

Sovereign Wealth Funds: AN EXPERT'S POINT OF VIEW

By Professor Josh Lerner

Although sovereign wealth funds (SWFs) have existed for more than five decades, they have attracted considerable attention recently because of the accelerating pace of their growth and because of a number of highly public transactions that drew them into the global spotlight.

For an expert's perspective on SWFs, *Investment Management Review* spoke with Josh Lerner, the Jacob H. Schiff Professor of Investment Banking at Harvard Business School, with a joint appointment in the Finance and the Entrepreneurial Management Units. Along with Antoinette Schoar of MIT's Sloan School of Management, Professor Lerner is undertaking research—due to be completed by the end of the year—that for the first time provides a definitive look at their activities, their performance and the determinants of differences across various SWFs. He has also worked on an advisory basis with a number of these funds.

What is a sovereign wealth fund (SWF)?

Although there is no universally accepted definition of a sovereign wealth fund, my minimalist description is that an SWF is a fund owned by a state that invests in various financial assets.

According to the IMF, there are as many as 40 different SWFs, in nations as disparate as United States and Kazakhstan. Market estimates of their size are difficult to determine because they often lack transparency: disclosure regulations and practices differ widely from country to country. But as of early 2008, the Securities and Exchange Commission estimated that total SWF assets were nearly \$2.5 trillion. To place this figure in a broad investment context: the amount SWFs currently manage exceeds the \$1.4 trillion by hedge funds, but it is much less than the \$53 trillion managed by mature-market institutional investors (such as pensions, insurance funds and endowments) and represents only 1.2 percent of global financial assets, which exceed \$190 trillion.

Most of their growth has occurred recently. In 1990, for example, SWF assets were estimated at only \$500 billion. Over the past three years, they have achieved a 24% annual growth rate and could grow to \$12 trillion AUM—a growth rate of \$1 trillion a year—during the next eight years.

What is the history of SWFs?

Countries like Kuwait, Norway, and Singapore have used SWFs as instruments through which to buy assets with their surplus foreign exchange since the 1950s. They had little or no international debt and large current account surpluses, and sought new strategies to insulate themselves from exchange fluctuation. The Kuwait Investment Board, established in 1953 to invest Kuwait's surplus oil revenue, is widely considered to be the first SWF.

SWFs generally fall into two categories, based on the source of the foreign exchange assets:

- Commodity funds are financed by surplus foreign exchange earnings from commodity exports owned or taxed by the government. They serve different purposes, including the stabilization of fiscal revenues, intergenerational savings, and balance of payments sterilization (that is, keeping foreign exchange inflows from stoking inflation).
- Noncommodity funds are financed through excess foreign exchange assets accumulated as a consequence of running persistent current account surpluses, often from exports outstripping imports.

To date, SWFs have invested in a broad range of asset classes, including government bonds, asset-backed securities, corporate bonds, equities, real estate, the derivatives markets, alternative investments (such as private equity and hedge funds), and foreign direct investments in individual firms and properties. Historically, their dominant mode of operation has been investment through partnerships or minority investments in companies, with the perception that these are less politically sensitive. They have traditionally been long-only, minority-stake, passive investors, although there have been instances where short investments or currency plays of different kinds have been made.

The reaction to their recent increased visibility in the market, however, has raised the question of whether the development of operational best practices, focused on governance, transparency and accountability—all of which vary tremendously country by country—would benefit the international financial system. The IMF is currently developing best practice guidelines for SWFs and expects to release a first draft this coming October.

Why have SWFs gained so much visibility lately?

Despite the visibility and publicity these funds have received recently, there's not a lot we really know about these institutions, in part because of a lack of credible data and reliable research. We do know, though, that they've received attention because of their rate of growth. With so much money flowing into commodity-based countries in general, and oil-producing countries in particular, these funds have experienced explosive expansion. In addition, instead of investing in partnerships with other funds—their traditional mode—they made a few high-profile direct investments, which have attracted some controversy.

In my view, SWFs have been caught in the same crossfire as private equity groups. Throughout much of the Western world, there's a great deal of anxiety about globalization—and its implications for passive ownership, for employment, etc. When there's a broad apprehension about macroeconomic trends that are very difficult to control or manage, the tendency is to look for a source to blame that exemplifies the phenomenon. Just as there are been claims that private equity groups destroy jobs and inflict other deleterious economic effects—many of which, it seems, are overstated, as our recent study for the World Economic Forum documents—it is also fair to say that much of the anxiety over sovereign funds has been a manifestation of the general unease over the emergence of developing countries and their role in the global financial markets.

What is the future of SWFs?

No one can argue that SWFs are big and growing. They are already sizeable enough to be a significant factor in the global financial system, and are likely to grow larger over time, in both absolute and relative terms. Certainly, when there's no evidence that the price of oil will go back to \$20 a barrel or that commodity prices in general will return to the levels of, say, the 1990s. SWFs are a phenomenon that will be with us for a considerable amount of time.

My view is that, fundamentally, it's a good idea for states with substantial foreign currency holdings to launch SWFs. From an investment management perspective, it makes financial sense. If we put ourselves in the shoes of the Chinese government, with a large and growing collection of foreign revenues and foreign exchange, it is no longer logical to put it all into U.S. Treasury bonds, which has been the primary investment of choice for many years.

As in university endowments, which to me are an apt analogy, SWFs are increasingly seeking the benefits of portfolio diversification, which means larger exposures to equities and equity-linked securities. Emulating some of the strategies that successful, long-run investors have taken seems like a distinctly valid approach.

One of the most challenging questions has been that of disclosure. In their search for positive returns, university endowments can be secretive about their investment choices, not because they're hiding anything but because there is a tendency for imitation. If an endowment's manager has an innovative insight for generating above-market results, that level of performance is hard to maintain when 40 funds-of-funds are duplicating the strategy. Alpha can be competed away very quickly.

Clearly, SWFs' investment decisions are more complicated than university endowments': countries' selections are often politicized in a way that a typical university endowment is not. An overlay of political sensitivity goes with being an SWF and as a result the discussion about these issues is not likely to go away soon.

In many senses, the role of SWFs have been hugely advantageous to the U.S. economy—and by direct extension to the global economy—by introducing extremely timely and beneficial liquidity when there was great deal of anxiety about the financial system. At the same time, we will probably see more demands on SWFs—just as private equity groups have faced more pressure—to disclose their activities.

Market participants across the globe will be watching closely to see how all this is going to play out.

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