



The cotton tree, *Bombax ceiba* (*B. malabaricum*), can grow to 25 metres or more in height. Its magnificent red flowers appear in spring before the new season's leaves, making it one of the most attractive of Hong Kong's roadside trees. The dried flowers are used in herbal preparations to reduce inflammation, and the cotton-like substance in its seed capsules is traditionally used for stuffing pillows and cushions.

RESERVES MANAGEMENT

Despite considerable volatility in the bond, equity and currency markets, the Exchange Fund achieved an investment return of 5.7% in 2004, which was in line with the return on its benchmark.

THE EXCHANGE FUND

The Exchange Fund performs a key role in maintaining the stability of Hong Kong's monetary and financial systems. Since its establishment in 1935, the Exchange Fund has held the backing to the banknotes issued in 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 Fund. On 31 December 2004 the assets of the Fund amounted to \$1,061.9 billion.

The primary objective of the Exchange Fund is to safeguard the exchange value of Hong Kong's currency and to maintain the stability and integrity of the monetary and financial systems of Hong Kong. On 31 December 2004 the foreign currency reserves amounted to US\$123.6 billion. It is also the investment objective of the Fund to maintain the long-term purchasing power of the foreign currency reserves, which represent a store of value for the people of Hong Kong.

The high volatility in financial markets in recent years has highlighted not only the importance of risk management in the investment process but also the need to diversify into new markets and instruments. The management of the reserves by the HKMA is in line with international best practices.

Investment objectives

The Exchange Fund is managed according to the following investment objectives:

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

An investment benchmark, derived from these objectives, governs the Fund's long-term asset allocation strategy, and represents an optimal use of assets designed to meet the objectives.

The Exchange Fund's investment benchmark is reviewed regularly to ensure that it consistently meets the investment objectives. The latest modifications were made in January 2003. According to the current investment benchmark, 77% of the Exchange Fund is allocated to bonds and 23% to equities and related investments. In terms of currency allocation, 88% is allocated to the US dollar bloc (which includes the Hong Kong dollar) and the remaining 12% to other currencies.

The investment process

The Exchange Fund is managed as two distinct portfolios: the Backing Portfolio and the Investment Portfolio. The Backing Portfolio fully matches the Monetary Base, which, under Hong Kong's Currency Board system, consists of

- Certificates of Indebtedness, which are used to back the banknotes issued by the three note-issuing banks
- government-issued notes and coins in circulation
- the sum of the balances on the clearing accounts held by banks with the HKMA (known as the Aggregate Balance)
- Exchange Fund Bills and Notes, which are issued by the HKMA on behalf of the Government.

The Backing Portfolio holds highly liquid US dollar-denominated securities.

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

The long-term asset allocation strategy of the Exchange Fund is governed by the investment benchmark, which defines the allocation of investments to different asset classes by country and by sector as well as the overall currency mix for the Fund. To qualify as an approved investment, a new market or financial instrument must meet the minimum credit, security and liquidity requirements of the Exchange Fund.

The Exchange Fund's investment strategy is determined by the Exchange Fund Advisory Committee (EFAC), while the day-to-day management of the Exchange Fund is conducted by the Reserves Management Department of the HKMA. In discharging its responsibilities, the Department operates within the investment guidelines endorsed by EFAC. Through fundamental analysis of different economies and assessments of market development and trends, the HKMA's investment professionals determine the allocations to asset classes by country and by sector as well as the appropriate timing for market entries and exits. To generate more active returns above market returns, these professionals also engage in the selection of specific securities within each market.

Stringent controls and investment guidelines have been established to monitor the risks arising from increasing volatility in the financial markets. In addition, the HKMA conducts detailed performance attribution analyses to make the most effective use of the investment skills of both the internal and the external managers.

Use of external managers

The Exchange Fund employs external fund managers located in 13 international financial centres to manage about one third of its total assets and all of its equity portfolios. The purpose of appointing external managers is to tap the best of the investment expertise available in the market, to capture a diverse mix of investment styles within the global investment field, and to transfer market knowledge and information. In 2004 the Exchange Fund's diversification into different asset classes, management styles, and markets has increased the number and types of specialist managers employed, particularly in the fixed income asset class. Looking ahead to 2005, the Fund intends to continue this diversification.

Externally managed portfolios are subjected to the same stringent controls, investment guidelines and performance attribution analyses as the internally managed portfolios. Assets are custodised with several major global master custodians.

Hong Kong equity portfolios

With effect from January 2003, the management of the Hong Kong equity portfolios was transferred to the HKMA from Exchange Fund Investment Limited. The HKMA manages these portfolios exclusively through external fund managers.

Risk management and compliance

The Risk Management and Compliance Division at the HKMA is responsible for risk control functions. The Division monitors, reports and controls the market, credit, liquidity and operational risks arising from the investment process. It is also responsible for the selection of benchmarks and evaluation of investment performance. Both internally and externally managed portfolios are evaluated against their respective benchmarks, and the Division conducts detailed performance attribution analysis to identify the skills of investment managers to improve effective asset allocation. Risk control tools, such as value-at-risk and scenario stress testing, are used to quantify the market risks in the portfolios under normal and extreme adverse market conditions.

The Risk Management and Compliance Division constantly strengthens and improves its internal diagnostic and analytical capabilities in line with best practices to keep pace with the changes in the investment approach of the Exchange Fund.

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PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2004

In 2004 the US Federal Reserve started to tighten after maintaining easy monetary conditions for an extended period. By the end of 2004 the Fed had raised the federal funds target rate from a 45-year low of 1.0% to 2.25%. Short-term interest rates rose in line with the increase in the federal funds target rate but long-term interest rates, such as the yield on the 10-year US Treasury bond barely moved. As inflationary expectations were well contained, the yield on the 10-year US Treasury bond ended the year at 4.22%, which was close to the level of 4.25% at the beginning of the year.

After a promising start in the first quarter of the year, global equity markets declined sharply in the middle of the year but rallied strongly in the fourth quarter on positive earnings. The S&P 500 ended the year 9.0% higher, while the NASDAQ gained 8.6%. The Hong Kong equity market outperformed most other equity markets by rising 13.2% during the year.

For the first part of the year, the US dollar recovered some of the losses in the previous two years. However, mounting concerns about the current account deficit in the US brought on another bout of dollar depreciation in the last months of the year. In 2004 the euro strengthened by 7.8%, while the yen rose by 4.6% against the US dollar. Commodity prices also surged. Gold prices reached a high of US\$457 per ounce before closing the year at US\$438 per ounce. Crude oil prices began the year at US\$32.5 per barrel, and soared to a high of US\$55.6 per barrel before ending the year at US\$43.5 per barrel.

TABLE 1 Market returns

	2004	2003
Currencies		
Appreciation against US dollar		
euro	+7.8%	+20.2%
yen	+4.6%	+10.7%
Bond markets		
JP Morgan US Government Bond (1-3 years) Index	+0.9%	+2.0%
Equity markets		
Standard & Poor's 500 Index	+9.0%	+26.4%
Hang Seng Index	+13.2%	+34.9%

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

The Exchange Fund's performance in 2004

The Exchange Fund was positioned defensively in this difficult environment. In 2004 the Exchange Fund recorded income from bonds of \$25 billion, \$12 billion from Hong Kong equities, \$11.2 billion from foreign equities and \$8.5 billion from foreign exchange gains. The total investment income of \$56.7 billion represents an investment return of 5.7%, which is in line with the return of the investment benchmark for the year.



Chief Executive Joseph Yam and Executive Director (Reserves Management) Amy Yip announce the Exchange Fund results for 2004.

TABLE 2 Gross investment return of the Exchange Fund (in Hong Kong dollar terms)¹

	Return on total assets	Return on investment benchmark ²	CPI(A) ³
2004	5.7%	5.7%	+0.4%
2003	10.2%	9.5%	-1.2%
1993 – 2004 cumulative	117.0%	N.A.	24.5%
1993 – 2004 annualised	6.7%	N.A.	1.8%

¹ For the Annual Reports from 2001 to 2003, return on total assets and return on investment benchmark are in US dollar terms.

² Established in January 1999.

³ December year-on-year percentage change in the HK-CPI(A) index. CPI(A) is calculated based on the 1999/2000 base new series.

TABLE 3 Currency mix of the Exchange Fund's assets at 31 December 2004 (including forward transactions)

	HK\$ billion	%
US dollar bloc		
US dollar ¹	835.3	78.7
Hong Kong dollar	92.5	8.7
Non-US dollar bloc	134.1	12.6
Total	1,061.9	100.0

¹ Include US dollar bloc foreign currencies such as Canadian dollar, Australian dollar and New Zealand dollar.

The investment return on the Exchange Fund relative to the investment benchmark and domestic inflation rate for the period from 1993 to 2004 is set out in Table 2. Since 1993 the Exchange Fund has generated a compounded annual return of 6.7%, which compares favourably with the compounded annual inflation rate of 1.8% over the same period. The currency mix of the Fund's assets at 31 December 2004 is set out in Table 3.

Transparency

The Exchange Fund is one of the most transparent among the reserves managed by central banks and monetary authorities. Four press releases on Exchange Fund data are issued by the HKMA each month. Three of these releases disseminate monetary data in accordance with the International Monetary Fund's (IMF) Special Data Dissemination Standard. The International Reserves constitute the official currency reserves of Hong Kong and the analytical accounts of the central bank comprise specifically prescribed balance sheet data. The template on international reserves and foreign currency liquidity provides 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 fourth release, on the Exchange Fund's Abridged Balance Sheet and Currency Board Account, is made in accordance with the HKMA's policy of transparency. This policy of transparency, which was maintained throughout 2004, helps promote public understanding of the Exchange Fund's operating results and financial position.

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