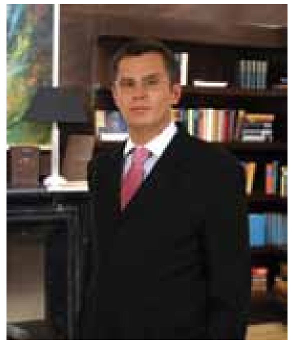
The Global Economic Security Significance of Sovereign Wealth Funds

An Interview with Dr. Alexander Mirtchev



A year ago, in a discussion with Dr. Mirtchev on the global economy, the topic of Sovereign Wealth Funds was brought up. At the time, we had just produced the G8 Summit magazine for the l'Aquila summit in Italy. One of our articles discussed how Sovereign Wealth Funds could be the unlikely saviors of renewable energy. Behind the scenes, SWFs have become a great topic of significance in the ongoing quest for global economic recovery. We are extremely fortunate to have Dr. Alexander Mirtchev provide insights in this important and strategic sector of the global economy. Dr. Mirtchev is President of Krull Corp. USA, a global strategic solutions provider, with a focus on new economic trends and emerging policy challenges. He is also a Vice-President of the Royal United Services Institute for Defence and Security Studies, Council Member of the Kissinger Institute on China and the United States at the Woodrow Wilson International Center for Scholars and a Board Director of the Atlantic Council of the United States. He serves as independent director of a sovereign wealth fund, has served as chairman and director of multi-billion dollar international industrial enterprises and has had distinguished public office and academic career.

What role do sovereign wealth funds (SWFs) play in the modern global economy?

To begin with, SWFs are a modern iteration of economic power projection by states on the international scene. In one form or another, vehicles resembling SWFs have been around for a long time. Similar entities investing state funds, generated from reserves or trade surpluses (such as from natural resources), or utilizing substantial state support or privilege, could very well include conglomerates such as VOC (the Dutch East India Company) or the British East India Company. Another thing they appear to have in common with modern SWFs is that they were the pioneers in frontier markets, often creating regional trade beyond what the local governments and businesses were able to create. It should not be forgotten, however, that SWFs are often perceived to be driven by political, rather than economic, considerations. At the end of the day, they often are, which is only natural, as their shareholders are governments. Thus, the story is much more complex.

In modern times, the first investments by SWFs were predominantly in "frontier markets"–their own. Both Kuwait Investment Authority (established 1953) and Singapore's Temasek fund (1974) made investments in their own economies, at a time when the term "rapidly developing economies" was not in use. More recently, the investment horizon of SWFs has broadened, ranging from "trophy assets" such as Citibank and Merrill Lynch to real "frontier" projects, such as, for example the Sinopec/CNOOC buyout of the stake of Marathon Oil in Angola's offshore deepwater Block 32 for US$1.3bn or CIC's $500mln investment in SouthGobi Energy Resources' mining operations in Mongolia.

In the final analysis, SWFs are all unique–they represent different countries with different economic strategies, resources and proclivities. At the same time, they do have common features that provide a basis for comparison and a framework within which it is possible to understand what their future strategies may be.

What lessons did the SWFs learn from the global financial and economic crisis?

The first lesson learned by the SWFs in the present financial crisis is a new type of prudence and the end of growth and intensified "glamour cherry-picking". This would not be prudence in the traditional sense, but rather prudence on a global scale, with a view to strategic long-term positioning. Before the crisis, prominent SWFs became notorious for their big-name acquisitions, in particular in the financial sector. Now they are sitting on the paper losses from their investments, but with the full understanding that name recognition, past performance of the targeted corporation, etc., are important, but should hardly be the determining factors. For example, Temasek invested 8.3 billion US dollars into Merrill Lynch, which was later acquired by Bank of America in an all-stock deal worth 50 billion dollars, while Government of Singapore Investment Corp (GIC) invested billions into Citigroup and Swiss bank UBS. The state-owned Kuwait Investment Authority injected a total of 5.0 billion dollars in Citigroup and Merrill Lynch in January 2008. The Abu Dhabi Investment Authority, controlled by the largest member of the United Arab Emirates, poured 7.52 billion dollars into Citigroup in late 2007. Now, more than ever, they could be considered to be risk-averse investors.

Secondly, SWFs will have learned the hard way that even though they are in many ways "special", the market is the market, and they should bargain down deals–like any other market player, rather than being the "elephant in the room". The present lower values in the market and the fact that cash is in short supply will put them in a good position to realize that they do not have to "save face" by paying over the top for assets.

Thirdly, it is likely that SWFs would place much higher value and give more precedence to the "production" side–they would be focusing even more not only on the acquisitions of natural resources, technologies or capacities that their economies lack, but also on the prospective and targeted growth of their own national and regional markets. For example, the Chinese oil giant Cnooc was persistent, and despite failing to buy Unocal, it was able to acquire Norway's Awilco Offshore ASA. Countries like China will look for more natural resources that they lack. Sinosteel Corp. completed a full takeover and delisting of Australian iron-ore concern Midwest Corp. The oil producing countries' SWFs will concentrate on diversification away from oil into equipment manufacturing, hi-tech, telecoms and other value-added activities.

Fourthly, the temptation to "make it big" would be reduced– SWFs would reduce their penchant for "dramatic deals" and be under pressure to stick to their core purpose. Thus, facilitating the economic strategy of their governments and economies will likely come to the fore.

Last, but not least, due to the financial crisis there is likely to be increased sensitivity, in the developed countries in particular, about the activities of SWFs, and the funds would not only try to "play by the rules", but would direct their actions to be widely seen to "play by the rules". This tendency would result in the SWFs becoming more "accommodating" to the economies they deal with. This may also lead to SWFs creating a parallel system and "arrangements", including financial.

What is the current economic benefit of SWF activity?

Before the financial crisis the SWFs were predominantly welcomed as an alternative source of large-scale equity financing that was cheaper and easier to obtain than to go through an IPO. Now they look more and more as the only source of available financing for a cash-starved international financial system.

Increased government scrutiny, regulation and participation in the financial system is not likely to be considered an investment incentive by the SWFs in general. On the contrary, due to the fact that SWFs have not only business rationale to their activities but also a strategic and geopolitical underpinning, they would be loath to be restrained by what they may consider unfair "regulatory shackles". The SWFs would try to fit in the new global regulatory regime that is likely to emerge, but at the same time would want to be able to dictate, to a certain extent, the terms and conditions under which they operate in the global economy.

The new role of SWFs as financing sources has already been acknowledged by the G20 and is to be reflected in the new governance arrangements surrounding the IMF and the World Bank. How far these concessions would be accepted by the governments that control the SWFs' activities is still a subject to debate, as SWFs and their governments may decide to take a "proactive" role in the global market on their own, rather than via the established structures of the IMF and the World Bank, as the rules of that game may not be fully to their liking.

SWFs were already "bottom fishing" for distressed assets that could be attractive in the long term already when the crisis was still in full swing. In the wake of the global crisis, SWFs have become more active. They have intensified the search for investment projects, and the period of "withdraw and regroup" could be considered at an end. SWFs would be more tempted to forego immediate returns for potential growth in the mid-term, relying on acquisitions that provide synergies and economies of scale with assets and production facilities that they already own.

What current challenges do SWFs face?

One of the biggest challenges for SWFs is likely to be the uncertainty surrounding the intended policies of the developed economies towards SWFs. There is little doubt that SWFs are going to face attempts to impose certain curbs on their operations, imposed by the current and prospective market regulators, putting them under increased regulatory scrutiny, in line with the tightening global financial regulations. Even though host governments would welcome long-term investments from SWFs, there is a growing popular feeling and political pressure to codify and regulate the global financial system, enhance its surveillance and the interventionist powers of governments. This will inevitably affect how SWFs operate in the developed economies–would their governments be happy to have their activities regulated and maybe virtually controlled by foreign states?

An additional factor that remains, despite the changing market conditions, is the overall distrusts towards SWFs among the governments of the developed economies, and in particular the fact that any major SWF investment can be viewed through the prism of national security. A range of developed country's governments have expressed implicit and sometimes explicit concern over the activities of SWFs, in particular those of China. The concerns raised range around protection of local assets of strategic significance and the growing influence of the countries, projected via the activities of their SWFs. According to Natsuko Waki from Reuters, deal participation by SWFs stirs "jitters that foreign governments may take control of assets that are important for national security and strategic reasons".

These concerns will channel more narrowly the ability of SWFs to undertake the projects in the developed economies that their new strategy will dictate. They may also bring forth considerations that SWFs will be turned away from the developed economies and would concentrate on the emerging markets to look for what they consider strategic investments. It is likely that we will see SWFs taking key industries in relatively small emerging markets.

What are the concerns of states about SWF activity?

From the times when kings invested in building pyramids, raising armies and bankrolling explorers, sovereign wealth has attracted political controversy. And when sovereigns band together, woe on the free world! Fortunately, the sovereigns have changed with times and represent internationally legitimate public authorities.

SWFs tend to be viewed in a manner, different from private equity funds or other private investors. This is due to the perception that SWFs have a different outlook on risk, investment periods and other "traditional" investment considerations. Notably, the frontier is part of the DNA of SWFs, and this "frontier" make up to a large extent determines their competitive advantages, as well as, in some cases, the problems that SWFs sometimes face.

With the end of the global crisis in sight, SWFs could become unwelcome guests, even if they contributed to the recovery of a specific economy. They provided an alternative source of financing for cash-strapped economies, but when "currency wars" are on the front burner the issue of protectionism is making its presence known in a forceful way across the globe.

The concerns raised in some quarters about SWFs belie the reality of their operation: the funds report their activities to the public authorities of home countries which are at least as transparent as a private equity firm would be. Prior to the crisis, a few private equity firms in fact voiced objections to the funds on the grounds of unfair competition based on cheap money, but soon found them good investors and attractive clients.

Taking into account that the major SWFs, with a few exceptions, are from countries that are not considered among the "developed" economies, there are also concerns that SWFs represent disguised foreign policy vehicles. This could be of particular importance when the SWF in question is from a country that is considered significant from a national security standpoint, and its investments in a target market, such as the US or the EU can generate perceptions of "encroachment" on matters that are deemed "strategic interests" for the target market, as was the case with Dubai Ports.

The most loudly expressed political concerns are that joint activities by several SWFs could result in them "banding together" to achieve political objectives without any red flags being raised and without appropriate scrutiny. The response to these concerns is that they stem from more of a "protectionist" mindset than a valid political concern, and that recent examples of SWFs working together are much more commercially oriented than having any political imperative.

Are SWFs a responsible market player?

Sovereign wealth funds in general behave like any other investor, and bear the same level of responsibility.

Despite being inherently different from each other, as they reflect their countries' economies, etc., there is an increasing tendency for cooperation between SWFs in international investments. It could be considered that such cooperation is a sign of their maturity as investors, who are more aware of the market principles and are seeking to offset any limitations or inefficiencies that they may have in respect of specific projects by combining with others that may have access to better "investment tools". It could be argued that SWFs cooperating in different projects represents a sign of their maturity as investors, who have become more aware of the market opportunities. On certain occasions, such joint activities could help them become market leaders in specific sectors.

One example of such cooperation is the joining of forces by China's CIC, Singapore's GIC and the Korean Investment Authority to support the Blackrock acquisition of Barclays Global Investors. This was deal-specific cooperation with specific prerequisites and repercussions that signified the new power of SWFs. Another type of cooperation is the recent general agreement of the Korean Investment Company, Malaysia's Khazanah Nasional Berhad and Australia's QIC. This is more of a general "cooperation" agreement, which is a framework arrangement that is to provide the basis for potential future joint transactions, but does not entail specific commitments in its own right.

One area, where SWFs have already made certain advances, is to increase transparency by joining forces in specific investments, irrespective of political considerations that may be in place. The cooperation of sovereign wealth funds today implies that the international investment advisers, typically form tightly regulated markets, see synergies in bringing a number of funds together for a transaction.

The immediate consequence of such cooperation is that at least several parties to the transaction have to open books to each other, negotiate agreement that all parties are comfortable with, and overall increase the level of transparency about the application of the sovereign wealth. Every time one fund manager reaches out to his peers, market gets a bit more information about both and regulators are immediately aware of the intent of the deal. Among others, this would also allow SWFs to introduce elements of comparatively independent supplementary financing mechanisms in their transactions, a phenomenon that could actually evolve into an additional layer of the global financial system.

In addition, the increasing tendency of SWFs to “team up” with Western private, institutional and state-owned investors for joint investments abroad is providing an additional impetus towards transparency and accountability that actually benefits Western investors – such as, for instance, the case of the discussions about joint Indian-US exploration of offshore areas off the U.S. East Coast and in the Gulf of Mexico (which may be under threat as a consequence of the Gulf of Mexico oil spill).

How can SWFs promote growth in developing and emerging markets?

There are a number of reasons why SWFs are drawing disproportionate attention, mainly growing from the perception that SWFs are “atypical” investor. This perception has a certain level of validity, which is actually self-perpetuating–the more SWFs are considered as a separate breed, the more their actions are viewed from this angle. On that basis, their importance alters, in line with, among others, the following:

• They are established as significant market players – they may not be crucial but need to be taken into account. The perception is that they have access to vast resources that can be applied to investments under a completely different level of manoeuvrability, can react much quicker and can affect markets.

• In certain cases, SWFs are viewed as an extension of states and perceived within the framework of certain state policies.

• They are seen, rightly or wrongly, due to their specifics, as having a more long-term strategy than other investors, and are seen as sometimes going “out-of-step” with prevailing market sentiments at a given time.

• Sometimes, SWFs have an accumulation of funds that are relatively “liquid” which is a consideration, as well as the perception that they have better access to financing. It is fair to say that their risk calculations could sometimes be considered atypical. This view is reinforced by the perception that SWFs have in their arsenal “deeper pockets” or certain unquantifiable guarantees.

• They could be a market-maker (or the elephant in the room), in particular in relatively smaller economies.

The modern markets are complex, and as complexities carry both opportunities and risks, investors are trying to utilise the complexities to the extent that they can bear the risks involved, and from CITIC to the Government Pension Fund of Norway, it is an issue of risk-reward calculation. As a result, the process of SWFs investing in frontier markets would gradually become more and more transparent, in view of their increasing integration in the financial system and their partnerships with international institutions, such as the World Bank or IFC. SWFs are continuously maturing and realising the advantages that international partnerships could bring, in particular in developing markets, and they are often “brought in” by Western private equity groups or by industry-sector players. This increasing accountability and transparency will not be something that happens overnight, but is already a discernible process.

What are the advantages SWFs can bring to the development of the Third World?

SWFs are just like any other investor – they are not a charity, and are interested in returns, reduction of risk and capital growth. Sometimes, however, the long-term or broader view on returns and risks that they take is creating the impression of an agenda, different from that of other investment vehicles and organizations. Yet, at the end of the day, the investment decisions and abilities of SWFs depend on the specifics, nature and size of their holdings in particular regions. Some assets are deemed strategic, others–temporary, or a building block in a long-term approach.

In addition, SWFs have a broader take on investment risks, due to their more long term vision and approach, and are gradually becoming more focused on realising new opportunities in asset-backed or more traditional sectors in less developed markets, such as the example of recent mining investments by SWFs in Zambia, Uganda and Liberia, or, at the other end of the spectrum, the recent investment by Diar (Qatar) in a resort in the Seychelles. As evidenced by the recent agreement of the SWFs of countries like South Korea, Netherlands and Saudi Arabia to invest $600 million in a World Bank-sponsored equity fund for less-developed countries or the recent co-investment by IFC and Chinese funds in the development of a 14-story office block in Dar es Salaam, Tanzania, there is also an attraction and added prestige in working together with multilateral organisations in frontier markets.

In what way can global economic security benefit from intensified activities by SWFs?

As long-term investors, sovereign wealth funds could have the potential to stabilize companies they invest in since these funds do not live by quarterly returns. In a way, the ultimate sovereign wealth fund is the International Monetary Fund which combines transparency and long-term perspective with agreed-upon stabilization goals.

However, they have already moved beyond the "withdraw and regroup" stage brought about by the crisis, not to mention the time of the "glamour investment", which is over. This comes with the need for SWFs to prioritize their portfolios and focus on new areas of growth, which underlies the rationale for joining forces on an ad hoc basis.

Firstly, SWFs have demonstrated increasing awareness that their level of expertise is not universal, and find that obtaining additional expertise via cooperation is a viable option for them. Secondly, this allows them to share risk and enable access to welcome co-financing, another major consideration. Thirdly, in the crisis and post-crisis environment, such co-operation allows them to achieve a new level of legitimacy in markets where they have not operated before.

In the process of cooperation, SWFs appear to be seeking to offset any limitations or inefficiencies that they may have in respect of specific projects by combining with others that may have access to better "investment tools". It should also not be ruled out that SWFs would also join forces like other traditional market players in order to achieve better transaction returns.

Significantly, SWFs could expand their contribution to global economic security and stability by contributing their long-term outlook. According to Ashby Monk of the Oxford SWF Project, "these funds... have intergenerational time horizons that grant them a unique ability to consider risk factors not priced in today's short-term markets (but which will no doubt be priced in the long-term)".

Down the line, SWF partnerships can enable state-owned funds to optimize local knowledge, leverage capital, spread investment risks and maximize returns. They could also create a bigger, more diverse and transparent entity, whose long-term investments—often holding assets for years—might help stabilize global markets.

What are the future prospects for SWFs?

Growth for SWFs would predominantly depend on two things—the support of their governments and their own investment strategies (and how successful they are). The SWFs that are largely dependent on their government financing their activities (for example, from oil or other natural resources revenues) will experience a reduction in new capital inflows, but that effect will not be fully translated from the price of oil to the growth of the funds.

SWFs, as can be seen by the competition between India's ONGC and CNOOC in Uganda, face the same risks as any other market players—both systemic market risk, and non-systemic political, legal, commercial and other forms of risk, and are subject to the need to maximize return for their shareholders, where governments are often less patient than private investors. However, as indicated by Andrew Rozanov of Permal Group, who is credited with having coined the term "sovereign wealth funds", the priorities and mandates of SWFs can bring forth a number of inherent contradictions, due to the divergence of their targets. These targets, which focus on stabilization, long-term savings and economic development at the same time, "push in opposite directions". In turn, this implies that these priorities may sometimes be in opposition and work at cross purposes, which could affect the performance of SWFs.

Those funds that invested in producing assets beyond oil will be able to enjoy whatever spurt of growth other industrial sectors enjoy, or they will be able to minimize the negative effect of the oil price on their funding via diversification of their investments. Another point that needs to be taken into account is the fact that SWFs would more and more make their investments with a more long-term strategy than private equity firms – the government of China for example will eventually benefit from the acquisition of oil producing assets even if the price is low, because that would provide them with sufficient flexibility to satisfy their own energy demand in boom times and sell the surplus on the market in "lean times". And the revenue of the government from the products which the country was able to produce using the extra oil supplies will eventually find its way to the SWFs.

What are the potential pitfalls to SWFs' future role in the global economy?

SWFs are part of the market, and the market will inevitably have its say. As pointed out by Edwin Truman of the Peterson Institute for International Economics, whose work inspired the Santiago Principles governing SWF conduct, sovereign funds are not immune to or beyond the effects of global economic cycles, such as the worldwide financial and economic crisis. Irrespective of whether or not the shareholders are private individuals, institutions or governments—the balances are the same, so are the requirements of creditors. In practice, the notion that SWFs are "more patient" than private investors does not really hold water. SWFs often face the same horizon as other market players, and are subject to the same exigencies—they need to maximize return for their shareholders, and governments could be even less patient than private investors.

Where a difference may arise is in that SWFs tend to be in a stronger position than other investment companies to withstand the pressure of market fluctuations and "stick" with a specific investment. Size and sovereign support can get you only so far, and the market pressure will eventually tell, so success for SWFs would often depend on whether or not they are aware of the market trends and comply with market realities.