The Management of the Exchange Fund's Assets

AT HK$461 BN, OR HK$73,100 PER PERSON IN THE TERRITORY, THE EXCHANGE FUND IS A VERY SIGNIFICANT ASSET FOR THE PEOPLE OF HONG KONG. THE RESERVES MANAGEMENT DEPARTMENT OF THE HKMA IS RESPONSIBLE FOR MANAGING THE INVESTMENT OF THE FUND, AND MAINTAINS A CONSISTENT, PRUDENT AND CONSERVATIVE APPROACH IN DISCHARGING THIS IMPORTANT RESPONSIBILITY.

INVESTMENT STRATEGY

The strategic purposes of the Exchange Fund are set out in the Exchange Fund Ordinance, Chapter 66 of the Laws of Hong Kong, and 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".

In its management of the Fund in pursuit of these purposes, the HKMA continues to make use of both its internal management team, and also a list of external fund managers. About three quarters of the assets of the Exchange Fund are managed internally, with the remaining one quarter managed by the external managers.

The internal management is conducted by the HKMA's Direct Investment Division, who conduct their operations in three separate portfolios of assets. The first is a Hedging Portfolio consisting of assets as a hedge against the interest-bearing liabilities of the

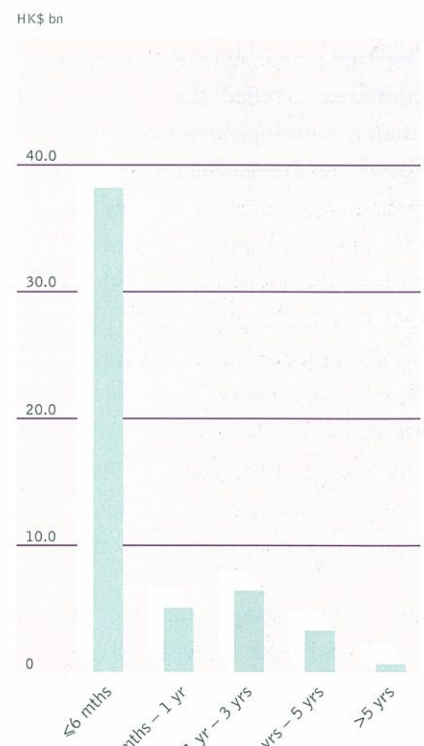
Fund. The second is a Liquidity Portfolio of reserves to meet market operational needs whenever required. And the third is an Investment Portfolio whose main purpose is to preserve the value of the Fund for the future benefit of the people of Hong Kong.

As the purposes for which the three portfolios are set up are different, their investment strategies also differ. For the Hedging Portfolio, the primary concerns in investing the assets are credit quality, which is kept extremely high, and the maturity of the assets, which is largely chosen to match the maturity of the liabilities being hedged. The portfolio consists of HK dollar and US dollar money market and fixed income securities. This emphasis on credit quality and maturity affords the maximum assurance to holders of the Exchange Fund's liabilities that their claims will be honoured in full and on time.

As a subset of the liabilities of the Exchange Fund, the Bills and Notes issued by the Fund play an important role. These securities are actively traded in the secondary market, and provide a yield curve for Hong Kong government debt. The maturity profile of outstanding Exchange Fund Bills and Notes is matched exactly by a sub-portfolio of corresponding assets (see Chart 1).

Assets in the Liquidity Portfolio consist of US dollar money market and fixed income instruments of maturity within one year. These assets are chosen for their liquidity, and the ease with which they can be sold to raise US dollar cash should the HKMA need to. As always with such securities, there is a price to pay in the form of lower yields, and the return on the Liquidity Portfolio reflects this.

CHART 1 : EXCHANGE FUND BILLS AND NOTES
(Maturity profile of outstanding as at 31.12.95



The Investment Portfolio is a multi-currency portfolio invested mainly but not exclusively in US dollar assets and striking an appropriate balance between credit quality, liquidity and return offered by such assets. The term structure of the Investment Portfolio reflects its longer term horizons. Although such investments can go down in value as well as up over the short term, the average return over the long term is greater than that on a cash or money market portfolio.

Although the objectives and strategies for the management of the Fund's assets have remained unchanged over the course of the year, the actual style of management continues to reflect the modernisation programme that the HKMA has been pursuing for the operational and management information systems for the reserves. In 1995 this included the building and installation of a new IT platform for the Reserves Management and Monetary Policy and Markets Departments of the HKMA. Installation of this multi-million dollar computer project is ongoing and will be completed in 1996.

The remaining one quarter of the assets of the Exchange Fund are managed by external fund managers. The first fund managers were appointed in the 1970s; the main reasons for their appointment was the lack of experience at that time within the predecessor to the HKMA, and the difficulty, given the communications of the time, of operating in markets in different time zones to Hong Kong. Neither of these two reasons fully apply any more, as the HKMA has built up its own team of experienced staff, with much improved communications and market accessibility. However it has proved useful to keep funds with external managers, for their wider experience, their different opinions on markets, as a source of training for the HKMA's own staff and a good check on the internal fund management programme.

The external managers are divided into a number of pools, and managers within a pool are given identical investment benchmarks, guidelines and objectives, so that their performance can be monitored not only against their index but also against each other. The HKMA rewards good managers with extra funds, but does not hesitate to withdraw funds or terminate a portfolio altogether for fund managers who underperform. As a whole, the external managers continue to add both to the flexibility with which the Exchange Fund's assets are managed and to the return on those assets.

The emphasis on the security of the Exchange Fund's assets applies equally to funds managed internally and those managed by the external managers, and has led to an enhancement of the role of the HKMA's Credit Review Committee. This Committee is responsible for the development, maintenance and operation of all aspects of the HKMA's credit policy for its own investments. The collapse of Barings in March of 1995 prompted a full review of the exposures being run by the HKMA in its management of the Exchange Fund with several parts of the credit policy subsequently refined. It remains true that the Exchange Fund has never suffered a loss due to an external default, and the Credit Review Committee is dedicated to continuing this record.

The accounts of the Exchange Fund have since 1995 been published on a semi-annual basis, starting from June 1995. Underscoring the HKMA's commitment of moving towards greater transparency in disclosure, the Financial Secretary has further decided to publish the amount of foreign currency assets held by the Fund on a quarterly basis, with the first set of figures released being for the quarter ending 30 September 1995. At the same time back figures for the period from December 1993 were also released. These data are shown in two forms, viz settled assets (ie excluding forward transactions) and the underlying asset position (ie including forward transactions). Showing the position by excluding forward transactions is the standard convention for accounts and balance sheets, while a clearer picture of the overall foreign currency asset holdings is presented by including forward deals. This latest initiative continues the move towards greater disclosure over the last few years, and is a contrast to the pre-1992 period when the accounts of the Funds were kept confidential and not published at all.

INVESTMENT RETURNS IN 1995

The year 1995 was exceptionally good for bonds of all maturities, with overall total returns the third highest since the second World War. Bonds rallied in all markets, led by interest rate cuts by almost all major central banks, and bondholders were rewarded with very large total returns indeed. The Exchange Fund shared fully in this benign and favourable environment, and the accumulated surplus of the Fund increased by HK$34.3 bn, the largest ever increase in one year in the history of the Fund.

At the same time, currency movements in 1995 were also very pronounced, with the US dollar first falling by over 20% to record lows against the Yen and the DM in the middle of the year, and then recovering by over 25% against the Yen and rather less against the DM. The HKMA does not take aggressive positions in the currency markets because of its prudent management style. Nevertheless we were able to add value from correctly following these currency movements and fine-tuning the currency allocation of the Fund.

As Chart 2 shows, most of the assets of the Exchange Fund remained invested in US dollars at end 1995, with a relatively small portion in other foreign currencies, notably DM and Yen.

OUTLOOK FOR 1996

Although 1996 has started with further cuts in official interest rates by overseas central banks, the outlook for longer term interest rate levels in the US and elsewhere for the rest of the year is mixed. As the Exchange Fund is a major holder of fixed income assets, rising interest rates in overseas markets will impact on the earnings of the Fund, and to reflect this, the HKMA will continue to run a conservative position. Equally there are prospects of a stronger US dollar, which also reduces the HK dollar value of the non-US dollar assets in the Fund and thus has the potential to impact the Fund's earnings negatively. For both these reasons, it is unlikely that returns in 1996 will match the excellent performance of the Fund in 1995.

CHART 2 : CURRENCY MIX OF THE FUND'S ASSETS
(Underlying position)
AT END 1995