Blowing hot and cold

Even if the desperate remedies taken by governments to get banks lending again prove effective, sovereign wealth funds are already major players in the financial markets and their importance is set to increase over the coming years.

Sovereign wealth funds – the name given to government-owned capital funds – can trace their origin back some 50 years, but their regular appearance in the media's business pages is a fairly recent phenomenon. Alongside them stand government-owned investment companies, such as Abu Dhabi's Mubadala Development Company, which have some different characteristics from sovereign wealth funds and sovereign pension funds.

At present, sovereign wealth funds have a total of between $2,500bn and $3,000bn under management, although some contend that to this figure should be added the $700bn of mortgage-related assets that will be taken on by America's very own sovereign wealth fund, following US treasury secretary Henry Paulson's initiative to take them off the hands of the banks. And if that is the case, then the part-nationalisations agreed by European governments also merit inclusion.

Sovereign pension funds have so far attracted rather less attention than sovereign wealth funds, although as The Financial Times newspaper recently observed they represent even greater wealth. According to Morgan Stanley's calculations, sovereign pension funds in western Europe, the US and Japan alone have total assets of $4,400bn.

To put this in some sort of perspective, the oil-rich Arab states of the Gulf Cooperation Council hold an estimated $1,500bn in assets in investment funds, or more than double the amount allocated to the Paulson bailout plan in the US.

WEALTH IS SET TO INCREASE Even if fuel and other commodity prices fail to maintain their recent giddy heights, the power and combined wealth of all three types of investor is set to increase further over the next few years. Already, their influence is such that the final demise of Lehman Brothers came about after Korea Development Bank, one of the world's major sovereign wealth funds and regarded as a likely buyer, backed away from any deal. The trend will be accelerated if the recent meltdown of the US financial system heralds a sharp and irreversible shift from the West to the East in the balance of power.

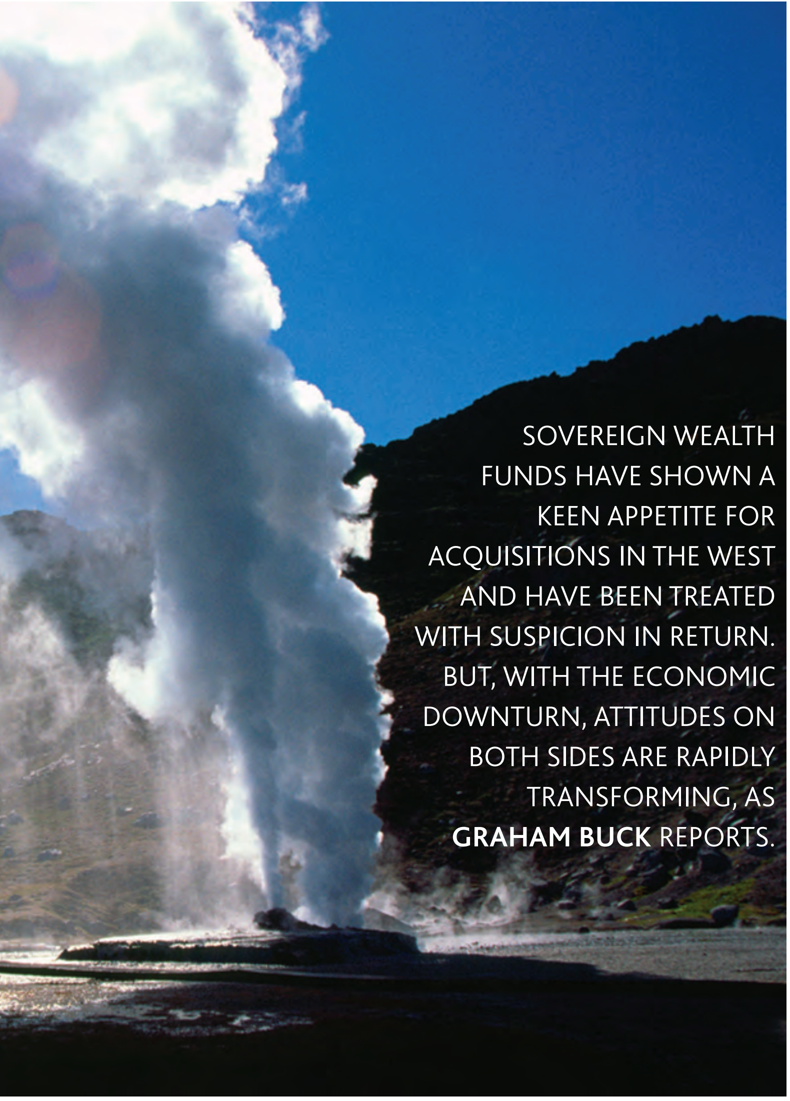
A report issued in July by investment group State Street predicted that higher oil prices and strong export growth in Asian and Middle East countries would more than double the value of funds controlled by sovereign wealth funds from their current level to more than $7,000bn by 2012. Given their likely asset allocation mix, sovereign investors could collectively own more than 5% of each of the 8,000 companies in the FTSE Global All Cap Index. By 2020, the report predicts that total sovereign wealth fund assets will be as much as $20,000bn, equating to growth of up to 20% per year over the period. The percentage of that wealth invested in equities is also seen as rising, from 50% to 60%, at the expense of bonds and the dollar.

As emerging countries play a greater role in the world economy, sovereign wealth funds will be the fastest-growing category of institutional investor, ahead of pension, insurance, private equity and hedge funds. As the report points out, the funds can be categorised as patient and long-term investors able to exert influence over major corporate decisions, including the hiring and firing of senior executives and the selection of acquisition targets.

"As their resources grow and as recipient governments and corporate boards gain greater familiarity with sovereign wealth fund

Executive summary

- **Is the world poised for a lengthy period of sluggish economic growth or even recession? A recent report suggests that with many of their investments having turned sour, sovereign wealth funds have been hoarding cash in recent months. This is bad news for countries such as the US where rapidly growing national debt and current account deficits have underpinned the active encouragement of investment in corporates and markets alike. What might just turn the situation around are the bargain prices on the table for so-called trophy assets such as football clubs and historic buildings.**



SOVEREIGN WEALTH FUNDS HAVE SHOWN A KEEN APPETITE FOR ACQUISITIONS IN THE WEST AND HAVE BEEN TREATED WITH SUSPICION IN RETURN. BUT, WITH THE ECONOMIC DOWNTURN, ATTITUDES ON BOTH SIDES ARE RAPIDLY TRANSFORMING, AS **GRAHAM BUCK** REPORTS.

investors, there is scope for [them] to exert greater influence in their target companies," the report states. This focus on long-term growth could see the funds' stakes in companies, which so far have generally been limited to a maximum of 10%, increase in line with the greater control.

The power of the biggest funds has already increased significantly since the onset of the credit crunch. Sovereign wealth funds such as China Investment Corporation (CIC), the Government of Singapore Investment Corp and the Investment Authorities of Kuwait and Qatar have provided capital injections in return for stakes in entities such as Citigroup, Merrill Lynch, Morgan Stanley, UBS, Blackstone Group, Barclays and the London Stock Exchange. But if the funds had hopes of making a profit from these strategic investments, these were quickly dashed. The returns have so far been disastrous as the credit crunch has been succeeded by a full-scale global financial crisis, and banking stocks have plummeted.

THE SANTIAGO PRINCIPLES The recent failures and 11th hour rescues of some of the financial world's leading names also meant that little media attention was given to a meeting of representatives from 26 sovereign wealth funds – including the very biggest – that took place during September in Santiago, Chile. There they agreed a voluntary code of practice to apply to their future operations, developed under the auspices of the International Monetary Fund.

The so-called Santiago Principles were presented to the IMF last month and, if adopted, will require sovereign wealth funds to:

- publicly disclose the source of their funding and their purpose;
- set out their legal basis and structure as well as their relationship with other state bodies;
- establish clear and publicly disclosed rules on their approach to funding and spending; and
- meet the regulatory and disclosure requirements of the countries in which they operate in addition to those of their host country.

AS EMERGING COUNTRIES PLAY A GREATER ROLE IN THE WORLD ECONOMY, SOVEREIGN WEALTH FUNDS WILL BE THE FASTEST-GROWING CATEGORY OF INSTITUTIONAL INVESTOR, AHEAD OF PENSION, INSURANCE, PRIVATE EQUITY AND HEDGE FUNDS.

The guidelines also restrict sovereign wealth funds from making any investment decisions influenced by political considerations, propose improved transparency and accountability in their dealings, and apply best-practice corporate governance rules. Despite the common front in reaching this voluntary code, there are thought to be differences of opinion between some of the long-established funds and those more recently set up, with some also submitting less readily to financial transparency.

The initiative comes in response to the heated debates raging in many countries, principally in North America, about the motives of foreign governments in using their investment companies and sovereign wealth funds to acquire stakes in some of the world's major institutions. The US has already introduced guidelines that restrict investment by sovereign wealth funds. The suspicion is that often the reasons for investment may be strategic rather than purely commercial, with the primary objective to increase the influence of the fund's host nation rather than to achieve high returns. These fears are heightened by the lack of transparency that characterises sovereign wealth funds.

But the US and Europe cannot afford to adopt too hostile a stance. Just as these scruples are giving way to the very real need for their financial institutions to secure further cash injections, so many sovereign wealth funds are questioning their traditional policy of investing abroad to diversify their risk.

As research firm Global Insight recently reported, volatile commodity prices and falling equity markets have blunted the appetite for further acquisitions, despite record oil prices reached earlier this year having swollen their coffers. There is little enthusiasm for further acquisitions of banks. China, which has not authorised any major investment in a foreign bank so far this year, recently vetoed state-owned China Development Bank's proposed takeover of Germany's Dresdner Bank.

Sovereign wealth funds are now reviewing a range of alternative investment classes that even extends to trophy assets such as football clubs. The world's commercial property markets could be another home for much of this money. More than half of the funds are thought to invest in commercial real estate, but property services group CB Richard Ellis forecasts that over the next seven years they will allocate as much as $725bn to the sector, with more focusing on trophy assets, such as Abu Dhabi Investment Council's $800m investment last summer in New York's iconic Chrysler Building.

The group suggests that, having focused largely on the US property

market, the funds will add buildings in the UK and Europe as well as Japan to their portfolio and also consider acquiring property companies. This could see them biding their time as property markets move lower, and moving in once prices appear to have bottomed out.

THE PLAYERS The estimated size of the very biggest state-backed funds is daunting. With an estimated $1,810bn in reserves, China's State Administration of Foreign Exchange (SAFE) is the world's biggest investment fund. SAFE diversified last year by providing capitalisation of $200bn to set up CIC as a sovereign wealth fund. CIC quickly made a name for itself, with a $5bn investment last December in Morgan Stanley that gave it a 9.9% stake (although Mitsubishi UFG has more recently surpassed it with a $9bn investment).

SAFE is also the world's second-largest holder of US government debt behind Japan. Having grown by $400bn this year alone, SAFE could fairly rapidly exceed all other nationally owned funds combined but has to date adopted a relatively conservative investment policy of buying small stakes in Western companies.

Alongside SAFE and CIC sits state-owned China Development Bank. With reserves of more than $300bn, China Development lends mainly to key national projects but last year purchased a $3bn stake in Barclays and is in the process of converting to a commercial bank.

Outside China, the Abu Dhabi Investment Authority (ADIA) is probably the world's largest sovereign wealth fund. Although it has not disclosed the amount it has under control, estimates put it at between $650bn and $875bn. ADIA became the largest shareholder in Citigroup last November, when it agreed to invest $7.5bn in return for a 4.9% stake and more recently is reported to be a major investor in UK and US real estate. Abu Dhabi is also providing $1bn of investment in Hollywood film production over the next five years, unperturbed by Sony Corporation's ill-fated purchase of Universal Studios in the late 1980s that resulted in a $2.7bn write-off.

With reserves of around $250bn, Kuwait Investment Authority (KIA) has also had a stake in Citigroup since January, when it provided a $3bn injection for the group and $2bn for Merrill Lynch. More recently KIA has shored up its local stock market, pumping in around $1bn during September as foreign investors withdrew from the region after Lehman Brothers' collapse. KIA also indicated that it planned to become a long-term investor in a number of local businesses.

Singapore has the Government of Singapore Investment Corp, with reserves of around $220bn and holdings in Citigroup and UBS of 4% and 9% respectively. It also has state investment agency Temasek Holdings, which was set up in the early 1970s and is among the longest-established sovereign wealth funds. Temasek's $134bn portfolio is focused on Asia, but it has provided investment for Standard Chartered, Barclays and Merrill Lynch in return for stakes.

Sovereign pension funds, mostly set up since the early 1990s, are buffer funds to accumulate reserves against the cost of unfunded state retirement benefits over coming years. The biggest, by some way, is the $1,900bn Social Security Trust fund of the US, which is composed entirely of bonds from the federal government.

It is followed by Japan's Global Pension Investment Fund, which has around $800bn of assets under management: 22% in domestic equities, 15% in foreign stocks and over 10% in foreign bonds. However, the next in size – Norway's Government Pension Fund Global (GPFG) with $346bn – is 100% invested outside Scandinavia, has more than half of its wealth in equities and owns more than 1% in aggregate of Europe's quoted companies. In contrast to the lack of transparency for which many sovereign wealth and pension funds are criticised, GPFG is lauded for its transparency.

ACTIVE ENCOURAGEMENT Given the events of the past few weeks, the unanswered question is whether the world is now poised for a lengthy period of sluggish economic growth or even recession. If so, the resulting knock-on effects on energy and commodity prices could blunt the appetite of SWFs and SWPs for further overseas acquisitions as they divert funds to home. Saudi Arabia's government-run pension fund, the Public Establishment for Retirement, has been known to lend money to needy Saudi banks in the past, and analysts say the fund may do so again soon. Kuwait Investment Authority recently pumped around $1bn into the local stock market to arrest a plunge in equity prices and Russia appears likely to follow its lead. ADIA's charter specifically mandates it to invest outside the Gulf region, but the recent liquidity squeeze has caused some to question whether the government might be persuaded to amend it.

With many of their investments having turned sour, reports suggest that sovereign wealth funds have been hoarding their cash in recent months rather than embarking on further acquisitions. But bargain basement prices for many trophy assets could yet persuade some of them to reconsider their stance. The US Treasury, faced with financing the country's rapidly growing national debt and current account deficits, has been actively encouraging sovereign wealth funds to invest in US corporates and markets. It may need to woo them even more assiduously over the next few years.

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