



NORWEGIAN MINISTRY OF FINANCE

The measures of the Norwegian government aimed at the effective management of Government Pension Fund – Global during the world financial crisis.

*20 April 2009*

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Royal Norwegian Embassy, Baku

## Topics

The petroleum sector and the Norwegian economy

The Pension Fund and economic policy

Governance

Investment strategy

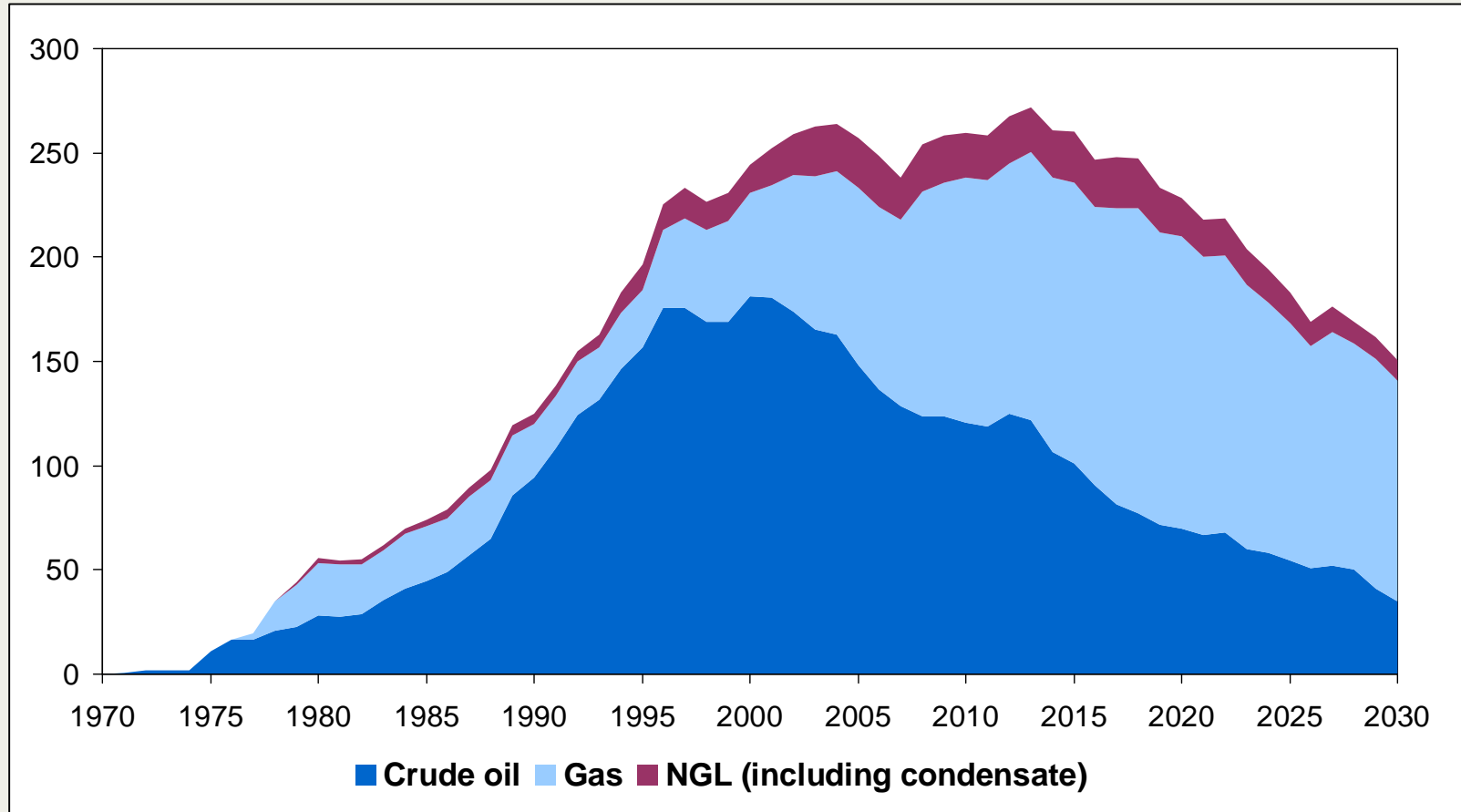
Fund performance, in particular for 2008

Corrective measures

Ethical guidelines

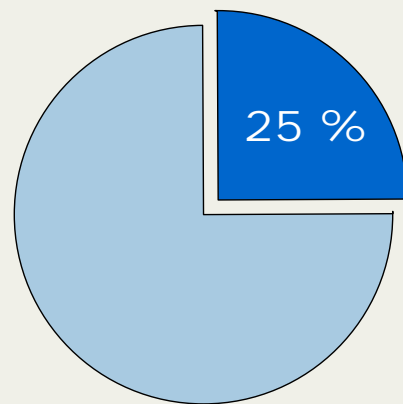
## Oil and gas extraction in Norway

-Total petroleum production in Norway, mill. Sm<sup>3</sup> o.e.

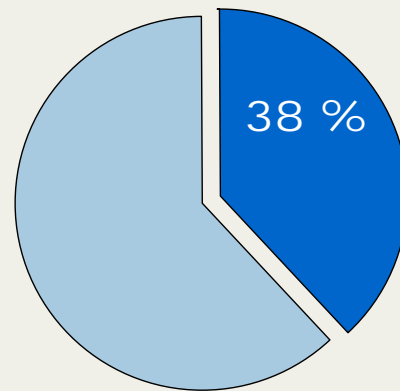


Source: Norwegian Petroleum Directorate

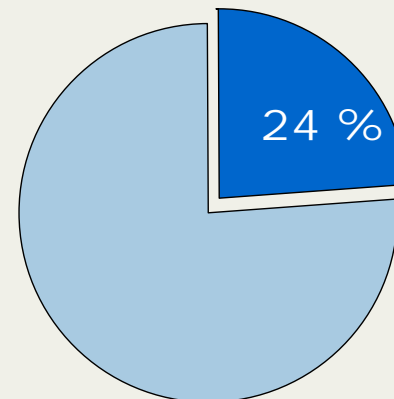
## The petroleum sector in relation to the Norwegian economy



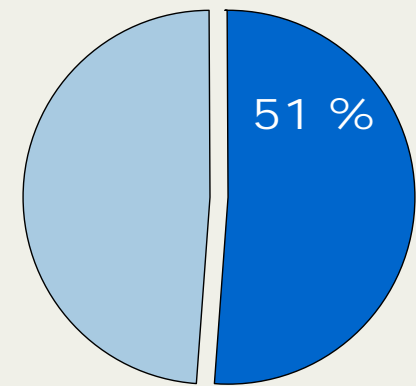
The petroleum sector's share of GDP



The petroleum sector's share of state revenues



The petroleum sector's share of total investments



The petroleum sector's share of total exports

Source: Statistics Norway, Ministry of Finance

Clarification 1: The Norwegian Government Pension Fund Global is a SWF, with the best of intentions for stakeholders and the financial market place

Clarification 2: The Norwegian Government Pension Fund is not really a pension fund, but a petroleum fund

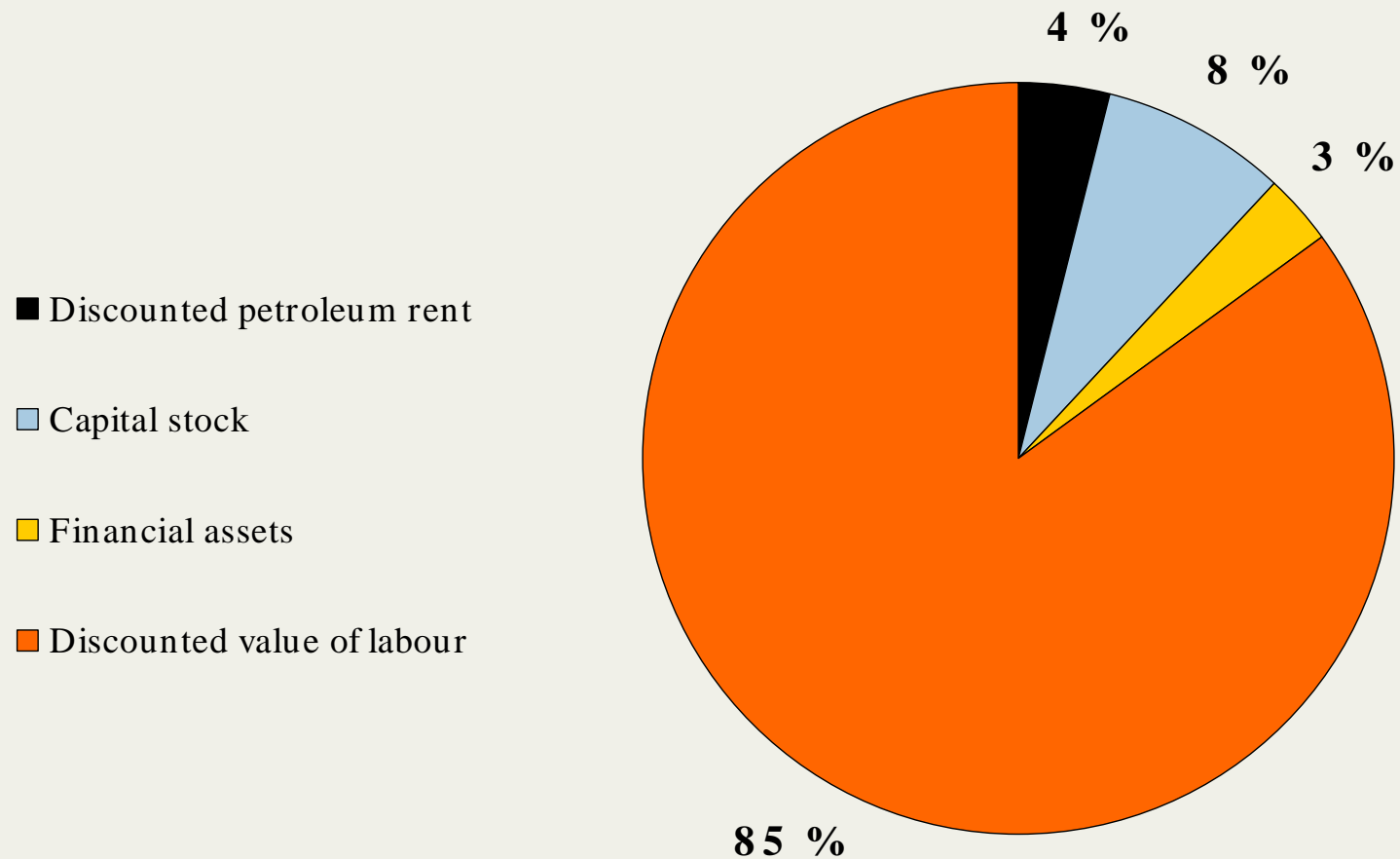


## Common pitfalls in oil producing countries

1. Lack of fiscal discipline
  - Challenge: How to transform a windfall to a permanent income?
  - Overheating instead of sustained higher growth
  - Dutch disease
2. Bad investments
  - Large scale industry investments with high political prestige
  - Public infrastructure projects with vague/low economic return
  - Neglect of education
3. Loss of focus in structural policy
  - Main focus on how to grab a part of the oil revenues
  - Productivity growth in non-oil activity suffers
  - Labour supply falls
4. Poor governance
  - Resource wealth often associated with weak government institutions
  - Rent-seeking activities
  - Increased risk of corruption

## Manpower is our most important resource

National wealth per capita in Norway. 2006



Source: Ministry of Finance, NB08

## In the long run productivity is the key to welfare

### Key findings in OECD's Growth Study

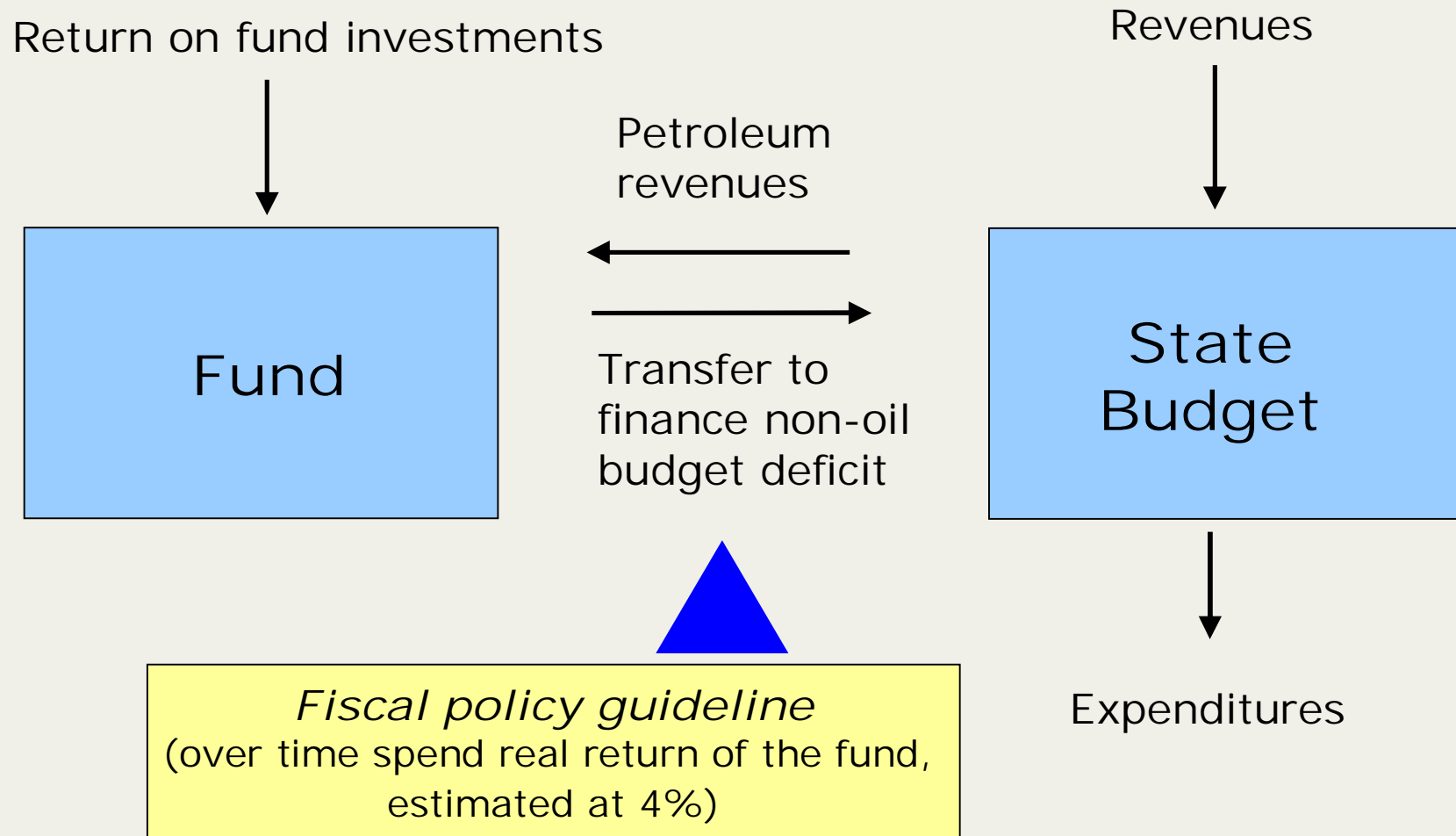
- Stability-oriented macroeconomic policies (+)
- Flexible and competitive product markets (+)
- A high degree of exposure to foreign trade (+)
- Flexible labour markets (+)
- Education and training (+)
- High level of taxation (-)
- Spending on R&D (+)



## Different types of funds

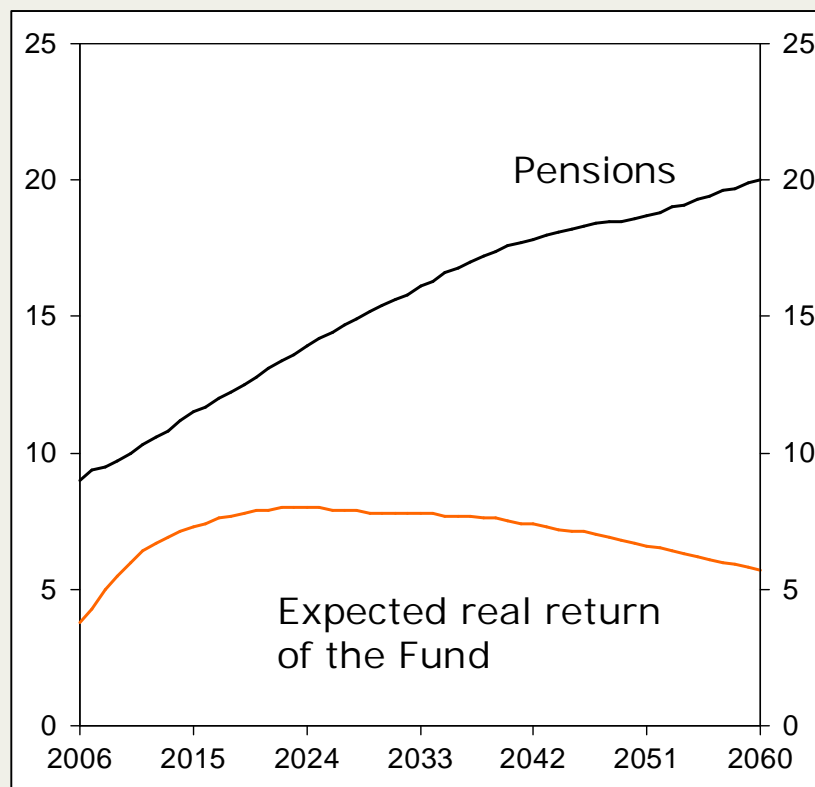
- Savings fund: Aim to build up wealth for future generations
    - Fixed inflows. Discretionary outflows.
  - Stabilization fund: Aim to reduce impact of volatile revenues
    - Inflows/outflows contingent on whether revenues “high/low”
- BUT
- Money is fungible. Government borrowing means fund can be misleading (and lead to inefficient cash management)
  - Rigid rules on inflows and outflows may become inappropriate
  - Financing fund: Aim for both saving and stabilization role
    - Integrated with state budget. Net inflow equals overall fiscal balance

## The Fund mechanism – integrated with fiscal policy



## Why a “Pension Fund”? Strong increase in pension expenditure is a challenge for public finances

Pension expenditure and expected real return on the Fund as share of mainland GDP

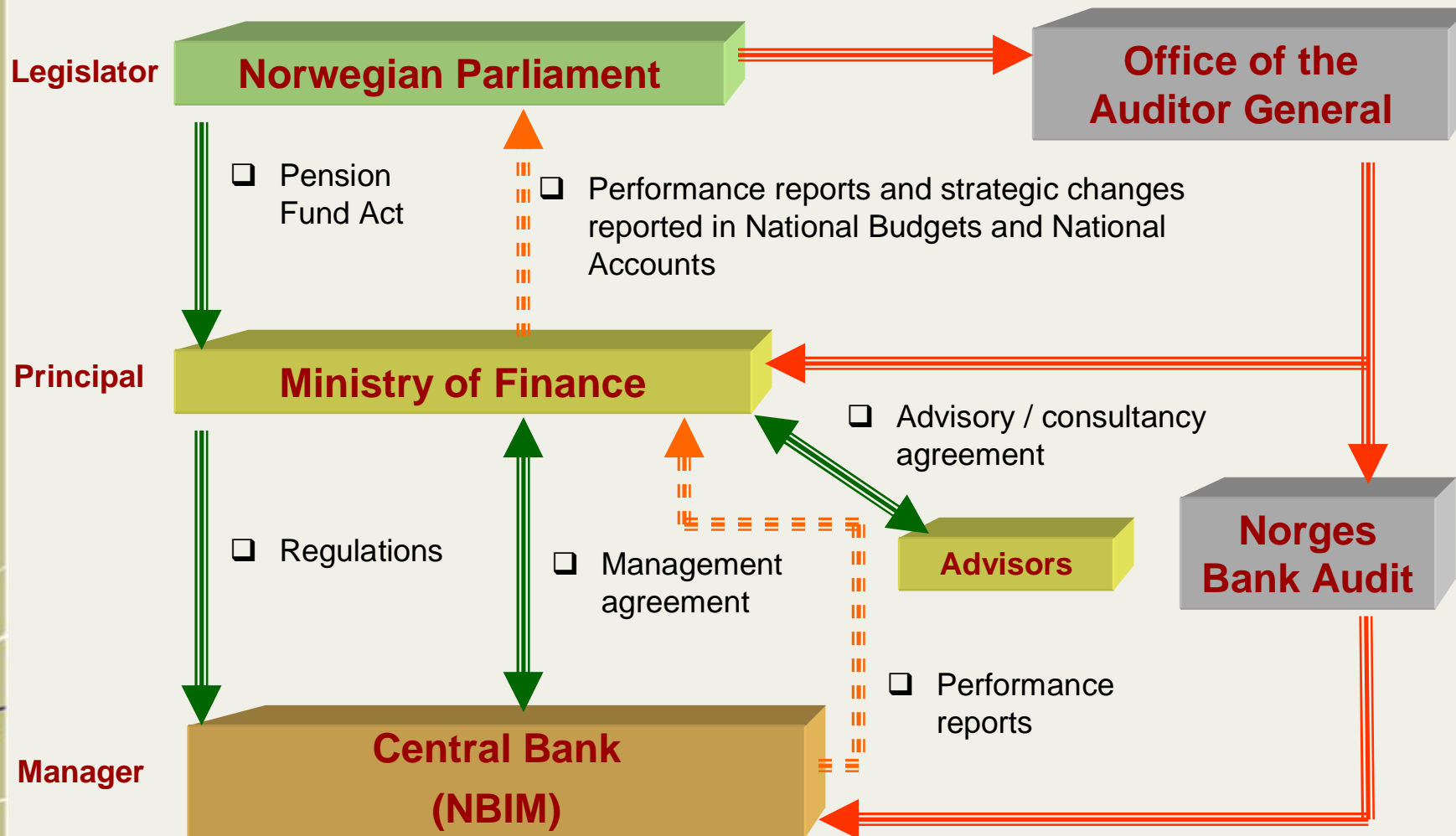


Source: Statistics Norway, Ministry of Finance

- Calls for a cautious fiscal policy over the next decades
- The Pension Fund has a dual purpose
  - ✓ long term saving
  - ✓ short- and medium term stabilization

## Pension Fund - Global Governance Structure

Founded on Act, regulations and separate contracts



## Asset management: Clear lines of responsibilities

- Ministry of Finance – “Owner”
  - ✓ overall responsibility (separate asset management department)
  - ✓ strategic asset allocation (benchmark + risk limits)
  - ✓ monitoring and evaluating operational management
  - ✓ ethical guidelines
  - ✓ reports to Parliament
  - ✓ international advisor on resource funds
- Central Bank – “Operational manager”
  - ✓ separate entity within central bank (NBIM)
  - ✓ implement investment strategy (benchmark)
  - ✓ active management to achieve excess return
  - ✓ risk control and reporting
  - ✓ exercise the Fund’s ownership rights
  - ✓ provide professional advice on investment strategy

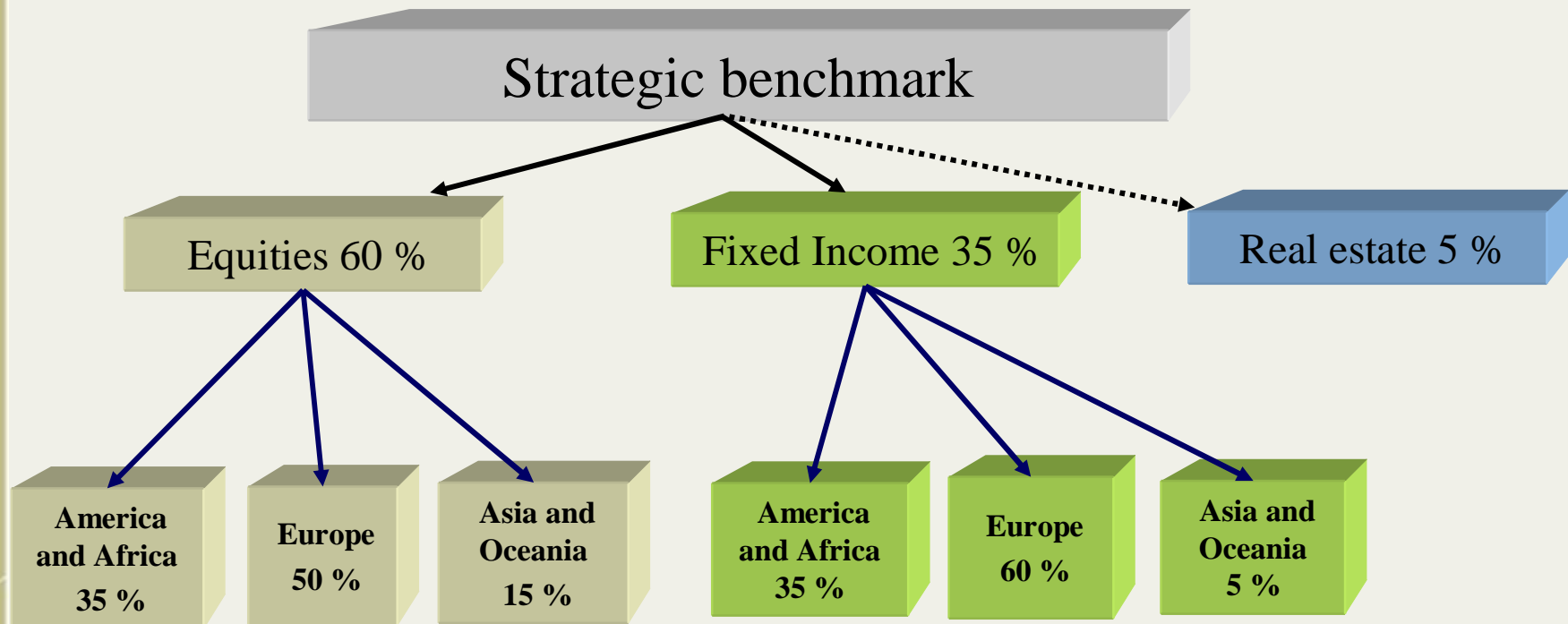
## The Fund's circumstances

- General accumulation of assets belonging to the people
- Finance minister responsible for the management and strategic asset allocation (risk & return choice)
- Strong risk bearing capacity
  - ✓ very long investment horizon
  - ✓ no leverage
  - ✓ no claims for the immediate withdrawal of funds
  - ✓ no direct link to liabilities
- Governance challenges – Decision making process (speed)
- Main risk: Political authorities lose faith in the strategy for managing the petroleum wealth

## Investment Strategy: Maximise returns

- Objective: Maximise international purchasing power, taking into account
  - ✓ appropriate market risk
  - ✓ appropriate operational (reputational) risk
  - ✓ ethical guidelines
  - ✓ principles of clear lines of responsibility (accountability), professionalism and transparency
- Implementation:
  - ✓ financial investor (avg. holding < 1%, max limit 10 %)
  - ✓ passive indexation main contributor to risk
  - ✓ active risk budget (max 1.5% tracking error) delegated to Norges Bank

## Benchmark for the Pension Fund – Global



### Equity index:

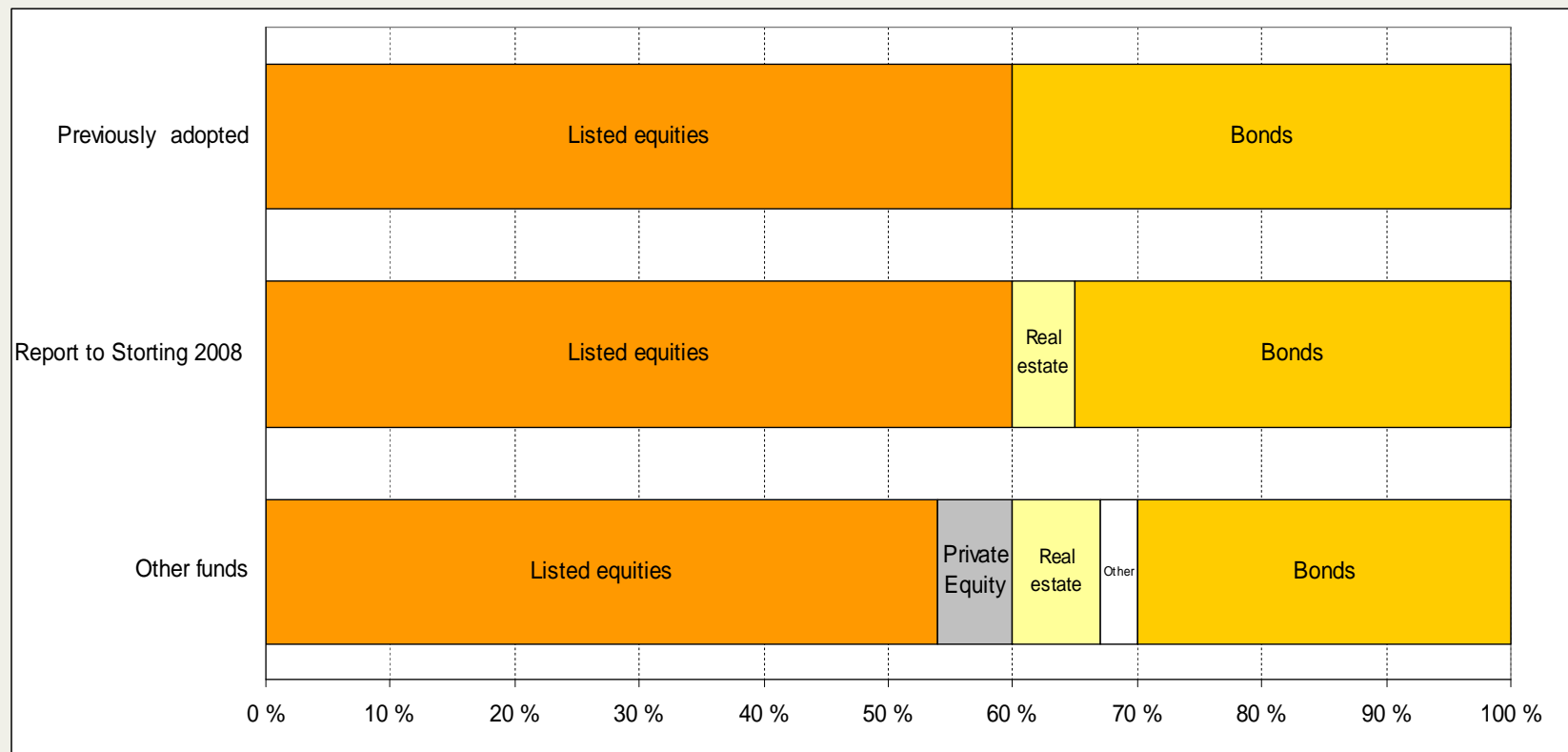
**FTSE All-Cap Index, 46 countries**  
**Approx. 7700 equities**

### Fixed income index:

**Barclay Capital's Global Aggregate interest indices for 11 currencies. Approx. 7500 bonds**



## The investment strategy of the Fund and peers



Source: Ministry of Finance and CEM Benchmarking Inc (2007).

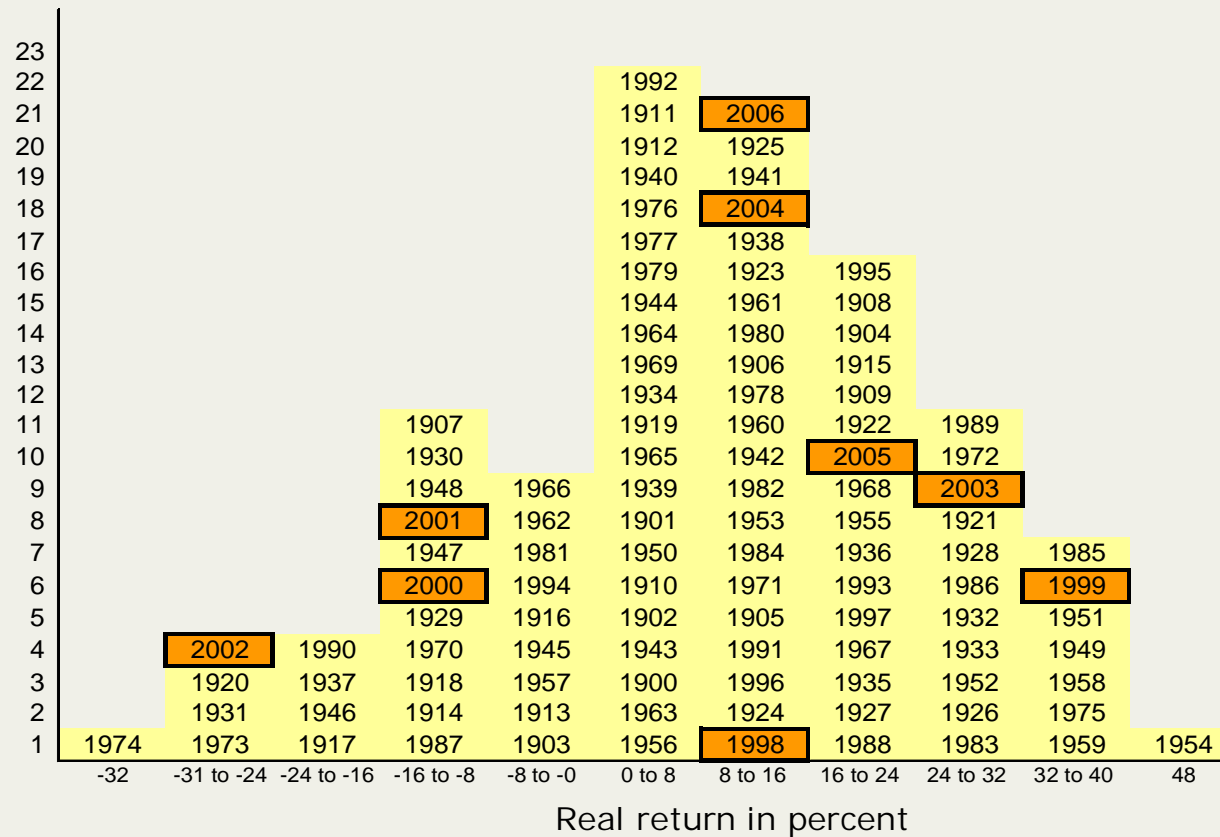
## Why equities?

- Diversification: Even the minimum risk portfolio has a (small) allocation to equities
- Long investment horizon
- Equity risk premium
- In order to harvest this risk premium, we must tolerate fluctuations in return and fund value from year to year

## Large variations in equity returns since 1998

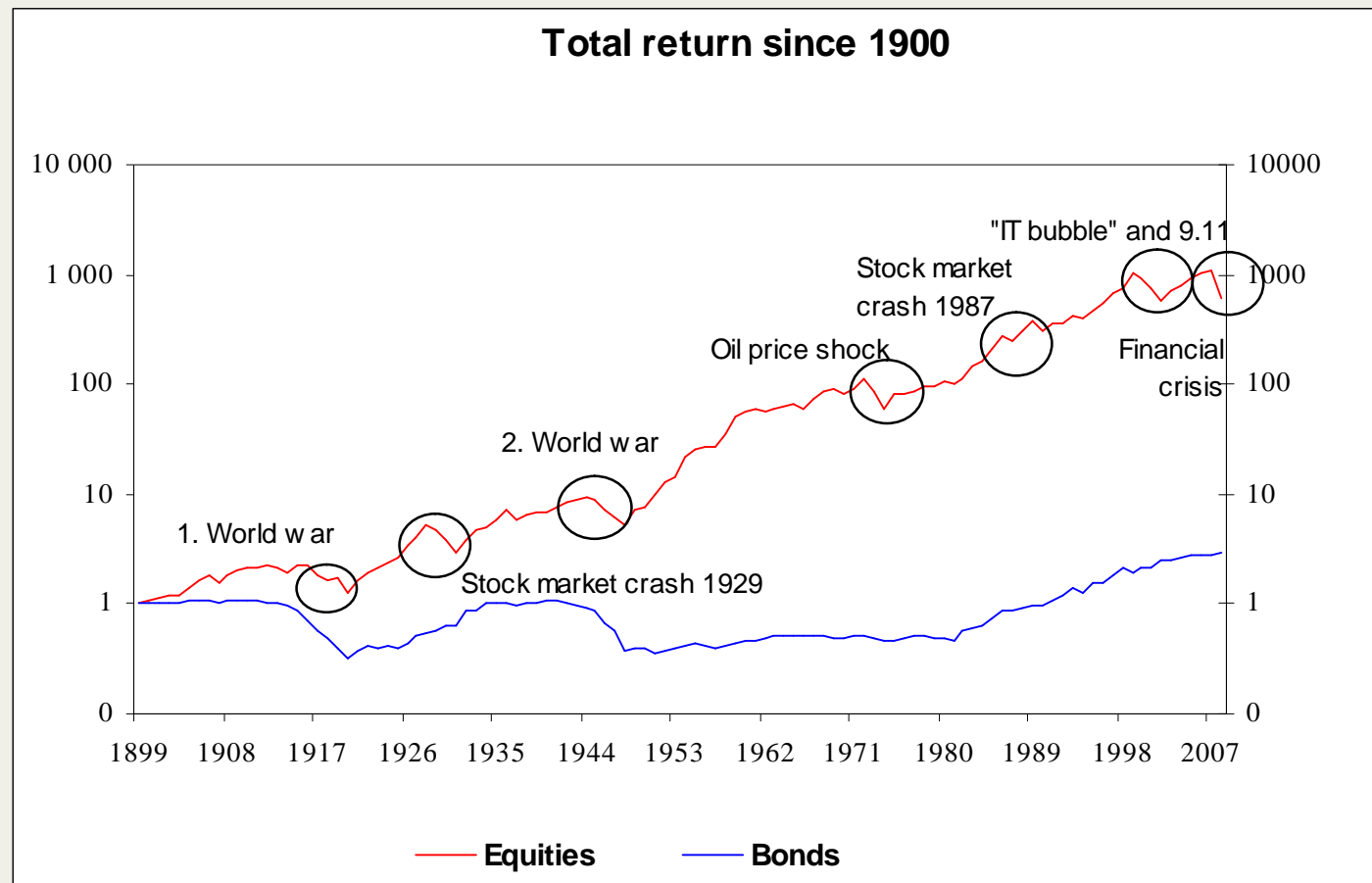
Annual real return in an equity portfolio similar to the Fund since 1900

Number of years



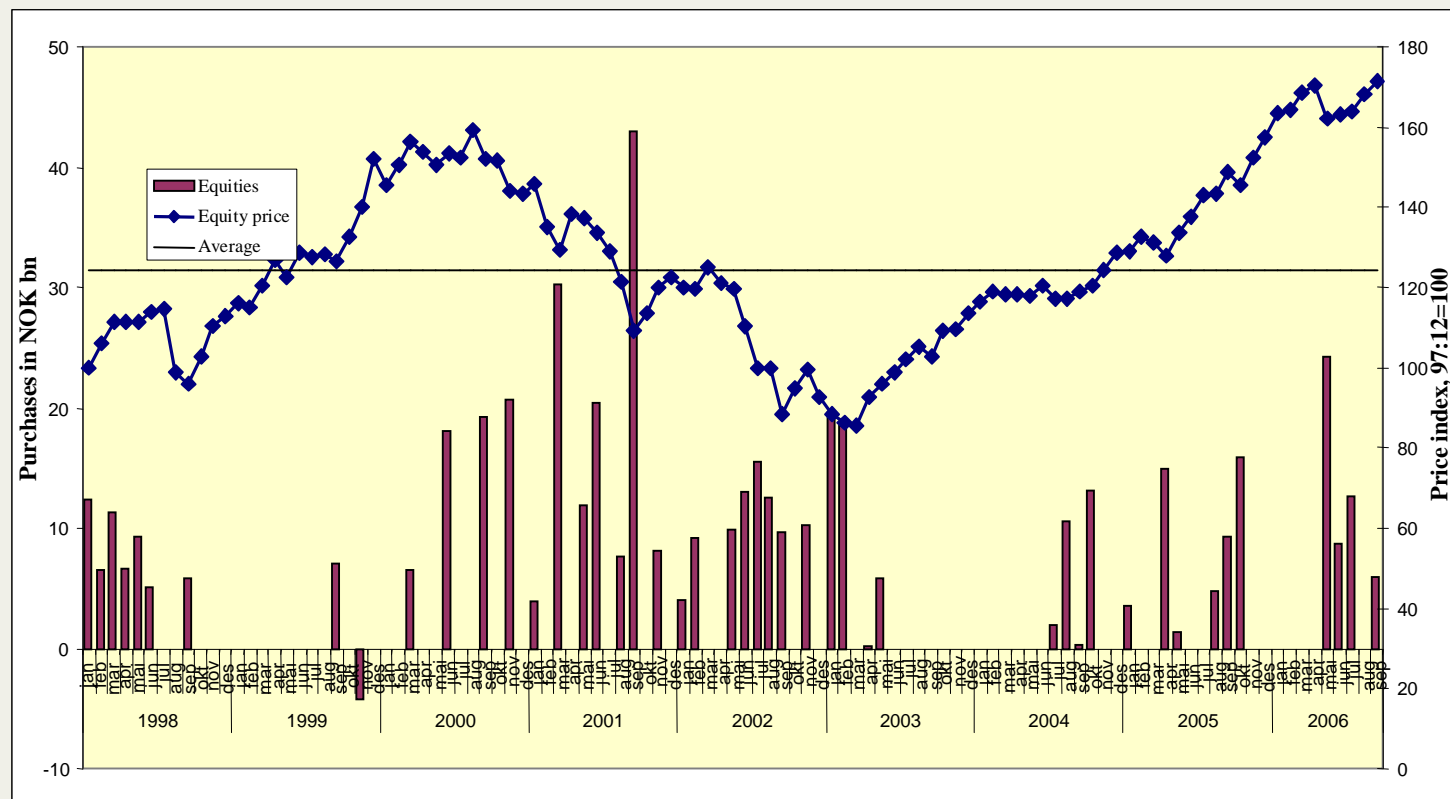
Source: Ministry of Finance/Dimson, Marsh and Staunton

## Equities have significantly outperformed bonds in the long run



Source: Ministry of Finance/Dimson, Marsh and Staunton

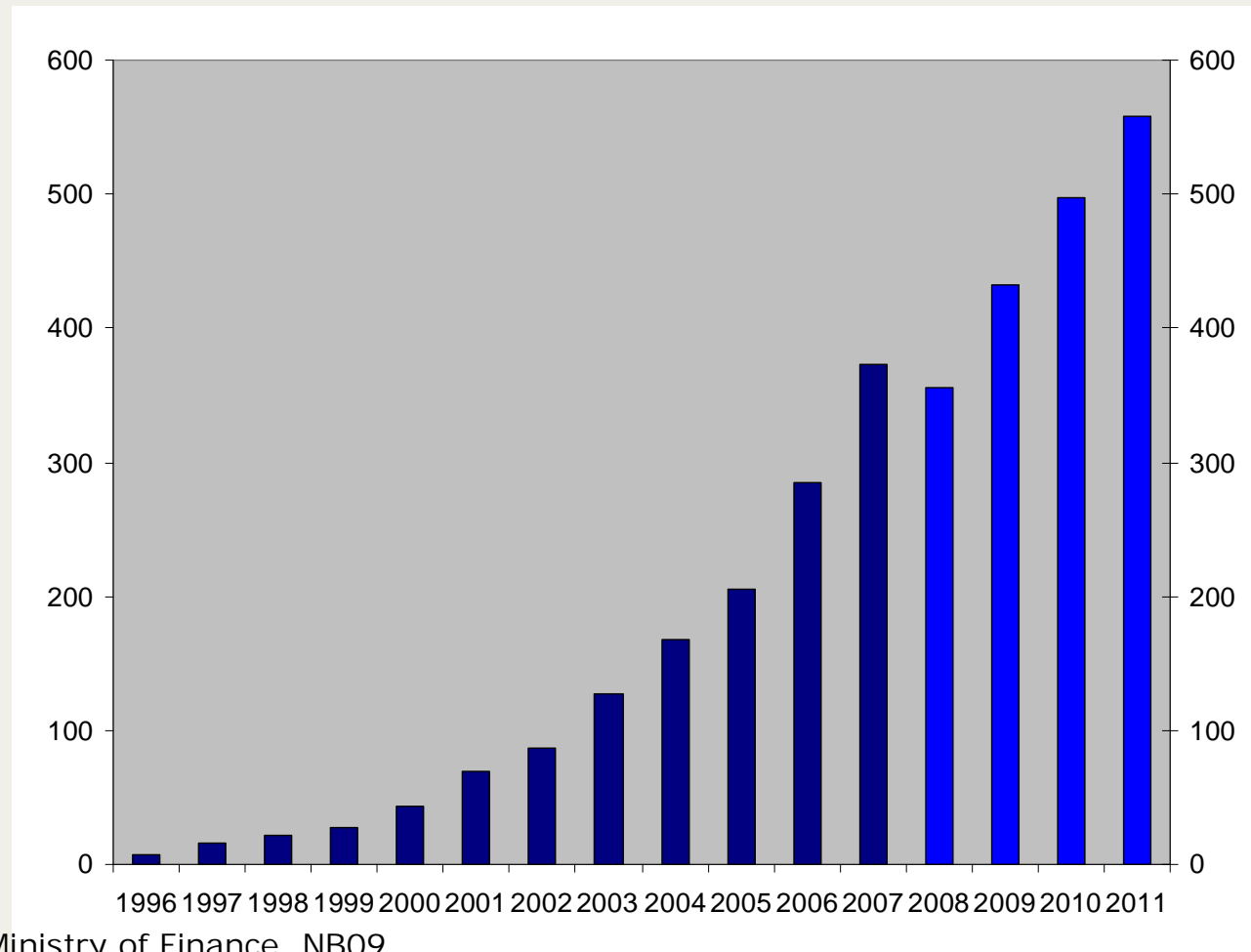
## Our rebalancing strategy means that we buy in falling markets



Source: Norges Bank

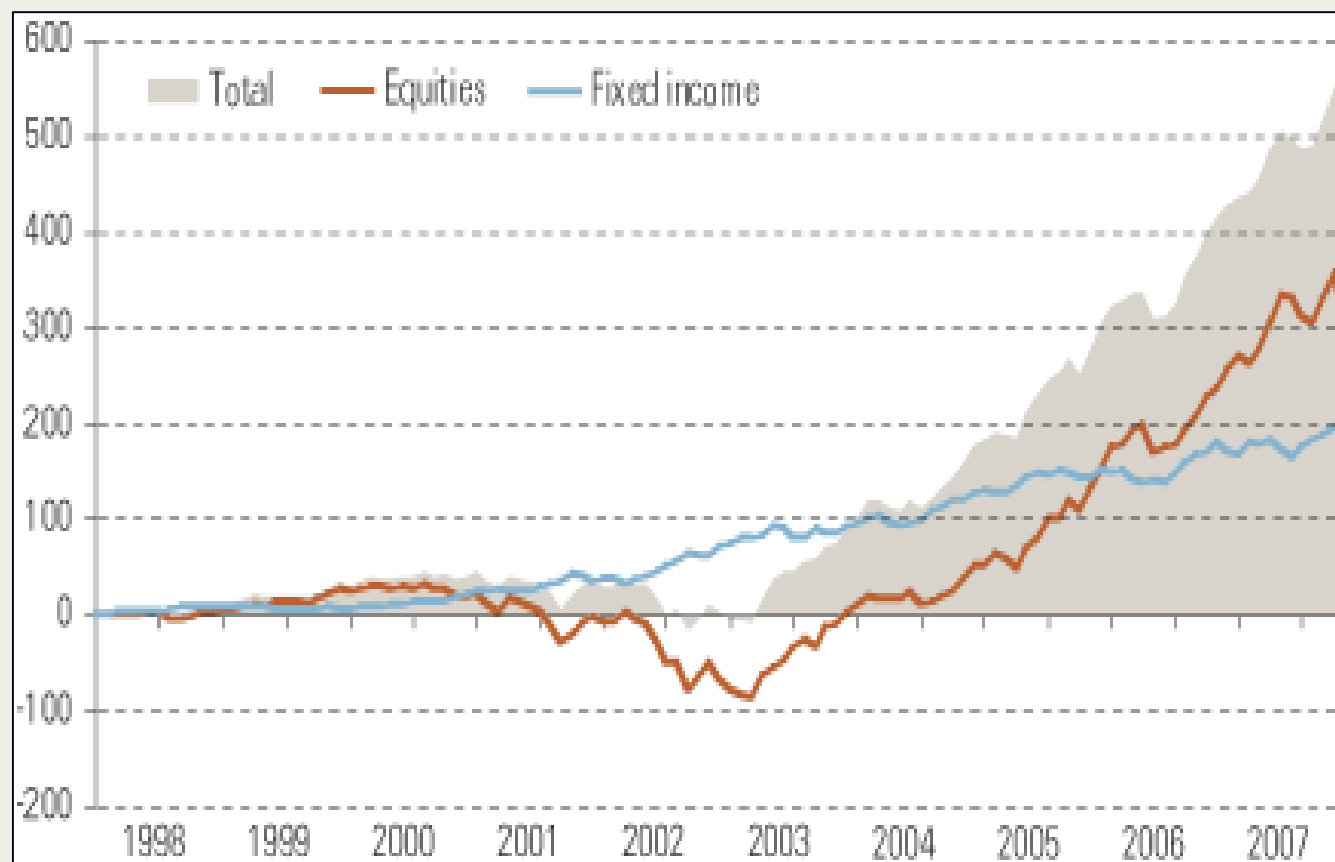
## Norway's SWF is large and still growing fast

-The Fund's market value 1996–2011. Billion USD, year end.



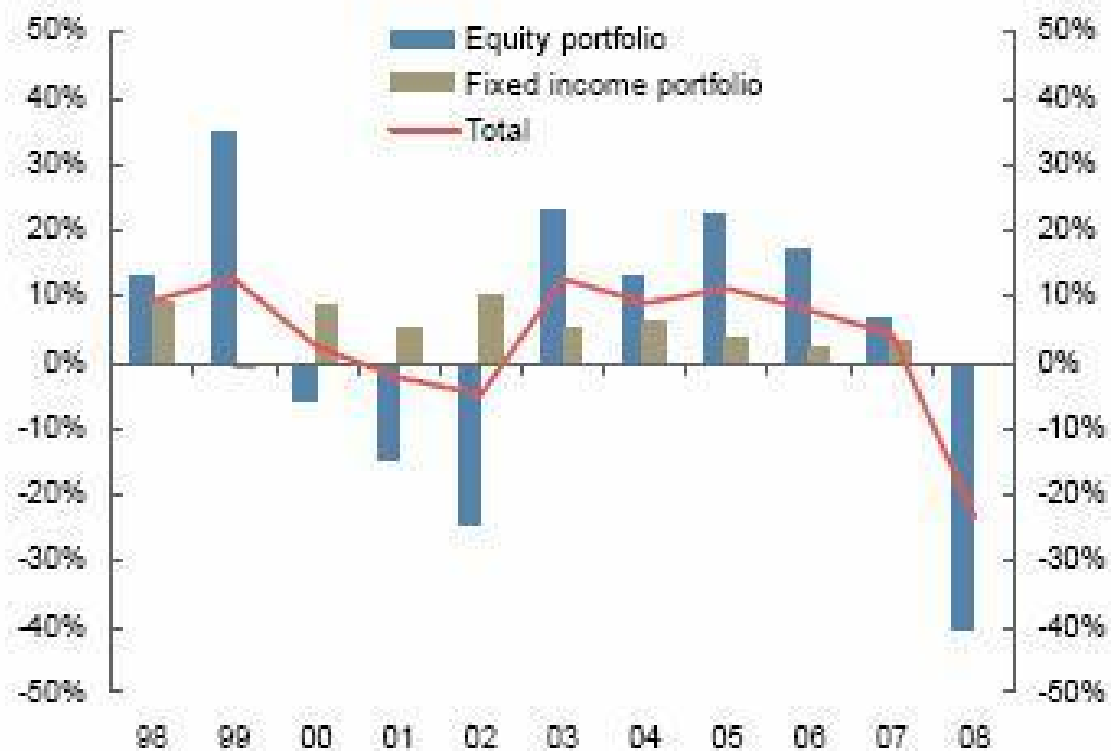
Source: Ministry of Finance, NB09

## Cumulative return on the fund 1998-2007. NOK billion



Source: Norges Bank

- Annualised return rate





## 2008 Results

- - 23,3 % net result, - 3,4 % net underperformance against reference portfolio
- Equity: - 40,70 %
- Reference value: - 39,56
- Adjustment for transaction costs: - 0,82 % net contribution from management
- Bonds: -0,52 %
- Reference value: 6,08 %
- - 6,60 % net contribution from management

## 2008 Results, Equity

- Reversal of recent trends (premiums for cyclical industries, commodities and emerging markets)
- 4 tools to increase yield relative to reference portfolio, all were in the red for 2008:
- Expanded indexation. Problem: rapid reduction of actors' risk limits, illiquidity in the market
- Capital expansions: only 2 out of 6 contributed positively to the net value added of management
- Internal sector mandates. Problem: US and banking sector
- External mandates: focus on emerging markets
- Main contributors to negative result: expanded indexation and sector mandates.

## 2008 Results, Bonds

- Low exposure to subprime MBS
  - More than 80 % of US bonds had AAA credit rating
  - Yet, general real estate crisis had severe impact
  - Increased exposure from credits on portfolio
  - Considerable exposure to European bank bonds
  - Other types of securities also affected
- 
- General problem: considerable diversification, but limited risk reduction. Exposure to underlying, systemic risk. Positions vulnerable to rise in credit cost.
- 
- Main remaining challenge: illiquidity in markets

## Operational corrective measures, bonds

- Acquiring internal management capability in all investment areas (including US MBS market)
- Reduction of number of operational mandates, in general and in particular against MBS
- No more credits on MBS portfolio, reducing risk exposure
- Interest swaps discontinued
- Future strategy:
  - Rebalance liquid parts of portfolio
  - Retain illiquid bonds until they mature. Yields are good, but default risk.

## Operational corrective measures, equity

- Results of management within expectations, less need for correction
- Long term trend: more emphasis on specialised external managers in specific markets/sectors
- Low prices of shares: opportunity to buy!
- Reinforced by losses reducing relative share of equity

## Risk reduction and surveillance

- Exceeding risk limit in October 2008
- Halting or delaying planned investment changes that contribute to increased expected relative volatility (increased risk)
- Supplementing quantitative risk models with pragmatic and discretionary methods:
  - Concentration analyses
  - Factor exposure
  - Liquidity exposure
  - Surveying counterpart risk

## Conclusions

- Main strategy remains unchanged
- More emphasis on exploiting Fund's advantages in size and investment horizon
- Prime examples: retaining positions in illiquid papers, expanding portfolio in a low-price environment

# Ethical guidelines and corporate governance

Two main ethical obligations:

- 1) The obligation to ensure sound financial returns so that future generations will benefit from the petroleum wealth.
- 2) The obligation to respect fundamental rights for those who are affected by the companies in which the Fund invests.
  - ✓ exercise ownership rights – corporate governance
  - ✓ avoid investments in companies whose practices constitute an unacceptable risk that the Fund is or will be complicit in grossly unethical activities





## Exercise of ownership rights

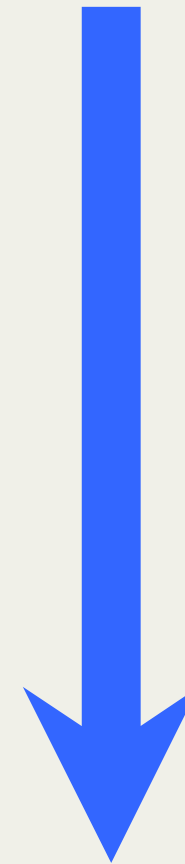
- The overall objective of the ownership effort is to safeguard the (long-term) financial interests of the Pension Fund
- The principles governing the exercise of ownership rights:
  - ✓ the UN Global Compact
  - ✓ the OECD Principles of Corporate Governance and the OECD principles for Multinational Enterprises
- Priority areas
  - ✓ corporate governance
  - ✓ children's rights
  - ✓ environment
- Tools for exercising ownership rights
  - ✓ voting
  - ✓ contact with portfolio companies
  - ✓ contact with regulatory authorities
  - ✓ contact and collaboration with other investors

## Exclusion of companies based on Negative screening and Ad-hoc assessment

- Negative screening (products)
  - ✓ weapons that through their normal use may violate fundamental humanitarian principles (e.g. cluster munitions and nuclear arms)
- Ad-hoc exclusion (production methods and conduct)
  - ✓ serious violations of fundamental ethical norms (human rights incl. child labour, corruption, severe environmental damage)
  - ✓ forward-looking assessment
- The Ministry of Finance has excluded 29 companies as of October 2008, based upon recommendations by the Council on Ethics

## SWF- Elements of transparency

- Governance structure
  - ✓ Lines of responsibility
  - ✓ Guidelines and reporting
  - ✓ Risk management systems
  - ✓ Supervision
  - ✓ Audit
- Investment objectives
  - ✓ Purpose
  - ✓ Investment horizon
  - ✓ Rules governing allocations to and withdrawals from the fund
- Investment strategy and implementation
  - ✓ Fund size
  - ✓ Risk and return
  - ✓ Asset composition
  - ✓ Individual holdings
  - ✓ Rebalancing strategy
  - ✓ Phasing-in of new investments



## Contact details

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## Links

Ministry of Finance

- [www.government.no/en/dep/fin](http://www.government.no/en/dep/fin)

Government Pension Fund

- [www.government.no/gpf](http://www.government.no/gpf)

Norges Bank Investment Management

- [www.nbim.no](http://www.nbim.no)

Council on Ethics

- [www.etikkradet.no](http://www.etikkradet.no)