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Joining Trend, SWFs Push into Shareholder Activism to Boost Returns

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Sovereign wealth funds are wading into the contentious arena of activist investing, campaigning for better corporate governance and launching hostile takeovers while pouring money into the coffers of hedge funds that ply the controversial strategy.

Leo de Bever, CEO of Alberta Investment Management Corp. (AIMCo), smelled opportunity in April 2009. Precision Drilling Corp., a Calgary-based oil field services company, had taken on an unsecured bridge loan the previous year to finance its purchase of a rival driller the previous. With credit markets frozen, Precision couldn't replace the loan, which carried a 17 percent interest rate, with cheaper debt. The company turned to de Bever, who oversees more than C$75 billion ($63 billion) for 28 pensions and endowments, including the Alberta Heritage Savings Trust Fund, a sovereign wealth vehicle. AIMCo invested C$380 million in the driller, including notes, equity and warrants.

The Alberta fund took a seat on Precision's board and provided financial guidance - not exactly a storm-the-ramparts siege. "We know what it takes to constitute a board and management that can put the right conditions in place to help the company," de Bever says. "Sometimes when you can buy them cheap and improve the governance, the share price will rise and we're paid for our work."

AIMCo employed the kind of shareholder activism that is gaining traction with sovereign wealth funds. They want to enhance performance in a period for which many strategists forecast tepid returns. "It's something we've taken note of," says Michael Burns, executive director of the Alaska Permanent Fund Corp. (APFC), which has $51.1 billion under management. "It is out there, and we're seeing more and more of it."

Still, AIMCo faced criticism, with some characterizing the move as a government bailout. The attacks faded only after Precision's stock price tripled. The fund sold most of its shares in 2013, keeping a stake of 1 percent or so - and a board seat on key committees.

Watershed Year

AIMCo's activism has seldom been aggressive. De Bever says that when he identifies a weakness in a company the firm owns, he prefers to keep the tone diplomatic. "It's a more effective approach," he contends. "When you force a company to defend itself against no-holds-barred hostile interventions, not only do you divert their attention away from running the company, you also risk creating a lot of noise in the press and becoming known as someone who's difficult."

Others are less reticent. In the fall of 2014, the Qatar Investment Authority (QIA), which manages an estimated $300 billion, spearheaded a hostile takeover attempt of London-based Songbird Estates, the company that controls Canary Wharf, home to much of the city's financial industry. Franklin Resources, a San Mateo, California-based mutual fund firm, recently signed on in support of QIA's bid. But $652.7 billion sovereign wealth fund China Investment Corp., Songbird's second-largest shareholder, opposed it on the grounds that the $4 billion offer is low. Songbird rejected the bid this month.

After the financial crisis, sovereign wealth funds that had been burned by investments in the financial and other sectors looked to increase management accountability at the companies they held. Today they are displaying increasing assertiveness. "We can certainly state that only recently have several sovereign wealth funds assumed more visible or active positions with respect to their portfolio companies," says Cristina Ungureanu, head of corporate governance advisory at Sodali, a London consulting firm.

A watershed of sorts came in 2012, she notes. That year QIA orchestrated commodities trader Glencore International's purchase of mining giant Xstrata, in which the fund held a 12 percent position. Temasek Holdings, a Singaporean sovereign wealth fund, successfully pushed London-based Standard Chartered to appoint more independent directors to its board the same year. And Norges Bank Investment Management (NBIM), which oversees Norway's $850 billion Government Pension Fund Global (GPFG), began a policy of seeking the separation of the CEO and chairman positions at its portfolio companies.

For some state-owned investors, hedge funds are the preferred route for a number of reasons. Kenneth Heinz, president of Chicago-based Hedge Fund Research (HFR), says he's seen more of such allocations lately. "Sovereign wealth funds are increasing their commitment to activist hedge funds in the current environment, a trend I expect to continue," he says. "Unlike other strategies, which people can attempt to replicate or can be done in isolation based strictly on arm's length analysis, activism is truly capital-intensive, relationship-sensitive, personality- and expertise-driven and idiosyncratic." In other words, kids, best leave it to the pros.

Informed Investors

In addition to its hostile Songbird campaign, QIA displayed a penchant for activism when it invested $340 million in the initial public offering of William Ackman's Pershing Square Holdings, whose shares were listed

in Amsterdam last October, buying a 4.6 percent stake in the closed-end hedge fund. Ackman has been on a roll: In 2014, Pershing Square Holdings generated a net return of 40.4 percent. Among Pershing Square's best-performing activist positions were Irvine, California-based pharmaceuticals company Allergan; Calgary's Canadian Pacific Railway; and Zoetis, a Florham Park, New Jersey-based veterinary drugmaker. Pershing Square did not respond to a request for comment.

Activist funds' assets under management increased from $32 billion in 2008 to $95 billion in 2013, according to New York-based data firm S&P Capital IQ. Given the government investors' assets - $5.3 trillion in total, according to the Sovereign Wealth Center - even a toe dipped into the waters of activism can create large ripples. On average, activist hedge funds generated a return of 4.83 percent last year, HFR reports, compared with 3.19 percent for hedge funds overall.

Sovereign wealth funds have traditionally favored passive strategies in public markets. The funds have long investment horizons, so they don't need to generate quick profits. Because of their public nature, they typically want to keep low profiles and indexing provides an easy way to invest their large asset bases.

This has begun to change. "Sovereign wealth funds largely behave like informed investors with concern about financial performance and protecting their investments," says Patrick Schena, co-head of the Sovereign Wealth Fund Initiative at Tufts University's Fletcher School. It's not only about performance. Some sovereign funds are incorporating environmental, social responsibility and corporate governance (ESG) criteria in their investment goals.

"God's Work"

That's helped change the public face of activism, which is no longer seen as the exclusive purview of rapacious provocateurs. "It was not so long ago that the "˜activist' moniker had a distinctly negative connotation," U.S. Securities and Exchange Commission chair Mary Jo White said in a December 2013 speech. "But that view of shareholder activists, which has its roots in the raiders of the 1980s takeover battles, is not necessarily the current view, and it is certainly not the only view."

There is evidence that activists get results. Targeted companies generated superior returns between 2003 and 2013, according to a study by S&P Capital IQ. It found that they beat the market by a stunning 11.7 percent in the 12 months after activism campaigns began.

Size helps activist performance. "Large asset owners have the ability to exert influence in a way that brings the corporation to a higher order of governance that will benefit all shareholders," Schena says. "If sovereign wealth funds felt compelled not to do so because of political or other considerations, that would put them at a disadvantage to other shareholders."

Activism also provides portfolio diversification for large institutional investors like sovereign wealth funds. "By definition, activist investors initiate campaigns against underperforming managements, those which have failed to generate adequate shareholder value and which have underperformed equity market proxies," says HFR's Heinz. "In this way they serve as a natural hedge to a large sovereign wealth fund portfolio of traditional assets, many of which do well in good market environments, by not chasing high-performing stocks but by investing in underperformers under the pretense of making strategic changes."

The activist hedge fund may persuade sovereign wealth funds to join them in pushing for change. "The activist also serves as a third-party expert capable of advising the fund not only on holdings but on voting, proxies, board of directors positions and opinions on current or proposed board managers," Heinz says. "This represents valuable knowledge to the sovereign wealth fund."

Lacking Leadership

And of course, hedge funds provide cover for state-owned investors that might be publicity-shy. That said, activism is unlikely to change the global environment. Hossein Kazemi, senior adviser at the Chartered Alternative Investment Analyst Association in Amherst, Massachusetts, says hedge funds have limited capacity. Furthermore, activism has marginal appeal in most of the world. "This is a U.S.-centric strategy," Kazemi says. "It's a difficult strategy to implement in emerging markets."

Likewise, it's unlikely that big foreign-state-owned investors will declare open season on U.S. blue chips. "Imagine if the China [sovereign] fund tries to take a stake in a U.S. company and tries to push it around," says Kazemi. "It would provoke quite a reaction from Congress." Indeed, recent court testimony showed that in 2008 then-U.S. Treasury secretary Henry Paulson Jr. rebuffed at least two bids by CIC to rescue beleaguered insurer American International Group, leaving U.S. taxpayers on the hook for $182.3 billion.

Nevertheless, over the past three years Alberta's AIMCo has sought to increase shareholder value, occasionally aggressively. "If we see an organization that's lost its way, that has an obvious governance weakness that we feel we can fix and that the company will improve - and its share prices will rise - then we'll take action," CEO de Bever says.

In 2011 the fund battled Canada's largest grain handler, Regina, Saskatchewan-based Viterra. AIMCo, then Viterra's largest shareholder, released a scathing statement: "[AIMCo] will not accept Viterra's vague plans for board renewal, further platitudes about seeking shareholder input, or closed-door processes on important governance issues," it said. "Among these concerns, AIMCo does not believe the current Viterra board has the required skills or expertise to meet the company's leadership needs."

Viterra added an AIMCo representative to its board. A year later Baar, Switzerland-based Glencore bought Viterra for $6.1 billion, or $16.25 per share - more than double AIMCo's $8 purchase price.

AIMCo has been known to join forces with activist hedge funds when they share a goal. The fund teamed up with New York-based JANA Partners for a failed 2012 takeover attempt of Dutch delivery company TNT Express.

Global Standard

Agendas may conflict. In 2013, AIMCo backed the board of Agrium, a Calgary-based agricultural products supplier in a fight with JANA. The hedge fund thought Agrium was worth more dead than alive, de Bever recalls. AIMCo believed it could be salvaged. "Over time we've discovered that we have different objectives than the hedge funds," de Bever says. "They tend to be more interested in short-term gains because their ability to sustain longer-term policy is limited. But our interest is in having as many stable, well-functioning companies as possible over the long term."

The differences between activist sovereign wealth funds and their peers can be chalked up to the inclinations of the funds' CEOs and boards. "It can depend on whether the CEO has developed an interest in activist investing and wants to pursue it," de Bever observes. "A lot of boards may not be as tolerant as ours. You have to be prepared to withstand the pressure."

The weightiest player engaging in sovereign wealth fund activism is NBIM. The sheer size of its assets under management gives NBIM the scale to effect change.

Since the end of 2007, the manager of Norway's gigantic sovereign wealth fund has boosted its equity allocation to 61 percent from 42 percent and increased concentrations. By 2016, NBIM expects to hold a stake of 5 percent or more in 100 companies, versus 45 in 2013. Big positions facilitate activism. In June 2014, NBIM announced that it no longer was content with stock indexing. "We seek to capitalize on the fund's unique combination of characteristics," the firm said in a statement. "The sheer size of the fund presents opportunities."

NBIM emphasizes environmental and social issues - partly because of constituent pressure - but governance is important too. "Active ownership protects shareholders' rights and provides a basis for profitable commercial activity," it said in a recent strategy report. "Responsible investment safeguards the value of investments." So the firm has set up an advisory board to examine portfolio companies' governance, sits on board nominating committees and publishes voting decisions ahead of time. NBIM did not respond to requests for comment.

Critics and Criticism

NBIM's advisory board is likely to encourage other sovereign wealth funds. "The institution of the board in some respects sets a global standard in the manner in which large state and sovereign investors can invest efficiently while also participating with other investors to ensure that managements serve the best interests of all shareholders," Schena says.

AIMCo, QIA and NBIM remain exceptions. APFC wants to invest directly in companies but isn't likely to rattle cages. "When we buy into a company, we believe we're buying into their governance," says executive director Burns. "We know that there can be opportunities to add value, but spending a lot of time trying to outthink a company in their own bailiwick can be presumptuous."

If sovereign wealth funds increase activism, they'll face challenges. Critics continue to contend that the practice results in lower invested capital, R&D spending, capital expenditures and employment. The potential for negative attention, especially surrounding layoffs, is irksome for sovereign funds given their public status.

Sovereign wealth funds with poor transparency and accountability face further problems. "Oftentimes the issues arise when you have sovereign wealth funds in countries that are not democratic," Schena says. "That can lead to concerns that activist positions will be informed by, or be structured to advance, certain political or geostrategic interests that will not contribute to shareholder value."

The funds most associated with activism have been based in democratic nations with strong traditions of transparency: NBIM and AIMCo earn grades of A-, or fully compliant, from GeoEconomica, a Geneva-based consulting firm, on its Santiago Compliance Index, whereas QIA earns a D, for noncompliant. Participation in activist campaigns raises issues in a case such as QIA's, not least because the fund is administered on behalf of an authoritarian nation that has not hesitated to use economic leverage to further political goals.

More Engagement

NBIM, AIMCo and QIA are all signatories to the Santiago Principles, a 2008 list of voluntary best practices established by the predecessor to the International Forum of Sovereign Wealth Funds. The principles encourage transparency, particularly related to sovereign wealth funds' exercise of their shareholder rights. Principle No. 21 states, "If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments."

AIMCo's de Bever says his fund strives to meet such obligations. "We disclose as much as the average Canadian company," he asserts. "We take it seriously when we ask a company to improve its governance. It would be hypocritical of us to ask a company to do something that we're not doing ourselves."

De Bever thinks more sovereign wealth funds are likely to turn activist in the future, especially on ESG issues. "You're seeing more and more engagement," he says. That's something portfolio companies will have to grapple with.