

Svein Gjedrem: Management of the Government Pension Fund – Global

Introductory statement by Mr Svein Gjedrem, Governor of Norges Bank (Central Bank of Norway), at the hearing before the Standing Committee on Finance and Economic Affairs of the Storting (Norwegian parliament), Oslo, 29 April 2009.

Please note that the text below may differ slightly from the actual presentation.

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I would like to thank the Committee for this opportunity to report on Norges Bank's investment management in connection with the Storting's deliberations on the Government report on the management of the Government Pension Fund – Global in 2008.

On behalf of the Government, the Ministry of Finance has delegated the responsibility for the operational management of the Government Pension Fund – Global to Norges Bank. The management mandate is specified in regulations and supplementary guidelines laid down by the Ministry. A management agreement has also been entered into. This model promotes a clear division of responsibilities, transparency and professionalism.

Norges Bank's Supervisory Council – appointed by the Storting – supervises the Bank's activities to ensure compliance with the rules and approves the Bank's budget and accounts. In accordance with the current Norges Bank Act, the Supervisory Council organises the audit of Norges Bank, appoints the central bank auditor and lays down audit instructions. An agreement was entered into, following a tender process, with the auditing firm Deloitte AS on financial auditing of the Fund with effect from the 2007 accounting year. Deloitte and Central bank Audit submit a joint auditor's report on the annual financial reporting for the Fund. The Government has submitted a draft bill recommending that the Supervisory Council should appoint an external auditor. This would be in line with international developments and best practice in this field.

The Executive Board is Norges Bank's executive authority. The Executive Board has increased its oversight of investment management in recent years. In 2006, an advisory board was set up to support the Executive Board in the field of investment management. The board comprises four experts with extensive experience from large funds and institutions managing equities, fixed income instruments and other assets.

Previously, Central Bank Audit was also responsible for Norges Bank's internal auditing. When Deloitte was made responsible for the financial auditing of the Fund's accounts, the Executive Board's audit committee and an internal audit unit were also established. The audit committee comprises three of the Executive Board's external members. The committee serves as a preparatory body for the Executive Board on matters relating to risk management and internal control.

In 2008, the Executive Board issued a new job description and investment mandate for the executive director of NBIM. The organisation of NBIM is based on the executive director's responsibility and authority as general manager of NBIM, which includes reporting directly to the Executive Board and regular supervision by the governor of Norges bank on behalf of the Executive Board. This virtually eliminates the possibility of one person holding a double role as both general manager and as chair of the Executive Board.

The executive director's investment mandate sets rules for the Fund's choice of investments and risk limits for NBIM's investment management. The financial crisis revealed that the risk measures used previously, and which were based on what was regarded as best international practice, were inadequate. The Executive Board has therefore also set supplementary risk limits, for example for the size of the percentage deviation between the actual portfolio and the benchmark portfolio, the degree of leveraging and liquidity requirements for the Fund's investments. The mandate is also intended to ensure that active

risk positions are taken in a balanced manner and to avoid active strategies with a considerably skewed outcome set.

NBIM's monthly and quarterly reports to the Executive Board are to reflect the guidelines in the investment mandate.

The results for 2008 were influenced by the global financial crisis. The total return on the Fund was a negative 23 per cent, the weakest in the Fund's history. There was a negative return of 41 per cent on the equity portfolio, while the return on the fixed income portfolio was close to zero. The real rate of return after costs has been one per cent since 1998.

International stock exchanges lost more of their value in 2008 than in any other single year in recent history. Absolute results, especially with regard to equities, were highly abnormal. An investor such as the Government Pension Fund – Global will earn more in the long term because of wide fluctuations in equity values. Many investors have suffered losses on equities. As a result of this experience, required returns will be higher in the future.

Under the Fund's investment strategy, more equities are purchased when equity prices fall and fewer when prices rise. Thus, the Fund purchased a large volume of equities in the period 2001-2003 and is buying a considerable volume now. Of the equities now held, 40 per cent were acquired in 2008 when prices were falling. The Fund's average ownership share in international equity markets was $\frac{3}{4}$ per cent at the turn of the year, with allocations to equities accounting for close to 50 per cent at that time.

The Fund has a longer investment horizon than the vast majority of other market participants. The important question is therefore how sound today's investments prove to be in the long term.

The government now owns a fair share of the global business sector. This represents real value that will provide a return reflecting both global economic growth and the risk related to fluctuations in equity prices.

The financial crisis is having a broad impact and most forms of investment are falling in value. State ownership in the Norwegian business sector and its share of subsea petroleum reserves on the continental shelf have declined in real value. For large investors, there have been few places to hide from the panic that has gripped financial markets. Prices for government bonds, particularly German and US bonds, rose last year, but yields are now very low and will provide little protection when inflation eventually picks up again. Household housing wealth also fell substantially in real value from summer 2007 to end-2008. The same probably applies to the value of infrastructure investments.

The return generated by Norges Bank's investment management in 2008 was 3.4 per cent lower than the benchmark portfolio against which we are measured. This is considerably weaker than might have been expected in the light of our investment strategy, which relies on a large number of small, independent positions.

In the period since 1998, the Fund has recorded a cumulative annual excess return of 0.04 percentage point lower than the return on the benchmark portfolio defined by the Ministry of Finance. Norges Bank's aim is to generate added value through our investment choices. After many years of high performance, the Fund is now right back where it started. The Fund's underperformance and the fall in overall return can largely be attributed to the financial crisis. Assessment of the results of our active choices should, in our opinion, also take into account the long-term perspective on which the Fund's investment strategy is based.

Norges Bank's investment results since 1998 are different for the two asset classes, equities and fixed income instruments.

Although active equity management generated negative results in 2008, these were well within the limits predicted by our risk models for any one year. However, since the beginning the annual excess return on equities has been close to $\frac{1}{2}$ percentage point. We have

established an equity management strategy that seems to be fairly robust to market fluctuations and that has, as we have seen, generated solid returns viewed over a longer period.

Developments in the Fund's fixed income portfolio have followed a different path. The annual return on the actual portfolio was ½ percentage point lower than the return on the benchmark portfolio.

The results were not due to investment in high-risk fixed income instruments.

At the end of 2008, as much as 64 per cent of the bonds in the Fund's fixed income portfolio had the best credit rating, AAA, 20 per cent had the second best, AA, while ten per cent were rated A. Five per cent of bonds were rated BBB, which is the rating the credit rating agency Standard & Poor's has assigned companies such as Telenor and Statkraft. Only one per cent of the fixed income portfolio has a lower credit rating. Realised losses as a result of bankruptcies have been low.

The following table provides a static situation report. As the recession follows its course, and the credit rating agencies continue to respond positively to criticism, ratings will probably be adjusted to a certain extent. The emphasis will nevertheless be on high-quality paper.

How then can an excess return become negative from one year to the next?

To explain this, allow me to draw your attention to developments in yields on bonds with a BBB rating, i.e. among the less high quality bonds in the Fund's portfolio. The above chart shows the pronounced changes in the difference in yield between these bonds and government bonds, or the credit spread. This does not per se reflect a higher risk of bankruptcies. If this were the case, perhaps half of these solid companies would have to file for bankruptcy in the course of a few years. In this analysis from the Bank of England, risk premiums on corporate bonds are instead divided into three components. One component takes account of expected losses and another uncertainty with regard to expected losses – in other words, fear. The third primarily indicates that these bonds have become illiquid, or more difficult to buy and sell. These liquidity premiums, and perhaps also premiums for the initial panic and fear, do not pose a problem for a fund like the Government Pension Fund. On the other hand, a prolonged period of fear and liquidity shortages – if the authorities are not able to reverse these developments – could lead to higher future losses.

The Fund's fixed income portfolio is well diversified across different types of bonds and different regions and the active strategies had low correlation in normal markets. However, the financial crisis revealed that these strategies were exposed to more underlying, systematic risk. Correlation was not expected to be high between investments in, for example, Japanese inflation-indexed government bonds, bonds issued by international organisations such as the European Investment Bank, European covered bonds and US mortgage-backed bonds.

These experiences and the abrupt turnaround in market liquidity suggest that active management of the fixed income portfolio should be limited and measured on the basis of a number of criteria, as laid down by Norges Bank's Executive Board.

The Fund currently has extensive holdings of bonds that are difficult to trade in today's market. Realised losses related to these investments have, as mentioned above, been limited. The flipside of large book losses is that this portfolio has a high return, reflecting not only the increase in credit risk but also high liquidity premiums and fears and uncertainty in the market. The return, measured as the difference in the effective interest rate between the actual portfolio and the benchmark portfolio, is now close to two percentage points.

History has seen a number of deep financial crises, and market conditions will return to normal in time.

The final results of the management of the Fund's fixed income portfolio since the beginning of the financial crisis cannot be deduced from the quarterly results while the crisis is at its

most intensive. Values are not lost as long as borrowers fulfil their obligations. The Fund is prepared to retain ownership of a large volume of bond holdings until they mature in a few years. Moreover, unless the economic outlook goes from bad to considerably worse, the Fund will record a substantial excess return in the years ahead.

The Ministry of Finance has set risk limits for Norges Bank's management of the Fund. This limit is defined using a statistical concept – expected tracking error (relative volatility) – which puts a ceiling on how far the Fund's actual investment portfolio can deviate from the benchmark portfolio. Expected tracking error must not exceed 1.5 percentage points or 150 basis points. This limit entails an expectation that the gap between the return on the fund and the benchmark portfolio will be less than 1.5 percentage points in two out of every three years.

At the beginning of 2008, the Fund's expected tracking error was 43 basis points, which is slightly higher than the historical average for the fund. Expected tracking error then increased gradually through 2008. Towards the end of the year, observations were at the highest levels in the history of the fund. At the end of October 2008, expected tracking error exceeded the limit set by the Ministry of Finance.

This relative increase in market risk occurred at a time of wide daily market fluctuations. It was not the result of new active risk positions. Although new investments were of course suspended, there were no fire sales either under the prevailing conditions. Market risk has subsequently decreased considerably.

In conclusion:

The fund is a long-term savings plan and capable of riding out large swings in the markets. This is the very foundation of the investment strategy with its high allocation to equities. Our ability to adhere to this strategy in a critical phase – even if this should last some time – is crucial if the fund is to deliver the returns we expect in the longer term.

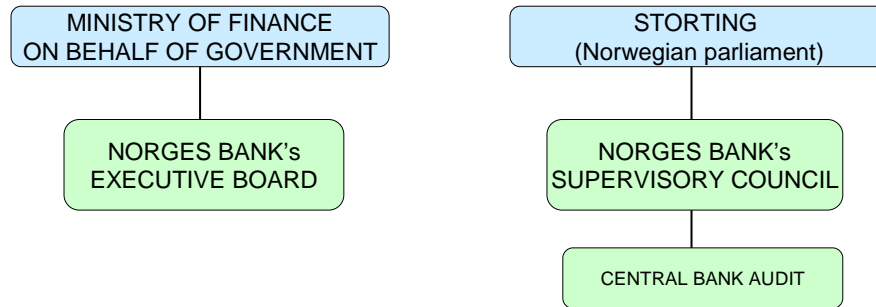
In 2008 Norges Bank's management results were weak in both absolute and relative terms. Relative returns in 2008 were significantly worse than might have been expected based on the investment strategy chosen. In the management of the fixed income portfolio, the crisis in the financial system revealed that risk exposure in the various mandates was not sufficiently independent.

The Executive Board has reinforced its oversight of the Bank's investment management. It has issued a new mandate to NBIM that delegates investment management responsibility and introduces additional limits in the risk profile for investment management.

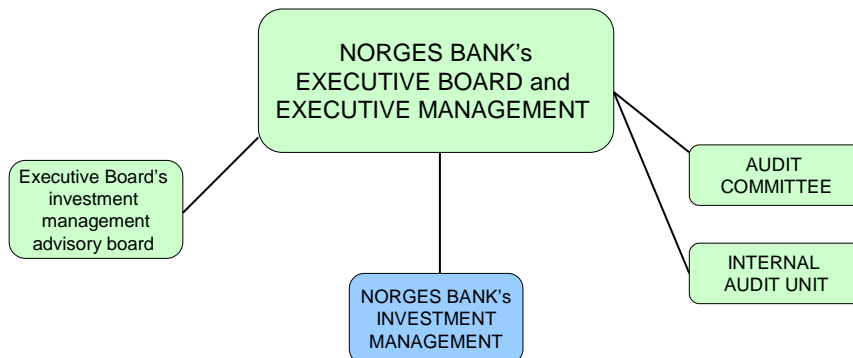
As with the fund's long-term investment strategy, the results of our operational management of the fund need to be measured over time. I am confident that the operation we have built up will deliver good results in the long term.

Thank you for your attention!

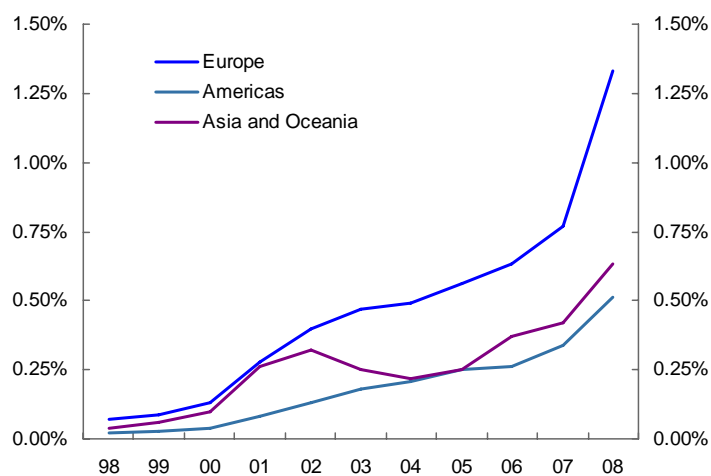
Governance model



Management structure of Norges Bank



Long-term ownership



Sources: FTSE and Norges Bank

Government assets

Fall in market value in 2008. In billions of NOK

Government Pension Fund – Norway	-30
Government direct ownership ¹	-230
Government share of subsea petroleum reserves ²	-2 200
Government Pension Fund – Global ³	-130 (-630)

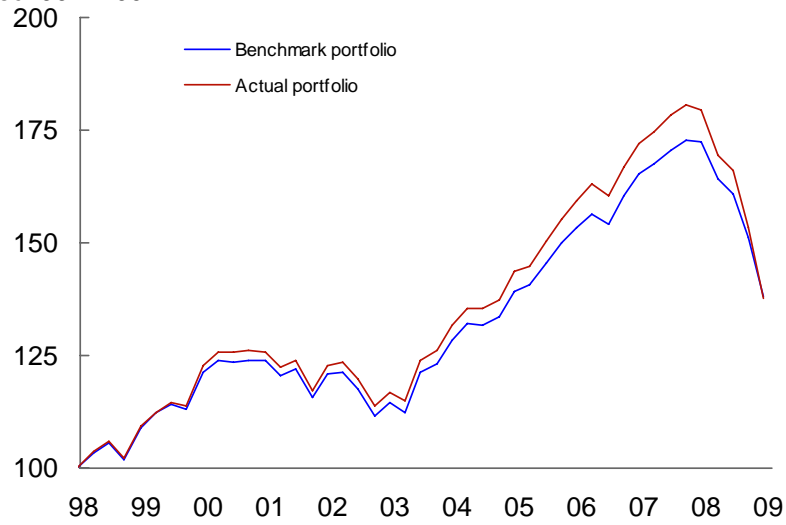
Household housing wealth ⁴	-400
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- 1) Decrease in value adjusted for dividends. Companies listed on the stock exchange
- 2) Fall in value of the government share of subsea petroleum reserves with a decline in the price of oil from NOK 500 to NOK 300 per barrel. The oil price was approximately NOK 500 per barrel at the beginning of 2008 Q4 and has varied between NOK 260 and NOK 350 per barrel in 2009
- 3) Negative return in NOK. Negative return measured in international currency in brackets
- 4) Fall in housing wealth from August 2007 to 2008 Q4 (nominal terms)

Sources: Ministry of Finance, Ministry of Trade and Industry, Folketrygdfondet and Norges Bank

Return 1998 - 2008

Benchmark portfolio and actual portfolio. Indexed, 31
Dec1997=100

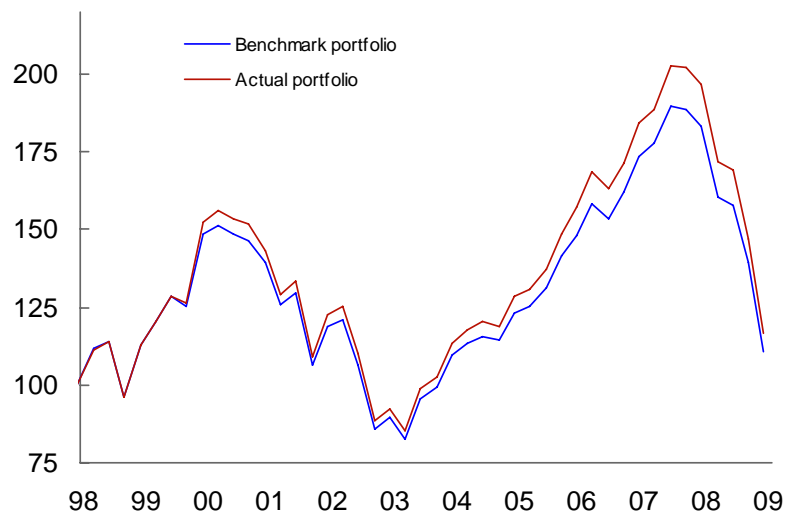


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Return on equities 1998 - 2008

Benchmark portfolio and actual portfolio. Indexed, 31
Dec1997=100

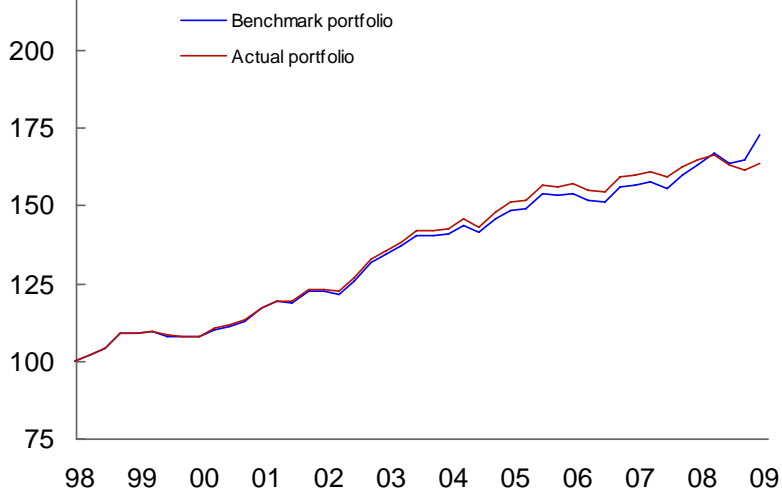


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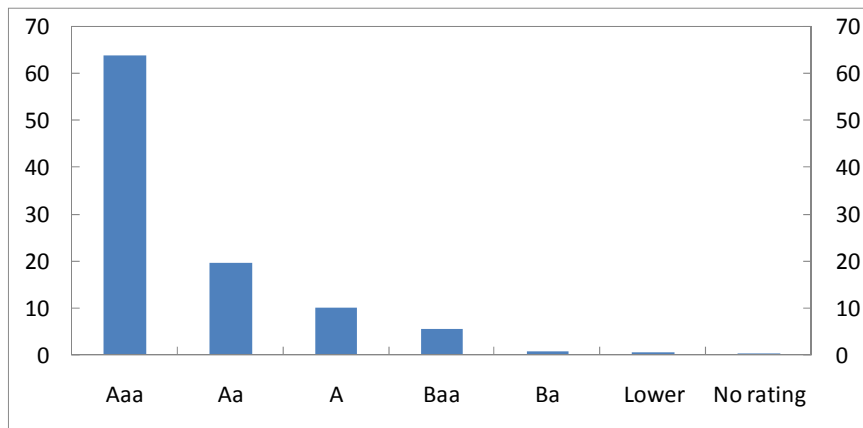
Return on fixed income instruments 1998 - 2008

Benchmark portfolio and actual portfolio. Indexed, 31 Dec 1997=100

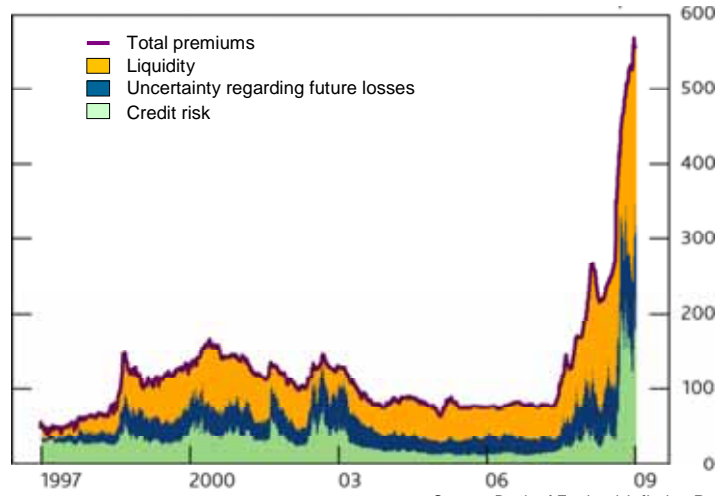


Credit ratings, fixed income portfolio¹⁾

Government Pension Fund - Global. Per cent as at 31 Dec 2008



Risk premiums for corporate bonds



Source: Bank of England *Inflation Report*, February 2009

Risk – expected tracking error (relative volatility)

