MSc Finance, MSc Strategic Professional Accounting and Finance

ACFI7015 Research Project

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Impact of sovereign wealth funds on investee firm's performance

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1. Introduction

Sovereign Wealth Funds (SWFs) are investment pools created and funded by a country's government with an aim of investing a nation's excess reserves, mostly from exports of natural resources and trade surpluses so that the country has a long-term financial stability (Bortolotti et al., 2010). Pension funds, as these long-term, large and very important players in global finance operate more than $11 trillion. Its total assets stood at $5 trillion as of February 2023 (Megginson et al., 2023). This study seeks to analyse the effect of SWFs on the firms' financial performance and the firms' ESG performance. The primary research question asks, "What is the impact of SWFs on the financial and ESG performance of their investee firms?" To address this, the study sets out three specific objectives: analysing the effects on SWFs financial performance, as well as, estimating the role of SWFs in shaping ESG performance and admitting the differences in such impact between different SWFs. The literature review to this research is presented in a manner that examines historical background and development of SWFs in the first instance, before proceeding to what can be considered as the research question of interest herein; namely, how and why SWFs invest as they do. It will then look at the financial and ESG consequences based on the literature review of existing empirical evidence and theoretical frameworks and finally will try to show differences in the performance effects of SWFs depending on its origin, size, and investment strategies. Overall, this approach offers a systematic way of analysing how SWFs engage in shaping the financial performance and ESG profiles of their investee firms.

2. Overview of Sovereign Wealth Funds

There are several general types of SWFs which are also distinguished by their aims and approaches. Stabilization Funds are particularly implemented for floor a country's economy from the fluctuations of the prices of the commodities especially in those countries with the natural resources (Megginson et al., 2023). These funds provide shocks absorbers by charging extra revenues when prices of their commodities are high and distributes same during low prices with view to checking fluctuations. Savings Funds are different and they aim to ensure pass on of wealth to future generations by transitioning the same to investment instruments The Funds therefore do not invest in one asset class (Dewenter et al., 2010). Most of these funds are long-term based so as to guarantee the nation's fortune after exhaustion of natural resources. Reserve Investment Funds are designed to earn income out of the excess foreign reserves usually maintained with the central banks. To achieve these objectives, these funds look at improving on returns through investment in other classes of assets while meeting the liquidity objectives and at the same time seeking for better yields. Different forms of SWF have its uses in the stewardship of a country's wealth, which is predicated on the economic agenda and or circumstances of the state (Capapé and Santiso, 2017).

Depending on the investment target, SWFs use passive to active management to attain the laid down goals and objectives. Market activity is monitored through indices, and investment is spread widely in order to reduce risk and expense of investment. (Bernstein et al., 2013) Meanwhile, active management consists in making some select investments on the strength of research and analysis of benchmark and other related indices with higher risk adjusted return possibilities. SWFs also differ in terms of the investment time frame; for example, some of them invest for the very long-term, in line with the objectives of SWFs to preserve wealth and foster long-term, stable economic growth, whereas others may invest for the short-term, in order to capitalise on certain opportunities or to cover short-term needs (Cuervo-Cazurra et al., 2023). The decision between these strategies depends on the goal of the SWF, risk appetite and environment for investment.

The geographical and sectoral distribution of SWF investments can be best understood by their investment strategies and attitude towards risk taking. On geographical basis, SWFs invest across different geographic area in order to avoid specific country risks. While some of the funds could focus their investments in the developed countries because of reasonable stability, others may target higher returns from the developing countries that have more growth exposure albeit with more risks (Di Bonaventura Altuve, 2024). On a sectoral basis, SWFs invest broadly across many industries but there is a preference towards sectors like infrastructure, real estate, technology and financial services. The diversification across sectors is done to get the optimum risk return opportunity for the SWFs and having some specific long-term goals, they invest in some strategic sectors. (Junghanns and Körnert, 2022)

SWFs are big investors in the global financial markets and affect the prices of assets and the movement of markets because of their size (Gomes and Khan, 2016). They often have long-term investment horizon and relatively stable cash inflows, therefore, their investment can contribute to liquidity of the markets and their stability especially during periods of market tension. Thus, the increasing role of SWFs is also problematic, in particular, from the points of view of transparency and political orientation of their investment activity (Junghanns and

Körnert, 2022). As recognisable and legally established international investors, SWFs are capable of providing to the global financial stability, but their size and potential require supervision to ensure that they will act in sync with worldwide economic and financial interests without disturbing the stability of the markets and without deepening perceived antagonisms between opposite nations.

3. Financial Performance Impact of SWFs

Theoretical Frameworks

The existing theoretical framework concerning institutions, investment and financial performance is a good starting point of understanding how SWFs shape up their investee firms. Agency Theory is among the main theoretical models which are used to explain the behavior of many institutional investors, including SWFs. This theory looks at how principals and agents engage with one another especially with a view on the fact that the agents may not act as expected by the principals (Markowitz, 2020). These conflicts can be minimised where SWFs as large institutional investors affect the corporate governance structures, harmonise the interests of the management with outside shareholders' and might improve efficiency and profitability.

RBV theory is also useful for comprehending the effects of SWFs on financial results. RBV postulates that the special and exclusive possession, acquisition and management of resources brings about sustainable competitive advantage (Gouett, 2020). First of all, due to the financial endowment and long-term investment time horizon, SWFs can offer the funds and certainty that firms require to implement a range of growth, innovation, and capacity initiatives that will improve their financial outcomes.

Another relevant theory is Stakeholder Theory and it postulates that a company success is defined by how effectively it manages its stake holders, the shareholders, employees, customers, suppliers or the entire community (Markowitz, 2020). SWFs may also have more diverse charter that goes beyond the wealth maximization principle, to embrace other values such as social or environmental goals; thus pushing firms to use the funds in a way that reflect appreciation of stakeholder interests. These can result in performance increases with respect to the financial health and also the advancement of social welfare (Knill et al., 2012).

Financial Performance

Findings of prior empirical research regarding the effect of SWFs on the operating performance of the target firms have been mixed. The most important incentives covered in the research concern the financial performance to include Return on Investment (ROI), stock prices, and market valuation of the enterprise (Knill et al., 2012). Some of the prior papers have argued that SWF investment has positive influence on stock price in the short run; this may be due to market confidence in the fund not to pull out and the financial power of these funds. For instance, Kotter & Lel (2011) established that SWF investments entailed positive abnormally returns around the announcement date hence conforming to market approval on SWF participation.

As for the effectiveness of SWFs, the returns may be more or less attractive, the fact is that the effectiveness of such funds often depends on the time horizon and the strategy used by the Fund. Long-term horizons are usually linked to predictable returns, especially in industries that SWFs are able to use their muscles to push for expansion and development (Wang et al., 2021). On the other hand, short-term investments could result into more instable fluctuations of financial results because of risks associated with efforts to take advantages of particular opportunities.

Various studies comparing a firm's performance prior to investment by an SWF to that after investment, suggest that these SWFs have a moderating influence on the performance with quality, particularly in conditions of fluctuating market volatility or in a recession. Organizations which benefit from SWF investment tend to record better funding (Dyck et al., 2010), better corporate governance, and better strategic direction, giving better revenue and profit figures, and generally better market share performance over time.

Factors Influencing Financial Performance

There are different factors that defines the financial results of SWF investments, which are investment approach, management and the global economic environment. The ability of an SWF to affect the improvement of a country's financial performance depends on the strategy that is implemented on the investment (Dyck et al., 2010). The former, which involves the SWF purchasing stakes in the broad market, are characterised by low returns but minimal volatility, while the latter are marked by high volatility and potentially larger returns.

Another remarkable aspect of SWFs is that the internal governance structures of a SWF enhances or hinders it performance as investors (Bahoo et al., 2020). Learners who exercise good governance standards in the management of their funds, such as compliance with investment policies, proper disclosure of information and other regulatory measures in the allocation of their funds stand high chances of enhancing the right investment decisions that will enhance positive financial performances. Whereas, some SWFs with low levels of governance may be characterised by low levels of interest alignment, political influence or/and low operational efficiency likely to deter good performance (Godsell, 2022).

Other factors affecting the investment returns of SWFs include economic conditions of the markets in which SWFs invest. In so doing, it will be realized that in volatile economic conditions, SWFs are likely to post good financial outcomes, because the operating environment for the investee firms is probably good when the economy is stable and growing. On the other hand, SWFs can struggle to keep up the good performance during the economic downturns especially if the invested assets are in areas of/regions of contraction (Bahoo et al., 2020).

Case Studies

More concrete illustrations of SWF investment effects are examples of particular firms that have been invested in by these SWFs. Volkswagen AG is one of the companies that benefited from the funding from one of the biggest classified SWFs-investor, the Qatar Investment Authority (Godsell, 2022). Scrutiny of Volkswagen has associated QIA with the automaker's corporate skills of steering through troubled waters, and the subsequent provision of funds for vital portfolio growth endeavors as the company shifts toward electric automobiles. QIA can be seen supporting Volkswagen in achieving its long term goals and objectives because via the long term capital it has injected a stability within the Volkswagen debt financing.

Another example of headed investment is that made by Temasek Holdings in Alibaba Group. Temasek is a Singapore based SWF which invested itself into Alibaba when the company had not gone for IPO and this SWF has been instrumental in growing Alibaba into the second largest e-commerce company in the world (Wurster and Schlosser, 2021). Major shareholders of Alibaba such as Temasek have shown their long term commitment besides providing strategic direction and as a result Alibaba have recorded high revenue growth and almost monopolistic position in the Chinese Market.

Comparative Analysis of SWFs

Studies comparing SWFs show variations in the effects of the funds on investee firms, which may be conditioned by the fund's origin and size as well as the investment strategy. For example, Middle Eastern SWFs, the ADIA and the QIA among them, usually have huge AMC and can afford to take long term investment horizons in property, infrastructure and energy. Such funds are often defined by the provision of big, long-term, as well as stable capital that helps create the stability in the firms they invest in (Wurster and Schlosser, 2021).

On the other hand the Asian SWFs like Temasek Holdings of Singapore and the CIC of china are less rigid in their investments. These funds often focus on Technology and Innovation based industries in tend to as their home countries are experiencing high economic growth rates and embracing advanced technologies (Bortolotti and Fotak, 2020). In the case of the host firms, the effects of such SWFs are normally evidenced by enhanced growth and competitiveness; more so where the latter is within international markets.

Another important increase is the size of an SWF, which also defines to some extent the impact of the fund on the financial performance. The effects of ownership size are so significant, because more extensive funds, having larger amounts of money under their manage-ment, are powerful, so they may express considerable impact on corporate governances, strategies and, as a result, they enjoy more sensitive financial effects (Chen et al., 2022). Although smaller SWFs do generate significant effects, the ability of these SWFs to affect the management of their investee firms may be productive in big global firms.

Altogether, the effects of SWFs on investee firms are likely to be mixed but are sensitive to the characteristics of the fund and it environment. In the same way that SWFs have been credited with improving the stability of the global financial system some have more growth oriented mandates and hence contribute to the more growth oriented strategies for their investees (Černohorský and Tesnerová, 2021). Appreciation of these differences is crucial to a grasp of the SWFs' bigger position in the global financial system and the ability of these funds to mold the financial destinies of the entities into which they invest.

4. ESG Performance Impact of SWFs

Importance of ESG in Investment Decisions

ESG considerations have been growing in importance for several years now especially for institutional investors such as SWFs. This has been attributed to increased realization that, apart from being the right or ethical thing to do, sustainability leads to better business results (Černohorský and Tesnerová, 2021). This shift in investor awareness is because they find that organizations, which demonstrated good performance in ESG, are invariably managed well, can weather risks more effectively and can generate stable returns in the long run. ESG evaluation is thus valuable for SWFs as it is compatible with their strategic time perspectives together with public mission, the objectives of which include saving money for future generations, supporting economic stability and development (Gomes and Al-Khayyal, 2015). In addition, the development of the global frameworks and regulations in the responsible investment has supported the focus on ESG integration into SWF investment processes because such funds try to achieve financial efficiency coupled with positive social and environmental effects.

Empirical Evidence on ESG Performance

Research on SWFs' engagement and impact on ESG performance of their target portfolio companies offers crucial insights into how ESG considerations are incorporated into institutional investment (Cumming and Monteiro, 2023). Studies show that increases in the amount of SWF investment and especially the SWFs with a stated ESG investment mandate, have the ability to materially improve firm ESG scores. For instance, Dyck, Lins, Roth, and Wagner, (2019) pointed that institutional investors such as SWFs have positive implications on environmental and social compulsions in the target firms. Such enhancement is sometimes due to CFOs' activism in SWFs that demand enhanced ESG reporting and performance. Also we can see that the firms with SWF investment have comparatively better standing in different ESG indices indicating the overall positive effect of SWFs for sustainable corporate governance (Cumming and Monteiro, 2023).

Three ways in which SWFs have adopted ESG into its investment management processes are as follows. A significant number of SWFs have formulated ESG policies that determine their investment approach, and designate ESG factors as material, hence, assessed collectively with financial analysis (Martínek, 2021). Some SWFs use ESG factors to allow or disallow particular sectors or corporations, based on their ethical outlooks, like on fossil fuels, weapons, or tobacco. Some go further, engaging as shareholders to try to compel the companies in which they have invested to have higher standards of ESG. This can be through discussions with management or exercising the right to vote in different ESG related shareholder resolutions or even seeking to occupy a place, on the board, to effect a change.

Mechanisms of ESG Influence

There are several ways through which SWFs affect the ESG practices in the investee firms. There are various indices used to unmask this; one of the most direct ones is through voting power. Because of the aspects of large shareholders, SWFs can exercise their voting rights to affect key corporate governance issues involving ESG concerns. It is possible to use this voting power to vote in favour of shareholder resolutions on sustainability, diversity, transparency or other ESG issues (Boubakri et al., 2023). This is so wherever SWFs have large stakes and can thus use their voting power to influence the policies and practices of the company in question.

Another kind of influence is being represented on the board level and this include the following. Some of the SWFs aim at getting a place in the boards of directors of the firms they invest in so as to be part of the company’s management decisions. (Martínek, 2021) Board representation provides SWFs with an opportunity to demand greater ESG engagements, see to it that these engagements are incorporated into the corporate development plan and evaluate the management of ESG programs and projects.

Another important way of exerting a positive impact on ESG is an active participation in the management of firms by SWFs. This can be done through regular engagement with the management of the companies to propose improvements in ESG standards. Engagement may also occur in different levels, may be one-on-one with management or through press releases demanding change for the better from companies (Cumming and Monteiro, 2023). SWFs, by acting as an engagement actor, can encourage the management of companies on the setting of higher ESG goals and standards, or more disclosure and clarity on existing ones as well as the managing of specific ESG risks and opportunities.

Case Studies

Several examples are given to show how SWF investments have had a positive impact on the change in ESG performance. A good example of such an SWF is the GPFG of Norway, which is among the largest SWFs globally, and operating with a robust policy on responsible investment. As the largest corporation voting shareholder (Gomes and Al-Khayyal, 2015), GPFG has effectively advocated for constructive improvement of ESG in its investee firms with corresponding large positive impact on firm behaviour. For example, the outcome of GPFG investment in the mining industries has contributed to changes in the practices of the sectors most notably on issues of environmental standards involving emissions of greenhouse gases and sustainable use of natural resources.

Another is the case of the Qatar Investment Authority (QIA) where it is possible to note the progressive changes regarding the consideration of ESG factors in investment management. It's proof that QIA funds its companies with sustainability in mind as concern as it has ventured into the renewable energy market (Gomes and Al-Khayyal, 2015). These investments have also improved the ESG since these investments focus on the development of renewable energy sources to enhance the improve the financial position of the firms engaged in such an investment.

5. Comparative Analysis: Financial vs. ESG Performance

The Integration of financial with ESG has greatly become relevant concerning SWF Investments in this context. The statistics show that ESG is highly correlated with higher returns, particularly in the long run. ESG factors are habits, and higher performers operating in environmentally, socially, and governing aspects demonstrate lower risks, higher efficiency and reputation, and thus, better financial results (Černohorský and Tesnerová, 2021). For SWFs, which mostly have long-term investment horizons, this alignment also points at the fact that high standards of ESG go hand in hand with high financial performance and may even complement each other (Chen et al., 2022). Therefore, incorporating ESG factors into investment portfolio enables SWFs to earn sustainable financial revenues and at the same time contribute to the realization of other underlying societal objectives.

They are enhanced as agents of positive change as their financial might has established them as investment heavyweights all over the world. SWFs, therefore, have an opportunity to promote positive change in the firms and sectors they invest in for both the financial and the non-financial value they co-create (Bortolotti and Fotak, 2020). Thus, SWFs are in a position to help transition to a low-carbon system, improve social welfare, and contribute to the development of better corporate governance systems, which are in their turn the key to creating a more sustainable and inclusive world economy.

However the management of the relationship between efficiency and ESG is a challenge or an opportunity for SWFs. These are; scope complexity which is generally large making the ESG factors hard to manage, short-termism and long-termism where there might be a conflict of interest, lack of standardization where ESG standards and expectations differ depending on region and industry (Wurster and Schlosser, 2021). At the same time, these challenges create the potential for SWFs to step up and set a good example as well as examples of sustainable funding in and creating value that goes beyond merely financial. As a result of proper adoption and implementation of ESG principles in SWFs' investment processes, SWFs will be in an excellent place to present themselves as market leaders in responsible investment, with the possibilities of delivering social value enhancing returns in the resource-efficient future (Godsell, 2022).

6. Methodological Considerations in the Literature

The methodologies more frequently applied in the course of analysing Sovereign Wealth Funds (SWFs) are event studies, regression analysis, and case studies. Event analyses also evaluate the effect of SWF indirect investments by means of looking at the effect around the time of investing on different stocks, a move that helps to get an understanding on the reaction of the market. As with other correlation based studies, considerable use is made of regression analysis in an effort to examine the link between SWF involvement and other more financial factors while holding other variables constant. (Godsell, 2022) The case-study type provides focused information about SWFs or investee firms and gives a perspective on the ways that SWFs work and affect performance of firms in terms of financial and ESG returns.

However, the current literature on SWFs has the following limitations. Another important limitation is data availability problem because many SWFs are still operate in fairly secretive manner and there is often no access to comprehensive and reliable data. One of the problems arising from the application of distinct methods of analysis consists in the methodological bias that renders comparisons between investigations difficult and unreliable (Boubakri et al., 2023). However, the findings are still not very general as it can include results that are specific to a certain country or simply the results of SWF operations in some particular sector, while the global practice of SWFs function is much vaster.

To fill these gaps, future research might include focused longitudinal analysis wherein the authors follow the performances of SWF investments with constant time intervals and thereby get a wider and enhanced view of SWF impacts (Junghanns and Körnert, 2022). Moreover, extending the portfolio of performance measures beyond financial ones, for instance, social and environmental impacts, would offer a better understanding of the effects SWFs have and could have in the light of their increasing concern for ESG factors.

7. Conclusion

In conclusion, SWFs have a significant position in the international financial landscape not only as investors but as agents demanding improvements in corporate governance and ESG indicators. Works like Agency Theory and Stakeholder Theory provide a theoretical understanding of how SWFs can improve both the classical value and the ESG value of the firms in which they invest. The evidence points to the fact that SWFs' investments can enhance firm's performance reflected in enhanced value relevance and ESG standards, though the effect depends on the approach to investment, governance, and social context. Nevertheless, SWFs have certain restrictions in relation to the optimization of the use and investments potential for achieving both target rates of financial returns and Integration of ESG factors, regarding the limitations of data availability and methodological novelties in the works carried out.

The link between the two demonstrates that sustainable and healthy financial performance is possible and sustainable, for this reason, SWFs have a critical role to play regarding sustenance of sustainable development globally. Although, for the findings to be even more valid, future research should endeavour to overcome some of these limitations using more superior research methods such as cross-sectional studies, and the assessment of non-financial performance measures. When the research on SWFs is conducted and the findings are accumulated, the academics can offer the insights that will be useful to these funds in managing the challenges of investing in the contemporary world in a manner that will enhance the achievement of economic and social objectives.

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