have pre-existing prejudices towards foreigners, in general, and Arabs, in particular.

In contrast, domestically, the lack of transparency has attracted relatively little attention. Though this is starting to change, with the partial exception of Kuwait, there has not been much sustained pressure for the SWFs to open their books and provide the body politic with a better under-

standing of what is being done with their money. This leads to suspicions that it is not being properly accounted for. In both the domestic and the international cases, greater transparency would be welcome and would likely undermine many of the suspicions of the cynical. As the lawyers say, “Disclosure is your friend.”

The lack of transparency also applies to corporate governance and, again, has implications both domestically and internationally. Not only do these entities not always have a well-defined legal status, public audit trail or other attributes usually expected of a public institution, they have not always exercised their responsibilities vigorously as shareholders and owners of the businesses they invest in. For example, based on the RiskMetrics Study, SWFs have generally not participated actively in corporate governance. Of course, they are faced with a bit of a conundrum: take an active role and be vilified for exercising too much control, or be passive and risk the accusation of being an ineffective corporate citizen.

V

In my opinion, what is needed is a more entrepreneurial environment, where people are empowered and motivated, where an independent culture is encouraged that embraces performance-related pay, and where the degree of centralized decision making that characterizes many institutions in the Middle East is not encouraged. With their resources and prestige, SWFs are ideally positioned to play a leadership role and set an example of institution building in a region that sorely needs it. Whether this is achievable may be debated, but that should, at least, be the goal.

Furthermore, these institutions could contribute more to their domestic econo-

mies while simultaneously addressing the region’s most pressing economic problem — unemployment. In an environment with the demographic time bomb of one of the youngest and fastest growing populations in the world,⁷ judicious investments in targeted industries that complement overall development could have a significant multiplier effect in terms of job creation. Incubating start-ups and small and mid-sized companies (SMEs) that are good generators of employment could also help unleash the entrepreneurial instincts of the region’s business community.

Catalyzing the creation of a buyout and venture-capital industry and developing the region’s capital markets are additional areas where the SWFs could play a significant role. Nor is there reason to believe that incorporating these types of locally oriented policies into the mix of SWF investments would lower the returns of the funds. On the contrary, it would diversify their investments and perhaps boost returns while helping to kick-start certain desirable sectors of the local economy, sectors where workers might perform more than just menial jobs. Of course, this assumes that the region’s educational institutions are graduating students with the requisite motivation and skills to perform such duties.

The analogy I would make is to petroleum. In the olden days, the countries of the Arabian Peninsula were content to pump oil and let others refine and produce petrochemicals from it. Now these countries are increasingly performing such activities themselves. While Saudi Arabia, for example, is not the primary owner of capital in the world, with perhaps half a trillion dollars to invest, it certainly has a significant comparative advantage and could capture more of the value-added by doing more of the investing (refining) itself.

Part of the problem lies in finding qualified local staff; yet, in the University of Petroleum and Minerals, the Saudis have created a fine academic institution capable of turning out respected engineers and technicians. Why should Saudi Arabia not seek to create centers of excellence where bright young Saudis could be trained to work in a sophisticated investment environment, where they are paid for their results and retain some of the fees? In addition to the actual management of the funds, there are also numerous secondary support functions revolving around fund management — custodial services, fund accounting and administration, and consulting, to name a few — that could be helpful in ameliorating the region's growing unemployment problem.

To extend this argument to investment strategies, the range of possible outcomes could also potentially have an impact on the region's future revenue stream. For instance, a conservative bond-oriented strategy implemented across an SWFs investments would have expected returns in the 5 percent per annum range, while a more equity-focused strategy might be expected to return 10 percent a year, albeit with more risk. ADIA's Annual Review⁸ indicates that its 20-year performance through December 2009 was 6.5 percent in dollar terms. Yet the returns of certain sophisticated long-term investors, such as the endowments of some major U.S. universities, have averaged as high as 15 percent per year over extended periods of time. For example, the average annual return of Yale's endowment for the 20 years ending June 2009 was 13.4 percent. Adjusting for the estimated impact that returns in the second half of 2009 might have had on Yale's performance, a 15 percent annualized number does not seem far-fetched, though this is not to im-

ply that these kinds of returns can necessarily be achieved going forward.

Given the magnitude of the reserves that the GCC nations are likely to have, the returns they achieve could make a difference. For example, for each trillion dollars invested, a difference in return of 8 percent a year would generate \$80 billion in additional cash flow per year — a non-trivial amount even by the gargantuan sums of the Gulf.

On top of this, there is the potential value-added in terms of the investment process itself. As noted above many, SWFs use external managers to invest the bulk of their money, particularly in more specialized asset classes, including equities and alternative strategies. Based on the numbers published by ADIA, which has one of the most developed teams of any fund, 80 percent of all assets are managed by external managers.⁹ In the cases of the smaller SWFs, the percentage is likely to be even more substantial. Given their financial resources and the political will, there is little reason that investment institutions in the region cannot begin to manage more of their own assets internally — and capture the value-added themselves. While the results may not be as exciting as those driven by investment returns, if one assumes an average annual fee of 0.7 percent is paid for the estimated 90 percent of SWF assets that may be externally managed, it translates to roughly \$10 billion a year based on current asset levels.

VI

Clearly the level of assets and the growing influence of the SWFs of the GCC can be taken as a symbol for the global shift in power that is starting to take place between the emerging markets and the developed countries. Though led by China, the SWFs are also playing a role in the

transition as they increasingly invest their capital into Western markets and companies — a reversal of the historical pattern, which has seen Western companies expand their global reach by buying assets in the developing countries. Ironically, the West's attitude toward foreign investment does not seem much different from the way the developing countries reacted to purchases by the developed nations of swaths of their economies in the '50s, '60s and '70s. Perhaps at heart no one likes the idea of foreigners buying up their assets.

This global intertwining of interests, however, does have a potential upside: it creates greater interdependence and potentially improved, and more equitable, lines of communication among the various parties. While both sides have legitimate and some not-so-legitimate fears, they are mutually beholden. It reminds one a little of the Cold War, when people coined the term MAD — “mutually assured destruction” — to talk about the nuclear arsenals of the United States and the Soviet Union. Like the Russians and the Americans then and the Chinese now, the Arabs have too much (in this case, of their own money) at stake to rock the boat very much.

Nonetheless, the SWFs do have the potential to make a more positive contri-

bution to their own economies. As their absorptive capacities rise, the opportunities to invest domestically will increase, and they could have a significant impact on the local economies both by setting an example and investing wisely. Yet there is a paradox here. As they do so, they will be increasing the influence of the states they represent in a region already excessively state-dominated, where 90 percent of the workforce in countries like Kuwait are civil servants, and perhaps 40 percent of the region's equity markets are directly or indirectly government-owned.

This type of state domination may, in turn, reinforce the so-called natural-resource curse, part of which is explained by the severing of the link between citizen and state in rentier economies: the citizens do not pay taxes and the governments, in return, pay little attention to the citizens. Hence the slogan “no representation without taxation,” and often no accountability, either. The SWFs can no doubt play an important role in this area. But changing the terms of the debate will not be easy. Only time will tell whether they can contribute to setting a more positive, productive new tone to the region or whether it will continue to be business as usual.

¹ In recent years a mini-industry has sprung up seeking to estimate the assets of SWFs. Since most do not publish any data on their size, calculations are often a residual based on cumulative current-account deficits and should be treated with caution.

² Sven Behrendt, Chapter 1 in *Managing Arab Sovereign Wealth in Turbulent Times — and Beyond*, Sven Behrendt and Bassma Kodmai, eds., Carnegie Papers, April 2009, p. 4.

³ Steffen Kern, “Sovereign Wealth Funds.” Deutsche Bank, July 15, 2009, p. 5.

⁴ Garbis Iradlan, “GCC Regional Overview.” Institute of International Finance, September 28, 2009, p. 5.

⁵ F. Gregory Gause III, “‘Rentier Exceptionalism’: Oil and Political Mobilization in Saudi Arabia” (unpublished essay, Princeton University, November 17, 2009).

⁶ IRRRC Institute RiskMetrics, “An Analysis of Proxy Voting and Engagement Policies and the Practices of Sovereign Wealth Funds,” October 2009, p. 42.

⁷ “The GCC in 2020,” The Economist Intelligence Unit, September 2009, p. 2.

⁸ Abu Dhabi Investment Authority, Annual Review 2009, p. 3.

⁹ *Ibid.*, p. 3.