Ministry of Finance
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Inclusion of emerging markets in the benchmark portfolio for equities of the Government Pension Fund – Global

1. Background

In a letter of 26 November 2007 from the Ministry of Finance, the Advisory Council on Investment Strategy (the Strategy Council) has been asked to render advice on what additional emerging markets, if any, to include in the Fund's equity benchmark.

The mandate of the Strategy Council emphasizes the following four general principles governing the Fund's investments:

- The objective of the management of the Fund is to achieve the maximum possible expected return, subject to moderate risk.
- The Fund shall be a financial investor, and not a tool for strategic ownership in individual companies.
- The Fund shall be well diversified.
- A long-term investment horizon shall be adopted.

These principles are the main premises underpinning the recommendations made by the Strategy Council in the present letter.

It is not part of the Council's mandate to give advice on ethical questions, which is a matter for the Council on Ethics.

2. Investments in emerging equity markets

The term "emerging equity market" refers to a stock market that is in transition, increasing in size, activity or level of sophistication. A market is usually classified as emerging if it is located in a low- or middle-income economy or if its investable market capitalization is low relative to gross national income.

Typical characteristics of emerging equity markets are investment restrictions such as foreign ownership limits, capital controls, extensive government involvement with listed companies and other regulations affecting foreign investment. In addition, issues such as operational efficiency, quality of market regulation, supervision and enforcement, corporate governance practices, minority shareholder rights, transparency and level of accounting standards are also important for potential foreign investors to consider. So-called country risk factors, such as political, economic and financial risks, are often evaluated separately from market risks by foreign investors.

In the Regulations relating to the Government Pension Fund – Global, an important distinction is made between eligible markets (the investment universe) and markets that are included in the Fund's benchmark. The benchmark may be interpreted as an indication of where the Fund *shall* be invested unless Norges Bank wishes to draw on the risk allowance it has been allocated for deviations from the benchmark. Eligible markets include those markets in which the Fund *may* be invested.

In the current benchmark comprising 27 equity markets, all markets have to be open to foreigners, have satisfactory legislation regarding investors' rights, and satisfy minimum requirements regarding settlement systems, size, liquidity, and political and macroeconomic stability. The markets should also contribute to increasing the expected risk-adjusted portfolio return. The latter requirement favours markets with large market capitalisations. The current benchmark includes the following five emerging equity markets: Brazil, Mexico, Taiwan, South Korea and South Africa.

Since 2004, the set of eligible markets has been larger than the set of markets included in the Fund's benchmark. In 2007, the earlier list of eligible markets was abolished. Since then, new markets have been approved according to internal guidelines on the part of Norges Bank, based on overarching stipulations from the Ministry of Finance concerning valuation, return measurement and the management and control of risk. As of January 2008, Norges Bank has approved investments in 11 equity markets that are not included in the Fund's benchmark.

3. Index methodology

New emerging markets may be included in the Fund's benchmark by adopting a broader version of the FTSE All Cap index. Since 2003, FTSE has developed a framework for including new markets in the FTSE benchmark. The Strategy Council is of the view that FTSE's current methodology, described in Appendix 1, offers many advantages when compared to the earlier screening processes adopted for the Fund in 2000 and 2003. The advantages may be summarised as follows:

- FTSE has a set of rules for including or excluding new markets in or from its benchmark. Markets that are not included in the FTSE benchmark are either too small, have very low liquidity or fail to qualify due to assessments pertaining to more qualitative risk factors. The following criteria must be met before a country can be included in the FTSE benchmark:
    - Permission for direct equity investment by non-nationals
    - Availability of accurate and timely data
    - Absence of any significant exchange controls which would prevent the timely repatriation of capital or dividends
    - The demonstration of significant international investor interest in the local equity market
    - Existence of adequate liquidity in the market.
- If the Fund adopts the FTSE framework, upgrades and downgrades of markets will have an immediate effect on the Fund's benchmark. This is preferable to a system where the Ministry has to initiate a new review in order to change the market composition of the benchmark.
- The FTSE methodology takes into consideration the costs incurred by adding or removing countries to or from the benchmark. Changes occur infrequently and are announced at least six months in advance.

It is the Council's view that FTSE's rules for selecting markets for the global benchmark offer a thorough and transparent methodology. It also involves minimum requirements in areas that have been of concern in the reviews of the Fund's benchmark in 2000 and 2003. Against this background, the Council has narrowed its search for an alternative benchmark to alternative combinations of the markets covered by the global FTSE All Cap index.

4. Alternative benchmarks

The FTSE All Cap index encompasses markets in 48 countries, including Norway. The set of constituent companies in each country is fully free-float adjusted, based on periodic reviews, and in accordance with FTSE's index rules, to reflect the actual availability of stock for public investment in the market. The weight of each company in the index is adjusted to reflect the market capitalisation investable for foreign investors, and the index methodology reduces the number of companies in the FTSE index. As shown in Appendix 3, the number of companies included in the FTSE benchmark is significantly less than the total number of companies listed in each emerging market.

FTSE has classified countries into three groups: Developed Countries, Advanced Emerging Countries and Secondary Emerging Countries. When comparing the Fund's current benchmark to the FTSE classifications shown in Table 1, we find that the current benchmark includes all the FTSE developed foreign markets (as of January 2008). The five emerging markets in the Fund's benchmark are the five largest of the most mature emerging markets in the FTSE benchmark. Therefore, any further expansions of the benchmark involve investment in secondary emerging markets.

Developed	Advanced Emerging	Secondary Emerging
Belgium	Brazil	***Argentina***
Finland	Mexico	***Chile***
France	South Africa	***China***
Greece	South Korea	***Colombia***
Ireland	Taiwan	***Czech Republic***
Italy	***Israel (classified as developed from June 2008)***	***Egypt***
Netherlands		***India***
Portugal		***Indonesia***
Spain		***Malaysia***
Germany		***Morocco***
Austria		***Pakistan***
UK		***Peru***
Denmark		***Philippines***
Switzerland		***Russia***
Sweden		***Thailand***
USA		***Turkey***
Canada		***Hungary (classified as advanced emerging from June 2008)***
Australia		***Poland (classified as advanced emerging from June 2008)***
Hong Kong		
Japan		
New Zealand		
Singapore		

Table 1. Countries covered by FTSE All Cap. Markets outside the scope of the Fund's current benchmark are shown in bold. The Norwegian market is not included here, as the Government Pension Fund – Global is not permitted to invest in Norwegian assets. FTSE changes with effect from June 2008 are indicated in parenthesis. In addition, FTSE has announced that China 'A' Shares, South Korea and Taiwan are on the watch list for possible upgrades. Greece and Pakistan are on the watch list for possible downgrades/exclusions.

The Council has evaluated two alternatives to the current benchmark:

Alt. 1: FTSE All Cap (including Developed, Advanced Emerging and Secondary Emerging Countries). As of June 2008, this would add one developed (Israel), two advanced emerging (Poland and Hungary) and sixteen secondary emerging markets (China, India, Russia, Argentina, Chile, Colombia, Czech Republic, Egypt, Indonesia, Malaysia, Morocco, Pakistan, Peru, Philippines, Thailand and Turkey).

Alt. 2: FTSE All Cap Developed, FTSE All Cap Advanced Emerging Countries and only the three largest markets classified as FTSE Secondary Emerging Countries. As of June 2008, this would add one developed (Israel), two advanced emerging (Poland and Hungary) and three secondary emerging markets (China, India and Russia).

Alternative 1 involves an emerging market portion of about 10 pct. of the equity benchmark (based on the fixed regional weights in the Fund's benchmark). With a somewhat more restrictive selection limited to the largest secondary emerging markets, as in alternative 2, the portion of emerging markets in the benchmark would still be about 8 pct. Country weights for alternatives 1 and 2 have been calculated in a separate table in Appendix 4. This table confirms that investments in India, China and Russia will form the largest components of the new investments under both alternatives. The main argument for selecting alternative 2 would be the limited diversification gains from adding the smallest countries.

5. Implications for expected return and risk

The inclusion of additional emerging markets in the Fund's benchmark must be expected to have only marginal effects on the Fund's total return and risk. This is due to the small size of these markets, relative to the Fund's total benchmark, and .a less than perfect correlation between emerging equity markets and the remainder of the portfolio.

Past return data for the various FTSE aggregates are only available from December 2002. It is not meaningful to choose between alternative benchmarks based on an analysis of such short time series. The experience since 2002 still support the view that the effect over time on the Fund's total risk will be limited. While the risk associated with FTSE Developed over this period (measured by the annual standard deviation of return in US dollars) was 9.1 pct., the corresponding numbers for FTSE Advanced and Secondary Emerging were 17.1 and 17.4 pct., respectively. The historical risk associated with the FTSE All Cap, including all emerging markets, was still only marginally higher than 9.1 pct, at 9.4 pct.

The five years since 2002 turned out to be a very favourable period for investors in emerging markets. The average annual nominal rate of return in FTSE emerging markets (advanced plus secondary) was 36 pct over that period, compared to 19 pct. in developed markets. Some argue for a higher return in emerging markets, as these countries are expected to achieve higher economic growth than developed countries over time. This effect has not been documented empirically, however. Dimson, Marsh and Staunton[1] point out that GDP growth has not been, based on past returns, a good indicator of equity investment opportunities. Hence, even if one could predict in advance what countries would have the highest GDP growth, there is still no evidence that these markets would do best.

The Council is of the view that the best case for strategic exposure to emerging markets has to do with low correlations with assets in developed markets and their implications for overall portfolio risk.The Fund's investment strategy is founded on the principles that it shall be well diversified and the investment horizon long-term. Therefore, the Fund should diversify by acquiring a representative selection from the world's stock and bond markets. This strategy is expected to achieve the maximum possible return at a moderate level of risk in the long run. Increasing the emerging market exposure by choosing the broadest available FTSE benchmark would be consistent with the principles referred to above,even if it is difficult to quantify the expected improvement in terms of risk and return.

Emerging markets currently constitute about 10 pct. of the FTSE All Cap benchmark. If the emerging market portion grows as a result of the relative success of these markets, it will be an advantage for the Government Pension Fund to have an early presence in these markets. At the same time, any increase in the risk associated with the Fund's portfolio of stocks and bonds from implementing a broader benchmark than the present one is likely to be small.

The Strategy Council has also reviewed country risk, as measured by the International Country Risk Guide (ICRG), supplied by Political Risk Services. The index covers political, financial and economic risk, and is a composite index where political risk carries a twice as high weight as each of the two other risk factors. The index values are presented in Appendix 2. According to this indicator, there is a low level of country risk attaching to investments in Poland and Hungary. Investments in China, India and Russia appear to involve a moderate level of political risk, but low composite risk. There is a wide dispersion of index values for each of the remaining twelve countries classified as Secondary Emerging markets by FTSE. In aggregate, these markets are probably exposed to moderate political risk, and low composite risk, according to this indicator.

It is the Council's view that the country risk implied by using the FTSE benchmark should not prevent a long-term, well-diversified investor, such as the Government Pension Fund, from gaining from broader exposure to emerging equity markets. If anything, the review of the ICRG points in favour of choosing the broadest available benchmark of investable markets.

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[1] Dimson, Marsh and Staunton, 2005. Economic growth and global investment returns. Global Investment Returns Yearbook 2005.

6. Other funds' equity benchmarks

Most large institutional investors have parts of their equity portfolios invested in emerging markets. CEM Benchmarking[2] has defined a peer group for the Government Pension Fund - Global, comprising the 19 largest pension funds in the world. 13 of the peers had a specific policy allocation to emerging equities. At the end of 2006, the average allocation for these 13 funds was 53 percent to listed equities. The average allocation of listed equities to emerging markets were 5.5 pct. Large institutional investors hold investments in emerging markets in other asset classes like bonds, real estate and private equity as well, although to a far lesser extent than in listed equities.

Some of the world's largest pension funds have recently increased their exposure to emerging markets. According to the investment plan 2007-2009 for the largest Dutch pension fund, ABP, its strategic asset allocation to emerging markets is 16 percent of total listed equity. ABP has adopted the MSCI Emerging Markets index, comprising 25 emerging markets as of June 2007.

The largest US pension fund, CalPERS, has two different index providers for its global equity benchmark. For US equities it uses Wilshire 5000, and for international (global ex. US) the benchmark provider is FTSE. It includes all countries encompassed by the FTSE benchmark (developed, advanced emerging and secondary emerging). CalPERS recently approved a new weighting structure for the listed Global Equity portfolio, in which market capitalization weights are used to establish all segments and country targets. Emerging markets will account for approximately 12 percent of its equity portfolio.

CalPERS invests in emerging markets through the use of external managers. Before investing, managers will be required to assess country and company prospects based on a predefined set of principles. The emerging market managers shall report back annually to CalPERS on their application of the principles.

The examples from ABP and CalPERS support the Council's view that the selection of emerging markets for inclusion in the Fund's benchmark may be based on FTSE's selection of emerging markets. The examples also illustrate that these large funds have a larger allocation to emerging market equities than does the Government Pension Fund – Global.

7. Advice from Norges Bank

The question of whether to include additional emerging markets in the benchmark portfolio of the Government Pension Fund – Global has also been examined by Norges Bank. In the Bank's letter of 1 February 2008 to the Ministry of Finance, it is

[2] The Ministry of Finance has for several years commissioned CEM Benchmarking Inc. to compare the management of the GPFG to that of other funds.

recommended that the Ministry of Finance uses the FTSE Global All Cap as a benchmark, including developed, advanced emerging and secondary emerging markets. Norges Bank writes (Council's translation):

"Norges Bank recommends a broadening of the equity benchmark of the Government Pension Fund – Global, to include countries classified as either Developed, Advanced Emerging or Secondary Emerging within the FTSE Global All Cap.
…
At the same time, Norges Bank assumes that the current requirements for a sufficient process for approval of new countries, prior to investing in a new market, are continued."

The Council is of the view that Norges Bank's recommendation is in line with alternative 1 as outlined in Section 4 of this letter. The Council has taken note of Norges Bank's view, as expressed in the letter of 1 February 2008, that the Ministry of Finance should not exclude the smallest countries included in the FTSE index from the Fund's benchmark on the basis of limited diversification benefits or operational concerns.

8. Conclusion

The Strategy Council recommends that the Fund's benchmark portfolio for equities is expanded to include countries classified as either developed, advanced emerging or secondary emerging in the FTSE All Cap index. This means that the number of emerging markets will be adjusted in line with changes in FTSE's country classification over time. Investments should, as recommended by Norges Bank, be subject to the approval of each market based on an internal approval process for new markets.

The Council has based its recommendation on the following:

- FTSE's rules for selecting markets for the global benchmark offer a thorough, transparent and up-to-date methodology for maintaining a benchmark comprising both developed and emerging markets. At the same time, this change in methodology offers continuity, since FTSE's methodology involves minimum requirements in areas that have been of concern in the reviews of the Fund's benchmark in 2000 and 2003.
- A fundamental principle underpinning the investment strategy of the Government Pension Fund – Global is to spread risk by acquiring a representative selection from the world's stock and bond markets, in order to thereby achieve the maximum possible return at a moderate level of risk in the long run. Increasing the emerging market exposure to include all markets in the FTSE All Cap benchmark is consistent with the fundamental principles behind the investment strategy.
- The effect on the total risk and return associated with the equity portfolio is expected to be small.
- If the emerging market portion grows as a result of the relative success of these markets, it will be an advantage for the Government Pension Fund to have an early presence in these markets.

- The Council has taken note of the fact that some very large international funds have chosen a broader equity benchmark than has the Government Pension Fund – Global. These other funds have chosen a benchmark that is well matched with the notion of including all emerging markets encompassed by the FTSE All Cap index.

Oslo, 28 February, 2008

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Appendix 1
Excerpt from “Ground rules for the management of the FTSE Global Equity Index Series”, version 2.0, January 2007.

1 Criteria for inclusion

1.1 The following criteria must be met before a country can be included in the FTSE All-World Index Series or FTSE Global Small Cap Index Series:

- Permission for direct equity investment by non-nationals
- Availability of accurate and timely data
- Non-existence of any significant exchange controls which would prevent the timely repatriation of capital or dividends
- The demonstration of significant international investor interest in the local equity market
- Existence of adequate liquidity in the market

A country’s classification as Developed, Advanced Emerging or Secondary Emerging is dependent on the following:

Data quality: availability & timeliness	Efficient settlement systems
Free flow of foreign exchange	Liquidity – minimum stock market turnover
GDP (per capita)	Market maturity
Market breadth: number of eligible constituents	Membership of economic group or common currency block
Market depth: number of industrial sectors	Total stock market capitalisation
Reliable price information	
Stock market capitalisation vs. GDP	
Unrestricted/low restrictions on foreign investment	

2 Adding new countries

2.1 New countries, which in the view of the FTSE Policy Group and FTSE Regional Committees comply with these Ground Rules, may be added at any time after a prior announcement.

2.2 New regional indices may be added at any time after a prior announcement.

2.3 Countries and markets currently eligible for the FTSE Global Equity Index Series are shown in an appendix to the index rules.

2.4 The country and regional indices currently calculated for the FTSE Global Equity Index Series are set out in an appendix to the index rules.

3 Criteria for changing country classifications

3.1 The FTSE Regional Committees will review the classification of countries between Developed, Advanced Emerging and Secondary Emerging on a regular basis.

3.2 Countries can move between Developed, Advanced Emerging and Secondary Emerging depending on the criteria in Ground Rule 2.1.2. The FTSE Policy Group will publish a watch list of countries being monitored for promotion or demotion and will normally give at least three months notice before changing the classification of any country.

4 Deletion or suspension

4.1 If one or more of the eligibility criteria as defined under Ground Rule 2.1.1 are not met by a constituent country, the deletion or suspension of all related index calculations may be implemented after consideration by the appropriate FTSE Regional Committee and approval by the FTSE Policy Group.

Appendix 2. Index of country risk from the International Country Risk Guide (ICRG). As of July 2007.

ICRG country risk	Political	Economic	Financial	Composite
25 developed countries	**83.8 VL**	**42.5 VL**	**39.4 L**	**82.9 VL**
(Minimum)	(61.5 M)	(36.0 L)	(31.0 M)	(72.8 L)
5 emerging markets in current benchmark	**72.1 L**	**40.2 VL**	**41.8 VL**	**77.1 L**
(Minimum)	(65.5 M)	(38.0 L)	(39.0 L)	(71.3 L)
Poland + Hungary	**76.3 L**	**36.3 L**	**36.3 L**	**74.4 L**
(Poland)	(75.0 L)	(39.5 L)	(38.5 L)	(76.5 L)
(Hungary)	(77.5 L)	(33.0 M)	(34.0 M)	(72.3 L)
China + India + Russia	**65.8 M**	**40.2 VL**	**45.2 VL**	**75.6 L**
(China)	(69.5 M)	(41.5 VL)	(47.5 VL)	(79.3 L)
(India)	(62.5 M)	(35.0 L)	(43.0 VL)	(70.3 L)
(Russia)	(65.5 M)	(44.0 VL)	(45.0 VL)	(77.3 L)
Remaining secondary emerging markets	**65.2 M**	**38.4 L**	**39.5 L**	**71.5 L**
(Argentina)	(70.5 L)	(41.0 VL)	(37.5 L)	(74.5 L)
(Chile)	(80.5 VL)	(44.5 VL)	(40.5 VL)	(82.8 VL)
(Colombia)	(56.0 H)	(38.5 L)	(36.0 L)	(65.3 M)
(Czech Republic)	(80.0 VL)	(38.0 L)	(39.5 L)	(78.8 L)
(Egypt)	(61.0 M)	(34.5 M)	(41.5 VL)	(68.5 M)
(Indonesia)	(61.0 M)	(38.0 L)	(40.0 VL)	(69.5 M)
(Malaysia)	(77.0 L)	(42.0 VL)	(43.0 VL)	(81.0 VL)
(Morocco)	(71.0 L)	(33.5 M)	(41.5 VL)	(73.0 L)
(Pakistan)	(45.5 VH)	(33.5 M)	(38.5 L)	(58.5 H)
(Peru)	(64.5 M)	(42.0 VL)	(42.0 VL)	(74.3 L)
(Philippines)	(62.0 M)	(39.5 L)	(38.0 L)	(69.8 M)
(Thailand)	(56.0 H)	(39.5 L)	(42.0 VL)	(68.8 M)
(Turkey)	(62.0 M)	(35.0 L)	(33.0 M)	(65.0 M)

"VL" = very low risk, "L" = low risk, "M" = moderate risk, "H" = high risk. The Political Risk index is based on a range of up to 100 points, Financial Risk up to 50 points, and Economic Risk up to 50 points. The total points from the three indices are divided by two to produce the weights for inclusion in the composite country risk score. The composite scores, ranging from zero to 100, are then broken into categories from Very Low Risk (80 to 100 points) to Very High Risk (zero to 49.5 points).

Political risk ratings are based on the following components: Government stability, socioeconomic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religion in politics, law and order, ethnic tensions, democratic accountability, bureaucracy quality.

Economic risk ratings are based on the following components: GDP per head, real GDP growth, annual infl. rate, budget balance as % of GDP and current account as a % of GDP.

Financial risk ratings are based on the following components: Foreign debt as a % of GDP, foreign debt service as a % of exports of goods and services, current account as a % of exports of goods and services, net international liquidity as months of import cover and exchange rate stability (last 12 months).

Composite ratings are the sum of the three index values, multiplied by 0.5.

Appendix 3.
Total number of listed companies and number of companies included in the FTSE All Cap index.

No. of companies	Total	FTSE index	Classification
South Korea	1 694	247	advanced
Brazil	392	99	advanced
Taiw an	1 222	373	advanced
South Africa	401	97	advanced
Mexico	131	41	advanced
Israel	612	65	advanced
China	1 440	162	secondary
India	4 796	212	secondary
Russia	309	24	secondary
Malaysia	1 027	80	secondary
Poland	267	33	secondary
Indonesia	344	39	secondary
Turkey	314	51	secondary
Chile	244	31	secondary
Thailand	518	68	secondary
Hungary	41	6	secondary
Egypt	603	25	secondary
Czech Republic	29	7	secondary
Argentina	103	15	secondary
Colombia	114	11	secondary
Philippines	238	14	secondary
Peru	193	4	secondary
Morocco	65	9	secondary
Pakistan	652	21	secondary

Source: Ministry of Finance

Appendix 4.
Country weights under the current and alternative benchmarks, applying the Fund's regional weights.

Country weights (%)	Current	Alternative 1	Alternative 2
Japan	7.10	5.96	6.19
Australia	2.69	2.26	2.35
Hong Kong	1.63	1.37	1.42
Singapore	0.50	0.42	0.44
New Zealand	0.06	0.05	0.05
South Korea	1.76	1.48	1.54
Taiwan	1.27	1.06	1.10
China		0.95	0.99
India		0.91	0.94
Malaysia		0.25	
Indonesia		0.14	
Thailand		0.11	
Philippines		0.03	
Pakistan		0.02	
USA	30.30	30.07	30.30
Canada	2.57	2.55	2.57
Brazil	1.03	1.02	1.03
South Africa	0.64	0.64	0.64
Mexico	0.46	0.45	0.46
Chile		0.10	
Egypt		0.05	
Argentina		0.04	
Colombia		0.04	
Peru		0.02	
Morocco		0.02	
Hungary		0.13	0.13
Czech Republic		0.11	
Turkey		0.27	
Poland		0.29	0.29
Russia		1.36	1.37
Israel		0.31	0.31
Italy	3.01	2.86	2.88
Netherlands	2.28	2.17	2.18
Sweden	1.95	1.85	1.87
Finland	1.26	1.20	1.21
Belgium	0.82	0.78	0.78
Denmark	0.76	0.72	0.73
Greece	0.64	0.61	0.61
Ireland	0.53	0.51	0.51
Austria	0.46	0.44	0.44
Portugal	0.31	0.29	0.30
Switzerland	4.58	4.35	4.38
Spain	3.27	3.11	3.14
France	7.89	7.50	7.56
Germany	6.09	5.79	5.83
UK	16.15	15.35	15.47
Sum	**100.00**	**100.00**	**100.00**

Source: Ministry of Finance