
Chazen Society Fellow Interest Paper

The Political and Economic Implications of Sovereign Wealth Fund Investment Decisions

JEREMY BROWN MBA '09

Sovereign wealth funds (SWFs) have been thrown into the media spotlight recently, with calls for the nationally controlled investment vehicles to accept or adopt some level of regulation to govern their actions and investment decisions. This paper attempts to apply general ideas from the world of asset management to demonstrate a model in which SWFs can generate excess economic returns while minimizing the political risk that is inherent in a nation-state controlling and managing an investment fund.

History and Background of SWFs

The difficulty in analyzing SWFs in any coherent review begins with the difficulty of determining a simple definition of a SWF. A February 2008 study conducted by the International Monetary Fund (IMF) lists eight separate definitions, which are further distinguished by five different objectives. For the purposes of this review, however, the focus is on two definitions that are broader than those in the IMF report. These come from the Sovereign Wealth Fund Institute and the United States Department of the Treasury. The Sovereign Wealth Fund Institute, an impartial organization established to study fund effects on global economics, defines a sovereign wealth fund as follows:

A Sovereign Wealth Fund (SWF) is a state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets. SWFs can be structured as a fund or as a reserve investment corporation. Some funds also invest indirectly in domestic state owned enterprises.¹

¹ Sovereign Wealth Fund Institute, "About Sovereign Wealth Funds," Sovereign Wealth Fund Institute Inc., <http://www.swfinstitute.org/swf.php>.

The institute's definition of an SWF includes not only the asset funds that are currently associated with SWFs but also public pension schemes (such as CalPERS, in the U.S.) and state-owned enterprises. While the Treasury Department uses a more narrow definition of a sovereign wealth fund "as government investment vehicles funded by foreign exchange assets, which manage those assets separately from official reserves," it is important for analytical purposes to hold the two definitions in distinction from each other.² For the purposes of this paper, the institute's definition is used to assist in the understanding of and advisory proposition toward those entities that fit the Treasury Department's standards.

Today SWFs generally derive their initial asset base from two primary sources: commodity exports and excess foreign-exchange reserves. The overarching theme of these funds is to diversify the wealth of these nations by reallocating assets into other asset classes that provide a higher rate of return than traditional governmental reserves. The funds also focus on diversifying their assets away from their local economies to help hedge against the idiosyncratic risk of their own country. In theory, each fund should maximize its long-term economic returns through a diversification strategy that will increase the risk-adjusted returns of the initial asset allocation. However, in practice, it is hard to separate the economic interests of the funds from the perceived potential for political gain by pursuing investments that could be of strategic harm to another nation.

Recent Issues in SWF Management

Before addressing the theoretical best practices of SWF management, it is important to review the events that led to a public demand for greater investigation into SWF management. Although many investment opportunities by SWFs have been publicly scrutinized, two important events, the blocked 2006 acquisition of Peninsular & Oriental Steam Navigation Company (P&O) by DP World and the 2006 Iceland-Norway financial short sale, distinctly demonstrate where SWFs can go astray in mixing policy and economic return.

The DP World (DPW) controversy was the first time that the potential threats of SWFs entered the American consciousness. A state-owned company in the United Arab Emirates (UAE), DP World sought to gain control of multiple United States ports in conjunction with its takeover of British-owned P&O. The ports in contention were, interestingly enough, already owned and managed by a foreign company (albeit British). The executive branch of the government approved the deal, but its consummation was blocked by a congressional vote on the

² United States Department of the Treasury, "Under Secretary for International Affairs David H. McCormick Testimony Before the Joint Economic Committee," press release, February 13, 2008. <http://www.treas.gov/press/releases/hp823.htm>.

grounds of national security, despite a long-standing alliance with the UAE in both trade and the war on terror. The overturning by Congress ignited a serious global debate in the United States between those who advocated “practicing what we preach” in regard to globalization and those whose post-September 11 concern about national security overruled economic and political progress in relations with the Middle East. In response to this event, the Treasury Department’s Committee on Foreign Investment in the United States passed legislation in 2007 that requires greater scrutiny of assets acquired by foreign governments.

The United States, however, was not alone in warning about the political consequences of SWF management. In 2006, the prime minister of Iceland, Halldór Ásgrímsson, publicly questioned the intentions of a Norwegian investment fund that shorted the bonds of Icelandic banks. The Norwegian investment was based on sound financial acumen, but the act seemed to violate a Nordic mutual-defense pact against financial destabilization, and it simply seemed unneighborly.

While the incident passed without severe political and economic repercussions, the act itself raised more than a few eyebrows. In isolation, the act could be viewed as simply a prudent, but shrewd, financial investment. In fact, from a diversification standpoint, Norway’s shorting of Icelandic bonds could be seen as a prudent hedge against an Icelandic financial meltdown for a country that already had significant exposure to that particular industry. Yet, those with an eye toward the past will remember that in 1992 international investor George Soros famously “broke” the Bank of England by shorting more than US\$10 billion worth of pounds, pocketing more than US\$1 billion in the process and forcing the Bank of England to withdraw from the European exchange rate mechanism (ERM). Given the immense assets under management by SWFs, it is entirely plausible that such an action could be taken by an SWF against a central bank. The real fear in such an action is that a nation, through its SWF, could embark on a plan of financial terrorism that could undermine the financial stability of competing nations.

These two events clearly demonstrate how the political and economic consequences of SWF investments for strategic rather than economic purposes are simply a function of ability and intent. Today these issues continue in the wake of the financial crisis triggered by the U.S. subprime-mortgage crisis. The large capital investments by SWFs in financial institutions in the period from March 2007 to April 2008 totaled more than US\$44 billion dollars. In this 12-month period, SWFs acquired stakes of 9 percent or greater in Citigroup, Merrill Lynch,

Morgan Stanley and UBS.³ Although the investments are currently viewed as economically beneficial (to help recapitalize ailing financial institutions), more time is required to correctly assess the impact of these investments from a political point of view.

It is also important to note that these actions have not come without a significant policy response. On March 20, 2008, the Treasury Department reached an agreement with Singapore and Abu Dhabi on principles for sovereign wealth fund investment, outlining five policy principles for SWFs.⁴ An international effort to establish SWF principles was set forth in October 2008, when the IMF-led International Working Group of Sovereign Wealth Funds established its 24 Santiago Principles, designed to set standards for SWF principles and practices. The voluntary principles represent a large step forward in monitoring and reviewing SWF practices and will help guide future dialogue between the primary stakeholders. However, while the Santiago Principles establish standards for practice, they primarily revolve around transparency and reporting, rather than suggest actual best practices in management.

The Political and Economic Incentives for Asset Allocation

In their search for preemptive guidelines, SWFs need only to look to the world of global finance to help them solve their disclosure and credibility issues. In fact, the management method pioneered by some of the endowments and pension funds in the United States could prove to be a more viable option than forced regulation.

After the introduction of modern portfolio theory (MPT) by Harry Markowitz in 1952, the focus of optimal investment in the eyes of financial economists shifted from individual security selection to asset allocation. Asset allocation can generally be understood as the distribution of an investor's resources across a set of asset classes. A Markowitz efficient portfolio is defined as a portfolio where additional diversification cannot lower the portfolio's risk for a given level of return. From this, an efficient frontier is established that determines the optimal risk return allocations over the set of all possible portfolios. These concepts were further developed into the capital asset pricing model (CAPM), which, for a given level of return, separated the risk into diversifiable risk and nondiversifiable risk, or beta. These concepts, and their mathematical

³ Sovereign Wealth Fund Institute, "Sovereign Wealth Infusions for Banks," updated April 1, 2008, Sovereign Wealth Fund Institute. <http://www.swfinstitute.org/research/subprimereport.php>.

⁴ United States Department of the Treasury, "Treasury Reaches Agreement on Principles for Sovereign Wealth Fund Investment with Singapore and Abu Dhabi," press release, March 20, 2008. <http://www.treas.gov/press/releases/hp881.htm>.

derivations, have led investors to focus on maximizing their return for a given level of risk through portfolio diversification.

While financial economists still debate the accuracy and relevancy of the MPT and CAPM, two developments since the Nobel Prize was awarded to Markowitz in 1990 have significantly furthered the practice of asset allocation. The rise to prominence of alternative asset classes and the development of the Yale model of investment management by David Swensen have had a material impact on the practice of asset allocation and on investment returns in the last 20 years. The insights gained from these developments, when combined, can significantly help SWFs to manage both economic and political returns on their nation's capital.

The *Handbook of Alternative Assets* defines five major alternative asset classes for investors: hedge funds, managed futures and commodities, private equity (including venture capital), credit derivatives and corporate governance. The benefits of investing in alternative assets arise, not from the idiosyncratic nature of each asset class, but rather from the expansion of the investment opportunity set. This is important for asset allocation, because these asset classes generally have low correlations with the more traditional asset classes of equities, fixed income and real estate investments. Also, alternative assets classes, such as credit derivatives, are generally an endeavor undertaken by specialist firms whose specific knowledge and experience operating in these often illiquid markets provide further access that is not always accessible to the manager of a fully diversified portfolio of assets.

The second major insight into asset allocation comes from practitioner David Swensen, as outlined in 2000 in his seminal book *Pioneering Portfolio Management*. The theory of asset allocation outlined by Swensen is often referred to as the Yale model, a reference to his successful investing record after taking over the management of the university's endowment in 1985. In the preceding 20-year period, assets under management grew from \$1.3 billion to \$14 billion, while averaging net investment returns of more than 16 percent per year.⁵ Since his rise to popularity, Swensen has been at the forefront of institutional investing, particularly advocating investment in alternative asset classes.

Swensen's concept of institutional investing—specifically, his approach of diversifying institutional assets with an emphasis on risk-adjusted returns—can impart significant lessons to SWFs. Swensen is also a proponent of investing with investment managers, from hedge fund

⁵ Marc Gunther, "Yale's \$8 Billion Man," *Yale Alumni Magazine* 68, no. 6 (July/August 2005). http://www.yalealumnimagazine.com/issues/2005_07/swensen.html.

Chieftan Capital to venture capital firm Kleiner Perkins Caufield & Byers, to take advantage of the individual strengths of successful investors. This approach is a radical departure from more traditional investments in U.S. equity indexes or individual stock selection, because it leaves the institutional investor to simply perform thorough research to find the best managers in a particular asset class and then allow them the latitude to pursue their specialized strategies.

Implications for SWFs

Sovereign wealth funds in developing countries are primarily faced with problems similar to those faced by many U.S. endowment and pension managers in the 1980s. During that period, these institutional funds were hampered by low returns generated by a lack of diversification and focus on capital preservation through low-yielding and highly correlated assets. Today SWFs manage a large portfolio of assets because of concentrated historical investments in commodities or from excess capital reserves that are generally held in low-yielding fixed-income assets. By focusing on asset classes that have low correlations to their current economic exposure, can therefore expand their investment opportunity set and help to preserve the wealth that they have garnered.

Of somewhat greater importance is that if SWFs shift their focus from individual investments to investment managers, they can simultaneously increase their investment returns without having to take the political risk of being responsible for individual investment decisions. For example, if the Norwegian fund had chosen to hand its capital over to a global macro hedge fund, such as the one managed by George Soros, it would not have put itself in the political hot seat with a key regional ally. The investment manager, not the nation itself, would have control over investment decisions, therefore eliminating the negative political effects of such transactions. The avoidance of this reputational risk is of paramount importance to SWFs, particularly to those in emerging-market countries that are attempting to establish themselves as important and legitimate institutions in the global economy.

Also, many SWFs, especially those in countries with less sophisticated or less developed capital markets, may not have the investing expertise to compete in the global financial marketplace. While the top quartile of alternative investment managers has, on average, produced excess returns, direct investments by SWFs have not proven to be as profitable historically. By focusing its efforts on investment-manager due diligence and asset allocation across the total portfolio, SWFs may be able to better use their human capital achieve higher returns with less political risk. Furthermore, by outsourcing the direct-investment portion of their

strategy, SWFs will not have the temptations to wield their power for political gains, because the decision-making process on the country-specific level is diminished.

While these ideas may help managers of SWFs to rethink their strategies in light of political and economic risks, the suggestions are not without significant hurdles. First, SWFs today control US\$2.5 trillion in investable assets, a number that is expected to reach US\$12 trillion by 2015.⁶ The sheer size of these funds may preclude them from optimal investment decisions because their large asset base has the potential to move markets. For example, SWF investment in U.S. venture capital investments may be limited due to the fact that these firms tend to take smaller initial investments in the hope of long-term absolute growth. Additionally, many investment managers decline to accept new money into their funds, despite their added compensation, because they fear style drift may occur with the need to invest a larger amount of capital.

While many of the ideas outlined earlier focus on investment strategy, the current regulatory debates focus more on disclosure and intent. As Swensen himself has pointed out, the transparency associated with investment disclosure can come at a steep price to investment returns, because the market can use the information to follow a particular strategy and crowd the returns of particular investments. In proposing guidelines for SWF regulation, domestic and international institutions must carefully balance the economic advantages of fund management with low transparency and the political gains from full disclosure. Finally, not all alternative investment classes are ideal for SWF investment. Corporate governance, often called shareholder activism—or, more anachronistically, corporate raiding—is an asset class in which the political consequences of investment would outweigh any potential economic gain. Under this strategy, hedge funds and institutional investors acquire large, often controlling stakes, in underperforming companies and force management to make significant changes or sell the company. The idea of foreign governments gaining control and forcing out management to pursue their own agenda is clearly too sensitive to security risks for any nation to allow that type of investment.

Conclusions

In recent years, the debate over the governance and regulation of SWFs has become an important research area for geopolitical studies. While much attention and analysis has focused on issues of national security and international capital flows, significantly less attention has been given to the

⁶ Anders Aslund, “The Truth About Sovereign Wealth Funds,” *Foreign Policy*, December 2007. http://www.foreignpolicy.com/story/cms.php?story_id=4056.

ideology behind the investment decisions of these growing economic actors. Today, in the midst of a global economic crisis, the need for the efficient flow of capital is more important than ever. However, SWFs remind us that the sources of funds used for investment decisions may have significant political implications for all international economic actors. While many economists and countries are calling for greater international coordination of economic decisions, it is important to remember that new regulation is not without unintended consequences.

SWFs represent an excellent opportunity for emerging-market countries to gain greater financial sophistication while securing the economic future of their citizens. However, all investment decisions carry considerable risk, and these assets need to be managed with a special focus on capital preservation and risk management. The ideas in this paper are an attempt to move past the regulatory and xenophobic cries for regulation and help to better understand how SWFs can maximize their investment decisions to ensure long-term political stability. As Adam Smith reminded us, “No society can be flourishing and happy if the greater part of the members are poor and miserable.”⁷

⁷ Adam Smith, *The Wealth of Nations*, bk. 1, ch. 8 (1776).