Reserves Management

The Exchange Fund recorded an investment return of 2.7% in 2013. Despite the volatile global financial and investment environment, the Investment Portfolio, which does not include contributions from the Long-Term Growth Portfolio (LTGP), achieved a return of 4.9%.

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 74:26. In terms of target currency mix, 77% of the assets are allocated to the US dollar and the Hong Kong dollar, and the remaining 23% 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 and Mainland bonds and equities, private equity, and overseas investment properties. These assets were housed under the LTGP, but starting from 2013, all emerging market and Mainland bonds and equities were transferred to the Investment Portfolio. The LTGP now holds only private equity and real estate investments. The cap for the net asset value of the LTGP is maintained at one-third of the Accumulated Surplus of the Exchange Fund.

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.

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 75% of the Exchange Fund, which includes the entire Backing Portfolio and part of the Investment Portfolio. This part of the Investment Portfolio includes a set of portfolios invested in major fixed-income markets and various derivative overlay portfolios implementing macro risk management strategies for 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 25% 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 to capture 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 2013

The global investment environment in 2013 continued to be volatile. US Treasury yields surged sharply in response to the US Federal Reserve's first hint in May of a possible scaling down of asset purchases, with the 10-year US Treasury yield once rising more than 100 basis points after staying below 2% for much of the early part of the year. Thereafter, US Treasury yields were mainly driven by concern over the Federal Reserve's hinting at reducing its asset purchase programme. The Federal Reserve eventually announced its reduction of asset purchases starting from January 2014 at the Federal Open Markets Committee meeting in December. The 10-year US Treasury yield continued to rise in the second half of 2013 to close the year at above 3%. Other major government bond yields moved largely in tandem with the Treasury yields, with the exception of the Japanese Government Bond market which was supported by the Bank of Japan's aggressive monetary easing policy.

On equity markets, investor sentiment remained generally favourable throughout the year. Together with support from abundant liquidity and improving economic fundamentals, major stock markets posted impressive gains, with American and European equities reaching consecutive record highs. Emerging market equities, however, lagged behind the performance of the developed markets, due to heightened concerns over potentially strong capital outflows as a result of the US's policy normalisation.

On currency markets, the euro strengthened in the second half of the year as market confidence returned on the back of recovering European economic fundamentals, and a receding concern for the euro-zone sovereign debt crisis. On the other hand, the Bank of Japan's aggressive monetary easing policy introduced in April further weakened the yen. Despite some short-lived corrections in the middle of the year arising from the market's doubt over "Abenomics", the yen continued to weaken for the rest of the year as the market started to price in the probability of further monetary policy easing in Japan.

The performance of major currency, bond and equity markets in 2013 is shown in Table 1.

Table 1 2013 market returns

Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+4.5%
Yen	–17.7%
Bond markets	
Relevant US Government Bond (1 – 30 years) Index	–3.4%
Equity markets [1]	
Standard & Poor's 500 Index	+29.6%
Hang Seng Index	+2.9%

[1] Market performance on equities is based on index price change during the year.

Reserves Management

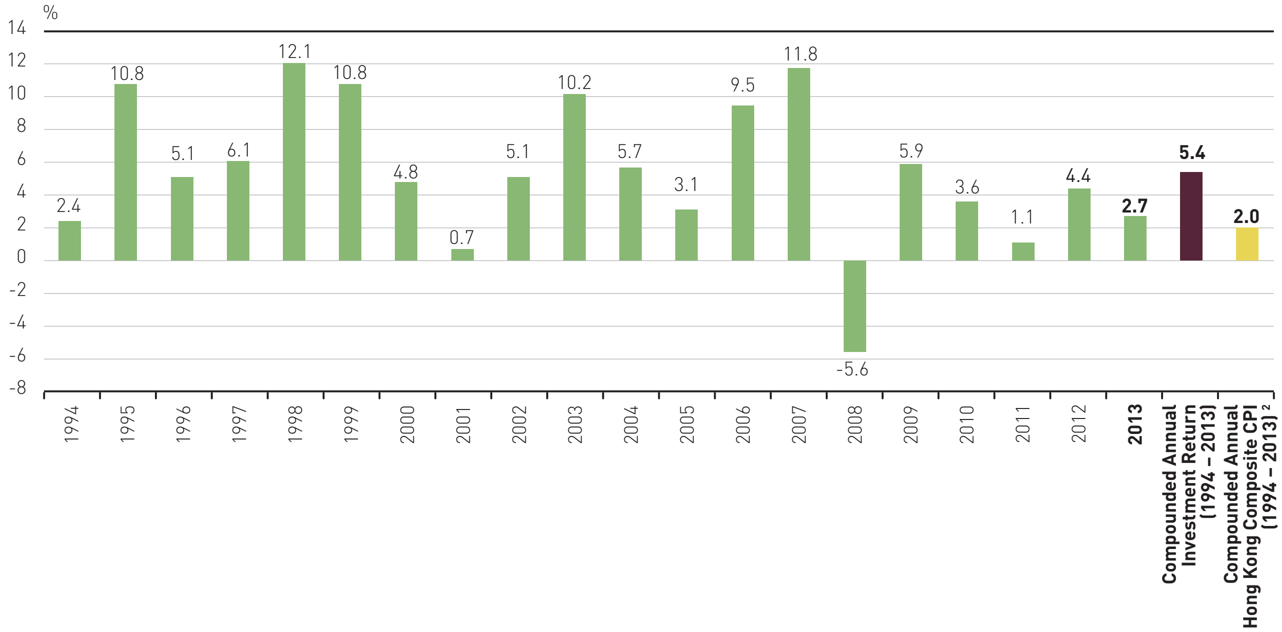
The Exchange Fund's performance

The Exchange Fund recorded an investment income of $81.2 billion in 2013, comprising valuation gains from Hong Kong and foreign equities of $10.1 billion and $71.8 billion respectively, a valuation gain on other investments held by the investment holding subsidiaries of the Fund of $16.8 billion, an exchange valuation gain of $1.6 billion, and a valuation loss of $19.1 billion from bonds. Apart from the $81.2 billion investment income, the valuation loss and dividend income of the Strategic Portfolio amounted to an overall gain of $48 million.

The investment return of the Exchange Fund after excluding the Strategic Portfolio was 2.7%. The annual return of the Fund from 1994 to 2013 is set out in Chart 1. Table 2 shows the 2013 investment return and the average investment returns of the Fund over a number of different time horizons. The average return was 2.7% over the past three years, 3.5% over the past five years, 4.1% over the past 10 years and 5.4% since 1994.[1] Table 3 shows the currency mix of the Fund's assets on 31 December 2013.

1 Averages over different time horizons are calculated on an annually compounded basis.

Chart 1 **Investment return of the Exchange Fund (1994 – 2013)** [1]



[1] Investment return calculation excludes the holdings in the Strategic Portfolio.
[2] 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** [1]

	Investment return [2 & 3]
2013	2.7%
3-year average (2011 – 2013)	2.7%
5-year average (2009 – 2013)	3.5%
10-year average (2004 – 2013)	4.1%
Average since 1994	5.4%

[1] The investment returns for 2001 to 2003 are in US dollar terms.
[2] Investment return calculation excludes the holdings in the Strategic Portfolio.
[3] 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 2013 (including forward transactions)**

	HK$ billion	%
US dollar	2,250.0	74.2
Hong Kong dollar	278.6	9.2
Others [1]	504.2	16.6
Total	**3,032.8**	**100.0**

[1] Other currencies included mainly Australian dollar, Canadian dollar, euro, renminbi, sterling and yen.