

Aureus Asset Management
Investment Perspectives
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Sovereign Wealth Funds: Their Size and Impact

Introduction

Since the late 1990s, many emerging countries have taken advantage of a global boom to accumulate vast reserves of foreign currencies. Until recently, most of these reserves were invested for safety and liquidity. However, a growing number of countries have recently demonstrated a willingness to invest a portion of their wealth in long-term assets. Sovereign wealth funds, quasi-independent bodies funded with the portion of official reserves these countries deem appropriate, are vehicles through which these investments are typically made.

Concurrently, the United States finds itself short of the capital needed to solve the crises affecting the residential housing industry and bank balance sheets. Many European financial institutions face similar difficulties. With limited sources for new large (\$5.0 billion and over) equity investments, some of the most prestigious companies in the Western world have turned to sovereign wealth funds for the capital needed to replenish depleted balance sheets.

Aureus believes sovereign wealth funds will play an increasingly important role in international finance. Potential implications from this trend include: 1) faster globalization of assets; 2) a diminished role for the dollar; and, 3) greater global political and economic influence for emerging countries. After an overview of sovereign wealth funds, we explore these implications in more detail.

Overview

As of August 2007, the accumulated reserves of the world's emerging countries totaled \$4.7 trillion, while those of the developed world were \$1.6 trillion. Only ten years ago, the percentages implied by these figures were reversed. After the currency crises endured by Asia and Russia in 1997-1998, and by Argentina and Brazil in 2001-2002, these countries embarked on a strategy of export-led growth combined with a fiscal goal of accumulating enough reserves so that the developed world would never again have a stranglehold over fiscal or monetary policies. This strategy has been successful, aided by the unprecedented demand for commodities and goods many of these countries have in abundance.

Sovereign Wealth Funds: Their Size and Impact- continued

Historically, most of this new found wealth has been invested in short-term, dollar denominated assets. Many of these countries have now grown their reserves to levels far greater than needed to protect their currencies. The countries have noted that the dollar's slide has reduced the value of those reserves. While the central banks of these countries will probably maintain substantial reserves in the form of dollars, for reasons of liquidity, they have begun to diversify. Many countries now split their reserves into two discrete types of funds: a central bank fund stressing short-term safety, and a sovereign wealth fund emphasizing return and diversification.

Sovereign wealth funds now control about \$2.5 trillion, an amount that many experts predict will increase significantly over the next ten years. Today, the largest of these funds include:

Sovereign Wealth Funds: Estimated Size *(in Billions)*

	<u>Amount</u>
United Arab Emirates	\$ 500
Singapore	400
Norway	300
Saudi Arabia	250
Kuwait	200
China	200
Russia	150

Source: Wall Street Journal

Globalization of Assets

The pace of investment by sovereign wealth funds in both private and public companies in Europe and the US is growing very rapidly. As one example, in 2007 overseas investments by various Middle East entities have doubled from a year earlier, to over \$75 billion. The list of companies receiving large investments from sovereign wealth funds includes Dow Chemical (\$9.5 billion from Kuwait), Citicorp (\$7.5 billion from Abu Dhabi), Morgan Stanley (\$5 billion from China), Merrill Lynch (\$5.0 billion from Singapore), and UBS (\$9.7 billion from Singapore and Saudi Arabia). Significant investments have also been made in US private equity firms including Blackstone and Carlyle. More are certain to follow, in both privately held and publicly traded companies.

The interlocking nature of these investments is a strong argument for further growth of these emerging countries especially as manufacturing, financial, and management know-how continues to be transferred through cross-border holdings. The pace of asset flows around the world supports a globally synchronized investment posture as investors will be increasingly attracted to countries with rapid expansion and with ties beyond their national borders.

Diminished Role for the Dollar

As the sovereign wealth funds rapidly diversify their assets into a number of different countries, the percentage of their assets held in dollars should decline. Unless the US reverses its very long record of trade and budget deficits, this switch away from the dollar will continue, as will the pressure on the dollar's value in relation to other currencies. In order to protect exports, countries in Asia, as opposed to Europe, have been unwilling to let their currencies rise vs. the dollar. This is a major reason why the US still has large current account deficits with Asia, and why Asian countries will seek to invest some of their dollar balances back into US companies.

Political and Economic Challenges

As sovereign wealth funds become large shareholders in iconic and/or strategic Western institutions, questions will inevitably be raised about the long-term intentions of those funds. A preview of this dynamic came in 2006 when members of Congress forced Dubai Ports World (controlled by the Abu Dhabi Investment Company), to sell six US port operations to an American owner. To date, investments in companies like Citigroup, Morgan Stanley, UBS, and Merrill Lynch have been passive. However, as the fervor over the port situation indicates, it does not take much to change the perception of a passive investment into a political or economic issue.

Summary

The rise in importance of sovereign wealth funds is a trend which will continue, in our judgment. Its implications for investors are significant.

Aureus believes the shift in economic power to various emerging countries is an important long-term theme, reinforced by actions being taken by sovereign wealth funds. While this shift may, at times, present political and economic challenges, three distinct trends appear likely: greater infrastructure and financial growth in emerging countries, a diminished role for the dollar, and increasing interest in certain US companies on the part of foreign investors. Companies in emerging countries may grow earnings significantly and, as markets develop, valuation multiples for those companies may expand. Those countries' investments in US Treasury bonds will be trimmed, in favor of equities and other long term holdings. Finally, some major US companies will attract capital from abroad.

A truly contemporary US investor embraces the changes taking place around the world and invests accordingly. At Aureus, we continue to advocate global investment exposure through participation in the publicly traded securities of companies outside the US. Also, we try to reduce the impact of a falling dollar on our clients' assets. Additionally, we are trying to identify those US companies especially attractive to foreign investors.