

Reserves Management

The global financial markets embarked on a recovery path in 2021. Although the global economy continued to be affected by the evolving COVID-19 pandemic situation, a number of factors, including an increasing vaccination rate as well as accommodative monetary policies and fiscal measures around the world, have contributed to notable recovery in the global economy and financial markets. Against this background, a number of overseas equity markets achieved record highs during the year, and the Exchange Fund's overall equity holdings were able to achieve a decent return despite the sluggish performance in Hong Kong equities. During 2021, the Exchange Fund recorded an investment income of HK\$191.9 billion, representing an investment return of 4.1%.



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 and within the terms of the delegation, is responsible to the Financial Secretary for the use and investment management of the Exchange Fund.

MANAGEMENT OF THE EXCHANGE FUND

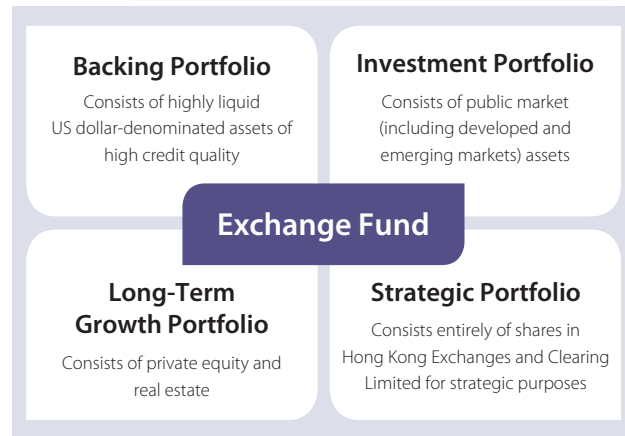
Investment objectives and portfolio structure

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

- (i) to preserve capital;
- (ii) to ensure that the entire Monetary Base, at all times, is fully backed by highly liquid US dollar-denominated assets;
- (iii) to ensure that sufficient liquidity is available for the purposes of maintaining monetary and financial stability; and
- (iv) subject to (i)–(iii), to achieve an investment return that will help preserve the long-term purchasing power of the Exchange 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 (Figure 1).

Figure 1 Portfolio Segregation of the Exchange 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 the Currency Board arrangements. The IP invests primarily in the bond and equity markets of the member economies 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 HKMA has put in place a cap¹ to guide the pace of diversification into the LTGP since its inception. As the LTGP has become increasingly mature in investment scale and asset diversity, the EFAC decided in January 2022 to replace the cap by a target asset allocation that is determined concurrently with that of other asset classes, subject to prudent risk management principles.

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. The Strategic Portfolio is not included in the assessment of the Fund's investment performance because of its unique nature.

¹ The cap for the market value of investments under the LTGP was set at the aggregate of one-third of the accumulated surplus of the Exchange Fund, and the portion of the placements by the Future Fund and subsidiaries of the Exchange Fund linked to the LTGP.

Reserves Management

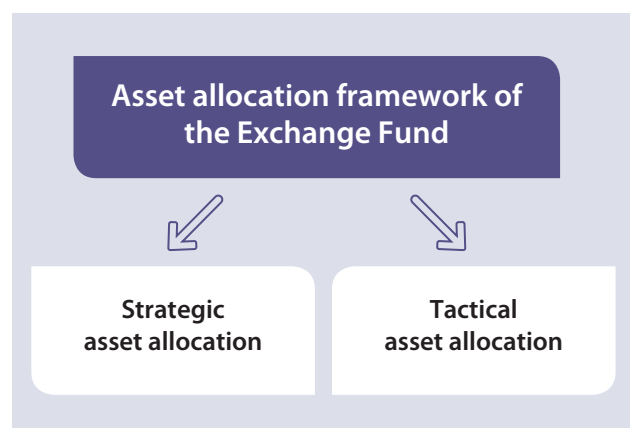
Placements with the Exchange Fund

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 IP², with the major exception of the Future Fund³, which links its interest rate to the return of both the IP and the LTGP in accordance with the portfolio mix. The portfolio mix of the Future Fund between the IP and the LTGP was about 40:60 in 2021.

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 error⁴ limit are determined by the Financial Secretary 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 (Figure 2).

Figure 2 Asset allocation of the Exchange Fund



Investment management

Direct investment

The HKMA's Exchange Fund Investment Office houses its investment and related risk management functions. Exchange Fund Investment Office staff members 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 of 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 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. The HKMA sets stringent controls and investment guidelines for both internally and externally managed portfolios, and ensures a proper risk monitoring and compliance system is in place. Three lines of defence are in place to implement effective risk management and governance of investment-related activities. Key risk categories (including credit, market, liquidity and operational risks) are regularly monitored, and the risk management process provides a robust framework to support strategic planning and investment diversification.

² 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).

³ The Future Fund was established by the Government in 2016 with a view to securing higher investment returns for the fiscal reserves to support increasing needs in the future.

⁴ "Tracking error" measures how closely a portfolio follows its benchmark.

Reserves Management

RESPONSIBLE INVESTMENT



The HKMA believes that, by putting an appropriate emphasis on responsible investment and sustainable long-term economic performance, it can better achieve the investment objectives of the Exchange Fund and reduce risks

associated with environmental, social and governance (ESG)-related matters of its underlying investments. The HKMA supports responsible investment by integrating ESG factors into the investment processes for both public and private market investments of the Exchange Fund, underpinned by the guiding principle that priority will generally be given to ESG investments if the long-term risk-adjusted return is comparable with other investments. For more details about the HKMA's responsible investment framework and implementation, see the *Sustainability* chapter on pages 184 to 191.

PERFORMANCE OF THE EXCHANGE FUND

The financial markets in 2021

Global equity markets rose sharply and hit new record highs on the back of ultra-loose monetary policies and fiscal measures, driving an accelerated recovery of the global economy and financial markets. However, Hong Kong and Mainland equity markets underperformed amid market reforms. The Standard & Poor's 500 Index in the US rose by 27%, while the Hang Seng Index in Hong Kong dropped by 14%.

For the bond markets, rising inflation expectations and tapering of asset purchases by the US Federal Reserve (Fed) led to a rise in US Treasury yields and falling bond prices during 2021. Ten-year US Treasury yields increased by about 60 basis points from 0.9% at the beginning of the year to 1.5% at the end of the year.

In the currency markets, the US dollar strengthened against other major currencies, particularly towards the end of 2021, on the back of expectations about the Fed's tapering pace. In particular, the euro and the yen depreciated by 7.1% and 10.3% against the US dollar respectively.

The performance of major currency, bond and equity markets in 2021 is shown in Table 1.

Table 1 2021 market returns

Currencies

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

Euro	-7.1%
Pound sterling	-0.9%
Renminbi	+2.6%
Japanese yen	-10.3%

Bond markets

Relevant US Government Bond (1–30 years) Index	-2.6%
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Equity markets^a

Standard & Poor's 500 Index	+26.9%
DAX Index	+15.8%
FTSE 100 Index	+14.3%
TOPIX Index	+10.4%
MSCI Emerging Markets Index	-4.6%
Hang Seng Index	-14.1%

a. Market performance on equities is based on the index price change during the year.

Reserves Management

The Exchange Fund's performance

The Exchange Fund recorded an investment income of HK\$191.9 billion in 2021. This comprised gains on bonds of HK\$12.6 billion, net gains on equities of HK\$47.8 billion (with gains of HK\$68.8 billion from foreign equities, and losses of HK\$21.0 billion from Hong Kong equities), a positive currency translation effect of HK\$16.8 billion on non-Hong Kong dollar assets and gains of HK\$114.7 billion on other investments held by the investment-holding subsidiaries of the Fund. Separately, the Strategic Portfolio recorded a valuation gain of HK\$3.1 billion.

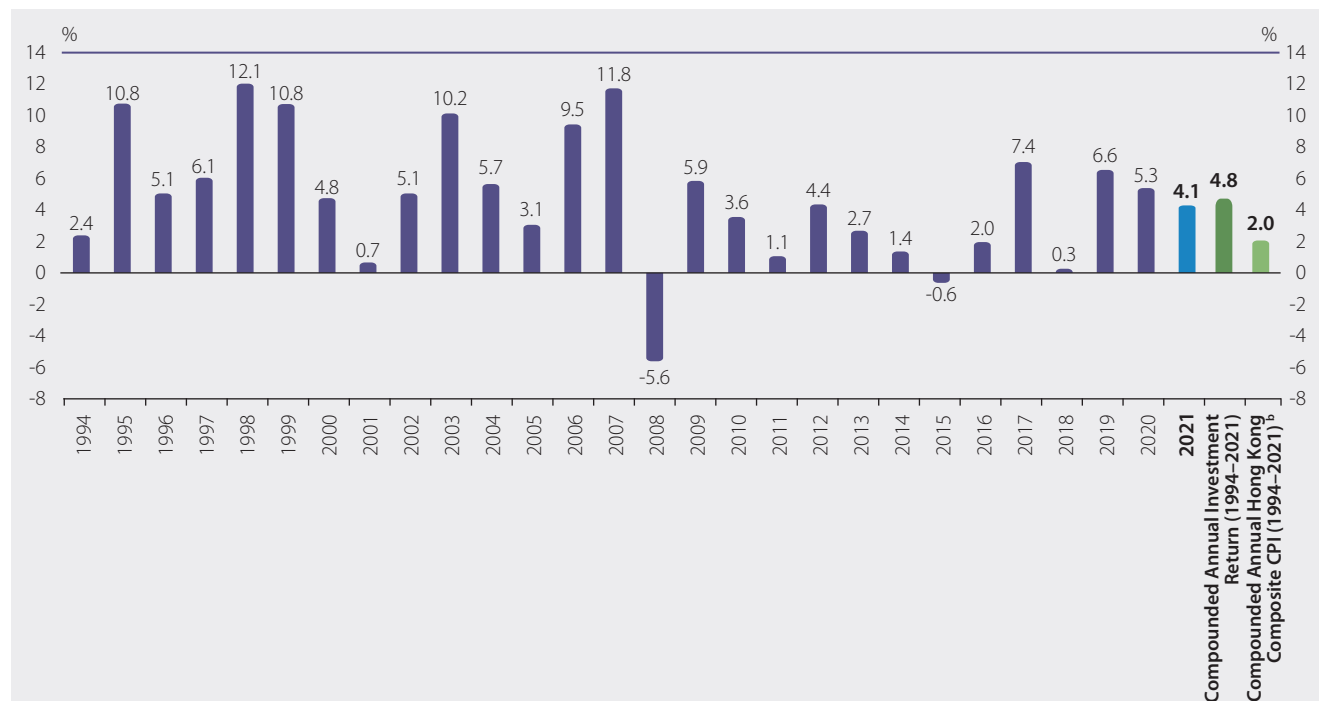
Total assets of the Exchange Fund reached HK\$4,570.2 billion at the end of the year. The market value of investments under the LTGP totalled HK\$515.3 billion, with private equity amounting to HK\$392.5 billion and real estate HK\$122.8 billion. Outstanding investment commitments of the LTGP amounted to HK\$225.7 billion.

The investment return of the Exchange Fund in 2021, excluding the Strategic Portfolio, was 4.1%. Specifically, the IP achieved a rate of return of 3.7%, while the BP gained 0.4%. The LTGP has recorded an annualised internal rate of return of 15.4% since its inception in 2009.

The annual returns of the Exchange Fund from 1994 to 2021 are set out in Chart 1. Table 2 shows the 2021 investment return and the average investment returns of the Fund over several different time horizons. The average return was 5.3% during 2019–2021, 4.7% during 2017–2021, 3.3% during 2012–2021 and 4.8% since 1994. Table 3 shows the currency mix of the Fund's assets on 31 December 2021.

See pages 211 to 319 for the audited 2021 financial statements of the Exchange Fund.

Chart 1 Investment return of the Exchange Fund (1994–2021)^a



- a. Investment return calculations exclude holdings in the Strategic Portfolio.
 b. The Composite Consumer Price Index is calculated based on the 2019/2020-based series.

Reserves Management

Table 2 Investment return of the Exchange Fund in Hong Kong dollar terms^a

	Investment return ^{b, c}
2021	4.1%
3-year average (2019–2021)	5.3%
5-year average (2017–2021)	4.7%
10-year average (2012–2021)	3.3%
Average since 1994	4.8%

- a. The investment returns for 2001 to 2003 are in US dollar terms.
 b. Investment return calculations exclude holdings in the Strategic Portfolio.
 c. 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 2021 (including forward transactions)

	HK\$ billion	%
US dollar	3,790.2	82.9
Hong Kong dollar	202.3	4.4
Others ^a	577.7	12.7
Total	4,570.2	100.0

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