Reserves Management

The Exchange Fund recorded an investment return of 3.6% in 2010. This was achieved in an uncertain and difficult investment environment.

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 help 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 target bond-to-equity ratio of the benchmark is 75:25. In terms of target currency mix, 82% of the benchmark is allocated to the US dollar and the Hong Kong dollar and the remaining 18% to other currencies.

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 assets 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 an effort to better manage risk and enhance long-term returns, the Fund has started, in a cautious and modest manner, to explore opportunities for diversification of investment.

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.

Reserves Management

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 to 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 market factors, and may fluctuate from year to year.

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 2010

The global investment environment in 2010 remained difficult and volatile. Investor sentiment was shaken by the European sovereign debt crisis in the first half of the year, leading to a decline in the global equity markets. Following the speech by the US Federal Reserve Chairman in August to provide additional monetary accommodation if it proved necessary, global equity markets rebounded sharply.

Bond markets also remained volatile with global yields edging lower in the first half as major central banks continued to pursue an accommodative monetary policy to provide support for their economies. However, bond yields rebounded towards the end of 2010. On currency markets, the euro weakened substantially in the first half as the European sovereign debt crisis deepened, but recovered most of the losses when the situation stabilised in the second half. For 2010 as a whole, the euro fell by 6.5%, while the yen gained more than 14% against the US dollar.

The performance of major currency, bond and equity markets in 2010 are shown in Table 1.

Table 1 **2010 market returns**

Currencies	
Appreciation (+)/depreciation (-) against the US dollar	
Euro	-6.5%
Yen	+14.8%
Bond markets	
Relevant US Government Bond (1 - 3 years) Index	+2.5%
Equity markets	
Standard & Poor's 500 Index	+12.8%
Hang Seng Index	+5.3%

Reserves Management

The Exchange Fund's performance

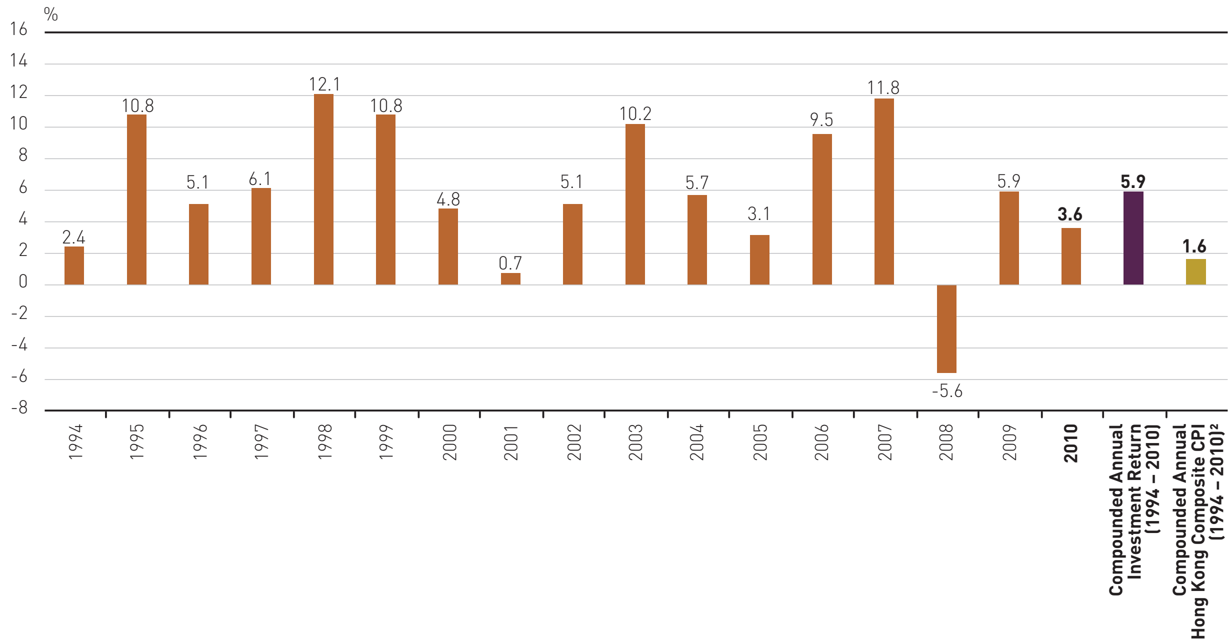
The Exchange Fund recorded an investment income of $79.4 billion in 2010, comprising gains from Hong Kong and foreign equities of $11.6 billion and $27.1 billion respectively, valuation gains from bonds and other investments held by the investment holding subsidiaries of the Fund of $42.1 billion and $1.7 billion respectively, and a loss of $3.1 billion from foreign-exchange revaluation. Apart from this $79.4 billion investment income, the valuation gain and dividend income of the Strategic Portfolio amounted to $2.6 billion.

The overall investment return of the Exchange Fund (excluding Strategic Portfolio) is 3.6%. The return takes into account contribution from both the Backing Portfolio and the Investment Portfolio. On the back of the significant inflow of funds into the Hong Kong dollar in late 2008 and 2009 leading to an expansion in the Monetary Base by over $600 billion, the Backing Portfolio has also grown in size by an equivalent amount. As the Backing Portfolio can only be invested in high quality, short-term and liquid US dollar assets to provide full backing to the Monetary Base, its return has been stable but low. The increasing share of the Backing Portfolio, coupled with its relatively low rate of return, affects the overall return of the Exchange Fund. Excluding the investment return of the Backing Portfolio, the return on the Investment Portfolio is 6%.

The annual return of the Fund from 1994 to 2010 is set out in Chart 1. Table 2 shows the 2010 investment return and the average investment returns of the Fund over a number of different time horizons. The average return was 1.2% over the last three years, 4.9% over the last five and 10 years and 5.9% since 1994.[1] Table 3 shows the currency mix of the Fund's assets on 31 December 2010.

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

Chart 1 Investment return of the Exchange Fund (1994 – 2010) [1]



[1] Investment return calculation excludes the holdings in the Strategic Portfolio.
[2] Composite Consumer Price Index is calculated based on the 2004/2005-based series.

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

	Investment return [2 & 3]
2010	3.6%
3-year average (2008 – 2010)	1.2%
5-year average (2006 – 2010)	4.9%
10-year average (2001 – 2010)	4.9%
Average since 1994	5.9%

[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.

Table 3 Currency mix of the Exchange Fund's assets on 31 December 2010 (including forward transactions)

	HK$ billion	%
US dollar	1,853.0	79.0
Hong Kong dollar	217.0	9.3
Others [1]	275.0	11.7
Total	**2,345.0**	**100.0**

[1] Including mainly euro, yen, sterling, Australian dollar, Canadian dollar, Singapore dollar, Swiss franc, Swedish krona, Norwegian krone and Danish krone.