

How Does Sovereign Wealth Fund Investment Impact the Stock Market?

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Sovereign Wealth Funds (SWFs) are government owned investment funds. They are generally considered separate from pension funds. While SWFs have been around since the 1950s, they have only recently gained widespread attention following numerous well-publicized acquisitions during the beginning stages of the global financial crisis. Surprisingly, little is known about this increasingly important group which controls roughly \$4 trillion globally. Contributing to the lack of information on SWFs is the funds' tendency to be relatively opaque coupled with the lack of an international body to oversee SWF investment. As a result, exact holdings for many SWFs remain unknown. Target governments, investors, and potential SWF advisors remain interested in answers to important questions regarding the determinants, impact, and patterns of SWF investment.

One area for which we have some evidence is the financial performance of SWF investment in public equity. Dewenter et al. [1], Kotter and Le [2], and Knill et al. [3] show that initial stock market reaction to SWF investment is positive with a roughly 1.4% announcement day abnormal return for target firms. It is less clear, however, what drives this positive reaction as monitoring, relief of capital constraints, and liquidity have all been offered as explanations. Regardless of the cause, target short-term price response indicates that SWF investment is welcomed by the market.

Counter to short-term evidence, SWF public equity targets exhibit relatively weak performance in the one to three years following SWF investment. Several possibilities may explain this under-performance including: typical inefficiencies common in government operations,

non-financial (i.e., strategic) investment motives, constraints unique to SWFs, or investment biases (i.e., home bias). Further, SWF investment patterns and performance in public equity appears to be inconsistent with that of other institutional investors including mutual funds and hedge funds. Collectively, longer horizon results indicate a non-positive market reaction to SWF investment.

Overall, SWFs appear to be a unique class of investors. Additionally, much less is known about SWF investment in private equity and real estate compared to that of public equity. More research in this area is needed. Perhaps not surprisingly, the relative lack of information on SWFs has caused some governments to be concerned with SWF investment. In some cases, SWF investment has been directly blocked by foreign governments. The establishment of best practices for SWFs in the Santiago Principles of 2008 is a step toward transparency. Further transparency and disclosure of existing investments by SWFs is needed and would improve government and market confidence in the future participation of SWFs. Finally, policy makers and investors should take care in their view and treatment of SWFs as motives, structure, and transparency differ greatly amongst funds.

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