Poor communication and differing incentives between politicians and national wealth managers are undermining performance, argues Gary Smith.

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SERVING THE SERVANTS: POLITICS IS HAMPERING NATIONAL WEALTH MANAGEMENT

Poorest communication and differing incentives between politicians and national wealth managers are undermining performance, argues Gary Smith.
There are often important links between the institutions that fall within the category of national wealth manager, especially in developing nations, and not least in Asia where sovereign wealth funds (SWFs) with pension-type responsibilities have been created out of foreign-exchange reserves. Central banks, sovereign wealth funds and state pension funds may have differing mandates, and hence different characteristics, in each country but the key macro forces they confront are similar the world over.

In 2008 and early 2009, many of these institutions saw the value of investments plunge. The reaction to this from politicians, the public, and then from the institutions themselves, often appeared to be detached from previously assumed strategy. This was particularly true when a high-profile investment, such as a stake in a Western bank, was falling in value. The scrutiny that China Investment Corporation (CIC) received in the wake of its early investments in Blackstone and Morgan Stanley, (see Li Xiang and Mao Lijun, ‘Sovereign fund spin-off ‘considered’’, China Daily, 7 July 2010), and the criticism of both Korea Investment Corporation (KIC) and Temasek over their investments in Merrill Lynch, are all good examples (see Park Hyong-Ki, ‘Young and Clueless,’ The Korean Times, 21 August 2008). It would appear then, that it was not sufficiently well explained that these stakes were expected to deliver returns over a time horizon that spanned years not days.

Pro-cyclical investing during the crisis suggests that politicians and national wealth managers have yet to get to grips with the critical challenges associated with their work. Here, I will argue that this owes much to the lack of cohesion between the short-term objectives of politicians and, what should be, the motivation of national wealth managers: maximising long-term returns.

CROSSHEAD: THE PROBLEM OF AGEING SOCIETIES

The proliferation of SWFs in recent years (according to the SWF Institute, a research organisation into funds’ impact on economics and policy, 17 have been launched since 2005) might in itself be used as support for the argument that nation states are not only aware of the challenge of an ageing society, but are responding by creating institutions with appropriate asset allocation and investment horizons.

This assumption, however, does not bear close scrutiny for two reasons.

Firstly, national wealth managers did not generally behave as rational long-term investors during the crisis. There was a failure to rebalance into falling equity markets – and by default, presiding over a shift in asset allocation from equity to fixed income. (Footnote - The evidence for this is widespread, but in the absence of official annual reports, is anecdotal. The Norwegian Pension Fund Global, however, was a clear exception on two counts, firstly by publishing an annual report and secondly because the fund rebalanced into a falling equity market – and also completed a previous asset allocation change to increase equity exposure from 40% to 60%).

Secondly, it also appears that in order to reduce risk, central bank reserve managers acted counter to the aims of the European Central Bank, the Federal Reserve and other central banks by reducing, rather than increasing, their exposure to higher yielding fixed income assets during the crisis. A recent report from the International Monetary Fund (IMF) suggested that reserve managers pulled $500 billion out of specific banks and markets in a flight to quality during the global financial crisis. The IMF staffs noted this behaviour highlighted a potential conflict between the central banking reserve management mandate and financial stability (Jukka Pihlman and Han van der Hoorn, ‘Procyclicality in Central Bank Reserve Management; Evidence from the Crisis,’ IMF Working Paper 10/150, June 2010). What is very worrying is that during the crisis many government-owned institutions within the national wealth manager fold did not act as long term and counter-cyclical investors. If national wealth managers, some of whom represent SWFs with supposed long-term investment aims, could not do this – then what hope is there for long term state sponsored investing?
THE CURSE OF ASYMMETRIC RISK APPETITE

I have used the chart of asymmetric risk appetite (Chart 1) in numerous meetings with national wealth managers in recent years. The chart highlights that national wealth managers have an asymmetric appetite for risk and reward, which is not good news for strategic planning and long-term optimal investment. Incremental increases in assets under management (or reserves, for a central bank) are welcomed but an equal incremental decline brings disproportionate discomfort. This so-called “law of asymmetry” goes to the very heart of so much that is important in driving the actions of the national wealth manager community. The chart has never been fundamentally rejected, which indicates that we do indeed have a problem!

Why the problem? Again, two reasons.

Firstly, there are the difficulties associated with managing the expectations of politicians, who expect a constant flow of good news from their national wealth managers, and who find dealing with bad news a significant challenge. This, in turn, makes long-term planning tricky.

Secondly, there is a lack of a well understood and clearly marketed liability profile. This is the key reason for what often appears to be pro-cyclical, often sub-optimal investment behaviour. Recognising this would be the first step in arriving at a solution. Can the key stakeholders reach an agreement on what the most important liabilities for national wealth managers actually are, and hence what an appropriate investment strategy should be? And over what horizon this should be measured?
I will now turn to three consequences of these problems.

**A GENERALISED MYOPIA TOWARDS THE PROBLEM OF AGEING SOCIETY**

Firstly, the problems lead to a rather disturbing trend in that SWFs’ asset allocation tends to over time drift from conservative to riskier instruments.

Previous work on how national wealth management evolves (Kamar Jaffer and Sohail Jaffer (edited), ‘Investing in the GCC Markets: New Opportunities in a Changing Landscape, CPI Financial, October 2009) suggests that there is a tendency for asset allocation to evolve from risk-free, to risky assets – an evolution that is driven by growth in assets, or foreign-exchange reserves and an overwhelming desire not to harvest losses in the first years. The reasons are relatively easy to understand and once again are political.

When a new institution such as a SWF is created, there is a great political incentive to ensure that the institution survives. This encourages an initial conservative asset allocation and preference for fixed income. As a fund establishes itself, a riskier asset allocation might follow as has been seen in the case of Norway, or more recently CIC. What is counter-intuitive is that this evolution towards a riskier asset mix takes place over a period in which the demographic profile of the nation is almost certainly ageing. Whereas individual investors are encouraged to first invest in risky assets when young, and then to risk-free assets when close to retirement, national wealth managers seem to follow the opposite path. How odd. How worrying.

Priorities are confused. The reasons for state-sponsored saving are easy to understand: an ageing population should be a principal reason for this. However, in many nations with a SWF, not only is the initial asset allocation designed to ensure that short-term performance problems are avoided (rather than aim to maximise long-term returns), but at least in 2008/2009, the tendency was to behave pro-cyclically, rather than in a counter-cyclical manner.

**WEAKNESSES MASK DIFFERENCES**

That the demographic challenge rarely elicits a clear policy response is not a surprise. Demographics may throw up intense challenges a quarter of a century from now, but most governments are elected on four- or five-year terms. Dealing with longer term demographic issues is not a priority, especially since solutions (such as extending retirement ages) are likely to involve upsetting the older working population (a large and growing voting cohort).

That populations are ageing in almost every country in the world is well recognised. However, a second consequence of our problems is that, even though the universal trend is well understood, the considerable differences between nations (even close neighbours) are underappreciated.

The charts below show the changing number of old people in relation to 100 working people. In 2000, Japan had 28 old people for every 100 working age people. By 2040 it will have 68 old people for every 100 working age people. The old-age dependency ratios are shown for a variety of Western nations in chart 2, and a variety of Asian nations in chart 3.
Ageing Societies: Implications for National Wealth Management?

Chart 2 Source: U.S. Census Bureau: International Database, Country Rankings, BNPP IP April 2010

The forecasts may not be precisely accurate, but two of the three key inputs into the calculation are reasonably clear. The first is the birth rate, the other longevity. The lesser known factor is of course the net migration number. But bear in mind that one nation’s immigrant is another nation’s emigrant – the world cannot solve the ageing problem at the global level through migration.

Singapore has an institutionalised framework to force its citizens to save through a compulsory pension scheme – the Central Provident Fund – and two SWFs with clear priorities in order to prepare for the looming pension burden. It is right to do so. But, as the charts above show, not everyone is in the same position as Singapore. Yet many of their national wealth managers behave in a similar way to those in the island state.

DEDICATED FOLLOWERS OF FASHION
The second problem, then, is that there is too much pressure to emulate the strategies of others. Emulation pressures have existed in the SWF space for some time. As long ago as 2007 Japan, China, and South Korea all publicly stated that they were looking at creating institutions that would mimic the Singaporean SWF Temasek (Jim Rogers, ‘Ho Ching,’ Time Magazine, 3 May 2007). Of course, the latter two nations eventually did.

As Singaporeans save hard, the state-managed vehicles for investing these savings grow in size and importance, gain international prominence and perhaps even admiration. It is little wonder that the Singapore model is thus emulated by other nations – and not just by other Asian nations.

But this raises questions. Creating institutions to copy the savings intentions of Singapore can make sense. But the reason for doing so should be the need to prepare for an ageing demographic, rather than a desire to emulate a trophy institution in another country?

There are clear differences in the demographic burden between nations, as shown in charts 3 and 4. These clear differences must drive different approaches to saving and investing at a national level. But this does not seem to be so.

The authorities in Singapore have adopted their current plan because they face looming demographic challenges. These challenges will be somewhat different in other nations in Asia, as is clear from the chart. These other nations in Asia (especially south Asia) should not, therefore, seek to emulate Singapore’s model in its entirety.

POOR COMMUNICATION LEADS TO OBSCURED RATIONALE
Thirdly, there are signs that poor communication by finance officials coupled with politicians’ lack of understanding is leading to the original rationale for SWFs to become obscured.

Some of the arguments that are being used in favour of SWF creation by other nations bear little relation to the need to deal with a longer-term ageing problem, or even to deal with any traditional liability at all. Notice the clamour for India to establish a SWF which seem to be motivated by factors ranging from the “need” to catch up with the other Bric nations who do have one, or, more specifically, to compete with the Chinese in the oil and gas industry (Rakteem Katakey, 'India said to propose sovereign fund for oil assets,' Bloomberg, 17 March 2010.). This might be a worthy idea, but it is a significant departure from the traditional view of what a SWF should do, or even how one might be financed. India has considerable foreign exchange reserves (about $250 billion) but these are a consequence of a capital account surplus, and indeed India actually runs a current account deficit – and as such might not be considered a traditional candidate to establish a SWF. Consider also reports of the need for an Islamic SWF, to represent the 1.6 billion Muslims in the world, despite many of the Islamic nations already having national SWFs. (Rushdi Siddiqui, ‘The need of the hour: an Islamic SWF,’ Gulf News, May 24 2010).

It seems that having a SWF, or even being represented by one, now has great international cachet. This cachet has led to funds being mooted independent of need – and ability to fund them. This trend has in turn been exacerbated by the
Santiago principles, which created an exclusive club where SWFs could meet and discuss strategy. (Footnote, In September 2008, at a summit in Chile, the International Working Group of Sovereign Wealth Funds agreed to a voluntary code of conduct that had been initially drafted by the IMF. The agreement consists of 28 Generally Agreed Principles and Practices (GAPP) which the funds would work towards.)

What is also surprising is that the pressure on developing nations (especially those with windfall wealth who may be looking to establish SWFs) from the international community seems always to be focussed on governance and transparency. Although these issues are very important, and encourage a more equitable national participation in a wealth windfall, why is the advice from the international community not more differentiated? There is a danger that the “be like Norway” message could extend beyond the realm of good governance and transparency, and into a recommendation to embrace the Norwegian model in its entirety. This would be most inappropriate, particular to investment strategy and asset allocation. The differences between an oil producing nation in Africa, Asia and Europe are enormous, with respect to existing levels of development, and future (demographically determined) national liabilities.

REPAIRING FLAWED STRATEGIES
There are two ways in which the flawed strategies of national wealth managers can be repaired.

Firstly, there needs to be clarity of purpose, a understanding by politicians of what the fund is trying to achieve, which in turn must play which role in determining asset allocation. What is needed then is an explicit mandate that can outlive electoral cycles.

Secondly, once this has been achieved, there is a role for marketing and a press campaign in the local media. There can be seen in many countries a significant failure in the marketing of the business plan by national wealth managers. This is not as simple as it may first appear – you cannot market a non-existing message. There is also the issue of who formulates the message, and what strategy should it be based on.

National wealth managers, then, need to be both educators, and also skilled marketers. Selling the strategy to stakeholders before implementation is surely the only route to both optimal investing, and job satisfaction for national wealth managers.

Without both of these skills, the tripwire of short-term bad performance will continue to impede decision making and asset allocation. It is only with the backing of all national stakeholders and a clear long-term strategy, that short-term bad news on performance may be easier to tolerate. And this also – whisper it – opens up the possibility of buying the dip, being counter rather than pro-cyclical, might be possible in the longer term.

Many of the problems in national wealth management can be explained by the need to deal with politicians. The asymmetric risk chart applies to national wealth managers largely because this asymmetry is fundamental to the DNA of politicians: they are motivated to focus on the short term.

Like wasps, politicians are fact of life and, as the chart also suggests, national wealth managers are only too aware of lawmakers’ sting. Yet, that monetary policy is now largely independent of government interference in most countries, shows that lawmakers are not beyond reason, that they can at times put the greater good ahead of electoral cycles.

The stakes here could not be higher. The single largest liability on the balance sheet of any nation is the future cost of unfunded pension promises. For the greater good, then, national wealth managers must be allowed to focus on the long term. They will no doubt struggle to, but these struggles must be overcome.
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BIOGRAPHY:

Gary Smith joined the BNP Paribas Group in 2004, and worked for four years within Fixed Income Sales, where he was responsible for a team covering institutional clients including Central Banks. He joined BNP Paribas Investment Partners in 2008 as Head of Official Institutions. He has global responsibility for relationships between these key customers and the various members of the BNP Paribas Investment Partners group. In 2010 he was appointed Global Head of Official Institutions.

Before joining BNP Paribas he spent nine years with Morgan Stanley, and six years with Merrill Lynch, working in the fixed income field. He began his career in the economics department of Greenwell Montagu in 1986.

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