

Sovereign Wealth Funds Are Going Mainstream

by Loch Adamson, Institutional Investor, 30 Aug 2010

Once-buccaneering sovereign wealth funds are tempering their risk appetite after the crisis, yet they remain the world's ultimate long-term investors.

The financial crisis has forced most investors to question their assumptions about markets and reconsider their strategies. For sovereign wealth funds, those shadowy juggernauts that once seemed impervious to market swings, the challenge has been particularly great.

When sovereign funds burst onto the public scene a few years ago, their massive buying power and lack of transparency aroused fear and distrust in many Western capitals, where officials worried that governments might use sovereign funds to achieve political rather than commercial objectives. Then, when the crisis erupted and Western banks were desperate for capital, sovereign funds suddenly found themselves courted for their deep pockets and long investing horizons. Among some of the more notable deals: The Abu Dhabi Investment Authority came to Citi-group's rescue by paying \$7.5 billion for a 4.9 percent stake; China Investment Corp. injected \$5.6 billion into Morgan Stanley; and Singapore's Temasek Holdings made chunky investments in Merrill Lynch & Co., Barclays and Standard Chartered.

These days, however, the formerly high-flying sovereign wealth funds have come back to earth. Many suffered losses on their big financial services investments. Others have been whipsawed by the same volatile market swings that have hammered countless institutional investors. And some — like the Kuwait Investment Authority, Ireland's National Pensions Reserve Fund and Russia's two funds, the Reserve and National Wealth funds — have been raided by their own treasuries to bail out troubled banks and companies in their domestic economies. Now many sovereign funds find themselves like most other institutional investors: struggling to scrape together profits in unpredictable markets and rethinking their appetite for risk as they restructure their portfolios.

"Many sovereign wealth funds are now asking themselves, 'Does a strategy that was formulated in the pre-crisis environment still remain valid in a post-crisis world?'" says Ousmène Mandeng, head of public sector investment advisory at the \$35.3 billion-in-assets Ashmore Investment Management in London. "That is not an easy question to answer. The short-term outlook is uncertain, and the medium-term view is likely to be a function of the short term if we slide back into another recession. Many institutions are still holding back a little until they have a better idea of what this new environment will look like."

Although the performance of specific funds is hard to judge because so few disclose their results, sovereign funds have clearly taken some big hits in the crisis. Assets managed by sovereign wealth funds declined to an estimated \$3.8 trillion at the end of 2009, from \$4 trillion a year earlier, according to a report published in July by the United Nations Conference on Trade and Development. Those figures most likely understate the true volatility of the funds. Analysts at Deutsche Bank estimate that sovereign wealth fund assets hit a low of about \$3 trillion in early 2009, when global markets were tanking.

The Abu Dhabi Investment Authority, established in 1976 to invest the Gulf emirate's massive oil earnings, is the world's largest sovereign wealth fund, with an estimated \$627 billion in assets at the end of March, according to Institutional Investor's first ranking of the World's Biggest Sovereign Wealth Funds. Norway's Government Pension Fund Global is the second-largest fund, with \$461.5 billion in assets. The Saudi Arabian Monetary Agency, China Investment Corp. and Hong Kong Monetary Authority round out the top five.

The new cautious attitude among sovereign wealth funds is most evident in the financial sector, where funds made some of their most prominent investments — and recorded some of their most notorious losses. Some sovereign wealth funds have pulled back sharply from Wall Street. Temasek reportedly sold its stake in Bank of America Corp. last year at a loss estimated at as much as \$4.6 billion. Others have dialed back their exposure more modestly. As for new money, the funds have abandoned their spendthrift ways. Sovereign wealth funds made just 28 deals, worth a total of \$10.2 billion, in the financial services sector in 2009, a far cry from the 49 publicly reported deals worth \$81.7 billion in 2008, according to the Monitor Group, a market research and advisory firm based in Cambridge, Massachusetts. Across all industry sectors, funds tracked by the Monitor Group made just 113 publicly announced investments, worth a total of \$68.8 billion, in 2009 — down from 175 deals, worth \$128 billion, a year earlier. Hedge funds are still able to attract the interest of sovereign wealth funds, but private equity, which has long been the favorite playground of the sovereigns, lost much of its shine during the crisis.

More broadly, several sovereign funds have been turning to passive strategies for more of their exposure and limiting active investing to areas where they believe they have a clear advantage or market view. The approach is

one that Abu Dhabi's former chief, Ahmed bin Zayed al-Nahyan — who was killed in a glider crash in Morocco in March — began to implement in 2007, raising the fund's passive allocation to 60 percent from 45 percent.

This shift is far from uniform, and sovereign funds haven't given up on risk entirely. But the new attitude represents a significant change from the precrisis years, when many sovereign funds boldly sought higher returns by ramping up their equity allocations, taking direct stakes in companies and seeking more arcane (and less liquid) investments in private equity and hedge funds.

“The crisis has left an indelible mark on sovereign wealth funds for the simple reason that all of the assumptions that went into managing those assets have been questioned dramatically,” says Andrew Rozanov, head of sovereign advisory at London-based fund-of-hedge-funds firm Permal Investment Management Services and the man who coined the term sovereign wealth fund. “Some funds discovered that they'd underestimated the amount of U.S. dollar liquidity that they needed to hold in their portfolios. Others realized that they'd miscalculated the risk tolerance of the general public, which didn't fully understand and appreciate their long-term investment horizons. And many of those funds that were trying to emulate some version of the Yale endowment model were disappointed — and may now be taking a long, hard look at its key tenets.”



In Norway the Finance Ministry demanded that Norges Bank Investment Management, the central bank arm that oversees Norway's giant pension fund, submit to an external review of its active-management program. Other sovereign investors have kept internal debates about investment strategy private, but there is little doubt among asset managers who work closely with sovereign investors that such debates are raging widely.

Beyond the urgent need to address portfolio strategy, several sovereign wealth fund investors have faced political demands on their capital. Under a government-ordered rescue plan, the Kuwait Investment Authority in January 2009 took a 16 percent stake in the struggling Gulf Bank to help the company raise 375 million dinars (\$1.3 billion) in emergency funding, and it injected about 400 million dinars into a dedicated fund to support the local stock market in the first four months of that year. Abu Dhabi has had to bail out its troubled fellow emirate, Dubai, pumping in an estimated \$10 billion in emergency funding since last year. That funding has dramatically reduced the amount of oil revenue available to ADIA.

In Russia the government used the National Wealth Fund, a pool designed to be invested abroad for future generations, to support the domestic stock market at the peak of the crisis. It has also tapped the Reserve Fund to help make up its budget shortfall, a purpose for which it was intended. The Russian government has also started diverting hydrocarbon revenues to the budget, a move that could starve its sovereign wealth funds of capital.

In the wake of those cash drains, sovereign wealth funds now face the problem that without clear governance guidelines defining how their funds can be deployed, their complex liabilities may be hard, if not impossible, to model and manage. That heightened vulnerability has made some investment teams more cautious. “The greatest risk to sovereign wealth funds that I see is political risk, not the risk of broader macroeconomic uncertainty,” says Judith Posnikoff, a co-founder of Irvine, California-based fund-of-hedge-funds firm Pacific Alternative Asset Management Co., which works with a number of sovereign funds. “If the global economic recovery continues to slow, certain regions of the world may see a need to raid those funds.”

The challenges facing sovereign funds may have multiplied, but these investors remain a potent force with enviable long-term prospects. Sovereign wealth funds control about 3 percent of all institutional money invested in global markets, according to Deutsche Bank, and they are likely to enjoy strong inflows from oil and other commodity revenues and a recovery in export earnings. Steffen Kern, a director of research at Deutsche Bank in Frankfurt, projects that sovereign wealth fund assets will more than double, to \$10 trillion, by 2020. Stephen Jen, who followed the rise of sovereign wealth funds for several years as a global currency strategist for Morgan Stanley and now works as head of macroeconomics and currencies at London hedge fund firm BlueGold Capital Management, says sovereign fund assets could hit \$10.9 trillion as early as 2015.

Sovereign wealth funds also face a more-benign political environment, reducing the prospect of foreign opposition to their investments. A key factor here has been the 2008 adoption of generally accepted principles and practices, known as the Santiago Principles after the city in which they were drafted. These principles, which call for funds to

have clear governance and investing guidelines, follow economic criteria and comply with regulatory requirements in countries where they invest, followed rounds of negotiations among 26 countries under the auspices of the International Monetary Fund. Although some critics dismiss the voluntary guidelines as toothless, the principles have provided a framework for better disclosure and helped allay the fears of Western politicians. The subsequent creation of the International Forum of Sovereign Wealth Funds, which brought together senior managers of 22 sovereign funds and officials from six recipient countries at a meeting in Sydney in May, has eased tensions further by creating a permanent avenue for dialogue.

As they seek to adjust their risk appetite, sovereign funds are well positioned to take advantage of market opportunities, says Mohamed El-Erian, CEO and co-CIO of Pacific Investment Management Co. in Newport Beach, California. “Virtually everybody was caught offside by the financial crisis,” he says. “The question is, How quickly do people emerge from damage--containment mode and start looking forward? I see that as a function of two attributes: an investor’s initial conditions and mind-set. For us sovereign wealth funds score highly on both. They are long-term, patient investors, with surplus capital — and they are trying to figure out how they need to be positioned for the next ten to 20 years.”

The most dramatic and visible example of a sovereign wealth fund positioning itself for future growth while doing postcrisis damage control can be found within the halls of Norges Bank -Investment -Management in Oslo. Norway’s Government -Pension Fund Global, as it is known, is the second-largest sovereign fund in the world, with \$462 billion in assets, after Abu Dhabi’s ADIA, but the similarities end with size. Unlike ADIA, which is notoriously secretive and inaccessible, NBIM is transparent about its strategy, which has long relied on passive indexing.

Under the leadership of Yngve Slyngstad, who took over as CEO in January 2008, NBIM embarked on a major overhaul of its portfolio strategy right in the thick of the crisis. Slyngstad wanted to ramp up returns by taking larger stakes of up to 10 percent in individual companies, up from a previous ceiling of 5 percent, increasing allocations to emerging markets and making long and short bets on global investment sectors and currencies. Norway’s Finance Ministry approved the new strategy and parliament ratified it in June 2008. The fund, which had been building up its equity holdings since the summer of 2007, lifted its allocation to 60 percent from 40 percent only to be hit by the chaos that followed the September 2008 bankruptcy of Lehman Brothers Holdings.

By the end of 2008, the fund was down 23.3 percent, the worst loss in its 14-year history. The fund took big hits on its holdings of U.S. bank stocks; fixed--income didn’t perform much better, owing to the fund’s exposure to U.S. mortgage--backed securities and bonds issued by European financial institutions. Worse, the active--management program didn’t perform as Slyngstad had hoped, contributing a negative excess return of 3.4 percentage points relative to the fund’s customized benchmark portfolio. But having agreed on a strategy with the Finance Ministry, Slyngstad and his team stayed with it.

“We were able to make such a significant move in the middle of the financial crisis because of the governance structure of the whole fund,” says Slyngstad. After plunging equity prices reduced the fund’s allocation to 50 percent at the end of 2008, he and his team bought equities in the first quarter of 2009 — at the depressed prices then prevailing — to get back to their 60 percent target. “We have a 30-year horizon, so it would have been more of a challenge to explain had we not rebalanced,” he explains. “We couldn’t just say that, ‘Well, we forgot the rules this time, because this time was different.’”

NBIM’s approach stood out among sovereign wealth funds, according to Gary Smith, head of central banks, supranationals and sovereign wealth funds at BNP Paribas Investment Partners in London. Many of NBIM’s peers didn’t make an effort to rebalance their portfolios even as equity markets plummeted. “They allowed market forces to change their asset allocations for them,” Smith says.

Smith blames the sudden paralysis at most sovereign funds on their political masters, who recoiled at the scale of the equity losses suffered in the crisis. By contrast, he says, NBIM had done such a good job of selling its asset-allocation strategy to the Finance Ministry before the crisis that politicians didn’t second--guess Slyngstad. The ministry was more intent on understanding the contribution that active management had made to the fund’s losses. By August 2009 the ministry had launched an external review of the new strategy, and by the time the report was published, in December 2009, the fund was already well on its way to recovery. Norway’s fund posted a record return of 25.6 percent in 2009, 4.1 percentage points higher than its benchmark portfolio. This year the fund rose 3.9 percent in the first quarter, but widespread declines in global equity markets caused the fund to lose 5.4 percent in the second quarter.

The pros and cons of active management have been on the minds of all institutional investors, especially sovereigns. Before the crisis many large institutions assumed that active management was the best way to invest virtually all their assets, says John Nugée, London-based head of the official institutions group at Boston's State Street Global Advisors. Now that approach has begun to shift, he says. Many sovereign investors are assuming that passive management is a good place to start when entering a new or unfamiliar asset class.

"Passive management ties in with increasing asset-class diversification too," Nugée says, "because if you have a presumption of managing slightly more of your assets passively, you preserve that part of the risk budget — that portion of the volatility that would have gone into actively managing a portfolio — and you make it available to move into other, new asset classes in a passive way."

The distinctions now being made between active and passive management are part of a more fundamental shift in institutional portfolio strategy, and one that some sovereign funds are at the forefront of. Many fund managers are now reviewing their portfolios by looking at the underlying risks inherent in certain asset classes. A fund putting money into private equity, for example, is effectively taking on illiquidity risk and certain macro-economic risks, such as inflation. Most managers ignored those perils during the boom years, if they were even aware of them at all, but the crisis demonstrated how broad, systemic risks could affect seemingly diversified investments in a similar way.

Prompted in part by the review of its active-management program, NBIM has begun to focus more closely on systemic risks and integrate those assessments into its portfolio strategy. And rather than concentrating only on the potential negatives of those risks, Slynstad says, he and his team are using risk factors to size up possible opportunities. Europe's sovereign-debt crisis is a case in point. The Norwegian fund went into the crisis significantly underweight the government bonds of many southern European countries, he says. His team has taken advantage of the recent turmoil to increase that weighting, buying bonds at depressed levels and getting a hefty yield premium for taking on the credit risk. "We are now looking at these events as opportunities rather than as the scary things you have to avoid," Slynstad says.

Even as they refine their approach to risk, sovereign wealth funds continue to show an appetite for big, high-profile investments. In August 2009, Qatar Holding, an arm of the Qatar Investment Authority that makes direct investments, bought 10 percent of Germany's Porsche Automobil Holding for a reported \$9.98 billion. In May of this year, Qatar Holding splashed out again and bought fabled London department store Harrods for a reported £1.5 billion (\$2.3 billion).

Other funds have shown an interest in commodities and infrastructure plays. In July 2009, China Investment Corp. paid a reported C\$1.74 billion (\$1.5 billion) for a 17.2 percent stake in Teck Resources, Canada's largest mining and metallurgical company. Last month, ADIA reportedly agreed to team up with Morgan Stanley and U.K. private equity group 3i Group to bid for the high-speed railway that links London with the Channel Tunnel.

Such prominent investments are bound to attract closer scrutiny, especially given the fact that many sovereign funds give limited information about their strategy and often fail to disclose the amount of funds they manage. The Santiago Principles have helped ease political concerns; but Sven Behrendt, a visiting scholar with the Carnegie Middle East Center in Beirut, contends that only four of the 26 funds that signed up to the agreement — the Australian Future Fund, Ireland's National Pensions Reserve Fund, Norway's Government Pension Fund Global and the New Zealand Superannuation Fund — comply fully with the principles.

Sovereign wealth funds will have plenty of opportunity to show their hand in the years ahead. Their pockets are deep, and growing, and they still have a much longer time horizon than most institutional investors.

"We will see greater differentiation among institutions as their needs start to diverge," says Ashmore's Mandeng. "Pension funds will come under greater redemption demands and will need to be in redeemable assets. Sovereign wealth funds, however, are still likely to have more latitude — and may well prove to be the only true long-term investors left standing."

Sovereign Wealth Funds: II's 2010 Ranking

Institutional Investor's inaugural ranking of the world's largest Sovereign Wealth Funds was compiled from questionnaires filled out by the institutions themselves and from information drawn from fund web sites and annual reports. When official data were unavailable, we relied on estimates from a variety of outside analysts. Estimates are footnoted where used. All data are in millions of dollars as of March 31, 2010, converted from local currencies as necessary, unless otherwise specified. II used the International Working Group of Sovereign Wealth Funds' definition: Sovereign Wealth Funds are special purpose investment funds or arrangements, owned by the general government. Created for macroeconomic purposes, SWFs hold, manage or administer assets to achieve financial objectives and employ a set of investment strategies that include investing in foreign financial assets. SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses and/or receipts resulting from commodities exports. Senior Editor Jane B. Kenney led the project, with the assistance of II's Asia Bureau Chief, Allen T. Cheng.

Sovereign Wealth Funds - 2010 II Ranking									
Rank	Sovereign Wealth Fund (Country)	Total Assets Under Management	Equities Domestic	Equities Non-Domestic	Fixed Income Domestic	Fixed Income Non-Dom.	Cash and Equivalents	Real Estate	Alternative Investments
1	Abu Dhabi Investment Authority (United Arab Emirates)	627,000 ⁽¹⁾							
2	Government Pension Fund Global (Norway)	461,498							
3	Saudi Arabian Monetary Agency (Saudi Arabia)	428,962 ⁽¹⁾							
4	China Investment Corp. (China)	300,000							
5	Hong Kong Monetary Authority (Hong Kong)	277,462							
6	Kuwait Investment Authority (Kuwait)	277,000 ⁽¹⁾							
7	Caisse de depot et placement du Quebec (Canada)	197,401							
8	Government of Singapore Investment Corp. (Singapore)	185,000							
9	Temasek Holdings (Singapore)	132,934 ⁽¹⁾							
10	National Social Security Fund (China)	113,589							
11	National Wealth Fund (Russia)	89,245				89,245			
12	Libyan Investment Authority (Libya)	65,000 ⁽¹⁾							
12	Qatar Investment Authority (Qatar)	65,000 ⁽¹⁾							
13	Fond de Regulation des Recettes (Algeria)	53,760							
14	Reserve Fund (Russia)	52,703							
15	Fonds de Reserve pour les Retraites (France)	46,413							
16	Future Fund (Australia)	37,548	6,705	9,528	7,765		5,821	1,409	6,319
17	Alaska Permanent Fund Corp. (USA)	34,940	9,330	9,499	5,617	1,008	1,320	3,390	4,776
18	National Pensions Reserve Fund (Ireland)	32,895		12,900		1,789	5,278	607	12,322
19	Brunei Investment Agency (Brunei)	30,000 ⁽¹⁾							
20	Khazanah Nasional (Malaysia)	28,192							
21	Fonds Strategique d'Investissement (France)	26,906							
22	National Fund of the Republic of Kazakhstan (Kazakhstan)	25,356							
23	Oil Stabilisation Fund (Iran)	20,000 ⁽¹⁾							
24	Korea Investment Corp. (South Korea)	18,458							
25	State Oil Fund of the Republic of Azerbaijan (Azerbaijan)	16,235							
26	Alberta Heritage Savings Trust Fund (Canada)	14,110	1,974	4,862	3,483		121	1,584	2,087
27	New Zealand Superannuation Fund (New Zealand)	11,944	809	5,577	110	1,862		1,063	2,523
28	Permanent Wyoming Mineral Trust Fund (USA)	11,735	1,853	1,122	6,329	502	883	308	738
29	Economic and Social Stabilization Fund (Chile)	10,778			3,766	3,782	3,230		
30	Bahrain Mumtalakat Holding Co. (Bahrain)	9,080 ⁽²⁾	5,965 ⁽³⁾	764 ⁽²⁾			32 ⁽²⁾	2,319 ⁽²⁾	
31	Pula Fund (Botswana)	6,590 ⁽¹⁾							
32	Petroleum Fund of Timor-Leste (Timor-Leste)	5,376			5,341		3		32
33	Pension Reserve Fund (Chile)	3,267			1,143	1,146	978		
34	Heritage and Stabilisation Fund (Trinidad & Tobago)	2,992		664		1,304	1,024		
35	State Capital Investment Corp. (Vietnam)	2,232	1,097				1,094	41	
36	Palestine Investment Fund (Palestine)	800 ⁽¹⁾							
37	Government Investment Fund (Indonesia)	198	11		143		33		11

Footnotes
* Assets are in US\$ million as of March 31, 2010, unless otherwise indicated, and are converted from relevant currencies at the exchange rates on that date, as necessary. Portfolio mix might not equal total assets because of conversion and rounding.
(1) Estimate.
(2) As of December 31, 2009.
(3) As of December 31, 2009; includes direct investment holdings.