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Responsible Investment and the Norwegian Government Pension Fund Global

Main Report

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Table of Contents

1. Introduction **3**

2. Motivation for and practice of responsible investment **4**

2.1. Principal motivating factors *4*

2.2. Stated rationales *6*

2.3. Responsible investment principles *7*

2.4. Ownership strategies *8*

2.5. Impact assessment *9*

3. Research evidence on responsible investing **10**

3.1. Motivations and principles of responsible investment *10*

3.2. Ownership strategies *11*

3.3. Portfolio monitoring, voting and engagement *11*

3.4. Observation lists and exclusions *13*

4. The Fund's strategy, experience, and organisation **15**

4.1. Formal structure *15*

4.2. The investment mandate *16*

4.3. Guidelines for observation and exclusion *16*

5. Observations **17**

5.1. The responsible investment framework *17*

5.2. Motivation *18*

5.3. Implications of being large and long-term *19*

5.4. Developing Responsible Investment principles and strategies *20*

5.5. Observations about the current structure *22*

5.6. The limits to responsible investing *23*

5.7. The three pillars of recommendations *24*

6. Pillar One: Objectives and strategy **25**

7. Pillar Two: Transparency and accountability **27**

8. Pillar Three: Integrate the Fund's responsible investment work **28**

9. Conclusions **31**

10. References **32**

Responsible Investment and the Norwegian Government Pension Fund Global

Main Report

Abstract: We provide analysis and advice to the Norwegian Ministry of Finance on the responsible investment strategy for the Norwegian Government Pension Fund Global. Based on a detailed review of the literature and extensive consultations with investment professionals, we present a broad overview of the motives for responsible investment, of relevant research evidence, of how this relates to the Fund, and what comparator funds are doing in this area. We present three groups of recommendations for the Fund, focusing on the objectives and strategy for investing responsibly, on measures related to transparency and accountability, and on changes to the Fund's governance structure that will facilitate a more integrated approach to responsible investing. The Executive Summary provides a longer synopsis.

1. Introduction

The 2013 Strategy Council for the Norwegian Government Pension Fund Global (the GPFG, or the Fund) was asked to give advice on how to develop the Fund's responsible investment strategy further, increase transparency, and encourage debate on important decisions related to the management of the Fund. We have not evaluated Norges Bank's operational management of the GPFG or the Council on Ethics' recommendations on observations and exclusions.

The Council's mandate is included as an Appendix to the Executive Summary (a separate document). Members of the Council are Professor Elroy Dimson of London Business School and Cambridge Judge Business School; Mr Idar Kreutzer, Chief Executive Officer of Finance Norway; Mr Rob Lake, consultant and formerly Director of Responsible Investment at Principles for Responsible Investment (PRI); Ms Hege Sjo, senior advisor to Hermes Investment Management; and Professor Laura Starks of the University of Texas. Biographical details are also appended to the Executive Summary.

In order to address the mandate, we gathered information from many sources. These sources include hard-copy and website materials from the Norwegian government, the Council on Ethics, and Norges Bank. We held meetings, discussions, and interviews, including extensive dialogues with senior investment professionals and staff at Norges Bank and the Council on Ethics. We also had interactions with Norwegian portfolio managers, NGOs, consultants, researchers, environmental, social and governance (ESG) data providers, and investment professionals from comparator funds in Europe, North America, and the Pacific. In particular, we reviewed the approaches to responsible investment followed by a number of funds that may be regarded as comparators to GPFG because of their size, purpose and interest in responsible investing.[1] We considered standard setters and guidelines relevant for institutional investors.[2] Finally, we reviewed how asset managers and sell-side analysts respond to clients' ownership preferences.[3]

With the support of the Ministry of Finance, we organised two events to help inform us further on responsible investment research and practices. The first was a Summit on Responsible Investing held at Cambridge University's Judge Business School on 31 May 2013. The purpose of the summit was to bring together asset owners and investment managers with experts on responsible investing in order to

1 We held interviews with APG (Netherlands, on behalf of the pension fund ABP); CalPERS (US); the Ethical Council of the Swedish AP Funds; the New Zealand Superannuation Fund (NZSF); and PGGM (Netherlands, on behalf of the pension fund PFZW). We also reviewed publicly available materials from ATP (Denmark) and CPPIB (Canada), BTPS (UK), TIAA-CREF (US), the Folketrygdfondet (Norway), KLP (Norway), and Storebrand (Norway).

2 The list included, among others, the PRI, ICGN, ACSI/FSC (Australia), CCGG (Canada), the NAPF (UK), FRC (UK), the Kay Review (UK), governance codes and the UK Stewardship Code. The abbreviations for the organisations in this and the previous footnote are listed in the References.

3 Organisations we considered included Hermes Fund Managers and F&C, on the buy side, and Goldman Sachs GSSustain, Société Générale and UBS, on the sell side.

develop more clarity on the purposes and outcomes of such investing strategies. A report on this summit is forthcoming in the *Journal of Investment Management* (Towner, 2013). The second event was a Responsible Investment Conference held on 20 June 2013 in Oslo. The purpose of this conference was to provide an opportunity for the Strategy Council to hear the views of NGOs and other stakeholders regarding the Fund's responsible investment strategy. A report on this conference is also forthcoming in the *Journal of Investment Management* (Takaki, 2013).

Members of the Strategy Council participated in the Sustainability and Finance Symposium sponsored by the University of California, Davis and CalPERS to bring together academics and practitioners for debate and discussion on sustainability finance from the view of a large asset owner. They also attended at least 13 other professional meetings in Europe and North America. The Council would like to take this opportunity to express gratitude to all of those who shared insights during this process.

Based on this work, we present in the next four chapters a body of analysis that leads to a set of recommendations regarding the Fund's responsible investment strategy. These recommendations are built on three foundations: Pillar One addresses objectives and strategy, Pillar Two deals with transparency and accountability, and Pillar Three examines governance structures for the Fund. These three pillars are each allocated a chapter in this report. We end with a short concluding chapter.

2. Motivation for and practice of responsible investment

In this chapter we establish a starting point for discussing responsible investment (RI) strategies. We develop a framework for understanding the different components of responsible investment practices. This is a pragmatic and practical approach to topics that have different definitions to different parties.

Our framework for developing responsible investment practices comprises five sections. First, we discuss the motivation for responsible investment practices. Second, we examine the statements made by a number of comparator funds to support their responsible investment principles. Third, we discuss the principles that have been adopted. Fourth, we examine the funds' ownership strategies. This involves a discussion of portfolio monitoring, voting, engagement, collaboration with other owners, dialogue with regulators, shareholder proposals, transparency, and "observation lists" and exclusions. Finally in this chapter, we consider impact assessment of responsible investment practices

2.1. Principal motivating factors

Motivations for responsible investment vary across investors, and this affects their objectives and strategies. In an attempt to present an overview of why and how investors address "responsibility" we define a generic set of motivations. In our discussions we provide links to academic research and to the practices of comparable funds and other contemporary practices.

Being clear on the motivation for responsible investing is a substantial challenge, but it is an important prerequisite for an effective strategy. A definition of "best practice" for responsible investing is not particularly helpful, because asset owners and their managers are often responding to issues that relate to the asset owner's particular situation. Thus, the task for an asset owner is to define clear objectives, priorities, strategies and key performance indicators based on the fund's own characteristics, investment strategies and constituents' expectations.

Asset owners, investment managers and other concerned parties ascribe different meanings to responsible investment. The terms that investors commonly employ include socially responsible investment (SRI), sustainable and responsible investing (also referred to as SRI), long-term investing, environmental, social and governance (ESG) issues, ownership practices and stewardship.

Below, we present the major motivations for why investors engage in responsible investment activities. The aim is to make a connection between an investor's starting point and the strategies and activities that are applied. We identify five general types of motivation and explore how these are used in practice. The challenge is that investors are sometimes vague in their statements regarding

responsible investment strategies and tactics, and this may make it difficult to discern their ultimate motivations. We therefore highlight the main arguments behind each motivation for responsible investing, including whether it is primarily non-financial. The five motivations are as follows:

Avoid unethical products. The argument is that there is an ethical or moral conviction regarding ownership of companies with certain products or services. The conviction is that there are products the investor simply does not want to be involved with and the investor is willing to forego potential returns from these investments. The most common exclusions result from production of certain arms and weapons, tobacco or pornography.

Avoid firms with unethical conduct. This motivation resembles the first, but exclusions reflect breaches of ethical standards of behaviour as perceived by the investor or by an external organisation. This motivation reflects values – matters of ethics, morality and responsibility – that are considered important. Illustrations are protecting the environment, respect for human rights, and fairness in business relationships and society at large. The selected strategy could be either negative screening/exclusion or engagement to stop particular practices.

Be responsive to interest groups. The investor may be concerned about reactions from constituencies unless certain issues are managed, most notably those relating to environmental or social concerns. The fund owner/manager may not find issues unethical, but may worry that constituencies consider certain practices or products to be unacceptable. This is a "licence to operate" argument, but the appropriate response may not be explicitly defined. Without clear guidelines, it is challenging to operationalise the strategy. Exclusion is just one of several feasible responses.

Universal ownership. Very large funds with globally diversified portfolios can own a stake in thousands of companies. This provides cost and risk effective exposure to worldwide economic value creation. Yet undesirable, but possibly profitable, conduct may provide a gain to one company at the expense of others, thereby harming overall portfolio returns. For example, some companies might benefit by externalising environmental costs through pollution, but this could raise costs for others. Such adverse effects could be greater than the gains to the polluters, resulting in the portfolio as a whole earning lower returns. Business practices that impose social or environmental costs on others may lower future economic performance, and it can therefore be in the interest of the investor to modify such behaviour. Externalities can lead investors to engage with investee companies or to work with policymakers to internalise costs.

Sustainability can enhance performance. The argument is that by applying sustainable or longer-term thinking to the investment process, risks can be avoided and opportunities spotted. In particular, an increased understanding of risks and opportunities linked to environmental, social and governance (ESG) issues are expected to lead to better investment decision making. The belief is that good governance of companies, markets and countries can protect investors' and other stakeholders' interests. Illustrations in relation to corporate governance include transparent corporate governance structures, alignment of management incentives with long-term owners' interests, ensuring equal treatment of all shareholders, faithful and accurate financial reporting, and skilled and independent board members. In terms of environmental issues, important areas include climate change, population growth, resource scarcity, new technology and supply chain issues. In terms of social issues, the argument is that costs and operational effectiveness are influenced by the way companies interact with employees, others in their supply chains, and the community. Similarly, bribery, corruption and unfair practices could trigger unwelcome regulatory responses.

There are overlaps between this fifth motivation and the universal ownership argument. The potential for sustainability to provide a systematic uplift to returns relies on a degree of market failure, with issues and consequences being missed by investors and overlooked by regulators. Integration of ESG considerations into investment analysis might enhance an active management strategy, while passive strategies might apply an "overlay" based on ESG scores to tilt the portfolio toward companies that have higher rankings. Strong believers of the argument, including some we interviewed, construct

portfolios based on ESG attributes, at either a firm or industry level, and invest according to thematic or best-in-class criteria, as well as screening out worst-in-class companies.

Table 1 illustrates the connections between the motivation for responsible investing, its underlying premises, and the responsible investment approach.

Table 1 – Motivation, premise and responsible investment approach

Motivation	Premise	Approach
1. Avoid unethical products	• Moral standards regarding products • Willing to forgo returns (nonfinancial motivation)	• Exclusion of industries or companies
2. Avoid firms with unethical conduct	• Moral standards regarding firm conduct • Willing to forgo returns (nonfinancial motivation)	• Negative screening / Exclusion • Engagement to influence behaviour
3. Be responsive to interest groups	• Respond to concerns of stakeholders • The owner/manager may not object to the practice • Focus on fund's "licence to operate" (nonfinancial motivation)	• Difficult to operationalize • Exclusions primarily
4. Universal ownership	• Owning a very large, diversified portfolio of stocks • Focus on portfolio, not on individual companies • Mitigate costs of externalities (financial motivation)	• Engagement with companies • Engagement with regulators and others
5. Sustainability can enhance performance	• The market does not price sustainability issues effectively • Need to address a market failure • Aim for externalities to be internalised (financial motivation)	• Promote better analysis and reporting • ESG integration in investment • Engagement on sustainability • Engagement on transparency • Portfolio ranking and screening • Voting policies

2.2. Stated rationales

In accordance with the Ministry of Finance's mandate to the Strategy Council, the comparator funds we have investigated have all chosen to embrace responsible investment aspirations. Other large sovereign wealth funds or major public pension funds do not have such an approach to responsible investing. Yet, even within our sample of funds, it is clear that responsible investment has no singular motivation and that there is no single strategy or set of approaches that is followed universally. Each fund has specific investment objectives and strategy, its own legal mandate, and particular expectations placed on it by its beneficiaries and the society within which it operates.

Thus, although funds report varying rationales and practices, there are similarities as well. In Table 2, we provide illustrations of comparator funds' and investment organisations' statements regarding responsible investment.

Table 2 – Investment rationales for responsible investment

Source of rationale	Investment statement
Other funds	
ABP	ABP believes that companies with strategies that focus on environmentally-friendly, social and administrative aspects in addition to the financial aspects will perform better in the long-term.
ATP	At ATP, we believe that integration of responsibility in investment decisions contributes to a high risk-adjusted return for the benefit of ATP's members. Responsibility is usually the precondition for long-term, healthy earnings – and thus for the preservation of the real value of equity investments. The objective of the ATP Policy of Social Responsibility in Investments is to safeguard the value of ATP's investments and to be instrumental in obtaining the lowest possible capital costs for the companies through a focus on and respect for social responsibility.
CalPERS	Long-term value creation requires effective management of three forms of capital: financial, physical and human.
CPPIB	We firmly believe that organizations that manage Environmental, Social and Governance (ESG) factors effectively are more likely to endure and create more value over the long-term than those which do not. As we work to fulfil our mandate to Canadians over generations, we recognize ESG factors to invest for long-term value.
AP1	Första AP-fonden is a long-term investor and an active owner. In its role as owner, the Fund places high demands in the areas of environmental, social and corporate governance. Companies that are actively committed to environmental consideration, social responsibility and corporate governance, commonly known as ESG

	(Environmental, Social and Governance), can reduce both their risks and expenses. Through sustainable business operations they create sustainable long-term value.
NZSF	Responsible asset owners who exercise best-practice portfolio management should have concern for environmental, social, and governance (ESG) issues of companies. Improving ESG factors can improve the long-term financial performance of a company.
PGGM/ PFZW	Responsible investment is part of our investment beliefs. In our opinion it contributes to higher and more stable returns. We believe that ESG factors have an impact on the risk and return of our investments. As a universal investor PGGM Investments has an interest in the quality and continuity of the global investment universe.
BTPS	The Trustee has a fiduciary responsibility to meet the Scheme's liabilities and as a long-term asset owner considers sustainable factors to improve long-term risk adjusted returns. The area of sustainability as defined by the Trustee covers long-term factors such as environmental, social and governance (ESG).
Organisations	
ACSI/FSC	There is no question that ESG issues will invariably impact the ability of companies and their investors to achieve sustainable growth and prosperity into the future.
Kay Review	Institutional investors acting in the best interest of their clients should consider the environmental and social impact of companies' activities and associated risks among a range of factors that might impact corporate performance.
CCGG	CCGG believes that companies that follow well-accepted principles of "good governance" have less risk and generate greater long term value for their shareholders than comparable companies with less robust governance practices. "Governance" includes how the board is structured and how it operates, the board's approach to executive compensation and shareholder engagement, and the board's oversight of the company's risk management policies, including its environmental and social risks
PRI	As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios.

Note: The full names of the funds and organisations, together with sources for their investment statements, are provided in the References.

2.3. Responsible investment principles

Most of the funds we have consulted are working on refining their responsible investment principles, as a link between their high-level investment beliefs and statements, and their more detailed strategies. There are two dimensions to these. First, principles produce a basis for the funds' own responsible investment strategy. Second, principles underpin the expectations the funds have for companies and assets in which they invest.

All of the funds we consulted are signatories to the UN-supported Principles for Responsible Investment. This is one example of principles addressing how funds should exercise responsibility. Several other initiatives have emerged providing a comply-or-explain guide to investor responsibility both for internal organisation and external asset management. Some of these include the UK Stewardship Code (FRC, 2012), the Dutch shareholder collaboration guide *Best Practices for Engaged Share Ownership* (Eumedion, 2013), the International Corporate Governance Network's (ICGN) *Principles for Institutional Investor Responsibilities*, the Singapore Code of Corporate Governance *Statement on the Role of Shareholders* (SCGC), and *The Code for Responsible Investing in South Africa* (CRISA).

The second dimension covers the funds' expressed expectations to companies. Many funds base their policy at least in part on international standards, although through interviews we have learned that primary considerations tend to be local preferences and corporate governance codes. The UN Global Compact (UNGC) is the most widely used international reference point. The AP Funds and ATP expect companies to operate in accordance with all conventions ratified by their own country; this embraces both the conventions for which the UN Global Compact is a framework, and others. For example, a recent exclusion decision by the AP funds referred to the UN Convention on Biological Diversity (UNCBD). ABP, ATP and PFZW also refer to the OECD *Guidelines for Multinational Enterprises* in their principles. These standards provide guidance on corporate practices that the international community considers appropriate. Anchoring responsible investment principles in authoritative international standards is often viewed as providing legitimacy to funds' approaches in the eyes of stakeholders.

2.4. Ownership strategies

Ownership strategies can be pursued through a variety of platforms. This includes portfolio monitoring, voting, engagement, collaboration with other owners, dialogue with regulators, shareholder proposals, transparency, observation lists, and exclusions.

Portfolio monitoring. Many funds say they regularly screen their entire portfolio to identify companies that are potentially in breach of the UN Global Compact or the funds' own guidelines. This screening typically covers both their equity and fixed income holdings, and the issues are often based on the Global Compact's ten principles. Companies identified in this way may then become targets for engagement in order to persuade corporate management to change their practices. We also find that comparator funds are typically free to exclude companies if they conclude that such an engagement has been unsuccessful, and if divestment is feasible for them in financial terms.

Voting. Funds are increasingly exercising ownership rights, even with marginal stakes in companies. Some funds assign proxy voting services to cover the holdings in large portfolios. The challenge for most funds is to ensure that their own voting policies – which should be a product of the overall responsible investment principles – are incorporated into the voting decisions. The large number of proxy votes required to be voted within a limited time period creates challenges for most funds. Good practice seems to involve clear voting guidelines, incorporation of previous voting analysis, dialogue with the company in advance of "against" votes, and follow-up communication in controversial situations. Some funds or managers have guidelines for shareholder meeting participation and corresponding communication.

Engagement. Most funds we reviewed say that they engage with companies, but the purposes of the engagements vary significantly as do the forms of the engagement and how success is measured and recorded. The range of intensity varies between writing a letter to the company addressing issues of concern for the owner to the more powerful approach of holding meetings with the senior management and board about issues affecting the long-term performance for the company. Engagements may originate from concerns about the company's financial performance, strategic plans or issues specifically related to the firm's environmental, social and governance behaviour.

Collaboration. Impacting company behaviour requires resources, a clear strategy, patience, and persistence. Funds say that this is a challenge. One solution is to collaborate with other funds, but several assert that there are practical and sometimes political obstacles to effective cooperation.

Dialogue with regulators, policy-makers and standard-setters. The funds we reviewed reported that they think it is important to take part in policy-making and standard-setting processes that affect the market as a whole. They seek to be active in influencing market-wide regulation, standards and 'soft codes' (e.g. on proxy access in the US and the European Securities and Markets Authority's inquiry into the proxy advisory industry), ESG disclosure standards (e.g. the IIRC, the Global Reporting Initiative (GRI), CDP and CDP Water) and international climate change policy, e.g., by endorsing the Global Investor Coalition's (2011) Statement on Climate Change.

Shareholder proposals. The final tool of the active owner is filing shareholder proposals, which have expanded in recent years in ambition and frequency (as discussed further in Chapter 3.3). Funds with a stronger US presence revealed a greater familiarity with this mechanism for owners to promote corporate change.

Transparency. During our reviews of other funds we also found that they believe transparency is important for the maintenance of their stakeholders' trust in their organisation and their investments. Each fund has to strike its own balance in how to meet the expectations that are placed upon it without compromising its investment objectives. Some funds believe that they will have greater influence by conducting their engagements privately because companies will be more open to their consultations. Some of these funds provide detailed information regarding the issues on which engagement is under

way and the number of companies concerned. Other funds publish the names of companies with which they are engaging. (e.g. APG). We found variation in reports on proxy voting, with some funds publishing their voting record at regular intervals, some announcing their votes immediately after company meetings, and some announcing their votes before the meetings. Still other funds use a mix of strategies.

Exclusions. Exclusions and "blacklists" are used to varying extents by the funds we interviewed. Some of the funds do not exclude any companies at all, or have very limited approaches to exclusion. For example, CPPIB excludes only companies whose business would be illegal if conducted in Canada, under legislation prohibiting the development, manufacture, or sale of cluster munitions. CalPERS excludes companies where required to do so by law. BTPS does not exclude any companies at all.

Most comparator funds exclude companies that manufacture particular products, most notably specified weapons and tobacco. ABP, the AP Funds, ATP, NZSF and PFZW can exclude companies if engagement fails to bring about the desired change in behaviour. In practice funds have used exclusion-after-engagement to differing extents, each applying its own judgement of what is appropriate in its particular circumstances. In practice funds have made different judgements about whether and when to exclude companies following engagement. The priority issues selected by the different funds also vary. For example, as of the writing of this report, ABP has made two conduct-based exclusions under its Global Compact policy (both in relation to human rights); the AP Funds five (human rights, workers' rights, environment, civil and political/social land cultural rights); PFZW nine (all human rights); NZSF ten (human rights, bribery, environment, health and safety).

Exclusion decisions differ according to each fund's particular circumstances. In the case of the funds where the ultimate owner is the state (AP funds, NZSF), exclusion decisions are made by the board of the entity that has operational responsibility for the management of the fund, at arm's length from government. In contrast, ABP and PFZW are non-state, sector-wide funds, with close historical relationships with their fund managers.[4] In these two cases, exclusion decisions are made through processes of close consultation between the asset owner and the asset manager.

Exclusion and active ownership are closely integrated at these funds. Active ownership is often rendered more powerful by the prospect that a company can be excluded if dialogue does not bear fruit. However, one asset owner told us that their preference for engagement, rather than exclusion, is principles based. This is because divestment firstly eliminates the fund's shareholder rights, secondly could result in short-term losses, and finally compromises investment strategy.

2.5. Impact assessment

The funds we addressed attach importance to understanding the effectiveness of their responsible investment activities, learning lessons and demonstrating leadership to understand the implications of such an investment strategy. We observed good examples of structured recording and reporting of engagement activities among asset managers.

Examples of impact assessment include activities by CalPERS and CPPIB. CalPERS has been collaborating with the University of California, Davis and Columbia Law School on a Sustainable Investment Research Initiative that included an academic/practitioner symposium in June 2013. They are now developing an online database of research on sustainable investment. CPPIB is collaborating with McKinsey 'to identify structures and metrics that support longer-term behaviours and enhance long-term value creation' by companies.

[4] Both were until 2010 elements within single organisations that combined asset owner and asset management functions. ABP is the majority owner of its manager APG. PFZW is legally entirely separate from PGGM.

However, as we detail in the following section, research in this area remains limited. More research is needed on the financial implications of responsible investing strategies such as engagements, incorporating ESG into investment decisions, and on the effectiveness of responsible investment in achieving environmental and social objectives in the interests of long-term investors.

3. Research evidence on responsible investing

The academic research supporting responsible investing beliefs and motivations is in some ways lagging practice. In considering responsible investing, the research can be divided into three major areas in line with ESG (environmental, social and governance). There is extensive and definitive research on the benefits of better corporate governance, while there is much less research on the effects of a firm's environmental or social profile. (There also exists a wide literature concerning governance from the country perspective such as investor protection. We restrict the discussion here to firm corporate governance.)

3.1. Motivations and principles of responsible investment

As was brought up at the Summit on Responsible Investing (Towner, 2013) regarding the theory behind motivations for responsible investment strategies, a tension can exist between the non-financial benefits of such a strategy and a goal of maximizing expected risk-adjusted returns. For some investors, the moral considerations outweigh financial rewards. As pointed out by Professor Glac at the Summit, according to Ross (1954) such considerations are part of Kant's theory regarding ethical responsibility, primarily non-maleficence ("do no harm"), beneficence, and fidelity.

A large body of theoretical work has considered the costs and benefits of firms' corporate governance, with the general conclusion that firms should benefit from better governance structures, i.e., better governed firms should have greater value, everything else equal (e.g., Shleifer and Vishny, 1997 and Becht, Bolton, and Roell, 2003). However, in direct empirical tests of the relation between corporate governance and firm value, the empirical evidence has been mixed (e.g., Gompers, Ishii, and Metrick, 2003; Core, Guay, Rusticus, 2006; Bebchuk, Cohen, and Ferrell, 2009). Part of the problem with such studies is that the causality is not clear, that is, the relation is endogenously determined and could even be driven by other factors. These empirical studies of corporate governance have primarily focused on the market for corporate control, the role of antitakeover amendments in the corporate charter, the structure of the board of directors, the incentives provided to management, the protection of minority shareholders and the role of the large shareholder, particularly institutional investors, in monitoring the firm.

While extensive evidence exists on the benefits of better corporate governance for firm value, there is more limited evidence on the benefits of environmental and social issues (generally described as a firm's corporate social responsibility). In economic theory, Benabou and Tirole (2010) have argued that firms may engage in responsible behavior for three rationales. First, engaging in responsible behavior may strengthen the firm's market position because it helps firm management avoid myopic decisions. Such a result would increase the value of the firm. Second, shareholders may choose to delegate their own social responsibility to the firm because it is economically efficient to do so. Again this would be expected to increase the value of a firm with better social responsibility activities.

As a third possibility, Benabou and Tirole (2010) argue that a firm's management may increase the firm's social responsibility in order to satisfy their own desire to enhance their philanthropic abilities. That is, corporate social responsibility would be a consumption activity for the managers. This rationale suggests that firm value could decrease in the presence of more socially responsible activities. Similar arguments have been put forth by Baron (2008) who also points out that a firm's socially responsible activities may increase productivity because employees will work harder or better for such a firm. In line with this argument, a survey of CEOs by McKinsey (2007) found that the CEOs ranked their employees as the stakeholder group with the greatest impact on the way in which their firms manage societal expectations. (Consumers were the next group.) A related, but different

theory is that by Besley and Ghatak (2007), who argue that more responsible firms will earn higher profits as a reputational premium to support good behaviour.

Correspondingly, there is more limited empirical research on the outcomes of firms' environmental and social choices. Eccles, Ioannis, and Serafeim (2012) present evidence that companies that were early adopters of sustainability policies outperformed a matched sample. In an analysis by Eccles, Krzus, and Serafeim (2011) the authors examine the interest of institutional investors and others through the Bloomberg ESG platform. They conclude that investors appear more interested in the 'E' and 'G' than the 'S.' They argue that this result may be because, relative to social data, environmental implications are easier to quantify in valuation models and a large amount of research exists indicating a relation between firm value and governance. As pointed out by Towner (2013), a problem is that research has not yet been able to identify the mechanism of value creation to an investor's portfolio from such corporate activities.

3.2. Ownership strategies

As already noted, the funds we reviewed attach importance to ownership strategies. They believe that monitoring their investments and exercising influence when needed is central to responsible investment, and is a means of helping to achieve financial objectives. This role of a large institutional investor as a monitoring shareholder is backed by considerable research support. As pointed out by Hirschman (1971), institutional investors have three choices when they are dissatisfied with a firm's performance and managers' actions: they can simply exit the ownership position by selling their shares, they can exercise "voice" by engaging with management to try to institute changes in the firm, or they can remain passive, a stance Hirschman terms "loyalty." We will discuss exit or divestment later in this chapter, but it should be noted that institutional investors that are universal owners may find it problematic to exit their ownership positions. Besides forgoing the opportunities from active ownership to influence change, they will also increase the tracking error of their portfolios.

3.3. Portfolio monitoring, voting and engagement

The effects of institutional investors exercising their ownership rights (i.e., shareholder activism or engagement) to influence change in a firm have been studied extensively. For example, theoretical evidence suggests that monitoring and engagement are a natural role for the large, often institutional, investor due to the high costs of monitoring and the free rider problem. That is, only the large investor has the resources and incentives to be a monitor. Because the costs of monitoring are borne by the monitor, but all shareholders benefit, only a large investor will be able to receive sufficient gains to cover their costs (e.g., Shleifer and Vishny, 1986; Admati, Pfleiderer, and Zechner, 1994).

Empirical evidence has found that firms that are targeted for engagement are those that are most likely to need changes and to be changed successfully. The primary characteristics of these firms are that they exhibit poor performance, poor corporate governance, high institutional ownership, and low inside ownership. The shareholder activist is more likely to be able to change corporate governance if there exist other institutional investors to join (or at least support) the engagement and if there are not high insider holdings, which could prove obstructionist to changes.

Institutional investors can choose to engage firms on either a public or private basis. Examples of public engagement include publicly targeting firms that are deemed to require change and submitting shareholder proposals to be considered at the annual shareholders meeting. The early empirical evidence on public engagement examined whether such engagement results in changes to firms and whether this activism has added value. Using a number of different metrics, the studies have mixed conclusions on whether public engagement is effective. That is, while some studies show positive returns on the announcement of engagement or the submission of shareholder proposals, the early studies show little evidence of improvement in the long-term operating or return performance of the companies on the receiving end of the proposals. These studies did, however, find differences in the operations of the firm subsequent to engagements by institutional investors, for example, changes in the firms' strategies. Gillan and Starks (2007) review this literature.

Although the beneficial effects of *public* activism have found only limited academic support, the direct evidence on *private* engagement has shown that individual institutions have been successful overall in their attempts to institute changes in firms' corporate governance and management decisions. These studies examine the "behind the scenes" approaches of the institutional investors such as the investors' goals for changes at the firm, the actions taken by the investors (e.g., private correspondence, records of phone calls and meetings with management and with the board), and the subsequent outcomes. In particular, the analyses of engagements by TIAA-CREF (Carleton, Nelson and Weisbach, 1998), the Hermes Fund (Becht, et. al. 2009), and another institutional investor (Dimson, Karakas, and Li, 2013) find evidence of success by these investors in achieving beneficial changes to the corporate governance and other aspects of their portfolio firms. Similarly, recent studies have found activism by hedge funds to change firm governance and capital structure to typically, but not always, add value in their engagements (see the review by Brav, Jiang and Kim, 2010).

There are a limited number of studies regarding shareholder engagement on environmental and social issues. One study focused on such engagements by one institutional investor examines over 2000 engagements on environmental, social and governance issues by one institutional investor (Dimson, Karakas and Li, 2013). The authors show that the engagements take time (500 days, on average) until their conclusion and success rates are low: about 18% of the engagements were considered successful. However, even the unsuccessful engagements did not significantly underperform a matched sample of firms and the successful engagements tended to outperform their matched counterparts.

Another study has focused on U.S. shareholder proposals on these issues (e.g., Del Guercio and Tran, 2012). The research finds that some institutional investors (primarily public pension funds, union funds, and SRI investment advisers) sponsor proposals in these areas and that sponsorship of these types of proposals has been steadily increasing over time, suggesting that institutions are becoming more interested in engaging firm management on these issues. Positive voting on these proposals has also been increasing over time.

Extensive empirical evidence also exists regarding apparently successful indirect monitoring by institutional investors. For example, studies have found that institutional investor monitoring (as proxied by the presence of a large number of institutional investor shareholders or concentration by institutional investor shareholders) is associated with beneficial corporate governance and changes in the corporate governance. Moreover, surveys of institutional investors find that they believe certain corporate governance profiles are important to firm value and that they try to influence firms to adopt such beneficial governance mechanisms (McCahery, Sautner, and Starks, 2010).

An important study showing the international reach of institutional investors with regard to corporate governance is that by Aggarwal, Erel, Ferreira, and Matos (2011), which shows that not only has governance been improving around the world, but also that this improvement appears due to institutional investor influence. Beyond finding that institutional investors export the best corporate governance practices to foreign firms, they also find that institutional ownership seems to play a disciplining role on the firm and they argue that the independence of foreign institutional investors from local corporate managers is an important aspect of this role. They conclude that "monitoring and activism by institutions travel beyond country borders and lead to better firm performance."

However, it is important to recognize (and empirical evidence has supported this) that institutional investors are not identical and they have different preferences, opinions and abilities regarding whether to engage the managements of their portfolio firms. That is, monitoring abilities and incentives vary across institutional investors.

3.4. Observation lists and exclusions

The central questions surrounding exclusion or divestment are the questions of the associated benefits and costs. That is, what benefits can arise from the actions? With regard to the costs of the action, the central issue is whether the divestment has an effect on the investor's portfolio risk and return. Little research exists on either aspect.

There are several potential benefits from divestment or exclusion. The first is not being associated with undesirable conduct. Such a benefit is beyond the financial performance of the decision. A second possible benefit is the impact of investors' divestment actions on the corporation's actions or policies. On a broader scale, when the divestment is created by actions of a country (e.g., South Africa in the last century, Sudan currently), the question is whether the investors' actions toward a corporation would persuade the firm's management to try to influence national actions and policies, and whether the corporation itself has sufficient influence on policymakers and government to effectuate change. Finally, if many investors divest securities with business in a country, will the outcome be large enough to cause the country to change?

Although some theoretical research argues that the threat of an institutional investor exiting a firm can affect management behaviour, there is limited empirical research on this claim. There is also limited evidence on the question of whether divestment affects the actions or performance of the underlying firms after they have been divested from institutional investors' portfolios. Two wide scale divestments of companies operating in countries with objectionable policies have served as the laboratory for such studies. First, researchers have examined the effects of divestment during the South Africa debate: they generally found no effects on the portfolio companies (Teoh, Welch and Wazzan, 1999). In contrast, engagement was considered to have been successful in achieving changes in South Africa.

Researchers also examined the effectiveness of a U.S. law, Sudan Accountability and Divestment Act (SADA) in 2007, designed to "support U.S. states' and investment companies' decisions to divest from companies with certain business ties to Sudan." The U.S. General Accounting Office performed a preliminary study of the effects of 23 state pension funds that divested or froze assets of about USD 3.5 billion in holdings of 67 operating companies that came under this act. The preliminary analysis found no financial effects on the operating companies' stock prices.

The research on whether divestment affects an investor's portfolio outcome is also limited. Obviously it will be a matter of degree. If an investor divests (or excludes) only one small holding from a large portfolio, then the effects on the portfolio's risk and return are likely to be small as the tracking error, from such an omission (i.e., the degree of divergence from the benchmark portfolio's risk exposures) would be small. At the other extreme, if an investor excludes a large number of firms (or a set of large firms) from their portfolio, the tracking error could in turn become quite large. Consequently, the ability to mitigate these exposures would be difficult to replicate through other portfolio strategies and the tracking error of the investor's portfolio would become quite large, resulting in large divergences of the portfolio's risk and return from that of a benchmark that includes the omitted securities.

A portfolio that excludes a large number of securities from a particular equity strategy (e.g., large cap value, large cap growth) or sector (e.g., energy), may change the risk and return profile sought in the portfolio goals and strategies. For an investor that seeks benchmark risk and return, such exclusions will require changes in portfolio strategy to attain the target profile. For example, consider a portfolio manager with exclusions that result in a portfolio with increased systematic risk relative to the benchmark. In order to lower the portfolio risk back to the benchmark risk, this portfolio manager will need to deviate further from the benchmark allocation. For example, he may need to increase holdings of less risky securities or change the asset allocation to larger holdings of a safer asset class.

The issues of the consequences of increased tracking error have been supported by studies of portfolios with South African divestment. These studies on the consequences of divestment on a

portfolio of S&P 500 index companies have confirmed that the portfolio could be significantly changed by divestment of a significant number of companies. For example, if each of the 153 South African-related companies in the S&P 500 were replaced by the largest "unrestricted" company in its industry, the portfolio would no longer closely resemble its benchmark. The total capitalization of the firms in the new restricted portfolio would be less than 62 per cent of the capitalization value of the S&P 500. Thus, the portfolio would have had a tilt toward smaller companies and given the nature of the restriction, the tilt would have been toward smaller domestic companies and away from large multinationals, thus changing risk exposures and opportunities on several dimensions. In this example, the researchers found that the restricted portfolio's beta with respect to the S&P 500 was 1.08, so it would have 8% more market risk. They also found 3% less diversification. The authors also pointed out that to adjust back to a beta risk of 1.00, the portfolio managers would have to either tilt the portfolio toward the least risky remaining stocks or hold more cash. The ultimate outcome would depend on whether the portfolio tilt ended up outperforming or underperforming the benchmark (Wagner, Emkin and Dixon, 1984; Grossman and Sharpe, 1986).

As pointed out by Chambers, Dimson and Ilmanen (2011), the Norway model differs from the Yale endowment model in its reliance on beta returns through a portfolio consisting primarily of publicly traded securities, with a constrained low tracking error and a rigorous asset allocation that allows little deviation from the policy portfolio. They contrast this approach with that of the Yale model "which aims for investment managers to bridge their deficit in systematic risk exposure by exploiting market mispricing." Thus, a problem for a universal owner such as the GPFG that relies primarily on beta returns is that the larger tracking errors will move the portfolio performance away from the benchmark beta returns. Such a divergence could necessitate a change in investment strategy in the asset allocation or the seeking of alpha returns to account for the divergence in systematic risk exposure created by large numbers of excluded securities. Thus, the strategic benchmark, identified by the Ministry of Finance and endorsed by Parliament may not be reachable through the traditional Norway model if excluded securities represent large numbers of firms or a smaller set of firms that account for an economically significant proportion of portfolio assets.

The externalities to a portfolio created by exclusions can also be examined through the studies of ESG/SRI fund portfolios (see Renneboog, Ter Horst, and Zhang, 2008 for a review). These funds are of several different types (negative screening, positive screening, a combination of the two, or engagement) and much of the research does not differentiate the analysis by type of SRI fund. These studies typically test three hypotheses regarding the ESG/SRI funds' return performance relative to that of the market. The first hypothesis is that ESG/SRI funds should underperform because they necessitate constrained optimizations. That is, since the funds cannot invest in all companies, they do not receive the benefits of diversification (less risk for the same return) and/or they do not get the benefit of a higher performing asset that is excluded.

The second hypothesis is that ESG/SRI funds should outperform the market because ESG/SRI investing is beneficial for the investor from a financial perspective. Two possibilities could explain this hypothesis: (1) ESG factors indicate higher quality managers; (2) screening by ESG factors implies that the risks of future ESG problems are reduced. Finally, the third hypothesis is that ESG/SRI funds should perform the same as the market. The empirical tests of these hypotheses are mixed. Some studies have documented lower returns to SRI/ESG portfolios, which the authors have interpreted to imply that the constraints on the portfolios matter. Consistent with this interpretation is evidence that so-called sin or vice stocks outperform the market (Hong and Kacperczyk, 2009). Other studies have come to the conclusion that SRI/ESG portfolios do not underperform, which the authors interpret to mean that investors can use such screens without harming their portfolio risk and return. One problem with this literature is that the different SRI/ESG portfolios tend to have varying screening mechanisms, and the studies generally do not distinguish between the alternative types of screening. A simulation study of the performance of the underlying firms in these funds (rather than the funds) indicates that there are few differences caused by the various types of screening (Humphrey and Tan, 2013).

4. The Fund's strategy, experience, and organisation

In the mandate to the 2013 Strategy Council (reproduced as an attachment to the Executive Summary), reference is made to the purpose and objective of the Fund: "*The purpose of the Government Pension Fund Global (GPFG) is to facilitate government savings to finance rising public pension expenditures, and support long-term considerations in the spending of government petroleum revenues. The investment objective is to maximise the purchasing power of the fund capital, given a moderate level of risk. In this way, we aim to ensure that both present and future generations can benefit from our common national savings.*"

The overall strategy for the Fund as a whole, and for responsible investment within this strategy, has been articulated most recently in the Report to Parliament (White Paper) on the Management of the Government Pension Fund in 2012 (Ministry of Finance, 2013a). In Table 3 we summarise the key features of the Fund's overall strategy, including investment characteristics, objectives, and the approach to responsible investment.

Table 3 – Purpose, strategy, responsibility and focus areas of the Fund

Feature	Aspects of implementing the strategy	
1. Purpose of the GPFG	• Facilitate government savings to finance rising public pension expenditure • Seek the maximum possible return given a moderate level of risk • Ensure that both present and future generations can benefit from its common national savings • Good long-term financial return depends on sustainable development in economic, environmental and social terms, and on well-functioning, efficient and legitimate markets • Responsible investment practices and transparency are prerequisites for support by the Norwegian population	
2.Investment strategy characteristics	• Harvest risk premiums • Diversification • Exploitation of the long term • Responsible investment practices	• Cost effectiveness • Moderate degree of active management • Clear governance structure
3. RI strategy	• International cooperation; contribute to best practice • Environment-related investments • Research and analysis	• Integrate ESG into investment activities • Active ownership • Observation and exclusion
4. NBIM's 6 focus areas for active ownership	• Equal treatment of shareholders • Role of the board • Well-functioning financial markets	• Children's rights • Climate change • Water management
5.Exclusion based on products	• Produce weapons that violate fundamental humanitarian principles • Produce tobacco • Sell weapons or military material to states that are affected by investment restrictions.	
6.Exclusions based on firm conduct	• Serious or systematic human rights violations • Serious violations of individual rights in war or conflict • Severe environmental damage • Gross corruption • Other serious violations of fundamental ethical norms	

4.1. *Formal structure*

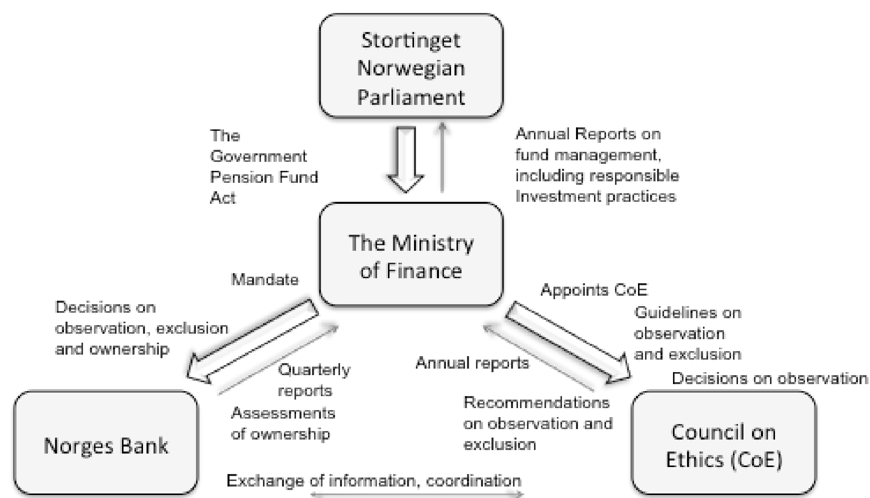
The structure by which the purpose and objectives of responsible investment are laid down and governed – under the ultimate authority of the Government Pension Fund Act - is formed by:

- The Investment Mandate for the Government Pension Fund Global (Ministry of Finance, 2010)
- The Guidelines for Observation and Exclusion from the Government Pension Fund Global's Investment Universe (Ministry of Finance, 2010a)
- The Investment Mandate for the Government Pension Fund Global laid down by the Executive Board of Norges Bank for the Executive Director and Chief Executive Officer of Norges Bank Investment Management (NBIM, 2012)
- Norges Bank Investment Management's Policy – Responsible Investor (NBIM, 2011).

Figure 1 illustrates the current structure, instructions and reporting of the responsible investment

practices. The wide arrows and acompanying text indicates the instructions down in the hierarchy, and the narrow arrows illustrate the reporting upwards in the structure.

Figure 1 – The current structure for tasks associated with the Fund's responsible investments



4.2. The investment mandate

The part of the Ministry of Finance (2010a) investment mandate that covers responsible investment practices is described in Chapter 2 in the mandate, which is divided into two sections. One covers the Bank's work with "responsible investment management", and the second covers "active ownership". The main principles of the first section are as follows:

- The goal is to achieve the highest possible return. A good long-term return is regarded as being dependent on sustainable development in economic, environmental and social terms, and on well-functioning, legitimate and effective markets (Section 2-1.1)
- The Bank is required to integrate corporate governance, environmental and social issues into its investment activities in line with internationally recognised principles for responsible investment.
- Considerations for the Bank: its role as a financial investor, the long-term nature of the investment strategy and the highly diversified investment universe (Section 2-1.2)

The second section about "active ownership" states:

- The primary goal of active ownership is to safeguard the financial interests of the Fund (Section 2-2.1).
- Active ownership should be based on the UN Global Compact, the OECD's Principles of Corporate Governance and the OECD's Guidelines for Multinational Enterprises.
- The Bank is required to have internal guidelines for its exercise of ownership rights that state how these principles are integrated (Section 2-2.2).
- The Bank shall actively contribute in developing good international standards for responsible investment practices.

4.3. Guidelines for observation and exclusion

The Ministry of Finance (2010a) specifies the Guidelines for Observation and Exclusion from the GPFG Investment Universe. These Guidelines provide the criteria according to which companies can be removed from the Fund's investment universe or placed under observation by the Ministry of Finance, and the procedures by which decisions on exclusion and observation are made.

The purpose of the Guidelines is to ensure that the Fund does not invest in companies that are responsible for or contribute to unacceptable activities. The Council on Ethics researches companies and makes recommendations for exclusion to the Ministry of Finance. The Ministry may decide to exclude a company or, if it believes the grounds for exclusion have not been established, to place it under observation. The Ministry may ask Norges Bank to engage with companies.

At the time of writing: 40 companies are excluded under the product-based criteria; 20 companies are excluded under the conduct-based criteria. 14 of these have been excluded based on the criteria "severe environmental damage", three for serious or systematic human rights abuses, two for other particularly serious violations of fundamental ethical norms, and one for serious violations of the rights of individuals in situations of war or conflict (Ministry of Finance 2013b). One company is under observation, because of the risk of gross corruption in its operations.[5]

According to its 2012 Annual Report, in that year the Council on Ethics contacted 64 companies, held nine company meetings, and based on their recommendation, the Ministry of Finance decided to exclude one company. In 2011 the Council contacted 31 companies and undertook 9 meetings. Five companies were excluded by the Ministry of Finance based on recommendations from the Council.

5. Observations

In this chapter we present key observations from our analysis, which underpin our recommendations starting in the next chapter. These key observations are as follows. First, a fundamental framework is needed to discuss responsible investment. Second, effective responsible investment requires considerations of the motivations underlying such practices. Third, universal ownership, by a large, long-horizon fund, has implications for responsible investment practices. Fourth, effective practical solutions to responsible investment principles and ownership strategies are needed. Fifth, we discuss the current division of tasks between the Council on Ethics, the Ministry of Finance, and Norges Bank. Sixth, we note the limits to responsible investment by the Fund. Finally, we link these observations to the recommendations that follow.

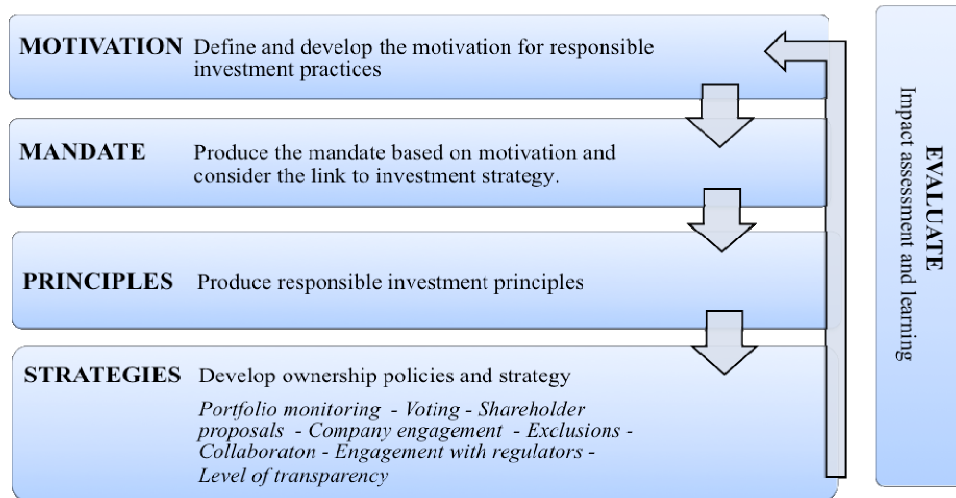
5.1. The responsible investment framework

It is useful to outline a responsible investment framework. This framework captures the aspects of responsible investment that we have noted as relevant in considering the practices of other funds (Chapter 2), the opinions of the Fund's stakeholders as reflected in the conference we organised in Oslo (Takaki, 2013), the research on responsible investment (Chapter 3) and the current structure of the Fund (Chapter 4). The framework has five principal components; Motivation, Mandate, Principles, Strategies, and Evaluation, which provide bases for our discussions in this chapter and for the recommendations in Chapter 6. The components are depicted in Figure 2.

As explained in Chapter 2, the first component, Motivation, denotes the process of determining the motive or objective for responsible investment practices. The second component, Mandate, encapsulates considerations of how the motivation links to the investment strategy; that is, to what extent the motivation for responsible investment affects the investor's portfolio strategy and asset mix. The third component, Principles, depicts the development of the principles and policies for responsible investment. The principles underpin the fourth component, Ownership Strategies. Lastly, Evaluation refers to the appraisal of the framework's components. This entails impact assessment and learning, so that responsible investment policies and practices can evolve over time.

[5] The Ministry of Finance (2013a) has also decided to place a company under confidential observation under the criterion serious violations of individuals' rights in situations of war or conflict.

Figure 2 – The Responsible Investment Framework



5.2. *Motivation*

In Chapter 2 we presented generic motivations for responsible investment activities. Many funds that employ responsible investment practices start from the premise that stock price performance and consequently, portfolio returns, will be affected by ancillary issues, which may or may not be subject to measurement by traditional financial metrics. If such matters, often environmental, social and governance issues, affect firm value as assumed by these funds, then economic arguments exist for the portfolio companies to consider them. However, it is not clear from an academic perspective how (or whether) these ancillary issues actually affect asset prices and portfolio returns. The efficient market view suggests that when an issue emerges as being important for firm value, it will be impounded into share or debt prices. Moreover, if the issue is considered to have the potential to influence a firm's future performance, the probability of such an effect will already be priced into the firm's securities.

Nonetheless, many funds take as their starting point for responsible investment a belief that global trends such as population growth, resource depletion, migration, climate change, and social aspects including dimensions of human rights, are potentially relevant to the creation of financial value. On this basis, some of the ancillary issues may already be reflected in asset prices. However, it is also widely recognised that not all such issues are currently financially material. For example, certain environmental or social issues may not become matters of financial substance at all.

Given these considerations, a general need for clarity in the Fund's investment mandate becomes critical. The current Investment Mandate expresses an approach to responsible investment and was re-stated most recently in the Ministry of Finance's (2013) report on The Management of the Government Pension Fund in 2012: "*The Ministry is of the view that good long-term returns depend on sustainable development in economic, environmental and social terms*…". The Ministry instructs the manager to "*be organised in a way that achieves good long-term return, whilst at the same time maintains the Fund's role as a responsible investo*r".

The Ministry's statements reflect parallels with two of the motivations for responsible investing. Parts of the Ministry's statements in this regard are in keeping with the universal ownership argument (see Chapter 2), whilst other parts of the statements echo the motive that sustainability enhances long-term portfolio performance. In addition, a reader may infer that a trade-off exists between maximising expected returns and maintaining the Fund's role as a responsible investor. Enhanced clarity in the mandate could provide more effective guidance to the manager of the Fund.

5.3. Implications of being large and long-term

In Chapter 2 we emphasised the link between investment strategy and how funds address responsible investment. For example, the ownership strategies that are appropriate for a concentrated portfolio, with a relatively small number of holdings, differ from strategies that are suitable for a fund with widely dispersed holdings. It is important to take into account how investment strategy interacts with responsible investment practices.

The Fund holds more than 7,000 companies in its equity portfolio. In some cases, the manager is seeking to make a meaningful contribution to investment performance by over-weighting a substantial company, relative to its weighting in the benchmark index. The manager will do this when the shares are thought to be underpriced. In additional cases, the manager will under-weight or entirely avoid holding a company that is thought to be overpriced. However, many other companies will be held to provide diversification in the portfolio. The manager will not have a conviction that the securities are mispriced and consequently will hold these stocks in accordance with their weighting in the index. To do otherwise – for example, to have a zero holding in shares that are deemed to be fairly priced – would mean taking an unjustified bet on the stock market performance of such companies.

Concentrated positions, in companies that can contribute in a meaningful way to portfolio performance, should be subject to detailed security analysis. These major holdings should also be evaluated along many dimensions, incorporating environmental and social, as well as governance, aspects. However, it is not efficient for the manager to analyse all companies to the same depth. The large number of positions that are held primarily for reasons of diversification should be investigated in lesser detail. For these portfolio holdings, it is appropriate to make a more cursory appraisal of their responsible investment credentials.

When a large number of stocks are held, portfolio diversification tends to be high, turnover should be low, and holding periods should be long. This is especially true when the investor's time horizon is exceptionally long term. But an effect of stable holdings that are held for the very long term is that there may be a potential misalignment between the interests of the investor and the interests of the executives in the portfolio companies. For example, it may be in the owner's interest for the companies to internalise negative externalities like emissions or pollution. Similarly, the owner may benefit if charges are imposed for consumption of public goods like national security or water usage. Any one company may of course benefit from engaging in antisocial behaviour. However, if the company imposes a burden on others, it can reduce the benefits that could be enjoyed by the owner of a diversified portfolio of companies. The owner may therefore wish to see responsible behaviour imposed on investee companies through legislation, regulation, standard setting, and adherence to the expectations of a responsible owner.

The GPFG has significant holdings in many companies and is often among the firm's largest owners. At the end of 2012, the Fund had stakes of more than 2 percent in 891 companies and exceeded 5 percent ownership in 34 companies. With the growth of the Fund, these types of large ownership positions are expected to multiply. For the largest holdings the Fund has potentially more leverage, and will be approached by the company and other shareholders for views on matters relevant for the owners. The expectations the Fund specifies for these companies can have signalling effects for other businesses, and thereby have a bigger impact than an engagement with a single company might suggest. So there is scope for deeper engagement with a moderate number of individual companies.

The complexities of holding dialogues with a large number of companies mean that it is necessary for the Fund to establish priorities in its ownership strategies. The basis for such priorities must be developed from an understanding of the relevance of engagement for long-term portfolio performance. But in addition, there is also a need for caution. Owners should not unnecessarily interfere with corporate management. A large, long-horizon owner should consider carefully whether it should engage with investee companies to change profitable and legal business practices. Alongside hoped-for benefits from change, modifying current business models can impose both costs and risks.

We have addressed governance, environmental and social issues. As we pointed out in Chapter 3, corporate governance has been studied extensively, but there is still a need for additional research that is of relevance to long-horizon investors. Areas of interest include the stability and functioning of the financial system, corporate tax strategies and tax regulation.

On environmental issues, there is extensive discussion on the effects of climate change, resource scarcity and productivity, deforestation and biodiversity loss; there is also evaluation of the impacts of government responses through regulation and market-based instruments (McKinsey, 2009, 2011; Mercer, 2010). However, little of this work provides guidance on what matters for portfolio investors. Worse still, there has been virtually no work examining the impact on portfolio performance of issues in human and labour rights, and social trends like wealth disparities within and between countries.

There is a need for research that addresses how investment management outcomes can be enhanced (or not) through responsible investment practices. Empirical research naturally requires data. Increased transparency on responsible behaviour – by asset owners, investment managers and investee companies – would facilitate new research insights on responsible investing.

5.4. Developing Responsible Investment principles and strategies

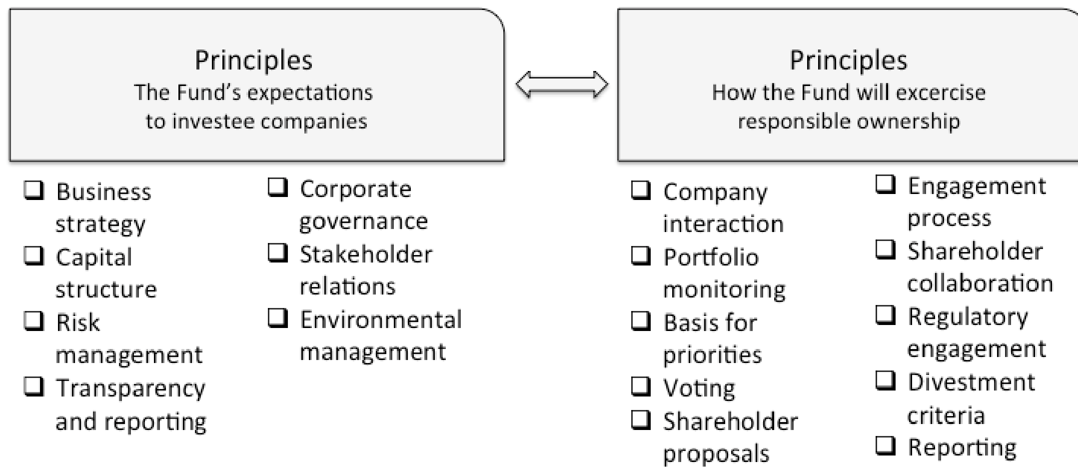
In Chapter 2.3 we noted that the funds we examined refer to a wide range of principles and standards in their work with responsible investments and ownership strategies. Well developed principles can guide funds' strategies, while unclear statements may lead to unrealistic external expectations and suboptimal use of resources. Further, clear principles provide predictability and consistency in a fund's exercise of ownership strategies. As such the principles are important for public trust in a fund. For a fund that is run on behalf of a diverse body of underlying owners, legitimacy is an important issue. In the case of the GPFG, this means that, while the Fund must adhere to its overarching financial purpose, it should also respond to the consensus views of the people of Norway.

The Fund must also be seen as a legitimate and responsible investor in non-Norwegian markets in which it does, or might, operate. If the Fund were to be regarded as an agitator or as an opportunist, or to be pursuing unclear agendas, this could undermine its capacity to invest on the best terms globally. For direct investments, such as real estate (currently) or potentially for other asset classes in the future, it is especially valuable to be seen as a desirable co-investor. Articulating and following accepted principles is one way of strengthening the perception of the Fund as a professional and predictable asset owner.

In general, we see strong arguments for the Fund to be supporting and taking advantage of global initiatives such as those referred to in Chapter 2.3. However, attempting to comply with a myriad of international standards can make management of responsible investment practices more challenging. These international principles may provide varying directions and different levels of guidance to funds, and hinder developing a coherent and structured foundation for investment strategies.

A complementary approach, illustrated by the example in Figure 3, may be to develop proprietary principles to guide the work with responsible investments practices. These would be high-level statements that express what the Fund as owner expects from investee companies. The fundamental requirement from owners is that companies are managed to maximise long-term shareholder value. Principles covering the key elements that affect this overarching objective can help to align the interest between owner and company and to add accountability to shareholders. In addition, owners need principles that guide how ownership strategies will be applied and how expectations will be met.

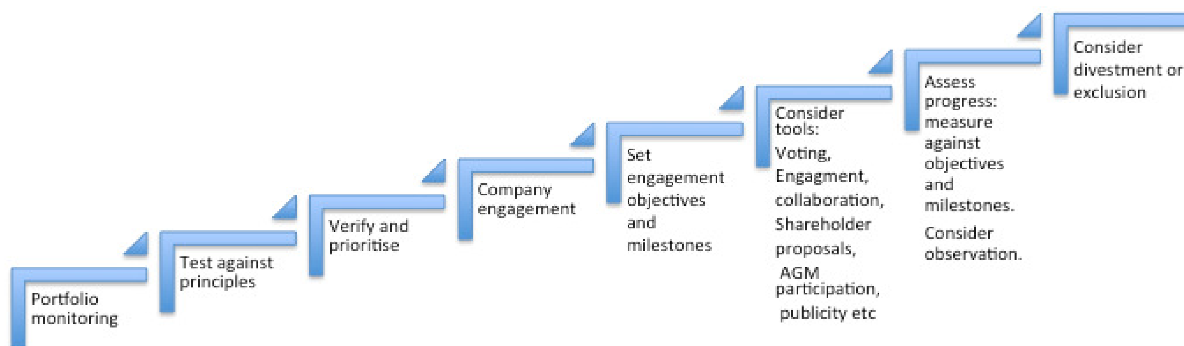
Figure 3 – Illustration of Responsible Investment Principles



Asset owners and managers might find it necessary to specify expectations further and in more detail by formulating more practical and detailed *policies*. For example, a principle could state that companies should manage risks and opportunities linked to environmental issues in a manner that ensures long-term value. To underpin this principle the owner could develop a more detailed policy highlighting that the manager expects the companies to manage specifically relevant topics such as emissions, water usage and waste management. Such environmental policies would typically be directed to particular industries or sectors with exposures to these issues.

Policies could also describe the whole chain of ownership tools and how these generally are applied. Figure 4 depicts an illustration of how an ownership strategy could be developed linked to a specific issue, for example a breach of the principles given in Figure 3.

Figure 4 – An illustration of a chain of ownership tools [6]



Ownership strategies often follow a chain of events that starts with issues arising from portfolio monitoring. The owner then needs to develop priorities based on the principles, and verify the issue. An engagement plan includes the objectives of the engagement, for example, ascertain information, enhance transparency, improve business conduct or improve governance. The strategy for achieving the engagement objectives should in each case describe the choice of ownership tools. The strategy

[6] In the interests of simplicity, this diagram does not refer to engagement with policy-makers or regulators – an approach that will be appropriate in certain circumstances once issues have been verified and identified as being relevant to the portfolio as a whole.

would depend on several factors, for example, the ownership stake, the expected support from other shareholders, and the jurisdiction, among other factors.

A variety of ownership tools is available such as engagement with management and/or the board, voting of proxies, stock lending restrictions and submitting shareholder proposals. The strategy could also include the plan for intensification if opposition to engagement objectives is sustained. That is, the strategy should describe an escalation process for taking the dialogue to executive management, the board, other shareholders and General Meetings.

As a last resort if there is no impact of the chosen strategy, the Fund could then consider whether the company should be placed under observation for possible divestment of the security from the portfolio. This decision would depend on the initial motivation for the engagement.

5.5. Observations about the current structure

In this section we highlight some of the challenges related to how the work with responsible investments practices is governed today.

Increasing overlap in activities between the Council on Ethics and Norges Bank. We observe that an increasing overlap in objectives and activities has developed between the Council on Ethics and Norges Bank. First, the Ministry of Finance, Norges Bank and the Council on Ethics all participate in international debate on responsible investment. Second, engagement as an ownership tool has become increasingly important as the Fund has developed, and notably since the evaluation of the Ethical Guidelines in 2009. As the Ministry of Finance (2013a) notes, this evaluation indicated that more emphasis should be placed on the potential for contributing to positive change in the conduct of companies and the interaction between the exercise of ownership rights and exclusion of companies should be strengthened. Consequently, in examining and understanding the conduct of companies, there is convergence in activities and information gathering between the Council on Ethics and Norges Bank.

In particular, following the new guidelines in 2010 the Council on Ethics has widened the scope of issues they consider and they have enhanced company contact. For example the Council on Ethics' (2012) Annual Report states: *"the Council has for example embarked on several such sector studies within the environmental area. The studies address certain forms of oil production entailing major local pollution problems, certain types of mining activities in which waste handling poses special risk, unlawful logging and other particularly harmful logging, unlawful fishing and other particularly harmful fishing activities, harmful dam projects, as well as activities having an extensive impact on protected areas of particular value. Within the area of human rights, the Council on Ethics has for several years been paying special attention to infrastructure projects in Myanmar and natural resource extraction in particularly volatile areas in the Democratic Republic of the Congo."*

In addition to exclusions recommended by the Council on Ethics following the Guidelines for Exclusions and Observations, in 2012 NBIM divested from 23 companies involved in palm oil production on the grounds that they were not taking appropriate action to prevent greenhouse gas emissions caused by tropical deforestation. NBIM (2012) took the view that "*their long-term business model was… unsustainable*." This follows the addition of tropical deforestation to the Climate Change Expectations document in 2012, and is the first time that NBIM has divested from companies in connection with any of their three environmental or social focus areas. Another example where we observe overlapping research and activities is both institutions' work to protect children's rights.

Without changes in the structure this overlap will likely intensify. Furthermore, increased investment exposure to emerging markets may lead NBIM to spend more resources understanding issues typically considered by the Council on Ethics.

A demanding role for the Ministry of Finance. The current structure creates a demanding role for the Ministry. For example, the exclusion recommendations from the Council on Ethics are detailed in content and legalistic in style. The company being considered for exclusion is invited to comment directly to the Council on the facts and documentation under consideration. However, there is no formal process of appeal or "public defence" if the company management deems it necessary to clarify or protest the basis for the alleged breaches. The analysis is based on public information, but descriptions and analysis may highlight situations and connections not absorbed by markets or regulators.

The Ministry is challenged by NGOs and other stakeholders for decisions regarding the Fund's investments, such as not processing recommendations quickly enough and not adopting all of the exclusions proposed by the Council on Ethics. This type of challenge is likely to increase because as the Fund grows it will become an even more significant shareholder in a number of the world's largest companies. Thus, the Fund will be subject to further scrutiny from business leaders, other shareholders and debt holders, and the regulators, authorities and political leaders in the countries in which it invests. The exclusion recommendations are public and highly detailed, and will be subject to thorough interpretations.

This observation is noted by the Ministry of Finance (2012) in the White Paper (2011-12): "*…the present system constitutes a source of operational risk, and it cannot be ruled out that exclusion may take place on the basis of circumstances that no longer apply as per the exclusion date. This may result in unmerited reputational damage on the part of the affected company. The policy of high transparency with regard to the decisions of the Ministry, as well as long and detailed recommendations, may in such cases have a negative impact on the companies. It is important to be conscious of these consequences of the current system and organisation of the exclusion and observation work."*

As the Ministry of Finance points out, there are outcomes from the current regime, especially since other investors replicate the exclusion lists. As the deciding body, to an increasing extent the Ministry should anticipate pressure from companies and others to justify the exclusions. There may even be risks of litigation from companies and other shareholders. The consequences of making "inappropriate" exclusion decisions will require more time and resource in the Ministry to process the recommendations. Increased time between an alleged incident and a final decision will elevate with the risk that information about breaches has become obsolete. The Ministry may require more personnel to verify the recommendations and consider the consequences, leading to further duplication of work among the Ministry of Finance, Council on Ethics and Norges Bank.

Moreover, the Ministry's operational role in exclusion decisions may place it in a sensitive position, given that these decisions may be interpreted by some as reflecting the opinion of the government of Norway as a whole about a company or even a country.

5.6. The limits to responsible investing

As a sovereign wealth fund, the actions the asset manager takes on behalf of the Fund will be associated with the Norwegian government. This dilemma will be exacerbated by the growth of the Fund, its increasing significance in global capital markets, and the increased use of ownership activities. These factors will intensify pressures on the asset manager and the owner from organisations, other states, companies and numerous stakeholders.

The Fund and the Norwegian government will continue to be scrutinised and tested for how these dilemmas are handled. Examples include, but are not restricted to, the following:

National procurement policies. Many companies are existing or potential suppliers to the Norwegian state. There is an obvious inconsistency between putting firms under observation or exclusion in connection with the Fund while, at the same time, accepting them as suppliers to the state.

Conduct by state owned enterprises. There may be state-owned Norwegian firms that do not meet the Fund's principles. If the Fund sets expectations for investee companies, there could be pressure on the ministry responsible for a state owned business to meet the Fund's standards.

Public policy and foreign aid. Public-policy and foreign-aid activities may be at odds with the commercial operations of companies held by the Fund. An illustration might be investment in businesses that interfere with Norwegian work on rainforests. There is a case for harmonising the Fund's engagements with the country's policy and aid initiatives.

Investments to serve political purpose. There are significant political pressures on the Fund. For example, some groups demand investment strategies that encourage speedier migration to a more sustainable economy, while others want to provide domestic benefits (such as improved Norwegian infrastructure) that exceed what can be supported by the state budget.

It is important that asset management is not regarded as the preferred alternative to addressing dilemmas that confront the government. The investment manager should not be expected to take actions to offset Norwegian public policies that may be deemed unsatisfactory. Nor should the Fund, which has a long horizon, be subject to short-term pressures relating to issues that may be transitory. The Fund has the power to enter into dialogue with the firms that it, in part, owns. Nevertheless, as we highlight in Chapter 5.4, this power should be used with care, and should not undermine the perceived legitimacy of the Fund in global markets.

5.7. The three pillars of recommendations.

The Strategy Council has considered how other funds address responsible investment practices, considered relevant research and listened to representatives of the Fund's multiple stakeholders. In this chapter we have highlighted the topics we consider to be most relevant for responsible investment practices, and have discussed what we consider to be effective practices. We have also observed the current structure for responsible investment practices by the Fund. Based on these considerations we recommend the Ministry of Finance to consider changes in the Ministry's investment mandate to Norges Bank. We also recommend certain structural changes in the tasks performed by the Ministry, the Council on Ethics and Norges Bank.

Our recommendations consist of three pillars. The first pillar considers the responsible investment objectives and strategy. The purpose of Pillar One is to ensure that the Fund achieves consistency among its objectives, priorities and activities in the responsible investment framework. Unclear or conflicting objectives can lead to unintended consequences such as unpredictable actions, difficulty in meeting priorities and hindering the effective use of resources, all of which could negatively affect the Fund's performance.

In Pillar Two we provide recommendations regarding the level of transparency on the Fund's responsible investment process, strategy and practices. The objectives of this Pillar are multiple. The first objective is to ensure continuous learning and improvement in the responsible investment processes and in the organisations involved with those processes. The second is to secure public trust and legitimacy in the Fund through accountability. The third is to ascertain the right level of transparency that provides maximum effectiveness in implementing ownership strategies.

In order to implement the recommendations in Pillars One and Pillar Two, we see a need to integrate all the responsible investment activities of the Fund. This is the basis for our recommendations in Pillar Three.

6. Pillar One: Objectives and strategy

The purpose of Pillar One is to ensure that the Fund achieves consistency among its objectives, priorities and activities. Ambiguous or conflicting objectives can lead to unintended consequences such as unpredictable actions, difficulty in meeting priorities and hindering the effective use of resources, all of which could negatively affect the Fund's performance.

We recommend that the mandate from the Ministry of Finance to Norges Bank is as clear as possible on three dimensions. These dimensions are, firstly, that the Ministry of Finance specifies the objective for responsible investment of the Fund. Secondly, the Ministry of Finance should require Norges Bank to develop and communicate a set of overarching responsible investment principles. Finally, Norges Bank should be asked to develop and apply ownership strategies that support the objective and principles for responsible investment.

We also recommend that the mandate from the Ministry of Finance requires the Bank to conduct research into issues related to responsible investment that may have material effects on portfolio returns.

Recommendation 1: Clarify the objective for responsible investment. In Chapter 2 we presented the principal motivations that have been expressed by others for investing responsibly, and in Chapter 3 we summarised relevant research evidence. We have examined the practices of other funds, and have sought and considered the expectations of the Fund's constituents. We recommend that the fundamental objectives for the Fund's responsible investment practices capture three premises:

First, the ultimate responsibility of the owner is to safeguard the purchasing power of the Fund for future generations through cost effective asset management at a moderate level of risk.

Second, the purchasing power available for future generations will depend on the total value created by the businesses owned by the Fund. The owner therefore needs to understand significant issues (whether currently considered to be financial or nonfinancial) that may have an impact on the future value of the Fund. The priority in responsible investment should be on initiatives that are expected to have a material effect on the Fund's financial value.

Third, based on assessments of overlapping consensus in the Norwegian population, it is the responsibility of the owner to impose certain restrictions on the investment strategy followed by the Fund.

We stress that the ultimate responsibility is to seek the maximum return given moderate risk levels. The Fund's responsible investment activities should be directed at value enhancing activities, and not be a vehicle for political objectives. We do, however, see a need for principles and ethical considerations that may not have financial effects on the Fund's performance.

Recommendation 2: Responsible Investment should be integrated and included in the Investment Mandate. The existing investment strategy will have an impact on the effectiveness of various ownership strategies. We therefore advise that fundamental decisions regarding responsible investment practices should be considered holistically and in tandem with the overall investment approach. In the future new insights into issues involved with responsible investing may cause the Fund to consider changing the portfolio's asset allocation. The Strategy Council recommends that any such considerations be based on research about the expected effects on portfolio returns.

The mechanism whereby investor responsibility is integrated into investment will vary with the Fund's approach. If the owner pursues a strategy that seeks to outperform through active portfolio management, it is potentially useful to integrate ancillary issues (e.g., relevant ESG considerations) into investment decisions at the security level. On the other hand, if the owner believes that the Fund will achieve its best performance through index replication, then market-wide initiatives are likely to

be particularly important. Examples of the latter include improving corporate transparency, ensuring fair business practices, pricing externalities, and improving capital market quality and efficiency.

To the extent that the Fund pursues a mixture of investment approaches, a segmented responsible investment strategy is likely to be appropriate.

Recommendation 3: Develop Responsible Investment principles and base ownership strategies on these. We propose that the Fund be governed by one set of responsible investment principles in line with discussions in Chapter 5.4. It is our recommendation that the principles holistically cover all matters that influence how investee companies are aligned with the owner's objective of maximising long-term value creation. These principles articulate the expectations the Fund has to investee companies including business purpose, strategies, financing, transparency, corporate governance and the management of key stakeholders and the environment.

The purpose of ownership strategies should be to investigate and follow up these principles. We recommend that the development of ownership strategies is based on principles about how the various elements are applied. By this we mean that the Fund should have principles for how and when to apply the different tools in the ownership strategy; including portfolio monitoring and verification, voting, company interactions and engagement, shareholder collaboration, the use of shareholder proposals, criteria for divestments and exclusions, and reporting and assessment of the effects of the strategies.

We recommend that the Fund is governed by a principle that states that priorities should be on ownership strategies that are expected to have a material effect on portfolio risk and performance.

Recommendation 4: Initiate research to elevate the understanding of portfolio performance. It follows from the main objective in Recommendation 1 that the Fund has a responsibility to develop an enhanced understanding of which issues may affect future portfolio returns. As noted in Chapter 5.3, an investor as large as the Fund can gain disproportionately from such research.

The Fund should express interest in research that has the potential to fill the knowledge vacuum about the impact of ESG matters on real portfolio value. Areas cited in Chapter 5.3 include the stability and functioning of the financial system, the effects of climate change, resource scarcity and productivity, deforestation and biodiversity loss, human and labour rights, corporate tax strategies and tax regulation, and social trends like wealth disparities within and between countries.

It is important to differentiate between studying these topics from a policy perspective and investigating their impact on portfolio performance. Studies of ESG issues can identify matters that are of widespread importance, some of which should be the subject of policy initiatives by the governments of Norway and other countries. Such studies are important, but they generally fall outside the mandate of the Fund.

The investigations that should be prioritised by the Fund are those that may inform investment strategy, and enhance the wealth of future generations. The outcome from such research may result in new insights on asset allocation, sector and industry exposure, weightings in relation to other factors, allocations to new asset classes such as private markets or infrastructure, and other themes that underpin investment decisions.

Recommendation 5. Endorse policy changes that enhance portfolio value. Research as described above can provide insight into the need for regulatory change and new proposals on standards and public policies. As noted in Chapter 5.4, there are limits to the gains from following internationally recognised global standards. Indeed, our view is that Norway should be a leader, not a follower, when it comes to seeking regulatory change or adoption of demanding standards.

It is therefore in the Fund's interest to participate in discussions, and to support or instigate standards

or regulations that will enhance the overall value of the Fund's portfolio. On a high level, we recommend that the Fund prioritise policy initiatives that seek to improve corporate transparency, ensure fair business practices and improve capital market quality and efficiency and internalise externalities.

7. Pillar Two: Transparency and accountability

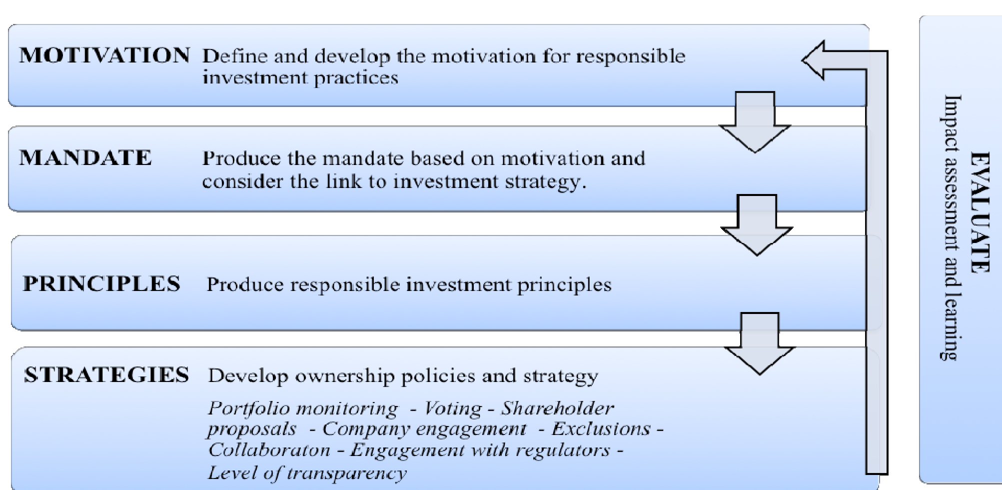
In Pillar Two we provide recommendations about the level of transparency on the Fund's responsible investment framework. By framework we mean the process of determining objectives, and the development of principles and ownership strategies. The central aims of this Pillar are to facilitate continuous learning and improvement in the framework, to secure public trust and legitimacy in the Fund, and to ascertain the right level of transparency that provides maximum effectiveness in implementing ownership strategies.

The recommendations in Pillar Two are in essence to disclose the objective, principles and policies, and ownership strategies arising from the recommendations in Pillar One.

Recommendation 6: Disclose the Responsible Investment Principles and ownership strategies. One particular challenge facing the Fund is to strike the appropriate balance between transparency within the Fund and discretion about operational management of the portfolio. Because of the Fund's size, almost any actions will impact companies, markets and regulators. Thus, it is difficult to achieve the appropriate balance between the need for prudence in sensitive situations and the degree of openness needed to provide stakeholders with the trust that the Fund is following its mandates and meeting the long-term interests of the people of Norway.

Principally, the Strategy Council recommends openness about the Fund's responsible investing, objectives, principles, policies and strategies, and rather than on company specific matters. In practice, this openness would involve describing the process for establishing the Fund's framework for responsible investment, as illustrated in Figure 5 and as explained in Chapter 5.1.

Figure 5 – The Responsible Investment Framework*



* This exhibit is the same as Figure 2

Disclosure should emphasize responsible investment principles and corresponding ownership strategies. The recommended disclosures include the procedures for applying ownership strategies. In the mandate given to Norges Bank, the Ministry of Finance should ask the asset manager to develop and disclose principles for the application of the components in the ownership strategy and how these ownership tools will be applied. This proposal follows from the discussions in Chapter 5.3 and in

Recommendation 3. Reporting on specific and ongoing company engagements may be detrimental to progress or to future engagements. As a means of balancing the need for transparency against the necessary discretion, the Bank could publish aggregated, but informative, summary reports.

Recommendation 7: Report on impacts of responsible investment strategy. We have recommended that the Fund disclose the process for the development of ownership strategies. Research into the effectiveness and impact of ownership strategies is a prerequisite for improvements and for effective resource allocation. Changing course as a consequence of changes in circumstances or when strategies are less effective than anticipated will often be necessary. Disclosing and providing reasoning and discussions about these changes can add to the trust in how the Fund manages ownership strategies. A culture of openness is necessary to evaluate effectively the impact of the Fund's responsible investment strategies, as well as to enable learning through experience. By sharing the insights from such research and assessments, the Fund can take a leadership role in selected areas of responsible investment practices.

8. Pillar Three: Integrate the Fund's responsible investment work

The objective of Pillar Three is to advise on how the resources and competencies related to responsible investment may best be utilised to achieve the objectives proposed in Recommendation 1. By best utilised we mean not only in relation to resource costs, but more importantly, the ultimate impact of the principles and ownership strategies as described in Recommendation 3. In order to implement the recommendations in Pillar One and Pillar Two, there is a need for structural changes in the Fund's approach to its responsible investment practices.

Recommendation 8: Exclusion decisions to become part of an integrated chain of ownership tools. In Recommendation 3 we advised that the mandate to Norges Bank should include a requirement to develop responsible investment principles as the basis for ownership strategies. We pointed out in Chapter 5.4 that to be most effective, ownership strategies typically require an integrated use of tools. Our recommendation is that exclusion or divestment decisions related to companies' conduct should be made on the basis of the Fund's clearly stated principles and usually after all ownership strategies have been considered. The Guidelines for Observation and Exclusion would therefore be integrated into the new responsible investment principles. Ownership strategies are not likely to be appropriate in the case of product-based exclusions.

It is our conviction that applying a chain of ownership tools better supports the motives behind conduct-based exclusions. There are however additional and important supporting rationales for integrating exclusion decisions within the Fund's responsible investment activities. The first rationale is to avoid the duplication of resources that currently takes place between the Council on Ethics and Norges Bank, and to an extent also the Ministry of Finance. By resources we refer here to the processes of analysing portfolio companies, understanding if there might be breaches of the guidelines, and the information gathering and company interactions that take place to verify potential breaches. In Chapter 5.5 we pointed out the increasing overlap in these activities currently performed by the Council on Ethics and Norges Bank. The resources and competencies of these institutions could be better utilised if combined.

A consequence of merging the resources related to responsible investment would be to reorganise the work and decision making processes. Our recommendation is that, given the Investment Mandate from the Ministry of Finance, the Board of Norges Bank should decide on the principles and ownership strategies, including the final decision to divest from companies that breach the Fund's principles. A favourable consequence of transferring exclusion decisions from the Ministry of Finance is the avoidance of the problems of role overlap and the demands on the Ministry that are addressed in Chapter 5.5.

The organisational effects of this recommendation are discussed in Recommendation 9.

Recommendation 9: Delegate exclusion decisions to Norges Bank. The Government Pension Fund Act defines the Ministry of Finance as the owner of the Fund. The management of the Fund is delegated to the Board of Norges Bank as the asset manager. The Board of Norges Bank subsequently delegates investment decisions to Norges Bank Investment Management (NBIM). Accountability requires clear descriptions of responsibilities and roles, a governance structure that ensures transparency on objectives, procedures and activities and an effective reporting framework.

The hierarchy of decision processes and reporting lines related to the work with responsible investments, and the Strategy Council's corresponding recommendations, are illustrated in Figure 6.

Figure 6 – Reporting and the Responsible Investment Framework

The Ministry of Finance – the owner of the GPFG. As the owner of the Fund, the Ministry of Finance is responsible for the whole framework for Responsible Investment. One of the responsibilities for the owner is the process of defining the objectives for the work with responsible investments and understanding the link between the investment strategy and the objectives. Based on this understanding, the Ministry of Finance produces the investment mandate based on the objectives for responsible investment practices (*Recommendation 1*) and considerations about the impact on the Fund's investment strategy (*Recommendation 2*).

The third premise in the overarching objective in Recommendation 1, which states that *based on assessments of overlapping consensus in the Norwegian population, it is the responsibility of the owner to impose certain restrictions on the investment strategy followed by the Fund.* The decisions to divest or exclude companies affect the investable universe and criteria for these decisions should be explicitly stated in the mandate to Norges Bank.

According to Recommendation 3, the Ministry of Finance would require Norges Bank to develop Responsible Investment Principles as the basis for ownership strategies. As noted above, the criteria for exclusions should be explicitly formulated in the mandate. In addition, the Ministry of Finance should require Norges Bank to incorporate these criteria into the Responsible Investment Principles.

The mandate should also include requirements about reporting on the application of the responsible investment principles, as well as an impact assessment of the ownership strategies. Recommendation 4 proposes that Norges Bank should initiate research to elevate understanding of the impact of responsible investment on portfolio performance. This should provide important input into the process of evaluating the mandate and the link to investment strategies. The owner (the Ministry of Finance) should then report the results of the assessments to the Norwegian Parliament. This report should include assessments on financial performance as well as how the responsible investment framework is being applied.

The Board of Norges Bank – the manager of the GPFG. Based on the mandate from the Ministry of Finance, the Board of Norges Bank should decide on investment strategy, develop the responsible investment principles, and decide on ownership strategies based on the principles (*Recommendation 3*). As discussed in Chapter 5.4, some of the responsible investment principles require supporting policies that provide more detail. These should be developed and implemented by NBIM.

The implication of Recommendation 9 is that the Board of Norges Bank would also have the responsibility to make divestment and exclusion decisions, and to decide on the level of transparency regarding such decisions. In some instances Norges Bank may wish to exclude or divest from companies that are in breach of the Fund's principles, based on financial considerations about risk and return. Such a decision could be reached, for example, at the end of an exhaustive use of ownership strategy tools as depicted in Figure 6. Concluding that the financial risk does not merit ownership of certain companies would fall under the general asset management responsibilities typically delegated to NBIM and reported on at frequent intervals. There could also be cases in which companies breach criteria explicitly specified in the mandate from the Ministry of Finance – such divestments should be subject to resolutions at the Board of Norges Bank.

Recommendation 10: Ensure accountability and alignment of interest. Subsequent to adoption of Recommendations 8 and 9, the Board of Norges Bank would have extended responsibilities for managing the Fund. We now address further implications arising from the proposal to delegate the management of certain non-financial matters to the asset manager.

Under our proposals, Norges Bank will be responsible for divesting (or not investing) in companies that violate certain criteria set by the Ministry of Finance and embodied in the mandate. Asset managers are generally evaluated and remunerated based on financial returns after costs. One implication of the recommendations in this report is that Norges Bank will be required to make decisions that may have adverse effects on the portfolio performance. There will also be cost implications that are not value enhancing for the Fund. Such costs include analysis, verification and preparation of decision propositions to the Board of Norges Bank. It is likely that Norges Bank will need to add expertise and resources that are not currently represented in the asset management organisation. In order to make sure that Norges Bank has the right incentives to follow the owner's instructions effectively, the owner should make adjustments in how the asset manager is measured with respect to this work. The owner should also specify that the Board of Norges Bank needs the expertise to manage the additional requirements.

We list below some mechanisms that could enhance accountability and provide incentives to counter the inherent conflicts between the financial and non-financial objectives of the mandate:

Index adjustments. In evaluating the Fund's performance, the reference index should be adjusted to take into account exclusion of companies on the basis of non-financial criteria.

Measure resource. The resources required for analysing, verifying and preparing documentation on potential breaches of responsible investment principles set by the owner should be measured. The costs of such resources should be excluded from the asset management costs of the Fund.

Relevant expertise. The Council on Ethics possesses valuable expertise about the issues that are governed by the current Guidelines for Observation and Exclusion. We recommend that these guidelines be integrated into the Investment Mandate from the owner to the Board of Norges Bank. The Board will then have the responsibility to operationalise the mandate. As a consequence, the Board of Norges Bank will need to have, or have effective access to, relevant expertise. This could be accomplished, for example, by establishing a committee appointed by the Board of Norges Bank that provides advice and recommendations to the Board in matters related to exclusions. The knowledge and competence that has been accumulated in the secretariat of the Council on Ethics should be utilised and integrated into NBIM, the asset management organisation.

Apply effective oversight functions. Norges Bank's work with the Fund's responsible investment principles and ownership strategies should be subject to internal controls in line with the general oversight functions of the Bank. Reports from such controls should enable the Fund owner to assess whether their mandate is being followed appropriately.

Transparency and reporting. Increased transparency about how Norges Bank works with investment principles and subsequent ownership strategies will in itself provide accountability to the owner and to the public. This argument was highlighted in Pillar 2.

9. Conclusions

As the 2013 Strategy Council for the GPFG, we were asked by the Ministry of Finance to provide guidance on the Fund's responsible investment strategy and practices. To develop this guidance, we first examined the current strategies and practices of asset owners and managers committed to responsible investing. Consequently, we conducted a large number of interviews and analysed many public documents from these sources as well as others, including professionals from Norges Bank and the Council on Ethics. We also considered the views of other parties involved in responsible investing including stakeholders in the Fund, NGOs, consultants, researchers, and data providers. In addition, we analyzed the current state of research in responsible investing. To further enhance our understanding of the views of these parties we held two conferences and attended a number of other conferences dealing with aspects of responsible investing.

Based on our extensive analysis, we developed specific recommendations for the Fund. These recommendations are based on three foundational pillars. Under the first pillar our recommendations address the Fund's objectives and strategy for responsible investment, including needs for clarity on the motives, integration of responsible investment into the investment mandate, a unifying set of principles and procedures, research on global trends, and finally, endorsement of policy changes that enhance portfolio value. Under the second pillar we provide recommendations in order to increase the Fund's transparency and accountability with respect to responsible investing, including disclosure of the Fund's principles, policies, strategies and impacts of responsible investing. Finally, under the third pillar we recommend changes to the Fund's governance structure in order to achieve a more integrated approach to its responsible investing, specifically by integrating the Fund's responsible investment work into one organisation, while maintaining the expertise and competencies developed by the Council on Ethics and by ensuring accountability and alignment of interests. In our report we have provided the background and bases for each of our recommendations.

We believe the recommendations will further contribute to strengthening the work on responsible investment in GPFG. Applying a more unified and holistic approach will give the Fund a more powerful and influential responsible investment strategy. This is achieved through our recommendations to integrate the resources and insights developed by the Council on Ethics and Norges Bank, by utilising one overarching set of responsible investment principles, and one common procedure for ownership activities including portfolio monitoring and analysis. Our recommendations on research into issues relevant to long-term returns, and on initiatives to address relevant policy and regulatory issues, will strengthen the approach further.

The Strategy Council believes these recommendations will accomplish three goals. First, they will enable the Fund to stay at the forefront of responsible investment practices for large, highly diversified, long-term global investors. Second, these recommendations should strengthen the legitimacy of the Fund among the Norwegian population and stakeholders who are critical to the success of the Fund. Finally, these recommendations will guide the Fund owner and managers to pursue responsible investment practices that enhance the value of the Fund.

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Oslo, Norway
11 November 2013

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