Remarks by Mr Norman T. L. Chan,
Chief Executive of the Hong Kong Monetary Authority
on 14 January 2013
at the announcement of
Exchange Fund's investment results for 2012

(Translation)

<u>Investment performance of the Exchange Fund in 2012</u>

I am going to announce the investment results of the Exchange Fund in 2012. Benefitting mainly from the favourable performance of the global equity markets in the first quarter and the second half of last year, the Exchange Fund recorded gains of HK$73.3 billion from equities, of which, Hong Kong equities contributed HK$30.7 billion. Gains from bonds amounted to HK$33.1 billion. Gains on other investments were HK$3.6 bn. On the other hand, investment in foreign exchange recorded a very small loss of HK$1.4 billion. Overall, the Exchange Fund achieved an investment income of HK$108.6 billion for the full year of 2012.

2. In terms of dollar amount, the investment income of HK$108.6 billion achieved in 2012 is the second highest in the history of the Exchange Fund. The rate of return in 2012 was 4.4%, of which the return on the Backing Portfolio was 0.4%. Meanwhile, the Investment Portfolio, excluding the contributions from diversified investments, achieved a rate of return of 8% for 2012.

3. In 2012, the fee payments to the Fiscal Reserves amounted to HK$37.8 billion, while the fee payments to placements by HKSAR government funds and statutory bodies amounted to HK$8 billion. The Accumulated Surplus of the Exchange Fund increased by HK$55.8 billion to HK$623.7 billion.

<u>Latest developments in investment diversification</u>

4. Let's now turn to the latest developments regarding investment diversification of the Exchange Fund.

5. As at the end of 2012, the aggregate market value of the diversified investments of the Exchange Fund, i.e. the Long-Term Growth Portfolio, was HK$149 billion. This was made up of emerging market bonds and equities of HK$41 billion, private equity HK$47 billion, real estate HK$14 billion and renminbi bonds and equities HK$47 billion. Outstanding investment commitment of the Long-Term Growth Portfolio at the end of 2012 was HK$64 billion.

6. I have repeatedly emphasised that the Long-Term Growth Portfolio investments are medium to long term investments with relatively low liquidity, and we should not focus too much on the short-term returns of these investments. Having said that, I would like to report that the overall performance since the HKMA began to invest in these new asset classes in 2008 has been quite satisfactory. The annualised internal rate of return on private equity funds and real estate is approximately 10% while the annualised rate of return on emerging market bonds and equities including renminbi assets is 8%.

7. As the total amount of diversified investments is approaching the cap of one-third of the Accumulated Surplus of the Exchange Fund, the Exchange Fund Advisory Committee (EFAC) reviewed in November 2012 the HKMA's work in managing the Long-Term Growth Portfolio and decided that the cap for the Long-Term Growth Portfolio should be maintained at one-third of the Accumulated Surplus of the Exchange Fund. Moreover, given the improvement of liquidity and depth of the markets for emerging market equities and bonds, the EFAC has decided to group all emerging market equities and bonds including RMB assets under the "Investment Portfolio", thereby allowing more room for the Exchange Fund to further pursue diversification of investments.

Investment outlook for 2013

8. While we managed to achieve a decent return for the Exchange Fund in 2012, the global financial markets were indeed quite volatile and choppy last year. I expect

that global financial markets will continue to be subject to many uncertainties in 2013. Although Europe has earned some respite from its debt crisis, the outlook for the real economy and employment situation in the eurozone does not provide any ground for optimism. As for the US, the momentum for growth remains lacklustre. While the full impact of a “fiscal cliff” was averted with a last-minute tax deal between the Democrats and the Republicans, we expect major challenges over raising the country’s debt ceiling and reducing government spending by the end of February this year. Should this highly politically charged process be managed poorly, tremors similar to those that shook the global financial markets in August 2011 may recur. At present, sentiment in the US and European stock markets is rather positive. However, we must be mindful that the current asset prices are the result of both close-to-zero interest rate and the massive quantitative easing by the US and other major advanced countries. The valuations of the equity markets do not appear to be supported by improved fundamentals, and it is unclear how long they can hold. Furthermore, the US Treasury yields have already dropped to very low levels following several rounds of quantitative easing, with the 10-year Treasuries yield falling below 2%. Investors who rely on interest incomes from their bond holdings are greatly affected. The movement of the yield curve in the future is also fraught with great uncertainties. In this highly unstable macro economic environment, the HKMA will continue to manage the Exchange Fund prudently and pursue the investments in the Long-Term Growth Portfolio in a gradual manner.