Annual Report
Financial Committee

Advisory Committee to the Finance Ministry
for Chile's Sovereign Wealth Funds

2008

This publication corresponds to the 2008 Annual Report of the
Ministry of Finance's Financial Committee.
The electronic version of this document is available on the
Ministry of Finance's website at www.hacienda.cl/english/fondos_soberanos.

Intellectual Property Register N° 179,447

ISSN: 0718-5790

800 copies printed

Design and layout | Zet Arts & Facts - www.zet.cl
Illustrations | Alfredo Cáceres
Printing | Quebecor World Chile S.A.

April 2009, Santiago, Chile

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Financial Committee

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for Chile's Sovereign Wealth Funds

2008

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Preface

The Financial Committee was created in 2007 to advise the Finance Minister on the investment of fiscal resources, particularly, the Economic and Social Stabilization Fund and the Pension Reserve Fund envisaged in the Fiscal Responsibility Law. This external Committee, formed by experienced professionals in the areas of finance and economics, meets periodically to analyze issues related to the funds' investments.

Since the Committee's creation, it has played an active role in analyzing the Republic's Sovereign Wealth Funds situation and evolution. In its recommendations, it takes a long-term view, with particular emphasis on the international economic and financial context. As a result, in the face of the crisis and its extraordinary impact on the stability and liquidity of the international financial system, it reassessed its proposal –put before the Finance Minister at the end of 2007– to amend the Sovereign Wealth Funds' investment policy so as to diversify the funds' portfolios to include equities and corporate bonds. The Committee suggested that, in view of the crisis, this modification be postponed until the volatility and uncertainty seen in international markets return to more normal levels.

This report –the second prepared by the Committee– sets out its work and activities during 2008 and is part of a systematic effort to increase access to information about its deliberations and recommendations and about the situation of the two funds. In this way, the Committee fulfills the requirement under Decree N° 621, issued by the Ministry of Finance in 2007, which stipulates that the Committee must present an annual report on its work to the Finance Minister and submit a copy of this report to the Finance Commissions of the Senate and the lower house of Congress and to the Special Joint Budget Commission of Congress.

Members

of the Financial Committee

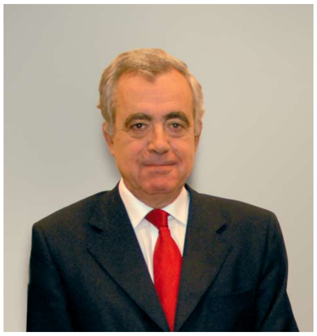
From left to right:

President **Andrés Bianchi Larre**

Bianchi studied legal and social sciences at the Universidad de Chile and holds a masters degree in economics from Yale University. He was governor of the Central Bank of Chile (1989-1991) and Chile's ambassador to the United States (2000-2006). He has also served as president of Banque Crédit Lyonnais and Dresdner Banque Nationale de Paris and as joint executive secretary of the UN Economic Commission for Latin America and the Caribbean (ECLAC) and has worked as a consultant for the World Bank, the Inter-American Development Bank and the central banks of Bolivia, Colombia, Mexico and Venezuela. He currently sits on the board of a number of companies.

Vice-president **Ana María Jul Lagomarsino**

Jul studied economics at the Universidad de Chile and holds a Ph.D. in economics from the University of Pennsylvania. She worked at the International Monetary Fund (IMF) for 27 years where she rose to become assistant director and represented Chile and five other Southern Cone countries as executive director on the IMF's board. She has also worked as a consultant on fiscal affairs for the Ministry of Economy and Finance of Peru and and the Inter-American Development Bank and as a private consultant in Chile.

Counselor **Eduardo Walker Hitschfeld**

Walker studied economics at the Universidad Católica de Chile and holds a Ph.D. in business administration with concentration in finance from the University of California at Berkeley. He is currently a professor at the School of Business Administration of the Universidad Católica de Chile. He has been a visiting professor at the Finance Department at the University of Texas's McCombs School of Business and head of research at AFP Habitat as well as an international consultant. He is also a member of the Capital Markets Committee, the Risk Classification Commission and the Technical Investment Council.

Counselor **Martín Costabal Llona**

Costabal studied economics at the Universidad Católica de Chile and holds an MBA from the University of Chicago. He has served as the Chilean government's budget director and finance minister, held executive posts at Pizarreño and Infraestructura Dos Mil and been general manager of AFP Habitat. He is currently a member of the board of Empresas CMPC and Empresas Pizarreño and a member of the Technical Investment Council.

Counselor **Oscar Landerretche Moreno**

Landerretche studied economics at the Universidad de Chile and holds a Ph.D. in economics from the Massachusetts Institute of Technology (MIT). He is currently a professor at the Economics Department of the Universidad de Chile and academic director of the joint masters program in public policy of the Universidad de Chile and the University of Chicago.

Counselor **Andrés Sanfuentes Vergara**

Sanfuentes studied economics at the Universidad de Chile and holds a masters degree in economics from the University of Chicago. He served as president of BancoEstado (1990-2000) and has worked as a consultant and as a professor at the Universidad de Chile and the Ilades-Georgetown program.

CHAPTER **01**

Fiscal Policy and Funds' Objectives

A_ Fiscal policy

Chile's current fiscal policy seeks to contribute to the country's macroeconomic stability and to provide public goods that increase opportunities and social protection for all Chileans. In order to comply with these objectives, emphasis has been placed on the efficient use of public resources and the transparency of their management.

Since 2001, fiscal policy has been anchored in a structural surplus rule. This rule reflects the central government's trend finances and is designed to reduce the impact on public finances of cyclical fluctuations in economic activity, the price of copper and other similar variables. In this way, it decouples public expenditure from cyclical changes in fiscal income, tying it instead to the more permanent or structural component of fiscal income. This helps to avoid the need for drastic cuts in public expenditure in response to adverse economic events, with the government saving during booms, when it receives temporary income, and drawing on these resources during periods of weaker economic growth and/or relatively low copper prices.

In September 2006, a Fiscal Responsibility Law came into force, providing a framework for the implementation of a fiscal policy that ensures the sustainability of public expenditure over time and contributes to the economy's competitiveness.[1] This law created the Pension Reserve Fund (PRF) and empowered the President of the Republic to create the Economic and Social Stabilization Fund (ESSF), which was officially established in February 2007 under Decree with Force of Law (DFL) N° 1 issued by the Ministry of Finance in 2006. These two funds receive the resources that result from the application of the structural surplus rule.

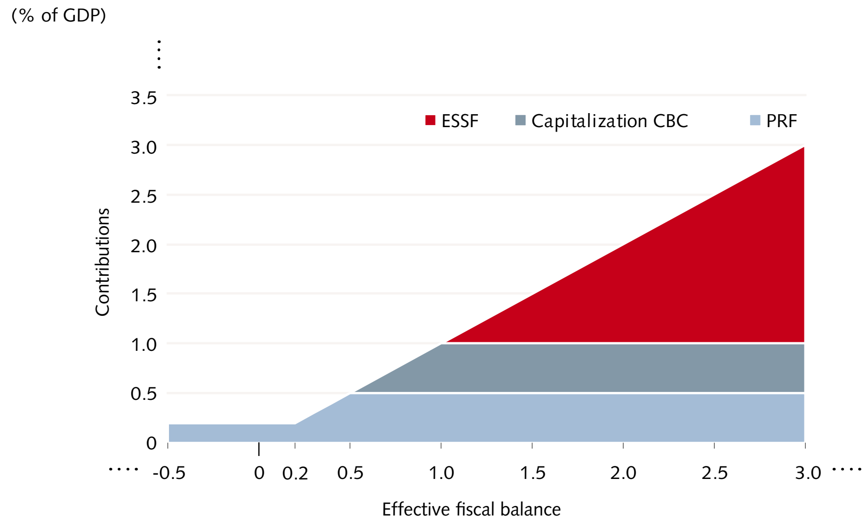
B_ Funds' objectives, rules and management

Objectives

The two funds created under the Fiscal Responsibility Law (the "Sovereign Wealth Funds" or "Funds") have clear but differing objectives. In the case of the PRF, its purpose is to serve as a complementary source of financing for future pension contingencies whereas the main purpose of the ESSF is to finance possible future fiscal deficits and to pay down public debt. In this way, the ESSF helps to isolate fiscal spending from the volatility of government revenues.

1 Law N° 20,128.

Figure 1 **Fiscal savings rule and capitalization of the CBC**



SOURCE: Ministry of Finance.

Rules for contributing to the funds

The Fiscal Responsibility Law established the rules for the creation of the ESSF and the PRF and for contributions to the funds as well as the option of capitalizing the Central Bank of Chile (CBC) during a period of five years. Figure 1 illustrates the operation of these rules for different levels of fiscal balance.

Under the law, the PRF increases each year by a minimum amount equivalent to 0.2% of the previous year's Gross Domestic Product (GDP). If the effective fiscal surplus exceeds this amount, the contribution to the PRF can rise to a maximum of 0.5% of the previous year's GDP. This policy will remain in force until the PRF reaches the equivalent of 900 million *unidades de fomento (UF)*.

The law also authorized the government to capitalize the CBC by an annual amount equivalent to the difference between its contributions to the PRF and the effective fiscal surplus, providing this difference is positive, with an upper limit of 0.5% of the previous year's GDP. This capitalization can take place over a period of five years as from September 2006.

Finally, the remainder of the effective surplus, after payment into the PRF and capitalization of the CBC, must be paid into the ESSF. Repayments of public debt and provisional payments into the ESSF during the previous year can, however, be deducted from this contribution.[2]

2 The law currently in force permits the use of resources from the current year's fiscal surplus, which must be deposited in the ESSF during the following year, to pay down public debt and make provisional contributions to the ESSF.

Rules on use of the funds

The PRF is designed exclusively to complement budget financing of fiscal liabilities arising from the government's guarantee on basic old-age and disability solidarity pensions, and old-age and disability solidarity pension contributions. Between July 2008 and 2016, annual withdrawals of up to the previous year's returns may be made and, as from 2016, of up to a third of the difference between expenditure on pension liabilities in the current year and expenditure on this item in 2008 adjusted by the change in the consumer price index during the intervening period.

The PRF will cease to exist in September 2021 if the withdrawals to be made in a calendar year do not exceed 5% of the sum of expenditure on the government's guarantee on basic old-age and disability solidarity pensions, and old-age and disability solidarity pension contributions established in that year's budget. When the PRF ceases to exist, any balance in the fund must be transferred to the ESSF.

The ESSF, is designed to finance government expenditure if there is a fiscal deficit and/or to make normal or extraordinary repayments of public debt (including *bonos de reconocimiento*).

Management policy

Under Decree N° 1,383 of 2006, the Ministry of Finance appointed the CBC as fiscal agent to act in its name and on its behalf in the management and investment of the Funds' resources. The CBC must abide by specific instructions given by the Finance Minister ("Investment Guidelines") which establish the requirements and conditions necessary for the proper exercise of functions entrusted to the CBC in its role as fiscal agent.

CHAPTER **02**

Financial Committee's Mandate and Role

A_ Functions

The Fiscal Responsibility Law specified the creation of a Financial Committee to advise the Finance Minister on the investment of the resources of the PRF and the ESSF and the definition of the guidelines needed for their implementation.

On December 23, 2006, the Finance Minister announced not only the creation of the Funds but also, in compliance with this requirement, the establishment of an external advisory committee formed by professionals with important economic and financial experience.

This Committee was officially established by Decree N° 621, issued by the Ministry of Finance in 2007 and published in the Diario Oficial (Official Gazette) on August 11, 2007. The Committee's initial members –Andrés Bianchi Larre, Martín Costabal Llona, Ana María Jul Lagomarsino, Oscar Landerretche Moreno, Andrés Sanfuentes Vergara and Eduardo Walker Hitschfeld– were also appointed under this Decree. The Finance Minister appointed Andrés Bianchi as the Committee's president and its members elected Ana María Jul as its vice-president. In September 2008, the Ministry of Finance officially announced the appointment of Martín Costabal, Oscar Landerretche and Eduardo Walker for a further two-year period.[3]

The Financial Committee's functions and the norms of procedure required for its proper operation were also defined by this Decree, under which its main functions and responsibilities are:

› To advise the Finance Minister, when so requested, on key issues related to the Funds' long-term investment policy such as the allocation of their investments by asset class, the incorporation of new investment alternatives, definition of the limits to allowed deviations and determination of the limits of the Funds' investment possibilities.

› To put to the Finance Minister, when so requested, instructions on the Funds' investments and their custody and proposals on the tender and selection processes for the management of the Funds' portfolios.

3 Under Decree N° 621, three seats on the Committee must be filled each year for a period of two years. As a result, these three members were initially appointed only for one year.

- To express an opinion at the request of the Finance Minister about the structure and content of the annual reports presented to the Ministry of Finance by the institution(s) responsible for the Funds' management or custody and, on the basis of these reports, to express an opinion about the Funds' management and, particularly, its consistency with their investment policies.

- To express an opinion about the structure and content of the reports on the Funds prepared quarterly by the Ministry of Finance.

- To advise the Finance Minister, when so requested, on any matter related to the Funds' investment.

In addition, the Committee can express its views on other matters relating to the Funds' long-term investment policy. Both these views and its recommendations must take into account the principles, objectives and rules of the Funds as set out above.

In order to promote transparency, the Financial Committee decided that the decree regulating its activities, the minutes of its meetings and the corresponding press releases should be available to the public. For this purpose, a special section of the Ministry of Finance's website was created on which updated information on all these issues is available.[4]

4 *http://www.hacienda.cl/english/fondos_soberanos*

B_ Meetings

In 2008, the Financial Committee held ten formal meetings. These are the main instances at which it agrees its recommendations about the Funds' investment policies to the Finance Minister. In the intervening periods, its members exchange information and analysis via e-mail.

Under Decree N° 621, the Committee must meet at least once every six months but, in both 2007 and 2008, its members considered that more frequent meetings were necessary.

The Financial Committee is assisted by specialized Ministry of Finance staff headed by Eric Parrado, the ministry's coordinator for international finance, who acts as the ministry's liaison with the Committee. This group also includes two senior economists, two other economists and an international finance lawyer as well as the head of the Budget Office's Public Finance Division, the head of its Financial Programming Area and two analysts in this field.

In general, the Financial Committee's meetings are divided into four parts. In the first, Ministry of Finance staff present a detailed report on, among other issues, the state of the Funds, including the amount of savings accumulated and their returns, as well as information, studies and international comparisons about the investment policies of other sovereign wealth funds (SWFs). In the second part, the Committee analyzes and assesses the Funds' performance and its consistency with their investment policy. In the third part, the Committee's members –if they deem it necessary– discuss and draw up specific recommendations to be presented to the Finance Minister and, finally, approve a press release about the Committee's deliberations and recommendations.

The main topics analyzed in each meeting and a summary of the agreements adopted are presented below.

01_Fiscal Policy and Funds' Objectives
02_Financial Committee's Mandate and Role
03_Main Recommendations in 2008
04_Key Figures of the Sovereign Wealth Funds

JANUARY

M	T	W	T	F	S	S
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MARCH

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APRIL

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Meeting 1: JANUARY 25

The Financial Committee devoted its first meeting of 2008 to a review of the process for hiring an international consultant to assist in the selection of external managers for the Funds' future portfolios of equities and corporate bonds.[5] After considering the fees charged by the six firms participating in the bidding process, their time frames and experience and the coverage of their databases, the Committee recommended that the Finance Minister hire the firm Strategic Investment Solutions (SIS). In this meeting, the Committee also continued to work on the details of the Funds' new investment policy. In particular, it put forward a recommendation for specific benchmarks to be used for each asset class and proposed that the percentage of assets held as short-term instruments be reduced to 5% in both funds at the end of 2008.

5 At the end of 2007, the Committee put to the Finance Minister a recommendation for the diversification of the Funds' investment policy, incorporating equities and corporate bonds.

Meeting 2: MARCH 17

This meeting focused on analyzing the content of the report on its activities that the Committee must prepare annually. It was also agreed to post the report on the Ministry of Finance's website. In addition, it analyzed the process of hiring SIS and the investment guidelines given to the CBC by the Ministry of Finance in accordance with the Committee's recommendations on the new investment policy. Finally, it reviewed the latest international publications and initiatives relating to SWFs. Finance Minister Andrés Velasco participated in part of this meeting

Meeting 3: APRIL 7

In its third meeting of the year, the Committee reviewed the final draft of the annual report on its activities in 2007. As legally required, this report was submitted to the Finance Minister at the end of April, and copies were submitted to the Finance Commissions of the lower house of Congress and the Senate and to the Special Joint Budget Commission of Congress. In addition, 600 copies were distributed to different institutions, the media and key figures in the public and private sectors.

JUNE

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JULY

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SEPTEMBER

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Meeting 4: JUNE 2

The Committee's fourth meeting was devoted mainly to evaluating the process of selecting external managers for the Funds' future portfolios of equities and corporate bonds. A universe of 110 external managers had been contacted and asked to submit information about their organization, experience and track record. Discussion focused on the preliminary results of this part of the process. In addition, Ministry of Finance staff presented information about the plan announced by President Michelle Bachelet for a Bicentennial Human Capital Fund to finance scholarships for Chileans to study abroad.

Meeting 5: JULY 2

In its fifth session, the Committee continued to review the process of selecting external managers. The CBC presented a report on the final results of the first stage of this process in which 49 firms were pre-selected. The Committee approved this list and made suggestions about the information that the pre-selected firms should be asked to present in the second stage of the process in order to assess their efficiency and technical capacity for managing the Funds' future portfolios of equities and corporate bonds. In addition, it made a number of recommendations about the selection criteria that should be used to evaluate the candidates' relative strengths and proposed modifications to the weighting of these criteria.

Meeting 6: SEPTEMBER 5

The sixth meeting was devoted to the review of a shortlist of 20 potential external managers selected by the CBC with the support of SIS after evaluating the proposals received in answer to the questionnaire sent to the candidates in the second stage of the selection process. It was agreed that the candidates on this shortlist would be interviewed by the CBC, the Ministry of Finance and SIS in San Francisco, U.S. The Committee also reviewed the results of the international seminar "Sovereign Wealth Funds: Responsibility to Our Future" organized by the Ministry of Finance, and concluded that this had provided an opportunity to increase public awareness of different aspects of the Chilean funds and to compare them with other countries' SWFs. It also analyzed the agreement reached by the International Working Group of Sovereign Wealth Funds (IWG-SWF) during its meeting in Santiago about the adoption of principles and practices that should be generally accepted by SWFs.[6] In the Committee's opinion, this agreement constituted a further step in fostering greater SWF transparency and maintaining the free global flow of investment in the context of an open and stable financial system.

6 For further information about these agreements, known as the Santiago Principles, see the Ministry of Finance's 2008 Annual Report on Sovereign Wealth Funds.

SEPTEMBER

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Meeting 7: SEPTEMBER 23

In its seventh meeting, the Committee analyzed the evolution of the international financial crisis, agreeing to maintain permanent monitoring of the causes and effects of interventions by the governments and central banks of the main industrialized economies in their bid to guarantee the stability and liquidity of the international financial system. The Committee also examined the condition of the institutions in which some of the Funds' assets were invested as well as that of their custodian bank, confirming that these did not include institutions facing serious financial difficulties. In addition, the Committee agreed with the Ministry of Finance's conclusion that the crisis had not had a significant impact on any of the short-listed external managers. It also continued to review the process for selecting external managers, analyzing the results of the interviews carried out in San Francisco after which ten firms were selected for interviews in Santiago. The Committee approved the results and made a number of additional suggestions about the information that the candidates should present in Santiago.

OCTOBER

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Meeting 8: OCTOBER 20

At its eighth meeting, the Committee made a detailed examination of the state of the Funds' investments, identifying the countries and institutions in which they were held. It also analyzed the recent episodes of international financial turbulence, examined the decisions and policies adopted by different governments and central banks, and evaluated their potential impact on the Funds' investments. In addition, the CBC presented the list of the ten external managers selected after the round of interviews in Santiago. In its opinion, these fulfilled the necessary requirements in terms of portfolio management experience, technical suitability, quality of service, solvency, transparency and competitive costs. The Committee agreed with this selection.

NOVEMBER

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DECEMBER

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Meeting 9: NOVEMBER 27

The Committee's ninth meeting focused on the analysis of the Funds' condition and their individual investments in the context of the international crisis. It found that there were no investments in institutions whose solvency and/or liquidity had been particularly affected by the global crisis. In view of the exceptional volatility and uncertainty prevailing internationally, the Committee recommended that the Finance Minister postpone the implementation of the new investment policy that it had proposed at the end of 2007. In addition, it agreed to continue monitoring international financial conditions so as to recommend the most appropriate approach to implement a more diversified investment policy in the future.

Meeting 10: DECEMBER 29

At its tenth meeting, the Committee analyzed the possibility of increasing the number of issuers eligible for the Funds' investments. In view of the mounting intensity of the world economic crisis and the advantageous position of Chile's financial sector in terms of solvency and supervision, the Committee recommended adding deposits in foreign currency at local banks to the list of eligible instruments.[7]

Following the recommendation at its previous meeting that the Funds' diversification into equities and corporate bonds be postponed, the Committee endorsed the CBC proposal that the process of selecting external managers for these asset classes be concluded. It suggested that the finalists of the 2008 process should be considered when a decision to implement the new investment policy were taken.

7 This recommendation was formalized at the Committee's meeting of January 9, 2009.

CHAPTER **03**

Main Recommendations in 2008

A_ Investment policy

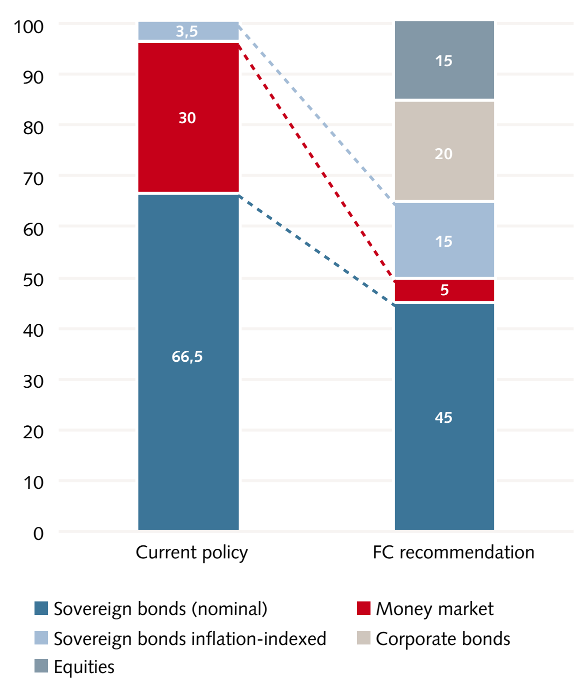
Since March 2007, the PRF and the ESSF have been invested in asset classes similar to those in which the CBC holds the international reserves. As a result, their initial portfolios comprised only short and medium-term low-risk financial instruments.

Under this policy, 30% of their portfolios was invested in money market instruments, 66.5% in nominal sovereign bonds and 3.5% in inflation-indexed sovereign bonds. In addition, limits were placed on their currency exposure by establishing the following allocation: 50% in US dollars, 40% in euros and 10% in yens.

However, considering that the nature and purpose of these funds differ from those of international reserves, the Financial Committee recommended in its October 2007 meeting that the Finance Minister gradually modify the Fund's investment policy with a view to diversifying their portfolios. It suggested that, by late 2008, they have an allocation comprising 15% in equities, 20% in corporate bonds, 45% in nominal sovereign bonds, 15% in inflation-linked sovereign bonds and 5% in money market instruments *(figure 2)*.

Figure 2 **Initial investment policy and Financial Committee recommendation**

(% of portfolio)



SOURCE: Ministry of Finance

In the Committee's opinion, this new asset allocation would offer higher returns in the medium- and long-term while still taking on an acceptable level of risk.

The Committee's recommendation was accepted by the Finance Minister and, with a view to starting its implementation, new investment guidelines were given to the CBC in February 2008. These included a mandate to select external managers for the portfolios' new components.

This proposed investment policy –although very conservative in comparison to those typically adopted by other SWFs– involved a higher level of risk than the initial policy. This would be reflected mainly in more volatile returns (losses or gains) particularly in the short term, due to the incorporation of equities and corporate bonds into the Funds' portfolios.

Despite the progress achieved in the course of the year towards selecting external managers (as described in the following section), the Committee subsequently recommended that the implementation of the new investment policy be postponed in view of the extraordinary intensity of the international financial crisis.

It is common knowledge that 2008 brought a deepening of the financial problems unleashed in the US in 2007 by the so-called sub-prime crisis. Its effects then spread globally, undermining the international financial system and the solvency of important institutions around the world. Uncertainty about the true level of exposure of financial institutions to "toxic assets", the sharp fall in the value of real estate in the US and numerous European countries, a deterioration in mortgage repayments, the contraction of consumption caused by rising unemployment, the loss of wealth and a sharp downturn in expectations only accentuated doubts as to whether financial institutions were sufficiently capitalized to absorb future losses.

The crisis peaked in September 2008 with the collapse of Lehman Brothers, which was followed by the bankruptcy of Washington Mutual, the bailout of American International Group (AIG) –one of the world's largest insurers– and the Belgian-Dutch bank Fortis. These developments and other global events resulted in the semi-paralysis of the financial system, a sharp and generalized fall in stock prices and an increase in market volatility, with a significant impact on the financial system's liquidity. Illiquidity and an ever greater lack of confidence in the solvency of financial institutions were reflected in a widening of the difference between the interest rate on inter-bank lending (LIBOR) and the risk-free interest rate (US Treasuries). This difference, known as the TED spread, reached levels of close to 450 basis points (or 4.5 percentage points) in the third quarter of 2008 compared to an average since 2006 of 35 basis points (*figure 3*). This situation and the severe problems faced by a number of financial institutions led to their intervention by some central banks and governments in a bid to maintain the integrity of the international financial system.

Figure 3 **TED spread, 2006-2008**

(basis points)

SOURCE: Bloomberg.

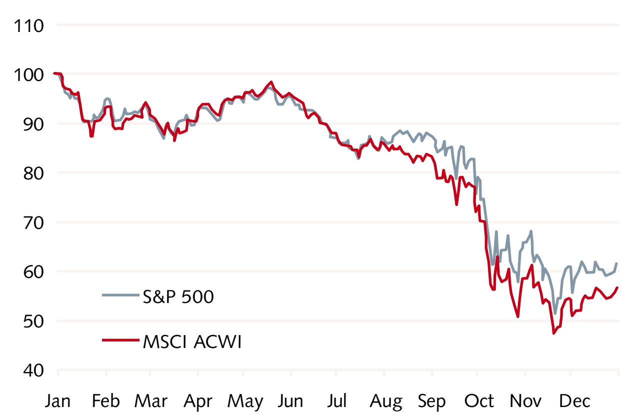
Simultaneously, stock prices plummeted on most of the world's exchanges. Thus, the Standard & Poor's 500 Index (S&P 500) lost almost 39% during 2008 while the Morgan Stanley Capital International All Country World Index (MSCI ACWI) lost 43.5% (*figure 4*).[8]

The crisis also affected corporate bonds. The decrease in companies' sales and their growing financing difficulties led to a widespread market perception that many might not be able to meet their financial obligations. The Barclays Capital Global Aggregate: Corporates Bond Index lost more than 15% between July and October 2008 and, although it showed a recovery over the rest of the year, still closed the year down by 8.6% (*figure 5*).[9]

Figure 4 **Stock market, 2008**

S&P 500 and MSCI ACWI

(January 2008 = 100)



SOURCE: Bloomberg.

8 The S&P 500 measures the stock market performance of the 500 largest US companies while the MSCI ACWI measures the performance of stock markets in both developed and emerging economies.

9 The Barclays Capital Global Aggregate: Corporates Bond Index represents the value of a portfolio of fixed-income securities issued by companies in different countries and economic sectors

In contrast, developed countries' sovereign bonds and, particularly, US Treasuries showed important price increases reflecting higher demand for these instruments as a refuge in the face of prevailing market uncertainty and increased investor risk aversion. As a result, the Barclays Capital Global Aggregate: Treasury Bond Index closed the year with a gain of 10.2% (*figure 6*).[10]

Figure 5 **Corporate bond market, 2008**

Barclays Capital Global Aggregate: Corporates Bond Index

(January 2008 = 100)

SOURCE: Barclays Capital.

Figure 6 **Sovereign bond market, 2008**

Barclays Capital Global Aggregate: Treasury Bond Index

(January 2008 = 100)

SOURCE: Barclays Capital.

10 The Barclays Capital Global Aggregate: Treasury Bond Index measures the performance of sovereign fixed-income securities issued by different investment-grade countries.

As from August, there was a sharp drop in the price of inflation-indexed bonds, reflecting their more limited liquidity and expectations that a number of developed economies would enter a period of deflation. As a result, the Barclays Capital Global Inflation-Linked Index lost 7.7% in 2008 (*figure 7)*.[11]

At the same time, financial market volatility showed a marked increase. In the case of both stock prices, measured using the MSCI ACWI, and corporate bonds, measured using the Barclays Capital Global Aggregate: Corporate Bond Index, this peaked at the beginning of the last quarter of 2008 (*figure 8*).

The CBOE Volatility Index (VIX), an indicator of the volatility expected by the market in the S&P 500 over the next thirty days, reacted similarly, with its value increasing considerably during the most serious episodes of the crisis (*figure 9*).

Figure 7 **Inflation-Indexed sovereign bond market, 2008**

Barclays Capital Global Inflation-Linked Index

(January 2008 = 100)

SOURCE: Barclays Capital

11 The Barclays Capital Global Inflation-Linked Index measures the performance of inflation-indexed bonds in the main markets.

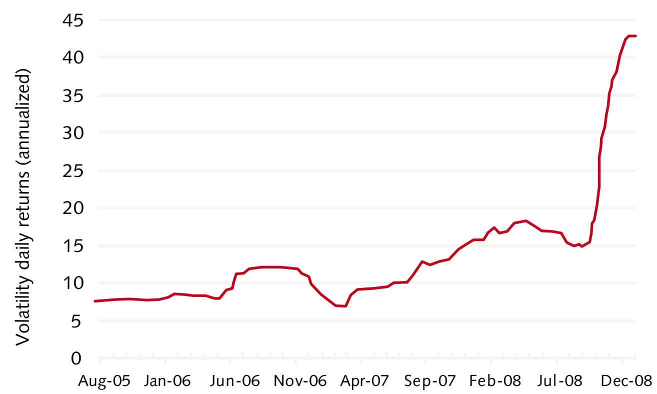
Considering the almost unprecedented severity and reach of the economic and financial crisis and the extraordinary level of market volatility and uncertainty, the Financial Committee in its November meeting agreed to recommend the postponement of the proposed new investment policy for the ESSF and the PRF. In addition, the Committee undertook to continue monitoring international financial conditions so as to recommend the most appropriate strategy for diversifying the Funds' portfolio in the future.

Figure 8 **Stock market and corporate bond market volatility (*), 2005-2008**

(%)

MSCI ACWI

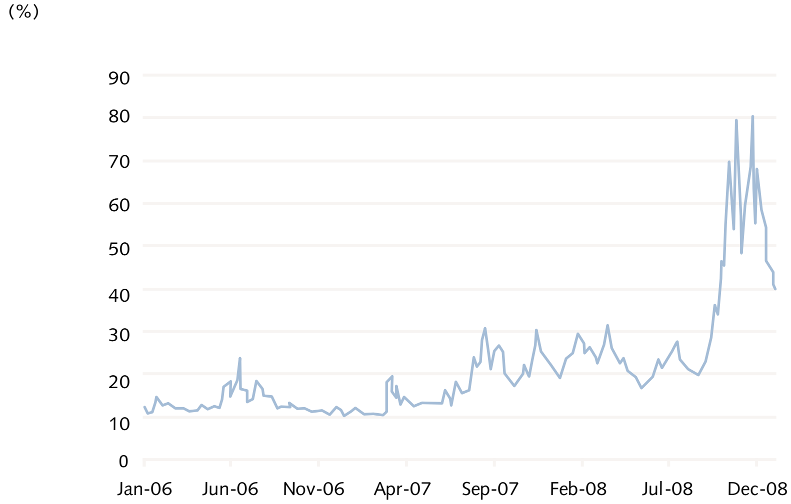
(*) Corresponds to the annualized volatility of the daily returns of indexes calculated daily over a moving six-month period.



Barclays Capital Global Aggregate: Corporates Bond Index

SOURCES: Ministry of Finance, Bloomberg and Barclays Capital.

Figure 9 **CBOE Volatility Index (VIX), 2006-2008**



SOURCE: Bloomberg.

B_ Selection of external managers

Context

An important part of the Committee's activities in 2008 were devoted to the process of selecting external managers for the equities and corporate bonds to be incorporated into the Funds' portfolios in late 2008. The Committee proposed that several managers be appointed for each asset class and that each be assigned a set investment amount. It also recommended that, initially, the management of these assets be predominantly passive, evolving gradually towards more active management. In addition, it suggested that both the Ministry of Finance and the CBC participate together in the selection process.

Selection of external consultant

After analyzing the design of the selection process, the Committee recommended the hiring of an external consultancy firm in order to have specialized technical support in the evaluation of candidates and, through the consultant's databases, wider access to information about potential candidates. The Committee suggested that the consultancy firm be selected on the basis of the following criteria: cost (consultancy firm's fees); time frame (the number of weeks it would take to provide the necessary advice); experience (its list of clients and services provided) and the coverage of its databases (quantity and quality of their information). Using these criteria, the Committee recommended that, out of a total of six specialized firms, Strategic Investment Solutions (SIS) be hired.

Selection of external managers

The process of selecting external managers was divided into four stages:

Stage 1
REQUEST FOR INFORMATION

Through a request for information, 110 institutions, which had previously expressed interest in managing the Funds' equity and corporate bond portfolios, were invited to participate in the process. The CBC, the Ministry of Finance, and the SIS consultancy firm assessed the capabilities and qualifications of these institutions on the basis of the information they submitted, pre-selecting 26 companies for the equities portfolio and 23 for the corporate bond portfolio (*table 1*). All of these companies were invited to participate in the second stage of the process. The CBC presented the results to the Committee, which agreed with its choice.

Stage 2
REQUEST FOR PROPOSALS

In July, the CBC sent a request for proposals to each of the pre-selected companies. The responses received were used to assess qualitative and quantitative aspects of these companies such as their investment style, ability to manage investments subject to risk limits, staff qualifications and turnover, willingness to transfer expertise and technology to the Chilean authorities, structure of decision-making processes and cost. These criteria were weighted as previously agreed by the CBC, the Ministry of Finance and the Committee and a shortlist of ten companies for each type of portfolio was compiled. The CBC presented its reasons for selecting these companies to the Committee, which agreed with its choice.

Table 1 **Number of companies in each stage of the selection process**

	Stage	Nº of companies
1	Request for information (universe of managers)	110
2	Request for proposals (pre-selected)	49
3	Interviews in San Francisco (short-listed)	20
4	Interviews in Santiago (finalists)	10

SOURCE: CBC

Stage 3
INTERVIEWS IN SAN FRANCISCO

The 20 short-listed companies were invited to participate in a round of interviews in September at SIS's offices in San Francisco, U.S. In these interviews, the information they had submitted in the previous stages was analyzed and validated, acquaintance was made with the staff who would manage the portfolios, administrative costs were negotiated and details of the level of additional services that the candidates could offer to the CBC and the Ministry of Finance were established. Finally, five finalists for each portfolio were selected, taking into account their different levels of cost, investment styles, geographical diversification and other criteria proposed by the Committee. The CBC presented these results to the Committee which approved them.

Stage 4
INTERVIEWS IN SANTIAGO

Subsequently, the ten finalists were interviewed in Santiago by the CBC, the Ministry of Finance, members of the Financial Committee and SIS. On the basis of these interviews and analysis of the information obtained in previous stages of the process, the CBC presented the Committee with a list of the five finalists for each portfolio in order of preference in case the Ministry of Finance decided to hire less than five external managers for each asset class. These results were approved by the Committee.

Financial Committee's Recommendation

In its last meeting of the year, the Committee recommended that the selection process for external managers to participate in the Funds' diversification into equities and corporate bonds be concluded. This proposal was in line with the recommendation adopted at its November meeting to postpone investments in these asset classes due to the exceptional volatility and uncertainty of the international financial and economic outlook. In addition, the Committee suggested that, when this investment policy is launched, the companies on the 2008 shortlist be considered.

CHAPTER 04

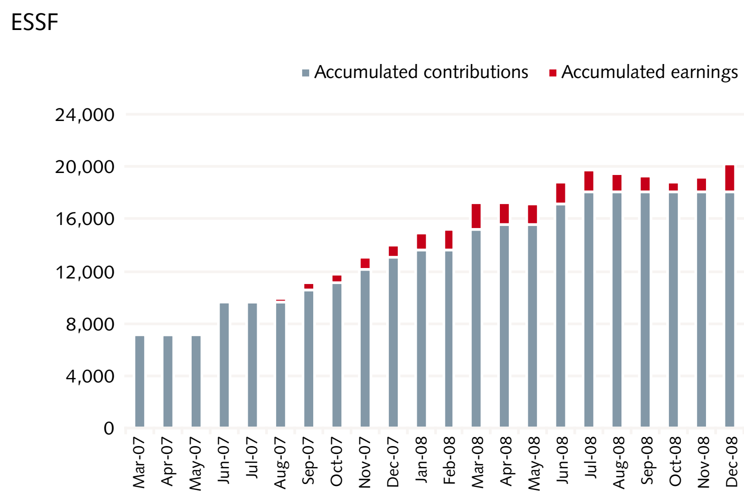
Key Figures of the Sovereign Wealth Funds

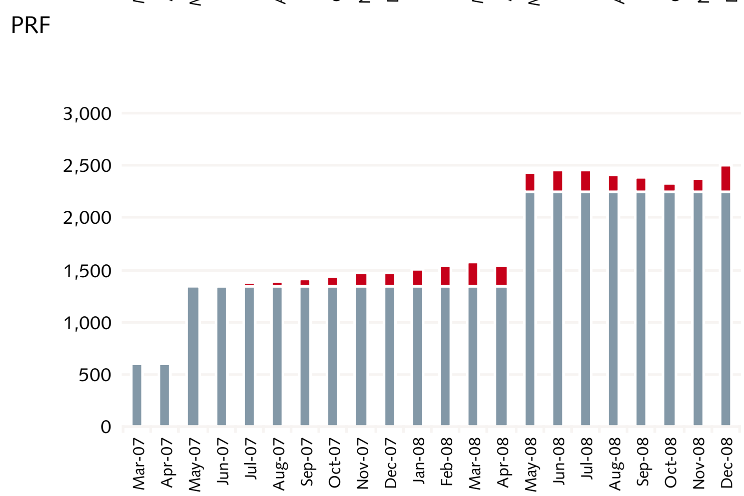
A_ Market value

At the end of 2008, the market values of the ESSF and the PRF reached US$20,211 million and US$2,507 million, respectively, up from US$14,033 million for the ESSF and US$1,466 million for the PRF at the end of 2007. The increase in value of the ESSF was explained by net investment earnings of US$1,178 million and new contributions for US$5,000 million while, in the case of the PRF, it was explained by net earnings of US$131 million and new contributions for US$909 million (*figure 10*).

Figure 10 **ESSF and PRF: Market value, March 2007-December 2008**

(US$ million)





SOURCE: Ministry of Finance

B_ Returns

In 2008, the return in US dollars, measured using the time-weighted rate of return (TWRR), on both the ESSF and the PRF was 7.6% while, measured using the internal rate of return (IRR), it reached 6.8% for the ESSF and 6.4% for the PRF (*box 1*).

The results obtained by the ESSF and the PRF in 2008 are explained mainly by the return (7.2%) on the financial instruments in their local currency and to a much lesser extent (0.4%) by returns arising from changes in the value of the euro and the yen against the dollar (*table 2 and box 2*).

Box 1_Rates of return: Time-Weighted Rate of Return (TWRR) vs. Internal Rate of Return (IRR)

There are two main methods of calculating the return on an investment portfolio: the time-weighted rate of return (TWRR) and the internal rate of return (IRR).

The former is used to measure returns that depend directly on the portfolio manager's decisions and excludes the effect of contributions and withdrawals since these are generally outside the manager's control. It is calculated on the basis of the daily returns obtained from variations in the investments' market value. As a result, if contributions (withdrawals) are made on a particular day, the final value is adjusted by subtracting (adding) the contributions (withdrawals). The TWRR, therefore, reflects the performance of an investor who makes all capital contributions and withdrawals at the beginning of the investment period.

By contrast, the IRR is used to measure the returns actually obtained by an investor, taking into account the timing and amount of capital contributions and withdrawals. The IRR is the discounted rate at which the portfolio's final value is equal to the present value of all contributions and withdrawals.

Table 2 **ESSF and PRF: Determinants of returns (TWRR), 2008**

(%)

Fund	Component	Quarter I	Quarter II	Quarter III	Quarter IV	2008
PRF	Local currency	2.8	-1.1	1.9	3.5	7.2
	Variations in exchange rates	4.5	-0.8	-4.4	1.4	0.4
	Total return (US$)	**7.4**	**-2.0**	**-2.5**	**4.9**	**7.6**
ESSF	Local currency	2.8	-1.1	1.9	3.5	7.2
	Variations in exchange rates	4.5	-0.8	-4.4	1.4	0.4
	Total return (US$)	**7.3**	**-1.9**	**-2.5**	**4.9**	**7.6**

SOURCE: Ministry of Finance

Box 2_Determinants of the Funds' returns

Returns on the investments of the ESSF and the PRF depend on a number of factors, principally interest rates and variations in exchange rates, which may have a positive or negative effect on the value of their portfolios.

1. The return on short-term fixed-income securities corresponds to their interest rate and tends to be very stable.
2. The return on medium and long-term fixed-income securities is determined mainly by the level and variation of interest rates in the country in which they are issued. For example, if a country's interest rates are low, bank deposits in that country or bonds issued by its government will offer a lower return than in countries with higher interest rates. In addition, changes in interest rates affect the market value of fixed-income securities, particularly longer-term bonds, since an increase in interest rates reduces their value and a drop increases it. Returns arising from these factors are known as local currency returns.
3. Fund's returns are also affected by changes in the value of the currency used to report its performance. For example, if a fund's reporting currency is the dollar, the value in this currency of investments in euros (yens) will increase (decrease) if these currencies appreciate (depreciate) against the dollar.
4. The return on a fund is, therefore, the sum of the return it obtains in the local currency and the return that arises from variations in exchange rates.

In 2008, the local returns of the ESSF and the PRF reflected a conservative investment policy which gave preference to fixed-income instruments with a low credit risk such as sovereign bonds and term deposits in financial institutions with an international risk rating of more than A-. The greater demand for securities issued or backed by developed-country governments as the result of the financial crisis in which investors around the world rebalanced their portfolios from riskier assets in favor of other safer and less volatile alternatives –process known as flight to quality- increased their market prices. In addition, the reduction of the exposure of the ESSF and the PRF to the banking sector, from 30% at the beginning of 2008 to around 16% at the end of the year, meant a decrease in their credit risk.

The effect of exchange-rate variations, although less important, was also positive. This was mainly due to the appreciation of the yen, which meant an increase in the dollar value of yen-denominated securities.

As shown in Box 3, the results obtained by the ESSF and the PRF in 2008 compared favorably with those of most other SWFs around the world.

Although the returns of the ESSF and the PRF are monitored and reported in dollars, they can also be expressed in Chilean pesos. In this case, their return depends not only on the factors discussed above but also on the peso-dollar exchange rate, with the value of their portfolios in pesos increasing (decreasing) when the peso depreciates (appreciates) against the dollar. In 2008, the peso weakened significantly against the dollar and the return of both funds, measured in pesos, was 37.6%, well exceeding their return in dollars (7.6%).

Box 3_Performance of selected SWFs

In 2008, many investors, including a large number of SWFs, suffered important losses. The size of these losses was determined mostly by the investment policy –more aggressive or more conservative– adopted by each fund in accordance with factors that include its objectives, risk tolerance and investment horizon.

Funds with more aggressive strategies require a longer investment horizon and a greater risk tolerance in their bid to obtain higher returns. Their portfolios, which typically include an important percentage of equities, corporate bonds and alternative investments, generally have more volatile returns, suffering important losses during market downturns as well as significant gains when markets recover. However, the evidence suggests that, in the long term, such investment policies deliver higher returns than more conservative and less volatile alternatives.

More conservative investors are often unwilling to accept significant volatility in their returns. They, therefore, invest mostly in less risky asset classes and their portfolios are heavy on fixed-income sovereign assets and money market instruments.

Norway's SWF, for example, which receives oil income, allocates a significant part of its portfolio (50%) to equities while other SWFs, such as those of Ireland, New Zealand, Alaska and, to a lesser extent, Australia, have also adopted policies that include important allocations of equities and alternative investments. By contrast, more conservative SWFs, such as Chile's, allocate a large part of their portfolios to lower-risk asset classes such as fixed-income securities and money market instruments (*table R3.1*).

In 2008, those funds with more aggressive strategies suffered important losses. For example, measured in their reporting currency, Norway's fund showed a loss of 23% to December while, in the case of the SWFs of Ireland, New Zealand and Alaska, the losses reached 30%, 26% and 25%, respectively. Losses on Australia's SWF –which has an intermediate investment policy as regards risk exposure– were significantly lower (9%) and Chile, with a more conservative strategy, obtained a positive return of 7.6%.

It should, however, be noted that, despite the significant losses that many funds with aggressive investment policies sustained in 2008, they still show positive returns over their whole life and these should increase once markets recover from the current financial crisis.

Table R3.1_Strategic asset allocation and returns (selected SWFs)

(%)

Fund	Asset allocation				Return[b]	
	Money market instruments	Fixed-income	Equities	Alternative investments[a]	2008	Since Inception (annual average)
Norway	—	50	50	—	-23.3	2.9
Ireland	10	22	58	10	-29.5	0.6
New Zealand	—	19	53	28	-26.2	4.0
Alaska	—	31	47	22	-24.7	2.5[c]
Australia	46	17	28	9	-8.5	-4.1
Chile	30	70	—	—	7.6	9.5

SOURCE: Reports of selected SWFs

(a) Alternative investments include principally private equity, hedge funds, commodities and real estate.

(b) Returns are shown in each fund's reporting currency: Norway (basket of currencies), Ireland (euro), New Zealand (New Zealand dollar), Australia (Australian dollar), Alaska (US dollar) and Chile (US dollar).

(c) Past five years.

Figure 11 **Index of ESSF and PRF, April 2007–December 2008**

(March 31, 2007 = 100)

ESSF

PRF

SOURCE: Ministry of Finance.

Measured using the TWRR, the mean annual return in US dollars on the ESSF between March 31, 2007 and the end of 2008 was 9.5% and, in the case of the PRF, 9.4%. The indexes shown in Figure 11 reflect the accumulated returns on the investments of each fund since March 31, 2007, excluding the effect of contributions. In both cases, the index rose from 100 on March 31, 2007 to a peak of 117.2 points at the end of 2008. Additionally, the annualized IRR since the Funds' inception reached 8.6% for the ESSF and 8.4% for the PRF.[12]

12 The first contributions to the PRF were made on December 28, 2006 and, in the case of the FEES, on March 6, 2007.

Glossary

Glossary

Asset class —a specific investment category such as equities, corporate bonds, sovereign bonds and money market assets. Assets of the same class are generally similar as regards risk and structure, have similar market reactions, and tend to be subject to the same regulation.

Basis point —one hundredth of a percentage point; the smallest unit of measure for bond returns or changes in interest rates.

Bond —a financial liability of an organization (for example, a company or a government) to investors under which the issuer undertakes not only to return the capital but also to pay an agreed interest rate at specific dates.

Cash —cash in hand and bank demand deposits.

Corporate bond —a bond issued by a private company.

Duration —a measure of the exposure of a bond's price to changes in interest rates; the longer the duration, the greater its sensitivity to changes in interest rates.

Equity —a security representing ownership of part of a company and the right to participate in its profits/losses.

Fiscal Responsibility Law —Law Nº 20,128 published in the Official Gazette on September 30, 2006.

Fixed income —financial instruments that provide a yield over a given period of time that is known at the time of their acquisition; these securities or bonds represent debt for the issuer (for example, companies or governments) and the issuer or borrower must return the full amount borrowed and pay the agreed interest in a specified period.

Inflation-indexed sovereign bond —a bond issued by a government whose value varies in line with an inflation index; in the US, these securities are known as Treasury Inflation-Protected Securities (TIPS).

Investment policy —the criteria, guidelines and instructions that regulate the amount, structure and dynamics of an investment portfolio.

LIBID —London Interbank Bid Rate, the interest rate paid on inter-bank deposits; by definition, this rate is equal to LIBOR minus 0.125%.

LIBOR —London Interbank Offered Rate, the interest charged on inter-bank borrowing.

Liquidity —ease with which an investment (or instrument) can be sold.

Money market instrument —a short-term security, with a maturity of up to a year, which can readily be converted into cash and does not have a significant risk of changes in its value.

Portfolio —the combination of investments acquired by an individual or institutional investor.

Risk —the possibility of suffering a loss; the variability of the return on an investment.

Risk rating —an indicator of the credit risk of a security, institution or country, issued by a credit rating agency.

Sovereign bond (nominal) —a bond issued by a government.

Spread —the difference between the yield-to-maturity of two fixed-income securities; used to assess the comparative performance of different assets.

Stocks —securities that represent the ownership or capital of a company; buyers of stock become owners or shareholders of the company and, therefore, have earnings or losses depending on its results. If the company makes a profit, it can pay dividends to its shareholders and its share price will tend to rise whereas if it makes a loss, it will not be able to pay dividends and its share price will tend to drop.

Sub-prime mortgage —a mortgage granted to a person whose credit profile would not permit access to standard financing; these mortgages are relatively more expensive and risky.

US financial agency —a US mortgage institution with explicit or implicit government backing.

Volatility —a measure of an asset's risk, representing the variation shown by its price over a given period of time; values can fluctuate with market swings, due to events such as variations in interest rates, unemployment and economic changes in general.

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