Øystein Olsen: Financial economics and the challenges in managing Norway's Government Pension Fund

Introductory remarks by Mr Øystein Olsen, Governor of Norges Bank (Central Bank of Norway), at the NBIM (Norges Bank Investment Management) Financial Research Conference, Oslo, 30 August 2011.

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It is a great pleasure for me to welcome each of you to the first NBIM Financial Research Conference. The objective of today's conference is to present and discuss a set of papers at the forefront of academic research on financial economics.

This event is also part of Norges Bank's efforts to strengthen ties with the academic community. In addition to some of the best researchers in financial economics, we have in this room some of the top investment professionals in Norway. The opportunities for interesting discussions should be good.

At the outset, the intention of this conference was to present leading academic research, without placing weight on its direct relevance to NBIM. However, as this conference will show, there is considerable common ground between the research frontier of financial economics and our challenges in managing the Government Pension Fund.

Over the last three decades, researchers have moved a long way from the Capital Asset Pricing Model. One important result of empirical financial research is that expected returns on traded assets vary much more over time and across assets, than was previously thought and implicitly assumed by the CAPM.

Researchers have documented and studied how asset valuations seem to move far more on news that affects risk premiums than on news on future cash flows. This was vividly illustrated by the market turbulence of 2008–2009, as well as the last few weeks.

In their investigation of why risk premiums vary so much, researchers have moved far beyond the simplest models of introductory finance classes. Theoretical progress, data availability and computational advances have made it possible to study the implications of potentially important features:

- investors are different and not necessarily fully informed or rational;
- markets are incomplete and have frictions;
- returns might have fat tails and face sudden disasters;
- and government regulations are important.

Models of investor heterogeneity, non-tradable, non-financial risk, market frictions and time-varying uncertainty go a long way in accounting for variations in market risk premiums. This has profound implications for portfolio theory and practical portfolio strategies. Modern portfolio theory builds on differences in defining characteristics between investors. Investors with distinctly different non-tradable, non-financial risk, who are affected differently by market frictions and regulations, should hold different portfolios.

In the NBIM Strategy Plan for 2011–2013, we stated that *we will implement an investment strategy built on the Fund's defining characteristics – with strategies that are long-term oriented, scalable, and focused on underlying value*. This sentence covers a wide range of interesting questions. All the speakers today will, in fact, offer perspectives on the challenges outlined here.

All the prominent scholars who are presenting papers today will analyse some of the aspects of how and why market risk premiums vary. Financial regulations and financial frictions are

important to our understanding of why risk premiums change over time. A thorough understanding of financial regulations and financial frictions might also be important in identifying unique investor characteristics.

Axel Weber will shed light on the implications of financial sector regulation on the functioning of markets and the pricing of assets.

Lasse Pedersen has provided valuable research on the micro structure of funding markets and how liquidity risks create systemic problems. In particular, he will cover frictions in financial markets.

It is quite clear that the Government Pension Fund differs from the average investor in important respects. In addition, we need to understand how variation in risk premiums can be consistent with highly competitive financial markets. Why don't all investors buy "value" or rebalance?

Ken Froot will talk about rare events and disaster risks, how these events are priced in markets. He will also give insights on individual investor characteristics which give comparative advantages in holding these priced risk premiums.

Ken French will speak about two ways for an investor to generate excess returns: informational advantages and systematically harvesting risk premiums which the investor has a comparative advantage in holding.

Both Froot and French will mainly talk about average portfolio weights in highly competitive markets. In the last talk today, ***Stan Zin*** will cover how different investors will change asset weights over time. He will also discuss what kind of risks an investor is exposed to through rebalancing and why investors might look at the same risk-reward trade-off differently.

All of these exciting papers we will discuss today offer interesting perspectives for academic researchers and practitioners alike. As I argued at the start of my talk here, the challenges facing the management of our fund overlap with the research frontier of financial economics. However, we should not expect final and absolute answers. CAPM, partly developed by our own Jan Mossin, represented a huge leap forward in 1966. Today it has been replaced by better tested theories, just as future research will make today's research frontier look antiquated.

Rounding off the day, the CEO of NBIM, ***Yngve Slyngstad***, will present the Norwegian Finance Initiative. This is part of NBIM's efforts to build capacity to ensure our strategies have a well-founded theoretical basis.