Sovereign Wealth funds are the new buzz term of the investment industry. But do the figures add up?

In June 2008 the OECD estimated that there was about $3trillion held globally in sovereign wealth funds (‘SWFs’). This is more than the total amount held by all public sector pension schemes around the world and the sector is projected to grow rapidly, with some private sector estimates suggesting this amount could quadruple over the next decade.

This article looks at the recent history of the SWFs, the voluntary code of ‘Santiago’ principles that governs their activities, and how they have very quickly gone from villain to hero in the eyes of the Western economies.

What exactly is an SWF?

SWFs can generally be described as special purpose investment funds or arrangements that have been created by and are owned by various general governments for macroeconomic purposes.

There is no standard structure or investment strategy amongst the various SWFs at large in the world today. Each has been set up with distinct objectives amid the political and governmental backdrop of its sponsoring state. Some SWFs are set up as separate legal entities. Others are really just a pool of state-owned assets. Some SWFs have a board or steering committee to determine their investment strategy. Again, others receive their investment strategy from government officials. A number of SWFs have consciously delegated their investment management function to an external advisor. This was partly in response to the concerns raised that political pressures would play a part in investment decisions. Others keep their investment management function in-house.

While states set up SWFs for their own specific aims, it’s generally the case that the funds exist to invest massive trade surpluses outside the owner state, thereby avoiding the risk of high inflation being triggered by investing the money domestically. Additionally, in the case of SWFs who have accumulated their funds from the exploitation of oil and gas reserves, the idea is to invest the monies around the world to diversify for when the oil and gas run out.

International concerns

Increasingly, SWFs are being seen as an intrinsic part of the solution to the credit crunch. However, not long ago, their activities were seen as a problem for Western markets.

In the early days of the SWFs, many were content to invest quietly in US Treasuries, stocks and bonds. However, as their portfolios became more diverse - ranging from acquisitions of public companies, to co-investments alongside private equity houses, to industrial joint ventures, to Premier League football clubs - and started to encompass strategically important service providers, such as utility companies, concerns started to emerge that SWF investments could be unduly subject to the political whims of foreign powers. While the SWFs argued that they provided a stabilising influence to the worlds' markets, there was widespread disquiet that SWFs were starting to really ramp up their programme of acquisition.

This culminated in the Dubai Ports World controversy, a high-profile dispute in February-March 2006 between the US and the United Arab Emirates.

The controversy was over whether the sale of port management businesses in six major US seaports to Dubai Ports World, a company owned by the government of Dubai, would compromise port security.

The business had earlier been under the British company P&O, which had been acquired by Dubai Ports World. As part of the purchase deal, Dubai Ports World was to assume the leases of P&O to manage major US port facilities in New York, New Jersey, Philadelphia, Baltimore, New Orleans and Miami, as well as operations in 16 other ports. However problems arose when Democratic and Republican members of the US Congress started to question the deal as a threat to national security. Subsequently, the US House of Representatives voted to block the deal and Dubai Ports World were forced to turn over operation of the ports to a US 'entity'.

EU states such as Germany and France had also voiced unease that SWFs (from Russia or China in particular) may invest in Europe to influence strategic companies like utilities, rather than for purely commercial reasons. These concerns were compounded by difficulties EU firms can face in investing in the home countries of the SWFs.

"SWF countries must acknowledge that their growing weight in global financial markets brings responsibilities," EU Economic and Monetary Affairs Commissioner Joaquin Almunia told a news conference at the end of February 2008.

The Santiago principles

Amid the international anxieties surrounding the motives of the SWFs and the lack of reciprocal open markets in some cases, there was pressure on certain SWFs to operate more openly. The highly transparent and politically neutral system of governance and investment adopted by Norway's SWF is often cited as a good example of best practice.

Various proposals had been put forward for the regulation of SWFs. In Europe, for example, these had ranged from an EU committee on foreign investments - to mirror arrangements in the US - an EU-wide screening mechanism, and a 'golden share' type mechanism for non-EU foreign investment.

Eventually, the wealth funds themselves responded to the pressure to be more transparent. The International Working Group of Sovereign Wealth Funds, an international working group made up of 23 nations, including Singapore, the United Arab Emirates, Kuwait, Qatar, China, Russia and the United States, was established on April 30 2008 to identify and draft a set of principles that properly reflect their investment practices and objectives. After consultation, they published in October 2008 a set of ‘Generally Accepted Principles and Practices for SWFs’, which have been dubbed the Santiago Principles. In effect, the Santiago Principles are a voluntary code of conduct for SWFs and are meant to dispel any residual suspicion regarding any hidden agendas of sponsoring states.

The 24 principles, which were presented to the International Monetary Fund, was intended to encourage people to view the SWFs as transparent and long-term investors that boost the stability of the global financial system.

The Santiago Principles cover three main areas concerning SWFs:
*Their legal framework, including information on sources and uses of funds
*Their institutional framework (governance structure and accountability processes); and
*Their investment and risk management framework, including how they manage risk and make investment decisions. For example, one requirement is not to use privileged information from the state sponsor.

Recent SWF activity

With the combined effect of the global financial crisis and the reassurance provided by the Santiago Principles, SWFs have been enjoying a much warmer reception of late. In the last year, SWFs have been actively investing, ranging from emergency investments made in the banking sector to mammoth joint ventures (such as an $8bn partnership with General Electric and a partnership with Advanced Micro Devices, the world's second largest computer chip-maker, in each case backed by Abu Dhabi sovereign wealth).

At present, some SWFs might well be licking their wounds from the last year, both from the rescue financing provided to troubled banks on public markets and from exposure to private equity. These paper losses, coupled with reductions in export growth rates and oil prices mean that SWFs are treading particularly carefully right now.

However, once confidence in valuations is regained, SWF investment activity will prove to be a most dominant theme in global markets that is here to stay.

Attitudes reversed

In summary then, attitudes towards SWF shifted sharply in the course of the last year. Whereas not so long ago they had been greeted with outright hostility and suspicion, they moved to becoming a pre-eminent source of global capital in the latter part of 2008.

Instead of the wary acceptance of SWF activities that has been begrudgingly given to date, there may well be jostling amongst Western powers to court SWF investment in future. Suddenly, the Dubai Ports World controversy seems like ancient history.

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For those contemplating transactions with SWFs, there are some specific legal issues to be born in mind before contracting with these entities. For more information, Charles can be contacted at C.Fletcher@taylorwessing.com