Reserves Management

The Exchange Fund recorded an investment return of 11.8%, 126 basis points above the return on its investment benchmark in 2007. This was achieved in extremely volatile markets affected by the US sub-prime mortgage crisis and subsequent credit tightening.

THE EXCHANGE FUND

The Fund's primary objective, as laid down in the Exchange Fund Ordinance, is to affect, either directly or indirectly, the exchange value of the currency of Hong Kong. It can also be used to maintain the stability and integrity of Hong Kong's monetary and financial systems to help maintain Hong Kong as an international financial centre. The Exchange Fund is under the control of the Financial Secretary and may be invested in any securities or other assets he considers appropriate, after consulting the Exchange Fund Advisory Committee (EFAC).

MANAGEMENT OF THE EXCHANGE FUND

Investment objectives and benchmark

EFAC has set the following investment objectives for the Exchange Fund:

(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.

These objectives take full account of the statutory purposes of the Exchange Fund, and are incorporated into the investment benchmark of the Fund, which guides its long-term strategic asset allocation. Currently the bond-to-equity ratio of the benchmark is 77:23. In terms of currency mix, 88% of the benchmark is allocated to the US dollar bloc (which includes the Hong Kong dollar) and the remaining 12% to other currencies.

Having regard to the benchmark requirements, the Exchange Fund is managed under 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 Investment Portfolio 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.

In 2007, a Strategic Portfolio was established to hold shares in Hong Kong Exchanges and Clearing Limited acquired by the Government for the account of the Exchange Fund for strategic purposes. Because of the unique nature of the Portfolio, it is not included in the assessment of the investment performance of the Exchange Fund.

The investment process

The investment process of the Exchange Fund is underpinned by decisions on two types of asset allocation – the strategic asset allocation and the tactical asset allocation. The strategic asset allocation, reflected in the investment benchmark, represents the long-term optimal asset allocation given the investment objectives of the Exchange Fund. Guided by the strategic allocation, assets are tactically allocated in an attempt to outperform the benchmark and thereby achieve a positive active return, or alpha.[1] This often means the actual allocation is different from the benchmark, or strategic, allocation. The differences between the actual and the benchmark allocations are known as "tactical deviations". While the benchmark and the limits for tactical deviations are determined by the Financial Secretary in consultation with EFAC, tactical decisions are made by the HKMA under delegated authority. Within the limits allowed for tactical deviating, portfolio managers may take positions to take advantage of short-term market movements.

Investment management

Direct Investment

HKMA staff in the Reserves Management Department directly manage the investment of about two-thirds of the Exchange Fund, which includes the entire Backing Portfolio and part of the Investment Portfolio. This part of the Investment Portfolio is a multi-currency portfolio invested in the major fixed-income markets. The staff also manage positions in financial derivatives to implement investment strategies or control the risks of the Fund.

Use of external managers

In addition to managing assets internally, the HKMA employs external fund managers based 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 transfer knowledge and information from the market to in-house professionals.

Expenditures relating to the use of external managers include management and custodian fees, transaction costs and withholding tax. They are determined by, among other things, market factors and fluctuate from year to year. Details of these expenditure items, including those related to portfolios managed internally by the HKMA, can be found in the Notes to the Financial Statements of the Exchange Fund.

Risk management and compliance

The high volatility of financial markets in recent years has highlighted the importance of risk management. Stringent controls and investment guidelines have been established for both internally and externally managed portfolios, and compliance with guidelines and regulations is closely monitored. Risk-control tools are also deployed to assess market risks under both normal and 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.

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[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 end of an accounting period.

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2007

Financial markets were extremely volatile during the year. As the inflation outlook for major economies generally heightened in the first half, markets expected tighter monetary policies, and global investors continued to seek higher investment returns in the asset markets. As a result, major stock markets performed well for most of the period before the summer and major government bond markets declined as interest rates rose.

The markets changed considerably during the summer with the onset of the credit crunch stemming from the US sub-prime mortgage crisis. From early 2007, the housing slowdown in the US caused a large number of defaults on sub-prime mortgages. As the values of the underlying properties of these mortgages fell, many banks with exposure to the sub-prime mortgage market incurred heavy losses. The risk appetite of investors declined sharply in the wake of reports of write-downs by banks. There was a shortage of liquidity in the market and short-term interbank rates rose substantially for long periods.

As investors shifted their investment to safer assets and the Federal Reserve cut its federal funds target rate three times by a total of 100 basis points starting in the autumn, key government bond yields declined from their recent peaks. In the stock markets, the S&P 500 and DAX indices declined by around 10% from mid-July to late August and, after rebounding in September following an interest rate cut by the Fed, dropped again in November as a result of investor concern. The year ended with slightly easier credit conditions, as major central banks co-operated to provide liquidity support to the market.

The US dollar weakened against all major currencies during the year. In June, the Japanese yen weakened to a recent low against the US dollar, as investors built up carry-trade positions. However, a reversal in market sentiment caused by the sub-prime mortgage crisis led to the unwinding of these positions, and by November the yen had strengthened by over 10%.

The performances of major bond, equity and currency markets in 2007 are shown in Table 1.

Table 1. 2007 market returns

Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+10.9%
Yen	+6.7%
Bond markets	
Relevant US Government Bond (1-3 years) Index	+7.4%
Equity markets	
Standard & Poor's 500 Index	+3.5%
Hang Seng Index	+39.3%

The Exchange Fund's performance

The Exchange Fund earned a gross investment income of $142.2 billion in 2007, comprising $61 billion from bond investments, $55.8 billion from Hong Kong equities, $6.7 billion from foreign equities, and a foreign exchange revaluation gain of $18.7 billion. The valuation gain and dividend income of the Strategic Portfolio amounted to $4.7 billion, making a total return of $146.9 billion. The total investment income represented an investment return of 11.8% (excluding the Strategic Portfolio), which was 126 basis points better than the return of the investment benchmark for the year.

Table 2 shows the annualised investment return of the Exchange Fund compared with the investment benchmark and domestic inflation from 1994 to 2007. The annual return of the Exchange Fund from 1994 to 2007 is set out in Chart 1. Since 1994, the Exchange Fund has generated a compounded annual return of 7.0%, which compares favourably with the compounded annual inflation rate of 1.5% over the period. The comparison of the investment return of the Exchange Fund against the benchmark return from 1999 to 2007 is shown in Chart 2. Table 3 shows the currency mix of the Fund's assets on 31 December 2007.

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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]
2007	11.8%	10.6%	+1.3%	+2.8%
2006	9.5%	8.9%	+0.6%	+1.9%
1999 – 2007 annualised	6.8%	5.6%	+1.2%	-0.5%
1994 – 2007 annualised	7.0%	N/A	N/A	+1.5%

[1] For the Annual Reports from 2001 to 2003, the 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.

Chart 1. Investment return of the Exchange Fund (1994-2007)

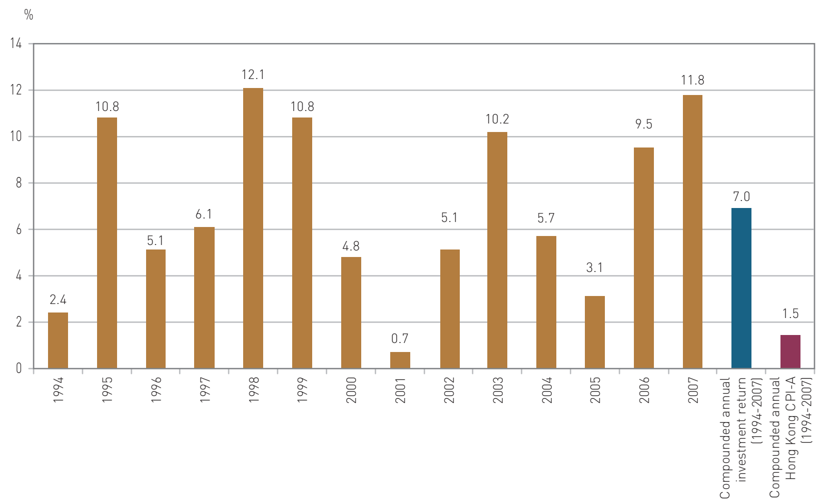

Chart 2. Investment return of the Exchange Fund and the Exchange Fund's investment benchmark (1999-2007)

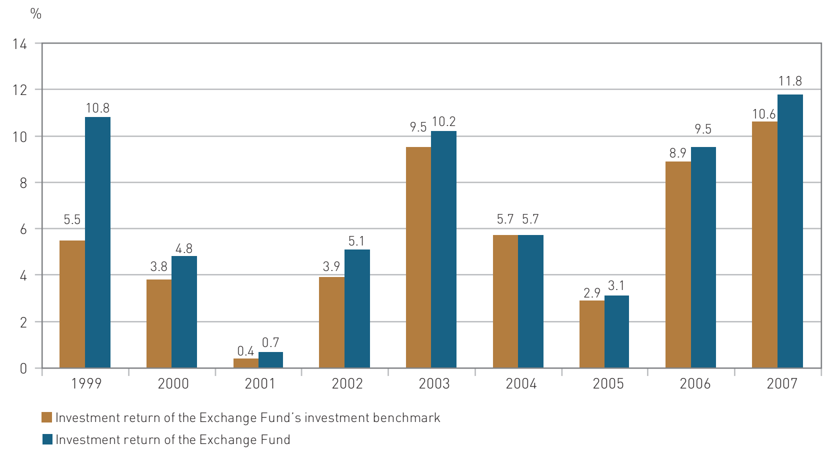

Table 3. Currency mix of the Exchange Fund's assets on 31 December 2007 – including forward transactions

	HK$ billion	%
US dollar bloc		
US dollar[1]	1,032.6	73.0
Hong Kong dollar	215.5	15.2
Non-US dollar bloc	166.3	11.8
Total	1,414.4	100.0

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