



FINANSDEPARTEMENTET

# Management of the Government Pension Fund

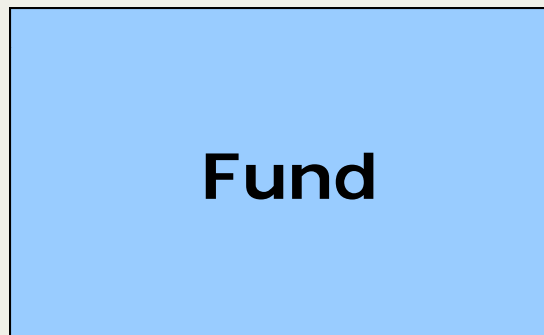
Dili, May 2010

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Asset Management Department

## The Fund mechanism – integrated with fiscal policy

Return on investments



Petroleum revenues



Transfer to finance non-oil budget deficit

Revenues



Expenditures

- consumption
- investment (infrastructure, human capital)

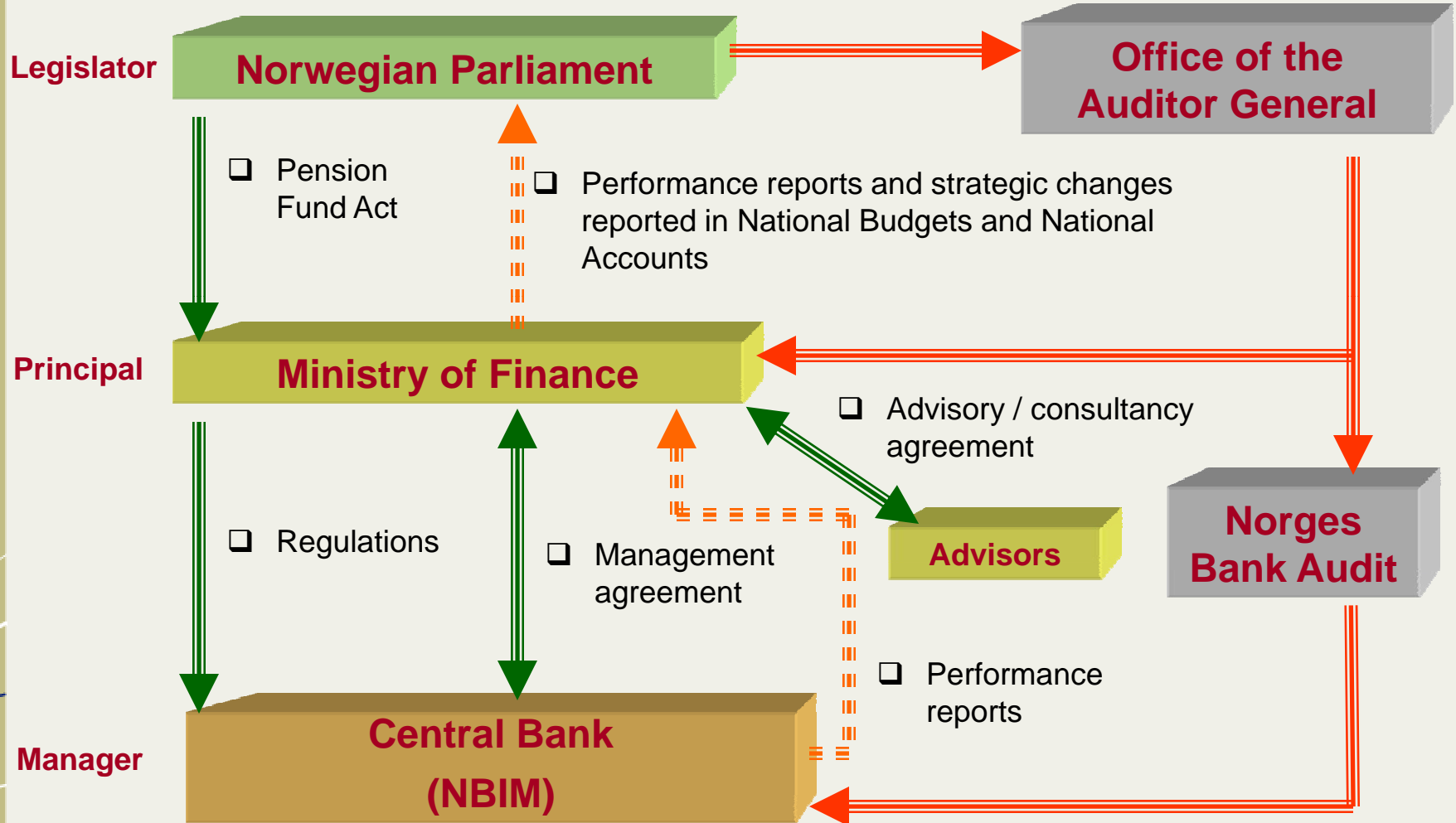


### ***Fiscal policy guideline***

(over time spend real return of the fund, approximately 4%)

# Pension Fund Global Governance Structure

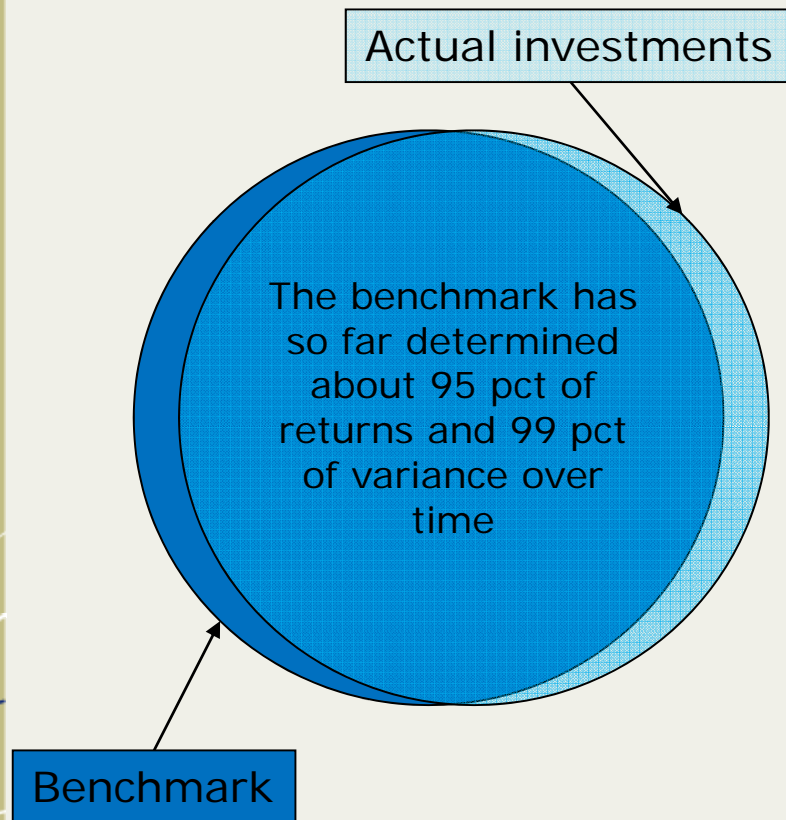
Founded on Act, regulations and separate contracts



## Asset management: Clear lines of responsibilities

- Ministry of Finance – “Owner”
  - ✓ separate asset management department with overall responsibility for managing the Fund
  - ✓ strategic asset allocation (benchmark + risk limits)
  - ✓ monitoring and evaluating operational management
  - ✓ responsible investment practices
  - ✓ reports to Parliament
- Central Bank – “Operational manager”
  - ✓ separate entity within the central bank (NBIM) charged with the operational management of the Fund
  - ✓ 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 total variance is dominated by the market risk of the benchmark portfolio



### The benchmark

- reflects the owner's chosen investment strategy
- is used for risk management
- is used for assessing manager's skill

### Active management

- The manager can deviate from benchmark
- Quantitative risk limit (1%\* tracking error), and qualitative requirements

\*Proposal to reduce tracking error limit from 1.5 % to 1 %, White Paper no. 10 (2009-2010)

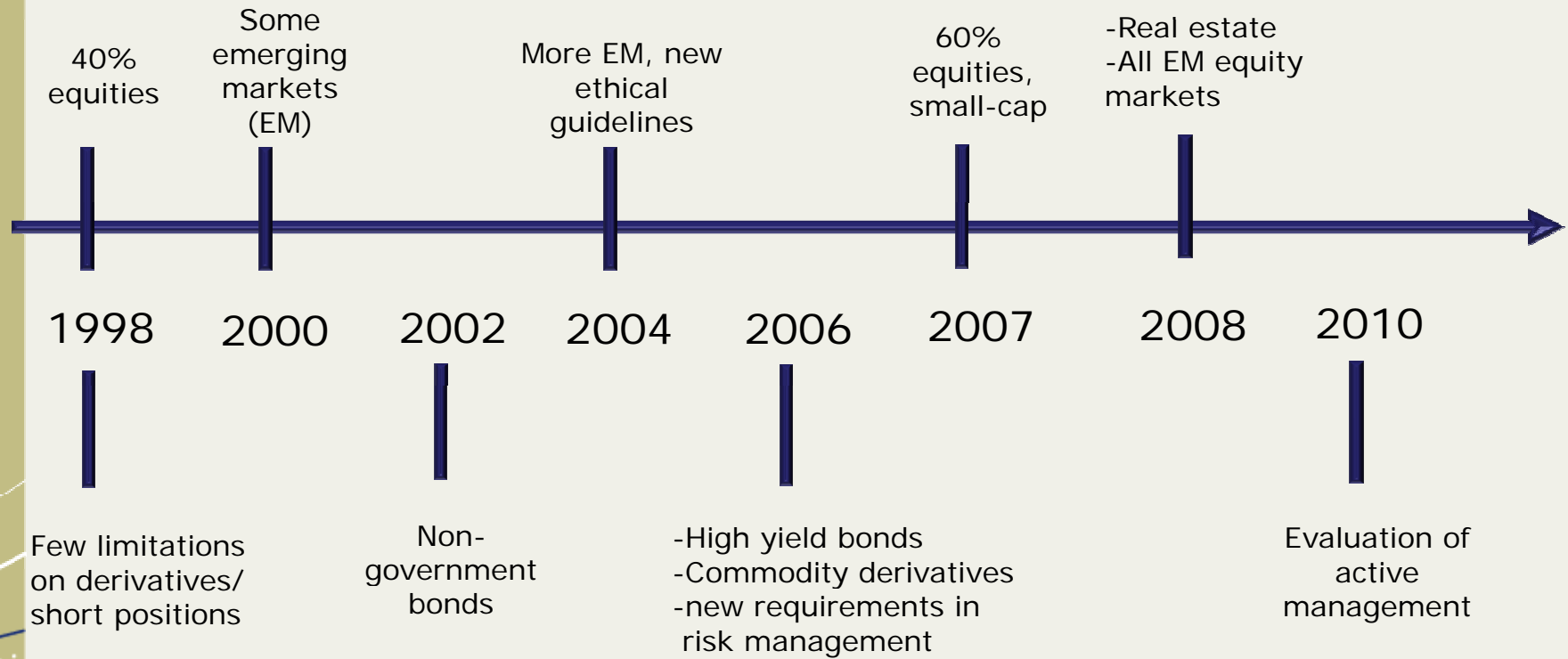
## Our circumstances

- 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

## Assumptions on how markets work

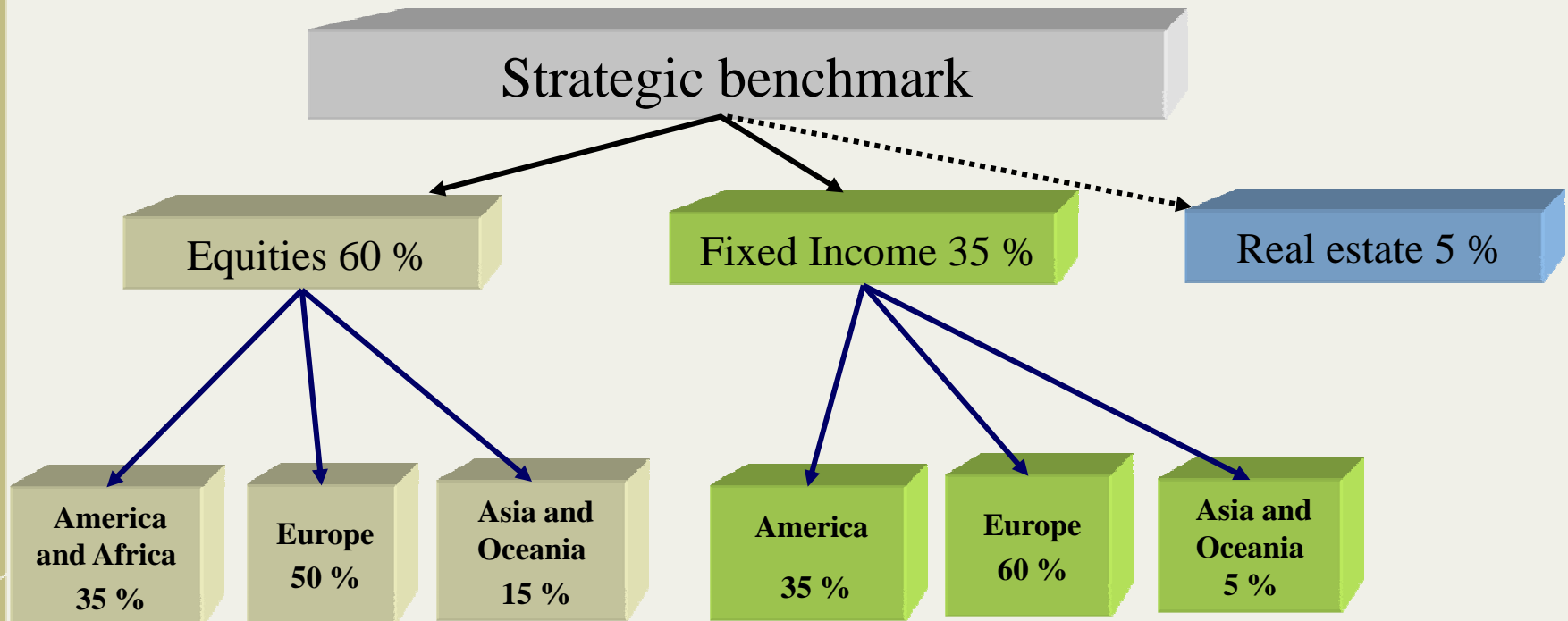
- Market efficiency
- Diversification
  - ✓ improved trade-off between expected return and risk
- Risk premiums
- Benchmark and active management
  - ✓ benchmark reflects the owner's preferences for the balance between risk and expected return
- Manager and market liquidity
  - ✓ performance in illiquid markets highly dependent on manager skill
  - ✓ Incentive systems
- Responsible investments
  - ✓ possible market failures
  - ✓ sustainable economic development in the long term

## Gradual changes in the investment strategy





## Benchmark for the Pension Fund Global



**Equity index:**

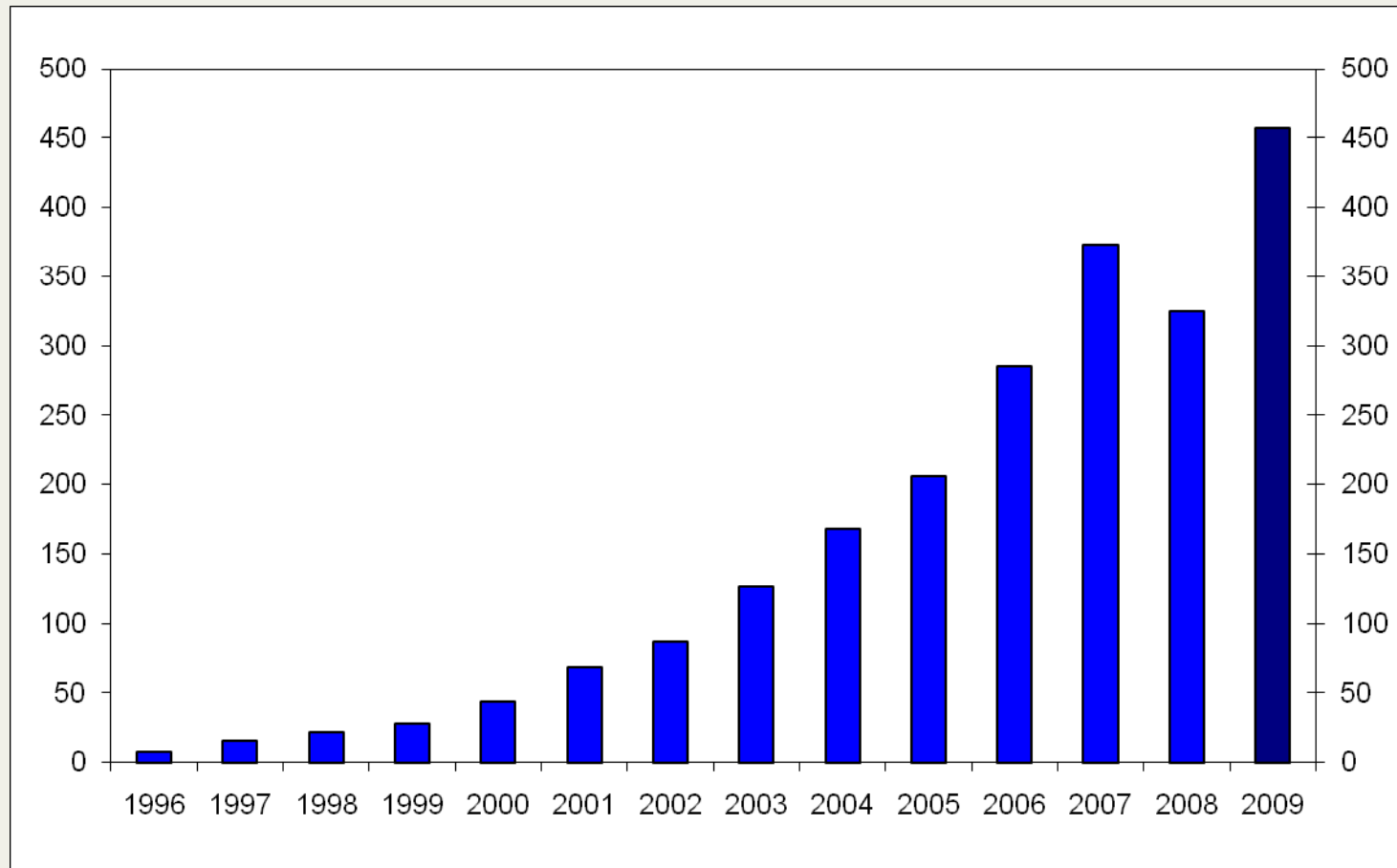
**FTSE Global All-Cap Index  
More than 7 000 equities**

**Fixed income index:**

**Barclays Capital Global Aggregate/Global  
Inflation Linked  
(Treasury/ Gov. Related / Corporate / Securitized)  
More than 10 000 bonds**

## Strong growth in value of Fund, but significant short term effect of financial crisis

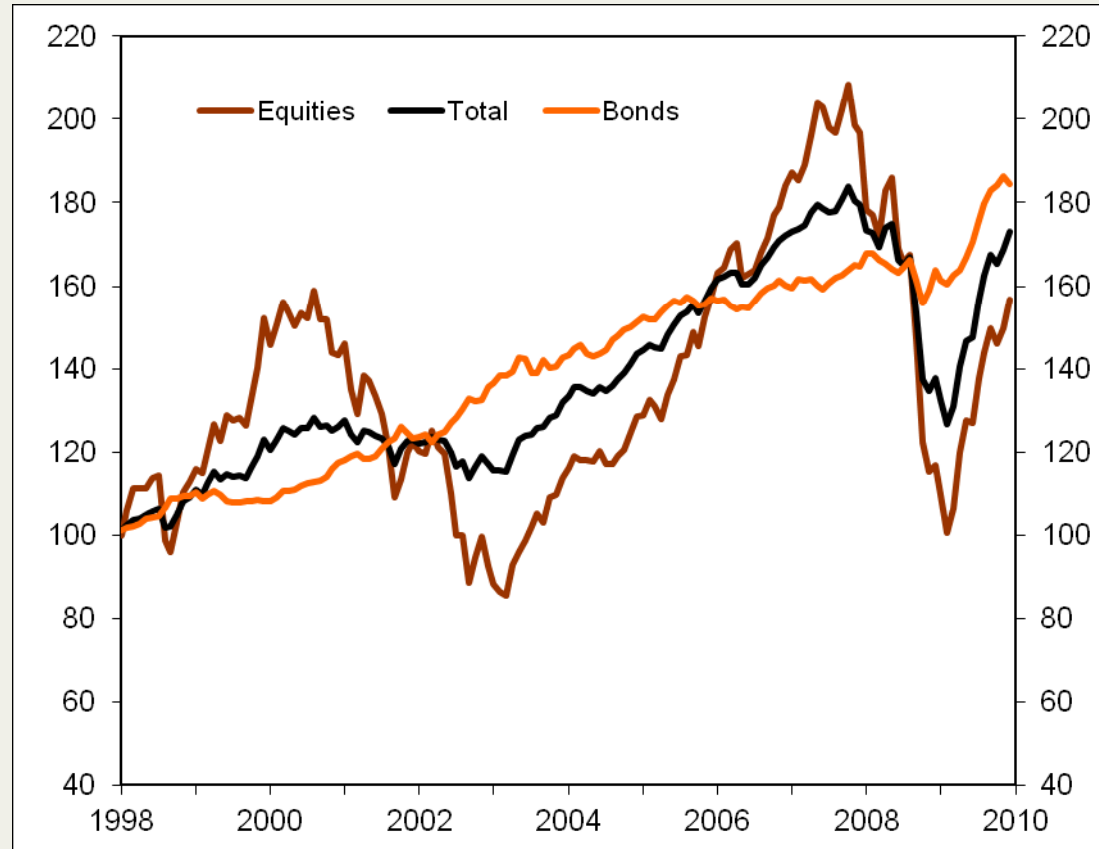
-The Fund's market value 1996–2009. Billion USD, year-end.



Source: Ministry of Finance

## Accumulated nominal return on the Government Pension Fund Global

End of 1997 = 100.



**Average net real return 1998–2009: 2.70 per cent (FX-basket)**

Source: Ministry of Finance

## Reporting and transparency

- Ministry reports to Parliament on all important matters relating to the Fund
- Ministry publishes all advice from external consultants
- Performance, risk and costs are reported every quarter and published on website. Focus on contribution to value added in operational management
- Press conference on a quarterly basis, shortly after an official meeting with the Ministry of Finance
- Annual report listing all investments, both equities and fixed income

## Some lessons:

- Don't move too fast
  - ✓ It takes time to build a competent organization
  - ✓ Gradual evolution of investment strategy to make sure risk is understood and managed well
- Don't take more risk than you can carry
  - ✓ The worst mistake you can do is to be forced to sell after you have lost money
- Your returns over time are determined by strategy – not by active management
  - ✓ You cannot outsource the decision on how much risk to take
- Clear division of responsibilities
- Transparency
  - ✓ Legitimacy
  - ✓ Reduced risk of corruption and mismanagement