GAMBLING WITH OUR NATIONAL TREASURE

U.S. dollar currency

As a preamble, let us remind the reader that that all payments to the East Timorese Government are made by the petroleum companies in U.S. dollars and that the U.S. dollar is the legal East Timorese currency. In East Timor, revenue and expenses are luckily in the same currency, and, as a consequence, the economy is naturally totally protected from the vagaries of the foreign exchange market.

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How is the Petroleum Fund invested?

Until 2008, 100% of the Petroleum Fund was invested in no-risk, U.S. Government backed, fixed income securities such as United States Treasury Notes, all in U.S. dollars.

In 2009, the whole Fund was still in Government Notes, but 9% had been transferred to currencies other than the U.S. dollar.

Starting in 2010, part of the Petroleum Fund was moved from no-risk U.S. dollar denominated, U.S. Government backed notes, to higher risk, non-government backed, commercial equities and foreign currencies, until by 2014 as much as 40% of the Petroleum Fund was invested in higher risk securities and 26% in currencies other than the U.S. dollar.

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Just remember that the Timorese non-petroleum Gross Domestic Product, that is the total economic value of the whole country over one whole year, is of the order of **$300 million**.

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First mistake: betting on diversification

A conservative and risk averse Timorese government would have stayed away from higher risk commercial equities and would have kept all its savings in U.S. Government backed securities, or bonds. This is what the Timorese Government did until 2009, and by the way achieved that way a net return of **6.77%** in 2007.

For some reason, probably related poor advice, and certainly poor judgement, the Government decided in 2010 to "diversify" our Petroleum Fund National Savings into higher risk equities, non-U.S. Government backed, such as shares in commercial companies. Ironically, after 2010 the net return on investment never reached the high of 6.77% witnessed when the whole Fund was invested in U.S. notes. The maximum return after "diversification" was **5.88%**, in 2013, and would have been **6.01%** if there had been no foreign exchange loss that year. In a great economic crisis similar to the 2008 market crash, the Fund would have ended up losing a very large chunk of its value. Should the 2008 stock market crash be re-enacted in 2015, the Fund would **lose** a staggering **$4 billion**. In fact, because of recent international stock market downturns, in 2015 the Fund is likely to **lose** as much as **$850 million** financially. See further below for details.

Is East Timor wealthy enough that it should risk losing a single dollar in the greedy hope of some higher potential gains? We don't think so, but it gets a lot worse than that.

Lesson number 1: Government should refrain from gambling on the stock market.

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Second mistake: betting on foreign exchange

Why would the holder of a U.S. dollar investment account living in a country where the currency is the U.S. dollar and receiving all his income in U.S. dollars want to risk exchanging his funds first to foreign currencies and then back to U.S. dollars? He would have to pay foreign exchange fees twice but, more importantly, he would run a huge double risk because of the highly variable international currency exchange rates. People exchange currencies only for international trading purposes, or for speculation (i.e. gambling). As conservative investors, if they don't have to, they carefully stay away from foreign exchange markets because the potential for loss is great. In the case of East Timor, between 2010 and 2014, 26% of its Fund was invested in foreign currencies, for some strange reason, when there was no need to do so, because the country is paid in U.S. dollars and spends U.S. dollars, and just as importantly, the U.S. dollar denominated stock markets historically outperform foreign stock markets. Migrating from the U.S. dollar to other currencies was not only dangerous, it was also useless and it has proven to be disastrous for the Timorese people.

In 2014, the Fund recklessly lost **$425 million** due to foreign exchange vagaries. In 2013 it had already lost $19.4 million. That is over $400 for every man, woman and child in the country.

Lesson number 2: Government should refrain from gambling on the foreign exchange market.

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Third mistake: making a loss into a gain just by saying so

In its 2014 Annual Report, published a few weeks ago, the Finance Minister writes, verbatim, to justify the $425 million foreign exchange loss: *"The Petroleum Fund incurred a foreign exchange loss of US$ 425 million for the year. We should not place too much weight on the returns for any one year. The Fund posted foreign exchange gains in three other years, including a considerable gain in 2012 of almost $725 million. Since 2009 total foreign exchange gains have outweighed foreign exchange losses"*.

The Minister then lists the foreign exchange gains and losses as follows:

2009: + $155.6 million

2010: +$21.7 million

2011: -$51.7 million

2012: +$725 million

2013: -$19.3 million

2014: -425.5 million

On paper, the overall gain looks like **$405.7 million**, which you obtain by adding all the figures from 2009 to 2014. That looks great indeed, but how could a $725 million foreign exchange surplus be achieved in 2012, at a time when only about 10% of the Fund had been transferred to foreign currencies, or approximately $1,438 million? Did the exchange rate of the U.S. dollar versus foreign currencies vary by 50% within the year, or anywhere close?

In reality, after carefully analyzing all the Petroleum Fund annual reports, one discovers that the real facts on foreign exchange gains and losses were as follow:

2009: + $155.6 <u>thousand</u>

2010: +$21.7 <u>thousand</u>

2011: -$51.7 <u>thousand</u>

2012: +$724.9 thousand

2013: -$19.3 million

2014: -425.5 million

The first four figures are thousands of dollars, not millions.

The reported gain of $405.7 million is in fact a **net loss of $444.0 million**. The Minister had failed her mathematics exam by an amount of **$845.7 million**. That is an awful lot of money, enough to power the electrical plants at near full capacity for 12 years, or to build a serious brand-new reinforced concrete road from Dili to Bacau, or to pay for 30,000 university scholarships abroad, or to feed the whole population for 3 years. A lot of money, in a country where the average income apart the petroleum revenue is less than $1 a day.

Lesson number 3: Governments should refrain from managing billions of dollars of poor people's money when they mistake a $450 million loss for a $400 million profit.

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Teachings for the future

So, what can be said of the administration that manages our National Savings in the Petroleum Fund?

1. They gamble with our money on the stock market, and take huge risks that would cost us billions of dollars, should a general stock market downturn occur. Remember the October 2008 stock market collapse and the Long Recession that followed. Within 18 months the major indexes had lost 55% of their value, sometime more. At the time all the Petroleum Fund was all invested in U.S. Government Bonds, thank heaven, and the returns for the years 2008 to 2010 were all positive. Should a similar crisis happen today, because of "diversification" the **loss** would be a staggering **4 billion dollars**. In fact, very depressingly, it is more than probable that the Fund will incur a financial **loss** on the stock market of about **$700** million in 2015. See bottom note.

2. They gamble with our money on the foreign exchange market, taking huge but absolutely unnecessary risks and losing huge amounts of money. They **lost $425 million** in 2014 due to foreign exchange vagaries, and it is predicted that the loss for 2015, for similar reasons, will be at least **$450 million**. Add that loss to the loss above and you find a **$1,150 million equity and exchange loss**. See bottom note.

3. After losing huge amounts of our money, they mislead us by telling us that the huge loss is actually a huge profit.

We hope that they have much fun gambling with our savings. After all, very few individuals around the planet can boast 17 billion dollars to gamble with.

Incidentally, in 2014 almost $7 billion dollars ($7,000 million) of the Petroleum Fund was invested in 1,980 businesses around the world, an average $3.3 million per company. We paid $134 million for shares in Apple, Inc., $74 million for Microsoft, $60 million for Google, $30 million for Facebook, all quite volatile stocks.

How much was invested in East Timor's economy?

The Timorese people thought they had entrusted their National Treasure to a responsible Government, and assumed their Ministers and their legions of advisers knew what they were doing, but it now seems the East Timorese Government had confiscated our National Savings for its own gambling benefit, and in the process not only lost vast amounts of money in a reckless manner, and will continue to do so, but also attempted to camouflage the loss and make it look like a profit.

Can we continue to trust our incompetent and greedy administration? What is our officials' agenda, other than traveling the world in comfort, pretending to be World-class Statesmen and women, taking themselves seriously in international circles, and congratulating each other at the United Nations for their ability to govern the world? Is their agenda to reserve our National Savings for themselves, to pay for their 100% pensions and perks for a century after they retire, while the nation is officially the hungriest in Asia?

Our officials have extensively proven to us through their reckless mismanagement of the Petroleum Fund that they are incompetent. Isn't the present Petroleum Fund scandal one more indication of the irrationality of all their other absurd pursuits, among which we can count the multi-billion dollar ports without a ship, the impossible pipelines and LNG plants, the four-lane toll road between nowhere and nowhere, the impossible airports, the petrochemical plants and refineries without a market and without raw material, the floating port in Hera that sunk the day it was installed, the cement plant that was never built, the roads that are flimsily fixed using ridiculously small budgets borrowed from Japan, the absolutely irrational Timor Sea boundary dispute, the unreasonable spying allegations, the new irresponsible dispute (as if we had not enough of them already) about Article 8(b) of the Timor Sea Treaty, the absolutely useless Chinese patrol boats that cost 5 times or more what they should have cost, the huge power plants that were bought on a whim but can't find fuel for themselves, the mystery of the ConocoPhillips and ANP Bayu Undan accounts, etc.? Our officials and their advisors seem to relish unrealistic dreams of grandeur and above all rather undiplomatic disputes with other nations, but what have they done for their country, in concrete terms? Are the roads any better than they were ten years ago, or the people any less hungry?

East Timor has lost all credibility before the world. No honest investor will ever risk a single dollar in such an unsafe and irrational country, except perhaps the Chinese, who are most probably intent on buying out our island for a few billions of dollars, to turn it into an advanced military base for their Navy and Air Force (they know our country offers the unique gateway to the Indian and other oceans they singularly lack at home). This would explain the deep water port at Suai but would hardly restore our international credibility or popularity.

In our country, heads of government sign international treaties and contracts and then abruptly change their minds, invoking the most futile reasons: don't they know the value of the word given, or of a solemn commitment? What other recent instance do we have of a responsible government vociferously repealing international treaties freely entered into? There are indeed examples in history, complete with the stirring up of nationalistic expansionist furor, but these are too ugly to mention here.

East Timor has now clearly proven to the world that it cannot even be trusted with the honest and professional management of its National Treasure.

East Timor is governed by a class of incompetent, and above all arrogant, politicians, manipulated by a class of self-righteous Australian Labor Party politicians, and its leaders are not even elected any more by the people from which they so decisively estranged themselves.

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Note:

Comments on past returns and prediction for 2015

Between 2011 and 2014, investment in U.S. bonds decreased by 7% in real value, or -$0.6 billion, to $8.3 billion, while of the total Petroleum Fund revenue of $10.3 billion during the period, $1.6 billion was invested in foreign currency notes, $3.7 billion in U.S. stocks and $2.6 billion in foreign stocks. An amount of $3.0 billion was spent by the government.

In 2013 and 2014, virtually all of the Petroleum Fund revenue was invested in stocks ($3.5 billion), while $1.5 billion was spent by government. No investment in bonds was made.

The general gains and losses affecting the value of our assets reported in the Petroleum Fund Annual Reports follow more or less the major world financial indexes, particularly in 2012 and 2014, although it is difficult to understand from the annual reports how a loss on assets could have happened in 2011 when the Dow Jones Index increased by nearly 6% during the year, or why the reported gain on assets in 2013 was only one half of the Dow Jones Index increase for the year. It is also difficult to figure how a foreign exchange loss could be incurred in the divesting of U.S. dollars in 2013 when foreign currencies appreciated by 4% against the U.S. dollar.

Based on the 2014 gains and losses reported in the last annual report, which are in good accordance with major international indexes, it can be predicted that in 2015 the Fund will incur a **loss of $700 million** on equities, as major stock markets lost nearly 10% of their value during the year (against a gain of 8.5% in 2014). The Fund will also incur a foreign exchange **loss of $450 million**, the U.S. dollar having continued its appreciation at a rate of nearly 10% in 2015 (it was 11% in 2014).

The **total loss** on equities and foreign exchange for 2015 is very likely to be in the vicinity of **$1,150 million** ($1.15 billion), largely exceeding all earlier “diversification” gains. The profit on government bonds and notes will likely be around $350 million.

The overall loss for 2015 will therefore be about $800 million, against an overall profit of $527 million in 2014. On the bright side, the inflation rate in the U.S., where most of the assets are still invested, has seriously decreased from 3% in 2011 to a minimal 0.2% to 0.3% in 2015, which means that erosion of the Fund due to inflation will only be about $50 million.

Predicted overall loss for the Petroleum Fund in 2015: $850 million, if no financial commotion occurs before the end of the year (October is historically the month of market crashes).

To think that “diversification” was undertaken to reduce risk and exposure of the Petroleum Fund! Without “diversification” the gain for 2015 would have been $350 million.

At a time when revenue from our oil and gas fields has already decreased by more than 50% since 2012, from $3.6 to less than $1.8 billion, stop the reckless financial bleeding of our National Savings!