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Report to the Storting (white paper)

The Management of the Government Pension Fund in 2015

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 spending objectives for the state's petroleum revenues and saving to finance public pension. Sound long-term management will help ensure that Norway's petroleum resources 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 two funds are managed by Norges Bank and Folketrygdfondet, respectively, under mandates issued by the Ministry of Finance.

In the White Paper to parliament, the Ministry of Finance presents and evaluates the Government Pension Fund's management and performance in 2015. Further development of the investment strategy for the Fund is discussed, with an emphasis on unlisted real estate and infrastructure. The work done on responsible investment is also accounted for.

The Fund's investment strategy

The investment objective of the Government Pension Fund is to achieve the highest possible return with a moderate level of risk. There is broad political agreement that the Fund should not be used as a foreign or environmental policy instrument. The investment strategy builds on the Ministry's investment beliefs, as well as the Fund's purpose and distinctive characteristics. The strategy has been developed gradually on the basis of thorough assessments. Important strategic choices have been endorsed by the Norwegian parliament. The strategy is designed to be sustainable over time, including in periods of financial market turbulence.

The investment strategies for the GPFG and GPFN are set out in the mandates, and are reflected in, among other things, the composition of the benchmark indices. In both cases, the equity portion is set to 60 percent, reflecting a trade-off between long-term expected returns and risk. Fixed-income securities account for the remainder of the benchmark index for the GPFN. In the GPFG, up to 5 percent of the Fund may be invested in a separate real estate portfolio, with a correspondingly lower share of fixed-income.

Norges Bank and Folketrygdfondet are permitted to deviate somewhat from the benchmark indices set by the Ministry of Finance. This allows managers to exploit the funds' distinctive characteristics – such as their long horizon and size – to seek a return exceeding the benchmark index. A further advantage is the opportunity for cost-effective implementation of the benchmark indices.

Positive performance in a turbulent year

Global financial markets were turbulent in 2015. The year was characterised by low interest rates, falling oil prices and weaker outlook for emerging markets. Exchange rates fluctuated considerably, as did quarterly returns. The GPFG achieved a full-year return of 2.7 percent, measured in the currency basket of the Fund. This represents a sharp drop compared to the high returns generated in recent years. Real estate had the highest return, while the fixed-income portfolio generated almost no return.

The GPFG’s market value at year-end was NOK 7,471 billion after management costs. Measured in Norwegian kroner (NOK), the market value increased more than NOK 1,000 billion in 2015. Net inflows of petroleum revenues amounted to approximately NOK 50 billion, while returns in foreign currencies totalled close to NOK 350 billion. More than half of the increase in the Fund’s value can be attributed to the depreciation of the Norwegian krone, which does not affect the Fund’s international purchasing power.

The real rate of return on the GPFG in 2015 was 1.8 percent after management costs. In the period 1998–2015, the GPFG has achieved an average annual real rate of return of 3.7 percent. Every year, the Fund receives income in the form of share dividends, interest payments and rental income. This cash flow is expected to remain relatively stable over time, and totalled NOK 193 billion in 2015, equivalent to 2.8 percent of the Fund’s capital.

The Nordic financial markets outperformed the global market in 2015. Measured in NOK, the GPFN achieved a return of 7.0 per cent, with equities generating a significantly higher return than the fixed-income portfolio. The GPFN’s market value at year-end 2015 was NOK 198 billion, while the annual net real return totalled 4.7 percent.

Norges Bank and Folketrygdfondet aim to maximise return after costs, subject to the limits set in their mandates. The return generated by the GPFG in 2015 was 0.45 percentage points above the benchmark index. This excess return is higher than can be expected over time, given the limited deviation from the benchmark index. The highest excess return was on the equity portfolio. Since 1998, the annual excess return has averaged 0.26 percentage points. In total, this is equal to about NOK 82 billion. Last year, the GPFN outperformed its benchmark index by 0.48 percentage points. This figure is in line with the average annual excess return since 1998.

The specified excess return includes management costs. The returns on the benchmark indices cannot be achieved without cost. Estimates indicate that the management costs of Norges Bank and Folketrygdfondet are approximately equal to the costs of index management. The Ministry of Finance therefore considers the reported excess return as a reasonable measure of the value added through active management. Measured as a proportion of capital under management, last year’s costs amounted to 0.06 percent (GPFG) and 0.09 percent (GPFN). These figures are within the limits set by the Ministry, and low compared to the costs of other funds.

In evaluating performance, a distinction can be made between excess returns a manager has achieved by taking on more systematic risk and excess returns attributable to other factors. This approach may help explain excess returns after they have been achieved. Excess returns that stem from higher risk-taking by a manager can in theory be achieved more efficiently by adjusting the composition of the benchmark index. Although different models are used to explain performance, these do not provide an unambiguous explanation of how risk has impacted performance or what adjustments to the benchmark index are possible. This report presents several risk-adjusted return measures. These indicate that Norges Bank and

Folketrygdfondet have generated robust excess returns given the risks taken in active management.

Uncertainty about the Fund's future value

Measured in Norwegian kroner, the market value of the GPFG has almost doubled in the three-year period 2013–2015. The returns achieved during this period have been high compared to the average expected return over time and, additionally, the Fund has received substantial inflows of oil and gas revenues. Nonetheless, around half of the increase in the Fund's value is attributable to the depreciation of the Norwegian krone, which does not boost the Fund's international purchasing power. Although the development of these variables is uncertain, several factors suggest that the Fund is likely to grow more slowly going forward.

International interest rates have been low and falling for many years. This is reflected in low returns on the Fund's treasury and corporate bonds. Declining interest rates have generated price gains for the Fund, but the scope for further gains is limited given the current low interest rate level. Although the US Federal Reserve began raising its policy rate late last year, the Bank of England and European Central Bank have stated that rate increases will not come until a later date.

The Fund's value is also influenced by transfers to and withdrawals from the Fund. The GPFG is an integral part of the fiscal budget and the fiscal policy framework. The state's oil and gas revenues are transferred to the GPFG in full, while in the long term spending via the fiscal budget over time follows the expected real rate of return on the Fund (the fiscal policy guideline). The spending of petroleum revenues is thus detached from the earning of them. This helps insulate the fiscal budget from fluctuations in petroleum revenues and supports a stable development of the Norwegian mainland economy.

Over the past 10–15 years, high production and oil and gas prices have contributed to the rapid accumulation of capital in the GPFG. Production on the Norwegian continental shelf appears to have peaked, and oil prices have fallen sharply in recent years, reducing the state's net cash flow from petroleum activities. At the same time, petroleum revenue spending via the fiscal budget has gradually increased after the adoption of the fiscal policy guideline in 2001. In the budget for 2016, the non-oil deficit was estimated at NOK 209 billion. Measured as a proportion of the Fund's capital, the spending of petroleum revenue falls well within the limits stipulated by the fiscal policy guideline. The cash flow from petroleum activities was estimated at NOK 204 billion. Oil prices have fallen further since the budget was presented last autumn.

Already at the introduction of the fiscal policy framework, it was envisaged that the Fund would experience an initial phase of substantial net inflows and rapid capital accumulation followed by a far longer period of net withdrawals and weaker growth in the Fund's value. In phase we currently are entering into,the non-oil deficit is likely to be covered in part by Fund returns in the form of dividend, interest and rental income. The shift has occurred a few years earlier than anticipated due to the decline in oil prices. However, it is possible that there will be years with net inflows ahead, depending on the development of prices, production levels and the non-oil deficit in the fiscal budget.

For many years, net inflows have boosted the GPFG's capital year by year, including in periods of low returns. Going forward, its growth will primarily be determined by returns in the international financial markets.

Unlisted investments

A key theme of this year's report is investments in unlisted real estate and infrastructure. The Ministry of Finance has assessed whether the proportion of the GPFG invested in real estate should be increased, and whether investment in unlisted infrastructure should be permitted. Consideration has also been given to whether the GPFN should be allowed to invest in unlisted real estate and infrastructure. The Ministry has received recommendations from Norges Bank and an expert group (Van Nieuwerburgh, Stanton and de Bever) on the scope and regulation of such investments by the GPFG. Folketrygdfondet has given advice about the GPFN.

The Government Pension Fund invests primarily in listed equities and bonds. The benchmark indices for equities and bonds can be closely followed at low cost, and facilitate wide diversification to reduce risk. Performance and the risk associated with deviation from the benchmark indices can be measured on an ongoing basis. Unlisted markets do not offer the same opportunity to diversify risk through broad-based ownership and small ownership shares. Management is more complex, and requires different, more specialised expertise. Nor are there reliable benchmark indices for unlisted investments. Returns and risk cannot be measured regularly as in listed markets, since changes in value are estimated, for example through asset valuations.

In principle, unlisted investments can help boost returns or reduce risk in two different ways. First, in the longer term unlisted investments may have different return and risk properties from corresponding listed investments. As a result, the average investor can expect to profit from the inclusion of unlisted investments in his portfolio, in the form of either improved risk diversification or higher expected returns. Second, investors with advantages in unlisted markets can generate excess returns compared to the average investor. Potential advantages include investment horizon, size and management expertise.

Real estate investments in the GPFG

In 2008, it was decided that up to 5 percent of the GPFG should be invested in a separate real estate portfolio. The objectives included risk diversification and the harvesting of premiums from less liquid assets. The real estate portfolio is still being scaled up, and accounted for some 3 percent of the Fund at the end of 2015. Norges Bank's actual real estate investments are included in the Fund's benchmark index. An international, valuation-based index (IPD) of unlisted real estate values has been adopted as the return target. It is not possible to undertake investments that closely mirror the index.

Norges Bank and the expert group have recommended changes to the regulation of the GPFG's investments in unlisted real estate. In their view, the current return measure is less suited to the intended purpose, and a benchmark index composed of listed equities and bonds would be preferable. This would also enable better management of the risk associated with the Fund's real estate investments. The report of the expert group shows that it is uncertain whether investments in unlisted real estate have resulted in better risk diversification or higher expected returns. It also points out that real estate values are currently high. Norges Bank, on the other hand, builds on different analyses than the expert group and belives that real estate investments will improve the return-risk ratio over time.

The Ministry of Finance plans to move away from the current provision that up to 5 percent of the GPFG's capital shall be invested in a separate real estate portfolio that is integrated into the Fund's benchmark index. The benchmark index will thus only include listed equities and bonds. The investments in real estate investments can then be evaluated against a broadly composed index which, in principle, can be followed closely and at low cost.

This change entails that the scope and composition of the real estate investments will be decided by Norges Bank subject to the limits set in the mandate from the Ministry of Finance. It also reflects the fact that this type of management demands specialist expertise and market proximity. The expected return will be uncertain and depend on the manager's advantages and choice of specific investments. Moreover, this solution gives a clear division of labour between the Ministry and Norges Bank, mirroring the arrangement for other active management strategies.

To improve risk management, the Ministry of Finance plan to include unlisted real estate investments in the existing limit on expected relative volatility, as proposed by Norges Bank. As a result, all strategies that entail deviations from the benchmark index will be subject to a joint and overall risk limit.

In addition, the Ministry of Finance is preparing to cap investments in unlisted real estate at 7 percent of the GPFG. Returns on real estate may at times differ from the return on listed equities and bonds. Accordingly, Norges Bank must aim for a lower proportion of unlisted real estate to avoid breaching the limit and having to liquidate investments in the event of sharp, sudden drops in the value of listed investments. In the Ministry's opinion, a cap of 7 percent will allow Norges Bank to carry out its management around a long-term unlisted real estate proportion of approximately 5 percent of the GPFG. The Ministry considers this limit sufficient to realise any economies of scale offered by the market.

Unlisted infrastructure investments in the GPFG

A lack of data on unlisted infrastructure makes it difficult to assess whether such investments improve risk diversification or raise expected returns for the average investor. A further question is whether the Fund has advantages compared to other investors for such investments.

The expert group and Norges Bank consider that the range of investment opportunities can be expanded by permitting investments in unlisted infrastructure. However, the Ministry of Finance believes a number of significant factors speak against permitting such investments.

Many infrastructure investments are exposed to high regulatory or political risk. It is common with long-term contracts where profitability is subject to the direct influence of political authorities in other countries, through the setting of tariffs or other regulation. There have been several examples in recent years of authorities changing the conditions for such investments through the renegotiation of signed agreements or changes to grant schemes.

In the case of *unlisted* investments, the ownership share in each individual investment will generally be large. As a result, Fund's investments will also be more visible and subject to criticism. Conflicts with the authorities of other countries regarding the regulation of transport, energy supply and other important public goods will generally be difficult to handle, and will entail reputational risk for the Fund. The Ministry considers that a transparent, politically endorsed state fund like the GPFG is less suited to bear this type of risk than other investors. High transaction costs and reduced liquidity make it more difficult to sell unlisted investments if problems arise.

The unlisted infrastructure market is small for the GPFG. Infrastructure is primarily owned by public authorities, and is scarcely available to investors. Uncertain estimates indicate that unlisted infrastructure only accounts for 0.5 percent of the global investable capital market. The majority of the infrastructure market is listed. In this respect, infrastructure differs from real estate, where most of the market is unlisted. Permitting investment in unlisted infrastructure will therefore do less to expand the Fund's investment opportunities than unlisted real estate.

Both the expert group and Norges Bank have discussed the Fund's distinctive characteristics and potential management advantages. Such benefits are difficult to quantify. Norges Bank has just a few years' experience in the unlisted space, and the real estate portfolio is still being built up. The Ministry is of the opinion that more experience should be gained in this area before any expansion to include additional types of unlisted investment.

Following an overall assessment, the Ministry of Finance is not prepared to permit the GPFG to invest in unlisted infrastructure at this stage.

The GPFG has a financial target, and is not an instrument for promoting state investment in developing countries or renewable energy. There is no financial rationale for permitting infrastructure investments only in these sub-markets. The risk level of these sub-markets is higher than that of other investments in unlisted infrastructure. Any desire to invest on a non-financial basis should be pursued through other means than the GPFG. There are already many public schemes to promote investment in developing countries and renewable energy. Furthermore, the Storting has asked the Government to prepare the establishment of a limited company mandated to invest in companies that develop and use green technologies, in partnership with the private sector. The Government will return to this question in its revised budget for 2016.

Unlisted investments in the GPFN

Folketrygdfondet has recommended allowing the GPFN to invest in unlisted infrastructure and real estate. In its view, access to a wider range of investment opportunities will help diversify risk and boost the return after costs.

The GPFN invests primarily in Norway, but also has some investments in the rest of the Nordic region. The GPFN's investment strategy, unlike that of the GPFG, does not seek the widest investment diversification possible. In isolation, permitting investment in unlisted real estate and infrastructure may help diversify risk. However, this can also be achieved by other, simpler means. The state already has substantial real estate and infrastructure holdings in Norway. Accordingly, there is little rationale for the state in investing part of the GPFN in unlisted real estate and infrastructure to improve risk diversification.

The Norwegian infrastructure investment market is small and undeveloped. Any investments in infrastructure by the GPFN will most likely result from the sale of such assets by the central or local government. Such a change of ownership will leave the state's overall risk level unchanged, and usually generate significant transaction costs.

Unlisted investments normally require different, more specialised expertise than listed investments. It is uncertain whether Folketrygdfondet can realise economies of scale or has other advantages in for such investments.

Following an overall assessment, the Ministry of Finance is not prepared to permit the GPFN to invest in unlisted real estate and infrastructure.

Unlisted investments in the GPFN are discussed in chapter 5.

New reporting and risk management requirements for the GPFG

The Ministry of Finance aims to promote the greatest possible transparency in the management of the GPFG. The Fund currently is seen as one of the world's most transparent. Transparency is both of independent value and vital for the management and control of the Fund.

The limit on deviation from the benchmark index was increased somewhat on 1 February 2016, as planned in last year's white paper and endorsed by parliament. In conjunction, the Ministry of Finance has introduced a new limit of risk and more detailed reporting requirements on the risk assumed by Norges Bank in its active management. Norges Bank's Executive Board is now required to cap the negative excess return which in extreme cases may be expected to result from the Bank's investment strategies.

Transparency facilitates a broad discussion and understanding of the Fund's management, and provides a foundation for evaluating Norges Bank's management performance. Transparency may also strengthen the ability to pursue profitable long-term strategies in periods with returns below the benchmark index. The mandate now requires, inter alia, reporting on investment strategies, the sources of positive and negative excess returns, and the results achieved under all investment strategies entailing substantial costs or high relative risk. Furthermore, Norges Bank's Executive Board has to issue a public assessment of its management performance. The new reporting requirements apply starting with the 2015 annual reporting.

Responsible investment

The Government Pension Fund has overarching financial objectives, but also aims to be a responsible investor. Strong long-term financial returns depend on well-functioning markets and sustainable development. This applies particularly to large, diversified, long-term investors whose returns are primarily linked to production in the global economy..

The mandates for the GPFN and GPFG refer to internationally recognised standards for responsible investment. Norges Bank and Folketrygdfondet exercise ownership rights on behalf of the two funds. Important instruments in this context include the promotion of international standards and research, company dialogue, clarification of expectations and the submitting proposals and voting at general meetings. In February 2016, Norges Bank published an expectation document on human rights.

The Ministry of Finance has adopted ethically motivated guidelines on the observation and exclusion of companies from the GPFG. Certain criteria exclude companies based on their products, for example tobacco, arms and coal. Other exclusion criteria are based on conduct, such as serious human rights violations and severe environmental damage. The Council on Ethics recommends companies for exclusion or observation, and the final decision is made by Norges Bank. Until 2015, such decisions were taken by the Ministry of Finance. Four companies were excluded last year.

In 2016, two new criteria have been included in the guidelines on observation and exclusion, reflecting the parliament’s feedback on the fund report for 2014 and on the National Budget 2016. One criterion targets conduct resulting in unacceptable greenhouse gas emissions at aggregate company level. The other criterion is product-based, and targets mining companies and energy producers who derive 30 percent or more of their revenues from thermal coal or base 30 percent or more of their operations on thermal coal.

As part of the GPFG’s responsible investment efforts, separate mandates have been adopted for environmental investments. Around NOK 54 billion was invested under these mandates as at the end of 2015. In recent years, the returns under the environmental mandates have been lower than the return on the Fund as a whole.

Two government commissions

In January 2016, the Government appointed a commission mandated to evaluate the GPFG’s equity share. The share of equities is the single decision with the greatest impact on the Fund’s overall long-term return and risk. The commission, which is chaired by Knut Anton Mork, is due to submit its report by 15 October 2016. The Ministry of Finance intends to circulate the report through a public consultation. An assessment will also be sought from Norges Bank. The Ministry aims to discuss the question of the GPFG’s equity portion in the Fund report to be published in the spring of 2017.

Norges Bank has developed a competent organisation and delivered good long-term operational results in the management of the GPFG. Nevertheless, the evolution of the investment strategy and growth in the Fund's capital are making new demands on its governance. Last year, the Government initiated the appointment of a new deputy governor at Norges Bank, which has been given special responsibility for asset management. Further, a commission chaired by Sven Gjedrem was appointed to review the Norges Bank Act and the Bank's governance structure. The commission's mandate also covers the management of the GPFG. The commission will present its recommendations in the spring of 2017.