THE FLETCHER SCHOOL
TUFTS UNIVERSITY

The Sovereign Wealth Fund Initiative
February 2012

Redefining Political Risk Management: The SWF Dimension

Dr. Eliot Kalter[1]

Sovereign wealth funds (SWFs) are becoming significant players in an unstable global financial stage. The financial crisis of 2007-08 and now the Euro crisis point to the dangers, not only of unsustainable economic and structural policies, but also of depending on the availability of financing from capital markets that punish "poor performers," or not, depending on "risk appetite." European countries did not suddenly create unsustainable deficits; rather, the easy availability of financing encouraged the profligate behavior until the capital markets shifted to a "risk off" position and an unwillingness to finance what became unsustainable deficits. These events have made clear the importance that long-term investors (LTIs) make their asset allocation decisions based not only on a careful assessment of current economic and financial risk factors, but also those factors that will affect these conditions in the long-term future.

Within this global environment, SWFs have the capacity to become increasingly important as a source of financing and global stability. Their rapidly growing assets under management are increasing being allocated far beyond their borders and into a greater array of asset classes and

[1] Dr. Eliot Kalter is a senior fellow at The Fletcher School's Center for Emerging Market Enterprises and co-heads its Sovereign Wealth Fund Initiative.

sectors. SWF's specific mandates and "clean" balance sheets facilitate their ability to make long-term investment, without constraints faced by many developed country under-funded pension funds. It is in this context that SWFs and other LTIs need to focus beyond financial risk, to the long-term political risk factors that underlie the sustainability of the decision framework within which investment decisions are made.

The size and diversification of SWF assets have risen sharply in the last 10 years and are projected to continue to do so. SWFs are not homogeneous and have different mandates with associated different portfolio allocations, ranging from low risk tolerance for stabilization funds to higher risk tolerance, longer time horizons for savings SWFs.[2] That stated, in a global economy with low-risk assets yielding historically low returns, many SWFs and other LTIs are seeking higher returns through diversification of asset allocation to longer term and riskier assets:

Figure 1

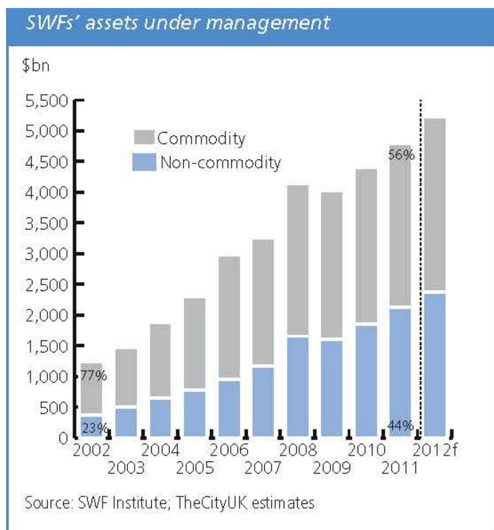
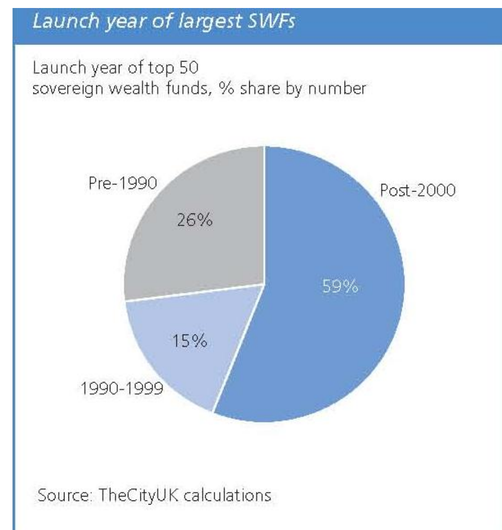


Figure 2



[2] "While pension reserve funds can derive their investment horizons from the timing of the future anticipated liabilities falling due, which can be decades in the future." IMF paper WP/11/19 Investment Objectives of Sovereign Wealth Funds—A Shifting Paradigm.

- In the past 10 years, SWF assets have risen from $1 trillion in 2002 to almost $5 trillion by 2011, with the number of new SWFs launched in the last ten years greater than in the previous forty years (since the first 1956 Kuwait SWF) (Figures 1 and 2). [3] [4] The source of SWF growth largely comes from oil revenue in the MENA region and external surpluses in Asia, with the two regions together accounting for over 55% of all SWF's and 75% of their assets. [5]
- SWF assets will likely continue to grow rapidly. The IMF World Economic Outlook projects sizable external surpluses continuing in Asia and the MENA regions in the medium term. As in the past, sovereigns will continue to transfer a calculated proportion of these resources to SWFs, in part because their asset allocation decisions are less constrained than those of central banks where the expected return on external assets can be overwhelmed the cost of sterilizing capital inflows.
- The percent of SWF foreign transactions increased from 35% in 2003 to over 85% in the first half of 2010.[6] The destination of foreign transactions has also diversified. The split between OECD countries and emerging market countries has varied greatly in the past 10 years, averaging about 50/50 but rising to 80% in emerging market countries in the second half of 2010. Moreover, the EM investments were to more diverse geographies,

---

[3] TheCityUK Sovereign Wealth Funds report, April 2011

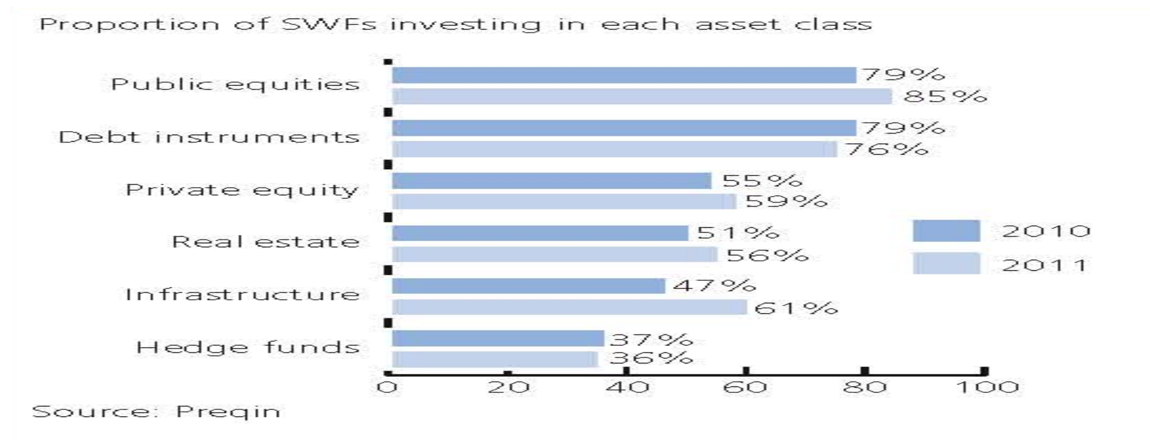
[4] SWF public policy and asset allocation after financial crisis. Presentation for Fletcher School of Law and Diplomacy. Eliot Kalter

[5] Preqin 2011 SWF Review.

[6] Financial Markets Series Sovereign Wealth Funds, April 2011 based on Monitor-FEEM SWF Transaction Database

with Brazil, Russia, and India as well frontier markets in the Sub-Saharan Africa receiving record amounts of SWF investments.[7]

Figure 3

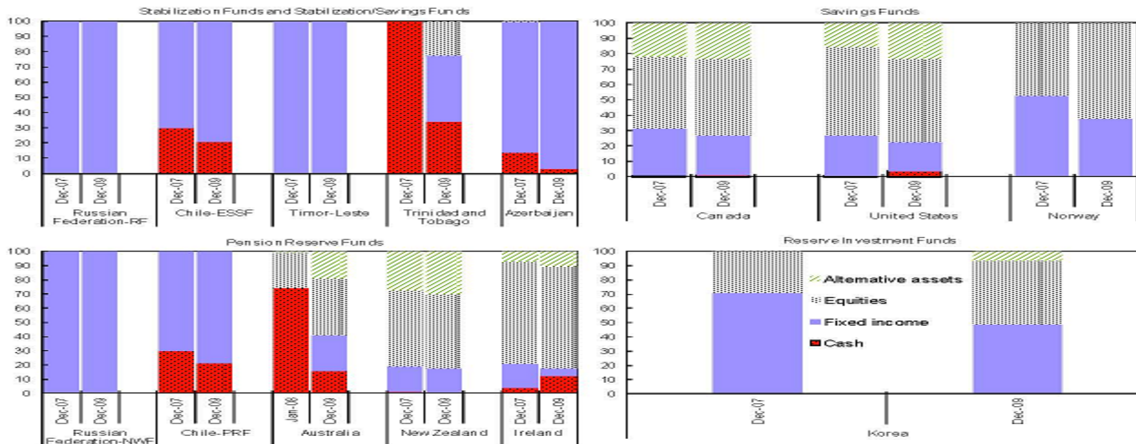


- While a long time series of shifting asset allocation is not available, the proportion of SWFs investing in diverse asset class is impressive, rising in 2011 (compared with 2010) to 85% (79%) in public equities, 59% (55%) in private equity, 51% (56%) in real estate, 61% (47%) in infrastructure and 36% (35%) in hedge funds (Figure 3).[8]

[7] The Monitor ("Braving the New World") reports that: "Another feature of SWFs in emerging markets in 2010 was their expansion into more diverse geographies. Brazil, Russia, and India received more SWF investment than ever before. India was particularly popular with Singaporean funds, with Temasek and GIC investing a total of $582 million. Although this is a relatively small sum, this was the first time we had observed SWFs actively scouring the Indian market for investments. Likewise, Russian companies received over $800 million in investments from our SWFs, while Brazil attracted over $3 billion of investment, with the majority of the value accounted for by QIA's $2.7 billion investment in Banco Santander's Brazilian unit. Frontier markets in sub-Saharan Africa also saw a number of direct SWF investments in agricultural land, mobile telecoms, and mining with a total value of just under half a billion dollars."

[8] Preqin 2011 SWF Review

Figure 4: SWF Asset Allocation, 2007 vs. 2009



Source: SWF websites and authors' calculations.
Note: Norway classified as savings fund. For some SWFs, cash may be included in fixed income.

- The IMF compares the shift in asset allocation for a dozen SWFs from 2007 to 2009 and shows average asset allocation to alternative investments rising from close to zero in 2007 to 10 % in 2009 and with allocation to equities increasing from 30% to 40% (Figure 4).[9] These trends are consistent with information about OECD pension funds showing asset allocation to alternatives rising from close to zero ten years ago to over 15% in 2010.[10]
- Information from a wide variety of sources shows that as SWF's diversify by geography and asset class, they are doing so in a diverse range of sectors including commodities, transportation, financials, real estate, chemicals, and manufacturing.

[9] IMF paper WP/11/19 Investment Objectives of Sovereign Wealth Funds—A Shifting Paradigm.

[10] See Eliot Kalter pension study on returns from diversification.
http://www.sbs.gob.pe/repositorioaps/0/0/jer/presentaciones_aios_2010/Oportunidades%20y%20riesgos%20en%20el%20uso%20de%20instrumentos%20de%20inversiones%20alternativas,%20Eliot%20Kalter.pdf

The reasons driving this diversification of asset allocation are clear, with investors searching for higher returns in riskier assets and the lower risk through well diversified portfolios. As stated in a recent publication by the New Zealand Superannuation Fund, "investors with a long-term horizon can outperform more short-term focused investors over the long term…risk and return are strongly related, with investment diversification improving the risk to return ratio of the Fund." [11] However, the question must be addressed as to whether the capacity of SWFs and other LTIs to take into account relevant risk factors has grown at the same pace as their rapid asset allocation diversification.

Sovereign and company risk assessment traditionally take into account solvency risk (the underlying ability to meet obligations) as well as liquidity risk (sufficient cash flow to meet current obligations). The IMF analyzes macroeconomic, financial and structural factors that result in a country's projected economic growth, debt and debt service and, thus, a country's ability to meet current and future (domestic and external) obligations. Risk analysis for market portfolios is well covered by financial advisory firms based on an assessment of risk characteristics of asset classes and the correlation of fund holdings. A good example of this approach is the State Street Global Markets use of five tenets of portfolio construction that take into account, inter alia, non-normal return distributions such as "fat tails", correlations between fund holdings and the returns from the source of funding, and "risk factor analysis" to identifying underlying investment risk factors that describe the return variation in a particular portfolio or asset.[12]

---

[11] New Zealand Superannuation Fund, "How We Invest"
http://www.nzsuperfund.co.nz/index.asp?pageID=2145893772

[12] State Street "Regimes, Risk Factors, and Asset Allocation" September 2011, Will Kinlaw

However, the analysis of political risks that underlie the sustainability of the above-mentioned decision frameworks within which investment decisions are made has not kept up with SWF and other LTI asset diversification. Political risk is commonly defined in terms of unexpected political climate, where investors must take into account underlying causes for adverse political change or "any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives."[13]

Political risk can also stem from investors not well understanding the eventual impact of existing political climate. For example, in a macro sense, investors did not fully incorporate the financial implications of the political/social system in the EU which lead to unsustainable budgets in the face of structurally low growth. Similarly, investors did not take into account the impact of the anti-regulatory bias that existed in the main financial center countries with competition for business leading to sub-optimal regulatory frameworks. In the micro sense, political risk exists, *inter alia*, if there is not a clear understanding of the existing relationship between governments and their labor unions, or the judiciary system that may be biased or underdeveloped with consequences for business operations and growth.

Importantly, SWFs must not only face political risk in the country targeted by their investments but also political risk in the country of SWF origin. Based on the EIU Democracy Index, over half of SWF assets have authoritarian regimes as their origin.[14] This increases the risk of political upheaval or sudden asset allocation shifts with pressure for SWF assets to be used for shorter-

[13] Eurasia Group and PricewaterhouseCoopers, "Integrating Political Risk Into Enterprise Risk Management" 2006.

[14] Taming Leviathan: a Regulatory Framework for Sovereign Wealth Funds, Bocconi University, November 2011

term investments or public savings, financial sanctions freezing SWF assets, and investments made for political rather than commercial purposes.[15]

While political risk analysis is important for all investors, it is particularly important for investors that are not only well placed, but also politically and financially depended upon, for long-term investments. We emphasized above that within a volatile global financial environment, SWFs have the capacity to become increasingly important as a source of long-term financing and global stability. However, we have also seen that SWFs will quickly withdraw from sectors (reduced allocations to the financial sector following losses after the 2008 crisis) and geographic regions (the current reduced allocation to EU countries) when they have made decisions without better understanding of political risks. Emphasis must thus be made on a number of fronts to better equip SWFs and other LTIs to account for political risk consistent with the speed of their asset diversification.

This effort is already underway on a number of fronts. The credit rating agencies take political country risk into account by looking to some degree at factors like level of democratization, the concentration of decision making, the level of corruption, and the independence of judiciary. OPIC has begun the process of developing political risk insurance, so far aimed at private equity funds investing in renewable energy. The Generally Accepted Principles and Practices issued by the International Working Group of Sovereign Wealth Funds in October 2008 (the "Santiago Principles") are seen as a positive way of promoting free global capital flows. Nevertheless, the ongoing euro drama makes it clear that in assessing risk SWFs will need to deepen their analysis

[15] Eliot Kalter and Thomas F. Holt, Jr., "Key International Issues for Sovereign Wealth Funds," The Fletcher School Sovereign Wealth Fund Initiative, Fall 2009. Available at: http://fletcher.tufts.edu/SWFI/~/media/Fletcher/Microsites/swfi/pdfs/SWFI_KeyIssues_FINAL_10-2009.pdf

of countries' socio-political dynamics affecting both country and company risk. This includes the need for a clear-eyed assessment of a country's political ability to confront growing public sector indebtedness and the willingness of its citizens to accept fiscal austerity. SWFs and other LTIs more generally must now deepen their understanding of recipient countries socio-political risks and develop strategies that take into account countries' financial, political and social interests and priorities.