Annual Report

SOVEREIGN WEALTH FUNDS 2008

Sovereign Wealth Funds

Sovereign Wealth Funds

future Chile

April 2009, Santiago, Chile

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

Intellectual Property Register N° 179,448
ISSN: 0718-7424
800 copies printed
April 2009, Santiago, Chile

Design and layout: Zet Art & Facts
Illustrations: Alfredo Cáceres
Printing: Quebecor World

ANNUAL REPORT
SOVEREIGN WEALTH FUNDS

MINISTRY OF FINANCE

2008

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MINISTER'S REMARKS

2008 will be remembered as the year in which the world was engulfed in one of the most serious financial and economic crises since World War II. Chile, immersed in the global economy, has not been immune to the financial difficulties experienced by developed countries. However, Chile now has strengths that it never before possessed and, in contrast to other emerging markets, is on a sound footing to face the impact of this complex period.

It is in this crisis that we have begun to see the first fruits of all our efforts to ensure fiscal responsibility. The implementation of formal mechanisms as part of the fiscal policy has allowed us to save during upswings, providing us with resources to draw on during downturns. The assets accumulated in the Economic and Social Stabilization Fund (ESSF) have enabled us to finance countercyclical fiscal stimulus measures to boost activity and employment during 2009.

Fiscal responsibility not only implies a balanced approach in the short term; it also involves taking a long-term view. That is why, with our eyes on the future, we will continue to build up the assets of the Pension Reserve Fund (PRF), even at this time of crisis, to provide a complementary source of financing for the pensions and social security obligations for the most vulnerable sectors of the population.

This long-term approach to fiscal policy also involves laying down the foundations of Chile's future development through a commitment to its most valuable asset - its people. As President Michelle Bachelet announced, we will soon create a Bicentennial Human Capital Fund to finance scholarships for Chileans who want to further their studies abroad.

The management of these two sovereign wealth funds, whose assets belong to all Chileans, is a task to which we have devoted our best efforts, and we have results to show. Since their creation until the end of 2008, the ESSF and the PRF generated earnings of US$2,367 million or 1.4% of GDP. These returns are the result of a prudent investment policy, backed by the advice and dedication of a committee of top-level experts and the Central Bank of Chile in its role as fiscal agent for the funds' management. Thanks to their efforts, it has been possible to obtain sound results even in the midst of the international crisis.

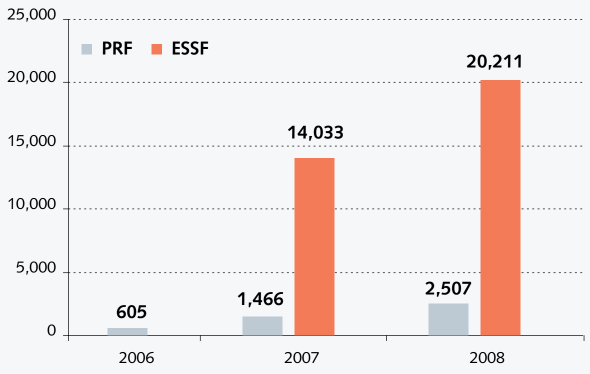
However, as well as seeking positive results from our investment policy, we have also set ourselves high disclosure and transparency standards. The publication of this first annual report on Chile's sovereign wealth funds is part of our institutional efforts to increase transparency and access to information in all areas of interest to the public, including the performance of these funds and the risks implicit in their investments.

Today, as Chileans see their government implementing an ambitious countercyclical policy to counteract the effects of lower international growth, they are better placed to understand the decisions we took, as a country, to strengthen the institutional framework of our fiscal policy. And they also understand that the creation of these sovereign wealth funds and their proper management are, without doubt, one of the most tangible and solid legacies of the government of President Michelle Bachelet.

Andrés Velasco
MINISTER OF FINANCE

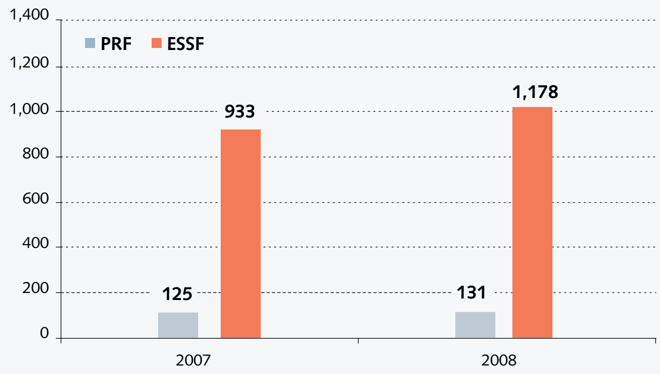
SUMMARY

Figure 1_ PRF and ESSF: Market value
(US$ million)



Source: Ministry of Finance

Figure 2_ PRF and ESSF: Net financial earnings
(US$ million)



Source: Ministry of Finance

The Pension Reserve Fund (PRF) and the Economic and Social Stabilization Fund (ESSF) together reached a market value of US$22,717 million in 2008, equivalent to an annual return of 7.62%.[1]

In the context of the severe financial crisis that developed in 2008, the performance of the Pension Reserve Fund (PRF) and the Economic and Social Stabilization Fund (ESSF) compared favorably with that of other sovereign wealth funds and international institutional investors.

PERFORMANCE OF CHILE'S SOVEREIGN WEALTH FUNDS

The market value of the PRF and the ESSF in 2008 was the highest since their creation.

As of December 31, 2008, the PRF and the ESSF were worth US$2,507 million and US$20,211 million, respectively (*figure 1*). Their increase with respect to 2007 was explained by their net financial returns as well as by new contributions of capital.

The total net financial earning on the two funds amounted to US$1,309 million in 2008.

US$131 million corresponded to the PRF and US$1,178 million to the ESSF (*figure 2*). Since the creation of the two funds, their investments have generated earnings of US$2,367 million.

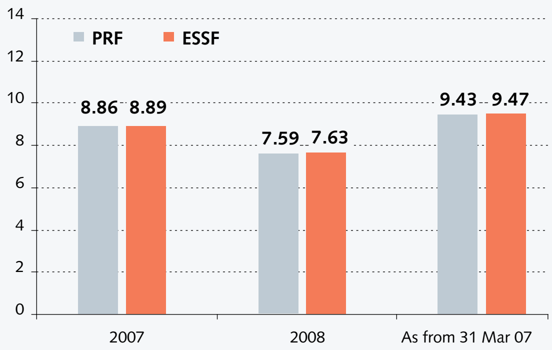
Measured as from March 31, 2007,[2] **they obtained a net annualized return of 9.47%.**

In 2008, the PRF and ESSF reported a return in dollars of 7.59% and 7.63%, respectively, taking their annualized return accumulated since March 31, 2007 to 9.43% and 9.47% (*figure 3*). The annualized internal rate of return (IRR) since their creation reached 8.41% for the PRF and 8.62% for ESSF.

1 Unless the internal rate of return (IRR) method is specifically indicated, returns reported in this document are calculated using the time-weighted rate of return (TWRR) method. For further information, see Section 4.2 and Box 4.

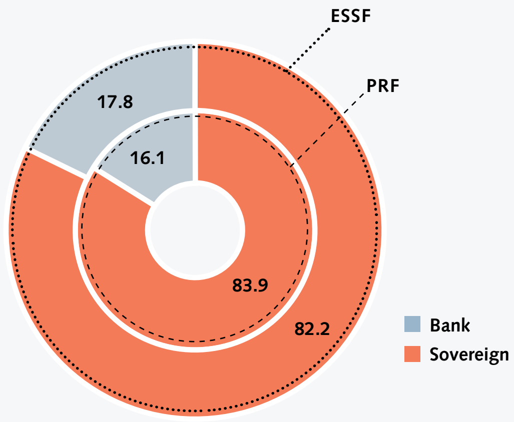
2 Since March 31, 2007, the time-weighted rate of return (TWRR) has been used to measure returns.

Figure 3_ PRF and ESSF: Net return
(%)



Source: Ministry of Finance

Figure 4_ PRF and ESSF: Credit risk, December 31, 2008
(% of portfolio)



Source: Ministry of Finance

In 2008, the bank credit risk of the funds' investments showed a drop.

At the end of 2007, around 4% of the credit risk of their portfolios corresponded to government agencies, 30% to banks and 66% to sovereign securities whereas, in December 2008, over 80% of their investments were in sovereign securities and approximately 18% in bank deposits (*figure 4*).

NEW INVESTMENT POLICY

Given the high level of global financial uncertainty, the Finance Ministry decided to postpone the implementation of a new investment policy for the funds recommended by the Financial Committee, which had been due to come into effect at the end of 2008.[3] At the request of the Finance Ministry, the Central Bank of Chile (CBC) also halted the process of appointing external managers for the new asset classes envisaged under this investment policy. Future decisions in this area will depend on the evolution of the international financial and economic situation.

3 Under this new investment policy, stocks and corporate bonds would have been incorporated into the investment portfolios of the PRF and the ESSF. For further information, see Section 4.1 of this report and the reports issued by the Financial Committee in 2007 and 2008.

1 SOVEREIGN WEALTH FUNDS

1.1 FISCAL POLICY

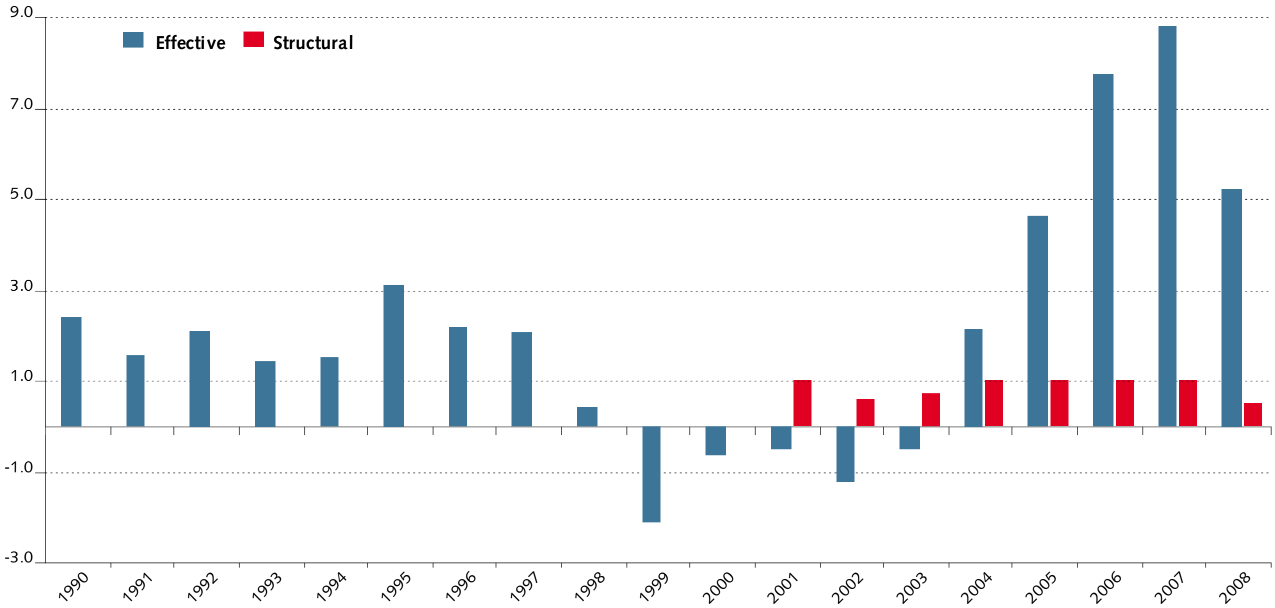
Over the past twenty years, Chile's hallmark has been maintaining a fiscal responsibility policy and continuously strengthening of its institutional framework. In 2001, a structural surplus rule was introduced for the central government budget and this was followed in 2006 by the creation of the country's two sovereign wealth funds as a vehicle for managing the surpluses resulting from the application of this rule.

Under the rule, annual fiscal expenditure is calculated in accordance with the central government's structural income, independently of fluctuations in revenues caused by cyclical swings in economic activity, the price of copper and other variables that determine effective fiscal income. This implies that the government saves during upswings, when it receives significant transitory revenues, and can avoid the need for a drastic tightening of fiscal spending during downturns, thereby stabilizing the growth of public expenditure over time. In 2001, the structural surplus target was set at 1% of GDP and this was reduced to 0.5% of GDP under the fiscal budget for 2008.

The implementation of this countercyclical fiscal policy resulted in an important accumulation of financial assets. This reflected the high copper prices of recent years that, as from 2005, meant a large increase in the effective budget surplus, which reached as much as 8.8% of GDP in 2007 (*figure 5*).

The Fiscal Responsibility Law, which came into effect in the second half of 2006, established norms and an institutional framework for the accumulation and management of these fiscal assets, creating two sovereign wealth funds: the Pension Reserve Fund (PRF), into which the first payment was made on December 28, 2006, and the Economic and Social Stabilization Fund (ESSF), which was officially established under Decree with Force of Law (DFL) Nº 1, issued by the Finance Ministry in 2006. This decree merged into a single fund the savings accumulated under Decree Law (DL) Nº 3,653 (1981) and those held in the Copper Income Compensation Fund. The first payment into the ESSF was made on March 6, 2007.

Figure 5_ Effective and structural fiscal surplus
(% of GDP)



Source: Ministry of Finance

In May 2008, President Michelle Bachelet also announced the creation of a third fund, the Bicentennial Fund, which will be used to ensure funding for the Bicentennial System for the Overseas Training of Advanced Human Capital. This fund will be set up with an initial contribution of US$6,000 million and its annual returns will be used to finance scholarships for Chileans to study abroad.

1.2 PURPOSE OF THE PRF AND THE ESSF

The Pension Reserve Fund (PRF) was designed to complement fiscal obligations in the areas of pensions and social security. Specifically, the fund is earmarked as backing for the government's guarantee to basic old-age and disability solidarity pensions and solidarity pension contributions for low-income pensioners.

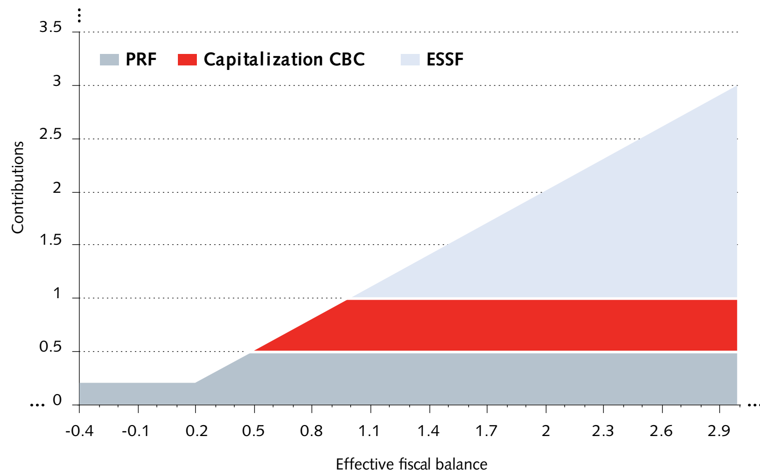
The Economic and Social Stabilization Fund (ESSF) was created to finance the fiscal deficits that may occur during periods of weak growth and/or low copper prices and can also be used to pay down pubic debt. In this way, it helps to reduce cyclical variations in fiscal spending, ensuring long-term financing for social programs.

1.3 POLICY ON CAPITAL CONTRIBUTIONS

The minimum annual amount paid into the PRF is equivalent to 0.2% of the previous year's GDP although, if the effective fiscal surplus exceeds this amount, the contribution can rise to a maximum of 0.5% of the previous year's GDP. The transfer of resources must be made during the first half of the year. This policy will remain in force until the PRF reaches the equivalent of 900 million *unidades de fomento*.

Under the Fiscal Responsibility Law, the government was authorized to capitalize the CBC during five years as from 2006 by an annual amount of up to the difference between its contributions to the PRF and the effective fiscal surplus, with an upper limit of 0.5% of GDP. In 2006, 2007 and 2008, this capitalization was equivalent to 0.5% of GDP.

Figure 6_ Fiscal savings rule
(% of GDP)



Source: Ministry of Finance

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 advanced payments into the ESSF during the previous year[4] can, however, be subtracted from this contribution (*figure 6*).

1.4 USE OF THE FUNDS

The different ways the PRF and the ESSF can be put to use are established under the Fiscal Responsibility Law, DFL Nº 1, discussed above and by the Pension Reform Law. This makes for their transparent management and provides a legal framework that contributes to Chile's macroeconomic and financial stability.

The assets of the PRF can only be used for the purposes set out above or, in other words, to complement financing of pension and social security liabilities. Between July 2008 and 2016, annual withdrawals of up to the fund's returns in the previous year 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 inflation-adjusted expenditure on that item in 2008. In September 2021, the PRF will cease to exist if the withdrawals to be made in a calendar year do not exceed 5% of the sum of expenditure on the government's guarantee to basic old-age and disability solidarity pensions and the old-age and disablement solidarity pension contributions established in that year's budget.

In the case of the ESSF, its assets may be used to finance fiscal deficits and to pay down public debt (including *Bonos de Reconocimiento*).

It is important to note that the annual interest generated by the investments of the PRF and the ESSF are considered structural fiscal income and, therefore, form part of the fiscal budget. Initially, this was the case only for earnings on the ESSF but, under the pension reform, those of the PRF are used to finance the pension liabilities described above.

4 The law 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 advanced contributions to the ESSF.

2 INSTITUTIONAL FRAMEWORK

Investment of the assets of the PRF and the ESSF calls for a clear and transparent institutional framework that provides the necessary structure for taking and implementing decisions, monitoring risk and controlling investment policy. The basis for this framework was established in the Fiscal Responsibility Law which, in articles 12 and 13, regulates the investment of fiscal resources. In addition, Supreme Decree Nº 1,383, issued by the Finance Ministry in 2006, appointed the CBC –subject to the approval of its governing board– as the fiscal agent for the management of both funds and established the general framework for their administration.[5] In addition, Supreme Decree Nº 621, issued by the Finance Ministry in 2007, created the Financial Committee to advise the Finance Minister on the investment of the assets of the ESSF and the PRF.[6]

2.1 FINANCE MINISTRY AND CENTRAL BANK

The Fiscal Responsibility Law and Supreme Decree Nº 1,383 (2006) empowered the Finance Minister to administer fiscal resources on behalf of the Republic while the Fiscal Responsibility Law expressly authorized the Finance Minister to delegate operational management of assets of the PRF and the ESSF to the CBC or other external managers. Since March 2007, the Finance Minister has entrusted this task to the CBC as fiscal agent in view of its prestige and experience in the management of international reserves.

5 This decree was published in the Diario Oficial de la República de Chile (Official Gazette) on February 17, 2007 and the decision of the CBC's governing board to accept this responsibility was published in the Official Gazette on February 24, 2007.

6 Published in the Official Gazette on August 11, 2007.

The functions of the CBC and norms on procedures for the funds' proper management were also established by Supreme Decree N° 1,383, under which the CBC's main functions as regards these funds are:

a. To directly manage all or part of these fiscal resources in representation and on behalf of the Republic;
b. To tender and delegate the administration of all or part of these fiscal resources to external managers in representation and on behalf of the Republic;
c. To open separate current accounts for the exercise of its role as fiscal agent;
d. To maintain a register of the transactions and other operations carried out in the management of the fiscal resources;
e. To hire the services of a custodian institution (*see box 1*);
f. To supervise and evaluate the performance of external managers and custodian institution(s);
g. To report daily on the position of the funds' investments and prepare monthly, quarterly and annual reports on the management of their portfolios, as well as an annual report on the services provided by the custodian institution(s); and
h. To make the payments corresponding to the exercise of its role as fiscal agent.

At the same time, the CBC must comply with the investment guidelines established by the Finance Ministry. These specify the assets considered eligible, the strategic asset allocation of the funds' portfolios, the benchmarks for evaluating the CBC's performance, and the investment limits and restrictions to control the fund's risk exposure.

The Finance Ministry reports on the state of the PRF and ESSF to the Chilean Congress by publishing monthly and quarterly reports.

Box 1 Custody of securities

Custodian institutions are responsible for the safekeeping of an investor's financial assets. Their main function is to hold and safeguard the securities entrusted to them and they are obliged to return these assets whenever so requested by the investor. They are, in addition, responsible for facilitating the transfer of these securities in accordance with the buying and selling instructions given by the investment manager and for exercising all the rights associated with the holding of these securities, such as the collection of interest and dividend payments, and for representing the investor at shareholders' and bondholders' meetings.

The assets that an investor entrusts to a custodian institution are registered in their owner's name so that, should the custodian experience financial problems, there is no risk to the investor's assets.

In 2007, the CBC hired J.P. Morgan Chase Bank N.A. as the custodian for the PRF and the ESSF. It is responsible for: i) holding the securities and cash flow resulting from their investments; ii) clearing all transactions as instructed by the CBC, including payment and transfer of the securities; iii) preparing daily, monthly and annual reports about the funds' investments and the performance of their manager; and, iv) supervising compliance with investment limits.

In 2008, once the first phase of the creation of an institutional framework for the PRF and ESSF had been completed, priority was given to the consolidation of the professional teams responsible for the funds. Both the CBC and the Finance Ministry hired additional staff in 2008 to provide support in areas related to the funds' investment strategy, management, supervision and reporting.

2.2 FINANCIAL COMMITTEE

The Financial Committee (FC) was officially created under Supreme Decree N° 621, issued by the Finance Ministry in 2007. Its role is to advise the Finance Minister on the analysis and design of the investment strategy of the PRF and the ESSF. The Financial Committee is an external advisory body, formed by professionals with vast experience in economic and financial matters. Its members, appointed under Supreme Decree N° 621, are: Andrés Bianchi Larre (President), Ana María Jul Lagomarsino (Vice-President), Martín Costabal Llona, Oscar Landerretche Moreno, Andrés Sanfuentes Vergara and Eduardo Walker Hitschfeld. In September 2008, the Finance Ministry announced that Martín Costabal, Oscar Landerretche and Eduardo Walker would sit on the Committee for a further two-year period.[7]

The FC's main functions and responsibilities are:

a. To advise the Finance Minister, when so requested, on the funds' long-term investment policy including the selection of asset classes, benchmarks, range of deviations permitted, eligible investments and the inclusion of new investment alternatives;
b. To recommend to the Finance Minister specific instructions on the funds' investments and their custody, the process of selecting managers, and the structure and content of reports;
c. To express an opinion at the request of the Finance Minister about the structure and content of the reports presented to the Finance Ministry by the institutions responsible for the funds' management and custody, and its views about their management and its consistency with their investment policies;
d. To express an opinion about the structure and content of the reports prepared quarterly by the Finance Ministry; and
e. To advise the Finance Minister, when so requested, on all the matters related to the funds' investment.

7 Under Supreme 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

Principal activities in 2008[8]

In 2008, the FC focused on monitoring the funds' current investment policy and on the development of the new policy which it had recommended in 2007 with a view to diversifying their portfolio by including two new asset classes: equities and corporate bonds. This policy had been scheduled for implementation at the end of 2008 but was postponed in response to the financial crisis of the last quarter of the year. [9]

1:(From left to right):
Eduardo Walker, Martín Costabal, Ana María Jul, Andrés Velasco, Andrés Bianchi, Andrés Sanfuentes and Oscar Landerretche.

ACTIVITIES AND RECOMMENDATIONS

A. **Publication of the Financial Committee's Annual Report.**

The FC prepared its first annual report, setting out its main activities during 2007 and the main recommendations it had issued. In compliance with legal requirements, this report was presented to the Finance Commissions of the lower house of Congress and the Senate and to the Special Joint Budget Commission of Congress. The report is available on the Finance Ministry's website at (*www.hacienda.cl/english/fondos_soberanos*)

B. **Definition of investment structure and benchmarks.**

At the beginning of the year, the FC completed its definition of the funds' strategic asset allocation and the benchmarks to be used to measure the performance of each of the asset classes contained in their portfolios.

8 For further information, see the Financial Committee's 2008 Annual Report.

9 For further information about this new investment policy, see Section 4.1 of this report.

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C. **Monitoring of investment policy.**

The FC maintained detailed monitoring of the funds' investment portfolios and assessed their consistency with their investment policy, paying particular attention to their credit risk which was analyzed regularly.

D. **Appointment of external managers for the funds' future holdings of corporate bonds and equities.**

The FC recommended that the Finance Minister hire Strategic Investment Solutions (SIS) to support the CBC and the Finance Ministry in the selection of future external managers. The FC also participated in this process, providing advice on the criteria to be considered in assessing candidates and monitoring compliance with the different stages established for the selection process. The CBC presented the results of this process to the FC which agreed with its decision.

E. **Postponement of new investment policy.**

At the end of 2008, the FC recommended that the Finance Minister postpone the implementation of the funds' new investment policy in view of the high levels of market volatility and uncertainty created by the financial crisis. In line with this recommendation, it also suggested that the process of selection of external managers be halted.

2: In order to exchange experiences in the creation and management of sovereign wealth funds, the Finance Ministry organized an international seminar.

2.3 TRANSPARENCY, DISCLOSURE AND BEST PRACTICES

The Chilean government's commitment to developing and improving all aspects of the funds' management includes the transparency of their decisions and access to relevant information. To this end, it systematically prepares and publishes reports about their situation, provides information about the main issues discussed in each meeting of the Financial Committee and about its recommendations, and discloses all significant decisions about their management adopted by the Finance Ministry. The decision to publish this report, complementing the Financial Committee's annual report, is a step further in the process of increased transparency and disclosure.

In order to guarantee public access to all relevant information about the ESSF and the PRF, the Finance Ministry has created a special website (*www.hacienda.cl/english/fondos_soberanos*), containing all monthly, quarterly and annual reports about the funds, the recommendations of the Financial Committee and its annual report, the legal and institutional framework for the funds, press releases and other information. This commitment to effective and opportune access to information was particularly important in 2008 when the international financial crisis and the liquidity problems experienced by different financial institutions around the world meant increased demand for information about the position of the institutions in which the funds' assets were deposited as well as about the intermediaries and custody services used. This led to a decision to publish a quarterly report about these institutions, rather than the annual report issued through to September 2008.

As part of Chile's commitment to best sovereign wealth fund (SWF) practices, the government decided to participate actively in initiatives launched by several international organizations in a bid to establish an operating framework for SWFs and promote their transparency. Both the Finance Ministry and the CBC have taken an active role in the International Working Group of Sov-

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ereign Wealth Funds (IWG-SWF),[10] created in May 2008 under the auspices of the International Monetary Fund (IMF). This initiative was created to draw up and promote a common set of voluntary principles for SWFs, based on existing practices, in order to help maintain the free flow of cross-border investment and the openness and stability of financial systems.

In 2008, the IWG-SWF held a number of meetings during which its members exchanged views about the development and definition of these voluntary principles. The key meeting in this process took place in Chile in September 2008 when a broad agreement was reached on a series of Generally Accepted Principles and Practices (GAPP) endorsed by the main countries with SWFs. This agreement is known internationally as the "Santiago Principles" (*see box 2*). Chile's active role in this meeting reflects its government's commitment to promoting transparency in the management of resources that belong to all Chileans and to the creation of a permanent forum for the exchange of views and information among different SWFs and the countries in which they invest.

In order to share the valuable international experience in SWFs and the views of international organizations on their role in the global economy, the Finance Ministry organized an international seminar "Sovereign Wealth Funds: Responsibility to Our Future" at which speakers included John Lipsky, First Deputy Managing Director of the IMF; Guido Mantega, Brazil's Finance Minister; Andrés Velasco, Finance Minister of Chile; Martin Skancke, Director General of the Norwegian Finance Ministry's Asset Management Department; Linah Mohohlo, Governor of the Bank of Botswana; David Murray, Chairman of Australia's Future Fund Board of Guardians; Hamad Al Hurr Al Suwaidi, Undersecretary of the Department of Finance and Director of the Executive Council of Abu Dhabi; and Pierre Poret, Head of

10 Further information about the International Working Group of Sovereign Wealth Funds (IWG-SWF) is available on its website (http://www.iwg-swf.org/).

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the Investment Division of the Organisation for Economic Co-operation and Development (OECD).

During this high-level meeting, countries from all continents, at different stages of development and with different forms of government and economic and social policies, exchanged views on the creation, management and future development of SWFs as vehicles that contribute to the stability of their economies and the welfare of their inhabitants. Summing up the discussion, Chile's Finance Minister indicated that the seminar had been an opportunity to explore the experiences of "large and small countries, rich and poor countries, with governments from the right, center and left, during which we found that, in all these cases, we had something in common - a belief that when there is temporary income from oil, copper or other mineral or natural resources, a large part of these extraordinary revenues should be saved, hopefully in the line with these principles of transparency and accountability." John Lipsky from the IMF drew attention to the importance of the Santiago Principles, pointing out that almost two-thirds of SWFs were created in the previous decade. "This event has been very valuable as an opportunity to compare experiences and management principles, to set an example and a standard for new funds and also to give the countries that receive investments from SWFs greater confidence that they will be used in a reliable and positive way from the point of view of international markets," he said.

Chile's efforts in this field were reflected in a ranking published by the Peterson Institute for International Economics in April 2008 in which the ESSF was awarded 82 points out of 100 for transparency and responsibility, taking 6th place out of 34 SWFs. In the overall ranking, which also included other aspects such as fund structure, objectives, fiscal treatment, organization, corporate governance and use of derivatives, the ESSF ranked 8th.

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3: The IWG-SWF met in Chile in September 2008 when the Santiago Principles were adopted.

4: Working during the IWG-SWF sessions (left to right): David Murray, Chairman of Australia's Future Fund Board of Guardians, and Eric Parrado, Coordinator for International Finance at the Chilean Finance Ministry, with the group's two presidents: Hamad Al Hurr Al Suwaidi; Director of the Executive Council of the Emirate of Abu Dhabi, and Jaime Caruana, Director of the IMF's Monetary and Capital Markets Department.

5: Explaining their view of the advantages of sovereign wealth funds for people's welfare and the stability of the economy (left to right): Martin Skancke, Director General of the Norwegian Finance Ministry's Asset Management Department; Guido Mantega, Finance Minister of Brazil; Andrés Velasco, Finance Minister of Chile, and John Lipsky, First Deputy Managing Director of the IMF.

Box 2 "THE SANTIAGO PRINCIPLES"

In order to promote greater transparency in investment policies and institutional arrangements, the members of the International Working Group of Sovereign Wealth Funds (IWG-SWF) have implemented or plan to implement the following principles and practices, on a voluntary basis, each of which is subject to home country laws, regulations, requirements and obligations. The publication of this set of Generally Accepted Principles and Practices (GAPP), known as the Santiago Principles, will help countries with SWFs and the countries in which these funds invest, as well as international financial markets, to gain a better understanding of the essence of SWFs.

The following GAPPs constitute the "Santiago Principles":

- **GAPP 1:** The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).
  - **1.1:** The legal framework for the SWF should ensure the legal soundness of the SWF and its transactions.
  - **1.2:** The key features of the SWF's legal basis and structure, as well as the legal relationship between the SWF and the other state bodies, should be publicly disclosed.
- **GAPP 2:** The policy purpose of the SWF should be clearly defined and publicly disclosed.
- **GAPP 3:** Where the SWF's activities have significant direct domestic macroeconomic implications, those activities should be closely coordinated with the domestic fiscal and monetary authorities, so as to ensure consistency with the overall macroeconomic policies.
- **GAPP 4:** There should be clear and publicly disclosed policies, rules, procedures, or arrangements in relation to the SWF's general approach to funding, withdrawal, and spending operations.
  - **4.1:** The source of SWF funding should be publicly disclosed.
  - **4.2:** The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.
- **GAPP 5:** The relevant statistical data pertaining to the SWF should be reported on a timely basis to the owner, or as otherwise required, for inclusion where appropriate in macroeconomic data sets.
- **GAPP 6:** The governance framework for the SWF should be sound and establish a clear and effective division of roles and responsibilities in order to facilitate accountability and operational independence in the management of the SWF to pursue its objectives.
- **GAPP 7:** The owner should set the objectives of the SWF, appoint the members of its governing body(ies) in accordance with clearly defined procedures, and exercise oversight over the SWF's operations.
- **GAPP 8:** The governing body(ies) should act in the best interests of the SWF, and have a clear mandate and adequate authority and competency to carry out its functions.
- **GAPP 9:** The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.
- **GAPP 10:** The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.
- **GAPP 11:** An annual report and accompanying financial statements on the SWF's operations and performance should be prepared in a timely fashion and in accordance with recognized international or national accounting standards in a consistent manner.
- **GAPP 12:** The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner.
- **GAPP 13:** Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.

- **GAPP 14:** Dealing with third parties for the purpose of the SWF's operational management should be based on economic and financial grounds, and follow clear rules and procedures.
- **GAPP 15:** SWF operations and activities in host countries should be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which they operate.
- **GAPP 16:** The governance framework and objectives, as well as the manner in which the SWF's management is operationally independent from the owner, should be publicly disclosed.
- **GAPP 17:** Relevant financial information regarding the SWF should be publicly disclosed to demonstrate its economic and financial orientation, so as to contribute to stability in international financial markets and enhance trust in recipient countries.
- **GAPP 18:** The SWF's investment policy should be clear and consistent with its defined objectives, risk tolerance, and investment strategy, as set by the owner or the governing body(ies), and be based on sound portfolio management principles.
  - **18.1:** The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.
  - **18.2:** The investment policy should address the extent to which internal and/or external investment managers are used, the range of their activities and authority, and the process by which they are selected and their performance monitored.
  - **18.3:** A description of the investment policy of the SWF should be publicly disclosed.
- **GAPP 19**: The SWF's investment decisions should aim to maximize risk-adjusted financial returns in a manner consistent with its investment policy, and based on economic and financial grounds.
  - **19.1:** If investment decisions are subject to other than economic and financial considerations, these should be clearly set out in the investment policy and be publicly disclosed.
  - **19.2:** The management of an SWF's assets should be consistent with what is generally accepted as sound asset management principles.
- **GAPP 20:** The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.
- **GAPP 21:** SWFs view shareholder ownership rights as a fundamental element of their equity investments' value. If an SWF chooses to exercise its ownership rights, it should do so in a manner that is consistent with its investment policy and protects the financial value of its investments. The SWF should publicly disclose its general approach to voting securities of listed entities, including the key factors guiding its exercise of ownership rights.
- **GAPP 22:** The SWF should have a framework that identifies, assesses, and manages the risks of its operations.
  - **22.1:** The risk management framework should include reliable information and timely reporting systems, which should enable the adequate monitoring and management of relevant risks within acceptable parameters and levels, control and incentive mechanisms, codes of conduct, business continuity planning, and an independent audit function.
  - **22.2:** The general approach to the SWF's risk management framework should be publicly disclosed.
- **GAPP 23:** The assets and investment performance (absolute and relative to benchmarks, if any) of the SWF should be measured and reported to the owner according to clearly defined principles or standards.
- **GAPP 24:** A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.

3 ANALYSIS OF THE INTERNATIONAL ECONOMY

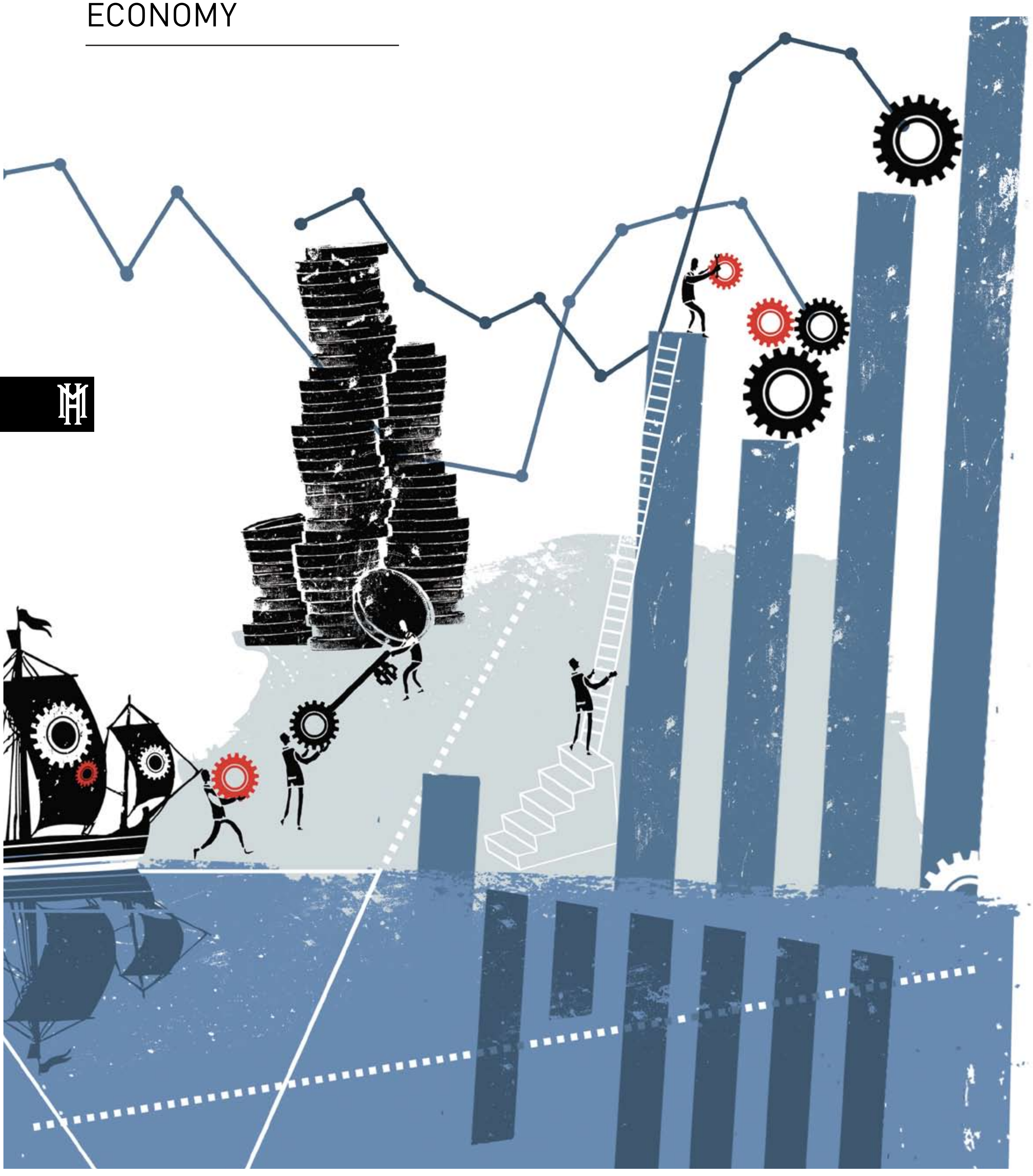


Table 1_ Annualized growth of economic activity
(%)

	2007	2008				
	Year	**Q I**	**Q II**	**Q III**	**Q IV**	**Year**
USA	2.0	0.9	2.8	-0.5	-6.3	1.1
Euro zone	2.6	2.6	-0.7	-0.7	-6.0	0.8
Japan	2.4	1.4	-4.5	-1.4	-12.1	-0.6

Sources: Fed, ECB, Bank of Japan and CBC

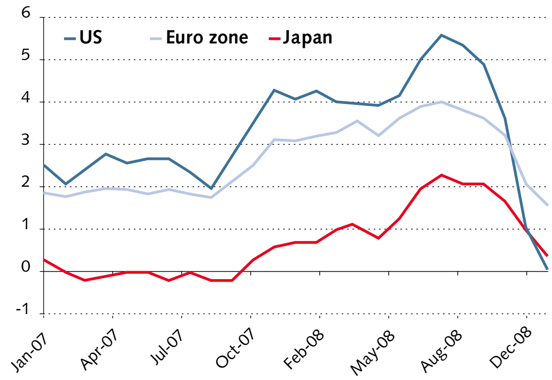
In 2008, financial markets showed increasing instability, particularly in the wake of the liquidity and the subsequent solvency problems of important US and European financial institutions. This global financial crisis affected the real sectors of economies throughout the world, with the resulting impact on their level of activity and labor markets. In a bid to contain its negative effects, governments and central banks took a range of countercyclical measures. All these events had an impact on economic variables that, in turn, affected the performance of Chile's sovereign wealth funds.

The most important variables of relevant economies are analyzed below in order to facilitate understanding of the funds' performance in 2008.

3.1 ECONOMIC ACTIVITY

The financial crisis reduced the financing available to the real sectors of economies and deepened the global slowdown particularly at the end of 2008. The US economy experienced a contraction as from the third quarter and, over the whole year, expanded by 1.1% (*table 1*). This coincided with weaker consumption, tighter access to credit and an increase in unemployment which reached 7.2% in December. In the case of the euro zone, the contraction began in the second quarter and annual growth was 0.8%. This reflected a weakening of investment as a result of the financial crisis, weaker consumption and a lower level of exports due to the deceleration of global demand, while unemployment reached 7.6% at the end of the year. The Japanese economy also contracted as from the second quarter of 2008 and, over the whole year, showed a drop of 0.6%. This coincided with a low level of exports and an increase in unemployment, which reached 4.0% in December.

Figure 7_ Inflation
(%)

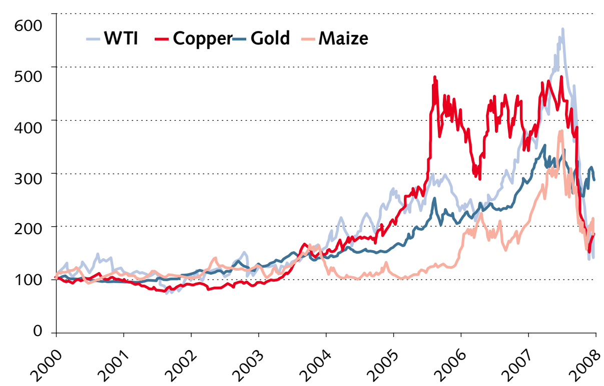


Source: CBC

3.2 INFLATION

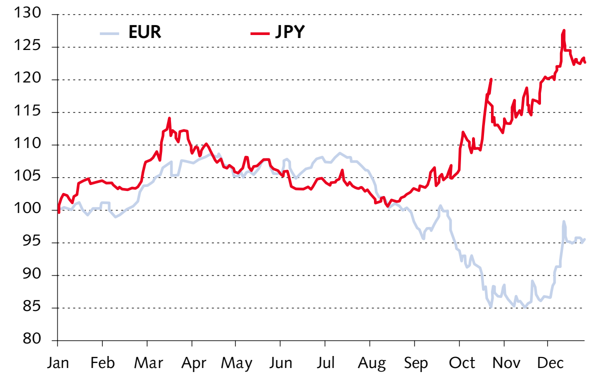
During most of 2008, increases in energy and food prices meant important inflationary pressures in the majority of countries and, through to the third quarter, a number of economies around the world were running high inflation rates. In the US, for example, inflation reached 5.6%, its highest level since 1991, and, in the euro zone, rose to 4.0%, more than one percentage point over the target of the European Central Bank's (ECB), while in Japan, it reached 2.3%. However, the global economic deceleration and the drop in the price of oil and other commodities in the last quarter significantly reduced price pressures and meant an important drop in inflation in the latter part of the year. By December, annual inflation had fallen back to 0.1% in the US, 1.6% in the euro zone and 0.4% in Japan (*figure 7*).

Figure 8_ Commodity price indexes
(January 2000 = 100)



Source: Bloomberg

Figure 9_ Exchange rates
(January 2008 = 100)



Source: Bloomberg

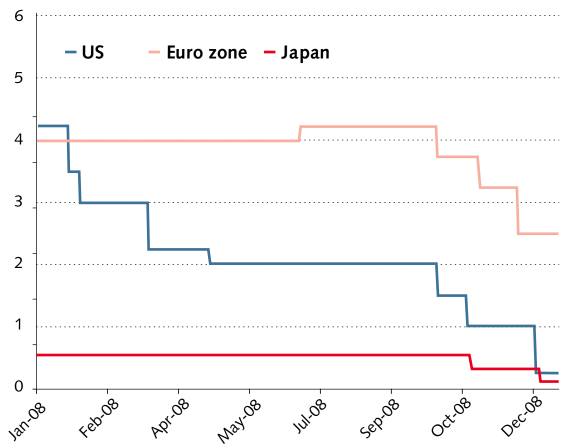
3.3 COMMODITY PRICES

In 2008, the prices of different commodities reached historic records, reflecting strong demand, low stocks and concern about the level of world reserves of non-renewable natural resources. The WTI oil price hit US$145.3/barrel while copper reached US$4.08/lb. However, the crisis and the resulting deceleration of international demand meant a sharp drop in these prices in the last quarter and copper closed the year at US$1.40/lb, with an important impact on Chile's fiscal revenues (*figure 8*).

3.4 EXCHANGE RATES

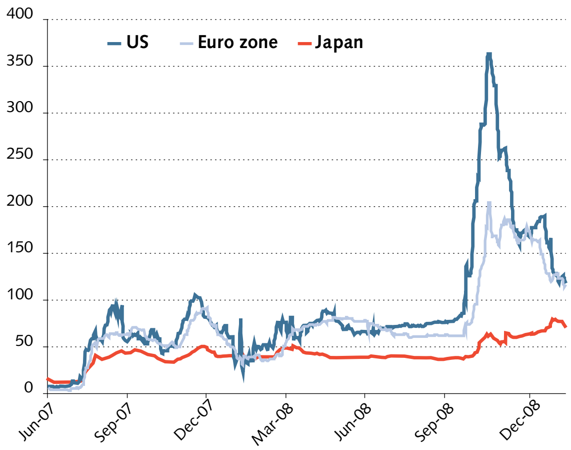
In the first half of 2008, the perception that the US economy would continue to weaken led to an appreciation of the euro and the yen against the dollar. However, in the second half, the dollar strengthened significantly against the euro, due to an increase in demand for sovereign assets in dollars, and the yen also showed a marked appreciation. Over the whole year, the dollar strengthened by 4.4% against the euro and weakened by 18.8% against the yen (*figure 9*).

Figure 10_ Monetary policy interest rates
(%)



Source: Bloomberg

Figure 11_ LIBOR-Overnight indexed swap spread
(basis points)



Source: Bloomberg

3.5 MONETARY POLICY INTEREST RATES

For Central Banks, 2008 was an extraordinarily complex year in which they faced both important inflationary pressures and liquidity problems with the latter's impact on consumption and economic activity. In the first quarter, the US Federal Reserve (Fed) reduced its federal funds rate by 200 basis points (bps) to 2.25% and, in April, to 2.0%. Inflationary pressures meant that it then maintained this rate until the financial crisis deepened in the wake of the collapse of Lehman Brothers and the events that followed this bankruptcy. The Fed then introduced further cuts, taking the rate to a range of 0-0.25% at the end of the year.

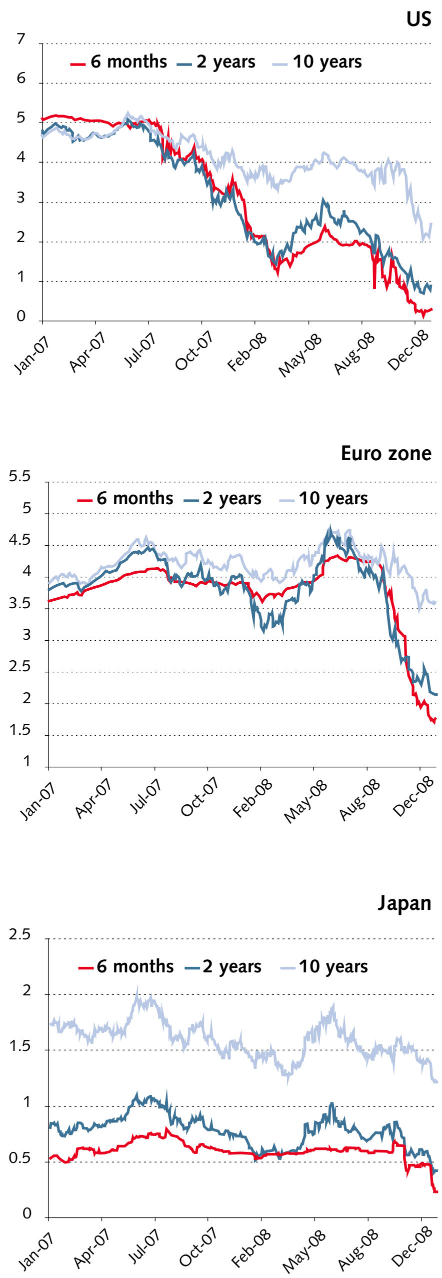
In the euro zone, the ECB held its benchmark interest rate at 4.0% during the first half and, in the third quarter, raised it to 4.25% in a bid to control inflation. However, at the depth of the international crisis, it cut the rate to 2.5%. The Bank of Japan held its benchmark rate at 0.5% during most of the year but, in the last quarter, reduced it by 40 bps to 0.1% (*figure 10*).

3.6 LIQUIDITY

Uncertainty about the real level of exposure of financial institutions to mortgage-backed securities (MBS) and their derivatives raised doubts about their capital adequacy to absorb future losses on these instruments. This uncertainty resulted in a decline in financial markets liquidity which intensified significantly after the bankruptcy of Lehman Brothers in September 2008. This bankruptcy affected financial institutions globally and forced governments to take a series of emergency measures to inject liquidity and even to bailout some institutions.

The spread between LIBOR and the overnight indexed swap rate, an indicator of financial market liquidity, began to show a significant increase in the US in 2007 but reached a historic record of 365 bps in October 2008 when financial markets ground to a virtual halt. However, government and Central Bank action had partly restored liquidity by the end of the year and the spread dropped back to around 125 bps (*figure 11*).

Figure 12_ Sovereign interest rates (6-month, 2-year and 10-year)
(%)



Source: Bloomberg

3.7 SOVEREIGN INTEREST RATES

During 2008, interest rates on government bonds of all maturity dates dropped in the US, Europe and Japan. In the first quarter, increased demand for lower-risk sovereign instruments and the Fed's interest rate cuts meant a significant drop in short-term interest rates while, in the second quarter, these rose, particularly in the US, due principally to expectations of a solution to the credit crisis. However, as from the third quarter, the Lehman Brothers bankruptcy meant that rates fell again in response to increased demand for sovereign bonds and a drop in expectations of inflation (*figure 12*).

4 PRF AND ESSF

4.1 INVESTMENT POLICY

For any sovereign wealth fund or investment portfolio, the definition of an investment policy is the single most important step in the investment process. The strategic asset allocation is the main result of the policy which defines the percentage of the portfolio represented by different asset classes which will largely determine the expected long-term return and the investments' level of risk.

Current investment policy

The investment policy defined when the PRF and the ESSF were created involved asset classes similar to those used by the CBC for international reserves. This choice was based mainly on the CBC's vast experience managing these asset classes. In the first quarter of 2008, a new investment policy, more closely aligned with the funds' characteristics, was drawn up but its implementation was postponed as a result of the economic and financial crisis, and the original investment policy remained in force throughout 2008.

Under this policy, 66.5% of the funds' assets are held as nominal sovereign bonds, 30% as money market instruments - such as short-term bank deposits and Treasury bills - and 3.5% as inflation-indexed sovereign bonds (*table 2*). This is a conservative policy given that it does not include asset classes with a higher level of risk such as equities, corporate bonds and alternative investments.[11]

Table 2_ Strategic asset allocation
(%)

Asset class	Allocation
Nominal sovereign bonds	66.5
Money market	30
Inflation-indexed sovereign bonds	3.5

Source: Ministry of Finance

Table 3_ Maximum allocation by type of credit risk
(%)

Issuer	Maximum allocation
Sovereign	100
Multilateral	60
Banks	50
Agencies	30

Source: Ministry of Finance

Table 4_ Currency allocation
(%)

Currency	Allocation	Range of variation
USD	50	45 – 55
EUR	40	35 – 45
JPY	10	5 – 15

Source: Ministry of Finance

11 Alternative investments include principally hedge funds, private equity, commodities and real estate.

Table 5_ Performance benchmarks
(%)

Benchmark	USD	EUR	JPY	Total
Money market	**15.0**	**12.0**	**3.0**	**30.0**
6-month LIBID	7.5	6.0	1.5	15.0
6-month Treasury bill rate	7.5	6.0	1.5	15.0
Nominal sovereign bonds	**31.5**	**28.0**	**7.0**	**66.5**
J.P.Morgan Global Bond Index 1-3 years	14.2	12.6	3.2	29.9
J.P.Morgan Global Bond Index 3-5 years	9.5	8.4	2.1	20.0
J.P.Morgan Global Bond Index 5-7 years	3.9	3.5	0.9	8.3
J.P.Morgan Global Bond Index 7-10 years	3.9	3.5	0.9	8.3
Inflation-indexed sovereign bonds	**3.5**			**3.5**
Barclays US Govt. Inflation-Linked Bond Index	3.5			
Total	**50**	**40**	**10**	**100**

Source: Ministry of Finance

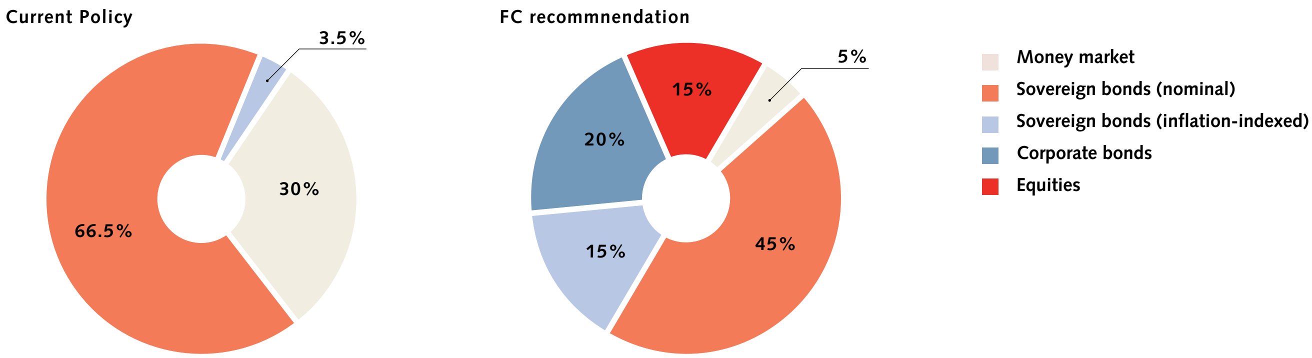
Under the funds' investment policy, variations on the strategic asset allocation are permitted, but there are limits on maximum exposure to each type of credit risk associated with the instruments' issuers (*table 3*).

In addition, a reference allocation by currency has been established, specifying 50% in US dollars, 40% in euros and 10% in yens with a restriction of up to 5% variation on these values (*table 4*). These guidelines also allow investments in instruments in other currencies but require exchange-rate coverage tied to one of the three other currencies.[12]

In order to assess the CBC's management performance, benchmarks were defined using indexes, specific to each currency, for nominal sovereign bond markets, the money market and inflation-indexed bonds (*see box 3*). In the case of money market instruments, the benchmarks are 6-month LIBID and the 6-month Treasury bill rate, both with a three-month lag, while for nominal sovereign bonds, different maturity ranges of the J.P. Morgan Global Bond Index are used and, for inflation-indexed sovereign bonds, the 1-10 year Barclays US Government Inflation-Linked Index (*table 5*).

12 The other currencies permitted are sterling, the Canadian, Australian, New Zealand and Singapore dollars, the Norwegian, Swedish and Danish krones and the Swiss franc.

Figure 13_ Current investment policy vs. FC recommendation
(% of portfolio)



Source: Ministry of Finance

Investment policy recommended by the Financial Committee

In 2007, the Financial Committee recommended a gradual modification of the funds' investment policy on the grounds that they have longer investment horizons than international reserves and should, therefore, be permitted a higher level risk in a bid to achieve higher returns.

Its recommendation envisaged a reduction in the proportion of nominal sovereign bonds and money market instruments in favor of an increase in inflation-indexed sovereign bonds and the incorporation of equities and corporate bonds. As a result, it was hoped that the funds would be able to achieve higher long-term returns (*figure 13*).

The Finance Minister accepted this recommendation and the new policy was scheduled to come into force at the end of 2008. Its implementation was, however, postponed in view of the exceptional level of uncertainty seen in international markets in the last quarter of the year.[13]

13 Further information about this policy and its postponement can be found in the Financial Committee's 2008 Annual Report.

Box 3 Performance benchmarks

Indexes representative of the markets for different asset classes are typically used as benchmarks to measure the performance of a fund manager. The Barclays US Govt. Inflation-Linked Index, for example, is representative of a portfolio of inflation-indexed US Treasury bonds and can be used as a benchmark for investment decisions involving this asset class.

If the fund manager obtains a return above the benchmark, this means that the instruments selected by the manager provided, on average, a higher return than those included in the benchmark or, if the return was lower, that the fund manager failed to add value. It should, however, be noted that few investors are able to achieve higher returns than the benchmark on a permanent basis.

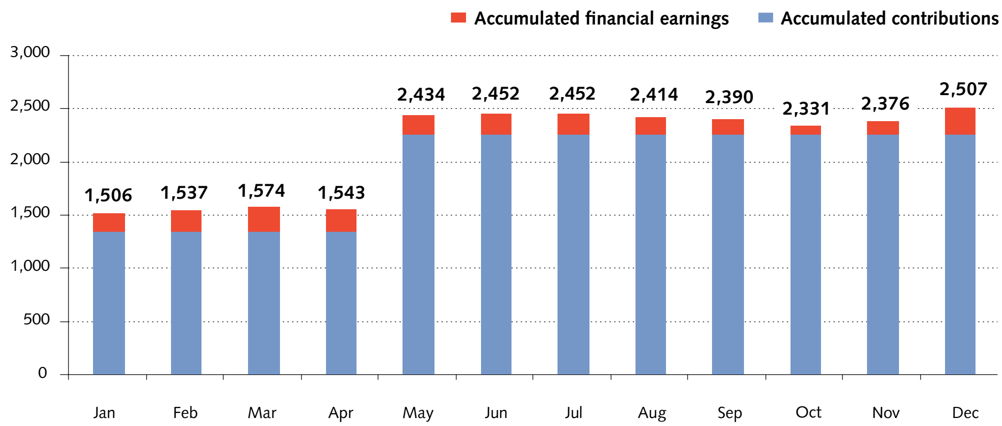
Each asset class included in a portfolio has its own benchmark and the benchmark for the whole portfolio is obtained by weighting the indexes used for each asset class by their allocation as defined in the fund's investment policy.

Box 4 Rates of return: Time-Weighted Rate of Return (TWRR) vs. Internal Rate of Return (IRR)

There are two main methods of measuring return: the time-weighted rate of return (TWRR) and the internal rate of return (IRR). In general, the former is used to measure returns that have their origin exclusively in the portfolio manager's investment decisions, excluding the effect of the amount and timing of contributions or withdrawals. It is calculated on the basis of daily returns in accordance with changes in the investments' market value. The TWRR obtained by a fund manager can, therefore, be compared directly with the portfolio's benchmark.

The IRR is the actual return on the investments and includes the effect of cash flow. Returns during periods with more resources under management will, therefore, have a greater impact on this indicator.

Figure 14_ PRF: Contributions and financial earnings, 2008
(US$ million)



Source: Ministry of Finance

4.2 MARKET VALUE AND ANALYSIS OF RETURNS

This section examines the market value and returns of the PRF and the ESSF in 2008. It should be noted that their investments are valued using the market-to-market method and returns are measured in US dollars using the time-weighted rate of return (TWRR) method (*see box 4*).

Returns include administrative and transactional costs but exclude custody and income generated by the securities lending program[14] since these are not related to investment decisions. Returns for periods of more than one year are compound annualized rates while those for less than a year correspond to the change seen during the stated period.

Pension Reserve Fund (PRF)

As of December 31, 2008, the market value of the PRF was US$2,507 million, up by US$1,040 million with respect to a year earlier. The increase was explained by a contribution of US$909 million (0.5% of 2007's GDP) and by net earnings of US$131 million. Between the PRF's launch on December 28, 2006 and end-2008, contributions to the fund totaled US$2,250 million and its net earnings reached US$257 million (*figure 14*).

14 This income is generated by the loan of financial instruments held in custody. These loans are often backed by collateral.

Table 6_ PRF: Annual contributions
(US$ million)

Year	Amount	% of previous year's GDP
2006	604.5	0.5
2007	736.4	0.5
2008	909.1	0.5

Source: Ministry of Finance

Table 7_ PRF: Net returns
(%)

Return	2007	2008	Since fund inception (annualized)
TWRR	8.86[a]	7.59	9.43[b]
IRR	12.05	6.42	8.41

(a), (b) Calculated as from March 31, 2007.
Source: Ministry of Finance

The PRF's investment portfolio yielded interest of US$71 million in 2008 and US$117 million since inception.

The contribution to the PRF in 2008, measured in dollars, was up by 23.5% with respect to 2007. This reflected the annual growth of nominal GDP in 2007 (10.3%) and an appreciation of the peso against the dollar (*table 6*).

The net return on the PRF in 2008 was 7.59%, and, as from March 31, 2007, reached an annual 9.43% (*table 7*) while the IRR in 2008 was 6.42% and, as from the fund's inception, rea-ched an annual 8.41%.

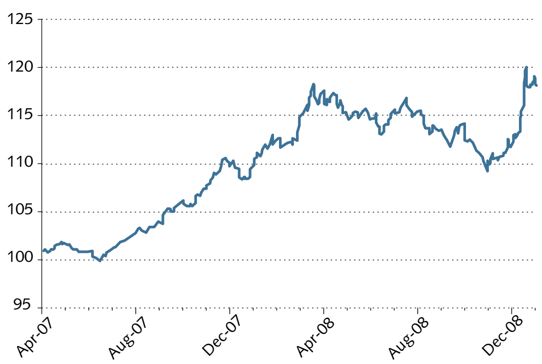
Quarterly returns on the PRF showed wide variations in 2008 (*table 8*). This was highest in the first quarter (7.36%) when it was boosted by a marked appreciation of the euro against the dollar –reflected in an increase in the dollar value of its investments in euros– and the strong performance of its financial instruments in their local currency (*see box 5*). In the second quarter, however, the PRF showed a loss of 1.95% due to a moderate appreciation of the dollar against the euro and higher interest rates. Its loss increased to 2.51% in the third quarter when higher global demand for low-risk dollar-denominated instruments meant a marked appreciation of the dollar against the euro. In the last quarter, however, the PRF showed a gain of 4.86% due to the generalized drop in interest rates and the depreciation of the dollar against the euro and the yen. As a result, over the whole year,

Table 8_ PRF: Net returns in local currency and exchange-rate return
(%)

	Q I	Q II	Q III	Q IV	2008
Local currency	2.84	-1.13	1.94	3.49	7.18
Exchange-rate return	4.52	-0.82	-4.45	1.37	0.41
Total (US$)	**7.36**	**-1.95**	**-2.51**	**4.86**	**7.59**

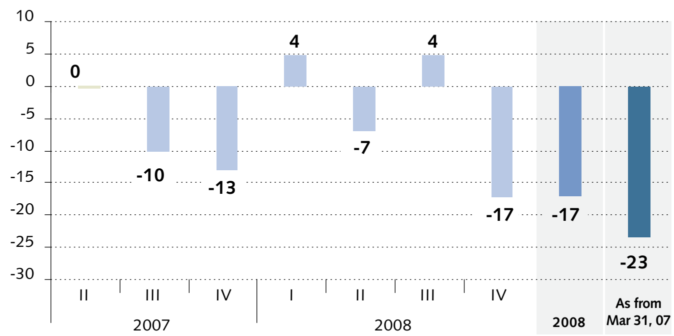
Source: Ministry of Finance

Figure 15_ PRF: Index of returns
(March 31, 2007 = 100)



Source: Ministry of Finance

Figure 16_ PRF: Returns vs. benchmark
(basis points)



Source: Ministry of Finance

the PRF reported a return of 7.18% on its assets' local currencies and a 0.41% exchange-rate return (*see box 6*).

The PRF's performance can be illustrated using an index whose value varies daily depending on returns on its portfolio. At the end of 2008, this index reached 117.15 (*figure 15*).

The PRF's total investment costs in 2008 were US$320 thousand, comprising US$211.8 thousand in custody services, US$97.5 thousand in management fees paid to the CBC, and US$10.7 thousand in other costs related to consultancy services for the implementation of the new investment policy. The CBC's costs were equivalent to 0.45 basis points (bps) (0.0045%) of the fund's portfolio. All these costs were covered by income of US$338.9 thousand from the securities lending program (*table 9*).

The CBC's performance in 2008, measured as the difference between the fund's returns and its benchmark, was -17 bps and, since March 31, 2007, reached -23 bps (*figure 16*).

Table 9_ PRF: Investment costs and securities lending income
(US$ thousand)

Items	2007	2008
Custody services (J.P. Morgan)	-	211.8
Management ESSF (CBC)	49.2	97.5
Other costs	-	10.7
Total costs	**49.2**	**320.0**
Securities lending	**-**	**338.9**

Source: Ministry of Finance

Box 5 Determinants of returns

The returns on Chile's sovereign wealth funds are determined mainly by two variables: interest rates and exchange rates.

The returns obtained by investments in their local currency depend on the level and variation of interest rates. If interest rates are high, an investor can obtain higher returns on instruments such as bank deposits while changes in interest rates are particularly important in the case of sovereign bonds. An increase of interest rates will reduce the price of the bonds, while a decline will have the opposite effect.

Exchange rates also have an impact since the value of the funds in the currency used to measure their performance (dollars) varies with the value of that currency against the other currencies in which they hold assets (euros and yens), increasing when the latter appreciate and dropping when they depreciate.

Box 6 Methodology for calculating exchange-rate return

The effect of variations in exchange rates on the funds' performance can be measured using an index that replicates their currency allocation or, in other words, 50% US dollars, 40% euros and 10% yens.

Assuming that the funds' assets are adjusted daily in order to maintain this allocation, their daily return is:

$$r_{FX}(t) = 0.5 \cdot r_{USD/USD}(t) + 0.4 \cdot r_{USD/EUR}(t) + 0.1 \cdot r_{USD/JPY}(t),$$

where

$r_{FX}(t)$ = daily return on the currency allocation portfolio

$r_{USD/USD}(t)$ = daily return generated by movements of the dollar against the dollar

$r_{USD/EUR}(t)$ = daily return generated by movements of the dollar against the euro

$r_{USD/JPY}(t)$ = daily return generated by movements of the dollar against the yen

Given that the dollar is the currency used to measure the funds' performance and, therefore, the return in this currency is zero ($r_{USD/USD}(t) = 0$), this formula can be simplified and the daily return on the currency index is:

$$r_{FX}(t) = 0.4 \cdot r_{USD/EUR}(t) + 0.1 \cdot r_{USD/JPY}(t).$$

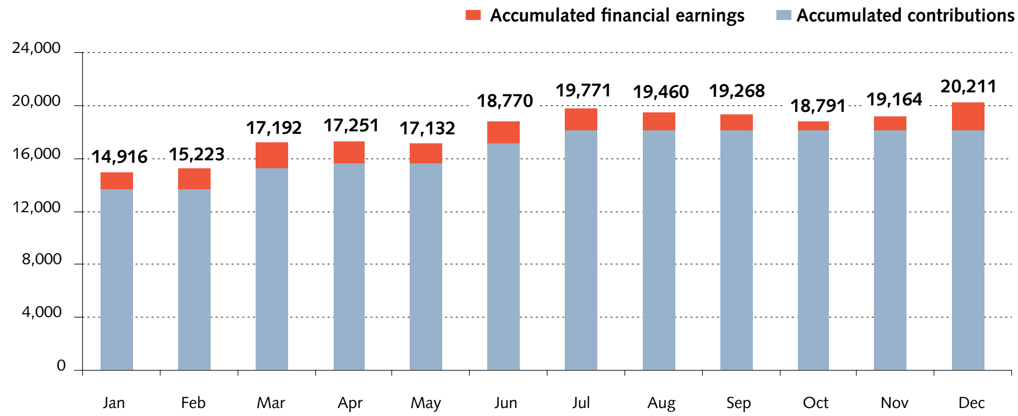
However, this methodology, which is used in this report to calculate the effect of exchange-rate variations on the PRF and the ESSF, is only an approximation in that it does not consider the actual rebalancing made by their manager.

Figure R6.1 shows the performance of the currency index in 2008. It is important to note that, despite its volatility, the exchange-rate return in 2008 was practically zero.

R6.1 Currency Index
(January 2008 = 100)

Source: Ministry of Finance

Figure 17_ ESSF: Contributions and financial earnings, 2008
(US$ million)



Source: Ministry of Finance

Economic and Social Stabilization Fund (ESSF)

At the end of 2008, the ESSF reached a market value of US$20,211 million, up by US$6,178 million with respect to a year earlier. This increase was the result of new contributions for US$5,000 million and net financial earnings of US$1,178 million. Between the launch of the ESSF on March 6, 2007 and end-2008, contributions totaled US$18,100 million and its net financial earnings reached US$2,111 million (*figure 17*).

The investment portfolio of the ESSF yielded interest of US$624 million in 2008 and US$950 million since its inception.

Contributions to the ESSF in 2008 were below the US$13,100 million paid in during 2007 (*table 10*). It should, however, be noted that the latter included resources from the previous Copper Income Stabilization Fund as well as part of the 2006 fiscal surplus.

The net return on the ESSF in 2008 was 7.63% and, as from March 31, 2007, reached an annual 9.47% while the IRR in 2008 was 6.80% and an annual 8.62% as from its inception (*table 11*).

Table 10_ ESSF: Annual contributions
(US$ million)

Year	Amount	% of previous year's GDP
2007	13,100	8.9
2008	5,000	3.1

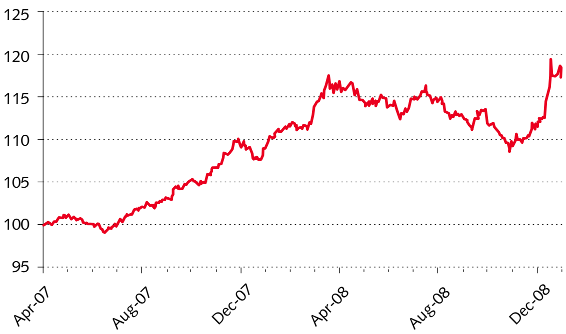
Source: Ministry of Finance

Table 11_ ESSF: Net returns
(%)

Return	2007	2008	Since fund launch (annualized)
TWRR	8.89[a]	7.63	9.47[b]
IRR	10.20	6.80	8.62

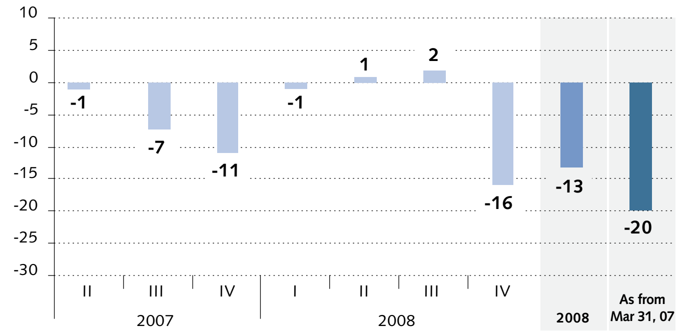
(a), (b) Calculated as from March 31, 2007.
Source: Ministry of Finance

Figure 18_ ESSF: Index of returns
(March 31, 2007 = 100)



Source: Ministry of Finance

Figure 19_ ESSF: Returns vs. benchmark
(basis points)



Source: Ministry of Finance

The quarterly returns obtained by the ESSF in 2008 were similar to those on the PRF, reflecting the fact that both have virtually identical investment policies. In the first quarter, the ESSF showed a gain of 7.31% but, due to global financial volatility, this was followed by losses of 1.87% and 2.52% in the second and third quarters, respectively. In the fourth quarter, however, a generalized drop in interest rates and the appreciation of the euro and the yen against the dollar meant a return of 4.87% (*table 12*).

The ESSF's performance can be illustrated using an index whose value varies daily depending on returns on its portfolio. At the end of 2008, this index reached 117.22 (*figure 18*).

The total investment costs of the ESSF in 2008 were US$1,847.7 thousand, comprising US$972.3 thousand in custody services, US$791.2 thousand paid to the CBC and US$84.3 thousand in consultancies. The CBC's cost was equivalent to 0.45 bps of the ESSF while income from the securities lending program reached US$3.5 million, exceeding the total cost of managing the fund (*table 13*).

Table 12_ ESSF: Net returns in local currency and exchange-rate return
(%)

	Q I	Q II	Q III	Q IV	2008
Local currency	2.79	-1,05	1.93	3.50	7.22
Exchange-rate return	4.52	-0,82	-4.45	1.37	0.41
Total (US$)	7.31	-1.87	-2.52	4.87	7.63

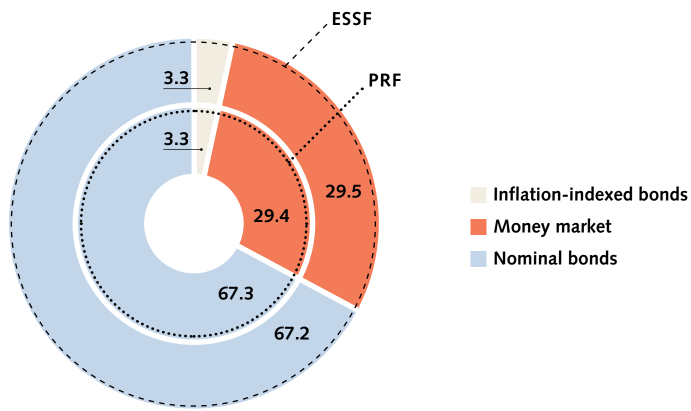
Source: Ministry of Finance

Table 13_ ESSF: Investment costs and securities lending income
(US$ thousand)

Items	2007	2008
Custody services (J.P. Morgan)	-	972.3
Management ESSF (CBC)	465.8	791.2
Other costs		84.3
Total costs	**465.8**	**1,847.7**
Securities lending	-	**3,504.1**

Source: Ministry of Finance

Figure 20_ PRF and ESSF: Composition by asset class, December 31, 2008
(% of portfolio)



Source: Ministry of Finance

The CBC's performance, measured as the difference between the fund's return and its benchmark, was -13 bps in 2008 and, since March 31, 2007, reached -20 bps (*figure 19*).

Despite the severe financial crisis that developed in 2008, returns on the PRF and the ESSF compared favorably with those obtained by other sovereign funds and institutional investors around the world (*see box 7*).

4.3 PORTFOLIO ALLOCATION AND CHARACTERISTICS

The strategic asset allocation and limits on risk exposure established for the ESSF and the PRF, and the close monitoring of international markets by the CBC, the Financial Committee and the SWF team at the Ministry of Finance allowed the funds to obtain good financial results in 2008.

At the end of the year, the composition of both funds by asset class was very similar to the benchmark. For the PRF, this consisted of 67.3% (US$1,687 million) in nominal sovereign bonds, 29.4% (US$736 million) in money market instruments[15] and 3.3% (US$84 million) in inflation-indexed sovereign bonds and, in the case of the ESSF, 67.2% (US$13,584 million) in nominal sovereign bonds, 29.5% (US$5,957 million) in money market instruments and 3.3% (US$670 million) in inflation-indexed sovereign bonds (*figure 20*).

15 Includes sovereign securities with a maturity of less than a year.

Box 7 Performance of selected sovereign wealth funds

In 2008, the performance of many SWFs around the world was negatively affected by the global economic and financial crisis. The size of their losses depended mostly on their exposure to the riskier asset classes that were heavily hit by the crisis. For example, Norway's SWF, which allocates almost half of its portfolio to equities, showed a loss of 23% while other SWFs with large holdings of equities and alternative investments were also badly affected. The most striking cases were the SWFs of Ireland, New Zealand and Alaska which reported losses, measured in the currency they use to measure performance, of between 25% and 30%. SWFs with less exposure to these asset classes experienced less volatility and smaller losses. Australia's SWF, with an intermediate policy as regards risk exposure, for example, reported a loss of 8.5% while Chile's SWFs, with a more conservative policy, showed a gain of 7.6% (*table R7.1*).

It is generally investors in search of higher long-term returns and with a higher risk tolerance who adopt the most aggressive investment policies and are willing to accept a greater level of volatility in returns, including possible short-term losses. In this context, it should be noted that, despite the significant losses sustained by many funds with aggressive investment policies in 2008, they still show positive returns over their whole life and these should increase once markets recover from the current financial crisis.

Table R7.1_ Asset allocation and returns (selected SWFs)
(%)

Fund	Asset allocation				Return[b]	
	Money market instruments	Fixed-income	Equities	Alternative Investments[a]	2008	Since Inception (annualized)
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

(a) Alternative investments include principally hedge funds, private equity, commodities and real estate.
(b) Returns are shown in the currency used by each fund to measure its performance as follows: 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.

Source: Reports of selected SWFs

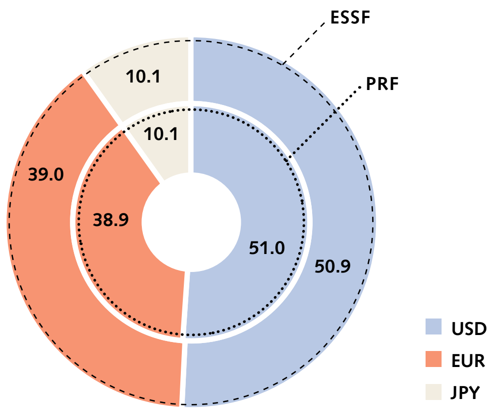
The currency composition of the PRF and the ESSF held steady throughout 2008 and was similar to the investment-policy target. As of December 31, 2008, both funds held 51% of their assets in dollars, 39% in euros and 10% in yens (*figure 21*).

Credit risk was a key concern in 2008. The Lehman Brothers bankruptcy triggered a serious liquidity problem in international financial markets with a negative impact on the solvency of other banks around the world. This prompted bailouts by a number of governments, which partially or totally guaranteed bank deposits and, in some cases, even nationalized financial institutions. As a result, the allocation of the PRF and the ESSF for bank deposits was reduced from 30% at the end of September to around 17% at the end of the year (*figure 22*). In addition, the CBC actively monitored the funds' exposure to bank deposits and avoided investing in those of any institution that could have problems in future, preferring those with a lower relative risk.

Despite credit ratings agencies' massive downgrades of banks, the credit quality of the portfolios of the PRF and the ESSF was not seriously affected (*table 14*). Their holdings of sovereign securities corresponded mostly to Germany, France and the United States or, in other words, those countries with the best risk ratings (*figure 23*) while the remainder were securities issued by the Japanese government with an AA- rating. Moreover, bank deposits with a rating of between A+ and A represented only 4.7% of the PRF and 10.7% of the ESSF and all other bank deposits had a higher rating.

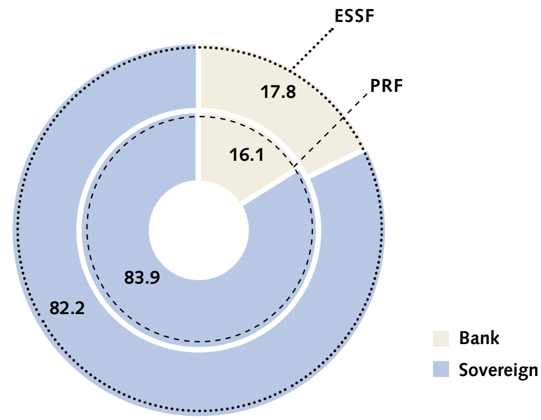
Most of the banks in which the funds' assets were deposited were in Europe, due mainly to their higher interest rates and to the fact that a number of these banks were strengthened by government intervention. As a result, bank risk was partially transformed into sovereign risk (*table 15*).

Figure 21_ PRF and ESSF: Currency composition, December 31, 2008
(% of portfolio)



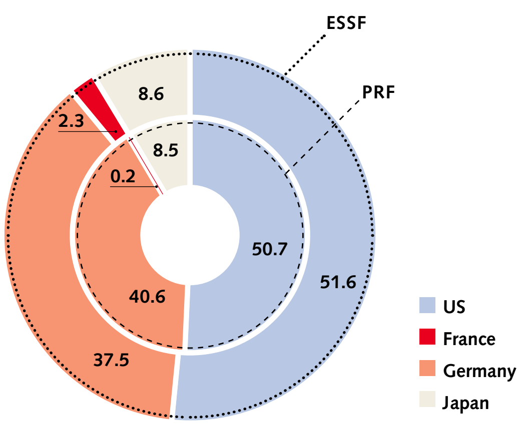
Source: Ministry of Finance

Figure 22_ PRF and ESSF: Composition by type of credit risk, December 31, 2008
(% of portfolio)



Source: Ministry of Finance

Figure 23_ PRF and ESSF: Composition by issuer of sovereign bonds, December 31, 2008
(% of total)



Source: Ministry of Finance

Table 14_ PRF and ESSF: Credit risk exposure, December 31, 2008
(% of portfolio)

Issuer	Risk rating						
	AAA	AA+	AA	AA-	A+	A	A-
PRF							
Sovereign	76.8	-	-	7.1	-	-	-
Bank	-	-	2.6	8.8	1.7	3.0	-
ESSF							
Sovereign	75.1	-	-	7.1	-	-	-
Bank	-	-	3.2	3.9	7.8	2.9	-

Source: Ministry of Finance

Table 15_ PRF and ESSF: Bank deposits, December 31, 2008

Bank	Country	PRF	ESSF
ABN AMRO Bank N.V.	Netherlands	X	X
Alliance & Leicester PLC	United Kingdom		X
Allied Irish Banks PLC	Ireland	X	X
Banco Bilbao Vizcaya Argentaria S.A	Spain		X
Banco Santander Central Hispano S.A.	Spain		X
Bank of Ireland	Ireland	X	X
The Bank of Nova Scotia	Canada	X	
Barclays Bank PLC	United Kingdom	X	X
Bayerische Landesbank	Germany	X	X
Bayerische Hypo- und Vereinsbank AG	Germany		X
BNP Paribas	France		X
Caixa General de Depósitos S.A.	Portugal	X	X
Calyon Corporate and Investment Bank	France	X	X
Crédit Industriel et Commercial (CIC)	France	X	X
Danske Bank Aktieselskab	Denmark	X	X
Dexia Bank Belgium	Belgium	X	X
Dexia Credit Local	France	X	X
DnB NOR Bank ASA	Norway	X	X
ING Bank NV	Netherlands	X	X
ING Belgium SA/NV	Belgium	X	X
KBC Bank NV	Belgium		X
Mizuho Corporate Bank	Japan		X
Svenska Handelsbanken AB	Sweden	X	X

Source: Ministry of Finance

5 DESCRIPTION OF FINANCIAL RISKS

Table 16_ Duration: Portfolios and benchmark, December 31, 2008
(years)

Fund	Portfolio	Benchmark
PRF	2.31	2.41
ESSF	2.34	2.41

Source: Ministry of Finance

The PRF and the ESSF are exposed to different types of risk arising from their investments in different asset classes in the international markets. These risks can be divided into market, credit, liquidity, active and operational risks. The exposure of the ESSF and the PRF to the first four types of risk is limited by their investment guidelines while the CBC's institutional framework and infrastructure provide the controls required to mitigate the latter one.

5.1 MARKET RISK

Market risk arises from the losses in the value of financial instruments that can occur as a result of variations in interest and exchange rates.

Interest-rate risk

Changes in interest rates have a direct inverse impact on the price of fixed-income instruments. An increase in the interest rates would reduce the price of these instruments while their decline would produce the opposite effect. A portfolio's sensitivity to these changes is determined mainly by its duration, with a longer duration implying greater sensitivity *(see box 8)*.

For both the ESSF and the PRF, the benchmark duration at the end of 2008 was 2.41 years. The funds' investment guidelines stipulate that their effective duration must not exceed the benchmark by more than five months *(table 16)*. As of December 31, 2008, the difference was no more than 1.2 months.

Exchange-rate risk

Since the performance of the PRF and the ESSF is measured in dollars and both funds have investments in euros and yens, their value is affected by exchange-rate variations. For example, the dollar value of a sovereign bond issued in euros is a function of the value of the dollar against the euro, with an appreciation (depreciation) of the dollar meaning losses (gains) additional to those caused by changes in interest rates. The PRF and the ESSF have a 50% exposure to exchange-rate risk as a result of their investments in euros (40%) and yens (10%).

Box 8 Bond duration

The modified duration of a bond is an indicator of the sensitivity of its price to changes in interest rates. The longer its duration, the greater is this sensitivity.

In conceptual terms, its duration corresponds to the present value of its cash flows weighted by its maturity and can be expressed as:

$$Dur_M = \frac{\sum t_i \cdot vp_i}{(1+IRR) \cdot PV},$$

where

pv_i = present value of cash flows in period i

PV = present value of total cash flows

IRR = internal rate of return on bond

t_i = period of time

The change in the price of a bond (ΔP) as a result of a small change in interest rates (Δi) can be estimated as:

$$\Delta P = -Dur_M \cdot \Delta i .$$

A portfolio's duration is calculated as the weighted average of the duration of its different assets.

Box 9 Risk ratings

Credit ratings agencies are specialized institutions that monitor and analyze the financial situation and solvency of debt issuers (companies, countries, multilateral organizations, etc.). The best known are Standard & Poor's, Fitch Ratings and Moody's. They provide an opinion on the relative capacity of an issuer to meet its contingent liabilities (interest payments and capital repayments, etc.). Market players use these ratings as an objective and independent measure that provides them with a fast and efficient estimation of the probability of receiving the payments represented by financial instruments.

These agencies use different scales to quantify and express risk levels. For example, Standard & Poor's uses the following scale of decreasing solvency: AAA, AA, A, BBB, BB, B, CCC, CC, C, D, to which it adds a plus sign (+) to indicate a positive outlook and a minus sign (-) for a negative outlook. In general, issuers or instruments with a rating of AAA to BBB- are considered investment grade and have a low to moderate default risk while those from BB+ to D are considered speculative and as representing a high credit risk.

Table 17_ Minimum requirements and limits by issuer and credit risk

Credit risk	Risk rating (1) (2)							Minimum requirements
	AAA	AA+	AA	AA-	A+	A	A-	
Sovereign(3)	100%		90%			30%		A- over previous 24 months
Multilateral	800		600			0		Long-term AA-
Bank	600		400			300		Long-term A- / Minimum capital of US$1,000 million
Agencies in US	800		0			0		Long-term AAA / Minimum capital of US$1,000 million

1)By at least two of Fitch, Moody´s and Standard & Poor´s.
(2) In US$ million unless specifically indicated as percentage.
(3) As a percentage of total portfolio.

Source: Ministry of Finance

5.2 CREDIT RISK

Credit risk arises principally from the possibility of default by an issuer or a drop in the price of an instrument as the result of a change in the issuer's perceived solvency. Exposure to this risk is controlled by establishing minimum ratings requirements (*see box 9*) and limits on the amount and percentage of total portfolio allocated by asset class and/or issuer *(table 17)*.

Similarly, the risk arising from transaction execution -or, in other words, the losses that may occur if the counterpart in a transaction does not pay for a security or does not hand it over when it has been acquired - is mitigated by using payment-on-delivery transactional or post-transactional systems. In addition, the risk of holding the funds' securities at a custodian institution is addressed by registering them in the name of the Republic of Chile, thereby maintaining a separation between ownership of the funds and the custodian.

5.3 LIQUIDITY RISK

Liquidity risk arises from the losses that would occur from the premature sale of securities in order to cover cash-flow needs. These can occur either because of the effect of lack of demand or market depth on their price or because of the need to sell medium-term securities at an inopportune time.

In the PRF and the ESSF, this risk is addressed by maintaining a high percentage of liquid short-term securities. As of December 31, 2008, money market instruments accounted for 29.4% of the PRF and 29.5% of the ESSF. Liquid assets are defined as time deposits, certificates of deposit and Treasury bills, all of which are less sensitive to changes in interest rates and have a market that permits their rapid sale.

5.4 ACTIVE RISK

An investment portfolio can have a passive management strategy under which it invests in instruments that are very similar to its benchmark and, therefore, also similar in terms of risk and return. However, a fund manager can also adopt an active strategy, taking positions that are different to the benchmark –as regards, for example, duration or currency composition– in order to achieve a higher return. In this case, the strategy is considered active and adds another type of risk. This risk is known as active risk.

The active risk can be measured by the tracking error (TE) which indicates the extent to which a portfolio differs from the benchmark. The more active an investment strategy, the higher is the TE.

At the end of 2008, the TE of the PRF and the ESSF was close to 20 bps. This is considered low and indicates a passive strategy. It should, however, be noted that, according to the industry norm, a fund needs a life of at least three years in order to accurately estimate its TE and, since the PRF and the ESSF have been in existence for less than two years, their TE informed is only an approximation.

5.5 OPERATIONAL RISK

Operational risk refers to the losses than can occur as a result of mistakes in internal processes and systems, external events or human error. Examples of this type of risk include transactional errors, fraud and failures to comply with legal obligations (contracts), etc.

In the case of the PRF and the ESSF, this risk is mitigated by delegating their operation to the CBC and, specifically, its International Investments Division, thereby taking advantage of the CBC's infrastructure for the management of international reserves. The CBC also has controls in place to provide a proper division of responsibilities and functions, software in line with market quality standards and back-up systems that ensure operational continuity as well as internal and external auditing systems to evaluate the effectiveness of these controls.

5.6 VOLATILITY AND OTHER INDICATORS

One of the indicators typically used to measure a portfolio's risk level is the volatility of its returns calculated as their standard deviation. In 2008, the annual volatility of the returns of the PRF and the ESSF was 8.2% and 8.1%, respectively, and, measured as from March 31, 2007, drops to 6.6% for the PRF and 6.5% for the ESSF *(table 18)*. The increase seen in 2008 reflected significantly larger fluctuations in the prices of all asset classes as a result of the financial crisis. Exchange-rate fluctuations (7.1%) were, in fact, an important cause of the funds' volatility in 2008.

Table 18_ PRF and ESSF: Annualized monthly volatility vs. benchmark
(%)

Volatility	1 year	31-march-2007
PRF	8.2	6.6
ESSF	8.1	6.5
Benchmark	8.2	6.6

Fuente: Ministry of Finance

Table 19_ PRF and ESSF: Historic maximum and minimum returns
(%)

Range	Month		Quarter	
	PRF	ESSF	PRF	ESSF
Maximum	5.49 (Dic-08)	5.46 (Dic-08)	7.36 (I 08)	7.31 (I 08)
Minimum	-2.50 (Oct-08)	-2.48 (Oct-08)	-2.51 (III 08)	-2.52 (III 08)

Fuente: Ministry of Finance

The PRF's highest monthly return since its inception was 5.49% and, in the case of the ESSF, 5.46% (both in December 2008) while the lowest was -2.50% for the PRF and -2.48% for ESSF (both in October 2008). Similarly, the highest quarterly returns were 7.36% for the PRF and 7.31% for the ESSF (first quarter of 2008) and the lowest were -2.51% for the PRF and -2.52% for the ESSF (third quarter of 2008) *(table 19)*.

Finally, value-at-risk (VaR) can be used to quantify a fund's potential losses in a given period of time and with a given probability. At the end of December 2008, the monthly VaR, calculated on the basis of the daily portfolio volatility with an 84% level of confidence, was US$76 million for the PRF and US$615 million for the ESSF.

APPENDICES

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Glossary
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GLOSSARY

Agency_ a government financial agency or private financial agency with explicit or implicit government backing.

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

Benchmark_ a market index representing an asset class invested passively; used to measure the performance of a fund manager.

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.

Bonos de Reconocimiento_bonds issued by the Instituto de Normalización Previsional (Institute for Pension Normalization) on account of contributions made by workers to the former pension system prior to joining the current AFP system.

Commodities_tangible goods such as oil, precious metals and/or foodstuffs that are traded on different international markets.

Corporate fixed-income security_a debt security 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.

Equity_a security which provides ownership of a company and the right to participate in its profits/losses.

Exchange-rate return_the return on a financial instrument that is generated by variations in exchange rates; this only exists when a portfolio is valued in a currency different from that in which its securities are denominated.

External manager_a financial entity responsible for investing assets according to guidelines established by their owner; an external manager is usually used when an investor lacks the capacity or necessary experience to invest in a particular asset class or wants to diversify management style.

Financial Committee_the body created by the Finance Ministry's Supreme Decree N° 621 in 2007 to assist and advise the Finance Minister in analyzing and designing Chile's sovereign wealth funds' investment strategy.

Fiscal agent_an entity appointed by a government to act on its behalf or on behalf of one of its agencies in any type of financial transaction; the Central Bank of Chile (CBC) serves as the fiscal agent for Chile's sovereign wealth funds.

Fiscal Responsibility Law_a law, which came into force in the second half of 2006, establishing norms and the institutional framework for the accumulation and management of fiscal savings arising from current fiscal policies.

Hedge fund_an alternative investment that is generally structured in such a way as not to be subject to the regulation and restrictions that typically apply to other investment vehicles; many different types of hedge fund exist such as equity market neutral, convertible arbitrage, fixed-income arbitrage, distressed securities, merger arbitrage, etc.

Internal rate of return (IRR)_the effective yield on an investment calculated taking the present value of all net cash flows as zero.

International Working Group of Sovereign Wealth Funds (IWG-SWF)_the entity created under the auspices of the IMF to promote transparency and the development of institutional framework for sovereign wealth funds around the world.

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

Leverage_borrowing.

LIBID_London Interbank Bid Rate, the interest rate paid on interbank deposits; by definition, this rate is equal to LIBOR minus 0.125%.

LIBOR_London Interbank Offered Rate, the interest rate charged on interbank borrowing.

Market value_the value at which financial instruments are traded.

Money market instrument_a short-term liquid asset, without a significant risk of changes in its value; these instruments are tradable and have a maturity of up to a year.

Mortgage-backed securities_a financial instrument backed by a group of individual mortgages.

Multilateral_refers to international organizations such as the World Bank, the International Monetary Fund, the Inter-American Development Bank, etc.

Overnight indexed swap_a fixed-variable interest rate swap in which the variable part is paid according to an index linked to the overnight reference rate.

Private equity_a type of alternative investment in which an investor holds a stake in a non-traded company; these investments may be made directly or indirectly through a private equity fund.

Return_synonym of profitability or yield; the level of earnings produced by an investment, generally measured as a percentage.

Return in local currency_the return generated by a financial instrument in the currency in which it is denominated.

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

Santiago Principles_the voluntary code of principles and practices drawn up by the International Working Group of Sovereign Wealth Funds (IWG-SWF) and agreed upon in Santiago in 2008.

Sovereign bond (nominal)_a bond issued by governments.

Sovereign bond inflation-indexed_a bond issued by governments whose value varies in line with an inflation index; in the US, these securities are known as Treasury Inflation-Protected Securities (TIPS).

Spread_the difference between the yield-to-maturity of two fixed-income securities; used to assess the comparative performance of different bonds.

Strategic asset allocation_the percentage of a portfolio allocated to each assets class, defining a fund's long-term investment policy.

Time-Weighted Rate of Return (TWRR)_a measure of return that, unlike the IRR, excludes the effect of net cash flows; calculated as the geometric mean of daily returns excluding contributions and withdrawals.

Tracking error_the standard deviation of the difference between a portfolio's return and that of its benchmark; used to measure the active risk arising from active positions taken by a portfolio manager as compared to totally passive management as represented by the benchmark.

Treasury bill_a financial liability entered into by the US government with a maturity of less than a year which is sold at a discount on its face value.

Value at risk_an indicator used by the market to define the amount that could be lost over a given period of time with a given probability.

Volatility_a measure of a security'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.

ABBREVIATIONS

CBC	Central Bank of Chile
Bps	Basis points
ECB	European Central Bank
EUR	Euro
FC	Financial Committee
Fed	US Federal Reserve
ESSF	Economic and Social Stabilization Fund
PRF	Pension Reserve Fund
GAPP	Generally Accepted Principles and Practices
GDP	Gross domestic product
IMF	International Monetary Fund
IRR	Internal Rate of Return
IWG-SWF	International Working Group of Sovereign Wealth Funds
JPY	Japanese yen
LIBID	London Interbank Bid Rate
LIBOR	London Interbank Offered Rate
MBS	Mortgage-backed securities
SWF	Sovereign Wealth Fund
TE	Tracking error
TWRR	Time-Weighted Rate of Return
UF	Unidad de Fomento (an inflation-linked currency unit)
USD	US dollar
US$	US dollar
VaR	Value at risk

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