Sovereign Wealth Funds in the New Normal

Petroleum plant in Jubail, Saudi Arabia.

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As the global financial crisis recedes, state-owned investment companies are well placed to seize a new set of opportunities and navigate changing risks

SOVEREIGN wealth funds, essentially state-owned investment entities with long time horizons, are among the investors best equipped to navigate financial markets after the global crisis. Yet they too face potential challenges in steering a course through what is likely to be a multiyear, bumpy resetting of the global economy.

How sovereign wealth funds confront these challenges will speak directly to their effectiveness in investing national wealth to benefit current and future generations. It will also affect their contributions to stabilizing a fluid global economy that will experience significant multiyear changes in the systemic drivers of growth, employment, wealth, and welfare creation.

This article considers three key topics: where sovereign wealth funds stood on the eve of the global financial crisis, where they stand today, and future implications.

As the crisis broke

Three main factors defined where sovereign wealth funds stood as a group in the run-up to the most acute phase of the recent global financial crisis and the worldwide economic and sociopolitical dislocations that followed:

- Consistent with their "patient capital" characteristics and their long-term orientation, sovereign wealth funds were gradually adopting a bolder investment approach, which included taking on significantly more exposure to liquidity and equity risk.
- The funds were exhibiting greater awareness of the sensitivity in some industrial countries to foreign ownership of domestic physical assets. A manifestation of that awareness was joint agreement on a voluntary set of principles (known as the Santiago Principles) that emphasize transparent and sound governance structures, appropriate regulatory and disclosure requirements, and commercially based investment and risk-management approaches.
- They operated in a highly supportive internal environment fueled by booming domestic economic growth, continued large accumulation of international reserves, and ready availability of credit.

Each of these factors was deemed consistent with delivering higher risk-adjusted returns over time. They also reflected the then-widespread view—held both in the private and public sectors—of a cyclical and secular "great moderation" in the economic and policy realms. "Goldilocks" (as in "not too hot, not too cold") became the one-word bumper sticker for this period.

Like virtually every sector of the financial and policy worlds, sovereign wealth funds as a whole were caught off guard by the disruption in global liquidity and funding that followed the disorderly failure of the Wall Street investment bank Lehman Brothers in September 2008. Virtually overnight, and as a cascading number of markets seized up, investors around the world were hit with dramatic repricing in all risk factors—particularly liquidity. As a result, markets around the world experienced varying, yet notable, degrees of a sudden stop.

With the global financial services sector at the center of the storm, the direct holdings of sovereign wealth funds in financial companies came under particularly intense pressure—especially as some of the funds had moved earlier to inject capital into major Western banks. Meanwhile, rather than continuing to receive large new inflows, some sovereign wealth funds found themselves under pressure to support other national (and, in some cases, regional) entities that were facing sudden and acute cash needs.

Investment returns vanished

As a result, there was a dramatic change for sovereign wealth funds during the six-month period that ended in March 2009: investment returns turned dramatically negative; cash, collateral, and counterparty management became even more acute priorities for risk management; some isolated liquidity pressures emerged; and major strategic decisions were postponed until there was greater clarity about the global financial system and where it was headed.

More generally, the seizing of global markets generally caused a pause in the longer-term evolution of asset-liability management in emerging economies—a process that had seen a number of systemically important countries and regions move steadily from delayed recognition of their improving circumstances to debt buybacks and then to more sophisticated asset management. Until emerging economies could see more clearly what the changes to the global economy might be, several of them felt it best to wait before embarking on the subsequent stages of their own evolution, which often involved major changes in how they manage their economies (including a pronounced shift away from direct controls and toward much greater reliance on indirect instruments).

Sovereign wealth funds also experienced a significant change in how they were perceived in many industrial countries. Most notably, countries that had once warned these funds against taking a direct stake in their domestic companies began actively seeking sovereign wealth fund investments to counter the highly disruptive impact of private sector deleveraging (asset shedding) at home. The tables had turned. Sovereign wealth funds were being wooed to help recapitalize struggling companies—either through new cash injections or by exchanging more senior claims on those companies for instruments lower down in the companies' capital structure.

Sovereign wealth funds today

What are the main issues sovereign wealth funds confront as the global financial crisis recedes? To answer this question calls for an explicit look at where the global economy stands and how it is likely to change.

Thanks to a massive injection of public sector capital and liquidity—undertaken in a dramatic "whatever it takes" crisis management mode, mainly in the advanced economies—the global financial system began to normalize in 2009. Key financial markets—particularly short-term funding and liquidity management—began to function smoothly again; companies were able to regain access to new funds through bond issuance; and trust returned to a range, albeit reduced, of counterparty relationships.

The core of the global financial system has overcome the massive cardiac arrest it experienced after September 15, 2008, the day Lehman Brothers failed. That is the good news, and it has come as a result of bold and imaginative policy responses.

Several sovereign wealth funds are already well on their way to formulating and implementing forward-looking asset allocations with a global focus.

Yet, given the severity of the 2008–09 global financial crisis, the bold policy response was not able to offset fully the damage to other parts of the global economy. Economic growth and international trade suffered, unemployment soared, and, in a manner that marked a dramatic break from past crises, industrial countries were hit particularly hard.

The bold policy response also, and inevitably, entailed risk and unintended consequences. Noncommercial considerations started to affect the functioning and valuation of significant markets, including the mortgage-backed segment in the United States. Central bank balance sheets ballooned with assets acquired from the private sector. Public debt soared as governments spent freely and massively to prop up the economy and as tax revenues declined. These elements of collateral damage have, in themselves, become important drivers of markets and economies. Just witness what has happened in Europe, where the debt crisis morphed into regional dislocations requiring a massive policy response on the part of the European Union and European Central Bank with a major assist from the International Monetary Fund.

The global financial crisis has given way to the next phase in the multiyear, serial dislocations of balance sheets. Concerns about the private sector have been replaced by bigger wor-

ries about public balance sheets in industrial countries—and rightly so. Sovereign risk is in play. Regulation is in flux. The integrity of key institutions is under pressure. And high levels of structural unemployment are of economic, political, and social concern.

The new normal

The massive jump in public indebtedness, in absolute terms and as a percentage of gross domestic product, is an important component of what we at PIMCO call the "new normal." And although it is too early to predict what every component of this new normal will be, certain elements are already visible.

Important changes during the next three to five years will likely include

- a reduction in the trend rate of economic growth of economies that bet heavily on the financial sector;
- persistently high unemployment in industrial countries, followed by a slower reversion to what will be a higher natural rate of unemployment—in an environment of more fragile safety nets;
- a dramatic shift in emphasis from unfettered market activities to greater government involvement;
- pronounced divergence between core countries and those on the periphery, most notably in the euro area; and
- a meaningful, regulatory-led reduction of risk both in the activities and balance sheets of banks.

Overall, the global financial crisis of 2008–09 marked a dramatic end to the great age of leverage, credit, and debt entitlement—a time when people felt entitled to make major purchases on the basis of expected income in the distant future and hopes of large price appreciation. Finance-driven economies are no longer deemed to represent a higher and more stable phase of development. And, with several systemically important emerging economies embarked on a development breakout, the world must find ways to make room for a long-term realignment of economies.

This new normal will further blur the traditional distinctions between industrial and emerging economies. It is also likely to involve a gradual shift in the analytical characterization of the United States—from an economy that operates essentially as large and closed toward one that is more open and more susceptible to developments in the rest of the world.

The global financial crisis has also undermined the standing and credibility of the Anglo-Saxon economic model that emphasizes liberalization, deregulation, interconnectivity, and unfettered markets. This model acted as an important magnet for global convergence. Given the absence of an alternative convergence magnet, greater pressures in the new normal may suspend, or even reverse, some aspects of globalization.

Implications for state investors

Together, these factors constitute an important change in the operational landscape for global investors, including sovereign wealth funds. They call for some retooling of investment strategies and risk management, as well as business and other operational strategies. They will require challenging adaptations in the optimal mix of human, technological, and analytical resources and better communication with economic and political stakeholders (including political sponsors and society at large).

Sovereign wealth funds are at an advantage when it comes to managing the bumpy journey to the new normal: their stable and patient capital and long-term orientation in investment objectives put them in an excellent position to make a first move. Indeed, the question should not be whether this pool of patient capital is able to pursue a first-mover strategy—it is. The question is whether it is willing to do so. The demands on operational processes will test the responsiveness of sovereign wealth funds' governance structures, the robustness of their investment processes, and the effectiveness of their internal and external communication activities.

Governance structures will be called on to respond to a combination of cyclical and secular changes, appropriately shifting over time from "defense" to "offense."

At the most fundamental level, institutions will need clear overall guidance from their governing bodies, so managers of sovereign wealth funds can allocate their assets in a forward-looking long-term manner anchored by solid cash, liquidity, counterparty, and collateral management.

Moreover, holistic risk-management frameworks must supplement conventional asset-class diversification with targeted and cost-effective management of tail risks—events that are rare, but that carry catastrophic consequences.

The governing bodies of sovereign wealth funds will have to rely on managers and staff armed with forward-looking analytics and technology. They must also play a more important role in protecting sovereign wealth funds from pressure to support noncommercial activities—domestically, regionally, and internationally.

Responsive structures that govern key areas of *investment management* cannot be built overnight. They require significant and sustained effort devoted to processes that can dynamically develop the necessary frameworks and, as a result, ensure investment decisions marked by a relatively high degree of conviction and foundation.

Superior navigation on the bumpy journey to the new normal requires, first, strong defense in the form of prudent cash, liquidity, counterparty, and collateral management. Once this is achieved, investors can pursue with more confidence opportunities that mesh well with a sovereign wealth fund's greater ability to underwrite liquidity risk factors. For example, when valuations are already disrupted, price appreciation will be consistent with the realities of the new normal, and there are identifiable short-term catalysts that accompany price appreciation, closing the valuation gap between technical and fundamental factors.

As Donald Sull (Sull, 2009) of the London Business School has admirably documented in his detailed work, positioning for the new normal also requires *institutional adaptability and agility*.

On paper, sovereign wealth funds outshine many other investors when it comes to their adaptability and agility. For example, lacking the home bias that forces many investors to deal largely in domestic securities, several sovereign wealth

funds are already well on their way to formulating and implementing forward-looking asset allocations with a global focus.

These considerations should never discount the reality that sovereign wealth funds operate in a complex sociopolitical context, at home and abroad. They must, therefore, have the trust of their political sponsors and society at large. Indeed, this is crucial to the contract implicit in setting up an investment management operation in the public sector.

Communication is increasingly recognized as vital to ensuring public buy-in—in both good times and bad. The global financial crisis has highlighted the importance of establishing the proper context for politicians and others to evaluate what is taking place in the portfolios of sovereign wealth funds. This requires a higher degree of disclosure than has traditionally been the case, and several sovereign wealth funds have already stepped up their efforts in this regard.

Appropriate communication and statutory guardrails help minimize the risk that special-interest groups will improperly capture sovereign wealth funds. The key lies in greater clarity in disseminating timely information on sovereign wealth funds' objectives, overall strategy, and medium-term evaluation metrics.

Retooling required

In the aftermath of the global financial crisis, the world is in the midst of major cyclical dislocations and large secular realignments. The bumpy road to the new normal means virtually every segment of the global economy must retool.

Although sovereign wealth funds were not able to completely sidestep the global financial crisis, they have recovered nicely and are well placed as a group to navigate the journey to and through the new normal. Indeed, the patient nature of their large capital pools and the long-term nature of their objective functions are the best set of investment characteristics for virtually all global investors.

Exploiting their advantage is far from assured or automatic. Success requires continuous improvement in the institutional responsiveness of sovereign wealth funds to challenges in the areas of governance, investment processes, and communication.

Such improvements are not easy to deliver. They may take some sovereign wealth funds out of their operational comfort zone, and they involve risk. Yet, given the scale of ongoing and prospective changes in the global economy, the alternative of backward-looking business as usual would be even riskier. ■

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Reference:

Sull, Donald, 2009, The Upside of Turbulence: Seizing Opportunity in an Uncertain World *(London: Harper/Collins Press).*

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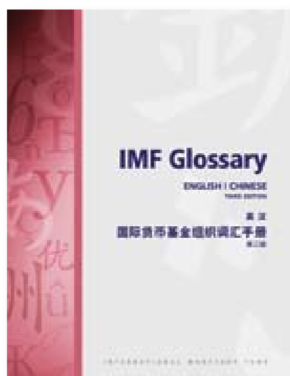

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