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Report to the Storting (white paper)

The Government Pension Fund 2018

Preliminary and unofficial translation from Norwegian.
For informational purposes only.

Executive summary in English

The purpose of the Government Pension Fund is to support long-term considerations in the government's spending of petroleum revenues, as well as savings to finance pension expenditure under the National Insurance Scheme. The Fund's contribution to the financing of government expenditures will be of particular importance as the population ages and government finances are subjected to mounting pressure. An aging population will mean increased expenditure on pensions, as well as on health and care services, while government revenues will at the same time be weakened as the result of a smaller portion of the population working and paying tax. Sound long-term management of our joint savings in the Government Pension Fund will help ensure that Norway's petroleum wealth can benefit both current and future generations.

The Government Pension Fund comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN). The funds are managed by Norges Bank and Folketrygdfondet, respectively, under mandates laid down by the Ministry of Finance.

The GPFG is an integral part of the fiscal budget and the fiscal policy framework. The government's petroleum revenues are transferred to the GPFG in their entirety, while spending via the fiscal budget over time shall follow the expected real rate of return on the Fund (the fiscal policy guidelines).

The Government Pension Fund is managed with an objective to achieve the highest possible return with an acceptable level of risk. Management shall be transparent, responsible, long-term and cost effective. There is a broad political consensus that the Fund should not be used as a foreign policy or climate policy instrument.

This report concerns the management of the GPFG and the GPFN. It includes a presentation of management performance in 2017 and a comprehensive review of Norges Bank's management of the GPFG. The report also discusses further development of the investment strategy and the responsible management framework.

Starting this year, the report will be named after the year in which it is published. The title has thus been changed to the Government Pension Fund 2018.

The investment strategy for the Fund

The investment strategy has been developed over time based on financial studies, practical experience and thorough assessments. Important strategic choices have been endorsed by the Storting. This contributes to the sustainability of the chosen long-term strategy, including in periods of financial market turbulence.

The investment strategies for the GPFG and GPFN are set out in the management mandates for the funds laid down by the Ministry of Finance, with, inter alia, the preferred level of risk being reflected in the weighting of the equity and fixed-income benchmarks. The equity share of the GPFG is being gradually increased from 62.5 percent to 70 percent, in line with the Storting's deliberation of last year's report. The equity share stipulated for the GPFN is 60 percent. Fixed-income securities account for the remainder of the benchmark indices.

The investment strategy adopted for the Government Pension Fund is based on the premise that risk can by reduced by diversifying the investments across different asset classes, countries, sectors and companies. It is also based on the premise that financial markets largely are well-functioning, thus implying that it will be difficult to systematically outperform the general market. This approach suggests that investors should diversify their investments broadly and seek to minimise asset management costs.

Hence, the Government Pension Fund is managed close to the benchmark indices defined by the Ministry of Finance. These benchmarks can be closely mimicked at a low cost. This involves the investments being diversified across a large number of individual equities and fixed-income securities, intended to reflect the investment opportunities available in international financial markets. For the GPFG, more than 99 percent of the volatility of Fund returns can be attributed to the benchmark index. Costs are low compared to those of other large funds.

Norges Bank and Folketrygdfondet deviate somewhat from the benchmark indices. This enables the asset managers to track the benchmarks in a cost-effective manner, as well as to exploit distinctive characteristics of the funds to outperform the benchmark indices. The Ministry has in the mandate for the GPFG stipulated certain requirements that also entail deviations from the benchmark index, including, inter alia, on environment-related investments. Both Norges Bank and Folketrygdfondet have generated excess return over time by deviating from the benchmark index. The investment strategies for the GPFG and the GPFN are discussed in sections 2.1 and 4.1.

High returns in 2017

2017 was a year of high returns and historically low volatility in global financial markets. There was increasing economic growth, low inflation and low interest rates. For last year as a whole, the GPFG achieved a return of 13.7 percent, measured in the currency basket of the Fund. The generated return was positive for both fixed-income securities and real estate, but highest for equities. The market value at the end of 2017 was Norwegian kroner (NOK) 8,484 billion, net of management costs. Measured in NOK, the market value increased by 977 billion, predominantly as the result of favourable returns on the investments measured in foreign currencies.

Returns in the Nordic financial markets in 2017 were more or less in line with those in the rest of the world. Measured in NOK, the return on the GPFN was 13.2 percent. Equities generated a significantly higher return than fixed-income securities. The market value at yearend 2017 was NOK 240 billion.

Norges Bank and Folketrygdfondet seek to generate the highest possible return, net of costs, within the mandates laid down by the Ministry of Finance. Last year, the GPFG outperformed the benchmark index by 0.70 percentage points, and the annual average excess return since 1998 has been 0.28 percentage points. This amounts to a total of about NOK 140 billion, before asset management costs. In 2017, the GPFN outperformed the benchmark index by 0.46 percentage points, and the annual average excess return since 2007 has been 1.06 percentage points.

Measured as a proportion of assets under management, costs last year were 0.06 percent in the GPFG and 0.07 percent in the GPFN. This is within the limits stipulated by the Ministry of Finance.

The performance of the GPFG and the GPFN is discussed in sections 2.2 and 4.2.

Expected return and future developments in the value of the Fund

International financial markets have generated very high returns over the last few years. At the same time, volatility has been relatively low. There is reason to expect considerable volatility in the value of the Government Pension Fund over time. Norges Bank estimates annual expected fluctuations in the value of the GPFG at yearend 2017 at NOK 920 billion, measured by standard deviation. This implies that annual fluctuations in Fund value are expected to exceed this amount in one out of three years. Any Norwegian krone exchange rate changes are additional to this.

The low international interest rate level reduces the expected return on the Government Pension Fund going forward. A number of observers have noted that a significant share of the interest rate decline in recent years reflects structural changes in the world economy – thus being of a long-term nature. The Ministry of Finance estimates the expected real rate of return on the GPFG over time at about 3 percent with an equity share of 70 percent. The actual real rate of return on the Fund can be significantly higher or lower than this, both in individual years and over longer periods.

Lower oil and gas revenues also mean that growth in the value of the Fund is expected to level off in coming years. Production on the Norwegian continental shelf appears to have peaked, and oil prices have for the last few years been below the average over the last 10-15 years. This reduces the central government's net cash flow from petroleum activities. For many years, petroleum revenue inflows have boosted the GPFG capital year by year, also in periods of negative returns. Going forward, it should be expected that developments in the value of the Fund to a greater extent will be determined by returns in the international financial market.

When measured in Norwegian kroner, the value of the Fund is also affected by developments in Norwegian krone exchange rates. The depreciation of the Norwegian krone can, when taken in isolation, be estimated to have increased the Fund's value by about NOK 1,000 billion since its inception. Most of this has happened over the last four years. The Norwegian krone exchange rate has no impact on the international purchasing power of the Fund.

Review of Norges Bank's management

The Ministry of Finance has since 2009 reviewed Norges Bank's management of the GPFG at the beginning of each term of the Storting. The objective of such reviews is to facilitate transparency and insight into Norges Bank's management of the Fund. This is important for inspiring confidence in such management, and may serve to strengthen the ability to retain the commitment to profitable, long-term investment strategies, also during periods of weak performance. The Ministry has commissioned several external evaluations as part of its review, including, inter alia, from an expert group and from Norges Bank.

The review in this report follows up on the Storting's petition resolution for an assessment of costs and benefits of the various investment strategies used by Norges Bank in its active management. The Ministry of Finance measures benefits by excess returns and costs by the risk and management cost impact of the strategies.
The expert group has assessed the excess return achieved by Norges Bank relative to the benchmark index defined by the Ministry of Finance. Various models and methods have been

used to shed light on performance. In some analyses, the expert group seeks to distinguish between the return achieved by the asset manager by taking on systematic risk and returns that are the result of other choices. This can provide insight into how performance is achieved. The expert group's analyses suggest that part of the excess return appears to be the result of increased systematic risk taking. The mandate allows for the Bank to assume more or less risk than is inherent in the benchmark index.

An assessment of achieved performance also needs to take into consideration that the benchmark index return cannot be achieved at zero cost. Costs are incurred in making investments in line with the benchmark index; so-called passive management. The expert group notes that the return contributions of the manager should be measured after deduction of the extra costs associated with active management. It is possible to estimate how much of the costs would also have been incurred under passive management and how much have been incurred as the result of Norges Bank's deviations from the benchmark index, but such estimates are uncertain.

Overall, Norges Bank's management performance has been good. The total excess return over the period from January 1998 to June 2017 is estimated at between NOK 75 and 112 billion, depending on how costs are calculated. This illustrates the benefit of Norges Bank being able to deviate somewhat from the benchmark index to exploit the distinctive characteristics of the GPFG, such as size, long time horizon and low liquidity need. Such deviations offer scope for generating excess return, while at the same time enabling the Bank to handle ongoing index changes in a cost-effective manner.

The equity investments have generated the largest excess return contribution over the period as a whole. In terms of strategies, as measured over the period from 2013, the excess return has predominantly been generated through external security selection in equity management and through market exposure strategies, including index adaptation, factor strategies and securities lending income. Some strategies have delivered minor or negative overall performance contributions, including, inter alia, fixed-income investments over the period as a whole and allocation strategies over the sub-period from 2013. Allocation strategies include, inter alia, investments in countries outside the benchmark index. This general conclusion also applies when costs and risk are factored in. Internal security selection has over the most recent period delivered an excess return that more or less covers the asset management costs, but provides little financial compensation for estimated risk.

The GPFG is invested for the long term, and performance needs to be evaluated over time. The Ministry of Finance notes, at the same time, that the Executive Board of Norges Bank is responsible for the Bank's management of the GPFG being appropriately organised, within the limits stipulated by the Ministry. This also includes the choice of strategies, the assessment of the return and risk performance of such strategies over different time horizons and market conditions, as well as transparency and reporting on said strategies. Based on this division of responsibilities, external analyses and evaluations, as well as management performance as a whole, the Ministry is not proposing any change to the limit on deviations from the benchmark index in this report.

The expert group is recommending more transparency in the determination and implementation of the Bank's internal benchmark indices. This will provide more insight into the performance of the various strategies, the exploitation of risk limits, the apportionment of costs and the asset management incentives. The Ministry will follow up on this in its dialogue with Norges Bank.

As part of the review of Norges Bank's management, the consultancy firm Inflection Point Capital Management (IPCM) prepared a report on global responsible investment best practices. This is an evolving field, but with major differences between investors in their commitment and approach to such issues. The consultancy report provides a useful overview and shows that responsible investment needs to be tailored to the purpose, size and political context of each fund. IPCM believes that there is not one joint approach, and highlights a set of best practice characteristics. The Ministry is of the view that these characteristics are largely reflected in the responsible investment practices of the GPFG.

The review of Norges Bank's management performance and strategies is discussed in section 2.4. Costs are discussed in section 2.3, while the limits on deviations from the benchmark index are discussed in section 3.5. The report on global responsible investment best practices is discussed in section 5.3.

Larger equity share and more risk taking in listed markets for the GPFG

The equity share of the strategic benchmark index is the single decision with the greatest impact on expected return and risk in the GPFG. The expected return on equities is higher than on fixed-income securities, thus implying a greater contribution to the objective of maximising the purchasing power of the Fund. At the same time, equities involve more risk. This increases the volatility of realised returns, as well as the risk of long-term losses.

In last year's report, the Ministry of Finance proposed an increase in the equity share of the strategic benchmark index for the GPFG from 62.5 percent to 70 percent. This was endorsed by the Storting. As a basis for deciding the equity share of the Fund, a comprehensive process had been initiated. The Ministry of Finance received, inter alia, advice from a government-appointed commission chaired by Knut Anton Mork and from Norges Bank. The Ministry also received input via a public consultation on the commission report.

A plan for the implementation of the new equity share has been established in consultation with Norges Bank. The Storting will be informed after the equity share of the strategic benchmark index has reached 70 percent. The Ministry of Finance will review the rebalancing rules in view of the new equity share.

The phase-in of the new equity share and the rebalancing rules are discussed in section 3.1.

The fixed-income investments in the GPFG

The fixed-income investments in the GPFG shall contribute liquidity, reduce the volatility of Fund returns, as well as facilitate the harvesting of risk premiums associated with, inter alia, interest rate risk and credit risk. The current fixed-income benchmark reflects a trade-off between these purposes. In view of the decision to increase the equity share to 70 percent, the Ministry of Finance proposed a review of the fixed-income benchmark in last year's report.

Norges Bank submitted its advice and assessments in letters to the Ministry of Finance in the autumn of 2017. The Bank recommends a considerable narrowing of the benchmark index, to comprise only nominal government bonds with a maturity of less than 10.5 years that are issued by the US, the UK or Eurozone countries. This implies, inter alia, that corporate bonds and about 20 currencies would no longer be included in the benchmark index. In its advice, Norges Bank did not propose changing the investment universe.

The Ministry of Finance is of the view that the advice from Norges Bank entails several changes to the main principles underpinning the investment strategy. These include, inter alia, the principle of broad diversification of the investments in the benchmark index and, as a main rule, inclusion in the benchmark index of the risk factors to which exposure is wanted. The Ministry finds that additional analyses are needed and has therefore appointed an expert group to assess the fixed-income investments in the GPFG. The Ministry intends to present its assessment in the report on the Government Pension Fund in the spring of 2019. The fixed-income investments in the GPFG are discussed in section 3.4.

Unlisted equities in the GPFG

The Ministry of Finance assesses the investment opportunities of the GPFG on a regular basis in view of, inter alia, research and financial market developments. This report addresses whether unlisted equities should be allowed in the GPFG on a general basis. In assessing this issue, the Ministry of Finance has commissioned several external analyses and evaluations from, inter alia, an expert group and Norges Bank.

Investors primarily gain access to the unlisted equity market via private equity funds. In such funds a manager is authorised to invest in and manage a small number of unlisted companies. The manager raises capital from a number of investors and seeks to generate a return before the private equity fund is dissolved, normally after ten years. This is done by restructuring the governance, management, capital structure and operations of the companies. The largest segment is leveraged buyout, which aim to improve the performance of established, profitable companies.

Unlisted equities can provide Norges Bank with additional investment opportunities in its management of the GPFG, but only via so-called active management. There are no benchmark indices for such investments that can be closely mimicked at low cost, and performance will depend on the specific investments chosen by the Bank. A key issue is whether distinctive characteristics of the GPFG may place Norges Bank at an advantage or a disadvantage in making investments through private equity funds, compared to other investors. Investing the GPFG directly in unlisted companies, which are not under the control of such funds, is not considered a viable option by the Ministry.

The size of the GPFG may confer a cost advantage. However, this is conditional upon a significant portion of the GPFG being invested in the unlisted equity market, predominantly through leveraged buyout. A minor portion of the investment opportunities for the GPFG would be in venture capital for start-up companies, for the reason that such funds tend to be small. At the same time, it is not cost effective to invest in a very large number of private equity funds. Another advantage for the GPFG is a low liquidity need. A strategy involving considerable investments being made during periods of market turbulence could nonetheless be challenging to implement in practice.

The Ministry believes that investments in unlisted equities would challenge key characteristics of the current management model, such as low asset management costs, closely tracking the benchmark and a high degree of transparency. This means that the issue of whether to allow this type of investment is of key importance to the nature of the Fund in the long run.

Low costs are a characteristic of the GPFG. External equity management costs in the listed market are about 0.5 percent, while the overall costs of the Fund are about 0.06 percent, measured relative to assets under management. In comparison, the annual cost of investing in private equity funds can be estimated at about 6 percent of assets under management.

The management of the GPFG closely tracks the benchmark, thus implying that the Fund is distinguished from other investors in that it primarily takes systematic risk in listed markets, with a limited element of active management. This is reflected in the GPFG having a larger public equity allocation and a smaller allocation to unlisted investments than many other large funds. The majority of the Mork Commission's members emphasized this as an argument in favour of increasing the risk taking in the GPFG by increasing the equity share to 70 percent.

Transparency is an important prerequisite for broad support for, and confidence in, the management of the GPFG. Many private equity funds disclose little information about their activities, and unlisted companies are not subject to the same reporting requirements as listed companies. It is not clear to the Ministry that the same transparency can be achieved for investments in unlisted equities as for the other investments of the Fund. Necessary transparency requirements may narrow the investment opportunities for Norges Bank. Transparency and democratic anchoring also imply that the reputation of the GPFG is more vulnerable to non-financial risk than that of many other investors.

Whether to allow unlisted equity investments in the GPFG is a matter of weighing advantages and disadvantages. Allowing such investments can provide Norges Bank with additional investment opportunities in its operational management. The Ministry holds that advantages such as size and liquidity could give grounds for expecting a somewhat higher return than that of the average investor. However, such advantages are uncertain, and the contribution to overall risk and return of the GPFG would in any event be limited. At the same time, unlisted equity investments may affect the reputation of the Fund and challenge key characteristics of the current management model. The Ministry is also taking into account that the equity share is now being increased to a level where it may be inappropriate to expose the GPFG to other types of risk.

Based on an overall assessment, the Ministry of Finance does not propose that investments in unlisted equities should be allowed in the GPFG on a general basis. Moreover, the Ministry notes that Norges Bank may currently invest in unlisted companies whose board of directors has expressed an intention to seek a listing, which the Ministry will follow up on in its dialogue with the Bank.

Unlisted equity investments in the GPFG are discussed in section 3.2.

Environment-related mandates and unlisted infrastructure investments in the GPFG
In the last two reports on the Government Pension Fund, the Ministry of Finance has addressed whether to allow unlisted infrastructure investments in the GPFG. These comprise various types of infrastructure that are available to investors in the unlisted market, from

airports and toll roads to solar power plants and hospitals. The conclusion has been not to allow unlisted infrastructure investments at the present time. In the report submitted in the spring of 2017, it was noted, inter alia, that a transparent and politically endorsed sovereign fund like the GPFG is not well suited to carry the particular risks associated with such investments.

This conclusion was endorsed by the majority of the members of the Standing Committee on Finance and Economic Affairs in its deliberation of the report, subject to the following comment:

«The investment strategy for the GPFG has been developed gradually over time, and the majority refers to the ongoing efforts of the Gjedrem Commission with regard to the Central Bank Act, next year's in-depth review of Norges Bank's management and further market developments, which when considered as a whole make it appropriate to revert to the issue of expansion of the investment universe in the near future.»

The Ministry of Finance intends to follow up on the said comment of the Standing Committee on Finance and Economic Affairs by assessing whether unlisted renewable energy infrastructure investments can be effected within the scope of the special environment-related mandates, with the same transparency, return and risk requirements as apply to the other investments in the GPFG. In this context, the Ministry also intends to review the regulation of the environment-related mandates in general, including the size of such mandates.

The environment-related mandates and unlisted infrastructure investments are discussed in section 3.3.

Responsible investment

The Government Pension Fund has an overarching financial objective. Within this scope, the Fund shall also be a responsible investor. Strong long-term financial returns are assumed to depend on well-functioning markets and sustainable development. This applies, in particular, to a large, diversified, long-term investor whose returns primarily follow value added in the global economy.

The mandates for the GPFG and the GPFN refer to internationally acknowledged standards and principles for responsible investments. Norges Bank and Folketrygdfondet exercise the ownership rights of the funds. Important responsible management tools are, inter alia, the promotion of international standards and research, company dialogue, clarification of expectations, as well as the submission of proposals and the casting of voting in general meetings. A new expectation document on tax and transparency was published by Norges Bank in April 2017. An additional expectation document, on anti-corruption, was published in February 2018.

The Ministry of Finance has adopted ethically motivated guidelines for the observation and exclusion of companies from the GPFG. Certain criteria in the guidelines are based on products, such as tobacco, weapons and coal. Other criteria are based on conduct, such as serious human rights violations or severe environmental damage.

The Council on Ethics provides recommendations on exclusion and observation of companies. The decisions are made by Norges Bank. The Bank may in some cases opt for a different instrument than recommended by the Council on Ethics. The overarching objective is to identify the most appropriate instrument for each individual case. For the coal criterion, Norges Bank may make decisions without any recommendation from the Council on Ethics.

Climate is an important financial risk factor for the Government Pension Fund in the long run. The fund report submitted in the spring of 2017 included a comprehensive discussion of climate risk, which is integral to the management of the GPFG and the GPFN. This year's report discusses a climate risk reporting framework, based on the recommendations of an international working group (TCFD), and how such recommendations can be implemented by Norges Bank and Folketrygdfondet.

Responsible investment is discussed in chapter 5.

Ongoing initiatives

In November 2017, Norges Bank advised the Ministry of Finance on omitting the oil and gas sector from the equity benchmark for the GPFG, with a view to reducing oil price risk in central government wealth.

The issue raised by Norges Bank is complex and has many aspects. The Ministry of Finance intends to subject the advice to thorough and proper examination, as is the existing practice for all key choices in the management of the GPFG. In order to establish a comprehensive basis for decision making, the Ministry has therefore appointed an expert committee, circulated the advice from Norges Bank for public consultation and written to the Bank to obtain additional information. The Government intends to present its assessment to the Storting in the autumn of 2018.

In June 2017, a commission chaired by former central bank governor and former secretary general of the Ministry of Finance Svein Gjedrem submitted its proposal for a new Central Bank Act. The commission proposed that the management of the GPFG recommends that the Government Pension Fund Global (GPFG) be managed by a separate statutory entity demerged from Norges Bank. The commission also presented two alternative management models should the Fund be kept under the Bank. The Ministry of Finance will continue its follow-up of the proposal and revert to the Storting in due course.

Norges Bank is considering Norwegian instead of foreign holding companies for the unlisted real estate investments. This matter raises several issues that need to be examined before Norges Bank is in a position to make a decision. The Ministry of Finance will revert to this matter.

These matters are discussed in sections 3.6 – 3.8.