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The New Power Brokers: Gaining Clout in Turbulent Markets

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Four groups of investors—Asian governments, oil exporters, hedge funds, and private equity firms—are having a growing impact on global capital markets. In our October 2007 report, we labeled them "the new power brokers" because their rising influence reflects a dispersion of financial power away from traditional institutions in Western developed economies and toward new players and other parts of the world (for new readers, see the sidebar *Meet the New Power Brokers*).[1] In this update, we examine how the four have fared since then, during the turmoil of skyrocketing oil prices, evaporating liquidity, and disappearing leverage.

We find that the financial and economic events since mid-2007 have, if anything, accelerated the trends we identified earlier: The power brokers' wealth and clout have grown. They have adapted by expanding their investment strategies. And they have increased the use of private financing as an alternative to public markets. Their actions have brought clear benefits in containing the financial market crisis but also have highlighted the risks associated with their rise.

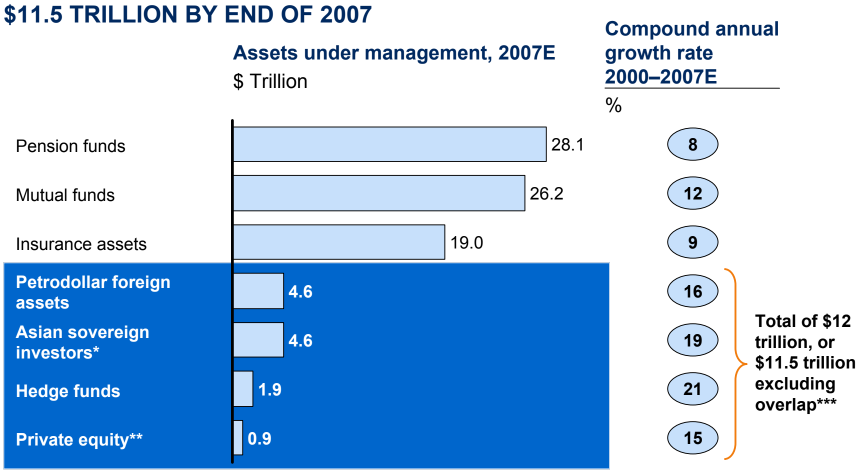
The combined financial assets of the four power brokers increased by 22 percent—even faster than before—to $11.5 trillion in 2007 (Exhibit 1).[2] Asian countries' trade surpluses and oil exporters' petro-profits have both continued to grow. Private equity, which relies on leverage to amplify returns, has survived the turbulence in reasonably good shape and its new fund-raising has continued. Hedge funds have been hardest hit by the crisis, and we have lowered our forecast of their future growth.

1 See *The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets*, The McKinsey Global Institute, available online at www.mckinsey.com/mgi. Based on new information, we have revised upwards our estimate of petrodollar foreign assets in 2006 to $3.9 trillion, bringing the total 2006 assets of the power brokers to $9.2 trillion, or $8.9 trillion excluding overlap.

2 This figure includes $670 billion in Asian sovereign wealth funds that we did not include in the original report. It excludes overlap of $450 billion due to the estimated investments of petrodollar investors and Asian sovereign investors in private equity and hedge funds.

Exhibit 1

NEW POWER BROKERS' ASSETS UNDER MANAGEMENT REACHED $11.5 TRILLION BY END OF 2007



* Includes Asian central banks ($3.9 trillion) and Asian sovereign wealth funds ($670 billion).
** Leveraged buyout funds only.
*** Excludes investments of oil and Asian investors in private equity and hedge funds.
Source: International Financial Services, London; Hedge Fund Research; Investment Company Institute; Preqin; McKinsey Global Institute analysis

As the power brokers' wealth has grown, so has their influence. Three individual institutions in this group, the central bank of China, the Bank of Japan, and the Abu Dhabi Investment Authority (ADIA), rank among the top ten largest asset managers in the world. But it was by using their riches to rescue other institutions that they emerged as key players in the crisis. ADIA provided Citigroup with $7.5 billion to recapitalize its balance sheet. Sovereign wealth funds such as the Kuwait Investment Authority and Korean Investment Corporation provided new funding for Merrill Lynch. The private equity firm TPG took a stake in the struggling mortgage lender Washington Mutual Incorporated. In these cases and others, the power brokers provided critical liquidity that recapitalized individual financial institutions, thereby helping contain the crisis.

Rising petroleum prices extended the financial reach of old and new players. Russia added $105 billion in foreign assets in 2007, securing its place as the world's third-largest holder of foreign reserves, after Japan and China. And second-tier oil-exporting countries such as Algeria, Iran, Libya, Nigeria, and Venezuela became significant investors in global capital markets.

The crisis underscored one of the biggest benefits offered by the power brokers: vast pools of liquidity. At the same time, concerns have mounted that some of this growing financial clout, particularly among the rising petro-powers, will be used for political ends. In our earlier report, we saw how the new power brokers have evolved since 2000 from fringe players to major actors in world capital markets. In this update, we will see how they have gained further prominence.

Meet the New Power Brokers

Petrodollar investors had $4.6 trillion in foreign assets at the end of 2007. Their wealth has soared along with oil prices, which rose from just $23 per barrel in 2002 to more than $100 in the first quarter of 2008. This is a diverse group, including investors in the six states of the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates) and other oil exporters in the Middle East and North Africa, as well as Norway, Russia, Venezuela, Nigeria, and Indonesia. The investors include central banks, sovereign wealth funds, companies, and wealthy individuals. Overall, government entities control 60 percent of petrodollar foreign assets, while wealthy individuals and companies hold 40 percent. These investors display varied investment styles, ranging from conservative and passive to more risk-seeking and active. The three largest petrodollar investors are the Abu Dhabi Investment Authority, which has up to $875 billion in assets; Norway's sovereign wealth fund, called the Government Pension Fund, with $380 billion; and Russia's Central Bank, with $320 billion.[3]

Asian sovereign investors include central banks, which held $3.9 trillion in foreign assets at the end of 2007, and sovereign wealth funds (SWFs), which held $670 billion.[4] Their foreign assets have grown rapidly over the past decade because of their countries' rising trade surpluses combined with government monetary policies aimed at preventing significant appreciation of their currencies. Apart from Singapore, Asian governments manage most of their foreign assets through their central banks, rather than through SWFs. The central banks have traditionally invested nearly all their foreign reserves in low-risk, fixed-income securities, particularly US Treasury securities. However, these countries have far more reserve assets than are needed for financial stabilization purposes. We calculate that the opportunity cost of investing excess reserves in relatively low-yielding assets is $123 billion per year, equivalent to 1.3 percent of these countries' GDP.[5] They are therefore moving more of their reserves into SWFs, which seek higher returns by investing in a wider variety of financial assets. And countries without SWFs, such as Japan and India are considering establishing them. The largest Asian sovereign

3 This figure excludes the $157 billion in Russia's sovereign wealth funds.

4 We exclude the $30 billion in Korea's sovereign wealth fund because those assets are included in Korea's central bank reserves.

5 This calculation is based on the amount of excess foreign reserve assets and the assumption that these assets could earn higher returns if invested in a broadly diversified portfolio. See the October 2007 report for more detail.

investors are the central bank of China, with $1.5 trillion in foreign reserve assets by end of 2007, and the central bank of Japan ($1 trillion), followed by Singapore's Government Investment Corporation, which is believed to have up to $330 billion in assets.

Private equity, the name commonly applied to leveraged buyout funds, is the smallest of the new power brokers, managing $900 billion in investors' assets at the end of 2007. Both private equity firms and hedge funds are financial intermediaries that invest the money of wealthy individuals and institutional investors, such as pension funds, foundations, endowments, insurance companies, and, increasingly, SWFs. A private equity firm typically generates returns by borrowing large sums to acquire a publicly traded company, and then restructuring it to improve performance. The equity firm's returns depend on its management skill, and are amplified by the leverage involved. Although the megadeals of early 2007 fueled popular perceptions of spectacular performance, we find that returns are quite variable. Only the top quartile of funds is significantly outperforming public equity market returns. Among the best-known names in the industry are Kohlberg Kravis Roberts & Company, The Blackstone Group, TPG, and The Carlyle Group in the United States, and Apax Partners, Permira, and CVC Capital Partners in Europe.

Hedge funds' global assets under management reached $1.9 trillion at the end of 2007. After accounting for the leverage that they use to boost their returns, hedge funds' gross investments in financial markets today could be as high as $5 trillion. Hedge funds are investment pools but differ from mutual funds in several ways, including their use of leverage, their highly active and diverse trading styles, and the fact that they are subject to fewer regulatory constraints than traditional institutional investors. Hedge funds, for example, can "short sell" assets, betting that the price will fall, whereas mutual funds cannot. They also invest in complex derivatives and other structured products. The industry includes more than 7,000 funds, although the 100 largest hedge funds control 71 percent of assets under management. Hedge funds employ a diverse set of investment strategies, ranging from directional bets on macroeconomic indicators and asset prices, to quantitative models that arbitrage price discrepancies, to funds exploiting event-driven asset price movements. The largest hedge funds globally include Highbridge Capital Management (majority owned by JPMorgan Chase), Bridgewater Associates, Farallon Capital Management, Renaissance Technologies, and Och-Ziff Capital Management Group.

ASIAN GOVERNMENTS AND OIL INVESTORS PROVIDE CRITICAL LIQUIDITY DURING THE CRISIS

The fortunes of the two largest power brokers, petrodollar investors and Asian sovereign investors, have continued to grow. The foreign financial assets of oil exporters rose to an estimated $4.6 trillion by the end of 2007, an 18 percent increase over the previous year.[6] Asian sovereign foreign assets grew to $4.6 trillion, of which $3.9 trillion are central banks' foreign exchange reserves and approximately $670 billion are held by SWFs, a figure we expect to grow as these governments seek higher returns on their wealth (see sidebar *Spotlight on Sovereign Wealth Funds*).[7]

Asian and oil sovereign investors proved to be an important source of liquidity during the financial crisis of the past year. As Western financial institutions reported multibillion-dollar write-downs of faltering assets, they turned to SWFs and wealthy private individuals to recapitalize their balance sheets. From March 2007 through June 2008, Asian SWFs invested $36 billion in Western financial institutions while oil-based SWFs invested $23 billion (Exhibit 2). For investors long accustomed to operating behind the scenes, these actions marked bold steps into the limelight and a break from past practices of working through asset management firms and investing in publicly traded securities.

By mobilizing so much capital so quickly, the SWFs helped limit the scope of the financial crisis and prevent more large-scale bank failures. Given the flexibility of their investment strategies and long investment horizons, these institutions were able to provide an infusion of capital when it was most needed—and when it was not necessarily the most attractive investment. At the writing of this report, their investments have lost approximately $14 billion in market value, although they will likely generate positive returns in the long term.[8] Two of the power brokers thus provided a first line of defense during the crisis. It is doubtful that Western governments could have provided taxpayer-funded financial assistance to the banks on the same scale without triggering a public uproar.

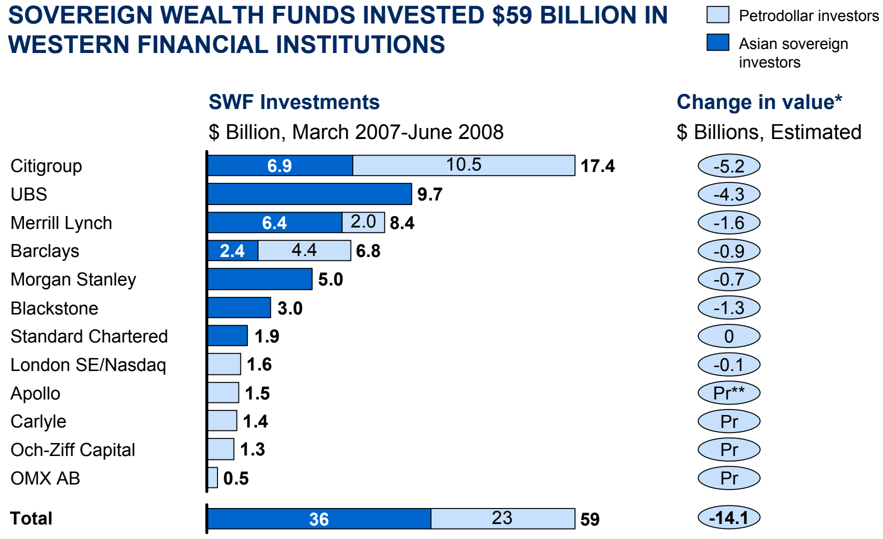
6 Based on new information, we have revised upwards our 2006 estimate of petrodollar foreign assets to $3.9 trillion. MGI estimates are based on interviews with financial industry experts in the region, proprietary data on wealth management, and public data on annual capital outflows. See the October 2007 report for more detail on how we arrived at these figures.

7 In our earlier report, we singled out Asian central banks because they were the dominant managers of those countries' reserves. In this update we broaden the category to Asian sovereign investors, reflecting the proliferation and growth of the region's sovereign wealth funds.

8 This calculation is based on the change in share price of each of the banks at the first day of the month of the SWF capital injection compared with the share price on June 2, 2008.

Exhibit 2

SOVEREIGN WEALTH FUNDS INVESTED $59 BILLION IN WESTERN FINANCIAL INSTITUTIONS



Note: Numbers do not add up due to rounding

* Estimated based on change in price of common stock from first day of month when transaction took place and June 2, 2008; in the case of Blackstone, change in price from IPO to June 2, 2008.

** Pr denotes private companies that do not trade in public markets. OMX AB went private due to transaction.

Source: Dealogic; Datastream; press reports; McKinsey Global Institute analysis

We noted in our earlier report that the rise of the power brokers has enabled many companies and other borrowers to raise funds from private sources—such as SWFs, private equity, and wealthy individuals—rather than by issuing publicly traded equities or debt. This trend has gained momentum during the crisis, as struggling financial institutions have secured capital directly from Asian and petrodollar investors. Although some observers are uncomfortable with government investors taking stakes in private commercial entities, it is unlikely that the banks could have raised the capital necessary through public markets, particularly while their share prices and credit ratings were falling. By expanding the set of fund-raising options, the power brokers should make the financial system more resilient and efficient.

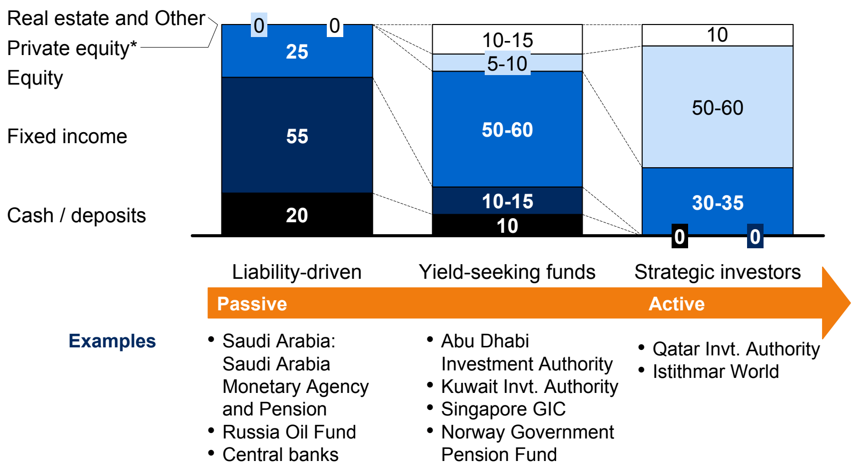
These rescues mark a step by Asian and oil sovereign investors toward more direct investments in companies (Exhibit 3). Separately, SWFs have also taken large direct investments in major US and European private equity funds and hedge funds—such as Carlyle, Blackstone, Och-Ziff Capital, and Apollo Management, to name a few. SWFs have been limited partners in private equity funds and contributors to hedge funds for many years; we estimate their investments total approximately $450 billion. But the $7.2 billion in direct investments since mid-2007 have given both Asian and petrodollar SWFs direct ownership in the private equity and hedge fund companies, as well as a piece of their lucrative income stream. These investments can take many forms. For example, China Investment Corporation bought pre-IPO shares in the private equity firm Blackstone and is reported to be investing with J.C. Flowers & Company in a fund focused on financial institutions. Through these direct investments, SWFs are seeking lucrative returns and, in some cases, are seeking to acquire new skills and build internal capabilities.

Exhibit 3

SOVEREIGN INVESTORS ARE SHIFTING TOWARD MORE EQUITY INVESTMENTS, SOMETIMES ACTIVE

Estimated asset allocations of sovereign investors

%



* Includes direct stakes in companies, not through a private equity fund.

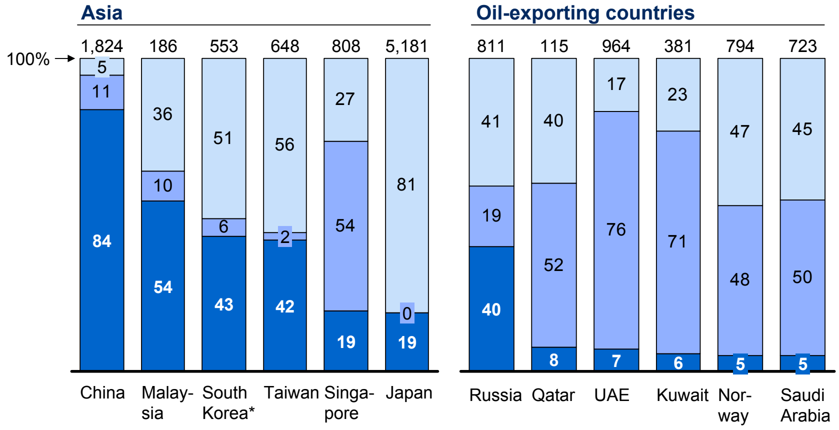
Source: Press reports; interviews; Institute for International Finance; *RGE Monitor*; "Understanding the New Financial Superpower," Setser and Ziemba (2007); Morgan Stanley; Cap Gemini/Merrill Lynch; McKinsey Global Institute

Spotlight on Sovereign Wealth Funds

Sovereign wealth funds (SWFs) attracted attention in 2007, not least because of their very public role in capitalizing some of the world's largest banks. With approximately $2.9 trillion in assets, and growing, they are important players in global financial markets.

But SWFs are just one part of a larger picture of rising wealth in the Middle East, Asia, and beyond. We estimate that in the oil-exporting countries, sovereign wealth funds account for 40 percent of total foreign investment assets, with the exact proportion varying across countries. The remainder—more than $2 trillion—is in the hands of central banks, wealthy individuals, and state-owned and private companies that are active in foreign markets. In Asia, sovereign wealth funds are relatively small outside of Singapore, accounting for just 2 percent of total foreign assets; central banks and even state-owned companies are far larger players in global capital markets (Sidebar exhibit).

Sidebar exhibit



	China	Malaysia	South Korea*	Taiwan	Singapore	Japan	Russia	Qatar	UAE	Kuwait	Norway	Saudi Arabia
Total ($ Billion)	1,824	186	553	648	808	5,181	811	115	964	381	794	723
Private individuals and companies	5	36	51	56	27	81	41	40	17	23	47	45
Sovereign wealth funds/government holding companies	11	10	6	2	54	0	19	52	76	71	48	50
Central bank reserves	84	54	43	42	19	19	40	8	7	6	5	5

* South Korea's sovereign wealth fund assets are deducted from official reserves to avoid double counting.

Source: Cap-Gemini Private Wealth Report 2006, IMF; Global Insight; McKinsey Global Institute Cross-Border Investments Database; ministries of finance of respective countries; McKinsey Global Institute analysis

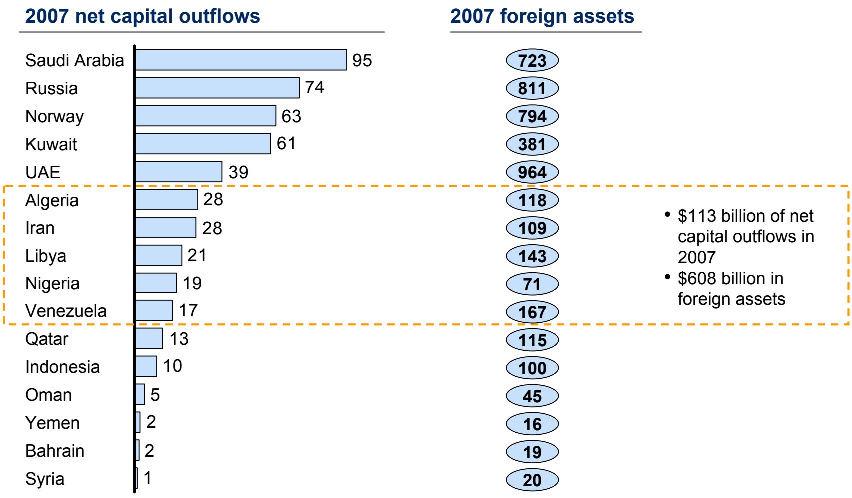
Moreover, SWFs are just one vehicle for managing sovereign wealth. Central banks, government ministries, government holding corporations, and state-owned companies are also important. And the distinctions between sovereign wealth funds and other types of government investors are blurring. Traditionally, central banks invested their reserve assets in highly liquid, safe instruments, such as US Treasuries, while SWFs pursued a more diversified portfolio of investments. But some SWFs, such as Russia's Reserve Fund or Alaska's Permanent Fund, also invest mainly in conservative fixed-income securities. And some central banks are beginning to expand their investment strategies as well. China's State Administration of Foreign Exchange, for instance, has announced in the first half of 2008 direct investments in three Australian banks, in British Petroleum, and in the French energy giant Total, moving its investment strategy closer to that of a sovereign wealth fund. For all these reasons, we find an exclusive focus on sovereign wealth funds too narrow.

NEW PETRODOLLAR POWERS EMERGE

The high oil prices of the past 12 months have elevated a new group of petroleum exporters into the ranks of major foreign investors. Saudi Arabia, Norway, Kuwait, and the United Arab Emirates have been active investors in global capital markets for 25 years or more. In 2007, Russia emerged as a major global financial player as well. Its foreign investment assets ($811 billion at the end of 2007) are second-largest among oil exporters after the United Arab Emirates, and they have been growing by 24 percent per year since 2002. Nearly 60 percent of these assets are held by the Russian government. Russia's central bank has $320 billion in foreign exchange reserves, as well as $157 billion in the country's two sovereign wealth funds.[9]

Exhibit 4

HIGH OIL PRICES ARE CREATING NEW PETRO-POWERS
$ Billion



Source: McKinsey Global Institute Global Capital Flows Database; McKinsey Global Institute Cross-Border Investments Database; McKinsey Global Institute analysis

Some of the smaller crude exporters, such as Algeria, Iran, Libya, Nigeria, and Venezuela, are gaining financial clout as well. When oil prices were lower, these countries channeled the bulk of their oil profits into domestic spending, with little left over to invest abroad. But as crude prices have climbed, these five countries are emerging as significant investors in foreign markets. They accounted for nearly one-quarter of net capital outflows from oil exporters in 2007, ranking right after the No. 5-ranked United Arab Emirates and before countries like Qatar and Indonesia (Exhibit 4). Together, these five emerging petro-powers have $608 billion in foreign assets. The rise of a broader range of countries with sovereign wealth funds heightens concerns about the potential noneconomic motives and political ramifications of their investments.

9 In February 2008, Russia broke up its Stabilization Fund into two new funds: the Reserve Fund (with $125 billion in assets) and the National Wealth Fund ($32 billion). The Reserve Fund is expected to invest in low-risk instruments such as US Treasury notes, while the National Wealth Fund will invest in higher-yielding assets, such as private equity.

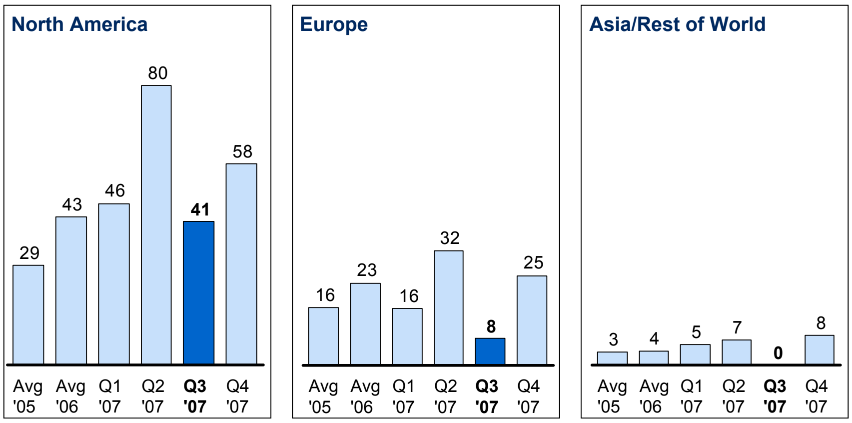
PRIVATE EQUITY: ADAPTING TO NEW MARKET CONDITIONS

For private equity, the first half of 2007 was the best of times, while the second half of the year was among the worst. New fund-raising by private equity firms around the world soared in the first two quarters of 2007—then plummeted in the third quarter after the US subprime mortgage crisis began (Exhibit 5). But fund-raising rose a bit in the last three months of the year, bringing total assets under management in leveraged buyout funds (LBOs)[10] to $900 billion.

Exhibit 5

PRIVATE EQUITY NEW FUNDRAISING FELL SHARPLY IN THIRD QUARTER 2007, THEN REBOUNDED

Fundraising* for leveraged buyout (LBO) funds
$ Billion



* Estimated breakdown to quarters according to closed funds breakdown.
Source: Preqin; McKinsey Global Institute analysis

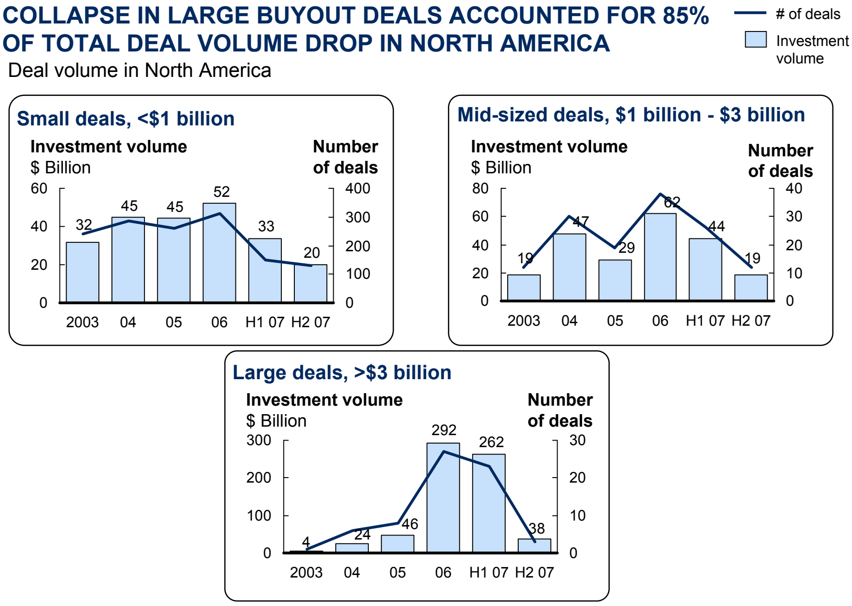
Still, the game has changed for private equity firms as funding—particularly for the largest buyout deals—has dried up. The spread between high-yield bond rates over swap rates, a common measure of private equity's cost of credit, increased from 190 basis points in June 2007 to 539 basis points in March 2008. As a result, the total value of announced deals in North America fell from $339 billion in the first half of 2007 to just $77 billion in the second half of the year—a 77 percent decline. Most of this drop reflects the near-disappearance of the "megadeals" worth more than $3 billion; deals for less than $1 billion showed only a modest decline (Exhibit 6). Europe has been hit even harder, with the value of total announced deals in 2007 lower than a year earlier.

10 In this report, we focus only on leveraged buyout funds (LBOs). We use the terms "private equity" and "LBOs" interchangeably. In broader usage, "private equity" also sometimes refers to venture capital, mezzanine financing, and distressed debt. We focus on LBOs because they are the largest segment and the focus of public debate.

Exhibit 6

COLLAPSE IN LARGE BUYOUT DEALS ACCOUNTED FOR 85% OF TOTAL DEAL VOLUME DROP IN NORTH AMERICA

Deal volume in North America



Source: Capital IQ, McKinsey Global Institute analysis

But private equity firms are weathering the storm by finding creative ways to deploy capital, thus expanding their influence and accelerating several trends we noted in our October 2007 report. First, private equity firms have increased purchases of minority stakes in publicly traded companies—deals called PIPE, for Private Investment in Public Equity. These deals require private equity firms to raise less debt for financing than buyouts. Total PIPEs jumped from $25 billion in 2006 to $87 billion in 2007.

Second, private equity firms are increasingly investing in emerging markets, where companies are smaller and require less leverage, and where competition is less fierce. Moreover, funding from local banks is sometimes available. Fund-raising for buyout funds targeting Asia and other emerging markets rose to $42 billion in 2007, up 20 percent from 2006. Total announced private equity buyout deals in China, India, Russia, and Brazil (including those from global private equity funds) grew from $25 billion in 2006 to $46 billion in 2007.

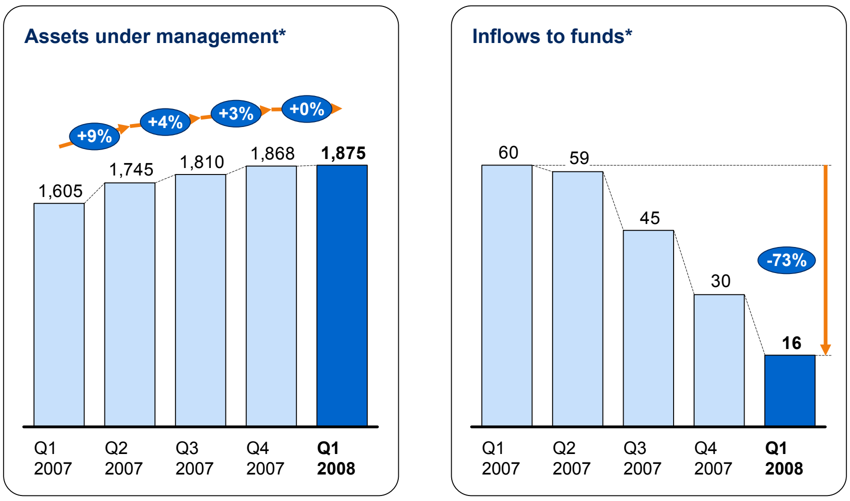
Private equity firms have also played a role in providing liquidity to contain the financial market crisis. In addition to helping recapitalize banks, several funds have found new investment opportunities in buying the distressed debt weighing on the balance sheets of banks. Private equity funds have announced fund-raising of $84 billion in new distressed debt funds in the first quarter of 2008, more than triple the total in all of 2007. Leverage for these deals is often provided by the banks themselves, and in some cases, private equity firms and hedge funds are purchasing the loans made to finance their own deals. These debt sales will likely prove to be lucrative for the private equity firms. And they will enable the banks to improve their balance sheets, which should help them resume lending.

HEDGE FUND INDUSTRY HIT HARDEST BY THE CRISIS

Hedge funds have been most adversely affected by the credit crisis of the past year. Although their total assets under management grew in 2007 to $1.9 trillion, new capital inflows from investors declined throughout the year and into the first quarter of 2008 (Exhibit 7). The decline affected all hedge fund strategies.

Exhibit 7

HEDGE FUND INFLOWS FELL SHARPLY OVER 2007
$ Billion



* Excluding assets of funds of hedge funds (FoHF).
Source: Hedge Fund Research; McKinsey Global Institute analysis

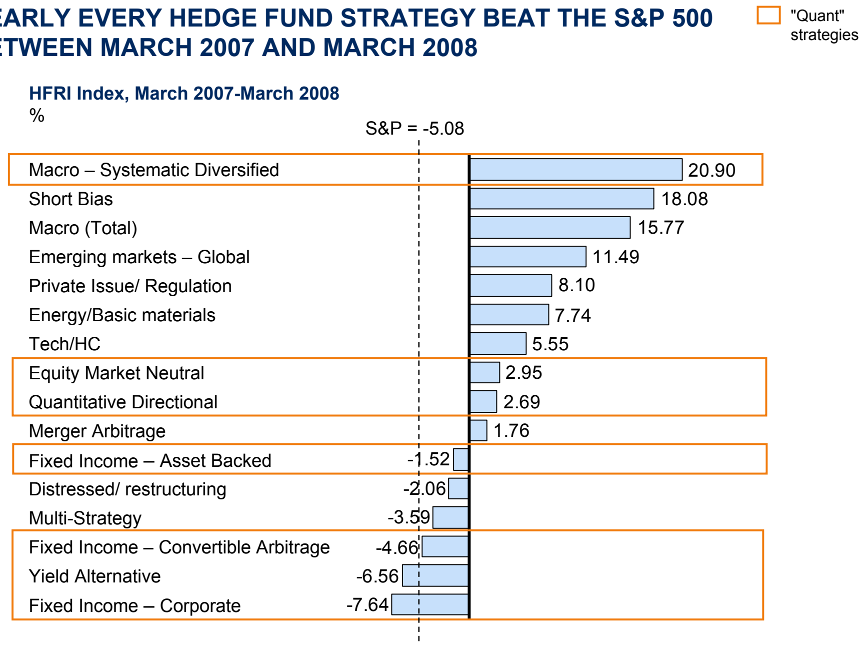
The main reasons have been investor nervousness and disappointing hedge fund returns. From October 2007 through March 2008, the Tremont index of aggregate hedge fund returns fell 3 percent. That's better than global equities—the MSCI World Index fell 16 percent—but still a decline. Total hedge fund industry returns were negative in the first quarter of 2008 for the first time since 2004. Moreover, the aggregate results mask large differences across hedge fund strategies. Several high-profile hedge funds closed down or defaulted in 2007 and 2008, including Bear Stearns' hedge funds, Peloton Partners, Sailfish Capital Partners, Focus Capital, and UBS's Dillon Read. Many fixed-income strategies have performed very poorly.

Hedge funds also are suffering from the drying up of credit used to enhance their returns. According to an analysis by JPMorgan Chase, hedge fund leverage decreased by 67 percent in 2007.[11] While it has increased somewhat since then, leverage remains about 40 percent below its early 2007 level. Banks are being particularly careful about lending to hedge funds. And like banks, hedge funds are taking large asset write-downs and credit losses.

These trends likely will lead to further consolidation in the hedge fund industry, favoring the larger hedge fund groups that use multiple investment strategies and may have larger capital cushions. Additionally, the hedge funds that have raised permanent capital through tapping public markets may be better positioned than others to ride out a rough market. Already, the 100 largest hedge funds control 71 percent of assets under management, up from 68 percent in 2006. That share may continue to rise.[12]

Exhibit 8

NEARLY EVERY HEDGE FUND STRATEGY BEAT THE S&P 500 BETWEEN MARCH 2007 AND MARCH 2008



Source: Hedge Fund Research, Inc., McKinsey Global Institute analysis

We may also see further growth in hedge funds employing directional strategies that bet on macroeconomic fundamentals. In our October report, we noted that over the past 10 years such strategies became a much smaller portion of the hedge fund universe, falling from 62 percent in 1996 to just 15 percent in 2006. But last year, those strategies performed far better than others (Exhibit 8). In 2007, the assets under management of hedge funds employing directional strategies increased to

11 J. P. Morgan Securities report, "How will the crisis change markets?" April 14, 2008.

12 Alpha Magazine, "Hedge Fund 100 List," May 2008.

16 percent of the total; we may see further increases in coming years as investors reconsider their hedge fund portfolios.

RISKS REMAIN

The rapid rise of the new power brokers also poses potential risks that warrant discussion. In our October report, we highlighted four main concerns: that the additional liquidity might foster asset price inflation; that state investors might use their wealth for political purposes; that hedge fund failures might destabilize the financial system; and that private equity firms' heavy leverage might increase credit defaults. Market events since then have shown that these risks are genuine and have underscored the need for regulators to find ways to minimize them.

The first risk is that the power brokers' liquidity could fuel asset price bubbles. We noted in the October report that Asian and petrodollar investors together had helped lower US long-term interest rates by as much as 75 basis points through their significant purchases of US Treasuries and corporate bonds. In retrospect, it is clear this low-interest rate environment helped create the conditions that spurred larger mortgages, additional home-equity loans, and subprime lending—all of which inflated housing prices and set the stage for the current credit crisis. Indeed, as global investors seek new investment opportunities for their rapidly rising wealth, the risk of asset price bubbles remains.

A second risk is that state investors might have noneconomic motives for their investments. The rise of SWFs in a broader range of oil exporters heightens this concern because some have a history of mixing politics with business. Venezuela's President Hugo Chavez, for instance, has openly sought to use his nation's oil wealth to advance his political agenda. And Russia briefly cut off natural gas supplies to Ukraine during a dispute in January 2006.

At the same time, some of the more established SWFs are showing increased openness regarding their investment strategies and operations. In March 2008, representatives from the Abu Dhabi Investment Authority and the Singapore Government Investment Corporation met with US Treasury officials and agreed that sovereign wealth funds should base investment decisions on commercial grounds rather than geopolitical goals. Representatives of the 25 largest SWFs are meeting with International Monetary Fund representatives in an effort to reach consensus on a "code of conduct" around transparency of investment criteria. Some SWF managers and government officials have started discussing their activities more publicly through the media.[13] This is not a comfortable position for investment vehicles accustomed to complete confidentiality. Nonetheless, they are showing a willingness to discuss Western government concerns.

One question remaining is whether SWFs will actively participate in the management of their portfolio companies. It's a question for which there is no clear right answer. In most of the recent investments in distressed financial institutions, SWFs agreed to invest without board representation. This may assuage public concerns about their motives. But it then raises questions about the efficacy of their involvement and long-term implications for the quality of management, since activist shareholders pressure management to raise performance. From an economic perspective, passive investors with very deep pockets may not be good for long-term corporate health. Striking the right balance will be essential.

A third concern is that hedge fund failures could cause the kind of systemic risk that followed Long-Term Capital Management's near-collapse in 1998. So far, even very large hedge fund failures have not led to the same kind of contagion. Nonetheless, many of the hedge funds that rely on quantitative models to drive investment contributed to equity market volatility in fall 2007.

A final risk is that the large amounts of debt that private equity funds load onto the balance sheet of their portfolio companies will cause a rise in defaults during this economic downturn. So far, this fear has not played out. According to Moody's, the volume of all corporate bond and loan defaults was $7 billion in 2007, compared with $10 billion in 2006 and $34 billion in 2005. Moreover, private equity firms are hardly cash-strapped—on the contrary, they are overly liquid, eagerly looking for investment targets that could generate acceptable returns. If, however, the economic downturn continues, it is possible that a growing number of portfolio companies might not be able to make their debt payments, in which case we would see an increase in defaults. That would be another blow to banks already reeling from mortgage losses.

THE POWER BROKERS' SIZE AND CLOUT WILL CONTINUE TO GROW

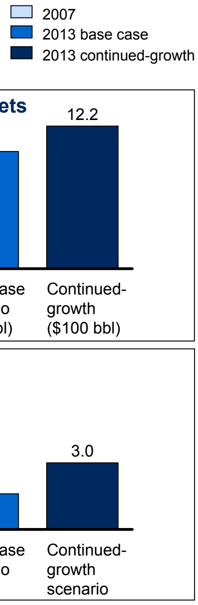
Despite the financial crisis, we foresee the four power brokers continuing to grow in wealth and clout. In our conservative, base-case scenario, we project their combined assets will grow to $21 trillion (excluding overlap between them) by

13 Examples include Gao Xiqing, president of the China Investment Corporation; Bader Mohammad Al-Saad, managing director of the Kuwait Investment Authority; and Russian Finance Minister Alexei Kudrin.

Exhibit 9

EACH OF THE NEW POWER BROKERS WILL GROW LARGER BY 2013

$ Trillion



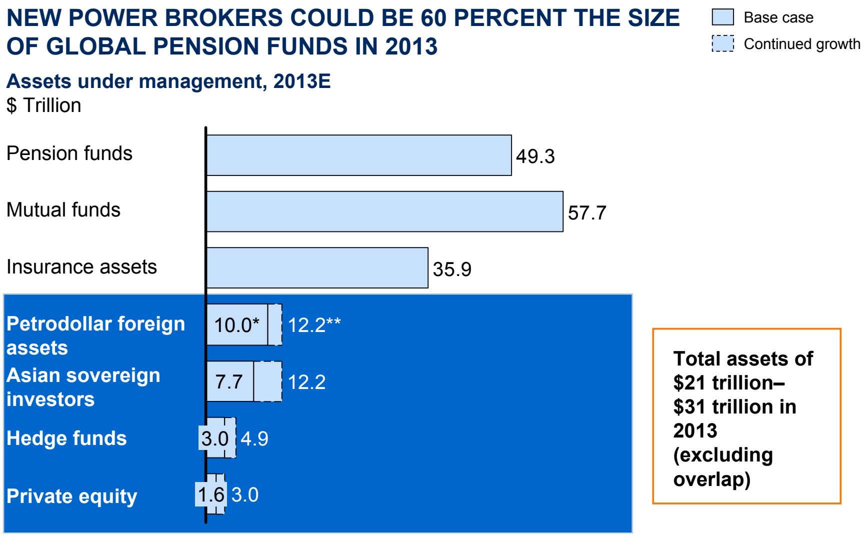
Source: McKinsey Global Institute analysis

Exhibit 10

NEW POWER BROKERS COULD BE 60 PERCENT THE SIZE OF GLOBAL PENSION FUNDS IN 2013

Assets under management, 2013E

$ Trillion



* At oil price of $70 per barrel.

** At oil price of $100 per barrel.

Source: Hedge Fund Research; Preqin; IFSL; IMF; Global Insight; McKinsey Global Institute Cross-Border Investments Database; McKinsey Global Institute analysis

2013 (Exhibit 9).[14] If, instead, they grow more briskly, at their 2000 to 2007 pace, their wealth would rise to $31 trillion: equivalent to roughly 60 percent of the expected size of global pension funds or mutual funds in 2013 (Exhibit 10). We have, however, made some adjustments to our forecast in light of recent events:

Petrodollar wealth is likely to grow more rapidly than we envisioned in October, when our base-case scenario assumed $50-a-barrel oil. With oil surpassing $120 a barrel in May 2008, it's hard to foresee a decline that dramatic. High prices may already be dampening demand somewhat in developed economies, but it will take years to significantly improve energy efficiency and develop feasible alternatives to oil. Meanwhile, demand is still rising steadily in booming emerging market economies. We expect oil exporters to invest more of their petro-profits domestically—a trend we are already seeing—but their economies and capital markets are too small to absorb all of the windfall.[15] So much of their growing revenue will continue to spill over into global capital markets, boosting their foreign assets. In our new base case, with oil averaging $70 a barrel, we forecast the oil exporters' foreign assets to grow to $10 trillion by 2013. At $100 a barrel, their foreign wealth could reach $12.2 trillion. We also project that the ranking of the financial clout of oil-exporting nations will change over this period, with both Saudi Arabia and Russia overtaking the United Arab Emirates, accumulating a total of $2.3 trillion and $2.4 trillion, respectively, in foreign assets at $100 per barrel oil. African oil exporters will experience the fastest growth over the period, at 30 percent annually, and their foreign assets will grow to $1.6 trillion at $100 per barrel oil.

Asian sovereign investors' assets depend on foreign exchange reserve accumulation, which is subject to considerable uncertainty. Allowing more appreciation of their currencies—as many international policy makers and financial institutions believe they should—would reduce the flow of capital into central banks' coffers and possibly lower trade surpluses. China has recently allowed its currency, the renminbi, to appreciate a bit to under 7 renminbi to the US dollar, from its longtime value of 8.29. Even assuming shrinking trade surpluses in coming years, however, we calculate that Asian sovereign assets will grow to $7.7 trillion by 2013 in our base case, of which $1.6 trillion will be in sovereign wealth

14 Assuming the portfolio allocation to private equity and hedge funds remains the same as today, petrodollar investors will have $550 billion in private equity and hedge funds by 2013 in our base case, while Asian sovereign investors will invest $450 billion in private equity and hedge funds.

15 See *The Coming Oil Windfall in the Gulf*, The McKinsey Global Institute, January 2008, available online at www.mckinsey.com/mgi.

funds.[16] If, instead, surpluses continue to grow at their 2000 to 2007 rate, Asian sovereign assets will climb to $12.2 trillion by 2013, of which $2 trillion could be in SWFs.[17]

The hedge fund industry will likely get through the current crisis and continue growing in coming years, but our forecast is now a bit lower than before the crisis. Although investor inflows had slowed to a halt by early 2008, the long-term fundamental trends that have driven the industry's growth so far will likely continue. New money will come from large institutional investors, such as pensions and endowments, increasing their allocations to alternative asset classes; from petrodollar investors seeking higher returns; and from growing funds of hedge funds, which opens up the asset class to less wealthy investors. Still, we have lowered our forecast since October. We now assume going forward that investor inflows will be a quarter of their 2000 to 2007 growth rates, or 9 percent per year, and that hedge fund returns will be at half their 2000 to 2007 growth rates, or 5 percent per year. That would mean their assets under management will grow to $3 trillion in 2013.

Private equity will continue to grow, in part because of the same trends fueling hedge fund growth—rising allocations from institutional investors and new money from petrodollar investors. Our base-case forecast is unchanged since October: New US and European fund-raising will continue at its 2007 pace, while fund-raising in Asia and the rest of the world grows at 10 percent annually, or half its previous rate. That would boost assets under management in buyout funds to $1.6 trillion by 2013. However, sovereign wealth funds are a wild card in this forecast. Currently, we estimate that just over half of SWFs (by assets) invest in private equity funds, and that their average allocation to private equity is less than 5 percent. If SWFs were to double their allocation to private equity by 2013 to 10 percent, their investments in private equity would grow from approximately $80 billion today to nearly $380 billion by 2013.[18] This would add an additional $200 billion to our forecast for private equity assets in 2013.

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16 This assumes that the RMB/$US exchange rate will decline to 5.6 by 2013 and that the Yen/$US exchange rate will decline to 90.4; other major Asian currencies are not expected to affect the forecast.

17 This calculation assumes a 4.4 percent real appreciation on assets, and an additional 10 percent of Asian central bank reserves are shifted into SWFs by 2013 (a total of $620 billion).

18 This calculation assumes that Asian SWFs grow to $1.6 trillion in assets by 2013, reflecting a shift of central bank reserve assets into SWFs, and that petrodollar SWFs grow to $4.8 trillion in assets, reflecting $100 per barrel oil.

The financial market turbulence of the past year has thrust the four new power brokers into the spotlight and accelerated trends we identified earlier. Financial power is dispersing more rapidly than before. These four investor groups will continue to grow, expanding their investment strategies in pursuit of higher returns and spurring the growth of private financing as an alternative to public markets. The concerns we've cited remain on the table and justify careful monitoring. But overall, the rise of these new power brokers has been largely beneficial to global capital markets.

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