Sovereign wealth funds (SWFs) have grown rapidly in recent years in both number and assets, emerging as significant and sometimes controversial players in global capital markets. Before 2000, almost two dozen SWFs existed around the world, investing state-owned profits from fiscal surpluses; official foreign currency operations; the proceeds of privatizations; or receipts resulting from exports of commodities such as oil, diamonds, and copper. Estimates in 2009 indicated that more than 50 SWFs are in operation, representing 35 nations from Brunei to Botswana, from Kuwait to Kiribati, and from the United Arab Emirates to the United States. Together, they held US$3.2 trillion in financial assets at the end of 2008—an amount that will increase over the next five years in almost any scenario for the global economy.¹

SWFs are, therefore, not a temporary feature of the global financial landscape. On the contrary, they will likely continue to proliferate and grow wealthier because of the continuing source of their capital inflows: trade surpluses. The five years beginning with 2005 mark the take-off point for this major emerging investment industry, much as the 1980s witnessed the birth of the mutual fund industry.

As SWFs have generated headlines, so have they stirred debate. Critics have raised concerns about their potential influence in financial markets and their possible political motives. Defenders view them as responsible and sophisticated investors, bringing a variety of benefits to financial markets. Much of the discussion, however, has been clouded by confusion because the term “sovereign wealth fund” is used to refer to a widely diverse group of state investment vehicles.

This chapter seeks to provide clarity by outlining the origin and growth of SWFs, describing their differing goals and investment approaches, and projecting their size relative to other types of institutional investors under different economic scenarios.

¹The value of SWF assets are subject to significant uncertainty because total assets under management are not publicly disclosed by many funds. The estimates in this chapter are based on official reports, press reports, and expert opinions.
UNDERSTANDING THE RISE OF SWFs

Although interest in SWFs has increased in recent years, they have existed for decades. The first such fund, the Kuwait Investment Authority, was created in 1953 to invest the Kuwaiti government’s oil revenues in behalf of its future generations. Over time, many governments followed suit, establishing a variety of financial vehicles to manage state-owned financial assets. Most of the new capital flowing into SWFs comes from the countries’ trade surpluses, though funds can also come from budget surpluses, returns on investments, land leasing fees, and other sources. Several of the largest and best-known SWFs—such as those in the Middle East, Norway, and the Russian Federation—invest the proceeds from oil and natural gas exports. Many Asian funds derive their revenues from trade surpluses resulting from their economies being net exporters of goods. Others invest the profits from the sale of non-energy commodities: Botswana’s Pula Fund, for example, manages revenue from diamond mining; and Kiribati’s Revenue Equalisation Reserve Fund was created to invest the earnings from the island nation’s phosphate mines.

SWF growth accelerated after 2002 primarily because of soaring petroleum prices, growing Asian current account surpluses, and, more recently, rising prices for commodities of all kinds. Crude oil prices shot up from less than US$20 per barrel in the late 1990s to a record US$147 in July 2008, before sliding to about US$70 in the summer of 2009.\(^2\) Meanwhile, after the Asian financial crisis of 1997–98, many countries in that region pursued successful export-led growth strategies that produced sizable trade surpluses. Many of the countries that have profited from these trends have economies or financial systems that currently are too small to absorb so much capital, or have leaders committed to preparing for a time in the future when their surpluses may wane. So these states created SWFs to invest a share of their export revenues in foreign financial assets such as equities; private and government debt; currencies; commodities; and stakes in hedge funds, private equity, and other asset classes. By the end of 2008, petrodollar\(^3\) and Asian funds together accounted for an estimated 88 percent of the financial assets held by all the world’s SWFs.

The biggest SWFs include those of the United Arab Emirates (Abu Dhabi), Saudi Arabia, Norway, Singapore, Kuwait, China, and the Russian Federation (Figure 1.1). Among the newest are the China Investment Corp., established in 2007, and the Fundo Soberano do Brasil, created in 2008.

Of course, the exact number of SWFs depends on the definition. In the public debate, “sovereign wealth fund” has been used to refer to many types of government-controlled investment vehicles with different revenue sources, goals, and investment approaches. The term is defined fairly broadly in this chapter, as an entity that manages state-owned financial assets, and is legally structured as a

\(^2\)Weekly prices of Brent crude oil, as reported by Datastream.

\(^3\)The term “petrodollar” in this chapter refers to profits from the sale of oil and natural gas.
separate fund or fund manager owned by the state. This structure is intended to insulate the entity from short-term political pressures and enable it to recruit professional fund management personnel. This chapter includes only funds that have a sizable portion of their assets invested outside of their local economies. Thus, it includes reserve funds, stabilization funds, and some government holding companies that have expanded internationally, such as Singapore’s Temasek Holdings and Malaysia’s Khazanah Nasional Berhad. The discussion does not include central banks, government finance ministries, or any entity whose primary function is to manage the government shares in domestic state-owned companies, such as China’s state-owned Assets Supervision and Administration Commission. One exception is the Saudi Arabian Monetary Agency, which is included as an SWF because it manages funds on behalf of Saudi Arabia’s pension fund and has a more diversified investment portfolio than do traditional central banks.

However, this effort to define SWFs also highlights that they are just one vehicle for managing sovereign wealth. State-owned companies are another increasingly important vehicle, particularly those active in making foreign acquisitions. And the distinctions between SWFs and other types of government investors are blurring. Traditionally, central banks invested their reserve assets in highly liquid, safe instruments such as U.S. treasuries, while SWFs pursued a more diversified portfolio. But some SWFs, such as the Russian Federation’s Reserve Fund or Alaska’s Permanent Fund, also invest mainly in conservative, fixed-income securities. And some central banks are beginning to expand their

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4This definition is similar to that adopted in the International Working Group of Sovereign Wealth Funds’ Generally Accepted Principles and Practices, also known as the “Santiago Principles.” A detailed discussion of these principles is provided in Chapter 5 of this volume.
investment strategies as well. China’s State Administration of Foreign Exchange, for instance, has invested in several foreign companies—investments closer to those of an SWF.

Therefore, in some discussions of state-managed wealth, a focus on SWFs is too narrow.\(^5\) This is particularly true in Asia, where the vast majority of sovereign assets are held in central banks rather than by diversified SWFs (Figure 1.2).

**THE DIVERSE AIMS AND INVESTMENT STRATEGIES OF SWFs**

SWFs are created with a variety of objectives that influence their investment approaches. Reserve funds, for example, manage state reserves in excess of those retained by the central bank for the execution of monetary policy. Usually, investments are made exclusively in foreign assets to provide exposure away from the domestic economy and mitigate Dutch disease effects. Because no explicit near-term expenditures or liabilities are related to the assets, reserve SWFs typically have long-term investment horizons and higher risk-return aspirations than do other sovereign investors. Therefore, they invest in broadly diversified portfolios of assets, including equities, fixed-income instruments, and alternative asset classes such as hedge funds and private equity funds, similar to many pension funds and endowments.

Stabilization SWFs also receive state assets—usually the proceeds from the export of oil and other commodities. The primary purpose of a stabilization SWF

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\(^5\)For more detail on petrodollar and Asian sovereign investors generally, see McKinsey Global Institute, 2009.
is to provide a source of funds that can be used to cushion the impact of commodity-price volatility on the exporting nation’s economy and budget. As a result, these SWFs usually have a lower risk-return profile, shorter time horizon, and higher appetite for liquidity than do reserve SWFs.

Government holding companies are created to provide oversight of a country’s assets by acting as a shareholder in state-owned enterprises. However, some of these companies, most notably Singapore’s Temasek Holdings, also reinvest proceeds from asset sales and dividend income into foreign assets. Given their origins, such funds typically take direct stakes in foreign companies and, in some cases, even majority control. In this regard, they are more like private equity funds than broadly diversified passive investors.

Some countries have multiple SWFs with distinct mandates. For example, in 2008, the Russian Federation split its former petrodollar stabilization fund into two entities—the Reserve Fund, which is actually a stabilization fund intended to cover budget deficits arising from drops in oil prices, and the National Wealth Fund, which seeks long-term returns.6

Meanwhile, some individual SWFs operate with multiple mandates. In the Middle East, for example, more SWFs are pursuing strategic foreign investments in specific companies that are not only commercially attractive but also can generate benefits for the local economy by bringing new skills, technologies, or business opportunities (McKinsey Global Institute, 2008). These investments may take the form of setting up a joint venture with a foreign company, establishing a more loosely defined partnership, or taking a sizable equity stake in a company.

For example, Abu Dhabi’s Mubadala Development Company invested US$1.35 billion in the U.S. private equity firm Carlyle in 2007, aiming in part to expand private equity investments in the Middle East and North Africa region (Kennedy, 2007); Carlyle recently closed a new fund targeted at investments in that region. A key reason for Mumtalakat Holdings’ 30 percent stake in McLaren Group is to develop Bahrain’s aluminum industry.

Although each SWF’s investment strategy is unique, they are grouped here into three broad categories (Figure 1.3):

- **Conservative, passive investors.** These SWFs employ a conservative strategy, focused primarily on fixed-income assets. They seek principal preservation and liquidity more than capital appreciation, and are therefore passive, minority investors with diversified portfolios. Funds in this category include the Saudi Arabian Monetary Agency, the Russian Reserve Fund and National Wealth Fund, and the Kuwait Investment Authority’s General Reserve Fund.

- **Yield-seeking, passive investors.** These investors hold more diversified portfolios of assets with higher expected returns and risk. Many funds in this category

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6The former Russian Oil Stabilization Fund was split into the Reserve Fund and the National Wealth Fund in February 2008. The National Wealth Fund, as it is called on the Ministry of Finance’s English Web site, is sometimes referred to elsewhere as the National Welfare Fund or the National Wellbeing Fund.
are believed to hold a large portion of their assets in equities, with the remainder split between safer, fixed-income assets and higher-risk alternative investments, including hedge funds, leveraged buyout funds, and real estate. This group includes some of the largest SWFs, such as the Abu Dhabi Investment Authority (ADIA) and Norway’s Government Pension Fund–Global.

- **Strategic, active investors.** The third category of investors is smaller than the first two and itself includes diverse SWFs with different investment strategies. The common element among these funds is that they have narrower investment mandates than do the passive portfolio investors, and many take much larger stakes in individual companies. For example, Dubai’s Istithmar World has real estate investments in New York and London and several significant private equity investments, including a stake in the U.S. luxury retailer Barneys and in Standard Chartered Bank. Other investors in this group, such as Mubadala, seek to promote national strategic and economic interests by investing in international corporate assets that may also yield local economic development benefits. Many funds in this category take an active approach to generating investment returns, for example, by being represented on the boards of directors of the companies in which they invest. Singapore’s Temasek and the Qatar Investment Authority are examples.

### SWFs REMAIN POWERFUL, DESPITE THE FINANCIAL CRISIS

The escalation of the global financial crisis in late 2008 caused deep losses for global investors—including SWFs—that were exposed to equities, mortgage-
backed securities, currencies, commodities, and other assets. The authors estimate that some SWFs, such as Norway’s, saw their losses exceed their governments’ new capital injections in 2008. But SWFs have long-term investment horizons, so it is not known if all those paper losses will be realized. For many SWFs, much of the paper losses were indeed reversed in 2009. Moreover, some investments—such as those in western financial institutions in late 2007 and early 2008—took a variety of complex forms whose returns may differ substantially from equity market performance.

Meanwhile, SWFs, including those of Saudi Arabia and the Russian Federation, that had invested more conservatively in government bonds and other fixed-income securities enjoyed investment gains in 2008. Moreover, petrodollar and Asian SWFs continue to receive large capital inflows from their nations’ trade surpluses. The estimated net result is that, collectively, global SWF assets held roughly steady through the crisis, totaling US$3.2 trillion at the end of 2008, about the same as a year earlier—a much better performance than the losses posted by global pension funds, mutual funds, insurers, and other traditional institutional investors (Figure 1.4).

Since the worsening of the global financial crisis in September 2008, many SWFs have moved to the sidelines, conserved cash, and focused on supporting domestic companies and banks. Most will retain their long-term investment horizons and focus on foreign assets, although some have indicated that they are reviewing their
specific investment strategies (Irish and Saadi, 2009; Moskwa and Stoltz, 2009). As the financial crisis subsides and recovery begins, they will be ready to jump at new opportunities. Some shifts in investment approaches are already being detected.

**More Diversification into Nontraditional Asset Classes**

In 2009, managers of several SWFs had discussed plans to broaden their investment strategies to include more nontraditional asset classes, such as real estate, commodities, and hedge funds. This direction may reflect a structural shift to seek opportunities outside of public equity and fixed-income markets, particularly in light of investment losses in 2008. Such a shift may serve several goals. The focus on real estate, for instance, reflects unique opportunities to snap up many properties at depressed prices. And real estate can also be a good hedge against inflation, which is a growing worry in the face of large government stimulus packages in the United States and other countries. For example, the Abu Dhabi Investment Company, which is owned by the Abu Dhabi Investment Council, stated in April 2009 that it plans to launch an international real estate investment fund (Carvalho, 2009). The Kuwait Investment Authority reportedly planned to take advantage of opportunities in global real estate and in equities.

With soaring commodity prices, some SWFs are also pursuing investments in commodity producers as a hedge against the risk of higher global inflation and an indirect way to secure future supplies of raw materials. The executive director of the Qatar Investment Authority, for example, said in March 2009 that the fund would turn its focus to commodities—particularly food and energy—in the second half of that year (England and Blas, 2009). But commodities are one area in which the investments of SWFs pale in comparison with foreign acquisitions by state-owned companies, with China’s bids for foreign energy producers as a notable example.

Meanwhile, the SWF appetite for hedge funds and other alternative investment vehicles appears undiminished by the crisis. The China Investment Corporation, for instance, recently announced new mandates for investments in hedge funds, channeling these investments through Blackstone and Morgan Stanley, with whom it had previous relationships.

**More Focus on Emerging Markets**

SWFs are looking more than ever to emerging markets for long-term growth opportunities. This trend is not new, but has been accelerated by the crisis. In 2007, research by the McKinsey Global Institute found that SWFs as a group were weighted more heavily toward emerging markets than were pension funds (McKinsey Global Institute, 2007). As the head of the Kuwait Investment Authority noted at the start of the global financial crisis in 2007, “Why invest in 2 percent-growth economies when you can invest in 8 percent-growth economies?” (Sender 2007).

Going forward, more focus on investments in emerging markets is expected. The Qatar Investment Authority, for example, plans to invest US$400 million in
infrastructure in Africa, particularly in South Africa, focusing on transportation, communications, and energy. It also has set up a joint venture with the Indonesian government to invest US$850 million in that country and plans to establish a US$1 billion fund to invest in agriculture, natural resources, and tourism in Vietnam. Kuwait has reported plans to raise its stake in the Industrial and Commercial Bank of China and to invest in China’s energy and industrial sectors (Irish and Drees, 2009).

**Hiring New Talent**

The crisis has caused financial institutions to lose thousands of employees in the United States and Europe, and SWFs are taking advantage of this outflow of talent. In 2009, for instance, the ADIA hired a managing director from JP Morgan to guide ADIA’s global real estate investment strategy and a senior investment banker from Rothschild to advise on cross-border mergers and acquisitions. The China Investment Corporation is hiring more than 20 senior professionals from around the globe and has named a former UBS executive to oversee its Special Investments Department, which will take large, long-term positions in publicly traded companies. The Korea Investment Corporation recently picked a U.S. hedge fund manager as its chief investment officer.

This hiring spree will expand the SWFs’ financial and investment expertise, allowing better selection and monitoring of external investment managers. Such hires may also be part of another trend—SWFs’ moves to manage a larger portion of their portfolios directly rather than through outside money managers.

**New Funds with More Targeted Goals**

Some of the newest SWFs are being created with more targeted investment goals. In 2006, for example, Abu Dhabi spun off the Abu Dhabi Investment Council from the larger ADIA to focus on local and regional investments. In 2008, Abu Dhabi created the state-owned Advanced Technology Investment Company to invest in high technology locally and internationally; its first major deal was a joint venture with chip-maker Advanced Micro Devices to create The Foundry Company, a semiconductor manufacturer. Also in 2008, Mubadala formed a joint venture with Rolls Royce to provide aviation services in the Middle East.

This proliferation of SWFs serves two purposes. First, it allows policymakers to create better-defined investment goals for each entity. Second, it creates competition among sovereign investment vehicles and may therefore spur better performance, given that the better-performing funds could get larger capital injections in the future.

**SWFs WILL CONTINUE TO GROW**

The recent global financial crisis and economic downturn has altered the dynamics that had fueled rapid growth in SWFs since 2000. At this writing, commodity prices, trade, and equities all remain far below their recent peaks. Nonetheless,
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Oil exporters and several Asian countries continue to run trade surpluses, and continue to allocate some portion of their surplus capital to SWFs. Research suggests that this process will continue in coming years, regardless of whether the world economy recovers relatively quickly or much more slowly. Thus, this chapter projects that total SWF financial assets will grow from US$3.2 trillion in 2008 to between US$3.4 trillion and US$5.8 trillion in 2013 (Figure 1.5).

Because the economic outlook remains so uncertain, SWF financial asset growth is modeled, in this chapter, according to different proprietary macroeconomic scenarios developed by McKinsey & Company and Oxford Economics. These scenarios each depict different trajectories for GDP growth, oil prices, Asian trade surpluses, financial market recovery, and other key variables.

In the conservative, base-case scenario, global GDP does not resume growth until mid-2010, depressing commodity prices and trade. Oil prices start rising slowly as the economy recovers, surpassing US$70 per barrel by 2013, and Asian current account surpluses decline. This scenario projects SWF assets to climb to about US$4.3 trillion by 2013.

As would be expected, SWF assets rise much higher, to US$5.8 trillion in 2013, in the best-case optimistic scenario, which envisions a more rapid recovery in global GDP, oil prices, and trade. But it is striking that SWF assets increase a bit even in the worst case. In this pessimistic scenario, global GDP does not start growing until 2011; crude prices linger below US$50 per barrel for several years before rising to just US$60 per barrel in 2013; and global trade remains well below its peak. Sluggish economic growth dampens global equities and fixed-income markets, limiting returns on investments. Nonetheless, appreciation of the current portfolio of assets would still be significant, and could offset governments’ drawing on SWF assets for other purposes. In such a scenario, SWF assets would remain essentially flat, at US$3.4 trillion, in 2013.

Figure 1.5  SWF Assets Could Reach US$4.3 Trillion by 2013

Sources: International Monetary Fund; Sovereign Wealth Fund Institute; McKinsey Global Institute analysis.

1 Includes sovereign wealth funds in Algeria, Bahrain, China, Indonesia, the Islamic Republic of Iran, Kuwait, Libya, Malaysia, Nigeria, Norway, Oman, Qatar, the Russian Federation, Saudi Arabia (including the Saudi Arabian Monetary Authority), Singapore, the Republic of Korea, United Arab Emirates, and República Bolivariana de Venezuela.
SWFs, along with other global investors, will continue to be buffeted by unforeseeable market forces in coming years. How the recent global financial crisis will be resolved, whether world GDP growth will return to precrisis levels, and how the economic landscape may be changed in the process remain uncertain. Even so, the financial assets controlled by governments around the world will continue to grow in all macroeconomic scenarios considered, meaning that SWFs will continue to be important players in global capital markets, and may even gain influence. Thus, they will also continue to command the attention and scrutiny of business leaders and policymakers for years to come.

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