



The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets

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McKinsey Global Institute

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Diana Farrell
Susan Lund
Eva Gerlemann
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Preface

The New Power Brokers: How Oil, Asia, Hedge Funds, and Private Equity Are Shaping Global Capital Markets is the result of a six-month research project by the McKinsey Global Institute (MGI). It builds on MGI's previous research on global capital markets as well as on research conducted by McKinsey's private equity practice and global banking practice. In this report, we provide new data and evidence on the size, investment strategies, and future evolution of each of the four new power brokers and explore their influence on world financial markets.

Susan Lund, a senior MGI fellow based in Washington, DC, worked closely with me to provide leadership on this project. The project team included Eva Gerlemann, a McKinsey consultant from the Munich office, and Peter Seeburger, a consultant from the Frankfurt office.

This report would not have been possible without the thoughtful input and expertise of numerous McKinsey colleagues around the world. These include Dominic Barton, Eric Beinhocker, Andreas Beroutsos, Markus Böhme, Kevin Buehler, Tim Church, Kito de Boer, Vijay D'Silva, Martin Huber, Conor Kehoe, Tim Koller, Stephan Kunz, Diaan-Yi Lin, Rob Palter, Emmanuel Pitsilis, Jean-Marc Pouillet, Charles Roxburgh, Bruno Roy, Antoon Schneider, Seelan Singham, Bob Sternfels, Hans-Martin Stockmeier, and Sanoke Vishwanathan. Martin N. Baily, senior fellow at the Brookings Institution and former chief economic adviser to President Clinton, was a key adviser on this research. We also benefited from numerous interviews with external experts and practitioners in the field.

Tim Beacom, Dirk Isert, Pamilyn Li, Jessica Nowak, Jason Rico, Manish Sharma, Moira Sofronas, Susan Sutherland, and Mario Wandsleb provided essential research. We would also like to thank the following MGI professionals for their tireless support of this project throughout its duration: Janet Bush, senior editor; Rebeca Robboy, external relations manager; Deadra Henderson, practice administrator; and Sara Larsen, executive assistant.

Our aspiration is to provide business leaders and policy makers around the world with a fact base to better understand some of the most important changes shaping global financial markets today. As with all MGI projects, this research is independent and has not been commissioned or sponsored in any way by any business, government, or other institution.

Diana Farrell
Director, McKinsey Global Institute
October 2007
San Francisco

Executive summary

Four actors—petrodollar investors, Asian central banks, hedge funds, and private equity—are playing an increasingly important role in the world’s financial markets. Although none are new, their rapid growth since 2000 has given them unprecedented clout. Research by the McKinsey Global Institute (MGI) finds that their size is likely to double over the next five years. Far from being a temporary phenomenon, the new power brokers represent a structural shift in global capital markets.

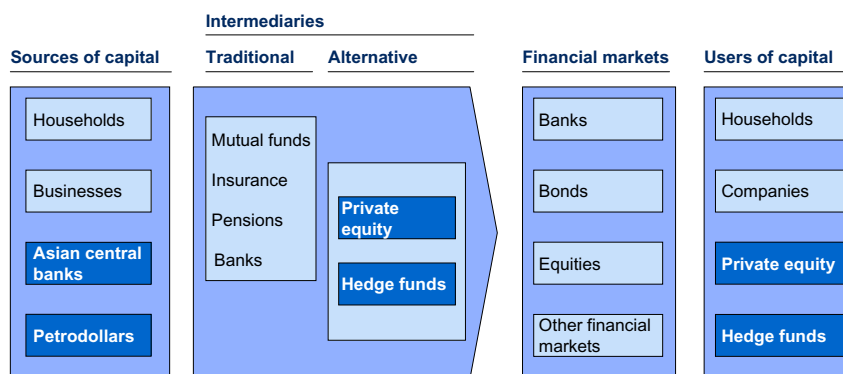
These players each have distinctive characteristics, but their growth is to an extent mutually reinforcing. By looking at them together, we shed new light on their collective impact. Petrodollar investors and Asian central banks both provide the world with very significant new sources of capital—but are also huge investors in the gray area between government and private. Hedge funds and private equity are innovative financial intermediaries that are pushing the risk-return frontier in new directions, offering investors unique diversification opportunities (Exhibit 1).

Our research shows that the new power brokers together bring significant benefits to global capital markets—but also create risks. The relative opacity of these players and a dearth of hard facts about them have compounded public concern. In this report, we do not address the regulatory issues that are on the table. We instead offer new evidence on the size of these power brokers, their growth prospects and likely future evolution, and their impact on global financial markets. In doing so, we seek to facilitate a more objective understanding of these actors and their growing influence.

Exhibit 1

NEW POWER BROKERS HAVE DIFFERENT ROLES AS SOURCES, USERS, AND INTERMEDIARIES OF CAPITAL

■ New power brokers



Source: McKinsey Global Institute analysis

THE NEW POWER BROKERS WIELD \$8.4 TRILLION IN ASSETS—WHICH COULD DOUBLE IN FIVE YEARS

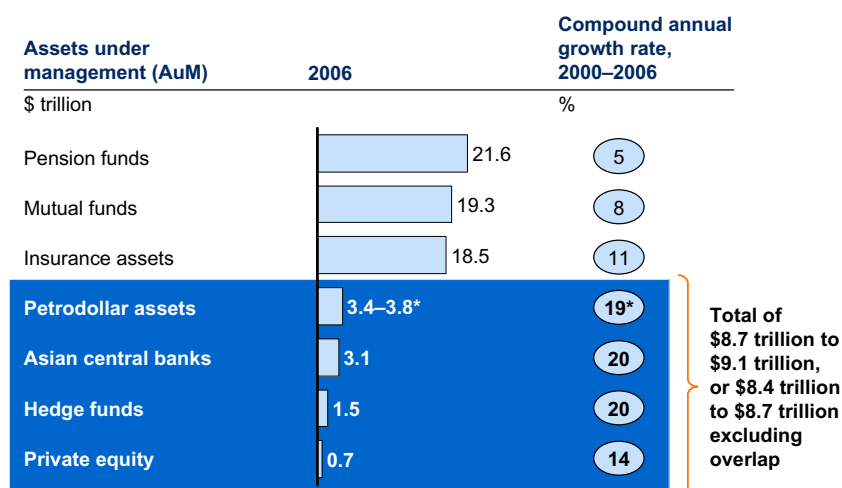
Excluding cross-investments between them, oil investors, Asian central banks, hedge funds, and private equity firms collectively held \$8.4 trillion in assets at the end of 2006 (Exhibit 2).¹ Their assets have tripled since 2000, making them 40 percent of the size of global mutual funds, pension funds, and insurance companies. Together, they represent some 5 percent of the world's \$167 trillion of financial assets—a considerable portion, given that five years ago they were on the fringes of the global financial system.

The financial clout of some individual players is impressive. China's central bank had \$1.1 trillion in reserve assets at the end of 2006, arguably making it the single wealthiest investor in international financial markets. The Abu Dhabi Investment Authority, the largest petrodollar investment fund, and the Bank of Japan each have estimated assets of up to \$875 billion—making them seventh and eighth among the top ten global investment managers. The five largest hedge funds each have at least \$30 billion in assets and estimated gross investments of up to \$100 billion after taking leverage into account.

¹ Petrodollar investors have significant investments in global hedge funds and private equity. We exclude this overlap when summing the collective assets of the new power brokers.

Exhibit 2

THE NEW POWER BROKERS ARE LARGE AND GROWING RAPIDLY



Note: E = Estimated

* Growth rate calculated based on data reported to the International Monetary Fund (\$2.5 trillion in 2006E does not include UAE and Qatar).

Source: Hedge Fund Research; Venture Economics; PE Analyst; International Financial Services, London; McKinsey Global Institute analysis

The simultaneous rise of these actors is far from accidental. Similar structural factors have fueled the growth of hedge funds and private equity, including strong investor demand from wealthy individuals and institutions seeking portfolio diversification. Petrodollar investors have contributed to their growth as well by making direct investments in hedge funds and private equity. Together with Asian central banks, they also provide liquidity that has lowered interest rates and enabled the higher leverage that hedge funds and private equity funds employ.

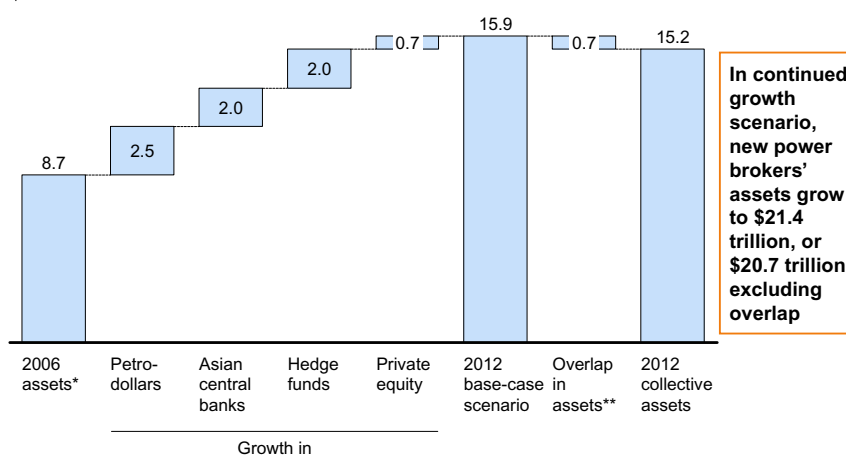
The size of the four new power brokers—and their influence on global capital markets—will continue to expand. Under current growth trends, MGI research finds that their assets will reach \$20.7 trillion by 2012, 70 percent of the size of global pension funds. But even if oil prices were to fall, China's current-account surplus declined, and growth in hedge funds and private equity slowed, our analysis shows that the assets of these four players would nearly double over the next five years, increasing to as much as \$15.2 trillion by 2012 (Exhibit 3).² These players are now a permanent feature of global capital markets.

² These figures exclude the overlap between the assets of the four players—for instance, petrodollar investments in hedge funds and private equity. The overlap will amount to an estimated \$720 billion in 2012.

Exhibit 3

NEW POWER BROKERS' ASSETS MAY GROW TO \$15.2 TRILLION BY 2012

\$ trillion



* Takes lower estimate for petrodollar foreign assets (\$3.4 trillion) in 2006.

** Estimated petrodollar investments in hedge funds and private equity.

Source: McKinsey Global Institute analysis

NEW POWER BROKERS INCREASE LIQUIDITY, INNOVATION, AND FINANCIAL DEVELOPMENT IN EMERGING MARKETS

The four players have broadened and diversified the global investor base significantly in terms of geographies, asset classes, and investment strategies, and boosted liquidity. Each has longer investment horizons than traditional investors, enabling them to pursue higher returns (albeit with more risk). They have brought new dynamism to private capital markets and have given a considerable boost to financial innovation. They may also catalyze financial development in emerging markets. All these developments improve the functioning of global financial markets—but also pose risks, as we discuss in the next section.

Petrodollars: Fueling global liquidity

With the tripling of oil prices since 2002, petrodollar investors have become the largest of the four new power brokers with an estimated \$3.4 trillion to \$3.8 trillion in foreign financial assets at the end of 2006.³ Although the sovereign wealth funds of oil exporters have attracted considerable public attention, these account for just 60 percent of total petrodollar foreign assets. Wealthy private individuals own the rest. Petrodollar foreign assets will continue to grow rapidly over the next five years—even if oil prices were to fall to \$30 per barrel. In our base case with oil at \$50 per barrel,

³ This includes oil exporters in the Middle East, as well as Norway, Russia, Venezuela, Nigeria, and Indonesia.

their assets would grow to \$5.9 trillion by 2012. This entails new investments of \$387 billion per year in global capital markets, or some \$1 billion per day.⁴

Despite significant diversity across oil investors, on average they have a stronger preference for equity and alternative investments than traditional investors. We estimate that petrodollar investors currently have around \$1.7 trillion in global equities and another \$350 billion in hedge funds, private equity, and other alternative investment funds. They are also driving rapid growth in the currently small market for Islamic finance. In addition, oil investors allocate a large share of their portfolios to emerging markets—since 2002, 22 percent of Gulf Cooperation Council (GCC) foreign investments have gone to Asia, North Africa, and other Middle Eastern countries.⁵ As petrodollar wealth grows, we will see a shift in liquidity to these regions, a trend that may hasten their financial system development.

Asian central banks: The cautious giants

Asian central banks had \$3.1 trillion in foreign reserve assets at the end of 2006, up from just \$1 trillion in 2000.⁶ Even more than in the case of petrodollars, these investments are concentrated in the hands of just a few institutions. The central banks of China and Japan held \$1.1 trillion and \$875 billion of foreign reserves, respectively, at the end of 2006. The next six largest foreign reserve holders—Hong Kong, India, Malaysia, Singapore, South Korea, and Taiwan—together held most of the rest, or nearly \$1 trillion. In our base-case scenario, which assumes flat or declining current-account surpluses in Japan and China, Asian reserve assets would grow to \$5.1 trillion by 2012, with average annual investments of \$321 billion per year in global capital markets.

Together with petrodollars, Asian central banks have been an important new source of liquidity to global markets. These banks currently invest the lion's share of their assets—some \$2 trillion—in US dollar assets, particularly government bonds. As a result, we estimate that Asian central banks have lowered US long-term interest rates by as much as 55 basis points.⁷ Going forward, some have plans to diversify their assets to earn higher returns. The governments of China, South Korea, and Singapore have announced plans collectively to shift up to \$480 billion into more

4 In comparison, oil prices were around \$80 per barrel in September 2007, shortly before this report went to press.

5 The GCC comprises Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE). *Tracking GCC Petrodollars*, Institute of International Finance, May 2007.

6 This includes the foreign reserve assets of central banks only and excludes assets in Asian government holding corporations such as Singapore's Temasek, and sovereign wealth funds such as South Korea's Government Investment Corporation.

7 Petrodollar investors may reduce US long-term interest rates by an additional 21 basis points.

diversified (and more risk-taking) sovereign wealth funds. This will spread liquidity to other asset classes, which will broaden the Asian “liquidity bonus” beyond US fixed-income markets to other asset classes. But given the slow pace of diversification, this shift will be unlikely to raise US interest rates much. If Asian monetary authorities allow more flexibility in their currencies, some of the investments from these funds may also stay within Asia, spurring significant development in the region’s financial systems and the nascent financial hubs.

Hedge funds: From mavericks to mainstream

Hedge funds had global assets under management of \$1.5 trillion at the end of 2006, up from just \$490 billion at the end of 2000. By the end of the second quarter of 2007, their assets had grown to \$1.7 trillion. Including their leverage, hedge fund gross investments in financial markets today may be as high as \$6 trillion. The turmoil in the US subprime mortgage market that developed in mid-2007 brought several multibillion-dollar hedge funds to the brink of collapse and many funds suffered huge losses. However, unless the industry experiences several years of continuously low returns, the evidence suggests that institutional investor demand for the diversification that hedge funds offer will likely continue. In our base-case scenario, hedge fund assets grow more slowly than in recent years but still reach \$3.5 trillion by 2012. This implies leveraged investments of up to \$12 trillion—vaulting hedge funds to roughly one-third the size of global pension funds.

Hedge funds have benefits for global financial markets, but those come with risks (as we discuss later). They provide liquidity to markets, now accounting for 30 percent to 50 percent of trading in US and UK equity and bond markets—and an even larger share in other asset classes, such as distressed debt and emerging market bonds. As large buyers and sellers of collateralized debt obligations and other credit derivatives, hedge funds have enabled banks to lend more than they otherwise would. While this has potentially lowered credit underwriting standards, it has also provided companies and other borrowers around the world with broader access to financing and has helped fuel growth of private equity. Finally, hedge funds have spurred innovation in financial instruments, trading strategies and electronic trading platforms, and risk-management systems—all of which enable more efficient spreading of risk and greater liquidity.

Private equity: Eclipsing public capital markets?

Despite the intense public focus it attracts, private equity is the smallest of the four new power brokers, with \$710 billion in investors' capital at the end of 2006.⁸ This may be two and a half times larger than in 2000, but the fact remains that private equity is a relatively small player. Private equity-owned companies are worth just 5 percent of the value of companies listed on stock markets in the United States and 3 percent of those in Europe.⁹ Moreover, private equity funds have generated very mixed returns. In the United States, while the top-quartile funds have posted very high returns, average returns have failed to outperform equity markets on a ten-year basis—suggesting the industry may be ripe for a shakeout and consolidation.

New fund-raising in private equity may slow down after the financial market turmoil that developed in mid-2007, and firms that have relied more on leverage than skill may shut down. Nonetheless, the evidence suggests that many pension funds, oil investors, and other institutional investors have plans to increase their portfolio allocation to private equity funds in the years to come. Even with growth rates slower than in the past few years, we project that global private equity assets under management could reach as much as \$1.4 trillion by 2012.

Private equity's influence is larger than its size would suggest. It is forging a new form of corporate governance that, in the best cases, has a demonstrable ability to improve the performance of struggling companies. Although the low interest rates of recent years have allowed some poorly performing private equity firms to survive, the top-performing private equity managers can sustainably improve corporate performance. As the pace and scale of buyouts has grown, private equity is causing many public companies to review their performance, to rethink their use of equity and debt, and to reshape their growth strategies.

THE NEW POWER BROKERS ALSO CREATE RISKS

For all of their benefits, the rise of the power brokers also poses new risks to the global financial system. Our research offers some evidence that should help calibrate the public debate.

8 This figure includes only leveraged buyout funds (LBOs). In broader usage, the term *private equity* sometimes includes venture capital and mezzanine and distressed debt funds as well, which would put the industry assets at \$1.1 trillion. In this report we concentrate on LBOs because they have generated the most public attention and are the largest segment. We use the terms *private equity* and *leveraged buyout funds* interchangeably.

9 We measure this in terms of the "enterprise value" of companies; i.e., the value of their debt and equity combined.

Asset price inflation. The new liquidity brought by petrodollars and Asian central banks may be inflating some asset prices and enabling excessive lending. Our research finds little evidence of an asset price bubble in public equity markets where rising valuations have mostly reflected increased corporate earnings (price-earnings ratios in the United States and Japan have actually declined over the past few years, and in Europe have increased only slightly). Concern may be more warranted in illiquid assets such as real estate. According to the Economist Intelligence Unit, real-estate values in developed countries increased by \$30 trillion between 2000 and 2005, far outstripping GDP growth.¹⁰ Petrodollar investors may have contributed to this rise in some markets through their real-estate purchases. More important, Asian central banks and petrodollars together have helped lower interest rates to nearly ten-year lows prior to July 2007, thereby fueling larger mortgages, additional home-equity loans, and subprime lending.

Noneconomic motives of state investors. Another concern is that the government connections of Asian central banks and petrodollar sovereign wealth funds may introduce an element of political considerations in their investments. This could lower economic value creation in host economies and, moreover, distort the market signals that allow financial markets to function efficiently. So far, the evidence shows that Asian central banks and petrodollar sovereign wealth funds have focused on returns and acted cautiously and discreetly—often through external asset managers—to avoid moving prices. However, some sovereign wealth funds in oil-exporting regions have signaled their intent to shift from being largely passive investors to taking larger equity stakes in foreign companies.

Systemic risk from hedge funds. The enormous size, high leverage, and increasingly illiquid investments of hedge funds raise their potential to create contagion across unrelated asset classes, or trigger the failure of some of the large investment banks that lend to them. Our research suggests that several developments in the hedge fund industry have reduced—but certainly not eliminated—these risks over the past ten years. First, hedge funds have adopted more diverse trading strategies, which should lessen the risk of “herd behavior” that could amplify market downturns. Nonetheless, many quantitative “equity-neutral” funds simultaneously suffered significant losses during the subprime crisis of mid-2007—indicating that their models were less diversified than it appeared. Our analysis also suggests that the largest banks have reasonable levels of equity and collateral against their hedge fund exposures and have improved their assessment and monitoring of risk. Some of the largest hedge funds have also begun to raise permanent capital in public stock and bond markets, which will improve their ability to weather market downturns without forced selling—as well as expose them to more public scrutiny.

¹⁰ “In come the waves,” *The Economist*, June 15, 2006.

Credit risk from private equity. Private equity funds are one factor behind the dramatic growth in high-yield debt in recent years and have been using their growing clout to extract looser lending covenants from banks. This may be increasing credit risk in financial markets. Our analysis shows that private equity defaults alone could prove costly to investors and could send some companies into bankruptcy, but they are unlikely to pose systemic risks to financial markets. Private equity accounts for just 11 percent of total corporate borrowing in the United States and Europe. Even if default rates in private equity loans rose 50 percent above historic highs, losses would amount to just 7 percent of syndicated loan issuance in the United States in 2006. Moreover, private equity funds tend to invest in relatively stable companies, limiting the effects of economic downturns on their performance.

In contrast to the intense media and regulatory hype, the evidence to date thus gives some reason for optimism that the risks posed by the new power brokers are manageable; nevertheless, current concerns are real and justify careful monitoring. The four players would find it in their own interest to note public anxieties and voluntarily take steps to minimize them, much as the derivatives industry did a decade ago.

For sovereign wealth funds in oil-exporting regions and in Asia, this means voluntarily increasing disclosure on their investment strategies, internal governance, and risk management to allay concerns of other investors and of regulators about their impact on the market. Norway's Government Pension Fund is one model. Policy makers in the United States and Europe, for their part, should ensure that they base any regulatory response on an objective appraisal of the facts, and differentiate between direct foreign corporate acquisitions by state-owned enterprises and investments by diversified financial market players such as sovereign wealth funds. The latter usually make passive investments through purchases of equities and debt securities.

For the risks posed by hedge funds and private equity, banks must have the appropriate tools, incentives, and oversight to accurately measure and monitor their exposures. Further development of valuation techniques for illiquid assets is needed. Banks should also ensure that lending standards do not decline as they move toward being loan originators without their own capital at risk, and they should be accountable for the long-term performance of the loans they underwrite.

In chapter 1, we describe in more detail how the rising influence of the four players is jointly shaping global financial markets. In chapters 2 to 5, we examine each of the new power brokers in turn, assessing the factors that have contributed to their growth, their impact on global financial markets, and their likely evolution.

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