The Sovereign Wealth Fund Controversy: The Issues and Suggestions

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Sovereign Wealth Funds have only recently caught the public's attention. Sovereign Wealth Funds are investment funds typically financed through excess foreign currency reserves. These funds are owned by the citizens of the Fund's country. Most of the discussion taking place concerns how these Funds can make host countries comfortable receiving their investment money. This paper takes the view that the obligation of the Fund is to maximize the utility of the owners of the Fund. The study discusses actions that both Sovereign Wealth Funds and host nations should take in order to make the market transparent and efficient.

INTRODUCTION

Sovereign Wealth Funds are government owned investment funds typically funded by foreign currency reserves, which are managed separately from official currency reserves. The origin can be from commodity sales or non-commodity factors. They have become controversial in large part due to their sudden growth.

The International Monetary Fund estimated in 2007 that sovereign wealth funds (SWFs) controlled as much as 3 trillion dollars in assets and that the total could jump to 10 trillion by 2012.(Johnson, 2007)[1] The Sovereign Wealth fund Institute listed 52 SWFs in 2009.[2] Note that SWFs are typically distinct from public pension funds and from state owned enterprises. The color of the distinction may be quite gray. For example, Norway has both a large public pension fund that invests inside Norway and is not included as a SWF and also has the fourth largest SWF which is their Government Pension Fund Global. This fund invests abroad and is managed separately from its other government pension fund. However, it is not required, that in order to be classified as a SWF, the fund needs to invest exclusively abroad.

Nine of the current SWFs have, or are estimated to have, over 100 billion dollars of assets under management. (Sovereign Wealth Fund Institute, 2009)[3] By far the largest fund is the Abu Dhabi Investment Authority (ADIA). In Mid-2009, the ADIA had assets of approximately 627 billion dollars. The second largest fund is SAMA Foreign Holdings of Saudi Arabia estimated to have 431 billion dollars of assets under management. (Sovereign Wealth Fund Institute, 2009)[4]

Of the largest 10 funds five are commodity based (all oil) and five are non-commodity based. Further, three of the non-commodity based funds are headquartered in China (including the Hong Kong Monetary Authority Investment Portfolio) and the other two funds are from Singapore.[5] Singapore's Temasek Holdings is the 10^{th} largest SWF in the world with assets of 85 billion dollars under management. Finally note that four of the 52 SWFs noted by the Sovereign Wealth Fund Institute are owned by United States states. They include the Alaska Permanent fund which is listed as the 21^{st} largest fund in 2009. (Sovereign Wealth Fund Institute, 2009)[6]

In Section II we will discuss the benefits and costs resulting from Sovereign Wealth Fund investments to the owners of the Sovereign Wealth Funds, the host nations when such investment is foreign investment, and to the global community in general. We will follow that analysis, in Section III, with suggestions for improving the current environment that the Sovereign Wealth Fund controversy has provided. In Section IV we will make proposals for improving the outcome of SWF investments from the point of view of their local economy, and we also offer a proposal to create a global institution for managing foreign investment issues. In section V we summarize the work of the paper.

BENEFITS AND COSTS DUE TO SOVEREIGN WEALTH FUND INVESTMENT

Benefit to the Sovereign Wealth Fund's Country of Origin

Sovereign Wealth Funds state their objectives in financial terms. That is they are hoping for strong investment performance. Most are long-term oriented and most are concerned with investment safety. They claim to be quite risk averse. In addition most funds claim to be passive investors. That means that they are not interested in controlling the direction of the strategy of the firms in which they invest and may even have prohibitions against holding board seats. Funds claim to be apolitical. However these last two arguments are sometimes tainted by particular social issues. For example, several companies have been excluded from the investment universe of the Norway Government Pension Fund Global due to their involvement in weapons production, environmental degradation, and even unfair labor practices. In addition, that particular Fund will vote its shares. Therefore, their capitalization position does matter. Still, heretofore, it does appear that the main objective is strong financial performance. That means that the Fund is expected to outperform a benchmark portfolio in terms of the overall relationship between risk and return. Benefits that flow from such performance include the ability to fund projects at home, create greater savings for future generations, help stabilize the domestic economy, and earn returns beyond those traditionally earned on foreign currency holdings. In addition, SWFs clearly create diversification benefits to the home country or state. Diversification reduces risk in several ways. Most SWF portfolio are likely to be well diversified (many funds hide their asset portfolios from the public view).[7] Portfolio diversification reduces the level of unsystematic risk. Secondly, many SWFs are located in resource rich but poorly diversified economies. By investing in a wide variety of industries, the possible negative impact on the country from lower resource prices can be partially offset. Further, earnings from the Fund can be used to fund socially desirable economic and social projects. Finally, it is possible, though Funds tend to deny it, that the SWF can be used to gain political leverage over the allocation of economic resources.

Costs to the SWFs Country of Origin

There are two important costs to the society for which the SWF performs. To the extent that financial capital is invested abroad, needed capital improvements and innovations at home are ignored or are tended to at a greater cost than would be the case if the SWF capital was employed at home. Perhaps one of the best examples concerned the questions raised around the quality of public institutional structures, such as schools, during the devastating weather in China in 2008. It is clear that many buildings were not well maintained and were below reasonable building codes. Tragic deaths resulted, some of which may have been avoided if some of China's Sovereign Wealth Funds had allocated more of their capital to improve social infrastructure rather than to enhance portfolio capital growth. In addition, investing outside the domestic economy improves the growth of foreign economies at the expense of the domestic economy. The choice to invest abroad lowers the cost of capital abroad and raises it domestically. These points should not be interpreted to mean that investing abroad is a net mistake but rather that the goals and benefits of global diversification and enhanced return to risk need to be tempered by the shorter term loss to the local market.

A second issue concerns poor investment choices. Several Funds have apparently made some poor investment choices. The China Investment Corporation purchased a large stake in the Blackstone Group only to see that investment loose significantly in the economic downturn. (vccircle.com, 2008)[8] The suspicion is that some choices by SWFs will yield quite positive results but that others will not. If SWFs cannot meet their performance objectives, reassessments should be required. In short, the SWF's performance needs to be evaluated and good performance needs to be rewarded and poor performance should bring forward the same response one would expect in the private sector (for example the firing of the poorly performing general manager of the Fund and/or a revamping of the Fund's goals and/or strategies). In sum, SWFs need to have market discipline tied to performance if such Funds are going to maximize the value of their shareholders' investment (i.e. the citizens of the country, state, or province).

Benefits to the Host Country

The most obvious benefit to host countries, created by the growth of Sovereign Wealth Funds, is the increased access to financial capital. During the recent decline in commercial bank, mortgage bank, and investment bank values, SWFs stepped in to add capital to struggling companies. From the SWF point of view, many of these companies are stalwarts managed by some of the best regarded financial minds in the world. They view the long-term prospects of these institutions as quite good. While the SWFs view these investments as astute investments, they have aided global society by infusing capital into companies that might otherwise have needed government support or who might have failed. The Funds typically are interested in long-term results and do not have the same pressures to produce short-term results as do most mutual funds, hedge funds, private banking units, and private equity funds.

In addition to the infusion of capital, SWFs also may improve pricing efficiency. The Funds have added to the quantity of analysis being conducted in equity and debt markets and hopefully to the quality as well. It is highly likely that market efficiency is improved. The Norwegian Government Pension Fund Global, for example, (noted here so often because of its public information requirements) regularly updates its performance monitoring. It has established well published benchmarks to monitor performance. There is pressure on its managers to perform well. In short, quality analysis is a requirement of the management effort.

Costs to Host Society

The most obvious perceived cost to the host society is that foreign governments may be important, majority, or total owners of a country's productive, strategic, and/or cultural assets. The ownership of such assets is generally not important unless they are managed to the detriment of the host country society. There is a notion that private capitalists have more pristine financial goals than do foreign governments. That is, there is a view that private capitalists, irrespective of their technical domicile, all want to maximize financial value for the risk undertaken, but that governments may have different agendas. This is a twist on the old developing country theme that tried to exclude private capitalists from local markets because of their interest in shareholder maximization rather than societal welfare. It is unclear that the goal of maximizing shareholder value, in the case of private sector global firms, need have a negative impact on host country society in developing countries, nor is it at all clear that Sovereign Wealth Fund investments in developed or developing countries will lead to host country problems. Reasonable safeguards seem warranted in both cases, but there does not appear to be an ex ante logic that such investments are harmful to society.

It is clear that security sensitive investments require significant scrutiny, but it is not clear that the investment by SWFs in such businesses create any greater security issues than significant investments by foreign or domestic private capitalists.

The issue of investment in cultural landmarks is of little interest. SWFs wish to earn returns on such investments and can only do so if they take care of, and possibly improve the quality of such assets.

Global Society Impacts

Economic theory has long argued that global society benefits from the free flow of resources including financial capital. Not only is economic efficiency improved as capital chases the greatest expected areas of success, but it has long been argued that global investment interests lead to a desire to reduce inter-country violence. Conversely blaming economic failure on foreign citizens continues to be a great political tool and the presence of increasingly large numbers of foreign investments might make such claims easier to make. Following from these perceptions is the leverage supplied by Sovereign Wealth Funds. That is, to the extent that the financial welfare of the citizens of one country is tied to the economic performance of another country, there will be a natural inclination to follow political actions that help countries hosting SWF investments. However, it is also true that SWF investors make easier targets than do private foreign capitalists. We suspect then, that from the investor side, SWF activity enhances a desire for peaceful and prosperous outcomes, however, from the host side; economic shortfalls will make SWFs prime targets.

MODELING ADVANTAGEOUS BEHAVIOR FOR SOVEREIGN WEALTH FUNDS

In this section we focus on the financial and relevant governance issues. This modeling is consistent with the *voluntary* agreement signed by members of the International Working Group of Sovereign Wealth Funds known as Generally Accepted Principles and Practices (GAPP) or the "Santiago Principles".(International Working Group of Sovereign Wealth Funds, 2008)[9] We do not, here, discuss the legal arrangements establishing the SWF.

Clarity of Objectives and Identification of Primary Money Managers

It is to the advantage of SWFs to clearly state their objectives. The most important reason is that the Fund's assets belong to the "people" of the sovereign state. Citizens have a right to know how the funds are being employed to their benefit. Most Funds are likely to report their objectives in strictly financial terms. If the objective is to outperform the market in terms of return and/or risk, the parameters should be established so that Citizens can see the outcome of the policy. The Annual report should speak to the performance relative to the objective with an explanation of the outcome. In addition, citizens should also know who is managing the investment process. If the management team cannot reach investment objectives in a reasonable time period a full explanation for the failure should appear in the annual report and the process of both selection and firing of the management team should be known to the public. While the key reason for openness on these points is to protect the owners of the Fund, an additional benefit is that outside governments are likely to view such openness positively. Establishing a consistent reporting policy will protect the SWF from foreign criticism.

Full Financial Reporting

It is crucial to the owners of the Fund that there be fully audited financial reporting. The citizens of the sovereign state should have the ability to view audited statements showing investment performance and holdings. Of course such statements should be found in an annual report which among other things gives the Fund's management team the opportunity to defend any short fall performance. Again, while we argue for full auditing to protect the Fund's owners, such statements are likely to lead to a more open relationship with host countries of SWF global investments. Since financial statements report what has happened in the past, such statements are not likely to be harmful to the requisite secrecy needed to make large future investments.

Discussion of Governance Position: Influence in Company Matters

The activeness of the Fund in investment recipient governance matters should be explicitly set out. Models run from full passivity in which the Fund not only is not represented on the Board but also does not vote its shares all the way through active management in which, if appropriate, the Fund not only advocates for certain policies but also obtains Board positions, if possible, and votes for those strategies that most benefit the Fund. It is not true that Funds are passive when they vote their shares. One expects that Funds wish to maximize something and their voting will reflect that. In any case, an entire spectrum of activism is available to Funds and their philosophy of activism should be spelled out. We feel that not only do the owners of the Fund have the right to know what the Fund intends to accomplish through the governance process, but we also feel that such openness will help SWFs politically in cross border investments.

Passive investing means that the Fund will not interfere in the management strategies of the investment target. The benefit of passive investing is likely to be strictly political. Host nations may like it because they feel that foreign government wants may be harmful, and SWF owners may prefer it if they do not agree with their Government's socio-political wants or that they feel that activism raises the likelihood of host country sanction. Alternatively, we generally see activism, with respect to financial strategy, as a positive force. SWFs are often significant shareholders and their owners have a reasonable right to play a role in financial strategy and financial performance. Significant shareholders can play an important role in removing poorly performing managers and in helping to move the company in a successful direction. The monitoring value of Sovereign Wealth Funds for all the investors in the company should not be underestimated. (Fernandez, 2009)[10]

Socio-political issues require a different type of discussion. Should SWFs have the same rights to fight for certain social and political viewpoints that private investors have? The extent to which this issue arises is unclear, but it is certainly a potential flashpoint for debate. For example, due to religious convictions alcohol sales are restricted in Qatar. The Qatar Investment Authority (QIA) might choose not to invest in companies whose key source of value is the sale of alcoholic beverages. However, in shrinking the investment universe, the level of unsystematic risk that can be eliminated is reduced. The potential policy decisions are numerous. The most obvious policy is for the QIA to not invest in such enterprises and accept the additional unsystematic risk as a small price to pay for social virtue. Alternatively, the QIA could invest in such companies and either try to change the company's focus (a questionable strategy if alcohol sales are the core source of firm profit), employ all or some of the returns from such investments to help fight alcoholism and to encourage abstinence from alcohol consumption, or simply consider the investment a financial investment helping to enhance portfolio value, a result which is, in itself, ethically positive for the people of Qatar.

All investments are not necessarily so obvious, nor are the solution so drastic. The Norway Government Pension Fund Global, for example, refuses to invest in Wal-Mart due to its labor practices. By making this choice the Fund is minimally reducing the diversification benefits available to its owners (the citizen's of Norway). Clearly, Norway believes the benefits of not investing in such a company exceed the costs of lost diversification and possibly lower returns. However, an alternative would be to make a significant investment in Wal-Mart and to try to fix the problem. However, if Wal-Mart's employment practices are the key to its success, all the Norway Government Pension Fund Global would gain would be some social satisfaction.

There is also the issue of political/social ideology. Most of the mature developed countries view freedom of the press as a strong foundation for democratic principles. Such principles do not seem to carry as much weight in some other countries. What would be the impact, for example, of a large investment in a major news agency by the China Investment Corporation? Would the China Investment Corporation attempt to manipulate coverage of issues of political importance to China or would they remain strictly interested in the financial outcomes of the news agency?

Social and political issues are important to both the citizens' of the Fund, to the host nation, and to global society in general. While adherents to the Santiago Principles are required to list objectives beyond the return/risk nexus, the number of non-financial incentives and the nuances of maximization are likely to make this requirement the most difficult in which to adhere.

Role of Home Government in Investment Policy Decisions

The role of the home government in investment policy decisions should be understood by the owners of the Fund. To what extent is there a "firewall" between the investment management team and the government? From the point of view of the owners of the Fund, government passivity may or may not be viewed as a positive factor. It is highly likely that foreign host governments will view passivity as important. Naturally the ability to interfere is implicit in the ownership of the SWF. That implicitness should not be underestimated. However, a clear policy concerning governments roll in investment decisions and managerial choices should be well understood.

Investment Prohibitions

Any prohibitions on investment behavior should be known by the public-owners. For example, the Norwegian Government Pension Fund Global has identified companies that, in their view, violate official Norwegian government positions on pollution, war, and labor practices. The Norwegian government does not allow the Fund to invest in those companies. It should also be noted somewhere in the technical information what the implications are of prohibiting the investment in certain firms or entire industries form the investment possibilities universe. Reducing the ability of portfolio managers to invest in certain firms or industries limits both their universe of possibly undervalued companies and also hinders their ability to diversify the portfolio. In short it is likely that the return to risk ratio will suffer. Such outcomes, however, should not be viewed as necessarily reducing the benefit to society, if society has parameters outside risk and return in valuing investment success.

In sum, Sovereign Wealth Funds owe it to their society's to be forthright with their investment plans, performance, reporting and governance. A side benefit will be the external gains that may accrue in terms of investment ease abroad.

MODELING THE HOST REGULATORY ENVIRONMENT WITH RESPECT TO SOVEREIGN WEALTH FUND INVESTING

Interestingly, although recipient countries were invited to the International Working Group of Sovereign Wealth Funds meetings leading to the development of the Santiago Principles, the Principles do not speak to the important issue of host country responsibilities. Some of the Principles directly identify the host governments as benefitting from the Principles, yet nowhere is there an agreement by host countries to treat fairly Sovereign Wealth Fund investors. We do not view the absence of such an agreement as trivial.

Statement about the Country's View on the Free Flow of Capital

Host countries need to have a public policy with respect to foreign investment. This policy should apply generally to any investor public or private. Specific issues around Sovereign Wealth Funds can be employed in a separate section. Host country private companies and non-federal government units need to understand where they can look for capital infusions and foreign capitalists need to know the extent to which they are welcome.

Statement about Views on Foreign Capitalist Categories: Private vs. Public

If a host country believes there is a difference between private and public capitalists that position should be stated explicitly. If sovereign investors are to be treated differently it should not be on a discriminatory basis (i.e. from which country the investment flows), but rather through a politically viewed difference between public and private investors.

Reporting Requirements

Countries have reporting standards in order to collect taxes and regulate governance. Reporting requirements should be quite public and any special requirements for certain industries, for example, should be public and clear. Again such rules should be non-discriminatory.

Governance of SWFs

If a host nation believes, as noted above, that sovereign investors pose problems that private investors do not, they may choose to limit SWFs to passive investments. “Passive investor” is a somewhat loose term. Some nations may choose just to keep SWFs off the Board of companies, but others may actually prohibit them from voting their shares. Whatever, the rules they should be explicit. Of course any type of discriminatory behavior designed only for SWFs will make investment in the host country less desirable and will require a greater rate of return than would normally be the case.

Prohibitions on Investment by SWFs

The most obvious discriminatory treatment that SWFs are likely to face concerns which investments are permitted. While investments in security related companies may top the list, other industries running from important profit centers, to banking, to cultural icons may elicit prohibitions on investment. The ramification of such intervention is to reduce any benefits that may accrue from SWF investment interest and execution.

PROPOSALS

Proposal I

This paper has focused on maximizing the benefits of the owners of the Fund. While we believe that the free flow of capital ultimately leads to more global benefits, we take the position that the Fund “should be” designed to maximize the owners’ welfare. There are always going to be some conflicts. For example, there may be the conflict of maximizing firm value versus owners’ value in terms of plant location or marketing strategies. However, these dilemmas are not unique to sovereign wealth funds as pension funds and even mutual funds might meet such dilemmas. In such cases, we believe the rule is to vote to the owners’ of the Funds best outcome, just as would a private investor.

While recognizing the grayness problems of investments, we believe that Sovereign Wealth Funds are well served by considering at least two funding tactics that are likely to provide social and economic value to their citizen owners. We note that the Santiago Principles may require that the strategy offered below be noted explicitly in the Fund’s Charter.

We propose that Sovereign Wealth Funds voluntarily allocate a certain proportion of capital dedicated to a financing facility for domestic entrepreneurial ventures. The Fund would help finance an “incubator” type system to increase the likelihood of start-up success. Financial arrangements could be of a strictly lending apparatus, a lending/equity model, or an all equity model. In the latter two cases the Fund would share in the private sector success or failure. Such Funds would likely be more successful if accompanied by low cost or free consulting services from University or private consulting firms.

We propose that a Fund invest a certain share of Fund financial resources in domestic capital infrastructure. Returns on infrastructure investments to the citizen owners are difficult to measure. However, there is generally a view that the investment in public infrastructure leads to enhanced private sector productivity. Of course, in some cases public infrastructure can earn direct returns (such as toll roads, bridges, railroads and port investments). Note also that the objective is to maximize the utility of the citizen owners. Such owners may have a “richer” utility function than the two parameter (risk and return) function often assumed. That means that even if investments in better school buildings, libraries etc. do not yield strong financial investment returns, the utility enhancing nature of the investment may well lead to a greater investment maximization outcome.

Proposal II World Investment Organization

We propose here the establishment of a World Investment Organization. The WIO would be a sister organization to the WTO and focus on both Direct Foreign Investment and Global Portfolio Investment. (Mattoo and Subramanian, 2008)[11] Financial economists generally agree that a world in which financial resources can flow freely is likely to produce better results than a world with many restrictions. The WIO would be formed to promote the free flow of capital but only when reasonable safeguards are in place. The WIO would help to establish rules for global investing including the focus of this paper Sovereign Wealth Fund investing when such investments are made abroad. The charge should be to establish reasonable reporting standards and codes of investment conduct including governance rules and investor and host country rights. Signers to the agreement would agree to operate by the WIO established rules and to adjudicate differences in a Court established for the purpose of judging disputes falling under the WIO umbrella.

SUMMARY OPINION

It is the author's view that, generally speaking, Sovereign Wealth Funds bring far more in benefits, to all interested parties, than they are likely to bring in costs. For the home country of the SWF, it is crucial that vast amounts of surplus foreign currency be invested for the welfare of the country. Of course poor investment decisions can be made, but overall the expectation is that the citizens of SWF investments will benefit from those investments. Host countries clearly benefit by gaining capital that they would otherwise not receive or receive only at greater cost. Thus it is likely that the cost of capital is lowered to the firms receiving the infusion. Global society benefits from a better allocation of financial resources and more financial security analysis. Many countries, if not all, have mechanisms in place for freezing capital assets or taking investors to court that have somehow violated the welfare of host country society. It is folly to think that a Sovereign Wealth Fund is somehow going to abscond with the host country's jewels. However, because the utility function of Sovereign Wealth Fund investors may differ from that of the typical capitalist, it is possible that some malfeasance would occur. Such inappropriate behavior can generally be limited by host country law. In addition, note that it is not clear that a Sovereign Wealth Fund would be somehow less ethical than a private capitalist. In fact, the opposite may be true.

In sum, we prefer to ere on the side of SWF freedom to invest abroad. While it can be argued that investing at home would benefit the SWF's country of origin as well, and we have here argued for some domestic investing, global investing is not only a great diversification tool but may also enhance the home country's wealth.

ENDNOTES

1. Johnson, S., (2007). The Rise of Sovereign Wealth Funds. Finance and Development, 44, No. 3.
2. Sovereign Wealth Fund Institute, swfinsitute.org/funds.php 7/11/09.
3. ibid. Sovereign Wealth Fund Institute.

4. Ibid. Sovereign Wealth Fund Institute.
5. It is noted that Singapore's Temasek Holdings claims not to be a SWF due to certain firewalls built against government interference. However, most analysts view it as a SWF due to the fact that it is owned by the Singapore government and is investing for the welfare of the nation.
6. Sovereign Wealth Fund Institute, swfinsitute.org/funds.php 7/11/09.
7. See: SWF Institute Linaburg-Maduall Transparency Index at swfinstitute.org.
8. vccircle.com10/17/08.
9. International Working Group of Sovereign Wealth Funds, Sovereign Wealth Funds Generally Accepted Principles and Practices, "Santiago Principles", October 2008.
10. See: Fernandez, N., Sovereign Wealth Funds: Investment Choices and Implications around the World, Finance Working Paper 238/2009, ECGI, February 2009. In which the author shows that within his sample, SWFs add value and management efficiency to the companies in which they invest.
11. Mattoo, A., and Subramanian, A., Currency Undervaluation and Sovereign Wealth Funds: A New Role for the World Trade Organization, Policy Research Working Paper 4668, The World Bank Development Research Group Trade Team, July 2008. In which the authors argue that the management of Sovereign Wealth Fund disputes should be under the umbrella of the WTO. We have no objection to the WIO being a subsidiary of the WTO assuming governing rights are properly constructed.