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FINANCIAL MARKETS SERIES

SOVEREIGN WEALTH FUNDS

APRIL 2011

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TheCityUK
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TheCityUK is an independent membership body, established in June 2010, promoting the UK financial and related professional services industry.

TheCityUK's key areas of activity include:

- Promoting the UK-based industry as a world leader offering unrivalled service and expertise to partners around the world.
- Creating a partnership for a sustainable industry: demonstrating the industry's role in enabling growth and prosperity in the wider UK economy.
- Using research, evidence, insight, data and analysis to meet the needs of its members and to provide the evidence to support our promotional objectives.

SOVEREIGN WEALTH FUNDS

APRIL 2011

While sovereign wealth funds (SWFs) have existed for decades, their profile has risen considerably during the recent global economic downturn. TheCityUK estimates that SWF assets could reach $5.5 trillion by 2012 as inflows from trade surpluses and commodities' exports continue. The political instability in the Middle East and North Africa in 2011 may have consequences on the direction of investments and rate of growth of some SWFs, although countries currently affected by the instability only account for around 3% of global SWF assets.

SUMMARY

Assets under management of SWFs increased by 11% in 2010 to a record $4.2 trillion (Charts 1, 2 and 3). There was also an additional $6.8 trillion held in other sovereign investment vehicles, such as pension reserve funds and development funds. Estimates of the size of this market differ widely due to varying definitions of SWFs and limited disclosure and lack of transparency of a number of SWFs, particularly some from the Middle East. Transparency in the market is gradually improving since the development and implementation of the Santiago Principles in 2008, a list of best practices for SWFs.

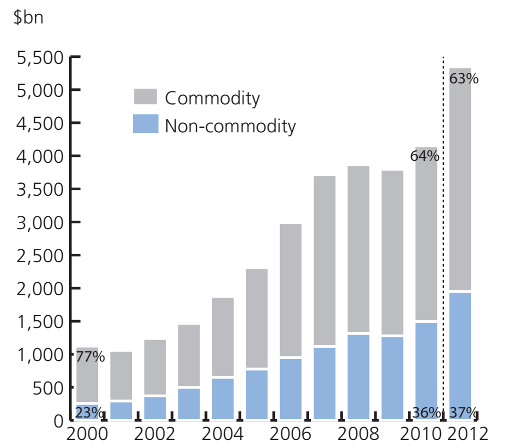
During the recent economic downturn, many SWFs have experienced a slowdown in the inflow of capital. As some Asian countries, particularly China, continue to build up foreign exchange reserves, and commodity demand increases with the recovery in the global economy, SWFs should see a resumption in strong capital inflows. TheCityUK projections are for SWFs' assets to increase to $5.5 trillion by the end of 2012. Countries such as Libya, Algeria and Bahrain collectively manage around $150bn in SWF assets which represents around 3% of global SWFs assets under management. Countries with the largest SWFs are so far not affected by the current political instability.

SWFs funded by commodities exports, primarily oil exports, totalled $2.7 trillion at the end of 2010 or close to two-thirds of overall SWFs' assets. Non-commodity SWFs, funded by transfer of assets from official foreign exchange reserves, and in some cases from government budget surpluses, pension reserves and privatisation revenue, totalled $1.5 trillion. Non-commodity funds are capturing an increasing share of SWFs' assets, a trend that is likely to continue in the coming years.

SWFs have started to regain their appetite for cross-border investments in recent months following a retreat towards domestic markets in the early

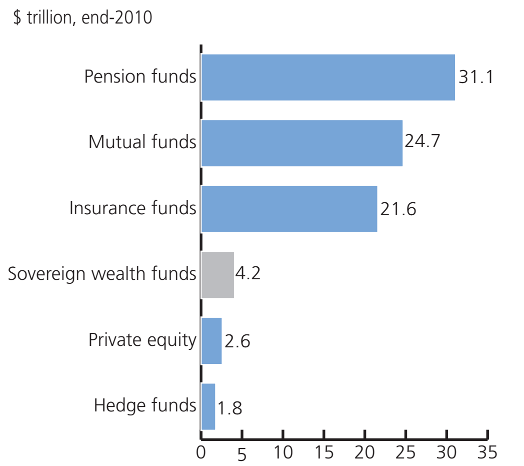
SWFs' assets under management reach **$4.2 trillion**

Chart 1
SWFs' assets under management



Source: TheCityUK estimates

Chart 2
Global assets under management



Source: TheCityUK estimates

part of 2009. The 92 publicly reported investments with a value of $22bn in the first half of 2010 was double the number and value on the same period in the previous year. SWFs increased investments into the financial sector in the first half of 2010 although there was more diverse exposure with a larger proportion of funds allocated to private equity and emerging markets' investments. SWFs also continued to make a larger number of small investments. Financial services were in receipt of one-third of SWF investments in the first half of 2010, up from less than a fifth in the previous year. The China Investment Corporation and Qatar Investment Agency were particularly active with $7.3bn and $5.3bn invested in the first six months of 2010, much of this in energy, metals and agriculture, as well as in alternative assets such as hedge funds and private equity.

Chart 3
Sovereign investment vehicles

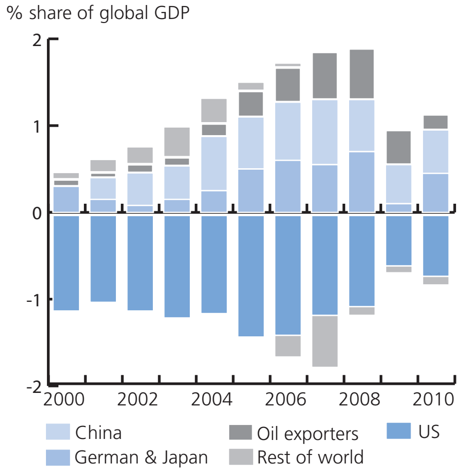
$ trillion	Sovereign wealth funds: Commodity funds	Sovereign wealth funds: Non-commodity funds	Sovereign wealth funds: Total assets	Other sovereign investment vehicles	Official foreign exchange reserves not in SWFs
2008	2.6	1.3	3.9	6.2	6.0
2009	2.5	1.3	3.8	6.5	6.9
2010	2.7	1.5	4.2	6.8	7.7
	- Stabilization funds - Savings funds			- Reserve invest. corp. - Development funds - Pension reserve funds - State-owned comp.	Central banks' official reserves

Source: TheCityUK estimates, OECD, Wikipedia, IMF

The UK and the SWF industry The UK and London in particular is an important centre for SWFs as a clearing house and location from where some of these funds are managed. Its strong position stems from the structural strengths associated with the cluster of financial and professional services, broad skills base, open market and pivotal international position of English law. A number of large SWFs such as the Kuwait Investment Authority, Brunei Investment Agency, Abu Dhabi Investment Authority and Temasek/General Investment Corporation of Singapore have local representative offices in London. A number of other SWFs are also looking into setting up offices in London.

The UK welcomes investment by SWF in the financial sector and other industries on the basis that the UK has a regulatory, competition and national security framework that ensures that all foreign investment, whether from a SWF or not, meets the appropriate criteria. The UK Government is committed to ensuring the UK remains an open and competitive market for international investment.

Chart 4
Global current account imbalances



Source: IMF, TheCityUK estimates

MARKET SIZE AND GROWTH TRENDS

Assets under management of SWFs increased by 11% in 2010 to around $4.2 trillion (Charts 1, 2 and 3). In addition to SWF assets, there was also $6.8 trillion held in other sovereign investment vehicles, such as pension reserve funds and development funds (Chart 5). Estimates of the size of this market differ widely due to varying definitions of SWFs and limited disclosure and lack of transparency of many SWFs. TheCityUK projections are for SWFs' assets to increase to around $5.5 trillion by the end of 2012.

Definition of SWFs

SWFs are defined as special purpose investment funds or arrangements, owned by the general government. Created by the 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. SWFs' assets are commonly established out of balance of payments surpluses (Chart 4), official foreign currency operations, the proceeds of privatisations, fiscal surpluses, and receipts resulting from commodity exports.

$6.8 trillion managed by other sovereign investment vehicles

A number of new SWFs were launched over the past couple of years. This included the French Strategic Investment Fund, established in 2008 with funds of around $28bn to help stabilize French firms and fund innovative projects. The Sovereign Fund of Brazil was established in 2009 to provide a source of finance in the event of futgure financial crisis and to assist Brazilian firms in trade and foreign direct investment. Some of the other countries that have opened or are planning to establish new SWFs include Angola, Bolivia, Canada, India, Japan, Nigeria, Taiwan and Thailand.

Assets of SWFs are larger than those of the hedge fund industry but much smaller than conventional fund management assets (pension, insurance and mutual funds) (Chart 2). SWFs assets are however increasing at a greater pace. Some SWFs are well established having been around since the 1950s. Their growing prominence is a more recent phenomenon with more than half of SWFs being established since 2000 (Chart 7).

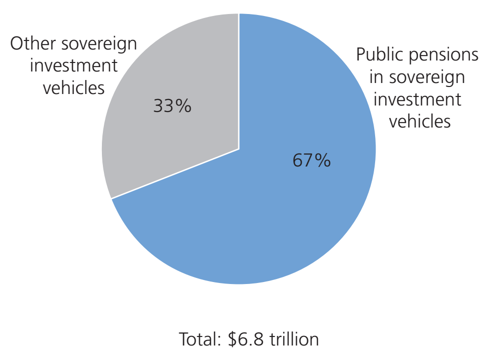
The profile of SWFs has risen considerably since 2007. The credit crisis has highlighted the growing role of investment by foreign governments, particularly in market conditions characterised by scarce liquidity. A number of SWFs have participated in stabilisation efforts on their domestic markets through for example direct capitalisation in banks and financial markets, purchasing real estate, and financing budget shortfalls and fiscal stimuli. For example, Russia's Reserve Fund was used to supplement the federal budget during 2010, with its total assets declining by around a half during this period to $25bn. Following a retreat from international markets in late 2008 and the early part of 2009, SWFs have gradually increased their cross-border investment activity (Chart 6). The political unrest in the Middle East and North Africa in the early part of 2011 may have consequences on the future direction of investments and rate of growth of some SWFs. Countries such as Libya, Algeria and Bahrain collectively manage around $150bn in SWF assets which represents around 3% of global SWFs assets under management. Countries with the largest SWFs are so far not affected by the disruption.

Nearly two-thirds

of sovereign wealth funds originate from commodities exports revenue

Chart 5
Sovereign investment vehicles

$bn, end-2010

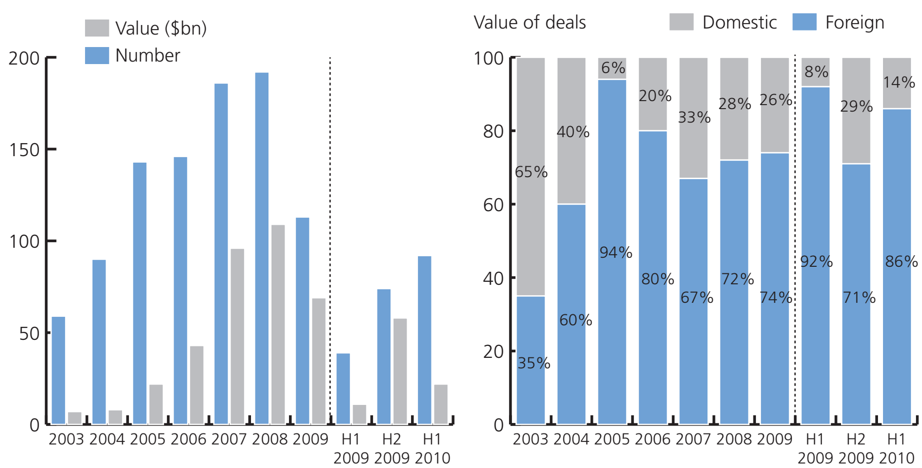


Source: OECD, TheCityUK estimates

Sources of funds SWFs are only one of many channels through which governments deploy their financial assets. The funding of SWFs comes from various sources, which can be combined. SWFs are generally the result of current account surpluses from exports of oil and other commodities or manufactured goods, fiscal surpluses, public savings or privatisation receipts.

SWFs fall into one of two major categories: commodity funds funded predominantly from oil revenue; and non-commodity funds funded mainly from official foreign exchange reserves and in some cases from pension reserves. TheCityUK attributes around two-thirds of SWF assets at the end of 2010 to commodity funds. Non-commodity funds have however

Chart 6
SWF investment trends



Monitor - FEEM SWF Transaction Database

grown at a faster pace over the past decade, a trend that is likely to continue.

Regional distribution of funds Asian and Middle Eastern countries each accounted for close to 40% of SWF assets. Europe accounted for most of the remaining funds (Table 1).

China had the largest individual country share with over a quarter of the global total. Countries from the Middle East are very prominent in individual country rankings with United Arab Emirates accounting for 17% of the global total and Saudi Arabia 11%. Norway is also an important centre with 12% of global assets.

Largest SWFs are the Abu Dhabi Investment Authority, Norway Government Pension Fund, SAMA Foreign Holdings, SAFE Investment Company and China Investment Corporation (Table 2). Estimates of holdings of some SWFs vary widely due to limited disclosure and transparency. This is particularly the case with a number of Middle Eastern funds.

Other sovereign investment vehicles Distinct from sovereign wealth funds but sharing many common elements with them are other sovereign investment vehicles such as sovereign and public pension reserve funds, government investment funds, government development funds and government affiliated corporate entities.

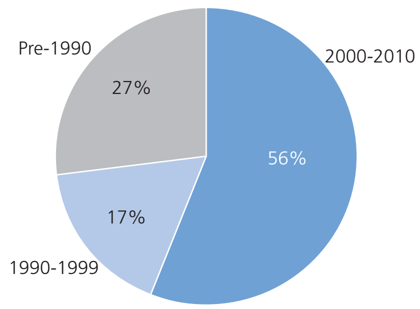
TheCityUK estimates that assets held by sovereign investment vehicles (excluding SWFs) totalled $6.8 trillion at the end of 2010, up from $6.5 trillion in the previous year (Chart 5). Countries, such as the US, Japan, and Sweden held funds totalling nearly $4.5 trillion, sometimes through social security institutions, to finance future payouts on pay-as-you-go pensions (Table 3). Remaining funds include government development funds, government investment corporations and overseas investments of government-owned enterprises.

COMMODITY SWFs

Commodity or natural resource SWFs are funded predominantly from oil exports, with gas and mineral revenue also representing important sources. Many oil exporting countries have set up SWFs to invest oil trade surpluses in global financial assets. Other investors include central banks, government investment funds, wealthy individuals and private and government controlled companies. The major oil exporting countries with commodity SWFs include the Gulf Cooperation Council and other Middle Eastern countries, Norway, Russia, Nigeria, Venezuela and Indonesia.

Chart 7
Launch year of largest SWFs

Launch year of top 50
sovereign wealth funds, % share by number



Source: TheCityUK calculations

Table 1
SWFs market share by country and region

end-2010		
By country	**$bn**	***% share***
China	1,090	*26*
United Arab Emirates	709	*17*
Norway	512	*12*
Saudi Arabia	444	*11*
Singapore	381	*9*
Kuwait	203	*5*
Russia	143	*3*
Others	668	*16*
By region		
Middle East	1,504	*36*
Asia	1,547	*37*
Europe	754	*18*
Americas	101	*2*
Other	244	*6*
Total	**4,150**	

Source: SWF Institute, TheCityUK estimates

Table 2
Largest SWFs

end-2010	***$bn assets under management***	***Country***	***Inception year***	**Source**
Abu Dhabi Investment Authority	627	UAE	1976	Commodity
Government Pension Fund – Global	512	Norway	1990	Commodity
SAMA Foreign Holdings	439	Saudi Arabia	n/a	Commodity
SAFE Investment Company	347	China	1997	Non-Commodity
China Investment Corporation	332	China	2007	Non-Commodity
Hong Kong Monetary Authority Investment Portfolio	259	China (HK)	1993	Non-Commodity
Government of Singapore Investment Corporation	248	Singapore	1981	Non-Commodity
Kuwait Investment Authority	203	Kuwait	1953	Commodity
National Social Security Fund	147	China	2000	Non-commodity
National Welfare Fund	143	Russia	2008	Commodity
Temasek Holdings	133	Singapore	1974	Non-Commodity
Qatar Investment Authority	85	Qatar	2005	Commodity
Libyan Investment Authority	70	Libya	2006	Commodity
Australian Future Fund	67	Australia	2004	Non-Commodity
Revenue Regulation Fund	57	Algeria	2000	Commodity
Others	481			
Total	**4,150**			

Source: SWF Institute, TheCityUK estimates

Types of sovereign investment vehicles

Both SWFs and other sovereign investment vehicles are government owned investment entities that seek to generate financial returns for the nation. Their funding, operations and objectives however differ.

SWFs

Stabilization funds are set up by countries rich in natural resources to provide budgetary support and protect the national economy from volatile commodity prices. These funds are built up in times of favourable commodity prices and drawn upon in cases of low commodity prices or shortage of reserves.

Savings funds have longer term wealth creation as a goal and are intended to share wealth across generations. For countries rich in natural resource, savings funds transfer non-renewable assets into a diversified portfolio of international financial assets to provide for long-term objectives.

Other sovereign investment vehicles

Sovereign and public pension reserve funds represent investment vehicles funded with assets set aside to meet the government's future entitlement obligations to its citizens.

Government investment funds are funds established to invest official Government reserves. Often, the assets in such arrangements are still counted as reserves.

Government development funds allocate resources for funding priority socioeconomic projects, such as infrastructure.

Government owned enterprises are companies over which the state has significant control. This category includes a wide variety of entities, including manufacturing and financial firms. State-owned enterprises can themselves undertake foreign investment.

Over a half of the $5.8 trillion in oil exporters' foreign investment assets was held by governments at the end of 2010 with wealthy individuals accounting for the remaining 39% (Chart 8). Four-fifths of government controlled funds were held in SWFs.

The focus of commodity SWFs is on maintaining domestic economic stability insuring against the risk of commodity price fluctuation; and providing an income stream to future generations in the event of long-term decline in export revenue from oil and other commodities.

Assets of SWFs originating from commodities' exports more than doubled in the six years up to the end of 2010 to over $2.6 trillion (Chart 9). Growth has slowed down significantly in the last couple of years, due to the fall in the price of oil. Commodity funds' share of total SWFs' assets declined during this period from 75% to 64% due to more rapid growth of non-commodity SWFs. TheCityUK estimates that SWFs from commodities will increase to around $3.4 trillion by the end of 2012. This is a conservative estimate based on a prolonged economic slowdown and price of oil between $50 and $70 during this period. Growth in funds in the coming years is likely to be in countries with largest oil reserves such as Saudi Arabia, Canada and Iran (Table 4).

NON-COMMODITY SWFs

Non-commodity SWFs are funded by transfer of assets directly from official foreign exchange reserves, and in some cases from government budget surpluses and privatisation revenue. As official foreign exchange reserves

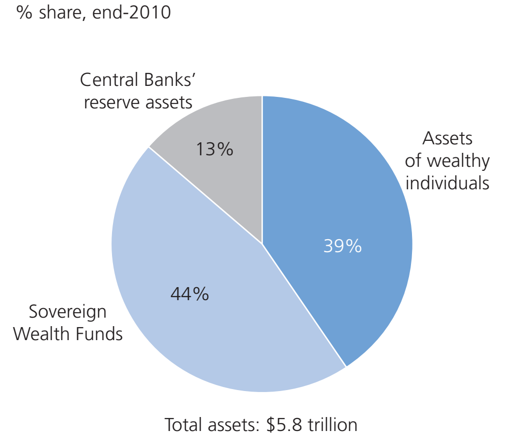
Table 3
Public pension reserve funds in OECD countries

end-2009

	$bn
Social Security Trust Fund (US)	2,540
Government Pension Invest. Fund (Japan)	1,138
National Pension Fund (Korea)	218
National Pension Funds (Sweden)	109
Canadian Pension Fund (Canada)	109
Fondo de Reserva de la Seg. Soc. (Spain)	84
Other	270
Total	4,468

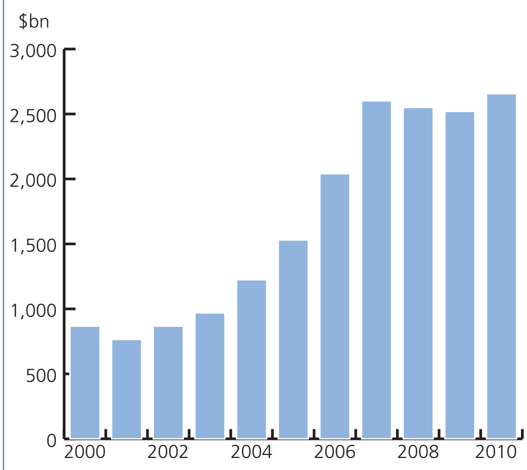
Source: OECD

Chart 8
Oil exporting countries' foreign investment assets



Source: TheCityUK calculations

Chart 9
Oil exporting countries' assets in SWFs



Source: TheCityUK estimates

SWF investment strategies

SWFs can differ significantly in their asset allocation and risk management strategies reflecting their different objectives and constraints. SWFs typically adopt a long term approach to investing and low leverage although stabilisation SWFs have shorter term investment horizons in order to take into account possible shorter term national liquidity and financing needs. Public disclosure of investment management strategy varies widely between SWFs, but overall is limited. SWFs have considerable freedom in their asset allocation decisions and are usually not constrained to certain asset classes or currency exposures unlike some institutional investment managers such as pension funds may be.

Commodity SWFs have a long term approach to investment decisions and a preference for equity and alternative investments. Around four-fifths of oil-exporting countries' funds are invested in overseas assets. Equity investments account for close to a half of their overseas investments, followed by fixed income with a quarter and bank deposits 15%. Government bonds are increasing their share as SWFs have become more risk averse.

Non-commodity SWFs have been an important source of liquidity on global capital markets and tend to invest in US assets, particularly US Government bonds. Figures on currency composition of official foreign exchange reserves show that the US dollar accounts for nearly two-thirds of the total. This may decline in the coming years as Asian central banks shift focus towards other currencies such as the euro. Asian central banks held the largest stock of US Treasury securities at the end of 2009 with China and Japan each accounting for more than a fifth of foreign holdings. They were followed by the UK 8% and oil exporting countries 5%. Assets of official foreign exchange reserves managed through SWFs are generally invested with a higher risk tolerance than official foreign-exchange reserves.

have grown, particularly in a number of Asian countries, some monetary authorities have concluded that their reserves are in excess of their immediate needs. Global official foreign exchange reserves totalled around $9.2 trillion at the end of 2010. Around a fifth of this, or $1.5 trillion, was held in SWFs. This was nearly twice the total five years earlier. Such funds share of global SWFs has increased over the past decade, and their 36% share at the end of 2010 is likely to rise further in the coming years.

Despite the economic slowdown, some Asian countries particularly China, have continued to accumulate foreign exchange reserves albeit at a slower pace. A decade ago, Asian central banks accounted for one-third of official currency reserves; at the end of 2010 they accounted for nearly two-thirds. The growth largely stems from current account surpluses of China and some other countries in this region. China and Japan are countries with the largest surplus on balance of payments, well ahead of oil-exporting countries and other developed countries. In 2010, China's foreign exchange reserves increased by around a fifth to reach $2.9 trillion or nearly a third of the global total. It was followed by Japan with 12% although some of this may be used to support the recovery in the aftermath of the 2011 earthquake. Russia was the next largest holder of official reserves with 5% of the total. Other Asian countries among the ten largest foreign reserve holders in the world include India, Taiwan, South Korea, Singapore and Hong Kong.

SWFs from pension reserves of New Zealand, France and Ireland totalled around $70bn or 2% of the global SWF market. Norway's Government

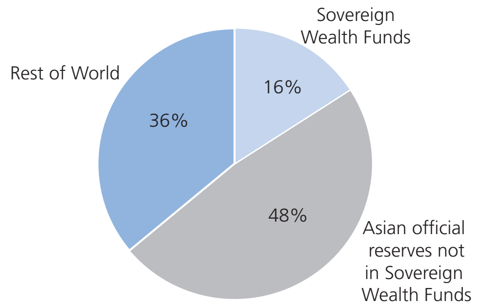
Table 4
Oil - proven reserves

July 2010	Barrels trillion
Saudi Arabia	264,590,000
Venezuela	211,170,000
Canada	178,100,000
Iran	137,010,000
Iraq	115,000,000
Kuwait	101,500,000
United Arab Emirates	97,800,000
Russia	79,000,000
Libya	46,000,000
Nigeria	37,220,000
Others	80,610,000
Total	1,348,000,000

Source: CIA Factbook

Chart 10
Official foreign exchange reserves held in SWFs

$bn, end-2010

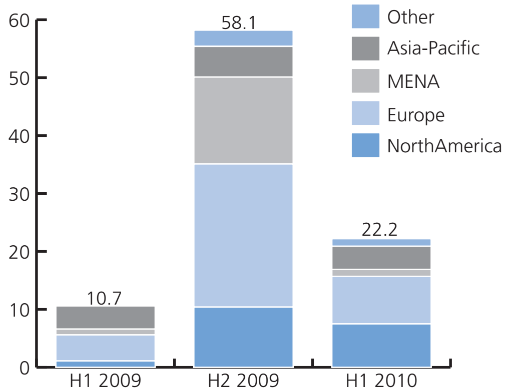


Total: $9.2 trillion

Source: IMF, Wikipedia, TheCityUK estimates

Chart 11
SWF investments by target region

$bn



Source: Monitor-FEEM SWF Transaction Database

Pension Fund is the second largest global SWF, largely funded from Government's oil-related revenues, 80% of which are transferred into this fund. For the purposes of this report we have classified this fund as a commodities SWF.

INVESTMENT TRENDS

The substantial size and high liquidity of SWFs' assets has turned the government sector into an important international investor group. Over the past decade, there has been a gradual shift from passive to active investment strategies. This involves taking minority or majority stakes in companies through cross-border mergers and acquisitions. Such investments totalled nearly $250bn between 1995 and June 2010, of which 31% was invested in Asian countries, 30% in Europe and a fifth in the US. Europe received over 40% of investments in the twelve months to June 2010, followed by North America and the Asia Pacific region each with around a fifth of the total (Chart 11). SWFs acquired minority stakes in around two-thirds of these investments. For the most part, the transactions where SWFs acquired a controlling stake were in emerging market companies.

Table 5
Largest SWF investments in H1 2010

	Country	Target	Country of target	Size of deal ($m)
International Petroleum Invest. Co.	UAE	Unicredit SPA	Italy	2,300
Qatar Investment Authority	Qatar	Harrods	UK	2,227
China Investment Corporation	China	AES Corp	US	1,581
Qatar Investment Authority	Qatar	PT Qatar Hold.	Indonesia	1,000
China Investment Corporation	China	Apax Partners	UK	956
Qatar Investment Authority	Qatar	Veolia Environm.	France	868
Qatar Investment Authority	Qatar	Fairmont Raffles Holdings	Canada	847
China Investment Corporation	China	JV-CIC & Penn	Canada	817
National Pension Reserve Fund	Ireland	West Energy Trust Bank of Ireland	Ireland	756
China Investment Corporation	China	GCL Polyu Energy Holdings Ltd.	China	710

Source: Monitor - FEEM SWF Transaction Database

International policy issues

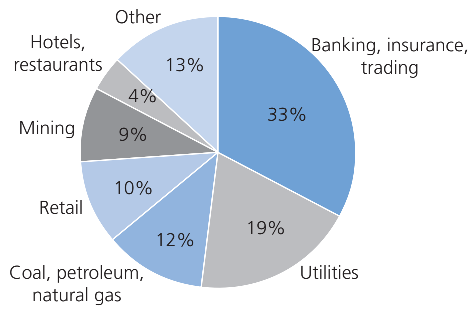
SWFs bring significant benefits to global capital markets in terms of increasing market liquidity and financial resource allocation. Some governments however have expressed reservations about SWFs because of the limited disclosure and transparency of some SWFs. Another concern expressed by some governments is that SWFs may invest to secure control of strategically important businesses or sectors for political rather than commercial reasons, and could use these investments to advance their own national interests.

In response to these concerns the International Working Group of Sovereign Wealth Funds (IWG) was formed in May 2008, with the IMF providing support in the form of a secretariat. In October 2008, the Group published a set of 24 voluntary Principles, the Generally Accepted Principles and Practices for Sovereign Wealth Funds, known as the Santiage Principles. Initial indications are that some SWFs have made progress in improving transparency, with more publishing annual reports and disclosing their assets under management. For example the Abu Dhabi Investment Authority published its first annual report and accounts in March 2010. But there remains a wide dispersion in the extent of transparency. Typically Asian SWFs achieved a higher rate of compliance while some Middle Eastern SWFs are lagging in initiatives to improve compliance. The IWG reached a consensus in April 2009 on the establishment of the International Forum of Sovereign Wealth Funds to follow up on the work undertaken in the context of the Santiago Principles. The Forum is a voluntary group of SWFs which meets at least once a year to exchange views on issues of common interest, facilitate an understanding of the Santiago Principles and SWFs activities, and encourage cooperation with investment recipient countries.

On the recipient country side, the OECD published guidance in 2008 on recipient country policies towards SWFs. Recipient countries should strive to avoid protectionism and uphold fair and transparent investment frameworks. A forum for public-private sector interactions, the Official Monetary and Financial Institutions Forum (OMFIF), held its inagural meeting at the beginning of 2010, to facilitate discussions between Western central banks and the SWF community.

Chart 12
Value of SWF investments by target sector

% share, H1 2010

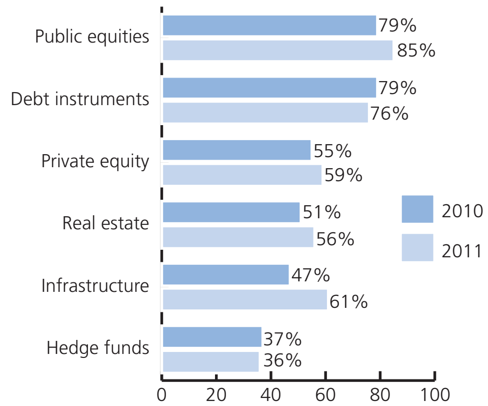


Total: $22bn

Source: Monitor-FEEM SWF Transaction Database

Chart 13
Sovereign Wealth Funds' asset allocation

Proportion of SWFs investing in each asset class



Source: Preqin

There have been three distinct periods of investment activity by SWFs since the start of the economic downturn:

- At the outset of the credit crisis in the second half of 2007 and first quarter of 2008, SWFs invested some $60bn in Western institutions that were experiencing financial difficulties. Some high profile investments during this period included funds invested by Middle Eastern and Asian SWFs into Citigroup, UBS, Merrill Lynch, Morgan Stanley and Barclays Bank. More than 80% of overall investments by SWFs during this period were in foreign markets. In just a few months the rapid fall in the value of US and European equity markets, particularly banking stocks, saw SWFs making substantial losses on some of these investments.

- In the second half of 2008 and early 2009 SWFs cut back on their foreign spending to help stabilise domestic banks and financial markets which were starting to be affected by the economic downturn and fall in commodity prices. SWFs had also faced public criticism in their countries following a string of losses on their foreign investments. From 2007 to early 2009, the world's SWFs lost around a fifth in total value, or $600bn following a sharp downturn in global asset prices, particularly prices for equity and alternative investments.

- Since the middle of 2009 SWFs have gradually been regaining their appetite for foreign investment. Much of the $80bn invested in the twelve months to June 2010 was allocated to foreign markets, primarily Europe. The China Investment Corporation and Qatar Investment Agency were particularly active with $7.3bn and $5.3bn invested internationally in the first half of 2010, much of this in energy, metals and agriculture, as well as alternative assets such as hedge funds and private equity. Recent SWF transactions suggest that acquisitions will be smaller and more diverse in the coming years with more focus on diversifying portfolios.

LINKS TO OTHER SOURCES OF INFORMATION

Arab Financial Forum
www.arabfinancialforum.org

International Forum of Sovereign Wealth Funds
www.ifswf.org

International Monetary Fund
www.imf.org

McKinsey & Company: The New Power Brokers
www.mckinsey.com/mgi

Monitor Group: Sovereign Wealth Fund Investment Behavior
www.monitor.com

OECD
www.oecd.org

Preqin: Sovereign Wealth Fund Review
www.preqin.com

Sovereign Wealth Fund Institute
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