



# NORGES BANK INVESTMENT MANAGEMENT **STRATEGY 2011–2013**

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## Strategy for Norges Bank Investment Management

Established by the Executive Board on 15 December 2010

# Introduction

Norges Bank Investment Management's (NBIM) mission is to safeguard and build financial wealth for future generations. We will continue to safeguard assets and focus on value creation. Our main goals for the next three years are as follows:

- We will implement an investment strategy built on the fund's defining characteristics and the owner's target of absolute return, with strategies that are long-term-oriented, scalable and focused on underlying value.
- We will simplify the infrastructure, obtaining an efficient and robust execution platform.
- We will strengthen the investment culture across NBIM, while maintaining our risk awareness and attention to detail where it matters.



## Investment Strategy – Improve risk-return

We will implement long-term-oriented and scalable investment strategies based on theoretically founded analytical insight.

### INVESTMENT OBJECTIVE

At the end of 2010, the Government Pension Fund Global is worth more than 3,000 billion kroner, and Norges Bank's foreign exchange reserves amounted to 220 billion kroner. The Ministry of Finance estimates that the fund will have assets of more than 4,000 billion kroner by the end of 2013. The owner's stated ambition is to build financial wealth, and the real return estimate of 4 percent forms the basis of the guidelines for economic policy.

We will strengthen our financial theory resources and research efforts on investment advice to the owner. In the first

part of the strategy period we will, in addition to proposing changes to existing benchmarks within asset classes, evaluate the regional distribution and currency composition of the fund, a new asset rebalancing regime and a new inflow structure. We will analyse investments in additional asset classes, including infrastructure, private equity and environmental investments. Our investment advice must still be developed based on an underlying investment target of a 4 percent real return over the medium term.

To achieve the owner's real return ambition, we intend to move our attention away from a benchmark focus in favour of the fund's long-term real return. We will develop investment strategies across asset classes to position the fund better on an absolute return-risk relationship. To support this, we will build large, long-term ownership positions in equities based

# *We will emphasise absolute returns as we capitalise on the fund's long-term outlook and size*

on fundamental research, and we will build an organisation ready for investments in private markets.

We will simplify the internal benchmarks while stepping up work on risk adjustment of investment results, provided that reasonable changes can be made within the bounds of the mandate and the owner's stated risk preferences. The internal benchmarks are currently being adjusted to take account of operational issues and risk. Changes in the internal benchmarks may lead to advice on mandate improvements.

NBIM has historically managed all funds with a target of 25 basis points annual net value added over a rolling three-year period. This target will be adapted in the coming years to better align it with the owner's overall real return target. New risk measures need to be developed, switching from relative market risk to valuation, business and cash flow risk. We will develop a target of improving the absolute return-risk relationship.

## **INVESTMENT STRATEGY**

We will implement long-term-oriented and scalable investment strategies based on theoretically founded analytical insight.

## **EQUITY MANAGEMENT**

In equity management, we will strengthen our internal research capacity with fundamental research searching for underlying value. Portfolio managers' investment universes will be specialised industry mandates, based on a list of companies within their sectors, with a clear expression of investment views using concentrated long positions. While keeping the individual portfolio manager's universe narrow, we will expand our coverage within and across sectors by hiring more industry specialists.

We will also expand our capital strategies, with larger own-

ership of individual companies and holding periods beyond three years. This approach aims to exploit the fund's long-term outlook and size, and may increase the potential gains and losses on individual stock investments. The focus will be on strategic positions or special situations such as capital placements, changes to capital structures, and investment in companies planning to be listed on exchanges.

A large part of the equity portfolio in developed markets will continue to be managed on a market exposure basis, with ownership positions similar across companies. We will further strengthen the enhancement strategies by exposing the fund to the desired risk factors in a cost-efficient manner. The focus will be on efficient inflow and rebalancing, minimising unnecessary portfolio turnover due to index changes, and managing corporate actions optimally to preserve asset value.

We will continue to fund external specialist equity managers, keeping both assets and the number of mandates close to today's level. The mandates will focus on emerging markets, small companies and selected industries. We will be attentive to large absolute fees, restricted capacity at managers, potential for correlation between mandates and reputational issues.

## **FIXED-INCOME MANAGEMENT**

The fixed-income area has been through considerable changes and will continue to simplify the instrument universe and benchmark composition. The transition to a simpler portfolio with fewer bond holdings will be carried out in an efficient manner.

There is limited scope for a large number of uncorrelated investments in the fixed-income area, and we will focus on managing the risk from individual but correlated positions. Individual mandates will be supplemented with a decision structure for larger positions, and key risk aspects such as

term, credit and liquidity will be managed for the combined portfolio. The combined positioning of the fund, including systematic risk and structural tilts, will be taken into consideration.

The fixed-income area will continue to build research capacity within the credit area to allow for more analysis on issuers and covenants on single issues. The portfolio will hold more concentrated exposure to fewer issuers than today. Trading activity will be reduced, the focus on new issues will increase, and bonds will not systematically be sold at the time of downgrade or index exclusion. We will increase the focus on covered bonds and other parts of the capital structure in the financial sector, especially in Europe.

Competence in macroeconomic research will be developed further, both for sovereign risk and for the increased investments expected in emerging market bonds. Analytical attention to bond markets in emerging economies will be increased in line with market developments.

The external fixed-income mandates have been scaled down significantly and will continue to account for a limited part of our fixed-income investments.

#### REAL ESTATE MANAGEMENT

We entered into our first real estate investment at the end of 2010, marking the beginning of the fund's exposure to private market investments. The investment case for real estate is driven primarily by its absolute return characteristics. Low transparency and liquidity, and the issues of taxation and financing make benchmarking a less relevant exercise, especially when compared to the other asset classes the fund currently invests in. Real estate asset allocation will be based on comparison with other asset classes in the same currency, and we aim to achieve a well-diversified real estate portfolio over time.

We will invest mainly in major markets, with the focus on the office and retail sectors. We will develop investment capability in the key markets in Europe first, with US and major markets in Asia considered by the end of the period. Risk related to liquidity, credit, counterparty, operational, legal, taxation, technical and environmental issues will be given considerable attention. Within environmental risk, we will attach emphasis to energy efficiency, water and waste management.

We expect that a majority of the investments will be through joint ventures. This may be complemented with funds in areas where we do not intend to build internal capabilities. By the end of the period, we will consider other avenues: public to private, recapitalisation and debt instruments. The option of buying a listed company will be given serious consideration.

#### OWNERSHIP

Our investments aim for a sustainable, long-term return. The fund is regularly among the largest shareholders in the companies we invest in. We believe that good corporate governance and the integration of environmental and social considerations into a company's corporate strategy impact the long-term absolute return on the fund. We have identified six focus areas for ownership and governance activity: shareholder rights, board responsibilities, efficient markets, climate change, water management, and children's rights. We will continue to focus on these areas over the next three years and will retain our long-term commitment to working on children's rights. All results will be reviewed, and new focus areas will be considered.

Our work on the principles of governance will continue, and we intend to expand our theoretical capability in ownership, governance and market structure issues in the coming years. Development of expectations documents and participation in regulatory consultations will be part of this. We will concentrate on international initiatives, changes in market structure and our six focus areas.

We have expanded our toolkit beyond voting and company dialogue to include expectations documents, shareholder proposals, legal action and participation in regulatory consultations. We do not expect to expand this list further, but will consider giving more attention to nomination of directors and contact with boards. We will express views publicly on issues with individual companies only if this can generally improve and emphasise our principle-based stance. Legal action will be evaluated on a case-by-case basis when necessary to safeguard our financial interests. We will uphold our profile as a persistent, long-term and principle-based investor.



## Investment Execution – simplify the Investment Platform

We believe we can express our investment views through simple instruments and long holding periods.

### **TRADING**

The trading function will continue to be a major focus at NBIM, as the size of the fund leads to transactions that may create market impact. Large inflows, investment policy changes and fund allocation make efficient transition essential for the return on the fund.

The revised investment strategy means that there will be a greater focus on executing larger orders over longer time periods. Our analytical platform will move from trading analytics to execution analytics, with the emphasis on finding

liquidity pools and choosing execution venues.

Technological developments in the market place start in the trading area, but we will change our ambition from being at the forefront of developments to being early adopters. We will keep pace with changes in trading technology and algorithmic trading. Active participation in new electronic trading platforms will require adequate resources for databases, data cleansing and connectivity. Electronic trading will continue to develop and expand in the fixed-income area.

We will integrate risk management across all transactions, and further develop internal pricing, for traders to take re-

sponsibility for overall execution performance. Inflow and transition will be integrated in overall trading responsibilities. The treasury functions of financing, cash management and securities lending will be centralised across asset classes. Securities lending and financing collateral will be managed on a consolidated basis globally to concentrate on enhancing risk management of the combined collateral pool, with less focus on cash reinvestment as a source of additional return. In addition, foreign exchange transactions will focus on emerging markets and developing electronic platforms.

NBIM will engage with regulators and exchanges regarding the changes in market micro-structure as a consequence of the recent market and regulatory developments in Europe and the US. Increased capital flow regulation and tax issues will be given additional attention.

## RISK MANAGEMENT

A strong and well-functioning control environment is core to our investment management. Key elements include valuation, return attribution, robust processes for market, credit and counterparty risk and an operational risk management framework that ensures efficient and effective internal control.

The change in investment strategy, with more concentrated investments and longer time horizons, will affect how we measure and report investment risks. The introduction of real estate puts new requirements on risk management both for the asset class and for the overall fund. The current four dimensions of market risk; benchmark deviation, relative volatility, factor exposure and position liquidity will be expanded with absolute risk measures. These include concentration, cash flow and systematic risk, as well as fund liquidity in connection with rebalancing. More work will be done on non-normal returns, shortfall measures, stress testing and scenario analysis. The credit and counterparty risk management framework will see few changes.

NBIM's seven governance committees serve an important

function as risk-mitigating forums, ensuring that key aspects of the business and investment risks have been considered. The committees for market risk, credit and counterparty risk, instrument universe, real estate investments, operational risk, valuation and business policies ensure input across business areas. The committees will continue as advisory forums for CEO decisions with few expected changes to the current format.

In the last strategy period, NBIM has built a strong basis for regulatory and investment compliance, and an extensive operational risk framework. We will maintain the operational risk management framework, but improve our forward-looking capabilities, increase the use of scenarios and stress tests, and better integrate with daily operations, while emphasising cost efficiency. The existing business continuity framework will be expanded.

Audit activity is expected to require considerable NBIM resources, and we will continue to ensure an auditable information repository, including governance, process, operations and management documentation. Fraud prevention and detection measures will continue to be given attention. We will review risks in all parts of the fund, with increased attention to private markets, outsourcing and service providers, and the increasing complexity of regulatory and tax regimes.

## OPERATIONS

We believe in simple processes and system solutions to improve operational efficiency and quality, and reduce operational risk. We will target a simple, efficient and consistent investment architecture. Consolidation and simplification will be key drivers for future changes to our technology infrastructure and system portfolio.

Quality and consistency of data are a first priority for accurate positioning of the portfolio, as well as for risk management and compliance. Data quality will continue to be given a high level of attention. The data warehouse environment will be

# *We will simplify the investment infrastructure*

consolidated into one data repository common to all asset classes and functions. Improved reporting tools will ensure data availability rather than custom-built applications.

We will consolidate the system infrastructure across asset classes and functional areas to improve efficiency and consistency. The system solutions need to be standardised, and simplification will be given priority over flexibility. Core investment functionality ranges from portfolio management, order management, pre-trade analytics and compliance to treasury and risk management functions. The middle- and back-office functions of trade settlement, transitions, corporate action instructions, collateral management, record-keeping, valuation and accounting services will all benefit from this consolidation.

Technological infrastructure will need continuous attention for the organisation to remain competitive. We will update the end-user platform, virtualise servers and implement new communication tools. High reliability and availability require redundancy in infrastructure components and communication lines in order to avoid single points of failure. Resilience in the setup of the main data centre, access to alternative sites, and regular disaster recovery testing are prerequisites for NBIM's business continuity plan.

Information security will be given increased attention, with stringent requirements for the confidentiality and integrity of data. Our extensive use of external providers requires assessment and mitigation of external security risks. The distributed nature of NBIM's global network brings a need for compensating security measures with efficient monitoring of network traffic.

## **SERVICE PROVIDERS**

NBIM will continue to concentrate on core investment activity and outsource investment services to external providers. These services range from IT infrastructure operations, application support and system development to back-office

processing, safekeeping and asset servicing. The scope of outsourcing will be reviewed. Global outsourcing enables us to have an international presence, 24/7 support, economies of scale and organisational learning across markets. Growth in assets under management and the people to manage them brings a need for additional investment infrastructure, support and development. NBIM will remain attentive to the use of business consultants and reduce usage where possible.

NBIM's solution architecture requires a major effort to integrate and coordinate services from multiple providers. We aim for vertical integration of services and to change service level agreements from resource-based to business-outcome-oriented. Vertical integration may mean consolidation across fewer service providers and insourcing of functions. We will also consider horizontal integration of services from fewer providers.

Custodial services today consist of several different vendors supporting various aspects of safekeeping, clearing, settlement and accounting services. NBIM will consolidate the service model for core custody services and consider moving to one global custodian to reduce the number of interfaces involved in trade processing and asset servicing. Benchmarking of fees and services, and a second vendor with contractual terms and operational processes in place may be required.



## Investment organisation – a global investment culture

NBIM aims to further build the confidence in our management of the fund.

### HUMAN RESOURCES

We will maintain a small, flexible and agile organisation. The increased volume of assets under management and additional asset classes will bring a need for more personnel than today. We expect to grow from 278 at the end of 2010 to around 400 employees by the end of 2013.

The bulk of recruitment in the next three years will be on the investment side, especially in equity industry research and real estate. A key objective ahead is to recruit, retain and develop highly qualified staff. We have to strengthen our ability to recruit in the international labour market, and increase

our visibility to give us a greater edge in the competition for the best employees. At the same time, we must build Norwegian expertise within and around NBIM to reflect the importance of its mandate within Norwegian society. We will recruit personnel for their potential, not their experience, and only fill positions when we find the right talents. We will aim for balanced staffing with Norwegian and international professionals at all international offices.

NBIM's international offices enable investment management across all time zones. With the recent opening of the Singapore office, we have positioned ourselves better for growth in the Asian markets. Most personnel growth will be in our offices outside Oslo. We expect the proportion of employees who work outside Oslo to move from 20 percent at the end

## *We will seek to strengthen our investment culture*

of 2010 to 40 percent by the end of 2013. We will also recruit more investment support staff at the international offices to ensure a seamless interface between investment activities and our corresponding operational activities.

### **INVESTMENT CULTURE**

#### **INVESTMENT FOCUS**

Investing is the core of our organisation. The mission is to make good investment decisions that give the fund a high return over time. The organisation will be built on a desire to achieve investment results, where risk willingness and courage of conviction is rewarded. We will foster an environment where people thrive on investing, and we will only succeed with portfolio managers focusing on investments.

We aim to build an organisation where one out of three employees are making investment decisions. The number of investment professionals combined with the trading and risk management functions should amount to half of our staff. We will nurture a focus on investments and consequences for investments in all our activities, effectively having more people work on investment decisions.

Theoretical depth and intellectual curiosity, as well as increased focus on the financial market, will shape the development of the organisation in the next strategy period. One way of achieving this will be by communicating investment strategies and the positioning of the fund across the organisation.

#### **COMPETENCY DEVELOPMENT - LEARN AND CHANGE**

The market place is constantly evolving, and we have to stay ahead of these changes. To remain agile and able to bring out the best in our employees, we promote a desire to change

and constantly improve all aspects of our investment and operational activities.

Over the last strategy period, significant organisational structures have been built. We have established a clear governance structure, with clear distinction between roles and functions, and with explicit delegation of authority throughout the organisation. We have also mapped our value chain into discrete processes and controls, established principles, policies and guidelines, and developed frameworks for risk management and control processes. In sum, these initiatives have created a structure that enables a stronger focus on future human capital development.

NBIM is a knowledge-based organisation, and our success is dependent on employees with a desire to learn and improve their capabilities. We will continue to encourage the use of our tailored courses, programmes and training, as well as a facilitated career development process. For NBIM to retain our core competencies, we will continue to perform competency mapping and succession planning. An important part of this is to continue our management development programme, as well as to systematically identify and establish a separate programme for potential future managers.

#### **COMPETE AS A TEAM**

NBIM operates in a highly competitive, global market, and we will continue to foster a competitive mindset in the years to come. Without an all-embracing drive for results, NBIM will not be able to deliver high returns over time.

We will encourage a performance culture in all parts of the organisation and work towards transforming qualitative targets into measurable behaviours. To achieve our strategic

goals and direction, we will therefore improve our performance management. All employees are held accountable and rewarded based on individual performance, as well as their teams' contribution to the organisation's overall results. During the coming period, we will design a new competency model linking performance measurement more closely with our core values, making them more tangible and measurable.

Delegation and the sum of multiple, small, relative-return-focused investments and decisions have historically been key. In the future, the decision processes required to take large, long-term positions will influence how we build and shape the organisation. Our organisation is built around specialist expertise, but in the future we will have more emphasis on cross-organisational training and investment understanding.

We can only be successful as a team, and it is imperative that we maintain a collaborative environment, our desire to win as a team and sharing of information to achieve common objectives. During the strategy period, we will strengthen internal knowledge-sharing through investment discussion forums, intra-office communication, collaboration tools and internationally mobile employees.

The key criteria for NBIM's future success will be a high level of specialist knowledge and helping others become better at their tasks by sharing our competence. We believe that our organisational values are expressed through the actions and

attitudes of each employee, and expect the highest standards from everyone at NBIM.

#### COMMUNICATION

NBIM aims to further build the confidence in our management of the fund. To achieve the trust of the owner and the Norwegian people, and legitimacy for our investment activities around the world, we have to be a respected, transparent and responsible manager. Respected for being professional in the way we do business, invest and execute. Transparent in the way we report and explain the fund's activities. Responsible in our long-term investment focus on sustainable value creation and ownership governance principles.

NBIM is to be appreciated as an organisation with strong integrity and clear principles. We have developed a recognised capability for cost-efficient execution and market exposure through our trading and index management. Furthermore, our work on ownership, corporate governance and sustainable investments has received considerable attention. It is our ambition to further strengthen awareness of two more aspects of our management: we will demonstrate our in-depth knowledge of the companies and assets in which we invest through diligent analysis and research, and we will show that our strategies are based on a continuously revisited base in financial theory through our increased work on the theoretical foundation of our investment activities.

We have seen that we need to explain more of our investment activity in order to strengthen our legitimacy in Norway and internationally. We will be open about how we evaluate markets, but not about how we regard single investments. We will express our views on recent market developments, but not forecast the future. We will be open about how we manage the business, build the organisation, and set strategies and policies, but not about individual contracts or business relationships. Our ambition is to be open about all relevant information that does not affect the fund's competitiveness or performance.

NBIM's key communication channel will be our Internet site, supported by the quarterly financial reports, conferences and media contact. We will direct our communication more to the public in order to improve people's knowledge of the fund and trust in NBIM's managerial role. To achieve this, we must also prepare for a more continuous dialogue with Norwegian media, as sensitive issues will require a higher level of responsiveness and clarity. It is in NBIM's long-term interests to facilitate open academic discourse on all aspects of how the fund is managed. We will seek to establish a structure for interaction with leading international academics.

We need to ensure the legitimacy of our investments in host countries as our global presence increases. It has to be clear to the companies and the countries in which we invest, that we share a common interest in long-term sustainable value

creation, that we contribute equity capital or lend in support of a strategy, and that we are a long-term, reliable and supportive investor with shared values and objectives. Making the results of our ownership work in the corporate governance area more visible to a broader public is an important objective. We will actively contribute our views on markets and regulations where desirable. As a minority shareholder, we will retain a principle-based approach and support the boards of companies in pursuit of our mutual interest in long-term profitability.

## Summary

NBIM's objective is to safeguard the owners' long-term financial interests and build wealth over the long term. This should be done through investment decisions based on analytical insight, and by implementing the strategy in a simple, cost-efficient and controlled manner. The guiding principles for the 2011-2013 strategy can be summarised as follows:

- We will emphasise absolute returns, moving away from a relative return focus, as we capitalise on the fund's long-term outlook and size
- We will simplify the investment infrastructure
- We will seek to strengthen our investment culture and be open about how we invest

The statements above reflect three interlinked components; the revised investment strategy paves the way for a simpler infrastructure, but requires organisational change.





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