Petroleum Fund: Strategy, Guidelines and Management

Address by Central Bank Governor Kjell Storvik. Conference on the Norwegian Petroleum Fund, New York, March 12 1998, held by The Norwegian-American Chamber of Commerce INC.

The new guidelines for the Petroleum Fund specify a benchmark portfolio with investments in both equity and fixed income instruments. The investment management aims at high long term returns within acceptable limits of risk exposure. To induce general confidence, adequate risk controls and transparent reporting of performance will be essential.

Future petroleum revenues are expected to be very large in relation to the Norwegian economy, but there is a substantial risk attached to them. The revenues are based on the extraction of a non-renewable natural resource. Intergenerational justice and economic policy considerations suggest that these revenues should not all be spent as they are earned.

The risk of seeing very low petroleum revenues in the future makes it essential to retain the competitiveness of a broad range of other industries, to reduce our dependence on petroleum. This implies that only a limited sum of the expected petroleum revenues should be spent domestically at any time. The Norwegian economy will still be fairly dependent on these revenues, and would face a difficult transition period if they should suddenly evaporate.

The Petroleum Fund thus has a double purpose. It serves as a buffer in case we are hit by an external shock, such as a fall in petroleum prices. It is also an instrument for saving part of Norway's petroleum revenues for the next generation. That generation will for instance have to cope with a dramatic change in the age structure of the population, with pension payment obligations that are expected to reach 15 per cent of GDP in 2030.

The size of the Petroleum Fund is increasing rapidly. It may reach 70 billions dollars within four years, and is likely to continue increasing for the next 20 years. The central bank proposed last year that at least 30 per cent of the Fund should be invested in equities. The Minstry of Finance agreed to the 30 per cent floor and set a maximum of 50 per cent, with the rest of the Fund invested in fixed income instruments. The chosen split between equity and fixed income implies some risk diversification, but should mainly be regarded as a compromise between high expected returns and low annual variability. That kind of compromise is probably familiar to most of you.

The rationale for having equities in the Fund portfolio will also be familiar to most of my audience. With a long investment horizon, there is ample international evidence that the return on equity investments has nearly always been higher than the return on fixed income. There is also evidence that a diversification gain can be obtained by combining equity and fixed income portfolios.

Norges Bank is managing the Petroleum Fund on behalf of the Ministry of Finance. Because of the political importance of the Fund, this is rather more than an ordinary portfolio management contract. We feel it is important that we obtain widespread national confidence in the way Norges Bank manages the Fund. If that confidence is lacking, it may become very difficult for our politicians to ensure that a sufficient share of our petroleum revenues are being saved for the future. In a sense, then, the whole Norwegian population should be regarded as our customers, rather than just the Ministry of Finance.

I believe the Ministry had several reasons for choosing Norges Bank as the manager of the Fund. As a central bank with large foreign reserves, we have a long experience of managing international portfolios, with particular insight into fixed income instruments. No other Norwegian manager has similar international experience. Secondly, as a central bank we are subject to the supervision of a council elected by the Norwegian parliament, which can thus keep a close watch on the quality of our operations. We also have a close relationship with the Ministry of Finance. These relationships probably contribute to the national confidence needed for the management of the Fund.

The Ministry of Finance set new guidelines for investment of the Petroleum Fund from 1 January this year. The guidelines are based on counsel from Norges Bank formally submitted to the Ministry in April and August 1997, and on an ongoing dialogue between the two institutions. This advisory role regarding the strategic guidelines for investment is a part of the Bank's general obligation to provide professional advice to the political authorities.

In addition to prescribing large equity investments, the new guidelines also introduced revised country weightings in the portfolio. The weightings used to be based on Norwegian import shares, which meant that about 75 per cent of the Fund was invested in Europe. With a short investment horizon, this may have been a reasonable strategy relative to the basic goal of maintaining the international purchasing power of the Fund.

With a larger Fund and a longer investment horizon, such concentration of investments on one of the five continents would leave us with too much exposure to certain non-quantifiable risks, such as wars and natural disasters which may involve a number of countries simultaneously. We also realised that substitution could change the import weights significantly over time. Given a distant horizon, it seemed a better idea to take a more balanced look at all production activities outside Norway.

We therefore recommended that European investments should be limited to 40-60 per cent of the portfolio, whereas investments in North America should be in the 20-40 per cent interval, and investments in the Pacific Area in the 10-30 per cent interval. We also recommended that a small share be invested in emerging markets, but on that point the Ministry disagreed. The reason was partly the greater variability of return in these markets, but mainly a wish to avoid capital markets without well developed infrastructures or without a high degree of liquidity. The Ministry selected companies quoted on the major exchanges in 21 countries as eligible for investment from the Fund.

Within each of the three regions, we recommended different country weightings for the equity and fixed income portfolios. For the equity portfolio we opted for standard market capitalization weights, which means that the investments will be concentrated in the largest and most liquid markets. Market capitalization weights also reduce the need to rebalance the portfolio when markets perform differently. For the fixed income portfolio we recommended GDP weights, which give a well diversified portfolio. Since these weights are closely correlated to market capitalizations, the liquidity of the investments will also be ensured.

Within each country the Ministry has chosen to define the benchmark portfolio by means of the Footsie equity index (FT/S&P Actuaries World Index) and the Salomon Smith Barney government bond index. The Footsie index was chosen partly because it is the worldwide equity index most frequently used by other investors. The choice of a government bond index should be regarded as a preliminary choice, since the Fund is actually also allowed to invest in non-government bonds.

The guidelines set by the Ministry state that the Petroleum Fund may not own more than 1 per cent of the share capital in any one company. The reason for this is not merely to compel diversification. It also reflects the view held by our political authorities that the Fund should be a purely financial investor, and should not in any way interfere with the operations of the companies in which it owns shares.

This implies that the Fund will not be used for strategic investments. Certain national business interests would no doubt have welcomed the Fund's assistance in their market positioning efforts abroad. But the Ministry has made it clear that any such assistance, if found desirable, will be given through other vehicles than the Petroleum Fund.

The maximum ownership rule is closely related to an issue that is at present the subject of lively discussion in Norway, namely the question of having ethical guidelines for the Fund investments. The purpose would be to avoid investments in companies that operate in a way considered unethical. The present guidelines reflect such concerns to some extent through the investment universe chosen. The government may soon be looking further into this issue, to decide whether extended guidelines would be desirable. We are awaiting their conclusions on that point.

The slide illustrates the two roles of Norges Bank, as a professional advisor relative to the investment guidelines, and as the Ministry's chosen investment manager. The latter role is somewhat unusual for a central bank. We are aware of the potential conflicts between our role as a central bank and our investment activities. To preclude any actual conflict, the executive director of investment management has been detached from all central bank activities. He does not take part in the general management of the Bank or in any economic policy discussions, and he is not given access to any confidential information that we receive in our capacity as a central bank. We have in fact tried to establish a nearly independent investment unit within the Bank, and intend to keep a watchful eye on how the zone of potential conflict develops over time.

Norges Bank wishes to behave as a professional investment manager, comparing its costs and performance to other large funds around the world. In order to achieve that, it is important that the new investment unit is slim and of high quality, with very competent people in key positions. Consequently, the Bank has had to offer more flexible wage schemes than have traditionally been available. I believe we are going to succeed in establishing a highly efficient investment unit.

The guidelines state that we should maximise returns on the Fund portfolio within certain risk limits. The Ministry has set some limits in terms of the country allocations, the proportion of equities allowed, and in terms of modified duration of the bond portfolio. However, the effective limit on deviations from the benchmark portfolio is set in terms of tracking error. The expected tracking error of the total portfolio, as defined in a BARRA total plan risk model, may not at any time exceed 150 basis points. This method of defining limits to market risk-taking is not yet standard in the investment management industry, but our experience so far has been encouraging. Every morning we compute the tracking error of the portfolio as it was at the end of the previous working day.

This is possible because we keep track of our fixed income portfolio in our internal accounting system, and because our global equity custodian daily transfers files describing our entire equity portfolio. We have spent a considerable amount of effort getting these information routines in place, since they will be essential to our control of the portfolio. This way we shall be able to follow every external manager and also the total portfolio very closely.

We started this year with a fixed income portfolio of about 15 billion dollars. During the year we shall increase the share of equity investments from zero to approximately 40 per cent. At the same time, the portfolio will grow as more government savings are allocated to the Fund. We are therefore engaged in an extensive transitional process, of establishing a new equity portfolio. The transition will continue throughout the year, with the assistance of the four index managers. The identity of these managers will not be disclosed while the transition process is still under way.

The slide illustrates our use of external services. From the outset we established close relationships to one legal advisor and one investment advisor; both companies of high international standing. These advisors have assisted us in the design of management contracts and in the planning of management mandates. We have appointed Chase Manhattan Bank as our global equity custodian, and will partly depend on their services for our compliance controls and reporting.

The four appointed external index managers will each take over their parts of the equity portfolio once it has been established. Their defined index is equal to the benchmark equity portfolio supplied by the Ministry. The index mandates were announced publicly in July last year, and a questionnaire was sent to a large number of potential managers and also made available on the internet. On the basis of the information obtained from the questionnaire, and the advice of our external investment consultant, we established a short-list of candidates for the final negotiations. We had specified all our legal requirements in a standard contract drawn up in cooperation with our external legal advisor, and had our conditions accepted in essence by all the managers. We also paid visits to their offices in order to obtain an impression of the quality of their organizations. We made sure that our people would have the opportunity to visit the managers for training purposes. The process lasted through the autumn, and the four contracts were only signed in December.

There are several reasons for initially choosing an index equity portfolio. Indexing carries substantially lower fees and normally also lower transaction costs than active management. Empirically the return to active management net of fees and transaction costs has not been superior on average to the return obtained by indexing. This conclusion has been documented to us by our external investment consultant, and is also in line with most of the academic literature in this field. Furthermore, indexing is a low risk strategy in that the tracking error relative to the benchmark is very limited.

This does not mean that we intend to continue indexing the entire equity portfolio. On 2 February we announced active equity management mandates, with 27 February as the deadline for applications. As before, the invitation was made available on the internet. The mandates are regional, covering five different regions within our investment universe, and with a mixture of traditional active and enhanced indexing styles.

There are two reasons mainly for not giving global mandates: We do not want more than a couple of active mandates in each market, in order to limit the frequency of counteracting bets from different managers. We also believe there is a wider choice of good quality managers for regional mandates. The announcement did not specify the investment styles in detail, and it also contained a reservation to the effect that the number of mandates actually awarded will be decided upon later this spring. There are three reasons for this: First, we would like to see what offers we get. Second, we are not sure how much of our internal control organisation will be in place by midsummer. We will absolutely not take on more mandates than we are able to follow up very closely. Third, the Ministry of Finance will make new transfers to the Fund at the end of each quarter, but the size of the transfers will depend on the realised costs and revenues in the government's budget. Since the growth rate of the Fund is very high in its initial phase, uncertainty about the actual size of new transfers may be of significance.

We have received some 260 applications from about 140 active managers. The selection process is going to be as thorough as it was for the index mandates, and will proceed for several months. After a first sorting of applications, a further questionnaire will be sent to a selection of managers. We primarily want the managers to convince us that their proposed strategies are sound and that they have implemented satisfactory risk controls. After a second sorting a number of managers will receive visits or be invited to Oslo. Before summer we expect to have a short list of potential active managers, and the final contract negotiations will start. The actual management under the mandates may nevertheless be delayed until late in the autumn.

As already mentioned, we are aware of evidence that the average active manager is not able to produce excess return, after corrections having been made for higher fees and transaction costs. When we have still opted for some active mandates, the reason is that we hope to be able to select a group of managers that are more competent than average. Our external investment consultant has produced some evidence of his selection skills in this respect. We shall therefore give active management a try for at least a few years.

Even with a firm belief in active management, however, we would probably retain indexing as the investment style for most of the equity portfolio. The reason is that a large number of active mandates may easily produce counteracting positions, which net out in the overall portfolio. That would imply paying active management fees for what turn out to be passive positions. In order to reduce the probability of such occurrences, we intend to limit the number of active mandates in the same markets.

Norges Bank has no previous experience of equity management. But we have brought in people with an equity background, and we intend to do some of the equity management in-house. This activity will be small scale at the outset, but may be expanded later on, depending on the experience gained. At any rate, we do not see 100 per cent external equity management as desirable. Some internal investment activities will be important for keeping track of what the external managers are doing, and for ensuring an efficient transition into equity portfolios when new transfers are made to the Fund.

The entire fixed income portfolio is now managed in-house. Norges Bank has long experience in this field, from investing the central bank's foreign reserves. That investment has mostly been passive, with some relative value trading. The passive indexing style will still be the dominant one, for the reasons given above regarding the equity portfolio. But we are also preparing for some active management, partly in-house and partly by external fixed income managers. A few fixed income mandates may be announced already this spring.

With all these new investment activities, Norges Bank this year will primarily be concerned with getting the simple things right. The single most important thing will be to get the risk and compliance controls running smoothly. We shall be able to measure both market risk and credit risk on a daily basis, and we shall endeavour to reduce operational risk as much as possible. Handling operational risk is generally important in investment management, and even more so for this particular Fund with its key role in macroeconomic policies. I end the talk as I started it by stressing the importance of our public relations, and of our information activities directed towards the Norwegian people. Losing their confidence might be very detrimental to the Fund, whatever the reason for such an eventuality.