

# Reserves Management

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The global economy and financial markets performed better than expected in 2017. Global equity markets went up on the back of synchronised economic growth in major developed and emerging market economies, strong corporate earnings, and market expectation of slow and gradual tightening of monetary policies by major central banks. While the US Federal Reserve raised interest rates three times as expected, and began to reduce its balance sheet in October, the 10-Year US Treasury yield remained stable and the US dollar weakened (rather than strengthened) against other major currencies. Under such a favourable environment, the Exchange Fund's investment income reached a record high of HK\$264 billion in 2017, representing an investment return of 7.4%.



## 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 securities or other assets he considers appropriate, after consulting the Exchange Fund Advisory Committee (EFAC).

## MANAGEMENT OF THE EXCHANGE FUND

### Investment objectives and portfolio structure

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

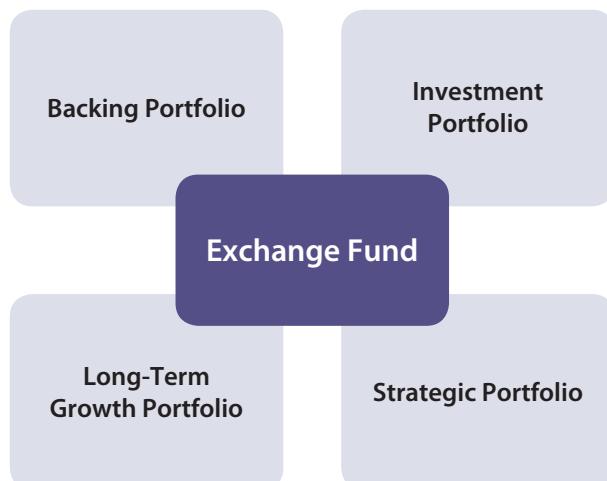
- (a) to preserve capital;
- (b) to ensure the entire Monetary Base, at all times, is fully backed by highly liquid US dollar-denominated assets;
- (c) to ensure sufficient liquidity is available for the purposes of maintaining monetary and financial stability; and
- (d) subject to (a)–(c), to achieve an investment return that will help preserve the Fund's long-term purchasing power.

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 the Currency Board arrangements. The IP 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.

To better manage risks and enhance returns in the medium and long term, the HKMA has been diversifying part of the Exchange Fund's investments, in a prudent and incremental manner, into a wider variety of asset classes, including emerging market and Mainland bonds and equities, private equity 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 one-third of the accumulated surplus of the Exchange Fund, with further capacity arising from the allocation of part of the Future Fund to long-term assets.

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



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### 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 IP<sup>1</sup>, with the exception of the Future Fund which links its interest rate to both the IP and the LTGP depending on the portfolio mix. As at the end of 2017, the portfolio mix of the Future Fund between the IP and the LTGP was about 65:35. The portion of the Future Fund linked with the LTGP is expected to gradually build up to around 50% by 2018.

### 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 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 error limit are determined by the Financial Secretary in consultation with 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 take positions to take advantage of short-term market movements.

### Asset allocation framework of the Exchange Fund



**Strategic asset allocation**



**Tactical asset allocation**

### Investment management

#### *Direct investment*

HKMA staff in the Reserves Management Department directly manage about 73% of the investments of the Exchange Fund, which includes 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 27% 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 capture sustainable returns, to benefit from diverse and complementary investment styles and to share market insights and technical expertise with the Exchange Fund.

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

#### *Risk management and compliance*

The high volatility of the financial markets subsequent to the 2008/09 global financial crisis 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 assessment has been strengthened to support the Exchange Fund's increased pace 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, allowing the HKMA to make the best use of the investment skills of internal and external managers.

<sup>1</sup> 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.

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### *Responsible investment*

The HKMA is supportive of responsible investment. For instance, the HKMA supports the Principles of Responsible Ownership issued by the Securities and Futures Commission on 7 March 2016, which are voluntary and help investors determine how best to meet their ownership responsibilities in relation to their investments in Hong Kong-listed companies. For the management of the Exchange Fund, the HKMA has encouraged the appointed external fund managers for its Hong Kong equity portfolio to adopt the Principles of Responsible Ownership in managing the investments. Furthermore, the front offices and the Risk Management and Compliance Division have incorporated environmental, social and governance (ESG) factors into various internal procedures for making and monitoring investment activities. The HKMA will closely monitor the development of ESG standards and assess how these standards can be further integrated into the investment process.

## PERFORMANCE OF THE EXCHANGE FUND

### **The financial markets in 2017**

The global economy and financial markets in 2017 performed better than expected. On the back of synchronised economic growth in major developed and emerging market economies, strong corporate earnings, and market expectation of slow and gradual tightening of monetary policies by major central banks, the global equity markets performed well. In particular, the Hong Kong equity market rose by 36%, outperforming other major equity markets.

**Table 1 2017 market returns**

<b>Currencies</b>	
Appreciation (+)/depreciation (-) against US dollar	
Euro	+13.8%
Yen	+3.5%
<b>Bond markets</b>	
Relevant US Government Bond (1–30 years) Index	+2.5%
<b>Equity markets<sup>1</sup></b>	
Standard & Poor's 500 Index	+19.4%
Hang Seng Index	+36.0%

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

In the bond markets, short-dated US Treasury yields shot up as the US Federal Reserve raised interest rates three times as expected, and began to reduce its balance sheet in October. Nevertheless, the 10-year US Treasury yield remained stable at about 2.4% over the year. Other major 10-Year government bond yields also ended the year little changed, with the exception of German Bunds which rose on the euro area's solid economic growth and market expectation of the European Central Bank's policy tightening.

In the currency markets, the US dollar weakened against other major currencies, despite the US Federal Reserve's interest rate hikes and the beginning of its balance sheet reduction. The depreciation of the US dollar was a result of the reviving economic growth in Europe and Japan, and market expectation of diminishing monetary policy divergence between the US and other major economies. The euro and yen appreciated by around 14% and 4% respectively against the US dollar in 2017.

The performance of major currencies as well as bond and equity markets in 2017 is shown in Table 1.

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### The Exchange Fund's performance

A record high investment income of **HK\$264 billion**, representing an investment return of **7.4%**.



The Exchange Fund recorded an investment income of HK\$264 billion in 2017. This comprised gains of HK\$80.4 billion on overseas equities, gains of HK\$58.3 billion on Hong Kong equities, gains of HK\$34.4 billion on bonds, a positive currency translation effect of HK\$53.5 billion on non-Hong Kong dollar assets and gains of HK\$37.4 billion on other investments held by the investment holding subsidiaries of the Exchange Fund. Separately, the Strategic Portfolio recorded a valuation gain of HK\$4.5 billion.

The investment income of HK\$264 billion last year is a record high for the Exchange Fund, surpassing the previous record in 2007 (HK\$142.2 billion) by HK\$121.8 billion.

The total assets of the Exchange Fund reached HK\$4,015.3 billion at year end. The market value of investments under the LTGP totalled HK\$235.6 billion, with private equity amounting to HK\$157.2 billion and real estate at HK\$78.4 billion. Outstanding investment commitments amounted to HK\$162.4 billion.

The investment return of the Exchange Fund (excluding the Strategic Portfolio) in 2017 was 7.4%. Specifically, the IP achieved a rate of return of 12.1%, while the BP gained 1.8%. The LTGP recorded an annualised internal rate of return of 13.7% since its inception in 2009.

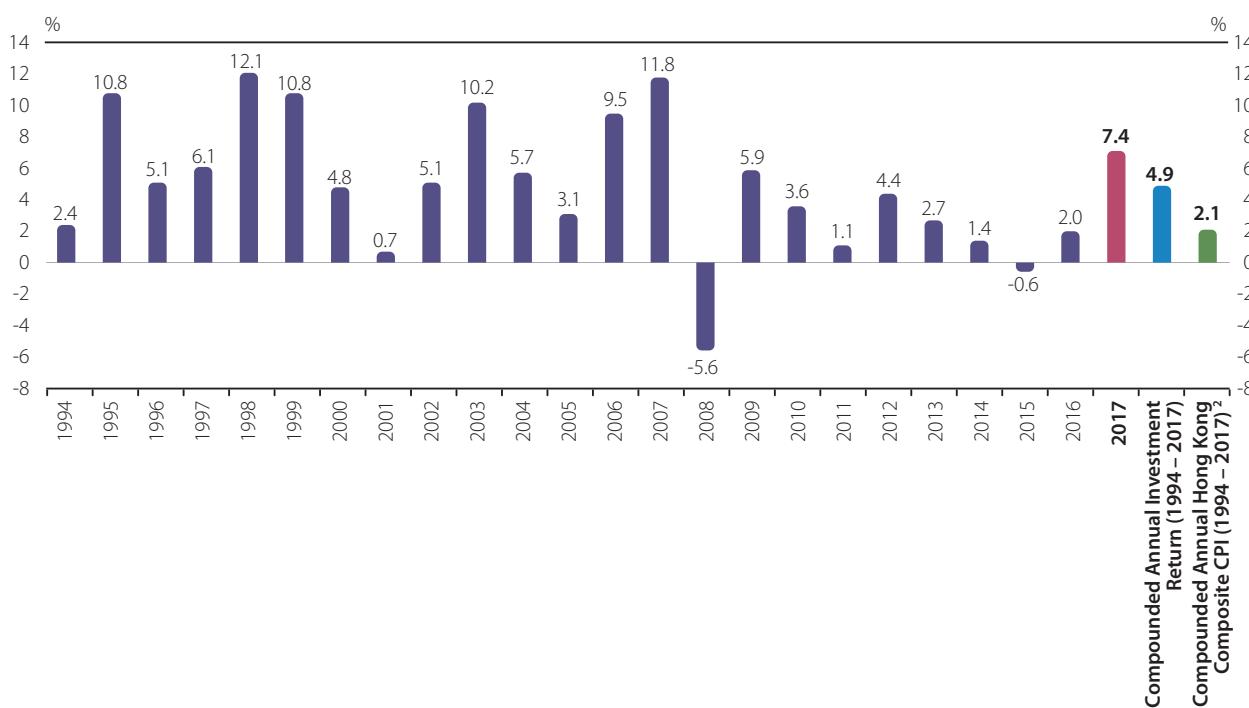
The annual return of the Exchange Fund from 1994 to 2017 is set out in Chart 1. Table 2 shows the 2017 investment return and the average investment returns of the Fund over several different time horizons. The average return was 2.9% over the past three years, 2.5% over the past five years, 2.2% over the past ten years and 4.9% since 1994.<sup>2</sup> Table 3 shows the currency mix of the Fund's assets as at 31 December 2017.



*HKMA Deputy Chief Executive, Mr Eddie Yue (middle), speaks at the press conference on 2017 Exchange Fund Results.*

<sup>2</sup> Averages over different time horizons are calculated on an annually compounded basis.

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**Chart 1 Investment return of the Exchange Fund (1994–2017)<sup>1</sup>**

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

**Table 2 Investment return of the Exchange Fund in Hong Kong dollar terms<sup>1</sup>**

	Investment return <sup>2 &amp; 3</sup>
<b>2017</b>	<b>7.4%</b>
3-year average (2015–2017)	2.9%
5-year average (2013–2017)	2.5%
10-year average (2008–2017)	2.2%
Average since 1994	4.9%

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 2017 (including forward transactions)**

	HK\$ billion	%
US dollar	3,319.9	82.7
Hong Kong dollar	297.7	7.4
Others <sup>1</sup>	397.7	9.9
<b>Total</b>	<b>4,015.3</b>	100.0

1. Other currencies included mainly euro, renminbi, pound sterling and Japanese yen.