RESERVES MANAGEMENT

The investment environment was difficult in 2005 with global financial markets pulling in different directions. Rising energy prices and continued monetary tightening in the US stifled the US equity and bond markets, while a 13.2% depreciation of the euro and the yen against the US dollar offset some of the gains in the euro-zone and Japanese equities. Against this backdrop, the Exchange Fund achieved an investment return of 3.1% in 2005, which was 0.2% better than the return on its benchmark.

THE EXCHANGE FUND

The primary objective of the Exchange Fund is to safeguard the exchange value of Hong Kong's currency and to maintain the stability and integrity of the monetary and financial systems of Hong Kong. It is also the investment objective of the Fund to maintain the long-term purchasing power of the Fund, which represents a store of value for the people of Hong Kong.

The high volatility in the financial markets in recent years has highlighted the importance of risk management in the investment process and the need to diversify into new markets and instruments. The management of the Fund by the HKMA is in line with international best practices.

Investment objectives and benchmark

The Exchange Fund's long-term asset allocation strategy is governed by the investment benchmark approved by the Financial Secretary after consultation with the Exchange Fund Advisory Committee (EFAC). The investment benchmark, which represents an optimal mix of assets, is 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 that sufficient liquidity will be available for the purposes of maintaining monetary and financial stability; and

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

The investment benchmark is reviewed regularly to ensure that it is able to meet the investment objectives consistently. Under the current benchmark, which was established in January 2003, 77% of the Fund is allocated to bonds and 23% to equities and related investments. In terms of currency allocation, 88% is allocated to the US dollar bloc (which includes the Hong Kong dollar) and the remaining 12% to other currencies.

The investment process

The Exchange Fund is managed as two distinct portfolios — the Backing Portfolio and the Investment Portfolio. Since September 1998, the Hong Kong dollar Monetary Base was re-defined to include Exchange Fund Bills and Notes in addition to Certificates of Indebtedness, government-issued notes and coins in circulation and the aggregate clearing balance maintained by banks with the HKMA. Under the Currency Board arrangements, the Hong Kong dollar Monetary Base must be at least 100% backed by US dollar reserves held in the Exchange Fund. The objective of the Backing Portfolio is therefore to hold highly liquid US dollar-denominated securities to provide a full backing to the Monetary Base.

The balance of the Exchange Fund assets is held in the Investment Portfolio which invests primarily in OECD bond and equity markets to preserve the value and long-term purchasing power of the Fund.

The investment benchmark 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.

Apart from the investment benchmark, EFAC also determines the Exchange Fund's investment strategy at its regular meetings having regard to the latest market conditions. Based on the investment strategy endorsed by EFAC, the Reserves Management Department of the HKMA is responsible for making day-to-day investment decisions for the Exchange Fund with the help of fundamental analyses of different economies and assessments of market developments and trends.

Use of external managers

Apart from managing assets internally through the Reserves Management Department, the Exchange Fund also employs external fund managers, located in 14 international financial centres, to manage about one third of its assets, including all of its equity portfolios. The purpose of appointing external managers is to tap the best of the investment expertise available in the market, capture a diverse mix of investment styles within the global investment field, and transfer knowledge and information from the market to the in-house professionals. In 2005 the Exchange Fund has expanded its investments to accept a wider range of management styles and markets through the employment of additional external managers, to gain market depth and improve returns. Externally managed portfolios are subject to the same stringent controls and investment guidelines as the internally managed portfolios. Assets acquired by the external managers are placed with major global master custodians.

Equity portfolios

The management of the Hong Kong equity portfolios was transferred to the HKMA in January 2003 from Exchange Fund Investment Limited. The HKMA manages these portfolios, and other global equity portfolios, exclusively through external fund managers.

Risk management and compliance

Stringent controls and investment guidelines have been established 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 the external managers. To measure risk exposure properly, risk-control tools such as value-at-risk and scenario stress testing are deployed to assess market risks incurred by the various investment portfolios under normal and extreme adverse market conditions.

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PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2005

2005 was marked by a significant rise in energy prices and the continued removal of the accommodative monetary policy stance by the US Federal Reserve. The price of crude oil rose from US$43.5 a barrel at the beginning of 2005 to US$61 at the end of the year, and the US Federal Reserve raised the federal funds target rate eight times during the year, each time by 25 basis points, to 4.25%. This tightening drove up the short-end of the US Treasury yield curve. However, the long-end of the curve remained largely steady as the higher energy prices apparently did not trigger any inflation expectation. As a result, the US Treasury yield curve flattened noticeably with 2-year and 10-year US Treasury yields closing at 4.40% and 4.39% respectively.

Global equity markets showed mixed results in 2005. Improving economic prospects in Japan sent TOPIX up by 43.5%, while the major European stock indices rose by 13-33%. The US and Hong Kong equity markets, on the other hand, showed less impressive results as higher interest rates hurt investor sentiment. The S&P 500 ended the year only 3.0% higher, while the Hang Seng Index rose by 4.5%.

Rising US interest rates provided strong support for the US dollar in 2005, with the euro and the yen depreciating by 13.2% against the US dollar. Supported by upbeat global demand, commodity prices continued to fare well. Gold prices surged by 18% to close at US$517 an ounce.

The performance of major bond, equity and currency markets in 2005 is shown in Table 1.

Table 1. 2005 market returns

Currencies	
Appreciation(+)/depreciation(-) against US dollar	
Euro	−13.2%
Yen	−13.2%
Bond markets	
Relevant US Government Bond (1-3 years) Index	+1.6%
Equity markets	
Standard & Poor's 500 Index	+3.0%
Hang Seng Index	+4.5%

The Exchange Fund's performance in 2005

Amid the difficult investment environment, the Exchange Fund earned a gross investment income of $38.2 billion in 2005, comprising $30.2 billion from bond investments, $7.0 billion from Hong Kong equities, $20.5 billion from foreign equities, and a foreign exchange revaluation loss of $19.5 billion. The total investment income represents an investment return of 3.1%, about 0.2% better than the return of the investment benchmark for the year.

Table 2 shows the annualised investment return of the Exchange Fund relative to the investment benchmark and domestic inflation rate for the period from 1994 to 2005. In addition, the annual return of the Exchange Fund

Table 2. Gross investment return of the Exchange Fund (in Hong Kong dollar terms) [1]

	Return on total assets	Return on investment benchmark [2]	CPI(A) [3]
2005	3.1%	2.9%	+1.7%
2004	5.7%	5.7%	+0.4%
1994–2005 annualised	6.3%	N/A	+1.3%
1999-2005 annualised	5.7%	4.5%	−1.3%

1. For the Annual Reports from 2001 to 2003, return on total assets and return on investment benchmark are in US 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.

from 1994 to 2005 is set out in Chart 1. The comparison of the investment return of the Exchange Fund against the benchmark return from 1999 to 2005 is shown in Chart 2. Since 1994, the Exchange Fund has generated a compounded annual return of 6.3%, which compares favourably with the compounded annual inflation rate of 1.3% over the same period. The currency mix of the Fund's assets at 31 December 2005 is in Table 3.

Chart 1. Investment return of the Exchange Fund (1994-2005)

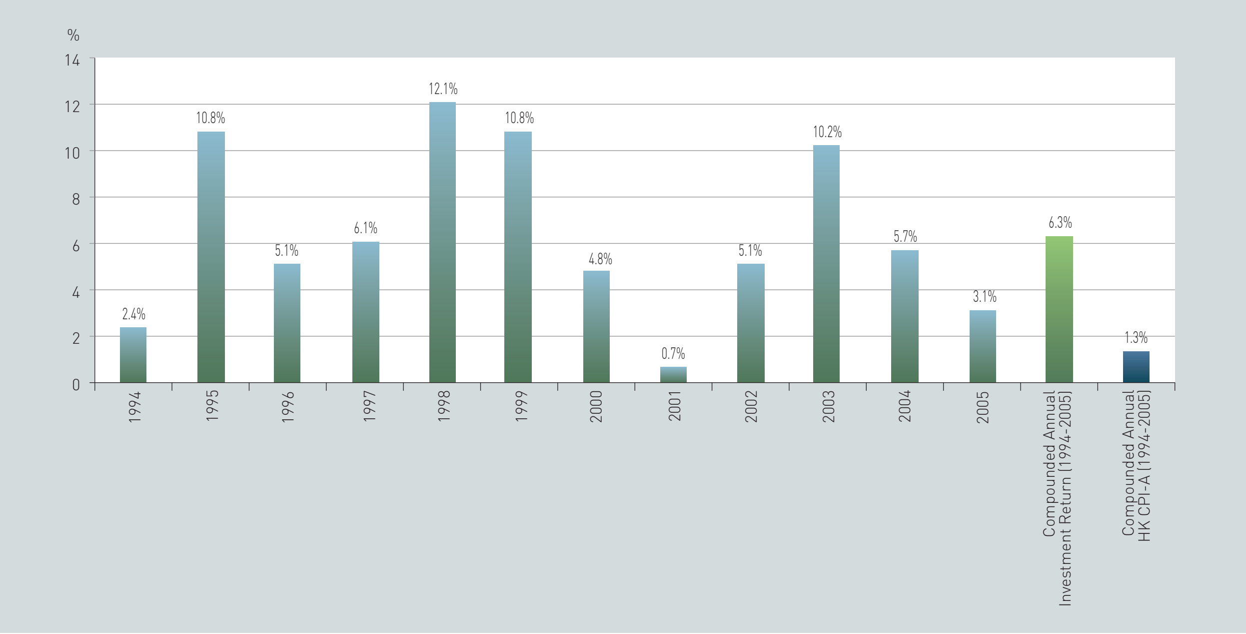

Chart 2. Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2005)

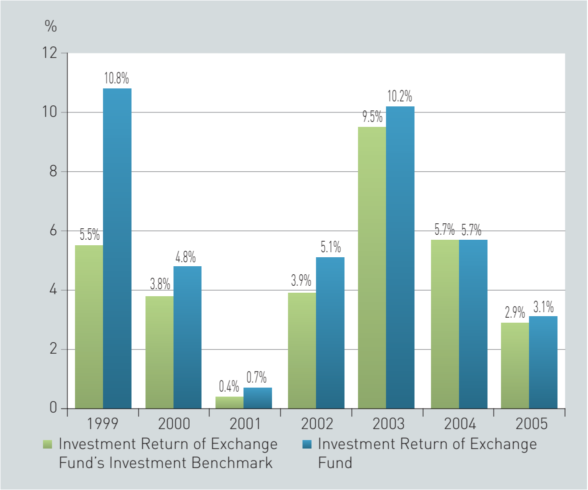

Table 3. Currency mix of the Exchange Fund's assets on 31 December 2005 – including forward transactions

	HK$ billion	%
US dollar bloc		
US dollar *	843.2	79.0
Hong Kong dollar	**95.6**	**9.0**
Non-US dollar bloc	128.0	12.0
Total	**1,066.8**	**100.0**

* Includes US dollar bloc foreign currencies such as Canadian dollar, Australian dollar and New Zealand dollar.

Transparency

The information disclosure of the Exchange Fund is one of the most transparent among central banks and monetary authorities. 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 participants' foreign currency assets and drains on such resources arising from various foreign currency liabilities and commitments. The fourth release, the Exchange Fund's Abridged Balance Sheet and Currency Board Account, is made in accordance with the HKMA's policy of transparency, which helps promote public assessment and understanding of the Exchange Fund's operating results and financial position.

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