

Market Insights

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Why Not a U.S. Sovereign Wealth Fund?

With the passage of the American Recovery and Reinvestment Act of 2009 and the Homeowner Affordability and Stabilization Plan (HASP), more government intervention initiatives arguably continue to fall into place. However, neither of these plans has been completely embraced by the markets yet, leaving a great deal of uncertainty as to their ultimate effectiveness. This paper explores another possibility for the U.S. of creating a sovereign wealth fund.

To our knowledge, the various forms of government intervention that have been contemplated, do not appear to have included the formation of a permanent U.S. sovereign wealth fund as part of the solution. Admittedly, starting a sovereign wealth fund is perhaps most feasible when a government body has an actual capital account surplus to invest, as opposed to record deficits. For example, many foreign sovereign wealth funds were launched as a result of accumulations of large capital account surpluses, often by natural resource-rich nations during commodity bull markets, or from nations running large trade surpluses.

Still, given that the United States government is already allocating unprecedented levels of capital to support the financial markets, the merits of creating a sovereign wealth fund via an additional dose of Troubled Asset Relief Program (TARP) capital seems to be worth exploring. As with most foreign sovereign wealth funds, it would be set up to be managed by investment professionals whose goal is to maximize long-term risk-adjusted returns for the fund. Further, it could serve a dual purpose of:

- 1) Potentially being a large buyer of newly issued securitized product and/or distressed assets that have the potential to generate strong long-term investment performance as the economy recovers.
- 2) Simultaneously serving as a supplemental overlay to government social security programs by targeting higher long-term investment returns than those generated by investing in government bonds. Further, it could enter into joint ventures with private capital sources as is contemplated by the PPIT provisions of the Financial Stability Plan.

To satisfy political demands, it could, over the short-term, be structured with a “home country bias” built into its geographic target weighting. Doing so would help bring more immediate weight of capital to U.S. financial markets, which would then phase out as recovery occurs. The timing of its launch would take advantage of the wide availability of dramatically re-priced assets. Such investment activity would not only provide pricing support to securitized asset classes, but would also acquire investments at a very attractive cost basis that could perform quite well for U.S. taxpayers over the long-term.

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Because a U.S. sovereign wealth fund would presumably not have mark-to-market accounting concerns, (and if made permanent would have a very long liability structure) the liquidity and interim volatility of its investments would not necessarily be a major issue. As for the potential counterargument, since it would buy assets at currently distressed prices, it would cause many financial institutions to incur realized losses on their toxic assets. It is not clear that such an outcome is materially different from encouraging private investors under the PPIT plan to buy such assets on a large scale. In addition, a taxpayer-owned sovereign wealth fund would get the upside from such investments, avoiding the adverse selection risk within the embedded “put option” that occurs from offering government non-recourse debt to private investors.

Although the concept may seem a bit far fetched, it is worth noting that at least four U.S. based sovereign wealth funds already exist: the Alaska Permanent Fund, Alabama Trust Fund, New Mexico State Investment Office Trust and Permanent Wyoming Mineral Trust Fund. These commodity-based funds have, per estimates from the SWF Institute, US\$52 billion in assets under management. A new federal sovereign wealth fund wouldn't be based on commodities of course, but it could be funded with some portion of the government intervention capital. And it might be easier to explain to taxpayers compared to other government intervention programs. It could serve to supplement such programs and thus diversify the intervention efforts, and would seemingly provide more balance in terms of taxpayer upside and downside.

Perhaps the main reason it may not be feasible is that it could encounter strong resistance. The independence to set its own investment strategy and make its own investment decisions allows it to be subject to ongoing political interference. Still, the concept does seem worth further evaluation.

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