Transparency, Long-term Investment, and the Political Economy of Sovereign Wealth Funds

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Abstract

Whereas Anglo-American financial institutions dominated the financial history of the twentieth century, the recent and rapid growth in the twenty-first century in the number of sovereign wealth funds (SWF), mostly from outside North America and Western Europe, represents an important structural change to the global economic landscape. If the conventional model of investment by large beneficiary institutions is to hold small passive stakes in firms as part of large diversified portfolios intermediated by asset managers in the leading financial centers, many SWFs seem to be partially rejecting this model for more tightly focused portfolios with larger stakes. Despite a range of securities regulations in the major capital markets that oblige transparency in terms of ownership and control, skepticism remains in political circles of the west regarding the motives underpinning the behavior of SWFs. Some worry SWFs will be used by their sponsoring governments to underwrite mercantilist industrial policies or to control the flow and access to natural resources, as many SWFs work under a shroud of secrecy. This paper evaluates this tension considering the scope of SWF regulation in the context of changing spatial and functional structures of institutional asset management, while providing a conceptual framework for appraising SWF transparency.

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Introduction

In 2006, the US government raised concerns over the purchase of UK-based ports operator P&O, which had contracts to run a number of US ports, by DP World, a state-owned company based in the UAE. Although the Committee on Foreign Investment in the United States (CFIUS) approved the deal in 2005, US Coast Guard Intelligence and members of the US Congress brought a number of potential security risks to the fore. Faced with the prospect of a Congressional bill to block the deal, DP World voluntarily divested P&O’s US operations. DP World’s experience (and some would say unfair treatment) was instrumental in the policies that sovereign wealth funds (SWF) and investment receiving countries would establish when sovereign funds rose to prominence in 2007, as they sought to buy discounted assets associated with the subprime financial crisis.¹

Having already supported the DP World bid as part of an ‘open market’ foreign policy, the Bush Administration, through the leadership of Treasury Secretary Henry Paulson, moved quickly to get ahead of any potential controversy surrounding SWF investments in the United States. In the fall of 2007, at the joint Annual Meeting of the IMF and World Bank, Paulson put forth an SWF agenda that sought to maintain and indeed promote openness to SWF investment. The main condition for this access was that SWF investments would have to be demonstrably commercial and eschew political objectives.² The IMF immediately took on the task of convening a roundtable of SWFs and host countries, known as the International Working Group of SWFs, to identify and draft a set of generally accepted principles and practices (GAPP) that could, in effect, neutralize politicization and ensure a commercial orientation.³

The rationale was to use governance and investment management standards similar to those followed by other large asset owners (e.g. public-employee pension funds) to focus SWFs on risk-adjusted financial returns only. The resulting Santiago Principles were thus representative of a large international effort (led by the advanced OECD economies) to foster increasingly open financial markets with common standards and principles of conduct. In effect, the Santiago Principles are simply another step in a long process of global financial and economic integration, which includes accounting harmonization and increased cooperation among regulators. At the center of this process is transparency.

But the push for transparency is not simply about promoting a form of international economic relations based on liberal


norms and expectations on the proper behavior and conduct of public institutions in private markets. The wider project to legitimize SWFs is, more fundamentally, about underwriting a particular form of institutional investor, and a particular spatial and functional structure of the investment management industry. While SWFs may be seen as an unprecedented institutional innovation, they are rather a variation on supplementary pension schemes that are responsible for managing the long-term welfare of beneficiaries, relying on global financial markets and the global financial services industry.\(^4\) If the economic function of intermediaries is to facilitate the transfer of capital across time and space, intermediation has the effect of adding a layer (and in many cases multiple layers) between asset owners and the entities in which they invest.\(^5\) For those skeptical of the motives of SWFs and their sponsors, this model of asset management, the separation of ownership from control, limits intrusion of non-commercial motives or undue influence.

In the wake of the global financial crisis this model is, however, coming under pressure from within and from without. From social movements like Occupy Wall Street to the economic elites at the World Economic Forum, there is widespread concern that the leading edge of the financial services industry has lost sight of its over-arching objective function: To facilitate the efficient allocation of economic resources over space and time under conditions of risk and uncertainty. Instead, the investment houses of the leading international financial centers too often seem to be working in their own interests, even destroying rather than creating value for clients, shareholders, and the real economy. At the same time, short-termism has become pervasive, driven by structural changes such as mark-to-market accounting coupled with cognitive constraints to long-term decision-making and heard behavior.\(^6\) Consequently, existential socio-economic challenges of the contemporary period that are material to the generation of value over the long term, such as demographic aging and climate change, are secondary concerns for many in the institutional investment community, if they are a concern at all.\(^7\) Thus, for some, parts of the financial world have become socially dysfunctional.\(^8\)

Yet, there is a small but growing community of large institutional investors—


which includes SWFs but also public pension funds, family offices, foundations, and endowments—that is pushing back against the misaligned incentives, high fees, poor returns, and short-termism embedded in the asset management and financial services industry, all of which the financial crisis has brought to the fore. This growing group of long-term beneficiary institutions is completely rethinking the way they access markets and deal flows and the tools of investment decision-making (e.g. Modern Portfolio Theory).

In particular, instead of delegating asset management to service providers in the major financial centers, they are increasingly looking for ways to in-source asset management. They are building internal teams and hiring new talent, and doing so for a fraction of what they are paying for external mandates.9 Instead of focusing on large diversified portfolios that follow the market, they are looking to concentrate portfolios, making fewer but larger investments. As a result, there is a growing appetite for direct investing. Ultimately, this shift is about extending investment time horizons.10

Implementing and sustaining a long-term investment strategy of any kind comes with certain challenges. As markets are prone to crisis and can be volatile in the short run, a long-term investor can easily be seen as performing poorly in the short term even if the long-term investment strategy is sound. Assuming any organization has to justify its existence, either to a sponsor or some other group (e.g. citizens at-large), the appearance of poor short-term performance can be detrimental to maintaining any sort of long-term focus. Individuals or groups can easily be myopic and, more importantly, not have sufficient financial literacy to understand the behavior of markets over time. Consequently, pressure may be put on the organization to change its investment approach, which in the long run may be less optimal.

For some long-term institutional investors, namely the New Zealand Superannuation Fund, which is required to publish monthly performance metrics, explicit public education and outreach has been adopted as a core organizational competency, as a way of mitigating potential push-back in the context of poor market performance or short-term systemic events. For other funds, particularly those from countries without a tradition of democracy and government transparency, it may seem easier to simply withhold information about investment performance and even the content of the investment portfolio.11

The first two sections of this paper consider the spatial and functional structure of the asset management industry in the context of the growth of supplementary occu-

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10A number of commentators have suggested that SWFs may be an important source of capital for addressing long-term social, economic and environmental challenges, while also acting as a counterweight to the structural and agential issues driving short-termism in global financial markets. See, e.g., Bolton, P., Samama, F. & Stiglitz, J. 2011. Sovereign wealth funds and long-term investing. New York: Columbia University Press.

11This discussion paper restates, in the context of ongoing research, the argument and portions of, Dixon, A.D. & A.H.B. Monk 2012 Reconciling transparency and long-term investing within sovereign funds. Journal of Sustainable Finance & Investment, 2(3-4), 275-286.

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pational pension funds in the latter half of the twentieth century, and, more recently, in the context of the growth of SWFs. A short section thereafter describes efforts by some large asset owners to redefine how they employ capital. The section thereafter briefly considers apparent non-transparency in terms of the implementation of the Santiago Principles, in the context of a regulatory regime that by default drives disclosure of short-term performance objectives. The penultimate section outlines a conceptual framework for considering different aspects of transparency with the objective of fostering discussion regarding acceptable forms of nondisclosure and opacity in the context of a long-term investment strategy.

Pension Fund Capitalism

In the 20th century, the accumulation and pooling of wealth was a consequence of what could be described as ‘Pension Fund Capitalism’\(^\text{12}\); primarily a developed-world phenomenon, Anglo-American countries and others such as Finland, Switzerland, Japan and the Netherlands made pre-funded supplementary occupational pensions, both public and private, important components of their respective national pension systems. With successive pension reforms driving the growth of capitalized pension arrangements in other advanced economies (e.g. Germany) and the growth of pension savings in middle-income economies, pension assets continue to grow in size and in geographic origin.\(^\text{13}\)

At year-end 2011, global pension assets in the 13 largest pension markets, accounting for 85 percent of all pension assets globally, stood at US$27,509 billion.\(^\text{14}\) To put the significance of this asset ownership in perspective, the world’s total equity market capitalization and total public debt securities were estimated to be US$54,000 billion and US$41,000 billion, respectively.\(^\text{15}\) While collectively retirement-income organizations represent a major component of global financial markets, there are a number of institutions that, individually, control significant amounts of financial assets, which places them apart from smaller pools of capital in their ability to innovate as organizations and confront asymmetric power relationships in the investment management industry.

For the vast majority of pension funds, however, asset management is delegated to for-profit private sector asset managers, most of whom are located in major international or regional financial centers. If dispersion characterizes the spatial structure of pension funds, albeit across high-income democracies, the functional structure in terms of the actual management of assets is one of concentration. Two factors drive this. First, local markets are too small and provide limited opportunities for diversification. The local market can be defined as the national economy, as in the case of the Netherlands or Australia, where the ratio of pension assets to GDP in 2012 was


138 and 92 percent respectively\textsuperscript{16}, or a regional economy, as in the case of Colorado Public Employees Retirement System. Second, many funds are located in areas where the local market for specialized financial services is limited. The main task of the pension plan board of directors is, in most cases, deciding on asset allocation based on risk-return targets and the selection of external asset managers (usually with the help of external pension consultants). Mandates are either given to a range of different managers depending on asset class (extensive delegation), or to a smaller set of asset managers (intensive delegation).\textsuperscript{17} In either case, contractual arrangements vary over time but are generally contingent on short-term performance metrics, such as exceeding a particular market benchmark (e.g. the S&P 500).

Few retirement-income organizations manage assets internally. Where organizations do manage some of their assets internally, they are most likely to manage highly rated fixed-income securities, such as US Treasuries, or large-cap blue chip equities. In either of these cases, the decision to manage assets internally is contingent on whether there is sufficient scale to do so. What is sufficient scale is an empirical issue. In any case, pension funds that manage assets internally are still outliers.

Sovereign Fund Capitalism

If pension fund capitalism characterized wealth accumulation and capital pooling in the second half of the twentieth century, nowadays we see increasing accumulation and pooling of wealth by additional means, and in a larger set of countries and regions. Notwithstanding the oil price shocks of the 1970s, commodity prices in general over the last decade reached historic highs, driven by rapid economic growth particularly in Asia and other emerging market economies, and by an insatiable thirst for commodities in the rich world. For those controlling the rents from these resources, whether public or private, the last decade has been a period of massive wealth accumulation, which does not appear to be subsiding anytime soon. Another source of wealth accumulation has come from current account imbalances in the global economy.\textsuperscript{18} Deficit countries, particularly the United States, have amassed significant liabilities vis-à-vis surplus countries—namely China.

While much of the wealth accumulation from commodity production or the re-balancing of global economic activity has accrued to private hands, a large portion of it has accrued to those governments that control commodity rents, the central banks that accumulate massive foreign exchange reserves, and governments that maintain consistently strong budget surpluses.\textsuperscript{19} To be sure, commodity exporters such as Saudi Arabia or export-led

\textsuperscript{17}Clark Pension fund capitalism.


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entrepôt economies such as Singapore respectively have been accumulating wealth in these ways for decades, and have piled it directly back into global markets (and their own).20 However, in the last decade the growth in wealth accruing to states has become a larger phenomenon, reaching more and more countries, and specifically emerging and developing economies.

There are currently at least 60 sovereign funds in operation around the world, with approximately five trillion dollars in assets under management. Figure 1 displays SWFs with at least US$5 billion in assets under management. Figures are based on best estimates using publicly available information representing year-end figures for 2011. As information on some SWFs is difficult to corroborate, as in the case of the Iranian National Development Fund, or to disaggregate from monetary authority reserve assets, as in the case of Saudi Arabia, all funds above the minimum threshold are not included. The largest SWFs with more than US$400 billion are Norway’s GPF-G, the Abu Dhabi Investment Authority, and the China Investment Corporation. In the western hemisphere, the largest SWF is the Alaska Permanent Fund followed by the Texas Permanent Education Fund, which was established in 1851, making it one of the oldest SWFs in existence. By limiting the extent of the map to larger funds, a number of smaller funds are not shown. This is particularly the case for the Africa region, where there is a growing number of SWFs in operation or in the planning stages.

What is interesting about this current phase of state wealth accrual is that some states are establishing distinct institutional investment organizations charged with managing and investing the country’s accumulated wealth in financial markets, as distinct from an entry in the treasury’s or central bank’s balance sheet. In that respect, some are given latitude in executing a mandate set by the government. As such, these government-owned institutional investors are a mechanism by which the state can access global financial markets.21 The most sophisticated, such as Singapore’s Government Investment Corporation, appear able to compete, at least in terms of performance, on par with the world’s largest and most competitive multi-asset managers. However, like other large beneficiary asset owners, most SWFs delegate asset management to for-profit asset management providers in the world’s largest IFCs or large regional financial centers. This is partly a function of either the local economy being too small and limited in terms of diversification and/or the lack of local asset management capabilities. But, more and more SWFs along with other large institutional investors are rethinking the business of asset management.

**Breaking with Convention**

Based on a research project conducted with my colleague Ashby Monk (Stanford) and funded by the British Academy that engaged SWFs and other large institutional investors, there are some key lessons that emerged about finance and investment after the crisis related to risk management,

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Figure 1: Sovereign Wealth Funds (source: author’s compilation)
Transparency and Sovereign Wealth Funds

the time horizon of investments and access
to deal flows. All three of these lessons are
having tangible impacts on the business of
institutional investment and, in particular,
its geographic location.\(^{22}\)

While criticism existed before the finan-
cial crisis, many conventional investment
beliefs, such as the Efficient Markets Hy-
pothesis, and the conventional asset allo-
cation methods, such as Modern Portfolio
Theory (MPT), have come into question.
The crisis demonstrated that (despite fol-
lowing the conventions of MPT) few institu-
tional investors actually knew their risk ex-
posures. Diversification across asset classes
failed to provide the risk minimization that
many thought it did (or would).\(^{23}\) Accord-
ingly, there is a growing realization that
risk needs to be re-conceptualized and re-
integrated into the organization, from as-
set allocation at the board level all the way
to the most sophisticated trading opera-
tions. For example, risk factor based asset
allocation strategies are increasingly com-
on among institutional investors. With
this strategy, investors look for “true” di-
versification based on risk buckets, geogra-
phies and economic sensitivities. Traditi-
onal allocations based primarily on asset
class (e.g. 60 percent equities, 40 percent
bonds) failed to provide the diversification
investors wanted.\(^{24}\)

Another way respondents are seen to be
taking risk more seriously is in a renewed in-
terest in bottom-up analyses of investment
opportunities. Financial models undoubt-
edly have their place, but they are not seen
as the refuge they once were. Instead of
relying on all kinds of quantitative data, in-
vestors are going into the field to tangibly
engage with potential investment projects
and investees. This analytical method is fa-
cilitated in some funds by another trend,
which is the shift from broadly diversified
portfolios to much smaller portfolios con-
centrated on fewer but larger holdings. The
rationale behind this shift is that it frees up
time and resources to better understand the
underlying business. Consequently, conven-
tional passive investment strategies of hold-
ing ‘the market’ while still significant are
less popular. If broad and passive portfolios
are best served by intermediation in large
international and regional financial centers
where most shares and fixed-income instru-
mements are issued, this is not necessarily
the case for smaller portfolios. A smaller
more focused portfolio allows institutional
investors the possibility of bypassing large
financial centers and the in process for-profit
services providers and intermediaries.

Respondents have realized also that
their investment time-horizons have become
too short. This comes through in the data,
as holding times for assets have been shrink-
ing over the past few decades.\(^{25}\) By allowing

\(^{22}\)See Dixon, A.D. and Monk, A.H.B, ‘Frontier Finance’, available at http://ssrn.com/abstract=2203656; The institutions in the sample represent approximately US$3 trillion in assets under management. The smallest organizations have assets of around US$20 billion, while the largest tops out at over half a trillion dollars. Our sample, furthermore, includes institutions from North America, East Asia, Western Europe, Australasia, and the Middle East.


their time horizons to become shorter and shorter, many pension and sovereign funds are giving away one of their key competitive advantages in the marketplace, which is time. Hence, more funds are increasingly cognizant of the fact that there are significant benefits to taking a long-term approach. This manifests itself in two ways. First, many long-term investors are moving more aggressively into illiquid assets to better take advantage of their long-term characteristics. Generally, these assets (such as infrastructure and timberland) have actual cash flows, inflation protection, downside protection and other attractive characteristics for long-term direct investors. Second, long-term investors are investigating ways to extend their time horizon through governance, measurement, and management changes. For example, there is a renewed focus on compensation policies to better align the interests of portfolio managers with the interests of the fund.

Lastly, respondents appear to be completely rethinking the way they access markets. One of the main areas under consideration for these institutional investors relate to the decision to continue relying on external and usually costly asset managers, or to in-source investment operations. Here, a growing number are investing through in-house teams in private and public assets. Doing so saves money by eliminating management fees, improves interest alignment between the mission of the fund and the in-house asset managers executing the investment strategy, and helps extend time horizons. Where external mandates are maintained, institutional investors are reconsidering the delegation process, what types of relationships to make, and most importantly the fees they are willing to pay. Here there appears to be a renewed focus on low base rates below one percent, incentive fees with cap and risk-adjusted hurdle rates, and clawback provisions to incentivize a long-term perspective. There is also a growing trend among our respondents to seek out talented and young asset managers and seed them with capital. The idea is to spot rising stars and extract concessions in terms of fees before the managers’ bargaining power becomes too strong.

There is, however, a fear that geopolitical motives can be hidden within a SWF’s ‘long-term investment strategy’ by providing these funds with plausible justification for non-commercial investments. In other words, at the international level there is skepticism regarding the motives underpinning SWFs’ behavior, where some worry that they will be used to underwrite mercantilist industrial policies that distort competition and efficiency in product and financial markets. On a domestic level, some SWFs also face skepticism as to the justification for saving current government income and investing it outside of the home country rather than spending it on goods and services today. Notwithstanding SWFs’ unique characteristics, which provide them with the structural foundations conducive to long-term investing, these funds are thus faced with

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certain institutional contradictions at both the international and domestic level that, it seems, can only be reconciled through a public demonstration of short-term performance.\textsuperscript{29}

**Myopic expectations?**

Western democracies traditionally have used transparency to understand ‘what’ and ‘how’ an organization is doing. Through periodic reporting and disclosure, a stakeholder can examine an organization’s strategies (the ‘what’) and its performance (the ‘how’) and benchmark this information against competitors to come to some understanding of the relative value of a given organization within the marketplace. For example, in the United States, the world’s largest capital market, federal regulations require institutional investors to abide by strict disclosure requirements. The *Investment Company Act of 1940*, which covers mutual funds and other types of professionally managed funds, requires publication of funds’ investment policy and periodic reporting of the funds’ financial statements. Moreover, the Act provides strict guidance as to the composition of directors of the fund and their fiduciary duties. Any changes to the funds’ investment policy or its board of directors must occur through a majority vote of the funds’ outstanding voting securities.\textsuperscript{30}

The emphasis on periodic reporting of a fund’s financial position and a clearly articulated investment policy is likewise a hallmark of institutional investor regulation in Europe.\textsuperscript{31} For example, the 2003 EU Directive on *Institutions for Occupational Retirement Provision* requires provision of a statement of investment principles as well as regular disclosure of the financial soundness of the fund. Similar measures are likewise found in the EU Directive on *Undertakings for Collective Investment in Transferable Securities* (UCITS), which covers mutual funds and other collective investment schemes.

Therefore, when it came to writing high-level principles for SWFs that could ensure commercial behavior (via the Santiago Principles), these same assumptions were at the forefront of the policy debate. The 24 principles governing SWF behavior in the Santiago Principles evoke the same doctrine of transparency that guides institutional investment in advanced economies. The Santiago Principles are divided into three sections: 1) legal framework, objectives, and coordination with macroeconomic policies; 2) institutional framework and governance structure; and 3) investment and risk management framework. In all three cases, transparency is either evoked directly, through some form of disclosure, or indirectly, through the funds relationship with the sponsoring government. For example, GAPP 1-5, 11-12 and 15-17 directly cite transparency by calling for periodic publication of statistical and financial data and public disclosure of the funds’ broader purpose in terms of: a) its fiscal and macroeconomic policy function and its relationship between the state sponsor; and b) its investment policy and financial objectives. GAPP

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6-10 evoke transparency indirectly by calling for clearly defined standards of conduct and responsibility for the funds’ governing body and its operational management, supported by a clearly defined accountability framework.

It is not until GAPP 18 and 19 does a proposition appear that SWF investment decisions should be based on sound portfolio management principles and solely for the purpose of maximizing risk-adjusted financial returns; and, as stated in GAPP 21, that if a SWF exercises its shareholder ownership rights, it should do so only for the purpose of protecting the financial value of its investment. That these three principles appear towards the end, yet encompass many of the primary national security concerns surrounding SWFs, is suggestive of the importance of transparency and accountability in bringing SWFs in line with other (Western) institutional investors. It would seem that international legitimacy (and access to global markets) demands disclosure.

The Santiago Principles thus make an assumption that if an outsider can understand the ‘how’ and the ‘what’ of SWFs through regular disclosure, that outsider can derive an insider’s understanding of the ‘why’; and this would offer insights as to whether the SWFs were focused on commercial or political goals. By this logic, then, if SWF performance deviates too much from the conventional ‘what’ and ‘how’, the outsider might infer that the behavior underpinning the investments was something other than commercial, which was (and is) the pressing concern of Western economies faced with the rising prominence of SWFs.

The problem with this logic is that it ignores the idiosyncrasy and heterogeneity of SWFs. These are funds that have differing risk budgets and mandates that make benchmarks very challenging to identify. Many have no direct liabilities. In addition, this heuristic ignores the issue of time (i.e., the ‘when’). Indeed, the Santiago Principles raise an important question about whether short-term performance is a suitable predictor of long-term performance, as the ‘how’ benchmark tends to be based on short-term metrics drawn mostly from short-term investors. This is problematic, as investment decisions that take into consideration both long-term and short-term risks will, at the margin, be different from those investment decisions that seek to maximize short-term performance only. By forcing long-term investors to disclose their performance on an annual or even quarterly basis, long-term investors are thus being asked to justify their long-term portfolios in relation to short-term portfolios.

Through the Santiago Principles, and its focus on transparency, the advanced democracies are, in effect, attempting to benchmark SWFs against conventional investors in the marketplace in order to ensure commercial and apolitical conduct. However, this ‘convention’ is built around ostensibly short-term institutions (e.g. regulations) and agents (e.g. market intermediaries). In order to understand the ‘why’ of sovereign funds, the implied benchmarks for evaluation created by the Santiago Principles should have included the what, how and when. As it stands, the current benchmarks will bias SWF towards shorter-term investments.32

Hence, in the context of this shift in practice where SWFs are interested in disintermediation and larger direct investments, there is an argument (which can be frequently heard among SWF stakeholders) for maintaining a certain degree of non-transparency so as to retain the ability to make long-term investments. Evidence for this can be found in the ongoing ambivalence over the disclosure policies in the Santiago Principles. While the raw data are unavailable, a report produced by the International Forum of Sovereign Wealth Funds based on member surveys provides interesting insights into the tensions surrounding increased transparency within SWFs. Respondents were asked if they disclose information on the following seven elements of investment policy: investment objectives, risk tolerance, investment horizon, strategic asset allocation, investment constraints, use of leverage, and the use of external managers. Of the 21 member funds that responded to the survey, only eight disclose information on all these elements, despite the fact that all are accepted convention and best practice among institutional investors in advanced markets.

Given that the responding funds signed up to the Santiago Principles and joined the IFSWF (on a voluntary basis) as a means of clarifying their objectives as an institutional investor on global markets, it is surprising to see these levels of (self-reported) non-transparency. One interpretation for the variability of disclosure is the possible contradictions between a SWF achieving its long-term objectives and maintaining high levels of transparency. The report even states that some members, ‘argue that certain types of information and the frequency with which it is released might create an overly short-term focus’. In other words, the community of SWFs is struggling to reconcile the demands for routine transparency and the demands for long-term performance.

A Framework

Is it possible, however, to produce a situation where a sovereign fund can be both transparent and non-transparent, instead of being either or? Is there a more effective means of fostering greater transparency in aggregate, while allowing for opacity in certain instances, particularly when such opacity justifiably reinforces a long-term strategy and vision? Arguably, revealing acceptable opacity for the preservation of a long-term strategy and vision, whether in the domestic or international domain, could manifest through an enhanced dialogue over the definition(s) of transparency. Yet, this requires a more systematic clarification of different types of transparency as pertains to sovereign fund operations and governance, which can be used by stakeholders to judge SWF transparency and which, likewise, can be used by SWFs and their sponsors in communicating how and in what ways they are transparent.

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33 The IFSWF is the successor to International Working Group of SWFs, which developed the ‘Santiago Principles’.
35 IFSWF 2011: 29
To this end, the following is a conceptual framework (in the sense of high-level principles) for parsing different types of transparency in the constitution and operation of sovereign funds, taking inspiration from Petra Geraats’s conceptual framework for central bank transparency. Five aspects of sovereign fund transparency are outlined: political, procedural, policy, operational, and performance. Each aspect may provide different motives for transparency.

- **Political transparency** refers to the exogenous rules and regulations underpinning the fund’s operations. Transparency in this domain will clarify the fund’s objectives and institutional arrangements as well as the sovereign fund’s relationship with the sponsoring government. This could include the sovereign fund’s mission statement and the legal framework that defines its existence. Absolute transparency in this domain would also describe the institutional arrangements (formal or otherwise) guiding the interaction between the fund and the government sponsor.

- **Procedural transparency** refers to the resourcing and, indeed, resources at the disposal of the fund to achieve its objectives. Transparency in this domain will generally describe the governance architecture and the decision-making process, both in terms of investments but also in terms of the organizational requirements. This could include policies for how the board is chosen, arrangements regarding board tenure, and how authority is delegated inside and outside of the fund, such as to an investment committee, the selection of external managers or the hiring of internal staff.

- **Policy transparency** refers to the rules and objectives that the fund—generally through its formal governance arrangementsimposes on its own operations and personnel. Transparency in this domain will thus highlight the fund’s strategic vision, investment, beliefs and strategy. This could include information about asset allocation, geographic distribution of investments, and information on risk budgeting.

- **Operational transparency** refers to the way the investment strategy is implemented and by whom. Transparency in this domain will describe the ways in which the fund seeks to put policies into action, such as how the fund plans to access financial markets, certain industries, geographies or even specific assets. This could include information on whether assets are managed ‘in-house’ or through external asset managers, and what type of involvement the fund has with the investee entities in which the fund invests.

- **Performance transparency** refers to the investment outcomes achieved by the fund. Transparency in this domain could be quantitative performance and judged against appropriate peers or, more often, bespoke benchmarks that reflect the fund’s risk-return profile. Transparency could also be qualitative and judged through external and independent audits of

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subjective criteria that focus on a specific organizational culture.

Conclusions

These different areas of transparency certainly invoke many of the underlying principles of the Santiago Principles and many of the national regulatory frameworks facing SWFs when investing internationally, save for transparency related to performance. For some funds it may be possible to be completely transparent to a significant degree across all these domains (i.e. SWFs from liberal democracies). But even these funds would still require complementary mechanisms to manage and mitigate potential criticisms, particularly related to short-term performance.

Ultimately, there are significant differences in how sovereign funds and their sponsors interpret transparency, particularly when transparency is voluntary, as in the case of the Santiago Principles. The contention that more transparency is antithetical to long-term investing reinforces the interpretive differences of transparency or the reluctance thereof. We would argue that one step toward greater transparency in aggregate is the delineation and subsequent discussion of transparency, as the conceptual framework discussed above does.

In certain cases it is arguable that non-transparency is not actually non-transparency. For example, is a fund that discloses quarterly returns less transparent than the fund that discloses smoothed long-term returns, particularly if the latter fund is transparent in other domains, such as how it is governed and how it implements its investment strategy and where? Here, there is a different temporal dimension to the transparency of performance, which seems logical and justifiable. If malfeasance and impropriety are prevented through other mechanisms, such as clear governance frameworks, then the presence of asymmetric information in the short term may be acceptable, at least at the domestic level, and perhaps tolerated internationally. The temporal dimension of transparency, particularly as regards to the dissemination of performance metrics, requires further discussion and argument. There is material value in the discussion of transparency in and of itself and how it is communicated. In that respect, SWFs can make greater strides toward increasing aggregate transparency by discussing why and in what instances they are not transparent.