THE GOVERNMENT PENSION FUND 2020

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Norwegian Ministry of Finance

Unofficial translation from Norwegian.
If discrepancy in meaning the official Norwegian version shall apply.

EXECUTIVE SUMMARY

The Government Pension Fund belongs to the people of Norway. The purpose of the savings in the Fund is to support the funding of pension expenditure under the National Insurance Scheme and to promote long-term considerations in government petroleum revenue spending, in order to ensure that the petroleum wealth will benefit both current and future generations. The Ministry of Finance has under the Government Pension Fund Act been given the formal responsibility for the management of the Fund, which comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN). The operational management is carried out by Norges Bank and Folketrygdfondet, within mandates laid down by the Ministry of Finance.

The Storting (Parliament), Ministry of Finance, Norges Bank and Folketrygdfondet each have distinct roles in the management of the Government Pension Fund. A clear division of roles serves to highlight responsibilities. Broad support for the investment strategy and the general framework of the Fund is a prerequisite for sound long-term management. The governance structure must therefore ensure that key decisions are endorsed by the Fund's owners, represented by the Government and the Storting. At the same time, there must be sufficient delegation of authority to ensure that day-to-day management decisions are made close to the markets in which the Fund is invested.

The overarching investment objective is to achieve the highest possible return, given an acceptable level of risk. A clear financial objective, together with sound long-term management, serves to ensure that also future generations will benefit from the assets accumulated in the Fund. Within the overarching financial objective, the Fund shall be managed responsibly.

The GPFG forms an integral part of the fiscal budget and fiscal policy framework. Government petroleum revenues are transferred to the GPFG in their entirety, whilst withdrawals from the Fund are determined by resolutions of the Storting. Over time, the Fund has become an ever more important source of funding for public expenditure.

The fiscal policy guidelines require petroleum revenue spending to over time be equal to the expected real rate of return on the GPFG. The guidelines further stipulate that petroleum revenue spending in any given year shall be adapted to the economic situation. Hence, spending may exceed the long-term expected real rate of return on the fund capital during periods of economic setback. This is however conditional upon petroleum revenue spending being reduced once the economic situation normalises.

The coronavirus outbreak has caused major setbacks in the Norwegian and global economy. Comprehensive economic measures have been adopted to limit the impact of the pandemic. Whilst the economic policy responses in other countries predominantly will be funded by government borrowing, the GPFG provides Norway with considerable fiscal space. For 2020, substantial transfers from the GPFG are proposed to cover the fiscal budget deficit.

The current transfers from the GPFG entails a reduced scope for future deficit funding via the Fund. However, under favourable economic conditions the Government has spent less than the expected real rate of return, partly to allow for higher spending in challenging times. It is emphasised that the current setback would have been greater, involving more bankruptcies and higher unemployment, in absence of forceful measures in response to the crisis. The Government is committed to limiting the downturn and supporting growth and development to drive economic recovery.

Current and past experience demonstrate that we need to be prepared for considerable market fluctuations. The Government Pension Fund is generally well placed to absorb such fluctuations. It is especially important to remain committed to the chosen strategy during periods of considerable market turbulence. The Storting's deliberation of the annual white papers on the Government Pension Fund serve to build support for the long-term investment strategy.

The white papers on the Government Pension Fund are normally published in the spring. Due to the virus outbreak, the Ministry of Finance decided to postpone this year's paper. This paper will therefore provide a brief summary of the 2020 half-year results, in addition to reporting on the performance in 2019. It also discusses further development of the investment strategy and addresses the responsible investment framework. To the extent that the coronavirus pandemic is of relevance to the Ministry's assessments, this is specifically mentioned. In Chapter 9, an overview of studies of the relationship between past pandemics, economic growth and financial markets is provided.

Investment strategy

The investment strategies for the GPFG and the GPFN have been developed over time on the basis of professional recommendations, practical experience and thorough assessments. Any material changes have been endorsed by the Storting. Transparency and broad anchoring of key investment strategy issues provide increased insight and understanding of the risk assumed in the fund management. This establishes a foundation for remaining committed to the long-term investment strategy, also during periods of turbulence in financial markets.

The investment strategy is defined in the fund mandates and is reflected in, inter alia, the composition of the benchmark indices established by the Ministry of Finance. The strategic benchmark index defines a capital allocation between equities 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 the equity portion of the GPFN benchmark is 60 percent. Fixed-income securities account for the remainder of the benchmarks. The mandates also stipulate various limits on what risk may be assumed in operational management, including a limit on deviations from the benchmark index.

The strategy is based on the premise that it is necessary to assume risk to achieve a satisfactory return over time. The choice of equity share has the greatest impact on the overall risk of the Fund. A larger equity share means a higher expected return, but also expectations of increased volatility and a higher probability of loss. The investment strategy entails investments are made primarily in listed markets.

A key premise underpinning the investment strategy is that overall risk can be reduced by broad diversification 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 companies and bonds. The benchmark indices have been designed to facilitate close replication at a low cost. These indices are also used to measure the management performance of Norges Bank and Folketrygdfondet.

Most of the Fund risk is determined by stock and bond market developments, as reflected in the benchmark indices. Norges Bank and Folketrygdfondet may, within defined limits, deviate somewhat from the benchmark indices in their operational management. Such deviations are used to ensure a cost-effective adoption of the benchmark indices. They may also be used to exploit distinctive characteristics of the funds to seek excess return. The GPFG management mandate further allows some scope for investments in unlisted real estate investment and unlisted renewable energy infrastructure. The contribution of active management to Fund risk has over time been moderate.

The investment strategies for the GPFG and the GPFN are discussed in chapters 2.1 and 4.1, respectively.

Strong performance in 2019; volatile markets in the first half of 2020

In 2019, the market value of the GPFG exceeded Norwegian kroner (NOK) 10,000 billion for the first time. At yearend 2019, the value of the Fund was more than three times the annual mainland GDP. The return last year was 19.9 percent, measured in the currency basket of the Fund. The return as measured in the currency basket is the relevant measure of developments in the international purchasing power of the Fund. The value of the Fund increased by NOK 1,832 billion through the year, to NOK 10,084 billion. Measured in NOK, this is the largest annual value increase in the history of the Fund. The strong performance reflects positive developments in global financial markets in 2019. The equity market strengthened last year, despite lower economic growth and increased uncertainty globally. The return on the GPFG equity portfolio was 26.0 percent, whilst the return on the fixed-income and unlisted real estate portfolios were 7.6 percent and 6.8 percent, respectively.

Financial market returns were also strong in Norway, although somewhat weaker than in international markets. Overall return on the GPFN was 12.4 percent in 2019, measured in NOK. Equities and fixed-income generated returns of 18.2 percent and 4.2 percent, respectively. The market value of the Fund was NOK 269 billion at year-end 2019, which represents an increase in value of about NOK 30 billion over the course of the year.

Norges Bank and Folketrygdfondet seek to achieve the highest possible return, net of costs, within the limits stipulated by the management mandates from the Ministry of Finance. In 2019, the return on the GPFG was 0.23 percentage points higher than the return of the benchmark, whilst the excess return in the management of the GPFN was 0.40 percentage points. Measured as a proportion of assets under management, costs last year were 4.7 basis points in the GPFG and 6.7 basis points in the GPFN.

After strong market performance in 2019, the coronavirus outbreak and subsequent strict restrictions to limit the spread of the virus triggered considerable market volatility in the first half of 2020. Following an optimistic start to the year, markets slumped as the coronavirus outbreak spread across countries. The steep downturn in the stock market was slowed down and eventually reversed due to, inter alia, significant monetary and fiscal policy stimulus.

The market value of the GPFG was NOK 10,398 billion as at the end of the first half of the year. Measured in the Fund currency basket and before the deduction of management costs, the return in the first half of the year was -3.4 percent. Measured in NOK, the return was 4.8 percent. The value of the GPFN was NOK 257 billion as at the end of June 2020, whilst the return in the first half of the year was -4.4 percent.

The Ministry focuses on the performance achieved over time. The average annual return on the GPFG over the last 20 years, until and including the first half of 2020, has been 0.17 percentage points higher than the return on the benchmark index. The average excess return on the GPFN has been 0.56 percentage points per year since 2007.

The performance of the GPFG and the GPFN is discussed in chapter 2.2 and 4.2, respectively.

Geographical distribution of the GPFG equity benchmark

In last year's white paper, the Ministry of Finance announced a review of the framework and benchmark for GPFG equity investments, including the geographical distribution and the composition of the sub-benchmark for emerging markets. The Ministry has received advice and assessments from Norges Bank and a report from the consultancy firm and index provider MSCI.

The composition of the current benchmark index is based on the market value of each company included in the benchmark; so-called full market capitalisation, subject to certain modifications. Firstly, the market capitalisation is adjusted by the index provider, FTSE Russell, to account for, inter alia, tradability, foreign ownership restrictions and so-called free float. The free float adjustment reflects whether parts of a company's shares are unavailable for public trading, for example as the result of strategic ownership. The geographical distribution of the benchmark index is further modified by assigning the market capitalisation values an adjustment factor based on geographical affiliation. These adjustment factors are stipulated by the Ministry. As a result, the GPFG equity benchmark has a higher share in developed markets in Europe, and a smaller share in developed markets in North America (the United States and Canada) than both full and adjusted market capitalisation values would otherwise imply.

In this white paper, the Ministry is proposing to modify the benchmark index adjustment factors. The change implies that the share of developed markets in Europe will be reduced somewhat, and the share of the United States and Canada correspondingly increased. The change is in line with the advice of Norges Bank. The purpose of the modification is to ensure that the equity benchmark better represents value creation in listed companies globally. The resulting relative ownership stakes will be more equal across the regions. No changes are proposed to the adjustment factors for emerging markets or developed markets in Asia Pacific. The coronavirus pandemic does not affect the Ministry's assessments in this matter.

As at the end of 2019, emerging markets accounted for about 11 percent of the equity benchmark. Investments in such markets may contribute to enhanced diversification and harvesting of risk premiums. Emerging markets do however differ from developed markets in that returns are more volatile, whilst risk is more affected by country-specific factors. Emerging markets are also less homogeneous than developed markets, and are to a significant degree characterised by weaker institutions, less transparency and weaker protection of minority shareholders. Such country-specific issues make maintaining the role as a responsible investor more challenging

The Ministry will continue reviewing the composition of the emerging markets sub-benchmark, including the assessment of whether more weight should be attached to the distinctive characteristics of such markets. In this regard, Norges Bank was in a letter of 15 April 2020 asked to analyse the implications of introducing a potential cap on how large a proportion of the benchmark may be accounted for by an individual emerging market. On 27 August 2020, the Ministry received the Bank's assessments of how such a cap might be structured and the associated implications. The Ministry intends to revert with its assessments of the emerging market investment framework and sub-benchmark in the white paper on the Government Pension Fund in the spring of 2021. The report from the committee that has reviewed the ethically motivated guidelines for the GPFG will also form part of the basis for such assessments. The committee has, inter alia, examined various country-specific issues and considerations. The Ministry will not include any new markets in the equity benchmark for the Fund until its composition has been decided.

The review of the equity benchmark is discussed in chapter 3.1.

Investments in companies seeking a listing – GPFG

In the *Government Pension Fund 2018* white paper, the Ministry of Finance examined whether to allow for the GPFG to be invested in unlisted equities on a general basis. The Ministry proposed not to allow for the inclusion of such investments. The Ministry referred to Norges Bank's existing permission to invest the GPFG in unlisted companies whose board of directors has expressed an intention to seek a listing, and that this access would be discussed in the dialogue with the Bank.

Norges Bank regards that an alternative to the current regulation may be to allow for the GPFG to be invested in shares of *large* companies that are not yet listed, with such investment being capped at 1 percent of the equity portfolio. The Bank finds it reasonable to expect a number of these companies to seek a listing at a later date.

In the Ministry's view, the Bank's proposal would entail a higher probability that the GPFG may remain invested in unlisted companies for a long time, without being able to reference a specific board resolution as the reason for the investment decision. The intention behind the mandate provision is to enable the Bank to invest *in advance of* an upcoming public offering. The Ministry finds it is reasonable to assume that there is less uncertainty about whether a listing will take place with a board resolution on listing than without such a resolution.

The Ministry is proposing to maintain the current requirement for intention to seek listing, whilst proposing to clarify the regulation in the mandate. Such regulation includes, inter alia, a requirement for a due diligence review in advance of each investment, and for the Executive Board to approve any investment in excess of certain threshold amounts. It is expressly stated that the Executive Board shall issue guidelines on the divestment of shares in unlisted companies whose planned listing does not take place.

The discussion of investments in companies seeking a listing can be found in chapter 3.2.

Climate risk in the GPFG

Climate change will affect companies and economic developments in coming years and is therefore an important financial risk factor for the GPFG. As a large, long-term investor with ownership in thousands of companies worldwide, the return on the Fund will be affected by climate change, climate policy and new technology. This is, at the same time, a complex and multifaceted risk factor, and there is limited knowledge on how investors can best manage the risk arising from climate change. The investments of the Fund will be affected by both the physical implications of climate change; so-called *physical risk*, and by regulatory and technological developments in the transition to a low-carbon society; so-called *transition risk*. There is considerable uncertainty as to the physical effects of climate change and the financial risk these give rise to, as well as to the financial implications. In addition, there is considerable uncertainty associated with climate policy and technological development during the transition to a low-carbon society. This involves significant risk, which needs to be managed by investors.

The Ministry of Finance and Norges Bank are, like other investors, seeking knowledge on how climate risk affects financial assets and on how such risk can be managed. In the white paper on energy equities in the GPFG, Norges Bank was requested to review its efforts on climate risk in the GPFG. The account provided by Norges Bank shows that assessments of financial climate risk form an integral part of the Bank's risk management, investment decisions and active ownership.

An important part of Norges Bank's climate risk involvement should, in the view of the Ministry, be to promote enhanced understanding and knowledge of climate as a financial risk factor. Contributions to research, development of a joint climate reporting framework and improved understanding of how companies manage climate risk are key aspects of Norges Bank's efforts in this regard. The Ministry supports the Bank's commitment to further development of analytical climate scenario tools, as well as expansion and improvement of its internal analysis models for different climate trajectories.

The Ministry expects Norges Bank to continue considering a range of climate risk measures, including participation in research projects. It is important that the Bank's efforts are based on a comprehensive strategy that includes priorities, objectives and activities. Reporting should to the extent appropriate be in line with leading frameworks (TCFD), including on climate scenarios for the portfolio and relevant sub-portfolios, relevant metrics and eventual stress testing.

Climate risk in the GPFG is discussed in chapter 3.3.

Amendments to the management mandate for the GPFG

On 29 November 2019, the Ministry of Finance adopted a number of amendments to the management mandate of the GPFG. The amendments partly need to be considered in view of the Storting's deliberation of last year's white paper. The amendments include, inter alia, new mandate provisions for the environmental investment mandates and unlisted renewable energy infrastructure investments, as well as for the fixed-income benchmark and framework. Reference is made to the discussions in chapter 3.4 and 3.5, respectively.

Other mandate amendments have also been made, which partly need to be considered in view of the new Central Bank Act, which entered into effect on 1 January 2020. These amendments are discussed in chapter 3.6.

Folketrygdfondet's advice on amendments to the management mandate for the GPFN

Folketrygdfondet has in a letter of 13 December 2019 submitted its advice on amendments to the management mandate for the GPFN. The background is that the GPFN's ownership stakes in companies listed on the Oslo Stock Exchange have reached a level so high that there is a risk of breaching the current 15-percent ownership stake limit in individual Norwegian companies. The large ownership stakes also reduce the scope for active management. Folketrygdfondet's advice is to reduce the proportion of the equity portfolio invested in Norway, and correspondingly increase the proportion invested in Denmark, Finland and Sweden. Folketrygdfondet also discusses other solutions, including expanding the scope for unlisted equity investments, increasing the ownership stake limit and making withdrawals.

The Ministry finds, based on an overall assessment, that the proportion of the GPFN invested in Denmark, Finland and Sweden should remain unchanged, and that the challenges of large ownership stakes in listed Norwegian companies on Oslo Stock Exchange should be resolved, fully or in part, through withdrawals from the GPFN. Withdrawals may take different forms, including lump-sum withdrawals and/or annual withdrawals. Withdrawals from the GPFN will require further assessments of, inter alia, authorisations and implications. This should include an assessment of operational implications on the part of Folketrygdfondet. The Ministry of Finance will be examining the specific scope and framework for such withdrawals.

The GPFN may under the current mandate be invested in unlisted companies where the board of directors has expressed an intention to seek a listing on a regulated marketplace in Norway or elsewhere in the Nordic region (excluding Iceland). Folketrygdfondet suggests amending the mandate provision for investments in unlisted companies. Because the permission for making such investments has been little used thus far, the Ministry will examine the possibility of somewhat expanding the current provision. It will for this purpose be necessary to obtain additional information from Folketrygdfondet on, inter alia, which other criteria than an expressed listing intention may potentially be used to identify companies assumed to be candidates for a listing at a later date.

The matter is discussed in chapter 5.1.

Responsible investment

The Government Pension Fund shall, within its overarching financial objective, pursue responsible investment practices that promote good corporate governance and take environmental and social considerations into account. This is also important for the legitimacy of the management of the Fund among the Norwegian population.

Moreover, responsible investment may improve the management of financial risk that may arise due to the environmental or social issues in the companies in which the Fund is invested. The Fund has a long time horizon, and risk and return of the Fund may be affected by such circumstances. The impact of, inter alia, climate change, climate policy and technological development on financial assets is receiving considerable attention. Climate risk is an important financial risk factor in the management of the Government Pension Fund.

Responsible investment forms an integral part of the management of the GPFN and the GPFG. The mandates laid down by the Ministry of Finance refer to internationally recognised responsible investment standards and principles. Norges Bank and Folketrygdfondet apply such standards and principles in their responsible investment activities, and are also involved in efforts to further develop these.

Norges Bank and Folketrygdfondet make investment decisions and exercise the ownership rights of the funds independently of the Ministry. Important responsible investment measures include advocacy of principles and expectations based on internationally recognised standards, company dialogue on relevant topics and issues, as well as voting in annual general meetings. Risk management is also an important aspect of responsible investment.

Norges Bank has as part of its responsible investment efforts prepared expectation documents on several issues, including climate, human rights, child labour, as well as tax and transparency. The expectation documents are primarily directed at the board of directors of the companies in which the Fund is invested, and form part of the Bank's ownership dialogue with companies.

In the expectation document on tax and transparency, the Bank expresses an expectation that companies pursue appropriate, prudent and transparent tax practices, and that tax should be paid where economic value is created. At the government level, Norway takes an active role in international efforts to increase transparency, exchange information and achieve an appropriate allocation of taxation rights globally. The Norwegian policy is that closed tax jurisdictions, international tax avoidance and appropriate allocation of taxation rights globally should be addressed and resolved through international cooperation at the government level and consensus-based solutions.

The Ministry of Finance has adopted Guidelines for Observation and Exclusion from the GPFG. Some criteria in the guidelines are based on specific products, such as tobacco, weapons and coal. Other criteria are conduct-based, such as serious human rights violations and severe environmental damage.

An independent Council on Ethics appointed by the Ministry of Finance provides recommendations to Norges Bank on the exclusion and observation of companies. Decision-making authority rests with the Executive Board of Norges Bank. The Bank may opt for a different measure than that recommended by the Council on Ethics. The overarching objective is to apply the most appropriate tool for each individual case. For the coal criterion, Norges Bank may make decisions without any recommendation from the Council on Ethics.

The investments of the Fund attract considerable attention, both in Norway and internationally. Even a strong framework for risk management, responsible investment and ethically motivated guidelines cannot serve as an ironclad guarantee against blameworthy situations in companies in the Fund's portfolio. It is not feasible to organise investment management with a view to preventing the Fund from ever being exposed to any unwanted situations at any given time. It is nonetheless important for risk management and the responsible investment framework to be refined and developed on an ongoing basis, in line with the size and complexity of the Fund.

Responsible investment is discussed in chapter 6.

Committee review of the Guidelines for Observation and Exclusion from the GPFG

In the spring of 2019, the Ministry of Finance appointed a committee to review the ethically motivated guidelines for the GPFG. The committee assessed, inter alia, the criteria for exclusion of companies, as well as the use and effects of the policy tools. Issues relating to individual countries, including countries with local regulations that contravene recognised international conventions and standards, as well as countries with generally limited information access, were also considered. The committee submitted its report on 15 June 2020.

The committee believes that the current ethical framework for the Fund has, by and large, worked well. It is nonetheless proposing certain amendments in response to evolving norms and new issues. These proposals include, inter alia, changes to the weapons and corruption criteria, as well as a new weapon sales criterion. Moreover, the committee proposes clarification of the requirements for coordination between Norges Bank and the Council on Ethics, as well as inclusion of the UN Guiding Principles on Business and Human Rights (UNGP) in the mandate for the management of the GPFG. For companies in countries with different norms, it is proposed to somewhat modify the use of measures, especially in relation to local companies with limited room for manoeuvre. The committee emphasises that companies shall be assessed on the basis of the same ethical standards, and as thoroughly, as at present.

The report was circulated for public consultation on 24 June, with 20 October 2020 as the deadline for submitting consultative comments. The consultative comments will, together with the committee's report, provide the Ministry of Finance with a sound and comprehensive basis for assessing the Guidelines for Observation and Exclusion from the GPFG. The Ministry intends to present its assessments in the white paper on the Government Pension Fund in the spring of 2021.

The findings and proposals of the committee are discussed in chapter 6.3.