

Understanding and Managing Political Risks of Sovereign Wealth Funds

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St. Gallen, May 21, 2013

The President

Prof. Dr. Thomas Bieger

Preamble

Rerum Cognoscere Causa

Virgil, 'Georgics' (29 BC), verse 490

Motto of the London School of Economics (1922 AC)

This thesis is the result of being fortunate enough to be at the right place at the right time – not only once but three times: During my former job as a journalist, I was researching the state of the chemical industry on the ground in Melbourne and Sydney when state-owned enterprise- and sovereign wealth fund (SWF) activity in Australia was at its peak. It was fascinating to see the emotions these 'new' market players were able to unleash from CEOs, government- and industry representatives and the Australian people alike. My next encounter with sovereign wealth funds came as a governmental affairs officer at a major Swiss bank where I saw them transforming from villains into white knights, throwing lifelines at Western banks and becoming more visible in public. Finally, as the secretary of the management board of the same bank, I have witnessed the challenges in the wake of the financial crisis and the role sovereign wealth funds have played in keeping the global financial system on track. This thesis is the (albeit belated) result of a couple of years of in-depth thinking about these interesting organizations at the crossroads of politics, society and the markets. The fascination about a unique financial market participant has been the driving force for my work on this topic ever since.

Unfortunately, however, a PhD thesis does not feed on fascination with the topic alone. Over the years, there have been numerous people who have shared their expertise on the subject, have helped me ordering my thoughts and have ensured my overall well-being. First of all, I want to extend my sincere gratitude to my supervisor Prof. Dr. Hans-Peter Fagagnini and my co-supervisor Prof. Dr. Bruno Gehrig who – in the best St Gallen tradition – have provided an optimum level of freedom and guidance on this project which I am very thankful for. I would also like to express my gratitude to the interviewees listed in the appendix (and some others who explicitly asked not to be mentioned) for sharing first-hand insight on the funds. Another important network was Sovereign Wealth Fund Initiative at the Center for Emerging Market Enterprise of the Fletcher School at Tufts University which selected me as one of their SWF Affiliates for 2012. I also want to thank the teams I have worked with under the leadership of René Buholzer and then Pierre Schreiber, for extending responsibility coupled with an unusual degree of freedom. A particular thank you goes to Alexander

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This thesis is in honour of my grandparents Nane and Nāni Grünenfelder and Natale Caslani. Ma prima di tutto, è dedicata a mia Nonna Argentina Caslani. Non passa un giorno che non ti pensiamo.

Singapore, June 2013

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Table of contents

Table of contents	I
List of tables and figures	V
List of abbreviations	VII
Executive Summary in English	IX
Executive Summary in German.....	X
1 Introduction.....	1
1.1 Sovereign Wealth Funds and Political Risk.....	1
1.2 Thesis objective, relevance and limits	3
1.3 Literature gap	5
1.4 Methodology	6
1.5 Thesis structure	8
2 Understanding, defining and mapping sovereign funds	10
2.1 A short history of SWFs.....	10
2.1.1 Historical forerunners.....	10
2.1.2 A new generation of SWFs	11
2.1.3 SWFs as a policy choice.....	13
2.2 Definition of SWFs	15
2.2.1 The search for a definition – sources and motivations.....	16
2.2.2 Potential elements of a definition.....	20
2.2.3 A working definition of SWFs.....	22
2.2.4 An SWF list, some special cases and some words of caution.....	30
2.3 Categorizing SWFs	32
2.3.1 A few thoughts about categorizations	32
2.3.2 Descriptive categorizations	34
2.3.2.1 <i>Date of inception</i>	34
2.3.2.2 <i>(Legal) structure</i>	36
2.3.2.3 <i>Assets under management</i>	36
2.3.2.4 <i>Geographical distribution</i>	38
2.3.3 Analytical categorizations	39
2.3.3.1 <i>Sources of funds</i>	40
2.3.3.2 <i>Policy objectives</i>	43

2.3.3.3	<i>Investment strategy</i>	47
2.3.4	Interpretative categorizations	53
2.3.4.1	<i>SWFs as symbols of modernity</i>	53
2.3.4.2	<i>Preserving autonomy and independence</i>	54
2.3.4.3	<i>SWFs as providers of governmental legitimacy</i>	56
3	A primer on political risk.....	57
3.1	Market participants and risk.....	57
3.1.1	Uncertainty, probability and risk.....	57
3.1.2	Risk and the company	60
3.1.3	An enterprise risk landscape	61
3.2	Enters political risk.....	64
3.2.1	Political risk in historical context.....	64
3.2.2	Theories of political risk	66
3.2.3	Classic definitions of political risk.....	70
3.3	Political risk reloaded.....	73
3.3.1	Deficiencies of the classic political risk concept	73
3.3.2	The new face of political risk.....	75
3.3.3	Towards a new definition for SWF political risk.....	79
4	Political risk of SWFs: A descriptive approach.....	80
4.1	Beware of the bogeyman: Concerns over sovereign wealth funds	80
4.1.1	SWF Concerns over time	80
4.1.2	Three clusters of concerns.....	85
4.1.3	From concerns to political risks	90
4.2	Defining SWF political risk	91
4.2.1	Some early attempts at a definition.....	91
4.2.2	A broad yet actionable and definition of SWF political risk	92
4.2.3	The phenomenology of political risk	96
4.2.4	Some further thoughts on SWF political risk.....	104
4.3	The sources of political risk: SWF stakeholders.....	106
4.3.1	Sovereign funds and their stakeholders.....	106
4.3.2	Stakeholder values and expectations.....	109
4.3.3	A very special stakeholder: The ‘sovereign’ in SWFs.....	114
4.4	A three-level view of SWF political risk sources	116
4.4.1	Home sweet home: Domestic political risk sources	116
4.4.2	Fearing the Trojan Horse: Host-country level political risk	121

4.4.3	World Wide Worries: transnational political risks.....	124
5	Conceptualizing SWF political risk: A framework	128
5.1	A model of SWF political risk	128
5.1.1	The need for legitimacy.....	128
5.1.2	Compliance: the core of legitimacy	130
5.1.3	Reputation as the second determinant of legitimacy.....	132
5.1.4	Legitimacy deficits as a precursor to political risk	135
5.1.5	Perception is reality: political risk factors.....	139
5.2	From the inside: Endogenous risk factors.....	140
5.2.1	Fund structure.....	140
5.2.2	Transparency	144
5.2.3	The resultant: Individual SWF reputation.....	145
5.3	Actions speak louder than words: Behavioural risk factors.....	147
5.3.1	Choice of investment sector and/or investment targets.....	147
5.3.2	Investment approach	151
5.3.3	Environmental and social governance	156
5.4	Contextual concerns: External political risk factors	160
5.4.1	Host country reputation.....	160
5.4.2	Collective SWF reputation.....	164
5.4.3	Economic environment	166
5.5	Preliminary results: The need to look behind the theory	168
6	Case studies of SWF political risk	170
6.1	Case study methodology and approach.....	170
6.2	Investments by SWFs in farmland and agricultural commodities	171
6.2.1	Introduction and SWF involvement.....	171
6.2.2	Theory: Assessing the likelihood of political risk.....	177
6.2.3	Evidence: Categorizing political risk.....	181
6.2.4	Analysis: Understanding political risk of farmland investments	187
6.2.5	Conclusion and some recommendations.....	189
6.3	Ireland's NPRF domestic financial sector bailout	191
6.3.1	Introduction and SWF involvement.....	191
6.3.2	Evidence: Categorizing political risk.....	192
6.3.3	Theory: Assessing the likelihood of political risk.....	193
6.3.4	Analysis: The political risk of domestic investment pressure.....	194
6.3.5	Conclusion: protect the SWF mandate.....	195

6.4	Case study conclusions	196
7	A proposal for SWF political risk management	197
7.1	Political risk management and sovereign funds.....	197
7.1.1	Enterprise risk- and political risk management.....	197
7.1.2	A plethora of approaches: some history and categorizations.....	200
7.1.3	SWFs, risk management and political risk.....	203
7.2	Monitoring and Assessment: The building blocks of a strategy	206
7.2.1	Monitoring: Know thy self, know thy enemy	206
7.2.2	Assessment: Analyse This.....	209
7.2.3	People and knowledge management	215
7.3	Advocacy: Three strategy clusters for sovereign funds	216
7.3.1	Legitimacy gaps and influenceability	217
7.3.2	Advocacy staples.....	219
7.3.3	Individual action.....	226
7.3.4	Partnership action.....	228
7.3.5	Collective action.....	235
8	Conclusions	239
8.1	The distinct nature of SWF political risk	239
8.2	Conceptualizing and managing SWF political risk.....	241
8.3	Closing remarks and outlook	243
	Appendix 1 – Master fund list.....	VIII
	Appendix 2 – Interview list	IX
	Bibliography	XI
	CV.....	XL

List of tables and figures

Figure 1: A sovereign wealth fund for Switzerland?	15
Figure 2: An overview of SWF definitions	19
Figure 3: SWF definition.....	24
Figure 4: SWFs and SWEs and SOEs	29
Figure 5: Periods of SWF inception	35
Figure 6: Selected indicators on the size of the capital markets	37
Figure 7: SWFs under consideration: Geographical distribution and source of assets.	39
Figure 8: Resource income, ‘Dutch Disease’ and the need for prudent management ..	45
Figure 9: Drilling Down: From macro policy to SWF strategic asset allocation.....	48
Figure 10: The Monitor SWF continuum.....	50
Figure 11: Invesco SWF investor profiles.....	51
Figure 12: Political risk in the risk/uncertainty framework	71
Figure 13: Selected definitions of political risk	72
Figure 14: Public interest in SWFs over time in relation to significant milestones.....	82
Figure 15: A shifting media focus on SWFs from 2007 to 2012	84
Figure 16: Definition of SWF political risk	92
Figure 17: Sources of compliance and reputation	131
Figure 18: The value- and buffer function of reputational capital	135
Figure 19: Legitimacy as a result of an SWF’s fit with stakeholder expectations.....	138
Figure 20: Public disclosure references in the Santiago Principles.....	144
Figure 21: ESG and political risk matrix.....	157
Figure 22: The FAO Food Price Index.....	172

Figure 23: Selected (planned) SWF involvement in agriculture	175
Figure 24: Aspects of political risk management	202
Figure 25: Structural evidence for political risk management at the top 6 SWFs	206
Figure 26: A graphical illustration of SWF stakeholder interests	209
Figure 27: Political risk impact	211
Figure 28: Issue life cycle 2.0.....	214
Figure 29: Influenceability and strategic options for action.....	218
Figure 30: Advocacy staples: three frameworks	219
Figure 31: The sustainability management continuum	223
Figure 32: Market stakeholder partnership models.....	230
Figure 33: Modelling SWF political risk and its management	241

List of abbreviations

AHSTF	Alberta Heritage Savings Trust Fund
APF	Alaska Permanent Fund
APFC	Alaska Permanent Fund Corporation
AuM	Assets under Management
BIS	Bank for International Settlements
cf.	compare
ch.	chapter
CDC	Caisse des Dépôts et Consignations (France)
CNOOC	China National Offshore Oil Corporation
CSR	Corporate Social Responsibility
DMA	Diversified monetary authority
EAM	External Asset Manager
EITI	Extractive Industries Transparency Initiative
ESG	Environmental and social governance
ESSF	Economic and Social Stabilization Fund (Chile)
etc.	Etcetera
EU	European Union
FAO	Food and Agriculture Organization of the United Nations
FCPA	US Foreign Corrupt Practices Act
FEEM	Fondazione ENI Enrico Mattei
FGLPA	Framework and Guidelines on Land Policy in Africa
GAPP	IFSWF's Generally Accepted Principles and Practices (Santiago Principles)
GPFG	Government Pension Fund Global (Norway)
IFAD	International Fund for Agricultural Development
IFC AMC	International Finance Corporation Asset Management Company
IFSL	International Financial Services London
IFSWF	International Forum of Sovereign Wealth Funds
IGO	International Governmental Organization
IIF	Institute of International Finance
IRA	Independent Regulatory Agency
IWG	International Working Group of Sovereign Wealth Funds
KIA	Kuwait Investment Agency
LNG	Liquefied natural gas

MIGA	Multilateral Investment Guarantee Agency
MIS	Management Information System
MPT	Modern Portfolio Theory
MSC	Marine Stewardship Council
NBIM	Norges Bank Investment Management
NGO	Non-governmental organization
NPRF	National Pensions Reserve Fund (Ireland)
NPRFC	National Pensions Reserve Fund Commission (Ireland)
NYSE	New York Stock Exchange
PBOC	People's Bank of China
PE	Private Equity
PFD	Permanent Fund Dividend (Alaska)
PPP	Public Private Partnership
QIA	Qatar Investment Authority
RAI	Principles for Responsible Agricultural Investment that Respects Rights, Livelihoods and Resources
RSPO	Roundtable on sustainable palm oil
SAA	Strategic asset allocation
SAFE	State Administration of Foreign Exchange (China)
SAMA	Saudi Arabian Monetary Agency
SIFMA	Securities Industry and the Financial Markets Association
SOE	State-owned enterprise
SVP	Swiss People's Party
SWF(s)	Sovereign wealth fund(s)
U.S.	United States of America
UHNWI	Ultra High Net Worth Individual
UNCTAD	United Nations Conference on Trade and Development
UNGC	United Nations Global Compact
UNPRI	United Nations Principles for Responsible Investments
VaR	Value at Risk
vs.	versus
WEF	World Economic Forum

Executive Summary in English

Sovereign wealth funds (SWFs) have been around since the 1950s. It was only in the last decade, however, that the public became aware of the size and particular features of these financial market participants. The heightened profile has led to increasing political scrutiny of the funds both domestically and abroad and has resulted in a re-emergence of political risk. While SWF investments in ailing Western banks have brought some relief from political pressure, structural changes are likely to keep political risk at the forefront of SWF business considerations.

As one of the first academic papers on the subject, this thesis aims at analysing the various aspects of sovereign wealth fund political risk and proposing a blueprint of how to manage it. A thorough mapping and categorization of sovereign funds and an in-depth review of political risk provide the basis for systematically describing public concerns, SWF stakeholders and manifestations of SWF political risk on three levels. The thesis then draws up a model which conceptualizes the funds' political risk as a result of legitimacy gaps and identifies three clusters of SWF political risk factors. The model is then applied to two case studies before serving as the basis for a political risk management framework tailored to the needs and peculiarities of sovereign wealth funds. In addition to drawing on core monitoring and assessment techniques, this thesis suggests a three-tiered advocacy approach involving individual, partnership and collective strategies to deal with political risk.

This thesis finds that SWF political risk is complex, comes in various forms and is bound to constant change. Therefore, a structured advocacy approach, both reactive and proactive and based on a thorough analysis of a SWFs' political risk factors, is of the essence. Various environmental and structural economic changes suggest that political risk for SWFs will become more prevalent in the future.

Executive Summary in German

Staatsfonds gibt es seit den 1950er Jahren. Die Öffentlichkeit ist jedoch erst in den letzten zehn Jahren auf die Grösse und die Eigenheiten dieser Fonds aufmerksam geworden. Das geschärfte Profil der Fonds hat auch politische Aufmerksamkeit im In- und Ausland erregt und zur Rückkehr politischer Risiken für die Staatsfonds geführt. Während die Rettung westlicher Banken während der Finanzkrise zu temporärem Aufschnaufen geführt hat, werden politische Risiken aufgrund struktureller Entwicklungen für SWF-Geschäftsentscheide zunehmend relevant werden.

Als eine der ersten akademischen Abhandlungen hat diese Dissertation das Ziel, die verschiedenen Aspekte von politischen Risiken für Staatsfonds zu untersuchen und einen Vorschlag für die Handhabung derartiger Risiken zu präsentieren. Die Basis dazu legen eine gewissenhafte Definition, Auslegeordnung und Kategorisierung aller Staatsfonds und eine vertiefte Revue des Begriffs des politischen Risikos. Darauf aufbauend beschreibt die Dissertation die öffentlichen Bedenken gegenüber Staatsfonds, deren Stakeholder und die Erscheinungsformen politischer Risiken auf drei Ebenen. Anschliessend präsentiert die Dissertation ein Modell, welches das politische Risiko von Staatsfonds als Legitimitätslücke konzipiert und drei Cluster von politischen Risikofaktoren identifiziert. Das Modell wird sodann auf zwei Fallstudien angewendet, bevor es als Basis für die Konzeptionierung eines politischen Risikomanagements fuer SWFs gebraucht wird. Zusätzlich zu den standardisierten Monitoring- und Assessment-Techniken schlägt das in dieser Dissertation vorgestellte Konzept einen dreiteiligen Advocacy-Ansatz vor, welcher individuelle, partnerschaftliche und kollektive Strategieansätze beinhaltet.

Als Fazit ist festzuhalten, dass politische Risiken für Staatsfonds sehr komplex sind, in verschiedenen Ausprägungen existieren und sich auch immer wieder verändern. Ein strukturierter und sowohl reaktiver als auch proaktiver Advocacy-Ansatz basierend auf einer gründlichen Analyse der politischen Riskofaktoren eines Staatsfonds ist daher von grösster Wichtigkeit. Dies auch, da verschiedene markt- und Umfeld-Entwicklungen den Schluss zulassen, dass politisches Risiko für Staatsfonds ein immer wichtigerer Risikofaktor werden wird.

1 Introduction

1.1 Sovereign Wealth Funds and Political Risk

As many analysts have noted, sovereign wealth funds have been around for much longer than commonly perceived. However, sovereign funds have hardly ever received more attention than in the run-up and during the financial crisis when for various reasons, they emerged from below the radar. Various factors both endogenous and exogenous to sovereign wealth funds suggest that public attention is set to continue and so will all the challenges resulting from an increased public profile. One of the major challenges of flying above the radar is a heightened level of political risk.

This thesis is one of the first attempts to describe and analyse the political risks sovereign wealth funds incur. Whether it is recipient countries requiring SWF investment to obtain special clearance such as in the U.S. or Australia, or the freeze and subsequent looting of sovereign funds such as in Libya: political risks for a fund are omnipresent and eclectic and come in a wide range of manifestations. Political risk has many sources, including sovereign ownership of the funds. Political risks are also a function of public concerns which, in turn, significantly depend on public awareness of the funds and their activities. As they became more active, powerful and therefore visible market players, SWFs have gone from new kids on the block to talk of the town. This has arguably only taken place within a couple of months in 2007:

- As other investors had to scale back, SWFs have steadily *increased their activities* during the build-up of the financial crisis, also profiting from their ability to run opportunistic investment strategies. SWF transaction numbers almost quadrupled from 2006 to 2007, with the total value of investments growing close to six-fold (Bortolotti et al. 2010b, 38, panel A).
- While many financial market participants were losing assets, sovereign funds were *becoming bigger*: With both global macroeconomic imbalances and energy prices running high as the world economy was approaching the top of the financial cycle, SWF inflows have swelled significantly, prompting a series of reports estimating SWF sizes and growth paths (for the most important ones, see chapter 2.2.1).
- Through transactional *activity* and more insight into the *financial prowess* of the funds came *visibility*, in particular through a couple of big sovereign fund deals in 2007. All of a sudden, policy makers and the general public became aware of the sizes of SWFs. Quite fittingly, the first ever FT piece containing the SWF word

was a May 19, 2007 article on the CIC buying a major stake in Blackstone (Financial Times 2007a).

According to data collected by Bortolotti, between 1985 and November 2009, sovereign funds have invested more than USD 120bn in OECD countries, more than double of their investments in non-OECD countries (USD 61bn) (Bortolotti et al. 2010b, 38pp). Most of the investments (USD 58bn) were made in the United States. Looking at it from a sector perspective, almost USD 100bn was invested in banks/financial services, with real estate-related investments ranking second at USD 50bn. While Norway's GPF was by far the most active investor (403 investments), the average deal size was only USD 12m, far below the CIC's USD 2.7bn or the QIA's USD 1.1bn average transaction size.

Rising OECD investments, more and more knowledge on the funds and growth projections reaching double-digit USD trillions have unleashed political concerns in recipient countries about the funds' transparency and motivations. Politicians across jurisdictions have been confronted with an electorate fearful of SWFs acting as agents of their countries of origin. The funds were suspected buying up Western iconic companies and engineering a reverse takeover of industrialised Western countries by their debtors in the East. At the same time, increasing levels of information brought about by modern communication technologies has given domestic constituencies more insight into their sovereign funds. As a result, stakeholder expectations of fund investment behaviour have become more refined and urgent, often conflicting with sovereign funds' desire to remain under the radar and with their long-term intergenerational savings objectives. Finally, as SWFs have become important market participants, there has been increasing pressure to conform to best practice in the investment space and to comply with rules and guidelines set up by industry and the international community.

As a result, political risk for sovereign funds has become an increasingly important factor, with scrutiny of SWF investments, legislative measures and considerable attacks on sovereign funds' reputation characterizing the years prior to the financial crisis. With lessons learned from the most turbulent phase in 2007/2008, SWFs have responded by stepping up their communications efforts (many funds now publish annual reports and actively engage with the media) and by negotiating and agreeing on the Santiago Principles, a self-regulatory code of conduct addressing the most urgent public concerns. As Europe is looking for foreign capital (and hence many political

concerns have given way to a pragmatic treatment of foreign investors) and the Arab Spring has lost some of its dynamism, political pressure on sovereign funds has gradually abated for the time being. However, due to continuing worldwide economic imbalances and high commodity prices, coupled with their links to their sovereign sponsors, SWFs are likely to remain in the public spotlight. As a result, sovereign funds will continue to face non-financial, political threats and will have to find ways to deal with this category of idiosyncratic risks to their operations and portfolio.

1.2 Thesis objective, relevance and limits

Thesis objectives

This thesis aims at rigorously analysing and categorizing sovereign wealth funds' political risk and devising a framework to manage such risk. Thereby, it shall contribute to theory building in a nascent field of study and provide a repository of ideas for public affairs practitioners in general and for those in financial services and sovereign wealth management in particular. Lastly and not to be discounted, this thesis may also appeal to the non-specialist reader who wants to learn about the reasons why sovereign wealth funds have suddenly encountered an increasing amount of public attention in the last couple of years.

In order to do so, this thesis builds on a thorough review of the literature on sovereign funds and on political risk in order to understand the particular dynamics of political risk in the field of sovereign-owned financial market participants. Together with in-depth case studies and interviews with a wide range of sovereign wealth fund insiders hailing from around the world, this forms the basis of hands-on recommendations on how to manage SWF political risk.

Relevance

One may argue that thinking about sovereign wealth funds' political risk has never been more relevant: While the first decades of sovereign wealth fund existence were dedicated to building up investment capacity, the financial crisis and the heightened profile of sovereign funds has shown the importance of risk management in general and of political risk management in particular. Mirroring KIA CEO Bader al-Saad's remark that 'one day someone woke up in the morning and considered [SWFs] to be a threat, a danger' (Der Spiegel 2008), the funds' entry into the public sphere was quick yet irreversible. As a result, the funds are facing a new category of risk which most of them were not prepared for. With the number of newspaper articles on SWFs

exploding, the funds portrayed variously as ‘barbarians at the gate’ or ‘white knights’, and recipient country politicians organizing one hearing after the other, the relevant functions of the various funds have been slow to identify the new risks and to mount a holistic response. In fact, many interviewees have identified non-financial and in particular political risks as one of the fields where even sophisticated sovereign funds will have to improve their track record.

Limits

As with all research projects, this thesis has some limits, both imposed by external circumstances and wilfully chosen by the author. There are three external factors which have had a significant impact on how research had to be structured.

- *First*, sovereign wealth funds are a very young field of study. Despite being able to incorporate the findings of adjacent disciplines, this requires more descriptive and definitional groundwork which may have partially compromised the depth of the study.
- *Secondly*, with some notable exceptions, sovereign wealth funds are amongst the most reclusive and least transparent financial market participants. While this is part of the fascination of coving them and increases the chance of interesting findings, it significantly complicates the collection of primary data¹. Most interviewees for this thesis have committed to background interviews only, citing the delicate position of sovereign funds between politics and private markets as a reason for their hesitation. Moreover, similar privacy-related reasoning also hampered open discussions about political risk, in particular those risks emanating from the respective fund principals, i.e. governments.
- *Thirdly*, research has also been affected by the considerable heterogeneity of the institutions lumped together under the sovereign wealth fund label. Together with the complexity inherent in analysing political risk, this has resulted in a need to summarize and generalize. This is also due to the multi-causality in the field of political risk which makes it difficult to fully understand the underlying reasons of SWF investment obstacles.

In addition, research has also been guided by some limits set by the author and aimed at sharpening the focus of this thesis. Most importantly, this refers to the delimitation

¹ The Monitor-FEEM SWF transaction database, one of the most extensive primary data sources on SWF investment activity, illustrates the lack of primary data in this field: the authors admit that it may capture only 10% of all SWF investments made in a given year (Monitor 2010, 87). As Monitor experienced increasing financial problems in 2011/2012, data gathering and reporting on SWFs was discontinued.

of the object of investigation and the decision to shed light on the SWF-specific aspects of political risk management only:

- As illustrated by the definition in chapter 1 and as opposed to some influential analysts², this thesis adopts a narrow definition of sovereign wealth funds. It explicitly excludes a variety of other sovereign-owned institutions such as state-owned enterprises (SOEs), sovereign pension funds and other entities managed by central banks (SAFE, SAMA of Saudi Arabia's holding portfolio). This narrow definition of SWF enables this thesis to keep a check on the inherent heterogeneity of SWFs mentioned above.
- On the second point, there is a broad and at times eclectic literature on political risk management which goes beyond the scope of this thesis. While the last chapter touches upon the most important elements of a modern political risk management framework, the focus is predominately on risk management strategies covering the three clusters of political risk factors identified in chapter 5.

1.3 Literature gap

Analysing SWF political risk requires an inherently interdisciplinary approach drawing on political science, economics, management and international law. SWF political risk is a new subject which necessitates combining insights from two major fields of study: (1) sovereign funds and (2) political risk, including its management (often referred to as public affairs/corporate diplomacy/sustainability management). Drawing on the findings of these literatures, this thesis aims at kick-starting systematic thinking about SWF political risk.

The literature on sovereign wealth funds is at a nascent stage, with less than 50 books (monographs and edited volumes) published at the time of writing. While there is a growing body of both practitioners and academic literature on SWFs, so far their political risks have attracted next to no attention. The early literature on SWFs was driven by financial sector economists, think tank researchers and central bank and government analysts. While remaining rather descriptive, this strand has foreshadowed contentious aspects of SWF behaviour but stopped short of shedding light on political aspects of fund activity. Subsequent strands of the literature have become more analytical, looking into sovereign wealth funds' corporate governance-, transparency

² Ashby Monk, for example, formerly Oxford-, now Stanford University and one of the early commentators on the subject, has followed a rather broad definition of SWFs which also includes what this thesis would classify as public and sovereign pension funds.

and investment practices. However, to this author's knowledge, there is only one article that makes explicit reference to potential political risks for SWFs (see Behrendt 2009). Recently, there have been some contributions on the political economy of the funds which are likely to provide further insights for the study of SWF political risk (upcoming see Bazoobandi 2013).

As further expanded on in chapter 3.2.2, political risk is a venerable field of study: the first contributions are going back some time and the literature has expanded rapidly in the wake of (U.S.) multinationals moving into developing countries after the 2nd World War. Reflecting the most salient risk at the time, the focus of the literature was heavily on governmental intervention in the form of expropriation or capital controls. Considering today's non-commercial risks, however, such a concept of political risk appears to be too narrow and needs to be complemented by broader thinking about non-commercial risks. In addition, the literature is rather mute on risks arising at the domestic level: With SWFs walking a thin line between operating independently and being accountable to their principals, these topics are of significant interest to sovereign wealth funds. Also, the broadening of the concept of political risk has some implications for its management which most of the relevant literature still has to catch up with. Reactive political risk management without a clear strategy is bound to fail. This is particularly true for sovereign wealth funds where political risk management needs to consider various elements differentiating a fund from private market participants.

As a result, while acknowledging the depth and breadth of the political risk literature, it gives rather scant answers as to how SWFs' particular characteristics as private market participants owned by a sovereign impact on political risk. Based on the existing literature, this interdisciplinary thesis aims at plugging this gap and providing a framework to analyse, classify and manage SWF political risk.

1.4 Methodology

As mentioned above, sovereign funds' political risk is a new field of study characterized by a high degree of complexity and severe limitations with regard to available data and theoretical foundations. As a result, the foremost objective of this thesis is to define the field, elaborate basic concepts and enable further research in this field. This is reflected in the methodological approach of this thesis which – among other methodological instruments – uses a concept referred to as 'grounded theory'.

Pioneered by sociologists Glaser and Strauss in 1967, grounded theory aims at generating or discovering theory which helps explaining social interaction. Its objective is to ‘elicit fresh understandings about patterned relationships between social actors and how these relationships and interactions actively construct reality’ (Glaser and Strauss 1967, 2). Grounded theory was developed in response to the unlimited positivism of the 1960s and 1970s and offered ‘a compromise between extreme empiricism and complete relativism [where] systematic data collection could be used to develop theories that address the interpretive realities of actors in social settings’ (Suddaby 2006, 634).

There are two key concepts at the core of grounded theory: Constant comparison and theoretical sampling. Constant comparison refers to the simultaneous collection and analysis of data and the feedback loop which ensures that data collection is adapted to reflect the emerging theory. This thesis has done so by holding the first set of interviews in an open format (theory generation) and asking subsequent interviewees for their opinion on the emerging ideas (theory validation). Theoretical sampling denotes a process whereby ‘decisions about which data should be collected next are determined by the theory that is being constructed’ (Suddaby 2006, 634).

SWF political risk is particularly suited to this kind of approach which takes into account that ‘perception is reality’ and that SWFs need to be analysed as part of a broader (stakeholder) environment (which reflects an almost new institutionalism type of argument). Most appropriate in cases where there is an interesting phenomenon and a researcher wants to ‘discover theory from data’ (Glaser and Strauss 1967, 1), grounded theory has been found to be an efficient way of making sense of the complexity of SWF political risk. In addition to grounded theory, this thesis also relies on case studies to validate the theory of SWF political risk before deducing some political risk management guidelines from the theory.

Considering the scarcity of data on SWFs in this field and given that grounded theory that ‘all is data’, this thesis is based on a variety of primary and secondary data sources. Primary data predominately derives from more than 20 interviews with sovereign wealth fund representatives, bankers/coverage people, government officials and academics conducted in Zurich, New York, London, Doha, Singapore, Hong Kong and over the phone (see interview list in the appendix). Primary data also includes content analysis and visualization of various sources (documents, newspapers).

Secondary data resulted from ‘comparing and contrasting’ the available literature on SWFs. This thesis also makes use of theoretical frameworks (such as the new institutionalism) and existing theories (e.g. obsolescing bargain theory) as and where needed.

1.5 Thesis structure

This thesis aims at (grounded) theory building in the nascent field of sovereign wealth fund political risk. It combines it with a growing body of practical insight into sovereign funds before developing a hands-on framework to deal with political risk. The thesis is structured as follows:

Considering SWFs are relatively unknown market participants, *chapter 2* starts with some historical background on the funds. Emphasis is given to the early days of the funds in the 1950s and 1960s and then to the last decade when the funds entered the public, non-specialist sphere and witnessed the financial crisis. With the debate on how to define sovereign funds only recently coming to a tentative end, this chapter also examines various definitional elements before proposing the definition this thesis is built on. Based on this, chapter 2 continues with a classification of the funds according to various criteria. It also includes some descriptive statistics and analytical work to highlight some lesser-known aspects of the funds, their objectives and their operations. It concludes that despite their heterogeneity, sovereign funds share some basic traits and can be grouped into various categories.

Chapter 3 offers a primer on political risk: it opens with some thoughts on risk and probability in general before shedding light on the function of and variations in risk from a company perspective. The chapter then turns to political risk as a particular example of idiosyncratic risk and how this type of risk and the conceptualization of it have developed over time. The last part of chapter 3 is dedicated to assessing if and how political risk may have changed over time, in particular as companies are adapting to the information age. It concludes that the traditional concept of political risk understood as governmental interference may need to adapt to new realities.

Chapter 4 combines the insights on sovereign funds and on political risk to provide a descriptive overview of SWF political risk. Following an analysis and clustering of the most important stakeholder concerns vis-à-vis sovereign wealth funds, chapter 4 proposes an actionable definition of SWF political risk as ‘the probability of

unexpected or difficult to anticipate political action resulting in adverse consequences for the sovereign wealth fund(s)'. It further sheds light on the manifold forms of SWF political risk before turning to analysing and classifying SWF stakeholders and their expectations as the ultimate source of political risk. Chapter 4 ends with showing the most important sources of political risk on the domestic-, recipient country- and international level.

Based on the descriptive groundwork of the previous chapter, *chapter 5* develops a model which conceptualizes SWF political risk as resulting from a lack of legitimacy. This can result either from a compliance breach or from a loss of reputational capital. Political risk arises as stakeholders try to narrow the gap between their expectations and fund reality. The remainder of the chapter identifies three areas which most legitimacy gaps can be attributed to (endogenous-, behavioural- and contextual risk factors) and analyses the drivers of legitimacy gaps in these areas.

Drawing on the findings of the stakeholder analysis in chapter 4, *chapter 6* applies the political risk model to a more extensive and some shorter case studies. It finds that the model performs well in disentangling the various manifestations of political risk. While its predictive capacity with regard to the emergence of issues may be limited, a careful monitoring and analysis of political risk factors contributes to SWFs being prepared to mount a fast and accurate advocacy and response.

Chapter 7 focuses on how to manage SWF political risks. It starts with shedding light on the relationship between enterprise- and political risk management before tracing the development of the latter over the last half a century. The chapter then provides some guidance on how to cut through the various terms obfuscating the essence of political risk management. With the track record and current state of structured thinking about political risk at SWFs patchy at best, chapter 7 then proceeds to propose an SWF political risk management framework covering risk monitoring, assessment and advocacy action. Responding to the three clusters of risk factors, advocacy is seen as involving individual-, partnership- and collective action. The last sub-chapter revolves around some suggestions on how to best anchor political risk management in the SWF organization.

Chapter 8 reviews the findings of the thesis, draws some conclusions, provides an outlook on the future of SWFs and suggests some fields for fruitful further research.

2 Understanding, defining and mapping sovereign funds

2.1 A short history of SWFs

Research on sovereign wealth funds would not be complete without a short review of their history. Conceptualizing them in more general terms as sovereign wealth, it becomes clear that their presence dates back to well before the mid-20th century. This period is commonly seen as the birth hour of the first modern sovereign funds. Adopting a historical perspective also contributes to a better understanding of the heterogeneity in terms of SWF purpose and sources of capital – an important factor often overlooked in the past decade that was characterized by generalization and simplification of SWF characteristics.

2.1.1 Historical forerunners

In 2010, the Norwegian GPFG announced a co-operative venture with the UK Crown Estate on prime central London real estate (NBIM 2011, 24pp). From a historical point of view, this transaction is highly symbolic in two ways: First, it shows how over time, national wealth held by absolute rulers transformed into highly professional, democratically accountable asset management organizations for the benefit of the broader population – similarly to what is happening to many SWFs today. And secondly, the co-operation was fittingly sealed in London, a place which SWF analysts commonly consider to be the birth place of the modern sovereign funds.

It can be argued that the emergence of sovereign wealth management has been intimately connected to the creation of surplus capital and the separation of sovereign wealth into an incorporated structure yet still under the purview of the state. As long as medieval rulers barely scraped by on what they could extract from their subjects and did not use to finance current expenditure, i.e. the costs of war, there was no accumulation of capital by the sovereign. This only changed at the onset of industrialization which boosted productivity and broadened and deepened the tax base, in particular in early industrializing nations such as Britain and France. It was during that time of relative peace and prosperity when the Crown Estate recorded a significant influx, necessitating a more professional management of the royal assets. By the 17th century, however, parliamentarianism was about to take hold of Europe while monarchies were in gradual decline, and revenue streams were slowly being diverted from feudal estates to secular administrations.

With economic power inexorably shifting to the private sector, the British East India Company arguably became the first organization to successfully combine private initiative with backing from the state. With its setup as an independent company funded by a monopoly to trade to the East of the Cape of Good Hope, it pioneered the mechanics found in today's modern funds. At the high of its operations, its revenues derived from Indian taxation were invested into commercial ventures further East, with the British state (and as opposed to today's SWFs) and private shareholders profiting from handsome dividends (The Economist 2011b). The French Caisse des Dépôts et Consignations (CDC), which is still operational today and is often seen as a precursor to modern sovereign funds, owes its existence to a similar shift of confidence from the public to the private sector after the Napoleonic wars. With state coffers empty and public borrowing hampered by investor reservations, the CDC as a state-backed, public deposit-taking institution was designed to restore trust by providing benefits for the broader public (see in particular the comment by Angela Cummine in Monk 2010j). Over time and well ahead of modern equivalents such as Temasek and the Russian Direct Investment Fund, the CDC has evolved into a holding company for state assets and a provider of seed capital and co-investment facilities.

2.1.2 A new generation of SWFs

With a slight risk of oversimplification: today's modern sovereign funds are a creation of the ideas floating around the 1950s London. Both the Kuwait Investment Authority (1953) and its predecessor organization, the Kuwait Investment Board (1945) were established in London with the help of the British government. Unsurprisingly, in 1956 Britain also had an important role in establishing the sovereign fund of Kiribati (which continued to be subject to the Crown until 1971) (Monk 2010j). There are at least two reasons why London was such a fertile ground for what may well be dubbed the modern sovereign wealth fund concept: *First*, it was the centre of an empire. This may have taken some hits during the first half of the century but still spanned the world from Gibraltar to Papua New Guinea. With funding from the British parliament drying up and plenty of historical lessons learned, there was a need to prepare countries for 'sustainable' independence after the 2nd World War. Against this background, the British Colonial Office was at the forefront of developing new solutions and tools to challenges of public finance, amongst them the first natural resources fund (Gordon L. Clark and Monk 2011b, 4). In order to do so, *secondly*, London profited from its position as the world's pre-eminent centre of global finance and the new ideas generated at the intersection of the traditional insurance- and the nascent fund

management industry, with Monk emphasizing the considerable impact of Markovitz' Modern Portfolio Theory which was first published in 1952 (Monk 2010j).

When looking at the inception of different funds, the 1960s, 1970s and 1980s have been characterized by considerable heterogeneity with regard to fund purpose and set-up, with the SWFs founded in that period ranging from oil- to more general resources-based funds and government holding companies. While the oil crisis arguably was an important co-determinant at least for the increase of resource funds (for more insight, see chapter 2.3.2.1)³, there has been little satisfactory theoretical explanation for the general popularity of SWFs in those days. Clark and Monk have made the case for these funds being set up to signal a new era of modernity for the population while other analysts have attributed the spread of the sovereign funds idea, in particular of state asset holding companies in South-East Asia in the 1980s, to mimetic processes and isomorphism (Grünenfelder 2008; for a similar overall concept, see Chwioroth 2010). The popularity of sovereign funds may also have profited from the 'Washington Consensus' school of development economics emphasizing sound fiscal frameworks and well-designed stabilization funds as the preferred stepping-stones to prosperity.

These attempts at theorizing SWF diffusion closely reflect a theoretical framework elaborated by LSE professor Mark Thatcher who cites three potential models to explain the spread of sectorial independent regulatory agencies (IRAs, e.g. telecommunications regulators) across the Gulf States (Thatcher 2009):

- *First*, a delegation/principle agent model where the adoption of an institution is based on rational cost-benefit calculations.
- *Secondly*, the international diffusion model according to which states are interlinked and organizational models spread from one country to the other, often intermediated by international organizations. Here, potential reasons may include coercion, regulatory competition, learning/following policy leaders or emulation/modelling.
- A *third* model cited by Thatcher refers to internationalization theory where changes at the international level provide incentives/reasons/legitimacy to domestic politicians for institutional reforms.

³ For one of the most encompassing inquiries into the effects of the 1980s oil windfalls, see (Gelb 1988).

The period from 2008 to 2012 has seen the setup of a considerable number of new sovereign funds, with more than 20 funds being either under consideration/parliamentary discussion or starting operations after having experienced various degrees of resistance (Monk 2011f). Considering the evidence at hand, it seems as if sovereign funds have followed the international diffusion (and partly the delegation-) model, in particular motivated by the experiences of policy leaders such as Norway (whose fund over the past couple of years has hosted countless visiting delegations and as a matter of policy has freely shared best practice). Hence it can be argued that the existence of sovereign funds may rather be ‘based on political calculus and the outcome of a discrete public choice’ than colonial coercion and historical luck (Behrendt 2009, 145).

2.1.3 SWFs as a policy choice

Nowadays, sovereign funds are a matter of policy choice, more often than not underpinned by sound economic analysis. This owes much to three factors:

- *First*, advancements in economics are underpinning public choice, with much more information now available on the many requirements needed to build up a sovereign fund, their economic advantages and the specifics of their operations (for many, see Reisen 2008, 9 including some thoughts on the “genuine” savings rate on p. 7).
- *Secondly*, there is readily available help for setting up an SWF: Support may come from established sovereign fund peers with a fund setup similar to the one the country wants to achieve (Monitor 2008, 22; Waki 2010d), by other countries, usually within bilateral assistance frameworks (Monk 2010h) or international organizations (see above).
- *Thirdly*, there is a desire for good governance slowly but inescapably following on from increasing democratization. If correcting for the fact that most SWFs are in developing or emerging countries, countries with better governance have been found to be more likely to set up a sovereign fund (Aizenman and Glick 2008, 11), thereby signalling modernity and reassuring international investors.

Against this background, it becomes clear that sovereign funds have become a policy instrument of choice for various economic purposes.

A sovereign wealth fund for Switzerland?

The Swiss political discussion around a possible sovereign fund exemplifies the turn in public perception of SWFs from unwelcome investors to useful instruments for a wide range of economic and fiscal governance challenges, both at the European and the Swiss level. European think tank representatives recently suggested siphoning off Germany's large external surpluses into a sovereign wealth fund (Financial Times 2012f). An SWF has also been mooted in Switzerland as a possible solution to the strong Swiss franc resulting from the Eurozone troubles.

In reaction to the continuing appreciation of the 'Swissie', on September 6, 2011, the Swiss National Bank (SNB) decided on a peg of 1.20 CHF per EUR. This came after currency interventions under former SNB president Hildebrandt were only partially successful in curbing the rise of the CHF as a 'safe haven' currency. This led to a substantial increase of the EUR portion (invested mostly in sovereign bonds) of the SNB's balance sheet. The increase was so substantial that some commentators have branded Switzerland the 'new China' due to amassing significant foreign exchange holdings through currency management (Financial Times 2012c). With the economic situation of the Eurozone worsening in early 2012 and deep concerns about the development of the SNB EUR reserves in case of a Eurozone break-up, there has been renewed interest in establishing some sort of Swiss sovereign wealth fund. The first concept of such a fund was presented in July 2012 by a UBS economist as a potential way to stop the rise of the Swiss franc (UBS 2011). A bit earlier, at the beginning of June 2012, the Swiss People's Party (SVP) had launched a parliamentary proposal aimed at using part of the SNB's EUR-denominated foreign exchange reserves to strategically invest in real assets abroad such as commodity/energy producers, real estate and telecommunications companies (NZZ 2012a; Tages-Anzeiger 2012). While both proposals are driven by some aspects of the strong Swiss franc and propose a sovereign wealth fund, only the SVP construct would actually qualify as such under the SWF definition of this thesis.

The *UBS fund idea* is based on the Swiss Confederation issuing additional debt with the aim to push up Switzerland's debt-to-GDP ratio from 37% to 57% (assuming a CHF 100bn bond sale), thereby weakening its currency. The proceeds of the debt sale would then be invested in across asset classes, with a preference for higher-yielding assets in the commodities-, energy- and real estate sector. As this type of fund would have considerable short- to medium term liabilities attached to it (Swiss

Confederation bonds) which are likely to prevent it from investing with a long-term perspective, it may not qualify as a pure SWF (for definitions, see chapter 2.2.3).

The SVP fund, on the other hand, aims at maintaining the value of the SNB's (excess) foreign exchange reserves by reducing EUR concentration risk and investing in a broad range of assets abroad. To this extent, it would function in a similar way to many Asian SWFs which are allocated a certain portion of their respective countries' FX reserves. The SVP proposal to make the fund a subsidiary of the SNB may run against established SWF best practice which recommends an independent setup. Also, the SVP's (implicit) strategic, almost political investment strategy (assets complimentary to what Switzerland offers in addition to investments in Eurozone companies to profit from low valuations) may run counter to what SWFs have achieved so far with the Santiago Principles. However, in terms of its funding and objectives, the fund proposed by the SVP may well be classified as an SWF.

This is even more so as the SNB's considerable FX reserves may also be seen as a result of sterilizing the effects of Switzerland's arguably most successful export, its safe haven status. Without interventions, the argument goes, the high Swiss franc would eventually lead to raising asset prices (in particular real estate) and a crowding-out of certain industry sectors (export-oriented and tourism sectors). To a certain extent, these symptoms are similar to a bout of Dutch Disease – with the most common medicine prescribed for it being a sovereign fund (see figure 10). Overall, however, although the discussion has resonated with view to the SNB's legal and institutional restrictions (use of FX reserves as per SNB law, (NZZ 2012b)), a Swiss sovereign fund looks highly unlikely for the time being.

Figure 1: A sovereign wealth fund for Switzerland?

2.2 Definition of SWFs

'Living next to you is in some ways like sleeping with an elephant. No matter how friendly and even-tempered is the beast, if I can call it that, one is affected by every twitch and grunt.' Pierre Trudeau, Washington Foreign Press Club, 1969

Despite lively academic and political discussions over the past couple of years, there remains scope to spend some time on how to best define sovereign wealth funds.

Lawmakers, academics, international organizations, service providers and lately sovereign funds themselves have elaborated a series of definitions aimed at more clearly delineating SWFs from what historically is a rather heterogeneous group of state-owned financial market participants. These include, yet are not limited to, central banks, state-owned enterprises (SOEs), national pension funds, government treasuries and other government-owned entities operating in private markets. This sub-chapter (a) provides an overview of the stakeholders involved in the development of a definition, (b) sheds light on what have turned out to be the most contentious elements of a potential definition, and (c) proposes a hands-on definition of SWFs.

2.2.1 The search for a definition – sources and motivations

While stabilization- and/or savings funds have been around for more than half a century (and their precursors arguably even longer⁴), the term ‘sovereign wealth funds’ is barely a decade old. It dates back to Andrew Rozanov’s 2005 article ‘Who holds the wealth of nations?’ (Rozanov 2005, 52) which provided a catchy name to a hitherto less-known group of financial market participants. That also gave rise to a wave of media articles and academic work which started to appear in 2006⁵. After Rozanov named the ‘beast’ and SWF visibility increased, also amongst laymen, it was a series of reports by investment banks and consultancies⁶ pointing at the growth rate and potential future size of the funds (S. Jen 2007a; Farrell et al. 2007; Fernandez and Eschweiler 2008). These reports triggered considerable interest from politicians, predominately from OECD countries⁷.

A cursory overview of the early publications on SWFs shows that sovereign wealth funds seem to have started indeed as ‘an externally imposed category in search of a definition’ (Gelpern 2010, 2). In the words of Edwin M. Truman, a former high-ranking US government official: ‘They had become members of a club to which they had not applied’ (Truman 2010, 9). An analysis of the early literature suggests that here have been at least four different groups involved in researching and defining the

⁴ See chapter 2.1.1

⁵ The first article mentioning the ‘so-called sovereign wealth funds’ in the Financial Times dates from May 24, 2007.

⁶ See e.g. (S. Jen 2007a) and (Farrell et al. 2007) which both attempted to estimate the future size of SWFs.

⁷ Early hearings included the U.S.-China Economic and Security Review Commission, Hearing on the Implications of Sovereign Wealth Fund Investments for National Security, February 7, 2008; United States House of Representatives, House Committee on Foreign Affairs, The Rise of Sovereign Wealth Funds: Impacts on U.S. Foreign Policy and Economic Interests, May 21, 2008; United States Senate, Committee on Foreign Relations, Sovereign Wealth Funds: Foreign Policy Consequences in an Era of New Money, June 11, 2008; U.S. House of Representatives Financial Services Committee, Subcommittee on Domestic and International Monetary Policy, Trade and Technology, Sovereign Wealth Funds: New Challenges from a Changing Landscape, September 10, 2008. Compilation from (Behrendt 2008).

emerging SWF phenomena (similarly Gelpern 2010, 7). These groups, which formed the early ‘epistemic community’ on sovereign fund matters (Behrendt 2009, 147), have exhibited different motivations for engaging in defining SWFs, thereby ‘choosing to emphasise [different] aspects of an SWF’s identity’ (Xu and Bahgat 2010, 3; similarly S. Jen 2007b, 3):

Market participants – Understanding market impact

In the tradition of Rozanov, the first comprehensive research reports on SWFs came from global investment banks, custodians and consulting firms (S. Jen 2006; S. Jen 2007a; S. Jen 2007b; Lyons 2007; Farrell et al. 2007; Kern 2007). In addition to stressing the size of SWFs and their growth potential, these reports emphasized that SWFs were not a new phenomenon and had been active financial market participants for decades. With an eye on potential business from the funds, service providers’ SWF definitions tended to focus on understanding the new market participants by describing their asset composition and investment strategies. These definitions generally contain statements about SWFs’ investment horizons (long), the currency composition/exposure (mostly foreign) and their risk tolerance (higher than the one usually expected from the management of foreign exchange reserves) (see e.g. S. Jen 2007b; Kern 2007).

Recipient-country governments – regulatory targeting/differentiation

As discussions about SWFs went beyond specialized financial circles and entered the mainstream media in early 2008, there was a dearth of knowledge amongst political stakeholders as to how to react to these developments. Early reports commissioned by recipient country governments and parliaments aimed at providing background for legislators unsettled by media reports and under pressure from their constituents (Department of the Treasury 2007; United States Government Accountability Office 2008; Demarolle 2008; European Commission 2008; Townsend 2008). By and large, the definitions proposed by these reports have drawn on prior research by investment banks and the IMF. Generally, the reports focused on the size and provenance of SWFs, included some case studies and were often complemented by reviews of the respective framework for reviewing foreign investment transactions and how it may relate to SWFs. Some of the reports also compared different SWF definitions. Mezzacapo provides the most in-depth overview of such definitions and also mentions the need to define ‘the scope of possible regulatory measures’ as one of the most salient motivations for a clear definition (Mezzacapo 2009, 4pp).

Academics and civil society – descriptive and normative approaches

The early academic response to the rise of SWFs' profile may be divided into two groups: The first group consists of authors often affiliated with central bank research departments and focusing on analysing SWFs' investment determinants and portfolio decisions (Balding 2008; Aizenman and Glick 2008). A second small yet influential body of research which predominately originated from think tanks, has traditionally focused on political concerns such as transparency and accountability, often resulting in some sort of ranking of the funds (Truman 2007; Badian and Harrington 2008; Barysch, Tilford, and Whyte 2008; Gilson and Milhaupt 2008; Röller and Véron 2008; Truman 2008a, to name but a few). The latter group of authors also tended to comment on recipient countries' frameworks for assessing foreign investment and whether or not these frameworks needed to be adapted to new players such as SWFs. While the latter group offers rather descriptive definitions of sovereign funds, the authors in the tradition of Aizenman/Glick and Balding contain in-depth discussions of prior definitions, in particular with regard to SWFs' investment objectives and portfolio characteristics.

International organizations, central banks – keeping markets open

Based on a mandate conferred on the occasion of the October 2007 Washington meeting of the G7/8 finance ministers (G7/8 Finance Ministers and Central Bank Governors 2007), the IMF, the World Bank and the OECD initiated workstreams aimed at identifying best practices in SWF management and recipient country behaviour respectively. In its February 2008 'work agenda', the IMF – unsurprisingly for a body underlining the funds' importance for their domestic economies and the need for open markets – adopted a more functional definition of the funds by emphasizing five typical objectives/purposes they may serve (IMF 2008). At the same time, the IMF Committee on Balance of Payments Statistics initiated work on refining the definition of foreign exchange reserves which is crucial in order to assess whether assets are under control of a central bank or a sovereign fund (Beck and Fidora 2008, 2). Following the establishment of the International Working Group of Sovereign Wealth Funds (IWG) in April 2008, the IMF secretariat, in conjunction with the founding SWFs, started working on the Generally Accepted Principles and Practices (GAPP) which were based on prior IMF/IWG work (IWG 2008a) and were published in October 2008 (IWG 2008b).

The table on the following page lists some of the most influential early SWF definitions in chronological order.

Year	Author	Affiliation	Source	SWF Definition
2005	Andrew Rozanov	State Street Global Advisors	Rozanov 2005	by-product of national budget surpluses, accumulated over the years due to favourable macroeconomic, trade and fiscal positions, coupled with long-term budget planning and spending restraint. [...] objectives: insulate the budget and economy from excess volatility in revenues, help monetary authorities sterilise unwanted liquidity, build up savings for future generations, or use the money for economic and social development.
2007	Stephen Jen	Morgan Stanley	Jen 2007b	SWF needs to have five characteristics: (1) sovereign; (2) high foreign currency exposure; (3) no explicit liabilities; (4) high risk tolerance; and (5) long investment horizon
2007	Gerald Lyons	Standard Chartered Bank	Lyons 2007	their main characteristics are: ownership by a sovereign nation state rather than a regional or local state entity; not national pension funds and not central banks or authorities that perform roles typical of a central bank
2007	US Treasury		Department of the Treasury 2007	a government investment vehicle which is funded by foreign exchange assets, and which manages those assets separately from the official reserves of the monetary authorities (the Central Bank and reserve-related functions of the Finance Ministry). SWF managers typically have a higher risk tolerance and higher expected return than traditional official reserve managers
2007	Steffen Kern	Deutsche Bank	Kern 2007	financial vehicles owned by states which hold, manage or administer public funds and invest them in a wider range of assets of various kinds. Their funds are mainly derived from excess liquidity in the public sector stemming from government fiscal surpluses or from official reserves at central banks
2008	US Government Accountability Office		United States Government Accountability Office 2008	funds that (1) [are] government chartered or sponsored investment vehicles; (2) invested, in other than sovereign debt, some or all of their assets outside the country that established them; (3) [are] funded through transfers from their governments of funds arising primarily from sovereign budget surpluses, trade surpluses, central bank currency reserves, or revenues from the commodity wealth of the countries, and (4) [are] not currently functioning as pension funds receiving contributions from and making payments to individuals
2008	David G. Fernandez, Bernhard Eschweiler	JP Morgan	Fernandez and Eschweiler 2008	SWFs are broadly defined as special government asset management vehicles which invest public funds in a wide range of financial instruments. Unlike central banks, which focus more on liquidity and safe-keeping of foreign reserves, most SWFs have the mandate to enhance returns and are allowed to invest in riskier asset classes, including equity and alternative assets [...]
2008	William Miracky et al.	Monitor/FEEM	Miracky et al. 2008	a government investment vehicle that meets three criteria: (1) It is owned by a sovereign government (2) It is managed separately from funds administered by the [...] central bank, ministry of finance, or treasury (3) It invests in a portfolio of financial assets of different classes and risk profiles, including bonds, stocks, property, and alternative instruments, with a significant portion of assets under management invested in higher-risk asset classes in foreign countries
2008	IMF		IMF 2008	government-owned investment funds, set up for a variety of macroeconomic purposes. They are commonly funded by the transfer of foreign exchange assets that are invested long term, overseas.
2008	IWG (later IFSWF)		IWG 2008b	special purpose investment funds or arrangements, owned by the general government. Created by the general government for macroeconomic purposes, SWFs hold, manage, or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. The SWFs are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, fiscal surpluses, and/or receipts resulting from commodity exports.
2010	William Miracky, Bernardo Bortolotti et al.	Monitor/FEEM	Miracky and Bortolotti 2010	an investment fund that meets five criteria: (1) It is owned directly by a sovereign government (2) It is managed independently of other state financial institutions (3) It does not have predominant explicit pension obligations (4) It invests in a diverse set of financial asset classes in pursuit of commercial returns (5) It has made a significant proportion of its publicly-reported investments internationally

Figure 2: An overview of SWF definitions⁸

⁸ Source: own compilation

Sovereign wealth funds – explaining the breed

The GAPP included the first definition of SWFs proposed by the funds themselves. Prior to the IWG, the contribution of SWFs to shaping their own ‘label’ had been limited (Gelpern 2010, 9). Some of the funds have even actively denied being an SWF (Monk 2008, 1). The definition proposed by the GAAP is rather broad and includes a series of terms which allow for ‘flexible interpretation’. For instance, it defines SWFs as ‘funds or arrangements’, thereby tolerating a wide range of legal structures. On the same token, it refers to the funds as employing ‘a set of investment strategies which include investing in foreign financial assets’. This marks a significant change from early accounts defining SWFs as fully invested in foreign currency denominated assets (IWG 2008b, 27). This wide definition reflects the IWG’s ambitions to create a comprehensive platform for SWFs and to keep that platform as open as possible to other sovereign funds willing to join. In 2009, this ambition resulted in the establishment of the International Forum of Sovereign Wealth Funds (IFSWF) which was further institutionalized at a summit held in May 2011 in Beijing. There, the IFSWF also announced it will be looking into a permanent secretariat. While still evolving, the GAAP proposal may also be seen as marking a preliminary end to a three-year search for a definition.

2.2.2 Potential elements of a definition

While different institutions have highlighted different characteristics of SWFs, the search for a definition has predominately revolved around at least four distinct building blocks and fault lines:

Ownership

While ownership may be expected to be the least contentious element of a definition, it raises a series of crucial questions. Most commentators agree on government ownership being one of the key elements of a definition. However, opinions vary as to whether it should also include ownership by sub-national governments such as the U.S. State of Alaska (Alaska Permanent Fund, APF) or the Canadian province of Alberta (Alberta Heritage Savings Trust Fund, AHSTF). Some have pointed to the fact that sub-national entities usually do not qualify as ‘sovereign’, thereby lacking the decision rights (and hence the alleged political objectives for the funds) commonly associated with central government (Monitor 2010, 6). The GAAP definition, on the

other hand, explicitly includes sub-national government ownership⁹. The IFSWF, the SWFs' trade association managing the GAAP, counts two sub-national funds amongst its members. It essentially argues that the sub-national funds are facing the same issues as their peers at the national level when it comes to investments outside of their host country.

Funding, assets/liabilities

With regard to funding, many definitions resort to providing a list of funding sources, commonly falling into three categories (commodity sources, fiscal sources and foreign reserves (Fernandez and Eschweiler 2008)). While the sources of assets may be of interest for a classification of funds, the need to include a description of the asset sources in a definition is debatable, also because there is a multitude of sources which could feed an SWF. It is important, however, to emphasize that funds must derive from *public* sources and shall not have any explicit (short-term) liabilities attached to them. In this context, there has been a long-lasting controversy about whether or not to count public pension funds as SWFs¹⁰. While they clearly display some sort of 'public' characteristics, their funding derives from individual contributions which results in direct liabilities towards their pensioners/beneficiaries. As pension funds technically belong to their beneficiaries, governments may have fiduciary duties but ultimately do not own the funds.

Purpose/objectives

As a result, the objectives of SWFs and pension funds differ significantly: For sovereign funds, objectives usually include profit maximization by adopting a highly independent and long-term investment approach across all asset classes. Pension funds, on the other hand, aim at managing low-risk and highly liquid portfolios for pensioners¹¹. Against the background of emerging concerns about SWFs, early definitions have focused on enumerating SWF purposes whilst emphasizing that most SWFs tend to have 'multiple, overlapping or changing objectives' (IMF 2008, 5;

⁹ Interestingly, within the IFSWF, the United Arab Emirates are represented by ADIA from Abu Dhabi, one of the seven emirates/monarchies forming the union. In addition to Abu Dhabi, Dubai is also running several state investment vehicles. It remains to be seen how these technically sub-sovereign entities interact in times of internal and external political stress, e.g. when called in by the union to bail out another member of the federation (as it allegedly happened with ADIA which is understood to have financially supported Dubai's government during the 2009 financial crisis).

¹⁰ In analogy to SWFs, some of the literature has used the term 'sovereign pension (reserve) funds' and 'pension reserve fund'/'social security reserve fund' to denominate pension funds financed by fiscal transfers and by employee/employer contributions respectively (Das, Mazarei, and Van der Hoorn 2010, 134; Truman 2010, 10).

¹¹ Ashby Monk's paper entitled 'Is CalPers a sovereign wealth fund?' (Monk 2008) provides a more in-depth discussion on this subject.

Fernandez and Eschweiler 2008, 5). The IMF made objectives an integral part of its first definition, claiming that SWFs ‘can be distinguished based on their main objective(s)’: *stabilization funds, savings funds, reserve investment corporations, development funds and contingent pension reserve funds* (IMF 2008, 5). Over time, the literature has tended to combine the objectives and started referring to them as ‘macroeconomic purposes’, as e.g. reflected in the GAAP and other policy reports (IWG 2008b, 27; Das et al. 2009, 5). This also with the aim to exclude public funds set up with very specialized/narrow mandates, e.g. exclusively for infrastructure financing.

Management/investment style

While SWF objectives may slightly differ across funds, most funds have been set up to take advantage of long investment horizons which generally enable them to take more risk and invest in less liquid asset classes than central banks or pension funds may do (Das, Mazarei, and Van der Hoorn 2010, 140pp). In this respect, the Monitor Group, in collaboration with the Fondazione ENI Enrico Mattei (FEEM), proposed an interesting concept which sees SWFs as ‘part of a continuum of sovereign government investment vehicles that runs along a spectrum of financial risk from central banks as the most conservative and risk-averse, to traditional pension funds, to special government funds, to SWFs, and finally to state-owned enterprises, which are the least liquid and highest-risk investments’ (Monitor 2008, 14pp, adapted from Kimmitt 2008; Truman 2007, 4). As both central banks and SWFs hold mostly foreign currency-denominated assets, many of the early definitions felt the need to emphasize that SWFs are managed separately from central bank reserves (Hildebrand 2007, 2; European Commission 2008, 4).

2.2.3 A working definition of SWFs

Given the proliferation of different definitions, it may be worth sparing a thought as to the different types and the purpose of definitions before elaborating on the one which underpins this thesis.

Types of definitions

According to the Encyclopaedia Britannica, a definition is ‘the specification of a meaning of an expression relative to a language’ (Encyclopaedia Britannica 2011). Generally, one distinguishes between *descriptive* and *stipulative* definitions. Descriptive definitions aim at summing up the general meaning of the term while stipulative definitions refer to definitions drawn up for a limited argument’s sake. Like all long-term oriented contributors to the SWF discussion, this thesis proposes a

descriptive definition of sovereign funds which should be applicable beyond the arguments made here in the context of how the funds manage political risk. Commonly, definitions are either *inclusive* or *exclusive* (Mezzacapo 2009, 7), referring to whether they describe the *definiendum* by pointing at characteristics it needs to demonstrate or by describing which qualities would preclude a certain object of investigation to fall under the *definiendum*. With view to sovereign funds, most definitions consist of both inclusive (e.g. necessity of state ownership) and exclusive elements (e.g. no short-term liabilities) (Roazanov 2010b, 4).

Purpose of a definition

The purpose of a definition is to distinguish one *definiens* from another and elucidate the determining characteristics of an object of investigation. In the context of this thesis, a sound SWF definition allows distinguishing SWFs with a certain degree of accuracy from other (similar) financial market participants, thereby enabling the researcher to isolate specific behaviour and characteristics prevalent among the group. A definition is not to be equalled with the scope of investigation of a research project¹². While a definition determines the basic population of a certain phenomenon, the scope of investigation can be much more limited, e.g. only focusing on SWFs funded by commodity revenues or all SWFs subscribing to the GAAP/Santiago Principles. Also, definitions should not include any classifications either: While it may make sense to classify SWFs according to the source of their funds or according to their objectives, a classification is usually the result of a first analytical effort. A definition must provide the most general and unambiguous description of a certain phenomenon, with classifications following at a later stage.

Challenges

Considering more than five years of widespread efforts from policy makers, regulators and academics to define sovereign wealth funds, there have been at least two major challenges:

- The *first challenge* refers to the scope of a definition. A wide definition, possibly including (sovereign) pension funds, SOEs and institutions managing foreign exchange reserves such as SAFE or SAMA, would result in capturing a wide variety of sovereign investment vehicles. They would, however, have very heterogeneous objectives (price stability, maintain value of pension assets, etc.) and principals (independent central bank governing boards, pensioners, etc.) which

¹² See chapter 1.2

may make it difficult to isolate distinctive features common to all SWFs (Rozanov 2010b, 5). Too narrow a definition, on the other hand, is likely to exclude many organizations facing similar challenges with regard to managing a sovereign's asset. The challenge is finding a definition which is narrow enough that it can be used as a homogeneous term yet wide enough to capture the significant differences between the 30 to close to 60 funds listed on various SWF tables (for a similar thought, see Fernandez and Eschweiler 2008, 3).

- *Secondly*, definitions often consist of building blocks which themselves may be in need of further definition or may have different meanings in different cultural contexts. Just consider the word 'sovereign': Depending on the political culture of a country, it may variously denominate the head of state, parliament or the territorial and political unity of the country itself. The same applies to other, widely used building blocks of an SWF definition such as 'independence from government' or the notion of 'long-term, performance-oriented investments', both of which may be perceived differently across SWF sponsors.

Based on the evolution of SWF definitions and borrowing in particular from prior work by Monitor/FEEM and the GAAP (Monitor 2010, 7pp; IWG 2008b, 27), this thesis proposes the following SWF definition:

SWF Definition
<p>A Sovereign Wealth Fund (SWF) is...</p> <p>A special purpose investment fund or arrangement,</p> <ol style="list-style-type: none"> 1. owned and controlled by a sovereign government; 2. managed independently of other state financial institutions; 3. mandated with managing assets transferred by the government in a performance-oriented way; and 4. operating without explicit short-term liabilities and holding a significant share of international investments.

Figure 3: SWF definition

Taking into account the points made above, this definition contains both inclusive and exclusive elements and is wide enough to result in a comprehensive population of objects of investigation. The definition steers clear from classifying SWFs yet allows for a wide variety of funds with different legal setups, asset sources and liability profiles. The definition consists of the following five elements which are detailed below:

'Special purpose investment fund or arrangement'

Depending on their fiscal arrangements, governments may dispose of a wide array of funds aimed at ring-fencing expenditure for various state obligations such as building infrastructure, providing health services or financing higher education. While SWFs may be included in government's budgetary calculations and may also be obliged to assist the public purse in times of budgetary stress, they usually do not contribute to running costs arising from providing public goods. 'Special purpose' therefore refers to the fact that SWFs may serve macroeconomic purposes that cut across fiscal cycles. Although most funds are linked to government budgets through a set of stringent funding and withdrawal rules, they tend to be isolated from short-term fiscal policy-making processes. Their degree of independence usually depends on the institutional arrangements of the fund. A survey by the IMF has shown that around half of the SWFs are set up as separate legal entities based on an act of law, usually decreed by parliament, with the other half constituting pools of assets (IWG 2008a). Provided there is a robust governance arrangement, however, SWFs may also operate as a special unit within a central bank (e.g. Botswana's Pula Fund) or a ministry of finance, e.g. the Irish NPRF (Das et al. 2009, 13). The IWG/IFSWF's Santiago Principles allow for SWFs to be part of a central bank balance sheet, provided the SWF assets are 'held for purposes other than balance of payment purposes' (IWG 2008b, 27, footnote 42). For the purpose of this thesis, the institutional criterion is left sufficiently wide to include SWFs irrespective of their legal form (similarly IWG 2008b, 27), provided the funds fulfil the additional criteria laid out below.

'Owned and controlled by a sovereign government'

While governmental ownership seems to be an unambiguous criterion, it is not without its pitfalls. Public pension funds, for instance, may look like government-owned institutions, yet they technically belong to their contributors/beneficiaries which – depending on the rules – may redeem capital at any time. In this respect, 'owned by the government' refers to funds that are funded by government – instead of individual contributions, thereby ensuring there are no short- or long-term liabilities attached to the fund¹³. According to the GAAP, funds may be owned by both 'central and subnational governments', as exemplified by two subnational IFSWF members. For the purpose of this definition, 'sovereign government' shall also include subnational

¹³ While the no-liabilities criterion may fit for definition purposes, reality is more complex: In his categorization of SWF liability profiles, Rozanov refers to no-liabilities as 'open-ended liabilities', with effectively no contractual liabilities attached. In addition to the ideal no-liability SWF profile, he allows for three other forms of implicit liabilities and distinguishes between '(1) contingent liabilities, typical of stabilization funds; (2) fixed future liabilities, typical of national pension reserve funds; (3) mixed or endowment-type liabilities (i.e. perpetual capital with interim outflows)' (Rozanov 2010b, 5pp).

governments up to the extent that they are ‘sovereign’ as to the management of their fund. Both the US State of Alaska and the Canadian province of Alberta exert full sovereignty over all decisions regarding the APF and the AHSTF respectively. And although Alaska and Alberta may not be able to effectively support their funds abroad, it can be reasonably argued that both countries’ federal governments would put their weight behind the funds if it ever came to a challenging situation. However, in order to reduce complexity inherent in such a two-level game between national- and sub-national governments and other stakeholders of the funds, this thesis will concentrate on SWFs at the national level.

Government control refers to the fact that the most basic strategic decisions establishing a sovereign fund are subject to political decisions. More often than not, the establishment of funds is preceded by fierce political debate which usually sees different political factions disagreeing on funding and governance issues (for an example from Nigeria, see Nnochiri 2012). The result of these deliberations is often a law which lays down the cornerstones of the fund (funding, purpose, strategy). Depending on the host nation’s political system, the openness of deliberations may vary. For the purpose of this definition, it is essential to underline that control over SWFs ultimately resides with governments as the sole underwriter of the funds’ existence – with all dangers of political interference this may result in (see case study NPRF in chapter 6.3).

‘Managed independently from other state financial institutions’

Many commentators deem it essential that SWFs are managed separately from state financial institutions in general and central bank reserves in particular (see S. Jen 2006 for an early thought about large reserve managers’ “liquidity” and “investment” tranches; Hildebrand 2007, 1; European Commission 2008, 2). According to two influential early authors, the separation of SWFs from other state financial assets (and other traits common to most SWFs) originates ‘in the specific nature of SWFs founded to improve the returns on sovereign assets (Beck and Fidora 2008, 1)¹⁴ or more generally to help achieving their policy objectives. The IMF, on the other hand, seems to be more relaxed about institutional independence: Based on a study of existing funds, the IMF sees three options for an independent SWF setup: (a) as a separate legal entity, (b) as a unit within the central bank, or (c) as a separate part of the ministry of

¹⁴ The adequate level of reserves for a country has itself been subject to an intense debate amongst academics and practitioners (Davis et al. 2001; Das et al. 2009; Das, Mazarei, and van der Hoorn 2010). Although this debate also has a significant political risk component, it precedes the establishment of an SWF and therefore does not fall into the scope of this thesis which only looks at political risk of established funds.

finance. The degree of independence of these three options will arguably depend on their specific governance frameworks, e.g. on the rules governing the composition of the board of the separate legal entity or the decision making framework of a central bank department managing an ‘investment’ tranche of reserves (Das et al. 2009, 13p). While one can assume that options (a) and (b) provide for a certain institutionally built-in degree of independence, it can be argued that being part of a ministry of finance may require a more stringent governance framework. This may be achieved by having explicit founding documents clarifying governance and decision-making frameworks and an operational separation of investment activities. The benefits of such ‘fund-within-a-fund’ arrangements are manifold: being able to use existing resources to kick-start a fund, leveraging operational synergies in IT, investment controlling and similar areas, and harnessing expertise across departments. However, freedom from political interference and the flexibility to implement advanced risk- and reward structures are likely to become more important as the ‘SWF portfolio’ branches out into more sophisticated investments. Over time, this may increase tensions between central bankers and performance-oriented SWF asset managers. In practice, most institutions affiliated to central banks, e.g. the HKMA’s Investment Portfolio, are managed with a strong focus on liquidity (Financial Times 2010c)¹⁵. The differences become even more visible when considering private-equity type funds such as Singapore’s Temasek or Malaysia’s Khazanah. The asset management strategies employed for these types of funds do have very little in common with central banking. This thesis will therefore adopt a strict interpretation of the independence criterion and will predominately focus on SWFs managed independently from state financial institutions.

‘Mandated with managing assets transferred by the government in a performance-oriented way’

Sovereign funds usually have an explicit management mandate from their political sponsors which is part of the legislation the fund is based on. Upon definition of the mandate, the government transfers or instructs the transfer of assets, with the amount and provenance depending on the fund’s objectives. As opposed to reserve managers, funds for economic development or charitable purposes, SWFs mostly follow a performance-oriented asset management strategy (Monitor 2010, 7), reflecting

¹⁵ In one of his first papers on SWFs and one of the first contributions on the topic in general, Stephen Jen points to a trend amongst reserve managers to seek higher returns for a portion of their assets. Given the IMF’s strict low-risk definition of official reserves, he argues that by shifting reserves into independent sovereign funds, ‘reserve holders could gain more flexibility with their portfolios’ (S. Jen 2006). This very much captures the essence of the difference between the management of currency reserves and a sovereign wealth fund.

governments' wishes to earn an extra yield on excess reserves. As long as development- or charitable-oriented activities do not account for a significant fraction of the fund's activities (which is the case with many funds), this thesis considers them to be performance-oriented. Indicators for a fund's performance orientation include the adoption of a wide range of investment strategies across various asset classes, i.e. the implementation of modern portfolio management strategies.

'Operating without explicit short-term liabilities and holding a significant share of international investments'

The criterion of not holding any short-term liabilities goes to the core of what distinguishes sovereign wealth funds from their 'close cousins' official reserves and 'sovereign' pension funds (S. Jen 2007b). By definition, official reserves do not have any liabilities attached. However, as they have to be instantly available in case of a balance of payments crisis, they have very short investment horizons yet are often heavily invested in foreign currency. Pension funds, on the other hand, may have long investment horizons. Yet due to their explicit liabilities mostly denoted in home currency, their risk appetite and foreign currency exposure is often very limited. As pension funds are considered to be crucial for domestic capital markets and have fiduciary obligations, they often face regulatory restrictions with regard to asset classes. Therefore, the liability structure has considerable influence on a fund's investment horizon, its strategy and the underlying risk appetite, the combination of which sets sovereign funds apart from their asset management peers¹⁶. Given the reasons laid out above, the liability- and international investments exposure criteria are a recurring feature of many established SWF definitions and have proven to be valuable beyond purely academic definition efforts.

SWFs and SWEs and SOEs

Sovereign involvement in the private sector comes in various shades (TheCityUK 2012, 5), with a substantial literature trying to make sense of the boundaries between SWFs, sovereign wealth enterprises and SOEs (instead of many, see Backer 2010, 59pp with further sources). With sovereign funds often lumped together with SOEs such as Dubai Ports and the China National Offshore Oil Corporation (CNOOC), a solid delimitation is of conceptual and practical relevance. *Ownership, the degree of*

¹⁶ In an interesting blog post titled 'Rethinking the 'W' in SWFs', Ashby Monk discusses the impact of SWFs increasingly looking for private sector capital (e.g. through co-financings or issuance of bonds) on their liability profile. He argues that while private capital may have positive effects on international and domestic legitimacy by acting as a seal of approval for the SWF's strategy, it may also contribute to short-term performance orientation (Monk 2010e).

operational activity and of *state control* are important vectors to distinguish between these state-owned yet privately operating organizations.

Sovereign wealth funds (SWFs) are organizations which are fully state-owned. However, state control is kept to a minimum in order to enable asset management in a performance-oriented way. Evolving from excess foreign exchange reserves or resource income, SWFs are funds without any operational activity (understood as production of goods and services). A small caveat may apply to SWFs such as Singapore's Temasek which holds mainly majority stakes in and exercises considerable control over operationally active companies, thereby giving the SWF more operational clout than a pure asset management organization.

The term *sovereign wealth enterprise (SWE)* was coined by the SWF Institute, a private research and consulting outfit. An SWE is defined as 'a sovereign investment vehicle that is owned and controlled by a sovereign wealth fund' (Sovereign Wealth Fund Institute 2008). According to the SWF Institute, SWEs may increase a sovereign fund's flexibility and make it more difficult to track their holdings. The parent SWF usually holds full control over SWEs. The SWE category is rarely referenced in the literature, with most commentators referring to them as portfolio companies.

The OECD refers to *state-owned enterprises (SOEs)* as 'enterprises where the state has significant control, through full, majority, or significant minority ownership' (OECD 2005, 11). Today, SOEs are commonly understood as operational, stand-alone organizations which may be listed or not. While control arrangements vary across countries, state control over SOEs is generally tighter than over SWFs, with the major challenge at SWFs being to find a balance between the state's responsibility for actively exercising its ownership functions [...] while at the same time refraining from imposing undue political interference in the management of the company' (OECD 2005, 3).

Figure 4: SWFs and SWEs and SOEs

2.2.4 An SWF list, some special cases and some words of caution

A list of SWFs

A thesis dealing with sovereign wealth funds would not be complete without attempting to list the subjects of investigation. This sub-chapter therefore refers to the list in appendix 1 which lists all the funds conforming to the definition proposed above. As a matter of fact, this SWF list has benefited from similar efforts taking place from 2007 to 2009 when early commentators used lists and rankings to illustrate the development of the funds and associated challenges (for an overview, see United States Government Accountability Office 2008, 46).

The fund list is based on a combination of publicly available sources which are validated against each other. Where possible, the list is based on information provided by the funds themselves, often contained in annual reports which tend to be published in the second quarter of the year. The fund list is compiled on the basis of the SWF definition presented above. AuM figures for the individual funds are based on the fund's own reporting, if available. Otherwise, AuM rely on a critical appreciation of research by Monitor (Monitor 2011), TheCityUK (TheCityUK 2011; TheCityUK 2013) and the SWF Institute's fund list (Sovereign Wealth Fund Institute 2013a), with the SWF Institute given preference in case of significant AuM variation between authors.

The special cases

The financial crisis of 2008 has brought to the fore other entities engaging in sovereign asset management which at first glance may be mistaken for sovereign funds. Some of the most prominent amongst them are the French Fonds stratégique d'investissement (FSI) and Britain's UK Financial Investments (UKFI)¹⁷. Both entities were established in 2008 as a response to external market developments. UKFI was set up to manage the UK government's stakes in financial institutions resulting from a series of bail-outs and recapitalizations while the FSI aims at strengthening French firms affected by market turmoil. Both funds are fully government-owned: UKFI has HM Treasury as the sole shareholder and the FSI is 49% owned by the government of France and 51% by the Caisse des Dépôts et Consignations (CDC), a French development bank. The CDC itself has also been labelled an SWF, with some analysts even claiming its foundation in 1816 making it the oldest SWF (see Angela Cummine's comments in

¹⁷ In 2010, the Italian government founded the Fondo Strategico Italiano SpA, which is closely modelled after the French Fund.

Monk 2010j). Although UKFI, FSI and CDC are clearly government-owned, they are at odds with the SWF definition proposed by this thesis. While they seem to fulfil the ownership, management and mandate criteria (points 1 to 3 of the SWF definition), it is their domestic focus and the existing liabilities which result in not counting them as SWFs. Set up as government holding companies, the three institutions exclusively hold domestic assets, either UK bank shares or a more eclectic mix of French companies. According to their mandates, new investments by FSI and CDS may only be made domestically (for a profound discussion of the FSI, see Fiechter 2010, 13pp). Moreover, at least the CDS has explicit liabilities insofar as it is funded by assets of French pensioners and provinces. While these may be borderline cases, they show the wide variety of governmental asset managers which without appropriate examination may be lumped together with SWFs – with all the implications this may have.

Some words of caution

The examples of funds above also show that real life has overtaken theory and that fund reality starts to branch out from relatively artificial classifications and buckets. A good example is provided by the members list of the IFSWF which also contains sub-national funds and funds with future pension obligations. As will be shown later on, SWFs are part of a continuum of governmental-owned organizations and exhibit a considerable variety of forms and purposes. While stringent definitions are a prerequisite for academic groundwork, policy makers tend to be more relaxed about it: As Setser pointedly remarked, ‘if something walks or quacks like a sovereign wealth fund, it probably is’ (Financial Times 2008d). In this case, it would also be likely to encounter similar political risk as SWFs do. A final word of caution with regard to generalize on SWFs refers to the high number of new SWFs which have been announced and/or set up in the last couple of years. The latest examples include Uganda, Panama, Mongolia, South Africa, Tanzania, Ghana and Israel. Although most exhibit a standard SWF setup, only time will tell if these funds develop along the lines set out above in the definition.

2.3 Categorizing SWFs

2.3.1 A few thoughts about categorizations¹⁸

As discussed in the previous chapter, SWFs exhibit a number of traits which are common to all funds and which are mirrored in the definition used for this thesis. At the same time, the funds are far from being a homogenous group of market participants and differ significantly when it comes to their legal frameworks, macroeconomic objectives, funding and withdrawal procedures, risk appetite/management and transparency and governance arrangements, to mention but a few. To the extent as sponsoring governments differ with regard to social, political and economic parameters, so do the respective funds (Xu and Bahgat 2010, 2).

Categorizing objects of investigation has long been one of the most effective ways to generate knowledge. It is also an important instrument of the grounded theory approach. First discussed in Aristotle's seminal work '*Categories*', categorizing refers to clustering objects according to common characteristics, i.e. to place them in pre-defined categories. Financial markets are no strangers to categorization: as market participants are becoming more sophisticated, so do the markets and the products they are investing in. Over time, this has led to a clustering of market participants based on specific characteristics, resulting in financial markets being populated by a wide array of investors now ranging from retail investors to mutual funds, pension funds, hedge funds and also SWFs, to name but a few. In an attempt to signal certain attributes such as the degree of risk, maturities and liquidity to investors, financial products have been categorized too, both by market participants as well as by legislators (e.g. most recently in the context of MiFID).

With regard to sovereign funds, categorization has gone hand in hand with analysts' efforts to better understand this particular type of (financial) market participants. As analysts started to zoom in on the funds, they realized that whilst SWFs had a stock of shared characteristics strong enough to call for a common moniker, they also differed in many ways. Furthermore, as analysis of the funds has become more sophisticated, also in an attempt to better understand their needs as clients, so have the categories the SWFs have been subdivided in, thereby creating an implicit 'taxonomy' of the

¹⁸ Although imprecise in philosophical terms, his theses uses 'categorization' and 'classification' interchangeably, referring to it as 'grouping objects based on their similar properties' (Wikipedia).

sovereign fund family¹⁹. A cursory glance at the literature over the past decade shows that there have been three broad waves of categorization: *Descriptive* categorizations, *analytical* categorizations and *interpretative* categorizations. While descriptive categorizations are concerned with ‘what’ is out there, describing the sovereign funds family’s basic attributes such as years of inception, size and geographical spread, analytical categorizations dig deeper and focus on ‘how’ funds are structured and ‘how’ they invest. Interpretative categorizations, meanwhile, attempt to answer broader questions relating to the spread of the SWF idea, their role with regard to sovereignty and their impact on the perennial debate about states vs. markets.

Descriptive categorizations

In the early days of analysis, when transparency of the funds was still evolving, information was scarce and public unease about the size of SWFs was at its peak. Funds were thus often classified (or ranked) according to their assets under management (AuM). Other categorizations, often contained in rather general articles and reports about the rise of the funds, include grouping the funds according to their date of inception or their geographical origins.

Analytical categorizations

As policy makers’ interests went beyond the mere description of the funds’ attributes, categorizations became more analytical, i.e. using information about the source of SWF funds and establishing causal relationships between the income side and the funds’ investment activities, levels of transparency and their reactions to external shocks such as the financial crisis. This type of categorization of SWFs requires going beyond publicly available information and piecing together data from regulatory filings, press- and financial market reports and – increasingly – the funds’ quarterly and annual reports themselves.

Interpretative categorizations

With most of the ‘hard facts’ about the funds in the public domain and following considerable efforts to understand their structures and investment behaviour, analysts have increasingly turned to looking behind the data and assessing the funds’ impact in a wider context. Scrutinizing the funds’ (self-declared) purposes and activities, the latest literature has categorized them according to the role they play in relation to their sponsors’ sovereignty or the geopolitical order in general (e.g. E. Helleiner and Lundblad 2008, 61).

¹⁹ Taxonomy is a term from biology where it refers to arranging species according to various characteristics (from the Greek taxis: arrangement; nomos: law).

Grouped by the three main clusters of categories, the remainder of this chapter reviews some of the categorizations proposed by the literature. In this context, it must be noted that most categories are not mutually exclusive, but often overlapping. Categorizing the funds provides some distinct benefits: Firstly, the funds' political risks differ depending on their characteristics and therefore on the categories they belong to. Secondly, SWFs' possibilities for and instruments to respond to political risk also vary, again depending on the specific setup and characteristics of the fund.

2.3.2 Descriptive categorizations

2.3.2.1 Date of inception

As it has been widely noted, SWFs are not a new phenomenon. While there has been considerable interest by industrialized (e.g. Japan, Israel), emerging (e.g. Malaysia, Brazil) and developing countries (e.g. Mozambique, Bangladesh) alike to set up sovereign funds, the oldest funds are almost 60 years old.

The emergence of sovereign funds has come in four waves, each of which has been a reflection of broader political and macroeconomic developments. Each wave also gave rise to prototypical funds that can still be traced back those roots today.

- The first sovereign funds dating from the 1950s (the Kuwait Investment Authority and Kiribati's Revenue Equalization Reserve Fund) were both initiated by British colonial administrations, in an attempt to – intentionally or by chance, as the Economist aptly puts it – 'build[ing] up an endowment to replace shrinking natural resources' (The Economist 2007; see also Kern 2007, 4).
- The oil shocks of the 1970s gave rise to a next wave of sovereign funds as oil-producing governments across all continents were faced with windfall revenues. The decade from the mid-1970s to the mid-1980s saw the founding of ADIA, the Brunei and Oman funds and the two sub-national SWFs of Alaska and Alberta, which some have seen as a reflection of the emergence of 'modern resource nationalism' (Bremmer 2010, 77pp).
- With Reaganomics and Thatcherite economic policy making inroads in the 1980s and the 1990s, economic liberalization in emerging markets paved the way for a third, albeit more heterogeneous wave of sovereign wealth funds which started with the formation of Temasek Holdings as an outlier in 1974. Whilst the third wave has seen the emergence of some resource-based funds, it is mainly characterized by sovereign funds managing excess foreign exchange reserves and

- privatized state holdings resulting from economic reforms favouring export-led growth and SOE restructuring. Therefore, sovereign funds from this period, such as Temasek, GIC, IPIC or Khazanah, are often holding companies with some kind of developmental mandates for their home countries.
- The last wave of SWF founding mirrors the accelerating, mostly export-driven growth of emerging markets and a unprecedented hike in commodity prices (see amongst others Bremmer 2010, 81). Global economic imbalances have led to the accumulation of considerable foreign exchange reserves amongst Asian exporters and commodities-producing nations across all continents. Almost five decades of experience with SWFs and the popularization of the term may also have contributed to making sovereign funds a plausible policy option, as witnessed by close to 20 governments now considering setting up an SWF, as the IFSWF claims on its website. In reality, this number has now risen closer to 30 when counting in the funds which became operational since the IFSWF announcement.

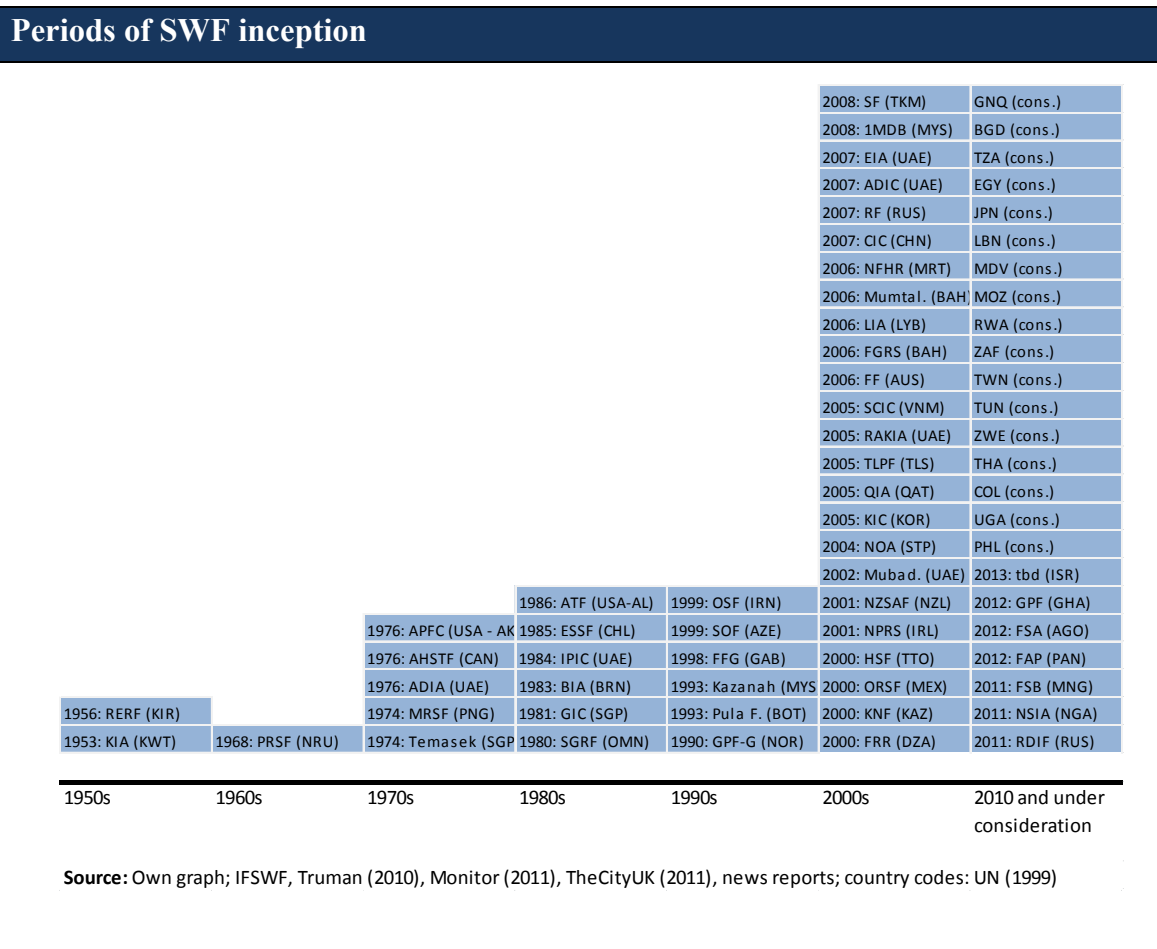


Figure 5: Periods of SWF inception

2.3.2.2 (Legal) structure

As mentioned in the Santiago Principles, most sovereign wealth funds fall into three structural categories (IWG 2008b, 11):

- (1) Separate legal entities, mostly constituted by a specific act of public law and providing the highest degree of operational independence. Examples include the QIA, ADIA and the Australian Future Fund.
- (2) State-owned corporations often governed by private law yet fully owned by the state, mostly represented by the ministry of finance. Examples are the Singaporean entities (which are so-called fifth-schedule companies with additional decision rights granted to the president of Singapore (Temasek 2012b)) or China's CIC.
- And (3) pools of assets without separate legal personality where the general rules for managing the pool are set out in specific legislation. The operational management of the asset pool may be either conferred to branches of the administration, e.g. a ministry or a parliamentary/mixed committee or to 'an independent entity, such as the central bank (as in Chile or Norway) or a separate statutory agency (as with the Alberta Heritage Fund) (Gaukrodger 2010, 14pp).

A survey conducted in 2008 by the IWG, a predecessor of the International Forum of Sovereign Wealth Funds, found that half of the existing sovereign funds are separate legal entities and another half has been set up as pools of assets (IWG 2008a, 5). With regard to the twenty-plus new funds planned for and set up from 2010 – 2013, there has been little clarity yet as to the legal structure they are to follow. However, according to an influential paper on policy- and operational considerations by the IMF, the separate legal entity setup has proven to be advantageous from both an independence- and a cost perspective (provided the fund reaches a certain size to amortize the sunk costs) (Das et al. 2009, 13).

2.3.2.3 Assets under management

Most of the early attempts to get a grip on the SWF phenomenon resorted, amongst other things, to ranking them according to their assets under management (AuM). At the beginning of 2013, there were around 50 sovereign funds worldwide, with total AuM amounting to USD 3434bn²⁰. Compared to selected capital markets indicators

²⁰ These numbers are based on this thesis' master fund list whose compilation is further detailed in chapter 2.1.4. Total SWF AuM vary amongst authors and are heavily dependent on the SWF definition and the AuM 'guesstimates' for the individual funds, with estimates ranging from USD 2585bn (Monitor 2011) to USD 5200bn (TheCityUK 2013) and USD 5938bn (Truman 2010), with the latter estimate also including funds with pension liabilities.

below, this is a sizable sum. However, as it is difficult to gauge the SWF sector's overall equity weighting, an estimate about their share of the global stock market capitalization would be misleading. The USD 259trn of outstanding bonds, equities and bank assets may be a more suitable number to compare to. Therefore, without considering substantial SWF holdings in real, non-securitized assets and with some margin of error, it is estimated that sovereign funds may hold up to 1.3% of worldwide bonds, equities and bank assets, up from 1.1% calculated on the basis of the 2009 IMF capital market numbers (IMF 2011).

Selected indicators on the size of the capital markets								
2011, in USD bn unless noted otherwise								
	GDP	Total reserves (minus gold)	Stock Market Capitalization	Debt Securities			Bank Assets	Bonds, Equities and Bank Assets
				Public	Private	Total		
World	70'221	10'651	47'189	44'622	53'766	98'388	113'735	259'213
European Union	16'411	468	8'530	10'808	20'741	31'549	43'465	83'543
North America	16'857	203	17'553	14'093	21'855	35'947	18'252	71'752
Japan	5'897	1'258	3'541	12'791	2'579	15'369	13'497	32'407
Emerging markets	25'452	6'944	9'771	5'290	3'951	9'240	26'526	45'538

Source: (IMF 2013)

Figure 6: Selected indicators on the size of the capital markets

Considering publicly available SWF rankings (for early examples, see Truman 2007; The Economist 2007; Kern 2007), it becomes apparent that total SWF assets are heavily concentrated amongst very few funds, with the remainder of total AuM spread across many medium- and smaller-sized funds. In 2007, Gerard Lyons coined the term 'Super Seven' which denominated the seven sovereign funds with AuM of more than USD 100bn at that time (Lyons 2007, 120). Another author affiliated with the OECD calls refers to these funds as 'heavy SWFs' (Reisen 2008, 7). While currently available data suggests that there are only six funds with AuM bigger than USD 100bn, these SWFs have experienced substantial growth in their portfolio over the last half a decade²¹. Without Russia's Stabilization Fund (which in February 2008 was divided

²¹ Arguably, there may be some more funds belonging to this exclusive club: Since its inception in 1976, the APFC has distributed USD 20.2bn in 'fund dividends' to eligible Alaskan citizens (APFC 2013, 1). Had

into the Reserve Fund the and the National Welfare Fund²²), by Q1 2013, the ‘Super Six’ accounted for around USD 2628bn AuM, significantly up from the USD 1690bn in 2007²³ and the USD 1950bn in Q3 2011. Balding offers a critical view on SWF asset sizes, particularly in regard to funds from state-centric economies such as the GCC states, but also Singapore. He argues that there may be some significant double-counting due to cross-shareholdings or joint-ventures with other government entities (Balding 2008, 32).

2.3.2.4 Geographical distribution

The geographical distribution of sovereign wealth reflects over a decade of above-average growth in emerging markets and a simultaneous price hike across all commodities. This has resulted in Asian countries running considerable current account surpluses and oil- and other commodities producing countries experiencing windfall commodity revenues. Therefore, sovereign wealth is heavily concentrated in the Gulf States (i.e. Western Asia) and Eastern- and South-Eastern Asia which together account for roughly two thirds of all SWF assets. While the biggest SWF may still be on European soil (Norway’s GPF-G, with USD 702bn AuM as per March 2013), Western and other industrialized nations belonging to the OECD generally play a minor role when it comes to sovereign wealth.

Considering the set of countries currently looking into establishing sovereign funds, the dominance of oil-producing countries and export-driven nations in this sector is set to continue. By the second half of 2010, there were at least 20 countries which have considered or have initiated first steps to set up a sovereign fund. As many commentators note, in some countries the SWF idea has been a recurring feature of the political discourse with little tangible results (Monk 2011f). In other countries, however, sovereign funds have been conceptualized and implemented very quickly, as the example of the Russian Direct Investment Fund shows. In Q1 2013, close to 20 funds are under consideration. Figure 6 shows that SWFs are mostly being considered

these assets been reinvested, even at a conservative rate of return, the USD 40bn APF would have grown to over USD 100bn. The same applies to the AHSTF where total pay-outs since 1976 have reached USD 34bn.

²² While the Reserve Fund may technically be seen as an SWF, the National Wealth Fund’s mission explicitly includes supporting the Russian Federation’s pension system, ‘co-financ[ing] voluntary pension savings of Russian citizens’ and ‘balanc[ing] the budget of the Pension Fund of the Russian Federation’ (see Mission Statements, Ministry of Finance of the Russian Federation). Based on its explicit pension obligations, it therefore does not qualify as an SWF and consequently has not been included in this analysis.

²³ The asset base of the funds is mainly a function of the size of inflows, withdrawal arrangements and age of the funds. Aizenman and Glick have made an interesting attempt at analysing and isolating potential factors (mostly country governance- and transparency-related) explaining the size of the funds. They find that better national governance is associated with larger fund sizes (Aizenman and Glick 2008, 17pp). However, the ‘chicken and egg’ question of cause and effect remains unanswered.

in Africa and in Asia, with one potential fund being discussed in (South) America. The chart on potential asset sources reveals that in line with the existing funds, most new funds are driven by either resource revenues or foreign exchange reserves while direct government contributions and privatizations make up the remainder.

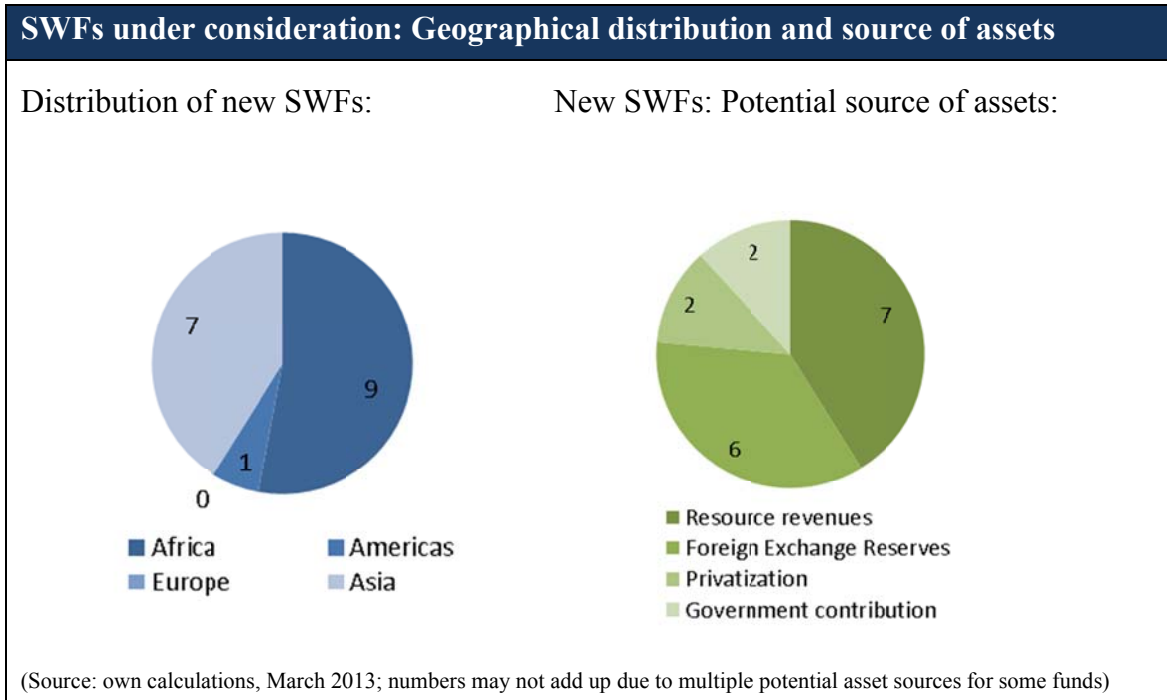


Figure 7: SWFs under consideration: Geographical distribution and source of assets

2.3.3 Analytical categorizations

The last sub-chapter showed that the different waves of SWF establishment were significantly influenced by macroeconomic factors such as commodity prices and trade imbalances. At the fund level, the source of SWF assets has a considerable impact on objectives and mandates of the fund which, in combination with the withdrawal rules, significantly determine the strategic asset allocation (SAA) and investment styles (IMF 2007; Fernandez and Eschweiler 2008, 7; Das, Mazarei, and van der Hoorn 2010, 137pp). Politico-economic considerations and past research suggest, for example, that commodities-based funds tend to have macro-stabilization objectives which likely result in an SAA favouring more liquidity and shorter investment horizons than sovereign funds aimed at intergenerational saving. While analytical categorizations can be made with a reasonable degree of precision, this sub-chapter shows that in the worst case, multiple objectives can lead to clashing SAAs.

2.3.3.1 Sources of funds

Today's sovereign funds are seen to have three main types of asset sources (instead of many, see Fernandez and Eschweiler 2008, 4pp) which – with partial exception of transfers from fiscal sources – predominately accrue in foreign currency:

- Proceeds from the sale of natural resources
- Excess foreign exchange reserves
- Fiscal/government transfers

Proceeds from the sale of natural resources

In Q1 2013, natural resource revenues were funding around 37 of the 52 existing SWFs and are expected to play a major role in about half of the planned sovereign funds. Most SWF natural resource revenues derive from the sale of hydrocarbons (30 oil and gas-based funds) while the remainder of the funds is financed from other commodities ranging from phosphate (Kiribati and Nauru, two of the oldest funds) to a wide mix including hydrocarbons, metals and minerals (Papua New Guinea, Canada and Kazakhstan)²⁴. Of USD 3434bn total SWF AuM, resource-driven funds account for USD 2186bn (up from 1650bn in Q3 2011), with oil and gas funds responsible for 95% of all resource-driven assets.

Funding for commodities-based sovereign funds may accrue directly or indirectly. Truman distinguishes between three ways of converting natural resources into SWF inflows: (1) taxing a natural resource producer which may be domestic or foreign; (2) directing a natural resource producer to deposit a share of its revenues in an SWF; (3) engaging the central bank in foreign exchange purchases which may be partially transferred to the SWF (Truman 2010, 21, Box 2.1). Mirroring the argument about governmental pension funds' liabilities precluding them to be classified as SWFs, Fernandez and Eschweiler consider commodity revenues 'real wealth', given it typically has 'no corresponding liability on the government's balance sheet' (Fernandez and Eschweiler 2008, 4).

Excess foreign exchange reserves

Excess foreign exchange reserves are the second-most important source of SWF funding. With only four funds (CIC, GIC, KIC and Botswana's much smaller Pula Fund) sharing USD 791bn AuM in total as per March 2013 (up from USD 700bn in

²⁴ Count based on the master fund list in Appendix 1.

Q3 2011), FX reserves-financed funds tend to be considerably bigger than natural resources funds. One reason might be that SWFs based on FX reserves generally receive a one-off transfer of a significant part of a country's reserves while commodities-based SWFs would have to be operational over an extended period of time to accrue the same amount in natural resources income (e.g. ADIA, KIA). Generally, these central bank balance sheet transfers have resulted in relatively new SWFs such as KIA and CIC to command over several hundred billion USD in assets within half a decade from their foundation²⁵. However, AuM figures suggest that over the last couple of years, FX-funded SWFs have grown at a much slower pace than their resource-funded cousins. As foreign exchange reserves mostly accrue through sterilization of foreign exchange interventions, analysts consider them to be 'borrowed' wealth (Fernandez and Eschweiler 2008, 5). As the argument goes, borrowed wealth should not be treated as free fiscal resource but invested with 'greater caution and more careful analysis' (Donghyun Park 2007).

Identifying 'excess' foreign reserves requires determining reserve levels necessary to cope with any potential crisis, e.g. in form of liquidity support. The emerging market crises in the 1990 (Asia, Russia, Mexico and others) shifted policy makers' focus from their country's current account to its capital account, in particular in countries with access to international capital market financing. According to Das, Mazarei and van der Hoorn, this promoted the use of the Greenspan-Guidotti rule to assess reserve adequacy (Das, Mazarei, and Van der Hoorn 2010, 17)²⁶. The rule mandates a 100% coverage of short-term external debt, thereby ensuring a country can't be destabilized by a sudden withdrawal of 'hot money'.

However, a high level of excess foreign reserves may not always result in the establishment of an SWF. In its 2010 edited volume on SWFs, the IMF proposes four alternative ways of using reserves (Das, Mazarei, and Van der Hoorn 2010, 18pp). Options one to three include (i) increasing reserve requirement ratios on banks' foreign deposits, (ii) relaxing foreign exchange regulations on residents' foreign investments and accompanying central bank intervention and, last but not least, (iii) paying off

²⁵ The effect would be even more pronounced if this thesis included central bank's 'investment tranches' such as Saudi Arabia's SAMA, the Hong Kong HKMA Investment portfolio or China's SAFE in its SWF definition, all of which are substantially bigger than the average natural resource-financed fund.

²⁶ In what was one of the earliest speeches of a central banker on SWFs, Swiss National Bank president P Hildebrand used the Greenspan-Guidotti rule to calculate countries' reserves and to predict which countries may soon establish a sovereign fund (Hildebrand 2007). In the meantime, out of the countries mentioned in his speech (Brazil, Morocco, India, Japan, Nigeria, Thailand, Taiwan and Poland), all except Morocco and Poland have had vivid domestic political discussions on setting up sovereign funds.

external debt. Option (iv) refers to managing external reserves as part of the central bank's balance sheet, thereby often splitting it in a liquidity- and an investment tranche, with the latter earmarked for a less-liquid, more return-oriented asset allocation (see also S. Jen 2006 for an early account of alternative central bank reserve management). While there is an active debate amongst the SWF analyst community on whether or not these portfolios may constitute sovereign funds (examples are China's SAFE, the HKMA's Investment Portfolio and Saudi Arabia's SAMA), for reasons mentioned earlier, they are not covered by the SWF definition proposed by this thesis.

Fiscal/government transfers

The third major source of SWF assets are contributions out of fiscal surpluses, proceeds from the sale of public assets/privatizations or direct transfers of government-held assets. As per March 2013, this group of funds includes about 11 SWFs with around USD 357bn (slightly up from 350bn AuM in Q3 2011). The three major funds, Singapore's Temasek (USD 157bn), the Australian Future Fund (USD 85.7bn) and Malaysia's Khazanah (USD 39.1bn), account for about four fifths of the assets. Although many funds in this category are considered to be relatively transparent in comparison to many resource-driven funds (see e.g. Linaburg and Maduell 2011), asset valuation in this fund category remains slightly more challenging as the share of illiquid and unquoted assets is higher. According to Temasek's 2012 review, for example, 27% of the Singapore fund's assets are not liquid/listed (Temasek 2012a, 17).

Out of the eleven funds financed by transfers, four funds can be classified as government holding companies (Temasek, Khazanah, Vietnam's SCIC, the UAE's EIA and the Abu Dhabi Investment Council). They have been entrusted with the management of SOEs or government stakes in privatized companies. The Russian Direct Investment Fund – until recently merely a cash shell, but now receiving generous funding – may develop into something similar as it is deploying its funding through private equity-type (PE) deals. Four remaining funds (Australia's Future Fund, Ireland's National Pensions Reserve Fund and the New Zealand Superannuation Fund) are pension reserve funds funded by transfers from government budgets. The youngest addition, the Fondo de Ahorro de Panama, is both a stabilization and savings fund.

2.3.3.2 Policy objectives

As analysts have pointed out, SWFs differ in many characteristics, including their policy objectives²⁷. To add even more complexity, objectives may be ‘multiple, overlapping, or changing over time’ (IMF 2008, 5pp). In Kiribati, for instance, the local sovereign fund has turned from a stabilization vehicle shielding the country from inflationary pressure and swings of resource prices into a return-oriented portfolio investor as phosphate reserves have gradually declined. It can be argued that to various degrees, the Middle Eastern oil funds have experienced a similar transition, constantly adapting their form and function to a changing domestic and international (market) environment (Gordon L. Clark and Monk 2011b). While some funds have multiple objectives, some countries have multiple SWFs with different mandates. Examples include Bahrain, Malaysia and Abu Dhabi which runs as much as four sovereign funds with objectives ranging from classical stabilization- and savings aspects (ADIA) to Mubadala’s development goals. Lastly, at times and for various reasons, funds fail to operationalize and implement their objectives. An example is Nauru, which squandered its phosphate wealth and is now again dependent on international donors (for the story of Nauru’s decline from riches to rags, see Folliet 2010).

Despite the challenge of making sense of multiple and changing objectives partially lost in implementation, there is widespread agreement amongst scholars that SWFs generally serve five major *economic* objectives (IMF 2008, 5; see also Chwioroth 2010, 6pp):

- (Revenue) stabilization
- Inter-generational saving
- Reserve investment
- Contingent pension reserve accumulation
- Development

Stabilization

Funds with a stabilization objective aim at shielding the economy from the volatility of commodity price swings. Most funds based on the proceeds of the sale of natural

²⁷ In line with an influential 2009 paper by IMF staff on the intricacies of setting up a sovereign fund, this thesis proposes the term ‘policy objectives’ to refer to the macroeconomic aims of policy makers. At the SWF level, the policy objectives then get translated into ‘operational objectives’ guiding all operations of the fund (Das et al. 2009).

resources naturally have a stabilization objective (Das et al. 2009, 9). In addition to choosing between present or future consumption, deciding on how to cushion government spending and to avoid an overheating of the domestic economy is one of the two major decisions any resource-producing nation is confronted with (Fasano 2000, 3). In this context, the focus may be either on *fiscal*- or *macroeconomic* stabilization (or a mix of both). Fiscal stabilization relates to smoothing the impact of volatile natural resource revenues on government spending, mostly by building up buffers in times of high natural resource prices. Engaging in macroeconomic stabilization means avoiding inflationary pressure and appreciation of the real exchange rate (Das, Mazarei, and Van der Hoorn 2010, 44pp). The latter carries the danger of economic decline in the non-commodities sector, a situation popularly known as ‘Dutch Disease’ (see box below). Setting up an SWF may considerably contribute to stabilization by establishing clear rules governing the accumulation and withdrawal of resources income. As exemplified by Norway’s GPF, which is fully integrated into the country’s fiscal processes, SWFs are important tools to both balance budgets amidst volatile commodity revenues and to avoid an overheating of the domestic economy by diversifying and directing investments abroad. Other examples of funds with a clear stabilization objective include the KIA and Chile’s Economic and Social Stabilization Fund²⁸.

Resource income, the ‘Dutch Disease’ and the need for prudent management

‘Wealth is not without its advantages and the case to the contrary, although it has often been made, has never proved widely persuasive.’

John Kenneth Galbraith (as cited in The Economist 2012b)

Although Galbraith’s quote sounds persuasive, national wealth comes with some challenges attached, in particular if it derives from natural resources. The basic economics of it were described in an article entitled ‘Booming Sector and De-Industrialisation in a Small Open Economy’ (Corden and Neary 1982). Following an article in the Economist on the negative impact of North Sea gas discoveries on the Dutch economy (The Economist 1977), the economic literature has variably referred to this phenomenon as ‘Dutch Disease’ or more broadly as ‘resource curse’. The theoretical concept describes how income from natural resources (or other windfall income, e.g. foreign aid) weakens a country’s manufacturing- and/or other sectors by

²⁸ For an in-depth review of the literature on commodity stabilization funds, see (Fotak, Bortolotti, and Megginson 2008, 20, Appendix A).

pushing up the exchange rate, thereby making its goods uncompetitive in comparison with other sectors. In addition, natural resource income often leads to crowding-out effects in terms of investments in other sectors, exacerbated by a brain-drain towards the resources sector.

The concept of the Dutch Disease has received strong empirical backing over the years (Gelb 1988; for many, see Davis et al. 2001; Bagattini 2011) and is also reflected in the Santiago Principles which define it as a ‘situation where a boom in a commodity sector of the economy could lead to a loss of competitiveness for other sectors in this economy’ (IWG 2008b, 13). Governmental management of natural resource booms requires dealing with four questions (Reisen 2008, 12 based on other sources): (1) How much to deplete of the natural resource? (2) How much to save of the proceeds? (3) How much to invest at home? (4) How much to invest abroad vs. retiring public debt.

Setting up resource funds, i.e. resource-based sovereign wealth funds, has been identified as one of the main policy measures to combat the effects of the resource curse (Fasano 2000; Ebrahim-zadeh 2003; Truman 2010, 21), including its political effects (weak states, accountability gaps, corruption) (for the latter, see Schwarz 2008). The Santiago Principles mentions the usefulness of SWFs to reach savings objectives (and presumably also sterilization objectives (for more on this, see Castelli and Scacciavillani 2012, 72)). Recent contributions to the literature on Dutch Disease and sovereign wealth funds emphasize that such funds are no panacea for the resource challenge and underline the importance of appropriate design and governance and the need to embed the funds into broader policy packages (Bagattini 2011; and Dixon and Monk 2011 with further sources).

Figure 8: Resource income, ‘Dutch Disease’ and the need for prudent management

Inter-generational saving

According to the literature, (inter-generational) savings objectives are often associated with resources-driven funds (instead of many, see Das et al. 2009, 9). With (a) most resources being finite, (b) revenues arising thereof drying up over some generations, and (c) the costs of exploitation and side effects increasing significantly, sustaining future income is key. An SWF mandated with maintaining inter-generational equity institutionalizes the interests of future generations and operates according to a set of

rules which ensure that present resource income is transformed into future financial cash flows (Das et al. 2009, 10). In addition to clear rules on withdrawals for fiscal purposes, they may also include guidelines for a long-term oriented SAA which often favour investment diversification abroad. Yet safeguarding wealth over generations is not limited to resource-driven funds alone: excess foreign exchange reserves may also dwindle over time as terms of trade are worsening. And inter-generational considerations are even more prevalent when it comes to preserving one-off windfall income from privatizations or administrating government holding companies made up of national wealth accumulated over generations. While most SWFs have an (inter-generational) savings aspect, the most important savings funds are ADIA, the QIA, Temasek and again the GPF-G.

Reserve investment

The objective behind reserve investment funds is to increase financial returns on a country's 'excess' foreign exchange reserves whilst taking into account their 'borrowed wealth' characteristics (see above). In theory, also resource-driven sovereign funds can have reserve investment objectives, although these objectives are predominately associated with pure excess reserve-financed funds receiving a one-off transfer from the central bank's balance sheet. One notable exception is Botswana's Pula Fund which remains on the central bank's balance sheet yet enjoys a robust ring-fencing of its assets. Other funds such as CIC, GIC or KIC are fully independent from the central bank's books and independently seek returns beyond those of a standard central bank portfolio. Generally, this usually results in taking on more risk than what would be permissible for a central bank which is operating solely under liquidity considerations.

Contingent pension reserve accumulation

Aiming at providing for 'contingent unspecified pension liabilities from sources other than individual pension contributions' (Das, Mazarei, and Van der Hoorn 2010, 46), sovereign funds mandated with pension reserve accumulation mirror the assumptions about a nation's future pension shortfall. Funds with a pension reserve mandate include Australia's Future Fund, Ireland's National Pensions Reserve Fund and Norway's GPF-G – mostly funds from mature economies, as a matter of fact, where demographic pressure is mounting²⁹. Although the funds do not have explicit pension liabilities, they usually are given a clear return target derived from statistical

²⁹ For a more in-depth discussion of so-called pension reserve funds (PRF), see (Gordon L. Clark and Monk 2011a).

assumptions about when and in which magnitude shortfalls are likely to materialize in the future.

Development

In a bid to strengthen and diversify their respective domestic economies, some sovereign funds have been given development objectives, thereby becoming instruments for direct or indirect domestic investment activity. Although some authors claim to have identified a specific type of ‘sovereign development fund’ (Santiso 2008; Sarkar 2010), requirements inherent to the SWF definition (sizeable investments abroad) suggest that funds fully dedicated to domestic development would not qualify as sovereign wealth funds. However, in addition to their primary policy goals, many funds such as the QIA or the State Oil Fund of the Republic of Azerbaijan (SOFAZ) have additional/secondary development mandates. Analysts have noted that funds with a clear development objective may be ‘somewhat different conceptually, and in the composition of their assets and behaviour’ (Das, Mazarei, and Van der Hoorn 2010, 46). In line with Santiso’s argument that ‘development funds’ may be investing for development both domestically and in developing countries (Santiso 2008, 11), one may interpret sovereign funds’ growing share of investments in emerging markets as further evidence of development objectives becoming more important³⁰.

2.3.3.3 Investment strategy

A fund’s investment strategy is influenced by a plethora of factors, most importantly by the policy objectives the SWF is supposed to achieve. These objectives, in turn, derive from economic variables (such as the sources of the fund) and political preferences (i.e. decisions about present vs. future consumption)³¹. Commodities-based sovereign funds, for example, often have strong stabilization mandates which, in turn, call for long-term, diversified investments abroad. In theory, this provides for steady, non-commodity price-correlated revenue streams and avoids any overheating and/or crowding-out of the domestic economy or some of its sectors.

A sovereign fund’s investment strategy is a decisive part of its operational objectives. In addition to provisions relating to the fund’s governance, operational objectives also include rules for the accumulation and withdrawal of funds (Das et al. 2009, 46pp). In the context of the investment strategy, policymakers decide on a fund’s strategic asset

³⁰ Another, potentially compatible interpretation of growing SWF investment activity at home and in emerging markets may be the fact that both domestic and emerging markets offer higher growth rates, thereby allowing to combine development- and profit maximization objectives.

³¹ For the argument’s sake, this sub-chapter omits discussions on possible institutional setups which are a precursor to all decisions on strategic asset allocation (Das et al. 2009, 4; 13pp)

allocation, including acceptable risks and returns. The graph below provides a stylized account of how economic policy considerations may translate into specific SWF SAAs³².

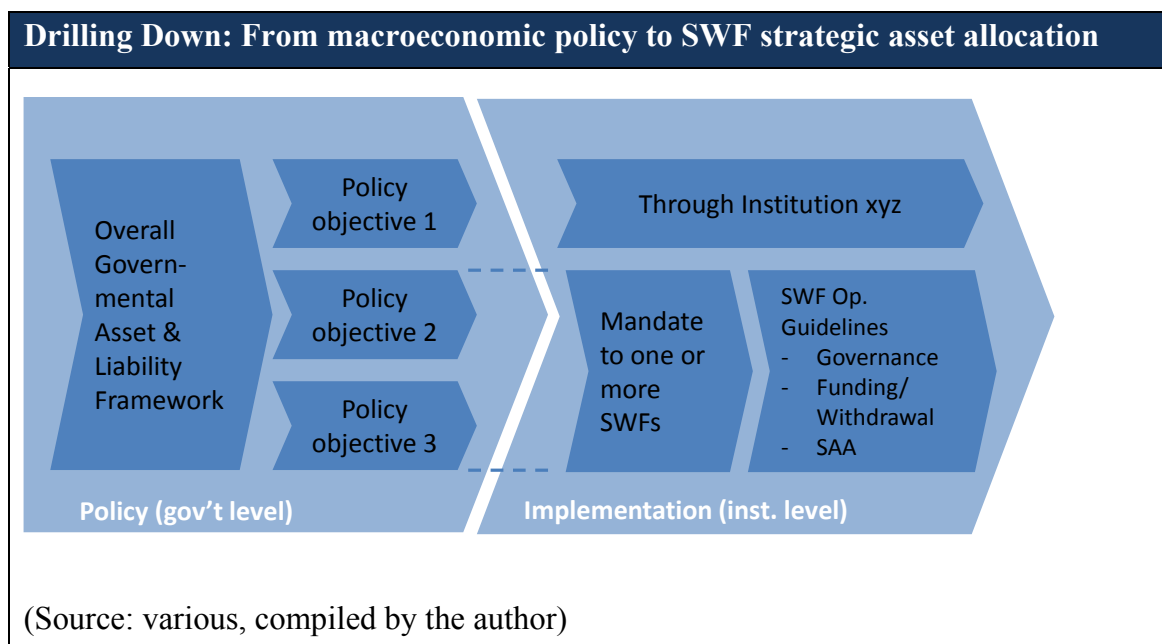


Figure 9: Drilling Down: From macro policy to SWF strategic asset allocation

The study of SWF investment strategies and asset allocations has been a prolific field of inquiry during the past couple of years. Analysts have encountered two main challenges: Firstly, a dearth of information on SWF portfolios, disclosure of which has often been patchy. Secondly, the fact that most funds have multiple and changing policy objectives, which makes any comparison amongst them and with optimal SSAs difficult. Despite the challenges, there is now a sizeable body of literature, both academic and commercial, where three strands can be distinguished:

- *A descriptive strand* shedding light on the funds' portfolio composition with regard to asset classes, geographical and sector distribution. Judging from the standard risk-return diversified portfolio characteristics of most funds, many of the authors conclude that SWFs behave as rational, economically driven investors (Balding 2008; Bortolotti et al. 2010a). This strand of literature also reflects

³² As pointed out by a few interviewees, in an attempt to take account of a nation's wealth in a more holistic way, many countries with more seasoned SWFs have now started to look at national asset and liability accounting/management. Their SWFs would arguably be an important instrument in implementing these frameworks.

-
- considerable public and business interest (in particular asset managers and investment banks) in the relatively new yet rather reserved market participants.
- *An analytical strand* assessing the impact of a wide array of variables on a fund's asset allocation. Authors find that funds often engage in trend chasing and are more likely to invest domestically when politicians have a say in the investment process (S. Bernstein, Lerner, and Schoar 2009; S. Bernstein, Lerner, and Schoar 2013). SWFs have also been found to invest in more 'familiar' asset classes (Chhaochharia and Laeven 2008), with Middle Eastern- and some Asian fund portfolios arguably also driven by 'industrial planning objectives' (Dyck and Morse 2011). A certain degree of home bias of the funds has also been confirmed by research carried out by the OECD Development Centre (Avendano and Santiso 2009). However, the OECD also finds that there are no significant differences between SWFs and other institutional investors when it comes to the factors informing their asset allocation. This also includes political systems of recipient countries, with other institutional investors exhibiting similar appetite to invest in non-democratic regimes. In an attempt to assess the impact of SWFs, a number of authors also focused on the influence SWF investments have on chosen asset classes, investment targets and on markets in general, concluding that due to their long-term commitment, SWFs generally have a positive and stabilizing influence on markets (Beck and Fidora 2008; Sa and Viani 2011). In terms of SWF investment impact on investment targets, however, analysts have been less benign: While share prices initially tend to respond favourably to SWF investment, there is strong evidence for negative abnormal returns for the years following the investment (Fotak, Bortolotti, and Megginson 2008; Chhaochharia and Laeven 2008; Dewenter, Han, and Malatesta 2009; Bortolotti et al. 2010b).
 - *A normative strand* which looks at how different types of funds could optimize their asset allocation under different conditions. This strand of literature (which is often very technical and aimed at asset management professionals) finds for instance that hedging objectives (e.g. against oil price fluctuations) may sometimes warrant a deviation from an optimal market portfolio (Gintschel and Scherer 2008). Based on this work on 'ideal' SAAs for sovereign wealth funds, other authors have looked into ways of assessing the extent of a fund's deviation from a theoretically optimal portfolio (Bertoni and Lugo 2011).

While the literature confirms that by and large, SWFs have behaved as rational investors, there is no doubt that their strategic asset allocation varies due to many

factors. Despite this heterogeneity, however, there have been many fruitful attempts at classifying sovereign funds according to their investment strategy.

Monitor's continuum of government investment vehicles

An early framework developed by Monitor, the management consultancy, conceptualizes SWFs as part of a continuum of government investment agencies defined by two variables, the risk appetite and liquidity needs (Monitor 2008, 14, adapted from Kimmitt 2008). At one end of the continuum, there are central banks managing official reserves in a risk-averse and liquidity-oriented way, while on the other end, there are illiquid SOEs taking entrepreneurial risks. The three different forms of sovereign wealth occupying the middle ground (pension funds, domestic sovereign funds and sovereign wealth funds) are all considered to be SWFs (see below). In this context, pension funds are understood as taking on government's future pension obligations and being funded and denominated in local currency. Domestic sovereign funds are seen as fostering domestic economic development and are funded locally too. Foreign currency-denominated sovereign wealth funds, finally, are considered to exhibit the highest risk tolerance and clear return objectives.

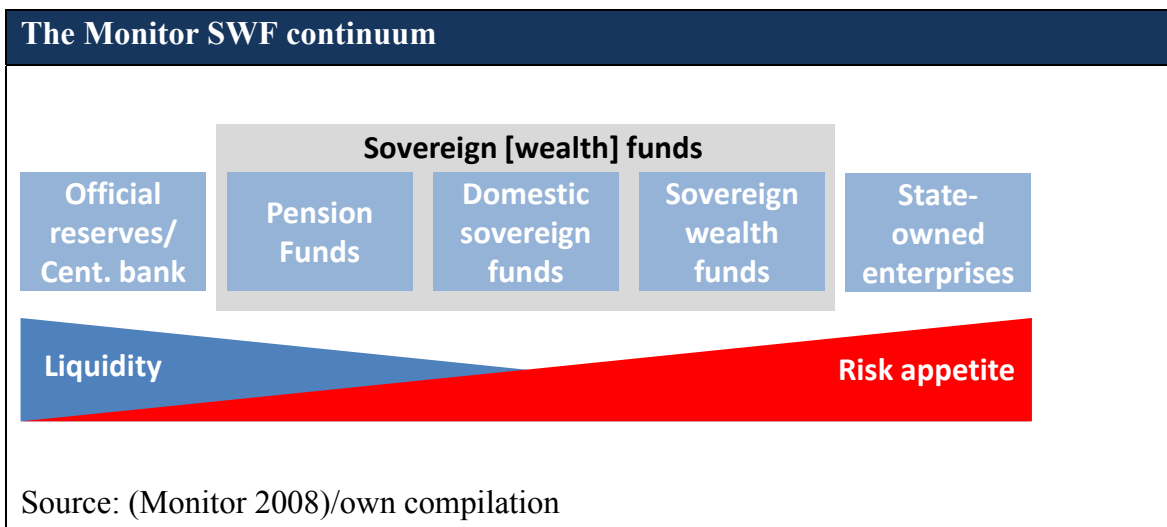


Figure 10: The Monitor SWF continuum

Invesco's SWF investor profile classification

Another framework proposed by Invesco, an investment management firm, classifies sovereign funds according to their primary and secondary objectives (Invesco 2011). SWFs with a primary development objective may have a local or an international

objective. SWFs with an investment objective, on the other hand, may have a diversification or a pure risk/return secondary objective. As a result, SWFs are assigned four distinct profiles (see next figure).

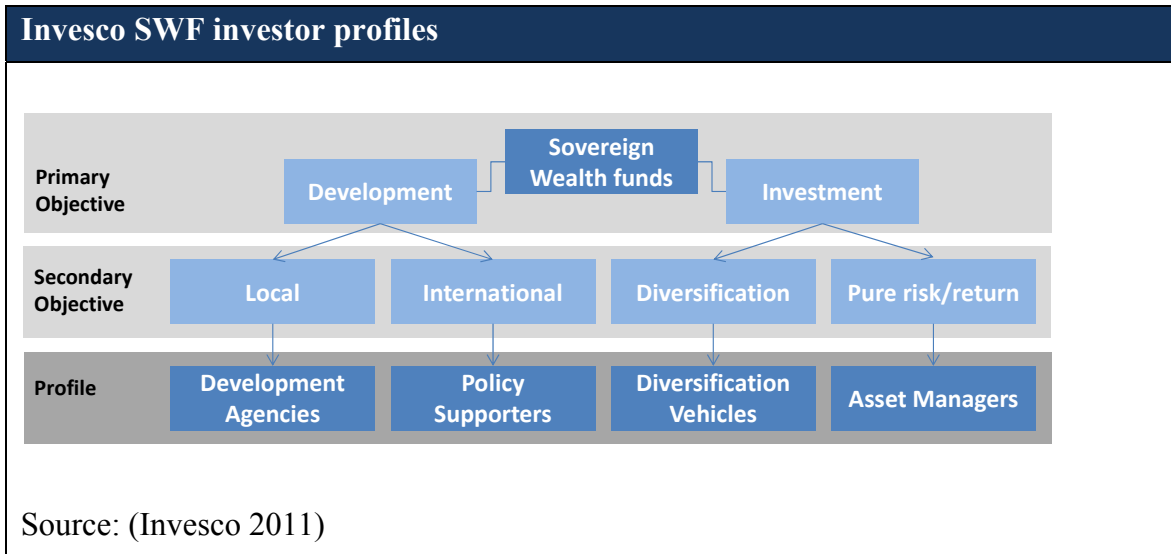


Figure 11: Invesco SWF investor profiles

Invesco also maps SWF portfolios along five of the most commonly used, continuous investment variables (Invesco 2011, 6):

- Time horizon (short – long)
- Risk profile (low – high)
- Product structure (direct – funds)
- Asset allocation (traditional – alternatives)
- Geographic scope (local – international)

This framework provides a structured way to identify commonalities and differences amongst various categories of SWFs which traditionally have been lumped into the same category.

The three SWF investor categories according to the IMF

Both the Monitor and Invesco framework fit considerably well with the three broad categories of SWF investors identified by the IMF (Das, Mazarei, and Van der Hoorn 2010, 7pp):

-
- *Conservative passive investors*: Following a liquidity-oriented, capital preservation investment strategy, conservative passive investors run diversified portfolios mostly invested in fixed-income assets. In terms of Investco's investment variables framework, these funds tend to have a rather short investment horizon, low risk profiles, invest directly into rather traditional asset classes and maintain a globally balanced asset allocation. Most SWFs following reserve investment- or stabilization objectives fall in this category, united by a common need to deploy reserves quickly when imbalances strike. SWFs belonging to this category include the KIA, CIC, GIC and Russia's Reserve Fund. This thesis estimates that around 20% of all SWFs might be classified as conservative passive investors.
 - *Yield-seeking passive investors*: As longer investment horizons allowing for higher risk, these funds maintain a more diversified asset allocation. Typically, a considerable share of assets is parked in equities abroad and the remainder may be allocated to both fixed income and higher-risk alternatives including PE, hedge funds and real estate³³. In order to reduce monitoring costs, such funds would opt for indirect investments through external asset managers or follow index/diversified equity investment strategies. Most yield-seeking passive investors have intergenerational savings and contingent pension reserve objectives allowing them to run more illiquid investment strategies. Funds in this category include the two biggest SWFs, the GPF-G and ADIA, Australia's Future Fund and the Irish National Pensions Reserve Fund. This thesis estimates that more than two thirds of all SWFs may be yield-seeking, passive investors.
 - *Strategic active investors*: This category is the smallest yet most diverse. It ranges from government holding companies such as Temasek and Khazanah, to PE-like investors such as Abu Dhabi's Mubadala and Bahrain's Mumtalakat, to very active investors such as the Qatar Investment Authority. This type of SWF investor usually has some kind of development objective, thereby aiming at investing in international assets which also yield benefits for local economic development. A classic example is the take-over of SR Technics, an aircraft service provider, by a consortium made up of Mubadala, Dubai Aerospace Enterprise and Istithmar. The acquisition was timed well and aimed at further strengthening the UAE as a global air travel- and freight hub. In this context, the

³³ Qatar's QIA was named the second-biggest investor in European real estate, spending EUR 3.5bn in the twelve months up to August 2012. The most high-profile deals included the London 2012 Olympics athletes' village and a shopping mall on the Champs Elysees (Arabian Business 2012).

‘active’ investor designation usually refers to these funds seeking either substantial stakes in companies and/or representation in the form of board memberships. While strategic active investors generally take on entrepreneurial risk with their significant direct stakes in companies, their asset allocation is rather traditional and more often than not geared towards their home markets. Around 15% of SWFs are considered to be strategic active investors.

2.3.4 Interpretative categorizations

In addition to categorizing sovereign funds according to descriptive and analytical categorizations, the literature has gone one step further by looking at the purposes SWFs serve beyond their economic objectives. While appreciating sovereign funds’ progress in disclosing their mission statements, many scholars have remained sceptical about self-reported SWF goals and objectives (for many, see Hatton and Pistor 2011, 5). Most of these alternative attempts at analysing alternative overarching objectives remain somehow speculative, predominately due to lack of empirically testable hypotheses. As they tend to rely on expert interpretations of how the funds benefit their sponsors beyond stabilization-, savings-, investment-, pension- and development objectives, this thesis will use the term ‘interpretative categorizations’. It highlights the fact that this sub-field of study is still in its infancy and has yet to be formalized. Time will tell if these ‘macro-objectives’ envisaged by SWF sponsors will come to fruition. For the time being, the literature seems to have identified at least three overarching objectives:

2.3.4.1 SWFs as symbols of modernity

As mentioned earlier, SWFs do not emerge on their own but are the result of a conscious policy choice, either by democratic institutions/processes or the ruling elite. Building on political economy considerations, in particular with regard to the ‘Dutch Disease’, Clark and Monk argue that setting up an SWF amounts to breaking with inherited institutions and symbolically committing to a ‘modern’ way of managing state assets (Gordon L. Clark and Monk 2011b, 6). This holds particularly true for countries which have experienced a sudden influx of wealth without having had the chance and/or being unwilling to adapt their social structures. The Gulf States (and many North African countries with an SWF) may be a good example of this theory. In this sense, so Clark and Monk, ‘the adoption of a SWF may be used to demonstrate to the local populace a commitment to a ‘new’ path for the nation: integration into the global economy and modernity’ (Gordon L. Clark and Monk 2011b, 10).

2.3.4.2 *Preserving autonomy and independence*

While economic integration by virtue of an SWF might have had some appeal, the Asian crisis of the late-1990s and even more the global financial crisis of 2008 drew attention to another unofficial objective of SWFs: preserving the sponsor's autonomy and independence. Perhaps the most prominent example was the Kuwait Investment Authority whose overseas investments enabled the Kuwaiti exile government to finance resistance and reconstruction during and after the occupation by Iraq (Behrendt and Helou 2010, 4). In an article on Singapore's GIC, it has been argued that the fund has acted as an insurer of last resort, essentially 'underwriting national welfare' by shielding the city-state from the vagaries of international economic turmoil (Gordon L. Clark and Monk 2009a; similarly Yeung 2011). Raymond provides further evidence for an investor/lender of last resort role for SWFs by looking at both stock market interventions and lending operations executed by the Kuwaiti-, Qatari-, Saudi Arabian- and Singapore funds respectively (Raymond 2011). Hatton and Pistor advance a very similar argument by portraying SWFs as an instrument used by ruling elites to secure their autonomy at the international level and to 'hedge against unexpected turmoil' at home (Hatton and Pistor 2011, 2)³⁴. They distinguish between four different ways elites are using SWFs to ensure independence: (i) paying off domestic adversaries³⁵, (ii) shielding the economy against volatility with the aim to mitigate public dissatisfaction, (iii) indicating to foreign partners the willingness to cooperate, and (iv) increasing 'legitimacy in the global arena by presenting governance structures familiar to the West'. Taking up various thoughts from an evolving field of literature on the role SWFs play in their sponsors' sovereignty, Dixon and Monk developed a typology of SWFs which distinguishes four types of funds (categories not mutually exclusive) (Dixon and Monk 2012):

- *Postcolonial SWFs*, which increase the capacity of mostly young and small states to engage with other countries and multinationals on par (by means of investing). The example given by the authors is Timor-Leste's Petroleum fund which is said to have solid ties with other nations through (albeit tiny) holdings of bonds. A more compelling example might be the Kiribati Revenue Equalization Reserve

³⁴ Hatton and Pistor also engage in a discussion about whether SWFs may be instruments of a new mercantilism (see e.g. Gelpern 2010, 20 for further sources). They reject the argument, also because of widespread SWF investments into Western financial institutions during 2008/2009 which had little benefit for their domestic economies.

³⁵ By the same token, SWFs may be used to support favourite factions in order to ensure they don't turn against the government. For instance, it is very likely that before Gadhafi's fall, Libyan Investment Authority funds were used for such purposes. Oman has also been seen as increasing domestic investment to 'soothe social discontent' (Bloomberg 2013).

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- Fund and the Kuwait Investment Authority which were both set up by colonial Britain to prepare the colonies for independence (and arguably to avoid any future liabilities for Britain).
- *Rentier SWFs*: Rentier states are defined as countries with a substantial accrual of external rents (i.e. mostly from resources), where taxation of the population is often non-existent or at very low levels. As a result, government accountability (which is usually linked to taxation) is very low, affording government much more independence. In such a setup, SWFs serve as a buffer to maintain government autonomy when resource rents decline. Dixon and Monk consider the SWFs of Brunei, Kuwait and most African SWFs to be rentier funds. The Irish NPRF may also fall into this category (see case study).
 - *Productivist SWFs* are those funds which strengthen a country’s position in complex global production networks by strategically investing for the benefit of the domestic economy. According to Dixon and Monk, these SWFs are amongst the most contentious due to their strategic investment activity. Examples cited include China’s CIC, but may also extend to Mubadala and Temasek.
 - *Territorialist SWFs*: Similarly to productivist SWFs, their territorial cousins aim at ‘developing and ensuring the continued dominance of local assets within broader global networks of production, R&D and distribution’ (Dixon and Monk 2012, 21). In contrast to productivist SWFs, territorialist SWFs are focused on propping up competitiveness of domestic firms. Examples include the French Fond stratégique d’investissement and the Italian Fondo Strategico Italiano³⁶.
 - *Moralist SWFs*, last but not least, are funds which help (mostly developed country) governments cope with intergenerational-, demographic- and other challenges such as environmental degradation, which may pose a threat to domestic sovereignty in the long run. An obvious example is Norway’s GPF, but also Alaska’s APF.

From a political economy point of view, it can be argued that maintaining sovereignty and independence may not be an objective on its own but rather serves to support ruling elites’ legitimacy. Gelpert supports this argument by pointing out the symbolic value of SWFs to their home constituents/stakeholders and the dangers for

³⁶ Following a narrow interpretation of the criteria laid out in chapter 2.2.3 of this thesis, both the French and the Italian fund are not considered SWFs as they neither operate independently from the government nor hold significant international investments. However, they may be considered SWFs in the wider sense of the term, i.e. governmental funds with a particular macroeconomic purpose.

governments if the funds lose money or have to make concessions to recipient countries (Gelpern 2010, 20).

2.3.4.3 SWFs as providers of governmental legitimacy

The above leads to the insight that ultimately, SWFs have been important contributors to governmental legitimacy – both vis-à-vis the citizens of the SWF home country as well as in relation to foreign governments³⁷. At the domestic level, citizens are more likely to support government decisions of diverting state assets into a sovereign fund if they can feel an impact beyond vague arguments of ‘intergenerational justice’ and ‘rainy day savings’. One way to do so is to have citizens participate in fund performance. For instance, the Alaska Permanent Fund (APF) pays out a yearly dividend to all Alaskan residents (for the most extensive treatise on the Alaska permanent fund dividend so far, see Widerquist and Howard 2012). Another way of ensuring legitimacy is practiced in Norway, where the GPF’s social and environmental investment rules represent and project Norwegian ethical convictions beyond borders.

SWFs also play a part in legitimizing governments vis-à-vis other governments. Chwioroth’s suggestion that SWFs are the result of ‘contingent emulation’ supports this argument. Looking into the proliferation of SWFs in the last decade, he concludes that sovereign funds have been seen as a ‘socially constructed appropriate institutional form or policy for particular countries to emulate’. In his view, the institutionalization of an SWF signals ‘conformity with a peer-group’s standard of behaviour as well as a desire to maintain or enhance esteem, pride, prestige and status’ (Chwioroth 2010, 3; 8pp; similarly Grünenfelder 2008).

³⁷ This is particularly true for smaller countries with disproportionately large SWFs which give them the clout to ‘punch above their weight’ on the international stage. Often cited examples include Qatar, Abu Dhabi and Singapore, all of which have strengthened their position in finance, media/sports/IT and education, medicine and arts well beyond their respective regions.

3 A primer on political risk

Business decision makers, investors and risk managers tend to ignore political risk until it produces a crisis [...].

Ian Bremmer, Preston Keat, *The Fat Tail* (2009)

This chapter sheds light on political risk which has seen renewed interest following the financial crisis and the Arab Spring. While mature – and to a lesser extent emerging – economies are still grappling with the aftershocks of the crisis, governments around the world have reaffirmed their claim to steer the markets with a vengeance. Meanwhile, the Arab Spring has almost singlehandedly brought back geopolitical risk on the investor radar and has had a considerable impact on some of the region’s sovereign wealth funds (e.g. Libya). This chapter delineates the concept of risk from uncertainty and presents a picture of the diverse risk landscape today’s market participants are dealing with, before zooming in on political risk theories and classical definitions. Guided by strong evidence that political risk is changing, this chapter identifies some weaknesses of traditional political risk definitions. Taking into account new actors, issues and institutions affecting the very nature of political risk, the chapter closes with a definition suitable for an interconnected, post-modern world.

3.1 Market participants and risk

3.1.1 Uncertainty, probability and risk

Risk is a rather elusive term which has long enthralled great minds ranging from philosophy to mathematics and finance and has produced a vast body of literature. A perennial challenge with regard to capturing the meaning of the term ‘risk’ has been the fact that in everyday language, risk is intermingled with notions of uncertainty and probability. In his opus magnum ‘Risk, Uncertainty and Profit’, Chicago-trained economist Frank Knight made a seminal contribution to disentangling risk from uncertainty (Knight 1921). For Knight, ‘risk proper’ is a measurable phenomenon which lends itself to the analysis of observable causalities by various statistical means (Jarvis 2011, 299). ‘True uncertainty’, on the other hand, is un-measurable in the sense that the universe of possible outcomes cannot be defined. In his own words (Knight 1921, Pt. 1, Ch. 1, para 26):

[...] Uncertainty must be taken in a sense radically distinct from the familiar notion of Risk, from which it has never been properly separated. The term "risk,"

as loosely used in everyday speech and in economic discussion, really covers two things which, functionally at least, in their causal relations to the phenomena of economic organization, are categorically different. [...] The essential fact is that "risk" means in some cases a quantity susceptible of measurement, while at other times it is something distinctly not of this character; [...] It will appear that a measurable uncertainty, or "risk" proper, as we shall use the term, is so far different from an unmeasurable one that it is not in effect an uncertainty at all. We shall accordingly restrict the term "uncertainty" to cases of the non-quantitative type.

In the Knightian framework, measurement refers to a probability analysis of a particular event. Knight distinguishes between three types of probability (Jarvis 2011, 302pp):

- *A priori probability*, referring to instances where there is a defined universe of outcomes. An example would be the casino game Roulette where the ball has a 1 in 37 chance of landing on a particular number.
- *Statistical probability*, where possible outcomes are derived in an empirical way by classifying past (or experimental) events/instances and tabulating their frequency in order to obtain a feeling for the probability of such events. As Jarvis notes, this type of probability is very common in the insurance industry (think probability of fire, burglaries; life expectancy in life insurance, etc.).
- *Estimated probability*, describing a situation where the universe of outcomes cannot be defined. Reasons for this may include that they are very infrequent (e.g. Bremmer's fat tails and Taleb's black swans) or that the causality between variables and outcomes is too complex. Knight suggests that the only way to make sense of such a 'universe of uncertainty' is to infer, to estimate the likelihood of outcomes.

Risk in a Knightian sense therefore relates to the first two types of probability (a priori- and statistical) while situations with estimated probabilities are referred to as situations of *uncertainty*.

From the point of view of this thesis, following Knight's differentiation would have some important consequences: As Jarvis aptly notes, most real-life situations of interest to economists or political scientists are idiosyncratic, i.e. are likely to have

estimated probabilities, and therefore resemble situations of uncertainty. This mirrors a famous quote of John Maynard Keynes who said he did not

‘mean merely to distinguish what is known for certain from what is only probable. [...] About these matters [prospect of a European war, interest rate in 20 years], there is no scientific basis on which to form any calculable probability whatever. We simply do not know.’ (John Maynard Keynes 1937, cited in Ferguson 2008, 344).

As a result, any attempt at managing risk from a Knightian point of view would have to rely on estimates and expert guesses rather than on statistical techniques assessing potential risks, thereby being prone to higher error probabilities. Jarvis acknowledges Knight’s seminal contribution to the study of risk, in particular his approach to tabulate ‘risk events associated with [commercial processes and institutions] to produce risk maps in terms of statistical probabilities. In his view, Knight’s framework paves the way for ‘various classifications of risk [...] to be correlated to institutional type of specific institutional features such as accountability mechanisms, transparency, probity, institutional capacity, statutory independence and budget procurement practices’ (Jarvis 2011, 309).

However, Jarvis disagrees with Knight’s conceptualization of uncertainty as a ‘kind of a monolith’ which eludes any attempt at analysing and managing it from a company perspective. To the contrary, he cites (i) increasing institutionalization of international trade, (ii) the strengthened codification of investor rights, and (iii) the emergence of the regulatory state as factors contributing to risk becoming increasingly measurable. ‘Uncertainty might thus not be the ‘black hole’ that Knight paints it [...]’ (Jarvis 2011, 308), thereby allowing for active management and mitigation of risk (see chapter 7).

This thesis considers risk encountered by companies to be subject to both statistical and estimated probability. Many outcomes of company actions are frequent and contingent enough to be predicted in a rather accurate way. For example, foreign direct investment in mature industrialized economies by little known entities (e.g. sovereign funds) hailing from emerging markets are reasonably likely to encounter investor-, media- and even parliamentary scrutiny. In case of estimated probability, there is a growing literature on scenario analysis and cognitive techniques which helps assessing ‘the probability that an event will turn into a measurable loss’, as Bremmer and Keat define risk (Bremmer and Keat 2010, 4).

While Bremmer and Keat's definition captures some important aspects, its focus on 'loss' may be too narrow. This thesis favours a more inclusive definition of risk proposed by a strand of the finance/risk management literature. In their work 'Quantitative Risk Management: Concepts, Techniques and Tools', McNeil, Frey and Embrechts define risk in the following way (McNeil, Frey, and Embrechts 2005, 1):

Risk is the likelihood of any event or action that may adversely affect an organization's ability to achieve its objectives and execute its strategies.

Although this definition still focuses on 'adverse' results only (and thereby neglects the opportunities risk may present), it has some distinct advantages. *First*, it shows that risk is the product of potential impact and probability that such an impact may occur (for many, see Habegger 2008a, 15). These two factors have been extensively used to tabulate risk in heat maps and rank it in order of priority, i.e. focusing on high-impact risks with a high likelihood to materialize (PWC 2008, 6; 30). *Secondly*, the impact is related to an organization's ability to achieve its goals, emphasising that risk impacts on forward-looking corporate activities, thereby affecting the options value of the firm. And *thirdly*, the focus on objectives and strategies underlines the importance of integrating risk considerations (or risk management) into every stage of business planning (PWC 2008, 21pp). It is important to remember that as a probabilistic concept, risk can be constantly mitigated but cannot be made to go away (Bremmer and Keat 2010, 52).

3.1.2 Risk and the company

Risk has been one of the most important driving forces of history and has played an important part in human development. In his book 'Against the Gods', Peter L. Bernstein credits the understanding of risk as helping mankind to free itself from a worldview where they felt to be held at the perils of god, nature and other incomprehensible forces. By developing the tools to analyse and rationally take certain risks, a whole raft of scientific (e.g. statistical studies for drug testing) and engineering (e.g. statics of buildings, bridges, etc.) progress has become possible (P. Bernstein 1998). Similar probabilistic thoughts also lie at the core of risk management and the models used in modern finance (CAPM, Black-Scholes).

The institution of the joint stock company may be considered a risk management device in itself, both for investors and the firm alike: By splitting up and thereby enabling trading of fractional ownership, it has allowed investors to hedge their bets by assembling a risk-adjusted portfolio of companies. From a company perspective, it has

meant being able to spread financial risk across a (usually) broad spectrum of investors. However, as emphasized by pioneering theorists of corporate organization Adolf Berle and Gardiner Means, the stock corporation and dispersed shareholdings in particular have also contributed to a separation of ownership and control. Among other things, this has also had a considerable impact on how companies handle risk: Unlike in a firm with a single owner (e.g. a SWF, as shall be shown later on) who has an incentive to monitor his own company's risk, the dispersed ultimate owners (principals) of modern companies have delegated risk management to board and management (agents).

Yet the risk discourse does not take place within the company and its shareholders alone. To an increasing extent, various categories of risk have to be quantified and communicated to regulators and supervisors and made public for the benefit of a broader audience. These developments apply across sectors, but have been most pronounced in the financial industry where a series of corporate malpractice incidents has spawned landmark legislation, ranging from anti-money laundering/anti-corruption to Basel III and Sarbanes-Oxley. This push towards transparency in general and risk matters in particular has also reached sovereign wealth funds, many of which have started to publish high-level annual reports including various risk metrics. Where sovereign wealth funds have adopted corporate governance best practice, risk levels/budgets are even openly debated in parliament (see for example Norway).

3.1.3 An enterprise risk landscape

From a company perspective, risk presents itself in a variety of forms ranging from compliance-, fraud-, market- and supply chain risk to product-, IT and physical risk, with no claim to completeness (see e.g. PWC 2008, 9pp). While some of these risks have internal- and others have external sources, many risks are based on a combination of both. Examples include fraud- or IT risks which may originate from both within the company and from externally.

While various industries may have their own risk classification preferences (e.g. the mining industry focusing on health and safety), the financial services industry traditionally distinguishes between three types of risk: market risk, credit risk and operational risk. Each type of risk requires monitoring different variables and stakeholders the risks may emanate from.

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- *Market risk* refers to ‘the day-to-day potential for an investor to experience losses from fluctuations in securities prices’ (Investopedia 2011) or ‘the risk of losses in on- and off-balance-sheet positions arising from movements in market prices’, as more accurately defined by the Basel Committee in its authoritative documents on bank capital and risk (Basle Committee on Banking Supervision 2006, 157). Market risk itself includes interest rate-, foreign exchange-, equity- and commodity price risk (OECD 2004a). Arguably a case of Knightian statistical probability, market risk is assumed to be distributed almost normally. Market risk is systematic risk which affects the entire market and cannot be diversified away, at least not within one country/market (for an in-depth account on market risk, see Ioannis et al. 2006, 1pp). While the equity risk component is usually driven by aggregate market preferences, interest rate-, foreign exchange- and commodity risks may also be influenced by policy decisions of central banks and governments.
 - *Credit risk* is defined as ‘risk that one party to a financial contract will fail to discharge an obligation and thus cause the other party to incur a financial loss’ (OECD 2004b). Whilst a classic case of Knightian statistical probability (credit risk levels are derived from statistically assessing past credit portfolio determinants), the credit risk distributions is slightly skewed to the right due to the occasional big credit losses. By actively managing credit portfolios, to a large extent credit risk can become unsystematic/idiosyncratic, i.e. diversifiable. From a financial intermediary’s point of view, credit risk may emanate from individuals, private companies or public entities and governments, with decisions of the latter resulting in sovereign risk.
 - *Operational risk*, lastly, is defined as the ‘risk of loss resulting from inadequate or failed internal processes, people and systems or from external events’ (Basle Committee on Banking Supervision 2006, 144)³⁸. As operational risk encompasses risks which do not qualify as market- or credit risks, it is also referred to as ‘residual’ risk. Financial services firms have been analysing and monitoring market- and credit risk for a long time but have only recently refocused on it after a series of corporate trading- and accounting fraud cases in the 1990s (Barings Bank, MCI, Enron). In response to these events and in an attempt to better define,

³⁸ Interestingly, while the Basel Committee includes legal risk (fines, punitive damages issued by regulators and/or supervisors, etc.) in its operational risk definition, it explicitly excludes ‘strategic and reputational risk’.

integrate and manage operational risk, the Basel Committee initiated work on the subject in early 2000, with the first consultative documents issued in 2001/2003.

While political risk is often subsumed under operational risk, it is important to understand that all three classic risk types can be driven by political factors. Interest rate- and foreign exchange risk, for example, are more often than not shaped by political decisions, as are commodity price risks. For an example on the latter, consider the 2009/2010 decision of the Chinese government to restrict export quotas of rare earths which significantly drove up prices and resulted in international trade arbitration (Reuters 2010c). Credit risk may also be influenced by political factors, with the 2011 European debt crisis acting as a telling example of how politics interferes with Eurozone bond values. Political risk is therefore best understood as a horizontal, cross-sectional risk category (for a similar thought, see Kobrak, Hansen, and Kopper 2004, 4) which can manifest itself in the form of market-, credit- or (most often) operational risk.

Also, all three types of risks are highly correlated, as shown by the financial crisis of 2008/2009 when market risk resulted in impaired collateral and, ultimately, in a high level of operational risks in the wake of the Lehman bankruptcy. Therefore, risk management processes at the firm level must be fully integrated, with political risk understood as an important cross-sectional source of risk potentially affecting the whole company. Although post-financial crisis re-regulation and the Arab Spring have brought about a new awareness for regulatory- and (macro-)political risk, corporate decision makers have long neglected political risk. As opposed to supervisory obligations dictating the measurement of market-, credit- and increasingly operational risk, companies have had no legal obligation to monitor political risk (Bremmer and Keat 2010, 3). According to Bremmer and Keat, political risk has also been viewed as too complex and therefore too difficult to measure and manage.

This is compounded by the emergence of a series of similar terms clouding the concept of political risk. The most important examples are ‘non-financial risk’ and ‘reputational risk’. While *non-financial risk* is a useful term in the sense that it clarifies that there is another category of risk beyond balance sheet- and P&L related risks, it is too broad to be operationalized beyond serving as a mere catchall. And although instinctively, there is little doubt that political risk is part of the non-financial risk continuum, some manifestations of political risk (e.g. protectionist taxation, expropriation or regulatory risk, to name but a few) do have a direct financial impact,

rendering the term ‘non-financial risk’ imprecise and insufficiently helpful for scientific analysis. The term ‘*reputational risk*’, on the other hand, has had more scientific backing, with a dedicated literature evolving around it. It describes various risks impacting on reputational capital first and only indirectly on the financial bottom-line (Fombrun, Gardberg, and Barnett 2002, 86). Reputational risk does not equate nor is it a subset of political risk: First of all, the emphasis of political risk is on the *cause* of certain non-financial risks while reputational risk focuses on the *consequences*, i.e. the loss of reputational capital (Denk 2003, 132pp). It is not a subset because there are many other factors which can have an impact on reputation. Just consider hygienic problems impacting on a food manufacturer’s reputation or – to take a recent example – ATM software bugs and a resulting week-long payments and withdrawal freeze severely impacting the Royal Bank of Scotland’s reputation (for the RBS incident and some more examples, see The Independent 2012). Losing reputational capital, however, may increase a company’s vulnerability to political risk and may therefore be an integral part of any political risk discussion.

Following an introduction to risk in general and in financial services firms in particular, the next sub-chapter will shed some more light on the amorphous yet impactful nature of political risk.

3.2 Enters political risk

3.2.1 Political risk in historical context

According to historians Kobrak and Hansen, ‘[...] political risk is a concept that suffers from its lack of historical treatment’. They aptly cite a widely held opinion during the boom of the 1990s that political risk is an ‘aberration of a more primitive economic paradigm’ and has no relevance in the New Economy (Kobrak, Hansen, and Kopper 2004, 4pp). Whilst the claim of a diminishing importance of political risk might be a bit of a stretch given the return of sovereign- and geopolitical risk and the widespread expectations of increasing government involvement (for many, see McKinsey Global Institute 2010; Euromoney 2011a), a look back into history reveals that political risk is indeed a reflection of the respective prevailing economic paradigm.

Understood as the probability that political action affects business, political risk is a rather young term, probably only dating back to the early 20th century (Kobrak,

Hansen, and Kopper 2004, 4). The concept of risks to trade and private property associated with governmental interference, however, has been around for much longer. In the 18th century, philosopher David Hume wrote about the ‘jealousy of trade’ and deplored trading nations’ hostile stance towards each other. Hume was well aware that war and trade followed different logics, with the former adopting a winner-takes-it-all paradigm and the latter being based on reciprocity. However, he concluded that states had become jealous commercial ‘gladiators’ pursuing international trade as ‘a matter of the military and political survival of nations’, with the logic of trade slowly succumbing to the logic of war (Hont 2005, 5pp).

Hume’s remarks mirror the rise of the mercantilist state which reached its apex in Elizabethan Britain and Colbertian France in the early/mid-17th century. According to Hume, politics had interfered very little with trade until the Renaissance. As Kobrin notes in his brilliant analysis of the ‘sovereignty at bay’ literature, it was the Peace of Westphalia in 1648 which brought about the ‘territorialization of politics’ and the birth of the modern nation state (Kobrin 2001, 3pp). Mercantilist politicians, economists and philosophers aimed at maximising national sovereignty and autonomy by controlling trade in general and foreign trade in particular. The strengthened, post-Westphalian state significantly weakened individual property rights, thereby exposing economic actors ‘to the vagaries of risk [arising] from communitarian-based social, political and economic orders’ (Jarvis and Griffith 2008, 7).

Adam Smith’s seminal treatise ‘The Wealth of Nations’, published in 1776, provided a harsh critique of mercantilism and paved the way for further freeing up trade and investment from interference by the state. In the UK, the most powerful economy at the time, this was helped by the re-emergence of the (joint stock) company which – after a century of illegality due to the South Sea Company scam – became legal again in 1824. The independence and the limited liability granted by company statutes encouraged private individuals to invest in companies, thereby providing investment capital for the emerging industrialization.

Following a relatively quiet period characterized by a ‘liberal consensus’ of limited government, free trade and respect for private property, and hence very little political risk (Kobrak, Hansen, and Kopper 2004, 7, 10, 12)³⁹, the 20th century has seen a

³⁹ It is important to note, however, that despite reduced governmental interference at home and abroad, risk arising from (macro-)political events continued to play its part in business. An often cited example (in this

comeback and a subsequent transformation of political risk. During the first half of the century, the two world wars (and their aftermath in Eastern Europe) led to widespread nationalization/expropriation, capital controls and state economic planning. The period following the Second World War was characterized by the re-emergence of multinational enterprise and transnational trading activity which reignited academic and practitioner interest in political and economic determinants of business success.

It is not surprising, therefore, that the earliest systematic academic thinking about political risk dates from the period after the Second World War. Although there is little clarity about the origins of the term ‘political risk’⁴⁰, it has likely emerged as an academic concept as well as a response by practitioners to what Kobrin calls the ‘dramatic expansion of the multinational enterprise’. It gradually started from the 1950s onwards (Kobrin 2001, 2) as U.S.- and later on European free cash flows were invested abroad. As Jarvis and Griffith remark, multinationals increasingly looked for political risk analysis to ‘navigate an often turbulent international environment’ (Jarvis and Griffith 2008, 12pp). Operating under different assumptions and adopting various perspectives, the growing literature on political risk has resulted in a number of distinct strands which will be explored in the next sub-chapter.

3.2.2 Theories of political risk

The literature on political risk is intimately linked to the post-war economic developments multinational corporations and their consultants had to react to. Mirroring real-life challenges, the study of political risk has been influenced by various disciplines, including (but not limited to) management, finance, economics and political science. By introducing new theoretical approaches and methodologies, many of these disciplines have left their mark on the study of political risk. However, the flip side of the coin is that the literature on political risk has remained diverse, if not fragmented, with no clear theory emerging until now. Some even claim it has ‘remain(ed) at the pre-theory stage of its evolution’ (Jarvis and Griffith 2008, 10). The following paragraphs contain a chronological examination of the literature, focusing on the relevant macroeconomic/political context of the time, the main subjects of investigation and the main theory and methods employed by the most pre-eminent authors.

case of political opportunity instead of risk) is banker Nathan Rothschild’s ability to profit from an early warning of Napoleon’s defeat in the battle Waterloo in 1815 (see e.g. Bremmer and Keat 2010, 42)

⁴⁰ While many articles on political risk open include some historical references, historians Kobrak et al. are one of the few authors who had a closer look at the origins of the term (Kobrak, Hansen, and Kopper 2004, 6–7, footnote 7), finding that it first appeared in an article by Franklin Root written in 1968.

The Catalogue School

The early political risk literature was mainly concerned with examining the factors affecting foreign direct investments of multinationals. The increase in investment activity in the 1960s was a result of financial liberalization and relative economic supremacy of the United States⁴¹. As a result of a wave of expropriation and nationalization, mostly motivated by communist/nationalist ideological beliefs (Suez Canal 1956, Cuba 1959, Guatemala 1951), companies (mainly from the US) became interested in what they saw as a new risk of conducting business (Jarvis and Griffith 2008, 8). A series of surveys of international executives in the early 1960s confirmed the importance of political factors for investment decisions yet showed a lack of analytical frameworks and processes for tackling political risk (Basi 1963; Root 1968; National Industrial Conference Board 1969 and others). By focusing on a rudimentary notion of ‘political instability’ and the discussion of uncertainty and risk for a corporate setup, these surveys remained rather descriptive. In an attempt to disentangle political risk from instability, the literature in the early and mid-1970s became more analytic and identified a variety of political risk factors and linked independent and dependent variables of political risk (Robock 1971; Haendel, Meadow, and West 1975; Kobrin 1975; Kobrin 1976; Kobrin 1977). There were also early yet patchy attempts to build theoretical frameworks, e.g. Raymond Vernon’s obsolescing bargain theory on MNCs and host government interaction (Vernon 1971)⁴². Given the early literature’s emphasis on listing potential sources, agents and manifestations of political risk, Jarvis and Griffith labelled it the ‘catalogue school’, reflecting the cumulative knowledge the various authors amassed on non-financial factors affecting business activity (Jarvis and Griffith 2008, 12pp; Simon 1982, 65).

The System-Event School

The 1970s and the 1980s saw a series of divergent economic and political developments which resulted in the political risk literature taking stock of the limits of prior approaches and improving them. In line with modernization theories

⁴¹ For a more in-depth account of the ‘re-emergence of global finance’, see (Eric Helleiner 1996). Important ground work on FDI was done by Stephen Hymer who suggested in his doctoral thesis (written in 1960 yet published only in 1976) that firms’ FDIs were motivated by two factors: the aspiration (i) to control foreign firms in order to reduce competition and (ii) to use the company’s ‘special advantage’ for the benefit of increased returns. This way, Hymer rejected the dominant paradigm of interest rate differentials as the main drivers of foreign investment and popularized the distinction between equity- (direct) and portfolio investments which remains dominant until today and also underpins the following chapters of this thesis (Hymer 1976, 33pp).

⁴² A good explanation is provided by Bremmer and Keat: Companies ‘have little incentive to walk away from the money they have invested and the infrastructure they have built [in foreign markets]. From the position of the corporation, this is an ‘obsolescing bargain’, meaning that its bargaining position becomes weaker as its investment in a country matures and begins to generate profits’ (Bremmer and Keat 2010, 135).

accompanying the de-colonization process, second-generation theories have related political risks to types of political systems and degrees of development (Jarvis and Griffith 2008, 13–15). As reflected in its name, the system-event school has also drawn some inspiration from systems theory, emphasising that firms ‘exist as systems within an environment’ (Kobrin 1979, 70; with a more in-depth view on “organizations and environment” to be found in Kobrin 1982, 9–29). Also, the debt crisis that started in Mexico in 1982 and later spread to Latin America, Africa and Southeast Asia led to more research into sovereign risk and to more quantitative research approaches for political risk in general. Despite adopting a more comprehensive view, second-generation approaches continued to focus almost exclusively on ‘political instability events’ for MNEs, thereby neglecting the political risks inherent in political processes of gradual change (Fitzpatrick 1983, 252pp; Jarvis and Griffith 2008, 15).

Third generation: Method vs. Theory:

With nation states, in particular emerging Asian markets, starting to compete for FDI in the 1980s and classic political risk in rapid decline, political risk analysis experienced a significant re-orientation towards industry- and project-specific perspectives. A series of risk consulting firms⁴³ with proprietary models emerged as ‘grand theories’ of political risk were abandoned in favour of more quantitative approaches following the ‘behavioural revolution’ in political science. In their classification of theoretical progress in analysing political risk, Jarvis and Griffith speak about third-generation approaches ‘abandoning theory for method’, resulting in a plethora of approaches without any dominant stream (Jarvis and Griffith 2008, 18). Using quantitative approaches was helped by the increasing availability of time series data on various manifestations of the dependent variable ‘political risk’ (confiscation, expropriation, capital controls, etc.) and the independent, explanatory variables such as regime type and social and economic indicators. The quantification of political risk also enabled the provision of insurance cover for non-commercial risks through international organizations, such as the Multilateral Investment Guarantee Agency MIGA, as well as by profit-oriented private insurance companies, such as Aon and

⁴³ Amongst others, these consulting outfits include the PRS Group, Business Monitor International, the Eurasia Group and the Control Risk Group, with the latter also offering operational risk protection services. In addition to these specialized political- and country risk consultancies, most classic management consultancies and audit firms such as PWC and Deloitte offer political risk services as part of their enterprise risk management (ERM) practices. For a broad overview of methodologies, see (Simon 1982, 65pp; Erb, Harvey, and Viskanta 1996)

Zurich⁴⁴. The foundation of MIGA in 1988, set up to promote FDI into developing countries, was a direct result of the work on FDI determinants in the 1960s and 1970s and has spawned an FDI/development-oriented strand of literature of its own (in addition to MIGA's most recent annual report Multilateral Investment Guarantee Agency 2011 see e.g. Moran 2001; Moran 2004; Moran and West 2005; Moran, West, and Martin 2008). This strand is primarily concerned with analysing FDI flows and their dependence on various political risk factors whilst promoting the use of political risk insurance to foster investment.

Fourth generation (and the future): A more encompassing concept of political risk

There have been at least three major developments influencing the political risk literature over the last two decades.

- *First*, advances in information technology such as mobile telecommunication and the internet have increased the quality and availability of social and economic data. In response to a series of civil wars in the 1990s (Yugoslavia, Somalia, Sierra Leone, Chechnya and others) and the ensuing humanitarian challenges, there have been on-going attempts by aid departments (e.g. the Canadian Country Indicators for Foreign Policy Project), NGOs (e.g. the International Crisis Group) and others (e.g. Reuters' AlertNet or Foreign Policy's Failed State Index) to identify the causes of such developments (Jarvis and Griffith 2008, 19).
- *Secondly*, the 1992 Rio Summit sharpened companies' awareness of potential environmental- and social precursors of political risk which resulted in a flurry of publications and widespread implementation of sustainability risk management systems. A more encompassing analysis of company stakeholders also resulted in firms beginning to understand their roles as corporate citizens within the wider society.
- *Thirdly*, from a political risk point of view, the financial crisis has seen a return of sovereign risk. As Gillian Tett has noted, following the re-emergence of credit risk in the wake of the Lehman Brothers collapse, market players have rediscovered sovereign risk, extending to both emerging and also established Western democracies (Tett 2011). The European debt crisis, which started in late 2009, has reinforced the importance of taking into account political factors when it comes to investment decisions.

⁴⁴ In a more geopolitical reasoning, Simon sees the Carter administration's reluctance or inability to support the regimes in Nicaragua and Iran as inducing most of the surging demand for private protection/insurance of US business interests in risky countries (Simon 1982, 66).

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- *Fourthly*, the events associated with the Arab Spring have brought to the fore a new wave of geopolitical risk which had been all but forgotten in the 21st century.
 - And *lastly*, in response to a rather turbulent first decade of the century with a considerable number of low probability/high impact risks, there has been an influential strand of literature looking into the ‘black swans’ and ‘fat tails’ of risk distribution, arguing that these (political) risk events are very difficult yet highly rewarding to predict (Taleb 2008; Bremmer and Keat 2010).

3.2.3 Classic definitions of political risk

As one might expect from a multidisciplinary and rather amorphous field of study, the literature has brought forward various definitions of political risk. Reflecting the strands of literature above, early definitions fall into two groups: the first one defining political risk as interference of the state with business operations and the second one describing political risk in terms of events and constraints on firms, e.g. expropriations, instability and other political occurrences (for a good overview, see Kobrin 1982, 33pp). Fitzpatrick distinguishes two more groups of definitions: a strand of literature emphasising political risk as part of a wider environment and another strand which tends to skip any specific definition in favour of acknowledging general risks to international business resulting from the political environment (Fitzpatrick 1983, 249pp). The latter strand, coming up in the late 1970s when there was a gap in definitional activity, took stock of the existing knowledge on political risk and broadened its scope to include occurrences beyond the restriction of property rights.

Looking back on half a century of analysing political risk, it can be postulated that so far, no single dominant theory has emerged. Considering the definitions in figure 15, there are three developments which pervade what has developed into an eclectic field of study:

- *First*, considering the importance of the adjective ‘political’ in political risk, very little has been written to elucidate this term. As one of the few to elaborate on this topic, Kobrin cites political scientist Harold D. Lasswell and others and defines political events as attempts to ‘attain, keep, increase or exercise power [...] to influence authoritative policy’. For Kobrin, the notion of authority is key, as it marks the difference between ‘moral suasion’ used by social or religious movements and the force of the law (Kobrin 1982, 29pp).

- *Secondly*, and related to the observation above, the literature has increasingly moved away from conceptualizing political risk as mere government intervention into MNE operations. As will be shown later on, more recent definitions account for a much broader concept of where political risk originates from (NGOs, for example) and whom it impacts on (also individual investors and in both host- and home countries).
- *Thirdly*, and probably most importantly, the accumulation of political risk cases and more sophisticated statistical analysis have facilitated a gradual shift of political risk from estimated- to statistical probability (See figure 14).

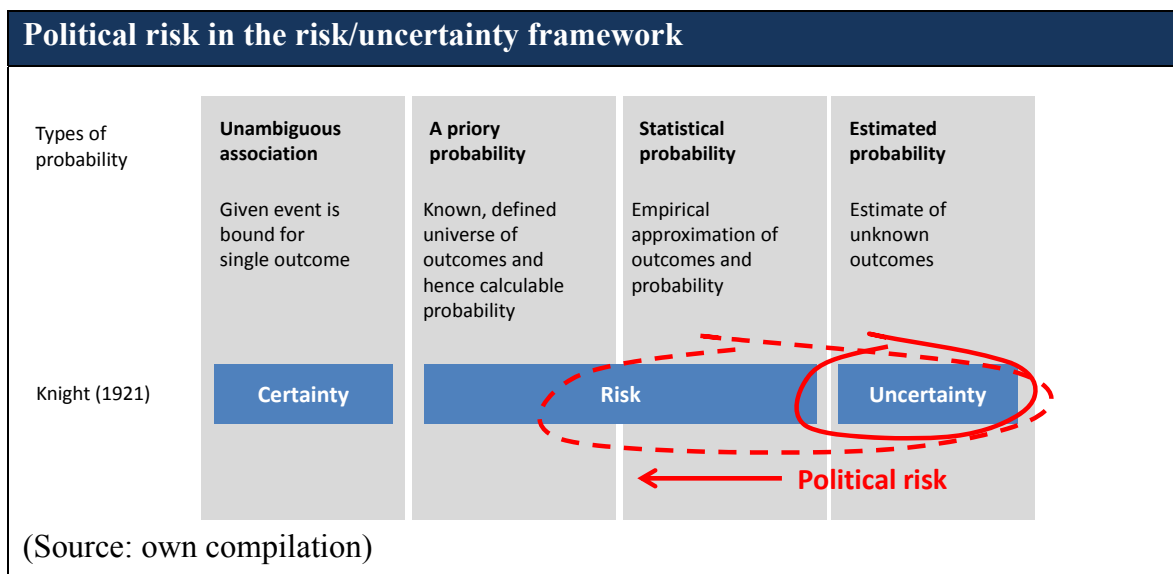


Figure 12: Political risk in the risk/uncertainty framework

Despite recent emphasis on ‘black swans’ and although political risk analysis is set to remain dependent on experts, quantitative techniques have made considerable inroads, dominating certain fields such as sovereign- and insurable political risk in general. Given its complexity, however, political risk is unlikely to become fully quantifiable/stochastic, hence the continuing emphasis on using a wide array of techniques to analyse and capture its variety.

Some definitions of 'political risk'				
Year	Author	Affiliation	Source	Definition of 'political risk'
1971	Stefan H. Robock	Columbia University	Robock (1971)	Political risk in international business exists (1) when discontinuities occur in the business environment, (2) when they are difficult to anticipate and (3) when they result from political change
1972	Franklin R. Root	Wharton School	Root (1972)	The possible occurrence of a political event of any kind [...] that can cause a loss of profit potential and/or assets in an international business operation
1972	J. Fred Weston, Bart W. Sorge	various	Weston and Sorge (1972)	Political risks arise from the actions of national governments which interfere with or prevent business transactions, or change the terms of agreements, or cause the confiscation of wholly or partially foreign owned business property
1975	Haendel et al.	various	Haendel et al. (1975)	The probability of occurrence of some political event(s) that will change the prospects for the profitability of a given investment
1988	José de la Torre, David H. Neckar	University of California/Underwriting agency	de la Torre and Neckar (1988)	The probability distribution that an actual or opportunity loss will occur due to the exposure of foreign affiliates to a set of contingencies that range from the total seizure of corporate assets without compensation to the unprovoked interference of external agents, with or without governmental sanction, with the normal operations and performance expected from the affiliate
2003	Christoph Denk	University of St Gallen	Denk (2003)	Political risks are politically induced, uncertain events which impact on the plans of individuals and organizations
2004	OECD	Int. Organization	OECD (2004c)	The risk of nonpayment on an export contract or project due to action taken by the importer's host government. Such action may include intervention to prevent transfer of payments, cancellation of a license, or events such as war, civil strife, revolution, and other disturbances that prevent the exporter from performing under the supply contract or the buyer from making payment.
2006	PWC/Eurasia Group	Consultancies	PWC and Eurasia Group (2006)	Any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives.
2009	Ian Bremmer, Preston Keat	Eurasia Group	Bremmer and Keat (2009)	Political risk is the probability that a particular political action will produce changes in economic outcomes.
2011	MIGA	World Bank Group	MIGA (2011)	Broadly defined , political risk is the probability of disruption of the operations of multinational enterprises by political forces or events, whether they occur in host countries or result from changes in the international environment. In host countries, political risk is largely determined by uncertainty over the actions not only of governments and political institutions, but also of minority groups such as separatist movements
				More specifically , [political risk is] defined as a breach of contract by governments; adverse regulatory changes by host countries; restrictions on currency transfer and convertibility; expropriation; political violence (war or civil disturbance such as revolution, insurrection, coup d'état, sabotage, and terrorism); and non-honoring of sovereign guarantees

Source: own compilation

Figure 13: Selected definitions of political risk

3.3 Political risk reloaded

Building on the classic definitions above, this sub-chapter considers some new developments which have gradually altered the character of political risk over the past two decades.

3.3.1 Deficiencies of the classic political risk concept

Despite considerable progress in the field, there are latent concerns that the traditional take on political risk has not kept pace with reality. Beyond failing to account for new developments (see next sub-chapter), the classic understanding of political risk exhibits a series of deficiencies which have persisted for some time now and need to be corrected to get an accurate picture of sovereign funds' political risk:

Neglect of political risk in (Western) industrialized economies

Starting off as an offspring of studying non-commercial risks of US FDI in developing countries, until very recently the literature has had a strong tendency to neglect political risk in industrialized economies. Political risk was thought of as residing in emerging markets where 'politics matters as least as much as basic economic fundamentals for the performance of markets' (Bremmer and Keat 2010, 68)⁴⁵. Various authors find that the recent financial crisis and the resulting spike in government intervention in the markets has drawn increasing attention to the heightened political risk levels across mature markets (Failey, Lu, and Wang 2009, 70; Apps 2010; Multilateral Investment Guarantee Agency 2011, 18). This is a particularly relevant point considering that most SWFs come from non-Western economies and have and will continue to invest heavily in Western industrialized countries and their deep and liquid capital markets.

Little awareness of home country political risk

Again as a result of the particular genesis of the literature (United States as 'safe' home country of MNEs), there has been virtually no discussion of home country political risk. Home country stakeholders have long been seen as generally benevolent towards 'their' multinationals – an assumption which may no longer be fully valid, considering shareholder bases of multinational companies are becoming increasingly internationalized, thereby blurring what used to be clear ownership situations.

⁴⁵ Another interesting and congruent definition is provided on the webpage of a Singapore-based risk consultancy which considers emerging markets to be 'markets where institutions are still evolving and/or maturing and business confidence can quickly change' (Purra 2012). The quick change argument ties in well with 'unexpected or difficult to anticipate political action' which is part of the political risk definition proposed by this thesis in chapter 4.2.2.

Moreover, success on the streets of both mature and emerging markets, most notably the Arab world, is empowering populations to ask for more transparency and accountability, generally resulting in more scrutiny of politics, the public administration and the states forays into the economy. Due to public ownership and thus heightened exposure of sovereign funds to the vagaries of these domestic popular pressures, home country political risk has become a powerful force SWFs have to factor into in their strategies.

A fixation on governmental interference/narrow set of stakeholders

Despite the variety of manifestations of political risk mentioned in the literature, most definitions have settled for conceptualizing political risk as some sort of governmental interference. This has resulted in two shortcomings: *First*, as Kobrin argued, it carries the implicit normative assumption that government intervention per se is detrimental to private business (Kobrin 1979, 69). This is a proposition which is hardly tenable when looking at the beneficial effects of government intervention aimed at guaranteeing competition, for example. It also does not fully account for the broad supporting role the state has in today's complex economies (for a similar thought, see Jarvis and Griffith 2008, 12). *Secondly*, conceptualizing political risk as mere governmental interference disregards the crucial role of stakeholders other than governments in damaging market participants' reputation. While 'authoritative' measures such as nationalization of property may have a lasting effect, 'non-authoritative' actions by NGOs or ad-hoc citizens movements impacting on a company's reputation may be equally or even more powerful. The last two decades has seen the emergence of stakeholder-based approaches for political risk which have also enjoyed a wide following amongst corporate practitioners (The origin of the stakeholder approach can be traced back to Freeman 1984; For a modern, structured approach, see Buholzer 1998). While it was interference by the US government which played an important part in bringing SWFs to the fore in 2006⁴⁶, the last couple of years have provided proof that political risk can arise from many other stakeholders. Therefore, a narrow conception of political risk may not adequately reflect the complex environment SWFs are conducting business in.

Lack of granularity at the low politics/micro-political risk level

Although there has been considerable progress in quantifying country-/macro political risk, there has been surprisingly little theorizing at the micro-political risk level, which

⁴⁶ Public interest in SWFs spiked in early 2006 after Dubai Ports World's attempt to take over port management concessions in some major US ports had drawn political cross-fire (see chapter 1.6). Interestingly, neither DP World nor its majority owner, Dubai World, may be classified as sovereign wealth funds.

looks at firm- and sector-specific risk. Jarvis and Griffith credits this lack of analysis to ‘the predominance of high politics’ and thus the focus on macro developments prevalent in 20th century political science (Jarvis and Griffith 2008, 6). Notable exceptions include some work on extractive industries and on joint-ventures with the host government, both of which were found to carry higher political risks (Robock 1971, 10; Simon 1982, 65). Based on Robock’s differentiation of micro- and macro-political risk, other authors have identified a series of firm-specific factors such as the level of technology transfer, the overall size of operations/investments or the governance structure which impact on a firm’s political risk levels (Alon et al. 2006; Alon and Herbert 2009). Both academics and international organizations (mostly multilateral development bodies and banks) currently attempt to sharpen political risk analysis by going ‘one level down’ and assess project-specific political risk. This may harbour significant interest to sovereign funds as they return to engage in more illiquid, project-related investments in emerging markets following an OECD overweight from 2005 – 2009 (Monitor 2011, 22).

3.3.2 The new face of political risk

In order to capture the full breadth of political risk ahead of proposing an encompassing definition, this chapter builds on a widely shared feeling that worldwide economic and political interdependency has considerably increased, rendering ineffective geographical, political, social and ethical borders. New stakeholders and accelerated social and economic developments due to technological changes have resulted in higher degrees of uncertainty (instead of many, see Habegger 2008a, 18pp; World Economic Forum 2011). While companies seized the opportunities of globalization by increasing their division of labour and outsourcing and off-shoring processes, the resulting interdependency has accelerated the transmission of risks and rendered firms more vulnerable to disruptions (Bremmer and Keat 2010, 33pp; Multilateral Investment Guarantee Agency 2011, 19). This sub-chapter attempts to trace recent changes to political risk along four dimensions.

A changing institutional environment

Since the First and in particular the Second World War, the role of the state in the economy has grown significantly. In the United States, for example, government spending has risen from below 10% in 1900 to close to 50% in 2010. Some analysts see the emergence of a new type of ‘state capitalism’ and have declared the end of the free market (Bremmer 2010). While the latter may be premature, it is evident, however, that companies have been significantly affected by this change in their

institutional environment. The ‘regulatory state’ (Glaeser and Shleifer 2003) has been strengthened by the financial crisis of 2008 which has brought unprecedented levels of emergency legislation and state support (Multilateral Investment Guarantee Agency 2011, 18pp)⁴⁷. Although earmarked to being phased out over the years, these measures are seen as having exacerbated the state’s grip on the economy in most Western industrialized countries, with the crisis providing a justification for pre-emptive regulation, in particular in financial services. From a New Institutionalism point of view, this may result in new institutions reflecting politicians’ and the people’s demands for tighter control of the economy. The re-animation of the CIFUS process (Committee on Foreign Investment in the United States) and the introduction of a similar processes in Germany and elsewhere (for a recent overview, see Thatcher 2012) are both examples for what New Institutionalists may call the search for ‘legally sanctioned legitimacy’ (Powell 2007)⁴⁸. Yet these developments have not been limited to industrialized economies alone. As many companies (and in particular sovereign funds) have expanded into emerging markets in search of higher yields, they realized that in these countries, ‘politics will matter at least as much as basic economic fundamentals for the performance of markets’ (Bremmer and Keat 2010, 68). Bar a few exceptions such as Chile, the state generally plays a powerful role in these countries – so powerful that the Economist sees state capitalism as the ‘emerging world’s new model’ (The Economist 2012a). In terms of political risk, the main drawback of state capitalism is a distortion of competition resulting from the state being both regulator and owner of regulated entities which often goes at the expense of foreign competitors.

Rising actors

This process of ‘Glocalisation’, combined with advances in information technology, has given rise to a new class of actors beyond the ‘governmental’ sources of political risk as contained in most classical definitions (for a similar analysis, see Steger 2003, 45pp).

- Arguably the most important new actors are *non-governmental organizations* (NGOs). While NGOs have been around in various forms for a long time (think churches, trade unions or the ICRC as one of the first international NGOs), they only gained prominence after a series of high-profile campaigns in the 1970s and

⁴⁷ Mandated by the G20, OECD and UNCTAD have been monitoring investment policy measures of the G20 since late 2009. Following six detailed, semi-annual reports, they maintain that overall, ‘countries have honoured their commitment to resist protectionism’. Vigilance may still be warranted, however, OECD and UNCTAD conclude.

⁴⁸ For more on legitimacy mechanisms, see chapter 5.1

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- 1980s (Greenpeace campaigns against nuclear testing and whaling, boycott of Nestlé infant milk). Mirroring a growing literature on corporations and their non-market stakeholders, Denk provides an in-depth account of how NGOs have become increasingly professional in their campaigning and have specialized in certain sectors and methods (Denk 2003, 55pp).
- NGOs also increasingly combine forces, organizing and operating as *issue-related NGO umbrella networks*, both domestically and transnationally. Examples include BankTrack and the Cluster Munition Coalition at the transnational level or Alliance Sud at the national level. Modern communication technology (email, social networks) enables these organizations to cheaply and efficiently coalesce and co-ordinate to simultaneously put pressure on corporates in different countries. By making use of local knowledge and mobilizing on the ground, these networks stretch corporate defences and have become very vocal advocates on a wide range of issues. These ‘transnational advocacy networks’, which are defined as ‘bound together by shared values, a common discourse, and dense exchanges of information and services’, have been increasingly able to influence both governments and powerful multinational companies (Keck and Sikkink 1999, 89; Stecklow 2005)⁴⁹. Some of them, for instance BankTrack, have also been actively engaged in the debate surrounding sovereign wealth funds and their role in international finance (Singh 2008).
 - A very recent type of actor includes ad-hoc networks/movements such as ‘Occupy Wall Street’. Analogous to transnational NGO networks, this grassroots movement has attracted a significant following in late 2011 by connecting similar popular demands across borders by leveraging modern technology to create a worldwide community. The Arab Spring movement might be another example of an ad-hoc network pressuring established organizations (in this case governments) across countries on a very specific issue (democratic rights).

Beyond these rather visible non-governmental actors, however, governmental bodies on various levels continue to be considerable sources of political risk.

- Particularly *local and regional interests* have been on the rise, as many multinational corporations have increasingly become aware of (Garver 2009). It emphasizes the fact that expropriation and sudden regulatory change – still important political risks – are increasingly driven by local and regional political

⁴⁹ For an in-depth discussion of the genesis of these networks, the mechanics behind them and the conditions under which they are likely to succeed, see Keck and Sikkink’s main volume (Keck and Sikkink 1998).

- forces (Minor 2003, 19). This is both a result of increasing devolution of central government functions to lower levels and their improved access to information.
- On the flip side of the coin, *supranational bodies and international organizations* have gained importance too – in particular when it comes to sovereign funds. Both the EU and the G8 have been very active during the early days of the policy discussion on SWFs (see chapter 2.1.1). The IMF and the OECD have both been instrumental in drafting self-regulation and codes of conduct in the area of sovereign funds.

Emerging issues

For a long time, the predominant belief was that the ‘business of business is business’, to paraphrase Milton Friedman. Success was measured in terms of profitability, with little attention being paid to other dimensions of corporate activity. The last quarter of a century has seen the emergence of a vivid debate on the role of multinational enterprise (and recently also investors) within society. This debate holds important lessons for sovereign wealth funds too. While prior to World War II, corporations faced relatively little scrutiny with regard to their non-financial performance, today’s ‘corporate citizens’ are expected to take on more encompassing responsibilities – partially (and paradoxically) as a result of their own success in operating across traditional political borders. Based on prior work by Vernon on multinational corporations’ impact on sovereignty, it has been argued that states are gradually losing their regulatory capacity, leaving corporations to step into the vacuum. Consequently, as the argument of the ‘extended view’ of corporate citizenship goes, corporations may ‘assist in the implementation of private, social and political rights’ (for many, see A. G. Scherer, Palazzo, and Baumann 2006, 515 with references), thereby following a ‘triple bottom line’ (Elkington 1998). Corporations may therefore not only comply with existing legislation, but may also auto-regulate themselves and supervise others in areas where governmental reach is limited. A common example includes multinational corporations’ adherence to fair trade- and environmental production standards, including their enforcement in poorly governed regions far away from the company’s end user markets. NGOs and other civil society actors both contribute to setting the rules for and auditing the implementation of these standards of conduct which can extend to human rights, environmental principles and social development goals. The United Nations’ Global Compact initiative, launched in 2000 to ‘align business operations and strategies everywhere with ten universally accepted principles in the areas of human rights, labour, environment and anticorruption’ (UN Global Compact

Office 2011), is a reflection of the wide array of issues corporations have to factor into their strategic and operational business planning⁵⁰. With compliance closely monitored by both governmental and non-governmental actors as well as the public at large, neglecting these issues may result in political risk manifesting itself as public scrutiny or outright hostility. Therefore, observing environmental-, social- and corporate governance (ESG) issues both within the corporation itself and when interacting with clients and other stakeholders has become an important factor in mitigating political risk.

3.3.3 Towards a new definition for SWF political risk

Political risk analysis has come a long way and has developed into an eclectic field of study with different schools and points of views. Recent advances in theory and method have contributed to political risk being perceived in a rather probabilistic than fatalistic way – or in Frank Knight’s words as ‘risk proper’ rather than uncertainty. This perception of political risk as a phenomenon which is (at least partially) assessable and calculable has spurred its integration into enterprise risk frameworks as a risk category cutting across and impacting on market-, credit- and operational risk alike.

The rationale for a new definition revisited

However, the last two decades have also emphasized certain deficiencies of the classic concepts of political risk. With their core dating from the 1970s when developing country government intervention into private property was ripe, these concepts have failed to account for the rise of new non-governmental actors, the emergence of new issues and a changing institutional environment. While lobbying-, stakeholder relations- and corporate citizenship strategies have since filled in the theoretical void and have become a staple of any ambitious company’s advocacy arsenal, much remains to be done to have political risk concepts adequately reflect these new developments.

⁵⁰ For a detailed account of the genesis of the Global Compact, see (Sagafi-nejad, Dunning, and Perlmutter 2008). Tracing back international standards of operations to a general unease about the practices of multinational corporations’ in the 1970, they show how the UN was instrumental in establishing corporate rules of engagement and thereby keeping nations committed to free trade.

4 Political risk of SWFs: A descriptive approach

Following an extensive definition and categorization of SWFs and a thorough discussion of political risk, this chapter broadens the view and sheds light on the phenomenon⁵¹ of political risk faced by sovereign wealth funds. It looks at the public's uneasy relationship with sovereign funds and identifies three clusters of concerns before proposing a stringent definition of SWF political risk based on insights from the previous chapter. Subsequently, this chapter tries to make sense of the variety of political risk manifestations by introducing a typology and drawing attention to three areas of SWF operations that may be impacted by political risk. The chapter concludes by identifying sources of political risk at three levels, domestically, in recipient countries and internationally. While the next chapter aims at conceptualizing political risk within a broader SWF risk framework and adopts a rather analytical view, this chapter is intended to remain descriptive and focuses on observing and describing what – to paraphrase Milan Kundera – often seems an unbearable variety of political risk.

4.1 Beware of the bogeyman: Concerns over sovereign wealth funds

“There is a lot of worry about sovereign wealth funds, but all of them are assumptions, they are not about real cases.”

Badr Al Sa'ad, Managing Director, Kuwait Investment Authority, at the 2008 World Economic Forum annual meeting in Davos

4.1.1 SWF Concerns over time

Concerns about sovereign wealth funds date back to long before the term was popularized in 2005. In 1986, US Secretary of Defence Caspar Weinberger cancelled a contract between the Defence Department and an affiliate of FIAT on the grounds that the Italian company was partially owned by the Libyan sovereign fund (Knill, Lee, and Mauck 2009, 3). In 1988, the British government under Margaret Thatcher voiced concerns about a 21.7% stake in BP by the KIA being used to further Kuwaiti national interests – resulting in KIA being ordered to reduce its stake by half (The Economist 2008a)⁵².

⁵¹ Derived from the Greek ‘phainómenon’ (that which appears), a phenomenon is commonly understood as an ‘observable occurrence’.

⁵² Interestingly, the UK's ‘Golden Share’ rule which was subsequently adopted by various governments around the world, was introduced right after the PB ‘incident’ (Barbary and Bortolotti 2011, 13).

SWFs in the spotlight

Public concerns about sovereign funds are intimately tied to the funds' public exposure. For the first few decades of their existence, SWFs managed to stay below the radar, with only the occasional presence in the public domain. Concerns were therefore uttered sporadically and were not widespread enough to incite professional (i.e. financial sector), let alone public interest. As of 2005-2007, the situation had changed significantly, with at least four factors potentially responsible for heightened public interest in sovereign funds:

- (1) Awareness of global imbalances and reserve accumulation had spilled over from specialist 'epistemic communities' into the mainstream press. The large-scale SWF investments into Western financial services firms during late 2007 and 2008 dragged the funds further into the spotlight⁵³;
- (2) Starting with Rozanov's 2005 article, the common moniker 'sovereign wealth fund' streamlined a subject/discussion fragmented by the use of various different terms (e.g. stabilization-, resource- or commodity rent funds) and refocused attention on SWFs;
- And (3), the discussion as of 2007 has owed much of its dynamism to a few specialized and highly influential blogs (i.e. the now-defunct SWF Radar and Ashby Monk's Oxford SWF Project) and twitter feeds which amplified the reach of specialist research papers and provided inspiration for mainstream media coverage.

The graph below illustrates public interest in SWFs as measured by Google searches and analysed by Google Trends. It shows a high level of activity during the first phase of the financial crisis and another spike in late 2008 when international organisations and the SWF community itself started to react to the publicity. It also shows how public interest in SWFs has emerged and declined in waves, with post-financial crisis attention to SWFs gradually converging to average levels.

⁵³ From the 46 SWF investments made in 2007 and the first quarter of 2008 as surveyed by Beck and Fidora, 25 were in financial services (including investments in exchange platforms). In terms of deal value, financial service investments amounted to USD 65.1bn out of USD 91.5bn total deal value (Beck and Fidora 2008, 11; own calculations). For more insight, see chapter 5.3.2, in particular the references to Bortolotti et al.

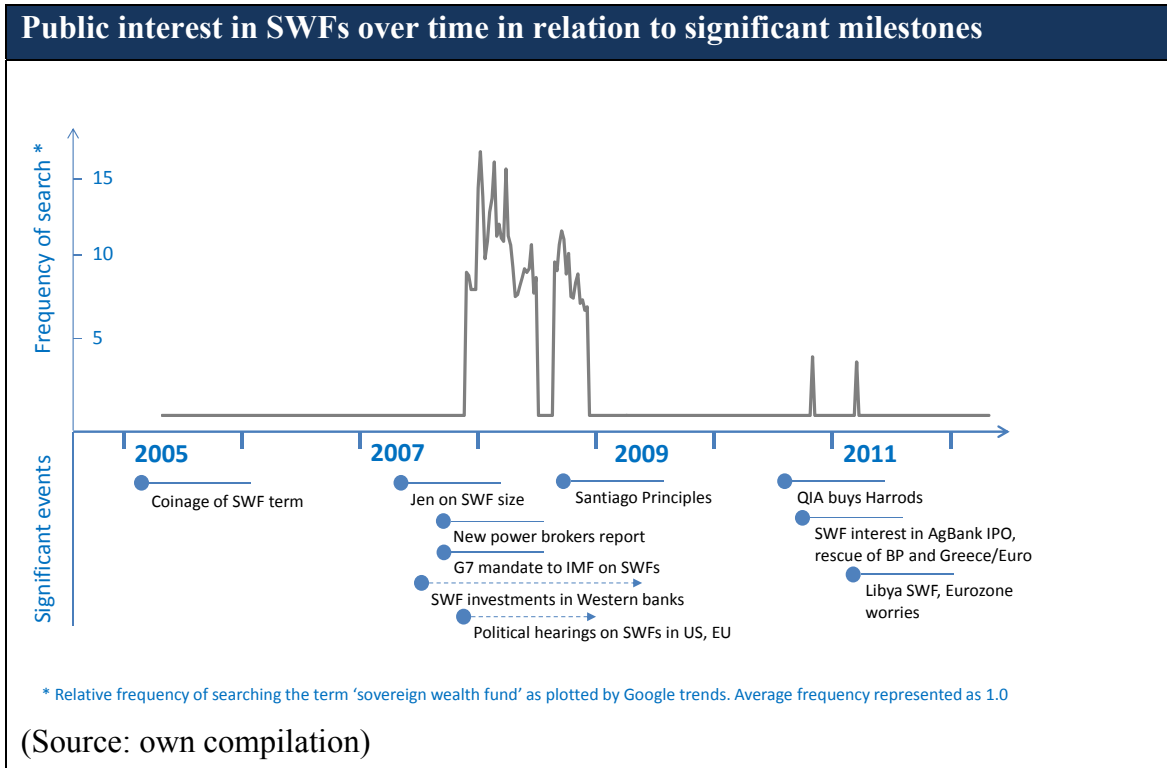


Figure 14: Public interest in SWFs over time in relation to significant milestones

From 'barbarians at the gate' to white knights⁵⁴ – and whither now?

In line with public exposure, concerns about sovereign funds have also changed over time. They generally reflect the predominant fears of their main constituents at particular points in time, with their salience determining the speed and degree of political response and hence political risk for the funds. The controversies surrounding petrodollar recycling in the 1970s and 1980s and the public unease about Japanese takeover activity in the 1980s were an early precursor of today's discussions. They touched upon various familiar topics such as strategic investment, the buy-out of Western economies, and economic nationalism, yet steered well clear of 'naming and shaming' government-backed funds.

Following a relatively quiet period during the 1980s and the 1990s, concerns about sovereign funds started to mount again after the turn of the century as worldwide economic imbalances and raising commodity prices resulted in significant emerging

⁵⁴ The term 'Barbarians at the Gate' derives from a book by Bryan Burrough and John Helyar on the leveraged buyout of RJR Nabisco but has been used extensively by opponents to the private equity and hedge fund industry (Burrough and Helyar 1990).

market official reserve accumulation and surpluses in commodity-exporting countries. With SWFs seen as the main representative of imbalances⁵⁵, concerns amongst Western investors and the public centred in on their independence from home governments and on the funds' financial power as measured by individual and collective assets under management numbers. As remarked by various analysts (Mezzacapo 2009, 27pp, with further references), many of these concerns could be traced back to transparency issues.

Public attention remained high during the financial crisis which peaked in 2008 and 2009. However, there has been a gradual shift in the perception of sovereign funds as they stepped in as lenders of last resort to provide capital to the ailing financial sector in Western industrialized nations (for many, see Kern 2009). With increasing evidence of most funds acting like 'massive, passive and patient' investors (Financial Times 2008a) and the Santiago Principles self-regulation in place and showing the first visible results (2009 has seen a surge in sovereign funds posting their first annual reports), the focus of the media has shifted to reporting on SWFs as another, yet particularly powerful class of institutional investor. While some unease about state-backed investment funds continues to linger, reporting on sovereign funds now largely concentrates on the business side, i.e. their appetite for particular asset classes/geographies and strategies and partnerships, with the occasional story about the often unknown top executives of the funds⁵⁶.

The two graphs below illustrate that shift in media focus: Based on the 12 most relevant articles on "sovereign wealth funds" as proposed by the FT.com search algorithm, IBM Many Eyes visualizes the cumulative article content for the periods of October 2007 to March 2008 and October 2011 to March 2012. Amongst other things, the results show that while in the earlier period, transparency- and governance related questions emerge as an important reporting focus, more recent reporting tends to emphasize market- and investment-related aspects. By comparing the two visualizations, it also becomes apparent that the origins of the funds (as indicated by

⁵⁵ Most stakeholders understand that sovereign wealth funds are an *effect* of global economic imbalances, not a *cause*. However, as imbalances have continued to grow and may become 'structurally entrenched' (for an excellent overview on the global trade challenge, see Magnus 2010, 126pp), SWF investment activity as one of the few visible effects has come under increasing scrutiny.

⁵⁶ In-depth media interviews with or profiles of sovereign fund executives have been rare, with the odd occurrence such as a McKinsey Quarterly interview with Mubadala's COO and a widely commented upon Handelsblatt interview with ADIA's managing director Sheikh Ahmed bin Zayed al-Nahyan attracting even more interest (Achi 2010; Handelsblatt 2010). Sadly, considerable media coverage and subsequent interest in sovereign funds resulted from the death of Sheikh Zayed two month later when he was killed in a holiday accident on March 29, 2010.

However, as this thesis will argue in the next chapter, public and political resentment of SWFs may be cyclical. It not only depends on factors the funds can influence themselves (such as their degree of transparency and their investment behaviour), but also on contextual factors such as the economic climate and – crucially – on peer behaviour. With the heterogeneity of SWFs likely to grow in light of a significant number of new funds, and the global macroeconomic imbalances and the flow of capital from East to West set to continue⁵⁷, a thorough analysis and typology of public concerns is warranted.

4.1.2 Three clusters of concerns

Suppose China, with its \$1.2 trillion in reserves steadily rising from its soaring trade surpluses, begins to invest, through its SWF, in Boeing, Microsoft, IBM, GE and U.S. companies that build our strategic submarines, stealth bombers, satellites and missiles. Will the United States rope off the industries that build the weapons of our national defence from any ownership by SWFs?

Pat Buchanan, US politician (Buchanan 2007)

Many reports on sovereign funds start with touching upon their potential benefits for host countries and the international financial system in general (for an overview, see Keller 2008, 339pp, based on; IMF 2007, 50): SWFs are seen as an important source of capital able to drive down risk premiums and add liquidity to financial markets. Due to their long-term investment horizon and because they usually do not operate with leverage, many consider sovereign funds to be stabilizing and moderating market participants⁵⁸.

Despite the obvious benefits, however, throughout the past decade the arguments against sovereign funds have proven to be remarkably dominant and highly consistent in terms of storyline. Interestingly, much of the concerns have originated from ‘main street’, with ‘Wall Street’ generally emphasizing the advantages of SWFs’ ‘patient capital’ (Truman 2010, 47). A closer look at the academic literature as well as the media yields three broad clusters of concern:

⁵⁷ Gelper traces the imbalances back to the post World War II reorganization of the financial system negotiated upon in Bretton-Woods and calls these imbalances ‘unfinished business’ (Gelper 2010, 11pp) – yet another indication that the spotlight may turn on SWFs again.

⁵⁸ While generally agreeing with SWFs being long-term investors, Castelli and Scacciavillani rightly mention that ‘after all, the long term is a sequence of short terms’. Therefore, they maintain, supervisory bodies ‘would fail to appreciate the argument that in the long run everything will be fine’ when it comes to short-term losses (Castelli and Scacciavillani 2012, 124).

*Concerns about setup and structure*⁵⁹

The first cluster refers to anxieties related to the structure and the corporate governance of the funds. Here, the (imaginary) point of reference adopted by many commentators is best practices lived by other institutional investors of similar size. The most important and yet most basic concern about SWFs is their perceived lack of transparency. Transparency is an overarching concern exacerbating many other reservations about SWFs, also because research suggests that there is a correlation between transparency (as measured by compliance with the Santiago Principles) and the SWF sponsoring country's level of democracy (for the origin of the concept, see Beck and Fidora 2008, 13; later Behrendt 2010). In this context, the Western public and policy makers are concerned about SWFs belonging to countries which do not share Western concepts of democracy, accountability and openness (for many, see Bahgat 2010, 165pp). These insights have resulted in considerable amounts of academic and practical work being dedicated to assessing individual fund transparency. Influential, regularly updated rankings include the Truman scoreboard for SWF best practices (Truman 2008a) and the SWF Forum's Linaburg-Maduell Transparency Index (Linaburg and Maduell 2011).

Concerns about a fund's lack of transparency include that it may enable funds to obfuscate the amount of financial reserves (S. Jen 2006), to take investment decisions based on a political agenda (for many, see Monitor 2008, 21pp) or to act as agents of foreign governments. As the IMF puts it, the lack of publicly available information generally 'makes it difficult to assess the SWFs' asset management activities and their impact on the capital markets' (IMF 2007, 50). Both domestic and recipient country constituencies have also condemned accountability deficits which are often associated with low levels of SWF disclosure. Public scrutiny of funds by their ultimate beneficiaries or by regulators from recipient countries ultimately depends on the timeliness and depth of information made available by the funds.

Other concerns within this cluster relate to corporate governance. With regard to the degree of independence of the funds from their governments, three aspects seem to be prevalent:

⁵⁹ According to Röller and Véron, this type of concern may be called 'microeconomic', referring to them potentially impacting on economic efficiency. Macroeconomic threats/concerns, on the other hand, relate to the funds' potential implications for financial markets in particular and the global economy in general (Röller and Véron 2008, 3).

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- (1) As brought up at an early stage by the former SEC chairman Christopher Cox, sovereign funds have called into question the ‘arm’s-length relationship between government as a regulator and business as the regulated’ (Cox 2007), in particular when governments become market participants.
 - (2) SWFs have also been accused of profiting from access to information and markets which is generally not available to other privately-held institutional asset managers, thereby potentially resulting in a distortion of the competitive landscape (Failey, Lu, and Wang 2009, 73). A related concern has been about SWF shareholders being offered more favourable deals than other shareholders when involved in recapitalizing Western banks (Financial Times 2008b).
 - (3) A third public concern associated both with a lack of transparency and weak governance is corruption. In early 2011, the SEC launched an investigation into potential violations of the US Foreign Corrupt Practices Act (FCPA) by financial institutions dealing with sovereign funds (Wall Street Journal 2011; Bloomberg 2011a)⁶⁰. According to legal experts, SWF representatives might be considered government officials which subjects dealing with them to higher standards of diligence.

Concerns about fund- and investment behaviour

A second category of concerns relates to the funds’ investment behaviour. Here, there seem to be two sub-categories of concerns, relating to investment targets/investment objectives and investment controlling. Firstly, concerns about investments in strategic sectors such as defence, media and utilities have attracted most public and regulatory scrutiny and have been amongst the first and most potent worries the public and politics have taken up. Such investment targets are seen as supporting the argument that sovereign funds invest according to a political agenda. Most commonly, such agendas have been thought to include – with a raising degree of public salience – considerations about access to management know-how, intellectual property/technology (for an early, almost prophetic forecast of SWF investment interests, see S. Jen 2007a, 3) and security of supply with regard to energy (Behrendt and Helou 2010), commodities and/or food, including its production factors (land, water) (The Telegraph 2010). Potential beneficiaries of such investments are seen as including the SWFs themselves, SWF home country governments and also domestic

⁶⁰ The main reasoning behind SWF FCPA concerns seems to arise from the hypothesis that FCPA cases often result from situations where bribes are used to secure access to a scarce commodity (be it information, resources, etc.). A few commentators have linked the financial sector’s need for capital and SWFs being the only providers of it to such situations of scarcity (see e.g. FCPA Blog 2011).

companies profiting from SWFs enhancing their competitive positions vis-à-vis their foreign peers. A related concern has been the worry that an SWF may exploit portfolio companies by ‘imposing goals and priorities not necessarily consistent with maximisation of its portfolio companies’ value’, thereby weakening corporate governance and creating more agency costs (for an empirical analysis of potential agency costs, see Fotak, Bortolotti, and Megginson 2008)⁶¹.

A second sub-category relates to concerns about SWF investment performance and potential mismanagement, mostly voiced by domestic stakeholders which see SWFs as custodian of the people’s assets (see Truman 2010, 36pp with further references). Transactions which came under close domestic public scrutiny include CIC’s investment in Blackstone in 2007 and Temasek’s various financial services investments during the financial crisis, both of which were heavily criticized for being value-destroying (at least in the short-term). A good example for general fund performance-related scrutiny is the variably harsh press reaction to the Norwegian GPF’s quarterly investment reports (Financial Times 2012d). This also owes to the fact that GPF investment reports are very detailed and transparent, with a completely free press and scores of bloggers dissecting them *à volonté* (for an influential example, see Haakon 2011)⁶². Cases of alleged mismanagement have predominately affected funds from failing states or countries with weak governance such as Libya (see Financial Times 2011c for more background on the turbulent past of the LIA) and Nigeria. In both countries, the respective SWFs are under pressure from various factions of society to provide ‘perks’ or to underwrite projects favoured by the ruling elites or negligent politicians.

Concerns about the funds’ macroeconomic implications

With many debates about the advantages and disadvantages of sovereign funds mired in high-level and often theoretical discourse, a third cluster of concerns reflects the fears of SWFs macro implications and their role in the future of capitalism. There have been two dominant strands of thought here, with one strand focussing on SWFs’

⁶¹ Rozanov provides an interesting counter-argument to the widespread strategic/political investment fears by suggesting that there are many other, well accepted financial institutions investing according to policy- rather than purely commercial motives (for more, see chapter 5.2.1). Amongst others, he cites central banks (where profit is very rarely a determining factor) and socially- and environmentally responsible investors in general which also follow non-commercial guidelines (Rozanov 2010b, 13pp).

⁶² Interestingly, this particular blogger is not only influential by position, but also mentions that in order to increase the range of his comments, he would switch from his native Norwegian to English for this particular post. Obviously, it worked as shown by his blog which occupies the number one position when searching for ‘GPF controversy investment performance’.

potential impact on global financial markets and the other strand professing concerns about the funds as agents of a new form of state capitalism.

Historically, one of the major macro concerns about SWFs has been the fear that their investment activity may lead to asset price bubbles and increasing financial market volatility. This may be accentuated by a gradual shift from rather conservative reserve management by central banks to more risk-tolerant SWFs, arguably resulting in higher equity- and more non-USD/emerging market exposure (Nystedt 2010, 213). Most of these concerns have been triggered by a combination of early studies focusing on the size of sovereign funds (for the most impactful ones, see S. Jen 2007a; Farrell et al. 2007) and a jittery financial market environment at the date of publication of the studies. In response to political worries, the IMF looked into these concerns in more detail in its 2007 Financial Stability Report on market turbulence. While some have argued that the financial clout of SWFs combined with unexpected changes in their asset allocation resulting from limited accountability may have the potential to move markets, the IMF did not support these arguments. It cited SWFs' long-term investment horizon as a moderating effect on markets (IMF 2007, 50; similarly Beck and Fidora 2008). An event-study analysis of 166 SWF investment- and divestment transactions across different sectors and markets, which has also taken into account SWFs' varying levels of corporate governance, corroborates these findings: Overall, the study 'did not find any significant destabilizing effect of SWFs on equity markets' (Sun and Hesse 2010, 185). The effect of SWF investment activity on fixed-income- and FX markets remains difficult to assess (due to mostly indirect holdings in these asset classes) yet does not indicate any particular market-moving power (Nystedt 2010, 219).

While the concerns about the funds' systemic impact have somewhat retreated in line with the abating financial crisis, concerns about SWFs allegedly blurring the line between the public and the private sector have become increasingly salient. In Truman's words, this line of thought is 'indicative of more general concerns about the role of governments in international economic and financial matters' (Truman 2010, 35) – a discourse which has increased in intensity following significant government intervention to stave off the financial crisis. In a discourse bordering on the philosophical, SWFs have been seen as if not the source, then at least the harbinger of what has been variously dubbed the 'end of the free market' (Bremmer 2010), a new age of 'state capitalism' (Lyons 2007; Bremmer 2009; *The Economist* 2012a), the new

Middle Ages or ‘neomedievalism’ (Khanna 2009). As Backer notes, there are concerns that SWFs ‘will subvert the private element of the global economic order’ (Backer 2010, 59). At the core, these concepts unite widespread concerns about the emergence of an alternative form of capitalism in the East and the potential effects thereof on Western industrialized nations. With the standing of emerging market governments improving both locally and abroad, the ‘Washington Consensus’⁶³ is being increasingly challenged by a ‘Beijing Consensus’ which emphasizes more state-centrist policies, softens the limits of the state and private enterprise and often blurs the distinction between regulators and the regulated (Keller 2008, 345; Magnus 2010, 331). Against this background, sovereign wealth funds have been accused of rolling back decades of privatization in Western industrialized economies. They have also been suspected of leading and co-ordinating disparate clusters of private- and state-owned firms united to engineer a take-over of the industrialized Western nations by the emerging East. The subtitle of one of the early books on SWFs by Lixia Loh, ‘States buying the world’, reflects these concerns (Loh 2010). While Hassan refers to these debates in a value-free manner as a ‘contest for the soul of capitalism’ (Hassan 2008, 77), for other observers, the front-lines are clear: their concern is a piece-by-piece sell-off of Western assets to Eastern investors profiting from high oil prices, the US trade deficit and undervalued emerging market currencies⁶⁴. Echoing the fears of many stakeholders in view of widespread SOE- and SWF investment activity in industrialized nations, Matt Taibbi refers to such a future scenario as ‘Griftopia’ (Taibbi 2011).

So far, there has been little empirical evidence to substantiate either the systemic or the rather philosophical macro-concerns. As many analysts have pointed out, however, perceptions may matter as much as reality – in particular as the degree of disclosure around SWFs remains relatively low.

4.1.3 From concerns to political risks

Concerns held by various stakeholders have the potential to constitute severe operational hurdles for individually affected SWFs and the sovereign wealth fund

⁶³ A particular school of thought propagated by the Bretton Woods institutions and highlighting free markets and competition as important determinants of economic development.

⁶⁴ For an alternative future in which the US economy and politics are dependent on sovereign funds, see (Bean 2010). With a considerable amount of black humour, Bean depicts a situation where the US would have to mandate power cuts as SWF-owned energy companies are re-routing oil and energy to a more profitable use in fast-growing China.

community in general. In addition, SWFs are often lumped together with other controversial actors such as SOEs, thereby further complicating investment activities. One of the interviewees for this thesis⁶⁵ cited the example of how SWFs became the target of public resentment following recent investment activity of Gazprom in Germany. With the public and the media not distinguishing between sovereign funds and a government-controlled gas conglomerate (the Russian government has been holding a controlling stake since 2005/2006), SWFs with pure financial investment objectives became ‘collateral damage’. This example also clearly shows the power of the media as amplifiers of public opinion, often resulting in pressure on politicians to take action. While political activity is where public concerns become a serious issue from an SWF point of view, media debates and grass root campaigns can also have a significant impact on an organization’s reputation. Based on previous thoughts about political risk and a more granular understanding of concerns brought up against SWFs, the next sub-chapter defines political risk for sovereign wealth funds and presents a typology of political actions. It also touches upon three aspects of sovereign fund activity and organization that political risk impacts upon before providing examples of SWF political risk at the domestic-, the recipient country- and the international level.

4.2 Defining SWF political risk

4.2.1 Some early attempts at a definition

As many interviewees for this thesis confirmed, so far there has been surprisingly little work on political risk faced by sovereign wealth funds⁶⁶. While a few authors have given narratives of political challenges encountered by SWFs when investing abroad (for many, see Goldstein and Pananond 2008; Lhaopadchan 2010), there has been little conceptual work done on this type of risk. Temasek’s investment in Thailand’s Shin Corp. has been discussed as one of the most preeminent examples of political risk, on par with others such as a Qatari fund vehicle’s unsuccessful takeover of Sainsbury’s. One of the very few to go beyond narratives and to delve deeper into political risk management is Wu (Wu 2008) who analysed the strategy of the Singaporean funds for political risk reduction. In order to reduce political risk, he recommends a calibrated investment approach (i.e. no majority stakes and board seats), public relations- and community outreach activities and active participation in drawing up the Santiago

⁶⁵ As a high-ranking SWF official, the interviewee in this instance prefers his quote to be given anonymously.

⁶⁶ Ironically, the SWF political risk discussion only took off with the controversy around the attempted purchase of a portfolio of US ports by Dubai Ports World which is not an SWF but rather an SOE.

Principles. However, he too falls short of coming up with deeper thinking about political risk concepts or definitions. In what is arguably the first article dealing exclusively with political risk for sovereign wealth funds, Behrendt proposes a ‘more rigorous model of political risk analysis’ (Behrendt 2009, 145pp) which is based on Markowitz’ modern portfolio theory’s investment universe concept and concentrates on potential *effects* of political risk. According to his model, political risk equals the restriction of a sovereign fund’s investment universe through political interference by various stakeholders. ‘The discrepancy between the ideal, large sovereign investment universe and the real, experienced and compressed one, resulting in higher levels of portfolio risk, constitutes the political risk that sovereign wealth funds are exposed to as they engage in global markets’ (Behrendt 2009, 146). This echoes similar findings which see the strategic asset allocation as one of the core elements of a modern sovereign wealth fund (Das et al. 2009, 14; G. L Clark and Monk 2010, 10). The remainder of this chapter proposes a definition and a structured way of thinking about the many forms of SWF political risk.

4.2.2 A broad yet actionable and definition of SWF political risk

While predominately focusing on what is an important *result/effect* of political risk, Behrendt does not provide an actionable definition of SWF political risk. Moreover, as compelling as it is in its simplicity, his concept of political risk seems to be unnecessarily narrow. For instance, neither a potential withdrawal of funds from an SWF for political reasons nor settling for a smaller, non-voting stake in an iconic company due to public concerns would necessarily have an impact on the investment universe. At the same time, it would be hard to argue that these two examples do not constitute political risk. The effects of political risk are more complex and go beyond investment universe effects: in essence, they include all adverse consequences stemming from the political realm and preventing a fund to go about its business as foreseen by its mandate. In order to strike a balance between definitional breadth and actionability, this thesis proposes the following definition of political risk faced by sovereign funds:

Definition of SWF political risk

Political risk for sovereign wealth funds is defined as the *probability of unexpected or difficult to anticipate political action* resulting in *adverse consequences* for the sovereign fund(s).

Figure 16: Definition of SWF political risk

The definition is based on the following elements:

- Political risk is a *probabilistic phenomenon* (see chapter 3.2.3). It is the probability (yet not certainty) that a given political action results in adverse consequences. As laid out in chapter 3, the study of political risk has made a considerable leap forward over the last couple of decades. Despite significant progress in methodology, measurement and analysis, however, political risk is unlikely to be rendered into a fully statistical phenomenon – in particular for the complex interplays characterizing sovereign funds. Following Knight (see figure 13 above) and accepted across the literature (for many, see Bremmer and Keat 2010, 24), political risk remains mired in a considerable degree of uncertainty, governed by estimated probabilities at best. In strictly Knightian terms, therefore, it would be imprecise if not misleading to speak of political risk as a ‘risk’, as the analysis of it still depends on estimates of unknown outcomes. In the words of political risk consultants Bremmer and Keat, it is as much about grappling with the ‘known unknowns’ (a priori- and statistical probability) as with the ‘unknown unknowns (estimated probability) (Bremmer and Keat 2010, 17). So while ‘political risk’ may have become the standard term for non-financial, idiosyncratic risk, it may not qualify as ‘risk proper’. As a consequence, there are likely to remain tensions between quantifiable financial risk and what Behrendt calls the ‘amorphous nature of [...] political analysis’ (Behrendt 2009, 144). This results in continuing challenges for the full integration of political risk analysis into quantitative corporate- or SWF risk management systems and warrants some more in-depth thinking about these phenomena in an SWF context. This conceptualization of political risk as partly unquantifiable also points at the necessity to work preemptively on sovereign fund reputation.
- SWF political risks are *unexpected, difficult to anticipate* events. While non-governmental pressure on sovereign funds is generally of an unexpected nature, delimitation questions mostly arise from when it comes to classify (home- or recipient) governmental- or parliamentary activity. This definitional element dates back to Robock who was looking for a way to distinguish political risk from other types of ‘continuous’ government action/intervention such as regular changes in the tax code. From his point of view, gradual changes with a clear evolutionary pathway does not constitute political risk as they are ‘not difficult to anticipate’ (Robock 1971, 8). From an SWF point of view, this caveat is also a concession to domestic and recipient country authoritative stakeholders which are generally authorized to interfere in SWF activities, either based on ownership or regulatory

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- powers. In other words, if an SWF mission statement or charter allows for the withdrawals of funds under specified circumstances, for example, a potential withdrawal would not qualify as political risk as long as fund management would be able to prepare for it, i.e. to reshuffle portfolios without any loss. On the same token, changes in recipient country legislation which have followed ordinary, well-anticipated procedures are rather a *question of compliance* than of political risk. E contrario, following this line of thought, an unexpected legislative change such as the Irish government's decision to tap its National Pensions Reserve Fund (NPRF) to support its ailing financial industry would have to be considered a political risk (for a similar appraisal of the situation, see Monk 2010g): Originally set up as a long-term pension reserve fund, due to be tapped only after 2025, the National Pensions Reserve Fund and Miscellaneous Provisions Act 2009 ordered the NPRF to significantly deviate from its mandate and to invest into 'credit institutions' (see case study in chapter 6). Rozanov provides a list of such (mostly domestic) interventions, most of which would classify as political risk events according to the aforementioned definition (Rozanov 2010a, 257–258). This thesis suggests two criteria to assume unexpected political action from its main stakeholder: *First*, some indications may be found in the statutes and mandates governing the funds: If they contain no reference to fund objectives other than profit maximization over the long term, any intervention making the fund deviate from this objective is considered unexpected, i.e. difficult to prepare for. However, many funds, amongst them the GPF and some Gulf funds, have 'double bottom lines' referencing multiple goals. In this case, a *further indicator* may be the degree of change of a fund's strategic asset allocation (SAA, which usually mirrors SWFs' long-term investment horizons) required to adjust to the double bottom line. If the changes are substantial and may require adjustments impacting on the value of the fund (see below, e.g. divestment of fixed-income instruments in a rush and therefore likely at a loss in order to buy bank equity), this most likely constitutes a case of political risk.
- Political risks are the result of *political action*. With reference to chapter 3.2.3 of this thesis and citing Harold D. Lasswell, actions are political if they are geared towards 'attaining, keeping, increasing or exercising power [...] to influence authoritative policy'. In this context, authoritative policy may not only refer to legislation and regulation. As will be shown later on, political action may also be targeted at an organization's reputation, thereby endangering its 'licence to operate' without having to resort to hard legislative measures (for similar thoughts,

- see Denk 2003, 13). Young's definition provides more insight into the reasons for political action, referring to such action as activities in which 'people organize collectively to regulate or transform some aspects of their shared social conditions, along with the communicative activities in which they try to persuade one another to join such campaigns or decide what direction they wish to take' (Young 2004, 377). By way of definition, political action is *collective* action, seeking to involve other stakeholders to press for a specific objective. Objectives usually include influencing reputation or pressing for regulation in order to align economic actors' structure and behaviour with specific stakeholder expectations. However, while there are many ways to target corporations, not all such actions are *political*: A court case covering intellectual property- or contractual matters may not qualify as it aims for a bilateral instead of a collective resolution of issues. In other words, such action is seeking an individual-concrete solution as opposed to pressing for a general-abstract resolution for the issue (similarly, see Denk 2003, 12–13)⁶⁷. Similarly, one expects there to be little inherently political about an NGO contacting a specific organization in order to influence its behaviour. In most cases, however, NGOs and other pressure groups will not stop with one organization but rather seek authoritative solutions (aka regulation) for a broad group of companies engaging in similar activities (e.g. financing oil extraction from tar sands), making it per definition a political campaign.
- *Adverse consequences*: Conceptually, political risk consists of two elements: a given political action (e.g. new legislation in a particular field or social protests against a particular company) and the potential consequences such an action may have (e.g. the roll-back of planned investments in the particular field or the restriction of a company's expansion plans). Traditional political risk definitions foresee a wide array of consequences, ranging from the loss of profit potential and change in prospect of profitability to altering the expected outcome or value of a given economic action (see chapter 3.2.3). While political risk may also occasionally have positive consequences and may create opportunities (e.g. adapted product offerings following changes in environmental legislation, see Buholzer and Rybach 2008, 201)⁶⁸, it is seen as having a predominately adverse impact on companies in general and sovereign funds in particular. The reason for SWF vulnerability is to be found in their long-term investment horizon which

⁶⁷ In civil law systems, this is also what distinguishes a bill (an abstract set of rules binding the general public) from an ordinance (a concrete order covering an individual case), thereby underlining the authoritative and all-encompassing nature of political action.

⁶⁸ For the value- and the buffer functions of reputational capital, see chapter 5.

usually results in portfolios heavily tilted to the illiquid side, thereby rendering potential changes in asset allocation even more costly.

The definition of SWF political risk proposed above is considered to be broad enough to capture what is a rather eclectic variety of political risk (Bremmer and Keat 2010, 5). At the same time, it is narrow enough to clearly distinguish between political risks for SWFs and mere operational difficulties resulting from the ordinary course of business (e.g. cumbersome yet legitimate investment approval regimes or disclosure requirements). This definition is geared towards sovereign wealth funds which traditionally have an ambivalent relationship with traditional concepts of political risks emphasizing government intervention. At the domestic level, the main challenge with regard to sovereign fund political risk remains the ability to distinguish between legitimate domestic governmental interference and genuine political risk. This points to the fact that the conceptualization of SWF political risk as indicated above may present some scope for further refinement, in particular with regard to various delimitation questions (government control vs. interference, regular legislative processes vs. unexpected changes, etc.).

4.2.3 The phenomenology of political risk

SWF political risk comes in a wide variety of forms, ranging from domestic constituents criticizing the fund to international organizations pressing for cross-border regulation geared exclusively towards sovereign wealth funds. Classifying SWF political risk based on different variables helps to break down what is often seen as a complex cluster of risk into digestible bits which can then be analysed and tackled with the appropriate political risk management strategies.

The timing: ex-ante, ex-post and latent political risk

Generally, political risk arises in response to a trigger event, i.e. a particular SWF investment. Political action based on an undefined public unease about SWF activity has been rare, also for political economy reasons⁶⁹. Most political risk builds up in anticipation of or following certain SWF activity. Given the confidentiality surrounding SWF investments, however, examples of active *political risk in anticipation* of an impending transaction are scarce. One of the few examples is the Norwegian sovereign fund's decision to sell off its stake in Wal-Mart, citing the US company's infringement of labour rights. This prompted criticism from the U.S.

⁶⁹ As Mancur Olsen suggests, concentrated interests are much easier to organize than groups coalescing around a diffuse set of concerns.

government via its ambassador in Norway before the fund started divesting its stake (New York Times 2007). In this case, ex-ante political risk only emerged due to the transparent Norwegian investment process where decisions of its Ethics Council are made public. More often, ex-ante political risk is related to a fund's overall reputation which stakeholders (in the absence of a crystallizing event such as a transaction) may take issue with. Examples are rare though, most probably also because (at least in theory) an SWF's reputation is built through countless interactions and transactions, each of which may trigger a reactive, *ex-post political risk* response. These responses are much more common: GIC's 2008 USD 11bn UBS investment faced domestic criticism in September 2011 when a major UBS trading loss in London prompted citizen bloggers to look into the investment performance of GIC's UBS stake. Similarly, CIC drew heavy criticism from the Chinese government when it became clear that its investment in private equity group Blackstone did not perform as expected. Evidence points to a third category of political risk which is not connected to any transactions but may rather be seen as a *latent political risk* feeding on general concerns about the set-up of sovereign funds, their motivations and their reputation. For instance, in late 2008 the German parliament decided to amend the Foreign Trade and Payments Act to better protect German companies from foreign takeovers. Despite not being in the focus of SWFs that were using the financial crisis as an opportunity to buy distressed assets, Germany is thought to have acted in reaction to general concerns towards and in anticipation of potential SWF investments⁷⁰. Another example of latent political risk is risk arising from small-stake SWF portfolio positions or the portfolio in general, without any major transaction triggering political risk.

As will be shown later on, the distinction between ex-ante and ex-post political risk has some important ramifications for political risk management: While ex-ante political risk may be mitigated by engaging with the relevant stakeholders, ex-post political risk forces SWFs to engage in defensive/reactive communication and engagement strategies, resulting in considerably reduced optionality. Therefore, it is

⁷⁰ The new mechanism allows the German government to review any investments of 25% or over in German companies by non-EU/European Economic Area investors for up to three months before communicating a decision. It is very likely that German Chancellor Angela Merkel has pushed the proposal against the background of a takeover battle which saw Neptun Orient Lines (NOL), owned by Temasek, bid for TUI's Hapag-Lloyd unit (Bloomberg 2008). The offer encountered considerable grassroots- (trade unions) and political resistance as NOL was seen as unwilling to commit to securing jobs and respecting the cultural importance of Hapag-Lloyd (Hamburg-Amerikanische Paketfahrt Aktiengesellschaft) to Hamburg (World Cargo News Online 2008). Hapag-Lloyd eventually was sold to a consortium consisting of a German logistics entrepreneur, local banks and insurance companies and local public bodies.

essential for SWFs to anticipate potential political risk sources and to mitigate the effects as early as possible.

The scope: micro-, meso- and macro political risk

Another much earlier classification distinguishes between micro-, meso- and macro-political risk. This distinction goes back to Robock who distinguishes between political risk affecting all ‘foreign enterprises’ (macro) and political risks impacting on ‘selected fields of business activity or foreign enterprises with specific characteristics’ (Robock 1971, 9). This two-fold categorization has become a staple of political risk analysis, with numerous articles referencing the original Robock source. Interestingly, more contemporary political risk classifications refer to Robock’s micro-political risk as ‘meso’-political risk while micro-political risk is reserved for firm-specific political risk. According to the most recent classifications, there are three levels of political risk:

- According to the original source, *micro-political risk* is related to risk in ‘specific fields of business activity’, for example public utilities (Robock 1971, 10). However, over time the meaning of micro-political risk has changed: More recent political risk classifications such as the one brought forward by Denk consider micro-political risk to affect *individual* companies, as ‘politically induced conflicts between a company and its stakeholders’ (Denk 2003, 33). In the SWF context, this translates into political risk impacting on individual funds, mostly resulting from specific attributes of these funds (see chapter 5). One example is the freezing of the Libyan Investment Authority’s (LIA) funds abroad due to the pariah status of the country’s government under late dictator Muammar Gaddafi. While the sanctions by the United Nations and the European Union were intended to target Libya as a whole, they were specifically targeted at its central bank and the LIA as the major deposit holder abroad (Financial Times 2011b). Generally, most SWF deal-related risks are by definition micro risks, with the political controversy between the fund and a specific set of stakeholders arising ex-ante or ex-post from particular attributes of the deal. Examples include the hostility faced by GIC in Switzerland following the acquisition of its stake in UBS or the (almost universal) general mistrust towards CIC as an investor hailing from China (Reuters 2012e). One of the rare examples of micro-political risk resulting from authoritative measures and impacting on sovereign funds is Indonesia’s 2006 single presence regulation issued by the central bank. Under this policy, it is forbidden to own a controlling stake in more than one Indonesian bank. With only three investors

- affected (SWFs Temasek and Khazanah who had to divest and merge their assets, and the Indonesian state which has since been granted an exception for its four state-owned banks (Jeffreys et al. 2011, 61)), this regulation may well be seen as micro-political risk tailored at the two funds, as one interviewee for this thesis argued⁷¹. As micro-political risks are an expression of stakeholders taking issue with the attributes or the behaviour of sovereign funds, these risks are comparatively easy to understand and to mitigate – permitted there is a willingness to engage on these issues, Denk argues.
- *Meso-political risks*, on the other hand, are political risks which affect a group of companies with similar characteristics (Denk 2003, 33). Shared characteristics may include the ‘industry they are active in or their legal setup’. Today’s concept of meso-political risks corresponds to what Robock originally called ‘micro’ risks. Denk argues that the typical examples of political meso-risks are regulatory changes affecting all companies in a certain industry sector (he cites political pressure on the Swiss banking secrecy) or risks connected to a certain legal setup. An example of the latter would be the political pressure on favourable carried-interest taxation enabled by the partnership-based structures of hedge funds and private equity funds. In the context of sovereign funds, meso risks are widespread: Conceptualizing sovereign funds as particular, state-owned investors with similar characteristics, political pressure on SWFs as a group may well be characterized as meso-political risk. Another example at the more granular level is the resentment many Gulf funds (and by way of lack of public knowledge other funds from Islamic countries such as Algeria or Iran) are facing when investing in Western industrialized countries. Although the dozen or so funds from the Gulf region have very little in common besides being funded by either oil or gas, stakeholders often see Gulf SWFs as a symbol of global imbalances and do not distinguish between the various funds which display a broad range of organizational structures, corporate setups and investment strategies. This makes the Gulf/GCC funds vulnerable to meso-political risk, even more so as following the Dubai Ports case, Western stakeholders invariably perceive them as harbouring ambitions to take over Western iconic assets (for a British popular perspective of Qatari investment activity in particular and GCC activities in general, see The Daily Mail 2012). Another example of meso-political risk is the criticism arising from a group of

⁷¹ Indonesia has a reputation for being a difficult place for foreign investors in general and Singaporean investors in particular: In May 2012, analysts considered DBS’ attempt to take over Indonesian bank Danamon very likely to unravel due to planned restrictions in foreign ownership of Indonesian banks (Bloomberg 2012).

- funds investing into the same controversial asset, for example cluster munitions. In April 2010, two well-known NGO networks issued a collaborative report on the ‘use, production, transfer, and stockpiling of cluster munitions’ (Boer and Vandembroucke 2010). The report not only (black-)lists 144 companies bankrolling cluster munitions producers, but also contains a special chapter focusing on public pension- and sovereign wealth funds. The NGOs maintained that sovereign funds merit special attention, citing their growth and the fact that as government-owned entities, SWFs should be particularly held accountable for obeying the Convention on Cluster Munitions signed by their respective governments. The ability to react to meso-political risks crucially depends on whether affected sovereign funds are willing and able to work together, to commit to a common (lobbying) strategy and to support its implementation.
- *Macro risk* refers to systemic political risk affecting most companies regardless of their individual attributes or activities within certain, mostly geographical boundaries. Macro-political risks may emerge at the national- or at the international level, with the latter often subsumed under ‘geopolitical risk’ or even tail risks (see Bremmer and Keat 2010, 37pp for a more detailed overview.). Historically, the concept of macro risk has been a result of widespread confiscation, expropriation and capital controls, mostly by Latin-American governments in the 1970s and 1980. These events affected all companies, both domestic (to a lesser extent) and foreign ones (US-American companies in particular). Modern macro-political risk is less centred on expropriations⁷², yet remains a mixed bag of politically induced risks ranging from global terrorism to revolutions or war, but also including currency devaluations. Many of these risks are of ‘black swan’ nature, very complex to analyse and hence almost impossible to predict. With considerable macro risk hitting in the first decade of the new century (the 9/11 attacks, the ensuing wars in the Middle East, the financial crisis of 2008/2009 and the Arab Spring), companies have found it very difficult to respond to such events. Given their global investment footprint, mostly across asset classes, SWFs are highly sensitive to political macro risk. This sensitivity is compounded by the fact that despite progress in governance arrangements, SWFs are perceived as supporting the policies of their respective governments (see also Knill, Lee, and Mauck 2011 who cites the example of the US scrutinizing

⁷² However, nationalization and expropriation continue to be on investors’ minds, in particular when investing in Latin America which, amongst others, has seen pressure for nationalization as well as high-profile expropriations in Venezuela, Peru and lately Argentina.

investments of Russian sovereign funds following Russia's invasion of Georgia.). As a result, sovereign funds often get 'sucked into' bilateral or multilateral political disputes or economic currents surrounding their home countries (think massive domestic intervention by GCC funds as a result of crumbling stock markets). In contrast to micro- and meso-political risk, macro-political risk is very difficult to anticipate and to influence.

The impact: on setup, funding/withdrawal and investment activity of SWFs

In addition to classifying SWF political risk according to its active or reactive nature, its underlying mechanisms and its scope, it is important to have a closer look at its impact on sovereign funds. Following the definition used in this thesis, political risk results in 'adverse consequences' which may cover various aspects of a fund's operations: For example, during 2009, the Qatari government asked the QIA to acquire a 20% stake of each bank listed on the Doha stock exchange. At a total cost of USD 5.3bn, this had consequences both for the liquidity position and the SAA of the fund. Conceptually, constraints on sovereign funds imposed by political risk generally relate to three aspects of sovereign funds:

- *Fund setup-related 'adverse impacts'*: This refers to an SWF's corporate structure and governance, in particular reporting lines, decision mechanisms and questions relating to transparency and accountability. An objective frequently pushed for by political stakeholders relates to receiving more *information* on sovereign fund activity, in particular investment allocation and performance. For instance, following their loss-making financial services investments during the crisis, GIC has faced increasing pressure from domestic constituents (mainly bloggers critical of the Singapore government) to provide more information on these investments. While the Santiago Principles (which amongst other things were set up to improve information on SWFs) call for certain minimum standards of transparency⁷³, from a sovereign fund perspective, the provision of information must be balanced against other commitments. According to Rozanov, there are some good reasons why SWFs may only provide limited transparency (Rozanov 2010b, 10): (1) SWFs are governed by home country legislation which includes sovereign choices about the level of transparency; (2) Depending on the stakeholder, the need for transparency varies, from full disclosure to domestic supervisory organizations

⁷³ While there is no specific article on transparency, references to providing information on various fund aspects are made throughout the principles, with the most important ones included in GAAP principle 2 (public disclosure of fund objective), GAAP 4 (disclosure of funding-, withdrawal- and spending rules), and GAAP principles 5 and 11 (publication of statistical data and an annual report).

- and partial disclosure as mandated by the relevant laws to foreign regulators to lower levels of information to other non-authoritative stakeholders; (3) Transparency comes at a cost, in particular for significant and potentially market-moving asset management organizations such as sovereign wealth funds (for a similar thought more geared towards the costs of maintaining public buy-in, see Monk 2009b). In a rare statement on Singapore's sovereign funds and transparency, Minister Mentor Lee Kwan Yew adds another reason to be careful with transparency, in particular in terms of performance numbers: (4) Transparency raises people's expectations and generates 'populist pressure' to increase spending (The Strait Times 2008). Stakeholder pressure may lead to tipping the delicate balance faced by SWFs and may potentially result in 'adverse consequences' for the fund. In addition to a push for information, another result of political risk may be the *adjustment of structures and processes* for the benefit of certain political stakeholders. For instance, parliaments may press for a more direct control of their respective funds, including more influence on asset allocation. The funds' government principles face the challenge of 'providing prudent political oversight without creating a perception of political interference' (Monitor 2008, 25). This would result in foregoing the benefits of having an independent, long-term oriented fund to manage national wealth.
- *Funding and withdrawal-related 'adverse impacts'*: While at least technically related to corporate governance arrangements, the importance of funding and withdrawal rules warrant separate attention. Here, stakeholders try to minimize SWF inflows and maximize and/or simplify withdrawals. Understanding this category of political risk impact is very important as it has the potential to threaten SWFs' long-term investment horizons, thereby targeting the very heart of what SWFs are intended to deliver. The implications can be severe: There are a considerable number of examples of funds where the 'adverse consequences' of political risk (mainly drawdowns) led to either the fund being restricted in its mission, e.g. in the case of Iran's Oil Stabilization fund (Amuzegar 2005) or the Irish National Pensions Reserve Fund (NPRF) (following the use of emergency legislation in 2009 to mandate the fund to support the ailing domestic financial sector). While at the time of writing, the latter fund still holds some assets⁷⁴, it

⁷⁴ As per March 31, 2013, assets mainly consist of a so-called discretionary portfolio of EUR 6.1 bn and the directed portfolio whose domestic financial services investments attracted an interim valuation of EUR 8.6bn (Commission of the NPRF 2013, 1). This compares to a discretionary portfolio of EUR 14.9bn and a directed portfolio of 9.5bn for the end of 2010 during which the NPRF was mandated to invest EUR 3.7bn in cash into Allied Irish Bank and a contribution to the IMF support package for Ireland of up to EUR 10bn

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- may well be considered the latest victim in a row of funds which have been practically dissolved due to excessive drawdowns. In addition to the NPRF, examples include the funds of Nauru (a phosphate producer whose SWF was depleted through costly and inefficient projects (for an in-depth account of Nauru's fate, see Folliet 2010; The Economist 2008b)) and Papua New Guinea's Mineral Resource Stabilization fund (shut down in 1999 to pay off debt drawn against it (Morauta 2012)). An example of political risk potentially resulting in lower inflows is the Nigerian case cited above where state governors are trying to block a transfer of USD 2bn from the (rather porous) national crude account into a new sovereign fund with considerably stronger withdrawal safeguards (Monk 2010d).
- *Investment behaviour- and asset allocation-related 'adverse impacts'*: While stakeholder pressure on structural factors and funding- and withdrawal aspects of sovereign funds remains prevalent, it can be argued that a considerable part of political risk is aimed at influencing investment behaviour and asset allocation, including planned activities in that area. This recalls Behrendt's findings who conceptualizes political risk as 'the discrepancy between the ideal, large sovereign investment universe and the real, experienced and compressed one, resulting in higher levels of portfolio risk' (Behrendt 2009, 146). From an SWF portfolio perspective, the 'adverse impact' of political risk may therefore refer to (1) not being able to invest in a suitable asset, e.g. when becoming the target of an NGO campaign; (2) having to divest from a suitable asset, mostly due to similar reasons, and finally (3) being forced to invest in an unsuitable asset. With regard to the latter, the two most prevalent cases are SWFs being mandated to invest according to a certain geographic pattern or to invest in a particular asset class. An example of the former is pressure by principals to support domestic industries. An example of the latter would be political pressure on funds to support the government's food security strategies (see case studies). An asset may be deemed suitable if it was vetted by the fund's proper investment processes and hence corresponds to its SAA as derived from its mandate. E contrario, an unsuitable asset may not fit the strategic and/or tactical asset allocation of the fund and/or may not comply with the SWF's legal, environmental and ethical investment guidelines⁷⁵. In its

(Commission of the NPRF 2011). While some analysts argue that the directed portfolio positions constitute a significant upside for the future, others see the fund as basically dead and unable to fulfil its intended mission (The Irish Times 2010). See the case study in chapter 6 for more details.

⁷⁵ The classic example is the exclusion of companies by the Norwegian GPF upon decision of the Ethics Committee. Two recent high-profile cases related to Walmart (Reuters 2006) and Rio Tinto (Reuters 2008b).

background materials on the Santiago Principles, the IWG refers to this type of political risk by recommending that individual investment decisions shall be ‘protected from undue and direct political interference and influence’ (IWG 2008b, 17).

While for conceptual reasons, there needs to be a distinction between the various types of ‘adverse’ impacts on the funds, in practice they are closely linked: Governance changes resulting in simplifying withdrawals for domestic development projects may necessitate a modification of the SAA which redefines tactical asset allocation and therefore investment behaviour. Or there is political pressure for more transparency on fund holdings which may induce principles to cut funding, resulting in a different asset/liability profile of the fund requiring an adapted SAA. In Modern Portfolio Theory (MPT) terms, an adverse impact always stems from either increased risk or diminished returns, both of which can be a result of one of the three sub-categories mentioned above.

4.2.4 Some further thoughts on SWF political risk

Considering its complex phenomenology, political risk incurred by sovereign wealth funds appears to be a multi-layered phenomenon which warrants some further thoughts going beyond a mere definition and classification.

First of all and more than many other concepts in political economy, political risk is ‘in the eye of the beholder’, meaning it depends on the point of view of the observer. In an early text on political risk, Kobrin gives a graphical example: Restricting FDI, he writes, may look like economic nationalism to an investor but may equally be seen as an ‘attempt to implement a policy of indigenous nationalization by the host [government]’ (Kobrin 1979, 73). Similarly, a mandate to support the domestic banking sector during a crisis may be considered political risk from an SWF point of view, yet from a government/ministry of finance perspective, it may be labelled ‘efficient use of national resources’. Another example refers to political pressure for more transparency – a demand which may be completely rational from a financial markets perspective, but may be less compelling from a national-, let alone individual fund perspective (see chapter 4.2.3, fund-related adverse impact, for Rozanov’s take

Another example relates to the Australian Future Fund which divested from a range of defence assets, including some cluster munitions producers following an ethical screening of the investment portfolio in 2011. Interesting in this context: While the International Convention on Cluster Munitions was signed by the Australian government in 2008, the Convention is still awaiting parliamentary ratification (Bloomberg 2011b).

on the subject). This dichotomous nature is a conceptual challenge when it comes to defining sovereign funds' political risk, in particular the funds' interactions with domestic government as their primary stakeholder and owner: from the perspective of most governments, their respective funds are yet another instrument to achieve micro- and macroeconomic goals, be it by furthering domestic development, achieving food security or supporting technology transfer. Hence, any governmental interference with a fund's asset allocation or distribution of profits is seen as occurring 'for the greater good' of the country and its citizens. From a fund point of view, however, such intervention may detract from long-term profit maximization as one of the basic objectives of sovereign funds. While there are efforts underway in certain SWF home countries⁷⁶ to adopt a holistic 'country balance sheet' view, this thesis looks at political risks from a purely SWF point of view where any unexpected domestic intervention is considered political risk.

These two examples underline another important element which needs to be taken into consideration when discussing sovereign fund activity: political risk is a concept which is particularly prone to normative discussions. As sovereign funds have become more visible investors over the last decade, there has been a gradual mix-up of normative and positive commentary on the topic of SWF political risks, both in the policy discourse and in academia. Literature from the *normative strand* would usually focus on whether SWFs pose a real risk to (mostly recipient) markets. It would then also discuss whether government interference of any kind might be justified/legitimate. This normative way of thinking about sovereign funds was popular in 2007 and 2008 before SWFs became a welcome source of capital. It culminated in a widely cited 'SWF Risk Index' compiled by two Reuters Breaking Views columnists ranking 'the top 20 prominent funds according to the potential risk they present to Western interests' (Reuters 2008a). The index is based on three components: (1) transparency, (2) strategic control (to which degree the funds have sought control, influence of decision making or board seats), and (3) political threat (which assesses the sponsoring government's sympathy of Western governments, its degree of democracy and its ability and willingness to interfere in recipient governments' domestic affairs). *Positive or factual approaches*, on the other hand,

⁷⁶ In order to overcome 'left pocket, right pocket'-type challenges of public finance, many albeit smaller countries such as Singapore and Brunei, are currently looking at ways to better co-ordinate various public balance sheets, including SWFs, in order to gain an overall view on their country's wealth. The UN's inclusive wealth initiative, with its first report published in June 2012, is aiming at providing conceptual guidance for country balance sheets which are intended to complement country's flow-based GDP figures in the future (The Economist 2012b).

would refrain from normative judgements but rather measure relative progress with regard to various fund dimensions. A typical, often empirical representative of this approach is the strand of literature which assesses SWF governance and investment behaviour against an ideal type of fund (for the most influential example, see Truman 2007; Truman 2008a; but also Behrendt 2011b).

4.3 The sources of political risk: SWF stakeholders

4.3.1 Sovereign funds and their stakeholders

Following a thorough definition and phenomenology of political risk, this sub-chapter turns to SWF stakeholders and their role in political risk. Sovereign funds operate within a complex, multi-stakeholder environment and maintain relationships with a wide range of actors: governments as the sponsors of the fund and the domestic population as the ultimate beneficiaries, recipient-country governments, regulators and industry, and a wide range of non-governmental stakeholders such as the media, industry associations, NGOs and international organizations (to name but the most important ones). Stakeholder theory can help to visualize relationships, incentives, mechanics and motivations and may help to classify stakeholders according to various criteria – also with a view to better conceptualize SWF political risk.

The stakeholder concept

The term stakeholder itself first appeared in R. Edward Freeman's seminal book 'Strategic Management: A Stakeholder Approach' (1984). Based on prior work at the Stanford Research Institute and various strands of literature arising thereof (most notably work on corporate citizenship/business in society), Freeman defines stakeholders as:

any group or individual who can affect or is affected by the achievement of the organization's objectives (Freeman 1984, 46).

While there has been little disagreement about the kind of entity able to be a stakeholder – literally everyone may qualify⁷⁷ –, the academic and practical discussion over the past two decades has focused on what constitutes the basis for the relationship between stakeholders and their entities (for a good overview on the main controversies

⁷⁷ Stakeholders can be individuals, groups, organizations or other groups united by a common interest. These days, the stakeholder concept may also extend to entities without any legal or quasi-personality such as 'the environment' or – important in the context of sovereign funds – 'future generations', provided that the 'stakes' of the latter are represented by 'real' groups able to press for their interests.

in the literature, see Mitchell, Agle, and Wood 1997, 855pp; Andriof et al. 2002, 29pp). Based on a verbatim interpretation of the term, some see stakeholders as having ‘a stake’, a claim to the company/organization, based on legal or often moral ground. Others maintain that both stakeholders and the organization itself may have something ‘at risk’. Some authors distinguish between unidirectional and bidirectional relationships, voluntary and involuntary and legitimate and illegitimate stakes. These views reflect the on-going discussion between proponents of a narrow versus a broad concept of stakeholders.

This thesis adopts Freeman’s original definition and uses a broad concept of potential SWF stakeholders. It predominately focuses on stakeholders which are able to initiate *political action*. The controversies around sovereign funds have shown that both stakeholders with legal and moral claims can interfere with SWFs’ intentions – as can those with illegitimate and involuntary stakes and those whose relationships with the fund are believed to be unidirectional⁷⁸. In the interest of a holistic political risk management, however, it is advisable to look at all entities interacting with a sovereign fund as important potential stakeholders. The reason is that non-political stakeholders such as market participants may also use political action to further their interests, which may ultimately result in political risk.

Categorization and prioritization of stakeholders

Efforts to categorize stakeholders have been at the forefront of the literature since the very beginning. Given the growth of economic, political and societal actors with a ‘claim’ to some aspect of SWF activity, categorizations are predominately motivated by helping organizations to prioritize their stakeholder management efforts (for an early example, see Freeman 1984, 8–22; Andriof and Waddock 2002). The wider a stakeholder concept, the more important it is to have clear criteria to allocate the (usually) scarce stakeholder management resources (see chapter 7 of this thesis). A widely used categorization distinguishes between three types of stakeholders (for many, see Denk 2003, 15pp):

- *Social stakeholders* include groups such as the media, NGOs, business associations/interest groups, and grassroots movements. Relationships with this stakeholder category are determined by notions of morality, values and convictions, with social mechanisms such as grass root campaigns or direct action

⁷⁸ A good example may be indigenous people protesting against investment projects potentially underwritten by SWFs. Through NGOs and increasingly directly by using modern technology, such stakeholders are able to leverage their ‘voice’, thereby virtually overcoming what was thought to be a unidirectional relationship.

- à la Greenpeace constituting their favourite method of engagement. In the Conference Board's stakeholder classification, social stakeholders are labelled 'special interest relations', reflecting their 'diffused interest in and claims on' companies (The Conference Board 2007, 13). In the SWF context, an example of an important social stakeholder is the home country population, the ultimate beneficiaries of the fund. Other social stakeholders are the media and NGOs, both at a domestic level and in recipient countries.
- *Market stakeholders* include shareholders, employees, clients, competitors, peers and other actors. This cluster lumps together what the Conference Board refers to as 'enabling relations' (providers and controllers of resources), 'customer relations' and 'peer relations' (The Conference Board 2007, 13). There are good reasons to lump them together: The relationships amongst these actors are mostly contractual and/or based on supply and demand. Ideally, interaction takes place at arm's length, i.e. amongst market participants with equal rights (which differs from having equal powers). In order to exert pressure, market stakeholders usually concentrate on market mechanisms (such as negotiations, divestments and using various shareholder rights), but may also employ social or authoritative mechanisms (see below). While SWFs usually do not have private shareholders⁷⁹, their stakeholders in this space are similar to those of any other financial institution (except deposit-taking financial institutions which due to retail client stakeholders are subject to different dynamics). Amongst others, market stakeholders include external asset managers, investee companies both domestically and abroad, stock exchanges and – last but not least – SWF employees and fellow SWFs.
 - *Authoritative stakeholders* are legislative-, executive and judiciary bodies, regulators, international/supranational organizations, political parties and others. Based on the belief that some societal problems need solutions beyond market mechanism, these bodies have been (democratically or otherwise) authorized to take authoritative decisions. The Conference Board refers to them as 'normative relations' (The Conference Board 2007, 13)⁸⁰. Therefore, relationships with these

⁷⁹ Some SWFs are set up as private stock companies, for example Temasek, where the Singapore ministry of finance is the sole shareholder. However, SWFs have entered into JVs and collaborative ventures where private partners may also hold some stock.

⁸⁰ Interestingly, the Conference Board also includes trade unions, professional/trade associations, financial analysts and rating agencies in their normative stakeholder category. As the first two organizations mostly operate through social mechanisms, this thesis considers them to be social stakeholders. Financial analysts and rating agencies, on the other hand, may have considerable power, but ultimately rely on pure market mechanisms to exert pressure and hence may rather be classified as market stakeholders.

stakeholders are commonly based on authority through the law, with authoritative mechanisms such as legislative changes or classical expropriation or use of force resulting in political risk. The most important SWF stakeholders in this group include their sponsors, usually either the ministry of finance or the central bank, an governments, parliaments and various regulators in those countries the funds do business in and – dependent on their power to set binding rules – various international organizations such as the IMF and the WTO.

These three types of stakeholders differ in terms of their capacity to stand up for and further their interests, i.e. to exercise power in the sense of the definition of political risk presented earlier: Generally only authoritative stakeholders have the capacity to influence policy and to set rules directly. Both market- and social stakeholders will have to do so indirectly by working the political transmission belt, i.e. by stirring up public or media attention which then may or may not lead to ‘authoritative action’. Having said that, however, the threat of a media campaign or demonstrations at neuralgic places are often powerful enough to influence an organization’s course without having to resort to legislative measures, thereby satisfying this thesis’ requirements for ‘political action’ (the exercise of power)⁸¹. The reason for this heightened vulnerability of companies results from an increasingly interconnected and mediatised environment. If a company’s actions do not live up to stakeholder expectations, it can lose reputational capital which then may result in a company losing its ‘licence to operate’ (Steger 2003, 106pp). The differences in stakeholder capacity to use these gaps need to be reflected in SWF political risk management strategies and in the instruments employed to build reputational capital and mitigate political risk.

4.3.2 Stakeholder values and expectations

Depending on the nature of their stake (financial, contractual, moral, etc.), stakeholders are – to variable degrees – affected by organizational activity (see definition above). As a result, stakeholders develop certain expectations towards an organization, including but not limited to how an organization shall be structured and behave. Stakeholder expectations are fed by a specific set of values generic to each stakeholder and their power to press through their expectations. NGOs critical of globalization, for example, may expect companies to source locally and to avoid cross-continental transportation, but will only be able to use social mechanisms to have their

⁸¹ Buholzer and Rybach provide a good example of how NGOs used inflatable whales and concerted action in front of Credit Suisse headquarters on three continents. They did so in order to drum up public attention to stop the bank to finance an oil- and gas project on the island of Sakhalin (Buholzer and Rybach 2008, 186).

stakeholder fulfil their expectations. Regulators, on the other hand, may expect the stakeholder to comply with a wide range of rules, non-compliance with which may be ruthlessly prosecuted. Both the values and the expectations resulting thereof can be incoherent and conflicting and may significantly change over time⁸². Nevertheless, expectations are central to the concept of political risk: The extent to which stakeholder expectations are met determine an organization's legitimacy. In other words, not meeting expectations may lead to a loss of reputational capital or – even worse – a case of non-compliance, with both cases resulting in a greater propensity for political risk.

With reference to SWFs, stakeholder expectations may cover a wide array of topics: The Norwegian population, for example, expects its fund to be a socially and environmentally conscious investor which resulted in institutional and legal safeguards (Council on Ethics 2010). Similarly, U.S. lawmakers translated their expectations of how SWFs (and other foreign investors) may invest in the United States into the Committee on Foreign Investment in the United States (CFIUS) process⁸³. And the Qatari ruling family – similar to other governments in the Gulf region – expects their SWF to form partnerships with (Western) companies on a win-win basis and to act as a facilitator for domestic development (Financial Times 2010e).

Demanding accountability

Stakeholders not only profess their expectations towards an organization, but they also try to hold organizations accountable for them, i.e. to make sure an organization such as an SWF comes as close to their expectations as possible. A common understanding of accountability (BusinessDictionary.com 2012) refers to the

'obligation of an individual or organization to account for its activities, accept responsibility for them, and to disclose the results in a transparent manner'.

From an organization's point of view, most organizations are accountable to different stakeholders for different reasons. Sovereign wealth funds, for example, are

⁸² An example is many organizations' preference for organic, local agricultural produce. When it comes to food security, however, they tend to ignore that insistence on this type of smallholder farming may jeopardize productivity and therefore endanger food supply.

⁸³ The CFIUS is 'an inter-agency committee authorized to review transactions that could result in control of a U.S. business by a foreign person ("covered transactions"), in order to determine the effect of such transactions on the national security of the United States' (U.S. Department of the Treasury 2011). Many review regimes, most notably the ones in France and Germany, were set up in the wake of SWFs entering into public perception and were modelled after the CFIUS. In reaction to a series of attempted SWF takeovers, Australia amended its pre-existing foreign investment review process in early 2008 and now looks more closely into a potential investor's independence from foreign governments (Financial Times 2008c)

accountable to their supervisory organizations (i.e. governing boards or ministries of finance or to host-country regulators, e.g. the SEC) based on host country sovereignty and regulatory powers. It can be argued that by virtue of stewardship obligations, SWFs are also accountable to their home country population at large (although here the strength of the link arguably depends on the degree of democratization). With regard to sovereign funds, accountability ensures stakeholders can check if the funds are structured, behave and interact in accordance to the expectations of those who have something at stake with them.

Although modern multi-stakeholder environments and increasing interest group pressure suggest otherwise, organizations are not accountable to everyone, at least not to the same degree/intensity. In other words, the ability of SWF stakeholders to hold sovereign funds accountable varies significantly and depends on the sources accountability springs from. Gelpern suggests sovereign funds find themselves in a matrix of accountability distinguishing between public and private and internal and external accountability. In her framework, public accountability refers to an SWF's obligations towards its domestic (internal) or its international political stakeholders (external). Private accountability is based on statutes, contracts and the like, both on an internal and an external level (Gelpern 2010, 25pp). In light of the findings of this thesis, however, Gelpern's matrix seems incomplete on two accounts: On the internal/external dimension, she lumps together the recipient country- and the international level which are subject to different mechanisms of accountability (just consider the diverging interests of international bureaucrats and recipient country politicians). And on the private/public accountability side, Gelpern does not allow for any form of 'soft' accountability. Considering these thoughts and drawing on the prior categorization of stakeholders this thesis suggests a three-tiered concept of accountability⁸⁴:

- *Moral/ethical accountability* results in informal obligations for the organization to 'account for activities and disclose results'. In this context, organizations provide information because they believe it is the 'right' thing, either measured by absolute ethical standards (e.g. assuring investors about using resources responsibly) or by comparative reasoning (i.e. not wanting to fall back behind competitors). With regard to sovereign funds, an important example of ethical/moral accountability refers to the funds' responsibilities towards their domestic population.

⁸⁴ An additional axis will be provided in the next sub-chapter where the concept will be expanded to three levels of stakeholders.

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- *Contractual accountability* refers to formal, mostly contractual obligations between two or more parties to account for activities and results. Here, accountability is a result of a prior commitment to a set of rules, with compliance/adherence monitored either by peers or by courts. The most obvious example of SWF contractual accountability refers to the Santiago principles, but there are many more examples where funds need to disclose information to counterparties ahead of certain transactions.
 - *Authoritative accountability* arises from formal obligations placed upon the funds by legislation or authoritative acts of other parties politically authorized to do so, such as regulators. In these cases, supplying information and accounting for behaviour is mandatory, with non-compliance resulting in serious adverse consequences. Examples of authoritative accountability include the summons of sovereign funds to present to parliamentary panels (most prevalent in 2007/2008) and the extensive disclosure and reporting requirements under the SEC regime when investing in the United States (Form 13F)⁸⁵.

Generally, the three categories of stakeholders mentioned above (social-, market- and authoritative) can be mapped to the three types of accountability they impose (or try to impose) on the funds. In order to better push through their expectations, both social- and market stakeholders are naturally searching for ways to translate their expectations into authoritative accountability for the funds. This may be done through various mechanisms, including pressing court cases, supplying amicus curiae briefs or lobbying parliament or regulators. Media- and increasingly new media advocacy campaigns are another way of trying to achieve authoritative accountability by pushing for regulatory or legislative action.

The mechanics: market-, authoritative and social mechanisms

Stakeholders may also be classified according to the mechanisms they employ to exert pressure on sovereign funds to operate according to their expectations. Mirroring the classification of stakeholders presented above, the literature distinguishes between three mechanisms of how stakeholder expectations may be translated into political risk (instead of many others, see Denk 2003, 30pp). These mechanisms, which were also used to analyse political risk for banks, are also applicable to sovereign funds:

⁸⁵ Under U.S. securities law, 'institutional investment managers' holding more than USD 100m in (certain) U.S. securities have to file a quarterly form 13F report detailing its holdings with the U.S. Securities and Exchange Commission (SEC) (U.S. Security and Exchange Commission 2011). These reports have traditionally been a valuable contribution to researching SWF portfolio composition.

- *Social mechanisms* rely on building up grass root pressure on a sovereign fund. These mechanisms bank on organizations caring about their reputations which may be damaged through consistent social pressure. As for potential instruments, Denk cites direct contacts to persuade organizations to unilaterally subscribe to minimal standards in any given field and a continuum of protest action ranging from peaceful to more intrusive, media campaigns and direct action. As opposed to market- and authoritative mechanisms, social mechanisms are based on the power of persuasion, with no contractual- or authoritative power involved. Generally, the more direct contact points an organization has with its customer base, the more vulnerable it is to this type of mechanisms. For instance, retail banks are known to be more vulnerable to NGO campaigns than banks exclusively focused on investment banking activities.
- *Market mechanisms* refer to mechanisms where sovereign funds and their stakeholders are operating on a level playing field governed by contractual relationships and private law. Here, instruments employed by stakeholders to further their interests may include negotiations, a wide array of shareholder rights (right to information, to elect executives, to vote on and to table own proposals at annual general meetings and so forth) and – as a last resort – strikes and boycotts.
- *Authoritative mechanisms* are based on legal powers and exert a collective binding force on the relevant subjects. Besides various legislative measures ranging from constitutional amendments and general legislation to implementation measures, authoritative instruments also include judicial decisions and fiscal resolutions. Also expropriations, transfer restrictions and sanctions belong to this continuum which ends with (militarized) interstate disputes. With regard to sovereign wealth funds, authoritative mechanisms result in the most direct political risks for the funds. A recent instance of political stakeholders using authoritative mechanisms to exert pressure is the attempt by Nigerian state governors to reach a decision by the country's supreme court to block the transfer of USD 2bn of oil-related income from the national crude account to the newly created sovereign wealth fund (Nnochiri 2012). Another high-profile court case involving an SWF as a defendant was the Sarriò against Kuwait Investment Authority/Kuwait Investment Office proceedings. As with other cases involving SWFs and authoritative mechanisms, this case has brought up interesting questions with regard to foreign state immunity (for an extensive discussion of the case and its legal implications, see Gaukrodger 2010, 16pp).

While all three clusters of stakeholders (market-, authoritative and social, see above) usually tend to resort to their respective familiar mechanisms to push through their interests, they occasionally chose to use other mechanisms, as Denk aptly notes (for an illustration of this thought, see the matrix in Denk 2003, 32). In other words, market stakeholders may not only use negotiation tactics, but sometimes may also engage in media campaigns (social mechanisms) or resort to lobbying (authoritative strategy). In analogy to Denk, out of this broad array, this thesis will focus on those mechanisms which are of *political nature*. In this context and in line with political action defined as ‘exercising power’, a mechanism may be considered political if either (a) or (b) holds: (a) the relevant stakeholders seek a solution which does not only impact on an individual firm, but is more general in nature (e.g. a law or industry guidelines) or (b) if the risk emerges from public, political or social organizations commanding a certain degree of control over the collective imagination (e.g. the media, political parties, NGOs) as this increases the propensity of stakeholder expectations resulting in authoritative guidance.

As a sovereign wealth fund, it is important to be aware of the mechanism a particular stakeholder uses to exert pressure on the fund: each mechanism has its own dynamics which need to be understood before mounting a response. For example, when GIC invested in UBS, the resulting debate in Switzerland was predominately a media debate, mostly following the patterns and dynamics of what has been defined as social mechanisms. As GIC had no legal or contractual obligation to respond and potential damage was limited, it provided the necessary information to satisfy the public interest. However, it generally maintained a low profile which prevented it from inciting further issues.

4.3.3 A very special stakeholder: The ‘sovereign’ in SWFs

The word ‘sovereign’ hints at an SWF’s most crucial stakeholder(s) and warrants some thoughts on the meaning of this constitutive part of the funds’ identity and its implications for political risk. In this context, the most salient questions refer to the degree (if any) of sovereignty SWFs enjoy in relation to domestic-, recipient country- and international authoritative stakeholders. And, from a political risk perspective, what sovereign ownership mean (or not mean) when it comes to mitigating and managing political risk.

While the legal basis of SWFs varies considerably (ranging from separate legal entities to pools of assets without legal personality), none of the funds may be considered

‘sovereign’ according to the original meaning of the term as understood in international law: As Behrendt notes, SWFs neither command internal sovereignty (as referred to by ‘supremacy over all authorities and independence from political interests within a state’s jurisdiction’) nor external sovereignty (understood as independence from other sovereigns at the international level) (Behrendt 2009, 145). When operating and investing abroad, SWFs are subject to rules and regulations of host countries as any other private company⁸⁶. From an internal point of view, funds are subject to domestic authorities⁸⁷ and unlikely to be independent from political interests. Gelpert, on the other hand, looked at stakeholder perceptions of ‘sovereign’ and found that it means different things to different stakeholders (Gelpert 2010, 8pp): For market participants, it refers to ‘autonomous, somewhat insulated from market pressures, and therefore freer to take longer-term risks’. For host (recipient) country governments, Gelpert sees ‘sovereign’ referring to ‘responsible public behaviour’. For civil society observers, finally, sovereignty may ‘imply a fiduciary relationship with the people or some subset thereof’.

While this short recap of the literature suggests a wide array of meanings, this thesis opts for understanding ‘sovereign’ from an ownership and control perspective: As Behrendt concludes, ‘sovereign’ refers to SWFs being *owned* by a branch of a sovereign entity, usually either the finance ministry or the central bank (for more insight on SWF ownership, see chapter 2.2.3). From a principle-agent perspective, the sovereign owner of the fund (the principal) then mandates an agent (or a system of agents) with the day-to-day running of the fund, often by paying some sort of remuneration (similarly for a discussion of principle-agent mechanics at SOEs Wicaksono 2009, 32pp). Controls, reporting requirements and – most importantly – aligned incentives ensure that the agent obeys the interests of the sovereign principle (as often laid down in the fund mandate). The challenge of the principal consists of exerting overall control without endangering the independence of the sovereign fund by exerting undue influence or falling prey of corruption (The Guardian 2010). As a result, while the principle remains sovereign in the very sense of the term, the agent is not, and in theory is supposed to be operating as a commercial actor subject to the various applicable rules. However, the ‘residual sovereignty’ of a fund, e.g. with regard to the possibility of asset seizure by foreign governments or other questions

⁸⁶ See also GAPP 15, which states that ‘SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate’ (IWG 2008b).

⁸⁷ There are widespread complaints, however, that some funds behave as quasi-sovereigns vis-à-vis other competitors in their home markets.

related to immunity, is dependent on a variety of legal factors (legal basis/legal structure, scope of delegation principle-agent, etc.) and remains subject to intense discussion (for a comprehensive overview, see Bassan 2011).

4.4 A three-level view of SWF political risk sources

Building on the thoughts on SWF stakeholders in the previous sub-chapter, the following passage identifies the most important sovereign fund stakeholders on three levels: the domestic level, the recipient country level and the international level. It touches upon the nature of the ‘stake’ of those stakeholders, their expectations towards a sovereign fund, and the mechanisms they may use to hold SWFs accountable.

4.4.1 Home sweet home: Domestic political risk sources

While political risk for SWFs has long been most salient in recipient countries, domestic pressure resulting from an ‘inward turn’ of SWFs during the financial crisis has become a powerful constraint on SWF activity (for more background on the “inward turn”, see Leong 2012). Therefore, any holistic SWF political risk analysis ought to start with the interests/expectations of the various domestic stakeholders, including the reasons for their power over the funds:

- As the principals of their respective funds, *domestic governments* and their administrations have a lot at stake: First and foremost, they want to ensure their fund(s) achieves its (their) objectives as laid down in its (their) mission statement(s). In simplified terms⁸⁸, this includes either realizing returns superior to the central bank’s conservative investment approach and ensuring stabilization- or sterilization objectives can be met. These are expectations generally relating to behavioural aspects of the fund whose accountability to the government rests on a legal/authoritative basis. In addition, most governments also have an implicit interest in maintaining a certain degree of control over the fund, expecting the funds to follow certain investment rules (e.g. Norway’s strict ‘ethical investment’ policy, but also the no alcohol/tobacco policies of some funds from Islamic countries) and to be ready to be called upon in case of domestic emergencies (e.g. ADIA’s support of Dubai (Zawya 2010) or to appease their population (Waki 2011). As Waki rightly mentions, the risk to the funds may be indirect, with governments spending more resources income on citizen welfare (GCC) or boosting popularity through rapid reconstruction (Libya) resulting in less inflows into their respective sovereign funds. Government’s ability to interfere depends on

⁸⁸ for more detail, see chapter 2.3.3.2

- the fund's governance arrangements: If these arrangements are robust enough, a sovereign fund may also lead to a more responsible fiscal policy by automatically diverting a predetermined portion of disposable government income into the SWF (for a similar argument, see Turnbull 2012). Relations of SWFs with *other government agencies* may prove tricky too: Anecdotal evidence from China suggests that there can be a fair amount of competition between SWFs and other state agencies or central bank departments: Prior to the creation of CIC in 2007, there has been a turf war between the Chinese ministry of finance and the People's Bank of China (PBOC) as to which institution is better equipped to manage excess foreign reserves (see also Monk 2011a). When CIC was set up as an independent entity (yet predominately staffed with Chinese ministry of finance officials), bureaucratic conflict continued, with the PBOC's SAFE fund also branching out into equity investments. Some analysts suspect this may have been SAFE's way to convince political leaders to reduce transfers from the PBOC's foreign exchange reserves to CIC by offering an alternative way of achieving higher returns (Wright 2008). Similar mechanisms are at play in *federal states* where resource rents accrue in one particular part of the federation. If federal governments centralize these inflows in a supra-federal sovereign fund without appropriately compensating the state of origin, this can lead to internal conflict. An example is Papua New Guinea where natural gas is concentrated in one region, or the situation in Alaska where in the early days certain elements of the fund⁸⁹ were ruled unconstitutional by the United States Supreme Court (United States Supreme Court 1982). Due to their authoritative nature, stakeholders at the federal level have emerged as a rather powerful force to reckon with.
- The power of *domestic parliaments* over and their interest in their sovereign funds varies: While there are parliaments with a clear role in governing their funds (e.g. the Norwegian⁹⁰ or the Kuwaiti one⁹¹), most parliaments have very little say in the

⁸⁹ In its decision *Zobel v. Williams* of June 14, 1982, the United States Supreme Court ruled that making individual dividend payments to Alaskans dependent on their length of residency was unconstitutional. While the benefits of the fund would have remained with Alaskans, this decision could also be seen as an attempt by the Supreme Court to broaden the beneficiaries of the fund and making the wealth accessible to all U.S. residents willing to move to Alaska.

⁹⁰ The Norwegian parliament has wide-ranging powers in determining the fund's investment strategy, including the broad lines of the ethical investment mandate. These rather encompassing competences are a reflection of the incorporation of the fund as a pool of assets, with its management, control and oversight allocated to five (!) independent bodies to insure maximum checks and balances.

⁹¹ KIA has a legal obligation to report twice a year on its investment performance to the Kuwaiti parliament. This law was passed in reaction to parliament discovering serious mismanagement of funds after the turbulent period starting with the invasion of Kuwait by Irak (Gelpen 2010, 31; for an account of the scale of mismanagement, see New York Times 1993).

operations of their respective SWFs⁹². Extensive research suggests, however, that parliaments are a powerful source of political risk: One of the main reasons is the difference in time horizons between long-term oriented SWFs and politicians caught up in the electoral cycle (for a view from the ground, see Murray 2012). As a result, the latter have an inherent interest to underweight notions of intergenerational equity and to use fund assets at present to support those sectors which reap the most benefits for their constituencies (withdrawal-related adverse consequences). In support of this hypothesis, research has found that SWFs where politicians are involved, are more likely to invest at home than those funds which add an additional degree of separation by farming out assets to external asset managers (EAMs). The former funds are also more likely to ‘chase’ equity trends, thereby foregoing the returns of early investments into nascent sectors and companies (S. Bernstein, Lerner, and Schoar 2009). Research by Dyck and Morse provides evidence for industrial planning objectives across SWF portfolios, in particular for Gulf- and Asian SWFs, resulting in a bias for domestic investments and specific industries (Dyck and Morse 2011). In analogy to a similar argument on bureaucracies in so-called rentier states and based on anecdotal evidence, politicians have also been found to use SWFs as a labour market policy tool, mandating the funds to take a certain number of nationals onto their payroll (see Schwarz 2008, 601)⁹³. Aware of these diverging interests between politicians and funds, most founders have foreseen but a very limited role of parliaments in the day-to-day governance of the funds. Parliaments may be granted considerable influence during the setup of funds, with the legislative framework usually provided by parliament, but typically no say in investment matters. However, there have been a few high-profile examples of parliamentary interference which may well amount to political risk: In Kuwait, for instance, public and parliamentary pressure throughout 2008 forced KIA to withdraw assets from its international portfolio in order to support the domestic economy (Barbary and Bortolotti 2011, 8). Another case was Russia where in the wake of the financial crisis of 2008, both original SWFs were used to cover budget deficits, defend the national currency and stabilise the economy in general and domestic banks in particular (for the

⁹² Some analysts suggest that this may change with increasing democratization following the Arab Spring (Leong 2012, 3). It remains to be seen, however, how easily (mostly Gulf-) rulers will let go of their SWFs, many of which nominally belong to them in a personal capacity.

⁹³ Considering the forceful push for employment of nationals without regard to their qualifications in the Gulf States in particular, it is likely that most funds in the region are expected to at least partially comply with ‘Emiratisation’ or similar policies. Nowadays, many funds run dedicated scholarship-, training- and development plans (e.g. ADIA, KIA and Mubadala) – whether these have emerged as a reaction to or as a corporate citizenship measure in anticipation of these policies, remains to be debated.

- original sources, see Gelpern 2010, 26pp). Upon parliamentary scrutiny of its investment performance, in 2009 KIA also had to sell its Citi stake (Financial Times 2009c)⁹⁴. And Bahrain's Mumtalakat fund has undergone a probe by parliament 'into what it sees as mismanagement at the fund' (Waki 2010a). Against the background of these findings, some analysts maintain it is during times of decline that 'politics is introduced in the management of national wealth' (Behrendt 2009, 149). This particularly rings true for the scrutiny of public investments which are otherwise left to technocrats.
- *Domestic media and non-governmental organizations* are important stakeholders as their representation of SWFs directly influences the perception of all other stakeholders, both at home and abroad (Fieseler and Meckel 2008, 9). With their agenda-setting and issue-shaping power, the media and NGOs set the public discourse and act as a transmission belt potentially inducing political action. The expectations of domestic media and NGOs towards their SWFs are likely to depend on the respective degree of democracy and freedom of a country: In fully democratic countries, the media are seen as the 'fourth power' and expected and accepted to adopt a watchdog function which also extends to SWF activities. NGOs fulfil a similar function, albeit representing more specialized interests. Generally, the media and NGOs expect SWFs to be transparent about their setup, their asset allocation and their activity, thereby enabling them to go about their business of intermediating information and providing non-governmental checks. If SWFs do not fully meet the media's information needs, SWFs may encounter political risk of the fund setup-related adverse impact sort. As the media have very little formal power over their own SWFs, with the latter only subject to moral accountability at best, political risk for the funds mostly results from social mechanisms such as article series or investigative pieces⁹⁵. In more autocratic nations with selective or restricted news- and investigative reporting, the situation may be slightly different: the (governmental) media's interest is likely to lie in supporting and transmitting the government's position on the respective fund. While there is little political risk to be expected from that side, the information gap is often bridged by independent, yet possibly less powerful outlets with little

⁹⁴ Interestingly, the KIA profit was reported to be more than USD 1bn or 37% on its initial investment after less than two years. Although political pressure for the sale did not lead to a loss in this case, it can be argued that it prevented KIA from reaping the full profits of holding on to the stake for longer. In other words and in line with the concept on 'adverse impacts', shortening the long-term SWF investment horizon generally results in opportunity costs.

⁹⁵ Günter Wallraff's investigative pieces, amongst other things on working conditions at various organizations, are amongst the first examples of this kind of media campaigns pressing for corporate change.

- firepower. An example of a rather critical media platform was Singapore's widely read Temasek Review citizen blog which amongst other issues criticized the Singaporean funds for what they thought to be ill-timed financial services investments and the very unpopular takeover of the Australian Stock Exchange ASX. The blog was shut down in July 2011 after Temasek (the SWF) had asked it to change its name due to the likelihood of confusion and the blog apparently also feeling pressure from other media (ChannelNewsAsia 2011).
- As the ultimate beneficiary of a sovereign fund, the *domestic population at large* is one of the most important yet (often) most powerless stakeholders. A salient example of Olson's diffused interests, the population's expectations towards its fund may vary considerably, ranging from expecting it to fulfil its objectives without squandering public funds or taking losses, to stimulating the domestic economy or to elevating the country's standing abroad (for the last expectation, see Monitor 2008, 24). There may also be a build-up of monetary expectations, with Alaskans now expecting a yearly check from their fund, the so-called Permanent Fund Dividend (PFD). While the PFD is calculated to remain at a sustainable level (for more background, see Widerquist and Howard 2012), citizens across countries in general have a temporary revenue expectation mismatch vis-à-vis their funds, resulting in a preference for immediate consumption instead of saving for future generations. With regard to domestic population impact, most SWFs are based in countries with limited democratic rights (Barbary and Bortolotti 2011, 1)⁹⁶. As a result, citizens generally have little levy on their funds to overturn intergenerational equity. However, it is widely expected that increasing democratization will lead to the domestic population becoming more powerful in fund matters, also as a potential source of political risk: As the population is granted more rights to influence domestic affairs and to possibly elect their leaders, governments and parliaments may have a strong incentive to use the funds to appease or to win over their domestic constituencies. While there is little proof of such domestic use of funds, it is very likely that some funds in the region have been tapped during the Arab Spring of 2010, with the objective of providing 'stabilization in the wider term' (Grünenfelder 2011). As direct accountability of most funds to its population is rather limited, the people would resort to social mechanisms to enlist support of their political agents. An

⁹⁶ They claim that at the time of writing (mid-2011), '72% of SWF AUM are controlled by authoritarian governments or hybrid regimes' which also dominate the investment flows (excluding the GPFG whose tracking provided challenging due to open-market purchases of minority stakes and the extensive use of EAMs).

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- important source of political risk is the domestic population scrutinizing their sovereign fund's investment behaviour. Funds may be criticized for (a) a low domestic investment quota, (b) not supporting ailing domestic sectors and/or (c) incurring losses on their foreign investment portfolios (see for instance Failey, Lu, and Wang 2009, 69).
- Other examples of often underestimated stakeholders are (*domestic and foreign*) *commodity producers* operating in countries with resource-funded SWFs. If production is not government-owned and fund inflows are a function of resource royalties and/or taxes, resource firms do have a strong incentive to minimize their tax burden by invoking reasons for limiting SWF inflows (for one of many examples, see Dow Jones 2012). So do other domestic stakeholders which profit from disposable government income: Mirroring the argument made above about SWFs potentially leading to responsible fiscal policy, such domestic stakeholders may look for political support to reduce SWF inflows and boost spending on their pet projects (which can range from social spending to agricultural subsidies, for example).

4.4.2 Fearing the Trojan Horse: Host-country level political risk

'You are sovereign only at home; abroad, someone else wields the power'
 The Economist, Asset-backed insecurities, January 17, 2008

The recipient-country level has traditionally been the source of most of the SWF political risk. As a result, in addition to the IMF's efforts to support SWF self-regulation, the OECD started to work on a 'Declaration of sovereign wealth funds and recipient country policies' which was adopted on June 5, 2008 (OECD Investment Committee 2008). Considering the most prevalent fears (see chapter 4.2.1), recipient country stakeholders generally expect SWFs not to interfere with matters at the national-, the company- and the cultural level. However, recipient country stakeholders greatly differ in terms of their ability to further their expectations.

- *Recipient country political stakeholders* can be subdivided in governments, parliament and political parties, each of which harbours its own expectations towards SWFs. Being elected to maintain the wellbeing of their citizens, recipient country *governments* are walking a fine line: On the one hand, they are expected to protect their home countries from takeovers of economically important companies

- or national icons by sovereign funds. On the other hand, governments are well aware of the importance of maintaining an open economy to ensure economic growth for the benefit of their citizens (for similar thoughts, see Monitor 2008, 25). So while governments are likely the most powerful stakeholders in terms of creating political risk, they may also be the most pragmatic when it comes to SWF investments – in particular with view to the financial crisis of 2008/2009 when SWFs came to the rescue of many Western governments. Political risk to FDI (and in analogy to SWFs) resulting from recipient country governments has been found to depend on a variety of institutional factors such as government partisanship, coalition formation, idiosyncratic political events (such as elections) and others (for an in-depth overview, see Bechtel 2009)⁹⁷. For example, overall right-leaning governments have been found to be more accommodating to foreign investors than left-leaning ones. In order to further their interests towards SWFs, domestic governments may use authoritative mechanisms at the national level (e.g. investment approval processes such as CFIUS)⁹⁸ or may opt for negotiating an international response. Political risk resulting from host country governments can arise at the micro-, yet also at the meso-political risk level, thereby potentially enabling SWFs to mount a common response. As opposed to recipient country governments, parliaments and (often more pronounced) political parties may have split interests: On the one hand, they want to support what is best for the country, on the other hand they may strategically opt for opposing government policy on SWFs in order to gain votes. It can be hypothesized that the degree of opposition depends on whether a country is to be classified as a majoritarian- or a consensus democracy, with executive-legislative relations governed by either dominance or a balance of power (for the original typology and the differences in political and economic performance arising thereof, see Lijphart 1999). In authoritarian political regimes, it can be assumed that parliament and political parties support the government's line on SWFs.
- As opposed to their domestic cousins, *host country media- and social stakeholders* such as NGOs have proved to be amongst the most fervent critiques of SWFs, both of their portfolio- and greenfield investments. Catering to their domestic audience,

⁹⁷ Starting with Hibbs (Hibbs 1977), there has been a burgeoning literature on the effects of political determinants on macroeconomic outcomes. Political risk factors arising thereof will be looked at more closely in chapter 5.5.

⁹⁸ Although dating from 1975, the CFIUS only rose to prominence in 2007 when it was amended with national security provisions aimed at government-controlled investors in reaction to China National Offshore Oil Corporation's and Dubai Ports' (unsuccessful) attempts to take over US companies. Gelpert suggests the CFIUS has served as a blueprint for other recipient country governments (Gelpert 2010, 18; for an overview of CFIUS-inspired approval processes in other countries, see Kern 2010, 33pp).

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- recipient country media are mirroring and amplifying popular concerns about SWF investment (sell-off of national assets, potential loss of jobs, etc.). Media reporting on SWFs is often both driven by and also driving their reputation (Fieseler and Meckel 2008, 7). In what seems to be the only empirical study on the media and SWFs so far, Fieseler and Meckel argue that the media have a tendency to report on negative examples of SWF activity. In combination with many funds' rather low levels of transparency and little enthusiasm for active communication, the media become the only source of information, thereby shaping the perceptions of politicians, the population and other stakeholders alike. Recipient country media often take issue with sovereign fund transparency levels, in particular when it comes to activities in the host country. As a consequence, the media are likely to push for more information, in particular when a deal is impending. While the media are an important stakeholder, however, they solely rely on social mechanisms to ask for accountability. Although there have been very few examples of *domestic NGOs* combatting sovereign funds, SWFs may prepare for NGO resistance when participating in projects with ecological or social implications, presumably most prevalent in direct investments.
- *Recipient country trade associations* are important stakeholders as SWF investments often touch upon economic policy- and employment-related questions. There are different types of trade associations, with attitudes towards sovereign funds and the power to influence policy varying considerably: Sector trade associations are representatives of a group of members with narrow, specialized interests. Their attitude towards sovereign funds is determined by the degree the sector would profit from an SWF investment. An example of a positive sectoral trade association attitude is the 2008 SWF policy paper by the Swiss Bankers Association which advocates a liberal policy position towards SWFs (Swiss Bankers Association 2008). Sector trade associations can wield considerable power within peak associations, in particular based on their concentrated interest structure and the disproportionate rewards for relatively few members potentially resulting from policy change/status quo. National peak associations have a bigger, yet more diverse membership which generally moderates their policy positions (for example, see *economiesuisse* 2008 for the Swiss peak association's position on SWFs). Often portraying themselves as the 'voice of the economy' and participating in consultation- and policy processes, peak associations occupy a central role in the formulation of economic policy, in particular in the corporatist systems of consensual democracies (Lijphart 1999,

171pp). Predicting peak association's position towards sovereign funds is difficult and requires analysis on the policy positions of individual member federations and on their voting rights.

4.4.3 World Wide Worries: transnational political risks

While capital and investment flows have seen a considerable liberalization over the last decades, political risk at the level above the nation state has increased as well: As noted in chapter 3.3.2, modern communications technology now enables stakeholders with similar interests to procure information and to connect and to co-ordinate across national borders. This has created a more level-playing field vis-à-vis transnational/multinational companies which have started their internationalization long before.

- In the early days of the SWF controversy, *international debtor nations* were amongst the most vocal critics of sovereign funds. Commodity-based funds were accused by importers of natural resources to profit from high prices whilst countries investing excess foreign exchange reserves were blamed for manipulating their exchange rates in a quasi-mercantilist manner to exert political pressure (for more background on the imbalance argument, see Gelpern 2010, 11pp). A classic reflection of debtor nation fears is a quote from Hillary Clinton's speech at the Democratic National Committee Winter meeting in 2007 where she wondered why the United States was not able to be tough on matters related to China: 'And I say, because of the debt that under this government, under this president, has exploded, we are now dependent upon China, and how do you get tough on your banker?' (Clinton 2007). Mindful of the power of its major creditor, the United States Treasury even installed a direct computer link allowing the Chinese central bank (PBOC) to bypass Wall Street government bond trading houses (Reuters 2012d)⁹⁹. While debtor nations are not showing any signs of turning against their creditors (also because a breakdown of the symbiosis is thought to lead to significant costs and financial market turmoil), sovereign wealth funds may do well to follow the internal political dynamics of these particularly powerful, mostly Western stakeholders.

⁹⁹ Creditor nations are aware of their power, too, as it has been shown by a rather astonishing episode in early 2010 when the Chinese army called for a sell-off of U.S. government debt 'in retaliation for recent arms sales to Taiwan' (The Washington Times 2010). Although it is SAFE and the PBOC rather than the CIC which hold Chinese U.S. government debt, it underlines the mechanics of how domestic political pressure could alter a sovereign fund's asset allocation, thereby constituting a prime example of political risk.

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- As SWFs are by definition active players in the international capital markets, *international governmental organizations (IGOs)* framing the exchange of goods and capital across nations continue to be important stakeholders. By initiating the Santiago principles and the OECD Declaration on Sovereign Wealth Funds and Recipient Country Policies, IGOs have been instrumental in securing a level playing field for SWF investors. Invoking market participants' moral and sometimes legal accountability (e.g. in WTO/trade matters), however, IGOs may also try to steer international investment, thereby constituting potential political risk for sovereign funds (investment behaviour or withdrawal/funding-related adverse impact): For instance, given SWFs' financial clout, the UN and other IGOs have long advocated a push for increased investments in Africa (AFP 2012), thereby adding additional reputational pressure on SWFs. Considering the pressure on development aid in cash-strapped Western economies, it may also be possible that IGOs increasingly turn to SWFs (and their host nations) for additional financial support. Some issues SWFs may be asked to support could range from environmental- and climate change initiatives (many SWFs come from heavy carbon-exporting nations) to workers' rights issues, with SWFs potentially being asked to prove their sustainable investment credentials. While SWFs do not have providers of capital pressuring them to adopt international covenants such as the UN's Global Compact or the Principles for Responsible Investment (UNPRI), it is clear that the responsible IGOs would like to see SWFs committing to their principles rather earlier than later¹⁰⁰. Most IGOs command moral accountability over SWFs at best, but the reputational impact for an SWF of turning against expectations of international community practice cannot be underestimated. This also as SWFs, through their governmental quality and using their financial clout, have long been suspected to circumvent established institutions of international governance. IGOs harbour another type of political risk which may affect SWF operations: As a matter of fact, many SWFs originate from countries without full democratic rights. Often, these countries may also be at odds with international positions on other controversial issues (e.g. human rights violations), thereby increasing the political risk for their SWFs to become targets of international sanctions (Barbary and Bortolotti 2011, 9). Although the Libyan SWF was one of the very few sovereign funds to experience the full impact of an international asset

¹⁰⁰ As anecdotal evidence of the subtle wooing of these initiatives towards SWFs, see the interview with Jerome Tagger, COO of the UNPRI in the April 2011 issue of *Sovereign Wealth Quarterly*, a special interest publication of the Sovereign Wealth Fund Institute for sovereign investors (The Sovereign Wealth Fund Institute 2011).

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- freeze, there are a number of other SWFs which may be equally in danger. In another sign of national and international IGO/NGO opinion being taken into account, sovereign funds are increasingly being subjected to comprehensive reputational risk review/due diligence processes by financial counter-parties.
- Another important source of transnational political risks are *market stakeholders, in particular sizable international institutional investors and investee companies*. First and foremost, international market players expect SWFs to fully comply with market rules without resorting to any ‘sovereign solutions’ potentially available to them. In order to ensure efficient markets, SWFs are expected to provide a certain amount of transparency. Most funds are only subject to moral accountability to their fellow market players, unless they are in a contractual relationship. For instance, both Mubadala and Temasek have issued international debt, making them contractually accountable to their investors which then may use political pressure to receive more information. In addition, as SWFs are increasingly a) farming out assets to EAMs, amongst them specialized entities (hedge funds, private equity funds) and b) entering into strategic partnerships with other companies, the web of contractual obligations to provide transparency is increasing. Furthermore, SWFs have not shied away from going to court to settle commercial disputes with market stakeholders. For example, Norway and Abu Dhabi have sued Citigroup for misrepresenting financial information (Financial Times 2010d). Generally, this is a reassuring sign of depoliticised conflict resolution by sovereign funds. Another type of SWF market stakeholders which may increase in importance are *investee companies*. So far, companies with considerable SWF ownership have not been seen to club together to further their interests towards their main sovereign shareholders, probably also due to their dispersed interests. However, based on prior research by Monitor, Barbary and Bortolotti argue in a recent paper that ‘the political risk associated with an SWF investment negatively affects financial performance of investee companies’ (Barbary and Bortolotti 2011, 5pp). As potential reasons, they cite upheaval risk impacting on the country’s sovereign wealth management¹⁰¹ and ‘geopolitical risk triggered by targeted sanctions’ (see above). Although it looks unlikely at the moment, SWFs may also prepare for a co-ordinated backlash from investee companies acting on adverse SWF investment impact.

¹⁰¹ This echoes Natsuko Waki’s point of governments appeasing their constituencies through increased hand-outs and welfare- and social benefits, thereby potentially reducing SWF inflows (Waki 2011).

- *International NGOs and NGO networks* such as Greenpeace or Banktrack, a network of 20 NGO members and another 15 partners, have become important players at the international level. They work together based on a ‘shared discourse’ and attempt to influence policy according to ‘principled ideas and values’ (Keck and Sikkink 1998, 1pp). Combining headquarter resources and country-based intelligence, these organizations assess international financial deals with view to environmental and social governance (ESG) criteria. They expect SWFs as professional investors to comply with the most important international covenants (UN Global Compact, etc.) and to also transparently report on their compliance (e.g. by using the Global Reporting Initiative’s (GRI) reporting guidelines). SWFs are not deposit-taking institutions, therefore NGOs lack an important channel of influence (clients). However, sovereign funds’ reputation would still suffer from non-compliance becoming widely known – with the effect likely to be compounded by many other institutional investors having already made considerable progress in adapting to these new realities. But NGO critique is not focused on ESG issues alone, as RevenueWatch’s 2010 report on a proposed Nigerian SWF shows: it contains a series of recommendations on how to set up the governance of the fund and announces future reporting on the subject (Revenue Watch Institute and CSEA 2010).

5 Conceptualizing SWF political risk: A framework

Based on a clear definition and a thorough analysis of concerns, the prior chapter described and classified SWF political risk across various dimensions, and the three levels SWFs are operating on. It concludes that political risk originates from social-, market- or authoritative stakeholders which all have individual expectations they try to hold SWFs accountable for. By variably resorting to social-, market- or authoritative mechanisms, stakeholder expectations have the potential to gradually transform into political risk for SWFs. This chapter looks at the ‘black box’ at the intersection of stakeholder expectations and SWF attributes and develops a model which captures SWF political risk in its complexity and contributes to a better understanding of its dynamics. For this purpose, it introduces three well-known concepts, legitimacy, reputation and compliance, before turning to analyse the four most important clusters of political risk factors for sovereign funds.

5.1 A model of SWF political risk

5.1.1 The need for legitimacy

Organizations do not exist in a vacuum. As shown in the prior chapter, SWFs are operating within a complex web of market stakeholders, sovereign principals, domestic beneficiaries, recipient country stakeholders and non-governmental organizations at the national and the international level, to mention but a few. As such, sovereign funds are facing a multitude of (often conflicting) expectations arising from their stakeholders. Political science and political economy are well equipped to make sense of these interactions: New institutionalist theories in particular provide a powerful tool of analysis to understand these dynamics.

Emerging as a reaction to the dominance of behavioural theories in the 1970s and 1980s, new institutionalism re-introduced institutions to social and economic analysis (for a widely-cited overview, see Hall and Taylor 1996). New institutionalists believe that institutions exist within a broader social, economic and political framework. Within this framework, organizations are constantly seeking to establish congruence between their own and societal value systems (Dowling and Pfeffer 1975, 122). As a consequence, organizational structure and activities are seen as ‘either reflections of or responses to’ an organization’s environment (Powell 2007, 1). Translating new institutionalist thinking into stakeholder theory, this means that organizations are

shaped by and therefore try to meet the expectations of their stakeholders. The extent to which organizations are doing this ultimately depends on the accountability mechanisms linking the sovereign fund and its stakeholders.

Considering the effort involved in meeting stakeholder expectations, it also leads to the question why organizations are engaging in such costly activities. To answer this question, new institutionalist theory invokes the concept of legitimacy. Suchman, combining insights from thirty years of research on this matter by a wide array of scholars, brings forward a broad yet sensible definition which describes legitimacy as

‘a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions’ (Suchman 1995, 573).

As Powell notes, ‘institutional effects oblige organizations to conform to the expectations of the fields in which they are members’ (Powell 2007, 4). In the case of sovereign wealth funds, this would be some sort of international institutional financial investor community, with some funds also fitting in quite well with what could be called ‘alternative investors’ (hedge funds, private equity, activist institutionals). Institutions conform to expectations because a disparity between value systems is likely to result in a threat to legitimacy, potentially causing ‘legal, economic and other social sanctions’ which is commensurate with what this thesis conceptualizes as political risk. From this point of view, legitimacy (or rather the lack thereof) is seen as a constraint on organizational behaviour which incentivizes organizations to engage in various activities to legitimize their existence, their structure and their behaviour. As referred to in chapter 4.2.3, *accountability* plays an important role in building up and maintaining an organization’s legitimacy. ‘Accounting for activities, accepting responsibility and disclosing results’ helps stakeholders to follow, evaluate and appraise organizational activity. In exchange for being accountable for their activities, either from a moral-, contractual- or legal point of view, organizations are conferred legitimacy by their stakeholders.

Legitimacy (and trust) have played a prominent role in the debate on sovereign wealth funds, both from a domestic point of view and when investing abroad: In an early paper on SWFs, Ashby Monk finds that lack of legitimacy resulting from a mismatch between SWF norms and activities and stakeholder expectations constitutes a major obstacle to SWF operations (Monk 2009a; similarly Gordon L. Clark and Monk

2009c). Following a new institutionalist line of thought, he underlines the importance of aligning governance (understood as ‘procedures, policies, structures and decision-making norms’) with societal expectations, in particular in recipient countries. In another paper, Clarke and Monk argue that Singapore’s GIC was set up as an ‘insurer of last resort’, with the aim of shielding Singapore from the vagaries of international economic crises. This has ensured the small city state’s independence and thereby maintained the population’s high standard of living. GIC’s legitimacy with domestic stakeholders has thus partially resulted from meeting the fundamental independence needs of the Singaporean citizens (Gordon L. Clark and Monk 2009a). Legitimacy also plays a part when it comes to stakeholders’ assessment of fund objectives, as Reisen notes: While many stakeholders denounce strategic fund objectives such as domestic diversification, Reisen observes that funds following such investment patterns are often perceived as similarly legitimate as those following stabilization or intergenerational savings objectives (Reisen 2008, 9). Last but not least, the Santiago Principles may be considered a successful example of sovereign funds trying to build up legitimacy by committing to a set of rules addressing various stakeholder expectations/concerns.

5.1.2 Compliance: the core of legitimacy

In the model proposed by this thesis, legitimacy depends on both compliance- and reputation-related factors. *Compliance* results from meeting ‘hard’ stakeholder expectations, usually relating to either legal/authoritative obligations set by lawmakers and regulators or contractual obligations with powerful enforcement mechanisms. *Reputation*, on the other hand, is a result of meeting moral/ethical stakeholder expectations or contractual obligations with enforcement mechanisms relying on reputational mechanics. While compliance is a rather binary concept (i.e. an organization complies with certain rules such as the US FCPA or it does not, hence is un-compliant), reputation has different shades of grey and may result in both opportunities and threats. Without being compliant with the applicable laws and regulations, an organization cannot be legitimate. However, an organization can have a very bad reputation but could still be considered legitimate. Therefore, compliance is a necessary condition for legitimacy while reputation may only be a sufficient one.

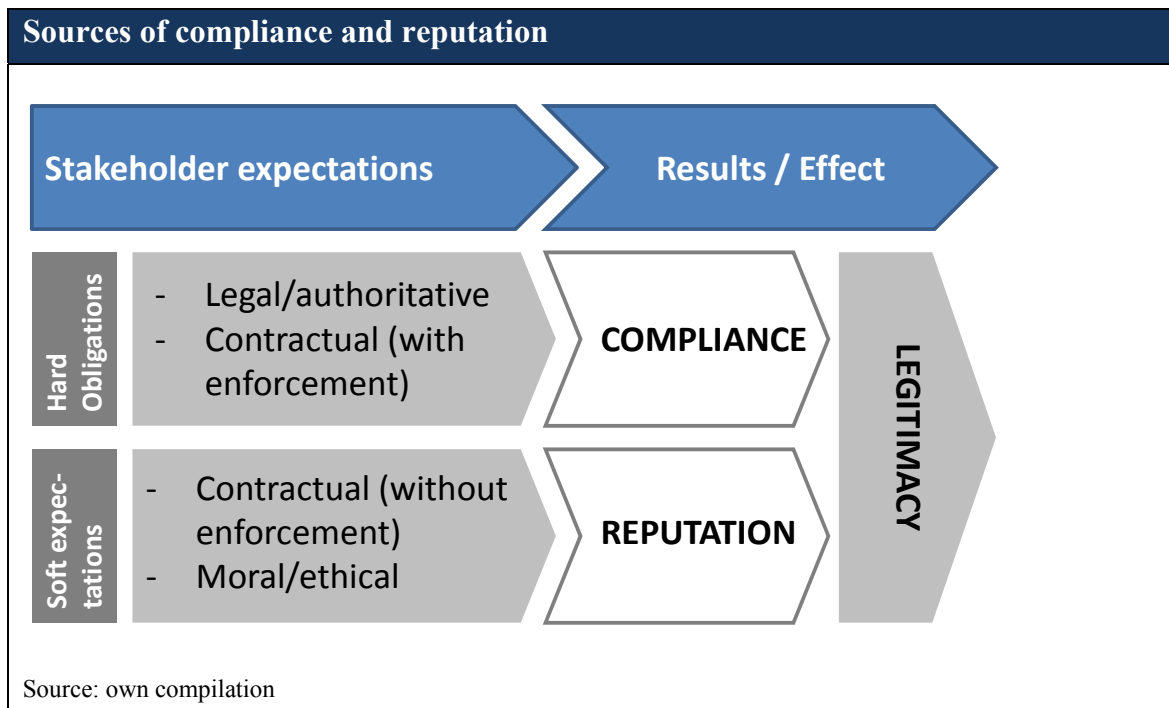


Figure 17: Sources of compliance and reputation

Compliance is defined as conforming to rules set out by authoritative or contractual stakeholders. As used today, the term refers to following ‘hard law’ which is the result of ordinary law-making processes or contractual obligations. As active market participants, sovereign wealth funds have to comply with law originating at the domestic level, in recipient countries and – rarely – with supranational law. The Santiago Principles state that SWF operations should be conducted in compliance with all applicable regulatory and disclosure requirements (GAAP 15). Examples include domestic regulatory rules, competition- and takeover codes (direct investments) or disclosure/reporting requirements (portfolio investments) in recipient countries. Content-wise, regulation to comply with may range from securities- and financial reporting- and corporate governance rules to environmental and social standards. Given raising levels of regulation for businesses, the last decade has seen the emergence of an ample literature on how to detect, analyse and comply with new rules, particularly in the financial services industry (for a hands-on overview, see Mills 2008).

Compliance also covers sovereign funds’ adherence to contractual obligations, in particular those with strong enforcement attached. This is the case with most contracts entered into with international financial market players. Under these contracts, the

actions of both parties can be challenged in court and enforced across multiple jurisdictions¹⁰². The situation is less clear in the case of international covenants such as the UN Global Compact, the Extractive Industry Transparency Initiative or self-regulatory contractual arrangement such as the Santiago Principles. Despite them exhibiting some sort of legal character, these covenants rather constitute ‘soft law’, drawing their force from peer pressure and reputational mechanics.

In the model underlying this thesis, compliance constitutes the core of legitimacy (see the illustration in the following chapter). There are two different aspects of compliance risk: (1) The risk of non-compliance and (2) compliance risks arising from an unexpected change of the rules of doing business. As described above, the former is an endogenous type of risk: if not taking adequate measures to comply with the applicable rules, organizations in general and sovereign funds in particular are running the risk of immediately forfeiting both their legal and their social ‘licence to operate’. As opposed to non-compliance, these risks arising from unexpected regulatory change are exogenous, i.e. emerging from outside of the fund’s sphere of control. Regulatory change may result as a specific reaction to sovereign fund activity or may be more general in nature. The relationship of compliance risk with political risk is indirect: While compliance risk does not equate political risk, ‘political action’ may unexpectedly change the rules of the game, potentially resulting in heightened compliance risk for affected parties. A failure to comply not only leads to authoritative sanctions such as penalties, but is also likely to have a detrimental impact on a company’s reputation with regulators and the public (Economist Intelligence Unit 2005, 5) – in particular in the light of multiple recent compliance breaches in financial services organizations¹⁰³.

5.1.3 Reputation as the second determinant of legitimacy

The last two decades have seen the concept of political risk being gradually complemented by in-depth thinking about corporate reputation, in particular reputational risk. Reputation is an elusive and amorphous concept (The Conference Board 2007, 6), with various definitions proposed in the literature: The Oxford

¹⁰² As the example of ADIA’s and KIA’s court action against Citigroup indicates, sovereign wealth funds are increasingly active in defending their investor interests in court. Interestingly and contrary to common perception, however, there have been very few high-profile court cases challenging SWF behaviour.

¹⁰³ Amongst the most notorious ones were rogue trades by SocGen’s Jérôme Kerviel and UBS’s Kweku Adoboli, the insider trading scandal surrounding a former Goldman Sachs board member and the scandals on LIBOR- and rate setting mechanisms in other jurisdictions which are still under investigation.

Dictionary defines reputation as ‘what is generally said or believed about a person’s or a thing’s character’ (Thompson 1992). Wartick defines reputation as ‘the aggregation of a single stakeholder’s perceptions of how well organizational responses are meeting the demands and expectations of many organizational stakeholders’ (cited according to Fieseler and Meckel 2008, 5). This echoes the well-known saying that ‘the company owns the brand, [but] stakeholders own its reputation’.

As opposed to compliance which results from fulfilling hard obligations, reputation results from meeting or exceeding ‘soft expectations’. These may include moral and/or ethical expectations, but also quasi-contractual obligations where there is little enforcement. Therefore, it depends entirely on the organization if it is willing to voluntarily follow these expectations and to build up a reputation for itself. A good example of SWF contractual obligations with a reputational impact are sovereign funds’ compliance with the Santiago Principles. Originally, the signatories to the Santiago Principles had not foreseen any review- and/or sanctioning mechanisms. However, public interest in assessing progress has resulted in both a widely-reviewed ‘Santiago Compliance Index’ by Sven Behrendt, one of the first scholars specializing in SWFs (for the latest edition, see Behrendt 2011b) and lately in an official IFSWF report on ‘member experiences’ implementing the principles, with the report likely to be continued (IFSWF 2011b). Depending on where SWFs score on these scorecards, their reputation with stakeholders may be affected, potentially resulting in counterparties having reservations when entering into business with these funds.

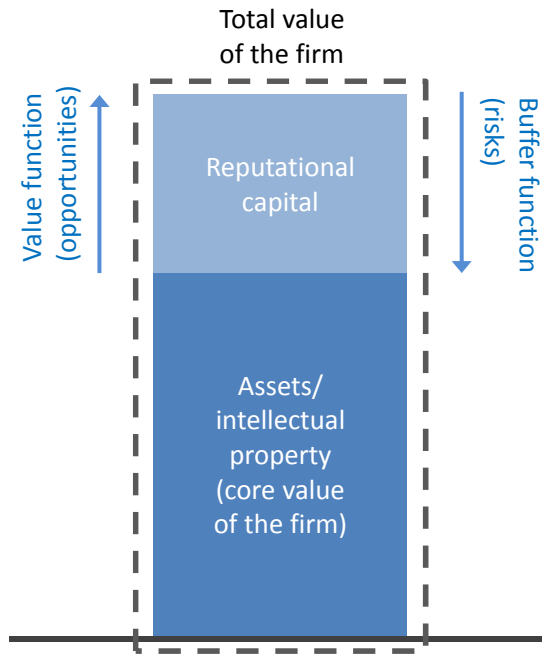
As the well-known saying goes, (stakeholder) perception is reality and therefore has a real impact on any organization. Both academia and practitioners have produced a multi-faceted literature on how reputation can be managed for the benefit of organizations. The concept of reputational capital links reputation with corporate strategy and financial management. According to Fombrun’s seminal book on the subject, reputational capital is calculated as ‘the market value of the company in excess of its liquidation value and its intellectual capital’ (Fombrun 1996). In other words, reputational risk refers to the risk of disappointing stakeholders’ expectations as to how a company is organized and goes about its business. Maintaining and growing reputational capital should be of utmost importance to any organization. Reputational capital can be built up in various ways, ranging from constantly providing impeccable products or services to customers to going the extra mile and

engaging in corporate citizenship activities. In abstract terms, reputational capital is a direct result of meeting or exceeding stakeholder expectations.

Denk distinguishes between expectations arising from market-based exchanges (e.g. product quality) and expectations going beyond market-based interactions (e.g. caring for the environment). As Henisz and Zelner point out (Henisz and Zelner 2003, 4), from an investor's point of view, reputation matters most in repeated games where players (or companies) 'have to take into account the impact of their current action on the future actions of other players' (Wikipedia 2012). This is particularly relevant for sovereign funds which by definition have a long-term investment horizon. This brings them into repeated contact with certain stakeholders such as business partners/market stakeholders, foreign governments, regulators and the media.

Amassing reputational capital has a positive effect on organizations: From Fombrun's perspective, reputational capital induces organizational stakeholders to act in favour of the company and to prefer it to other organizations with lower reputational capital levels. A company's reputation may affect five aspects of its operations: 1) customers' purchasing decisions, 2) employee engagement, commitment and retention, 3) investor appetite to invest, 4) media coverage, and 5) financial analysts' view of the company. For example, a good reputation may result in employees working hard(er), customers choosing the company's products over others, investors investing in its stock and the media reporting favourably on the company (Fombrun and Van Riel 2004, 8pp). From this point of view, reputation creates opportunities for a firm and provides an added-value. However, and most importantly in an SWF risk context, reputational capital also has a buffer function: it protects the core value of the firm by making political stakeholders think twice about mounting campaigns. A firm's high reputational capital makes it more costly for stakeholders to attack and also absorbs some of the heat if they do so nevertheless. In addition to creating opportunities, reputational capital therefore also acts as a buffer against political risk

The value- and a buffer function of reputational capital



(Source: own figure on the basis of (Fombrun 1996; Fombrun, Gardberg, and Barnett 2002; Fombrun and van Riel 2004))

Figure 18: The value- and buffer function of reputational capital

While Fombrun's framework is applicable to a wide range of organizations, conceptualizing reputational capital for sovereign funds may be more complex: Reputational capital may be earned as a trusted investor and/or counterparty on international financial markets. However, due to the strong links between the domestic polity and its sovereign fund, SWF reputational capital not only depends on the fund itself, but also on the reputation of its home country. And as a result of the emergence of a somewhat collective reputation of the sovereign fund sector, reputation may finally depend on other funds or on collective SWF behaviour too, as this chapter will later argue.

5.1.4 Legitimacy deficits as a precursor to political risk

Building on the thoughts above and on SWF stakeholder analysis in the prior chapter, this sub-chapter develops a model conceptualizing sovereign wealth funds' political risk as a function of legitimacy. In this context, political risk is conditional on gaps between stakeholder expectations and the setup/behaviour of a particular fund. When

SWFs lose legitimacy, it makes them vulnerable to outside influence, thereby enabling stakeholders to ask and press the fund to align its structure or its operations with their expectations. At the core of legitimacy is compliance, resulting from observing hard obligations, mostly of supervisory- or contractual nature. However, legitimacy also depends on reputation. Organizations harvest reputational capital by constantly meeting or even exceeding moral/ethical stakeholder expectations and contractual obligations without enforcement. While an organization's level of legitimacy is difficult to measure, it is clear that a lack of it has serious repercussions for organizations to fulfil their mandates.

Legitimacy is a major precondition for any organization and corporation to obtain and maintain its '*licence to operate*' (for many, see Financial Times Lexicon 2012)¹⁰⁴. This licence is not a formal regulatory blessing of a company's activities but rather constitutes an informal 'badge of approval' by an organization's stakeholders. Conceptualizing the firm as part of a social eco-system, Freeman sees corporate survival depending on 'there being some 'fit' between the values of the corporation and its managers, and the expectations of stakeholders towards the firm. The degree of this fit – amongst other things – determines the ability of the firm to sell its products' (Freeman 1984, 107). This also holds for money management activities where trust occupies a central role – arguably much more than in other sectors due to the all-encompassing nature of client relationships. In the model proposed below, the licence to operate does not come for free: sovereign funds and other organizations 'pay' for it by being accountable to their stakeholders. This often comes at a cost which may include publishing annual reports, accepting responsibility for side-effects of business activities or taking into account the wishes of particular stakeholders when developing a project or doing an investment.

So how does a loss of legitimacy come about? Legitimacy may be impaired in two ways: either by a significant loss of reputational capital or by a breach of compliance. While both may directly impact on legitimacy, the mechanisms behind them differ significantly:

- Sovereign wealth funds – like any other organization doing business in today's regulated markets – are compliant if they meet both their contractual obligations towards third parties and their obligations arising from authoritative acts such as

¹⁰⁴ The term '*licence to operate*' originates from the mining industry where due to its local/on the ground operations, social- and community stakeholders traditionally wield considerable influence.

- laws and supervisory decrees. A *breach of compliance* usually results in the other party initiating court procedures or in a fine and/or other authoritative sanctions. Therefore, non-compliance almost automatically and directly results in a loss of legitimacy in the form of being subject to sanctions, mostly of the legal/regulatory kind. From a political risk point of view, a breach of compliance increases the fund's vulnerability to political interference as authoritative stakeholders are trying to bring the SWF back in line with their expectations. As opposed to the effects of losses of reputational capital, a compliance-related loss of legitimacy happens almost immediately: As an example, imagine what happened if a sovereign fund was to be found not to comply with recipient country shareholding disclosure rules. Depending on the severity of the breach, it would result in a fine and likely in a significant reputational loss. This would open a weak spot to stakeholder demands and political risk and ultimately endanger the sovereign fund's licence to operate. Therefore, a breach of compliance not only has a direct effect on an organization's operations, but also affects its vulnerability to political risk.
- The impact of *reputation* on legitimacy follows a slightly different mechanic. Reputational risk refers to the risk of diminishing an organization's reputational capital¹⁰⁵. In Fombrun's view and in analogy to the VaR (value at risk) concept, reputational capital is 'the [residual] value of the company that is 'at risk' in everyday interaction with stakeholders' (Fombrun, Gardberg, and Barnett 2002, 87). As a consequence, there is a direct link between reputation and political risk: If stakeholder expectations are repeatedly disappointed (and hence reputational capital declines), so does legitimacy. As the gap between stakeholder values, norms and expectations and SWF principles, structure and behaviour increases, it chips away at reputational capital. At a certain point, the deviation from 'how it should be' in a society may become so significant that it is no longer a question of reputation but a question of compliance. Even before reaching that point, however, the loss of reputational capital makes it more promising for political stakeholders to resort to political action to push for their interests (for many, see Denk 2003, 134). With reputational capital declining, companies or sovereign funds are losing the 'benefit of the doubt' in public disputes, thereby becoming more vulnerable to stakeholder demands. From an SWF point of view, reputational capital management comes with some distinctive challenges (see chapter 5.4). One of

¹⁰⁵ While most of the literature focuses on reputational risks, Fombrun explicitly adopts a two-pronged approach which also acknowledges the chances arising from building up corporate reputation (Fombrun, Gardberg, and Barnett 2002, 88). Given the focus of this thesis on reputation as one aspect of political risk, however, it will predominately look into the downsides.

them relates to the fact that it has been a relatively short time since sovereign funds have acquired a public profile. Due to a rather hostile climate and the resulting lack of pro-active information of and interaction with social and political stakeholders in the early days as ‘public’ investors, SWFs have built up comparably little reputational capital – and have often lost some of it due to being closely associated with their home countries. As a result, when public emotions run high, there is little reputational capital to grant SWFs the ‘benefit of the doubt’ (or to act – as Fombrun calls it – as a safety net) in public disputes. This reduces legitimacy and makes them more vulnerable to stakeholder demands/political risk.

Figure 20 summarizes the main findings of the model where legitimacy depends on both compliance and reputational capital. Moral/ethical-, contractual or authoritative/supervisory accountability enables stakeholders to assess sovereign fund characteristics and to benchmark SWF performance against expectations. Unless there are major compliance breaches resulting directly in political/regulatory intervention, any gaps may reduce reputational capital. This, in turn, indirectly leads to political risk by increasing the vulnerability to various stakeholder demands. As a result of decreasing legitimacy, sovereign funds may experience a slow revocation of their licence to operate, which potentially leads to higher costs of doing business.

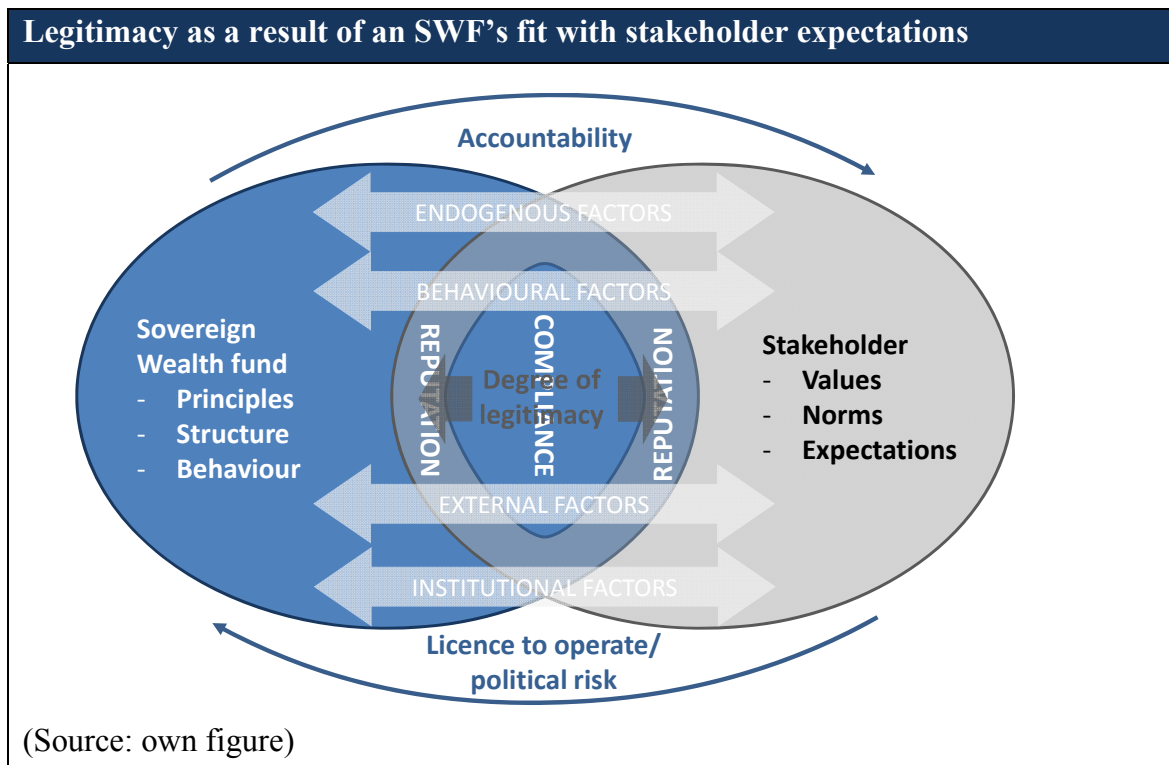


Figure 19: Legitimacy as a result of an SWF's fit with stakeholder expectations

5.1.5 Perception is reality: political risk factors

Having laid out the general mechanics of how stakeholder expectations may translate into political risk, the next sub-chapter will shed some more light on legitimacy gaps. Based on in-depth interviews with both SWF representatives and external stakeholders, it identifies four areas where there is an increased likelihood of gaps between SWF characteristics and stakeholder expectations. These four areas are in line with the clusters of public concerns identified in chapter 4.1.2, reflecting areas with the potential to translate into political risk. In analogy to medicine, this thesis will refer to these areas as political risk factors, reflecting their pivotal role in determining sovereign funds' risk of political interference. They constitute areas where sovereign funds have very distinctive choices to make in order to consciously *take*, efficiently *mitigate* or actively *avoid* political risk. Before having a closer look at the various risk factors in detail, however, there are two aspects of particular significance which need to be mentioned:

- *First*, political risk does not easily lend itself to mono-causal explanation. Due to the complexity of the matter, more often than not, political risk results from a variety of factors which cannot be easily isolated. Although multivariate statistical analysis could be of help in disentangling the various political risk factors, it is bound to fail due to the fact that most of these factors are hard to quantify (think of individual SWF reputation, for example). As a consequence, the methodologically soundest way of circumventing these restrictions may be an in-depth discussion of each cluster of factors. While the literature which has developed around it may not be specifically geared towards sovereign funds (but rather institutional investors), it provides important indications as to the different expectations and incentives at work.
- *Secondly*, the degree to which SWFs are able to influence political risk factors not only varies across funds, but more importantly across the various factors. While endogenous factors such as corporate governance aspects are by definition under the funds' (and their guardians') own control, the ability to influence behavioural- and even more so external factors is markedly reduced. This has some important implications when it comes to drafting political risk management strategies (see chapter 7): individual fund action needs to be complemented by partnership- and collective action strategies in order to appropriately tackle political risk.

5.2 From the inside: Endogenous risk factors

As noted in an influential empirical study on sovereign brand reception, an individual SWF's reputation may be influenced by external factors but is predominately based on 'its own attributes' (Hill&Knowlton and Penn Schoen Berland 2010, 16). Being given a choice of various reputational factors which may influence (SWF- and general) investment approval¹⁰⁶, respondents opted for transparency, accountability and good governance as the most important ones. The following sub-chapter details how these factors may contribute to SWF political risk.

5.2.1 Fund structure

While there is considerable variance across sovereign funds in terms of their setup and structure (IWG 2008a, 5pp; IFSWF 2011b, 13), it is widely recognized that mandate, policy objectives and governance arrangements significantly determine a fund's legitimacy. E contrario, unclear mandates or unstable governance opens the door for political risk, not only by making it more likely for SWFs to be hijacked by special interests (for a similar thought, see El-Erian 2010, 232), but also by promoting the perception that the fund is following objectives other than commercial ones. There have been various ideas as to what fund structures may encompass. Truman's fund structure indicator, used in his influential SWF best practices blueprint to produce an SWF ranking, looks at objectives/mandates, fiscal treatment and the degree of separation from national reserves (Truman 2008a, 6pp). In addition, there are good reasons to also look at governance-related indicators to assess the likelihood of political interference for certain structures.

- *Objectives/mandate*: A clear mandate with reference to commercial goals is of utmost importance to fend off political risk. While there are no 'hard' legal obligations as to how define a mandate, there are stakeholder expectations as reflected in emerging best practice such as the Santiago Principles. They recommend a 'clearly defined and publicly disclosed' policy purpose (GAAP 2) and investment decisions aimed at 'maximizing risk-adjusted financial returns (GAAP 19). Non-financial goals may also permissible but have to be clearly stated and publicly disclosed (GAAP 19.1) (for GAAP references, see IWG 2008b). Rozanov has argued that there are other investors which do not follow exclusively commercial mandates either, citing in particular central banks and investors with 'responsible investment' mandates (Rozanov 2010b, 13pp). One potential reason

¹⁰⁶ The choice included transparency, accountability, good governance, strong management, strategic vision, performance of the fund, the fund's social responsibility and its motivation.

- why both central banks and responsible investors (mostly big public pension funds) have faced little concern about their non-commercial mandates might be their emphasis on a strong governance framework. This ensures they are perceived as independent and not in danger of being used as a political instrument. Sovereign funds go to great lengths to prove that they have no political motivations, as Temasek's widely followed amendment of its mandate in 2009 shows: While the 2002 version cited Temasek's important role in managing companies critical to Singapore's economy, the 2009 charter focuses on Temasek's role as 'an investor with obligations to its stakeholders', guided by purely commercial objectives. The fact that the U.S. embassy in Singapore dedicated an entire diplomatic cable to the mandate change proves the signalling power of mandates with view to mitigating concerns, mostly at the international level (Wikileaks 2009a). Considering the evidence at hand, it can be postulated that the more concrete and commercial the mandate, the less likely a fund is to experience political risk¹⁰⁷. This also applies at the domestic level where a clear mandate may shield a fund from home country stakeholder demands. Interestingly, this seems to be particularly easy for mandates which state specific long-term liabilities, e.g. the funding of pension shortfalls (IFSWF 2011b, 13). Mandates of classic sovereign funds without any liabilities seem to be more difficult to defend, both against domestic demands and foreign suspicion regarding which purpose the fund may be ultimately used for.
- *Fiscal treatment*: This cluster of factors covers the SWF's funding- and withdrawal arrangements and how the fund relates to national reserves (Truman 2008a, 8). Again, there are no hard obligations funds have to follow but rather a set of good practices established by the SWF community upon consultation with major stakeholders. GAAP 4 mandates that there should be 'clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations'. Although GAAP 4 lacks clarity as to the material content of these rules, it is clear that weakly formulated and embedded rules are a political risk factor. This is particularly prevalent in times of crisis when domestic- but also recipient country stakeholder expectations may diverge from the sovereign wealth fund ones (IFSWF 2011b, 13).

¹⁰⁷ This assumes, of course, that the fund follows its mandate and observed behaviour does not significantly deviate from mandated behaviour. Unfortunately, there are various examples of failed funds such as the LIA which in theory had sound mandates but have not lived up to reality.

- *Governance and legal structure*: Governance-related factors are of significant importance with regard to political risk. As Monk noted in an early paper, ‘legitimacy and governance are intertwined’, with organisational legitimacy depending on ‘how closely the quality of a specific organisation’s institutional governance [...] aligns with the environmental and societal expectations of, and norms for these governance practices. At a certain degree of alignment, legitimacy will be granted by the target’s society’ (Monk 2009a, 459pp). In its 2008 SWF work agenda, the IMF concluded that governance ‘provides the checks and balances that ensure that organizations are run efficiently and in accordance with the stated objectives of their owners’ (IMF 2008, 14). Albeit a rather broad concept, governance in a sovereign fund context mainly covers a) the fund’s external relations and b) the fund’s internal processes. With regard to the former, it determines the roles of fund and government and the rules according to which the relationship between principle and agent works. Depending on the setup, there are likely to be other actors involved such as ministries of finance and central banks. In 2008, the IWG provided an interesting overview of SWF governance variations (which unfortunately has not been updated since) (IWG 2008a, 10pp). Internal governance, on the other hand, covers the fund’s relationship with its supervisory body – often an (independent) board of guardians – and internal decision making processes. Why does governance matter from a political risk factor point of view? *Governance arrangements influence both the perception of the fund by stakeholders and the ability of stakeholders to exert pressure on the fund.* In particular, strong governance eases the fear that governments could use SWFs for political purposes. Therefore, it could even be argued that governance is a risk factor with a double weighting. Entering into an in-depth material discussion of governance arrangements is out of scope for this thesis¹⁰⁸. However, it will mention a couple of governance aspects which are important from a political risk point of view. *First of all*, legal structure matters in two ways: first, with regard to the capability of stakeholders to influence their decision-making. *Secondly*, from a legal point of view, fund structure may also be an important determinant of

¹⁰⁸ The OECD has been at the forefront of trying to establish best practice in corporate governance, also for state-owned enterprises (SOEs) (OECD 2005). Although there are distinct differences between SOEs and SWFs (see chapter 1), the OECD report addresses various questions which are of interest to SWFs alike. Another good source which also partially covers sovereign wealth funds (in particular those following a PE investment approach/organized as holding companies such as Temasek and Khazanah) is (Wicaksono 2009). Considering the governance-related literature on sovereign funds which mainly focuses on a broader understanding of (external) governance (inter-institutional questions such as budget integration and Santiago compliance) (Gilson and Milhaupt 2008; see e.g. Gordon L. Clark and Monk 2009c; Das, Mazarei, and van der Hoorn 2010; Yeung 2011), there remains considerable scope for further research into SWF internal governance aspects.

whether fund operations are considered commercial or of ‘sovereign’ nature. Most sovereign wealth funds are incorporated as separate legal entities yet there are a number of funds which constitute a pool of assets without legal personality¹⁰⁹. Everything equal and considering that these funds are closer to government and fiscal authorities (IFSWF 2011b, 14), it can be argued that the latter funds may experience a higher propensity for political risk at the domestic level as there are less institutional safeguards to protect them from political interference. On the other hand, an SWF’s legal personality and therefore independence may also give way to a certain amount of ‘sibling rivalry’ (for more insight, see S. L. Jen 2010, 132pp), particularly in relation the respective central bank. From an external point of view, pools of assets may be seen as less likely to/capable of investing for political purposes, thereby potentially reducing political risk. *Secondly*, best practice decision-making builds up reputation and legitimacy and mitigates political risk. GAAP 6 underlines the importance of a sound governance framework. Materially, frameworks should be up to the standards expected by the international investment community, i.e. commensurate with the size of the fund, and be representative of the domestic population as the ultimate SWF stakeholder. Independent boards and strong checks and balances generally inspire confidence abroad and mitigate concerns that the fund may be used for strategic/nationalistic purposes. Examples of funds often criticized for their unclear governance arrangements are the Arab sovereign funds and some central Asian funds where there is a traditional link between fund executives and government/the ruling families (see e.g. Monk 2010b; The Guardian 2010). Also Singapore’s Temasek was criticized when it appointed Ho Ching, wife of current Prime Minister Lee Hsien Loong, as its CEO. While it merely surprised international investors, the domestic blogosphere was awash with allegations of nepotism. This shows that funds with strong and impartial decision making processes tend to enjoy higher legitimacy with the ultimate domestic beneficiaries, thereby mitigating fears of mismanagement and avoiding potential public pressure in times of crisis and/or underperformance. As a reaction to the incident, Singaporean public officials are now in fact emphasizing the importance of ‘political independence’ for Ho Ching’s potential successor (Reuters 2012c).

¹⁰⁹ The IWG survey of 2008 estimates the ratio between legal entity/pool of assets to be 50/50 (IWG 2008a, 5); However, considering a recent trend towards incorporation amongst newer funds, it is likely that a majority of the funds have legal personality now.

5.2.2 Transparency

Having a sound fund structure and well-governed decision making processes may not reduce political risk unless funds are willing to talk about their governance. The idea of ‘doing good and talking about it’ is reflected in the Santiago Principles: the signatories have realized that both SWF transparency about structure and operations and recipient country transparency about investment screening processes/equal treatment of investors are necessary to maintain an open investment climate (IWG 2008b, 4). In the 2008 SWF work agenda, the IMF suggests transparency should cover three areas: (i) objectives; (ii) organizational structure and institutional arrangements; and (iii) investment portfolio (size, composition, returns, risk indicators). Elaborated under the auspices of the IMF, the 24 ‘Generally Accepted Principles and Practices’ (GAAP) have taken up the main thrust of the proposal and now contain references to various aspects of SWF structure and operations which shall be ‘publicly disclosed’. An IBM Many Eyes analysis of the Principles shows the notional importance conferred to transparency.

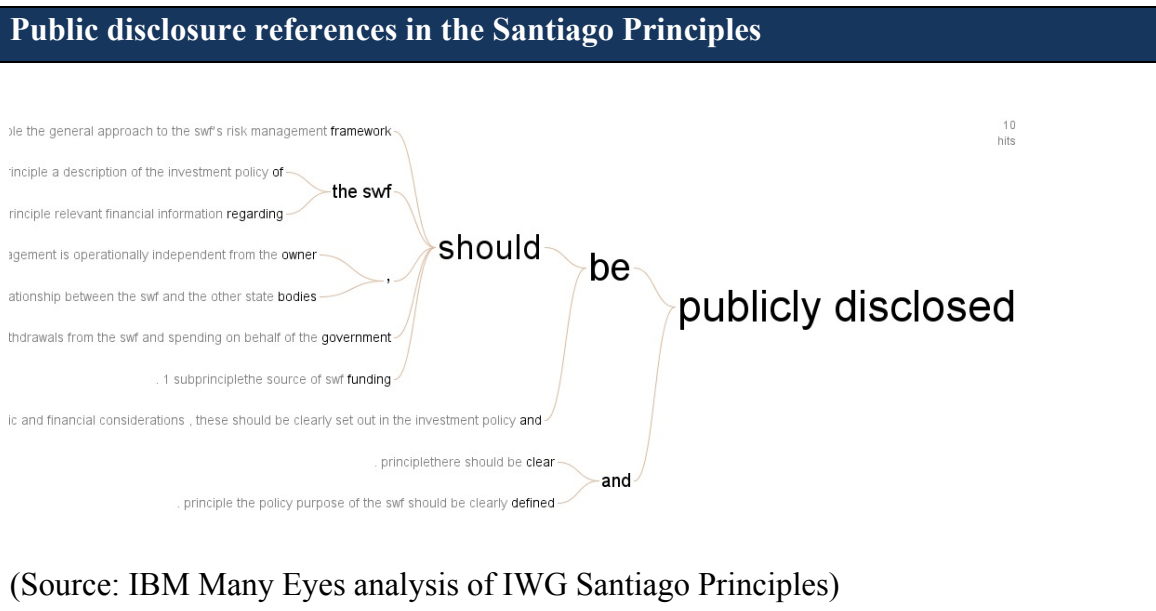


Figure 20: Public disclosure references in the Santiago Principles

As the IFSWF notes in its first Santiago Principles implementation review, ‘disclosure facilitates public understanding and trust of management, and therefore [it] has a positive impact on domestic legitimacy’ (IFSWF 2011b, 13). SWF transparency as a way to ease concerns was also mentioned by the OECD in its guidelines for recipient countries dating from 2008 (OECD Investment Committee 2008, 6). Well-known

economist and institutional investor Mohamed El-Erian supports this view, citing the importance of transparency to prevent misunderstandings (El-Erian 2010, 232). As mentioned before, however, transparency also comes at a cost (for many, see Monk 2010c; Rozanov 2010b). Hence, considering institutional constraints, sovereign funds need incentives to provide more information.

There are two reasons why transparency is beneficial, not only from a commercial-, but also from a political risk point of view:

- (1) Transparency is a *prerequisite for compliance*, not only with domestic and recipient country regulators, but also with contractual counterparties when it comes to due diligence and partnerships. Also, as Monk notes, transparency may enable a fund to gain access to markets which otherwise may be out of reach for a government-owned asset manager, thereby enabling further portfolio diversification (Monk 2010c).
- (2) Transparency *strengthens legitimacy* by keeping stakeholders, in particular domestic ones, informed about SWF operations. Thereby, it prevents them challenging SWF legitimacy in times of crisis. This, in turn, helps eschewing fire sales and ensuring a true long-term investment horizon (Monk 2010c). E contrario, a lack of transparency may often turn into a liability/political risk when funds are finding themselves weakened. However, as Rozanov aptly mentions, this only applies to mature funds where stakeholders have reached ‘the required level of financial sophistication and understanding of markets’.

While in theory, everyone agrees on transparency being a good thing, the intricate question is about the *degree* of transparency: how much is needed to satisfy stakeholder demands and mitigate political risk without impinging on SWFs’ freedom to operate. Rozanov suggests distinguishing between stakeholders and the level of detail they need. Regulators may need more information (without necessarily having to *publicly* disclose it (see also IMF 2008, 16 footnote 19)) than non-governmental organizations or domestic stakeholders (Rozanov 2010b, 10pp).

5.2.3 The resultant: Individual SWF reputation

Both fund structure and transparency are important determinants of an SWF’s reputation and thereby its legitimacy. Due to the wide variety of stakeholders holding expectations, it is very difficult to determine how SWF structures and governance

should look like. Albeit very vague in some governance-related aspects, the Santiago Principles provide an indication of what is seen as best practice – in particular deepened in the ‘Discussion of the GAAP-Santiago Principles’, a discursive annex which follows the principles and is considered an integral part of them. Still, the principles only set out a minimum level, the achievement of which may not make an SWF immune against additional stakeholder expectations. In fact, there have already been calls to adapt the Santiago Principles which shows that minimizing these political risk factors remains an on-going task – even more so as SWFs are not only measured against the absolute levels of the Santiago Principles, but also on a relative level against each other.

While SWF structure and degree of transparency often depend on domestic preferences and constraints and therefore may be difficult to pass judgement on, there have been on-going efforts to compare various endogenous aspects across sovereign funds. In all of these indices, governance and transparency indicators occupy a central role. The most prominent indices are the ones developed by Truman (Truman 2008a; Truman 2007; Truman 2010) and the Sovereign Wealth Fund Institute’s Linaburg-Maduell Transparency Index (Linaburg and Maduell 2011 and prior/subsequent issues). These indices compare SWFs against imaginary best practice and rank SWFs according to a combined score they receive across various indicators. Behrendt takes the Santiago Principles as a benchmark and assesses to which extent the funds fulfil the commonly agreed standards (Behrendt 2011b). The Reuters Breakingviews SWF Risk Index adopts a different perspective altogether (Reuters 2008a): Taking into account three criteria including transparency, strategic control and political threat, the index ‘ranks the top 20 prominent funds according to the potential risk they present to Western interests’. In comparison to the other indices, it is less broad and predominately adopts the perspective of one group of stakeholders, namely Western governments/regulators. Despite being based on an interesting, albeit normative concept, the index has not been updated since its first issue in 2008.

While there have been critics highlighting various methodological and other issues surrounding the indices, the relative ranking of sovereign wealth funds may be a rather accurate reflection of their endogenous political risk factors. Considering their emphasis on structural- and governance-related factors, these indices are a good proxy for potential legitimacy gaps, mostly resulting from a loss of reputational capital. It is known that these lists have been used by potential counterparties to SWF deals to

make a risk assessment of their contractual partners – and also by some SWFs before collaborating with other sovereign funds. From an individual fund reputation point of view, one could hypothesize that the bigger the gap between two funds on one of the indices, the less likely they would enter into collaboration. Anecdotal evidence suggests this may indeed be the case: in business circles, it is commonly known that some Gulf SWFs are shunned as deal partners, also because of the reputational risk of an investment ‘by association’. Trying to align endogenous factors with stakeholder expectations may therefore not only mitigate political risk, but also help in achieving higher rankings in the indices above, thereby reaping a double ‘*reputational dividend*’.

In addition to the static endogenous factors, most indices also contain factors related to the behaviour of sovereign funds, mostly to their investment activities. Although a clear-cut differentiation between governance- and behavioural factors is often challenging, the next sub-chapter attempts to identify a series of behaviour-related political risk factors.

5.3 Actions speak louder than words: Behavioural risk factors

Citing a Wall Street banker describing them as ‘massive, passive and patient’, a 2008 Financial Times article wondered whether SWFs are in fact dream investors for any company seeking capital (Financial Times 2008a). The article concluded that while some of the passivity of the funds might be down to not yet having the capacity to be active investors, appearing as ‘friendly investors’ and ‘minimize any political backlash’ might be close to active investment too. During the ensuing crisis when capital was in short supply and SWFs often acted as ‘white knights’ (see chapter 4.1.1), there was generally less scrutiny of SWF investment behaviour. With markets readjusting to a ‘New Normal’, however, the scrutiny of SWF behaviour is on the rise and will likely receive even more attention in the future. This emphasizes the importance of assessing investment behaviour-related factors when analysing a sovereign funds’ political risk profile.

5.3.1 Choice of investment sector and/or investment targets

The international business- and political risk literature has recognized for a long time that the choice of investment location, -sector and -target have a significant impact on the risk profile of investments, both on the portfolio-, but even more on the direct

investment side. This is particularly true for idiosyncratic risks such as political risk which are difficult to diversify away.

Country risk factors: Factors related to country risk have been amongst the most common components of political risk models (see chapter 3.2.2). In the meantime, the academic groundwork has led to the emergence of various commercial country risk service providers offering investors detailed risk scores down to regional and industry levels. Proprietary models by independent suppliers are also regularly used by financial services providers and sovereign wealth funds to assess credit and portfolio risks. As modern technology enables access to wider data sources, including crowd-sourcing options and real-time data from the countries in question, these models are becoming more sophisticated. A discussion of these factors would be out of scope of this thesis¹¹⁰, also because they constitute just one factor of many influencing sovereign funds' political risk profile.

Sovereign investors may not focus on traditional country risk measures such as the political system, the ideological position of the government, etc. alone. Given that the funds often enjoy preferential access to the government of their home country, SWFs should also focus on particular aspects of country risk, e.g. the impact of their home government's political relations with a certain country. So far, there has been very little research on this from an SWF political risk perspective. However, there is a substantial body of work on political relations and trade which may provide additional insight. The literature presents some evidence that political relations have a beneficial impact on trade levels, although cause and effect are heavily disputed (for some additional sources, see Knill, Lee, and Mauck 2011, 3pp). Knill et al. also find evidence that SWF investment decisions are influenced by political relations. However, contrary to common expectations and to the literature, they find that 'SWFs prefer to invest in nations with which they have relatively weaker political relations'. In addition, SWF investments seem to lead to an improvement (deterioration) in political relations for relatively more closed (open) target nations (Knill, Lee, and Mauck 2011, 5pp). While empirical evidence for this behaviour is strong, theoretical explanations are rather shaky. Based on realist political science theory, Knill et al.

¹¹⁰ For an in-depth look at country risk, see Howell who has been one of the academic founders of this discipline which grew out of international business studies (Howell 2007 and earlier versions). He has also been involved in the PRS Group which is one of the first commercial providers of country risk information. For an international trade/export guarantee perspective on country risk, see MIGA's series on world investment and political risk (for the latest edition, see Multilateral Investment Guarantee Agency 2011) and three in-depth reports on the subject by the World Bank (Moran 2001; Moran 2004; Moran and West 2005; Moran, West, and Martin 2008)

suspect that SWF investment may be an instrument to improve bilateral relations or to seal the intention to take up relations in the future. Regarding the openness argument, it is postulated that nations with many trading partners (i.e. open target nations) may ‘not place as much value on a given bilateral relation’, as the costs of substituting it with another one is much lower than in open nations. This is particularly relevant from a political risk point of view: it follows that contrary to conventional wisdom, investing in an open country may become a (political) risk factor as political relations are deteriorating.

Investment sector-related factors: At the sub-market level, the question arises if particular investment sectors are saddled with higher levels of political risk. The idea of politically sensitive investment sectors goes back to the early political risk literature (Robock 1971, 5). It has also prominently featured in the analysis of the 2007/2008 backlash towards sovereign fund investments, with defence and energy identified as particularly risky for the funds (for many, see Keller 2008; for a U.S. sectoral perspective, see United States Government Accountability Office 2009). Considering past controversial SWF activity, there are three reasons why certain economic sectors are considered to be sensitive:

- The sector is connected to a *country’s primary resources* such as land, water, forests or natural resources. Examples of controversies arising thereof include SWF investments in farmland (see the case study in the following chapter) or the general allegation that SWF investments in Africa are made with a clear focus on natural resource exploitation (for a similar argument made by Hillary Clinton, see Reuters 2011c).
- The sector is deemed *strategic to a country’s economy*. This definition often covers infrastructure, transport, energy or financial services, but may also be broadened depending on political opportunity¹¹¹. Examples of SWFs experiencing political risk in this category include Singapore’s Temasek and its difficult forays into the Indonesian banking sector and the attempted Hapag-Lloyd takeover by a subsidiary of Temasek (see chapter 4.2.3).
- The sector is *strategic from a national security point of view*, such as defence, the (nuclear) energy- or certain high-tech sectors related to cryptography and similar

¹¹¹ See for instance a proposal by the United Kingdom’s Labour government to install a so-called ‘Cadbury Law’ which would prevent foreign takeovers in sectors of strategic economic importance, amongst them those with ‘strong community roots’ (The Daily Mail 2010). This proposal was announced on the back of a controversial sale of chocolate producer Cadbury’s to Kraft and ahead of the 2011 UK national elections.

dual-use goods. Sometimes, this category also covers the media- and press sector. SWF investments in this sector are fraught with political risk, both when investing abroad and when engaging in this sector at home, where domestic constituents may see the sovereign fund as an agent of the government¹¹².

Sensitivity can result from a combination of the above, with the second and the third reasons often overlapping. Sectors may either be declared sensitive by authoritative/legal mechanisms (i.e. being subjected to investment approval processes such as CFIUS) or by social mechanisms where stakeholders press for more scrutiny in certain sectors.

Investment target-related factors refer to specific attributes of investment targets which make them subject to higher political risk levels. As opposed to sector-wide characteristics as described above, these attributes are specific to the investment target and/or ascribed to it by stakeholders. Based on the interviews conducted for this thesis and taking into account past occurrences of political risk, the arguably most risky SWF investment target is a company viewed as a '*national icon*'. Examples of national icons involved in controversial takeovers (albeit mostly without SWF involvement) include automobile manufacturers such as Jaguar, Land Rover or Chrysler, airlines such as Swissair, industry flagships such as Corus Steel or Sulzer or consumer brands such as UK tea manufacturer Tetley or department store Harrod's. National icons are perceived as being intimately linked with their home country, be it for historical, economic or traditional reasons. Hence, there usually is intense public- and therefore political interest in and scrutiny of any deals involving such companies. The political ideology which provides the basis for political scrutiny of such transactions is commonly referred to as 'economic nationalism' (Seifert 2007).

Sovereign wealth funds have had their fair share of political risk involving national icons: examples include the controversy over the QIA's failed 2007 attempt to take over Sainsbury's (through an investment vehicle called Three Delta) (The Guardian 2007) and GIC's much-discussed investment in UBS in 2007, but also Temasek's 2007 investments in Thailand's telecom sector (for a good overview and further sources, see Wu 2008). Following the resulting political controversies, Temasek decided to 'seek a lower profile' in its investments. Chairman S. Dhanabalan said that under the new investment approach, '[Temasek] has to take various factors into

¹¹² An example of continuous stakeholder scrutiny is Temasek's partial ownership of Singapore Press Holdings which also holds a quasi-monopoly in the Singapore media market.

account, such as whether the company or the activity is iconic for that country, whether it will arouse all kinds of emotional sentiments' (Financial Times 2007b). Activities related to iconic companies can also involve divestments, as shown by GPFG's decision to divest its Walmart stake: As the company feared that the divestment may have a signalling effect in the market, its iconic national brand status enabled it to enlist support from political stakeholders to put pressure on the GPFG – to no avail, however¹¹³. Similar to investment sector-related political risk, investment target-related risk factors are often a reflection of a country's general openness to trade and investment. In other words and all things equal, an investment into a national icon is likely to generate less political stakeholder response in open countries such as the UK (which due to various factors has become the preferred destination of SWF investments in Europe¹¹⁴) or Switzerland than in countries traditionally more reserved towards foreign investment such as Germany or France.

5.3.2 Investment approach

The logic of the capitalist system depends on shareholders causing companies to act so as to maximise the value of their shares. It is far from obvious that this will over time be the only motivation of governments as shareholders.

Larry Summers, U.S. Academic/Former U.S. Secretary of State (Summers 2007)

One of the most important behavioural SWF political risk factors is a fund's investment approach. The way a fund invests mainly depends on the source of its assets and its mandate. In addition to potential political demands, a fund's strategic asset allocation (SAA) will have to take into account the opportunities and limits set by asset source and fund mandate. While the investment of most SWF assets is determined by the SAA, fund management is likely to maintain some degree of freedom, with choices to make which can have a significant impact on the fund's political risk.

¹¹³ In an early paper on sovereign fund investment impact on financial markets, Beck and Fidora looked into potential effects of a GPFG portfolio rebalancing/exclusion decision on individual stocks and financial markets in general. According to their calculations, there is no evidence of a significant impact on stocks and markets (Beck and Fidora 2008, 21pp). Having said that, however, it may be noted that the Norwegian fund is known for holding very small stakes through external managers, which partially limits the explanatory power of this experiment.

¹¹⁴ One estimate puts the SWF share of total UK stock market capitalization at more than 10% (Sir David Walker cited in Tencati and Perrini 2011, 106). It is estimated that the Norwegian GPFG holds GBP 25bn of the FTSE 100 market capitalization, equivalent to roughly 4%, thereby 'dwarfing China's GBP 9bn holdings' (The Telegraph 2012).

Direct investments or external asset managers: As the IMF noted in an early paper on SWF operational aspects, the use of external managers reduces operational risk, adds expertise and capacity to the investment process and enables the fund to focus on the SAA (Das et al. 2009, 18). In line with interviewees ascribing higher political risks to ‘transactional’ investments such as significant bank stakes or direct infrastructure investments, this thesis argues that investing through external managers may be an efficient way to reduce political risk (Summers 2007). Direct investments, in particular sizeable stakes, increase sovereign fund visibility. This not only attracts stakeholder scrutiny (Castelli and Scacciavillani 2012, 82), but also enables direct intervention by authoritative stakeholders. For example, it is understood that following the international sanctions against Libya, it was easier to block the Libyan sovereign fund’s direct stakes (e.g. in Pearson’s, the publisher of the Financial Times) than access its various holdings with external managers. External managers also contribute to shielding fund management from political pressure from domestic political constituents for higher returns and reduce the risk of corruption. Finally, farming out assets to managers up to date with local regulatory requirements may also mitigate regulatory/compliance risk.

Despite all this, direct investments – in particular sizable stakes in companies providing a potential additional benefit to the home country – seem to become more popular with sovereign funds. While traditionally within the mandate of development funds (see chapter 3.2.2.3), in the last decade a number of funds with various mandates have started to invest directly. Although data on SWF investments in general is scarce, the Monitor/FEEM database reveals that direct investments have risen from USD 4bn in 2000 to USD 53bn in 2010¹¹⁵, outpacing the rise of SWF AuM in the same period. The number of funds engaging in direct investments has risen from 17 in 2008 to 21 in 2010 (Monitor 2011; based on the same data Castelli and Scacciavillani 2012). Data from the SWF Institute indicate a 2011 direct investment volume of USD 89.2bn, spread across 612 significant investments. This constitutes a 12% increase on the 2011 SWF Institute number (Sovereign Wealth Fund Institute 2012a). The numbers for 2012 (USD 59bn direct investments) indicate a slowdown (Sovereign Wealth Fund Institute 2013b).

There are three reasons which may have contributed to the rise of direct investments over the past three years:

¹¹⁵ SWF direct investments peaked at USD 96bn (2007) and USD 109bn (2008), mainly due to significant sovereign fund investments into ailing Western financial institutions during the financial crisis.

- (1) there is some dissatisfaction amongst many SWFs with the performance of and the fees charged by their external asset managers, in particular when looking back at the 2008/2009 financial crisis (Monitor 2011, 8);
- (2) modern core-satellite asset management strategies also enables savings- and stabilization funds to reap some ‘alpha’ (active managers’ performance) on their ‘satellite’ assets (Castelli and Scacciavillani 2012, 82)¹¹⁶; and
- (3) in addition to the older funds such as KIA, ADIA and GIC, younger funds have also started to actively build up in-house investment- and legal-, compliance and general management capacity based on knowledge transfer and through secondment of (senior) industry figures from external managers to the funds (Financial Times 2009b; Monitor 2011, 2pp).¹¹⁷

Stake size and ownership rights: Another important factor in determining political risk is the size of a particular investment and the ownership rights attached to it/requested on its behalf. This applies more to equity participations than to capital participation (loans, (convertible) bonds, etc.). There is an extensive literature on how stake size, control rights and similar factors impact on a target’s share price (for further references, see Fotak, Bortolotti, and Megginson 2008; Bortolotti et al. 2010a; Bortolotti et al. 2010b; Nystedt 2010, 205)¹¹⁸. Here, the focus is on the opposite effect: how do (equity) stake size and ownership rights affect the level of political risk sovereign wealth funds are facing. Generally, stakes above a certain threshold trigger notification obligations, mostly to a country’s stock exchange. As SWF investments, in particular indirect ones, often remain below the radar, such notifications are a rare opportunity for stakeholders to gain more insight into SWF investments¹¹⁹, thereby increasing the potential for political scrutiny. At the same time, weighty stakes beyond

¹¹⁶ Castelli and Scacciavillani note that sovereign fund portfolios are increasingly split into a core- and a satellite component, with the latter investing according to a more sophisticated ‘alpha’-seeking mandate (Castelli and Scacciavillani 2012, 75; 85). This mirrors established practice in central banks which have a long history of splitting their portfolios according to liquidity needs (see for example the HKMA). By farming out its strategic direct holdings to Qatar Holding, a fully-owned subsidiary, the QIA has also adopted an interesting approach, the results of which may become more visible over the coming years.

¹¹⁷ In view of Qatar Holding’s recent acquisitions, the Sovereign Wealth Fund Institute speculates that SWF are increasingly considering opportunistic direct investments. As one of the reasons, they cite a general ‘disillusion’ with Western tenets of modern portfolio theory which could not protect SWFs from significant losses during the financial crisis (Sovereign Wealth Fund Institute 2012b). This echoes the nascent debate in asset management circles on whether financial markets’ ‘last free lunch’ of risk reduction through diversification is slowly disappearing as correlation between asset classes is on the rise.

¹¹⁸ With some exceptions, most of these studies find evidence for positive abnormal returns of target firms’ share price following the SWF investment announcement, but negative mid- to long-term returns over a up to three year holding period (for a brief discussion and comparison, see also Bortolotti et al. 2010a, 10pp).

¹¹⁹ The reality of course is that SWFs have many possibilities to legally disguise their stakes, e.g. by registering them on behalf of nominees.

an SWF's small stakes portfolio come with various ownership rights, ranging from shareholder consultation- to voting rights and potentially the right to appoint a certain number of fund representatives to the Board of Directors. This, in turn, can exacerbate both foreign and domestic stakeholder sensitivities with regard to SWF influence on the firm and may fuel existing fears that sovereign funds are investing to seek control. Public perception of the funds as owners and therefore SWF legitimacy ultimately depends on how sovereign funds exercise their ownership rights. This arguably does not only apply to equity stakes, but also to joint-ventures and similar constructions.

Traditionally, SWFs have predominately invested in small, non-voting stakes. While this still holds true to a certain degree for stabilization- and savings funds within their indirect, 'core' investments, increasing investment knowledge seems to have resulted in more active investment patterns amongst sovereign funds across all asset classes: starting with considerable direct investments in financials during the crisis of 2008/2009, on average sovereign wealth funds now purchase a 'sizable minority stake in target companies', as Bortolotti et al. document. They also find that in most cases, shares are purchased directly from target companies (e.g. through primary share offerings). The exception is Norway's GPF which favours open-market purchases of much smaller stakes, thereby arguably reducing political risk (Bortolotti et al. 2010a). At the same time, however, the GPF follows an active ownership policy, using shareholder rights to 'safeguard the fund for the long term' (NBIM 2012a, 46pp). The GPF also furthers ESG principles by linking the exercise of ownership rights to six ethical/corporate governance principles and various international agreements such as the UN Global Compact. It does so by using the full array of market instruments available to active investors, ranging from publishing expectation documents as to how companies should handle various ESG issues, voting at AGMs and filing shareholder proposals to taking legal action (NBIM 2012a, 47).

With regard to *investor activism*, theory and empirical findings are inconclusive. In theory, an active investor role as mirrored by taking board seats and/or actively pushing for shareholder value creation generally increases visibility and is fraught with political risks. Based on this common insight, Bortolotti et al. propose a 'constrained foreign investor' hypothesis: it predicts that foreign investors, particularly high-profile ones such as SWFs, 'will be afraid of taking an active governance role in order not to generate political opposition or regulatory backlash'. Moreover, governance pressure by SWFs will be limited by their general reluctance to divest (as this does not fit with

their long-term investment horizons and may generate additional local pressure) and by their investments through primary share offerings resulting in becoming ‘allies of target firm managers’. They find empirical evidence for the hypothesis, with funds only acquiring board seats in a quarter of the companies they invested in (for OECD-headquartered companies, the percentage falls to 7.4%). In a later version of their paper, Bortolotti et al. thus refer to what they see as surprisingly passive funds as ‘quiet leviathans’. However, this ‘passive and quiet’ image of the funds conflicts with both forecasts by eminent SWF researchers and practitioners and with observable SWF behaviour in the markets. Ziemba argues that following the losses of 2008/2009, many funds are turning to exercising their ownership rights more actively, also as a means to better protect their investments (Monitor 2011, 82). This view is shared by Castelli and Scacciavillani who see investor activism as an important part of an encompassing risk management strategy (Castelli and Scacciavillani 2012, 129)¹²⁰. A recent example of such ‘protective’ activism is Qatar’s push for better deal terms for the Xstrata – Glencore merger which following Qatar’s resistance has also seen opposition from Norway’s sovereign fund (Financial Times 2012b; Financial Times 2012g)¹²¹.

Considering stake size and ownership rights from a political risk factor point of view, there is firm evidence that SWF legitimacy suffers when funds acquire a reputation of being controlling and active investors. This can lead to market stakeholders pushing for limiting SWF ownership rights or regulators pondering additional reporting requirements and stewardship obligations. Interestingly, however, the experiences of the financial crisis have seen some stakeholders calling for SWFs to take a more active role in the companies they invest in (for an authoritative voice on this topic, see for instance Walker 2011, 5pp). Along the lines of the debate on stewardship obligations, they argue that shareholders – in particular large ones – have certain rights, but also commensurate obligations to hold management accountable (State Street 2009, 9). While many funds are likely to remain passive investors only holding small equity stakes, funds with the ambition to be more active and invest beyond equities will face this dilemma – and accordingly higher levels of political risk which need to be managed in a structured way (see chapter 7).

¹²⁰ They also liken the attitude of passive funds to the one of absentee landowners where the delegation of property management to trustees has often resulted in the latter to prosper and the former to impoverish (Castelli and Scacciavillani 2012, 129).

¹²¹ Kalb also sees tentative signs of investor activism and SWF co-ordination in private markets, i.e. when several sovereign funds act as limited partners in a private equity-type venture (Kalb 2011, 8).

5.3.3 Environmental and social governance

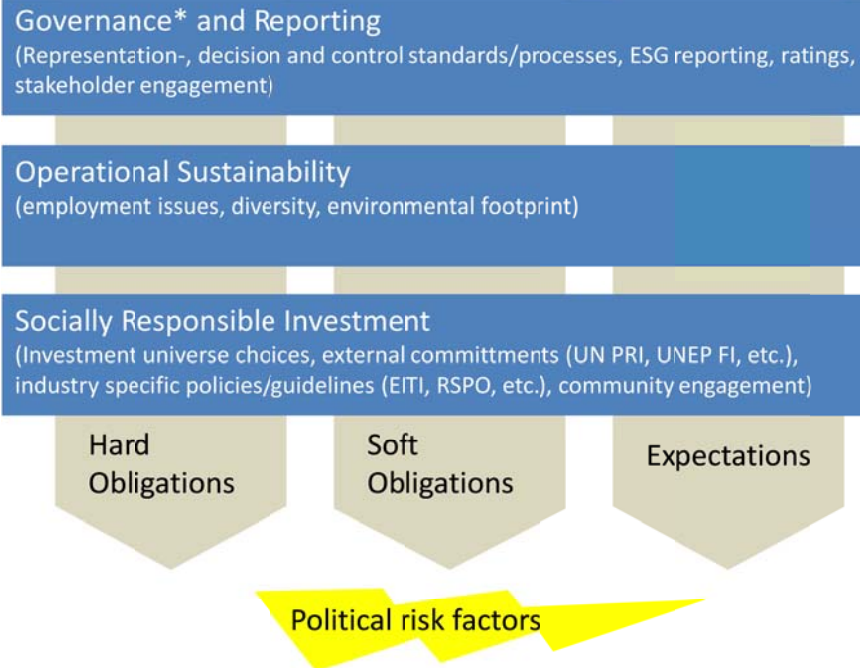
A last behavioural risk factor relates to the degree to which sovereign funds meet stakeholder expectations in the field of non-financial performance, in particular with regard to environmental and social governance issues (ESG). Having focused on but one bottom line (profit) for a long time, companies now confronted with stakeholders asking them to take into account a triple bottom line, with additional emphasis on social and ecological issues. Robock recounts an early instance of political risk resulting from ignoring stakeholder warnings that a project by ASEA (a predecessor of ABB) in Mozambique would strengthen the Portuguese colonial presence in the country (Robock 1971, 7). Today, investing with a focus on the triple bottom line covers a wide array of topics, with implicit or explicit standards on corporate governance¹²², operational ecology, environmental behaviour, social-, labour and human rights standards, to name but a few. The complexity of the field and investor interest is reflected by a rapidly expanding literature. It variably refers to overlapping aspects of the field as socially responsible investment (SRI), ethical investment, (corporate) social responsibility, sustainability, ecology, corporate citizenship or – increasingly – ESG.

While there have been long-lasting and fruitful discussions and theories as to whether it makes sense for institutional investors and SWFs to observe ESG principles, it is clear that all ESG-related legislation, codes of conduct and other standards are driven by particular stakeholder expectations with varying degrees of authoritative power. Ignoring expectations may have consequences: Depending on the intentions and on the stakeholder, political risk may result from a potential compliance breach (in case of hard obligations) or – more often – from the reputational capital loss for not meeting soft obligations¹²³. The following matrix gives an overview of the three main clusters of ESG issues and how they relate to obligations towards and expectations from stakeholders.

¹²² With corporate governance-related aspects discussed in chapter 5.3.2, this chapter will focus on the environmental and social aspects of ESG.

¹²³ Conversely and in line with the opportunity function of reputation described above (chapter 5.1.3), SWFs may also distinguish themselves both as institutional investors and from their peers when engaging in SRI (Waki 2010b). The Norwegian fund is a good example for the reputational benefits associated with being referred to as an industry/sector leader in most SWF-SRI-related discussions.

ESG and political risk matrix



* See chapter 5.3.2

(Source: own compilation based on conversations with Bruno Bischoff)

Figure 21: ESG and political risk matrix

Apart from a few Western funds such as Norway, Alaska, Australia and New Zealand which have explicit commitments to ESG issues, SWFs have been rather slow in adapting to this new asset management paradigm. It has been argued that Islamic investment principles (which also contain ethical exclusion rules) may have partially made up for a lack of ESG focus, particularly amongst GCC sovereign funds (Executive Magazine 2008). Nevertheless, the general reluctance to engage in the ESG/corporate responsibility space (for instance, very few SWFs issue [separate/integrated] CSR reports) has been surprising, considering SWFs' global reach, the size of the asset base, and the vulnerability to pressure from external stakeholders resulting thereof. Moreover, it should help that there is a considerable overlap of interests between sovereign funds and ESG proponents, with SWFs' long-term investment horizons emphasising the importance of ESG matters.

With democratization and demands for accountability in SWF home countries and direct investments on the rise, ESG-related political risk is likely to become an important issue for SWFs in the years to come. In addition to governance/reporting issues covered in the previous chapter, political risk in the ESG area mainly arises in the socially responsible investment space. Although SWFs are mostly pure asset managers without resource-intensive operations to scrutinize, operational sustainability-related political risks shall not be discounted either. For instance, in their function as state-owned companies, many sovereign funds are facing expectations to employ a certain quota of domestic professionals. While this may contribute to a diverse workforce, potential skills gaps can increase operational risk and lead to adverse consequences for the fund.

With regard to political risk potentially arising in the socially (and environmentally) responsible investment space, sovereign funds can be affected in two dimensions:

- *First*, in what may be referred to as *indirect ESG impact* where the application of ESG rules impacts on the SWF in an indirect way by reducing portfolio value (for a similar thought, see Bendell 2009): From an investee company perspective, sovereign fund ownership may become a liability when dealing with other investors, regulators or clients which adhere to ESG policies restricting business with entities connected to sovereign funds. Following a similar line of thought, Barbary and Bortolotti have found political risk emanating from sovereign wealth fund ownership to be a potential reason for investee companies' poor long-term performance after an SWF investment (Barbary and Bortolotti 2011, 7). Reasons why ESG-sensitive investors may not invest in (partially) SWF-owned companies include: (1) the human rights or social standards track record of the SWF's home country (e.g. whether it is a signatory to the relevant international conventions and/or its performance/position within the relevant international league tables with regard to democracy, human rights, etc.); (2) a perceived lack of transparency of the fund itself, making it difficult to verify its claims in the ESG area, or (3) unclear fund governance, in particular with regard to the separation between home governments and funds. Reduced investment by ESG-sensitive investors may have repercussions for both the investee company (potential lack of financing, investor activism against management, loss of clients, etc.) and ultimately the fund itself: Through pressure on portfolio companies/assets, the sovereign fund may see the value of its investment dwindle (adverse impact). While by and large, sovereign wealth funds are seen as unproblematic owners, there have been a few examples of

passive ESG impact: In 2008, for instance, the UK's Co-operative Bank announced it declined loan applications from companies controlled by sovereign wealth funds due to the SWF sponsoring governments' human rights abuses (Central Banking 2008).

Secondly, SWFs are also affected by what may be referred to as *direct ESG impact*, relating to pressure on SWFs arising from the degree to which they themselves are investing according to ESG standards. Here, stakeholder pressure is directly on SWFs as asset owners or on external managers as SWF representatives instead of SWF portfolio companies. From this perspective, SWF legitimacy and ultimately political risk will depend on whether SWFs are able to meet stakeholder expectations regarding the incorporation of ESG standards into their investment processes. This means that ESG rationales may force funds to either (1) invest in assets which may not be compatible with their asset allocation, (2) to divest from certain activities and/or (3) to pair up certain investments with robust (local) stakeholder consultation processes. An example referring to the first point is mentioned by Waki who sees a danger of SWFs being used to subsidise governments' environmental policies, e.g. when it comes to financing alternative energy providers (Waki 2010b). An example of point 2 is pressure from non-governmental stakeholders on various sovereign wealth funds to sell their participations in companies active in cluster munitions (see chapter 4.2.3). Pressure in this field may also come from a fund's principals such as Norway's Ethic Council, the board of directors or government committees. An example of the latter is the Norwegian Ministry of Foreign Affairs' Policy Coherence Commission which asked the GPF to map and reduce its investments in 'tax havens' and to work with other funds on a common approach for this issue (Policy Coherence Commission 2008, 174).

Recent years have seen the emergence of both ESG standards for particular investors and sectoral standards for both investor and investee companies focusing on a certain sub-) asset class, e.g. agricultural commodities or oil and gas. Most of these standards are contractual obligations without enforcement, operating through reputational- and peer review mechanisms. Most of the investor standards are sponsored by United Nations agencies while sectoral initiatives usually trace their way back to NGO pressure resulting in industry commitments. *Investor standards* include the United Nations Principles for Responsible Investment (UNPRI) (focussing on portfolio investments of institutional investors), the United Nations Global Compact (UNGC) and the Equator Principles which focus on ESG issues

in project financing¹²⁴. As opposed to the UN-related initiatives, the latter is an industry initiative similar to the Extractive Industries Transparency Initiative (EITI), the Global Roundtable for Sustainable Beef, the Marine Stewardship Council (MSC) or the Roundtable on Sustainable Palm Oil (RSPO)¹²⁵. There are also a few sectoral standards in the farmland investment space as touched upon in next chapter's case study. While very few sovereign wealth funds are signatories to the standards above¹²⁶ and therefore cannot be held accountable to, deviating from these standards is likely to come at an ever increasing price.

5.4 Contextual concerns: External political risk factors

From a sovereign wealth fund perspective, political risk is a challenging risk category: As opposed to other types of risk which can be controlled internally, political risk crucially depends on many other factors beyond a fund's control. While endogenous- and behavioural political risk factors may be influenced through appropriate strategies, external political risk factors are more difficult (but not impossible, as shown in chapter 7) to influence. This sub-chapter describes the three arguably most important external political risk factors: a fund's home/host country reputation, SWF's shared reputation as sovereign investors and – perhaps the one least susceptible to fund's political risk management strategies – macro-economic conditions.

5.4.1 Host country reputation

Host country reputation is an important factor to be taken into account by all firms operating from or in any way connected to a particular country. In line with the two-pronged concept of reputation as presented above, host country reputation can be a blessing or a curse: while French luxury companies, US entertainment outfits and Swiss watchmakers benefit from the upside, Chinese firms find it difficult to establish premium brands and hardly anybody would associate African firms with quality products. As Wally Olins puts it, 'many companies like Sony in Japan and Coca-Cola

¹²⁴ Following the Rio +20 summit in June, some financial institutions and governments signed the Natural Capital Declaration which is understood to be complementary to other standards by further detailing the role of natural capital as a part of ESG.

¹²⁵ With the investor-related standards lacking enforcement mechanisms, there have been efforts to standardise reporting on ESG issues in order to ensure comparability. This is an important pre-requisite for reputation-based pressure based on 'naming and shaming'. The most widely used standards are the ones elaborated by the Global Reporting Initiative (GRI). Given the slow uptake of GRI reporting in the US and following the push of ESG issues at the Rio +20 summit, the United States reacted with the creation of a 'Sustainability Accounting Standards Board' (SASB, modelled on the Financial Accounting Standards Board (FASB)) to improve the availability of standardised ESG information to investors (Financial Times 2012a).

¹²⁶ SWF signatories to the UNPRI include the GPF, the New Zealand Superannuation Fund and the Alberta Investment Management Corporation which manages Alberta's Heritage Savings Trust Fund, an SWF at the sub-national level.

in the U.S. derive their personality and strength from their national origins' (Olins 1999, 1). This is supported by Fombrun and van Riel who find, however, that at a certain point, 'companies with powerful global aspirations find themselves forced to de-emphasize their national roots' in order to overcome barriers to new markets (Fombrun and Van Riel 2004, 119pp). Therefore, given sovereign funds' close links to their home governments and with most funds carrying their country in their name, it is no surprise that country reputation significantly influences SWF political risk – mostly in recipient countries and at the international level, but interestingly also at home.

The 2010 Sovereign Brand Survey by consultancies Hill&Knowlton and Penn Schoen Berland confirms that 'the reputation of a country [is] a major influence on the reputation of its sovereign wealth fund, with elites seeing almost no difference between the two' (Hill&Knowlton and Penn Schoen Berland 2010, 4). For instance, when investing in the region, the Singaporean funds are often seen as an arm of Singapore, Inc., with stakeholder acceptance thereby determined by recipient country attitudes towards Singapore (Tripathi 2006). Respondents to the Sovereign Brand Survey (which unfortunately was discontinued after its first issue) indeed indicated that the acceptance of sovereign wealth fund investment in a recipient country significantly depends on the reputation of the host country. According to the study, investments from Norway, Singapore and Hong Kong are generally seen as welcome whilst Algeria, Botswana and Nigeria are trailing the list of preferred FDI origins. Other surveys on foreign investor preferences may yield slightly different individual country rankings, yet confirm the overall picture (Keller 2008, 346 footnote 118). While Norway's strong SWF governance definitely contributes to the reputation of the fund, Monk suspects that the GPF's warm reception as an investor may come down to the plain fact that it is Norwegian: as a small and neutral country, Norway does not pose any threats which keeps public concerns about strategic SWF investments at bay (Monk 2011d). To a certain extent, this may also be the case for Singapore, Hong Kong, Kuwait, Dubai and Abu Dhabi (the most welcomed funds according to Hill&Knowlton/Penn Schoen Berland), all of which are small countries without any apparent power motives¹²⁷.

¹²⁷ Interestingly, while Singapore as a small and stable country has enjoyed a good reputation in the West, South-East Asian neighbours have long viewed it with reservations, citing its military- and economic strength as a threat and seeing its sovereign funds as instruments of power. This underscores the regional differences in and complexities of national reputation.

Assessing country reputation is complex: it has many different dimensions which include a country's political-, economic- and social indicators as well as more 'soft' perceptions of it by various stakeholders. Country reputations may also change over time, either in gradual or rather abrupt fashion, e.g. following a particularly damaging event. There are a wide variety of indices which – some more scientifically than others – try to measure the reputation and/or the brand value of countries. A broad-based and methodologically sound attempt was made by Fehlmann et al. who assessed Liechtenstein's country reputation. Based on their research and in collaboration with Charles Fombrun's Reputation Institute, they developed the Fombrun-RI Country Reputation Index (Fehlmann et al. 2002; see also Passow, Fehlmann, and Grahlow 2005). Another widely used measure is the Anholt-GfK Roper Nation Brands Index which 'measures the power and quality of each country's brand image' based on six dimensions: exports, governance, culture and heritage, people, tourism, investment and immigration (GfK 2012). These indices are a broad-based, aggregated measure of how a country is perceived by stakeholders. In addition and highly relevant in a sovereign wealth fund context, country reputation may also be shaped by other more specialized rankings which capture a country's performance with regard to specific aspects at a particular point in time. Examples include Transparency International's yearly Global Corruption Index or the Freedom in the World family of indicators published by Freedom House.

As complex as country reputation may be, as almost unstoppable are its effects on funds' political risk profiles: with stakeholders tending to lump the funds together with their respective countries, unfavourable country reputation results in a loss of reputational capital, thereby potentially widening the legitimacy gap and inducing political responses. Bremmer provides a good example of how a company may be held hostage by its respective country reputation: In the wake of the controversy surrounding the publication of prophet Mohammed caricatures in the Danish newspaper *Jyllands-Posten*, Islamic activists called for a boycott of Danish dairy producer Arla Foods (Bremmer and Keat 2010, 18). Risks to fund legitimacy may also result from the specialized country rankings mentioned above: These indices are closely watched as they are also believed to give an indication of how the respective sovereign funds behave with regard to these metrics. Some analysts have regressed SWF performance in certain fields such as Santiago compliance or fund transparency against country democracy- or openness indicators, finding that there is a significant

correlation between a country's democracy scores and the respective sovereign fund's compliance with 'good governance' indicators (see e.g. Behrendt 2010, 19)¹²⁸.

Therefore and for practicality reasons, country-level democracy-, governance- and transparency indices also constitute an important element of ESG-conscious investors' decision matrix. As a result, funds from countries with low governance scores may find themselves increasingly at a disadvantage in the international capital markets, with co-operation with other institutions potentially scuppered and access to deals closed. This mirrors the opportunity function ascribed to reputation above: Hill&Knowlton/Penn Schoen Berland emphasize that country reputation 'ultimately [affects] the investment opportunities available to [sovereign wealth funds]' (Hill&Knowlton and Penn Schoen Berland 2010, 5).

Upon closer examination of how country reputation affects a fund's political risk, there are three additional factors which may be taken into account:

- First, the *country-fund reputation mechanism described above is not a one-way street*: funds may also shape the reputation of their respective countries. The smaller a country and the more active its fund, the more likely the relationship is bi-directional, with the funds as active and visible parts shaping the perception of their country abroad. A good example is Qatar: The general public and also decision makers may rather know it through its high-profile sovereign fund investments than through experience with the country itself¹²⁹. This provides some potential opportunities for collaboration of fund and country on the external image front which will be further explored in chapter 7.
- This example also points to the *crucial role of knowledge and communications* when it comes to country and fund reputation. It is a common saying that fear is bred by ignorance. The Sovereign Brand Survey mentioned above finds a broad correlation between familiarity and favourability of various investor classes, suggesting a strong inverse relationship (Hill&Knowlton and Penn Schoen Berland 2010, 6pp). With elites the least familiar with sovereign funds, it is no

¹²⁸ However, while these correlations usually are at highly significant levels, they have to be taken with caution from a methodological point of view as they do not clarify cause and effect. Strictly speaking, it is impossible to say whether a country's democratic credentials cause SWF transparency or vice versa (although assuming the latter is highly counter-intuitive).

¹²⁹ At least this has been the case until Qatar embarked on a more active foreign policy during the Arab Spring by supporting Libyan rebel groups and positioning itself as a liberal signpost and trusted ally in the region.

surprise if the potentially little goodwill towards a particular SWF may be overshadowed by adverse country reputation.

- This underscores the *importance of good governance* to separate fund reputation from the potential vagaries of country reputation. For sovereign funds, good governance may provide a shield from being automatically associated with the actions of the respective governments. As Monk notes in an early paper where he developed his theory on SWF legitimacy, ‘governance is a mechanism to achieve legitimacy at the level of the organisation, even if, politically, the sponsor and the target are misaligned’. In this case, misalignment refers to country- and fund governance, thereby increasing the propensity for political risk. A good example for a case where a fund seems to have overcome the strong correlation between country- and fund reputation by strengthening its governance framework (and being transparent about it) is the State Oil Fund of the Republic of Azerbaijan (SOFAZ). Azerbaijan as a country is classified as ‘not free’ by Freedom House, with a political liberties- and civil rights rating of 5 and 6 respectively. In the Economist Intelligence Unit’s 2011 democracy index, Azerbaijan ranks 140th out of 167 countries (Economist Intelligence Unit 2011, 7). Against all expectations, however, the SOFAZ ranks very high in both the Truman SWF scoreboard (78 points out of 100, position 7 ahead of Temasek, the Chilean ESSF and the GIC, to mention but a few (Truman 2010, 129)) and the Sovereign Wealth Fund Institute’s Q1 2013 edition of the Linaburg-Maduell Transparency Index (scoring a perfect 10 together with funds such as the GPF and the NZSF). This suggests that while country reputation significantly influences individual fund reputation and legitimacy, a sound system of governance can mitigate its impact.

5.4.2 Collective SWF reputation

Individual SWF good governance and appropriate behaviour may significantly mitigate yet not abolish political risk. As Fotak puts it in a report by Monitor, ‘after all, SWFs from diverse countries have discovered that they have a common reputation and that the actions of foreign, unrelated entities can have serious consequences for all sovereign funds’ (Fotak 2010, 28). Hence, the legitimacy of sovereign investors and potential political risk not only depend on their own characteristics and behaviour, but also on the legitimacy of other representatives of the industry. For example, it is well known that the scandals surrounding the Libyan LIA had a disadvantageous effect on collective sovereign wealth fund reputation, resulting in doubt being cast over governance mechanisms and the impact of non-democratic principles/governments on

particular funds¹³⁰. Also, with some funds, in particular those from the Gulf which regularly find themselves under more scrutiny than others, SWFs have actively sought to differentiate themselves to avoid kin liability (Euromoney 2009). This is particularly prevalent for what is a rather small group of sovereign investors: At the moment, the SWF sector includes some 50-odd funds, with around 20 more in their early stages. In addition, the number of industry participants is by definition finite, with the number of sovereign wealth funds approximately determined by the number of existing countries.

Following intense public pressure in 2007/2008, well-run sovereign funds started to understand the importance of how they were perceived as a group. The 2008 Santiago Principles can be seen as a collective effort to safeguard and improve industry reputation. Considering the variety of sovereign funds as emphasized in the Santiago Principles and as witnessed by their different behaviour, there have been some interesting choices for the different funds to make between individual and collective reputation. This is reflected in one of the early papers on this subject where Winn et al. point at ‘the dichotomy between industry survival (via collective legitimacy) and firm advantage (via individual reputation)’ (Winn, MacDonald, and Zietsma 2008, 36). Following their line of thought, this thesis argues that sovereign wealth funds found themselves in a situation of a ‘*reputation commons*’: Based on the influential concept developed by Hardin (Hardin 1968), some sovereign funds may deplete shared SWF reputational capital for short-term, individual gains, with adverse effects for the whole group in the long term. Collective action such as the Santiago Principles presents a viable solution to the ‘tragedy of the commons’ and are most likely to arise as a result of persistent and direct stakeholder attacks. As Winn et al. suggest, the engagement of leading firms in the sector for the common good is a second factor fostering collective action. Ahead of the publication of the Santiago Principles, it has been the Norwegian and Singaporean funds plus ADIA playing that role, mindful of the potential reputational and ultimately political risk they would incur in the absence of collective action.

Having said that, however, Norway’s commitment as a driving force behind the negotiations with U.S. authorities and the subsequent Santiago principles still remains surprising: Considering it’s excellent reputation with both financial market participants and the informed public and echoing findings from Mancur Olson’s seminal book on

¹³⁰ This has been exacerbated by the fact that according to estimates by Barbary and Bortolotti, ‘72% of SWF AUM are controlled by authoritarian governments or hybrid regimes, with only 28% of the total being controlled by funds in democracies’ (Barbary and Bortolotti 2011, 5).

collective action (Olson 1971), the incentive for Norway to spend scarce time and resources on collective action is rather limited, particularly when considering the problem of other funds free-riding on the reputational gain of the initiative. ADIA, for instance, which arguably ranks lower with the public due to the country of origin effects, had a much bigger incentive to engage in collective action, with the reputational gain potentially exceeding the costs.

This leads to the conclusion that political risk arising from common SWF reputation is essentially a collective action problem. Mancur Olson's theory suggests that there have been three reasons why sovereign funds have been rather successful in collaborating on this issue/political risk factor (albeit they are arguably some way from overcoming it).

- *First* and arguably the flip side of the disproportionate reputational impact mentioned above, the relatively small number of (existing and potential new) sovereign funds provides for concentrated rewards for agreeing to common principles/not deviating from certain standards.
- *Secondly*, the small number of funds also simplifies spotting non-compliant funds, for instance through efforts of the academic community or peer control (e.g. Santiago Principles member lists/scorecards), thereby rendering social and political pressure to join the group and to limit free-riding more effective.
- And *thirdly*, yet not foreseen by Olson, the importance of standard setting funds can provide the initial impetus to get things going.

As alluded to above, Norway's engagement and its willingness to allow other funds to share its reputation by joining the same group may not be taken for granted. Against all rational predictions, this suggests a mix of self-interest as well as altruistic motives on the side of the GPF and the Norwegian government. This is consistent with the academic argument of Norway considering both efficiency and ethics when it comes to the management of their fund (for many, see Gordon L. Clark and Monk 2010). As a conclusion, individual funds remain partially hostage of collective SWF reputation. Encouraging collective action (through various channels which will be discussed in chapter 7) may be the only way to mitigate political risk.

5.4.3 Economic environment

The last cluster of external political risk factors refers to the economic environment. As partially touched upon in chapter 4.1.1, the economic environment has a significant

impact on the legitimacy of the funds, both in third countries and at home. Generally, SWFs have been found to encounter more political resistance during times of economic prosperity when capital is plenty and markets are in ‘seller markets’ mode. During cyclical or structural downturns, on the other hand, SWFs are mostly seen as a welcome source of capital in recipient countries. However, the effects may not always be as clear-cut and persistent over the cycle as expected.

In a downturn scenario, sovereign funds may be either perceived as ‘saviours’ when strengthening the balance sheets of recipient country firms or welcomed for propping up confidence in a country’s economy by investing in its sovereign bonds and/or in other assets. Under such circumstances, it has been aptly noted that the ‘need to appease foreign media and politicians seems less pressing’ (Monitor 2010, 28). In addition to SWF investments in Western financial institutions during the financial crisis, a recent example of such positive environment-related factors on political risk includes a substantial Qatari investment in a Greek gold miner (and other investment commitments ahead of a planned privatization drive in the wake of the Greek economic crisis) (The Telegraph 2011). Similarly, it can be argued that the European debt crisis has significantly eroded stakeholder reservations against the Chinese sovereign fund, with CIC using the impetus to mount what some journalists have called a ‘charm offensive’ by committing to continue to invest in European government debt (Financial Times 2011a)¹³¹. From a fund’s long-term investment perspective, these investments make sense as downturns often present buying opportunities, making cyclically undervalued recipient country assets an attractive investment proposition.

However, investing in times of economic hardship may also come with its own political risks attached. Considering SWF investment activity following the economic turmoil, there are two potential political risk scenarios funds should be taking into account as the cycle is nearing its end:

- *First*, political risk arising from SWFs being perceived as taking advantage of a difficult economic situation. Snapping up cyclically undervalued assets by sovereign funds may exacerbate stakeholder concerns about a domestic industry sell-off. While profiting from ‘buying low and selling high’ may be accepted

¹³¹ As The Economist rightly states (The Economist 2011a), ‘how much official Chinese money has found its way into peripheral euro-zone countries is a matter of guesswork’ – and arguably will remain so for some time to come.

- market* practice, it may not be necessarily understood in the *political* discourse which operates according to a different set of values. This can lead to stakeholders expecting funds to act against economic principles, thereby threatening legitimacy and ultimately leading to political risk. A telling example is offered by the Norwegian GPFG which in 2006 took the *economically* sensible decision to short the stocks of Icelandic banks. However, the decision was seen as insensible from a *political* point of view and met considerable resistance from the Icelandic public and politicians. Particular sensitivity arose from the fact that the quasi-governmental quality of the GPFG made the transaction to be perceived as an economic attack on the economy of Iceland, thereby prompting an official response by the Icelandic government (The Economist 2008a). Such responses by authoritative stakeholders often harbour the biggest political risk potential.
- A *second* scenario refers to political risks arising from the competition for scarce funds. As investment opportunities are increasing abroad during an economic crisis, sovereign wealth funds may be equally pressured by their home governments and their domestic constituencies to support economic growth at home. As Backer notes, for example, the financial crisis ‘appeared to create a stronger inbound investment pressure’, in particular on Middle Eastern funds (see Backer 2010, 47 with further references). This double pressure may not only result in considerable competition for the fund’s resources, but can also affect SWF legitimacy if the investment strategy prevents the fund from supporting domestic concerns. As Rozanov notes, this may ultimately require funds to ‘make some adjustments to accommodate increased spending’ (Waki 2011, 62), potentially resulting in adverse impacts on the strategic asset allocation side: providing more short-term liquidity and hence reaping less illiquidity premia.

5.5 Preliminary results: The need to look behind the theory

While sovereign wealth fund political risk remains a complex phenomenon, the methodology developed in the last two chapters helps breaking down complexity: Based on a clear definition, this thesis looked at the phenomenology of political risk (timing, scope, impact), linked it with stakeholder theory and identified accountability mechanics used by stakeholders to exert pressure. It also discussed the main SWF stakeholders and their interests/expectations on three levels before conceptualizing political risk as a lack of legitimacy brought about by either a loss of reputational capital or a breach of compliance. The remainder of the chapter then identified three clusters of political risk factors: endogenous factors (fund structure and transparency),

behavioural factors (choice of investment sector/target, investment approach, environmental- and social governance issues) and external factors (host country reputation, collective fund reputation, economic environment).

Considering the model elaborated in the last two chapters, there are three aspects which need to be mentioned before moving on to the case studies:

- *First*, building a model crucially depends on access to empirical data, which in this case includes information about sovereign wealth fund political risk incidents, the parties involved and the resulting reactions. However, despite significant progress over the last couple of years, first-hand information on the SWF industry, let alone behind-the-scenes intelligence on fund-internal reasoning, remains scarce. While thorough analyses of the literature and in-depth interviews with SWF representatives and analysts have partially made up for the lack of data, significant gaps remain.
- *Secondly* and by definition, a model does not equate reality but is based on simplifying it, thereby identifying patterns and dependencies which help to cut through complexity. In the case of this thesis, this means knowingly ignoring the heterogeneity of sovereign funds, stakeholders and issues in the interest of a viable model, with plenty of scope for further research remaining in this field.
- *Thirdly* and considering all of the above, a model based on scarce information and knowingly toned down in complexity requires ever more stringent testing. That is the reason why the next chapter presents some case studies to validate the model. The application to real cases of political risk is intended to assess the use of the model to predict political risk before using it as a base for the SWF advocacy proposals to be developed in chapter 7.

6 Case studies of SWF political risk

6.1 Case study methodology and approach

This chapter presents some in-depth case studies touching upon various aspects of the SWF political risk model presented in the prior chapters. A case study is defined as:

- (1) *A detailed analysis of a person or group, especially as a model of medical, psychiatric, psychological, or social phenomena.*
- (2) (a) *A detailed intensive study of a unit, such as a corporation or a corporate division, that stresses factors contributing to its success or failure.*
(b) *An exemplary or cautionary model; an instructive example.*
(The American Heritage Dictionary of the English Language 2000).

In the sovereign fund context, aspect (2a) of the case study definition seems to be particularly relevant. The ‘unit’ of analysis here are sovereign funds as a group or individual sovereign funds and their behaviour under particular circumstances of political risk. As alluded to in the definition, the focus is on the various factors determining the impact of political risk on the object of investigation (the SWF).

Case studies are qualitative research methods which are ‘particularly well suited to new research areas or research areas for which existing theory seems inadequate’ (Eisenhardt 1989, 548). The study of sovereign funds is one of these areas where both theory and empirics are at an early stage. Yin suggests using case studies if (a) the focus is on ‘how’ and ‘why’ something occurred, (b) the behaviour of the object of investigation cannot be controlled/influenced, and/or (c) contextual factors are an important part of the research question (Yin (2002) as cited in Baxter and Jack 2008, 545). This thesis focuses on how and why sovereign funds experience political risks and explicitly includes contextual factors in its analysis. Without any opportunity to influence sovereign fund characteristics in order to generate variable data points, a multiple case study design is chosen to validate the findings from grounded theory development.

Multiple case studies can help to test single and multiple, interlinked hypotheses (commonly understood as theories) by artificially altering parameters/variables through the careful selection of differing cases (similarly Eisenhardt 1989, 534pp). It thereby allows one to ‘compare and contrast’ stakeholders, issues and mechanics in the SWF field in a quasi-experimental setting. From a methodological point of view,

sampling is not random like in an experiment, but cases are chosen based on the nascent theory and in such a way that there is maximum variety with regard to the various parameters. In line with grounded theory, Eisenhardt refers to this process as ‘theoretical sampling’, intended to cover pre-defined theoretical categories (for many, see Eisenhardt 1989, 536pp). With regard to this thesis, this means, for instance, choosing cases with political risk occurring at various levels, resulting from different stakeholders or impacting on both individual funds and the sector as a whole. Despite seeking maximum variance, however, it is imperative to ‘bind the case’ (Baxter and Jack 2008, 546) i.e. limit individual cases to ‘single settings’ (Eisenhardt 1989, 534). In the case of SWF political risk, this means focusing on one instance of political risk over time where either issues/political risk factors (e.g. farmland investments, takeovers of national icons), stakeholders (e.g. a certain NGO) or level/region of analysis (e.g. sovereign investments in Switzerland) remain constant. This is helped by a careful definition of the research question in order not to ‘become overwhelmed by the volume of data’ (Eisenhardt 1989, 536). The research question guiding through this chapter will be: To which extent do the case studies corroborate the theoretical sovereign wealth fund political risk model presented earlier?

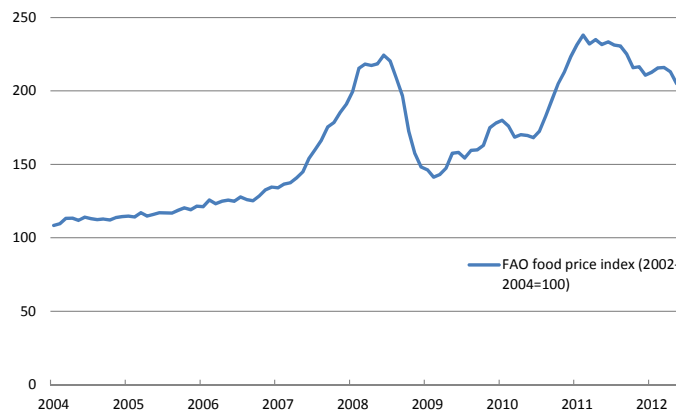
6.2 Investments by SWFs in farmland and agricultural commodities

6.2.1 Introduction and SWF involvement

This case study sheds light on the political risk various sovereign wealth funds have encountered when investing in farmland, agricultural commodities and related sectors/firms. The ‘single setting’ here is on a specific, investment-related political risk factor which gained prominence in 2008 when food prices experienced a sharp increase: As measured by the Food and Agriculture Organization of the United Nations (FAO), the FAO food price index¹³² almost doubled within a year, peaking at a reading of 224 in June 2008, the highest level in 30 years before sharply receding to below 150 by the beginning of 2009. Food prices have spiked again in mid-2010, reaching a new all-time high of 238 index points in February 2011. Lately, analysts, policy makers and humanitarian agencies have been preparing for another upswing, with markets being abuzz with speculation about a structural shift towards higher food prices.

¹³² According to the official definition, the ‘FAO Food Price Index is a measure of the monthly change in international prices of a basket of food commodities’. It consists of the average of five commodity group price indices ([meat, dairy, cereals, oils/fats, sugar], representing 55 quotations), weighted with the average export shares of each of the groups for 2002-2004 (FAO 2012).

The FAO Food Price Index



(Source: FAO)

Figure 22: The FAO Food Price Index

The market for farmland

The increase was seen as a result from both supply- and demand side developments with regard to food, feed and fuel (instead of many, see IFPRI 2008a; IFPRI 2008b; World Economic Forum 2011; The World Bank 2011):

- On the *demand side*, rising levels of prosperity in emerging markets have pushed up demand for food in general and dairy and meat products (protein) in particular. This has also led to rising prices for animal feedstock. Within the last decade, China has gone from a positive agricultural trade balance to becoming a net food importer. In addition, rising prices for agricultural input factors such as energy and fertilizer have further contributed to food and feedstock becoming more expensive.
- On the *supply side*, high energy prices have also generated demand for biofuels which have diverted a considerable amount of food and feedstock away from the markets into biofuel production, often supported by substantial government subsidies¹³³. Supply across products has also been low due to long underinvestment in agriculture stemming from low return expectations (see theory of the ‘pork cycle’) and distorted price signals on the back of long-standing protectionist policies. Poor weather has hit major exporters such as the U.S. and

¹³³ In 2008, around 30% of the U.S. maize production was thought to be used for the production of ethanol (IFPRI 2008a, 1).

Australia, with some attributing the increase in frequency of such ‘extreme weather events’ to climate change. The loss of arable land resulting thereof (desertification) has been exacerbated by increasing urbanization in emerging markets. Finally, some stakeholders also blamed speculators for high food prices, although evidence remains inconclusive.

Agricultural commodities and in particular production factors such as (arable) land are historically popular investment categories, but lost some of their lustre in the last decades (Schanzenbächer 2011, 190). Reasons include low yields, high political and regulatory risk and investor trends running in the opposite direction (‘old economy’ vs. ‘new economy’). While retail investor interest arguably returned with the ‘commodities supercycle’ starting at the turn of the new century, institutional investors have already been active in this market for some time (for an in-depth analysis of the investor/manager base, see OECD and HighQuest Partners 2010). While before 2008, farmland transaction volume averaged 4m hectares, 2009 saw a transaction volume of 56m hectares, mostly in Africa (The World Bank 2011). One of the most significant deals involved South Korean ‘chaebol’ Daewoo aiming to lease 1.3m hectares of farmland on Madagascar, an area almost half the size of Belgium.

Alleged sovereign wealth fund involvement

Triggered by the events of 2008, sovereign wealth funds have become more interested in this market, studying investment opportunities both in firms active in the agricultural sector and directly into production factors. This mirrors findings by analysts who see the latest farmland investment cycle as driven by governmental rather than private investors (The World Bank 2011, 49pp). Middle Eastern sovereign funds and CIC have been portrayed as the most active investors in this asset class. In 2009, CIC purchased a significant stake in (agricultural) commodities trader Noble Group (Financial Times 2009b). According to a Chinese article cited in the Sydney Morning Herald, China also owns more than 8000 square kilometres of farmland all around the world, with CIC often directly involved in providing financing (The Sydney Morning Herald 2012a). Following political visits, Kuwait was interested in leasing sizable tracts of Land in Cambodia and Sudan (The Economist 2009). QIA has invested in a wide range of projects in Kenya, Argentina, Brazil and Australia through subsidiary Hassad Food (Reuters 2010a) and both the Australian and the New Zealand sovereign funds are reportedly lining up deals, interestingly focused on mature markets.

There are various reasons why sovereign funds have been looking into the market for agricultural commodities and farmland in particular:

- *First*, farmland investments fit generic SWF strategic asset allocations/investment strategies: As a rather illiquid and investment-intensive asset class, farmland enables sovereign wealth funds to reap illiquidity premia through their long-term investment horizon. Due to their alternative asset qualities (low correlation), such investments have also proven to be more resilient to financial market turmoil, are technically inflation-protected, have been a promising way out of low-yielding traditional assets and have successfully contributed to portfolio diversification (for similar reasons applying to all investors, see OECD and HighQuest Partners 2010, 16pp).
- *Secondly* and arguably most importantly, a substantial share of sovereign funds hail from either small (city) states (Singapore, Brunei, Nauru, Kiribati), from countries with challenging conditions with regard to food production (Northern African- and Gulf countries) or from countries with a combination of both (Qatar, Kuwait)¹³⁴. Therefore, most of their food requirements need to be covered by imports. Many sovereign wealth funds are a part of the food security strategy of their sponsoring countries.

While some sovereign investors are purely financial investors interested in the particular characteristics of the asset class, some SWFs have a direct or an indirect role in their country's food security strategy. Assessing the underlying objectives for institutional investors in general, NGO GRAIN assumes a 'fairly even split' between financial and food security investors (Euromoney 2011b). When not directly investing in farmland themselves, sovereign funds have also been understood to support state-owned enterprises or private sector companies in employing capital according to the strategy (see for instance Financial Times 2009b; This is Africa 2012). Sovereign fund mandates to contribute to national food security are mostly implicit: A cursory overview of the objectives of the funds covered by this thesis yields no explicit food security objectives¹³⁵. However, as shown in the table below, sovereign funds remain active in the field in many different ways, with the definition between food security- and investment/diversification/hedging purpose often blurred.

¹³⁴ Aware of the vital role of agriculture for the region, in 1970 the Arab states founded the Arab Organization for Agricultural Development (AOAD) which actively co-ordinates various programmes on food security in the region.

¹³⁵ According to the Santiago Principles, the policy purpose of a fund should be clearly defined and publicly disclosed and based on economic and financial objectives (GAAP). 'Any other types of objectives', for instance food security 'should be narrowly defined and mandated explicitly' (IWG 2008b).

Selected (planned) SWF involvement in agriculture

Fund	Main agricultural investments motivation	Structure of agricultural investments	Geographical scope	Details
Qatar Investment Authority	Food security	through separate investment vehicle	domestic and international	Various investments fully owned or JVs through Hassad Food, a part of Qatar Holdings which is a 100% subsidiary and holds QIA's direct investments. Co-ordination with Qatar National Food Security Program
New Zealand Superannuation Fund	Financial motives	through explicit investment strategy, with direct investments and through external managers	International	NZSF rural land strategy targeting NZD 300m - 500m investments 'up to the farm gate in major food-producing regions in the developed world'. External managers include FarmRight
Australia Future Fund	Financial motives	cornerstone investor in external manager	domestic	PrimeAg fund manager targeting a AUD 600m fund investing in Australian rural property incl. water rights
China Investment Corporation	Food security	direct investments	International	direct stakes in commodities trader Noble Group; CIC to support SOEs and private companies contributing to Chinese Ministry of Agriculture's overseas farming plan
Abu Dhabi Investment Authority	Food security	direct and indirect investments (tbd)	International	Government plan to set up strategic food reserve and encourage investment in food processing and production factors
Kuwait Investment Authority	Food security	direct investments (tbd)	International	Various high-level contacts yet little concrete investment activity according to diplomatic cables leaked by Wikileaks
Libyan Investment Authority	Food security	direct investments through Libyan African Investment Portfolio	International	Direct investment in Nigerian rice production in partnership with local development organization

(Source: own compilation)

Figure 23: Selected (planned) SWF involvement in agriculture

Inconclusive evidence of the scale of SWF involvement

While the reasons for SWF investments in agriculture vary considerably, such investments have been fraught with political risk across the board. (Sovereign) farmland investments have sparked a considerable backlash from a wide array of stakeholders which has only marginally abated from its heydays in late 2009. Interestingly, however, it remains unclear if sovereign funds have played the role they have been reported to play – and even more so whether the ‘big land grab’ is happening at all. In its flagship publication on the issue, the World Bank says that, ‘although few sovereign wealth funds appear directly as the origin of [farmland] investments, investment funds are key players’ (The World Bank 2011, 53). Cotula, on the other hand, finds that where governments are acquiring equity stakes in land,

sovereign wealth funds play a smaller than anticipated role (Cotula et al. 2009, 99). Notwithstanding the debate about the degree of SWF involvement, ‘in many cases the announced [farmland] deals have never been implemented’, with farming having started on only 21% of the announced deals (The World Bank 2011, xiv)¹³⁶. Two years earlier, Cotula et al. have adopted a similar argument, citing the time lag between announcement and implementation and the (political) risk in between as potential reasons (Cotula et al. 2009, 39pp). Anecdotal evidence for this is provided in a diplomatic cable from the U.S. embassy in Kuwait which cites Kuwaiti officials saying that ‘despite high profile press reports, the [government of Kuwait] has not invested in buying farm land in developing countries’ (Wikileaks 2009b). Political and operational risks have been one of the major reasons cited for the lack of finalizing investments. Following this line of thought, some even say that reports on a farmland investment rush are grossly overstated: Given doubts about the success rate of the deals, Woertz argues that the ‘land grab’ controversy has mostly been a media-driven, self-referencing dash for a ‘good story’ (Woertz 2011, 6). With Chinese involvement in Africa constituting a big part of the ‘land grab’ narrative, Brautigam had a closer look at Chinese presence and investments across African countries. With regard to agriculture, she concludes there is very little evidence of strategic Chinese investment activity aiming at producing food and shipping it back to China (Brautigam 2011, 256pp). She backs up her findings with a case study of how a significant and widely cited Chinese land deal in Africa took on a life on its own on the Internet although it had actually never happened (Brautigam 2012).

In the light of these findings, the challenge of this case study consists of the fact that a lack of transparency on the terms and the actual implementation of the deals makes it difficult to cite concrete manifestations of SWF political risk in this field (for a similar thought, see GRAIN 2008, 6). However, despite the inconclusive evidence around ‘land grab’ in general and (the degree of) SWF participation in particular, the discussions around the issue underline that sovereign wealth fund land investments harbour considerable political risk, in particular when perception becomes reality. The next sub-chapter will apply the methodology elaborated in the prior chapters to better understand potential and actual political risk surrounding SWF farmland investments.

¹³⁶ In his aptly titled paper ‘Arab Food, Water and the Big Gulf Land Grab that Wasn’t’, Woertz adopts an even bleaker view on farmland investment implementation on the ground. Based on personal interviews, he maintains that many of the involved Gulf institutions ‘do not have a single agro engineer among their ranks and are at best in a process of commissioning feasibility studies and scouting land leases’ (Woertz 2011, 6pp).

6.2.2 Theory: Assessing the likelihood of political risk

As the Economist notes, agricultural investments (abroad) have always been controversial, referring the pejorative ‘Banana republic’ term arising from such investments in the colonial era (The Economist 2009). Stakeholder backlash to the latest wave of agricultural investments has been even more powerful, also due to unprecedented reporting by the media and NGOs from the ground. Subsumed under the term ‘land grab’, media reports have started to increase with a time lag of half a year, spiking almost a year after the food price index (The World Bank 2011, 51pp). With stakeholder attention and media activity remaining at high levels, the controversy has not abated and flares up regularly in the public and the policy discourse – for instance again in February 2011 when food prices hit another all-time high. This sub-chapter looks at generic concerns surrounding land investments and assesses the likelihood of farmland investment-related political risk based on the theory developed in the earlier chapter.

Concerns

The concerns associated with investing in agricultural commodities and in particular in farmland have remained remarkably stable over the last couple of years. They can be grouped into three clusters:

- A first cluster of concerns refers to the *adverse local impact* in the country of investment. The lack of land titles and legal frameworks incentivizes the corruption of officials and leads to disruptive dispossession of local smallholder farmers without compensation. This often results in local food insecurity, compounded by the fact that for food security investments, most of the harvest is being exported. This, in turn, breeds dependence on big farmers and food aid and may result in farmers finding themselves in a vicious circle of unemployment, poverty, poor health and loss of perspectives. Other concerns at the local level include fears of environmental degradation, deforestation and monoculturation as a potential result of an export-oriented, unsustainable model of agriculture.
- A second cluster points at the *market effects* of farmland investments, claiming that speculative capital makes food prices more volatile and is exacerbating price hikes. This has serious consequences for the poor which spend a disproportionate amount of their income on food. Some also claim that speculative agricultural commodities and farmland investment (as opposed to investments for hedging purposes) may contribute to a speculative bubble, the bursting of which would

- disproportionally hit poor countries and would throw many more people into poverty.
- A third cluster touches upon the *wider political and security consequences* of farmland investments which Jacques Diouf, Director General of the United Nation’s Food and Agriculture Organization (FAO) has denounced as ‘neo-colonialism’. Concerns at this level refer to the danger of exploitation of poor nations by rich ones, the potential for local upheaval and even armed conflict and war. As various analysts have noted, many local riots from Haiti to Bangladesh and Madagascar (see above) and most notably the Arab Spring have had their origins in and have been fuelled by public protests about high prices of food staples (for many, see Euromoney 2011c). This hints at the particularly destabilizing effects of high food prices in developing and emerging markets/newly industrialized countries with weak governance and unsuitable food import/export policies. This cluster of concern may also include the potential interstate conflicts, e.g. arising from water rights connected to farmland investments (Woertz 2011, 9)¹³⁷. This cluster of concerns is particularly prevalent in the discussion around SWF land investments as the funds are often seen as the extended arm of their governments, raising additional questions around sovereignty and non-interference.

Political risk factors

Political risk factors are generic factors to take into account when determining a particular activity’s political risk. A quick analysis of these factors for land investments confirms that farmland investments have a heightened potential for political risk.

- *Endogenous risk factors* are factors based on the individual funds’ own attributes which may contribute to a lack of legitimacy (see chapter 5.2). According to the model, such risk factors include fund structure, transparency and individual fund reputation. With regard to farmland transactions, the lack of clarity and transparency on (a) fund mandates, (b) land holding structures and/or (c) deal terms may turn out to harbour significant risks, with NGOs potentially complaining about the secrecy most deals are shrouded in (instead of many, see GRAIN 2008, 6 for an early example). A lack of transparency makes it difficult

¹³⁷ Some industry figures such as Peter Brabeck-Letmathe, chairman of Nestlé, even claim that the underlying motivation for farmland deals is not land, but access to water. This mirrors a recent strand of analysis which sees agricultural trade as importing and exporting ‘virtual water’ embedded in the agricultural produce.

for stakeholders to assess the risks and benefits, thereby breeding suspicion and ultimately both local resistance and domestic scrutiny in the sovereign fund's country of origin. RAI principle 3 reflects these concerns and recommends a high level of transparency and good governance for land investors.

- *Behavioural risk factors* include the choice of investment sector, the investment approach and environmental- and social governance-related aspects. With most activity in emerging countries often challenged by weak governance¹³⁸, farmland investments may harbour significant generic country risk. This is compounded by heightened investment sector-related risk as farmland constitutes a primary resource with often strategic characteristics for low-income, agrarian-based recipient countries. Moreover, sovereign funds may have to take into account the fragmented nature of the sector in most investment countries (smallholder farming) (Euromoney 2011d). While from an Olsonian point of view, the dispersed interests of farmers may make it difficult to mount organized resistance to land deals, it also complicates ESG-mandated consultation, thereby further endangering deal legitimacy. Additional risk may also arise from the direct investment approach necessary to invest in such a particular asset class which is part of the satellite portion of sovereign fund portfolios. Anecdotal evidence suggests that apart from some private equity-like structures and despite the popularity of the investment case, there is still a relative lack of investment vehicles suitable for sovereign fund participation (similarly, see Schanzenbächer 2011, 191; Euromoney 2011d). Also, targeting full ownership of farmland investments may add further political risk, in particular if sovereign wealth funds operating under the 'constrained foreign investor hypothesis' are perceived as colluding with corrupt local officials (similarly, see Wikileaks 2009b) or as not pushing enough to hold recipient country authorities accountable for good governance (see chapter 5.3.2). The arguably most pressing political risk factor when investing in farmland are ESG issues, in particular as activities in the sector are increasingly covered by a multitude of multilateral and industry guidelines (RAI, FGLPA, Tirana Declaration, IFPRI Code of Conduct). This echoes the views of a banker in the agricultural sector who says that while it may be cheap to buy or lease land, it is the social responsibility connected to it which makes it

¹³⁸ Although based on a survey of private sector investors and therefore not directly applicable to government-led investment, the OECD sees a clear shift of land investment activity towards South America and Africa (OECD and HighQuest Partners 2010, 13pp). The World Bank has estimated that in 2009, around two-thirds of land investments were made in Sub-Saharan Africa (The World Bank 2011, xxxii) – not surprising if accounting for World Bank estimates that the latter region, together with South America and the Caribbean, represents roughly 72% of potentially available uncultivated land (The World Bank 2011, xxxiv).

- challenging (Euromoney 2011d). As these guidelines are rather soft- than hard obligations, following them is a reputation- rather than a compliance issue. However, all of them, in particular the RAI, are very encompassing and cover the whole investment process from negotiations and consultation with local stakeholders to implementation and trade-/export-related issues. While intended to reduce political risk by providing a blueprint for stakeholder inclusion, such guidelines may also provide NGOs a yardstick to measure SWF performance against, amounting to a ‘direct ESG impact’ for sovereign funds (see 5.3.3). Another ESG/socially responsive investment challenge in this field relates to the fact that most farmland investments are located in countries with oppressive regimes and/or low levels of governance. As such, this may present a risk to both the fund’s reputation (collaboration with the regime, see above) and pose ‘classical’ political risk such as expropriation or (arbitrary) food export restrictions¹³⁹. Generally, farmland investments carry the risk of direct ESG impact, with NGO pressure directly on sovereign asset owners and their reputation.
- *External political risk factors* include host country reputation, common SWF reputation and the economic environment. While the latter risk factor usually refers to the inverse relationship of sovereign fund political risk with the need for capital in the markets, farmland investment-related risk may be dependent on macroeconomic/market variables too: The highest level of stakeholder resistance arguably exists in times of high food prices when the present and highly visible plight (poverty cycle) outweighs potential future benefits of putting capital to work on underused land. The economic situation and more importantly the level of prosperity in recipient countries, in particular their degree of food security, also matter from a public relations perspective: the more pronounced the difference in prosperity between recipient countries and the investor, the more credible and hence powerful the arguments about exploitation and food insecurity through SWF land deals are. While the reputation of the sovereign fund’s sponsoring country usually is an important co-determinant of political risk, the effect might be more muted with farmland investments. One of the reasons might be that most of the investments are in non-OECD countries with weak governance/civil society, thereby developing less stakeholder resistance on the ground. Common SWF reputation remains a risk factor, in particular as it creates a common destiny for all

¹³⁹ Interestingly, the IFPRI code of conduct proposal explicitly mandates investors to adhere to national policy measures restricting food exports in times of crisis.

funds investing in agricultural land whereby one botched transaction may taint the industry's common reputation.

6.2.3 Evidence: Categorizing political risk

One of the most notorious manifestations of political risk of farmland investments was the collapse of the Daewoo deal in Madagascar in March 2009. Popular resistance had led to the fall of President Ravalomanana some months earlier, giving the new president a strong incentive to shelve the Daewoo collaboration (Financial Times 2009a). Although the deal did not involve an SWF but a private company, it shows that farmland transactions are inherently politically risky. Based on various analytical categories, this sub-chapter 'slices and dices' the manifestations of political risk found when researching sovereign funds' farmland investments. Following a quick discussion of whether such risk fits the *definition* established by this thesis, this sub-chapter identifies the most important stakeholders involved in the 'land grab' controversy and looks at the phenomenology of this type of political risk.

Political risk definition

Sovereign wealth fund political risk is defined as '*the probability of unexpected or difficult to anticipate political action resulting in adverse consequences for the sovereign fund(s)*'. The risks connected to land investments are probabilistic events which due to their complex nature harbour considerable 'unknown unknowns'. Political risk in this field is also difficult to anticipate, both when emanating from non-governmental and governmental stakeholders. While the first are notoriously difficult to predict, the fund's authoritative/governmental stakeholders – mostly surprised by the food price hike – have also acted in an unexpected way. By nature, stakeholder pressure in the farmland investment field has aimed at influencing authoritative policy, be it to prevent SWFs from buying/leasing land or to mandate them to follow ESG guidelines when investing in these assets. The consequences for sovereign funds have been diverse yet mostly adverse, ranging from reduced investment optionality, deals abandoned due to local resistance to reputational loss. Therefore, taking into account all of the above, most land-related investment risk can be subsumed under political risk. A background conversation of U.S. embassy staff with Kuwaiti authorities on farmland investment matters confirms this view (Wikileaks 2009b).

Stakeholders, interests and mechanics

The 'land grab' issue has seen a complex setup of various social-, market- and authoritative stakeholders with diverse interests and expectations participating in the debate. In order to further their interests, also towards sovereign funds, they have

resorted to various mechanisms to exert political pressure. The most active political stakeholders include the following:

- *Domestic governments* have been a source of pressure on sovereign funds to invest in farmland, seeing them as a suitable instrument to initiate policy measures to halt the increase in food prices and thereby to appease the local population (for an overview of the political economy of food prices, in particular in the Gulf states, see GRAIN 2008, 4pp). Governmental interests of the major farmland investors from the Gulf and also elsewhere are mostly centred on food security, with farmland investment performance considerations of secondary importance. The mechanisms to hold their funds accountable for and to exert influence on their investment activity are mostly authoritative, although the Santiago Principles are seen as providing certain restrictions with regard to mandating a fund to invest in a strategic manner.
- *Recipient country governments, incl. local political bodies/politicians*, often have a strong interest in attracting foreign investment to their countries/regions, in particular if such investments unlock the potential of resources at their disposal (The World Bank 2011, 129). However, where a lack of institutional safeguards fosters a high level of corruption, it increases officials' incentives to push through as many deals as possible. Sovereign wealth fund farmland investments require political authorization both when signing the purchase/land lease and potentially when taking the decision to export the harvest. The authoritative nature of recipient country governmental stakeholders and the long investment horizon required for farmland results in a classic obsolescing bargain situation for the sovereign funds, with negotiating power slowly yet inexorably shifting to local stakeholders.
- The *local population, incl. farmers*, have been found to have an ambivalent view on land investment: It could lead to their displacement without compensation and hence to them having to forego their traditional way of life as pastoralists or smallholding farmers. However, investment may also result in being offered employment and the opportunity to upgrade their skills. In terms of making their voice heard, the local population generally has to rely on social mechanisms, even more so as farmland investment countries predominately feature lower levels of democratic accountability.
- *Non-governmental organizations*, both recipient country- and international ones, have been amongst the most vocal critics of sovereign funds' farmland

- investments. NGO activity is based on a moral imperative of trying to compensate the disadvantages of the vulnerable (farmers, recipient countries in general) in the ‘battle’ against those with more resources (local/recipient country governments, sovereign funds, financial markets in general). In order to do so, NGOs rely on social instruments, including the provision of information and the initiation and co-ordination of campaigns. Often, they also ‘hijack’ the media focus on existing platforms such as the Public Eye Award for the worst company which is awarded at the side-lines of the World Economic Forum. In 2012, for instance, Barclays was shortlisted for their role in influencing food prices. The campaigns against the ‘land grab’ have seen involvement of both encompassing NGOs such as Oxfam and Friends of the Earth and more specialized organizations and/or networks such as GRAIN and farmlandgrab.org (originally set up as a depository for an early report on the subject (GRAIN 2008)). However, NGOs also include *international think tanks* such as the International Food Policy Research Institute (IFPRI) or the International Rice Research Institute (IRRI) which have contributed analysis with a more policy-centered view. NGOs in general have also pressed for more tangible rules on farmland investment, with IFPRI presenting some actionable proposals for a code of conduct in April 2009 (IFPRI 2009, 3). Finally, there are also cross-organizational bodies such as the International Land Coalition (ILC, comprising 116 NGOs and IGOs) which participate in the discourse. In May 2011, the ILC issued the Tirana Declaration, a set of guidelines which define (and denounce) ‘land grab’ (ILC 2011).
- *Regional and international organizations* have played an important part in the controversy surrounding farmland investments. There have been two types of organizations involved in the debate: First, regional international organizations such as the Arab Organization for Agricultural Development or the African Union. Secondly, international organizations in the strict sense of the term, mostly specialized members of the UN family such as the FAO or the International Fund for Agricultural Development (IFAD). At a first stage of the land grab controversy and based on their mandates, organizations such as the FAO provided analysis and intelligence on food prices, farmland investments and their impact on various stakeholders. Following up on the FAO’s Initiative on Soaring Food Prices, the Rome-based UN agencies specializing in food and agriculture¹⁴⁰ have also joined forces and established a High-Level Task Force on the Global Food Crisis.

¹⁴⁰ The three main organizations are the World Food Program (WFP), the International Fund for Agricultural Development (IFAD) and the Food and Agriculture Organization (FAO).

Organizations had also initiated work on guidelines on farmland investments as early as 2006, with the ‘Framework and Guidelines on Land Policy in Africa’ (FGLPA) ready for formal adoption by the African Union Assembly of Heads of State and Government in July 2009 (African Union 2011). In February 2010, the World Bank in partnership with FAO, IFAD and UNCTAD published the ‘Principles for Responsible Agricultural Investment that Respects Rights, Livelihoods and Resources’ (RAI) (The World Bank et al. 2010). A broad stakeholder initiative modelled amongst others the EITI, the RAI have become the most influential (yet also most controversial) guidelines in the field¹⁴¹.

Phenomenology

Considering the particular nature of business involving land, the complex web of stakeholders involved in it and the multitude of legal-, quasi-legal- and moral provisions to be followed, political risk in this field is not easy to categorize. Generally, farmland investment risk have materialized at the micro-, meso- and macro-level, with individual funds, all sovereign funds investing in this asset class or all farmland investors within a certain country being affected. Risks have been both ex-ante and ex-post, with most of the risk now arguably being latent as sovereign funds have become the ‘poster-child crooks of the anti-globalization movement’ (Woertz 2011, 8).

Although the description of concrete manifestations of SWF political risk may at times lack granularity (for possible reasons, see 6.2.4), the following sub-chapter attempts a rough classification of observed and potential political risk on three levels of analysis.

- At the *domestic level*, there has been relatively little political risk arising from farmland investments. One of the possible scenarios includes sudden political pressure on the funds to participate in governments’ food security strategies, without the engagement being covered by a proper mandate and without fitting into the SWF’s specific asset allocation. While understandably, there is little evidence for such cases, the speed with which certain countries rushed into the farmland asset class suggests however, that the respective sovereign funds have experienced a certain degree of pressure on the asset allocation side.

¹⁴¹ As with many international responses to policy challenges, there have been a few other, less influential guidelines and principles which have developed in parallel to the RAI. Examples include the FAO’s ‘Towards voluntary guidelines on responsible governance of tenure of land’ dating from January 2009 and the ‘Large-scale land acquisitions and leases: a set of minimum principles and measures to address the human rights challenge’ by the UN Special Rapporteur on the Right to Food presented in March 2010.

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- *Recipient country political risk* is arguably the most prevalent category of farmland investment risk, ranging from micro-risks targeting a particular sovereign fund and its transaction to macro risks affecting all investors in the field. Micro-level risk includes local resistance towards a specific project, one of the classic occurrences of political risk. An illustrative example is provided by the Libyan SWF's land investments in Liberia where local resistance could only be overcome by partnering with an NGO (Cotula 2011). However, as local groups usually have only social mechanisms to further their interests, the most serious political risk for sovereign wealth funds comes from authoritative actions of recipient country governments. Here, one can distinguish between political debate and parliamentary/committee inquiries and the policy measures resulting thereof. An example of the former, meso-type political risk is an Australian Senate committee's decision to have a more in-depth look at the Australian Foreign Investment Review Board's practice with regard to purchases of agricultural land by sovereign wealth funds (Senate Standing Committees on Rural and Regional Affairs and Transport 2011; The Sydney Morning Herald 2012b). This has come on the back of Qatari- and Chinese sovereign investments, leading to considerable investment insecurity for these funds¹⁴². One step further, macro-level policy measures affecting all investors in the agricultural space have turned out to be the most potent political risks for sovereign funds: Mirroring classic examples such as foreign exchange controls in times of balance of payment crisis, the food crisis by definition has seen a considerable number of national policy responses: In order to protect their own citizens, governments have restricted food exports (e.g. China, India, Bolivia) and/or installed price controls for staple foods which are to be observed by all investors in the sector (IFPRI 2008a, 2). The wide ranging impact this type of risk has on investment decisions is underscored by the (originally confidential) remark of Kuwaiti official who said that there would be 'no way of actually obtaining the food [from farming abroad] in a genuine global crisis. If the host country government didn't shut off exports during a food crisis, it could be overthrown.' Kuwait – as other food-insecure investors – does not have 'an army to get it, even if they wanted to' (Wikileaks 2009b). Another popular policy measure in this field has been to limit land ownership by foreigners as done in

¹⁴² Interestingly, the ensuing discussion also touched upon the Australian Future Fund's own 'long awaited move [...] into agricultural land investment' which was hampered by shareholder disputes over PrimeAg Australia, the SWF's investment partner. While these disputes have been the source of considerable risk for the Future Fund and may be seen as domestic political risk, they are led by market stakeholders employing classic market/shareholder mechanisms. Therefore, these risks are unlikely to qualify as political risk within the definition laid out in this thesis (AFR 2011).

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- Thailand and Brazil (Woertz 2011, 8). The Ukraine has similar restrictions, with foreign investors circumventing the political obstacles and leasing land instead of buying it (Euromoney 2011e).
- The ‘land grab’ issue has also seen considerable political risk at the *international level*, mainly due to its close links with development questions. At this level, political risk mainly emanates from two stakeholders: internationally active NGOs (and their media followers, including social media) and international organizations. The media- and NGO campaigns against the ‘land-grabbing’ sovereign funds are a classic meso-political risk targeted at a specific set of market participants all over the world. Specifically targeting SWF reputation, they push sovereign funds for more transparency on certain transactions, thereby forcing SWFs to divulge more data than originally envisaged to quell critics. NGO networks/initiatives such as landgrab.org ensure the compilation, analysis and preparation of what is seen as trustworthy local evidence which then is disseminated to international news outlets and third-country political decision makers (for some examples of such awareness-raising reports, see GRAIN 2008; Merian Research and CRBM 2010; Oxfam 2011). This NGO transmission belt aims at ensuring the inclusion of the affected locals in the global discussion (similarly Cotula 2011, 3). The campaigns draw particular force from the fact that in the ‘land grab’ narrative, sovereign funds are portrayed as agents of their (mostly rich) governments, helping them to cheaply buy up land in developing countries. In order to enlist grass root support, public visibility and thereby financing and similar to the mechanisms described in chapter 4.3.2 (footnote 77), they also ‘take the fight to the streets’ in developed countries, e.g. by protesting at relevant industry gatherings such as the June 2012 Terrapinn Agricultural Investment Summit in London (The Gaia Foundation 2012). Citing ‘speculation’ as one of the reasons for the food price hike, social stakeholders have also pressed for regulation of agricultural commodities trading (e.g. minimum holding periods, etc.), thereby indirectly impacting on SWF portfolios. As mentioned above, ESG investment commitments, standards and guidelines by international organizations are another potential source of political risk (direct ESG impact). With regard to farmland investment, the relevant provisions include general guidelines on human rights, environment, anti-corruption and project finance (Global Compact, Equator Principles) and the more specific guidelines on agri-investments mentioned above (RAI, etc.). At this point in time and as mentioned by the World Bank in the extended paper, ‘no agreement has been reached yet by private industry as to

whether and how to adopt voluntary self-regulation'. The RAI (and other guidelines) therefore remain soft obligations, with non-compliance resulting (at worst) in a loss of reputational capital. The ambivalent character of the guidelines in this field is further emphasized by the fact that despite the World Bank claiming broad stakeholder support, there is a growing number of NGOs which strongly oppose the RAI: In October 2010, more than 100 NGOs – amongst them major ones such as Friends of the Earth and one of the leading agri-specialist NGOs GRAIN – signed a declaration denouncing the RAI as a move to window-dress and legitimize what they see as a non-negotiable prohibition of (large) land deals (La Via Campesina et al. 2010). For sovereign funds, this leads to an ambiguous situation where compliance with the spirit of the code may ultimately be turned against them. The probably most serious political risk at the international level may be the cross-border conflict potential embedded in farmland investments. With land being deeply intertwined with questions of sovereignty, in particular in times of food shortages, investment activity in this field remains potentially risky as illustrated by ongoing cross-border conflicts between states (and investors) over water rights along the river Nile (Woertz 2011, 9pp).

6.2.4 Analysis: Understanding political risk of farmland investments

Following a thorough categorization of political risk encountered when investing in farmland, this sub-chapter draws a conclusion by looking at legitimacy gaps of sovereign fund land investments and asking how these gaps foster political risk. It shows how political risk turns into issues and proposes potential ways to avoid, mitigate or accept political risk.

According to the model developed in the prior chapter, political risk is a function of legitimacy (see chapter 5.1.4). A loss of legitimacy potentially results in the sovereign fund losing its 'licence to operate' and becoming vulnerable to political interference which aims at realigning its behaviour with stakeholder expectations. Sovereign wealth fund farmland investments have seen legitimacy gaps both on the compliance- and the reputation side.

- On the *compliance side*, the model distinguishes between legal/authoritative and contractual obligations (with enforcement). With regard to the first type and recalling the discussion above on the international guidelines covering farmland investments, sovereign funds have very little binding obligations and have therefore experienced little compliance risk, even more so as the various

- guidelines are hotly contested. Some risk of non-compliance and hence political risk may arise from not following abrupt changes in national policy in times of spiking food prices. More important, however, are threats to legitimacy on the contractual level, in particular with contracts enforceable in recipient country courts. As Cotula emphasizes in his study on the contractual arrangements of land deals in Africa, considerable risk to farmland investors arises from the ‘gap between legality [of government commitments] and legitimacy [of the people’s customary land rights]’ (Cotula 2011, 2). Therefore, inclusive contract negotiation, contract design and commitment are of utmost importance (which is also reflected in RAI principle 3 on good processes and proper legal environment). This is even more so as determining the true value of the land continues to be one of the most contentious challenges (for many, see The Economist 2009; The World Bank 2011, 95pp).
- On the *reputation side*, sovereign wealth funds have seen the loss of reputational capital in three areas: (1) although guidelines such as the RAI are not mandatory and still under discussion, sovereign wealth funds have been passive at best when it comes to endorsing the principles. Upon a search of the World Bank-administered stakeholder exchange platform, there is no evidence for any sovereign wealth fund involvement¹⁴³. With social stakeholders in particular expecting investors to publicly commit to such guidelines, collective sovereign wealth fund reputation has taken a hit here. (2) This has been exacerbated by farmland investments constituting the second major contentious ‘issue’ (after Western financial institution support) sovereign funds had to deal with collectively, thereby making them the ‘whipping boys’ of international development circles. And because SWF farmland investment approaches not only include the Qatari collaborative model but some less popular ones such as China’s¹⁴⁴, sovereign funds have also had to take a collective reputational loss with the ‘land grab’ issue, arguably more than they would deserve on average. (3) There has been a considerable gap between the moral/ethical expectations of sovereign wealth funds and their farmland investment stakeholders, in particular the local population and NGOs, which could not be resolved by resorting to hard evidence. Farmland investors argue that they reverse a long period of

¹⁴³ Interestingly, the only reference to SWFs is related to the Santiago Principles which are seen as a successful product of an industry/stakeholder dialogue which the RAI should draw on for ‘good practices and experiences gained’ (The World Bank et al. 2010).

¹⁴⁴ China has encountered local and national political opposition, in particular in African countries, for not only investing, but also bringing in significant numbers of its own people

underinvestment in agriculture, bring unused ‘marginal land’ into production, and increase productivity and thereby (local) food security by adopting the latest agronomic practices while generating jobs and strengthening rural economies. Local stakeholders and NGOs, on the other hand, argue that farmland investors do not take into account the traditional use of marginal land by pastoralists, fail to account for the external social and environmental costs of large-scale and mechanized farming of monocultures and provide little local added-value nor food security. With the debate based on significantly differing value systems (efficiency vs. fairness) and inconclusive evidence due to the complexity of local settings, there has been little agreement on the fundamentals. International organizations have not been able to bridge this gap either: As some analysts have noted, the World Bank ‘appears deeply torn’ with regard to farmland investments, with its main report on it hovering between support for open markets and concerns about the impact of this type of investment (The Telegraph 2010). As so often in public disputes about big questions (think of atomic energy or climate change), the lack of evidence with regard to the pros and cons of farmland investment usually favours the more sensationalist claims, thereby contributing to the proliferation of the ‘land grab’ argument.

6.2.5 Conclusion and some recommendations

Concluding this case study, it can be argued that political risk of SWF farmland investments may be best summarized by the famous saying that ‘perception is reality’. In theory, farmland investment harbours significant risk potential as confirmed by analysing the various political risk factors. Investment sector- and country risk, ESG issues, the secrecy surrounding such deals and the situation in the agricultural commodities market are the most potent *political risk factors*. SWF political risk may arise on all *three levels of analysis*: Domestically, food security sensitivity can lead to governmental pressure on SWFs’ asset allocation. In recipient countries political risks may range from local riots to policy measures restricting investment in and export of agricultural commodities. At the international level, political risk may consist of NGO resistance or investment regulation mandated by international organizations. While the evidence of sovereign funds involved in large-scale farmland investment is inconclusive, continuing media reports and NGO activity on SWF involvement has turned it into a genuine issue. This thesis argues that the ‘land grab’ controversy is the second broad issue in the last decade to affect individual and collective sovereign fund reputation alike. An *analysis of the legitimacy gaps* suggests that most of the political risk in this field has not come from compliance breaches but from a loss of

reputational capital. It is the perception of sovereign funds acting as agents of their respective governments and snapping up land all over the globe which has turned into a widely accepted ‘reality’.

Although some interviewees for this thesis suggested that sovereign funds are generally more risk-tolerant than other investors in the agricultural sector, the mitigation of political risk remains important. With regard to strategic advice, this diagnosis would lead to the following suggestions for sovereign funds investing in this field:

- *First, create transparency* about transactions involving farmland, either through established channels such as an annual report, background work with the media (for a good example provided by Qatar, see Reuters 2012b) or – more timely – by pushing out information as it happens. This would contribute to showing the true size of the phenomenon of sovereign farmland investment. Considering the endogenous risk factors mentioned above and the relevant Santiago Principles, transparency also includes being straightforward about the motives behind farmland investments (food security or financial motivation). Transparency also discourages corruption, thereby mitigating another important risk for sovereign funds.
- *Secondly, incentivize private sector actors* to invest on behalf of the sovereign fund. These ‘partnership strategies’ (see chapter 7) may include teaming up with domestic (i.e. SWF home country) private partners and mandate them to take ownership of the project (as it is common in Gulf countries, see e.g. GRAIN 2008, 5). This risk mitigant in the direct investment field might be comparable to engaging external asset managers for portfolio mandates. Studying transactions up to 2009, Cotula et al. see little evidence of sovereign funds taking direct majority stakes but rather notice an increase in risk-sharing co-financing and joint-venture approaches, in particular championed by Qatar (Cotula et al. 2009, 35pp). Saudi Arabia is another example of a successful model where the government supports private sector actors in their farmland investments by providing access to capital and contacts.
- *Thirdly, partner with local firms* to implement any potential farmland investments. There are three reasons why this potentially reduces political risk: (1) A local partnership disincentivises political interference by the recipient country/local government. This is even more the case if financing for local operations is

- provided by local banks, thereby increasing the cost of government intervention.
- (2) Local partnering ensures that local stakeholders share the benefits of the investment. Most importantly for NGOs, they need to be included in the dialogue and treated as business partners. And (3) involving local partners also dissipates stakeholder concerns about the funds acting as an extended arm of their governments. The effects of this strategy may be even more pronounced if the partner is an authoritative stakeholder such as the local or the national government, provided there is no misappropriation of land and corruption (for an example involving Bulgaria, see Radio Bulgaria 2012).
- *Fourthly, commit to minimal investment standards* as suggested by NGOs to bridge the ethical/moral expectations gap. Although the current codes governing agricultural investments are not hard obligations, they constitute a first step towards engaging with stakeholders – also with regard to the provisions NGOs are opposing to and also with fellow sovereign funds, given that in the farmland investment field, shared SWF reputation seems to be more fragile than elsewhere.

6.3 Ireland’s NPRF domestic financial sector bailout

The second case study sheds light on Ireland’s National Pensions Reserve Fund (NPRF) and the way to and the impact resulting from bailing out domestic banks. This case study is of particular relevance because it touches upon the fine line between governmental control and political risk.

6.3.1 Introduction and SWF involvement

Ireland’s National Pensions Reserve Fund was established in 2001 through the National Pensions Reserve Fund Act (2000), with the objective to contribute to rising pension obligations from 2025 onwards (Oireachtas 2000). The NPRF is funded by the Irish government setting aside 1% of GDP each year. Despite its name, the NPRF does not hold explicit short-term liabilities¹⁴⁵ and invests in bonds and equities, mainly through external asset managers. Managed by the National Treasury Management Agency, the fund has no legal personality but rather constitutes a pool of assets. Anne Maher provides a good overview of the setup and investment strategy originally intended for the NPRF (Maher 2001).

¹⁴⁵ According to Rozanov’s classification, the NPRF holds fixed future liabilities, see footnote 13.

Similar to other sovereign wealth being redirected during the financial crisis (for other examples, see Rozanov 2010a, 257pp; Castelli and Scacciavillani 2012, 98pp), the NPRF was tapped twice for domestic financial stability purposes:

- In 2009, legislation was passed to alter the mandate of the fund (Oireachtas 2009). It enabled using most of the cash balances and part of the sovereign bond holdings (EUR 7bn) to recapitalize failing domestic banks. In a separate transaction, the NPRF also invested EUR 3.5bn in Bank of Ireland and Allied Irish Banks preference shares.
- Authorized by a change of legislation (Oireachtas 2010), the NPRF was tapped for 12.5bn EUR in order to supplement a EUR 85bn support package for Ireland by the European Union and the IMF. EUR 35bn were earmarked for fixing bank balance sheets and the remainder was used to prop up Ireland's public finances, mainly through the NPRF buying Irish government bonds (Reuters 2010b; Financial Times 2010f).

According to the June 30, 2012 Quarterly Performance and Portfolio Update, the NPRF's assets stood at EUR 13.9bn (NPRF 2012), down from EUR 19.3bn on March 31, 2008. By March 2013, assets have only slightly recovered to EUR 15.2bn (NPRF 2013). Considering that more than EUR 20bn were investments into preference shares of the two biggest Irish banks, fund assets, at first sight, do not look like they have taken a hit beyond the impact of the financial crisis. However, as many analysts have aptly mentioned, there are hidden valuation issues and the risk profile of the fund has shifted dramatically, casting serious doubts on whether it can still perform according to its mission (FT Alphaville 2010). In addition, the fund is unlikely to receive any budget/GDP contributions for some time to come.

6.3.2 Evidence: Categorizing political risk

Prima facie, these interventions by the Irish government and parliament look like classic manifestations of domestic-level political risk which is defined as 'the probability of unexpected or difficult to anticipate political action resulting in adverse consequences for the sovereign fund':

- While the problems facing the Irish economy in general and its financial sector in particular have been common knowledge for some time, using the NPRF for domestic purposes came as a surprise. As Monk notes, supporting domestic bank balance sheets through the NPRF was only considered when faced with the terms

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- of the external IMF bailout (Monk 2010i). Until one year before tapping the fund, the Irish finance minister said that he ‘won’t succumb to [such] temptations’ (The Irish Times 2010).
- Both instances of tapping the fund were inherent political actions, pushed through by the Ministry of Finance based on (emergency) changes to the underlying legal framework of the fund.
 - Both interventions resulted in what this thesis refers to as ‘investment behaviour- and asset allocation-related adverse impacts’ (see chapter 4.2.3): The ‘directed investments’ instructed by the Irish treasury, i.e. the government, have not only underperformed, but have also skewed the risk profile of what used to be a long-term investment organization¹⁴⁶.

Although the fund had been given some assurances, including an attractive fixed 8% dividend, for its ‘directed investments’, the investment rationale remains questionable. As a seasoned SWF advisor said: ‘Would the manager have taken the decision with profit considerations? The answer is no. It is a perfect example of political pressure and decisions being forced upon them’ (Waki 2010e).

An important question in this context is whether the NPRF’s change of mandate, which was enacted in an ordinary way through parliament, may constitute political risk or falls into the category of the Irish government exercising its supervisory rights. Considering (a) the share of directed investments in comparison to total fund AuM, and (b) the radical and repeated (2009 and 2010) change of the NPRF’s mandate from a savings fund with long-term pension liabilities to a domestic development/bailout fund, there is a strong argument to assume a case of political risk. This even more so as the latest change of the statutory law in mid-2013 established the Ireland Strategic Investment Fund which finalizes the dismantlement of the NPRF by taking over the discretionary portfolio and re-focusing on ‘commercial investments in Ireland’ (Department of Finance Ireland 2013).

6.3.3 Theory: Assessing the likelihood of political risk

With the political risk factors elaborated upon in chapter 5, this thesis offers some conceptual instruments to assess a situation’s potential for political risk. In the case of the NPRF’s directed investments, there have been a few political risk factors at play:

¹⁴⁶ Since the 2009 investments, the portfolio of the NPRF has been divided into two components: a ‘directed portfolio’ containing the ‘public policy investments [...] made at the direction of the minister of Finance’ and a ‘discretionary portfolio’ which includes all other investments.

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- With regard to endogenous risk factors, the NPRF’s setup provided for a considerable level of political risk: The fund is no separate legal entity but a pool of assets managed by the National Treasury Management Agency. The National Pensions Reserve Fund Commission (NPRFC) acts as the board of the fund. While staffed with high-calibre independent professionals (e.g. Knut N Kjaer, the former CEO of NBIM), the commission is powerless against changes of the underlying mandate, in particular if enacted in a legally correct way. Interestingly and presciently, the Irish national pension regulator warned of such a scenario, saying that ‘the biggest concern for a fund of this kind would appear to be the danger of Government interfering with or accessing the fund’. They cite the independent NPRFC as an institutional security valve to ensure the independence of the fund (Maher 2001, 13).
 - While behavioural risk factors are thought to be less important when it comes to domestic governmental interference, in its ‘obituary’ for the NPRF, the Irish Times surprisingly refers to the lack of an ethical investment policy at the fund. It may be speculated that in addition to the fund’s poor performance during the first couple of years, this may have impacted the NPRF’s standing/reputation amongst the Irish population, thereby opening the doors for it to be subject to a parliamentary weighting of options when it came to crunch time (bankruptcy vs. raiding the fund, see below).
 - This leads to the arguably most important political risk factor at play: the economic environment. As shown by several instances of tapping SWFs for domestic purposes, all entities subordinated to the state ‘become fungible when a crisis arises’ (Bodie and Briere 2011, 33). Such situations are referred to as domestic competition for scarce funds (see chapter 5.4.3). Also, from a reputational point of view, the second intervention was likely to be easier to get through as the NPRF’s reputation as a long-term investor was still reeling from the first round of directed investments.

6.3.4 Analysis: The political risk of domestic investment pressure

As conceptualized by this thesis, political risk arises from legitimacy gaps which are a function of stakeholder expectations.

- Considering the NPRF, the arguably most important stakeholder is the acting government. Back in 2009 and even more so in 2010, it was faced with a difficult choice: either sourcing enough domestic investment to plug the ‘black hole’ of

Irish bank balance sheets (Waki 2010e) or to ask for international support. Against this background during the first intervention in 2009, there was a strong incentive for the Irish government to exchange future pension reserve assets for present consumption. While pension reserves have no lobby attached to them and can be left to be dealt with by subsequent governments, the rescue of the domestic banking system by the country's own means provides a tangible and politically attractive present benefit. In 2010, however, given the size of the rescue package which could only be financed with external help, the main driver behind using NPRF assets was the option to maintain some independence vis-à-vis foreign creditors.

- The incentives faced by the Irish parliament to pass the according legislation were similar, with maximizing votes on the back of a 'successful' rescue to be weighted higher than a future shortfall in national pension assets. Moreover, parliament could shift the blame to the Irish government, thereby generating even more political capital from the situation.
- Throughout this difficult period, the Irish population as the ultimate beneficiaries of the fund remained surprisingly muted, with very little public activity being reported. This may reflect Mancur Olson's theory of dispersed interests which make it difficult for 'latent groups' to mount a powerful response.

6.3.5 Conclusion: protect the SWF mandate

This is an illustrative example of sovereign wealth funds being used by their respective governments to preserve autonomy, independence and governmental legitimacy (see chapter 2.3.4 or Monk 2010i). From this perspective, Monk even argues that Ireland was lucky to have a sovereign fund. However, he deplores seeing long-term needs being crowded out by the necessities of the day (Monk 2010g) – this even more so as the literature has long seen sovereign wealth funds as a solution to insulate assets from short-term political needs. This case study underscores the need for strong governance frameworks, in particular with regard to a fund's mission and mandate. If not adequately anchored, the fund risks becoming prey to short-term government interests. As shown by this case study, the legal level of a fund mandate matters: There are strong arguments to protect mandates as diligently as possible, potentially even by codifying them on the constitutional level.

6.4 Case study conclusions

The case studies show that political risk can emerge from stakeholders on all three levels and comes in various forms, ranging from political interference at home to regulatory risk and loss of reputational capital abroad. The thorough application of the model enables the identification of the main stakeholders and the most salient political risk factors leading to various manifestations of political risk.

As suspected, given the ‘new face of political risk’ (see chapter 3.3.2), SWF political risk can often be attributed to the loss of reputational capital. While complex regulation may increase the risk of authoritative intervention, legitimacy gaps due to non-compliance are less prevalent amongst sovereign funds. This is rather surprising as most SWFs have become sophisticated asset management organizations commanding good regulatory risk capabilities. When tracing back political risk to the three clusters of political risk factors, there is little evidence for one risk cluster to be more pronounced than the others. While allowing for a certain variation depending on individual fund characteristics (e.g. funds from non-OECD countries impacted by host country reputation such as when investing in farmland), endogenous-, behavioural- and external risk factors seem to be of equal importance. As a consequence, all of the political risk factors have to be taken into account when designing risk management strategies.

Building on the insights from prior chapters on the phenomenology (timing, scope, impact and levels) and potential reasons for political risk (legitimacy gap in the context of three clusters of risk factors), the next chapter looks at how to manage these risks. As many analysts have pointed out, in essence political risk management at SWFs amounts to strengthening legitimacy. For SWFs, the proximity to their home governments may provide both a blessing and a curse in this respect.

7 A proposal for SWF political risk management

As the prior chapters have shown, the phenomenology of political risk is complex, straddling three levels of analysis, various stakeholders and a multitude of interests. Following a brief introduction to the rationales for and current practice of political risk management, this chapter proposes a framework for sovereign wealth funds which draws on a modern three-tiered approach of monitoring, assessment and advocacy. It proposes SWF-specific monitoring- and assessment techniques complemented by a selection of advocacy staples. The three tailor-made advocacy strategies constituting the core of the framework are based on the understanding that the influenceability of political risk factors and the issues arising thereof varies considerably. Therefore, individual SWF strategies need to be combined with partnership- and collective action to effectively manage political risk.

7.1 Political risk management and sovereign funds

7.1.1 Enterprise risk- and political risk management

A popular definition of enterprise risk management is provided by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), an industry body of auditors and accountants: ‘Enterprise risk management is a process, effected by the entity’s board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within the risk appetite, to provide reasonable assurance regarding the achievement of objectives’. This definition points at three important characteristics of risk management:

- *First*, risk management is a process, with various iterations needed to find the right balance between enabling business and controlling risks - hence also the reference to the risk appetite, a reflection that without the willingness to accept risk, there will not be any opportunities.
- *Secondly*, risk management is not a pure management function but requires collaboration and co-ordination of supervisory- and executive bodies and employees alike.
- *Thirdly*, risk management is not an end in itself, but an auxiliary function to achieve objectives with ‘reasonable assurance’.

While the above definition is geared toward the traditional financial and operative risks faced by companies (see chapters 3.1.2 and 3.1.3), the overall characteristics also

apply to the management of political risk: it is an iterative process due to the need to build up trust and legitimacy, it involves people in various functions and on various hierarchical levels (as political risk is cutting across traditional company risk buckets), and it should be an enabler for business. Similar to the overall risk management functions, political risk management aims at turning uncertainty into calculable risk: It is about achieving objectives with ‘reasonable assurance’, thereby mirroring Knight’s statistical probability (see figure 12). While the term ‘management’ implies the organization being in full control of political risk, political risk management remains a trial-and-error process which will yield tentative protection at best.

This thesis does not provide a concise definition but rather adopts pragmatic understanding of political risk management: it encompasses all activities, either by the firm itself or together with partners, aimed at managing political risk as defined in chapter 4.2.2¹⁴⁷. In this context, management refers to devising what Rossiter and Karplus call ‘co-ordinated and conscious programs’ (cited after Sangsrit 1994, 37). The objective invariably is to *avoid*, *mitigate* or find a way to *accept* political risk.

There are three additional aspects of political risk management which are worth noting as they somewhat differ from standard enterprise risk management practices:

- *Focus on relationships*: Most ordinary enterprise risk (such as market risk) is completely stochastic in nature. As a consequence, it can be managed by diversification. Political risk, on the other hand, may only be partially responsive to portfolio/diversification efforts (differently: Kennedy 1988). Consider a loss of reputational capital, for instance, the effects of which are difficult to mitigate through a diversified geographical setup: contrary to common perception, the risks arising thereof may even be amplified by being present in various countries. Therefore, political risk management rather relies on relationship-based instruments such as partnerships or corporate citizenship strategies.
- *Less conducive to quantification*: As discussed in chapter 3, despite various efforts in practice and academia over the last two decades, political risk remains difficult to quantify. This and the focus on relationships has some consequences for how political risk is managed: Instead of depending on fully automated management information systems and automatic checks with clear-cut intervention thresholds,

¹⁴⁷ This thesis defines political risk for sovereign funds as ‘the probability of unexpected or difficult to anticipate political action resulting in adverse consequences for the sovereign fund(s)’, see chapter 3.

the human element will continue to play an important role in assessing the fluid evidence for and dealing with political risk.

- *More need for justification:* Although political risk has had a long track-record of interrupting corporate strategy, using company resources to manage these idiosyncratic risks still seems to be in need of justification (Sangsnit 1994, 36; and, based on a broad survey, PwC and Eurasia Group 2006, 3). Having management to agree on building up an organization and running programmes to manage political risks often requires more effort than setting up processes to manage more traditional enterprise risk.

As a consequence, integrating political risk into enterprise risk management can be challenging and may require cultural change. The proliferation of political risk consultancies providing outsourced political risk management capability shows that it has become an important part of enterprise risk management but is often outsourced. However, considering various developments over the last two decades, there are convincing reasons for embedding political risk management directly into risk management systems of internationally active organizations:

- *Geographically,* an increasing number of firms have broadened their activities and derive considerable revenues from activities in emerging markets. While these markets offer interesting growth prospects, politics is thought to play a much more pronounced role in these countries, thereby increasing political risk (PwC and Eurasia Group 2006, 2; Bremmer and Keat 2010, 68). Therefore, building up political risk management capability (or contracting it out under certain circumstances) is seen as a good investment to protect a firm's assets.
- *Issue-wise,* the proliferation of new regulation both in OECD countries and emerging markets has resulted in new risks (for an in-depth, yet pre-financial crisis overview, see Economist Intelligence Unit 2005). Regulatory complexity has further increased with the financial crisis which prompted to broaden and deepen regulation across the board. Although strictly speaking, political risk management does not include ensuring regulatory compliance, safeguarding an organization's legitimacy is likely to contribute to less regulatory interference (see for instance the various short-selling bans introduced during the food- and then the financial crisis. Political risk management also has a role to play when it comes to the early detection of emerging regulation.

-
- *With regard to political actors*, it has been widely noted that the public scrutiny of organizations has intensified over the last two decades, with Shell’s Brent Spar incident constituting an often-cited example of stakeholder activism (see chapter 3.3.2). Buholzer and Rybach see three factors contributing to increased stakeholder scrutiny (Buholzer and Rybach 2008, 191): *First* of all, regulation and resulting reporting requirements have brought about a hitherto unknown level of transparency (e.g. SOX, but also increasing best practice to report on non-financial performance). *Secondly*, media attention and reporting frequency have increased significantly, aided by, *thirdly*, the global reach and the speed of internet-based modern communication technology and social media in particular. As one commentator remarks, ‘social media is challenging the very license to operate by putting every business under the microscope every day’ (see comments by Richard Brown to Divol, Edelman, and Sarrazin 2012).

7.1.2 A plethora of approaches: some history and categorizations

With some risk of oversimplification, it may be argued that over the last half a century, political risk management has developed in three stages:

- Systematic thinking about political risk management dates back to the 1960s and 1970s when multinational corporations, often from the U.S., recognized the need for early warning systems (see chapter 3.2 with further references). In comparison to today’s approaches, early political risk management systems (for some examples, see Simon 1982, 62pp) exhibited significant shortcomings: (1) the underlying definition of political risk was too narrow, mostly focusing on classic political risk such as currency controls and expropriation in recipient countries. There was little reference to political risk at the domestic- or the international level; (2) too much emphasis was being put on assessing potential risks, with very little thinking about how to influence/manage these risks; (3) as a consequence, the early concepts were mostly reactive and did not take into account the opportunities inherent in proactive approaches.
- In the 1980s, political risk management made a significant leap forward, influenced by progress in stakeholder analysis and the emergence of neo-institutionalism/New Institutionalism. The fact that the first chapter (after the introduction) of Stephen Kobrin’s influential book on ‘Managing Political Risk Assessment’ is dedicated to ‘Organizations and Environments’ mirrors a broadening of political risk management concepts to include the systematic analysis of company stakeholders and the firm’s institutional environment. The

- 1980s has also seen methodological progress, with Shell emerging as the first company to adopt scenario planning in order to assess and manage mainly non-financial risks¹⁴⁸.
- Today's encompassing concept of political risk management is built on the understanding that companies as 'corporate citizens' have responsibilities beyond profit maximization (see chapter 3.3.2). An increasing number of NGOs are holding companies accountable to various sets of rules, often elaborated with the backing of international organizations. Depending on the activities and the reach of a company, issues such as climate change, fairness in development and human rights are now part of the 'triple bottom line' that companies have to observe and report on. Classic political risk has seen a considerable decline due to (1) more open markets, (2) governments constrained by international commitments, and (3) less political conflict thanks to economic growth in emerging markets. Risks related to company reputation, however, have seen a strong increase. As a consequence, today's best-practice political risk management has become much broader, with the boundaries of formerly separate (sub-) disciplines increasingly blurring.

Looking at existing company setups and the academic literature, it becomes clear that there are various adjacent instruments, functions and disciplines commonly subsumed under the term or contributing to political risk management. Some of the most common ones in this field include issue management, crisis management, reputational risk management, corporate diplomacy, corporate citizenship strategy, stakeholder dialogue, sustainability risk management, lobbying, corporate communications and public/governmental affairs. While all of these touch upon certain aspects of political risk management, they vary with regard to the degree of strategic focus and reactivity.

As shown by the figure below, some concepts are merely instrumental while others amount to proper strategic proposals of how to deal with political risk. As political risk management has considerably widened its scope and the literature has been characterized by a considerable heterogeneity of terms and concepts, the graph below does not claim to be comprehensive. It rather illustrates that this thesis conceptualizes

¹⁴⁸ The scenario methodology is closely associated with Shell where in the 1980s, Peter Schwartz and his team conducted scenario analysis on the impact of oil prices. Schwartz' 'The Art of the Long View' into which he distilled his findings a decade later, is considered to be a classic of the scenario literature (Schwartz 1996). However, the emergence of scenario techniques dates back to the 1940s, with the U.S. military and the RAND Corporation playing an important part in their development.

political risk management as a holistic and strategic management function. This has some important consequences as will be shown later on when discussing how to embed political risk management into an organization.

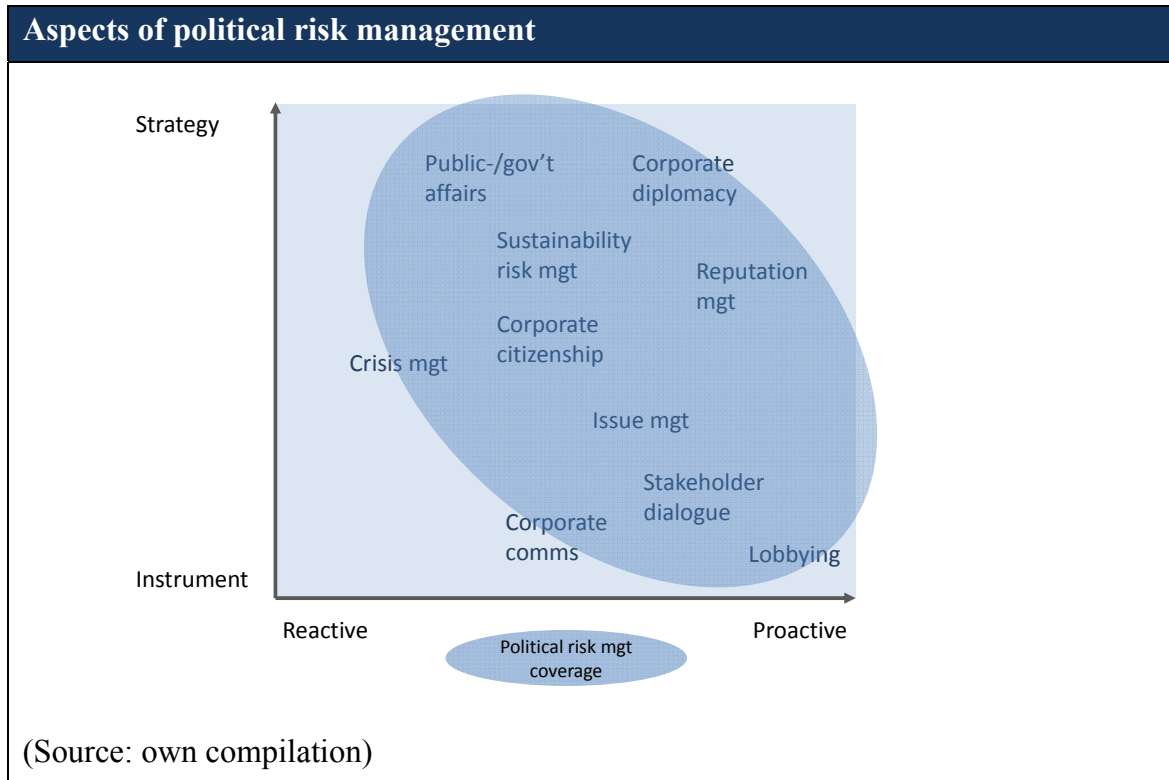


Figure 24: Aspects of political risk management

The graph also shows that the objectives of political risk management can be classified along two dimensions:

- *Proactive-reactive*: Political risk management (or the instruments used for it) may be proactive or reactive: Proactive political risk management aims at strengthening legitimacy by building up reputational capital and compliance capacity, thereby reducing the propensity of political risk. As Kennedy notes, ‘generally, proactive managers are less likely to experience adverse government intervention’ (Kennedy 1988, 28). Similarly, this also applies to political risk emanating from social- and market stakeholders. At times and mirroring the opportunity function of reputation, proactive action may also create new possibilities (for many, see Zetter 2008, 26pp): an SWF may be the first one to be approached for a certain deal precisely because it has a strong reputation overall or in a certain field of business.

- However, political risk management may also have a reactive function and ensures successful mitigation or even acceptance of risks which could not be avoided.
- *Integrative-protective*: Writing from a recipient country political risk perspective, Gregory distinguishes between integrative and protective political risk management techniques (Gregory 1983). Integrative techniques aim at reducing the frequency of losses by ‘influencing relations with institutions and actors in the political environment’ in order to ‘facilitate the integration of the foreign venture into the host society’ (Brink 2004, 156). According to the theory, integrative measures such as setting up JVs or strengthening local sourcing should result in a higher degree of acceptance of the company by local stakeholders. Protective techniques, on the other hand, aim at keeping company operations as independent from the host country as possible, thereby reducing the incentives for politics to interfere and/or mitigate the effects of interference. Protective techniques include not transferring intellectual property and – although integrative at first glance – the financing of operations with high proportions of local debt (for more examples, see Brink 2004, 156pp).

7.1.3 SWFs, risk management and political risk

As with other asset management organizations, financial risk management is of significant importance to sovereign wealth funds. Due to their function as intergenerational savings vehicles and long-term investors, SWFs are generally loss-averse and require strong risk management credentials over the business cycle. Aware of the need for sophisticated risk management frameworks commensurate with SWFs’ size and clout in financial markets, the Santiago Principles suggest that the funds may operate frameworks that ‘identify, assess and manage the risks of its operations’ (GAAP 22). In addition to giving some general guidance on what such frameworks may include, the Santiago Principles also mandate that the ‘the general approach to the SWF’s risk management framework’ may be publicly disclosed (GAAP 22.2). The considerable emphasis on such topics at international fund gatherings is yet another sign that risk management is on top of SWF executive agendas, in particular after the considerable losses in equities most funds have faced during the financial crisis. Examples of such events with a considerable risk management component are the May 2011 meeting of the International Forum of Sovereign Wealth Funds (IFSWF) (Castelli and Scacciavillani 2012, 123)¹⁴⁹ and most events of the private SWF Institute.

¹⁴⁹ The website of the IFSWF provides additional materials on the Beijing meeting, with risk management discussions predominately focusing on currency exposure and ‘fat tail’ risk.

Furthermore, the academic discussion on SWF (financial) risk management has picked up considerably over the last couple of years, also reflecting the increasing complexity of SWF investment strategies (instead of many, see Darcet, du Jeu, and Coleman 2010; B. Scherer 2011). However, as Castelli and Scacciavillani note, until recently (and arguably with some exceptions) ‘SWFs were not renowned for their risk management culture’ (Castelli and Scacciavillani 2012, 122).

The need for SWF political risk management

Given the scarcity of contributions to SWF political risk, it is of no surprise that there has been even less reference to managing such risks – in particular as there are strong indications that political risks are becoming more important for sovereign funds. In addition to the developments mentioned in chapter 3.3.3 regarding the ‘new face’ of political risk and the non-company specific factors described in chapter 7.1.1, there are a few SWF-specific developments which suggest it to be a good time to further strengthen the funds’ political risk management frameworks.

- *First*, the lessons drawn from the financial crisis and improving in-house investment capacities due to temporary secondments from banks or permanent hires have led to an increasing trend of in-sourcing investments. Without an external asset manager fronting the fund and managing SWF investments indirectly, political risk is likely to increase (see chapter 5.2).
- *Secondly*, there is tentative evidence that sovereign wealth funds have been upping their equity-, alternatives- and infrastructure holdings, all of which are considered to be politically more risky than fixed income investments. At the same time and in response to losses suffered during the financial crisis, sovereign funds have become more active investors, trying to protect their equity stakes through actively seeking board seats and enacting their shareholder rights (Financial Times 2012b; Financial Times 2012e). Analysts have attributed this strategic shift to the need to counteract falling yields in passive investments, in particular global bond markets (for a recent example of an expert report suggesting an adjusted SAA for Norway’s GPF, see Financial Times 2012d). According to the political risk factors identified in chapter 5 of this thesis, these developments are likely to result in increasing political risk.
- *Thirdly* and as mentioned before, the visibility of sovereign wealth funds and their investment activities has increased over the last couple of years, both internationally and at home. As a result, sovereign fund activity has been incurring

more scrutiny by a wide range of stakeholders. As opposed to private asset managers, with their domestic population, SWFs have a silent, yet powerful political constituency they are accountable to. As domestic reactions to the losses incurred during the financial crisis have demonstrated, stakeholders are well aware of how successfully sovereign funds manage their risks and do not shy away from pressing for change.

As the consultancy Monitor notes, dealing with political risks in a systematic fashion is considered a sign of maturity of the funds (Monitor 2008, 22). However, so far, evidence suggests that systematic political risk management capability is still patchy:

- (1) The interviews conducted for this thesis give little evidence of SWFs looking at political risk in a systematic and holistic way. While there are some exceptions to the rule (e.g. the GPF and Temasek), institutionalized political risk management amongst SWFs remains a scarce commodity and is often mistaken for simply increasing communication efforts and improving transparency.
- (2) Also, apart from some suggestions for instruments and advice given in articles on political risk (Wenlou 2008; Wu 2008), academia has seen little in-depth thinking and conceptualization about managing SWF political risk. In a widely cited 2008 report on investment behaviour of SWFs, Monitor presents a short case study on how Mubadala successfully avoided political risks when acquiring an 8% stake in U.S. chipmaker AMD. Besides referring to the importance of informing key political stakeholders ahead of the transaction and sharing benefits with the local population by building a semiconductor plant, however, the report falls short of proposing a blueprint for political risk management (Monitor 2008, 44).
- (3) When looking at sovereign wealth funds' organizational setup, there is little evidence of organizational units and/or staff dedicated to managing political risk full-time. The graph below provides some structural evidence of the more anecdotal sort:

Structural evidence for political risk management at the top 6 SWFs

		Annual Report	Active comms*	Risk Mgt Unit	Designated Non-Financial- or Reputational Risk Mgt Unit	How the unit is embedded	Other indicators
Norway	GPFG	Yes	Yes	Yes	n/a	n/a	Active ownership policy; acknowledges risks from 'natural disasters, terrorism and war; Council on Ethics
China	CIC	Yes	Yes	Yes	Public Relations and International Cooperation	Operation and Management Department	International advisory board
UAE/Abu Dhabi	ADIA	Yes	Yes	no info	Corporate Communications & Public Affairs Unit (CC&PA)	Finance and Administration Department	Broad CC&PA mandate: External Relationship Mgt Media Relations, PA/Gov't Relations, Marketing & Brand Mgt, Internal Comms
Singapore	GIC	Yes	Yes	Yes	n/a	n/a	Risk identification and assessment process by a cross-functional group
Kuwait	KIA	No	No	no info	Information and Public Relations Office	Managing Director's Office	Clause 8 of Law Nr 47 prohibits the disclosure to the public of any information related to the KIA's work
Singapore	Temasek Holdings	Yes	Yes	Yes	(Strategic) Risk Management Unit	Management/Board	Politics and reputation explicitly mentioned as potential origins of risk.
Qatar	QIA	No	No	no info	n/a	n/a	n/a

* Active communications is defined as more than 6 press releases per year.

(Source: own compilation)

Figure 25: Structural evidence for political risk management at the top 6 SWFs

7.2 Monitoring and Assessment: The building blocks of a strategy

Managing political risk is an iterative process which is commonly subdivided into three stages: *identifying*, *analysing* and *responding* to risk (for an overview and additional sources, see Buholzer and Rybach 2008, 194pp). This sub-chapter sheds light on how to monitor and assess SWF political risk before the next sub-chapter presents three clusters of potential responses/advocacy activities.

7.2.1 Monitoring: Know thy self, know thy enemy¹⁵⁰

Political risk management at SWFs starts with continuously identifying potential political risks across the whole spectrum of stakeholders. In the context of this thesis, monitoring at sovereign funds refers to spotting legitimacy gaps which potentially result in stakeholder responses. There is a growing body of academic literature and accounts of political risk management/public affairs professionals on how to best and most efficiently monitor an organization's environment (instead of many, see Steger 2003, 121; Denk 2003, 219; Buholzer and Rybach 2008 with further sources).

¹⁵⁰ This quote is commonly attributed to Sun Tzu's seminal treatise 'The Art of War'.

According to Denk, the study of business has a long tradition of looking into how to best anticipate weak signals of change in a company's environment. Steger equates monitoring frameworks with 'early awareness systems' found in many other sectors ranging from military/intelligence to international organizations looking for signs of impending crises or humanitarian disasters. In political science/public affairs, the literature distinguishes between 'environmental scanning' and monitoring (Denk 2003, 226pp):

- *Environmental scanning*, introduced by Aguilar (Aguilar 1967), refers to 'the acquisition and use of information about events, trends, and relationships in an organization's external environment, the knowledge of which would assist management in planning the organization's future course of action'. According to Choo whose doctoral dissertation is one of the reference works in the field (Choo 1993), environmental scanning both looks at and looks for relevant information. Depending on an organization's assumptions of its environment (analysable or unanalysable) and its intrusiveness in terms of data gathering (active or passive), he distinguishes between undirected viewing, conditioned viewing, enacting, and searching (Choo 2001). Environmental scanning as conceptualized by the original authors is rather general in nature and covers a broad array of factors which may influence a company's business.
- In the context of this thesis, '*monitoring*' is congruent with Choo's original term 'searching' which takes place 'when the organization perceives the environment to be analysable and it actively intrudes into the environment to collect an accurate set of facts about the environment' (Choo 2001). As a particular sub-set of environmental scanning, monitoring is more focused and more results-oriented, in particular in a commercial context where the monitoring function needs to be justified within the organization. As opposed to environmental scanning, monitoring also needs a conscious decision on which field, organization or trend to follow and therefore requires prior structuring and prioritization of the company's environment.

Given this thesis' broad concept of SWF political risk which may arise from social-, market- and authoritative stakeholders alike, it is suggested to keep monitoring a sovereign fund's environment in as broad a way as possible. There is an ample literature on potential sources of information for an encompassing monitoring exercise (Choo 1993, 90; Denk 2003, 227pp; Buholzer and Rybach 2008, 195; Zetter 2008, 71, who predominately focuses on the UK). The literature distinguishes between internal

and external and personal and impersonal sources of information used for monitoring. Information may be gathered from three clusters of sources: (1) Personal contacts with stakeholders (politicians, the administration, NGOs, clients, shareholders, media); (2) coverage of primary sources (parliamentary gazettes, political party communication, NGO position papers/newsletters, citizen blogs, client/business partner feedback); (3) automatic or manual monitoring of the media as the ‘transmission belt’ (classic channels such as TV and print, but increasingly also blogs, social networks and the Internet in general)¹⁵¹. This can be done in-house or may be entirely or partially outsourced, most often to either (1) specialized commercial suppliers or (2) trade associations.

Given the readily available (commercial) hands-on advice on how to monitor various sources, there is little need to further comment on it. However, it may make sense to touch upon one aspect of sovereign wealth fund monitoring activities which significantly differs from private companies: SWFs are able to tap a broader range of information sources than other private entities. Depending on the governance arrangements, sovereign wealth funds often profit from having board members with a high degree of political knowledge and international contacts. Given their mandate to manage public assets and the resulting close links to their principals, SWFs may also profit from their respective governments’ political and economic monitoring capabilities, e.g. through being given access to embassy- and even secret service information streams. While it is unclear how many SWFs profit from such arrangements, these arrangements may harbour political risks themselves: collaborating with governments on what is seen as an important business function makes it more difficult to uphold SWFs’ reputation as private market players. Market stakeholders in particular may variably perceive such collaboration as commercial espionage or even insider trading which may result in political risk. The Australian Future Fund, for instance, was subject to an investigation by the Australian Securities & Investments Commission for selling Telstra shares less than a month before a proposal to separate the former communications monopolist (Bloomberg 2009). Although the Future Fund was found not guilty of using any private information, Monk notes that such cases are inherent to SWF activity where tip-offs are beneficial for both politicians and the population (Monk 2009c). Such cases also illustrate the

¹⁵¹ Interestingly enough in this context, social media are both a source of political risk and a potential monitoring- and even reputation-enhancing instrument. This mirrors the ambivalent character of political risk, often constituting a threat and an opportunity alike.

importance of sound governance in order to avoid the exploitation of other market participants.

7.2.2 Assessment: Analyse This¹⁵²

Following the identification of potential new issues during the course of the monitoring process, the assessment stage of the political risk management process aims at understanding the mechanics, assessing the development and weighting likelihood, and the impact of a particular issue. Here, sovereign wealth funds may use the same analytical tools as other companies, with sovereign ownership likely to confer little advantage in this field.

Identification: stakeholders and mechanics

A thorough assessment of the mechanics of an issue affecting a sovereign fund starts with looking at the stakeholders involved and their stake/interest in the issue at hand.

A graphical illustration of SWF stakeholder interests		
Domestic population	Returns	Achieves returns Insures citizens for rainy days Provides immediate and tangible benefits for citizens
	Management	Is transparent and trustworthy Does not squander public funds Achieves returns by observing certain (investment) guidelines
Domestic govt/admin	Returns	Achieves returns superior to central bank's foreign exchange reserves management
	Activities/Control	Invests funds according to pre-determined investment rules Adheres to the checks and balances as provided by its sponsor May be used for domestic purposes in times of crisis
	Achievement of objectives	Ensures objectives (sterilization, stabilization, etc) are achieved
Recipient country govt/parl	Investments	Pursues investment objectives/targets in an open and transparent way Consults with relevant stakeholders prior to investments Lives up to its post-investment obligations, depending on form of ownership Has a honest, long-term investment outlook
	Sovereignty	Ensures investment activity complies with national law Refrains from investing in politically sensitive sectors and/or in national icons
Recipient country civil society/firms	Status quo	Secures domestic production capability, national icons, jobs, welfare Maintains social standards Avoid undue influence on firms
	Controlled opportunities	Gain access to capital, new markets (SWF home market) Provides employment, training opportunities
Int. Organizations/NGOs	System stability	Ensure financial stability and smooth trade Obey international rules
	Sustainable investment	Preserves the environment, cultural heritage, social structure

(Source: own compilation, based on (The Conference Board 2007, 18))

Figure 26: A graphical illustration of SWF stakeholder interests

¹⁵² 'Analyse this' is a 1999 gangster comedy starring Robert de Niro and Billy Cristal as his psychiatrist.

Chapter 4 of this thesis provides an overview of the generic interests and expectations of and the mechanics employed by the most important stakeholders on three levels. In order to gain a succinct picture, it often makes sense to plot the most important stakeholders of an SWF against their main interests as in the graph above. This contributes to using scarce political risk management resources wisely.

In an attempt to go one step beyond stakeholder interests and to analyse the intended behaviour of stakeholders, Denk refers to the political science classic ‘The Essence of Decision’. The book proposes three conceptual lenses which may contribute to ‘explain or predict’ stakeholder activities and motivations (Denk 2003, 233pp):

- *The rational actor model* which sees stakeholders maximize their benefits, be it monetary- or non-monetary ones (e.g. votes for politicians or NGO members).
- *The organizational behaviour model* which points at inter-organizational logic, culture and processes as the determinants of stakeholder behaviour. For instance, the non-hierarchical setup of the Occupy movement means that a company in their focus won’t be able to settle an issue with a firm commitment.
- *The governmental politics model* which refers to the ‘politics’ within an organization, i.e. the negotiations and power struggles of various actors making up a stakeholder. An example is the infighting between NGO moderates/hardliners.

Although stakeholder behaviour is likely to remain difficult to predict (e.g. think of the Swiss political parties’ muted reaction to GIC’s UBS investment), identifying the relevant stakeholders involved in an issue is an important first step in tackling it.

Prioritizing: stakeholder risk potential and impact analysis

With advocacy resources (money, time, information) generally scarce, prioritizing a sovereign wealth fund’s engagement with stakeholders is of utmost importance. This is exacerbated by the fact that organizations only have a limited pool of reputational capital to use in public controversies (Fombrun and Van Riel 2004). Therefore, it is indispensable to have a clear idea about a stakeholder’s political risk potential/power which is determined by various factors: Most importantly, it depends on the type of accountability mechanism which links an SWF to a particular stakeholder (see chapter 4.3.2). The more formal, i.e. the more contractual or even authoritative the accountability mechanism is, the bigger the stakeholder’s risk potential. Secondly, risk potential is a function of how effective stakeholders are in attacking a sovereign fund’s legitimacy. While there is little to be done on the compliance side (except for

authoritative stakeholders by suddenly changing the legal environment), legitimacy often falters due to attacks on the reputational capital side. Gauging stakeholder risk potential is an important step to assess the potential impact of a particular issue.

In addition to the *external view* capturing stakeholder power, assessing the potential impact also profits from an internal view gauging the level of vulnerability of an organization. The *internal view*, to be co-ordinated by an SWF's political risk management function, includes involving a broad cross-section of fund-internal experts in their particular fields to assess the organization's vulnerability to a particular issue. This echoes Buholzer and Rybach who suggest an assessment process surrounding a so-called 'issue reporting sheet' as a knowledge management tool to 'point out the relevance [of a particular issue] to the bank' (Buholzer and Rybach 2008, 196). Vulnerability may depend on the exposure of the fund to a certain region or asset class or on its origins and governance. In more general terms, assessing fund vulnerability may be guided by the political risk factors described in chapter 5 of this thesis. The matrix resulting from combining both the internal and the external view on political risk shows four types of political risk impact:

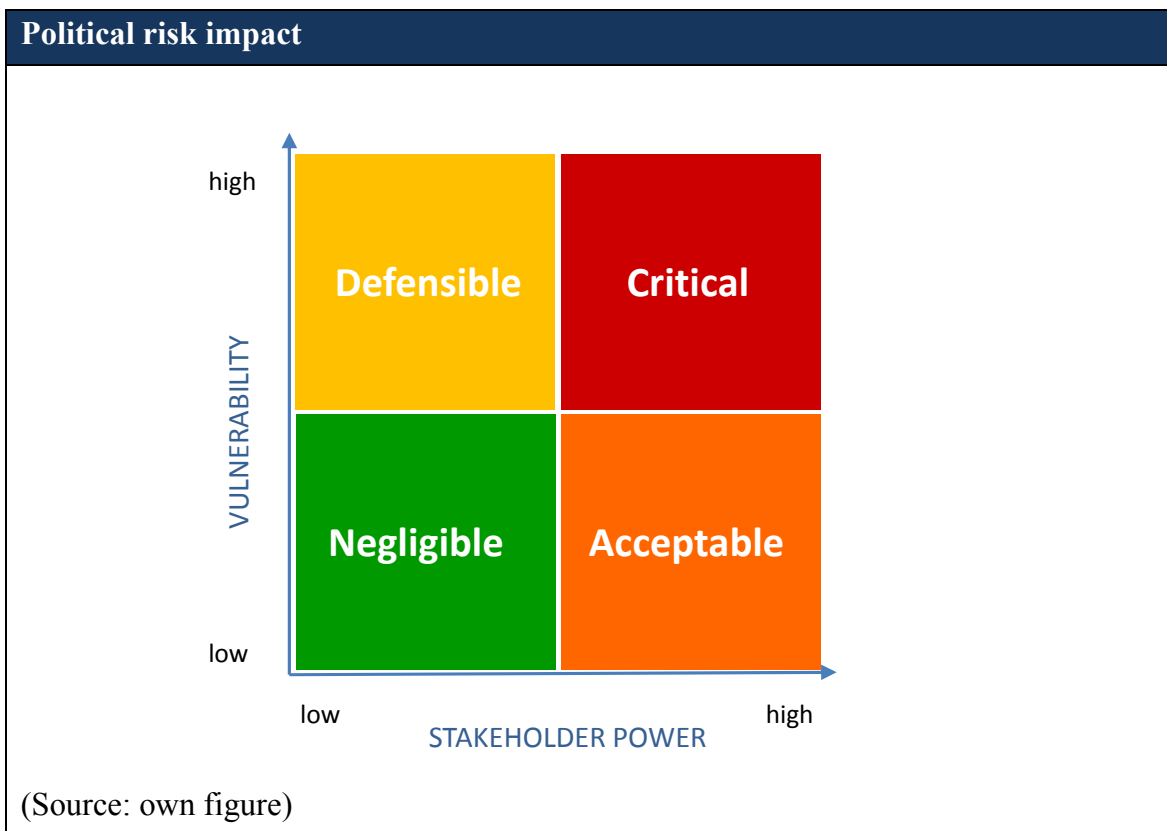


Figure 27: Political risk impact

- *Critical impact*: when both stakeholder power and vulnerability are high, an issue is critical and needs to be dealt with as a first priority. An example would be a recipient country body authoritatively blocking an SWF investment. In the case of an impending CFIUS verdict, for example, a sovereign wealth fund has no other choice but to obtain approval, otherwise the deal falters.
- *A defensible impact* arises if vulnerability is high, but stakeholder power is low. Here, the sovereign wealth fund is set to experience a considerable amount of ‘adverse impact’ and therefore has an incentive to push for its position, in particular as the grip of stakeholders on the issue is low.
- *An acceptable impact* results from strong stakeholder power yet low vulnerability, thereby enabling the sovereign fund to accept the impact without too much of a damaging consequence, also because resisting powerful stakeholders may be too costly.
- *Negligible impact*, lastly, refers to cases where a low degree of vulnerability and low stakeholder power gives the fund a choice to either accept the impact or advocate against it, without too much damage done either way.

These four types of impact mirror the classic way of dealing with risk which consists of either avoiding it (critical), mitigating it (defensible) or accepting it (acceptable).

Timing: issue life cycle

The knowledge about stakeholders and their interests and the assessment of the potential impact of and reactions to political risk need to be complemented with a dynamic view of how issues develop. The classic literature on political risk distinguishes between five phases (for the original sources, see Hainsworth and Meng 1988; Meng 1992; thereafter Denk 2003, 98; Buholzer 2007, 5):

- *Latency phase*: at this stage, the awareness of a growing gap between a particular situation and the expectations of certain stakeholders is restricted to expert circles.
- *Emerging issue*: here, experts are actively debating the issue, with some early signals seeping through to (specialized) media and interested stakeholders. A particular trigger may or may not propel the issue to the next stage.
- *Acceleration phase*: during this phase, the issue is rapidly entering the mainstream media, with the expert discussion giving way to a public and open discourse amongst stakeholders. This attracts the interest of politicians who evaluate the most promising side to be on.

-
- *Maturing phase*: here, public pressure forces stakeholders, in particular politicians and special interest groups, to look for an authoritative solution as the public interest peaks. Following a potential agreement, the emphasis switches to implementation problems and hence becomes more technical which often leads to declining public interest.
 - *Contraction phase*: once a solution to align expectations is found, the focus shifts to implementation. While the main stakeholders are checking up on promises and commitments, the attention of the general public is waning.

While public awareness increases over the cycle (before weakening towards the end), political risk management options generally decrease. This is a result of stakeholders investing considerable reputational capital to support their position on the issue which makes it difficult and costly to change. Some analysts also argue that over the cycle, the public debate becomes increasingly dominated by notions of morality and rational arguments are often relegated to the backseat (similarly, see Buholzer 2007, 5).

For sovereign wealth funds, the challenge not only lies in identifying the stage the issue is at, but also on which level (home country, host country, internationally) it is unfolding. The amplitude and the timeframe of the issue are likely to differ and so do the instruments an SWF can employ at different stages. For instance, SWF performance issues driven by (sub-sections of) the domestic population are likely to have a much longer time horizon and less pronounced peaks than the political controversies arising from taking a stake in a recipient country national icon. Likewise, corporate citizenship measures implemented at home (e.g. Temasek's and GIC's various programmes in the field of education and research) are likely to be met with considerable scepticism abroad.

As a result of technological development and the emergence of new actors, the issue life cycle has considerably changed over the last two decades (see graph below). Looking at what may be called the 'issue life cycle 2.0', three major changes stand out (similarly, see Denk 2003, 113pp), all of which have some impact on sovereign funds:

- (1) Due to the internet in general and social networks in particular, issues emerge much faster, with stakeholders such as politicians and also the established media often trailing the agenda-setting by the blogosphere and social networks. With regard to SWFs, the 'land grab issue' is a good example of how a rather specialist subject leapfrogged from an emerging issue straight to politicians considering

- authoritative measures (ban on derivatives on or even unleveraged trading of agricultural commodities and limits on land purchases).
- (2) Because of the proliferation of channels/topics, the attention span of the public is shorter and opinions are more fickle, resulting in issues maturing more quickly.
 - (3) With the internet constituting what Denk calls a (giant) memory, the half-life of issues has become considerably longer, exacerbated by stakeholders providing their own repositories of position papers and past campaign materials. This and potential linkages between issues can make long-forgotten issues resurface and or being actively ‘relaunched’, as Denk aptly notes. An example of linkage in the SWF field are the allegations of ‘neo- and sino-colonialism’ which are reflected in stakeholder responses in both CIC’s investments in the African resources sector and its investments in agricultural commodities trader Noble Group and direct farmland holdings. Such linkages create a narrative/perception of the fund which is sticky and difficult to manage.

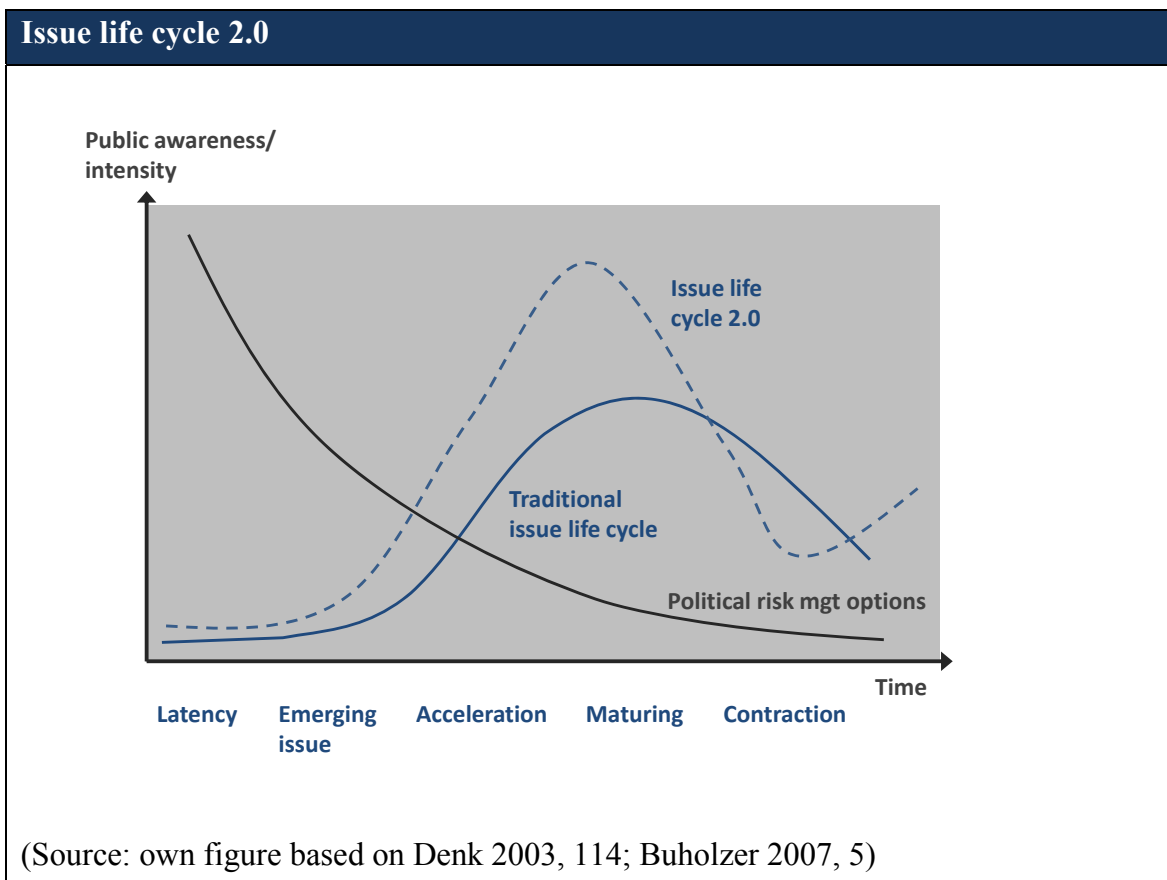


Figure 28: Issue life cycle 2.0

The issue life cycle is an idealized model of reality and therefore has only limited predictive and explanatory power. When it comes to assessing SWF political risk, it provides a handy tool to cut through complexity and capture some potential next stages of an issue by trying to determine its location in the cycle. For instance, the issues surrounding GIC's late-2007 UBS investment (takeover of a national icon in Switzerland, domestic disagreement about timing of international financial services investments) have arguably matured in 2008. There has been little stakeholder critique thereafter until UBS lost a hefty sum through a rogue trade in 2011. This resulted in CEO Oswald Grübel stepping down and the Singaporean domestic discussion about underperformance resurfacing with full force after it was disclosed that GIC had lost 77% on its initial UBS investment (Reuters 2011b).

The dynamic dimension of the issue life cycle also shows the importance of choosing the right political risk analysts and fostering institutional knowledge management. This vouches for the best monitoring results and ensures – in analogy to the increasing traceability of an organization's past on the internet – consistency in an organization's messaging over time.

7.2.3 People and knowledge management

In various forms, this triad of monitoring the organization's environment, assessing the likelihood and impact of risks and finding the best way to respond to them has become the cornerstone of most modern operational and political risk management frameworks. Considering the nature of the risk category in question, however, it should not be forgotten that as opposed to other risks relying on computers calculating standard deviations, managing political risk is set to remain an activity inherently dependent on human analysis skills. As a consequence, the selection of political risk management staff is crucial.

Bremmer and Keat argue that 'the disposition of those who assess risk helps determine how accurate or biased the analysis and understanding of political risks will be' (Bremmer and Keat 2010, 11). Hence, the assessment of issues/political risk factors benefits from a broad-based setup, involving internal (and external) experts from a broad array of disciplines in order to avoid 'groupthink' and tunnel vision. In this respect, some sovereign wealth funds may find it difficult to recruit the right calibre of internationally minded, yet locally knowledgeable people. Sovereign wealth funds' perennial staffing challenges may be further exacerbated by governmental policy imposing national employment quotas. Such policies are popular in Gulf countries

(‘Emiratization’) and in Malaysia (‘Bumiputera’) and constitute a significant threat to government-owned entities such as SWFs.

Against the background of these challenges, the quality of monitoring and analysis also profits from employing a diverse array of techniques and methods. Used across various disciplines, they were developed to break inherited thought patterns, stimulate perception and creativity and facilitate the identification of links and interdependencies. Such methods include cognitive mapping, the Delphi technique, focus groups and the popular SWOT analysis, to mention but a few (for an encompassing glossary of methods for risk analysis, see the annex in Habegger 2008b, 217pp).

The right choice of people and methods needs to be complemented by an efficient way of storing and distributing knowledge obtained in the monitoring and analysis stage of political risk management. While considered to be a trivial challenge which is seldom touched upon in the literature, codifying and sharing knowledge within an organization is crucial and ensures the organization speaks with ‘one voice’ over time. Steger recommends an IT-based solution relying on electronic databases enabling managers to run queries on various issue attributes (geographical indicators, main stakeholders, etc.). Buholzer and Rybach suggest using so-called ‘issue reporting sheets’ which ‘describe key facts of a given social, political, legislative, regulatory, or sustainability-related issue or development, point out its relevance to the bank, and, most importantly, lay out the [organization’s] official [...] policy position on the issue’ (Buholzer and Rybach 2008, 196). Ideally, instruments are linked up by a feedback loop which enables adjusting the organization’s response and drawing lessons for similar situations in the future.

7.3 Advocacy: Three strategy clusters for sovereign funds

In chapter 5, this thesis has identified three clusters of political risk factors (endogenous-, behavioural- and contextual) most SWF legitimacy gaps can be related to. These legitimacy gaps harbour political risk which for monitoring, assessment and advocacy’s sake is broken down into ‘digestible’ and clearly labelled clusters of concerns/topics, commonly referred to as issues. Following the discussion of some strategies and instruments to monitor and assess SWF political risk, this sub-chapter presents various advocacy strategies aimed at tackling those legitimacy gaps. It draws on the notion that advocacy strategies not only require action by individual funds, but

more often than not, rely on either partnership- or even collective action to bridge legitimacy gaps.

7.3.1 Legitimacy gaps and influenceability

SWF political risks are driven by legitimacy gaps which result from either non-compliance or, more commonly, a loss of reputational capital. This may happen, for example, if a fund does not comply with relevant FCPA provisions when securing an investment or if a fund fails to adequately consult with stakeholders before investing in a high-profile asset. However, political risk may also be latent and not connected to any SWF transactions, i.e. resulting from lingering stakeholder concerns.

Addressing fund legitimacy starts at home, with funds devising unilateral strategies to *avoid*, *mitigate* or *accept* their legitimacy gaps. Examples include strengthening compliance practices or communications activities. However, considering the variety of issues included in the three clusters of political risk factors identified earlier, it becomes evident that political risk management strategies also necessitate the involvement of partners or require collective industry- or even wider efforts. This echoes Wu who not only prescribes a targeted investment- and public relations approach, but also community outreach and co-operation amongst SWFs as the key to reducing political risk (Wu 2008, 20pp). As the case study on farmland investments shows, an SWF's best in class consultation and local engagement strategies might be scuppered by other funds ignoring best practice. This contributes to a collective reputational loss for SWFs as they are constantly being mentioned in conjunction with the 'land grab' issue. This example shows the need for partnership- and collective political risk management instruments as part of an SWF's advocacy strategy.

Political risk factors have varying degrees of influenceability. While endogenous risk factors can be easily influenced, behavioural risk factors and even more contextual risk factors are more difficult to manipulate. For instance, it is evident that macroeconomic factors determine a company's overall need for capital which stands in an inverse relationship with SWF political risk¹⁵³. However, this factor will be very difficult to influence unless there is collective action with other monetary and fiscal policy stakeholders such as governments and central banks. A declining influenceability has an impact on the strategic options available to SWFs for dealing with political risk

¹⁵³ Capital scarcity not only reduces a sovereign fund's political risk, but generally also leads to higher returns (for a similar thought, see Castelli and Scacciavillani 2012, 153). Conversely, it can be argued that a capital glut not only tends to increase recipient country political risk, but also domestic political risk brought about by stakeholder scrutiny of the fund's decreasing returns.

factors: While individual action may suffice to influence endogenous risk factors (think for instance publishing the first annual report), the decline in influenceability necessitates relying increasingly on partners or even collective action. The graph below illustrates the importance of partnerships when it comes to political risk management for internationally active, government-owned funds.

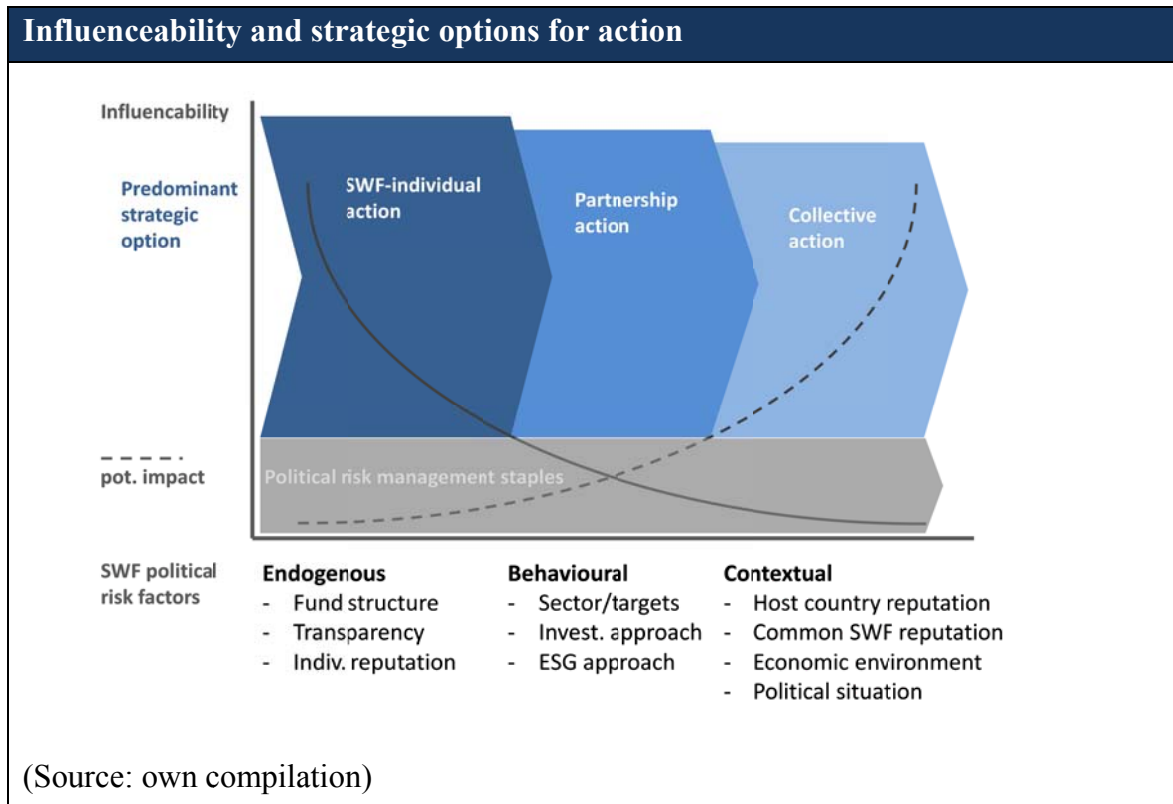


Figure 29: Influenceability and strategic options for action

Another reason for the increasing importance of partnerships and collective action for dealing with political risk is the increasing impact these political risk factors may have. While endogenous factors are often contained within one fund, contextual political risk factors may have a comparably wider scope and therefore require collective SWF efforts.

In addition, the graph also shows that there are generic instruments which may be used across political risk factors to strengthen fund legitimacy. Labelling them ‘political risk management staples’ points at the basic character of these instruments in the sense that they are considered the ‘bread and butter’ of sovereign wealth fund political risk management activity. Activities in this field include the day-to-day media- and

communications work, governmental relations and trade association management. The next sub-chapter will shed light on some of these instruments before leading over to an in-depth discussion on individual, partnership- and collective action options specifically tailored for SWFs.

7.3.2 Advocacy staples

Proactively fostering sovereign fund legitimacy requires proactively setting up a framework to continuously engage with all major sovereign fund stakeholders. Continuous engagement builds up reputational capital, but may also ensure opportunities. A holistic political risk management blueprint for sovereign funds requires drawing up engagement strategies in three distinct fields as shown in the table below. While the main objective remains advocacy, to various degrees the frameworks below also help SWFs in monitoring or assessing/analysing political risks.

Advocacy staples: three frameworks					
Communications	Framework	Stakeholders	Additional functions	Proactive/reactive	Communications
	Governmental relations	own principals, recipient country governments	monitoring	proactive and reactive	
	Trade association mgt	international trade associations	monitoring, assessment	proactive and reactive	
	Sustainability mgt	NGOs, grassroots organizations, local stakeholders, ESG rating agencies, employees, the public at large	monitoring, assessment	proactive and reactive	

(Source: own compilation)

Figure 30: Advocacy staples: three frameworks

Government relations

Government relations is an integrative political risk management activity and covers two types of stakeholders: the fund's owners/principals as well as the political actors in recipient countries and on the international level, acting both as gatekeepers to and regulators of their markets¹⁵⁴. For markets receiving considerable weight by the fund's SAA, it is advisable for fund management to schedule *regular private meetings* with key political stakeholders. In addition to government and administration

¹⁵⁴ Most investment approval processes such as CFIUS in the U.S. or similar ones in Germany and Australia are politicized rather than pure judicial reviews, thereby exhibiting a certain degree of arbitrariness which may be significantly reduced by openly providing information.

representatives, such stakeholders may include parliamentarians, political party staffers and foreign ambassadors. Meetings may also be scheduled with representatives from international organizations shaping the international framework for FDI, trade and financial relations (for some thoughts on SWFs and international fora, see Castelli and Scacciavillani 2012, 131pp; 158). Agendas for these background discussions should include proactive topics set by the fund itself (e.g. the importance of fund operations/shareholdings in a given market, financial and non-financial benefits for the recipient country, etc.). In addition, it may also openly address concerns brought up by the guests. From a stakeholder's point of view, these concerns are most credibly dealt with by the fund's leadership team or – in case it requires rather technical explanations – by expert staff such as the chief economist. A less high-profile, yet equally effective way of increasing legitimacy with public figures is to give them *preferential access to information*, e.g. by sharing a press release within the embargo period, proactively providing updates on topics of stakeholder interest (depending on the nature of fund activities in a given country) or to offer them direct access to fund executives.

Regarding the goals of such governmental relations activities, one may distinguish between three objectives (see Zetter 2008, 31pp):

- *First*, engagement in order to raise an organization's profile. Given that most SWFs already enjoy a high degree of visibility, the objective here may be re-phrased to proactively building up reputational capital.
- A *second* objective for engagement may include shaping the policy environment in more general terms. For sovereign wealth funds, this refers to reiterating the importance of open markets and the adherence to the Santiago Principles, i.e. promoting Truman's call for 'reciprocal responsibility' (Truman 2008b).
- A *third* objective refers to 'introducing, blocking or amending legislation' (Zetter 2008, 50).

Governmental relations also include the fund's relations with its *own principals*. These interactions are mostly well defined by the fund's statutes and/or constitutional basis. They often include reporting by the fund's board and/or management to parliament or other bodies such as the ministry of finance. While these standardized interactions may constitute the best bet to strengthen the fund's legitimacy with its principals, there might be other minor fora to further engage with policy makers. One of them may be the participation in government consultations which – if open to the fund – provide an

excellent opportunity to be heard on a variety of questions affecting the SWF. An example here is the NZSF which in an attempt to participate in important discussions with potential ramifications for the fund is making regular submissions to the New Zealand treasury's savings working group (NZSF 2010).

Trade association management

Trade associations and similar (international interest) groups are important contributors to the policy-making process. They act as an important early warning indicator for their members, aggregate policy positions from and advocate them on behalf of their membership (for more background, see Buholzer 1998). Hence, from a political risk perspective, they fulfil a (albeit indirect) monitoring-, assessment and lobbying function. With the International Forum of Sovereign Wealth Funds (IFSWF), the funds have availed themselves of their very own trade association. For successful political risk management by trade association, sovereign wealth funds will have to deal with two challenges: (1) How to make the IFSWF a powerful yet trusted representative of sovereign wealth fund interests vis-à-vis various stakeholders. (2) How to ensure and co-ordinate IFSWF- or individual SWF participation in various other fora at the national- or more often international level. With regard to the first challenge, the IFSWF has appeared to be a rather passive organization up to its Beijing meeting in May 2011, with some observers wondering about its 'We're going to meet / we met' public relations strategy resulting in four press releases in two years (Monk 2011b). Since then, the IFSWF has announced 'steps towards a permanent secretariat' and published a report on compliance with the Santiago Principles (IFSWF 2011a; IFSWF 2011b).

However, these activities arguably fall short of the potential role the International Forum could play to strengthen SWF legitimacy. In analogy to other industry associations, for instance, the IFSWF would be in a good position to tackle stakeholder concerns about SWF systemic risk by providing SWF industry data in an anonymized and aggregated way (for an example from the mutual fund industry, see Nystedt 2010, 219). It is also unclear if the association has assisted in the diffusion of best practices, in particular to the numerous new funds set up in the last two years. Most importantly, however, it is difficult to assess to which degree it has become the 'go-to' body for recipient country governmental stakeholders on all SWF-related issues. This would harbour considerable potential to increase legitimacy and manage political risk, both by monitoring emerging political risk factors/issues and by advocating on behalf of its

members. However, collective action problems¹⁵⁵ such as agreement on the lowest common denominator and a bias to preserve the status quo would imply a strong leadership for the IFSWF if it were to meaningfully contribute to reducing political risk (Steger 2003, 185).

In addition to and in co-ordination with the IFSWF, SWFs may also engage in (1) other, more specialized international industry associations, and (2) other international fora such as the World Economic Forum (WEF), to mention but a few.

- SWF legitimacy profits from active participation in other international, more specialized associations, in particular in the field of finance. Examples of such organizations include the Institute of International Finance (IIF), the Securities Industry and the Financial Markets Association (SIFMA). As counterparts to IOSCO, the International Organization of Securities Commissions, these industry associations play an important part in adjusting and driving the rules of cross-border financial investments. While the funds' sovereign owners are likely to (at least partially) defend SWF interests through governmental fora, there is little evidence for direct SWF involvement so far. Given these working groups are staffed with representatives of recipient country market regulators, such a collaboration would significantly enhance trust and legitimacy, thereby reducing the risk of regulatory risk. One important aspect of an enhanced SWF trade association strategy would be to ensure that SWFs speak with one voice on policy matters of common concern (Steger 2003; for a financial service provider's perspective on one voice, see Buholzer and Rybach 2008). For this purpose, the IFSWF would have an important role in aligning policy positions across members, ensuring a high degree of *'unité de doctrine'* and pre-emptively checking for potential political risk factors inherent in certain policy positions.
- The WEF has seen SWF participation rising again since the peak of the financial crisis, with funds using the media attention to distribute their messages (for a few sound bites, see Waki 2010c). Given that WEF membership predominately consists of private companies and government officials, regular SWF engagement in working groups (the so-called agenda councils) may be an effective way to collect intelligence from and foster trust with a wide range of important

¹⁵⁵ The IFSWF's Santiago compliance report serves as a case in point: despite the importance of the report in assuaging stakeholder concerns, 20% of the IFSWF members did not participate in the survey (IFSFW 2011b, 10). This indicates that group coherence, one of the most important prerequisites for powerful interest intermediation, is still low.

stakeholders. Being part of these circles may also positively reflect on individual SWFs' reputation (maybe except with certain NGOs which are still very critical of the WEF).

Sustainability management

Proactive risk management strategies also include a framework for continuous engagement on the sustainability side, aiming at ensuring legitimacy in the ESG field. This framework requires entertaining relations with a broad set of heterogeneous actors, ranging from NGOs, proxy agencies specializing in sustainability matters and ESG rating- and index providers to employee representatives and charities. For sovereign wealth funds, an additional stakeholder in this field includes portfolio companies. As illustrated by the graph below, sustainability management instruments can be mapped according to their focus on profit/minimizing loss and the degree of reciprocity the partnerships involve.

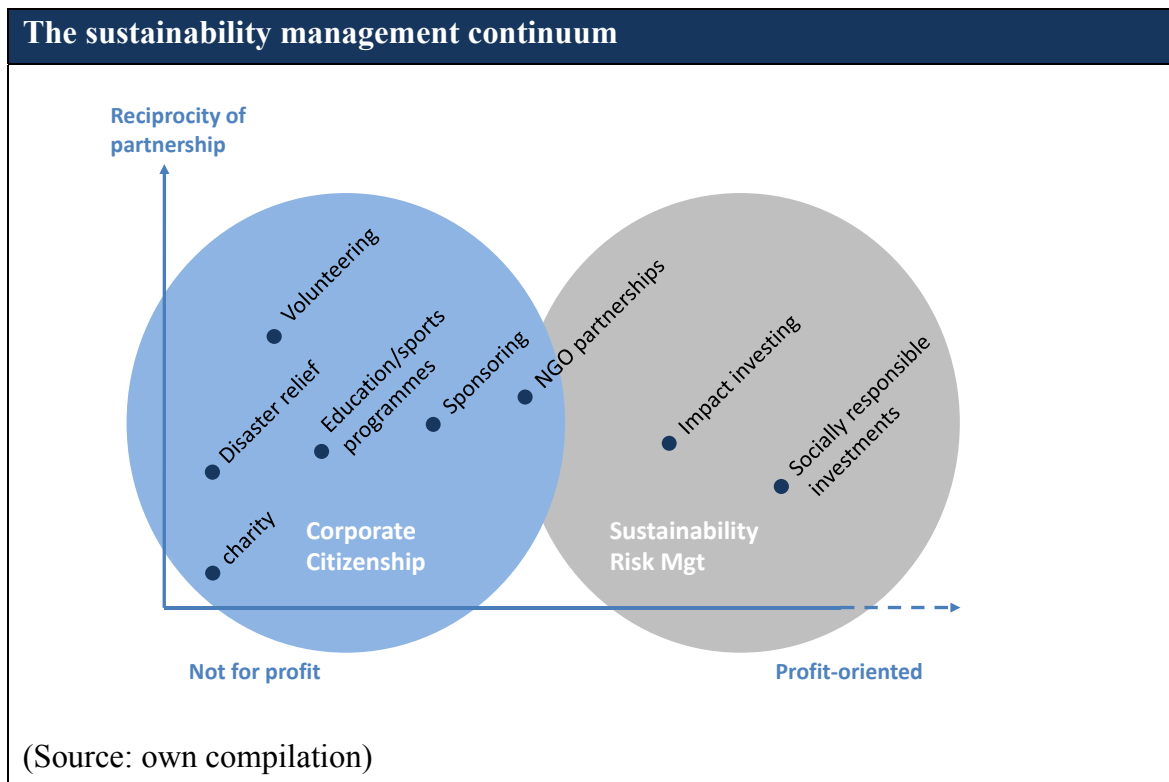


Figure 31: The sustainability management continuum

The basic objectives of sustainability management are twofold and reflect the protective/risk- and the opportunity function:

-
- (1) Analysis and advocacy on where there is an existing and/or potential mismatch between the organization’s behaviour and stakeholders’ ESG-related expectations and/or ESG provisions codified by international bodies. This also includes providing advice on socially responsive investments. For sovereign wealth funds, this also includes monitoring the performance of their investee companies. As some funds have realized (see chapter 5.3.3), their activities and behaviour can be a significant risk factor which may be best tackled by engaging in a constant dialogue with these firms. The focus here is to minimize the impact of ESG-related issues on an SWF’s portfolio (protective function).
 - (2) Providing information on and explaining the company’s performance with regard to ESG- and philanthropy matters to social stakeholders in particular and the broader public in general. The degree to which an organization is living up its responsibility towards society is often referred to as corporate citizenship or corporate (social) responsibility¹⁵⁶. A reputation as a good corporate citizen with the public at large fulfils a protective function as NGOs and politicians will find it difficult to explain the reasons for a potential attack on an SWF to their members and constituents respectively (Fombrun, Gardberg, and Barnett 2002, 93). As opposed to the ‘protective’ function described above, this aspect of sustainability management emphasizes the potential reputational gains available to those firms which engage in corporate activities beyond their economic responsibilities.

The track record of sovereign wealth funds with regard to ESG engagement is mixed (for an overview of current SRI/ESG practices at SWFs and pension funds, see Wong and WWF-Norge 2008, 10pp): Some funds such as the GPF, the NZSF and (partially) Temasek follow elaborated ESG/SRI engagement strategies and report on them in their annual reports (for some examples, see NZSF 2011, 36; NBIM 2012a, 46pp). Most funds, however, have very little to show in this field although a strong sustainability management framework has been recognized as an efficient tool to manage political risk. Legitimacy in this field is ‘processual’ rather than absolute: engaging in an honest and continuous dialogue and acting on it might be more important than the absolute level of ESG achievements. This is also the case when considering that with regard to sustainability, there are very little hard obligations to

¹⁵⁶ As mentioned before, there is a considerable proliferation of terms when it comes to describing a company’s activities beyond its economic responsibilities. The more fashionable corporate citizenship has become, the fuzzier the concept has become. This thesis sees it as interchangeable with corporate social responsibility which is understood to be the result of various firm efforts to go beyond fulfilling economic obligations.

comply with but rather soft commitments to follow, with failure to do so leading to a loss of reputational capital.

On the corporate citizenship side, sovereign wealth funds are active across the whole spectrum of instruments: many of the funds run scholarship- and education programmes (see e.g. the various programmes financed by the Temasek Trust (Temasek 2012a, 76pp))¹⁵⁷, engage in corporate volunteering activities (for many, see GIC 2012, 30 and Temasek's T-Touch initiative) and even sponsor cycling teams (Samruk Kazyna, Kazakhstan's sovereign wealth fund, has been sponsoring Team Astana since 2009 (see Monk 2009d; Monk 2010f)). Mostly aimed at improving legitimacy of the funds with their home country population, sovereign wealth fund corporate citizenship activities have been predominately focused on domestic stakeholders. A cursory overview suggests, however, that the reciprocity of the instruments remains low, with citizens having little interaction with the funds themselves but rather with foundations, charities, etc. funded by the SWF. Therefore, in addition to or as a substitute of democratic ways of influence, sovereign wealth funds may set up 'Citizen Councils' to better gauge the population's expectations and thereby strengthen their sense of ownership. With regard to recipient countries, corporate citizenship activities may be concentrated in jurisdictions with substantial direct investments.

Do good and tell'em about it: Communications and reporting

A solid communications and reporting framework is a political risk management staple which cuts across all other functions. From a legitimacy point of view, an organization's communication- and reporting efforts ensure that stakeholders have an adequate amount of information to evaluate a company's performance against their expectations. As Steger aptly suggests, it 'is the gap between promises or raised expectations and actual behaviour [...] that allow adversaries to run campaigns against the company' (Steger 2003, 110).

A solid communications and reporting framework covers three aspects:

- (1) Proactive communications aiming at ensuring the 'buy-in [of stakeholders] in both the good times and the bad times' (El-Erian 2010, 232).

¹⁵⁷ ADIA even has a fully dedicated 'Scholarship Department' which reflects that in addition to strengthening reputation, corporate citizenship measures also mitigate risks, e.g. commercial risks brought about by a shortage of domestic talent (ADIA 2012, 32).

- (2) Situational or reactive communication efforts or even a crisis communications concept to deal with extraordinary situations, e.g. an unexpected loss or the death of a fund executive (Financial Times 2010b).
- (3) Reporting on the fund according to internal schedules (annual reporting, performance updates) or following potential external obligations such as sustainability reporting according to Global Reporting Initiative (GRI) principles or sustainability-related indices, if applicable (Steger 2003, 201pp)¹⁵⁸. In this context, one of the most difficult challenges is to achieve the right degree of transparency, i.e. to strike a balance between stakeholders' thirst for information and the organization's need for privacy and commercial secrets.

With a few exceptions, sovereign wealth fund communication practices are considered as 'still evolving' (El-Erian 2010, 232), with particular weaknesses identified in the field of media relations where the funds have been found to be very reserved towards journalists (Fieseler and Meckel 2008). Active communications and a sound media engagement strategy ensure that the sovereign fund stays in control of which sources are used for reporting.

In addition to the risk management staples identified above, the next sub-chapters focus on SWF-specific political risk management instruments. They reflect (1) the particular requirements to tackle the three clusters of SWF political risk factors and (2) opportunities for risk management so arising from SWFs' governmental ownership.

7.3.3 Individual action

As noted by Gerard Lyons in one of the first articles on sovereign funds, 'in many respects, SWFs are their own worst enemy', predominately referring to a lack of transparency, in particular with regard to their intentions (Lyons 2007, 2). The endogenous risk factors identified in chapter 5.2 of this thesis support this view. As a result, political risk management in this field has to focus on ways to (i) strengthen fund structure (objectives/mandate, fiscal treatment, governance), (ii) to improve transparency, and (iii) to foster individual SWF reputation. While some of these tasks are likely to require co-ordination with or decisions from third parties, in particular the fund's principal, success will depend on individual action by the fund itself.

¹⁵⁸ Indices such as the Dow Jones Sustainability Group Index or the FTSE4Good assess the sustainability of a company based on their proprietary ratings. Given the impact of these indices on investor interest (in particular passive index investors), the announcement of the yearly rankings within these indices has become important for many listed companies. So far, the indices focus on operating companies. As a result, index rankings may only have an indirect ESG/political risk impact on most SWFs (see chapter 5.3.3).

Fund structure, in particular mandates and objectives, remain a contentious issue and therefore require unambiguous communication towards fund stakeholders. The most credible way to do this involves a clear statement of commercial intent in the fund's mandate and/or articles of association. A good example of the latter is CIC's assurance that it will 'separate its commercial activities from governmental functions, make its business decisions independently, operate based on commercial grounds' (FTSE 2009, 11). Therefore, clarifying mandates and objectives should be made an important tenet of a fund's governmental relations- and communications strategy, with the former focussing on lobbying principals and the latter ensuring broad communication of the mandate to other stakeholders. Best practice in this context is the Alaska Permanent Fund Corporation which in addition to corporate policies helping stakeholders to assess the degree of compliance with various provisions also publishes the APF's board meeting minutes¹⁵⁹.

Improving transparency may be one of single most valuable ways of managing political risk. As Bremmer and Keat mention without any specific industry in mind, 'a lack of reporting and transparency can transform itself into political [...] risk' (Bremmer and Keat 2010, 181). In addition to the communication measures mentioned above, funds may consider two other measures:

- (1) *Give the fund a face*: considering the enormous interest in media profiles or in-depth interviews with SWF CEOs in the past (for some widely cited examples, see Handelsblatt 2010; Achi 2010; Financial Times 2010e), this particular type of media activity offers significant potential to make the fund and its people more tangible and less threatening, in particular for recipient country stakeholders.
- (2) *Explain the fund's work*: in a response to the 'mystification' of sovereign funds, activities in this context should be mainly directed at the domestic population, recipient country political stakeholders and the international investor community. Catering to varying degrees of stakeholder expertise, domestic stakeholders may be best reached by print- and in person communications (e.g. in schools) emphasizing their stake in 'their' sovereign fund¹⁶⁰. Participating at or even organizing their own investment conferences are an effective way for SWFs to reach out to and interact with international investors (for many, see Financial

¹⁵⁹ The minutes archive actually goes back to 1997 and also includes eight volumes of Trustees' Papers: <http://www.apfc.org/home/Content/publications/reportArchive.cfm>.

¹⁶⁰ This may also include educating the population about the benefits of keeping borders open for investments by other sovereign funds, thereby mitigating the risk of retaliatory measures for the own SWF (for an interesting example from Australia, see Emerson 2012).

Times 2010a). For recipient country governments, sovereign funds may have their governmental affairs people arrange private meetings or may opt for meeting recipient country political stakeholders at multilateral and international policy events (for some examples, see CIC 2012, 36).

The measures above are likely to have a positive impact on individual SWF reputation. Executive focus on and active engagement with the creators of the most important SWF indices (Truman, Linaburg-Maduell) may further contribute to individual SWF reputation. Similar to the management of external ESG ratings, this should be coordinated by a dedicated SWF-internal team, e.g. working alongside those responsible for active owner strategies. However, there is only so much an SWF can single-handedly do to improve its reputation: given that reputation is a function of how well one meets stakeholder expectations, it is not surprising that successful political risk management crucially depends on partnership activities as detailed in the next chapter.

7.3.4 Partnership action

As conceptualized by this thesis, partnership action refers to all endeavours undertaken by a specific fund together with a small number of partners. Partners refer to stakeholders ranging from social-, to market- and authoritative ones. Partnerships offer at least three distinct advantages for SWFs (similarly see Monk 2011c; Kalb 2011):

- (1) *Knowledge*: partners provide access to local markets knowledge and expertise of certain asset classes which are characterized by information asymmetries and may not be readily available in-house¹⁶¹.
- (2) *Economies of scale*: In particular for smaller funds, partnerships enable reaping the benefits of scale while keeping the benefits of diversification.
- (3) *Risk management*: Partnerships can be beneficial for managing risk, not only by sharing financial risk, but also by mitigating political risk, in particular when co-investing alongside a local or well-reputed partner.

While in most SWF partnership deals commercial objectives are more important, funds are well aware of the non-financial benefits of working together (Waki 2009). Funds can partner with social-, market- and authoritative stakeholders. This chapter argues that partnership activity is an efficient way to deal with behavioural political

¹⁶¹ Local knowledge was also found to have a positive effect on investment returns. A widely cited study shows that for mutual funds, investments within 100 kilometres of fund headquarters significantly outperform more distant investments (Coval and Moskowitz 2001). From a financial geography point of view (for more insight on this field, see Wójcik 2009), partnerships with local investors may therefore be seen as a way to close this gap (Monk 2011e).

risk factors, and also to potentially mitigate some contextual ones. SWF partnership activity has long been seen as one of the most important trends shaping sovereign investment activity in the next decade (for an early survey corroborating this, see Gordon L. Clark and Monk 2009b; similarly Ziemba 2010).

Partnerships with social stakeholders

Potential partners for SWFs in this field can be NGOs, but also recipient country constituents. Partnerships with NGOs have become a popular instrument for firms to better understand the extent of expectations and soft obligations in the field of environmental and social governance (for an in-depth discussion and more sources, see Baur 2011). While such partnerships with organizations such as the WWF are difficult to negotiate due to NGOs walking a thin line between working with firms and applying outside pressure, they are likely to have a positive effect on individual fund reputation and legitimacy. Such partnerships may also be helpful for funds wishing to implement socially responsible investment strategies: negative and positive screening of investee companies as well as shareholder advocacy and engagement (albeit to a lesser extent) may profit from NGO insight (Wong and WWF-Norge 2008, 8) and are likely to reduce fund vulnerability on the ESG side. Analogous to exchange programmes between certain regulators and banks, an interesting experiment would be to second sovereign wealth fund employees to NGOs and vice versa. This would foster the mutual understanding of the mind-set and the challenges and restrictions faced by the respective organizations.

NGO partnerships can also help strengthen legitimacy with local stakeholders when it comes to SWF direct investments. Bremmer and Keat argue that working together with ‘local stakeholders, NGOs and community groups [helps to] win public approval for projects and to diminish the risk of being branded a bad neighbour’ (Bremmer and Keat 2010, 32). As shown in the case study on farmland investments, consulting with local stakeholders and identifying and meeting their expectations is crucial. The better the alignment of incentives between the fund and local partners (e.g. ensuring high agricultural yields through profit-sharing agreements), the more durable the partnership and the more beneficial for legitimacy (Henisz and Zelner 2003, 36).

Partnership activity with social stakeholders also includes collaborations with academics who want to gain further insight into an important financial market player. Research on particular aspects of the funds, e.g. their investment behaviour, can help to dissipate concerns and demystify the funds in general. This is even more prevalent

as policy reports elaborated by recipient country ministerial staff often rely on academic groundwork. Anecdotal evidence resulting from trying to set up interviews for this thesis suggests that most sovereign wealth funds (with some exceptions such as GIC, the Future Fund and the GPFPG) are not yet used to openly interact with academics. Arguably neither is the IFSWF which due to the aggregated data it could provide would be even more interesting to contact for cross-sectional studies (i.e. comparing and contrasting different funds). For many industries entertaining a traditionally strong bond with academia (such as the chemical or food industry), more transparency has had a positive long-term effect on their reputation and has led to a fruitful exchange of views. Research- and university partnerships could be another instrument for a fully operational IFSWF to mitigate political risk.

Partnerships with market stakeholders

Partnering with market stakeholders can also contribute to avoiding, mitigating or better enduring political risk. Market stakeholders are all partners which the fund entertains commercial relations with. This not only refers to private, mostly institutional investors, but also to other sovereign funds, portfolio companies and international organizations active in private markets. Mostly, these partnerships are about co-investing in a particular asset, but some may also involve activities on the financing side or non-investment related undertakings. The graph below provides an overview of the various ways to partner with market stakeholders.

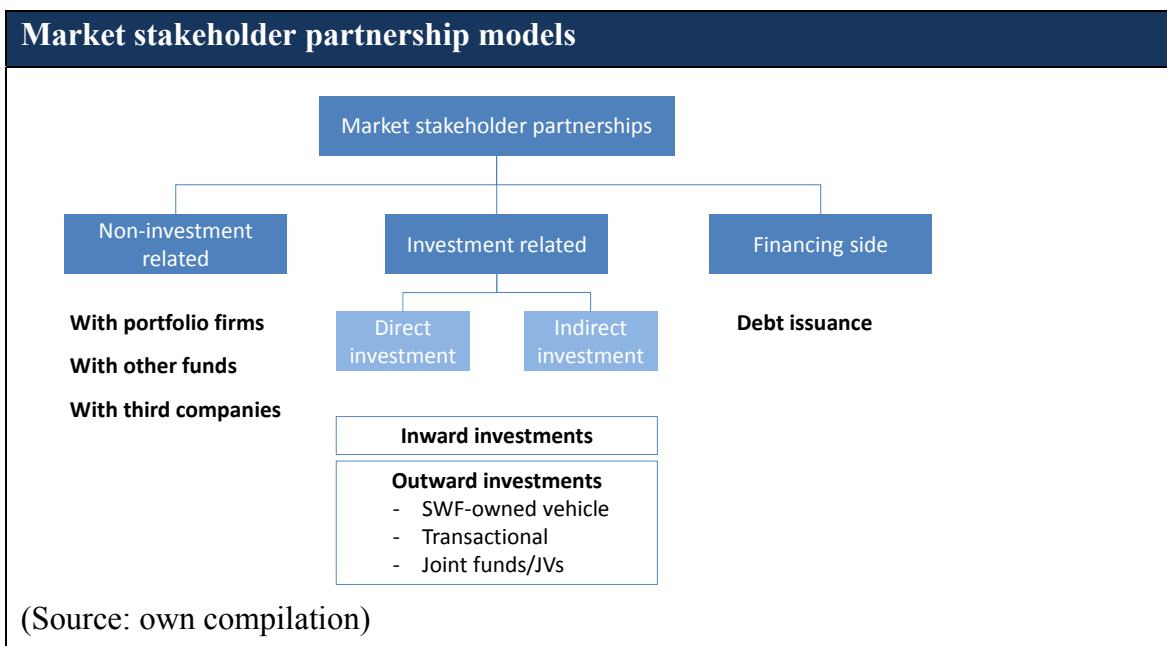


Figure 32: Market stakeholder partnership models

On the investment side, one has to distinguish between partnerships with regard to indirect- and direct SWF investments.

- On the *indirect* investment side, there has been a long-lasting debate about whether investing through external asset managers is an effective way to reduce political risk (IMF 2008, 15). In the early stage of the SWF controversy, investment mandates were seen as the silver bullet to dissipate concerns about politically motivated investments and the use of insider information (e.g. obtained through SWF principals) (Summers 2007; Cox 2007; Keller 2008). The Santiago Principles mention ‘contracting out responsibility for making individual investment decisions’ as one of four ways to avoid ‘undue political influence’ (IWG 2008b, 17). External investment service providers can be private asset management companies, private equity fund managers (with SWFs mostly acting as limited partners (Kalb 2011, 8pp))¹⁶² or increasingly also managers set up by governments or international organizations, e.g. the World Bank’s International Finance Corporation Asset Management Company (IFC AMC) which explicitly invites SWFs to invest in its funds (IFC 2012). Investments through intermediaries are beneficial for political risk in various ways: (1) they separate the investment process from governmental influence, thereby emphasising SWFs’ private sector credentials and mitigating concerns about unfair competition potentially arising from preferential access to (domestic) governmental stakeholders. (2) To a certain degree, farming out investments also enables SWFs to avoid political risks arising from holding substantial stakes in companies and being seen as exercising ‘undue control’. (3) Indirect investments, in particular when investing into funds run by international organizations with significant experience in frontier markets, also help avoiding country risk. Truman suspects, however, that the benefits of indirect investments may only be reaped if mandates are granted at arms’ length, i.e. given without detailed instructions on what to invest in and how to vote on the stakes (Truman 2010, 53pp). Others are more critical: Faily et al. argue that the financial crisis has shown that despite external managers, SWF fund management continues to be held accountable for underperformance or even losses. They cite Korea, Singapore and China as prime examples of domestic criticism. Moreover, as mentioned before, passive ownership strategies may also be fraught with political

¹⁶² While the participation in private equity is generally seen as an indirect investment with less political risk, some claim that the ‘agency gap problem [between the partners of PE fund and investee companies] is greatly reduced’ due to the short lines of communications (Walker 2011, 3pp). Arguing along these lines, SWF investments through PE may be less effective than expected in reducing political risk.

risk, with funds increasingly being accused of not living up to their responsibilities as ‘massive and passive’ institutional investors.

- Partnerships on the *direct* investment side may cover equity-, debt- and hybrid transactions. They may be carried out through SWF-owned vehicles open to outside investors or joint ventures with partners, increasingly fellow sovereign funds. As Kalb mentions, in the private equity space SWFs may also set up their own general partners to follow particular strategies alongside private investors (Kalb 2011, 148pp). For example, in addition to Seatown Holdings founded in 2010, in the first week of 2012 Temasek announced a second fund focused on privately owned firms in North Asia (Reuters 2012a). Both Seatown Holdings and Pavilion Capital are open to outside institutional investors, with Seatown planning to open up to retail investors at some point in the future. On the debt side, sovereign funds may provide debt capital to target firms but may also increasingly engage in transactions involving debt converting into equity at some point. Bolstered by regulatory demand for increased capital levels in the context of Basel III and the ‘too big to fail’ debate, contingent convertible capital (CoCos) transactions have attracted considerable interest amongst sovereign wealth funds. The latest manifestation of this was QIA and the GPFM stepping in as cornerstone investors when Credit Suisse issued mandatory convertible bonds in July 2012 (Reuters 2012f).

In terms of political risk management, direct investment partnerships, either with local or other market stakeholders, serve a couple of functions: (1) Partnerships emphasize sovereign wealth funds’ character as ‘purely financial investors’ and dissipate concerns about nationalist goals (Kalb 2011, 3). (2) The knowledge provided by local partners contributes to better assessing country risk and to identifying investment sector- and investment target related political risk. (3) Investing alongside local partners also raises the cost of governments and NGOs interfering with an SWF investment in a recipient country. (4) Investing together with a better reputed partner, e.g. a sovereign wealth fund from an OECD country, helps SWFs to raise their individual fund reputation, thereby also strengthening legitimacy in the markets. (5) Co-investments may be seen as a way to compensate declining fund inflows, thereby maintaining independence from the sponsoring government. Ziemba argues that particularly in 2008/2009, oil-based SWFs saw their inflows being cut due to the preceding oil price drop and more allocation to domestic investment following the financial crisis (Ziemba 2010, 81). (6) Finally, partnering with other investors may help SWFs to deal with building capacity

needs resulting from a persistent insourcing trend (Monk 2011c). This also includes sharing best practices on (political) risk management.

Sovereign wealth funds may enter investment partnerships for *outward* investments, i.e. in recipient countries, or for *inward* investments in the domestic economy.

- *Outward investment partnerships* may target the partner's country of origin or third countries and are the most prevalent form of SWF investment partnerships. Most of the direct investment strategies described above fall in this category.
- *On the inward investment side*, sovereign wealth funds may occasionally act as partners for private investors interested in investing domestically. Interestingly, however, here are a growing number of sovereign-owned funds which are exclusively mandated with attracting investment by offering co-financing, local expertise and – implicitly – political cover. These funds include the Russian Direct Investment Fund (RDIF), France's Fonds Stratégique d'Investissement, the Italian Fondo Strategico Italiano Spa (which is modelled after the French fund) and Abu Dhabi's AD Invest (for some announced transactions, see 1MDB 2010; RDIF 2012). The latter two are not classified as sovereign wealth funds according to this thesis but exemplify the popularity of funds being used as investment promotion agencies. In fact, the boundaries between these funds and sovereign wealth funds with a development objective (see chapter 2.3.3.2) are rather blurred in reality.

In addition to partnering with market stakeholders on the investment side, there have also been activities on the funds' *financing side*. Although not strictly partnership activities, SWF debt sales involve private investors and are therefore seen as another way of reducing political risk. Since the financial crisis, international financial markets have seen a series of debt offerings from Temasek (2009, 2010), Bahrain's Mumtalakat Holding (2010) and Khazanah (2010) (Bloomberg 2010). Most of the SWFs issuing debts are government holding companies which – as opposed to foreign exchange reserves-based funds – have lower cash flow levels. It can be argued that raising debt helps SWF political risk in three ways: (1) It is a way to diversify funding sources, thereby making the fund more independent from domestic political scrutiny of fund performance. (2) More importantly from a political risk point of view, debt may also enable funds to make more risky investments without being accused of irresponsibly putting state money at risk. (3) Issuing bonds also requires funds to increase transparency towards debt holders and reduces the risk of being accused of running 'political' investment strategies (Bloomberg 2010).

Finally, SWF political risk management on the market stakeholder level may also include non-investment related partnership activity. Here, we can distinguish two types of strategies:

- (1) Working together with portfolio companies to mitigate indirect ESG-related risk with a potential to reflect on the fund itself. A catchy example is NBIM which is running workshops for companies on water-related risks and the sustainable use of water (NBIM 2012b). In addition to furthering purely ethical objectives, such activities also aim at mitigating the adverse impact of unsustainable business models on GPFG investments and to minimize the legitimacy gap. Such initiatives also include capacity building on the governance side which aims at strengthening portfolio companies' boards and processes. Temasek, for example, through its Temasek Foundation, supports the 'Stewardship and Corporate Governance Centre', arguably in response to the significant risks bad portfolio company governance may harbour for an SWF (Temasek 2012a, 82).
- (2) Engaging in knowledge transfer with other funds, particularly with regard to capacity building on the business side. Here, partnership action aims at protecting sovereign wealth funds' common reputation as risk-conscious, commercially-minded investors.

Partnerships with authoritative stakeholders

In order to manage political risk, sovereign wealth funds may also partner with authoritative stakeholders, in particular the funds' own principles and recipient country governments. Partnerships are either on a predominately commercial basis or cover other aspects.

In *commercial partnerships*, funds are partnering with recipient country government entities, similarly to market stakeholders and mostly in the form of public-private partnerships (PPP). Often, the objective is a simple swap of SWF 'patient' capital (as opposed to capital market pressure) for a higher degree of legitimacy through the partnership in the country of investment. This infers that the more long-term the investment horizon and the higher the level of country risk, the higher the mutual benefits of such arrangements. Therefore, against this background and considering general SWF appetite for reaping illiquidity- and long-term investment premia, it is no surprise that infrastructure (which is inherently politically risky to invest in) has become a popular target for such partnership activities. Examples include Khazanah's partnership with the Infrastructure Development Finance Company, a PPP between the

Indian Government and the biggest Indian banks (Reuters 2011a), and Samruk-Kazyna's plans to set up a fund with Tajikistan and Kyrgyzstan for regional co-investments (Waki 2009). Such partnerships are effective ways to mitigate behavioural political risk factors, in particular to moderate country risk and investment-sector related risks. An interesting concept is followed by Temasek whose foundation supports – amongst many other causes – the Singapore Wealth Management Institute. Under a special scholarship programme, this institution has also delivered training to more than 55 regulators from the region, thereby arguably raising awareness for the intricacies of managing sovereign wealth (Temasek 2012a, 82).

Partnerships with authoritative stakeholders go well *beyond commercial relations* and also touch upon other aspects of political risk management. As discussed in chapter 5.4, host country reputation is a powerful, yet complex political risk factor. The complexity of country reputation is exacerbated by the bi-directional nature of the relationship between country and fund. Therefore, partnering with the host country on improving reputation has potentially large benefits, not only on the political risk side, but also with regard to the SWF's attractiveness as an employer. In their in-depth study of Liechtenstein, Fehlmann et al. suggest setting up a joint 'country reputation agency' financed by a country's most important stakeholders to monitor, analyse and manage country reputation (Fehlmann et al. 2002, 54pp). Such an agency – if not already in existence – would need to identify the country's reputational gap and devise the appropriate strategies to tackle them. Given most funds' international reach, SWFs are uniquely placed to be one of the instruments to implement such a strategy. The fund may also co-ordinate its own corporate citizenship activities abroad with agency activities in order to fulfil its messenger function.

7.3.5 Collective action

Partnership action of various kinds contributes to ensuring compliance and strengthening (individual) reputation. However, it may not prove effective to tackle contextual political risk factors whose influenceability is low. While home country reputation may be amenable to funds partnering with their administrations, tackling common SWF reputation and risks arising from the economic environment requires collective action. In this thesis, collective action-based political risk management strategies are defined as all action relying on co-ordinated sovereign wealth fund industry action.

The most successful collective action strategy so far has been the Santiago Principles, the sovereign wealth fund industry's common 'code of conduct' initiated as 'a direct response to the fears and concerns about the alleged risks and dangers' of SWF investment activity (D. Park and Estrada 2011, 2). First suggested by U.S. treasury official Clay Lowery in June 2007 (U.S. Department of the Treasury 2007), the principles were elaborated within a surprisingly short period of time and published on October 11, 2008 (Truman 2010, 121), albeit with relatively little media- and stakeholder resonance at the time¹⁶³. While there is little disagreement that the Santiago Principles were an important policy innovation (Behrendt 2011a, 38) and have strengthened overall SWF legitimacy, critics have concentrated on two aspects of the voluntary set of guidelines: (1) The material content of the guidelines, where concerns range from the principles not fully prohibiting investment decisions 'subject to other than economic and financial considerations' (GAAP 19.1) and not recommending full transparency. (2) The 'soft-law' nature of the provisions, with critics emphasising the voluntary character of the guidelines ('weak and toothless [but effective]' (Monk 2010a)), the lack of an enforcement mechanism, the uneven implementation and the incomplete coverage of the SWF universe. These two dimensions are reflected in work done by Truman and Behrendt who have drawn up indices focusing and assessing the principles' content and their implementation (Truman 2010, 121pp; Behrendt 2011a; Behrendt 2011b).

In order to realize the full potential of the Santiago Principles as a political risk management tool, the principles need to be further refined in four dimensions:

- *Broaden them*: While from 2008 to 2012, the number of SWFs has grown significantly, the Santiago Principle signatories i.e. the membership of the International Forum of Sovereign Wealth Funds (IFSWF) has remained at 24 funds. Given it is often the new funds which profit most from exchanging best practice and the reputational capital resulting from belonging to an established 'club', the IFSWF should seek to broaden the base of Santiago signatures – even more so as it is the newly created funds which often have a high media profile (as an example of the extensive coverage of the new Nigerian Sovereign Investment Authority, see allAfrica.com 2012), thereby influencing common fund reputation. Truman also suggests calling upon countries with multiple funds (such as the U.S.

¹⁶³ Behrendt attributes the muted reaction of the international press to the fact that a month prior to the publication, Lehman Brothers had filed for what remains the largest bankruptcy filing in U.S. history (Behrendt 2011a, 37).

-
- or the UAE) to ensure all of their funds join and comply with the guidelines (Truman 2010, 164).
- *Deepen them*: The Santiago Principles are predominately a reflection of recipient country authoritative stakeholder concerns. So far, political risk factors such as environmental- and social issues are hardly represented in the principles. Neither is there any reference to stakeholders other than the fund's own principals and authoritative stakeholders in recipient countries. Given that the source of political risk increasingly shifts to non-governmental actors interested in ESG-related issues, the Santiago Principles need to be deepened in respect to issues and potential stakeholders to interact with.
 - *Institutionalize them*: In order to ensure the adaption to changing realities, the Santiago principles should be complemented with a review process (see Truman 2010, 164). This process may not only assess the implementation of the GAAP across SWFs as mandated by GAAP 24 and first published in July 2011 (IFSWF 2011b). There also needs to be a regular review of the material scope of the guidelines in order to ensure they effectively address stakeholder concerns. Only a close match guarantees a high level of legitimacy. A permanent secretariat for the IFSWF may significantly contribute to building up analysis-, review- and advocacy capability and capacity. Such a permanent secretarial body was announced upon the occasion of the May 2011 IFSWF meeting in Beijing but has not yet materialized (IFSWF 2011a). Following its meeting in Mexico City on September 5-7, 2012, the IFSWF issued another press release which announced discussions about the 'establishment of a permanent location for the Forum and its Secretariat' (IFSWF 2012).
 - *Communicate them*: Finally, the institutionalization of the IFSWF may also lead to better communicating the Santiago Principles as a means to align SWF activity with stakeholder expectations. A strengthened (and broader-based) IFSWF would allow sovereign wealth funds to share best practice, engage in SWF corporate responsibility programmes, co-ordinate industry positions and align governmental relations programmes. Similarly to giving individual funds 'a face', a strong and credible communicator as a potential IFSWF secretary could be positioned as the 'Mr (or Mrs) SWF'. The secretary general, which would be supported by a moderate number of staff, could deflect some of the initial political pressure in case of another wave of economic patriotism (Castelli and Scacciavillani 2012, 168).

Given their significant financial clout and their signpost qualities in financial markets, sovereign wealth funds may also use their industry association to co-ordinate with the IMF, the OECD, the WTO and other international financial associations to keep international markets open for the benefit of international trade and investment.

8 Conclusions

8.1 The distinct nature of SWF political risk

The SWF political risk challenge

While sovereign wealth funds have been around for a long time, research for this thesis confirms that political risk has never been more salient a topic for state-owned investors than in the last decade. The reasons are likely to be twofold: *First*, sovereign wealth funds have become more active and more visible financial market players. With combined assets closing in on the USD 4tn mark and an increasing number of direct investments, the funds have drawn attention from policy makers, regulators and the public alike. *Secondly*, new actors, such as NGOs and ad-hoc movements, and also SWFs' domestic constituencies, are pursuing an increasingly broader range of issues and have radically changed the face of political risk. Long conceptualized as mere governmental interference, SWF political risk nowadays may range from public discontent about underperformance to resistance to sovereign wealth fund investments by local third country stakeholders.

Demystifying sovereign wealth funds

Despite their commonalities such as the sovereign ownership and the long-term investment horizon, sovereign wealth funds are a diverse group of financial market participants. With the youngest funds dating from the beginning of 2013, SWF founding dates span more than half a century and their assets under management range from the equivalent of an 'Ultra High Net Worth Individual' (UHNWI) to the GDP of a medium-range country. While some are independent entities with a legal personality, others are pools of assets managed by central banks. Most importantly, however, sovereign wealth funds differ with regard to the sources of their assets, with the literature distinguishing between funds based on natural resources, foreign exchange reserves or contributions in kind such as SOEs. In many cases, the SWF's funding structure determines its main policy objective which, in turn, conditions its investment strategy and its strategic asset allocation. In addition to these rather traditional categorizations which emphasize the financial functions of the funds, SWFs have also been found to act as symbols of modernity, as guarantors of (financial) autonomy and independence and as providers of governmental legitimacy.

Understanding political risk

Given SWFs' public profile, it is of no surprise that political risk has become an important topic amongst the funds. Although taking risks is an inherent function of

private companies in general and financial market participants in particular, political risk is a rather particular type of risk: while generally subsumed under operational risk, political risk does not follow probabilistic patterns but is found to constitute an example of ‘risk proper’ or uncertainty in a Knightian sense. Tracing the development of political risk concepts through time, it has been shown that the conceptualization of political risk has broadened, with governmental interference ceding to be the defining part. Furthermore, theoretical and methodological progress has contributed to political risk becoming increasingly accessible to statistical analysis. However, this thesis also shows that the classic concept is only partially suitable to assess sovereign wealth funds’ political risks: In addition to ignoring the ‘new face of political risk’ mentioned above, classic political risk concepts neglect domestic- as well as political risks arising in Western/OECD countries. This necessitates the development of a different concept of SWF political risk.

Defining and describing political risk for SWFs

As an intermittent step to a new definition, a thorough analysis of the literature and media sources since the emergence of the sovereign wealth fund label in 2005 identifies three clusters of concerns, relating to the funds’ setup and structure, their investment behaviour and their macroeconomic implications. With concerns forming the basis of stakeholder action, this thesis defines political risk for sovereign wealth funds as the *‘probability of unexpected or difficult to anticipate political action resulting in adverse consequences for the sovereign fund(s)’*. Broad enough to reflect the variety of political risk yet narrow enough to remain actionable, the definition paves the way for a more in-depth phenomenology of political risk which can be classified in various ways. One popular way to think about political risk has been from a stakeholders’ point of view, reflecting the progress stakeholder theory has made over the last two decades. In this context, it has been found that understanding stakeholder values and expectations is important, also due to the various forms of accountability linking SWFs with their stakeholders. In the last part of chapter 4, these findings are applied to sovereign wealth funds’ main stakeholders on the domestic-, the recipient country- and the international level. The evidence suggests that despite a widespread belief to the contrary (and depending on other factors such as democratization, etc.), domestic and international political risks are and will remain of serious concern to sovereign funds.

8.2 Conceptualizing and managing SWF political risk

A model of SWF political risk

Drawing on new institutionalist theories, the centrepiece of this thesis conceptualizes political risk for sovereign funds as a result of a lack of legitimacy. It is brought about by a gap between stakeholder expectations and fund reality. A failure to meet ‘hard’ expectations/obligations is seen as a breach of compliance while ‘soft’ expectation gaps may hurt a fund’s reputational capital. With stakeholders pressing for the fund to conform to their expectations, legitimacy deficits are the precursor to political risk. Taking into account the societal concerns towards SWFs and considering past evidence of SWF political risk, this thesis groups SWF legitimacy gaps into three buckets of ‘political risk factors’ (endogenous, behavioural and external). This reflects the fact that here is a high propensity for sovereign funds to be affected by political risk in these areas. Classic examples of political risk are home government interference based on weak mandates (endogenous political risk factor), NGO campaigns following a neglect of ESG-issues (behavioural political risk factor) or adverse impact resulting from the sub-standard reputation of a fund’s home country (external political risk factor). The graph below shows how the different elements of the concept/model play together.

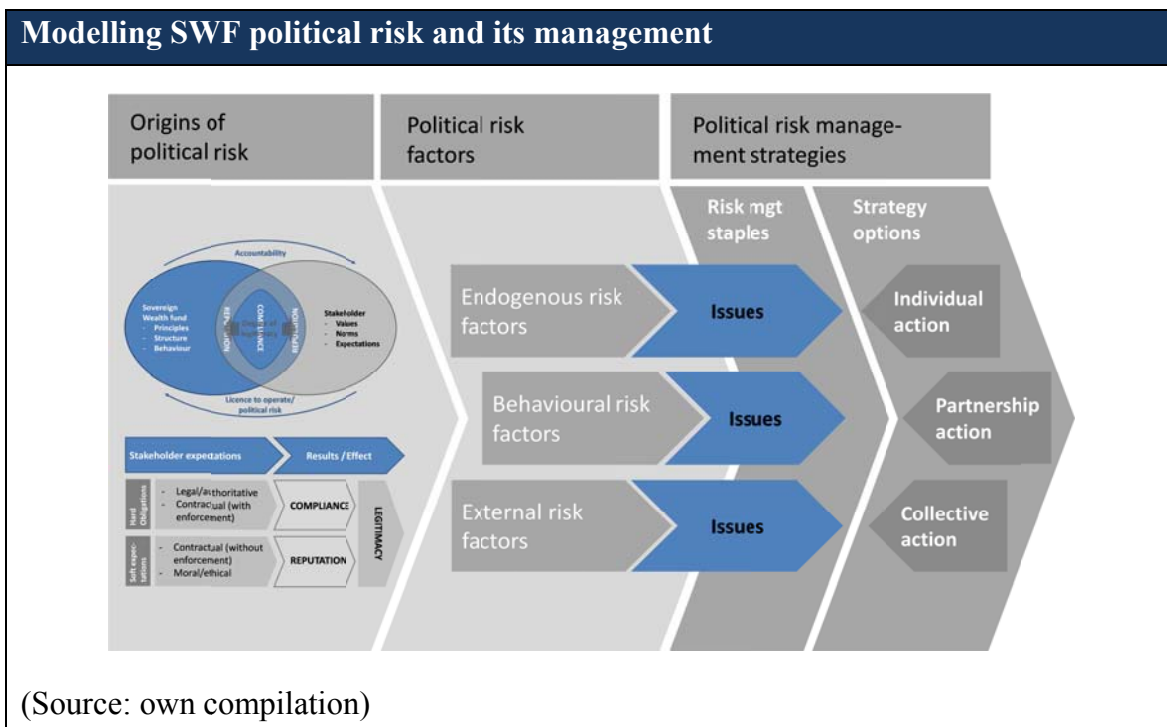


Figure 33: Modelling SWF political risk and its management

Some evidence

The case study on the political backlash experienced by many funds with regard to farmland investment confirms the applicability of the overall approach to describe and model SWF political risk: Drawing on the stakeholder framework presented in chapter 4, the case study identifies the most important stakeholders, interests and concerns when it comes to land investments. Taking into account the political risk factors of such investments, it finds that there are significant risks arising from the fields of transparency, country risk, ownership and ESG-related matters. Based on the definition of political risk, the case study then identifies and categorizes various manifestations of political risk on three different levels before using the legitimacy gap concept to analyse the origins of stakeholder pressure. It concludes that in addition to improving transparency around farmland investments and following international sector investment guidelines, partnership strategies at the domestic- and the recipient country level seem to be a promising way to reduce political risk.

Political risk management

The interviews held for this thesis and further desk research confirm that political risk management at sovereign wealth funds is in its infancy. At the same time, the high profile of SWFs and the emergence of new issues and stakeholders underscore the necessity for structured thinking and decisive action in this area. This thesis proposes a framework based on what has become the ‘holy trinity’ of political risk management: *Monitoring*, *assessment* and *advocacy*. It finds that in addition to the classic monitoring devices, sovereign wealth funds may profit from their governmental stakeholders’ access to information (a practice which harbours some distinct risk in itself). SWF assessment capacity crucially hinges on the diversity of people and knowledge management, with the former constituting a challenge to some of the more peripheral funds. Turning to possible advocacy strategies, this thesis suggests that each of the three clusters of political risk factors requires a particular cluster of political risk management strategies: While issues arising from endogenous political risk factors such as pressure for transparency are best dealt with by the funds themselves, behavioural risk factors/issues profit from an SWF partnering with stakeholders. As suggested, this can be a partnership with social stakeholders such as NGOs and academics to counter ESG issues or concerns relating to systemic risk. More interesting in this context, however, are partnerships with market stakeholders in the field of direct- and indirect investments, with both an outward- and an inward investment focus. There is some evidence that investing through external asset managers, for instance, or investing alongside more reputed market players

significantly lowers political risk. Partnerships with authoritative stakeholders may result in a co-optation of interests, thereby further reducing the risk of legitimacy gaps. Finally, issues brought about by exogenous/external political risk factors such as common SWF reputation may arguably only be tackled with collective action by all the funds. While the Santiago principles currently provide a solid basis to do so, this thesis suggests to broaden, deepen, institutionalize and better communicate them.

8.3 Closing remarks and outlook

As one of the first scientific papers on the subject of sovereign funds and political risk, this thesis is bound to exhibit some shortcomings. However, the relatively short history of the field also suggests that there is considerable scope for further research.

From a *methodological point of view*, one of the major limitations has been the *difficulties in accessing primary data*. Although it is well known that sovereign wealth funds and the IMF are thinking hard about political risk, many funds have been unwilling to share and openly discuss their view on the subject, thereby necessitating the extensive mining of secondary sources. This considerably hampers theory building and developing testable hypotheses. Secondly, as a consequence and closely connected to theory building, this thesis has encountered *difficulties in establishing causality*. Due to the complexity of the matter, it has been very difficult to authoritatively test and assess the relationship between political risk and the various characteristics of the funds. As a result, the *quantification of political risk* in general and of sovereign wealth funds in particular is still in its infancy (for one of the few encompassing frameworks, see Brink 2004). Although high up on the wish list of most CEOs and political risk managers across many industries, shifting political risk from Knight's 'unknown unknowns' to statistical probability (chapter 3) will therefore require further efforts.

Once the theoretical and empirical basis is built, further research *from an internal SWF point of view* may concentrate on how to best integrate the analysis and the management of political risk into SWF enterprise risk management (ERM)- and management information systems (MIS). In this context, additional knowledge will help to predict political risk (analysis function) and/or to identify and benchmark the most efficient instruments to deal with it (scorecard function). For this purpose, there also needs to be more (interdisciplinary) research on promising organizational structures, processes and feedback mechanisms to anchor political risk management in

SWF organizations. Then, following implementation and lessons learned, the focus may shift to how to ensure constant adaptation of the wider SWF political risk management structure to an ever-changing environment with different stakeholders and issues. Considering ‘the only constant is change’, the identification and the management of sovereign funds’ political risk will continue to be affected by ‘unknowns unknowns’. For sovereign wealth funds, success will be determined by how quickly and efficiently they will be able to react and how much reputational capital there has been built up to deal with the first blow.

From an *SWF-external perspective*, further research is suggested in three fields:

- (1) One of the most promising deep-dives relates the *relationship of the funds with their principals*. SWF corporate governance arrangements are walking a fine line between facilitating control by principals, ensuring the independence of the fund and acting as signalling devices to stakeholders. A more profound understanding of best practice in this field, also in the context of further developments of the Santiago Principles, would be beneficial for the analysis of SWF political risk¹⁶⁴.
- (2) Another interesting field of inquiry may be the *applicability of certain concepts to SOEs*. Companies such as China’s National Offshore Oil Corporation (CNOOC) or Saudi’s Aramco are facing similar challenges when investing abroad. Would a partial privatization as seen with Brazil’s Petrobras in 2010 or along the lines of CNOOC’s NYSE listing help to mitigate political risk? This leads to another field of potentially fruitful further research:
- (3) *Assessing alternative ways to manage sovereign wealth*. Given the high number of countries recently establishing funds, sovereign wealth funds seem to have become the ‘dominant design’ for national wealth management. However, debt repayments, tax reductions, direct dividends, a (partial) ‘people’s IPO’ of an SWF or a combination of all of these may constitute efficient and politically less risky alternatives. Further research in this field should tie in with efforts to conceptualize SWFs as one element of a national balance sheet approach.

This thesis is one of the first attempts at analysing political risk faced by sovereign wealth funds. It proposes a framework to identify and classify political risk in order to manage it in an efficient and targeted way. Against this background, this thesis harbours some modest hopes that sovereign wealth funds may gradually overcome

¹⁶⁴ For instance, an interesting avenue to follow would be to link up SWF oversight/governance questions with the ample literature on central bank independence.

public suspicion and may be universally accepted as professional (yet particular) asset managers. There are some encouraging signs: Inspired by the Santiago Principles, SWFs have become more transparent and have enjoyed an increasingly favourable reception as investors.

However, while the financial crisis has provided some temporary relief from stakeholder pressure, political risk seems set for a comeback: With demands for (democratic) accountability on the rise in both Asia and the Middle East, domestic scrutiny of sovereign funds is gradually intensifying. In addition, high energy prices and the ‘unfinished business’ of global structural economic imbalances will further increase SWF balance sheets, will lead to pressure to invest and will likely be viewed with increasing suspicion in recipient countries. As much as it may be beneficial for international capital markets and SWFs in particular: Reports of the death of political risk are – to paraphrase Mark Twain – (still) greatly exaggerated.

Appendix 1 – Master fund list

Country	Fund name	Inception	Main source	Structure	Size
Norway	Government Pension Fund Global	1990	RR (oil)	FI	702.5
UAE/Abu Dhabi	Abu Dhabi Investment Authority	1976	RR (oil)	FI	627
China	China Investment Corporation	2007	FXR	FI	482
Kuwait	Kuwait Investment Authority	1953	RR (oil)	FI	296
Singapore	Government of Singapore Investment Corporation	1981	FXR	FI	247.5
Singapore	Temasek Holdings	1974	GC	GHC	157.5
Qatar	Qatar Investment Authority	2005	RR (gas)	FI	115
Australia	The Future Fund	2006	GC	FI	85.7
Kazakhstan	Kazakhstan National Fund	2000	RR (various)	FI	67
Libya	Libyan Investment Authority	2006	RR (oil)	FI	65
Russia	Reserve Fund	2007	RR (oil)	FI	62.1
Korea	Korea Investment Corporation	2005	FXR	FI	57
UAE/Abu Dhabi	Mubadala Development Company	2002	RR (oil)	PE	53.1
Algeria	Fund for the Regulation of Receipts	2000	RR (oil)	FI	48.7
Iran	National Development Fund (until 2011 Oil	1999	RR (oil)	PE	44
USA/Alaska	Alaska Permanent Fund Corporation	1976	RR (oil)	FI	40.3
Malaysia	Khazanah Nasional Berhad	1993	GC	GHC	39.1
Azerbaijan	State Oil Fund of the Republic of Azerbaijan	1999	RR (oil)	FI	34.1
Brunei	Brunei Investment Agency	1983	RR (oil)	FI	30
Ireland	National Pensions Reserve Fund	2001	GC	FI	18.2
New Zealand	New Zealand Superannuation Fund	2001	GC	FI	17.5
Canada	Alberta Heritage Savings Trust Fund	1976	RR (various)	FI	16.4
Chile	Economic and Social Stabilization Fund	1985	RR (copper)	FI	15
UAE/Abu Dhabi	International Petroleum Investment Company	1984	RR (oil)	FI	14.5
Timor-Leste	Timor Leste Petroleum Fund	2005	RR (oil)	FI	11.8
Russia	Russian Direct Investment Fund	2011	GC	PE	11.5
UAE/Abu Dhabi	Abu Dhabi Investment Council	2007	GC	FI	10
UAE/Federal level	Emirates Investment Authority	2007	GC	GHC	10
Oman	State General Reserve Fund	1980	RR (oil)	FI	8.2
Peru	Peru Fiscal Stabilization Fund	1999	GC	FI	7.1
Bahrain	Mumtalakat Holding	2006	RR (oil)	GHC	7.1
Mexico	Oil Revenue Stabilization Fund	2000	RR (oil)	FI	6
Saudi Arabia	Sanabil al-Saudia	2008	RR (oil)	FI	5.3
Angola	Fundo Soberano de Angola	2012	RR (oil)	FI	5
Botswana	Pula Fund	1993	FXR	FI	4.9
Trinidad and Tobago	Heritage and Stabilization Fund	2000	RR (oil)	FI	4.3
USA/Alabama	Alabama Trust Fund	1986	RR (oil)	FI	2.3
UAE/Ras Al Khaimah	RAK Investment Authority	2005	RR (oil)	GHC	1.2
Nigeria	Nigeria Sovereign Investment Authority	2011	RR (oil)	FI	1
Vietnam	State Capital Investment Corporation	2005	GC	GHC	0.6
Turkmenistan	Stabilization Fund	2008	RR (oil)	FI	0.5
Kiribati	Revenue Equalization Reserve Fund	1956	RR (phosphate)	FI	0.5
Gabon	Sovereign Fund of the Gabonese Republic	1998	RR (oil)	FI	0.4
Panama	Fondo de Ahorro de Panama	2012	GC	tbd	0.3
Mauritania	National Fund for Hydrocarbon Reserves	2006	RR (oil)	FI	0.3
Tanzania	tbd	under	RR (gas)	FI	0.3
Bahrain	Future Generations Reserve Fund	2006	RR (oil)	n/a	0.2
Papua New Guinea	Mineral Revenue Stabilization Fund	1974	RR (various)	FI	0.2
Ghana	Ghana Petroleum Funds	2012	RR (oil)	FI	0.1
Equatorial Guinea	Fund for Future Generations	under	RR (oil)	n/a	0.08
Sao Tomé & Príncipe	National Oil Account	2004	RR (oil)	FI	0.01
Israel	tbd	2013	RR (gas)	FI	0
Nauru	Phosphate Royalties Stabilization Fund	1968	RR (phosphate)	FI	0
Mongolia	Fiscal Stabilization Fund	2011	RR (various)	FI	0
Bangladesh	tbd	under cons.	FXR	n/a	0
Egypt	tbd	under cons.	PP	GHC	0
Japan	tbd	under cons.	FXR	n/a	0
Lebanon	tbd	under cons.	RR (gas)	n/a	0
Maldives	tbd	under cons.	FXR	n/a	0
Mozambique	tbd	under cons.	RR (oil)	n/a	0
Rwanda	tbd	under cons.	GC	n/a	0
South Africa	tbd	under cons.	FXR	n/a	0
Taiwan	tbd	under cons.	PP	PE	0
Tunesia	tbd	under cons.	GC	n/a	0
Zimbabwe	tbd	under cons.	RR/PP	n/a	0
Thailand	tbd	under cons.	FXR	n/a	0
Colombia	Oil Savings and Stabilization Fund	under cons.	RR (oil)	n/a	0
Uganda	tbd	under cons.	RR (oil)	n/a	0
Philippines	tbd	under cons.	FXR	n/a	0
Source:	PP: partial privatization; RR: Resource revenue (resource); FXR: Foreign Exchange Reserves; GC: Government contributions/budget surplus				
Structure:	GHC: Government holding company; FI: Financial investor (small stakes/portfolio approach); PE: Private equity type investor				

Appendix 2 – Interview list

<p>Mr Lito Camacho Country Head Singapore, Vice Chairman Credit Suisse Asia Pacific Credit Suisse, Singapore October 10, 2009, phone interview, 45min</p>
<p>Dr Sven Behrendt Managing Director Goeconomica, Genf - November 15, 2010, phone interview, 60min - April 12, 2011, Zurich, 60min</p>
<p>Paul Tregidgo Managing Director, FID Emerging Markets Group/Global Govt Segment Credit Suisse, New York February 25, 2011, New York, 60min</p>
<p>Dr Hans-Ulrich Doerig Chairman (retired) Credit Suisse, Zurich June 6, 2011, Zurich, 60min</p>
<p>Ambassador David Mulford, Ph.D Senior Advisor Credit Suisse, New York June 20, 2011, New York, 45min</p>
<p>Prof Darryl S.L. Jarvis, Ph.D Vice Dean (Academic Affairs), Associate Professor Lee Kuan Yew School of Public Policy National University of Singapore September 26, 2011, Singapore, 45min</p>
<p>Kuan Ern Tan Investment Banking, Head of Singapore Coverage Credit Suisse, Singapore September 30, 2011, Singapore, 45min</p>
<p>Prof Mukul Asher, Ph.D Lee Kuan Yew School of Public Policy National University of Singapore October 8, 2011, phone interview, 45min</p>
<p>Dr Sung Cheng Chih Senior Advisor/former Chief Risk Officer Government of Singapore Investment Corporation (GIC), Singapore October 20, 2011, phone interview, 60min</p>
<p>Mohamed Elguindi Head Asset Management Qatar Credit Suisse, Qatar October 25, 2011, Doha, 45min</p>
<p>Rami Touma Head IBD Coverage Qatar Credit Suisse, Qatar, October 25, 2011, Doha, 45min</p>

<p>ADIA representative November 7, 2011, phone interview, 60min</p>
<p>Dr Bernd Schanzenbächer Managing Partner EBG Capital, Zürich November 23, 2011, Zürich, 90min</p>
<p>Pal Haugerud Director General Asset Management Department Norwegian Ministry of Finance December 15, 2011, phone interview, 60min</p>
<p>David Murray Honorary Chair, International Forum of Sovereign Wealth Funds Former Chairman, Future Fund, Australia March 21, 2012, Hong Kong, 45min</p>
<p>Vineet Nagrani Segment Leader Sovereign Wealth Funds Credit Suisse March 21, 2012, Hong Kong, 30min</p>
<p>Victoria Barbary, Ph.D Head Sovereign Wealth Centre Euromoney Institutional Investor June 19, 2012, London, 60min</p>
<p>Bruno Bischoff Deputy Head Sustainability Affairs Credit Suisse Various conversations over the course of 2009 - 2012</p>
<p>Otti Bisang Senior Sustainability Advisor (ret.) Credit Suisse Various conversations over the course of 2009 - 2012</p>
<p>Siang Hee, Tan, Ph.D Executive Director CropLife Asia, Singapore Various conversations end-2011/beginning of 2012</p>
<p>Rafael Gomes, Ph.D Manager, Risk Management Consulting Accenture, London Formerly Director of Risk Analytics, Exclusive Analysis, London Various conversations in 2009</p>
<p>Ben Mitchell Key Account Manager Sovereign Wealth Funds Credit Suisse, London Various conversations over the course of 2009 - 2012</p>

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CV

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Professional experience

- 2012 Credit Suisse, Singapore
 Regional Management Asia-Pacific
- 2010 – 2012 Credit Suisse, Zurich
 Secretary to the Executive Board/PB Management Committee
- 2006 – 2010 Credit Suisse, Zurich
 Public Affairs Manager
- 2005 – 2006 Global Business Reports, London/Istanbul
 Business journalist

Education

- 2008 – 2013 PhD programme (part-time)
 University of St. Gallen
- 2004 – 2005 MSc in European Politics and Governance
 London School of Economics and Political Science
- 1999 – 2004 Lic.rer.publ. HSG / Master's in International Relations & Management
 University of St. Gallen
- 1999 Military service in the intelligence unit of a tank batallion
- 1992 – 1999 Baccalaureate in classics (Latin)
 Kantonsschule Rychenberg, Winterthur