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The Rising Role of Sovereign Wealth Funds

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Introduction

It is estimated that there are more than sixty Sovereign Wealth Funds operating around the Globe today.[1]

Some are large and well-known:- Government Pension Fund Global of Norway, Abu Dhabi Investment Authority (ADIA), China Investment Corporation (CIC).

Some are sub-national Funds:- Alaska Permanent Fund, Alberta Savings Heritage Trust Fund, even Western Australia Future Fund.

Most of the big Funds are members of the International Forum of Sovereign Wealth Funds (IFSWF) which has 31 members.

It is generally accepted that Sovereign Wealth Funds (SWFs) began with the founding of the Kuwait Investment Office in 1953. Originally SWFs were established to invest the proceeds of oil or gas revenues. Later they were seeded from other revenues. The number sharply increased in the first decade of this Century. In the second decade of this Century there has been a marked growth of SWFs in Africa.

Today I will offer you some observations about the operations of SWFs and talk specifically about Australia's Sovereign Wealth Fund, the Future Fund.

In doing so I will draw out some of the characteristics that have been, and remain, important to the Future Fund.

But the term Sovereign Wealth Fund describes a wide array of vehicles, governance arrangements, purposes and investment approaches, so let me start by defining what this term means.

What are Sovereign Wealth Funds?

The definition used by IFSWF -the International Forum of Sovereign Wealth Funds, is as follows:-

Sovereign Wealth Funds are:

special purpose investment funds or arrangements that are owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to

[1] This is the estimate of the International Forum of Sovereign Wealth Funds (IFSWF) see Annual Review 2017

achieve financial objectives, and employ a set of investment strategies that include investing in foreign financial assets.

The first thing to note about this definition is that a SWF is a fund owned by the general government, that is what makes it Sovereign. In States that are absolute monarchies, the Sovereign Wealth Fund can be literally, the Sovereign’s Wealth Fund. In countries where Governments are elected, the Fund is owned by the general Government, which usually appoints Trustees to hold the assets on its behalf. Trustees do not own the money. The money and investments are owned by the General Government. Since the Fund is owned by a Sovereign it will be entitled to general Sovereign immunities including tax immunities.

A pension, or Superannuation Fund is quite different to a SWF. Those funds are ultimately owned by their members. In a winding up they are entitled to the money. In the winding-up of a SWF the money goes to the owner- the general government.

The second thing to notice about the definition is that a SWF has a macroeconomic purpose. Different funds have different purposes and I will come to some examples shortly.

The next thing to notice is a SWF has financial objectives. It is not an operating company. This distinguishes it from a State-Owned Enterprise (SOE).

And finally the definition contemplates investing in *foreign* financial assets. This distinguishes a SWF from a purely domestic development Agency. It also adds an element of controversy to their operations.

Within this framework, Sovereign Wealth Funds take many guises.

The intent in setting up the Kuwait Investment Office was to diversify the country’s income out of total reliance on oil revenue to more broad based earnings from financial assets.

In Chile the Economic and Social Stabilisation Fund, which superseded the older fund - the Copper Stabilisation Fund – was used to save a portion of revenues from copper exports.

When the financial crisis of 2008 hit, and falling demand reduced commodity prices, the Government was able to support the Chilean Budget by drawing on the capital of ESSF. This is one reason why Chile fared better than its Latin American peers through the crisis.

Botswana and, more recently, Rwanda~~, Botswana~~ and Morocco, have ~~recently~~ established funds that variously provide for public savings, help manage foreign currency reserves and support economic development.

In South East Asia, the Singapore fund, Temasek and the Malaysian fund, Khazanah were originally set up to acquire and manage stakes in strategic industries and support development. In time they broadened out to invest and generate financial returns, including returns on foreign investment.

Each year at least 25% of the Sate of Alaska's mineral lease rentals, royalties and other proceeds are paid into the Alaska Permanent Fund and invested alongside existing capital from previous contributions.

Each year a portion of the Alaskan fund is paid out to Alaskans – with each eligible Alaskan receiving a payment of one to two thousand dollars - and the rest is saved by government or used to support the budget. Alaska has no state income tax. There the State Government sends out cheques rather than collecting them from its citizens.

As is apparent from this brief survey, Sovereign Wealth Funds are set up for a range of reasons.

Different classes of funds

Some have been created to turn a depleting asset - such as oil - into perpetual financial assets.

Others have been set up for stabilisation purposes, reducing the impact of external shocks on a country's economy and budget.

Some have been set up as development funds intended to support development objectives by investing domestically, supporting priority industries and attracting foreign investment partners.

Others are intergenerational savings funds that allow countries to save for future needs, transferring wealth from one generation to another.

In practice many funds pursue a combination of these objectives.

It is not only the purposes of Sovereign Wealth Funds that are diverse, so too are their legal structures, governance arrangements and investment portfolios.

Some receive regular contributions from oil and gas revenues. Others, such as Australia's Future Fund, were seeded with an historic capital contribution and have not received any further injections since.

Given their different purposes Sovereign Wealth Funds have differing risk and return objectives, liquidity requirements and approaches to managing their exposures to currency, commodities and the domestic and international business cycle.

Some, such as Norway's fund, only invest offshore. Ireland's Strategic Investment Fund prioritises investing in Ireland. Some have an appetite for a wide range of asset classes, including private equity, infrastructure and hedge funds. Others prioritise lower risk, highly liquid investments.

Prominence of Sovereign Wealth Funds

While diverse, Sovereign Wealth Funds are an identifiable category of investor and one that has become increasingly prominent.

Their growing prominence in the 21st Century is due to the growing value and growing number of these funds.

Estimates suggest – depending on the definitions used and the data available – that today Sovereign Wealth Funds invest up to USD 8 trillion.

This growth in size and number has been driven by higher commodity prices that boosted the assets of commodity-rich nations and by favourable balance of trade results, particularly in Asia, which lifted foreign exchange reserves.

The fact that some funds are so large, and they purchase assets in foreign jurisdictions has, from time to time, meant that they generate controversy. A particular fear is that some countries will use financial power through sovereign funds to pursue diplomatic or geo-political objectives.

Such concerns surfaced significantly in 2006 and 2007 when high profile investment proposals from State Owned Entities attracted considerable criticism in the United States.

Two investment proposals generated particular controversy - the proposed acquisition of six US port facilities by Dubai Ports World and the proposal by China National Offshore Oil Corporation to acquire Unocal Oil Company.

Of course these investment proposals were from State Owned Entities – that is operating companies - rather than Sovereign Wealth Funds.

But the distinction between SOEs and SWFs was not then (and is not now) clearly understood.

In response to the controversy that these proposals generated, Sovereign Wealth Funds, together with the IMF and US Treasury, launched a process that resulted in the development of a set of Principles – eventually signed off in Santiago Chile and known as “the Santiago Principles” designed to foster improved practice by Sovereign Wealth Funds.

These Principles were designed to allay fears that SWFs were being used as cover for political advantage and re-assure governments that they could recognise them as legitimate investors pursuing financial objectives.

It is 10 years since the Santiago Principles were established and they have gone some way to build an understanding about what SWFs do and how they operate.

Transparency among those funds that have adopted the Principles has increased. Funds have shared best practices and ideas on effective investment both with each other and with broader audiences.

Financial Crisis in 2008

In 2008 Funds with deep pockets and liquidity were actively courted by Investment and other Banks scrambling to raise capital and avoid financial collapse.

ADIA and KIA provided capital to Citigroup. GIC also supplied capital to Citigroup for convertible preferred stock.

Temasek invested in Merrill Lynch, CIC in Morgan Stanley, QIA in Barclays and Credit Suisse. Financial regulators and Governments desperate to stabilise financial institutions welcomed the capital only SWFs could supply.

But the crisis has passed and the wheel has turned again.

We see a renewed trend towards tighter investment regimes around the world which is affecting Sovereign and State owned investors including here in Australia where a number of SOE investment proposals have been rejected by the FIRB and the Government.

Sovereign Wealth Funds – increasingly sophisticated and conscious of the challenge of generating strong returns - have also become active in diversifying their investments into private markets, including sensitive asset classes such as infrastructure.

It is legitimate for Sovereign Wealth Funds to seek investments in markets where they see opportunities. In fact it is important that they are able to do so, so that capital can flow freely to where it is most efficiently and effectively deployed.

It is also entirely legitimate for countries to expect Sovereign Wealth Funds to demonstrate their commitment to good investment practice, transparency and accountability.

In this environment I believe Sovereign Wealth Funds will benefit from continuing to address the concerns of recipient countries by explaining their objectives, governance and investment strategies.

They need to build on the progress made. Some need to work harder on transparency.

Ensuring that their strategies and intentions are well understood is important for Funds, their home populations and recipient countries. Ultimately each of these groups benefits from ~~the~~ encouraging the free flow of capital.

So let me now turn to the Future Fund and the role we play for the Australian Government.

The Future Fund – clarity of purpose and mandate, independence and accountability

The Future Fund was set up in 2006 and received its initial and only contributions of $60.5 billion more than a decade ago. Contributions to the Fund came out of Budget surpluses and a small slice of the proceeds of privatisation of the telecommunications company, Telstra.

This $60.5 billion has grown to just under $149 billion, that is, the Future Fund has made the Government $88 billion. This represents investment returns since inception of 7.9% per annum.

At the heart of the success of the Future Fund is the clarity of purpose and mandate and I will talk about why these have been so important.

The Future Fund was established in response to the assessment that Australia faced emerging costs particularly those associated with an ageing population.

Clarity of purpose

Clause 3 of the Future Fund Act is clear about the object behind setting up the Fund:

The main object of this Act is to strengthen the Commonwealth's long-term financial position by establishing the Future Fund.

Since the Government owned the money to be invested in the Fund it could have spent it, it could have been used for election purposes, but the idea was to save it for future generations.

Under the legislation the money is to be locked up until 2020. There can be draw-downs from then, if the Government wishes to use the Fund to ~~has been unable to fund~~meet its defined benefit pension liabilities. These liabilities are paid out of consolidated revenue. The money released from the Fund goes back to consolidated revenue. It is not hypothecated in any way to pensioners. It goes into the pot which is used to pay all expenses – welfare payments, health and government pensions.

Recently the Government has decided to defer drawing down the Fund until 2026-27. This will allow the Fund to grow further and produce higher income for taxpayers when it is drawn in the future.

The money in the Future Fund capital is not owned by any individual. Individuals do not contribute into the Fund. They cannot draw from it.

The Fund is an intergenerational fund. It is a contribution from the taxpayers of 2006 to future generations.

Clarity of mandate

So what is the mandate?

This is set out in the Investment Mandate Directions issued by the Ministers as authorised under legislation enacted by Parliament.

The Directions set a benchmark target return for the Future Fund of inflation plus 4 to 5% per annum over the long term. It has a risk mandate specifying it can take "acceptable but not excessive risk".

In pursuing this, it is to invest in financial assets and avoid triggering takeover provisions in the Australian market. Otherwise it is largely free to make investments as it sees fit.

Importantly, the Fund is not tasked with pursuing multiple objectives.

It is not required to prioritise domestic investments.

It is not required to support certain industries or regions.

It is not required to try to help manage the currency.

The Fund's task is to maximise long-term risk adjusted returns.

This clarity of objective is enormously valuable. It gives a clear mandate (although I should say not an easy one given the prospective low return investment environment) and the flexibility to do what is needed to pursue it.

Robust governance

Supporting this clarity of purpose and mandate is a robust governance framework.

Legislation sets out the responsibilities of Ministers to appoint the Future Fund Board of Guardians. Guardians in turn are responsible for investing the assets of the Future Fund. This protects the independence of the Board.

Board members are named 'Guardians' to reflect their role in protecting the fund including protecting it from any Government interference.

Board members are appointed for their experience and credibility in investing and corporate governance. The Government is not represented on the Board.

The Board must be consulted on the Investment Mandate Directions if a change is proposed by Ministers and any submission the Board makes in response must be tabled in Parliament.

The costs of running the organisation and investing the Future Fund are met from the assets of the Fund, rather than through a funding appropriation.

This framework protects the ability of the Board to design and implement an investment strategy best suited to the achievement of its risk and return objectives and to do so free of political influence.

Alongside this independence sits our accountability framework. Through our annual report, regular updates on the portfolio and regular appearances before hearings of a Senate committee we work hard to keep Australians informed of our activities and to build confidence in what we do.

It is the clarity of purpose and mandate together with the strength of our governance that has been vital to our ability to deliver good performance over a little more than a decade.

How we invest

Let me now turn to our investment program in more detail.

We compete in global markets for investment opportunities and for skilled people.

In each of these areas our purpose is central.

Our objective is to strengthen the Government’s long-term financial position which means investing for the benefit of future generations of Australians.

This phrase – “investing for the benefit of future generations of Australians” - guides us in having a long-term focus and reminds us strongly of what we are here to do.

Having this front of mind helps us identify the kinds of external investment managers and partners with which we want to establish relationships.

It also guides us in establishing those relationships in the right way - with strong alignment of interest and fair terms focused on maximising long-term risk adjusted returns for our portfolio.

We are very conscious that the partnerships we establish and the investments we make will directly impact future generations of Australians.

We also find that our purpose is valuable in attracting and retaining staff.

As we compete to attract talent, the chance to do something for the country is genuinely attractive. Working with a purpose, as well as within a unique institution, is something we can offer to our staff that they find has real value.

Staff are remunerated well, but the opportunity to contribute to Australia as well as develop their career and experience in a unique best-in-class institution is an important part of our employee value proposition.

‘Investing for the benefit of future generations of Australians’ also informs how we develop and manage the portfolio.

We are conscious that every dollar we generate through investment is a dollar that adds to Australia's wealth and lessens the reliance on future taxes. Every dollar we lose is a dollar that will have to be found from other sources in the future.

We dynamically manage the portfolio and adjust its positioning to reflect how we see the global investment environment and the risks and rewards that we see.

While this is not about trying to time markets, it does mean that we think carefully about how much risk we want and whether we believe we are likely to be rewarded for that risk.

We are willing to be patient and we are determined not to chase returns by increasing risk to excessive levels.

This approach should mean that when markets are strong we will do well, but perhaps not as well as those with higher levels of risk in their portfolios.

It also means that in periods when markets are weaker, our portfolio should be less impacted.

As a result we typically expect to generate a smoother path of returns.

We also manage the portfolio as a whole rather than as a set of separate asset classes.

We do not work to a set asset allocation, but instead seek the best investment opportunities globally and aim to construct a portfolio best placed to meet our objectives.

Today the portfolio is broadly diversified across listed equities (32%), private equity (14%), infrastructure (8%), property (7%, debt (9%) and hedge funds (15%). Around 25% of the portfolio is invested in Australia.

In the current environment, while synchronised growth should continue in the short term, we recognise the risks that remain and continue to evolve.

Globally, interest rates are rising and this will put downward pressure on asset prices. International trade and political tensions continue to impact markets and create the potential for market shocks.

Like other Sovereign Wealth Funds, and alongside pension funds and other large institutional investors, we see prospective returns as unlikely to be as robust as they have been in the recent past.

Our long-term purpose, clarity of mandate and governance arrangements combine to give us the necessary focus and confidence to apply our investment strategy and processes through the cycle.

As Australia's Sovereign Wealth Fund we recognise the diversity of investment approaches among Sovereign Funds, pension plans and other large investment institutions, but we believe that good governance and clarity of purpose are the foundations for sustained success. They have stood us in good stead and remain very much at the heart of our thinking and practice.