

# Reserves Management

The Exchange Fund recorded an investment return of 4.4% in 2012. Despite the highly uncertain investment environment, the Investment Portfolio, excluding contributions from the Long-Term Growth Portfolio (LTGP), achieved a return of 8%.

## THE EXCHANGE FUND

The Exchange 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. The Fund may 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 portfolio structure

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 help 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 portfolio structure and the target asset mix of the Fund.

Broadly speaking, the Exchange Fund has two major portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio holds highly liquid US dollar-denominated assets 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. The long-term target bond-to-equity mix for the two portfolios as a whole is 75:25. In terms of target currency mix, 79% of the assets are allocated to the US dollar and the Hong Kong dollar, and the remaining 21% to other currencies.

To better manage risks and enhance returns in the medium and long term, the HKMA has been diversifying part of the Fund's investment, in a prudent and incremental manner, into a greater variety of asset classes, including emerging market bonds and equities, private equity, overseas investment properties, and Mainland bonds and equities. These assets had been housed under the LTGP. In November 2012, EFAC reviewed the HKMA's work in managing the LTGP. On the advice of EFAC, the Financial Secretary decided that the cap for the portfolio should be maintained at one-third of the Accumulated Surplus of the Exchange Fund. He also decided that all emerging market equities and bonds including Mainland assets would be grouped under the Investment Portfolio while private equity and real estate would remain in the LTGP, thereby allowing more room for the Exchange Fund to further pursue diversification of investments.

The Strategic Portfolio, established in 2007 to hold shares in Hong Kong Exchanges and Clearing Limited that were acquired by the Government for the account of the Exchange Fund for strategic purposes, is not included in the assessment of the Fund's investment performance because of the unique nature of this Portfolio.

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## **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 achieve an excess return over the benchmark. 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 deviations, 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 80% 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 20% of the Exchange Fund’s assets, including all of its listed 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.

Expenditure relating to the use of external managers includes fund management and custodian fees, transaction costs, and withholding and other taxes. The expenditure is primarily determined by market factors, and may fluctuate from year to year.

### ***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 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.

## PERFORMANCE OF THE EXCHANGE FUND

### The financial markets in 2012

Global financial markets continued to be volatile. Amid heightened concerns about the future of the euro and the adverse impact on the economic environment in the euro area, major equity markets in developed economies suffered a correction in the second quarter that erased most of the gains in the previous quarter. Markets then rallied in the second half of the year, supported by further accommodative monetary policies of major central banks, and some compromise among US politicians to mitigate the negative effects of the “fiscal cliff” on the US economy.

On the bond markets, continued assurances of a prolonged low interest rate environment, additional asset purchases by the US Federal Reserve and, to some extent, the escalating European sovereign debt crisis, supported

US Treasuries. The 10-year US Treasury yield kept below 2% for most of the year, while other major government bond yields moved largely in tandem with the Treasury yields.

On currency markets, the euro weakened in the second quarter as market sentiment deteriorated over the sovereign debt crisis in the European peripheral countries, but rebounded after the European Central Bank allayed investors’ concerns by pledging to purchase euro area sovereign bonds. The yen weakened substantially against the dollar in the fourth quarter as the newly elected Prime Minister vowed to push for more aggressive easing to alleviate the stringent deflationary pressure in Japan.

The performance of major currency, bond and equity markets in 2012 is shown in Table 1.

**Table 1** 2012 market returns

#### Currencies

Appreciation (+)/depreciation (-) against US dollar

|      |        |
|------|--------|
| Euro | +1.6%  |
| Yen  | -11.0% |

#### Bond markets

|   |       |
|---|-------|
| Relevant US Government Bond (1 - 3 years) Index | +0.4% |
|---|-------|

#### Equity markets <sup>1</sup>

|                             |        |
|-----------------------------|--------|
| Standard & Poor’s 500 Index | +13.4% |
| Hang Seng Index             | +22.9% |

<sup>1</sup> Market performance on equities is based on index price change during the year.

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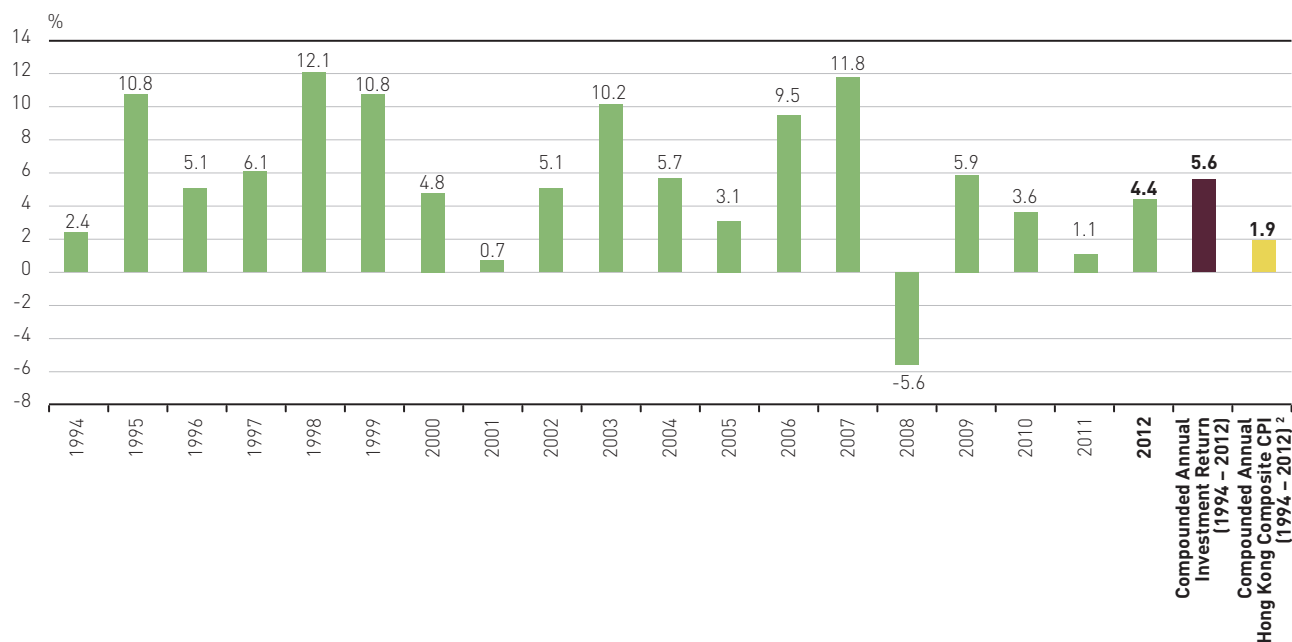
## The Exchange Fund's performance

The Exchange Fund recorded an investment income of \$111.6 billion in 2012, comprising gains from Hong Kong and foreign equities of \$30.7 billion and \$42.8 billion respectively, a total return from bonds and a valuation gain on other investments held by the investment holding subsidiaries of the Fund of \$33.1 billion and \$6.4 billion respectively, and a loss of \$1.4 billion from foreign exchange revaluation. Apart from the \$111.6 billion investment income, the valuation gain and dividend income of the Strategic Portfolio amounted to \$0.8 billion.

The investment return of the Exchange Fund after excluding the Strategic Portfolio was 4.4%. The annual return of the Fund from 1994 to 2012 is set out in Chart 1. Table 2 shows the 2012 investment return and the average investment returns of the Fund over a number of different time horizons. The average return was 3.0% over the past three years, 1.8% over the past five years, 4.9% over the past 10 years and 5.6% since 1994.<sup>1</sup> Table 3 shows the currency mix of the Fund's assets on 31 December 2012.

<sup>1</sup> Averages over different time horizons are calculated on an annually compounded basis.

**Chart 1** Investment return of the Exchange Fund (1994 – 2012) <sup>1</sup>



<sup>1</sup> Investment return calculation excludes the holdings in the Strategic Portfolio.

<sup>2</sup> Composite Consumer Price Index is calculated based on the 2009/2010-based series.

**Table 2** Investment return of the Exchange Fund in Hong Kong dollar terms <sup>1</sup>

|                               | Investment return <sup>2 &amp; 3</sup> |
|-------------------------------|--|
| 2012                          | 4.4%                                   |
| 3-year average (2010 – 2012)  | 3.0%                                   |
| 5-year average (2008 – 2012)  | 1.8%                                   |
| 10-year average (2003 – 2012) | 4.9%                                   |
| Average since 1994            | 5.6%                                   |

<sup>1</sup> The investment returns for 2001 to 2003 are in US dollar terms.

<sup>2</sup> Investment return calculation excludes the holdings in the Strategic Portfolio.

<sup>3</sup> Averages over different time horizons are calculated on an annually compounded basis.

**Table 3** Currency mix of the Exchange Fund's assets on 31 December 2012 (including forward transactions)

|                     | HK\$ billion   | %            |
|---------------------|----------------|--------------|
| US dollar           | 2,122.1        | 76.3         |
| Hong Kong dollar    | 193.3          | 7.0          |
| Others <sup>1</sup> | 465.7          | 16.7         |
| <b>Total</b>        | <b>2,781.1</b> | <b>100.0</b> |

<sup>1</sup> Other currencies included mainly Australian dollar, Canadian dollar, euro, renminbi, sterling and yen.