Sovereign Wealth Fund for Thailand?

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Good Morning, Ladies and gentlemen:

I will get directly to the point with a question of whether it is always best for an emerging market country to set up a sovereign wealth fund. My short answer is that it depends on a lot of factors.

Sovereign wealth fund has become a hot topic in Asia recently because of the rapid international reserves accumulation. Many countries have intervened heavily to hold down their currencies, Thailand included.

This has led to very high levels of reserves. These reserves are at the central banks. And because the central banks are normally cautious with their foreign investments, so they get low rates of return. These rates are now, in some countries, lower than the costs to the central banks in neutralizing the money supply. The negative carry has therefore been pushing some central banks into yearly losses.

To solve this problem, some people advocate for these countries to set up sovereign wealth funds. The funds will then invest in securities with higher risks to generate higher rates of return than what have been earned by the central banks.

On the other hand, there is another group of countries have accumulated substantial reserves because of oil export. These countries also want higher yields for their investments abroad.

Suppose the country sets up a sovereign wealth fund, what form of foreign investment is best to produce higher yields?

The fund will have to diversify its investments into an acceptable universe of securities. Obviously if it wants to earn more than the central bank, it will have to take on investments with higher risks. It could be debt instruments or equities or even real estate and property.

It will also have to diversify its portfolio widely to disperse risks. Its time horizon for holding investments will tend to be short term to medium term at most. The emphasis is on the rate of return, the flexibility to change portfolio and not on taking management control of the target companies.

This type of investment is normally welcomed by most countries. However, one has to question whether it is necessary for the government to do this.

A better and simpler alternative would be for the government to disperse the foreign assets out of the accounts of the central banks into the hands of private individuals instead. The country should simply liberalize portfolio investment outflow for its citizen.

Private individuals normally can look after themselves well and decide on foreign investment selection by themselves, or with the help of qualified financial institutions. They would earn bigger rates of return than civil servants can ever achieve, because civil servants are never paid high enough to do this.

True, there may be some private individuals that fall into the trap of subprime CDOs occasionally, but it is part of the learning process. I am therefore strongly against central banks trying to worry about its citizen buying risky investments. Because private individuals can take higher risks, for higher rewards, than the civil servants, the country as a whole will get higher rates of return on its combined foreign assets.

Therefore, the easiest way to enhance yield on short term foreign assets is not to set up sovereign wealth funds, but instead to liberalize portfolio investment outflow to private individuals.

The countries that still need sovereign wealth funds to do this job are limited only to the following conditions.

First, the country that has too few population, or the population that is particularly risk averse to investing abroad, or lack of knowledge to do so. Then, there is a case perhaps for the government to do the job on behalf of its citizen.

Second, the country in which wealth is highly concentrated in the hand of too few individuals. Or the country whose export revenues build up so fast, and the revenues mostly belong to the government, as in many oil exporting countries. Here there may also be a case for sovereign wealth funds.

These two conditions certainly do not apply to Thailand.

But there is another type of investment that may lend itself to the vehicle of sovereign wealth funds?

These are the investments that are strategic and long term. By long term I don't mean a few years but decades. For these investments, there may be a case for sovereign wealth funds.

In developed countries, there are many private companies that are able to expand their operations across borders. When these private companies invest long term into foreign companies, it is because the target companies fit in with their business plans.

This is the type of investment that generates the highest yield over the long term. Why? It is because these multinational companies can coordinate and manage their operations to control resources around the globe, to leverage on their know-how and their intellectual property.

This is how an economic unit can generate superior returns, by having better products, better management and better utilization of resources on a global scale.

Therefore, if your country has many private companies with global competitive advantages that can invest abroad, then there is no need to set up a sovereign wealth fund. Simply allow them to do so. Again, they will tend to make better decisions than civil servants.

But the problem is that, in many emerging markets, the number of companies that can expand across borders is still very small. Many companies are still majority owned by the government. And many companies are still constraint by their limited capitals. Most of them can not yet invest abroad aggressively.

In this case, I can see an argument for the government to set up a sovereign wealth fund that buys into strategic foreign companies to enhance the global competitive advantages of certain business sectors of the country.

For example, a country with a strong agriculture sector may buy into bio-technology research companies to leapfrog on crop yields, or buy into fertilizer companies to control supply. A country with strong base metal industries may buy into mining companies.

In fact, some people say that the best investments that most emerging market countries can make is in commodities. This is because the more emerging markets as a whole become developed, the more they will consume commodities and drive up prices. So it makes sense to lock up some supply today. Or a country with competitive advantage in aviation may buy into foreign airports or airport management companies. The list of potentially good investments can go on.

But there are two problems. One on the host country front, and another on the home country front.

On the host country front, many host countries are now weary of sovereign wealth funds coming in to control resources or high technology. Nowadays, sovereign wealth funds are not welcomed with open arms.

On the home country front, there is also a potential difficulty. These investments are not for short term yearly returns. In fact, the benefits that the country derives from these investments may not be directly obvious.

These investments may even incur losses, whether temporary losses from marking to market or losses on their eventual sales. But, on the other hand, the benefits may occur in other businesses else where in the form of synergy.

How then can you explain the losses to the public?

In my opinion, this is the real difficulty of sovereign wealth fund in emerging markets.

Some investment bankers may argue that the most difficult part of sovereign wealth fund is to have a good strategic vision and to identify the right target companies.

To have a strategic vision is difficult because it requires a lot of far sight, and a lot of understanding of world businesses. To identify the right target companies is even more difficult because it requires very good analysis.

Actually I do not doubt the vision of the leaders in the region. Nor do I doubt the ability for them to obtain the advice from global investment banks to select the right companies. But the problem is that in most countries, this type of operation can not be done in secrecy. I therefore see the real difficulty in explaining to the general public.

What will be their reaction when the sovereign wealth funds incur losses, even though it might be temporary and even though there might be an explanation that synergy is being generated elsewhere. It can still be difficult.

It will become even more difficult if the country is like Thailand in that whenever an opposition party switches to become the government, it will have the tendency to try to find faults with the previous administration.

We have seen many examples in the past of committees that were set up to investigate past deals. A loss in the sovereign wealth funds may provide a golden opportunity for revenge.

In the end, the answer whether or not a country should set up a sovereign wealth fund may not lie so much with economics. It may lie more with politics.

Thank you.