Reserves Management

The HKMA adopts best market practices to manage the Exchange Fund in a prudent manner. Despite jittery equity markets and considerable volatility in currency markets, the accumulated surplus of the Exchange Fund grew by 5.6% in 2000. At the end of 2000, Hong Kong's foreign currency reserve assets totalled US$107.5 billion, making them the third largest in the world.

The Exchange Fund

The Exchange Fund was established in 1935. Since its inception, the Fund has held the backing to the note issues of Hong Kong. In 1976, the backing for coins issued and the bulk of the foreign currency assets held in the Government's General Revenue Account were also transferred to the Exchange Fund. At 31 December 2000, the assets of the Exchange Fund totalled $1,023.4 billion.

The primary objective of the Exchange Fund is to safeguard the exchange value of the currency of Hong Kong and to maintain the stability and integrity of the monetary and financial systems of Hong Kong. At $838.5 billion, the foreign currency reserves represent a very significant store of value for the people of Hong Kong. The main investment objective therefore is to maintain the long-term purchasing power of these reserve assets.

The changing financial landscape and unrelentingly high market volatility highlight not only the importance of risk management in the investment process but also the need to diversify into new markets and instruments. The investment process of the Exchange Fund is in line with international best practices.

Asset allocation of the Exchange Fund

At the beginning of 1999, the Exchange Fund adopted a new long-term asset allocation strategy. This asset allocation strategy, known as an investment benchmark, is presented in Table 1.

Table 1	Investment benchmark of the Exchange Fund
Bonds	80%
Equities	20% (Hong Kong: 5%)
Currencies	80% US dollar bloc
	15% European bloc
	5% Yen

The investment benchmark, which directs the long-term strategic investment of the Exchange Fund, is derived from the investment objectives of the Exchange Fund. A review of investment objectives and hence the investment benchmark of the Exchange Fund was conducted following the introduction of a new arrangement in April 1998 to enable the fiscal reserves placed with the Exchange Fund to enjoy the same return achieved by the Exchange Fund as a whole, and the merger of the assets of the Land Fund into the Exchange Fund in November 1998.

The new investment benchmark of the Exchange Fund adopted by the Exchange Fund Advisory Committee in early 1999 is an optimal mix of assets designed to meet the following investment objectives:

1. to preserve capital;
2. to ensure that the entire monetary base will be at all times fully backed by highly liquid short-term US dollar denominated securities;
3. to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and
4. subject to (1) – (3) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

The investment process

The Exchange Fund is managed as two distinct portfolios – the Backing Portfolio and the Investment Portfolio. In September 1998, the Monetary Base was redefined to include Exchange Fund Bills and Notes in addition to Certificates of Indebtedness, coins in circulation and the aggregate clearing balance maintained by banks with the HKMA. Since then, the Backing Portfolio has been established to hold highly liquid US dollar denominated interest bearing securities to fully back the monetary base.

The balance of the Exchange Fund assets that constitute the Investment Portfolio are invested in OECD bond and equity markets to preserve the value and long-term purchasing power of these assets.

The long-term asset allocation strategy of the Exchange Fund is dictated by the investment benchmark, which defines the allocation of investments to different asset classes by country as well as the overall currency mix for the Fund. The Exchange Fund is permitted to invest in 20 bond markets, 10 equity markets and 18 currency markets.

The Exchange Fund Advisory Committee determines the long-term investment strategy, while the Reserves Management Department of the HKMA is responsible for the day-to-day management of the Exchange Fund. In carrying out its responsibilities, the Reserves Management Department operates within the investment guidelines approved by the Exchange Fund Advisory Committee. Using fundamental analyses of economies and assessments of market developments and trends, the investment professionals determine the allocations to asset classes by country and the appropriate timing for entry into and exit from markets. To generate active returns above market returns, these professionals also engage in the selection of specific securities within each market.

To monitor the risks arising from the increasing complexity of the investment process, stringent controls and investment guidelines have been put into place. Market practices such as value-at-risk and stress testing have become an integral part of this process. In addition, the HKMA actively conducts detailed performance attribution analysis to make the most effective use of the investment skills of both the internal and external managers.

Use of external managers

The Exchange Fund employs over 40 external managers located in ten major financial centres to invest about 40% of its total assets. The purpose of engaging the services of external managers is to benefit from their expertise, skills and geographical coverage in selected markets.

In 2000, a strategic review of the use of external managers was conducted. To benefit from the performance of different assets and markets, the new strategy for the use of external managers increases the number and types of specialist managers to be employed. Performance evaluation and risk management of the externally managed portfolios will also be updated.

The disposal and investment management of the Hong Kong Equity Portfolio

Subsequent to the initial public offering of the Tracker Fund of Hong Kong (TraHK) in November 1999, the Exchange Fund continued to dispose of the Hong Kong stocks through the Tap Facility in 2000. Total gross proceeds of $83.3 billion were received from the disposals through the IPO and Tap Facility during the period between 12 November 1999 and 31 December 2000.

Exchange Fund Investment Limited appointed a number of passive and active managers in 2000 to manage the Exchange Fund's long-term Hong Kong equity investment portfolio.

Risk management and compliance

The Risk Management and Compliance Division of the Reserves Management Department is responsible for the risk control function. It is primarily responsible for monitoring the market, price, credit and operational risks arising from investment process. It is also responsible for the selection of benchmarks and evaluation of performance. Returns achieved by the internally and externally managed portfolios are evaluated against the assigned benchmarks. Performance attribution analysis to identify the skills of investment managers is actively employed to enhance effective allocation of assets.

Performance of the Exchange Fund

The financial markets in 2000

In the beginning of 2000, markets expected above-trend synchronised global growth with benign inflation. Despite very stretched valuations, this scenario would have been favourable for equity markets and bearish for bonds. According to this scenario the euro would rebound against the US dollar as Euroland's economic recovery outpaced that of the US.

Inflation did stay benign, as the US economy surged at a record rate of 5.2% in the first half of 2000. However, when Nasdaq plummeted from its mid-summer highs and inventory started to accumulate in the third quarter, the long-expected slowdown of the US economy began. As the US economy slowed, the euro recovered against the US dollar by the end of the year.

The equity markets reacted negatively to disappointing corporate earnings. Nasdaq plummeted by 52% from its mid-year peak to bring about a year-on-year drop of 39%. In line with the fall of the Standard and Poor's 500 by 10% in 2000, the Hang Seng Index also ended 11% lower by the end of the year.

The performance of major bond, equity and currency markets is set out in Table 2.

Table 2 2000 market returns

Currencies	
Appreciation of US dollar	
Against Yen	11.6%
Aganist Euro	6.8%
Merrill Lynch Global Government Bond Index, 1-5 years (in US$ terms)	0.9%
Equity markets	
Standard & Poor's 500 Index	-10.1%
Hang Seng Index	-11.0%

The Exchange Fund's performance in 2000

The investment strategy steered a steady course through a difficult investment environment in 2000. Our strategic positioning in the bond market limited the adverse effect from exchange losses and the fall in the equity markets. The interest income and the investment gains from the source of bond positioning, together with some dividends received from equities, amounted to $67.4 billion. This more than offset the losses incurred mainly in Hong Kong equity and foreign exchange, and produced an overall gross investment income for the Exchange Fund of $45.1 billion, or a return of 4.8% on its total invested assets.

The investment return of the Exchange Fund relative to the investment benchmark and local inflation rate for the period from 1993 to 2000 is set out in Table 3. The currency mix of the Fund's assets at 31 December 2000 is set out in Table 4.

Table 3 Gross investment return of the Exchange Fund

	Return on total invested assets	Return on investment benchmark*	CPI(A)
2000	4.8%	3.8%	-1.4%
1999	10.8%	5.5%	-2.9%
1993 – 2000 cumulative	76.0%	N/A	33.1%
1993 – 2000 annualised	7.3%	N/A	3.6%

* established since January 1999

Table 4 Currency mix of the Exchange Fund's assets (at 31 December 2000)

	HK$ billion	%
US dollar	691.0	67.5
Hong Kong dollar	166.7	16.3
European currencies	120.7	11.8
Yen	42.3	4.1
Others	2.7	0.3
Total	**1,023.4**	**100.0**

Increased transparency

The initiatives to increase transparency of disclosure reported in the 1999 Annual Report were implemented in the course of 2000. Since May, the HKMA began publishing the Data Template on International Reserves and Foreign Currency Liquidity (the "Liquidity Template"), which provides a comprehensive account of the International Monetary Fund (IMF) participant's foreign currency assets and drains on such resources arising from various foreign currency liabilities and commitments. Concurrently, in full compliance with the Special Data Dissemination Standard (SDDS) of the IMF, monthly announcements of two other reports including Hong Kong's International Reserves and Analytical Accounts of the Central Bank were made in accordance with a pre-announced calendar. In addition, an abridged balance sheet of the Exchange Fund and a set of Currency Board Accounts are also published for each month before the end of the following month.