LEVIATHAN'S DOUBLE BOTTOM LINE:
SOVEREIGN WEALTH FUNDS AS TOOLS OF STRATEGIC STATECRAFT

By

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SUBMITTED TO THE MIT SLOAN SCHOOL OF MANAGEMENT IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF BUSINESS ADMINISTRATION AT THE MASSACHUSETTS INSTITUTE OF TECHNOLOGY

JUNE 2012

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Submitted to MIT Sloan School of Management

on May 11, 2012 in Partial Fulfillment of the

requirements for the Degree of Master of Business Administration.

ABSTRACT

Sovereign wealth accounts for a massive, and growing, source of global financial capital. Sovereign wealth funds (SWFs) hold about $5 trillion in assets, nearly double the aggregated assets of the global hedge fund community. Sovereign capital is markedly more concentrated among a relatively small number of sovereign funds (about 40) as opposed to the nearly 7,000 global hedge funds. The concentration and use of these resources has a considerable impact not just on the world’s capital markets, but on foreign policy as well.

This paper explores the extent to which sovereign funds are embodying a “double bottom line” investment approach that allows them to reap financial and strategic benefits simultaneously. Some SWFs are not only earning excess financial returns, but have accrued political influence (“intimidation by implication”) and a greater ability to meet broader sovereign needs as a result of their size, positioning and investment patterns. Power theory helps to explain, in part, how and why a sovereign double bottom line occurs. Because SWF portfolios remain largely opaque, the paper relies on available public information about SWFs in China, Abu Dhabi and Qatar to examine the extent to which SWFs are benefitting from political and/or policy payoffs alongside their financial returns.

Because some critics deem the use of SWFs to serve national strategic goals as potentially destabilizing to global financial markets, this is a controversial idea. Yet while state actors may merit a particularly watchful eye, their actions are in fact no more threatening than those of other market participants. SWFs are as legitimate a tool of statecraft as other financial foreign policy implements. Sovereign funds are shaping a new normal in geoeconomics, in which states lacking the financial resources to pursue this double bottom line may find themselves at a disadvantage in foreign policy circles, and ultimately in the ability to serve the long term needs of their citizens. It is possible that in the 21st Century, the market will not be guided by the “invisible hand,” but instead by Leviathan’s.

Thesis Supervisor: Elena Obukhova
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ACKNOWLEDGEMENTS

Few intellectual pursuits occur productively without the support and encouragement of others. In my case, this thesis benefitted greatly from the contributions of many. In particular, I am grateful for the thoughtful and dedicated guidance of my advisor, Professor Elena Obukhova, whose course on Global Strategy first inspired me to consider a longer project on an issue of global significance. Her course’s probing of strategically relevant topics beyond U.S. borders sparked the idea to pursue a thesis with international focus.

Mark Renton’s judicious guidance and patient exploration of the issues was critical to understanding the nuances of sovereign wealth and its discontents. John Farley’s thoughtful comments and sharp eye considerably (as always) improved the quality of my writing. I am grateful to my many classmates at MIT who supported and encouraged me throughout this process, and my parents and Diana Farley who support and encourage me through life. And of course, for Caroline, who inspires me on a daily basis.
EXECUTIVE SUMMARY

"Leviathan is becoming a finance capitalist as well as a captain of industry."
– The Economist, January 26, 2012

Guo jin min tui (国进民退) - The state advances while the private sector retreats.
- Chinese adage

In the seven short years since Andrew Rozanov first coined the phrase “sovereign wealth fund,” (SWF) these government-owned investment vehicles have been labeled existential threats to capitalism, saviors in times of crisis, and nearly everything in between. State capital has soared to $12 trillion, making it the 4th largest global asset class. About $5 trillion of this is held in sovereign wealth funds, which are fundamentally reshaping debates at the nexus of global finance, politics and diplomacy.¹ The size and nature of SWFs has given state sponsors new political voice alongside the established economic one. The funds’ ability to “intimidate by implication,” which resulted in (among other outcomes) successfully prodding Eurozone banks to conduct stress tests in 2010, reinforces the idea that their economic power can subtlety manifest by making others more dependent on you than you are on them.²

Moreover, SWF investment patterns frequently correspond to the needs of their sovereigns in a way that undermines the idea they are mere coincidence. China’s investments in energy, Gulf states’ in land or agriculture, or any number of funds working to strengthen domestic economies are not passive occurrences. Such potential strategic payoffs, taken together with new political influence, show that some SWFs embody a new “double bottom line” in which nations’ investment capital secures not just financial returns, but political or strategic payoffs as well. The implications of this new force for political influence are massive.

In 2005, sovereign wealth and hedge fund assets were about equal, at around $1 trillion. Since then, sovereign wealth has skyrocketed, and SWFs now oversee about 2 ½ times hedge fund assets ($5

trillion vs just over $2 trillion). The assets of SWFs equal about one-third of the total market cap of the S&P 500 and European exchanges, about $16 trillion. Sovereign capital is highly concentrated; only about 40 SWFs manage that $5 trillion, whereas nearly 7,000 hedge funds manage the industry’s $3 trillion. Some individual funds, like the Abu Dhabi Investment Authority (ADIA) or the Government Pension Fund of Norway, are as big as leading US mutual fund complexes like Vanguard (more than $500 billion). Israel elected to launch a sovereign fund to manage revenues flowing from the country’s recent natural gas discovery (estimated at 50% of current GDP), rather than utilize other investment vehicles.

The rise, size and provenance of these funds concern many, and have raised significant questions around funds’ intent, management and scope. Before the 2008 financial crisis, criticism focused particularly on foreign ownership of strategically important firms or industries. Concerns over direct sovereign involvement in cross-border investments are age old, but increased market integration and globalization heightened fears over the issue. A Financial Times op-ed by former US Treasury Secretary Larry Summers described SWFs as vehicles that “shake the logic of capitalism.”

Much of this criticism has focused on perceived politicization of investment – that as investors, states have unique interests that could serve to weaponize finance and destabilize markets. The 2008 passage of the Santiago Principles, the vital (and largely benign) SWF investments into a number of global financial firms in 2007 - 2008, and the reemergence of sovereign debt as a destabilizer of global markets somewhat dampened criticism. Sovereign wealth continues to grow, fueling a rise in “state capitalism,” and keeping a focus on SWFs, who continue to be viewed by some with skepticism and suspicion. Like any other large institutional investor, sovereign funds have the potential to move markets. But it is the subtle influence and relationships across global markets – not direct acts of

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aggression – that most strongly indicate SWFs represent a new phase of global finance. Understanding their motives, movements and nuances is a task for financiers and policymakers alike.

Power theory helps to explain some of the changing landscape. Former U.S. Assistant Secretary of Defense Joseph Nye coined the phrase “soft power” to describe the ability to use co-option and/or payments to obtain a benefit, as opposed to “hard power,” which relies on coercion and/or payments to do so. Sovereign wealth funds meld the two, a development which may be termed “SWFt” power. They provide the “carrot” of sizable, patient capital, and wield a “stick” via their ability to serve as investors of last resort. This has resulted in sovereign wealth funds becoming, in some ways, a proxy for power/influence at home and abroad. The ability of non-OECD states to leverage SWF resources to earn excess financial return and accrue global influence, facilitate domestic economic development or meet the long term needs of citizens is reorienting relationships. Yet the new sovereign “double bottom line” remains largely unexamined.

The extremes of this debate pit those who see the potential weaponization of sovereign wealth at one end of the spectrum, against those who see sovereign wealth as nothing more than a benign resource used to earn strictly financial returns. The truth, as the China, Abu Dhabi and Qatar examples (among others) demonstrate, lies somewhere in between. The current rebalancing of economic relationships between developed and developing nations makes this all the more evident and important to understand. For the first time, developed countries (and their firms) have become reliant on developing ones for critical capital infusions. Sovereign capital’s arrival as global financial force may mean that countries who do not seek policy benefits alongside financial returns could find themselves left behind. The question is increasingly becoming why not pursue strategic goals along with financial ones?
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INTRODUCTION

In early 2006, Dubai Ports World (DPW), owned by the Dubai government, asked the U.S.’s Committee on Foreign Investment (CFIUS) to approve its planned acquisition of the British firm P&O. The deal would have resulted in DPW’s ownership of a number of U.S. ports. CFIUS approved the transaction, and the deal had President Bush’s explicit support. Despite this, a public uproar arose, with many critics citing national security concerns over the proposed takeover. This negative attention contributed to the deal ultimately falling through. It was the second time in as many years that negative publicity of foreign ownership of U.S. assets helped scuttle cross-border deals in the U.S.; in 2005, the China National Offshore Oil Corporation (CNOOC) failed to acquire Unocal (a U.S. petroleum explorer, which eventually merged with Chevron). Controversy over state ownership of foreign assets had re-emerged at the top of many policy makers’ agendas.

In 2005, State Street’s Andrew Rozanov coined the term “sovereign wealth fund” (SWF), to describe the government-owned investment vehicles that were exploding in size and number.5 A commodity boom and growing trade surpluses of the early 2000s prompted a number of states to launch new investment vehicles to manage revenue surpluses. As of this paper’s writing, aggregate SWF assets are around $5 trillion.6 Sovereign wealth is now the 4th largest global assets class, after pension funds ($30 trillion), insurance funds ($24.5 trillion) and mutual funds ($23.5 trillion), but ahead of private equity funds ($2.6 trillion) and hedge funds ($2 trillion).7 State capital is highly concentrated, and growing exponentially; of the nearly 40 SWFs in operation, nearly three-quarters of them were launched after 2000. They have grown at a remarkably faster clip than hedge fund assets – the two held roughly equal assets in 2005; now SWFs hold 2 ½ times as much. There is no indication of the trend slowing.

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6 The city.uk. “Sovereign Wealth Funds 2012.” February 2012.
7 Ibid
The rise in state wealth has not been without controversy, particularly because most sovereign funds have been launched by developing, non-OECD (Organization for Economic Cooperation and Development) states. State involvement in cross-border investment has long been considered a threat to global market stability. As University of Chicago economist Eugene Staley wrote in War and the Private Investor in 1935, “the factor of national allegiance must be detached from migratory capital.” A few years later, as a post-WWII economic regime was emerging, prominent U.S. State Department adviser Herbert Feis advised: “Capital which moves abroad should not carry with it the power of an organized national state, nor will it be forced to serve the political purpose.”

Freer flowing capital and more tightly integrated markets have done little to dampen this sentiment. Nearly 70 years later, an op-ed by former U.S. Treasury Secretary Larry Summers identified sovereign funds as vehicles with the potential to “challenge the very definition of capitalism.” State sponsors of SWFs, in turn, described such criticism as a new form of protectionism. Yet despite the concerns and criticism, sovereign wealth has grown at an incredibly fast pace. The International Monetary Fund’s 2009 assertion that “the role of sovereign wealth funds as providers of significant cross-border long term capital is here to stay” accurately conveys the shifting foundations of global foreign policy and finance.

In fact, the crises that have roiled the market in recent years have shown not only that SWFs are here to stay, but have solidified their status as saviors in times of crisis. After SWFs invested more than $100 billion in critically needed capital into global financial firms during the 2007 - 2008 crisis, policymakers now publicly court SWF capital (typically to muted criticism). These changing conditions have facilitated sovereign wealth funds embodiment of a new double bottom line in investing, whereby their resources are used to try not only to earn excess financial returns (alpha), but to serve strategic

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policy goals as well. This is in an apparent direct contradiction of Santiago Principle 19, which calls for strictly commercial investment practice, and which is reaffirmed in many funds’ annual reports. Whether this constitutes an illegitimate form of strategic statecraft has been the focus of considerable debate. This paper examines the cases of China, Abu Dhabi and Qatar to understand the extent to which SWFs represent a new double bottom line that melds policy and finance. Because of the opacity of SWF investment portfolios, the paper relies on publicly available information about investments, statements by fund officials, and statements and actions by other market actors to knit together the landscape of double bottom line investing.

Seeing such a double bottom line as strictly threatening is to miss the more crucial and nuanced role SWFs are playing in global finance. Logic does not necessarily support the fear that states present a more pressing and obvious threat to market stability (or national security vis-à-vis finance) than non-state investors do. In fact, the complex nature of state relations may make them more likely to serve as “co-stakeholders in the future of the global financial market place.” As The Economist recently noted, “China and Russia have found it easier to get on with each other as state capitalists than they ever did as Communists.” And George Soros surely demonstrated destabilizing threats need not spring from nationalist sentiment in his involvement with the British pound devaluation in the 1990s.

But one state’s land grab can still be regarded as another’s development opportunity. The extent to which, Gulf states, for example, use some of their vast resource wealth to achieve food or economic security, or that China can turn current account surpluses into natural resources will reshape state politics within and between each other. In the 21st Century, shared or complementary economic goals may be vastly more important - and financially fruitful - than shared political ideology. As such, the subtleties of the evolving financial landscape warrant a closer look; players who can manipulate any

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asymmetries in economic relationships will continue to gain an edge in foreign relations as well as the marketplace.
SOVEREIGN WEALTH FUNDS: A BACKGROUND

"Unlike hedge funds, sovereign-wealth funds are not necessarily driven by the pressures of profit and loss. With a few exceptions (like Norway's), most do not even bother to reveal what their goals are—let alone their investments."
- The Economist, January 17, 2008

Definitions and Investment Profiles

Sovereign wealth fund definitions vary. This paper defines sovereign wealth funds as: “Pools of money derived from a country's reserves, which are set aside for investment purposes that will benefit the country's economy and citizens.”

Of the four main types of state capital (sovereign wealth funds, pension funds, currency reserves, and state owned enterprises), SWFs typically have the longest investment horizon and most aggressive risk profile. Their short term liabilities are limited (funds profiled here do not have immediate pension obligations), and they possess a greater willingness to invest in alternative asset classes beyond strictly Treasuries or equities. Table 1.1 outlines these differences.

Table 1.1 – Sovereign Wealth Investment Profiles

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>Assets</th>
<th>Investment Profile</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Currency Reserves</strong></td>
<td>• No liabilities, but needed for immediate deployment if necessary</td>
<td>• Highly liquid&lt;br&gt;• Low risk tolerance&lt;br&gt;• Held by Ministries of Finance &amp; Central Banks</td>
</tr>
<tr>
<td><strong>Sovereign Wealth Funds</strong></td>
<td>• No immediate liabilities</td>
<td>• Long term&lt;br&gt;• Higher risk tolerance&lt;br&gt;• Able to invest in alternative assets</td>
</tr>
<tr>
<td><strong>Pension Funds</strong></td>
<td>• Considerable liabilities to meet pension obligations</td>
<td>• Highly liquid&lt;br&gt;• Low risk tolerance&lt;br&gt;• Often highly regulated</td>
</tr>
<tr>
<td><strong>State Owned Enterprises</strong></td>
<td>• Traditional firm liabilities and assets.</td>
<td>• Company dependent, varies by firm, industry and country of origin</td>
</tr>
</tbody>
</table>

13 http://www.investopedia.com/terms/s/sovereign-wealth-fund.asp#ixzz1T3c2zDx
Sovereign Wealth Fund History: 1954 - 2008

The brief history of sovereign funds has been well documented.\textsuperscript{14} Kuwait launched the first fund in 1954 to manage the country’s newly discovered oil revenues, preceding even its independence from Britain. The Kuwait Investment Authority now manages more than $200 billion. Other commodity rich states like Abu Dhabi, Oman, Brunei and Azerbaijan followed suit, launching funds to, among other things, smooth revenues across boom and bust periods, facilitate economic diversification, stave off Dutch Disease, preserve wealth for future generations, or some combination thereof. Commodity revenues have long fueled much of sovereign wealth accumulation, and by 2000, commodity funds managed more than $500 billion. These funds now account for over $2.7 trillion in SWF assets, or 56\% of total assets under management.\textsuperscript{15}

(Source: “Sovereign Wealth Funds 2012, thecity.uk)

But as Chart 1 shows, natural resource wealth no longer drives the main source of excess sovereign revenues. Increasingly, natural resource poor states are drawing current account surpluses beyond what can be prudently managed in reserve accounts. Following in the path of commodity rich

\begin{footnotesize}
\begin{enumerate}
\item See in particular: Truman, Edwin M. "Sovereign Wealth Funds: Threat or Salvation?" Peterson Institute for International Economics. Washington, D.C. September 2010
\item Thecity.uk, “Sovereign Wealth Funds 2012.” February 2012.
\end{enumerate}
\end{footnotesize}
states, they also created state investment vehicles to manage growing assets. Singapore launched Temasek in 1974 to oversee state ownership of Singapore firms after the country gained independence. It now manages a $185 billion portfolio with domestic and foreign assets, and has served as the model for numerous subsequent SWF launches, including the China Investment Corporation (CIC) and the Korean Investment Corporation (KIC). Singapore then launched the Government Investment Corporation (GIC) in 1981 to manage the country’s burgeoning foreign reserves. Malaysia, Hong Kong and China followed suit in the 1990s with funds of their own. Trade surplus funds now oversee more than half a trillion in assets collectively, or more than 44% of total SWF assets.\textsuperscript{16}

By 2000, sovereign assets under management approached $650 billion, across more than 15 funds. It would be another five years before the term “sovereign wealth fund” was even coined, but the start of the millennium marked a turning point for sovereign wealth, as SWFs exploded in number and size. Between 2000 and 2008, more than 20 funds launched as a result of the commodity boom and growth in trade surpluses. Much of the wealth initially hailed from the oil rich Gulf region to manage spiking oil revenues. Ken Rogoff and Maurice Obstfeld describe the era as follows: “Under the influence of monetary accommodation, low real interest rates, and the emerging (and indeed advanced) world’s accelerating economic growth, commodity prices, notably the price of oil, began to rise at an accelerating price. An immediate effect of this, familiar from past episodes of commodity-price boom, was a big increase in the current account surpluses of commodity exporters.”\textsuperscript{17} As Rogoff and Obstfeld mention, the spike commodity prices was joined by surging emerging economy growth – particularly across Asia, giving rise to funds in South Korea, Taiwan, Vietnam, Indonesia and China.

The early part of the 2000s witnessed the birth of what have become some of the most prominent and publicly active funds. The Qatar Investment Authority (QIA), which has gone on to invest in Harrods,
Credit Suisse, Miramax films and Volkswagen, the China Investment Corporation (CIC), one of the world’s largest and most discussed funds, and the Libyan Investment Authority, which gained notoriety after the fall of Colonel Qaddafi, all hail from this period.

By the time the credit crisis of 2008 was in full swing, sovereign wealth assets were between $1 and 2 trillion. The explosion of wealth, mostly in non-OECD states triggered increasingly loud criticism. With newspapers trumpeting the potential fallout from state owned enterprise deals (particularly CNOOC/Unocal and Dubai Ports World), it wasn’t long before commentators and policymakers turned an eye to a growing force in global finance — the sovereign wealth fund.

SWFs Arrive as Global Economic Force...And Financial Boogeyman

Sovereign wealth funds’ rise was met with outright skepticism — if not full throated disapproval. The chorus decrying the menacing potential of sovereign investors was loud and growing. “Sovereign Wealth Funds: The New Foreign Menace?” asked Stimson Research. “The Scariest Funds of All,” trumpeted Businessweek. “Sovereign Funds Shake the Logic of Capitalism,” declared the Financial Times. The criticism echoed concerns of earlier eras, that capital with nationalist or sovereign ties merited particular wariness. Jeffrey Garten, former Dean of Yale’s School of Management, wrote in a 2007 Financial Times op-ed: “These funds are going to have the ability to buy any global company, to create panic in markets if they move too precipitously, even to dwarf the political clout of international financial institutions. They can no longer be ignored.”

The funds’ perceived lack of transparency specifically raised concerns that sovereign wealth could be weaponized. Following sovereign fund investments in private equity firms Blackstone and the Carlyle Group, worries intensified that foreign investors could now access proprietary company information, illegally secure intellectual property, gain a commanding stake in strategically important firms or sectors, or amass economic power within foreign markets.

A 2008 EU Communiqué argued, “A more specific concern raised by SWF investment in equities relates to the opaque way in which some SWFs function and their possible use as an instrument to gain strategic control.” On a state level, balancing national security and economic concerns led many governments to establish committees like CFIUS, to examine national security implications of foreign investments. The challenges of balancing the two are extremely broad, and has lead to unusual results, which France demonstrated in defining the country’s yogurt maker Danone as “strategic to the national economy” and therefore ineligible for acquisition by a foreign firm (Pepsi Co) in 2005. By contrast, the French government has remained largely silent as the Qatar Investment Authority has become the largest outside shareholder of Lagardere, the French aerospace and media conglomerate. In an attempt to resolve these tensions, the Organization for Economic Cooperation and Development (OECD) has provided a forum for intergovernmental dialogue on reconciling national security concerns with the need to preserve and expand open, international markets.

As SWFs’ strategic asset allocation increasingly embraced alternative asset classes like real estate, private equity, and infrastructure, critics protested these opaque assets allowed funds to pursue seemingly infinite nefarious ends. To minimize the potential “politicization” of investments, some called for full outsourcing of investments to third party asset managers. U.S. Treasury Secretary Hank Paulson proposed the following to the International Working Group on Sovereign Wealth Funds, as it began the discussions that evolved into the Santiago Principles (the “Principles”): “SWF investment decisions should be based solely on commercial grounds, rather than to advance, directly or indirectly, the geopolitical goals of the controlling government. SWFs should make this statement formally as part of

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20 The Qataris currently hold a 12.8% stake in the company and recently signaled they may seek representation on the company’s advisory board.

Leviathan’s Double Bottom Line
their basic investment management policies.” Such concerns were incorporated into the Santiago Principles as Principle 19: “The sovereign wealth fund’s investment decisions should aim to maximize risk adjusted financial returns in a manner consistent with its investment policy, based on economic and financial grounds.” (emphasis added). Many funds publicly endorse Principle 19, sometimes by explicitly in annual reports. In practice, Principle 19 is far more nuanced.

The Santiago Principles and Moves Towards Transparency

As criticism of sovereign funds grew, sovereign and other international investors began to voice their own concerns of protectionism. Given the power that public debate played in derailing the CNOOC and DPW deals, over the objection of President Bush, concerns of protectionism were understandable. In response to the dual concerns of the funds’ critics as well as the funds themselves, more than 20 SWFs, together with the International Monetary Fund, formed the International Working Group on Sovereign Wealth Funds (IWG-SWF). Participating funds, the IMF and a handful of observer states convened between March and October 2008 to discuss best practices for the industry. Led by the Abu Dhabi Investment Authority, the IWG-SWF settled on 24 voluntary principles to address concerns over transparency, risk management, accountability and governance, among others. The Santiago Principles emerged in October 2008. Principle 19 addresses the potential politicization of investments, explicitly calling for sovereign investments to be made on “economic or financial grounds.” Twenty-four funds signed on to the Principles. CIC writes in its most recent annual report, “Investing is based purely on a commercial basis and observing the laws and regulations of the countries in which it invests.” These Principles, together with an increasing willingness to publish annual reports and conduct interviews,

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22 Australia, Azerbaijan, Bahrain, Botswana, Canada, Chile, China, Equatorial Guinea, Iran, Ireland, South Korea, Kuwait, Libya, Mexico, New Zealand, Norway, Qatar, Russia, Singapore, Timor-Leste, Trinidad & Tobago, the United Arab Emirates, the United States, and Vietnam. Saudi Arabia, the OECD, and the World Bank will participate as permanent observer
23 China Investment Corporation Annual Report, page 6
helped sovereign funds burnish their image. But looming changes to global markets would soon explode, reshaping SWFs’ operating environment and the landscape into which the Santiago Principles emerged.

**Sovereign Wealth Funds Amidst a Global Rebalancing: 2008 – Present**

The Santiago Principles were announced when sovereign funds were making highly public – and equally critical – capital infusions into global financial firms. Funds from Abu Dhabi, Qatar, China and Singapore (presumably among others) provided more than $100 billion dollars of essential capital to Barclays, Credit Suisse, Citigroup, Merrill Lynch, and Morgan Stanley. This is the first time that emerging economies have served so publicly and crucially as lenders to indebted Western institutions. In the case of Barclays, at least, the firm pursued foreign SWF capital over resources from its home government in the U.K. This trend created what Columbia Law School Professor Katharina Pistor calls, “A network of equity ties linking the world’s largest financial players, i.e. financial intermediaries and sovereign investors ‘of last resort’, effectively giving the latter not only a stake in selected financial intermediaries, but through them—a stake in the global financial market.” This stake in the global financial market has integrated funds not just into the financial system, but into a political one as well, allowing them to assert themselves in newfound relationships and opportunities.

SWF influence, stemming in part from their ability to serve as attractive investor of last resort, has been particularly reaffirmed as sovereign debt reemerged as a destabilizer of the global economy, further muddying the role of sovereign involvement in capital markets. These two points most publicly converged in European policymakers actively courting non-European, non-OECD state investors during the Euro sovereign debt crisis. *The New York Times* reported in October 2011, “A day after European

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24 This estimate is based on Pistor 2009 reports – which were garnered from public filings and reports. Other investments may have been made, but remain unreported. Global network finance: Pistor, Katharina. “Institutional innovation in the global financial market place.” *Journal of Comparative Economics*, Volume 37, Issue 4, December 2009, Pages 552-567.

25 “Barclays declined financial support from the UK government it had made available after the collapse of Lehman Brothers and instead turned to SWFs.” “Pistor, Global Network Finance: Organizational Hedging in Times of Uncertainty.”

26 Ibid.
leaders unveiled their latest plan to save the euro, top officials opened talks with China in an effort to lure tens of billions of dollars in additional cash, giving China perhaps its biggest opportunity yet to exercise financial clout in the Western world.\textsuperscript{27} The patient capital of sovereign funds is particularly attractive for those seeking investment in uncertain financial environment, regardless of fund provenance.

2009 alone witnessed the creation of eleven new SWFs to minimal fanfare. Five other states are on track to launch or have publicly announced the intention to launch funds in 2012. Israel most recently announced its intention to found one funded by the proceeds from its natural gas discoveries, estimated to produce new revenues of 50\% of current GDP. Debate has evolved from whether states with surpluses should launch sovereign funds to why shouldn’t they, as Nigeria exemplified as they recently prepared to launch their own $1 billion fund. A Columbia University conference underscored how substantially issues around SWFs have changed – its focus on “Sovereign Wealth Funds and Long Term Investing” explored deeper involvement by states as investors in capital markets, particularly to intentionally leverage investments to alleviate global climate change.

\textit{Global Political Economy: Recent Evolution of Global Financial Architecture}

The credit crisis of 2007 – 2008 and subsequent Euro-sovereign debt crisis triggered striking developments in balance of global financial power. In the early 1990s, nearly all emerging market countries ran current account deficits, spending more than they earned in revenue. But over the past two decades, developed countries (including the U.S. and some Western European countries) have become global debtors while emerging market countries (such as China and a number of the Gulf states) have become global creditors. Emerging economies, as a group, shifted from a current account deficit of

$74 billion to a surplus of $600 billion, while the U.S. swung in the opposite direction, shedding a $236 billion surplus and moving to a nearly $1 trillion deficit in 2008.²⁸

Many prominent economists have cited this changing relationship between developed and developing economy capital flows as critical to understanding broader economic trends. Ben Bernanke noted in 2009, “It is impossible to understand this [credit] crisis without reference to the global imbalances in trade and capital flows that began in the latter half of the 1990s.”²⁹ Larry Summers and Marty Feldstein argued earlier, “It is impossible to understand the current account surpluses of emerging market countries without also understanding the current account deficits of developed economies.”³⁰ This rebalancing is shaping a new era of foreign policy and finance – of which sovereign wealth sits at the center. Pistor writes specifically of sovereign wealth funds in this environment:

“Specifically, SWFs represent a different mode of governance as compared to that endorsed by financial intermediaries in the West, i.e. one that gives government actors a key role in setting aside investment capital and determining strategies for its allocation. Their rise to fame in recent years is and of itself is indicative of the transformation of global financial relations and the hybridization of governance regimes that can no longer be easily categorized as private vs. public; state vs. market; or transactional vs. relational. The most visible evidence for this transformation is the rise of global imbalances between emerging markets that accumulated vast amount of reserves on one hand, and developed economies that accumulated substantial debt, on the other.”³¹

Economics and finance have long served foreign policy purposes. Shifting account balances, reallocations of foreign direct investment and newfound sovereign wealth are redirecting capital flows and redefining relationships among policy, diplomacy and development. Few bilateral relationships illustrate the stark reversals in capital flows better than that between Angola and Portugal. At one point,

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³⁰ Obstfeld and Rogoff
Portugal’s massive sovereign debt prompted the country’s Prime Minister, Paulo Passos Coelho, to solicit investment from Angola, one of its former African colonies. The Financial Times reported, “One of Angola’s main ambitions was for Sonangol (an Angolan petroleum and natural gas producer), seen by analysts as almost a proxy for an Angolan sovereign investment fund, to acquire a stake in Galp Energia, Portugal’s dominant oil and gas utility, in which the Portuguese state has a 7 percent holding. Mr. Passos Coelho made it clear during his visit that the Lisbon government would not raise any objections, clearing the way for a deal.”

Cash flows between creditor and recipient nations have broadly changed, not solely among developed nations and their former colonies.

British Prime Minister David Cameron has courted SWFs to invest in the U.K.’s infrastructure, a sector others have defined as nationally sensitive and strategic, and therefore off limits to foreign ownership. The Guardian reported in March 2012: “The prime minister’s plan, modelled on the funding of the mains water and sewage network, would see sovereign wealth funds and pension funds given the right to lease roads over a long period. They would be set a series of targets to, for example, reduce congestion and carry out improvements. British Chancellor of the Exchequer George Osborne recently travelled to China to persuade the world’s largest fiscal-surplus country to invest in Britain’s infrastructure.”

China is now the world’s largest lender. Developed countries are no longer the sole lender nations to emerging markets; developing countries increasingly lend with and among each other. Such increased financial integration is one of the most interesting hallmarks of the changing era of finance, and one demonstrated repeatedly in the sovereign wealth fund industry. It has presented opportunities for new investors (and their sovereign sponsors) to gain influence by virtue of financial strength. It is in this new environment that is largely responsible for the emergence of double bottom line sovereign

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investing. Power theory helps to understand how this double bottom line has come to manifest, and what potential implications are.

POWER THEORY IN GLOBAL FINANCE

"The skillful leader subdues the enemy's troops without any fighting."

- Sun Tzu

Harvard professor and former Assistant U.S. Secretary of State Joseph Nye coined the term "soft power" over 20 years ago to describe the use of co-option and/or attraction to obtain a benefit. Foreign direct investment and sanctions have long been leveraged as tools of "hard power," which, by contrast, relies on coercion and/or payments to affect outcomes. Sovereign wealth sits decidedly between the two, which some would interpret as a dimension of "smart" power. In an era when China, the world's largest lender, articulates a vision of "shared prosperity," backed by nearly $3 trillion in reserves, the axiom that an underlying dimension of economic power is to make others more dependent on you than you are on them is particularly relevant. The subtle influence of state as investor is among its most powerful manifestations of power - not just in the foreign policy arena, but around how states are able to use monetary wealth to achieve other types of prosperity and security for their own citizens.

In the now vastly interconnected global economic system, governments can increasingly appeal to each other on an economic basis to get other nations to 'want what they want,' rather than needing to "take what they want" by military force. Tools of engagement have shifted in a way that favors the subtlety of finance. Military might is still a critical component of diplomacy, but increasingly, "To succeed in a networked world requires leaders to think in terms of attraction and co-option rather than command."34 It is largely this attraction that has facilitated the emergence of sovereign double bottom line investing. China’s growing economy, for example, has served it on the foreign policy stage in a way

its military has yet to do; the country’s pursuit of energy resources in Africa stands out as an example. "China describes its investments in Africa as ‘normal commercial practice,’ but many of its state-owned firms have won contracts on the back of a high profile campaign by Beijing to expand its political, diplomatic and economic presence on the continent."35

China, Abu Dhabi and Qatar in particular have found themselves in a strengthened global position as a result of the events over the past few years. China especially has seemed to benefit from opportunities to “intimidate by implication;” perhaps because in exploiting asymmetries of power, “Both substance and style matter. If the most powerful actor is seen as producing global public goods, it is more likely to develop legitimacy and soft power."36 Helping stabilize other sovereign economies or firms during crises surely falls into such a category.

The potential weaponization of finance is a long-standing, constantly evolving issue, representing finance as a lever of “hard” power. But economic aggression need not stem from nationalist sentiment or the political interests of the state. A 2001 London School of Economics paper entitled “Does One Soros Make a Difference: A Theory of Currency Crises with Large and Small Traders,” examined whether individual traders pose destabilizing threats to the broader market. It appears they do, regardless of national allegiance. It reported, “Economists and policymakers have long debated whether speculation, especially speculation by large traders, is destabilizing. In our model, a large trader in the market may exacerbate a crisis and render small traders more aggressive."37 By simply following a key premise of the global market in seeking to maximize their own welfare, or that of their shareholders, individual traders

http://eprints.lse.ac.uk/25045/1/dp372.pdf

Leviathan’s Double Bottom Line 23
can further destabilize a market. They aren’t motivated by power in any traditional sense, and yet the outcome is the same.

In some ways, the noncommercial/political interests of the state may even serve to stabilize markets and political relations. “Among nations, the greater the interdependence (the greater the costs of exiting from an economic relationship), the greater the probability that the nations will not seek political demands that could lead to conflict.”\(^{38}\) SWF capital can be so deeply woven into the success of its investments, intentional aggression causing massive losses or devaluation seems unlikely, as it could poses the threat of mutually assured destruction. If Iran, a major oil producer and global enfant terrible, disrupted the 5% of the world’s oil supply they control, it may not only cause a U.S. recession, but would roil Iran’s own economy. Were China, the critical lender to the U.S., to call its debt in ahead of schedule, it would jeopardize the U.S. economy, but as China’s main market, the downturn would subsequently threaten China’s own export power.

What Joe Nye and Richard Armitage write of American smart power: “The USA can become a smart power by once again investing in global public goods – providing things people and governments in all corners of the world want but cannot attain in the absence of leadership by the largest country. Development, public health, coping with climate change, and maintaining an open, international economic system are good examples,” is no less true for other states.\(^{39}\) Implicit in the Nye/Armitage argument is that these are cross-border investments, and are not necessarily for profit. Yet, were sovereign funds to publicly pursue similar goals for their own citizens, backed by funds to earn financial return, controversy arises.

The 21st Century has been characterized by nations’ new wealth being converted into power – either accrued as political power and influence or the power to pursue and achieve strategic rewards for


one’s citizens. To successfully convert soft or smart power resources to outcomes “requires the critical ability to create in the target, perceptions of such qualities as benignity, competence and charisma.” Investment by SWFs has been so “benign” as to result in states and firms now actively and publicly courting them, and assenting to their requests behind closed doors. The early benignity has bestowed fund sponsors with new or increased influence on the global stage.

Threats to national economies and global markets are real. Currencies can be devalued, commodity prices may spike precipitously, sovereign debt can be called in ahead of schedule. Economic diplomacy can and should be viewed through a political and hard power lens. But the nuances of investment and new the state’s ability to create mutually beneficial outcomes for both principal and agent are much more important to defining the new balance of power in marketplace. The market manifestation of “smart power” may be funded, in the 21st Century, by sovereign wealth. In such relationships, states who can manipulate asymmetries the best will emerge the strongest parties.

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STRATEGIC SOVEREIGN WEALTH INVESTMENT: WHY LEVIATHAN'S DOUBLE BOTTOM LINE MATTERS

Santiago Principle 19: The sovereign wealth fund's investment decisions should aim to maximize risk adjusted financial returns in a manner consistent with its investment policy, based on economic and financial grounds."

“"In some cases, SWFs are used to promote regional development, including investments in farming and infrastructure.”

“The fiduciary duties of sovereign wealth funds to their government sponsors entail not just the pursuit of financial returns but also the pursuit of social goals.”
- Joseph Stiglitz, Sovereign Wealth Funds and Long-Term Investing

What constitutes “economic” or “financially grounded” investing? Do investments in farming and infrastructure violate Santiago Principle 19 if they primarily result in a nation availing its citizens of food security, while making only benchmark returns? Why is the idea of a sovereign double bottom line so controversial?

Recent studies examining direct links between sovereign investing and political interests have been mixed. Avendano and Santiso (2009) found no evidence of political motivations for sovereign investments in a study comparing them with mutual fund investments. But Knill, et. al. (2010) found “political relations are an important factor in why sovereign wealth funds invest.” The lack of clarity on this issue can in part be attributed to the incredible difficulty in establishing causality between motivation and outcome for such a diverse industry. “Sovereign wealth fund” is an umbrella term – the breadth and depth of differences in fund organization, management and strategic asset allocation make it challenging to establish a standard for explicit causal relationships across the industry. Countries have vastly different economic and social outlooks, not to mention political regimes and domestic interests.

Nevertheless, there is sufficient evidence to suggest that individually, certain of the largest and most prominent funds have embodied an approach that has accrued benefits to their sponsors that are not

solely commercial in nature. The nuances of statements by fund officials, SWF investment patterns and the behavior of others in relation to SWFs are necessary to understanding this.

The “double bottom line” concept well conveys the multidimensional implications of financial activity. John Elkington coined “triple bottom line” in 1994 to measure the financial, social and environmental performance of the corporation over a period of time to “take account of the full cost of doing business.” 42 “Double bottom line” evolved from this notion to indicate the multidimensional impact of a financial activity (most frequently its financial and social performance, but may convey other bidimensional aspects). For our purposes, the double bottom line takes into account the full impact or benefit of investing than its full “cost.” Thus it is an appropriate way to identify sovereign wealth funds’ ability to gain influence or other strategic payoffs while pursuing excess financial returns.

A sovereign double bottom line manifests in two ways. In addition to earning excess financial return, funds benefit from: i) Increased or newfound political influence (“Intimidation by Implication”), or ii) Furthering strategic interests of the sponsor’s citizens, particularly with regards to securing energy or agriculture resources to meet non-physical security needs. 43 It also bears noting that collateral benefits may accrue to a fund’s sponsor, even if the fund fosters a solely commercial aim, in part due to network impact and the unavoidable influence of investments: “Even if each individual transaction that linked two parties to each other and to the broader network was motivated primarily by commercial concerns (i.e. the need to raise capital and the desire to make profits), the changing economic environment has created conditions under which the maintenance of these ties has at times become critical for stabilizing key players in global finance.” 44

43 “Intimidation by implication” was first articulated with regard to sovereign wealth by Gillian Tett in a 2010 article in the Financial Times “Asian Players are a Worry for Eurozone.”
"Intimidation by Implication"

Any investor’s ability to intimidate by implication stems from the fact that power arises in financial relationships from making a counterparty more dependent on you than you are on them. The size and structure of some of these sovereign funds positions them strongly in the global market. They are massive (in the hundreds of billions of dollars, some are in the ballpark of U.S. mutual fund complexes). By nature, they are long term investors. Taken together, this makes them extremely attractive to those seeking investment, particularly in times of crisis. In power theory terms, this works to create an enabling environment for long-term attraction. Sovereigns have moved from investors of last resort, to being actively sought (and publicly) sought as investors on a more regular basis. This further results in the funds’ state sponsors accruing influence that allows them better control over outcomes. The public courting of sovereign investors by OECD governments well illustrates this point.

“The players provoking particular behind-the-scenes unease are those sitting in Asia. For while the sovereign wealth funds of countries such as China generally loathe the limelight, their potential market power – or ability to intimidate by implication – is rising steadily, as their coffers swell....Europeans who participated in the Busan meeting say it was actually comments from Asian officials that created a tipping point. In the days before and after that G20 gathering, eurozone officials met powerful Asian investment groups and government officials who expressed alarm about Europe’s financial woes. And while those officials did not plan to sell their existing stock of bonds, they specifically said they would reduce or halt future purchases of eurozone bonds unless something was done to allay the fears about Europe’s banks. That, in turn, sparked a sudden change of heart among officials in places such as Germany and Spain. After all, as one European official notes, the last thing that any debt-laden European government wants now is a situation where it is tough to sell bonds. “It was the Asians that changed the mood, not anything Geithner said,” says one eurozone official.”

Further underscoring the extent to which China’s sovereign fund has gained influence in the five short years since its launch, Italy’s finance minister Giulio Tremonti, who previously decried what he saw as China’s “reverse colonization” in Europe, sought support from CIC and SAFE “in the hope that Beijing [would] help rescue it from financial crisis by making ‘significant’ purchases of Italian bonds and

investments in strategic companies” in September 2011. An indication of how much changed since the heated debates in the mid-2000s on foreign ownership of “strategic national assets,” Italian officials also courted investment from CIC in Cassa Depositi e Prestiti, a state-owned entity that “Manages a major share of the savings of Italians – postal savings – which it uses to help support the growth of the country, providing financing to major strategic sectors: transportation networks and local public services, public building and social housing, energy and communication, support for SMEs and export finance, research and innovation, the environment and renewable energy.” Thus governments are now explicitly and publicly seeking foreign state investment in their strategic industries.

CIC ultimately refused to make a considerable buy into Italian bonds, and CIC Chairman Liu Jiwei subsequently stated “We have always supported the proactive measures the EU has taken to deal with the euro debt crisis. We believe that aside from taking some emergency relief steps, the EU should continue taking fiscal and financial structural and fundamental reforms to give a clearer signal to the international community. Heavily indebted countries should, according to their national condition, adopt appropriate fiscal policies. The international community should continue to pro-actively support the EU’s efforts to deal with the crisis.” Three months later, in an April 2012 interview, CIC Executive Committee Chairman Jin Liquin claimed CIC is “Now ready to invest in Europe.” But Liquin meant not bonds, but companies and infrastructure, as the fund has begun doing in the U.K.

It is a mistake to focus solely on absolute gains in a power context for sovereign funds. Economic power has always been a critical tool of foreign policy, and can be wielded from both a hard or soft power approach. But sovereign funds underscore the extent to which some economic relationships benefit both parties, while still accruing relatively more power to one entity over the other. The power structure of some sovereign investments is evident in the subtle asymmetries that emerge from an

48 Cassa Depositi e Prestiti website. http://www.cassaddpp.it/cdp/AreaGenerale/English/index.htm
otherwise mutually beneficial engagement. Particular asymmetries occur in times of crisis because sovereign funds are differentiated from other investors due to their long term investment horizon. “In a perfect market, buyers and sellers are price takers who feel the structural power of market forces of supply and demand that are beyond their control. But if they can differentiate their product enough to create an imperfect market, they can gain pricing power and become price makers rather than takers.”

Here, sovereign funds do not create an imperfect market, but take advantage of an imperfect market. This is seen in courting sovereign investors in times of crisis, for infrastructure, in Barclays’ preferential seeking of funds from foreign governments over their own, and adds political contours to otherwise strictly economic relationships. Such opportunities to intimidate by implication is one of the new manifestations of sovereign power in a double bottom line, and one China in particular seems to have mastered.

Sector Investing that Mirrors Long Term Sovereign Needs

The second manifestation of a sovereign double bottom line appears in SWF investing patterns that largely mirror citizens strategic (non-commercial) needs, particularly around commodities (either energy or agriculture related), or in developing a domestic economy. Some claim this is strictly a drive for excess financial returns. But some of the portfolio differentiation across funds mimics differences in sovereign interests. It is unlikely at best (and would indeed strain credulity to believe) that these funds’ investments so frequently coincide with their sponsor states' current policy ambitions by chance.

In 2010, the Monitor Group reported: “Publicly available information on SWF direct investing suggests that funds are developing a clear strategy toward the energy sector, commodities and associated processing industries, as well as the real estate, infrastructure, and agricultural assets.” In 2010, SWF’s publicly reported direct investments in commodities amounted to 27 deals, totaling $6.9

billion – 13% of the annual expenditure and 16% of annual deal volume. "Driven by the economic need of sovereign owners, funds from resource scarce countries in Asia poured money into hydrocarbon exploration." The "economic needs" of sovereigns does not mean the same as strictly commercial investing. Economic needs refer to long term resources needed for economic or social development of a country, purely commercial investing bears no strategic "needs" in mind as it seeks excess returns above a benchmark.

Sovereign investments in Sub-Saharan Africa are another example. A recent study of SWF investment in Sub-Saharan African land reported: "Land scarcity in many countries, bio-fuels production for alternative energy production, food crops production for increasing food demand in emerging countries and a high yield in intensive agricultural production compared to other kinds of investments and other political motivations led investment towards land and water rich countries." The China and Abu Dhabi examples illustrate the extent to which the two countries are turning abroad (and particularly to Africa) to secure such needs.

For China, and indeed, any growing but natural resource poor economy, securing sufficient energy assets to manage future growth is essential. "Commercial motivations" of investment vary, making it difficult to disentangle the commercial, economic or financial from strictly political motivations. Some funds continue to publicly reject this idea entirely: "Temasek Holdings and the Government of Singapore Investment Corporation, are state-sanctioned means to secure the economic future of Singapore; they are not strategic devices developed by the Singapore government to pose geopolitical or economic threats on other states." But Joseph Stiglitz, former Chief Economist of the World Bank in fact, sees an explicit "fiduciary duty" of SWF overseers beyond financial returns. "The

52 Ibid
53 www.dse.unifi.it/upload/sub/seminar/bertini.pdf
fiduciary duties of SWFs to their government sponsors entail not just the pursuit of financial returns but also the pursuit of social goals.  

The flexibility to pursue goals beyond the financial comes from moving more asset management in house ("insourcing"), which allows a greater degree of control over investment strategies, and by embracing more diversified – and particularly alternative – asset classes. Both trends are occurring across the SWF industry. In the past three years, CIC increased of investments in alternative asset classes from 6% to 21%. The Kuwait Investment Authority has risen from 13% dedicated to alternative investments in 2004 to 27% in 2010.  

One other interesting point to note that may add color to SWF investment patterns and broader strategies is that if sovereign investors are solely in pursuit of excess financial returns in some of their commodity investments, there is reason to believe they could be doing so much more effectively than they currently are. A February 2012 Financial Times study indicated that between 2010 and 2012, oil sector returns from investing in brent crude directly have outpaced those in two of the world’s largest oil firms, Royal Dutch Shell or Exxon Mobil, or the Dow Jones EM Oil and Gas Index. The value of brent crude rose by 59%, whereas the company shares each increased by less than 40%, and the EM oil and gas index only appreciated 22%. CIC investments in energy span asset classes. The fund’s portfolio remains private, so it is impossible to say what percentage is allocated to underlying assets versus equity stakes or other proxy vehicles (ETFs, etc.). But such broad geographic and asset class diversification of investments across Canada, Latin America, Australia and Africa suggests a broader goal than strictly financial return.


56 Fletcher SWF Institute fund profiles.
http://fletcher.tufts.edu/SWF/~/media/Fletcher/Microsites/swfi/pdfs/2012/profiles/KIA%20Fund%20Profile_v2.pdf

57 http://blogs.ft.com/beyond-brics/2012/02/24/chart-of-the-week-do-em-energy-companies-do-better-than-brent/#axzz2rAm30D4M
The World Economic Forum has acknowledged the double bottom line aspect of sovereign investing, noting in its 2012 Energy for Economic Growth piece: “In some cases, SWFs are used to promote regional development, including investments in farming and infrastructure. The global economic recession prompted Gulf SWFs to begin investing a larger proportion of their assets closer to home to combat high unemployment and declining economic growth.” Indeed, despite an historic reticence of SWF officers to publicly concede non-commercial motivations, the door to doing so seems to be opening. In the wake of an announcement around CIC’s joint launch with Black Rock of a China focused investment fund, strategic objectives were explicitly identified. “The fund will have a strategic mandate as well as financial objectives, ‘helping China attract the right kind of foreign investment and helping Chinese firms globalise’.”

For some countries, ignoring broader strategic interest when deploying sovereign funds could result in the antithesis of commercial investing. In the short term, strictly alpha generating strategies may produce more money – but these countries already have money. And what happens when markets are flat over long periods – are states expected to abandon efforts to meet other security

58 The Financial Times, “Chart of the week: do companies or crude generate better investor returns?” February 24, 2012.
responsibilities solely because they do not earn explicit financial return? "When considered over the past fifteen years or so, it is arguable that financial markets have hardly returned anything more than the global real rate of economic growth. In this context, it is not obvious that a traditional financial institution, which is how we would label the current form of SWFs, remains the only form consistent with sovereign interests." For sovereign wealth to be limited to strictly generating further wealth (as in excess financial return), could be counterproductive in some cases, and may even border on the irrational.

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CASE STUDIES

“Let me issue and control a nation’s money and I care not who makes its laws.”

– Mayer Amschel Rothschild

If, as Amschel Rothschild said, those who hold a nation’s money are even more significant than those tasked with its laws, then Sheikh Hamid bin Zayed al Nahyan, Lou Jiwei, and Sheikh Hamad bin Jassim bin Jaber Al Thani are three of the most powerful individuals in global finance. As Managing Director of the Abu Dhabi Investment Authority (ADIA), Chairman and CEO of the China Investment Corporation (CIC) and Chairman and CEO of the Qatar Investment Authority (QIA) respectively, the three men oversee more than $1 trillion in total assets.

ADIA, with current holdings estimated in the order of $625 billion, was founded in the mid-1970s with the country’s oil revenues. It has since been joined by IPIC (the international Petroleum Investment Council in 1984), the Mubadala Investment Company in 2002, and ADIC (the Abu Dhabi Investment Corporation in 2007). Abu Dhabi does not release exact asset under management statistics for its fund complex, but estimates put holdings at between $600 and 700 billion. All four funds have a mandate to strengthen and develop the Abu Dhabi economy and benefit the country’s citizens.

The China Investment Corporation has nearly $500 billion in holdings. About half is invested domestically through the Central Huijin Investment Company to support Chinese banks, the remainder is dedicated to foreign investment. Founded in 2007, CIC, joined the SAFE Investment Company (1997) and the China-Africa Development Fund to leverage excess reserves “for the benefit of the Chinese people.” In contrast with Abu Dhabi, CIC was founded with capital from China’s excess foreign reserves. Both are long term investors, but investment patterns between the two diverge. QIA has engaged in some of the most public transactions of the three, and is known for its investments in Harrods, the Credit Suisse building in London, and Paris Saint Germain, a French football (soccer) team. QIA holdings are
"considerably more" than $100 billion, but the fund does not publicize exact holdings and assets numbers.61

This paper uses the Abu Dhabi, China and Qatar cases to examine the extent to which SWFs embody a double bottom line – earning excess financial returns, as well as political influence or strategic results. All three funds are high profile actors both in the SWF industry the broader market. But they also offer contrast in their: sources of wealth, investment strategies, and their sponsors’ strategic interests. China leverages CIC capital in pursuit of (among others) energy assets, where Abu Dhabi, an oil rich nation, uses its capital to secure agricultural assets (again, among others), and QIA’s investments reflect an attempt to diversify the domestic economy. All three facilitate domestic social and economic development. Because of the opacity of the funds’ portfolios, and the relatively long horizon on which states endeavor to earn strategic goals (namely, energy or food security), it is difficult to establish an explicit causal relationship between political motivation and sovereign fund activity. Nevertheless, the experiences, impacts and investing patterns of these funds provide sufficient information that lends credibility to the idea that certain individual SWFs are embodying a double bottom line – through which they simultaneously accrue financial returns, as well as political or strategic ones.

"CIC is looking for a strategic element relevant to China, particularly investments in the resource sector, in oil and gas, and perhaps in infrastructure. The second criterion is whether the transaction can be structured in a way that it leaves a positive impression of CIC and China."

- Felix Chee, Head of Toronto Office, China Investment Corporation

"Many analysts believe that economic development rather than military supremacy is the primary objective for China’s international engagement for a host of reasons — not the least of which are to raise the living standards of its enormous population, to dampen social disaffection about economic and other inequities, and to sustain regime legitimacy after the demise of communist ideology as an acceptable organizing principle."

- U.S. State Department CRS Briefing, "Comparing Global Influence: China’s and U.S. Diplomacy, Foreign Aid, Trade, and Investment in the Developing World"

The China Investment Corporation (CIC) has been among the most debated and controversial sovereign wealth funds since its launch in 2007. In part because of its size (nearly $500 billion, of which half is allocated for foreign investment), and in part because of the rise of China more generally, CIC’s actions have invited more scrutiny than nearly any other fund. CIC’s officers, for their part, have repeatedly and explicitly rejected the idea of a strategically motivated fund. Lou Jiwei stated in 2009, "Our investment is to make money. I don’t care how many tons of oil we can ship home, what I do care about is the stock price."62

In 2011, the Chinese government released a White Paper on “China’s Peaceful Development.” The document outlines China’s core interests, reaffirming some and redefining others. For the first time, "China’s political system and ensuring sustainable economic and social development” joined state sovereignty, national security, territorial integrity and national reunification, as being among the country’s official core interests.63 In light of this, CIC’s investing patterns, taken together with statements by CIC officials, and the behavior of other market actors, certainly establishes cause to

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believe that CIC best exemplifies a sovereign double bottom line. Much of China's success in intimidating by implication is examined earlier, here I will focus on its resource driven investing patterns.

CIC's story would be incomplete without including that of the SAFE investment Corporation, launched in 1997 (the State Administration of Foreign Exchange in Hong Kong, 华安公司). Officially used to manage some of the country's $3.2 trillion of reserve currency, the history and activities of SAFE have largely occurred under the radar. The SAFE Investment Corporation is estimated to oversee about $500 billion in assets, $6 billion of which are invested in the UK. Public investments include Royal Dutch Shell, Rio Tinto, BG Group, Tesco, BHP Billiton, and Barclays.64 The SAFE Investment Company is one of the earliest examples of China strategically leveraging its trade surpluses. "SAFE has built up one of the largest US equity portfolios of any foreign government entity investing abroad, including the major sovereign wealth funds," Brad Setser, an economist at the Council of Foreign Relations notes.65 Many believe it would be difficult to understand how CIC would have emerged without SAFE’s earlier forays into foreign equity investments. SAFE has also been one of the most prominent players in the sovereign/private equity space, with a $2.5 billion buy into the $17.8 billion Texas Pacific Group (TPG) Partners VI in June 2008, the largest sovereign private equity commitment to date.66 Such considerable (and higher risk) investments into private equity lay the groundwork for CIC’s expansion in the area. One of CIC’s first investments was in private equity giant The Blackstone Group.

China’s rapid economic growth (nearly 10% per year for the first decade of the 2000s) combined with a population larger than North America and Europe combined (1.3 billion people) has generated soaring demand for food, energy, and minerals. Energy needs alone drove China to become a net energy industry importer in 1995 (it became a net importer of oil in 1993). Its energy demands are expected to

continue increasing at an annual rate of 4 - 5\% through at least 2015, making the procurement of stable supplies of petroleum and other raw materials a priority for the government.\textsuperscript{67} It's not strictly oil motivating the Chinese – the country's consumption of the world's aluminum, copper, nickel and iron has grown from 7\% in 1990 to 20\% today.\textsuperscript{68} Too meet such stark needs, a variety of approaches is needed, of which CIC investment figures in. \textit{Foreign Affairs} magazine reports: "An unprecedented need for resources is now driving China's foreign policy."\textsuperscript{69} Further:

"China is an energy panda that is obsessed by the question of where its next mouthful of bamboo will come from. The Chinese elite sees the world in terms of brutal competition for limited resources. And it has no truck with Western ideas about relying on the market. ("Western countries can feel secure purchasing oil internationally because they created the system," says one diplomat. "China did not.") China is utterly convinced that it needs to use all the elements of national power—its companies and banks, its aid agencies and diplomats—to get its rightful share."\textsuperscript{70}

But in light of CIC's major publicly acknowledged investments, what constitutes a "strict commercial orientation" is open to interpretation. The fund's holdings are extremely broad, only 4\% per cent last year remains in cash, and CIC's portfolio holds: large-cap US stocks, emerging-market equities, commodities, futures, real estate, and infrastructure.

\textit{CIC's four basic principles underlying its investment approach and strategy (Source: 2009 Annual Report)}

1. CIC invests on a commercial basis. The underlying investment objective is long-term, sustainable, and risk-adjusted returns for its shareholder.

2. CIC is a financial investor. As such, it does not seek to control any company.

3. CIC is a responsible investor which abides by local laws and regulations in the countries in which it invests, and exercises its corporate responsibility consciously.

\textsuperscript{69} Ibid
\textsuperscript{70} The Economist Special Report on State Capitalism "Going Abroad: The World in Their Hands." January 21, 2012
4. CIC's investments are research driven to provide a basis for sound, prudent investment decisions, and allocation driven to assure a disciplined approach to investing.

CIC's annual report notwithstanding, a report by the U.S. Congressional Research Service notes, "Access to energy resources and raw commodities to fuel China's domestic growth has played a dominant role in many of their financial relationships. Many of these activities are tied to PRC pledges of foreign aid." Three investment streams in particular underscore CIC's alignment with Chinese development needs: i) Africa, ii) Canada and iii) Russia. In all three cases, China has steadily and successfully sought trade accords, oil and gas contracts, scientific and technological cooperation, and de-facto multilateral security arrangements with numerous countries.71

China reportedly began importing about a third of their annual crude imports from African countries in 2007. It is ramping up its exports of copper, iron ore, and other resources from the continent. Despite explicit statements by CIC officials to the contrary, a U.S. State Department report notes: "Beijing would like to secure this supply through ownership and investments, partly to avoid the price and supply uncertainty associated with buying such commodities on spot markets."72 The CIC investments outline in the chart below reflect that the country does not solely invest in the sectors that meet strategic interests (namely, extractives), but have a broader portfolio of "support" investments that can lubricate relationships to maximize resource access. Beijing "Has been courting the governments of these states aggressively, building goodwill by strengthening bilateral trade relations, awarding aid, forgiving national debt, and helping build roads, bridges, stadiums, and harbors. In return, China has won access to key resources, from gold in Bolivia and coal in the Philippines to oil in Ecuador and natural gas in Australia."73

71 Ibid.
A specific example involves bilateral Sino-Russian relations, which have been marked since the fall of the Soviet Union by mutually strategic commodity and economic interests. But a particularly interesting investment occurred in the wake of Russia’s official launch of its own sovereign wealth fund, the Russian Direct Investment Fund (RDIF), which has struggled for foreign investors because of the difficulty doing business in Russia. In October 2011, CIC announced a $1 billion investment into RDIF, creating a new vehicle (the “Russia-China Investment Fund”). The majority of the $2 billion in total assets will be used for investments in Russia, Belarus, and commodity rich Kazakhstan.

The investment is notable for a number of reasons, one of the main of which clearly helps to lubricate relationships in all three countries, of which Kazakhstan is increasingly important as a potential...
path for resource transportation. As Daniel Zweig notes, “Securing China’s energy needs does not simply entail obtaining resources; it also requires getting them home. Transport is no easy feat for a country that still has no cross-border pipeline. The China National Petroleum Corporation struck a deal for a major pipeline with the Russian oil giant Yukos in 2003, but the plan fell apart after the Russian government first dismantled Yukos and then accepted Japan’s higher bid on the project. Negotiations for a pipeline that would transport Caspian Sea oil to China through Kazakhstan are slowly moving forward.”74 In May of 2012, China and Russia signed a new strategic trade deal, in which CIC’s investments in the country have been cited as an important part. “China’s Xinhua news agency quotes the head of China Investment Corp (CIC), the country’s sovereign wealth fund, as suggesting that it will likely increase its investment in Russia. The China-Russia Investment Fund (CRIF), he said, would start operating before the end of June with a capital of $1 billion.”75

Stanford’s Ashby Monk and Oxford’s Gordon Clark, in fact argue that a move may already be underway - from China as institutional investor to a more strategic positioning. “Instead of thinking of the CIC as an investor governed by the long-term risk-adjusted rate of return on its investment portfolio, it may be better to think of the CIC as an arm of the Chinese government just like other state-owned enterprises concerned with its resource needs and its status as a global power.”76 Felix Chee, CIC’s representative in the firm’s Toronto office seems to implicitly reinforce this theory in a 2011 speech: “CIC is looking for a strategic element relevant to China, particularly investments in the resource sector, in oil and gas, and perhaps in infrastructure. The second criterion is whether the transaction can be structured in a way that it leaves a positive impression of CIC and China.”77

74 Ibid.
Economics and diplomacy are the central, mutually reinforcing components of China’s growing soft power, well exemplified by CIC embodying a double bottom line investment approach. Monk and Clark’s assertion that “As one of the world’s largest sovereign wealth funds, the CIC has eschewed conventional portfolio investment in developed financial markets for strategic investment in resources and jurisdictions deemed essential to China’s long-term growth” is exactly on target. This, coupled with the country’s growing influence resulting from CIC’s investments in troubled firms or sovereigns throughout the crisis, well reflects the dual outcomes (intimidation by implication, as outlined earlier, and pursuit of strategic goals) of the sovereign double bottom line.
THE GULF STATES: ABU DHABI AND QATAR

The experiences of Abu Dhabi and Qatar differ considerably from that of CIC. Abu Dhabi is arguably the largest sovereign wealth holder – they do not reveal exact figures, but estimates put the Abu Dhabi Investment Authority (ADIA) at between $600 and 700 billion. The Qatar Investment Authority (QIA) is about half the size of the asset pool CIC focuses abroad, at “over” $100 billion.

Like most states in the Persian Gulf area, Abu Dhabi and Qatar are oil rich, agriculture poor economies, both with a strong traditional focus on the local extractive economy. In 1976, Abu Dhabi launched the Abu Dhabi Investment Authority (ADIA) from a financial surplus from oil exports. Most of its funding comes from the Abu Dhabi National Oil Company (ADNOC) and its subsidiaries which pay a dividend to help fund ADIA and its sister fund Abu Dhabi Investment Council (ADIC). The Qatar Investment Authority followed this pattern and launched in 2005.

Though the largest SWF, ADIA’s work is complemented by that of Mubadala, a fund dedicated to diversifying and strengthening the local economy. There is considerable debate over whether Mubadala constitutes a sovereign wealth fund. As a wholly owned government investment vehicle, sourced with funds from a state-owned oil company, it fits within the parameters of SWFs in this paper. Launched in 2007, Mubadala has pursued a number of high profile investments, including joint ventures with GE, ConocoPhillips and the Carlyle Group. Many of Mubadala’s investments focus on infrastructure, transportation, and energy, water and utilities. It is a fraction of the size of ADIA, at $13 billion. Mubadala’s mandate to develop the local economy from state funds is a direct illustration of double bottom line investing. Mubadala is not working to earn excess financial returns via investing portfolios; rather, it wants to build and strengthen the local Abu Dhabi economy through strategic acquisitions and transactions.

For its part, ADIA is increasingly diversifying investments in other emerging economies, and has publicly stated its hope to broaden its investments in India – Asia’s third largest economy – to improve
the economic relationships between the two countries. The fund already has invested between $400 and $500 million in Indian real estate through property and private equity funds, and announced in March 2011, plans to raise a $1 billion fund to invest in Indian infrastructure, coming on the heels of ADIA expressing a “keen interest” in deepening its investment in India.

The Gulf States are some of the world’s largest importers of cereals and agriculture products, as food security has been a growing concern for governments across the Middle East. In addition to investments in Africa cited earlier, recent investments by Abu Dhabi and Qatar into commodity houses further suggests that these funds are embracing a double bottom line investment approach. Abu Dhabi and Qatari funds (and their subsidiaries) have invested billions in Glencore (the global commodity trading powerhouse), and Xstrata (a firm targeted for purchase by Glencore).

“The decision by Aabar, one of Abu Dhabi’s sovereign wealth funds, to take a $1bn stake in Glencore’s initial public offering means a lot more to the emirate than diversifying its investments to provide long-term cash generation in a post-oil era. Securing supplies of food and other raw materials is a nagging concern for rulers of these desert states, Gulf nations, including Abu Dhabi, plan billions of dollars of investments in global food supply and infrastructure as they guard against price shocks and supply shortages in core resources. As such, Aabar’s stake in Glencore takes on a broader resonance and is not only about making a quick buck.” 78

Further agriculturally focused investments include Qatar’s investment in Adecoagro, a farmland venture in Argentina, Brazil and Uruguay, and a joint ADIA-Singapore fund to invest in China’s agriculture sector. In fact, one researcher reports, “Jockeying for agricultural assets has the potential to produce increasing tension in the international trading system, not between developed and developing countries but between the fast growing countries themselves.” In part to solve such issues, sovereign funds who share an interest in food security may pursue similarly focused investment collaborations in the future. As the Monitor Group reports, “The water-food-energy scarcity nexus has emerged as a particularly grave and chronic impediment for economic growth, social stability and security. Population and raising incomes are going to put tremendous pressure on the availability of water, food, and energy. The result of any

one of these resources being in seriously short supply could foment a major humanitarian, political or economic disaster." In this regard, states who elect to pursue excess returns in lieu of financial and strategic purposes may be questioned as to whether these funds truly serve citizens best interests.

Such long term agricultural needs illustrate the complexity of discerning whether a sovereign investment is “strictly commercial.” Most of these investments could plausibly have been executed solely in search of excess financial returns. But in these cases, a double bottom line investing approach may offer even better long term returns. Governments with constrained access to those natural resources they consider vital for national competitiveness must look beyond their country’s borders to secure such assets through whatever means possible.

CONCLUSION

The pace at which sovereign wealth has grown in the past decade fully established it as a global player in finance. When Andrew Rozanov first asked “Who holds the wealth of nations” just seven years ago, it seemed unlikely that the subsequent decade would be so defined by the activities of states who have excess capital, and the havoc wreaked on the global system by those who don’t. State actors in the financial markets have long been viewed with suspicion, and it is unlikely to change as the wealth accumulated by non-OECD states continues to vastly outpace that of others.

The influence that China has gained via CIC in Europe shows the extent to which SWFs may serve as a proxy for power for their sovereigns under certain conditions. The ability of China, the Gulf states, or really any emerging economy to meet the future needs of its citizens (vis-à-vis energy or food/water security, among others) considerably shapes domestic politics. In this regard, sovereign wealth funds’ embodiment of a double bottom line, that represents the sponsor’s ability to earn excess financial return while accruing political or strategic benefits, may define the next era in global finance and foreign policy. Power theory indicates that subtle manifestations of economic power may sometimes be more successful and long lasting than their “hard” power counterparts.

The global financial community continues to grapple with the fall out of two successive crises. It has not yet been resolved whether firms or nations have sufficiently stabilized themselves in a way that positions them to succeed long term. Consequently, the massive (and growing) sovereign wealth fund complexes may continue to accrue wealth, influence and agility to operate on a global financial stage. It remains to be seen if former Secretary Summers’ fear of funds “shaking the logic of capitalism,” will be borne out. In the meantime, SWFs will continue to evolve, working to successfully achieve their goals – whatever they may be.
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