



Insurance Firms: The Missing Link in the Sovereign Wealth Fund Acquisition Spree



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The Missing Link

Sovereign Wealth Funds (SWFs) are emerging as key players in global capital markets. Based largely out of the Middle East and Asia and funded by oil and merchandise exports, respectively, SWFs flaunt 3 trillion-dollar-deep pockets and high projected growth rates. In addition to these factors, their recent spree of acquisitions in the U.S. financial services industry and the contentious levels of transparency around their investment motives have caused SWFs to rise to the limelight over the last year.

Though some SWFs exhibit a passive approach to their investments, others take a more strategic approach that seeks something beyond a typical return on investment. For some strategic SWFs in the Middle East and Asia, the foremost externality sought is the development of world-class financial centers, such as New York or London, in their home countries. By acquiring stakes in stock exchanges, hedge funds, private equity funds and banks, foreign governments have “move[d] up the value curve quickly, as they acquire intellectual property and access to research, design, and development that may take years to develop at home.”¹ While SWFs have indeed jump-started the development of their home country financial markets through these acquisitions, noticeably missing are acquisitions of insurance firms, which play an integral role in the development of financial markets and economies overall.

The lack of adequate attention paid to the role of insurance services in the development of these financial centers seems striking when considered in conjunction with the current

state of local and regional insurance markets in the Middle East and Asia. Insurance markets in the Middle East present high potential for growth, but are “acutely underdeveloped,” “neglected”² and undercapitalized. For example, though one of the richest in the world, the region accounts for less than 1 percent of global premiums.³ Likewise, the Chinese financial sector bears its own set of problems, arising largely from the state ownership of domestic insurance firms. The Chinese insurance market can be considered “immature with significant structural weaknesses.”⁴ For example, state-owned firms often suffer from weak balance sheets because their policies guarantee returns that are higher than the returns earned from invested assets, whose allocations are restricted by regulatory mandates.⁵ Further, Chinese insurance firms tend to lack strong management skills as a result of operating in a protected industry with little or no foreign competition.

As Middle Eastern and Asian governments seek to close the gap between the current state of their financial sectors and the sophistication of world-class financial sectors by gaining access to valuable resources and skills, it is likely that SWFs will seek to invest in insurance firms in the near future. These valuable resources and skills will be the true prize, serving more as motivating factors than will pure investment returns. Meanwhile, while the waters are calm, insurers should begin to consider the potential problems and benefits that may arise from a SWF investment.



The Rise of SWFs

Though SWFs have existed for many years, they have only recently captured the public's attention. SWFs are beginning to emerge as a new class of asset managers that will eventually play a major role in global capital markets. While the investment approaches among SWFs can vary, this report focuses on funds with a strategic approach that seek to gain something beyond a typical investment return.

A New Class of Asset Managers

SWFs are state-owned asset management firms funded by the accumulation of foreign exchange reserves, for example from oil exports in the Middle East and trade surpluses in Asia. Sitting on excess reserves, many governments have created SWFs to enable them to make investments that diversify their risk or create a hedge against their primary source of revenue (e.g., oil or merchandise exports).

Some governments may also create SWFs as one way to manage inflation risk. When foreign exchange flows into a country, it typically accumulates in the reserves of the central bank and is held in the form of government securities such as U.S. or Euro treasuries. These high foreign exchange inflows usually create inflationary pressures, as too much money will be chasing too few goods.

In addition, the opportunity cost of holding foreign exchange reserves is high, since government securities typically earn a lower rate of return than equity or other types of investments. Through the creation of SWFs, governments can invest in a variety of financial instruments in order to earn a higher risk-adjusted return and create savings for a rainy day.

Though SWFs have only recently entered the limelight, they have existed for many years. For example, funded by revenue generated from guano, the first SWF was set up in the Pacific island nation of Kiribati. Kuwait houses the first major SWF, which it set up in 1953. To date, about three dozen SWFs exist, with total assets valued at close to \$3 trillion. Of this amount, approximately \$2 trillion can be traced to funds generated from oil revenue, including the largest of all SWFs, the \$875 billion Abu Dhabi Investment Authority.⁶ (See Table 1)

Nevertheless, SWFs are only in the infancy stage of their development, and are just beginning to emerge as key players in financial markets. Currently, their assets appear insignificant compared to the assets of other major players in asset management, such as insurance companies (\$16 trillion), mutual funds (\$22 trillion) and pension funds (\$18 trillion).⁷ However, the International Monetary Fund (IMF) predicts that SWF assets will reach \$12 trillion by 2012, and Morgan Stanley estimates the same figure by 2015. This explosive growth will stem both from growth in existing SWF assets, as well as from the creation of new SWFs in the future.



Table 1. Top Sovereign Wealth Funds

Sovereign Wealth Funds	Assets (\$ billion)	Year of Inception
UAE: Abu Dhabi Investment Authority	875	1976
Norway: Government Pension Fund - Global	380	1996
Singapore: GIC	330	1980
Saudi Arabia: Various	300	NA
Kuwait: Reserve Fund for Future Generations	250	1953
China: China Investment Corporation (CIC)*	200	2007
Singapore: Temasek Holdings	159.2	1974
Libya: Oil Reserve Fund	50	2005
Qatar: Qatar Investment Authority	50	2005
Algeria: Fond de Régulation des Recettes	42.6	2000
U.S.: Alaska Permanent Fund Corporation	38	1976
Brunei: Brunei Investment Authority	30	1983
Other	171.4	-
Total	2,876.3	

*Includes Central Huijin Investment Co. The CIC is the umbrella organization.
 Note: Much variation surrounds the estimation of SWF assets.
 Source: Morgan Stanley (as reported in "Asset Backed Insecurity" *The Economist*, January 17, 2008)

A Strategic Investment Approach

While some SWFs have adopted a conventional or passive approach to their investment strategies, others have taken a more strategic approach. Examples of SWFs with strategic investment approaches include Abu Dhabi Investment Authority, Mubadala (Abu Dhabi), Dubai International Capital, Isthimar (Dubai), Qatar Investment Authority and China Investment Corporation. Strategic funds seek to gain something beyond a typical return on their investment. For example, they may negotiate with a firm in which they invest to open a local operation or establish its headquarters in their home country or city. As such, they often seek to make investments in telecommunications, energy and financial services firms, which they hope will help bolster these sectors in their home economies.

Thus, while to some observers it may appear that SWFs have earned poor returns on their recent investments in financial services firms, the funds are likely most interested in reaping externalities that more than offset these losses. Gerard Lyons of Standard Chartered Bank notes: "The economic rationale behind such strategic acquisitions is clear. Some countries may see this as a way to move up the value curve quickly, as they acquire intellectual property and access to research, design, and development that may take years to develop at home."⁸ Accordingly, strategic SWFs typically seek low or no corporate governance arrangements, often foregoing Board seats and avoiding involvement in the day-to-day management of their target companies.

The Attractiveness of Financial Services Firms

2007 witnessed SWFs engage in an acquisition spree. What stands out most is the fact that most of the target firms belong to the financial services industry. Between March 2006 and February 2008, 14 of 15 SWF deals were in the financial services industry, spanning across stock exchanges, hedge funds, private equity funds and banks. What also stands out is the size of the deals: put plainly most were massive deals, ranging from approximately \$1 to \$13 billion.⁹ In total, since September 2007, SWFs have invested over \$60 billion in OECD-country (Organisation for Economic Co-operation and Development) banks and other financial services firms.¹⁰

Why have financial services firms piqued the interest of SWFs? The reality of SWF motives has played out very differently from how SWFs and their buyouts have been portrayed in the media.

The Apparent Motives of Strategic SWFs

SWFs are often portrayed as foreign vultures swooping down on prized assets in order to gain some political ground. Politicians on both sides of the Atlantic have generated a great deal of xenophobia, rooted in the fact that SWFs are owned by governments from the Middle East and Asia. This xenophobia also explains why there has been a rush to call for legislation to protect against the ‘foreign invaders.’ But what many observers and commentators have conveniently glossed over is that, had it not been for SWF money pouring into these financial services firms, these targets would have been left with hardly any prized assets at all.

On the other hand, some observers have posited that these SWFs have tried to buy on the cheap in order to reap large investment returns. But the SWFs that acquired large stakes in these firms have not behaved like archetypal corporate raiders or private equity firms buying low with many strings attached. Of course, like any investor, SWFs know a good deal when they see one. After all, they did buy when the chips of the financial services firms were down. But what separates SWFs from these other types of large investors is the fact that most of their

buys have been friendly in nature, with few, if any, demands placed in return. For example, these SWFs generally have not asked for board representation or made any demands on management that any other large investor in their place would have done, especially given that the financial institutions were potentially tottering on the edge. Even as the second half of 2007 saw the market values of many financial services firms plunge because of the sub-prime crisis and the consequent credit crunch, these SWFs did not change their stance.

A Fondness for Financial Services

So, why do SWFs seem to have a special fondness for financial services firms? To answer this question, we need to first examine who the acquirers have been: the names of Abu Dhabi, Dubai, Qatar and China feature prominently in this list.¹¹ A little digging into the background of these cities or countries shows that they all have one thing in common: the ambition to develop world-class financial centers such as New York or London. For these cities or countries, the goal of transforming themselves into global financial hubs like New York or London may constitute a dream at this point, but attaining the status of a regional financial powerhouse may be an imminent reality. Once successful, these financial hubs will also enable these cities or countries to diversify away from their main source of revenue (e.g., oil in the Middle East or manufacturing in China).

Often overshadowed by the more flamboyant emirate of Dubai, Abu Dhabi, the capital of the United Arab Emirates and incidentally the much richer emirate, has very serious plans of developing itself as a global financial center. One of the many times it has demonstrated its seriousness was on March 18, 2008, when the Abu Dhabi Securities Market entered into an agreement with NYSE Euronext to “jointly develop and explore new opportunities in trading systems and other related technology, investor and issuer services, and investment products. ...NYSE Euronext will provide ADSM, by [the] end [of] 2008, with state-of-the-art information and market infrastructure systems and technology to host all financial instruments admitted to trading on ADSM. In addition, NYSE

Euronext and ADSM will explore the development of new ventures, including the implementation of ADSM's derivatives market."¹² Obviously world-class financial centers are not built only by having first-rate exchanges: in November 2007, Abu Dhabi was successful in attracting the Royal Bank of Scotland to open its regional headquarters in the emirate.

Just 90 miles away, Dubai has always nursed ambitions to develop into a global financial center. To this end, it has constructed the Dubai International Financial Centre (DIFC) on a 110-acre free zone. The DIFC's website writes: "Located at the crossroads of the major international capital markets of New York and London (in the West) and Hong Kong (in the East), Dubai is the complementary hub connecting the region with the 24 hour/7 days a week global financial network...Its remit is to create a regional capital market, offering investors and issuers of capital world-class regulations and standards."¹³ To achieve this status, Dubai has been very active in trying to attract financial services firms to set up their regional headquarters in the DIFC and has attracted some of the world's largest players with respect to stock exchanges, hedge funds, private equity funds and banks.

Qatar, like Abu Dhabi and Dubai, also hopes to develop a global financial center. In terms of distance, Doha, the Qatari capital, is fairly close to both Abu Dhabi and Dubai. The eventual presence of three 'world-class financial centers' in such close proximity does seem unnecessary on the face of it, and is fomenting some serious competition. *The Times* observes that "a serious game of one-upmanship is being played by these two cities (Doha and Dubai) in their attempt to develop financial markets of global significance...In the competition to rule the Middle Eastern financial markets, Dubai is way ahead of Doha. Now all it has to worry about are the ambitions of an even richer neighbour, Abu Dhabi."¹⁴ Qatar, like Dubai, has also constructed the Qatar Financial Centre, which "is designed to attract international financial institutions and multi-national corporates to establish business operations in a 'best-in-class' international environment."¹⁵

In Asia, a similar story is unfolding as China tries to establish Shanghai as a world-class financial center. China is trying to diversify away from the manufacturing sector, which currently dominates the economy but is suffering from high costs and a number of shutdowns. Though China already boasts Hong Kong, an established financial center, it is trying to establish Shanghai as an alternative financial center. The setting up of a financial center in Shanghai could potentially have some positive externalities, such as the resurrection of China's financial sector, which is currently nowhere near world class.

In fact, Shanghai is competing with Hong Kong to become the financial capital of China. *The New York Times* observes: "Hong Kong and Shanghai are not just competing with each other — they are also vying with Tokyo and Singapore to become the most important financial center in Asia. Each wants to be the place where investment banks, hedge funds, insurance companies and other big investors send their best and brightest to oversee trading during the hours after the sun sets in New York and before it rises in London."¹⁶ To reinforce the image of its vaulted financial ambitions, Shanghai is set to open the Shanghai World Financial Center, a 1614-foot 101-story building, in the spring of 2008.

So, What's Missing?

To date, the attraction to financial services firms seems limited to banks, hedge funds or private equity funds, and exchanges. Of all the SWF acquisition deals done, not a single one involves a pure insurance firm. But if any of these cities or countries plans to become a world-class financial center in the range of a New York or London, it must necessarily attract a large number of insurance and reinsurance companies. The financial centers must also ensure a substantial presence from insurers with respect to the types of operations and the number of people in the local office, for example. Using SWFs to buy large stakes in insurance or reinsurance companies is not the only means to achieving this end, but can certainly serve as a short cut.

The Likelihood of SWFs Targeting Insurers

Foreign governments seeking to develop world-class financial centers will necessarily require the presence of insurance firms. The insurance industry plays an integral role in the development of financial markets, as well as in the development of broader economic activity. At the same time, insurance markets in the Middle East are often underserved, fragmented, unsophisticated and undercapitalized. In China, the insurance industry is also undercapitalized and faces a severe talent shortage. As these foreign governments seek to close the gap between the current state of their financial sectors and the sophistication of world-class financial sectors, it is likely that SWFs will seek to invest in western insurance firms. Among insurance lines, it is likely that foreign governments will place greatest importance on reinsurance and commercial property and casualty (P&C), followed by life and personal lines.

While Middle Eastern SWFs have not indicated their interest in insurance firms, the Chinese, via a proxy, have signaled their interest. Yang Chao, the chairman of China Life Insurance, China's largest insurance company, indicated he plans to buy a "strategic stake" in a large insurance company in Europe or North America.¹⁷ While China Life does have some surplus cash, it remains to be seen how the state-owned entity will pay for a potential acquisition that is so expensive. That said, it is not beyond the realm of possibilities that the Chinese Investment Corporation (CIC, China's SWF) will help pay for this acquisition. In fact, there is a precedent for it. In 2007, the CIC injected \$20 billion into the China Development Bank, a state-owned bank, to help recapitalize it.

The Role of Insurance

The insurance industry plays a major role in the transfer of risk and the provision of risk management services within an economic system.¹⁸ As emerging economies grow and experience a boom in commercial activity, with growth stemming from local and international businesses, they will logically require commercial P&C insurance services to protect themselves from the risks associated with the creation of this new wealth. Further, as insurance companies absorb the risks associated with economic development in these emerging markets, they will seek to manage those risks. One way of managing those risks is through reinsurance. Thus, the development of other lines of insurance will reinforce growth in reinsurance activity. Growth in reinsurance will, in turn, enable insurance companies to provide the economy greater protection than their assets would otherwise allow.

Thus, by establishing themselves as reinsurance hubs like Bermuda, financial centers can serve as gateways of economic activity in their broader regions. One factor supporting the notion that financial centers will strive to establish themselves as reinsurance hubs is the fact that, in March 2008, the DIFC hosted the World Insurance Forum. During the Forum, which was held outside of Bermuda for the first time, the governor of the DIFC stated that the DIFC intended "to become the reinsurance hub of the Middle East, North Africa, South Asia and Levant..." and wanted "to act as the regional gateway to an untapped and vibrant region of 2.1 billion people and a combined economy worth \$2.3 trillion in terms of GDP."¹⁹

Similarly, Qatar Financial Center (QFC) has also highlighted the importance of the insurance and reinsurance segments. It notes that the "insurance segment was one of the vital components of the economic wheel..." and that, in March 2008, the QFC "had eight risk cover providers (with five in the reinsurance sector) and 12 applications were in different stages of processing."²⁰

Meanwhile, as the population and wealth of emerging economies grows, so too will the demand for personal lines of insurance. Life insurance companies can provide individuals with psychological and financial security through contracts such as long-term savings policies with death or longevity benefits or with features that protect against investment risk.²¹ On the P&C side, insurance companies can provide general liability, auto, home and other types of insurance that correlate highly with increased purchasing power.

Finally, insurance companies play a major role in providing funds to capital markets. As insurance companies in the region grow, they may reinvest their capital into the stock and bond markets, thereby fostering additional growth throughout the economy.

0.1123	1.1601	-	1.16%	↓	0.186
0.118	1.662	+	0.16%	↑	11.600
1.121	0.1201	+	0.10%	↑	N/A
20.232	1.0233	-	1.53%	↓	10.201
0.186	1.1611	+	1.15%	↑	13.203
1.1601	0.1602	-	0.87%	↓	N/A
1.662	0.105	-	0.11%	↓	20.160
0.1201	1.230	+	0.11%	↑	N/A
1.0233	1.1577	+	1.12%	↑	N/A
1.1611	0.873	+	3.23%	↑	1.662
0.1602	0.1150	-	2.14%	↓	10.201
0.1602	0.1123	+	2.18%	↑	0.873
0.105	0.118	+	1.16%	↑	1.123
1.121	1.121	-	1.66%	↓	N/A
31.230	0.232	-	1.62%	↓	N/A

The State of Local Insurance Markets

The lack of adequate attention paid to the role of insurance services in the development of these financial centers seems striking when considered in conjunction with the current state of local and regional insurance markets in the Middle East and China.

Though it may be inferred that low insurance penetration rates in the Middle East and China are reflective of low demand for insurance products, these emerging insurance markets are expected to grow rapidly, with some growing at double-digit rates. Insurance penetration, defined as gross premiums as a percentage of gross GDP, is typically low in the Middle East and Asia. In the MENA (Middle East and North Africa) region, penetration was approximately 1 percent compared to an average of 6 to 9 percent in industrialized countries in 2005.²² Penetration rates in India and China are also under 3 percent, well below the international average.

Nevertheless, high growth rates in Middle Eastern and North African insurance markets will be fueled in part by: macroeconomic growth, the emergence of compulsory insurance classes, the privatization and restructuring of government pensions and the growth of financial services, for example in asset-based financing.²³ In China, growth in the insurance market will be fueled in part by: a weak social security system, a growing elderly population and lack of alternative savings vehicles, as well as economic growth spurred by the implementation of economic reform programs.²⁴ Insurance companies that can effectively serve the needs of personal and commercial consumers in these regions can reap large growth opportunities.

Unfortunately, local insurance companies in the Middle East are not in a position to meet the underserved markets' needs for a variety of reasons. First, the local markets are often fragmented, with dozens of companies specializing in niche product lines or distribution channels. In addition, while basic insurance lines like motor and health are often available, there is a real need for complex lines such as marine, aviation and energy, for example. Companies often lack the skills or resources needed to develop these more sophisticated lines. Finally, many insurance companies are run like family businesses, and may not be able to obtain capital at an international level.²⁵

Unlike Middle Eastern insurance markets, the Chinese insurance market is highly concentrated, with state-controlled insurance companies dominating the market. However, the position of state-controlled insurance companies has eroded in recent years, albeit very little, due in part to new foreign and domestic players entering the market.²⁶ The big state-owned firms dominate the market and are growing at around 20 percent a year, due in large part to their advantage as incumbents, China's booming economy and low penetration rates. Their Achilles' heel, however, is that given a level playing field, they may not be able to compete with western insurance firms, which are at the cutting edge of operations and innovation.

The Quest for Externalities

Given the gap between the desired and actual state of insurance services in these regions, Middle Eastern countries and China will likely seek to gain externalities by investing in western insurance firms. By investing in European or American insurance companies through SWFs, Middle Eastern and Asian economies may gain access to the skills and resources needed to better serve individuals and enterprises, and grow their position in their regional markets. However, the insurance markets in the Middle East and China are currently very different from each other, and the externalities they may be seeking are likely different from each other.

Certain Middle Eastern cities and countries have invested or plan to invest substantial resources to support the development of their financial hubs. They strive to have a number of key factors converge in order to attract commercial activity. For example, these cities or countries have taken steps to put in place proper rules and regulations, legal services, infrastructure and talent to support economic growth. As an example, Dubai also plans to grow into a regional transportation and entertainment hub. It has invested substantially in the expansion of a \$1.2 billion port system, made an \$82 billion investment in airport and aerospace infrastructure as well as a planned investment of \$3.8 billion in its metro system. Dubai has also sought to invest in strategic assets around the world, including a \$5 billion SWF investment in the MGM Mirage.²⁷

With that foundation in place, the fastest way for Middle Eastern cities or countries to develop a financial hub would be through the acquisition of large stakes in financial services firms. Through these acquisitions, acquirers can negotiate for or encourage the establishment of their targets' regional headquarters there. Through these negotiated terms, SWFs can move up the value curve quickly and build out their financial centers. It is also possible that SWF investments in financial services companies may serve as an act of goodwill, designed to attract more financial services providers to the region.²⁸

Unlike Middle Eastern countries, China does not need to do much else to attract foreign firms. The market potential in China alone is enough to bring them there. Almost every major insurance firm has a presence in China but the combined market share of these companies, including joint ventures, is estimated to be only around 4.6 percent.²⁹ Instead, Chinese insurance firms would likely want to buy stakes in insurance firms to get themselves up to speed on the latest best practices or other 'software,' rather than getting the firms to actually come into the country.

By reaping any of these externalities, SWF investments would likely bring substantial changes to the scope and complexity of insurance products offered to commercial and personal clients in these markets. It is worth noting that while SWFs do have alternatives, such as buying western insurers outright or launching new reinsurers from scratch, they will likely not pursue these paths. Generally, SWFs are reluctant to make outright purchases, as such bold moves would require increased disclosure, potentially trigger political and regulatory backlash, and likely engender negative publicity. It is also unlikely that SWFs would launch their own reinsurers. As it is, SWFs are struggling to attract the talent they need to manage their investment portfolios. Getting the right talent and experience to run a reinsurance operation might prove even harder. Thus, SWF acquisitions of stakes in western insurance companies will likely prove to be one the most straight forward and practical routes to developing insurance services in the Middle East and Asia.

The Potential Impact of SWF Investments on Insurers

While the waters are calm, insurance companies should begin to think about the potential problems and benefits that may arise from a SWF investment. While much hype – some warranted and some not so much – has surrounded the hypothetical problems that may arise from a SWF investment, it is possible that, in reality, insurance companies may stand to benefit from such investments.

Much of the concern surrounding SWFs has revolved around the lack of transparency in the motives and portfolio holdings of these investors. For example, “[t]here is still widespread suspicion in Washington and the European capitals that the funds – especially those owned by Russia, China, and oil states in the Middle East – could use their burgeoning wealth to steer investments for political purposes. Many of the funds release little information about their investment aims or holdings, further deepening the anxiety.”³⁰ Additionally, some SWFs invest in stakes of less than 5 percent in order to avoid the SEC’s threshold for additional disclosures. Accordingly, U.S. and European governments have been particularly sensitive to SWF investments in strategic sectors of the economy, which include the financial services sector. Further, as continued debate exists around the appropriate monitoring of SWFs, it is possible that SWFs and targets of SWF investments will be exposed to greater scrutiny from regulatory bodies.

The controversy around SWFs may continue for some time. Nevertheless, it is important for insurance companies to consider how they may potentially benefit from SWF investments. As investors, SWFs provide potentially quick, large-scale capital infusions with few strings attached. Though sub-prime mortgage-related credit problems within the financial services industry have generally hit the banking sector the hardest, there is evidence of these problems spilling over into mortgage and other types of insurance companies. For example, the investment portfolios of insurance companies may include debt backed by troubled mortgages, which may generate losses. Insurers facing these circumstances may seek to raise capital to shore up their balance sheets, and a capital infusion from a SWF may just meet those needs.

Additionally, SWFs have long investment horizons, and have little desire to get involved in the day-to-day management of companies. It is also possible that Middle Eastern and Chinese SWF investments may either facilitate the entry of or improve the market position of American and European insurance firms in these emerging markets.



A Simple Cost-Benefit Analysis for SWFs

While it is likely that SWFs will increasingly turn their attention to investments in high-growth emerging economies, they will likely not lose sight of their ambition to build world-class financial centers over the next several years. To fulfill this ambition, strategic SWFs will potentially need to confront the risks of political backlash, new regulations requiring increased transparency and low returns on investment from investments in western insurance companies. They will likely bank on the fact that the positive externalities associated with their investments in insurance companies will make their investments more than worthwhile. Perhaps the biggest benefit for these countries is that their economies will become more diversified. In the end, a diversified economy, much like a diversified gene pool, stands a better chance of survival.



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