ESG PRINCIPLES IN INVESTMENT PROJECTS FINANCED BY SOVEREIGN INVESTMENT FUNDS

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Abstract

Sovereign wealth funds (SWFs) have over $11.83 trillion in assets under management as of October 2023. Most of these 176 funds are sponsored by non-Western countries and their growth has made SWFs important international investors, particularly in private equity funding. We first define SWFs, then discuss their evolution into today's categories of stabilization, savings, and development/strategic funds. We discuss the documented importance of SWF funding sources – oil sales revenues versus excess reserves from export earnings – and summarize the empirical literature studying how SWFs allocate funds geographically and across asset classes.

Keywords: *sovereign wealth funds, international financial markets, government policy and regulation, environmental, social, and governance policies*

Sovereign Wealth Funds (SWFs) have emerged as significant players in the global financial landscape, wielding substantial influence over economies and markets worldwide. These state-owned investment vehicles manage vast pools of capital amassed from reserves, surpluses, or revenues generated by a country's natural resources or other state-owned enterprises. Beyond mere financial management, SWFs play a pivotal role in fostering economic development and ensuring financial stability, both domestically and internationally.

The impact of SWFs extends beyond direct investment into sectors; they also play a vital role in shaping the financial landscape. By participating in capital markets through equity investments, debt securities, and alternative assets, SWFs enhance liquidity, deepen markets, and foster transparency. Their long-term investment horizon and patient capital approach provide stability amidst short-term fluctuations, thereby attracting other institutional investors and stimulating capital market growth.

"Sovereign fund is a fund established for the purpose of realizing the basic constitutional rights of citizens, forming investment projects with important social aspects, based on experience and potential, with high financial and economic efficiency, and financing the budget deficit" (Jumaniyazov, I. T., & Abdurahmonov, Q. (2023)). Based on the research, it can be said that special attention is paid to the wider coverage of the stabilization of economic processes of sovereign funds.

"Sovereign funds are a financial and economic institution and one of the structures implementing the policy set by the government. Sovereign funds serve to implement social and economic functions of the country. Also, the term "sovereign funds" is used in relation to financial funds established by the state for the purpose of developing the economy over many years" (Jumaniyazov, I. T., & Islomov, A. (2023)).

"The operation of sovereign funds should be directed towards achieving the objectives and tasks of the anti-cyclical budget policy, in which the formation and use of funds is a monetary policy conducted by the state should be connected with it" (Asror, A., & Inomjon, J. (2023)). It can be said that the effective use of financial resources is important in the activity of sovereign funds.

E.H. Hansen considered sovereign funds as a tool for regulating the money supply in the country. According to the approach of this researcher, one of the important tasks of sovereign funds is to prevent the depreciation of the country's currency, thereby increasing the purchasing power of the national currency. By paying attention to these issues, there will be an opportunity to increase the income of the population. As a result, the initial and main influence of sovereign funds is the purchase price of the currency (Хансен, Э.Х. 2006).

According to I. Jumaniyazov, "sovereign fund is a centralized fund that is formed by the state and ensures its effective use by attracting a part of the income from the export of goods, budget surplus, gold currency and other reserves in order to ensure the development of the national economy and international competitiveness. is a fund" (I. T. Jumaniyazov, & A. Khaydarov. (2023)).

"According to the approach of the Institute of Sovereign Funds, the main criteria for evaluating the activity of sovereign funds are the level of openness, the level of profitability of the investment portfolio and the size of assets" (Jumaniyazov, I. T. (2019)).

All SWFs that take ESG considerations into account when making investment decisions ('ESG SWFs') have several types of guidelines at their disposal. A well-known and widely-used principle is a negative or positive investment screen. A non-financial negative investment screen means that specific equity stocks or industries are excluded from an investment fund's portfolio based on social, environmental and ethical criteria (Renneboog, Ter Horst & Zhang, 2007). A common-used negative screen is for example the exclusion of alcohol, tobacco, defense and gambling industries, or companies with poor labor conditions, little environmental protection, violation of human rights or animal testing (Renneboog, Ter Horst & Zhang, 2007). Other practices related to negative screens vary for each investment fund. For instance, the fund can only exclude companies if their revenues derived from an undesirable sector exceeds a specific threshold. A non-financial positive investment screen concerns the practice that a fund selects those shares that meet superior CSR standards and/or are 'best in class'. These screens often use criteria such as corporate governance, environment, sustainability and labor conditions. Negative and positive investment screens are often referred to as the first and second generation of screens (Renneboog, Ter Horst & Zhang, 2007). Next to these two socially responsible investment guidelines, a third approach combines negative and positive screens and results in a selection of companies based on their economic, environmental and social (ESG) criteria. The fourth and last approach combines the third approach with shareholder activism, which means that the portfolio manager(s) try to influence a target company's decisions and actions by direct conversation with management or usage of voting rights. The effect of using investment screens on fund performance can be twofold.

Table 1

Overview of SWFs that use ESG criteria in their investment process

Name	Country	Main CSR goal	Screening criteria	Main CSR/SRI activities reported	Exclusions, voting and engagement publications in 2018
Government's Pension Fund – Global	Norway	To contribute to well-functioning markets and good corporate governance.	Follows UN international principles and OECD principles of corporate governance. *Negative:* Publish own expectations regarding several CSR areas. *Positive:* Invest specially in climate solutions.	Attendance of meetings on responsible investment. Active contribution to development of climate-change and water-management priciples. Support and initiate research projects on ESG-related topics. Publish position papers on corporate governance issues.	Dialogue with 1000 companies that represent 2/3 of equity portfolio value. Publish strategic subjects of dialogue. Divested in 30 companies: 15 companies (climate), 9 (corruption), 4 (human rights), 2 (other). Published voting activity at all shareholder meetings.
Canada Pension Plan	Canada	Sustainable investing.	*Negative:* Publish and follow own principles. *Positive:* Select 'best in class' firms for active investment.	Establishment of climate change steering committee. Design and implementation of toolkit that investment teams will use for investment evaluation. Expansion of fund's renewables portfolio.	Actively engaged with target companies to promote improved management of ESG. Exercised voting rights and publish proxy voting principles and guidelines. Issuance of green bonds.
Australian Future Fund	Australia		Designed own ESG policy with principles. *Negative:* Certain traditional screens (tobacco, mines, munitions) and other exclusions based on ESG policy.	Exercise ownership rights associated with investment according to corporate governance voting principles.	Published proxy voting summary, provide voting principles in annual report and provide own report on implementation of Santiago Principles. Dialogue and engagement activities with portfolio companies to establish a climate of long-term asset stewardship.
New Zealand Superannuation Fund	New Zealand		Designed RI framework to integrate ESG considerations into investment process. *Negative:* eight screens related to munition, tobacco and other topics.	Active investment, engagement, voting, exclusion and/or divestment from companies.	Conducted work on climate change scenarios to understand their investment implications. Updated exclusion list: approx. 280 companies from 15 countries are excluded.
Ontario Teachers' Pension Plan	USA	Integrate, engage, influence and evolve.	*Negative and positive:* environmental, social and governance	Integrate ESG considerations into investment process, build relationships with target companies, use influence to make expectations regarding ESG clear.	Developed plan for climate change policy advocacy. Developed long-term tailored engagement plans for public and private target companies. Developed customized governance guidelines and expectations for specific markets and countries.
Fonds de Reserve pour les Retraites	France		Incorporate ESG criteria into portfolio management.	Convict businesses to adopt necessary measures to reduce their impact on climate.	Developed active policy of voting proxies at shareholder meetings.

The responsible investment actions include investment, engagement, voting, exclusion and/or divestment. Fifth, the Ontario Teachers' Pension Plan integrates ESG considerations into its investment process, build relationships with targets and use its influence to make expectations clear. It uses environmental, social and governance criteria. Last, the Fonds de Reserve pour les Retraites uses negative screens and is particularly focused on reducing the carbon footprint of its equities investment portfolio. It also incorporate ESG criteria into its portfolio management process and investment decisions. It has an active policy of voting proxies and tries to convict businesses to adopt necessary measures to reduce their impact on climate.

The other ways of how SWFs use using CSR and ESG criterions when making investment decisions are shown in Table 5. This table summarizes the main CSR goal, screening criteria and main CSR or SRI activities reported by the SWF themselves in their annual report or responsible investment reports, if available. The main conclusion that can be drawn from this table is that the majority of the SWFs do not have an (explicit) ESG strategy or criteria. Even though the most SWFs do not have a strategic approach to ESG investments, those who do have this integrate the considerations in a transparent manner and document it extensively (see Table

5). The six SWFs that do have an explicit ESG strategy are the GPFG, Canada Pension Plan, Australia's Future Fund, New Zealand Superannuation Fund, Ontario Teachers' Pension Plan and the Fonds de Reserve pour les Retraites. Some SWFs without ESG strategy still signed the United Nations Principles of Responsible Investment (UN PRI), such as the GPFG and the South African Public Investment Corporation.

Conclusions

This research aims to provide a new step towards understanding the motives and consequences of SWF investments, especially for SWFs that incorporate ESG considerations into their investment processes and decisions. The conclusions provide information for (professional) investors and leaders in politics, governments and business, and can be used as a source of knowledge for decision making on how to deal with (foreign) SWFs. Nevertheless, future academic research is needed to further unravel the objectives and effects of investments from SWFs, how SWF characteristics affect the performance of target firms, and how firm characteristics affect the investment choices of SWFs. The most important recommendations for further research are the following:

- Additional coverage of SWFs: Almost every empirical study on the influence of SWF investments on target firms is conducted with a subsample of SWFs, even though there are many more SWFs that actively invest on a large scale (SWFI, 2019). This study contributes by collecting ownership data on all SWFs available in FactSet. Still, far too little is known about the details of (other) SWF investments, and the current data reveals that the largest SWFs in this sample are usually the most transparent and autonomous SWFs. Hence, inclusion of additional SWFs, and especially those with a high degree of opaqueness and a high AUM, would allow interesting replications of the research that already has been done for the lower number of (relatively transparent and autonomous) SWFs. Furthermore, adding large, politically dependent and opaque SWFs to the sample gives opportunities to further examine whether SWF and firm characteristics influence target firm performance and SWF investment decisions, respectively.

• Transparency and autonomy classifications: Related to the additional coverage of SWFs is the recommendation to incorporate data on these SWFs into scoreboards such as those designed by Truman (2015) and Linaburg and Maduell (2018). This way, it is likely that the number of SWFs that is classified as either transparent or opaque and either autonomous or politically dependent increases, which helps to conduct analyses with balanced sample sizes and increased statistical power. Furthermore, increased coverage of transparency data might help to answer the question for policymakers whether the benefit of cross-border SWF investments is greater than the benefit provided by SWF investments (Megginson & Gao, 2019). Moreover, Stone and Truman (2016) recently found that SWFs are making progress to improve their transparency, which could also future results regarding the impact of opaqueness of SWFs on target firms and investment decisions.

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