

Reserves Management



Global financial markets performed better than expected in 2019 as the effect of accommodative monetary policies from major central banks outweighed concerns about the global growth slowdown and US-China trade tensions. Global equity markets rebounded following a significant correction in the fourth quarter of 2018, while major government bond yields declined and bond prices went up. Under such a favourable environment, the Exchange Fund recorded an investment income of HK\$262.2 billion in 2019, representing an investment return of 6.6%.

Reserves Management

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 HKMA, under the delegated authority of the Financial Secretary (FS) and within the terms of the delegation, is responsible to the FS for the use and investment management of the Exchange Fund.

MANAGEMENT OF THE EXCHANGE FUND

Investment objectives and portfolio structure

The Exchange Fund Advisory Committee (EFAC) has set the following investment objectives for the Exchange Fund:

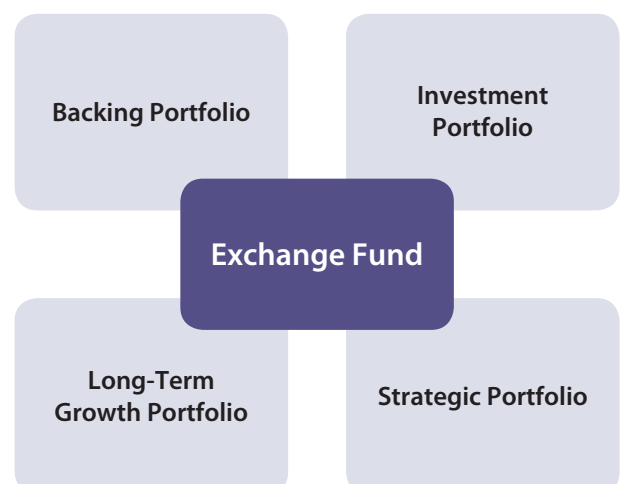
- (a) to preserve capital;
- (b) to ensure that the entire Monetary Base, at all times, is fully backed by highly liquid US dollar-denominated assets;
- (c) to ensure that sufficient liquidity is available for the purposes of maintaining monetary and financial stability; and
- (d) subject to (a)–(c), 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 portfolio structure and the target asset mix of the Fund.

Broadly speaking, the Exchange Fund has two major portfolios: the Backing Portfolio (BP) and the Investment Portfolio (IP). The BP holds highly liquid US dollar-denominated assets to provide full backing to the Monetary Base as required under Currency Board arrangements. The IP invests 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 its assets.

To better manage risks and enhance returns in the medium and long term, the HKMA diversifies part of the Exchange Fund's investments in a prudent and incremental manner into a wider variety of asset classes. This includes emerging market and Mainland bonds and equities, private equity (including infrastructure), and real estate. Emerging market and Mainland bonds and equities are held under the IP, while private equity and real estate investments are held under the Long-Term Growth Portfolio (LTGP). The cap for the market value of investments under the LTGP is set at the aggregate of one-third of the accumulated surplus of the Exchange Fund and the portion of the Future Fund and placements by subsidiaries of the Exchange Fund linked to the LTGP.

The Strategic Portfolio, established in 2007, holds shares in Hong Kong Exchanges and Clearing Limited that have been acquired by the Government for the account of the Exchange Fund for strategic purposes. This Portfolio is not included in the assessment of the Fund's investment performance because of its unique nature.



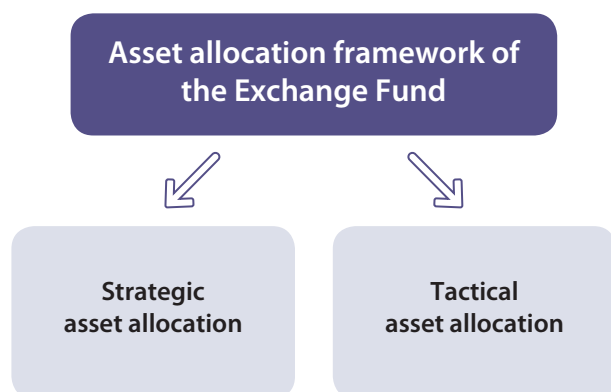
Reserves Management

Placements with the Exchange Fund

The Exchange Fund, from time to time, accepts placements by fiscal reserves, Government funds and statutory bodies. The interest rate is generally linked to the performance of the IP¹, with the major exception of the Future Fund, which links its interest rate to both the IP and the LTGP with reference to the portfolio mix. As at the end of 2019, the portfolio mix of the Future Fund between the IP and the LTGP was about 40:60.

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 long-term 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 means the actual allocation is often different from the benchmark (or strategic) allocation. The differences between the actual and benchmark allocations are known as “tactical deviations”. While the benchmark and tracking error² limit are determined by the FS in consultation with the EFAC, tactical decisions and allowable ranges for tactical deviations are made and set by the HKMA under delegated authority. Within the ranges allowed for tactical deviations, portfolio managers may assume positions to take advantage of short-term market movements.



¹ The rate is the average annual investment return of the IP for the past six years, or the average annual yield of three-year Government Bond for the previous year subject to a minimum of 0%, whichever is higher.

² "Tracking error" measures how closely a portfolio follows its benchmark.

Investment management

Direct investment

The HKMA set up the Exchange Fund Investment Office (EFIO) in August 2018 to house its investment and related risk management functions. Staff members of the EFIO directly manage about 71% of the investments of the Exchange Fund, comprising the entire BP and part of the IP. This part of the IP includes a set of portfolios invested in global fixed-income markets and various derivative overlay portfolios implementing macro risk management strategies for the Fund.

Use of external managers

In addition to managing assets internally, the HKMA employs external fund managers to manage about 29% of the Exchange Fund's assets, including all its listed equity portfolios and other specialised asset classes. The purpose of engaging external managers is to tap the best investment expertise available in the market to realise sustainable returns, draw on diverse and complementary investment styles, and gain their market insights and technical expertise in investment.

Expenditure relating to the use of external managers includes fund management and custodian fees, transaction costs, and withholding and other taxes. The expenditure is determined primarily by market factors and may fluctuate from year to year.

Risk management and compliance

The growing complexity of the investment environment underlines the importance of risk management. Stringent controls and investment guidelines are in place for both internally and externally managed portfolios, and compliance with guidelines and regulations is closely monitored. As the investment environment has become more complex, risk assessment has been strengthened to support the Exchange Fund's increased level of investment diversification. Risk-control tools are deployed to assess market risks under both normal and adverse market conditions. Detailed performance attribution analyses are also conducted to identify sources of performance, enabling the HKMA to assess how to make the best use of the investment skills of both internal and external managers.

Reserves Management

Responsible investment



The HKMA is supportive of responsible investment (RI) by weaving environmental, social and governance (ESG) factors into the investment process for both public and private market investments of the Exchange Fund.

In terms of public market investments, the HKMA implements both process-related and investment-related measures. One process-related measure taken by the HKMA is the adoption of the Principles of Responsible Ownership (PRO) issued by the Securities and Futures Commission in 2016, which help investors determine how best to meet their ownership responsibilities in relation to their investments in Hong Kong-listed companies. In managing the Exchange Fund, the HKMA has developed internal guidelines on ESG factors covering the process of selection, appointment and monitoring of external fund managers. The appointed external fund managers for the HKMA's Hong Kong equities and Mainland active equities portfolios are required to adhere to the PRO in managing the investments on a "comply-or-explain" basis, and external fund managers appointed to manage the HKMA's portfolios in developed market equities need to adhere to internationally recognised ESG standards. Apart from externally managed funds, ESG factors are also incorporated into the credit risk analysis of the HKMA's internally managed bond investment.

As for ESG investments in the public market, the HKMA has invested in green bonds since 2015 as one of the early investors in this market, and participates in the Managed Co-Lending Portfolio Programme, which is run by the International Finance Corporation with a focus on sustainable investments across emerging markets. Going forward, the HKMA will continue to grow its green bond portfolio by either direct investment or investing in green bond funds. The HKMA also plans to construct ESG-themed mandates in equities investment by adopting an ESG equities index as a benchmark for passive portfolios and engaging active equities managers who apply ESG factors in their investment decisions.

With respect to private market investments, the HKMA examines the ESG policies and practices of general partners as part of its due diligence process. In particular, ESG risk evaluation is conducted as a mandatory part of due diligence in all LTGP investments. For the LTGP, the HKMA invests in projects with sustainable features; for instance, the HKMA has invested in renewables since 2013 in direct and co-investments in the energy sector, as well as green buildings and warehouses with green and sustainable features in its real estate portfolio. Going forward, the HKMA will continue to source projects with sustainable features and include green accreditation as a predominant factor in real estate investment.

The HKMA will monitor the development of ESG standards closely and assess how these standards can be further integrated into its investment process. The process is facilitated by its collaboration with like-minded investors and relevant international organisations. In particular, being a signatory of the UN-supported Principles for Responsible Investment, which is the world's leading proponent of RI, the HKMA expects to participate in the formulation of ESG best practices and to motivate other investors in adopting RI. Besides, the HKMA is also a member of FCLTGlobal, a not-for-profit organisation that works to encourage a longer-term focus in business and investment decision-making through workshops and research studies. In 2019, the HKMA also became a supporter of the Task Force on Climate-related Financial Disclosures.

For more details about the HKMA's RI policy framework, see the *Corporate Social Responsibility* chapter.

Reserves Management

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2019

Despite concerns about the global growth slowdown and US-China trade tensions, global financial markets performed well in 2019 on the back of accommodative monetary policies from major central banks. Following a significant correction in the fourth quarter of 2018, global equity markets rallied in 2019. In the bond markets, major government bond yields declined markedly while bond prices went up in the first three quarters of 2019 as a result of monetary easing. Although bond prices retreated in the fourth quarter amid a slight rebound in yields, the overall gains in the bond markets were still satisfactory in 2019.

In the currency markets, major currencies performed differently against the US dollar. After declining by 3.8% in the third quarter due to an escalation of US-China trade tensions, the renminbi recovered part of its earlier losses in the fourth quarter given easing trade tensions. Overall, the renminbi depreciated by 1.4% against the US dollar. While the pound fell by 3.2% in the third quarter due to the heightened risk of a no-deal Brexit, it had since rebounded significantly as more clarity on Brexit emerged in the fourth quarter, eventually gaining 4.0% against the US dollar.

The performances of major currency, bond and equity markets in 2019 are shown in Table 1.

Table 1 2019 market returns

Currencies

Appreciation (+)/depreciation (-) against US dollar

| | |
|----------|-------|
| Euro | -1.8% |
| Pound | +4.0% |
| Renminbi | -1.4% |
| Yen | +1.0% |

Bond markets

| | |
|--|-------|
| Relevant US Government Bond (1–30 years) Index | +7.1% |
|--|-------|

Equity markets¹

| | |
|-----------------------------|--------|
| Standard & Poor's 500 Index | +28.9% |
| DAX Index | +25.5% |
| FTSE 100 Index | +12.1% |
| TOPIX Index | +15.2% |
| MSCI Emerging Markets Index | +15.4% |
| Hang Seng Index | +9.1% |

1. Market performance on equities is based on index price changes during the year.

Reserves Management

The Exchange Fund's performance

The Exchange Fund recorded an investment income of HK\$262.2 billion in 2019. This comprised gains on bonds of HK\$114.5 billion, gains on Hong Kong equities of HK\$22.1 billion, gains on other equities of HK\$100.7 billion, a negative currency translation effect of HK\$13.0 billion on non-Hong Kong dollar assets, and gains of HK\$37.9 billion on other investments held by the investment holding subsidiaries of the Fund. Separately, the Strategic Portfolio recorded a valuation gain of HK\$2.5 billion.

The total assets of the Exchange Fund reached HK\$4,206.7 billion at the year end. The market value of investments under the LTGP totalled HK\$335.1 billion, with private equity amounting to HK\$233.4 billion and real estate at HK\$101.7 billion. Outstanding investment commitments reached HK\$219.3 billion.

The investment return of the Exchange Fund in 2019, excluding the Strategic Portfolio, was 6.6%. Specifically, the IP achieved a rate of return of 9.7%, while the BP gained 2.5%. The LTGP has recorded an annualised internal rate of return of 12.6% since its inception in 2009.

The annual returns of the Fund from 1994 to 2019 are set out in Chart 1. Table 2 shows the 2019 investment return and the average investment returns of the Fund over several different time horizons. The average return was 4.7% over the past three years, 3.1% over the past five years, 2.9% over the past 10 years and 4.8% since 1994³. Table 3 shows the currency mix of the Fund's assets on 31 December 2019.

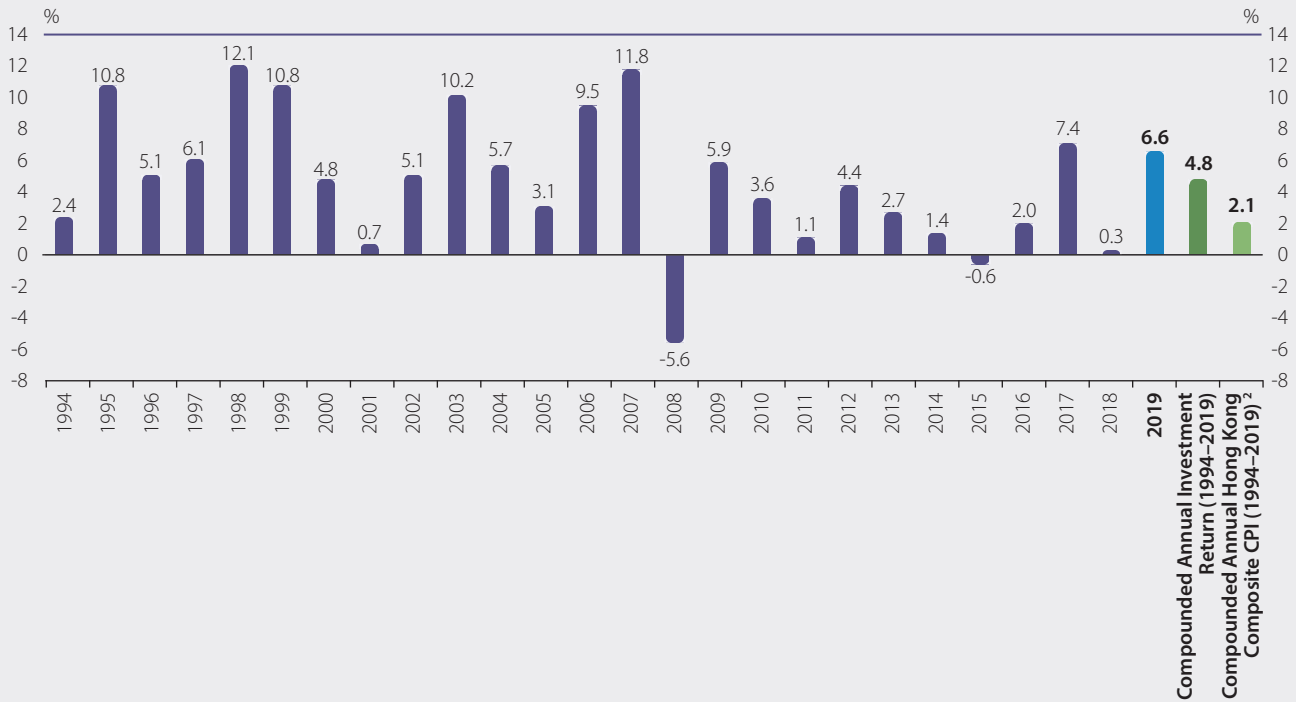


HKMA Deputy Chief Executive, Mr Howard Lee, speaks at the press conference on the Exchange Fund results for 2019.

³ Averages over different time horizons are calculated on an annually compounded basis.

Reserves Management

Chart 1 Investment return of the Exchange Fund (1994–2019)¹



1. Investment return calculations exclude the holdings in the Strategic Portfolio.
2. The Composite Consumer Price Index is calculated based on the 2014/2015-based series.

Reserves Management

Table 2 Investment return of the Exchange Fund in Hong Kong dollar terms¹

| | Investment return ^{2&3} |
|-----------------------------|--------------------------------------|
| 2019 | 6.6% |
| 3-year average (2017–2019) | 4.7% |
| 5-year average (2015–2019) | 3.1% |
| 10-year average (2010–2019) | 2.9% |
| Average since 1994 | 4.8% |

1. The investment returns for 2001 to 2003 are in US dollar terms.
2. Investment return calculations exclude 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 2019 (including forward transactions)

| | HK\$ billion | % |
|---------------------|----------------|--------------|
| US dollar | 3,482.4 | 82.8 |
| Hong Kong dollar | 303.7 | 7.2 |
| Others ¹ | 420.6 | 10.0 |
| Total | 4,206.7 | 100.0 |

1. Other currencies consisted mainly of the euro, renminbi, pound sterling and Japanese yen.