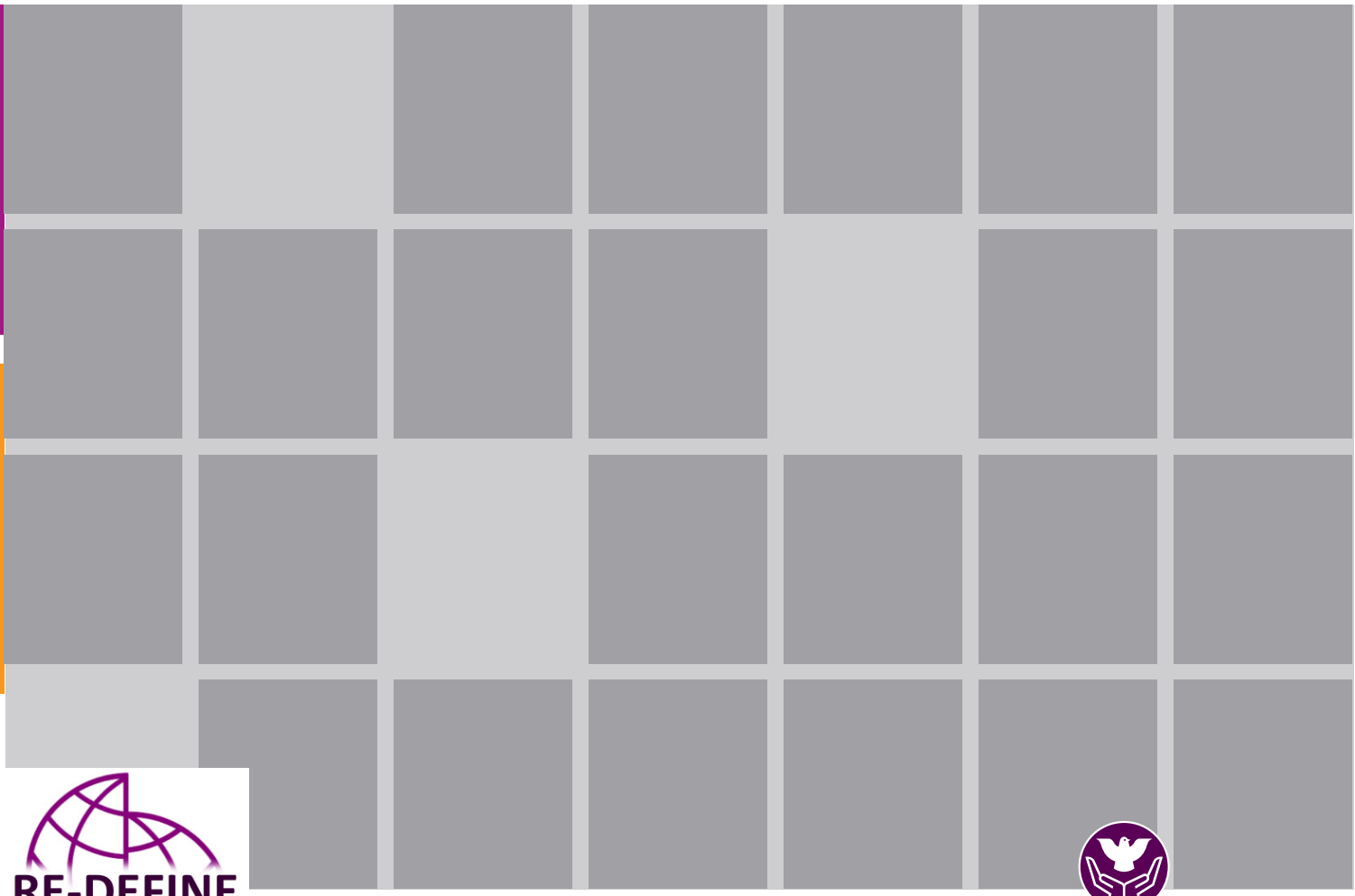
DISCUSSION PAPER

Investing for the Future

by Sony Kapoor



NORWEGIAN CHURCH AID
actalliance

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Norwegian Church Aid *(NCA) is an ecumenical organisation for global justice. Our work is carried out with no intention of influencing people's religious affiliation. Norwegian Church Aid is a member of ACT alliance, one of the world's largest humanitarian alliances.*

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Re-Define *is an international Tank dedicated to improving the quality of policy-making. It advises a number of governments, central banks, financial regulators and international institutions on matters of public policy, particularly on finance, taxation and the economy. Re-Define also works on international development and environment and advises both institutional investors as well as civil society organizations on the global economy*

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Views here are those of the author and do not always correspond to that of Norwegian Church Aid

Abbreviations

ADIA	Abu Dhabi Investment Authority
BCG	Boston Consultancy Group
CDC	Commonwealth Development Corporation
CIC	China Investment Corporation
COFIDES	Compañía Española de Financiación del Desarrollo
DFI	Development Finance Institution
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GIC	Government of Singapore Investment Corporation
GPF	Government Pension Fund- Global
IEG	Independent Evaluation Group
IFC	International Finance Corporation
IMF	International Monetary Fund
LCT	Low Carbon Technology
LDCs	Least Developed Countries
MoF	Ministry of Finance, Norway
NBIM	Norges Bank Investment Management
NDFI	Norway's Development Finance Institution
NGO	Non-governmental Organisation
MNCs	Multi-national Corporations
MSCI	Morgan Stanley Capital International
OECD	Organisation for Economic Cooperation and Development
SWF	Sovereign Wealth Fund
WB	World Bank
WWF	World Wide Fund for Nature
UN	United Nations

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Foreword

Jobs for development

Norway is a provider of capital. We own the largest sovereign wealth fund in the World – the Government Pension Fund – Global, which currently owns about 1,25 per cent of the world's stocks. Managing such wealth is a huge responsibility that also provides unique opportunities. How and where we decide to invest this money is very important.

The world in general and the developing world in particular lack jobs. According to the World Bank, 600 million new jobs are needed by 2020 to avoid higher unemployment. One key factor for creating jobs is access to money for investment. Companies in developing countries, especially those small and medium sized enterprises where most jobs are created, are often starved of capital.

Despite high growth rates and abundant investment opportunities in poor developing countries, only 1 per cent of this Fund has been invested in the low income and lower middle-income group of countries. This group accounts for 13 per cent of the world's GDP. In our opinion, this is not just a missed opportunity for the Fund, but it is also unfair and robs developing countries of capital needed to create jobs.

The developing world is likely to grow faster than advanced economies in the OECD for a long time. Therefore, there is a potential win-win opportunity. By investing more in developing countries Norway can make it easier for economies to develop by providing much needed risk capital and thus create jobs, while also securing the value of the Fund for future generations of Norwegians.

The Oil-fund is a unique investor. It has an almost infinite investment horizon, not needing to touch the principal, and as a consequence it can bear more risk than most. The fact that we are managing the fund for our grandchildren also implies a need to invest in the world we would like them to have. This has implications for how the fund invests and in what.

A fundamental part of today's Fund is the ethical guidelines and the enforcement of these guidelines. Investing more in developing countries will require new guidelines suited for this purpose. Norway set a standard in 2004, when the original guidelines where established. We can do so again.

Investment can create more inequality in a society, even if the society as a whole gets more resources. The responsibility for tackling this mainly rests with the individual state by redistribution through taxation, for instance. Without proper national and international legislation on issues such as tax and transparency it can be difficult for a country or community to benefit from investment. Even so, an investor can decide to invest in sectors or in ways that contribute to inclusive growth. We know that agriculture, infrastructure, energy, as well as other labour intensive

activities have a good distributive effect through knock-on effects and through jobs being created in the economy. Funding for SMEs is another critical area. We should explore these options, as well as research what other opportunities might work, given the special characteristics of the Norwegian Pension Fund Global.

The prime recommendation of this report is that a new fund, the Global Pension Fund – Growth, is established. The main goal is investing in assets beyond liquid equity and bonds, and real estate. As it can be more challenging to invest in developing countries and local knowledge is required, cooperation with actors such as the International Finance Corporation (IFC) and bilateral development finance institutions such as Norfund is suggested.

Norwegian Church Aid would like to stress the following:

- Norwegian authorities should establish a new fund for this purpose and enter into cooperation with relevant financial institutions in order to invest more and build own expertise.
- The new fund should invest in ways contributing to inclusive growth such as agriculture, energy or infrastructure. The fund should study how the distributive effects could be enhanced and consequently invest in those sectors.
- A new fund requires a new ethical framework. This challenge must be considered in any revision of the ethical guidelines.
- Rules based on continuing improvement of companies' practice with regard to the environment, sustainability and governance should be established.
- Ethical rules and standards must not be developed in a way that excludes the possibility to invest in small- and medium-sized companies in developing countries.
- Investments in developing countries should as a rule not happen through tax havens. Strict standards and guidelines for transparency should be established in any cases where use of tax havens is needed.
- People adversely affected by our investments must be heard. A mechanism for hearing the voices of those affected by our investments and an ombudsman's office for tackling grievances should be considered when establishing a new fund.

Norwegian Church Aid would like to thank Sony Kapoor and his team at Re-Define for the outstanding work they have put into the report. We hope it kicks off a fruitful debate on the opportunities and potential of the Fund to the benefit of future generations both in Norway and in the developing world.

Enjoy the report!

Anne-Marie Helland
Secretary General
Norwegian Church Aid

Author's Note

I remember that feeling of surprise when I first looked at the GPF in 2007. Having worked both in the financial industry and in public policy, I was struck by some aspects that still make me uneasy.

The **first** was how in 2007 the portfolio was comprised almost entirely of investments in liquid securities in the developed world. These still constitute more than 90% of the GPF.

The **second** was how some of the largest investments of the GPF were in oil companies. Even today three of the ten largest equity holdings of the GPF are in oil majors, and as much as 10%-15% of the overall portfolio is heavily exposed to oil, gas or coal.

That surprise led me in mid-2008 to write a note to the then Finance Minister Kristin Halvorsen with two suggestions. **First**, that the GPF, as a long-term investor, should expand its investments in fast-growth developing economies. This would deliver higher returns, diversify some of the risks away and engender development. **Second**, that the GPF, which derived its new revenues from oil and gas, should sell off all stakes in the sector and seek out investments in green technologies in order to reduce its overexposure to carbon and to benefit from the growth of the green economy.

Neither of these suggestions were implemented on any scale, so when the NCA approached Re-Define to analyse the operations of the GPF, I jumped at the opportunity. The on-going discussion in the run up to the Norwegian elections makes me hopeful that the time for a mature and informed debate on improving the GPF has finally, if belatedly, arrived.

In its 15 years of operation, the GPF has generated an annual return of only 3.17%, falling well short of its 4% target. It is increasingly unlikely, perhaps even impossible, that the GPF will ever meet it. The sclerotic returns are the direct result of the Ministry of Finance's decision to invest more than 90% of the portfolio in slow-growing mature economies. Meanwhile, more than half of the countries in the world, including some of the fastest growing developing economies, remain off-limits to the GPF. So do instruments such as infrastructure and growth (private) equity that the GPF, as a large long-term investor, is uniquely placed to take advantage of.

The GPF sharply underperforms in comparison to many of its peers - other SWFs such as Temasek and GIC of Singapore, large pension funds such as Calpers and the Harvard and Yale university endowments. All of these have large investments in developing economies and invest in illiquid asset classes such as infrastructure and private equity. Even institutions such as Norfund and the IFC – the private sector arm of the World Bank, which have a dual profitability and development mandate - do better than the GPF.

The GPF's approach, which can be explained by an understandable conservatism to stick with the familiar and thus avoid negative headlines at all costs, has now placed a bet on the future of OECD economies being bright. This locks in low returns and exposes the GPF to concentrated risks of ageing populations and over-indebtedness faced by many mature economies. The GPF has inadvertently taken on a lot of risk for very little return.

NBIM justifies its portfolio decision by saying that liquid public equity and debt markets in emerging economies do not fully capture opportunities arising from growth. This is a reason to invest in nascent firms through private (growth) equity and in much needed infrastructure, not to stay on the sidelines. In this report we show how investing up to $200bn by 2020 in such investments through a GPF-Growth fund would improve the profitability of the GPF and reduce the long-term risks it faces.

Not only will this be good for Norway, it will also enable faster growth in poorer economies and create millions of much-needed jobs.

Climate change related risks also loom large over the GPF. Fast forward to 2025 and the GPF is expected to be worth double of the $760bn it is worth today, with most of the new money coming from the sale of the oil and gas Norway drills. Like it or not, the policy action to tackle climate change that Norway rightly supports, will have a negative impact on the future value of the GPF.

As much as half of the future expected value of the GPF in 2025 is negatively exposed to policy measures, such as an increase in the price of carbon emissions or an agreement to limit their quantity, that are necessary to tackle the impending threat of climate change. Despite this, the GPF has invested as much as 10%-15% of its portfolio in oil, gas and coal related assets, which will also lose value in the face of such policy action.

The only way to prudently manage this risk is for the GPF not only to divest all such assets, but also in addition to invest heavily in low carbon technology and other green investments. These will gain in value when policymakers act on tackling climate change at the same time as new revenue for the GPF would fall, thus reducing the overall risk.

In managing its risks prudently, the GPF can also contribute to tackling climate change.

Taking the measures we have laid out is the only way the GPF can deliver on its fiduciary duty towards Norwegian citizens of maximizing returns for moderate risk in a manner that is both sustainable and responsible. It is time to turn words into action.

Introduction

Great potential

The Norwegian Government Pension Fund – Global (GPF or Fund) is now the world's largest sovereign wealth fund. It is now worth $760 billion[1] and is expected to grow to more than $1,100 billion by 2020[2]. Unlike many other SWFs and other long-term investors such as pension funds, the GPF money is not committed to finance any particular liability and, despite the name, does not fund pensions. Instead, it is run as a vehicle for inter-generational wealth sharing in the sense that on average 4% of the outstanding size of the Fund (which is assumed to be the natural real rate of return) is spent every year, so it works as an endowment for the citizens.

Not having any liabilities means that the GPF can be a truly long-term investor, since legislation says that principal of the Fund will not be spent. On average 4% of the fund is used every year, depending on the business cycle, and is so small that such a sum can always be mobilized. This means that even in the midst of a crisis the Fund should not come under pressure to try and sell illiquid investments. The target investments should be those believed to be the most profitable over a long-term horizon. Its large size, potential for making truly long-term investments and the lack of any specific funding commitments give the GPF **the potential for being one of the most powerful and effective investors and sources of capital in the world.**

Objectives and drivers

The GPF differs from other funds in that it manages the savings of a country, not a single investor. The official objective of the GPF is 'to maximise international purchasing power with moderate risk in order to ensure that future generations will be able to derive the maximum possible benefit from national savings.' The Norwegian government also states that the 'goal of good financial return is closely linked to the ambition to be a responsible investor.'

This objective is operationalized by the Ministry of Finance (MoF), which reports to the parliament. The Ministry's interpretation of this objective is critical, as it decides what the Fund, which is managed by Norges Bank Investment Management (NBIM), can and cannot do. The ministry interprets the objective to mean that 'the Fund has a strong capacity for bearing risk; it has a long investment horizon and there is no obvious liability. Hence, it aims to achieve the highest possible return consistent with the owners' risk preferences for a moderate level of risk.' The only quantitative target is the implicit assumption of a 4% real rate of return over the long-term.

[1] NBIM, 10 October 2011, 'Government Pension Fund Global'. http://www.nbim.no/en/About-us/Government-Pension-Fund-Global/

[2] NBIM, 17 July 2013, 'Projection for the size of the fund'. http://www.nbim.no/en/Investments/Market-Value/forecast-for-the-size-of-thefund-/

Unrealized Potential

What the analysis by NBIM and the Ministry of Finance, as well as by external experts and by this report reveals, is that the current running of the Fund may not fully reflect these objectives and that the Fund could be doing much more to exploit the unique potential that its large size, its long-term horizon and its responsibility mandate confer on it. At a more mundane level, the Fund has generated a return of only 3.17% since it started investing in 1998 and, if anything, the prospects for future profits, unless the Fund strategy is changed, look even bleaker. For example, the yield on the Fund's holdings of bonds, which constitute 40% of its portfolio, have fallen from 4.5% to just 1.9% since 2010. Moreover, NBIM expects these to stay depressed: 'Forward-looking yield measures indicate that real hold-to-maturity returns on developed market government bonds could be very low compared to recent history and low relative to long-term averages[3].'

As the Strategy Council to the Fund admits, the GPF is highly unlikely to be able to meet the 4% target, unless it is ready to 'accept a reasonable probability of lower returns or of actual losses over a shorter horizon' and/or invest in more illiquid assets where its money is locked-in for a longer term.

Broadly speaking, the Strategy Council thinks that **the Fund should 1) accept higher risk (from various sources) 2) expand exposure to illiquid assets 3) extend rebalancing to become more pro-actively contrarian 4) develop various forms of insurance selling.**

The Fund invests mostly in mature economies

In order to look at where the Fund should go, it is useful to start with an analysis of where the GPF is at in terms of how and where it invests. As of the 31st March 2013, the GPF has 62.4% of its assets in listed equities (shares), 36.7% in fixed income (bonds) and 0.9% in real estate. Within each asset class, the GPF follows a strong geographic allocation formula, which has until recently been 54% in Europe 35% in North America, Latin America and Africa (the bulk being in the USA) and 11% in Asia and Oceania. Of this, only 6% was invested in emerging and developing countries and 94% in developed economies. In 2012 the Ministry of Finance announced a change to the regional allocation formula to 41%, 40% and 19% respectively. The developed/emerging (developing) country mix will be 90% / 10%. While listed equity holdings will stay at 60%, the Fund will now target 35% bonds and 5% property investments.

Two remarkable features about the portfolio allocation of the Fund, even after the recently announced changes, stand out. **First**, that 99% of its investments are in listed liquid securities, the main attraction of which is that these can be liquidated at a short notice, usually without substantial penalties. **Second,** that, even after the

[3] NBIM, March 2011, 'On fixed-income investments'.
http://www.regjeringen.no/Upload/FIN/Statens%20pensjonsfond/2011/NBIMmemo_fixed-income_investments.pdf

rebalancing, 90% of its investments will be in developed economies with only 10% in emerging and developing markets. We address each in turn.

It is not just that the growth rates and yields in developed countries are expected to be lower, but also that risks in these economies are expected to rise.

According to the IMF, for example, 'as a group, developed economies are, however, in a new situation: the debt-to-GDP ratio is higher than ever previously observed and significant policy changes are needed to make policies sustainable. The high debt burdens and expected lower growth rates have significantly increased sovereign risk in developed economies, as can be seen most starkly in Eurozone countries such as Greece and Portugal.

The allure of developing countries

The dominance of the EU, the US, Japan and other OECD countries in the global economy is a historical anomaly. For much of the past 2,000 years or so, economies such as India and China and also other nations that fit into the broader category of developing countries have dominated the world economy. Evidence is mounting that OECD countries are now locked in relative decline and that the future once again belongs to developing countries, where China and India are likely to dominate.

Not all developing countries are doing as well as China and India, of course. Particularly low-income economies in Africa seem to have been left behind. However, there is good cause for optimism that the same kind of catch-up growth powered by a rural to urban migration and a move up the value chain that has done so well for China is also possible in these other economies. Some of them, such as Ethiopia, have already been doing well and have registered growth rates that are impressive.

The future shape of the world is starting to emerge and in this, both emerging markets and poor low income countries will grow faster than OECD economies for a long period, and in 50 years (by 2060) will constitute a much higher proportion of world GDP, world trade and world financial assets than they do now. Consequently, the share of OECD economies on all of these parameters is set to shrink.

For example, of the 95 countries that grew at 4% or faster in 2011, only Chile and Sweden were OECD members. A similar pattern is observable over an ever-longer time horizon and assuming that the OECD, IMF, World Bank, World Economic Forum and several banks are not completely wrong in their forecasts, this is set to continue. If, as stated, the GPF is set to help finance future imports from the rest of the world, it cannot afford to ignore the fundamental structural shift in the relative weights of OECD vs. non-OECD economies. Nor can it, if it is to meet or exceed the 4% return target, afford to ignore the fact that most growth in the world economy will come from non-OECD countries. As the GPF itself admits, returns on investments are capped by GDP growth rates in the long-term and, with GDP growth rates in OECD countries likely to be no more than 1.5%-2.5%, the GPF's 90% asset allocation to OECD/Developed markets looks very archaic.

An often cited reason for not going deeper into emerging/developing markets –

exchange rate risk - has been tackled by NBIM's and Ministry's own analysis, which shows that this is not a particularly significant risk for long-term investors. Exchange rates tend to converge to fundamental values over the long-term, and there are few investors with a longer-term horizon than the GPF.

Not only is a shift towards developing economies necessary in order to generate the target rate of return, but it is also beneficial from the perspective of portfolio diversification. This will help mitigate risk while increasing returns. The logic becomes even more powerful when one notes that every single member of the GPF's peer group has a substantially higher allocation of investments in emerging and developing markets, and that the GPF is an outlier in having by far the largest allocation of investments to the developed world.

This is also consistent with the Strategy Council of the GPF, a government-appointed advisory body, which calls for the Fund to bear more risk of short-term losses (more likely in emerging and developing markets) and make more illiquid investments (emerging and developing markets are less liquid) in order to generate a higher return. For example, Sub-Saharan Africa, long considered as a high-risk region, has consistently reported the highest returns on foreign investment of more than 20% per annum.

The conclusion is very stark and clear. The GPF must substantially rebalance its portfolio away from OECD/Developed economies towards emerging and developing countries. Otherwise it will fail in the fiduciary duty it owes the citizens of Norway, the ultimate owners of the Fund, to maximise return at moderate risk in a manner that is sustainable. It will also be a huge loss for citizens in the developing world, who could benefit enormously from well-structured investments.

The share of developing countries in the global economy is more than 50% of global GDP when measured on a purchasing power parity (PPP) basis, and more than 40% on the basis of market price. A 'universal investor' such as the GPF should not, under such circumstances, have only 10% of its portfolio dedicated to these economies.

The need to look beyond listed securities

The Ministry of Finance and NBIM accept that much of future growth will come from emerging and developing economies. However, they believe that the link between GDP growth and returns on investment is not very strong, while using this logic to conclude that a significant rebalancing of their OECD/Developed country focus is not necessary. They also suggest that investing in developed country Multinational Corporations (MNCs) gives them indirect exposure to faster growth in the developing world, as many developed country MNCs have significant investments in and trade with the faster growing developing world.

A deeper look reveals that, compared to developing country companies, most OECD MNCs have only got a limited exposure to developing/emerging markets so the GPF will miss out on the benefits of faster growth unless it can look beyond developed countries. A strong explanatory variable for the observed weak link between growth

and returns on listed security investments referred to by NBIM is the fact that a significant proportion of growth in developing economies is associated not with existing firms, but with new firms and unlisted firms.

New firms can be risky and investing in unlisted firms is illiquid, so the GPF has shied away from these and has focussed exclusively on buying listed stocks only. However, as the Strategy Council clearly points out, the unique selling proposition (USP) of the GPF is its very long-term horizon, which makes it perfectly suited to make illiquid investments, for example, in unlisted firms. Its unique ability to withstand potential losses in the short-to-medium term for longer-term gain also makes venture capital and private equity type investments fit for purpose.

Once the GPF starts looking into such investments, another reason for staying away from emerging/developing markets, namely the danger of excessive concentration and the limited size of listed securities available for purchase, falls away, as the investment universe of the Fund expands significantly.

A bigger role in developing/emerging economies is also consistent with the Strategy Council's suggestion that the GPF consider offering insurance-like instruments, as the GPF could, in theory at least, help plug a large latent demand for guarantees linked to trade finance, investments and credit-enhancements.

Last but not least, an enhanced role in developing and emerging markets is also a logical consequence of one of the key drivers of the GPF – that it is a responsible investor – as long as such investments contribute to growth, poverty reduction and increased welfare in the recipient countries.

Investing in venture capital to help encourage entrepreneurs, private unlisted firms, infrastructure and providing guarantees of various kinds in emerging and developing markets will allow the GPF to maximise the benefits it can derive from faster emerging/developing country growth, diversify some of its risk, as well as fulfil its role as a responsible investor.

The need for such investments

With the exception of some developing/emerging economies such as China and some other countries in East Asia, most developing countries have rather low savings rates and can be accurately characterized as labour rich, capital poor. For example, the savings rate in the Least Developed Countries (LDC) group in recent decades has only been 6.7%, a fraction of the 38% seen in China, which admittedly is an outlier. Without external funding and capital support, GDP per capita in LDCs would have been 3% lower than observed. The need for capital is clear.

However, foreign sources of funds, especially in the form of aid flows, portfolio investments and lending, are highly volatile and hence potentially problematic for the purpose of sustainable development. Reliance on external financing leaves countries vulnerable to the vagaries of the international economy, over which they have little or no control. Interest rates move up or down in response to monetary policy in developed countries, while commodity prices can fluctuate up to 70% from one year to the next. For the purpose of sustainable development then, it is essential

to tap stable sources of funds. There is no better source for these than the GPF, which by its nature has a very long-term horizon, a responsibility mandate and a higher than average tolerance for short-term losses in pursuit of longer-term profitability.

The mechanism by which the GPF can contribute to growth, jobs and poverty reduction is well known.

In an environment of the kind that prevails in several low and middle-income countries, there is an insufficient availability of domestic savings, particularly of the kind that be turned into risk capital or long-term loans. Government revenues and borrowing capacity in many of these countries is also low. This combination of a low quantity and quality of private sector savings and low government capacity means that there is a significant funding shortfall particularly for infrastructure investments, which in turn are critical for growth as well as poverty reduction. This funding gap has been estimated to be about $1 trillion every year.

The insufficient availability of risk capital also thwarts the development and scaling up of private firms, and means that entrepreneurial skills are not able to fully contribute to growth and productivity enhancements in the economy.

By providing the kind of long-term capital for infrastructure that is missing, as well as risk capital for firms particularly in places where public equity markets are underdeveloped, the GPF can both contribute to increasing demand in the short-term, as well as productivity and supply over the longer-term. Together these developments will put the economy on a path to higher growth and create much-needed jobs.

Domestic Savings/GPF Investments – Monetize – Credit - Productive Investments (supported by aid, public infrastructure spending and skills and technology from FDI) (Keynesian multiplier) – Growth and Jobs – Domestic Savings / Profits for GPF

Some of the most promising growth-enhancing and poverty-reducing investments in poor developing countries are those that are targeted towards infrastructure, productive manufacturing investments and the development of the financial sector. All of these, more so than others, require long-term capital. The only thing scarcer in developing and emerging economies than capital is long-term capital. For example, in Burundi, long-term credit (more than five years of maturity) represented only 3% of total credit, compared with 17% and 80% for medium-term (one to five years) and short-term (less than one year) credit, respectively. Here again, the role of the GPF as a potential long-term provider of debt and equity capital is very suitable.

Another element that is missing in emerging and developing markets in general and LDCs in particular is risk capital. Because of the high levels of poverty and the paucity of capital, there are few pools of money where the owners are ready to take a substantial downside risk. At the same time, it is exactly these countries that are the hotbeds of entrepreneurial talent. Even with relatively small amounts of credit being made available to the unbanked, microfinance has worked well in encouraging entrepreneurs (even though its overall impact on growth is less certain). Micro-

equity and, at a larger scale, venture capital hold an even greater promise both in encouraging entrepreneurship and contributing to country-level growth.

The fact that economic volatility, weather risk and credit risk are generally higher in developing and emerging markets often holds growth and development back and has a negative impact on the lives of the poor. The GPF, with its substantial risk bearing capacity and long-term horizon, can help provide guarantees and insurance in exchange for a premium that, because of its internationally diversified portfolio, can be lower than what can be provided from within the country.

The provision of credit and equity to listed and unlisted firms, as well as infrastructure projects, investing in micro-equity and venture capital and providing insurance and guarantee services - can all help the GPF tap into the faster potential GDP growth of developing and emerging markets, while also helping to contribute to increasing this growth, tackling poverty and increasing welfare.

Providing equity and credit to developing and emerging markets, making long-term commitments, funding venture capital and providing guarantees are potentially win-win propositions for the GPF and for the recipient economies.

Leveraging the existence of development finance institutions

On paper, such an idea that there is a win-win proposition looks good, but the question is whether this can work in practice. The evidence for this is very clear: yes, it can. The International Finance Corporation (IFC), an arm of the World Bank (WB), supports private sector-driven growth and poverty reduction through the provision of credit, equity, guarantees and advice in developing and emerging economies. Importantly for our purpose, the IFC is also self-financing, so makes only commercially viable investments. And the IFC has a higher track record of profitability than the GPF.

In order to maximise its impact on development, the IFC works only in emerging and developing countries, prioritizing sectors such as infrastructure, SMEs, financial services, green energy etc. that can deliver the biggest bang for the buck in terms of both growth and poverty reduction. The IFC has also a well-established and reputed investment process and development-outcome tracking system that is designed to ensure that its work crowds-in the private sector, rather than crowding it out and that its positive impact on the lives of people is maximized. While the focus on development and poverty reduction can be improved, there is a consensus that the IFC does have a positive footprint on development, while also remaining profitable.

What is of particular interest to Norway, is the fact that the IFC has set up an Asset Management Company (AMC) designed specifically to attract sovereign wealth funds and other long-term investors as co-investors on a commercial basis. Some of the other SWFs have already put capital into the AMC, which has made its first few investments. At least as long as the GPF does not have boots on the ground in developing and emerging economies, it should channel the increased share of developing/emerging market investments that we recommend through the IFC's AMC.

Several countries have IFC-like institutions at a national level. For Norway, this role is played by Norfund, which makes development-friendly investments in much the same way as the IFC, but on commercial terms. Like the IFC, Norfund and its sister organizations such as the CDC of the UK and Swedfund from Sweden are profitable and have a positive impact on development.

Because the GPF is so big and the relative size of the IFC, as well as other development finance institutions, is relatively small, we suggest that the GPF spreads its increased allocation of funds towards developing and emerging markets through not just the IFC, but also the more reputable DFIs. Norfund already has an attractive proposal for channelling some of the GPF money that should be taken up in a modified form and used as a template to negotiate similar memorandums of understanding with other DFIs.

As part of this move the GPF should also seek to establish a ten year programme mix of in-house expertise-building and an option to use the best performing in-country offices of the IFC and various DFIs to start making direct investments on its own behalf (beyond the co-investment programmes that it must begin with).

The GPF needs to set up a special window for the GPF-Growth, which will invest $30 bn a year every year until 2020, at which point the Fund will be reviewed. At this time, the GPF-Growth should be worth around $200 bn, around 20% of the outstanding value of the whole GPF.

The most promising near-term method of leveraging GPF funds in a manner that is both good for development and good for Norway is to channel around 20% of the whole GPFs portfolio though the IFC and other DFIs by 2020. This can be done through setting up a special window GPF-Growth.

In order to make sure that these funds are used in a manner that both generates commercial rates of return and has a positive footprint on development, we recommend that the Ministry of Finance appoint an independent oversight board comprising of international experts in development, emerging market investments and various sector experts.

Going by the IFC's own estimate of the number of jobs created by the kind of work it does, it is possible for GPF-Growth to generate as many as 100 million jobs.

Tackling climate risks

Because the Fund gets new money from the sale of oil and gas every year, its final value (when the oil runs out) is very highly dependent on the price at which it is able to sell this oil. This means that the Fund has a large negative exposure to policy actions that need to be taken to tackle climate change. Any increase in the rise of the price of carbon emissions or restriction in their quantity will have a negative impact on the final value of the Fund.

Despite this large exposure to carbon, the GPF continues to invest heavily in oil and gas majors, which account for three out of its ten largest investments. In order to

manage its exposure to carbon risk prudently, the GPF ought to sell off its stakes in the oil, coal and gas sector. This is necessary, but not enough, given the size of the risk it faces. To manage this carbon risk it should also actively seek out green investments.

This proposal is also discussed in some detail in the report.

Chapter 1: The context of this report

The forthcoming Norwegian elections have prompted a debate on the structure and investment strategy of the Oil Fund. Several proposals, including some to split up the Fund, are doing the rounds. Some parties and stakeholders have suggested that more funds should be allocated to developing countries, while others say the GPF should prioritize making green investments. Still others have suggested that more money from the Fund should be ploughed domestically in the Norwegian economy.

Many of these proposals are not new. What is new is the context. After 15 years of operations, it is only appropriate to have a fundamental discussion about the operation of the Fund that is much bigger than had been anticipated and now exceeds Norway's GDP in size. The emerging post-crisis environment, which has starkly highlighted the divergent growth prospects of developed and developing countries, is another reason why a discussion on where the Fund should be invested is due. Deep financial, political, social and economic risks that were assumed to be a problem only in developing countries have reared their ugly head at the heart of the European Union and the developed world, even as developing countries continue, as a group, to become less risky. The assumption that developed economies are 'safe' and developing economies 'risky' has been turned on its head. Last, though no means least, the threat of climate change now looms larger than ever before, and it is only appropriate that the operation of the Fund, which gets its money from oil and gas, be re-examined in this context.

Most of the proposals that have been put forward have not so far been backed by substantial analytical reports. This report aims to plug that gap. It discusses the context and makes concrete suggestions to improve the Fund's structure, strategy and operations in a manner that reflects the emergent reality of the world around us.

A Brief History of the Fund

Norway first discovered oil in 1969 in the North Sea at the Ekofisk oil field, and production started in 1971. The oil revenue that started flowing in contributed to the development of Norway and its transformation into a developed economy. In a far-sighted act in 1990, the Norwegian parliament established a Government Petroleum Fund to help manage oil revenues in a long-term framework that could help minimise any overheating of the economy, as well as preserve some wealth when the oil ran out.

However, this Fund received its first capital injection only in 1996 and it was not until 1998 that a sovereign wealth fund, now known as the Government Pension Fund – Global was first set up with an explicit mandate to promote inter-generational wealth sharing. The present fiscal framework, under which only 4% of the

outstanding amount is spent on average, was adopted in 2001, firmly entrenching the Fund as an endowment. Ethical guidelines were then adopted in 2004.

Norwegian leaders have shown tremendous restraint and responsibility by agreeing to save more than 10% of GDP (in some years) for future generations, and this achievement should not be underestimated. Many other countries in similar positions have squandered their resources.

Because getting such a broad and far-reaching agreement must not have been easy and the consensus is still viewed by many as somewhat fragile, those responsible for managing the oil fund have been very conservative and tread very carefully whenever any proposals to change policy are considered. The consensus is considered by some to be susceptible to calls for deploying more resources at home in Norway or to promote Norwegian interests abroad, or for eradicating world poverty and such-like. **The guardians of this consensus are afraid to consider even reasonable suggestions in the fear that responding to them may unleash a torrent of fresh demands.**

Given that an unprecedented debate on the nature of the Fund has now opened up, it is time to have a mature discussion about what the Fund ought and ought not to do, and how it could fulfil its fiduciary duty towards Norwegian citizens better.

The Desire to Maintain Consensus Supports a Conservative Bias

The easiest manner, in which the consensus can be shattered, is if the investments made by the Fund blow up in a spectacular manner or are in other ways seen to be improper or irresponsible. The Ministry of Finance, which decides the parameters for investments by the GPF, has been very sensitive to this possibility, so it has followed a very conservative approach to the investment strategy for the Fund - only expanding the list of allowable investments very gradually over time.

For example, until 1998 the Fund was only invested in top-rated bonds. Equity investments were allowed in 1998, but only in developed economies. Some emerging markets were added in 2000 and corporate bonds were allowed in 2002. The share of equity investments was increased to 60% in 2007 and the Fund did not make its first real estate investment until 2011. However, even with these gradual changes, the Fund is invested with over 90% in liquid securities in developed economies, using what looks like a very conservative strategy.

Let us do a thought experiment that may help understand the MoF's caution a bit better. Imagine if Norges Bank Investment Management, which has responsibility for the day-to-day management of the Fund, had made a large investment in a firm that went belly up or was implicated in corruption, or if a promising African country in which NBIM was heavily invested had a coup d'état? Undoubtedly, this would generate bad headlines and possibly trigger a debate along the lines of 'If this is how badly our sacrifice is invested, we might as well not save so much money…or we must use it better by doing…' or 'how can we trust them with our money…' This is a debate the MoF rightly wants to avoid.

First, this conservatism makes it averse to allowing investments in any financial

instrument for which prices are not immediately and transparently available.

Second, it also rules out investments from which the GPF would find it hard to pull out quickly, should the need arise. Both of these mean that the MoF is loath to allow NBIM to make investments in private equity and in infrastructure, where pricing is not transparent or readily available, and where lock-in periods and illiquidity mean that investments cannot be sold-off in a hurry.

Third, it also means that the MoF rules out investing in countries where markets are less than fully transparent and governance may be problematic.

Fourth, this same conservatism drives the MoF to prescribe index-hugging, which limits the room for discretionary investments.

Fifth, this leads to a restriction on the maximum voting share the GPF can own in any one firm to just 10%.

One underlying driver of all five of these measures is that following this strategy would limit any criticism of the Fund, were things to go wrong, as the Fund would have made 'prudent'-looking investments in transparent and well-governed countries along with the many other investors who follow index-investment strategies. There is safety in numbers when things go wrong, and this minimises the risk of unfavourable headlines for the GPF.

The Conservative Bias Generates a Sub-optimal Strategy

Support for such conservatism also comes from the fact that the MoF may, with some justification, think that NBIM does not, yet, have the kind of human capacity that would allow it to effectively make investments in more exotic asset classes or countries. So, more familiar geographies such as Europe and more familiar assets such as bonds and stocks have been over-weighted in current strategy. Up until last year, for instance, Europe was given a disproportionate 50%-60% weight in the Fund's investments. Even now, the plan is to reduce the weight to a still hefty 40%.

Another factor supporting this conservatism is the fact that it is very hard to accurately measure and monitor the performance of investments in illiquid assets, at least over the quarterly horizon the Fund reports at. While performance metrics can be generated even more frequently, they become rather meaningless.

While the MoF continues on its path of gradually opening up the investment possibilities for NBIM, its efforts so far can be best be described as 'too-little-too-late'.

The natural outcome of the MoF's understandable conservatism is that the GPF has ended up with a de-facto strategy that sees it concentrate its investments in liquid developed country securities and hug stock and bond indices. This amounts to a bold bet on the future for developed economies being bright. In fact, it looks anything but, particularly relative to the much better growth prospects for developing economies.

The conservative bias has inadvertently resulted in a bold and risky bet that looks increasingly indefensible.

This Strategy Is No Longer Tenable

No matter how sensible this strategy may have been in the past, it is no longer tenable. Over the 15 years of its existence the GPF has delivered a return of only 3.17% against the budgeted expected return of 4%. This low return is the natural outcome of the conservative investment benchmark strategy chosen and the very limited room for discretion given to NBIM to deviate from this. Even the Strategy Council of the Fund agrees that, unless the GPF changes its investment strategy, the 4% return will not be achievable.

As debt burdens in developed economies continue to mount, growth remains sclerotic and political uncertainty increases, the risks of this de-facto bet on a bright future for developed economies looks more and more risky and short-sighted. It looks even more indefensible as developing and emerging economies continue to report robust growth and deliver promising returns on investments. For a Fund that supposedly seeks to diversify its investments to minimise risks, the Fund is unacceptably exposed to the structural and demographic problems afflicting over-indebted developed economies across the world.

The GPF has underperformed in comparison to many other comparable large pension funds, university endowments and other sovereign wealth funds. Its peers have made more investments in faster growing developing economies and are able to invest in illiquid alternative investment classes such as private equity and infrastructure. The higher returns come from faster growth and the ability to generate additional liquidity premiums.

The GPF has demonstrated a conservative bias even in implementing the ethical guidelines for the Fund and interpreting the responsible investor mandate enshrined in the legislation. The Fund uses negative screening, where it filters out those firms and business lines that would most egregiously violate its set of adopted ethical guidelines, but it makes no effort to reward those business lines or firms that would further the GPFs goals of being ethical and promoting sustainability. The only exception, a window for 'Green Investments', is so inadequate that it merely serves to highlight the deficiencies of the GPF's approach.

How Can the GPF's Strategy Be Improved?

Before one looks into ways in which the GPF's strategy could be improved, it is important to point out that the assumption that the political consensus is very fragile may not hold true. It has been 15 years since the GPF was set up in its current form and citizens have got used to the idea. An acid test of whether this political maturity has been reached came in the immediate aftermath of the collapse of Lehman Brothers, when the GPF lost more than 23.3% of its value over the course of a few weeks.

Despite these losses and the natural criticism this led to, there was no serious challenge to the basic structure of the Fund. Most criticisms dissipated as the Fund

regained much of the lost value in the post-crisis bounce-back of financial markets in 2009. While it is true that these losses happened in the context of a global financial meltdown, this and the on-going debate in Norway shows that the basic concept of intergenerational wealth-sharing is now firmly entrenched.

The most natural way of improving the GPF's strategy is to broaden its investment universe to include illiquid asset classes such as infrastructure and private equity, and to refocus is geographic allocation away from developed economies in Europe and North America towards faster growth emerging and developing economies in Asia, Africa and Latin America.

A related move is for the Fund to move away from a passive, non-strategic stance towards more active management and a strategic approach. Last but not least, the Fund needs to measure and manage climate change-related risks at the same level that it treats market and credit risks now.

Doing this will deliver multiple benefits:

First and foremost, it will significantly enhance the returns on investments. Equally important, this will reduce the overall risk of the GPF's portfolio by adding true structural diversification to its current portfolio, which is a large and risky one-way bet on the growth potential and future of developed economies being bright.

At the same time, increased investments in developing economies, where a shortage of long-term risk capital is a major impediment to growth, infrastructure and poverty reduction, will have a large positive impact on development outcomes. This is in line with the GPFs stated mission to be a responsible investor and promote sustainability.

It will help tackle poverty directly by creating much-needed jobs in the developing world. The indirect effects, through reducing infrastructure bottlenecks, promoting growth and helping generate additional public resources that can be deployed to tackle inequality and provide access to essential services, may be even greater.

Despite all new money in the GPF coming from oil and gas, the Fund has no comprehensive climate change strategy, though it is supposedly a priority area of focus. It continues to invest heavily in oil and gas majors, and old-fashioned utilities (including those dependent on coal-fired plants for generating electricity). Not only is this problematic from an ethical perspective, but it also highlights an imprudent approach to risk management, given how exposed the Norwegian economy in general, and the Fund in particular, already are to the oil and gas sector. It makes the Fund very vulnerable to policy action to address climate change that will inevitably increase the price of carbon emissions or limit their quantity, or both.

Managing climate change-related risks at the level of the Fund in the manner that market risk and credit risks are handled, introducing carbon stress tests on the portfolio to minimise the GPF's exposure to expected rises in the price of emissions would all mean that the Fund would be simultaneously more prudent and would promote a more sustainable footprint.

Such an approach would inevitably lead to decisions to sell-off most of the Fund's stake in 'dirty' industries and, if done diligently, should drive the GPF towards a positive screening approach towards green investments, as laid out in Re-Define's 'Building a Green Financial System – Funding the Green New Deal' Report for the European Parliament[4].

Conclusion

Norwegian leaders were far-sighted when they first set up the framework for a sovereign wealth fund in 1990. Many other countries have found it too hard to resist the temptation to spend rather than save oil riches.

Once the oil money started flowing into the Fund in 1996, those who had worked hard to build a political and technocratic consensus on the need for a SWF were rightly cautious about safeguarding it. The policy was particularly vulnerable to 'negative headline risk', driven by investments turning sour. This led to a conservative bias on how the Fund should be invested. So investments in non-transparent and illiquid assets, as well as less developed countries, were shunned in favour for an index-based strategy focussing mostly on developed economies that tracked the market and limited the scope for discretion. This bias was lent support by a genuine lack of human capacity and expertise, as well as real difficulties in measuring and monitoring performance of less liquid assets. It was the best strategy to avoid any challenges to the consensus on the GPF.

The natural, but perhaps unintended consequence of this understandable approach was that the GPF has implicitly taken a concentrated bet on developed countries, which are expected to grow much slower than developing economies. This is a risky bet, particularly as the world economy is in the midst of a transition towards emerging and developing economies, and this bet has been largely responsible for the Fund's sclerotic returns.

The Fund has underperformed with respect to its peers, while having a concentrated exposure to the risks of demographic decline and structural problems in developed economies – so it is time for a new investment strategy. This would need to allow NBIM to make illiquid investments and reallocate a substantial proportion of the portfolio away from the developed towards the developing world. It is also time to address the Fund's unacceptably high exposure to actions to address climate change, which the Fund argues for itself in its engagement with companies and policy makers.

The risk of negative headlines remains, but the political consensus on inter-generational wealth sharing is now much more robust in Norwegian society than it was 15 years ago. The on-going debate in the context of the forthcoming elections presents a perfect opportunity for a well-informed and mature debate on how to improve the management and strategy of the GPF. This opportunity should not be squandered.

[4] Re-Define, 2011, 'Funding the Green New Deal: Building a Green Financial System'. http://re-define.org/sites/default/files/GEF-Funding%20the%20GND%20web.pdf

A move towards such investments would not only diversify away some of the risks faced by the GPF, but it would also deliver a return of 4% and higher. Additionally, this has the capacity to deliver a substantial development dividend by directing capital towards labour-rich, but capital-poor developing economies, where it can help generate additional growth, create jobs and lead to poverty reduction. This would also support the GPF's stated ambition to drive sustainability and responsible investments. Moving toward integrating climate-change risks in its main risk management will mean that the Fund becomes less risky and promotes a sustainable footprint.

Sometimes it is possible to reap double dividends. Moving in the direction suggested in this report, the GPF will be 'Good for Norway, Good for Development and Good for the Environment'.

Structure of the Report

In this Chapter we laid out the history of the Fund and explained the context for this report. In Chapter 2 the Report discusses some key facts about the GPF, but does not analyse them in great detail. This is done in Chapter 3, which discusses the GPF's strategy at length and offers a critical analysis. Chapter 4 builds on the analysis in earlier chapters and suggests an optimal strategy for the GPF to follow. Chapter 5 follows with concrete recommendations on how the new strategy could be operationalized. Chapter 6 discusses the unmet needs of developing countries and how GPF investments there could help deliver positive outcomes on job creation and poverty reduction.

Chapter 2: A brief overview of the GPF

Size

The Norwegian Government Pension Fund – Global is the world's largest sovereign wealth fund. As of August 2013, it was worth $760 billion and it is expected to grow to more than $1,100 billion by 2020[5].

At the end of 2012, it held shares in 7,427 listed companies and 4,047 kinds of bonds from 1,196 issuers. Its large size means that even when it is so thinly spread, the GPF owns an average of 1.1% of all listed companies in the world, with the average stake rising up to 2.5% in Europe.

In fact it is the largest single owner Fund in the world.

Objectives and Drivers

The GPF differs from other funds in that it manages the savings of a country, not a single investor. The official objective of the GPF is 'to maximise international purchasing power with moderate risk in order to ensure that future generations will be able to derive the maximum possible benefit from national savings.' The Norwegian government also states that the 'goal of good financial return is closely linked to the ambition to be a responsible investor[6].'

This objective is operationalized by the Ministry of Finance, which reports to the parliament that owns the Fund on behalf of the Norwegian people. The Ministry's interpretation of this objective is critical, as it decides what the Fund, which is run on a day-to day-basis by Norges Bank Investment Management, can and cannot do. The Ministry interprets the objective to mean that

- 'The Fund has a strong capacity for bearing risk',
- 'It has a long investment horizon',
- 'There is no obvious liability'.

Hence, it aims to achieve 'the highest possible return consistent with the owners' risk preferences for a moderate level of risk.' The only quantitative target is the assumption of a 4% real rate of return over the long-term, which led to the fiscal rule adopted in 2001 specifying that no more than 4% of the value of the Fund should be used for deficit financing, so that the Fund does not get depleted.

[5] NBIM, 17 July 2013, 'Projection for the size of the fund'. http://www.nbim.no/en/Investments/Market-Value/forecast-for-the-size-of-thefund-/

[6] Norwegian Ministry of Finance, 2013, 'Government Pension Fund Global'. http://www.regjeringen.no/en/dep/fin/Selected-topics/the-government-pension-fund/government-pension-fund-global-gpfg.html?id=697027

In terms of operationalizing these objectives the ministry believes that

- There should be effective control of operational risk,
- Investments must be made responsibly,
- The Fund should take advantage of being a large and long-term investor,
- The Fund should follow good governance principles[7].

The key drivers for the investment strategy specified by the MoF are

- A belief that markets are largely efficient,
- A commitment to diversification,
- A focus on gaining from risk premiums,
- A clearly articulated benchmark,
- Care in selecting and monitoring asset managers, especially for less liquid assets,
- Integration of responsible investment into the Fund[8].

NBIM states that in order to achieve the stated MoF objective of the highest possible international purchasing power, there is a need for having a 'broad-based ownership of global production of goods and services[9].'

While it is hard to argue with any of the stated objectives or the drivers, it will become clear in the next chapter that the MoF is following many of them in spirit only. For example, despite the Fund's risk-bearing capacity being acknowledged, it is not really being used. The same goes for the Fund's potential as a long-term investor, which is not being exploited properly; nor is the Fund well-diversified in its exposures to risks. The Fund has also done little to manage climate-related risks, while paying lip service to sustainability and by excluding much of the developing world, and thus does not have a 'broad-based ownership of global production of goods and services.'

Potential to Be the Ultimate Long-term Investor

Unlike many other SWFs and other long-term investors such as pension funds, GPF money is not committed to finance any particular liability and, despite its name, it does not fund pensions. Instead, it is run as a vehicle for inter-generational wealth sharing in the sense that on average 4% of the outstanding size of the Fund (the assumed annual return) is spent every year, so it works as an endowment for the citizens of Norway[10].

Not having any liabilities means that the GPF can be a truly long-term investor, since legislation says that the principal of the Fund will not be spent. On average, the percentage of the Fund spent every year and is so small, and such a sum can always

[7] NBIM, 17 July 2013, 'Projection for the size of the fund'. http://www.nbim.no/en/Investments/Market-Value/forecast-for-the-size-of-thefund-/and Strategy Council 2010, 26 November 2010, 'Investment strategy and the Government Pension Fund Global'. http://www.regjeringen.no/Upload/FIN/Statens%20pensjonsfond/SR_Final_GPFG_25Nov.pdf
[8] ibid
[9] NBIM, 4 March 2013, 'Annual Report 2012'. http://www.nbim.no/en/press-and-publications/Reports/2012/annual-report-2012/
[10] Norwegian Ministry of Finance, 2009, 'The management of the Government Pension Fund in 2009', *Report No.10 (2009-2010) to the Storting'*. http://www.regjeringen.no/pages/2500165/PDFS/STM200920100010000EN_PDFS.pdf

be mobilized. This means that even in the midst of a crisis the Fund should not come under pressure to try and sell illiquid investments. The target investments should be those believed to be most profitable over a long-term horizon, not those that can be sold easily.

Few other funds have explicitly stated the desire to protect the principal, and most other 'so-called' long-term investors have liabilities they have to fund. This means that they may not always be able to behave as long-term investors despite wanting to, as sometimes they will need to sell their investments unexpectedly. In this sense, the GPF has the luxury of being able to take the longest possible investment horizon, because it will never be forced to liquidate its core portfolio, as it has no core obligations.

During the on-going financial crisis some of the best known long-term investors, including the Harvard and Yale endowment funds, which have had a stellar track record, came under enormous pressure, because many of their investments are locked into illiquid investments (as is appropriate for true long-term investors). Because they fund a substantial proportion of the annual operating expenses of their respective universities and could thus not sell illiquid investments without serious losses (particularly in the midst of a crisis), the universities were forced to cut back on activities[11].

Because the GPF does not fund current expenditure and has no planned long-term liabilities, it can be the ultimate long-term investor and have no fear of illiquidity. However, despite the fact that it could be making 50-year investments, which lock funds in for the long term, the GPF only invests in liquid securities that are also the investment of choice of investors with much shorter investment-horizons and tighter liquidity constraints.

Investment Strategy

It is widely believed in the asset management industry that the decision on how much to invest in which asset classes and in which geographic segments is the most important decision for a fund manager to make, as this will be the main driving force for the risk and return characteristics of a portfolio[12]. This is also true for the GPF, where the strategic allocation of assets between geographic areas and across asset classes have driven the GPF's return. Historically, the MoF has been very conservative in its approach and has skewed the portfolio heavily towards developed markets. It has also severely limited the asset classes that the GPF is allowed to invest in.

The MoF recently introduced some significant changes to its portfolio allocation, expanding the share of equity investments and marginally increasing assets allocated to emerging markets. It also allowed the GPF to make real estate investments, but for the most part most asset classes and most countries in the world remain out of bounds for the GPF.

[11] Gold, H., August 17 2009, 'Tough lessons for Harvard and Yale', *Real Clear Markets.* http://www.realclearmarkets.com/articles/2009/08/17/tough_lessons_for_harvard_and_yale_97363.html

[12] Dogu, L. F., 2009, 'It's all about your asset allocation', *Forbes.* http://www.forbes.com/2009/12/23/asset-allocation-mutual-funds-etfs-personal-finance-bogleheads-view-dogu.html

NBIM made its first real estate acquisitions in 2012. The MoF now specifies that the GPF should hold 60 % of its assets in equities, 35 % to 40 % in fixed income and can hold as much as 5 % in real estate[13]. Halfway through 2013 the actual holdings were 63.4 % in equities, 35.7 % in fixed income and 0.9 % in real estate. Investments in real estate are expected to increase further.

The regional weights until 2012 were 50%, 35% and 15 % for equities and 60%, 35% and 5 % for fixed-income instruments for Europe/North America and Africa/Asia and Oceania respectively[14]. These too were changed in 2012 to gradually reduce investments in Europe to about 40 % of the Fund from more than 50 %. The GPF will at the same time increase investments in other regions, especially in emerging markets, so Europe's share will be gradually cut back to 40%[15].

The end of year geographic weights in the table show that geographic rebalancing away from Europe has already started. The shares of other regions will rise.

Table 1: Geographic weighting

31.12.2012	*Equity*	*Fixed income*	*Total*
America, Africa, Middle East	34.3%	43.4%	37.8%
Europe	48.9%	43.4%	46.8%
Asia / Oceania	16.8%	13.2%	15.4%
Of which are emerging markets	10.2%	6.6%	8.8%

Source: The 2012 annual report of the GPF-Global

In line with these broad changes to asset and geographic weights, the MoF is generally moving in the direction of allowing NBIM to invest across a larger number of emerging economies - having allowed it to buy bonds in Taiwan, Russia, China, Colombia and Turkey and equities in Qatar, Kenya, Oman and Romania.

Despite this recent move towards expanding the countries and instruments in which NBIM can invest, the MoF's overall strategy for the GPF remains highly restrictive. More than half the countries in the world, including some of the fastest growing, but poor developing countries remain off-limits for GPF investments. Moreover, the GPF is only able to invest in listed equities and bonds and now in the real estate market, while important asset classes such as infrastructure investments and private equity remain off limits.

Beyond having these regional and asset class weights, the MoF specifies benchmark indices comprised of a broad range of equities and bonds that the Fund is supposed

[13] NBIM, 16 September 2011, 'Government Pension Fund Global: Investment Strategy'. http://www.nbim.no/en/Investments/

[14] These were, as the head of the Norges Bank notes, partly determined using Norwegian import weights from the mid-1990s. He also suggested that they Fund should consider abolishing them

[15] NBIM, 4 March 2013, 'Annual Report 2012'. http://www.nbim.no/en/press-and-publications/Reports/2012/annual-report-2012/

to track. The equity benchmark is the FTSE Global All Cap index[16] comprised of 7,103 listed companies and the fixed income benchmark is the Barclays Global Aggregate Index[17] consisting of 9,487 bonds from 1,926 issuers. The MoF specifies that the tracking error (deviation from these indices) should be no more than 1%. This gives NBIM some scope for actively managing its portfolio, but not much. The tracking error for the most recent quarter was only 0.6%. The MoF has also specified that the Fund cannot hold more than 10% of voting shares in any listed companies. This stops NBIM from acquiring strategic stakes in firms of the kind that other sovereign wealth funds often buy.

This means that NBIM has little discretion in making investment decisions, and that the GPF is primarily a passive investor that hugs the index.

Performance of the Fund

In drafting its fiscal framework the Norwegian government has assumed that the GPF will deliver a 4% real rate of return over the long term. However, the performance of the GPF so far has fallen short. In its 15 years of operation since 1998, it has 5.25% nominal rate of return that falls to 3.26% once it is adjusted for inflation and further down to 3.17% once operating costs are deducted[18]

It is this 3.17% then, which is available to the government to spend, not the 4%. Under the current fiscal framework, where the government spends 4% of the value, the principal of the Fund would get depleted over time, which goes against the idea of inter-generational wealth sharing.

As we discussed in a previous section, it is asset allocation, which is the main driver of the return on a portfolio. In fact, the return on the benchmark indices and asset weights the MoF has specified for NBIM is an even more unsatisfactory 4.94% nominal. NBIM has done rather well, within the very little room for discretion it has, to have generated a 0.23% excess return over the benchmark[19].

The MoF is right to say that what really matters is the Fund's performance over the long-term. Fifteen years of a track record where the GPF has underperformed relative to the 4% expected return, combined with poor growth prospects in countries where the GPF is mostly invested are enough to question the appropriateness of the current approach. It is reasonable to conclude that the current investment strategy of investing passively in indices of bonds and equities mostly in the developed world is highly unlikely to deliver the target rate of return for the Fund.

[16] FTSE, 31 December 2012, 'FTSE Global All Cap Index', *FTSE Factsheet.* http://www.ftse.com/Indices/FTSE_Global_Equity_Index_Series/Downloads/GEISLMS.pdf
[17] Wikipedia, 2013, 'Barclays Capital Aggregate Bond Index'. http://en.wikipedia.org/wiki/Barclays_Capital_Aggregate_Bond_Index
[18] NBIM, 2013, 'Government Pension Fund Global: Quarterly Report – 2 Quarter 2013'. http://nbim.no/Global/Reports/2013/Q2/2Q%20report%202013_web%20ENG.pdf
[19] NBIM, 4 March 2013, 'Annual Report 2012'. http://www.nbim.no/en/press-and-publications/Reports/2012/annual-report-2012/

Responsible investments

As discussed earlier, the legislation governing the GPF specifies that good financial returns are linked to being a responsible investor. This implicitly recognizes, that those investment strategies, which ignore the environment, social and economic impact and sustainability of business operations will fail to deliver good financial returns in the long-term.

A second driver of the responsible investment policy is the belief that the GPF 'should not make investments which constitute an unacceptable risk that the Fund may contribute to unethical acts or omissions, such as violations of fundamental humanitarian principles, serious violations of human rights, gross corruption or severe environmental damages[20].'

In interpreting the requirements of responsibility and sustainability, the MoF has specified that NBIM should follow principles of good governance and integrate responsible investments into the day-to-day management of the Fund.

In order to operationalize this, NBIM engages with companies it holds shares in. In particular, it focuses on six strategic areas:

- Equal treatment of shareholders,
- Roles and responsibilities of the board,
- Well-functioning financial markets,
- Children's rights,
- Climate change,
- Water management.

It bases its engagement on the United Nations Global Compact and the OECD's Principles of Corporate Governance and Guidelines for Multinational Enterprises.

Beyond this, the Fund also follows a negative screening strategy, wherein it excludes companies such as those producing tobacco or landmines, which are deemed to violate its ethical guidelines. Last, but not least, the Fund can also exclude companies the operations of which violate the guidelines of the Fund. For example, the GPF recently sold off its stake in 23 palm oil companies in Indonesia and Malaysia, as it deemed their business model unsustainable[21].

However the Fund has come in for growing criticism from a number of quarters, including from the OECD. It is often accused of 'talking the talk' but not knowing enough about what the companies it invests in get up to. The OECD, for example, has said the Fund lacks a strategy for identifying and dealing with possible human

[20] Council on Ethics, 26 June 2013, 'Guidelines for the observation and exclusion of companies from the Government Pension Fund Global's investment universe'. http://www.regjeringen.no/en/sub/styrer-rad-utvalg/ethics_council/ethical-guidelines.html?id=425277

[21] Food Climate Research Network, 2012, 'Norwegian pension fund pulls out of 23 palm oil companies'. http://www.fcrn.org.uk/research-library/industry-actions/corporate-sector/norwegian-pension-fund-pulls-out-23-palm-oil-comp

rights violations by the firms it invests in as highlighted in a case with the Korean steel maker Posco[22]. The Fund, for its part, has argued that the OECD guidelines should not apply to it as a minority shareholder[23].

Given that it is mandated to only be a minority shareholder, does this mean that signing up to the OECD guidelines was meant to be an empty gesture? It has also been criticised for it's narrow interpretation of its ethical policy – for example limiting human rights mostly as children's rights. Stung by criticisms, the Fund has just announced that it will seek to engage more actively with the firms it in and has appointed a corporate governance advisory board to help build capacity[24].

Overall, it is fair to conclude that the ethical footprint of the GPF's investment policy is severely limited because of three reasons. First that it takes a very narrow view of being responsible and sustainable and has narrow focus issues that may not address the vast majority of unethical practices. Second is has very limited capacity, even when it has the right intention, to actually engage with the firms it invests in and change practice. And third, because it mostly uses negative screening to exclude sectors and companies it misses huge opportunities to use positive screening to enhance the ethical and sustainability dimension of its investments.

Climate change related risks

On the one hand, the GPF has listed tackling climate change as a priority area of focus where it tries to influence its portfolio companies as well as affect policy. It has, in fact, co-financed an excellent study on the subject of long-term investors and climate risk but appears to have ignored the far-reaching conclusions from this report[25]. It has no meaningful strategy to address the impact of climate change or policy actions to prevent climate change on its portfolio despite the fact that the likely financial impact of both is substantial. The limit of its actions seems to be to try and stop major companies it invests in from lobbying against legislation to tackle climate change.

Based on the latest figures available, 3 of its 10 largest equity investments are in the oil and gas sector. As much as 10%-15% of the GPF's overall portfolio is invested in this sector, in utilities generating power from coal-fired plans or in companies mining coal. According to the World Wide Fund for Nature (WWF), the GPF is invested in 147 of the 200 companies holding the largest reserves of coal, oil and gas in the world[26].

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[22] Milne, R., August 8 2013, 'Norway's oil fund urged to boost ethical credentials', *FT.* http://www.ft.com/intl/cms/s/0/735865bc-ef07-11e2-9269-00144feabdc0.html#axzz2bY8x1q8W

[23] NBIM, 24 May 2013, 'Complaint regarding investment in the South Korean steel company POSCO', http://www.nbim.no/en/press-and-publications/News-List/2013/complaint-regarding-investment-in-the-south-korean-steel-company-posco/

[24] Milne, R., August 8 2013, ' Norway's oil fund plans to turn active', *FT.* http://www.ft.com/intl/cms/s/0/e6e2b6fa-0036-11e3-9c40-00144feab7de.html#axzz2bY8x1q8W

[25] Mercer, 2011. *Climate Change Scenarios - Implications for Strategic Asset Allocation*: London, UK

[26] WWF, 27 June 2013, 'Norwegian savings invested in the world's climate crisis'. http://wwf.panda.org/?209214/Norwegian-savings-invested-in-the-worlds-climate-crisis

How compatible these investments are with the GPF's self-professed efforts to tackle climate change, as well as its 'responsibility' and 'sustainability' mandates is questionable. Partly to assuage criticism of its environmental credentials, the GPF launched a five-year pilot project in 2009 to invest more than $3bn into green investments, a first sign of positive screening[27]. However, the size of this pilot effort and its impact on the Fund's large exposure to climate change-related risks is negligible, especially given that of the roughly $1.5 trillion the GPF is expected to be worth in 2025, half will come from the sale of oil and gas[28].

Conclusion

It is clear that as the largest single owner Fund in the world, with the additional advantage of potentially being able to invest for the very long-term, the GPF can be one of the most powerful and effective sources of capital in the world.

However, the very restrictive asset allocation and investment strategy that limits investments primarily to liquid asset classes and in the developed economies means that the Fund is not actually behaving as a large Fund with a long-term horizon should.

In mid 2013, for example, fully 99.1% of all GPF investments were in liquid securities, namely listed stocks and bonds, and more than 90% in developed economies - despite the fact that this is not representative of the current or future expected shape of the global production of goods and services. It is these restrictions on investments that are also primarily responsible for the GPF having failed to meet its 4% targeted rate of return over the 15 years of its operation.

Given that the global economy is in the midst of a major structural shift, where emerging economies and other developing countries will be the main drivers of growth, this strategy appears to be very short-sighted and will fail to deliver the target rate of return.

As the analysis in this report will conclusively show, without a major reallocation of its portfolio to include illiquid investments suitable for a true long-term investor and towards investments in the developing world, the GPF will continue to deliver sclerotic returns. The opportunity cost of this strategy for Norwegian citizens, who ultimately own the Fund, is very large. At the same time a continuation of the current strategy has also a large opportunity cost for citizens of the developing world, who could benefit tremendously from the kind of patient capital and counter-cyclical approach the GPF could bring.

Business as usual could mean that the GPF violates the spirit, if not the letter, of its fiduciary duty to Norwegian citizens to deliver high returns consistent with a moderate level of risk. The returns from the current strategy are too low and the inherent risks are too high.

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[27] Nicholson, C., September 1 2009, 'Norway fund moves towards green investments', *Dealbook.* http://dealbook.nytimes.com/2009/09/01/norway-fund-moves-toward-green-investments/

[28] Re-Define, 2011, 'Funding the Green New Deal: Building a Green Financial System'. http://re-define.org/sites/default/files/GEF-Funding%20the%20GND%20web.pdf

The Fund also fails to account, in any sensible way, for the large financial risks it faces both from the potential impact of climate change on its portfolio companies and from policy action to counter the threat of climate change. This 'see no evil, hear no evil' strategy is financially imprudent and ethically dubious, particularly given the GPF's self-professed focus on tackling climate change.

Meanwhile, a narrow interpretation of its ethical mandate, a lack of deep capacity or expertise to engage actively, as well as a limited negative screening approach, all limit the ethical footprint of the Fund. It is probably failing to fulfil its mandate of being responsible and incorporating sustainability into its investments. Perhaps most alarmingly, its schizophrenic attitude towards climate change means that it is failing to prudently measure or manage its substantial exposure to climate risks.

Our report highlights how this risk could be better identified and tackled, and what this would imply for the investment strategy of the Fund.

Chapter 3: The GPF's Strategy is Sub-Optimal

An Indictment of the Current Approach by the Strategy Council

As highlighted earlier in this report, the GPF is locked into what looks increasingly like a high-risk/low-return strategy that generates a long-term return below the 4% real rate that has been factored into the budgetary process in Norway. This leaves it very vulnerable not just to a very high risk of under-performance, but also to the kinds of structural risks (such as an ageing population and high levels of indebtedness) that most developed countries now face.

In a report that criticises the present investment strategy prescribed by the MoF, the Strategy Council to the GPF says: 'This target is more challenging in the current investment climate, when real long-term yields are low. For example, 'riskless' real long-term yields have fallen from 4% to almost 0% during the past decade[29].' The latest annual report from NBIM confirms that the yield on the Fund's fixed income investments that constitute nearly 40% of the portfolio have fallen from 4.5% at the beginning of 2010 to just 1.9% by end 2012[30].

The Strategy Council goes on to say that 'no safe strategy currently exists to achieve a 4% real return. To make the 4% target conceivable over a long horizon, investors must accept a reasonable probability of lower returns or of actual losses over a shorter horizon. The fact that the Fund is not obliged to achieve 4% real return every year, or even every decade, enables greater risk-taking in the GPF portfolio[31].'

The Council suggests that the Fund is being too conservative in its investment strategy and that it is capable of exploiting the fact that it has no liabilities much better so as to become a true long-term investor. The Council also implies that, unless the Fund takes on more risk and starts to behave as a true long-term investor, for example, by investing in illiquid assets, it may never achieve a 4% real rate of return. For example, since it began investing in 1998, the Fund has generated an annual net real return of only 3.17%.

The questions that have been raised not just by the Council, but also increasingly by other commentators and analysts, can be roughly summarized as follows:

- Is the Fund's current investment strategy capable of delivering the desired rate of return?
- Does it use its large size to good effect?

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[29] Strategy Council 2010, 26 November 2010, 'Investment strategy and the Government Pension Fund Global'. http://www.regjeringen.no/Upload/FIN/Statens%20pensjonsfond/SR_Final_GPFG_25Nov.pdf

[30] NBIM, 4 March 2013, 'Annual Report 2012'. http://www.nbim.no/en/press-and-publications/Reports/2012/annual-report-2012/

[31] Strategy Council 2010, 26 November 2010, 'Investment strategy and the Government Pension Fund Global'. http://www.regjeringen.no/Upload/FIN/Statens%20pensjonsfond/SR_Final_GPFG_25Nov.pdf

- Is the Fund too conservative and risk-averse?
- Does the Fund behave as a true long-term investor?

Two implicit additional questions are:

- Should the Fund rebalance its geographic asset allocation away from developed markets towards developing countries?
- Should it invest in illiquid asset classes?

The Council identifies what it sees as some of the salient features of the Fund[32]. These are

- The owners of the Fund, the Norwegian government on behalf of the citizens, have a long-term horizon with little need for liquidity, so the Fund has a natural advantage in making illiquid investments;
- The long-term horizon makes the Fund much more tolerant of short-term return volatility and paper losses, so it can make bets that look riskier in the short-term;
- The large size of the Fund may impose some constraints on it, especially where its entry can overwhelm the market. At the same time, it also brings advantages of scale;
- The Fund can benefit from becoming a provider of liquidity - particularly in dislocated markets - through buying asset classes that are unpopular;
- Finally, a value-bias, wherein the Fund focuses on assets that not many other investors are interested in (so that it can put its patient and liquidity supplying nature to good use), would be a good fit for the Fund.

Broadly speaking, it thinks that the Fund could

- Accept higher risk (from various sources),
- Expand exposure to illiquid assets,
- Extend rebalancing to become more pro-actively contrarian,
- Develop various forms of insurance selling.

We agree whole-heartedly with the Strategy Council's analysis and recommendations for the GPF to change strategy. This ought to include substantially expanding investments in illiquid assets, adopting an explicit long-term horizon that is much more tolerant of short-term volatility and considering selling insurance.

Are the GPF's Peer Group Performing Better?

Given the Strategy Council's indictment of the GPF's present strategy, it makes sense to look at whether other comparable investors have been able to deliver better returns.

Let us first look at large pension Funds. ABP, the Dutch pension fund, now worth more than $370 bn, has delivered a 7.2% cumulative nominal return over the past 20

[32] ibid

years. This is equivalent to a 5.1% real rate of return[33]. Calpers, another pension fund behemoth now worth more than $250 billion, delivered an annual return of 7.9% during the past decade[34]. It has earned an annual return of more than 9% over the past 30 years[35].

Now let us look at endowment funds, which the GPF resembles even more closely in terms of its mandate. Yale's endowment fund has delivered an annualized rate of 13.7% over 20 years. For Stanford, the return over the last decade has been 9.7%, and Harvard University's endowment has almost matched the performance of Yale's fund by delivering a 12.3% return over the past 20 years[36].

It is perhaps even more important to look at how other large sovereign wealth funds have performed. Temasek, Singapore's Sovereign Wealth Fund worth more than $173 billion, has delivered a 16% rate of return[37] since its inception in 1974[38], with the ten and twenty year returns being 13% and 14%. New investments made since 2002 have delivered over 18% annualized (compounded) returns to Temasek. It uses a very moderate level of leverage, which increases the rate of return, but, even without this, its returns have often been in the double digits. The simple annual return on assets since 2002 has been more than 6.5%.

The record of Abu Dhabi's sovereign wealth fund, ADIA, which is comparable to the GPF's $760 billion in size, is also good. In U.S. dollar terms, the 20-year and 30-year annualised rates of return for the ADIA portfolio were 7.6% and 8.2% respectively, as of 31 December 2012.[39]

China's sovereign wealth fund, the CIC, worth more than $450 billion, is a relative newcomer. Established in 2007 it has seen a cumulative annualized return since inception of 5.02%[40].

Even the GIC, the Singaporean foreign exchange reserve management fund, estimated to be worth more than $250 bn (managed more conservatively than Temasek), has a better track record than the GPF. The annualised rolling 20-year real rate of return until March 2013 was 4.0%, with nominal rates of return in USD terms of 8.8% over 10 years and 6.5 % over 20 years[41].

As we will see in a later chapter, it is not just the GPF's peer group, which is performing well, but also a group of investors known collectively as Development Finance Institutions (DFIs). The primary mandate of these institutions, such as the

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[33] ABP, 1 February 2013, 'Press Release: ABP reduces pensions by 0.5% in 2013'. http://www.abp.nl/images/Press-release-2012-ABP-Q4_tcm160-156046.pdf
[34] CalPERS, July 2013, 'Facts at a glance'. http://www.calpers.ca.gov/eip-docs/about/facts/facts-at-a-glance.pdf
[35] Marois, M., January 31 2013, 'California Workers Rush Calpers Ahead of 'Air Time' Ban', *Bloomberg*. http://www.bloomberg.com/news/2013-01-31/california-workers-rush-calpers-ahead-of-air-time-ban.html
[36] Harvard Magazine, 28 September 2012, 'Stanford, Yale endowments outperform Harvard'. http://harvardmagazine.com/2012/09/harvard-2012-endowment-trails-stanford-yale
[38] TEMASEK Review 2013, July 2013, 'From our Chairman'. http://www.temasekreview.com.sg/#overview-fromOurChairman
[39] Adia, 2012, '2011 Annual Review'. http://www.adia.ae/En/pr/Annual_Review_Website_2011.pdf
[40] China Investment Corporation, 2013, 'Annual Report 2012'. http://www.china-inv.cn/cicen/include/resources/CIC_2012_annualreport_en.pdf
[41] GIC, 31 March 2013, 'Report on the management of the GIC portfolio for the year 2012/2013'. http://www.gic.com.sg/en/report/report-on-2012-2013#.UgUKV1PU5K5

International Finance Corporation – the private sector arm of the World Bank - is to foster the development of the private sector in developing countries. However, they are also self-financing, which means they endeavour to make profitable investments. Norfund is the Norwegian part of the family.

What is remarkable, is that many of these DFIs, including Norfund, have consistently delivered a higher return than the GPF. This is the case despite their primary mandate being development, and the fact that they operate mostly in countries with imperfectly developed market and governance standards.

It can be seen that a number of Funds in the GPF's peer group that includes pension funds, university endowments and other sovereign wealth funds, have delivered significantly higher returns - some over periods much longer than the 15 years of the GPF's existence. It would not be unreasonable to conclude that the GPF has underperformed in comparison to its peers. What is remarkable is that even a number of Development Finance Institutions, including Norfund, have also delivered better returns than the GPF, despite operating in challenging environments.

How Does the GPF's Peer Group Invest?

Given that many in the GPFs peer group have outperformed it, it only makes sense to examine their investment strategies and see if these offer any obvious lessons for the GPF. These must be interpreted with some caution, as strategies that have worked well in the past may not work so well in the future – particularly as the world is in the midst of a large structural shift of growth and economic weight towards developing countries.

ABP holds about 40% its portfolio in fixed income assets, but also holds a substantial proportion in the form of illiquid assets that include private equity, infrastructure and hedge funds[42]. Moreover, it has a higher proportion of its portfolio exposed to emerging and developing markets than the GPF. Similarly, Calpers dedicates a significant proportion of its portfolio to investments in illiquid asset classes[43].

The university endowments of Yale, Harvard and Stanford are known for having large allocations to alternative asset classes such as private equity, hedge funds and infrastructure investments, sometimes as much as 50% of their portfolio. They also allocate a significant proportion of their portfolios to emerging and developing economies. The model, first pioneered at Yale, recognizes that for true long-term investors such as endowments too much liquidity is a bad thing to be avoided, rather than a good thing to be sought out, since it comes at a heavy price in the shape of lower returns[44].

Now let us look at the sovereign wealth funds. Unlike the GPF, which has been a passive, non-strategic investor in mostly developed country bonds and equity

[42] ABP, 1 February 2013, 'Press Release: ABP reduces pensions by 0.5% in 2013'. http://www.abp.nl/images/Press-release-2012-ABP-Q4_tcm160-156046.pdf
[43] CalPERS, 7 August 2013, 'Asset Allocation'. http://www.calpers.ca.gov/index.jsp?bc=/investments/assets/assetallocation.xml
[44] Wikipedia, 2013, 'David F. Swensen'. http://en.wikipedia.org/wiki/David_F._Swensen

indices, Temasek is an active and strategic investor, which uses more instruments and focuses much more heavily on the developing/emerging world, particularly on Asia. 58% of its investments are in mature economies and 42% in growth economies[45]. Temasek holds targeted strategic stakes in firms, having just made an investment of $3 bn in the Industrial and Commercial Bank of China, for example. Its role as a strategic investor is clear, because 37% of its equity investments were in firms where it has a more than 20% stake. Its willingness to exploit its long-term horizon can be gauged both from the size of large (and hence less liquid) stakes, as well as the fact that 27% of its portfolio is in unlisted assets that are often illiquid[46].

ADIA too has a broader geographic reach and invests in more asset classes than the GPF. It manages a diversified global investment portfolio across more than two dozen asset classes and sub-categories, including quoted equities, fixed income, real estate, private equity, alternatives and infrastructure.

CIC has recently made substantial changes to the way it is run. In 2011 the CIC adopted an explicit investment horizon of 10 years to reflect its nature as a long-term investor and made relevant changes to its asset allocation strategy and risk management process. For instance, it has built up positions in non-public market assets, particularly direct investments and private equity investments in such industries as energy, resources, real estate and infrastructure. At the end of 2012 the CIC had 32% of its investments in listed equities, 19.1% in fixed income, 12.7% in absolute return strategies, 3.8% in cash holdings and 32.4% in long-term investments such as infrastructure[47].

GIC invests in private equity both directly into firms and indirectly through funds. It also invests directly into infrastructure ventures both in developed and developing countries[48].

What Lessons Can We Learn From Asset Allocation Strategies of the GPFs Peer Group?

Looking through the asset allocations and investment strategies of the peer group of the GPF, a number of things stand out. In almost all cases, in comparison to the GPF, the peer group has

- A more active approach to investment in contrast to the GPFs approach which is passive;
- A more strategic approach that does not preclude large stakes which the GPF shuns;
- A substantial allocation of investments towards illiquid asset classes, particularly private equity and infrastructure;
- A higher exposure to investments in emerging economies and the rest of the developing world;

[45] TEMASEK Review, 2013, 'Portfolio Highlights'. http://www.temasekreview.com.sg/#portfolio-portfolioHighlights
[46] TEMASEK Review, 2013, 'Portfolio'. http://www.temasekreview.com.sg/#Portfolio
[47] China Investment Corporation, 2013, 'Annual Report 2012'. http://www.china-inv.cn/cicen/include/resources/CIC_2012_annualreport_en.pdf
[48] Miller, M., May 4 2012, 'Sovereign wealth funds return', *The Deal Magazine*. http://www.thedeal.com/magazine/ID/046521/features/sovereign-wealth-funds-return.php

- A risk management approach that pays more attention to performance over the long term.

A discussion of its strategy by GIC is particularly instructive[49]. It recognizes that emerging market assets are more volatile in the short term. It also highlights that they may be riskier in other dimensions, such as presenting a higher risk of fraud, loan defaults and low liquidity during periods of market stress. However, despite recognizing these potential problems, the GIC took a strategic decision to increase its exposure to developing countries in 2003. It took the view that these countries would outperform the developed markets, and since 2003 it has built up an exposure of 15% of its portfolio to developing country equities - with a focus on emerging Asia.

Its bet that the boom-bust cycle that has plagued developing countries in the past would be less severe as governance improved, and that structural improvements in emerging markets would be sustained, has paid off and generated handsome returns.
GIC's view that emerging and developing markets would out-perform developed markets in the long-term - the only time horizon that matters to a long-term investor - has a very powerful logic for the GPF.

Another aspect of the GIC's approach has a special resonance for the GPF. It has a policy of attempting to determine the intrinsic value of its investments, and it buys assets when their prices are below intrinsic value, and sells them when they are expensive.

The GPF would be well served by moving from its present mostly mechanistic buying and selling decisions towards a more fundamentals-based approach.

'Long-term investing enables GIC to harvest risk premiums from different asset classes. It also allows us to take a contrarian stance when short-term deviations are extreme and prices are significantly away from their long-term fundamentals.' Crucially, GIC recognizes that it can 'only enjoy the rewards of long-term investing if they are prepared to tolerate short-term losses or underperformance relative to market indices from time to time[50]', another important lesson for the GPF.

The GPF needs to change its risk management practices, so as to measure performance over a longer time horizon and give less importance to short-term deviations from market indices as measures of risk.

Other SWFs have also turned to the developing world in a major way. Asia in particular — and not just China, but also India, Singapore, Indonesia and Malaysia have received a large influx of SWF investment. Latin America, previously a geography in which one saw very little direct SWF investment, has become more popular with funds chasing superior returns. For example, it has been reported that

[49] GIC, 2013, 'Our Experience and Strategy'. http://www.gic.com.sg/
[50] ibid

over half of new SWF investments in 2010 were in non-OECD economies[51], with the figures for 2011 and 2012 being comparable.

It is not just that other SWFs channel a much greater proportion of their new investments into emerging markets, but also that these investments are, unlike those of the GPF, strategic in nature. Many other SWFs take larger stakes in a smaller number of companies and ventures compared to the GPF. The GPF deliberately spreads itself thin, taking small stakes in a much larger number of companies, almost the whole market index itself.

The approach of the GPF stands in stark contrast to funds such as the Qatar Investment Authority, which in 2010 'invested US $2.7 bn in Santander Brazil to acquire a 5% stake in the bank. It also made a big investment in Iberdrola (over 6%), which boosted its profits from its Latin American operations to over 30% of the total in 2010[52].' The IPIC, one of the Abu Dhabi SWFs, for example, has acquired 100% of CEPSA, a company present in a number of developing markets such as Brazil, Colombia, Peru, Panama, Egypt and Algeria. The list of such strategic investments, particularly in developing countries, by other SWF's continues to expand dramatically.

The lessons for the GPF are very clear. It needs to 1) be more strategic 2) have a risk measurement and risk management system more suited for a long-term investor 3) invest more in illiquid asset classes, particularly infrastructure and growth private equity 4) significantly ramp up its exposure to developing and emerging markets 5) have a more active approach to the management of its stake in companies.

These lessons are entirely consistent with the analysis in the report so far and with the recommendations from the Strategy Council that we discussed earlier and which we fully endorse.

The need to move beyond the present benchmarks to include developing economies

In common with many other funds, the GPF uses benchmark indices, against which performance is measured and judged. The benchmarks derive from the FTSE global index for equities, and for fixed income it uses a series of bond indices issued by Barclays. Most recently, since the GPF has been allowed to invest in property, it also has a real estate index, based on the investment property databank. NBIM, which manages the GPF, is supposed to ensure that the annual returns on the equity, fixed income and property portfolios do not deviate much from these indices. The MoF decides what the benchmarks are and how much the GPF is allowed to deviate from these – at present the maximum allowable tracking error is only 1%.

While it is clear that there is a need to measure the performance of the GPF, it is far from obvious how this should be done. By choosing the indices that NBIM does and

[51] Capape, J. & Santiso, J., 2012, ' Sovereign Funds are Helping Strike a New World Economic Balance', *ESADEgeo Position Paper No. 18* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1877224
[52] ibid

by limiting the allowable tracking error (deviation) to a small number, the MoF is effectively forcing NBIM to buy the indices with very little room for discretion.

The Ministry has basically decided that the GPF should only be allowed to make small passive investments in the secondary markets for liquid stocks and bonds across mostly developed economies, with a slowly expanding extension of that mandate into emerging and some developing economies. It has also decided that these investments should mirror the composition of the indices it has chosen as performance benchmarks closely – hence the low allowed tracking error. As discussed in the previous sections, this naturally leads to a passive, index-tracking strategy for the GPF that is sub-optimal and at odds with what most of its peer group are doing.

On the one hand the GPF is expected to deliver an absolute annual real rate of return of 4%, which has been budgeted for, albeit over the long term. On the other, in the short term the performance of the GPF is measured relative to the benchmark indices we have discussed. This must mean that the Ministry of Finance expects that these indices themselves will, over a sufficiently long horizon, deliver annualized absolute returns that are 4% or higher. In fact, this assumption is critical for connecting what the parliament, the ultimate owner of the Fund, expects from the GPF, to the way that it is actually run and the investments it makes.

This very fundamental assumption is questionable. Now, over the long term, returns on investments for a large investor, which purports to be a 'universal investor', should not deviate too much from global growth rates. These, as can be seen from the table below, have on average been a bit below 4% - particularly since the outbreak of the financial crisis, but the deviation is within margins of error in the longer term.

Table 2: World real growth rates (%)

	1999	2000	2001	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
World	*3*	*4.8*	*2.7*	*3.8*	*4.9*	*4.7*	*5.3*	*5.2*	*3.1*	*-0.7*	*5.1*	*3.8*	*3.0*

Source: CIA World-Factbook

However, what the aggregate figures hide, is the fact that the largest contribution to global growth now comes from developing economies. For example, in 2011 95 countries out of the 185 that figures are available for had real growth rates of 4% or above[53]. Of these, only two – Sweden and Chile – are members of the OECD. The vast majority of the others that grew at 4% or faster are developing and emerging economies in Asia, Africa and Latin America. It may be worthwhile pointing out here that of the GPF's total portfolio, less than 10% is invested in countries that grew at 4% or faster, and that more than 90% is invested in countries that grew at less than 4%.

Nor is this divergence in growth a one-off. Broadly similar patterns have now been observed for many years and, as the most recent work from both the OECD and the

[53] CIA World Factbook, 2013, 'Country Comparison: GDP – Real Growth Rate'. https://www.cia.gov/library/publications/the-world-factbook/rankorder/2003rank.html

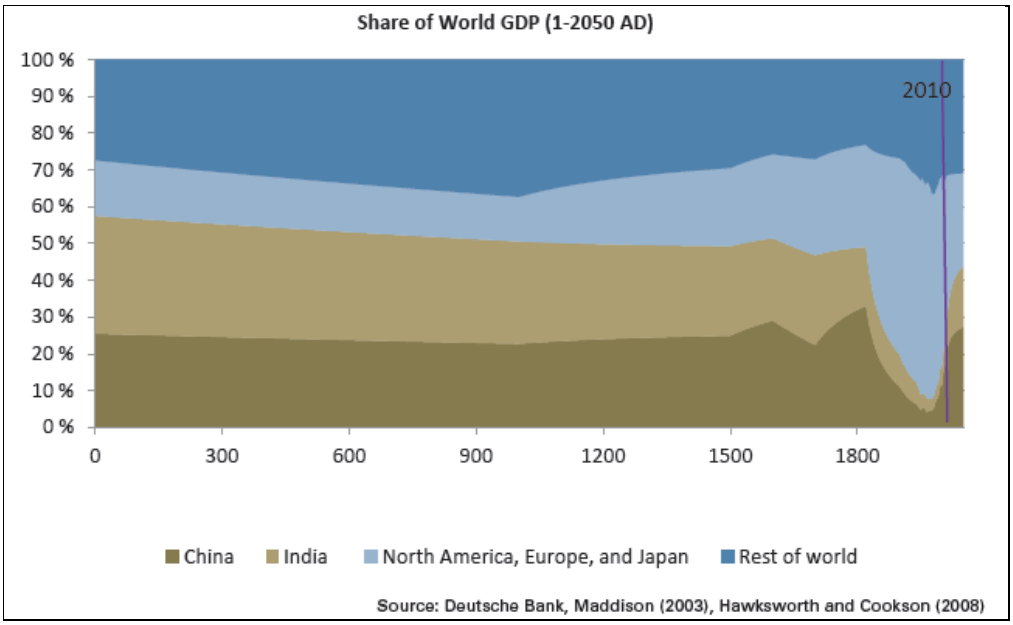
US National Intelligence Council[54] points out, these are likely to continue. For example, the OECD now expects the share of global GDP attributable to OECD economies to shrink from 64.7% in 2011 to 49% in 2030, and 42.3% in 2060 - with the share of the non-OECD economies accounting for the balance[55]. Both organizations expect that future growth will be driven by developing countries.

Under a different definition that divides the world into advanced economies on the one hand, and emerging and developing on the other, the share of advanced economy GDP is even smaller – less than 60% in 2012 in market value and less than 50% when defined in purchasing power parity terms (PPP)[56]. (The OECD includes countries such as Mexico and Chile that are still emerging and not fully developed.)

The robustness of faster growth in emerging and developing economies can be gauged from the fact that even prior to the crisis 90% of these economies were growing faster than developed economies and that 94 of them had consistent growth rates over 5% per annum[57].

Box 1: The (re) emergence of the developing world

The dominance of Europe, the US and Japan in the global economy is a historical anomaly. For much of the past 2,000 years or so economies such as India and China and also other nations that fit into the broader category of developing countries have dominated the world economy. Evidence is mounting that OECD countries are now locked in relative decline, and that the future once again belongs to developing countries, where China and India are likely to dominate, while other developing countries will also do much better.



[54] National Intelligence Council, December 2012, *Global Trends 2030: Alternative Worlds.* http://www.scribd.com/doc/115962650/Global-Trends-2030-Alternative-Worlds

[55] OECD, November 2012, 'Looking to 2060: Long-term global growth prospects', *OECD Economic Policy Papers*. http://www.oecd-ilibrary.org/docserver/download/5k8zxpjsggf0.pdf?expires=1375920306&id=id&accname=guest&checksum=123334890FD812773838FE720F30CC9B

[56] Bhattacharya, A., May 31 2013, 'Structural Transformation of the Global Economy', *G-24*, http://www.g24.org/Publications/Lecce_May31%202013_Final.pdf

[57] Bhattacharya, A., May 31 2013, 'Structural Transformation of the Global Economy', *G-24*, http://www.g24.org/Publications/Lecce_May31%202013_Final.pdf

Not all developing countries are doing as well as China and India, of course. Particularly some low-income economies in Africa seem to have been left behind. However, there is good cause for optimism that the same kind of catch-up growth powered by a rural to urban migration and a move up the value chain that has done so well for China is also possible in these other economies.

A number of them have already been doing well and have registered growth rates that are impressive. According to the IMF, growth during 2011-2015 in sub-Saharan Africa will be higher than in any other region of the world. During the full time-span from 1992 to 2015, for example, average output growth is expected to be 5.2 %, an impressive achievement. According to the World Bank, while risks continue to lurk in Africa, the region offers the highest rate of return to investment in the world.[58]

These figures also highlight another obvious anomaly with the GPF's investments. Not only is the less than 10% invested in developing and emerging economies (inappropriate from the perspective of the nearly 60% of the share that these countries are expected to have of the global economy in 2060), but it is also highly skewed with respect to the 35%-40% share of the global economies that these countries already account for. According to calculations by Norwegian Church Aid, the contrast is even starker for the sub-category of lower middle-income countries and low-income countries. Their share of GDP is 13%, but they account for less than 1% of the GPF's portfolio allocation.

Another stark example is how few of the GPF's investments are in Africa. These amount to about $5bn[59], about 0.65% of the GPF's investments in contrast to its 2.4% share of world GDP at present (at market value-the share at purchasing power parity is higher). Africa is expected to account for 5% of world GDP within two decades. Already, of the twenty-five fastest growing economies in the world eleven are in Africa[60].

Table 3: Twenty-five fastest growing economies

	Country	GDP – Real Growth Rate
1	Libya	**104.5 %**
2	Sierra Leone	**19.80 %**
3	Mongolia	**12.30 %**
4	Niger	**11.20 %**
5	Turks and Caicos Islands	**11.20 %**
6	Turkmenistan	**11.00 %**
7	Panama	**10.70 %**
8	Afghanistan	**10.20 %**
9	Macau	**10.00 %**
10	Timor-Leste	**10.00 %**
11	Cote d'Ivoire	**9.80 %**
12	Bhutan	**9.70 %**
13	Papua New Guinea	**9.10 %**
14	Iraq	**8.40 %**

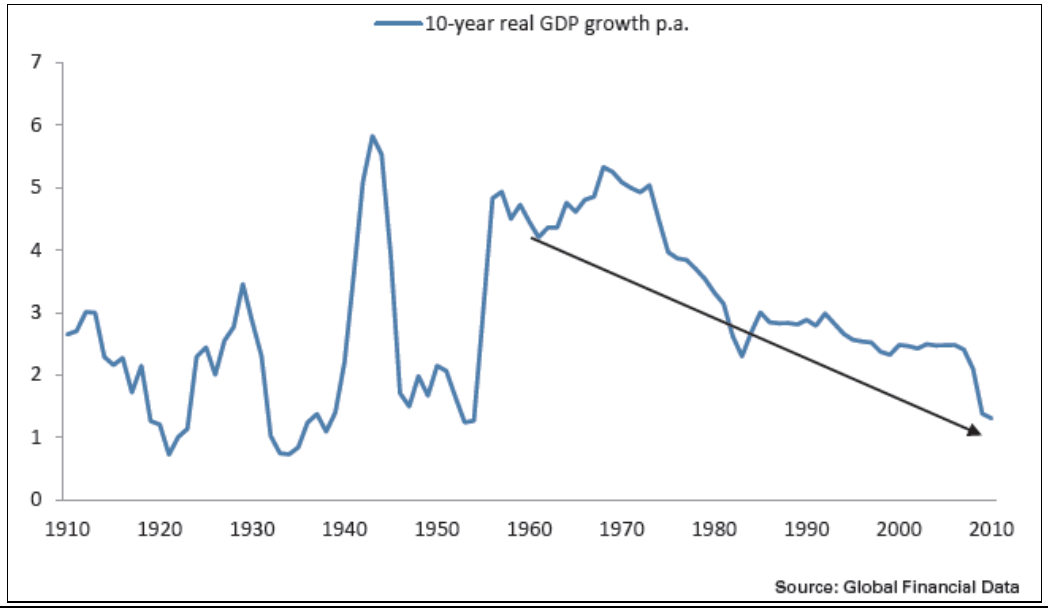
[58] Reuters, December 3 2010, 'Private capital to Africa seen at $55 bln in 2010', *Africa Good News.* http://africagoodnews.com/content/private-capital-to-africa-seen-at-55-bln-in-2010
[59] Bjornestad, S., 10 August 2013, 'Oljefondet skal investere mer i Afrika', *Aftenposten.* http://www.aftenposten.no/okonomi/Oljefondet-skal-investere-mer-i-Afrika-7276198.html#.UgcW0xbvwUs
[60] UNIS, 19 March 2012, 'Africa as a pole of global growth'. http://www.unis.unvienna.org/unis/pressrels/2012/unisinf439.html

15	Angola	**8.40 %**
16	Liberia	**8.30 %**
17	Laos	**8.30 %**
18	Uzbekistan	**8.20 %**
19	Burkina Faso	**8.00 %**
20	China	**7.80 %**
21	Rwanda	**7.70 %**
22	Tajikistan	**7.50 %**
23	Mozambique	**7.50 %**
24	Zambia	**7.30 %**
25	Armenia	**7.20 %**

Now, in a global economy that is growing at less than 4% on an annualized basis, the GPF may still realistically expect to be able to harness a long-term return of 4%, but only if it selectively favours investing in those parts of the global economy where the average growth rates are higher – namely the developing economies. However, what we observe is the exact opposite. More than 90% of the GPF's investments are concentrated in developed countries, which have not seen growth rates approaching 4% in many years and which are expected to grow only at rates of 1%-3% over the longer term (as the following graph illustrates).

Box 2: Problems in developed economies

Growth rates in the developed world have become sclerotic and are expected to stay depressed. The EU, for example, which is the world's largest economy at present, would be lucky to eke out a growth rate of 1.5% over the next decade or so, even if it emerges intact from the Euro crisis. The graph below shows the steady decline in the growth of OECD economies since the days of heady growth in the 60s.



Norway's own growth rates in recent years (though better than many other OECD economies') are illustrative of the problem, particularly when compared with the growth rates of faster growing economies such as India and China in Asia and Zambia in Africa.

Table 4: China, India, Norway and Zambia growth rates (%)

Country	1999	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Norway	*0.8*	*2.7*	*1.6*	*0.6*	*3.3*	*4*	*4.6*	*3.7*	*2.6*	*-1.4*	*0.4*	*1.7*	*3.1*
China	*7*	*8*	*8*	*8*	*9.1*	*9.1*	*10.2*	*11.9*	*9*	*9.1*	*10.3*	*9.2*	*7.8*
India	*5.5*	*6*	*4.3*	*8.3*	*6.2*	*8.4*	*9.2*	*9*	*7.4*	*7.4*	*10.4*	*7.2*	*5.4*
Zambia	*1.5*	*4*	*4.2*	*4*	*4.6*	*5*	*5.8*	*6*	*6*	*6.3*	*7.6*	*6.6*	*6.5*

Thus the present asset allocation strategy and benchmarks used for performance management by the GPF are fundamentally incompatible with the 4% real rate of return that the Norwegian parliament expects from the GPF over the longer term. Either the parliament must abandon this target in favour of a lower more realistic 2%-3% target, or the GPF must change its strategic allocation significantly. The present strategy imposes a large cost on Norwegian citizens in terms of lost opportunities to generate better returns at similar or even lower levels of risk from a portfolio that is better diversified and more representative of the shape of the present and emerging global economy.

As things stand today, the Ministry of Finance has a list of allowable countries (all OECD and a few emerging and developing countries), allowable investments (listed and traded corporate, sovereign, sub-sovereign, covered and mortgage bonds and listed and traded equities) with a limited percentage of the portfolio (5%) now investible in property. As we have discussed, this suffers from being concentrated largely in exactly those mature economies where growth is likely to remain low for the foreseeable future.

In order to better reflect the current and the future shape of the world economy, as well as to try and harness the fruit of faster expected growth in the non-OECD economies, the GPF must significantly expand its geographic reach of allowable countries, use alternative benchmarks for performance measurement and loosen the very restrictive tracking error regime.

NBIM appears to agree with this conclusion, having acknowledged **'**that emerging economies are experiencing stronger growth than developed economies.' It goes on to say that 'it seems inappropriate to exclude emerging countries from the equity benchmark portfolio on the grounds that they would currently contribute only marginally to the benchmark portfolio's risk and return characteristics.' NBIM also believes that small markets should not be excluded on the basis of limited diversification characteristics[61]. The context of these remarks is that the MoF had rejected the inclusion of more developing countries in the benchmark on the grounds that many of these are small markets, where the GPF has no or limited exposure, so that they are only contributing marginally to the characteristics of the investment portfolio.

[61] Norges Bank, 5 February 2008, 'The benchmark portfolio for the Government Pension Fund – Global'. http://www.norges-bank.no/upload/66666/submission-05-02-2008.pdf

In another report[62] NBIM highlights the need to review the present approach of using regional weights, saying instead that the 'Fund's international purchasing power is best safeguarded through ownership of the means of production, as it is this capacity that generates the supply of goods and services that the fund can purchase.' It concludes by saying that according to both its own analysis and from the standpoint of the Ministry's external advisers 'today's benchmark portfolios do not fully represent the best investment strategy for the Fund.'

Partly recognizing this, the MoF did make some changes to the benchmark portfolio and to regional weights in 2012. First, it reduced the allocated weight of Europe from 50% to 40%. Second, it announced an intention to move away from regional weight allocations in its equity portfolio towards market weight allocations. Third, it announced that the weights in its bond portfolio would be adjusted according to the fiscal health of a country. Fourth, it announced the inclusion of a number of additional emerging markets in its equity and bond portfolios. However, these changes, while broadly in the right direction, simply do not go far enough.

The NBIM report concludes saying that 'it may be possible to construct simple, transparent, investable and verifiable indices for the Fund's exposure to and structurally stronger growth in emerging economies[63].'

A study for NBIM conducted by Harvey and discussed in the Box below lends further weight to the case for changing benchmarks to increase the weight accorded to emerging and developing economies.

Box 3: The GPF should allocate more money to emerging markets[64]

As of December 31, 2011, Norway's GPFG benchmark had 10.47% of its equity portfolio invested in emerging markets – as defined by Morgan Stanley Capital International (MSCI). This benchmark strategically underweights emerging markets compared to both market capitalization weights (12.58% free float and 20.2% total market capitalization) and GDP weights (32%). The figure below shows the time series of the MSCI weights in emerging markets and the current GPFG allocation.

The report recommends that the Ministry of Finance increase its weight in emerging markets to 16%. This would take the benchmark half way to the total market capitalization weights.

It also suggests that there are strong reasons to believe that there are higher expected returns to be obtained from investment in emerging markets relative to developed markets. These expected returns reflect the higher growth opportunities that are available in these markets.

These returns come at the cost of higher market volatility and less liquidity. While this could be a very significant risk for an investor with a shorter investment horizon, the GPFG is in a unique position as a long-term investor to mitigate this type of risk. While short-term volatility of emerging market returns is higher than developed returns, longer-term investors should not care much about such volatility.

First, there is considerable evidence that political risk is rewarded with higher expected returns. Second, political risk is mean reverting (falls after rising), which implies an opportunity for the long-

[62] NBIM, 6 July 2010, 'Development of the investment strategy for the Government Pension Fund Global'. http://www.nbim.no/en/press-and-publications/submissions-to-ministry/2010/development-of-the-investment-strategy-for-the-government-pension-fund-global/

[63] ibid

[64] Harvey, C., 2012, 'Allocation to Emerging Markets in a Globally Diversified Portfolio'. http://www.regjeringen.no/pages/1934920/Harvey.pdf

term investor. Again, the GPFG has the advantage of having both full global diversification (which minimizes a negative outcome in any given country) and a very long holding period, which means that some transitory political risks are unlikely to diminish the long-term expected returns. Third, given today's environment (European and developed country debt crisis), it is not obvious that there is any substantive difference between developed and emerging markets when it comes to political risk and corporate governance.

Conclusion

From the above analysis it is clear that the GPF urgently needs to take a fresh look at its investment strategy that appears to be fundamentally incompatible with generating what the Norwegian parliament expects to be a 4% real rate of return over the long term. Importantly, the present index tracking strategy that excludes large swathes of the developing world has also been sharply criticized by the Strategy Council to the Fund, which has found that the GPF does not put its large size and long-term nature to good use.

The GPF also underperforms many of its peers, most of which take a more strategic approach to investment, invest much more heavily in developing and emerging markets and often seek out illiquid investments such as private equity, infrastructure and large strategic stakes in listed companies - all of which the MoF has forbidden NBIM to invest in. The MoF has also excluded many of the world's fastest growing economies from the list of allowable investments by NBIM and forces the GPF to track the index closely by specifying a very small – 1% tracking error.

The deep problem lies exactly with the fact that the MoF specified indices and universe of allowable investments are skewed very heavily towards low growth developed economies and shun countries with faster growth prospects.

This strategy is untenable and it is time for comprehensive reform. The critical elements of these reforms would need to be to

- *Move to a negative list countries – The GPF should be allowed to invest in all countries apart from those that are explicitly forbidden. Substantial reasons would need to be given by the MoF for excluding a particular country;*
- *Allow the GPF to take large strategic stakes in companies by abolishing the 10% maximum threshold;*
- *Move towards an explicitly long-term oriented risk management and risk measurement system that does not penalize short-term volatility and illiquidity ;*
- *Move further beyond the market capitalization based equity weights that have been recently adopted by the GPF towards a GDP based approach akin to what has been adopted on the fixed income front;*
- *Allow the GPF to invest in private equity and infrastructure, particularly in developing economies where public equity markets are not fully operational and infrastructure needs are the greatest (note: By private equity in this report we mean growth equity, not leveraged buyouts).*

Chapter 4: Investing in Growth

As the discussion in the previous Chapter showed, economic weight in the world is now shifting inexorably towards developing economies, where the majority of global growth is expected to be concentrated.

Schroeders, for example, makes an elegant case for investing in developing countries, as shown in the Box below.

Box 4: The case for developing country investments [65]

Demographics: In most western societies the proportion of the population at working age is falling, as people live longer and birth rates fall. In most developing countries an expanding working population means a more economically productive population and greater potential for economic growth.

Fiscal strength and policy improvements: Strong government balance sheets mean that many emerging economies are at least as robust (if not more) than developed economies. Whereas many developed economies are in a period of forced deleveraging, less indebted emerging market governments are able to spend and invest more and this will boost growth.

International trade: Emerging market economies need natural resources to grow, which are often supplied by other emerging market countries. For example, as China and India expand their infrastructure, they often turn to Brazil and Russia for commodities and energy. This means that it is other developing countries that are well placed to benefit from growth in emerging markets. Also, many developing countries are moving up the value chain of trade and are getting better at capturing more benefits from the value added to international supply chain networks.

Consumption: Rising household incomes increase spending, particularly on discretionary items such as cars and electronics, many of which are produced domestically. This also promotes economic growth.

The case for longer-term economic growth in emerging markets is fairly well established, and, as these markets expand, so does the range of investment opportunities.

NBIM agrees with this promising rise of developing economies and its implications for investments, saying that the 'projected rise of China and India to make up around half of the world economy over the next 40 or so years is in stark contrast to the combined current market capitalisation share of these countries in global equity indices of 3%. Even in relation to their current share of world GDP, which is 12% based on market exchange rates, they are arguably under-represented in world equity markets. A similar argument applies to emerging markets in the aggregate[66].'

The same NBIM study also states that more favourable demographics, scope for productivity catch-up and healthier public finances mean that growth prospects are better in the developing world for several decades to come[67]. It showcases the striking decline in the average GDP growth rates in developed economies from 5% in the 1960s and 70s to 1.5% now in the graph we have used in the previous chapter.

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[65] Schroders, 2013. http://www.schroders.com/global/home

[66] NBIM, 30 March 2012, 'Economic growth and Equity Returns'. http://www.nbim.no/en/press-and-publications/discussion-notes/discussion-notes-2012/economic-growth-and-equity-returns/

[67] NBIM, 30 March 2012, 'Economic Growth and Equity Returns', *NBIM Discussion Note.* http://www.nbim.no/Global/Documents/Dicussion%20Paper/2012/DiscussionNote_5-12_Final.pdf

Growth and returns on investment

NBIM acknowledges that there is a sound theoretical case for expecting higher returns from investments in higher growth economies.

But it eventually rejects the intuitive conclusion that more promising growth prospects in emerging and developing economies should lead it to significantly increase its allocation of investments in these countries away from the EU and US, where growth is likely to remain sclerotic in the foreseeable future. Its rejection is based on an observation of only 'a weak correlation between equity returns and growth in emerging markets[68]'.

Another important consideration in NBIM's decision is that it believes that companies based in mature economies that it invests in already capture at least some of the fruits of faster emerging and developing world growth through the expanding trade, investment and corporate structure links between the two groups of countries. Investing in a US-based MNC with operations in China and India, for instance, will capture some of the fruits of faster growth. This is an entirely reasonable assumption and is backed by the fact that for open, developed economies such as Switzerland and Sweden the growth in earnings per share has outstripped GDP growth consistently.

However, the analysis below challenges these conclusions and builds a strong case for substantially increasing GPF exposure to emerging and frontier markets.

First, NBIM admits that the 'weak correlation between equity returns and growth in emerging markets' hypothesis, which it bases its decision to reject an increase in strategic allocation of assets away from developed to developing markets, has been subject to some fundamental challenges. Some studies, for example, show that 'the return on capital is positively correlated with growth in GDP per capita and negatively correlated with the level of GDP per capita[69].' Another important study used by NBIM demonstrates that investing into markets according to a perfect-foresight forecast of one-year-ahead GDP growth yields very high absolute and risk-adjusted returns.

NBIM rejects this as being irrelevant, because it does not have perfect foresight, completely ignoring the fact that unlike many other investors it has time on its side. What really matters is that the longer term prediction of faster growth in emerging and developing market is correct, rather than the year-by-year forecast, as the GPF would invest in these economies for the long haul.

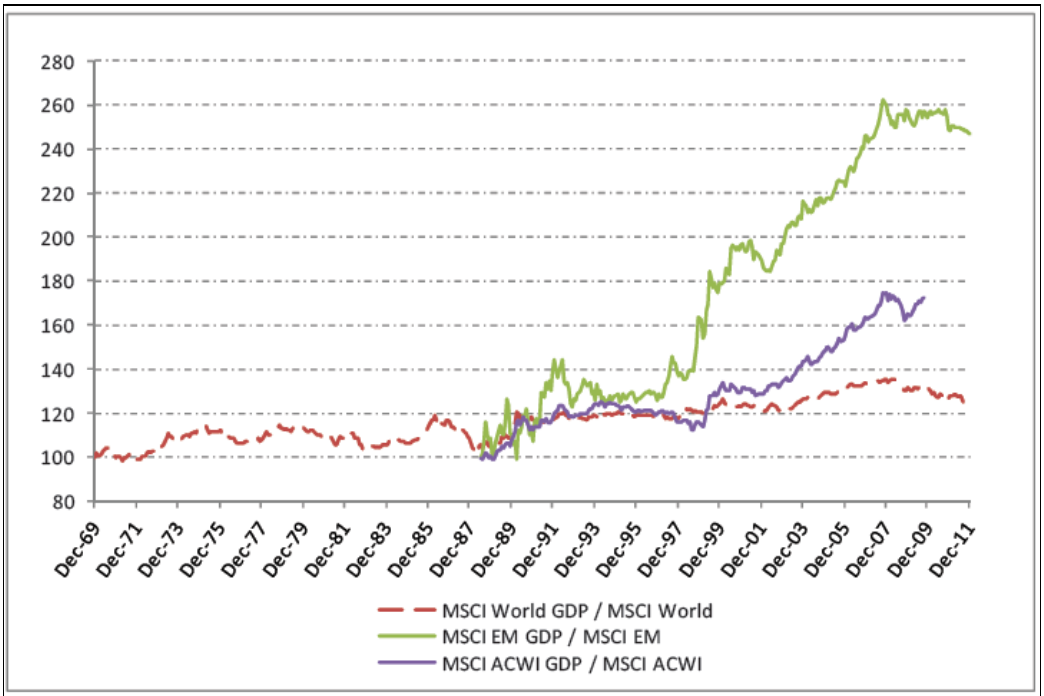
This perspective is supported by work done at Morgan Stanley[70] and reflected in the graph below that shows that a GDP-weighted allocation of assets (which weighs developing and emerging markets much more heavily) would have significantly

[68] ibid
[69] ibid
[70] MCSI, March 2012, 'Global equity allocation: analysis of issues related to geographic allocation of equities', *Index Report*. http://www.regjeringen.no/pages/1934920/MSCI.pdf

outperformed the market capital-based allocation that the GPF uses, which puts excessive weight on mature economies.

As it points out, 'Emerging markets today constitute a non-negligible part of the opportunity set for global investors. In recent decades, they have allowed investors to take advantage of the relatively greater set of economic growth opportunities in the developing world. Proponents of emerging markets argue for taking advantage of higher growth rates in these markets and a potential risk premium captured by emerging markets. In fact, because forecasts of economic growth do not take into account increases in free float through the effect of market liberalization on ownership structure, they may underestimate the actual growth potential. Proponents also point out the potential diversification benefits emerging markets may bring[71]."

Morgan Stanley discusses the history of emerging market investment. Much of the same rationale applies today, particularly to what are now considered to be frontier markets. 'Early investors in emerging markets had a very simple, yet powerful rationale for investing in these markets. They postulated that they would benefit from rapid economic growth if they invested in markets at early stage of development and with big potential for development. They anticipated that developing countries would progressively adopt market-oriented policies in a globalizing world and that they could invest in companies at low valuation, as these markets were under researched and undiscovered. Indeed, the last twenty years have seen a continuously expanding universe due to the opening of previously closed markets or markets reaching sufficient size and liquidity to become investable[72].'



Source: MSCI. Monthly data as of December 31, 2011 in USD. MSCI EM and MSCI ACWI GDP Weighted Indices are simulated before 2005. The MSCI World GDP Weighted Index is simulated before 1988.

[71] ibid
[72] ibid

The GPF, which has been set up so that the Norwegian oil wealth can be shared across generations, has a theoretically infinite investment horizon. As per the legislation that governs it, the principal should not be touched and only 4% of the Fund's target annual return on investment should be spent.

It would be silly for a fund with such a long investment horizon to base all its investments, as it currently does, on the shape of the world economy as it used to be, when developed countries dominated the landscape, whilst ignoring not just the fast pace at which a new future shape of the world economy is emerging, but even the economic realities of today.

In fact, the balance of evidence very clearly points to the significant financial advantage that early investors in developing countries, where growth is taking off, enjoy.

While the risks of ups and downs in any year for such investments are higher than corresponding investments in more mature economies, most of these ups and downs are pure noise for investors with a long-term investment horizon, who are not forced to sell every time the outlook darkens a little.

There are substantial additional financial benefits to be harvested by investors such as the GPF, who can afford to ignore short-term fluctuations. Also, since the GPF is likely to support future imports into Norway, and the trade share of these economies is set to rise sharply, it makes sense to start moving GPF exposure towards these economies away from the concentrated bet the GPF has made on developed economies.

NBIM attributes the failure of many studies to find a robust link between growth and returns on equity to the fact that they focus on the listed equity sector, whereas most new value added may come from new or unlisted firms. It acknowledges that some of the biggest profits in these economies will arise when unlisted private firms the GPF ought to invest in are finally listed on the stock market.

Here it appears to agree with the proposition that 'the part of GDP growth that is driven by new and unlisted firms or by net debt and share issuance of existing firms does not benefit the holders of existing equity capital. Instead, the returns on existing shares depend, among other things, on whether companies can reinvest earnings in projects with positive net present value.[73]' We agree with this.

But to us, the natural logic of this is not for the GPF to reject making additional investments in developing countries, but to consider investing in new and unlisted firms. We develop this case further in subsequent sections.

On its third point, that benefits of emerging market growth are already captured by its investments in MNCs in the developed world that have substantial operations in developing countries, we disagree.

[73] ibid

The fact that some of the fruits of growth in developing markets may be captured by developed country MNCs does not mean that all or even a majority of them would be so captured. In fact, while a majority of MNC sales and assets may be to foreign countries, emerging and developing countries account for no more than a tenth in most cases through contribution to profits may be higher.

Some believe that foreign exposure allows US-based companies and other MNCs to capitalize on rapid growth in emerging markets like China, India, and Latin America, and earn much stronger profits than if they were totally dependent on the struggling US economy[74]. However, according to McKinsey & Company, the biggest 100 companies in the S&P 500 derive only 17% of their revenue from emerging markets. This is so despite 36% of global GDP being produced by developing economies. Clearly, investors in US-oriented companies and funds are missing a substantial piece of the action.[75] Across the S&P 500 as a whole, only 12% of revenues come from emerging markets. Investing in the S&P as a whole, as the GPF does, is certainly not an efficient way to get exposure to growth in the emerging world[76].

Going beyond the fact that investing primarily in developed country stock indexes means one may not be fully capturing the growth in the developing world, one may simply miss out completely on whole swathes of opportunities, as a report from the Boston Consulting Group shows. It lists '100 global challenger' companies from the emerging markets that are growing so quickly overseas that they are reshaping industries and surpassing many traditional multinational companies. The report finds that these companies are outpacing household names in the US and Europe and are having a profound impact on the global economy[77].

It is also useful to check that investing in developing and emerging market companies does indeed bring a high degree of exposure to these economies. This is easily done by looking at the following table that shows that foreign sales account for no more than 30% of emerging market multinationals, so that 70% of the sales are local, offering a high degree of exposure to the fast-growing domestic economy.

Table 5: Percentage of foreign sales for MNCs

Year	North America	Europe	Pacific	Emerging Markets
2002	*29*	*68*	*35*	*30*
2010	*41*	*77*	*42*	*31*

Source: Worldscope, MSCI

[74] Newman, R., June 30 2011, 'Why U.S. companies aren't so American anymore', *US News.* http://money.usnews.com/money/blogs/flowchart/2011/06/30/why-us-companies-arent-so-american-anymore

[75] Orlowski, S., August 22 2012, 'Can emerging markets provide shelter from looming S&P correction?', *Emerging Money*. http://emergingmoney.com/etfs/emerging-markets-shelter-eem-mqbky/

[76] ibid

[77] Boston Consulting Group, January 15 2013, 'Press Releases: BCG names 100 global challengers from emerging markets that are reshaping global industries'. http://www.bcg.com/media/PressReleaseDetails.aspx?id=tcm:12-125636

Supporting our perspective that growth in emerging markets is best captured by investing in emerging market firms is a McKinsey report[78] that demonstrates that multinational players do not seem to be capturing growth as well as their counterparts from emerging markets are.

In fact, this is true even for growth prospects in developed economies. According to McKinsey, 'one striking finding was that companies headquartered in emerging markets grew roughly twice as fast as those domiciled in developed economies—and two and a half times as fast when both were competing in emerging markets that represented 'neutral' turf, where neither company was headquartered. We found this to be the case across industries[79].'

Therefore, none of the three reasons that NBIM gave for not moving more aggressively into investing in developing countries hold true. First, its hypothesis that faster growth does not translate into higher stock market return is questionable. Second, the natural outcome of the fact that a majority of growth opportunities may be captured by unlisted firms is that the GPF must try and capture these opportunities by expanding into making unlisted and illiquid investments and not bury its head in the sand. And last, its hypothesis that investing in US and European MNCs is an efficient way of getting exposure to emerging market growth is plain wrong.

Hence, the case for the GPF directing much larger chunks of GPF investments towards the developing world is robust and there is a large opportunity cost of not doing so.

The case for investing in illiquid and unlisted assets

A clear conclusion from the previous section is that in order to best exploit the investment opportunities that the shift of economic growth to emerging and frontier economies brings, one must be ready to invest in illiquid and unlisted assets.

The MoF appears to broadly agree, saying that a better use of the Fund's distinctive features will mean that the investment strategy will continue to be developed in the direction of unlisted and other less tradable assets.

The NBIM analysis also further strengthens the case for moving in early into growth economies. By its own admission, if the GPF only starts investing in developing countries after they reach the rather high threshold currently used by the Fund, they would have already become fashionable and better growth prospects priced into the public equity markets that the GPF invests in. So NBIM's own analysis[80] actually strengthens the central recommendations of our report – that the GPF should move in early into frontier economies and that it should invest through a whole range of instruments, including private equity and infrastructure - not just through public equity markets.

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[78] Atsmon, Y. et al., May 2012, 'Parsing the growth advantage of emerging-market companies', *Mckinsey Quarterly.* https://www.mckinseyquarterly.com/Parsing_the_growth_advantage_of_emerging-market_companies_2969

[79] ibid

[80] NBIM, 30 March 2012, 'Economic Growth and Equity Returns', *NBIM Discussion Note.* http://www.nbim.no/Global/Documents/Dicussion%20Paper/2012/DiscussionNote_5-12_Final.pdf

This logic also flows from our earlier analysis of the investment strategies followed by the peer group of the GPF, all of which allocate a significant proportion of their portfolio to assets that may be illiquid or unlisted or both. They also allocate a much larger proportion of their portfolios to investments in the developing world.
The prime examples of such assets are

- Large strategic stakes in listed firms which are illiquid because they are hard to sell,
- Stakes in new or unlisted firms, where investments may be made in the form of venture capital/or private equity – which are by their very nature illiquid,
- Investments in infrastructure projects, which are also illiquid because of their long-term horizon and large size.

NBIM appears to agree with our logic and analysis of the need for the GPF to make unlisted and illiquid investments in developing economies, saying that it 'has previously recommended that the investment universe for the Government Pension Fund Global be expanded to include unlisted investments. Investments in private equity funds active in emerging markets, including the least developed countries, are a natural part of a broad management mandate for this asset class[81].'

It also agrees with us that the biggest opportunities for the GPF in emerging markets is to use alternative asset classes, saying that unlisted investments will often be the only realistic option for investing in least developed countries in particular and that the 'the public market covers only a small percentage of overall investment opportunities[82].'

Another NBIM study highlights that the additional return, traditionally associated with small cap companies, may now be best earned in less developed markets, as opportunities in developed markets dry up. A more active approach to investing, not passive index investments, may be best suited to capture this additional return[83].

The NBIM study also makes a case for the GPF to make illiquid investments, saying that 'investors with a long investment horizon and little need for liquidity of their own will be well positioned to benefit as providers of liquidity. A long investment horizon generally ensures that the liquidity risk, or the risk that a short-term need for liquidity will arise, will be low. Accordingly, investors of this type will be in a position to earn a premium by offering liquidity and thus bearing the liquidity risk. Because of their long horizon, the liquidity risk will be minimal for these investors and the liquidity premium can accordingly be viewed as compensation for bearing a risk that for them is relatively low[84].'

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[81] Norges Bank, 2010, 'Norges Bank's assessment of the basis for unlisted investments focusing on the environment and sustainable growth', http://www.nbim.no/Global/Documents/Submissions/2010/enclosure%20to%20the%20letter%2006072010.pdf
[82] ibid
[83] Norges Bank, 2009, 'Norges Bank's assessment of the theoretical and empirical basis for active management and our strategy for the management of the Government Pension Fund Global', http://www.norges-bank.no/Upload/77853/EN/Active_management_enclosure.pdf
[84] ibid

NBIM appears to wholeheartedly agree with the recommendations of the Strategy Council, the lessons from its peer group and the central suggestions of this report that 1) the GPF needs to expand its geographic focus to include a larger proportion of emerging markets and least developed countries, and 2) that it must move beyond investing merely in liquid securities to include private equity and infrastructure investments (see boxes). It also sees the value in co-investing with managers who have a presence on the ground and more experience in these asset classes and countries - a point we develop on further in the next section.

Box 5: The case for GPF investments in private equity[85]

NBIM rightly says that 'investments in private equity mean exploiting the fund's distinguishing characteristics as a large, long-term investor with no short-term liquidity needs.' It further states that this is in line with the position taken by the MoF in its report to the Storting (Number 10) on the development of the investment strategy for the Fund. It goes on to say that such investments can in 'some cases help to increase the overall return on the fund's equity investments. Besides, the equity market premium, the return from this asset class will include a liquidity premium and possible added value from concrete actions by the manager.'

Furthermore, NBIM feels confident in its ability to 'build up gradually an organisation with the expertise to identify the best managers and also gain access to them. The latter factor needs to be seen in the light of the fund's characteristics, such as its ability to tie up capital for long periods, its reputation as a responsible investor, and its size. NBIM will also have opportunities to co-invest with selected managers, so increasing the potential returns.'

It is very important to clarify what we mean by private equity. For the purpose of this report, most references to private equity are primarily in the context of developing and emerging markets, where this generally takes the form of growth equity – investments in firms that are often unlisted in the absence of developed public equity markets. Leveraged buyout type deals, the stock of private equity in most developed countries are not a part of this report or its recommendations.

Box 6: The case for GPF investments in infrastructure[86][87]

Investors such as Sovereign Wealth Funds have 1) unparalleled scale and 2) longer time horizons than typical investors. So they hold clear competitive advantages in markets for long-term, illiquid assets. However, in practice many investors focus their resources and capital on generating returns over periods that rarely exceed two years. So a SWF with much longer investment horizons will 'naturally have a leg up in asset classes for which shorter-term rivals are prevented from entering due to time horizon. One asset class that fits this description is infrastructure.'

[85] Norges Bank, 2010, 'Norges Bank's assessment of the basis for unlisted investments focusing on the environment and sustainable growth', http://www.nbim.no/Global/Documents/Submissions/2010/enclosure%20to%20the%20letter%2006072010.pdf

[86] Clark, G. et al., 2011, 'The new era of infrastructure investing', http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1837813

[87] Norges Bank, 2010, 'Norges Bank's assessment of the basis for unlisted investments focusing on the environment and sustainable growth', http://www.nbim.no/Global/Documents/Submissions/2010/enclosure%20to%20the%20letter%2006072010.pdf

The decades-long profiles for such investments, while problematic for short-term investors, are well suited for funds with inter-generational objectives. Also, while 'liquidity is generally a cause for concern among short-term infrastructure investors, it is not a concern for a fund that can hold an investment for the life of the asset. In short, infrastructure's 'problems' do not appear to be problems at all for the community of long-term investors.'

On infrastructure, NBIM points out that an 'investor can also expect to receive a liquidity premium over time. This is a premium to which a long-term investor with no liquidity needs such as the Government Pension Fund Global should be exposed.'

It goes on to say that 'the combination of considerable future investment needs, pressure on public budgets and attractive portfolio characteristics make it reasonable to assume that private venture capital will play a growing role in the funding of infrastructure investments in the future. Investment opportunities in this asset class are therefore considered sufficient for the Fund to be able to build up a portfolio of infrastructure investments over time through a combination of fund investments, co-investments and direct investments.'

Some institutions are now starting to invest directly and build in-house capability. For example, 'a handful of pioneering pensions and sovereign wealth funds have already developed internal capabilities to source, structure, and asset-manage large multi-billion dollar infrastructure assets.'

To sum up, infrastructure investments are perfectly suited for the GPF, and this is an asset class the GPF should prioritize. The demand for infrastructure investments in developing economies is particularly high, given their early stage in the development process and because funding is in short supply. So the most promising opportunities for the GPF for investing in infrastructure are in the developing world. The size and scale of these is highlighted in the next box.

Box 7: The infrastructure funding gap[88]

As discussed earlier in this report, developing countries have a high growth potential of between 5% and 7%, while OECD economies are expected to grow at a much slower pace of 2%-2.5% in the foreseeable future. This growth, even with productivity increases, will be capital intensive and require substantial investments in infrastructure, the lack of which can be a significant constraint on growth.

The existing infrastructure gap is huge. More than 1.4 billion people in the world have no access to electricity, 0.9 billion live without safe drinking water and 2.6 billion without access to even basic sanitation.

While needs vary across regions, the gaps are particularly high for sub-Saharan Africa and for South Asia. SSA needs to invest $75bn-$100bn every year, more than 12% of the regions GDP. Low-income countries such as Ethiopia need to invest as much as 15% of GDP every year.

The need for infrastructure investments in the developing world is estimated to be $2 trillion every year, but only $1 trillion is currently being spent. Of this, about 35%-50% is for East Asia Pacific, 5%-15% for Latin America and the Caribbean, 20%-25% in South Asia, 5%-15% in Sub Saharan Africa and 5%-10% in the Middle East and North Africa. In terms of the sector mix, electricity accounts for

[88] Bhattacharya, A., Romani, M. and Stern, N., 2012. 'Infrastructure for Development – Meeting the Challenge'. http://www.g24.org/Publications/ResearchPaps/PP-infrastructure-for-development-meeting-the-challenge.pdf

between 45% and 60% of the total investment needs, followed by water at 15%-30%, transport at 15%-25% and telecoms at 10%-15%.

Of current spending, government budgets account for $500bn-$550bn, aid and multilateral development banks for $40bn-$60bn, national development banks for $70bn-$100bn and the private sector for between $150bn and 250bn, leaving a financing gap of about $1 trillion every year that needs to be urgently plugged.

Stresses on public budgets, overseas development aid cutbacks and rising concerns about debt sustainability means that the private sector will need to play a major role in plugging this gap. The fact that banks from developed economies are deleveraging (reducing their lending) in response to the crisis as well as regulatory changes is also putting pressure on current sources of private financing. Pension funds and sovereign wealth funds, ultimate sources of long-term risk capital, thus have an even more important role to play.

The biggest funding gaps, as a proportion of GDP, are in South Asia and Sub-Saharan Africa, where the potential for positive development impact is also the highest.

Clearly, there is a very robust economic and financial case for the GPF to start making significant investments in private (growth) equity and in infrastructure, particularly in developing countries - including least developed frontier economies.

Two questions arise: First, does it have the capacity to undertake such investments? Second, are such investments compatible with the GPF's declared ambition to be a responsible investor and with the ethical guidelines that govern its investments?

We answer both in turn.

The short answer to the first question is no, the GPF does not have the capacity to undertake such investments at present. However, given the urgent need for the GPF to change course, its present lack of capacity and experience in the asset classes and geographies needs to be addressed. It would be best for the GPF to start working with partners who have the appropriate experience in these areas. There may be, as NBIM suggests, even a potential for higher profit through co-investments with others, as well as the advantage of lower risk owing to the longer experience of partners. Who should the GPF partner with then?

Interestingly, in 2008 Norfund, Norway's Development Finance Institution had made a concrete proposal for the GPF to invest in developing economies using Norfund's expertise. It suggested that the GPF establish a fund for investment in private equity in developing countries that it could ask Norfund to manage on its behalf. It is notable that Norfund has generated a higher rate of return with its dual development and profit mandate than the GPF with its purely profit-oriented mandate. It has recorded a return on investments of about 10% since its inception in 1997.

Norfund rightly points out that 'Norway's current investment portfolio does not sufficiently exploit the investment opportunities available in the world's emerging economies. During the last decade private equity funds had a good return on investment in these regions. The risk associated with this type of investment has been significantly reduced as the regulatory, legal and financial framework is developed and matured in many of the affected countries.'

Norfund's performance underscores the point that the GPF is missing promising opportunities in the developing world. That such opportunities exist was also echoed by Lars Thunell, the former of the International Finance Corporation, the biggest DFI in the world, 'If we look at the IFC investments in equity, we have had very, very good returns. We find that if you go in early and if you know what you are doing, you can actually earn more money. And we actually have had better returns in Africa than we have had in Brazil or India—mainly, I think, because there has been less competition there, and we're breaking new ground[89].'

So, while the GPF does not have the in-house capacity to make such investments yet, it does have a number of promising partners in Norfund, the IFC, as well as other DFIs - as we will discuss more in detail in a subsequent chapter. NBIM works with external managers as a matter of course, particularly in areas such as emerging markets, where it lacks expertise. For example, almost 4% of its equity portfolio is managed by external managers and it hands out close to a 100 external mandates across its portfolio. Thus working with DFIs would not be unusual.

Such an approach is also completely with the GPF's self-professed ambitions on ethics, responsible investment and sustainability. It will also help satisfy the demand from a number of quarters in Norway for the GPF to contribute to international development. DFIs have a dual mandate: 1) Being profitable and 2) Promoting development. By virtue of being development focussed (mostly) public institutions, they are also rightly seen to be more ethical and socially and environmentally conscious than most purely private sector entities would be. Their mandate to promote development also means they do good and useful work.

It is our firm belief that such an approach of the GPF significantly expanding its investments in developing countries by starting to co-invest with DFIs will be **good for Norway and good for development.**

Conclusion

For the most part, NBIM, through its discussion notes and reports, acknowledges the case we have made – that there is a strong case for it to invest substantially in fast growing developing countries. However, at the same time, it offers arguments such as the link between growth and returns on investments not being completely robust and that some of the fruits of this growth are already captured by its investments in developed country MNCs to justify not having invested in fast growth economies yet.

Using NBIM's own evidence, as well as that from external research, we have shown that neither of these arguments holds and that the case for larger developing country investments is robust. NBIM itself acknowledges this when it admits that much of the upside from growth in these economies is probably not captured by existing public equity investors, but by those who invest in nascent firms that are not yet listed. It also agrees with both the Strategy Council as well as our analysis that it is uniquely

[89] McKinsey & Company, June 2012, 'Lars H. Thunell on encouraging private-sector investing in emerging markets'. http://www.mckinsey.com/insights/social_sector/lars_h_thunell_on_encouraging_private-sector_investing_in_emerging_markets

suited to make such illiquid investments in private equity, as well as in infrastructure in developing countries because of its unique long-term nature.

We have also shown that, while developed country MNCs capture some of the faster growth of developing countries in their profitability, the vast bulk of this is captured by developing country firms themselves. What is more, many of these firms are actually also starting to outperform developed country MNCs in their home markets, particularly owing to a lower cost base, as well as more innovative approaches that have been honed in their more difficult home markets.

The case for NBIM to substantially ramp up its investments in developing economies in the form of public equity, private equity and infrastructure is indisputable. Infrastructure investments in particular have characteristics that are perfectly suited for a large long-term investor such as the GPF. We highlight how big the funding gap for infrastructure in developing countries is – particularly in South Asia and in Sub-Saharan Africa. Clearly, there are ample opportunities for a large investor such as the GPF in this sector.

The question then is if the GPF has the capacity to be making such investments. It does not, but development finance institutions such as Norfund, as well as the IFC can come to the rescue here. These institutions have had country level presence in many of these fast growing developing economies for a long time and have developed special expertise in identifying opportunities for investments in growth equity, as well as in infrastructure - that are both profitable and make a contribution to development.

Co-investing with these DFIs, as Norfund has already proposed to the MoF, would be a win-win proposition for both. It would, on the one hand, allow the GPF to avoid wasting any time and start investing profitably in fast growing developing economies at once at some scale, as the funding gap in infrastructure indicated. At the same time it would generate a substantial positive development impact by allowing DFIs to scale up their operations and will also mean that the GPF has a much larger development footprint that is in line with its mandate for 'responsibility' and 'sustainability'.

Given that the largest infrastructure investments are in the energy sector, it would also mean that the GPF can partly address the glaring deficiency we have briefly discussed in a previous chapter – that the GPF has no real strategy to manage its substantial exposure to climate change and that it does little more than pay lip service to the matter. Strategically targeting green energy infrastructure in developing countries would kill two birds with one stone.

Chapter 5: How the new GPF strategy would work

Addressing the current political debate on the nature of the GPF

In the on-going debate on the GPF in Norway, it has been suggested that the GPF ought to be split up. The justification used for this in the election debate has been that it may be too big or cumbersome to manage, or that splitting it into competing funds would introduce competition and may lead to improved performance.

The good thing about this debate is that it at least acknowledges the fact that the GPF needs to improve its performance. But we do not agree with either of the two justifications for splitting up the Fund.

The size argument is spurious and in some ways managing multiple funds adding up to the same total will demand even more management time and expertise than managing a single fund. The second motivation should also be rejected for two reasons, both of which are substantial.

First, as we have comprehensively shown in the analysis so far, the main driver of the return on the GPF are the restrictions that the MoF imposes on it in terms of severely limiting the list of allowable countries and financial instruments. As we have shown, most of the fastest growing economies in the world are on the forbidden list and instruments such as private equity and infrastructure that are perfectly suited for an investor such as the GPF are also not allowed. Moreover, the MoF imposes a very tight tracking error restriction on the GPF limiting its room for manoeuvre even more.

It is such restrictions that are the main driver of the poor returns the GPF has delivered so far and no matter how many competing funds it is split into, they will also underperform in the same way unless these restrictions are removed. The correct approach then is not to split the Fund, but to remove the restrictions as this report has recommended. A higher sustainable rate of return will inevitably follow.

The second reason we are sceptical about splitting up the Funds to induce competition for producing greater returns is that the experience of Sweden has not been particularly good in this regard. In fact, there is an on-going debate in Sweden now about whether it makes sense to merge the various pension funds that were created by splitting up the monolithic single pension fund, partly with the intention of improving returns. Much to the chagrin of policymakers, the split up funds, with few exceptions, bunched together with similar strategies and performance.

The thing that increased most was the cost of management that arose from duplication. Nobody had the incentive to make investments that may not do well when others did well, as this would create negative publicity. These herding effects are well known in financial markets. In financial markets it pays to screw-up when everybody else also screws up.

In this chapter we will recommend that the GPF be split up into two windows, much as the GPF global and the domestically-oriented pension fund already operate - but the split should be along functional lines. One core part of the GPF should continue to invest mostly in liquid equity and fixed income securities, the majority of which will still be in developed economies, even as it significantly expands its investments in developing economies.

The other part, GPF-Growth, should specifically focus on developing economies and target infrastructure and private equity investments in these economies. Similar illiquid investments in developed economies should also fall under this window, but we expect that the majority of GPF-Growth would be invested in fast-growing developing economies, where the biggest opportunities lie. GPF-Growth should also strategically target the provision of insurance services, as recommended by the Strategy Council and as elaborated in some detail in a later section.

This split would be convenient from the perspective of risk management, board oversight, expertise development, reporting and focus, as these aspects are very different between funds focusing on liquid index investing and those that take a more strategic active approach and make illiquid investments. In some ways, keeping both under the same window would be mixing apples with oranges, though most endowments and other SWFs such as Temasek do exactly that. The split is not necessary, as much of the same impact can be achieved through an expansion of the GPF's mandate, but it is still recommended for clarity and to better convey the differences to ordinary citizens, the ultimate owners of the Fund.

Another suggestion that has been prominent in this election cycle has been that the GPF should sell its oil and gas-related investments and invest in green technologies. This suggestion has more merit than simply splitting up the Fund to induce competition. As highlighted in an earlier section, the GPF faces a very high downside risk if policy action to mitigate climate change results in a rise in the price of carbon emissions or a restriction in their quantity. Rather than manage this risk, it has, through investing as much as 10%-15% of its portfolio in carbon intensive assets, doubled up this risk.

In this context this proposal, which the author of this report had first articulated in a seminar at the Norwegian Ministry of Finance in 2008 and then again in a white paper for the Norwegian Ministry of Foreign Affairs in 2008[90], makes sense. A positive case for profitably targeting green investments is laid out in another Re-Define report[91].

The correct way to approach this discussion is not from the ethical perspective, but through the lens of managing risks prudently. If the GPF were to introduce rigorous carbon stress tests as Re-Define has championed in the European Union and integrate climate change-related risks into its main risk management systems alongside credit risk, market risk and operational risk, selling off carbon heavy assets and a positive screening of green investments would be the only sensible step. The

[90] Norwegian Ministry of Finance, 8 December 2006, 'NOU 2008: 14'. http://www.regjeringen.no/nb/dep/ud/dok/nou-er/2008/nou-2008-14.html?id=525832

[91] Re-Define, 2011, 'Funding the Green New Deal: Building a Green Financial System'. http://re-define.org/sites/default/files/GEF-Funding%20the%20GND%20web.pdf

case for positive screening is further bolstered by a recent meta-study by Deutsche Bank, which concludes that positive discrimination criteria used for responsible investments that include environmental sustainability generate superior returns[92]. The Re-Define blueprint for green finance also highlighted how green investments are perfectly suited for oil and gas-driven long-term investors such as the GPF.

The case for setting up GPF-Growth

The analysis in the report so far has shown that the economic imperative for the GPF to significantly expand its investments in developing countries is irrefutable. Some of these investments can be captured by expanding the benchmark equity and fixed income indices that the MoF prescribes. In particular, the recent move to market capitalisation-based weights is encouraging, though this report suggests that a further move to GDP weights for equity investments, particularly for developing economies is needed to best capture growth potential. Moving to a negative screening approach to countries (investments in all countries are allowed unless they are explicitly forbidden), is in many ways even more important, as the current GPF universe excludes most of the fastest growing economies in the world.

The report has also shown that the most promising opportunities in these countries can only be captured if the GPF is able to move into making investments in unlisted and illiquid assets, such as private (growth) equity and infrastructure. It concluded the last chapter on the note that DFIs may be good partners for such investments and that this approach is likely to be good for both Norway and for developing countries.

Non-investment in developing countries is both against professed economic self-interest and against the spirit of the principles underpinning ethical guidelines, which are based on concern for sustainability and human rights. By neglecting win-win developing country investments, the GPF has failed not only to maximise the returns for a given moderate level of risk, but also goes against the spirit of the 'responsibility' and 'sustainability' parts of its mandate, as well as ethical guidelines as highlighted by the author in a white paper for the Ministry of Foreign Affairs in 2008[93].

However, effectively making such investments will require many changes to the present approach of the GPF. So much so, that in our opinion it makes sense to set up a new window within the GPF. **We call it the GPF-Growth, as it is the desire to capture faster growth in the developing world which is the main motivation behind setting up this window.**

As the box below explains, given the additional challenges and the significant difference in approaches required between what has been the approach of the GPF thus far and what will be necessary for investments in illiquid assets in developing

[92] DB Climate Change Advisors, June 2012, 'Sustainable investing: Establishing long-term value and performance'. http://www.dbcca.com/dbcca/EN/_media/Sustainable_Investing_2012-Exec_Summ.pdf

[93] Norwegian Ministry of Finance, 8 December 2006, 'NOU 2008: 14'. http://www.regjeringen.no/nb/dep/ud/dok/nou-er/2008/nou-2008-14.html?id=525832

countries, an approach that conducts these operations through a separate window makes most sense.

Box 8: The logic of setting up a new investment window

Geographic limitations of the current investment portfolio: Given the GPF's present focus on investments in listed securities, many developing countries are underweighted. Also, the MoF at present forbids investments in almost half of the developing world.

GPF-Growth will invest primarily in developing regions that are underrepresented in the Fund's portfolio. Note: Even with the revision of weights to include developing markets under the current model of the GPF, they are likely to remain underrepresented given the relatively small size of their listed security markets.

Asset Class Restrictions: The GPF at present is forbidden from investing in private equity or infrastructure, or from offering insurance. GPF-Growth will focus exclusively on these asset classes. The skills required to manage a portfolio of listed assets are very different from those that will be needed to manage illiquid investments.

Time horizon and Risk Management: The GPF's current investments are almost entirely liquid, so they can be monitored and benchmarked easily and managed on a mark to market basis. This effectively gives the GPF a short-term measure of risk in the form of market volatility, even though it may retain its holdings of liquid securities for a long period of time. Investments under GPF-Growth, in contrast, will necessitate a different approach, wherein investments are effectively locked in for a period of many years, monitoring is harder and daily market prices would not mean much.

This will require a new perspective on time horizons and risk management that would be different from the expertise that exists within the main GPF. As the MoF says, 'there are no investable benchmark indices for this type of investments. It is therefore not possible to distinguish between overarching strategy choices and decisions on operational execution in the same manner as for listed shares and bonds. Such investments require a different division of work between client and manager, with a larger degree of delegation[94].' It also rightly points out that for such investments absolute risk limits would need to be emphasised more than the relative risk that is the focus of current strategy.

Ethical guidelines and responsibility: In contrast to the main GPF that implements its responsibility mandate primarily through a process of negative screening and some active engagement, the GPF-Growth will be more ethical and contribute to the GPF's 'responsibility' and 'sustainability' mandates by its very design - choosing to invest in countries where it can contribute to sustainable development.

On other issues, such as corruption and respect for human rights etc, the GPF-Growth may need to take a different approach that focuses more on engagement and a drive to improve standards rather than having a high bar to entry, given the more difficult and less well-governed circumstances that exist in poor developing countries.

The GPF lacks the capacity, for example, to look through the corporate structures of the MNCs it invests in to evaluate the impact of their operations – through subsidiaries or suppliers/partners on critical matters such as human rights. NBIM has stated that OECD guidelines do not apply to it as a minority shareholder that it always is.

GPF-Growth will hold larger more strategic stakes in firms, is likely to appoint representatives to the board of many of the firms/projects it invests in and will need to take a much more activist approach to engaging with the management of firms it invests in. It should evaluate its ethical impact on the

[94] NBIM, 6 July 2010, 'Development of the investment strategy for the Government Pension Fund Global'. http://www.nbim.no/en/press-and-publications/submissions-to-ministry/2010/development-of-the-investment-strategy-for-the-government-pension-fund-global/

basis of improvement in outcomes such as human rights and environmental impact as a result of its engagement.

The GPF-Growth should be a window of the GPF-Global that specifically targets mostly making unlisted and illiquid investments and offering insurance in developing countries. As the Strategy Council to the Fund has said, 'large long-horizon investors, such as the GPFG, are naturally suited to writing various forms of insurance.' It goes on to say that this includes 'traditional insurance, such as cover against earthquake and natural catastrophes, and opportunistic provision of more standard forms of insurance[95].' Insurance against natural risks, as well as macroeconomic shocks, would be most valuable for developing countries and is currently underprovided, if provided at all. The DFIs, particularly the IFC, could prove to be useful partners in this[96]. The author of this report, for example, had worked in partnership with the IFC to offer weather linked insurance in developed countries, while trading derivatives for Aquila, a large US energy-trading firm.

The Fund should legally be set up as a subsidiary of the GPF-Global, which should be split into two subsidiaries and be managed by NBIM using external mandates given to Norfund and various other DFIs. The other subsidiary would look like a version of the current GPF and invest mainly in liquid asset classes. The GPF-Growth needs to have a separate board of its own, with both Norwegian and international experts with expertise in the kinds of investment it will make and in the countries it will operate in.

In addition to other experts, the GPF-Growth board should also have representatives from the Ministry of Finance, the Ministry of Foreign Affairs and the Ministry of Trade and Industry - the three main ministries within Norway, which will have a stake in and expertise on the kind of work the GPF-Growth would do.

The risk-management framework of the GPF will have to be adopted for the GPF-Growth and absolute risk and performance benchmarks such as GDP growth will play a more important role than the measurement of performance against an index and limits on tracking error. Similarly, daily reporting of values would perhaps be meaningless, so should be replaced by less frequent quarterly reporting with the caveat that it is very hard, if not impossible, to make judgements on the performance of a true long-term illiquid asset over the short-term. The insurance portfolio would need to be run on actuarial basis.

GPF-Growth will also have to adopt a separate set of operational guidelines, which interpret the ethical investment and responsible investor framework of the GPF in a manner more suitable for the work of GPF-Growth, as briefly discussed in the previous Box.

[95] Strategy Council 2010, 26 November 2010, 'Investment strategy and the Government Pension Fund Global'. http://www.regjeringen.no/Upload/FIN/Statens%20pensjonsfond/SR_Final_GPFG_25Nov.pdf
[96] International Finance Corporation, 2013, 'Bringing weather insurance to East Africa'. http://www1.ifc.org/wps/wcm/connect/region__ext_content/regions/sub-saharan+africa/news/giif_eastafrica

While this report recommends that the GPF-Growth issue external investment mandates to a number of DFIs (we discuss this in detail in a subsequent section), including Norfund, it makes sense to look in some detail at the proposal that Norfund made to the MoF, as it offers several useful insights into how the GPF-Growth may operate.

Box 9: A brief discussion of Norfund's proposal for channelling GPF investments and our suggestions

The contents of this Box are derived from Norfund's letter to the Ministry of Finance that contained a proposal to channel more GPF investments to developing countries through Norfund as laid out in the recommendations of NOU 2008:14.

In coming up with a number for the optimal size of such a fund Norfund looked at two factors. First, that the proportion of investments the Fund should have in developing countries should relate to the size of their financial markets. Second, it estimated the size of investments the fund should have in these regions by looking at the average share of major international pension funds currently invested in private equity in developing countries.

Norfund believes that the fund's objective should be to maximize risk-adjusted financial returns on invested capital, and it believes that targeting an annual net return of 15-20% on invested capital is feasible. However, it warns that the fund will not reach these performance levels in the early years, because of start-up and ramp-up costs or the "J-curve" that characterizes the return profile of private equity funds.

While these returns are certainly achievable, we believe that GPF-Growth should target a more modest real rate of return of 7%-10%, not 15%-20%, though that is certainly achievable on small investments.

Norfund also rightly goes on to say that performance measurement must be flexible enough that you take into consideration the time period before the investment values realized. While the new fund's mandate should include all developing countries, Norfund suggests that its initial priority should be sub-Saharan Africa and South and Southeast Asia.

We agree, as these are the developing regions that hold the biggest promise in terms of expected growth rates. Using DFIs as external managers would allow the GPF-Growth to target a broader array of countries, as some will have a special focus on Latin America. However, the more the GPF-Growth prioritizes countries where the shortage of capital is most acute, the larger its development footprint is likely to be. Sub-Saharan Africa and South Asia are where the shortfall of capital is most severe and the development needs most acute. It is also the part of the world that would best contribute to a structural diversification of the GPF's investments away from the predominance of developed economies.

Norfund believes that the new fund should invest primarily in regional private equity funds.

While it may need to start with such investments at the outset, we strongly believe that it should also have a bigger focus on making direct equity investments and investing directly in infrastructure projects, depending on the opportunities available.

Norfund usefully highlights the complementarity between its own portfolio and that of the GPF. 'Most of Norfund's investments to be found in some of the poorest and least developed countries, exemplified by Swaziland, Tanzania, Nepal, Nicaragua and Nigeria. It invests today in different types of assets, from renewable energy by Statkraft through SN Power, to direct investments in companies and financial institutions, in addition to investments in regional private equity funds. It invests only in very exceptional cases in listed shares and bonds. The vast majority of the GPF's investments are in developed countries in liquid instruments such as shares and bonds.'

In the proposal we have put forward in this report, the GPF-Global will be split into two windows that will also have a complementarity of mandates in terms of a different focus on geographic areas, as well as the kinds of investments made.

Norfund also proposes some useful metrics for prudent risk management, such as limits on the maximum percentage stake in a single fund, maximum absolute investment in a single fund, the maximum percentage of fund of funds managed by the same management, limits on exposure to a single industry, limits on concentration in a country and in a region and a deliberate strategy of diversifying across regions and sectors. It also rightly points out that, given that PE investments are characterized by long investment horizon of seven to ten years, and relatively illiquid secondary markets, the focus of risk management needs to be on due diligence prior to major capital investments, as well as regular dialogue with the portfolio funds and companies. Where the percentage of GPF-Growth's stake is high, it should seek representation on the boards of firms.

We agree with many of these risk management measures.

Finally, it suggests that it could set up a special purpose company, Norfund Management A / S, which will be owned directly by either Foreign Affairs Ministry or the Ministry of Industry and Trade, and sign agreements with Norfund's existing fund, as well as the new GPF window to manage assets.

We think that for the sake of continuity GPF-Growth should be a subsidiary of GPF-Global that we have suggested should be split into two windows. This is different from Norfund's proposal, party because we envisage GPF-Growth to be much bigger than the fund Norfund has suggested, and also anticipate that it would seek external mandates beyond Norfund that include the IFC, other DFIs and potentially managers in the private sector.

It is also very useful to look at the next box, in which NBIM describes how such investments would differ from its normal investments and what additional resources they may require. This is completely consistent with what Norfund suggests will be required and also in line with the experience of the author of this report.

Box 10: Managing an unlisted portfolio[97]

Investments in the private market differ structurally from investments in the public market. The investor must be prepared to hold an investment for a longer period. It will not be possible to sell the investment if developments are not as expected. Investments will not be transparent. A degree of reputational risk has to be expected with investments in the private market, both in terms of the manager and in terms of the underlying portfolio companies. An example of this might be negative news stories in connection with major organisational changes or strategy changes at portfolio companies.

With listed assets, periodic valuations and risk management will normally be based on transaction-based market prices. In the private market transactions are less frequent, so periodic valuations will be more uncertain and based on estimates.

The input of resources per krone invested will be higher than in the public market. This applies particularly to investments in private equity.

Unlisted investments demand administrative resources as explained below.

[97] Norges Bank, 2010, 'Norges Bank's assessment of the basis for unlisted investments focusing on the environment and sustainable growth'. http://www.nbim.no/Global/Documents/Submissions/2010/enclosure%20to%20the%20letter%2006072010.pdf

Legal evaluation and contract reviews: Although the partnership agreements that are entered into tend to have many similarities, each individual agreement needs to be reviewed and quality-assured. The need to negotiate special terms and conditions in the form of addenda must also be considered in each individual case.

Quality assurance of valuations: The valuation of unlisted fund investments will normally be based on periodic reporting from the manager. Different approaches to determining the fair value of the underlying investments also mean that there may be a need for quality assurance of the data reported. The reporting time lag (normally at least three months) means that there may be a need to adjust the figures received from managers in periods with large swings in financial markets.

Assessment of tax issues: Many institutional investors, such as pension funds and insurance companies, are exempt from taxation in their home country. Investment in private assets will often require separate assessment of the tax implications that the chosen structure can be expected to have.

Cash flow management: The investor needs to establish systems and procedures for effective management of irregular inward and outward payment flows. The structure with periodic payments in and out of the fund requires certain liquidity in other parts of the portfolio.

Allocating the investments of the GPF-Growth

As we have mentioned in the previous section, the GPF-Growth should begin operations by using the family of DFIs as external managers. It can also look beyond them, particularly for the larger and more mature markets amongst developing economies. The longer term goal should be to develop in-house capacity and this process can be catalysed by deploying staff on the ground alongside DFI fund managers, so they can learn by doing. Even so, the process of building a critical mass of in-house capacity will take years and even then the GPF-Growth is likely to continue to use DFIs for external mandates in the same way that the GPF today mixes in-house investments with external mandates, particularly for niche and specialist areas.

GPF-Growth should give out mandates to various DFIs based on a number of criteria such as:

- Historical performance,
- Management and governance structures,
- Country presence,
- Geographic focus,
- Expertise in various asset classes,
- Sector focus,
- Ethical track record,
- Track record of development impact.

Based on our research of the capacity of DFIs to make useful investments, and of the opportunities that exist in the developing world, we recommend that the GPF-Growth should target $30 billion of investments every year between 2014 and 2020 and seek to become a $200 billion dollar Fund that constitutes about 20% of the GPF-Global by 2020. Just to put things in perspective, the World Bank has estimated that Africa alone needs $31 bn a year for the next 10 years to get its infrastructure up to the level of the island nation of Mauritius. As we have discussed

in the Box on the funding gap on infrastructure, developing economies face an annual funding shortfall in infrastructure development of as much as $1 trillion every year. The largest gaps, in terms of percentage of GDP, are in Sub-Saharan-Africa and South Asia, the two regions that we have suggested the GPF-Growth should prioritize.

The question is whether there is enough diversity amongst the DFIs for this to work well, and whether they can offer enough capacity to successfully invest the large scale of funds the GPF-Growth will want to channel through them. The short answer to both questions is yes. The longer answer follows below.

DFIs made more than $30 bn of new investments in the private sector in developing countries in the form of loans, guarantees and equity positions in most of the recent years. Having spoken to a number of DFIs, including the IFC, CDC, the Soros Development Fund and Norfund, we have concluded that most could handle a doubling of the size of their investments without compromising on quality. In short, it is the shortage of funds, not investment opportunities, that limits the size of their operations.

What is interesting about the DFI landscape is that while there are some inevitable overlaps, most DFIs have found some niche or the other and focus on particular geographic areas or prioritize the use of certain instruments, or concentrate on certain sectors. This often makes their work complementary to that of the other DFIs.

For example, DFIs concentrate on different investment instruments. Some, such as CDC, COFIDES & Norfund, have a strong focus on using equity instruments, while others, such as DEG and FMO, mostly use loans, but none of them are heavy users of guarantee instruments[98]. Some, such as CDCs, also invest primarily through fund managers, whereas others invest more directly.

In terms of geographic focus, some, such as the UK's CDC and the Dutch FMO, follow country targets - 75% and 40% of their investments are in low-income countries respectively. Most others do not use such explicit targets for countries, but do concentrate their work in areas such as sub-Saharan Africa.

Most DFIs also follow some sector focus. For example, FMO concentrates on housing, energy and finance sectors. Three-quarters of its investments are in these sectors, which it argues are the sectors with the biggest development impact[99]. The EIB, in line with its operations in Europe, has infrastructure as its key development priority, because it delivers essential services such as clean water and access to power and plays an essential role in supporting trade, productivity and growth. This is also the PIDG's focus. Norfund is known for its specialization in hydropower, and the German DEG - in the agricultural sector.

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[98] Kingombe, C., 2011, 'Comparing Development Finance Institutions: A Literature Review', *ODI*. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/67635/comparing-DFIs.pdf

[99] FMO aims to select projects with the highest development impact – not just economic but also social and environmental.

When all DFIs are taken together, finance, infrastructure, industry and manufacturing are often the largest sectors. Agriculture and green investments perhaps get a lower share than might be optimal. While bilateral DFIs tend to support SMEs with finance, through both direct and indirect investments, the IFC often funds bigger projects. Overall, it is fair to conclude that the DFIs all have different areas of specialisation and expertise[100]that are often complementary.

DFIs often have multiple objectives, but the most common ones are investing in sustainable private sector projects, maximising development footprints, remaining financially viable and mobilizing additional private capital. Many, such as Norfund, also have additionality as a key objective, wherein they are committed to help support viable private sector businesses that would otherwise not have been started, because of high perceived risk or shortage of capital. While most are owned just by the public sector, some have a mixed private and public ownership structure and some are entirely in the private sector[101].

A big attraction for using DFIs to invest is their experience, good track record, dual mandate and country offices. A local presence is particularly important in developing country markets. 'Foreign investors perform better if they speak the dominant language of the market in which they are investing. A study of 32 countries shows that local analysts are more accurate in their estimates than those working from a base outside the country[102]. This is particularly true in the case of emerging markets and companies whose primary targets are local customers and consumers[103]." "All else being equal, this means that in venture capital better returns are obtained when the venture capitalist is physically close to their portfolio companies and runs smaller funds.[104]." Most DFIs have staff on the ground in multiple countries with the IFC, the largest DFI having an impressive network of 104 offices in 95 different countries.

Seeing the synergy that SWFs channelling investments through DFIs can bring, the IFC launched an initiative targeting exactly such partnerships, which is described in the box below.

[100] Kingombe, C., 2011, 'Comparing Development Finance Institutions: A Literature Review', *ODI*. https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/67635/comparing-DFIs.pdf
[101] ibid
[102] Bae, K. et al., 2008, 'Do local analysts know more? A cross-country study of the performance of local analysts and foreign analysts', *Journal of Financial Economics*. http://ideas.repec.org/a/eee/jfinec/v88y2008i3p581-606.html
[103] Norges Bank, 2010, 'Norges Bank's assessment of the basis for unlisted investments focusing on the environment and sustainable growth'. http://www.nbim.no/Global/Documents/Submissions/2010/enclosure%20to%20the%20letter%2006072010.pdf
[104] Phalippou, L., 2011, 'An evaluation of the potential for GPFG to achieve above average returns from investments in private equity and recommendations regarding benchmarking'. http://www.regjeringen.no/Upload/FIN/Statens%20pensjonsfond/2011/Phalippou.pdf

Box 11: The IFC Asset Management Company[105]

IFC Asset Management Company (AMC) mobilizes and manages third-party funds for investment in emerging markets. It manages funds on behalf of a wide variety of institutional investors, including sovereign funds, pension funds, and development finance institutions.

AMC helps IFC achieve one of its core development mandates—mobilizing additional capital resources for investment in productive private enterprise in developing countries. It invests in IFC projects. All AMC investments adopt IFC's Performance Standards regarding investee companies' environmental, social, and governance and other sustainability practices. Although wholly owned by IFC, AMC makes independent investment decisions and owes its fiduciary duty to the funds it manages.

AMC enhances IFC's development impact by increasing the size and number of investments IFC can transact. AMC also allows IFC to make investments that it would not have been able to execute on its own.

Leveraging IFC's network of more than 104 offices in 95 different countries, AMC introduces some of the world's largest investors to emerging markets in general and emerging-markets private equity in particular.

As of 15 September 2012, AMC had approximately $4.5 billion in assets under management. Separately, the Korea Investment Corporation (KIC) and State Oil Fund of the Republic of Azerbaijan (SOFAZ) each invested approximately $150 million in the International Finance Corporation's new African, Latin American, and Caribbean Fund, which has a mandate to find commercially viable opportunities to finance growth and jobs in the developing world.

Now that we have established that the DFIs offer a critical mass for the GPF-Growth to start channelling investments into developing economies, it is only prudent to also look at whether the DFIs are able to offer attractive returns for the Fund. Here the track record of DFIs is mostly good, with the majority delivering significant positive returns over their lifetime and in most years.

For example, the CDC, perhaps the DFI with the highest profitability, has organically grown its assets from GBP 638 million in 1999 to more than GBP 2.6 billion as of 2013. In the five year investment cycle from 2004 to 2008, CDC invested £1.5bn in private sector companies in Africa, Asia and Latin America and delivered average annual returns of 18% per annum. It doubled its net assets from £1.1bn to over £2.3bn.[106]

CDC also mobilized substantial additional capital, helping two of its fund managers, Aureos and Actis, attract over US $2.3bn in third party capital for investment in poor countries. In its operations, it generated £2.5bn of portfolio cash for reinvestment in developing economies and has committed over £2.7bn to investment funds, predominantly in Africa and Asia[107].

While none of the other DFIs have such a spectacular track record, many such as Norfund and the IFC have consistently delivered profits in excess of what the GPF

[105] International Finance Corporation, 2013, 'IFC Asset Management Company'. http://www1.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/what+we+do/ifc+asset+management+company
[106] CDC, 2013, 'Financial Performance'. http://www.cdcgroup.com/financial-performance.aspx
[107] ibid

has managed so far. Moreover, the GPF-Growth investments, which are channelled through the DFIs, will have a pure financial basis and will generate a higher rate of return that is more in line with what the private sector funds DFIs investing along achieve. Again, conversations with private equity funds, as well as the DFI's themselves, reveal that double-digit rates of return on GPF-Growth investments are easily achievable. These look more realistic if one considers that the rates of return on fixed capital both in China[108] and Africa[109] exceeded 20% for a number of decades.

Tackling climate risks

The GPF is, as we have discussed, heavily exposed to multiple dimensions of climate risk. The Box below, which is taken from another Re-Define publication, helps understand these risks.

Box 12: Sovereign Wealth Funds, Climate Risks and Opportunities[110]

Climate risks are particularly important to institutional investors. Many of the assets on their portfolios would be negatively impacted by the effect of climate change, for example, through the increased incidence of floods and droughts. Changes to policies pertaining to tackling climate change - such as a decision to increase carbon taxes or limit emissions trading quotas - would also affect many of their investments in utilities and energy intensive industries.

Yet another risk is reputational, where companies that are part of the portfolio of such investors could find their products boycotted or their reputation damaged if they are known to be laggards in taking action against climate change. Another risk is that of changes in consumer behaviour. As US carmakers that were selling fuel-guzzling cars found out to their detriment in the mid-2000s, customers can be fickle with their choices and companies that do not focus on producing energy efficient products or cutting their own energy consumption are putting themselves on the wrong side of trends in customer behaviour and regulatory action.

Such investors usually hold universal portfolios i.e. are exposed to most of the major asset classes and a significant proportion of them have long investment horizons. This means that they have a strong motivation to be concerned about externalities across both time and space. Actions such as excessive carbon emissions by some of the companies they are invested in that can have negative implications for some of their other investments either in the present or in the future will impact their bottom line. Hence, such externalities, which are one of the main drivers of under-investment in green sectors are at least partially internalized by longer term investors. This implies that they can potentially be champions of such green investing.

Because excessive emissions will have a significant impact on the returns they can expect from their investments and from their portfolios as a whole, they have a strong incentive encourage polluting companies to act in a way that is better aligned with successfully tackling climate change.

In fact, talking about climate risks alone is inappropriate. It is equally pertinent to talk about climate opportunity, wherein the expected growth in green investments, the on-going development of new promising green technologies and the large scale development of energy efficient products are all

[108] Wen, Y., 2012, 'Reducing the U.S. Deficit by Recycling Capital Inflows', *Fed Reserve Bank of St. Louis.* http://research.stlouisfed.org/publications/es/article/9332 and Wang, P., Wen, Y. and Xu, Z., 2012, 'Two-way capital flows and global imbalances: A neoclassical approach', *Federal Reserve Bank of St. Louis.* http://research.stlouisfed.org/wp/2012/2012-016.pdf

[109] Bigsten, A. et al., 1998, 'Rates of Return on Physical and Human Capital in Africa's Manufacturing Sector'. http://users.ox.ac.uk/~econ0087/hcteal.pdf

[110] Re-Define, 2011, 'Funding the Green New Deal: Building a Green Financial System'. http://re-define.org/sites/default/files/GEF-Funding%20the%20GND%20web.pdf

very promising investment opportunities - where medium to long term investors have a competitive advantage.

They could, for example, persuade the companies they invest in to make energy efficient investments and choose to invest in firms developing promising new low carbon technologies (LCTs). Long-term investors in particular are perfectly placed to take advantage of illiquid investments, investments under-priced by markets and investments driven by secular trends such as the need to tackle climate change. Green investments tick all three of these criteria.

Grantham LSE/Vivid Economics has estimated that the cost of carbon could be $110/tC02e to $220/tC02e by 2030 across a number of mitigation scenarios that they have modelled and at this level the economics of many industries, not just particular companies, can completely change, thus having a substantial positive or negative impact on the portfolios of investors.

In a comprehensive study, the consultancy Mercer has estimated that a typical portfolio seeking a 7% return could manage the risk of climate change by ensuring around 40% of assets are held in climate-sensitive assets. They also suggest that investors.

- Need to introduce a climate risk assessment into on-going strategic reviews
- Increase asset allocation to climate-sensitive assets as a climate "hedge"
- Use sustainability themed indices in passive portfolios
- Encourage fund managers to proactively consider and manage climate risks
- And engage with companies to request improved disclosure on climate risks

Fossil fuel funded sovereign wealth funds such as the Norwegian GPF are perhaps the best source of funding for green investments. They are heavily exposed to dirty industries, as the new money flows come from the sale of oil and gas, so they have a massive downside risk in actions being taken to mitigate climate change. That is why it makes financial sense for them to diversify their risks by actively investing in industries that will benefit from the policy measures taken to tackle climate change and new Low Carbon Technologies that are being developed with zeal.

As the discussion in this box and in the opening section of this chapter shows, the Norwegian GPF ought to take a more serious and strategic approach to tackling the climate risks (and opportunities it faces). In addition to the measures laid out in the box above, the GPF needs to incorporate managing climate risks not in its ethical guidelines, where it belongs along-side market risk, credit risk and operational risk. Such a change would inevitably lead the GPF to divest most of its carbon intensive assets and would also, from a risk diversification perspective, lead to a more positive focus on investing in green assets.

Conclusion

At present there are a number of proposals being discussed in the Norwegian political debate on how the GPF should be reformed. The good thing is that they all recognize that something needs to be changed. There is a perception, which we believe is justified, that the GPF is under-performing. There is another perception, once again justified, that the GPF has no strategy to tackle risks arising from climate change. In this chapter we have rejected the proposals to split the Fund either

because it is too cumbersome or in order to induce competition between the new entities.

Instead, we have, on the basis of sound analysis in previous chapters that we have developed in detail in this chapter, recommended that the Fund indeed be split up, but along functional lines. A new GPF-Growth window that invests around $30bn every year to target reaching $200bn by 2020 should be set up. This should invest primarily in developing countries through private (growth) equity and in infrastructure projects, not in public equity markets. Within this, Sub-Saharan Africa and South Asia should be priority areas. Meanwhile, the main Fund should continue to focus on more liquid investments, but move to a negative screening approach to countries and try to allocate equity investments on the basis of both market capitalization and GDP and bond investments in accordance with GDP.

We have clearly laid out the logic for this split – that the risk management expertise, the management talent, reporting and due diligence etc. required for the two funds is sufficiently different from each other to justify such a split.

We have also laid out a strong case for the GPF-Growth starting to invest immediately through DFIs such as Norfund, CDC and IFC, using them much as the GPF currently uses external mandates. Such a move would be good for development and good for Norway.

We have also suggested that the GPF put climate risk alongside other forms of risk it manages at the portfolio level. This, when used with methodologies such as carbon stress tests, will lead to a greening of the whole portfolio of the GPF without even having to take ethical considerations into account as being green for the GPF is essential purely from a risk management perspective.

Taking the steps recommended in this chapter will mean that changes to the GPF will be good for Norway, good for development and good for the environment. The analysis in this report is targeted towards informing the political and technical debate.

Chapter 6: The development potential of the GPF

The previous sections in this report have shown how investing in developing economies will be good for Norway and deliver a lower risk and higher return for the GPF-Growth. In this last chapter we focus showing that this fund would also be good for development.

As Bank Ki Moon, the UN Secretary General has said, 'We cannot afford not to invest in the developing world. We all know that it is where the greatest need is; but that is also where some of the greatest dynamism is' (UN Global Compact Leaders Summit, June 2010). This is consistent with the research presented in this report and the organizational stance of Re-Define based on our work in financial markets and in developing and developed economies.

Former UN Secretary General Kofi Annan has rightly pointed out that 'It is the absence of broad-based business activity, not its presence, which condemns much of humanity to suffering. Indeed, what is Utopian is the notion that poverty can be overcome without the active engagement of business.' This indeed is the reason that DFIs exist at all or that donors, in their aid programs, often pay attention to the development of the private sector.

Even non-governmental organisations that are less naturally supportive of the role of the private sector in development are increasingly involved in promoting entrepreneurship, access to finance and the development of private equity and infrastructure investments in poor economies.

Oxfam, in launching its 'Better Returns Better World' project that seeks to attract investors to poor countries with the prospect of higher profits, as well as a positive development impact, now accepts that the goals of good profitability and a positive development impact are, in fact, compatible. It states 'there are both compelling commercial and ethical arguments for investors to make a much greater contribution to the delivery of poverty alleviation and development goals[111]' - a sentiment Re-Define agrees with entirely.

As part of this program, the development NGO Oxfam has itself become an investor in the developing world focussed on the dual goals of profitability and development that we believe the GPF-Growth will deliver. The foundation of the project is Oxfam's belief that 'there are both compelling commercial and ethical arguments for investors to make a much greater contribution to the delivery of poverty alleviation and development goals', a belief shared by us at Re-Define.

[111] Crossley, R. et al., 2010, 'Better Returns in a Better World: Responsible investment – overcoming the barriers and seeing the returns', *Oxfam.* http://www.oxfam.org/sites/www.oxfam.org/files/better-returns-better-world-181110-en.pdf

Box 13: Oxfam as an Investor

Oxfam has launched a Small Enterprise Impact Investing Fund – as a joint initiative between itself, the City of London Corporation and Symbiotics, a Swiss microfinance firm. The fund will support social projects and provide financial returns for its investors.

SEIIF aims to raise $100m and make debt and equity investments targeted at financial intermediaries supporting small businesses with a strong focus on food production and sustainability[112]. According to its promoters, this new fund will assist embryonic and small businesses and in doing so generate wealth, employment and economic growth in areas where business potential has historically been constrained due to a lack of affordable capital[113].

'The fund is intended as a low-risk product, targeting returns of 5% with capital preservation. Investors will be locked in for an initial five-year period, with quarterly redemptions thereafter[114].'

With the exception of some developing/emerging economies such as China and some other countries in East Asia, most developing countries have rather low savings rates and can be accurately characterized as labour rich, capital poor. For example, the savings rate in the Least Developed Countries group in recent decades has only been 6.7%, a fraction of the 38% seen in China, which admittedly is an outlier. Without external funding and capital support, GDP per capita in LDCs would have been 3% lower than observed. The need for private capital for the development of industry and economy is still considerable[115]. There is an almost $1 trillion per year funding gap for financing much needed infrastructure in developing countries.

However, foreign sources of funds, especially in the form of aid flows, portfolio investments and lending, are highly volatile and, hence, potentially problematic for the purpose of sustainable development. Reliance on external financing leaves countries vulnerable to the vagaries of the international economy, over which they have little or no control. Interest rates move up or down in response to monetary policy in developed countries, while commodity prices can fluctuate up to 70% one year to the next. In general, the availability of external funds for developing countries is too little, too volatile and too pro-cyclical[116].

For the purpose of sustainable development then it is essential to tap stable sources of funds. What better source for these than the GPF which by its nature has a very long-term horizon, a responsibility mandate and a higher than average tolerance for short-term losses in pursuit of longer-term profitability? The GPF can be a perfect partner for the development finance institutions that seek to plug this funding gap and meet the challenge of promoting private sector development and growth in developing economies. The GPF's current approach, where it buys assets when others are selling (as enshrined in its recent rebalancing rule) is perfect for providing

[112] Grene, S., 2012, 'Oxfam turns investor with Mongolia loan', *FT.* http://www.ft.com/cms/s/0/b5b42004-0f10-11e2-9343-00144feabdc0.html#axzz2As71tIeH
[113] Grene, S., 2012, 'Oxfam moves into fund world', *FT.* http://www.ft.com/cms/s/0/f05e207a-434a-11e1-9f28-00144feab49a.html#axzz2AzeIPndS
[114] ibid
[115] Hovland, K., November 2 2012, 'Norway Oil Fund CEO: Cutting Share of European Stocks to Take Years', *WSJ.* http://online.wsj.com/article/SB10001424052970204712904578094720410699536.html?KEYWORDS=Norway+Oil+Fund+CEO%3A+Cutting+Share+of+European+Stocks+to+Take+Years
[116] Aidwatch, 2013, 'Global financial flows aid and development'. http://eurodad.org/wp-content/uploads/2013/03/2013_AW-Briefing-paper_Global-financial-flows-aid-and-development1.pdf

much needed stable, long-term and counter-cyclical financing particularly for Sub-Saharan Africa and South Asia, where the funding shortfall is the greatest.

Explaining the kinds of funds that many of the least developed countries face, Lars Thunell, the former head of the IFC, has said,

'Take South Sudan. There is no electrical utility there. One percent of the population has access to electricity. But it is based on their own generators. You need to have electricity if you are going to have manufacturing, if you are going to have your children be able to do their homework, if you are going to be able to cook food. Transport is also very important, because many countries in Africa are landlocked. Within a plant itself, you can reach very similar productivity numbers that you could reach in China. But getting things in and out is very, very expensive. So you become totally uncompetitive on a worldwide basis. If you look at jobs and creating the environment for small- and medium-sized enterprises— because that is where you have the most people employed—what matters is the investment climate, then access to finance.'

The following box from the IFC illustrates the scale of challenges faced by poor developing countries.

Box 14: Challenges faced by developing countries[117]

Today **1.6 billion people**, a quarter of the world's population, **live without electricity.** For those who do have access, supply is often irregular and expensive. Electricity is cited more frequently than any other obstacle to doing business by firms in emerging-market countries. At current rates of investment, the number of people without access to electricity will decline only slightly, from 1.4 billion in 2009 to 1.2 billion by 2030.

Achieving universal access to electricity would require an additional annual average investment of $36 billion globally. The heart of the debate about energy is how to use all energy sources more efficiently, expand supplies, and increase access for the world's poor in ways that will ensure a sustainable future for all.

An estimated 880 million people lack access to **safe water** and 2.5 billion people are without **sanitation**. More than a billion people lack access to either an **all-weather road** or **telephone services**. Helping to deliver this infrastructure is a development priority. The lack of infrastructure is particularly acute in **Sub-Saharan Africa,** where 73 % of households are without basic sanitation.

The need for more capital in poor developing countries is acute. Economic theory and real world experience point to a minimum threshold of capital being needed before modern production processes can start. For example, factory production requires basic infrastructure – roads, functioning ports, electricity, a literate and numerate workforce. Once this basic infrastructure and human capital achieved, then marginal productivity has potential to become very high in low-income countries.

The need for external capital support and the very useful role that DFIs and the GPF-Growth can play is clear from the fact that impoverished households have very low savings rates. The lack of capital, savings and high endemic population growth rates in many poor developing countries result in the poor becoming poorer. Only when the economy has a capital-labour ratio above a certain minimum threshold, can it achieve economic growth.

[117] International Finance Corporation, 2013. http://www1.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/home

Challenges in promoting the development impact

No matter how suitable the GPF may be to invest in developing economies, in order to truly have a positive development impact the GPF-Growth and other investors need to not only invest in certain sector in poor developing countries, but also engage actively on multiple fronts, as this report also recommends. As Oxfam suggests, there are four main ways in which institutional investors can contribute to poverty reduction and development. These are:

- The allocation of capital to different asset classes, regions or countries,
- The allocation of capital to specific companies,
- Engagement with companies to influence their policies and practices,
- Engagement with public policy makers on poverty and development issues.

Despite the optimistic message in the report so far, it would be silly not to recognize that there would be some people sceptical about a core premise of this report, that it is possible to pursue profitability and have a positive development impact at the same time. One is right to be concerned, because these goals may often be difficult to reconcile, but this is not impossible. These difficulties have often been highlighted in the functioning of the DFIs. Looking at how DFIs fare on their pursuit of dual goals may have lessons for the way in which the GPF-Growth ought to allocate and manage its investments, particularly along the lines of what Oxfam has said are the main ways institutional investors can increase their positive impact on tackling poverty.

For example, the Independent Evaluation Group (IEG), the World Bank's independent watch-dog, has implied that the IFC may not be paying as much attention to its development impact as it ought to. In its latest report, it has suggested that the IFC 'should pledge to ensure that its operations focus as much on poverty reduction in developing countries, as securing economic returns for investors[118].'

The report suggests that, while the IFC has generated good financial returns, it has failed to prioritize poverty reduction enough at both the design phase of its projects and in the evaluation of their impacts. It also suggests that a greater focus should be put on lending to sectors such as telecommunications, agribusiness and infrastructure, which had been seen to provide jobs directly and facilitate private business for the poor.

This evaluation has important lessons for GPF-Growth. It means that the sector allocation of the GPF-Growth's investments will be very relevant for its overall development impact, so sectors such as infrastructure, agribusiness and telecoms should be prioritized. It also means that it is important to consider both profitability, as well as likely development impact at both the design phase of the project, and its final evaluation. This means that the GPF-Growth should, to the extent possible, ensure that both ex-ante and ex-post practices to assess the development impact of DFI investments should be improved as a pre-condition for qualifying for GPF-

[118] Giles, C., April 29 2011, 'World Bank arm to target poverty', *FT.* http://www.ft.com/intl/cms/s/0/e2fb55be-71be-11e0-9adf-00144feabdc0.html#axzz2bfWxaKE6

Growth investments. Given the near doubling of resources the GPF-Growth can deliver to DFIs, it can have a lot of leverage on this point and it should exploit this. This will not only mean that its investments would be more sustainable, but also that it will minimise the reputational risks that the MoF worries about and maximise its development footprint.

Moreover, as we have suggested in previous chapters, the GPF-Growth should focus on metrics that show an improvement in the ethical, development and environmental criterion important for Norwegian citizens, the ultimate owners of the Fund. It should set a lower entry bar on these issues than it does for its investments in developed economies (where in reality it does not even have sufficient information to assess the impact of its investments as highlighted by the OECD[119]), but focus on delivering improvements through an active engagement.

Development impact through job creation

The high current level of unemployment and low quality of many of the jobs is one of the most serious developmental challenges facing the developing world. This is not only a challenge in the least developed countries, but also in more dynamic emerging economies such as South Africa and India.

A lack of decent jobs not only depresses the GDP and growth prospects by reducing aggregate demand and the productive potential of an economy, but also creates security problems. It reduces the tax take of the government, which in turn reduces its potential to deliver welfare and basic services, such as healthcare and education. In fact, as the IFC states in its jobs report[120] 'Jobs boost living standards, raise productivity, and foster social cohesion, and they are the main path out of poverty.'

The IFC goes on to highlight the scale of the development challenge by saying that 'by 2020, 600 million jobs must be created in developing countries—mainly in Africa and Asia—just to accommodate young people entering the workforce.

In developing countries, the quality of jobs is just as important. Almost a third of workers are poor, and about half—particularly women—are vulnerable, often working in informal jobs, which frequently provide fewer rights and protections for workers.'

The urgent need for an expansion of the role of DFIs, whose mandate it is to foster the creation of sustainable private enterprises in developing countries, is highlighted by the fact that the private sector provides 9 out of 10 jobs in developing economies. Within this, Small and Medium Enterprises (SMEs) represent two-thirds of all permanent full-time employment.

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[119] Milne, R., August 8 2013, 'Norway's oil fund urged to boost ethical credentials', *FT.* http://www.ft.com/intl/cms/s/0/735865bc-ef07-11e2-9269-00144feabdc0.html#axzz2bY8x1q8W

[120] International Finance Corporation, 2013, 'IFC Jobs Study: Assessing private sector contributions to job creation and poverty reduction'. http://www1.ifc.org/wps/wcm/connect/5c201d004e2c09d28d32ad7a9dd66321/IFC_Job+Study+Condensed+Report..pdf?MOD=AJPERES

To the extent that DFIs and the GPF-Growth, by extension, can help remove bottlenecks, such as a lack of access to funding by providing funding to such entities directly or indirectly, they can have a large development impact through growth and additional job creation.

Many DFIs such as the IFC have the creation of private sector jobs as a top priority and often measure their development impact by measuring the number of additional jobs created as a direct and indirect result of their investments. We recommend that the GPF-Growth use the same metrics as the IFC and other DFIs do in order to measure and report on its positive development impact. This would also indicate a shift away from the passive approach it has taken so far to its ethical guidelines and responsibility mandate to a more proactive approach.

What is crucial is that the GPG-growth will have both a unique opportunity and a unique responsibility, given its scale, to improve the measurement techniques used to measure development impact, as well as the techniques used to maximise development outcomes.

Investments by DFIs have a number of direct and indirect effects on job creation. These are generally classified as

- Direct jobs (jobs in a company);
- Indirect jobs (jobs created in the company's suppliers and distributors);
- Induced jobs (jobs resulting from direct and indirect employees of the company spending more money);
- Second order growth-effect jobs (jobs resulting from the removal of an obstacle to growth);
- Net job creation (accounting for job losses in the company's competitors).

Box 15: How many jobs does the IFC create? [121]

Among IFC client companies, the number of direct jobs created, net of job losses, tends to be small, but the number of indirect jobs generated can be significant, though more difficult to measure. In a variety of sectors— agribusiness, cement, tourism, steel, and infrastructure—the total job effects can be a large multiple of direct jobs, and vary by country, industry, and company.

Job creation resulting from improved access to services, such as finance and electricity, also can be very large. For example, IFC client companies provided some 2.5 million direct jobs in 2011. But the number of indirect jobs ranged from 7 times to 25 times as many direct jobs in the case studies that IFC conducted. Moreover, these indirect jobs benefited the unskilled and the poor.
The GPF-Growth's contribution to infrastructure investments in developing countries can have a huge positive development impact as a lack of infrastructure, such as lack of access to power, is often cited as the most important factor that holds back private enterprises in the developing world.

[121] ibid

Based on its direct and indirect effects, additional investments of $200 billion by the GPF-Growth can help create as many as 100 million jobs in the private sector in poor developing economies, thereby having a substantial positive outcome on growth potential, poverty reduction and quality of life in these countries.

Conclusion

The GPF-Growth can maximise its development impact by prioritising sectors such as infrastructure investments, SME funding and agriculture. Geographically, it should concentrate most on Sub-Saharan Africa and South Asia, the two regions with the biggest funding shortfalls, highest growth potential and biggest development needs.

While DFIs have generally delivered positive development outcomes, they have come in for criticism for having put profit motives over their development mandates. Some such as the IFC, have come under criticism for not having the tools to measure their development impact properly. Hence, we recommend that the GPF-Growth use its large size that can double the resources the DFIs are able to channel every year, as a strong leverage point to ensure that the DFIs spruce up their practices for maximising and evaluating their true development footprint.

Overall, we recommend that the IFC's approach of focusing on job creation is the right one.

We also believe that the GPF-Growth should engage actively, as suggested by Oxfam's guidelines, and the focus of its ethical guidelines should be on registering improvement through active engagement - not through the kind of crude negative screening the GPF has been using thus far.

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DISCUSSION PAPER

This report deals with why Norway should invest more of it's oil wealth in developing countries. It outlines the investment rationale for doing so and how this can be done while considering development and the environment.

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