MINISTRY OF FINANCE

Meld. St. 9

(2021–2022)

Report to the Storting (white paper)

The Government Pension Fund 2022

MINISTRY OF FINANCE

Meld. St. 9

(2021–2022)

Report to the Storting (white paper)

The Government Pension Fund 2022

Recommendation of the Ministry of Finance of 1 April 2022,
approved by the Council of State on the same day.
(Government Støre)

Unofficial translation from Norwegian. For information only.

Responsible long-term investment

Executive summary

The Government Pension Fund is an intergenerational fund. The Fund is owned by the 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 further long-term considerations in the spending of government petroleum revenues, thus ensuring that the petroleum wealth benefits both current and future generations.

The Ministry of Finance holds the formal responsibility for the management of the Government Pension Fund under the Act. Norges Bank and Folketrygdfondet carries out the operational management of the GPFG and the GPFN, respectively, within management mandates stipulated by the Ministry. The investment objective of the two Funds is to achieve the highest possible return, given an acceptable level of risk. Within the scope of this objective, the Funds shall be managed responsibly. A clear financial objective, together with responsible, long-term fund management, ensures that the Government Pension Fund will benefit both current and future generations.

Norges Bank and Folketrygdfondet make decisions about individual investments and exercise the ownership rights of the Funds independently of the Ministry of Finance. The investment strategy for the Funds and the investment framework are defined by the Ministry, with key choices having been endorsed by the Storting. A clear division of roles highlights responsibilities. The governance structure ensures that key decisions affecting risk and return, as well as decisions regarding the responsible investment framework, are endorsed by the Fund's owners; the people of Norway, represented by the Government and the Storting. At the same time, there must be sufficient delegation of responsibility to ensure that operational management decisions are made close to the markets and companies in which the Funds are invested. Transparency and broad endorsement of the investment strategy and the investment management framework support understanding of the risk assumed. This establishes a foundation for remaining committed to the chosen strategy, also during periods of considerable financial market turbulence.

The investment management framework for the Government Pension Fund is established by the Government and the Storting, but the Fund is not a policy tool. However, withdrawals from the GPFG contribute to the funding of welfare schemes and political priorities. The financial objective of the Fund and the ability to fund public expenditure are closely related. Over time, the GPFG has become an ever more important source of public expenditure funding. In 2021, about one quarter of fiscal budget expenditure was funded from the GPFG.

According to the fiscal policy guidelines, annual withdrawals from the GPFG shall over time correspond to the expected long-term annual real rate of return on the Fund capital; estimated at 3 percent. The guidelines further stipulate that petroleum revenue spending in any given year shall be adapted to the economic situation. This implies that one may spend more than the expected real rate of return during periods of economic setback, but also that spending should be less in economic upturns. Persistently running large fiscal deficits would impair the long-term sustainability of public finances.

Large increases in the Fund capital over the last two decades have offered scope for a significant increase in petroleum revenue spending. Historically, large petroleum revenue transfers into the Fund have increased the Fund value, even during periods of stock market decline. In coming years, periods without increase, or periods of decline, in the Fund value must be expected. The Fund value will increasingly be determined by the development in the international financial markets. As the Norwegian welfare state has increasingly been funded by transfers from the GPFG, public finances have become more vulnerable to market fluctuations. Increased vulnerability and reduced Fund growth prospects suggest that caution should be exercised in the continued phase-in of Fund revenues into the Norwegian economy.

The investment strategy

The Ministry of Finance emphasises the importance of an investment strategy that is professionally acknowledged and tailored to the distinctive characteristics and purpose of the Fund. The strategies for the GPFG and the GPFN have been developed over time, based on thorough assessments, professional recommendations and practical experience. The investment strategy is defined in the management mandates for the two Funds and reflected in, inter alia, the composition of the benchmark indices established by the Ministry. 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 for the GPFG is 70 percent, while it is 60 percent for the GPFN. Fixed-income securities account for the remainder.

The choice of equity share is the decision with the greatest impact on overall risk in the Fund. A larger equity share entails higher expected return, but also increased volatility in the value of investments and a higher risk of loss. By endorsing the chosen equity share, the Fund's owners; the people of Norway, represented by the Government and the Storting, have expressed what is considered an acceptable level of risk. The investment strategy further entails the Fund capital being primarily invested in listed markets.

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

Most of the Fund risk is determined by general equity and bond market developments. Norges Bank and Folketrygdfondet may deviate somewhat from the benchmark indices in their operational investment management, within risk limits stipulated in the mandates. The intention behind this is to ensure cost-effective adoption of the benchmark indices, as well as to exploit distinctive Fund characteristics or advantages to generate excess return. The GPFG management mandate further allows some limited scope for investments in unlisted real estate and unlisted renewable energy infrastructure. The investment strategies for the GPFG and the GPFN are discussed in chapters 2.2

and 4.2, respectively (in Norwegian only). Potential implications of increased inflation for developments in the value of the GPFG are addressed in chapter 2.6 (in Norwegian only).

Strong performance in 2021

Market developments in 2021 reflected that the global economy was rebounding from the coronavirus pandemic, with robust growth in many countries. Expansionary monetary and fiscal policy served to boost overall demand. Moreover, higher commodity and energy prices have contributed to a steep increase in consumer prices. Higher inflation and a positive economic growth outlook created expectations of monetary policy normalisation in many countries, with an increase in key policy rates. This development caused long-term interest rates to increase during the year, and led to weak returns on fixed-income securities globally. At the same time, company earnings reverted to pre-pandemic levels during 2021, and high equity returns were registered globally. However, new virus outbreaks, inflationary pressure and monetary policy normalisation caused stock market uncertainty over the course of the year. The second half of the year, in particular, was characterised by considerable share price volatility. There were also major differences between sectors and countries. The energy, finance and technology sectors delivered the strongest performance, while interest rate-sensitive sectors such as telecommunications, power and water utilities accounted for the weakest performance. Geographically, returns were highest in North America.

The market value of the GPFG increased by NOK 1,432 billion in 2021, to reach NOK 12,340 billion. The increase is primarily the result of positive financial market returns. The return on the GPFG in 2021 was 14.5 percent, measured in the currency basket of the Fund and before the deduction of investment management costs. The market value of the GPFN at year-end 2021 was NOK 333 billion, which represents a NOK 41 billion increase over the course of the year. The return on the GPFN last year was 14.0 percent, measured in NOK and before the deduction of investment management costs.

Norges Bank and Folketrygdfondet seek to achieve 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 2021, Norges Bank achieved a return on the GPFG that was 0.74 percentage points higher than the return on the benchmark index, while Folketrygdfondet achieved an excess return of 0.97 percentage points in the management of the GPFN. The Ministry emphasises the overall performance achieved in the GPFG and the GPFN over time. The average annual return on the GPFG over the last 20 years has been 0.2 percentage points higher than the return on the benchmark index. The average excess return on the GPFN has been 1.0 percentage point 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 4.0 basis points for the GPFG and 5.4 basis points for the GPFN.

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

Responsible investment

The Government Pension Fund Act requires the Fund to be managed responsibly within the scope of its financial objective. Environmental, social and corporate governance considerations form an integral part of the management of the GPFG and the GPFN, in line with the mandates laid down by the Ministry of Finance. The mandates 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, responsible investment serves to further the objective of achieving the highest possible return, given an acceptable level of risk.

Norges Bank and Folketrygdfondet make decisions about individual investments and exercise the ownership rights of the Funds independently of the Ministry. 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, company dialogue on relevant topics and issues, as well as voting in annual general meetings of investee companies.

Norges Bank has, as part of its responsible investment efforts, prepared expectation documents on several issues, including, inter alia, climate, human rights, children's rights, as well as tax and transparency. The documents are directed at the boards of directors of investee companies, and are used as, inter alia, a basis for the Bank's ownership dialogue with the companies. Folketrygdfondet has prepared expectation documents for companies on, inter alia, strategy, capital structure and financial objectives, anti-corruption, remuneration, human rights, climate and the environment.

The Ministry of Finance has adopted Guidelines for Observation and Exclusion of Companies from the GPFG (the ethical guidelines). The guidelines feature both *product-based* exclusion criteria, which encompass the production of tobacco, cannabis, coal and certain weapon types, and *conduct-based* exclusion criteria, which encompass, for example, serious or systematic human rights violations and severe environmental damage. An independent Council on Ethics appointed by the Ministry of Finance makes recommendations on the observation or exclusion of companies under the ethical guidelines. Decision-making authority rests with the Executive Board of Norges Bank . For the coal criterion, the Bank may make decisions without any prior recommendation from the Council on Ethics. Before exclusion is decided, the Bank shall consider whether other measures may be suited for reducing the risk of continued violation of ethical norms, or may be more appropriate for other reasons. The Bank shall consider the various tools at its disposal in relation to each other and use these in an integrated manner. Active ownership may be effective in reducing the risk of violating ethical norms by influencing companies to change their conduct. What is the most appropriate tool must be considered on a case-by-case basis.

The investments of the Fund attract considerable attention. Even a strong framework for risk management, responsible investment and ethically motivated guidelines cannot serve as a guarantee against blameworthy situations in Fund portfolio companies. It is neither feasible, nor appropriate, to organise investment management with a view to preventing the Fund from ever being exposed to unwanted situations.

Responsible investment is a rapidly evolving field in which new knowledge is gained and new practices are established. The Government wants to make the GPFG world leading in responsible investment and the management of climate and nature risks. The Government's ambition will be addressed through continual development of the responsible investment framework for the Government Pension Fund in view of, inter alia, developments in internationally recognised principles and best practices. In this white paper, the Ministry is further proposing that the