Reserves Management

In 2001, global financial markets were extremely volatile, reflecting the rapid slowdown in economic activity and the tragic events of 11 September. Despite the combined easy monetary and stimulative fiscal policies in the US, global equity markets fell as corporate earnings failed to meet investor expectations. In managing Hong Kong's official reserves, the HKMA adopted a prudent investment strategy to generate a positive investment return, which was higher than the return achieved by the investment benchmark.

The Exchange Fund

The Exchange Fund is one of the pillars for a stable monetary system for Hong Kong. Since its establishment in 1935, the Exchange Fund has held the backing to the banknotes issued in 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 2001, the assets of the Exchange Fund amounted to $979.1 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 31 December 2001, the foreign currency reserves totalled $866.8 billion. It is also the investment objective of the Fund to maintain the long-term purchasing power of the foreign currency reserves, as they represent a store of value for the people of Hong Kong.

The increasing volatility in the financial markets in recent years has highlighted not only the importance of prudent management in the investment process but also the need to diversify into new markets and instruments. The management of the reserves by the HKMA is in line with international best practices.

Asset allocation of the Exchange Fund

Since the beginning of 1999, the Exchange Fund has adopted a new long-term asset allocation strategy. This asset allocation strategy, which is the 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 is derived from the investment objectives of the Exchange Fund. A review of the investment objectives and hence the investment benchmark of the Exchange Fund was prompted by the introduction of a new arrangement in April 1998 and subsequent merger of the assets of the Land Fund into the Exchange Fund in November 1998. The new arrangement enables the fiscal reserves placed with the Exchange Fund to enjoy the same return achieved by the Exchange Fund as a whole.

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

(a) to preserve capital;

(b) to ensure that the entire monetary base will be at all times fully backed by highly liquid short-term US dollar denominated securities;

(c) to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and

(d) subject to (a) – (c) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

The investment benchmark of the Exchange Fund is reviewed annually in the light of the changes in the volatility of the financial markets in the preceding 12 months to ensure that the mix of assets will be able to meet the long-term investment objectives of the Exchange Fund.

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 held highly liquid US dollar denominated 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 governed 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. To be included in the approved investment universe, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Exchange Fund.

The strategic investment strategy is determined by the Exchange Fund Advisory Committee, while the day-to-day management of the Exchange Fund is conducted by the Reserves Management Department of the HKMA. In discharging its responsibilities, the Reserves Management Department operates within the investment guidelines approved by the Exchange Fund Advisory Committee. By means of fundamental analyses of different economies and assessments of market development and trends, the investment professionals determine the allocations to asset classes by country and the appropriate timing for market entries and exits. To generate more active returns above market returns, these professionals also engage in the selection of specific securities within each market.

To monitor the risks arising from increasing volatility in the financial markets, stringent controls and investment guidelines have been set. In addition, the HKMA conducts detailed performance attribution analyses to make the most effective use of the investment skills of both the internal and the external managers.

Use of external managers

The Exchange Fund employs global external managers located in ten major financial centres to manage some 30% of its total assets. The externally managed assets are custodised with several major global master custodians. The diversification of assets into different products and markets increases the number and types of specialist managers to be employed. The purpose of appointing external managers is to benefit from their expertise, skills and geographical coverage of selected markets. An external manager's investment expertise and a commitment to assist in Hong Kong's development as a financial centre are essential criteria in the selection and appointment process.

Externally managed portfolios are subjected to the same stringent controls, investment guidelines and performance attribution analyses as the internally managed portfolios.

The disposal and investment management of the Hong Kong equity portfolio

In 2001 the Exchange Fund, through Exchange Fund Investment Limited (EFIL), continued to dispose of Hong Kong shares acquired during the 1998 stock market operation through the Tap Facility of the Tracker Fund of Hong Kong (TraHK). By 11 April 2001, the Exchange Fund had fully recouped the cost of the market operation mainly through the Initial Public Offer of TraHK, the subsequent Tap Facility of TraHK and dividends received in respect of the Exchange Fund's Hong Kong equity portfolio. In 2001, proceeds amounting to $35,163 million were received from the disposal through the Tap Facility.

EFIL appointed further a number of external managers in 2001. These external managers, together with those appointed earlier, manage the Exchange Fund's long-term Hong Kong equity investment portfolio.

Risk management and compliance

The Risk Management and Compliance (RMC) Division at the Exchange Fund is responsible for risk control functions. It monitors the market, price, credit and operational risks arising from the investment process. It is also responsible for the selection of benchmarks and evaluation of performance and risks arising from the investment process. Externally and internally managed portfolios are evaluated against the assigned benchmark. The Division engages in detailed performance attribution analyses to identify the skills of investment managers to enhance effective asset allocation. In addition to traditional risk control tools, value-at-risk and scenario stress testing are used to quantify the market risks in the portfolios under normal as well as extreme adverse market conditions.

To keep pace with the changes in the investment approach of the Exchange Fund, the RMC Division is constantly strengthening its internal diagnostic and analytical capabilities in line with best practices in the market place.

Performance of the Exchange Fund

The financial markets in 2001

With the slowdown in the US economy, growth in other major economies also decelerated in 2001. Inflationary pressures subsided in the face of excess global capacity, and many central banks lowered short-term interests at an unprecedented pace. Economic growth prospects were further dampened by the tragic events of 11 September, which drove central banks to further monetary easing.

Equity markets fell on disappointing corporate earnings. The S&P500 lost 13% while the NASDAQ ended the year 21% lower. The Hong Kong equity market, historically more volatile than the US equity markets, declined by 24% during the year.

The performances of major bond, equity and currency markets are set out in Table 2.

The Exchange Fund's performance in 2001

The investment strategy steered a steady course through an extremely difficult investment environment in 2001. We positioned ourselves defensively by under-weighting equities and over-weighting bonds and the US dollar. The interest income and the investment gains from the bond holdings amounted to $50.8 billion. This more than offset the losses incurred in Hong Kong and foreign equities and foreign exchange, and produced an overall investment income for the Exchange Fund of $7.4 billion, or a return of 0.7% on its total assets. The result compares favourably with the returns achieved by similar funds in the private sector (Chart 1).

The investment return of the Exchange Fund relative to the investment benchmark and local inflation rate for the period from 1993 to 2001 is set out in Table 3. The performance of the Exchange Fund compares favourably with both investment benchmark and domestic inflation rate for the same period. The currency mix of the Fund's assets at 31 December 2001 is set out in Table 4.

Increased transparency

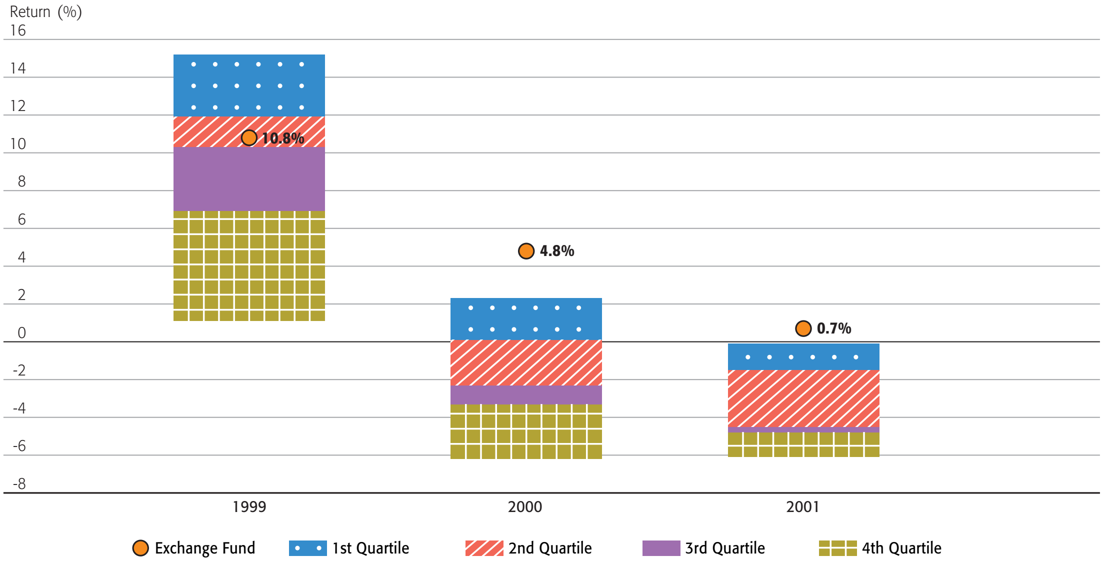
Consistent with the HKMA's commitment of moving towards greater transparency, we have implemented additional disclosure over the last three years. Commencing in 1999, an abridged balance sheet of the Fund was published on a monthly basis together with a set of Currency Board Accounts. Concurrent with this initiative were the implementation of the International Monetary Fund's (IMF) Special Data Dissemination Standard (SDDS) in monthly announcements of Hong Kong's International Reserves and Analytical Accounts of the Central Bank. The former constitutes the official currency reserves of Hong Kong and the latter comprises specifically prescribed balance sheet data. Starting from April 2000, SDDS was further strengthened by the implementation of a Data Template on International Reserves and Foreign Currency Liquidity aiming at providing a comprehensive account of the IMF participant's foreign currency assets and drains on such resources arising from various foreign currency liabilities and commitments.

Through strict adherence to the timeliness and quality of the disclosure implemented under these initiatives, the high standard of transparency of the Exchange Fund's financial position and operating results was maintained throughout 2001.

Chief Executive Joseph Yam and Executive Director (Reserves Management) Amy Yip announce the results of the Exchange Fund for the year 2001.

CHART 1

Investment performance of the Exchange Fund and a universe of comparable Balanced Funds[1]



[1] Balanced Funds with 20% – 30% equity component
Source: Watson Wyatt and Standard & Poor's

TABLE 2

2001 market returns

Currencies	
Appreciation of the US dollar	
Against the yen	15.1%
Against the euro	6.0%
Bond markets	
Merrill Lynch Global Government Bond Index, 1–10 years (in US dollar terms)	-0.8%
Equity markets	
Standard & Poor's 500 Index	-13.0%
Hang Seng Index	-24.5%

TABLE 3

Gross investment return of the Exchange Fund (in US dollar term)[1]

	Return on total assets	Return on investment benchmark[2]	CPI(A)[3]
2001	0.7%	0.4%	-6.2%
2000	4.8%	3.8%	-1.9%
1993 – 2001 cumulative	76.5%	N/A	24.3%
1993 – 2001 annualised	6.5%	N/A	2.4%

[1] For the Annual Reports in 2000 and before, return on total assets and return on investment benchmark is in Hong Kong dollar term
[2] Established since January 1999
[3] HK-CPI(A) on 1999/2000 base new series

TABLE 4

Currency mix of the Exchange Fund's assets (at 31 December 2001) – including forward transactions

	HK$ billion	%
US dollar	688.1	70.3
Hong Kong dollar	101.7	10.4
European currencies	153.9	15.7
Yen	33.0	3.4
Others	2.4	0.2
Total	**979.1**	**100.0**