Quarterly Report

Government Pension Fund – Global Second quarter 2008

NBIM
Norges Bank Investment Management

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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- Weaker growth and accelerating inflation – troubled waters for financial investors
- Liquidity and credit crisis not yet over
- Allocation to equities above 50 per cent for first time
- Average ownership interest in European companies exceeds 1 per cent
- NBIM's management generates excess return of 0.24 percentage point

Key figures

The market value of the Government Pension Fund – Global at the end of the second quarter of 2008 was NOK 1 992 billion (see Chart 2-1), an increase of NOK 46 billion during the quarter.

Falling prices in equity and fixed income markets during the quarter led to a return of -1.9 per cent measured in an international currency basket (see Chart 2–2). NBIM's investment management performance is measured relative to a benchmark portfolio defined by the Ministry of Finance. One important management goal is to generate a higher return over time on the actual portfolio than on the benchmark portfolio. NBIM generated an excess return of 0.24 percentage point in the second quarter of 2008, while the annualised excess return over the past three years has been -0.02 percentage point (see Chart 2–3).

The Ministry of Finance has set a limit on the extent to which the composition of the fund's portfolio may deviate from the benchmark portfolio. This has been accomplished by setting a limit for the expected deviation between the returns on the actual portfolio and the benchmark portfolio. This limit has been set at 1.5 percentage point expected tracking error. The fund's expected tracking error is well below this limit (see Chart 2–4).

Chart 2-1 Market value 1999-2008. In billions of NOK

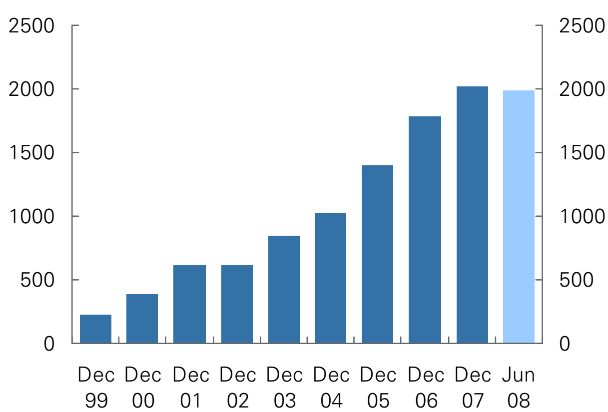


Chart 2-2 Quarterly return and three-year rolling return 2000-2008. Per cent

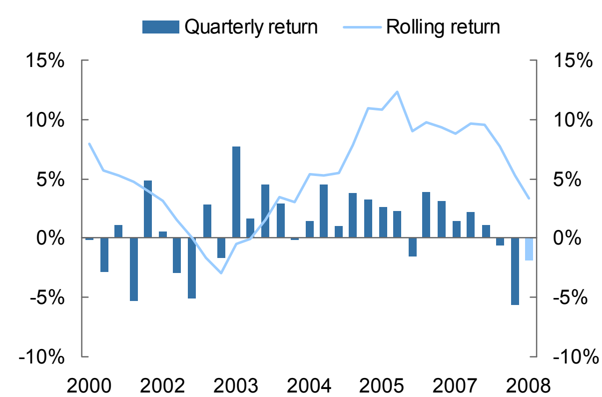


Chart 2-3 Quarterly excess return and three-year rolling excess return 2000-2008. Percentage points

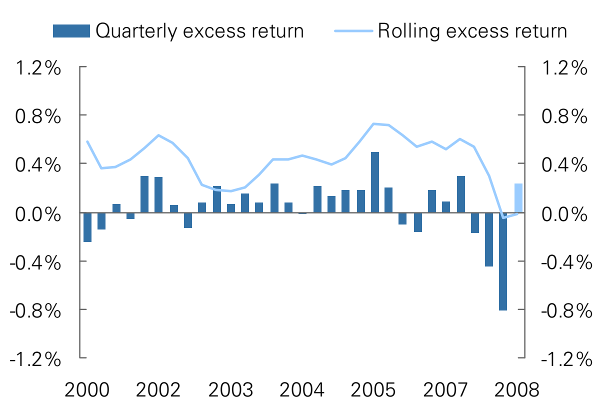
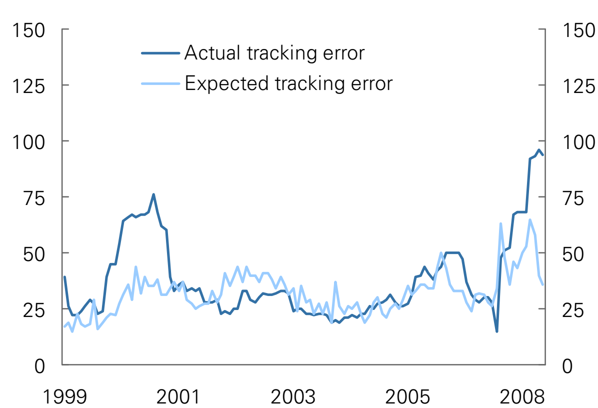


Chart 2-4 Expected and actual tracking error 1999-2008. Basis points



The markets

The second quarter featured considerable volatility in both equity markets and parts of the fixed income market. Equity prices climbed during the first part of the quarter, but the trend reversed in May, and global equity indices fell over the quarter as a whole. The crisis in the financial system continued, with a number of financial institutions reporting further heavy losses. A combination of lower growth and accelerating inflation led to lower corporate earnings expectations. The rise in yields during the period can be attributed to greater uncertainty about inflation.

The financial crisis that began in summer 2007 with a drop in the prices of securities backed by US sub-prime mortgages continued into the second quarter of 2008. Interbank borrowing rates remained well above the risk-free rate (see Chart 3-1). This indicates that the situation has not normalised, and that banks were demanding a substantial premium for assuming counterparty risk. The high and persistent interest rate spread may be a sign that market participants anticipate further deterioration in credit conditions.

In the US, banks reported increased losses on all parts of their lending, including areas not directly linked to mortgages. Two small US banks went into receivership in the second quarter, and the price of insurance against defaults on securities issued by US and European banks rose sharply (see Chart 3-2). The financial services sector has raised new capital of more than USD 300 billion since the crisis began, but has had to write off losses of almost USD 500 billion, and so the sector's capital position has deteriorated overall. Banks may tighten their lending practices, and there is a risk of this in itself undermining economic activity and impairing borrowers' ability to service their loans.

The uncertainty about the economic outlook is also related to house prices. The increase in bank lending in recent years has coincided with a lengthy upswing in house prices in both the US and a number of European countries (see Chart 3-3). The combination of lower house prices and higher unemployment served to undermine consumers' expectations. This has previously coincided with reduced demand for consumer goods (see Chart 3-4), so reducing the earnings potential of companies in the sector.

Prices for several key commodities rose during the quarter. Crude oil traded at up to USD 140 per barrel (see Chart 3-5). Prices for key agricultural products have also climbed sharply in the past year (see Chart 3-6). This has had a particular impact on many emerging economies, where food and energy account for a large proportion of aggregate demand, resulting in rapidly accelerating inflation. It also had a more pronounced effect on observed inflation in the industrialised nations in the second quarter (see Chart 3-7). The combination of accelerating inflation and lower growth is a particular challenge for financial investors, and will generally lead to lower valuations of both equity and fixed income investments.

The US is in a phase of low growth, and there are signs that growth is also slowing in Europe. Growth in emerging markets held up well in the second quarter and was presumably a major contributor to the tight commodities markets. Whether this growth can be sustained in a situation of accelerating inflation and weaker growth impulses from the industrialised nations is a key question in the market.

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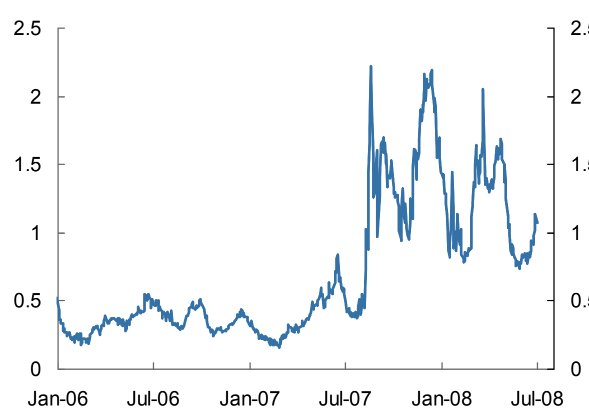
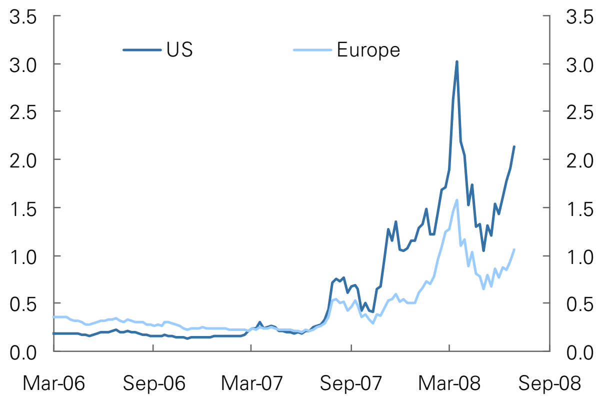
Chart 3-1 Spread between bank borrowing rates in the money market and US Treasury bill rates.[1] Per cent



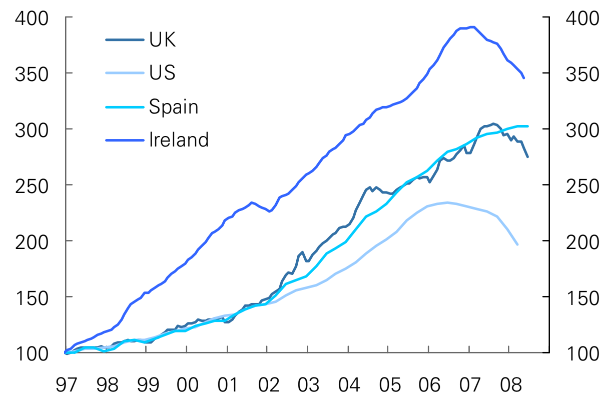
[1] Three-month rates
Source: Ecowin

Chart 3-2 Price of insurance against defaults on bonds issued by European and US financial institutions



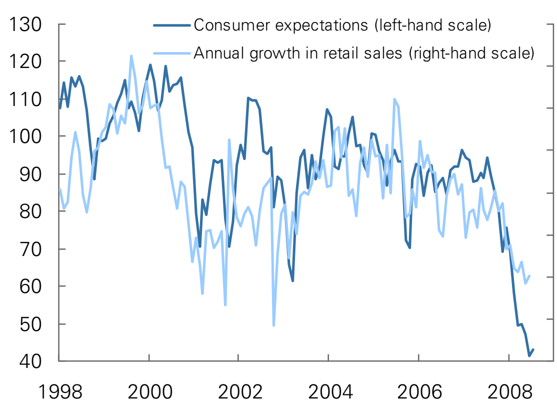
Source: Markit, NBIM

Chart 3-3 House price movements in selected countries. Index (01.01.97=100)



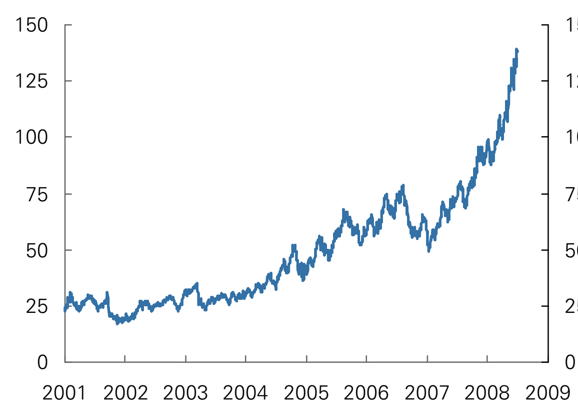
Source: National authorities, Halifax, Case-Schiller

Chart 3-4 Consumer expectations and retail sales in the US



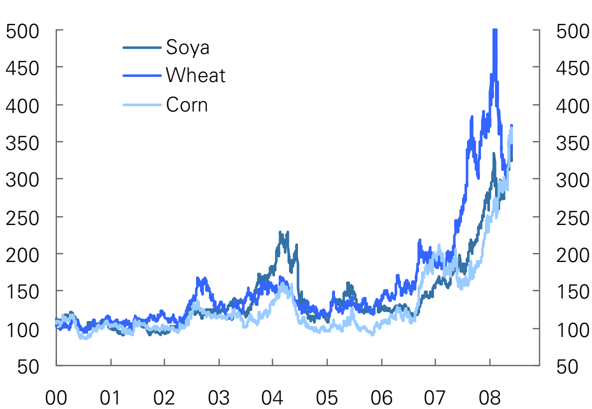
Source: Conference Board

Chart 3-5 Crude oil spot price (Brent). USD per barrel



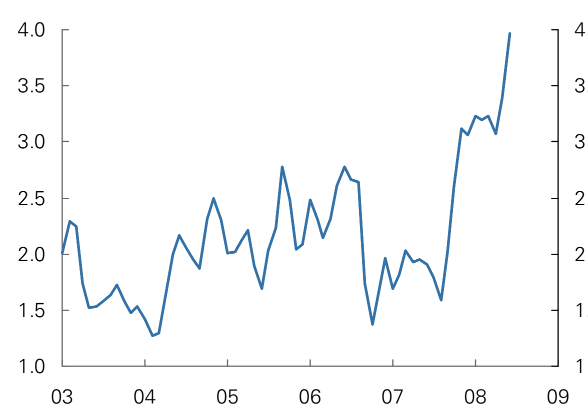
Source: Ecowin

Chart 3-6 Prices for key agricultural products. Index



Source: CBOT

Chart 3-7 Consumer price inflation. Annual rates. Per cent



Source: Ecowin. A weighted average of national inflation rates in industrialised countries.

Equity market

The return on the broad FTSE Global All Cap index was -1.4 per cent measured in the fund's currency basket. Over the past year, emerging equity markets have produced a much higher return than investments in the industrialised countries. In the second quarter, however, there were only moderate regional variations in returns. Asia Pacific was the strongest region with a return around 5 percentage points higher than in Europe, which was the weakest geographical region (see Chart 3-8).

Economic developments nevertheless resulted in major variations in returns between different industrial sectors (see Table 2.1). Investments in the Oil & Gas sector generated a return of 19.1 per cent measured in the fund's currency basket, while the equivalent return in the Financials sector was -11.4 per cent. A significant divide in the performance of these two sectors has emerged over the past year (see Chart 3-9). Returns were also weak in the Consumer Goods and Consumer Services sectors.

A simple measure of the valuation of the equity market can be obtained by comparing current pricing of companies relative to earnings. Calculated for a global index (FTSE World), the price/earnings ratio had fallen to around 13.1 at the end of the second quarter, which is low in comparison to the past 12 years (see Chart 3-10). One way of interpreting this is that the market is discounting very low earnings growth. Another is that investors are demanding a high premium for investing in this market.

Fixed income market

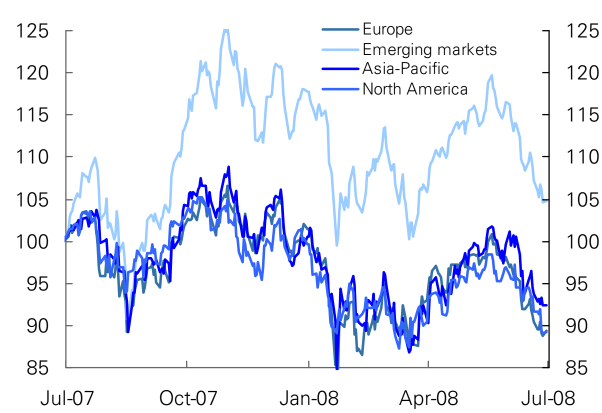
Yields in the major markets climbed steeply in the second quarter (see Chart 3-11). The ten-year US Treasury yield rose by 0.5 percentage point, and equivalent yields in Europe and Japan by 0.7 and 0.3 percentage point respectively. This can be attributed to higher observed inflation and to uncertainty about the inflation outlook and central banks' response. Overall, the broad Lehman Global Aggregate fixed income index produced a return of -3.3 per cent during the period.

Over the past year as a whole, lower interest rates and increased uncertainty in the market for corporate bonds and securitised debt have resulted in government bonds generating a better return than these sectors. This trend reversed to some extent in the second quarter, with the government bond index falling furthest in a phase of higher interest rates (see Chart 3-12).

Table 3-1 Return in international currency on the FTSE index in the second quarter of 2008 by industrial sector. Per cent

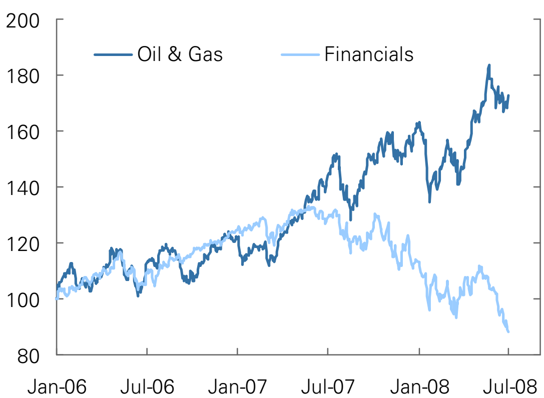
Sector	Return
Oil & Gas	19.08
Basic Materials	11.44
Utilities	4.31
Technology	1.33
Health Care	0.25
FTSE All-World Index	**-1.43**
Telecommunications	-2.42
Industrials	-4.20
Consumer Services	-6.23
Consumer Goods	-7.32
Financials	-11.41

Chart 3-8 Regional equity market returns. Common currency. Index



Source: FTSE

Chart 3-9 Return on investments in the Oil & Gas and Financials sectors. Index

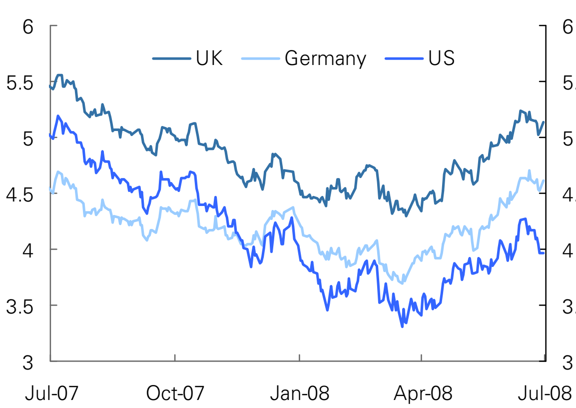


Source: FTSE World Index

Chart 3-10 Estimated price/earnings ratio in the equity market

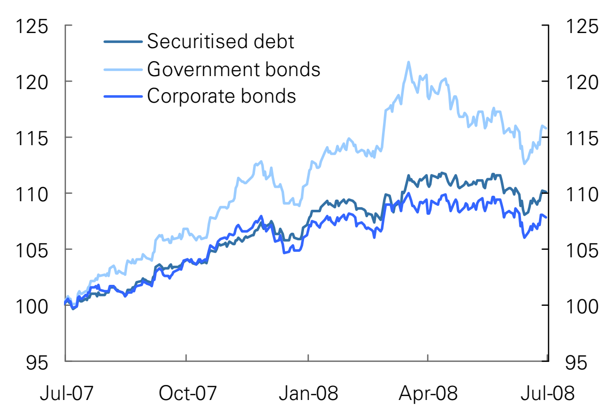
Source: IBES, Worldscope, NBIM

Chart 3-11 Yield on government bonds with ten years to maturity. Per cent



Source: Ecowin

Chart 3-12 Global bond sector returns



Source: Lehman Global Aggregate

The portfolio

The strategic allocation to equities was raised from 40 to 60 per cent in summer 2007. The background to this was presented in NBIM's Annual Report for 2007. For a large fund with significant inflows of new capital, it would not be appropriate to make this change all at once. Instead, changes of this kind need to be implemented over a period of time and by using the inflows of new capital into the fund. At the end of the second quarter, the allocation to equities had increased to 52 per cent, which meant that the fund's equity portfolio was larger than its fixed income portfolio for the first time (see Chart 4–1).

The increase in the strategic allocation to equities and inflows of new capital into the fund mean that the size of the fund's holdings in equity markets is growing. During the second quarter, the value of the fund's holdings of European equities increased to more than 1 per cent of the total value of the companies included in the benchmark portfolio (see Chart 4–2).

NBIM may employ external managers in the implementation of its management mandate. The level of external management has been reduced in both absolute and relative terms. At the end of the second quarter, assets under the management of external managers accounted for 11 per cent of the fund's total assets. This is the lowest level since equities were first included as an asset class in the fund in 1998 (see Chart 4–4).

In both the equity and fixed income portfolios, the fund has a strategic overweight of European investments in terms of these markets' size in a global context. 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 (see Tables 4–1 and 4–2).

The fund may hold up to 10 per cent of a company's voting shares. The limit was raised from 5 per cent after the Storting (Norwegian parliament) approved the change in June 2008. At the end of the second quarter, the fund's largest ownership interests in individual companies were close to 5 per cent.

Since the beginning of the second quarter, investment management has been organised into five management units: equity management, fixed income management, external management, risk strategies, and capital strategies. The risk strategies and capital strategies groups will be able to take larger and more concentrated positions in the market, including across asset classes.

Chart 4-1 Breakdown by asset class 2004-2008. Per cent

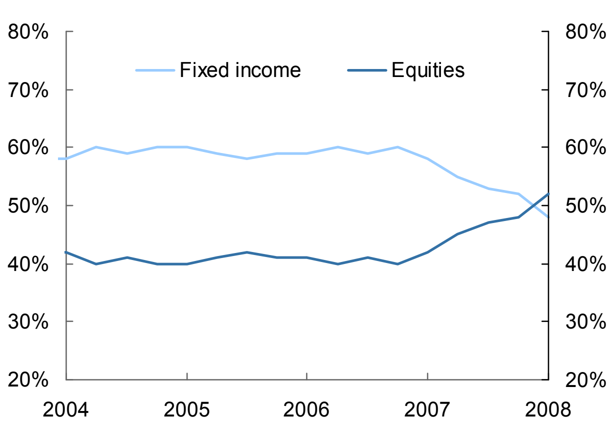
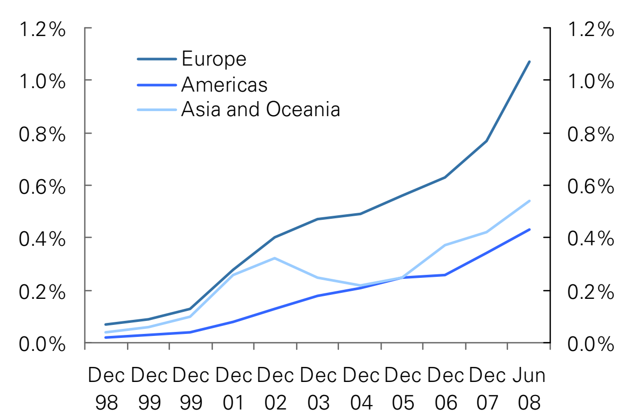
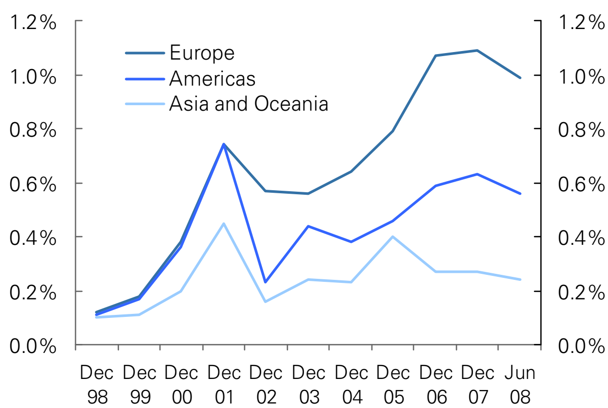


Chart 4-2 Ownership interests in equity markets 1998-2008.[1] Per cent



[1] Percentage of FTSE index's market capitalisation.

Chart 4-3 Ownership interests in fixed income markets 1998-2008.[1)] Per cent



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

Chart 4-4 External management 1998-2008. In billions of NOK and per cent

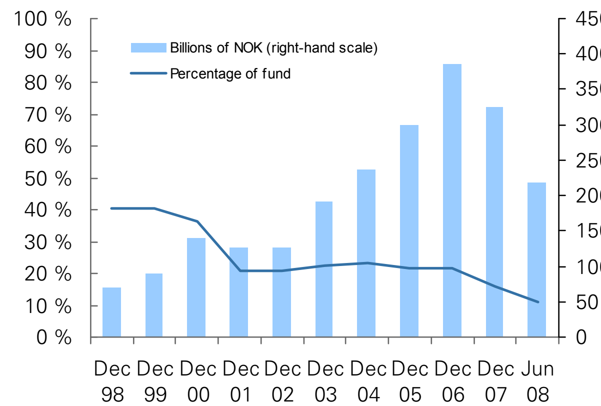


Chart 4-5 Regional breakdown of the equity portfolio as at 30 June 2008. Per cent

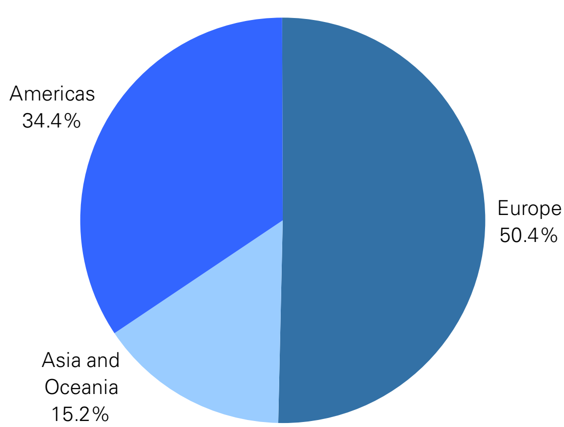


Chart 4-6 Regional breakdown of the fixed income portfolio as at 30 June 2008. Per cent

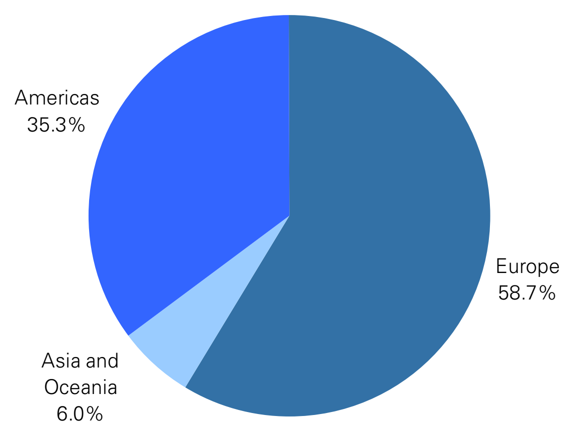


Table 4-1 Largest equity holdings as at 30 June 2008

Company	Country	Holding in millions of NOK
Royal Dutch Shell plc	Netherlands	14 874
BP plc	UK	12 406
TOTAL SA	France	10 290
Nestlé SA	Switzerland	9 573
HSBC Holdings plc	UK	9 553
Exxon Mobil Corporation	US	8 768
Vodafone Group plc	UK	8 228
Roche Holding Ltd	Switzerland	7 220
E.ON AG	Germany	6 984
Telefónica SA	Spain	6 850

Table 4-2 Largest bond holdings as at 30 June 2008

Issuer	Country	Holding in millions of NOK
Federal Republic of Germany	Germany	117 646
Fannie Mae	US	66 374
Italian Republic	Italy	55 706
European Investment Bank	Supranational	48 470
Japanese Government	Japan	35 267
French Republic	France	26 647
HBOS plc	UK	21 985
Freddie Mac	US	21 384
Hellenic Republic	Greece	20 245
Republic of Austria	Austria	16 213

Market value, risk and return

The market value of the Government Pension Fund – Global at the end of the second quarter of 2008 was NOK 1 992 billion (see Table 5–1), an increase of NOK 46 billion during the quarter. New capital of NOK 91 billion was transferred to the fund, while a negative return on investment reduced the value of the fund by NOK 39 billion, and a stronger krone in relation to the currencies in which the fund is invested reduced its value in NOK terms by NOK 6 billion. A change in the krone exchange rate has no effect, however, on the fund's international purchasing power.

Over the past 12 months, the fund's market value has increased by NOK 51 billion (see Chart 5–1). New capital of NOK 331 billion has been transferred, while a negative return in international currency and a stronger krone have reduced the market value of the fund by NOK 147 billion and NOK 133 billion respectively. Since it was established in 1996, a total of NOK 1 887 billion has been transferred to the fund (see Table 5–1). The return on the fund in international currency has increased its value by NOK 352 billion, while a stronger krone in relation to the investment currencies has reduced its value by around NOK 248 billion.

In the second quarter of 2008, the fund generated a return of –1.87 per cent measured in international currency (see Table 5–1). There was a return of -1.60 per cent on the equity portfolio and -1.72 per cent on the fixed income portfolio. Since 1997, the fund has generated an annualised annual gross return of 4.95 per cent (see Table 5–2). Once management costs and inflation are deducted, the annual net real return has been 2.9 per cent.

The return achieved by Norges Bank on the actual portfolio is measured in relation to the return on the benchmark portfolio defined by the Ministry of Finance. The difference between these return figures is the gross excess return achieved by NBIM. In the second quarter, the return on the fund was 0.24 percentage point higher than the return on the benchmark portfolio (see Table 5–1).The main positive contributions were from external management and fixed income management.

At the end of the second quarter of 2008, the three–year rolling annualised excess return was -0.02 percentage point, the five-year rolling annualised excess return was 0.20 percentage point, and the annualised excess return since 1998 was 0.32 percentage point (see Table 5–2).

Transaction costs are incurred when new capital is phased into the fund and when re-weighting the benchmark portfolio. Norges Bank has estimated the direct and

Chart 5-1 Changes in market value Q3 2007 to Q2 2008. In billions of NOK

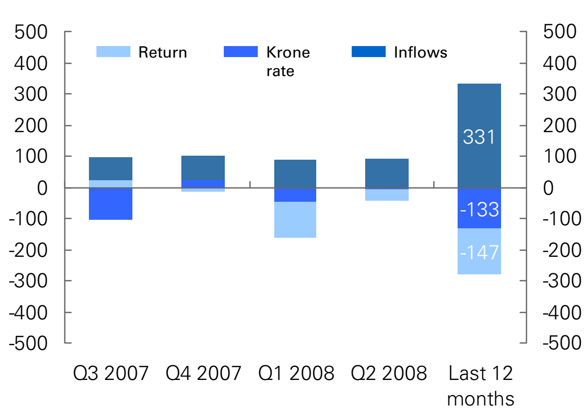


Chart 5-2 Absolute volatility 2003-2008 measured in NOK. Per cent

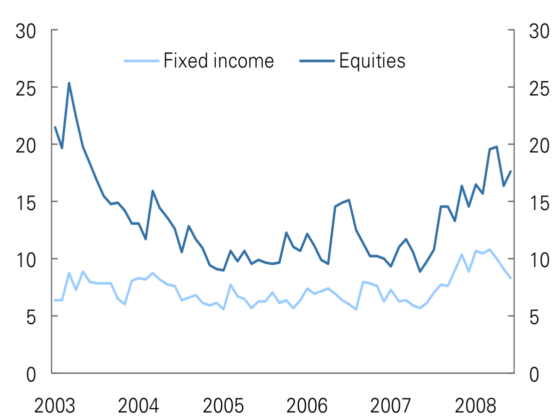


Table 5-1 Key figures as at 30 June 2008. Quarterly figures

	Q1 2007	Q2 2007	Q3 2007	Q4 2007	Q1 2008	Q2 2008
Market value (billions of NOK)						
Fixed income portfolio	1 124	1 120	1 054	1 061	1 011	961
Equity portfolio	753	819	878	958	935	1 031
Fund	1 876	1 939	1 932	2 019	1 946	1 992
Inflows of new capital	93	68	76	77	88	91
Return	27	42	21	-14	-115	-39
Change due to movements in krone	-28	-46	-104	24	-46	-6
Return in international currency (per cent)						
Equity portfolio	2.59	7.40	-0.30	-2.77	-12.67	-1.60
Fixed income portfolio	0.74	-1.19	2.10	1.30	0.87	-1.72
Fund	1.48	2.23	1.15	-0.64	-5.62	-1.87
Benchmark portfolio	1.39	1.93	1.33	-0.20	-4.79	-2.10
Return in NOK (per cent)						
Equity portfolio	1.04	4.86	-5.57	-1.59	-14.71	-1.90
Fixed income portfolio	-0.78	-3.53	-3.29	2.53	-1.49	-2.02
Fund	-0.05	-0.19	-4.20	0.56	-7.83	-2.17
Benchmark portfolio	-0.15	-0.49	-4.03	1.01	-7.02	-2.41
Excess return	0.09	0.30	-0.17	-0.45	-0.81	0.24
Management costs (per cent)						
Estimated transition costs	0.01	0.01	0.02	0.04	0.05	0.03
Annualised management costs	0.09	0.09	0.09	0.09	0.10	0.10
Changes in value since start-up (billions of NOK)						
Inflows of new capital	1 488	1 556	1 632	1 709	1 797	1 887
Return	454	496	518	504	390	352
Change due to movements in krone	-66	-112	-218	-194	-241	-248
Market value of fund	1 876	1 939	1 932	2 019	1 946	1 992

indirect transaction costs associated with phasing in new capital at NOK 641 million in the second quarter of 2008. This is equivalent to 0.7 per cent of the total amount transferred (NOK 91 billion) and 0.03 per cent of the market value of the fund at the beginning of the quarter. The benchmark portfolio has not been adjusted for these transaction costs. This means that the excess return reported is lower than it would have been if the costs associated with phasing in new capital had been excluded.

Fluctuations in global equity and fixed income markets lead to variations in the market value of the fund. The fund's expected volatility is a statistical measure which estimates "normal" variations in the market value of the fund over the next year. Since summer 2007, market fluctuations as measured by absolute volatility have increased in both the equity and fixed income portfolios (see Chart 5–2).

The Ministry of Finance has set a limit for the expected deviation between the returns on the actual portfolio and the benchmark portfolio. This limit has been defined as 1.5 percentage point expected tracking error.

Expected tracking error can vary widely even with an unchanged level of active management. This is because these measures are influenced by various market developments, such as changes in market volatility and changes in correlations between the various asset classes and securities. After rising in the first quarter, expected tracking error fell back in the second (see Chart 5–3). The fund's expected tracking error is well below the limit set by the Ministry of Finance.

NBIM uses a variety of risk models and methods to manage the risk in the overall portfolio. The risk limit in the management mandate from the Ministry of Finance has been defined using a single model, RiskManager. This risk model estimates the size of the variations in returns that can be expected based on the portfolio's composition and historical market data.

The model indicates that the actual return should be within the interval formed by the darkest-shaded area in Chart 5–4 in approximately two out of every three cases. The chart compares realised monthly excess returns since 2002 (dots) with the variations predicted by the model at the same time.

Since mid-2007, fixed income markets have been affected by factors that have caused volatility and correlations to depart from historical levels. It will take some time to adjust the model, and it may therefore be less precise during periods with major changes. Over the past year, it appears that modelled risk in RiskManager, expressed as expected tracking error, has underestimated the actual risk in the portfolio. The model's weaknesses and strict normal market assumption in the estimation of risk are supplemented at NBIM with additional analyses.

The fixed income portfolio generally features high credit ratings. At the end of the second quarter, 88.6 per cent of the portfolio was rated Baa or higher (investment grade) by Moody's (see Table 5–3).

Through the Regulation on the Management of the Government Pension Fund – Global and supplementary guidelines for the fund, the Ministry of Finance has set limits for risk and exposure. These limits and the portfolio's actual exposure are shown in Table 5–4. There were no breaches of the investment guidelines during the quarter.

Chart 5-3 Expected tracking error July 2007 to June 2008. Basis points

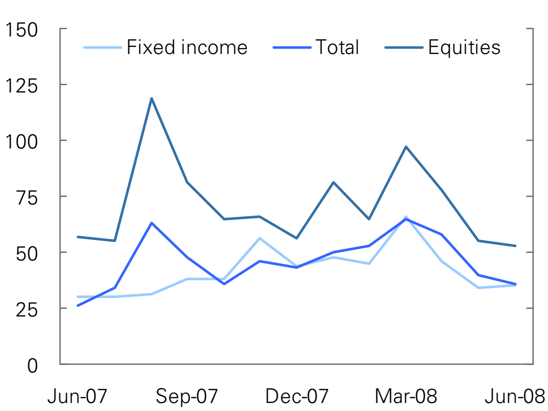
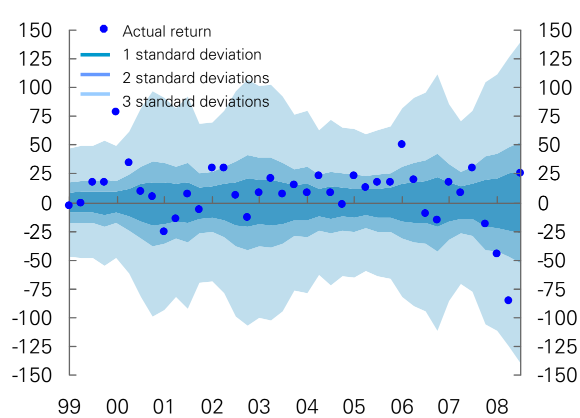


Chart 5-4 Confidence interval for risk and realised excess return 1999-2008. Basis points



Source: NBIM, Riskmetrics

Table 5-2 Key figures as at 30 June 2008. Annualised figures

(Measured in NOK)	Last 12 months	Last 3 years	Last 5 years	Last 10 years	Since 01.01.98
Actual return (per cent)	-13.13	-0.45	2.55	2.90	3.63
Benchmark return (per cent)	-12.03	-0.43	2.35	2.61	3.31
Excess return (percentage points)	-1.10	-0.02	0.20	0.29	0.32
Standard deviation (per cent)	8.19	8.28	8.31	8.56	8.47
Tracking error (percentage points)	0.94	0.66	0.54	0.48	0.47
Information ratio	-1.16	-0.04	0.37	0.60	0.67
(Measured in international currency)					
Gross annual return (per cent)	-6.93	3.34	6.04	4.61	4.95
Annual inflation (per cent)	3.98	2.97	2.63	2.08	2.02
Annual management costs (per cent)	0.09	0.10	0.10	0.09	0.09
Annual net real return (per cent)	-10.58	0.36	3.23	2.39	2.78
Annual gross excess return (per cent)	-1.10	-0.02	0.20	0.29	0.32

Table 5-3 Fixed income portfolio by credit rating[1)]

Percentage of fixed income portfolio	Aaa	Aa	A	Baa	Ba	Lower	P-1	No rating
Government and government-related bonds	18.2	12.0	2.6	0.6	0.1	0.1	-	0.6
Inflation-linked bonds	5.6	3.2	0.2	-	-	-	-	-
Corporate bonds	1.2	7.1	7.9	6.1	0.4	0.2	-	0.1
Securitised debt	31.1	1.1	0.6	0.1	0.1	0.1	-	0.2
Short-term certificates	-	-	-	-	-	-	0.3	0.01
Total bonds and other fixed income instruments	**56.1**	**23.5**	**11.4**	**6.9**	**0.6**	**0.4**	**0.3**	**0.8**

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

Table 5-4 Key figures for risk and exposure

Risk	Limits	Actual		
		31.12.07	31.03.08	30.06.08
Market risk	Tracking error max. 1.5 percentage points	0.43	0.65	0.36
Asset mix	Fixed income portfolio 30-70%	52.6	52.0	48.2
	Equity portfolio 30-70%	47.4	48.0	51.8
Market distribution, equities	Europe 40-60%	48.8	50.3	50.4
	Americas and Africa 25-45%	36.4	34.9	34.4
	Asia and Oceania 5-25%	14.8	14.8	15.2
Currency distribution, fixed income	Europe 50-70%	59.4	59.8	58.7
	Americas 25-45%	35.1	33.4	35.3
	Asia and Oceania 0-15%	5.5	6.7	6.0
Ownership interest	Max. 10% of a company (from June 2008)	4.99	4.99	4.99

Corporate governance

Active ownership is the exercise of the ownership role associated with the equities held by the fund. The aim of active ownership is to promote long-term financial returns in line with international standards through various types of shareholder initiative. Norges Bank has chosen to focus on both traditional corporate governance issues and issues relating to sustainable environmental and social development.

Voting at general meetings

NBIM managed shares in more than 7 000 listed companies in the second quarter of 2008, and aims to exercise its voting rights at the general meetings of all these companies. Most general meetings are held in the second quarter, and the following provides a brief summary of the trends we have observed in 2008 (see Table 6–1 for voting statistics).

In the US market, there has been a continuation of topics from previous years. Shareholders in many companies have again shown a lack of confidence in the board and management by voting "withhold" on the re-election of directors and by supporting shareholder proposals calling for better corporate governance and shareholder rights. The most important topics have been:

- Lack of independence on the board and important board committees
- Same person serving as chairman and CEO
- Majority voting for director elections
- Unclear link between executive remuneration and corporate performance
- Shareholders' right to vote on executive remuneration plans
- Various forms of anti-takeover mechanism

In Japan, as in 2007, proposals to introduce and retain various forms of anti-takeover mechanism encountered the greatest resistance at general meetings. In the wake of last year's takeover attempts by foreign investors, many hundreds of Japanese companies put forward proposals to introduce and retain such mechanisms. In addition, more shareholder proposals were filed than in previous years. Generally speaking, there was a trend towards increased activism from both Japanese and international investors.

At European companies, shareholder proposals are often associated with situations where an investor or group of investors attempts to replace directors and take control of the company. There have been several such situations in 2008. There have also been an increasing number ofshareholder proposals relating to corporate governance and shareholder rights. In several European markets, the general meeting must approve remuneration plans for senior management. In 2008, there was considerable resistance to such plans at some companies, due partly to a lack of information and an unclear link between remuneration and performance.

Environment

In the second quarter, NBIM continued to engage with companies concerning their lobbying on legislation related to climate change. In June, the US Senate considered a major bill on the regulation of greenhouse gases. The bill, which covered the entire economy and would entail national emission caps and trading in emission quotas, did not come up for plenary debate. Industry was nevertheless active in promoting its interests.

In its dialogue with large energy companies, NBIM has stressed the interest that diversified investors have in effective global solutions to the challenge of climate change. This must start with credible steps in the major industrialised nations. Companies have legitimate grounds to participate in the debate, but this will go against investors' interests if the outcome is for global controls on greenhouse gas emissions to be blocked. NBIM held meetings with senior executives or regulatory affairs officers at six companies during the quarter.

Child labour

At NBIM's initiative, some of the large multinational companies in cotton and vegetable seed production in India gathered for a meeting in June. The aim of the meeting was to discuss the possibility of a co-ordinated approach to the issue of child labour and the development of an industry standard for that particular sector and region. NBIM has identified the sector as particularly vulnerable in terms of child labour and the associated social and financial risks. This is exacerbated by the fact that production is growing. NBIM vill contribute to the further process to develop a common definition of child labour, a common standard for monitoring and controls for measuring and reporting child labour.

Table 6-1 Voting in the first half of 2008. Number of meetings and per cent

	First half of 2008			First half of 2007		
Region	Meetings	Voted	Per cent	Meetings	Voted	Per cent
Americas	2 547	2 515	99%	1 017	977	96%
Europe	1 647	1 099	67%	793	517	65%
Asia and Oceania	2 663	2 529	95%	1 266	1 226	97%
Total	**6 857**	**6 143**	**90%**	**3 076**	**2 720**	**88%**

Focus

Phasing small-cap companies into the equity portfolio

The Government Pension Fund – Global's equity portfolio is highly diversified across both regions and countries. From the time of the first equity investments in 1998, the benchmark index for equities (FTSE) consisted of the largest listed companies, while NBIM was also able to invest in smaller companies provided that they were listed.

Based on recommendations from, among others, Norges Bank (see the Bank's letter dated 20 October 2006 for a detailed discussion), and following a debate in the Storting, the Ministry of Finance decided in June 2007 to extend the composition of the fund's strategic benchmark portfolio to include small-cap companies. These are the companies with the smallest market capitalisation in the FTSE index, as opposed to mid-cap and large-cap companies, which were already included in the fund's benchmark portfolio.

This decision entailed a major change in the composition of the benchmark index, as small-cap companies make up a substantial proportion of the FTSE index's universe. The transition to full exposure to the small-cap segment was carried out over a five-month period starting in October 2007 and entailed an expected investment of NOK 129 billion in more than 4 500 new companies (see Chart 7–1). The phasing-in of the new benchmark portfolio was completed at the end of the first quarter of 2008.

The previous benchmark index (FTSE All-World) is a sub-index of the new benchmark index (FTSE All Cap), as the latter includes both the large-cap and mid-cap companies of the previous index and the small-cap segment. The broader All Cap index includes more than 7 000 companies, of which around 4 500 are in the small-cap segment. Together, these companies account for around 12 per cent of the new benchmark index's total market value. Chart 7–2 shows the expected transaction requirement in the small-cap segment by country at the beginning of the transition process.

Implementation of the change

The fund's size meant that full exposure to the additional 12 per cent of the All Cap index for which small-cap companies account would entail a large transaction volume. As liquidity in the market for small-cap companies is often limited, a large transaction volume could lead to extensive indirect transaction costs through a substantial impact on share prices. It is important to note that a change in the benchmark portfolio needs to be accompanied by a simultaneous change in the actual portfolio's exposure in order not to increase the fund's active risk. Two main strategies were considered when planning the transition:

a) Changing the benchmark portfolio all at once: The benchmark portfolio is changed instantly, while exposure in the actual portfolio is built up through a combination of capital inflows and sell-offs of existing investments
b) Changing the benchmark portfolio in stages: Gradual modification of the benchmark portfolio based on expected inflows of new capital

As the fund has substantial inflows of new capital in the form of government petroleum revenue, strategy (a) would mean that the securities sold off would have to be bought back again at a later date. A strategy of this kind could therefore lead to unnecessary transaction costs for the fund. As a result, strategy (b) was considered the better option. It also opened up the possibility of spreading purchases of shares in small-cap companies over an extended period and so further reducing the expected market impact. Chart 7–3 summarises the actual transaction volume by region during the three phases in which the benchmark portfolio was modified.

Liquidity in the small-cap segment was so low that only about 50 per cent of the actual transaction volume was carried out on the same date as the change in the benchmark portfolio. The remaining trades were spread around the transition date in order to minimise indirect transaction costs, but this also increased the relative risk when the fund was overexposed to small-cap companies before – and underexposed after – the changes in the benchmark portfolio.

The transition was completed at the end of the first quarter of 2008. Chart 7–4 shows the composition of the actual benchmark portfolio on 31 March 2008. In total, transactions with a value of NOK 117 billion were performed. Norges Bank estimates the total transaction costs at NOK 1 110 million, or 0.95 per cent of the transaction value.

Chart 7-1 Expected new and previous equity benchmark portfolio. As estimated on 31 October 2007. Per cent and in billions of NOK

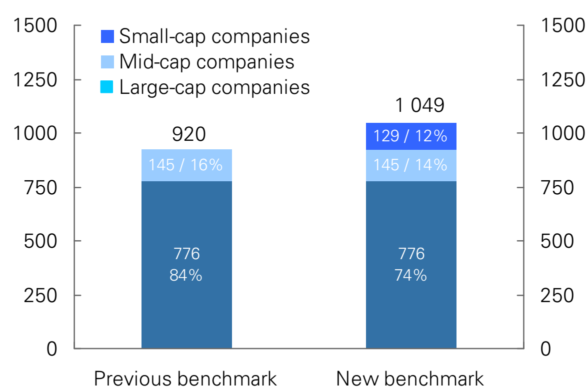


Chart 7-2 Expected purchases of small-cap companies by country. As estimated on 31 October 2007. In billions of NOK

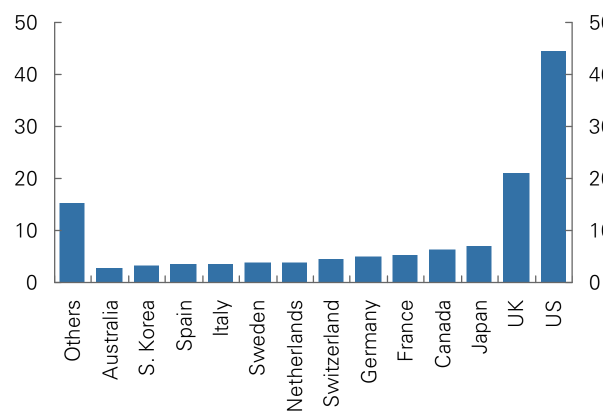


Chart 7-3 Actual small-cap transaction volume by region. In billions of NOK

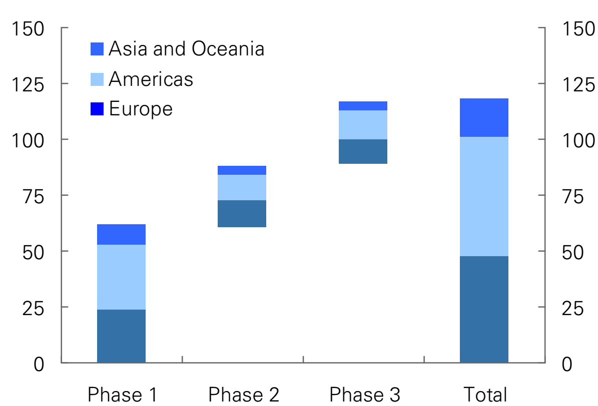
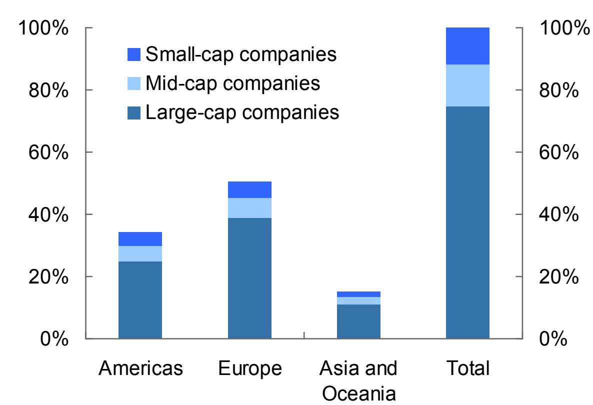


Chart 7-4 Equity benchmark portfolio with full exposure to small-cap segment. Per cent



Financial reporting

Operating expenses

The Management Agreement between the Ministry of Finance and Norges Bank establishes the principles for Norges Bank's remuneration for managing the Government Pension Fund – Global. For 2008, this fee is to cover the Bank's actual costs, provided that these costs are less than 0.10 per cent of the fund's average market value. In addition, the Ministry reimburses NBIM for performance-based fees paid to external fund managers. Norges Bank has entered into agreements on performance-based fees with the majority of external active managers, in accordance with principles approved by the Ministry of Finance.

Annualised, total costs in the first half of 2008 amounted to 0.10 per cent of the average market value of the fund (see Table 8–1). Excluding performance-based fees to external managers, costs amounted to 0.07 per cent of the fund's market value. By way of comparison, the equivalent costs in the first half of 2007 amounted to 0.08 per cent of its market value.

Profit and loss account and balance sheet

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. A separate audit report for the Government Pension Fund – Global has been submitted to the Ministry of Finance.

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 2007.

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 2007.

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 2007 contain further information on significant estimates and assumptions.

Table 8-1 Management costs in the first half of 2008. In thousands of NOK and as a percentage of the fund's market value

Cost component	First half of 2008		First half of 2007	
	NOK 1 000	Per cent	NOK 1 000	Per cent
Internal costs	313 811		287 872	
Custodian and settlement costs	136 254		110 210	
Minimum fees to external managers	188 274		260 800	
Performance-based fees to external managers	222 001		134 266	
Other costs	101 137		45 277	
Total management costs	**961 477**	**0.10**	**838 425**	**0.09**
Total management costs excluding performance-based fees	**739 476**	**0.07**	**704 159**	**0.08**

Table 8-2 Profit and loss account

(Figures in millions of NOK)	Q2 2007	Q2 2008	Year to date 31.12.07	30.06.07	30.06.08
Profit/loss on financial assets excl. exchange rate adjustments	313 811		287 872		
Interest income, deposits in foreign banks	131	122	431	228	222
Interest income, lending associated with reverse repurchase agreements	8 643	3 614	33 564	16 141	9 246
Net income/expenses and gains/losses from:					
- equities and units	52 730	-14 667	41 627	70 767	-136 496
- bonds and other fixed income instruments	-20 070	-20 241	19 750	-13 586	-12 516
- financial derivatives	6 247	4 124	5 265	7 289	3 162
Interest expenses, borrowing associated with repurchase agreements	-7 898	-4 878	-32 509	-16 032	-11 290
Other interest expenses	-128	-224	-118	-146	-241
Other expenses	-46	102	-179	-97	87
Profit/loss before exchange rate adjustments	**39 608**	**-32 049**	**67 831**	**64 563**	**-147 825**
Exchange rate adjustments	-43 812	-12 910	-146 412	-69 666	-58 069
Profit/loss	-4 204	-44 959	-78 581	-5 103	-205 894
Accrued management fee	-452	-483	-1 783	-838	-961
Profit/loss after management fee transferred to krone account	**-4 656**	**-45 441**	**-80 364**	**-5 941**	**-206 855**

Table 8-3 Balance sheet

(Figures in millions of NOK)		31.12.07	30.06.07	30.06.08
ASSETS				
FINANCIAL ASSETS				
Deposits in foreign banks		23 905	23 279	16 599
Lending associated with reverse repurchase agreements		669 607	810 193	418 811
Equities and units		945 113	799 176	1 018 657
Bonds and other fixed income instruments		1 120 540	1 009 241	1 115 088
Financial derivatives		2 094	6 222	0
Other assets		5 229	25 341	15 077
TOTAL FINANCIAL ASSETS		**2 766 488**	**2 673 453**	**2 584 231**
LIABILITIES AND CAPITAL				
FINANCIAL LIABILITIES				
Short-term borrowing		187	11 080	220
Borrowing associated with repurchase agreements		710 898	667 247	538 855
Financial derivatives		0	0	1 633
Unsettled trades		33 480	55 599	42 921
Other liabilities		3 185	0	9 043
Management fee due		1 783	838	961
TOTAL FINANCIAL LIABILITIES		**749 533**	**734 764**	**593 634**
Capital	Note 1	2 016 955	1 938 688	1 990 598
TOTAL LIABILITIES AND CAPITAL		**2 766 488**	**2 673 453**	**2 584 231**

Note 1. Capital

(Figures in millions of NOK)	31.12.07	30.06.07	30.06.08
Deposits in krone account on 1 January	1 782 139	1 782 139	2 016 956
Transfers during the year	315 180	162 491	180 498
Profit/loss transferred to krone account	-78 581	-5 103	-205 894
Capital before deduction of management fee	**2 018 738**	**1 939 527**	**1 991 560**
Management fee to Norges Bank	-1 783	-838	-961
Capital – deposits in krone account	**2 016 955**	**1 938 689**	**1 990 598**

Note 2. Securities lending

Loans of securities through external lending programmes totalled NOK 515 3 billion on 30 June 2008. Total collateral of NOK 540 billion had been provided for these loans. Of this collateral, NOK 249 billion had been re-invested in repurchase agreements and bonds. Neither collateral nor re-investments are included in the balance sheet.

Unrealised losses on re-invested cash collateral amounted to NOK 3.5 billion on 30 June 2008. Of this, NOK 0.4 billion was recorded as unrealised losses in the profit and loss account in the first half of 2008 under "Net income/ expenses and gains/losses from bonds and other fixed income instruments".

Note 3. Uncertainty in the valuation of securities

For all securities priced on the basis of sources other than observable market prices, there is some uncertainty as to whether the price used reflects a best estimate of fair value. This uncertainty is normally very limited for the bulk of the securities in which the fund invests.

As the turmoil in financial markets has worsened since summer 2007, valuation has become particularly demanding and uncertain in the sector for securitised debt and related structured products. What began as concern about subprime mortgages in the US developed during the course of 2007 and the first half of 2008 into a more general and deeper credit and liquidity crisis.

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 uncertainty. These methods mean that the value of some types of instrument has been revised downwards by means of an uncertainty/liquidity deduction from the value reported from the ordinary price sources. The size of this liquidity deduction depends on the estimated uncertainty about the price from the price source.

The following presents the estimation of market value for securitised debt, including asset-backed securities (ABSs), residential mortgage-backed securities (RMBSs) and commercial mortgage-backed securities (CMBSs), and structured investment vehicles (SIVs).

Securitised debt (ABSs, RMBSs and CMBSs)

Net exposure to securitised debt covered by the price uncertainty method was NOK 76.3 billion on 30 June 2008. On that same date, total unrealised losses of NOK 4.0 billion had been recognised in the profit and loss account under "Net income/expenses and gains/losses from bonds and other fixed income instruments", a decrease of NOK 1.1 billion since the end of the first quarter.

Structured investment vehicles (SIVs)

Through its securities lending programmes, including the re-investment of cash collateral, the fund is exposed to senior securities of 11 different SIVs with a combined value of NOK 5.3 billion after adjustments. At the end of the second quarter of 2008, two of the SIVs to which the fund is exposed had entered enforcement mode. Settlements in these cases have not been finalised.

Total unrealised losses on SIVs of NOK 1.2 billion have been recorded in the profit and loss account under "Net income/ expenses and gains/losses from bonds and other fixed income instruments". Of this, NOK 0.3 million is attributable to the risk classification method and NOK 0.9 million to ordinary price sources. The corresponding write-down at the end of the first quarter of 2008 was NOK 1.6 billion. NOK 0.3 billion of the previous write-down was reversed in the second quarter of 2008.

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