MINISTRY OF FINANCE

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Report to the Storting (white paper)

The Government Pension Fund 2024

Recommendation of the Ministry of Finance of 12 April 2024, approved by the Council of State on the same day (Government Støre)

Unofficial translation from Norwegian. For information only.

1 Executive summary

The Government Pension Fund is owned by the Norwegian State and comprises the Government Pension Fund Global (GPFG) and the Government Pension Fund Norway (GPFN). The purpose of the Fund is stipulated in the Government Pension Fund Act: The savings shall support the funding of pension expenditure under the National Insurance Scheme and facilitate long-term considerations in the spending of government petroleum revenues, thus ensuring that the petroleum wealth benefits both current and future generations. The investment objective is to generate the highest possible return, given an acceptable level of risk. The Fund shall be managed responsibly. A financial objective and long-term management ensure that both current and future generations may benefit from the national petroleum wealth.

The GPFG is integrated into the fiscal policy framework. The net government cash flow from petroleum activities is transferred in its entirety to the GPFG, while funds are transferred annually from the Fund to cover the non-oil budget deficit. Over time, the return on the GPFG has become an increasingly important source of public expenditure funding. The corollary to the Norwegian welfare state being increasingly funded by transfers from the Fund, is that public finances have become more vulnerable to international financial market volatility.

The fiscal policy guideline links the spending financed by the Fund to the expected real rate of return on the GPFG, which is estimated to 3 percent. In the national budget documents, the Government has in recent years indicated that withdrawals should be well below 3 percent during normal times, which will be most years, in order to limit fund spending over time to the expected real return. This is implied by the need for extra savings that can be drawn down in the event of major economic downturns or a large decline in Fund value. We can thereby avoid challenging adjustments that involve major budget expenditure cuts or significant tax increases.

This year marks 50 years since the Bratteli Government presented the first comprehensive white paper on the integration of petroleum activities into the Norwegian economy, Report No. 25 (1973-74); *The Role of Petroleum Activities in Norwegian Society*. The report stated an ambition that the petroleum revenues should primarily be utilised to develop "a qualitatively better society". An emphasis was placed on "averting an outcome characterised only by rapid and uncontrolled growth in the use of material resources without any other changes to society". The large petroleum revenues have provided Norway with significant fiscal space, compared with most other countries. Strong growth in the value of the GPFG over the past two decades has given scope for significant increases in the spending financed by the Fund, within the limits of the fiscal policy guideline.

A large national wealth also entails considerable investment management responsibility. The Ministry of Finance has been given the formal responsibility for the management of the Government Pension Fund and defines the investment strategy and framework for the Fund. Key choices are deliberated by the Storting and endorsed prior to implementation. Norges Bank and Folketrygdfondet conduct the operational management of the GPFG and the GPFN, respectively, within management mandates stipulated by the Ministry.

The framework for the management of the Government Pension Fund is defined by the political authorities, but the Fund is not an instrument for the attainment of political objectives beyond financial savings. The objective of generating the highest possible return, given an acceptable level of risk, underpins the Fund's ability to fund public expenditure. Norges Bank and Folketrygdfondet make individual investment decisions and exercise ownership rights in investee companies, independently of the Ministry. This makes for a clear division of roles, which highlights responsibilities. The governance structure ensures that decisions of crucial importance to the Fund’s risk and return, as well as the responsible investment framework, are endorsed by the Storting. However, it is emphasised that there must be sufficient delegation to ensure that operational investment decisions are made close to the markets in which the Funds are invested. Broad endorsement helps ensure that the risk taken in the management of the Fund is understood and accepted by the Storting. This reinforces the ability to remain committed to the chosen investment strategy over time, also during periods of market turmoil, and to avoid ill-considered strategy decisions.

The investment management shall be as transparent as possible, within the limits defined by proper implementation of the management mandate. Transparency is important in preserving the legitimacy of the Fund and the confidence of the Storting and the public in its management. The management of the GPFG is rated highly in transparency rankings of large funds internationally.

In recent years, the value of the GPFG has increased significantly and returns have been higher than is to be expected in the long term. Large transfers of petroleum revenues have contributed to an increasing Fund value even in years of negative returns. The Norwegian krone depreciation has served to further increase the Fund value, as measured in NOK. In the years ahead, we must be prepared for the Fund value not increasing at the same rate as registered so far, and for periods of potential decline in Fund value.

Investment strategy

The Ministry of Finance is committed to an investment strategy for the GPFG and the GPFN that is professionally acknowledged and tailored to the distinctive characteristics and the purpose of the Funds. Purpose, size, ownership and other distinctive characteristics may give rise to a number of investment opportunities, but may also entail certain limitations. The strategies have been developed over time, based on professional recommendations, thorough assessments and practical experience.

The investment strategy is defined in the management mandates for the GPFG and the GPFN and is reflected in, inter alia, the composition of the benchmark indices. The strategic benchmark indices define a capital allocation between equities and fixed income securities, and reflect the owner’s investment preferences and risk tolerance. The equity share for the GPFG is 70 percent, while it is 60 percent for the GPFN. In general, investments that offer scope for higher returns will also entail a higher risk of loss. In other words, there is a trade-off between return and risk. In endorsing the choice of equity share, the Storting has expressed the level of risk considered to be acceptable in the management of the Fund.

A key premise underpinning the investment strategy is that risk can be reduced by spreading investments broadly, so-called diversification. Diversification of investments across different asset classes and companies globally reduces vulnerability to developments in individual companies, industries, countries and regions. Over time, a diversified portfolio will have lower risk than a concentrated portfolio. Reduced diversification and curtailment of the Fund's investment opportunities may result in higher risk, without a commensurate increase in the expected return.

The benchmarks have been designed with a view to ensuring broad diversification and facilitating close replication at low costs. The benchmarks are also used to measure the management performance of Norges Bank and Folketrygdfondet. Within defined risk limits, the investment managers may deviate somewhat from the benchmark indices. This is intended both to facilitate cost-effective management and to utilise distinctive characteristics of the Funds, such as size and a long investment horizon, to achieve excess return. For the GPFG, there is also some limited scope for investments in unlisted real estate and unlisted renewable energy infrastructure.

The design of the investment strategy is premised on a long time horizon for the investments. The GPFG and the GPFN can withstand more risk, in terms of return volatility from one year to the next, than an investor with major payment obligations, and therefore a shorter investment horizon. The Funds can weather stock market volatility without having to divest at an unfavourable time.

The investment strategies for the GPFG and the GPFN are discussed in chapters 2.2 and 4.2, respectively (in Norwegian only).

Investment performance in 2023

Continued high inflation contributed to further policy rate increases in many countries throughout 2023. Towards the end of the year, inflation slowed down more quickly than expected. As a result, several central banks signalled that policy rates were likely to be lowered during 2024. Yields on global long-term government bonds rose throughout much of 2023 but fell back towards the end of the year. The decline in yields towards the end of the year contributed to a positive return on bonds.

The global equity market surged over the year, despite continued high inflation and policy rate increases. Falling yields on long-term bonds towards the end of the year contributed to the strong global stock market performance in 2023. Consumption and economic activity remained robust throughout the year, although there were some signs of weakening demand in the second half of the year. The technology sector generated the highest returns in 2023, largely driven by demand for new artificial intelligence solutions. The consumer durables and manufacturing sectors also contributed significantly to the return on the Fund's equity portfolio. Geographically, the return measured in US dollars was highest in North America, followed by developed markets in Europe and Asia-Pacific.

During 2023, the value of the GPFG increased by NOK 3,327 billion, to NOK 15,757 billion. Favourable financial market developments led to a Fund return of NOK 2,214 billion, corresponding to a return of 16.1 percent measured in the currency basket[1] of the Fund and before the deduction of investment management costs.[2] In addition, the GPFG received a net transfer from the central government of NOK 711 billion, as a result of revenues from petroleum activities being significantly higher than the non-oil budget deficit. When considered in isolation, the Norwegian krone depreciation relative to the currency basket of the Fund served to increase the Fund value in NOK terms by 409 billion. However, NOK exchange rate changes do not affect the international purchasing power of the Fund.

The market value of the GPFN increased by about NOK 36 billion last year, to NOK 354.3 billion. The return on the GPFN was 11.4 percent, measured in NOK and before the deduction of investment management costs.

Norges Bank and Folketrygdfondet seek to generate the highest possible return, net of costs and given an acceptable level of risk, within the limits stipulated in the mandates from the Ministry of Finance. In 2023, Norges Bank achieved a return that was 0.18 percentage points lower than the return on the benchmark index, while Folketrygdfondet achieved a return that was 1.47 percentage points higher than the return on the benchmark index.

The Ministry emphasises the overall performance achieved in the GPFG and the GPFN over time. The average annual excess return on the GPFG has been 0.23 percentage points over the last 20 years, while the average excess return on the GPFN has been 0.99 percentage points per year since 2007. The Ministry is satisfied with this performance, given the level of risk assumed. Measured as a proportion of assets under management, investment management costs last year were 4.5 basis points (0.045 percent) in the management of the GPFG and 6 basis points in the management of the GPFN.

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1 The currency basket of the Fund is a weighting of the currencies included in the benchmark index for the Fund.

2 In the text part of its *Annual Report 2023,* Norges Bank reports a return on the GPFG of NOK 2,222 billion. This amount is before changes in deferred tax. In the financial statements in the same report, the return on the GPFG in 2023 is reported to be NOK 2,214 billion. For the same reasons, the Fund value reported by Norges Bank for 2023 differs from the market value referred to by the Ministry of Finance.

The performance in the management of the GPFG and GPFN is discussed in more detail in chapters 2.4 and 4.4, respectively (in Norwegian only).

Responsible investment

The Government Pension Fund is to be managed responsibly. The management mandates for the GPFG and the GPFN are based on the premise that favourable long-term returns depend on sustainable development in economic, environmental and social terms, as well as on well-functioning, legitimate and efficient markets. Environmental, social and governance considerations therefore form an integral part of investment management. The mandates from the Ministry of Finance require Norges Bank and Folketrygdfondet to adopt responsible investment principles in accordance with internationally recognised standards. By advocating long-term value added and responsible business conduct, the responsible investment practices for the Government Pension Fund are held to further the overarching financial objective of achieving the highest possible return, given an acceptable level of risk.

The responsible investment framework comprises, inter alia, advocacy of good corporate governance and responsible business conduct principles, as well as contributing to the development of international standards and best practices, supporting academic research in this field, engaging in dialogue with companies and voting in annual general meetings. Norges Bank has, as part of its responsible investment efforts, prepared expectation documents on various issues, including, inter alia, children's rights, human rights, the climate, biodiversity, and human capital. Correspondingly, Folketrygdfondet has outlined what it expects from companies on various topics. The documents are directed at the boards of directors of the GPFG and the GPFN investee companies and are used as, inter alia, a starting point for ownership dialogue and engagement with standard setters.

The Ministry of Finance has adopted Guidelines for Observation and Exclusion of Companies from the GPFG (the ethically motivated guidelines). For the GPFN, the mandate also stipulates that the Fund shall not invest in companies that are excluded pursuant to the ethically motivated guidelines for the GPFG. The guidelines feature both product-based and conduct-based exclusion criteria. The product-based exclusion criteria encompass the production of tobacco, cannabis for recreational purposes, coal, and several types of weapons. The conduct-based exclusion criteria encompass, inter alia, serious violations of the rights of individuals in situations of war or conflict, severe environmental damage, unacceptable greenhouse gas emissions and serious or systematic human rights violations, including violations of fundamental labour rights. An independent Council on Ethics appointed by the Ministry of Finance makes observation or exclusion recommendations to the Executive Board of Norges Bank, which makes decisions in these cases. Before deciding whether exclusion is appropriate, the Executive Board shall consider whether other measures may be suited for reducing the risk of continued norm violations. This may, for example, be for the Fund to remain invested and seek to influence the company to change its conduct through the specific exercise of ownership rights. Such influence can be an effective means of reducing the risk of ethical norms violations.

Responsible investment is a rapidly evolving field, and the investments of the Fund attract considerable attention. The investment strategy for the GPFG implies that the Fund is invested in a large number of companies, including in countries and regions with different norms and values. The Ministry of Finance is committed to ensuring that the responsible investment practice of the Government Pension Fund shall be in line with leading international practice and aims for the GPFG to take a leading role on responsible investment, subject to its role as a large, global long-term sovereign wealth fund.

The responsible investment of the GPFG and the GPFN is discussed in chapters 2.3 and 4.3, respectively (in Norwegian only).

Unlisted equities (GPFG)

Norges Bank currently has no general permission to invest parts of the GPFG in unlisted equities. Unlisted equity investments were last considered in 2018.[3] At that time, it was decided that the investment universe for the fund should not be expanded to include such investments.

In its consultative comments on NOU 2022: 12; *The Fund in a changing world*, Norges Bank referred to trends that may indicate that a larger share of global value added is now generated in the unlisted market. In the view of the Bank, this suggests that the issue of unlisted equities should be reassessed. Against this background, the Ministry

[3] See discussion in Meld. St. 13 (2017-2018); *The Government Pension Fund 2018*.

asked, in a letter of 27 March 2023, Norges Bank to examine various aspects of unlisted equities. In letters of 27 and 28 November 2023 to the Ministry, Norges Bank advised that unlisted equity investments should be permitted as part of active management. Under the Bank's proposal, unlisted equities would not be included in the benchmark index for the Fund, but Norges Bank would be able to make such investments within its active management limits.

Institutional investors predominantly access the unlisted equity market via private equity (PE) funds. Analysis and index provider MSCI has been commissioned by the Ministry of Finance to estimate the size and composition of the global capital market available to investors. MSCI's analysis shows that the unlisted equity market, measured by assets under management in private equity funds, has grown significantly in recent years. However, it still represents a small share of the global capital market, and it is uncertain whether this growth has been at the expense of listed equities.

Analyses of historical returns by Norges Bank and Professors Døskeland and Strömberg[4] indicate that private equity fund investments have achieved a non-negligible excess return net of costs, compared with the global listed equity market. However, it is challenging to measure and analyse risk and return for such investments. The analyses are sensitive to the choice of methodology, and the findings vary widely between different studies.

A key question is whether distinctive characteristics of the GPFG may represent advantages for Norges Bank when investing in private equity funds. The Ministry has previously received expert reports noting that the Bank may be in a position to outperform the average investor by utilising the Fund's advantages, including its size and low liquidity needs. However, the Fund's distinctive characteristics may also entail disadvantages.

Private equity funds charge very high fees. Although there may be a high excess return net of costs, high fees may in themselves have a negative impact on the legitimacy of the Fund. The current management mandate requires Norges Bank's agreements with external managers to include a cap on fees, which the Bank considers it unlikely that private equity funds would accept. This requirement would therefore have to be adjusted if the Fund were to invest in private equity funds.

The Ministry assumes that Norges Bank will make best efforts to comply with responsible investment, transparency, cost efficiency and reputational requirements in a sound manner in the event of the investment universe being expanded to unlisted equities. It will however not be possible to eliminate all risk associated with the non-financial aspects of unlisted equity investments.

Given the information currently available to the Ministry, the Ministry does not wish to expand the investment universe to generally include unlisted equities.

Such an expansion entails potential investments that would have to be managed in a manner that is substantively different from the current investment management, and which would involve a number of key elements not sufficiently elucidated. The Ministry is therefore of the view that it is appropriate to gather further knowledge about both financial and non-financial aspects of such investments. As part of the follow-up of NOU 2022: 12; *The Fund in a changing world*, the Ministry is planning to establish a new, external expert council for the GPFG; see further discussion in chapter 3.2 (in Norwegian only). The council may be asked to assess various issues affecting the management of the GPFG. The Ministry intends to ask the expert council, once it has been established, to look at, inter alia, whether transparency, responsible investment, cost efficiency and reputational requirements, etc., will be compatible with expanding the investment universe for the GPFG to include unlisted equities. The Council will also be asked to assess the financial aspects of such investments, including expected risk and return, and how unlisted assets in general should be regulated in the management mandate.

The Ministry will revert to the Storting with an assessment as to whether the investment universe of the Fund should be expanded to generally include unlisted equities when it has completed its review of the issue.

This issue is discussed in more detail in chapter 3.1 (in Norwegian only).

[4] Report from Professor Trond M. Døskeland of the Norwegian School of Economics (NHH) and Professor Per Strömberg of the Stockholm School of Economics. Professors Døskeland and Strömberg (2023) have based their assessment on a comprehensive report they prepared for the Ministry of Finance in 2018, when the issue of unlisted equities in the GPFG was last considered. The reports are available on the Ministry website.

Follow-up on NOU 2022: 12; The Fund in a changing world (GPFG)

In September 2021, a public commission chaired by Ulf Sverdrup was appointed to assess how international political and economic developments may affect the GPFG. The Ministry of Finance received the Commission's report, NOU 2022: 12; *The Fund in a changing world,* in September 2022. The Ministry discussed the follow-up of the report in the white paper on the Government Pension Fund published in the spring of 2023.

The Commission noted in its report the importance for the Ministry and Norges Bank to have access to up-to-date information and knowledge of global developments, from both internal and external sources. In this context, the Commission emphasised the increased geopolitical risk, but also pointed to other types of risk.

The Ministry has continued its follow-up of the Commission's recommendations. This includes the establishment of a contact forum between the Ministry of Finance and the Ministry of Foreign Affairs at civil servant level, for the purpose of strengthening the exchange of information on matters that may be of significance to the GPFG. The forum will further facilitate consistent dissemination of information regarding the GPFG from Norway's foreign missions to the authorities of other countries. A key consideration in this context is to ensure that the Fund is understood as a financial investor, with no political objective beyond financial savings.

As mentioned, the Ministry is also intending to establish an expert council that can be asked to examine various issues affecting the management of the GPFG. The council will report to the Ministry but will also contribute to knowledge transfer and public discussion through its reports. The expert council shall be comprised of individuals with a high level of expertise in relevant fields, who are independent of the Ministry. It is intended for the expert council to be established in 2024.

Follow-up of the Sverdrup Commission's report is discussed in more detail in chapter 3.2 (in Norwegian only), as well as in Meld. St. 17 (2022-2023); *The Government Pension Fund 2023*.

Fiscal strength (GPFG)

The fixed-income benchmark for the GPFG is comprised of a government bond index (70 percent) and a corporate bond index (30 percent). Since 2012, the composition of the government bond index has been based on the size of included countries' economies, as measured by gross domestic product (GDP). The purpose of GDP weights is to limit exposure to countries with high and increasing debt-to-GDP ratios. However, economic size is not a precise measure of a country's debt servicing capacity. The management mandate for the GPFG therefore includes a provision requiring Norges Bank to endeavour to take account of differences in fiscal strength in the composition of government bond investments.

This provision is not intended as an instruction from the Ministry for the government bond portfolio to deviate significantly from the benchmark index at all times. However, differences in fiscal strength between countries may have a non-negligible impact on the Fund's performance. The Ministry emphasises that Norges Bank is to manage the Fund's exposure to such risk. The Ministry has proposed certain modifications to the wording of this provision to clarify that the requirement is intended to apply to the Bank's ongoing risk management. This issue is discussed in more detail in chapter 3.3 (in Norwegian only).

Handling of large ownership stakes in the Norwegian equity market (GPFN)

The mandate for the GPFN caps ownership stakes in Norwegian companies at 15 percent. The limit highlights that the GPFN is a financial owner, and not a strategic owner. Over time, however, the GPFN's ownership stakes in the Norwegian stock market have reached a level where there is a risk of breaching the ownership stake limit. This issue has been discussed in several white papers on the Government Pension Fund. In Meld. St. 9 (2021-2022); *The Government Pension Fund 2022*, a new, comprehensive assessment of various alternatives for addressing the ownership stake challenge was announced.

In order to resolve the issue of large ownership stakes, the Government proposes the introduction of a rule for annual withdrawals from the GPFN as of the 2025 fiscal budget. The Ministry of Finance is of the view that that the withdrawal rule should be adopted as a simple, mechanical rule, under which a fixed percentage of the GPFN capital is transferred to the fiscal budget each year. Under the Ministry's proposal, these withdrawals will be budgeted as revenues in the fiscal budget in the same way as dividends from the direct ownership interests of the State, and the spending of such revenues will not be earmarked for any specific purpose.

As with the GPFG, the savings in the GPFN shall support the funding of the National Insurance Scheme's pension expenditure and serve long-term fiscal considerations. A withdrawal rule for the GPFN should therefore facilitate the preservation of the real value of the Fund. Withdrawals should nevertheless be sufficiently large to handle the ownership stake challenge, but no larger.

Withdrawals from the GPFN will be a new source of budget funding. As with the transfers from the GPFG, these withdrawn funds will not be earmarked. The budget being partly funded by withdrawals from the GPFN may affect how much it is advisable to transfer from the GPFG in each budget year, in view of the prevailing economic situation.

A proposal for a percentage rate for the annual withdrawal from the GPFN will be presented in connection with the 2025 budget. Prior to this, the Ministry will obtain an updated assessment from Folketrygdfondet on the appropriate withdrawal percentage to sufficiently handle the ownership stake challenge. The Ministry will also ask Folketrygdfondet for an estimate of the expected long-term real rate of return on the GPFN.

For further discussion of the handling of the large ownership stakes in the GPFN, see chapter 5.1 (in Norwegian only).