Managing Norway’s oil wealth

Speech by Governor Øystein Olsen at FeBAF, the Italian Banking, Insurance and Finance Federation, Rome, 14 April 2015.

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

Introduction

First, let me thank you for the opportunity to speak here at FeBAF – the Italian finance federation.

Norwegians love Italy for its food and wine, its architecture, its great cities and breath-taking scenery. Italy is blessed with both natural and cultural assets that have been refined and managed by the Italian people for hundreds of years.

Norway is not known for its wine, but I think it is safe to say that we have been more than lucky in terms of natural resources. The management of Norway's currently most important natural resource – petroleum – is the topic of my speech today.

Over the past two decades, Norway has transformed oil and gas resources into financial wealth. Oil revenues are invested abroad through a sovereign wealth fund – the Government Pension Fund Global, or the oil fund for short – which is managed by the central bank of Norway.

My speech today is intended to shed some light on how Norway's petroleum wealth has been managed. I will seek to explain how we see ourselves as a global financial investor. I will also elaborate on the main elements of our investment strategy.

Historical background

Chart: GDP per capita in Norway, 1970-2015. Indexed to OECD

To put the Norwegian economy and our wealth position into some perspective, let me start by going back in time. When the first oil was brought to the surface in 1971, income levels in Norway were low compared with other western countries. The picture has reversed since then. We have gradually caught up to the wealthiest nations. Measured by GDP per capita, Norway now ranks close to the top.

Even excluding the oil sector, Norway's mainland economy has shown relatively robust developments. But there is no doubt that the extraction of oil and gas has played a major role. Given the high oil prices of the past fifteen years in particular, a booming oil industry has been an important driver of economic growth. Last year, the petroleum sector accounted for more than 50 percent of our exports, and more than 20 percent of GDP.

Chart: Business investment

The high oil prices of recent years have spurred investment in the petroleum sector to record-high levels. The level of investment in this sector in 2014 was as high as total investment in domestic non-oil industries. The positive spillovers to the oil service industry and other business sectors have been substantial, in particular through the past decade. Norwegian employment has remained high and unemployment low, even when the financial crisis hit in 2008. It is estimated that 1 out of 9 jobs in Norway are linked to the oil industry.

Fiscal rule

It was established at an early stage that Norway's oil and gas resources belong to the Norwegian people. The tax system for the petroleum industry was designed to make sure that the bulk of the large revenues, the economic rent from the petroleum sector, would accrue to the state. Petroleum companies pay a surtax of 51 percent of profits, on top of the normal corporate tax rate of 27 percent. The government also has direct ownership shares in the most profitable oil fields.

However, policymakers' handling of Norway's newly discovered petroleum wealth got off to a rather bumpy start. During the first 25 years of oil production, Norway experienced two deep recessions. Both downturns were rooted in hugely optimistic income expectations. In the 1970s, the public sector was the big spender, and the government had to tighten policy later on. In the 1980s, a credit-fuelled consumption boom in the private sector led to necessary cut-backs after the oil price plunge in 1986.

These two episodes of turbulence made clear how vulnerable a small open economy is to terms of trade disturbances, as well as to short-termism and exuberant expectations. To prevent the same mistakes from being made again, fiscal institutions were set up in the 1990s. Among the most important of these are the oil fund and the fiscal rule.

Chart: The fund mechanism

The Norwegian parliament passed the act relating to the oil fund in 1990. Under the act, the net fiscal surplus, including oil revenues, is transferred to the fund, and invested in international markets. A main purpose of the fund mechanism is to make the actual spending of oil revenues transparent.

Towards the end of the 1990s, inflows to the oil fund increased, and there were expectations of considerable petroleum revenues in the future. There was increasing political pressure to spend more. In a climate of high inflows and even higher expectations, it was demanding to restrain fiscal spending. At the same time, it was clear that future pension obligations would be substantial.

Economic policy guidelines were clarified in 2001 through the introduction of the fiscal rule. Under these guidelines, government spending of oil revenues – measured by the non-oil budget deficit – is limited to the expected real return on the fund – estimated at 4 percent annually. The idea is to leave the capital in the fund untouched, saving it for future generations.

Chart: A growing fund

The fiscal institutions that were established proved to be well suited to managing the revenues from the petroleum industry. Even though most of the income was to be saved, the fiscal rule provided for a gradual but sustainable increase in petroleum revenue spending.

Fiscal policy was not set on autopilot. The guidelines provided for countercyclical fiscal policy in the short term, around the longer term path. In particular, the fund provided fiscal leeway during the economic setback in 2008 and 2009.

Fund governance

Let me now turn to the actual management of the fund.

Chart: A fund owned by the Norwegian people

The Ministry of Finance holds the political responsibility for the oil fund. The overall management principles and strategy are anchored in the Norwegian parliament, to which the Ministry reports at regular intervals.

The operational management of the fund is fully delegated to Norges Bank. Our task as manager of the fund is strictly commercial: to maximise returns within the guidelines defined by the government. This structure ensures that the fund is not used as a foreign policy instrument. Individual investment decisions are made by Norges Bank Investment Management, a separate division within the central bank. Norges Bank reports on risk and return to the Ministry, and we also provide advice to the government on the investment strategy.

The investment strategy

Our management objective is to achieve the highest possible long-term return, with an acceptable level of risk. The investment strategy is developed by keeping in mind the fund's objective as well as its key characteristics: its size and its long-term horizon. Let me elaborate on some important aspects.

The fund's purpose is to support long-term considerations in the spending of government petroleum revenues. Both current and future generations should benefit from the petroleum resources. Hence, the fund itself has a long-term investment perspective. This has fundamental implications for the investment strategy.

Historically, real assets like equities have yielded more than nominal assets like bonds. Equities have also proved to be more risky. However, the short-term variations in equity prices largely stem from changing discount factors or risk appetite, not from variations in income forecasts for the companies [1]. With the fund's long-term perspective, such changes in risk premiums are of minor importance. Thus, the fund has ample capacity to bear this risk. Sixty percent of the fund capital is invested in listed equities.

Recently, a new asset class was introduced – real estate. This improves the fund's balance between risk and return. According to the fund's management mandate, up to five percent of the fund is to be invested in real estate. Real estate investments are currently concentrated on 10 global cities in Europe and the US, but a large chunk is also invested in logistics property in various countries, including Italy. Property in major Asian cities may be included in the fund's assets this year.

The fund's second-largest asset class is bonds or fixed income. The purpose of the fixed income portfolio is to protect the value of the fund from heavy losses when the stock market falls, and to provide liquidity. The strategic bond weight is currently 35 percent. Seventy percent of the fixed income portfolio is invested in government bonds in developed markets. These investments are distributed across countries on a GDP-weighted basis.

Chart: A countercyclical investor

The long-term horizon puts the fund in a position to be a countercyclical investor on a systematic basis. This is done through rebalancing the share of the portfolio allocated to equities. According to the rebalancing rule, when the equity share increases to more than 64 percent of the fund, we sell equities and buy bonds. Conversely, when the equity share falls below 56 percent, we sell bonds and buy equities.

This strategy has proved to be profitable for the fund, and has increased the average annual return by about 0.5 percentage point [2].

Chart: International real interest rates

So far, the fund has earned an overall annual real return – after inflation and management costs – of 3.8 percent. The cumulative return on the fund in money terms is equivalent to more than a third of the fund's total capital at the end of 2014. Going forward, the returns are likely to be lower.

The starting point for calculating the expected rate of return on the portfolio is the real interest rate on high-grade government bonds. In recent years, bond yields in real terms have been close to zero. Low bond yields reflect global economic conditions: Governments, businesses and households are seeking to save more, while demand for safe investments has increased. Substantial asset purchases by central banks are pushing in the same direction. Low yields may also reflect modest expectations of economic growth further ahead.

Historically, equities have yielded higher returns than bonds. We also expect that to be the case ahead. Still, it is doubtful that equity prices will continue to rise at the same pace as in recent years. Weak or moderate growth in the real economy will feed through to the return on equities.

The share allocated to real assets has increased gradually after equities were first introduced in 1998. Soon, almost two-thirds of the fund will be invested in real assets. As we gain experience in real estate investing, it may be natural to invest in other types of real assets, or increase the equity allocation further. In the long run, a bond allocation of 20-25 percent should suffice to maintain the fund's needed hedge against fluctuations in equity prices and execute the rebalancing strategy.

Chart: Global investments

Another of the fund's characteristics, which in particular has an effect on risk management, is its large size. A main tool to manage the risk faced by the fund is diversification. With a fund of this size, we have ample opportunities to diversify. Stocks in different companies in a variety of sectors, loans to governments and corporations, and real estate investments in a number of global cities are all parts of the portfolio. At the end of 2014, the fund had investments in securities from almost 10 000 issuers in 75 countries. The fund is a global investor.

Prices in financial markets carry information about the risk and return prospects of different assets, and the markets are fairly efficient most of the time. Hence, a natural starting point for the allocation across regions is the size of the different financial markets. However, the weights assigned by the fund to different geographical regions are the result of a trade-off between various considerations.

The fund is a minority shareholder and dependent on good corporate governance and protection of our rights in legal systems. Regulatory conditions in investee countries must be relatively stable, and we must be reasonably sure that our investments are safe.

From the start in 1998, a large share of the fund was allocated to Europe. At that time, the emphasis was on exchange rate risk related to the trade pattern of the Norwegian economy. As European countries are our most important trading partners, Europe was overweighted compared with market weights. Three years ago, the Ministry of Finance concluded that exchange risk had diminished, partly due to increased globalisation. Consequently the fund's overweight in Europe was reduced. At the same time, the allocation to emerging markets was increased.

The average ownership share in a listed European company is now around 2.5 percent, which is twice the ownership share on other continents. Almost 2 percent of the fund is invested in Italy.

The share invested in emerging markets is growing, as these markets develop. Over the past couple of years, we have started investing in Slovenia, Ghana and Mauritius, to provide three examples. At the end of 2014, 10 percent of the fund was invested in emerging markets. Still, close to 80 percent of the fund is invested in North America and Europe, where markets are largest and the most advanced.

Through the fund's investments in equities and bonds, we seek to ensure broad exposure to global equity and bond markets. In the management mandate, the Ministry of Finance has defined public stock and bond indices, which are used to benchmark our performance. These benchmarks are based on the FTSE and Barclays indices.

These indices are constructed to meet the needs of a typical investor. As pointed out earlier, the oil fund is not a typical or average investor. Rather, the fund has certain distinguishing characteristics. The investment strategy seeks to exploit these characteristics to improve the overall balance between risk and return. Our portfolio will therefore deviate from the index along a number of different dimensions:

- First, the index providers adjust for so-called free float. The free float of a company represents the portion of a company's shares that are readily available for trading. Shares owned by governments, employees and company founders are assumed not to be readily available for trading. In the free float adjustment, these shares are removed by the index provider and the stock enters the index with a lower weight. In our management of the fund we use a different starting point to better reflect the relative economic importance of companies.
- Second, the duration of the fixed income index is determined by market dynamics. In the current low-rate environment, issuers have chosen to opt for longer dated bonds. Over the past year, the average duration of our strategic reference index has increased by more than half a year. In our management of the fund, we have chosen not to lock in low yields for a prolonged period and the fund has a shorter duration than the index.
- Third, the index providers exclude certain countries and segments in the construction of the indices for different reasons. As a result, the indices do not represent the full set of opportunities for an investor such as the fund. To give the fund higher exposure to global economic activity, we invest in some emerging markets that are not included in the indices.
- Fourth, as specified in the management mandate laid down by the Ministry of Finance, we have established environment-related mandates. And as also specified in the mandate, we take account of differences in fiscal strength between countries in the composition of government bond investments.

Based on the kind of systematic adjustments indicated above, a tailor-made operational portfolio has been constructed. This reference portfolio serves as a basis for more traditional selections of securities. The fund's largest holdings in terms of ownership share, both in equity and fixed income, are based on our own analyses of investee companies and countries.

Chart: External managers

The large majority of the fund's investment decisions are made within our own organisation. Still, we have always used external management companies in areas where developing in-house capabilities has not been an efficient option. Most of the external mandates have in recent years been directed to specialists in specific sectors or countries.

The fund is a long-term, responsible investor. The objective of our management is to achieve the highest possible return at acceptable risk levels. Norges Bank's work on responsible investing underpins this objective. As a long-term investor, we are dependent upon healthy and sustainable developments in investee companies and markets.

Our work with responsible investment rests on three pillars: We promote international principles and standards, and express our expectations as an investor on certain issues. We exercise active ownership through voting and engagement with companies. And we integrate environmental, social and governance issues into the investment process and risk management.

Chart: Responsible investment I

Promoting good industry standards is an effective way of safeguarding our investments and assets in the long term. Our efforts to promote high standards of corporate governance and sustainable business practices build on principles and guidelines developed by organisations such as the UN and the OECD.

As a financial investor, the fund is affected by the regulation of financial markets. We engage with regulators and participate in consultations on new regulations. We support the development of harmonised rules across markets.

We express our expectations towards the companies in our investment portfolio through published expectation documents and direct engagement. So far, we have established three focus areas: climate change, water management and children's rights. The documents set out our expectations of how companies should manage risk in these areas.

Chart: Responsible investment II

The purpose of our interaction with investee companies is to support the companies in their creation of long-term value.

One of the most important tools at our disposal for exercising ownership rights is voting. We vote at nearly every annual general meeting of the companies in our portfolio.

As mentioned, equal treatment of shareholders, including minority shareholders, is of paramount importance to us. Shareholders should have the right to nominate and dismiss directors, file shareholder proposals at general meetings and approve significant changes to the capital structure of a company.

Chart: Responsible investment III

We seek to identify, assess and report on different kinds of risks to future returns by analysing environmental, social and governance issues. The aim is to gain greater insight into companies and portfolio risks. We look at issues that could have a significant impact on an individual company or on the fund's overall investments. Risk is analysed at country, sector and company level.

Negative external effects are likely to involve a cost for companies sooner or later, potentially through taxes or regulations. Based on our assessment of such risks, we may choose to divest from a company. On the other hand, we seek overweight in companies with positive external effects.

All of these measures are part of our work on responsible investment. The aim is to establish a unified chain of tools that all support responsible investment as an integral part of our management objective: the highest possible returns.

Transparency

A fund owned by the government must be highly transparent, not only to the Norwegian public but also in an international context.

Transparency and disclosure of information is a key feature 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 complete list of all the investments held at the end of the year, and also provides an overview of corporate governance work. Voting records from general meetings are published in real time.

Concluding remarks

Let me conclude. We have been able to extract a large share of Norway's petroleum resources at favourable prices, and we have transformed a portion of our petroleum wealth into financial assets. Norway's oil production is now well past its peak. High oil prices may also be a thing of the past.

The fund is invested exclusively in foreign assets. The return we achieve on our investments is intimately linked to global economic developments. Current growth prospects seem modest by historical standards, so future returns may also be lower.

Although the fund will continue to provide a substantial contribution to the government budget, the fund capital as a share of GDP may be approaching the peak. The forces driving economic growth in Norway will therefore be more similar to those of other countries in the years ahead. Nevertheless, for Norges Bank, managing the fund in a profitable, responsible and transparent way will be an important task – hopefully for generations to come.

Footnotes

1. John H. Cochrane (2011): "Discount rates", The Journal of Finance 66 (4), 1047–1108.
2. For an analysis of the impact of rebalancing, please see Norges Bank (2012): The history of the rebalancing of the fund, Discussion Note 4