Sovereign Wealth Funds

By Peter Andrew Hottinger
La Compagnie Peter Hottinger SA

and Pierre-Emmanuel Iseux
La Compagnie Peter Hottinger SA

Sovereign wealth funds or SWFs are government investment funds that are responsible for managing assets usually with a long-term outlook. The assets under management come from many sources, but in most cases, the funds' assets are supplied by oil, gas or mining royalty income or other trade surpluses of owner states.

More than 40 SWFs have been created since 2006. The rising price of oil and other commodities is the prime factor that has forced numerous states to diversify their domestic financial reserves into what are often regarded as more lasting investments. Today, more than 100 SWFs manage assets estimated at over US$ 5,000 billion in aggregate, accounting for more than 2% of the world bond and equity markets. The assets of SWFs are highly concentrated. Over 2/3 of the assets are held by 6 funds located in the United Arab Emirates (managing US$ 800 billion), Norway (550 billion), Singapore and Saudi Arabia (400 billion each), Kuwait (over 300 billion) and China (750 billion). Several major categories can be distinguished:

• *Economic stabilization funds.* These are created by states whose budget resources are heavily dependent on exports of commodities, and they are designed to guard against price fluctuations (e.g. Angola).

• *Funds managing reserves for transfers between generations.* These are developed in countries with a wealth of commodities, where the state anticipates the depletion of its source of wealth by accumulating reserves for the benefit of future generations and invests in creating its future development model (e.g. Abu Dhabi).

• *Funds to finance pensions.* Certain states create funds to supplement the funding of pensions which is falling short on account of the increasing demographic imbalances within the population (e.g. Norway).

• *Reserve investment funds.* Certain states with high trade surpluses invest part of their foreign-exchange reserves in funds of this kind (e.g. China).

Defining the objective

Sovereign wealth funds exhibit two main types of profile:

• a political profile to represent the state and its economic interests;

• a financial profile to diversify its sources of income and provide for part of the country's contingent or future financial requirements.

The recent development of these funds in countries that are often emerging has aroused mistrust among industrialized countries owning assets that are potentially for sale. Consequently, the Santiago Principles were developed in 2008 under the leadership of the International Monetary Fund establishing a framework for supervision, with the development of generally accepted principles and practices to govern investments by sovereign wealth funds. These were the main recommendations:

• Establish a robust, transparent governance structure allowing appropriate supervision of operations and management of risk and guaranteeing the accountability of senior managers.

• Ensure compliance with current regulations and transparency requirements applicable in countries in which sovereign wealth funds are invested.

• Guarantee investment by sovereign wealth funds according to economic criteria that take due account of risk and financial performance.

• Have a stake in the stability of the world financial system and ensure the free movement of capital and investments.

SWFs are also required to observe ethical restraints and standards of moral probity and integrity. The same rules cover malpractice, insider dealing, conflicts of interest, the policy for disclosure of portfolio assets and various checks and inspections to deter all unethical or fraudulent activity. Lastly, the separation of duties between the investment committee, the fund-management teams and the custodian banks is designed to curb any untoward or unethical action.

Income generating resources

No theoretical model exists to determine the level of financial reserves that a country must retain prudentially and above which it may set up a sovereign wealth fund. However, to judge a country's ability to respond to a liquidity crisis, the ratio of reserves to short-term foreign debt is often used. The level of reserves to retain must be higher if the current-payments balance is heavily in deficit or if the currency parity is overvalued. That level may, conversely, be lower if the foreign-exchange regime is flexible or if the state is capable of borrowing in large amounts at short notice on the international capital markets.

For stabilization funds, dedicated income is usually based on the difference between commodity prices and a benchmark. For savings funds, deposits are usually determined as a proportion of budget receipts or commodity revenues and may differ widely between funds. As an example, that proportion is set at 25% of all oil revenues in the U.S. State of Alaska. On the other hand, the Kuwait Investment Authority, a savings fund dedicated to future generations, receives 10% of (oil or non-oil) budget revenues, together with financial investment income.

Global governance framework

More than half of the sovereign wealth funds in existence are separate from the state's government and central bank and have legal personality. Some are public-law entities such as KIC in South Korea, KIA in Kuwait, QIA in Qatar or ADIA in Abu Dhabi. Others are private-law companies such as CIC in China, Temasek Corporation and GIC in Singapore. In every case, they are managed by a board of directors comprising 6 to 12 members, appointed by the finance minister and often by another member of the government.

Other sovereign wealth funds have no legal personality and are aggregations of financial assets appearing in the financial statements of the state or central bank. This is the case for the SWFs of Norway, Saudi Arabia, the government of the Province of Alberta in Canada, Russia, Chile and Mexico. As a rule, they are under the supervision of the finance ministry, which directly defines investment policy.

Each state must therefore strike a balance between a sovereign wealth fund's accountability to government and its strategic and operational independence from government. This freedom of action varies among different funds and remains entirely dependent on the will of the state and on government strategy.

Investment committee and decisions

Sovereign wealth funds may be of very large size and often have a structure and internal organization enabling them to manage their own portfolios. On the other hand, many funds, some of lesser size, outsource management of their assets to a number of external asset managers. Even though for many years, these assets have been managed mainly by major Western banks, sovereign wealth funds today are increasingly selecting independent management companies with recognized investment processes. Even so, the allocation of the assets placed in the hands of asset managers is still decided by the funds' senior managers through an investment committee. This committee usually consists of representatives of government, the central bank, international financial organizations and risk managers. As an example, 75% of the assets under the management of the Abu Dhabi Investment Authority are outsourced to external asset managers, while that authority's board of directors, drawn exclusively from members of government, develops the strategy and investment policy on the basis of statutory objectives and also supervises the fund's management.

The decisions of the investment committee, whether affecting internal or outsourced investment, are chiefly made to serve three types of objective:

• Seeking a conservative management style to allow virtually immediate availability of assets in the event of budgetary contingencies.
• Seeking attractive performance. The objective is to invest in asset classes with a long-term horizon to achieve an expected return.
• Seeking a strategic result beneficial to the owner country's economic and social development. On similar lines to a private equity fund, the objective is to support the development of private companies in order to contribute to the development of the country's industrial and commercial fabric.

In all three cases the (internal or external) asset managers must always be sought for their specific expertise, investment processes and consistently good past performance.

Asset allocation and risk management

When defining objectives, the investment committee automatically adopts an asset-allocation strategy providing the framework for management of the funds outsourced to external asset managers, identifying perception of risk and financial return preferences. Stabilization funds should, however, be distinguished from the other types of funds: The chief concern of stabilization funds is risk management, for example with the aim of protecting a state's budget against commodities price volatility, whereas with the other types of funds, the overriding concern is maximizing wealth and long-term profitability.

For these other funds, the asset-allocation strategy and management processes are totally different. An example of this is a portfolio diversified into several sectors and countries with a predominant share of risky assets, namely listed equities and bonds with varied credit ratings. These funds are evidently managed with a long-term investment outlook, assigning a precise overall risk-premium target in order to increase the potential overall return.

As regards risk management, the closer the possible or probable dates when the fund's capital may be utilized, the lower will be the fund's flexibility in seeking performance; it will then have to reduce its risk in order to guarantee the capital potentially required. It is also essential for risk supervision to be performed by a committee that is dedicated, independent and totally transparent.

SWFs therefore face a number of challenges that will inevitably slow their expansion. The major issues confronting SWFs are the lack of transparency and accountability, particularly in Africa and the Middle East. Ultimately, lack of transparency leads to continuous political squabbling and is liable to result in every form of untoward use or even corruption.

peter.hottinger@cph1786.ch
pierre.iseux@cph1786.ch
www.cph1786.ch