Sovereign Wealth Funds: The Good, the Bad, and the Not-So-Transparent.

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Over the past several years, concerns have been raised in the United States regarding the size and more importantly the intentions of sovereign wealth funds (SWFs). These funds, while not unique from an historic perspective, have grown substantially and represent some of the largest cash positions in the world at a time when traditionally robust US investors are suffering a severe cash crunch. Is concern over these funds unfounded or do they represent a tangible threat with regard to their power to purchase major controlling stakes in US real estate assets?

What is a Sovereign Wealth Fund Exactly?

According to deputy US Treasury secretary Robert Kimmitt, sovereign wealth funds are basically government-owned investment funds. They are funded by foreign currency but are managed separately from official currency reserves. Essentially they are vast sums of cash accumulated by governments that operate with a surplus typically due to their ownership interests in wealth-generating assets such as oil. More often than not, the money is used to invest in foreign assets as these governments attempt to counter historical inflation scenarios (2-3%) much less the current inflation numbers which are closer to 5 or 6%. At least until the recent global economic crisis, SWF assets would gradually lose value if their governments left that money in the bank. For instance, in November of 2007 the Dubai SWF purchased a 4.9% stake in Citigroup and Kuwait's fund promised another $3 billion to help reinforce the struggling financial giant during recent liquidity problems. However, Middle Eastern oil money is not the only game in town.

Sovereign Wealth Fund Players

As is widely known, many countries have accumulated SWFs including China, Russia, Kuwait, Australia, Malaysia and Chile. Even Alaska has a fund, though relatively small in comparison, amounting to $39.8 billion. The largest of these funds by far is the fund accumulated in the United Arab Emirates. At last measure, their fund stands at approximately $875 billion, more than initially was approved by Congress for our economic bailout plan, followed by Norway, Saudi Arabia, Singapore and China with $397 billion, $365 billion, and $312 billion, respectively. By and large the US has enjoyed solid economic and political relations with many of these countries but has recently experienced less than friendly relations with a few countries on the list including Iran and Venezuela. Fortunately these countries have relatively small SWFs standing at $12.9 billion and $800 million, respectively. Ultimately, the intentions of these funds (or how they spend current reserves) may be of great concern depending on the type of relations we enjoy with the various countries and their respective funds and how transparent their investing activities are. An insightful chart ranking the funds can be found at http://www.swfinstitute.org/funds.php. The chart details the size, origin, and transparency of the fund based on a transparency index. The SWF Institute's website is also replete with news of financial moves these funds are currently making. An excerpt from the chart can be found below:

Country	**Fund Name**	**Assets $Billion**	**Inception**	**Origin**	***SWF to Foreign Exchange Reserve Ratio***	***Linaburg-Maduell Transparency Index***
UAE - Abu Dhabi	Abu Dhabi Investment Authority	$875	1976	Oil	29.5	3
Saudi Arabia	SAMA Foreign Holdings	$433	n/a	Oil	12.7	2
Singapore	Government of Singapore Investment Corporation	$330	1981	Non-Commodity	1.9	6
China	SAFE Investment Company	$311.6**		Non-Commodity	0.2	2
Norway	Government Pension Fund – Global	$301	1990	Oil	7.1	10
Kuwait	Kuwait Investment Authority	$264.4	1953	Oil	12.7	6

The Catch

The real concern is not necessarily the size of these funds, but what exactly these state-run entities plan to do with this money. To fully understand this, the starting point is to explore different kinds of funds and their various structures as there are several different ways these funds are built depending on the individual country's investment philosophy and source of revenue. Some SWFs trade using funds earned directly

from commodity export revenue such as oil or minerals while others only use foreign exchange reserves or the money they accumulate by trading currencies. The commodity funds are used for two main purposes: as revenue stabilization and as a buffer to prevent inflation caused by excessive amounts of one currency entering a country at any given time. Funds that are not based on commodity income are more commonly used to make stand-alone investments (purchases or ownership of entire companies generally in one industry) such as Temasek Holdings' ownership of MediaCorp and PSA International. This is a particularly relevant strategy when a country feels it has accumulated too much of one currency, and it helps a country scale back holdings in a particular currency if the currency is showing a weakening trend. Suffice to say that most countries are ultimately positioned to secure long-term, safe profits—the US being the best place historically for placement in safe investments.

Legacy in the Press

Arguably, the most publicized of these concerns was the 2005 Dubai Ports World deal in which a sovereign wealth funded organization was attempting to purchase a contract that would have ostensibly allowed them to control logistics at several US ports. According to one source, "After the deal was secured, the arrangement was reviewed by the Committee on Foreign Investment in the United States, which reviews foreign investments in US businesses that may have negative economic or security implications for the US, headed by the U.S. Treasury Department and including the Departments of State, Commerce, and Homeland Security. It was given the green light, but soon after, both Democratic and Republican members of Congress expressed concern over the potential negative impact the deal would have on port security. They cited the 9/11 Commission report, which stated that two of the 9/11 hijackers were United Arab Emirates nationals, and reports that the UAE was a major financial base for the al Qaeda terror network." Eventually the clamor subsided and the deal was approved, but the situation garnered much attention and pulled SWFs into the international spotlight.

Regulation on the Horizon

After the Dubai Ports World uproar faded, many wondered aloud if more US regulation was necessary to prevent foreign consortia from wielding abundant cash reserves as a political, as well as economic, weapon. Many in the US Congress have also called for tighter regulation. The Committee on Foreign Investment in the United States (CFIUS) is, and has historically been, the official answer to that question from the US government's standpoint. In 1975, CFIUS was formed by an Executive Order used by then-President Gerald Ford that sought to review the status of foreign investment in the US. This was an effort approved by Congress to ensure that from a national security perspective someone was making sure US companies were performing due diligence with regard to selling assets, or ultimately controlling interests, in businesses that had potential strategic value to our enemies. CFIUS annually reviews voluntary declarations from US and foreign companies that seek to sell or purchase potentially harmful assets such as technologically advanced systems or oil reserve capacity. Ten percent ownership (in a US company by a foreign firm) is usually the official line that, if crossed, triggers CFIUS interest in a deal. Recent deals that have garnered additional attention are the Chinese National Petroleum Company's (CNPC) attempted acquisition of UNOCAL, a California-based oil firm, and the Chinese leader in personal computing Lenovo's effort to acquire IBM's personal computer and laptop division. Consequently, the CNPC deal was quashed as UNOCAL eventually merged with Chevron, but Lenovo's IBM bid was successful. Of the roughly 2,000 CFIUS submissions since 1988, only 45 investigations were opened and only 14 required a presidential decision. Either more than 99.99% of companies have become extremely forthcoming with foreign relationships and minute details of their foreign business dealings, or, some further question as to the core efficacy of CFIUS is required. CFIUS does, however, release a report each year that describes various trends in foreign investment to the US and breakdowns by economic sector. A link to the 2008 report can be found at the end of this article.

Could SWFs Really Hurt the US?

Several members of OPEC, who also possess SWFs, have recently expressed interest in decreasing the influence of the fluctuating US dollar by changing the currency for which they receive oil payments from the dollar to a more balanced basket of currencies. This could potentially damage the reputation and long-standing relationship of the US dollar in other countries. Historically, the US dollar has been used, and substantially strengthened, by the fact that oil-producing countries accept the dollar as its sole trading currency for oil payments. This gives the dollar greater global circulation and deeper dollar confidence and forces banks to utilize our currency. If oil-producing countries start refusing the dollar as payment or opt for a

basket of currencies instead, the strength of the dollar could be eroded as confidence in the currency wanes. This is one example of how SWFs could harm the dollar: by choosing not to use it or to accept it less often, especially if European countries follow suit.

"Impervious to Market Swings"

As recent events have demonstrated, owning an SWF is not a government's get-out-of-financial-crises-free card. Even SWF countries feel the pain during a downturn as manifested in recent OPEC oil production cuts by 4.2 million barrels per day in the last 3 months—the largest production decreases ever for the organization. Apparently, this is an effort to increase the price of a barrel of oil as many oil-producing countries have a break-even point that is not being met by current oil prices. While having cash is certainly enviable in a credit crunch, a cash heavy fund is directly exposed to inflation especially if reserves are limited to one or two currencies and not diversified to fortify themselves against a drop in that currency's value. An example of this can be seen at the BBC link at the end of this article.

Recent Purchases

Over the past few years, SWFs have been on a spending spree. Temasek Holdings, the SWF in

Singapore, has invested over $50 billion in the US financial sector. Dubai's SWF, the Abu Dhabi Investment Authority (ADIA), purchased an ill-timed 4.9% stake in Citigroup. In July of 2008, the ADIC, an investment arm of the ADIA, recently purchased a 90% stake in the Chrysler Building in New York City for $800 million. But financial assets aren't their only acquisitions. Mr. William Schwab, formerly of J.P. Morgan, was recently hired by the ADIA and will be responsible for leading a team of professionals in managing and implementing ADIA's global investment strategy in the real estate sector. These countries are aggressively seeking talented professionals from the West to manage their money and bring Western investing philosophies to their organizations thus providing solid educational backgrounds and lending legitimate financial acumen throughout the financial transaction process.

Future Potential

While total SWF holdings stood at around $4 trillion as of January 2009, the International Monetary Fund has stated publicly that it expects cumulative SWF balances to balloon to about $12 trillion by 2012*. The sheer size of this growth is not going unnoticed by economists and political analysts across the globe. The main cause for this growth is the recent spike in commodity price, mainly oil, and while the price of oil has subsequently witnessed a widespread downturn, no analyst will make the statement that oil can't return to those prices in short order given the right economic atmosphere. Oil prices will rise again and will show us that demand/supply curves and efficient market hypotheses are not the be all and end all when discovering what drives prices up and down. This phenomenon will have a direct effect on what we pay for everything from gas to real estate, commercial and residential, and merits constant attention accordingly.

*A recent article in The Economist magazine makes the case for a diminished SWF presence on the world stage in 2009 and beyond. According to the article, these funds have decreased in current totals and future projections. That article can be read here.

To further explore this topic, follow the links below:
http://www.swfinstitute.org/
http://en.wikipedia.org/wiki/Committee_on_Foreign_Investment_in_the_United_States
http://news.bbc.co.uk/2/hi/business/7745711.stm
http://memrieconomicblog.org/
http://www.treas.gov/offices/international-affairs/cfius/docs/FINSA_Annual-Report.pdf
http://www.economist.com/finance/displaystory.cfm?story_id=12998177