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Sovereign Wealth Funds: The New Kid on the Block

In our November 2006 Sigma Summaries, we highlighted the growing popularity of private equity firms and how they were changing the investment landscape. With cheap capital (low interest rates) and a seemingly insatiable demand by institutional and individual investors alike, it is no wonder the number of private equity firms proliferated. Flush with cash, bankers willing to lend, and a bravado driven by the prospect of earning extraordinary returns, merger and acquisition activity flourished, measured by both the number of transactions and the average size of such deals.

We cautioned our readers that investors who wanted to jump on the private equity bandwagon should do so with "eyes wide open." We conjectured that the eventual rise in interest rates would reduce the economics of future deals. We felt that the abundance of capital would eventually shrink as regulators and lenders pulled in the reins. What we did not foresee was how quickly the tide would turn.

By the spring of 2007, the focus was no longer about private equity but subprime lending and the decline of the real estate market. In the simplest of terms, many homeowners took advantage of historic low interest rates and easy credit to borrow money via adjustable rate mortgages. Oftentimes, these homeowners borrowed up to their limit, leaving very little equity in their home, if any at all. This wasn't a problem as long as real estate prices continued to rise and interest rates remained low. However, as real estate prices peaked in most locales and started to move back to more rational levels, many homeowners found themselves in the precarious position of owing more money than their house may be worth. In addition, as these adjustable rate mortgages reset, many homeowners are seeing their monthly mortgage payments increase dramatically, putting a further strain on their finances. These homeowners typically have sizable balances on their credit cards as well and are having a difficult time staying current on their monthly credit card bills.

As a consequence of this subprime fiasco, consumers have become more restrained in their spending. Financial institutions have announced massive write-offs, and lending standards have improved. With risk being more appropriately priced into the credit markets, low investment grade and non-investment grade bonds are now trading at a higher yield premium versus U.S. Treasury securities, thereby reflecting the perceived higher risk. With falling real estate prices, a slowing economy and rising debt levels, consumer confidence is waning and investor confidence has been rattled. This has led to a fall in equity valuations and a change in monetary policy with the Federal Reserve now prepared to reduce interest rates to stimulate economic activity, even at the risk of higher inflation. On a global stage, the U.S. dollar continues its fall relative to most major currencies. Thus, all else being equal, U.S. goods appear more attractive to foreign investors.

Private equity firms have also been negatively impacted by the upheaval in the credit markets. Not only are fewer deals being announced, but also a number of high profile acquisitions have recently been aborted. For example, Cerebus called off its $4.1 billion acquisition of United Rentals, and J.C. Flowers terminated its attempt to acquire Sallie Mae for $25 billion. Some of the deals that have been consummated are not generating the returns hoped for. Case in point: it has been reported that the six commercial banks that helped finance the Harrah's Entertainment deal may see their entire profits swept away as they try to sell up to $20 billion in debt that was used to finance the acquisition.

Amidst all of this noise and uncertainty, there is another development worth noting: the rise in stature and magnitude of Sovereign Wealth Funds (SWF). Sovereign Wealth Funds are pools of money that are derived from a country's foreign reserves surplus. Rather than invest these funds solely in foreign currencies and government bonds, host nations are now investing in hard assets such as oil and gas reserves. They are also passively investing in publicly traded companies, with financial services representing a common area of interest.

To put the size of these SWF into perspective, it is estimated that 36 funds are currently in existence. On a combined basis, the value of these funds is approximately $3 trillion. The value of these funds is expected to increase, with estimates as high as $10 to $12 trillion over the next five years. While the oil rich nations in the Middle East control much of this wealth, China and other developing countries are also expected to be major players in Sovereign Wealth Funds in the very near future.

Given the size of their cash hoard, the managers of these investment pools are scouring the globe seeking investment opportunities. At the same time, it is interesting to note that the financial services industry is in desperate need of capital to rebuild its balance sheets. Given these concurrent events, it is no wonder that many Sovereign Wealth Funds are all too eager to lend billions of dollars to the financial services industry, both in the U.S. and overseas. For example, UBS recently received a cash infusion estimated at $11.6 billion whereas Morgan Stanley and Merrill Lynch each received $5 billion. Citigroup received a cash infusion of $7.5 billion from the Abu Dhabi Investment Authority in late 2007 and in early 2008, received another $12.5 billion from a consortium of Sovereign Wealth Funds and institutional investors.

There are mixed feelings about the growing influence of SWF on U.S. soil. On the one hand, these investors have tended to be passive stakeholders with a long-term time horizon. Historically, they do not meddle in the day-to-day operations of the companies they invest in. Thus, the ability to borrow large sums of money from passive shareholders may be viewed in a favorable light. To some, the emergence of Sovereign Wealth Funds is simply another example of the globalization of world trade.

On the other hand, given the weak U.S. dollar and depressed share prices of many domestic companies, is management simply selling out on the cheap? Questions are also being raised as to whether these fund managers (foreign countries) will remain long term and passive shareholders if a company continues to struggle. To what extent can or will they exert their influence on the board of directors or senior management within the companies that they own? What would be the impact if these fund managers not only became more active, but actually antagonistic?

In addition, what implications might there be on a more macro basis? Does it matter that these

stakeholders represent U.S. trading partners? Does the U.S. lose any political or economic influence on the world stage when so much foreign wealth is invested in leading U.S. companies? What impact might there be if the U.S. government turned hostile to one of these stake holding countries or vice versa?

At the moment, we at Sigma have not changed our investment thesis or outlook on any one company or the market in general due to the emergence of Sovereign Wealth Funds. However, we feel that this is a development that bears a close watch, and we are maintaining vigilance on their growing influence in the U.S. marketplace. We are prepared to revisit this issue as circumstances warrant.

Christopher J. Kress, CFA

The Economic and Market Environment

Last Minute Update 1/22/08: As we go to print with this letter, the confluence of events surrounding the uncertainty in the bond insurance markets coupled with the lack of transparency with regard to counter party claims has further roiled investor confidence resulting in indiscriminate selling which is shaking investors to their core. Resolution will come as comments from a combination of regulators, central banks and major market players form a context for the information now floating about unchecked. As this transpires, uncertainty will be replaced by information that will create a mosaic which will allow investors to begin to resolve these uncertainties and move forward in a more constructive manner.

In Sum: A bear market in equities appears to be unfolding and is probably in the middle to latter stages based upon historical patterns. Sovereign Wealth Funds have emerged as an important source of capital and may prove the necessary salve to restore confidence in the current uncertain environment. A moderate global economic slowdown seems probable also. In response, central bankers have been lowering interest rates or signaling an intent to do so. Some stocks and stock indices are beginning to appear attractive on a valuation basis. In the current economic and interest rate environment, high quality fixed income investments have been re-priced and now carry a premium for their risk profile, and these investments are now priced to provide returns below their long-term averages.

Geo-political: As indicated in the previous discussion regarding Sovereign Wealth Funds (SWF), it would appear that a new "wrinkle" is making its appearance on the global capital markets stage with wide ranging repercussions. As Thomas Friedman suggests in his seminal work The World is Flat, this financial and economic inter-connectedness may well pave the way for improving economic harmonization. Armed conflict continues in Iraq, Israel/Gaza Strip and Afghanistan. Pakistan remains unstable, and concerns are rising in Serbia. Further, the North Korean and Iranian nuclear cat and mouse disarmament game continues.

Economic: Global economies stand on the precipice of recession. A sharp deterioration in consumer and investor sentiment throughout the world has unfolded in a relatively short period of time, catalyzed by the continued debt woes afflicting the U.S. economy, which has caused a serious sell-off in stock markets. At the time of this writing, Washington was in the midst of debating a series of measures (discussed below) designed to spur consumer spending and business investment in order to moderate the apparent economic contraction. At this point we are clearly in an economic slowdown in the U.S. with

the strong likelihood of a domestic recession looming. Employment will be of paramount importance dictating how severe and long the contraction will be, and given a looming labor shortage in mature economies, it would appear unlikely that many employers would be willing to measurably impact their workforces, so a relatively short pause in economic growth is the most likely outcome.

Monetary: In concert with fiscal measures designed to stimulate the economy, on 1/22/08 the Federal Reserve Board materially reduced interest rates in a preemptive shock treatment for the economy. The tone of debate among the Federal Reserve Board of Governors would seem to focus on rescuing the economy even if inflation risks remain. Central bankers around the rest of the globe would be equally inclined to ease monetary policy as the economic slowdown anecdotally appears widespread.

Fiscal Policy: Notwithstanding the fact that U.S. fiscal policy has been on course towards balancing the federal budget for the past several months, a departure is in order as traditional Keynesian economic theory holds that governments should spend in deficit if economic activity contracts in order to spur growth. The White House and Congress have pledged cooperation in quickly determining a fiscal course of action to aid the economy. Generally, getting cash back in consumers' hands, either through tax rebates or reduced withholding schedules, appears to be the most likely course of action. Accelerated depreciation for business investment would be an expected companion measure. A final policy package should emerge within the next several weeks.

Equity Markets: Price changes for many global and capitalization based equity indices are approaching "bear market" levels, traditionally measured as a 20% fall from prior peaks. More severe bear markets, such as the decline in 2000-2002 were closer to 40%. As a result, it is possible that further declines are possible. From a valuation standpoint, equities appear reasonably attractive. While caution is advised when making new equity commitments, current valuations provide many opportunities for the long-term investor to purchase quality companies at what we perceive to be distressed prices. Companies that will benefit from their global operations because of the weaker U.S. dollar would still be recommended.

Fixed Income Markets: Interest rates are at unsustainably low levels, as panicked equity investors have taken refuge in the safety of bonds. In the near term, we would expect interest rates to decline further based on the stimulus actions of the Federal Reserve relating to monetary policy and as investors continue to flock to fixed income securities as a source of refuge.

Robert M. Bilkie, Jr., CFA
President
January 20, 2008

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Please remember to contact Sigma Investment Counselors if there are any changes in your financial situation or investment objectives.

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