March 2020

Dreaming of a Sovereign Wealth Fund

President Cyril Ramaphosa announced during his State of the Nation address in February 2020 that South Africa intends to establish a Sovereign Wealth Fund. The immediate reaction has generally been very negative with most wondering how the country can possibly afford it and how it can avoid the long tendrils of corruption. We take a closer look at what a Sovereign Wealth Fund actually is and whether it makes sense for South Africa to consider it.

What is a Sovereign Wealth Fund (SWF)?

A SWF is a government-owned investment fund built up over time by cashflow from the country's reserves. Reserves are excess funds that are saved for future investment into the economy or to benefit the population in some way. These excess reserves are generally as a result of a budget surplus (i.e. tax receipts higher than government expenditure) or a trade surplus (i.e. when value of exports exceed the value of imports), but can also be due to the privatisation of State Owned Enterprises (SOEs) or the revenue generated from exporting a specific natural resource (e.g. oil).

Due to the fact that the SWF is built out of excess reserves and are not for meeting short term liabilities in a country, the funds generally target longer term returns and can therefore invest in a range of risk assets (as opposed to any foreign exchange reserves that are normally retained in highly liquid assets).

Many countries that have built successful SWFs have done so to diversify their government revenues in the future. There are many countries whose revenue has been dominated by oil exports for many years with the revenue earned well in excess of what is needed to meet spending needs. These excess revenues are then invested in alternate, non-oil related assets so that future revenue will come from both their oil revenue but also the revenue derived from the investments in the SWF. The country is then diversified in terms of revenue to mitigate to an extent the negative consequences of a drop in the oil price.

The properties of revenue from resources like oil and other commodities are precisely why SWFs often make sense: significant volatility in resource prices, the unpredictability of extracting the commodity, and the fact that the resources are not renewable (i.e. they do run out eventually).

Success story: Norwegian Sovereign Wealth Fund

The largest Sovereign Wealth Fund in the world has more than US$1trillion in assets under management. This translates to approximately US$200,000 per Norwegian citizen. The fund owns about 1.3% of all global equities, as well as real estate and fixed income instruments. It is funded by the revenues generated through the country's sea-based oil drilling. The fund pays a portion of the gains out to the citizens as a dividend or uses it for incentives that would improve the country. A recent example of this was providing monetary incentives for the purchase of electric cars.

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What is driving the ANC government to establish a SWF?

The motivation for a SWF can be tracked back to the 1950s when the ANC and its allies adopted the Freedom Charter, effectively agreeing that the country's wealth, land and mineral deposits should be owned and shared by all the people. The creation of a SWF is a long-standing ANC resolution that has just never been implemented.

The party line has been that a SWF would be established as a means to "preserve and grow the country", which would give "practical meaning to the injunction that the people shall share in the country's wealth".

In essence, the view is that historically the wealth generated by South Africa's mineral deposits (especially during commodity super cycles) has been enjoyed by the few rather than the population at large. To be clear, it is not referring to nationalisation of the mines, it refers to excess government revenue generated through for example mining royalties or windfall taxes when commodity prices are high. The SWF is one of the ways in which excess revenues generated by the country's significant remaining mineral deposits could be used to build the country for future generations. That is the theory.

Finance minister Tito Mboweni stated: "There are a variety of possible funding sources such as the proceeds of spectrum allocation, petroleum, gas or mineral rights royalties, the sale of noncore assets, future fiscal surpluses and money we set aside". He indicated that the initial target capital for the fund was R30bn. Treasury are busy conducting a feasibility study and no timeline has yet been confirmed for the establishment of Fund.

Mboweni stated that a SWF was an important long-term tool for saving and investment for future generations. "We must learn to save during the good times, and a fund can play an important role as a countercyclical fiscal tool," he said. He said the fund would ensure that SA "continues to invest in the future generations of this country in a fiscally prudent manner". What are the challenges with a SWF?

The most significant concern with SWFs around the world has been a lack of transparency. Political influence has in many cases driven the selection of investments and implementation has been riddled with corporate governance issues and corruption. Where an investment is not selected entirely on merit but rather as a result of political influence or fraud or corruption, it is fairly obvious to the rational mind that the investment outcome will be worse.

A notable exception to this has been the Norwegian SWF, where all decision making is done by an outsourced, professional business with an independent board and political/government interference is virtually non-existent. In our opinion, this goes a long way to explaining why it has also been the most successful. Basically, the investment and management of the funds is left to external experts with a clear mandate, and the government then decides how to optimally spend the proceeds from these investments.

All the transparency concerns lead to some of the world's main SWFs meeting in Chile in September 2008 under the leadership of the IMF. A working group from the summit then drafted the 24 Santiago Principles, a set of international standards regarding transparency, accountability and independence in how SWFs operate.

A second concern is the sheer size and importance of some of the SWF and the potential they have to influence asset prices and markets. The PIC in South Africa is an example of a government owned fund that owns such a large proportion of the equity market that any decision they make can and does move prices. This can be detrimental if those managing the SWF don't exercise their duty of care when trading.

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Does a SWF make sense for South Africa?

For a country with significant mineral wealth and potential offshore gas discoveries, it theoretically makes sense to establish a SWF to put aside excess revenues from these sources during the boom years to help build the country for future generations. In our opinion, the theory behind establishing a SWF makes a lot of sense. But there are a few hurdles that need to be overcome to ensure it is beneficial, including:

- **The country's current financial situation:** Government (and SOE) debt levels are relatively high and rising quickly given our current fiscal trajectory (and that was before the impact of the coronavirus). The country is not growing, we have record levels of unemployment and a bloated civil service. All point to every spare cent being needed to fund existing expenditure and reduce debt (rather than build a future fund). There are no "excess" funds available and any outsized revenues in the short term should all be used to reduce the debt burden. So, if a SWF does make sense, it is certainly not in the short to medium term.
- **Government's ability to deliver:** Given the last decade of corruption and general government failure on delivery, the public's trust is justifiably low. This is highlighted by the mismanagement and corruption being revealed at the Public Investment Corporation, the state-owned investment firm. Should we be giving President Ramaphosa more time to deal with corruption at all levels of government and should we be giving the NPA under Shamila Batohi more time to ensure the corrupt end up behind bars. It will be very interesting to watch how the Solidarity Fund set up to help fight Covid-19 is managed. The president was at pains to point out that it will be managed independently with clear oversight and transparency in a public-private partnership. The hope is that if it is managed properly, a degree of confidence could return. But at the moment, it is a huge ask to think that the fund could be set up such that it is managed independently of political influence and corruption.

In summary, we believe that a SWF makes a lot of sense in theory and could be a very effective vehicle for managing windfalls like commodity price spikes, but there is a need to build the country's trust that it can be managed effectively and a material issue related to the timing of its introduction (especially now with the impact of COVID-19).

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data provided by Reuters and Datastream

31 March 2020

		3m	YTD	1yr	3yr pa	5yr pa	10yr pa	5yr Vol1	10yr Vol1
LOCAL MARKET INDICES									
FTSE/JSE All Share Index (ALSI)	ZAR	-21.4%	-21.4%	-18.4%	-2.1%	-0.1%	7.7%	13.3%	12.7%
FTSE/JSE SA Listed Property	ZAR	-48.2%	-48.2%	-47.9%	-23.0%	-13.5%	2.8%	21.9%	18.5%
SA All Bond Index (ALBI)	ZAR	-8.7%	-8.7%	-2.9%	5.3%	5.2%	7.4%	8.2%	7.6%
SA Cash Index (SteFI)	ZAR	1.7%	1.7%	7.3%	7.3%	7.2%	6.5%	0.1%	0.2%
Balanced Benchmark	ZAR	-13.2%	-13.2%	-9.0%	2.0%	3.3%	9.2%	8.9%	8.2%
SA Inflation (1 month lag)	ZAR	1.5%	1.5%	4.6%	4.2%	5.2%	5.1%	1.2%	1.3%
GLOBAL MARKET INDICES									
Global Equity (Datastream World)	USD	-20.9%	-20.9%	-9.9%	2.5%	3.8%	7.2%	13.6%	13.8%
Emerging Markets Equity (Datastream EM)	USD	-23.6%	-23.6%	-17.4%	-1.3%	0.0%	1.0%	17.6%	17.8%
Global Property	USD	-23.1%	-23.1%	-18.0%	-0.1%	0.9%	6.4%	14.3%	15.0%
Global Bonds (Barclays Global Bond Index)	USD	2.0%	2.0%	6.2%	4.3%	3.0%	2.2%	5.3%	5.3%
Global Cash	USD	0.4%	0.4%	2.1%	2.0%	1.5%	0.9%	0.2%	0.2%
MAJOR INDICES BASED TO RANDS									
FTSE/JSE All Share Index (ALSI)	ZAR	-21.4%	-21.4%	-18.4%	-2.1%	-0.1%	7.7%	13.3%	12.7%
Global Equity (Datastream World)	ZAR	1.0%	1.0%	11.6%	12.8%	12.2%	17.1%	15.8%	14.1%
Emerging Markets Equity (Datastream EM)	ZAR	-2.4%	-2.4%	2.3%	8.6%	8.1%	10.4%	13.9%	12.7%
Global Property	ZAR	-1.8%	-1.8%	1.5%	9.9%	9.0%	16.3%	16.5%	14.1%
SA All Bond Index (ALBI)	ZAR	-8.7%	-8.7%	-2.9%	5.3%	5.2%	7.4%	8.2%	7.6%
Global Bonds (Citigroup)	ZAR	30.3%	30.3%	31.5%	14.7%	11.3%	11.7%	16.6%	14.6%
COMMODITIES									
Gold (US Dollars)	USD	6.0%	6.0%	24.4%	8.9%	6.3%	3.8%	12.8%	15.8%
Gold (Rands)	ZAR	35.4%	35.4%	54.1%	19.9%	14.9%	13.4%		
CURRENCIES									
Rand / Dollar	ZAR	-27.7%	-27.7%	-23.8%	-10.0%	-8.1%	-9.3%	17.1%	15.8%
Rand / GBP Pound	ZAR	-19.5%	-19.5%	-17.8%	-9.7%	-4.2%	-7.1%	17.3%	14.9%
Rand / Euro	ZAR	-24.8%	-24.8%	-21.0%	-11.0%	-8.5%	-7.0%	15.9%	14.0%

Spot Rates		31-Mar-20	Latest Quarter	1 Year Ago	5 Years Ago	10 Years Ago	20 Years Ago
CURRENCIES							
Rand/US$	Rand	17.86	13.98	14.42	12.12	7.34	6.55
Rand/GBP	Rand	22.15	18.55	18.80	17.98	11.14	10.44
Rand/EUR	Rand	19.60	15.70	16.19	13.01	9.94	6.26
RATES							
Libor 6m $	US$	1.18	1.91	2.66	0.40	0.44	6.53
Repo Rate	Rand	5.25	6.50	6.75	5.75	6.50	11.75
Prime	Rand	8.75	10.00	10.25	9.25	10.50	14.50
All Bond Index Yield	Rand	11.23	9.55	9.44	8.05	8.69	9.74
COMMODITIES							
Gold ($/oz)	US$	1,612.10	1,520.50	1,295.72	1,187.60	1,113.15	277.45
Platinum	US$	727.00	971.00	850.00	1,129.00	1,645.00	482.00
Oil (Brent Crude) $	US$	22.60	66.31	68.55	54.56	81.01	24.84
INFLATION							
SA Inflation	%	4.6	4.0	4.5	4.0	5.1	9.4

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