At Sovereign Funds, a History of Bad Timing

By DEALBOOK

After becoming international wheelers and dealers just a few years ago, sovereign wealth funds have staged a retreat. Instead of hunting for bargains beyond their borders, many of these government-run investment pools seem to be staying close to home.

That may not be surprising, judging from the conclusions of a new study to be released by the National Bureau of Economic Research, Harvard Business School and the Massachusetts Institute of Technology.

The study, which analyzed about 2,600 sovereign fund investments over the last 25 years, appears to show that these funds are “trend chasers” rather than good market timers — more specifically, they are likely to invest at home when domestic equity prices are higher, and invest abroad when foreign prices are higher.

This tendency to shun assets when their prices are low has taken its toll on the returns at these funds, the study found.

Early into the recent financial crisis, sovereign funds, especially in the Middle East and Asia, made multibillion-dollar investments in major financial institutions in the United States and Europe — deals that have generally performed poorly because of the subsequent collapse in bank stocks.

The study, called “The Investment Strategies of Sovereign Wealth Funds,” was conducted by Josh Lerner and Shai Bernstein of Harvard University, and Antoinette Schoar of the Massachusetts Institute of Technology. It is scheduled for release this week as a National Bureau of Economic Research and Harvard Business School working paper; DealBook got a look at a draft copy.

The report found that sovereign fund investments made in a fund’s home country tend to do worse than foreign investments, at least in the short term. Industry price-to-earnings ratios of domestic investments tend to drop in the first year, while international investments have a positive change in the first year.

Moreover, when politicians are involved in sovereign funds’ decision-making, more money is funneled to poorly performing domestic deals, the researchers concluded.
“Greater investment at home is a symptom of poor investment decisions,” the study said, “since the funds are prone to home bias or else to have decisions distorted by political or agency considerations.”

The study suggests that sovereign funds often have goals that go beyond making a profit. They might be willing to accept investments in their home country that are less profitable than international ones but have high “social” returns, for example. Other reports suggest that state-run funds can be used in furtherance of governments’ geopolitical and strategic economic interests, as when the Singaporean funds make investments in their larger neighbors, India and China, the study said.

Of course, sovereign wealth funds face restrictions that other investment funds don’t, and this can force them to leave profits on the table.

For example, Norway’s Government Pension Fund caused a public uproar in 2006 by betting on a decline in shares of Icelandic banks — a move that many considered to be profiting at the expense of another Nordic country’s pain. The fund later had to back out of the trade.

– Cyrus Sanati