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Political Risk – An Important Issue for Sovereign Wealth Funds

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A number of recent, high-profile political events have significantly impacted financial markets and heightened investor's sensitivity to political risk issues. The political-economic crisis in Europe, revolutions and rebellions in North Africa and the Middle East, and tensions in the South China Sea and Persian Gulf have garnered the most attention but more ubiquitous political risks such as regulatory changes, new tariff barriers, and currency controls also adversely affected cross border investments over the last two years. Political risk is any event that can directly or indirectly alter the value of an economic asset.[i] This definition is quite broad but it is important for investors to understand all the ways that political risks can affect an investment and not just focus on those events that make the news. Political risk includes everything from government actions (expropriations and breaches of contract, discriminatory taxation) to geopolitical events (international wars, terrorism) and social-economic changes that can lead to social unrest.[ii]

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Sovereign Wealth Funds (SWFs) are in a unique position when it comes to political risk issues. SWFs face all of the political risks that other financial firms and hedge funds face when investing around the world but because they are government owned entities, their investments in target countries are subject to additional scrutiny and political risks that private sector actors do not face. Government ownership can also lead to pressure on SWF management teams to limit losses (and achieve appropriate returns) and restrict some SWF investment options such as the ability to short equities. To their benefit, most SWFs are long-term investors which provides an advantage -- they can ride out short-term downturns and, in some circumstances, invest in assets that are riskier in the short- to mid-term. SWFs have not been immune to the political events noted above. For example, the Arab Spring and sovereign default concerns in Europe led to a 'risk off' position and global sell-off of investments with higher risks in early 2011. These events, and the accompanying losses, increased SWF concerns about political and country risks and the identification of ways to deal with them.[iii] SWFs have taken measures to protect their investments by diversifying their portfolios but they will need to incorporate political risk analysis into their investment strategies to better protect investments and maximize returns.

Political risk issues will be increasingly important for SWFs as the shocks from the 2008 financial crisis continue to have an impact around the world. Fund managers, under great pressure to avoid losses and deliver appropriate return, have diversified SWF portfolios which has introduced a new set of political risks. Prior to 2008, many SWFs were heavily weighted in equity investments and, in particular, primarily invested in large cap, stable companies based in the U.S. and Europe.[iv] One study found that seventy-five percent of SWF equity investment assets were in countries that were members of the Organization for Economic Cooperation and

Development (OECD).[v] SWF foreign direct investment (FDI) was also heavily weighted toward developed countries with emerging markets only making up twenty-five percent of SWF FDI in 2007.[vi] The investments in developed countries, with strong legal systems and liquid markets, offered significant protection for the SWF investments. There was little risk of expropriation and the funds could get their money out quickly (especially for equity investments), if necessary. As a result, financial analysis of the investment targets became paramount with little focus on political risk.

SWFs began to shift more of their investments into emerging markets in response to the financial crisis that hit the U.S. and other developed countries in 2008. With large losses -- up to twenty-five percent for some funds -- SWF managers came under domestic pressure to reassess their investment strategies and asset allocations.[vii] In addition, many funds reviewed their risk management frameworks, potential liquidity needs, and related investment horizons and risks.[viii] This resulted in SWFs moving investments into emerging markets and adding alternative investments to their portfolios. An example of this shift in focus to emerging markets is Temasek, a SWF from Singapore, which decided to reduce its asset allocation in OECD countries from one-third to one-fifth of total assets.[ix] Not only did funds increase their investments in emerging markets, they also began investing in frontier economies like Argentina, Kazakhstan, Lebanon, Sub-Saharan Africa, and Pakistan.[x] The high correlations between emerging market and developed market equities; low returns available from low-risk, fixed income investments like U.S. treasuries; and political events such as the Arab Spring have led SWFs to further diversify their investments by adding asset classes such as real estate, private equity, hedge funds, emerging markets, high yield and credit.[xi] The move to emerging and frontier markets has exposed SWF investments to increased risk of political instability, terrorism, corruption, currency controls, and contract enforcement. It also increases the geographic scope of the political analysis that should be undertaken by SWFs to protect their investments. Additionally, private equity and real estate investments are less liquid which can be an acute problem if there is a need to quickly exit an emerging market. This problem would be exacerbated if other foreign investors are also trying to exit the market at the same time. In this new investment climate, political risk analysis is just as important as financial analysis.

The pressure on SWF managers to improve their performance has led SWFs to increase their use of newer investment vehicles, sovereign wealth enterprises (SWEs). SWEs provide SWFs greater flexibility in their investment decisions. For example, if a SWF has a restriction on shorting stocks, the SWF can create a wholly owned subsidiary that owns a portfolio with a long short equity strategy to get around this restriction. In addition, SWE's can be incorporated as private companies which can provide a bit of distance from the SWF.[xii] SWEs can be organized as any type of economic entity – they can handle investments or operate companies.[xiii] Examples of SWEs include:

- Kuwait Investment Authority's National Technology Enterprises Company which invests in technology companies and venture capital funds.[xiv]
- Abu Dhabi Investment Council's Invest AD which created a joint venture fund to invest in listed and unlisted companies in Africa.[xv]
- Temasek's Pavilion Capital Pte, a wholly owned company that invests in closely held companies with a focus on small and medium enterprises in China.[xvi]

These entities give SWFs a great deal of flexibility – they can partner with other companies and invest in all types of assets around the world. As such, SWEs are ideally suited to take advantage of investment strategies that are informed by political risk analysis.

Political risks are also shifting as a result of the 2008 financial crisis. These shifts will require special attention from SWFs when investing in both developed and emerging markets. The political risks that had been associated mainly with emerging markets (state intervention in the economy, increased trade barriers, government instability, and sovereign default concerns) are increasing in developed markets. Intrastate turmoil and interstate conflict will likely increase over the near- to mid-term as the economic downturn has led to greater poverty, more crime, more migration, and greater instability around the world.[xvii] The ongoing political-economic crisis in Europe and budget concerns in Washington are leading to cuts in foreign assistance and a reluctance to intervene in regional conflicts that do not affect the vital interests of the U.S. and its allies. The combination of these factors will result in increased social unrest around the world, unexpected changes in government (both through constitutional and extra-constitutional means), and more local and regional conflicts. As this instability will predominantly be focused in emerging and frontier economies, SWF investments in these economies will face greater political risk.

Political risk analysis is an important instrument that can help SWFs avoid losses and increase investment returns. As noted above, political events can rapidly change the value of assets and undercut the traditional financial and economic frameworks that are used to build investment strategies. As such, political risk analysis should be fully integrated into the investment decision-making process for SWFs. Political risk analysis can help SWFs:

- Uncover and highlight knowable but obscure risks (such as discriminatory taxation). With this information the SWFs can make informed decisions about whether or not they should invest in a country and how to structure their investment if they decide to enter a market.
- Limit losses (and perhaps realize gains) when faced with fat tail events by identifying risks that could cause significant losses, monitoring triggers that would cause significant political disruptions, and developing plans to shift investments as soon these events surface.
- Anticipate changes in government policies.
- Identify social-economic forces that could lead to political or labor unrest.
- Determine political risk insurance requirements for FDI projects.

Assessing political risk is difficult and requires a systematic approach in order to be successful. One of the factors that complicates the incorporation of political risk into financial risk analysis is the fact that political risk assessments must be done for both individual investments as well as at the portfolio level. Assessments for individual projects are important to prevent losses -- a significant short-term loss on an investment (20-30%) will impair long-term returns -- and create opportunities. By assessing the political risk of the entire investment portfolio, some higher risk investments, which offer attractive returns, may be advisable if the risks are fully known and less correlated with lower risk investments also in the portfolio. An analytic challenge nonetheless persists because political risks will vary depending on the type of investment (portfolio or direct investment), time horizon and country where the investment will take place and the best tools to assess political risks will also vary depending on those same factors. As a result, each investment must be assessed individually. Furthermore, political risk analysis must be continuous as country dynamics and the international political environment are constantly changing.

The international environment is fraught with political risks – some are well known while others are often harder for investors to identify. These risks are complex and evolving. SWFs have diversified their investments to mitigate political and financial risks. This, however, has exposed their investments to new threats. SWFs can prosper in this environment if they deploy their investments in a robust fashion and integrate political risk into their investment strategies.

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[i] Ian Bremmer and Preston Keat, *The Fat Tail: The Power of Political Knowledge for Strategic Investing* (New York: Oxford University Press, 2009), 9.

[ii] Ibid, 10.

[iii] Patrick Thompson, global head sovereigns for JP Morgan's Asset Management division which manages assets for more than 60 sovereign clients, noted the increased concern of SWFs for political risk issues in March 2011 in Natsuko Waki, "Sovereign wealth funds are using a "barbell" approach of managing assets both passively and actively as they seek real returns in a low-yielding climate" *Reuters*, March 3, 2011, accessed February 3, 2012, http://uk.reuters.com/article/2011/03/03/uk-wealth-sovereign-idUKTRE7224BW20110303

[iv] Roxannna Faily, Kevin Lu, and Shuilin Wang, "Sovereign Wealth Funds, Financial Crisis, and Management of Noncommercial Risk" in *Investing with Confidence – Understanding Political Risk Management in the 21st Century*, ed. Kevin Lu et al. (Washington, DC: The World Bank, 2009), 64-65.

[v] Bernardo Bortolotti, Veljko Fotak, William L. Megginson, and William Miracky, William, Sovereign Wealth Fund Investment Patterns and Performance (March 25, 2010). FEEM Working Paper No. 22.2009. Available at SSRN: http://ssrn.com/abstract=1364926 or doi:10.2139/ssrn.1364926 p 8. See also Vidhi Chhaochharia and Luc A. Laeven, Sovereign Wealth Funds: Their Investment Strategies and Performance (May 2010). Available at: http://cgt.columbia.edu/files/papers/Laeven_The_Investment_Allocation_of_Sovereign_Wealth_Funds.pdf.

[vi] Faily, 65-66.

[vii] Ibid., 68.

[viii] Peter Kunzel, Yinqiu Lu, Iva Petrova, and Jukka Pihlman, Investment Objectives of Sovereign Wealth Funds—A Shifting Paradigm (January 2011). IMF Working Paper. Available at: http://www.imf.org/external/pubs/ft/wp/2011/wp1119.pdf, 11.

[ix] Ibid.

[x] “Can Frontier Markets help a SWF’s Portfolio?,” SWF Institute, accessed February 4, 2012, http://www.swfinstitute.org/swf-article/can-frontier-markets-help-a-swf%e2%80%99s-portfolio/

[xi] Natsuko Waki, “Sovereign wealth funds are using a "barbell" approach of managing assets both passively and actively as they seek real returns in a low-yielding climate” *Reuters*, March 3, 2011, accessed February 3, 2012, http://uk.reuters.com/article/2011/03/03/uk-wealth-sovereign-idUKTRE7224BW20110303

[xii] “Sovereign Wealth Enterprise – Frequent Asked Questions,” SWF Institute, accessed February 6, 2012, http://www.swfinstitute.org/statistics-research/sovereign-wealth-enterprise-swe/

[xiii] Larry Catá Backer, Sovereign Wealth Funds as Regulatory Chameleons: The Norwegian Sovereign Wealth Funds and Public Global Governance Through Private Global Investment (May 4, 2009). Georgetown Journal of International Law, Vol. 41, No. 2, 2009. Available at SSRN: http://ssrn.com/abstract=1398835, 22.

[xiv] “Kuwait VC SWE Invests in NeuString,” SWF Institute, accessed February 6, 2012, http://www.swfinstitute.org/swf-news/kuwait-vc-swe-invests-in-neustring/

[xv] “Abu Dhabi Investment Council Invests in Rwanda Bank IPO,” SWF Institute, accessed February 6, 2012, http://www.swfinstitute.org/swf-news/abu-dhabi-investment-council-invests-in-rwandan-bank-ipo/

[xvi] “Temasek Creates SWE to Invest in North Asia,” SWF Institute, accessed February 6, 2012, http://www.swfinstitute.org/swf-news/temasek-creates-swe-to-invest-in-north-asia/

[xvii] See Robert Blackwill, “The Geopolitical Consequences of the World Economic Recession – A Caution” (2009). RAND Occasional Paper. Available at: http://www.rand.org/pubs/occasional_papers/2009/RAND_OP275.pdf.