



## **Sovereign Wealth Funds: Perceptions and Realities**

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*Robert C. Pozen, Chairman of MFS investment Management, was a featured speaker at the Tiburon Strategic Advisors Summit XIV, held in New York on April 10-11, 2008. This article is based on Mr. Pozen's remarks.*

Widespread public fears about Sovereign Wealth Funds (SWFs) may lead to a backlash of protectionism. However, on balance “these fears are not well-founded,” says Robert Pozen, Chairman of MFS.

Pozen provided data on the size and growth of SWFs, who have gained prominence through their recent investments in financial institutions, such as UBS, Merrill Lynch, Citibank, and Morgan Stanley. As evidence of public misperceptions, he cited a Wall Street Journal survey from February of 2008, showing that 72% of the Americans believe foreign governments control large amounts of Treasury debt and are gaining “leverage over America’s financial security.” The same percentage believes SWFs provide insufficient disclosure about their investments.

The source of sovereign wealth funds is rapidly growing trade surpluses, primarily funded by exports of commodities and oil. Oil and gas exports represent the source of two thirds of the assets in these funds. Singapore now has the largest SWF, estimated to be just over \$200Bn, and China’s fund is almost as large. SWFs hold approximately \$2.5 trillion in assets, roughly one-quarter the size of the US mutual fund assets. In the context of \$55 trillion in capital in the world’s equity markets, SWF holdings are large but not overly significant.

Much of the public concern regarding SWFs stems from fear they could buy control of US companies, particularly those related to national security. Pozen pointed to a number of laws which will stop this from happening. The [Exon-Florio](#) provisions allow the President to block investment if it jeopardizes national or homeland security, and its charter was recently expanded to require extra scrutiny of critical infrastructure (energy, communications, transportation). Foreign ownership is restricted in specific industries (aviation, banking, communication/broadcasting, maritime/shipping, mineral leases, and power/utilities). No foreign ownership is permitted for nuclear power industries.

Another concern centers on whether SWFs will act to optimize their economic interests in their investment process or, if not, what the potential adverse effects might be. For example, SWFs might invest for political motives, in order to



dominate certain industries, and use their power to drive down prices in certain markets. However, Pozen pointed to antitrust legislation regulating ownership in industries as well as predatory pricing laws that will mitigate or eliminate these concerns. "So far," said Pozen, "sovereign wealth funds have invested with their economic interests in mind, and without political motivation."

It is also unlikely SWFs will adversely impact market stability. SWFs have long-term investment horizons and, given their large size and lack of liquidity pressure, are unlikely to cause short-term volatility in the markets.

Two specific concerns have been raised relative to SWFs and insider trading. First, will SWFs and foreign countries cooperate with the SEC with respect to enforcement? Pozen believes they will, and cites no evidence of any failure on the part of SWFs to cooperate. In the past, foreign state-owned industries have cooperated in such matters. Second, a concern has been raised that foreign governments will provide insider information giving SWFs an advantage in trading. Pozen cites no evidence of this occurring and believes information flows could be traced. "Maybe this could happen once or twice before it is stopped," says Pozen.

"The real issues involve disclosure," says Pozen.

Disclosure concerns have surfaced in three areas: to SWF beneficiaries, to securities markets, and to the U.S. Treasury. Pozen focused on the latter two, since he believes it is inappropriate to question the level of disclosure between SWFs and their investor governments. With respect to the securities markets, SWFs are subject to the same disclosure rules as any other investors, for example requiring filing if they control 5% or more of a public equity class. They must disclose to the U.S. Treasury any direct investment of 10% or more of an entity. The European Union has taken a more aggressive stance on the disclosure issue, and has issued proposals that would require SWFs to provide their investment objectives, asset and currency allocations, and quarterly portfolio holdings. Pozen noted that the Norway, Canada, and New Zealand SWFs already provide this level of disclosure. Some SWFs have rejected the idea of investment codes stipulating disclosure requirements, and a couple (Abu Dhabi and Singapore) have adopted codes pledging never to use investments as foreign policy tools and to invest solely based on maximizing risk-adjusted returns. In return, they want assurances against discrimination, insofar as they will not be subject to rules not imposed on other investors.

Pozen predicted a wave of protectionism in the face of growing investments by SWFs. For example, a bill under consideration by the California assembly would prevent California pension plans from investing in private equity funds that also have SWF investors. "There will be a backlash," says Pozen, "but the public



needs to be reminded that SWF investments may be responsible for cutting interest rates by as much as 1% by buying Treasuries, and they have certainly propped up stock prices.” He notes that SWFs have bailed out many financial institutions, without demanding board seats, and have helped these institutions expand abroad. In order to assuage protectionist fears, Pozen recommends the U.S. insist on reciprocity for U.S. investments in other countries.

Pozen said SWFs have been victimized by misperceptions, and are not buying security-related companies, dominating strategic industries, destabilizing the securities markets, or trading on inside information. “The reality is there are tough issues on how much more to disclose and the degree of reciprocity as a response to protectionism,” says Pozen.

Pozen also noted that SWFs represent a big opportunity for U.S. asset management firms, but warns SWF investors are sophisticated and “drive a hard bargain.”

### **Our Analysis**

We concur with Pozen’s assessment of the issues facing SWF investment. The benefits far outweigh the risks. We believe protectionist measures, such as those proposed by the California legislature, are misguided. In the current environment, SWFs are providing an extremely important source of liquidity for financial institutions, and represent a valuable opportunity for U.S. investment managers. Pozen perhaps understates the importance of the liquidity SWFs have provided to the market. The bulk of their investments have been in U.S. Treasuries, so they have effectively lent the U.S. government huge sums, and it is these investments that are jeopardized by the devaluation of the dollar.

Disclosure is the important issue, and voluntary measures may help, but it is unrealistic to expect significant progress in this area, given the general lack of transparency in private investment vehicles, such as hedge funds, in the U.S. markets. Expect more SWF investments in financial firms, as these firms continue to deal with write-offs from the credit crisis.

Wirehouse reps will come under pressure, as some clients will be reluctant to place funds in institutions with SWF ownership, and this will benefit independent RIAs. Wirehouse reps will need to devote resources to educating clients about SWFs, and may face some defections, but we do not see how independent RIAs can capitalize on this through proactive marketing.

At a macro level, the risks posed by SWFs to the financial system are relatively insignificant in comparison to the risks posed by highly leveraged pools of capital in an era of increased volatility.



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