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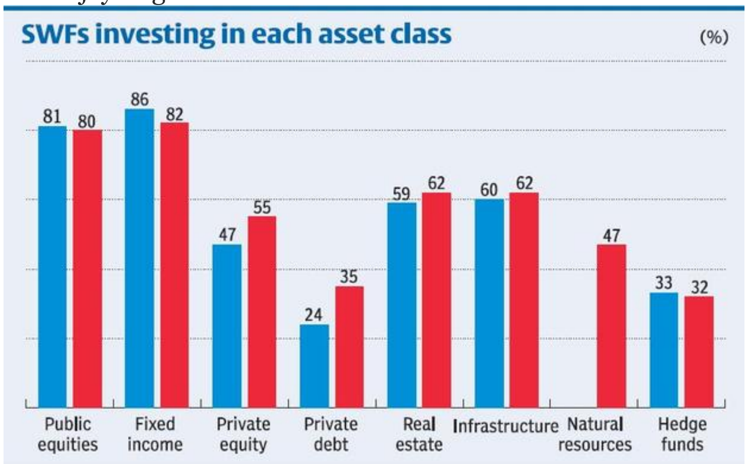
A sovereign wealth fund for India?

Nandini Vijayaraghavan



Source: 2016 Preqin Sovereign Wealth Fund Extract
Note: Preqin started collecting natural resources data on SWFs since 2015

Fifteen largest public funds

Rank	Fund	Country	Type	Fund Size ($ billion) June-16	Fund Size ($ billion) June-15
1	Social Security Trust Funds	USA	National Pension	2,813	2,790
2	Government Pension Investment Fund	Japan	National Pension	1,264	1,150
3	Government Pension Fund - Global	Norway	SWF	850	873
4	China Investment Corporation (CIC)	China	SWF	814	747
5	Abu Dhabi Investment Authority (ADIA)	UAE	SWF	792	773
6	Kuwait Investment Authority (KIA)	Kuwait	SWF	592	592
7	SAMA Foreign Holdings	Saudi Arabia	SWF	582	686
8	SAFE Investment Company	China	SWF	474	542
9	Federal Retirement Thrift	USA	Public Pension	470	443
10	Hong Kong Monetary Authority Investment Portfolio	Hong Kong	SWF	457	428
11	Stiching Pensioenfonds ABP	Netherlands	Public Pension	444	440
12	National Pension Service of Republic of Korea	South Korea	National Pension	409	439
13	GIC Private Limited	Singapore	SWF	350	344
14	Qatar Investment Authority	Qatar	SWF	335	256
15	CalPERS	USA	Public Pension	302	304

Source: http://www.swfinstitute.org/fund-rankings/

Given India's stable external account, the time is ripe to secure long-term strategic interests in oil, gold and manufacturing

Suggesting that India incorporate a Sovereign Wealth Fund (SWF) may appear quixotic given the country's sustained current account deficit (CAD), still significant inflation, and growing external debt stock to GDP.

But the proposal merits a closer look. CAD has fallen (improved) to a five year trough primarily driven by declining crude oil prices. FX reserves are the ninth largest in the world. Foreign direct investments in India have grown ten-fold, albeit from a low base of $4 billion in FY01 (12 months ended March 31, 2001) to $44.9 billion in FY16.

Benefits of SWFs

The SWFs of several nations enable governments to augment resources and achieve strategic objectives. A review of the 15 largest public funds in the world indicates that an SWF is not just a vehicle for crude oil exporting nations to invest their surpluses. Countries such as China and Singapore have used SWFs to meet their commodity import requirements, promote the expansion of domestic companies overseas, attract foreign direct investment and increase government revenues.

India's SWF may be structured along the line of Singapore's Temasek Holdings, which invests its multiple asset classes across Asia, Australia and New Zealand, Europe, North America, Africa and the Middle East, in addition to being the holding company for Singapore's listed public sector undertakings. According to the Temasek Review 2016, 28 per cent of its portfolio is invested in Singapore and the balance 62 per cent is invested overseas. The Government of India (GoI) incorporating an SWF would facilitate achieving key political and economic goals.

First, the SWF may purchase stakes in overseas companies, especially crude oil and gold manufacturers, commodities which together accounted for 30 per cent of India's $380.4 billion merchandise import bill in FY16. The declining trend in crude oil and gold prices resulted in the share of these two commodities in India's import bill declining to 30 per cent in FY16 from 43 per cent in FY12. However, with the OPEC agreeing to a 1.20 billion barrels output cut from January 2017, crude oil prices are likely to witness some appreciation. Hence, it becomes imperative for India to acquire strategic stakes in oil and gold companies while prices are still low.

Second, the SWF's earnings will diversify GoI's revenues and augment foreign exchange reserves. With the benefit of hindsight and hypothetically speaking, had GoI invested ₹45 billion ($1 billion) on January 1, 2011 in the S&P500 index, the investment would have more than doubled to ₹113.75 billion by December 31, 2015. The 153 per cent pre-tax total return comprises 10 per cent dividend yield, 63 per cent capital gains and 80 per cent currency gains.

The historical returns generated by a portfolio invested in an S&P500 tracking Exchange Traded Fund has been provided for illustration purposes. SWFs typically invest in multiple asset classes including public (listed) equities, fixed income, private equity, private debt, real estate, infrastructure, natural resources and hedge funds. A SWF's asset allocation is driven by its risk adjusted return preference. Asset allocation is driven several factors including the country's strategic requirements for resources, technology, foreign exchange, recurring income in the form of dividends and interest and capital appreciation.

Thirdl, the SWF acquiring strategic stakes in foreign manufacturing companies would enable India forge the strategic partnerships necessary to strengthen the country's manufacturing sector in line with GoI's 'Make In India' thrust.

PSU corpus

Finally, GoI holds controlling stakes in public sector undertakings (PSUs). The aggregate free float market capitalisation of the better performing PSUs, constituents of Bombay Stock Exchange's PSU Index, is ₹5,198 billion ($82 billion) as of December 1, 2016. The GoI transferring its equity stakes in these companies to a SWF will streamline PSU management and will be revenue neutral to GoI as the SWF dividends will replace PSU dividends.

A prudent and diversified investment policy should generate stable long term returns, as demonstrated by Temasek Holdings and Norway's Government Pension Fund. How will the SWF be funded? The GoI-promoted SWF issuing long dated retail bonds in an era of softening domestic interest rates and the ongoing crack down on black money will be well-received. The retirement corpus of GoI's Employment Provident Fund Organisation and total assets of government-owned banks amounted to ₹2,385 billion ($38 billion) of March 31, 2015 and ₹91 trillion ($1,367 billion) as of March 31, 2016 respectively. If these entities were to invest 5 per cent of their assets in the SWF's stock, equity capital would be $70 billion.

After the Indian government's well meaning but poorly timed and badly administered demonetisation on November 8, 2016, bank deposits swelled by an estimated $29.80 billion (₹1.89 trillion). Though a significant portion of these deposits are likely to be withdrawn, the deposit base of Indian banks will expand. This will enhance the Indian banks' ability to invest long term funds in the SWF.

Stable capital inflows into India and remittances by Indian expatriates are essential to facilitate recurring foreign exchange denominated investments in the SWF. This does not seem to be a cause for concern at the current juncture .

Only political will and nimble action are required to launch this long overdue initiative.

The writer is a Singapore-based corporate finance professional.

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