

# Is it wise for the Petroleum Fund to become a major owner?

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Should the capital in the Petroleum Fund be invested in selected, preferably Norwegian companies, or should it be spread over a number of smaller investments abroad? It may be useful to examine what large funds in other countries do.

National funds have been built up in several countries and states based on revenues from petroleum extraction. Kuwait, Abu Dabi (United Arab Emirates), Alaska and Alberta (Canada) established petroleum funds several decades ago, and countries such as Iran, Kazakhstan and Azerbaijan are currently building up petroleum funds. Venezuela is an example of a country that has made several unsuccessful attempts. Singapore also has a large national fund, far larger than the Petroleum Fund, based on other export earnings. Ireland is in the process of building up a national pension fund, with the aim of saving the equivalent of one per cent of GDP each year. At the end of the first quarter of 2002, the Petroleum Fund amounted to NOK 625 billion. The world's largest pension fund is CalPERS, with around NOK 1300 billion under management. This fund provides pensions for public employees in California.

In New York, two pension funds for teachers and university employees, the TIAA and the CREF, with total assets of approximately NOK 2500 billion, have grouped their financial management under one roof.

The largest pension fund in Europe, ABP in the Netherlands, manages assets of about NOK 1200 billion for employees in the public sector. Several of the largest pension funds for private US companies have more assets under management than the Petroleum Fund.

Examples of both good and bad asset management can be found among the large national funds and pension funds. Over time, best practice has been established, i.e. typical properties of funds that are necessary to achieve a combination of high returns and considerable confidence.

Perhaps the most important characteristics of good asset management are clearly defined goals and a clear division of responsibility between the owner or board and manager.

The petroleum fund in Alberta is a good example of what can happen if management goals are not clearly defined. While best practice means setting clear financial goals, the Alberta approach combined financial with political goals. When financing projects internally in the province, it was unclear to the general public whether the goal was to achieve financial returns or political objectives.

After many years of unfavourable results and increasing public dissatisfaction, the strategy was changed in the late 1990s. The fund's objective has now been clearly defined as financial returns. The experience of Alberta and other countries with abundant resources are described in the recently published book *What does oil money do to us?* (in Norwegian only).

A clear division of responsibility between owner and manager is essential to managing risk and measuring management performance.

Experience from the large international funds has shown that returns and risk are largely determined by the owner's choice of management strategy. This is as it should be. High returns cannot be achieved without a willingness to take risks. In fact, a high return is the market's reward for the willingness to take risks. It cannot be an advantage to any owner, whether their assets are large or small, to leave it up to others – an adviser or a manager – to decide how much risk to take.

Efforts have been made to organise the management of the Petroleum Fund in a way that is fully consistent with best international practice. The most important management decisions are made by the owner, represented by the Ministry of Finance. Norges Bank's management performance is measured on a regular basis.

It is likely that large funds can achieve high return by investing some of the portfolio as large positions in individual companies. Kuwait tried this approach in the 1980s. However, the attempt was unsuccessful; the return was reduced and risk increased. Kuwait's experience may perhaps be due to bad luck; funds were invested in the wrong companies at the wrong time.

This example also leads us to an important question: What kind of specialist expertise is available in\* a large pension fund or a national petroleum fund that enables it to take on an active role as a major owner?

If purchasing large holdings was profitable in relation to the additional risk involved, this would be part of the strategy pursued by large funds the world over. This is not the case. When large national funds, pension funds and life insurance companies in various parts of the world choose to be financial investors instead, this may be because they are not willing or

able to have the core expertise in the various sectors that is required in order to achieve a high return relative to the risk taken.

The national pension fund being built up in Ireland is interesting in a number of respects. Even though there have been arguments in favour of investing a substantial share of the funds domestically, a form of management has been chosen where funds are largely being invested abroad. A large domestic portfolio would probably give a low return and high risk. Irish business and industry still has access to capital through the national and international capital market.

A Canadian consultancy firm, Cost Effectiveness Measurement Inc. (CEM), has specialised in collecting and analysing data from major investment managers and pension funds. One of the main conclusions that can be drawn from the data is that active management has not been profitable for the majority of the funds. Returns after costs would have been higher if the assets were broadly invested to reflect the average return in the markets.

This type of management is often referred to as index management. Active management has not only meant lower net returns, but also in some cases considerably higher risk for the owners.

In other words, experience would indicate that it may be a sound strategy for many funds to invest in thousands of securities without spending time and money on analysing each individual security. The Government Petroleum Fund has invested in more than 2300 equities. Larger funds around the world often have more than twice as many companies in their equity portfolio. The data from CEM indicates that the larger the share of a pension fund's assets under index management, the higher the net return.

It goes against our intuition to think that it is not profitable to spend time and money on analysing investment choice. Here, however, we must remember that international capital markets are generally efficient, which means that the markets quickly price in all relevant company information. It is difficult to acquire an advantage in obtaining and analysing information about companies that would enable us to systematically predict price movements ahead of the market.

The data from CEM also shows that there are pension funds that manage year after year to create added value by engaging in some active management. The larger the fund, the greater the probability of achieving good results. This is partly due to substantial economies of scale in investment management and partly because a large fund provides more resources to develop and maintain a competent organisation.

The international market for investment management reflects a split in the management product on the supply side: A few, very large index managers offer diversified investments in the markets at a very low price. Specialised active management is also available. In order to create added value for customers, i.e. higher net return than the market average, active managers must succeed in acquiring and further developing an information advantage.

There is a similar split in Norges Bank's management of the Petroleum Fund. A core portion of the portfolio is managed effectively with a view to achieving the average return in the different markets.

At the margin, Norges Bank tries to achieve added value by focusing active management on those capital market segments where capable managers are likely to achieve a higher-than-average return. The management costs are less than 0.1 per cent of total assets under management. So far, Norges Bank's investment management has created added value every year.

Clear objectives and a clearly defined division of responsibility between the owner and the operational manager are necessary to build up confidence in the management of a fund. Considerable emphasis has been placed on explaining how the assets in the Government Petroleum Fund are managed. Information about results, risks and costs are presented in quarterly reports, the annual report and on Norges Bank's website.



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