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Date: 2 February 2012
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Government Pension Fund Global – strategic benchmark index for equity investments

In this letter, Norges Bank provides advice on the strategic benchmark index and regional weights for the Government Pension Fund Global's equity investments. The letter builds on the assessments made in our letter of 6 July 2010 on the development of the investment strategy for the Fund.

Our recommendation is that a leading and readily available market-weighted index is used as the strategic benchmark index for equity investments. We also recommend that the strategic regional distribution of equities moves in the direction of market weights, which entails a reduction in the allocation to Europe. We recommend that this is carried out gradually. Finally, we recommend that a separate allocation to emerging markets is not introduced.

<u>Starting point in a market-weighted strategic benchmark index for equity investments</u>
The strategic benchmark index for equity investments should reflect the role played by this asset class in the Fund. It should be based on leading, readily available indices to ensure the greatest possible openness and transparency. A market-weighted global benchmark index from one of the leading index suppliers reflects investment opportunities in the equity markets. It gives equal percentage ownership of all companies included in the index and can fulfil the role that the strategic benchmark index should play as a long-term yardstick for the operational management of the Fund.

The use of market-weighted indices as a strategic benchmark index is a good basis for the management of the Fund. The indices are based on objective, mechanical rules for which stocks are included, to what extent and at what time. Criteria that are prioritised include companies' size and the liquidity of their shares. The technical weaknesses of equity indices are more limited than those of fixed-income indices. The Fund's current benchmark index for equity investments covers 98 percent of the market capitalisation of the markets included.

Investments in equities confer ownership of a stake in the companies' future value creation. One issue is whether a market-weighted portfolio best reflects global value creation. A GDP-weighted index will assign higher weights to countries with high levels of economic activity but a relatively small investable equity market. The challenge is that much of a country's growth and economic activity may take place at companies and institutions that are not quoted.

The index is, however, intended to represent what is available to buy, not the underlying level of economic activity. The index suppliers exclude equities held by dominant shareholders or national authorities, known as free-float adjustment. Markets where a large percentage of shares are held not by institutional or private investors but by strategic owners will have lower weights in a market-weighted index than the full market value of the companies in that country would dictate. Free-float adjustment of the Fund's present benchmark index for equity investments currently serves to reduce the market value of the index by around 20 percent. Differences in ownership structure between markets also mean that a market-weighted benchmark index will have an approximately 5 percentage point lower content of Asian shares and a correspondingly higher content of American shares than the full market value of companies in these regions would dictate.

Empirical analysis shows that portfolios constructed on the basis of different weighting criteria to a market-weighted portfolio can offer a better trade-off between risk and return. The most obvious alternative weighting criteria are macroeconomic criteria such as GDP in different countries or regions, or company fundamentals such as revenue or number of employees. A third approach is to use time series for companies' returns to construct an index with a different risk/return profile. In a separate note[1,2], Norges Bank Investment Management (NBIM) discusses a number of alternative weighting regimes.

Our conclusion is that these alternative weighting criteria should not be laid down in a strategic benchmark index for equity investments, as they are complex to calculate, require relatively frequent adjustments, and will often not be fully investable for a fund such as the Government Pension Fund Global. NBIM can develop an operational benchmark portfolio that takes account of these considerations.

Norges Bank recommends that the starting point in a market-weighted benchmark index is retained.

<u>Exposure to sources of systematic risk</u>

In Report No. 10 (2009-2010) to the Storting, the Ministry of Finance wrote that systematic risk should be given greater attention in the management of the Fund. Norges Bank's letter of 6 July 2010 was based on the fact that the Fund is particularly well-suited to bearing certain

[1] Notes on investment strategy published by NBIM as "Discussion notes" on www.nbim.no.
[2] "Alternatives to a Market Value Weighted Index".

types of systematic risk and should probably therefore have a different exposure to these sources of systematic risk than a market-weighted average. The combination of a long time horizon, no short-term liquidity requirements and a patient owner means that the Fund may be particularly well-suited to taking on certain types of risk. This will, above all, be the case in periods of great uncertainty about future returns. In a separate note[3], NBIM discusses various methods for harvesting factor risk premia.

A global market-weighted benchmark index will not necessarily offer the best possible trade-off between risk and return for a fund such as the Government Pension Fund Global. The investment strategy should therefore be designed in such a way that the Fund can harvest risk premia dynamically, and the portfolio can be constructed in ways that build on its natural advantages.

Norges Bank believes that the strategic benchmark index should not be adjusted to take account of systematic risk premia for equity investments.

Principles for determining the benchmark index and regional distribution

The Fund's strategic benchmark index for equity investments currently consists of three regional indices assigned fixed weights. Within each of these three regions, the strategic benchmark index is market-weighted. The Fund's regional weights, with a high allocation to Europe, have been motivated by the aim of reflecting Norway's future import pattern. Given certain assumptions, an approach of this kind could help reduce the risk at the time the Fund's capital is to be consumed. In our letter of 6 July 2010, we noted that the relationship between the regional weights and the objective for the management of the Fund is unclear.

The objective of the greatest possible long-term international purchasing power is best served by broad ownership of the production of goods and services. The Fund's geographical distribution should depart from market weights only if such a composition of the Fund helps reduce risk or increase expected returns. In the current benchmark index, Europe has a weight of 50 percent, the Americas 35 percent and Asia 15 percent. By way of comparison, Europe accounted for 27 percent of the market value of the FTSE index at the end of 2011, the Americas 52 percent and Asia 22 percent (see Table 1). This means that the Fund has substantially higher ownership of European companies than of companies in the Americas and Asia (see Chart 1).

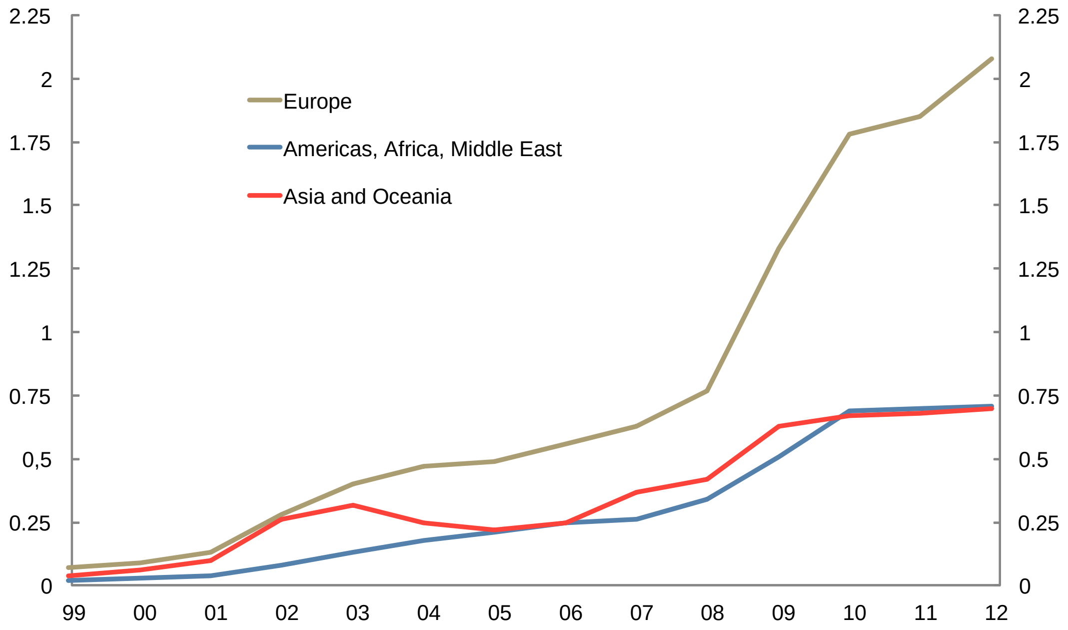
[3] "Capturing Systematic Risk Premia".

Table 1: Different weighting regimes

	GDP weights	GDP weights (PPP)	Market weights	Import weights	Fund's strategic regional weights
Americas	36%	33%	52%	11%	35%
Asia/Pacific	31%	38%	21%	14%	15%
Europe	33%	28%	27%	75%	50%

Source: FTSE, IMF, Statistics Norway

Chart 1: The Fund's ownership of different equity markets



Norges Bank attaches importance to being a predictable and long-term investor which shares a mutual interest with the companies and countries in which we invest in creating long-term value. Our rights as an investor must be respected, regulatory conditions must be relatively stable, and we must be reasonably sure that our investments are safe. We will always be a minority shareholder dependent on good corporate governance, limited discrimination and the protection of our rights in law and legal systems. It is possible that the Fund should assign a larger weight to Europe than other regions if these considerations are prioritised.

Financial protectionism is a risk in today's global capital markets. This includes the regulation of capital flows and the taxation of capital. In addition, there will always be a risk that the Fund's capital could at some point be expropriated or frozen for a long period. It may be natural to view Europe as an extended domestic market for the Fund with lower risks of this kind than in other regions. This should not, however, prevent the start of a process of adjusting to and moving in the direction of global market weights.

Norges Bank recommends that the strategic regional distribution of the Fund's equity investments moves in the direction of global market weights. The transition to a new benchmark index should take place over a long period and in stages.

<u>Emerging markets</u>

The benchmark index has been expanded in several stages since the Fund's inception through the inclusion of small- and mid-cap stocks and additional countries. In a separate note[4], NBIM looks more closely at the relationship between a country's economic growth and stock market returns. The analysis shows that high levels of growth in a country do not in themselves provide grounds for an unequivocal assumption of higher stock market returns. The relationship between economic growth and corporate earnings in a country is weak. It is only growth in excess of expectations as reflected in equity prices that can provide a basis for higher future risk-adjusted returns.

In another note[5], NBIM considers which underlying factors might result in higher risk and so higher expected returns in emerging markets. Factors such as stability in the governance structure, regulation of financial markets, legal system and legislative quality, extent of corruption and, ultimately, danger of expropriation contain elements of risk that need to be considered. In some cases, foreign investors and the interests of minority shareholders enjoy only limited protection. Foreign investors in some markets are subject to special rules and restrictions, and some countries do not fully allow the free movement of capital in their currency. It is not certain that the Fund will have a natural advantage over other funds in harvesting risks of this type.

When it comes to whether the Fund should have a higher strategic allocation than market weights to what FTSE classifies as emerging markets, we currently believe that market weights offer the best approximation of development trends and risk in these markets.

Norges Bank recommends that a separate allocation to emerging markets over and above market weights should not be introduced.

<u>Norges Bank's recommendations</u>

Our recommendations for the strategic benchmark index and regional weights for equity investments can be summed up as follows:

- The strategic benchmark index should be a long-term, objective yardstick for the operational management of the Fund and must be based on a leading, readily available market-weighted index.

[4] "Economic Growth and Equity Returns".
[5] "Risks and Rewards in Emerging Equity Markets".

- The strategic regional composition of equity investments should gradually move in the direction of market weights, which means a lower weight of European stocks than at present.
- A separate allocation to emerging markets over and above market weights should not be introduced.

Yours faithfully

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