ANNUAL REPORT
FINANCIAL COMMITTEE

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

2011

This publication corresponds to the 2011 Annual Report of the Finance Ministry's Financial Committee.

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Contents

Tables

Figures

Diagrams

Boxes

Preface

The Financial Committee was created in 2007 to advise the Finance Minister on the investment of Chile's two sovereign wealth funds, the Economic and Social Stabilization Fund (ESSF) and the Pension Reserve Fund (PRF).

This Report – the fifth prepared by the Committee – sets out its work and activities in 2011 and is part of a systematic effort to increase access to information about its deliberations and recommendations and the situation of the two Funds. In this way, the Committee fulfills the requirement established under Decree N° 621, issued by the Ministry of Finance in 2007, which stipulates that it must present an annual report on its work to the Finance Minister and submit a copy of this report to the Finance Commissions of the Senate and the lower house of Congress and to the Joint Budget Commission of Congress.

The Committee

Members of the Financial Committee

KLAUS SCHMIDT-HEBBEL DUNKER
President

Schmidt-Hebbel studied economics at the Universidad Católica de Chile and holds a Ph.D. in economics from the Massachusetts Institute of Technology (MIT). He is currently a professor at the Universidad Católica de Chile, an associate professor at the Universidad de Chile, an international consultant and company director. He has served as chief economist of the OECD in Paris and as director of its Economics Department and previously worked as head of economic research at the Central Bank of Chile and principal economist at the Research Department of the World Bank in Washington. In addition, he has chaired the Chilean Economics Society. He joined the Committee in August 2009.

CRISTIÁN EYZAGUIRRE JOHNSTON
Vice-President

Eyzaguirre studied economics at the Universidad de Chile and holds a masters degree in economics from the University of California at Berkeley. He has served as general manager of Banco Bice and finance manager of Empresas CMPC and as deputy director of Chile's Tax Service (SII), advisor to the Chilean Manufacturers' Association (SOFOFA) and a professor at the Universidad de Chile. He currently sits on the boards of a number of companies and is a member of the Investment Committee of the Hogar de Cristo. He joined the Committee in March 2010.

ARTURO CIFUENTES OVALLE
Counselor

Cifuentes studied civil engineering at the Universidad de Chile and holds a Ph.D. in applied mechanics from the California Institute of Technology (Caltech) and an MBA in finance from New York University. He is currently a professor at the Business School of the Universidad Adolfo Ibáñez and a member of the governing board of the Humanities and Social Sciences Division of the California Institute of Technology (Caltech). He previously worked as a researcher at the IBM T.J. Watson Research Center in New York and as an executive for different Wall Street companies (Triton Partners, Wachovia Securities, Ambac Assurance Corporation and R.W. Pressprich). He has also served as a consultant to private-sector companies and government bodies in the United States, Chile and Australia and as a professor at the Universidad de Chile, California State University and the University of Southern California. He joined the Committee in August 2011.

MARTÍN COSTABAL LLONA
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Costabal studied economics at the Universidad Católica de Chile and holds an MBA from the University of Chicago. He has served as the Chilean government's budget director and finance minister, held executive posts at Pizarreño and Infraestructura Dos Mil and been general manager of AFP Habitat. He currently sits on the board of a number of companies and is a member of the Technical Investment Council established as part of Chile's pension reform. He joined the Committee in January 2007.

ERIC PARRADO HERRERA
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Parrado studied economics at the Universidad de Chile and holds a masters degree in economics and Ph.D. from New York University. He is currently a professor at the Business School of the Universidad Adolfo Ibáñez and an international consultant. He has served as coordinator for international finance at Chile's Finance Ministry, senior economist and manager for financial stability at the Central Bank of Chile and an economist at the International Monetary Fund (IMF). He joined the Committee in August 2011.

EDUARDO WALKER HITSCHFELD
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Walker studied economics at the Universidad Católica de Chile and holds a Ph.D. in business administration with specialization in finance from the University of California at Berkeley. He is currently a professor at the School of Business Administration of the Universidad Católica de Chile, an international consultant and member of the Technical Investment Council established as part of Chile's pension reform. He has been a visiting associate professor at the Finance Department of the McCombs School of Business at the University of Texas in Austin and served as head of research at AFP Habitat and a member of the Capital Markets Committee and the Risk Classification Commission. He joined the Committee in January 2007.

CHAPTER 1

Fiscal policy and Funds' objectives, institutional framework and investment policy

A. Fiscal policy

Chile's fiscal policy seeks to contribute to the country's macroeconomic stability and to provide public goods that increase opportunities and social protection for all Chileans[1].

Since 2001, Chile's fiscal policy has been anchored in a structural or, more correctly, cyclically-adjusted balance rule[2], that seeks to reduce the impact on public finances of fluctuations in economic activity, the price of copper and other secondary variables. This helps to avoid the need for drastic changes in public expenditure in response to cyclical or unanticipated economic events, with the government saving during boom times and drawing on these resources during cyclical periods of weaker economic growth and/or international copper prices[3].

A Fiscal Responsibility Law (Law N° 20.128) was introduced in September 2006 in order to ensure the sustainability of public expenditure over time and contribute to the economy's competitiveness. This law created the Pension Reserve Fund (PRF) and empowered the President of the Republic to create the Economic and Social Stabilization Fund (ESSF), which was officially established in February 2007. These two funds receive the resources that result from the application of the structural balance rule.

B. Objetives and rules of use of Funds

Objectives

The two funds created under the Fiscal Responsibility Law (henceforth, the "Sovereign Wealth Funds" or "Funds") have defined objectives: in the case of the Economic and Social Stabilization Fund (ESSF), to accumulate resources to finance possible future fiscal deficits or to pay down public debt and, in the case of the Pension Reserve Fund (PRF), to serve as a complementary source of financing for future fiscal pension liabilities.

Rules on contributions to Funds

The rules for the creation of the Funds and contributions to them, illustrated in Figure 1, are established by law[4].

1 Schmidt-Hebbel (2012) and Velasco et al. (2012).

2 See footnote 1 in Larraín et al. (2011).

3 Some aspects of the structural or cyclically-adjusted balance rule have been modified since its introduction. For a detailed discussion of its design, modifications, application and results, see Marcel et al. (2001), Rodríguez et al. (2006), Velasco et al. (2010), Advisory Committee for the Design of a Second-Generation Structural Balance Fiscal Policy for Chile (2011) and Larraín et al. (2011).

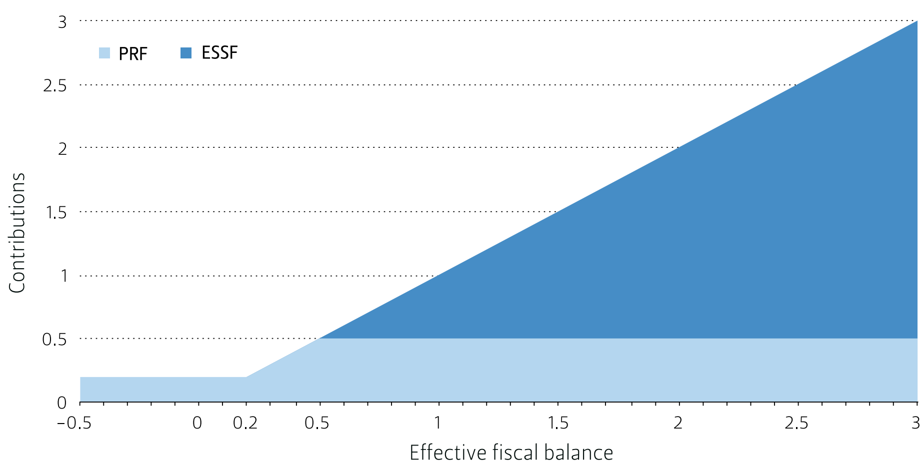
4 The Fiscal Responsibility Law for the PRF and Decree with Force of Law (DFL) 1, issued by the Finance Ministry in 2006, for the ESSF.

The PRF increases each year by a minimum amount equivalent to 0.2% of the previous year's Gross Domestic Product (GDP). If the effective fiscal surplus exceeds this amount, the contribution to the PRF can rise to a maximum of 0.5% of the previous year's GDP. Contributions to the PRF only have to be made until the fund reaches the equivalent of 900 million unidades de fomento (UF).

The ESSF increases each year by the balance (if positive) resulting from subtracting the contribution to the PRF from the effective fiscal surplus, discounting repayments of public debt and advance contributions into the ESSF[5].

Figure 1 Fiscal savings rule

(% of GDP)



Source: Ministry of Finance.

Rules on use of Funds

As from 2016, the PRF can be used to complement financing of fiscal liabilities arising from the state guarantee on basic old-age and disability solidarity pensions and old-age and disability solidarity pension contributions. The annual withdrawals that can then be made may not exceed a third of the difference between expenditure on pension liabilities in the current year and expenditure on this item in 2008 adjusted for inflation. Until 2016, withdrawals equivalent to the fund's return in the previous year may be made.

The PRF will cease to exist as from 2021 if the withdrawals to be made in a calendar year do not exceed 5% of the sum of fiscal pension spending established in that year's budget. When the PRF ceases to exist, any balance in the fund must be transferred to the ESSF.

5 The legislation discussed permits the use of resources from the current year's fiscal surplus, which must be deposited in the ESSF during the following year(s), to pay down public debt and make advance contributions to the ESSF.

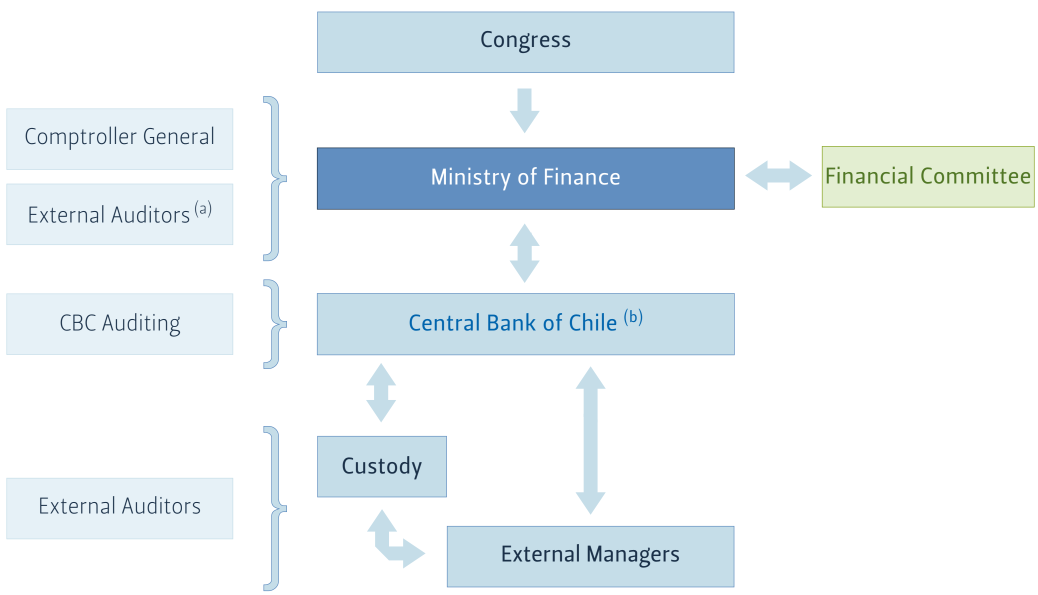
The ESSF can be used at any time in order to complement the fiscal income required to finance authorized public expenditure if there is a fiscal deficit. It can, in addition, be used to make normal or extraordinary repayments of public debt (including *bonos de reconocimiento*) and to finance the annual contribution to the PRF when the Finance Minister so decides.

Withdrawals from the ESSF and the PRF require a decree issued by the Finance Ministry.

C. Institutional framework

The legal framework for the Funds establishes a clear division of functions and responsibilities that facilitates accountability and operational independence in their management. The principal functions of each of the bodies involved in their management are summarized below (see Diagram 1).

Diagram 1 Institutional framework for Chile's sovereign wealth funds



(a) External auditors are used to audit the financial statements prepared by the General Treasury.
(b) Until end-2011, the Central Bank of Chile (CBC) had directly managed all the assets of the ESSF and the PRF. However, as from 2012, external managers will be delegated by the CBC to manage approximately 35% of the PRF (equities and corporate bonds).

Ministry of Finance and dependent bodies

The Fiscal Responsibility Law specifies that the Funds are the property of the State of Chile and that the General Treasury is the bearer of the resources. Under this law, the Finance Minister is responsible for deciding how the Funds are managed and their investment policies. To this end, the Ministry draws up investment guidelines, defining eligible instruments and issuers, investment limits, the use of derivatives and other matters, which must be adhered to by the agents responsible for investing their assets. In addition, the Finance Ministry monitors compliance with these investment guidelines and prepares monthly, quarterly and annual public reports on the situation of the Funds.

The General Treasury is responsible for the Funds' accounting and for preparing their audited financial statements while the Finance Ministry's Budget Office is responsible for aspects of the Funds related to the budget.

Central Bank of Chile

Under Decree N° 1.383 of 2006 (the "Agency Decree"), the Ministry of Finance appointed the Central Bank of Chile (CBC) as fiscal agent for management and investment of the Funds' assets. In this task, the CBC must abide by the investment guidelines drawn up by the Finance Ministry. The CBC is empowered to delegate part of the management of the Funds' assets to external managers.

Following a selection process undertaken in 2011, the CBC appointed BlackRock Institutional Trust Company, N.A., Mellon Capital Management Corporation and Rogge Global Partners Plc as delegated managers for 35% of the PRF's portfolio as from January 2012 (see Chapter 3 for details of the selection process).

Financial Committee

The Fiscal Responsibility Law specified the creation of a Committee (henceforth, the Financial Committee) to advise the Finance Minister on matters relating to the investments of the PRF and the ESSF. This Committee monitors their investments and advises the Minister on the definition of the guidelines required for their implementation. On December 23, 2006, the Finance Minister announced not only the creation of the Funds but also, in compliance with this requirement, the establishment of the Financial Committee, officially created under Decree N° 621 issued by the Finance Ministry in 2007. This Decree stipulates that the Committee must have six members who have experience in investment portfolio management, have served as manager of financial institutions or hold or have held academic posts. They are appointed for a period of two years, with half the seats coming up for renewal each year. The Committee's president receives a fee of 25.5 *unidades tributarias mensuales* per session, with an annual upper limit equivalent to five sessions, while its other members receive a fee of 17 *unidades tributarias mensuales* per session, also with an annual upper limit equivalent to five sessions. The Committee must meet at least once every six months.

The Financial Committee's functions and the norms of procedure required for its proper operation were also defined by Decree N° 621, under which its main functions and responsibilities are:

- To advise the Finance Minister, when so requested, on key issues related to the Funds' investment policy such as the allocation of their investments by asset class, the incorporation of new investment alternatives, the benchmarks to be used, the limits to permitted deviations from their asset allocation and the limits of the Funds' investment possibilities;

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

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

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

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

- To express its views and recommendations regarding other matters related to the Funds' investment policies, taking into account the principles, objectives and rules that govern the Funds.

In order to promote transparency, the Financial Committee decided that the decree regulating its activities, the minutes of its meetings and the corresponding press releases should be publicly disclosed. For this purpose, a special section of the Ministry of Finance's website was created on which all information on these issues is posted[6].

6 www.hacienda.cl/english/sovereign-wealth-funds.html

D. Investment policy

In order to contribute to the competitiveness of the Chilean economy, the ESSF and the PRF invest exclusively in foreign-currency instruments in accordance with the investment policy described below:

Economic and Social Stabilization Fund

In line with the objectives set out above, the main aim of the ESSF's investment policy is of maximizing the fund's accumulated value in order to partially cover cyclical reductions in fiscal revenues while maintaining a low level of risk. Its aversion to risk is reflected in the choice of an investment portfolio with a high level of liquidity and low credit risk and volatility, thereby ensuring the availability of the resources to cover fiscal deficits and avoiding significant losses in the fund's value.

The investment policy in force has been consistent with these objectives. It stipulates investment in fixed-income instruments denominated in reserve currencies which typically perform well at times of crisis. This permits not only the maximization of the value of the fund's accumulated resources measured in foreign currency but also their conversion into pesos (in which most fiscal spending takes place) when their use is most needed. During the 2008 crisis, for example, their returns were not affected and were, in fact, very favorable in pesos terms. This was in contrast to other countries' sovereign wealth funds which, with their more risky profile, suffered important short-term losses (see Box 1). Specifically, the ESSF's asset allocation comprises 30% in money market instruments, 66.5% in nominal sovereign bonds and 3.5% in inflation-indexed sovereign bonds while its currency allocation consists of 50% in US dollars, 40% in euros and 10% in yens.

Box 1 Returns and risks of sovereign wealth funds

The results obtained by sovereign wealth funds (SWFs) depend principally on the investment policies defined in accordance with the objectives for which they were created since these policies determine factors that include their risk tolerance and investment horizon. For example, the investment policies of SWFs whose objectives are related to financing pensions – as in the case of Australia's and New Zealand's funds or the PRF – or saving resources for future generations – as in Norway – have riskier investment policies in line with their longer-term investment horizons and, therefore, greater risk tolerance. Other more conservative SWFs such as stabilization funds – as in the case of Chile's ESSF and East Timor's SWF – invest mainly in fixed-income assets since their main objective is to support the financing of public spending when fiscal income decreases, which may occur within a shorter horizon.

Table B1 compares the principal characteristics of different countries' SWFs, including their size, the type of fund, asset allocation, annual returns in dollars in 2007-2011, their annualized average return in this period and the standard deviation of their annual returns.

In this table, it can be seen that the mean annual return – measured as the time-weighted rate of return (TWR) – in dollars of Chile's SWFs since their inception (5.0%) compares favorably with that obtained by other countries' funds in the same period. Since the beginning of 2007, the Irish fund, for example, obtained a return of -0.7% while other results included Alaska (1.8%), Norway (1.9%), Trinidad and Tobago (3.4%), New Zealand (3.6%), East Timor (4.3%), Canada (4.5%) and Australia (7.6%).

Table B1 Strategic asset allocation and returns in dollars of selected SWFs

(% unless otherwise indicated)

Fund	Size (US$ billion)	Type of fund (a)	Asset allocation			Return in dollars						
			Fixed-income	Equities	Alternative inves-tments (b)	2007	2008	2009	2010	2011	2007-2011 (annuali-zed) (c)	Standard deviation (annuali-zed) (d)
Australia	75	P	32	32	36		-26.3	44	24.8	1.4	7.6	30
Chile (e)	**18**	**P/S**	**100**	**0**	**0**	**8.9**	**7.6**	**2.4**	**1.8**	**3.4**	**5,0**	**3**
Canada	14	SA	24	51	25	20.7	-31.7	28.7	15.7	1.8	4.5	24
East Timor	9	S	96	4	0	7.4	6.9	0.6	3.8	2.8	4.3	3
New Zealand	14	P	6	64	30	15.1	-44.2	48.4	24.3	0.8	3.6	34
Trinidad and Tobago	4	S	69	31	0	4.2	3.1	3,0	7.5	-1.5	3.4	3
Norway (f)	509	SA	41	59	0	10.2	-27.2	30.8	8.8	-4	1.9	21
Alaska	39	SA	23	44	33	8.8	-24.7	18.9	11.9	0.3	1.8	17
Ireland	7	P	22	40	38	14.2	-33.3	23.6	4.4	-1.6	-0.7	22

Source: Prepared by Ministry of Finance on basis of the respective SWF's annual reports.

(a) "SA" = savings, "P" = pensions and "S" = stabilization.

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

(c) In the case of Trinidad and Tobago, the figures correspond to the latest available information (September 2011). The return for Australia was estimated using information for 2008, 2009, 2010 and 2011. The return published by each SWF was converted into dollar using the variation of the dollar against the currency used to calculate the published return.

(d) Calculated on the basis of annual returns.

(e) Includes ESSF and PRF.

(f) Government Pension Fund Global.

The funds with the largest fixed-income allocation showed the highest returns in 2011. The SWFs of Chile and East Timor, for example, with an allocation of over 90% to this asset class, reported the best results in dollars (3.4% and 2.8%, respectively). Trinidad and Tobago, however, despite an important fixed-income allocation (69%), suffered a loss (1.5%), due principally to its holdings of equities1 while the returns of other funds reflected the strategies adopted for their portfolios of equities and alternative investments. The return in dollars of Canada's SWF, for example, was 1.8% while other results included Australia (1.4%), New Zealand (0.8%), Alaska (0.3%), Ireland (-1,6%) and Norway (-4.0%). Similarly, the volatility experienced by these latter funds in 2007-2011 was much greater than that seen in the SWFs of Chile, East Timor and Trinidad and Tobago, with their more conservative investment policies.

[1] At the date of publishing this Report, information for Trinidad and Tobago was not yet available for the last quarter of 2011.

Pension Reserve Fund

The PRF's principal objective is to generate resources to finance part of fiscal pension liabilities. To this end, it has established the specific objective of maximizing the expected return subject to a risk tolerance defined as a 95% probability that, in a given year, it will not suffer a loss of more than 10% of its value in dollars. Given the size and timing of the liabilities it is designed to finance, the PRF has a medium to long-term investment horizon.

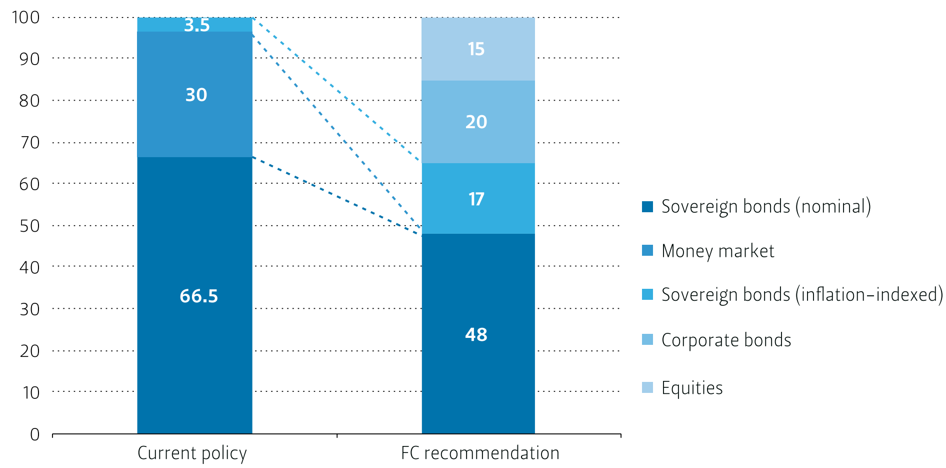
As of end-2011, the investment policy in force for the PRF (since the inception of both the PRF and the ESSF) was similar to that for the ESSF. However, at the beginning of 2012, following an exhaustive process of selecting external managers which concluded in November 2011, it began to implement a new investment policy (see Box 2), establishing an asset allocation of 48% in nominal sovereign bonds, 17% in inflation-indexed sovereign bonds, 15% in equities and 20% in corporate bonds (see Figure 2). The adoption of this new policy was recommended by the Financial Committee at the end of 2010 with the support of a study prepared by the Mercer consultancy firm which used the previously defined return and risk parameters.

This policy of diversification will allow the PRF to invest in accordance with its long-term objective of complementing financing of future fiscal pension liabilities. This will bring it more closely into line with the investment policies of the country's private Pension Fund Administrators (AFPs)[7], reflecting the nature of the liabilities to be financed by the PRF (pensions). From the point of view of asset classes and their risk profiles, the PRF's investment policy has until now been even more conservative than that of the "E" fund managed by AFPs, which considers an allocation of up to 5% in equities and permits investment in corporate bonds. Its new investment policy will allow the PRF to move towards an allocation similar to that of a "D" fund (15% in equities) which would be more consistent with the return and risk profile objectives defined for the fund. In other words, it will continue to have a moderate level of risk tolerance while also moving towards an investment policy more closely aligned with the underlying liabilities it is designed to finance.

7 Most of the fixed-income investments held by the different types of funds administered by the AFPs (including "D" and "E" funds) are principally local instruments (in pesos and unidades de fomento) and, therefore, without exchange-rate risk. In the case of the PRF, its resources are invested overseas and are not hedged against exchange-rate risk.

Figure 2 **Current investment policy and Financial Committee (FC) recommendation**

(% of portfolio)



Source: Ministry of Finance.

Box 2 Why diversify at a time of turbulence?

Under the hypothesis of efficient markets, the prices of financial assets reflect all the information about them that is available to the market. Moreover, the empirical evidence suggests that, in general, markets tend to behave in line with this hypothesis.

For most investors, it is, therefore, very difficult to anticipate market behavior. Active strategies, such as market timing (the choice of the date for buying or selling instruments) and selectivity (the choice of a particular instrument rather than another) in a bid to outperform a benchmark, tend not to be effective.

In view of this, it is, in practice, difficult to determine the optimum time to invest. Investment policies must, therefore, be implemented from a long-term perspective, considering that, over a long-term horizon, the expected returns envisaged in the investment policy should be obtained, regardless of the time of entry.

In line with this, the Financial Committee recommended implementation of the PRF's diversification policy – which is expected to be completed in the first quarter of 2012 – despite the financial turbulence seen in 2011. The Committee takes the view that, although the fund may experience some short-term volatility, the new policy will in the long term generate higher expected returns than the current policy while representing only a moderate level of risk.

CHAPTER 2

Situation of the Funds

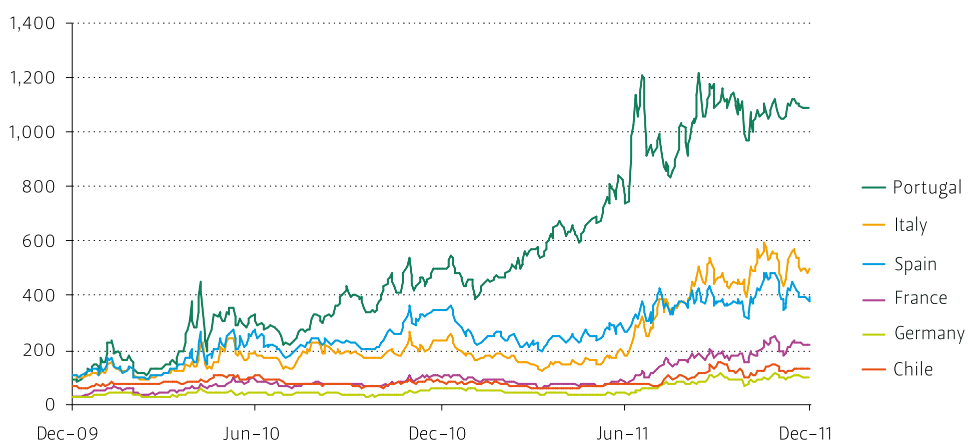
A. Market analysis

2011 was marked by the deepening of the European crisis and by a series of events that affected the main financial variables that have a direct impact on the performance of the portfolios of Chile's sovereign wealth funds.

In the euro zone, the deepening crisis had a significant effect on a number of systemically important countries such as Spain and Italy. Towards the end of the year, these two countries faced higher financing costs, reflecting greater uncertainty about the sustainability of their public debt and significant fiscal deficits. In Greece, the deterioration was such that markets reflected the expectation that holders of its sovereign bonds would sustain losses of over 50% in order to mitigate part of the short-term financial pressures on this country. Nonetheless, at the end of the year, there were still doubts as to whether Greece would comply with its financial obligations and adjust its spending in order to reduce its fiscal deficit. The situation in other countries such as Portugal also worsened in 2011 and, in the second quarter of the year, it became the third country, after Greece and Ireland, to request financial support from the European Community and the International Monetary Fund. In this situation, the financing costs of these countries and of financial institutions with exposure to them (principally European institutions) and the cost of credit default swaps (CDS[8]), increased considerably (see Figure 3). In the last two months of the year, the European Central Bank responded by again reducing its monetary policy interest rate and launched a massive program of three-year lending at a 1% rate of interest for European banks in a bid to address the lack of liquidity seen in financial markets (see Figure 4).

Figure 3 5-year credit default swaps: Selected European countries and Chile, 2010-2011

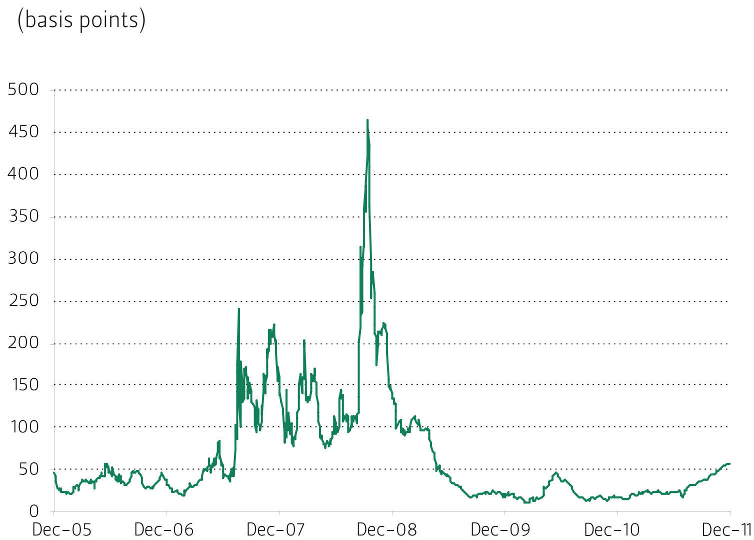
(basis points)



Source: Bloomberg.

8 This represents the cost of financial instruments to protect against default by an issuer.

Figure 4 TED Spread[9], 2006 – 2011



Source: Bloomberg

In the third quarter of 2011, Standard and Poor's reduced its risk rating for the United States from AAA to AA+ in view of this country's high level of government borrowing and political difficulties in reaching agreement on a significant fiscal adjustment (see Box 3). The US economy has, however, been showing a modest expansion, leading to a gradual improvement in its employment figures although significant weaknesses persist in the real estate sector and as regards household indebtedness and investment. This led the Federal Reserve to extend its public undertaking to hold its monetary policy interest rate in the range of 0-0.25% through to the end of 2014.

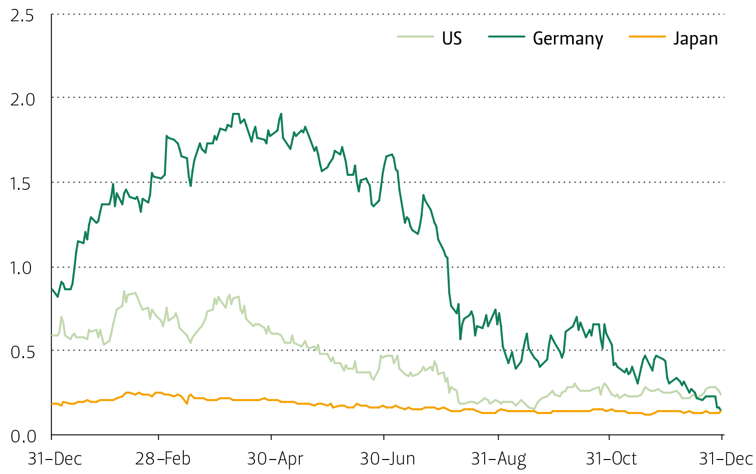
In May, the Japanese economy began to recover from the important adverse impact of the earthquake of March 2011. The Bank of Japan held its monetary policy interest rate in the range of 0-0.1% in order to stimulate this recovery.

Interest rates on bonds issued by the United States, Germany and Japan dropped to historically low levels in the second half of 2011, reflecting their use as a haven in the face of the deepening European crisis (see Figure 5).

9 The TED spread is the difference between the interbank borrowing rate (LIBOR) and the risk-free rate (US Treasury bills). A higher TED spread typically indicates a lower level of market liquidity.

Figure 5 **Yield to maturity on 2-year sovereign bonds: US, Germany and Japan, 2011**

(%)

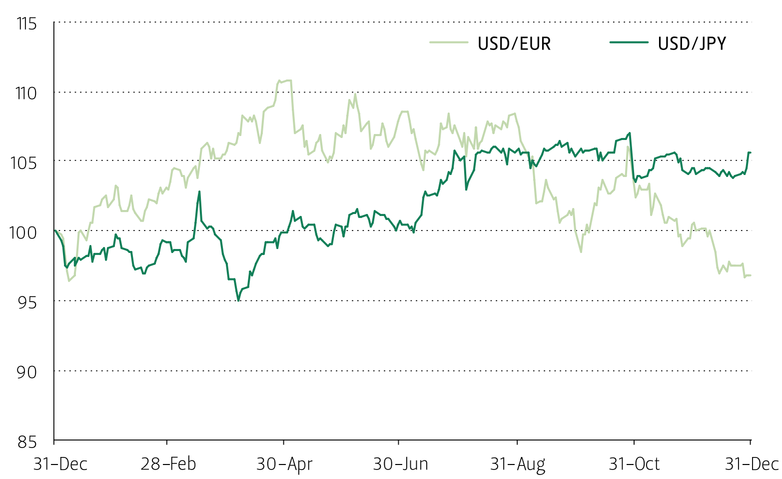


Source: Bloomberg

Exchange rates fluctuated considerably in 2011. The euro (EUR) closed the year at 1.30 USD/EUR, representing a depreciation of 3.16% over the course of the year, while the yen (JPY) closed at 76.91 JPY/USD, equivalent to an annual appreciation of 5.5%. It is important to note that the value of the dollar against the yen reached an historic record at the end of October, triggering the intervention of the Bank of Japan in a bid to depreciate the yen (see Figure 6).

Figure 6 **Exchange rates, 2011**

(December 31, 2010 = 100)



Source: Bloomberg

The intense volatility of capital markets was reflected in the VIX Index, which represents the expected volatility of the Standard & Poor's 500 Index (S&P 500) in the United States (see Figure 7).

Figure 7 Stock market (S&P 500) volatility (VIX), 2006-2011

Source: Bloomberg

Box 3 US government borrowing limit and implications for Chile's sovereign wealth funds

The difficulties faced by the US government in mid-2011 in its bid to increase its borrowing limit - or, in other words, the maximum amount of debt that Congress authorizes the Treasury to take on - highlighted the country's complex fiscal situation. The government was forced to seek authorization for an increase after reaching the existing limit in May 2011 since it would otherwise have been unable to cover its budget needs and/or financial obligations. However the process proved complex because authorization was tied to implementation of concrete measures for sustainable reduction of the fiscal deficit.

In this context, Standard and Poor's warned that it would reduce its risk rating for the United States unless concrete measures were defined to ensure the sustainability of the country's indebtedness. This triggered uncertainty in international financial markets which have historically viewed debt issued by the US government as the safest investment instrument.

After several months of debate in Congress and without reaching a specific agreement on how to reduce the fiscal deficit, an increase in the borrowing limit was approved at the beginning of August and a Committee was established to define reductions in the deficit. Moreover, if this Committee were unable to agree on which items of expenditure to cut by end-2011, automatic reductions would be triggered. However, Standard and

Poor's still reduced its rating for the US from AAA to AA+, arguing that the agreed measures were insufficient to reduce the country's indebtedness in the medium term. It is important to note that other risk rating agencies such as Fitch and Moody's maintained their ratings for the US and interest rates on its bonds not only did not increase (as would have occurred if financial markets considered sovereign risk to have increased) but even dropped after the announcement.

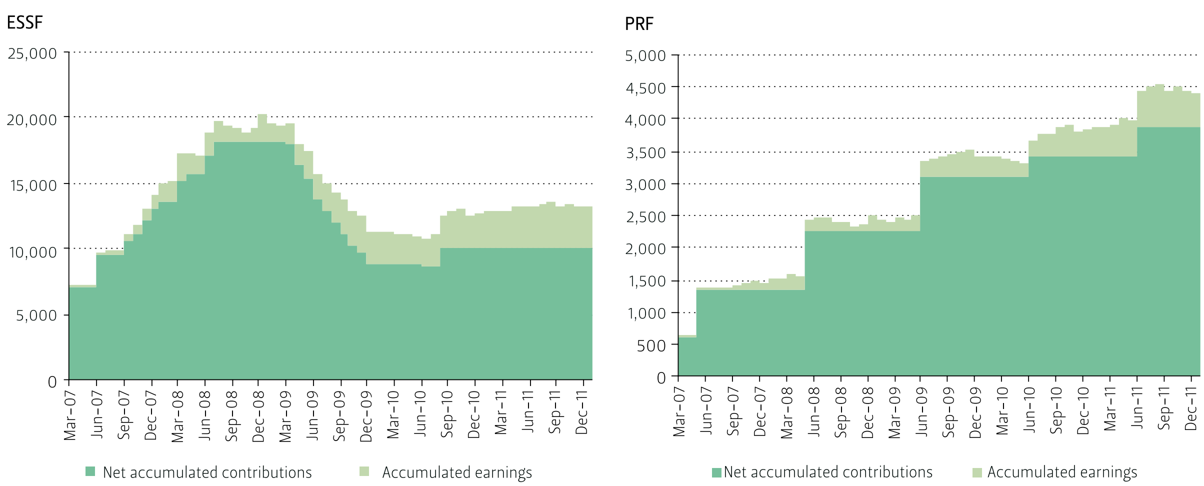
Chile's sovereign wealth funds benefitted from the generalized market uncertainty about the financial solidity of different countries, particularly as a result of the European crisis, because their portfolios consist principally of US, German and Japanese fixed-income instruments which are considered reserve assets. This, in turn, confirmed that the Financial Committee was correct in taking a long-term view and recommending that no changes be made in the Funds' investment policy despite the difficulties faced by the US government.

B. Market value

At the end of 2011, the market values of the ESSF and the PRF reached US$13,157 million and US$4,406 million, respectively, as compared to US$12,720 million for the ESSF and US$3,837 million for the PRF at the end of 2010. The increase in the value of the ESSF was explained by net investment earnings of US$437 million while the increase in the PRF was the result of a contribution of US$443 million and net earnings of US$126 million (see Figure 8).

Figure 8 ESSF and PRF: Market value, March 2007-December 2011

(US$ million)



Source: Ministry of Finance.

C. Returns

1. Conceptual definitions

The return on the Funds' investments reflects a number of factors related to the value of their fixed-income portfolios. These include principally the level and movements of interest rates and movements in exchange rates[10].

The return on short-term fixed-income instruments is determined basically by their interest rate and tends to be stable in their local currency while the return on medium and long-term fixed-income instruments depends principally on the level and movements of interest rates in the country where they are held. An increase in interest rates, for example, reduces the market value of bonds and while a drop in rates increases it. The return that results from these factors is referred to here as "return in local currency".

A fund's return also depends on changes in the value of the currency used to measure its performance against the other currencies in which it holds assets. In a fund whose return is measured in dollars, for example, the value in dollars of its investments denominated in euros (or yens) increases as a result of an appreciation of the euro (yen) against the dollar and decreases if they weaken against the dollar.

The total return on a fund is, therefore, a combination of the return obtained in local currency and the return generated by exchange-rate movements.

2. Returns in 2011 and 2007-2011

In 2011, the net return in dollars, measured using the time-weighted rate of return (TWR), was 3.41% for both the ESSF and the PRF. Measured using the internal rate of return (IRR), it was 3.42% for the ESSF and 3.06% for the PRF.

These returns were explained mainly by a return of 4% generated by accrued interest earnings and changes in the interest rates on the financial instruments included in their portfolios. The return was reduced by 0.59% due to variations in exchange rates, principally the depreciation of the euro against the dollar, which was partly offset by the appreciation of the yen against dollar (see Table 1).

10 The return on a bond also depends on the issuer's creditworthiness and how this evolves over time. However, in the case of Chile's sovereign wealth funds, this variable has been of less importance since they invest principally in instruments with high credit ratings.

Table 1 **ESSF and PRF: Determinants of returns (TWR) in dollars, 2011**

(%)

Found	Component	Quarter				2011
		I	II	III	IV	
ESSF	Local Currency	-0.35%	1.37%	2.17%	0.73%	4.00%
	Variations in exchange rates	2.09%	1.17%	-2.54%	-1.24%	-0.59%
	Total return (USD)	**1.74%**	**2.54%**	**-0.37%**	**-0.51%**	**3.41%**
PRF	Local Currency	-0.35%	1.38%	2.17%	0.72%	4,00%
	Variations in exchange rates	2.09%	1.17%	-2.54%	-1.24%	-0.59%
	Total return (USD)	**1.74%**	**2.55%**	**-0.37%**	**-0.52%**	**3.41%**

Source: Ministry of Finance.

The Funds' returns in Chilean pesos also depend on the peso-dollar exchange rate, with the value of their portfolios in pesos increasing (decreasing) when the peso depreciates (appreciates) against the dollar. In 2011, when the peso showed a significant depreciation against the dollar, the return in pesos was 14.75% for both Funds.

In 2011, the returns obtained by both the ESSF and the PRF were identical to those on their benchmarks (see Box 4). This is consistent with the increased emphasis given since May 1, 2011 to their "passive management" (see Box 5) under which their portfolios must be similar to those of their benchmarks. Since March 31, 2007, the average annualized returns obtained by the ESSF and the PRF were below their benchmarks by 13 basis points and 19 basis points, respectively[11].

Figure 9 shows indices representing the accumulated return on each fund. In the case of the ESSF, the index increased from 100 on March 31, 2007 to 126.5 at end-2011 while the index for the PRF increased from 100 to 126.1 over the same period.

Measured using the TWR, the mean annual return in dollars on the ESSF and the PRF since March 31, 2007[12] reached 5.07% and 5.01%, respectively, while the annualized IRR since their inception reached 4.93% for the ESSF and 4.03% for the PRF[13].

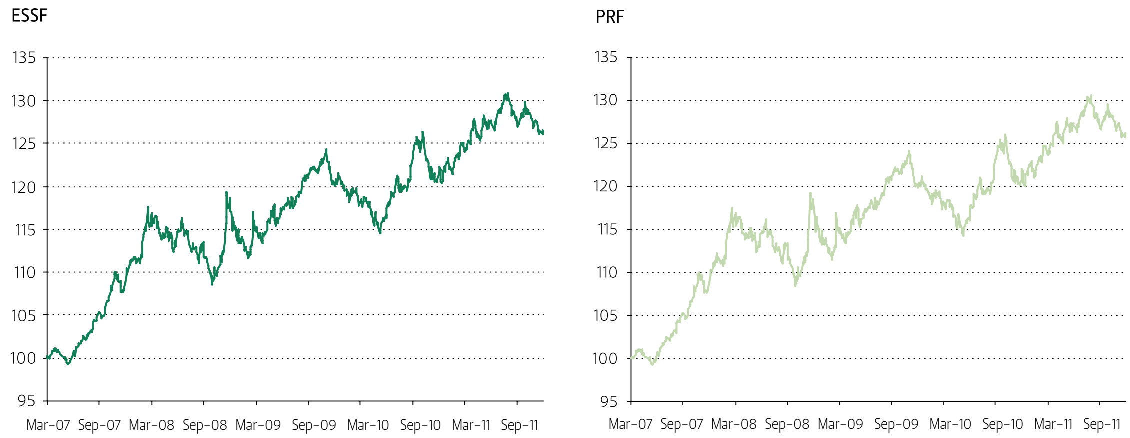
11 This means that the instruments acquired by the fund manager on average generated lower returns than those implicit in the benchmark over the period from 2007 to 2011; this was explained by lower returns in 2007 and 2010.

12 Although the first contribution to the PRF was made on December 28, 2006 and the first contribution to the ESSF on March 6, 2007, the TWR is measured as from March 31, 2007 when the CBC's performance as their manager began to be measured.

13 The IRR is calculated as from the date at which the respective fund received its first contribution.

Figure 9 ESSF and PRF: Index of accumulated returns, April 2007-December 2011

(March 31, 2007 = 100)



Source: Ministry of Finance.

Box 4 **Benchmarks**

Benchmarks, or indices representing the market for different asset classes, are used to measure the performance of portfolio managers. The Barclays U.S. Government Inflation-Linked Bond Index, for example, represents a portfolio of US Treasury inflation-indexed bonds and serves to measure a manager's decisions as regards this asset class.

A benchmark is established for each asset class contained in an investment portfolio and the benchmark for the entire portfolio is then calculated by weighting the selected indices by the percentages allocated to these asset classes under the investment policy.

If the manager achieves a return above that on the benchmark, it implies that he selected instruments that, on average, delivered higher returns than those included in the benchmark or used market timing that produced positive ex-post results. It is, however, important to note that it is not usual for managers to systematically obtain returns that exceed their benchmarks.

Box 5 Passive management

Passive management is an investment strategy that seeks to replicate the return on a benchmark for an asset class or a combination of asset classes. In general, it involves a limited number of transactions geared principally to producing an investment portfolio similar to that of the benchmark.

By contrast, an active management strategy seeks to achieve a return in excess of that on the benchmark. This kind of management assumes that the manager is able to anticipate possible changes in market trends ("market timing") and/or select instruments that, on average, will perform better than the benchmark ("selectivity"). The costs of active management are, in general, higher than for a passive strategy since the former calls for constant monitoring of markets to identify investment opportunities as well as involving a larger number of transactions. Earnings will depend to a large extent on the manager's ability to generate returns that exceed transaction costs and the manager's fees.

The empirical evidence shows that, in general, active managers in traditional financial markets do not obtain returns, net of management costs, which surpass those on market indices.

In view of this, the Financial Committee decided in 2010 that investment of both the ESSF and the PRF should be more geared to passive management. This decision was implemented by the Central Bank of Chile (CBC) as from May 1, 2011 and the results obtained by the CBC in 2011 are consistent with this management approach.

CHAPTER 3

Selection of external managers

A. Selection process

An important part of the Financial Committee's activities in 2011 were related to the selection by the Central Bank of Chile (CBC) of external managers for the PRF's diversification as from the beginning of 2012 into equities and corporate bonds. The Committee proposed that several managers be selected for each asset class and that each manager be assigned a specific investment amount. The Committee also suggested that the selection process begin with a request for proposals from the companies that had reached this stage in the selection process launched in 2008, that the CBC be supported in the process by the Finance Ministry and that a passive management strategy be adopted.

The selection of external managers comprised five stages:

a. Hiring of a consultant. Based on the Committee's recommendations, the Finance Ministry authorized the CBC to start the selection process with a Request for Proposal (RFP) from the companies that had reached this stage in the selection process launched in 2008 and by hiring a consultant to provide support for the selection process in accordance with the CBC's standards for processes of this type. This would provide specialized technical support for the evaluation of potential external managers as well as access to the extensive database of the selected consultant. The CBC contacted a number of companies and finally Strategic Investment Solutions (SIS) was selected as the consultant.

b. Request for Proposal. In mid-August 2011, in line with the Finance Ministry's instructions, the CBC invited 46 companies that had participated in the request for proposal of the selection process carried out in 2008 to participate in this new process[14]. The questionnaire sent to the companies incorporated the concerns of the Finance Ministry's technicians and of the Financial Committee. Out of the companies invited to participate, 15 presented proposals for investment in equities and 12 for investment in corporate bonds. On the basis of the replies received, both qualitative and quantitative aspects of these companies were evaluated such as their investment style, capacity for management subject to limited risk budgets, staff qualifications and turnover, the structure of their decision-making processes and the management and other costs involved. These criteria were weighted as previously agreed by the CBC and the Finance Ministry and a short list of five companies for each asset class (equities and global corporate bonds) was drawn up.

c. Interviews in San Francisco, United States. The five companies selected for each asset class were invited to participate in a round of interviews at the beginning of October in San Francisco. Representatives of the CBC, the Finance Ministry and SIS attended these interviews during which the information provided in the earlier stages of the selection process was analyzed and validated, the staff who would be responsible for the portfolios were presented, management costs were negotiated and the level of additional services that would be offered to the CBC and the Finance Ministry was discussed. As a result of these interviews, three companies were pre-selected for each asset class.

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14 This list was updated in line with corporate events since 2008.

d. Interviews in Santiago and presentation to the Financial Committee. The pre-selected companies were subsequently interviewed in Santiago by the CBC, the Finance Ministry, members of the Financial Committee and SIS. On the basis of these interviews and taking into account the views of SIS, the CBC presented the Financial Committee with a proposal on the companies to be hired.

e. Final selection. On the basis of the selection process carried out by the CBC and the recommendations of the Financial Committee, the Finance Minister authorized the hiring of two companies for each asset class and the process culminated with approval of the decision by the Board of the CBC and formal communication of the results to the companies selected. These were BlackRock Institutional Trust Company, N.A. and Mellon Capital Management Corporation for the equities portfolio and BlackRock Institutional Trust Company, N.A. and Rogge Global Partners Plc for the corporate bond portfolio. These companies will start to manage the PRF's new portfolios as from January 2012 and the portfolios are expected to be operating under their permanent regime during the first quarter of 2012.

CHAPTER 4

Activities and recommendations of the Financial Committee

A. Study on ESSF strategic asset allocation

In the second half of 2010, the Finance Minister decided to commission a study of the ESSF's investment policy in order to ensure its compliance with the objective for which the fund was created. Dr. Eduardo Walker, a professor at the Universidad Católica de Chile, was hired by the Finance Ministry to carry out this study.

After participating actively in drawing up its terms of reference at the end of 2010, the Financial Committee reviewed the study's progress during much of 2011, making suggestions about the assumptions and model used and proposing possible new points of analysis in order to achieve a better understanding of the study's conclusions. The study was completed at the end of 2011 and, during the first half of 2012, the Financial Committee expects to complete its analysis of the conclusions with a view to making recommendations to the Finance Minister based on the study (see Box 6).

Box 6 A strategic asset allocation for the ESSF

The purpose of the study, carried out at the request of the Finance Ministry, was to evaluate the ESSF's investment policy. It had to consider the investment policy's objective of maximizing the fund's accumulated value in order to partially cover cyclical reductions in fiscal revenues while maintaining a low level of risk. The study, therefore, analyzed possible investment policies without considering other alternatives for covering fiscal revenues such as the sale of copper futures or the purchase of copper options.

To this end, it developed and calibrated a financial model from which it was possible to derive the main parameters to be taken into account by the policy. It sought an optimum strategic asset allocation that would maximize a specific expected utility associated with an average level of consumption over a certain horizon. The consumption was defined as the fiscal revenue (average) and the balance in the ESSF plus its accumulated returns over each horizon.

The study's principal conclusions were:

- Although revenues from mining represent less than 20% of total fiscal revenues, the latter's volatility in the medium and long term is determined largely by the volatility of revenues from mining.
- The results indicate that portfolios which help to hedge against fiscal-revenue risk have themselves a high volatility (measured in unidades de fomento) which is similar to that of investments in equities. This volatility is necessary when covering a liability (fiscal revenues) whose value is also volatile. There is, therefore, a trade-off between short-term volatility (which implies possible headline or reputational risk) and the capacity to hedge against adverse surprises in fiscal revenues.
- Short- and long- term investments in yens and, to a lesser extent, in long-term bonds denominated in Swiss francs and long-term bonds in euros are the principal asset classes that help to hedge against fiscal-revenue risk.
- The practical recommendations that can be derived from this study point towards increasing the relative importance of the yen and other currencies and reducing that of the US dollar and the euro.

B. Other recommendations, 2011

1. External managers vs. exchange-traded funds and mutual funds

At the beginning of 2011, the Financial Committee analyzed the respective advantages and disadvantages of using external managers as compared to other alternatives offered by the market for exposure to equities and corporate bonds, the two asset classes to be introduced under the PRF's new investment policy. Specifically, it looked at exchange-traded funds (see Box 7) and international mutual funds, which are widely used by Chile's private pension fund administrators (AFPs). After analyzing information provided by the Finance Ministry and the CBC, the Financial Committee decided to recommend the use of external managers, principally for the following reasons:

Lower costs: In general, the costs of investing through exchange-traded and mutual funds are higher than those of using external managers since, in the latter case, clients tend to be institutional investors which, because of their volume of resources, can negotiate better fees.

Greater flexibility: Exchange-traded and mutual funds are standard products targeting a large number of clients and the companies offering them cannot, therefore, tailor them to the particular requirements of one investor. In contrast, external managers, because they provide services principally to institutional investors, can adapt their technical knowledge of an asset class to the needs of each client. There are, for example, a very limited number of suppliers of exchange-traded funds that replicate the benchmarks chosen for the PRF. This is resolved using external managers who have experience in following other global indices closely.

Absence of impact of other clients: In mutual funds, a withdrawal by one client can mean that the fund has to sell financial instruments to raise the necessary cash. Such sales can, in turn, produce capital gains or losses that are distributed among all the fund's clients for whom they may have tax implications. This does not occur in the case of exchange-traded funds since withdrawals take the form of an exchange of shares and do not, therefore, produce capital gains or losses. In the case of external managers, there is similarly no impact from other clients.

CBC's experience: The CBC has vast experience of investing directly in sovereign fixed-income instruments and, in the case of its international reserves, of supervising external managers for other asset classes. However, it has not needed to invest in exchange-traded or mutual funds and its internal operating processes and controls are, therefore, not necessarily suited to direct investment in these vehicles.

Box 7 Exchange-traded funds

An exchange-traded fund (ETF) is a fund holding a set of financial assets that is listed and trades on some organized and regulated market.

ETFs were initially used to passively track some stock market indices[1]. However, their use has rapidly expanded into new asset classes such as fixed-income instruments and commodities and towards more active strategies. Unlike traditional mutual funds, ETFs trade like stocks with a price that exists at all times. Although ETFs traditionally acquired all the instruments of the index they tracked, there are now ETFs that can make intense use of derivatives (the so-called synthetic ETFs) in order to achieve exposure to the index they track whilst also adding new risk dimensions such as credit risk.

1. The Standard & Poor's Depositary Receipts (SPDR) was the first ETF, created in 1993 to replicate the performance of the S&P 500 Index.

2. Foreign-currency deposits with local banks

At the end of 2011, the Financial Committee recommended considering foreign-currency deposits with local banks as an investment alternative for the ESSF, subject to eligibility and risk criteria similar to those applying to investments with overseas banks. The Committee noted that, in this way, it would be possible to expand the range of bank investment options without incurring cross-border risk or affecting the exchange rate in Chile since these would be investments in foreign currency in instruments issued and traded in Chile.

3. Externalization of part of the CBC's portfolio

In response to a question from the Finance Ministry, the Financial Committee recommended analyzing the option of externalizing part of the PRF's portfolio currently managed by the CBC. This would increase diversification and provide another point of comparison in addition to the fund's benchmark. There was, however, concern about the management costs involved and enquiries were, therefore, made in the market about two possible options (externalization of 15% and 30% of the PRF's total portfolio). The results of these enquiries were presented to the Committee but no formal recommendation was made in order not to interfere with the process of selecting external managers for its holdings of equities and corporate bonds.

APPENDIX

Summary of meetings, 2011

MEETING 1
JANUARY 17

At this meeting, the Finance Minister informed the Committee of his decision to implement the PRF's new investment policy. Preliminary discussion took place as to the use of external managers vs. exchange-traded and mutual funds. The changes introduced in the PRF's and ESSF's investment guidelines on passive management were presented to the Committee. The principal content of the 2010 Report of the Financial Committee was discussed. Finally, the situation of the Funds was analyzed and market conditions were reviewed.

MEETING 2
JANUARY 28

Discussion at this meeting focused principally on the respective advantages of using external managers vs. exchange-traded and mutual funds for implementing the PRF's new investment policy. A decision was postponed until the following meeting. The advantages and disadvantages of externalizing part of the portfolio managed by the CBC were also analyzed.

MEETING 3
MARCH 4

On the basis of information provided by the Finance Ministry and a memorandum prepared by the CBC, the Committee recommended the use of external managers for the two asset classes to be introduced under the PRF's new investment policy (equities and corporate bonds) and rejected the option of investing directly in exchange-traded and mutual funds. The Committee recommended that the Finance Ministry analyze externalization of part of the portfolio managed by the CBC (15% of the PRF). The Finance Ministry reported that the guidelines for passive management of the PRF and the ESSF were close to completing the corresponding formalities. The members of the Committee presented additional comments on its 2010 Report.

MEETING 4
APRIL 1

The Committee reviewed some aspects of the time required to select external managers. It endorsed the Finance Ministry's proposal to restart this process with the companies that had previously reached the request for proposal stage in 2008, taking account the subsequent corporate changes that could have occurred. It asked to see the questions that would be included in the request for proposal and the list of the companies to be contacted. In the case of externalization of part of the PRF's portfolio currently managed by the CBC, the Committee endorsed the Finance Ministry's suggestion that it make enquiries about the costs involved in order to evaluate its feasibility.

MEETING 5
MAY 27

At this meeting, Professor Eduardo Walker presented the first report on the study "A strategic asset allocation for the ESSF", which he had been commissioned to prepare by the Finance Ministry. He explained the conclusion of the review of bibliography, the fund's dynamics and the concept of surprise in fiscal revenues that the ESSF is designed to cover. He then described three analytical solutions and, finally, presented the study's conclusions as regards the determinants of fiscal revenues and estimates of surprises. The members of the Committee discussed this first report and made some initial recommendations. The Committee was informed that the CBC had started the process of selecting external managers for the PRF's new asset classes but that this would take longer than initially anticipated due to the CBC's need to select and hire a consultant.

MEETING 6
JULY 29

On the basis of comments received from the Financial Committee and staff of the Finance Ministry and the Budget Office, Professor Eduardo Walker, the consultant hired to review the ESSF's investment policy, presented a new version of the model to be used to define this policy. He also presented the results of an analysis using autoregressive vectors, the covariances of the model's main variables and the conclusions of the study of events. Walker told the Committee that, according to the study's preliminary results, long-term fixed-income instruments in reserve currencies, particularly the yen, are useful for hedging against deviations in fiscal revenues. The members of the Committee discussed the model used and the conclusions. In addition, in the case of the selection of external managers for the PRF's investments in equities and corporate bonds, the Committee was informed that the request for proposal questionnaire that would be sent to the companies participating in the process was in the final stage of its preparation and had been drawn up with the assistance of Strategic Investment Solutions, the consultancy firm hired by the CBC to advise it on the selection process. The Committee also reviewed the dates estimated by the CBC for the subsequent stages of the process and analyzed technical aspects of the PRF's new investment policy. The Finance Ministry presented the results of enquiries to international companies about the possible costs of managing part of the PRF's portfolio currently under management by the CBC. The Finance Ministry indicated that this possibility could be considered once management of its equities and corporate bonds had been implemented. Finally, the Committee discussed a possible scenario of default or a downgrade in the rating of instruments issued by the United States, concluding that it was not necessary to introduce changes of investment policy since instruments issued by this country remained among the safest in the world.

MEETING 7
SEPTEMBER 26

At this meeting, appreciation was expressed of the valuable contribution made to the Committee's work by its two outgoing members - its president, Andrés Bianchi, and its vice-president, Ana María Jul. Klaus Schmidt-Hebbel took over as the Committee's president, following his appointment by the Finance Minister. The Committee also welcomed its two new members, Arturo Cifuentes and Eric Parrado, and elected Cristián Eyzaguirre as its vice-president. A summary of the second report of the study "A strategic asset allocation for the ESSF" was presented. Complementing the information provided at previous meetings, the consultant presented portfolios according to original and simulated efficient frontiers (Michaud methodology) for different periods of time and with different levels of risk tolerance and betas. He also presented the study's conclusions and the Committee made a number of comments and suggestions for incorporation into the final version of the report (see Chapter 4.A. Study on ESSF strategic asset allocation). The Committee was informed that, in the process of selecting external managers for the PRF's investments in equities and corporate bonds, 27 companies, out of the total of 46 contacted, had submitted proposals and that, in the next stage of the process, the companies presenting the best-evaluated proposals would be analyzed and interviewed in San Francisco, United States while the Committee would have the opportunity to interview the finalists in Chile in mid-October. Finally, the Committee confirmed its recommendation to hire external managers for the PRF in current international market conditions.

MEETING 8
NOVEMBER 7

At this meeting, the Committee was informed by the manager of the CBC's International Markets Division of the results of the selection of external managers for the PRF's new asset classes. After asking questions and exchanging views and in the light of the general recommendation of the CBC, the Strategic Investment Solutions consultancy firm and the staff of the Finance Ministry, the Committee endorsed the process and the three companies selected (two for each asset class). The Committee also analyzed technical aspects of the investment guidelines for the PRF's new policy, made some recommendations and suggested the timing for the transfer of the funds to the companies selected. Finally, it carried out a preliminary analysis of the proposal to expand the bank issuers eligible for the ESSF.

MEETING 9
DECEMBER 12

The final conclusions of the study "A strategic asset allocation for the ESSF" were presented at this meeting. They incorporated the suggestions made by the Financial Committee at its September meeting and by the Finance Ministry. The Committee recommended that other academics from the field of finance be asked to give an opinion about its conclusions. The Committee was informed that contracts with the external managers for the PRF's new asset classes should be signed at the end of December and that the resources would be transferred at two pre-established dates in line with the Committee's suggestion. It was reported that February 1, 2012 had been set as the date for the CBC to implement its part of the PRF's new investment policy. The members of the Committee recommended that, in future, foreign-currency deposits with local banks be considered as an investment alternative for the ESSF, subject to the same eligibility and risk criteria applying to investments with overseas banks, since this would expand the range of bank investment options without incurring cross-border risk or, given that these are foreign-currency investments, affecting the exchange rate in Chile. Finally, the Committee defined its plan of work for 2012.

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Glossary

Active management — an investment strategy that seeks to obtain a return higher than a benchmark.

Alternative investments — investments other than those traditionally used (equities and fixed-income); they include principally private equity, hedge funds, commodities and real estate.

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

Basis point — one hundredth of a decimal point; 1 basis point = (1/100) of 1%.

Bond — a financial liability of an issuer (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 a specific date(s).

Bono de reconocimiento — an instrument issued by Chile's Instituto de Normalización Previsional representing a worker's contributions to the old pension system before joining the new AFP system.

Cash — cash in hand and ¬bank demand deposits.

Corporate bond — a bond issued by a corporation or company.

Credit default swap (CDS) — a financial instrument used by investors as protection against default on a bond; can also be used to take a speculative position on a bond covered by the CDS.

Duration — a measure of the exposure of a bond's price to changes in interest rates; the longer the duration, the greater the loss to which it is exposed in the case of an increase in interest rates.

Equities — securities that represent the ownership or capital of a company; buyers of stock become owners or shareholders of the company and, therefore, have earnings or losses depending on its results.

Exchange-traded fund (ETF) — a market-traded financial instrument that typically replicates a market index; traditionally used to obtain passive exposure to stock market indices but has expanded into fixed-income and commodities and, even, active strategies.

Fiscal Responsibility Law — Law N° 20.128 published in Chile's Official Gazette on September 30, 2006.

Fixed-income — investment instruments with a yield over a given period of time that is known at the time of their acquisition; sovereign and corporate bonds and bank deposits are fixed-income assets.

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

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

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

Headline or reputational risk — the risk of an adverse public perception of an entity's management.

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 charged on interbank borrowing.

Liquidity — the ease with which an investment or instrument can be sold without a significant loss in its value.

Money market instrument — a short-term asset with a maturity of less than a year that can readily be converted into cash and is less volatile than other asset classes.

Mutual fund — an investment vehicle managed by an entity bringing together the capital of different investors and providing them with exposure to different asset classes; unlike ETFs, it is not traded on the market.

Passive management — an investment strategy that seeks to replicate the return on an index representing an asset class or combination of asset classes.

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

Return generated by exchange-rate movements — the part of return generated by variations in the value of the dollar against other currencies in which assets are held

Return in local currency — the return generated by a financial instrument in the currency in which it is denominated; corresponds to that part of returns associated with the level of interest rates and their movements, creditworthiness and other factors.

Return (total) — the combination of return in local currency and that generated by exchange-rate movements.

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

Risk rating — the level of solvency of the issuer of a financial instrument (company or country) as defined by a credit rating agency.

Sovereign bond — a bond issued by a government.

Spread — the difference between the yield-to-maturity on two fixed-income securities; used to measure their relative risk level.

Standard & Poor's Depositary Receipts (SPDR) — the first exchange-traded fund created in 1993 to replicate the performance of the S&P 500 Index.

TED Spread — the difference between the interbank borrowing rate (LIBOR) and the risk-free rate (US Treasury bills); a larger TED spread is typically related to a lower level of market liquidity.

Time-weighted rate of return (TWR) — a measure of return obtained by compounding or multiplying daily returns, excluding contributions and withdrawals; unlike the IRR, it, therefore, excludes the effect of net cash flows.

Volatility — a measure of a financial asset's risk, representing the variation shown by its price over a period of time.

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