Into the Institutional Void: Managing the Sovereign Wealth of Emerging Economies

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Introduction

Over the last 6 years, the term "sovereign wealth fund" or SWF has become firmly established in the lexicon of global finance. As many before us have well established, these entities are neither recent phenomena, nor homogeneous enough in substance to warrant such a unitary moniker. In fact, sovereign investment vehicles in the modern sense have been in existence since the establishment of the Kuwait Investment Office in 1953. They represent a very heterogeneous mix of investment pools that differ markedly by origin, size, purpose, mandate, and investment strategy. They are dynamic institutions, whose purpose and mandate can and does change over time[2] and so can be linked in parallel fashion with the development agenda and objectives of their sovereign. In this regard, SWFs are institutions largely created by and exploited for the benefit of emerging economies, i.e. they are emerging market institutions.[3] Furthermore, and importantly, since 2000, within emerging economies, they have been rapidly increasing in both size and number even as new funds enter the planning stage.

In this chapter, our goal is to offer an analytical overview of the roles and investment practices of SWFs in emerging economies. Our focus is to examine both the recent growth of sovereign investment vehicles, as well the investment patterns of these entities in order to understand their role in the overall development agenda of an economy.

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[2] See Jonathan Brookfield, Ravi Shankar Chaturvedi, and Patrick Schena, "Sovereign Wealth Funds and the Privatization of State Assets: Toward a Life-cycle Framework", in Braving the New World: Sovereign Wealth Fund Investment in the Uncertain Times of 2010, Monitor Group, 2011

[3] Javier Santiso also eloquently makes this point. See Javier Santiso, "Sovereign Development Funds: Key Financial Actors of the Shifting Wealth of Nations", EmNet Working Paper, OECD, October 2008

The chapter proceeds as follows. In section 1 we briefly define and explain the raison d'etre of the sovereign investment vehicle. In section 2 we consider the emergence and growth of SWF in emerging economies. Our focus is to establish our premise of SWFs as distinctly emerging market institutions that are designed to address the challenges of development and economic growth. We document the rapid expansion of SWFs in emerging economies since 2000, explore the drivers for such growth and the paradox of an outbound investment agenda relative to the needs of national development. In section 3, we focus discretely on the tensions created by an inward investment program. Finally in section 4 we summarize our findings and offer reflections to consider the way forward for SWFs in emerging economies, including the challenges that remain.

Among our key findings, we observe that there has been a rapid increase of SWFs in emerging economies since 2000. In addition, there has also been a sustained flow in the number of new funds planned. The primary drivers for the creation of new SWFs are both financial and institutional. From a macro financial perspective, the growth in SWFs is directly attributable to the sizable global current account imbalances, the associated build-up in foreign exchange reserves, and the opportunity costs of efficiently managing these reserve assets. Institutionally, the SWF structure serves as a means to fill various institutional voids, including governance, accountability, and transparency.

Not all SWFs in emerging economies are created equal. Large funds tend to dominate outward investment activity, both portfolio and DFI. SWF investments are broadly diversified. Portfolio investments have been prioritized to developed markets, but with increasing allocations to emerging and frontier economies, as these markets deepened and represent good opportunities for risk diversification. With respect to outward direct investments, SWFs differentiate sector preference based on target geography. In developed economies, investment concentration has focused on four key sectors: financial services, real estate, and energy. In emerging economies investments have been focused on natural resources and increasingly on infrastructure and related sectors. Finally, whereas SWF DFI had in most years been dominated by flows to developed economies, we detect a discernible shift in that pattern to emerging economies since 2011.

Minding the Institutional Void

All too frequently, the definition of a sovereign wealth fund is designed to support or accentuate the focus of one's analysis. Here we prefer a broad definition that allows us to capture processes of institutional change within funds. Accordingly, we define sovereign investment vehicles as discrete publicly owned investment companies or state agencies whose specific purpose is to invest public-owned or stewarded assets for the preservation and appreciation of stakeholder wealth.[4] This definition does not discriminate in favor of the nature of assets (portfolio investments versus real assets), ownership (excess reserves versus pension assets of state employees), or mandate (inter-generational wealth transfer versus economic development). Rather its primary definitional nexus is its purpose. For clarity, we exclude from our definition profit-seeking operating companies, specifically state-owned operating companies.

To study SWFs institutionally in the context of an emerging economy, we first consulted the World Bank classification scheme, which ranks economies based upon income per capita and defines emerging economies as those with per capita GDP below the high-income threshold of $12,476.[5] However, our preference is to combine this formal definition with a more functional approach. Whereas in advanced economies both public and private actors can rely on a variety of outside institutions to minimize sources of market failure, this is not necessarily the case in emerging economies. Rather emerging economies' growth potential has been inhibited because of inadequate or incomplete

[4] This definition is broadly consistent with that suggested by the International Forum of SWF. See …
[5] Other definitions are more subjective. For example, McKinsey uses a (self-described) more simplistic approach. See …

institution building. Institutional voids remain to cause market failures – product, service, and financial.[6]

It is into these institutional voids that sovereign investment vehicles have appeared in emerging economies. Whether to channel the volatile flows of commodity revenues, stabilize fiscal spending, manage the build-up of foreign exchange reserve, privatize state assets, invest in domestic infrastructure, transform resource to financial wealth, or promote accountability and enhanced governance, SWFs serve as a bridge between developed markets and the broader global economy and their unique domestic contexts. As such they represent a heterogeneous mix of investment programs.

Most formally, based upon an IMF classification scheme, SWFs are generally categorized as stabilization funds, savings funds, pension reserve funds, or reserve investment corporations. To this we add development funds. The majority of SWFs have been established as inter-generational savings funds or fiscal stabilization funds, with sovereign pension and reserve investment funds fewer in number. Importantly, some sovereign vehicles have multiple objectives (or are transitional in nature), while other sovereigns (e.g. Singapore and UAE) have established multiple funds each with separately defined purposes, mandates, and investment activities.[7] Sovereign development funds (Khazanah, Mumtalakat, and Mubadala are noted examples) in some cases operate as state holding companies. They often are capitalized with transfers of real assets, including shares of state-owned enterprises. Their charters include the management and privatization of these assets. Singapore's Temasek represents an interesting example of a fund that has effectively transitioned from a development fund to a long-term savings vehicle.

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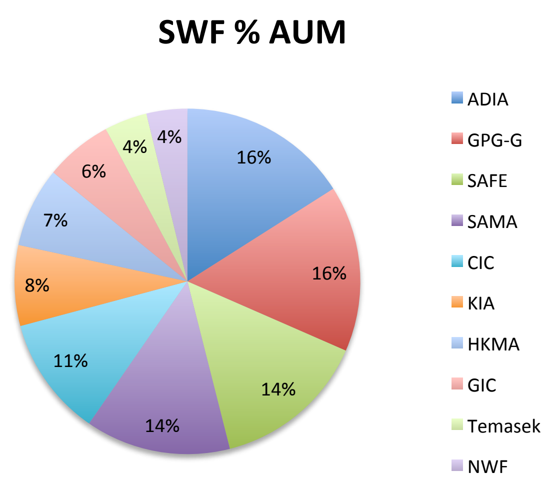
[6] Tarun Khanna and Krishna Palepu, "Why Focused Strategies May Be Wrong for Emerging Markets". Accessed http://hbr.org/1997/07/why-focused-strategies-may-be-wrong-for-emerging-markets/ar/1

[7] Peter Kunzel, Yinqiu Lu, Iva Petrova and Jukka Pihlman, "Investment Objectives of Sovereign Wealth Funds—A Shifting Paradigm", IMF Working Paper, Prepared by, January 2011

At year-end 2012, SWFs had over $5T in asset under management.[8] Among SWFs asset concentration (see Figure 9) is high with the top 10 funds holding 78.8% of total SWF AUM, the top 20 funds 93.1 %, and 18 funds holding assets in excess of $50B.

Figure 1



Source: Fletcher SovereigNET, Sovereign Wealth Fund Institute

Based of the diversity in purpose and mandate, investment allocation patterns vary and broadly speaking are driven less by sovereign status or asset ownership, but rather based upon mandate, investment horizon, and liability structure. Many SWFs enjoy the competitive benefit of long investment horizons that allows them to harvest liquidity premia, as part of a broad-based risk diversification strategy. SWF asset allocations are also significantly influenced by global macroeconomic and financial factors. In recent years low returns across developed market equity and fixed income have increased SWF interest in emerging and frontier markets, as well as in those asset classes that have traditionally enjoyed higher risk-adjusted returns, such as as private equity and real estate.[9]

Table 1

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[8] Cited by TheCityUK, accessed www.thecityuk.com/research/our-work/articles-2/sovereign-wealth-funds-target-realestate-as-global-assets-hit-record-5-2-trillion/.

[9] See Eliot Kalter "Institutional Investor Asset Management in a Low Return/High Risk World", delivered at the Institutional Investor Americas Government Funds Roundtable in September 2012 accessed at http://fletcher.tufts.edu/sovereignet

Country	Fund	Purpose	Source
Kazakhstan	Kaz Natl Fund	Stabilization	Oil
Algeria	Rev Reg Fund	Stabilization	Oil
Iran	Oil Stab Fund	Stabilization	Oil
Singapore	Temasek	Savings	Non-commodity
US-NM	NM St Inv Council	Savings	Non-commodity
Brazil	Sov Fund	Savings	Non-commodity
UAE	ADIA	Savings	Oil
Kuwait	KIA	Savings	Oil
Qatar	QIA	Savings	Oil
UAE	ICD	Savings	Oil
Libya	LIA	Savings	Oil
UAE	IPIC	Savings	Oil
US	AK Per Fund	Savings	Oil
Brunei	Brunei Inv Agency	Savings	Oil
US	Texas Per School	Savings	Oil
Canada	AB Heritage Fund	Savings	Oil
Oman	Gen Res Fund	Savings	Oil & Gas
China	SAFE	Reserve Investment	Non-commodity
China	CIC	Reserve Investment	Non-commodity
China	HKMA	Reserve Investment	Non-commodity
Singapore	GIC	Reserve Investment	Non-commodity
Korea	KIC	Reserve Investment	Non-commodity
Saudi Arabia	SAMA	Reserve Investment	Oil
China	NSSF	Pension Reserve	Non-commodity
Australia	AFF	Pension Reserve	Non-commodity
Ireland	NPRF	Pension Reserve	Non-commodity
New Zealand	NZ Super Fund	Pension Reserve	Non-commodity
Russia	NWF	Pension Reserve	Oil
Norway	GPG-G	Stab/Savings/Pension	Oil
Azerbaijan	State Oil Fund	Stab/Savings	Oil
East Timor	Tiimor-Leste	Stab/Savings	Oil & Gas
Chile	Soc & Eco Stab Fund	Stab/Pension	Copper
Malaysia	Khazanah	Sov Dev	Non-commodity
Bahrain	Mumtalakat	Sov Dev	Non-commodity
UAE	Mubadala	Sov Dev	Oil
France	Strg Inv Fund	National Strategic	Non-commodity

Source: Fletcher SovereigNET, Sovereign Wealth Fund Institute

The asset allocation patterns for macro stabilization funds are dependent upon a number of factors, particularly funding source (e.g., whether fiscal or foreign exchange surplus or commodity revenue) and constraints imposed by implicit or contingent liabilities. Such mandates are designed to smooth fiscal gaps in domestic budgets and so are constrained by underlying liability structures primarily contingent on fiscal shortfalls. Accordingly, stabilization funds tend to adopt asset allocations heavily oriented to cash and fixed income securities and avoid less liquid assets. Examples include Chile and

China's SAFE[10], who hold sizable positions in liquid assets, but very low or zero allocations to alternatives. Chile's Social and Economic Stabilization Fund has in fact consistently maintained holdings of 70% in fixed income and 30% in cash.

In contrast, savings funds with less rigid liability structures, have longer effective investment horizons and so adopt more aggressive investment strategies by geography and asset class, along with higher allocations to alternative assets. An example in this classification is Alberta's Heritage Savings Trust Fund, which increased allocation to alternatives between 2008 and 2010 from 18% eventually to 24%.

SWFs with pension-like mandates have exhibited two distinct allocation patterns. The Norway fund and China's National Social Security Fund in 2010 have no allocation to alternatives. However, since that time Norway has approved up to a 5% allocation to real estate and has also made several investments under that allocation. The NSSF[11], however, maintains a rather static 60/40 allocation to equities and fixed income. The New Zealand, Irish, and Australian, and funds conversely make aggressive use of alternative assets. In 2010, these were 21%, 21.3%, and 25.1% respectively. Among pension-like funds, Australia demonstrated the most marked shift towards alternatives increasing its allocation from a low of 1.5% of assets in 2008, including investments in real estate, infrastructure, and other alternatives.

Finally, among investment reserve funds the Korea Investment Corporation, the China Investment Corporation, and the Government Investment Corporation of Singapore aggressively diversify their portfolios both geographically and by asset class and in so doing maintain significant allocations to alternative assets. The GIC for example holds sizeable allocations to both real estate and private equity, as well as others holdings in hedge funds and commodities. The KIC, who once maintained a 20% allocation to

[10] SAFE serves as the vehicle that invests most of China's foreign exchange reserves. As such its mandate includes features of traditional reserve asset management.
[11] The NSSF will hold private positions in Chinese financial services firms.

alternatives, primarily in structured products, has eliminated those positions and is rebuilding its alternatives allocation with positions in real estate, private equity, hedge funds, and commodities totaling 6.8%.[12]

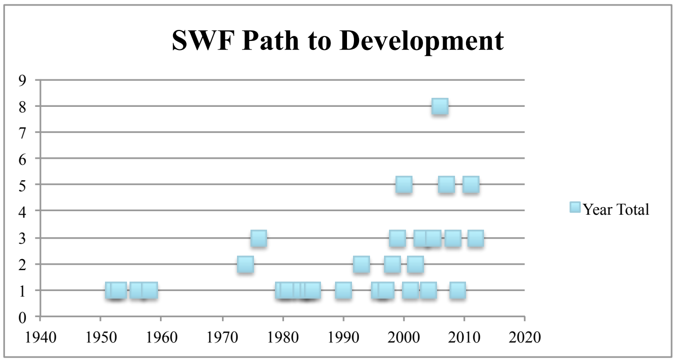
The largest sovereign investors also maintain active programs in direct investing. This activity is heavily concentrated among funds and in sectors where capacity – in private equity investment and sector analysis particularly – has been developed. For example in 20011 and 2012 both the 10 most active SWF investors accounted for 10 approximately 80% of total transactions. Among these the three Asian reserve funds - CIC, GIC, and Temasek - alone are responsible for nearly 50% of transactions. From a sector perspective, sovereign funds have exhibited a strong preference for investments financial services, as well as in natural resources, real estate and infrastructure, the latter all with commodity and real asset exposures similar to other alternative strategies. Together these four sectors accounted for 75-80% of all SWF transactions in 2011 and 2012.

Surging SWFs in Emerging Economies and The Paradox of Outbound Investment

Though some funds predate, most of the activity related to the creation of sovereign investment vehicles has occurred since 1990. Furthermore the emergence of new funds has accelerated still further since 2000. As indicated in Figure 1, 40 new funds have been established since 2000. These represent 61% of total SWFs. Notice both the clustering since 2000, as well as the concentration of fund activity in years when multiple funds were established.

Figure 2

[12] See GIC and KIC websites



Source: Fletcher SovereigNET, Sovereign Wealth Fund Institute

Today sovereign investment vehicles are in number broadly distributed geographically, though, on an asset basis, they are especially concentrated in East Asia and the Middle East, where over 72% of the assets of sovereign wealth funds originate. Table , along with Figure , provide a view into the formation and size of sovereign wealth funds and clearly demonstrate the recent acceleration in the build-up of sovereign assets.[13] Importantly, of the 40 funds created since 2000, 31 or 78% are in what might be broadly defined as emerging market economies.

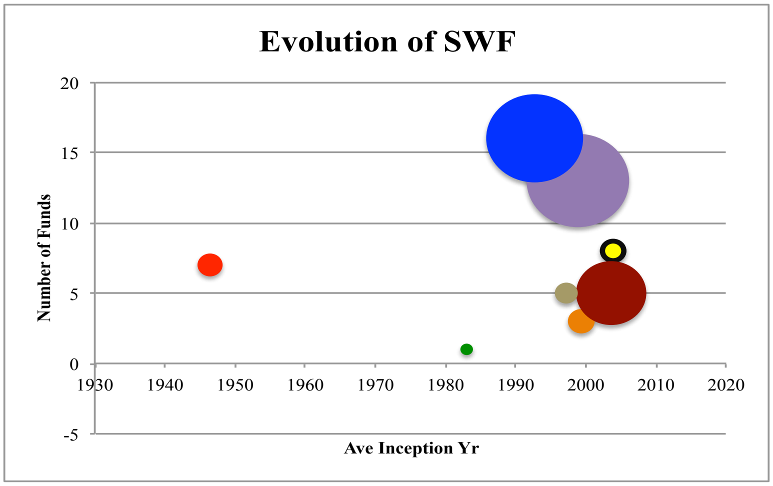
Table 2

Region	AF	CA	EA	EU	LA	ME	NA	PC	SA
Number	8	3	13	5	8	16	7	5	1
AveYr of Incep	2004	1999	1999	2004	2004	1993	1946	1997	1983
Total Size	135	137	2,000	938	49	1,786	120	100	30

Source: Fletcher SovereigNET, Sovereign Wealth Fund Institute

Figure 3

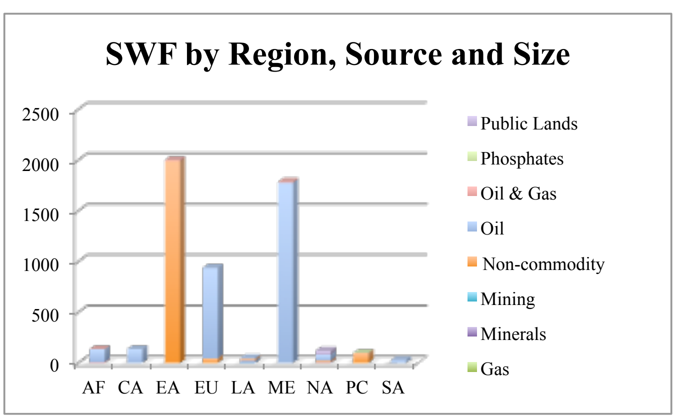
[13] In order to represent aggregate fund inception by region, we employ an arguable crude measure in Table 1 and Figure 2, which simply averages fund year of initiation for all funds within a region.



Source: Fletcher SovereigNET, Sovereign Wealth Fund Institute

Traditionally the assets of sovereign wealth fund stem from three principal sources: commodity revenues, excess foreign exchange reserves, and real state assets. Figure 3 provides a graphical representation of sovereign wealth fund assets by region and source. It is evident from the chart that the vast majority of sovereign assets have derived from oil exports or excess reserves primarily resulting from structural balance of payments surpluses. The sovereign funds in East Asia, most notably the GIC in Singapore and the China and Korea Investment Corporations, primarily fund their SWFs from excess budgetary or foreign exchange reserves. By contrast the funds in the Gulf, Africa, Central Asia, and Europe, i.e. specifically Norway, are largely funded from petroleum revenues.

Figure 4



Source: Fletcher SovereigNET, Sovereign Wealth Fund Institute

From a macroeconomic perspective, the creation of a sovereign investment vehicle is frequently the result of economic challenges posed by the rapid and recurring accumulation of state assets, either through the sale of state-controlled commodity inventories or the build-up of excess foreign exchange reserves. These are accentuated by rising resources prices and increases in commodity exports and capital flows. While each of these is generally considered a positive development outcome, together they can become especially acute challenges, where the absorptive capacity of the local economy is inadequate to permit the investment of these assets domestically. In the case of commodity exporters, particularly petroleum, public, as well as macro-economic, policy is further complicated by what Michael Ross refers to as the four distinctive qualities of petroleum revenues: scale, source, stability, and secrecy.[14] Specifically, the base of oil revenues usually results from the large scale, recurring sale of state petroleum assets where year-over-year volumes can be extremely unstable owing to the volatility in global commodity prices. This can result in fiscal instability, as state budgets fall prey to fluctuations in state revenues. Moreover, given the sector concentration of wealth, there is frequently a shroud of secrecy that envelops the state oil sector, which further complicates effective resource management [15]

Beyond the budgetary challenges of managing resource wealth, sectoral imbalances in the domestic economy can suppress non-resource sectors, such as manufacturing and agricultural, i.e. the so-called "Dutch Disease". The impact is two-fold. First, as the resource sector expands it draws labor and capital away from other sectors and in so doing raises their production costs. Second, as monies earned in the resource sector enter the local economy, they increase the country's real exchange rate, reducing the cost

[14] See Michael Ross, The Oil Curse: How Petroleum Wealth Shapes the Development of Nations (Princeton, NJ: Princeton University Press, 2012)

[15] For example, Ross reports a recent analysis of Cameroon, which found that 46% of state oil revenues between 1977 in 2006 were transferred to the national budget, while the remaining 54% could not be accounted for. See Ross, p

of imports. Imported goods replace those domestically produced and so further suppress the affected industrial or agricultural sectors. [16]

Among other effects, the Dutch Disease can result in inflation, higher real exchange rates, and uneven or distorted sectoral development in the local economy. Because absorptive capacity is developed gradually, there is a need to capture and manage this accumulation of assets in order reintegrate them into the domestic economy upon based its ability to absorb them efficiently and without externalities.[17]

Commodity-based economies are much more vulnerable to the Dutch Disease than other export-driven economies. Because exchange rate appreciation affects all sectors of a local economy, in a commodity-exporting economy, non-commodity exports diminish, burdened by an exchange rate that does not reflect their international competitiveness. In such cases, economic policy must address this issue - for example through transfer payments to the non-commodity sector - or face the demise of significant employment centers. In contrast, exchange rate appreciation in economies with a broader export base will represent the relative competitiveness of a large part of the export sector. In these circumstances, policy makers must determine whether the factors driving the exchange rate appreciation are long-term and structural or short-term. If the latter the Central Bank may chose to absorb the currency appreciation through exchange rate intervention resulting in a further accumulation of international reserves. Such action will require sterilization to offset the inflationary impact of the reserve accumulation. However, if the factors driving the currency appreciation are structural in nature, then coordinated policy action would allow the exchange rate to appreciate, while tightening fiscal policy, thereby reducing real interest rates and the incentive for capital inflows.

[16] Ibid.

[17] Massimiliano Castelli and Fabio Scacciavillani, The New Economics of Sovereign Wealth Funds (West Sussex: Wiley, 2012)

The sovereign investment vehicle enters this policy role, tailored upon the overall macroeconomic policy agenda and investment priorities of the country. By capturing excess revenues in a systematic fashion and investing them in a diversified portfolio of foreign assets, governments can leverage a sovereign fund to further insulate the domestic economy from inflationary pressures, while earning higher risk adjusted returns on invested assets and delivering other benefits, including flexibility in hedging fluctuations in commodity prices and providing enhanced governance.[18] This mandate to invest externally – in many cases by law[19] - is indeed paradoxical given what are in many cases the extensive development needs of the local economy. However, it is by strict adherence to this mandate that the country's development program is protected against unbalanced sector development and the negative impacts of inflation and high real exchange rates. In this regard, the example of Papua New Guinea (see Box Case 1) serves as an interesting case in point.

Box Case 1: Papua New Guinea

> The government of PNG was faced with sizable new source resource revenue from liquefied natural gas production. Its past experiences with a Mineral Resources Stabilization Fund established in 1974 and other trust account models were mixed. Under those frameworks, proceeds were invested domestically, resulting in a high opportunity costs stemming from low returns on domestic assets and the limited size and scale of domestic financial markets. In this case, the state recommended formation of a single sovereign investment vehicle that would be able to deploy assets outside of the domestic economy. Among the drivers in this case was the challenge of the economy to absorb the large amounts of additional government spending without causing excess aggregate demand pressures, resulting in high imports. An additional concern was that the increased liquidity in the economy would also increase inflationary pressures. The rationale was that an investment program that was externally oriented would help protect the competitiveness of the non-resource sectors of the local economy by sterilizing mineral resource revenues. The government believed that investing the proceeds offshore would give it the flexibility to invest in the domestic economy consistent with its absorptive capacity and at a rate "that does not unduly appreciate the currency or cause undue inflationary pressures".[20]

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[18] Ibid.

[19] Many countries – e.g. Korea – prohibit their SWFs from investing domestically.

[20] Department of Treasure and Bank of Papua New Guinea Joint Sovereign Wealth Fund Working Group, Discussion Paper: Possible Creation of a Sovereign Wealth Fund, 16 April 2010

The new fund in PNG was established in 2011, having its origin in LNG revenues. It was one of five funds established in 2011, and as noted one of 40 established since 2000. Consistent with the prescribed macroeconomic role of SWFs, these new funds have been sourced overwhelmingly from resource or export earnings (see Table 2), generated by persistent current account surpluses resulting from increasing commodity prices and strong export-led growth models combined with a competitively managed approach to exchange rates.

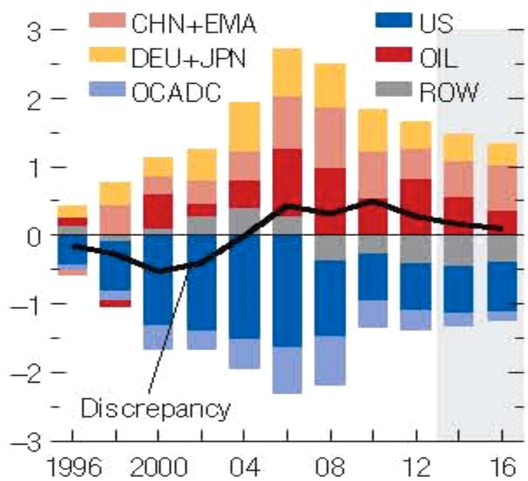
Table 3

Count of Region	Column Labels							
Row Labels	Copper	Gas	Minerals	Mining	Non-commodity	Oil	Oil & Gas	Grand Total
2000					1	4		5
2001					1			1
2002						2		2
2003					2	1		3
2004					1			1
2005					1	1	1	3
2006	1				2	4	1	8
2007	1				2	2		5
2008					1	2		3
2009					1			1
2011		1		1	1	1	1	5
2012			1		1	1		3
Grand Total	**2**	**1**	**1**	**1**	**14**	**18**	**3**	**40**

Source: Fletcher SovereigNET, Sovereign Wealth Fund Institute

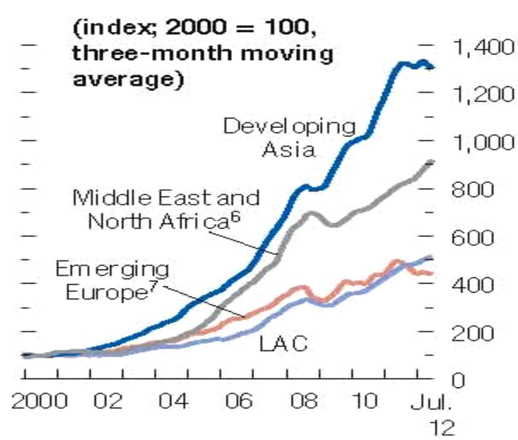
This pattern is consistent with the pace and direction of the build-up in foreign exchange reserves beginning in the aftermath of the Asian financial crisis in 1998. Much of this growth is attributable to very sizable external current account imbalances (see Figure 4), especially among emerging economies, which rose from 1% to 3% of GDP by 2006. As illustrated in Figure 5, developing Asia's international reserves have increase by 1300 percent since 2000, those of the Middle East and Africa by 900 percent; there were also important increases in Emerging Europe and Latin America. While this capital flowed into existing funds, it was also instrumental in fostering the formation of new funds. In addition to PNG, others of these in emerging economies included funds in three BRIC countries – Russia, China, and Brazil.[21]

Figure 5



Source: IMF WEO, 2012

Figure 6



[21] The Indian government, after long deliberation, at this point has decided that its foreign reserves were not sufficient to establish a sovereign investment vehicle. For background, see "Sovereign Wealth Fund Plan Scrapped", The Indian Express, Febuary 25, 2013 - http://www.indianexpress.com/news/sovereign-wealth-fund-plan-scrapped/1079153/

Source: IMF WEO, 2012

Earlier in this section we referenced the challenges posed by the secrecy with which resource revenues are often managed. This lack of fiscal transparency presents ample opportunity for corrupt behavior to siphon revenues for the private gain of officials and others. The sovereign investment vehicle can also address this dimension of institutional void by providing a systematic and transparent framework to capture, invest, and manage sovereign assets for the benefit of all stakeholders. We recognize that, because of institutional gaps, including the full imposition of rule of law, the general quotient for corruption may be higher in emerging, than developed, economies, perhaps by definition. Thus, we acknowledge an inevitable degree of selection bias as countries adopt SWFs. We examined this in the newly established funds. Specifically, we coded each of the countries that have established funds since 2000 based upon their Transparency International score[22] in the inception year of the fund. Based on the analysis, we find among newly established funds, that 42 percent of funds had TI scores of less than 3 in the year that their SWF was established, while 68 per cent of funds had scores less than 5. If developed economies are excluded, 54 and 79 per cent of emerging economies have scores less than respectively 3 and 5. Though hardly causal, this analysis suggests the opportunity for SWFs to contribute to institution-building in the management of state assets.

If one were to first accept our premise that SWFs are indeed emerging market institutions, then acknowledge as a primary motivation for the establishment of SWF a desire to effectively manage capital flows so as to insulate domestic economies from externalities associated with high levels of export earnings, then directionally we might expect that SWF investment flows would be predominantly outbound (except in the

[22] The TI variable a corruption perception score on a 10-point scale compiled by Transparency International. See http://www.transparency.org.

special case of sovereign development funds to which we will return in the next section). Furthermore, to the extent that such revenues pools are invested in liquid, exchange-traded securities, then they must find their way to deep, well-developed capital markets, as predominantly found in developed economies. Similarly, with regard to direct investments, the legal and governance frameworks of developed market countries also have appeal in attracting direct foreign investment (DFI), whether by SWFs or other investors.

This rationale is born out when examining the investment patterns of sovereign wealth vehicles. SWFs are primarily portfolio investors with some 95% of their assets invested in traded securities.[23] As noted, SWF investment strategies include sizable allocations to global equity and fixed income securities, as well increasing positions in alternative or absolute return strategies the utilize both private equity and hedge funds. Despite having both fixed and contingent liabilities in local currency, SWFs located in economies with small or less developed equity and fixed income markets will prefer the liquidity and scale afforded by developed global markets. New Zealand is an interesting case in point. The New Zealand Superannuation Fund, established in 2003 employs a reference portfolio as a benchmark against which to invest the assets of the Fund. The Reference Portfolio is broadly defined as 20% fixed income, 70% global equity, 5% listed property, and only 5% New Zealand equities. Actual holdings will vary from time to time based on the market outlook of the Fund's managers. For example at year-end 2012, the Fund had actual holdings of New Zealand equities equal to 23% of its portfolio (a considerable overweighting against its benchmark).

A predisposition for outbound investment is equally pronounced when examining the direct investment patterns of sovereign investment vehicles. Annual analyses by the UN Conference on Trade and Development monitor DFI flows of sovereign funds. As

[23] World Investment Report 2012, UNCTAD

suggested in Table 3, since 2005 SWFs have invested over $125B in direct cross-border deals with nearly two-thirds *of the value* of these investments made in developed economies, primarily Europe.

Table 4

Table I.5. FDI by SWFs by host region/country, cumulative flows, 2005–2011
(Millions of dollars)

Target economy	2005	2006	2007	2008	2009	2010	2011
World	**11 186**	**19 005**	**39 673**	**63 085**	**93 476**	**106 534**	**125 152**
Developed economies	**5 738**	**12 582**	**26 573**	**38 354**	**62 016**	**71 722**	**84 346**
Europe	4 394	9 438	17 775	23 429	39 078	42 148	53 143
European Union	4 394	9 438	17 746	23 399	39 049	42 118	53 113
United States	125	1 925	5 792	10 210	10 335	12 007	14 029
Developing economies	**5 449**	**6 423**	**12 926**	**23 544**	**29 277**	**31 210**	**35 868**
Africa	900	900	1 304	7 560	7 560	8 973	11 418
Latin America and the Caribbean	228	228	1 149	1 216	1 291	1 696	3 118
East and South-East Asia	4 278	5 040	5 270	7 366	9 845	9 930	10 721
South Asia	43	143	1 092	1 209	1 239	1 268	1 268
West Asia	-	112	4 112	6 193	9 343	9 343	9 343
Transition economies	**-**	**-**	**174**	**1 187**	**2 183**	**3 602**	**3 938**

Source: United Naitons Conference on Trade and Development

When one examines SWF investment behavior on the basis of transactions, this similar directional pattern reappears. Using the Monitor-Fletcher SWF Transaction Database as our source, we analyzed SWF transactions from 2007 through 2012. The SWF DFI activity in this period is highly concentrated with nearly 74% of all transaction occurring in 15 countries, many developed economies. However, and importantly, a trend analysis of the transactions shows a structural shift in 2011 and 2012, as more SWF deals were completed in these years across non-OECD countries than within the OECD.

Table 5

Count of Parent Ent	Column L		
Row Labels	Domestic	Foreign	Grand Total
United States	4	148	152
UK		105	105
UAE	73	12	85
South Africa	13	17	30
Singapore	40	19	59
Qatar	18	1	19
Malaysia	34	20	54
Japan		19	19
India		68	68
Germany		18	18
France		21	21
China	40	98	138
Canada		31	31
Brazil	1	17	18
Australia	5	40	45
Grand Total	**228**	**634**	**862**
% Total	**26.5%**	**73.5%**	

Source: Monitor-Fletcher SWF Transaction Database

Figure 6

Source: Monitor-Fletcher SWF Transaction Database

Finally, as is also evident from Table 5, when the investments in these 15 target economies are analyzed with respect to the direction of the investment, i.e. where the transaction was made by a foreign SWF or by the host country's SWF, we find that over 73% of these deals where in fact outbound, i.e. made by a foreign SWF.

The Development Agenda and the Tensions of Inward Investment

A fundamental concern in establishing a sovereign wealth fund is the means by which the entity is integrated into the development agenda of the host country. If properly designed, the fund can contribute directly to realizing the host country's development goals first by insulating the local economy against the ill effects of inflation and high real exchange rates, then by taking a lead role inward investment. However, the tensions associated with an inward investment program must be balanced against the pressing development requirements of the host country. Dixon and Monk[24] suggest a staged approach. Because the commodity price volatility of a resource base is the most damaging factor for developing economies it is the most important factor to address first. The approach they propose is sequenced. In the first stage a country with substantial resource wealth would give priority to deploying a stabilization fund in order to sterilize commodity and export revenues. This includes confronting "smooth commodity price volatility by setting clear rules for the disposition of revenue during periods of high commodity prices so that the government has a stable source of income following clear withdrawal rules during periods of low commodity prices".

After having provided a base for fiscal and monetary stability, the host government is advised to establish a development fund to make strategic investments - also domestically - that support wider social and economic objectives, including industrialization. The development fund complements direct investments through the state budget allocation process. A secondary benefit of a development fund might be to support co-investment by foreign investors who might otherwise be concerned about issues of governance and political risk. Finally a development fund, functioning as a quasi-private equity investor, can also promote the development of domestic capital markets by enhancing the governance of pre-IPO companies, thereby improving the overall investment climate.[25]

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[24] Adam Dixon and Ashby Monk, "What Role for Sovereign Wealth Funds in Africa's Development?", Oil-to-Cash Initiative Background Paper, Center for Global Development, October 2011. In this analysis, The authors target their comments to Africa specifically, but their prescriptions are broadly applicable to both commodity and non-commodity emerging economies.

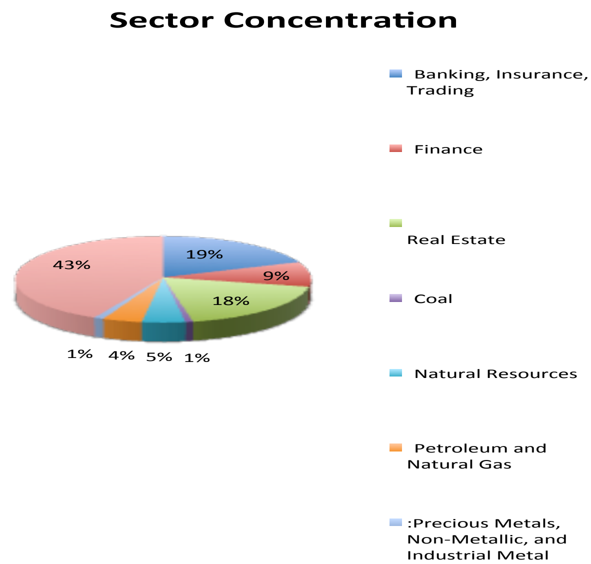
[25] Dixon and Monk advise finally that emerging economies later establish a savings fund as excess reserves build in order to support intergenerational wealth transfer and prevent the expropriation of revenues in favor of future consumption.

Returning to Table 5, in its interesting to note that among the 15 target economies analyzed domestic deals are especially pronounced in the case of three countries - UAE, Singapore, and Malaysia (well over 50% of the total). In each case, the host country has established an investment vehicle whose principal purpose is to effectively oversee the management of state assets (including privatization) and to invest in strategic sectors of the domestic economy. Such funds advance a development mandate often under a different operating model than that used for outward investment. They also frequently take the form of holding companies and require sizeable amounts of both short and long-term operating capital to support their investment programs, as well as the liquidity or capital needs of portfolio companies. [26] Somewhat like development banks, development funds can enjoy greater access to capital – especially internationally - than selected investee firms and so function in some respects as internal capital market, whose investment priorities are defined in line with the host country's development agenda.

Development priorities are often revealed through transaction activity. With respect to sector preferences we note that much of SWF direct investment activity is highly concentrated by sector. For example, service sectors – particularly financial services and real estate - and extractive or natural resource sectors have attracted considerable SWF direct investment. UNCTAD's analysis of dollar volume of investment in this respect is also consistent with a transaction-level analysis. Figure 5 presents all SWF investment transactions between 2007 and 2012 focusing on highly concentrated sectors. It demonstrates that over 50% of investment transactions were made in these sectors. Such concentration also generally holds regardless of whether a SWF is investing domestically or outbound.

[26] See Patrick J. Schena and Ravi Shankar Chaturvedi, "Sovereign Wealth Funds, Debt Issuances, and the Development of Capital Markets" accessed at http://fletcher.tufts.edu/SWFI/~/media/Fletcher/Microsites/swfi/pdfs/Nov11SchenaChaturvediSWFBondIssuances.pdf

Figure 7



Source: Monitor-Fletcher SWF Transaction Database

Cross-sector investments - such as those in infrastructure - are often masked in sectoral analyses of this type. Because the scale and horizon of their investment programs enables SWFs to invest in long-term, large-scale projects, they are in many respects ideal infrastructure investors.[27] SWFs participate in the sector either through direct investments in projects, investments in companies, which provide infrastructure services, or investment in funds mandated to invest in the infrastructure sector. A cross-sector analysis of infrastructure-related investments has identified over 130 transactions in 2011 and 2012 collectively in sectors directly or indirectly related to infrastructure (including real estate, transportation, and extractive services).

This growing wave of cross-sector investment is consistent with the active efforts on the part of governments to build core infrastructure for sustainable economic growth. Host country SWFs participate both directly and indirectly either as joint venture partners or co-investors. In doing so they are able to facilitate inbound investment, while leveraging such partnerships to develop in-house capacity to do large direct deals. In this

[27] UNCTAD, p 14

regard, SWFs can complement the funding activities of regional and multilateral development banks. The Africa Development Bank, for example, has called upon African SWFs to 'spur intra-African investment through allocating part of their assets to growing sectors in Africa'.[28] Similarly the UNCTAD sees the potential of SWFs driving large-scale investment in development through general partnerships established independently or jointly with recipient country governments. Its 2012 World Investment Report cites the example of Qatar Holding's US$1 billion investment to establish a joint venture fund to invest in infrastructure and natural resources in Indonesia.[29] Despite its considerable interest in developed market real estate and showcase assets,[30] the QIA is reported to have considered or formally established other such vehicles – with Libya, Bulgaria, Malaysia, and India – presumably to advance both financial and its broader strategic interests.

It is interesting that India, with among the greatest infrastructure capital requirements, is the lone BRIC without a SWF. Over the last five years, the Indian government has actively courted Qatari investment.[31] More recently, the Indian Ministry of Finance has announced a concerted effort – to include government-sponsored road shows – more generally to attract SWF investment specifically to its infrastructure sector.[31] The Indian government is also seeking SWFs to invest in the proposed National Investment Manufacturing Zones (NIMZ) to be set up across the country.[32] Perhaps not coincidentally, the QIA has reportedly stated its intention to expanded it investment program in India to as much as US$10 billion annually.[33]

[28] See African Development Bank website, accessed www.afdb.org/en/blogs/afdb-championing-inclusive-growthacross-africa/post/the-boom-in-african-sovereign-wealth-funds-10198/
[29] World Investment Report 2012, UNCTAD
[30] For example, the QIA is the largest shareholder in Tiffany & Co
[31] India to woo sovereign funds to aid infrastructure projects', *Hindustan Times*, 14 January 2013
[32] Government eyes sovereign funds for NIMZs', *Hindustan Times*, 25 February 2013
[33] See 'Qatar Investment Authority looks to invest US$10 billion in India', *The Economic Times*, 11 April 2012, accessed http://articles.economictimes.indiatimes.com/2012-04-11/news/31325043_1_wealth-fund-foreigninvestors-investment-destination

Filling the Void: Reflections on a Way Forward

SWFs have been designed and deployed to address a number of the challenging macroeconomic problems faced by emerging economies. They are called upon to mitigate the externalities resulting from the development process itself – volatile revenues, inflation, real exchange rate appreciation, reserve accumulation, and the opportunity costs of holding excess foreign exchange reserves – while woven into the development agenda of the host country. As such they vary widely in purpose and mandate and their investment activities reflect this diversity.

SWFs have grown rapidly in size and number since 2000 primarily in non-OECD, emerging economies. Asset under management have also grown to over US$5 trillion establishing many of these investment programs as among the largest institutional investors globally and affording their host countries considerable 'voice' even beyond the global financial dialogue. While large funds have tended to dominate both portfolio investment and FDI and priority given to developed markets investment opportunities, there are clearly identifiable shifts in SWF portfolio and FDI flows to emerging and frontier economies, especially as public capital markets deepen and the institutional foundations for inward investment – legal framework, credit-investor protections, regulatory structures – are established and developed. Investment concentration has persisted in several key sectors: financial services, real estate, natural resources, and energy. However, especially in emerging economies, SWF are viewed as well-positioned infrastructure investment partners given their long effective investment horizons and their ability to invest in scale.

In addition to their direct functional role, SWFs can advance domestic institution building, while – both directly and indirectly – serving as a bridge between global markets and investors and their local markets. As frequently the largest host country institutional investor operating in global capital markets, SWFs have access to investment and capital market expertise, which when combined with their own experience, can enhance the building of local financial and investment capacity and facilitate the development of a local market institutional investor base, improve domestic information and governance structures, and drive financial deepening and so the development of local capital markets – both public and private. Similarly, SWFs can help facilitate inward investment both directly – for example as a co-investor in the case of large scale infrastructure deals – or indirectly as catalyst to improving the domestic investment climate.

However, lest we falsely attribute to SWFs the role of panacea, it is important to recognize the challenges that remain. Far from acknowledging a defined institution-building role, SWFs are preoccupied with the day-to-day challenges of successfully fulfilling their investment mandates as the investment agents of key government stakeholders. As such they are susceptible to actions that diverge from the interests of their stakeholders and give rise to agency costs. Alternatively, they may be subject to political and bureaucratic pressures by stakeholders that detract from their ability to maximize returns or otherwise effectively realize their mandates.

In 2008 an original group of 26 IMF-member countries with SWFs organized into the International Working Group of SWFs, now known as the International Forum of SWFs (IFSWF). Among the foundational tasks of this group was to a define and adopt a framework of 'generally accepted principles and practices that would properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis'.[34] This charter, known as the Santiago Principles, was a necessary response to concerns that the investment behavior of SWFs could be motivated by other than commercial objectives and result in destabilization of the international financial system. However, as with any governance

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[34] See International Forum of Sovereign Wealth Funds website for details related to founding, membership, and implementation of the Santiago Principles. Accessed www.ifswf.org/index.htm

framework in which participants must opt-in, the Santiago Principles are plagued by two continuing challenges: low adoption – especially among newly established funds – and inconsistent application.[35]

To be effective in building institutional capacity through SWFs, it is imperative that the role of the SWF be carefully designed into the development agenda of the host country and that its investment activities be monitored to mitigate agency effects and to insure that the fund is fulfilling its mandate in a disciplined way. This requires that the relationship between the fund and all of its stakeholders rest on a formal governance framework that is based on transparency and full accountability on the part of the fund's management. It further requires a professionalization and continuous executive review of the investment management process from the objectives of the fund's mandate, through the articulation of its investment strategy, to the implementation its risk management and reporting functions. Adoption of the Santiago Principles is perhaps a necessary, but by no means sufficient condition for compliance. It includes as well active encouragement of a culture of accountability and good governance.

The expansion and development of the global economy, continued external imbalances, and the further development of emerging economies suggests that both the number and size of SWFs will continue grow as emerging market actors leverage institutional fund structures to both manage their macroeconomic policy objectives, while advancing their domestic development agendas. As emerging economies grow and mature, the role of the fund and the relationship between fund and stakeholders will also evolve. Stakeholders must facilitate this transformation to insure that SWFs effectively serve the macroeconomic, developmental, savings, and institutional goals of their hosts.

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[35] See, for example, Behrendt, S, 'Sovereign wealth funds and their commitment to the 'Santiago Principles', Geoeconomica Briefing, April 2011, accessed http://geoeconomica.com/index.php/newsreader-9/items/the-santiagoprinciples.html and also Bagnall, S and Truman, EM, 'IFSWF report on compliance with the Santiago Principles: admirable but flawed transparency', Peterson Institute for International Economics Policy Brief, August 2011, accessed www.piie.com/publications/pb/pb11-14.pdf