Sovereign Wealth Funds: Perceptions and Realities*

Robert C. Pozen

Thank you for that lovely introduction. Sovereign wealth funds are definitely in the news. We have read story after story in the papers that sovereign wealth funds have recapitalized a number of American and European financial institutions. These include UBS and Merrill Lynch where the Korean sovereign wealth fund helped buy some securities to help recapitalize Merrill Lynch.

It is surprising, given all the capital that has flowed from these funds to U.S. financial institutions, how much criticism there has been of sovereign wealth funds. And this criticism has not only come from American policy makers but also from Europe. We hear almost every week a new reform proposal – critics want to make sovereign wealth funds abide by a code of practice or require that they make more disclosures.

So I will start off by reviewing some of the opinion and survey data we've seen concerning the perceptions of sovereign wealth funds, particularly in the U.S. I will then analyze what I consider to be the realities of sovereign wealth funds, broken down into five main areas: the source and size of sovereign wealth funds; their projected impact on the capital markets; concerns about their intruding into security and political matters; concerns about their impact on trading and market stability; and lastly, issues of protectionism and reciprocity.

So let me begin with a recent survey that was done among Americans. Now one of the incredible findings from this survey is that Americans know very little about sovereign wealth funds. In this survey only 6% of the respondents said that they had seen or heard anything recently about sovereign wealth funds. Yet they have strong negative feelings against sovereign wealth funds, even though they admit to knowing very little about them. Seventy-two percent of respondents say that sovereign wealth funds don't reveal enough about where and how they are investing. Sixty-eight percent say that when sovereign wealth funds buy shares in U.S. companies, this gives them too

* Transcription of a speech given at the IGE/Prudential Lecture on International Finance on Tuesday, March 25, 2008

much power. And 67% say that sovereign wealth funds pose a risk to western countries' national security.(Figure 1>)

<Figure 1>

Public Opinion on SWFs

Please rate how much you agree or disagree with each of the following statements:

	Agree	Disagree	Net Agree
Foreign governments currently own or control large amounts of debt owed by our government, and letting them also buy stakes in U.S. companies gives them even more leverage over America's financial security.	72	12	+60
Foreign governments don't reveal enough about where they are investing their money or the size of stakes they have in U.S. companies.	72	11	+61
Allowing foreign governments to buy shares in U.S. companies gives them too much power in our marketplace.	68	21	+47
Allowing foreign governments to buy stakes in U.S. companies could compromise our national security.	67	20	+47

Source: Public Strategies, Wall Street Journal, 2/21/08

We hear this same sentiment in Germany. Ms. Merkel said that "state-owned funds have political-strategic aims that could be problematic in sensitive areas." She added, "This is a new phenomenon that we must tackle with some urgency." Similarly, Mr. Sarkozy proclaimed: "There is no question of France remaining unable to react and to face the rise of power of extremely aggressive sovereign wealth funds. France must protect the companies and give them the means to develop and defend themselves."

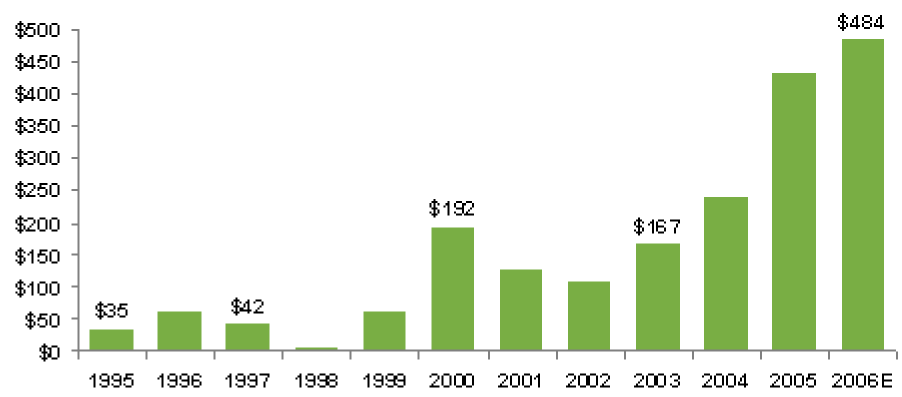
Turning from perception to reality, the first thing we should know is that sovereign wealth funds have been around for twenty or thirty years. And most of them were begun by countries, at the urging of the IMF, in order to diversify and stabilize the flow of oil revenues. In fact two-thirds of all sovereign wealth funds derive most of their money from oil. Between 2000 and 2006, the net capital outflows from these oil-producing countries totaled $1.7 trillion.(<Figure 2>) This is much larger than the amounts in prior years. Obviously, this sharp increase has a lot to do with the price of oil going over $100 a barrel. This is one of the key factors driving the growth in sovereign wealth funds.

<Figure 2>

Oil Producers

Net Capital Outflows from Oil-Producing Countries with Petrodollar Assets

($ Billions)

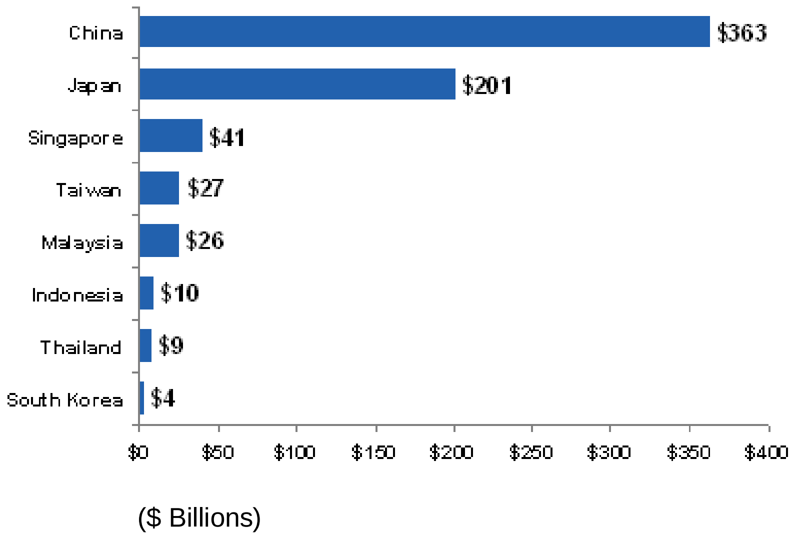


Source: McKinsey Global Institute, 2007; *New York Times*

The second factor driving the growth of sovereign wealth funds, and more relevant to Korea, is the large trade surpluses which have been accruing mainly in the Asian countries. In the statistics on trade surpluses for 2007(<Figure 3>), China leads the way, with Japan next and other countries in Asia showing significant surpluses. These countries have allocated some of these trade surpluses to start up sovereign wealth funds. In China's case, which has the largest reserves of $1.4 trillion, it transferred $200 billion U.S. dollars to its sovereign wealth fund and it already has a social security fund investing in stocks and bonds. Korea, as is well known in this room, established a sovereign wealth fund in 2005 and funded it with $20 billion U.S. dollars. At this time, Korea has foreign reserves of $247 billion U.S. dollars.

<Figure 3>

Asian Trade Surplus



Source: McKinsey Global Institute, 2007; *New York Times*

There is also a third source for sovereign wealth funds: countries channeling retirement contributions into these funds. These countries include Canada, New Zealand and Singapore.

So we have three basic sources of sovereign wealth funds. The largest are the commodity funds, led by the UAE followed by Norway, Saudi Arabia, Kuwait, Russia and Libya. The other category includes both the trade surplus and pension funds: the largest being Singapore with two funds and China with two funds, followed by Hong Kong and Australia. In total, the assets of sovereign wealth funds at the end of 2007 were at least $2.5 trillion.(<Figure 4>)

At this time, the U.S. and Europe are experiencing a financial crisis and much of the capital to help their financial institutions is coming from the sovereign wealth funds in the emerging markets. In general, industrialized countries export capital to emerging markets, but here the emerging markets (with the exception of Norway) are producers of oil and they are the surplus countries. So these investments have been very positive for these Western financial institutions. Yet it is these recapitalizations of Western banks and brokers – over $100 billion in the past year – that have intensified the debate about sovereign wealth funds.

<Figure 4>

Major SWFs by Region, Source & Size

FUNDING SOURCES

Commodity/Oil
United Arab Emirates – $875B
Norway – $322B
Saudi Arabia – $300B*
Kuwait – $250B
Russia – $127B
Libya – $50B

Trade/Pensions
Singapore – $438B*
China – $300B*
Hong Kong – $140B
Australia – $50B

Multiple funds

Source: Deutsche Bank, September 2007

Having reviewed what we know so far about sovereign wealth funds, let us now delve into the second and more difficult set of questions on what we can project in terms of the growth of sovereign wealth funds and their possible impact on capital markets.

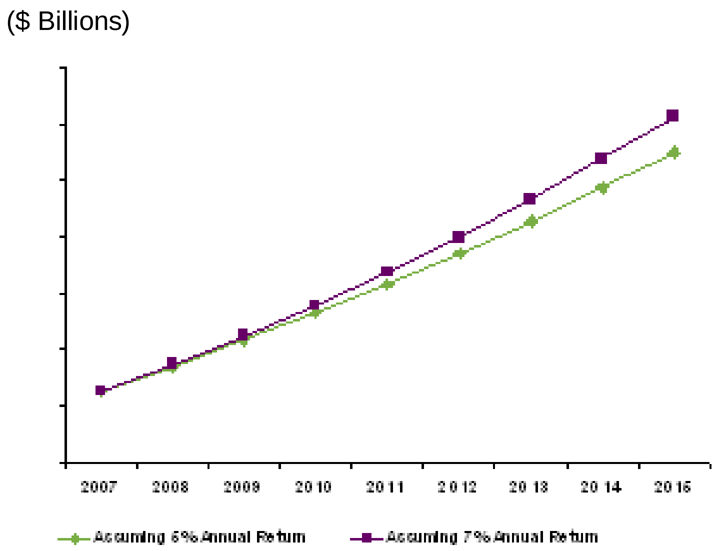
I will say by way of preface, especially for those of you who are professors of economics, that we are looking at first order effects because we cannot accurately predict second order effects. Nevertheless, it will be helpful to get a sense of the direction and magnitude of possible growth. Here I am starting at $2.5 trillion U.S. dollars as the total assets of sovereign wealth funds, and I am making the assumption that as in 2007, there will be roughly $728 billion of new reserves added to the global system.(<Figure 5>)

In my view, every country with a sovereign wealth fund, whether it be an oil producer or a trade surplus country, is already over-reserved. That is, they over-reacted to the Asia financial crisis by building up more reserves than they need to defend their currency. While I am not assuming that any country is going to take its existing reserves and transfer them to sovereign wealth funds, I am assuming that because these countries are already over-reserved, all new incremental reserves will be transferred to sovereign wealth funds.

<Figure 5>

Asian Trade Surplus

(Asset estimates assume $728B in yearly incremental add to SWFs)



Source: McKinsey Global Institute, 2007; *New York Times*

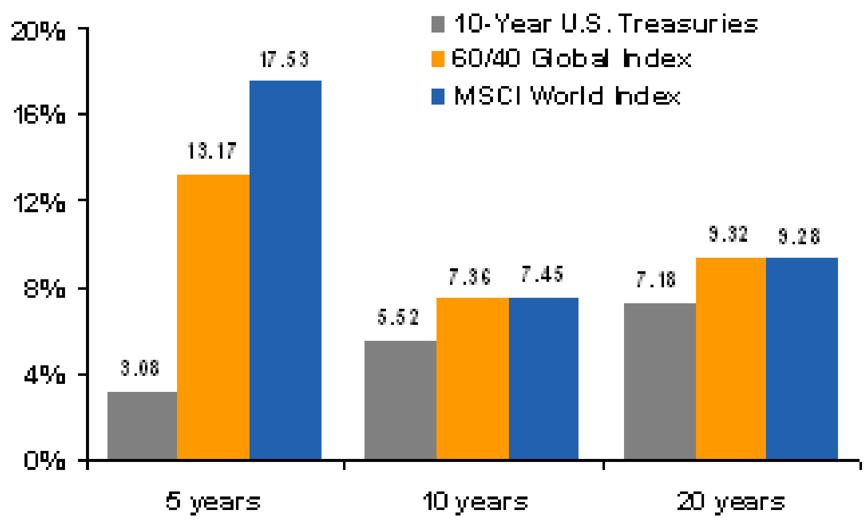
Thus, we start at $2.5 trillion and we add $728 billion in reserves every year until the end of 2015, and we assume a modest return of 5% or 7% a year, so we get to $11 or $12 trillion by the year 2015. My calculations are consistent with those that have been done by other economists, though everyone has their own methodology. So I think it is a reasonable estimate that these funds will have roughly $11 trillion in 2015.

The monies now in sovereign wealth funds were previously held in central bank reserves and invested mainly in U.S. Treasuries – which over the last five years have returned roughly 3% per year. Meanwhile, the returns of a global stock index over the same period were 17% per year and the returns of a 60-40 portfolio of global stocks and bonds were 13% per year.(<Figure 6>) Thus, governments are trying to obtain a better return on this huge buildup of reserves, especially when they exceed the amount needed to defend their national currency. Of course, the U.S. Treasury portfolio would be less volatile from year to year than a stock or balanced fund, but that does not really make a big difference here because these sovereign wealth funds are investing over a time horizon of twenty to thirty years.

<Figure 6>

Return Comparisons

Annualized returns for the periods ending 12/31/2007



Past performance is no guarantee of future results.

Source: MFS. The 60/40 Global Index is a blend of the MSCI World Index (60%) and the Lehman Brothers Global Aggregate Index (40%).

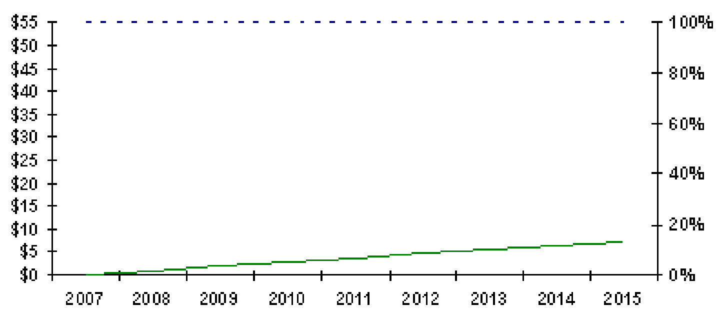
It is not possible to invest in an index.

I will suggest that a model portfolio for a sovereign wealth fund might look like this: 50% in stocks (other than emerging stocks), 20% in bonds (other than emerging market bonds), 6% in emerging markets stocks and bonds, 6% in alternative investments, 6% in commodities and 12% in real estate. That is the sort of portfolio that we see in the sovereign wealth funds where we know what their asset allocations are.

What are the implications of that model portfolio for the capital markets? If we say sovereign wealth funds are going to have $11 trillion in 2015 and 50% will be in stocks, that is about $5.5 trillion in stocks (other than emerging market stocks). The total market capitalization of all publicly traded global stocks is currently somewhere between $50 and 60 trillion so I am using $55 trillion as a midpoint.(<Figure 7>) Will the stock market keep growing between now and 2015, or will it be contracting or staying the same? In fact, the stock market has been contracting over the last 5 years. It has been contracting because of a combination of mergers, buybacks and going private transactions that have offset IPOs. Therefore, I am assuming that the size of the global stock market will remain flat until 2015. As a result, sovereign wealth funds will hold roughly 10% of the global stock market in that year. Is that a good thing or a bad thing? One possible hypothesis is this: if you look at the demographics of the industrial world, its citizens are getting older and the population is moving away from stocks into more bonds. So it can be argued that this influx of stock investments from sovereign wealth funds is coming just in time – just as the Baby Boom generation in the U.S. and Europe starts to retire around 2011.

<Figure 7>

Supply and Demand for Stock



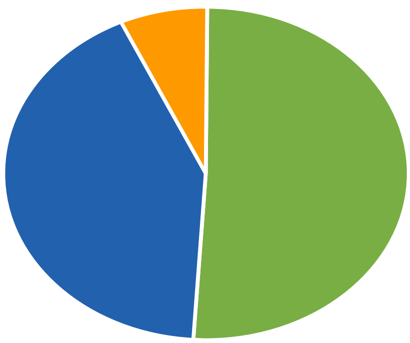
Source: Citigroup, Bloomberg.

Turning to bonds, returns for AA bonds and for high-yield bonds are significantly higher than the yields on U.S. Treasuries. We can predict that as monies flow to sovereign wealth funds, they will not invest in U.S. Treasuries but into diversified portfolios of higher yielding bonds. So I am estimating that 20% of sovereign wealth funds will be allocated to non-government, non-emerging market bonds -- or about $2.2 trillion in 2015. Then I have to make some assumptions about where the bond markets will be in 2015, so I looked at their growth over the last eight years. All these bond markets have roughly doubled in the last eight years. If we assume they will double again by 2015, we get the amounts shown in the graph. Under all those assumptions, we can estimate that sovereign wealth funds in 2015 will have roughly 10% of the corporate bond market, 9% of the securitized bond market and 7% of the high-yield bond market.(<Figure 8>)

<Figure 8>

Supply and Demand for Bonds

Non-Government Global Bond Market 2007 and 2015 Estimates



Sources: MFS, Merrill Lynch. 2007 data as of 12/31

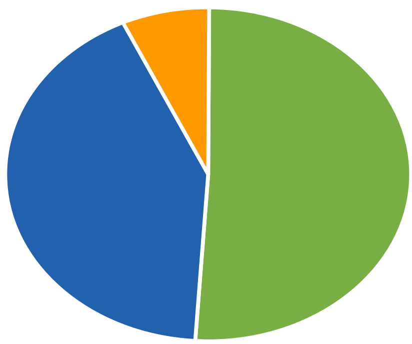
I have kept emerging markets stocks and bonds in a separate category. This is an area where most American and European pension managers have been very shy so we see only somewhere in the area of 3% of pension assets invested in emerging market securities. However, if you were mainly in emerging markets stocks over the last 3, 5, or 10 years, you would have been an investment genius. And the returns from emerging market bonds were also excellent during these periods.

Sovereign wealth funds are likely to have a total of 6% in emerging market securities rather than 3% because many of these funds are located in emerging markets – so they are comfortable with emerging markets securities. If we assume that 5% of sovereign wealth funds' assets will be invested in emerging markets stocks, that comes to about 10% of that stock market in 2015. If we assume that 1% of these funds will be invested in emerging markets bonds, which is a much smaller universe than emerging markets stocks, that would be about 12% of that bond market in 2015.(<Figure 9>)

<Figure 9>

Emerging Markets – Stocks and Bonds

2007 and 2015 Estomates



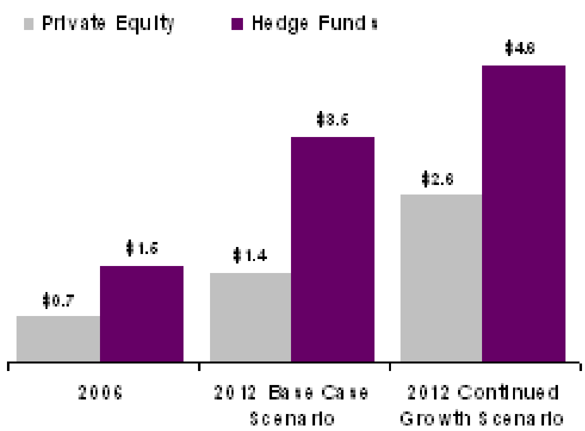
Source: MFS, 2007 data as of 12/31

Another area is alternative investments such as hedge funds and private equity funds. We know that alternative investments have been favored by various sovereign wealth funds -- they seem to like to invest in them, and they feel comfortable with them. Looking at growth statistics, sovereign wealth funds in 2012 will be about $7.7 trillion in size. The graph shows the growth estimates for hedge funds and private equity funds by 2012. If we make the assumption that 6% of sovereign wealth fund assets will be invested in hedge funds, that is $450 billion, and that will be a little over 10% of the hedge fund universe in 2012. If we assume that 3% of sovereign wealth fund assets will be invested in private equity funds, again that would be about 10% of the private equity universe in 2012.(<Figure 10>)

<Figure 10>

Alternative Investments

($ Trillions)



Source: McKinsey Global Institute. October 2007.

Once again, I do want to stress that with all of these projections, these are first order estimates only. Once prices adjust, there will be a second order effect – but it is virtually impossible at this point to predict second order effect trends with any accuracy.

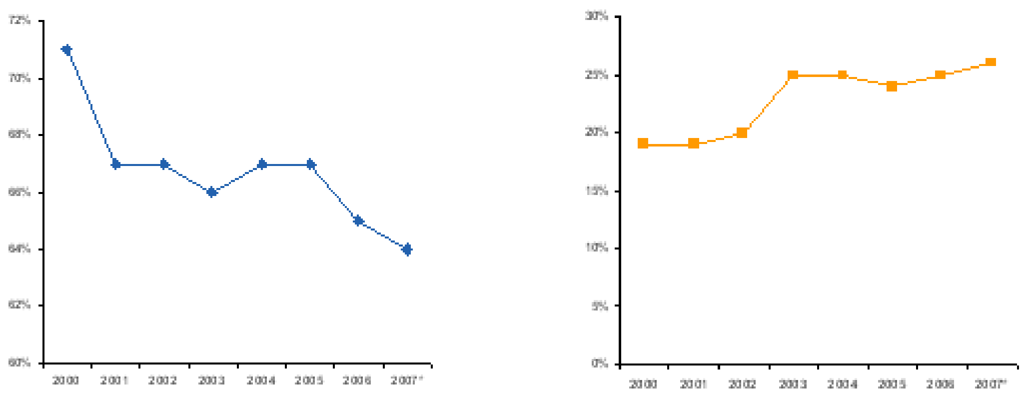
The last aspect of this set of projections is currency movements. Here, it is likely that currency implications will be negative for the U.S. dollar as a result of the growth of sovereign wealth funds. We can see from the chart that, over the last seven years, the composition of central bank reserves has moved substantially against the U.S. dollar in favor of euros.(<Figure 11>) And we would predict that, given the very high percentage of central bank reserves that are in U.S. dollars, the sovereign wealth funds would tend to invest in a more diversified basket of currencies. But there are two important caveats. One is that many countries, including Korea, want to keep the U.S. dollar strong and keep their currency relatively weak to promote their exports to the U.S. Therefore, we may find certain countries increasing their dollar reserves in order to strengthen the U.S. dollar against their local currency for trade reasons.

<Figure 11>

Currency Movement

% of Central Bank Reserve Investments in U.S. Dollars & Euros

Dollars **Euros**



Multiple funds

Source: Deutsche Bank, September 2007

Second, as we all know, oil is now denominated in dollars. But we had the first non-dollar contract coming out of Venezuela, not surprisingly, where an oil contract was denominated in Euros. So this is another factor, which can have a huge effect on currency movements. If oil producers move out of U.S. dollar contracts to more contracts denominated in a basket of currencies, this would be adverse for the dollar.

In summary, it is reasonable to project that if sovereign wealth funds grow to $11 trillion by 2015, they are likely to hold between 7% and 12% in many asset categories. The question is, what does that mean? Let's put this in perspective. Right now, pension funds and mutual funds hold roughly $18 trillion each in assets, so by 2015 they could each easily hold $30 trillion. Under these projections, sovereign wealth funds will only be one-third the size of those two types of financial intermediaries, but sovereign wealth funds would be more concentrated in a smaller number of entities.

These statistics bring us to the third and final portion of my presentation – the policy questions raised by the growth of sovereign wealth funds. To begin with, critics have questioned whether sovereign wealth funds can simply take over the defense and energy-related sectors in the United States. The answer is no. The US has had a law on its book for a number of years called Exon-Florio, and this has been recently amended in two important respects. The types of industries covered were expanded to include “homeland security” and infrastructure, which includes energy and communications. The approval provisions were also extended in time to become “evergreen” -- which means that once your transaction is approved, they can still go back and reopen the inquiry. So every foreign transaction that involves more than 10% of a U.S. company in any of these industries -- security-related, energy-related or infrastructure -- has to be approved by a governmental committee headed by the U.S. Treasury. As we have seen in a number of recent cases, such foreign acquisitions have periodically been turned down by the U.S. government.

There are also specific industries in the United States where foreign ownership is strictly capped. In domestic aviation, for example, at least 75% must be controlled by U.S. citizens; and the same limit applies to shipping. With radio and TV licenses, no more than 20% may be owned by foreigners; as to nuclear power facilities, no foreign ownership is allowed. In addition, the Federal Reserve has elaborate procedures in place to approve or disapprove any foreign purchase of 10% or more of a U.S. bank or U.S. bank holding company.

Although these sensitive industries cannot be taken over by foreign sovereign wealth funds without governmental approval, critics still argue that these funds are likely to produce a misallocation of global resources for one of three reasons. The first is that sovereign wealth funds will promote “national champions”. But how are they going to do that? If sovereign wealth funds try to make huge acquisitions, they will be limited by anti-trust laws. Alternatively, suppose a company prices its products below market to gain a dominant position. While that will help the growth of the company, it will also lose a lot of money. Moreover, the company would be subject to anti-dumping and predatory pricing rules.

The second argument is that sovereign wealth funds are really a guise for countries to obtain geopolitical dominance. For example, will Russia's sovereign wealth fund purchase gas transmission lines in Western Europe? It is possible that such purchases could be viewed as threatening to France or Germany, but they are very capable of requiring special government approvals in the energy or defense areas. More broadly, special approvals may be required in any industry by any country where geopolitical dominance is at issue.

Third is the general question of allocation efficiency – the allegation being that these sovereign wealth funds are going to invest for political reasons and not financial goals. But most of these funds are managed by investment professionals. Moreover, would countries be using their reserves more efficiently by investing in local projects rather than investing globally through sovereign wealth funds? If countries put their excess reserves in "white elephants" locally, that would truly be a misallocation of resources.

A separate set of arguments relates to market instability. Various people have argued for guidelines that would prevent sovereign wealth funds from causing sharp swings in securities markets. However, if you are a big institutional investor, the last thing you want to do is buy and sell very quickly because you will incur tremendous transaction costs. Recently, some financial institutions in the U.S. and Europe have been forced to sell assets because of liquidity pressures. This is what we have seen recently in the mortgage market. However, sovereign wealth funds have minimal leverage, and most have no redemption demands. So it is hard to imagine them coming under liquidity pressures to sell quickly.

The Chairman of the SEC has recently argued that host countries of sovereign wealth funds may not cooperate in insider trading cases involving these funds. But there is no evidence to support that argument so far, despite active trading in public shares of enterprises where the country still owns the majority of the shares. Similarly, Chairman Cox has expressed concern that governments will give state secrets to sovereign wealth funds so they can trade on this information. Again there has been no evidence so far that state secrets have been given to these funds. If this did happen several times, regulators would likely notice the trading pattern and stop the leaking of state secrets.

Next we come to the crux of the matter -- transparency. You cannot read a paper on sovereign wealth funds without the word transparency showing up. But what does transparency mean in this context? More disclosure? And if so, to whom and about what?

When we talk about disclosure of investment returns or strategies, we are usually talking about disclosures by the manager to its clients or beneficiaries. Here the beneficiaries are the citizens of the country represented by the Ministry of Finance in most cases. Is there any doubt that the Ministry of Finance is receiving enough information about the investment returns and strategies of these sovereign wealth funds?

In fact, most of the proposals are aimed at disclosures to other participants in the securities markets. For instance, how do we know that sovereign wealth funds won't be secretly buying up a lot of stock in public companies to obtain control on the sly? The answer is that if any sovereign wealth fund, alone or acting in concert with someone, acquires 5% or more of any equity class of any publicly traded company, the sovereign wealth fund must make a public report to the SEC. If the target is a private company in the U.S. and a foreigner acquires more than 10%, the sovereign wealth fund would still required to make filings with the U.S. Treasury.

What is not being disclosed that needs to be disclosed? A list put together by the European Union includes how fund managers relate to government officials, how the home country regulates its sovereign wealth fund, and how the internal controls and risk management policies of a sovereign wealth fund operate. But these public disclosures are not required of a hedge fund or private equity fund in which a sovereign wealth fund may invest.

In addition, the European Union wants sovereign wealth funds to disclose their investment objectives, asset allocation and currency allocation. One commentator has even suggested that, before a sovereign wealth fund changes its asset or currency allocation, it needs to discuss this prospective change with relevant countries. But no investor should be required to give advanced signals as to where they're going to invest in the future. Instead, it may be reasonable for sovereign wealth funds to produce and distribute an annual report of their largest holdings, but not until February of the subsequent year.

Finally we have the argument on backlash. U.S. Treasury Secretary Paulson has said that if sovereign wealth funds continue to make big investments in the U.S., there will be a protectionist backlash among Americans. And he may be right, given the survey results we saw at the beginning of this talk. But is anybody trying to educate the American public about the positive aspects of investments by sovereign wealth funds -- how they are helping to recapitalize financial institutions, how they are helping to lower interest rates, and how they are helping to increase demand for U.S. stocks?

One possible solution is reciprocity. President Sarkozy of France said recently: “I believe in globalization but I don’t believe that sovereign wealth funds can buy anything here and our own capitalists can’t buy anything in their own countries. I demand reciprocity before we open Europe’s barriers”. The U.S. should insist on reciprocity from the countries sponsoring sovereign wealth funds. If these funds are allowed to buy certain types of companies in the U.S., then U.S. investors should be able to buy similar companies in the home countries of these sovereign wealth funds.

Recently, officials of certain sovereign wealth funds rejected the idea of a special code of conduct for their funds. But last week Abu Dhabi and Singapore signed off on an investment code with nine principles. They pledged not to use their investments as foreign policy tools, and solely to maximize risk-adjusted returns. At the same time, they don’t want to be discriminated against if they play by the rules.

So what can we conclude?

Sovereign wealth funds are now major players in the global capital markets and they are going to become even more important in the future. But there are lots of misperceptions about these funds. There are procedures in place to prevent them from buying security-related companies without prior approval. If their intent is to dominate within strategic industries, they will have many obstacles to contend with. Also, everything we’ve seen thus far indicates that they are not likely to destabilize securities markets, and are unlikely to trade on inside information without being caught.

However, we do need a good analytical discussion about disclosure. What are sovereign wealth funds disclosing now and what more needs to be disclosed? We should also come to a global agreement on reciprocity. Reciprocity is a policy tool that could be used to defuse some of the political backlash over investments by sovereign wealth funds in U.S. companies.

Questions & Answers

Q Thank you for your exciting presentation of sovereign wealth funds. Now that you have debunked most of the irrational fears of sovereign wealth funds, I believe that the underlying issue is the fear of a loss of control to a few. Since 1948, the Western powers have controlled world affairs, but small powers can now exert control -- it is in the hands of those that they do not know. And this is the real issue. Regardless of whether it is the oil power or Russian power, the world is moving into the autopilot system. There is no central control system because a huge amount of money is moving around. Isn't that the basic issue -- they don't have the ability to control this $11 trillion moving around?

A Thank you for that question. First, I tend to agree with you that the more general underlying concern involves a potential loss of control of the international finance system and that we are struggling to regain control. And second, if there is a shift in the balance of power, these sovereign wealth funds represent a serious player that Europe and America must take into account. If these are the concerns, they will not be met by more disclosure by sovereign wealth funds.

The problem is we have a global market with securitized assets spread all around the world. In my view, the biggest challenge in the current fiscal crisis is that we don't know where most of the losses are -- they keep popping up in unusual places. The solution to this problem does not lie with sovereign wealth funds. We need to change the accounting rules for off-balance sheet entities and the disclosure rules for contingent obligations to these entities. When you see a bank suddenly take $40 billion of off-balance sheet assets and liabilities on to its balance sheet, that's disconcerting to investors.

Q Mr. Pozen, I am sure we have a lot of exciting investors here. But I am not sure if the

$55 trillion as the total flat level of all the stock markets is very encouraging. We all hope that the indexes are going to go up. So when you say that the stock markets have actually been contracting, it is depressing. Would you like to elaborate on that?

A If we look over the last five years, we see first a tremendous amount of activity in mergers and acquisitions, and second a lot of activity in going private transactions, and third a lot of stock buybacks. If we put that all together, the amount of stock taken out of circulation exceeds the amount of new shares generated through IPOs. So I think there is a consensus that, over the last five years, the global supply of stock has actually contracted a little.

Now I cannot guarantee you that the supply of global stock will stay flat until 2015. I was using the assumption that said that if it stayed flat, the total market capitalization would be $55 trillion. Under that assumption, sovereign wealth funds are likely to own 10% of the global stock market in 2015. However, if the stock market doubles in size by 2015, everyone will like that and sovereign wealth funds will hold a much smaller percentage of the global stock market.

I think this is the problem you have when you engage in these predictions. As many professors know, you have to make some assumptions. But what I have been doing is looking back over the last five to eight years and seeing what happened and assuming, in a naïve way I admit, that similar trends will occur going forward. As I mentioned, it's impossible to predict with any degree of certainty these growth projections.

Q Good morning. We have had a lot of news out of Wall Street over these past couple weeks. We've had Bear Stearns being bought by JP Morgan, and we've had better than expected quarterly earnings announced by investment banks like Goldman and Lehman. We've wondered how this would affect the investment decisions of sovereign wealth funds in the financial sector given what we know about their investment tendencies. How would they react to all these incidents?

A Sovereign wealth funds that invested in Bear Stearns, Citigroup, or UBS have not done very well with these investments over the past year. So sovereign wealth funds may be reluctant in the near future to invest in troubled financial institutions. These funds are trying to obtain reasonable returns over a long time horizon. The big advantage sovereign wealth funds have is that they can hang onto a stock for five, ten or fifteen years; they are not subject to the pressures that other managers are to produce short-term returns. We will have to wait and see whether these investments in financial institutions will turn out to be good ones over many years.

Sovereign wealth funds are not going to invest in "national champions" and lose money; and they are not going to bail out financial institutions and keep losing money. If they lose money, the government would be upset and rightly so. These funds want to get better risk-adjusted returns through a more diversified portfolio than holding mainly US Treasuries.

Q We have recently seen these funds going into the commodity market and this has created some huge volatility. Can these funds be allowed to invest in the commodity markets and drive up prices?

A When I suggested a the model portfolio for sovereign wealth funds, I included a 6% chunk for commodities because I think we should all learn from the Yale and Harvard Endowment that to have a truly diversified portfolio, you need to hold commodities as well as stocks and bonds. Over the last couple years, as we all know, commodity prices have generally been driven up by the surging demand in China and other parts of the world. Whether this trend continue will depend mainly on what happens to the economies of the world – in terms of the demand for these commodities, and whether at these prices someone will be smart enough to develop reasonable substitutes. Thus, I think that sovereign wealth funds should not be deemed the main cause of price rises in commodities.

Q Thank you for your talk today. I learned a lot. A few months ago, I met a British official and he raised the ethical question that sovereign wealth funds are basically playing with tax funds. I wondered your take on that. And South Korea is talking about expanding its sovereign wealth funds and there are concerns about the ethical aspects of such investing. So I would like to hear your advice about that, too.

A Sovereign wealth funds are funded by oil revenues, exchange reserves derived from trade, or pension contributions. I don't know of any country that has imposed a tax on its citizens and put the tax proceeds into sovereign wealth funds. It is true that governments are choosing to put monies into sovereign wealth funds rather than in public expenditures. But that is an internal decision that each government should make for itself within its own political process.

On the ethical front, we do have one sovereign wealth fund in Norway where the Parliament has adopted ethical guidelines. I have actually written a case study on this subject for Harvard Business School, which is available through its publishing arm. The case describes in detail the ethical guidelines of the Norway Fund. That Fund excludes companies that manufacture certain sorts of weapons. Those are fairly clear criteria. But there is a second set of criteria relating to human rights violations. The Fund may not invest in a company that is a serious violator of human rights. But those terms are not well defined and have proved to be quite controversial.

So far I have not seen other sovereign wealth funds drawing up ethical guidelines for investing. The Norway model has not been followed. However, if the parliament or the government decides that its sovereign wealth fund should follow a particular set of ethical values, that could be done. I just hope that the criteria will be precisely defined.

Q When sovereign wealth funds are coming into the Korean stock market, do you think that they could cause volatility? If you could give advice to the Korean government as to how to better manage sovereign wealth funds, do you think they should be more conservative or do you think it should be allowed to be more aggressive?

A Let me answer your first question, which seems to be: If other sovereign wealth funds start investing in the Korean stock market, will that market become more volatile? My view is that sovereign wealth funds tend to be long term investors, so they are not moving in and out of a stock every day like hedge funds. Since sovereign wealth funds are big, they would incur high transaction costs if they moved in and out quickly. So I would think that to the extent that other sovereign wealth funds invest in the Korean stock market, they will not cause a sharp rise in daily volatility of stock prices.

Now the second question about whether Korea should have a more conservative or aggressive portfolio in its sovereign wealth fund. I think you have to look at the government's total portfolio. Korea holds almost $250 billion in reserves, which have been invested mainly in U.S. Treasuries. So from the perspective of the whole portfolio of the Korean government, it seems reasonable to have its sovereign wealth fund invest $20 billion in stocks and corporate bonds.

Moreover, I am reluctant to use words like "aggressive" and "conservative". What do they really mean? What you really want is good diversification. You don't want to have a huge concentration in one company, and you don't want to have investments that are all in small companies or all in large companies. If you mean by "conservative" putting all assets into bonds, I think that is probably a mistake. For a long-term investor, stocks generally have higher returns than bonds. In addition, the Korean government is already holding a large amount of conservative bonds. In short, the Korean sovereign wealth fund should invest prudently in light of the whole portfolio of the government and should have a significant amount of stocks in a diversified manner.

Q As far as I am aware of, when the Korean government created the sovereign wealth fund, it had two objectives. One was to increase the yield of foreign exchange reserves and the other was to use the sovereign fund to make Korea an international financial center. One objective is based on financial reason but the other one is a policy issue. So I wondered your opinion on this.

A I think the first objective is quite reasonable for the sovereign wealth fund. However, if Korea wants to be an international financial center, it has to compete directly with Singapore, Hong Kong, Tokyo and other places. I am not sure the sovereign wealth fund is the best policy tool to achieve that second objective. To become a major financial center requires a broad range of measures such as tax credits and employee training. I am not an expert on this subject, but it seems a little unrealistic to put too much weight on sovereign wealth funds as a vehicle to make Korea an international finance center.

Q I think that the chief threat for sovereign wealth funds is financial protectionism. So in some sense, sovereign wealth funds from emerging economies have played a grand rescue role in investing. However, the more sovereign wealth funds there are, the more protectionist backlash there will be to them. What do you think of this? Until Asia and the U.S., or East and West, even out the surpluses and deficits in their current accounts, the sovereign wealth funds will not go away. But suppose there was some balance between the East and West, what would happen?

A If there were an evening out of trade surpluses and deficits among countries, then would we still have sovereign wealth funds? To begin with, I am not sure that such an evening out is likely to happen in the near future. The imbalances are there for basic economic reasons that will probably continue to apply. The imbalances may narrow as we have changes in currency values, but all current signs seem to indicate that they're not likely to vanish. Second, as I've said, two-thirds of sovereign wealth funds are funded through oil revenues. These are not closely related to general trade issues.

So financial protectionism is probably going to remain a problem. In my talk, I've suggested a response through a mutual reciprocity policy. Here is another idea: suppose sovereign wealth funds would say, "We are not going to recapitalize any institutions in the U.S. or Europe unless we are invited to invest in them by the government officials in the home countries of these institutions". If sovereign wealth funds invest in these institutions after such an invitation, there may be less protectionist backlash to these investments.

Q This is not related to the central theme, but you mentioned that there are other losses that you do not know about or where they come from. We have $7 trillion in losses in the stock market. So far there are a lot of people who entrusted financial firms to invest their money wisely but they are finding out they are not that wise and therefore they suddenly worry about that money. They withdraw their money and put it under their mattresses. What are the losses versus the fear effect on investors?

A Financial advisers are like everyone else -- some will do a good job and some will not. So people who believe that all financial advisers do a good job are naïve. It has been estimated that the securities based on residential mortgages are approximately $550 billion, but we are not certain who will bear those losses in the long run. Only $200 billion of these losses have been publicly reported thus far. So in the short run, many investors are afraid to trade certain types of bonds or trade with certain counter-parties. This has led to a substantial decrease in liquidity in the markets. The Federal Reserve has tried to increase liquidity by accepting much broader types of collateral than usual for borrowing U.S. Treasuries, and that has been helpful. But the fears will not be assuaged until we see most of the losses reported. My personal intuition is that the actual losses will be less than people fear, but only time will tell. Thank you.

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