Reserves Management

During 1999, the accumulated surplus of the Exchange Fund grew by 20%, and by the end of the year Hong Kong's foreign currency assets stood at US$96.3 billion, the fourth largest in the world. In managing Hong Kong's official reserves, the HKMA adopts a prudent investment strategy. It also continuously upgrades its investment and risk management techniques in line with best market practices in order to achieve investment returns with minimum risks.

Objectives

At $748.3 billion, or $107,279 for every person in Hong Kong, the official reserves of Hong Kong represent a significant store of value for the people of Hong Kong. These official reserves include foreign currency assets amounting to US$96.3 billion at the end of 1999, which made the Hong Kong SAR Government's foreign currency reserves the fourth largest in the world, after Japan, the Mainland of China, and Taiwan.

The primary purpose of the Exchange Fund is to safeguard the exchange value of the currency of Hong Kong and to maintain the stability and integrity of Hong Kong's monetary and financial systems. As the reserves represent a store of value for the future, a secondary objective is to maintain the long-term purchasing power of these assets.

The increasingly volatile market conditions in recent years highlight the importance of prudent management and the critical role played by risk management in the investment process. In managing the official reserves, the HKMA ensures that the Exchange Fund is invested through a consistent and conservative approach that is in line with international best practices.

Asset allocation of the Exchange Fund

At the beginning of 1999, the Exchange Fund adopted a new long-term asset allocation strategy. This asset allocation strategy, commonly known as an investment benchmark, is presented in Table 1.

Table 1 Investment benchmark of the Exchange Fund

Investment benchmark	
Bonds	80%
Equities	20% (Hong Kong: 5%)
Currencies	80% US dollar-bloc 15% European-bloc 5% Yen

The investment benchmark, which directs the long-term strategic investment of the Exchange Fund, is derived from the investment objectives of the Exchange Fund. The new arrangement, introduced in April 1998, to enable the fiscal reserves placed with the Exchange Fund to enjoy the same return achieved by the Exchange Fund as a whole, and the merger of the assets of the Land Fund into the Exchange Fund in November 1998 prompted a review of the investment objectives and long-term asset allocation strategy of the Exchange Fund.

The investment benchmark of the Exchange Fund adopted in early 1999 is an optimal mix of assets designed to meet the following investment objectives:

1. to preserve capital;
2. to ensure that the entire monetary base will be at all times fully backed by highly liquid short-term US dollar denominated securities;
3. to ensure sufficient liquidity for the purpose of maintaining monetary and financial stability; and
4. subject to (1) - (3) above, to achieve an investment return that will preserve the long-term purchasing power of the assets.

The Exchange Fund

The Exchange Fund was established in 1935. Since its creation, the Fund has held the backing to the note issues of Hong Kong. In 1976, the backing for coins issued and the bulk of the foreign currency assets held in the Government's General Revenue Account were also transferred to the Exchange Fund. At 31 December 1999, the assets of the Exchange Fund totalled $1,014 billion.

The Exchange Fund is managed as two distinct portfolios - the Backing Portfolio and the Investment Portfolio. In September 1998, the monetary base was redefined to include Exchange Fund Bills and Notes in addition to Certificates of Indebtedness, coins in circulation and the aggregate clearing balance maintained by banks with the HKMA. At the same time, the transparency of the operation of the currency board arrangements was increased by designating certain asset and liabilities items in the Exchange Fund balance sheets as those relating to the currency board operations and by the regular publication of these accounts. This led to the establishment of the Backing Portfolio to hold short-term highly liquid US dollar-denominated interest bearing securities to fully back the monetary base.

The balance of the assets of the Exchange Fund that constitute the Investment Portfolio are invested in OECD bond and equity markets to preserve the long-term purchasing power of these assets.

The investment process

The long-term asset allocation strategy of the Exchange Fund is guided by the investment benchmark, which defines the allocation of investments to bonds and equities by country as well as the overall currency composition of the fund. The Exchange Fund is permitted to invest in 20 bond markets, 10 equity markets and 18 currency markets.

The strategic investment direction is set by the Exchange Fund Advisory Committee, and the day-to-day management of the Exchange Fund is conducted by the Reserves Management Department of the HKMA. In carrying out its responsibilities, the Reserves Management Department operates under authority delegated from the Financial Secretary and within investment guidelines approved by the Exchange Fund Advisory Committee. Using fundamental analyses of economies and assessments of market developments and trends, the investment professionals determine the allocations to asset classes by country and the appropriate timing for entry into and exit from markets. To generate active returns above market returns, these professionals also engage in the selection of specific securities within each market. The HKMA regularly conducts thorough reviews of the investment process and of the related technological and risk management support to ensure that returns are achieved with low risk, minimum volatility and in accordance with the investment guidelines authorised by the Exchange Fund Advisory Committee.

Use of external managers

The Exchange Fund employs more than 20 external managers located in nine major financial centres to invest over one-third of its total assets. The purpose of engaging the services of external managers is to benefit from their expertise, skills and geographical coverage in selected markets. Within the Reserves Management Department are divisions dedicated to monitoring the investment activities undertaken by the external managers for compliance with investment guidelines and to analysing their investment performance in order to determine the value-added provided by these external managers. The assets managed by external managers are vested in specially chosen custodians.

In line with the changes to the investment benchmark, a review of the strategy for the use of external managers was undertaken in 1999. A number of modifications to the principles guiding the strategic use of external managers were adopted. To provide diversification of investment risks, to tap the full range of investment expertise available in the market and to capture the performance delivered by different assets and markets, the new strategy for the use of external managers will increase the amount of assets as well as the types of portfolios managed by external managers.

Risk management and compliance

The Risk Management and Compliance Division at the Exchange Fund is crucial to the risk control function. It monitors credit, operation, price and market risks arising from the investment activities and measures and evaluates the investment performance achieved. Externally and internally managed portfolios are subjected to evaluation of returns against benchmark and performance attribution analysis. They are also tested for risk and compliance using the latest available tools in the industry. Value-at-risk and scenario stress testing are used to quantify the market risks inherent in the portfolios under normal as well as extreme adverse market conditions.

To keep pace with the changes in the market place and in the investment approach of the Exchange Fund, the HKMA is acutely aware of the need to enhance and expand its internal diagnostic and analytical capabilities. We continue to emphasise people development and to use technology to substitute for human labour wherever practicable in order to facilitate the internal re-engineering efforts.

The disposal and investment management of the Hong Kong Equity Portfolio

Exchange Fund Investment Limited (EFIL) was established in 1998 to manage the Hong Kong equity portfolio purchased by the Exchange Fund in August 1998 together with the Hong Kong equities transferred from the Land Fund.

EFIL has been charged with two sets of responsibilities: the orderly disposal of the majority of the Hong Kong equities and the management of the portion of the Hong Kong equities to be retained as a long-term investment of the Exchange Fund.

The investment benchmark of the Exchange Fund allocates 5% of its assets to the Hong Kong equity market as a long-term investment. Based on the market value of the Exchange Fund as at the end of December 1999, this long-term portfolio has a value of about $50 billion. EFIL is also responsible for overseeing the investment management of this long-term portfolio through external managers.

The remainder of the Hong Kong equity portfolio will be disposed of in an orderly manner. EFIL is responsible for identifying opportunities for such disposal.

The Tracker Fund of Hong Kong

In April 1999, EFIL appointed three financial advisers to assist in developing a disposal programme. Having considered various alternatives, EFIL began the disposal programme with a unit trust replicating the Hang Seng Index. This unit trust, named the Tracker Fund of Hong Kong (TraHK), was launched in November in the form of an initial public offering and an international offering and was listed on the Hong Kong Stock Exchange.

TraHK, the first collective investment fund of its kind in Hong Kong, received an enthusiastic response from both retail and institutional investors in Hong Kong and institutional investors in Asia, Europe and North America. The initial issue size of $33.3 billion represented a substantial increase from the indicative offer size of $10 billion and was the largest initial public offering ever to have taken place in Asia outside of Japan. The success of TraHK is a significant milestone in the orderly disposal of the Hong Kong equity portfolio. Apart from providing Hong Kong investors with a new investment instrument, TraHK has helped to increase the depth and liquidity of the stock and futures markets in Hong Kong. Since the commencement of trading on 12 November 1999, TraHK has become an actively traded security on the Hong Kong Stock Exchange.

Appointment of external managers

EFIL has started the process of appointing external managers to manage the Exchange Fund's long-term Hong Kong equity investment portfolio. Approximately half of this portfolio will be managed by "passive" index tracking managers while the other half of the portfolio will be managed by "active" managers whose mandate will be to outperform the Hang Seng Index.

Performance of the Exchange Fund

The financial markets in 1999

The 1999 consensus economic forecasts were well off the mark. In the beginning of 1999, the markets expected global excess capacity and deflation, bearish for corporate earnings and equity markets and positive for bonds. Instead, growth in the global economy was surprisingly strong and prompted policy makers to raise interest rates. The US bond market put in its worst performance since 1994, and 1999 was one of the best years of the decade for equities.

The performances of major bond, equity and currency markets are set out in Table 2.

The Exchange Fund's performance in 1999

The Exchange Fund steered a steady course through the jittery interest rate environment in 1999 and was able partially to offset the negative impact of interest rate increases through a defensive bond and currency

Table 2 1999 market returns

Currencies	Against the Euro	Against the Yen
Appreciation / Depreciation of US dollar	13.8%	-9.8%
Bond markets*	**Hedged**	**Unhedged**
	3.3%	-3.1%
Equity markets	**In US dollars**	**In local currency**
Standard & Poor's 500 Index	21.0%	21.0%
Nikkei 225 Index	54.5%	37.9%
Hang Seng Index	73.6%	74.1%

* Merrill Lynch Global Government Bond Index, 1-5 years.

positioning. The Fund also benefited from extraordinary returns on the Hong Kong equity portfolio. The rates of gross investment return on the Exchange Fund's average total assets for the year 1999, and for the seven years from 1993 to 1999, are provided in Table 3. These returns compare favourably with the domestic inflation rate for the same period. The currency mix of the Fund's assets at 31 December 1999 is provided in Table 4.

Table 3 Gross investment return of the Exchange Fund

	Return on average total asset	Investment benchmark return*	CPI(A)
1999	10.8%	5.5%	-2.9%
1998	12.1%	n.a.	-1.4%
1993-1999 cumulative	67.9%	n.a.	35%
1993-1999 annualised	7.7%	n.a.	4.4%

* established since January 1999

Table 4 Currency mix of the Exchange Fund's assets (at 31 December 1999) - including forward transactions

	HK$ billion	%
US dollar	598.6	59.0
Hong Kong dollar	255.9	25.2
European currencies	112.4	11.1
Yen	43.3	4.3
Others	4.2	0.4
Total	**1,014.4**	**100.0**

Increased transparency

The initiatives to increase transparency of disclosure reported in last year's Annual Report were followed through in 1999. During the year, an abridged balance sheet of the Exchange Fund and a set of Currency Board Accounts were published for each month before the end of the following month. Concurrently, in full compliance with the Special Data Dissemination Standard (SDDS) of the International Monetary Fund (IMF), monthly announcements of Hong Kong's International Reserves and Analytical Accounts of the Central Bank were made in accordance with a published calendar. In 2000, SDDS will be further strengthened by the implementation of a Data Template on International Reserves and Foreign Currency Liquidity (the "Liquidity Template") commencing with end-April 2000 as the first reference month. The Liquidity Template, which will be completed and released before the end of each month following the reference month, aims to provide a comprehensive account of the IMF participant's foreign currency assets and drains on such resources arising from various foreign currency liabilities and commitments. The public disclosure of this information in a timely and accurate manner will promote informed decision making in the public and private sectors, thereby helping to improve the functioning of global financial markets.