

PAOLO BAFFI CENTRE
on Central Banking and Financial Regulation

Sovereign Investment Lab



Università Commerciale
Luigi Bocconi

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Cautious change

Sovereign Wealth Fund
Annual Report 2012

Sovereign Investment Lab

The Sovereign Investment Lab is a group of researchers brought together in the Paolo Baffi Centre of Central Bankinancial Regulation at Università Commerciale Luigi Bocconi. The Lab tracks the trends of sovereign fund investment activity worldwide and conducts path-breaking research on the rise of the State as an investor in the global economy. Research output aims to meet the highest scientific standards, but also to be accessible for a variety of stakeholders also outside academia: institutional investors, policymakers, diplomats, regulators, and the media.

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From the Editor

Despite the economic downturn, high market volatility and the sovereign bond crisis in the Eurozone, sovereign wealth funds (SWFs) have continued to grow in the last years, with assets under management in 2012 exceeding the \$3 trillion mark. Yet, despite the growing size – and importance – of SWFs, we still observe a persistent knowledge gap about the role, mission, and strategies of one of the most relevant, yet most poorly understood, new actor in global finance.

SWFs have been out there for decades, managing the wealth of nations as patient long-term investors under the radar screen of financial media and the public at large, and then capturing attention before the crisis, raising misplaced fears about their allegedly politically-driven investments threatening national security. As markets collapsed and the financial system went in freefall mode, Western governments immediately changed their attitude towards SWFs, seizing the opportunity to tap large pools of fresh capital from emerging countries to bail out their ailing banks. Economic realpolitik muted previous political concerns, and the public perception changed favorably as SWFs gained the reputation of “responsible” global investors, even though no major change in strategies or overall transparency had occurred.

We are glad to present our annual report on SWF investment in 2012. The reader will find here the usual high quality data which made the Sovereign Investment Lab a rather unique source for independent, reliable information on global SWF transactions. Additionally, this issue boasts contributions from international experts such as Thouraya Triki, Issa Faye, Adam Dixon and April Knill covering the rise of new African funds, the challenges of co-investment and sovereign investment in private equity.

SWFs are taking stock of previous experience. Stronger than ever, they realize the critical role they could play in the global economy and are embracing cautious change. After suffering huge losses in their investments in the financial industry at home and abroad, they have started to diversify away from banks both geographically and across sectors. They are paying more attention to deal execution, building

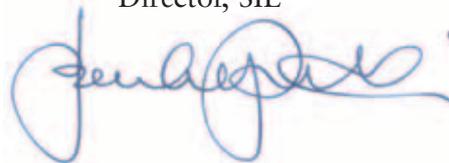
in-house capacity to carry out investments and revoking mandates to external asset managers to save fees and gain efficiency. They are starting to play a more active role as shareholders, raising their profile in the corporate governance of target firms by appointing directors and thus benefiting other small shareholders. In order to assuage political concerns in recipient countries, they have started to work in close cooperation with local private and sovereign investors or in syndicates involving other international SWF as co-investors.

2012 has been an important year for SWFs. The main facts can be summarized as follows.

- **More deals, less value.** *In 2012, we observed 21 SWFs completing 270 deals with a total publicly reported value of \$58.4 billion, a 14 percent increase in the number of transactions, but a 30 percent decrease in total deal value relative to 2011. This smaller average deal size is symptomatic of a new emphasis on diversification.*
- **A real estate boom.** *Real estate has always been a sector of choice for sovereign investment, but 2012 activity in the sector has been particularly impressive. With 53 publicly reported deals worth \$15 billion, the percentage of total value invested in the sector increased by 50 percent with respect to 2011, reaching an all-time high of 26 percent of total deal value, surpassing the total amount invested in the financial industry.*
- **Bank bailout slowing down.** *By deals, financial services received more publicly reported investments from SWFs than any other sector: 66 deals worth \$14.3 billion. However, domestic bailouts in the sector shrunk from the 77 percent of total deal value recorded in 2011 in the domestic market to 53 percent, for a total value of \$4.8 billion.*
- **Strong interest in commodities, the energy sector, and associated processing industries.** *During 2012, the combined expenditure in those sectors was \$15.8 billion, 27 percent of total deal value. Particularly, the \$4.4 billion QIA's purchase of the 7.9 percent of share capital of Xstrata is the largest deal of the year.*

- **Intensifying cooperation and a landmark deal.** *Qatar Holding of QIA acted in concert with other SWFs to support the merger of Glencore with Xstrata, a \$70 billion deal creating a new global commodity giant and setting a new high-mark of successful co-investments involving SWFs.*
- **Europe, not USA, this time.** *European targets still attract almost a half of value (73 deals accounting for \$28 billion , 48 percent of total value), while we document a sharp decline in activity in North America, dropping to only 6 percent of total deal value (\$3.4 billion). Indirect exposure to emerging market growth is highly visible in the choice of established multinational firms as targets.*
- **Going South-South.** *In 2012, South-South foreign SWF investment flows (i.e. within MENA, Africa, Asia-Pacific and Latin America) accounted for a total value of \$15.6 billion in 104 transactions, while South-North for \$30.1 billion in 110 deals. One third of SWF total capital invested abroad is recycled in the southern hemisphere, boosting productivity and growth in the region.*
- **Qatar, the small giant.** *QIA sticks out as the unquestionable champion of 2012. In 2012, QIA outgunned all other funds in spending terms by purchasing assets worth \$16.8 billion, increasing its share of total direct equity investment to 29 percent, a 95 percent increase relative to the previous year.*

Bernardo Bortolotti
Director, SIL





Introducing Sovereign Wealth Funds

The term “sovereign wealth fund” has come to be used as a catch-all term for any state-owned investment vehicle funded from budget surpluses, regardless of its purpose, strategy, asset allocation or investment behaviour. In reality, the sovereign investment universe is much more complex since the management of national reserves depends on the unique circumstances of individual countries. Some states such as Venezuela, Iran, or Botswana choose to establish stabilisation funds to protect their currencies against excess volatility. Others like India, keep large surpluses in foreign exchange reserves due to the volatility of their income streams and structural deficits. The Japanese perceive that providing for their aging population is their most pressing priority, so they maintain their wealth in large pension funds. Oil-rich nations in the Persian Gulf region invest their oil revenue surpluses abroad to provide for future generations when their oil reserves are depleted.

Since the purpose of each fund is defined by its country’s unique macroeconomic requirements, sovereign investment vehicles have immensely diverse investment strategies, behaviour, and asset allocation. That said, if we examine their portfolios, they can be loosely grouped into six buckets along a spectrum of financial risk from central banks and stabilisation funds (which hold the most-liquid and lowest-risk assets), pension and social security funds (also interested in seeking returns for their beneficiaries), to domestic investment and state-owned enterprises (which have the riskiest and most-illiquid assets).

Sovereign wealth funds are just one type of sovereign investment vehicle and can be placed in the

middle of this spectrum. SWFs have an independent corporate identity (they are not managed by a central bank or finance ministry) and invest for commercial return over the long term. Unlike central-bank, stabilisation, or public pension funds, SWFs have no explicit liabilities – i.e., their assets are not routinely called on for stabilisation or pension contributions – so they can have a greater tolerance for risk and illiquid assets to generate superior returns. As such, these funds have a strategic asset allocation that incorporates a wide range of assets that can include any of the following: equities, bonds, private equity, real estate, hedge funds, exchange-traded funds, futures contracts, commodities, etc. These investments may be made through asset managers or directly, in domestic assets or international markets.¹

Against this background, a “Sovereign Wealth Fund” is an investment vehicle that is:

- 1 Owned directly by a sovereign government
- 2 Managed independently of other state financial and political institutions
- 3 Does not have predominant explicit current pension obligations
- 4 Invests in a diverse set of financial asset classes in pursuit of commercial returns
- 5 Has made a significant proportion of its publicly reported investments internationally

¹ All SWFs with equity portfolios, and many with only fixed-income portfolios, employ asset managers. However, the funds that invest a significant proportion of their portfolios directly often do so through a series of wholly owned subsidiaries that often are registered in low-tax environments such as Mauritius or the Cayman Islands.

SWFs are just one type of sovereign investor, and differ widely in purpose, portfolio allocation and strategy.

This is the definition that the Sovereign Investment Lab uses to identify the funds addressed in the body of this report and listed in *Table 1* below.

SWFs, specifically, usually are formed for one of three purposes. First, and usually in the case of commodity funds, is intergenerational savings. Governments receiving large incomes from a finite natural resource often choose to invest surpluses to provide for future generations at a time when the income stream will have dried up. Two of the most notable of this type of fund are the Abu Dhabi Investment Authority (ADIA) and the Kuwait Investment Authority (KIA).

The second purpose for an SWF is to diversify national reserves. As surpluses accrue, they create inflationary and exchange-rate pressures, which may have major implications for economic development in emerging economies. Diversifying national reserves relieves these pressures, while providing superior long-term returns to traditional liquid assets such as sovereign bonds. CIC and GIC are examples of such funds.

The third purpose for an SWF—economic development—traditionally has been confined to those formed from government-linked company portfolios. Temasek and Khazanah have long invested in

their domestic economies, looking to develop government-linked companies and ready them for initial public offering, or to diversify and build capacity in their home economies. Now other countries, for example, the United Arab Emirates and Vietnam, are looking to achieve the same aim, in return for a healthy profit.

The International Forum of Sovereign Wealth Funds, the official representative body of SWFs, formed in 2008 to create a voluntary code of conduct, otherwise known as the “Santiago Principles,” for SWF investment behavior. It defines an SWF thus: “Special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets ...”² This broad definition, however, encompasses a wide range of organisations from the stabilisation funds of Botswana, Chile, and Trinidad and Tobago, funds owned by sub-national governments such as the Alaska Permanent Fund, as well as more-traditional sovereign wealth funds such as ADIA, GIC, and CIC.

Some funds straddle one or more of these buckets. The most obvious of these are pension reserve funds such as Australia’s Future Fund and the New Zealand Superannuation Fund. These funds are established to use budget surpluses to fund future

² International Working Group of Sovereign Wealth Funds, Sovereign Wealth Funds Generally Accepted Principles and Practices “Santiago Principles”, October 2008, <http://www.ifswf.org/pubs/gapplist.htm> (accessed May 10, 2012)

Table 1: Sovereign Wealth Funds, Assets under management

Country	Fund Name	Inception Year	Source of Funds	AUM (US\$BN)
Norway	Government Pension Fund – Global [£]	1990	Commodity (Oil & Gas)	746.30
China	China Investment Corporation ^{**}	1976	Trade Surplus	482.20
UAE-Abu Dhabi	Abu Dhabi Investment Authority [†]	1990	Commodity (Oil & Gas)	450.00
Kuwait	Kuwait Investment Authority [†]	2007	Commodity (Oil & Gas)	296.00
Singapore	Government of Singapore Investment Corporation [†]	1953	Trade Surplus	220.00
Russia	National Wealth Fund and Reserve Fund [£]	2006	Commodity (Oil & Gas)	172.90
Singapore	Temasek Holdings [§]	1981	Trade Surplus	157.90
China	National Social Security Fund ^{**}	2000	Trade Surplus	141.40
Qatar	Qatar Investment Authority [†]	1974	Commodity (Oil & Gas)	135.00
Australia	Australian Future Fund ^μ	2006	Non-Commodity	83.10
UAE - Dubai	Investment Corporation of Dubai [†]	2006	Commodity (Oil & Gas)	70.00
Libya	Libyan Investment Authority [†]	2003	Commodity (Oil & Gas)	64.20
UAE-Dubai	International Petroleum Investment Company [£]	1984	Commodity (Oil & Gas)	60.00
UAE-Abu Dhabi	Mubadala Development Company PJSC [£]	1993	Commodity (Oil & Gas)	55.00
Kazakhstan	Kazakhstan National Fund [†]	1983	Commodity (Oil & Gas)	52.30
Republic of Korea	Korea Investment Corporation ^{**}	2006	Government-Linked Firms	43.00
Malaysia	Khazanah Nasional Berhad [£]	2000	Government-Linked Firms	40.20
Brunei	Brunei Investment Agency [†]	1983	Commodity (Oil & Gas)	39.00
Azerbaijan	State Oil Fund of Azerbaijan ^μ	1999	Commodity (Oil & Gas)	34.30
Ireland	National Pension Reserve Fund ^μ	2001	Non-Commodity	19.60
New Zealand	New Zealand Superannuation Fund ^μ	2001	Non-Commodity	17.90
East Timor	Timor-Leste Petroleum Fund ^μ	2005	Commodity (Oil & Gas)	13.00
UAE - Dubai	Istithmar World [†]	2003	Government-Linked Firms	11.50
Bahrain	Mumtalakat Holding Company ^{**}	2006	Government-Linked Firms	11.20
UAE	Emirates Investment Authority [†]	2007	Commodity (Oil & Gas)	10.00
UAE-Abu Dhabi	Abu Dhabi Investment Council [†]	2005	Commodity (Oil & Gas)	10.00
Oman	State General Reserve Fund [†]	1980	Commodity (Oil & Gas)	8.20
UAE-Ras Al Khaimah	Ras Al Khaimah Investment Authority [†]	2005	Commodity (Oil & Gas)	2.00
Vietnam	State Capital Investment Corporation [†]	2005	Government-Linked Firms	0.60
Kiribati	Revenue Equalization Reserve Fund [†]	1956	Commodity (Phosphates)	0.50
São Tomé & Príncipe	National Oil Account [†]	2004	Commodity (Oil & Gas)	< 0.01
Oman	Oman Investment Fund	2006	Commodity (Oil & Gas)	Unknown
UAE - Dubai	Dubai International Financial Center	2006	Government-Linked Firms	Unknown
			Total OIL & GAS	2,218.20
			TOTAL TRADE SURPLUS	1,001.50
			TOTAL OTHER	227.60
			TOTAL AUM	3,447.30

£ AUM as of May 2013

** AUM at the end of 2011

£ AUM as of February 6, 2013

§ AUM as of March 2012

μ AUM as of March 2013

¥ Estimate by SWF Institute

£ AUM at the end of 2012

† Sovereign Investment Lab estimate of assets under management (AUM).

Source: Authors calculations using International Financial Services London Research (2009), SWF Institute Website

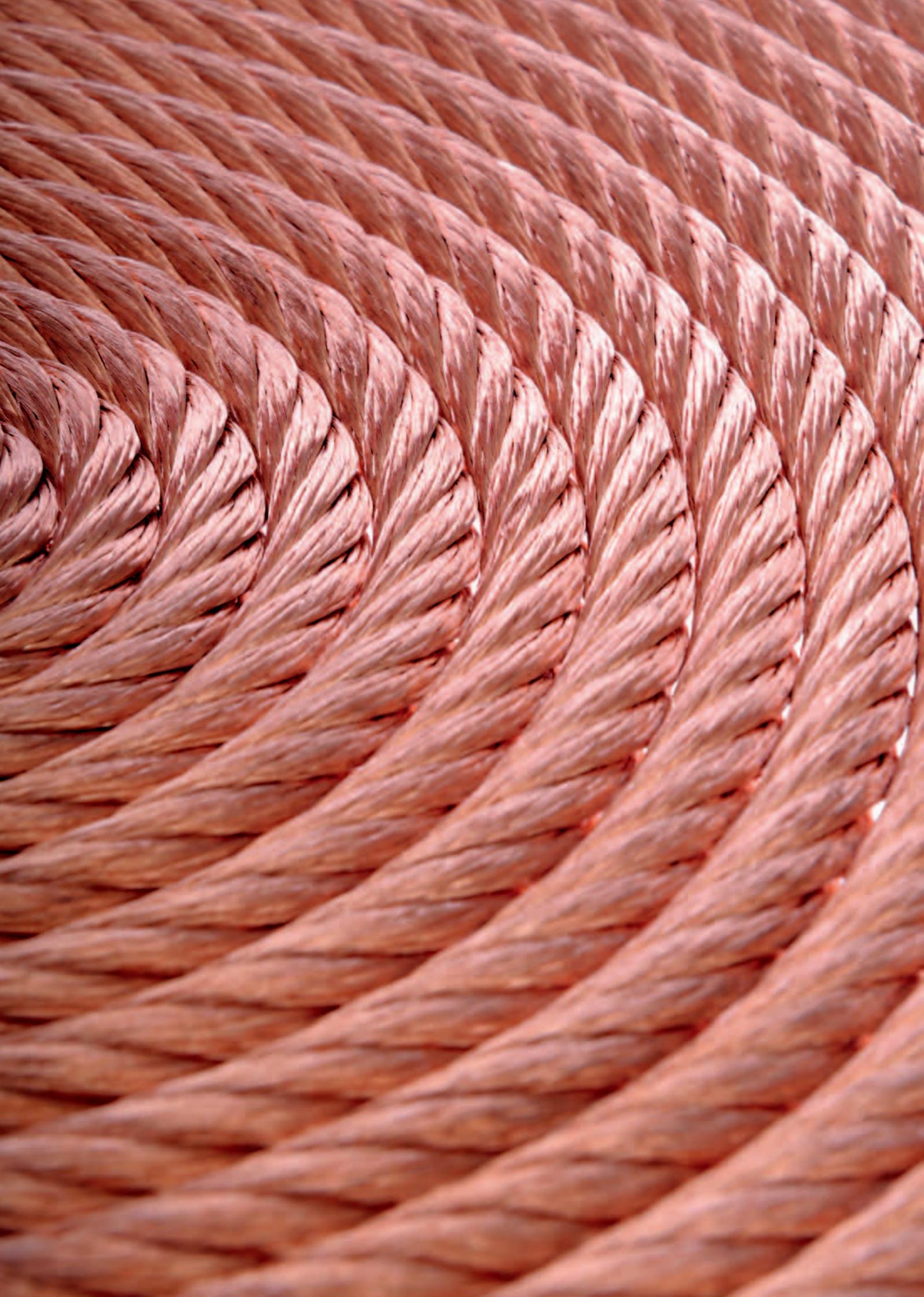
public pension liabilities. Currently, therefore, these funds have no liabilities and invest with a risk profile of a sovereign wealth fund. However, their asset allocation and risk tolerance will alter when they start being drawn down.

Many SWFs with an economic development purpose are also hybrid models with a role that overlaps SOEs. Funds like Mumtalakat and Vietnam's State Capital Investment Corporation are active in the operations of many of the government-linked companies in which they are stakeholders. Their operations have many parallels to modern private equity firms that actively engage with portfolio companies to add post-investment value. However, as these funds exit their portfolio companies, which both Temasek and Khazanah are doing increasingly, they can increase their investments in financial assets, developing broad-based equity portfolios, and thus transition toward a reserve-diversification fund.

Other funds that have this hybrid role are those from Abu Dhabi, most obviously the Mubadala Development Company. Mubadala's mandate is to develop and diversify the economy of Abu Dhabi and it thus has extensive operations across many sectors within the emirate. However, it also has a for-profit foreign equity portfolio that it uses to support the investments it makes at home financially. It also undertakes joint ventures with international companies such as GE and Finmeccanica and has bought companies such as SR Technics (aerospace) and John Buck International (property development) for specific projects.

The Qatar Investment Authority (QIA) is also an example of a hybrid model fund. While it is known for its high-profile financial investments abroad, particularly in the United Kingdom, QIA (usually through its wholly owned subsidiary Qatari Diar, a property development and investment company) has undertaken domestic investments to develop the Qatari economy; its largest and most high-profile investment is the \$24.4-billion joint venture with Deutsche Bahn to develop the country's railroad system in 2009. It also invests in agricultural land abroad for food-security purposes through Hassad Food and the Al Gharrafa Investment Company.





SWF Investment in 2012

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Activity

In 2012, we observed 21 SWFs completing 270 deals with a total publicly reported value of \$58.4 billion. This represents a 14 percent increase in the number of transactions we reported in 2011, but nearly a 30 percent decrease in investment by value. This decline in activity is certainly unsurprising. With global growth slowing down, the Eurozone shrinking and declining commodity and oil prices, 2012 could not be a spectacular year for SWF investments. More broadly, the ebbs and flows of sovereign investments seem to follow the steady decline in cross-border capital flows, which according to McKinsey Global Institute shrunk 60 percent from the pre-crisis peak, according to McKinsey Global Institute.

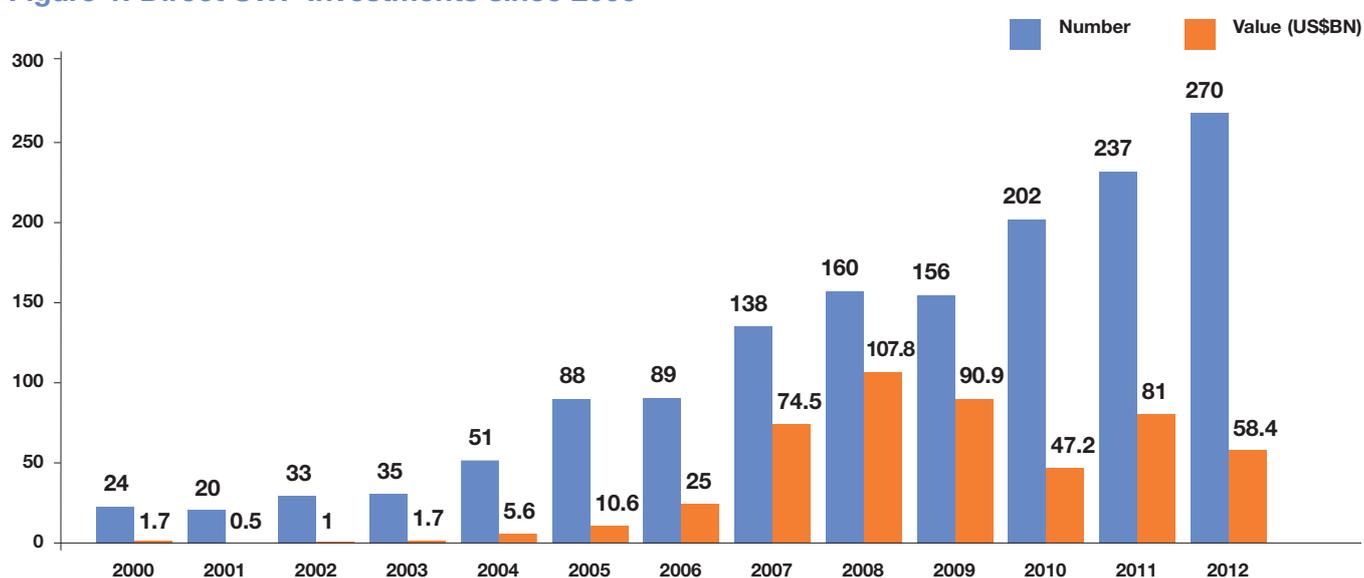
2012 was also a tale of two periods: the first semester was characterized by the sovereign debt crisis in peripheral countries of Europe and the spreading of perceptions about a possible euro breakup; the second half opened with the announcement by the ECB president Mario Draghi that “whatever it takes to save the euro” would be tried. This statement, combined with the provision of liquidity by central banks, reassured markets, curbed volatility and spurred the market rally which – as we write – is still underway. On balance, these countervailing forces led to an initially declining investment value settling at a new bottom.

The fallback of investment by value was combined with a significant increase in the number of reported transactions. The apparent disconnect between our two measures of activity can be explained by structural and organization factors. In the wake of

In 2012 we observe more deals, less value, thus an emphasis on diversification.

the crisis, SWFs are reducing the number of external managers and increasing the proportion of assets managed in-house, as they seek to grow their internal capabilities so as to be able to manage more of their assets independently in the future. Since we track direct investments by funds and their subsidiaries, more deals appear on our radar screen, increasing the number of reported transactions. Second, the emergence of SWF as major players in the global arena and the awareness of their role as financial powerhouses has provided incentives to adopt principles and rules of responsible investors, and transparency ranks high among them. After taking formal steps by signing the Santiago Principles, SWF are taking seriously the issue of voluntary disclosure of new investments, while retaining information about total asset under management, considered as a “state secret” for most of them.

Of course, the higher number of deals coupled with a lower total monetary value indicates that the average deal size is declining. This smaller average deal size is also symptomatic of a new emphasis on diversification. SWFs, still recovering from heavy investment in financials on the onset of the 2007-2008 crisis, are more conscious of the need to properly diversify, both in terms of geography and sectors, by acquiring smaller stakes in a large number of firms.

Figure 1: Direct SWF Investments since 2000

Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

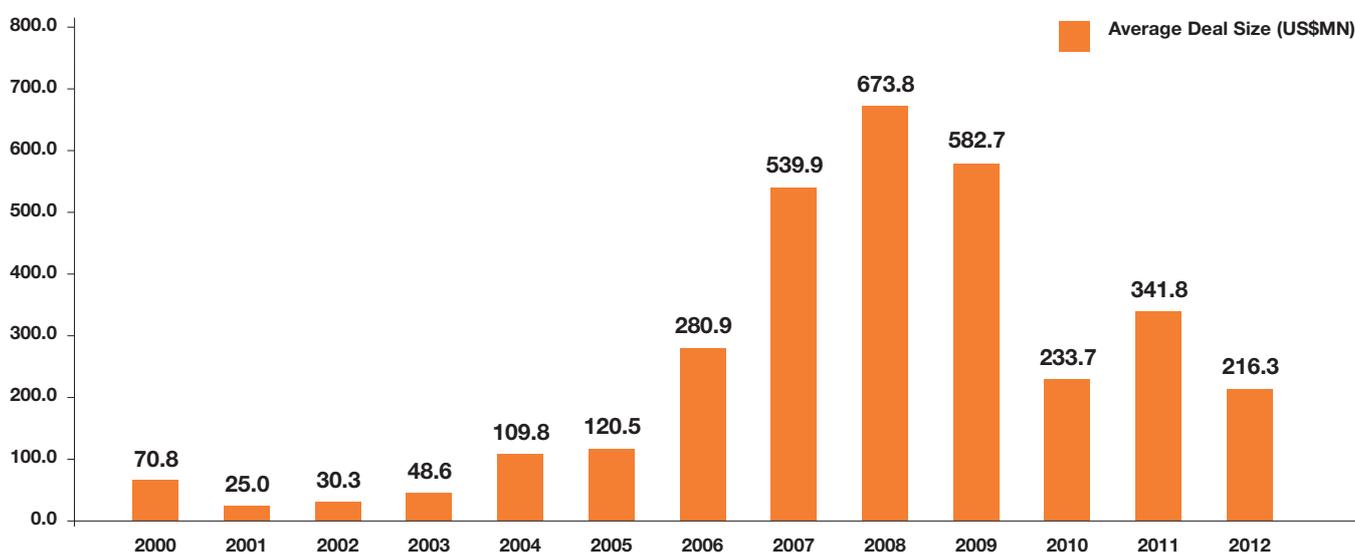
Sectors

In 2012, as usual, financial services received more publicly reported investments from SWFs than any other sector: 66 deals worth \$14.3 billion, 25 percent of total investment. Since 2008, significant flows of sovereign investment took the form of capital injections in distressed banks in both developed and emerging economies, but, compared to previous years, we observed a marked decrease of domestic bailouts of financial firms by SWFs. In 2012, the proportion of SWF investment in domestic banks shrunk from the 77 percent recorded in 2011 to 53 percent, for a total value of \$4.8 billion.

Interestingly, the largest deals of this type in 2012 occurred in China. Starting in 2003, China has used a domestic investment arm, Central Huijin, subsequently incorporated into the China

Investment Corporation (CIC), to recapitalize the large national banks after a surge in defaults on loans issued to politically connected, state-owned enterprises in the 1990s. The fund was not only used to inject capital, but to reorganize the banks, with a strong focus on improving governance, ahead of public share issuances. Yet, after multiple rounds of refinancing and after large public equity sales over the past decade, Central Huijin was once more forced to intervene in 2012. The fund bought a sizable stake of China Export and Credit Insurance Corporation worth \$3.2 billion, the second largest deal of the year by value. CIC increased also its stakes in four of China's biggest lenders in the last quarter of 2012. Yet a recent report by the China Banking Regulatory Commission indicates that the five largest Chinese banks each reported a raising value of non-performing loans as of

Figure 2: Average Deal Size since 2000



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

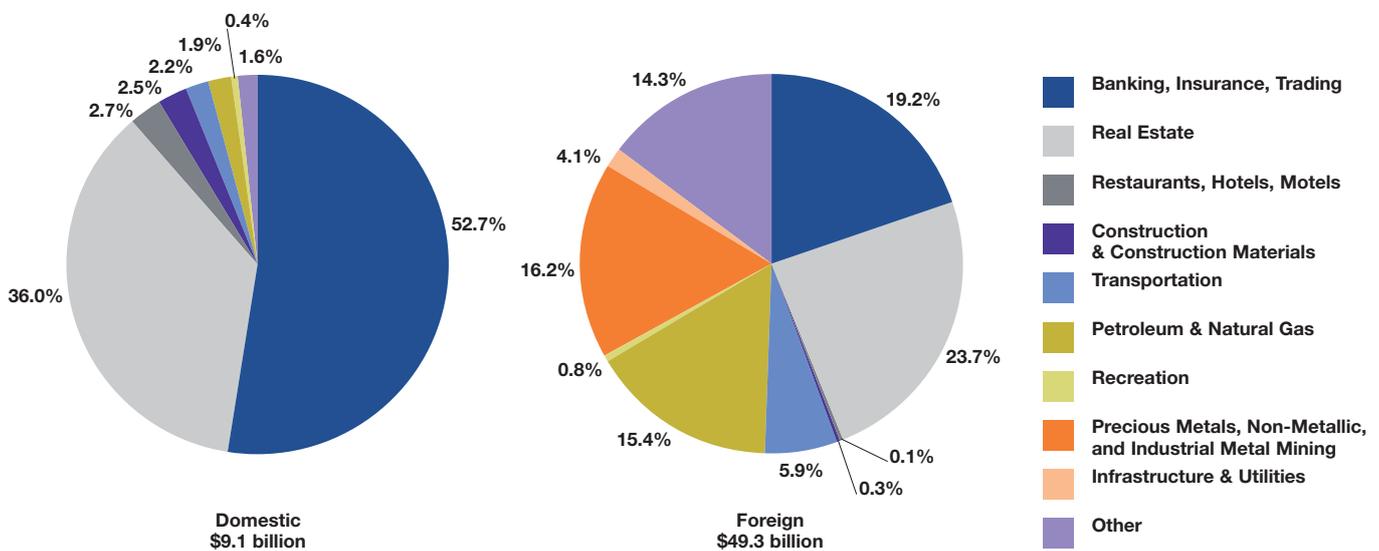
December 2012. With slowing GDP growth and shrinking bank profits due to bad loans, it is likely that the most recent round of capital infusions is not going to be the last.

While the narrowing of SWF investment in domestic banks can be seen as a sign of partial recovery, the effects of the crisis still loom large for some global players in the financial industry. In 2012 Credit Suisse, bailed out by Qatar Investment Authority (QIA) in 2008, required additional funding provided by the Norwegian Government Pension Fund Global (GPF), Temasek and QIA in deals totalling \$1 billion, while Aabar Investments, a subsidiary of Abu Dhabi's International Petroleum Investment Corporation (IPIC), injected capital into Italian UniCredit, becoming its single largest shareholder with a 6.5 percent stake.

A very different story is unfolding from investments in some emerging countries. Here the rationale for investments is certainly not supporting ailing banks, but obtaining exposure to vibrant economic growth captured by local financial institutions. India is a notable example of this trend in 2012, with the Kuwait Investment Authority (KIA) taking stakes in five local investment funds, and a consortium made of Abu Dhabi Investment Authority (ADIA), Temasek and the Government Investment Corporation (GIC) from Singapore investing \$656 million in HDFC Bank, the largest Indian bank by market capitalization.

Amongst international deals, the logic of co-investment has also been successfully applied in reverse direction in the United Kingdom, where Apax, one of the largest private equity firms, has successfully

Figure 3: Value of Direct SWF Investments by Sectors in Domestic and Foreign Markets, 2012



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

raised \$1.2 billion of capital jointly from ADIA, CIC and the Australian Future Fund.

Real estate has always been a sector of choice for sovereign investment, but 2012 activity in the sector has been particularly impressive. With 53 publicly reported deals worth \$15 billion, the percentage of total value invested in the sector increased by 50 percent with respect to 2011, reaching an all-time high of 26 percent of total value, surpassing the total amount raised in the financial industry. Several factors can explain the surge in interest in real estate deals. First of all, despite recent trends, real estate property still represents a “safe” asset type in the long term, and as such particularly attractive in an environment of rising inflation expectations. Second, after the last couple of years seeing the busting of a real estate price bubble,

many real estate markets appear particularly cheap. Third, real estate investments, with their relatively low liquidity, tend to appeal particularly to long-term investors such as SWFs – and, at least in theory, offer a liquidity premium in the form of higher risk-adjusted returns. In the current low-interest rate global economy, this liquidity premium looks particularly attractive.

2012 marks not only an increase, but also an important shift in SWFs’ investment behaviour in the sector. Traditionally interested in brick-and-mortar icons of Western most attractive cities, SWF have started to play a key role also as real estate developers in emerging countries, broadly diversifying by target country and project type. Temasek formed an alliance with Khazanah Nasional Berhad, the Malaysian SWF, to develop two com-

mercial property projects in Singapore and in Malaysia: the \$4.6 billion joint venture named M+S Pte Ltd to develop land parcels in Marina South and Ophir-Rochor in Singapore, and the \$952 Pulau Indah Venture for commercial development in Iskandar, Malaysia. While the development of domestic property markets is the clear objective of this collaboration between SWFs, foreign penetration in BRICs appears to be the aim of the Stabilized JV, another joint real estate deal involving CIC and GIC as partners. The two Asian SWFs committed a total of \$612 million to expand the Brazilian activities of Singapore based Global Logistic Properties, the world second largest owner of industrial facilities.

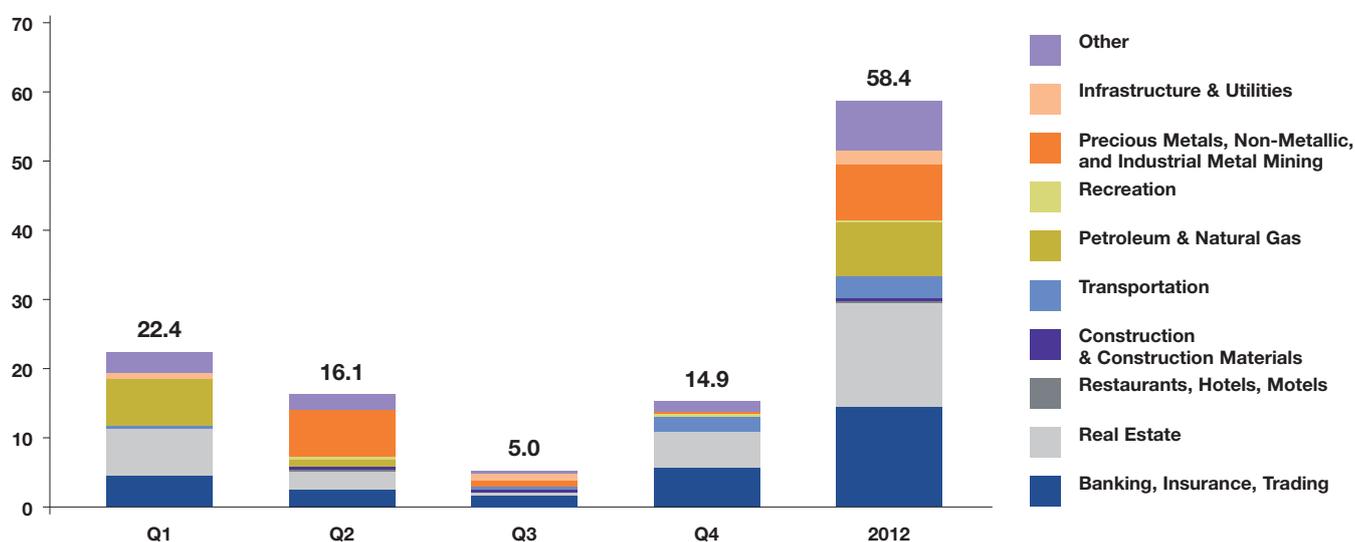
While 2012 clearly showed this type of portfolio rebalancing in favour of new developments, the usual European “safe havens” still attracted considerable investments by SWFs. The total value of reported real estate transactions involving European targets is \$6.6 billion and, as usual, London sticks out as the location of choice. In 2012 SWFs placed in the property market of London 11 deals worth \$2.7 billion. Amongst the most significant deals, the Qatar Investment Authority (QIA), CIC and KIA purchased 1 Cabot Square, 1 Great Winchester Street and 1 Bunhill Row, respectively. By no means did the City of London exhaust SWFs’ appetite for high quality assets in Europe. The Norwegian GPF completed the second largest deal of the year in the sector by acquiring the Uetilhop office complex in Zurich, while QIA expanded its portfolio in the French market, buying in Paris with nothing less the historical building on the Champs-Elisèes hosting the Lido.

SWFs are changing their behaviour from passive shareholders to active players in the corporate governance of target firms.

A second trend is emerging: SWFs are developing a strong interest in commodities, the energy sector, and associated processing industries. In terms of asset allocation, investing in commodities is a sensible strategy for SWF of all stripes. Indeed, countries with persistent trade surplus, such as China, pour money in these sectors to satisfy their energy needs and afford the primary inputs for their fast growing industries. Resource-rich countries recycle part of the revenues in the same sectors in order to ensure the future provision of exhaustible resources.

During 2012, SWFs’ publicly reported direct investments in commodities amounted to 12 deals, valued at \$8 billion, while the energy sector reported 16 deals worth \$7.8 billion. The combined expenditure in those sectors is \$15.8 billion, 27 percent of total deal value. Indeed, 2012 can also be read as a story of two targets: Xstrata, recently merged with Glencore, the UK based commodity trading company, to become one of the world’s largest global diversified natural resource companies, and Total, the French integrated energy company. Publicly reported direct investment in these two firms by QIA and CIC totals \$11.6 billion, accounting for 73 percent of value raised in commodities and energy sectors. The \$4.4 billion QIA’s purchase of the 7.9 percent of share capital of Xstrata is the largest deal

Figure 4: Value of Direct SWF Investments by Target Sector, 2012



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

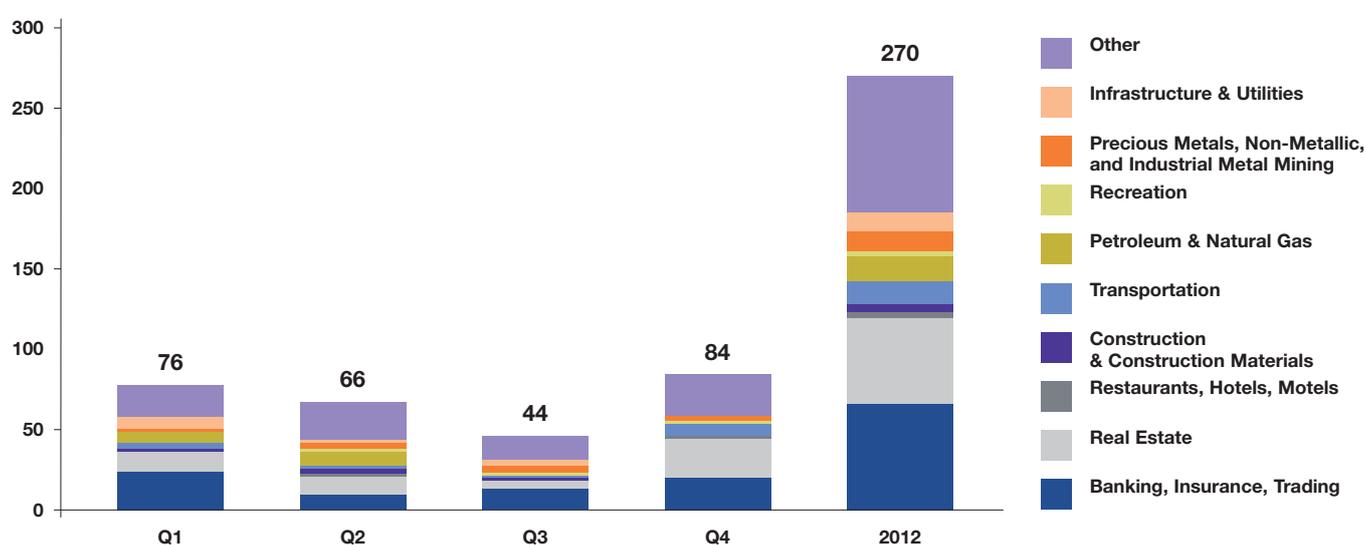
of the year, while the purchases of the 2 percent of Total by CIC and QIA rank fourth and fifth in the yearly ranking by deal value.

Beyond deal numbers, the historical significance of the Xstrata deal has less to do with mining and commodities than with the seismic change in the behaviour of SWF and their future position in the in the global economy. Up to now, SWFs have been passive shareholders with large stakes but unwilling to play any active role in the corporate governance of target firms. Xstrata is a game-changer in that respect. For the first time in history, a SWF, namely Qatar Holding of QIA, acted in concert with the Norwegian GPF and CIC to get a \$70 billion deal done, creating a global commodity giant competing with Rio Tinto and Vale and with positive shareholder impact. By accumulating a stake up of 12

percent, QIA turned itself into a pivotal minority blockholder in Xstrata, rejected the initial offer and forced the bidder Glencore to offer better terms to all shareholders. Interestingly, bargaining between Glencore and Qatar Holding, orchestrated by former UK prime minister Tony Blair, yielded also a change of the initial retention packages foreseen for Xstrata top executives to include a performance link and more equity than pure cash, as requested by small shareholders. QIA’s “kingmaker” role in the Glencore bid definitely sets a strong precedent and a new landscape in which SWF incrementally and inexorably emerge as the powerbrokers in the global corporate arena.

At a smaller scale, SWF investments in large conglomerates in the commodities sector advanced apace also in BRICs. In March 2012, Abu Dhabi’s

Figure 5: Number of Direct SWF Investments by Target Sector, 2012



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

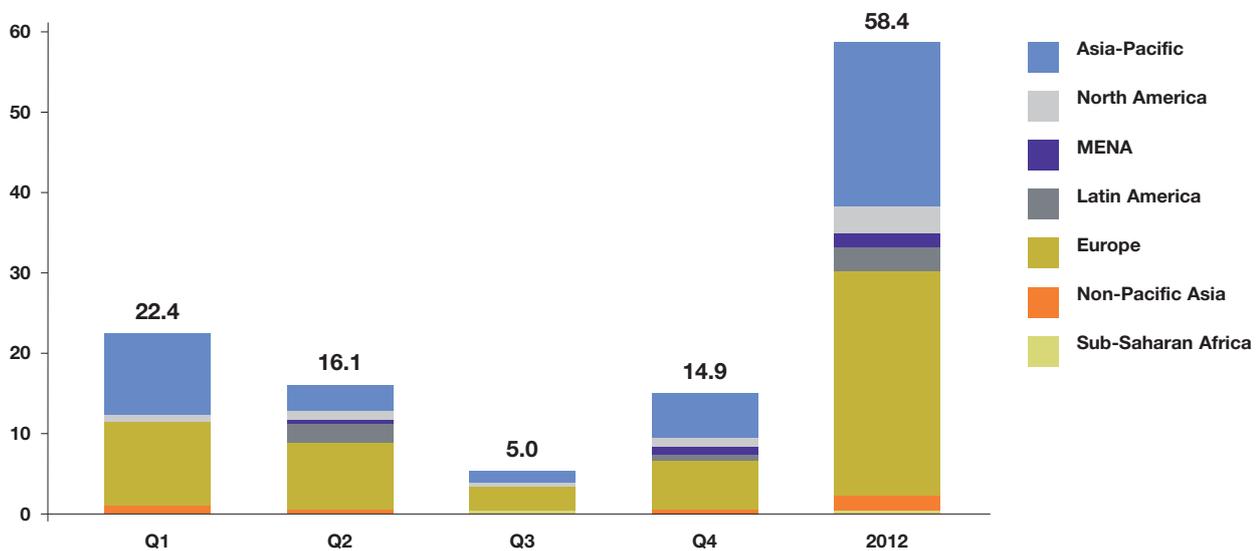
state investment fund Mubadala announced the signing of a strategic partnership agreement with Mr. Eike Batista, the founder of EBX Group of Brazil. Under the terms of the agreement, Mubadala made a \$2 billion primary investment in exchange for a 5.63 percent preferred equity interest in Centennial Asset Brazilian Equity Fund LLC and other offshore holding companies of Mr. Batista. In the same wake, CIC acquired a sizable stake of Polyus Gold International, the largest gold producer in Russia and one of the top 10 gold miners globally by ounces produced.

The recent growth of SWF investment in commodities highlights a strategic shift to the whole value chain of commodities. After having invested significantly in the primary provision of coal, petroleum, and natural gas, raw minerals, SWF direct invest-

ment moved down the value chain, with a strong preference given to vertically integrated targets in the energy industry and commodities business. This progressive strategy of expansion along the value chain can have multiple purposes – yet, most likely, it is a result of the desire to acquire increasing control over raw materials and other natural resources. This increased control can have direct economic benefits – by allowing higher profit margins through integration – but it is also a manifestation of the political goals of countries, such as China, wanting to ensure access to the resources needed to fuel rapid domestic industrial growth.

Part of this ‘crawling down the value chain’, investments in commodities were complemented by smaller scale investments in unconventional oil and oil exploration and production. Singapore’s Temasek

Figure 6: Value of Direct SWF Investments by Target Region, 2012



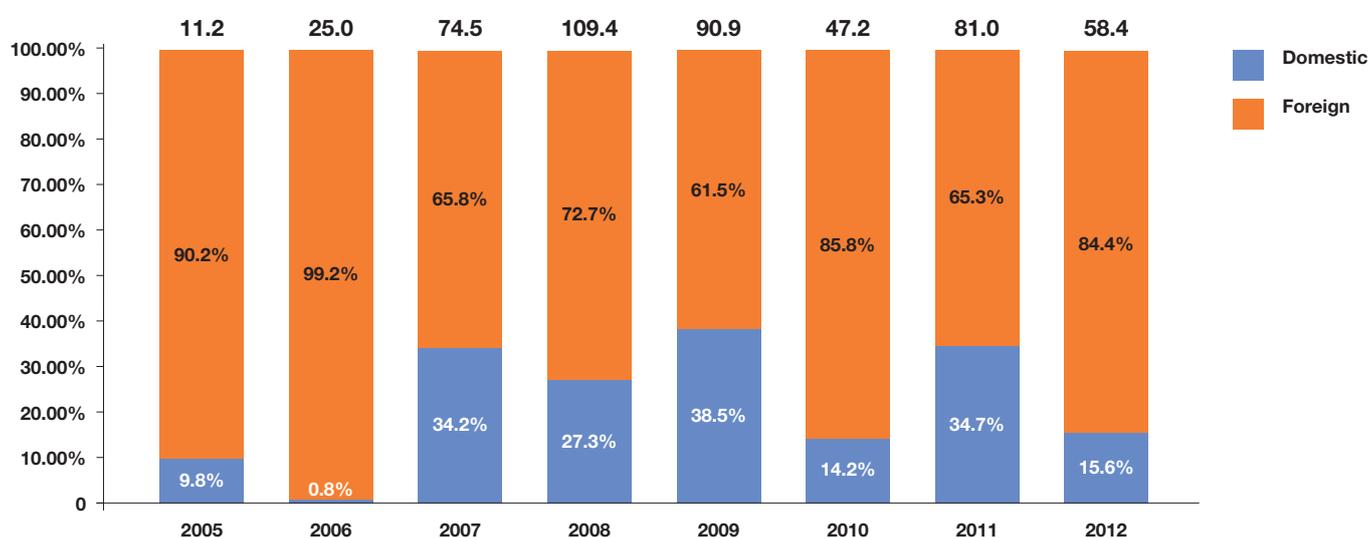
Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

SWF direct investment in commodities is moving down the value chain, with a strong preference to vertically integrated targets.

invested \$300 million in Kunlun Energy, an international energy company controlled by PetroChina Company Limited listed in Hong Kong and operating in mainland China, Kazakhstan, Oman, Peru, Thailand, Azerbaijan and Indonesia. CIC also expanded its portfolio in the energy sector by pledging \$150 million in Sunshine Oilsands Ltd., a Calgary based public company, focused on the development of oil sands leases in the Athabasca oil sands region.

SWF have traditionally shown appetite for investments in transportation, in infrastructure and utilities as a source of stable, long term income streams providing an inflation-edge for their portfolios. However, in 2012 publicly reported investments in these sectors account for only 26 deals worth \$5.1 billion, a slight fallback relative to previous years. Despite this trend, FGP Topco Ltd., the holding company of London Heathrow Airport (formerly BAA) continued attracting sovereign investors. QIA and CIC acquired a 20 and 10 percent stake, respectively, pledging a total of \$2.1 billion in the company; together with Singapore's GIC, SWFs today hold 42 percent of share capital of one of the largest transport facilities in the UK. Other large European infrastructures entered ADIA's radar screen in 2012. Particularly, ADIA joined a consortium led by Macquarie's infrastruc-

Figure 7: SWF Investments in Domestic and Foreign Markets, 2005-2012



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

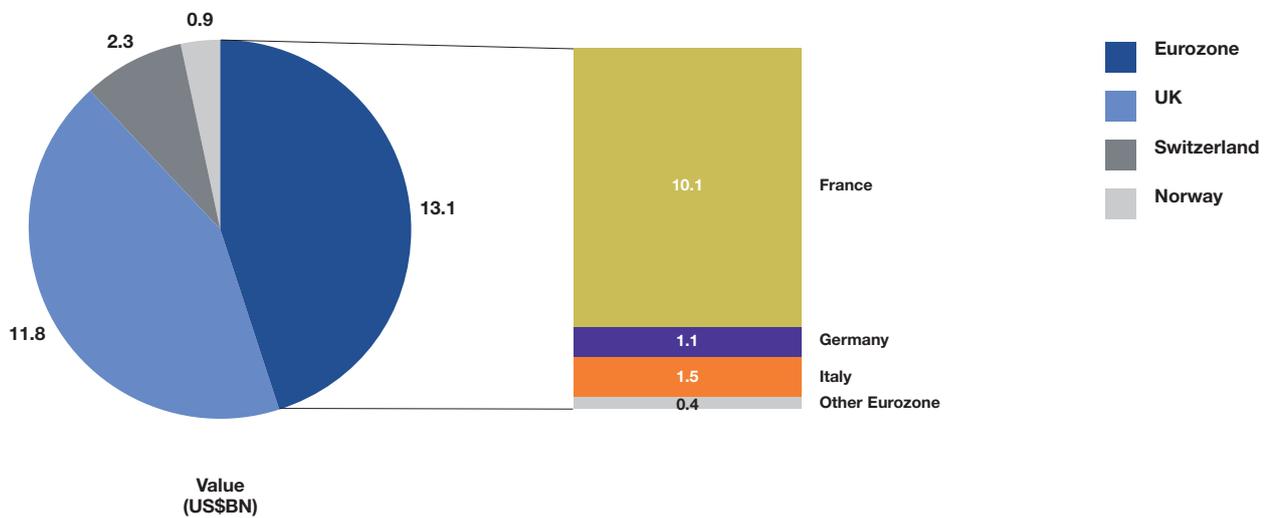
ture funds investing \$1 billion in the German utility E.ON's gas distribution network Open Grid Europe. The assets have commanded strong interest because they include Germany's largest gas distribution network with 12,000 kilometres of pipelines and serve as a link between Eastern and Western Europe. ADIA has also added another piece in its jigsaw puzzle of gas infrastructure with the acquisition of 7 percent of Gassled, the Norwegian gas transportation network, as partner of the consortium Solveig Gas Norway AS.

Geography

Direct equity investments by SWFs tend to broadly follow the stages of economic development. The breakdown by market type confirms the usual pattern reported in previous years with the majority of

investment value (56 percent, \$33 billion) flowing to OECD economies, followed by BRICs (26 percent, 15.3 billion). Since 2007, emerging markets have attracted an increasing share of total investments, reaching 13 percent (\$7.8 billion) in 2012. Frontier markets (i.e. economies with thin capitalization and illiquid markets but endowed with a potential to graduate as fully fledged emerging economies) are still lagging behind. As in the past, SWFs reveal a strong preference for targets with strong legal system and well-functioning institutions – Western markets. This could be a consequence of their size – SWFs, as large investors, need large markets. But it could also be a result of fear – rarely are foreign investors, especially government-owned ones, accepted kindly by public opinion. Strong laws and courts then can assuage fears of expropriation and abuse by powerful and connected locals.

Figure 8: Foreign SWF Investments in Europe, 2012



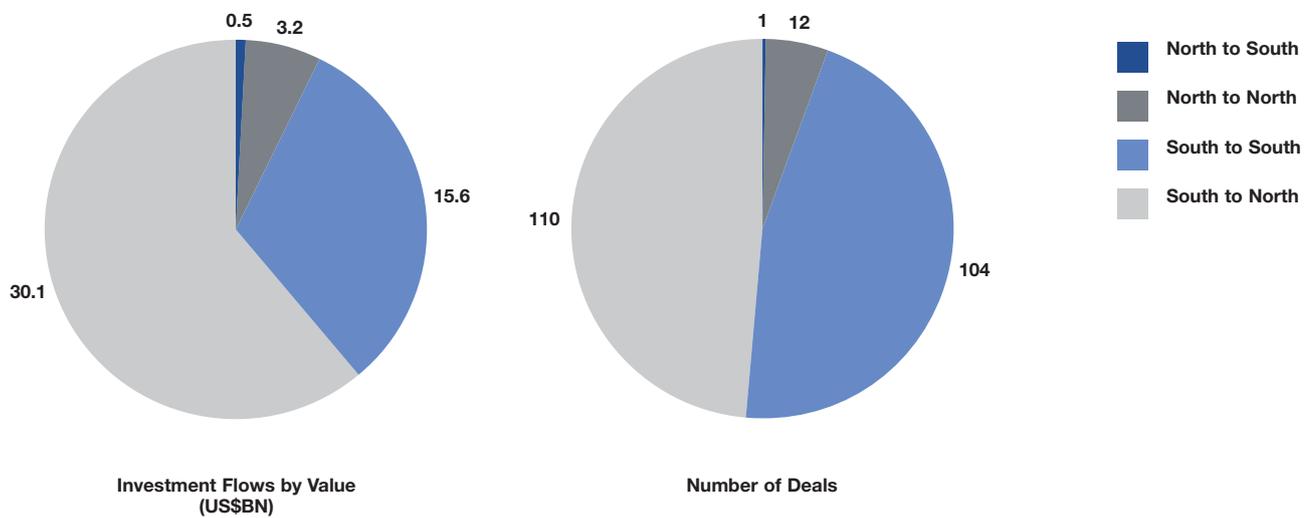
Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

Europe stands out as the usual region of choice. Indeed, any major change is noticed in the regional distribution of investments with respect to 2011. European targets still attract almost a half of value (73 deals accounting for \$28 billion, 48 percent of total value), followed by the Asian-Pacific region accounting for \$20.4 billion, 35 percent. In the last year, we report a sharp decline in activity in North America, dropping to deal value worth \$3.4 billion, only 6 percent of total value. Overall, while wishing to diversify – which, in geographical terms, means investing away from the USA – SWFs are still reluctant to shift away from Western markets.

Beyond aggregate measures about target regions, a fundamental distinction in the geography of investment by SWFs is between domestic and foreign deals, which in turn hinges upon their investment

strategy and ultimately their mission. Some funds (such as Mubadala, Temasek, etc.) have a strong domestic focus and a broad mandate to support the national economy via sovereign equity investment. Other funds, due to the limited absorption capacity of their national economies, invest internationally a larger share of surplus, seeking better returns and diversification opportunities. Obviously, the share of domestic investment of SWF reflects the economic outlook in that the focus of investment may shift at home if the national economy requires support. From this perspective, 2012 witnessed a significant increase in the share of SWF activity in foreign markets with respect to the previous year. In 2012, direct equity investments abroad are worth \$49.3 billion, 84 percent of total, a 30 percent increase relative the previous year. As long as some procyclicality can be traced in the international patterns of SWF activity,

Figure 9: Investment Flows Between and Within Emispheres, 2012



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

this recent trend can be interpreted as a sign of recovery of the investing countries. According to the IMF, while Chinese growth has somehow slowed this year, with GDP growth estimated at below 8 percent, the overall growth rate is still impressive. At the same time, performance of Gulf countries has been comparably more modest and similarly slower than in the previous year, with the UAE GDP growing by about 4 percent, Qatar by circa 6.5 percent and Saudi Arabia by about 7 percent. If these trends persist, SWF assets are likely to keep growing, albeit possibly at a slightly slower rate.

While a very large share of cross-border investment landed in Europe, this number should not be interpreted as a blanket vote of confidence for European economies. Indeed, the distribution of SWF deal value is highly skewed in favour of a few

SWF investment in Europe is not a vote of confidence on the Eurozone, but a strategy to seek exposure to emerging countries growth via established multinationals.

countries and firms. As usual, the United Kingdom received the largest share of investments thanks to the \$5 billion deal of Xtrata and its successful operations in the transport section. France boasts above average figures thanks to the multiple investments in the energy giant Total by QIA and CIC. Finally, Switzerland, a country not particularly integrated with the rest of the European

Smaller stakes, larger deals: the rise of SWF co-investment

SWFs are ideally positioned to capture risk premium because they are by nature long-term investors. With few (if any) short term liabilities and unaffected by liquidity needs, they are able to tolerate volatility and investment risk better than any other type of investor. As a result, SWFs tend to hold a lot of “equity-type” risk in their portfolio. Direct equity investment has been the conventional way that SWF followed to tap this risk premium by acquiring sizable stakes in publicly listed companies. While this strategy exposed SWFs to the “right” risk factors, it obviously yielded poor portfolio diversification, a problem appearing in earnest in the course of the financial crisis when SWFs suffered huge losses in their acquisitions of Western banks.

SWFs started soon to realize this flaw of direct investment and reacted by shifting strategy in favour of co-investments. Indeed, in the last years, SWFs and other like-minded investors have increasingly cooperated by forming alliances and consortia aimed at joint bidding and joint direct investment. This trend is highly visible in our data. In 2012, SWFs launched 41 co-investments (i.e. acquisitions reporting two or more SWFs as bidders for the same company) on 17 targets for a total value of \$24.7 billion. Quite strikingly, collaboration among SWFs in reported direct equity transactions yielded 44 percent of total deal value.

Improved diversification is reflected in the decline of average deal value from 2009 onwards. Teaming up with other SWFs for co-investments yields additions important benefits. First of all, meaningful capital can be committed by the different partners generating economies of scale. Second, significant savings can be realized by avoiding managing fees and sharing financial and technical advisors. Total fees paid to fund manager are estimated at 3 percent per annum, and by the law of compounding the return gap overtime may generate wealth differences which cannot be ignored by investors with long horizons. Finally, as pointed out by Kalb (2011)^{*}, cooperation yields an additional side benefit in terms of mitigation of

political concerns. As widely recognized, host countries are often fearful that SWF may be used as a tool by foreign to pursue a political agenda. By acting in concert, SWF may reassure the recipient countries that they are motivated by commercial financial objectives and this avoids political backlash of foreign acquisitions.

Yet, just as often, SWFs are teaming with other, non-government, investors. For example, a July 2012 Credit Suisse recapitalization of approximately USD 3.8 billion was executed by a group of existing shareholders and six institutional investors, including three SWFs (Qatar Holding, Norway’s GPF and Temasek Holdings), one publicly-traded investment firm (BlackRock Investment Management) and two private-equity firms (Capital Research Global Investors and Olayan Group). Some of the benefits are similar or stronger – for example, teaming with non-government players can send an even stronger signal of non-political interference. Yet, even more, SWFs seem to increasingly rely on the expertise of other players – especially private equity firms – to gain both advice and training. As the recent trend is of ever more internal management and direct investment, SWFs are finding themselves short of both manpower and expertise – both of which can be gained through such partnerships.

Unsurprisingly, the top deals of 2012 were all co-investments, and we find the usual suspects on board across countries and sectors: QIA teamed up with GIC and Norwegian NBIM in bidding for Xstrata, with CIC for Total, and with Temasek and ADIA for the Indian bank HFDC. Thanks to their ingenuity, SWF are steering to the port larger deals with smaller stakes, achieving better diversification and leveraging the firepower of their wealth in syndicated deals. The jury is still out, but for the time being this strategy seems to pay off well.

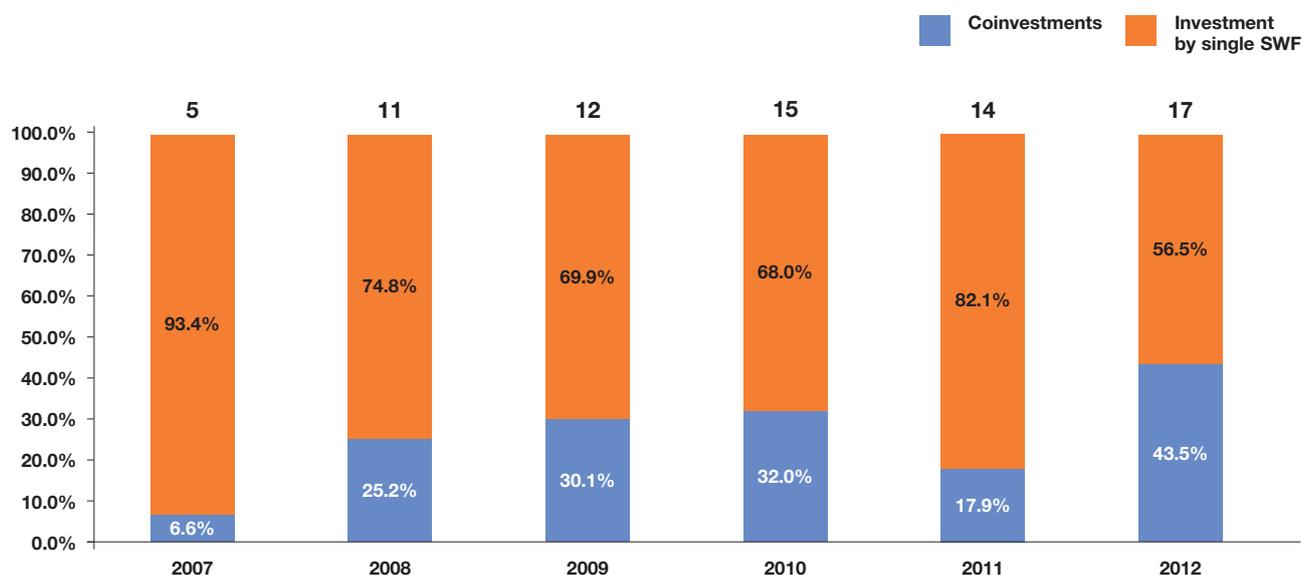
^{*} Kalb, S.E The growing trend of cooperation among sovereign wealth funds, in Park, D. (ed.) Sovereign Asset Management for a Post-crisis World, Central Bank Publications, 2011

TOP 10 Coinvestments

Target Name	SWFs involved in the Coinvestment	Total Deal Value (US\$BN)	Sector
Total SA	China Investment Corporation Qatar Investment Authority	6.39	Petroleum & Natural Gas
Xstrata plc	Government of Singapore Investment Corporation Pte Ltd Qatar Investment Authority	5.17	Precious Metals, Non-Metallic, and Industrial Metal Mining
M+S Pte Ltd	Khazanah Nasional Bhd Temasek Holdings Pte Ltd	4.64	Real Estate
FGP Topco Ltd.	China Investment Corporation Qatar Investment Authority	2.18	Transportation
China Pacific Insurance (Group) Co. Ltd	Abu Dhabi Investment Authority Government of Singapore Investment Corporation Pte Ltd Government Pension Fund - Global	1.34	Banking, Insurance, Trading
Apax VIII LP	China Investment Corporation Future Fund Government of Singapore Investment Corporation Pte Ltd	1.19	Banking, Insurance, Trading
Credit Suisse AG	Government Pension Fund - Global Qatar Investment Authority Temasek Holdings Pte Ltd	0.97	Banking, Insurance, Trading
Pulau Indah Ventures Sdn Bhd	Khazanah Nasional Bhd Temasek Holdings Pte Ltd	0.95	Real Estate
HDFC BANK LTD	Abu Dhabi Investment Authority Government of Singapore Investment Corporation Pte Ltd Temasek Holdings Pte Ltd	0.66	Banking, Insurance, Trading
Stabilized JV	China Investment Corporation Government of Singapore Investment Corporation Pte Ltd	0.61	Real Estate

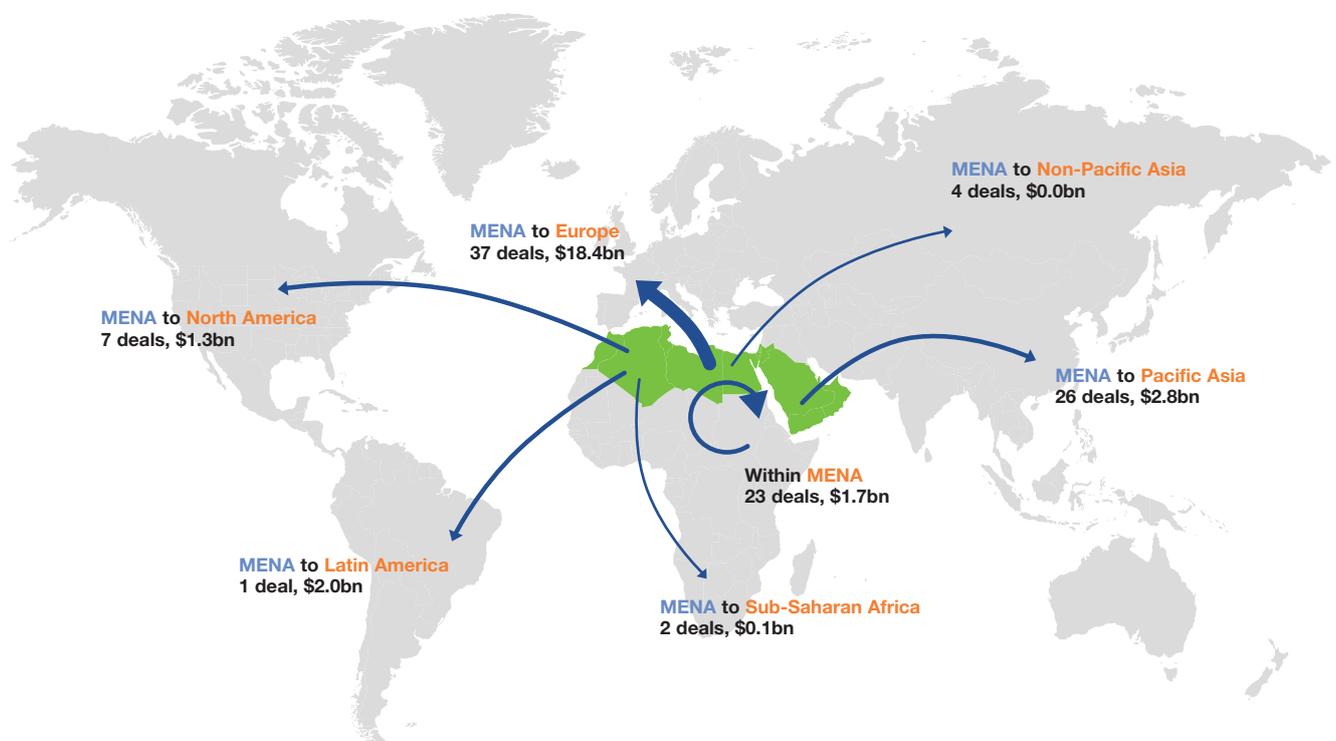
Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

Coinvestments by SWFs (% of total value in US\$ and number of deals)



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

Figure 10: Investment Flows from Middle East & North Africa SWFs, 2012



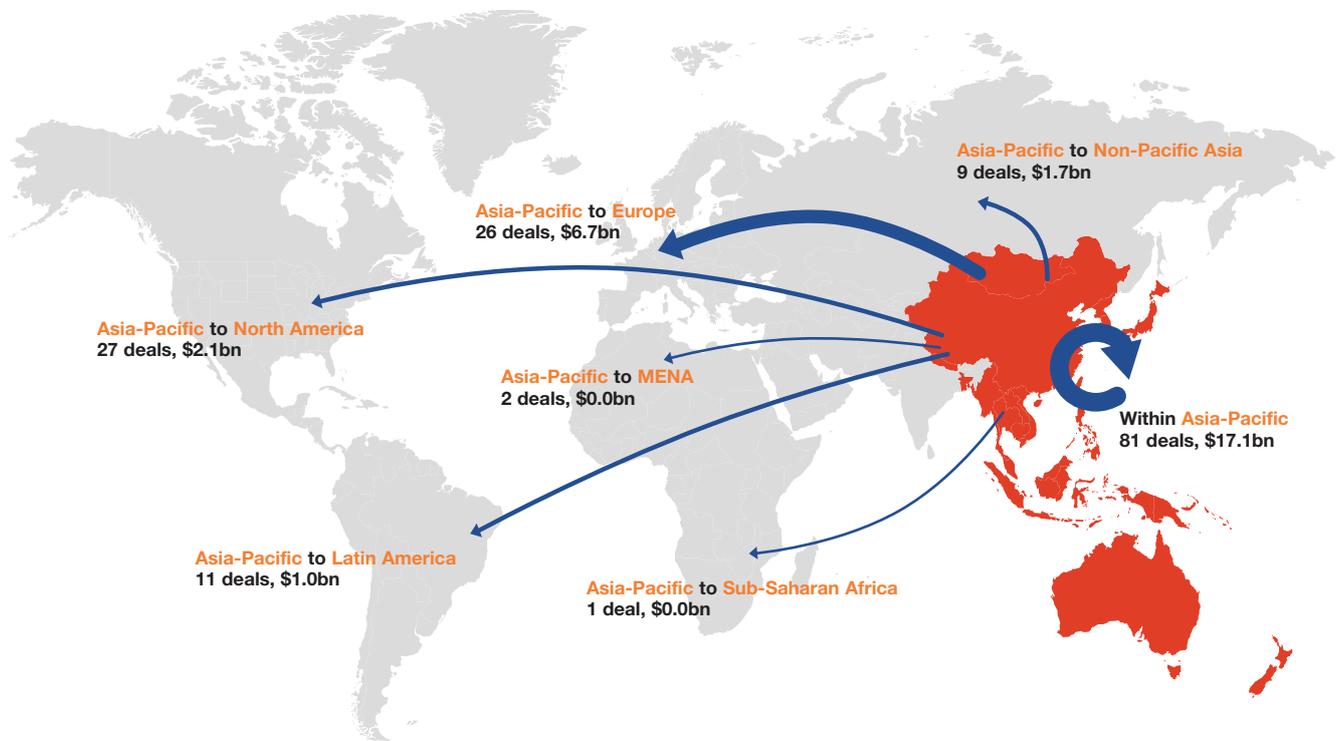
Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

economies, raised \$2.3 billion of SWF investment in Credit Suisse and real estate deals, more than the rest of the Eurozone excluding France. Furthermore, SWF investment in Europe has been overwhelmingly targeted to multinationals such as Xstrata and Total, with a large exposure to emerging market growth – perhaps as a means to gain exposure to high-growth regions while avoiding dealing with weaker institutions.

BRICs are the second largest target region of SWF foreign investment, with 68 deals worth a total

\$10.6 billion. Not surprisingly, China takes the lion's share within this group with \$4.6 billion investments primarily from Singapore. In 2012, Temasek and GIC displayed a strong appetite for assets in financial institutions of mainland China, investing more than \$3 billion in the giant state-owned Industrial and Commercial Bank of China and in the China Pacific Insurance Group (in partnership with the Norwegian GPF). Energy and chemicals entered also on the Singaporean SWFs' radar screens with the acquisition of Kunlun Energy and China Bluechemical.

Figure 11: Investment Flows from Asia-Pacific SWFs, 2012



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

The rest of SWF investment in BRICs is quite evenly split between Brazil and India. The previously-mentioned quest for commodities is here epitomized by the \$2 billion Mubadala’s bid on the Centellian Asset Brazilian Equity Fund. Exposure to real estate development projects is provided by a joint venture involving CIC and GIC. In 2012, SWF foreign investment in India was focused primarily to local financial institutions. Indeed, nine out of the top ten deals of the years involved local banks such as HDFC Bank and mutual funds such as Birla Sun and Canara Robeco. And the usual

suspects - KIA, ADIA, Temasek and GIC - were the successful bidders.

Our previous comments on sovereign investment in BRICs suggests that a significant proportion of cross-border investment by SWFs (primarily originating from the Gulf and from Asia) may flow in neighbouring countries and remain in the region, within a logic of South-South trade and financial integration between BRICs and emerging countries. In 2012, South-South foreign SWF investment flows (i.e. within MENA, Africa, Asia-Pacific

BRICs are the second largest target region of choice, with China taking the lion's share.

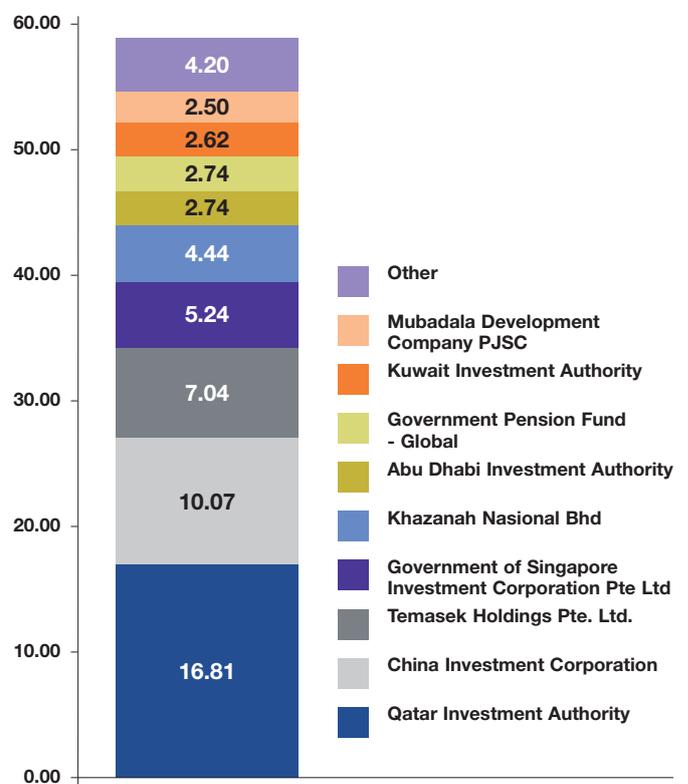
and Latin America) accounted for a total value of \$15.6 billion in 104 transactions, while South-North for \$30.1 billion in 110 deals. One third of SWF total capital invested abroad is recycled in the southern hemisphere, boosting productivity and growth in the region.

In the public discourse about the resurgence of state capitalism, SWF have often been labelled as “barbarians at the gate”, taking over strategic assets of Western economies to affirm the economic and political power of emerging nations. This observation fails to consider that a significant part of SWF activity takes place within national borders. 2012 was not an exception in that respect as domestic investments, even after a pullback relative to previous year, remained quite strong. SWF purchased domestic assets worth \$9 billion in 43 deals. SWF investment in home countries is primarily focused in two countries: China, where CIC spent heavily to support distressed local big banks and financial institutions, and Singapore, with Temasek focused in the development of high valued property projects, such as M+S Pte Ltd, in partnership with Malaysia’s Khazanah.

Funds

Whatever criterion one selects to evaluate direct investments by SWFs, QIA sticks out as the unques-

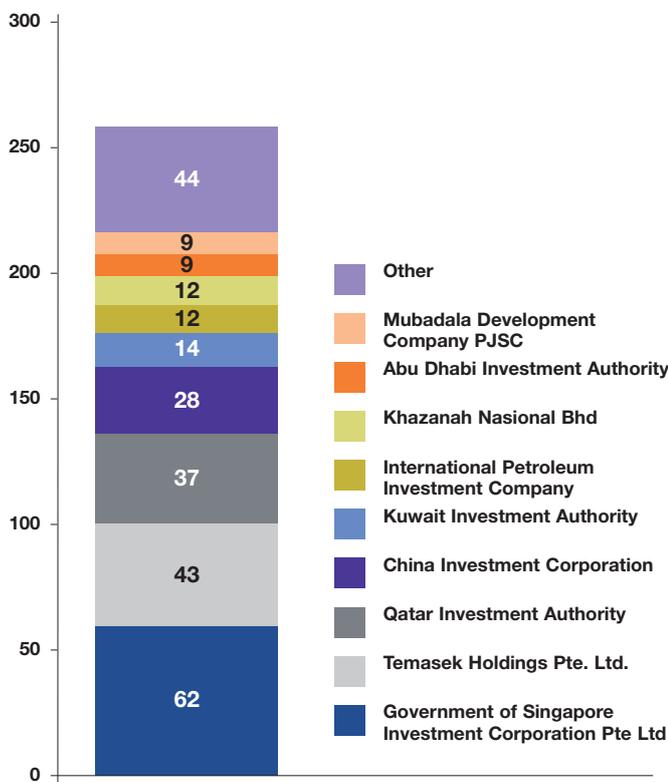
Figure 12: Value of Direct Investments by Top Spending SWFs, 2012



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

tionable champion of 2012. We have already stressed the pivotal role QIA played in arranging the Xstrata deal and its prevalence across target industries and countries. In 2012 QIA outgunned all other funds in spending terms by purchasing assets worth \$16.8 billion. Our previous reports have documented that QIA, since its formation in 2005, has often undertaken significant direct investments. However in 2012, thanks to its 37 sizable deals,

Figure 13: Number of Direct Investments by Top Spending SWFs, 2012



Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

QIA has increased its share of total direct equity investment to 29 percent, a 95 percent increase relative to previous year.

What can explain this spending spree? Qatar boasts a series of impressive records: the world highest per capita GDP, the third largest gas reserves, and the second highest growth rate of industrial production. Thanks to these records, in a few years the

country gained the enviable reputation of “pigmy with the punch of a giant”, primarily through the estimated \$30 to \$40 billion of investable surplus on an annual basis allocated to its SWF, QIA. Since 2005, QIA’s assets grew exponentially reaching the \$135 billion tick and gaining a firm position amongst the top ten SWFs by size. 2012 data show that QIA’s momentum is still intensifying. Within the broad mandate to secure the future prosperity of Qatari people, QIA and its investment arm Qatar Holding worked as a “nimble”, opportunistic investor, taking advantage of direct equity investments unavailable to other institutional investors and funds following a more rigorous, bottom-up approach. Yet, QIA has also shown a penchant for trophy assets – often, real estate icons – and a continued over-exposure to large stakes in financials. Whether this is astute timing (financials are available at a discount, after all), or dangerous hubris, only time will tell.

CIC continued being one of the most active spenders, with \$10.1 billion and 28 reported direct investments. Still, CIC’s 2012 balance is far from spectacular, reporting a significant pull back especially in terms of number of deals, almost halved relative to previous year. As widely known, CIC has accumulated vast wealth with a notional value of \$ 482 billion, but has not still defined a stable funding model from the Central Bank of China. Uncertainty and political squabbles over the operating activity of the fund are still important hurdles for a firm boost in investment.

The combined activity of the two SWFs from Singapore is also noteworthy. Apparently, Temasek

Table 2: Direct SWF Investments of over \$1 billion, 2012

Fund	Target Name	Target Country	Sector	Deal Size Country (Value US\$ Billion)
Qatar Investment Authority	Xstrata plc	UK	Precious Metals, Non-Metallic, and Industrial Metal Mining	4.37
China Investment Corporation	China Export & Credit Insurance Corp.	China	Banking, Insurance, Trading	3.21
Khazanah Nasional Bhd	M+S Pte Ltd	Singapore	Real Estate	2.79
China Investment Corporation	TOTAL SA	France	Petroleum & Natural Gas	2.65
Qatar Investment Authority	Total SA	France	Petroleum & Natural Gas	2.63
Temasek Holdings Pte. Ltd.	Industrial and Commercial Bank of China	China	Banking, Insurance, Trading	2.31
Mubadala Development Company PJSC	Centennial Asset Brazilian Equity Fund LLC	Brazil	Precious Metals, Non-Metallic, and Industrial Metal Mining	2.00
Temasek Holdings Pte. Ltd.	M+S Pte Ltd	Singapore	Real Estate	1.86
Qatar Investment Authority	FGP Topco Ltd.	UK	Transportation	1.45
Qatar Investment Authority	Total SA	France	Petroleum & Natural Gas	1.11
Government Pension Fund - Global	Uetlihof office complex, Zurich	Switzerland	Real Estate	1.08
Abu Dhabi Investment Authority	Open Grid Europe GmbH	Germany	Infrastructure & Utilities	1.01

Publicly available data for direct SWF equity & real estate deals, joint ventures and capital injections. Source: Sovereign Investment Lab, Università Bocconi

is catching up rapidly to its companion GIC by asset size, with a reported deal value of \$7 billion committed in the 43 deals executed in 2012. GIC instead expanded its activity in 62 smaller scale deals, broadly diversifying its spectrum across countries and industries.

2012 rankings report the entry of a “new kid on the block” in the top ten of SWFs by activity. Khazanah Nasional Berhad from Malaysia gained a prominent position thanks to its \$4.4 billion spent in a 12 domestic acquisitions aimed at boosting long term investment.

Challenges Ahead

Realizing that SWFs are diverse entities and that trends differ, we nevertheless believe that the overall leitmotif of the year is “cautious change”. SWFs realize they need a different approach – the large, passive investments in the US financial industry that absorbed a significant portion of SWF funds over the previous decade have performed poorly and led to substantial soul-searching. The result has been a newfound emphasis on diversification (both industrial and geographical) and a new call for active

SWFs have embraced change, but still many of them are still torn between the desire of activism and the fear of political opposition.

involvement. Yet, neither of these trends is being embraced with conviction. A desire to diversify geographically is clashing with the need to find markets that are large enough to accommodate SWF investments and with a reluctance to invest in countries with weak institutions, where long-term investments by foreign governments might prove particularly vulnerable to politically-motivated opposition. The plan to diversify away from financials is only marginally being implemented, perhaps a victim of seemingly attractive investments in financial firms that ‘look cheap’. The goal of activism is clashing with the limitations of an often small staff and with the fear of reigniting the political opposition that the recent need for capital has silenced in the West. After the crisis, SWFs might have learned their lesson, but with the notable exception of QIA they are still trying to figure out how to apply it.



Beyond revenue stabilization: African SWF's Quest for Development

Thouraya Triki and Issa Faye
African Development Bank

Significant revenues from commodities over the last decades had led to the inception of a number of SWFs in Africa, notably in oil exporting countries (e.g., Libya, Nigeria, and Chad). Botswana (Pula Fund) and Ghana (Minerals Development Fund) pioneered the establishment of African SWFs in 1993. According to our research, the continent counts at least 22 SWFs (Appendix A1). With the notable exceptions of the Libyan Investment Authority (LIA) and the Algerian Fonds de Regularisation des Recettes (FRR), which rank among the largest 20 SWFs worldwide in terms of size¹, African funds are dwarfed by their peers from other regions of the world (mainly Asia and the Middle East (*Figure 1*)).

SWFs are often created either to stabilize government fiscal and/or foreign exchange revenues and macroeconomic aggregates by smoothing out fluctuations in export prices and demand, or to save for future generations a fraction of the revenues accruing from the sale of non-renewable natural resources. There is considerable controversy about the relative merits of SWFs and their value added. Proponents of SWFs argue that these funds can help foster economic growth and prosperity for current and future generations by showcasing successful experiences such as Norway. They also point out

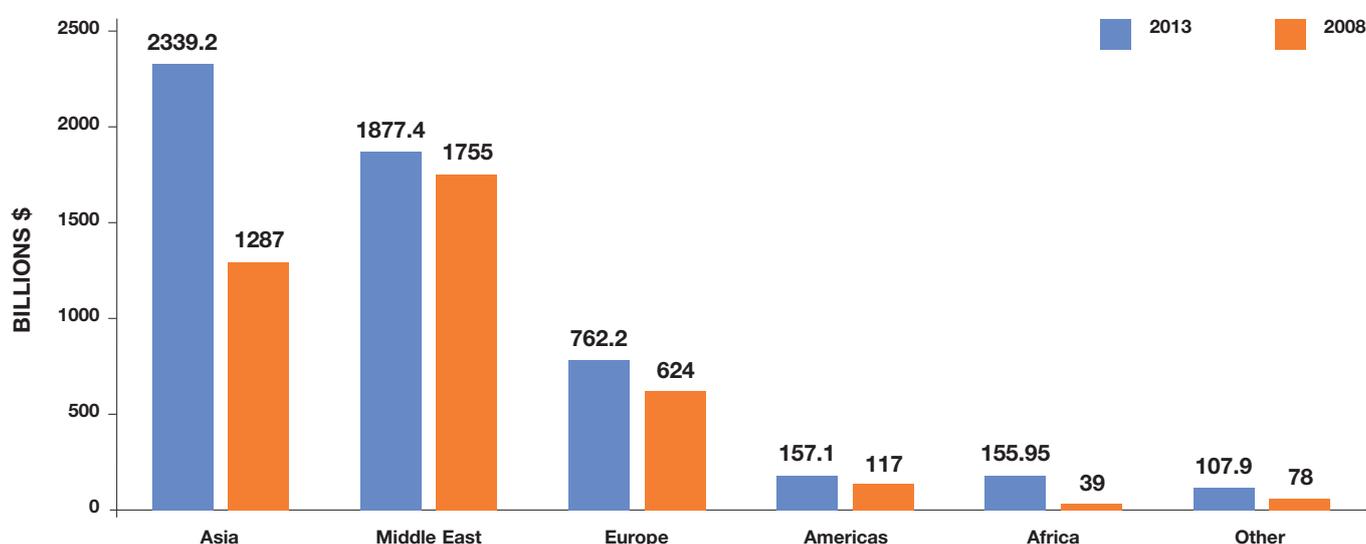
that these vehicles can help stabilize the global financial system by providing cross-border liquidity in times of financial turmoil. Opponents, on the other hand, are expressing serious concerns that SWFs would endow governments with too much power, which could move the global economy away from liberalism and impede market forces and competition. A second reservation concerns the possibility that SWFs may threaten national security in recipient countries if investments are made for strategic or political rather than economic objectives. Such a scenario would trigger a protectionist backlash that could have disastrous effects on the world economy.

Where does Africa stand in this debate? To what extent, if at all, SWFs can benefit African economies? Can the controversy discussed above be resolved in the case of Africa? Unfortunately, the literature does not provide clear answers to these questions, as research about SWFs' potential support to Africa's development is rather scant. This largely reflects the strong opacity surrounding SWFs existence, holdings, and institutional arrangements.

What do African SWFs look like?

According to our research, Africa counts at least 22 SWFs (*Table 1*). Among the five (5) largest African SWFs, four (4) are sourced from oil revenues, the

¹ SWFs Institute ranking as of May 2013.

Figure 1: SWFs' Assets under management by region

Source: Authors calculations using International Financial Services London Research (2009), SWF Institute Website

last being sourced from diamonds, minerals and other natural resources. Strong opacity surrounding their existence, holdings and institutional arrangements makes tracking of African SWFs a challenging task. A plausible explanation for this limited attention is the small size of African SWFs relative to their counterparts from other regions of the world as well as their passive management strategies.

It comes out fairly clearly from *Table 1* that African SWFs are commodity-based and derive their funding from commodity sales. They are also predominantly driven by stabilization motives and to a lesser extent by the need to generate higher returns on domestic resources in order to accumulate wealth for future generations. For most African countries, stabilization needs are twofold. On the short term,

African countries need to smooth their expenditures in a context of volatile commodity prices to avoid challenges in macroeconomic planning resulting from revenue instability. On the long term, African countries need to protect themselves against decline in revenues resulting from depletion of non-renewable resources. Moreover, non-renewable commodities are often the single most important source of foreign currency revenues in these countries which makes them haunted by the paradox of plenty or the so called resource curse.

Available information suggests that African SWFs have been subject to regular capital withdrawals to balance governments' budgets and repay external debt. For instance, the balance of Nigeria Excess Crude Account (ECA) decreased from USD Sudan almost wiped out its Oil Revenue Stabilization Fund

(ORSF). Similarly, Algeria has been using its Fonds de Regularisation des Recettes (FRR) to repay public debt and fund fiscal deficits while Mauritania withdrew USD 45 million from its Fonds National des Revenus des Hydrocarbures leaving a balance of USD 34.25 million as of march 2009.²

Such statistics suggest that African governments kept spending while also accumulating resources in their stabilization funds, which may have potentially resulted in zero net savings. This raises concerns about intergenerational equity and long term fiscal and macroeconomic sustainability, especially in a context of external negative shocks. Yet, one might argue that reducing external debt decreases the financial burden on future generations which is only true if the reduction in debt is permanent and leads to improved economic growth. In the African context, this still needs to be proved.

As of May 2013, African SWFs had USD 155.95 billion in assets under management, much less than their peers from the Middle East, which held assets amounting to USD 1.88 trillion (*Figure 1*). Interestingly, African SWFs have experienced a surge from 2008 to 2013 despite fluctuating oil prices. Potential explanations for this growth include an increase in the volume of commodity exports, a raise in the share of foreign reserves received by SWFs, or the establishment of new SWFs on the continent.

According to our estimates, the Libyan Investment Authority (LIA) is the largest with assets amounting to USD 65 billion.³ Additional SWFs will presumably be launched in African countries including Tanzania, Zimbabwe and Mauritius.⁴ Similarly, sev-

eral countries which have already stabilization funds are now considering the establishment of new funds with savings and development mandates. This is the case of Nigeria for instance which replaced in 2011 the ECA by three sovereign funds that are expected to accumulate savings for future generations and develop critical infrastructure.

African SWF's governance structures and reputation

So far, public disclosure about assets, strategies, rationales, and structure of African SWFs remains extremely heterogeneous and scarce. Governance problems in African SWFs may arise from lack of institutional arrangements. For example, Nigerian finance minister announced that the ECA is not backed by a law and that “the process of accessing the ECA is not as transparent and clear to the Nigerian people, therefore there is a general perception that there is some level of mismanagement”.⁵ Governance issues may also arise from poor enforceability of existing institutional arrangements. For instance, Chad amended in 2005 its national revenue management law and ended up canceling the fund for future generation. This type of behavior casts doubt about the quality of governance in African SWFs.

² <http://www.fr.for-mauritania.org/1373-0-Exclusif-For-Mauritania-publie-des-documents-confidentiels-sur-le-pillage-du-Fond-National-des-Revenus-des-Hydrocarbures-par-la-Junte.html>

³ SWFs Institute ranking as of May 2013.

⁴ <http://oxfordswfproject.com/2010/11/19/field-work-in-mauritius-please/> and <http://oxfordswfproject.com/?s=zimbabwe>

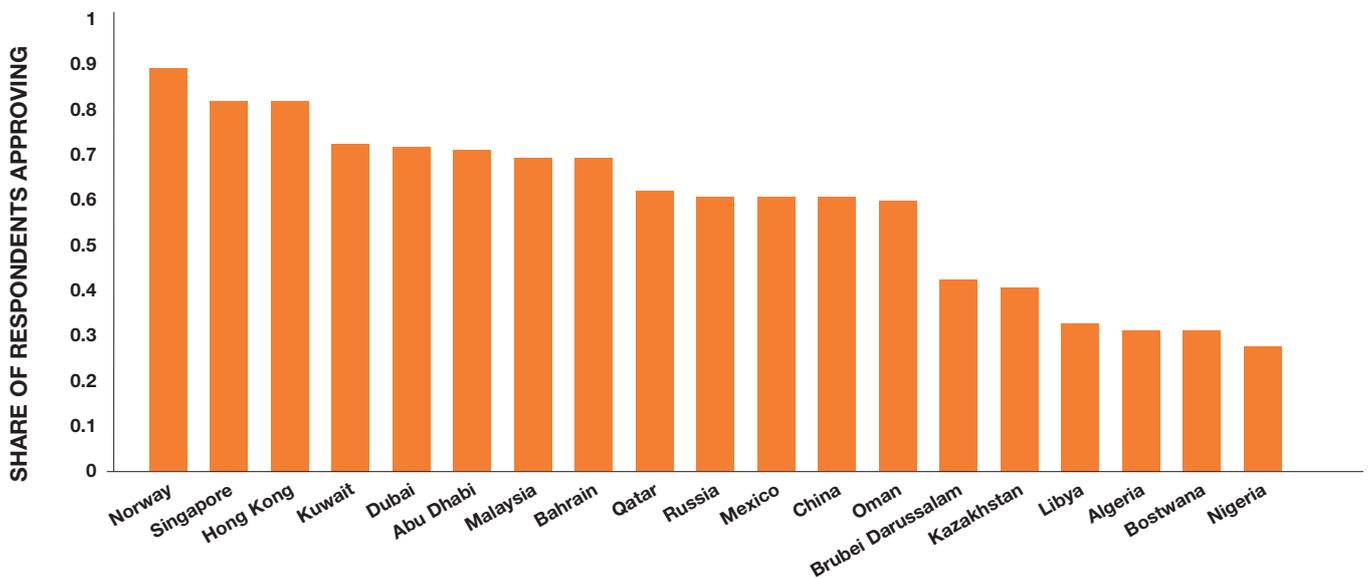
⁵ <http://oxfordswfproject.com/page/2/>

Unfortunately, it is very difficult to find accurate information about how and where African SWFs invest their resources. Available data suggest that African SWFs have been adopting prudent investment strategies with an emphasis on liquidity, reflecting mainly their stabilization mandates. For example, an IMF report shows that Nigeria’ ECA was mainly invested in short-term, liquid government securities and money market instruments while research published by JPMorgan shows that the Pula fund has invested 59% of its assets in bonds and 13% in cash and restricts its investments to rated assets. African SWFs are also actively investing outside Africa. For example, Sao Tome and Principe oil revenue management law prohibits investments in companies controlled by locals

Hence, African SWFs are mainly seeking “safe investments” in stable economies leaving limited resources for their local economies, and even less for their neighboring countries. The current financial crisis experienced by developed countries may lead to changes in these investment patterns. Yet, this remains to be proven.

The Libyan Investment Authority (LIA) has been for a long period the only African SWF that has a relatively active and aggressive investment strategy. LIA was created in December 2006 by a decree of the Comité Populaire Général, with the purpose of consolidating existing investment vehicles. Most of LIA’s investments in Africa were undertaken by the Libyan African Investment Portfolio, a subsidiary of

Figure 2: Extent of SWFs investment approval by home country



Source: Sovereign brands survey 2010. The figure summarizes responses to the question: to what extent do you approve or disapprove of SWFs from the following countries investing in your country? (Strongly/somewhat disapprove).

LIA. We were able to track 114 investments made by LIA over the last 3 decades, out of which 24 are located outside Africa.

West Africa is the main target of LIA investments, followed by East and Central Africa while North Africa and Southern Africa rank at the bottom. However, the value clustering shows a different picture with North Africa capturing USD 9 billion, the highest share of investments. This probably reflects the stable and business friendly environment offered by North African countries compared to Sub-Saharan Africa. The sector distribution of LIA investments in Africa shows a large number of small scale deals in the real estate, hotels and restaurants, and agriculture sectors as well as a small number of large deals in Infrastructure and oil and gas sectors. LIA deals outside Africa targeted mainly companies from Italy and the United Kingdom. Oil and gas and manufacturing captured the largest number of these investments while the financial sector benefited from the highest share of deal values.

The United Nations' sanctions against Gaddafi's regime in 2011 lead to the freezing of USD 170 billion worth of Libyan assets. This had repercussions on its SWFs activities. For instance, the Green Network which is part of the Libyan African Investment Portfolio had all its assets frozen.⁶ The post revolution stage in the country could lead LIA to play a greater role in the reconstruction of the

⁶ <http://uk.reuters.com/article/2011/05/26/tech-us-niger-libya-telecommunications-idUKTRE74P3IB20110526>

⁷ <http://www.libyaherald.com/wp-content/uploads/2012/11/Libya-Herald-supplement-Nov2012.pdf>

Despite their small size, home-grown SWFs can be beneficial for African nations if they go beyond stabilization to become instruments for economic growth.

local economy and a change in its investment strategy on the continent. In this context, regulating, supervising, and enhancing transparency should be sought to achieve greater efficiency of the LIA.⁷

Cash infusions made by Africa-based SWFs have not always been greeted with alloyed gratitude. A 2010 survey conducted by Hill & Knowlton and Penn Schoen Berland on national officials' attitudes towards SWFs shows that African SWFs in Libya, Algeria and Nigeria were ranked less favorably than their Middle Eastern peers (*Figure 2*). According to this survey, even African host countries like Egypt share this view. Given that some of these funds do not invest abroad, the negative perception likely reflects the negative image of African countries rather than wrong doing by these funds.

This negative perception most likely translates into additional barriers to African SWFs activities. Recent turmoil in Libya and allegations about control of LIA resources by political elite are likely to further cast doubts about the legitimacy of African SWFs and showcase the importance of strong governance structures. Nonetheless, the negative perception does not mean that Africa's SWFs money is not welcome

The potential of African SWFs is curbed by mismanagement and weak institutional agreements.

in other regions of the world. Headlines from the business press have reported investments by LIA in some European (e.g. Italy and Spain) financial institutions to prevent some of the deleterious effects of the 2008 global financial crisis despite allegations about LIA weak governance. In July, 2008, LIA bought a share in the Dutch-Belgian bank of Fortis, which needed additional funds to maintain solvability. Similarly, the LIA drew public attention when it backed a new London hedge fund (FM Capital Partners) with hundreds of millions of dollars.

What are the benefits of SWFs for African economies?

The landscape of African SWFs drawn earlier suggests that African SWFs are relatively small compared to their peers from other regions like Asia and the Middle East. They also suffer from governance and reputation problems that limit their ability to invest outside their home countries and to achieve good financial performance. Given their cyclical role, most African SWFs (which have a stabilization purpose) have also limited capacity to invest in long term illiquid assets. Thus, one might argue that African SWFs have very limited value added for African economies that is linked to short term stabilization.

However, home grown SWFs can be beneficial for African nations if they are used and structured properly. This implies that African SWFs, at least most of them, would have to go beyond their stabilization motives to position themselves as instruments geared towards achieving economic growth, inter-generational resource transfers, infrastructure financing, financial sector stabilization, deepening and broadening, and regional integration. Similarly, we also believe that foreign SWFs can provide a sizeable source of FDIs to African countries which should lead to human and physical capital formation and ultimately sustained growth (Rios-Morales and Brennan, 2009). The benefits of creating or attracting SWFs in Africa can be appreciated from many different perspectives as discussed below.

Unlike reserves management by central banks which is usually limited to investments in US and European sovereign fixed income securities, SWFs' holdings are more diversified and could be structured to maximize risk-adjusted returns that are not necessarily pegged to the dollar value. A business week article, published in 2008, indicated that the Abu Dhabi Investment Authority has returned about 10% a year since its inception.⁸ Such rates exceed by far any return that African central banks could potentially earn from fixed income securities. Given Africa's demographics and important financing gaps observed in almost all sectors, accumulating resources is very important to meet the increasing needs that may arise from existing and future generations.

SWFs could be useful in supporting economic diversification given that they often invest in a wide range

⁸ <http://black-capital.com/news/2010/04/inside-the-abu-dhabi-investment-authority-adia-june-2008/?lang=en>

A1: Description of African SWFs

SWF name	Country	Date of establishment	Funding Source	Fund Type	Most recent estimate of Assets under management (US\$bn)	Data Source	Year
Fonds de Régulation des Recettes	Algeria	2000 ^a	Oil	Stabilization Fund	77.2	b	2013
Fundo Soberano de Angola	Angola	2012	Oil	Diversification fund	5.0	n	2013
Fonds de Stabilisation des Recettes Budgétaires	Chad	2006 ^c	Oil	Stabilization Fund	0.003	d	2010
Pula Fund	Botswana	1994 ^e	Diamonds and Minerals	Development fund	6.9	f	2013
Fonds de Stabilisation des Recettes Budgétaires	Congo	Unknown	Oil	Stabilization Fund	1.64	d	2010
Fonds de Stabilisation des Recettes Budgétaires	Equatorial Guinea	Unknown	Oil	Stabilization Fund	1.39	d	2010
Fonds de Réserves pour Générations Futures	Equatorial Guinea	2002	Oil	Development Fund	0.080	d	2013
Fonds Souverain de la République Gabonaise	Gabon	1998 ^g	Oil	Development Fund	0.4	d	2013
Minerals Development Fund	Ghana	1994	Gold and other minerals	Development Fund	n.a.		
Ghana Petroleum Funds:	Ghana	2011	Oil	Stabilization Fund	Estimated at 0.012 combined	o	2013
<ul style="list-style-type: none"> • The Petroleum Holding Fund • Ghana Petroleum Funds 							
Ghana Heritage Fund	Ghana	2011	Oil	Development Fund	0.01	p	2012
Ghana Stabilization Fund	Ghana	2011	Oil	Stabilization Fund	0.05	p	2012
Libyan Investment Authority	Libya	2006 ^a	Oil	Development fund	65	f	2013
Fonds National des Revenus des Hydrocarbures	Mauritania	2006 ^a	Oil and Gas	Stabilization Fund	0.3	h	2009
Mauritius Sovereign Wealth Fund	Mauritius	2010	Non commodity	Stabilization Fund	3		
Minerals Development Fund	Namibia	1995 ⁱ	Minerals	Development Fund	n.a.		
Nigerian Sovereign Investment Authority:	Nigeria	2011 ^j	Oil	Stabilization and Development Fund	1 combined	J	
<ul style="list-style-type: none"> • Future Generations Fund • Nigerian Infrastructure Fund • Stabilization Fund 							
National Oil Account	São Tomé and Príncipe	2004 ^a	Oil	Development Fund	0.010	k	2009
Oil Revenue Stabilization Fund	Sudan	2002 ^l	Oil	Stabilization Fund	0.15	m	2009

(a) Monitor group

(b) Direction Générale de la prévision et des politiques, Ministry of Finance, Algeria.

(c) Asfaha (2007)

(d) Banque des États de l'Afrique Centrale (2010)

(e) Bank of Botswana, <http://www.bankofbotswana.bw/index.php/content/2009103013033-pula-fund>.

(f) Mercer (2010)

(g) Gabon holds since 1998 a reserve account at the level of the BEAC (Banque des États de l'Afrique Centrale) under the name of the Fund for Future generations. In 2010, this fund was renamed the Fonds Souverain de la République Gabonaise. According to BEAC report as of January 2010, the fund for future generation balance amounted to USD 0.380 billion.

(h) Ministère des finances, direction générale du trésor et de la comptabilité publique, available at : <http://www.fr-for-mauritania.org/1373-0-Exclusif-For-Mauritania-publie-des-documents-confidentiels-sur-le-pillage-du-Fond-National-des-Revenus-des-Hydrocarbures-par-la-Junte.html>.(i) MDF website available at <http://www.mme.gov.na/MDF/index.htm>.(j) <http://www.swfinstitute.org/swfs/excess-crude-account/>.(k) Final report on assessment of public finance management in Sao Tome and Principe 2009, EC Multiple Framework Contract Beneficiaries, March 2010 available at http://ec.europa.eu/europeaid/what/economic-support/public-finance/documents/sao_tome_e_principe_pefa_report_2010_en.pdf.

(l) Truman (2008)

(m) Medani(2010)

(n) <http://www.swfinstitute.org/fund-rankings/>.(o) <http://www.swfinstitute.org/swfs/ghana-petroleum-funds/>.(p) ESADegeo (2012) available at: <http://www.investinspain.org/icex/cma/contentTypes/common/records/mostrardocumento/?doc=4640952>.

of asset classes. They also have long term investment horizons and exhibit higher risk tolerance than central banks in managing foreign currency reserves. Thus, Africa-based SWFs can play an important role in supporting their local economies by directly providing capital, or by encouraging their international investees to invest in African companies. Countries like China and Saudi Arabia have been successful in supporting their economies by using their SWFs.

African SWFs' investments can also be made strategically to secure inputs needed in local economies. For example, in 2007, the Abu Dhabi Mubadala took an 8.3% stake in Guinea Alumina Corporation, a USD 3 billion joint venture aimed at transforming the bauxite of Guinea into alumina. This venture will provide the alumina plant that the government of Abu Dhabi is planning to set up with, a life-long access to cost-effective alumina. African SWFs can facilitate technology transfer to African industries through their investments in multinationals as well, and by encouraging these companies to set up Research and Development (R&D) facilities in Africa.

Similarly, foreign SWFs resources could be channeled to Africa to develop new sectors or supporting existing ones. This could have striking effects on the amount of foreign direct investment received by African recipient economies. Africa's performance during the last decade shows that the continent has favorable investment prospects which fit well with the long-term, high-return perspective of SWFs. Since, foreign SWFs are looking for good investment opportunities in new emerging markets; this can turn out to be good news for Africa.

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Teaming Up: Will Collaboration and Co-Investment Gain Ground?

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A new trend?

More and more sovereign wealth funds are interested in collaborating and co-investing with other large institutional investors, namely large public pension funds. In this short piece, we consider some of the reasons why, what sorts of platforms are out there, and whether the trend can become a viable alternative to moving capital through traditional intermediaries located in the major international and regional financial centers.

Life on the frontier

If one looks at a map of where sovereign wealth funds are located, right away he or she will notice that most are located far from the major international financial centers. This is especially the case for funds located in central Asia and Africa. This makes accessing attractive deal flows more difficult. It also means that they are far from the buzz of ‘the Street’ or ‘the City’. To counteract this geographic fact, these funds are likely to find themselves paying a lot of money in external fees to service providers in the major financial centers.

But even funds geographically close to a major center may not be better off. Another glance at the sovereign wealth fund map would reveal that even those close to major centers like London or Hong Kong, are in relatively small cities. As such, they

are likely to have resource constraints in terms of local talent and expertise needed to effectively manage an investment portfolio. Like funds on the distant frontier, these funds are also likely to be overly reliant on service providers in the major financial centers.

The economics of financial centers

Let’s consider briefly why financial centers exist in the first place and why they persist over time. On the one hand, financial centers fulfill two important functions for the market economy: 1) mobilizing and pooling economic resources, and 2) facilitating the transfer of those resources across space and time. In other words, financial centers exist to ‘make the market’. They are where geographically dispersed savers and borrowers come together. They are where the deals are. In that respect, investors have no choice but to move capital through major financial centers, particularly those looking for diversification opportunities.

On the other hand, financial centers exist and persist because of economies of agglomeration. Finance is a knowledge-intensive business. As such, talented and specialized workers and specialized intermediate services matter for success. Large financial centers attract a large and varied pool of talent that financial firms can draw from. They

also house a range of intermediate service providers, such as law and accounting firms.

Consider, for example, a fund that wants to diversify into new asset classes or new geographies. To put this into effect would likely require new asset managers or specialist consultants with a specific industry or geographical expertise. In all likelihood the large labor pool of the financial center will have such expertise; and, because that labor pool is large, such services are readily available.

An argument can be made that those financial firms (e.g. asset managers and investment banks) located in the financial centers benefit from the existence of a deep market and these powerful agglomeration economies such that they have leverage over those (e.g. asset owners) located outside of the financial center that are dependent on their services. In other words, insiders can take advantage of their position vis-à-vis outsiders and exact higher fees.

Frontier Finance

In the wake of the financial crisis, asset owners of all sizes came to realize that the deals they struck with service providers were filled with asymmetries and misaligned interests. They were, and in most cases still are, paying for alpha but only receiving beta returns. Moreover, if most asset owners have long-term interests, either from having long-term liabilities or through a specific mandate to sustain and grow wealth for future generations, their service providers generally have much shorter time horizons. The latter want to get paid in the next year or two, not in the next 20 or 30. But, for most asset

owners, their small size or their locational constraints mean that they have almost no choice but accept the terms they are given.

However, there is a growing group of large institutional investors, of which sovereign wealth funds are included, that are pushing back. We call these frontier investors, because they are geographically located on the frontier of major financial centers, and they are looking for innovative ways of shaking up the asset management industry. They are on the frontiers of finance literally and figuratively.

Instead of delegating asset management to service providers in the major financial centers, they are increasingly looking for ways to in-source asset management. They are building internal teams and hiring new talent, and doing so for a fraction of what they are paying for external mandates. Instead of focusing on large diversified portfolios that follow the market, they are looking to concentrate portfolios, making fewer but larger investments. In particular, there is a growing appetite for direct investing.

But they still face a dilemma. Even if they are large, how can they get access to the best deals, particularly those very far away? Normally simply going through a service provider in a major center can provide access to those deals. Yet again, there is an appetite for bypassing the major centers and the fees that come along with doing so.

Hence, there is a growing interest in collaborating and co-investing with other like-minded institutional investors. Doing so can bring scale, different types

of expertise and local knowledge, and in some cases provide political legitimacy. The latter is particularly important for sovereign wealth funds that face skepticism surrounding their objectives and whether there is some geopolitical intent behind their investments. Having a local partner can provide assurance that deals are purely of a commercial motive. By having like-minded partners with similar time horizons, aligning interests is more feasible.

Platforms for collaboration and co-investment

For collaboration and co-investment to work, a few crucial steps need to be taken. A large issue is how to prevent free riding. It is very easy for one fund to be left doing the groundwork, which eventually will lead to failure of the partnership. Other steps are: ensuring that the partnership has adequate resources it needs to be successful, the right talent and expertise, and a structure that is amenable to all. The former are a more feasible proposition. The latter, finding the right structure, is more of a challenge.

Even if funds have similar ideas about the investment universe and how to go about accessing that universe, they are likely to have different internal governance structures and compliance demands that are shaped by their sponsor in their country of origin. Collaboration and co-investment is easier said than done. However, we think the three following platforms are a way forward.

The Alliance

An alliance is a loose affiliation of like-minded investors that come together regularly to exchange information and share deals, but with not formal

After paying for alfa and receiving beta, SWFs are forming alliances with like-minded partners even if search and match costs are not trivial...

legal agreement on cooperation. This platform is ideal for smaller funds with limited resources, or funds that face constraints to committing adequate resources. The problem with an alliance is that free riding may become a problem, as there is little 'skin in the game' and no formal contract.

The Syndicate

A syndicate, like an alliance, brings like-minded investors together, but in the context of a formal agreement and a dedicated administrator that coordinates deals and the membership. The benefit of the syndicate is that it limits free riding. However, it is harder to get off the ground, as members need to come to a formal agreement and commit resources to setting up the administrator. This may be difficult for funds with limited resources. It also requires a higher level of trust among funds.

The Seed

The next level up from a syndicate is the seed. With this platform, like-minded investors come together and fund a de novo asset manager. This is basically an external asset manager that is established by the limited partners for the exclusive benefit of the limited partners. Hence, seeding a new manager is about maximizing interest alignment. The chal-

allenge with the seed, notwithstanding the initial demands of reaching agreement among the partners on structure and financial commitment, is finding the right talent to run it. Search and match costs are not trivial.

A hill worth climbing?

Currently, most collaboration and co-investment is ad-hoc and infrequent. There are examples of funds coming together to buy large infrastructure

assets, and there is definitely more dialogue among large institutional investors through various forums. The ideas are there, as is the appetite. However, when it comes to formalizing collaboration and co-investment the legal hurdles are high. It is a case of organizational design meets the law, and not just one set of laws but multiple. For some, then, it is easier to just stick to the old ways. But for those that stick with it and overcome the challenges, the long-term savings are likely to be large. Watch this space.

Sovereign Wealth Fund Investment in Private Equity

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According to a recent article in Reuters, Sovereign Wealth Funds (SWFs) are on target to hit \$5.6 trillion in global assets under management by the end of 2013. To put this into perspective, \$5.6 trillion is roughly the size of Japan's economy or slightly larger than a third of US GDP (both as of the last quarter of 2012). Why do we care about this? This makes SWFs the wealthiest investors out there (hedge funds are second with a paltry ~\$2 trillion), and when this much money is invested, it matters where the money is invested. SWFs invest both domestically and internationally. Since \$5.6 trillion is a lot to invest, it is perhaps natural that SWF look outside their home nation for investments. This is where it gets interesting, however. SWFs are, by definition, "sovereign" – that is, characterized by a sovereign government. Though not all SWFs are actually run by the government and the stated objectives may vary (i.e., the preservation and smoothing of national wealth, diversification from a country's main source of wealth, and/or enhancement of return on foreign reserves), the potential for political influence is present. There is no evidence that SWFs are investing for political gains, however, some government leaders, such as those from the US and the UK, have expressed discomfort with SWFs investing in firms within their borders. The popular press hasn't helped either. Many articles have been written regarding attempted SWF investments questioning whether or not political motivations are involved.

Making matters worse, SWFs are like hedge funds in that they are not regulated in their investments and their disclosure of investments, performance, etc. is less than some might want to see. This is fine when investments are domestic but when they are international, target governments want to know the intentions of investors, especially when large chunks of target firms are purchased. Governments often have a type of agency that reviews foreign acquisitions (i.e., all foreign acquisitions, not just those of SWFs). Since these agencies cannot review every potential investment due to resource constraints, investments in or acquisitions of small firms, i.e., private equity, are often less scrutinized.

Interestingly, private equity is one of the fastest growing asset classes in which SWFs are investing. According to Prequin (2012), about 60% of SWFs are currently investing in this alternative asset category. Could SWFs be investing in private equity to avoid scrutiny by leaders or are they simply investing/diversifying surplus wealth that would otherwise be earning the risk-free rate of return? Because many SWFs don't disclose much information, we aren't able to unearth the answers to these questions directly. We are resigned to using available data and to asking slightly different questions (albeit, still novel and arguably interesting). That is, what drives SWFs to choose public equity versus private equity? Do they care about whether or not the private firm is headquartered in the same nation? To the extent

SWFs prefer to invest in private equity in their home country, and when they do it abroad they are more likely to target nations with weaker legal institutions.

that investments are international, are SWFs concerned with the level of investor protection in target countries? Do they care about the bilateral political relationship between their country and the target country?¹ And finally, based on the answers to these questions, do SWFs invest similarly to other institutional investors? The answers to these questions might help to guide government leaders in making policy with regard to SWF investment within their borders.

Using data on SWF investments from 1991 through 2010, my co-authors and I study the choice of 19 SWFs to invest in private versus public equity. Our paper examines 424 investments made by SWFs to ascertain whether or not SWFs invest similarly to other institutional investors, such as pension funds,

mutual funds and hedge funds. The data suggests that similar to institutional investors, SWFs prefer to invest in private equity in their home country (e.g., when a SWF invests internationally, it is roughly 23% less likely to invest in private equity). This preference, however, does not appear to be as strong as what is seen with other institutional investors. Since private equity is considered riskier than other asset classes, even when invested domestically, the allocation to private equity of other institutional investors is generally quite small (on average, private equity investment comprises 5.8% of the allocation to alternative investments, which itself is only a fraction – perhaps 5% – of the overall portfolio). Moreover, according to a survey conducted by Goldman Sachs in 1995, 49% of the 204 largest institutional investors would not invest in private equity internationally at all.

The data further suggests that when SWF investments are international in scope, SWFs are more likely to invest in private equity versus public equity when target nations have weaker legal conditions. This is actually counter to the investment behavior of other institutional investors, who are typically drawn to invest in nations where investment protection is better, especially when investing in a riskier asset class. Finally, our research suggests that SWFs are more likely to choose private targets over public targets when political relations between their domicile nation and the target nation are weak. This is once again counter to how institutional investors behave. Other institutional investors prefer to invest in countries with which their domicile nation has strong political ties. Comprehensively, the results found in our research are inconsistent with invest-

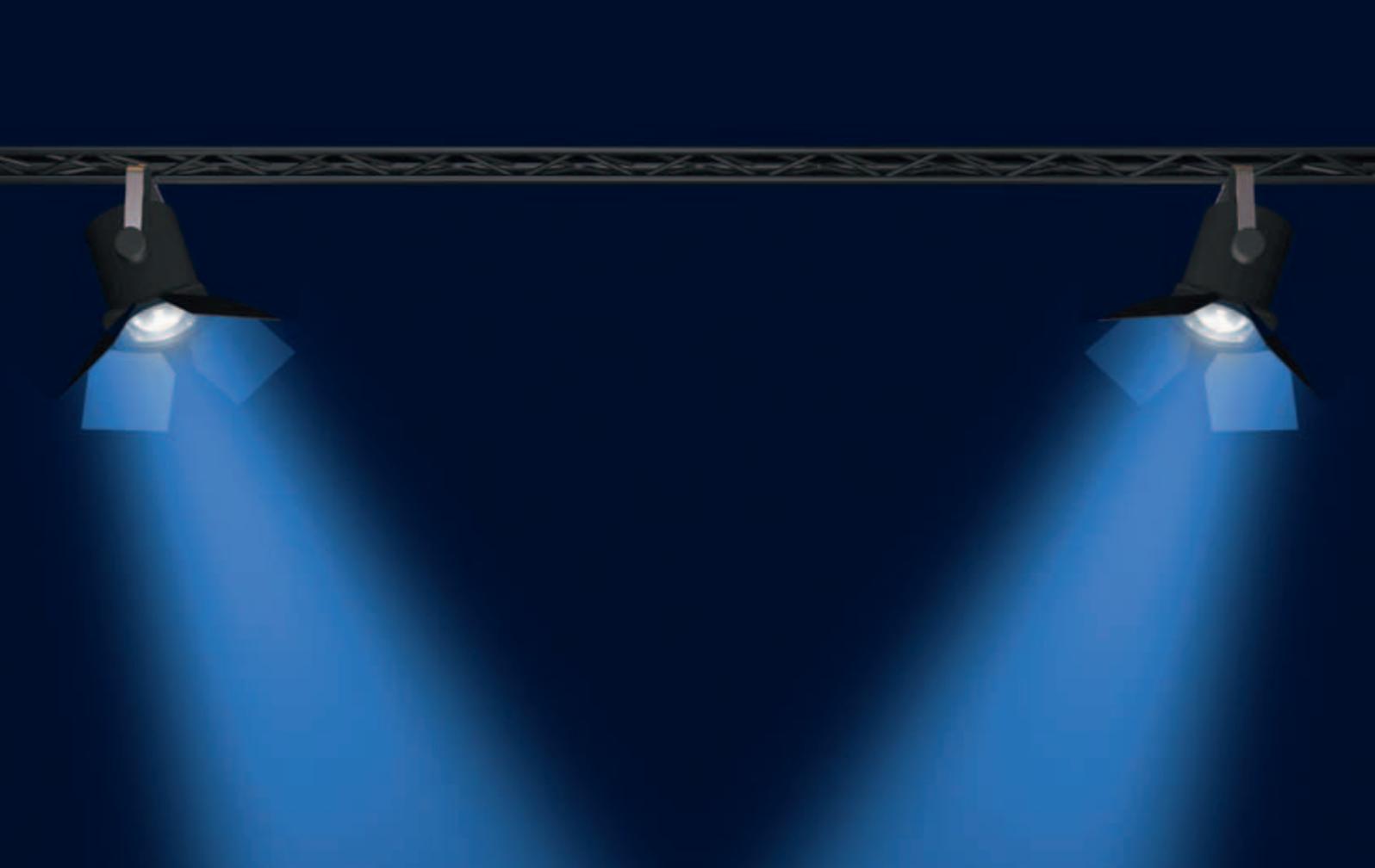
¹ There is some evidence to suggest that political motives play a role in SWF investment. Knill et al. (2012a), for example, suggests that bilateral political relations between the SWF's domicile nation and the nation of its target is a factor in SWF investment. Bernstein et al. (2009) find that when politicians are involved, P/E ratios of investments are higher and that valuations fall in the year after investment suggesting that political distortions may be the reason. Dyck and Morse (2011) find that political motives may explain variance in SWF investment patterns.

ment patterns predicted for other institutional investors, and suggest that SWFs make investment decision with regard to investing in private equity distinctly from other institutional investors.

Though these results do not answer the question as to whether or not SWFs invest with political motives in mind, it certainly leaves room for the possibility. It would even perhaps make sense if politics played a role in investments. After all, the sovereign entities associated with these pools of money are charged with making decisions that are for the betterment of their nation's citizens. Put more succinctly, political motivations are natural, and not necessarily malignant. At times political motivations can not only be benign, but also benevolent. That is not to say that government leaders should assume that all political motivations are beneficial to both nations. Rather, it is to suggest that government leaders should keep in mind that SWFs are very diverse. They range in size, scope, objective and structure. It is not only inappropriate to stereotype them, it is suboptimal. The potential for malicious intent is not zero but neither is the potential for synergies. Thus, it is important for national leaders to make policy flexible enough that it can protect its citizens from investments that might allow for adverse results while still allowing investments that might bring opportunity. It is also important that this line of research continues to unearth as much as we can about SWF investment. Investment by this type of institutional investor shows no sign of ending.

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The literature on SWFs is evolving and increasingly recognizing the heterogeneity of the funds so defined – and the necessity to frame the debate within the realities of a world economy deeply affected by the 2007-2008 financial crisis and by the still lasting sovereign-debt crisis in Europe. Also the issue of legitimacy and sovereignty emerges in multiple, mostly law-oriented papers discussing the role of SWFs in establishing and protecting national sovereignty or in increasing a state’s relative economic power. SWF activism and their role in corporate governance is also explored from different points of view. At the same time, one area remains largely unexplored – perhaps one of the fundamental questions about SWFs – are SWFs a ‘good idea’? Of course, answering this question needs, first, identification of the goals of SWFs – and the literature has made good progress in describing the various objectives SWFs are set to accomplish. But a ‘western bias’ in commentary and research has led to a literature strongly focused on the impact of SWFs, on the political risks related to receiving SWF investment and on the development of a legal and institutional framework to enable safe and transparent SWF investments – while ignoring the impact of SWFs on their domestic economies.

Spotlights on research

General Definition and Investment Patterns

Tvedt, Jostein, 2012, Sovereign wealth funds, portfolio choice and corrective taxes, *Macroeconomics and Finance in Emerging Market Economies* 5(2), 187-196.

In a setting where investors have preferences for future wealth, sovereign wealth funds should invest relatively less in equities than the representative private investor. Tax asymmetries make it relatively more attractive for sovereign wealth funds to invest in fixed income than in stock markets. A high fraction invested in equities may be an indication that the sovereign wealth fund's principal has other preferences than the representative private investor. Host countries may levy corrective taxes on foreign sovereign wealth funds based on the 'private behaviour equivalent' principle, in order to reduce potential social costs related to the sovereign wealth funds' investment activities.

Schwartz, Herman, 2012, Political Capitalism and the Rise of Sovereign Wealth Funds, *Globalizations* 9(4), 517-530.

Sovereign wealth funds are neither novel nor constitute any decisive shift towards state control. States and markets are co-constitutive, but states have power precisely because of their ability to define property rights and thus draw the boundary between public and private activity. The way they

draw that boundary determines the nature of capitalism in any specific market. 'Sovereign wealth fund' is a nominal label covering three distinct types of organization that distribute property rights in different ways. The first acts to buffer states from the economic problems associated with large-scale resource exports. The second helps states simultaneously develop industry and an industrial bourgeoisie. The third is a vehicle for patrimonial rent extraction via political capitalism. The current spectacular increase in the number and holdings of sovereign wealth funds thus does not presage a distinct shift away from the (easily exaggerated) neoliberalism of the last two decades.

Wei, Xiaoyun, Liyan Han, 2013, Optimal Allocation between International Reserves and Sovereign Wealth Funds for Different Horizons, *International Journal of Applied Mathematics and Statistics* 39(9).

We present a dynamic model to allocate international reserves and sovereign wealth funds for different horizons. Particular attention is paid to dynamic rebalancing cases. The numerical method was used to obtain optimal allocation ratio of two assets. The results show that, in both buy-and-hold and rebalancing cases, there are strong horizon effects. Government with a longer horizon chooses significantly more reserves than someone with short horizon in buy-and-hold case. The reason is long-horizon governments have an intrinsically larger need

for reserves to quell possible M2 flight and repay short term external debt for stability purpose. In rebalancing case, however, when the horizon is lengthened, the government should hold less liquid reserves, for high yield of SWFs makes the demand for liquid assets decrease when government extends its horizons in rebalancing case. We also conclude that, for horizon presented here, the governments who optimally rebalance their portfolio at regular intervals would hold significantly less reserves than ones implementing buy-and-hold policy. A possible reason is they could receive updated information at the end of each period and rebalance portfolio based on existing information.

Lenihan, Ashley T., 2013, Sovereign Wealth Funds and the Acquisition of Power, New Political Economy, Published Online at <http://dx.doi.org/10.1080/13563467.2013.77965>.

Sovereign wealth funds (SWFs) are increasingly powerful actors in the international political system and world economy. The current discourse often focuses on SWFs as political versus market actors. In this exploratory article, however, it is shown that SWFs may be both. They may be employed as a means to increase a state's relative economic power, even when their individual investments are generally made on the basis of economic, market-driven, logic. After a brief overview of SWFs, and literature review of the issues that attend them, I examine the traditional neorealist understanding of internal balancing and argue that there is evidence to support the claim that SWFs can be employed as tools of this state strategy. Four methods, and two cases (Singapore and China), of internal balancing

through SWFs are then examined. I find that some SWFs are used for internal balancing purposes in the conventional sense, but that the phenomena may be better captured by the newer concept of non-military internal balancing (in which a state's relative economic power is enhanced without damage to the overall relationship they currently maintain with the target state).

Global Crisis and Investment Strategy

Fei, Yiwen, Xichi Xu, Rong Ding, 2013, Sovereign wealth funds and financial crisis – a shifting paradigm, China Finance Review International 3(1), 42-60.

The purpose of this research is to empirically analyze the influence of the financial crisis on the investment behavior of sovereign wealth funds (SWFs).

Using 615 deals from 20 SWFs, a series of research are designed and conducted to compare the SWFs' governance, external environment, investment strategy and financial markets' feedback around the crisis. The paper finds that the recent financial crisis did not only bring SWFs heavy losses and the pressure to improve its image and governance structure, but also a precious opportunity of a better external environment by easing the nerves of the recipient country's government. Their investment strategies will be more positive, diversified and complementary to their own real economy. The event studies illustrate that financial markets turn to be more effective after the crisis. The market reaction to SWF's investment tends to mitigate speculative trading to a larger extent, which is shown by the lower

cumulative abnormal return and turnover volatility. This paper tries to test the change of SWFs' behavior pro- and post-crisis. It reveals that SWFs have changed their effects on SWF's home country, SWF's host country, the financial market and the real economy after the financial crisis, which is helpful for government and institutions to maintain the stability of the national economy and security market.

Wu, Friedrich, Christine Goh and Ruchi Hajela, 2012, Transformation of China's sovereign wealth fund since the 2008-2009 global crisis. *Thunderbird International Business Review* 54, 347–359.

China Investment Corporation (CIC) transformed its initial investment strategy of focusing mainly on the US financial sector during 2007-2008 into a new strategy of diversified investments across geography and sectors since 2009. Massive financial losses and domestic political backlash during the global financial crisis of 2008 gave impetus to CIC's rethinking of strategy. In the midst of the crisis, CIC engineered a capacity-building and reorganization exercise to reposition itself for a new strategy that has since allowed for more diversification of investments. A more receptive global investment climate for sovereign wealth funds has also aided CIC's efforts to present itself as a responsible global investor and facilitated its investments. Postcrisis, CIC's new strategy of diversification is characterized by continued investments in the financial sector, but with new investments increasingly directed to real sectors of energy, natural resources, and real estate in both developed and emerging economies. Notwithstanding a global recovery that is fraught with uncertainties, CIC's judicious timing in making diversified investments, and

its attention to reducing risks and enhancing returns, have been rewarded by an impressive turnaround in performance since 2009. Going forward, the success and sustainability of the new strategy will be contingent on how well CIC can navigate domestic bureaucratic rivalry and the shifting climate of the international investment environment in the medium to long term. Ultimately, CIC's shareholder, the government of the People's Republic of China (PRC), holds the key to its future direction and goals.

Yi-chong, Xu, 2012, Sovereign wealth funds: the good, the bad or the ugly?, *Journal of the Asia Pacific Economy* 17(2), 193-207.

Concerns about sovereign credits in 2007–08 were quickly replaced by concerns over sovereign debts in 2010–11. Sovereign creditor countries might have triggered political outcries in developed countries just before the global financial crisis broke out in 2008; sovereign debt problems in many developed countries placed the global economy in a vulnerable position. This paper examines what these developments tell us about the nature of sovereign wealth funds (SWFs), their performance and their impact on the changing global financial situation and, more importantly, international political economy.

Transparency, Legal and Political Issues

Dixon, Adam D., Ashby H. B. Monk, 2012, Rethinking the sovereign in sovereign wealth funds, *Transactions of the Institute of British Geographers* 37(1), 104-117.

Nation-states are increasingly sharing sovereignty,

both with other states and with supranational and non-governmental institutions. This is partly due to a long period of economic and financial globalisation, which has undercut territorial notions of sovereignty and varieties of capitalism. In trying to understand this phenomenon, we are drawn to sovereign wealth funds (SWFs), as they offer a unique lens into the changing dynamics of contemporary capitalism, global economic integration and state sovereignty. Indeed, the SWF provides governments with a tool for both engaging with new spatial forms as well as resisting them. While politicians may conceptualise the objective of such funds in the most practical terms, they serve an under-appreciated role in maintaining state sovereignty in a globalised world. In this paper, we build on emerging interdisciplinary scholarship concerning the rise of SWFs by broadening the interpretation of the utility of SWFs for the sponsoring government in relation to the practice and constitution of sovereignty, explicitly bridging political and economic geography. To this end, we offer an innovative, stylised typology of SWFs in relation to the state and sovereignty. The objective is to better understand the potential long-term significance of SWFs and the factors that might underpin further development of new SWFs in different countries in the future. Moreover, we believe SWFs can be differentiated according to the role they play in sovereignty and what underlies their claims to legitimacy within their respective nation-state. By understanding the rise and purpose of SWFs, we hope to better understand the sovereign in SWFs.

Salar Ghahramani, 2013, Sovereign wealth funds and shareholder activism: applying the Ryan-Schneider antecedents to determine policy implications, *Corporate Governance* 13(1), 58-69.

Purpose – The purpose of this paper is to examine the propensity of sovereign wealth funds (SWFs) for shareholder activism and their potential impact on corporate governance. The study highlights the relationships between SWFs and corporate governance and also applies eight antecedents/determinants of institutional activism to analyze whether SWFs have a predisposition for shareholder activism. **Findings** – The study only finds two instances of SWF activism. Additionally, it finds that despite their mostly passive investments, SWFs possess a natural tendency toward shareholder activism. Some are more likely to engage in activism than others, however. SWFs with a higher proportion of their assets invested in equities, those with portfolios fully or partially constructed to emulate the broader financial markets through indexing, and those that depend less on external fund managers are the likeliest candidates for activism. The study also finds that the regulatory environment can curb the natural SWF inclination for activist behavior. Due to the lack of transparency within the SWF universe, this study largely depends on the limited data available for sovereign wealth funds. Given the growing importance of SWFs, managers, directors, and policymakers must assess SWF activism, its influence on corporate governance, and its implications for public policy deliberations. This project, to the best of the author's knowledge, is the first study that applies tested financial models to SWFs in order to determine if they have inherent activist tendencies.

Dixon, Adam and Ashby H. B. Monk, 2012, Reconciling transparency and long-term investing within sovereign funds, *Journal of Sustainable Finance & Investment* 2(3), 275-286.

One of the potential consequences of the international community's focus on transparency and commercial orientation, when it comes to sovereign wealth funds, has been to shorten the latter's investment time horizons. As a result, these theoretically long-term investors are pressured into behaving like many short-term investors in the marketplace today, pushed by structural conditions that demand short-term performance in order to secure legitimacy. In evaluating the tension between transparency and long-term investing, we offer a conceptual framework for thinking through different types of transparency pertaining to the investment process as a means of discussing and communicating acceptable and non-acceptable asymmetric information in relation to financial performance.

Clark, Gordon L., Adam D. Dixon and Ashby H. B. Monk, 2013, *Sovereign Wealth Funds: Legitimacy, Governance, and Global Power*, Princeton University Press.

The worldwide rise of sovereign wealth funds is emblematic of the ongoing transformation of nation-state economic prospects. *Sovereign Wealth Funds* maps the global footprints of these financial institutions, examining their governance and investment management, and issues of domestic and international legitimacy. Through a variety of case studies--from the China Investment Corporation to the funds of several Gulf states--the authors show that the forces propelling the adoption and development

of sovereign wealth funds vary by country. The authors also show that many of these investment institutions have identifiable commonalities of form and function that match the core institutions of Western financial markets. The authors suggest that the international legitimacy of sovereign wealth funds is based on the degree to which their design and governance match Western expectations about investment management. Undercutting commonplace assumptions about the emerging world of the twenty-first century, the authors demonstrate that even small countries with large and globally oriented sovereign wealth funds are likely to play a significant role in international relations. *Sovereign Wealth Funds* considers how such financial organizations have altered not only the face of finance, but also the international geopolitical landscape.

Ed. Sauvant, Karl P., Ed. Sachs E., Lisa, Ed. Jongbloed, Wouter P.F. Schmit, 2012, *Sovereign Investment: Concerns and Policy Reactions*, Oxford University Press.

Sovereign Investment: Concerns and Policy Reactions provides the first major holistic examination and interdisciplinary analysis of sovereign wealth funds. Sovereign wealth funds currently hold three trillion dollars' worth of investments, almost twice the amount in all the hedge funds worldwide, and are predicted to hold nine trillion more by 2015. This relatively new and rapidly expanding phenomenon remains relatively unregulated, but the International Monetary Fund and the G7 aim to establish temporary and voluntary rules to introduce transparency and uniformity until more permanent regulatory structures are institut-

ed. What permanent rules and procedures should govern sovereign wealth funds? What bodies should enforce them? Do the current provisional rules answer the national security concerns of host countries? Editors Karl P. Sauvant, Lisa Sachs, and Wouter P.F. Schmit Jongbloed address these questions in a collection of essays by leading authorities from the IMF, academic institutions, law firms, multi-national corporations, and think tanks. Together, these authors analyze how sovereign wealth funds have helped to limit the effects of the current global economic crisis, and what rules can govern their operation in the future.

A Knill, BS Lee, N Mauck (2012), *Bilateral political relations and sovereign wealth fund investment*, *Journal of Corporate Finance*.

We examine the role of bilateral political relations in sovereign wealth fund (SWF) investment decisions. Our empirical results suggest that political relations play a role in SWF decision making. Contrary to predictions based on the FDI and political relations literature, we find that relative to nations in which they do not invest, SWFs prefer to invest in nations with which they have weaker political relations. Using a two-stage Cragg model, we find that political relations are an important factor in where SWFs invest but matter less in determining how much to invest. Inconsistent with the FDI and political relations literature, these results suggest that SWFs behave differently than rational investors who maximize return while minimizing risk. Consistent with the trade and political relations literature, we find that SWF investment has a positive (negative) impact for relatively closed (open) countries. Our

results suggest that SWFs use – at least partially – non-financial motives in investment decisions.

Case Studies

Chambers, David, Elroy Dimson, and Antti Iilmanen, 2012, *The Norway model*, *Journal of Portfolio Management* 38, 67-81.

Norway's Government Pension Fund Global (GPF) was recently ranked the largest fund on the planet. It is also highly rated for its professional, low-cost, transparent, and socially responsible approach to asset management. Investment professionals increasingly refer to Norway as being a model for managing financial assets. Chambers, Dimson, and Iilmanen present and evaluate the strategies followed by the GPF, review its long-term performance, and describe how it responded to the financial crisis. They conclude the article with some lessons that investors can draw from Norway's approach to asset management, contrasting the Norway model with the Yale model of pension fund management.

Carling, Robert and Stephen Kirchner, 2012, *Future Funds or Future Eaters? The Case Against a Sovereign Wealth Fund for Australia*, *Center for Independent Studies*.

This monograph argues that the existing Future Fund is unnecessary and that greater use of a SWF will harm Australia's current and future prosperity. The Future Fund is not a source of new saving in the financial system. It disintermediates the private

sector from saving and investment decisions and risks politicising the process of capital allocation in the economy. The fungibility of assets in the Future Fund with other sources of revenue and government borrowing means there are no guarantees as to how these funds will be used in the future, even under existing legislation, which places various restrictions on the use of fund assets. The Future Fund eases the federal government's future revenue and borrowing constraint, weakening incentives for responsible long-run fiscal management. The investment returns on the Future Fund's assets are inadequate compensation for the foregone alternative uses of these funds. The federal budget should be well placed to withstand cyclical fluctuations in commodity prices and the domestic and international economy without the benefit of a SWF. The federal budget can and should run deficits and surpluses in response to revenue fluctuations, but this is an entirely separate issue from whether there should be a SWF. The government does not need a SWF to run surpluses. Australia's low net debt to GDP ratio and well-developed capital markets mean that the federal government does not face significant borrowing or liquidity constraints in managing fluctuations in the budget between surplus and deficit over time. The floating exchange rate also insulates the economy from the positive external shock arising from the terms of trade boom. Far from being a problem for the Australian economy, exchange rate appreciation is the appropriate response to a terms of trade boom. Even if it were desirable, a SWF with substantial un hedged foreign currency-denominated assets would be ineffective in curbing exchange rate appreciation because the net foreign currency denominated assets of the

Commonwealth would be too small relative to the depth and liquidity of foreign exchange markets and Australia's large net capital inflows. Many of the desirable objectives of a SWF could be achieved through binding fiscal responsibility legislation, such as a beefed-up Charter of Budget Honesty. Overseas SWFs are typically backed by such legislation, but Australia's Future Fund currently operates outside any broader fiscal policy framework. Unless governments are prepared to accept binding fiscal responsibility legislation, they cannot be trusted with a SWF. Australia should not make greater use of a SWF in the absence of a comprehensive and binding legislative framework for fiscal policy governance. We recommend that the Future Fund be wound up and its assets transferred to the trustees of existing public sector superannuation schemes to match the liabilities each scheme has accrued.

Appendix

Methodology

Our research on SWF's direct investments (i.e. equity and real estate deals, joint-ventures and capital injections) focuses on two main objectives: comprehensiveness of research and accuracy of information. To ensure comprehensiveness, we survey multiple sources, primarily relying on established business and financial databases but employing also pressreleases, published news, fund annual reports and many other data sources. To ensure accuracy, we follow a strict process for capturing deal information and we establish a clear hierarchy of sources, based on our estimate of reliability:

- 1 Financial transaction databases: Bloomberg, SDC Platinum, Zephyr (we have also used Datamonitor and Dealogic in the past)
- 2 Database for target firm information: DataStream
- 3 Sovereign Fund disclosures, including annual reports, press releases and other information contained on their websites
- 4 Target and vendor company disclosures: press releases and other information contained on their websites
- 5 Regulatory disclosures: stock exchange filings for publicly listed companies; Regulators; SEC 13D and 13G Filings; Land Registries; Competition Commissions, and Bond/IPO prospectuses etc.
- 6 Service provider disclosures: such as lawyers, investment banks, and project financiers working with the SWFs
- 7 Information aggregators: LexisNexis and Factiva. Those include news reported by newswires (Dow Jones, Reuters, Business Wire, Associated Press and others) and national news agencies (KUNA, Xinhua, WAM etc.) numerous wellregarded selected newspapers (e.g. The Wall Street Journal, Financial Times, New York Times), and their regional equivalents (e.g. Economic Times, China Daily, The National), and the local trade press.
- 8 Other websites, including Zawya.com, Google Finance, Yahoo! Finance, AME Info, BBC News and others. Most of the deals are amassed and consolidated from the financial transaction databases, while the other sources are mostly used for corroboration where necessary. At least one high-quality source is captured for each data point, and, where possible, multiple sources are identified. News items from information aggregators such as LexisNexis are carefully examined to ascertain the reliability of the original source.

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