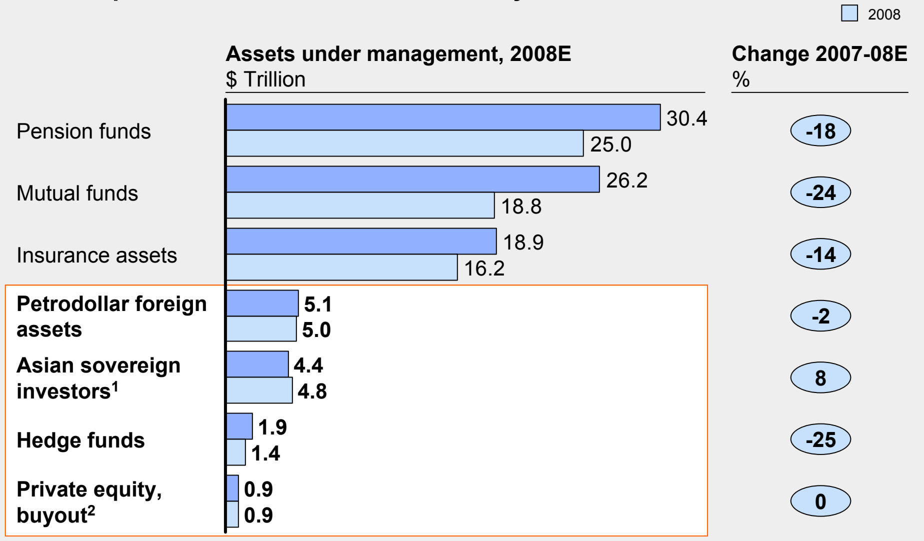
Executive summary: Still power brokers?

The global financial and economic crisis has altered the paths of four influential groups of investors—oil exporters, Asian governments, hedge funds, and private equity firms. In a 2007 report, we labeled these four the “new power brokers” because their growing wealth and clout reflected a dispersion of financial power away from traditional institutions in Western developed economies and toward new players and other parts of the world.[1] But the crisis has raised questions about the power brokers’ future growth and influence. In this report, we look back at how their fortunes diverged over the last year, and we look ahead to project where they may go from here.

By our estimates, the power brokers’ collective assets totaled $12 trillion at the end of 2008, roughly the same as 2007 (Exhibit 1). While this was better than the sharp declines in wealth of most institutional investors, there is no denying that the crisis has abruptly halted the power brokers’ rapid ascent.

Exhibit 1

The new power brokers’ assets held steady in 2008



1 Includes Asian central banks ($4.3 trillion) and foreign holdings of Asian sovereign wealth funds ($490 billion).
2 Reflects estimated marked-to-market values of portfolio companies. Measuring only cumulative fundraising, assets would have grown to $1.2 trillion.
SOURCE: International Financial Services, London; Hedge Fund Research; Investment Company Institute; Preqin; McKinsey Global Institute analysis

Hedge funds and private equity were hit hard last year when credit markets seized up, depriving them of the leverage that amplified their influence in global financial markets. They were battered further by the decline in global equities, which erased much of their investors’ wealth. As we write this report, the hedge fund industry is smaller and still shrinking, while private equity firms are searching for other

1 Based on new information, this report updates figures for 2006 and 2007 published in our earlier reports, *The new power brokers: How oil, Asia, hedge funds, and private equity are shaping global capital markets*, McKinsey Global Institute, October 2007; and *The new power brokers: Gaining clout in turbulent markets*, McKinsey Global Institute, July 2008. Both are available at www.mckinsey.com/mgi/. For new readers, see the sidebar: *Meet the power brokers* at the end of this summary.

investment opportunities as the buyout market lies dormant. Both industries will have to adapt to a new environment of tighter credit and potentially more regulation.

Oil exporters and Asian sovereign investors have fared better. Soaring oil prices in the first half of 2008 created a windfall for petrodollar investors—though falling financial markets erased much of the gain in the second half of the year. Asian sovereign investors' assets increased despite a sharp falloff in the region's trade surpluses at the end of the year. This growth was due entirely to China, whose assets now exceed $2 trillion. In 2008, oil investors and Asian governments combined provided the world's financial markets with roughly $4.5 billion per day in new capital—up from $2.5 billion in 2007. We project the assets of both will continue to grow in coming years, although at a slower rate than in the past.

So are these four groups of investors still power brokers? For petrodollar investors and Asian sovereign investors, the answer is clearly yes: the source of their wealth—trade surpluses—will continue over the next five years. For hedge funds and private equity buyout funds, the future is less clear, but we expect the best funds in each industry will survive and perhaps even thrive. Although our projections for their future growth are lower now than they were a year ago at the market peak, both will remain significant forces in global financial markets.

STALLED GROWTH

The power brokers' rapid rise before 2008 was fueled by a boom in the global economy, trade, the financial industry, and oil prices. And the power brokers did not just benefit from the boom—they were an integral part of the dynamics at play. Credit was ample and cheap, helping drive the growth of hedge funds and private equity. Easy credit also encouraged US consumers to go on a borrowing and spending binge, boosting their purchases of Asian exports and gas-guzzling trucks and SUVs. Soaring Asian exports fueled rapid economic growth in that region, adding to global energy demand and pushing up oil prices. Asian and oil exporters' trade surpluses turned into swelling capital flows that poured into global financial markets. This helped lower US interest rates even more, spurring further consumption and financial leverage, and prompting institutional investors to seek higher returns in vehicles such as hedge funds and private equity. The growth of the power brokers was mutually reinforcing.

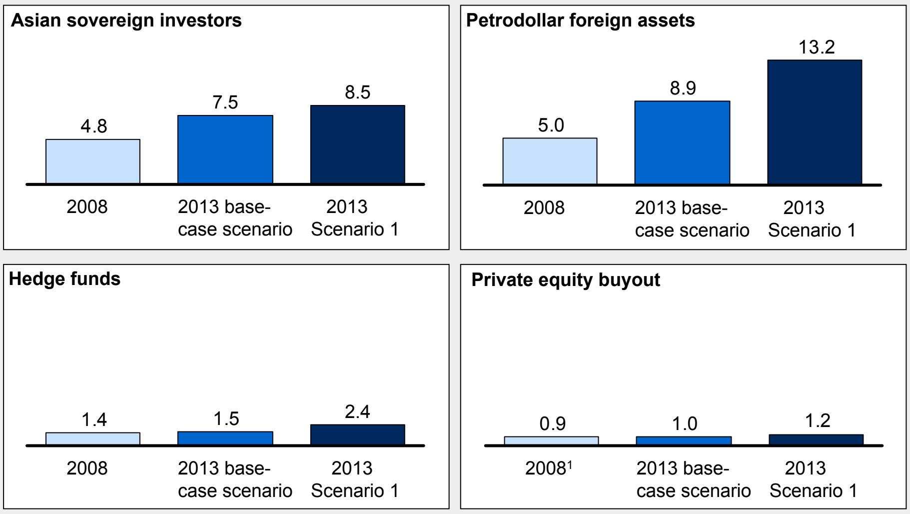
These dynamics, however, contributed to the increasingly large global financial imbalances that fed the financial crisis. At the time of this writing, it remains unknown how the crisis will be resolved, when global GDP growth will resume, or how the economic landscape may change in the process. Amid such uncertainty, we project the power brokers' future growth based on four proprietary global macroeconomic scenarios developed by McKinsey & Company and Oxford Economics. These scenarios depict different trajectories for GDP growth, oil prices and production, Asian trade surpluses, and financial market recovery.

In our conservative base-case scenario, which assumes the global recession lasts through mid-2010, assets in hedge funds and private equity buyout funds decline in 2009 before slowly growing again. In contrast, oil exporters' and Asian sovereign investors' foreign financial assets continue to grow in coming years, and indeed reach higher levels than we foresaw in our original 2007 research (Exhibit 2). For policymakers and business leaders, this presents a serious challenge: how to ensure that this surplus capital is invested in productive opportunities that will raise living standards, rather than contribute to future asset bubbles.

Exhibit 2

Diverging paths going forward

$ Trillion



1 2008 figure reflects marked-to-market value of assets under management. Based on cumulative fundraising of past 5 years, assets under management would be $1.25 trillion.

SOURCE: McKinsey Global Institute analysis

PETRODOLLARS: SHAKEN, BUT POISED FOR GROWTH

Oil-exporting nations reaped an enormous revenue windfall in the first seven months of 2008, as petroleum prices skyrocketed to a record high of over $145 per barrel in July.[2] These riches enabled the countries' central banks, sovereign wealth funds, high-net-worth individuals, and other petrodollar investors to invest more than $1.3 trillion in foreign financial assets in 2008—a 58 percent increase over the previous year. Growing crude exports also enabled more investment in their local economies, which reached $970 billion.

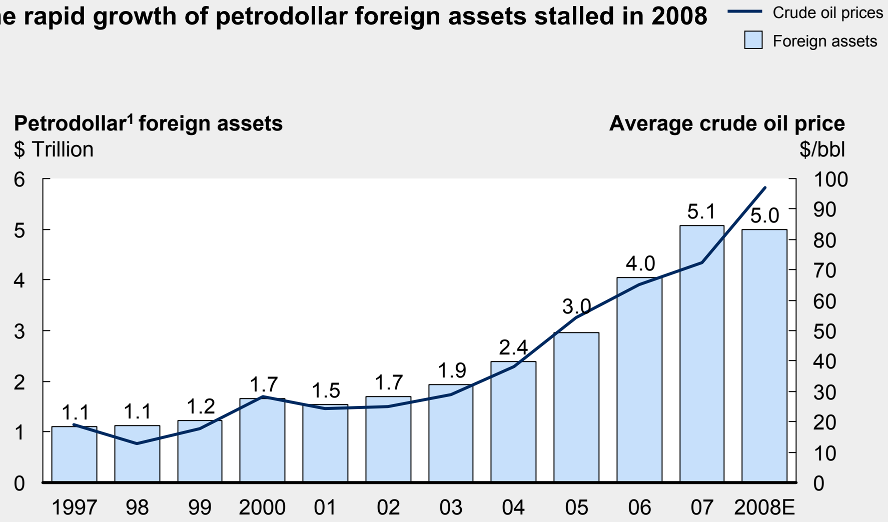
But oil and stock prices tumbled in late 2008, drying up new capital and erasing significant portfolio wealth. The central banks and sovereign wealth funds that had invested more heavily in global equities, such as Norway's Government Pension Fund - Global, saw their investment losses exceed new capital in 2008. The vehicles that had invested more conservatively in government bonds and other fixed-income securities, including those of Saudi Arabia and Russia, performed better. Many countries also used their wealth to stabilize their domestic banking systems and economies. By the end of 2008, the foreign financial assets of all petrodollar investors totaled $5.0 trillion, slightly less than a year earlier (Exhibit 3), leaving this group still the largest of the four power brokers.

Petrodollar foreign investment activity has been minimal since the financial crisis escalated in September 2008, and some investors are reportedly reviewing their investment strategies. However, most will maintain their fundamental focus on long-term returns. When financial markets stabilize, they may look for future opportunities in commodities and in emerging markets. Sovereign wealth funds are taking advantage of the exodus of talent from Western banks to build their own investment capabilities. In the Middle East, there is a growing focus on partnerships with foreign companies that will also help promote local economic development.

2 Weekly prices of Brent crude oil, as reported by Datastream.

Exhibit 3

The rapid growth of petrodollar foreign assets stalled in 2008



1 Petrodollar countries are the Gulf Cooperation Council states (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates), Algeria, Indonesia, Iran, Libya, Nigeria, Norway, Russia, Syria, Venezuela, and Yemen.

SOURCE: Institute for International Finance; International Monetary Fund; US Department of Energy; McKinsey Global Institute Cross-Border Investment Database

Before the crisis, some Western policy makers, economists, and others raised concerns about the growing financial power of petrodollar and Asian sovereign wealth funds (SWFs). Some observers criticized the SWFs' secrecy about their investments, goals, and governance, and some worried about the potential for large funds to use their growing financial clout to pursue political objectives. Since then, however, many SWFs have taken steps to allay these concerns by agreeing to the International Monetary Fund's Santiago Principles, which set out common standards regarding transparency, independence, and governance.[3]

Looking ahead, we see petrodollar investors poised for future growth in almost any scenario. Their foreign assets reach nearly $9 trillion by 2013 in our base case, and more than $13 trillion if the economy recovers more quickly.

ASIAN SOVEREIGN INVESTORS: THE CRISIS SLOWS GROWTH

The global financial and economic crisis has curtailed Asian exports while triggering a record outflow of foreign capital from the region. Nonetheless, Asian sovereign investors—the region's central banks and sovereign wealth funds—saw their collective foreign financial assets grow by 9 percent in 2008, reaching $4.8 trillion by year-end. Although this growth rate was far slower than in the past, this group was the only one of the four power brokers to increase in size last year.

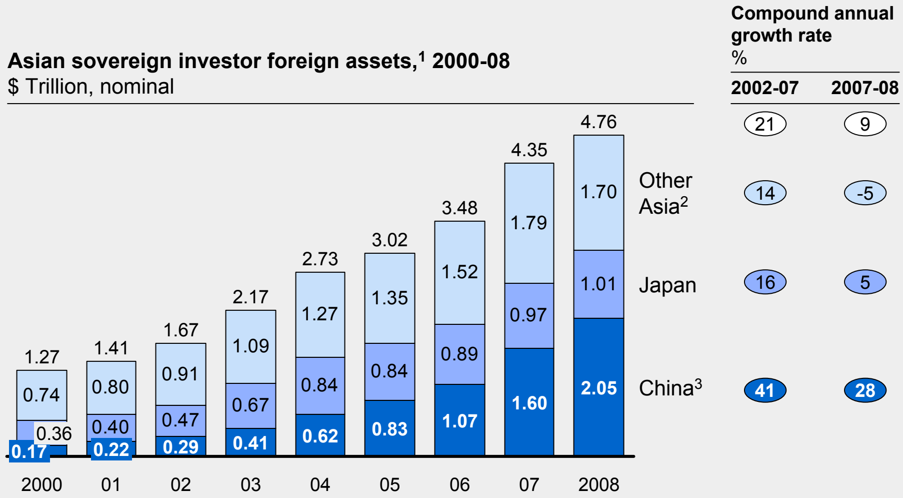
China accounted for virtually all the growth, with the assets of its central bank and sovereign wealth fund climbing 28 percent to more than $2 trillion (Exhibit 4). Across the rest of Asia, Japan's and Taiwan's foreign assets grew just slightly, while the foreign wealth of most other Asian governments declined.[4]

3 In May and June 2008, the International Working Group of Sovereign Wealth Funds, consisting of sovereign wealth funds from around the world, met to agree on a common set of principles and practices in response to the growing call for transparency. The outcome, known as the Santiago Principles, set the framework for clarifying the operations of sovereign wealth funds.

4 Throughout this report, *other Asia* refers to Bangladesh, Cambodia, Hong Kong, India, Malaysia, Pakistan, Philippines, Singapore, South Korea, Sri Lanka, Taiwan, Thailand, and Vietnam.

Exhibit 4

Asian sovereign investor assets grew in 2008, driven by China



1 Includes central bank reserve assets and sovereign wealth funds' foreign assets.
2 Other Asia: Bangladesh, Cambodia, Hong Kong, India, Malaysia, Pakistan, Philippines, Singapore, South Korea, Sri Lanka, Taiwan, Thailand, and Vietnam.
3 Does not include foreign assets of state-owned banks or other companies.
SOURCE: Global Insight; People's Bank of China; McKinsey Global Institute analysis

The continued growth of China's central bank reserves poses a dilemma for its policy makers: how to maintain exports without continuing to invest in more dollar-denominated assets. China's central bank now has an estimated $1.4 trillion of dollar assets, making it vulnerable to the future of the US economy and the value of the dollar. Chinese policy makers are now seeking to promote more domestic consumption to lessen dependence on exports. But even if its current account surplus declines over the next five years, its central bank reserve assets would still double by 2013. Policy changes to allow faster Chinese currency appreciation or more private foreign investment could change this outcome. In our base-case scenario, Asian sovereign foreign assets collectively grow to $7.5 trillion by 2013—slower growth than since 2000, but still significant.

Asian sovereign investors' investment strategies are unlikely to change substantially despite the recent turmoil. On the margin, they may seek to invest more in currencies other than the dollar and to hedge the risks of higher global inflation, in part through investments in commodities. Changes within Asian sovereign wealth funds are also apparent. They have increased transparency to allay concerns about their investments and have accelerated their hiring of outside financial professionals, many from foreign financial institutions. These moves reflect maturing and increasingly sophisticated investment organizations that may eventually become less dependent on external investment managers.

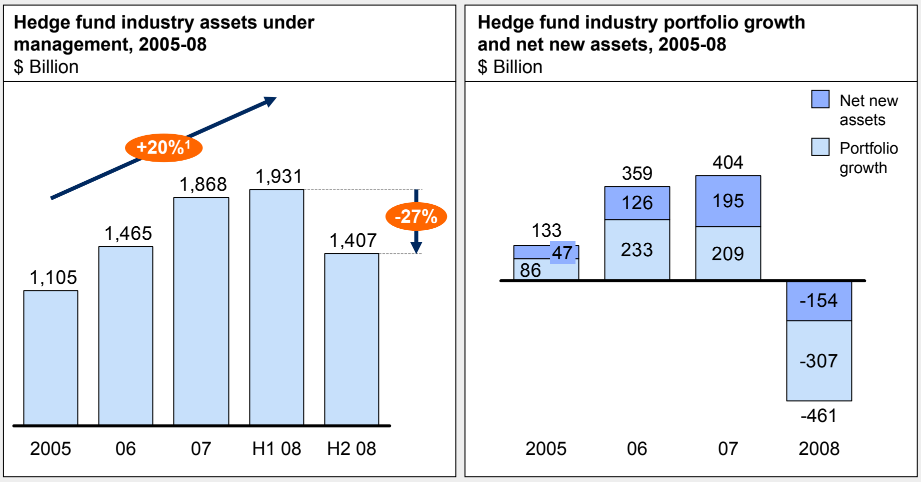
HEDGE FUNDS: CAN THEY REBOUND?

The breakdown of global credit and capital markets in September 2008 sparked a dramatic reversal of fortune for the hedge fund industry. Liquidity evaporated and investors fled to cash and other safe assets. Several major prime brokers that provided financing and other services for hedge funds curtailed their lending dramatically, while one major player—Lehman Brothers—went bankrupt, disrupting the funds' operations. Total assets under management dropped 27 percent in 2008, to $1.4 trillion, reflecting both investment losses and net asset withdrawals by investors (Exhibit 5). Hundreds of hedge funds have closed, and as many as 30 percent of those left may be at risk of liquidation because their portfolios' worth has fallen so far below their peaks.[5]

Hedge funds' influence in global capital markets has also waned. Before the crisis, hedge funds moved from the margins of the financial industry to center stage: at their peak, total investable assets[6] may have exceeded $6.5 trillion, and they accounted for a majority of the trading volume in some asset classes. Leverage has since dried up, reducing their gross assets by nearly two-thirds, to $2.4 trillion by our estimates.

Exhibit 5

Hedge fund assets under management fell 27 percent from their peak due to both performance and net asset withdrawals



1 Compound annual growth rate.
NOTE: Figures may not sum due to rounding.
SOURCE: Hedge Fund Research; McKinsey Global Institute analysis

Will the hedge fund industry rebound? We expect the answer is yes. Our research shows that a significant portion of hedge funds has delivered higher and less volatile returns than investments in public equities and bonds over time, and investor commitment to such funds remains high. To be sure, the industry's assets may shrink further in 2009 as investor redemptions continue and more funds close. But funds with long track records of good performance will survive and will likely gain scale. Our base-case projections, grounded in a conservative outlook for global economic recovery and the size of investor portfolios, show the industry in 2013 with assets under management of $1.5 trillion. This is below the industry's peak, but significant nonetheless. If financial markets and investor portfolios recover more quickly, hedge fund assets could grow to $2.4 trillion. In either case, it is clear that while the industry's meteoric rise since 2000 has been interrupted, it will remain an important part of the capital markets' landscape.

PRIVATE EQUITY: BEYOND BUYOUT

Leveraged buyout (LBO) assets under management, measured in the standard way as the cumulative sum of the past five years of fundraising, rose to $1.25 trillion in 2008, up from $900 billion in 2007. Assets managed by the broader private equity industry—

5 Most hedge funds below their peak size will not earn any performance fees until they regain their "high-water" level. In the past, many fund managers in that situation chose to liquidate, although whether they do so in the current environment remains to be seen.

6 Includes hedge funds' assets under management, borrowing, and off-balance sheet leverage through derivatives positions.

consisting of venture capital, distressed debt, infrastructure, real estate, and other types of investment funds—also rose, reaching $2.9 trillion at the end of 2008.

However, these figures mask deeper problems for the buyout industry. With credit markets frozen, the global value of buyout deals fell from $580 billion in 2007 to just $150 billion in 2008, of which just $18 billion occurred in the final quarter of the year. The decline in the largest "megadeals"—worth more than $3 billion each—accounts for two-thirds of the drop. With banks still facing huge credit losses, funding for these largest deals is unlikely to revive anytime soon. The industry should hope that history is not a guide; after the buyout peak in 1988, it took 20 years for megadeals to return.

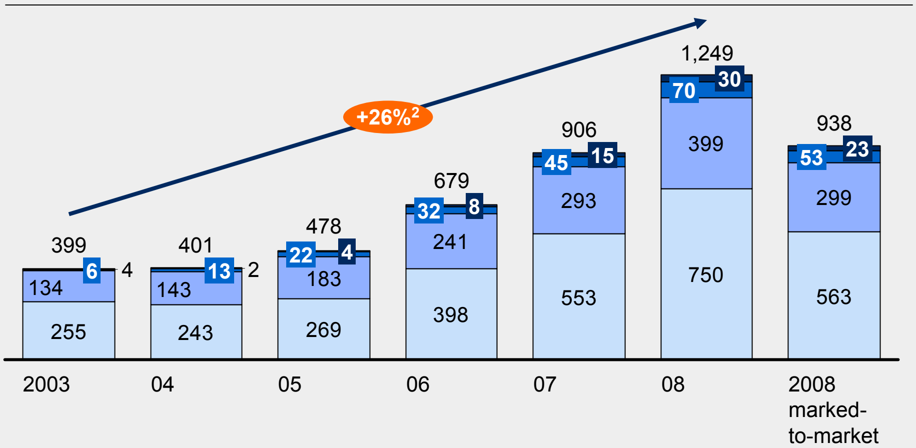
Meanwhile, many private equity investors lost substantial wealth in the stock market declines of 2008 and are struggling to raise liquidity. New fundraising for buyouts fell to an annualized $89 billion in the first quarter, down 78 percent from the prior year. Investor sales in the secondary market for private equity commitments have increased, driving their value down to 50 cents on the dollar, the lowest point in five years. And a marked-to-market valuation of buyout assets deployed would reduce their value to around $900 billion, by our calculations, indicating significant losses for investors ahead (Exhibit 6).

Exhibit 6

Private equity fundraising accelerated in 2008, but estimated portfolio losses offset the increase

Rest of the world
Asia
Europe
North America

Leveraged buyout assets under management,[1] 2003-08
$ Billion



1 Assets under management defined as the sum of funds raised for current year plus four previous years.
2 Compound annual growth rate.
SOURCE: Preqin; McKinsey Global Institute analysis

With the LBO business on hold, some buyout funds are exploring alternative investment avenues. We estimate that buyout funds have $535 billion of "dry powder," or capital committed by investors but not yet deployed, which could be a significant source of capital while financial markets recover. Buyout managers are shifting funds to distressed debt, bankruptcy financing, PIPEs (private investments in public equity), emerging markets, and financial institutions. It remains to be seen, however, whether they can earn the same types of returns from these investments as from buyouts.

Meet the power brokers

Petrodollar investors had $5.0 trillion in foreign financial assets at the end of 2008.[1] Their wealth has soared along with oil prices, which rose from just $23 per barrel in 2002 to above $145 in July 2008. The group includes investors in the six states of the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates); other oil exporters in the Middle East and North Africa; and Norway, Russia, Venezuela, Nigeria, and Indonesia. The investors include central banks, sovereign wealth funds (SWFs), companies, and wealthy individuals. Government investment vehicles control 65 percent of total foreign assets. Oil investors' investment styles are diverse, ranging from conservative and passive to more risk-seeking and active. By country, the three largest petrodollar investors are Russia, with $1.1 trillion in foreign financial assets at the end of 2008; the United Arab Emirates, with $710 billion to $980 billion[2]; and Norway, with $860 billion.

Asian sovereign investors held $4.8 trillion in foreign financial assets at the end of 2008. This group includes central banks and sovereign wealth funds. Their foreign assets have grown rapidly over the last decade because of their countries' rising trade surpluses combined with government monetary policies aimed at preventing significant appreciation of their currencies. Central banks manage 90 percent of the group's foreign assets, and they invest mainly in low-risk, dollar- denominated assets as well as euro and yen assets. By country, the largest investors are China, with more than $2 trillion in foreign financial assets at the end of 2008, and Japan, with a bit more than $1 trillion.

Hedge funds had $1.4 trillion in assets under management at the end of 2008. Hedge funds and private equity firms are financial intermediaries that invest the money of wealthy individuals and institutional investors, such as pension funds, foundations, endowments, insurance companies, and, increasingly, SWFs. The term "hedge fund" covers a diverse set of lightly regulated investment vehicles that differ in their investment strategies, time horizon, liquidity, and use of leverage. They differ from mutual funds in several ways, including their investor base, use of leverage, fee structure, ability to take long and short positions, and lack of constraints on using derivatives and other types of financial instruments. Because hedge funds are not required to register with investment authorities or report on their activities, there is significant opacity around the industry. By most estimates, it included more than 7,500 funds at its peak, although the 200 largest hedge funds control more than 70 percent of assets under management.

Private equity has long been virtually synonymous with leveraged buyout funds (LBOs). Buyout assets under management, measured in the standard way as the cumulative sum of the past five years of fundraising, reached $1.25 trillion in 2008, making this the smallest of the four power brokers. However, assets managed by the broader private equity industry—which includes buyout and venture capital, distressed debt, infrastructure, real estate, and other types of investment funds—totaled $2.9 trillion. A private equity buyout fund typically generates returns by acquiring a publicly traded company, restructuring it to improve performance, and selling it several years later.

1 We use *petrodollars* broadly to refer to profits from the export of oil and natural gas.

2 We give a range for the UAE because the exact size of the largest sovereign wealth fund, the Abu Dhabi Investment Authority, is not publicly disclosed. We use a range of reported estimates for its size

The best private equity firms generate returns by choosing undervalued target companies and introducing superior governance and restructuring operations; returns are amplified by the leverage used to buy the company. A typical buyout fund remains open for up to five years, after which investors receive their payout (less performance fees paid to fund managers).

More broadly, the financial crisis will accelerate the evolution of the private equity industry. Buyout funds that survive will have strong skills in operational improvement and active management. Investors will gain more power relative to fund managers, at least for the next few years, and may put pressure on fees. For now, private equity firms will continue to look beyond buyout for investment opportunities. In the long term, when buyouts resume, fund managers' focus will return to mid-market deals rather than the megadeals of recent years. In our base-case scenario, assets under management of leveraged buyout funds remain flat at $1 trillion through 2013, under the assumption that megadeals do not recover. Over the same period, however, total private equity industry assets under management grow slightly, reaching $3.4 trillion in 2013.

* * *

In retrospect, we see more clearly than ever that the power brokers were fundamental contributors to the global financial industry and capital markets boom from 2002 through 2007. Oil investors and Asian governments provided huge sums of new capital to global capital markets. The influence of hedge funds and private equity funds grew as leverage enabled them to account for a large share of trading volumes and M&A transactions, respectively. The power brokers fueled and benefited from the boom, and from each other. Now the financial crisis and global economic recession have cast great uncertainty over their future growth and roles. Their paths have diverged: oil and Asian investors remain important sources of capital and will continue to grow; hedge funds and private equity buyout funds have stalled, but they certainly will not disappear.