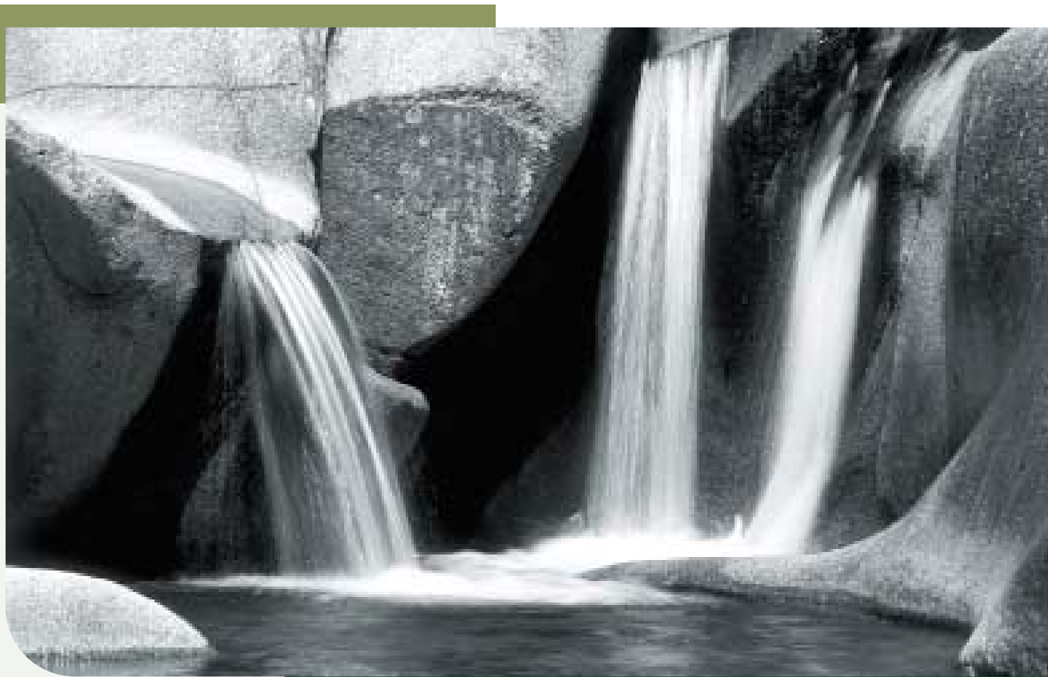
Reserves Management



In 2002 global financial markets were extremely volatile. In light of the uncertainties, the Fed funds target rate was further reduced by 50 basis points to 1.25% – a historic low. Global equity markets fell for the third consecutive year. The US dollar weakened against major currencies amid geopolitical concerns. The HKMA managed to steer through these financial headwinds by adopting a prudent investment approach in managing Hong Kong's official reserves. In 2002 the Exchange Fund achieved an investment return of 5.1%, 120 basis points above the investment benchmark.

THE EXCHANGE FUND

The Exchange Fund is one of the building blocks of monetary stability in 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 2002 the assets of the Exchange Fund amounted to $955.1 billion.

The primary objective of the Exchange Fund is to safeguard the exchange value of the Hong Kong dollar and to maintain the stability and integrity of Hong Kong's monetary and financial systems. At 31 December 2002 foreign currency reserves amounted to $872.8 billion. The investment objective of the Fund is also to maintain the long-term purchasing power of the foreign currency reserves, which 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 different markets and instruments. The management of the reserves by the HKMA is in line with international best practices.

Asset allocation of the Exchange Fund

The investment benchmark directs the Exchange Fund's long-term strategic investment, with an 80/20 ratio for bonds/equities mix and an 80/20 ratio for the US dollar bloc and other currencies. The benchmark 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 at all times will be 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 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 is 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 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. As a prerequisite to qualify as an approved investment, 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.

Stringent controls and investment guidelines have been set to monitor the risks arising from increasing volatility in the financial markets. In addition, the HKMA conducts detailed performance attribution analyses 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 global external managers located in 13 financial centres to manage some 30% of its total assets. The purpose of appointing external managers is to tap the best of the investment expertise available in the market, to capture a diverse mix of investment styles within the investment world, and to transfer market knowledge and information. The Exchange Fund's diversification into different asset classes and markets increases the range of specialist managers to be employed.

Externally managed portfolios are subjected to the same stringent controls, investment guidelines and performance attribution analyses as the internally managed portfolios. They are held with several major global master custodians.

A coincidental outcome of these appointments is the growth of Hong Kong as a fund management centre. The majority of external managers and related service providers, such as custodians, either set up or expand their presence in Hong Kong after, or coincidental with, their appointment by the Exchange Fund.

The disposal and investment management of the Hong Kong equity portfolio

In 2002 the Exchange Fund, through Exchange Fund Investment Limited (EFIL), disposed of a total of $21,977 million worth of Hong Kong equities acquired during the 1998 stock market operation through the Tap Facility of the Tracker Fund of Hong Kong (TraHK). The Tap Facility was exhausted in the fourth quarter of 2002 and was subsequently terminated. The Exchange Fund recouped a total of $165.2 billion by 31 December 2002 through the Initial Public Offer of TraHK, the Tap Facility, and dividends received in respect of the Hong Kong equity portfolio. At 31 December 2002, a total of $50.9 billion worth of Hong Kong stocks was retained by the Exchange Fund as a long term investment, representing about 5% of the Fund's total investment assets.

With effect from January 2003 the management of the Hong Kong equity portfolio was transferred from EFIL to the HKMA. The HKMA manages this portfolio through the external fund managers originally appointed by EFIL. They continue to manage their portfolios in accordance with the existing investment guidelines.

Risk management and compliance

The Risk Management and Compliance (RMC) Division is responsible for risk control functions of the Exchange Fund. It monitors the market, price, credit and operational risks arising from the investment process. The Division is also responsible for the selection of benchmarks and evaluation of performance and risk 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.

In keeping pace with 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. In 2002 it implemented a new performance attribution model for analysing the skills of equity managers further to the existing analysis for bond managers. The reports produced by these analyses provide useful information for achieving a better manager mix for the management of Exchange Fund assets.

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2002

Following a synchronised global slowdown in 2001, growth remained choppy throughout 2002 amidst increasing geopolitical risks and waning confidence in corporate reliability. Consumption in the US remained resilient, underpinned by increasing mortgage refinancing activities. Fiscal stimulus and strong housing gains also provided a boost to consumers. Both the Fed funds target rate and discount rate were reduced further by 50 basis points to historic lows of 1.25% and 0.75% respectively. The threat of war and disruption in oil output in Venezuela caused crude oil prices to surge above US$30 per barrel.

Global equity markets fell for the third consecutive year. Corporate misconduct further depressed sentiment. The S&P500 ended the year 23.4% lower, while the NASDAQ lost 31.5%. The Hong Kong equity market, historically more volatile than the US market, outperformed major global markets and lost only 18.2% in 2002.

The US dollar weakened on heightened geopolitical tension with Iraq, concern over the current account deficit in the US and weaker equities. The yen strengthened 10.4% against the dollar, and the euro rose 17.9% in 2002.

The performances of major bond, equity and currency markets are set out in Table 1.

Chief Executive Joseph Yam and Executive Director (Reserves Management) Amy Yip announce the results of the Exchange Fund for 2002.

The Exchange Fund's performance in 2002

Despite the difficult investment environment, the HKMA's investment strategy steered a steady course through the volatile financial markets by defensively over-weighting bonds and under-weighting equities. In addition, the over-weighting of the euro also contributed positively to the investment performance. In 2002, the Exchange Fund recorded an interest income and valuation gains of $54.3 billion from bond and other investments. Foreign exchange valuation gains amounted to $27.2 billion. These more than offset the losses incurred in Hong Kong and foreign equities. The investment strategy produced an overall investment income for the Exchange Fund of $47.0 billion, or an investment return of 5.1%. Although direct comparisons are not easy or appropriate, the Exchange Fund achieved an investment return that was favourable in comparison with other similar funds in the private sector (Chart 1).

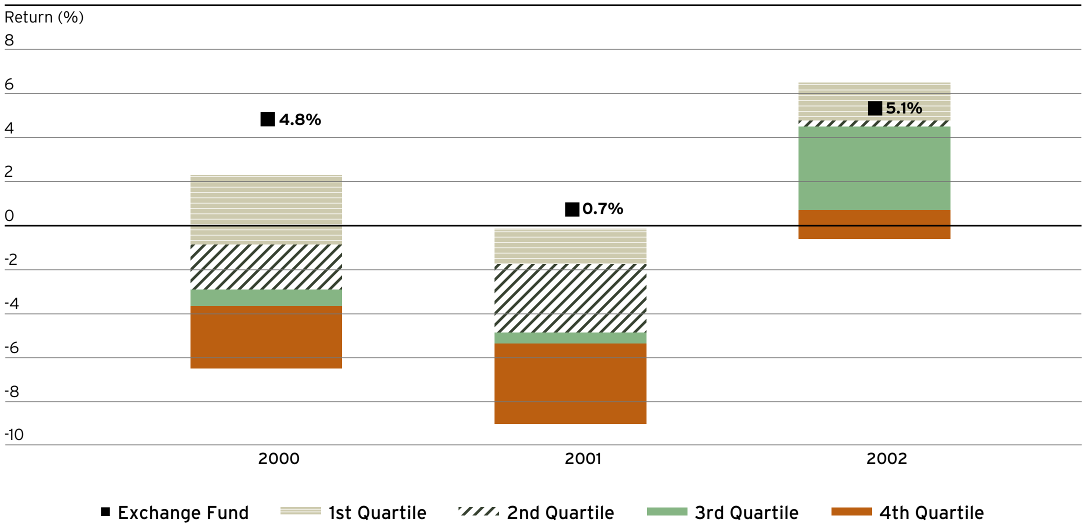
The investment return of the Exchange Fund relative to the investment benchmark and domestic inflation rate for the period from 1993 to 2002 is set out in Table 2. Since the adoption of the investment benchmark in January 1999, the Exchange Fund has achieved a compounded 5.3% annual return, or an out-performance of 190 basis points per annum above the benchmark's compounded 3.4% annual return for the same period. For the ten years from 1993 to 2002, the Exchange Fund has generated an average annual return of 6.4%, which compares favourably with the average annual inflation rate of 2.3% over the same period. The currency mix of the Fund's assets at 31 December 2002 is set out in Table 3.

Transparency

Consistent with the HKMA's commitment of transparency, four press releases on Exchange Fund data are issued by the HKMA each month. Three of these releases disseminate monetary data in accordance with the International Monetary Fund's (IMF) Special Data Dissemination Standard (SDDS). The International Reserves constitute the official currency reserves of Hong Kong and the analytical accounts of the central bank comprise specifically prescribed balance sheet data. The template on international reserves and foreign currency liquidity provides a comprehensive account of the IMF participant's foreign currency assets and drains on such resources arising from various foreign currency liabilities and commitments. The fourth release, on the Exchange Fund's Abridged Balance Sheet and Currency Board Account, is made in accordance with the HKMA's policy of maintaining a high level of transparency. This high standard of transparency was maintained throughout 2002 and helped promote the public understanding of the Exchange Fund's operating results and financial position.

» Information Centre » Press Releases » the Exchange Fund category

CHART 1 **Investment performance of the Exchange Fund and comparable Balanced Funds**[1]



[1] Balanced Funds with 20% - 30% equity component.

Source: Watson Wyatt and Standard & Poor's

TABLE 1 **2002 market returns**

Currencies	
Appreciation against the US dollar	
euro	17.9%
yen	10.4%
Bond markets	
Merrill Lynch Global Government Bond Index, 1-10 years (in US dollar terms)	18.6%
Equity markets	
Standard & Poor's 500 Index	-23.4%
Hang Seng Index	-18.2%

TABLE 3 **Currency mix of the Exchange Fund's assets (at 31 December 2002) - including forward transactions**

	HK$ billion	%
US dollar	686.6	71.9
Hong Kong dollar	63.4	6.6
European currencies	174.8	18.3
Yen	26.6	2.8
Others	3.7	0.4
Total	**955.1**	**100.0**

TABLE 2 **Gross investment return of the Exchange Fund (in US dollar terms)**[1]

	Return on total assets	Return on investment benchmark [2]	CPI(A) [3]
2002	5.1%	3.9%	+1.0%
2001	0.7%	0.4%	-6.2%
1993-2002 cumulative	86.3%	N/A	25.5%
1993-2002 annualised	6.4%	N/A	2.3%

[1] For the Annual Reports in 2000 and preceding years, return on total assets and return on investment benchmark is in Hong Kong dollar terms.

[2] Established in January 1999.

[3] December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 1999/2000 base new series.