**Response to the follow up questions for the FA Panel meeting held on 4 May 2006**

a. The size, portfolio, return and relevant parameters of the Norwegian Government Pension Fund and any other investment funds which are broadly comparable to the Exchange Fund; and

b. In connection with item (a) above, explain in what ways and to what extent the investment funds concerned are broadly comparable to the Exchange Fund.

## Background

1. The Exchange Fund's long-term asset allocation strategy is governed by the investment benchmark approved by the Financial Secretary after consultation with the Exchange Fund Advisory Committee (EFAC). The investment benchmark, which represents an optimal mix of assets, is designed to meet the following investment objectives:

(a) to preserve capital;
(b) to ensure that the entire Monetary Base at all times will be fully backed by highly liquid short-term 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 preserve the long-term purchasing power of the Fund.

2. It may not be appropriate to make direct comparisons between the Exchange Fund and other investment funds which do not have the same emphasis on capital preservation and requirement for high liquidity resulting from Hong Kong's currency board arrangement. Many central banks or monetary authorities also do not publish performance data or asset allocation, or provide a breakdown of their fund management fees. We are aware of only one, the Reserve Bank of Australia, that has published information on its benchmark asset allocation, benchmark return and investment return. The RBA's information, however, is not directly comparable to that of the Exchange Fund, since its financial year ends on 30 June each year whereas the Exchange Fund's financial year ends on 31 December.

3. Taking the above limitations into consideration, we have identified one fund and one group of funds which may shed some light on these questions. It should be borne in mind that these examples were originally chosen as a reference for the management costs of the Exchange Fund rather than as comparators for investment return. The first example is the Norwegian Government Pension Fund – Global[1]. The second is a group of Hong Kong funds which are available to Hong Kong institutional investors in the form of retirement schemes. These data are compiled by Watson Wyatt every quarter and are available by subscription. Although the investment objectives of the Exchange Fund are different from these groups of investors and these funds are much smaller, the asset composition, particularly the allocation

[1] The Norwegian Government Pension Fund comprises (i) The Government Pension Fund – Global (previously known as the Government Petroleum Fund, established in 1990); and (ii) the Government Pension Fund – Norway (The National Insurance Fund, established in 1967). The Norwegian Government Pension Fund – Global is selected for comparison with the Exchange Fund, since their sizes, asset allocation and investment style are comparable (although not exactly similar).

between equity and fixed-income assets of these funds, is in the same range as that of the Exchange Fund and provides some basis for comparison.

**Norwegian Government Pension Fund – Global**

4. At the end of 2005 the market value of the Norwegian Government Pension Fund – Global amounted to US$207 billion (1,399 billion Norwegian kroner) compared with US$137.6 billion (HK$1,067 billion) for the Exchange Fund. The Norwegian Government Pension Fund – Global was, however, significantly smaller than the Exchange Fund in earlier years.

5. Both the Norwegian Government Pension Fund – Global and the Exchange Fund use internal and external managers to manage their assets. Both funds have appointed external managers to manage fixed-income and equity mandates. The externally managed assets for the Norwegian Fund and the Exchange Fund were of comparable size at the end of December 2005. In addition, both funds have a similar number of externally managed mandates. However, in terms of its benchmark, the Norwegian Fund has a higher weighting towards equities than the Exchange Fund.

6. The following table summarises the characteristics of the two funds:

| | **Norwegian Government Pension Fund - Global** | **Exchange Fund** |
|---|---|---|
| Fund Size as at 31 December 2005 (in trillions of HK$) | $1.61 | $1.07 |
| Asset Allocation Benchmark | 60% fixed income<br>40% equities | 77% fixed income<br>23% equities and related investments |
| Percentage of assets managed externally | About 20% | About one-third |
| Types of externally managed mandates | Fixed income and equities | Fixed income and equities |
| Number of externally managed mandates at end December 2005 | 70 mandates | 78 mandates |
| External management fees (as percentage of funds under management) | 0.27% | 0.14%* |

*Includes both external fund management and custodian fees.

Investment Return:

| Year | Norwegian Government Pension Fund – Global | | Exchange Fund | |
|---|---|---|---|---|
| | **Fund size (HK$ billion)*** | **%** | **Fund size (HK$ billion)** | **%** |
| 1997 | $119 | 9.07 | $637 | 6.10 |
| 1998 | $176 | 9.25 | $912 | 12.10 |
| 1999 | $216 | 12.44 | $1,003 | 10.80 |
| 2000 | $342 | 2.50 | $1,023 | 4.80 |
| 2001 | $534 | -2.47 | $979 | 0.70 |
| 2002 | $685 | -4.74 | $955 | 5.10 |
| 2003 | $985 | 12.59 | $1,012 | 10.20 |
| 2004 | $1,299 | 8.93 | $1,062 | 5.70 |
| 2005 | $1,609 | 11.09 | $1,067 | 3.10 |
| 1997-2005 (compounded annual investment return) | | 6.34 | | 6.45 |

* Based on year-end exchange rates.

**Other Funds**

7. Watson Wyatt, an international investment asset consultant with an office in Hong Kong, prepares a quarterly *Managed Fund Report*. This report provides a survey of the characteristics of externally managed funds available to Hong Kong institutional investors in the form of retirement schemes under 13 fund categories. The 13 fund categories range from "Growth Fund", which has a 90% equity benchmark, to "Global Bond Fund", which has a 100% fixed-income benchmark. The Watson Wyatt fee information included in paragraph 9 refers only to fund management fees and excludes other fees such as trustee, administration, and custodian fees. The fee information for the Exchange Fund includes both fund management and custodian fees.

8. Of these categories, the category "Capital Stable Fund" is the closest to the asset composition of the Exchange Fund. This category consists of eight funds, each with a different manager. The Watson Wyatt benchmark for this fund category consists of 30% equities and 70% fixed-income assets. This compares with the Exchange Fund's allocation of 23% and 77%, respectively. The return of the Exchange Fund in 2005 was 3.1%, compared with a weighted average return of 2.3% for the eight funds. These funds are, of course, much smaller than the Exchange Fund.

9. The following table compares the eight funds with the Exchange Fund:

| Fund | Asset size on 31/12/05 (HK$ million) | 2005 Return (%) | 31/12/05 Equity allocation | 31/12/05 Fixed income & cash allocation | 2005 External fund manager fees |
|---|---|---|---|---|---|
| Fund Manager #1 | $177 | 1.1 | 32% | 68% | 0.95% |
| Fund Manager #2 | $1,459 | 4.8 | 35% | 65% | 0.45% |
| Fund Manager #3 | $212 | 6.7 | 28% | 72% | 0.80% |
| Fund Manager #4 | $2,064 | 1.4 | 35% | 65% | 0.75% |
| Fund Manager #5 | $834 | -1.0 | 34% | 67% | 0.75% |
| Fund Manager #6 | $164 | -0.3 | 32% | 68% | 0.65% |
| Fund Manager #7 | $389 | 2.4 | 34% | 66% | 0.80% |
| Fund Manager #8 | $311 | 3.9 | 22% | 78% | 0.63% |
| Watson Wyatt "Capital Stable" Category Benchmark** | n/a | 1.6*** | 30% | 70% | n/a |
| Exchange Fund | $1,066,799 | 3.1 | 23%* | 77%* | 0.14% |

Source: Watson Wyatt and HKMA
* Benchmark Weighting
** Benchmark calculated by Watson Wyatt with return data calculated in HK dollars
*** Performance above 1.6% indicates out-performance versus benchmark while performance below 1.6% indicates under-performance versus benchmark.

10. While, as stated in paragraph 2, comparisons of this type are of limited usefulness, the Exchange Fund compares favourably with both the Norwegian Government Pension Fund – Global and the funds in the Watson Wyatt report. It is particularly noteworthy that the compounded annual investment returns for the Norwegian Fund and the Exchange Fund are very similar, but the volatility in the return on the Exchange Fund was

considerably lower. The return on the Exchange Fund was also positive in every year since 1997, while the Norwegian Fund experienced negative returns in two years.

Hong Kong Monetary Authority
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