

SOVEREIGN FUNDS

Sovereign wealth funds as providers of capital

BY CLAIRE SPENCER



Sovereign wealth funds (SWFs) have existed for many years, but many commentators still regard them as a mysterious and even menacing presence in the global market, suspecting political motives behind their foreign investments. Transparency has been an issue, but there have been improvements of late. SWFs have been invited to self-evaluate using the Santiago Principles and the Linaburg-Maduell Transparency Index in the hope of quashing the mistrust that surrounds them. It is clear that capital shortages in the global market are severe, and SWFs may be well placed to address those shortages, if they are permitted to do so.

An SWF is a state-owned investment fund composed of various financial assets, including stocks, bonds, real estate or any other financial instrument funded by foreign exchange assets. Gopal Ramanathan, a partner at KPMG, explains that there are two primary starting points for these investment vehicles. “Funds may have their origin in either commodities or non-commodities. The former are created through commodity exports, either taxed or owned by the government, whereas the latter are usually created through transfers of assets from official foreign exchange reserves,” he says. With regards to structure, SWFs typically take the form of a fund or a reserve investment corporation, with a few used to invest directly into domestic state-owned enterprises. However, both

the combination of financial instruments and the investment structure vary, depending on which country and/or asset class the SWF is investing in. For instance, tax and corporate laws tend to differ by jurisdiction.

Furthermore, all SWFs are created for different purposes and have different objectives as a result. Indeed, the only truly shared objective between them is the deliverance of long-term financial returns. As such, unlike private equity firms and strategic investors, most SWFs do not wish to manage the companies they invest in. In addition, they have a higher-risk tolerance than traditional foreign exchange reserves due to their preference of returns over liquidity.

Investing in tough times

Information surrounding the investment activities of SWFs is less freely available than for other institutional investors. However, the general feeling is that the last quarter of 2008 was disappointing for SWFs. Transaction volume seems to be down, with many potential investments postponed or cancelled. As such, SWFs are acting with prudence in the opening stages of 2009. “SWFs, like many institutional investors, are still making investments with sponsors with whom they have long term relationships, and are also looking at the opportunities presented by the global economic slowdown,” observes Courtney Nowell, a partner at Patton Boggs. “As any prudent investor would do, many of them are

proceeding more cautiously in light of the fact that assets are difficult to value. SWFs and other institutional investors are also taking advantage of the slowdown to examine the risk exposure within their existing portfolios, and taking the steps necessary to effectively manage that risk,” she says.

On the other hand, SWFs are more able than most institutional investors to put their money to work at the moment. Twelve SWFs have been created since 2005, and it is estimated that they control as much as \$2.5 trillion worth of assets. In the case of many Middle Eastern SWFs, their growth was enhanced in the first half of 2008 by rising oil prices. However, their continued success in 2009 is more likely to rely upon diversification across sectors and countries, particularly now that oil prices are much lower.

In addition, SWFs are generally thought to hold a long term investment outlook, which will be invaluable in the current climate. “Although information on investments is not widely available, it appears that most of the investments are done for a longer term, generally in excess of five years,” notes Mr Ramanathan. “Long term investment horizons fit in with the aim of preserving these funds, ensuring that they remain in place and provide income flows into the longer term future.” However, Ms Nowell believes that SWFs are more flexible than most are aware. “SWFs have different timelines and return expectations for different asset classes. When an SWF makes the leap from being a straight purchaser of currency or government-backed debt to becoming a multiple asset class investor, it is usually because the fund is purposefully diversifying to take advantage of the different types of returns and investment timelines offered by different assets. A well-diversified SWF will have both short and long term assets, in addition to those that could be financed or refinanced to meet cashflow needs,” she says. The prospect of an investment vehicle that is both adaptable and well-capitalised should, then, be an exciting one for an illiquid global market.

Dispelling suspicion

Yet, many market participants still regard SWFs as a threat, believing that their opac-

ity is hiding some malevolent political intent. National security should always be a priority in cross-border dealmaking, but this should not be confused with financial protectionism, which is old-fashioned and highly counterproductive in a global market. According to the Sovereign Wealth Fund Institute, SWFs generally make it clear that they do not engage directly in macroeconomic policies, except in the following cases: transfers to the budget for exceptional and targeted needs, and the draw-down of funds for transfer to the central bank in case of exceptional balance of payments or monetary policy needs.

Of course, these are just words, and without improvements in transparency, few will be convinced of their truth. In the vast majority of cases, the lack of transparency can be attributed to the fact that SWFs are not legally compelled to reveal anything – so do not bother. “Many SWFs, especially those in the Gulf region, are not necessarily very transparent, as they are often run by a small team or group of people who report directly to the ruler of the state, and consequently do not need to report their holdings or strategies to the public at large,” explains Mr Ramanathan. He adds that “though there have been no serious incidents to date, this could give rise to serious questions being asked about the investment policies of such SWFs.”

Ultimately, SWFs have been institutional investors for decades, and there is scant evidence to suggest that political motives outweigh commercial viability in the investments they make. In many ways, they are like any other institutional investor. “Many SWFs, like pension funds and endowments, have internal investment restrictions that limit the types of

investments that may be made,” explains Ms Nowell. “These investment restrictions are decided upon by the investor’s governing body, and are clearly communicated to an investment sponsor, seller, or joint venture partner. Any institutional investor subject to restrictions on the types of investments that may be made will consider these restrictions when evaluating a potential investment, and they are a common consideration when negotiating investments on behalf of an SWF, pension fund, or other institutional investor.”

On the other hand, the only SWF which has explicitly stated its ethics or internal investment restrictions to parties other than its investment partners is Norway. According to Thorvald Moe, deputy secretary general in the Norwegian ministry of finance, the Norwegian SWF has “ethical guidelines,” which state that they seek to avoid investing into companies that use child labour, and that they favour ecologically sound investments. There is no way of knowing for sure that the other SWFs operate under a similar code of conduct unless they choose to disclose it, so it is perhaps unsurprising that there have been some misgivings directed towards them.

Happily, steps have been taken to address their opacity. The International Working Group of Sovereign Wealth Funds recently published the Santiago Principles, a set of generally accepted principles and practices for SWFs. These include a best practices framework for the governance and regulation of SWFs. In addition, Carl Linaburg and Michael Maduell of the Sovereign Wealth Fund Institute created the Linaburg-Maduell Transparency Index – a method of rating the transparency of SWFs. Using Norway’s highly transparent SWF as a

benchmark, other SWFs are invited to use the index, based on 10 essential principles, to assess and improve their own transparency. The minimum rating a fund can receive is a 1, but the Sovereign Wealth Fund Institute recommends a minimum rating of 8. These frameworks should eventually dispel criticisms pertaining to the transparency of SWFs.

Investing into the future

It is hoped that SWF investments into the ailing global economy will improve SWFs’ reputations as well as the economy itself. However, they have invested a lot of money into Western stock markets in recent years, and lost a great deal of it when the markets crashed in 2008. As such, there are fears that SWF investment will not focus on Western economies in the short to medium term. It is true that they have been less active of late, but it is more likely that they, like many other institutional investors, are just biding their time until government rescue packages have the desired affect. Certainly, it is very unlikely that they will stop investing in the US and Europe, even if they do focus on emerging markets for the time being.

Caution is advisable in all investment, but it is generally the case that the driving force behind SWF investment is to ensure the future of the inhabitants of the country in question. Indeed, companies can increasingly be assured that this is the case. To date, 11 SWFs around the world are scoring 8 or more on the Linaburg-Maduell Transparency Index, and it is thought that this figure will continue to improve this year. With transparency comes trust, and trust will ensure that SWFs can fulfil their potential as providers of capital when so many other sources have dried up. ■



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As co-head of the Private Capital and Investment Group, Courtney Nowell focuses her practice on domestic and international business transactions, primarily representing investors in private equity and other investment funds, including LBO, venture capital, distressed debt, and real estate funds, as well as funds focused on the secondaries market.

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Before joining the firm, Ms. Nowell worked in the National Tax Department of a national accounting and professional services firm, where she reviewed tax opinions, drafted requests for administrative guidance from the Internal Revenue Service (IRS), and monitored tax legislative developments.