Comments on

Review of the Active Management of the Norwegian Government Pension Fund Global

Ang, Brandt and Denison (2014)

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Summary of recommendations

- Identify value added at each stage of investment process (transparency)
- Adopt Opportunity Cost Model
  - Establish a zero cost equity + fixed income benchmark and ask NBIM to beat this benchmark using securities from any asset class
- Increase NBIMs risk taking
  - Allow NBIM to deviate more from the benchmark than the current 1% tracking error limit.

Value added

- Passive investable benchmark
- Rebalanced benchmark (as provided by the MoF)
  - Cost effective rebalancing
  - Benchmark improvements
  - Factor tilts
  - Public security selection
  - Other asset classes: Real estate, private equity, infrastructure
  - Environmental, social and governance criteria
- The Fund

Summary of recommendations

- In short: Allow NBIM more flexibility in deviating from the benchmark (potentially by allowing discretion to invest in all asset classes).
- Are these good suggestions?
- Yes, if the people of Norway think it is a good idea to take on more risk to obtain additional returns through active management
- No, if the expected return on the passive benchmark meets the objective of the fund (as defined by the people of Norway.)

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Starting point

- Agree that it is a good idea to take on more risk to obtain additional returns through active management
- Questions to be addressed
  - Who should decide in what assets classes to invest?
  - In what asset classes should the Fund invest?
  - How do we set active risk budget?

Who should decide in what asset classes to invest?

- Current Model: Ministry of Finance delegates the management of the Fund to the Central Bank/NBIM
- NBIM operates according to a management mandate
  - Allowed to invest in public equities (65%), fixed income (35%), and real estate (5%)
  - Benchmark index with tracking error (1%)
  - Restrictions (Geography, Environmental, Social, governance)
- NBIM maximizes fund return subject to the restrictions implied by the mandate

Who should decide in what asset classes to invest?

- Proposed model: Ministry of Finance delegates the management of the Fund to the Central Bank/NBIM
- NBIM operates according to a management mandate
  - Specify a zero cost equity + fixed income reference portfolio with tracking error and downside risk limits
  - Investment restrictions (Geography, Environmental, Social, governance)
- NBIM maximizes fund return subject to investment restrictions and cost of capital as defined by the reference portfolio.
  - Cost of capital for an investment is essentially the expected return return on equity and fixed income combined to have the same risk as the investment at hand (CAPM)

Who should decide in what asset classes to invest?

- Key difference between current and proposed model:
  - Fund manager (NBIM), in principle, allowed full discretion on investable assets
- Such discretion makes economic sense
  - In the absence of incentive conflicts, delegate decisions to the party with superior skills and better information.
  - With proper governance structure and improved transparency (as recommended by Ang, Brandt and Denison) incentive conflicts is probably not a main concern

Who should decide in what asset classes to invest?

- Available variations over the core idea: GICs investment framework

Changes to GICs investment framework, 1981-2013

FIRST TWO DECADES

Conservative Stance

Focused on building organizational capabilities

Conservative asset allocation focused on liquid assets

Venturing into Asia

Beginning exposures to real estate and private equity

2000s

Shift to an Endowment Approach

Greater tolerance for risk and lower need for liquidity

Increased allocation to private markets and emerging markets

2013

Focus on Long-term Drivers of Returns

Introduction of a Reference Portfolio

A more targeted Policy Portfolio to harvest long-term returns

Augmented with an Active Portfolio of skill-based strategies

GICs current investment framework

Investment Framework

Reference Portfolio

Maintains investments in global equities and bonds, to assure good returns over time without exposure to excessive risk.

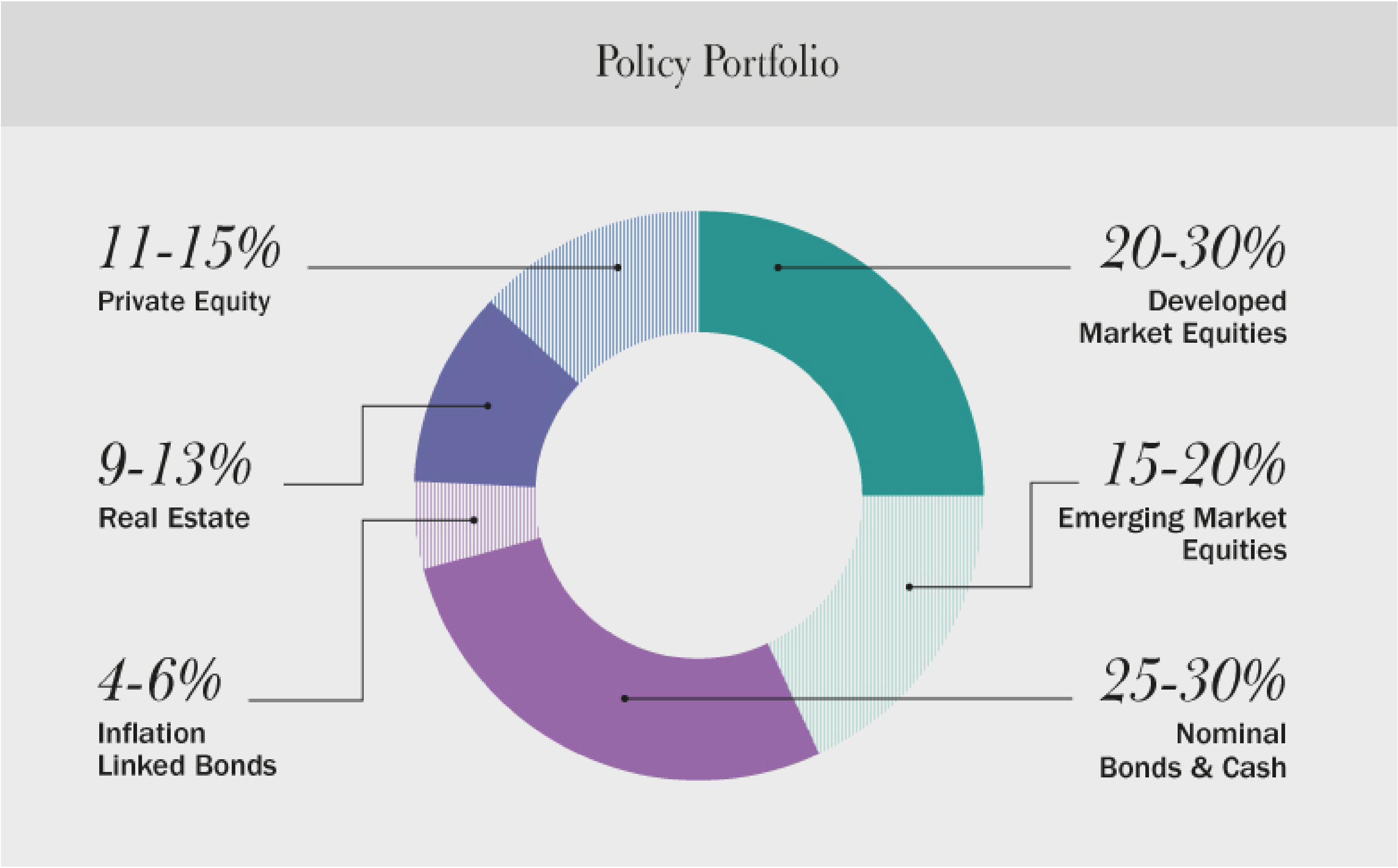
Policy Portfolio

Aims to achieve higher returns over time by taking systematic risks.

Active Portfolio

Accepts higher levels of risk, and aims to achieve superior skills-based "alpha" returns.

GICs current investment framework



Summary so far

- Recommended change to investment mandate makes economic sense and reflect best practice
- However, does not imply that MoF should allow Fund manager to invest in all available assets .
  - Can still restrict investment in a given asset class
  - But, such restrictions goes against the fundamental idea of looking for value added beyond the "asset class silos" AND will (almost) always be weakly dominated by a mandate that allow all asset classes
  - Almost (headline risk): The Funds will not survive to harvest long term returns if it looses the support from the Norwegian people (Child labor, tobacco, arms, shale gas/oil sands,…)

In what assets should the fund invest?

- In particular, should the Fund be allowed to invest in private equity and infrastructure?
  - Determined by the risk budget
  - For a given risk budget (that is not too large,) the fund manager will hit the risk limit before exhausting available asset classes
  - Even if the Fund was permitted to invest in these asset classes, the current low tracking error (1%) and the scale required to invest in private equity and infrastructure effectively limits this possibility
- Notice it does not work the other way around: Increased risk budget does not imply that the Fund will invest in private equity and infrastructure
  - The essence of the proposed delegation model is to allow the Fund manager discretion on spending the risk budget

How do we set active risk budget?

- Joint decision
  - MoF must have an opinion on what asset classes are attractive and acceptable and allow the Fund manager to build the capabilities to invest in these asset classes
  - What risk budget (including downside risk) is required (return objective) and sustainable (How large and frequent losses can the Fund experience while keeping support from the public opinion.)
- To enable the MoF and the Central Bank to make these decisions, transparency and detailed information needed.

Summary

- Ang, Brandt and Denison (2014)
  - New delegation model: Increase Fund manager discretion, measure performance against cost of capital.
  - Document value added (transparency)
  - Increase risk budget (from 1% to 1.75%)
- Comments on proposed changes
  - Delegation model follows best practice. Makes economic sense (absent incentive conflicts, delegate to the more informed party,)
  - The ability to document value added will be crucial. Delegation model is data intensive.
  - Although a tracking error to 1.75% is small relative to other investors, it is not clear that it will make a difference given the current set of investable assets. Today the Fund is using less than their allocated risk budget.
  - Non investment restrictions will harm return. Public opinion is important for long run survival. Transparency has the potential to mitigate “headline risk.”

The future starts now

- Slowly build capabilities to invest in private equity and infrastructure.
  - Hard to know if current investment universe will generate sufficient return in the future
  - At some point, the Fund will be so large (hopefully) that the scale required will be obtainable even with relatively small tracking error.
- On Private Equity: Invest both directly and as limited partners (LPs.)
  - Evidence show that successful investors invest directly in private firms (for example together with General Partners) and as LPs.
  - Potential explanation: A team with first hand experience through direct investment will ask all the right questions and look at all the right numbers before investing as a LP.