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Government Pension Fund Global - benchmark index for equities

In autumn 2018, the Ministry initiated a review of the benchmark index for equities.[1] Norges Bank assessed the composition of the index in its letters of 21 and 22 August 2019. We did not propose any changes to the methods and rules for the composition of the index. In its letter of 19 January the Ministry asks for the Bank's assessment of whether it is appropriate that new equity markets are not included in the fund's benchmark index for equities on an ongoing basis. The Bank is also asked to assess how a decision to not include new equity markets may affect the return and risk characteristics of the benchmark index and the fund. The Bank's assessment follows.

The fund's benchmark index is constructed on the basis of the FTSE Global All Cap index and currently includes all but two of the markets in that index. The two markets in question entered the FTSE Global All Cap after the Ministry launched the review of the benchmark index in 2018, and so were not included in the fund's benchmark index. If the index provider decides to include a new market in the index, the main rule is that the market automatically becomes part of the fund's benchmark index. The reverse applies if the index provider decides to remove markets from the FTSE Global All Cap. This automatic connection between the markets in the FTSE Global All Cap and the fund's benchmark index was introduced in 2008.

The number of markets in the benchmark index for equities has grown from 21 developed markets in 1998 to 46 developed and emerging markets today. The net

[1] See the Ministry's letter of 6 November 2018.

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increase of 25 markets since 1998 came about in the following way: 5 new markets entered the index in 2001. 19 new markets entered in 2008 in connection with the introduction of the current main rule for including markets in the index. Following 2008 two additional markets have entered the index and one market has been removed. The combined market value of the markets currently included in the benchmark index is estimated to make up 99.5 percent of the universe currently covered by FTSE[2]. The diversification benefits of including the remaining 0.5 percent in the equity benchmark are considered to be limited.

The Ministry outlines in its letter of 19 January an alternative where the question of which markets are to be included in the benchmark for equities is considered in connection with future broad reviews of the framework for, and composition of, the benchmark index, rather than on an ongoing basis as is the case today. The Bank believes that it may be appropriate to adjust the rule for which markets are included in the fund's benchmark index for equities in such a way that there no longer is an automatic connection between the index provider's decisions and the composition of the fund's benchmark index. It would be natural for the index provider's assessments of individual markets to be given weight in reviews, but for them to be supplemented with assessments from the Ministry and recommendations from Norges Bank.

To ensure a robust solution, it should also be possible to consider which markets to include in the benchmark index outside these scheduled reviews where this is warranted by particular events. Examples of such events might be surprising regulatory changes in a market, sanctions against a market, or changes in the index provider's coverage or assessment of a market.

The solution outlined would mean that the Ministry takes a position more explicitly on this aspect of the investment strategy. The Bank believes that this may be appropriate. This solution will also facilitate transition plans decided by the Ministry that differs from the index provider's plans, and as such facilitate a more cost-efficient alignment of the portfolio to index changes. A natural starting point may be for the Ministry to decide that the benchmark index is to include the same markets as it does today.[3] The proposed adjustments to the rule for which markets are to be included in the benchmark index are in itself not expected to impact notably on the index's long-term return or risk characteristics. This applies regardless of the choice of index provider.

Yours faithfully

[2] Estimated the following way: The market value of the equity markets included in the fund's benchmark index as a share of all equity markets FTSE classifies as either developed, emerging or frontier.

[3] The fund's benchmark index for equities currently includes one market that is not part of the MSCI ACWI IMI index. This market makes up 0.07 percent of the benchmark index. We assume that we can return to the issue of how this market is to be handled in the benchmark index in the event of a change of index provider.

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