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A Disclosure Framework for Public Fund Investment Policies

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Abstract

Assets under management by public funds, including sovereign wealth funds and sovereign pension funds, continues to grow at a strong pace. As funds grow larger and new sovereign funds come into the market, the identification of suitable investments in an increasingly crowded marketplace becomes correspondingly more difficult. The universe of potential investments is narrowed by a trust deficit between many sovereign funds and the regulators in countries in which these funds invest; this trust deficit can result in higher transactional costs that price public funds out of the market, or can create unacceptably high regulatory risks that deter funds from considering certain investments. Because transparency can foster trust, this paper seeks to remedy the trust deficit by outlining a disclosure framework for investment policies that are most relevant to recipient country regulators.

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Keywords: Sovereign wealth funds; public pension funds; investment policies

1. Introduction

Assets under management by public funds, including sovereign wealth funds and sovereign pension funds, continue to grow at a strong pace. Sovereign wealth funds alone have grown from holding about $3.4 trillion in assets in March 2008 to about $6.4 trillion in assets in March 2014 (Sovereign Wealth Fund Institute, 2014). As funds grow larger and new sovereign funds come into the market, the identification of suitable investments in an increasingly crowded marketplace becomes correspondingly more difficult. These difficulties are exacerbated by a trust deficit between many sovereign funds and the regulators in countries in which these funds invest.

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How can public funds remedy this deficit? Several important efforts have already been initiated, and more are under development. Most prominently, a group of sovereign wealth funds, assisted by the IMF, produced a now well-known set of generally accepted principles and practices (GAPP) known as the "Santiago Principles." The purpose of the Santiago Principles was to "identify a framework of generally accepted principles and practices that properly reflect appropriate governance and accountability arrangements as well as the conduct of investment practices by SWFs on a prudent and sound basis." International Working Group (2008). The Santiago Principles cover three key areas: (i) legal framework, objectives, and coordination with macroeconomic policies; (ii) institutional framework and governance structure; and (iii) investment and risk management framework. This paper seeks to expand on the work in the third key area by providing a more detailed framework for disclosure of public fund investment policies.[1]

Investment policy disclosure has important benefits for the sovereign, but it also presents risks. For example, Dixon and Monk argue that sovereign investors may have difficulty in explaining performance results and investment strategies to their constituencies, particularly when the constituencies view fund performance with a short-term orientation (as may be the case with elected politicians that hold the fund's purse strings). Additionally, "domestic opponents of a country's SWF could utilize the poor performance to reinforce their argument against the existence of the fund or the fund's strategy." This, they argue, may lead the fund to adopt a short-term investment approach and/or decrease transparency. Dixon & Monk (2012).

While short-termism is a legitimate concern, to the extent it is an issue for public funds it is more likely the result of the disclosure of performance metrics (the 'how') than the disclosure of general investment strategies (the 'what'). Arguably, performance metrics are most relevant to the domestic audience that has a stake in the performance of the fund. They are not likely to be of much value to a recipient country regulator in evaluating whether or not to approve a particular transaction. By contrast, the investment policies of the fund—the 'what'—are highly relevant to a recipient country regulator as it attempts to determine the purpose of a fund's investment and how a sovereign fund will engage with the company or project in which it has invested. Under this view, as expressed in the Santiago Principles, disclosure can help to "reduce protectionist pressures, and help maintain an open and stable investment climate."[2] International Working Group (2008).

2. A Framework for Public Fund Investment Policy Disclosure

Investment policies serve a number of different purposes. They can provide discipline and guidance to investment activities by setting appropriate risk tolerances and time horizons. They may also prescribe certain types of investments and proscribe others, acting as a reflection of the ethical concerns of the fund's public beneficiaries. With respect to both purposes, policies that provide information on the goals and governance impact of an investment are most relevant to recipient country regulators. These policies are more relevant than policies that address the governance of the fund itself, because regulators are primarily concerned with the impact of a particular investment. However, fund governance issues may be relevant as well, particularly as they relate to the independence (or lack thereof) from the fund's sponsor government.

Assuming the critical importance of investment policies and governance impacts, and with a view to increasing trust with recipient country regulators so as to broaden the universe of possible investments, public funds should consider disclosing eight key investment policies, explained in turn:

1. Does the fund manage assets internally?

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[1] The Santiago Principles contain a relevant subprinciple, but with little guidance on the kind of information that should be disclosed. Subprinciple 18.3 states that "[a] description of the investment policy of the SWF should be publicly disclosed," and explains that "[t]he description could include qualitative statements on the investment style (e.g., active/passive, financial/strategic) or investment themes, the investment objectives, the investment horizon, and the strategic asset allocation. These disclosures, together with the disclosure of relevant financial information…should give an indication of risk appetite and exposure. In addition, the SWF may describe the use of leverage in its portfolio or disclose other meaningful measures of financial risk exposure." International Working Group (2008).

[2] International Forum of Sovereign Wealth Funds has stated in a separate publication that "Disclosure of elements of their investment policy is an important way for Members to reassure portfolio companies, recipient countries, and other stakeholders about the Member's commercial nature." International Forum of Sovereign Wealth Funds (2011).