

SOVEREIGN WEALTH FUNDS IN THEORY AND PRACTICE



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KAROLINUM

Sovereign wealth funds in theory and practice

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LIST OF ABBREVIATIONS

| | |
|--------------------|---|
| CalPERS | Californian Public Employee's Retirement System |
| CDM | Consensus Demand Meter |
| CFR | Council on Foreign Relations |
| ČNB | Czech National Bank |
| DECS | Debt Exchangeable for Common Stock |
| DJIA | Dow-Jones Index Average |
| EIA | Energy Information Administration |
| ER | Excess Return |
| ESA 95 | European System of National and Regional Accounts |
| FED | Federal Reserve System |
| FEEM | Fondazione Eni Enrico Mattei |
| GAPP | Generally Accepted Principles and Practices |
| GDP | Gross Domestic Product |
| GLC | Government Linked Company |
| IFSL | International Financial Services London |
| IMF | International Monetary Fund |
| IMFC | International Monetary and Finance Committee |
| IPO | Initial Public Offering |
| LMTI | Linaburg Maduell Transparency Index |
| MSCI | Morgan Stanley Capital Index |
| NBIM | Norges Bank Investment Management |
| NOK | Norwegian Krone |
| OECD | Organization of Economic Cooperation |
| PAYG | Pay as you go |
| PES | Advisory Board of the Czech Minister of Finance |
| PI | Petersson Institute |
| PPRF | Public Pension Reserve Fund |
| ROA | Return on Assets |
| ROE | Return on Equity |
| S&P 500 | Standard and Poor's Index |
| SEA | Sovereign External Assets |
| SEC | Security and Exchange Commission |
| SPF | Sovereign Pension Fund |
| SSRF | Social Security Reserve Fund |
| SWE | Sovereign Wealth Enterprise |
| SWF | Sovereign Wealth Fund |
| TARP | Trouble Asset Relief Program |
| TCUK | The City UK |
| TSR | Total Shareholder Return |
| UAE | United Arab Emirates |
| WA | Wealth Added Framework |

INTRODUCTION

Sovereign Wealth Funds (hereafter referred as “SWFs”) have been currently becoming a more and more important part of the international financial system. These institutions administrated USD 6.1 trillion under their asset management as of the end of 2013. SWFs are the funds owned by a state, set up for various macroeconomic purposes. Usually, they are financed through the transfer of foreign currency assets which are mainly long-term investments abroad. Even though their significance has been growing especially in the last years, SWFs do not represent a new phenomena and some of the funds from Kuwait, Abu Dhabi and Singapore have been existing for tens of years. The high prices of oil and other commodities, financial globalization and a permanent global disharmony result in a quick accumulation of foreign currency assets, especially in those states exporting oil and in some Asian countries. The growing number and size of SWFs in those countries and their growing role in international markets are a secondary effect.

In recent years people significantly changed their view on SWFs as investors. While these funds were regarded as unsought investors before the global crisis, in 2008 they were enabled to enter the largest American banks. This fundamental turnaround had to do with the need for failing financial institutions to gain financial means and in those days SWFs were the only ones which were willing to take over high risks and to provide those means. SWFs can be officially regarded as standard players in the world financial market since 2008, when they accepted the principles of its functioning (the so called Santiago Principles). By setting up a SWF, their home countries gain many economic and financial advantages, for instance easier depositing of revenues and easier inter-generation transfer of revenues from non-renewable resources. From the point of view of international financial markets, these state investment funds can more easily attain better allocation of revenues from commodities surpluses in various countries and, at the same time, they can increase the liquidity of the market even at times of a world financial crisis. The increasing impact of SWFs also raises a number of questions, eg. about their transparency, size and investment strategies.

The aim of our publication is to provide a reader with some information on SWFs as a growing phenomenon in the global financial market including all macroeconomic and microeconomic connections. In this work¹, we analyze the establishment, development, current and future tasks of SWFs. We also discuss relevant basic concepts of this sphere because the issue of SWFs is not, in fact, covered in the Czech literature at all. The publication is divided into three main chapters: theoretical part, empirical part and concluding remarks.

1 An earlier version of this work was published in Czech in Karolinum Press in the year of 2011.

In the first chapter we focus on SWFs from the theoretical point of view, we present an overview of literature, explain basic concepts, SWF's investment strategies, pending trends and key transactions. In the second chapter we deal with SWFs from the empirical point of view. We analyze the development of these funds in recent years (including their impact on economy), two indices of SWFs' transparency and main SWFs' macroeconomic impact and potential risks. In this chapter we also discuss the theoretical possibility of setting up a SWF in the Czech Republic. In the third chapter we summarize this work and present our main conclusions and recommendations. We believe that this publication will be useful, not only for specialists, but also for those readers who want to get acquainted with this issue.

Prague, June 2014
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1.

THEORETICAL PART

In this first chapter we focus on SWFs from the theoretical point of view. We provide theoretical background needed for the following empirical analysis. We present an overview of literature, explain basic concepts and SWF's investment strategies. Finally, we discuss pending trends and analyse key transactions.

1.1 LITERATURE REVIEW

Despite the fact that SWFs have been running on the market for several tens of years, this issue is not much covered in the Czech or foreign literature, even though recently there have been more and more new publications and analyses on this issue. One of the first more complete studies on SWFs was done by the McKinsey Global Institute (Farrel et al., 2007), in which these state investment funds were mentioned in the context of their growing force and impact resulting from increasing oil prices which created a significant source of their revenues. Other studies and analyses are developed by renowned international institutions, for example the International Monetary Fund (IMF) and the Organization of Economic Cooperation and Development (OECD), the Morgan Stanley bank, specialized institutions like the Sovereign Wealth Fund Institute in Las Vegas, Fondazione Eni Enrico Mattei (FEEM) under the University of Turino, Council on Foreign Relations (CFR), Peterson Institute or directly by universities (University of Washington, University of Michigan, University of