Who's the banker now?

The contrarian

Nativism on finance's monopoly board

Much of the received wisdom on sovereign wealth funds is wrong, says Jon Entine, but they do pose a threat to market transparency

In The Simpsons Movie, when Homer and his family arrive in Alaska to start a new life, they are greeted with the hubris of a state whose coffers overflow, thanks to North Slope oil: "Here's $1,000. We pay everyone in Alaska to let us destroy the environment."

It's a riff on the crisis du jour: sovereign wealth funds set up by governments to invest their assets – or in the case of the Alaska Permanent Fund, to disburse a part of the government's riches as an annual dividend to residents.

What is a joke for the Simpsons is a serious matter for the rest of the world. Petro-rich Arab countries, Russia, and Asian emerging market tigers led by China are swimming in dollars. While they used to be content buying US Treasury notes to stabilise their currencies, they are redeploying bulging cash reserves to buy equities. The worry is that government-owned sovereign wealth funds (SWFs) may destabilise the global financial system by politicising investments, bidding up bonds, stocks, and real estate, only to turn around and use inflated assets to permanently rearrange the hotels on the world Monopoly board.

It is estimated that SWF assets will increase sevenfold in ten years to $17.5 trillion. That has sent hysteria creeping into financial capitals. German chancellor Angela Merkel has floated the possibility of launching a German SWF to counter bids when foreign hordes scour for bargains. Former US Treasury secretary Lawrence Summers fears that the nouveau riche "may want to see their national companies … extract technology or achieve influence".

Acquisitions by foreign countries will always fuel conspiracy theories, especially when the acquirers are authoritarian. Protectionist fears scuttled the takeover in 2006 of six major US port operations managed by P&O after the British-owned firm was acquired by a United Arab Emirates company, and forced Dubai Aerospace to abandon its bid for the Auckland airport.

But what's really at stake?

If anything, protectionism is at least as much a threat to global financial security as the rise of foreign ownership. China recently paid $3 billion for a stake in private equity fund Blackstone; Singapore's Temasek and the China Development Bank bought 10 per cent of Barclays; and Barney's, the landmark New York clothing store, is now owned by Dubai's Istithmar. Those are limp strategic assets.

There is also a counter-argument in favour of SWFs. As UK chancellor Alistair Darling and US Treasury secretary Henry Paulson have both said, foreign investments are essential to grease a dynamic world economy. That proved true in the last few months of 2007, when sovereign wealth funds pumped more than $35 billion dollars into distressed European and US banks.

SWFs do present genuine risks, but they are more financial than geopolitical. Greed is good when markets operate transparently because maximising risk-adjusted returns naturally checks potential manipulators. But that is not the system that has evolved in recent years. Like private equity companies, most SWFs – Norway's fund being one notable exception – lack transparency. For the most part their private structure allows them to sidestep accepted corporate governance practices.

Foreign investments are essential to grease a dynamic world economy

World bourses are increasingly dominated by hedge funds operating under a cloak of invisibility or public companies whose trading practices are inscrutable even to their principals. But under current laws, governments and investors know very little about the potential consequences of these changes.

The dangerous joker card is that SWFs are likely to increase investments in these opaque funds. Think of Blackstone: it is one of the largest private employers in the US, yet its operations face few disclosure requirements. Chinese investors dipped their toes into the hedge fund world by buying a minority stake, but they did not even demand voting rights. After losing a third of their investment in six months, that passive role is going to change.

It will not be long before SWFs move from bailing out banks to become major private equity players in their own right. They are acquiring the necessary expertise. That will accelerate the dramatic shift away from transparency under way in financial markets. Unless governments move to pry open the operations of both private equity firms and sovereign wealth funds, today's market gyrations could seem like a ride in a kiddie park. ■

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