Management of the Government Pension Fund Global

Yngve Slyngstad's introduction to the Storting's hearing on the Government Pension Fund Global.

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

A broad upswing in global equity and fixed-income markets contributed to a return of 9.6 per cent on the Government Pension Fund Global last year. The equity market performed particularly well, and the Fund's equity investments returned 13.4 per cent. Fixed-income investments also made a positive contribution of 4.1 per cent, despite the sovereign debt crisis in southern Europe, which figured prominently in the media at times during the year.

The Fund's market value is now around NOK 3 150 billion. In recent years, the value of the Fund has shown steady growth in NOK terms. In the first quarter this year the Fund returned 2.1 per cent. Again the equity market made the greatest contribution to the return on the Fund. Despite a downturn in the Fund's Japanese investments, the equity portfolio returned 2.9 per cent in the first quarter of this year.

The past two years have brought strong returns. This has to be seen in the light of the poor performance in the crisis year of 2008. The Fund has now recouped all those losses and more.

The purpose of the Fund is to distribute the purchasing power from our petroleum wealth across generations. The long-term perspective is reflected in both the Fund's strategy and its management. Thanks to its long-term perspective, the Fund could through the financial crisis purchase 0.6 per cent of the world's listed equities in the course of two years, giving it the right to a substantial portion of future value added in the world's companies.

The market value of the Fund will vary over time. During the financial crisis, the expected annual variability of the Fund was close to NOK 550 billion measured by the method based on daily price observations. Even though expected variability is now somewhat lower, sizeable variations in Fund values can also be expected ahead. Even the risk associated with investments, such as government bonds, that were widely viewed as relatively safe in the past, has increased over the past two years.

In the light of transparency considerations, the Fund uses publicly available benchmark indices. The benchmark indices are not necessarily suited for the Fund's purpose in all contexts. An active approach to index construction is therefore needed, with regular assessments of whether their construction reflects the owners' objectives and provides an optimal trade-off between risk and return. Fund management must also be geared towards the long-term return on the Fund. This must be reflected in the strategic advice we provide and the actual execution of our management of the Fund.

The most commonly used benchmark indices for fixed-income investments are market-weighted, which entails steadily higher Fund exposure to indebted operators that are raising new debt. As an increase in debt can in itself reduce the scope for servicing the debt, market-weighting gives rise to challenges for the Fund. We have therefore recommended the use of GDP weights as a basis for determining the appropriate exposure of the Fund to a country's sovereign debt.

Investments in nominal bonds now account for almost 40 per cent of the Fund. At today's interest rates, these investments will not provide a high real return. However, an important purpose of fixed-income investments is to reduce the variability of the Fund's overall return, which can best be achieved through investments in sovereign debt.

Norges Bank has therefore recommended that 70 per cent of fixed-income investments be allocated to sovereign debt and 30 per cent to corporate debt. Corporate debt will play a different role and should have a different percentage share in the allocation breakdown than sovereign debt.

The Fund's management objective is to achieve the greatest possible international purchasing power within the risk limits set by the owners. To achieve this, we need to be part of the growth in the global economy. Today's regional weights, with Europe given a particularly high weight, should therefore be reassessed to determine whether they are appropriate.

Moving ahead, we will place substantial emphasis on developing expertise. All our investment units are now deploying efforts to increase their insight into the underlying value of our investments.

Norges Bank recently undertook its first investment in real estate. Property investments will account for 5 per cent of the Fund's value in a few years, with a corresponding reduction in bond holdings. We expect real estate investment to improve the relationship between Fund's return and financial risk.

The Fund has two important features, which are its size and long-term horizon. Both features represent levers that can be used to boost returns.

Real estate is a new investment area for the Fund, with large positions in private markets. It is difficult to construct good benchmark indices for these investments. It is only by analysing the underlying economic values that we can judge whether the investments will provide the desired real rate of return over time.

Procurement of services is an important component of our business strategy. We buy in investment management services in areas where it is not appropriate or realistic for the Bank to build up the same expertise internally. This is generally specialist expertise in certain sectors or emerging markets.

The aim of these external investment mandates is to provide the best possible basis for high long-term returns at the lowest possible cost and risk. It is important that the agreements result in the closest possible alignment of interests between Norges Bank and the manager, and a long-term investment approach on the part of the manager.

The contractual fees paid to external managers are based on purely commercial considerations. The fee structure in most of the management agreements includes a performance-based fee component.

The return achieved by the manager is compared with an index plus a minimum excess return. The manager will not receive a performance fee until the return exceeds this benchmark. All agreements now stipulate an upper limit for the fee payable each year and rules for retaining fees accrued if they exceed the upper limit.

We hope that the fee structure we have now established can contribute to changing market practice and that we are in a position to conclude contracts with the best management organisations. It can be costly for the Fund to put itself in a position where it does not have access to buying in high-quality external expertise.

The Fund held shares in 8 500 companies worldwide at the end of 2010. The Fund is now among the largest shareholders in a considerable number of companies.

As a large shareholder, the Fund must also have extensive insight into the companies' operations. At the same time, the Fund will always be a minority shareholder and must rely on the support of other owners to gain acceptance for our views. Active ownership must therefore be based on a clear and long-term approach.

As shareholders, our work is conducted in accordance with principles. We have chosen to concentrate our efforts on six focus areas where we can expect to have an impact and develop a high level of expertise. Active ownership is based on international guidelines recommended by the UN and the OECD.

We draw up expectations documents as an instrument for promoting our interests as owner. We conduct annual surveys of the companies to determine whether they have take into account our expectations. We also hope that the companies take their own initiatives within these areas in their corporate governance.

The Fund's owners have established a framework with a long-term strategy. Norges Bank is seeking to develop its expertise further with a view to safeguarding the long-term perspective and preserving the value of the Fund.

Thank you for your attention.