Management of the Government Pension Fund

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The Fund mechanism – integrated with fiscal policy

Return on investments

**Fund**

Petroleum revenues

Transfer to finance non-oil budget deficit

**State Budget**

Revenues

Expenditures
- consumption
- investment (infrastructure, human capital)

***Fiscal policy guideline***
(over time spend real return of the fund, approximately 4%)
Ministry of Finance

Pension Fund Global Governance Structure

Founded on Act, regulations and separate contracts

Legislator

Norwegian Parliament

- Pension Fund Act

Office of the Auditor General

- Performance reports and strategic changes reported in National Budgets and National Accounts

Principal

Ministry of Finance

- Regulations

Advisors

- Advisory / consultancy agreement

Manager

Central Bank (NBIM)

- Management agreement

Norges Bank Audit

- Performance reports
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

- 1998: Few limitations on derivatives/short positions
- 2000: Some emerging markets (EM)
- 2002: 40% equities
- 2004: More EM, new ethical guidelines
- 2006: 60% equities, small-cap
- 2007: -Real estate
- 2008: -All EM equity markets
- 2010: Evaluation of active management
Ministry of Finance

Benchmark for the Pension Fund Global

**Strategic benchmark**

- **Equities 60%**
  - America and Africa: 35%
  - Europe: 50%
  - Asia and Oceania: 15%

- **Fixed Income 35%**
  - America: 35%
  - Europe: 60%
  - Asia and Oceania: 5%

- **Real estate 5%**

**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

Source: Ministry of Finance
Accumulated nominal return on the Government Pension Fund Global
End of 1997 = 100.

Source: Ministry of Finance

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