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White Paper No. 55:  
Yale Versus Norway

September 2012

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Every investor knows about Yale University and the extraordinary success of its endowment portfolio under the guidance of the redoubtable David Swensen. Indeed, many families have tried to emulate Yale's approach to asset management, for obvious reasons. Yet, those families – and even most institutional investors who have tried to copy Yale – have failed. The reasons for these failures are many, but these are the main stumbling blocks: few investors have the huge asset base Yale boasts (about \$20 billion); almost no one was as early into venture and buyouts investing as Yale; it's a rare investor who can match the talent and dedication of Yale's in-house investment staff or investment committee. But the main reason for the failures is far simpler: if you want Yale's results, you need David Swensen to manage your assets.

By contrast, almost no one has heard of the Norway Government Pension Fund (NGPF). But here are a couple of facts about the NGPF.<sup>1</sup> First, it's now the largest sovereign wealth fund<sup>2</sup> in the world - \$580 billion at mid-2011. Compare this to the largest US pension fund, CalPERS, which has about \$230 billion.<sup>3</sup> Second, its investment track record is quite good, and Edwin Truman recently awarded the NGPF top position on his "scorecard," ahead of 53 other sovereign wealth funds from 37 countries.<sup>4</sup> Finally, and most important, it's only a modest exaggeration to say that the NGPF is the "anti-Yale" in its investment approach.

We're guessing that few of our readers have ever heard of the chief investment officer of this remarkable fund, the "David Swensen" of sovereign wealth funds. His name is Yngve Slyngstad, and he works for (are you sitting down?) *a bank*, specifically for the Norges Bank, Norway's central bank based in Oslo.<sup>5</sup> One important reason why no one has heard of Mr. Slyngstad is that Norway uses a "team model," rather than the "star" model embodied by David Swensen. This suggests that to the extent the Norway Model may be of interest to family investors, it ought to be a lot easier to imitate than the Yale Model.

## ❖ The "Yale Model"

When we think of the Yale Model, although it's a bit of a caricature, we think of these characteristics:

- A strong equity orientation, thinking of equity in its broadest sense. Only about 4% of the Yale portfolio is invested in bonds.
- A very large willingness to trade liquidity for return. Including hedge, private equity, and real assets (natural resources and real estate), roughly 82% of Yale's portfolio is illiquid. Compare this with Yale's total of 16% in US and non-US long equities.

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- A firm belief in active management. Yale owns almost no index-like investments.
- The “star” model of endowment management: virtually every important decision at the Yale Investments Office is made by David Swensen.

## ❖ The “Norway Model”

Again, it may be slight exaggeration, but looking at the Norway Model what we see is that it’s “virtually the opposite of the Swensen model.”<sup>6</sup> For example:

- Norway relies almost exclusively on publicly-traded securities.
- The proportion of active management in Norway’s portfolio is *de minimus*, because the fund is constrained by a very small tracking error policy.
- Norway owns no private equity, and little hedge.
- While Yale owns almost no fixed income, Norway’s strategic benchmark includes a 40% weighting to bonds.<sup>7</sup>
- Until 2008, Norway owned no real estate.
- Norway follows a rigorous socially responsible investment policy that eliminates many securities from its investable universe (and therefore, according to Modern Portfolio Theory, Norway’s returns should be constrained).<sup>8</sup>
- As noted, Norway follows a team approach in which the staff operates by consensus and the investments are closely supervised by an Advisory Council, a Strategy Council, and even a Council of Ethics.

## ❖ Similarities to Family Investors

There are characteristics of the Norway Government Pension Fund that would seem to make it simpatico with family investors:

***Remarkable wealth.*** We’ll start with the proposition that Norway is to other countries what wealthy families are to other families – in other words, Norway is a very rich place. Even before oil was discovered in the 1960s, Norway was an affluent society, but today it is often ranked as the wealthiest country in the world on a per capita basis.

***Worrisome aspects of wealth.*** And like wealthy families everywhere, Norway worries about the possible negative consequences of its wealth. Some of these consequences affect only countries,<sup>9</sup> but others will be familiar to families. For example, if Norway were to spend its oil revenue as it came in,

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or to spend too much of the NGPF every year, it could reduce the incentive for its citizens to become educated and productive. Similarly, every wealthy family worries about raising entitled, unproductive children content to feed at the family trough.

***Sensible spending.*** Norway has seriously constrained spending from the NGPF to roughly 4% of the fund's value, a sustainable rate for a tax-exempt institution and well below what most American institutions spend. Private charitable foundations, for example, are required by the US Government to spend 5% of their assets every year, and most endowed institutions have spending rules that result in spending between 4.5% and 6.5% per year. Moreover, the spending rate changes depending on how well the Norwegian economy is doing. If things are going well, spending from the NGPF is reduced, while during slow economic periods spending is increased. This policy acts as a break on government spending in Norway.

***Stewardship.*** Norwegians believe strongly in the notion of stewardship. Specifically, they believe that the benefits of the oil boom shouldn't be enjoyed simply by that segment of the population that happens to be alive while the revenue is flowing. Instead, the revenue from oil production should be stewarded so that it can continue to be enjoyed by future generations of Norwegians. Clearly, this parallels exactly the view that well-managed families have of their stewardship obligations.

***Governance.*** The NGPF is well-governed. As noted above, the fund follows a "team" approach, rather than a "star" approach. The fund is managed by Norges Bank Investment Management, reports up to the Norwegian Ministry of Finance, and is advised by a Strategy Council and a Council of Ethics. There are also outside consultants and advisors. Wealthy families, too, struggle with governance, wanting to be both inclusive and effective, two goals that are often in conflict.

***Socially responsible investing.*** Finally, as noted above, Norway believes that its wealth should be invested ethically. As a result, the NGPF is subject to a variety of environmental, social and governance (ESG) considerations that constrain its ability to invest. Ethical investing is also a prominent feature of many family portfolios, and it seems to resonate especially with younger members of wealthy families.

## ❖ Implications for Family Investors

Not everything about the NGPF is applicable to or an object lesson for family investors – after all, not that many families are investing nearly \$600 billion! But the implications for family investors are nonetheless significant:

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***NGPF's core beliefs.*** The Norway fund believes that (a) markets are largely efficient, (b) diversification is an important risk control, (c) the equity risk premium will be the main source of returns, (d) the fund should be managed to a specific benchmark, (e) external managers are important, especially for less liquid market sectors, and should be carefully selected and monitored, and (f) the fund should be managed with reference to socially responsible criteria.<sup>10</sup> Except perhaps for the last of these core beliefs, most families would agree with the NGPF.

***Size matters (or maybe not).*** Most discussions of capital market participants divide investors into institutional players (e.g., pension funds, sovereign wealth funds, large endowed institutions, banks, mutual funds) and retail investors. But wealthy families fall in-between these two extremes, rarely investing as much as the big institutional players but investing much more than a typical retail investor. As a result, some of the advantages of size also accrue to wealthy families, assuming the family is experienced enough and well-organized enough to take advantage of their size.

For example, assuming a reasonable level of spending, many wealthy families are deploying vastly more capital than will ever be needed by living generations, and hence they have very long investment time horizons, much like the NGPF.<sup>11</sup> The NGPF is able to take a long view, accepting a certain amount of volatility and illiquidity in exchange for higher expected returns. The specific investment strategies available to large, long-term investors are discussed below.

***Is it possible to sustain a long-term view?*** Many investors – colleges and universities, for example – have investment lifetimes that are, for all practical purposes, infinite: Harvard, William & Mary, St. John's, and Yale are already more than three hundred years old and still going strong. Yet very few of them invest as though this were true. The problem, as the NGPF found out, is that a long-term outlook can become awkwardly short-term when the markets crash.

In 2008, for example, the NGPF, after many years of excellent performance, experienced truly poor results. The overall fund was down -23% (nearly 400 basis points below its benchmark) and the equity portion of the fund lost 40% (modestly below its benchmark). The bond portion of the fund lost only -0.53%, but this was a whopping 660 basis points below the benchmark.

Howls went up across the land (the land being Norway) and Parliament was in an uproar. Expert advice was solicited and numerous analyses of the fund's failures were published. There was a real danger that the fund would pull in its horns and revert to a cautious, low-returning strategy that wouldn't put it in the headlights again. (So far that hasn't happened, and fortunately Norway's portfolio has recovered strongly.)

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Families, of course, face the same problem. When times are good, portfolio risk rises and everyone is happy. But when the market turns down and the risk dog bites, the temptation to flee the field of battle can be overwhelming. In the case of the NGPF, the consensus of opinion was that the fund had failed to alert the public and policymakers to the possible risks inherent in the portfolio, resulting in a very negative surprise. The implications of this episode are clear for families: make sure the appropriate family members are fully educated about the risks and rewards of the investment strategy, well in advance of those risks coming home to roost.

***Diversification.*** Diversification is a core value at NGPF, but it's a value that has been slow in coming and which still has a ways to go. Emerging markets equities weren't added to the NGPF portfolio until 2000, corporate bonds until 2002, inflation-linked bonds until 2005, small caps until 2007 and real estate until 2008. There is still no exposure to private equity, although this issue is under discussion. Fortunately for the NGPF, the missing asset classes didn't harm performance until – well, until they did.

Just before the market collapse in 2008, the NGPF, riding the wave of enthusiasm engendered by years of good results, raised its equity allocation from 40% to 60% of the portfolio. Obviously, this was bad timing in the extreme, and it illustrates the dangers of attempting to time the markets. Norway (family investors take note) would have been better served to make such a major change in portfolio allocations over an extended period of time.

Among the lessons for families are these. First, it's better to build a diversified portfolio from the beginning. And second, if you are going to make major portfolio changes, either make them slowly over time or make them in a counter-cyclical way. The best time for the NGPF to have increased its equity allocation would have been 2009, not 2007.

***Avoiding inadvertent indexation.*** When you are investing almost \$600 billion, one of the great dangers is that you will end up owning everything in the market. The NGPF, for example, owns about 1% of every listed company in the world. For them, indexing is an intentional, probably unavoidable, strategy. While families aren't nearly so large, many family portfolios are so overly diversified and include so many managers that, when you really drill down, what you find is a big and expensive index fund. If a family investor really has so little conviction in its active managers that it's unwilling to concentrate among a few of them, it would be a lot cheaper just to buy a real index fund.

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**Costs matter.** As Messrs. Chambers, Dimson and Ilmanen point out, “There is only one consistent source of performance deviations from a benchmark ... not skill but cost drag.”<sup>12</sup> As a result, the NGPF is intensely focused on keeping costs down. During the first decade of this century, NGPF’s all-in costs ranged between 7 and 9 basis points, not counting performance fees paid to outside managers. For a wealthy family, fees at this scale seem more like custody fees than asset management fees, but the main point – keeping costs low – is every bit as important for family investors as for the NGPF.

**But costs aren’t everything.** Possibly in its zeal to keep costs down (but also in an effort to keep tracking error within a narrow, prescribed range), the NGPF has largely ignored a potential source of excess return: active management. A large, sophisticated investor with a skilled staff and/or expert outside advisors ought to be able to add incremental return by identifying and gaining access to the best managers in the world, but only 7% of NGPF’s funds are managed by active managers. Going forward, NGPF expects to increase its use of active management in an effort to improve the alpha of the fund. Wealthy families – at least those with a sophisticated in-house investment staff or those employing expert outside advisors – are also in a position to exploit the benefits of active management, especially in less efficient sectors of the market.

**Risk premia.** As noted above, the NGPF has assumed as part of its core beliefs that the equity risk premium (ERP) would represent the major source of return for the fund. But there are at least three difficulties with this idea. The first is that no one knows precisely what the size of the ERP is, and therefore no one knows how much risk to take for any increment of return. A recent survey of the literature suggests that estimates of the size of “normal” ERP range from 0% to 7%.<sup>13</sup>

A second problem is that even if the ERP is positive and is sizeable, it clearly isn’t stable. From the early 1980s through the 1990s, the ERP was very large. But since then it has been small-to-non-existent, and it has been essentially zero over the past thirty years. (Bonds have beaten stocks over that period.)

Finally, an exclusive focus on the ERP as the sole source of return ignores other forms of risk premia that might be available to the NGPF. For example, the fund should be able to exploit the value<sup>14</sup> and liquidity<sup>15</sup> premia, and possibly the size premium.

Unlike the focused-premium approach of the NGPF, family investors should be able to take advantage of multiple risk premia. In addition to those just mentioned, most families will be small

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enough to harvest additional premia available in niche markets that are too small to be exploited by a very large institutional investor.

**Transparency.** Transparency affects overall long-term returns indirectly but powerfully. When an investor is transparent with its constituencies about the risks and rewards it is seeking, those constituencies are likely to be more forgiving of and patient with periods of underperformance, since those periods were telegraphed ahead of time. The Norwegian Ministry of Finance states, in Report No. 17 to the Storting (that is, the Norwegian Parliament), “Transparency is a prerequisite for securing widespread confidence in the management of the Government Pension Fund. The risk which is assumed in management activities must be presented properly.”<sup>16</sup>

Family constituencies obviously differ from the constituencies of the NGPF, but they exist and need to be recognized and addressed. Imagine, for example, a situation in which one unit of a family is managing the overall family portfolio. If that generation doesn’t keep the other family units in the loop about the pros and cons of the portfolio, the uninformed family groups are likely to bail on the portfolio at precisely the wrong time.

**Socially responsible investing.** As noted above, ESG factors are very important to the NGPF, presumably because they are important to the people of Norway. Evidence about the effectiveness or ineffectiveness of ESG factors in investment portfolios is contradictory, but if a substantial portion of a family wants ESG factors to be considered for use in the portfolio, while other family members want them excluded, there is clearly a problem that needs to be addressed. The worst way to resolve the dilemma is to ignore it.

**Goals-based investing.** Maybe the most important aspect of the NGPF is how rigorously it has been designed for the goals it was established to meet. The fund wasn’t designed to outperform the Yales of the world, nor was it designed to avoid market risk and simply preserve capital. As noted above, the purpose of the fund was to exercise stewardship over a non-renewable asset (oil revenues) and to avoid the Dutch disease. Its mandate is to maximize purchasing power (on an international basis) *subject to risk levels that are acceptable to the fund’s managers and, most important of all, to the people of Norway.*<sup>17</sup> The fund doesn’t much care what returns other sovereign wealth funds are achieving, since those funds presumably have different goals and risk tolerances. Since inception in 1998, the NGPF has returned just over 5% per annum with a Standard Deviation of 7.67%, has outperformed its benchmark and has beaten inflation by nearly 3% per year. The question of whether this is good or bad versus other funds isn’t important. NGPF’s performance has been



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excellent in pursuit of the goals it set out to meet. This is often a difficult lesson for families to learn, but it is a crucially important one.

## ❖ Summary

While there are certainly aspects of the Yale Model that are useful to private investors, the Norway Model seems to speak much more directly to families and, equally important, seems to be implementable by all but the smallest family investors.

The Norwegian government “aims for the [NGPF] to be the world’s best managed fund.”<sup>18</sup> As noted, it is already rated the best sovereign wealth fund according to the “scorecard” developed by Edwin Truman. The NGPF isn’t perfect, of course. The lack of hedge fund exposure has resulted in a level of volatility that turned out to be greater than the Norwegians really wanted to live with, and the lack of real estate exposure means the fund has no exposure to the largest asset class in the world. Finally, the avoidance of illiquid private equity means the fund has no exposure to “aspirational”<sup>19</sup> assets. NGPF is looking at these issues as this is written. But the good seems clearly to outweigh the bad: the Norway Model is relatively easily adaptable by family investors who wish to own long-term-oriented, broadly diversified, low cost, transparent, value-focused, contrarian investment portfolios.

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<sup>1</sup> This paper relies heavily on “The Norway Model,” a paper written by David Chambers, Elroy Dimson and Antti S. Ilmanen, October 2011, available at SSRN: <http://ssrn.com/abstract=1936806>, and the exceptionally useful English-language websites maintain by the Norges Bank (<http://www.nbim.no/About-us/Government-Pension-Fund-Global/>) and the Norwegian Ministry of Finance (<http://www.regjeringen.no/en/dep/fin.html?id=216>).

<sup>2</sup> Despite its name, the NGPF isn’t a traditional pension fund at all, as it has no pension liabilities and isn’t funded by corporate or public pension contributions. It is funded by oil profits and withdrawals from the fund are paid into the state treasury.

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<sup>3</sup> It's difficult to internalize just how tiny these Nordic countries are. Norway's total population is about double that of Pittsburgh, Greycourt's headquarters city, or just under five million souls. If a country like the US, with a population of 313 million, had a similarly sized sovereign wealth fund, it would be worth \$36 trillion!

<sup>4</sup> *Sovereign Wealth Funds: Threat or Salvation?* Washington, DC: Peterson Institute for International Economics, 2010.

<sup>5</sup> Technically, Mr. Slyngstad's title is CEO.

<sup>6</sup> "The Norway Model," op. cit., note 1, p. 1.

<sup>7</sup> Specifically, a 60% weighting in the Barclays Capital Global Aggregate Index and a 40% weighting in the Barclays Capital Global Inflation-Linked Index Europe.

<sup>8</sup> More than fifty large companies are excluded from the investment universe. Norway also stresses positive actions on a variety of ESG (environmental, social and governance) factors, including board responsibilities, children's rights, climate change, and water management. See "The Norway Model," op. cit., note 1.

<sup>9</sup> An important reason for establishing the NGPF, rather than simply spending the oil revenue as it came in, was to avoid the so-called "Dutch Disease." A very rapid increase in spending as a result of oil revenue in Norway would likely have caused inflation in the prices of goods and services across the economy, vastly reducing the competitiveness of Norway's former leading industries. Once the oil revenue dried up (production has already peaked), Norway would be left high and dry.

<sup>10</sup> See "The Norway Model," op. cit., note 1, p. 5, and the Ministry of Finance Website at <http://www.regjeringen.no/en/dep/fin/Documents-and-publications/Propositions-and-reports/Reports-to-the-Storting/2008-2009/report-no-20-2008-2009-to-the-storting/1.html?id=559123>.

<sup>11</sup> Indeed, the NGPF time horizon might well be shorter than that of a multi-generational family. As noted above, oil production in Norway has peaked, and distributions from the NGPF are expected to exceed contributions in roughly 2020. See "The Norway Model," op. cit., note 1.

<sup>12</sup> "The Norway Model," op. cit., note 1, p. 14.

<sup>13</sup> See Hammond, Brett P., Jr., and Leibowitz, Martin L., "Rethinking the Equity Risk Premium: An Overview and Some Ideas," The Research Foundation of the CFA Institute, 2011. Hammond and Leibowitz review the literature and come up with nineteen estimates of the ERP, ranging from 0% to 7%.

<sup>14</sup> The robust finding that "value" stocks tend to outperform "growth" stocks.

<sup>15</sup> For example, the NGPF could act as a liquidity provider to the markets by behaving in a contrarian fashion, offering liquidity to investors who are following the herd.

<sup>16</sup> Report No. 17 to the Storting, "The Management of the Government Pension Fund in 2011," Recommendations of the Ministry of Finance of 30 March 2012, available at <http://www.regjeringen.no/en/dep/fin.html?id=216>.

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<sup>17</sup> “The Norway Model,” op.cit., note 1, p. 3.

<sup>18</sup> “The Norway Model,” op. cit., note 1, p.12.

<sup>19</sup> See Ashvin B. Chhabra, “Beyond Markowitz: A Wealth Allocation Framework for Individual Investors,” *The Journal of Wealth Management* 7, no. 4 (Spring 2005): 8–34.