

Weathering the Storm

**SOVEREIGN WEALTH FUNDS IN THE GLOBAL
ECONOMIC CRISIS OF 2008**

SWF Annual Report 2008
April 2009

MONITOR

Founded in 1983, Monitor Group is a global firm that serves clients through a range of professional services — strategic advisory, capability building and capital services — and integrates these services in a customized way for each client.

Monitor Group has approximately 1500 employees worldwide and is focused on helping clients grow in ways that are most important to them. To that end, we offer a portfolio of services to our clients who seek to stay competitive in their global markets. The firm employs or collaborates with some of the world's foremost business experts and thought leaders to develop and deliver specialized capabilities in areas including competitive strategy, marketing and pricing strategy, innovation, national and regional economic competitiveness, organizational design and capability building.



FEEM is a nonprofit, nonpartisan research institution devoted to the study of sustainable development and global governance. Officially recognized by the President of the Italian Republic in 1989 and in full operation since 1990, FEEM has grown to become a leading research centre, providing timely and objective analysis on a wide range of environmental, energy and global economic issues. FEEM's mission is to improve — through the rigor of its research — the credibility and quality of decision-making in public and private spheres. This goal is achieved by creating an international and multidisciplinary network of researchers working on several innovative programmes, by providing and promoting training in specialized areas of research, by disseminating research results through a wide range of outreach activities, and by delivering directly to policy makers via participation in various institutional fora.

EDITORS:

William Miracky
SENIOR PARTNER, MONITOR GROUP
william_miracky@monitor.com

Bernardo Bortolotti
DIRECTOR, FONDAZIONE ENI ENRICO MATTEI
bernardo.bortolotti@feem.it

Weathering the Storm

SOVEREIGN WEALTH FUNDS IN THE GLOBAL ECONOMIC CRISIS OF 2008

From the Editors	2
Monitor-FEEM SWF Definition	6
Trends	10
2008 AS IT HAPPENED.....	10
2008 HIGHLIGHTS.....	11
YEAR IN REVIEW 2008	16
Q4 OVERVIEW	27
SELECTED NEWS AND EVENTS OF 2008	31
Articles	38
SOVEREIGN WEALTH FUNDS AND ACTIVE OWNERSHIP	38
By Andrew Rozanov, Managing Director and Head of Sovereign Advisory, State Street Global Markets	
SWFS AND THE CRISIS: PUTTING A BRAKE ON GROWTH.....	45
By Paola Subacchi, Chatham House	
SOVEREIGN WEALTH FUND LOSSES IN LISTED FIRM STOCK INVESTMENTS	53
By Veljko Fotak, Doctoral Candidate, University of Oklahoma Bill Megginson, Professor & Rainbolt Chair in Finance, University of Oklahoma, Hui Li, MBA Student, University of Oklahoma	
INVESTING IN ENERGY: WHAT NOCS SHOULD LEARN FROM SWFs	59
By Victoria Barbary, Office of the Chairman, Monitor Group	
Appendix	64
MONITOR-FEEM SWF TRANSACTION DATABASE	65
TEN LARGEST DEALS OF 2008	69
HIGHLIGHTS OF THE LITERATURE ON SWFs	70
SELECTION OF LITERATURE ABSTRACTS	73
ACKNOWLEDGEMENTS.....	92



SAILS ON THE CHARLES RIVER, BOSTON, MASSACHUSETTS
IL DUOMO, MILAN, ITALY

From the Editors

Since global markets first recognized the growing phenomenon of sovereign wealth funds (henceforth SWFs), these funds have been controversial. Initially depicted as scary new “barbarians at the gate” shaking the logic of capitalism, SWFs quickly

SWFs are likely to remain important sources of liquidity to a distressed global economic system.

turned into the white knights of Wall Street as the sub-prime crisis started to hit hard. The synchronic worldwide recession triggered by the market crash provided an automatic stabilizer of the global imbalances partly responsible for the rise of sovereign wealth, and today the funds are no longer seen as something to be dreaded and their activities

no longer routinely make headlines. However, with assets worth more than \$2 trillion, SWFs are likely to remain important sources of liquidity to a distressed global economic system.

Interestingly, the public firestorm on SWFs ignited with limited fact-based information about what they really are, how many assets they manage, where they invest, and how they operate. True, the lack of transparency of most funds contributed to the controversy, but their prominence in the media and in the policy agenda dwarfed the available knowledge on this new and challenging phenomenon.

A small group of front-runners, and certainly Monitor ranks among them, started to fill this information gap. The research community reacted more slowly, but started to produce a first batch of studies using the scarce data and information publicly available. However, it became quickly apparent that the benefit from joint work and mutual sharing of data and information of such a new and complex phenomenon could be substantial.

This is the logic underlying the partnership between Monitor Group and Fondazione Eni Enrico Mattei (FEEM) that we are launching today with this joint SWF Annual Report.

We have united forces to create one of the largest and most comprehensive databases on global SWF deals using publicly available data. This has been achieved by setting forth a rigorous definition of SWFs, by merging and cross-checking the two existing databases which have been independently assembled, and by streamlining our routines for the collection and screening of data to monitor current and future SWF investment.

The result is a rich source of information about SWFs. The Monitor-FEEM SWF Transaction Database contains 1,158 deals completed by 17 funds in 11 countries for the period between January 1, 1981 and December 31, 2008, and will be regularly updated on a quarterly basis.

We are pleased to present to the reader the first issue of our joint SWF Annual Report, covering SWF activity during 2008 and using the newly created database. The report aims to provide descriptive information about the recent trends with additional insights gained from ongoing research produced in-house and externally. Accordingly, we feature contributed articles by our team and from renowned international experts. We are particularly pleased to host in this issue an article by Andrew Rozanov, an investment banker and financial analyst who is universally

We are pleased to present to the reader the first issue of our joint SWF Annual Report, covering SWF activity during 2008 and using the newly created database.

In this issue, we host articles by Andrew Rozanov of State Street Global Markets and Paola Subacchi from Chatham House.

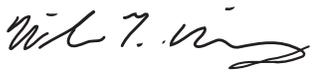
recognized as a leading figure in the study of SWFs. Indeed, he coined the term in his path-breaking article “Who owns the wealth of nations?” (2005). The report also boasts an interesting article by Paola Subacchi from Chatham House, the well known London-based think tank, which has also tracked the evolution of SWFs since the early days.

The report shows not only that the global economic crisis has manifested a profound effect on investment strategies in 2008 but also quantifies this effect and enables us to offer the following conclusions.

- Despite the crisis, the volume of investment activity remained substantial, though the total dollar value of SWF deals declined later in the year, dropping from \$67.8 billion in Q1 of 2008 to \$35.1 billion in Q4.
- During the crisis, SWFs lost at least \$57.2 billion on paper from their initial investments, as demonstrated by Fotak, Megginson, and Li. This SWF performance is driven primarily by their large exposure to the financial services sector, but also likely due to unfortunate stock picking or a tendency to invest in distressed industries as a way to minimize political or PR opposition.
- Nonetheless, and despite representing a declining share of overall deal activity, the financial services sector continued to be an important target for SWF investment. In 2008, it accounted for 28 percent of the deals, worth 75 percent of the total value (\$96.2 billion).
- As the year progressed and the economic crisis spread, many funds importantly shifted their investment strategies, retreating from distant markets and increasing domestic and regional investments, particularly in emerging markets. In Q4 of 2008, as funds

sought to prop up local economies, domestic investment by SWFs made up over 40 percent of all deals, the highest level since 2002. In the same quarter emerging markets investments amounted to over 70 percent of SWF deal value for the first time since 2004.

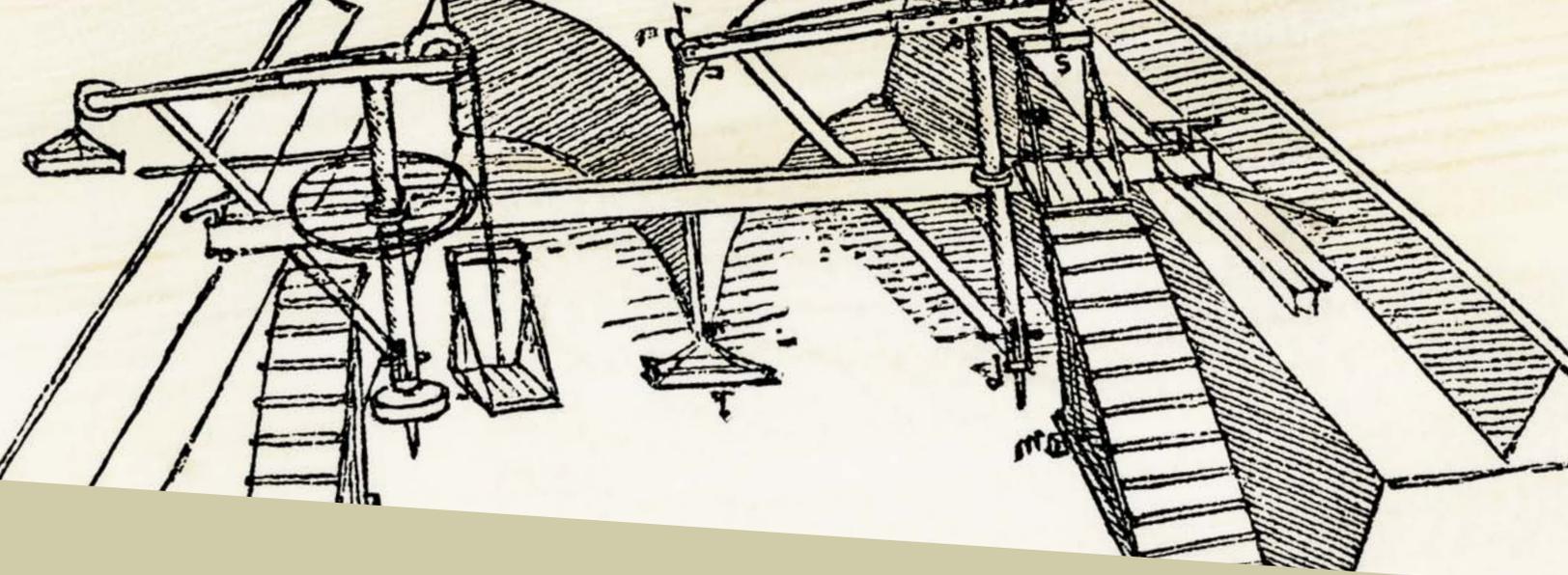
- The crisis has put a brake on SWF growth, so that projections made during 2007 now appear overly optimistic, as Subacchi argues. Reduced export revenues and oil prices suggest that assets under SWF control will reach \$5-6 trillion by 2012, rather than the \$10 trillion to \$12 trillion previously forecast.
- In the future, SWFs seem likely to prefer investing for sustainability and the long term rather than for higher risk-adjusted returns from equities in developed market economies.



William F. Miracky
Senior Partner, Monitor Group



Bernardo Bortolotti
Director, FEEM



DEVICE, LEONARDO DA VINCI

Monitor-FEEM SWF Definition

Sovereign wealth funds have been the subject of much public attention and recent research. There is an abundance of commentary and analysis on their intentions and uses, structure and governance, and impact and performance. Despite the buzz, there still is no clear and generally accepted definition of a sovereign wealth fund. This critical issue remains unresolved.

This lack of clarity and consensus has prompted Monitor Group and FEEM to formulate a definition around which to structure discussion and research. We define a SWF on the basis of the essential characteristics that differentiate them from other government-owned investment vehicles. Our objective is to reach a consensus among researchers, policy makers, and other thought leaders on this important topic.

A SOVEREIGN WEALTH FUND IS AN INVESTMENT FUND THAT MEETS FIVE CRITERIA:

1. It is owned directly by a sovereign government
2. It is managed independently of other state financial institutions
3. It does not have predominant explicit pension obligations
4. It invests in a diverse set of financial asset classes in pursuit of commercial returns
5. It has made a significant proportion of its publicly-reported investments internationally

We made an exception to the first criteria for funds based in Abu Dhabi, Dubai and Ras Al Khaimah because we believe that the emirates within the UAE federation possess decision rights comparable to those of a sovereign authority. We do not believe that sub-national governments in North America possess these decision rights.

Norway's Government Pension Fund — Global, however, is not an exception to the fourth criteria despite its name. The Fund is a continuation of the former Petroleum Fund, which was established in 1990. "In spite of the name change, the Fund is more similar to an endowment than to a pension fund", stated Norges Bank Governor Svein Gjedrem in June 2008. The Fund is a long-term savings instrument to help "cope with future financial commitments linked to an aging population," and has no current explicit pension liability streams.¹

We have included two UAE funds—the Mubadala Development Company and the RAK Investment Authority—that appear to contravene the fifth criteria because they are stated to primarily invest in the development and diversification of their home economies. However, both funds have been active abroad. Before 2008, only a third of Mubadala's publicly-reported equity and real estate investments and joint ventures were at home, 44 percent were in the OECD, and the remaining quarter were in non-domestic emerging markets. The RAK Investment Authority

1 Speech by Svein Gjedrem at the conference "Commodities, the Economy and Money" on 20 June 2008.

(RAKIA), despite its principal domestic focus, has extensive interests in Georgia and India, reflecting a strategy to fortify its portfolio of global investments. In the current economic climate, however, this has taken a back seat to developing its home economy. Nevertheless, its international investments and willingness to invest abroad warrant RAKIA being considered as a SWF.

Our criteria enabled us to filter out several funds that are commonly included on lists of sovereign wealth funds. Dubai International Capital is a notable exclusion because it ultimately is based on the personal wealth of the ruler of Dubai, Sheikh Mohammed bin Rashid Al Maktoum. As such, it acts more like a private equity fund. Clearly it is intimately interconnected with Dubai's economy and state investment vehicles but its managers emphatically deny that it is a SWF.

We have also excluded funds used solely for currency stabilization, economic development or charitable purposes that have non-commercial objectives. By nature, these tended to violate either criteria four or five in our definition.

At present, 31 funds, from 23 nations, meet our criteria. Singapore has two funds represented in this list, and the UAE has eight. By region, about 40 percent (13) of these funds are based in the Middle East and North Africa. Funds from the Asia-Pacific make up a third of the set (10). Four funds are based in Sub-Saharan Africa and three are based in Non-Pacific Asia. Norway is the only European fund that conforms to our definition.

The aggregate value of the assets under management of these 31 funds is estimated at \$1.8 trillion. The largest fund is Norway's Government Pension Fund—Global, estimated at \$326 billion. About half of the funds were established in the last decade, with two-thirds of these since 2003. The oldest, in Kuwait and what is now Kiribati, were setup in the 1950s.

Table 1: List of Funds that Satisfy the Monitor-FEEM SWF Definition

COUNTRY/SUB-NATIONAL AFFILIATION	FUND NAME	ASSETS UNDER MANAGEMENT (USD BN)	FOUNDING DATE
Angola	Reserve Fund for Oil	Unknown	2004
Australia	Future Fund	42.2	2006
Azerbaijan	State Oil Fund of Azerbaijan (SOFAZ)	1.5	1999
Bahrain	Mumtalakat Holding Company	10	2006
Brunei	Brunei Investment Agency (BIA)	30	1983
China	China Investment Corporation (CIC)	190	2007
Equatorial Guinea	Fund for Future Generations	Unknown	Unknown
Gabon	Fund for Future Generations	Unknown	1998
Kazakhstan	Kazakhstan National Fund	38	2000
Kiribati	Revenue Equalization Reserve Fund	0.4	1956
Kuwait	Kuwait Investment Authority (KIA)	169	1953
Libya	Libyan Investment Authority (LLA)	65	2006
Malaysia	Khazanah Nasional Bhd	23.1	1993
Norway	Government Pension Fund— Global	326	1990
Oman	State General Reserve Fund	8.2	1980
Qatar	Qatar Investment Authority (QIA)	58	2005
Republic of Korea	Korea Investment Corporation (KIC)	20	2006
Russia	National Wealth Fund	83.6	2008
São Tomé and Príncipe	National Oil Account	12.2	2004
Singapore	Government of Singapore Investment Corporation (GIC)	247.5	1981
Singapore	Temasek Holdings	85	1974
Timor-Leste	Petroleum Fund	3.2	2005
UAE	Emirates Investment Authority	10 - 20	2007
UAE/Abu Dhabi	Abu Dhabi Investment Authority (ADIA)	282	1976
UAE/Abu Dhabi	Abu Dhabi Investment Council (ADIC)	Unknown	2006
UAE/Abu Dhabi	Mubadala Development Company	14.7	2002
UAE/Dubai	DIFC Investments (Company) LLC	Unknown	2006
UAE/Dubai	Investment Corporation of Dubai (ICD)	82	2006
UAE/Dubai	Istithmar World	9	2003
UAE/Ras Al Khaimah	RAK Investment Authority	1.2	2005
Vietnam	State Capital Investment Corporation	0.5	2006

Source: Setser and Ziemba, “GCC Sovereign Funds: Reversal of Fortune,” January 2009; Deutsche Bank Research; Peterson Institute for International Economics; SWF Institute; Kawach, “UAE’s overseas investment income to rebound in 2009”, Emirates Business 24-7, April 2009; Hadfield, “Kuwait Investment Authority loses \$31bn in nine months”, Meed Middle East Business Intelligence, February 11, 2009; Mubadala Annual Report 2008.



SINGAPORE SKYLINE

Trends

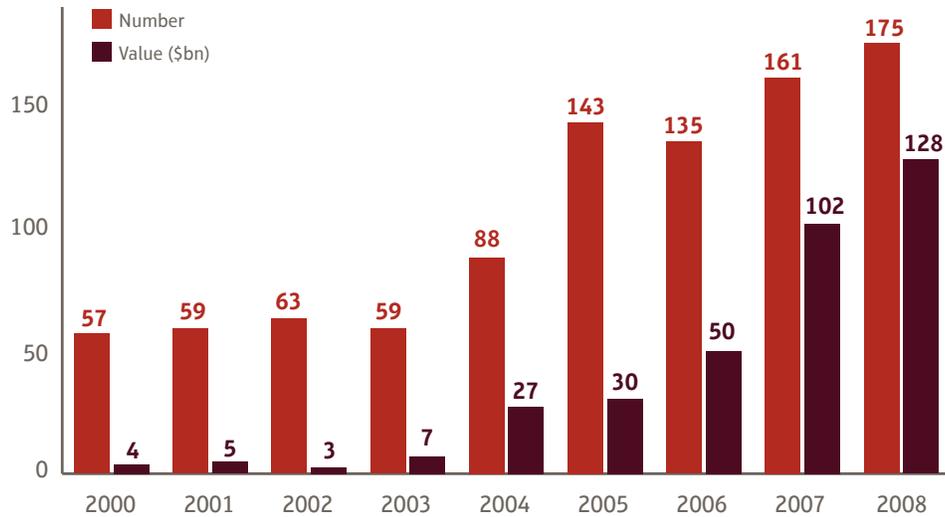
2008 As It Happened

The onset of the global financial crisis during 2008 has had a profound effect on the investment strategies of SWFs, and as such the year has been a game of two distinct parts (if not halves). During Q1, there was a frenzy of investment, with the quarter accounting for a third of the year's deals, representing 53 percent of the publicly-reported value for the year. In comparison, SWF investment during the rest of the year was lean, with sovereign funds retrenching their spending, particularly in OECD markets. This was a marked contrast to 2007, when SWF cash flooded into the West in the third and fourth quarters—a total of \$41.3 billion, more than double the \$18.4 billion SWFs reportedly spent in the OECD during the first six months of 2007. A chronological description of 2008 thus provides a more accurate picture of SWF investment patterns than looking at the year as a whole.

2008 Highlights

1. During 2008, funds in the Monitor-FEEM SWF Transaction Database executed 175 deals worth \$128 billion. This continues the trend of increasing SWF activity, evidenced since 2003. This was almost 10 percent more deals than in 2007 and an increase in publicly-reported spending by \$26 billion from \$102 billion in 2007.
2. The financial services sector continued to be a target for SWF investment. In 2008, it accounted for 28 percent of the deals (49), worth 75 percent of the total value (\$96.2 billion).
3. Despite the global economic crisis, Europe was the largest market for SWF investment in terms of recorded value— accounting for 49 percent by value of the year's investment (\$48.6 billion). Although SWFs invested heavily in North America in the first quarter, they shied away from the US thereafter.
4. SWFs made the most investments in Asia Pacific. There were 67 transactions in this region (38 percent of the total). Europe and the Middle East were the second most popular regions for SWFs (each had 38 transactions). In contrast, North American markets only attracted 26 SWF investments in 2008.
5. In the final three quarters of 2008 there was a trend for funds to invest in their domestic markets. There were 46 domestic deals in 2008, valued at \$33.7 billion. Only seven of these transactions, with a total value of \$470 million, were undertaken in Q1.
6. Although overall SWF activity, both in terms of number of deals and their value, increased year-on-year in 2008, only Q1 was notable for its activity. The first quarter accounted for a third of the year's deals, representing 53 percent of the reported annual value.

Figure 1: SWF Transactions by Number and Value since 2000

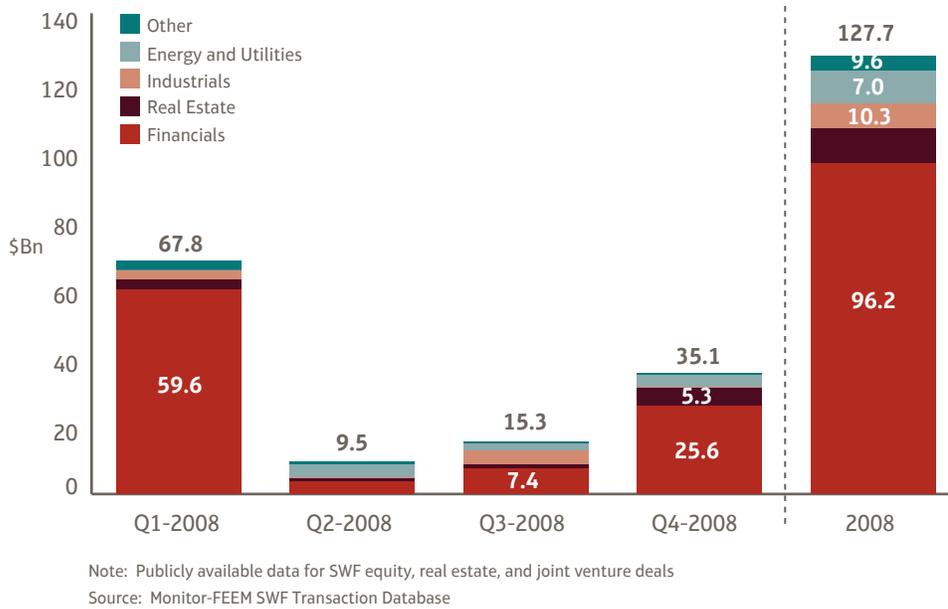


Note: Publicly available data for SWF equity, real estate, and joint venture deals
Source: Monitor-FEEM SWF Transaction Database

During the first quarter of 2008 there was a rush of SWFs snapping up stakes in Western banks. Sovereign funds provided a total of \$57.9 billion of much-needed capital for European and American financial institutions.² One fund, the Government of Singapore Investment Corporation (GIC), accounted for \$33.5 billion (58 percent) of this investment, although the Kuwait Investment Authority (KIA) was also a substantial player investing a total of \$5 billion in Citigroup and Merrill Lynch in January.

² This followed a slew of investments in this sector in Q4 2007: Abu Dhabi Investment Authority invested \$7.5 billion in Citigroup—for a 4.9 percent stake; China Investment Corporation spent \$5 billion on 10 percent of Morgan Stanley; and Singapore’s Temasek paid \$4.4 billion for a 9 percent stake in Merrill Lynch.

Figure2: Value of SWF Investments by Target Sector



In just a few months, the rapid fall in the value of US and European banking stocks saw SWFs making substantial paper losses on these investments: Citigroup’s share price, for instance, plummeted by 30 percent in the first quarter. In a bid to protect themselves from political backlash at home, some sovereign wealth funds appeared to look to investment in private equity funds.

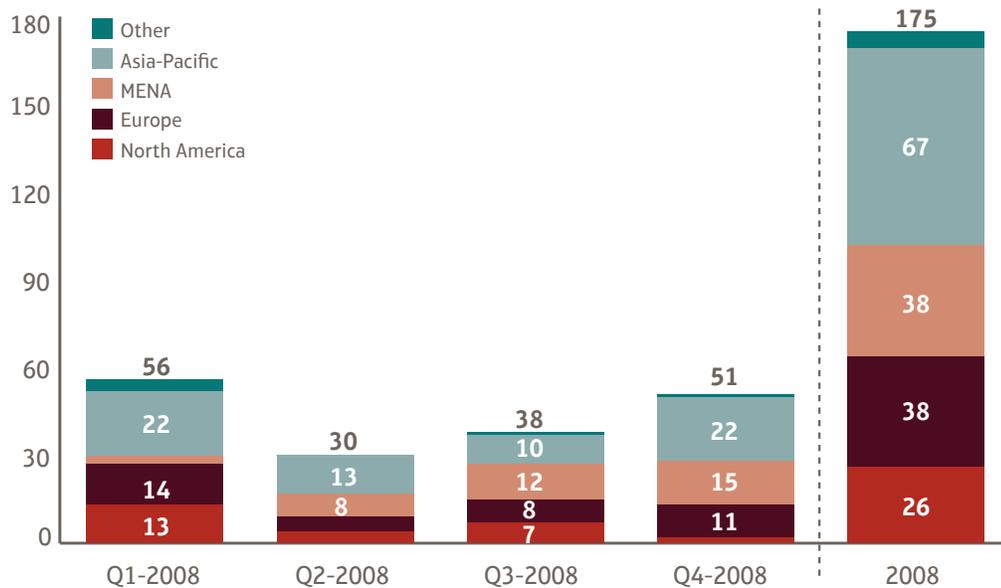
Following their September 2007 investment in private equity heavyweight Blackstone, in February 2008 China Investment Corporation (CIC) invested \$4 billion in a new private equity fund managed by JC Flowers, headed by a former Goldman Sachs investment banker. Days later, GIC committed \$2.5 billion to a new private equity fund managed by Texas Pacific Group (TPG). The fund followed this up with a \$1.5 billion investment in the main investment vehicle of the Benetton family in April. Istithmar World, a Dubai-based fund, also got in on the act, buying a majority stake for an undisclosed sum in US institutional asset manager Gulf

Stream Asset Management which manages \$3.8 billion of corporate credit portfolios for global institutional investors in ten investment funds.

The collapse of Bear Stearns in mid-March, however, formed a watershed after which SWF investment slowed, particularly in OECD economies. During Q2, the number of SWF deals declined by almost 50 percent from 56 to 30, while the reported value of the deals completed in that quarter (\$9.5 billion) represented only 14 percent of that of the deals completed in Q1 (\$67.8 billion).

Unsurprisingly, it was investment in the US and Europe that was hit hardest by this retreat. In Q2, only two deals valued at \$400 million were undertaken in the US; in Europe there were four deals with a reported value of just over \$3.5 billion. SWF investment in these geographies during Q1 had been, respectively, 12 deals worth a reported \$26.4 billion, and 13 deals valued at \$33.3 billion.

Figure 3: Number of SWF Investments by Target Region



Note: Publicly available data for SWF equity, real estate, and joint venture deals
Source: Monitor-FEEM SWF Transaction Database

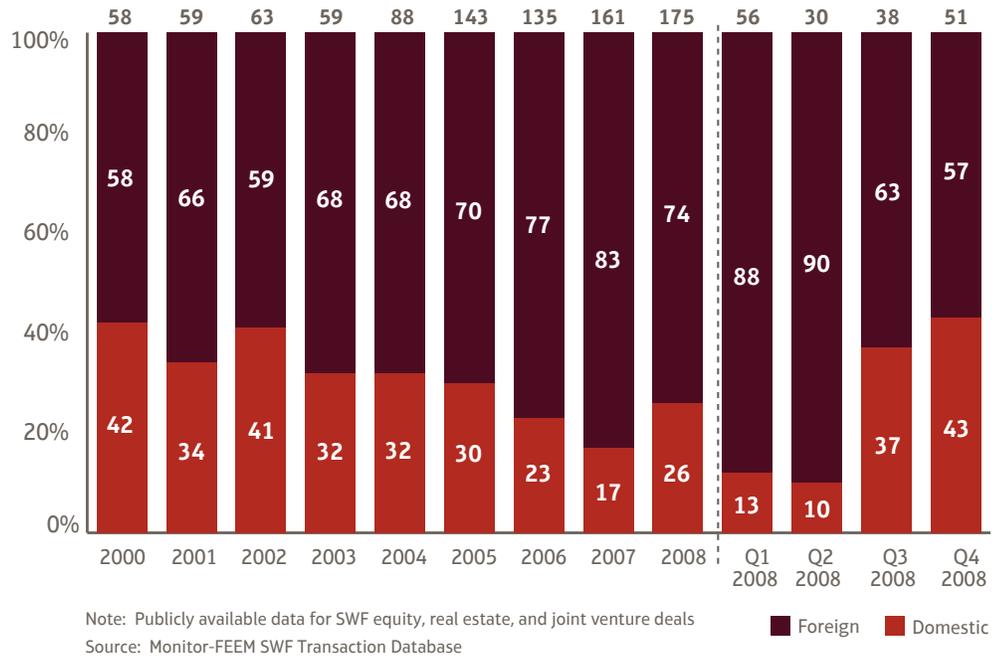
SWF investment in financial services in these regions were hit particularly hard; the second and third quarters each saw only one major SWF investment in OECD financial services—that of the Qatar Investment Authority (QIA) in the UK’s Barclays in June (\$3.5 billion), and Temasek Holding’s investment in Merrill Lynch in July (\$3 billion). Q4 saw two major investments in European financial services firms. In October, QIA followed up previous investments in Barclays and Credit Suisse to contribute to the recapitalization of the banks.

Rather than returning to markets in which they had got their fingers burnt and were nursing heavy losses, SWFs recovered their nerve and largely shifted their investment focus towards emerging markets in Q3. From July to the end of September, 21 of the 39 SWF transactions were in emerging markets, and these were spread across a range of sectors, including industrials and aerospace, in addition to their mainstays of financials and energy.

In the third and fourth quarters, domestic investments accounted for 40 percent of the transactions undertaken.

Moreover, it was to their domestic markets that SWFs turned during the latter part of 2008. In the third and fourth quarters, domestic investments accounted for 40 percent of the transactions undertaken. In 2008 as a whole, 26 percent of all the funds reported investments were made in home markets, returning to a similar level to 2006, after a dip to 17 percent in 2007. This represented a reversal of a trend of declining domestic investment by SWFs since 2002.

Figure 4: Number of SWF Deals by Location of Target: Domestic vs. Foreign



Year In Review 2008

The Monitor-FEEM SWF Transaction Database reveals that in 2008, SWFs made 175 publicly-recorded transactions with a reported value of \$128 billion. This is 14 more transactions than were completed in 2007, and exceeded the reported dollar value of these investments by \$20 billion. This continues a trend of increasing expenditure by SWFs that has been evident since 2003. However, this is a much smaller year-on-year increase than in 2007, when the reported value of SWF investment more than doubled from \$50 billion in 2006 to \$102 billion.

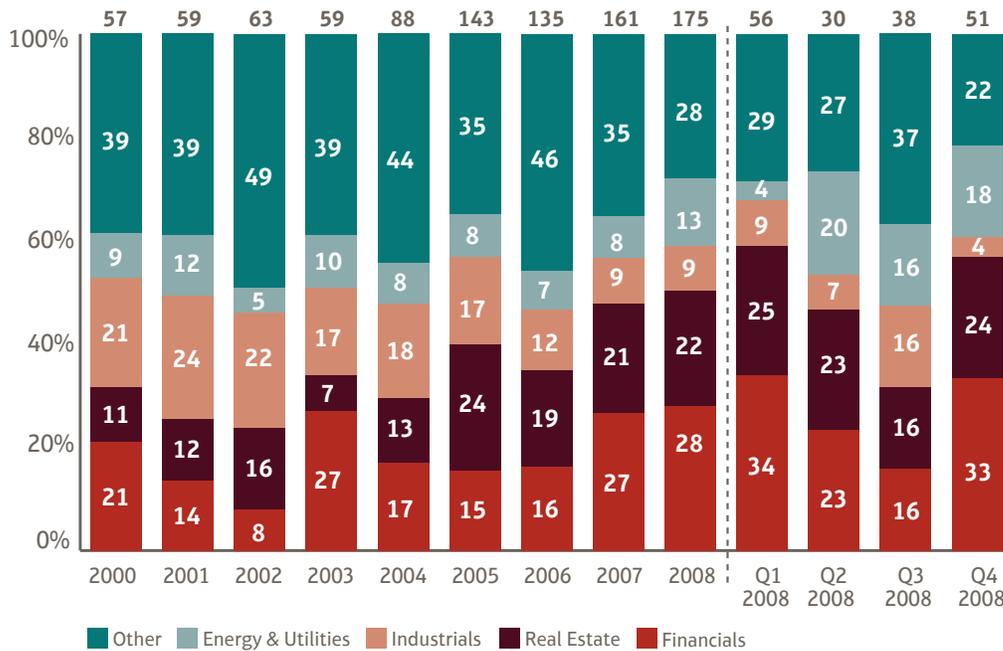
Sectors

The split between publicly-recorded SWF transactions in major sectors in 2008 was similar to that in 2007. Financial services continued to be a major target sector for SWF investment. Taking the year as a whole, financial services accounted for a

greater proportion of SWF investment than it had previously. Between 2000 and 2007, financial services accounted for 19 percent of SWF transactions and 44 percent of their reported value; but in 2008, the sector accounted for 28 percent of the deals (49), worth 75 percent of the total value (\$96.2 billion). In 2008, the majority of SWF investment in financial services was in the OECD, which accounted for 24 deals, with a reported value of \$69.1 billion.

Real estate was also a major sector for investment, particularly in emerging markets. Just over a fifth of the completed SWF investments in 2008 (39) were in property, and these were valued at \$10.3 billion. Over half of these investments (21), valued at \$5.2 billion, were in emerging markets. Asia Pacific was the most attractive real estate market for SWFs; here, SWFs made 17 deals with a reported value of \$3.5 billion.³

Figure 5: Number of SWF Investments by Target Sector



Note: Publicly available data for SWF equity, real estate, and joint venture deals
Source: Monitor-FEEM SWF Transaction Database

³ Ten of these deals were in the region's emerging markets; however, only half of them had their value reported, which totalled \$718 million.

Geographical Distribution

SWFs reportedly spent \$87.2 billion in OECD economies in 2008, an increase from \$59.6 billion in 2007, whilst in emerging markets, SWFs made investments with a recorded value of \$40.9 billion, approximately the same as in 2007. However, in terms of the number of transactions, 76 SWF deals (43 percent) were completed in

the OECD in 2008, while 99 (57 percent) were in emerging markets. This suggests that in 2008, SWFs undertook more, but smaller transactions in emerging economies than they did in developed markets.

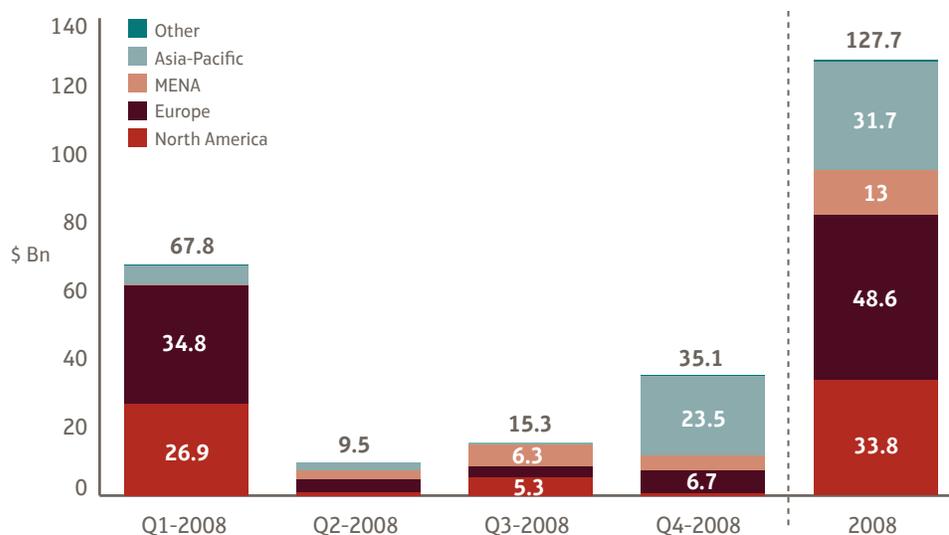
This suggests that in 2008, SWFs undertook more, but smaller transactions in emerging economies than they did in developed markets.

Emerging economies in Asia Pacific were particularly attractive to SWF investors, accounting for 67 transactions, with a reported value of \$31.7 billion. By contrast, markets

in the Middle East and North Africa only accounted for 40 deals, with a publicly-recorded value of \$13.5 billion.

SWFs looked particularly to their domestic markets in 2008, reversing a trend of declining domestic investment since 2003. Over a quarter (26 percent) of SWF transactions and expenditure (\$33.7 billion) in 2008 was in home markets, compared to 17 percent of transactions worth \$32.1 billion (31 percent of reported expenditure) in 2007.

Figure 6: Value of SWF Investments by Target Region



Note: Publicly available data for SWF equity, real estate, and joint venture deals
Source: Monitor-FEEM SWF Transaction Database

Controlling Stakes

As Monitor pointed out in *Assessing the Risks*, while SWFs do take controlling stakes in companies, they seldom do outside of emerging markets, and they are less likely to do so in ‘sensitive sectors’ in developed economies.⁴ 2008 was no different; less than a quarter of SWF transactions resulted in controlling stakes (40 deals). Over half of these (21) were in the funds’ domestic markets, whilst only 10 were in the OECD; these deals were in the real estate, industrial and financial services sectors.

Asian funds were also more likely to take controlling stakes than their Middle Eastern counterparts. Of the 40 controlling stakes taken by SWFs in 2008, 24 of these were taken by Asian funds. The lion’s share was accounted for by two funds. Khazanah Nasional Bhd, the Malaysian fund, took 11 controlling stakes, eight of which were in domestic companies; Temasek took nine, of which only two were

⁴ Sensitive sectors include Energy and Utilities, Financial Services, Information Technology, Infrastructure and Government, Telecom, and Transport and Aerospace.

HOW INVESTORS REACT TO NEWS OF SOVEREIGN WEALTH FUND INVESTMENTS: EVIDENCE FROM EVENT STUDIES

Are stock market investors pleased or displeased to learn that a sovereign wealth fund (SWF) has purchased an equity stake in a publicly-traded company? Do investors react differently depending upon the identity of the fund, the size of the stake, and whether the listed stock has performed well or poorly in the months leading up to the SWF investment? Four recent academic studies have examined these questions, using a key tool of academic research called an event study. As its name implies, an event study calculates the stock price reaction of a sample of target companies to the announcement of a specific event, with the dates of the announcement lined up in event rather than calendar time. This means that the day of the announcement is defined as day 0, the day before the announcement is day -1, the day after is day +1, and so on. Event study methodology allows researchers to very precisely calculate the average and median market responses to a large number of specific financial events that are often spread out over many years or even decades.

The answers that researchers have found to the questions posed above are first, that investors are pleased to learn that an SWF has bought stock in a publicly traded company, as that company's stock price increases on the purchase announcement. Second, the identity of the fund making the purchase does matter, with somewhat more positive stock price responses being observed following investments by more transparent SWFs. Third, the size of the stake purchased does not seem to matter much, but fourth, pre-event performance does. Specifically, the worse the target firm's stock price has performed in the months prior to the SWF stake purchase, the more positive is the price reaction to the acquisition announcement. The four academic studies that yield these answers are briefly described below, starting with three that do not involve members of the Monitor Group-Fondazione Eni Enrico Mattei (FEEM) team, and then the one study that does.

Kotter and LeI analyze a sample of 163 SWF investment announcements between 1982 and 2008. They find that the market reacts positively to announcements of investments by

SWFs.¹ They also find that transparency of the fund is related to the market reaction at the time of the announcement, but they document that SWF investments do not significantly affect target firm growth, profitability or governance in the three years following the investment. Dewenter, Han and Malatesta analyze a sample of 196 acquisitions and 47 divestitures by SWFs involving publicly traded firms.² They find positive market reactions to acquisitions and negative reactions to divestitures. In a long-term analysis, they find mostly insignificant, slightly negative abnormal returns. Another study focusing on SWF transaction is Chhaochharia and Laeven perform an event study on a sample of 89 investment transactions, and find positive market reactions at the time of the announcement, but they find poor long-run performance of investment targets.³

Bortolotti, Fotak, Megginson, and Miracky (hereafter BFMM) perform their event study analysis using a sample of 235 SWF acquisitions of equity stakes in publicly traded companies around the world, and find that SWFs tend to purchase stock in listed companies that have performed poorly during the year prior to the investment.⁴ They present results from two event studies: one short-term, in order to evaluate the market reaction to the announcement of a SWF investment and one long-term, to investigate the impact of SWF investments on target companies. Their final sample contains observations related to investments by 21 SWFs in 195 distinct firms in 32 target countries, with the earliest being in 1991 and the latest in 2008. BFMM find that stocks of companies receiving SWF equity investments increase significantly, by about 0.9 percent, on the announcement of these investments, suggesting that investors welcome SWFs as shareholders. In particular, in the three-day interval including the day of the invest-

1 Kotter, Jason and Ugur Lel, "Friends or Foes? The Stock Price Impact of Sovereign Wealth Fund investments and the Price of Keeping Secrets," Federal Reserve Board Working Paper (2008).

2 Dewenter, Kathryn L., Xi Han and Paul H. Malatesta, "Firm Value and Sovereign Wealth Fund Investments," University of Washington Working Paper (2009).

3 Chhaochharia, Vidhi and Luc Laeven, "Sovereign Wealth Funds: Their Investment Strategies and Performance," International Monetary Fund Working Paper (2009).

4 Bortolotti, Bernardo, Veljko Fotak, William Megginson, and William Miracky, "Sovereign Wealth Fund Investment Patterns and Performance," University of Oklahoma Working Paper (2009).

ment announcement, the previous day and the following day, abnormal returns are positive and statistically significant. There are two possible explanations for these significantly positive announcement-period abnormal returns: either market participants react positively because they believe SWFs will improve target firm performance (a certification effect) or the large but temporary increased demand for target firm shares forces stock prices higher through a liquidity effect.

BFMM find that the market reaction is stronger for financial targets, as expected. Since many of the financial investments were, in effect, bailouts, this result is unsurprising. Also, they find that the market reaction is weaker if the fund had a pre-existing stake in the company, indicating that the announcement of the new investment has a weaker signaling effect. Finally, BFMM find that pre-event performance is strongly linked to the market reaction, indicating possible leakage of information, or at least the presence of rumors, in the month preceding the investment. Yet, they find no evidence

of the other hypothesized explanatory variables playing a role and thus rule out a possible liquidity effect, as the latter would be related to the size of the stake acquired. On balance, investors are pleased to learn that SWFs are investing in listed companies — particularly if that investment is viewed as a “rescue” — but the reaction is neither especially large nor strongly linked to specific deal characteristics. As described elsewhere in this report (see pp. 53-58), the long-term stock market performance of target firms is significantly negative. Far from being saviors of their targets, SWFs often effectively become hostages.

not in domestic companies, the remaining investments being the purchase of a Thai IT company and an Indonesian financial holding company. The majority of these controlling stakes were thus in emerging markets — only four were in OECD countries. When Middle Eastern funds took controlling stakes, they showed a greater propensity to take them in OECD markets: 20 percent of Middle Eastern SWFs' controlling stakes were in OECD markets.

Funds

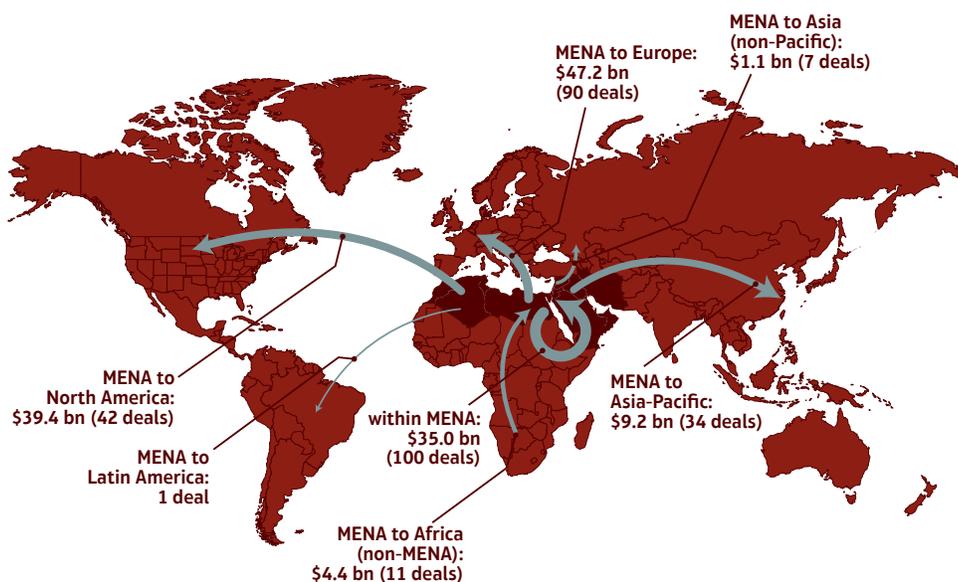
In 2008, 15 of the 17 SWFs we have identified as being active completed direct equity or real estate transactions or established joint ventures. This included a new fund: the Abu Dhabi Investment Council (ADIC). ADIC was established by Law No. 16 of 2006, and its founding terms suggested that ADIC would have a bigger policy role than the emirate's largest SWF, the Abu Dhabi Investment Authority (ADIA). In July, ADIC made its first publicly-reported investment — the purchase of a 90 percent stake in the iconic Chrysler Building in New York for \$800 million. Since then, however, the fund has concentrated more on domestic and regional matters. ADIC took over all local subsidiaries previously owned by ADIA—including the Abu Dhabi Investment Company, Etihad Airways, and National Bank of Abu Dhabi—and has looked towards helping the development of the domestic and regional economy.

On the whole, the Middle Eastern funds were the most active in 2008, undertaking 56 percent (98) of the deals in 2008, but they spent only \$47.2 billion (37 percent of the total). By contrast, Asia Pacific funds undertook 45 percent of the deals, but had a reported expenditure of \$80.5 billion (63 percent).⁵ This is a marked contrast with the previous year, when Asian funds were the most active, undertaking

5 This may result from Middle Eastern funds being less likely to reveal how much they have spent on a transaction than Asian funds. In 2008, 32 percent of deals on the Monitor-FEEM Transaction Database did not have a dollar value recorded, for MENA funds this was 41 percent, while for Asia Pacific funds it was only 20 percent. This is an increase on 2007 when only 25 percent of the deals did not have the dollar value disclosed.

62 percent of the transactions, worth 58 percent of the total value. Temasek and GIC dominated the field in 2007, undertaking 55 deals (79 percent of the total) with a reported value of \$23.1 billion (23 percent of the total). The Middle East's most active funds in 2007—the Qatar Investment Authority (QIA) and Istithmar World—only undertook half this number of deals, representing half the reported value of the Singaporean funds' transactions.

Figure 7: Investment Flows from MENA-based SWFs, 2000-2008

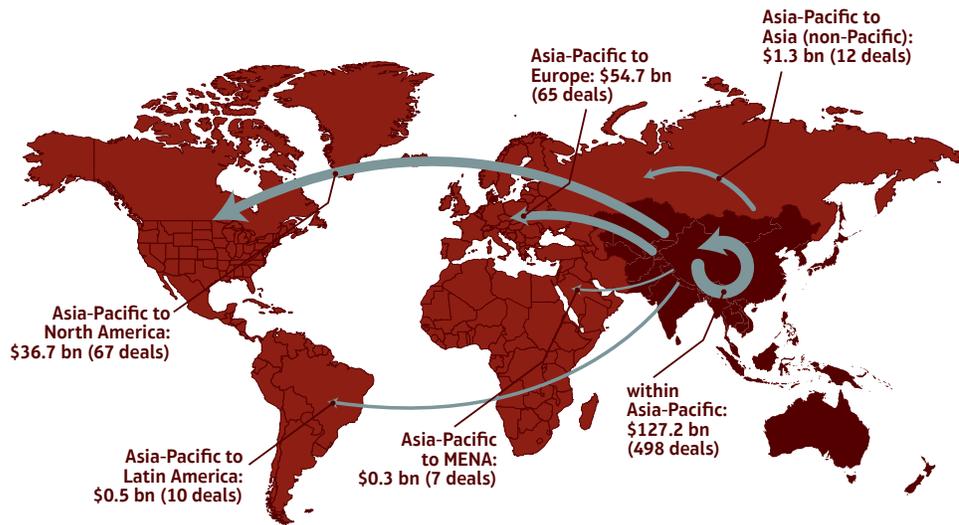


Note: Publicly available data for SWF equity, real estate, and joint venture deals
Source: Monitor-FEEM SWF Transaction Database

In 2008, Gulf funds kept pace with those from Singapore. The most active funds were GIC and the Mubadala Development Company; GIC undertook 36 deals and Mubadala 26, of which 44 percent were undertaken in the first quarter. The next most active funds were QIA and Temasek, which undertook 24 and 23 transactions respectively, spread relatively evenly throughout the year. GIC was also the biggest reported spender of 2008, completing transactions worth a reported \$41.8 billion.

CIC and QIA were also big investors, making investments worth \$26 billion and \$14.8 billion respectively.

Figure 8: Investment Flows from Asia-Pacific-based SWFs, 2000-2008



Note: Publicly available data for SWF equity, real estate, and joint venture deals
Source: Monitor-FEEM SWF Transaction Database

In the latter part of 2008, there was a convergence between investment strategies. Prior to 2008, there had been a marked difference between funds such as ADIA and KIA that primarily invested in the OECD, and those—Temasek and Khazana—that were more domestically focused. The financial crisis of 2008, however, has blurred this distinction as funds have been pulled towards investing at home to finance bailouts and stimulus packages. Moreover, a dearth of attractive investment opportunities in the United States, Europe, and Japan has drawn SWFs towards emerging markets in search of appealing investment openings.

Mubadala is a case in point. Of the publicly-reported investments it made before 2008, only a third of Mubadala’s publicly-reported equity and real estate investments and joint ventures were at home. In 2007, for example, the Company had a

mixed geographical spread: 65 percent of its deals were in emerging markets, and 35 percent in the OECD, but it only made three investments in the UAE. In 2008, Mubadala reinvented itself as a domestic development company. More than half of its recorded transactions in 2008 were in the UAE, and these accounted for over 70 percent of its publicly-reported spend for the year. On the other hand, exceptions to this trend are QIA and GIC, which have continued to invest substantially in the OECD. Of GIC's 36 publicly-recorded transactions, 17 were in OECD countries, accounting for 94 percent (\$39.1 billion) of its total reported spend. More than half of QIA's transactions were in OECD countries, which amounted to 88 percent (\$13 billion) of their total spend.

Q4 Overview

According to our data, in the final quarter of 2008, SWFs completed 53 transactions, with a reported value \$35.1 billion. The number of investments was only one more than SWFs completed in the third quarter, but the recorded value of these deals was more than double that spent by SWFs in Q3, and surpassed the combined total spend of the previous two quarters by over \$10 billion. Although this suggests a recovery in SWF activity from the comparatively low levels of Q2 and Q3, this quarter does not compare either to the number of deals undertaken in the first quarter (56) or to its reported value (\$67.8 billion).

Of the 17 funds we have identified as active, 12 executed reported deals—the same as recorded as undertaking transactions in the previous quarter and more than the second quarter (10 funds).

Q4 Highlights

1. In the fourth quarter of 2008, funds in the Monitor-FEEM SWF Transaction Database executed 53 deals, with a reported value of \$35.1 billion. This represents a rise in the reported value by over a factor of two from \$15.3 billion and a rise of 25 percent in the number of transactions. But, if the distorting China Investment Corporation's \$20 billion recapitalization of the Agricultural Bank of China is excluded, the totals would be very similar.
2. There was a continuing trend for funds to invest in their domestic markets in Q4. There were 23 domestic deals accounting for \$24.7 billion, 70 percent of the total reported spend.
3. Funds in the Monitor-FEEM SWF Transaction Database focused their attentions on emerging markets during the final quarter of the year. Targets in emerging economies accounted for 36 transactions, with a reported value of \$26.2 billion.

Sectoral Analysis

During the final quarter of 2008, the financial services sector was, once more, the largest for SWF investment. This sector accounted for 17 transactions, with a total value of \$25.6 billion—73 percent of the total reported value of SWF investments this quarter. This is a marked increase on the last two quarters, in which financial services only accounted for \$3.6 billion (Q2) and \$7.4 billion (Q3).

That said, \$20 billion of this reported value is accounted for by a single deal, in which CIC recapitalized the Agricultural Bank of China (ABC), in preparation for an eventual public listing.⁶

Real Estate also had a strong quarter, accounting for 12 deals worth a reported \$5.3 billion. Property investments were spread across geographies and markets. Q4 was the sector's strongest of the year in terms of recorded value, which was double that of the first quarter. However, this represented fewer deals than in Q1 (14).

In Q4, there was little SWF investment in industrials: there were only two transactions with a mere reported value of \$100 million, dropping from six deals worth \$4 billion in Q3. This is the same reported value in this sector as Q2, although in the second quarter this was represented by only two deals.

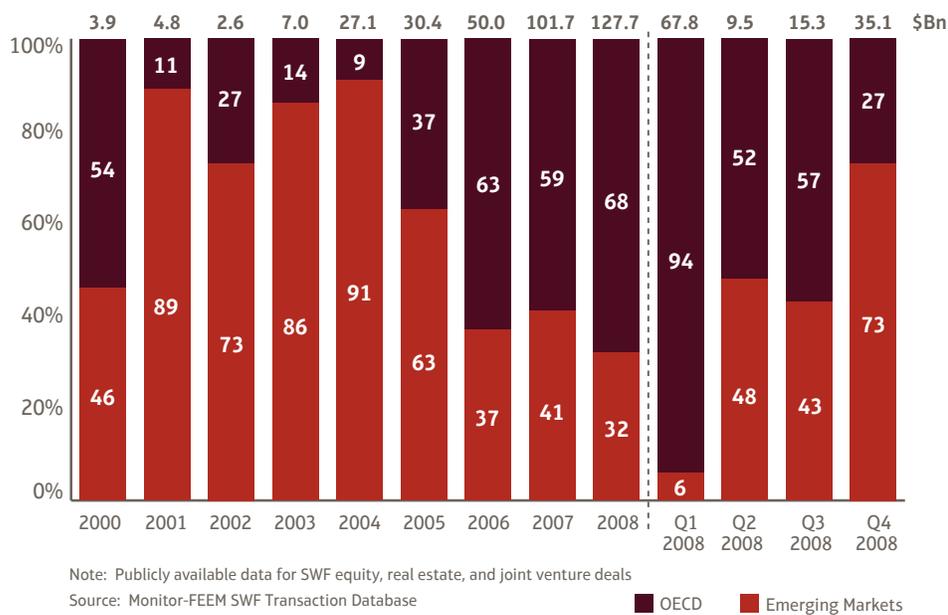
Geographical Analysis

Emerging markets were the primary target for SWFs in Q4. Of the 53 transactions completed, 36 were in emerging markets. Funds' domestic economies were particularly attractive targets this quarter, as SWFs sought to bolster their own economies against the global economic downturn and implement various bailouts and stimulus programs. Forty three percent of SWF transactions in Q4 (23) were in domestic markets. In terms of expenditure, this was where SWFs concentrated their investment dollars: 96 percent of SWFs' reported total emerging-market expenditure

⁶ Although this skews the value of the data somewhat, it is illustrative of a trend of investments in domestic banks by Gulf SWFs—most notably Qatar and Kuwait—which did not complete before December 31.

was domestic. To put it another way, SWFs only spent a reported total \$1 billion in non-domestic emerging markets.

Figure 9: Value of SWF Deals by Location of Target: OECD vs. Emerging Markets



This is not, however, to say that SWFs completely turned their backs on Western markets. SWFs made 11 investments in Europe, with a public value of \$6.7 billion. These were spread throughout the financial, real estate and energy sectors. SWFs continued to avoid North American markets, making only two investments worth \$700 million in the region in Q4.

Funds

The Middle East and North Africa funds once more dominated SWF activity. They accounted for 66 percent (35) of the SWF transactions completed in Q4, with a reported value of \$12.7 billion. Fourteen of these deals, with a reported value of \$4.2 billion, were made in domestic markets, while a further seven deals worth \$1.3 billion were made in emerging markets abroad.

Middle Eastern Funds were also active in OECD markets. Fourteen of their deals, worth a reported \$7.3 billion, were in developed countries.⁷ These deals were primarily in energy and financial services.

The most publicly active SWFs were both Middle Eastern funds: Qatar Investment Authority (QIA) (13 deals, \$4.9 billion) and the Mubadala Development Company (seven deals, \$1.4 billion).

Funds based in Asia Pacific made 18 deals worth \$22.9 billion. Of these, half — worth a reported \$20.5 billion — were made in domestic markets. More than their Middle Eastern counterparts, Asian funds concentrated on emerging markets. In Q4, these funds avoided European markets, and only signed one deal in North America, with a reported value of \$600 million.

The most publicly active Asian funds were GIC (six deals, \$2.2 billion) and Malaysia's Khazanah Nasional Bhd (four deals, \$494 million). However, the China Investment Corporation's \$20 billion recapitalization of the Agricultural Bank of China aside, the Government of Singapore Investment Corporation (GIC), was the biggest spender of the Asian funds in Q4 2008, spending \$2.2 billion in the three deals it completed in this quarter.

⁷ Western Europe, North America, Japan, Australia and New Zealand.

Selected News and Events of 2008

JANUARY	
01	QIA kicks off the year with a \$3 billion investment in Credit Suisse
15	GIC continues the trend, investing \$6.8 billion in Citigroup
16	KIA puts its faith in the US banking system - \$5 billion goes into Citigroup and Merrill Lynch
FEBRUARY	
01	February starts with a bang as CIC invests \$4 billion in a new JC Flowers fund
08	GIC splashes out once more, investing \$14.4 billion on troubled Swiss lender UBS
25	The EU looks to plan a code of “common principles on transparency and governance” for SWFs investing in Europe
29	DIFC investments finalizes its long-term battle to buy Swedish financial market operator OMX AB for \$3.4 billion
MARCH	
14-16	JP Morgan Chase in conjunction with the Federal Reserve Bank of New York, provided a 28-day emergency loan to insolvent investment bank Bear Stearns. On 16 March, JP Morgan Chase signed a merger deal in a stock swap worth \$2 a share or less than 10 percent of Bear Stearns’ market value
APRIL	
02	World Bank President Robert B. Zoellick outlined a plan for SWFs to invest one percent of their holdings in equity in sub-Saharan Africa to tap long-term global liquidity and boost investment opportunities and development.
20	US Treasury reaches an agreement on principles for SWF investment with GIC and ADIA
27	Sanabil al-Saudia, a new \$5.3 billion Saudi Arabian SWF announced
MAY	
01	Representatives of SWFs, recipient countries, OECD, and the European Commission met at IMF Headquarters. Participants agreed that SWFs invest on the basis of economic and financial risk and return-related considerations. An International Working Group of SWFs (IWG) was established by the meeting to present a set of principles that properly reflects their investment practices and objectives by October 2008

32 WEATHERING THE STORM

Trends

JUNE	
05	OECD 'Declaration on Sovereign Wealth Funds and Recipient Country Policies' adopted in Paris. This offers guidance reaffirming the relevance of long standing OECD investment principles for recipient country policies toward SWFs (non-discrimination, standstill, progressive liberalization, and unilateral liberalization) and guidelines for recipient country investment policies relating to national security that help to make these policies effective and ensure that they are not used as disguised protectionism.
25	Barclays Bank Plc announces a share issue to raise approximately £4.5 billion. The QIA agreed to invest up to £1,764 million in these shares. After a low shareholder uptake of only 19 percent, the QIA invests the full amount on 22 July.
JULY	
09	ADIC completes its acquisition of a 90 percent stake in the Chrysler Building for \$800 million
09-10	IWG convenes its second working session in Singapore
10	Kuwait Investment Authority continued the emirate's long-term relationship with Dow Chemicals, investing \$1 billion to help finance the company's takeover of Rohm and Hass.
31	QIA continued its liking for European investments with Qatari Diar's acquisition of Cegelec SA (CS), a Nanterre-based provider of electrical engineering services, for \$3 billion.
SEPTEMBER	
01-02	IWG met in Santiago, Chile, and reached preliminary agreement on a draft set of principles and practices
15	Investment Bank Lehman Brothers files for bankruptcy protection, sending tremors along Wall Street
24	Bader Al Sa'ad, head of KIA admits that the fund has lost \$270 million on its January investment in Citigroup
OCTOBER	
11	The IWG releases the 'Generally Accepted Principles and Practices' for SWFs—the Santiago Principles—to a muted press reception.
13	QIA launches a \$5.3 billion plan to purchase Qatari bank shares to shore up confidence in the emirate's banks after a region-wide slump in banking stock
16	QIA follows up its January investment in Credit Suisse by providing the bank with a further \$2.2 billion
24	President Nicolas Sarkozy of France announces the creation of a French sovereign wealth fund, promising to protect the strategic heights of the economy from the global financial storm
30	QIA invests a further \$3.3 billion in Barclays bank after the British government require it to raise £6.75 billion in tier 1 capital

NOVEMBER	
	02 QIA signed a Memorandum of Understanding with the British Government on a new Low Carbon Innovation Partnership to set up a new £250 million Qatar-UK Clean Technology Investment Fund and to investigate the creation of a Low Carbon Innovation Centre in Qatar
	11 Stephen Jen of Morgan Stanley estimates that SWFs have lost 18 to 25 percent of their value in 2008, totaling up to \$700 billion
	18 KIA is authorized by the Kuwaiti cabinet to set up a long-term investment portfolio, in cooperation with other government institutions, to invest in the Kuwait Stock Exchange
DECEMBER	
	08 The International Finance Corporation approved a Sovereign Funds Initiative which will enable it, to raise and manage commercial capital from sovereign funds for equity investments in some of the poorest developing countries.

HOW WILL SWFs INVEST IN 2009?

Funds such as QIA and CIC claim that they're going to be lying low, particularly in Western markets, over the coming year. Although they're nursing heavy losses, their revenue streams are contracting, and they're increasingly being called on to provide liquidity for home markets, SWFs will not disappear completely from the world market. They will still seek good investments in companies that have the potential to provide them with good returns.

Investment Trends: Sectors, Geographies, Asset Classes

We believe that SWF investments abroad are likely to move away from financial institutions and consumer goods towards sectors in which the fund's home economy can benefit from knowledge transfer. This has been a particularly marked trend with Middle Eastern funds, whose economies are arguably in need of such investment. Abu Dhabi, for example, has sought to diversify its energy competencies into renewables resulting in the setting up of the Masdar Energy City project, which is stewarded by the Mubadala Development Company.

Masdar was a major beneficiary of Mubadala's July joint venture with U.S. conglomerate GE. Meanwhile, the fund invested \$2 billion in developing photovoltaic technology and £600 million in the London Array wind farm during 2008 with a view to helping Masdar's development. Another Abu Dhabi deal—Aabar Investments' purchase of a 9.1 percent stake in German carmaker Daimler for \$2.7 billion in March 2009—appears to have been made in the same vein. The deal is part joint venture, whereby funds will be channeled into electric car development and an engineer training center in the Emirate.

SWFs may also consider switching at least some of their European and U.S. equity asset allocation to Asia. "Follow the money" will be the key, and this, after all, is likely to be Asia's century. Although the region's export-led economies have been hurt by the collapse in global demand, it has two major advantages over the rest of the world that will position it as the first region to recover from the downturn. First, as large net importers of raw materials, Asian economies will profit from the dive in commodity

prices, unlike commodity-exporting Latin America. Second, most Asian countries have low public-debt-to-GDP ratios, giving them more room for fiscal stimulus than other emerging economies and even some major developed economies.

When they do invest in OECD markets, SWFs may be cautious. Companies attracting SWF cash are likely to be established, with good balance sheets and no pension shortfalls, and founded on sound business principles with long and distinguished histories to prove it. Appealing targets will include technology companies with strong IP, as well as conventional and renewable energy, both of which have good prospects. These sectors are likely to outperform in the longer term and provide valuable knowledge transfer for funds' domestic economies.

Nevertheless, SWF investments in domestic markets will increase. The funds may need to act as providers of liquidity in domestic markets, propping up businesses or sub-national governments, and buying shares in domestically-listed companies. In

several countries, SWFs are the main holders of liquidity, as forex reserves have not kept pace with increases in GDP, state or government liabilities, or trade balances. It has befallen several SWFs—for example, Kuwait, Qatar and Oman—to provide stabilizing liquidity to their home markets, whilst Abu Dhabi's bailout of its sister Emirate, Dubai, in February 2009 is well documented.

SWFs may also increasingly act as development companies. In the current economic climate, some governments are attempting to diversify their economies to weather the storm and quell domestic discontent with the state of public finances. This strategy has particular resonance for funds like Temasek and Khazanah that have historically had a more domestic investment focus. In fact, these funds have pared back their OECD investments in recent months. Moreover, in 2008, Middle Eastern funds—historically more interested in foreign equities—turned towards domestic and regional development. As mentioned, Abu Dhabi has been particularly notable in this regard.

As a corollary, SWFs may display more interest in joint ventures. Mubadala is already following this strategy; in 2008, the development company undertook 12 JVs, all but one of which were in Q3 and Q4. Six other SWFs, including GIC, Khazana and LIA have also established JVs. Many of these appear to be vehicles for facilitating knowledge transfer. For example, Libya participated in a joint venture to develop domestic fertilizer production, while Khazana has entered into a partnership with Beijing China Sciences General Energy and Environment Company to develop municipal waste-to-energy (WTE) projects in China.

SWFs may also, for the time being, invest more in liquid asset classes, rather than equities or real estate, to minimize losses as the downturn intensifies. In a recent paper, Brad Setser and Rachel Ziemba noted that in contrast to the higher-risk holdings of Gulf SWFs, the Saudi Arabian Monetary Authority, with its more liquid and lower-risk portfolio, has fared better during the financial storm with lower overall losses. Such examples may persuade SWFs to follow suit until global markets stabilize and resume growth.

Investment Management and Governance

SWFs have a moral and fiduciary responsibility to their governments to ensure that their investments are profitable; many SWFs have the explicit remit of investing their money for the benefit of future generations of citizens. In some countries, reporting losses has already fuelled domestic political pressure, which may result in SWFs changing strategy. In Singapore, for example, a relatively poor performance by Temasek in 2008 prompted the replacement of Ho Ching, wife of Singapore's Prime Minister Lee Hsien Loong, as Chief Executive by Chip Goodyear, a former CEO of BHP Billiton.

There may be more pressure for transparency, accountability, and management professionalism in home states, as public representatives demand to know how the public's money is being spent and to be assured that it is being managed professionally. This may well be a good moment for SWFs, particularly those in the Middle East, to push forward with transparency reform. Currently, the eyes of the world are not focused on SWFs as OECD countries, in par-

ticular, are preoccupied with salvaging their own economies from the global economic downturn. When the global economy picks up, more transparency in fund strategies and structures may prevent a return to the SWF controversies of 2007 and 2008.

Taking this opportunity will enable funds to set the transparency agenda themselves, something they have already started with the “peer-review” nature and voluntary compliance of the Santiago Principles. That said, it is not in the funds’ interest to be completely transparent. Glass-like transparency, as we see in the case of the Norwegian Pension Fund—Global, prevents funds from being able to take greater risks and accumulate greater returns, as it has to ensure the buy-in from taxpayers. Gulf funds, which originate in business environments less oriented to transparency and accountability, now have a great opportunity to tailor transparency standards to suit them, rather than risking the imposition of more onerous standards at a later date.

Another possibility is that SWFs may become more activist investors going forward, as Andrew Rozanov argues

elsewhere in this report. The tangible increase in SWFs’ domestic investment gives them more room to be active. Undertaking joint ventures with large companies, as the Abu Dhabi funds have done, provides the scope for SWFs to be more involved in managing their investments without the constraints they encounter when investing in Western institutions. Such a position may help assuage pressures SWFs face at home by demonstrating that they are actively seeking to make their money work positively, rather than putting it at the mercy of Western investors, which are deemed responsible for the economic crisis throughout the developing world. Yet, to date this is relatively uncommon. With a few exceptions, such as Mubadala’s JVs, and GIC’s decision to take a seat on the board of US power generation and distribution company AEI Services in May 2008, SWFs have remained uninterested in corporate governance. Nevertheless, this may be a trend to watch for through 2009 and maybe beyond, particularly as it becomes more common for states to become significant shareholders in corporations.



MOORISH CARVING, ALHAMBRA, SPAIN

Articles

Sovereign Wealth Funds and Active Ownership

By Andrew Rozanov, Managing Director and Head of Sovereign Advisory,
State Street Global Markets⁸

Since the purchase by China Investment Corporation of a large block of shares in Blackstone Group in May 2007, the activities of sovereign wealth funds (SWFs) and other state investment vehicles have come under increased scrutiny. Their apparent appetite for acquiring large stakes in Western companies, coupled with the relative lack of transparency surrounding their investment objectives and operations, has led to concerns in many recipient countries. To address these issues and counter negative publicity, many SWFs have gone out of their way to assure politicians, regulators and the general public in developed countries of their benign intentions and the purely commercial nature of their investments. Some SWFs that acquired large positions in Western banks and other public companies even decided to for-

⁸ The views expressed in this article are those of the author and do not necessarily represent the views of the company or any of its affiliates.

feit board representation and voting rights to make absolutely sure that they would not be seen as intervening in corporate strategy and the day-to-day operations of private sector companies.

However, such an open and unapologetically passive stance, while reassuring from a political perspective, has drawn criticism from other quarters. If a large and important institutional shareholder removes itself completely from monitoring management and participating in corporate governance, it can be liable on at least two counts. The first problem has to do with the fiduciary duty owed by the fund to its beneficiaries. If the share price of a company drops dramatically and its current management team continues to underperform, then sooner or later the domestic authority in charge of overseeing the SWF – and in certain cases, domestic media and the general public—will start asking difficult questions about what is being done to address the situation. The second issue has to do with market efficiency and the so-called “agency problem.” If large shareholders renege on their responsibility to hold management accountable, then boards can no longer be relied upon to deliver the best possible outcome, in terms of both shareholder value and market efficiency.

How is this circle squared? How can a sovereign wealth fund maintain its politically correct “arm’s-length” relationship with investee companies, while making sure their management teams do everything possible to protect and enhance the value of its shareholding? This article contains one specific proposal which may help SWFs do just that. But first, let us look more closely at the two distinct types of players in the area of corporate governance and shareholder activism, and consider how SWFs might be able to interact with them to achieve their objectives.

The first type is a broad-based group of institutional investors who are united in their strong belief that, as a matter of core investment philosophy, they must exercise their rights as owners to ensure long-term value creation and sustainability of the underlying investee companies. These investors typically understand

and acknowledge that, apart from shareholders and management, there are other important “stakeholders” in any company—customers, employees, creditors, suppliers, governments and local communities—and that a business enterprise will only be successful in the long-term if there is a sustainable balance between the interests of all the relevant constituencies. In their corporate governance activities these investors often look beyond just financial considerations and take

into account such “extra-financial” issues as the environment, labor practices, and social responsibility.

This approach is best illustrated by the activities of participants in the International Corporate Governance Network (ICGN) and signatories to the United Nations Principles for Responsible Investment (UNPRI). The former is an investor-led body representing \$15 trillion in assets and focused on promoting best practice in the areas of corporate communications, reporting and accountability; disclosure and transparency; voting rights, corporate boards, and executive remuneration policies; shareholder returns; corporate

citizenship and corporate governance implementation.⁹ The latter is an equally high-profile investor-led initiative to formulate and introduce, in partnership with the United Nations, a solid framework for incorporating environmental, social and governance (ESG) principles and practices into institutional portfolio management and financial analysis.¹⁰

Just like other market participants and commentators, these institutions have taken note of the recent emergence of SWFs as a new and powerful investor class. They have also observed that, with only a handful of exceptions—most notably

How can a sovereign wealth fund maintain its politically correct “arm’s-length” relationship with investee companies, while making sure their management teams do everything possible to protect and enhance the value of its shareholding?

⁹ For more information, see Monks and Minow (2004), pp. 299-304; also, see www.icgn.org

¹⁰ For more information, see www.unpri.org

sovereign funds in Norway, France, Ireland and New Zealand—these entities are typically shying away from corporate activism. As a result, in 2008 efforts were launched to engage some of the key SWFs in a dialog about how they could be persuaded to subscribe to these values and to join the respective networks.¹¹

The second type of investors who are directly relevant to this discussion are the so-called “activist hedge funds.” This group is much smaller: according to Hedge Fund Research, in 2006 assets under management in this category were only \$117 billion.¹² This figure is likely to have decreased dramatically during the current financial crisis. However, these hedge funds typically punch above their weight, as their strategy tends to be much more focused and aggressive, they tend to control larger stakes, and they are quick to escalate their activist efforts from quiet, behind-the-scenes discussions with management to widely publicized all-out corporate insurgency, with no-holds-barred media campaigns and intense proxy fights.

The interests of an activist hedge fund are not always aligned with those of large institutional investors. One typical example would be the occasional attempt by an insurgent to pressure a company into increasing its debt load and using the cash proceeds to buy back stock or to pay out a special dividend. This reveals a fundamental difference in investment horizons: while an activist may prefer to “unlock value” and cash out quickly, many institutional investors may want to hold the stock over a much longer period. In this case, lower leverage and higher cash reserves may prove beneficial, as the company considers investment in new business lines or acquisitions that may only become available at a later date. Maintaining a capital structure with lower leverage may also be helpful in times of economic downturn and financial distress.¹³

11 For example, ICGN dedicated a major part of its 2008 Mid-Year Meeting in Gothenburg, Sweden to debating the impact of sovereign wealth funds on corporate governance. Senior representatives from Kuwait, China, Russia and Norway were invited to participate and share their views.

12 Orol (2008), p. 3.

13 For a more detailed discussion, see Orol (2008), pp. 157-161.

But there will also be times when the fundamental interests of both groups are in perfect alignment—for example, on issues like the composition, competence and independence of boards of directors; executive remuneration; “poison pills” and other takeover defences; and merger, acquisition and divestiture proposals. In such situations, large institutional investors that may not be prepared to lead the insurgency themselves have the option of throwing their collective weight behind the proposals of an activist hedge fund. It is precisely because of increasing instances of such institutional support that hedge funds practicing this strategy have grown so quickly in number and size and are now able to take on companies with very large market capitalizations.

So where do sovereign funds fit in this picture? Most SWFs that allocate a meaningful proportion of their assets to public equities—intergenerational savings funds, national pension reserve funds and foreign exchange reserve investment

Most SWFs tend to operate more like the large institutional investors than the small, nimble and aggressive hedge funds.

corporations—tend to operate more like the large institutional investors than the small, nimble and aggressive hedge funds.¹⁴ It would not be unreasonable to expect them gradually to evolve toward the active ownership model espoused by ICGN and UNPRI. However, as mentioned above, there will also be times when joining forces with activist hedge funds would make sense. Therefore, in

the long run, it would be to the advantage of SWFs to establish relationships and develop a dialog with both groups of active owners.

In the near term, however, there may be a pressing need to find a more immediate solution to the problem of large underperforming equity stakes in Western

14 There is a small number of sovereign funds, primarily in the Middle East and South-East Asia, which operate more like private equity funds than broadly diversified multi-asset class portfolio investors. These funds typically practice a much more hands-on style of investment and can be expected to be more deeply involved in corporate governance and strategy.

companies—a solution that would not only have to be effective in terms of prodding these companies’ boards and management teams to increase the value of the shares, but that would also be 100 percent commercial, implemented in a politically acceptable way and at an “arm’s length” from the sovereign owner. One possible solution could be for SWFs to outsource the management of their entire equity stakes in these companies to activist hedge funds, in a way that would fully take into account the long-term investment horizon, return expectations and various constraints under which SWFs operate, but also deploy the appropriate value-maximizing tools and strategies used by activist shareholders.¹⁵

SWFs could outsource the management of their entire equity stakes in these companies to activist hedge funds to improve the performance of their Western investments.

The idea of SWFs joining forces with activist hedge funds is novel, but not entirely unprecedented. For example, in late 2007 Qatar Investment Authority reportedly worked with Trian, the U.S.-based activist hedge fund owned by billionaire Nelson Peltz, on a potential deal in the United Kingdom.¹⁶ However, the concept of an SWF outsourcing its pre-existing equity stake in a publicly-traded company to an activist investor, under a set of pre-agreed guidelines, constraints and benchmarks, is new. Such engagement by SWFs with activist hedge funds could be mutually beneficial and could further contribute to the development of an already productive and fruitful relationship between the two groups of active owners. It could open up a whole new chapter in the history of corporate governance.

15 This proposal was first put forward by this author at a conference in London in February 2009 and received support from Edwin Truman, a renowned expert on central bank reserves and sovereign wealth funds (see “Sovereign Wealth Funds to Become “Activist Investors,” *Financial News*, March 2, 2009).

16 “Cadbury Rises as Peltz Raises Stake,” www.telegraph.co.uk (December 12, 2007).

References

Robert A.G. Monks and Nell Minow, “*Corporate Governance*,” 3rd edition, Blackwell Publishing, 2004.

Ronald D. Orol, “*Extreme Value Hedging: How Activist Hedge Fund Managers Are Taking On the World*,” John Wiley & Sons, Inc., 2008.

Elizabeth Pfeuti, “Sovereign Wealth Funds to Become ‘Activist Investors,’” *Financial News*, March 2, 2009.

Jonathan Sibun, “Cadbury Rises as Peltz Raises Stake,” *Telegraph*, December 12, 2007.

International Corporate Governance Network (ICGN) website: www.icgn.org.

United Nations Principles for Responsible Investment (UNPRI)
website: www.unpri.org.

SWFs and the Crisis: Putting a Brake on Growth¹⁷

By Paola Subacchi, Chatham House

Introduction

SWFs have come to epitomize the strong surge in global capital flows seen over the last decade and the emergence of new players such as China and the Persian Gulf States. Buoyant growth in trade has been the driving force behind both the expansion in capital flows and the massive build-up in foreign exchange reserves. Strong global demand and high oil prices helped the emerging market economies of Asia and oil-exporting countries achieve external surpluses that were channeled into FX reserves holdings and government investment funds, with the result that these surpluses have been invested largely through the public rather than the private sector. Reserve accumulation, in particular, has been the main feature of the Asian economies since the financial crisis of 1997-98, providing a means of stabilizing exchange rates as well as creating a cushion of security in case of recurrent balance-of-payment crises.

But for the small oil-dependent Gulf States channeling surplus revenues into central bank managed FX reserves held less appeal—this was inconsistent with their financial and development goals given the need for a multi-generational diversification of their economic base. SWFs provided a more suitable, and flexible, vehicle for stabilizing oil revenues, diversifying the economy and managing wealth for future generations (Jen, 2008). As oil prices and related revenues rose in 2004–2008, the scale of global SWFs also soared.

17 This contribution is part of a joint research project Chatham House-FEEM (Fondazione Eni Enrico Mattei). It was first presented at the workshop 'Everything changes: is there an enhanced role for SWFs in the post-crisis financial world?', held at Chatham House in London on 3 December 2008. The paper has greatly benefited from comments from participants, in particular Bernardo Bortolotti, Bill Megginson, Alastair Newton, John Nugée, Vanessa Rossi and Andrew Rozanov. The author thanks Nora Burghart for research assistance.

Falling oil prices and collapsing export revenues have substantially reduced SWFs' projected growth rates and allayed concern over their influence and future role.

By early 2008, before the violent eruption of the financial crisis, SWFs were regarded as significant and increasingly important players in global finance. However, a year later, they look considerably less powerful. Falling oil prices and collapsing export revenues have substantially reduced SWFs' projected growth rates and allayed

concern over their influence and future role. In addition, the decision of many SWFs to focus on their domestic markets and, in some cases, to provide aid for faltering domestic institutions has contributed to damping down political and media attention.

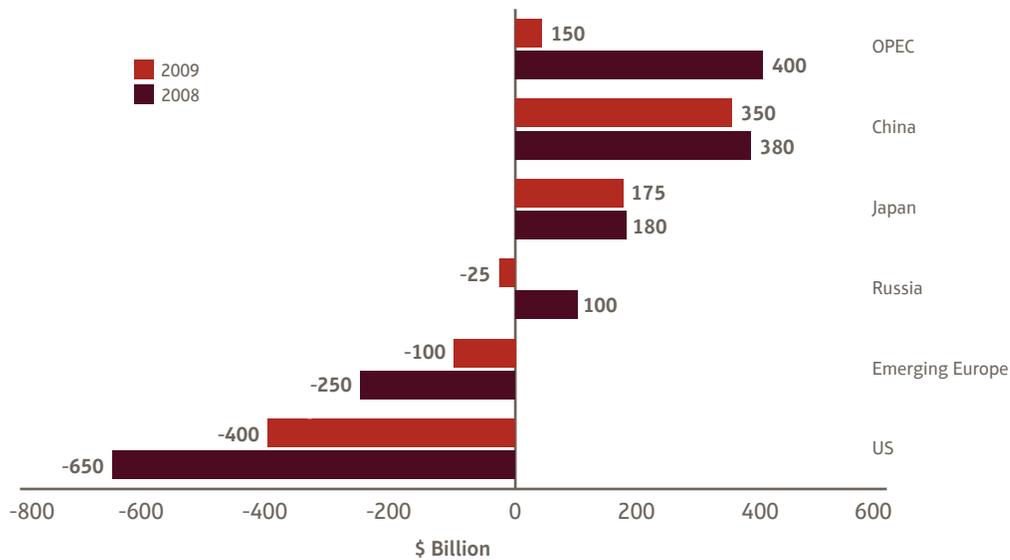
This contribution to the debate will examine the impact of the financial and economic crisis on SWFs, assessing the slowdown in growth in these funds linked to more adverse market conditions. Weaker growth and a more inward-looking investment approach are likely to result in a less prominent role for SWFs in the international financial system for some years to come.

Exports Revenues and FX Accumulation

After a prolonged period of strong global growth that served to exaggerate trade imbalances—generating ever larger trade surpluses for a few countries but wider deficits for others—the crisis has suddenly reversed global demand and brought growth prospects to a shuddering halt. World trade has fallen sharply and trade imbalances will also contract (Chart 1). In particular, a substantial drop in U.S. domestic demand along with lower energy prices has cut U.S. imports more than exports, rapidly reducing the United State's trade deficit. At the same time, demand has also fallen sharply in Europe. Given the dependence of many emerging market economies on American and European trade, the dramatic contraction in this trade has led to an equally dramatic collapse in production and activity in these economies, especially across Asia and oil exporting countries. For Japan and Korea this

has meant a 40-50 percent fall in exports, back to pre-boom levels, while for China exports have dropped by around 20 percent. For oil exporters, the most important impact of the crisis has been the drop in oil prices, from an average of \$100 a barrel in 2008 to around \$50 in 2009. As a result, export revenues and current account surpluses will see a sharp reversal in contrast to the steep increases registered up to 2008. While China’s estimated current account surplus of more than \$350 billion in 2008 may decrease moderately in 2009, OPEC’s similarly large 2008 surplus looks set to drop to well under \$200 billion.

Chart 1: Current account imbalances to shrink



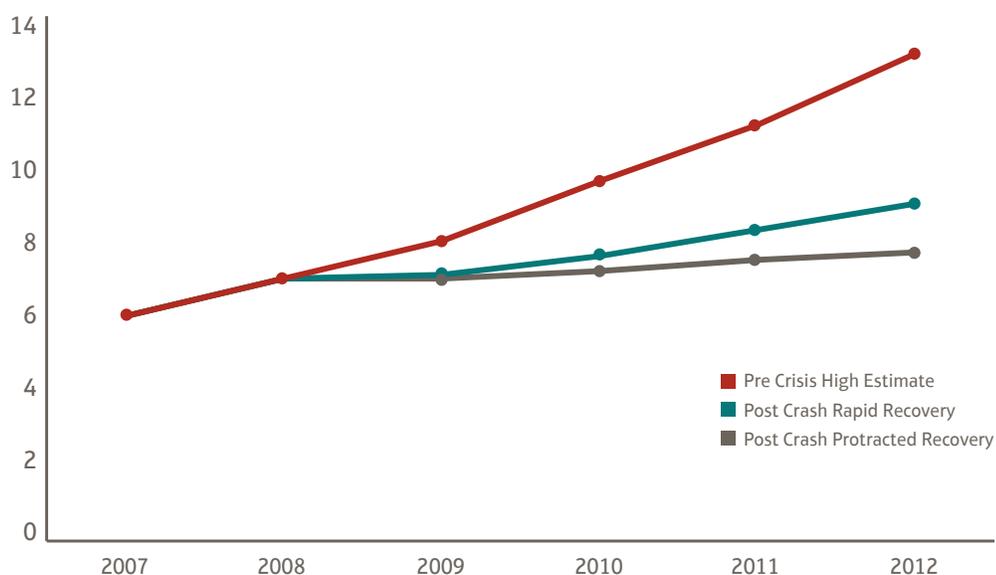
Source: Author’s Estimates, IMF

Mirroring the growth of trade and balance of payments and surpluses across emerging market economies, global FX reserves climbed to \$7 trillion in 2008. FX reserves held by the top 10 countries, headed by China, increased by 32.4 percent between September 2007 and 2008, with the BRICs showing the most impressive

growth rates. China's foreign exchange reserves grew by 27.3 percent in 2008 (Chart 2), less rapidly than the 43.3 percent increase in 2007—in fact this was the lowest growth in China's FX reserves since 2001 (although from a much higher base). At the end of 2008 China's foreign reserves—mostly in US dollars—were \$1.95 trillion.

However, as current account imbalances shrink and capital flows also drop sharply, such rapid growth in FX reserves will not be sustained in 2009. While some countries, such as China, should be able to maintain modest growth in FX reserves, other countries will see a decline (for example, Russia's reserves have already fallen). Future growth will depend on the speed and strength of the post-crisis recovery, but a return to the pre-crisis rate of accumulation is unlikely in the near term.

Chart 2: The crisis and FX reserves



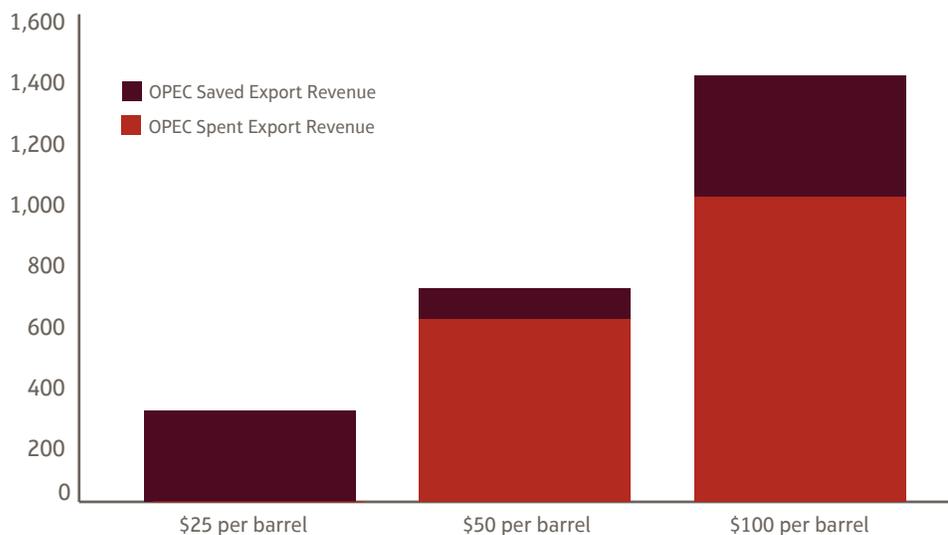
Source: Author's Projections

Oil Prices and the Growth of SWFs

A key driver of the expansion in SWFs, particularly those in the Middle East, is oil wealth. The SWF boom followed the oil windfall, which virtually disappeared by the end of 2008. Oil prices experienced extreme volatility last year, peaking at almost \$150 a barrel during the summer before dropping sharply from August to December. However, an average oil price of \$100 in 2008 probably created sufficient windfall savings to fund a total annual inflow of approximately \$300 billion into the SWFs of the oil producing economies (Setser and Ziemba, 2009).

With oil prices expected to average \$50 a barrel in 2009 and \$60 a barrel in 2010, according to the latest IMF forecasts, annual inflows into SWFs will clearly be much reduced. OPEC savings are estimated to fall to about \$50 billion with oil prices at \$50 per barrel (Chart 4) and the scope for savings would disappear at prices below \$30. Moreover, given the exceptionally large fiscal stimulus packages unveiled by the Gulf States in response to the economic crisis, oil revenues are even more likely to be used to support such expansionary policies.

Chart 3: SWF savings in opec countries on top of energy export revenues



Source: Author's Estimates

These estimates are broadly in line with Setser and Ziemba (2009). Although they suggest that oil-exporting economies only manage to break even at \$50 a barrel, this may be less the case for the Gulf than for other oil producers. For 2008, estimates do point to the Gulf region requiring oil prices of around \$50 a barrel to cover import costs, but such costs were inflated during this period by both booming Gulf growth and high global prices for essential imports such as food and building materials and these factors have since subsided. If oil prices were to stay around \$50 over the next five years, it is possible that some Gulf economies might consider tapping into savings (as suggested by Setser and Ziemba, 2009) rather than increasing borrowing or cutting spending. However, if oil prices rise in line with forecasts, then savings should recover. At \$75 a barrel, the Gulf economies are estimated to be capable of generating savings of around \$125-150 billion into SWFs—similar to the level achieved in 2005 when oil averaged about \$55 a barrel. In addition, the value of SWF holdings will also pick up as global markets recover, possibly creating substantial gains after the losses of the last year.

Taking a Break: Slower Growth for SWFs

Over the last six months, SWFs have contracted significantly in terms of value of funds under management as holdings have been hit by the drop in asset prices. Estimates of losses focus on investments in listed equities (valuations of unlisted equity investments are even more difficult to assess). According to the available evidence, this loss exceeded \$98 billion, or 78 percent of the original purchase price, as of late February 2009 (Bortolotti et al, 2009). At the same time, considerably weaker national savings (chiefly linked to lower oil revenues, as discussed above) have limited the scope for inflows of new funds into SWFs—priorities have shifted from long-run savings plans to supporting short-term fiscal packages and financial sector bail outs. In addition, there is likely to be a swing in preferences towards building up relatively secure central bank FX reserves in those countries which had previously limited FX reserves in favor of growing SWFs. Existing SWFs have also to take account of increasing demand for support for domestic markets, and adjust their strategy and objectives as a result.

The analysis presented here implies that, at best, the total value of funds under management in SWFs will stand still in 2009, while the influence of SWFs in global markets will also diminish. Indeed savings inflows into SWFs look set to remain weak over the next few years until a strong global economic recovery can become well established—the most likely source of faster short-term gains in SWFs will be from a one-off bounce back in global asset prices.

This represents a major reversal in opinion. Back in 2007 SWFs were widely predicted to reach about \$10 trillion by 2012. At that time, Stephen Jen was even more optimistic, suggesting that inflows could be as large as \$40 billion per year and the pool of assets managed by SWFs could reach \$12 trillion by 2015 (Jen, 2007). Recent events, however, suggest more caution. Jen more recently predicted that SWFs' assets would grow to \$9.7 trillion by 2015 (Jen and Andreopoulos, 2008). He estimated losses of about 25 percent in the first three quarters of 2008, eroding SWFs assets from \$3 trillion at the beginning of 2008 to \$2.3 trillion by October. Since then, the economic and financial market situation has actually deteriorated and SWFs' valuations might have to be downgraded yet again as a result of the fall out from the global financial crisis. It is now more likely that SWFs total assets will struggle to reach between \$5 and \$6 trillion by 2012, half the value predicted in 2007.

SWFs have contracted significantly in terms of value of funds under management as holdings have been hit by the drop in asset prices.

References

Bortolotti, B., Fotak, V., and Megginson, L. W., and Miracky, W., “Sovereign Wealth Fund Investment Patterns and Performance,” working paper, 2009.

Stephen Jen, “*How Big Could Sovereign Wealth Funds Be by 2015?*,” Morgan Stanley Research Global, 2009.

Stephen Jen, “The GCC: Transforming Oil Wealth Into Financial Portfolios,” *The Gulf Region: A New Hub of Global Financial Power*, edited by John Nugée and Paola Subacchi, Chatham House, London, 2008.

Stephen Jen and Spyros Andreopoulos, “SWFs: Growth Tempered—US\$10 Trillion by 2015,” Global Economic Forum, Morgan Stanley, November 10, 2008.

Bred Setser and Rachel Ziemba, *GCC Sovereign Funds: Reversal of Fortune*, Council on Foreign Relations, Working Paper, New York, 2009.

Paola Subacchi, “Asian and Gulf Sovereign Wealth Funds: A Tale of Two Continents,” *The Gulf Region: A New Hub of Global Financial Power*, edited by John Nugée and Paola Subacchi, Chatham House, London, 2008.

Sovereign Wealth Fund Losses in Listed Firm Stock Investments

By Veljko Fotak, Doctoral Candidate, University of Oklahoma

Bill Megginson, Professor & Rainbolt Chair in Finance, University of Oklahoma

Hui Li, MBA Student, University of Oklahoma

The past eighteen months have been a very painful time for stock market investors the world over, but how have the investments in listed company stocks that sovereign wealth funds have made in recent years performed? The newly created Monitor-FEEM SWF Transaction Database allows us to investigate the long-term performance of SWF investments in publicly traded firms. At an aggregate level, we find that SWFs have suffered substantial paper losses, totaling \$57.2 billion on the \$125.7 billion invested in listed firm stocks from inception through March 27, 2009. That corresponds to an unadjusted return of -46.7 percent. Table 1 reports the aggregate performance of SWF investments in listed companies and analyzes the performance of the 24 largest listed-firm investments (those worth at least \$1 billion) included in the Monitor-FEEM SWF Transaction Database. The findings are very disturbing for sovereign fund investors: those 24 transactions are associated with a total apparent loss of \$56.3 billion, which indicates that the substantial paper losses that SWFs have suffered are almost entirely due to few, large transactions.

Even more, the underperforming SWF investments are extremely clustered, both over time and in terms of target industry. No fewer than 12 of the 20 largest SWF investments in listed-firms occurred between November 2007 and February 2008—and ten of the deals in this four-month period, worth \$56.9 billion, involved direct investments in distressed Western banks. By March 2009, those ten bank investments were collectively worth a mere \$15.7 billion, implying an apparent loss of \$41.3 billion (or 73 percent of initial value) on these deals in barely one year. Since the total potential losses incurred by SWFs on all the listed-firm investments we track equal \$57.2 billion, it is clear that the massive hole in sovereign wealth fund portfolios today resulted from a mere handful of disastrous stock picks in the

western financial industry. Even worse, if we calculate the apparent losses on the 24 largest investments from inception through the cyclical low point (so far) for stocks on March 6, 2009, the apparent losses total over \$62.6 billion, or almost 70 percent of initial value. For the ten bank investments, the paper losses through March 6 were \$45.4 billion, or almost 78 percent of original value.

While Table 1 reveals that only three of the 24 largest SWF public-equity investments have proven profitable, long-term returns on SWF investments are on average positive. In particular, we find that the average return on SWF investments over a two-year horizon is equal to 42.4 percent. Also, we find that about 60 percent of SWF investments lead to positive returns over a two-year horizon. Yet,

Collectively, these funds have invested more new capital into the world's financial institutions recently than any other single entity except the United States government.

even though returns are, on an average, positive, there are still clear signs of underperformance. To more accurately gauge the performance of SWF investments, we compute the difference between the average return on SWF investments and the average return on a sample of “matched” firms. To construct this “matched” sample, for each firm in which a SWF has invested, we find the firm from the same country and industry which is most similar in size.

Our analysis indicates that, over two years, the average return on SWF investments in publicly traded companies is 15.5 percent lower than the average return on matched firms. We obtain similar results when comparing the performance of SWF investments to local market indices, indicating severe underperformance on a risk-adjusted basis. The average SWF investment is profitable, but underperforming. Yet, the largest investments are clearly not profitable, leading to substantial overall portfolio losses.

There are two possible explanations for the severe underperformance of SWF investments over the long term. On one hand, SWFs might be passive investors and the long-term negative performance might simply be a result of unfortunate

stock-picking. Alternatively, SWFs might be perceived to be active investors whose interests are conflicting with those of other, minority shareholders. Even the perceived possibility of such conflict of interest would result in agency costs and a loss of firm value, thus potentially leading to a negative stock-price reaction.

In order to determine which of those two hypotheses is correct, we systematically analyze the determinants of long-term performance. Unsurprisingly, our analysis indicates that SWF investments in targets in the financial industry have performed worse than the average SWF investment. Considering that almost one-third of the number (30.9 percent) and over half of the value (54.6 percent) of SWF investments in publicly traded companies have been directed to financial firms, the recent poor performance of the industry goes a long way towards explaining the underperformance of SWF investments. In total, SWFs invested almost \$90 billion in the stock of U.S. and European financial institutions between July 2005 and October 2008, and the newly created China Investment Corporation injected an additional \$40 billion into recapitalizing two state-owned banks in late 2007 and 2008. Collectively, these funds have invested more new capital into the world's financial institutions recently than any other single entity except the entire United States government.

More interestingly, our analysis indicates that financial firms in which SWFs have invested have actually performed poorly even compared to other financial firms. In other words, not only did SWFs invest disproportionately in a poorly performing industry, but they have consistently picked stocks that have underperformed even within that industry. Our data also indicates that, on average, investment targets have underperformed over the one year preceding the investment by the SWF, and that this underperformance tends to persist for at least six months following the investment. Taken together, this evidence indicates that SWF underperformance is at least partially explained by suboptimal stock picking. Yet, we also find that the degree of underperformance is related to both the governance and the transparency of the SWF and to the size of the stake acquired in the target company. This

evidence is not consistent with underperformance being purely due to suboptimal capital allocation. Ultimately, stock picking is responsible for at least a portion of the underperformance, but does not explain the entire phenomenon. Rather, SWFs are perceived to negatively impact the firms they invest in, leading to stock market underperformance. This is consistent with the imposition of agency costs resulting from the threat of conflicts between SWFs and other, minority, shareholders.

While our analysis clearly indicates that SWFs have picked underperforming investment targets, both in terms of industry and individual securities, we should not be too quick in attributing this underperformance to poor stock picking abilities. Certainly, the fact that most of these funds originate from emerging economies without well-developed financial markets increases the risk of inexperienced managers negatively affecting fund performance. Yet, anecdotal evidence indicates that SWF managerial teams are often staffed by well-established professionals, frequently hired from the private sector. Rather, unfortunate stock picking could be a consequence of political pressures which led SWFs to invest in distressed industries in order to minimize target-country regulatory and political opposition.

Table 1: Details of the Largest SWF Investments in Listed Stocks, with Investment Returns from Inception to March 27, 2009

ACQUIROR NAME	TARGET NAME	INVESTMENT DATE	VALUE OF INVESTMENT (\$MIL)	VALUE 03/27/2009 (\$MIL)	HOLDING PERIOD RETURN, INCEPTION TO MARCH 27, 2009	GAIN OR LOSS, (\$MIL)
Government of Singapore Investment Corporation (GIC)	UBS	2/8/2008	\$14,400.00	\$4,339.16	-69.87%	-\$10,060.84
Government of Singapore Investment Corporation (GIC)	UBS	12/10/2007	\$9,760.42	\$2,121.06	-78.27%	-\$7,639.36
Abu Dhabi Investment Authority	Citigroup Inc.	11/27/2007	\$7,500.00	\$684.87	-90.87%	-\$6,815.13
Government of Singapore Investment Corporation (GIC)	Citigroup Inc	1/15/2008	\$6,880.00	\$2,370.00	-65.55%	-\$4,510.00
Abu Dhabi Investment Authority (ADIA)	PrimeWest Energy Trust of Canada	9/7/2007	\$5,000.00	\$5,371.40	7.43%	\$371.40
China Investment Corporation	Morgan Stanley	12/19/2007	\$5,000.00	\$2,545.13	-49.10%	-\$2,454.87
Temasek Holdings	Merrill Lynch & Co Inc	12/27/2007	\$4,400.00	\$515.00	-88.30%	-\$3,885.00
Kuwait Investment Authority	Dow Chemical Company	7/10/2008	\$4,019.08	\$1,171.06	-70.86%	-\$2,848.02
Temasek Holdings	Standard Chartered PLC	3/27/2006	\$4,000.00	\$2,345.39	-41.37%	-\$1,654.61
Temasek Holdings	Merrill Lynch & Co Inc	7/27/2008	\$3,400.00	\$1,767.28	-48.02%	-\$1,632.72
Dubai International Financial Centre	OMX AB	2/29/2008	\$3,396.80	\$3,644.26	7.29%	\$247.46
Qatar Investment Authority (QIA)	Credit Suisse	1/28/2008	\$3,000.00	\$1,680.90	-43.97%	-\$1,319.10
Istithmar World	Time Warner	11/27/2006	\$2,000.00	\$2300.00*	15.00%*	\$300.00*
China Investment Corporation	Fortescue Metals Group	2/4/2008	\$2,000.00	\$552.96	-72.35%	-\$1,447.04
Korea Investment Corporation	Merrill Lynch & Co Inc	1/15/2008	\$2,000.00	\$238.02	-88.10%	-\$1,761.98

58 WEATHERING THE STORM
Articles

Kuwait Investment Authority (KIA)	Citigroup Inc.	1/16/2008	\$3,000.00	\$299.40	-90.02%	-\$2,700.60
Kuwait Investment Authority (KIA)	Merrill Lynch & Co Inc	1/15/2008	\$2,000.00	\$238.02	-88.10%	-\$1,761.98
Temasek Holdings	Shin Corp Pcl	1/23/2006	\$1,900.00	\$991.98	-47.79%	-\$908.02
Dubai International Financial Centre	Deutsche Bank	5/16/2007	\$1,800.00	\$540.31	-69.98%	-\$1,259.69
Dubai International Financial Centre	London Stock Exchange Plc	8/17/2007	\$1,648.02	\$534.65	-67.56%	-\$1,113.37
Investment Corporation of Dubai	Inmobiliaria Colonial SA	3/11/2008	\$1,504.51	\$199.40	-86.75%	-\$1,305.11
Qatar Investment Authority (QIA)	J Sainsbury	6/15/2007	\$1,400.00	\$554.38	-60.40%	-\$845.62
Temasek Holdings	Stats Chippac Ltd	5/18/2007	\$1,083.48	\$190.59	-82.41%	-\$892.89
Istithmar World	Standard Chartered Plc	10/6/2006	\$1,000.00	\$580.42	-41.96%	-\$419.58
Total			\$92,092.31	\$35,775.64	-61.15%	-\$56,316.67
Total, 189 sovereign wealth fund investments in listed firms			\$125,650.29	\$58,772.29	-53.23%	-\$66,878.00

* News reports indicate Istithmar sold its Time Warner stake during the “second half of 2008” for a return in the “mid-teens,” so this estimate assumes a 15 percent return.

Source: Monitor-FEEM SWF Transaction Database.

Investing in Energy: What NOCs Should Learn From SWFs

By Victoria Barbary, Office of the Chairman, Monitor Group

In the early 2000s, as oil prices soared, National Oil Companies (NOCs) rose to prominence, consolidating their power as aggressive resource holders and seekers, pushing the world's biggest International Oil Companies (IOCs)—ExxonMobil, Chevron, BP and Royal Dutch Shell—out of the spotlight. In 2007, *The Financial Times* published a list of the new “seven sisters”, all of which were NOCs from emerging markets—Saudi Arabia, Russia, China, Venezuela, Malaysia, Iran and Brazil. Between them they controlled almost a third of global oil and gas production, and over a third of reserves. Although these seven giants have a significant role in the oil industry, the influence of NOCs is not limited to these companies: NOCs as a whole dominate the sector. In 1970, IOCs controlled 85 percent of the world's proven oil reserves; in 2009, they control less than 10 per cent, while NOCs have command of 80 percent. NOCs are now, therefore, responsible for the majority of global oil production and play an integral role in the functioning of the global economy.

To date, NOCs have tended to invest aggressively in upstream expansion: exploring for and developing new reserves. This has been important for developing countries such as China and India for whom energy security is paramount, and whose thirst for fuel has risen rapidly, and (despite the current downturn) will continue to expand in the long term. This increasing appetite for energy has often led NOCs from emerging markets to engage with regimes vilified in the West and shunned by IOCs. The most notable example is in Sudan, where the China National Petroleum Corporation (CNPC) owns 40 percent—the largest single share—of the Greater Nile Petroleum Operating Company, a consortium that dominates Sudan's oil fields. Its partners are Malaysia's Petronas and the Oil and Natural Gas Corporation, an Indian NOC, which have 30 percent and 25 percent shares respectively.

This increasing appetite for energy has often led NOCs from emerging markets to engage with regimes vilified in the West and shunned by IOCs.

However, NOCs' quest to extend their reach has led to shortfalls in investment where it is really needed—downstream infrastructure, such as refining capacity, petrochemicals, petroleum product distribution, retail outlets and natural gas distribution. In the low-price years of the 1980s and 1990s, there was a dearth of investment in oil infrastructure, which left the industry unprepared for the surge in demand in the 2000s. Where there was investment, it was slow to come online because of shortages in equipment and skilled personnel. The industry continues to pay the price for these lean years; the International Energy Agency predicted in

its *2008 World Energy Outlook* that \$26 trillion (2007 dollars) will be needed in energy infrastructure before 2030, revising this figure up from \$22 trillion in 2007; about a quarter of this expenditure will be required to upgrade and expand the oil sector's infrastructure.

However, NOCs are unlikely to be willing or able to invest in upgrading technology. Like most state-owned firms, NOCs are prone to suffering inefficiencies, such as overstaffing and underinvestment, hindering their ability to compete at international standards. Indeed, the degree of NOCs' inefficiencies are highlighted by the fact that over the seven-year period around and NOCs' initial privatization offering, return on sales increases by 3.6 percentage points, total output by 40 percent, capital expenditure by nearly half, and employment intensity drops by more than a third.¹⁸ NOCs thus have some way to go to meet the operating standards of their IOC counterparts.

However, more than most, the business of pumping and selling oil can become entirely subsumed by politics, and some NOCs have become the tools of the princes, politicians and kingpins who wield ultimate authority over them. Moreover, even

18 Christian Wolf and Michael Pollitt, *Privatising national oil companies: assessing the impact on firm performance*, Judge Business School, University of Cambridge, Working Paper Series, 02/2008.

where NOCs are not mismanaged, the substantial income states derive from oil has meant that the firms are frequently in thrall to government objectives, and under pressure to maximize the flow of funds to national treasuries for financing wider socio-economic policy objectives, such as job creation and wealth redistribution. Such non-core, non-commercial obligations impose costs on NOCs and, in some cases, have diluted the incentive to maximize profits. Consequently, NOCs tend to produce less oil, more expensively than they should.

This is where SWFs have found their niche. Unconstrained by policy objectives (on the whole), and, therefore, more interested in plotting a strategic trajectory, SWFs have taken the opportunities to fill this shortfall. Although some SWFs, particularly the Libyan Investment Authority and the Mubadala Development Company, have looked to invest in upstream activities, more than two thirds of SWF investments in the energy sector in 2007 and 2008 were in downstream activities, alternative energy or power generation.

In September 2008, for example, Mubadala entered into a joint venture with Petrofac Ltd to 'provide a full range of engineering, design, procurement and construction services for onshore oil and gas, refining and petrochemical projects' in the UAE. This downstream investment complements the strategy of the Abu Dhabi National Oil Company, which has concentrated on developing new supplies, for example its joint venture with ConocoPhillips to develop the Shah Gas Field in September, and its award of a \$1.2 billion contract to Spain's Tecnicas Reunidas and Athens-based Consolidated Contractors International Co. for the Sahil and Shah Gas Fields in January 2009.

Asian SWFs have also sought to improve downstream infrastructure. For instance, in May 2008, GIC paid \$400 million for an 11 percent stake in US firm AEI Services, a company that has substantial interests in Asia and operates businesses in

power distribution, power generation, natural gas transportation, distribution and services, and retail fuel. Although such a relatively small equity purchase might not in itself seem important, a nominee of GIC Special Investments was also appointed to AEI's Board of Directors, an unusual move for a SWF to take, particularly in a Western company in a 'sensitive sector', underlining the importance the fund attached to being involved in the downstream energy industry.

It thus appears that SWFs are helping to bridge the gap between upstream and downstream capabilities, complementing the strategies of their NOCs. Moreover, it suggests that SWFs are sensible to the importance of downstream activities to energy security and development objectives and are heeding warnings that heavy investment will be needed in downstream operations to meet demand.

The business of pumping and selling oil can become entirely subsumed by politics, and some NOCs have become the tools of the princes, politicians and kingpins who wield ultimate authority over them.

Another move taken by SWFs is that of investing in alternative energy, much like several IOCs. For example, both Shell and BP—"Beyond Petroleum"—are investing heavily in wind and solar power, biofuels and hydrogen power. Through its Masdar City project, Mubadala has invested \$2 billion in photovoltaic energy

production development and owns 20 percent of London Array offshore wind farm project, which, when completed, will be the world's largest offshore scheme. Furthermore, through a joint venture with American conglomerate GE, Mubadala has enlisted its help to develop clean energy technologies. Similarly, Khazanah, the Malaysian fund, has entered into a joint venture with Beijing China Sciences General Energy and Environment Company to develop municipal waste-to-energy (WTE) projects in China, committing to investing up to \$150 million in eight WTE projects over three years. QIA also made an investment in American hybrid sports car manufacturer, Fisker Automotive, and has signed a Memorandum of Understanding with Britain's Carbon Trust on a new Low Carbon Innovation Partnership to set up a new £250 million Clean Technology Investment Fund and investigate the creation of a Low Carbon Innovation Centre in Qatar.

As oil prices have dropped since last fall such diversification of energy investment portfolios has protected SWF investors from the worst of the shock. NOCs, which tend to have oil-centric operations, have borne the brunt declining revenues. During 2008, their shares have declined overall by 64 percent as investors, who had been attracted by their potential value, started to favor companies with a sure cash flow from numerous sources. On the whole, IOCs, which have more varied portfolios—dabbling in refining and petrochemicals, LNG and alternative energy—only averaged losses of 34 percent in 2008. For example, ExxonMobil's shares dropped 15 percent during last year, in contrast to Gazprom's 74 percent.¹⁹ NOCs are beginning to learn lessons from their more commercially-minded SWF and IOC brethren. In 2008, China National Offshore Oil Corporation, China's dominant offshore oil and gas producer and third largest oil company, has started developing its downstream sales network, with the construction of the 12 million-tonne-per-year Huizhou refining project, in Guangdong province. By so doing, the company hopes to steal the advantage from its bigger national competitors, Sinopec and CNPC.

A unifying feature of SWF investments in the energy sector, both in the downstream oil industry and in alternative energy, is that SWFs are moving away from being purely passive investors towards taking an active role, and ultimately towards developing operational capacities and capabilities in these sectors. They are thus set to play an important role in developing energy infrastructure in the coming years. This is vital to energy security at a time when oil prices have plummeted. Moreover, by diversifying their energy portfolios, SWFs appear to have avoided sustaining the acute losses of the NOCs in their energy portfolios. SWF investment thus seems a move to avoid repeating the mistakes of the 1980s and 1990s, and offset the shortcomings of the investment strategies of their countries' NOCs.

19 Carola Hoyos, "Downturn hits national oil groups' shares", *Financial Times*, 25 January 2008.



CHINESE DRAGON

Appendix

MONITOR-FEEM SWF TRANSACTION DATABASE	65
TEN LARGEST DEALS OF 2008	69
HIGHLIGHTS OF THE LITERATURE ON SWFs	70
SELECTION OF LITERATURE ABSTRACTS	73
ACKNOWLEDGEMENTS.....	91

Monitor-FEEM SWF Transaction Database

Our research methodology focused on two main objectives: comprehensiveness of research and accuracy of information. To ensure comprehensiveness, we surveyed multiple sources, primarily relying on established business and financial databases as well as other reliable news sources and funds' websites. Most of the deals were amassed and consolidated from the business databases, with the other sources used for corroboration where necessary. To ensure accuracy, at least one high-quality source was captured for each data point, and where possible, two or more sources were established. Articles from information aggregators such as LexisNexis were carefully examined to ascertain the reliability of the original source. Moreover, news wires such as the Associated Press and Reuters were not used as a sole source of deal information because data quality tended to vary considerably.

We followed a strict process for capturing deal information, establishing a clear prioritized order for the reliability of sources.

1. Financial transaction databases: Thomson One Banker (and SDC Platinum), Bloomberg, and Zephyr
2. Fund websites (where available)
3. News sources: *Financial Times*, *New York Times* (DealBook), *Wall Street Journal* (DealJournal), *GulfNews*, *Zawya.com*
4. Information aggregators: *LexisNexis*
5. News wires: *Associated Press*, *Reuters*

The information captured is shown below:

Monitor-FEEM SWF Transaction Database Variables

Deal ID	Announced Year
Parent Entity Name	Completed Month
Country of Parent Entity HQ	Completed Year
Sub-National Affiliation	Completed Quarter
Region of Parent Entity HQ	Size of the Deal (USD MM)
Investing Entity Name	Deal Size Estimated Flag
Country of Investing Entity HQ	Deal Size Converted Flag
Target Name	Reported Currency and Unit
Target Description	Size of the Deal (Reported Currency)
Target ISIN	Size of the Deal (Reported Currency) Estimated Flag
Country of Target HQ	Size of Stake Acquired
Region of Target HQ	Size of Stake Owned After Transaction
Target OECD_BRIC_Other	Controlling Stake
Target Sector Raw	Advisor on Deal (Target)
Target Primary SIC Code	Advisor on Deal (Investor)
Target Industry Name (from SIC Code)	Deal Status
Announced Day	Acquisition Technique
Announced Month	Target Type

It is important to note that SWFs are discreet institutions, and much of their activity is private and unreported. Most estimates put the total funds controlled by SWFs as between \$2 trillion and \$3 trillion. About 10 percent of this amount is publicly reported and consists of direct investment in equities and real estate. While this is a relatively small percentage, we can only comment on what we see.

In some cases, this lack of transparency is due to investments in low-risk liquid assets, such as U.S. Treasury bonds, falling under the radar of our data collection. In other cases, a transaction is not visible because the SWF invests through third-party asset managers. While the total investment in a financial broker may be known, the

individual equity purchases cannot be attributed to the SWF. For example, Norway's Government Pension Fund—Global has over 7,000 equity holdings according to its website. However, these do not appear in M&A databases because the transactions were carried out by over 40 external equity and fixed income managers such as BlackRock, Janus Capital, and Wellington Management.²⁰

We followed a strict process for capturing deal information, establishing a clear prioritized order for the reliability of sources.

The Monitor-FEEM SWF Transaction Database includes only completed M&A deals, joint ventures, and real estate investments. Pending, rumored, and withdrawn deals are captured when available, but are not included in the aggregate statistics published in this report. Divestments are not recorded, so our data is not an accurate picture of a fund's current holdings.

While 31 funds fit within our definition, our research found only 17 to have carried out publicly-available transactions (emboldened in Table 1, see page 9). Eleven of these funds are based in the Middle East and North Africa and six are based in Asia-Pacific.

The Monitor-FEEM SWF Transaction Database contains 1,158 deals with a reported value of \$369.2 billion between 1 January 1981 and 31 December 2008²¹. Asia-Pacific-based funds comprise the majority of this data by number (70 percent) and value (62 percent). The leading SWFs in number of transactions are Temasek (comprising 43 percent of the database), GIC (16 percent), and Khazanah (9 percent). CIC has the largest publicly-reported expenditure of \$82 billion, but has carried out only 14 deals. Following CIC, GIC has a reported

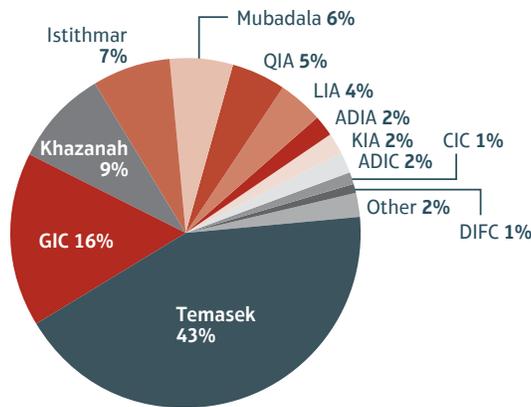
It is important to note that SWFs are discreet institutions, and much of their activity is private and unreported.

²⁰ Norges Bank Investment Management Annual Report 2007.

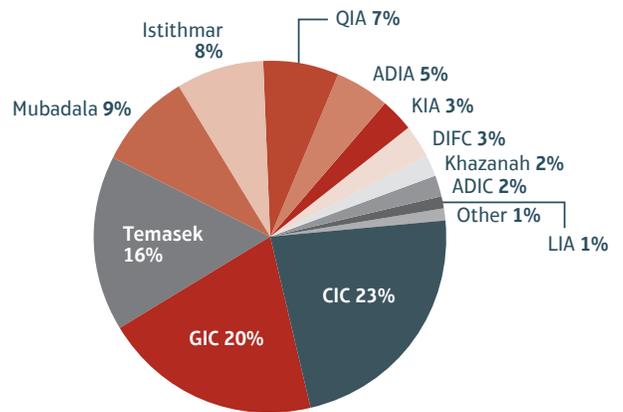
²¹ Aggregate figures differ from figures published in Monitor Group's SWF Investment Behavior Q3 2008 report. Figures have been re-stated due to the addition of deals collected by FEEM, and removal of deals that have not completed.

value of \$73 billion and Temasek has \$56 billion. Among the MENA-based funds, Istithmar, Mubadala, and QIA are the leading investors by number and value.

Number of Deals by Fund



Value of Deals by Fund (USD MM)



Note: Publicly available data for SWF equity, real estate, and joint venture deals

Source: Monitor-FEEM SWF Transaction Database

Ten Largest Deals of 2008

FUND	NATIONAL AFFILIATION	TARGET	COUNTRY OF TARGET HQ	COMPLETED DATE	SIZE OF THE DEAL (USD MM)	SIZE OF STAKE ACQUIRED	SIZE OF STAKE OWNED AFTER TRANSACTION
China Investment Corporation (CIC)	China	Agricultural Bank of China	China	10/21/2008	\$20,000	.	.
Government of Singapore Investment Corporation (GIC)	Singapore	UBS	Switzerland	2/8/2008	\$14,400	.	10%
Government of Singapore Investment Corporation (GIC)	Singapore	UBS AG	Switzerland	3/5/2008	\$9,760	9%	88%
Government of Singapore Investment Corporation (GIC)	Singapore	Citigroup Inc	US	1/28/2008	\$6,880	4%	4%
Temasek Holdings	Singapore	Merrill Lynch & Co Inc	US	1/11/2008	\$4,400	11%	.
China Investment Corporation (CIC)	China	JC Flowers & Co	US	2/1/2008	\$4,000	.	.
Mubadala Development Company	UAE/Abu Dhabi	JV with GE in a commercial financial services company based in Abu Dhabi	UAE	7/22/2008	\$4,000	50%	50%
Qatar Investment Authority (QIA)	Qatar	Barclays PLC	UK	6/25/2008	\$3,483	8%	.
Temasek Holdings	Singapore	Merrill Lynch	US	7/29/2008	\$3,400	.	.
Dubai International Financial Centre (DIFC)	UAE/Dubai	OMX AB	Sweden	2/29/2008	\$3,397	69%	98%

Note: Publicly available data for SWF equity, real estate, and joint venture deals

Source: Monitor-FEEM SWF Transaction Database

Highlights of the Literature on SWFs

Introduction

During 2008, SWFs attracted growing attention among scholars and informed observers. This section briefly summarizes the major SWF-related topics as discussed by the press, academics, politicians, institutions and other analysts. These include the definition and investment patterns of SWFs; their sources of growth; impact and performance; governance, transparency and geopolitical reactions; and case studies of individual or regional funds. This section highlights the most important contributions over the past year which should help the reader understand the evolution of the debate on SWFs.

SWFs have provided massive infusions of fresh capital to large banks under stress, helping to contain the present crisis.

The first contentious topic is the definition and investment patterns of SWFs, where no consensus has yet been reached as to whether the category of SWFs should include pension funds, stabilization funds and risk management funds or only funds whose main objective is generating commercial returns. Meanwhile, estimates of total assets under control of SWFs also vary greatly according to the accepted definition. Nevertheless, there is general agreement that the current total assets under management are at least \$2 trillion and seem destined to grow fast in the future at least in forecast made before the worsening of the global financial crisis in September 2008. SWFs are believed likely to remain important actors in the global financial markets over the coming years, especially now that they are going to be recognized (and welcomed) by markets and policymakers as institutional investors like any others. What we can predict is that SWFs will invest in virtually all countries in the developed world as well as in some emerging economies. As investors, they hold positions in almost one-fifth²² of companies worldwide. Individual SWFs differ significantly in their asset allocation and risk management strategies, reflecting their different

22 Nuno Fernandes and Arturo Bris in "Sovereign wealth revalued", Managing in a downturn, *Financial Times*, February 12, 2009.

purposes and constraints. Evidence gathered by Monitor Group and FEEM shows that SWFs rarely take controlling stakes in companies based in OECD markets, but they are often opportunistic investors willing to invest into companies when their stock prices fall.

A second common topic deals with the forces driving the past surge in growth of these funds and their expected growth in the near future. Many market participants contend that the acute global imbalances have been at the root of the SWFs' spectacular growth. Financial-sector SWF investments predominated in late 2007 and early 2008 but shifted as global financial conditions worsened. SWFs have also been supportive of stability in the international financial markets during the current crisis. They have provided massive infusions of fresh capital to large banks under stress, helping to contain the present crisis. Changing trends in global imbalances will continue to shape SWF development and their investments, although in the near term alternative investment strategies predominate, and the SWFs are paying greater attention to domestic and regional economic issues.

SWFs are believed likely to remain important actors in the global financial markets over the coming years.

The third major topic examines the financial impact and wealth effects of SWF investments in recipient companies around the world. We can identify two different approaches. The first measures the impact of SWF in terms of target firm balance sheet performance, and the empirical evidence suggests that firms with higher ownership by SWFs have higher firm valuations and better operating performance. The second approach is to employ an event study approach to analyze the abnormal stock return around the announcement date for firms that attract SWF investments. These studies generally show that SWF stock acquisitions have generally benign effects on invested firms. However, this result could not be considered a general conclusion because other studies on return and volatility find evidence of both a reduction of target returns and risk. Clearly, more research is needed to document whether SWF investment is or is not beneficial for target companies.

A literature review related to SWFs must include a discussion of corporate governance, transparency and geopolitical issues. Because SWFs are controlled by governments, critics have been concerned that their investment strategies may be politically motivated and potentially a threat to the economic competitiveness and national security interests of the recipient countries. On the other side, some SWFs supporters argue that these funds are benign and long-term investors with only a risk-return objective. Forcing SWFs to be more transparent in what they do may affect the commercial returns they can achieve. This debate moved into new ground during 2008 due to statements by leading stakeholders groups: the “OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies” in June 2008, and the “Santiago Principles” issued by International Working Group of SWFs (hosted by the IMF) in October 2008.

The fifth research area on SWFs spans all of the topics above and consists of case studies of individual or regional funds. We describe only a few of these but stress that this type of research is very informative. As we state that there is no a common definition of SWF, there is also no universal performance model applicable to all types of SWFs. There are too many differences between them regarding constraints, economic and non-economic objectives, varying degrees of transparency, governance and risk management. Nonetheless, one key question needs to be asked and answered: how will the current financial crisis influence SWFs’ investment strategies?

No matter how the current crisis plays out, or how host governments react to additional SWF investments, it seems clear that the environment that SWFs operate in has become more complex and this will doubtless change their role into the global financial system.

Selection of Literature Abstracts

General Definition and Investment Patterns

A Portfolio Analysis of Sovereign Wealth Funds

Balding, C., June 2008

<http://ssrn.com/abstract=1141531>

Abstract: Sovereign wealth funds have been subject to much commentary and little factual analysis. This study attempts to address the lack of hard data by combining both direct and indirect statistics to secure a more reliable understanding of how sovereign wealth funds invest and their impact on international finance and investment. The study comes to three conclusions. First, estimates of sovereign wealth funds inaccurately calculate their size, by inconsistently counting assets across countries, resulting in a misleading understanding of their size. Second, sovereign wealth funds have to date, acted as rational, economically driven investors, diversifying their portfolio by asset class and geographic region. Third, based upon the currently available data, there is little reason to believe that sovereign wealth funds are large relative international investors or have a large impact on international financial markets. Though countries would be wise to follow the development of sovereign wealth funds, the data does not currently support measures to restrict cross border investment.

SWFs and Foreign Investment Policies — An Update

Steffen Kern, Deutsche Bank Research, October 2008

A copy of this report is available in the Deutsche Bank Research archive:

<http://www.dbresearch.com>

Abstract: Sovereign wealth funds (SWFs) assets under management have grown to US\$3.6 trillion. Growth can be expected to continue at 15 percent per year, which would bring the industry to almost US\$5 trillion of assets by 2010 and US\$10 trillion by 2015. SWFs have attracted great attention lately, and have busied financial

dealmakers, policymakers, economists and the academic community at the latest since mid-2007 when the scale of the SWFs' business and their potential influence in conjunction with the emergence of new players, mainly in emerging markets, were fully realised by the wider public.

The authors provided a comprehensive analysis of SWFs, their relevance for financial markets and the related political issues. Since then, a lot has changed and an intense debate has evolved over increasing the transparency of SWFs and strengthening their governance. Some states have revised their investment policies. And most importantly, SWFs have pursued a number of landmark investments, not least in the ailing financial services industry.

The report concludes that SWFs are headed for a new state of normality. A state of normality in which they are recognised by markets and policymakers as institutional investors like many others, albeit of a separate breed; a state in which international principles will provide incentives for SWFs, facilitating their acceptance in foreign markets and political environments; a state in which internationally agreed principles provide a yardstick for open investment policies in recipient countries; and a state in which the largest SWFs will retain their status as celebrity institutional investors since their sheer size and aura will frustrate any plans for them to keep a low profile in their work.

SWFs: Growth Tempered—US\$10 Trillion by 2015

Jen, S., and Andreopoulos, S., Global Economic Forum, Morgan Stanley, November 2008
<http://www.morganstanley.com/views/gef/archive/2008/20081110-Mon.html#anchor7146>

Abstract: A lot has happened this year; even some SWFs may have been adversely affected by the market developments. Many of the SWFs may have sustained paper losses on their investments, just like most private institutional funds. In addition, with the US financial turmoil having infected most EM economies, there are now

rising domestic needs for SWFs to help deal with. Thus, lower oil prices, lower export growth rates, capital flight that has drained official reserves and new domestic fiscal needs may lead to a less rapid pace of asset accumulation for SWFs. The authors still believe that SWFs will be a very powerful source of demand for risky assets in the coming years, but now believe that the expected growth rate of their assets under management (AUM) will need to be revised down. In “How Big Could SWFs Be by 2015?” May 3, 2007, they argued that AUM of SWFs could surpass the world’s total official reserves by 2011. Now this ‘cross-over’ date may be delayed by three years and that, by 2015, instead of US\$11.9 trillion, total AUM of SWFs of US\$9.7 trillion now looks like a more realistic target.

Sovereign Wealth Fund Investment Behavior: Analysis of Sovereign Wealth Fund Transactions during Q3 2008

Miracky, W., Dyer, D., Fisher, D., Chin, E. and Barbary, V., Monitor Group, December 2008²³

A copy of this report is available at the website www.monitor.com

Abstract: The publicly-reported investment activity of sovereign wealth funds (SWFs) in the third quarter of 2008 sheds light on how SWFs have responded to the difficult and volatile economic and financial climate that has prevailed in the period since the release of the June 2008 report, *Assessing the Risks*. Two patterns that began to appear in Q2 have continued in Q3: First, SWFs continued to shy away from investments in the global financial services sector, and, second, SWFs continued to resist OECD investments in general, relative to alternatives in emerging markets. In addition, a third pattern began to emerge in Q3. During this quarter, SWFs showed a marked and renewed interest in domestic investments, which rose in percentage terms to their highest levels since 2003. During Q3, SWFs in the

²³ The data in the Q3 2008 Monitor Report refer to the old Monitor database before newly created common FEEM-Monitor database. For details, please see “Methodology” section.

Monitor SWF Transaction Database made 46 deals worth \$15.4 billion. These deals occurred in a diverse range of sectors, in which financial services continued to play only a small role in terms both of dollar value (only \$4 billion) and number of deals (11 percent). There was also a noticeable decline in SWF investment in real estate, which had dominated the reported SWF investments in the previous quarter. The dollar value declined from \$13.7 billion to \$3.2 billion and the number of deals from 12 (28 percent) to 8 (17 percent). Emerging markets maintained their appeal as destinations for publicly-reported SWF investment. Of the 46 publicly-reported transactions undertaken by SWFs in Q3, 65 percent (30) had targets based in Asia Pacific or the Middle East and North Africa (MENA). These deals accounted for 49 percent of the reported dollar value. Furthermore, in Q3, SWFs tended to concentrate on their home market; 46 percent of deals (21 out of 46) were made in the fund's home country - the highest proportion since 2003. Publicly-reported SWF investment in OECD countries continued to decline from \$37 billion in Q1, to \$9 billion in Q2 and \$8 billion in Q3. Europe accounted for 20 percent of the deals valued at 33 percent of the total reported value of the transactions in this quarter, while North America only accounted for 15 percent of the deals and 15 percent of the value.

Global imbalances and Sources of Growth

Sovereign Wealth Funds and Global Imbalances

Sir John Gieve, Bank of England Quarterly Bulletin, 2008 Q2

<http://www.bankofengland.co.uk/publications/quarterlybulletin/qb080207.pdf>

Abstract: In this speech, Sir John Gieve, Deputy Governor for financial stability, discusses the impact of sovereign wealth funds (SWFs) on the global financial system. He argues that the recent rapid growth of SWFs is a result of persistently large global imbalances, which, in turn, have helped create vulnerabilities in the world economy and financial system. That said, he argues that the fact they, and

their central banks, are looking for higher returns and asset diversification should improve the efficiency of global asset allocation. Their long-term investment horizons should also help to moderate financial market downturns. However, he concludes that some increase in the transparency of these funds and the recipient country's approach to them would be helpful to ensure that they contribute to further global financial integration rather than act as a catalyst for a new wave of financial protectionism.

The Impact of Sovereign Wealth Funds on Global Financial Markets

Beck, R., and Fidora, M., Occasional Paper Series, No 91, European Central Bank, July 2008
<http://ssrn.com/abstract=1144482>

Abstract: This paper analyses the impact of sovereign wealth funds (SWFs) on global financial markets. It presents back-of-the-envelope calculations which simulate the potential impact of a transfer of traditional foreign exchange reserves to SWFs on global capital flows. If SWFs behave as CAPM-type investors and thus allocate foreign assets according to market capitalization rather than liquidity considerations, official portfolios reduce their "bias" towards the major reserve currencies. As a result, more capital flows "downhill" from rich to less wealthy economies, in line with standard neoclassical predictions. More specifically, it is found that under the assumption of SWFs investing according to market capitalization weights, the euro area and the United States could be subject to net capital outflows while Japan and the emerging markets would attract net capital inflows. It is also shown that these findings are sensitive to alternative assumptions for the portfolio objectives of SWFs. Finally, the paper discusses whether a change in net capital flows triggered by SWFs could have an impact on stock prices and bond yields. Based on an event study approach, no evidence can be found for a stock price impact of non-commercially motivated stock sales by Norway's Government Pension Fund.

Sovereign External Assets and the Resilience of Global Imbalances

Alberola, E., and Serena, J.M., Banco de Espana Working Paper No. 0834, December 2008
<http://ssrn.com/abstract=1338064>

Abstract: Sovereign external assets (SEAs) comprise foreign exchange reserves and sovereign wealth funds (SWFs). The global stock of reserves reached US\$7trn in the second quarter of 2008, but data on SWF are rather elusive. Our estimation puts the SWFs at around US\$2.5trn dollars by 2007 and in the last years they have grown at a high pace, fostered by high commodity prices. Therefore, SEAs have surpassed the US\$10trn mark (around 5% of global assets and 15% of global GDP). This paper argues that reserves and SWF assets should be jointly considered for the assessment of global imbalances. Both are official capital outflows from developing to developed countries, both hinder internal adjustment in current account surplus countries, both help to cover the financing needs of deficit countries, in particular in the US, and, therefore, both contribute to sustain global imbalances.

The importance of SEAs in financing the external imbalances of the US has been widely recognized but scantily measured. Our rule-of-thumb calculations suggests that they have greatly increased their importance in the last years, having surpassed the US\$ trillion increase in 2007; relative to US financing needs, this amount represents around a 135% and 50% of net and gross needs, respectively, in 2007. Reserves have in the last years contributed 80% and SWFs 20%. Looking ahead, two main conclusions can be put forward: 1) the relative importance SWFs in the financing of the US deficits and global imbalances is set to increase (also relative to reserves), but this is conditional to commodity prices remaining at high levels. On the one hand, the economic motivation of SWFs—intertemporal smoothing—is more palatable than that of reserves (exchange rate management), despite political concerns on SWFs; on the other hand, SWFs do not have significant internal costs, contrary to reserves, whose monetary and fiscal costs are increasing in the margin; 2) SEAs can well buttress US financial needs in the years ahead, providing resilience

to the global imbalances. Dramatic shifts in the pace of SEAs accumulation - due for instance to an adjustment of commodity prices- or in the investment allocation would jeopardize these prospects.

Impact and Performance

Sleeping with the Enemy' or 'An Ounce of Prevention': Sovereign Wealth Fund Investments and Market Instability

Knill, A., Lee, B., and Mauck, N., January 2009

<http://ssrn.com/abstract=1328045>

Abstract: In this paper we investigate whether the accusations raised by the popular press regarding the potential destabilizing force of sovereign wealth fund investment have merit. Specifically, we examine the impact of sovereign wealth fund (SWF) investment on return and volatility, both for the target and the local market index. We find evidence of both a reduction of target returns and risk, but find that risk is not sufficiently reduced to offset the change in return. We also see the market risk-return ratios indicate uncompensated risk following SWF investment for the market as a whole. Firm volatility decomposition suggests that both total risk and idiosyncratic risk are not compensated at the same level following SWF investment as they were preceding it. The decrease in return without a corresponding decrease in volatility suggests that sovereign wealth fund investment could be potentially destabilizing.

Firm Values and Sovereign Wealth Fund Investments

Dewenter, Kathryn L., Han, Xi and Malatesta, Paul H., March 2009

<http://ssrn.com/abstract=1354252>

Abstract: Sovereign Wealth Funds (SWFs) manage investment portfolios on behalf of governments that own the portfolios. We analyze the impact of investments by these funds on the values of the companies in which they invest. The average announcement date abnormal stock return for firms that attract SWF investments is positive and statistically significant. When SWFs reduce their stockholdings in a firm the divestment announcement is associated with a statistically significant negative abnormal return, on average. These results are consistent with the hypothesis that SWF stock acquisitions have generally benign effects on investee firms. Moreover, though the evidence is fragile, the relationship between relative transaction size and announcement period abnormal stock returns appears to be nonlinear. For acquisitions, abnormal returns first increase with the fraction of the firm purchased by the SWF, reach a maximum, and then decline. For divestments, abnormal returns first decline with the fraction sold, reach a minimum, and then increase. This evidence tends to support the notion that the impact of SWFs on firm values reflects not only their incentives to provide valuable monitoring services, but also their potential for expropriating small shareholders by extracting private benefits of control. We also document instances where target firms experience one or more events indicative of SWF monitoring, influence, or potential tunneling.

Sovereign Wealth Funds: Investment Choices and Implications around the World

Fernandes, Nuno G., February 2009

<http://ssrn.com/abstract=1341692>

Abstract: This study focuses on a major global issue: the rise of sovereign wealth funds (SWFs). Using the largest data set of their holdings to date, we document a large SWF premium of more than 15% of firm value. Using data from 2002 through 2007, we find that firms with higher ownership by SWFs have higher firm valuations and better operating performance. Our results also indicate that SWFs have a stabilizing effect on financial markets. Additionally, they tend not to invest heavily in firms in high-tech industries or those operating in areas involving intensive research and development.

Sovereign Wealth Funds: Their Investment Strategies and Performance

Chhaochbaria, Vidhi and Laeven, Luc A., March 2009

<http://ssrn.com/abstract=1262383>

Abstract: Sovereign wealth funds have emerged as an important investor of global equity, attracting growing attention. Despite frequently voiced concerns that sovereign wealth fund investments serve political objectives and conflict with national interests, little is known about the investment allocation of sovereign wealth funds. We collect new data on over 40,000 equity investments by sovereign wealth funds and find that sovereign wealth funds tend to invest in countries that share similar cultural traits. This cultural bias indicates that sovereign wealth funds prefer to invest in the familiar. While other global investors display similar aptitude to investing in the familiar, the cultural bias for sovereign wealth fund investment is particularly pronounced. Moreover, share prices of firms respond favorably when sovereign wealth funds acquire stakes.

Sovereign Wealth Fund Investment Patterns and Performance

Bortolotti B., Fotak V., Megginson W. and Miracky W. (2009) Fondazione Eni Enrico

Mattei, Nota di Lavoro 22.2009, April 2009

http://www.feem.it/Feem/Pub/Publications/WPapers/WP2009-022.htm?WP_Page=1

Abstract: This study describes the newly created Monitor-FEEM SWF Transaction Database and discusses the investment patterns and performance of 1,216 individual investments, worth over \$357 billion, made by 35 sovereign wealth funds (SWFs) between January 1986 and September 2008. Approximately half of the investments we document occur after June 2005, reflecting a recent surge of SWF activity. We document large SWF investments in listed and unlisted equity, real estate, and private equity funds, with the bulk of investments being targeted in cross-border acquisitions of sizeable but non-controlling stakes in operating companies and commercial properties. The average (median) SWF investment is a \$441 million (\$55 million) acquisition of a 42.3% (26.2%) stake in an unlisted company; the most active SWFs originate from Singapore or the United Arab Emirates. Almost one-third (30.9%) of the number, and over half of the value (54.6%) of SWF investments are directed toward financial firms. The vast majority of SWF investments involve privately-negotiated purchases of ownership stakes in underperforming firms. We perform event study analysis using a sample of 235 SWF acquisitions of equity stakes in publicly traded companies around the world, and document a significantly positive mean abnormal return of about 0.9% around the announcement date. However, one-year matched-firm abnormal returns of SWFs average -15.49%, suggesting equity acquisitions by SWFs are followed by deteriorating firm performance. In cross sectional analysis, we find weak evidence of benefits associated with a monitoring role of SWFs and evidence consistent with agency costs created by conflicts of interest between SWFs and minority shareholder. SWFs have collectively lost over \$57 billion on their holdings of listed stock investments alone through March 2009.

Governance, Transparency and Geopolitical issues

Sovereign Wealth Funds Debate: Will China follow the Norwegian Model?

Andrew Rozanov, State Street Global Advisors, January 2008²⁴

<http://www.ssga.com/weblogic/LibrarySearchServlet?Site=PUBL&PublicationType=ESPS>

Abstract: In the last two years there has been a lot of talk among policymakers and market actors about the need for increased transparency and accountability of SWFs. In most cases, the proposed solution is for SWFs to follow the Norwegian model, which would entail full transparency, a broadly diversified portfolio and a self-imposed caps on maximum positions in individual companies. The article shows how the Norwegian model is inapplicable to an other SWF, i.e. China Investment Corporation (CIC). The three important points are: the different liability profiles of the two funds and, hence, a different behavior with regard to asset allocation, strategic investments and levels of transparency; Norwegian fund is a policy tool to maintain the economic status-quo while the Chinese fund is used at the opposite to rebalance the unequal economic path; Norwegian fund is focused on promoting abroad good corporate governance and sustainable social development while CIC has the same priorities but its efforts are domestically oriented.

A Blueprint for Sovereign Wealth Fund Best Practices

Truman, E. M., Peterson Institute for International Economics, Policy Brief, April 2008

<http://www.petersoninstitute.org/publications/interstitial.cfm?ResearchID=902>

Abstract: Management of sovereign wealth funds (SWFs) - pools of government-owned or government-controlled financial assets - has become a major focus of national and international economic and financial policy. The principal reasons are their size, lack of transparency, potential to disrupt financial markets, and the risk

24 Views being those of the author and not those of the company or any of its affiliates.

that political objectives might influence investment decisions. In this policy brief, Truman provides some background on SWFs and presents a blueprint for SWF best practices to make them more transparent, predictable, and accountable to their own citizens and governments, citizens and governments of host countries, and participants in financial markets.

The blueprint for SWF best practices is based on a scoreboard he has constructed for the current practices of 44 SWFs. The scoreboard contains 33 elements grouped in four categories: structure of the fund, governance, transparency and accountability, and behavior of the fund in managing its portfolio. The elements of the scoreboard can be incorporated into best practices without asking any fund to do something that at least one other fund does not already do. This blueprint meets the substantive principles that have been enunciated by G-7, US, and EU officials and provides a basis for evaluating the results of the International Monetary Fund-sponsored dialogue on SWF best practices.

The Rise of Sovereign Wealth Funds: Impacts on US Foreign Policy and Economic Interests

Truman, E. M., Peterson Institute for International Economics, May 2008

http://www.petersoninstitute.org/publications/pubs_year.cfm?ResearchTypeID=3&ResearchYear=2008

Abstract: Sovereign wealth funds are funded from foreign exchange reserves, earnings from commodity exports, receipts from privatizations, other fiscal revenues, or pension contributions. The author lists 56 sovereign wealth funds of 38 countries using the broadest definition of SWF, a separate pool of government-owned or government-controlled assets that includes some international assets. These funds have been around for more than half a century with a range of structures, mandates, and economic, financial, and political (domestic and international) objectives - normally a mixture. Consequently, it is perilous to generalize about sovereign

wealth funds and associated potential threats to US foreign policy, national security, or economic interests. The author's conclusions are three: (1) SWFs do not pose a significant new threat to US security or economic interests. We have adequate mechanisms to manage any potential threats they pose, which at this point are likely to be minimal; (2) SWFs are one of the many challenges of global economic and financial change in the 21st century. Whether these particular challenges of globalization are appropriately addressed will have profound implications for the United States and for the world economy and financial system; (3) the United States should continue to press countries with sovereign wealth funds to design and embrace best practices for these funds. At the same time, the United States should continue to try to minimize economic and political barriers to foreign investment in all forms from all sources here and around the world. Financial protectionism is the wrong answer.

Recasting the Sovereign Wealth Fund Debate: Trust, Legitimacy, and Governance

Monk, Ashby H. B, May 2008 (revised March 2009). Forthcoming in the New Political Economy journal

http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1134862

Abstract: Sovereign Wealth Funds (SWFs) are the subject of intense debate. While these financial institutions are hard to define in precise terms, all agree they are government-owned investment funds operating in private financial markets. Their relevance to the evolving economic, political and financial landscape cannot be overstated, as they challenge the received notions of practice and governance embodied in traditional, Western financial institutions. This has resulted in distrust—more accurately labeled as illegitimacy—by Western policymakers about SWF intentions. Indeed, several countries are considering new, protectionist policies designed to minimize perceived SWF threats. In this article, I seek to evaluate the SWF phenomenon by making three contributions: clarifying what a SWF is and is not; analyzing the concerns of policymakers; and examining the role of governance in these concerns. This paper's theoretical contribution is a conceptualization of

the interplay between organizational legitimacy and institutional governance. This is done through an interrogation of available literatures, reference to close-dialogue interviews with elites, and two brief case studies.

Sovereign Wealth Funds: Assessing the Impact

State Street Corporation, Vision Vol III, issue 2, July 2008

To obtain a copy this Vision Report on SWFs or for more information, members of the press can contact publicrelations@statestreet.com

Abstract: The latest report assesses the impact of SWFs on the global economy. With nearly \$3 trillion in aggregate financial resources and a rapid growth trajectory, SWFs are increasingly important cross-border investors. Across the industry, their rise to prominence has provoked discussion around issues of accountability, transparency and the appropriateness of government control over investment decision-making.

The increasing pressure on SWFs to become more open and to consider subscribing a common set of rules have dominated the discussion so far. Less attention has been paid to the actual nature of SWFs — their liabilities, their differing investment objectives and their likely impact on capital markets. The Vision Report on SWFs tries to focus on these areas, drawing on knowledge from George R. Hoguet, managing director, senior portfolio manager and global investment strategist specializing in emerging markets at SSgA; John Nugée, managing director, SSgA, and head of State Street's Official Institutions Group; and Andrew Rozanov, head of Sovereign Advisory and managing director of State Street Global Markets.

Sovereign Wealth and Sovereign Power - The Strategic Consequences of American Indebtedness

Setser, B.W., Council on Foreign Relations, Center for Geoeconomic Studies, CSR No. 37, September 2008

<http://www.cfr.org/publication/17074>

Abstract: In 2000 Center for Geoeconomic Studies was established to examine issues at the intersection of global politics and economics and few issues fit that description more closely than the subject of this Council Special Report. America's current account deficit is financed by foreign purchases of such assets as Treasury securities and stakes in U.S. firms. A good deal of these purchases today are made by the central banks and sovereign wealth funds of countries that do not share many American political values and foreign policy goals. Some argue that this is no cause for concern. But Brad W. Setser makes a compelling case that the U.S. deficit matters for economic and strategic reasons alike. The United States may have more to lose than its creditors if they sell American assets or stop accumulating them at their current pace. This gives creditors potential leverage over U.S. policy. Setser also argues that indebtedness limits America's ability to influence other countries' policies, for example through sanctions and lending arrangements. The problems associated with U.S. indebtedness cannot be addressed overnight. But the report proposes ways for the United States to guard against the effects of a disruption in foreign financing, such as consulting with allies who hold dollars and encouraging other creditor countries to spend and invest surpluses instead of accumulating reserves. It also suggests measures to reduce the need for financing in the first place, such as working to balance the U.S. budget and, most importantly, taking steps to reduce U.S. oil imports. Sovereign Wealth and Sovereign Power raises the potential strategic implications of U.S. indebtedness, challenging the sanguine view that global economic interdependence guarantees prudence. The report is a significant contribution to the debate on America's political and economic position in an age of globalization.

Sovereign Wealth Funds: Generally Accepted Principles and Practices - Santiago Principles

IWG International Working Group of Sovereign Wealth Funds coordinated by IMF, October 2008.

<http://www.iwg-swf.org/pub.htm>

Abstract: The International Working Group facilitated by the IMF finalized an important document --the Generally Accepted Principles and Practices (GAPP) for Sovereign Wealth Funds and has reached a preliminary agreement on a set of voluntary practices and principles referred to as the “Santiago Principles”.

The Santiago Principles represent generally accepted principles and practices that properly reflect the overarching objectives for SWFs. The following key areas are covered by the 24 Principles: (i) legal framework which sets out the form legal-ity charter, sources and uses of funds, and why in fact the SWF is established; (ii) institutional framework and governance structure which concerns the governing body, the separation from government, ethical behavior, transparency and accountability (regarding the latest, there are different models in different SWFs); and (iii) investment and risk management framework which looks at investment policies, risk exposure, the requirement not to use privileged information from government, and to deal with the exercise of ownership rights.

The guiding purpose of these Principles is to have in place a transparent and sound governance structure that provides for adequate operational controls, risk management and accountability; to ensure compliance with applicable regulatory and disclosure requirements in the countries in which SWFs invest; to ensure SWFs invest on the basis of economic and financial risk and return-related considerations; and to help maintain a stable global financial system and free flow of capital and investment.

Safe and Sound: an EU Approach to Sovereign Investment

Rölller, L.H., and Véron, N. Bruegel Policy Brief Issue 2008/08, November 2008

http://www.bruegel.org/Public/Publication_detail.php?ID=1169&publicationID=9145

Abstract: A growing share of inward investment into the European Union, including but not limited to sovereign wealth funds (SWFs), will come from countries with diverse political regimes with which Europeans may not always see eye-to-eye. The current crisis may increase both Europe's need for such investment and its sensitivity to the non-economic implications. New investor countries have incentives to refrain from political use of their assets, as illustrated by the recently published 'Santiago principles' for transparency and accountability of SWFs. But these incentives are not powerful enough to spare Europe its own assessment of security risks linked to new trends in foreign investment. The EU should proactively address the increasing likelihood of mounting political tensions over foreign investment. It needs a comprehensive, open and sustainable framework to address the security aspects of foreign acquisitions, without which there is a risk of protectionist drift that could harm the economy and impair the integrity of the single market. We recommend anchoring the aims and mechanisms for review of foreign investments in a common EU legislative framework, while implementation, including security assessment of individual investments, would remain a national prerogative. This new approach would enable Europe to maintain its openness to investment while credibly addressing security concerns.

Case Studies

Singapore inc. goes shopping abroad: Profits and Pitfalls

Goldstein, A. and Pananond, P., Journal of Contemporary Asia, 38(3): 417–438, August 2008
<http://www.ingentaconnect.com/content/routledg/jca/2008/00000038/00000003/art00004>

Abstract: Efficient state-led, market-driven intervention has been the hallmark of Singapore's success story but the exportability of state credibility, systemic efficiencies, and local advantages into alien contexts is a matter of academic and political controversy. This paper scrutinizes the Singapore's experience with outward investment, in order to objectively examine the role of Temasek and of the government linked corporations (GLCs). It uses the case of Temasek's investment in Thailand to reflect upon the economic and political impacts of the GLCs' global quest. It shows that resistance to Singaporean acquisitions reflects a combination of factors, including a general turn towards "economic nationalism," attempts by other governments to replicate the city-state's state-led modernization, and Temasek's and GLCs' under-estimation of the risks that are germane to their international strategy.

GCC Sovereign Funds: Reversal of Fortune

Setser, B., and Ziemba, R., Council on Foreign Relations, Center for Geoeconomic Studies, January 2009
<http://www.cfr.org/publication/18017/>

Abstract: For several years, high oil prices enabled the Gulf Cooperation Council countries to add large sums to their state coffers. Falling oil prices imply that some Gulf countries may need to draw on their depleted funds to cover their import bills. In this working paper, Brad W. Setser and Rachel Ziemba examine the impact of the fall in global equities on the Gulf's large funds and explore how various oil price scenarios could shape those funds' future growth. They present a model for estimating the size and likely growth of sovereign wealth funds in the countries of

the Arabian Gulf. It is an attempt to shed light on an important set of actors in global capital markets whose activities are generally opaque. The model allows the authors to analyze the past growth and predict the future trajectory of the Gulf's sovereign wealth funds under different assumptions about oil prices. It suggests a number of striking conclusions. The size of the Abu Dhabi Investment Authority (ADIA) has been overstated. It was also hard hit by the recent fall in global equities, as many of the same factors that worked in its favour from 2004 to 2007—a high allocation to equities, emerging market, and private equity—worked against it in 2008. The Saudi Arabian Monetary Agency (SAMA) by contrast benefited from its fairly conservative portfolio. It is now likely to hold the largest sovereign portfolio in the Gulf. The authors' analysis points toward a prudential rule for managers of sovereign funds. All these funds now look likely to shrink in 2009, as the price of oil has fallen to the point where many Gulf economies will need to draw on their foreign assets to sustain their current level of imports. Estimates of the Gulf's current and future external wealth consequently need to be scaled back to reflect the large losses of many Gulf funds this year and the much more subdued pace of future asset accumulation that seems likely over the next couple of years.

Acknowledgements

The editors, William Miracky and Bernardo Bortolotti, wish to thank the Monitor-FEEM SWF team for their hard work and contributions in creating this report:

- Davis Dyer, Senior Partner, Monitor Group
- Bill Megginson, Professor & Rainbolt Chair in Finance, University of Oklahoma
- Victoria Barbary, Office of the Chairman, Monitor Group
- Laura Pellizzola, FEEM
- Veljko Fotak, Doctoral Candidate, University of Oklahoma
- Edward Chin, Monitor Group

We also wish to thank Monitor Group Chairman Mark Fuller for his support of the research on this important topic. Additionally, Drosten Fisher has been a thought partner since the beginning of our research. Although on leave from Monitor, Drosten helped shape the ideas and perspectives expressed in this report.

This report was designed by Julia Frenkle and Lily Robles of Design Studio at Monitor, with assistance from Jade Jump and Alyson Lee, and in collaboration with Valentina Milella, from FEEM.

design studio

at Monitor Group

The Design Studio at Monitor is a graphic design firm based in Cambridge, Massachusetts with a speciality in information design. Since 1998, the designers have worked closely with clients to understand their message and content in order to provide smart and creative visual solutions. Please visit www.designstudioatmonitor.com for more information and project samples.

FOR MORE INFORMATION PLEASE CONTACT:

William Miracky
william_miracky@monitor.com

Edward Chin
edward_chin@monitor.com