Response to the Norwegian Ministry of Finance Consultation Paper--Evaluation of the Ethical Guidelines of the Norwegian Government Pension Fund-Global

by Carlos Joly, carlos.joly@gmail.com, submitted 14 September 2008

Joly credentials: Co-Chair, UN PRI Expert Group that drafted the Principles of Responsible Investment; co-founder UNEP Finance Initiative and Chair of its Asset Management Working Group; formerly Senior Vice President, Environment Policy and Investments, Storebrand Group and Researcher in Norges forskningraads etikkprogram at UiO; founder/ portfolio manager of Aksjefondene MiljoInvest and Gront Norge; SRI selection consultant to the Fonds de reserve de retraites de France. Currently Visiting Professor of Finance, Sustainable Development and Climate Change at Ecole Superieure de Commerce, Toulouse. The following remarks are presented in a personal capacity, as an expert with a long attachment to Norway and in response to the call for public comment by the Ministry of Finance.

Norway has good reasons to be proud of the organizational structure, performance, and worldwide respect achieved by the GPF-G. This paper seeks to give constructive input towards the GPF-G's future policy and operations in three ways:

1.) by responding to your question: "Can one raise arguments in support of using positive selection in the context of the Fund that can outweigh the arguments against doing so?" (Consultation Paper, p42, hereinafter CP). I say yes and provide such arguments below. In so doing I seek to clarify language concerning "risk-related returns", "maximization of returns" and "ethical investment" as used by Professors Thore Johnsen (NHH) and Ole Gjolberg (UMB) in their report to the Fund[1] to show that they beg the question and that their negative conclusion concerning positive selection does not follow from the evidence they present. Further, I seek to clarify what can reasonably be expected and demanded by the public of the Fund by way of "doing good" by investing ethically.

2.) By suggesting possible improvements to various aspects of the Fund's socially responsible investment approach, particularly as concerns Active Ownership and it relationship with Portfolio Composition. You practice negative selection but you could also consider, short of total exclusion, significantly reducing your existing exposure to companies with questionable or borderline acceptable ethical conduct as a form of active ownership pressure and in conjunction

1 T. Johnsen and O. Gjolberg, "Ethical Management of the Government Pension Fund-Global: An Updated Analysis (14 May 2008, as Appendix to CP on the Ministry of Finance's web site)

with engagement efforts. This falls short of exclusion, sends a signal to company management and other investors, and could be quite effective in certain situations where companies need a push in the right direction. This way of acting as a change agent has not been mentioned in CP or in the Prof. Chesterman/Albright Group Report (hereinafter C&A)[2], and could also apply to companies on an Observation List, should you decide to set one up. This is an answer to your question "Should changes be made to the interaction between the measures [active ownership measure and exclusion measure]?" (CP, p39).

3.) By raising an issue concerning coherence between the Fund's benchmark portfolio and the underlying assumptions to its Ethical Guidelines. This takes up a question you have not asked, but perhaps should think about: ought the Fund's benchmark portfolio seek to take into account sustainable development information that will with a significant probability affect future macroeconomic situations? And if so, how could this be done?

1.) Arguments in support of positive selection and critique of Johnsen and Gjolberg

1.1.Positive Selection SRI is not a homogeneous category and treating it as such results in facile and wrong conclusions

Positive Selection covers a number of different active management strategies, including Best in Class ESG funds, sector-specific funds in Alternative Energy, or Water or Microcredit, and thematic funds focused on social themes like health or an aging population. Each of these approaches has innumerable variants. Under positive selection it makes sense to also include Private Equity, Venture Capital, and similar non-listed investments, in addition to the already mentioned large cap best in class eco-efficiency or sustainable development or ethical funds. It must be noted that each of these types can be variously implemented with different sets of criteria, different hurdles for qualification and with different quality of the underlying analysis. Given the enormous disparity of approaches within SRI, to pretend that SRI taken as a single all-inclusive category should, in and of itself, generally outperform or underperform the market or traditional funds is unwarranted at the outset, because SRI does not apply

2 S. Chesterman and The Albright Group, "Assessment of Implementation of Articles 3 and 4 of the Ethical Guidelines for the Government Pension Fund-Global", (21 May 2008, as Appendix to the Consultation Paper on the MoF's website.)

to a homogeneous universe of investment objects defined by a single common denominator, like, for instance, the sector of IT stocks. It makes sense to ask whether technology funds will outperform or underperform precisely because they focus on a distinct industry sector and their stocks are driven by industrial commonalities. It does not make sense to ask if SRI funds as a category will, because the only thing the universe of SRI funds has in common is that in some way at some point in the stock selection process one or more of a plethora of variously defined environmental, or social, or ethical, or governance criteria are in any of a number of ways and with different degrees of rigor taken into account. In short, people well-acquainted with the field know that some SRI funds outperform, some underperform, some follow rigorous analytics and process, others don't. Experienced practitioners know that the talent of the portfolio manager and the quality of the investment process are by far the greatest factor in determining an SRI fund's financial performance, just as is the case with most other active investment approaches. The report by Professors Johnsen and Gjolberg (hereinafter J&G) cite a study that basically says this (Stenstrom and Thorell, Stockholm School of Business 2007, in J&G, pp 18-19) but do not give this fact due consideration when formulating their conclusion, despite the fact there is much other empirical data to support it.[3] In the investment world there is no algorithmic or categorical way of insuring good investment results. Why suppose SRI would be an exception? In short, as the saying goes, ask the wrong question and you'll get the wrong answer.

1.2.The nature of SRI

J&G seem to have a somewhat charicaturesque understanding of what SRI funds seek to achieve and what kind of companies the sustainable development funds seek to select. They think these funds pick “businesses that appear to be, in some sense, actively a force for good on ethical issues, the environment, peace, etc. In practice, these will be businesses that have a positive image, through their operations, their official policy declarations or their reputations and social involvement, when it comes to ethics, the environment, poverty alleviation, democracy, etc..” (J&G, p7). J&G's focus on appearances and image sound like whitewashing and greenwashing rather than what the serious SRI funds do, which is to look into the realities on the ground, such as a company's actual eco-efficiency

3 See Demystifying Investment Performance, a joint study of UNEP FI Asset Management and Mercers (2007, www.unepfi.org/publications), with its detailed summaries of the academic and broker literature; not covered in J&G. Note also a glaring hole in J&G's analysis: the French SRI market, which at 30 June 2008 totals €19,5 billion in assets under management in 196 equity and bond mutual funds (Novethic Survey).

performance relative to other companies in the same sector (e.g tons of toxic waste per $1,000 of sales, or tons of GHG emissions por $1,000 of sales), or the actual social conditions of their workplaces or the workplaces of their suppliers. These are facts which are measurable, reportable and comparable between companies. No serious SRI fund I know of claims to select companies on the basis of vague "peace" or "democracy" criteria, any more than the GPF-G does for its negative selection. The "doing good" that the serious SRI funds seek to achieve is in general covered by the following objectives:

1. good returns relative to the requirements of their investors or competitive returns relative to the traditional indices of reference (and it should be clear that no professional investor needs to accept sacrifice of competitive performance when doing or buying SRI);
2. dialogue and engagement with senior management on specific ESG issues, exerting what influence they have as shareholders singly or in alliance with others so that improvements are made not only on paper but most importantly in conditions on the ground;
3. better and more realistic disclosure and reporting by companies of their actual environmental and social performance, including how their understanding of ESG adds or will add value to business strategy and their business model, through their own meetings with management or the work of the specialized rating agencies or, more recently, the work of major brokers.[4]

1.3 Positive Selection need not imply fewer markets or more large cap bias

J&G state, as a conclusion, that "the GPF-G would have to focus its investments on larger companies and fewer markets than at present if it was to engage in more comprehensive positive screening" (J&G, p4). This does not follow from the facts. The data do not support this conclusion. The Fund has 7,000 names and the average ownership stake in each is reported as 0.8%, less than 1% (CP, p6). Simple arithmetic says that even were the Fund to select down to half that number, or 3,500 names, the average ownership stake would still be less than 2%. Even assuming rapid growth in fund assets there is a great deal of room before running into trouble with the Fund's 10% ceiling on ownership stake in a company or the numbers investment professionals consider prudent for diversification of risk. Furthermore, it is

4 A significant development in this regard is the Enhanced Analytics Initiative, whereby fund managers commit to channeling more trades through stockbrokers that distinguish themselves with better ESG company and issues analysis. This is a way in which SRI fund managers seek to influence the market by acting on the investment management supply chain, by paying for competence and quality of supply.

disingenuous to say that Best in Class selection necessarily reduces the number of investment objects below the number that a very large fund like the GPF-G requires. J&G say that increasing the number of selection criteria would necessarily cause reduction in the universe, while practitioners know that how each specific SRI criterion is defined and the level at which the qualification hurdle is placed make all the difference in how many companies result from the process. Indeed, the positive selection criteria definitions, their relative weights and the level at which the qualification hurdles are set can be tuned so as to yield a given number of qualifying names. If it were a desideratum, they could also be adapted and tuned to take account of differences in data availability for Large Cap versus Medium and Small Cap companies, thus negating J&G's line of argument.

An important benefit of reducing the number of companies in the Fund is that this would allow deeper coverage and more engagement and follow up by the Active Ownership team. C&A's evaluation has pointed out that engagement activities need to go beyond policy statements and through to what really happens on the ground: “active ownership can only be said to be successful when realities on the ground change, not only corporate policy” (C&A, p 29). Fewer names in the Fund would help accomplish this objective.

1.4 Disambiguating Risk: “risk-adjusted returns” is a poor tool for investment decisions relating to sustainable development or as protection against systemic market failures

The J&G discussion of risk can be quite misleading for a readership that is not familiar with the technical and narrow concept of risk used in modern portfolio theory. J&G posits profit maximization as a maxim given a defined level of risk. What does this really mean? We need to disambiguate the meaning of the word 'risk' in its use as a synonym for volatility relative to a benchmark, as when J&G talk of “risk-adjusted returns”, and differentiate it from 'risk' when it refers to the possibility of loosing money when a business disappoints or goes bad (what can be called fundamental risk), and again differentiate it from macroeconomic risk when the economic conditions of a country turn sour, and again from sovereign risk when, for example, a country changes its tax policy or foreign exchange mechanism or gets into a war or suffers an embargo. As regards SRI investment approaches, J&G look only at risk in its sense as volatility from a benchmark, that is, the difference of investment returns of an SRI fund in the past as compared to the returns of the market as a whole as reflected by the stock market indices.

Consider, though, what this leaves out and how this prejudices thinking about positive selection. Ask: what was the risk attributed to US mortgage backed securities before the debt crisis the world is now suffering? Low, if you thought about risk only in volatility terms. The US credit rating agencies, S&P, Moodys, and Fitch gave these bonds prime ratings, even AAA. But the real risk of loosing money was very high, if you bothered to take a thoughtful look at the fundamental risk implicit in the fact the securities were based on mortgages that were secured by inflated housing prices, an inflation directly caused and amplified in Ponzi scheme style by irresponsible credit practices. In other words, unsustainable collateral became a giant bubble. But of course most professional investors looked only at the technical volatility risk and not the fundamental risk and they took a trader's approach believing liquidity was assured under any market conditions. Some who saw the problem still joined the fun, driven by the idea “it's too big to fail” or by the incentive system of Wall Street capitalism, which motivates players to “dance while the party's going on” (in the immortal words of Charles Prince, Chairman and CEO of Citigroup, just weeks before he was sacked in the wake of Citi's implosion). The depth and gravity of the current crisis should make us realize that size of a market is no guarantee of its solvency, durability or proper pricing. “The bigger they are, the harder they fall.”

How does this relate to SRI? Think of an environmentally-driven market failure.

1.5. Impacts of Climate Change create macro and microeconomic risks to the Fund which the Fund is not taking into account today

Consider the incongruity of having long term good investment results as an overriding objective but measuring the risk of obtaining this by volatility measurements that have nothing to do with fundamental, macroeconomic or sovereign risk as described above. What happens then is that the technology of index-relative investment ends up determining portfolio composition and investment strategy, which is putting the cart before the horse. Indices like the FTSE, which the Fund use, mirror the relative capitalization weights of companies as these weights are in the present moment. In other words, these indices reflect the structure and beliefs of the economy as it was and is and not as it needs to become in order to sustain wealth creation in the future. The world economy is not working within the limitations imposed by its natural resources. We are faced with a systemic environmental risk that is insufficiently recognized by the stock and bond markets. This is the case with climate change. Climate change risk is a fact most Norwegians are convinced is true. Most Norwegians also believe it is normatively unethical not to act so as to mitigate this risk or to prepare for its impacts. This certainly falls within the "overlapping consensus" of values upon which the MoF bases its Ethical Guidelines.

But this realization then raises <u>two potential problems with the Fund's investment strategy:</u>

1. why does the Fund pursue a near index approach within each of its benchmark allocation boxes, in effect straight-jacketing the Fund into holding mis-priced assets?
2. does the MoF seek to take account of climate change impacts risk when it constructs the Fund's benchmark portfolio? (See below, section 3).

It is well known that the biggest gains in active investment are made when correctly anticipating the future valuation of equities. If one has the conviction that sustainable development is a precondition for the health of the economy in the future and that new environmental treaties and laws, changing consumer attitudes, and the inevitable impacts of climate change will have material effects on the competitiveness of countries and the profitability of companies, then the prudent investment philosophy is to be to some extent anticipatory and have a suitable early adopter process in place, so as not to be caught with large holdings that suddenly get down-rated, loose value and conform to what will become a past reality. The problem with using volatility risk as a guide to investment strategy is that it measures the past, but it does not capture at all the fundamental risks of continuing to invest in a paradigm that is becoming outdated. Just as the market made a gigantic mistake in mis-pricing mortgage backed securities it is likely the market, or large parts of it, are making a gigantic mistake failing to recognize unsustainable companies and pricing them accordingly, with a deep discount. In protecting its capital, the GPF-G would not want to find itself saddled with a large chunk of assets that the market will one day realize are overvalued from a sustainability point of view. Conversely, in seeking good returns, it will want to recognize which of today's mid caps will become tomorrow's large caps.

Clearly, given the size of the GPF-G, if an early adopter strategy is to be considered it has to be carefully designed and orchestrated. But the fact it has not been done before should be no hinder to developing a suitable approach. The dilemma in active investment management is always: how far ahead of the pack does one dare to stake money on one's convictions? But this quandary is not particular to SRI, it is true of all active investment. The advantage of the Fund is that its purpose is explicitly long term and can therefore afford the patience required by its convictions. I believe the Norwegian public and its Parliament have the good sense to understand this point and live by it.

Best in Class is a suitable approach to addressing many SRI issues, but it is not ideally suited to tackling the issue of macro and microeconomic impacts of climate change. There are other solutions.

1.6. What kind of Positive Selection would be best for the Fund?

Of the various forms of positive selection available to the GPF-G, clearly private equity has to stand out as a priority area. Private equity provides the Fund with the capability to directly influence the environmental, social and governance aspects of a business and importantly to ensure not only that the business acts in accordance with the Ethical Guidelines but also that the company's ESG policy and practices are integrated into its business model and add financial value to it. The CP's description how the Fund intends to invest in real estate seems to be very much in line with this view. Thus, if the choice is between creating a mandate for large cap Best in Class Sustainable Development and a mandate for SRI Private Equity I would favor private equity. From a consequentialist ethics perspective, the private equity sector of the investment business offers the greatest bang for the buck, financially as well as in the depth of ESG impact that could be obtained. To date, however, this hugely important segment of the investment business is practically absent when it comes to SRI.[5]

My recommendations to the GPFG in this area are as follows:

1.6.1. Private Equity SRI RFP

Release an RFP to private equity fund managers and private equity fund of funds managers to compete on approaches for a mandate that would integrate ESG and sustainable development thinking into the selection and management of the companies. This could be done alone or in an investor syndicate with

5 An unusual and remarkable example of private equity working with an environmental NGO to create a financial and environmental value-added proposition is the $38 billion takeover of TXU, the Texas utility, by Texas Pacific and Kohlberg Kravis. The NGO, Environmental Defense Fund, obtained concessions to reduce the number of planned coal-fired plants and reduce carbon emissions, and lower consumer tariffs. (As reported in NYT, 8 March 2008.)

like-minded sovereign or pension funds. The reverberations in the private equity business would be considerable.

1.6.2. Verify application of the Guidelines

Avoid private equity investments where the Fund cannot truly check whether the Ethical Guidelines are or will be seriously implemented.

1.7. Where does "profit maximization" come from? What relevance does it have to future investment strategy?

Nowhere in Act Nr 123 of 21 December 2005, which sets forth the purpose, structure and operating terms of the Fund does it say that profit maximization is a Fund objective. Instead it says the purpose of the Fund is "to facilitate government savings necessary to meet the rapid rise in public pension expenditures in coming years". This is wise, and tacitly acknowledges that what properly guides the Fund's fiduciary duty as a long term investor is prudence for the protection of capital and a level of return sufficient to meet expected future needs. In promulgating the Ethical Guidelines, the government explicitly places this fiduciary duty within the bounds of certain societal norms and ethical constraints, which is why it has promulgated the Ethical Guidelines.[6] Ratifying this, CP (p23) states: "It is an ethical obligation to ensure a <u>favourable</u> return on the Fund over time" (emphasis added.)

J&G nevertheless claim the objective of the Fund "is to maximise the return on the petroleum wealth, given an acceptable level of risk"(J&G, p 6) Furthermore, they claim "there is broad agreement" for profit maximization. I do not know how true this is and I suspect said agreement would not be so

6 The most heated arguments when drafting the UN PRI concerned the language of the preamble and revealed two contrasting views concerning the scope of the concept of fiduciary duty. On one side are adherents to a narrow interpretation which interprets fiduciary duty as requiring and allowing inclusion of ESG if and only if it is "material" to stock price performance. Holders of this view usually believe the overriding objective of a fund manager is profit maximization and that only this view of fiduciary duty satisfies profit maximization. On the other side are adherents to a broader view that claim that the financial interest of principals cannot be divorced from nor can it trump their deepest environmental, social and ethical interests and that there is no necessary conflict between good or competitive long term returns and ethical constraints on investment. The later recognize a longer term time dimension of materiality and understand that the process whereby ESG issues become material means that what may not be material today may well be strongly material tomorrow (witness the history of materiality of asbestos, tobacco, contaminated land, and, in the making, carbon emissions and climate change impacts.) For a state of the art discussion of these issues see <u>The legal framework for the integration of ESG in institutional investment</u> (2005), a groundbreaking legal study by Freshfields that I commissioned for UNEP FI (on www.unepfi.org/publications). I am currently directing the sequel to this study, a project which explores current views on ESG and fiduciary duty among the major investment consultants, and also explores in more depth the process of materiality and the interactions between materiality and ESG concerns. This forthcoming UNEP FI report is due from its Asset Management Working Group in 2009.

broad if the public and its Parliament understood that profit maximization is nothing but an aspirational goal. It is not a particularly useful operational or decision criterion in the normal course of portfolio decisions because of the uncertainties and indeterminacy attendant to all investment forecasts. Only in retrospect can one tell whether a prospective investment choice has indeed maximized returns relative to other actual choices or to unactualized theoretical alternatives. Clearly investors *qua* investors want to make as much money as possible, and most want to do this without breaking any laws. All institutional investors have certain constraints, and these vary from one investor to another. The Fund is no different in this regard; it has particular constraints, one of which is being congruent with Norwegian society's values as they might be understood by John Rawls' concept of an overlapping consensus.[7] J&G seem to forget this and focus solely on risk-adjusted returns, which is, as I argue below, at best of limited utility in thinking about the ESG issues and returns for future generations.

J&G's discussion makes it seem is as if without ESG integration there is a greater likelihood of profit maximization while ESG integration means there is a bias towards some financial sacrifice. But this is nothing more than their point of view or belief; it is neither a necessary truth nor an empirical fact, unless one throws into the equation patently illegal activities like corruption, price fixing, drug dealing or trading in stolen goods, or borderline practices like choosing to risk an environmental fine rather than conform to a regulation. One suspects the reason for J&G's insistence on positing the centrality of maximization is that without it the measurement of risk-adjusted returns has much reduced relevance. But this way of asking whether ESG integration makes sense for the Fund is tantamount to setting up the wrong criterion for measuring conformity with the Fund's long term investment objectives. Think of climate change, an issue the Fund rightly focuses on for Active Ownership purposes.

In today's world the environmental issue of climate change is increasingly acknowledged as a central condition of prosperity and well-being, and politics, laws, and business and consumer behavior are changing in response to this acknowledgment. The argument that SRI in general cannot or will not yield maximum risk adjusted returns or perhaps even competitive risk adjusted returns is based on a retrospective look, on short recent history in what is a quickly evolving world and it tells us very little

---

7 I take it that the CP's use of "overlapping consensus" language stems from the seminal work of the American philosopher John Rawls, A Theory of Justice (1971, Harvard University Press) and the school of thought that has followed. Central to Rawls' purpose is how to justify reducing inequality and how to ground a common morality in a pluralistic society.

about returns in the future as and when market valuations adjust to climate change realities.

Of course, valuations in different asset classes will adjust at different speeds and in different trajectories, but having an enlightened view about this is precisely what allows a well-informed active investment strategy to protect capital and achieve good returns, arguably the greater likelihood of better returns than traditional investment strategies that do not understand and adapt to the changes climate change will bring with it.

2. Should changes be made to the interaction between active ownership and negative exclusion?

Currently the GPF-G has two forms of exercising its ethical imperatives. Negative exclusion and active ownership (often called engagement). When active ownership efforts fail, and company ethical conduct is so negative as to warrant exclusion, exclusion is your only option. C&A propose a third way, setting up an Observation List of companies that fall in the questionable or borderline category. This is a sound recommendation and is similar to the Watch Lists that many Best in Class funds have set up for companies that do not yet qualify as investable but show sufficient improvement for qualification in the near future, subject to verifiable improvement on the ground. (Note that a GPF-G Observation List would seek to influence a company so that it can avoid excluding it whereas a Best in Class fund's Watch List seeks to influence a company so that it can be included among those qualifying as investable.)

My recommendations is this area are as follows:

2.1 Make the Observation List public.
C&A recommends the Fund not make an Observation List public. Here I differ. The point of the Fund's exclusions are not only to protect itself from complicity with harm but also to send a signal to a company and the market that the company is considered to be doing harm. Given the company's state of affairs there is no point in “protecting” the company or its management. The same argument would apply to Observation List companies. They are found to engage in harmful practices, their record is at best questionable, and the Fund wishes to influence these companies to deliver acceptable conduct. By

keeping this information private an important lever of influence is lost and nothing is gained. The market works on information. The more information is kept private, the more chance of market failure or unacceptable conduct. Thus, an argument from principle could be added to the efficiency argument: transparency is to be favored rather than misguided “protection” for a company or its management. C&A leaning in favor of kindness and consideration to questionable companies and their managements is far outweighed by the Fund's obligation to act for the public good, in this case by helping improve the general ethical conduct of business and fostering transparency. Note also that publicizing Exclusion or Observation is right in line with rating firms or brokers publicizing their upgrades or downgrades of a stock or bond's rating.

2.2. **Changing portfolio exposure weightings in conjunction with or in response to active ownership activities**

You could also consider, short of total exclusion, significantly reducing your existing exposure to companies with questionable or borderline acceptable ethical conduct, whether you create an Observation List or not, and whether such companies are put on an Observation List or not. You would use this as a tool in conjunction with your active ownership plan and based on results on the ground. This form of interaction of portfolio composition with active ownership/ engagement efforts could prove to be highly effective, particularly as the GPF-G develops a following among other investors who copy its actions.

2.3. **Joint calls on senior management**

You might encourage the active ownership team members and members and staff of the Ethical Advisory Committee to make joint calls on senior management along with the Fund's and/ its asset managers' portfolio managers and financial analysts. This would have several beneficial effects: a. it sends a strong signal to companies that financial and ethical performance are both critical for the Fund; b. it would provide insight into companies on the part of the Ethical Advisory Committee and its staff; c. it would provide the Fund's financial managers with better insight into the ethical concerns.

2.4. Better reporting of Active Ownership Activities and their Results

Create a reporting mechanism and template for each company chosen for engagement that includes the objective sought, an engagement plan, the engagement activities conducted, company management's response, a timetable for verification on the ground, a plan for follow up action, a whether there is a decision to hold, or exclude, or overweight/ underweight, or put on Observation List. In general, there is a greater likelihood that what gets measured and reported will get done. Also, insofar as the Fund is contemplating a broader palate of policy options than simple exclusion, thorough reporting will help understand the efficacy of these measures as well as educate the public about the Fund's functioning.

2.5.Take up the investment supply chain as an area for engagement activities.

Sovereign funds like the GPF-G, institutional investors like employer and employee pension funds and life insurance companies, banks, mutual funds for institutional investors and individuals, private equity funds, hedge funds, stock and bond brokers, asset managers, rating agencies, accounting bodies, and asset manager selection consultants, financial analyst certification bodies, all these entities form what is called the investment supply chain. Just as in pursuing its Ethical Guidelines the Fund looks into the ethical behavior of the supply chains of businesses it invests in, particularly as regards child labor issues, a case can be made the Fund should look close to home at its own supply chain and adopt an explicit policy and program to influence its own supply chain to provide services and products that are better aligned with the sustainable development and ethical premises of the Fund. The investment business and its supply chain is notoriously laggard relative to other industries when it comes to facing up to the impacts its products have on sustainable development. Without in any way criticizing the Fund, on the contrary –it is in many ways exemplary among sovereign funds when it comes to ethics--it is also true that the Fund can play a much more pro-active role in this respect than it has. The current financial crisis affecting the US and most developed economies marks a watershed and creates real opportunities for responsible actors, notably the very large sovereign funds and pension funds, to promote “a new paradigm for financial markets,” to borrow a phrase from George Soros. The market works on perceptions and replicates the moves of successful actors. Clearly the Fund is in a position of influencing the behavior of the investment supply chain, particularly if it works along with like-minded others. This is of course an evolutionary rather than a revolutionary process. It would indeed be a shame if the GPF-G did not marshal its market muscle and intellectual capabilities in this direction, exercising its influence and demonstrating exemplary conduct.

3.) What about the Ethical Guidelines and the Fund's Benchmark?

The CP does not invite comment on the question whether there is sufficient coherence between the Fund's Sustainable Development assumptions and its benchmark portfolio. Yet CP acknowledges that the most important determinant of financial return is the composition of the benchmark portfolio rather than the active management leeway granted to Norges Bank Investment Management by way of the Fund's 1.5% tracking error. “Calculations show that the return on, and volatility of, the GPF-G are primarily determined by the composition of the benchmark portfolio” (CP, p 7). Thus, it is legitimate to ask: what is the relationship between the benchmark and the assumptions upon which the Fund's investment strategy and ethical guidelines are said to be based? Is there sufficient congruence? Does the benchmark make sense in light of the sustainable development assumption of the Fund? Neither Professor Chesterman/Albright Group nor Professors Johnsen and Gjolberg raise the issue. But one hopes the MoF's call for public response is open for this kind of reflection. CP in various places states that sustainable development in the global economy is a requisite for long term investment performance and wealth creation. “The guidelines are based on the premise that good, long term financial returns will depend on sustainable development in economic, environmental, and social terms.” (CP, p22. See reiterations of this statement on pp 11, 30, 37.)

It is clear that much as Negative Selection generates NGO and media attention, and visibly supports Norway's reputation in the area of human rights, it is the composition of the benchmark portfolio that implicitly embodies the most influential judgments concerning ethics, sustainable development, the sources of world wealth creation, and the determinants of the Fund's long term financial performance. These judgments are made by the relevant officials in the MoF, perhaps tacitly, perhaps explicitly. But even though these judgments may not be explicitly formulated they are inherent in the benchmark portfolio's construction.

Market pricing is what determines country and company capitalization weights. One might ask whether market capitalization weights and company capitalization weights of companies as they happen to be today should be the overriding consideration for deciding how to allocate Norway's savings for use not in the next few years but in several generations to come. There is an obvious disconnect between the framework conditions for sustainable development and wealth creation versus the market's current pricing of major asset categories, yet it is this pricing that predominantly determines the Fund’s portfolio allocations. The Fund should have an active strategy for dealing with this disconnect, so as to avoid being caught in a financial crisis that might make today's credit crisis look like peanuts. Even if one assigns a 25% probability to a climate change driven financial crisis, that catastrophic impact would be so large that it makes sense to think this through, have a plan in place, and develop an avoidance or mitigation strategy to protect against its effects.

Questions that might reasonably be asked in assessing the wisdom of the benchmark portfolio's composition are:

- Which countries will be having the lion's share of economic growth and generating wealth in the next ten years? The answer could lead to significantly increasing the exposure to certain Emerging Markets. (Given the Fund's size and the tendency of markets to overshoot in either direction, clearly timing has to be given due consideration.)
- Which developed countries will be facing economic stagnation, or relative decline? The answer could lead to significantly reducing certain exposures.
- Where are systemic failures in regulatory oversight and market behavior most onerous and likely to re-occur? The answer could lead to underweighting US assets and currency.
- How are the macroeconomic impacts of climate change likely to affect the well-being and competitiveness of given regions, industries and assets (including real estate assets) and therefore asset valuations? The answers could be factored into investment strategy.[8]

On the basis of this discussion I end with the following recommendation:

3.1. The MoF should consider the risks and implications of its not actively integrating the macro and microeconomic consequences of climate change into the Fund's benchmark portfolio. These risks to the Fund's long term returns are deemed to be considerable and increasing. The MoF is convinced that "good, long term financial returns will depend on sustainable development in economic, environmental and social terms". It follows that the failure of many developed and developing countries to achieve a sufficient measure of sustainable development in environmental terms, and the consequences of the irreversible climate change processes already affecting the world, both these situations constitute an important financial risk to the Fund. This risk needs to be addressed in the Fund's investment strategy. Since the returns of the Fund are predominantly determined by its benchmark portfolio, the

8 A test fund that does this is being set up by the author for a large private investor.

MoF should therefore put in place a process for addressing climate risks in the composition of the benchmark.

carlos.joly@gmail.com

Submitted to Norway Ministry of Finance 14 September 2008