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ESG IN SOVEREIGN WEALTH FUND INVESTMENTS

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Abstract: Using a sample of 75,063 sovereign wealth fund (SWF) holdings in 7,668 firms between 2004 and 2018, this study examines whether there are sovereign wealth funds with an explicit focus on sustainable investing (ESG SWFs), and how their investments affect target firm's operating performance, value and ESG score compared to investments of other types of SWFs. To control for the influence of other types of SWFs that are related to ESG SWFs, it distinguishes between transparent versus opaque SWFs and autonomous versus politically dependent SWFs.

Key words: sovereign wealth funds, international financial markets, government policy and regulation, environmental, social, and governance policies

Introduction

Sovereign wealth funds manage investment portfolios on behalf of governments that own the portfolios (Dewenter, Han & Malatesta, 2010). Recently, they have emerged as major investors in corporate and real resources globally and have grown over $7 trillion assets under management (AUM) (Reuters, 2018). Despite their size, they represent a fairly new form of investment organizations, as they provide unusual financial flexibility and liquidity, have a sovereign background and most of them still display a lack of transparency about their activities. Even though Rozanov (2005) coined the term SWFs in 2005 already, they first became a topic of debate in 2007. Between July 2005 and October 2008, SWFs invested almost $90 billion in the stock of European and U.S. financial institutions, and in total SWFs invested more capital into financial institutions than any other investment entity except for the U.S. government (Megginson, You & Han, 2013). However, especially in their early days SWFs provoked concern due to perceived problems related to their sizable growth combined with political independence, government ownership and a lack of transparency. More specific, critics of SWFs pointed out that government's capital could be used through SWFs to enhance political goals and buy strategic firms in foreign countries (Knill, Lee & Mauck, 2012; Chhaochharia & Laeven, 2010; Fotak, Gao & Megginson, 2016), which in turn could have a deteriorating effect on a firm's operating and governance performance. Hence, their emergence initially caused resistance from recipient countries (Curzio & Miceli, 2010), which has been mitigated by their willingness to provide liquidity during the financial crisis and increased transparency about their objectives and activities.

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Sovereign Wealth Funds (SWFs) have emerged as significant players in the global financial landscape, wielding substantial influence over economies and markets worldwide. These state-owned investment vehicles manage vast pools of capital amassed from reserves, surpluses, or revenues generated by a country's natural resources or other state-owned enterprises. Beyond mere financial management, SWFs play a pivotal role in fostering economic development and ensuring financial stability, both domestically and internationally.

The impact of SWFs extends beyond direct investment into sectors; they also play a vital role in shaping the financial landscape. By participating in capital markets through equity investments, debt securities, and alternative assets, SWFs enhance liquidity, deepen markets, and foster transparency. Their long-term investment horizon and patient capital approach provide stability amidst short-term fluctuations, thereby attracting other institutional investors and stimulating capital market growth.

Literature review

There is no consensus in the academic and practitioner literature on the definition of a sovereign wealth fund, although most researchers agree that SWFs can be seen as government-owned investment vehicles with no explicit liabilities, significant exposure to risky foreign assets and a long-term investment horizon (Kotter & Lel, 2011). Truman (2010) uses a broader definition and defines SWFs as pools of government-owned or controlled assets that include some international assets. Hence, he also defines some pension funds as SWFs. Maybe the most authoritative definition comes from the IMF (2008a), who define SWFs as special purpose investment funds owned by the general government. SWFs hold assets to achieve financial objectives and employ a set of investment strategies that include investing in foreign financial assets. They have diverse legal, institutional and governance structures.

Result and discussion

In today’s global financial ecosystem, few players wield the same degree of power and influence as sovereign wealth funds (SWFs). The financial firepower of SWFs is hard to underestimate: currently, the assets under management (AUM) of the largest funds represent as much as twice the GDP of their respective countries. As of 2020, there were more than 100 SWFs globally, with AUM totaling over $10 trillion.

The largest SWF in the world—Norges Bank Investment Management (NBIM) of Norway—registered AUM to the tune of $1.3 trillion and effectively controlled the equivalent of about 1.5 percent of every publicly listed company in the world in 2021 (see figure 2). In absolute terms, some 30 percent of SWFs were concentrated in the Middle East and Asia.

So what are SWFs and what do they do? SWF Institute—a global corporation analyzing public asset owners—defines a SWF as a “state-owned investment fund

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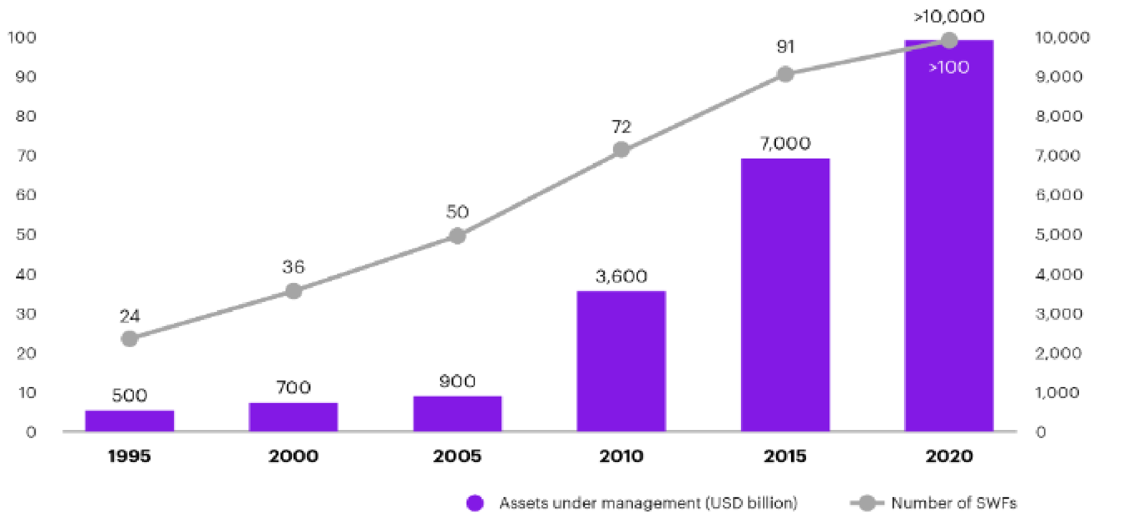
Figure 1
The assets under management of SWFs have grown substantially in the past 15 years



Note: SWF is sovereign wealth fund.

or entity that is established from privatization proceeds, governmental transfer payments, fiscal surpluses, and/or revenues resulting from natural resource extraction." Recently, SWFs have been increasingly tapping into other pools of funding such as the bond market.

Figure 2
The largest SWFs in the world by assets under management
(USD billion)

Notes: SWF is sovereign wealth fund.
AUM is assets under management.

SWF—a different type of principal investor

SWFs differ from other principal investors in four fundamental ways. First, unlike most principal investors which are privately owned, SWFs are government-backed investment vehicles controlled by their respective state governments. Second, SWFs typically have a very limited need for liquidity due to relatively stable sources of funding—SWFs can assemble a large pool of stable capital that otherwise would require a consortium of private entities. Third, SWFs typically have long-term investment horizons which oftentimes exceed decades (for example, Norway's NBIM has a 30-year investment window), which is usually not the case with other principal investors that have much shorter investment horizons (for example, a normal investment horizon of a private equity firm is around five to seven years). Fourth, SWFs' risk tolerance is aligned with their vision and mandate, and they can typically withstand cyclical pressures.

The strategic focus of SWFs is usually defined by the country's profile, national priorities, developmental agenda, and sometimes even its political agenda. In the case of developing countries, SWFs generally play a crucial role in helping governments deliver their national visions and transformational agendas.

These SWFs act as catalysts to develop and diversify their national economies away from dependency on income generated from finite natural resources. SWFs that act as development funds tend to have vast industrial expertise and capabilities to drive national agendas. On the other hand, SWFs in developed countries take a more passive approach by investing in established and less risky opportunities. Globally, such SWFs usually own minority stakes across a diversified set of asset classes—either directly or through fund managers, although many SWFs have become quite sophisticated and built solid investment and portfolio optimization capabilities internally.

SWF—not one size fits all

Conceptually, SWFs can be grouped into three archetypes, each with a different degree of focus on economic development and financial return objectives (see figure 3):[1]

1. **Capacity-builder SWFs** focus on economic development and strategic capability acquisition. Capacity-builder SWFs typically operate in developing countries, where they play a crucial role in helping governments deliver their national visions and transformational agendas. Good examples of a capacity-builder SWF are Khazanah Nasional in Malaysia and Nigeria Sovereign Investment Authority (NSIA) in Nigeria.
2. **Strategic investor SWFs** have a dual focus on financial returns and economic development. Strategic investor SWFs invest in portfolios to build up strategic sectors. Prominent examples here include the Public Investment Fund (PIF) in Saudi Arabia, Temasek in Singapore, Mubadala in the UAE, and the Qatar Investment Authority (QIA) in Qatar.
3. **Wealth manager SWFs** focus primarily on financial returns and invest mostly in international assets. Wealth manager SWFs aim to create and preserve wealth for future generations to come. Examples of such SWFs include the Government of Singapore Investment Corporation (GIC) in Singapore, NBIM in Norway, and the Abu Dhabi Investment Authority (ADIA) in the UAE.

[1] Kaernay anylasis

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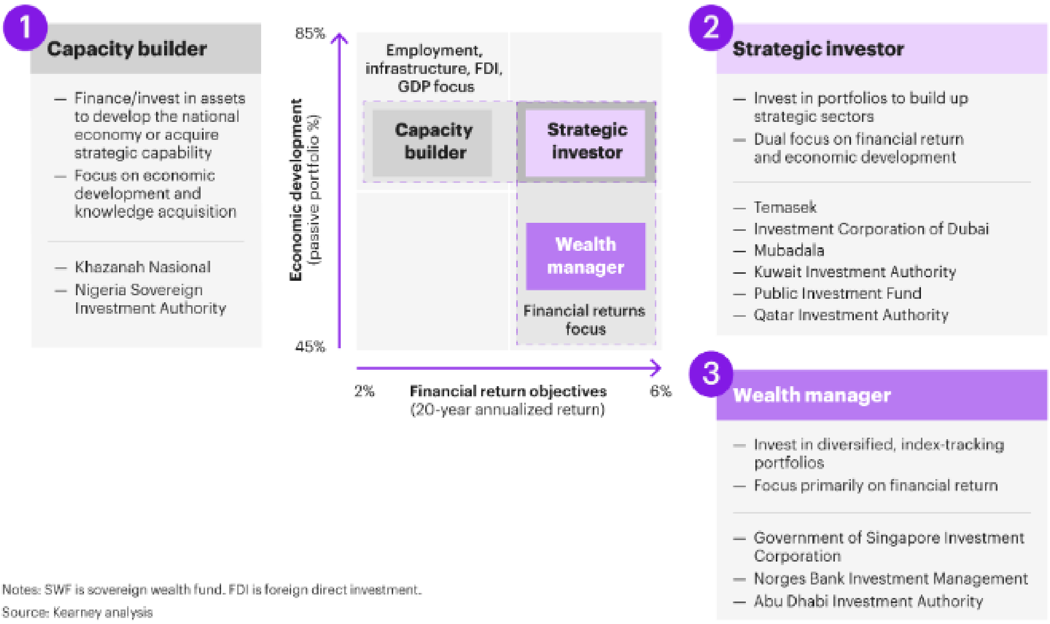
While there is no clear “winner” among these models, the success of any SWF depends on having a clearly defined vision and mandate that are fully aligned to the national aspirations and ultimately realized through meticulous execution.

Figure 3
SWFs can be grouped into three archetypes



Notes: SWF is sovereign wealth fund. FDI is foreign direct investment.
Source: Kearney analysis

Investment Fund (PIF) raised $3 billion via its first green bond sale—the first SWF globally to do so. Subsequently, in February 2023, PIF announced its plan to raise an additional $5.5 billion through its second green bond sale. To support its target of reaching net zero emissions by 2060, PIF expects to invest more than $10 billion by 2026 in eligible green projects, including renewable energy, clean transport, and sustainable water management. Most recently, PIF teamed up with Global Infrastructure Partners to acquire a 9.5 percent stake in Skyborn Renewables—an offshore wind developer and operator headquartered in Germany. This growing trend toward investment in green projects is echoed by Heenam Choi, chief executive of the Korea Investment Corporation (KIC): "Over the next 10 years, the best investment opportunities will be in climate change and related technologies." This sentiment has only been strengthened by the ongoing energy crisis.

Conclusion

This research aims to provide a new step towards understanding the motives and consequences of SWF investments, especially for SWFs that incorporate ESG considerations into their investment processes and decisions. The conclusions provide information for (professional) investors and leaders in politics, governments and business, and can be used as a source of knowledge for decision making on how to deal with (foreign) SWFs. Nevertheless, future academic research is needed to further unravel the objectives and effects of investments from SWFs, how SWF characteristics affect the performance of target firms, and how firm characteristics affect the investment choices of SWFs. The most important recommendations for further research are the following: • Additional coverage of SWFs: Almost every empirical study on the influence of SWF investments on target firms is conducted with a subsample of SWFs, even though there are many more SWFs that actively invest on a large scale (SWFI, 2019). This study contributes by collecting ownership data on all SWFs available in FactSet. Still, far too little is known about the details of (other) SWF investments, and the current data reveals that the largest SWFs in this sample are usually the most transparent and autonomous SWFs. Hence, inclusion of additional SWFs, and especially those with a high degree of opaqueness and a high AUM, would allow interesting replications of the research that already has been done for the lower number of (relatively transparent and autonomous) SWFs. Furthermore, adding large, politically dependent and opaque SWFs to the sample gives opportunities to further examine whether SWF and firm characteristics influence target firm performance and SWF investment decisions, respectively. • Transparency and autonomy classifications: Related to the additional coverage of SWFs is the recommendation to incorporate data on these SWFs into scoreboards such as those designed by Truman (2015) and Linaburg and Maduell (2018). This way, it is likely that the number of SWFs that is classified as either transparent or opaque and either autonomous or politically dependent increases, which helps to conduct analyses with balanced sample sizes and increased statistical power. Furthermore, increased coverage of transparency data might help to answer the question for policymakers whether the benefit of cross-border SWF investments is greater than the benefit provided by SWF investments (Megginson & Gao, 2019). Moreover, Stone and Truman (2016) recently found that SWFs are making progress to improve their transparency, which could also future results regarding the impact of opaqueness of SWFs on target firms and investment decisions.

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