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Escaping financial crises? Macro evidence from sovereign wealth funds' investment behaviour

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ABSTRACT

This paper investigates the determinants of the investment activity of Sovereign Wealth Funds (SWFs) at a macro level, with special emphasis on the possible reaction to a financial crisis in a potential target economy. The analysis relies upon a specially built proprietary database, which encompasses 1,903 acquisition deals spanning the period 1995–2010 and involving 29 out of the 79 existing SWFs. According to a three-step modelling approach, we find that this class of investors prefers to invest in countries with a higher degree of economic development, larger and more liquid financial markets, institutions that offer better protection of legal rights, and a more stable macroeconomic environment. Most importantly, and in stark contrast with the existing empirical literature on other major institutional investors, SWFs seem to engage in 'contrarian' investment behaviour, i.e. increasing their acquisitions in countries where crises hit. The results are shown to be valid if we consider both the likelihood of a country being the target of SWFs' investments and the amount SWFs choose to invest in each country. Capital flows stemming from SWFs' acquisition activity worldwide may therefore have a stabilizing effect on local markets during periods of financial turmoil, protecting the targeted countries from foreign shocks instead of propagating them globally.

1. Introduction

The article investigates the determinants of Sovereign Wealth Funds' (SWFs) investment behaviour at a macro level, i.e. in terms of the cyclical and/or structural characteristics of the target country. Within this general framework, the paper assesses whether SWFs follow the procyclical investment behaviour which seems

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to be typical of other institutional investors, by divesting from countries hit by a financial crisis thus propagating globally the transmission of shocks.

SWFs are state-owned investment vehicles which manage portfolios of financial instruments partly denominated in foreign currency. They derive their wealth from commodity revenues or from balance of payments or fiscal surpluses.

Interest in the investment behaviour of SWFs has increased rapidly over the last ten years, given their growing presence in global financial markets, particularly in the equity sector[1]: according to the specifically built proprietary dataset used in this paper – encompassing 1903 equity acquisitions spanning the period 1995–2010 – SWFs reached the peak of their investment activity in international equity markets in 2007, with investment totalling $124 billion.

Overall SWFs' assets under management (AuM) reached $7.3 trillion at end-2015 (Sovereign Wealth Fund Institute), a figure larger than that of other important investors such as private equity funds or hedge funds. In spite of their growing size, academic research on SWFs is fairly limited. This is partly due to large information gaps: most funds, in fact, publish only very limited information about their investment activity and overall portfolio structure. This has raised concerns among politicians, the public and international financial institutions that they could be pursuing hidden strategic objectives instead of the declared targets of return maximization.

Given their size, it is indeed critical to understand which factors might determine SWFs' investment choices and also whether they contribute to exacerbating crises by propagating shocks through international financial markets from one country to another. Anecdotal evidence (Ciarlone and Miceli, 2013) suggests that SWFs followed a countercyclical approach during the last global financial crisis, when they invested in bank stocks rescuing liquidity constrained western financial institutions. By means of a more robust econometric approach, the objective of this paper is to assess whether the prima facie evidence of SWFs acting as stabilizers during episodes of crises is confirmed or, alternatively, whether SWFs behave like other classes of institutional investors, which divest from countries where crisis hits thus propagating shocks on a global scale.

Portfolio investments can be thought of taking place in two stages: we consider a first stage when SWFs essentially choose the country where to invest, to then face a second stage when SWFs decide the amount of resource to allocate to equity investment in that particular country. By means of a three-step modelling approach, we find evidence that SWFs are more likely to invest in countries characterized by a higher degree of economic development, deeper and more liquid financial markets, a more effective protection of property rights, a more stable macroeconomic environment. As for the amount of financial resources to allocate, the country's economic size and its degree of financial development remain significant factors in determining the share of a SWF's portfolio allocated to it.

A more important result relates to the sign and significance of the financial crisis dummy indicator. According to our estimation results, in fact, a country experiencing such a negative event – however it might be defined – is more likely to attract equity acquisitions by SWFs. Regardless of the peculiar econometric specification, the crisis dummy indicator always significantly increases the likelihood of a country being targeted by SWFs' investment activity. The crisis dummy also positively and significantly affects the amount SWFs decide to invest in that country.

These results show that SWFs behave in a countercyclical way in their equity acquisition strategy: in stark contrast with the existing empirical literature about other major institutional investors – clearly showing a prevalence of a procyclical investment activity in times of financial stress – SWFs seem to engage in a ‘contrarian’ behaviour, by increasing their acquisitions in crisis-hit countries. Capital flows stemming from SWFs' investment activity, therefore, may end up having a stabilizing role on local markets during periods of financial turmoil, protecting the targeted countries from foreign shocks instead of propagating them on a global scale. This conclusion is in line with our expectations founded upon SWFs specific structural characteristics. Focusing, for example, on the investment approach of the Norwegian SWF, the largest in the world, Chambers et al. (2012) suggest a tilt towards patient, liquidity supplying and market-stabilizing value strategies. Being, by definition, large long-term investors with relatively stable risk preferences over time, SWFs are in the position to avoid pro-cyclical investing and, at the same time, earn liquidity and other premia through ‘contrarian’ transactions.

[1] Equities, indeed, do represent the most relevant share of SWFs' portfolios of assets: on average, this share is estimated to be between 50 and 55%, with the exception of a handful of SWFs which are not allowed to trade in equities.