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FINANCIAL INNOVATIONS LAB®

Best Practices of Sovereign Wealth Funds: The Case for The Philippines

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INTRODUCTION

Through taxes, fees, acquisitions, and other income-generating sources, governments at all levels accumulate and manage revenue for the purposes of debt reduction, economic stability, and future well-being. At the national level, countries manage their surplus wealth through central bank reserve investments, government savings programs, and expenditures for domestic development programs. Many also create sovereign wealth funds (SWFs) to invest surplus assets in a diversified portfolio approach to achieve national policy goals, hedge against economic risk, and benefit successive generations. These funds have grown in popularity over the past half-century, and for good reason: Well-structured funds work very well.

The first wave of sovereign wealth funds appeared between the 1970s and the 1990s, notably in resource-rich Kuwait, Norway, and Abu Dhabi, and in Singapore, which lacked commodity wealth but capitalized its fund through shares previously held by the government. Today, more than 50 countries have SWFs, from Indonesia and Vietnam to Kenya and Mexico. Capitalization of these funds varies; it may come from natural resource revenue, government foreign exchange reserves, surplus government savings, asset privatization, and some combinations of these.

Governments use SWFs to meet their particular economic goals, for example, to help stabilize the country's economic base through asset diversification, to increase the returns via international portfolio investments, to limit the effects of capital flows on money supply, and to protect against price volatility and boom-and-bust cycles.[1] Singapore, for example, created two distinct funds decades ago, one whose sub-funds invest in foreign assets and entities, and the other primarily invested in domestic holdings. Indeed, six of the eleven members of the Association of Southeast Asian Nations (ASEAN)—Brunei (commodity-based), Indonesia (non-commodity), Malaysia (non-commodity), Singapore (non-commodity), Timor-Leste (commodity), and Vietnam (non-commodity)—have established SWFs specifically to help diversify their economies, those being weighted either in trade or, as is the case with Vietnam, in a state-owned enterprise.

The Republic of The Philippines is one of Southeast Asia's fastest-growing economies and has a broad range of physical, financial, and human capital assets. It is still, however, a developing country.

A sovereign wealth fund could serve as a long-term investment vehicle and attract foreign investment, thus boosting national savings and promoting economic growth and social development.

In fact, prior administrations have considered establishing an SWF. The current administration recently announced the introduction of legislation to create the Maharlika Investment Fund (MIF), which would blend resources from various government programs as investments toward commercial and strategic development goals. The design of the fund has not been finalized.

In the meantime, the government can continue to examine existing SWFs and draw upon their governance and operational models to help structure its own MIF in accordance with best practices. In anticipation of this endeavor, the Milken Institute, in partnership with AP Investments, held a Financial Innovations Lab to explore perspectives and recommendations, examine SWF case studies, and assess their investment strategies and operational design. Areas of discussion included the fund's goals, legal structure, governance framework, investment strategy, and metrics for measuring performance.

Virtual and in-person Lab sessions conducted in September 2022 included senior officials from the Philippines Central Bank and Bureau of the Treasury, departments of Budget and Management, and Finance; SWF executives from advanced and developing economies; investment and SWF experts; and multilateral organizations. This report lays out their recommendations and potential paths forward in three crucial areas of concern: purpose and funding, governance and operations, and investment and performance management.

ISSUES AND PERSPECTIVES

Sovereign wealth funds are typically classified according to their funding sources or policy objectives. They may have different purposes based on those funding sources and have more than one mandate. But they are generally all characterized as government-owned investment funds or entities whose assets include the surpluses from the balance of payments, official foreign currency operations, proceeds of privatization, governmental transfer payments, fiscal surpluses, and/or revenue from resource exports.[2] Unlike traditional government (central bank) savings and social security programs, they tend to prefer returns over liquidity, have a higher risk tolerance, and invest long-term overseas and in domestic industries indirectly.[3]

Resource-rich countries like Kuwait and Norway establish SWFs to manage the massive revenue inflows from commodity exports (e.g., oil and gas). Countries that experience a sudden increase in wealth, particularly in the form of export revenues from newly exploited natural resources, struggle to safeguard their economies from the "resource curse," which dampens economic growth while inflating the real exchange rate. Their SWFs are designed for savings and stability purposes[4] (e.g., to finance budget deficits, build wealth for future generations, and "sterilize" the balance of payments surplus). The SWF helps to invest a country's surplus income, mitigating the adverse effects of this paradoxical phenomenon of having too much money, also known as the "Dutch disease" after the 1950s discovery in the Netherlands of Europe's largest natural gas field, and the resulting currency appreciation from those exports that made the country's other sectors less competitive domestically and damaged the overall economy.

However, most Asian SWFs, including four of the six ASEAN countries cited earlier, and those in China, South Korea, Australia, New Zealand, and India, are non-commodity funds. These countries have accumulated excess foreign reserves, and those trade surpluses finance their SWFs, as does the privatization of state-owned enterprises.

Singapore is not the only country with more than one SWF. Chile established two funds with different investment rules and objectives. Its Pension Reserve Fund finances pension obligations and social welfare spending, while the Economic and Social Stabilization Fund stabilizes revenues and resolves fiscal deficits in times of commodity price volatility. A fund's objectives can also evolve with time to suit the country's needs.

A fund's focus can be both developmental and strategic to align with the country's macroeconomic goal.

Governments of developing economies typically create SWFs with dual objectives and functions to deliver high financial performance while supporting economic growth and development. Griffith-Jones and Ocampo (2009) note that from a development perspective, the SWF is best funded through its current account surplus to pursue long-term returns from the persistent surplus of accumulated foreign reserves.[5] According to the 2021 annual review of SWF investments by the International Forum of Sovereign Wealth Funds, "Due to the [COVID] pandemic, sovereign funds deployed 19 percent of all capital towards direct investments in their local markets over the last two years, as opposed to an average of approximately 13 percent in the previous five years."[6]

SWF FUNCTION	FUND'S MAIN PURPOSE
Stabilization fund (Chile Economic and Social Stabilization Fund; Mexico Oil Income Stabilization Fund)	**Facilitate fiscal stability and/or exchange rate.** Countercyclical in construct, designed to offset macroeconomic (e.g., commodity price) volatility. Also manage capital inflow to the domestic economy over the long run to stabilize the exchange rate.
Savings and pension reserve fund (Australia Future Fund; New Zealand Superannuation Fund)	**Balance intergenerational wealth and address future explicit liabilities.** Build up savings for future generations and prepare for contingent liabilities, such as pension liabilities for an aging population.
Reserve investment fund (GIC Singapore; China Investment Corporation; Korea Investment Corporation)	**Invest accumulated reserves.** Invest accumulated foreign currency reserves to protect domestic currency; expect higher long-term investment returns.
Development and strategic fund (Nigeria Sovereign Investment Authority; Indonesia Investment Authority; Khazanah Nasional Berhad)	**Boost long-term productivity.** Finance high-priority local sectors and national interests, such as physical (transportation, communications) and social (education, health) infrastructure. Leverage and attract international investments, co-investments, and partnerships.

Source: Michael G. Papaioannou and Bayasgalan Rentsendorj, Sovereign Wealth Fund Investment Performance, Strategic Asset Allocation, and Funding Withdrawal Rules (2018), https://www.springerprofessional.de/en/sovereign-wealth-fund-investment-performance-strategic-asset-all/15985260; PWC, Sovereign Investors 2020: A Growing Force (2020), https://www.pwc.com/gx/en/sovereign-wealth-investment-funds/publications/assets/sovereign-investors-2020.pdf

International Standards for Sovereign Wealth Funds

Bolstered by high commodity prices and increasing global financial integration, the early 2000s saw a dramatic increase in new SWFs, with 46 created just between 2000 and 2009.[7] This development, in turn, led to growing concerns about opacity and governance, and rising financial protectionism. Hence, in 2008, representatives from SWFs, the Organisation for Economic Co-operation and Development, the European Commission, and the International Monetary Fund (IMF) created the International Working Group of Sovereign Wealth Funds (known today as the aforementioned International Forum of Sovereign Wealth Funds) and agreed on working principles.[8] These are the Santiago Principles, more formally, the Generally Accepted Principles and Practices (GAPP) of Sovereign Wealth Funds, which comprise 24 voluntary guidelines that assign best practices for the operations of SWFs. The principles are meant to "help maintain a stable global financial system and free flow of capital and investment" and ensure a "transparent and sound governance structure that provides adequate operational controls, risk management, and accountability."[9]

THE SANTIAGO PRINCIPLES

The GAPP covers practices and principles in three key areas:

1. *Legal framework, objectives, and coordination with macroeconomic policies*
   The first five GAPP principles fall under this heading. They state that SWFs should have a sound legal framework and governance structure with a clear delineation of responsibilities between the SWF and other governmental entities. This framework should support formulating and implementing objectives and investment policies necessary for an SWF to operate effectively and with transparent reporting of funding, withdrawals, policies, rules, and procedures.

2. *Institutional framework and governance structure*
   This section covers GAPP principles 6–17 and advises SWFs to have a robust governance structure that clearly defines the roles and responsibilities of the board and its committees. This structure ensures operational independence and shields investment decisions from political influence. It also addresses the imperative for annual reports, audits, and codes of conduct.

3. *Investment and risk management framework*
   The remaining principles advocate for each SWF to define a clear investment policy, demonstrating its commitment to a disciplined investment plan. A comprehensive risk management framework will help to inform investment strategies and risk tolerance, and promote accountability.

Source: Excerpts from Sovereign Wealth Funds: A Work Agenda (2008), https://www.imf.org/external/np/pp/eng/2008/022908.pdf

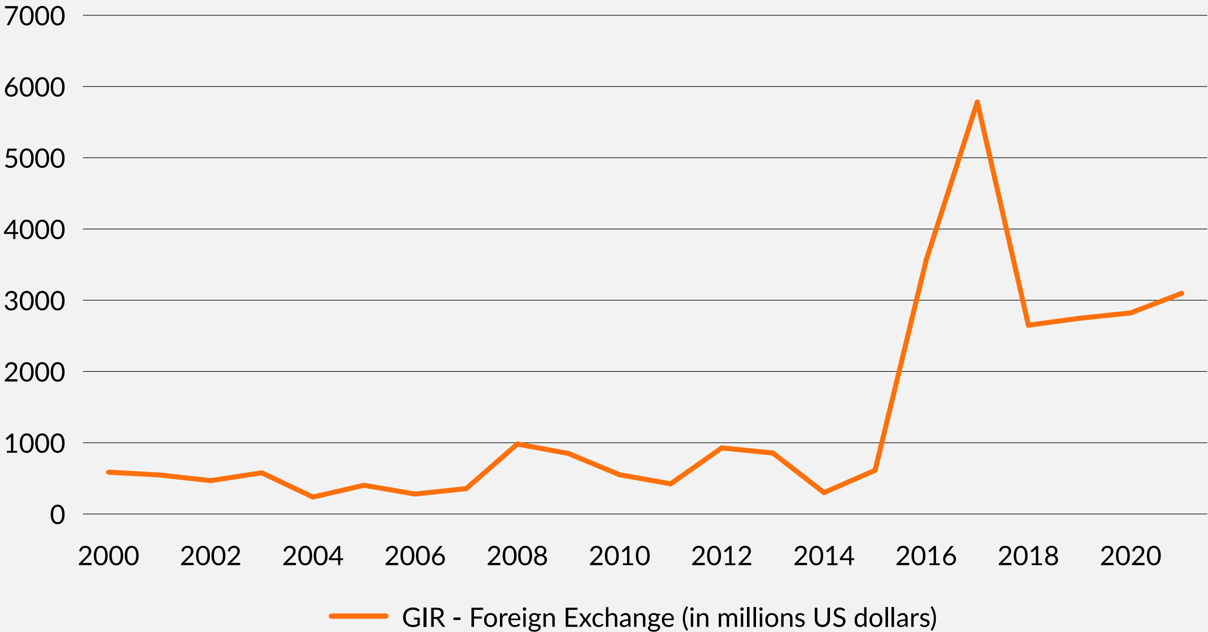
The Economic Context for the Philippines

The Philippines may have many good reasons for launching a sovereign wealth fund. Even without natural resource revenue, foreign reserves have risen steadily over the past five years to a record high of US$108 billion in 2021.[10] The rise is largely due to significant inflows of remittances from emigrant nationals (approximately 10 percent of GDP).[11] The country was the fourth-largest recipient of remittances globally in 2021.[12] Foreign direct investment (FDI) also increased sharply over the past decade, reaching a record US$12.4 billion in 2021.[13] The strong growth trajectory is expected to continue, with GDP projected at 6.5 percent in 2022 and 6.3 percent in 2023.[14]

The economy could grow even more impressively with greater domestic investments, especially in logistics, telecom, and transportation infrastructure. The deteriorating state of the transportation infrastructure continues to threaten economic robustness. In metropolitan Manila alone, according to a 2018 report by the city's development authority, approximately US$62 million in economic opportunity was lost daily due to severe traffic congestion; unchecked, that figure would reach US$95 million by 2035.[15] Problems with digital infrastructure, and the high cost and uneven quality of broadband and internet connectivity and services, have hampered digital adoption, to the detriment of companies that cannot compete in e-commerce traffic and digital financial transactions.[16] A 2018 survey of small and medium-sized enterprises named poor infrastructure, particularly roads, telecommunication, and internet, as a top business barrier.[17]

The Philippines could use its SWF to attract foreign direct investment, reducing the state's burden to finance infrastructure through taxes and debt. Indonesia's SWF has raised over US$20 billion from sovereign partners and others through co-investment opportunities.[18] A new SWF could also help fund existing government-controlled programs, serving as a foreign investment vehicle to the Social Security System and the Government Service Insurance System.

Figure 1: Philippines Foreign Exchange Reserves ($US Millions)



Source: Milken Institute, using data from Bangko Sentral ng Pilipinas (2023)

Amid current economic conditions, however, the SWF faces headwinds, as do other countries' funds. Disruptions from the COVID pandemic and the Russia–Ukraine war have resulted in declines of overseas remittances, and foreign reserves have contracted due to higher costs of crude oil and coal, as shown in Figure 1.[19] The poverty incidence has risen, from 16.7 percent in 2018 to 18.1 percent in 2021, encompassing some 20 million people[20] whose purchasing power parity is just US$1.90 per day.[21] The risk of a global recession, in addition to the country's growing poverty and unemployment rates, compelled the deputy governor of the Central Bank to warn in October 2022 that "if the Philippines has actual surplus funds, and society is well provided beyond a simple choice between life and death, putting up an SWF is one good possibility for optimizing public money. But this is far from where we are today."[22]

The Proposed Philippines SWF

Despite the complexities involved, there are pathways to address the risks and barriers, many of which are likely to be familiar, given that the government first began considering an SWF in 2013. A Department of Finance feasibility study led to a Senate bill in 2016, followed by a proposal to the President's Office in 2020 to create the Philippine Investment Authority. In the wake of the 2022 presidential election, House members with close ties to the new administration recently introduced the bill to create the Maharlika Investment Fund. It would combine public resources, from agency support from the Land and Development Banks of the Philippines as well as dividends from the Central Bank, and would have a dual purpose: commercial and strategic objectives.[23] While the existing bill is debated, this Financial Innovations Lab summary offers recommendations for government leaders to consider.

FINANCIAL INNOVATIONS LAB RECOMMENDATIONS

PURPOSE AND FUNDING

CLARIFY THE FUND'S OBJECTIVE AND STRATEGIES FOR ACHIEVING IT

In most design work, form follows function. The fund's purpose will determine its structure, governance, and capital allocations. As such, the first step is determining its objectives.

As discussed, the objective may be for monetary and fiscal stabilization, for diversification and protection against an overreliance on natural resource wealth, or to meet sustainable development goals. Nigeria's SWF includes three funds, one of which focuses on large-scale infrastructure projects across the country,[24] while the Mubadala Investment Company, one of Abu Dhabi's three main SWFs, allocates capital toward domestic economic opportunities and growth.[25]

Malaysia's Khazanah Nasional Berhad, which underwent reorganization in 2018, has a dual purpose: One group of funds is set up to maximize financial returns (a commercial purpose), another to promote social and physical infrastructure development (a strategic purpose). Their different investment goals and activities mean they are managed to tolerate different levels of risk and return.

Dual or multipurpose funds, similar to the proposed Philippines MIF, come with their own benefits and challenges. They allow flexibility for investment mandates to evolve with economic conditions, and they encourage the use of key performance metrics to determine success. However, having two or more objectives can be challenging if their investment strategies do not align. For example, funds seeking higher returns might choose to invest in a global portfolio, while those with a development focus would allocate to local projects. If the goal is greater stability, the SWF may focus more on traditional liquid assets as opposed to more illiquid or high-risk opportunities.

If the fund's objectives remain vague and not coordinated, then a dual or multipurpose fund could dilute its success. Thus, it's critical that the government outline its fund goals and how the commercial and direct/developmental approaches will complement, and not detract from, each other.

One possibility is to create a dual-purpose fund whose first objective targets development via a "strategic fund," as Malaysia did. This fund could include investments in domestic industries and sectors, from transportation and housing to telecommunications, that would improve overall productivity.[26] The investment will build 6.5 million units in the housing sector[27] and upgrade digital infrastructure to provide connectivity for almost 60 percent of the country's

23 million households that now lack internet access.[28] Climate-management infrastructure and interventions will help to reduce catastrophic losses, estimated at US$124 billion between 2022 and 2050.[29]

The government could also align the fund's development objectives with the goals of the Department of Trade and Industry, which recently announced it would target growth in three key export sectors: manufacturing and transport, technology/communications, and health/life sciences.[30] Coordination between the fund and other government agencies outlined in the current bill could accelerate industry investment, but the fund's structure must allow for independence from shifting political agendas.

With a secondary objective of attracting outside capital, the Philippines could look to the Indonesia Investment Authority (INA) template, whose structure allows for co-investment from international investors. Much like a traditional fund manager structure, INA is the general partner, and the co-investors function as limited partners. This model brings in additional capital that otherwise might stay away without the assumed track record that comes from having local knowledge and experience.

Whether with a dual-purpose or single focus, the first step is to assess the needs of the country and the economic conditions that would allow for new or different capital to bridge any funding gaps.

ESTABLISH APPROPRIATE AND REALISTIC FUNDING SOURCES

The fund's purpose and investment strategies are typically driven in part by the type of funding available. In the coming weeks, the government will decide where and at what levels it will acquire funding. Political risks accompany the use of existing government revenue funds, especially from national savings programs and pension funds. As mentioned, the current proposal calls for capitalization from existing agencies like the Land Bank and the Development Bank, as well as dividends from the Central Bank and other potential revenue sources.

It might seem feasible to tap into the country's foreign reserves as a common first step, but IMF accounting rules place restrictions on their domestic use—a particular challenge for a new SWF with a local development focus. Using national savings and pension plans comes with additional risk in that they won't provide additionality—they count as existing funding. Some countries have issued bonds to fund their SWFs or made one-time (or annual) budgetary allocations from a national surplus. These funding options are helpful, but they are also much more vulnerable to political interference and potential conflict of interest.

The country could also monetize sources of capital through the privatization of government-owned and controlled corporations (GOCCs). This approach was used by Singapore's Temasek Holdings in 1974 when it started with a portfolio of "shares in 35 companies, startups and joint ventures previously held by the government."[31] In the Philippines' case, of 108 GOCCs, from insurance and financing to charity work and gaming, the top 31 GOCCs hold assets worth US$323 billion, representing half of GDP.[32] A prime example is the Philippine Amusement and Gaming Corporation. It owns and operates 10 casinos in prime locations across the country, and total income in 2019 was US$1.87 billion.[33]

Less tangible assets could also be a potential funding source. For instance, resource exploration rights, which have been traditionally very conservatively managed, could be monetized, as could the utilization of assets in the telecommunications or tourism sectors to drive additional sources of revenue. For example, in 2019, the tourism industry accounted for 12.8 percent of GDP and represented 20 percent of total service exports.[34] The government could model different levy scenarios on tourism activities that would be significant enough to raise funds for the SWF but not so onerous that they would deter growth in the sector. All of these options would require community support and political will to move forward.

Any legislation for the new SWF should disclose how it will "ring fence," or protect, the funding, both to minimize the risk of political conflict of interest and to allow flexibility for the inclusion of new revenue sources.

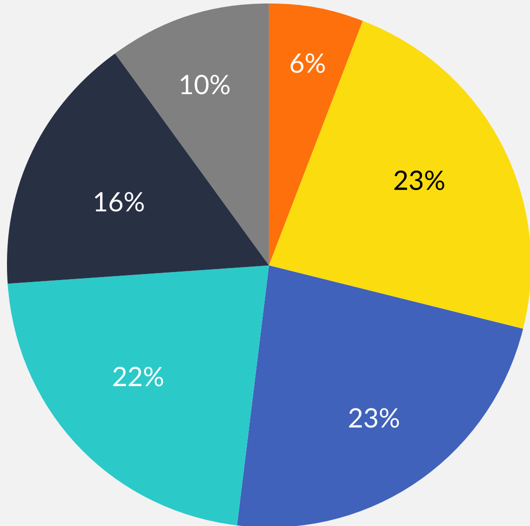
GOVERNANCE AND OPERATIONS

ESTABLISH AN OWNERSHIP STRUCTURE

With a clear objective and stable funding source, the next critical component is governance. Any government fund is at risk of political interference, as well as the temptation to withdraw from the fund in tougher economic times—both of which jeopardize the health and longevity of the SWF. This is why disclosure, transparency, and clarity of ownership and oversight are important. Withdrawals and transfers must minimize political risk. For many funds, this kind of action requires an act of parliament or state legislature; for others, it requires review from the fund's board and management.

Of course, ownership and management vary, as shown in Figure 2. Kazakhstan's SWF, Samruk-Kazyna, sits within the Central Bank, while Indonesia's Ministry of Finance manages its fund, Pusat Investasi Pemerintah. The Norwegian Government Pension Fund-Global is owned by the Ministry of Finance but operated by the Central Bank. Again, it will be critically important to define the relationship between the government agencies and the fund's managers and to outline their roles, responsibilities, oversight, and accountability. Norway's SWF is one of the world's largest and most transparent, and governance is anchored on a delegation of duties and systems for control and supervision (Figure 3).

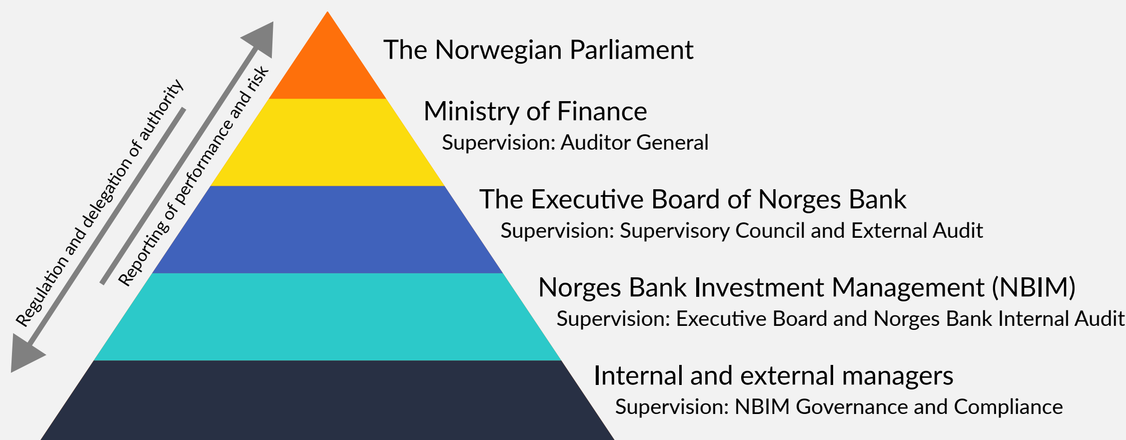
Figure 2: Management of SWFs



Source: Milken Institute, using data from Thunderbird International Business Review Vol. 52, No. 6 (November 2010)

NORWEGIAN GOVERNMENT PENSION FUND

Figure 3: Norwegian Governance Framework



Source: Milken Institute, using information from Royal Norwegian Ministry of Finance (2023)

The Norwegian Parliament established the regulatory framework under the Government Pension Fund Act. The Ministry of Finance acts as the fund's owner and is responsible for overall fund management, while the Norwegian Central Bank (Norges Bank) is responsible for operational management through its asset management unit, Norges Bank Investment Management (NBIM).[35] The Finance Ministry laid out fund management guidelines in a separate mandate that describes the general investment framework and stipulates requirements for risk management, reporting, and responsible management.[36]

While the Central Bank makes investment decisions independently of the Finance Ministry, the bank's executive board is subject to supervision from the Parliament-appointed Supervisory Council, which also appoints the Central Bank's auditor. The internal supervisory function at NBIM is carried out by the Compliance and Control Unit, which has the authority to report independently to the executive board. The bank must provide the ministry with quarterly fund management reports within set minimum requirements, and the ministry reports annually to Parliament.[37]

The governance structure, accountability, and disclosure policies define the roles and responsibilities of the public agencies involved and ensure sound control and supervisory bodies at all management levels. They also confirm that Parliament endorses key risks and returns decisions, and there is sufficient delegation of authority to ensure operational management decisions are made close to the markets in which the fund is invested.[38]

DESIGN OPERATIONS AND MANAGEMENT SYSTEMS

The fund must also define day-to-day operations and management. For some countries, staff from the Finance Ministry or Central Bank assume responsibility for this and are themselves managed through one or more external boards. For other countries, the operations and management are run by a separate entity altogether. The Canadian Pension Plan, established in 1997, is managed by an independent investment firm, CPP Investments, whose sole purpose is to administer the plan's investments. CPP Investments reports to an independent board of directors, whose members are affiliated with neither the plan nor the government. This structure is important, given that even the appearance of a conflict of interest can deter foreign investors.

Indeed, the board, and the oversight it provides, are integral components of every SWF structure. While it may be impossible to remove government involvement entirely, there are ways to minimize the risk through an independent and professional board. Research shows that political influence in board activities and management can worsen financial performance.[39]

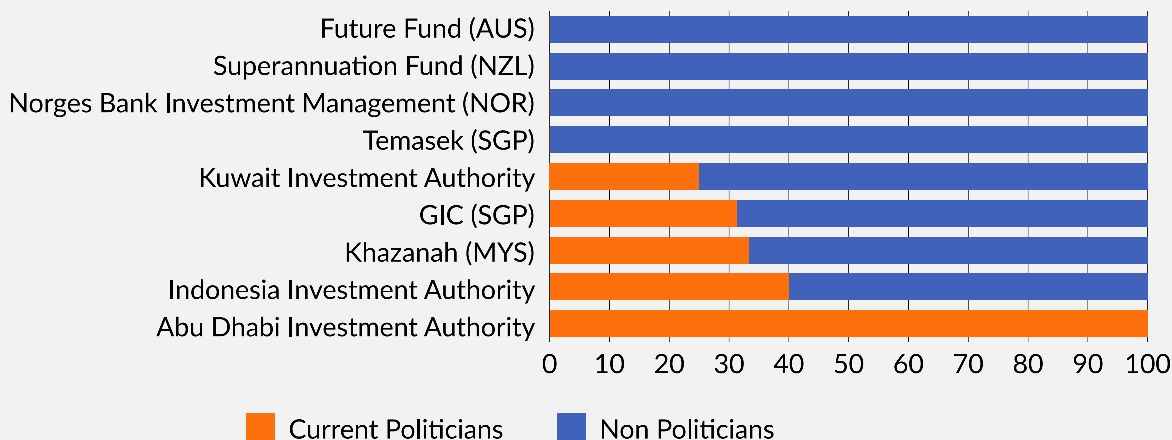
Similar to Canada's action with CPP Investments, New Zealand created the Guardians of the Superannuation Fund, a separate legal entity that manages the fund's operations while reporting to an independent board. The Minister of Finance selects board members through a process that includes an independent nominating committee in consultation with various parties within Parliament.

Figure 4 offers different kinds of board representation. Those comprising a majority of investment professionals and independent experts are preferable for bringing political neutrality and financial expertise.

CREATE STANDARDS AND ACTIVITIES THAT ENCOURAGE TRANSPARENT DISCLOSURE

As a quasi-government entity, the SWF is subject to public scrutiny. Establishing a structure for the disclosure of operations and activities is critical to minimize concerns about politicization or self-dealing and performance. The Santiago Principles outline areas that should be a focus of this type of communication, from the policy goals to the ownership structure and how asset allocation will be monitored, as shown in Table 1.

Figure 4: SWF Boards and Proportion of Political Representation



Note: For the Abu Dhabi Investment Authority (ADIA), six out of eight of the board are part of the royal family, while the other two are advisors to His Highness Sheikh Mohammed bin Zayed Al Nahyan, the President of the State (UAE)

Source: Milken Institute, using data from Future Fund, Superannuation Fund, NBIM, Temasek, Kuwait Investment Authority, GIC, Khazanah, INA, ADIA (2023)

TABLE 1: Transparency and Methods of Disclosure

FORM OF TRANSPARENCY	OBJECTIVES	METHODS
Political	To clarify the policy goals of the SWF To clarify the relationship of the SWF vis-à-vis the state	Mission statement Legal framework
Procedural	To clarify the governance architecture of the SWF	Board selection procedure (incl. requisite qualifications) Internal and external delegation procedures Corporate engagement procedures
Policy	To clarify the rules and objectives imposed on decision-makers in implementing an investment mandate	Disclosure of investment beliefs and strategic vision Corporate engagement policy
Operational	To clarify the way an investment strategy is implemented and by whom	Disclosure of internal and external mandates Disclosure of asset allocation, specific investments, and intended holding periods Corporate engagement actions
Performance	To clarify the investment outcomes achieved by the fund To clarify how investment outcomes serve policy goals	Short and long-term performance metrics External audits Qualitative assessment of investment activities Qualitative assessment of organizational culture and effectiveness

Source: Milken Institute, using information from Adam D. Dixon, Enhancing the Transparency Dialogue in the "Santiago Principles" for Sovereign Wealth Funds, 37 Seattle U. L. REV. 581 (2014), https://digitalcommons.law.seattleu.edu/sulr/vol37/iss2/10/

How best to standardize disclosure depends on whether the fund is seen as "the people's fund" or as an entity set up as a "government fund." If community is a focus, as in a development fund, then communication might be similar to that of a listed company, with an emphasis on financial health and overall impact. A government fund may follow more traditional public-sector disclosure formatting, which centers around investments and how returns are allocated.

It is equally important to structure the SWF disclosures to be in keeping with the policies for investment; if the mandate is to invest in long-term domestic projects (e.g., infrastructure projects that facilitate economic growth but may take decades to finalize), then communication should be built around a longer-term narrative that underscores performance over years and not just quarters. With a development mandate, it is also beneficial to develop a template for outcomes that includes both quantitative (financial) and qualitative (social impact) information. The Philippine government's multiagency Investment Coordination Committee creates standards for selecting projects like large infrastructure. The SWF could build on this process and use existing frameworks and similar standards for decision-making and communication of strategy.

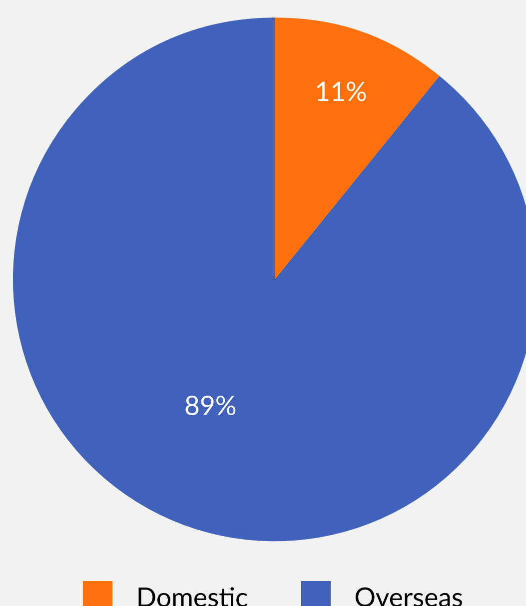
INVESTMENT AND PERFORMANCE MANAGEMENT

DETERMINE INVESTMENT STRATEGY AND PERFORMANCE BENCHMARKS

One of the most critical components of structuring involves the portfolio strategy and how to best match objectives with asset allocation. The first decision, based on the overall purpose of the fund, should be whether the SWF invests locally or internationally. Most SWFs and other governmental investment arms choose overseas investments (Figure 5), as these generally perform better in terms of maximizing returns for future generations or smoothing revenue from traditional industries. Investing locally may not have the pipeline of high-return projects that a diversified global portfolio has, but it may be a better strategy for achieving economic and social development goals. Much depends on macroeconomic conditions and the health and structure of the fund.

It is also important to consider geography and to hedge the portfolio against potential foreign exchange risk when investing in different countries and currencies. However, if the fund primarily invests in local currency, a hedge may not be necessary. Keep in mind that when large-scale infrastructure projects are structured in US dollars, currency risk can become a problem. For this reason, the SWF should take foreign exchange risk into account when determining a geographic strategy.

Figure 5: Asset Allocation of SWFs



Source: Milken Institute using data from Zeineb Ouni et al., Sovereign Wealth Funds Definition: Challenges and Concerns (2020)

After establishing geographic priorities, the next structural question is around specific asset allocation and investment strategy. SWFs have different financial return expectations, depending on their objectives, and these expectations will determine investment strategy. Some funds target a few percentage points over inflation. With a development focus, a fund might target something at or just over the level at which the country can borrow in the debt markets.

Investment strategy takes into account the expectations for returns and the fund's risk tolerance, as well as any issues of liquidity access or mandates around specific activities like co-investment. The SWF should create a benchmark relative return portfolio to assess the performance of its asset allocation strategy. Again, with a connection to the overall target returns, this could be a 70/30 or 60/40 benchmark that includes a percentage of passive equity and debt indexes. This type of relative return performance works well for many funds, but an SWF with a development mandate might benefit more from assessing returns in an absolute (fixed return) framework, which can allow for comparison on a longer-term basis.

Within the investment strategy, there should be a clear method for determining performance, not just at the portfolio level but also for the asset class and, potentially, at the individual investment level. As discussed, the SWF should integrate Santiago Principles on performance disclosure and transparency to help manage how managers will communicate with the government and the community. This means that key performance metrics are critical from the onset. These should include realistic financial targets and liquidity levels that also provide sustained sources of capital for the fund. Financial metrics often look at quarterly intervals, but yearly might also be appropriate (e.g., three, five, seven, and ten years) to allow for a longer time horizon. This outlook is especially important with a development mandate, where performance would take into account the longer-term horizons for large-scale infrastructure and industry-building.

Apart from traditional financial performance metrics, SWFs now tend to include environmental, social impact, and governance (ESG) factors under risk mitigation and performance measurements. These measures could include economic targets and indicators like job creation or new housing. With a mandate that focuses on domestic investment, it makes sense that the Philippines would include impact metrics to ensure that the SWF's development goals are met.

MAP POTENTIAL STRUCTURAL FINANCING ELEMENTS

The structural elements of an SWF will help achieve its overall investment strategy. If the fund has been designed with dual-purpose objectives, both to maximize returns and focus on domestic development, then it could be modeled as a two-fund investment structure. Recall the Malaysian SWF, Khazanah, whose "commercial funds" support financial performance and whose "strategic funds" target domestic economic impact and have lower thresholds for expected returns.

The focus on impact could also include flexibility in the types of financing that the fund distributes. A fund might use a portion of the capital as concessionary funding that could be structured as a lower-cost loan or equity, below market rates, allowing projects to move forward faster and cheaper. This type of development financing is often used for projects that would otherwise be deemed risky and less profitable but perhaps would deliver a social or economic benefit. Many SWFs are under a mandate to maximize profit, so it is unclear if there could be a carve-out from the Philippines fund to allow for a small percentage of capital that would go toward a development fund that provides concessionary returns but is subsidized by the remainder of the fund that is market-rate.

The government could also innovate by allowing the fund to accept foreign private investment and boost infrastructure development. The fund could be an investment vehicle to attract private investment that is often chasing deals in real assets, like infrastructure. Thus, an SWF could bring in new capital but also meet the economic and development goals through public-private partnerships in road, energy, and digital infrastructure, with transparent and competitive processes.

As discussed, Indonesia's INA acts not only as an allocator to a fund but also as the manager, overseeing external "co-investment" capital. This model presents both challenges and opportunities, but considering that the Philippines seeks to attract foreign investment, it could be beneficial. Management of foreign capital also requires significant oversight and disclosure.

INDONESIA INVESTMENT AUTHORITY'S FINANCING AND INVESTMENT STRATEGY (EXCERPTED FROM THE 2021 ANNUAL REPORT, "BUILDING THE FOUNDATION"[40])

Launched in 2021 by national legislation, INA was accorded special tax treatment and strong legal and regulatory status. It received early capital through a government cash injection of US$5 billion from the transfers of government shares in two state-owned enterprises. The cash was then placed in diversified instruments, such as a current account, time deposits, and bonds, and INA secured third-party loan facilities to use as a bridge fund.

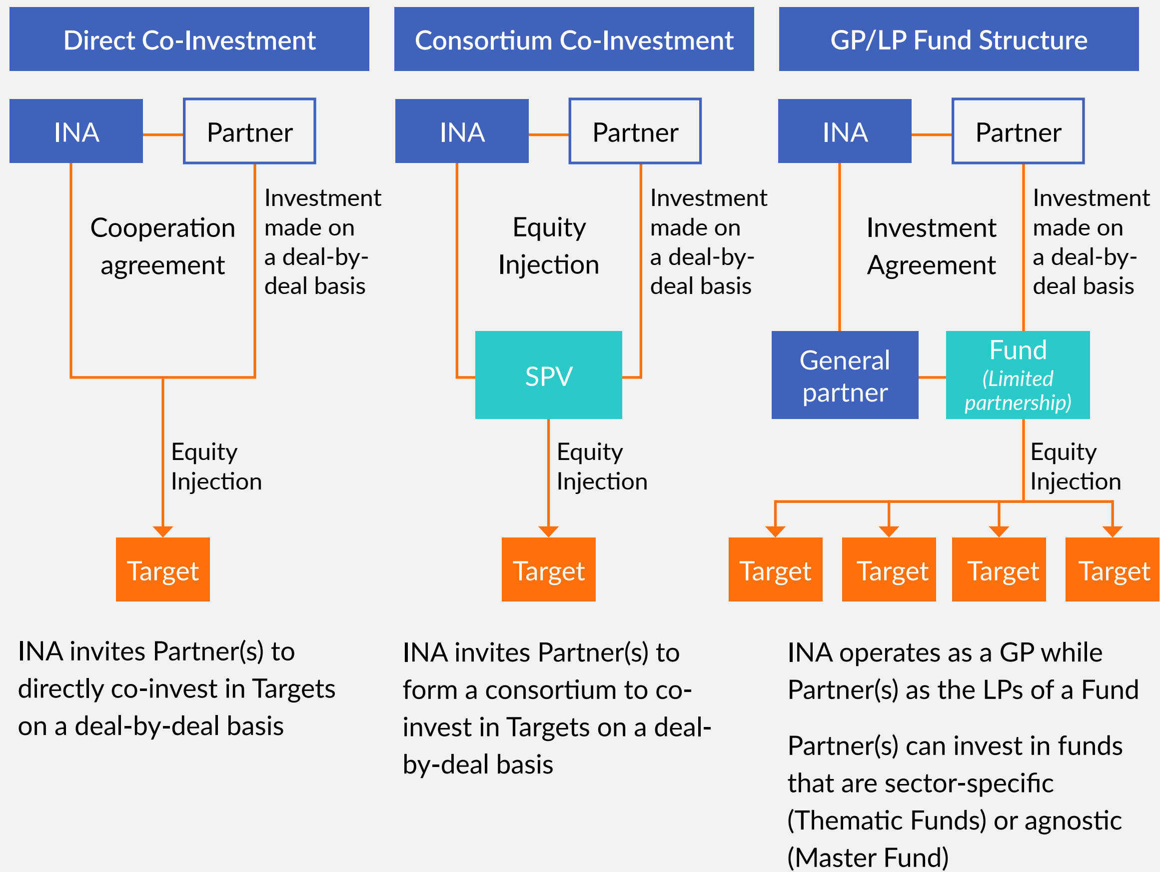
Five investment principles accord with its dual mandates for optimal returns and long-term sustainable development:

1. value creation, especially with global/domestic players;
2. long-term perspective for sustainable risk-adjusted return;
3. active and passive investments to balance returns and economic growth;
4. flexibility, particularly in investments that are in line with national development; and
5. employment of different investment methods (i.e., direct investment, fund manager, platform) to achieve the fund's strategic goal.

INA's investment areas include infrastructure and logistics, digitalization and digital infrastructure, waste management, green energy, agriculture, health care, financial services, property, and tourism. However, because most of Indonesia's infrastructure development in the past decade was financed by debt, INA's initial priorities were to purchase attractive assets of state enterprises in the infrastructure sector to strengthen their balance sheets and make room for new developmental projects and attract much needed foreign investment through flexible co-investment schemes (see Figure 6).

"The government's plan to mobilise INA to attract foreign investment is partly due to the fact that the regulatory changes and economic liberalisation that would satisfy external financiers require time to be effected and often face political and societal challenges … Under these circumstances, the government hopes that INA's co-investment would play a catalytic role in attracting external investors by compensating for gradual sectoral reform."[41] In turn, INA will benefit from external monitoring and expertise. As INA grows and generates revenue, 10 percent of the profits go into a reserve fund. Once the reserves reach 50 percent of the fund's initial capital, the balance of retained earnings can be invested; after retained earnings are built to over 50 percent capitalization, they can be redistributed.

Figure 6: Indonesia Investment Authority's Flexible Co-Investment Schemes



Source: Milken Institute, using information from Indonesia Investment Authority (2021)

CONCLUSION

Sovereign wealth funds offer a structured approach to governing and managing public financial assets, as well as a vehicle to invest in broader asset classes. They have been the drivers that enabled a number of emerging economies to achieve national development milestones and become players in the global economy. The Philippines could similarly benefit. As the government works on the fund's design, there is time to learn from other SWF examples how to structure the MIF into a robust, independent, efficient, and effective national treasure.

To summarize several imperatives:

- Articulate a clear objective with funding that can accelerate investment goals. Create a ring fence around revenue sources to ensure flexibility and minimize political conflict of interest. The legislation to create the SWF should set forth the funding source(s), allowing for future surpluses or revenue as the economy evolves.
- Create a governance structure with a clear delegation of duties, operational accountability, and disclosure policies based on the Santiago Principles to ensure effective communication, control, and supervision of the fund. Consider using investment professionals and independent experts to manage and oversee the fund for enhanced financial expertise and political neutrality.
- Engage community stakeholders, capital markets, government leaders, and the public through a structure for disclosure of operations and activities. This engagement will help sustain buy-in and support in the years ahead.
- Design a long-term investment strategy, and designate performance benchmarks aligned to short- and long-term goals, minimal currency risk, and a range of indicators to measure financial performance, ESG risk, and developmental goals. Benchmarks and indicators offer defined boundaries for savings, investments, and withdrawals, and serve as a template for disclosing investment and economic outcomes that include both quantitative (financial) and qualitative (social impact) information.

Ultimately, a well-structured SWF attracts foreign investment, increases the return on investment in national savings, and promotes growth and social development. The Milken Institute continues to support work toward the country's first SWF and will provide a forum for these essential conversations.

APPENDIX: UPDATE ON THE CURRENT BILL

Introduction

After the Financial Innovations Lab sessions in September 2022, the Philippines filed a legislative measure, House Bill No. 6398,[42] on November 28, 2022, to create the country's first sovereign wealth fund. On December 12, 2022, however, the original bill was substituted by House Bill No. 6608, also known as the Maharlika Investment Fund (MIF) Act. This bill has been passed by the lower house of Congress and is slated for deliberations in the upper house of Senate in early 2023. The new bill includes safeguards put in place based on feedback from stakeholders and inputs from the country's economic managers.

The bill outlines the legal framework for the MIF's establishment and administration. It has both strategic and commercial objectives. First, it aims to promote economic growth and social development by "investing national funds, and coordinating and strengthening the investment activities of the country's top performing Government Financial Institutions (GFIs)."[43] Second, it seeks to "generate consistent and stable investment returns with appropriate risk limits to preserve and enhance (the) long-term value of the Fund, obtain the optimal absolute return and achievable financial gains on its investments, and to satisfy the requirements of liquidity, safety/security, and yield in order to ensure profitability."[44]

Key Revisions in the New Bill

The original version of the bill has the country's pension funds (Government Service Insurance System and the Social Security System), along with the top-performing government financial institutions (Land Bank of the Philippines and the Development Bank of the Philippines), as founding contributors with an initial capitalization of Php250 billion (US$4.5 billion).

In the new bill, the initial capital is reduced to Php100–110 billion (US$1.8–1.9 billion). The pension funds are no longer mandatory contributors but are given the option to invest in the MIF, and the central bank's dividend remittance for the fiscal year 2022 is added to the initial capital. The corporate governance structure and management positions have changed. A risk management unit was added along with a provision to distribute net income to social welfare programs. And, finally, a penal provision was added by the House of Representatives.

FUND'S OBJECTIVES AND STRATEGIES

The MIF's development or strategic objective is anchored in Section 13 (Allowable Investments) of House Bill No. 6608, which authorizes the Maharlika Investment Corporation (MIC) to invest in Commercial Real Estate and Infrastructure Projects. The development projects undertaken by the MIC would be limited to National Economic Development Authority (NEDA) Board-approved major capital projects to ensure they are in line with the government's socioeconomic development

program. As NEDA Board-approved projects undergo interagency scrutiny, this would provide a level of guarantee that the projects will have significant socioeconomic impact and are aligned with the national government's development plan.

According to the Philippine Department of Budget and Management (DBM), the government will develop the MIF's legal framework and the MIC's investment guidelines by aligning their goals with the Department of Trade and Industry's target growth in three key export sectors—manufacturing and transport, technology/communications, and health/life.

APPROPRIATE AND REALISTIC FUNDING SOURCES

The MIF's initial capital will be sourced from top-performing GFIs and dividends from the central bank. The GFI's initial contributions will be from their investible funds. Subsequent contributions will be sourced from the central bank (50 percent of dividends from the third year onwards), Philippine Amusement and Gaming Corporation, royalties and/or special assessments from natural resources according to national regulations, proceeds from the privatization of government assets, and borrowings by the MIF. The MIF will be open to investments from other GFIs, government-owned and -controlled corporations, and private financial institutions and corporations.

Foreign reserves and annual budgetary allocations from the national government were removed given concerns that it may impinge on the central bank's independence and in light of the country's fiscal deficit. The bill seeks to "ring fence" the MIF by specifying withdrawal procedures and safeguard and transparency mechanisms to ensure the funding remains untouched until the MIF becomes financially and operationally viable.

Similar to the original bill, at least 25 percent of net profits will be directly distributed in the form of poverty and subsistence subsidies to families below the poverty threshold, while the rest of the net profits will be transferred to the national government and utilized for social welfare programs and projects, excluding infrastructure. The new bill adds that the national government's share of net profits will be proportionate to its overall contribution to the MIF.

OWNERSHIP STRUCTURE/DESIGN OPERATIONS AND MANAGEMENT SYSTEMS

Investors in the MIF will be accorded ownership and representation in the Board of Directors in proportion to their contributions. Seats will be reserved for the presidents of the two founding GFIs, Land Bank of the Philippines and Development Bank of the Philippines, and six seats will be allocated to other contributors.

To avoid political interference, the previous chairperson of the Board, the president of the Philippines, was replaced by the secretary of finance. And five out of the 15 Board members will be independent directors from the private sector who will be selected by a new advisory body. The Board will set out the MIC's investment and operational policies. The chief executive officer and the chief investment operating officer will be responsible for the management and administration of day-to-day operations.

STANDARDS AND ACTIVITIES TO ENCOURAGE TRANSPARENCY AND DISCLOSURE

To improve transparency, accountability, and protection of the MIF, the MIC will engage three auditors: (a) an internal auditor who will be independent of the MIC and under the control and supervision of the Board of Directors; (b) an external auditor (an internationally recognized auditing firm); and (c) the Commission on Audit, which will prescribe guidelines in line with international best practices and conduct the audit alongside the external audit firm.

A committee to provide oversight and supervision will be created to monitor and evaluate implementation of the act and will be known as the Maharlika Investment Fund Joint Congressional Oversight Committee (MIF-JCOC). The MIF-JCOC will comprise five members from the House of Representatives and the Senate

and be co-chaired by the chairpersons of the House Committee on Banks and Financial Intermediaries and the Senate Committee on Banks, Financial Institution and Currencies.

The MIC will be allowed incentives and exemptions from specific regulations to minimize bureaucracy and ensure operational efficiency and independence.

INVESTMENT STRATEGY AND PERFORMANCE BENCHMARKS

The MIF will invest locally and internationally, with a focus on development projects. Investment and risk management strategies will be determined by the Board of Directors, with guidance from the Advisory Board. The Advisory Board will comprise the secretary of the DBM, the director-general of NEDA, and two members from the private sector: the president of the Philippine Stock Exchange and the president of the Bankers Association of the Philippines.

STRUCTURAL FINANCING ELEMENTS

The MIF will have at least two investment funds or portfolios. The Board of Directors will determine the investment policies, risk management strategies, and performance standards and measurements. The Board will prioritize public infrastructure and developmental projects that would yield the highest return on investment while enabling lower living and basic commodity costs to achieve development impact. Section 15 notes that a sub-fund will be closed if it remains unprofitable for three years to address financial viability concerns during economic downturns.

To boost infrastructure development, Section 13 (Allowable Investments) authorizes the MIC to invest in Joint Ventures or Co-Investments to attract private capital and invest in NEDA Board-approved major capital development projects. But the mechanism for Joint Ventures or Co-Investment has not been outlined in the proposed legal framework.

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