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Outlook: Sovereign Wealth Funds

Oil-funded SWFs at a turning point

The current debate about the impact of the collapse of oil prices on SWF asset management has suggested that oil-funded SWFs are under pressure to liquidate assets, as governments seek to protect their budgets against dramatically declining revenues. We offer a contrarian point of view. We agree that some funds have seen substantial withdrawals. For example, the Russian government has drawn down the assets of its Reserve Fund from over $90 billion to roughly $50 billion during the past 18 months. The deposits and reserves of the Saudi government stored in the Saudi Arabian Monetary Agency (SAMA) have declined by roughly 20 percent over the past year.

But these “rainy day funds”, as such fiscal stabilisation vehicles are often called, are only a small subset of a much larger SWF universe. The role of many other oil-revenue based funds is rather different. Most were built with a long-term perspective in mind, as an instrument to manage oil wealth not only for the benefit of the current, but also future generations. The working hypothesis of long-term savings funds has been that finite oil wealth would be transformed into financial assets that could secure an infinite stream of income. Over time, financial returns would gain in significance in funding government expenditure whilst the importance of oil-related incomes would gradually contract. That thesis has been a bold one, but at the core of the dramatic rise of the SWF industry over the past two decades.

The drawing down of savings stored in fiscal stabilisation funds has been fairly predictable and little surprising. This is the scenario for which they were established in the first place. What is much more intriguing is to look at how long-term savings funds navigate the current period of depressed commodity prices. In that regard, the circumstances under which Norway’s government for the first time in the history of its Government Pension Fund Global (GPFG) withdrew 6.8 billion kroner in January are much more relevant. The fund is the largest SWF and one of the largest global investors. The government will probably withdraw as much as 80 billion kroner from the fund in 2016. But here is what sets it apart from fiscal stabilisation funds. Withdrawals will be more than offset by the cash flow generated by its investments which in 2015 amounted to over 190 billion kroner. In other words, government withdrawals will not bite into the GPFG’s capital base and reduce savings, but are covered by its profits. This is indeed a “significant shift in the fund’s history”, as Norway’s Central

Bank Governor, Oeystein Olsen, observed. Not only that, it is a watershed moment for the SWF industry at large. For the first time in its short history, there is empirical evidence that the objective for which long-term savings funds were built - benefiting current and future generations - can be met. Current profits, not past savings, fund government expenses. The core of the fund, its capital base, remains untouched.

The Norwegian case might be indicative for other oil-funded SWFs, most notably those in the Gulf region. Though the largest Gulf-based SWFs still entertain a restrictive financial disclosure policy, our back-of-the-envelop simulation suggests that they can be assumed to have reached the same level of significance for the budgets of their governments as the GPFG has for Norway's. We can speculate that the Abu Dhabi Investment Authority had an investment income of roughly $57 billion in 2015, based on an estimated $773 billion of assets under management and a 7.4 percent annual rate of return. This represents largely the expenditures of the United Arab Emirates' government. The Kuwait Investment Authority is estimated to manage roughly $590 billion, which results in an income of $44 billion or more than 70 percent of Kuwait's public expenditure, assuming a 7.4 percent return across its entire asset base. Along that same line of argument, we estimate that the Qatar Investment Authority could contribute as much as 30 percent to Qatar's government expenditures in 2016. Again, these figures for the time being remain speculative for the reasons we gave above. Better disclosure policies would certainly lead to more solid analysis. But they might not be too far off the mark either and support our argument. The large SWFs of the Gulf region and the profits they ought to earn, have become important instruments to help maintain the financial solidity of the governments that established them decades ago.

The consequences of this trend are profound. External asset managers who currently bemoan SWF redemptions are better advised to supply the products that this special investor class demands in current circumstances. Also, it is essential for governments as asset owners to ring-fence their funds' capital bases and defend them against the temptation to meet short-term oriented and politically motivated calls for funding. This is where the resilience of SWFs' governance arrangements will be put to test. But the broader, geostrategic consequences are relevant too. Some economies with a long history in oil and gas production are on track to transform themselves into economies based on financial assets. In other words, not only do energy consumers put a lot of thought into how to get out of fossil fuels, so do energy producers. That begins to pay dividends. And just as in the past century hydrocarbons exporters have depended on free access to international oil and gas markets, in the current century they will depend on unrestricted access to the international financial markets to ensure they can make the profits they need to fund their financial, and political future.

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About

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