<u>Management Costs for the Investment of the Exchange Fund and the Appointment of External Fund Managers</u>

This paper provides information on the investment costs of the Exchange Fund in response to the matters raised in the research paper by the Democratic Party produced on 23 April 2006 attached to the letter from the Clerk to the Legislative Council Panel on Financial Affairs dated 24 April 2006.

2. The research paper includes a table stating that the general operating costs of the Exchange Fund (which include investment management and custodian costs) had increased from $186 million in 1997 to $811 million in 2005, and uses these figures to argue that the investment management costs of the Exchange Fund have increased by 336% over this nine-year period and, in particular that the management and custodian fees rose by 34.6% between 2004 and 2005. In order for accurate year-on-year comparisons to be made of the cost of employing external fund managers and custodians, two clarifications to these figures are required:

(a) The figure for 2005 includes $130 million in trading expenses, which was not included in the category of “investment management and custodian fees” in previous years. The Exchange Fund prepares its accounts in accordance with accounting principles generally accepted in Hong Kong. In 2005 new Hong Kong accounting standards were adopted regarding transaction costs for marked-to-market financial instruments, assets and liabilities. These costs must be expensed immediately rather than being factored into the value of investments and liabilities as had been the practice under the previous accounting standards. In the 2005 Exchange Fund accounts published in the 2005 HKMA Annual Report, these costs are included in “investment management and custodian fees”. This change results entirely from the introduction of new accounting standards so that the $130 million should be deducted from the figure of $811 million for comparison with the figures for earlier years, which were prepared on the basis of the old accounting standards. This gives a figure for 2005 of $681 million, representing an increase of 7.75% from the figure of $632 million for 2004.

(b) To present the exact cost of employing external fund managers and custodians further subtractions need to be made of the element of withholding tax[1] and other operating expenses[2] within the heading of investment management and custodian fees. These subtractions produce the following comparison:

Table 1: Cost of external fund managers and custodians of the Exchange Fund 1997 – 2005	
	Management and custodian fees (HK$ million)
1997	140
1998	170
1999	178
2000	235
2001	272
2002	341
2003	421
2004	449
2005	489

3. The figures in Table 1 show an increase of 249% between 1997 and 2005, and an increase of 8.9% between 2004 and 2005. These increases are explained as follows:

(a) The growth of the Exchange Fund from about $636 billion in 1997 to over $1,066 billion at the end of 2005, including growth in the Accumulated Surplus (the total net profit earned by the Fund) from $190 billion in 1997 to $443 billion in 2005. Apart from year-on-year investment income and other growth in the Fund, the assets of the Land Fund, totalling some $211.4 billion, were merged into the Exchange Fund on 31 October 1998.

(b) The increased complexity in the composition of the Exchange Fund, which includes a greater element of equities and greater use of derivatives and other

[1] Withholding tax is levied on investment income in some of the jurisdictions where the Exchange Fund is invested. This is a cost of investment which is beyond the HKMA's control.

[2] Including trading expenses for futures, Central Moneymarkets Unit expenses, consultancy fees for rating agencies and marketing expenses for retail Exchange Fund Notes.

sophisticated investment instruments aimed at improving yield and diversifying assets. The 1998 intervention in the stock market led to part of the Exchange Fund's being invested in Hong Kong equities. Assets held in equities must be managed by external managers to avoid conflicts of interest. The following table shows the change in the mix of bonds and equities in the investment benchmark of the Exchange Fund between 1997 and 2005.

	1997	2005
Bonds	90%	77%
Equities & related investments	10%	23%

(c) The greater attention to risk management in a more globalised, volatile and unpredictable investment environment. The Asian financial crisis, which began in 1997, and other crises elsewhere led to a greater focus on risk in global financial markets. The HKMA tightened the risk-management mechanisms of the Exchange Fund including diversification and requiring increased reporting by external fund managers. This has led to some increase in fees and costs. Given the importance of the Exchange Fund in maintaining monetary and financial stability in Hong Kong, we believe that this expenditure is necessary and justified.

4. A total of 47 (establishment 48) HKMA staff were engaged in the appointment and monitoring of external fund managers, the direct investment of the Exchange Fund and risk management and compliance in 2005. The figure for 1997 was 25 (establishment 29). This increase is broadly in line with the growth of the Exchange Fund, and reflects the growing complexity of the Fund and the increasing attention paid to risk management.

5. The use of external fund managers, together with the work of the HKMA's own investment staff, has enabled the Exchange Fund to achieve a compounded annual return of about 5.7% between 1999 and 2005. The cost of investing the Exchange Fund through external fund managers, while no doubt large when viewed on its own,

represented about 0.14% of the funds under management (about one third of the Exchange Fund) in 2005. This figure compares well with the management costs of about 0.27% for the externally managed assets of the Norwegian Government Pension Fund[3] in 2005, and with the rate of 0.45% to 0.95% typically charged by private-sector managers for institutional investment funds with a mix of fixed-income and equity assets comparable to the Exchange Fund. The in-house costs of overseeing the external fund managers and the direct investment of the remainder of the Exchange Fund were about $62 million. Total direct management costs for the whole of the Exchange Fund, whether by external fund managers or direct investment in 2005, represented about 0.05% of the total assets of the Exchange Fund. To put this into perspective, the return on the Exchange Fund outperformed that of the benchmark portfolio by an average of about 1.2% between 1999 (when the current system of bench-marking began) and 2005. This outperformance represents an average of about $11.9 billion annually or almost 30 times the annual cost of management of the Fund on average.

6. The reasons for appointing external fund managers to invest about one third of the Exchange Fund's assets (including all of its equities portfolios) are

- to allow the Fund to be invested flexibly in a variety of specialised assets in a number of international financial centres
- to tap the best investment expertise available in the market
- to capture a diverse mix of investment styles and transfer knowledge and information about the market to in-house professionals
- to avoid conflict of interest and market sensitivity arising from the HKMA's roles as regulator and controller of the Exchange Fund's assets.

Without the use of external fund managers, it would be necessary for the HKMA to expand considerably its in-house resources for

[3] This is a government fund with an international presence and a size and composition broadly comparable to the Exchange Fund, which has also made public its management costs.

investment of the Exchange Fund. This would greatly reduce the HKMA's flexibility in international markets without guaranteeing that the same levels of expertise could be attained.

7. A co-incidental benefit of the appointment of external fund managers by the Exchange Fund is the growth of Hong Kong as a fund management centre because many external managers and related service providers either set up or expand their presence in Hong Kong after appointment by the Exchange Fund. A local presence by these fund managers greatly enhances the dissemination of market information and the quality of administrative support to the Exchange Fund, while helping to maintain and develop Hong Kong's status as an international financial centre.

8. External fund managers are subject to a rigorous, competitive appointment process. An initial screening is conducted to identify the best performers for each type of mandate, who are sent requests for proposals requiring extensive information on the investment history and approach of the institution, details of its investment professionals, its compliance record and the quality of its risk management, administration and infrastructure. HKMA staff then pay due-diligence visits to the head offices of the short-listed fund managers to confirm the details provided. Following these visits, recommendations for appointment are put to the Financial Secretary through the Exchange Fund Advisory Committee (EFAC) and its Investment Sub-Committee (ISC).

9. The performance of external managers is monitored continuously and regular reports are made to the ISC and EFAC. Where the performance of an individual fund manager falls below expectations, the appointment may be cancelled at short notice.

Hong Kong Monetary Authority
May 2006