Jan F Qvigstad: The global economic crisis and its impact on Sovereign Wealth Funds – the example of Norway

Speech by Mr Jan F Qvigstad, Deputy Governor of Norges Bank (Central Bank of Norway), at a meeting for financial sector representatives in Geneva hosted by the Royal Norwegian Embassy, Geneva, 11 May 2009.

The text below may differ slightly from the actual presentation.

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Introduction

Ambassador, Ladies and Gentlemen

First, let me thank you for inviting me to this seminar for a discussion on the impact of the global economic crisis on sovereign wealth funds.

Since I am the deputy governor of a central bank that manages one of the large sovereign wealth funds, I will use the Norwegian Government Pension Fund – Global as an example in my presentation.

The financial and economic crisis

What we are experiencing at this time is the deepest downturn in the world economy in the postwar period. The global economy will contract in 2009 for the first time in over 60 years. What is happening now is more than a normal fluctuation in the business cycle. The world is facing a crisis of confidence, with faltering faith in the future and a loss of confidence in banks, counterparties and contractual partners.

The first signs of an emerging crisis in financial markets came into evidence already in early 2007, when several financial institutions in the US came under stress. It intensified in August the same year, with the bankruptcies of the British bank, Northern Rock, and troubled banks in Denmark and Germany. On 15 September 2008, the crisis took a new and dramatic turn when Lehman Brothers filed for bankruptcy. The next day, money markets seized up. Confidence between banks had been compromised. Liquidity dried up, interest rates rose sharply and equity prices fell. Exchange rate volatility – the daily fluctuations in the exchange rate – showed a marked rise. Bond markets in turn shut down. In the days and weeks that followed, banks tightened credit standards on new loans to households and enterprises.

At that time, global economic growth was already slowing, but the situation deteriorated significantly throughout the last few months of 2008. The turnaround hit hard, with synchronised effects on virtually all financial and goods and services markets, not only in the US but also in Europe, Asia, Latin America and Oceania. For a long period there were hopes that growth in China and other emerging market economies would hold up. But they are also severely affected by the crisis.

During the year, we saw a bank, credit and liquidity crisis in the financial system which gradually came to encompass a crisis in the real economy.

The contraction in the world economy has resulted in a substantial decline in traditional exports, and global trade has fallen markedly since autumn last year.

The global downturn also led to a marked fall in prices for oil and other commodities through autumn 2008. For Norway and other countries that are dependent on exports of oil, gas and other commodities, government revenues and current account surpluses are reduced. This will most likely curb the growth of sovereign wealth funds in the near-term future.
The financial crisis dealt a heavy blow to investors all over the world, as global equity prices plummeted. 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 possibly 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.

For investments in fixed income markets, the picture is more varied. The crisis resulted in large and unexpected fluctuations in various parts of the fixed income market. While government bonds in some countries were regarded as “safe havens”, with a subsequent surge in prices, segments of the fixed income market were hit by higher credit premiums and dwindling liquidity.

The crisis presented major challenges for risk management. Historical relationships between risk factors collapsed, and liquidity was greatly reduced in most markets. Market volatility was very high in both equity and fixed income markets, and market movements were on par with the most volatile periods of the past century.

Clearly, these adverse developments have affected many sovereign wealth funds (SWFs) in the same way as they have affected other investors. It is, however, difficult to determine how strong the impact has been as available information about individual SWFs and their inflows, outflows, return and market values vary.

Let me therefore use the Norwegian Government Pension Fund – Global as an example. As you can see from this chart, the Norwegian fund is among the largest sovereign wealth funds, with total assets of some USD 350 billion at end-2008.

**The Norwegian Government Pension Fund – Global**

Before I talk about the Fund’s performance last year, please allow me to explain the principles and strategies underlying the Fund.

The Norwegian oil era started some 40 years ago, when oil was first discovered in the North Sea. Since then, the petroleum sector has grown to become an important part of our economy. Today, petroleum accounts for approximately 25 per cent of Norway’s gross domestic product (GDP) and nearly 50 per cent of total exports.

Norway’s total petroleum production will remain high for many years to come, even though production of oil is now declining after peaking around the turn of the millennium.

The economic challenges posed by petroleum extraction were widely recognised early on. As early as in 1974, the Norwegian parliament discussed these challenges in depth, and in the early 1980s, the idea of a fund that would stabilise petroleum revenue spending was launched. Due to domestic economic turmoil and financial crisis in the late 1980s and early 1990s, it took time before the idea of a fund was turned into actual savings.

The first allocation – some USD 400 million – was not made until 1996. Since then, the Fund has grown rapidly in size. As you have already seen, the Fund’s assets are currently valued at around USD 350 billion. The Fund is expected to grow further in coming years, and may double in 5-10 years.

The Fund was established as a tool to support prudent management of Norway’s petroleum wealth. One purpose is to shield the non-oil economy from price fluctuations.

The Fund is also a long-term savings instrument. It will help to cope with future financial commitments linked to an ageing population. Accumulation of capital in the Fund reflects the depletion of a non-renewable resource, which is exchanged for financial assets through the Fund’s investments. By setting up the Fund, it became possible to establish a path for
production of oil and gas that is independent of the profile for petroleum revenue spending. The alternative to a fund would have been to directly regulate production by putting a conservative upper limit on annual extraction.

Furthermore, to effectively shield the non-oil economy, and to make sure that private sector investment decisions could be made independently of the public sector’s saving of petroleum wealth, the Fund is only invested abroad. This also enhances the expected return on government wealth and contributes to diversification of risk.

The Fund is by law fully integrated with the government budget, and the same priorities are imposed on spending from the Fund as on any other government spending. This means that the entire petroleum revenues are transferred to the Fund. Then, as part of the budget resolution, the Norwegian parliament decides on an annual transfer from the Fund to cover the government budget deficit. This procedure effectively prohibits use of the capital in the Fund for purposes not considered sufficiently important to be prioritised in the regular budget process.

In 2001, the Norwegian parliament approved new fiscal policy guidelines stipulating that the annual transfer from the Fund to the fiscal budget — that is annual spending of oil money — should correspond to the expected real return on the Fund. The expected real return is estimated at 4 per cent. The point of reference for the spending rule is a normal cyclical situation. In the event of particularly high capacity utilisation, spending should be lower than 4 per cent, whereas in a cyclical downturn, somewhat higher spending may be appropriate.

The governance structure is based on a clear division of responsibilities between the political authorities and the operational management.

- The Ministry of Finance is the owner of the Fund. The Ministry defines the mandate and monitors and evaluates performance. Key changes to investment guidelines are presented to the Norwegian parliament before implementation.

- The management of the Fund is delegated to Norges Bank. The Bank’s task is to implement the investment strategy and exercise ownership rights. Norges Bank also provides professional advice to the Ministry on investment strategies.

Norges Bank has built an organisation with emphasis on investment returns and based on three fundamental principles: Accountability, transparency and professional standards.

Norges Bank manages parts of the funds internally, while parts are managed by external managers appointed by the Bank on a commercial basis.

Transparency and disclosure of information are key features of the Fund. All investment principles and guidelines as well as strategic advice and second opinion reports are made public. We publish quarterly reports on Fund performance, which are presented at press conferences. The Fund’s annual report discloses a list of every single investment held at the end of the year, and also provides an overview of corporate governance work, including voting at general meetings.

Initially, transparency was aimed at building confidence among Norwegians, but we have also seen that our policy of transparency is highly appreciated internationally.

The Fund’s investment strategy is to maximise financial return with moderate risk. The long-term strategic allocation is defined in terms of a benchmark portfolio, which consists of equities and fixed income instruments. Equities account for 60 per cent of the Fund’s strategic benchmark portfolio, while fixed income instruments account for 40 per cent.

Last year, the Ministry decided that the Fund should prepare the ground for investing in real estate at 5 per cent of the strategic benchmark portfolio. In time, this may reduce the fixed income share to 35 per cent.

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 currently owns a little more than 1¼ per cent of listed European equities, and the Fund’s average ownership share in international equity markets was ¾ per cent at the turn of the year, with allocations to equities accounting for close to 50 per cent at that time.

The Government Pension Fund – Global is invested in almost 7900 equities and bonds from 2200 different issuers. Although the Fund is well diversified, its size means that it will have large individual positions in capital markets.

The largest equity holdings include multinational companies like Royal Dutch Shell, Nestlé, BP, Exxon Mobil Corporation and Novartis, to name a few.

Since summer 2008, the Ministry of Finance has allowed the Fund to hold up to 10 per cent of a company’s shares. At end-2008, the largest ownership interests were in British Mondi (8.7 per cent), Australian Babcock & Brown Infrastructure Group (7.8 per cent) and Finnish UPM-Kymmene (5.8 per cent).

In bond markets, the largest issuers are sovereign states. The Fund will therefore normally have large holdings of government debt. The Fund’s average share of market capitalisation in fixed income markets at the end of 2008 was around ½ per cent.

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.

**Active ownership**

Active ownership has also become an important part of Norges Bank’s investment operations. The purpose is to help safeguard financial wealth for future generations by promoting good corporate governance and encouraging high ethical, social and environmental standards at investee companies.

As a shareholder in almost 7 900 companies, Norges Bank has both rights and obligations in relation to these companies. Our long time horizon exposes us to developments in markets traditionally of less concern to more short-term investors.

We use our position as a shareholder to address topics relating to traditional shareholder rights, such as the right to equal treatment and influence. We also focus on topics that influence the development and regulation of companies’ input factors – both regarding human resources such as labour, in particular children’s rights, and natural resources such as access to clean water and clean air.

Norges Bank’s Executive Board has established a set of principles and a strategy for the exercise of ownership rights. Openness and transparency are key principles in the management of the Government Pension Fund – Global, and we aim to be as open as possible about our active ownership work.

Our active ownership is practised in a number of different ways: through the exercise of voting rights, through dialogue and engagement with individual companies, through collaboration with other investors, through submissions to the regulatory authorities, and through research and public communication. We aim to vote at all general meetings of the companies in which the Fund has shares. We voted on 68 724 items at 7 871 general meetings in 2008.
The impact of the crisis on the Norwegian Fund

The Norwegian Fund has been hard hit by the crisis. In 2008, 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 1 per cent since 1998. This is well below the assumed long-term return of 4 per cent.

The negative return reduced the value of the Fund by nearly USD 100 billion. At the same time, new capital of close to USD 60 billion was transferred to the Fund during the year, the largest annual inflow in the Fund’s history. Furthermore, a weaker krone in relation to the currencies in which the Fund is invested increased the Fund’s value by some USD 80 billion. Consequently, in spite of the negative return, the Fund’s market value increased by nearly USD 40 billion during the year.

The market value of the Pension Fund was around USD 350 billion (NOK 2 275 billion) at the end of 2008.

The financial crisis is having a broad impact, and most forms of investment are falling in value. Other government assets, such as shareholdings in domestic industries and subsea resources in the North Sea have also fallen sharply in value, at market prices. 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. For households, housing wealth has also declined since summer of 2007 to the end of 2008. The same probably applies to the value of infrastructure investments.

After a little more than 10 years of experience, the Norwegian Fund has not reaped a risk premium in equity market as we had expected.

The return generated by Norges Bank’s investment management in 2008 was 3.4 per cent lower than the benchmark portfolio used as performance measure. This is considerably weaker than might have been expected in 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 ½ 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. Only one per cent of the fixed income portfolio has a lower credit rating. Realised losses as a result of bankruptcies have been low.

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

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, have 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 peak. 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.

**Conclusion**

The Norwegian Pension Fund has been hard hit by the crisis. Norges Bank’s management results in 2008 were weak in both absolute and relative terms. Relative returns 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. We also learnt that we must ensure clear responsibilities and limits to delegation.

The fund is a long-term savings plan and capable of riding out large market swings. 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. Norges Bank’s Executive Board has reinforced its oversight of the Bank’s investment management. It has issued a new mandate 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 based on active management and active ownership, the results of our operational management of the Fund need to be measured over time. To that extent, we need to maintain an incentive structure in order to retain and build long-term competence. We also need to ensure the quality of the investment management. In our view, the search for excess return has had a strong disciplinary effect on the organisation.
I am confident that the operation we have built up will deliver good results in the long term. Thank you for your attention!

“The global economy is in a severe recession inflicted by a massive financial crisis and acute loss of confidence”

IMF, World Economic Outlook, April 2009

Fall in all countries and markets
Index. 1 January 2004 = 100 and per cent (global trade)

1) Sum exports and imports in the US, Japan, Germany and China. USD 12-month change. Per cent

Source: Thomson Reuters
Fall in equity markets

Ten-year rolling real return on global equity markets 1908-2008. Per cent

Sources: Dímez, Marsh and Glaubton and Norges Bank

Higher credit spreads for private securities

Credit spread between corporate and US government securities. Percentage points

1) Moody's Baa-rated 10-year yields. Source: Thomson Reuters
**Increased market risk**

Absolute volatility 2004-2008. Per cent and in billions of USD

- **Per cent, left-hand scale**
- **Billions of USD, right-hand scale**

Source: Norges Bank

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**Major Sovereign Wealth Funds**

Assets in billions of USD

1) Based on figures available to Sovereign Wealth Fund Institute in March 2009

Source: Sovereign Wealth Fund Institute and Norges Bank
**Petroleum production in Norway**

Mill. scm oil equivalents per year. 1970-2030

![Graph showing petroleum production in Norway](image)

Source: Norwegian Petroleum Directorate

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**Governance Structure**

Norway's Government Pension Fund – Global

![Governance Structure diagram](image)

Source: Norges Bank
Main properties of the Fund

- **Accountability**
  A clear division of responsibilities and a system of checks and balances

- **Transparency**
  Open information on performance, risk, costs and investments

- **Professionalism**
  All investment decisions delegated to professionals in a clear line structure division

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Benchmark for the Fund

- **Strategic benchmark**
  
  - **Equities 60 %**
    - America and Africa 35 %
    - Europe 60 %
    - Asia and Oceania 15 %
  
  - **Fixed Income 40 %**
    - America and Africa 35 %
    - Europe 60 %
    - Asia and Oceania 5 %

Source: Ministry of Finance
Ownership of equity markets
Per cent. 1998 – 2008

Norway’s GPFG – large equity holdings
Holdings on 31 December 2008

<table>
<thead>
<tr>
<th>Company</th>
<th>Country</th>
<th>Millions of USD</th>
<th>Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royal Dutch Shell plc</td>
<td>UK</td>
<td>2 355</td>
<td>1.37 %</td>
</tr>
<tr>
<td>Nestlé SA</td>
<td>Switzerland</td>
<td>2 299</td>
<td>1.42 %</td>
</tr>
<tr>
<td>BP plc</td>
<td>UK</td>
<td>2 029</td>
<td>1.33 %</td>
</tr>
<tr>
<td>Exxon Mobil Corporation</td>
<td>US</td>
<td>1 885</td>
<td>0.43 %</td>
</tr>
<tr>
<td>Mondi plc</td>
<td>UK</td>
<td>101</td>
<td>3.71 %</td>
</tr>
<tr>
<td>Babcock &amp; Brown Infrastr. Gr.</td>
<td>Australia</td>
<td>15</td>
<td>7.64 %</td>
</tr>
<tr>
<td>UPM-Kymmene OYJ</td>
<td>Finland</td>
<td>400</td>
<td>5.77 %</td>
</tr>
<tr>
<td>Novartis AG</td>
<td></td>
<td>1 597</td>
<td>1.13 %</td>
</tr>
<tr>
<td>Roche Holding AG</td>
<td></td>
<td>1 542</td>
<td>1.08 %</td>
</tr>
<tr>
<td>Zurich Financial Services AG</td>
<td></td>
<td>622</td>
<td>1.90 %</td>
</tr>
</tbody>
</table>
Ownership of fixed income markets
Per cent\(^1\), 1998 – 2008

1) Per cent of Barclays index's market capitalisation.

Active ownership

Our goal
- Promote sustainable development and sound corporate governance in order to safeguard the financial interests of the fund

Our tools
- Proxy voting
- Company dialogue and engagement
- Investor networks
- Contact with regulators and standard setters
- Communicate principles for good corporate governance
Active ownership
What do we do?

Address topics relating to traditional shareholder rights
- The right to vote
- The right to participate in board elections
- The right to sell
- The right to information

Focus on topics that influence the development and regulation of companies’ input factors
- Social issues – children’s rights / child labour
- Environmental issues

2008 – An unusually demanding year
Annual changes in market value 1996-2008. In billions of USD

Source: Norges Bank
Market value of Norway's Pension Fund
Per cent of mainland GDP and in billions of USD

<table>
<thead>
<tr>
<th>Year</th>
<th>Per cent of GDP (left-hand scale)</th>
<th>Billions of USD (right-hand scale)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1995</td>
<td>20</td>
<td>100</td>
</tr>
<tr>
<td>1997</td>
<td>30</td>
<td>150</td>
</tr>
<tr>
<td>1999</td>
<td>40</td>
<td>200</td>
</tr>
<tr>
<td>2001</td>
<td>50</td>
<td>250</td>
</tr>
<tr>
<td>2003</td>
<td>60</td>
<td>300</td>
</tr>
<tr>
<td>2005</td>
<td>70</td>
<td>350</td>
</tr>
<tr>
<td>2007</td>
<td>80</td>
<td>400</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Norges Bank

The losses in perspective
Lower market values of government assets in 2008. In billions of USD

<table>
<thead>
<tr>
<th>Asset Category</th>
<th>Value (in billions of USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Pension Fund – Norway</td>
<td>-6</td>
</tr>
<tr>
<td>Government direct ownership¹</td>
<td>-35</td>
</tr>
<tr>
<td>Government share of subsea petroleum resources²</td>
<td>-350</td>
</tr>
<tr>
<td>Government Pension Fund – Global³</td>
<td>-20 (-96)</td>
</tr>
<tr>
<td>Household housing wealth⁴</td>
<td>-60</td>
</tr>
</tbody>
</table>

¹ Negative return adjusted for dividends of listed companies
² Estimated decrease in value based on reduced oil price
³ Negative return measured in NOK. Negative return measured in international currency in brackets
⁴ Reduced value of housing wealth from August 2007 to Q4 2008 (nominal values)

Sources: Ministry of Finance, Ministry of Trade and Industry, Foresight, and Norges Bank
Return 1998 – 2008
Benchmark portfolio and actual portfolio. Indexed, 31 Dec 1997 = 100

Return on equities 1998 – 2008
Benchmark portfolio and actual portfolio. Indexed, 31 Dec 1997 = 100
Return on fixed income 1998 – 2008
Benchmark portfolio and actual portfolio. Indexed, 31 Dec 1997 = 100

Lessons from the crisis

- Investment strategy: Correlation between diverse assets in the fixed income portfolio. Liquidity may have been structurally underpriced
- Risk management: Statistical models based on historical prices and correlations proved insufficient
- Organisation and governance: Ensure clear responsibilities and limits to delegation
Focus from Norges Bank’s Executive Board

- Maintain an incentive structure in order to retain and build long-term competence
- Ensure the quality of the investment management organisation. If you aim for the average the outcome will be mediocre
- Our size and active ownership strategy requires an active investment strategy