The Sovereign Wealth Fund Initiative
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A Conversation with Ted Truman
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Edwin M. ("Ted") Truman is a noted voice among sovereign wealth fund watchers and scholars. His most recent book, Sovereign Wealth Funds: Threat or Salvation? (Peterson Institute, 2010), explores the origins of SWFs and the buildup of international reserves, and unveils a "scoreboard" that ranks funds in 33 variables across four categories: structure, governance, transparency, and accountability.

Sovereign Wealth Fund Initiative co-heads Eliot Kalter and Patrick Schena had the opportunity to speak with Dr. Truman on March 12 to discuss the proliferation of new sovereign wealth funds, current trends in investment decisions, and the future role of the IMF's International Forum of Sovereign Wealth Funds. An edited transcript of their conversation is below.

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Sovereign Wealth Fund Initiative (SWFI): *One of the things we've noticed in recent years, and which has been widely reported of late, is a significant increase in sovereign wealth funds (SWFs) at the national, state, or sub-state levels. What is your perspective on the reasons for this phenomenon? Growth in exchange reserves globally, especially in Asia, has been a driver to some extent, but is there another story there?*

Ted Truman (TT): I think there are basically two factors. One is the buildup of what I would call surplus foreign exchange revenues in government hands. That involves more than just foreign exchange reserves; it is the whole process by which more wealth is building up in hand of sovereigns. The second factor is the understandable, maybe responsible, sense that this buildup should be invested wisely rather than left around in low-yielding assets. I think that both factors force governments to do more with what they have, and the fact that they have to do more led to an increase in the number of SWFs globally. I suppose there is also somewhat of a copycat aspect to this phenomenon also as SWFs have become more well known.

SWFI: *Are transfers a trend that is likely to continue?*

TT: To the extent that they're a function of external imbalances, one important question is whether external imbalances will grow or shrink; the jury is out on that point, as there are widely differing views. Another question is whether countries have more than adequate international reserves, either generated through their intervention activities or their quasi-intervention activities in terms of exports. On the latter point, it is difficult to say, as the reserves continue to accumulate, whether there will be large transfers. One result of the global financial crisis is that countries which thought they had "more than adequate" reserves found that they did not actually have "more than adequate" reserves. In most cases, the transfers of reserves to SWFs are likely to be out of the excess. That doesn't mean, of course, that many reserve investment activities are that different because often they are difficult to distinguish from SWF investments.

SWFI: *This perceived need to build up reserves has increased because of the global financial crisis. There was one in 2008-09, and we have since seen international reserves of central banks accumulate; then, of course, there came the European debacle. Has the European situation also contributed to that perceived need for the accumulation of reserves?*

TT: Both crises have contributed. In the last year—2011—you again found non-European countries coming under external financial pressure as there was a withdrawal of funds from a number of emerging market economies. This increased tensions and fears of not having adequate reserves. The problem is that one never knows how much is enough in the way of reserves. Certainly the literature increasingly says that you can't tell, so that adds up to endless expansion of reserves. And the question is how they are invested; some components of the SWF phenomenon have to do with essentially internal issues of how governments organize themselves. For example, in the Korean case there was basically an argument between the finance ministry and the central bank about the management of reserves; the finance ministry essentially wanted to manage more reserves, so that's why the Korean fund was created. To some extent, that is also the case in China, where the China Investment Corporation (CIC) is tiny, especially in its limited international investments, relative to the total reserves of the Bank of China. There were supposed to be further reserves transferred to CIC at the end of 2011, but the last time I checked, it had not happened. There are internal, almost bureaucratic issues about whether central banks want to turn over their funds to SWFs.

SWFI: *Another suggested factor leading to the accumulation of reserves is a mistrust of IMF. What is your perspective on the recent role of IMF, which seems to have gotten more favorable press, and has it had an impact in the opposite direction?*

TT: I would like to think so, and I suppose others would too, but I'll believe it when I see it. A general problem in that area, which is somewhat secondary, is that even though all the efforts the Fund has made to create facilities to make access to its resources less onerous and more automatic has not seemed to have any impact on desired levels of reserve accumulation.

SWFI: *You touched on the need for funds domestically, so that even those SWFs with a mandate to invest abroad have had pressure to invest more at home. Have you observed that that is still increasingly happening, or has it eased off a bit? Is there some danger that the SWFs don't have the mandate for the types of domestic investments they are being pressured to do, which could have some governance issues?*

TT: My view on that point is that employment of the wealth in SWFs is a question that each country has to constantly revisit. There is a question of whether you're investing for future generations (which most likely leads to more investments abroad), or to invest or spend at home in light of changing needs and the perception of needs. I think it's difficult to be categorical on this point. It is probably true to say—though it is a generalization, and most generalizations having to do with SWFs are dangerous—that when investments get shifted from abroad to at home, the governance issues in many respects increase,; in the sense that the opportunities for mismanagement of the assets increase; the losses associated on domestic investments tend to be higher than those associated with foreign investments, or there is less transparency. I think the fact that some countries have taken parts of their SWFs and used them to recapitalize their banking systems does not strike me as inherently wrong. It does mean that as far as the international financial system is concerned, you have a shift from foreign to domestic assets. Many funds, as we know, have a combination of both domestic and foreign assets, and have from the beginning.

SWFI: *If you think about the mandates of funds like Khazanah or Mumtalakat that have a development as opposed to wealth dimension, there is in fact a mandate to privatize state assets, and to transform that asset base to something more liquid. Both France and Italy have what can be called new funds—and we can debate whether they can be strictly defined as SWFs—but it seems that their investment mandates are more strategically inwardly focused. What are your thoughts on that?*

TT: The French fund, from my perspective, is not so much a SWF. This is a little arbitrary, but if a so-called "SWF" does not invest at all abroad, it becomes a different animal. The French fund is less relevant because its activities do not affect the international system. It is basically a defensive, anti-takeover device, and the Italian one is similar. At best, they are more in the financial holding-company model than in investing-surplus-wealth model. Temasek Holdings (Singapore) and many others started by consolidating investments in a single entity, and only later did they end up increasing investments abroad.

SWFI: *Related to mandates, is it an appropriate or effective use of a SWF to lessen impact of capital inflows on exchange rate appreciation?*

TT: To the extent that funds get accumulated through intervention, if that is what you mean, it's just like any other form of reserve accumulation—rather than letting the funds flow into the country and drive up the exchange rate, they can accumulate and are recycled via the central bank, finance ministry, or sovereign wealth fund. In that sense it does get involved in the whole issue of exchange rate policy. I don't think you avoid the intervention criticism by saying, "well, we're building up funds to put in a SWF rather than in foreign exchange reserves." So for those who criticize the intervention, it does not matter whether the funds are parked in reserves or SWFs. For those who favor it, they can argue that as long as you're going to do it, you might be better off having a government entity invest in a broader range of assets and, in effect, recycling the funds that would traditionally be associated with foreign exchange reserves, but I think that's pretty much a secondary consideration.

SWFI: *A potential impact of central banks transferring wealth to SWFs is that the funds are investing a greater number of assets, whereas a central bank would be more heavily invested in fixed income. Is that a potentially significant factor in the global pricing of fixed income?*

TT: The forms of foreign investment that SWFs use may differ, so that is correct; in principle, there may be financial market implications, in terms of a significant impact on the global pricing of fixed income instruments, but in practice I find that unlikely. Certainly, the sign is correct if you believe in a portfolio balance model—and there is some evidence to support a portfolio balance model— when external investors change their asset preferences. Therefore, when a foreign government changes its asset preferences from short to long term, and from bonds to equities, in principle it affects relative prices and returns. Whether the scale is sufficient to generate an observed phenomenon in any empirical sense, I am more skeptical about. The changes occur gradually over time and there are countervailing forces.

SWFI: *Let's come back to the European situation for a moment. There has been some discussion about Greece potentially employing a fund-based model to deal with state assets and try to raise capital. That might have an international impact in that those assets would be privatized outside of the Greek context. This plays back to idea that a fund-based mechanism or holding company managed with a focus on financial returns could potentially create maximum benefit. What type of construct could be used in a situation like this—an extreme case?*

TT: I think at one level there is probably something there. To use the Temasek example, it becomes more efficient to manage assets, and maybe even dispose of assets, using a holding company model rather than individually. But it is perhaps more an efficiency and transparency issue rather than an issue of wealth maximization in a broader sense. One could be suspicious about this being raised in the context of Greece as a delaying tactic. But, on the other hand, collecting assets in a form in which they become more marketable make sense in the same way that many countries have government-owned entities that have cleaned up their corporate structures and then sold shares to the public both domestic and international. They have essentially "corporatized" as part of a partial privatization process—obviously there are some parallels with SWFs and some manifestations of the SWF phenomenon.

SWFI: *On the asset allocation role of SWFs: one could look to SWFs, as their size increases, and their unique ability to invest long-term, as a potential stabilizer to global markets. Is that a viable or appropriate role for SWFs?*

TT: Again, it all depends on the SWF. Some SWFs are by design the opposite—they are stabilization funds. From the standpoint of the rest of the world, they are going to be pro-cyclical rather than counter-cyclical— in the case where SWFs have a scope, mandate, or requirement to shift investments from abroad to at home. The literature suggests that in the global financial crisis there was more repatriation, broadly defined, than expected. The extent of it did call into question the long-term buy-and-hold nature of the funds. The point is that enough of the funds followed a pro-cyclical policy that doing so influenced an overall pattern. Some SWFs obviously didn't conform to that pattern.

SWFI: *The data shows that, along the lines of what you're saying, the crisis started in the U.S. in 2008, and SWFs were shifting out of the U.S. after asset prices went down and into Europe just in time for European crisis. So they seem at least in aggregate to be moving, for short-term reasons, in wrong direction.*

TT: And that's part of the issue. Some people make the argument—I don't especially agree with it—that pressures to increase fund transparency and accountability and the focus of the general public on quarter-to-quarter, if not day-to-day, fund performance leads funds to be more short-term in their perspectives. I am sure there are some forces in that direction, but I think on balance the forces go the other way in the longer term. But in the short run, it is true that spectacular investment failures, if you want to put it that way, will lead to a certain conservatism on the part of managers in the future.

SWFI: *This brings us more generally to the Santiago Principles, and their adoption rate. For new funds, are the Principles just a check box—something important as part of initial constitution—or does this degree of overt transparency potentially impact their ability to be flexible in their investment allocation decisions?*

TT: I think the Santiago Principles, including my own work that contributed to that process, have net-net been positive for the environment in which SWFs operate, and have demystified their operations to some degree. On the other hand, the whole process of the Santiago Principles and the associated International Forum of Sovereign Wealth Funds (IFSWFs) is sort of in stasis in the sense that no new funds have signed up, despite the fact that these mechanisms have been in existence for three and a half years. There have been some problems with a few members of the IFSWF that do not even come close to following them or cooperating with their partners. In terms of the role of the Santiago Principles in the "best practices" mode, there are some important questions about how this movement gets carried forward. Some of the countries and individuals who were associated with the Santiago Principles processes and the IFSWF share that set of concerns. According to my data, of the SWFs that had been created since 2004—of which there are 14 funds that I have scored—I was somewhat dismayed to learn that the average score, whether on the Santiago Principles version or my own scoreboard version, is somewhat lower than the average for all SWFs as a group. If you did a multiple regression process we might find that the difference is not significant and has more to do with the countries themselves. This is surprising mainly because in the countries that have set up funds in that period of time, international organizations—the IMF, the World Bank, and the IFSWFs—have been trying to promote best practices. On the other hand a lot of funds have not had to or needed to go that route. So, for every East Timor, where that role of the IMF was very important, you had a Brazil which, as far as I know, has not signed up its fund for the Santiago Principles.

SWFI: *As you imply, perhaps the newer countries of the past years establishing SWFs are perhaps lower down in the "democracy index"?*

TT: Yes, that is certainly a possible explanation, and I think if you control for that feature, you might get a different kind of result. The specific correlation is not overwhelming, but a number of the newer funds are associated with jurisdictions that are lower on the democracy scale. One of the interesting cases in my view is the United Arab Emirates, which has at least a half-dozen of these funds, depending on how you classify them, across different emirates. Most of the half-dozen score poorly, but two of them score reasonably well on both my scoreboard or on the Santiago Principles: the Abu Dhabi Investment Authority (ADIA) and Mubadala. So even in a single political culture you get varying behaviors. Similarly the individual U.S. states that have funds do not score equally well, either.

SWFI: *In terms of the IFSWFs, some countries complain that they are not getting a lot from it. Is it living up to its potential?*

TT: In some sense, the IMF was "assigned" this job, to put it crudely, by the G7, and the other countries took it up. It helped that the countries with SWFs were not all developing countries, so there was an interesting mix of developing, middle income, and advanced countries involved in the process, and you ended up producing something very reasonable very quickly by international standards. For some of the funds, and to some extent the IMF itself, there is a question of who is paying for what, or a question of undue influence. The IMF has been providing a secretariat function, and there is a question of whether that is appropriate, given that by definition these funds have wealth of their own. Some of the countries might want to be separated from the IMF and its associated baggage. In this world of scarce resources, I expect that the IMF leadership probably feels it has done its job and can pass it off. The IFSWFs has talked about a process to set up its own "secretariat." I think the more serious issue for the IFSWFs is how it can enlarge participation, both in terms of improving compliance, for lack of a better word, and participation by a larger number of funds.

SWFI: *One fascinating subject is the extent to which funds will look to recreate themselves, or to undergo, at least partially, some degree of restructuring based on perceived changes to their mandates, the political climate, or other factors. In Chinese context, there is some talk of restructuring of the CIC related to the international portfolio, which may be driven by bureaucratic politics. Can you provide some reflection on new funds and what they can learn from the longer-term experiences of the established funds?*

TT: There is certainly a lot of learning by doing. I like to joke that a bunch of people woke up one day to discover they had something in common called a SWF and they were members of a club that they did not know existed and there were club rules with which they had to comply. The result has been that these countries, for both internal and external reasons, including the whole process that led to the Santiago Principles, have raised the profile of these entities. There has been a substantial amount of learning by doing and a certain amount of copycat behavior. Many of the funds have quite active technical assistance programs. But they are all constantly transforming themselves for two reasons. One, some of these funds started out as pure stabilization funds, and they've gotten to the point where that is not all that they are doing, so there is some evolution in their objectives over time. Two, the politics surrounding the funds can change at any time. In the United States, you can see this—the Alaska Permanent Fund has had many manifestations over its history. The Norwegian fund is often held up as a paragon, but it has constantly fiddled around with how it does its business since it was created in the early 1990s. Even in relatively stable environments, the structures of these funds have changed dramatically. I think that's natural—circumstances change. This is probably one reason why you don't want to have too rigid a structure, in case it doesn't work. You have to have some flexibility in it, even including the fact that you can change the structure, as the conditions change over time.

SWFI: *Thank you for your insights.*