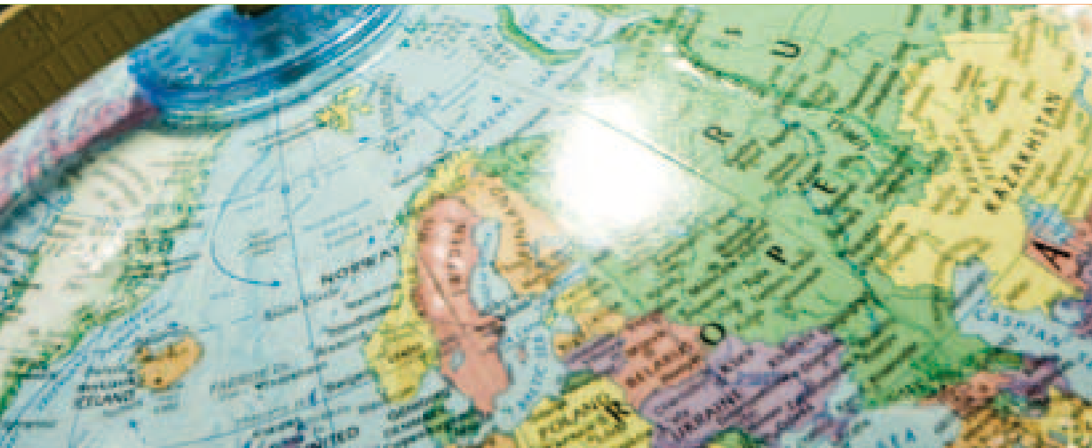
GOVERNMENT PENSION FUND – GLOBAL **ANNUAL REPORT**



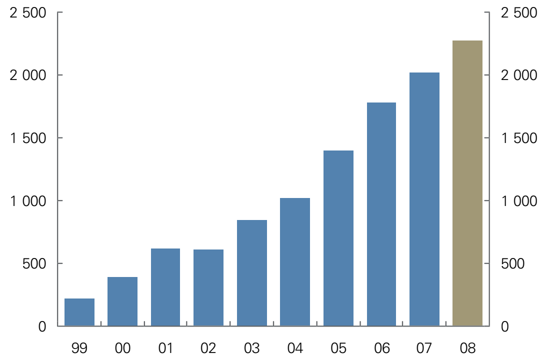
2008

NBIM
Norges Bank Investment Management

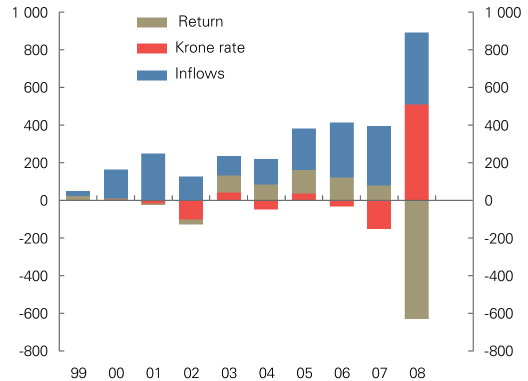
2008 in brief

- The financial crisis and global economic downturn presented major challenges for all areas of investment management.
- The market value of the Government Pension Fund – Global was NOK 2 275 billion at the end of 2008.
- Inflows of capital into the fund were record-high at NOK 384 billion and invested entirely in global equity markets.
- The fund's ownership of global equity markets rose to 0.77 per cent. The fund's allocation to equities was 49.6 per cent.
- The return on the fund was -23.3 per cent in international currency, the weakest result in the fund's history.
- The operational management of the fund generated a negative excess return of 3.37 per cent, which is considerably weaker than we would have expected given our investment strategy.
- Norges Bank Investment Management (NBIM) is making significant changes to its investment strategy in order to make better use of the fund's size and long-term investment horizon.

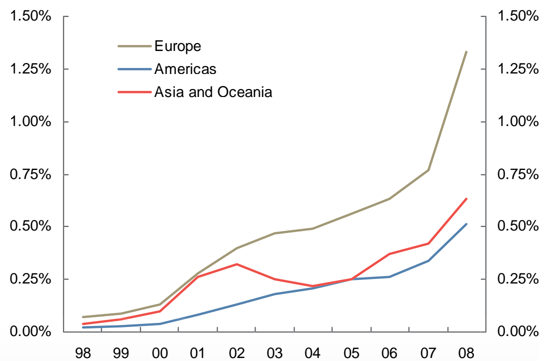
Market value of the Government Pension Fund – Global. Billions of NOK



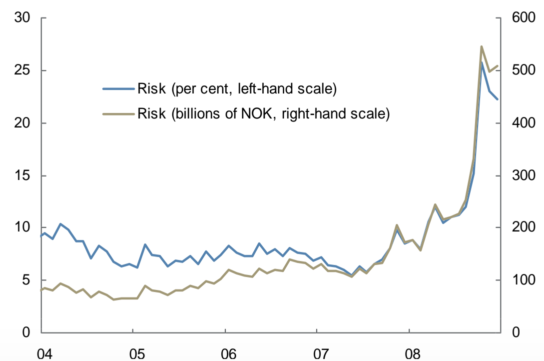
Changes in market value. Billions of NOK



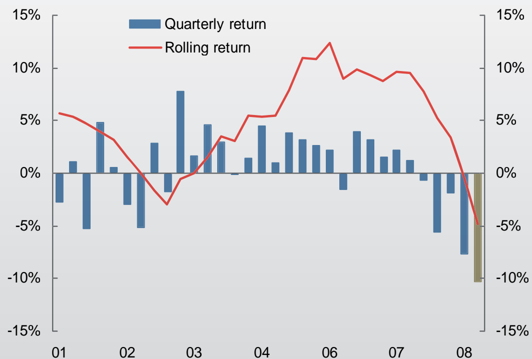
Ownership of equity markets. Per cent



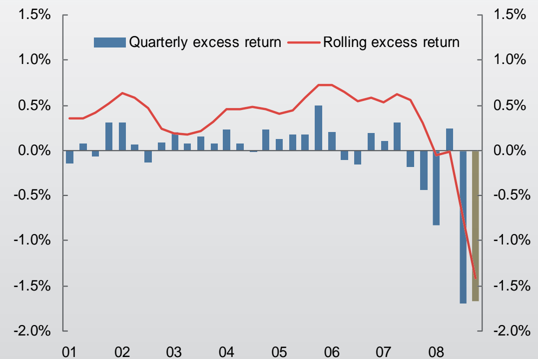
Absolute volatility. Per cent and billions of NOK



Quarterly return and three-year rolling annualised return. Per cent



Quarterly excess return and three-year rolling annualised excess return. Per cent



Our goal is to foster the financial interests of the fund's owners through active management and active ownership

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Published on www.nbim.no

Holdings

Disclosure of voting record

Global benchmark portfolio on 31 December 2008

Methodology for the calculation of returns

Exclusion of companies

Provisions on the management of the Government Pension Fund

Translation from Norwegian. For information only.

Svein Gjedrem
– Investing for the long term

The financial crisis has dealt a heavy blow to our investments in global equity and fixed income markets. The annual real return since Norges Bank commenced the operational management of the Government Pension Fund – Global is now just 1 per cent, which is well below the long-term return of 4 per cent assumed by the State. The fund has not reaped a risk premium in the equity market as we had expected.

During the same period, the nation has generated considerable revenue from the exploitation of petroleum resources. Global capital markets give us an opportunity to distribute the spending of this revenue between current and future generations. There are no other options for investing this wealth that could have shielded the fund from the global economic downturn. Other State assets, such as its shareholdings in industry and petroleum reserves in the North Sea, have also fallen sharply in value.

The fund is a long-term savings plan and capable of riding out large swings in the markets. This is the very foundation of the investment strategy with its high allocation to equities. Our ability to adhere to this strategy in a critical phase – even if this should last some time – is crucial if the fund is to deliver the returns we expect in the longer term. We need to attach importance to the real value of equity investments and safeguard assets by spreading the fund's investments. Norges Bank therefore supports the strategy that the State has chosen for the fund.

Our goal for the operational management of the fund is to foster its owners' financial interests through active management and active ownership. The results of our operational management in 2008 were disappointing. Our target is to add 25 basis points to the return on the fund over time. After a number of good years, last year's performance has put us right back where we started.

The financial crisis has revealed weaknesses in our active management. Norges Bank's Executive Board has reinforced its oversight of the Bank's investment management. Among other things, it has issued a new investment mandate to the Executive Director of NBIM. This mandate delegates investment management responsibility and defines the risk profile for investment management with the use of supplementary risk management methods.

The fund currently has extensive holdings of bonds that are difficult to trade in today's market, and the return on the fund needs to be seen in this light. Realised losses have been limited. The flipside of large book losses is that this portfolio has a high yield, reflecting not only the increase in credit risk but also a high liquidity premium and fears and uncertainty in the market. History has seen several incidences of deep financial crises, and market conditions will return to normal in time. The true value of the bond portfolio will, at the very latest, be realised when the loans are repaid.

As with the fund's long-term investment strategy, the results of our operational management of the fund need to be measured over the longer term. I am confident that the operation we have built up on the basis of the fund's size and long-term approach, with its specialist expertise and proximity to the markets, will deliver good results.

Oslo, 11 March 2009

Svein Gjedrem

Governor of Norges Bank and Chairman of the Executive Board

Our ability to adhere to this strategy in a critical phase is crucial if the fund is to deliver the returns we expect in the longer term

Yngve Slyngstad

An unusually demanding year

2008 was dominated by the global financial crisis. The challenges for our investment management were considerable, and the return for the year was -23.3 per cent in international currency.

During the year, we saw a bank, credit and liquidity crisis in the financial system which has gradually come to encompass a crisis in the real economy. The sharp fall in global equity prices was extraordinarily steep.

High oil prices led to record-high inflows of capital into the Government Pension Fund – Global of NOK 384 billion in 2008. The fund's market value was NOK 2 276 billion at the end of the year. The Ministry of Finance has decided to increase the allocation to equities in the fund from 40 to 60 per cent, and we made record purchases in equity markets during the year. Some 40 per cent of the equities currently held by the fund were acquired during the year. The fund now has holdings in almost 7 900 companies and owns approximately 0.77 per cent of global equity markets.

The fund has a much longer investment horizon than the vast majority of investors. The key question is how good today's investments will prove in the long term.

The return we generated in 2008 was 3.4 per cent lower than that on the benchmark portfolio against which we are measured. This is considerably worse than we had expected in the light of our investment strategy with large number of small and independent positions. This poor performance was due primarily to the investments in the fixed income portfolio proving less well-diversified than we had expected, and to us having made investments that exposed us to changes in the price of liquidity.

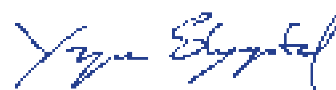
We have learned from this and made changes to our investment strategy. The idea is to turn our size and long-term investment horizon increasingly to the fund's advantage. We are also further increasing our risk management capacity.

We make active use of our ownership rights to safeguard financial wealth for future generations by promoting good corporate governance. We also encourage high ethical and environmental standards at investee companies. Our active ownership practices have been strengthened, and we have achieved results in our work to combat child labour, which is one of our priority areas.

Norges Bank Investment Management (NBIM) is a global centre of excellence thanks to a highly skilled, specialised and innovative workforce. At the end of 2008, NBIM had 217 employees at offices in Oslo, London, Shanghai and New York.

Norges Bank aims to provide open and detailed information on its investment management activities. We hope that this report gives readers a useful insight into these activities.

Oslo, 11 March 2009



Yngve Slyngstad
Executive Director NBIM

The fund made record purchases in equity markets in 2008 and is now a shareholder in almost 7 900 companies around the world

Governance model

Achieving our investment objectives

The Government Pension Fund – Global is to support government saving to finance pension expenditure and underpin long-term considerations in the use of Norway's petroleum revenue.

The Storting (Norwegian parliament) laid down the framework for the fund in the Government Pension Fund Act. The fund is administered by the Ministry of Finance pursuant to that act. The Ministry of Finance then sets the main rules for the fund's investments in its regulations and supplementary provisions.

The Ministry has also issued ethical guidelines for the fund. The fund is an instrument for ensuring that a reasonable share of Norway's petroleum wealth benefits future generations, and there is an ethical obligation for today's generation to manage the fund responsibly so that it produces a good long-term return.

The operational management of the fund has been delegated to Norges Bank. A management agreement, which further regulates the relationship between the Ministry of Finance as client and Norges Bank as operational manager, has also been entered into.

Executive Board reinforces oversight

The Executive Board has overriding responsibility for Norges Bank's operations. The Executive Board consists of seven members, all appointed by the King. The Governor and Deputy Governor of Norges Bank are its chairman and vice-chairman respectively.

In recent years, the Executive Board has reinforced its oversight of investment management at Norges Bank. In 2006, an Advisory Board was set up to support the Executive Board's work on investment management.

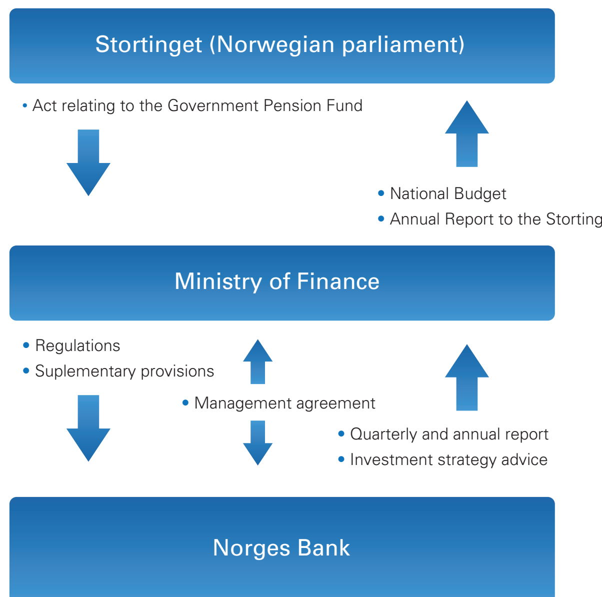
In 2007, an Audit Committee was created, consisting of three of the Executive Board's external members. The committee serves as a preparatory body for the Executive Board on matters relating to the Board's oversight functions and responsibility for risk management and internal control.

Supervision and auditing

Norges Bank's Supervisory Council organises audits pursuant to the Norges Bank Act. Central Bank Audit submits an audit report to the Supervisory Council on the Bank's annual financial statements. In 2007, the Supervisory Council entered into an agreement with accountancy firm Deloitte AS on financial auditing of the Government Pension Fund – Global. Deloitte and Central Bank Audit submit a separate audit statement to the Supervisory Board on the financial reporting for the Government Pension Fund – Global, presented in a note to Norges Bank's annual financial statements.

The Office of the Auditor General is responsible for the final audit of the Government Pension Fund – Global in the national accounts, and bases its work partly on material from Central Bank Audit under the terms of an agreement.

Underlying these objectives is an acknowledgement that Norges Bank manages substantial assets on behalf of Norwegian society



The Executive Board establishes the framework for NBIM's operations through strategy plans. The main objectives are to create added value through active management of the government's and Norges Bank's foreign financial assets, foster the owners' long-term financial interests through active corporate governance, and implement the owners' management strategy in a cost-effective, prudent and confidence-inspiring manner. Underlying these objectives is an acknowledgement that Norges Bank manages substantial assets on behalf of Norwegian society.

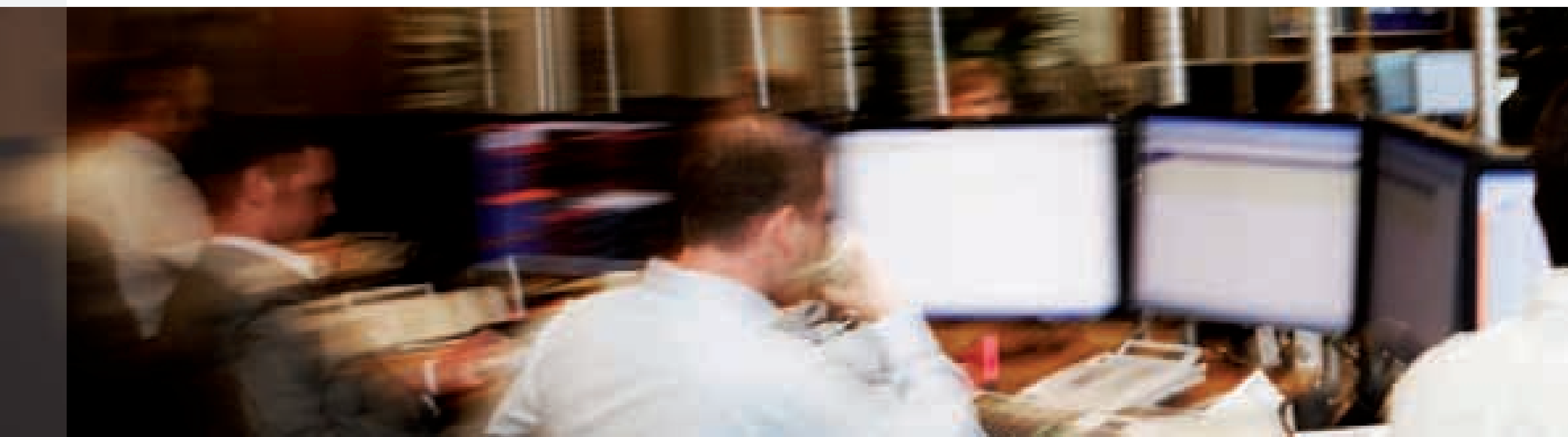
New guidelines for Executive Director of NBIM

In 2008, the Executive Board issued a new job description and investment mandate for the Executive Director of NBIM. The job description sets out his responsibilities and duties, including his responsibility for planning and organising operations, oversight and control.

The investment mandate for the Executive Director of NBIM supplements the investment framework established by the Ministry of Finance. The Executive Board delegates management responsibility and establishes a risk profile based on the main categories for risk management: statistical models, absolute deviation from the benchmark portfolio, factor exposures, and liquidity exposure. The mandate also defines the investment universe and sets out reporting requirements.

NBIM's role

To safeguard and build financial wealth



Norges Bank Investment Management (NBIM) has been entrusted with the operational management of the fund. The objective of NBIM's operations is to safeguard and build financial wealth for future generations.

The Ministry of Finance sets the key requirements for the fund's investments, its investment universe and asset mix, the maximum holding in individual companies, and the limits for Norges Bank's active management. The Ministry has also issued ethical guidelines for the fund's investments.

The management of the fund is handled by a separate wing of the bank, Norges Bank Investment Management (NBIM). The overall objective of NBIM's operations is to safeguard and build financial wealth for future generations by realising the owners' management strategy responsibly and cost-effectively.

Our goal for the management of the government's foreign financial assets is to safeguard the owners' long-term financial interests through active management and ownership.

NBIM performs several important tasks

We ensure that capital flowing into the Government Pension Fund – Global is invested in the markets at the lowest possible cost in line with the guidelines issued by the Ministry of Finance.

Once capital has been invested in the markets, we ensure cost-effective exposure to the benchmark portfolio that expresses the client's strategic priorities.

Our goal is to foster the financial interests of the fund's owners through active management and active ownership

We aim to outperform the benchmark portfolio defined by the Ministry of Finance. Our goal is an average annual net excess return of 25 basis points.

We make active use of our ownership rights to safeguard the fund's financial wealth by promoting good corporate governance and by demanding high ethical, social and environmental standards of investee companies. This active ownership reflects the ethical basis for the management of the fund as set out in the ethical guidelines for the fund.

Norges Bank advises the Ministry of Finance on the fund's long-term investment strategy. The aim is to generate the highest possible long-term return within the bounds of the owners' risk preferences.

The introduction of new capital, implementation of the client's investment strategy and exercise of ownership rights are best carried out as a combined process within the same organisation. Active investment management, on the other hand, is performed with the help of a large number of external management organisations as well as NBIM's internal managers. The Ministry of Finance takes advice on the development of the investment strategy for the fund from a variety of sources and draws its own conclusions.

The strategic benchmark portfolio

The strategic benchmark portfolio for the Government Pension Fund – Global is composed of FTSE equity indices for companies in 46 countries and of Lehman Global Aggregate fixed income indices in 11 currencies. The equity portion of the benchmark consists of equities listed on stock exchanges in Europe (50 per cent), the Americas and Africa (35 per cent), and Asia and Oceania (15 per cent). The regional distribution of the fixed income benchmark is 60 per cent Europe, 35 per cent Americas, and 5 per cent Asia and Oceania.

Norges Bank's website

The text of the Government Pension Fund Act and the regulations, supplementary provisions and guidelines issued by the Ministry of Finance are available via Norges Bank's website (www.norges-bank.no). All reports published on the management of the fund, as well as background material on the fund's strategy and the organisation of investment management at Norges Bank, are also available on the website.

Investment strategy

Making important changes

The broad lines of the investment strategy pursued by NBIM have been consistent over time, but 2008 brought important changes in the implementation of this strategy. The idea is to turn the fund's size and long-term investment horizon increasingly to its advantage.

Norges Bank advises the Ministry of Finance on the strategic direction of the Government Pension Fund – Global. We believe that it is appropriate gradually to extend the fund's investment universe in order to ensure the most diversified portfolio possible.

In 2008, Norges Bank recommended that the Ministry of Finance expand the fund's benchmark portfolio to include equity investments in more emerging markets, and that the fund be permitted to invest in unlisted equities (pre-IPO companies). Norges Bank also considered whether emerging bond markets and high-yield corporate bonds should be included in the fund's benchmark portfolio, but decided not to recommend such a change at present.

In summer 2008, the Storting (Norwegian parliament) agreed on a target of up to 5 per cent of the Government Pension Fund – Global being invested in real estate. We built up the expertise needed to be able to start implementing this strategic decision during the year.

Operational goals

Norges Bank aims to generate the highest possible return within the bounds of its management mandate. The broad lines of our investment strategy have been consistent over time. However, we regularly assess the composition of investment mandates included in the overall portfolio. The results for 2008 were weak and themselves provide grounds for a review of our strategy.

The key elements of the investment strategy are delegation of decision-making powers, specialised mandates, diversification across independent mandates, and cost-effective implementation.

Norges Bank's Executive Board has issued a management mandate to the Executive Director of NBIM. Within NBIM, risk limits and investment decisions are delegated to the individual portfolio managers. The delegation of risk mandates results in extensive specialisation within each particular mandate. The markets in which the Government Pension Fund – Global invests are nearly efficient. To be able to take investment decisions that create value for the fund, we need to be one step ahead in our analysis or use of specific information. This requires a high degree of specialisation. This specialisation is essential for the quality of individual decisions. Investment decisions are not made by committees. Risk is spread across a large number of independent positions.

We aim to take larger and more concentrated positions in particular companies when we believe that this brings

The Government Pension Fund – Global is large and has a much longer investment horizon than the vast majority of investors and institutions

an attractive trade-off between risk and return in the longer term. We also take larger positions in specific market segments in situations where the risk premium associated with these investments seems attractive to a long-term investor.

Diversification through independent mandates is to ensure that management is not dominated by common risk factors that impact on the entire portfolio simultaneously, and to keep overall risk well within the set limits.

Low costs in the implementation of the overall investment strategy are important for long-term management performance. We attach particular importance to efficiency when phasing in new capital and managing large portfolios.

Experience

In 2008, our management results were weak in both absolute and relative terms. Relative returns in 2008 were significantly worse than we might have expected based on the investment strategy chosen. In the management of the fixed income portfolio, the crisis in the financial system revealed that risk exposure in the various mandates was not sufficiently independent. Many of the mandates had common exposure to liquidity and credit risk that we had not observed under normal market conditions.

We had particularly poor results in the portfolio of US securitised debt, which was managed by a number of external managers. One important lesson is that we must not invest in specific market segments without establishing an adequate internal organisation that can quickly step in where necessary.

We made important changes to the implementation of our investment strategy in 2008. The potential to achieve independence between positions in fixed income markets appears to be smaller than we previously assumed. The number of fixed income mandates has therefore been reduced substantially.

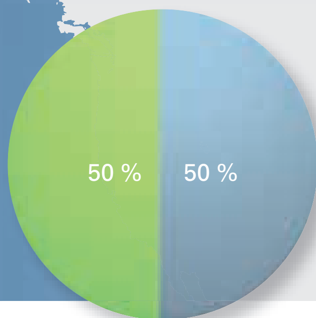
Reduced liquidity in parts of the fixed income market means that we are unable to make major changes to the portfolio in the short term. In the current situation, therefore, we are prepared to hold substantial holdings in the fixed income market to maturity.

Changes

The Government Pension Fund – Global is very large and has a much longer investment horizon than the vast majority of investors and institutions. The investment strategies we pursue in the future will take greater account of these factors, and we aim to turn them to the fund's advantage when developing new investment activities.

Our investments

0.77 per cent of the world's equities



Americas

In summer 2007, the Ministry of Finance decided to increase the strategic allocation to equities in the Government Pension Fund – Global from 40 to 60 per cent. The implementation of this decision is ongoing. At the end of 2008, the fund owned 0.77 per cent of global equity markets.

Following debate in the Storting (Norwegian parliament), the Ministry of Finance has decided on three important changes in the fund's investment strategy in the past two years. In summer 2007, the strategic allocation to equities was increased from 40 to 60 per cent, and the fund's benchmark portfolio was expanded to include small-cap companies. In summer 2008, 19 new emerging equity markets were included in the benchmark portfolio. This enlargement of the benchmark portfolio means that it now comprises almost 7 700 companies, as opposed to fewer than 2 500 before the changes.

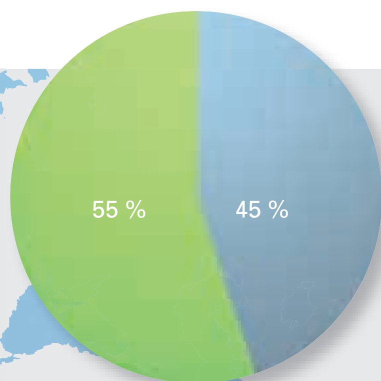
Allocation to equities is important

The size of the allocation to equities is one of the most important decisions for future returns on the fund. The strategic decision to increase this allocation was based on an assessment of expected long-term returns relative to the risks associated with fluctuations in value. Based in part on advice from Norges Bank, the Norwegian government decided in 2007 to increase the allocation to equities in the fund to 60 per cent.

The fund's ownership of global equity markets is growing

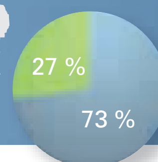
Since summer 2007, therefore, all inflows of new capital into the fund have been invested in equity markets. The allocation to equities in the fund nevertheless decreased towards the end of 2008 due to the steep fall in equity prices in the fourth quarter. The increase in the strategic allocation to equities and inflows of new capital into the fund mean that the fund's ownership of global equity markets is growing.

The fund's average ownership interest in global equity markets climbed from 0.49 per cent at the end of 2007



Europe

Asia and Oceania



Fixed income Equities

to more than 0.75 per cent on 31 December 2008. The fund's ownership of global equity markets has trebled in the past five years. Ownership of European companies at the end of the year amounted to 1.33 per cent of the total market value of the companies included in the benchmark portfolio.

The fund's average ownership interest in companies elsewhere in the world is also rising, but is slightly lower because the fund's share of market capitalisation outside Europe is smaller. The flipside to an increased allocation to equities is reduced ownership of fixed income markets. The fund's average share of market capitalisation in fixed income markets at the end of 2008 was 0.52 per cent.

More companies in the equity benchmark portfolio

The fund's equity portfolio is highly diversified across both regions and countries. From the time the first equity investments were made in 1998, the benchmark index for equities (FTSE) consisted of the largest listed companies, although NBIM was also able to invest in

Chart 1-1 Breakdown by asset class 2004-2008. Per cent

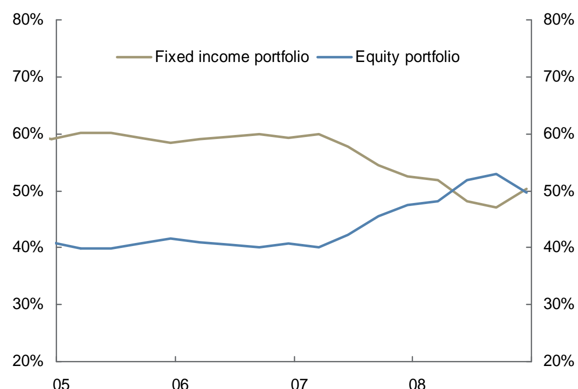
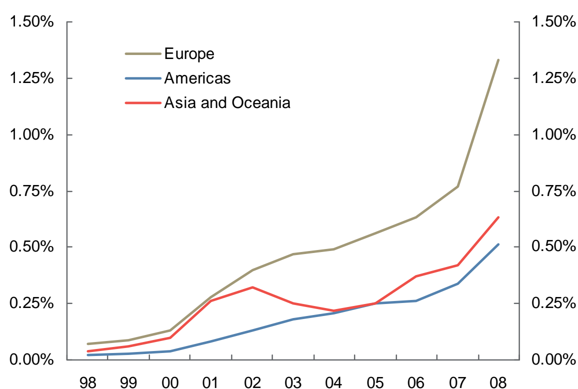


Chart 1-2 Ownership of equity markets1) 1998-2008. Per cent



1) Percentage of FTSE index's market capitalisation.
Source: FTSE, NBIM

smaller companies provided that they were listed. The term "small cap" is often used for the companies with the smallest market capitalisation, while "mid cap" and "large cap" are used for the larger companies that previously made up the fund's benchmark portfolio.

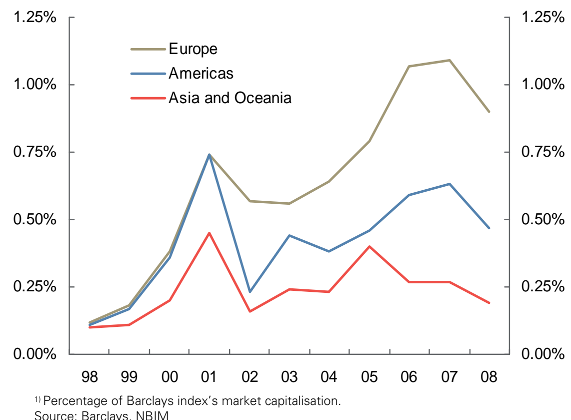
Based in part on advice from Norges Bank, the Ministry of Finance decided in June 2007 to expand the benchmark portfolio to include small-cap companies. This change means better diversification of the equity portfolio, better representation of the equity market, and greater exposure to a segment of the equity market that has produced above-average returns historically.

This decision entailed a major change in the composition of the benchmark index. Small-cap companies accounted for 11 per cent of the market value of the benchmark portfolio at the end of 2008. The transition to full exposure to this segment was implemented over a five-month period beginning in October 2007 and involved investment in more than 4 500 new companies. The phasing-in of the new benchmark portfolio was completed at the end of the first quarter of 2008.

More countries in the equity benchmark portfolio

In 2008, the Ministry of Finance decided that 19 new emerging equity markets should be included in the equity benchmark portfolio. The decision was backed by the Storting and was based partly on advice from Norges Bank. This change means better diversification of the equity portfolio, better representation of the equity market, and greater exposure to a growing part of the global economy.

Chart 1-3 Ownership of fixed income markets 1998-2008. Per cent



[1] Percentage of Barclays index's market capitalisation.
Source: Barclays, NBIM

The term "emerging markets" covers a wide variety of countries, but common denominators include low-to-medium average incomes and market regulations that restrict foreign investment in the local market. Russia, China and India are the largest of the new countries to be included in the benchmark portfolio, each accounting for approximately 0.8 per cent of the equity portfolio.

NBIM performs its own assessment of how suitable a market is for our investments. The market must be open to foreigners, the country must have laws protecting investors' rights, and the settlement systems must meet certain minimum standards. As a result, NBIM does not invest in all of the countries in the benchmark portfolio.

The inclusion of 19 emerging equity markets meant that the equity benchmark portfolio was enlarged by almost 1 000 companies. This change was made mainly during the fourth quarter.

Chart 1-4 Regional breakdown of the equity portfolio on 31 December 2008. Per cent

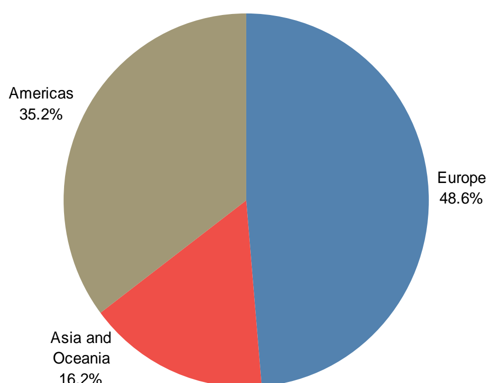
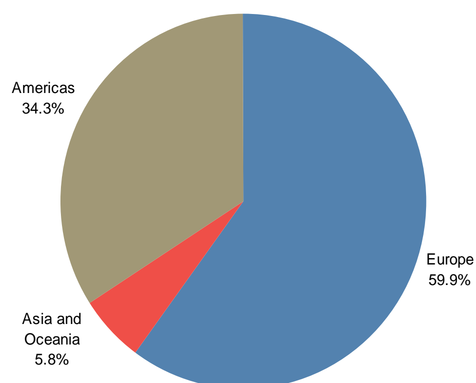


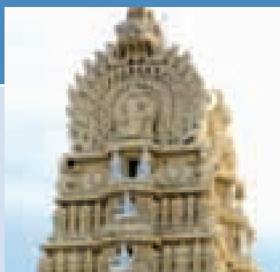
Chart 1-5 Regional breakdown of the fixed income portfolio on 31 December 2008. Per cent



Markets included in the benchmark portfolio for equity investments on 31 December 2007

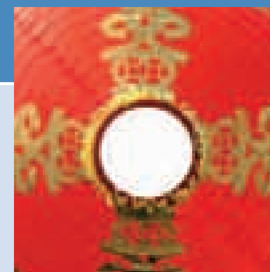
New markets in the benchmark portfolio for equities in which NBIM invests

India



- 0.8 per cent of the benchmark portfolio
- 228 companies in the portfolio
- Key industries: oil and gas, IT services, banks

China



- 0.8 per cent of the benchmark portfolio
- 206 companies in the portfolio
- Key industries: real estate, telecommunications, banks

Individual positions

A large fund with large individual investments

The Government Pension Fund – Global is invested in almost 7 900 equities and bonds from 2 200 different issuers. Although the fund is well-diversified, its size means that it will have large individual positions in capital markets. This is especially the case in bond markets, which sovereign states use to raise capital.

The fund has large positions in equity and bond markets. It is the benchmark portfolio for the fund that determines the size of these positions. The fund will normally have large positions in companies that have a high market capitalisation and thus account for a large share of the benchmark portfolio. As oil companies are among the world's largest companies, they are also well-represented in the list of the fund's largest shareholdings. Four of the ten largest positions at the end of 2008 were oil companies.

Since summer 2008, the Ministry of Finance has allowed the fund to hold up to 10 per cent of a company's shares, up from the previous limit of 5 per cent. At the end of 2008, the largest ownership interest in a company was 8.7 per cent. The fund held more than 5 per cent of four companies and more than 2 per cent of 195 companies. Ownership of listed companies is generally well-spread, and an interest of this size will make the fund one of the company's largest shareholders.

Table 2-1 Largest equity holdings on 31 December 2008

Company	Country	Holding in millions of NOK
Royal Dutch Shell plc	UK	15 263
Nestle SA	Switzerland	14 901
BP plc	UK	13 151
Exxon Mobil Corporation	US	12 217
Total SA	France	11 314
HSBC Holdings plc	UK	10 562
Vodafone Group plc	UK	10 354
Novartis AG	Switzerland	10 350
Roche Holding AG	Switzerland	9 997
E.ON AG	Germany	9 090

Table 2-2 Largest bond holdings on 31 December 2008
2008

Issuer	Country	Holding in millions of NOK
Federal Republic of Germany	Germany	94 976
UK Government	UK	85 500
Italian Republic	Italy	81 781
Fannie Mae	US	68 339
United States of America	US	65 896
Japanese Government	Japan	55 721
European Investment Bank	Supranational	49 009
French Republic	France	46 656
Kreditanstalt für Wiederaufbau	Germany	37 374
Freddie Mac	US	32 625

Since summer 2008, the fund has been allowed to hold up to 10 per cent of a company's shares

In bond markets, the largest issuers are sovereign states. The fund will therefore normally have large holdings of government debt. There are also large government and quasi-government institutions, as well as various international organisations, that fund their operations by borrowing in global capital markets. Companies generally borrow less in the bond market, especially outside the US, where companies have traditionally funded their operations with bank loans or equity.

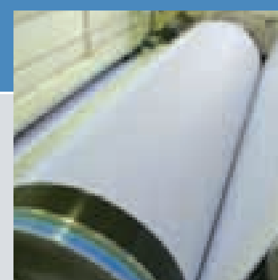
Table 2-3 Largest ownership interests on 31 December 2008. Per cent

Company	Country	Interest
Mondi plc	UK	8.71
Babcock & Brown Infrastructure Group	Australia	7.84
UPM-Kymmene OYJ	Finland	5.77
China Water Affairs Group Ltd	Hong Kong	5.00
Apex Silver Mines Ltd	US	4.96
Forthnet SA	Greece	4.92
Cogent Communications Group	US	4.90
Smithfield Foods Inc.	US	4.83
Franco-Nevada Corp.	Canada	4.51
Constellation Energy Group Inc.	US	4.36

Nestlé

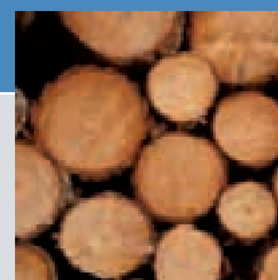
- World's largest food producer
- 500 factories in more than 80 countries
- 276 050 employees

Mondi

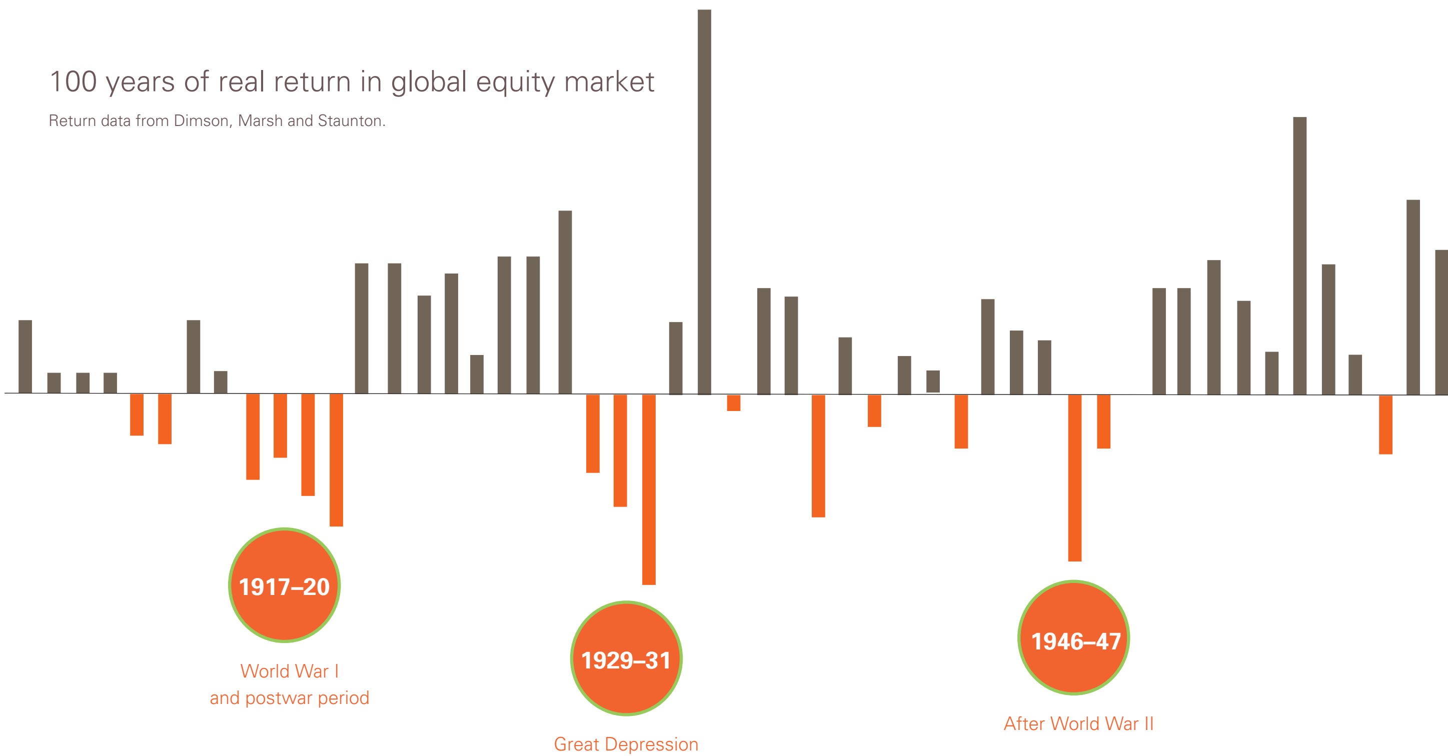


- Paper producer with market-leading positions in Eastern Europe and South Africa
- 35 000 employees in 35 countries

UPM



- One of the world's leading forest products companies
- Sales of EUR 10.0 billion in 2007
- 26 000 employees in 14 countries



Equities in the long run

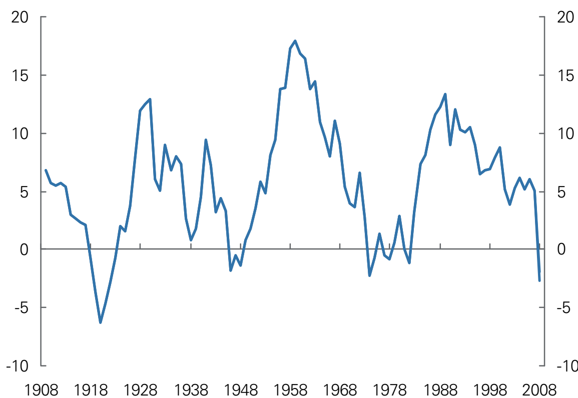
2008 from a 100-year perspective

History affords few examples of decades in which equity markets have produced negative returns, and these have been followed by long periods of higher returns. The Government Pension Fund – Global's strategy means that purchases of equities rise when markets fall.

2008 brought the biggest one-year fall in global equity prices in recent history. A long-term investor is better rewarded because the value of equities fluctuates widely. Many have lost money on equities recently, which will lead to higher required rates of return in the future.

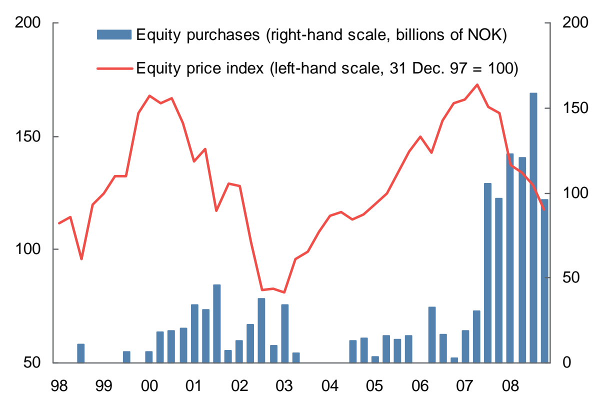
Broad ownership of global equity markets can be viewed as ownership of a share of private production

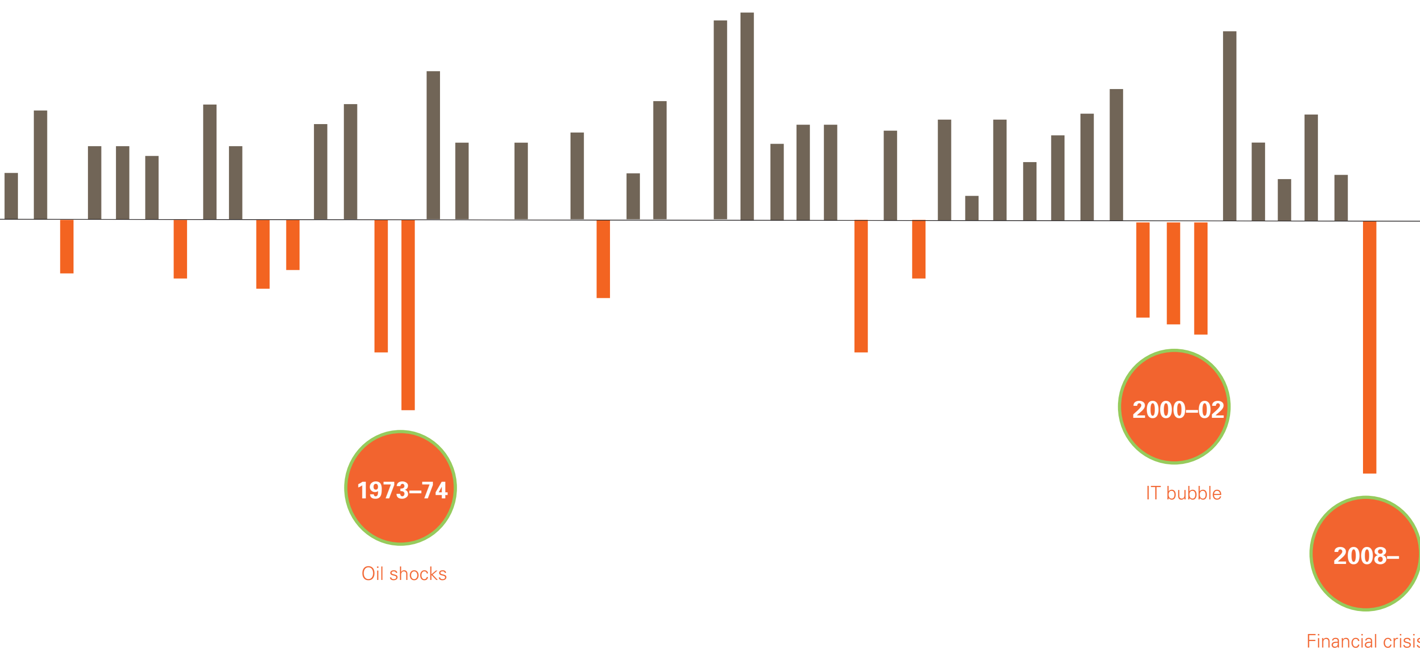
Chart 3-1 Ten-year rolling real return on global equity markets. Per cent



[1] Return data from Dimson, Marsh and Staunton.

Chart 3-2 Fund's equity purchases and equity price index 1998-2008





capacity in the global market economy. The market value of this production capacity is directly related to how financial markets price companies' expected value creation. As a result of the financial crisis and the global economic downturn, market valuations have fallen rapidly. Once the economic downturn is over, the return on private production capacity will rise once again. For a long-term investor, it is important to emphasise the real assets that we own.

The financial crisis has revealed that many institutions have based long-term investments on short-term funding. When this funding is no longer available, the time horizon for investments quickly becomes very short. Owners and investors have therefore incurred heavy realised losses.

The situation for savings in the Government Pension Fund – Global is different. Its investments are not funded by borrowing, and the institutional framework provides a real assurance of a long-term strategy. Growing risk in the markets will not force us to make changes that result in realised losses for our owners. This long-term approach provides the basis for investment choices that safeguard the fund's long-term returns.

The strategy for the fund means that more equities are purchased when equity prices fall, and fewer when they rise. This meant that the fund acquired large numbers of equities in the period 2001-2003 and record amounts in 2008. Of the equities now held, 40 per cent were acquired in 2008 when prices were falling.

09.08.07 BNP Paribas closes three funds due to the evaporation of liquidity in markets for asset-backed securities. Interbank borrowing rates rise sharply. The financial turmoil begins.

01.10.07 Swiss investment bank UBS announces heavy losses related to US sub-prime loans. The CEO resigns.

30.10.07 Merrill Lynch announces heavy losses related to sub-prime loans. The CEO resigns.

13.12.07 The Federal Reserve coordinates a large injection of liquidity into the bank sector by five leading central banks.

17.02.08 The UK government nationalises the bank Northern Rock.

17.03.08 Investment bank Bear Stearns is taken over by JPMorgan Chase in a deal backed by the Federal Reserve.

22.04.08 UK banking giant RBS announces plans to raise new capital of GBP12 billion.

22.05.08 Swiss banking giant UBS announces plans to raise new capital of USD 15.5 billion.

2008

The financial crisis spreads

The financial turmoil began in summer 2007 with a drop in the price of securities backed by US sub-prime mortgages. In the course of 2008, the turmoil evolved into a fundamental crisis of confidence in the financial system and a sharp downturn in the global economy. All parts of NBIM's management were affected by the financial crisis.

In August 2007, French bank BNP Paribas suspended withdrawals from two of its funds investing in asset-backed securities due to the evaporation of liquidity in these markets. Banks' own estimates of counterparty risk in the financial system rose rapidly and have been high ever since. We now consider this event to mark the beginning of the financial crisis.

Markets for US mortgage- and asset-backed securities have deteriorated gradually since the crisis began. The fund was directly exposed to this segment through external fixed income managers.

Many banks had set up special-purpose vehicles which held various securitised instruments but were funded on a short-term basis in the money market. When counterparty risk in the market increased, these companies ran into liquidity problems, and the banks increasingly had to take assets back onto their own balance sheets. The fund was directly exposed to this segment through the re-investment of cash collateral received by the fund in connection with securities lending.

Many banks had to recognise heavy losses in connection with the US housing market. The proportion of non-performing loans gradually also increased in other parts of banks' portfolios. The lower value of banks' investments and the collateral held by them led to greater uncertainty about banks' financial position and sharp falls in their market value. The fund had significant investments in all parts of banks' capital structure, both equity and various debt instruments issued by them.

Banks quickly responded to the need for more capital by raising capital in the market. During the financial turmoil, financial institutions have raised almost USD 1 trillion in new capital. The fund participated to a limited extent in banks' capital increases.

11.07.08 US authorities close mortgage lender IndyMac.

13.07.08 The US Treasury unveils a rescue package for the huge mortgage lenders Fannie Mae and Freddie Mac.

SEPTEMBER 2008

07.09.08 Fannie Mae and Freddie Mac are placed in conservatorship.

15.09.08 Investment bank Lehman Brothers collapses after announcing heavy losses. Bank of America announces that it is to acquire Merrill Lynch. The financial crisis is evolving.

16.09.08 AIG, the largest US insurer, borrows heavily from the Federal Reserve in return for a large shareholding in the company.

21.09.08 The Federal Reserve accepts applications from Goldman Sachs and Morgan Stanley to become commercial banks.

25.09.08 Large US bank Washington Mutual is closed down by the authorities, and large parts of it are sold to JPMorgan Chase.

28.09.08 Benelux bank Fortis is partly nationalised.

28.09.08 The Icelandic government takes control of the banks Glitnir and Landsbanki.

OKTOBER 2008

03.10.08 The House of Representatives passes TARP, a USD 700 billion package to rescue the US financial sector.

NOVEMBER 2008

09.11.08 China announces an NOK 3 trillion package of measures to stimulate the economy.

DECEMBER 2008

19.12.08 President Bush says that US authorities will use TARP to support the US car industry.

Authorities in the large industrialised nations launched a series of support packages towards the end of the year to counter the deterioration in the economic outlook

As losses in the financial sector grew, it became harder for banks to raise capital in the market. For a number of banks, the combination of heavy losses and difficulties sourcing market funding led to bankruptcy or takeover. After the Lehman Brothers bankruptcy in September, systemic risk in the financial sector increased further. The financial crisis struck hard in Europe, and authorities in several countries issued explicit guarantees for the capital of depositors and, in some cases, debt investors. In many countries, authorities pumped new equity capital into the financial sector.

Financial institutions' debt has grown rapidly in recent years, and the shortage of funding opportunities meant that many had to scale down the size of their investments. However, this sell-off of assets increased the pressure on the prices of these assets, further aggravating the problems. The financial crisis triggered rapid unwinding of risk, resulting in increased volatility. Investments that would have been highly liquid under normal market conditions became difficult to sell. The fund was exposed to the increase in the liquidity premium through various strategies.

The financial crisis's implications for the real economy became increasingly clear, and authorities in the large industrialised nations launched a series of support packages towards the end of the year to counter the deterioration in the economic outlook.

Market value

Large capital inflow

The Government Pension Fund – Global had a market value of NOK 2 275 billion at the end of 2008. New capital of NOK 384 billion was transferred to the fund during the year, the largest annual inflow in the fund's history.

The fund's market value increased by NOK 257 billion during the year. The fixed income portfolio grew by NOK 86 billion, and the equity portfolio by NOK 171 billion. The allocation to equities was 49.6 per cent at the end of the year, up from 47.5 per cent at the end of 2007.

A negative return on investment in 2008 measured in international currency reduced the value of the fund by NOK 633 billion. A weaker krone in relation to the currencies in which the fund is invested increased its value in NOK terms by NOK 506 billion. A change in the krone exchange rate has no effect, however, on the fund's international purchasing power.

Total capital of NOK 2 140 billion has been transferred to the fund since it was set up in 1996. The return on the fund in international currency during this period has been NOK -131 billion, while a weaker krone has increased the value of the fund by NOK 266 billion.

Chart 4-1 Market value 1999-2008. In billions of NOK

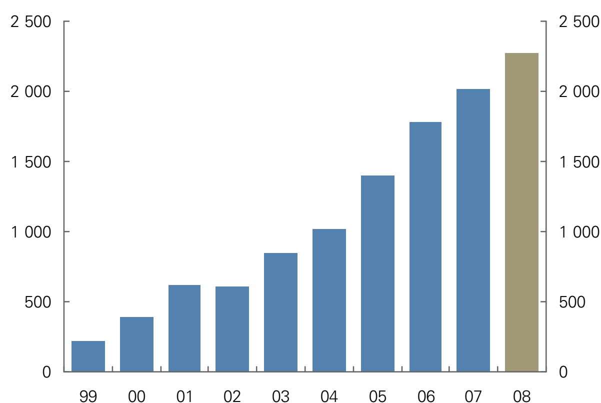


Chart 4-2 Annual changes in market value 1996-2008. **In billions of NOK**

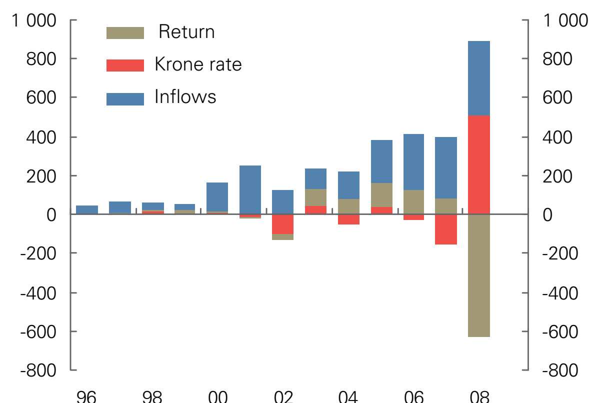


Table 4-1 Key figures on 31 December 2008. Quarterly data

	Q3 2007	Q4 2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Market value (billions of NOK)						
Fixed income portfolio	1 054	1 061	1 011	961	997	1 146
Equity portfolio	878	958	935	1 031	1 123	1 129
Fund	1 932	2 019	1 946	1 992	2 120	2 275
Inflows of new capital *	76	77	88	91	128	77
Return **	21	-14	-116	-32	-186	-300
Change due to movements in krone	-104	24	-45	-13	186	379
Return in international currency (per cent)						
Equity portfolio	-0.30	-2.77	-12.67	-1.60	-13.12	-20.58
Fixed income portfolio	2.10	1.30	0.87	-1.72	-1.19	1.55
Fund	1.15	-0.64	-5.62	-1.87	-7.68	-10.30
Benchmark portfolio	1.33	-0.20	-4.79	-2.10	-5.98	-8.62
Excess return	-0.18	-0.44	-0.83	0.24	-1.69	-1.67
Return in NOK (per cent)						
Equity portfolio	-5.57	-1.59	-14.71	-1.90	-5.84	-8.41
Fixed income portfolio	-3.29	2.53	-1.49	-2.02	7.08	17.12
Fund	-4.20	0.56	-7.83	-2.17	0.06	3.45
Benchmark portfolio	-4.03	1.01	-7.02	-2.41	1.89	5.38
Management costs (per cent)						
Estimated transition costs	0.02	0.04	0.05	0.03	0.08	0.10
Annualised management costs	0.09	0.09	0.10	0.10	0.09	0.11
Changes in value since start-up (billions of NOK)						
Inflows of capital	1 679	1 756	1 844	1 935	2 063	2 140
Return	518	504	387	355	169	-131
Change due to movements in krone	-265	-242	-285	-298	-112	266
Market value of fund	1 932	2 019	1 946	1 991	2 120	2 275

*) The inflows shown in this table differ slightly from those in the financial reporting (see Note 7) due to differences in the treatment of management fees.
** These numbers differ from previous reports. In this report the accounting method for calculation of returns in international currency and NOK-effect has been employed.

Return on the fund

The most challenging year in the fund's history

The return on the fund in 2008 was -23.3 per cent measured in international currency. This was 3.4 percentage points lower than the return on the benchmark portfolio and the weakest annual return in the fund's history.

The return on the fund in 2008 was -23.3 per cent measured in international currency. This was the weakest annual return in the fund's history and was due mainly to a negative return on equity investments. There was a return of -40.7 per cent on the equity portfolio and -0.5 per cent on the fixed income portfolio. Since 1 January 1998, the fund has generated an annualised gross annual return of 2.9 per cent. Once management costs and inflation are deducted, the annual net real return has been 1.0 per cent.

The return generated by Norges Bank on the actual portfolio is measured against the return on the benchmark portfolio defined by the Ministry of Finance. The difference between the returns on the two portfolios is the result of our active management. In 2008, the return on the fund was 3.4 percentage points lower than the return on the benchmark portfolio. The separate sections on equity and fixed income management describe in detail how the different parts of our investment management contributed to this overall performance.

Table 5-1 Key figures on 31 December 2008. Annualised data

(Measured in an international currency basket)	Past year	Past 3 years	Past 5 years	Past 10 years	Since 01.01.98
Portfolio return (per cent)	-23.30	-4.79	0.87	2.33	2.94
Benchmark return (per cent)	-19.93	-3.39	1.47	2.39	2.98
Excess return (percentage points)	-3.37	-1.41	-0.59	-0.06	-0.04
Standard deviation (per cent)	14.01	9.39	7.81	6.92	6.88
Tracking error (percentage points)	1.84	1.25	1.03	0.79	0.76
Information ratio	-1.83	-1.12	-0.58	-0.08	-0.05
Gross annual return (per cent)	-23.30	-4.79	0.87	2.33	2.94
Annual price inflation (per cent)	1.3	2.0	2.2	1.9	1.8
Annual management costs (per cent)	0.10	0.10	0.10	0.09	0.09
Annual net real return (per cent)	-24.38	-6.76	-1.37	0.34	1.00

Chart 5-1 Quarterly return and three-year rolling annualised return 2001-2008. Per cent

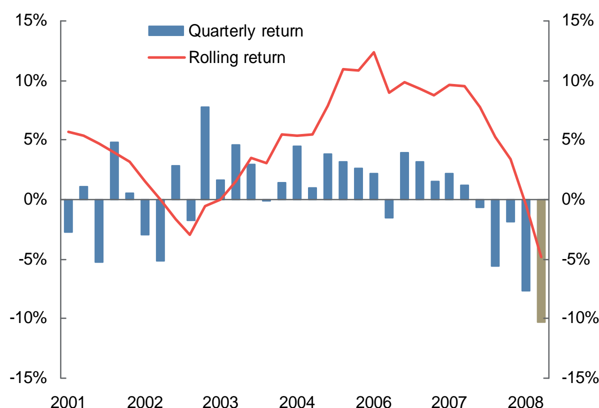


Chart 5-3 Quarterly and three-year rolling annualised excess return 2001-2008. Percentage points

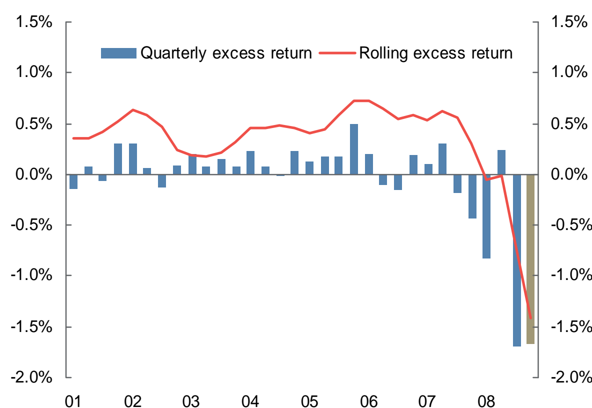


Chart 5-2 Annual return 1998-2008. Per cent

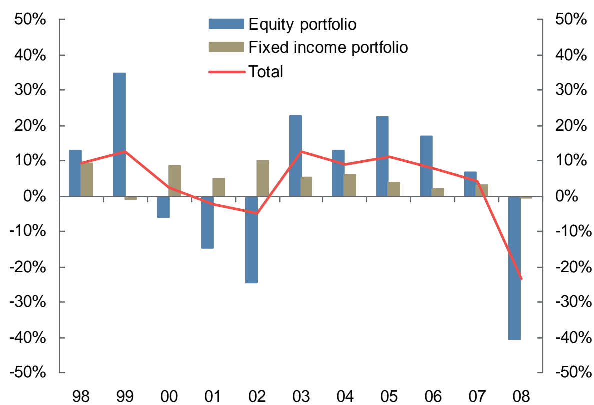


Table 5-2 Breakdown of 2008 returns by type of management. Percentage points

	External management	Internal management	Total
Equity management	-0.10	-0.71	-0.81
Fixed income management	-1.14	-1.42	-2.56
Total	-1.24	-2.13	-3.37

Transaction costs

Transaction costs are incurred when phasing new capital into the fund and when rebalancing the benchmark portfolio. Norges Bank has estimated the direct and indirect transaction costs incurred in 2008 at NOK 5.7 billion, breaking down as follows:

- Phasing in the small-cap segment: NOK 0.7 billion
- Equities in new markets: NOK 2.7 billion
- Phasing in an increased allocation to equities: NOK 2.2 billion
- Exclusion of companies: NOK 0.1 billion

These estimated transaction costs are equivalent to 1.4 per cent of the year's net inflows of NOK 384 billion and 0.29 per cent of the fund's market value. The benchmark portfolio has not been adjusted for these transaction costs. This means that the reported excess return is lower than it would have been if these costs had been included.

Fixed income management

Restructuring to create opportunities

The financial crisis resulted in large and unexpected fluctations in various parts of the fixed income market in 2008. NBIM had large positions in several parts of the market that were hit by higher credit premiums and dwindling liquidity. We have made significant changes to the management of the fixed income portfolio in the light of the weak results achieved.

Table 6-1 Return on the fixed income portfolio. Per cent

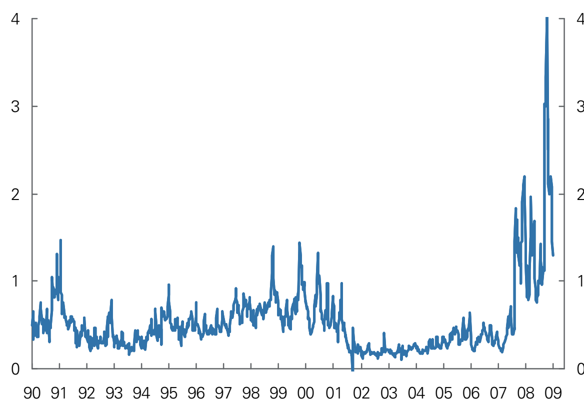
	Actual portfolio	Benchmark portfolio	Excess return
2007	2.96	4.26	-1.30
2008	-0.52	6.08	-6.60

The market value of the fund's fixed income portfolio increased by NOK 86 billion to NOK 1 146 billion in 2008. The return on the portfolio was -0.52 per cent measured in the fund's currency basket. The management of the fund resulted in a negative excess return of 6.6 percentage points relative to the benchmark portfolio. The portfolio was significantly underweight in government bonds, which proved unfortunate as the financial crisis evolved into a fundamental crisis of confidence in the financial system.

Securitised debt

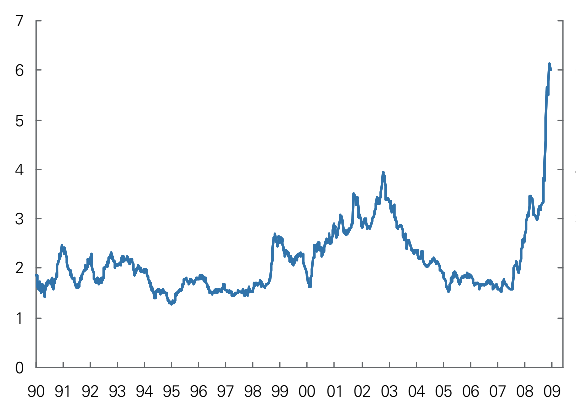
The financial crisis began with a drop in the price of securities backed by US sub-prime mortgages. The fixed income portfolio had limited exposure to these securities. However, we did have considerable exposure to the market for mortgage-backed securities of higher credit quality. US house prices fell sharply in 2008, and defaults on mortgages increased. The market for mortgage-backed securities therefore saw sharp drops in the value of the underlying assets. Investments in this segment made a

Chart 6-1 Spread between bank borrowing rates in the money market and US Treasury bill rates.[1] Percentage points



[1] Three-month rates. Source: EcoWin

Chart 6-2 Credit spread between corporate and US government securities.[1] Percentage points



[1] 10-year yields. Source: Moody´s Baa classified long-term yields. Ecowin

negative contribution in the second half of 2007 and accounted for around 40 per cent of the fixed income portfolio's overall underperformance in 2008. See also the separate section on this portfolio.

Money market investments

As uncertainty about the value of securities related to the US market for mortgage-backed securities grew, the crisis spread to the related money market. There is a large global market for borrowing and lending securities. NBIM lends securities and re-invests the cash received as collateral for these loans in various money market instruments with a higher rate of interest. Some of the investments made in 2006 and 2007 were in short-term bond funds and other vehicles with a seemingly conservative investment profile. Some of these funds' underlying assets were related to market segments that continued to drop sharply in value in 2008. Altogether, losses associated with these investments accounted for around 10 per cent of the fixed income portfolio's overall underperformance.

Banks' capital structure

As banks' losses on loans and investments soared, they had to take loans back onto their own balance sheets that had previously been funded on a short-term basis in the money market. As the extent of banks' actual obligations became clear, the market's valuation of credit risk in respect of bank funding changed dramatically, and bonds issued by financial institutions became hard to sell.

At the beginning of 2008, the fixed income portfolio had large positions in various parts of banks' capital structure. Bonds with different functions in a bank's capital structure have different rights if the bank goes bankrupt. The fixed income portfolio was particularly exposed to banks' regulatory capital. This portfolio consisted largely of European banks and was built up in the years up until 2007. All in all, the overweight in the financial sector totalled around NOK 60 billion at the beginning of 2008.

Chart 6-3 Holdings of bank bonds relative to the benchmark portfolio. In billions of EUR

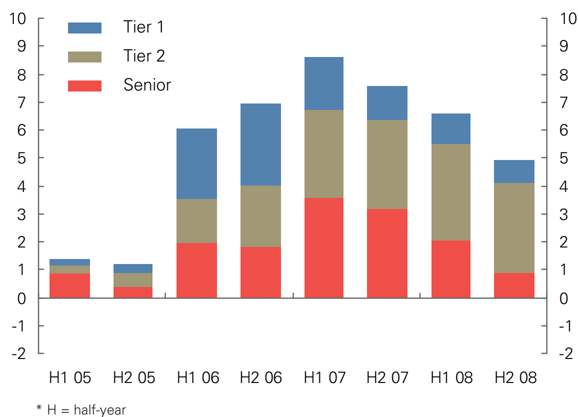


Chart 6-4 Net purchases of bank bonds. In billions of EUR

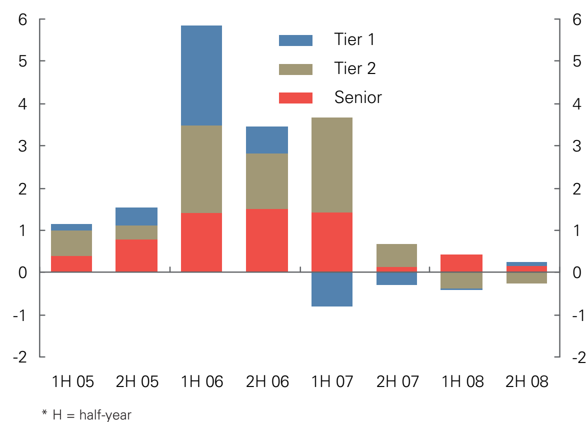


Chart 6-5 Holdings of covered bonds. In billions of EUR

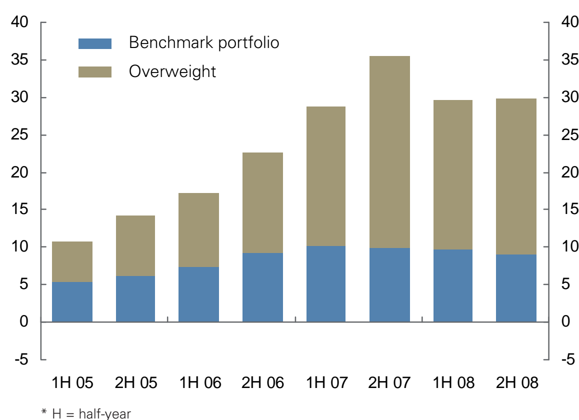
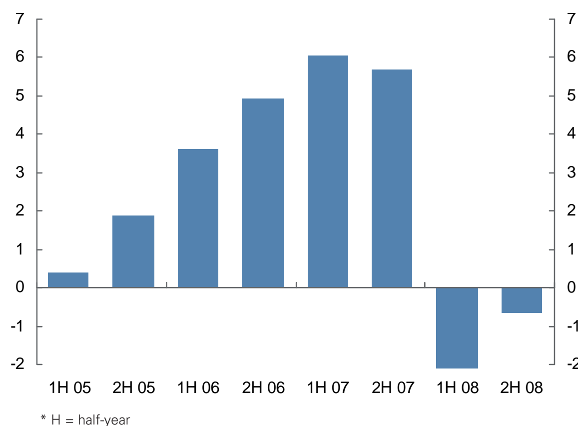


Chart 6-6 Net purchases of covered bonds. In billions of EUR



Covered bonds are a special type of debt issued by a financial institution. These bonds are linked to a specific pool of assets, normally high-quality residential mortgages or loans to the public sector. The bank is also responsible for this debt through its own capital. This market has a long history in a number of European countries, and the valuation of these bonds has assumed very low credit risk. There has not been a situation in any European market where the obligations under a covered bond have not been fulfilled.

Large positions were built up in this segment up until 2007. These investments were made largely as an alternative to holding government bonds. The underlying economic exposure is to real estate markets in countries such as Germany, Spain, France and the UK, and to the financial strength of the local banks. As in other segments of the fixed income market, the liquidity of these securities decreased considerably in 2008.

Altogether, losses on investments in bonds related to European banks accounted for almost a third of the fixed income portfolio's overall underperformance.

Liquidity crisis

The financial crisis quickly led to a sharp increase in the pricing of credit risk. Banks' scope to issue credit was reduced. Market participants that invest in credit risk scaled back their positions due to a drop in funding and reduced risk appetite. The financial crisis led to a credit crisis which undermined expectations of economic growth and the very foundation of credit provision.

At the beginning of 2008, the fixed income portfolio had large positions in interest rate swap contracts. These largely entailed swapping the cash flows from government bonds and other bonds with a very high credit rating. These positions will produce steady returns under normal market conditions. In 2008, credit and liquidity premiums climbed further than was priced into these interest rate swap contracts, resulting in significant negative excess returns from these relative value strategies. Altogether, these strategies accounted for around 10 per cent of the fixed income portfolio's overall underperformance. This management strategy was phased out in 2008.

Although the portfolio was diversified, the financial crisis revealed that these strategies had shared exposure to underlying systematic risk

Inflation-linked bonds

During the first half of the year, the market's inflation expectations were upward bound. Commodity prices were climbing, and observed inflation increased in both the industrialised countries and emerging economies. The financial crisis led to a dramatic change in these expectations in the second half of the year. The market began to discount a sharp economic downturn and a growing probability of deflation in a number of countries.

The fixed income portfolio had large positions in inflation-linked bonds in a number of markets. These instruments accounted for a particularly high proportion of the fixed income portfolio in JPY. Inflation-linked bonds fall in value when inflation expectations decline. Variations in the pricing of inflation-linked bonds in JPY were extreme in 2008 and coincided with a decline in liquidity in this market segment. Altogether, the losses on these positions accounted for around 10 per cent of the fixed income portfolio's overall underperformance.

Summary

Our fixed income management was exposed to the same problems that affected other financial institutions. Although the portfolio was diversified across different types of bonds and different regions, and the active strategies had low correlation in normal markets, the financial crisis revealed that these strategies had shared exposure to underlying systematic risk. Large positions built up in a situation when liquidity and credit premiums were low turned out to fall simultaneously in value when the market was driven by large shifts in the valuation of these risk factors.

Our fixed income management has now been re-organised to face a period of continued great uncertainty. We have created two main areas: one portfolio for indexing and rebalancing, and one portfolio containing the large and illiquid positions described above. We are prepared to hold these securities to maturity. Realised losses on these investments have been limited.

The indexing and rebalancing portfolio will take responsibility for cost-effective implementation of the strategic objectives for the fixed income portfolio.

Equity management

Negative contribution – but moderate impact

The financial crisis caused global equity markets to decline substantially in 2008. The fund's equity portfolio underperformed its benchmark by 1.15 percentage points, or 0.82 percentage points taking into account estimated costs related to strategic changes.

Table 7-1 Return on the equity portfolio. Per cent

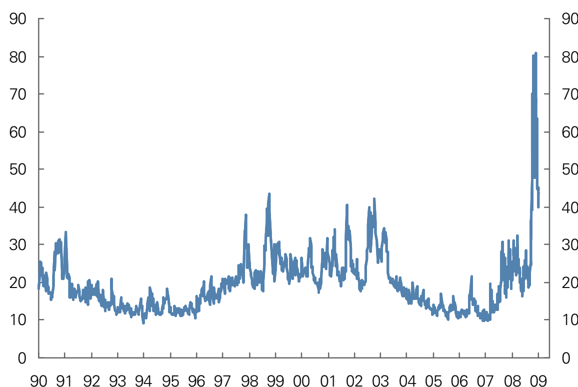
	Actual portfolio	Benchmark portfolio	Excess return
2007	6.82	5.67	1.15
2008	-40.70	-39.56	-1.15

The market value of the equity portfolio increased by NOK 171 billion to NOK 1 129 billion in 2008. The return on the portfolio was -40.7 per cent measured in the fund's currency basket. There was a negative excess return of 1.15 percentage points relative to the benchmark. Transaction costs incurred from increasing the equities allocation, phasing in new countries and including small-cap companies in the benchmark. Adjusting for these costs, there was a negative excess return of 0.82 percentage point. This is a moderate level of underperformance in a volatile market, and within expectations given the risk exposure.

The equity market declined sharply in all regions. Recent years' trend of high returns on cyclical sectors, commodities and emerging markets reversed. Following the Lehman Brothers bankruptcy, market volatility climbed to very high levels. The VIX index illustrates how derivative prices imply expected future volatility in the US stock market.

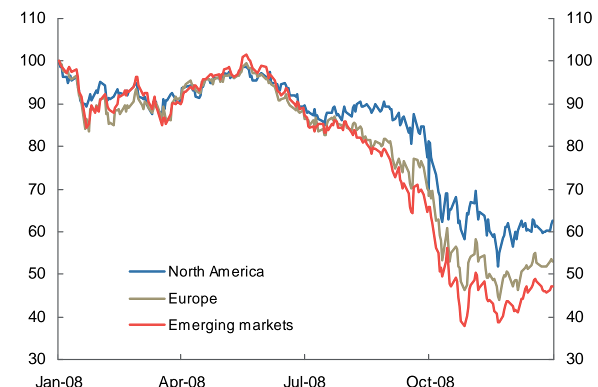
The starting point for equity management is an index portfolio which ensures that the fund always has the desired exposure to the equity market, is cost efficient and with low risk relative to the benchmark. We then employ four different types of strategy to outperform the benchmark: enhanced indexing, capital raising, internal sector mandates and external management.

Chart 7-1 Expected volatility in the US equity market (VIX index)



Source: CBOE volatility index, EcoWin

Chart 7-2 Regional equity market returns in USD. Indexed



Source: FTSE All-World

Enhanced indexing

Enhanced indexing strategies exploit differences in the value of closely related shares. Examples of these situations are where a company's shares are listed on more than one exchange, or where a company has different classes of shares carrying different rights. There may also be attractive investment opportunities in the relative pricing of shares involved in mergers and acquisitions and of shares in an investment company and its investee companies.

The financial crisis caused the risk limits for many investors taking this type of position to be rapidly reduced or withdrawn altogether. Many players wanted to unwind their positions simultaneously, and so a number of the positions taken as part of our enhanced indexing strategies saw abnormally large price movements. These swings led to a negative contribution from these investments equivalent to around 35 per cent of the equity portfolio's overall underperformance.

Capital Raising

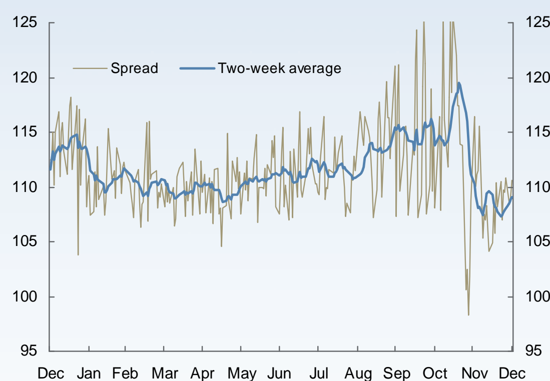
The fund's size and long-term investment horizon make it natural to participate in capital raising. The risk associated with these positions can be considerable in the short term, but we will take these positions when they offer a favourable trade-off between risk and return in the longer term. It will often be better to take part in these capital raisings than to wait until the shares are included in the benchmark portfolio before buying them. These investments are financed by selling similar shares from the portfolio. Investment decisions are taken on the basis of publicly available information, financial analyses and meetings with the companies.

NBIM took part in six capital raisings in 2008, two of which made a positive contribution. Taken together, these positions made a negative contribution equivalent

BHP Billiton

One of the closest relationships in the value of two related shares can be found between shares listed on two different exchanges but with identical dividend streams and equal voting rights. One example of this is BHP Billiton, which is listed in both the UK and Australia. Normally, the value of the two shares is more or less the same, as they are essentially identical with exactly the same economic rights and entitlements. However, the price spread between the two shares exceeded 25 per cent for a short period in 2008. This cannot be put down to changes in fundamentals, but was driven by investors' decreased risk capacity.

Chart 7-3 Spread between Australian and UK listings of BHP Billiton. Common currency



Source: Bloomberg, NBIM

After the Lehman Brothers bankruptcy in September, the market for capital from private investors dried up

to around 20 per cent of the equity portfolio's overall underperformance.

Internal sector mandates

Internal sector mandates are managed by specialists in selected sectors. Investment decisions are based on fundamental analysis of individual companies relative to their peers in the same industrial sector. There were a total of 19 different mandates in 2008, and these were managed mainly from our offices in London, New York and Shanghai. Of the almost 7 900 shares in the overall portfolio, our managers had positions in more than 900 during the year. Much of the information underlying these investments comes from direct dialogue with companies' management. Our managers held more than 1,600 meetings during the year with managers from the companies they analyse.

The financial crisis caused investors to move away from finding companies with the potential to surprise on the upside in terms of earnings, in favour of avoiding companies dependent on a well-functioning credit market. This led to a significant change in which shares produced the best relative return.

Taken together, the internal sector mandates made a negative contribution equivalent to around 30 per cent of the equity portfolio's overall underperformance. The bulk of the losses came from positions in the bank sector and the US. Almost half of the internal sector mandates nevertheless made a positive contribution in 2008.

External mandates

All of our external mandates are managed by specialists in a particular country, region or sector. With a close proximity to the market all 40 organisations involved base their decisions on fundamental analysis. 19 per cent of the value of the equity portfolio is managed by external managers. External equity mandates made a negative contribution equivalent to 15 per cent of the equity portfolio's overall underperformance. See also the separate section on external management.

Capital raisings in the financial sector

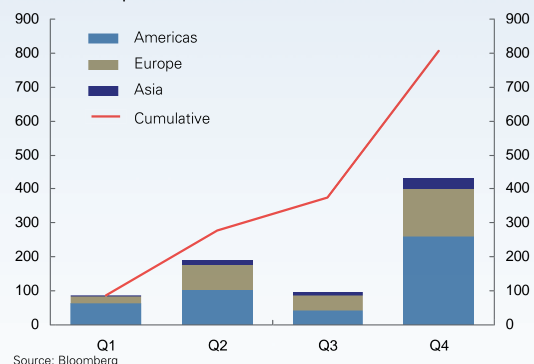
The financial crisis led to substantial erosion of many financial institutions' capital base. Until September, many banks went to the market to raise new capital. During this period, the market was well-functioning, and a wide range of players participated in this recapitalisation. Debt and equity totalling around NOK 2 000 billion was raised by financial institutions during the first nine months of 2008. The bulk of this went to a number of large US investment banks and banks with large holdings of US assets.

There were differences between the type of capital raised in the US and Europe. In the US, the recapitalisation included a higher proportion of hybrid instruments and debt. More equity was issued without pre-emption rights, and groups of key investors were invited to take part at a lower price than other investors in several cases. In Europe, more capital was raised through rights issues, protecting existing shareholders against dilution.

NBIM considered a large number of capital raisings by financial institutions during the year. Capital was invested in six institutions, including two investment banks. The total amount invested by the fund was around NOK 5.2 billion, which equates to around 0.26 per cent of the total amount of equity capital raised by financial institutions during the first nine months of the year. Prudence meant that less was invested than the fund's equity ownership would otherwise warrant. Participation in capital raisings in the financial sector accounted for less than 1.5 per cent of the fund's new equity investments in 2008.

After the Lehman Brothers bankruptcy in September, the market for capital from private investors dried up. A fundamental crisis of confidence led to plummeting equity prices in the financial sector. The lack of access to private capital led the authorities in the UK and the US to intervene. In the fourth quarter, therefore, capital was raised primarily through public rescue packages. Total injections of capital into the financial sector in the fourth quarter came to NOK 3 000 billion.

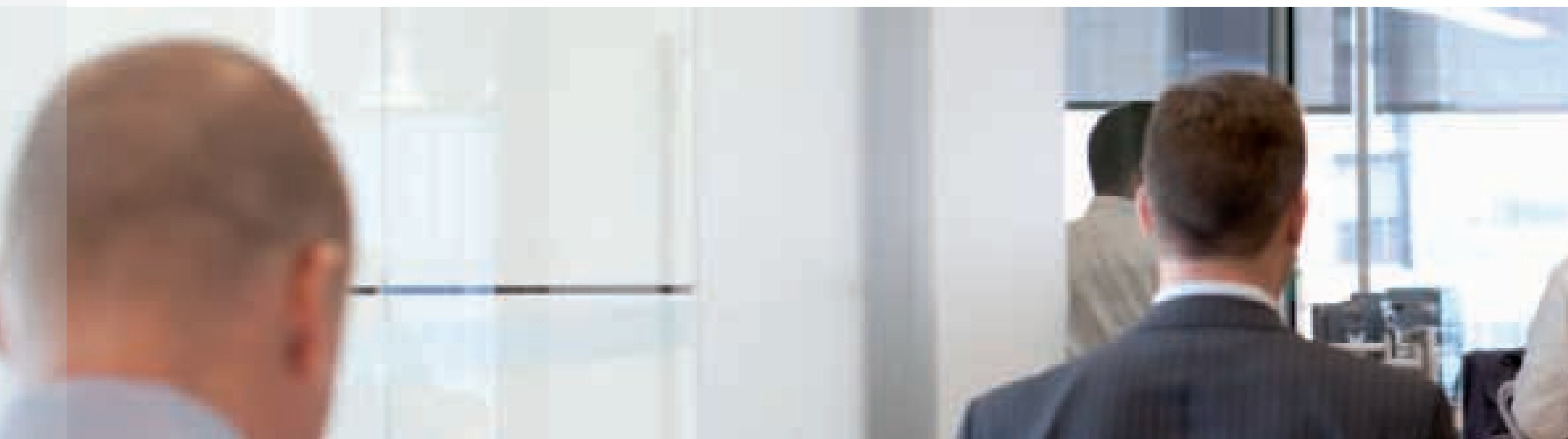
Chart 7-4 Recapitalisation of financial institutions. In billions of USD



Source: Bloomberg

External management

Utilising specialist expertise



NBIM uses external management organisations to manage parts of the equity and fixed income portfolios. We award mandates to managers with specialist expertise in clearly defined investment strategies. The combined value of externally managed portfolios was just over NOK 300 billion at the end of the year.

The use of external management companies to manage parts of the portfolio has accounted for a substantial proportion of overall risk exposure since the fund was started. The combined value of externally managed portfolios was just over NOK 300 billion, or around 13 per cent of the fund's capital, at the end of 2008. These external portfolios are managed by more than 40 different organisations. In almost all cases, these managers are based in the local markets in which the capital is invested.

In the beginning, most external equity mandates were regional mandates. We subsequently included more specialised mandates covering specific sectors and industries. In recent years, we have increasingly utilised specialist expertise for country mandates. Today, the bulk of externally managed capital is in specialised country or sector mandates.

A total of 24 new equity mandates were chosen in the course of 2008, mainly country mandates in emerging markets and mandates in specific industries. Norges Bank also phased out 15 externally managed equity mandates during the year.

At the beginning of 2008, NBIM decided to make major changes to external fixed income management. The number of external mangers was sharply reduced from 22 at the end of 2007 to 9 at the end of 2008. See also the separate section on the management of US securitised debt.

External fixed income management currently consists mainly of mandates for investment grade corporate bonds in the US and Europe. However, this activity was scaled back in 2008 and is currently relatively limited.

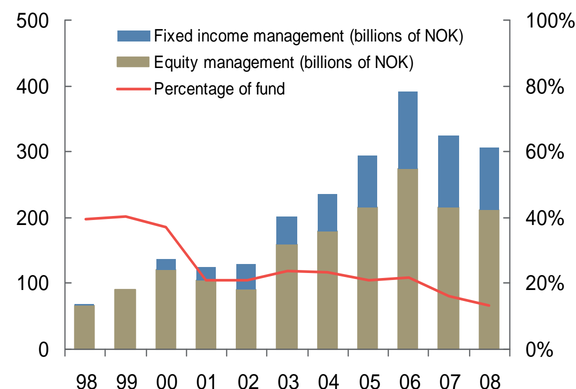
The aim of external management is to create a diversified portfolio which can be expected to outperform the benchmark portfolio over time. This is done by awarding mandates to companies with specialist expertise in clearly defined investment fields. This might, for example, mean extensive analytical capacity in a limited number of companies – a specific industry or a local equity market. We therefore look primarily for managers based in the markets in which they manage equities.

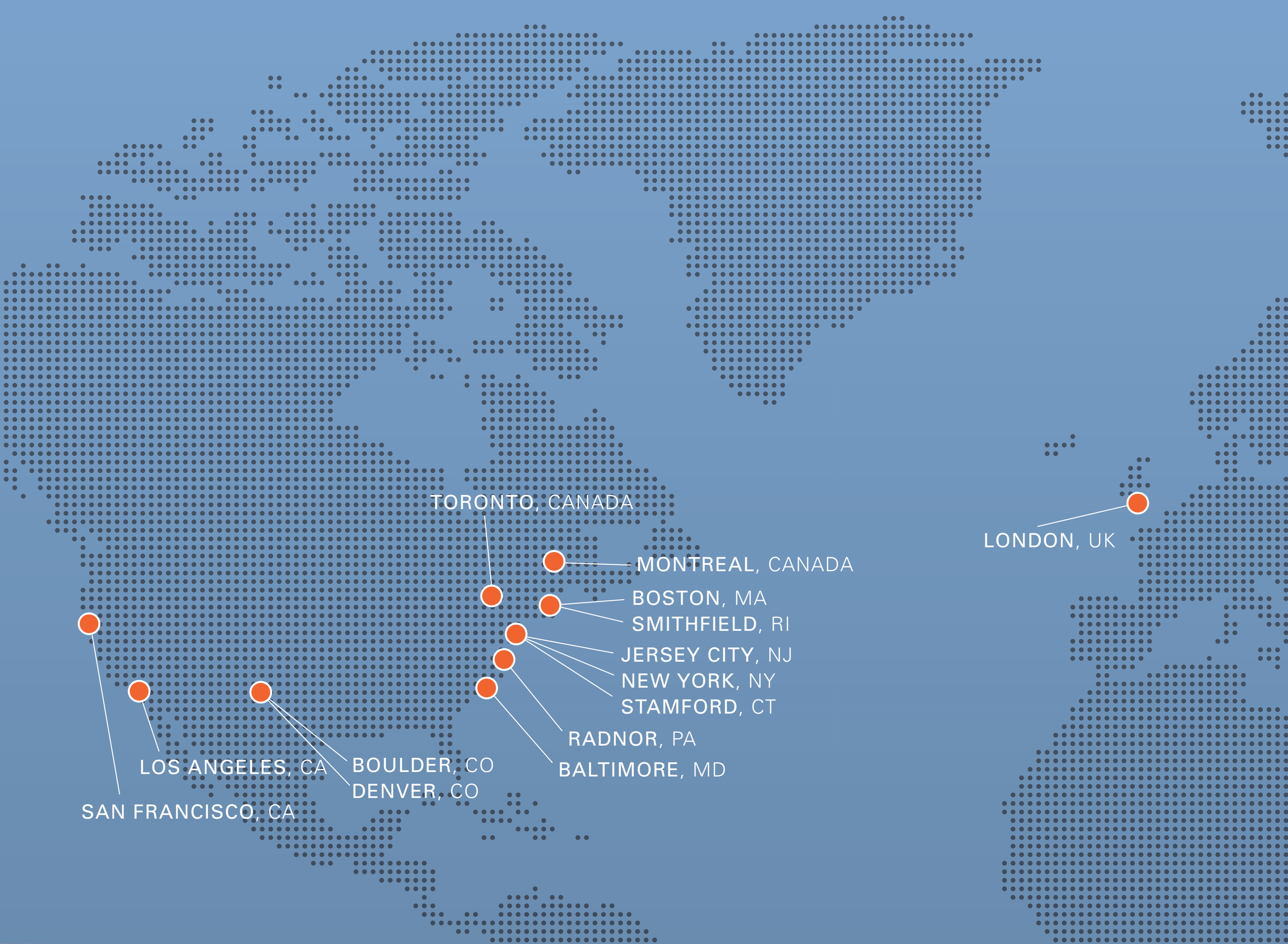
The combined value of externally managed portfolios was just over NOK 300 billion at the end of the year

We set very high security standards for our external managers. Risk relating to operational and organisational factors is limited partly by using our standardised contracts for all business relationships, and by investments being made using segregated accounts in our name.

External managers' performance is assessed continuously relative to expected return, risk and guidelines. External managers are assessed on the basis of their results after all management costs have been deducted. These managers generally have performance-based fee structures. This means that the income the managers generate will be in proportion to the excess returns.

Chart 8-1 External management 1998-2008. In billions of NOK and per cent





External equity managers as of 31 December 2008

Aberdeen Asset Management
Altrinsic Global Advisors
Atlantis Fund Management
Barclays Global Investors
BlackRock
Capital International
Columbus Circle Investors
Ecofin
FIL Pensions Management
Pyramis Global Advisors
Gartmore Investment
GLG Partners
Janus Capital
Keywise Capital Management
Lazard Asset Management
Levin Capital Strategies
Martin Currie Investment Management
Pheim Asset Management
Polaris Capital
Primecap Management
Prosperity Capital Management
Quantum Advisors
Rheos Capital Works
Scheer, Rowlett & Associates
Schroder Investment Management
Sectoral Asset Management
Sparx Asset Management
State Street Global Advisors
T Rowe Price
Tradewinds Global Investors
W.H. Reaves & Co.
Wellington Management
J.H. Whitney Investment Management

External fixed income managers as of 31 December 2008

Barclays Global Investors
BlackRock
Diversified Credit Investments
European Credit Management
Insight Investment Management
Putnam Advisory
TCW Asset Management
Greylock Capital Management
Smith Breeden

Most of our externaly managed funds are in specialised country or sector mandate

MOSCOW, RUSSIA

TOKYO, JAPAN

SEOUL, SOUTH KOREA

SHANGHAI, CHINA

HONG KONG, CHINA

MUMBAI, INDIA

KUALA LUMPUR, MALAYSIA

SINGAPORE

JAKARTA, INDONESIA

CAPE TOWN, SOUTH AFRIKA

SYDNEY, AUSTRALIA

US securitised debt

Losses from external management

NBIM has used external managers to invest in US securitised debt since the segment was included in the fund's benchmark portfolio in 2002. There were heavy losses on these mandates in 2008. One important lesson we have learned is the necessity of having internal capacity in every area in which the fund invests.

NBIM has employed external fixed income managers since the year 2000 in a bid to outperform the fund's benchmark index. In January 2002, the Ministry of Finance expanded the fund's benchmark portfolio to include US securitised debt (MBS and ABS). NBIM believed that competence in this type of management was highly specialised and specific to the US market, and therefore chose to rely exclusively on external management expertise. From 2002 to 2007, the number of mandates for the management of securitised debt grew rapidly. By the end of 2007, the fund had 23 different mandates with 11 different managers and total investments of NOK 120 billion.

These mandates had a number of important common features. The majority had leveraged the portfolio, with the result that total exposure to securitised debt was far higher than allocated capital. The mandates also had considerable exposure to the non-agency MBS category (securities not guaranteed by the government-backed mortgage companies). The fund's actual portfolio of securitised debt closely mirrored the composition of the market for these securities in the US during the years in which the portfolios were built up, whereas agency MBS make up the bulk of the benchmark portfolio. The gap between the portfolio's exposures and the benchmark portfolio's exposures was considerable.

External managers' holdings of US securitised debt totalled NOK 102 billion at the end of 2008, of which NOK 54 billion were non-agency MBS. These holdings therefore entailed substantial exposure to the US housing market.The bulk of these securities had the highest possible credit rating.

In August 2007, the US securitised debt market began to collapse. Borrowers found it much harder to refinance their mortgages, and their ability to make repayments was considerably impaired. The value of collateral was also eroded by the fall in house prices. Expectations of losses on the loans underlying securitised debt instruments have increased substantially since 2007, and in

Chart 9-1 External securitised debt mandates. In billions of NOK

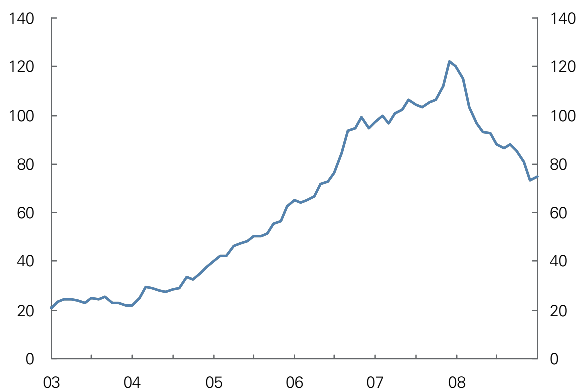
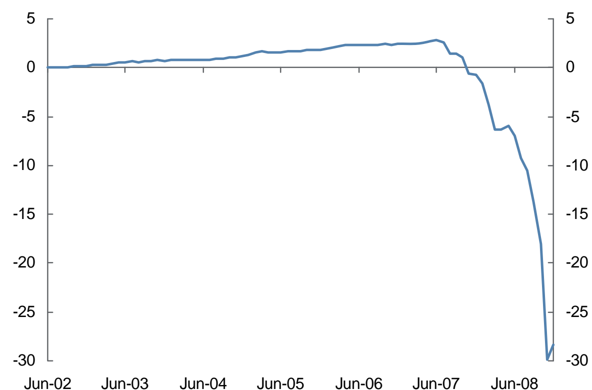


Chart 9-2 External securitised debt mandates. Cumulative excess return relative to invested capital 2002-2008. Per cent



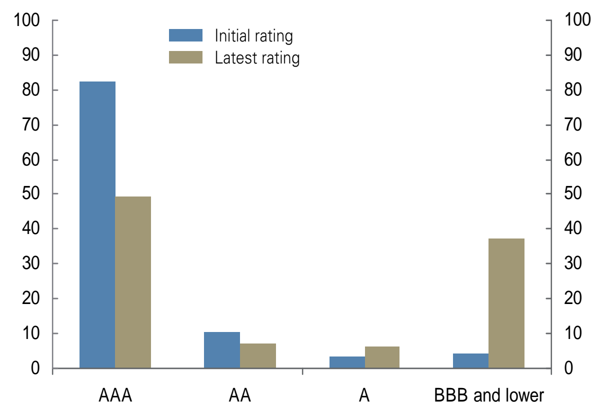
some cases losses are now being priced in even for the top-rated securities. At the same time, the secondary market for these securities has dried up. The fund's portfolio of top-rated non-agency MBS has therefore dropped significantly in value.

We significantly restructured this management segment during the year. Of the original 23 mandates with securitised debt exposure at the beginning of the year, only seven were active at the end of the year. Leveraging of the portfolio was phased out in all mandates, but a shortage of liquidity in the market has limited the possibilities for reducing exposure to securitised debt. The fund is therefore still exposed to fluctuations in the US securitised debt market.

In the situation that emerged in 2007 and developed in 2008, we had limited opportunities to make adjustments to the portfolio because the management of this market segment was handled exclusively by external managers.

One important lesson is that we must establish adequate internal expertise and the option of assuming management responsibility where necessary in all segments in which the fund invests.

Chart 9-3 Holdings of non-agenecy MBS on 31 December 2007 by credit rating. Per cent



The market for US securitised debt

A third of the bonds issued in the US are mortgage-backed securities (MBS). These are bonds based on underlying loans secured against real estate. There are two main types of MBS: agency and non-agency.

Agency MBS

Agency MBS are securities issued or guaranteed by the government-backed mortgage companies Fannie Mae, Freddie Mac and Ginnie Mae. These securities consist of a pool of underlying residential mortgages, but are issued with insurance against defaults on the underlying loans. Agency MBS are issued with the highest possible credit rating (AAA) as the issuing companies are considered to be guaranteed by the US government.

Non-agency MBS

Non-agency MBS are also based on mortgages, but are issued by private companies. Instead of a guarantee against default, these securities have a structure where any losses on the underlying mortgages are covered by securities with lower priority. The most secure security in each issue normally has the highest possible credit rating (AAA), as expected losses on the underlying mortgages are considerably lower than the security provided by the lower-priority securities in the issue.

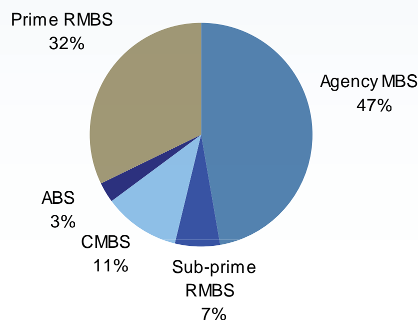
Different types of non-agency securitised debt

RMBS are securities backed by residential mortgages of varying quality, where prime denotes mortgages of good quality, and subprime denotes mortgages where the borrower is believed to be a higher risk.

CMBS are securities backed by loans to commercial real estate companies.

ABS are securities backed by a variety of secured and unsecured loans, the most important groups being student loans, auto loans and credit cards.

Chart 9-4 The fund's holdings of US securitised debt by sector on 31 December 2007. Per cent



Risk management

Extending the scope

2008 was an extraordinary year in the world's capital markets. NBIM has learned its lesson and is further strengthening its risk management capacity. We are focusing in particular on supplementary methods for measuring risk.

The financial crisis presented major challenges for NBIM's risk management. Historical relationships between risk factors collapsed, and liquidity was greatly reduced in most markets.

Most model-based risk systems estimate risk on the basis of historical relationships. When these relationships change significantly in a short space of time, the model will not be in a position to provide reliable estimates of future risk.

The rapid evolution of many financial instruments over the past decade has exacerbated the challenges. Complex instruments have largely been priced and risk-modelled using mathematical models based on the same historical relationships. The problems with the use of models and loss of liquidity have been particularly acute in fixed income management.

Investments are associated with risk

Investments in global securities markets are associated with considerable market risk and a relatively high probability of large variations in annual performance. This became all too clear in the course of 2008.

For the Government Pension Fund – Global, the level of market risk is determined primarily by the composition of the benchmark portfolio. The most important factors for market risk are the allocation to equities in the portfolio, movements in equity prices, exchange rates and

Chart 10-1 Absolute volatility 2004-2008. Per cent and in billions of NOK

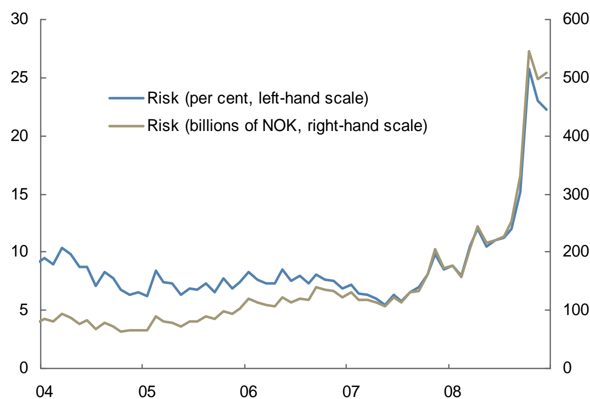
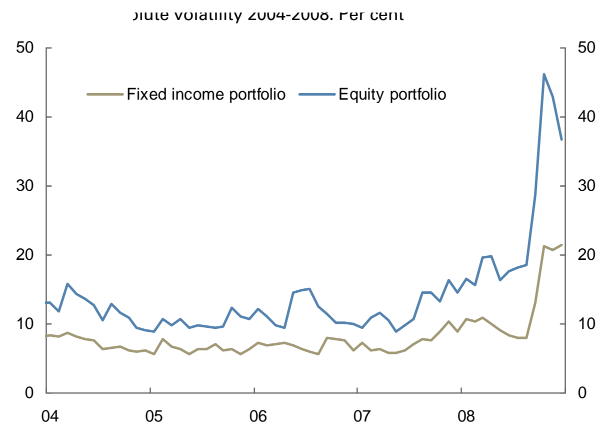


Chart 10-2 Absolute volatility 2004-2008. Per cent



Risk models have their strengths and weaknesses

Estimated relative and absolute volatility are statistical measures of risk that capture and measure different correlations in the portfolio's exposures across asset classes, markets, instruments and currencies.

A risk model capable of capturing these relationships and providing an overall estimate of risk is important because the fund is well-diversified. Models of this type are used as an important part of the restriction, control, management and communication tools for risk within and across all portfolios and markets. As these are model-based estimates, their accuracy will depend entirely on the assumptions behind the model. When capital markets change significantly in a short space of time, and historical relationships between risk factors collapse, the estimates will be less reliable.

The charts show the relationship between model-based estimated tracking error and actual tracking error with the associated confidence interval. Model-based expected tracking error has generally been higher than actual tracking error. This relationship changed as the financial crisis developed. Since the second half of 2007, the tracking error calculated by the model has been significantly lower than actual tracking error at times. This underlines how challenging the measurement of risk can be in the event of major structural changes in capital markets.

Chart 10-3 Standard deviation for risk and realised excess return 1999-2008. Basis points

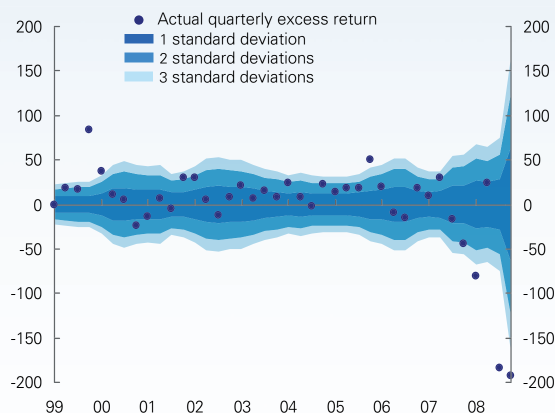
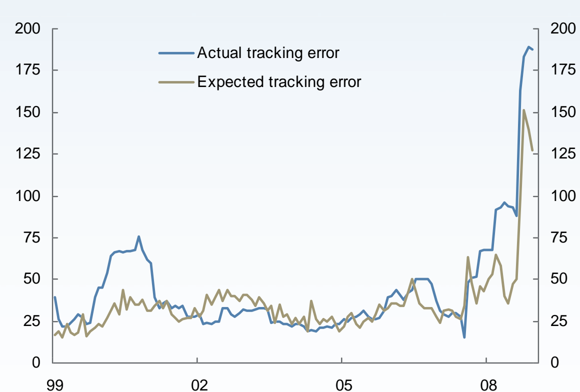


Chart 10-4 Expected and actual tracking error 1999-2008. Basis points



Pragmatic methods and estimations in risk modelling will, however, grow in importance

interest rates, and changes in the fixed income portfolio's credit risk.

Increased volatility

Standard deviation (volatility) is a statistical concept which says something about the size of the variations in return that can be expected in normal periods. Volatility is a common measure of portfolio risk. Market volatility was very high in 2008, and market movements were on a par with the most volatile periods of the past century.

Volatility was high in both equity and fixed income markets. This high market volatility was reflected in the fund's expected and actual absolute volatility. With a higher allocation to equities and rapidly rising market volatility, the sample space for our management of the fund will increase. In 2008 there has been a rapid increase in absolute volatility in both percentage and NOK terms.

Steps taken to reduce relative volatility

The Ministry of Finance has set a limit for how much risk NBIM may take in the active management of the fund. This limit is defined using a statistical concept – expected tracking error (relative volatility) – which puts a ceiling on how far the fund can deviate from the benchmark portfolio. Expected tracking error must not exceed 1.5 percentage points (150 basis points). This limit entails an expectation that the gap between the return on the fund and the benchmark portfolio will be less than 1.5 percentage points in two out of every three years.

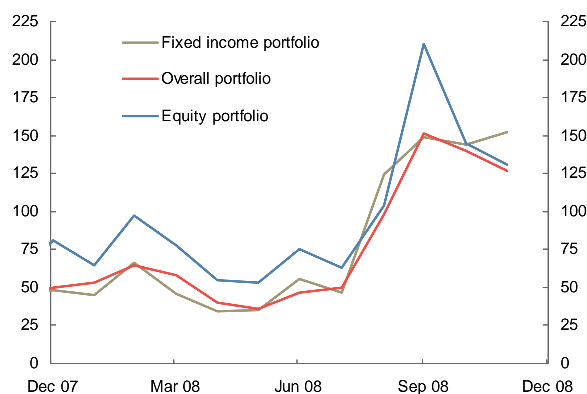
At the beginning of 2008, expected tracking error was 43 basis points, which is slightly higher than the historical average for the fund. Expected tracking error then increased gradually over the course of the year. Towards the end of the year, observations were at the highest levels in the history of the fund. Expected tracking error increased more than absolute market volatility, due largely to increased correlations between the returns on the fund's different investment strategies.

At the end of October 2008, the fund's expected tracking error exceeded the limit set by the Ministry of Finance. This sharp increase in tracking error was due to changes in market dynamics (volatilities and correlations) rather than changes in active positions. During the second half of the year, we suspended or postponed planned portfolio changes that could have increased tracking error.

Increasing the emphasis on supplementary methods and estimations

Risk in the active management of the fund's fixed income portfolio was greater than expected in 2008. One of the reasons for this was excessive emphasis on statistical models in the management of risk. These models underestimated expected relative risk by assuming normal

Chart 10-5 Expected tracking error 2008. Basis points



markets and reasonable continuity of relationships between risk factors. Another reason was underestimation of the correlation between different active positions. In particular, we underestimated the consequences of changes in the liquidity of positions following major changes in market conditions.

We are now increasing our capacity for all forms of risk management. NBIM will continue to use model-based risk systems: these systems have a clear role as long as we are alert to their weaknesses and supplement them with alternative methods to complete the risk picture. Pragmatic methods and estimations in risk modelling will, however, grow in importance.

Measuring changes in credit quality

Credit risk in the fund arises primarily as a result of the Ministry of Finance's choice of investment strategy, but also as a result of active management.

NBIM measures changes in the credit quality of the fixed income portfolio partly using credit ratings issued by credit rating agencies. Table 5-3 provides an overview of fixed income securities rated by Moody's, Standard & Poor's (S&P) or Fitch at the end of the year. The Ministry of Finance does not require a credit rating from these agencies.

Our goal is for the fixed income portfolio to be of good quality and also to be well-diversified without any major concentrations in terms of geography, sector or issuer. This is monitored using concentration analysis. The quality of the fixed income portfolio is also monitored using market indicators such as yield spreads and equity volatility. The probability of individual issuers defaulting is analysed by assessing various risk factors. The extraor-

Supplementary risk management methods

We increased the emphasis on supplementary methods for measuring risk in 2008. These are now established as part of NBIM's control structure. Besides the statistical models based on historical pricing, we manage risk in three main areas:

Concentration analysis

These are measurements based not on a quantitative model but on gross, nominal amounts. The main aim is to obtain a picture of risk that is robust when it comes to model specifications or assumptions.

Factor exposures

Here we measure the portfolio's exposure to traditional and alternative risk factors. These might include factors such as small-cap companies and emerging markets. The important thing here is to gain an overview (both static and dynamic) in order to manage systematic exposures to one or more risk factors.

Liquidity exposure

The ability to implement planned or unexpected changes in the composition of the investment portfolio is dependent on liquidity exposure. The size of our positions relative to overall market turnover describes how quickly such changes can be made. With positions in listed equities, calculating this relationship is relatively straightforward. It is more challenging when it comes to fixed income positions, where a high proportion of trading is over the counter. The financial crisis meant that liquidity dried up, because the participants supplying liquidity drastically scaled back their activities.

dinary market conditions in 2008 highlighted the need for supplementary measures of risk.

Monitoring counterparty risk

Counterparty risk arises in the fund through the use of unlisted derivatives and foreign exchange contracts as well as unsecured bank deposits. Counterparty risk also arises vis-à-vis custodian institutions with which securities are deposited and vis-à-vis international settlement and custody systems.

NBIM manages counterparty risk partly through requirements for high credit ratings when selecting and evaluating counterparties. These requirements are more stringent for unsecured credit exposure than for credit exposure with some form of collateral. The Ministry of Finance has decided that no counterparties involved in such transactions may have a credit rating lower than A- from Fitch, A3 from Moody's or A- from S&P. Changes in counterparties' credit quality are monitored continuously, partly through the use of alternative credit indicators as mentioned above.

Counterparty risk is checked against set credit risk limits through the measurement of positive market values with a supplement for expected volatility. To reduce risk, bilateral netting agreements have been entered into with counterparties for unlisted derivatives and foreign exchange contracts. NBIM has strict collateral requirements for these otherwise unsecured exposures.

Strengthening operational risk management

NBIM defines operational risk as the risk of financial losses or loss of reputation for the organisation or for the funds under management caused by weaknesses or errors in internal processes and systems, as well as errors due to human factors or external events.

We have further developed the framework for operational risk management in the past year. This framework is based on internationally recognised standards. We aim to use operational risk management as an integral tool in our operational management so that we can best identify risks and uncertainties, capture operational events and follow them up in a bid to improve internal processes and interfaces with partners and suppliers.

Identifying, managing and controlling operational risk is a management responsibility. This responsibility includes following up and reporting on operational risk in the various units. Results, risks, events and the status of risk-mitigating control activities and measures are reported and followed up monthly with support from our central function for operational risk management.

We made improvements in our contingency framework in 2008. Our updated framework for contingency and crisis management is based on internationally recognised standards.

NBIM aims to strengthen the central function for operational risk management. Important tasks for this function are increased follow-up of risk, events and losses, and follow-up of risk-mitigating measures and control activities across units and processes. The main intention behind this is, as far as possible, to ensure that internal processes and procedures at NBIM are continuously reviewed, tested and improved. We believe that robust and efficient processes are a key area in reducing overall exposure to operational risk.

Table 10-1 Fixed income portfolio by credit rating *

Percentage of fixed income portfolio	Aaa	Aa	A	Baa	Ba	Lower	P-1	No rating
Government and government-related bonds	30.7	11.3	2.3	0.4	0.1	0.0	-	0.1
Inflation-linked bonds	4.7	3.0	0.1	-	-	-	-	-
Corporate bonds	1.2	4.2	6.9	4.9	0.4	0.2	-	0.2
Securitised debt	27.4	0.9	0.6	0.1	0.1	0.3	-	(0.0)
Short-term certificates	-	-	-	-	-	-	0.0	-
Total bonds and other fixed income instruments	**63.9**	**19.5**	**9.9**	**5.4**	**0.6**	**0.5**	**0.0**	**0.2**

* Based on credit ratings from at least one of the following rating agencies: Moody's, Standard & Poor's and Fitch. The "No rating" category consists of securities not rated by these three agencies; these securities may, however, have been rated by other, local agencies.

Table 10-2 Key figures for risk and exposure

Risk	Limits	Actual				
		31.12.2007	31.03.2008	30.6.2008	30.9.2008	31.12.2008
Market risk	Tracking error max. 1.5 percentage points	0.43	0.65	0.36	0.98	1.27
Asset mix	Fixed income portfolio 30–70 %	52.6	52.0	48.2	47.0	50.6
	Equity portfolio 30–70 %	47.4	48.0	51.8	53.0	49.4
Currency	Europe 50–70 %	59.4	59.8	58.7	59.4	59.9
distribution,	Americas 25–45 %	35.1	33.4	35.3	35.3	34.3
fixed income	Asia and Oceania 0–15 %	5.5	6.7	6.0	5.3	5.8
Market distribution,	Europe 40–60 %	48.8	50.3	50.4	48.8	48.6
equities	Americas and Africa 25–45 %	36.4	34.9	34.4	36.3	35.2
	Asia and Oceania 5–25 %	14.8	14.8	15.2	14.9	16.2
Ownership interest	Max. 10 % of a company (from June 2008)	4.99	4.99	4.99	5.96	8.71

* The maximum 150 bp for tracking error was exceeded in the fourth quarter of 2008.

Table 10-3 New markets and instruments approved for investment by NBIM in 2008

New markets	Bulgaria, Egypt, Morocco, Pakistan, Peru, Romania, Slovakia, Vietnam and Russia
New instruments	Convertible bonds, convertible preference shares

Active ownership

Exercising our ownership rights

NBIM is to make active use of its ownership rights in order to help safeguard financial wealth for future generations by promoting good corporate governance and encouraging high ethical, social and environmental standards at investee companies.

As a shareholder in almost 7 900 companies, Norges Bank has both rights and obligations in relation to these companies. Active ownership is about how we exercise our shareholder rights and how we discharge our obligations.

One of the most important features of the Government Pension Fund – Global is its long time horizon. Coupled with a largely diversified portfolio, we are exposed to developments in the markets with which more short-term investors have traditionally been less concerned. These include both the functioning of the markets and matters of a social and environmental nature – in other words, issues that are crucial for the markets' legitimacy.

We use our position as a shareholder to address topics relating to traditional shareholder rights, such as the right to equal treatment and influence. We also focus on topics that influence the development and regulation of companies' input factors– both regarding human resources such as labour and natural resources such as access to clean water and clean air.

Norges Bank's Executive Board has established a set of principles and a strategy for NBIM's exercise of ownership rights. Openness and transparency are key principles in the management of the Government Pension Fund – Global, and we aim to be as open as possible about our active ownership work.

Our active ownership is practised in a number of different ways: through the exercise of voting rights, through dialogue and engagement with individual companies, through collaboration with other investors, through submissions to the regulatory authorities, and through research and public communication. We aim to vote at all general meetings of the companies in which the fund has shares. We voted on 68 724 items at 7 871 general meetings in 2008.

We voted on 68 724 items at 7 871 general meetings in 2008

The fund's average holding in the global equity market is around 0.77 per cent, but even with relatively low percentage holdings in individual companies, we will often be among a company's largest shareholders. In addition,

Table 11-1 Voting

	2008			2007		
Meetings/Region	Number	Voted	%	Number	Voted	%
Americas	3 143	3 093	98,4	1 547	1 489	96,3
Europe	2 147	1 444	67,3	1 257	852	67,8
Asia and Oceania	3 510	3 334	95,0	1 927	1 861	96,6
Total	8 800	7 871	89,4	4 731	4 202	88,8

the overall size of the fund may give NBIM influence beyond its stake in each individual company. This means that we are in a better position to influence markets and individual companies than many other investors.

Great importance is attached to contact with individual companies. When NBIM engages with a company, this will include long-term objectives and will often be a process that can stretch over a number of years. The aim of engagement is to communicate our expectations and help companies to evaluate and improve their governance processes. Our engagements with individual companies will not normally be disclosed in order to protect confidentiality and to ensure good and effective active ownership processes. It is important that we, as a shareholder, address and hold the board accountable for the matters we raise, and that our engagement is not viewed as an attempt to micro-manage the company. In time, if a company does not make satisfactory improvements, we may turn to other ways of influencing the company, such as openly recommending the replacement of directors or filing shareholder proposals. NBIM did not file any shareholder proposals in 2008.

NBIM publishes its voting records annually. These records and our voting guidelines can be found on our website, www.nbim.no.

Ethical rules and active ownership

In 2004, the Ministry of Finance laid down Ethical Guidelines for the Government Pension Fund – Global on the basis of a decision of the Storting (Norwegian parliament). The Ethical Guidelines are based on two fundamental principles:

- The fund is an instrument for ensuring that a reasonable share of Norway's petroleum wealth benefits future generations. This financial wealth is to be managed in such a way as to generate a solid return in the long term, which is contingent on sustainable development in an economic, environmental and social sense. The fund's financial interests are to be strengthened by using the fund's ownership interests to promote such sustainable development.
- The fund must not make investments which entail an unacceptable risk of the fund contributing to unethical acts or omissions, such as violations of fundamental humanitarian principles, gross violations of human rights, gross corruption or severe environmental degradation.

The ethical basis for the fund is to be promoted through the following three mechanisms:

- Exercise of ownership rights in order to promote long-term financial returns, based on the UN Global Compact and the OECD Principles of Corporate Governance and Guidelines for Multinational Enterprises.
- Negative screening from the investment universe of companies which, either themselves or through entities they control, produce weapons whose normal use violates fundamental humanitarian principles, or sell weapons or military material to countries specified in section 3.2 of the supplementary guidelines for the management of the fund (decided by the Ministry of Finance).
- Exclusion of companies from the investment universe where there is considered to be an unacceptable risk of contributing to serious or systematic violations of human rights, gross violations of individuals' rights in situations of war or conflict, severe environmental degradation, gross corruption, or other particularly serious violations of fundamental ethical norms .

The exercise of ownership rights is Norges Bank's responsibility. The Bank's Executive Board has adopted a set of principles governing this work. It is the Ministry of Finance and not Norges Bank that decides on negative screening and exclusions. The government has appointed a Council on Ethics which makes recommendations to the Ministry of Finance on screening and exclusions. The Ministry then issues instructions regarding exclusions to Norges Bank.

The list of companies excluded from the fund by the Ministry of Finance is published on our website, www.nbim.no.

The government embarked on an evaluation of the Ethical Guidelines in 2008. The results of the evaluation are to be presented to the Storting in 2009. Norges Bank has participated in the consultation process.

Americas

NBIM voted at 3 093 meetings in 2008.

We emphasized issues such as independent chairmen, board independence, independence of important board committees, majority voting in director elections, shareholders' right to vote on compensation plans, and various forms of anti-takeover mechanisms.

Board-related issues accounted for almost 70 per cent of all issues on which NBIM voted.

50 per cent of all shareholder proposals on which NBIM voted were in the US.

NBIM voted at 1 444 meetings in 2008.

In Europe, we focused on issues such as independent directors, independent board committees, share classes with different voting rights, various forms of anti-takeover mechanisms, and transparency.

We still see major challenges in terms of the voting process for foreign investors in some European markets.

Asia and Oceania

NBIM voted at 3 334 meetings in 2008.

In Japan, proposals for the introduction of various anti-takeover mechanisms encountered considerable resistance at general meetings. NBIM voted on 166 proposals in this category, voting against management's recommendation in 98 per cent of cases.

Board-related issues accounted for 62 per cent of all issues on which NBIM voted in Asia and Oceania. NBIM voted against management's recommendation in 10 per cent of cases.

Shareholder proposals have been on the increase and accounted for almost 1 per cent of the proposals on which NBIM voted in the region.

Corporate governance

Equal treatment and influence

Our work on corporate governance aims to encourage value creation and fair economic treatment of minority shareholders.

Voting

Voting is our main tool for influencing the board of directors elected to supervise the company on shareholders' behalf. In 2008, we voted on 68 478 proposals within the traditional definition of corporate governance. NBIM generally supported management's proposals, voting against 11 per cent of proposals from the company, compared with 10 per cent in 2007. We voted against board candidates if the board as a whole did not meet our expectations of adequate independence from management and dominant shareholders. We voted against executive compensation plans with no clear link between pay and performance. We also voted against proposals to give the board far-reaching powers to raise capital without consulting shareholders. These powers can be misused as an anti-takeover mechanism, as the board can prevent takeovers by issuing new capital. They can also result in excessive dilution of existing shareholders' ownership. The prevalence of these issues varies from market to market.

Engagement

Engagement on corporate governance issues comes in addition to communication between the company and our portfolio managers. NBIM focuses on a company's credibility in the market and the board's role, procedures and responsibilities. Our expectations of companies are based on international standards such as the UN Global Compact and OECD Principles of Corporate Governance and Guidelines for Multinational Enterprises. We take account of trends in each market and often raise issues that are not on the agenda for the general meeting.

NBIM engaged with 16 companies on corporate governance and shareholder rights in 2008. One key topic raised with many companies was board independence. This applies to the chairman, important board committees, and our expectation that a majority of directors can be defined as independent of dominant shareholders and the company's executive management. Voting rights and transparent reporting were also issues at some of these companies.

Collaboration with other investors

NBIM collaborates with other investors to get more capital behind our arguments and to show that we are not alone in our views. We are part of various formal networks of investors and other stakeholders in capital markets focusing on setting standards for corporate governance and active ownership.

We are a member of the following networks:

- International Corporate Governance Network, Council of Institutional Investors, Asian Corporate Governance Association – developing and discussing standards for good corporate governance
- UN Principles for Responsible Investment – developing and applying principles for responsible investment

Working with standard-setters and organisations

When it comes to the rules and regulations governing capital markets, we contact supervisory authorities and other standard-setters to promote our views or provide information that we consider appropriate in connection with ongoing processes. In 2008, we joined other investors in providing information and experience in the consultation process leading up to new financial markets regulations in Germany. Our goal was to avoid unwanted restrictions on investors' opportunities to engage in constructive dialogue with companies. NBIM also took part in a process for the development of new International Financial Reporting Standards (IFRSs) on the exploitation of natural resources and the reporting of benefit streams. Standards like these have the potential to simplify the valuation of companies and counteract corruption.

Legal actions

In December 2008, NBIM applied for an injunction from a local court to postpone an extraordinary general meeting of US company Constellation Energy Group (see box).

Voting is our main tool for influencing the board of directors

Active ownership in a takeover situation

In December 2008, NBIM applied for an injunction from a local court to postpone an extraordinary general meeting of US company Constellation Energy Group. The purpose of the meeting was to vote on the proposed sale of the company to MidAmerican for USD 26.50 per share, or a total of USD 4.7 billion. NBIM believed that the agreement underestimated Constellation's true value, and that it was debatable whether the board had acted in the shareholders' best interests.

On 3 December, Electricité de France (EDF) announced that it wished to acquire half of Constellation's nuclear power business for USD 4.5 billion. The general meeting on 23 December was approaching fast, and soundings of investors and advisers suggested that the outcome of the meeting was uncertain. The board did not wish to have contact with shareholders, and there were no clear indications that it was willing to try to negotiate a better solution than the MidAmerican agreement.

On 10 December, NBIM filed its first ever action in a US court. The aim was to postpone the meeting so that the board would have enough time to negotiate with EDF or others, and shareholders would have enough time to consider new information before voting. A week later, Constellation entered into an agreement with EDF along the proposed lines. MidAmerican did not get its acquisition, but did receive a historically high termination fee. Besides our active ownership practices in this takeover situation, this episode illustrates weaknesses in shareholder rights in the US. In this case, shareholders could have been forced to sell their shares with only 50 per cent of shareholders voting in favour. The board committed the company to issuing shares to MidAmerican without adequate payment or shareholder approval. The CEO was also chairman of the board, which may have undermined independence in the board's processes. The episode also illustrates how shareholders can make a difference through active ownership.

Social issues

Promoting children's rights

One of NBIM's strategic priority areas is promoting the rights of the child in multinational companies' operations and supply chains. In particular, this means focusing on corporate performance with regard to preventing child labour.

In 2008, Norges Bank published the document NBIM Investor Expectations on Children's Rights which summarises NBIM's expectations of companies in terms of children's rights in general and child labour in particular. These expectations are based on the UN Convention on the Rights of the Child and the ILO's conventions on child labour.

Voted in favour of human and labour rights

In 2008, we voted on 166 shareholder proposals concerning social issues at 110 companies. The majority of these proposals called for the implementation of guidelines on human and labour rights, and improved disclosure and reporting by the company on its social responsibility and human rights performance.

Engagement

During 2008 NBIM started implementing the NBIM Investor Expectations on Children's Rights systematically both as an analytical tool and in our dialogue with companies.

More than 430 companies have been systematically analysed on the basis of the criteria set out in the Expectations. These companies operate in the following sectors: agriculture, chemicals, mining, iron and steel, and textiles.

On the basis of this analysis, NBIM decided to enter into dialogue with companies that we find do not report adequately on their position on international conventions on human rights, children's rights and child labour, and companies that do not provide information on their risk management in these areas both in their own operations and in their supply chain. Another goal is, as far as possible, to encourage companies to be more transparent and make greater use of key performance indicators in their reporting.

At the end of 2008, NBIM had engagements with 19 companies on child labour, risk management in the supply chain, and board competence. Our work concentrated on four key geographical areas – India, Brazil, China and West Africa – where there is a high risk of child labour.

Within genetically modified seed production, we have initiated a co-operation between several companies with the aim of developing a common standard against child labour.

NBIM has also begun working with another large European institutional investor on the issue of child labour in West African cocoa production.

Contact with external organisations

To safeguard the quality and relevance of our work, we are in regular contact with stakeholder organisations, experts and international organisations such as UNICEF, the UN Global Compact, other UN bodies and ILO bodies

Table 13-1 NBIM's engagements on social issues in 2008

Sector	Number of engagements
Chemicals	3
Industrial metals (steel) *	5
Food and drink	8
Electronics and electrical equipment	1
Oil and gas producers *	1
IT hardware and peripherals *	1

* Some engagements also cover environmental and/or governance issues.

NBIM Investor Expectations on Children's Rights summarises NBIM's expectations of companies in terms of children's rights in general and child labour in particular

South America

5.7 million children aged 5-14 are involved in child labour in Latin America and the Caribbean.*

NBIM was in contact with 23 companies with operations in South America in 2008.

These companies operate in steel and mining.

West Africa

49.3 million children aged 5-14 are involved in child labour in sub-Saharan Africa.*

NBIM was in contact with 22 companies with operations in Africa in 2008.

These companies operate in mining and cocoa production.

Asia-Pacific

122.3 million children aged 5-14 are involved in child labour in the Asia-Pacific region.*

NBIM was in contact with 85 companies with operations in Asia in 2008.

These companies operate in mining, iron and steel, textiles, and agriculture sectors.

*The End of Child Labour: Within Reach, ILO 2006

Environmental issues

Prioritising carbon reductions

NBIM's goal is for companies to manage the external impacts of their operations and the natural resources used in their value chains on a long-term sustainable basis.

Voting

We voted on 80 proposals at 42 companies concerning environmental issues in 2008. Many shareholder proposals in the environmental field focused on setting specific targets for reducing emissions of greenhouse gases. NBIM believes that a target of reducing greenhouse gas emissions will enhance companies' long-term work on adjusting to the requirements of national and international regulations. Our main requirements for voting in favour of the introduction of such targets were that the proposal was formulated in such a way that the company itself was free to determine the size and details of the target, and that the company did not already have reasonable targets in this area.

Engagement and dialogue

NBIM continued ten established engagements with companies in the US in 2008. These dealt with how proposals for reductions in greenhouse gas emissions would impact on these companies' business and investment strategies, and which key issues these companies in turn were discussing with lawmakers. The basis for continuing these engagements was reinforced in connection with the hearing of a bill seeking to regulate greenhouse gas emissions in the US Senate in 2008. Our goal in these engagements was to communicate both our expectations and those of other long-term investors to the company. The companies with which we had talks are major players in the US energy sector and considered to wield considerable influence over US legislation in the climate and environmental fields.

It can be hard to identify visible and concrete results of our work in this area. However, as in 2007, we saw progress at the companies in question, with them developing and clarifying their position and communication in the field in line with our expectations.

We have also seen organisations such as the National Mining Association and the new American Coalition for Clean Coal Technology (in which companies with which NBIM has engagements are important players) contributing to the legislative process. This marks a change of attitude, because these organisations previously lobbied actively against legislation. The Climate Change Points

of Agreement published by the Electric Edison Institute on 14 January 2009 are another sign of a more constructive attitude from the companies with which NBIM has engagements.

Collaboration with other investors

NBIM became a signatory investor in the Carbon Disclosure Project (CDP) in 2008. The CDP is a coalition of almost 400 investors worldwide which aims to encourage companies to measure and disclose their greenhouse gas emissions. As a signatory investor, we also have access to the information submitted by companies.

In February 2008, NBIM organised a conference in Washington in which a select number of institutional investors took part together with management representatives from some of the companies with which we engaged during the year. The aim was to include other investors in the discussions that we have held, and to discuss the way forward.

In November 2008, NBIM signed the Investor Statement on a Global Agreement on Climate Change. This statement is in keeping with our emphasis on the need for clear long-term signals from national and international lawmakers regarding regulation of greenhouse gas emissions.

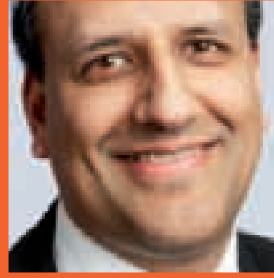
Table 14-1 NBIM's engagements on environmental issues in 2008

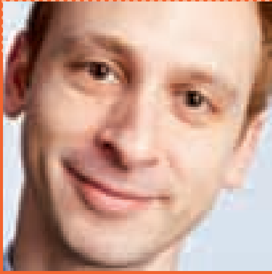
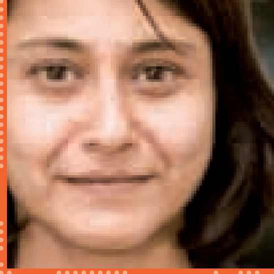
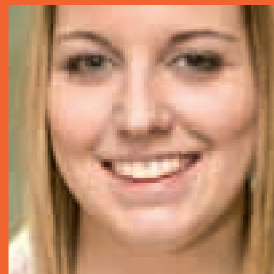
Sector	Number of engagements
Mining *	3
Oil and gas producers *	2
Electricity *	4
Energy and water	1

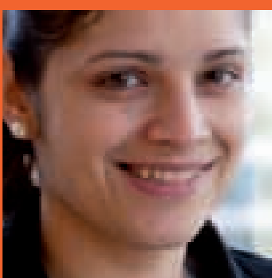
* Some engagements also cover social and/or governance issues.

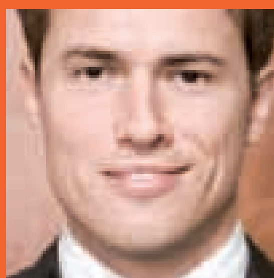
217 EMPLOYEES FROM 18 NATIONS

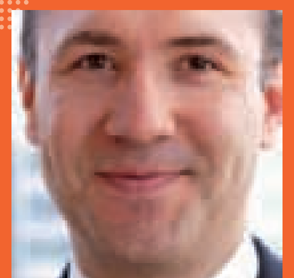
Activity at offices in Oslo, New York, London and Shanghai









NBIM

An international organisation

NBIM's operations can be summed up in two words: international and expert.

An international operation

Our global management mandate as operational manager of the Government Pension Fund – Global means that we are building up an extensive globally oriented organisation in Norway.

The mandate also requires an international presence and international expertise. NBIM currently has regional offices in London, New York and Shanghai. This international presence brings us closer to the markets in which we invest, and closer to our international partners. Both factors are important for us to be able to deliver quality in the execution of the management mandate.

An ever larger and more complex mandate means that NBIM is a growing organisation. The number of permanent employees increased by 39 during the year. Of a total of 217 permanent employees at the end of 2008, 28 per cent were non-Norwegians, and 42 per cent of new recruits were non-Norwegians. Besides Norwegian nationals, we have 61 employees from 18 different countries. The working environment is fast-moving, international, result-oriented and diverse. Our working language is English. NBIM seeks actively to recruit women and offers a youthful, fast-moving and result-oriented workplace

Expertise

Our mandate requires us to be a centre of excellence with a high degree of specialisation, expertise and innovation. The organisation's expertise is tied primarily to its employees.

Retaining, recruiting and developing expertise is a major challenge. We attach great importance to recruiting employees with specialist expertise in global investment management. The organisation also needs talented young graduates from leading educational institutions.

Remuneration system

The Executive Board defines pay and personnel policy as a means for NBIM to achieve its strategic goals. Our remuneration system has two main components: fixed pay and a variable component which depends on performance. Employees who take investment decisions are assessed quantitatively on the basis of returns, and the performance-based component will often be larger than the fixed component.

28 %

- 28 % of permanent employees are non-Norwegians
- 42 % of new recruits are non-Norwegians
- 25 % of permanent employees are women

25 %

25 % are employed at our overseas offices

- New York
- London
- Shanghai

Our mandate requires us to be a centre of excellence with a high degree of specialisation, expertise and innovation

Payments of performance-based pay reflect differences in individual performance and NBIM's overall performance.

Total payments of performance-based pay in 2008 were low. 78 per cent of employees received less than 50 per cent of the upper limit for performance-based pay. The proportion of employees with low levels of performance-based pay was higher than before. This needs to be seen in the light of the weaker management performance.

The system and scale for the remuneration of NBIM's Executive Director is determined by the Executive Board. His actual remuneration is decided by the Governor of Norges Bank according to specific criteria.

A new Executive Director of NBIM began on 1 January 2008 and was paid a salary of NOK 5 408 036 in 2008. In his previous position as head of equity management, he had an agreement on salary for the period 2005-2007 which was held back until the period was over. In 2008, therefore, he was also paid NOK 700 000 in salary for each of the years 2005-2007. In addition, he received bonuses for the results achieved as head of equity management in 2007 and previous years of NOK 3 263 000. He also received other benefits with a combined value of NOK 13 824. The Executive Director of NBIM is a member of Norges Bank's pension scheme, which is described in Norges Bank's Annual Report.

Remuneration at NBIM

Front-office departments:

Number of employees with performance-based pay: 95. Total fixed pay: NOK 87.5 million. Upper limit for performance-based pay: NOK 164.8 million. Performance-based pay as a percentage of limit: 19 per cent

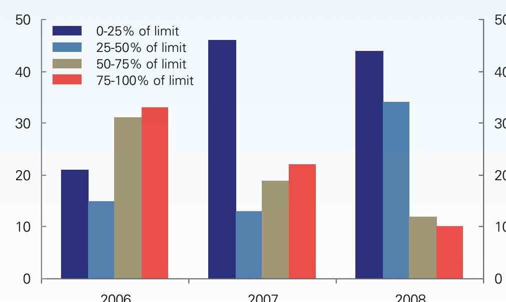
Other departments:

Number of employees with performance-based pay: 103. Total fixed pay: NOK 74.3 million. Upper limit for performance-based pay: NOK 32.2 million. Performance-based pay as a percentage of limit: 38 per cent

Total performance-based pay in 2008 was 22 per cent of the upper limit for performance-based pay. The upper limit for performance-based pay was 15 per cent higher than in 2007. The average payment per employee was 45 per cent lower than in 2007.

Excludes remuneration of the Executive Director of NBIM.

Chart 15-1 Performance-based pay relative to upper limit. Percentage of workforce



NBIM's organisation

Focusing on core activities

Active use of external suppliers means flexibility and efficiency in the implementation of our management mandate. We can then focus our attentions on our core activities.

Global investment management requires a global organisation. Our operations run around the clock, the complexity of our solutions is considerable, and our demands of suppliers are exacting. Large parts of our operational activities are carried out using suppliers with particular expertise in a specialist field. This helps NBIM to operate as a relatively small and flexible organisation.

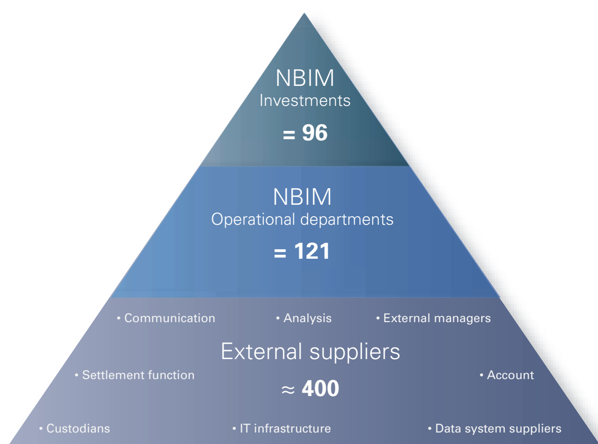
Some services need to be based on international suppliers. One example is the use of custody services. The custodian institution looks after our interests in the local securities markets. Here, we have to have large international financial institutions as our partners.

In other cases, we choose to use external suppliers rather than building up broad expertise in particular specialist areas. This gives us greater flexibility if deliveries are not of sufficient quality. In addition to external portfolio management services, we use external expertise in fields such as IT and communication services and transaction processing.

It will often be beneficial for NBIM to have access to service providers' expertise in the form of resources, networks and innovations. We expect our extensive use of external suppliers to reduce vulnerability in the operation and management of our systems. Thus, this strategic decision is motivated more by operational risk, stability and quality considerations than by cost savings.

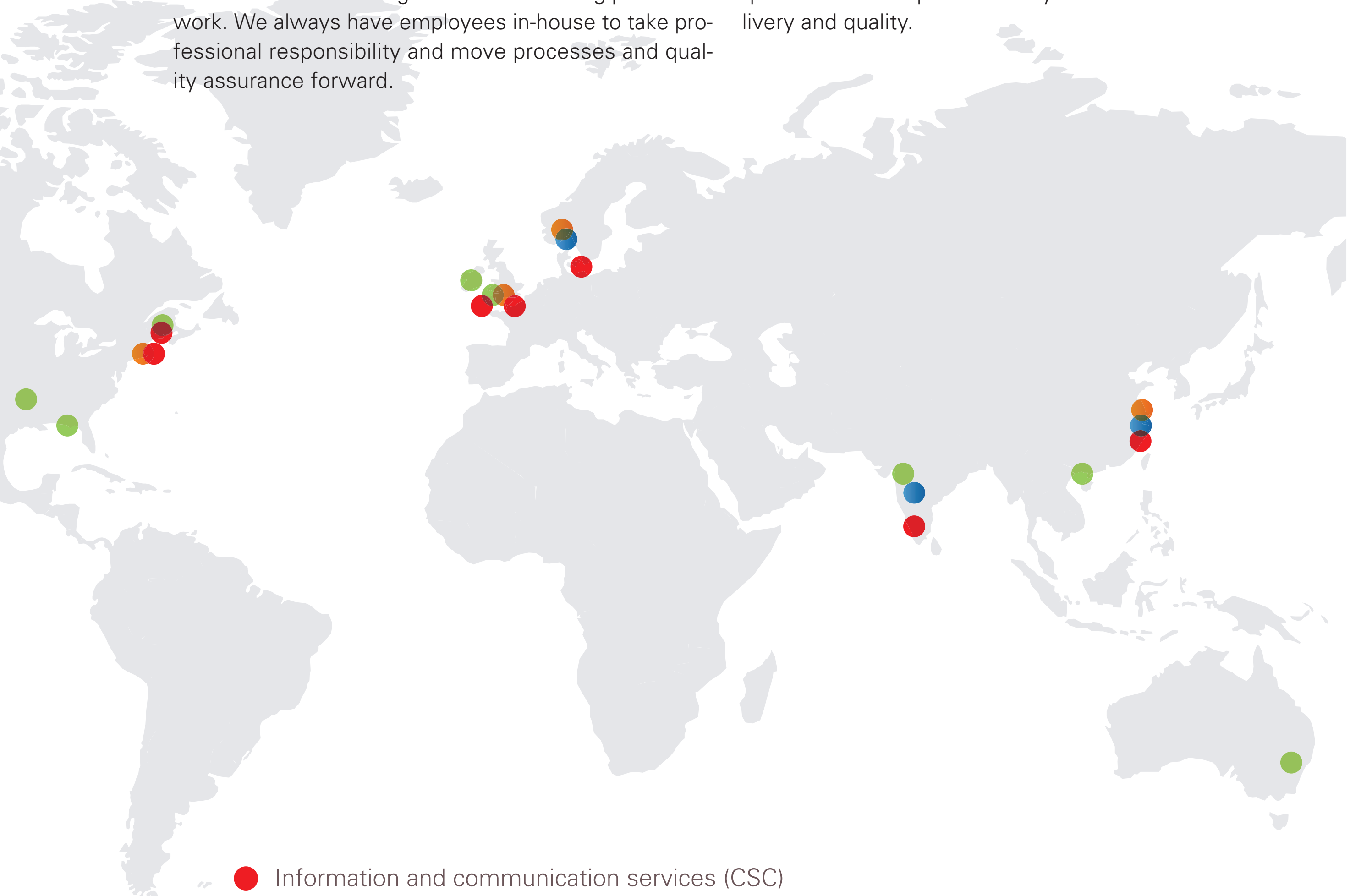
With four offices around the world, proximity to and close follow-up of suppliers are essential. All of our offices have access to the same services, and great importance is attached to all systems working on the same platform regardless of geographical location.

Adding together all of our external partners, we estimate that external personnel equivalent to around 400 full-time employees are linked to our organisation. This means that around 65 per cent of the total work involved in our investment management is performed through external partners.



Keeping tabs and assuring quality
It is also important to maintain the necessary oversight over outsourced activities. NBIM attaches great importance to retaining internal expertise in all specialist fields farmed out, and we have built up considerable experience and understanding of how outsourcing processes work. We always have employees in-house to take professional responsibility and move processes and quality assurance forward.

To assure the quality of services, we attach great importance to both formal and informal dialogue with our partners. The formalisation of service agreements provides a reassuring framework for outsourcing activities, while constant evaluation of suppliers on the basis of quantitative and qualitative key indicators ensures delivery and quality.



Systematic risk in the equity portfolio

We estimate a five-factor model for the equity portfolio based on historical returns for the past 11 years. The analysis shows that the equity portfolio has been exposed to a number of systematic risk factors at times. However, these exposures vary considerably over time, and exposure to most systematic risk factors has decreased over the past couple of years. The estimate of alpha, which is often used as an indicator of the quality of investment management, is positive, and seems to be robust to different market regimes.

A traditional multifactor model

Until the early 1990s, the capital asset pricing model (CAPM) was the dominant model for assessing risk and expected returns on equities. According to the CAPM, the expected return on an equity over and above the risk-free interest rate will depend on the risk premium for equities and that equity's correlations with the market portfolio, normally known as beta. Within CAPM, two arbitrary equity portfolios can produce different average returns only if the two portfolios have a different beta.

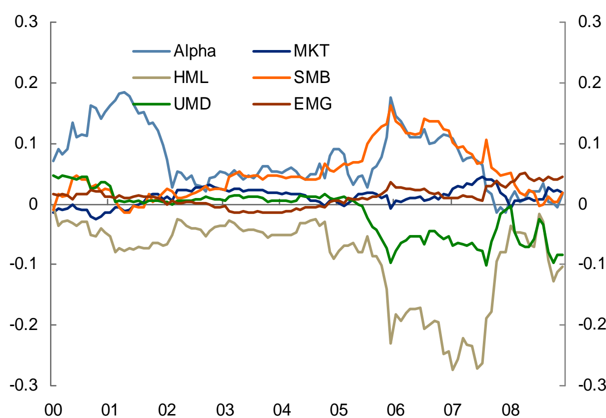
In the 1980s, however, a number of empirical regularities in equity returns were discovered that could not be explained by the CAPM. The "size effect" is an empirical regularity that means that investments in small companies have, on average, produced a market risk-adjusted excess return relative to investments in large companies. Another company characteristic that seems to result in systematic differences in return between equities is the ratio of book value to market value (B/M). Several studies have documented that companies with a high B/M have a systematically higher market risk-adjusted return than companies with a low B/M. This is often referred to as the "value effect".

In an important article, Fama and French developed a three-factor model that included factors representing the size effect and the value effect along with the market return. This three-factor model had much greater explanatory power for equity returns than the single-factor CAPM. The theoretical basis for the size and value factors is still unclear, but the Fama-French model has nevertheless become established as a standard in empirical studies of asset pricing.

In their original article, Fama and French[1] used the designations SMB (small minus big) for the factor representing the size effect and HML (high minus low) for the factor representing the value effect. SMB is defined as the return on a portfolio with an overweight of the smallest companies and an underweight of large companies. Similarly, HML represents the return on a portfolio with an overweight of the companies with the highest B/M in each size group and an underweight of the companies with the lowest B/M in each size group. Fama and French used a double sort method which was intended to reduce potential size effects in the calculation of the value effect and vice versa. In our factor model, we have used the same method as Fama and French when calculating the factor returns for each country. The global SMB and HML factors have been calculated by first aggregating the country factors up to regional level on the basis of each country's market value. The regional factors are then weighted together to produce a global factor using the regional weights in NBIM's equity portfolio.

A fourth empirical regularity which is often included in empirical studies of asset pricing is the "momentum effect". This effect means that an investment strategy based on buying companies that have produced a high

Chart 16-1 Coefficients estimated over rolling 24-month periods



return over the past 3-12 months, and selling companies that have produced a low return during the same period, produces a risk-adjusted excess return. One momentum factor used widely in the literature is UMD (up minus down). This is calculated as the return on a portfolio with an overweight of companies with the highest return in each size group and an underweight of companies with the lowest return in each size group. In our factor model, we use a UMD factor where the factor portfolio at the end of month t is based on the equity return from month t-12 to month t-1.

Equity markets in emerging economies have different risk characteristics to those in developed economies. For a global investment manager like NBIM, it will therefore be natural to include a factor representing emerging economies. In our factor model, we have introduced the factor EMG, which represents the return on a portfolio with an overweight of emerging equity markets and an underweight of developed equity markets.

The equity portfolio's factor exposures

In our analysis of the equity portfolio's factor exposures, we have taken the Fama-French model as our starting point and expanded it to include a momentum factor and an emerging markets factor. Table 16-1 shows the results of estimating this five-factor model using monthly data.

The results suggest that the equity portfolio has been exposed to a number of priced risk factors, including the market (MKT) and small companies (SMB). On the other hand, the equity portfolio has had a significant negative exposure to the value factor (HML). This means that the equity portfolio has, on average, been skewed towards equities with a low B/M, often referred to as growth stocks. Alpha, which is the estimated constant in the regression, can be interpreted as the part of the excess return that cannot be explained by passive exposure to the systematic risk factors. For this reason, alpha is often used as a measure of the quality of investment management. The estimate of alpha is positive. It is worth noting that the adjusted coefficient of determination R^2 is relatively low: just 35 per cent of the variation in the excess return on NBIM's equity portfolio can be explained by a traditional five-factor model. By way of comparison, Fung and Hsieh[2] found in their study of a large number of equity managers that more than 80 per cent of the variation in excess return can be explained by a traditional four-factor model.

Table 16-1 Estimation results for the period February 1998 to December 2008

Factor	Coefficient	T-value *
Alpha	0.0326	1.47
MKT	0.0260	3.26
HML	-0.0524	-4.47
SMB	0.0400	3.48
UMD	0.0110	2.01
EMG	0.0055	0.86
Adjusted R^2		35.5

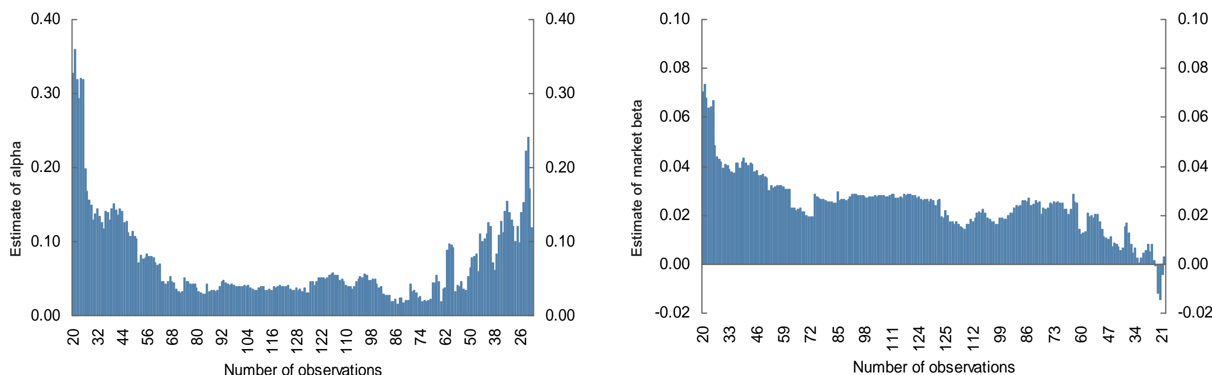
* The standard errors are adjusted for varying variance in the residuals.

The results above show that the equity portfolio has been exposed to a number of risk factors when considering the period as a whole. It may be interesting to see whether this has arisen as a result of a systematic skew towards these risk factors, or whether these exposures have varied over time. Chart 16-1 shows the estimates for the various risk factors over rolling 24-month periods.

The chart suggests that the equity portfolio's exposure to most of the risk factors varies considerably over time. Exposure to SMB was high towards the end of 2005 and in 2006. During that same period, the equity portfolio had significant negative exposure to HML. This was due partly to the transfer of capital to external managers with exposure to the small-cap segment, and is therefore partly the result of a conscious investment decision. Both SMB and HML exposure have decreased considerably over the past couple of years. Exposure to EMG increased in 2008. This was due partly to more emerging markets being phased into the benchmark index for the equity portfolio during the year. The estimate of alpha is positive for most of the period but has fallen in the past year.

It may also be interesting to look at whether exposure to the various factors is dependent on market movements. Chart 16-2 estimates alpha and the coefficient for MKT for various selections of observations. The first column on the far left of each chart represents the coefficient estimate in a regression based on the 20 monthly observations with the lowest market return. As we move towards the right of the chart, more observations based on market returns are gradually included. The last column on the far right of each chart represents the coefficient estimate in a regression based on the 20 month-

Chart 16-2 Estimated alpha (left) and market beta (right) conditional on market movements



ly observations with the highest market return. The column in the very centre of each chart represents the coefficient estimate obtained using all of the observations.

Chart 16-2 shows that the alpha estimate is positive in all market regimes. There is also a clear tendency for the alpha estimate to be higher in periods of high market volatility – whether strongly bullish or strongly bearish – than across all observations. The market beta also appears to be positive in most market regimes. However, it appears that the market beta is higher in a bear market and lower in a bull market.

Recent factor models

The traditional Fama-French model has long dominated in both academic studies and practical applications. In analyses of the return on equity funds, excess return is often divided into two components: alpha and beta. Beta is used for the part of the return that is attributable to systematic exposure to the risk factors specified in the factor model, while alpha is any return beyond that.

Many hedge fund strategies are often presented as high-alpha strategies without exposure to traditional beta factors. However, several studies suggest that part of the excess return from common hedge fund strategies can be replicated by investing passively in a set of alternative systematic risk factors[3]. It has therefore been argued that many hedge funds' alpha is to some extent a type of beta that traditional factor models are unable to capture. Recent replication models have introduced a number of alternative risk factors relative to the traditional models. In addition, recent factor models have attempted to capture the asymmetrical return profile that is characteristic of a number of common hedge fund strategies. If we expand the traditional definition of beta to include other systematic risk exposures that it is possible to replicate, often known as "alternative beta", the estimated alpha in a factor model will be reduced.

2008 was a poor year for both NBIM and the hedge fund industry. Although there are big differences between NBIM and the hedge fund industry, it may be interesting to see to what degree NBIM's equity portfolio has had similar factor exposures to an equity hedge fund. In this analysis, the traditional factor model is expanded to include more recent factors widely used in the literature on hedge fund replication.

A number of academic studies document that liquidity risk plays a significant role in the pricing of equities[4]. Gibson and Wang[5] find empirical support for the interpretation of excess return from several common hedge fund strategies as compensation for accepting liquidity risk. Such exposure might, for example, arise as a result of a hedge fund playing on what are known as reversal effects, where the manager systematically buys equities that have decreased greatly in value and sells comparable equities that have increased greatly in value. Liquidity risk has many dimensions, and there are therefore a number of different risk indicators. Gibson and Wang look partly at an indicator based on Amihud (2002)[6]. This liquidity measure is based on the relationship between absolute return and trading volume: the greater the change in price triggered by a given trading volume, the more illiquid a stock will be. In our model, we have chosen to use a size-adjusted indicator of liquidity risk based on Amihud (2002). This factor (ILL) is the return on a portfolio with an overweight of illiquid equities in each size group and an underweight of liquid equities in each size group.

We have included two factors with a non-linear return profile. The first (CRY) is intended to represent carry trades. This expression originates in fixed income management, but is often now used as an umbrella term for strategies that systematically collect risk premiums. These strategies are often compared with issuing insurance: there can be long periods of simply collecting premiums, but there can be a big loss if the sum insured has to be paid out. Within equity management, there are several examples of strategies that can be characterised as carry trades. These include arbitrage in takeover situations, with a systematic overweight of companies that are being acquired and an underweight of the acquiring company[7]. In our analysis, we have used the return on a strategy that is systematically long a high-yielding currency (NZD) and short on a low-yielding currency (JPY) as a proxy for carry trades. The other factor with a non-linear return profile (VOL) is the return on a strategy that systematically issues put options. With this strategy, it may be possible to collect option premiums for long periods. Should the equity market take a tumble, though, there will be an obligation to purchase equities at above the market price and so take a loss. Common to CRY and VOL is that these strategies have a very skewed return distribution, with many observations that are slightly positive and a few that are deeply negative.

Table 16-2 compares NBIM and the hedge funds when it comes to the different risk factors. The hedge funds seem to have greater market exposure than NBIM, while NBIM seems to have greater exposure to HML than the hedge funds. There are no big differences for the other traditional factors. However, there are significant differences between NBIM and the hedge funds when it comes to the new factors. NBIM seems to have less exposure to both liquidity risk and the asymmetrical risk factors. It is also worth noting that NBIM has generated significantly more alpha than the hedge funds in an expanded eight-factor model.

Table 16-2 NBIM versus equity hedge funds in the period April 2003 to December 2008

Factor	Coefficient	T-value *
Alpha	0.298	2.52
MKT	-0.436	-4.61
HML	0.338	2.94
SMB	-0.050	-0.40
UMD	-0.029	-0.41
EMG	-0.014	-0.27
ILL	-0.579	-1.97
CRY	-0.078	-1.95
VOL	-0.048	-2.01
Adjusted R^2		82.1

* The standard errors are adjusted for varying variance in the residuals.

Table 2 shows the results of an estimation of this expanded factor model. On the left side of the regression is NBIM's excess return less the excess return on a selection of long/short equity hedge funds. The return data for these hedge funds are from Hedge Fund Research Inc.

Conclusion

Our analysis shows that the equity portfolio has been exposed to a variety of systematic risk factors at times. This is attributable to a number of factors.

NBIM's equity management has been built up with a view to generating excess return through fundamental stock analysis within a number of specialised investment mandates. With this kind of framework, the individual manager will often hunt for mispriced stocks in market segments that are less efficient. This might be in the small-cap segment, and sometimes also in emerging markets. At the same time, active positions have a tendency to be financed by selling large companies where the financing costs are lowest. Active equity management will therefore have an inherent tendency to create exposure to the traditional risk factors. This can also be seen with most other equity managers[8]. Given NBIM's investment philosophy, we must therefore expect to see exposure to the traditional risk factors when the equity portfolio is viewed as a whole.

Exposure to systematic risk factors may also be an intentional effect of various investment decisions. One example of this is the allocation to external managers with exposure to the small-cap segment which affected the equity portfolio's exposure to SMB and HML in 2005-06. The important thing for NBIM is not, therefore, to eliminate all exposure to known risk factors at all times. Instead, considerable importance is attached to taking a conscious position on all risk exposures in the equity portfolio at any one time, whether these exposures are intentional or unintentional, and whether they are to traditional or alternative risk factors.

1 Fama, E.F. and K.R. French (1993): "Common Risk Factors in the Returns on Stock and Bonds", *Journal of Financial Economics,* 33(1), 3-56.
2 Fung, W. and D.A. Hsieh (2006): "The Risk in Hedge Fund Strategies: Theory and Evidence from Long/Short Equity Hedge Funds", Duke University, Working Paper.
3 See, for example, Jaeger, L. (2008): "Alternative Beta Strategies and Hedge Fund Replication", Wiley Finance.
4 Acharya, A. and L. Pedersen (2005): "Asset Pricing with Liquidity Risk", Journal of Financial Economics, 77, 375-410.
5 Gibson, R. and S. Wang (2008): "Hedge Fund Alphas: Do They Reflect Managerial Skills or Mere Compensation for Liquidity Risk Bearing?", Swiss Finance Institute Research Paper No. 08-37.
6 Amihud, Y. (2002): "Illiquidity and Stock Returns: Cross-section and Time-series Effects", Journal of Financial Markets, 5, 31-56.
7 Mitchell, M. and T. Pulvino (2001): "Characteristics of Risk and Return in Risk Arbitrage", Journal of Finance, 56, 2135-2175.
8 Fung, W. and D.A. Hsieh (2004): "Extracting Portable Alphas from Equity Long/Short Hedge Funds", *Journal of Investment Management,* 2(4), 1-19.
Fung, W. and D.A. Hsieh (2006): "The Risk in Hedge Fund Strategies: Theory and Evidence from Long/Short Equity Hedge Funds", Duke University, Working Paper.

Global voting – important but often difficult

Voting at general meetings is a fundamental shareholder right that gives us an opportunity to influence the governance of the company. As a shareholder, we must manage this right in the best possible way. There are many obstacles to efficient cross-border voting, and we are working towards improvement and simplification of the processes involved in global voting.

Why is voting a priority area for NBIM?

The general meeting elects the company's board and reaches decisions on matters of great importance to the company. Voting by NBIM and other shareholders at general meetings helps to make the company's board and management accountable. The role of the general meeting is not to micro-manage the company but to provide a means for shareholders to ensure that the board and management do not use their powers in ways that conflict with all shareholders' interests and rights in the company.

Traditionally, institutional investors with highly diversified international portfolios and small holdings in individual companies have tended not to exercise their voting rights. However, this investor group is gradually becoming a force to be reckoned with in most markets, and is in a better position than before to influence the outcome of matters put to the vote. This group is also in a better position to ensure that the decisions taken are indeed representative of the company's shareholder base.

Cross-border voting is both costly and labour-intensive, and the systems in the individual markets are not well suited to having a large proportion of equities held by international institutional investors. There are currently no global standards regulating the broad range of existing practices when it comes to voting. It is not only the practical and economic challenges of cross-border voting that present a problem for shareholder democracy.

Efficient and less costly voting processes will result in greater participation in voting and increase the influence that we and other institutional shareholders have over the development of listed companies. We aim to work with other investors, regulators and the many players involved in the voting process to bring about more efficient voting.

Together with the Center for Corporate Governance at the Tuck School of Business at Dartmouth College in the US, we have embarked on an analysis of the statutory and regulatory aspects of voting, local recommendations for best practice, and market practice at the largest companies in a number of countries. The results of this analysis will provide a sound foundation for our continued work on making the voting process more efficient and straightforward.

NBIM wants to help make voting more efficient

It has become easier and less expensive to exercise voting rights in most markets, but there is still a need for large amounts of manual processing in the actual casting of votes, and large volumes of information and documentation to be handled. For large investors, the cost of global voting can be justified; for smaller investors, the cost may be too high, with the result that they choose not to vote.

Registration and establishment of voting rights

Institutional investors vote mainly through their custo-

dian banks and their local agents. For practical, financial and, in some cases, legal reasons, the custodian bank rather than the actual shareholder may be registered as the owner of shares in a company's share register. Widespread use is also made of proxy agents and their web-based voting platforms. It is not uncommon for companies to use agents to handle all of the practical sides of a general meeting, and the local securities depository plays a role in establishing holdings and voting rights in many markets. This complex set of players, which can vary with the type of investor and the market in question, can be difficult and expensive for shareholders to deal with. NBIM wishes to promote and support the work that is under way in a number of markets to simplify the network of players that need to be involved in order to exercise voting rights.

In some markets, shares registered in the name of the custodian bank must be re-registered in the name of the shareholder for the shareholder to be able to exercise his voting rights. This re-registration is not automatic, needs to take place within set deadlines, requires collaboration between a number of players, and must often be done before the shareholder even becomes aware that a general meeting is to take place.

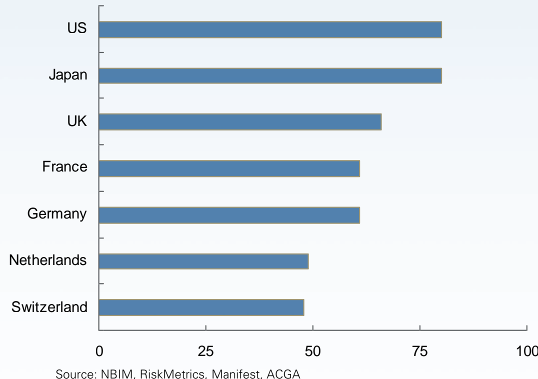
Ideally, a shareholder will be able to vote for the shares he holds on the day of the general meeting. In some markets, this is ensured by blocking the sale of shares for a set period ahead of a general meeting. In practice, this means that the investor has to choose between exercising his voting rights or retaining the freedom to sell his shares without restrictions. This blocking of shares is seen in many European markets.

In markets where shares are not blocked, voting rights are based on holdings on a set day – the record date –

Global voting

There are major variations from market to market, and even from company to company within the same market, in the degree to which shareholders exercise their right to vote at general meetings. The level of voting at a particular meeting will also depend on the matters on the agenda. Normally, participation is higher when it comes to contentious issues such as takeovers, changes in corporate control and competing board candidates. The nature and level of disclosure of information on voting participation vary. In some markets, including Sweden, Ireland and Denmark, there are no requirements for this information to be disclosed. Despite this lack of information, it can generally be said that participation has traditionally been higher at US companies than at European and Asian companies (with the exception of Japan). This can be explained partly by the higher proportion of global institutional investors in these markets, which have traditionally made less use of their voting rights than other shareholders.

Chart 17-1 Shareholder participation in voting. Per cent



Source: NBIM, RiskMetrics, Manifest, ACGA

ahead of the meeting. The shareholder is free to sell his shares after this date, and so there is no guarantee that those exercising their voting rights actually hold the equivalent number of shares in the company on the day of the meeting. The use of record dates is becoming more and more common, but there are major variations in the length of time between record date and meeting. In many markets, companies themselves can decide on the record date, which makes the situation even more complex. In the US, the record date can be as many as 60 days ahead of the meeting; in other countries, the record date comes just a few days before the meeting – two days, for example, in Italy and Australia.

NBIM aims to promote the simplification of the aforementioned processes for the establishment of voting rights in a number of ways. We want markets to introduce systems that do not require shares to be blocked, and we want it to be possible to cast votes closer to the general meeting.

Representation

Institutional investors that choose to vote globally normally do so by appointing an agent to attend general meetings and vote on their behalf. The voting rules in many countries have not been updated to take account of the large proportion of votes being cast by proxies. Such voting may therefore be complex and labour-intensive, due largely to manual processing by the players involved. In some markets, there are restrictions on who may be appointed a proxy, the number of shareholders for which a proxy can vote, and the degree to which the proxy can vote differently for the different shareholders represented.

In many markets, investors who use a proxy must issue a notarised power of attorney giving the proxy the right to attend and vote at a general meeting. In some markets, this power of attorney can cover all companies; in other markets, a separate power of attorney is needed for each general meeting, or a power of attorney may apply only for a limited period. In a number of markets, the proxy must be able to produce the original power of attorney ("wet copy"). There are obvious administrative costs associated with meeting these requirements.

Few countries allow electronic (or postal) voting. A number of markets have opened the door to electronic voting – including the US, Australia, Japan, the UK and Germany – but it has been introduced at only a small number of companies. NBIM wishes to promote and support the introduction of legislative changes so that physical attendance at general meetings is not required.

Information

All documentation and information relating to a general meeting needs to pass through a chain of service providers from company to investor, and the investor's voting instructions need to head back the same way. The more players involved, the longer these processes take. Each player sets his own deadline, often allowing a little extra time so that he can be sure to meet the deadline set for him.

General meeting documentation is often published only in the local language and so needs to be translated, which is expensive and often unsatisfactory. The time that shareholders ultimately have to decide how to vote depends largely on the complexity and length of this voting chain, and it is not uncommon for shareholders not to have the information needed for an informed decision. We want to try to ensure that companies provide more

We are working towards improvement and simplification of the processes involved in global voting

satisfactory and timely information about their general meetings and the matters being put to the vote so that we can cast an informed ballot.

Voting results and disclosure

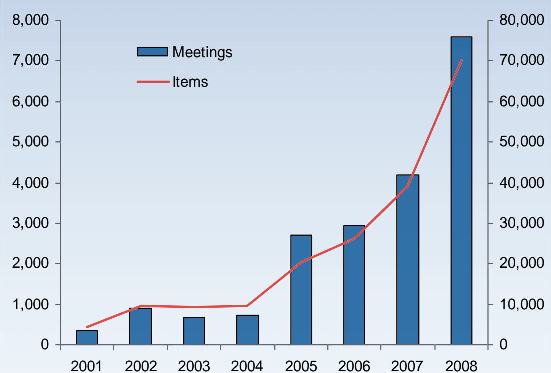
Investors who vote through custodian banks and proxy agents can request confirmation that their votes have been cast from the company or its agent. However, there is no requirement that companies confirm that they have received and accepted votes. There are also major variations in whether and how companies are to publish the results of general meetings.

In both its dealings with individual companies and its dialogue with regulators and the network of service providers, NBIM aims to encourage practices whereby all votes are counted, there is an audit trail for the votes cast, and companies publish the results of votes.

NBIM's voting 2001-2008

NBIM has exercised its voting rights at general meetings since 2001. Since 2005, all of this has been done internally to ensure more precise and consistent voting. We have also stepped up activity in the portfolio in step with the increase in the number of companies.

Chart 17-2 Voting 2001-2008. Number of items and meetings



We use a Web-based voting platform from RiskMetrics Group (RMG), which specialises in helping investors with voting worldwide. NBIM holds most of its shares through the global custodian bank JPMorgan Chase. Local banks act as agents for JPMorgan Chase in most countries, and it is these banks or their independent representatives that attend general meetings and vote with a power of attorney from NBIM. RMG ensures that the voting decisions that we take reach these local agents.

Financial reporting

Norges Bank's annual financial statements, which include the Government Pension Fund – Global, were approved by Norges Bank's Supervisory Council on 5 March 2009. These financial statements include a set of accounts and additional information for the Government Pension Fund – Global presented in a separate note. These accounts and an excerpt from Norges Bank's accounting policies are reproduced below.

Profit and loss account

(Figures in millions of NOK)	Note	2008	2007
Profit/loss on financial assets excl. exchange rate adjustments			
Interest income, deposits in foreign banks		494	431
Interest income, lending associated with reverse repurchase agreements		14 189	33 564
Net income/expenses and gains/losses from:			
- equities and units	3	-595 304	41 627
- bonds and other fixed income instruments	3	-686	19 750
- financial derivatives		-31 210	5 265
Interest expenses, borrowing associated with repurchase agreements		-20 124	-32 509
Other interest expenses		-613	-118
Other expenses		44	-179
Profit/loss before exchange rate adjustments	**1**	**-633 209**	**67 831**
Exchange rate adjustments		506 163	-146 412
Profit/loss before management fee		**-127 046**	**-78 581**
Accrued management fee	2	-2 165	-1 783
Profit/loss for the year		**-129 211**	**-80 364**

Balance sheet

(Figures in millions of NOK)	Note	2008	2007
ASSETS			
FINANCIAL ASSETS			
Deposits in foreign banks		18 111	30 004
Lending associated with reverse repurchase agreements	3	274 132	870 834
Cash collateral paid	3	114	0
Equities and units	4	1 126 760	945 113
Bonds and other fixed income instruments	4	1 612 236	1 213 806
Financial derivatives		0	2 094
Other assets	5	17 164	5 229
TOTAL FINANCIAL ASSETS	**8,9**	**3 048 517**	**3 067 080**
LIABILITIES AND CAPITAL			
FINANCIAL LIABILITIES			
Short-term borrowing	3	133	187
Borrowing associated with repurchase agreements	3	514 395	710 898
Cash collateral received	3	188 608	303 680
Financial derivatives	6	36 320	0
Unsettled trades		30 144	33 480
Other liabilities		3 463	97
Management fee due		2 165	1 783
TOTAL FINANCIAL LIABILITIES	8,9	**775 228**	**1 050 125**
Capital	7	2 273 289	2 016 955
TOTAL LIABILITIES AND CAPITAL		**3 048 517**	**3 067 080**

The Government Pension Fund – Global is presented as follows in Norges Bank's balance sheet:

(Figures in millions of NOK)	2008	2007
ASSETS		
Investments for Government Pension Fund – Global	2 273 289	2 016 955
LIABILITIES		
Deposits in krone account Government Pension Fund – Global	2 273 289	2 016 955

Notes to the financial reporting

Accounting policies

The accounting policies for Norges Bank were approved by the Supervisory Council on 13 December 2007. It has been agreed with the Ministry of Finance that the accounting policies for Norges Bank are also to be applied to the Government Pension Fund – Global.

1 General

1.1 Basis for preparing the annual financial statements

Norges Bank is subject to the Act of 24 May 1985 relating to Norges Bank and the Monetary System etc and is not required to comply with Norwegian accounting legislation. Nevertheless, the accounts have, with some exceptions, been prepared in accordance with the Accounting Act of 1998, supplementary regulations and generally accepted accounting principles in Norway. The departures are due principally to the special conditions applying to a central bank.

The principal departures from the Accounting Act are in the following areas:

- The profit and loss account and balance sheet are presented in a manner appropriate to the Bank's activities
- A cash flow analysis has not been prepared
- Financial derivatives and unsettled trades are reported net on the balance sheet
- The foreign exchange element linked to realised and unrealised changes in the value of financial instruments is separated and presented on a separate line
- The information in the notes to the accounts has been tailored to the Central Bank's activities

1.2 Change of accounting policy in 2008

The following change has been made to the accounting policies with effect from the financial statements for 2008:
Cash collateral received is now recognised on the balance sheet. The same applies to collateral in the form of securities where these are re-invested (see section 4.3). The comparative figures for 2007 have been restated accordingly. Further information can be found in the notes to the accounts.

1.3 Presentation of the Government Pension Fund – Global

The Government Pension Fund – Global is managed by Norges Bank on behalf of the Ministry of Finance and in accordance with management guidelines. The portfolio under management corresponds to the balance at any given time in the Ministry of Finance's krone account for the Government Pension Fund – Global at Norges Bank. The entire return on the portfolio is added to the krone account. Norges Bank bears no economic risk in connection with changes in the value of the fund. Therefore, the performance of the Government Pension Fund – Global does not affect Norges Bank's profit or Norges Bank's capital. The Government Pension Fund – Global's net investments are recorded as an asset on a separate line. The fund's krone account is recorded as a liability in the same amount to the Ministry of Finance. A separate set of accounts is prepared for the Government Pension Fund – Global and included as a note to Norges Bank's annual financial statements.

2 Use of estimates when preparing the annual financial statements

The preparation of the financial statements for Norges Bank involves the use of estimates and judgements which can affect assets, liabilities, income and expenses. Estimates and judgements are evaluated regularly and are based on historical experience and expectations of future events which are considered probable at the time the financial statements are presented. The estimates are based on best judgement, but may differ from the final outcome.

3 Currency translation

Transactions in foreign currency are recorded in the financial statements at the exchange rate prevailing on the transaction date.
Assets and liabilities in foreign currency are translated into NOK at the exchange rate prevailing on the balance sheet date.

In the profit and loss account, the foreign exchange element linked to realised and unrealised changes in the value of financial instruments is separated and presented on a separate line. Foreign exchange adjustments for the period are estimated based on the cost price in foreign currency and changes in exchange rates between the time of purchase (or the previous balance sheet date in the case of financial instruments purchased in earlier periods) and the balance sheet date.

4 Financial instruments

4.1 Recognition and derecognition

Financial assets and liabilities are recognised on the balance sheet when Norges Bank becomes a party to the contractual terms of the instrument. The transactions are recognised on the trade date.

Financial assets are derecognised from the balance sheet when the contractual rights to the cash flows expire or when the financial asset and significant risks and returns relating to ownership of the asset are transferred.

Financial liabilities are derecognised from the balance sheet when the liability has ended.

4.2 Fair value measurement

Initial measurement
A financial asset or liability is recognised at the purchase price including direct transaction costs. Direct transaction costs consist of commissions and stamp duties.

Subsequent measurement
Financial assets and liabilities are recognised at fair value on the balance sheet date. Fair value is the realisable value of an asset or the cost of settling a liability in an arm's length transaction between well-informed and willing parties.

The price quoted by a stock exchange, price provider or broker is used for securities that are traded in an active market.
Valuation methods are used to establish fair value for securities that are not traded in an active market. Valuation methods include the use of recent arm's length market transactions between well-informed and willing parties, if such information is available, reference to current fair value of another instrument that is essentially the same, discounted cash flow calculations, and option pricing models. If the valuation method is commonly used by market participants to price the instrument, and this technique has provided reliable estimates of prices achieved in actual market transactions, this technique is used. Market information is used in the valuation methods to the extent possible.

Changes in fair value are recognised in the profit and loss account. Direct transaction costs relating to financial instruments measured at fair value are presented in the profit and loss account on the same line as the instruments to which the costs relate.

Receivables and current liabilities other than derivatives are carried at amortised cost, and the effective interest is booked in the profit and loss account.

4.3 Securities lending

Securities lending is where securities are transferred from Norges Bank to a borrower against collateral in the form of cash or other securities. When the loan is terminated, identical securities are to be returned. The borrower is obligated to compensate the lender for various events relating to the securities, such as subscription rights, dividends etc. Securities lent are not derecognised from Norges Bank's balance sheet. Lending fees are accrued as interest income on lending.

The borrower takes over the voting rights attached to the securities during the lending period.
Cash collateral received is recognised on the balance sheet. The same applies to collateral in the form of securities where re-invested. Unrealised and realised gains and losses on re-investments recognised at fair value are booked in the profit and loss account.

4.4 Repurchase/reverse repurchase agreements

In connection with repurchase agreements, the security is not derecognised from the balance sheet when the agreement is entered into. During the contract period, the accounting for the underlying securities will follow the ordinary accounting policies for financial instruments. Cash received is recognised as a financial asset and with a corresponding short-term financial liability at amortised cost.

In connection with reverse repurchase agreements, the underlying security is not recognised on the balance sheet. The cash paid is derecognised from the balance sheet, and a corresponding receivable reflecting the cash amount to be returned is recognised.

4.5. Accrued interest income and expense

Accrued interest income and expense is recognised in the balance sheet on the same line as the related financial asset or liability

5 Tax

Norges Bank's operations are not subject to tax in Norway.

Paid withholding tax on dividends and coupons in foreign markets is entered as a reduction in the corresponding income item. If withholding tax can be reclaimed, it will be shown as a receivable until it has been refunded.

6 Management fee

Norges Bank's costs related to the management of the Government Pension Fund – Global are covered by the Ministry of Finance up to a set limit. The management fee is taken into account in the financial statements, but is not paid until the following year.

Note 1 Profit/loss before exchange rate adjustments

(Figures in millions of NOK)	Interest	Dividends	Realised gains/losses	Unrealised gains/losses	Total
Interest income, deposits in foreign banks	494	0	0	0	494
Interest income, lending associated with reverse repurchase agreements	14 189	0	0	0	14 189
Net income/expenses and gains/losses from:					
- equities and units	1 349	30 590	-81 986	-545 257	-595 304
- bonds and other fixed income instruments	62 652	0	-14 684	-48 653	-686
- financial derivatives	11 367	0	-6 259	-36 318	-31 210
Interest expenses, borrowing associated with repurchase agreements	-20 124	0	0	0	-20 124
Other interest expenses	-613	0	0	0	-613
Other expenses	44	0	0	0	44
Profit/loss before exchange rate adjustments	**69 359**	**30 590**	**-102 929**	**-630 229**	**-633 209**

Note 2 Management costs

	2008		2007	
	Thousands of NOK	Per cent	Thousands of NOK	Per cent
Internal costs	658 423		630 516	
Custody and settlement costs	341 135		273 476	
Minimum fees to external managers	420 376		513 442	
Performance-based fees to external managers	486 859		268 546	
Other costs	258 430		97 295	
Total management costs	**2 165 223**	**0,11**	**1 783 275**	**0,09**
Total management costs excluding performance-based fees	**1 678 364**	**0,08**	**1 514 729**	**0,08**

Note 3 Repurchase and reverse repurchase agreements, securities lending and cash collateral paid/received

3.1 Repurchase and reverse repurchase agreements

Norges Bank enters into repurchase and reverse repurchase agreements to finance positions at the lowest possible price and to generate additional income for the fund. The following tables present the repurchase and reverse repurchase agreements recognised in the balance sheet on 31 December 2008

Lending associated with reverse repurchase agreements

(Figures in millions of NOK)	2008	2007
Lending associated with reverse repurchase agreements, ordinary activity	160 009	669 607
Lending associated with reverse repurchase agreements, re-investment of cash collateral in connection with securities lending	114 123	201 227
Lending associated with reverse repurchase agreements	**274 132**	**870 834**

Short-term borrowing

This item comprises borrowing used in the liquidity management of the portfolio with a maturity of between one and ten days and amounted to NOK 133 million on 31 December 2008.

Borrowing associated with repurchase agreements

(Figures in millions of NOK)	2008	2007
Borrowing associated with repurchase agreements	**514 395**	**710 898**

3.2 Cash collateral

The fund pays and receives cash collateral in a number of contexts. These include the monitoring of positions in unlisted financial derivatives (OTC's), securities lending, and the margining of positions in repurchase and reverse repurchase agreements. This cash collateral is recognised on the balance sheet because Norges Bank has access to the bank deposits. The following tables show the amounts recognised on the balance sheet on 31 December 2008.

Cash collateral paid

(Figures in millions of NOK)	2008	2007
Cash collateral paid in connection with unlisted financial derivatives	114	-
Cash collateral paid	**114**	**-**

Cash collateral received

(Figures in millions of NOK)	2008	2007
Cash collateral received in connection with securities lending	185 606	298 012
Cash collateral received in connection with unlisted financial derivatives	2 882	5 668
Cash collateral received in connection with margining repurchase and reverse repurchase agreements	119	-
Cash collateral received	**188 608**	**303 680**

As a result of a change in accounting policy at the end of 2008, "Total financial assets" and "Total liabilities and capital" on 31 December 2008 have been increased by NOK 188 608 million. The comparative figures have been restated, with an equivalent increase of NOK 303 680 million as at 31 December 2007. This change has had no impact on the profit and loss account.

3.3 Securities lending

Securities lent

The table below shows the securities lent out through lending programmes at the end of the year. These assets are recognised on the balance sheet under "Equities and units" and "Bonds and other fixed income instruments".

(Figures in millions of NOK)	2008	2007
Loans of equities	182 612	181 929
Loans of bonds	191 482	334 424
Total loans of securities against collateral	**374 094**	**516 352**

Norges Bank has entered into lending agreements with external lending agents. These agreements contain provisions which protect Norges Bank's interests if the borrower of the securities is unable to return them or if the collateral provided for the loan is not sufficient to cover losses.

Collateral received in connection with securities lending

(Figures in millions of NOK)	2008		2007	
Collateral received	**Book value**	**Fair value**	**Book value**	**Fair value**
Collateral in the form of cash	185 606	185 606	298 012	298 012
Collateral in the form of equities	-	137 628	-	127 637
Collateral in the form of bonds	-	66 721	-	110 049
Total collateral	**185 606**	**389 955**	**298 012**	**535 698**

Re-investment of cash collateral

Collateral in the form of cash is re-invested in reverse repurchase agreements or diversified bond funds with short maturities and the highest possible credit rating (Aaa from Moody's). Norges Bank has entered into agreements with international commercial banks as managers of these funds. The table below shows re-investments at the end of the year as recorded on the balance sheet (at fair value).

(Figures in millions of NOK) **Re-investments in connection with securities lending**	2008	2007
Lending associated with reverse repurchase agreements	114 124	201 227
Asset-backed securities	39 150	45 720
Structured investment vehicles	2 461	10 791
Other fixed income instruments	21 564	36 755
Total re-investments in the form of bonds and other fixed income instruments	63 175	93 266
Total re-investments in connection with securities lending	**177 299**	**294 493**

Re-investments are recognised on the balance sheet under "Lending associated with reverse repurchase agreements" and "Bonds and other fixed income instruments". Re-investments were not recognised on the balance sheet on 31 December 2007.

Interest income of NOK 1 349 million from equities lending has been booked in the profit and loss account under "Net income/expenses and gains/losses from equities and units". Interest income of NOK 1 146 million from bond lending has been recognised under "Net income/expenses and gains/losses from bonds and other fixed income instruments". As a result of further negative market developments in 2008, an unrealised loss of NOK 5 640 million on re-invested cash collateral in the form of bonds has been recognised under "Net income/expenses and gains/losses from bonds and other fixed income instruments" in 2008, as against NOK 3 088 million in 2007.

Note 4 Equities and units and bonds and other fixed income instruments

(Figures in millions of NOK)	Cost	Fair value	Income accrued	Total fair value
Equities and units:				
- Listed equities	1 365 941	1 124 049	1 900	1 125 949
- Units in securities funds	1 132	811	-	811
Total equities and units	**1 367 073**	**1 124 860**	**1 900**	**1 126 760**
Government and government-related bonds:				
- Government bonds	381 682	455 910	8 655	464 565
- Bonds issued by local authorities	45 403	54 777	1 208	55 985
- Bonds issued by supranational bodies	46 247	57 091	966	58 057
- Bonds issued by agencies	124 831	144 418	2 605	147 023
Total government and government-related bonds	**598 163**	**712 196**	**13 434**	**725 630**
Inflation-linked bonds:				
- Inflation-linked bonds issued by government authorities	104 558	123 752	792	124 544
- Inflation-linked bonds issued by companies	1 941	1 803	4	1 807
Total inflation-linked bonds	**106 499**	**125 555**	**796**	**126 351**
Corporate bonds:				
- Bonds issued by utilities	19 513	19 326	357	19 683
- Bonds issued by financial institutions	206 338	177 765	3 785	181 550
- Bonds issued by industrial companies	87 038	84 298	1 801	86 099
Total corporate bonds	**312 889**	**281 389**	**5 943**	**287 332**
Securitised debt:				
- Covered bonds	243 882	283 923	6 544	290 467
- Mortgage-backed securities	148 558	144 328	532	144 860
- Asset-backed securities	34 639	26 595	124	26 719
- Commercial mortgage-backed securities	13 392	10 612	88	10 700
Total securitised debt	**440 471**	**465 458**	**7 288**	**472 746**
Short-term certificates	**140**	**177**	**0**	**177**
Total bonds and other fixed income instruments	**1 458 162**	**1 584 775**	**27 461**	**1 612 236**

Note 5 Other assets

(Figures in millions of NOK)	2008	2007
Withholding tax	663	292
Outstanding accounts with other portfolios under management	16 259	4 766
Accrued interest, securities lending	242	171
Total other assets	**17 164**	**5 229**

"Outstanding accounts with other portfolios under management" comprises the net value of deposits, loans, repurchase agreements and reverse repurchase agreements vis-à-vis other portfolios managed by Norges Bank. These related-party transactions have been performed on an arm's length basis.

Note 6 Financial derivatives

(Figures in millions of NOK)	Exposure				Fair value		
	31.12.08		Average 2008				Fair value, net
	Purchased	Sold	Purchased	Sold	Asset	Liability	
Foreign exchange contracts	**22 111**	**0**	**41 757**	**0**	**423**	**395**	**28**
Futures contracts	**27 003**	**43 070**	**108 334**	**116 600**	**1 690**	**922**	**768**
Interest rate swaps	415 535	474 465	617 619	592 507	26 280	59 634	-33 354
Total return swaps	2	-	12 802	4	41	-	41
Credit default swaps	95 750	61 310	150 134	82 675	6 288	4 894	1 394
Equity swaps	8 260	1 851	19 708	8 310	820	7 085	-6 265
Total swaps	**519 547**	**537 626**	**800 263**	**683 496**	**33 429**	**71 613**	**-38 184**
Options	**42 328**	**33 503**	**89 020**	**75 884**	**4 037**	**2 969**	**1 068**
Total financial derivatives	**610 989**	**614 199**	**1 039 374**	**875 980**	**39 579**	**75 899**	**-36 320**

Forward exchange contracts

This item consists of foreign exchange contracts with normal settlement for future delivery. Exposure is the sum of the nominal value of the contracts entered into.

Futures contracts

Exposure is the market value of the underlying instruments.

Unlisted (OTC) financial derivatives)

Interest rate swaps

This item includes both interest rate swaps and combined interest rate and currency swaps.

Exposure is the nominal value and expresses whether Norges Bank receives (has purchased) or pays (has sold) a fixed rate of interest

Total return swaps

In a total return swap (TRS), the protection purchaser transfers the total return on an underlying credit to the protection seller in exchange for a fixed or floating rate of interest. Total return denotes the sum of coupon payments and any change in value. The underlying assets for the TRSs in which the fund invests are commercial mortgage-backed securities (CMBS) and mortgage-backed securities (MBS) indices.

Exposure is the nominal value and expresses whether Norges Bank receives (has purchased) or pays (has sold) the index return.

Credit default swaps

In a credit default swap, the protection seller receives a periodic premium or lump sum from the protection purchaser as compensation for assuming the credit risk. The protection purchaser receives payment from the seller only if the credit protection of the underlying credit is triggered (credit event). A credit event may as an example include default on the underlying asset. The protection normally expires after the first credit event.

The underlying assets for credit default swaps are corporate bonds, securities issued by sovereign states, corporate bond indices, asset-backed securities (ABS) indices and commercial mortgage-backed securities (CMBS) indices.

Exposure expresses whether Norges Bank has purchased or sold protection for all or part of the credit risk associated with the various types of underlying asset.

Equity swaps

Equity swaps are agreements between two counterparties to swap cash flows based on changes in the underlying securities, which can be an equity, a group of equities or an index. In addition to the periodic cash flow, payments are received in connection with dividends and corporate events.

Exposure corresponds to the market value of the underlying equities or equity indices.

Options

Exposure is the market value of the underlying assets. Options written by the fund are reported under "Sold". Options where Norges Bank pays a premium are reported under "Purchased".

Note 7 Capital

(Figures in millions of NOK)	2008	2007
Deposits in krone account on 1 January	2 016 955	1 782 139
Inflows during the year	385 545	315 179
Management fee to Norges Bank	-2 165	-1 783
Profit/loss transferred to krone account	-127 046	-78 580
Capital – deposits in krone account on 31 December	**2 273 289**	**2 016 955**

Note 8 Currency distribution

(Figures in millions of NOK)	USD	CAD	EUR	GBP	JPY	Others	Total
ASSETS							
FINANCIAL ASSETS							
Deposits in foreign banks	9 265	-148	6 380	1 145	-883	2 352	18 111
Lending associated with reverse repurchase agreements	102 977		123 100	43 868	1 081	3 107	274 132
Financial derivatives			114				114
Equities and units	353 981	23 790	298 946	150 603	97 175	202 265	1 126 760
Bonds and other fixed income instruments	522 358	33 099	786 251	163 172	67 883	39 473	1 612 236
Other assets	2 829	-47	15 662	-1 401	37	85	17 164
TOTAL FINANCIAL ASSETS	**991 410**	**56 694**	**1 230 453**	**357 386**	**165 293**	**247 281**	**3 048 517**
FINANCIAL LIABILITIES							
Short-term borrowing	2	1	1	20	1	109	133
Borrowing associated with repurchase agreements	147 774	9 080	247 697	91 804	6 453	11 586	514 395
Cash collateral received	76 751		106 763	5 094			188 608
Financial derivatives	13 989	1 490	12 586	11 471	1 081	-4 298	36 320
Unsettled trades	30 754	-219	1 419	-848	-55	-908	30 144
Other liabilities	3 377					87	3 463
Management fee due						2 165	2 165
TOTAL FINANCIAL LIABILITIES	**272 646**	**10 352**	**368 465**	**107 542**	**7 481**	**8 742**	**775 228**

Note 9 Risk and valuation

Risk management is a key activity for Norges Bank. Processes have been established for identifying, measuring and monitoring all of the most important risks to which Norges Bank and the Government Pension Fund – Global's owners are exposed through the activities conducted. The four main areas are market risk, credit risk, counterparty risk and operational risk. Requirements for the management and measurement of these risk categories are laid down in the Ministry of Finance's extended guidelines.

Market risk

Market risk is the risk of changes in the value of the fund due to movements in interest rates, equity prices and/or exchange rates. Norges Bank measures both absolute and relative market risk for the fund.

Absolute risk can be estimated on the basis of the actual portfolio. Standard deviation is a statistical concept which says something about the size of the variations that can be expected in the return on the fund. The table below illustrates market risk as expressed by expected annual standard deviation in the fund's actual portfolio both overall and for the two asset classes.

Market risk

	Measure	31.12.08	Min. 2008	Max. 2008	Aver. 2008	31.12.07
Total portfolio	St. der.	22.2%	8.0%	25.8%	14.2%	8.6%
Equity portfolio	St. der.	36.7%	15.7%	46.4%	24.7%	14.5%
Fixed income portfolio	St. der.	21.5%	7.9%	21.5%	12.6%	8.9%

The overall figure for the end of 2008 means that, in two out of every three years, the value of the fund can be expected to fluctuate within a band of +/- 22.2 per cent of its total market value (one standard deviation) based on the actual portfolio at that time. Market risk rose considerably in 2008, with estimated expected risk increasing particularly in the second half of the year. Market risk can also be expressed on the basis of actual fluctuations in the portfolio during the year.

Two factors in particular explain the increase in risk: changes in the composition of the benchmark and changes in market conditions. The changes in the benchmark in 2008 were due mainly to an increase in the allocation to equities in the fund and the inclusion of emerging equity markets, and these explain some of the increase in risk during the year. However, stressed markets and unusually high volatility, especially in the second half of the year, explain most of the increase in 2008.

Risk model

The model used calculates expected standard deviation in the value of the fund on the basis of portfolio composition and assumptions about its sensitivity to fluctuations in relevant market factors and the correlation between them. Norges Bank performs risk calculations on a regular basis, with main runs each month. Both parametric calculations and calculations based on Monte Carlo simulations are used. The parametric method was used to calculate the figures in the table above. Volatilities and correlations are estimated on the basis of daily historical data where greater importance is attached to recent market data than to older data. As a result, the risk model responds very quickly to changes in the markets.

Liquidity risk

In connection with the management of the Government Pension Fund – Global, Norges Bank defines liquidity risk as the ability to make planned or unexpected changes to the composition of the portfolio due to exogenous or endogenous factors without incurring abnormally high transaction costs. The management of liquidity risk is integrated throughout the control structure right down to the individual investment mandate, and is performed using a set of quantitative management variables.

For the fund's positions in the equity market, the measurement of these management variables is not associated with major challenges, since the portfolio consists of equities listed on regulated exchanges. There are a few exceptions to this rule, however, as some local exchanges are not very well-functioning. For fixed income instruments, measurement is more complex due to a high proportion of unlisted instruments, and recent market developments have presented additional problems in terms of quantitative measures of liquidity for fixed income instruments.

Liquidity risk increased considerably in 2008, especially in the second half of the year. For many fixed income instruments, there was a sharp drop in liquidity due to many of the participants supplying liquidity drastically scaling back their activities. The Government Pension Fund – Global is of a size where a loss of liquidity on this scale presents substantial investment management challenges.

Credit risk

Credit risk is the risk of losses due to issuers of fixed income instruments defaulting on their payment obligations to the fund. Another form of credit risk is the counterparty risk that arises in derivative and foreign exchange transactions. Settlement risk, which arises in connection with the purchase and sale of securities as a result of not all transactions taking place in real time, also leads to counterparty risk.

Credit risk arises in the fund's fixed income portfolio partly as a result of the Ministry of Finance's choice of investment strategy and partly as a result of Norges Bank's active management. All fixed income instruments in the fund's benchmark have a rating from one of the major credit rating agencies: Standard & Poor's, Moody's and Fitch. All three agencies classify the issuers of fixed income instruments on the basis of their creditworthiness. A credit rating scale from AAA to D is used for long-term bonds. The highest rating is AAA from S&P and Fitch, and Aaa from Moody's. The lowest investment grade ratings are BBB from S&P and Fitch and Baa from Moody's. Lower ratings are known as non-investment grade. All bonds in the fund's benchmark portfolio have an investment grade rating. However, there is no requirement for a credit rating from the rating agencies for the fund's portfolio of fixed income instruments. The table below breaks down the fixed income portfolio on the basis of credit ratings from at least one of the rating agencies at the end of the year

Fixed income portfolio by credit rating

	Aaa	Aa	A	Baa	Ba	Lower	P-1	None	Total
Government and government-related bonds	495 032	182 737	36 906	6 928	1 993	639	-	1 394	725 630
Inflation-linked bonds	75 634	48 754	1 963	-	-	-	-	-	126 351
Corporate bonds	18 629	67 627	111 240	78 577	5 912	2 657	-	2 690	287 332
Securitised debt	442 645	14 981	9 926	2 418	983	1 792	-	-	472 746
Short-term certificates	0	-	-	-	-	-	177	-	177
Total bonds and other fixed income instruments	**1 031 941**	**314 100**	**160 035**	**87 923**	**8 889**	**5 088**	**177**	**4 084**	**1 612 236**

1) Based on credit ratings from at least one of the following rating agencies: Moody's, Standard & Poor's and Fitch. The "No rating" category consists of securities not rated by these three agencies; these securities may, however, have been rated by other, local agencies.
Source: NBIM

The following table shows exposure to credit derivatives.

	Nominal amount	Fair value
Credit default swaps, protection purchased	95 750	-4 304
Credit default swaps, protection sold	61 310	5 698

Protection purchased means that the fund's credit risk has been reduced, while protection sold means increased credit risk. Overall, credit exposure has been reduced slightly through credit default swaps. These contracts relate primarily to credit risk in the Baa, Ba and lower categories.

Norges Bank is also exposed to risk vis-à-vis counterparties in the execution of transactions, vis-à-vis custodian institutions with which securities are deposited, and vis-à-vis international settlement and custody systems (counterparty risk). The equity and fixed income portfolios include investments in unsecured bank deposits and unlisted derivatives and foreign exchange contracts. Derivatives are used for both trading and hedging purposes in the fund. The Ministry of Finance has decided that no counterparties involved in such transactions may have a credit rating lower than A- from Fitch, A3 from Moody's or A- from S&P. NBIM monitors counterparty risk by following up exposure relative to credit risk limits. These limits are determined partly by the credit rating of the counterparty, where a higher rating results in a higher limit.

The table below shows the counterparty risk associated with positions in financial derivatives (contracts with a positive market value) at the end of the year, and holdings of cash.

(Fair value in millions of NOK)	
Credit default swaps	6 288
Foreign exchange contracts	423
Swap contracts	26 321
Options	4 037
Equity swap contracts	820
Total derivatives	**37 889**
Term deposits	18 111
Cash deposits	-
Total term/cash deposits	**18 111**
Total counterparty risk	**56 000**

The positions are shown before netting, and collateral provided is not taken into account. To minimise counterparty risk, NBIM uses bilateral netting agreements, and a high level of collateral is required for otherwise unsecured exposure. Cash collateral received in connection with unlisted financial derivatives totalled NOK 2 882 million at the end of 2008 (see Note 3). The thresholds for requiring collateral are set at between EUR 0 and EUR 25 million, measured as net positive market value per counterparty.

Fair value measurement of financial instruments

Control environment

An extensive process for on-going valuation of the portfolios has been established involving sourcing and verification of prices at both external fund accounting service providers and Norges Bank's operating units. Valuation is also subject to a number of additional control procedures delegated to independent control environments at Norges Bank and the external service providers at period-ends. Hierarchies of independent price sources established by Norges Bank are used in the pricing process. The most important price checks happen at the month-end to ensure the quality of prices and that the pricing hierarchy is being followed in the measurement of returns and the preparation of accounts. Spot checks are also made during the month. Where necessary, the internal control units enlist the support of external pricing specialists chosen to assist with the pricing of particularly challenging investments. The resulting valuation is reviewed by a valuation committee, which is a forum for escalating significant pricing issues. The committee meets at least once a quarter ahead of the presentation of the accounts.

Establishing fair value

The turmoil in financial markets increased in 2008, reaching a provisional peak in the wake of the Lehman Brothers bankruptcy in September. This led to greater uncertainty about the valuation of some types of instrument. However, pricing risk is still considered to be limited for the majority of instruments in which the fund is invested. Most financial instruments had observable prices throughout the year. Prices are obtained from multiple sources that are independent of both internal and external portfolio managers.

In cases where no observable price is available due to limited activity in the market, models are used to price the positions in question. Most securities in this category have observable market data that are included in the model, while a small number are priced by means of extrapolation and estimation.

The table below breaks down the fund's investments into categories of price uncertainty.

(Figures in millions of NOK)

Categorisation of investments by price uncertainty	Observable market prices in active markets	Model pricing with observable data points	Model pricing with greater uncertainty about fair value	Total
Equities and units	1 124 096	1 921	743	1 126 760
Bonds	712 224	826 520	73 492	1 612 236
Total	**1 836 320**	**828 441**	**74 235**	**2 738 996**

Equity investments are considered relatively easy to value, as there are official and observable market prices based on an active transaction market for almost all positions in the portfolio. When it comes to holdings of bonds, the price uncertainty picture is somewhat more complex. The pricing of government bonds and liquid government-guaranteed bonds is based on observable market prices in an active market with quotes and frequent transactions. Corporate bonds, covered bonds and some government-guaranteed and government-related bonds, however, are priced using models with observable data points.

Exposure considered particularly uncertain in terms of pricing totalled NOK 74.2 billion at the end of the year. This consisted almost exclusively of asset-backed securities not guaranteed by US federal agencies such as Fannie Mae, Freddie Mac and Ginnie Mae. This represented a decrease in exposure of NOK 29.1 billion since the end of 2007, when there was exposure of NOK 92.5 billion to asset-backed securities and NOK 10.8 billion to structured investment vehicles (SIVs). The decrease was due primarily to falling prices for asset-backed securities, but also to instruments maturing and repayments of principal. When it comes to the remaining exposure to SIVs, only exposure of NOK 0.4 billion was considered particularly difficult to price at the end of 2008. An additional NOK 2.1 billion of SIV exposure was reclassified into the category for model pricing with observable data points. The remainder of the decrease in exposure to SIVs in 2008 was due primarily to repayments on maturity.

Following a number of analyses and discussions with various players in the market (price providers, brokers and external managers), simple valuation methods have been developed to take account of this additional uncertainty. These methods mean that the value of some types of instrument has been adjusted downwards by means of a liquidity deduction from the value reported from the ordinary price sources. The size of this liquidity adjustment depends on the estimated uncertainty related to the price from the price source.

The liquidity adjustment for accounting purposes over and above the prices from ordinary sources totalled NOK 3 424 million at the end of 2008, as against NOK 2 134 million a year earlier. Of this figure, NOK 975 million relates to cash collateral re-invested in bonds (see Note 3).

Norges Bank Investment Management´s Annual Report for 2008 was submitted by
Norges Bank´s Executive Board on 25 February 2009

Central Bank Audit and Deloitte AS have submitted the following joint audit report to the Supervisory Council on the financial reporting of the Government Pension Fund – Global as presented in the notes to Norges Bank's annual financial statements for 2008.

Translation from the original Norwegian version

Auditor's report to the Supervisory Council of Norges Bank

AUDITOR'S REPORT ON THE FINANCIAL REPORTING OF THE GOVERNMENT PENSION FUND – GLOBAL FOR 2008

We have audited the financial reporting of the Government Pension Fund – Global for 2008 included in Norges Bank's annual financial statements for 2008. The financial reporting, showing a net loss for the year of NOK 129 211 million, comprises a profit and loss account, a balance sheet and notes to the financial reporting. The financial reporting of the Government Pension Fund – Global has been prepared in accordance with the provisions of the Norwegian Accounting Act and generally accepted accounting practice in Norway with the departures set out in the accounting policies in the notes to the financial reporting . The financial reporting is the responsibility of the Executive Board of Norges Bank. Our responsibility is to express an opinion on the financial reporting.

We have conducted our audit in accordance with the Norwegian Act on Auditing and Auditors and generally accepted auditing practice in Norway, including auditing standards adopted by Den norske Revisorforening, and issue our auditor's report in accordance with International Standard on Auditing 800,"The auditor's report on special-purpose audit engagements". These auditing standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial reporting is free of material misstatement. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial reporting. An audit also includes assessing the accounting priciples and significant accounting estimates applied, as well as evaluating the overall financial reporting. To the extent required by generally accepted auditing practice, our audit also comprises a review of Norges Bank's financial affairs and its accounting and internal control systems relevant to the Government Pension Fund – Global. We believe that our audit provides a reasonable basis for our opinion.

In our opinion,

- the financial reporting gives a true and fair view of the Government Pension Fund – Global's financial position as of 31 December 2008, and the return for the financial year in accordance with the the Accounting Act and generally accepted accounting principles in Norway with the departures set out in the accounting policies in the notes to the financial reporting
- the management has fulfilled its duty to ensure proper and well arranged recording and documentation of accounting information.

Oslo, 25 February 2009

Central Bank Auditor	**Deloitte AS**
Svenn Erik Forsstrøm (signed) State Authorised Public Accountant	Aase Aa. Lundgaard (signed) State Authorised Public Accountant

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