Reserves Management

In 2006, the Exchange Fund achieved an investment return of 9.5%, or 0.6% above that of the investment benchmark, amid volatile financial markets. The year saw monetary tightening, rising energy and commodity prices, and a shift in investors' attention from the traditional US and European markets to emerging economies, particularly China and India. Global equity markets continued to show remarkable gains against a backdrop of ample liquidity and tight credit spreads, while the bond markets recovered in the latter half of the year. Although the US dollar lost its shine in the foreign exchange market, weakening against the euro by 10.5%, it finished the year stronger against the yen.

THE EXCHANGE FUND

The primary objective of the Exchange Fund, as laid down in the Exchange Fund Ordinance, is to affect, either directly or indirectly, the exchange value of the currency of Hong Kong. In addition, it can be used to maintain the stability and integrity of the monetary and financial systems of Hong Kong, with a view to maintaining Hong Kong as an international financial centre. Because of the need to meet these statutory objectives, the Exchange Fund is different from a typical investment fund and it is not appropriate to compare directly the investment results of the Exchange Fund with those of other investment funds, whose key investment objective is to maximise returns.

MANAGEMENT OF THE EXCHANGE FUND

The Exchange Fund Ordinance

The Ordinance provides for the establishment and management of the Exchange Fund. According to the Ordinance, the Exchange Fund is under the control of the Financial Secretary, and may be invested by him in any securities or other assets he, after having consulted the Exchange Fund Advisory Committee (EFAC), considers appropriate.

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 EFAC. The investment benchmark represents the optimal mix of assets designed to meet the following investment objectives endorsed by EFAC:

(a) to preserve capital;

(b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid 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.

According to the investment benchmark, the Exchange Fund is divided into two distinct portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio holds highly liquid US dollar-denominated securities to provide full backing to the Monetary Base as required under the Currency Board arrangements. The balance of the Exchange Fund is held in the Investment Portfolio, which is invested primarily in the bond and equity markets of the member countries of the Organisation for Economic Co-operation and Development to preserve the value and long-term purchasing power of the assets. Under the current benchmark, 77% of the Exchange Fund is allocated to bonds and 23% to equities and related investments. In terms of its exposure in the foreign exchange market, 88% of the Exchange Fund is allocated to the US dollar bloc (including the Hong Kong dollar) and the remaining 12% to other currencies.

The investment process

The Exchange Fund's investment strategy is determined by the Financial Secretary on the advice of EFAC, while the day-to-day management of the Fund is conducted by the Reserves Management Department (RMD) of the HKMA. In discharging its responsibilities, RMD operates within the investment guidelines endorsed by EFAC.

While the Financial Secretary determines the investment benchmark after consultation with EFAC, he also approves the limits within which the HKMA can deviate from the benchmark to take advantage of market movements in order to achieve a return that is higher than the benchmark return[1]. Such a return is known as an active return, or alpha. The investment managers of RMD monitor the global investment markets and identify suitable investment opportunities to achieve a positive alpha by exercising discretion under the delegated authority to deviate from the investment benchmark. Since the investment benchmark was established in 1999, the Exchange Fund has achieved an average positive alpha of 1.2% a year.

Use of external managers

In addition to managing assets internally, the HKMA also employs external fund managers, located in over a dozen international financial centres, to manage about one third of the Exchange Fund's assets, including all of its equity portfolios and other specialised assets. The purpose of appointing external managers is to tap the best investment expertise available in the market, capturing a diverse mix of investment styles, and transferring knowledge and information from the market to in-house professionals.

In 2006, the HKMA completed a review of its policy on the use of external managers. It concluded that external managers had benefited the management of the Exchange Fund with their complementary investment capabilities for certain approved asset classes and product types. As a result of the review, additional external managers were appointed to manage portfolios in a wider range of asset classes and markets to achieve more diversified investments and to improve long-term returns for the Exchange Fund. The appointments of some external managers with less complementary roles were terminated and the portfolios were transferred back to in-house management. While on the whole there has been an increase in management fees, the appointment of external managers plays a strategic role in helping diversify the Exchange Fund into more sophisticated asset markets and improve its return in the long run.

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 its other foreign equity portfolios, exclusively through external fund managers.

Risk management and compliance

The high volatility in the financial markets in recent years has highlighted the importance of risk management in the investment process. Stringent controls and investment guidelines have been established for both internally and externally managed portfolios. Risk-control tools are also deployed to assess market risks incurred by the various investment portfolios under both normal and extremely adverse market conditions. The HKMA also conducts detailed performance attribution analyses to make the best use of the investment skills of both internal and external managers.

› Monetary Stability › Exchange Fund

[1] The benchmark return for any accounting period is the return achieved by the benchmark portfolio during that period, assuming that the benchmark allocation of assets is strictly followed throughout the period without deviation. The benchmark return can therefore only be calculated after the completion of an accounting period.

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2006

2006 was a difficult year for bond investments because continued monetary tightening by the major central banks drove bond yields significantly higher in the first half of the year. The US Fed funds target rate reached 5.25% at the end of June 2006, after four rounds of tightening during the year, although signs of weakening growth in the US subsequently led to a pause in the increase in interest rates. The European Central Bank raised rates by a cumulative 125 basis points in 2006, bringing the key policy rate to 3.5%. The Bank of Japan ended its five-year quantitative easing policy and announced a 0.25% tightening on 14 July 2006, and the Bank of England raised interest rates twice taking the base rate to 5%.

The 10-year US Treasury bond yield peaked at 5.25% in mid-2006 before gradually easing to around 4.7% by the end of the year, while other major bond markets closely followed the US bond yield movements. The Treasury yield curve remained inverted throughout 2006.

Global equity markets made notable gains in 2006, driven mainly by investors' aggressive search for higher returns in a relatively low-yield environment. The US and the major European stock markets ended the year higher by more than 10%. The Hang Seng index rose by an impressive 34% in 2006, underpinned by the appreciation of the renminbi and record IPO activities in Hong Kong.

It was a mixed picture for the US dollar in the foreign exchange market in 2006. Rumours of major central banks divesting into non-dollar assets provided strong support for the euro, which appreciated by 11.8% against the US dollar. The yen, however, weakened by 0.9% against the US dollar, apparently penalised by the wide interest rate gap between the two currencies.

The performances of major bond, equity and currency markets in 2006 are shown in Table 1.

The Exchange Fund's performance in 2006

The Exchange Fund earned a gross investment income of $103.8 billion in 2006, comprising $31.9 billion from bond investments, $35.9 billion from Hong Kong equities, $18.7 billion from foreign equities, and a foreign exchange revaluation gain of $17.3 billion. The total investment income represented an investment return of 9.5%, which was 0.6% better than the return of the investment benchmark for the year. This active return, or alpha, was the fifth highest since 1999, when the investment benchmark for the Exchange Fund was established.

Table 2 shows the annualised investment return of the Exchange Fund relative to the investment benchmark and domestic inflation from 1994 to 2006. The annual return of the Exchange Fund from 1994 to 2006 is set out in Chart 1. The comparison of the investment return of the Exchange Fund against the benchmark return from 1999 to 2006 is shown in Chart 2. Since 1994, the Exchange Fund has generated a compounded annual return of 6.6%, which compares favourably with the compounded annual inflation rate of 1.3% over the period. Table 3 shows the currency mix of the Fund's assets on 31 December 2006.

Table 1. 2006 market returns

Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+11.8%
Yen	-0.9%
Bond markets	
US Government Bond (1-3 years) Index	+3.9%
Equity markets	
Standard & Poor's 500 Index	+13.6%
Hang Seng Index	+34.2%

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

	Return on total assets	Return on investment benchmark [2]	Alpha	CPI(A) [3]
2006	9.5%	8.9%	+0.6%	+1.9%
2005	3.1%	2.9%	+0.2%	+1.3%
1999 – 2006 annualised	6.2%	5.0%	+1.2%	-1.0%
1994 – 2006 annualised	6.6%	N/A	N/A	+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 2004/2005 base new series.

Table 3. Currency mix of the Exchange Fund's assets on 31 December 2006 – including forward transactions

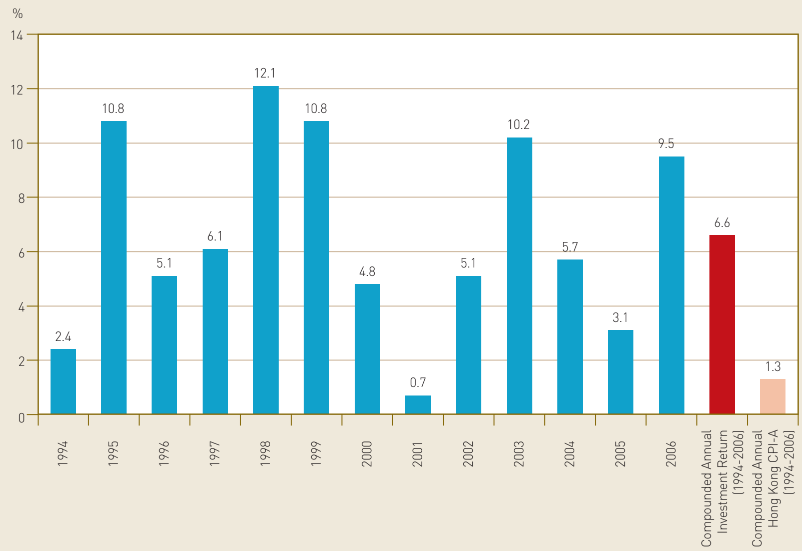
	HK$ billion	%
US dollar bloc		
US dollar[1]	909.8	77.4
Hong Kong dollar	130.9	11.1
Non-US dollar bloc	135.7	11.5
Total	1,176.4	100.0

1 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 Exchange Fund 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.

Chart 1. Investment return of the Exchange Fund (1994-2006)



Following the stringent requirements of Hong Kong's accounting standards and market best practices, the disclosure of risk management practices for the Exchange Fund has been included in the Annual Report since 2005. The information includes qualitative descriptions and quantitative measurement of the major types of risks (such as credit risk and market risk) the Exchange Fund is exposed to, and the approaches adopted to manage these risks. The disclosure improves transparency and provides the public with useful information to assist their understanding of the management of the Exchange Fund.

› Press Releases › Exchange Fund

Chart 2. Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2006)