The New Power Brokers

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The big four who run the new global economy.

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The speed and complexity of today's global financial markets can be unnerving for onlookers. Middle East investors are vying for stakes in NASDAQ and the London Stock Exchange. Rumors of a shift in China's appetite for U.S. Treasuries send shivers through U.S. credit markets. Massive hedge fund selling shakes equity markets. And much of the unease arises from the public's lack of information about four increasingly influential, but traditionally secretive, groups of players—investors from oil-exporting nations, Asian central banks, hedge funds, and private equity firms.

A new report by the McKinsey Global Institute calls these four players the new "power brokers" because of their growing size and ability to shape global financial markets. The research shows that the combined assets of these players have tripled since 2000 to around $8.5 trillion at the end of 2006. That is equivalent to 40 percent of the size of global pension funds—impressive for players that were on the fringes of financial markets just five years ago.

Given the sheer size of these new powers, the concerns about them are hardly surprising. Increasingly large investments by quasi-governmental investors from the Middle East, Russia, and Asia are stirring nervousness about potential threats to national security in the United States and Europe. The rush of cash emanating from these players could be fueling asset-price bubbles. Heavily leveraged private equity and hedge funds could create new sources of financial market instability. And because all these players are lightly regulated, they can move huge amounts of money beyond the scrutiny of financial market authorities.

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Such concerns are genuine and may be justified. But the first step toward accurately assessing the risks is laying out the facts. Even if you assume big is bad (and we don't), the criticisms are not always well targeted. Private equity funds, perhaps the most scrutinized of the four power brokers, are also by far the smallest. Like hedge funds they have expanded rapidly due to growing investor demand and low interest rates. Engineers of "leveraged buy-outs"—or LBOs in the 1980s—private equity funds have tripled in size since 2000 and have $710 billion in investors' capital (as of the end of 2006). But hedge funds are at least twice as large, holding assets of $1.5 trillion. If you count leverage—borrowed money hedge funds often use to boost returns—they may control as much as $6 trillion invested in financial markets. That would make hedge funds the largest of the power brokers, bigger even than the oil states.

Next in size are the Asian central banks, with foreign reserve assets of $3.1 trillion—the results of soaring trade surpluses, significant foreign investment in the region, and exchange rate policies. Finally, in terms of dollars in hand, the tripling of world oil prices since 2002 has made petrodollar investors the largest of the four new power brokers. McKinsey Global Institute estimates that oil investors have between $3.4 trillion and $3.8 trillion in foreign financial assets.

The simultaneous rise of these players is not a coincidence. In many ways, their growth has been—and will continue to be—mutually reinforcing. Oil-rich countries and Asian central banks together are the largest net capital exporters to the world, accounting for over half of global net capital outflows. The liquidity these players pump into global markets has lowered global interest rates, enabling hedge funds and private equity to gain prominence in the financial intermediation pecking order. Hedge funds, in turn, are adding liquidity through their active trading and large role in credit derivative markets.

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Big Four

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1. **Investors from oil-exporting nations**
2. **Asian central banks**
3. **Hedge funds**
4. **Private equity firms**

One result of their collective rise is obvious: financial wealth and power, for so long concentrated in the developed economies of the United States, Europe, and Japan, is dispersing. This trend has some clear benefits for global financial markets, but also raises concerns. What follows is an examination of the four players' growth, likely future evolution, and impact on global financial markets.

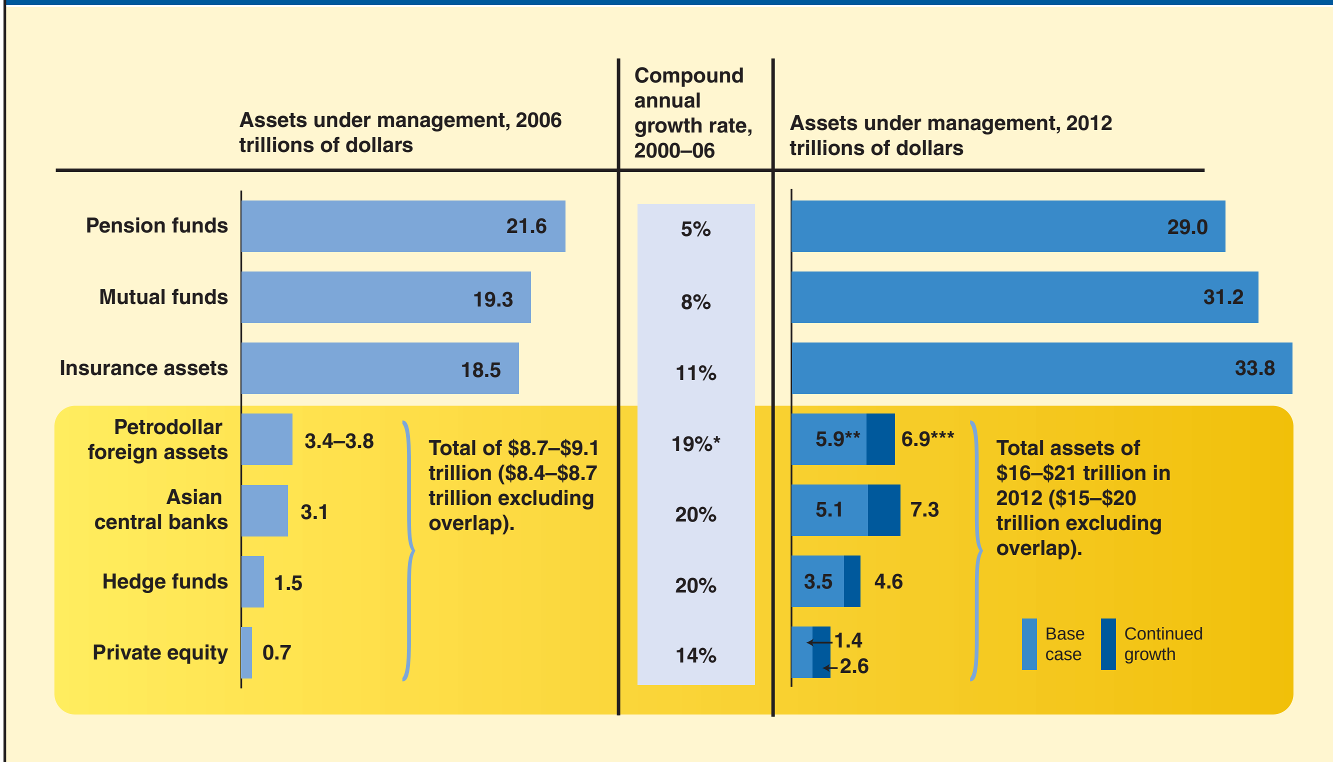
BIGGER AND BIGGER

In 2000, the four new power brokers together had an estimated $3.2 trillion of assets. By the end of 2006, their assets had grown to at least $8.5 trillion—or 5 percent of the world's financial assets.

The financial clout of some individual new players is impressive. China's central bank had $1.4 trillion in reserve assets by the middle of 2007, arguably making it the single wealthiest investor in international financial markets. The Abu Dhabi Investment Authority, the largest petrodollar investment fund, and the Bank of Japan each have estimated assets of up to $875 billion—making them seventh and eighth among the top ten global investment managers. The three largest hedge funds each have at least $30 billion in assets under management; considering the leverage they use to amplify returns, they each may have gross investments of up to $100 billion in global financial markets.

Far from being a temporary phenomenon, the new power brokers will be a prominent feature of the global landscape for years to come. If their current growth rates continue, the four power brokers would see their combined assets climb to $20.7 trillion by 2012—making them two-thirds the size of global pension funds. But they also will grow even if oil prices fall, Asian trade surpluses decline, and investor inflows into hedge funds and private equity slow. Even in this more conservative case, McKinsey Global

Four New Power Brokers Are Increasingly Influential in Global Capital Markets



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

**At oil price of $50 per barrel. If oil prices fell to $30 per barrel, petrodollar foreign assets would grow to $4.8 trillion in 2012.

***At oil price of $70 per barrel.

Sources: Hedge Fund Research; Venture Economics; PE Analyst; International Financial Services, London; Hennessee Group data; McKinsey Global Institute Cross-Border Claims Database; McKinsey Global Institute analysis.

Institute projects that their assets will double over the next five years, to $15.2 by 2012.

Consider petrodollar foreign assets. Last year, with oil at around $60 a barrel, petroleum-exporting countries became the world's largest capital exporters, surpassing Asia for the first time since the 1970s. These nations will be among the most important players in world financial markets over the next five years, thanks to the escalating energy demands of China, India, and other developing economies.

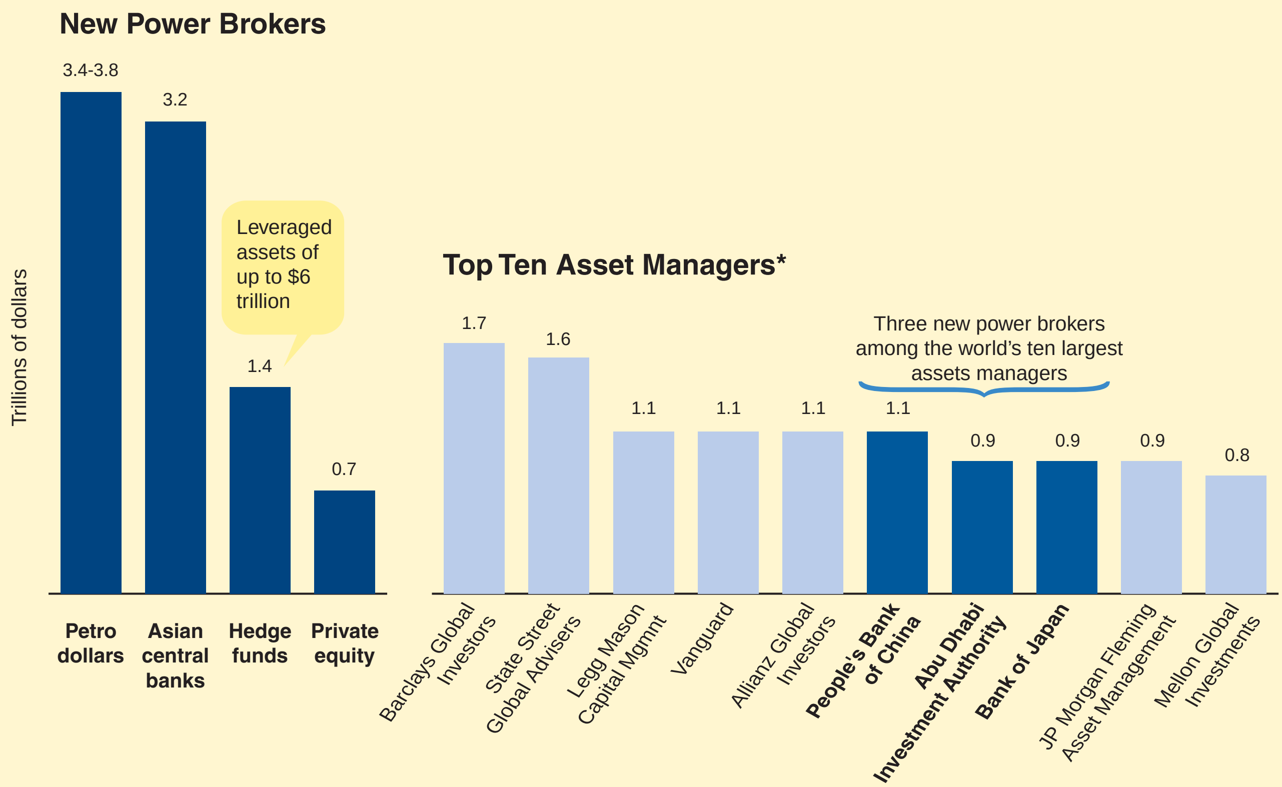
As for hedge funds and private equity, many commentators are predicting that the credit market turmoil of 2007 will spell an end to their rise. Our analysis suggests otherwise. Some of the growth in recent years, enabled by lower interest rates, may have been frothy. But wealthy individuals, pension funds, endowments, petrodollar earners, and Asian sovereign investors will continue to seek the higher returns that hedge funds and private equity offer.

As they grow, the four new players also are crossing into each other's territory as they diversify their investment strategies in search of higher returns. Hedge funds are buying companies while private equity funds are buying hedge funds. Asian central banks are following the example of the oil exporters by launching their own sovereign wealth funds. Meanwhile, petrodollar investors are creating more sophisticated vehicles such as private equity funds, and investing increasingly in hedge funds and in Asia.

CONCERNS ARE RISING

Many of these players have been around for decades. But their rapid growth in size and clout has also fueled new worries that warrant discussion. Nonetheless, our research suggest that the risks posed by the new power brokers need to be put into a broader context that scopes the risks and offsets them against the benefits they bring to the market.

China's Central Bank Would Be the World's Third Largest Asset Manager



*Asset managers' 2005 assets extrapolated to 2006E using historical growth from 2004 to 2005; new participants' assets are 2006 actual.
Sources: World IPE Ranking; Morgan Stanley; McKinsey Global Institute analysis.

Consider sovereign wealth funds. Some policymakers and economists in the United States and Europe worry that other nations will use their financial power for political ends. True, these funds in some cases are becoming more activist investors and are seeking large stakes in foreign companies. Yet the vast majority of assets in sovereign wealth funds are invested passively in highly diversified investment portfolios that span asset classes and geography. To date, both Asian central banks and oil funds have acted as sophisticated investors in global markets, careful to not disrupt markets or move asset prices. Before regulators in the United States and Europe try to impose rules or restrictions, they should carefully distinguish between the various types of sovereign investors.

Private equity funds have been under attack, criticized as "vultures" and "locusts" and worse, particularly in Europe, as they have scooped up increasingly huge companies. Many observers worry that their heavy borrowing may be increasing credit risk in financial markets as they load up portfolio companies with debt. Still, McKinsey Global Institute analysis shows that the industry is only a small part of the overall debt market—arguably still not large enough to risk destabilizing the broader financial system. In 2006, private equity accounted for just 11 percent of overall corporate borrowing in the United States and Europe. Even if defaults on private equity loans rose far beyond past rates, we estimate the implied losses would equal only 7 percent of syndicated lending issuance in the United States, and 3 percent in Europe.

The rise of hedge funds has resurrected concerns about their potential to destabilize financial markets and create contagion across markets. When Long-Term Capital Management ran into trouble in 1998, that fund's catastrophic losses posed this type of "systemic risk," prompting the Federal Reserve to coordinate a $3.6 billion rescue by a group of large banks. More recently, several multibillion-dollar hedge funds suffered big losses in mid-2007 as rising defaults on subprime mortgages caused turmoil in the debt and equity markets. Some smaller and mid-sized funds shut down. So the question arises again: Could a hedge fund meltdown trigger a broader financial market crisis?

McKinsey Global Institute's research suggests that several developments over the last decade may have reduced—but certainly not eliminated—the risks. Hedge funds have adopted more diverse trading strategies, reducing the likelihood that many would fail simultaneously. The banks that lend to hedge funds have improved their assessment and monitoring of risk, and have reasonable financial cushions—collateral and equity—to protect them in the case that one or more of their hedge fund clients were to fail (as we saw last summer). The largest hedge funds have begun to raise permanent capital in public stock and bond markets, while imposing more restrictions on investor withdrawals—changes that should improve their ability to weather market downturns.

RESHAPING GLOBAL CAPITAL MARKETS

Less noticed is that the new power brokers have also strengthened financial markets in many ways. Together, oil investors and Asian central banks are major contributors to the "global savings glut" that has lowered interest rates worldwide and enabled new forms of lending to many borrowers. McKinsey Global Institute estimates that the investments by Asian central banks and oil exporters have lowered U.S. long-term interest rates by as much as 75 basis points. Now, as the world faces a subprime-induced credit crunch, they may also provide much-needed liquidity. In recent months, a flurry of investments from oil countries and Asia has been directed toward banks, hedge funds, and private equity funds in the West. One example is the $1.3 billion investment in the U.S. private equity firm Carlyle Group by Abu Dhabi's state-owned Mubadala Development Company; another is the joint investment between Bear Stearns and China's CITIC Securities.

The new power brokers each have a longer-term investment horizon than traditional investors. Unlike mutual funds, investors from oil-exporting nations and Asia do not have shareholders that can withdraw their funds, nor do they need to generate cash to pay out liabilities, as pension funds do. Hedge funds and private equity firms, for their part, have fewer investors and impose limits on their ability to exit the funds. The power brokers can thus afford to think long term, countering the strong focus on quarterly earnings that drives decision-making in publicly traded corporations.

With their longer-term investment horizon, the power brokers not surprisingly have a strong focus on investments in Asia, the Middle East, and other emerging markets. Together they may spearhead faster financial market development outside the traditional power centers. In recent years, for instance, nearly one-quarter of capital outflows from the Gulf Cooperation Council countries has gone to Asia, the Middle East and North Africa, and other emerging markets. Asian central banks have plans to shift up to $480 billion into sovereign wealth funds that will pursue more diversified investments—including, perhaps, more investments within the region. And hedge funds and private equity, facing intense competition in the U.S. and European markets that is lowering returns, are also looking to China, India, and other emerging markets for future growth.

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Much of the activity of the new power brokers is in private forms of financing. For the last twenty years or more, financial power has shifted from banks to public debt and equity markets. But today the rise of the power brokers is breathing new life into private forms of financial intermediation. This is clear from private equity funds, which often buy public companies and de-list them from stock markets. But hedge funds, too, are increasingly making direct investments in companies, as are petrodollar investors. The power brokers are also increasing investor activism in the market—prompting a wide range of companies to review their performance and seek to raise their game.

The bottom line, in our view, is that each of the new powers is evolving in ways that will do more to foster than to disrupt steady growth in financial markets and in the global economy. The concerns about them are serious, and may well be justified. But we should make judgments based on the facts—not out of an emotional response to power's passing to a new set of actors on the global stage. Once considered mavericks, the power brokers are now in the mainstream. ◆