Global Economy Journal

Volume 9, *Issue* 3 2009 *Article* 7

The Volatility of Sovereign Wealth Funds

Thomas J. Grennes*

*North Carolina State University, tom_grennes@ncsu.edu

The Volatility of Sovereign Wealth Funds*

Thomas J. Grennes

Abstract

This paper evaluates sovereign wealth funds in light of the extreme volatility of energy prices and the severe global recession that began in 2008. A recent paper by Das characterized the assets of funds as showing steady growth in the past and likely increased importance in the future. However, recent developments have reduced the relative importance of funds and have demonstrated the sensitivity of the funds to energy prices and world business cycles. Investments by sovereign wealth funds have the potential to introduce political influence into corporate governance, but this potential is much smaller than the interventions into corporate governance by governments of the United States and elsewhere connected to corporate bail-outs during the recession. Lack of transparency remains a problem for certain sovereign wealth funds, but anti-recession interventions by governments have been characterized by extreme lack of transparency.

KEYWORDS: sovereign wealth funds, international investment, transparency, Norway fund

*Thomas Grennes is Professor of Economics and Professor of Agricultural and Resource Economics at North Carolina State University.

The paper by Dilip K. Das (2008) makes some informative points about sovereign wealth funds (SWFs), but it is also misleading in several respects. It emphasizes the growth of SWFs, but it misses the essential volatility of the funds and the sources of their revenue. It refers to “continued steady growth” of funds and forecasts that “their importance and weight in the global financial market will continue to grow steadily” (p7). In fact, most funds experienced crashes in 2008, when they lost 30-40% of their value (Setser and Ziemba 2009). The Norway Fund lost $101 billion in 2008 (Financial Times, 2009). The paper fails to show an awareness of the historical volatility of real oil prices and the incomes of oil exporters since 1970. Oil and natural gas are the main sources of revenue for most SWFs, and the main sources of volatility. For example, the real GDP of Saudi Arabia and the revenue of its SWF increased sharply with the oil price increase that ended in August 2008, just as they did in response to the 1980 oil price increase. However, the sharp drop in the price of oil from its 1980 peak decreased Saudi GDP per capita in 1987 to only 70% of its 1980 value, and it did not regain its 1980 value until 2002 (Caner and Grennes, 2008). Other specialized oil exporters experienced similar volatility, rather than “steady growth”. The portfolios of SWFs have also been affected by the current world recession that has diverted SWF investments from the international market to domestic spending in Russia, Norway, the Gulf States, and elsewhere.

Das finds it “reasonable” to assume that the rate of return earned by SWF investments would exceed the return earned by central banks. The presumption is that equities favored by SWFs would outperform safer bond-dominated portfolios favored by central banks. However, that did not occur in 2008, and it did not occur in the period 1999-2005. During the earlier period, the rate of return on the world stock market (Morgan Stanley Capital International) was less than the return on US government Treasury bills favored by traditional central bankers (Caner and Grennes, 2008). Managers of SWFs have sought and promised higher rates of return, but they have often failed to achieve them. Of the major SWFs, Saudi Arabia has chosen a less risky portfolio, closest to that of traditional central banks, and they suffered smaller losses in 2008 than other funds (Setser and Ziemba).

Das describes the objectives of SWFs as identical to those of hedge funds (p3). There are similarities, but there are also differences. Unlike hedge funds, the more transparent funds do not use leverage. Their portfolios are more like balanced mutual funds that combine equities and fixed income assets. Like mutual funds, SWFs face agency problems involving possible conflicts between goals of managers and goals of citizens who are implicit shareholders. (Chevalier and Ellison, 1997). Managers of the Norway Fund state their goal as maximum rate of return relative to risk. However, the steady increase in the riskiness of the fund’s portfolio through the end of 2008 has left management vulnerable to the criticism that they have chosen a higher level of risk than the one preferred by constituents. (Caner and Grennes, 2009).

Das looks favorably on the investments made by SWFs in failing firms, such as Lehman Brothers, and Merrill Lynch. He describes the lenders as “chivalrous white knights” who stabilized markets. Owners of the failing firms welcomed the investments, however, if the purpose of an efficient capital market is to allocate scarce capital to the highest rates of return, these SWF investments misallocated capital for the world as a whole. Mishkin (2006) has discussed similar misallocations of capital by government –owned banks (2008) that act as “white knights” toward struggling domestic firms. Picking losers can extend the life of unsuccessful businesses, but it imposes a deadweight loss on the broader economy.

Das acknowledges problems with SWFs related to government ownership of shares in private corporations and the lack of transparency of most SWFs. These are common criticisms made by officials in high income host countries. However, the massive bailouts in the United States and most high income countries that began in 2008 have resulted in far greater control over private corporations than investments by SWFs, and the intervention has been totally lacking in transparency. On this subject, there appears to be a double standard for sovereign wealth funds and host governments.

What have we learned from recent experience about the importance of SWFs? The sharp decline in energy prices indicates that SWFs are likely to be less important in the future than they would be if prices followed a continuous upward trend. The average real oil price since 1973 has been $47 per barrel (in March 2009 prices, Dvir and Rogoff 2009). Taking this long-run average price as the best guess for the future implies much less revenue for SWFs than a simple extrapolation from rising prices in the first half of 2008 that peaked at $147. In addition, some earlier estimates of the value of fund assets have been revised downward (Wall Street Journal 2009).

The recent world financial crisis has also reduced the importance of SWFs. The massive scale of government intervention in financial and real markets has swamped any possible influence in the same markets by SWFs. Whether SWFs might introduce some political influence on a private corporation by voting its shares is a very small issue relative to the influence acquired by the US government through its various bailout policies. The government has acquired a controlling interest in firms in banking, insurance, and automobiles. The Secretary of Treasury and the President have been involved in corporate decisions about chief executive officers, executive compensation, mergers, and even which automobiles models will survive. In addition, the form of the intervention has been far from transparent. The exact nature of the government’s ownership claims remains vague. How can participants in financial markets process information

DOI: 10.2202/1524-5861.1514

about firms, if crucial information is not publicly available? Legislation to stimulate the economy contains a "buy American" provision that remains unclear to interested parties. Citing orders from the Congress on the proper use of stimulus money, towns in Indiana and California have rejected equipment for public works projects made in Canada. Ontario towns have retaliated by excluding US contractors from bidding on municipal projects (Washington Post 2009). Lack of transparency remains a legitimate policy problem, but the scope of the problem extends far beyond SWFs.

What are the remaining issues relative to the transparency of funds? Much remains unknown about the policies of certain SWFs, and greater transparency by the opaque funds would contribute to greater understanding of how they affect financial markets. For example, it is known that institutional investors in general have demonstrated a preference for shares in larger firms (Gompers and Metrick 2001) in countries with strong legal protection for investors (Fernandes 2009). Evidence from the relatively transparent Norway fund indicates that its investment policy is similar to that of other institutional investors. To the extent that the Norway Fund and similar SWFs act like other institutional investors, the movement of funds between these two types of investors should have a negligible effect on financial markets. In fact, the Norwegian Fund outsources some of its investment choices to private managers, and internal managers are influenced by competition between them and private outsiders. More public information about the opaque SWFs is needed to know how similar their policies are to those of the Norway fund. Greater transparency about the holdings of SWFs would be consistent with more general proposals to improve the information efficiency of financial markets by disclosing more information to both regulators and the public. (Acharya and Engle, 2009).

What have been the effects of SWF policies on constituents in their own countries? Large losses have produced protests (Setser and Ziemba), and some SWF funds have been diverted to domestic bailouts. In Norway, massive fund losses in 2008 erased all the earnings from the previous ten years. There has been a call for an outside review of the fund's investment policies, but the finance minister (Kristin Halvorsen) and the fund manager (Yngve Slyngstad) have defended the policies. They have cited the fundamental volatility of stock markets, and they have repeatedly expressed their willingness to accept short-term losses to achieve long-term gains. However, some of the fund's biggest losses came, not from equities, but from fixed income assets, especially those directly or indirectly related to real estate. The Fund has deliberately increased the riskiness of its portfolio by increasing the share of equities and moving from safer bonds toward riskier mortgage-backed securities and investing directly in residential and commercial real estate. SWFs are peculiar institutions that have been described as public funds pledged to act as if they were private funds. The Norwegian Fund and other SWFs face principal-agent problems relative to their domestic constituents. The best solution to this agency problem may vary across countries, and for this important domestic issue there is no need for concerted international action.

CONCLUSION

Sovereign wealth funds grew rapidly through the middle of 2008, but a decrease in energy prices and a world recession have reduced fund expansion. Future fund growth is conditional on world economic growth and world energy prices. Warnings about the possibility that SWFs could interject political influence into business decisions have some merit. However, the response of governments to the recent world financial crisis has demonstrated that the United States government and governments in other host countries are far greater threats to business autonomy than are SWFs. Their interventions have been intrusive and non-transparent. Calls for greater transparency in the investment policies of SWFs are valid, but greater transparency in the financial market policies of host governments would contribute even more to the information efficiency of financial markets. SWFs face agency problems relative to their domestic constituents, but these domestic problems are best resolved at the national level.

REFERENCES

Acharya, Viral, and Robert Engle. 2009. “Derivative Trades Should All Be Transparent”. Wall Street Journal May 15.

Caner, Mehmet, and Thomas Grennes. 2008. “Sovereign Wealth Funds: the Norwegian Experience.” Social Science Research Council, November.

Caner, Mehmet, and Thomas Grennes. 2009. “Performance and Transparency of the Norwegian Sovereign Wealth Fund”. Revue D’Economie Financiere (forthcoming).

Chevalier, Judith, and Glen Ellison. 1997. “Risk-Taking by Mutual Funds as a Response to Incentives”. Journal of Political Economy 105(December):1167-1200.

Dvir, Eyal, and Kenneth Rogoff. 2009. “Three Epochs of Oil” NBER Working Paper 14927, April.

DOI: 10.2202/1524-5861.1514

Das, Dilip K. 2008. “Sovereign-Wealth Funds: Assuaging the Exaggerated Anguish About the New Global Financial Players: Global Economy Journal 8(4): 1-15.

Financial Times. 2009. “Norway Reviews 75bn Euro Loss”. April 3.

Gompers, P. and A. Metrick 2001. “Institutional Investors and Equity Prices”. Quarterly Journal of Economics 116,229-259.

Mishkin, Frederic. 2006. The Next Great Globalization. Princeton: Princeton University Press.

Setser, Brad and Rachel Ziemba. 2009. “GCC Sovereign Funds: Reversal of Fortune”. Council on Foreign Relations Working Paper, January.

Washington Post. 2009. “Trade Wars Brewing in Economic Malaise.” May 15.

Wall Street Journal 2009. “Wealth Funds Aren’t as Big as Assumed”. May 20.