Quarterly Report

Government Pension Fund – Global Second quarter 2009

NBIM
Norges Bank Investment Management

Contents

- The return on the Government Pension Fund – Global in the second quarter was 12.7 per cent. The excess return came to 2.1 percentage points.

- The return was record-high for a single quarter in both absolute and relative terms. The return was also larger in percentage terms than previous quarters' negative return.

- The value of the fund increased to NOK 2 385 billion, up NOK 309 billion from the first quarter.

- Inflows into the fund totalled NOK 40 billion, a similar level to the first quarter but significantly lower than in previous years.

- The allocation to equities rose to 60.3 per cent at the end of the quarter after a two-year transition period of equity purchases.

Key figures

The market value of the Government Pension Fund – Global at the end of the second quarter was NOK 2 385 billion. This was an increase of NOK 309 billion from the end of the first quarter, due primarily to a positive return.

The upswing in equity prices in the second quarter was the main reason for a return of 12.7 per cent measured in an international currency basket (see Chart 2–2).

The return on the fund was 2.1 percentage points higher than that on the benchmark portfolio. The annualised excess return over the past three years has been -0.98 percentage point (see Chart 2–3).

Market volatility abated in the second quarter but was still higher than in the period through to mid-2007 when the financial turmoil began (see Chart 2–4).

NOK 40 billion was transferred to the fund during the second quarter. This was a similar level to the first quarter but still the lowest since the fourth quarter of 2004. A total of NOK 84 billion was transferred to the fund in the first half of the year. Inflows in 2008 as a whole totalled NOK 384 billion.

The second-quarter return came to NOK 270 billion, while a stronger krone reduced the value of the fund by NOK 1 billion. The market value of the fund increased to NOK 2 385 billion.

The implementation of the increase in the allocation to equities from 40 to 60 per cent was completed during the second quarter. Future inflows will be used to purchase the lowest performing asset class in the period in line with the fund's strategy.

Chart 2–1 Market value 1999-2009. Billions of NOK

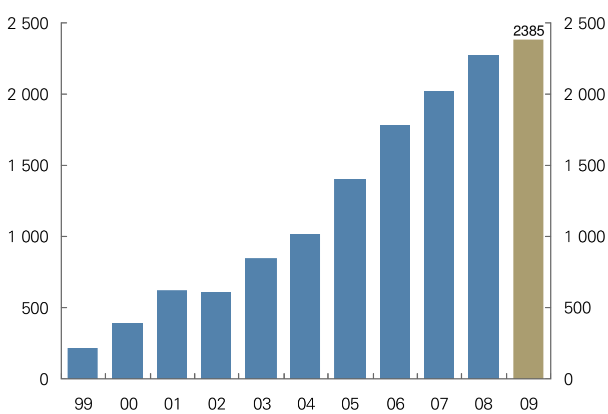


Chart 2–2 Quarterly return and three-year rolling annualised return 2001-2009. Per cent

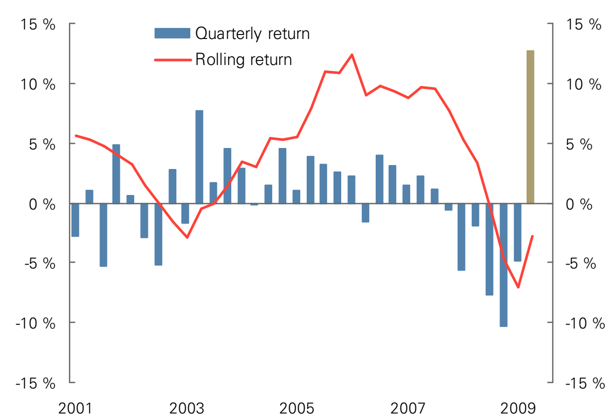


Chart 2–3 Quarterly excess return and three-year rolling annualised excess return 2001-2009. Percentage points

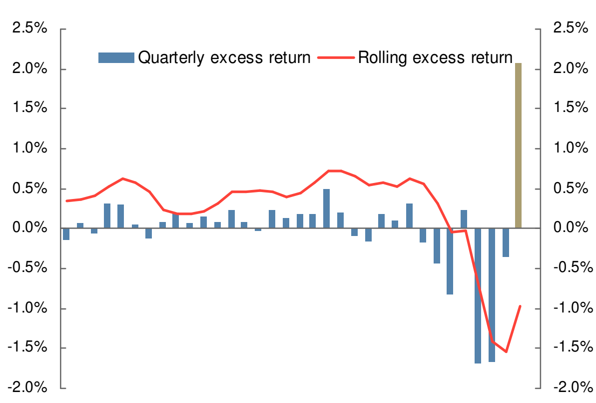
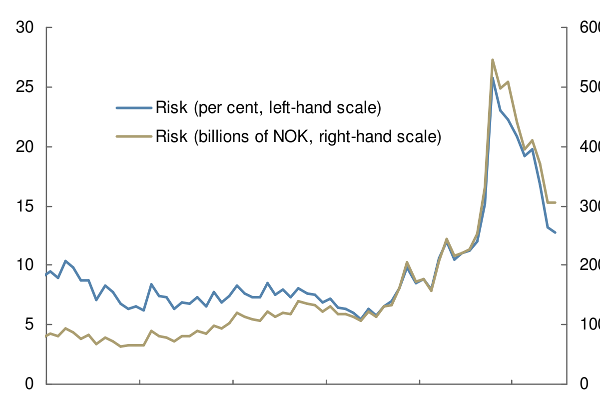


Chart 2–4 Absolute volatility 2004-2009. Per cent and billions of NOK



The markets

The second quarter saw a marked improvement in financial markets, and there were signs of renewed economic stability. Uncertainty about the financial sector subsided, equity prices rose sharply, and the credit spread between corporate and government bonds narrowed.

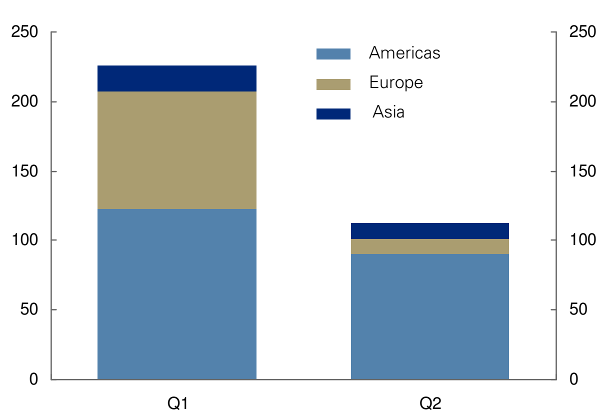
Greater confidence in financial stability was an important factor behind the market recovery in the second quarter. Confidence in major financial institutions improved, but only after extensive government action in many countries. In the US, the Federal Reserve published the stress test results for the 19 biggest banks' capital adequacy based on a scenario of falling economic growth. The Federal Reserve estimated that ten of these institutions would need to raise USD 75 billion in new capital as a buffer against this adverse outcome. During the second quarter, US financial institutions raised more than that amount in the market (see Chart 3–1). The share of new capital to financial institutions supplied by the government, fell from 75 per cent in the first quarter to 29 per cent in the second quarter.

The spread between interbank lending rates and government bond yields is an indicator of uncertainty about financial stability. During the second quarter, the spread fell back to the levels prevailing before the financial turmoil began in autumn 2007 (see Chart 3–2).

In mid-March, equity markets and, in particular, credit markets had priced in a particularly adverse outcome of the ongoing financial crisis and downturn in the global economy. During the second quarter, the uncertainty subsided, and liquidity returned to many markets. This is illustrated in Chart 3–3, which shows expected volatility in the US equity market, as measured by the VIX index, and the credit spread between corporate and government bonds. The risk in financial markets nevertheless remains higher than in recent years.

While the economic climate at the beginning of the year was dominated by dwindling output and investment and reduced employment, the second quarter brought some signs of renewed economic stability.

Chart 3–1 Capital raised by financial institutions in 2009. Billions of USD



Fixed income markets

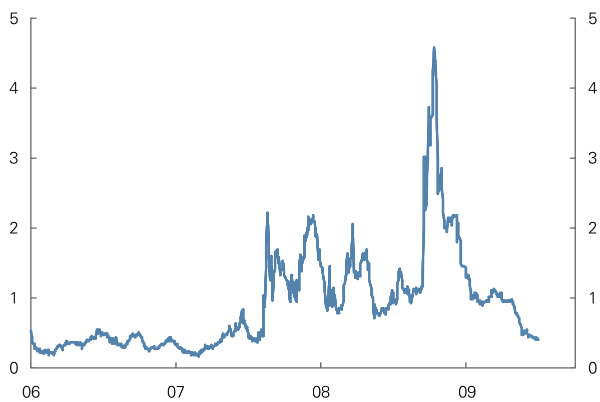
The extensive action taken by the authorities has given rise to other policy challenges. Government budget deficits are growing rapidly in many countries. One consequence of this is strong growth in issuance of government securities. The growth in US government bonds to finance the increased deficit is the main example of this (see Chart 3–4).

Ten-year government bond yields continued to climb during the second quarter. German and UK government bond yields increased by around 0.4 and 0.5 percentage point, respectively, while US yields rose sharply by around 0.9 percentage point (see Chart 3–5). Record-low central bank key rates, combined with higher bond yields, led to a pronounced steepening of yield curves in the second quarter.

Corporate bonds produced a considerably higher return than government bonds in the second quarter, and credit spreads narrowed significantly (see Chart 3–6), largely offsetting the decline in the value of corporate bonds in the second half of 2008.

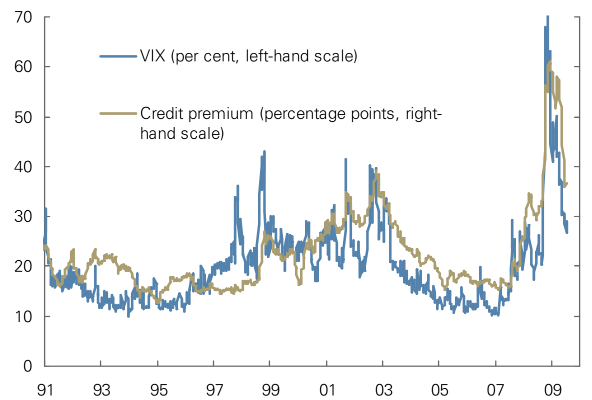
There was a particularly sharp decrease in the spread between bonds issued by financial institutions and government bonds. The cost of bond funding for financial institutions is still higher than for many of their customers, although the gap narrowed sharply during the quarter (see Chart 3–7).

Chart 3–2 Spread between interbank lending rates in the money market and US government bond yields. Percentage points



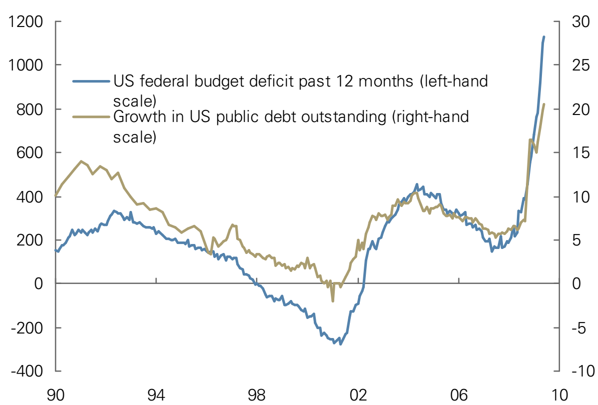
Source: EcoWin

Chart 3–3 Expected volatility in the US equity market and the credit spread between US corporate and government bonds. Per cent



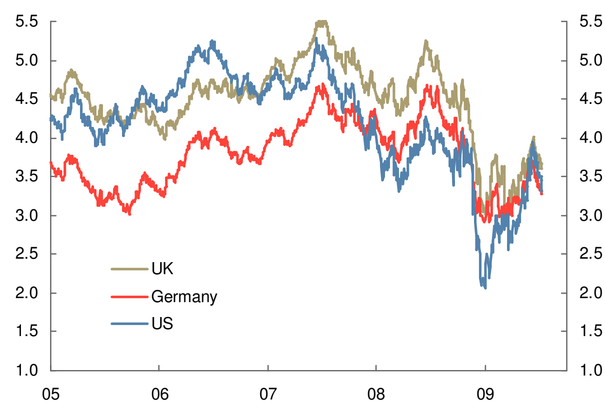
Source: CBOE, Moody's, BBB

Chart 3–4 US budget deficit in billions of USD and annual growth in US public debt in percentage points



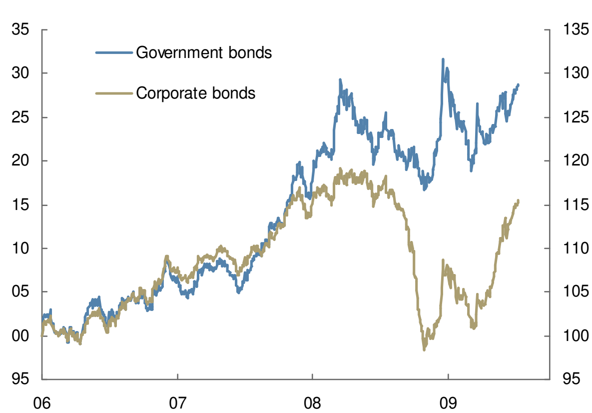
Source: US Department of the Treasury

Chart 3–5 Yields on government bonds with ten years to maturity. Per cent



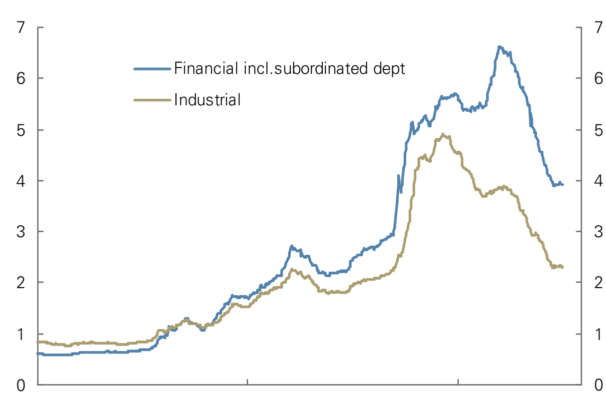
Source: EcoWin

Chart 3–6 Return on broad groups of bonds. Index (31.12.2005=100)



Source: Barclays Global Aggregate

Chart 3–7 Credit spread between different classes of corporate bond and government bonds. Percentage points



Source: Barclays Global Aggregate

Credit spreads narrowed despite record-high issuance of corporate bonds. According to Standard & Poor's, corporate bond issues amounted to USD 1 791 billion in the first half of 2009, compared with USD 2 360 billion in 2008 as a whole.

A broad spectrum of private bonds recovered gradually during the first half of the year. . Both corporate bonds and securitised debt performed positively in the second quarter. The picture for inflation-linked bonds was more mixed, with prices rising in the US but not in Japan.

Equity markets

The broad FTSE All-World Index gained 18 per cent in the second quarter in local currency. The sectors that performed worst in the second half of 2008 generated a particularly strong return.

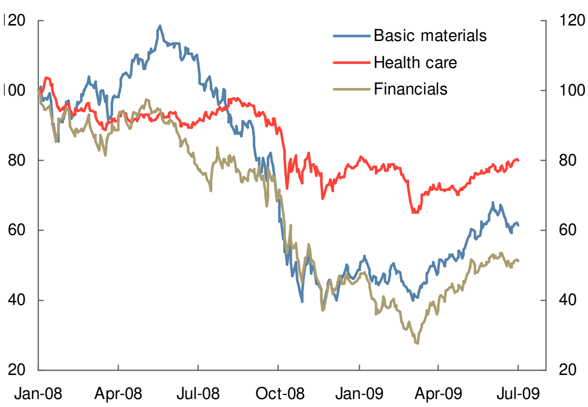
The upswing in financials followed with reduced uncertainty about financial stability, but was also buoyed by a steeper yield curve, which favours a boost in earnings from traditional banking activities. The upswing in financials must be seen in context of the considerable capital raisings by financial institutions in the first half of the year, primarily in the equity market. US financial institutions raised around USD 210 billion in new capital during the first half of the year.

The basic materials sector, which is often seen as an early indicator for shifts in economic cycles, produced a high return in the second quarter, driven by further strong demand from China and expectations of renewed economic stability (see Chart 3–8).

One important structural trend in equity markets in recent years has been the strong relative return in emerging markets. Following a downturn caused partly by investors' reduced risk capacity during the financial crisis, these markets have once again outperformed advanced economies so far this year (see Chart 3–9).

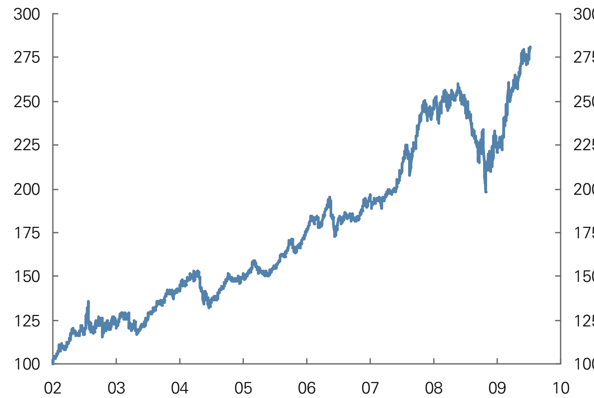
In the first half of this year, the Shanghai Stock Exchange gained no less than 64 per cent (see Chart 3–10). China's contribution to global economic growth in recent years has been greater than the size of its economy alone would imply. The Chinese authorities have implemented extensive fiscal and credit policy measures to prevent shrinking export growth from jeopardising economic growth. Strong growth in Chinese banks' lending (see Chart 3–11) is one of several indicators of increased economic activity ahead.

Chart 3–8 Return on investments in financials, basic materials and health care. Index (31.12.2007=100)



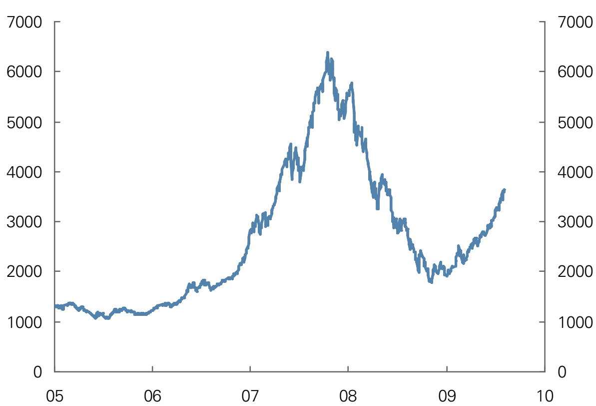
Source: FTSE World Index

Chart 3–9 Return on FTSE All-World Emerging Markets relative to FTSE All-World Developed Markets. Index (31.12.2001=100)



Source: FTSE

Chart 3–10 Chinese stock market. Shanghai Stock Exchange A shares. Index



Source: Factset

Chart 3–11 Real growth in Chinese GDP and growth in Chinese financial institutions' lending. Per cent

Source: People's Bank of China

The portfolio

The fund's allocation to equities was 60.3 per cent at the end of the second quarter, up from 52.6 per cent at the end of the first quarter. The decision was taken in summer 2007 to increase the strategic allocation to equities from 40 to 60 per cent, and this process was completed during the quarter.

During the two-year transition period, Norges Bank invested more than NOK 1 000 billion in global equity markets, and its ownership interests doubled (see separate feature article). At the end of the second quarter, the fund's total average holding stood at 1.0 per cent globally and 1.7 per cent in European companies. For other regions, the figure was 0.7 per cent.

The fund's global bond holdings have decreased as a result of the increase in the allocation to equities. At the end of the second quarter, the fund's average holding was 0.7 per cent in Europe, 0.4 per cent in the Americas and 0.2 per cent in Asia and Oceania. This was the fund's lowest percentage stake in bond markets since 2005.

In both the equity and fixed income portfolios, the fund has a strategic overweight of European investments relative to the size of the markets. This means that there will be a tendency for large European companies and bond issuers to dominate the list of the fund's largest investments.

External management amounted to just over NOK 375 billion at the end of the quarter, an increase of NOK 28 billion during the quarter. External equity management increased by NOK 54 billion, while external fixed income management decreased by NOK 26 billion. Altogether, external management accounted for around 16 per cent of the fund's assets at the end of the quarter, up from 13 per cent at the end of 2008.

Performance-based fees to external managers rose markedly from NOK 222 million in the first half of 2008 to NOK 771 million in the first half of 2009. A change in the method used to calculate provisions for accrued performance-based fees in the financial reporting explains almost all of the increase (see Note 2 to the financial reporting). In addition, many new mandates were added during the course of 2008, and a large proportion of external equity managers delivered favourable results in the first and second quarters this year.

Chart 4–1 Breakdown by asset class 2004-2009. Per cent

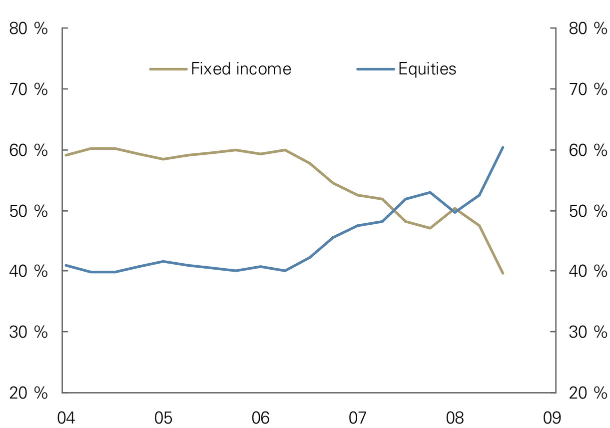
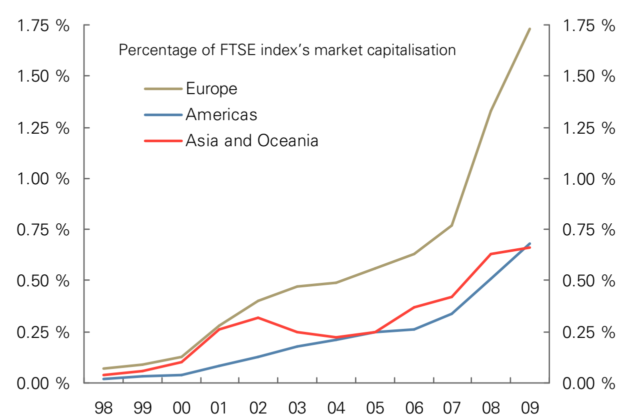
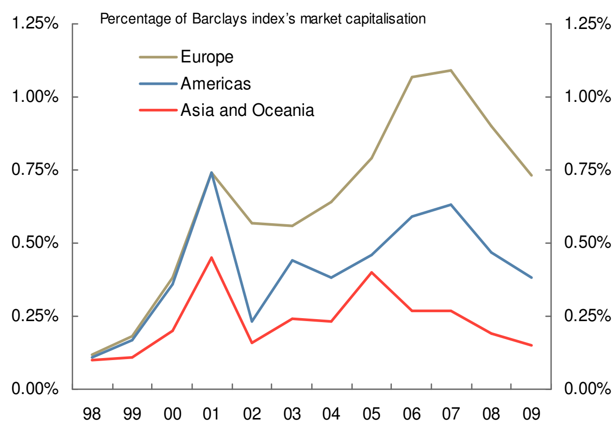


Chart 4–2 Ownership of equity markets 1998-2009. Per cent



Source: FTSE, NBIM

Chart 4–3 Ownership of fixed income markets 1998-2009. Per cent



Source: Barclays, NBIM

Chart 4–4 External management 1998-2009. Billions of NOK and per cent

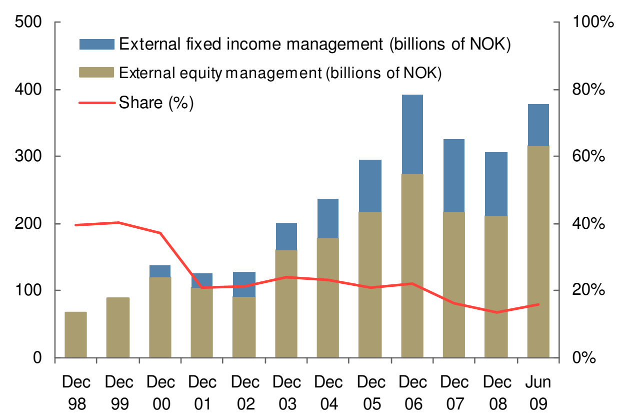


Table 4–1 Largest equity holdings on 30 June 2009

Company	Country	Holding in millions of NOK
Royal Dutch Shell PLC	UK	17 241
Nestle SA	Switzerland	17 021
HSBC Holdings PLC	UK	16 734
BP PLC	UK	16 352
Total SA	France	13 722
Exxon Mobil Corp	US	12 472
Vodafone Group PLC	UK	11 076
Telefonica SA	Spain	10 765
Roche Holding AG	Switzerland	10 583
Banco Santander SA	Spain	10 034

Table 4–2 Largest bond holdings on 30 June 2009

Issuer	Country	Holding in millions of NOK
UK Government	UK	80 779
United States of America	US	79 933
Federal Republic of Germany	Germany	70 139
Italian Republic	Italy	56 833
Japanese Government	Japan	42 730
Fannie Mae	US	42 036
French Republic	France	39 246
European Investment Bank	Supranational	35 005
Kreditanstalt für Wiederaufbau	Germany	29 246
Bank of Scotland PLC	UK	24 612

Market value, risk and return

The market value of the Government Pension Fund – Global at the end of the second quarter was NOK 2 385 billion. The overall return on the fund during the quarter was 12.7 per cent, while the excess return relative to the benchmark portfolio was 2.1 percentage points.

New capital of NOK 40 billion was transferred to the fund during the second quarter. This was a similar level to the first quarter but far lower than in previous quarters. A positive return increased the value of the fund by NOK 270 billion, while a stronger krone in relation to the currencies in which the fund is invested reduced its value by NOK 1 billion (see Chart 5–1). Changes in the krone exchange rate have no effect, however, on the fund's international purchasing power.

The return on the fund in the second quarter was 12.7 per cent measured in international currency. The return on the equity portfolio came to 19.5 per cent and the fixed income portfolio yielded a return of 5.1 per cent.

Since 1 January 1998, the fund has generated an annualised gross return of 3.4 per cent. Adjusted for inflation and management costs, the annual net real return over the same period was 1.5 per cent (see Table 5–1).

The return generated by NBIM on the actual portfolio is measured against that on the benchmark portfolio defined by the Ministry of Finance. The difference between these return figures is NBIM's contribution to the fund's performance. In the second quarter, the return on the fund was 2.1 percentage points higher than the return on the benchmark portfolio. Fixed income management produced an excess return of 3.7 percentage points, while equity management produced an excess return of 0.7 percentage point.

Fixed income markets showed some signs of normalisation in the second quarter, and the high liquidity premium in some markets was reduced. The excess return from fixed income management stemmed primarily from positions established before the financial turmoil erupted in 2007. These positions have been highly illiquid, associated with considerable pricing uncertainty . There was a particularly strong contribution from Tier 1 and Tier 2 bank bonds and from US mortgage-backed securities.

Prices in almost all segments of the bond market climbed in the second quarter, but the recovery was gradual and came at different times in different markets. This indicates that the upswing is attributable to a return to the normal functioning of market mechanisms and improved liquidity flows, rather than a general repricing of risk in fixed income markets.

Equity management also delivered a positive excess return in the second quarter from both internally and externally managed portfolios. The contribution from equity management was consistently positive during the first half of the year despite market volatility.

Transaction costs are incurred when new capital is phased into the fund and when the benchmark portfolio is rebalanced. NBIM has estimated the direct and indirect transaction costs related to phasing in new capital and rebalancing at NOK 433 million in the second quarter, or 0.02 per cent of the market value of the fund at the beginning of the quarter.

Chart 5-1 Changes in market value. Billions of NOK

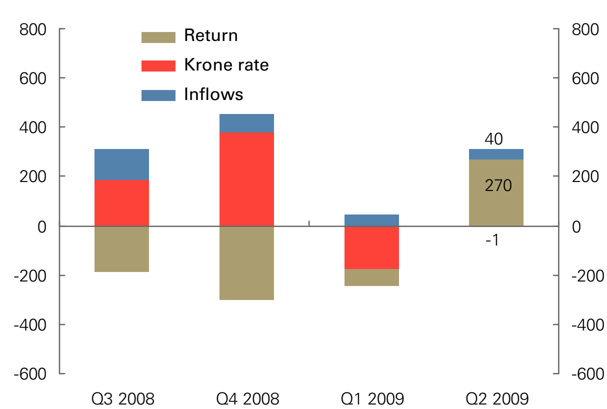


Table 5–1 Key figures on 30 June 2009. Quarterly data

	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009
Market value (billions of NOK)						
Fixed income portfolio	1 011	961	997	1 146	985	948
Equity portfolio	935	1 031	1 123	1 129	1 091	1438
Fund	1 946	1 991	2 120	2 275	2 076	2385
Inflows of new capital *)	88	91	128	77	44	40
Return	-116	-32	-186	-300	-66	270
Change due to movements in krone	-45	-13	186	379	-177	-1
Total change	-73	46	128	156	-199	309

*) The inflows shown in this table differ slightly from those in the financial reporting (see Note 3) due to differences in the treatment of management fees.

	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009
Return in international currency (per cent) **)						
Equity portfolio	-12.67	-1.60	-13.12	-20.58	-8.84	19.49
Fixed income portfolio	0.87	-1.72	-1.19	1.55	-0.88	5.07
Fund	-5.62	-1.87	-7.68	-10.30	-4.81	12.67
Benchmark portfolio	-4.79	-2.10	-5.97	-8.62	-4.48	10.60
Excess return	-0.83	0.24	-1.70	-1.68	-0.33	2.07
Return in NOK (per cent) **)						
Equity portfolio	-14.71	-1.90	-5.84	-8.41	-14.46	19.69
Fixed income portfolio	-1.49	-2.02	7.08	17.12	-6.99	5.25
Fund	-7.83	-2.17	0.06	3.45	-10.67	12.86
Benchmark portfolio	-7.02	-2.41	1.90	5.38	-10.36	10.78

**) The benchmark portfolio defined by the Ministry of Finance is adjusted for tax on equity dividend payments. The adjustment factors for tax were not correctly updated for the benchmark portfolio in the three previous quarters. This meant that the excess return reported for the last two quarters of 2008 and the first quarter of 2009 taken together was 0.0035 percentage point lower than the true figure. The historical data in the table have been restated accordingly.

	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Q2 2009
Management costs (per cent)						
Estimated transition costs	0.05	0.03	0.08	0.10	0.06	0.02
Annualised management costs	0.10	0.10	0.09	0.11	0.16	0.15
Changes in value since start-up (billions of NOK)						
Inflows of new capital	1 844	1 935	2 063	2 140	2 184	2 224
Return	387	355	169	-131	-197	73
Change due to movements in krone	-285	-298	-112	266	89	88
Market value of fund	1 946	1 991	2 120	2 275	2 076	2 385

Chart 5–2 Absolute volatility 2004-2009 measured in NOK. Per cent

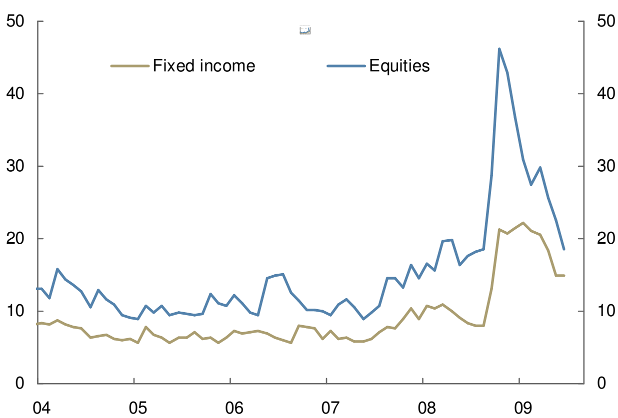


Chart 5–5 Expected tracking error 1999-2009. Basis points

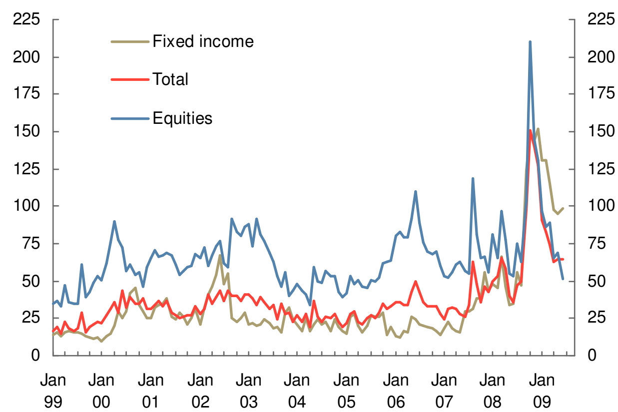


Chart 5–2 shows market fluctuations for the equity and fixed income portfolios. A model based on historical movements is used to calculate expected volatility. Although markets normalised somewhat during the first half of this year, expected volatility is still much higher than it was through to mid-2007 when the financial turmoil began. At the end of the second quarter this year, the model estimated the fund's expected absolute volatility at NOK 305 billion, or 12.8 percentage points (see Chart 2–4). This means that the value of the fund is expected to fluctuate within a band of +/- NOK 305 billion in two out of every three years, caused by changes in market returns.

Chart 5–3 shows movements in expected tracking error for the fund as a whole and for the fixed income and equity portfolios. Expected tracking error, or relative volatility, measures the fund's expected return variability relative to the benchmark portfolio, has fallen markedly since the most turbulent period in the second half of last year. This primarily reflects reduced market volatility, and only marginally a general reduction in the size of the fund's investments. Most positions in the fixed income portfolio that became highly illiquid at the beginning of 2008 are still held by the fund.

Table 5–2 Key figures on 30 June 2009. Annualised data

(Measured in an international currency basket)	Past year	Past 3 years	Past 5 years	Past 10 years	Since 01.01.1998
Portfolio return (per cent)	-11.17	-2.75	1.74	2.55	3.44
Benchmark return (per cent)	-9.23	-1.78	2.09	2.47	3.34
Excess return (percentage points)	-1.95	-0.98	-0.35	0.08	0.10
Standard deviation (per cent)	17.90	11.33	9.15	7.60	7.44
Tracking error (percentage points)	2.35	1.46	1.17	0.87	0.82
Information ratio	-0.82	-0.66	-0.30	0.09	0.12
Gross annual return (per cent)	-11.17	-2.75	1.74	2.55	3.44
Annual price inflation (per cent)	-0.3	1.9	2.1	2.0	1.8
Annual management costs (per cent)	0.13	0.11	0.11	0.10	0.10
Annual net real return (per cent)	-11.01	-4.70	-0.47	0.48	1.49

Table 5–3 Fixed income portfolio on 30 June 2009 by credit rating

Percentage of fixed income portfolio	Aaa	Aa	A	Baa	Ba	Lower	No rating
Government and government-related bonds	32.2	8.3	2.1	0.7	0.1	0.0	0.1
Inflation-linked bonds	4.0	3.1	0.1	-	-	-	-
Corporate bonds	0.5	4.3	8.5	6.3	0.4	0.2	0.1
Securitised debt	25.3	2.0	0.2	0.2	0.2	0.8	0.0
Total bonds and other fixed income instruments	**62.0**	**17.7**	**11.0**	**7.2**	**0.8**	**1.1**	**0.3**

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

Table 5–4 Key figures for risk and exposure

Risk	Limits	Actual		
		31.12.2008	31.3.2009	30.6.2009
Market risk	Tracking error max. 1.5 percentage points	1.27	0.74	0.65
Asset mix	Fixed income portfolio 30-70%	50.4	47.4	39.7
	Equity portfolio 30-70%	49.6	52.6	60.3
Currency distribution, fixed income	Europe 50-70%	59.9	60.0	60.1
	Americas 25-45%	34.3	35.1	34.8
	Asia and Oceania 0-15%	5.8	4.9	5.0
Market distribution, equities	Europe 40-60%	48.6	49.4	49.8
	Americas and Africa 25-45%	35.2	35.2	35.1
	Asia and Oceania 5-25%	16.2	15.3	15.1
Ownership	Max. 10% of a company	8.71	9.47	9.50

Active ownership

The strategy for active ownership was revised during the second quarter, and water management has been added as a new focus area. The quarter also brought an important breakthrough in industry cooperation against child labour

Norges Bank's Executive Board adopted a revised strategy for active ownership in June. There are now six focus areas:

- Equal treatment of shareholders
- Shareholder influence and board accountability
- Well functioning financial markets
- Climate change
- Water management
- Children's rights

The first three focus areas address important principles of good corporate governance. The principle of equal treatment of shareholders is particularly important for NBIM as a minority shareholder. This translates into the opportunity to exercise influence and equitable treatment in terms of companies' financial transactions. Experience over the past year has demonstrated that markets do not always function satisfactorily, resulting in costs to investors and uncertainty about the pricing of securities. As a large, long-term investor, this is an area where we have an opportunity to influence both policy makers and the market in general.

A document setting out NBIM's expectations for companies' management of climate change will be published during the third quarter. Water is a new strategic focus area in the environmental field. Depending on industrial sector and water consumption, water risk management will be important for companies' long-term financial performance (see separate article).

Industry initiative to against child labour

On 12 June – World Day against Child Labour – four companies in NBIM's portfolio (Monsanto, Bayer, Syngenta and DuPont) announced that they would be working together to combat child labour in seed production. The partnership was initiated by NBIM as part of its active ownership work. The industry standard "CropLife Position on Child Labor in the Seed Supply Chain" was published by CropLife International, a global trade association for the plant science industry. The standard describes the joint effort that these companies will make to eliminate the use of child labour by suppliers and other partners in the seed sector.

NBIM believes that this collaborative model is an effective means of achieving results and will also seeks to apply the model in other sectors. NBIM will have the opportunity to consult with UNICEF's Private Fundraising and Partnerships Division (PFP) in further sector activities.

Well functioning financial markets

In 2009, NBIM has taken an initiative for the European covered bond market. Covered bonds are issued by financial institutions. In addition to the collateral, the issuer is also responsible for this debt through its own capital. Covered bonds have a long tradition in the European residential mortgage market and are associated with low credit risk. Liquidity in this segment has been severely affected by the financial crisis. As a major investor, NBIM and other large investors, with support from several central banks in Europe, have taken the initiative to establish an investor council (Covered Bond Investor Council). One of CBIC's main objectives is to improve liquidity in the covered bond market through various measures such, as enhanced transparency and some standardisation.

Voting

Most companies hold their annual general meeting during the second quarter. The financial crisis has heralded a sharper focus on the role and responsibilities of the board of directors, and shareholder proposals in this area have attracted increased support in the US. NBIM has generally supported proposals for greater board independence. NBIM has also systematically voted against the chairman of the board in companies with CEO-chairman duality, and has voted in favour of shareholder proposals to separate these roles.

In Japan, with few exceptions, senior executives also make up a company's board of directors. There is mounting pressure from international and Japanese investors for greater board independence. NBIM supports this and has voted in favour of the election of external directors at many companies.

With regard to environmental issues, NBIM has supported corporate strategies to reduce CO2 emissions and promote energy efficiency, in addition to measures to improve reporting and enhance transparency relating to corporate impact on climate change.

Feature: Water management – a new focus area

A global shortage of water represents a financial risk to the fund. Norges Bank's Executive Board has therefore decided to extend the environmental focus area for active ownership to include water management.

NBIM is broadly invested in several sectors with high water-consuming and has identified seven sectors as particularly exposed to water related risk: food, agriculture, pulp and paper, pharmaceuticals, mining, manufacturing and power, and water supply. These sectors have water as an important input or output factor, and are therefore particularly relevant when it comes to water management. In terms of NBIM's portfolio, water is an important input and output factor for more than 1 100 companies. The fund's holdings in these companies have a combined market value of NOK 265 billion.

Water supply and demand are unevenly distributed between world regions. Economic growth, industrialisation and population growth are driving rising demand for water, while factors such as climate change, pollution and regulation are increasingly affecting the supply of water. Agriculture is the world's largest fresh water consumer. Manufacturing currently consumes around 22 per cent of available fresh water worldwide, according to UNESCO, and this figure is expected to increase, especially in the developing world.

Even today, companies with poor water management face significant operational risk associated with supply interruptions and higher treatment costs. There is also risk associated with regulation and with opposition from local communities and activist groups. In addition, poor water management can lead to liability for damages or the loss of licences and permits. In the future, securing access to the quantity and quality of water needed for production and complying with requirements for wastewater emissions may become important for more and more companies and their results.

Many companies in risk sectors and regions do not have a proper water policy with risk assessments and performance reporting. For investors like NBIM, which is broadly invested in sectors with high water related risk, companies' water risk management may be critical. Shortcomings in companies' water management reporting, makes it difficult to assess the degree of risk exposure resulting from their own operations or their supply chains.

NBIM believes that investors should have access to sufficient information to enable them to evaluate the potential impact of water shortages on a company's operations or earnings, and the likelihood of occurrence.

During the third quarter, NBIM will publish a document formulating the expectations we have of companies' management of water as a resource and the associated risk. These expectations are aimed at companies with operations or supply chains in sectors and regions that are particularly exposed to risk associated with water, and are based on international standards and best practice for water management.

Feature: From 40 to 60 per cent equities

In summer 2007, the decision was taken to increase the fund's allocation to equities from 40 to 60 per cent. In the second quarter this year, this allocation was achieved following equity purchases totalling more than NOK 1 000 billion. During the same period, the fund's ownership interests in global equity markets doubled.

In June 2007, the Norwegian parliament approved an increase in the strategic allocation to equities from 40 to 60 per cent. The share of assets allocated to equities is one of the most important choices influencing the fund's future return. The decision to increase the equities share was based on expected long-term returns, relative to the risks associated with the fluctuations in value. On the advice of Norges Bank, among others, the Government decided in summer 2007 to increase the allocation to equities in the fund to 60 per cent.

NOK 1 000 billion of equities

Since the transition began in the second quarter of 2007, the fund has purchased equities for a total of NOK 1 010 billion. Of this figure, NOK 641 billion has come from inflows of new capital, while NOK 369 billion has been transferred from the bond portfolio to the equity portfolio over the past two years. Without the transfer from bonds to equities, the allocation to equities would have been 44 per cent at the end of the second quarter this year (see Chart 6–1). Almost half of the transfer of capital from the bond portfolio took place during the first few months of 2009 when equity markets fell and inflows into the fund were low.

Implementation

In theory, the increase in the allocation to equities should have been implemented immediately, as the new asset allocation is expected to result in a superior risk-adjusted return. However, a change of this kind involves a number of trade-offs. Implementation over a short time span with large equity volumes relative to liquidity in the market would normally push up prices in the short term. At the same time, the fund's transactions would become more transparent and predictable. This could give other market participants an informational advantage, for example when pricing large individual transactions. A concentrated transition process could also lead to the fund buying securities at historically high prices or selling at historically low prices. A stable transition process over an extended period, where the capital is distributed relatively evenly, reduces the risk of an unfavourable market impact and the significance of market timing.

Re-allocating 20 per cent of the fund's assets to equities also involved such a large capital requirement that the transition process had to be carried out over a lengthy period. An immediate increase in the allocation to equities at the end of the second quarter of 2007 would have required equity

Chart 6–1 Movements in allocation to equities since Q2 2007

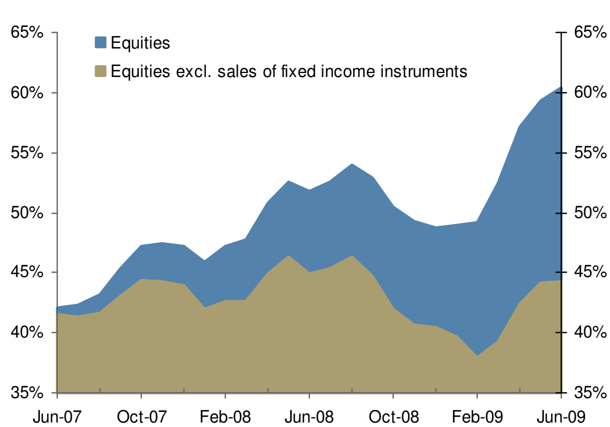
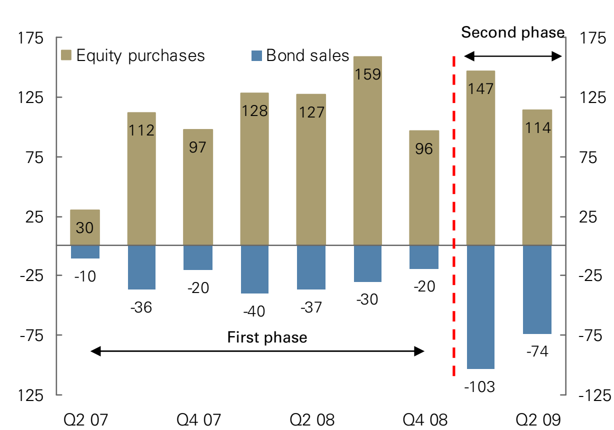


Chart 6–2 Purchases of equities and sales of bonds since Q2 2007. Billions of NOK



purchases of NOK 860 billion, assuming no changes in the value of the bond portfolio.

Due to the downturn in equity markets from the third quarter of 2008, the transition fell into two phases (see Chart 6–2). From the second quarter of 2007 until the fourth quarter of 2008, the fund used all inflows of new capital to increase the allocation to equities. Income from redeemed bonds and coupons was also re-invested in equities rather than bonds.

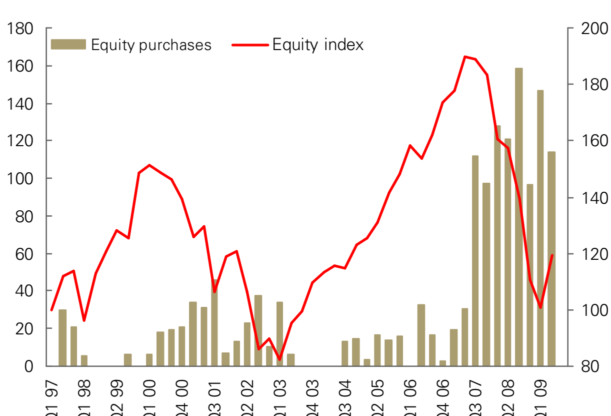
By the end of 2008, the allocation to equities was still only 49 per cent. In addition, inflows into the fund fell back in the first two quarters of 2009 due to lower oil prices. Inflows in these two quarters were NOK 44 and 40 billion, respectively, compared with NOK 128 and 77 billion in the last two quarters of 2008.

It was therefore decided to make greater use of capital from the bond portfolio in order to achieve the desired exposure to equities. Around NOK 177 billion was transferred from the bond portfolio to the equity portfolio during the first half of 2009. This involved substantial sales of fixed income securities at what were, historically, relatively high price levels.

The fund has purchased equities continuously over the past two years, both when the market was rising through to the end of 2007 and during the subsequent downturn (see Chart 6–3). The average purchase price for equities over the period as a whole was 22 per cent lower than at the beginning of the transition period. Similarly, the release of capital from the bond portfolio was performed at prices averaging 11 per cent higher than at the end of the second quarter of 2007.

The transition costs are estimated at NOK 8.7 billion, or 0.85 per cent of the capital invested. During the course of the transition period, the fund doubled its ownership interests in more than 7 000 companies in 46 countries from 0.4 to 1.0 per cent. These companies account for about 98 per cent of the world's investable equity market. Combined with relatively stable inflows of capital, falling equity markets have contributed to a substantial increase the fund's ownership stake.

Chart 6–3 Inflows into equity portfolio (billions of NOK, left-hand scale) and return on equities since Q2 1998 (local currency, 31.01.1998=100)



Financial reporting

Financial information for the Government Pension Fund – Global is presented below. The financial reporting for the fund forms part of, and comprises excerpts from, Norges Bank's financial statements.

Profit and loss account and balance sheet

Profit and loss account

(Figures in millions of NOK)	Note	Q2 2009	Q2 2008	Year to date 30.06.2009	Year to date 30.06.2008	Year to date 31.12.2008
Profit/loss on financial assets excl. exchange rate adjustments						
Net interest income, deposits in foreign banks		-63	122	77	222	494
Interest income, lending associated with reverse repurchase agreements		162	3 614	608	9 246	14 189
Income/expenses and gains/losses from:						
- equities and units		214 513	-14 667	152 116	-136 496	-595 304
- bonds and other fixed income instruments		49 333	-20 241	42 286	-12 516	-686
- financial derivatives		6 269	4 124	10 355	3 162	-31 210
Interest expenses, borrowing associated with repurchase agreements		-545	-4 878	-1 753	-11 290	-20 124
Other interest expenses		303	-224	307	-241	-613
Other expenses		-100	102	-148	87	44
Profit/loss before exchange rate adjustments		269 872	-32 049	203 848	-147 825	-633 209
Exchange rate adjustments		-1 333	-12 910	-178 461	-58 069	506 163
Profit/loss before management fee		268 539	-44 959	25 386	-205 894	-127 046
Accrued management fee	2	-762	-483	-1 621	-961	-2 165
Profit/loss transferred to krone account		267 777	-45 441	23 766	-206 855	-129 211

Balance sheet

(Figures in millions of NOK)	Note	30.06.2009	30.06.2008	31.12.2008
ASSETS				
FINANCIAL ASSETS				
Bank deposits		8 981	16 621	18 111
Lending associated with reverse repurchase agreements		136 824	599 029	274 132
Cash collateral paid		9	0	114
Equities and units	5,6	1 424 204	1 018 657	1 126 760
Bonds and other fixed income instruments	5,6	1 328 817	1 187 326	1 612 236
Other assets		8 671	15 077	17 164
TOTAL FINANCIAL ASSETS		2 907 506	2 836 710	3 048 517
LIABILITIES AND CAPITAL				
FINANCIAL LIABILITIES				
Short-term borrowing		2 059	220	133
Borrowing associated with repurchase agreements		309 971	538 855	514 395
Cash collateral received	4	142 138	252 479	188 608
Financial derivatives		15 700	1 633	36 320
Unsettled trades		31 619	42 921	30 144
Other liabilities		20 625	9 043	3 463
Management fee due		1 621	961	2 165
TOTAL FINANCIAL LIABILITIES		523 732	846 113	775 228
Capital	3	2 383 773	1 990 598	2 273 289
TOTAL LIABILITIES AND CAPITAL		2 907 506	2 836 710	3 048 517

Note 1. Accounting policies

The interim accounts for the second quarter have been prepared in accordance with the accounting policies for Norges Bank approved by the Supervisory Council on 13 December 2007. A presentation of the accounting policies applied in the preparation of the accounts can be found in the Annual Report for 2008.

The interim accounts do not include all of the information required in a full set of annual financial statements and should be read in conjunction with the Annual Report for 2008.

The preparation of the financial reporting for Norges Bank involves the use of estimates and judgements which can affect assets, liabilities, income and expenses. The accounting policies presented in the Annual Report for 2008 contain further information on significant estimates and assumptions.

Note 2 Management costs

	First half of 2009		First half of 2008	
	Thousands of NOK	Per cent	Thousands of NOK	Per cent
Internal costs	310 914		313 811	
Custody and settlement costs	139 331		136 254	
Minimum fees to external managers	227 261		188 274	
Performance-based fees to external managers	771 313		222 001	
Other costs	171 754		101 137	
Total management costs	1 620 572	0.15	961 477	0.10
Total management costs excluding performance-based fees	849 259	0.08	739 476	0.07

The method used to calculate the provision for accrued performance-based fees to external managers was changed in the first quarter of 2009, such that management fees are now recognised in the same period as the management results on which they are based. The result of this change is an increase in performance-based fees of NOK 518 million in the first half of 2009 relative to the previous method. This change affects only the timing of recognition and not the size of the fees paid

Note 3. Capital

(Figures in millions of NOK)	Note	30.06.2009	30.06.2008	31.12.2008
Deposits in krone account at beginning of year		2 273 289	2 016 955	2 016 955
Inflows during period		86 718	180 498	385 545
Profit/loss transferred to krone account		25 386	-205 894	-127 046
Capital before deduction of management fee		2 385 393	1 991 559	2 275 454
Management fee to Norges Bank		-1 621	-961	-2 165
Capital – deposits in krone account at end of period		2 383 773	1 990 598	2 273 289

Note 4. Securities lending

Loans of securities through external lending programmes totalled NOK 299.6 billion on 30 June 2009, as against NOK 515.3 billion a year earlier. These loans are secured through the receipt of collateral or, in the case of one lending agent, through a guarantee agreement. As at 30 June 2009, total collateral of NOK 316.4 billion had been received for these loans. Of this collateral, NOK 142.1 billion was received in the form of cash and the remainder in the form of securities. With effect from the 2008 financial year, cash collateral has been recognised in the balance sheet. Cash collateral received is re-invested in reverse repurchase agreements and bonds. The carrying amount of these re-investments on 30 June 2009 was NOK 136.0 billion.

Provisions for unrealised losses on re-invested cash collateral totalled NOK 6.1 billion on 30 June 2009. These losses are calculated on the basis of the market value of the re-investments. Of these losses, NOK 5.5 billion relates to unrealised losses based on valuations using ordinary price sources (breaking down into NOK 3.8 billion on securitised debt, NOK 0.6 billion on corporate bonds and NOK 1.1 billion on structured investment vehicles), while NOK 0.6 billion is a liquidity deduction resulting from the price adjustment method (see Note 6). An unrealised gain on these re-investments of NOK 2.6 billion has been recognised for the first six months of the year as a reversal of previous unrealised losses on these investments under "Net income/expenses and gains/losses from bonds and other fixed income instruments". The part of the re-investment programme that consists of investments in bonds was frozen 18 months ago, and these investments are being reduced as the bonds mature.

Note 5 Equities and units / bonds and other fixed income instruments

	Cost	Market value of securities	Accrued dividends/ interest	Carrying amount
Listed equities and units	1 598 283	1 420 632	3037	1 423 669
Units in unlisted fixed income and equity funds	703	535		535
Total equities and units	**1 598 986**	**1 421 167**	**3037**	**1 424 204**
Government and government-related bonds	535 497	570 604	9 536	580 140
Inflation-linked bonds	85 440	95 184	654	95 838
Corporate bonds	294 830	266 478	5 043	271 521
Securitised debt	381 458	376 846	4 472	381 318
Short-term certificates				
Total bonds and other fixed income instruments	**1 297 225**	**1 309 112**	**19 705**	**1 328 817**

Note 6. Fair value measurement

Establishing fair value

Pricing risk is considered to be limited for the majority of instruments in which the fund is invested. Equity investments are considered relatively easy to value, as there are official market prices based on an active transaction market for almost all positions in the portfolio. When it comes to holdings of bonds, the price uncertainty picture is more complex. The pricing of government bonds and liquid government-guaranteed bonds is based on observable market prices in an active market with quotes and frequent transactions. Corporate bonds, covered bonds, securitised debt guaranteed by US federal credit institutions and some government-guaranteed and government-related bonds, however, are priced using models with observable data points. The majority of these are nevertheless considered to be associated with relatively limited pricing risk, as the data points in the models are, to a relatively large extent, observable.

Exposure considered particularly uncertain in terms of correct pricing totalled NOK 63 billion at the end of the second quarter. This exposure consisted almost exclusively of securitised debt not guaranteed by US federal credit institutions. This was a reduction of NOK 1 billion from NOK 64 billion at the end of the first quarter.

The table below breaks down the fund's investments into categories of price uncertainty.
(Figures in millions of NOK)

Categorisation of investments by price uncertainty	Observable market prices in active markets	Model pricing with observable data points	Model pricing with greater uncertainty about fair value	Total
Equities and units	1 411 169	12 186	849	1 424 204
Bonds	568 546	676 979	62 292	1 328 817
Total	**2 000 715**	**689 165**	**63 141**	**2 753 021**

Following a number of analyses and discussions with various players in the market (price providers, brokers and external managers), valuation methods have been developed to take account of this additional uncertainty. These methods mean that the value of some types of instrument has been revised downwards by means of a liquidity deduction from the value reported from the ordinary price sources. The size of this adjustment depends on the estimated uncertainty related to the price from the price source. The liquidity adjustment for accounting purposes fell sharply from NOK 3 567 million at the end of the first quarter to NOK 1 922 million at the end of the second, due primarily to a significant improvement in market conditions and observed price quality for securitised paper. Of this figure, NOK 576 million relates to cash collateral re-invested in bonds (see Note 4).

Norges Bank is the central bank of Norway. Its primary responsibilities are price stability through monetary policy, financial stability and investment management. Norges Bank Investment Management (NBIM) is responsible for investment management activities. NBIM manages the Government Pension Fund – Global on behalf of the Ministry of Finance.

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