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Norway: what does the future hold for the world's largest pension fund?

Since it began production in the early 1970's, Norway has enjoyed a financial boon from oil, with related revenues accounting for up to 30% of the national budget. With oil wells expected to dry up, the state must now rethink the management of its sovereign pension fund.

The sole example of this type of fund in Europe, if we exclude Russia, Norway's Government Pension Fund Global (Statens pensjonsfond Utland) was established in its original form in 1990. It was split in 2006 to create a specific fund[1] to support the country's economy. With total assets in mid-2015 of EUR837 billion, the "historical" fund created to finance future pensions is the biggest sovereign wealth fund in the world.

Lower oil revenues combined with one of the highest production costs in the world are now forcing the Norwegian government to make plans to preserve this economic model, which remains primarily a means of underpinning its budget policy. In fact, even though the fund's objective is to "build financial wealth for future generations" and use the investment profits for the people of Norway when there are no more oil resources left[2], no decision has yet been taken as to when it may be used to cover expenditure on retirement pensions.

Preparing for the post-oil era

An announcement was made in Oslo in February 2015, during the public presentation of the Fund's latest annual report by Øystein Olsen, the governor of the central bank (which oversees its management[3]), that Norway may, for the first time, have to dip into its financial reserves in 2016[4].

With all hydrocarbon-related profits (taxation, exploration licences and equity interests in private companies in the sector) invested in it, the fund remains fundamentally dependent on both production volumes and energy prices on the market. Even though it is still the seventeenth-largest oil producing country in the world (and the largest in Europe), Norway produces 70% less oil today than it did in 2001, when, with annual production of more than 160 million tonnes, it was ranked the eighth-largest producer. In this climate of falling oil receipts[5], the country must do everything it can to ensure that its investments produce the best possible return, while scrupulously complying with its own rules of management and ethics.

A clause was introduced in 2001 to allow the Norwegian government take up to 4% of the fund annually to balance its budget. In reality, it takes roughly 3% (2.9% in 2014). A return (excluding inflation and management fees) below this threshold in future years would therefore mean the government would have to restrict its expenditure.

Even though the fund's return is still growing thanks to a successful investment strategy, the dividends do not make up for the loss of receipts and the annual net profit is falling proportionally. According to the latest projections by the ministry of finance[6], it is expected at EUR26.3 million in 2015 (versus EUR40.4 million in 2013), which will mean an erosion of the country's budget surplus.

1 The "Statens pensjonsfond Norge", which invests exclusively in the four Scandinavian countries.
2 http://www.nbim.no/en/the-fund/
3 Through its subsidiary Norges Bank Investment Management (NBIM).
4 http://fr.reuters.com/article/frEuroRpt/idFRL5N0VM6KT20150212
5 Oil receipts are estimated at EUR28.61 billion in 2015 (EUR42.48 billion in 2013, down by one-third in two years).
6 http://www.statsbudsjettet.no/Revidert-budsjett-2015/English/

Governance and responsibility

Norway opted for a defensive and diversified investment profile for this "commodity"[7] fund – exhaustible by nature – and in view of the long-term objective to build intergenerational savings. Each investment is limited to 10% (in reality, none exceeds 5%). The portfolio's allocation is currently split between 62.5% equities, 35.3% bonds and 2.3% real estate assets. The fund is invested in more than 9,000 companies (of which nearly 180 in France), in 75 countries. Europe still accounts for the lion's share (twice that of other continents), but there has been a clear development towards investment in emerging countries, notably those that show high growth.

From the outset, transparency has been a key feature of the fund, and it is frequently ranked as a global benchmark in this area[8]. Quarterly reports are distributed internally while the annual report is published. Norway actively contributed to the work by the IMF that gave rise to the adoption in October 2008 of the first code of best practices assigned to the operations of sovereign funds (called the "Santiago Principles[9]").

In 2004, the country broke new ground by establishing a Council on Ethics[10] (named at the proposal of the finance minister), tasked with examining in detail the activity of the companies in which the fund invests. The goal is to exclude any companies involved in:

- the manufacture of cluster munitions, nuclear arms and antipersonnel mines;
- the production of tobacco;
- serious or systematic human rights violations;
- environmental damage.

Optimising the fund's financial management

In the context of a declining global annual return (15.9% in 2013, 7.6% in 2014 and 4-5% projected in 2015), a change in asset allocation was called for. In 2014, the best return came from real estate investment at 10.4%, followed by equities (7.9%) and then bonds (6.9%)[11]. The fund's management board made a decision to double the allocation of real estate assets, with an objective of 5%. With this, new acquisitions were made in eleven European countries and the US[12], with plans for further acquisitions in Asia.

Following an agreement[13] signed on 28 May 2015 between several Norwegian parties, the fund must disengage from all companies that base at least 30% of their activity on coal. While this decision was welcomed by environmentalists, Svein Flåtten, deputy head of the ruling Conservative Party, says that "Investing in coal companies poses both a climate-related and future economic risk", with a possible devaluation of fossil fuels as part of the work to combat global warming.

Yngve Slyngstad, chief executive of the fund, readily describes it as an oil fund that is difficult to manoeuvre but resistant to crisis. Defending the performances achieved through low management costs and the stabilising role played during the 2008 economic crisis, he adds that the fund is purely financial in nature with a long-term vision. Strategic and national interests are not taken into consideration. Moreover, it does not wish to impose a Norwegian vision of what should be a sustainable investment, but rather operates on the basis of international principles, notably those issued by the United Nations[14].

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7 As opposed to reserve funds (budget surplus linked to taxation or exports).
8 Highest ranking (10) on the Linaburg-Maduell Transparency Index: http://www.swfinstitute.org/fund-rankings/
9 https://www.imf.org/external/french/pubs/ft/survey/so/2008/new090308bf.pdf
10 http://etikkradet.no/en/
11 http://www.swfinstitute.org/swf-article/worlds-largest-sovereign-wealth-fund-generated-7-6-return-in-2014/
12 http://www.wsj.com/articles/norway-fund-bulks-up-on-real-estate-1424795145
13 https://www.stortinget.no/en/In-English/About-the-Storting/News-archive/Front-page-news/2014-2015/hj9/
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