Mandate for the expert group reviewing Norges Bank’s active management of the GPFG

Background

The investment strategies for the Government Pension Fund Global (GPFG) have been developed over time, based on thorough assessments, professional recommendations, and practical experience. Key choices have been endorsed by the Parliament. The strategy is defined in the fund mandate and reflected in, inter alia, the composition of the benchmark index established by the Ministry of Finance. The strategic benchmark index defines a capital allocation between equity and fixed-income securities and reflects the owner’s investment preferences and risk tolerance. The equity share of the GPFG benchmark is 70 percent, whilst fixed-income securities account for the remainder of the benchmark.

The strategy is based on the premise that it is necessary to assume risk in order to achieve a satisfactory return over time. Through their endorsement of the equity share, the Fund’s owners, represented by the Government and the Parliament, have indicated what is considered an acceptable level of risk. The choice of equity share is the one decision with the greatest impact on overall risk in the Fund. The investment strategy entails that investments are primarily made in listed markets. A key premise underpinning the strategy is that overall risk can be reduced by broad diversification of investments across asset classes, regions, countries, industries, companies and issuers. The composition of the equity and fixed-income benchmarks implies that investments are diversified across a large number of stocks and bonds. The benchmark indices have been designed to facilitate close replication at a low cost and are also used to measure the investment management performance of Norges Bank.

Norges Bank may deviate somewhat from the benchmark index in their operational management, within risk limits stipulated in the mandate. The purpose of such deviations is to ensure a cost-effective adoption of the benchmark index, as well as to exploit distinctive Fund characteristics or accumulated advantages to generate excess return. The mandate further allows some scope for investments in unlisted real estate and unlisted renewable energy infrastructure.

The Fund’s benchmark index has been developed over time. In 1998 the equity index consisted only of large and mid-sized companies in developed markets. In 2000 some emerging markets were included in equity index, and in 2008 all emerging markets, as defined by the index provider FTSE, were included. In 2007 small cap companies were also added to the equity index. The fixed-income index originally consisted of nominal treasury and government guaranteed bonds, whilst credit and covered bonds were added to the index in 2002. Inflation-linked government bonds were added to the benchmark index in 2005. In 2012 emerging market debt was included in the index but subsequently removed again from the index in 2019. The fund’s investment universe still includes emerging market debt, but such investments are limited to 5 pct. of the value of the bond portfolio.

In the white paper to the Parliament in 2013 the Ministry discussed the inclusion of systematic risk factors such as size, value, momentum, and low volatility, to the Fund’s equity benchmark. The Ministry argued that the Fund was well positioned to bear the increased volatility such factors could entail, given the Fund’s characteristics as state owned, with a long investment horizon, low liquidity needs and high risk capacity. The Ministry further argued that, given the large size of the Fund, it would require a tailored strategy if such factors were to be exploited. The best adjustments to the factor strategies would be challenging to find and might also change over time. The Ministry’s work on the Fund’s strategic benchmark index is not a process that is well adapt for decisions that require frequent maintenance and changes. The Ministry therefore concluded that if such factor strategies were to be exploited in the management of the Fund, it would be best done within Norges Bank’s scope for active management.

In 2010 the Ministry opened for investments in unlisted real estate. The strategic allocation to real estate was set to up to 5 pct. and investments could consist of both listed and unlisted investments. The real estate investments were financed by reducing the fixed-income share of the benchmark index and were to be measured against a customized version of the IPD Global Property Index (today MSCI Global Property Index). Norges Bank made the first unlisted real estate investment in April 2011. In 2014 the bank transferred a portfolio of listed real estate investments from the equity portfolio to the real estate portfolio. As of 1 January 2017 the real estate strategy was changed, and the Mandate no longer stipulates a strategic allocation to real estate. The strategic benchmark index currently consists of equity and fixed income only. Norges Bank may still invest in listed and unlisted real estate within the limits for active management. This also applies to unlisted renewable energy infrastructure investments, which were included in the investment universe in 2019. The bank has chosen to finance unlisted investments with a tailored mix of equity and fixed-income securities to account for the market and currency risk of each investment.

Mandate

The expert group shall, by 3 January 2022, prepare a public report reviewing Norges Bank's active management of the Government Pension Fund Global (GPFG). The report shall include the following:

1. **A review of Norges Bank's historical financial performance in the management of the GPFG, including:**
    - Analysis of risk and return relative to relevant benchmarks for the Fund overall and for the equity and fixed-income portfolio, respectively.
    - Performance and attribution analysis of Norges Bank's main investment strategies, including significant sub-strategies.
    - Analysis of risk-adjusted performance of the above-mentioned portfolios and strategies, including a discussion of the appropriate choice of methodology for risk adjustment and relevant risk factors for a fund with GPFG's characteristics. Recognised, leading methods should be applied.

2. **An assessment of the results from Norges Bank's real estate strategy, including:**
    - Analysis of the real estate portfolio's contribution to Fund risk and return since 2017. The analysis should consider both the total real estate portfolio and respective listed and unlisted portfolios. It should also include the effect from Norges Bank's chosen financing model.

3. **A qualitative assessment of Norges Bank's current main investment strategies and significant sub-strategies in the management of the GPFG. The assessment shall include discussions of**
    - theoretical and empirical foundations,
    - known risk and return characteristics,
    - appropriate evaluation horizons,
    - scalability.

4. **An assessment of Norges Bank's potential to obtain excess returns in the management of the GPFG relative to the current strategic benchmark, given the Fund distinctive characteristics as large, state owned and with a long investment horizon.**

The Ministry of Finance will at the request of the expert group assist with the preparation of data and in conducting the empirical analysis as specified by the group.