Reserves Management

The Exchange Fund recorded an investment return of 5.9% in 2009. This was achieved in extremely volatile markets affected by the global financial crisis.

THE EXCHANGE FUND

The Exchange Fund's primary objective, as laid down in the Exchange Fund Ordinance, is to affect, either directly or indirectly, the exchange value of the currency of Hong Kong. The Fund may also be used to maintain the stability and integrity of Hong Kong's monetary and financial systems to help maintain Hong Kong as an international financial centre. The Exchange Fund is under the control of the Financial Secretary and may be invested in any securities or other assets he considers appropriate, after consulting the Exchange Fund Advisory Committee (EFAC).

MANAGEMENT OF THE EXCHANGE FUND

Investment objectives and benchmark

EFAC has set the following investment objectives for the Exchange Fund:

(a) to preserve capital;

(b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid US dollar-denominated securities;

(c) to ensure that sufficient liquidity will be available for the purposes of maintaining monetary and financial stability; and

(d) subject to (a) – (c), to achieve an investment return that will preserve the long-term purchasing power of the Fund.

These objectives take full account of the statutory purposes of the Exchange Fund, and are incorporated into the investment benchmark of the Fund, which guides its long-term strategic asset allocation. Currently the bond-to-equity ratio of the benchmark is 75:25. In terms of currency mix, 86% of the benchmark is allocated to the US dollar and other currencies (which include the Hong Kong dollar) and the remaining 14% to other currencies (which include mainly the euro, yen and sterling).

The Exchange Fund is managed as two distinct portfolios – the Backing Portfolio and the Investment Portfolio. The Backing Portfolio holds highly liquid US dollar-denominated securities to provide full backing to the Monetary Base as required under the Currency Board arrangements. The Investment Portfolio is invested primarily in the bond and equity markets of the member countries of the Organisation for Economic Co-operation and Development to preserve the value and long-term purchasing power of the assets.

In 2007 a Strategic Portfolio was established to hold shares in Hong Kong Exchanges and Clearing Limited acquired by the Government for the account of the Exchange Fund for strategic purposes. Because of the unique nature of this Portfolio, it is not included in the assessment of the investment performance of the Exchange Fund.

The investment process

The investment process of the Exchange Fund is underpinned by decisions on two types of asset allocation – the strategic asset allocation and the tactical asset allocation. The strategic asset allocation, reflected in the investment benchmark, represents the long-term optimal asset allocation given the investment objectives of the Exchange Fund. Guided by the strategic allocation, assets are tactically allocated in an attempt to achieve an excess return over the benchmark. This often means the actual allocation is different from the benchmark, or strategic, allocation. The differences between the actual and the benchmark allocations are known as "tactical deviations". While the benchmark and the limits for tactical deviations are determined by the Financial Secretary in consultation with EFAC, tactical decisions are made by the HKMA under delegated authority. Within the limits allowed for tactical deviations, portfolio managers may take positions to take advantage of short-term market movements.

Investment management

Direct Investment

HKMA staff in the Reserves Management Department directly manage the investment of about 80% of the Exchange Fund, which includes the entire Backing Portfolio and part of the Investment Portfolio. This part of the Investment Portfolio is a multi-currency portfolio invested in the major fixed-income markets. The staff also manage positions in financial derivatives to implement investment strategies or control the risks of the Fund.

Use of external managers

In addition to managing assets internally, the HKMA employs external fund managers based in over a dozen international financial centres to manage about 20% of the Exchange Fund's assets, including all of its equity portfolios and other specialised assets. The purpose of appointing external managers is to tap the best investment expertise available in the market, capturing a diverse mix of investment styles, and transfer knowledge and information from the market to in-house professionals.

Expenditures relating to the use of external managers include fund management and custodian fees, transaction costs and withholding and other taxes. They are determined by such things as market factors, and fluctuate from year to year. Details of these expenditure items, including those related to portfolios managed internally by the HKMA, can be found in the Notes to the Financial Statements of the Exchange Fund.

Risk management and compliance

The high volatility of financial markets in recent years has highlighted the importance of risk management. Stringent controls and investment guidelines have been established for both internally and externally managed portfolios, and compliance with guidelines and regulations is closely monitored. Risk-control tools are deployed to assess market risks under both normal and adverse market conditions. The HKMA also conducts detailed performance attribution analyses to make the best use of the investment skills of both internal and external managers.

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2009

The global financial crisis extended into 2009 with significant market uncertainty and volatility. In the first quarter, financial market pessimism continued to weigh on risky assets in the midst of weak consumer confidence, worsening employment data and a deepening recession in all developed economies.

However, since March, investor sentiment improved markedly with the unprecedented monetary easing by major central banks, and the generous fiscal and monetary policy measures introduced earlier. Through various credit easing programmes and government guarantees, the US Federal Reserve initiated the purchase of government bonds issued by the US Treasury, creating abundant liquidity in the financial system. Market optimism was further supported by signs of economic stabilisation in the second half of the year. The GDP of major economies recorded growth during the third quarter and business and consumer confidence improved.

Investors gradually moved away from the extreme caution shown in 2008 and their risk appetite returned in 2009, prompting the unwinding of risk aversion trades, especially in the second half of the year as investors sought better returns in a low-interest-rate environment. Global stock markets staged a strong rebound and major equity indices recovered about 50% of the losses incurred since the start of the financial crisis. Bond yields moved substantially higher from their depressed levels in late 2008, partly due to a reversal of the risk aversion mentality, and partly due to the fear of a big increase in the supply of government bonds. The US dollar also weakened during the year, falling about 17% against major currencies as safe-haven flows disappeared. Nevertheless, towards the end of 2009, investors again became more cautious about the sustainability of the global economic recovery, particularly after the emergence of the debt crisis involving Dubai World.

The performance of major currency, bond and equity markets in 2009 are shown in Table 1.

Table 1 2009 market returns

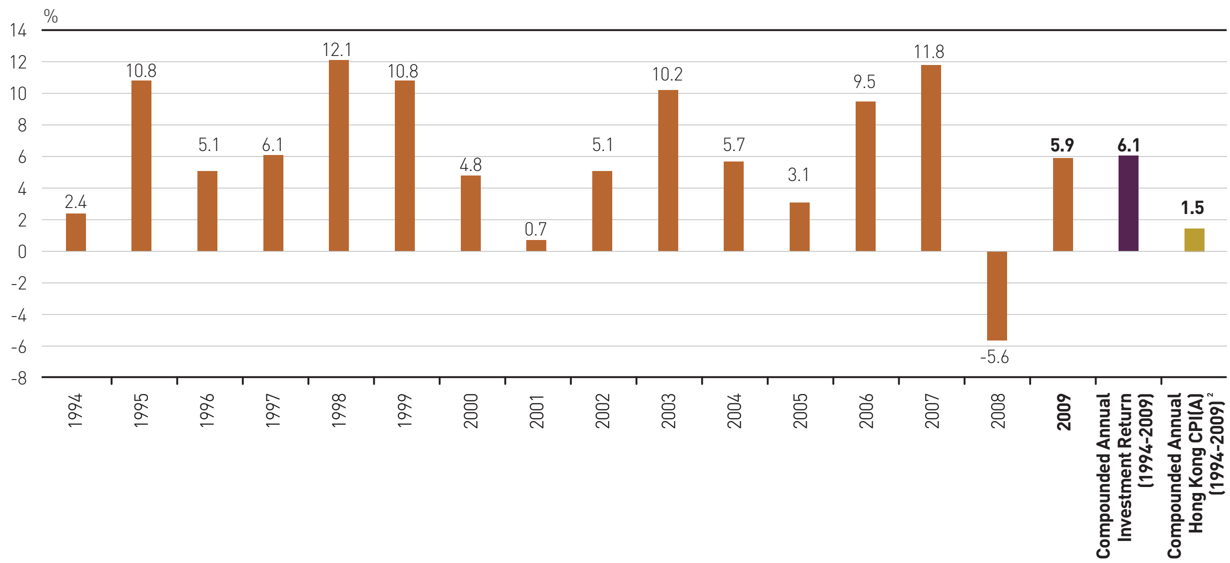
Currencies	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+3.2%
Yen	-2.6%
Bond markets	
Relevant US Government Bond (1 - 3 years) Index	+0.8%
Equity markets	
Standard & Poor's 500 Index	+23.5%
Hang Seng Index	+52.0%

The Exchange Fund's performance

The Exchange Fund recorded an investment income of $106.9 billion in 2009, comprising gains of $48.9 billion from Hong Kong equities and gains of $48.8 billion from foreign equities, a $9.8 billion gain from foreign exchange revaluation, and a valuation loss, net of interest, of $0.6 billion from bond and other investments. Apart from this $106.9 billion investment income, the valuation gain and dividend income of the Strategic Portfolio amounted to $4.4 billion. The investment income after excluding the Strategic Portfolio represented an investment return of 5.9%.

The annual return of the Exchange Fund from 1994 to 2009 is set out in Chart 1. Table 2 shows the 2009 investment return of the Exchange Fund and the average investment returns of the Fund over a number of different time horizons. The average return was 3.8% over the last three years, 4.8% over the last five years, 5.0% over the last 10 years and 6.1% since 1994.[1] These returns compare favourably with the average inflation rate during the corresponding period. Table 3 shows the currency mix of the Fund's assets on 31 December 2009.

Chart 1 Investment return of the Exchange Fund (1994 - 2009) [1]



[1] Investment return calculation excludes the holdings in the Strategic Portfolio.
[2] CPI(A) denotes the 2004/2005-based series of the CPI(A).

[1] Averages over different time horizons are calculated on an annually compounded basis.

Table 2 **Investment return of the Exchange Fund in Hong Kong dollar terms** [1]

	Investment return [2&3]	CPI(A) [3&4]	Excess return over benchmark
2009	5.9%	1.7%	122 bps
3-year average (2007 - 2009)	3.8%	2.1%	24 bps
5-year average (2005 - 2009)	4.8%	1.9%	N/A [5]
10-year average (2000 - 2009)	5.0%	0.1%	N/A [5]
Average since 1994	6.1%	1.5%	N/A [5]

1 The investment returns for 2001 to 2003 are in US dollar terms.
2 Investment return calculation excludes the holdings in the Strategic Portfolio.
3 Averages over different time horizons are calculated on an annually compounded basis.
4 CPI(A) denotes the 2004/2005-based series of the CPI(A).
5 N/A denotes not applicable. Compilation of active returns for individual portfolios started in 2006.

Table 3 **Currency mix of the Exchange Fund's assets on 31 December 2009 – including forward transactions**

	HK$ billion	%
US dollar and other currencies [1]	1,765.2	82.1
Hong Kong dollar	150.2	7.0
Euro, yen, sterling and other currencies [2]	234.0	10.9
Total	**2,149.4**	**100.0**

1 Including mainly Australian dollar, Canadian dollar and Singapore dollar.
2 Including mainly Swiss franc, Swedish krona, Norwegian krone and Danish krone.