CHAPTER 15

A Market View of the Impact of Sovereign Wealth Funds on Global Financial Markets

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After having been the center of attention through most of 2007 and the first half of 2008, sovereign wealth funds (SWFs) returned to relative obscurity once the commodity price bubble burst in mid-2008. While many SWFs appreciate being out of the spotlight, they remain relevant and important actors.¹ Their importance expanded even though their overall assets under management (AUM) may have shrunk. Any work on SWFs starts by carefully defining them. For example, in their release of the Santiago Principles (voluntary “generally accepted principles and practices that properly reflect SWFs investment practices and objectives”) SWFs defined themselves as

…special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports. (IWG, 2008a, p. 3)

Following this definition, central bank official reserves and public pension funds are not SWFs. From the market perspective, the exact definition is much less important than who controls these actors and their motives. Given their growing role and their participation in both local and international markets, SWFs are closely watched, but generally seen as another type of state-controlled actor investing for not-only-financial gain with a longer than usual investment horizon. A distinction is made in the market between SWFs and central bank reserve managers because SWFs are frequently viewed, especially in non-commodity countries, as attempting to diversify away from the U.S. dollar and U.S.

¹For example, private equity and hedge fund assets under management (AUM) have shrunk more drastically than those of SWFs, adjusting for double counting. Moreover, going forward, liquidity and financing conditions are unlikely to return to precrisis levels, meaning that, on a levered basis, the role of hedge funds in global financial markets has diminished more than the decline in AUM would suggest.
fixed-income assets.\(^2\) By going down the credit spectrum and widening their investment choices to include less liquid assets, SWFs should generally outperform their reserve manager cousins, but so far not enough data are available to indicate whether this has been the case.

Lack of data and transparency severely affect any analysis of the impact of SWFs on global capital markets. Data on several SWFs’ high-profile public equity transactions are available, but much less is known outside of large equity transactions. Hence, any conclusions about the possible impact of SWF decisions on equity, fixed-income, and foreign exchange (FX) markets are more tentative and are more driven by these funds’ likely asset allocation choices as they mature. Analysis is also limited to largely anecdotal evidence, press reports, and the SWFs’ own efforts to increase transparency into their holdings. As a result, the market implications of SWF investments highlighted in this chapter represent a market view rather than the market view.

This chapter is organized in six sections. The first section discusses whether the size (relative and absolute) of SWFs should be an independent source of worry for authorities and market participants. Next, the chapter looks at the academic literature on the effect of SWFs’ public equity investments on markets and notes that very little information is available regarding SWFs nonequity investments. The third section discusses where SWFs invest geographically and observes that SWFs invest most heavily in their own countries, followed by investments in Organisation for Economic Co-operation and Development (OECD) countries. Investments in non-home emerging markets by emerging-market SWFs are still miniscule. In the subsequent section the macro and market implications of a shift away from official reserves to SWFs are discussed. The discussion maintains that were the shift into SWFs to accelerate, emerging markets and Japan could be the big winners. The fifth section describes how market participants tend to react to the news of new SWF investments in new companies, sectors, or assets. The penultimate section discusses from a market participant’s point of view the impact on asset prices of SWFs’ different degrees of transparency. The chapter finishes with conclusions.

**ABSOLUTE AND RELATIVE SIZE OF SWFs IN CONTEXT**

Relatively speaking, the current AUM among SWFs are not particularly large or concentrated. Most estimates of the current size of SWFs put them at US$2 trillion

\(^2\)In practice, the distinction is more difficult to make. Reserve managers have been known to also invest in equities, private equity funds, and so on. In general, however, to the extent that a country wants its foreign assets to be counted as official reserves, it is limited in how much non-fixed income exposure can be taken (excluding FX deposits and money market fund investments). Another tough distinction is the SWF-like role sometimes played by internationally active state-owned enterprises (SOEs) buying up strategic assets, presumably for political reasons. Such SOE-driven transactions have become much more frequent in the wake of the commodity price bubble and frequently target emerging markets.
to US$3 trillion at the end of 2008. At the peak of media and political interest in SWFs in 2007, their total AUM was expected to grow to US$12 trillion by 2015 (Jen and Andreopoulos, 2007). To put this number in perspective, the IMF estimates the market capitalization at the end of 2007 of global stock and fixed-income markets at US$135 trillion. Hence, it is hard to argue that SWFs’ total size is currently too big for the market. For example, the OECD estimates that at the end of 2008, U.S. insurance companies and pension funds managed about US$14 trillion and U.S. mutual funds about US$10 trillion. This is, of course, the common argument for why the current size of SWFs is not a particularly significant concern. However, just as interesting could be their flow, that is, during periods of high commodity prices SWFs may be a much larger part of the new investable flows into various asset classes. This idea is returned to later in the chapter.

Even as individual asset managers, the size of SWFs is not particularly unusual. The Abu Dhabi Investment Authority (ADIA) is often named as the largest SWF, and is alleged to manage assets of about US$875 billion (Bortolotti and others, 2008), but this is still far smaller than some of the largest private asset managers, such as State Street Global (US$1.2 trillion), Barclays Global (US$1.1 trillion), and BlackRock (US$1.1 trillion). The next largest SWFs are generally believed to be the foreign holdings of the Saudi Arabian Monetary Authority (SAMA; US$433 billion), China’s State Administration of Foreign Exchange Investment Company (SAFE; US$312 billion), and Norway’s Government Pension Fund–Global (US$300 billion). Relative to managers of emerging-market official reserves, with a total size of US$4.1 trillion, SWFs are a growing share of the total, but still will not outgrow total official reserves for years (partly because SWFs’ assets are directly funded out of reserves in several countries).

SWFs are roughly comparable in size to other types of asset managers, but appear to trade much more like typical real-money managers than like hedge funds. Comparing SWFs’ AUM with the AUM of other investment managers should ideally acknowledge a degree of double counting because SWFs are known to have invested in both hedge funds and private equity funds. Hedge Fund Research (2009) estimates that the AUM for hedge funds declined from a peak of nearly US$2 trillion in mid-2008 to a low of US$1.3 trillion in 2009:Q1 and US$1.4 trillion in 2009:Q2. Private equity funds were estimated

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3 Estimates clearly vary across the literature. Bortolotti and others (2008) estimate total size (using a broad definition of SWFs) at about US$3.3 trillion, of which oil and gas-related SWFs accounted for roughly US$2.5 trillion. Kern (2009) put AUM at about US$3 trillion. Setser and Ziemba (2009b) estimated the foreign assets of major SWFs at US$1.5 trillion. Part of the differences is definitional; others relate to the lack of transparency of the largest funds. Finally, 2008 and the beginning of 2009 were difficult times, such that AUM shrank for several SWFs, accounting for another portion of the difference in estimates.

4 There is a discussion of ADIA’s ultimate size, with some commentators putting it closer to US$340 billion at the end of 2008 (Setser and Ziemba, 2009b).

5 Pensions and Investments Largest Money Managers survey, May 2009 (http://www.pionline.com/section/MoneyManagerDirectoryArchive). Presumably these large asset managers have SWFs among their clients, so there may be some double counting in the comparison of AUM.
to be managing about US$900 billion at the end of 2008 (Roxburgh and others, 2009). Although broadly comparable in size, hedge funds span the spectrum of investment strategies and frequently employ leverage. Private equity funds also employ leverage, but to a lesser extent than hedge funds. Although average leverage ratios are hard to estimate for the hedge fund industry, an end-2009 reasonable average would be one to two times after the 2007–09 global financial crisis versus perhaps three to four before the crisis. Hence, the importance of hedge funds in global financial markets has shrunk dramatically during and since the crisis, even though hedge fund industry AUM started to recover in the second quarter of 2009 as a result of better performance. SWFs, however, are not frequent users of leverage, and have not been broadly affected by the credit crunch because of the stability of their funding. Hence, on the private equity side, SWFs outpaced private equity funds as measured by the number and size of deals in 2008 (Ernst & Young, 2009). An IWG (2008a) survey suggests that only 23 percent of SWFs are absolute-return focused and that the vast majority (about 80 percent) do not employ leverage. The few that do, according to the IWG survey, mostly use leverage for hedging purposes, or invest in leveraged funds (so leverage is indirect), or both.

Another case made for the importance of SWFs has been their projected rapid growth, that is, they may not be significant enough today to have a major influence, but could soon be large enough to play a much greater role in the price formation of financial assets. The global financial crisis of 2007–09, as well as the popping of the oil bubble in 2008, hit many SWFs hard and their investment strategies were either redirected toward domestic development and macro support or, because their liquid assets formed part of official reserves, they were tapped for FX stabilization purposes. Suffice it to say that commodity exporters’ ability to allocate a significant share of their ample current account surpluses to SWFs when commodity prices were high shrank rapidly as oil collapsed from US$147 per barrel to US$35 per barrel. In fact, Setser and Ziemba (2009a) calculate that for the oil-exporting-country SWFs to see renewed inflows, oil prices would have to average above US$50 per barrel. At an oil price of US$75 per barrel, Gulf Cooperation Council SWFs would add about US$175 billion per year to their official reserves and wealth funds—a far smaller sum than the US$300 billion in annualized inflows these entities reportedly enjoyed during the first nine months of 2008. Hence, estimates about the future growth rates for SWFs are largely driven by current account surplus assumptions for commodity exporters and the extent to which countries want to reallocate from official reserves to SWFs. Given the generally poor investment performance of SWFs in 2008–09 and the fact that the global financial crisis has led to an upward revision in the desirable level of official reserves for many countries, the growth rate for SWFs going forward will probably slow compared with 2007 and 2008.

Analysts’ estimates for SWF AUM growth are being scaled back. At the height of market focus on SWFs in May 2007, Jen and Andreopoulos (2007) estimated...

Fears about the overall absolute size of SWFs almost certainly reflect political rather than market concerns. Given the arguments presented above, any concerns about the absolute size of SWFs have to be based on an argument that they are not being run on a financial basis and perhaps would seek to take controlling stakes in firms strategically important to their host countries. In fact, many large SWFs take stakes of more than 5 percent on very few occasions (unless this is their specific remit), especially in foreign markets, to reduce any political backlash. However, individual SWFs are large enough that were they to concentrate their holdings in less liquid markets, monitoring them to avoid any sudden disruption if the SWF decides to divest would be warranted, just as it would be for any other large institutional investor.

HOW DO SWFS’ PUBLICLY ANNOUNCED EQUITY INVESTMENTS AFFECT MARKETS?

Extensive finance literature examines the ways in which a large new investor can affect asset prices in a given stock, currency, or fixed-income instrument. The driving factors behind how large an impact a particular investment or transaction has on a target’s asset price depend on (1) the size of the investment relative to the market capitalization or liquidity of the asset, (2) whether the investor acquires a controlling stake, (3) whether the investor has nonpublic information, (4) whether the transaction takes place on or off an exchange, (5) whether the transaction is publicly announced, (6) the investor’s holding horizon, and (7) the investment decision’s implications for future investments by the same or similar entities. Most of these factors are equally relevant for SWFs. For state-controlled entities such as SWFs, however, another important factor can be added—is the transaction taking place for purely financial reasons or are noneconomic factors, such as resource diversification or technology transfers, also playing a role? In general, this issue is crucial to the way in which the media and politicians see SWF investments in their economies, but from a market perspective, the underlying rationale for an SWF transaction only matters if it indicates whether additional similar transactions are likely or if one SWF’s action signals probable next steps for other SWFs.

An academic literature regarding the impact of SWFs on global financial markets is emerging, but so far focuses only on the effect on equity prices. A useful literature review is provided by Miracky and Bortolotti (2009); their general conclusion seems to be that the target company’s stock price reacts favorably to an SWF investment, especially if the SWF is transparent in its investments. The literature suggests that the
size of the stake bought by the SWF does not matter and that the investment signal is even more important if the target asset’s share price has underperformed. It can be argued that this result picks up the significant investments by SWFs in the financial sector during 2007–08 and to a more limited extent in 2009. Reasonably, the studies suggest, follow-up SWF investments in a particular company have much less impact on equity prices. Divestment decisions by SWFs, which represent a more limited sample, seem to have a negative effect on the divested company’s share price. Miracky and Bortolotti’s literature review does not clearly indicate whether SWFs have a different impact on a target’s share price than do the investment decisions of other large fund managers, that is, whether there is something special about investments made by a government-controlled entity, or whether the effect depends more on how financially focused or transparent the type of investor is. There does, however, seem to be an indirect link suggesting that the more transparent an SWF, the bigger the positive impact, presumably akin to the impact of a large private institutional fund manager (see Kotter and Lel, 2008). Most likely the positive effect on a firm’s share price following the announcement of an investment reflects the increased demand for the asset rather than a belief that an SWF investment would result in assistance in managing the firm. However, SWFs are generally seen as stable, long-term investors, which should be reflected in the target’s share price similarly to what would typically be seen following the investment decision by a large pension fund. So far, this chapter’s author is not aware of any comprehensive research that has examined the impact of SWF investment announcements on macro indicators such as FX or government bond prices, although a number of recent studies—Beck and Fidora (2008); Kozack, Laxton, and Srinivasan (Chapter 14 of this book)—have started to explore this important field.

WHERE DO SWFs INVEST?

Although the current aggregate size of SWFs is not of any special concern, their market impact is affected by where they invest and the liquidity of that market. Thus, their relative size compared with the overall size of the market matters more than the overall size of their AUM. Buying US$10 billion of U.S. treasuries has a very different impact from buying US$10 billion of local emerging-market bonds. From a macro market perspective, SWF investments could have far bigger impacts in nontraditional asset classes, such as emerging markets, commodities, real estate, and private equity. In general, the IWG (2008a) study makes clear that most SWFs follow a typical asset allocation framework with a fairly high tolerance for nontraditional investment classes, such as private equity (about 35 percent of SWFs indicated such assets are eligible), real estate (35 percent indicated assets are eligible), and commodities (25 percent indicated assets are eligible).

Less information is available about geographic diversification, other than SWFs’ public equity investments, but the information to be had suggests significant scope for more international investments by SWFs in equities. In general, the traditional optimal portfolio allocation yielded by an intertemporal capital asset
pricing model (ICAPM) dictates holding portfolio shares equivalent to the market capitalization shares of individual countries. So far, as a result of home bias, actual institutional investor holdings typically fall far short of the international exposure suggested by ICAPM. With a handful of exceptions, the SWFs’ asset allocations are not known for their nonequity holdings, but those nonequity holdings are likely to be much more diversified than their equity holdings. For instance, fixed-income investments seem to be routinely diversified across countries in the developed markets (see, for example, the diversification strategy of Norway’s Government Pension Fund–Global). Investments in emerging-market fixed-income assets seem to be occurring more gradually, but the process is gaining momentum given the perceived opportunities and diversification benefits.

Despite the well-publicized investments by SWFs in “G3” (the United States, the euro area, and to a lesser extent Japan) financial institutions, the majority of investments occurred locally to support domestic economies. During 2006–08, about two-thirds of all large equity investments by SWFs occurred in emerging markets, most of those in the SWFs’ own countries (see Figure 15.1). Clearly, these transactions preceded the 2007–09 global financial crisis and thus suggest that the perception that SWFs predominantly invest abroad is not borne out by the data so far. Miracky and Bortolotti’s (2009) data for publicly disclosed equity investments in 2008 show that about 96 percent of SWF’s emerging-market equity investments were in their own countries, which leaves only US$1 billion invested in non-home emerging markets. This probably reflects both the perceived lower risk-adjusted return in non-home emerging markets and that given their own substantial investments in their own countries, their overall emerging-market exposure is still significant. One could also argue that the host country skepticism for large SWF investments also reduces the chance for this channel of
portfolio diversification. This probably means that the main channel for foreign investments is through foreign exchange and fixed-income exposures in the G10.

In general, the vast differences in international exposure between various SWFs is also explained by their reasons for being established. Some are much more explicit in their goals of investing substantial shares of their assets at home, while others are explicitly funded in foreign exchange and hence almost by definition fully invested in non-home country assets.

As many of the recently launched SWFs mature and establish firm investment processes and guidelines, it would make sense for the share of emerging-market investments in SWFs’ portfolios to increase. For example, the China Investment Corporation (CIC) disclosed in its first annual report that “because it was building its organization, infrastructure and capabilities, CIC had set relatively modest goals for deploying its capital in 2008. As the year unfolded, CIC made the decision to reduce the pace of its investing even further” (CIC, 2009, p. 33). In fact, by the end of 2008, 87 percent of CIC’s assets were still in cash and 9 percent were in fixed-income securities, with only 3 percent in equities. Overall, CIC’s investment guidelines suggest that "slightly over 50 percent" of its non-Central Huijin6 assets would be invested abroad and that its “investments are not limited to any sector, geography or asset class” (CIC, 2009, p. 28). Over time, SWFs would be expected to invest more widely internationally than a typical home-bias-driven investment manager given SWFs’ longer investment horizon, foreign currency funding, and appetite for higher risk-adjusted returns.7

MARKET AND MACRO IMPLICATIONS OF THE SHIFT TOWARD SWFS FROM OFFICIAL RESERVES

The rationale for shifting a share of a country’s conservatively run official reserves to an SWF must be to boost risk-adjusted returns and increase diversification. Therefore, there is potential scope for broader market implications for the major exchange rates and government bond yields that go beyond day-to-day announcement effects of any particular investment. The IMF’s Currency Composition of Official Foreign Exchange Reserves (COFER) database indicates that, on average, central banks of emerging and developing countries held about 58 percent of their official reserves in U.S. dollars and 31 percent in euros by end-2009.8 As discussed by Beck and Fidora (2008), global market capitalization weights for the dollar and euro, if a more traditional ICAPM-type portfolio management model is pursued, suggest a significantly smaller allocation to dollar- and euro-denominated assets and a much larger allocation to the assets of emerging markets and Japan. As newly launched SWFs gain confidence and experience, it is likely that there will

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6 Central Huijin is a CIC subsidiary managing the sovereign's investment in the local financial sector.
7 As previously noted, the traditional optimal portfolio allocation from an ICAPM-type model would be to hold portfolio shares equivalent to the market cap shares of individual countries.
8 These are the percentages for those central banks that disclose their reserves compositions. The actual percentage of US$ shares may be higher if China’s reserves composition were known.
be a gradual, but sustained, shift away from investing new inflows into dollar and euro financial markets and toward a focus on assets denominated in other currencies. Using market-cap weights, Beck and Fidora (2008) suggest three interesting implications of a shift from central bank reserves to SWFs:

- Inflows into global equity markets could be substantial given that official reserves are basically all invested in fixed income. Setser and Ziemba’s (2009a) research suggests that well-established SWFs—those of commodity-producing countries—are already large holders of equities. However, those SWFs funded through official reserves seem to be far behind “optimal” portfolio allocations of equity. The degree of progress on this front for some of the newer SWFs seems also to have been limited; for example, CIC’s 87 percent cash holdings are probably parked in liquid short-end securities, and the most liquid markets are denominated in U.S. dollars.

- Given that the United States has the world’s largest equity market, the implicit portfolio shift away from dollar to nondollar and non-euro currencies will be somewhat mitigated. Nevertheless, the U.S. market cap share of global financial markets (equity plus debt according to IMF, 2009) was roughly 35 percent at the end of 2009 compared with a share of U.S. dollars in reserves of 58 percent. For the euro area, the market cap share was 23 percent, compared with a share in reserves of 31 percent. This suggests an overweight of U.S. dollar and euro holdings in reserves. The big gainers of a shift toward the market capitalization would be emerging markets with a current global market cap of 20 percent and Japan of 9.5 percent. However, as the experience with the gradual diversification strategy already under way in many central banks has shown, SWFs are unlikely to engage in any market-destabilizing moves, and any investment strategies and portfolio reallocations will most likely be gradual and sustained, but quicker than for official reserves.9

- Considering the assets currently managed by newer SWFs (as of the end of 2008, covering those SWFs set up in 2006 or later according to the Sovereign Wealth Fund Institute, 2009) of US$530 billion and assuming that they are still in the process of investing those assets, the maximum inflows from these sources to emerging markets and Japan could be US$105 billion and US$51 billion, respectively, with the biggest loser being the U.S. dollar. Because SWFs are likely to invest much more in equities than are central banks, they are also likely to diversify away from the U.S. dollar more than central banks, and much more quickly.10

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9This holds true during normal times. The recent crisis has made this assumption more tenuous. There have been a few recent examples of more abrupt changes in US$ assets, for example, U.S. agencies or FX deposits. Large shifts are possible, but these shifts have been in the minority and not clearly destabilizing given the liquidity in these markets.

10If we assume no equity investments of central banks’ official reserves, then the 58 percent share held in U.S. dollars should drop to 37.8 percent if an ICAPM-level result is sought. In reality, it would be hard to believe that as long as the U.S. dollar remains the dominant reserve currency, official reserves holdings in U.S. dollars would drop below 50 percent. Emerging markets remain the main beneficiary of any shift of assets to SWFs from central bank reserves because emerging markets’ share of global equity markets is much higher than their share of global debt markets.
While the creation of new SWFs should boost inflows to emerging markets and Japan, the portfolio composition of well-established SWFs suggests that SWFs may go beyond the ICAPM-type result and invest more heavily in risky assets. Setser and Ziemba (2009a) estimate the portfolio composition of the large Gulf Cooperation Council-based SWFs and show that their risk appetites increased from the end of 2004 to mid-2008 with, on average, 50 percent of their international purchases in the form of equities and 50 percent in fixed income. Overall, Setser and Ziemba (2009a) estimate that equity holdings average about 50–60 percent with a fairly substantial 20–25 percent in alternatives (such as private equity, real estate, commodities, or hedge funds; see Figure 15.2). This suggests that the risk appetite of SWFs could be higher than indicated by a traditional model given that the share of global equity markets to total financial markets was roughly 45 percent at the end of 2007. Nevertheless, these large equity allocations may have been the high point and the lessons to be drawn by commodity-exporter SWFs are to be more conservative. SAMA, the Saudi Arabian Monetary Agency, seems to have fared the best during the recent crisis and it is also the most conservatively managed SWF in the region. In fact, Setser and Ziemba (2009a) point out that an important lesson from the crisis for commodity-exporter SWFs is to reduce their holdings of risky assets that are highly correlated to the global growth cycle (such as equities or emerging markets) because SWFs’ capital inflows are directly linked to global growth as well. The Norwegian Government Pension Fund–Global still strives for a high 60 percent strategic allocation to equities and 40 percent to fixed income. As a result of weak equity performance (the fund lost about 23 percent in 2008), the actual composition was 52 percent and 48 percent at the end of 2009:Q1. More recent data suggest very strong performance during 2009:Q2, given that the fund went overweight relative to its strategic benchmark. Its allocation to emerging markets still seems too low, but this may change (see Price, 2009). The fund requested during 2008 that its benchmark be
altered to include more emerging-market equities and private equity (however, in mid-2009 they decided to wait to invest in emerging-market and high-yield bonds).

As the analysis above suggests, the impact of SWFs on emerging financial markets and Japan is only set to grow. Even one of the most professionally managed and transparent funds—Norway’s Government Pension Fund–Global—still does not actively invest directly in high-yield and emerging-market bonds. Presumably that also excludes local-currency emerging-market investments. Thus, given the size of SWFs and their ongoing strategic reallocation of assets to new classes, regions, and currencies, it will be important for macro players to follow them because their actions can drive the short-term performance of currency and rates. It remains to be seen whether the asset flows are large enough to affect the major currencies, but it would be reasonable to assume that a steady and fairly long-term portfolio investment inflow into emerging markets will have an impact on valuations given the less liquid nature of these asset markets (see Figure 15.3).

![Figure 15.3 Large Potential for Emerging-Market Central Bank Reserves Diversification](image)


**HOW DO MARKET PARTICIPANTS REACT TO SWF INVESTMENTS?**

Investments by SWFs are widely followed by the market because of the size of the potential flows and the funds’ long investment horizons. The lack of transparency of many SWFs probably causes more market speculation about alleged investments than is warranted. In an environment in which other important market participants, such as hedge funds, have been in retreat, the relative role of SWFs has increased. The impact of SWFs’ investments on equity markets, when they invest directly in their own names, has been evaluated in a handful of academic studies. The clearest recent example of a direct, broadly based market impact was
the episode of large and sustained investments by several of the largest SWFs into the U.S. and U.K. financial sectors. Although studies focused on the individual stock impacts of the investment announcements, the capital injections from the SWFs had implications for the entire financial sector and for broader market indices—much-needed capital injections were coming from a source that would have been largely unexpected before the recent global financial crisis. However, these sectoral macro implications have not been widely studied. Having incurred major marked-to-market losses on their investments in western banks, and having confirmed that SWFs have a tendency to herd behavior, many SWFs must be in the process of reviewing their investment guidelines and slowing their diversification processes.

The dearth of studies about SWF investments’ impacts on FX and nonequity asset classes leaves researchers largely with anecdotal evidence and press reports. As mentioned, suggestions that a new asset class has been added to the list of eligible classes for a particular SWF can be very important. As shown in the IWG report (2008a) almost all SWFs make use of external managers, which means SWFs can invest indirectly and anonymously. However, the announcement of the selection of an external manager can lead to a repricing of assets in the asset class in which a particular asset manager specializes under the assumption that more SWFs could follow or that the announcement reflects an initial investment that could later be augmented. One example of this type of market impact was CIC’s announcement that it was planning to launch a US$4 billion private equity fund together with JC Flowers in 2008 (Chen, 2008). This announcement led to renewed optimism that additional funds would be made available to the private equity world, which was starting to feel the squeeze of the upcoming credit crunch. On March 3, 2009, various news agencies reported that China was again considering investment opportunities in the natural resources sector and a senior official for CIC was quoted in the reports (Heng, 2009). Oil prices jumped 9 percent the following day, while the S&P 500 (as a benchmark) rallied 2.4 percent on the day with the EUR/US$ largely unchanged. Of course, market sensitivity to SWF investment announcements is not limited to CIC. The Norwegian Government Pension Fund–Global was reported to be considering external managers to increase its exposure to Brazilian companies through allocations of US$250 million (see Price, 2009). The news stories were immediately circulated among market participants and helped support the Brazilian real during a day when nervousness remained high because of weak U.S. equity market performance.

Moreover, as mentioned briefly earlier, the market perceives that there are leaders and followers among the SWFs. Among the leaders are the more transparent and well-established funds. The Norwegian Government Pension Fund–Global has a wide following because it makes public its strategic investment strategy as well as most of its holdings. For the less transparent funds, the market is left to follow any large public announcements. A new initiative of, for example, investing in banks in emerging markets would rapidly be interpreted by market participants as setting the stage for a wave of new investments into
the emerging-market financial sector (as was in fact the case). Regardless of whether it was correct, this perception was strengthened by the activities of SWFs in the context of investing in western banks in 2008. An example is the Industrial and Commercial Bank of China’s (ICBC’s) 2007 US$5.5 billion investment in South Africa’s Standard Bank; not only did the South African rand rally 1.7 percent on the day, but market speculation about other emerging-market banks that could be attractive destinations for SWF investment began immediately. This occurred even though ICBC, while state controlled, is not an SWF (although it is 35 percent owned by a subsidiary of CIC [CIC, 2009]).

MARKET IMPACT AND TRANSPARENCY

Public investment decisions by SWFs do not only have a market impact, but a political impact as well. Although much of the political concern about SWF investments died down after SWFs came to the rescue of many western banks, the market impact of SWF investments and the focus the market places on them has, as argued above, only grown. In addition, some of the concerns about political transparency, and those related to the belief that SWFs’ investment decisions should be guided by purely financial considerations, have been somewhat mitigated by the publication of the voluntary Santiago Principles. In practice, signatories to the principles are already applying them, as evidenced by the release of CIC’s first annual report.¹¹ Moreover, trigger rules, such as the rule requiring any owner with a stake greater than 2 percent to disclose that interest, work as well for SWFs as for any other institutional investors. Whether SWFs should face special disclosure requirements is, again, more political, but from a market point of view those rules that typically exist in developed equity markets serve well. Being too restrictive would actually increase the incentive for SWFs to invest through external managers, and without explicit “look through” provisions, it would be very difficult for the host country to know the identity of the end investor.

Nevertheless, beyond political considerations, transparency for SWFs, as for any other large investor, is a dual-edged sword. Given the increased market focus on SWFs and the market reaction to publicly announced investments (including the backlash if a publicly acquired stake has to be sold), SWFs have to strike a careful balance between being transparent and revealing too much. However, little evidence so far indicates that the transparency level of the Norwegian Government Pension Fund–Global (managed by Norges Bank Investment Management) has affected its investment performance. As described by Beck and Fidora (2008), the Norwegian Government Pension Fund–Global discloses after

¹¹The Santiago Principles were developed by the International Working Group of Sovereign Wealth Funds. Among the generally accepted principles and practices, SWFs ensure that they will “invest on the basis of economic and financial risk and return-related considerations” (unless otherwise disclosed), take into account the stability of the global financial system, and step up their public disclosures (see IWG, 2008b; and Chapter 5 of this book).
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the fact that it has divested a stock and no significant negative price impact follows such an announcement. Conversely, the disclosure that the Norwegian Government Pension Fund–Global has purchased a particular stock has a positive impact; in many cases, however, this positive impact is to the SWF’s advantage and hence does not raise any real transparency concerns and should be easier to disclose. However, disclosing only the purchases and not the sales might subject an SWF to criticism by the broader market.

Disclosure of the identity of external managers provides some information about investment strategy. As a result of increased political sensitivity to direct investment, as well as its market impact, the use of external managers is popular. Norges Bank International Management publishes a list of its external managers, as did CIC in its latest annual report. The use of an external manager significantly changes the influence of an SWF in any given market. It is very difficult for the market to discern whether the external manager is investing on its own account, executing on behalf of an SWF, or simply managing a fund in which the SWF together with other investors has invested. While the use of external managers is traditionally more related to helping the SWF invest in areas in which it may not have sufficient expertise, or to creating an external benchmark to compare itself against, the implications for diminished market impact (and diminished political impact as well) must be a benefit. Of course, because many real-money managers have to disclose their holdings, SWF investments through real-money managers are disclosed—but without identifying the end investor. To the extent that SWFs invest in hedge funds, the transparency of their investments is even further reduced. However, using well-established asset managers as intermediaries should help assuage concerns that SWFs are investing with mixed financial and political motives. As the experience with the Norwegian Government Pension Fund–Global has shown, a mix of external managers and direct investment would be a natural outcome, and the composition will be dictated by the SWF’s in-house expertise and willingness to invest in more exotic asset classes with which it might have less experience.

CONCLUSION

SWFs faced intense public scrutiny in 2007 and 2008 as they emerged on the global scene as new and important market participants. Some of the political concerns about the entrance of state-controlled market participants have been allayed by the 2007–09 global financial crisis and by steps the SWFs have taken to gradually increase their transparency. From a financial-market perspective, the rise of SWFs raises far fewer concerns while presenting new profit-making opportunities for many investment banks and external managers vying for SWF business, which may affect this sanguine view. Unfortunately, despite recent improvements, the lack of data and transparency severely affects any analysis of the impact of SWFs on global capital markets. Data are available on several large SWF equity transactions, but much less is known outside of equities. Hence, any conclusions about the possible impact of SWF decisions on fixed-income and FX markets are
tentative and are more driven by speculation about their probable asset allocation choices as they mature. Ironically, as noted by some observers, the shifting of assets away from central bank reserves (the currency composition of which is reported by COFER) to SWFs may reduce the level of transparency in the system of emerging-market FX assets.

Concerns about the absolute size of an SWF more likely reflect political rather than market issues. From a market perspective, the size of individual funds or the SWF industry as a whole are not particularly unusual and do not cause any real distress. A market concern could arise, however, with any sectoral, geographic, or asset concentration by SWFs. This is not an idle worry. SWFs tend to cluster in similar sectors during similar periods, as revealed by the wave of investments in the U.S., euro area, and Japanese banking sectors during the recent crisis, which bought time for the banking sectors to restructure, but these capital injections ultimately proved to be insufficient. An interesting element of these investments was that they were fully transparent—the investing SWF was known as were most of the terms—which was probably a function of the regulated nature of the banking system, including the requirement for banks to disclose material information to their shareholders. However, were SWFs to invest to a significant extent in emerging markets, as an optimal portfolio allocation approach would suggest, the overall size of these funds and the new flows they could generate would then raise both market and macro issues. Would their entry dislocate asset prices and currencies? Would the market know when they exited? Would these sustained inflows allow the recipient country to run a different, more accommodative policy mix? These concerns, however, are generally no different from market concerns about any other large, nontransparent, institutional investor.

SWFs raise few specific concerns for market participants, and greater disclosure can do much to mitigate concerns. As a precedent, the U.S. mutual fund industry, through its representative organization the Investment Company Institute, provides useful data and general portfolio allocations and inflows for the industry as a whole. From a market perspective, such information is useful in monitoring broader industry trends and watching for any overconcentration. In fact, the development of an international working group of SWFs seems to be a first step toward greater transparency and disclosure, which will promote better understanding of the role SWFs play in the market. Supervisors and host-country governments also have an interest in gathering more information to ensure that investments are financially motivated and adhere to the standards of the host country. Based on the increased pressure for extended supervision and regulation of previously unsupervised pools of capital following the crisis, it would be hard to argue that SWFs should be exempt from host-country supervision. In fact, concentrated SWF investments could raise systemic risks and need to be supervised.

12See www.ici.org, which provides this mission statement: “Encouraging adherence to high ethical standards by all industry participants; advancing the interests of funds, their shareholders, directors, and investment advisers; and promoting public understanding of mutual funds and other investment companies.”
As newly established SWFs build track records, the market will become accustomed to the funds’ growing role, and whether portfolio concentration in one sector actually triggers any broader-based problems will be determined. Much of the market’s current perception of SWFs is still based on anecdotes and information from market intermediaries rather than on hard facts. To reduce the risk of political backlash against SWF investments in target countries, SWFs themselves would be well served to increase their transparency even further. Transparency need not be public, but could instead be directed toward the regulators and supervisors in the target country.

The true market implications of the rise of SWFs are likely to arise from long-term trends rather than any individual transaction. The growth in SWFs will mean greater headwinds for the U.S. dollar and the euro, and could benefit emerging markets and the yen. These results stem from the ongoing diversification of official reserves away from the U.S. dollar, and the fact that SWFs provide an attractive vehicle for emerging-market governments to speed up this diversification process.

The global financial crisis has slowed the growth of SWFs, but as the crisis dissipates, commodity prices recover, and the need for home-country investment support financed by the SWFs declines, the funds’ AUM should return to a growth path. This growth path will be driven by both macro and political factors, such as the choice of FX regime and whether sustainable current account surpluses can be run over the medium term. It is conceivable that the AUM of SWFs will triple by 2020; therefore, it is crucial to address residual political and market concerns now, before SWFs play an even bigger role.

SWFs will confront the market with challenges similar to those in previous episodes of the emergence of new classes of institutional investors. The rise of mutual funds, hedge funds, and private equity funds all presented the market with new issues, but in general, all these entrants have increased liquidity and stimulated deeper and broader markets globally. SWFs managed on the basis of financial rather than political principles fit that mold. Although it is reasonable to expect some accidents along the way, nothing particular about SWFs leads to doubts that the end result will be similar to that of other emerging institutional investors. However, there may be macro implications rather than market implications, as global imbalances fuel a faster growth of SWFs. SWFs have existed since the 1950s, so their institutional set-up is not new—the assets they manage and are likely to manage lead to the questions. Although the market implications of SWF investments highlighted in this chapter represent a market view rather than the market view, it appears the concerns raised by SWF investments are much more political than market driven.

REFERENCES


