Green volunteers plant shrubs during a campaign in the Tai Po Waterfront Park in September 2003. Hong Kong currently has over 1,000 Green Volunteers, all of whom are trained to nurture and care for trees and plants and to promote the greening of Hong Kong.

RESERVES MANAGEMENT

Global financial markets were volatile in 2003. The Fed funds target rate fell to a 45-year low of 1%. Global equity markets rebounded sharply and the US dollar fell further against the euro and the yen. The HKMA managed to steer through these financial headwinds by adopting a prudent investment approach in managing Hong Kong's official reserves. The Exchange Fund outperformed its investment benchmark and achieved an investment return of 10.2%.

THE EXCHANGE FUND

The Exchange Fund plays a central role in maintaining Hong Kong's monetary and financial stability. Since its establishment in 1935, the 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 Fund. At the end of 2003, the Fund's assets amounted to $1,011.6 billion.

The Exchange Fund's primary objective is to safeguard the exchange value of the Hong Kong currency and to maintain the stability and integrity of the monetary and financial systems. At 31 December 2003 the foreign currency reserves held by the Exchange Fund amounted to HK$919.1 billion or US$118.4 billion. It is also the investment objective of the Fund to maintain the long-term purchasing power of the reserves, which represent a store of value for the people of Hong Kong.

The high volatility in the financial markets in recent years has highlighted not only the importance of prudent investment management but also the need to diversify into various 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 Exchange Fund Advisory Committee endorsed, with effect from January 2003, some modifications to the investment benchmark for the Fund's long-term strategic asset allocation. Under the revised investment benchmark, 77% of the Fund is allocated to bonds and 23% to equities and related investments. In terms of currencies, 88% is allocated to the US dollar bloc (which includes Hong Kong dollar) and the remaining 12% to other currencies. The benchmark, which directs the Exchange Fund's long term asset allocation strategy, is derived from the Fund's investment objectives. Since 1999, the investment benchmark is reviewed regularly to ensure that it consistently meets the investment objectives. The recent review suggested some modifications in light of the changing financial landscape and the extremely high market volatility. This revised benchmark is expected to help improve the risk-adjusted return in the medium to long term.

Compared with the previous strategic asset allocation, the new investment benchmark has a lower allocation to non-US dollar currencies. With these modifications, the strategic investment benchmark is expected to continue to meet the Fund's long-term investment objectives. These objectives are

(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 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. At the time, the Backing Portfolio was established to hold highly liquid US dollar denominated assets to fully back the Monetary Base.

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

The Fund's long-term asset allocation strategy is governed by the investment benchmark. This defines the allocation of investments to different asset classes by country and by sector as well as the overall currency mix for the Fund. 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 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 by sector as well as the appropriate timing for market entries and exits. These professionals also engage in the selection of specific securities within each market.

Stringent controls and investment guidelines have been established to monitor the risks arising from increasing volatility in the financial markets. The HKMA also conducts detailed performance attribution analyses to make the most effective use of the investment skills of both internal and external managers.

Use of external managers

The Exchange Fund employs global external managers located in 13 financial centres to manage about one third of its total assets and all of its equity portfolios. 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 global investment field, and to transfer market knowledge and information. The Exchange Fund's diversification into different asset classes, management styles, and markets has increased the number and types of specialist managers employed. Looking ahead, the Exchange Fund intends to continue this diversification.

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.

Hong Kong equity portfolios

With effect from January 2003, the management of the Hong Kong equity portfolio was transferred to the HKMA from Exchange Fund Investment Limited. The HKMA manages this portfolio exclusively through external fund managers.

Risk management and compliance

The Risk Management and Compliance (RMC) Division is responsible for the 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 investment benchmarks and evaluation of investment performance. Externally and internally managed portfolios are evaluated against the assigned benchmark. The Division engages in detailed performance attribution analysis to identify the skills of investment managers to improve effective asset allocation. In addition to traditional risk control tools, value-at-risk and scenario stress testing is used to quantify the market risks in the portfolios under normal and extreme adverse market conditions.

The RMC Division continuously strengthens and upgrades its internal diagnostic and analytical capabilities in line with best market practices to keep pace with the changes in the investment approach of the Exchange Fund.

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2003

The financial markets were turbulent in 2003. An extremely accommodative monetary policy stance in the US was evident in a 45-year low Fed funds target rate of 1%. By mid-year, sentiment turned positive. The end of hostilities in Iraq coincided with strong economic data, and equity markets staged an impressive rebound. The US dollar continued to weaken against the euro and the yen. As the US dollar weakened, commodity prices surged. Gold rose almost 20% to close the year at a 7½-year high of US$415 per ounce.

Chief Executive Joseph Yam and Executive Director (Reserves Management) Amy Yip announce the results of the Exchange Fund for 2003.

TABLE 1 **2003 market returns**

Currencies	
Appreciation against the US dollar	
euro	20.2%
yen	10.7%
Bond markets	
JP Morgan US Government Bond (1-7 years) Index	2.3%
Equity markets	
Standard & Poor's 500 Index	+26.4%
Hang Seng Index	+34.9%

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

The Exchange Fund's performance in 2003

The investment strategy for the Exchange Fund steered a steady course in 2003 through an extremely difficult investment environment by adopting a defensive policy and increasing allocation to non-US dollar currencies and to equity markets. In 2003 the Exchange Fund recorded foreign exchange gains of $22.9 billion, mainly owing to the appreciation of the euro against the US dollar. Investment gains from Hong Kong equities and foreign equities were $21.2 billion and $26.8 billion respectively. Total income from bonds, at $18.8 billion, was substantially lower than previous years because of the very low interest rate environment. The investment strategy produced an overall investment income of $89.7 billion, or an investment return of 10.2%.

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]
2003	10.2%	9.5%	-1.2%
2002	5.1%	3.9%	+1.0%
1993 – 2003 cumulative	105.3%	N/A	24.0%
1993 – 2003 annualised	6.8%	N/A	2.0%

[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.

TABLE 3 **Currency mix of the Exchange Fund's assets (at 31 December 2003) — including forward transactions**

	HK$ billion	%
US dollar bloc		
US dollar [1]	786.2	77.7
Hong Kong dollar	77.9	7.7
Non-US dollar bloc	147.5	14.6
Total	**1,011.6**	**100.0**

[1] Included US dollar bloc foreign currencies such as Canadian dollar, Australian dollar and New Zealand dollar.

The investment return of the Exchange Fund relative to the investment benchmark and domestic inflation rate for the period from 1993 to 2003 is set out in Table 2. Since 1999, the Exchange Fund has achieved a compounded 6.3% annual return, or an annual out-performance of 1.7% above the investment benchmark's compounded 4.6% annual return for the same period. Since 1993, the Exchange Fund has generated a compounded annual return of 6.8%, which compares favourably with the compounded annual inflation rate of 2.0% over the same period. The currency mix of the Fund's assets at 31 December 2003 is set out in Table 3.

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. 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 2003 and helped promote public understanding of the Exchange Fund's operating results and financial position.

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