

Executive summary

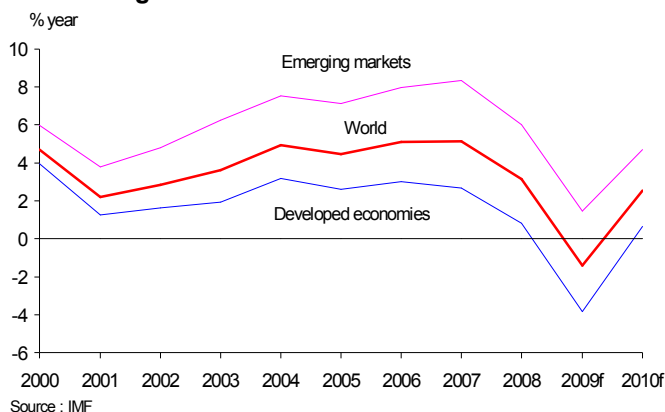
- With the emerging markets outpacing the developed economies over the past ten years and now recovering from global recession significantly faster, the economic and financial power of developing economies is rising inexorably. And although the recession has reduced global imbalances, some of the emerging markets, led by China and the Middle East, continue to run large surpluses and amass reserves.
- Although the lessons of the financial crisis will lead many countries to build an even larger cushion of reserves, the desire to diversify and invest part of these means that the rise of the sovereign wealth fund (SWF) will resume. Funds managed by SWFs peaked at close to US\$4 trillion at end-2008 but have fallen back to some US\$3-3.5 trillion, still well ahead of hedge funds and private equity – both of which have suffered much worse during the crisis and may now face tougher regulation.
- With oil and other commodity prices rising again, SWFs among the emerging markets will be in a particularly strong position in the coming years. Commodity-based funds account for 65% of total SWF managed funds, while those in Asia and the Middle East account for 80% of the total. Rising surpluses in these two regions (as well as other oil producers, including Russia despite its current problems) will boost funds available for SWFs to invest.
- Investment strategies of SWFs have come under scrutiny in recent years, but their investments have generally been long-term and the stakes taken by some in western banks have helped to defuse some reservations. The set of investment and operational principles drawn up by SWFs in conjunction with the IMF at their Santiago meeting in September 2008 will also help to allay concerns.
- Having sustained significant losses in 2008, SWFs have gained experience from the downturn, in terms of investment strategy and organisation. After a sharp dip during the recession, there are signs that SWF activity may be starting to pick up again and, with some now recruiting investment expertise from downsizing investment banks, they will emerge as stronger market players in the coming years.
- Looking ahead, SWFs will continue to rise in number, particularly among the oil-producing countries, as well as in overall size. Assuming growth in assets of some 12-15% pa, total funds under management could climb to US\$8 trillion by 2015. The largest and most active SWFs will be in those countries with the largest stockpile of reserves, including China, Singapore, Abu Dhabi and Qatar.
- Over the medium term, it is likely that the investment strategies of SWFs will shift. In line with the growing power of the emerging markets and the associated changes in patterns of global trade and investment flows, as well as a desire to lessen dependence upon US dollar assets, it seems likely that SWFs will seek to invest more in the main emerging markets, which in turn would also signal a diminishing focus on financial services as a target for investment.

Power of emerging markets still rising despite recession...

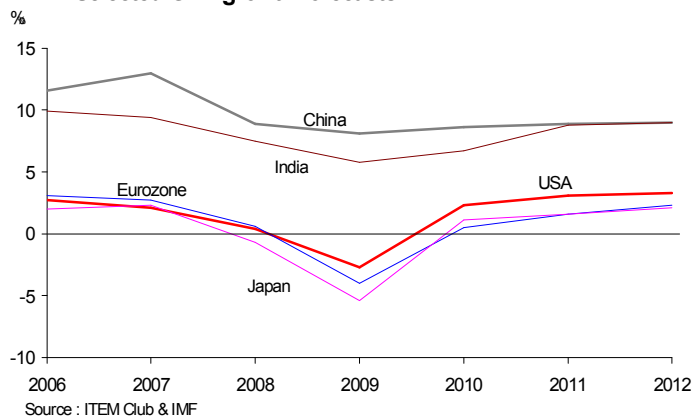
Despite the dislocation caused by the financial crisis and the subsequent global economic recession, which led to a drop of about 80% in cross-border capital flows, the emerging markets continue to play an increasingly powerful role in the world economy, reinforcing the shift in the pattern of wealth seen since 2000.

Having slowed to just 1.6% in nominal US\$ terms in 2008 (3% on a purchasing power parity basis), world GDP is expected to fall 2.3% this year (1.3% on a PPP basis), the first decline in 60 years, with world trade forecast to plunge by an unprecedented 14%. But the emerging markets are expected to grow by about 1% this year, albeit down from rates of over 6% in recent years, whereas the US will contract by about 2.5%, the Eurozone by 4% and Japan by 5.4%. And despite the severity of the financial crisis and the global recession, no emerging market has defaulted – indeed some of the worst affected economies have been (and still are) smaller European countries.

World GDP growth



Selected GDP growth forecasts



Although recovery is now under way, it will be slow and patchy in many countries, especially those in the developed world where unemployment is rising sharply, which will dampen consumer demand, and where government spending will have to be curbed in order to strengthen public finances. And given the major upheavals in global banking, those countries with large financial sectors are facing a lengthy period of subdued lending as the banks try to strengthen their balance sheets. As a result, the developed economies are forecast to grow by less than 1% in 2010 and most of them are unlikely to see growth returning to previous levels any time soon, with the Eurozone and Japan expected to be particularly subdued. In contrast, the emerging markets could grow by close to 5% in 2010, led by China and India but also supported by solid performances in other countries, including Brazil and the Middle East.

...supporting the profile of SWFs...

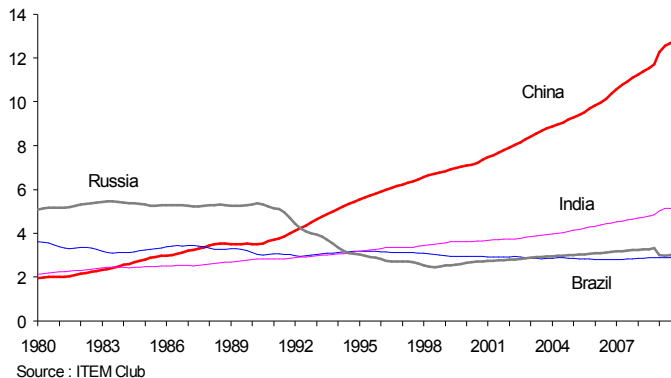
As a result, the emerging markets will continue to outperform developed economies. Since 2002, the emerging markets as a group have grown much more strongly than the developed countries, at 7.5% pa, led by the Asian giants China and India – the former growing by around 10% pa and the latter accelerating to over 9% prior to the downturn. The surge was headed by Asia-Pacific, with most countries being pulled along by the strength of Chinese demand, but all regions – including the traditional under-performers Latin America and Africa – joined in the good growth performance.

And this means that the power of the emerging markets in the global economy is climbing further, even in the new world order. Overall, in PPP terms, China has contributed about 25% of total global growth since 2000, compared with 14% accounted for by the US, and together the BRIC countries (Brazil, Russia, India and China) have accounted for some 40% of global growth. This has resulted in a marked shift in shares of global GDP. In 2008, the

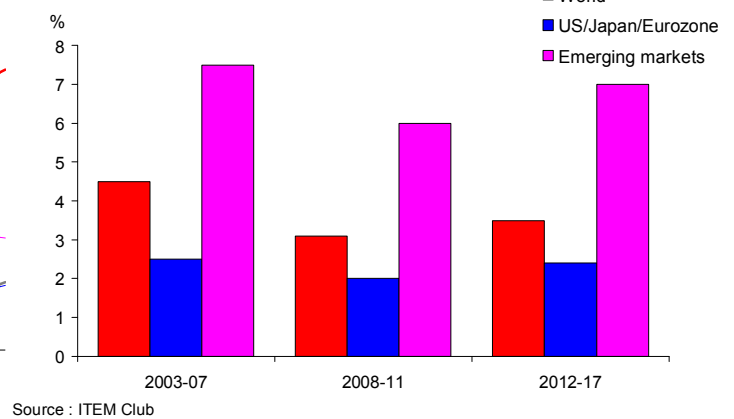
collective size of the BRIC economies exceeded that of the US economy (on a PPP basis) by over 8% – making up 22% of the global economy. Again, China has been the principal driver of this transformation, with its share in world output rising from 6% to 11% in a decade.

BRICs: Share of World GDP

% of total at Purchasing Power Parity



World Growth in 2003-2017



The rising power of the emerging markets has seen a growing focus on the role of the sovereign wealth funds (SWFs) in some of these countries, boosted by the surge in their balance of payments surpluses and reserves since 2004, largely on the back of high oil and commodity prices. Although these surpluses are falling in 2009 and some SWFs have lost heavily because of the drop in asset values since the middle of 2008, the changing dynamics of the world economy mean that SWFs are going to remain influential market players in the coming years.

...as balance of payments surpluses and reserves remain huge

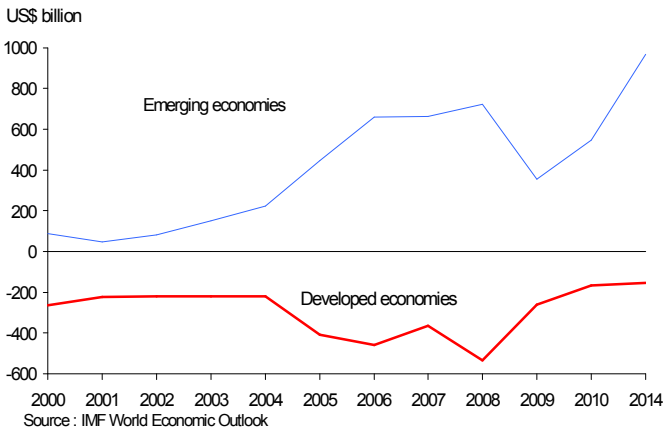
Rapid growth of SWFs among the emerging markets has been driven by their strong export performance, which has transformed the structure of global trade. According to IMF figures, emerging economies account for around a third of total global trade and have contributed more than a half of the increase in global import volumes since 2000. A particularly dynamic area has been 'intra-emerger trade' – with almost 50% of emerging market exports now going to other emerging economies. Intra-regional trade within emerging Asia has been especially strong. These strong trade performances, together with rapidly rising revenues experienced by energy and commodity producers, have underpinned a large increase in the aggregate current account surplus and reserves of emerging economies. According to IMF data, the emerging markets posted a current account surplus of US\$725 billion in 2008 compared with a deficit of US\$530 billion in the developed countries, with the US being the main deficit country. The emerging markets' collective surplus is expected to fall this year, but will still be high at over US\$350 billion, and IMF forecasts show the surplus rising to US\$970 billion in 2014. At the same time, reserves held by emerging markets now account for close to 75% of total world reserves, up from 60% in 2000.

This mountain of reserves is far in excess of what would be required for normal day-to-day needs such as protecting exchange rates or meeting import requirements. But during the global financial crisis, this stockpile provided vital shelter from the storm for many emerging economies, so countries will endeavour to rebuild them in case of a recurrence of financial [turbulence](#). Traditionally, reserves have been placed in low-risk – but also low return – assets like US treasury bonds. But as reserves have piled up in recent years, SWFs have been an increasingly important vehicle for investing these reserves more actively, building up long-term stakes in large companies in developed countries in order to diversify assets and offer greater economic security during leaner times, when for example oil or commodity prices turn down.

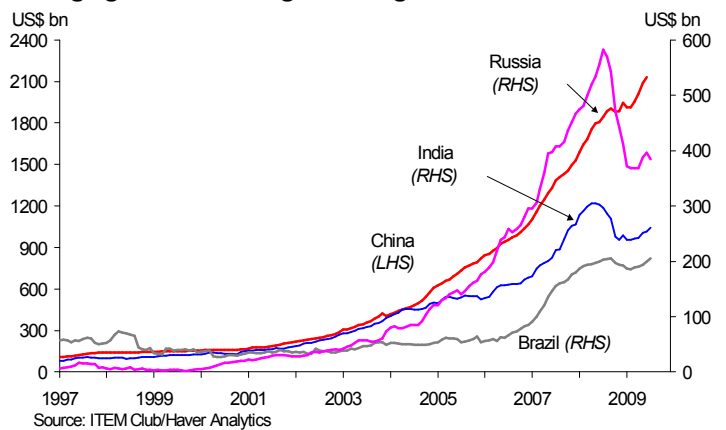
SWFs in the new global order

And with the emerging markets seemingly poised for faster growth than the developed economies in the next few years, investors have also stepped up purchases of emerging market assets sharply since Q1 2009. The combination of these foreign inflows and large external surpluses is prompting a renewed rise in foreign exchange reserves in parts of Asia and the Middle East. Countries have also accumulated reserves as they have bought US dollar assets to try to slow the rate at which their exchange rates appreciate against a weakening US dollar. These factors are once again boosting the potential funding for SWFs in these countries.

Global current account balances

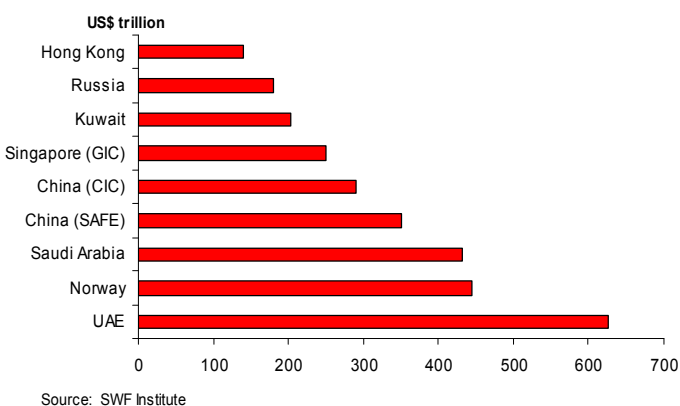


Emerging Markets: Foreign exchange reserves

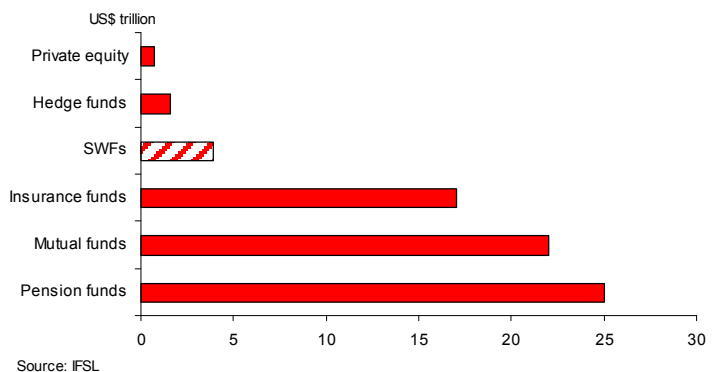


The largest of the SWFs are still commodity-based and in the Middle East, such as in the UAE and Saudi Arabia, but Norway has been running one of the largest funds for many years and those in Singapore, China and Russia have been expanding rapidly in recent years. In addition, a number of smaller oil producers such as Libya and other commodity producers have established funds for their surplus commodity earnings. Estimates of the total size of all SWFs vary widely; some 18 months ago we put the total at approaching US\$3.5 trillion and figures from International Financial Services London (IFSL) put the level at US\$3.9 trillion at end-2008, up 18% from a year earlier. (In addition, the US\$4.5 trillion of foreign currency reserves also held by emerging markets in Asia and the Middle East at that time implied a vast wall of money available for investment by a relatively small number of countries).

Largest Sovereign Wealth Funds



SWFs in perspective



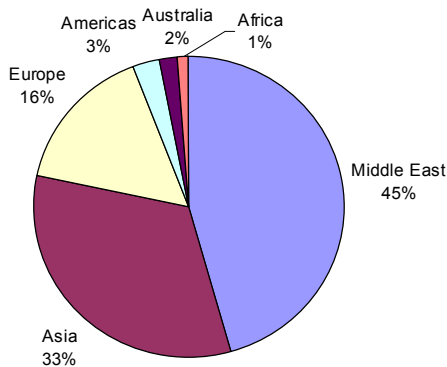
SWF assets remain small in comparison with those of mature institutional investors, which manage funds of over US\$60 trillion, including US\$25 trillion managed by pension funds, but at end-2008 were well above the level managed by hedge funds, put at around US\$1.5 trillion, and private equity funds, with less than US\$1 trillion.

SWFs resilient to financial crisis...

The value of SWF assets under management has clearly been hit by the impact of the financial crisis on all asset values, in particular equities and real estate. Since the start of the financial crisis, SWFs are estimated to have made substantial losses on funds of over US\$60 billion invested in major banks in the US, the UK and Europe. According to Deutsche Bank, typical equity portfolios held by SWFs may have lost 45% between end-2007 and early 2009, reducing overall SWF portfolios by around 18%, but it points out that few of these portfolio losses have actually been realised. Few SWFs disclose full details of their assets or gains/losses, so formal analysis of their performance is impossible but it is clear that on a mark-to-market basis some have sustained sizeable losses. As well as these paper losses, some SWFs have been placing greater emphasis on injecting liquidity into their domestic economies in order to counter the impact of recession, which means that their results will be linked more closely with local/regional markets rather than global markets.

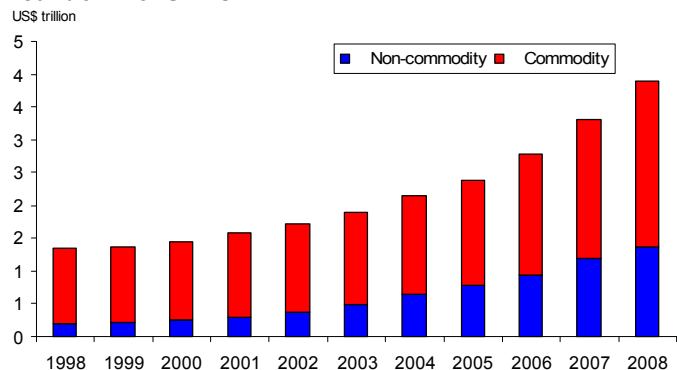
But amid signs of economic stabilisation, the pick-up in global equity markets and the renewed capital flowing into the emerging markets as noted above, there have been some signs of recovery in SWF activity and assets in recent months. This performance has been boosted in part by the continued stellar performance by China, which is defying the global downturn in posting GDP growth of almost 9% this year, only a little below the rate in 2008, and with reserves having climbed to US\$2.2 trillion by mid-year. This in turn has helped to bolster the amount of funds under management by SWFs – the China Investment Corporation (CIC), Beijing's sovereign wealth fund established in 2007 with some US\$200 billion of assets, is now estimated to have funds totalling around US\$300 billion, while China's State Administration of Foreign Exchange (SAFE) manages some US\$350 billion in a similar fashion to the CIC. As a result, we currently estimate total SWF market capitalisation at some US\$3-3.5 trillion, close to the level of 18 months ago as last year's sharp drop in asset prices has begun to reverse.

SWF market share by continent



Source: SWF Institute

Breakdown of SWFs



Source: IFSL

The performance by SWFs, which may be further boosted by the recent recovery in oil prices to US\$75pb and higher metal prices, is in stark contrast to hedge funds and private equity, which remain hard hit by the freezing up of credit markets and the subsequent slide in world equity markets that battered the wealth of private investors. Hedge fund assets fell by about 25% in 2008 and the industry is thought to be contracting further this year, as is private equity. Unlike SWFs, which are benefiting from higher inflows from the public sector as current account surpluses in some emerging markets benefit from rising oil and commodity prices, both hedge funds and private equity are still facing sharply lower levels of private funding as well as having to adapt to the new environment of tight credit and quite possibly greater regulation.

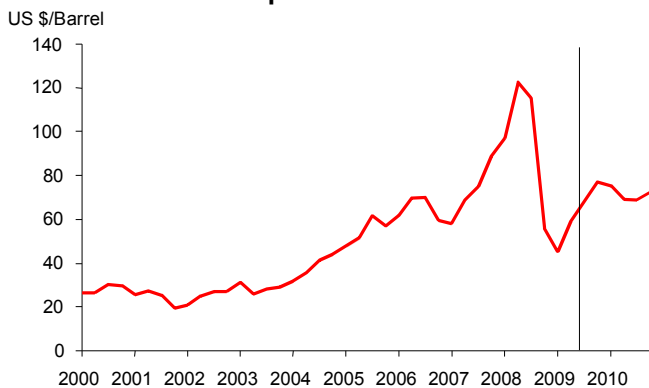
...and responsive to changing conditions...

And it is clear that SWFs have learnt from the downturn and will emerge as stronger players in financial markets. The losses sustained in 2008 are already leading to a review of both strategy and organisation – in terms of targeting asset allocation, how investment decisions are taken and how to monitor performance of investments. Many SWFs will follow the example of the Qatar Investment Agency, which is now recruiting sector experts to build specialist investment teams, and the Abu Dhabi Investment Authority, which is also employing expertise. The timing of the move to acquire financial market and sector-specific talent is, of course, particularly opportune given the downsizing under way in many investment banks and private equity houses around the world.

...and so will resume growth in the coming years

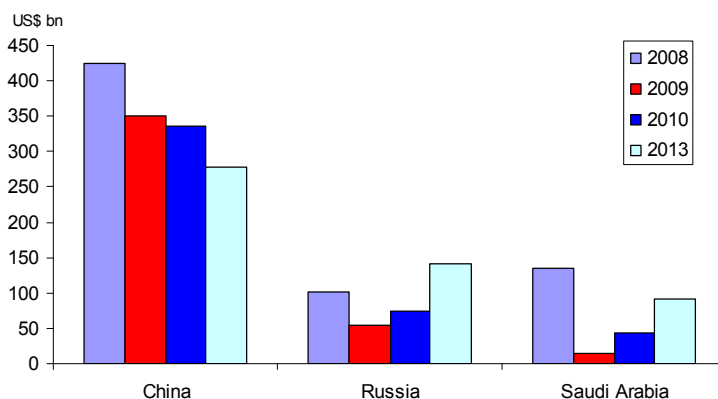
The pick-up in the world economy that is now under way, plus the rise in oil and commodity prices, will further bolster Asian and commodity-based SWFs. As well as the expected strong growth performance of China and India, which will lead the way among the emerging markets, other countries in the Middle East and Asia – these two regions account for close to 80% of total assets managed by SWFs and some 75% of total emerging market holdings of reserves – have seen GDP growth either holding up quite well during the downturn or recovering quickly from deep declines around the start of 2009. These countries are expected to grow more strongly over the next few years, with commodity-based revenues and surpluses building again. If the world oil price holds at around US\$75pb, oil producers' current account surpluses will recover strongly over the next few years, Saudi Arabia perhaps posting a surplus of over US\$40 billion in 2010 and then back above US\$80 billion in 2011 and 2012, albeit still below the surpluses seen in 2007 and 2008. Even Russia, which has been one of the hardest-hit of the emerging markets, will see its current account surplus climb back towards US\$175 billion by 2013 from around US\$50 billion this year.

UK Brent oil - nominal prices



Source : ITEM Club

Selected current account surpluses



Source: ITEM Club, Haver Analytics

As a consequence of these rebuilding surpluses and the response to lessons learnt during the global economic downturn, it is likely that commodity-based SWFs will once again start to increase in size and importance in the coming years. But the experience of the last 18 months may also mean that greater caution will prevail in the near term, both in terms of funds allocated to them and their investment strategies.

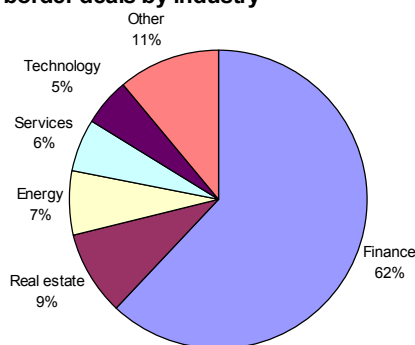
Investment strategies under scrutiny

SWFs played an increasingly prominent role in 2007 and 2008, with the levels of investment and the number of deals rising strongly until the financial crisis deepened suddenly in the second half of last year. According to figures from Dealogic, the number of SWF cross-border deals rose sharply in 2007 to over 40, from less than 15 in 2006, with the

total value of these deals climbing to over US\$50 billion. Back in 2005, the value of such deals was less than US\$10 billion. Estimates for 2008 show a sharp dip to US\$30 billion. The major focus of SWF investments has been in finance, especially in the build-up to the financial crisis as authorities in the US and the UK actively courted the involvement of SWFs – in contrast to their earlier suspicion about SWF acquisitions. At a time of mounting concern in the wake of the sub-prime crisis, the huge injection of funds was welcomed with open arms. Among the most prominent of these financial sector deals were the injections of US\$22 billion in Citigroup, US\$12 billion in Merrill Lynch and US\$11.5 billion in UBS.

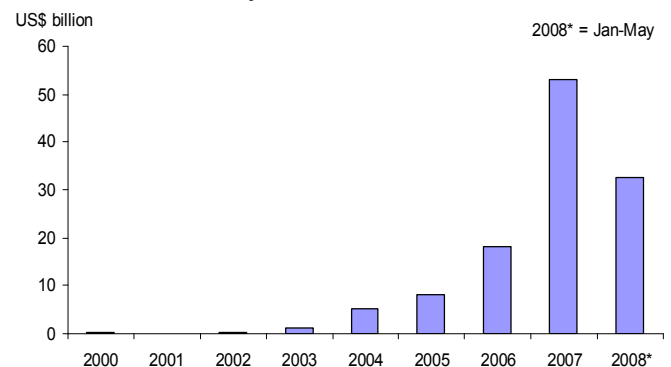
Prior to these banking sector ‘rescues’, the latter part of 2007 saw mounting concern about the role of SWFs, their lack of transparency and their growing power as the world price of oil, which funded much of the growth in SWFs, surged above US\$100 a barrel and headed towards the peak of close to US\$150 in July 2008. There were concerns that SWF investment is, at the end of the day, government investment – and that some governments may have motives that are other than purely economic, including the pursuit of geopolitical objectives opposed to the interests of the countries targeted by SWF investments. Although many SWFs had invested cautiously and had spread their assets widely over a long period, and with a low profile, especially the ‘future generations’ funds with high levels of transparency such as those in Norway and Canada, some appeared to be following a much more aggressive strategy, acquiring significant stakes in foreign companies that could be deemed strategic.

SWF cross-border deals by industry



Source: Dealogic, IFSL

SWF cross-border activity



Source: Dealogic, IFSL

The rise of the SWFs in recent years has effectively turned the government sector into an important source of international investment, even though the investment strategies of different SWFs can vary significantly in terms of asset allocation and risk management. Typically, however, SWFs have adopted a long-term approach to investment, with little evidence of disinvestment even during the recent sharp downturn in the markets and plunging asset values. But the deep recession has meant that some SWFs that are geared more towards stabilisation policies and that operate more closely with government have adopted shorter-term investment horizons, while some in oil-producing countries have switched attention from western markets and assets to invest more in domestic companies and stock markets in order to bolster national liquidity.

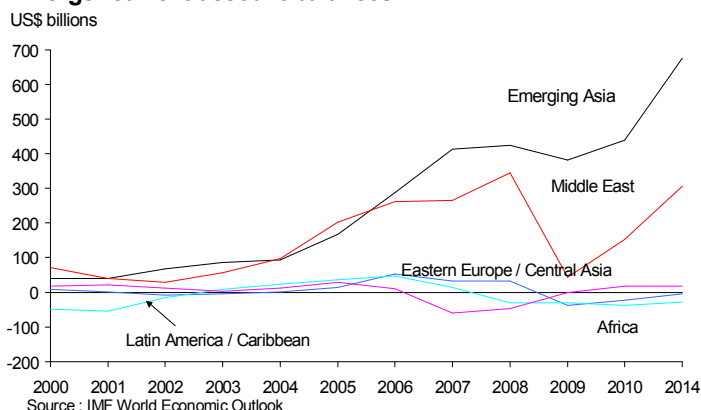
In order to address some of the concerns about investment strategy and transparency, the leading SWFs formed the International Working Group of Sovereign Wealth Funds in May 2008, and at its Santiago meeting in September 2008 delivered a set of 24 principles, the Generally Accepted Principles and Practices (GAPP) for SWFs. Albeit non-binding, these include aims such as a commitment to non-political objectives, greater transparency over issues such as voting rights and risk management, and commitment to separation of fund management from government. In response, the OECD has offered guidelines for recipient countries of SWF investments, including the avoidance of protectionism and maintaining fair and transparent investment frameworks.

Prospects for SWFs in the new economic climate

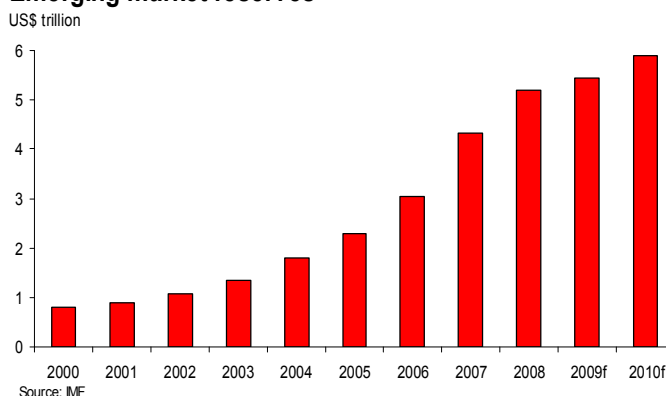
Looking beyond the current short-term difficulties posed by the global recession and the institutional changes that SWFs are implementing as a result, the key to their future lies in how emerging economies perform over the next decade or so and, linked closely with this, the trend in oil and other commodity prices. It is already fairly clear that the current global downturn has not eliminated the key structural drivers of growth for emerging economies – namely strong domestic momentum, productivity gains from continuing integration into the global economy and benefits from improved macro- and micro-economic policies. These attributes are seeing a return of investment and capital flows to the emerging markets, which began in Q2 and have picked up since then.

As a result, emerging economies are forecast to continue to grow faster than developed countries over the next decade. This performance is expected to underpin an ongoing shift in the economic balance of power, as well as patterns of wealth distribution, in the years ahead. In our forecast, which assumes commodity prices remain relatively high, the BRICs are expected to contribute 40% of global growth between 2010 and 2020 – with China accounting for a quarter. As a result, China is set to become the biggest economy in the world (in PPP terms) by the end of the next decade. The trade and growth prospects – and hence asset generation – of other resource-rich emerging markets including those in Asia and the Middle East, plus Russia, are also closely linked to the performance of the BRICs. This suggests that growth in the emerging world will remain robust, particularly if countries like Russia manage to introduce the type of reforms needed to get their non-oil economies moving faster.

Emerging current account balances



Emerging market reserves



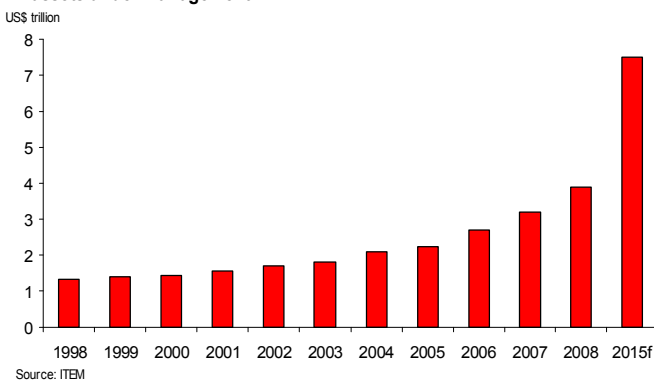
A stronger growth performance in the emerging economies points to a further rise in their financial surpluses, despite the fact that the main surplus countries will have to do more to boost domestic consumption and thus run smaller surpluses if they are to sustain rapid growth. Latest estimates suggest that Asian sovereigns and Middle East and other oil producers could hold net external assets of US\$20-25 trillion by 2015 if oil prices hold around US\$70 a barrel or higher – over 25% of global GDP. China's foreign exchange reserves, for example, will probably move towards US\$3 trillion by 2013. As noted earlier, only a portion of these additional reserves will be allocated to SWFs but, given the growing concern expressed by the largest emerging markets in the G20 about the long-term role for the US dollar as the world's reserve currency, increasing investment via SWF vehicles offers countries a chance to shift away from holding US dollar-based reserves.

Assuming that commodity prices do not collapse and that world equity markets continue to recover, we estimate that the value of SWFs will increase by some 10-15% pa over the next five years, which would lift their total capitalisation to some US\$8 trillion. This would be well below levels of US\$10-15 trillion projected prior to the financial crisis and

global recession, but would nevertheless mean that SWFs will become increasingly powerful players in world capital markets. If oil and gas prices stay high, then SWFs in Middle East countries such as Saudi Arabia, the UAE, Qatar and, potentially, Iran will see their assets mounting strongly, as will Russia and Libya. Given its oil resources, Iraq is another potential candidate for building up a large SWF, but in the near term the political obstacles remain significant and the initial need for infrastructure spending will consume most of current oil revenues.

The most active SWFs in terms of investment activity are likely to be those in China, Singapore, Abu Dhabi and Qatar (where gas revenues are set to grow very strongly), with China in particular seeking to utilise and diversify its continued surge in reserves in order to reduce its dependence upon US dollar assets. Despite its expected return to large current account surplus, Saudi Arabia is likely to remain cautious in terms of its foreign investment strategy. Some other oil producers such as Libya certainly have long-term potential but economic management is not yet providing clear and consistent strategic direction, while Kazakhstan is very much focused on its domestic agenda given its current problems. And based on the experience of the past five years, other oil-producing countries such as Angola and Nigeria, together with countries with high levels of official reserves, will go down the SWF route but most of these are likely to be small- or medium-sized funds.

SWF assets under management



Official foreign exchange reserves

(Jul/Aug 2009)

| | US\$bn | % share |
|-------------|--------|---------|
| China | 2178.2 | 30 |
| Japan | 1018.8 | 14 |
| Russia | 391.9 | 5 |
| India | 267.3 | 4 |
| South Korea | 237.4 | 3 |
| Brazil | 215.3 | 3 |
| Hong Kong | 218.0 | 3 |
| Singapore | 174.1 | 2 |
| Algeria | 145.5 | 2 |
| Germany | 60.4 | 1 |
| Others | 2458.9 | 33 |
| World | 7366.0 | |

Source: IMF

A shift in SWF investment strategy

Moreover, the pattern of SWF investment activity will probably follow along the lines of the development of world trade and capital flows over the past decade. Much of the growth in world trade in recent years has been among emerging market economies, especially within Asia, and increasingly so since the developed economies went into recession, so it seems very likely that capital flows and SWF investment will follow the same direction. The past five years have seen rising FDI flows to the emerging market economies, with the main BRICs attracting FDI from the developed world in sectors such as energy, heavy industry, car production, manufacturing and outsourcing in financial services, as international corporations have sought to exploit both their large and relatively cheap labour forces and their strongly growing domestic markets.

Although the growth in world investment flows has slowed since the onset of the credit crunch, investment into countries such as China and India has remained fairly buoyant and is already starting to pick up again. Following the losses on some of the financial sector investments in the west over the past two years, SWF investment patterns will probably follow this trend, shifting away from developed economies and at the same time starting to erode the predominance of financial sector investments. Underpinning this process will be the growing economic and financial power of the leading emerging markets and their long-term desire to try to diversify their asset base away from traditional reliance on US dollar assets.