



The Management of the Exchange Fund's Assets

At HK\$408 bn, or HK\$66,400 per person in the Territory, the Exchange Fund represents a significant asset for the people of Hong Kong, and the management and investment of those assets is a major responsibility of the Monetary Authority's Reserves Management Department.

Investment strategy

The choice of strategy for the Exchange Fund is determined by the statutory purposes for which the Exchange Fund was created and is maintained. These are "to affect... the exchange value of the currency of Hong Kong", and "to maintain the stability and integrity of the monetary and financial systems of Hong Kong". Because the circumstances in which the Monetary Authority might need to draw upon the Exchange Fund to carry out these two purposes cannot be predicted or known in advance, the management strategy that the Monetary Authority pursues for the assets of the Fund places a very high degree of emphasis on liquidity and the security of the assets, so that they can be available at short notice whenever required.

Within these two constraints, the assets are invested to maximise long term return. This approach can be summarised as follows:

"The Monetary Authority manages the Exchange Fund with the objective of maximising the long term return on the Fund, subject to ensuring that there is always adequate security of the assets of the Fund and sufficient liquidity to

meet the various calls that may be placed upon the Fund."

The major review of the investment operations and strategy that was initiated on the formation of the Monetary Authority in April 1993 is now largely complete, and the investment style and strategies pursued by the Monetary Authority now closely resemble that of comparable central banks and monetary authorities.

In giving effect to the investment strategy, the Monetary Authority identifies three main operational functions for the assets held in the Exchange Fund. It is important to observe that these are *operational* functions; the strategic purposes remain as laid down in the Exchange Fund Ordinance and at all times have priority over the operational functions outlined below. Thus, despite the notional division of the Exchange Fund into the various portfolios, all the assets remain available at all times to meet the statutory purposes of the Fund.

The three operational portfolios are:

(a) a portfolio of assets to act as a hedge against the interest-bearing

liabilities of the Fund, to ensure that the Fund can at all times meet all of the claims upon it;

(b) a portfolio of liquid reserves to be available whenever required to meet market operational needs; and

(c) an investment portfolio to preserve the value of the Fund for future generations of the people of Hong Kong.

The investment management style for these three portfolios is different. For the first of the three, a portfolio of money market and fixed income securities denominated in HK dollars and US dollars is held to match the maturity profile of the liabilities. The prime consideration in choosing the investments for this portfolio is the credit standing of the issuers; this is to provide maximum security for the assets and ensures that holders of the Exchange Fund's liabilities (eg Exchange Fund Bills and Notes) have the greatest protection and assurance that those liabilities will at all times be honoured.

For the liquidity tranche, the Exchange Fund hold prime liquid US dollar denominated money market

securities. The choice of US dollars is determined partly because the US dollar remains the base currency for the foreign exchange markets of the world and for the Monetary Authority's market operations, and partly because the money markets in New York are by a long way the largest and most liquid in the world, enabling very large sums to be mobilised if required without disturbing the market.

The investment portfolio is a multi-currency portfolio invested in the major money markets and fixed income markets of the world, with a small holding in US equities. The majority of the assets (over two-thirds) are held in US dollars, reflecting the fact that the base currency for the Exchange Fund is the HK dollar. But the holdings of other currencies (mostly DM and Yen) add valuable diversification and long term return to the Fund. The currency allocation is a long term decision: the Monetary Authority does not manage the currency positions aggressively and is at pains to ensure that all currency switches are done in a manner so as to not disrupt markets (see chart).

The investment portfolio is a long term one, and is invested to produce excess return over a long term benchmark. It is important to realise that, for portfolios of this type, returns can go down as well as up, and in the short term adverse market and currency movements (ie

List of Authorised Investments

The authority for the investments held by the Exchange Fund is the Exchange Fund Ordinance. Section 3(2) of the Ordinance states that:

"The Fund, or any part of it, may be held in Hong Kong currency or in foreign exchange or in gold or in silver or may be invested by the Financial Secretary in such securities or other assets as he, after having consulted the Exchange Fund Advisory Committee, considers appropriate; and the Financial Secretary may for the account of the Fund

- (a) *buy or sell such currency, foreign exchange, gold, silver, securities or assets accordingly; and*
- (b) *after having consulted the Exchange Fund Advisory Committee, enter into any financial arrangement that he considers appropriate for the prudent management of the Fund."*

The day-to-day management of the Fund is carried out by the Monetary Authority, operating under delegated authority from the Financial Secretary and within investment guidelines approved by the Exchange Fund Advisory Committee. These guidelines include a list of authorised investments and instruments; the current guidelines specify a list of authorised investments and financial arrangements that include:

- (i) Cash, call accounts and fixed deposits in HK\$ and various specified foreign currencies, with specified approved banks.
- (ii) Certificates of deposit, bankers acceptances and dated floating rate debt instruments issued by specified approved banks.
- (iii) The following marketable securities: Dated bonds, notes and other debt instruments, including Treasury Bills and other discount securities, issued by or carrying an unconditional guarantee of punctual payment of interest, principal and premium (if any) by specified approved issuers.
- (iv) "Strips" or Zero-coupon instruments constructed from any instrument in (iii) above.
- (v) Overseas equities traded on various specified approved stock exchanges.
- (vi) Sale and repurchase operations involving the above instruments.
- (vii) Forward dated foreign exchange contracts with specified approved banks.
- (viii) Deliverable bond futures and equity index futures traded on recognised and approved exchanges.
- (ix) Exchange traded currency option contracts traded on recognised and approved exchanges.
- (x) Interest rate swap arrangements.
- (xi) Gold and silver.

rising interest rates, or a stronger US dollar) will cause this portfolio to show reductions in value. However, over the long term, this portfolio has produced excess returns and has outperformed a more conservative short term investment strategy.

Most of the assets are managed directly by the Monetary Authority's Direct Investment Division, which grew further in 1994 and now numbers 10 staff including support and Information Technology personnel. The rest of the assets are

placed with private sector fund managers in Hong Kong and overseas, who manage portfolios on a discretionary basis in line with instructions and guidelines from the Monetary Authority. The results of the external managers are compared to those of the Monetary Authority's own investment management, and are then combined with them in the overall Exchange Fund accounts. These accounts are now published semi-annually, after a decision in March 1995 to move from the previous annual publication.

Investment returns in 1994

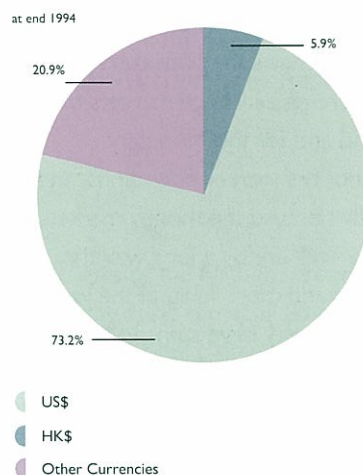
The assets of the Exchange Fund grew overall by HK\$60 bn in 1994, up 17% from the level of HK\$348 bn at end-1993. However, most of this growth in the assets reflected an increase in public savings with the Fund, such as transfers from the fiscal reserves, and in Certificates of Indebtedness, outstanding Exchange Fund bills and notes, and other liabilities. Such changes to the Fund's balance sheet affect both assets and liabilities equally, and do not change the net position of the Fund. By contrast, changes in the net assets, or Accumulated Surplus of the Fund, arise solely from the investment performance.

Prevailing market conditions in world bond markets in 1994 were very

unfavourable for holders of fixed income assets. Following the US Federal Reserve's decision to raise interest rates in February 1994, the first of six such increases in the year, interest rates and bond yields rose in almost all markets, and as a result the prices of fixed income bonds fell sharply. In the markets that the Exchange Fund is invested in, total returns for the year (ie the return from coupon income, plus the return from changes in the prices of bonds) ranged from -1.84% in DM to -6.89% in British pounds. These returns are the worst in percentage terms for well over 30 years and among the worst this century.

The Exchange Fund, as a large net holder of assets, was not immune to these adverse price movements. However, the Monetary Authority took action to reset the Fund to a very defensive stance early on in 1994, and this, coupled with the tighter control of market exposures possible with the improved management information systems now in place, enabled the Exchange Fund to avoid the worst effects of the fall in markets and to recoup fully losses incurred in the opening months of the year when bond prices began their fall. As a result the Exchange Fund's accumulated surplus showed a small increase over the year as a whole of \$1,068 mn.

Chart: Currency Mix of the Fund's Assets



Although this is the smallest percentage increase in the accumulated surplus for 10 years, it should be viewed together with the extraordinary gains of 1993 when markets were much more friendly to holders of fixed income assets. As a long term investment fund, the performance of the Exchange Fund, and the returns on the assets in the Fund, will always reflect the cyclical nature of world markets, and the gains of 1993 were clearly unrepeatable in 1994. That these exceptional gains have been preserved intact and even added to in one of the most difficult and adverse years for investors in the last 30 years is evidence that the prudent, conservative approach that the Monetary Authority has adopted towards the management of the Exchange Fund is appropriate and justified.

Exchange Fund Balance Sheet

HK\$m	1988	1989	1990	1991	1992	1993	1994
as at 31 December							
ASSETS							
Foreign currency assets	127,089	149,152	192,323	225,333	274,948	335,499	384,359
Hong Kong dollar assets	5,962	9,625	3,874	10,788	12,546	12,987	24,126
	133,051	158,777	196,197	236,121	287,494	348,486	408,485
LIABILITIES							
Certificates of Indebtedness	31,731	37,191	40,791	46,410	58,130	68,801	74,301
Fiscal Reserves Account	38,269	52,546	63,226	69,802	96,145	115,683	131,240
Coins in circulation	1,890	2,012	2,003	2,299	2,559	2,604	3,372
Exchange Fund Bills and Notes	0	0	6,671	13,624	19,324	25,157	46,140
Balance of banking system	860	978	480	500	1,480	1,385	2,208
Other liabilities	2,554	1,603	391	4,834	3,220	7,314	22,614
	75,304	94,330	113,562	137,469	180,858	220,944	279,875
ACCUMULATED EARNINGS	57,747	64,447	82,635	98,652	106,636	127,542	128,610

Note: As explained in the audited statement of the accounts (pages 66 to 69) figures for 1993 and 1994 shown above reflect accounting policies adopted in 1994. Figures for 1992 and prior years have not been restated.



A series of seven Bauhinia coins was introduced in 1993 and 1994. The new coins, which depict the Bauhinia, the flower of Hong Kong, do not bear reference that would become inappropriate to the status of Hong Kong as a Special Administrative Region of China from July 1997.



Hong Kong in the 1990s.

