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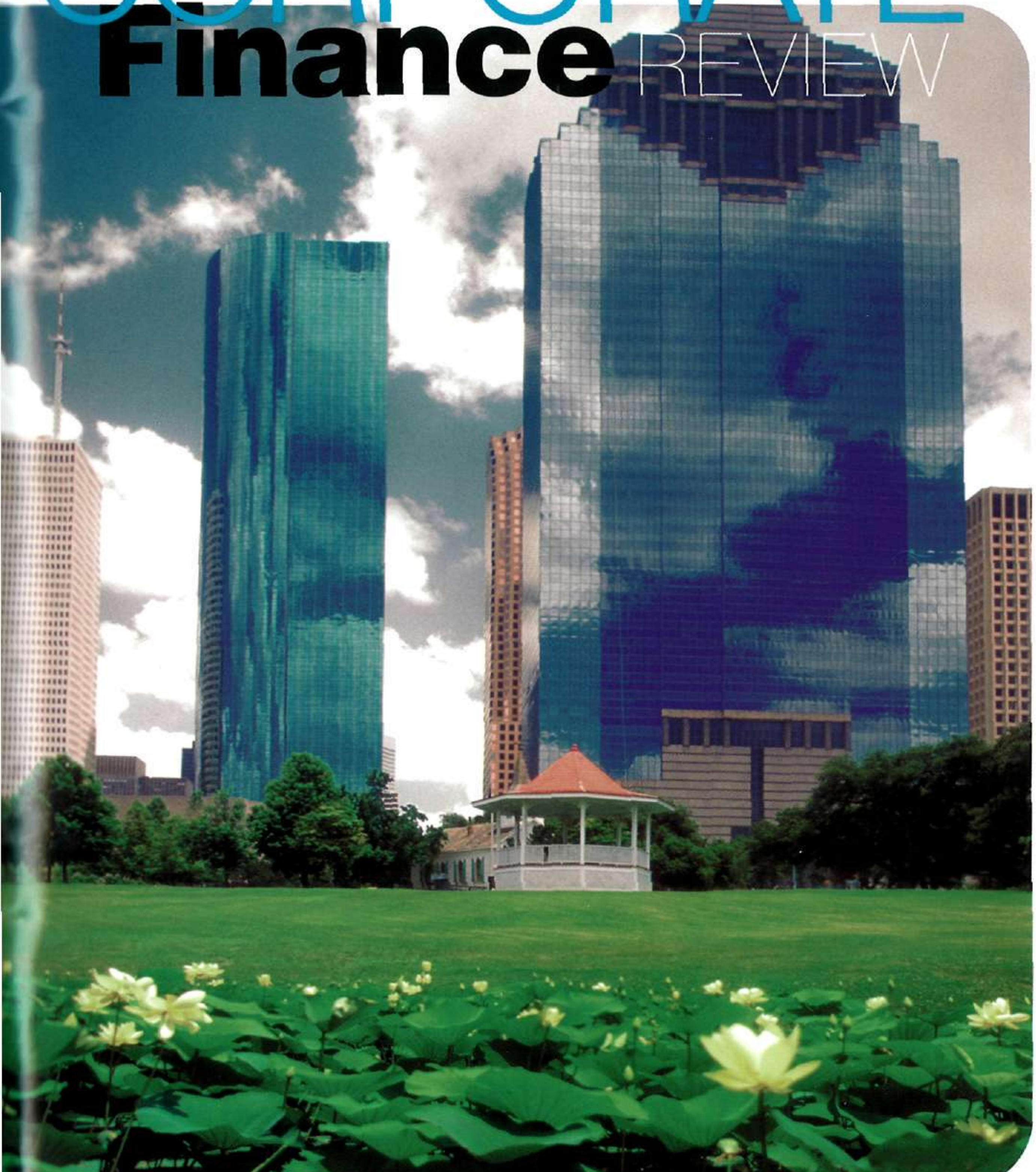

Current Trends in M&As

Sovereign Wealth Funds

Salary and Bonus Caps: Their Impact on the Battle for High-Level Executive Talent

There is Something About Pairs Trading

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HANK BOERNER

SOVEREIGN WEALTH FUNDS—CAPITAL MARKET PLAYERS FROM VARIETY OF BACKGROUNDS

As corporate and public-sector issuers seek out suitable investors for their debt and equity needs amidst the bear market and credit crunch, a distinct class of institutional investors has been coming into view: the sovereign wealth funds (SWFs). State-owned and sponsored institutions, numbering sixty or more and based in many nations, SWFs are putting some of their revenues to work in a variety of ways reflecting each country's preference or tolerance for risk, in addition to each country's culture and economic systems (including those of many socialist-leaning countries).

Depending on the fund examined, you will find SWF investments in corporate equities and fixed-income; real estate; hedge funds and investment pools; private-equity asset managers; seed monies for emerging technologies; commodities; options and other financial instruments; loans to governments; even investments to buy entire companies.

Even in the United States there are a considerable number of such funds: think of large public employee pension funds such as California's CalPERS, New York State Common Retirement Fund, Connecticut's state employee fund, and others in their class. There are dozens of state pension funds that are, in effect, the funds that hold the investable wealth of the states of the US. There is also a more pure play SWF: The State of Alaska, with its oil and gas sales, invests on behalf of its residents through the Alaska Permanent Oil Fund. Assets of this fund were at $29 billion on January 1, 2009; this reflected a loss of $10 billion between June 30 and November 30.

Looking beyond the shorelines of the US, we've identified and are monitoring at least fifty investment pools owned and directed by national and city-state governments around the world that could be considered SWFs. There are also state-owned pension schemes that may or may not invest in the same way as their country's SWF. These funds come in a variety of sizes and operate in very different ways. Some are very transparent—the gold standard is Norway's SWF—and some operate in near secrecy.

Defining the sovereign wealth fund

What is an SWF? Definitions vary. The US Department of Treasury tracks SWFs and other foreign investments and sees sovereign wealth funds as a distinct pool of investment monies funded by foreign governments but managed separately of the respective governments' reserves. These are investment institutions controlled by a wide range of governments on virtually all continents. Think of the SWF pool of a country as the assets held by government in another country's currency. For example, Russia can use its oil revenues to buy US Treasury Bonds or stock shares in an EU company.

The US Treasury Department has negotiated agreements with a handful of SWFs on their US investment activities, especially where it sees sensitive industries or sectors are concerned. There is a federal interagency council that reviews

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foreign purchases of US assets. The US Congress in 2007 adopted legislation that requires additional scrutiny and higher-level clearances for transactions involving foreign government control (which in effect is how SWFs are structured and managed).

The International Monetary Fund arranged dialogues on SWFs that led to creation of a set of twenty-four principles that SWFs agreed to follow (better transparency and disclosure of intentions of relationships included). The Organization for Economic Cooperation and Development is working on a set of standards for countries that *receive* SWF investments to ensure that these investments are evaluated on the same basis as other investments and that barriers are not raised to efficient flows of capital across borders.

Large or small, transparent or opaque, capitalist-leaning or not, the global SWFs are poised to become more important in a broadening range of investments throughout the world.

Building the base of investable funds

Global SWFs have been pursuing investments and deals in many countries, even in the worst economic downturn in decades. If you have cash and can tolerate some risk, this bear market can be very attractive. SWFs are mostly free to invest through the world's capital markets in instruments that are traded openly: stock indexes, common stock and corporate bonds are the easiest of SWF corporate transactions. Some American executives have lately been getting calls from SWF offices or their external asset managers and advisors to discuss long-term fundamentals and the possibilities of investment. And corporate visits and road shows are making the rounds of SWFs in Europe and the Middle East as investor relations officers seek new investors.

Sovereign wealth funds have been increasing direct and significant equity investments in American companies. In the past year, Morgan Stanley received $5 billion from the China SWF, China Investment Corporation. The United Arab Emirates SWF — the Abu Dhabi Investment Authority—bought a 4.9% share of Citibank as the global bank holding company's stock plummeted. Merrill Lynch got a $5 billion infusion from Temasek Holdings, one of two SWFs in the wealthy city-state of Singapore (invested just before the Bank of America acquired Merrill Lynch). The Blackstone Group (a leader in the private equity sector) sold a 10% stake to China's SWF. Its competitor, The Carlyle Group sold 7% of itself to the Abu Dhabi SWF.

Over the first decade of the twenty-first century SWFs have been taking major stakes in large corporate enterprises: for example, Singapore Investment Corporation bought a stake in Switzerland's UBS. A Monitor Group study of 420 publicly reported equity investments since 2000 revealed that *more than half* involved purchase of majority stakes.[1]

Benefit of having renewable investable funds

It would be hard to find large institutions anywhere in the world that have not suffered losses in the current bear market. SWFs are no exception; some are down 30% to 40% percent. But though many institutional investors — such as mutual funds, hedge funds, private equity managers — may be looking forward to the day when they can replenish their investable dollars or other currencies, a number of the SWFs are very capable of accumulating cash and reserves right now, thanks to the modern era's efficient transfers of wealth. Revenues from natural resources — commodities such as oil, gas, ores, precious stones, and other "extractable" forms of wealth — are sold from one country to another, and as the United States, Japan, and EU nations import these resources, some of the industrialized nations' wealth is transferred to other countries. This is especially beneficial for city-states or countries in the Middle East, Africa, or even northern Europe, which enjoy revenue flows from the oil.

The global oil and gas leaders in production, while experiencing less cash flow these days (with crude prices down

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significantly), may be able to build investable funds in SWFs as US dollars and euros and yen continue to flow to national treasuries of Kuwait, Saudi Arabia, Venezuela, Nigeria, Russian, Norway, etc. These are countries that can accumulate investable funds in their respective SWFs to continue to invest beyond the borders of the nations.

NOTE THAT HALF OF THESE LARGE SOVEREIGN WEALTH FUNDS DERIVE THEIR MAJOR FUNDING FROM OIL AND GAS.

Expect significant SWF growth ahead

Beyond today's revenue flows for vital commodities (such as oil and gas and mined resources), we can expect significant SWF asset growth when the global economy revives. Federal Reserve researchers estimate that total SWF capital is from $3.5 to $5 trillion in assets. The Abu Dhabi's SWF alone had almost $900 billion in assets at year-end 2008. Norway's fund, recently pumped up by increased revenues from North Sea oil sales, had just shy of $400 billion. Using year-end data, if we stay with the conservative estimates from the Chicago Federal Reserve researchers, the $3.5 trillion of the thirty SWFs examined compared as follows to other global categories of investors: hedge funds, $1.4 trillion; pension funds, $15 trillion; insurance companies, $16 trillion; and all mutual funds (investment companies), $21 trillion. Some experts are predicting that total sovereign wealth funds will hold collectively between $10 trillion and $15 trillion in the next decade.

The Federal Reserve lists the ten largest SWFs in this order (with year-end estimated holdings): Abu Dhabi Investment Authority ($875 billion); Government Pension Fund of Norway ($380 billion); Singapore—Government Fund ($330 billion); Saudi Arabia's SWF ($300 billion); Kuwait Investment Authority ($250 billion); China Investment Corporation ($200 billion); China/Hong Kong ($163 billion): Singapore—Temasek Holdings ($159 billion); Australian Government Future Fund ($61 billion); and Qatar Investment Authority ($60 billion).

Note that half of these large SWFs derive their major funding from oil and gas. Extractable resources are very fungible to a growing number of countries around the world; as revenues for these resources rise or flows expand, revenue streams flow back to oil or mining-state treasuries, and a portion is allocated to the country's SWF.

The oldest SWF in the world is Kuwait's, an oil-rich nation that sits between Iraq and Saudi Arabia and on top of a significant treasure of oil and gas reserves located in fields beneath the sands. This fifty-six-year-old SWF is a good example of how government investment vehicles work. The Kuwait Investment Authority manages the General Reserve Fund and Future Generation Fund, operating from offices in Kuwait City and London, UK. These are sophisticated managers: consider that the Dow Chemical Company received $3 billion funding from investor Warren Buffett and $1 billion from the Kuwait Investment Authority in recent months related to the planned acquisition of Rohm 8c Haas (a chemical manufacturer).

SWFs and environmental, social, and governance issues

Concerning environmental, social, and corporate governance (ESG) factors important to investors and ESG activism among SWFs, there are activist SWFs that invest in companies and then pressure their boards and management for changes. Some funds divest shares and make noise about the reasons why. The Government Pension Fund of Norway holds such large multinationals as Nestle, BP, Royal Dutch Shell, and Total. The fund has noisily divested Wal-Mart, alleging of use of child labor and other human-rights violations along with Boeing and General Dynamics in opposition to weapons manufacturing. Norway's SWF also recently divested shares of Barrick Gold Corporation, Canada's largest market cap company, citing pollution in its New Guinea mine operations. This was an embarrassment for Canada, which prides itself on the protection of its own natural resources and mining operations.

China's SWF bought $300 million of Costa Rica's government bonds; Costa Rica then dropped its recognition of Taiwan and recognized mainland China instead.

Quid pro quo? Such actions raise concerns about some SWFs and some aspects of SWF operations as their visibility increases in the US. *The Economist* magazine pointed out that "sovereign-wealth funds could soon become the most important buyers of such assets, and many others besides. If so, the world will witness the intriguing spectacle of its largest private companies being owned by governments whose belief in capitalism is often partial."[2]

Welcome or not, sought out or resisted, sovereign wealth funds are sure to be top-of-mind for more corporate managers and boards in the global search for capital in the months ahead. Especially as SWF investable funds grow and the capital markets revive. •

NOTES

1 For Monitor's research of SWFs, visit its website at www.monitor.com and click on the Tracking Sovereign Wealth Funds tab.

2 "The world's most expensive club," *The Economist* (May 24th, 2007).