

**Comments on the Report:
"Evaluation of Active Management of the
Norwegian Government Pension Fund –
Global"
Ang, Goetzmann and Schaefer**

Trond Døskeland
trond.doskeland@nhh.no
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NHH Summary

1. The investment decisions generating active returns were not independent of systematic risk factors.
 - Mainly caused by liquidity and volatility risk.
 - Why has this violation of the Fundamental Law of Active Management (uncorrelated investment decisions) not been identified or communicated before? Is this exposure intentional?

2. The report suggests a new factor benchmark approach.
 - It is better to harvest factor risk in the benchmark than from a bottom-up active management process.
 - But there are three, not two, alternatives.
 1. Factor risk included in the active management (today).
 2. Factor risk in the benchmark + active management without “static” factor risk (suggested by the Report).
 3. Reduce factor risk, but still some bottom-up active management.

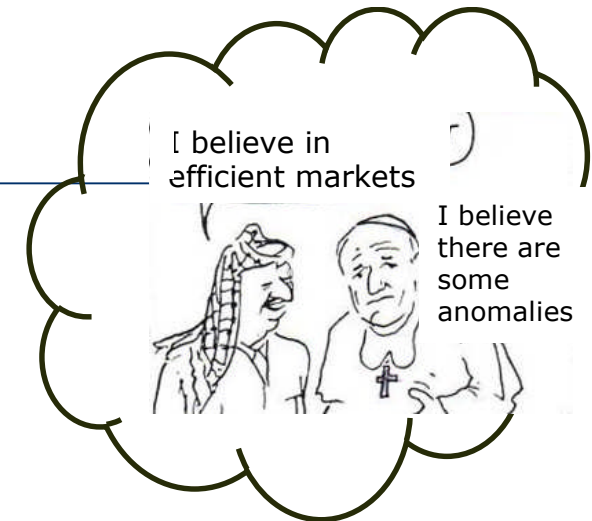
Section I



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I believe in...

- “Tests of the theory [EMH] on prices have produced violations suggestive of the potential for active management to add value to a multi-asset portfolio, but finding consistent out-performing active managers is difficult”
- Efficient markets or not? Just like religion, accept it or not, without conclusive evidence.
- Different geographical markets => Different degrees of efficiency?
 - Ferreira, Miguel and Ramos, WP (2009) study the determinants of mutual fund performance around the world using a data set of 16,316 open-end actively managed domestic and international equity funds in 27 countries from 1997-2007. The average alpha is insignificant negative, but with large differences **between countries**.
 - Teo, RFS (2009), finds that hedge funds with a physical presence (head or research office) in their investment region outperform other hedge funds by 3.72% per year. The local information advantage is pervasive across all major geographical regions, but is strongest for **emerging market funds** and funds **holding illiquid securities**.
 - Bae, Stulz, and Tan, JFE (2008) document, in their sample of thirtytwo countries, that local equity analysts issue more precise earnings forecasts than do foreign analysts. In particular, they find that the **quality differential is stronger in emerging markets**, where less information is disclosed by firms.
- “The most talented investors”
 - A recent study on Finnish data relates an IQ test from the military with later investment performance (Grinblatt, Keloharju, and Linnainmaa 2009). The study finds that high IQ investors exhibit superior stock-picking skills.

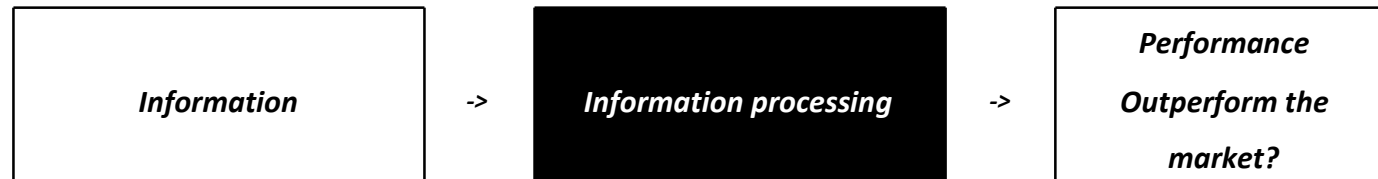


Section II



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Information Processing



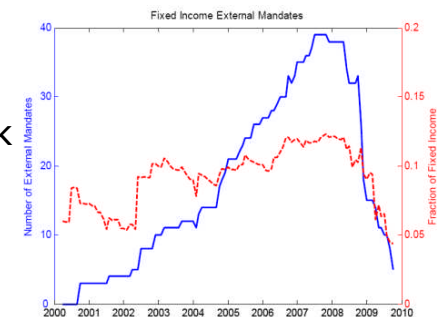
- Does the Fund outperform their benchmark, i.e. superior skills in processing the information?
- Evidence: Active return data 98-09.

Table S1: Average Returns (per month) to Active Management

| | Total Fund | | Fixed Income | | Equity | |
|---------|-------------|----------|--------------|----------|-------------|----------|
| | Full Sample | Pre-2008 | Full Sample | Pre-2008 | Full Sample | Pre-2008 |
| Mean | 0.02% | 0.03% | 0.00% | 0.01% | 0.05% | 0.06% |
| P-value | 0.56 | 0.01 | 0.98 | 0.45 | 0.08 | 0.02 |

Before fees and security lending.

- To open the Black-box of information processing, the authors should have gained access to more detailed information about the activity inside the Fund.
 - For example external mandates. In one out of two asset classes, the process of selecting external managers has failed (i.e. low active return and correlated to systematic risk factors). Why? Systematic risk in the benchmark of external managers?
- The data should be provided by the Ministry of Finance, not NBIM.
 - This is an evaluation of NBIM. You don't ask the suspect to hand over the evidence...



Section III



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Small benefits from factor exposure?

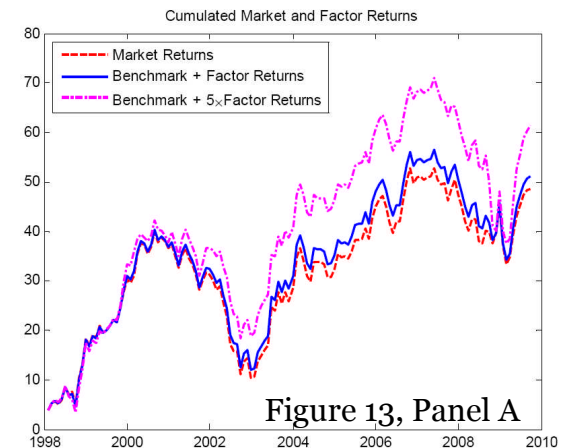
- In the literature thousands of factors have been examined. The report has settled on seven factors.
 - What will happen out of sample? If everyone buy the same risk factors the premium will vanish. So, are the return from these risks compensation for holding real, aggregate risks that the average investor is anxious to hold?
 - In the Report I miss an exhaustive discussion of why the Fund is better at having exposure to the proposed factors, for example FX carry and momentum?
- Probably will new factors be revealed, and old will be exploited and become of less importance, i.e. the premium disappears.
 - How and who is going to set/update the factor benchmark?
 - “(...) recommend that the asset owner, through Parliament and the Ministry of Finance, set static factor exposures relevant in the very long run”
 - “(...), the set of factor probably varies over time. An important area for active management would lie in identifying new risk premiums currently not meeting the benchmark criteria”

What about momentum?





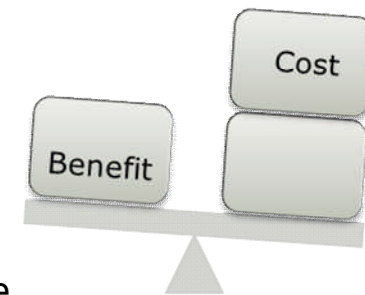
- The ultimate owner of the Fund is the Norwegian people.
 - One reason for why the Fund has succeeded is the high confidence in the Norwegian population. But the Norwegian people are similar to other investors, sadder to lose than happy to gain.
- Compared to a benchmark without factor risk, the proposed benchmark will increase the volatility of the Fund.
 - Sell insurance (negatively skewed factors) => Increase the losses in bad times.
- Other costs;
 - Less transparency,
Lesson from the financial crisis: Understand what you invest in! Who will really understand the new benchmark? In the report I can't find examples of other funds with the same strategy.
 - More trading.
 - More use of derivatives.
- => Worst case scenario: Change in the 60%-40% equity-bond allocation
 - Adding complexity to the Fund structure and volatility to the returns => Increased probability for a change in 60-40 allocation during bad times.
 - Worse than the potential gain from extra factor risk premiums.





- The Fund is already exposed to the most important factor, equity market risk.
 - Done in a simple, transparent way with not much need for trading
 - Long-term investor => Buy stocks in bad times, vice versa

- The benefit of being exposed to the proposed factors will not outweigh the cost!?



- How large is actually the benefit?
- Some of the costs (not enough emphasized in the Report) are
 - increased complexity, which factors?, dynamic or static factor exposure?, parameter uncertainty? home-made factor benchmark?, extensive use of derivatives?, counterparty risk?
 - more volatile returns (extra low returns in bad times), more trading,
 - higher probability for a change in the baseline benchmark (60/40)

- Identify and reduce factor risk
 - Less deviations from benchmark => Set a target (not a limit) for tracking error lower than today's limit
 - Bonuses adjusted for factor risk
 - Better risk management, communicate the factor risk
 - Need some bottom-up active management to be a competent investor, i.e. avoid "stupid buys"

