

Sovereign Wealth Funds: Good for Funding?

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Abstract Since the start of the financial crisis, firms increasingly search for new finance sources. Sovereign Wealth Funds – rapidly growing government-owned investment vehicles – are investing heavily in equity nowadays. We aim to find out how stock markets respond to their investments and disinvestments. When analysing a global sample for the period January 2004 - July 2011, we find significantly positive (negative) stock market returns on the announcement of an investment (divestment). Additionally, we find that the market reacts stronger to announcements of divestments since 2008. This provides some evidence for the idea that investors look more favourable upon Sovereign Wealth Funds nowadays. It appears that fears for too much corporate governance impact have weakened. This opens up funding opportunities for CFO's of today's money-hungry firms.

Key words: Sovereign Wealth Funds, Firm Value, Funding

1. Introduction

Sovereign Wealth Funds are government-controlled funds that invest and manage their countries' excess reserves. Even though the relatively unknown Funds have been around for a long time, their number and level of activity have increased dramatically since 2000 and this growth is expected to continue. Nowadays, the Funds have about \$5 trillion of assets under control. This has attracted a lot of attention, especially since well-known firms such as Volkswagen AG, Porsche, Citicorp, and Barclays have become involved.

The Funds resemble other institutional shareholders in that they also usually take large equity stakes in firms. However, being controlled and influenced by their governments, the Funds might pursue strategic or political goals. Additionally, many of them show a lack of

transparency. However, like other large shareholders, the Funds are likely to create value for the existing shareholders because of being able to improve the corporate governance of the firms they invest in. Therefore, CFO's of money-hungry firms may want to attract investments by liquid Funds.

2. Sovereign Wealth Funds and corporate governance

The first Sovereign Wealth Fund that is still active was founded by the Kuwaiti government in 1953 to manage the financial surpluses earned in the oil business. Back in 2000, the Funds managed about \$1.5 trillion in assets. Nowadays, however, they control around \$5 trillion. This means that the Funds market is already bigger than the hedge fund and private equity market combined. The assets under control are expected to grow significantly. Consequently, from 2000 onwards countries like China, Qatar, and Saudi Arabia have created Sovereign Wealth Funds to manage part of their reserves.

The creation of Funds changed the investment policies and risk profiles of the governments. The attention shifted from US Treasury Bills to more risky assets, such as shares, derivatives and real estate. This shift has resulted in debates on the impact of Sovereign Wealth Fund investments, since the investments could have a severe impact on the company that is being targeted by the Fund. One potential impact often referred to is the impact on corporate governance.

Sovereign Wealth Funds often take large stakes in companies and they keep these stakes for long periods of time. Like other large shareholders (e.g. pension funds, hedge funds, and mutual funds), the Funds can be expected to have an impact on the corporate governance of a target firm (e.g. Dewenter et al., 2010).

Since the Funds usually take significant stakes in firms, they will have more incentives to monitor the performance of these firms than small shareholders, who cannot account for the costs that accompany monitoring the managers of the firm. The presence of the Funds may lead to more monitoring activity, thus increasing the value of the target company.

Funds divestments are likely to have the opposite effects of investments. Since the market expects that divestments will lead to less

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monitoring opportunities, firms dealing with Fund divestment will experience negative abnormal stock price reactions.

3. Sovereign Wealth Funds transactions after 2008

Since early 2008, three developments have resulted in a more favourable look from politicians and media upon Fund investments (Persaud, 2010). Firstly, the International Working Group of Sovereign Wealth Funds (IWG) published 24 voluntary Fund principles; the so-called Santiago Principles (IWG, 2008). The principles ensure that the Funds are transparent, comply with the rules and regulations of the country they invest in, and make investments based on a risk-reward trade-off.

Secondly, the Funds took significant stakes in firms during the recent global financial crisis (Persaud, 2011). When liquidity on the financial markets evaporated, the Funds took stakes in Citi, Morgan Stanley, and UBS, amongst others. This restored trust and confidence in these firms. Consequently, politicians and media welcomed Fund investments.

Thirdly, the Funds have become more risk averse since the global financial crisis and this has resulted in several changes in their transactions patterns. Since, they will likely only make an investment when they foresee opportunities to increase firm value by means of monitoring activities. Because investors know the Funds have become more risk averse, they might expect that the Fund has scrutinized a target firm when they buy a stake of it.

4. Funds investment and divestment data

In order to find out about recent developments, we create a dataset of Fund investments and divestments for the period January 2004 – July 2011. A list of Funds is retrieved from the Sovereign Wealth Fund Institute (<http://www.SovereignWealthFundinstitute.org/>), thereby including the Funds with a capitalization of over \$1 billion, as suggested by Fernandes (2011). The 23 Funds sampled represent more than 99 per cent of the value of the Fund universe. Next, investments in firms with publicly traded equity are identified by searching databases.

Several filters are applied to clean up the sample. Investments in initial public offerings are omitted, as the Fund investment impact thereon is

undeterminable (Kotter and Lel, 2011). Simultaneous Fund investments (e.g. consortium investments) in the same firm are treated as one event (Dewenter et al., 2010). The stock price data of 44 targeted firms are not available. The clean sample then consists of 232 investments in 190 unique companies, in 40 different countries. In the same manner, there are 101 divestment events in 88 unique companies, in 18 different countries.

Moreover, specific data on the background of the Funds, including the country of origin and the level of transparency are retrieved. Firm characteristics data retrieved include the net debt ratio, the market capitalization ratio, the data on floating shares and the acquired or divested stake.

The Singaporean Funds Temasek and the Government of Singapore Investment Corporation make 79 (34%) of the Fund investments. Other active Funds are the Norwegian Government Pension Fund (25 investments), the three Funds from Abu Dhabi (together 24 investments), and the Malaysian Fund Khazanah (19 investments). The Singaporean Funds are also heavily divesting, with 47 (46%) of the sample divestments. Other active Funds are from Norway (22 divestments) and Malaysia (9 divestments).

We find that almost 50% of the investment and 60% of the divestment transactions take place in Asia and Australia and most of these transactions were undertaken by the Asian Funds. This contradicts suggestions by the media that the Funds invest exclusively in firms from OECD countries.

Out of the 232 investments, 98 were conducted during the years 2004-2007. The remaining 134 investments took place during the period January 2008 – July 2011. The Funds were especially active in 2008 and 2009. The divestment sample shows a similar distribution. Out of the 101 divestments, 40 were undertaken before 2008, while the remaining 61 were undertaken in the period January 2008 – July 2011, also with an accent on 2008 and 2009.

Our sample data on Fund and target firm investment characteristics show that the market capitalization of target firms ranges from \$5.75 million to \$193 billion and is rising (cf. Kotter and Lel, 2011). The divestments size varies widely as well, namely from \$7.2 million to \$230 billion. The debt levels is low in the two samples.

5. Funds investment and divestment announcement returns

Table 1: Share Price Reactions to the announcement of Sovereign Wealth Fund Transactions

This table presents the stock price reactions to announcements of Fund investments and divestments during the [0,+1], [-1,+1], [-2,+2], [-15,-1], and [2,10] event windows. The investment and divestment samples consist of respectively 232 and 101 observations during the period January 2004 - July 2011. Daily abnormal returns are used in the Market and Risk Adjusted Returns model in which the MSCI World Index is used as market proxy. *** indicates significance at 1%, ** indicates significance at 5% and * indicates significance at 10%.

	Observations	Average	z-Statistic	Corrado
A) Investments				
[0,+1]	232	0.0129	4.5631***	3.6264***
[-1,+1]	232	0.0148	4.1853***	2.9064***
[-2,+2]	232	0.0081	1.4048*	1.1865
[-15,-1]	232	-0.0070	-1.0861	-0.4384
[2,10]	232	-0.0061	-0.8205	-0.9715
B) Divestments				
[0,+1]	101	-0.0104	-2.8958***	-3.0215***
[-1,+1]	101	-0.0124	-3.0146***	-2.5564***
[-2,+2]	101	-0.0140	-2.6137***	-2.3635***
[-15,-1]	101	0.0162	1.1963	1.2967
[2,10]	101	-0.0044	-1.2402	-0.6304

The impact of respectively 232 Fund investments and 101 divestment announcements on the abnormal returns on the share price of a target firm during the period January 2004 – July 2011 is shown in table 1 above. For the investment sample, share prices of firms receiving a Fund investment on average rise with 1.29% ($t=4.56$) during the [0,+1] event window. The results remain significant

when changing the window. The divestment sample has an abnormal return of -1.04% ($t=-2.90$) during the [0,+1] period. The [0,+1] results for both of the samples are also significant using Corrado's non-parametric test. Moreover, there are neither significant price run ups prior to the announcement of either an investment or divestment nor are there any significant post-announcement effects.

6. Announcement returns for investment transactions

Table 2: Share price reactions for subsamples on the announcement of a Fund Investment

The table presents the stock price reactions to announcements of Fund investments for several subsamples during the [0,+1] window. The full sample consists of 232 observations during the period January 2004 - July 2011. Daily abnormal returns are used in the Market and Risk Adjusted Returns model in which the MSCI World Index is used as market proxy. The last two columns present the results when testing for differences between means. *** indicates significance at 1%, ** indicates significance at 5% and * indicates significance at 10%.

<u>A)</u>	Observations	Average	z-Statistic	Corrado	Mean Test	Mann-Whitney U Test
Investments before 2008	98	0.0124	2.9598***	2.4426***	-0.0049	0.0110
Investments after 2008	134	0.0132	3.4729***	2.7705***		
<u>B)</u>						
Domestic Investments	78	0.0048	0.5575	1.0335	1.7436**	1.6153*
Foreign Investments	154	0.0169	5.2039***	3.5928***		
<u>C)</u>						
Domestic Investments before 2008	39	0.0079	0.1206	1.2097	0.2737	0.4897
Domestic Investments after 2008	39	0.0018	0.6678	0.2286		
<u>D)</u>						
Investments by Transparent Funds	50	0.0042	0.2635	1.2745	1.3288	1.1155
Investments by Opaque Funds	163	0.0162	4.7511***	3.4753***		

Panel A of Table 2 above shows that investments before 2008 result in abnormal returns of 1.24% for the [0,+1] window, while investments after 2008 have an abnormal return of 1.32%. However, the results are insignificant different for both the parametric or the Mann-Whitney U test. These findings therefore cannot offer support for the idea that the Fund investments after 2008 result in higher returns, because the market would look more favourable upon these investments.

Next, panel B presents the results of domestic and foreign investments. The foreign investments resulted in abnormal returns of 1.69%, which are significant at the 1% level for both the parametric and the non-parametric test. The domestic returns are lower at 0.48%, but insignificant. The differences are significant at the 5% level for the parametric test and at the 10% level for the Mann-Whitney U test. Therefore, foreign investments result in higher returns than domestic investments.

Based on the results in Panel A and B, it is not surprising that Panel C provides no empirical evidence indication that abnormal returns for domestic investments before and after 2008 are

different. These investments have not become more of a strategic nature since the crisis started.

Next, panel D shows that transparent and opaque Fund investments result in abnormal returns of respectively 0.42% and 3.12%. The results for the transparent Funds are insignificant, as are the differences between the two samples. The results provide therefore no support for the idea that investors value investments by transparent Funds more than investments by opaque Funds.

Other regression results are that first-time investments lead to an increase of 0.36% ($t=1.55$) of the firm value, whereas follow-up investments lead to an increase of 3.12% ($t=5.69$). The differences are significant at the 1% level. Also, first-time investments by opaque firms result in significant abnormal returns of 0.67%, whereas their follow-up investments result in significant abnormal returns of 3.71%. The differences are significant at the 5% level. Yet the differences between initial and follow-up investments by transparent Funds are not significant.

7. Announcement returns for divestment transactions

Table 3: Share price reactions for subsamples on the announcement of a Fund Divestment

This table presents the stock price reactions to announcements of Fund divestments for several subsamples during the [0,+1] window. The full sample consists of 101 observations during the period January 2004 - July 2011. Daily abnormal returns are used in the Market and Risk Adjusted Returns model in which the MSCI World Index is the market proxy. The last two columns present the results when testing for differences between means. *** indicates significance at 1%, ** indicates significance at 5% and * indicates significance at 10%.

A)	Observations	Average	z-Statistic	Corrado	Mean Test	MWU
Divestments before 2008	41	-0.0033	-0.1742	-0.7752	1.9604**	1.0062
Divestments after 2008	60	-0.0152	-3.6131***	-2.9995***		
B)						
Domestic divestments	51	-0.0041	-0.9692	-1.0196	1.3535*	1.5588*
Foreign divestments	50	-0.0168	-3.1368***	-2.8904***		
C)						
Domestic divestments before 2008	20	0.0072	1.2043	0.5925	1.7822**	1.6215*
Domestic divestments after 2008	31	-0.0114	-2.2105**	-1.7467**		
D)						
Divestments by Transparent Funds	55	-0.0081	-1.1456	-1.0154	0.9987	0.8204
Divestments by Opaque Funds	44	-0.0120	-2.5244***	-2.7443***		
E)						
Entire Divestments	47	-0.0144	-1.7132**	-1.9652**	0.3104	0.7047
Partial Divestments	54	-0.0069	-2.3620***	-2.1946**		

Table 3 above presents the results for several divestment subsamples. Panel A shows that divestments after 2008 result in significant abnormal returns of -1.52%, but the divestments returns of -0.33% before 2008 are not significant. This difference is significant when using the parametric test, but not when using the non-parametric Mann-Whitney-U test. This offers some support for the idea that investors look more favourable upon Sovereign Wealth Funds since 2008.

From 2008 onwards, domestic divestments could be an indication that the trust in the firms has been restored and that the presence of Funds is no longer required. However, panel B does not show that domestic divestments result in a stronger market reaction than foreign divestments. Furthermore, panel C shows that divestments before 2008 result in insignificant returns of 0.72%, whereas the divestments after 2008 lead to significant abnormal returns of -1.14%.

It is not true that divestments by transparent Funds result in lower abnormal returns than divestments by opaque Funds. According to the findings in Panel D, divestments by the latter Funds result in significant abnormal returns of -1.20%, but the divestments by transparent Funds (-

1.20%) are not significant and the difference between the two averages are also not significant.

Panel E shows that foreign divestments lead to significant abnormal returns of -1.68% and domestic divestments result in insignificant returns of -0.41%. The differences are not significant. The idea that the connection of the Fund with its government gives the target firm an advantage is false.

8. Cross-sectional analysis investment and divestment transactions

Table 4 below reports the multivariate regression results on the full Fund investment and divestment sample. Unfortunately, the explanatory power of both of the specifications of the two samples is rather low. In the investments case, *Size* is the only significant variable. However, the univariate regression results (available upon request) reveal that *Size* does not significantly influence the abnormal returns when it is tested for in isolation. Instead, *Floating Shares* is the only variable that does have a significant negative influence. The

findings imply that abnormal returns decline when there are more shares freely floating around,

contradicting the expectations.

Table 4: Regressions for the Investment and Divestment Samples

This table presents regression results for the Investment and Divestment samples. It shows the OLS regressions with the Cumulative Abnormal Periods during the event window [0,+1] as the dependent variable. The first specification includes all the variables and the second regression includes the variables that are significant. The first independent variable is *Stake*, which refers to the stake the Fund takes in a company. *Stake*² is the squared stake a Fund has taken in a firm. The *Size* of the target firm is measured by the log of the total market capitalization in billion US Dollars. *Net Debt Ratio* refers to the amount of net debt (measured by total debt minus cash) as fraction of total assets. *Sector* is a dummy variable that refers to the sector the target firm operates in. Firms that were assigned a 0 do not operate in a strategic industry, whereas firms assigned a 1 do. *Floating shares* is the fraction of liquid shares not being held by large shareholders on the day before the transaction announcement. *Home Market* is a dummy variable, where 0 and 1 represent respectively a domestic and a foreign Fund making an investment in a company. *Transparency*, which is based on the Linaburg-Maduell Transparency Index, is also a dummy variable, where 0 represents the Funds that have a transparency level that is lower than 8, and 1 represents the other Funds. The p-values, which are corrected for heteroskedasticity by using White's test, are reported below the coefficient estimates. *** indicates significance at 1%, ** indicates significance at 5% and * indicates significance at 10%.

	<u>Full Investment Sample</u>		<u>Full Divestment Sample</u>	
	<u>1</u>	<u>2</u>	<u>1</u>	<u>2</u>
Constant	0.1781 (2.2147)**	0.0340 (2.9499)***	-0.02958 (-0.4521)	0.0000 (0.0002)
Stake	-0.0799 (-0.6900)		-0.0847 (-0.8207)	
Stake²	0.0304 (0.1629)		0.1793 (1.1318)	0.0600 (2.2699)**
Size	-0.0138 (-1.8100)*		0.0029 (0.4468)	
Net Debt Ratio	-0.0173 (-1.0598)		-0.0157 (-0.7604)	
Sector	0.0008 (0.091)		0.0065 (0.5722)	
Floating Shares	-0.0222 (-1.1859)	-0.0265 (-1.7004)*	-0.0324 (-2.3873)***	-0.0334 (-2.7608)***
Home Market	-0.019 (-1.0690)		0.0265 (2.7395)***	0.0164 (1.8303)*
Transparency	-0.0115 (-0.7051)		0.0036 (0.3889)	
Observations	165	206	66	80
Adjusted R-Squared	0.0155	0.0087	0.1023	0.0752
F-Statistic	1.3237	2.8044***	1.9254*	3.1425**

In the divestment case, *Stake*², *Floating Shares*, and *Home Market* have significant coefficients when tested in isolation (results available with the authors upon request). In case of *Stake*², the coefficient in the second specification remains positively significant at the 5% level. These findings indicate that larger divestments are associated with a less negative market reaction.

The variable *Floating Shares* remains negative and significant at the 1% level. These findings indicate that the more shares not held by

large shareholders, the stronger the market reaction. So, there are more other large shareholders with fewer shares freely floating around. These shareholders might also undertake monitoring activities, and the departure of the Fund might therefore have less impact.

Lastly, the coefficient of *Home Market* is positive at the 10% level. Therefore, domestic divestments result in a less strong market reaction.

9. Conclusion

During the last few years, Sovereign Wealth Funds have started to play an important role in the global financial markets and they have grown bigger than the hedge fund and private equity market combined. This rapid growth has attracted a lot of political and media attention, since many countries consider the government-controlled Funds to be a threat to domestic industries. However, the academic world has only provided limited research on the Funds.

In this article, we investigated 232 investments and 101 divestments in public firms that were undertaken by Funds in the period January 2004 – July 2011. We find that share prices of firms receiving an investment from a Fund rise significantly with 1.29% during the [0,+1] window. Similarly, divestments result in abnormal returns of -1.04% during that same period. These results are robust.

The positive (negative) market reaction on the announcement of a Fund investment (divestment) confirms other studies and indicates that the market expects the investing Funds to add value to the target company. Since the Funds usually take significant stakes, investors expect the Funds to improve the corporate governance of the target firm by means of monitoring.

Additionally, we do not find that opaque Funds are thought to pose more threat to investors than transparent Funds. Yet, subsequent investments by opaque Funds result in higher returns than first-time investments. Existing investors are unsure about the initial purpose of opaque Funds, but once realizing that no harmful actions follow, they welcome follow-up investments. Moreover, we do not show that investors value transactions by foreign Funds less than domestic ones.

Based on these findings, it cannot be concluded that the Funds pursue strategic objectives that have a negative impact on a target company. On the contrary, based on the market reaction, it is likely that investors expect the Funds to act as financial entities that pursue financial goals.

Additionally, we also investigated whether the attitude towards has changed since 2008, but we did not find significant differences between the period returns. However, in case of divestments, evidence was found divestments after 2008 result in a stronger market reaction than before. This offers some support for the idea that investors look more favourable upon the Funds since 2008.

Moreover, in case of investments, we find a negative relation between free floating shares and abnormal returns. The abnormal returns decline when large shareholders hold fewer shares. However, in case of divestments the market reacts stronger when more shares are freely floating.

Our findings imply that investors, governments, and target firms should not worry

about the Funds. Rather, they should favour Fund investments, since these create value by means of monitoring activities. Also, by taking stakes in a target firm the Funds can show trust when liquidity evaporates on the global financial markets.

Overall, because of their expected growth, Funds become important players in the financial world that gain a lot of influence by taking significant stakes in firms. The media-voiced fear for the Funds is understandable, but it lacks evidence. Investors do not expect the Funds to intend to acquire strategic stakes; their primary objective seems to be related to value maximization. Firms may therefore want to attract them, being liquid investors. So indeed, Sovereign Wealth Funds can be good for funding.

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