ANNUAL REPORT SOVEREIGN WEALTH FUNDS

Ministry of Finance

2010

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Contents

Minister's Remarks

2010 will be remembered as the year in which Chile suffered one of the strongest earthquakes ever recorded in the world. We were saddened by the death of 524 fellow Chileans and the disappearance of a further 34. The economic cost reached an estimated US$30,000 million of which US$8,400 million correspond to direct government outlay on reconstruction. Once again, however, our country showed its commendable strength and solidarity in overcoming this natural disaster.

The government acted decisively in arranging financing for the reconstruction. Responding quickly but prudently to this enormous economic challenge, it proposed a balanced financing package that included a temporary increase in some taxes, a permanent increase in others such as the tax on tobacco, an increase in the mining royalty, budget reallocations and borrowing. Since we were aware that the earthquake would affect economic activity, the measures taken by our government also included tax incentives for investment, particularly at the level of small and mid-sized enterprises.

Events have shown that these measures were correct. Our mixed financing approach was valued and explicitly recognized by Moody´s which upgraded Chile's rating in July 2010 This assessment was also evident in the financial markets when Chile made a sovereign bond placement at the end of the same month obtaining the lowest interest rates of its history. Moreover, despite the earthquake, Chile closed the year with GDP growth of 5.2%, having created over 400,000 jobs, and with very promising prospects for 2011.

“Fiscal savings by themselves would be enough to cover the government’s financing needs, but the new center-right administration has chosen to rely mainly on a combination of taxation and new debt issuance, and keep most of the fiscal savings for future use.”

SOURCE: Press release, Moody’s, June 16, 2010.

The proposed financing package illustrates the institutional quality and prudence of Chile’s fiscal policy. This valuable asset has been preserved and consolidated through the application of a structural fiscal rule. Our two sovereign wealth funds - the Economic and Social Stabilization Fund (ESSF) and the Pension Reserve Fund (PRF) - are a fundamental part of this policy. The first is used to save much of the surpluses that occur in years when the economy is booming or copper prices are high, serving as an insurance against the fiscal deficits that may occur in economically adverse times. In the case of the PRF, which receives an annual contribution, these savings will be used to complement budget financing for the future pensions of the most vulnerable Chileans. Thanks to these assets, Chile is one of the few countries in the world that is a net creditor, an enviable situation compared to that of many developed economies, particularly in the light of the serious fiscal difficulties we have seen in Europe.

At the end of 2010, these two funds held assets worth US$16,557 million, up from US$14,706 million at the beginning of the year. In other words, not only did we not draw on these external savings but also grew them through new contributions and the returns obtained. It would have been easier for our government to use these resources to finance earthquake reconstruction - as, at the time, many insisted we should - but we opted to take a more difficult road and proposed an arrangement that raised new resources and was balanced from the macroeconomic point of view. We were clear in indicating that we would use the resources of the ESSF only if absolutely indispensable since, apart from the effect that a massive repatriation of its assets would have had on key economic variables such as the exchange rate, its principal objective is to serve as a reserve against economic or financial crises.

Given the importance the government attaches to these two funds, it is committed to continue improving their management and those aspects of fiscal policy that will ensure Chile remains on its successful road of recent years. In this context, we have launched a study of the ESSF's investment policy in order to evaluate and ensure its consistency with the fund's objective of serving as a stabilization fund. In this way, we will be able to ensure maximization of the resources available in the future to address a drop in fiscal revenues as a result of the economic cycle or variations in the price of copper. In addition, the Finance Ministry requested that an Advisory Committee prepare proposals for perfecting the methodology for calculating the structural balance rule and its institutional framework in order to increase the predictability and sustainability of fiscal policy. In 2010, it was also decided to modify the PRF's investment policy and increase its diversification, investing up to 15% of the fund in international equities and up to 20% in international corporate bonds. This new policy, which will be implemented in 2011, is more consistent with the PRF's objective of supporting fiscal liabilities related to the pensions of the most vulnerable segment of the population.

We also want our sovereign wealth funds to be managed in accordance with the highest possible standards and, to this end, have been working to comply with the "Santiago Principles" established as a reference for best international practices. In this context, we carried out our first self-assessment against each of these principles and the results are presented in this report. Our citizens and the international community can, in this way, verify this government's commitment to the very best management of the ESSF and the PRF.

We have, at the same time, taken concrete measures to increase the information available about the two funds. In mid-2010, for example, we began to publish information about their returns monthly instead of quarterly and additional information about their investment portfolios. Initiatives of this type demonstrate our commitment to achieving the greatest possible transparency and providing Chile's citizens with ready access to information that allows them to understand clearly how the funds are invested and how they are performing.

We will continue to do our utmost to achieve solid economic policies that provide more and better opportunities for all Chileans.

FELIPE LARRAÍN
Minister of Finance

Summary

The Pension Reserve Fund (PRF) and the Economic and Social Stabilization Fund (ESSF) had a combined market value of US$16,557 million on December 31, 2010 and, since their inception, showed a net return in dollars of 5.50%.[1]

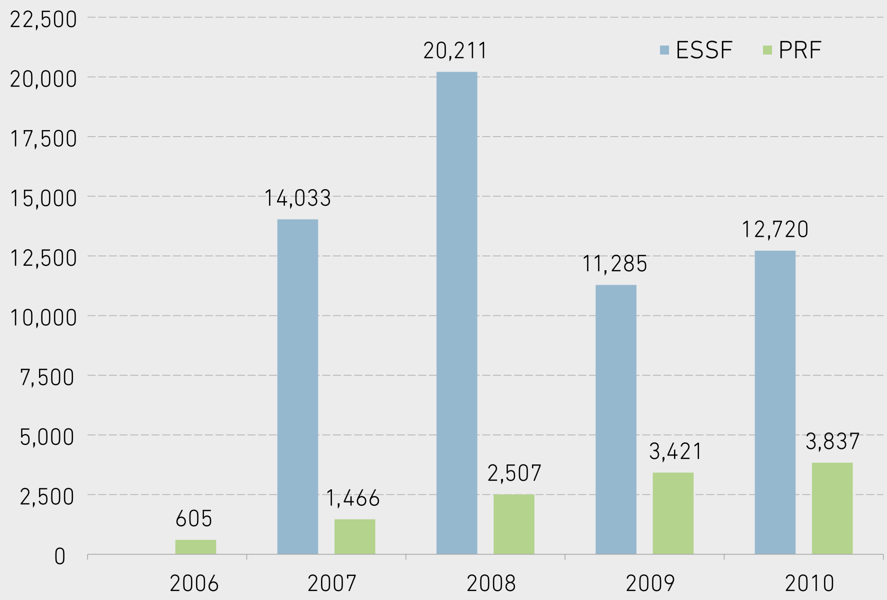

FIGURE 1
PRF and ESSF: Market value (US$ million)

SOURCE: Ministry of Finance.

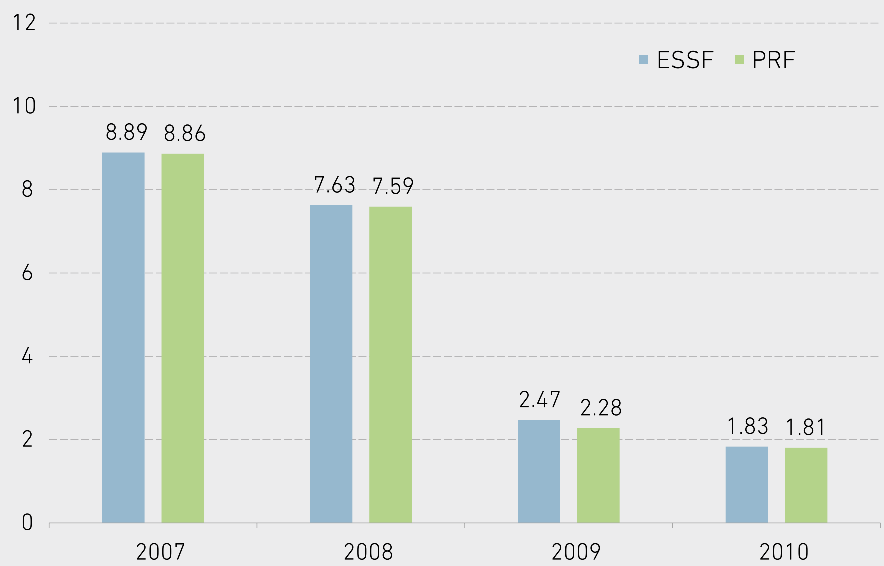

FIGURE 2
PRF and ESSF: Net annual return in US dollars (%)

SOURCE: Ministry of Finance.

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 (TWR) method. 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. Net return is less the costs of management by the Central Bank of Chile (CBC).

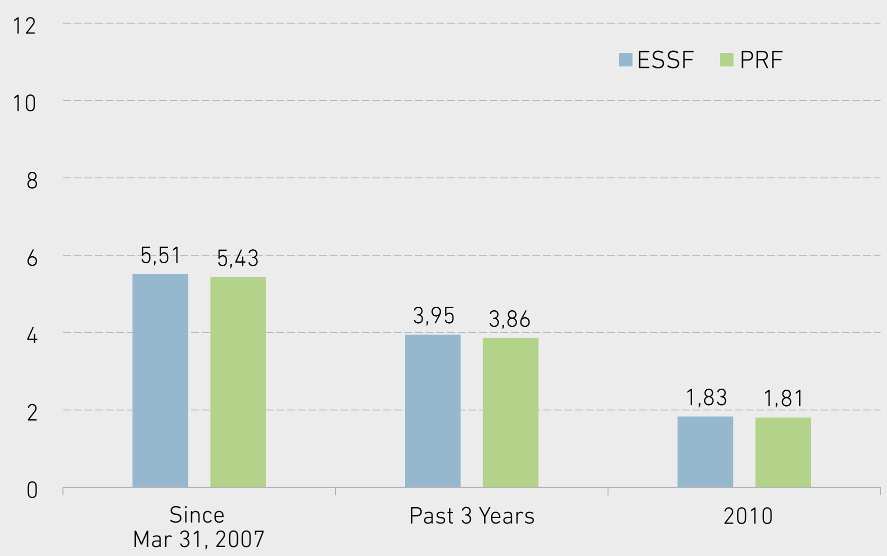

FIGURE 3
PRF and ESSF: Accumulated net annual return in US dollars[2]
(%)

SOURCE:
Ministry of Finance.

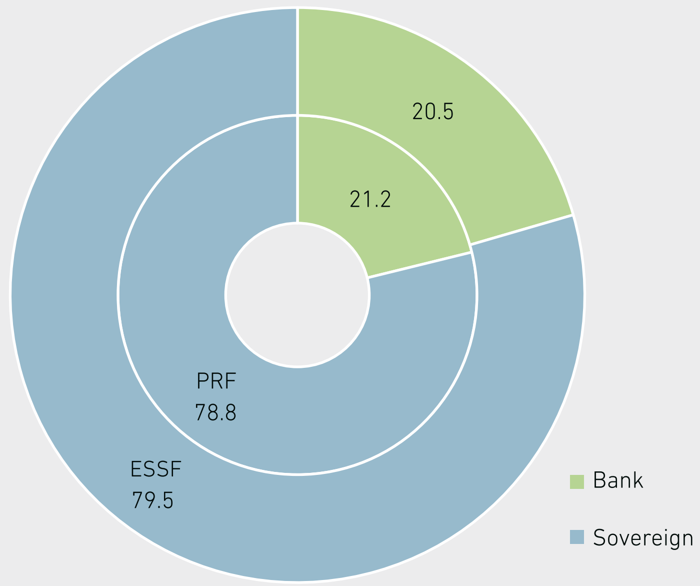

FIGURE 4
Composition of credit risk, December 31, 2010
(% of portfolio)

SOURCE:
Ministry of Finance.

2 The time-weighted rate of return (TWR) has been used to measure returns since March 31, 2007 when the performance of the Central Bank of Chile (CBC) began to be measured..

1

SOVEREIGN WEALTH FUNDS

1.1 FISCAL POLICY

In recent years, fiscal policy in Chile has been characterized by constant efforts to strengthen its institutional framework. In 2001, a structural balance rule was introduced for the central government budget and, in 2006, this rule was complemented by the creation of the country's two sovereign wealth funds as vehicles for saving the resources resulting from the rule's application.

Under the structural balance rule, annual fiscal expenditure is held to a level consistent with the central government's structural income and is, in other words, not influenced by 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 as, for example, between 2004 and 2007 and in part of 2008 and can avoid the need for drastic adjustments in fiscal spending in downturns such as that which occurred in 2009. In this way, the structural balance rule seeks to stabilize the growth of public expenditure.

In 2001, a target of a structural surplus of 1% of GDP was established and, under the fiscal budget for 2008, this was reduced to 0.5% of GDP. This was followed in 2009 by an ex ante reduction to 0% in order to address the crisis. In 2010, the methodology for calculating the structural balance was modified (Box 1), giving a structural deficit of 2.1% of GDP in 2010 *(Figure 5).*

Box 1: Modification of the structural balance rule

In the second quarter of 2010, the Finance Ministry convened an Advisory Committee to analyze the methodology used to calculate the structural balance rule and its institutional framework and to recommend possible improvements. This review sought primarily to increase the sustainability and predictability of fiscal policy.

The Finance Ministry accepted all the methodological recommendations put forward by the Committee in its preliminary report and adopted them in preparing the fiscal budget for 2011. The main changes introduced were the elimination of adjustments for temporary tax measures with a legally-established expiry date and the elimination of cyclical adjustments of the "other income" item and of interest earnings on the General Treasury's financial assets. In addition, the elasticity of health insurance contributions was re-estimated.

These methodological changes meant a very small reduction in the structural balance through to 2007 while, for 2008 and 2009, the reduction reached 0.6% and 1.9% of GDP, respectively, due principally to the effect of not making adjustments for temporary tax measures and interest earnings on the General Treasury's financial assets *(Table B 1.1).*

The Advisory Committee submitted its final report to the Finance Ministry in the first half of 2011 and the recommendations presented in this report are being considered for possible implementation in the fiscal budget for 2012.

Table B 1.1: Comparison of methodologies for calculating structural balance
(%)

	2005	2006	2007	2008	2009	2010
Effective balance	4.6	7.7	8.2	4.3	-4.5	-0.4
Structural balance under methodology in force in 2009 (a)	1.1	1.1	0.5	0.0	-1.1	
Structural balance under Advisory Committee methodology	1.0	1.1	0.4	-0.6	-3.0	-2.0

(a) There is no estimation for 2010.

SOURCE: Budget Office (DIPRES)

The application of this countercyclical fiscal policy in a context of the high copper prices that prevailed through to mid-2008 meant an important accumulation of financial assets. As from 2005, the budget showed an important effective surplus and this even reached 8.2% of GDP in 2007.

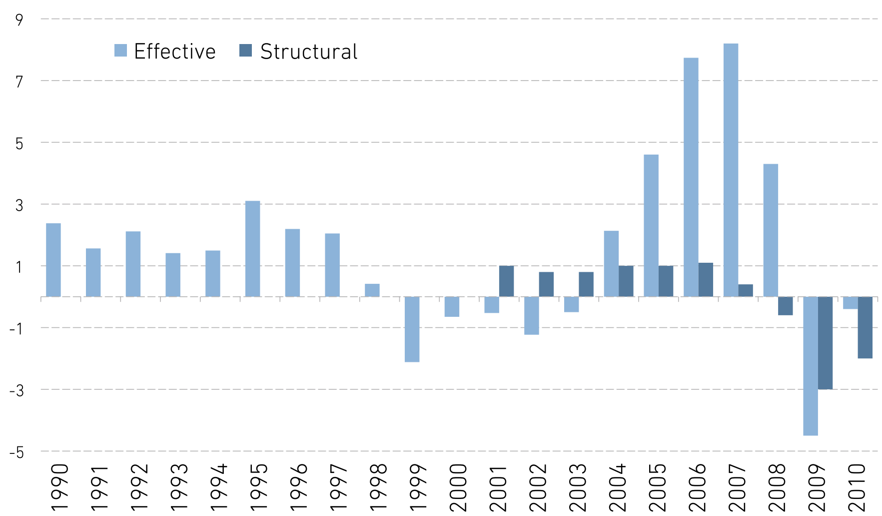

FIGURE 5
Structural and effective fiscal balance
(% of GDP)

SOURCE:
Ministry of Finance.

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 fiscal savings. It stipulated the creation of 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), officially established under Decree with Force of Law (DFL) Nº 1 issued by the Finance Ministry in 2006, which 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.

1.2 PURPOSE OF THE PRF AND THE ESSF

The Pension Reserve Fund (PRF) is designed to complement financing of fiscal pension and social security liabilities. Specifically, it is earmarked as backing for the state guarantee of basic old-age and disability solidarity pensions and solidarity pension contributions for low-income pensioners established under the Pension Reform Law.

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, thereby helping to reduce cyclical variations in fiscal spending. In addition, the ESSF can be used to pay down public debt and *bonos de reconocimiento* and to finance the regular contribution to the PRF as established under DFL Nº 1 issued by the Finance Ministry in 2006.

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 Central Bank of Chile (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. This occurred in 2006, 2007 and 2008, with the capitalization reaching 0.5% of GDP in each case.

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 advance payments into the ESSF during the previous year can, however, be subtracted from this contribution[3] *(Figure 6).*

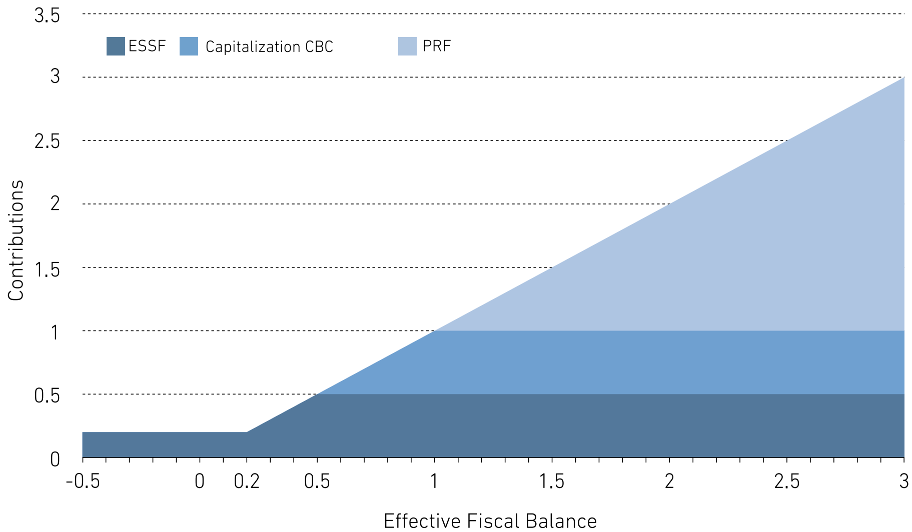

FIGURE 6
Fiscal savings rule
(% of GDP)

SOURCE:
Ministry of Finance

3 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 advance contributions to the ESSF

1.4 USE OF THE FUNDS

The different uses of the PRF and the ESSF are established by the Fiscal Responsibility Law, DFL Nº 1, discussed above, and 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 in Section 1.2 or, in other words, to complement financing of pension and social security liabilities. Until 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. As from 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 state guarantee of 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 for other purposes permitted under DFL Nº 1 such as to pay down public debt (including *bonos de reconocimiento*) and for contributions to the PRF.[4]

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4 Under DFL N° 1, the assets held in the ESSF may be used for the following: i) to finance the Budget Law by up to the amount established by this Law and included in the corresponding Calculation of General Fiscal Revenues; ii) to supplement revenues and/or finance increased spending that occurs during implementation of the budget in accordance with the authorizations and restrictions established by the legislation in force; iii) to pay capital, interest or other expenditures related to public debt, including those arising from interest rate and/or currency swaps; iv) to pay capital, interest or other expenditures related to the *bonos de reconocimiento* referred to in Temporary Article 11 of Decree Law N° 3500 (1980) including those payments arising from interest rate and/or currency swaps; v) to finance the contribution referred to in clause a) of Article 6 of Law N° 20128 when the Finance Minister so decides; and vi) to finance extraordinary contributions to the fund referred to in Article 5 of Law N° 20128 when the Finance Minister so decides.

2

INSTITUTIONAL FRAMEWORK

Investment of the assets of the PRF and the ESSF calls for a clear and transparent institutional framework that provides a proper structure for taking and implementing decisions, monitoring risks and controlling investment policy *(Diagram 1)*. 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 Central Bank of Chile (CBC) - subject to the approval of its governing board - as the fiscal agent for management of the resources of both funds and established the general framework for their management[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].

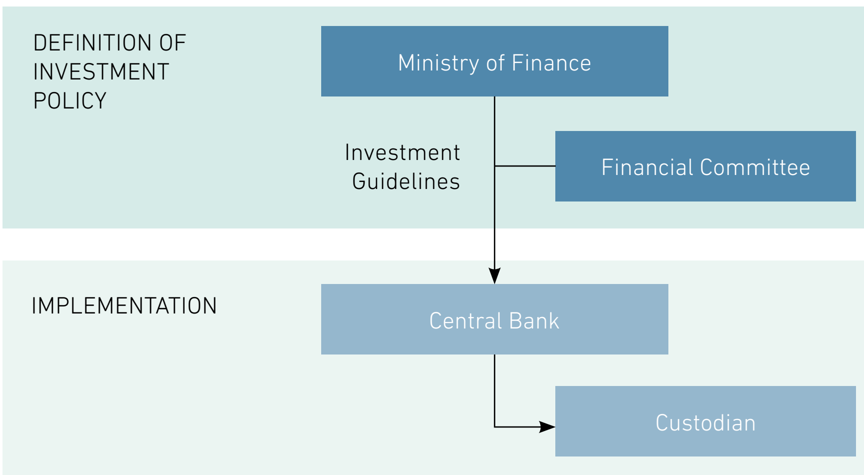


DIAGRAM 1
Institutional framework for ESSF and PRF

SOURCE:
Ministry of Finance.

2.1 MINISTRY OF FINANCE AND CENTRAL BANK

The Fiscal Responsibility Law empowered the Finance Minister to take decisions about the investment and management of the assets of the ESSF and the PRF. It also expressly authorized the Finance Minister to delegate their operational management to the CBC or other external managers. In March 2007, the Finance Minister 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 (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' management were established by Supreme Decree Nº 1.383 under which the main functions that the CBC can carry out at the Finance Minister's request are:

- To directly manage all or part of these fiscal resources in representation and on behalf of the Republic;
- 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;
- To open separate current accounts for the exercise of its role as fiscal agent;
- To maintain a register of the transactions and other operations carried out in the management of the fiscal resources;
- To hire the services of a custodian institution;
- To supervise and evaluate the performance of external managers and custodian institutions;
- 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);
- To make the payments corresponding to the exercise of its role as fiscal agent.

In fulfilling these functions, 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 investment limits and restrictions to control the funds' risk exposure.

The Finance Ministry reports on the state of the PRF and ESSF to the Chilean Congress and the general public through the presentation of monthly, quarterly and annual reports.

2.2 FINANCIAL COMMITTEE

The Financial Committee (FC) was officially created under Supreme Decree Nº 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. As of end-2010, its members were Andrés Bianchi Larre (President), Ana María Jul Lagomarsino (Vice-President), Martín Costabal Llona, Cristián Eyzaguirre Johnston, Klaus Schmidt-Hebbel Dunker and Eduardo Walker Hitschfeld.

The FC's main functions and responsibilities are:

- To advise the Finance Minister, when so requested, on the funds' long-term investment policy including the selection of asset classes, benchmarks, the range of deviations permitted, the eligible investments and the inclusion of new investment alternatives;
- 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;
- 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;
- To express an opinion about the structure and content of the reports prepared quarterly by the Finance Ministry; and
- To advise the Finance Minister, when so requested, on all the matters related to the funds' investment.

PRINCIPAL ACTIVITIES IN 2010[7]

Publication of the Financial Committee's Annual Report

In compliance with legal requirements, the Financial Committee prepared its third annual report, setting out its main activities and recommendations in 2009. 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. It is available on the Finance Ministry's website at www.hacienda.cl/english/sovereign-wealth-funds.html.

PRF investment diversification policy

The Committee presented Finance Minister Felipe Larraín with a document containing the information to allow him to make a decision about its recommendation that the PRF implement the investment diversification policy that had been postponed in 2008 in view of the international financial crisis.

Review of study of the PRF's sustainability

The Committee decided to devote one of its meetings exclusively to analysis of the first actuarial study of the PRF's sustainability. Carried out in compliance with the Fiscal Responsibility Law under which the fund's sustainability must be evaluated every three years, the study was prepared by experts at the Centro de Microdatos of the Universidad de Chile with assistance from overseas experts. The members of the Committee expressed their points of view and exchanged opinions about the model used, the assumptions on which the study was based and its conclusions. They also offered suggestions about these assumptions, the parameters to be modeled and the methodology that it would be advisable to use in the next study.

Evaluation of the ESSF's investment policy

At the end of 2010, the Finance Minister decided to carry out an evaluation of the ESSF's investment policy and its consistency with the fund's objectives and the Financial Committee collaborated with Finance Ministry staff in preparing the terms of reference for this study, defining its objectives, the tasks to be carried out and its timetable. It also recommended that two seminars be held, one of a technical nature to discuss the study's preliminary results and the other to publicize its conclusions.

7 For further information, see the Financial Committee's 2010 Annual Report.

Passive management

At the end of 2010, in response to an issue raised by the Finance Ministry, the Committee recommended increasing the passive emphasis of the ESSF's and the PRF's management. It based this recommendation on both international evidence showing how difficult it is for a fund manager to achieve net returns in excess of its benchmark and on the great volatility shown by many financial markets in recent years. Once implemented, this recommendation means that the CBC has to reproduce as closely as possible the return on the funds' benchmarks.[8]

8 This recommendation was implemented by the CBC on May 1, 2011.

3

SANTIAGO PRINCIPLES AND TRANSPARENCY

In line with Chile's commitment to best international practices, the government participates actively in international initiatives that seek to establish an operational framework for sovereign wealth funds and promote their transparency. In particular, both the Finance Ministry and the Central Bank of Chile (CBC) have from the beginning played an active role in the International Working Group of Sovereign Wealth Funds (IWG-SWF). This was established in May 2008 under the auspices of the International Monetary Fund (IMF) 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 Santiago, Chile in September 2008 when agreement was reached on a series of Generally Accepted Principles and Practices endorsed by the main countries with SWFs. This agreement is known internationally as the "Santiago Principles".

Subsequent to this agreement, many countries have striven to improve the practices of their SWFs, particularly as regards the information they disclose domestically and internationally, in order to facilitate comprehension of the performance of their investments and their financial objectives, thereby mitigating the apprehensions of many host countries. In line with this, Chile's Finance Ministry began as from mid-2010 to report monthly on the returns of the Economic and Social Stabilization Fund (ESSF) and the Pension Reserve Fund (PRF) and increased the amount of information disclosed about their portfolios.

In addition, in line with best practices, the government has decided to include a self-assessment of the funds' compliance with each of the Santiago Principles in the Finance Ministry's Annual Report on the funds *(Table 1).* This forms part of a systematic effort by the government to improve the information disclosed to the public and demonstrate that the funds are managed in accordance with best international practices. The complete self-assessment is presented in the appendices to this Annual Report.

All these efforts are reflected in international recognition of the transparency achieved by Chile's SWFs. Throughout 2010, for example, the Sovereign Wealth Fund Institute awarded Chile the maximum possible score in its Linaburg-Maduell Index which measures the transparency of the world's main SWFs *(Figure 7).*

Table 1: Self-assessment against Santiago Principles.

Principles			Year of implementation
Legal framework, objectives and coordination with macroeconomic policies	1	The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).	2006
	2	The policy purpose of the SWF should be clearly defined and publicly disclosed.	2006
	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.	2006
	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.	2006
	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.	2007
Institutional framework and organizational structure	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.	2007
	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.	2007
	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.	2007
	9	The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.	2007
	10	The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.	2007
	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.	2008
	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.	2008
	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.	2006
	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.	2007
	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.	2007
	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.	2006
	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.	2008

Investment policy and risk management	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.	«PRF: 2011 ESSF: 2007»
	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.	2007
	20	The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.	2006
	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.	na
	22	The SWF should have a framework that identifies, assesses, and manages the risks of its operations.	2007
	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.	2007
	24	A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.	2010

SOURCE: Ministry of Finance

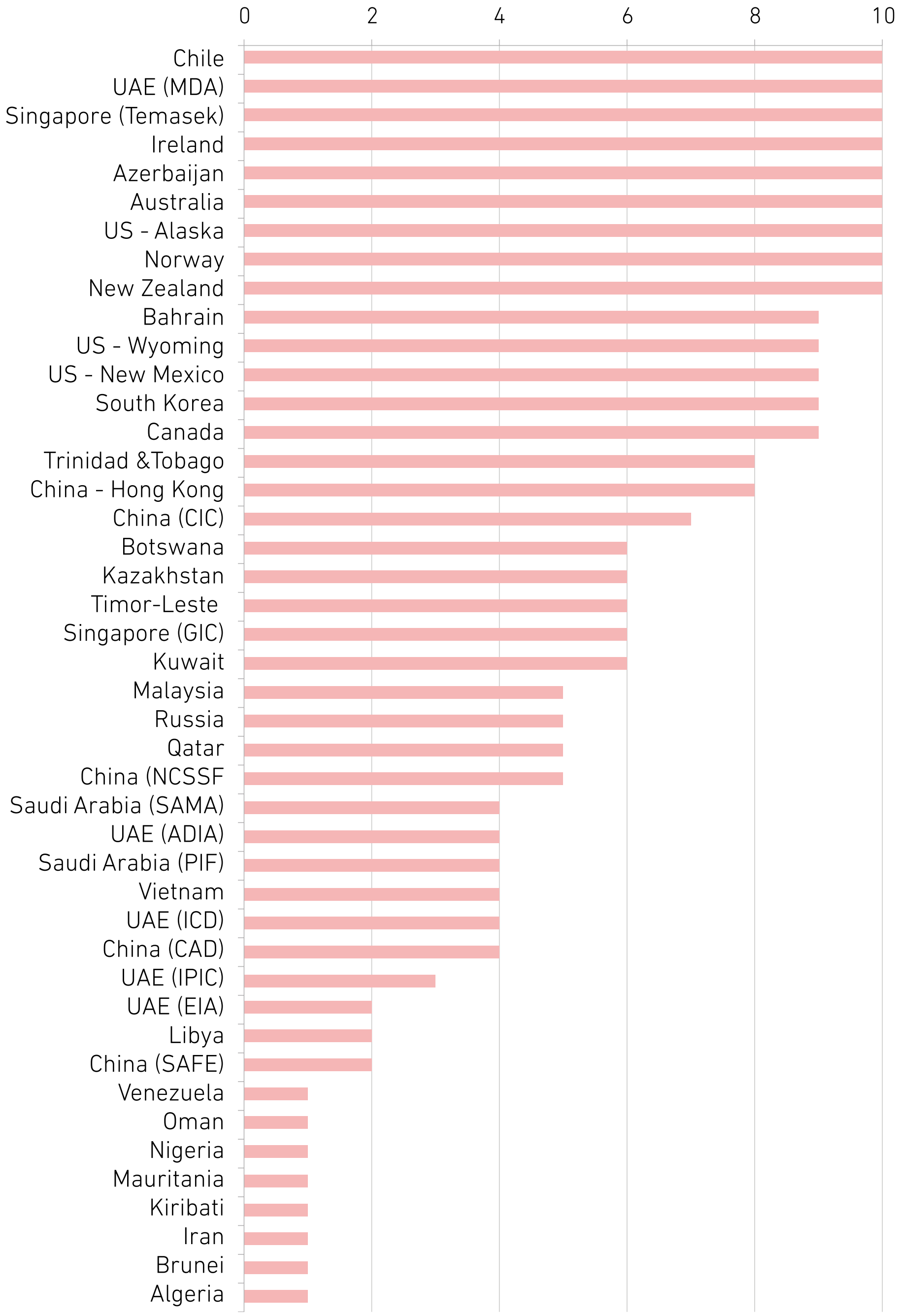


FIGURE 7

Linaburg-Maduell Transparency Index, QIV 2010

SOURCE:

Sovereign Wealth Fund Institute

4

ANALYSIS OF THE INTERNATIONAL ECONOMY

The international economy continued to expand in 2010, due partly to the growth experienced by emerging economies and to the expansive policies implemented by different countries in response to the crisis of 2008. However, as of the end of the year, there continued to be a great deal of uncertainty about the state of the world's main economies.

In 2010, the United States grew more slowly than had been anticipated in view of its significant deceleration during the crisis *(Figure 8).* High unemployment, together with lending restrictions and the deleveraging of households, hampered the reactivation of personal consumption, the main driver of the US economy. Problems in the real estate sector, the large fiscal deficit and the risk of deflation, among other factors, prevented it from returning to a normal growth path. The Federal Reserve maintained its monetary policy interest rate at an historically low level *(Figure 9)* and, in November, implemented Quantitative Easing 2 in order to avoid an increase in interest rates and stimulate the economy *(Figure 10)*. In this context, liquidity in the financial system, typically measured as the spread between LIBOR and the Overnight Index Swap rate, was comparable to the levels that existed before the crisis *(Figure 11).*

Despite the growth seen in Germany and France, recession persisted in many other euro zone countries in 2010. Large fiscal deficits and high levels of debt meant that they were unable to implement the measures necessary to stimulate domestic demand and return to growth. The problems of Greece and Ireland, in particular, revealed the difficulties faced by many countries in meeting their financial obligations. Financial interaction within the region and the systemic importance of some countries such as Spain resulted in significant financial market volatility due to the possibility of contagion across borders. These factors were important in the depreciation of the euro against other currencies seen in the first half of the year, a trend that was, however, reversed in the second half after the creation of the European Financial Stability Facility in May 2010 *(Figure 12).* In order to continue stimulating economic activity in the region, the European Central Bank did not increase its monetary policy interest rate.

Emerging economies recovered more quickly from the crisis than developed countries. The growth of China and India was particularly important given their size relative to the developed economies. Moreover, in 2010, China replaced Japan as the world's second largest economy after the United States. In this context, the central banks of a number of emerging economies began to increase their monetary policy interest rates in response to early signs of overheating and inflation *(Figure 13),* exacerbated by increases in the prices of food, fuels and other commodities *(Figure 14).*

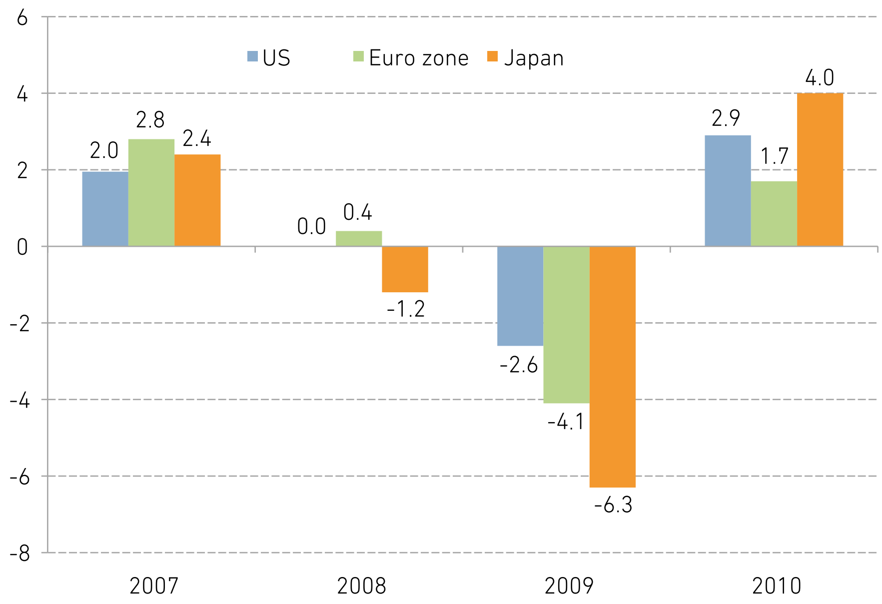


FIGURE 8

Growth rates, 2007-2010

(%)

SOURCE:

BEA, ECB, COJ

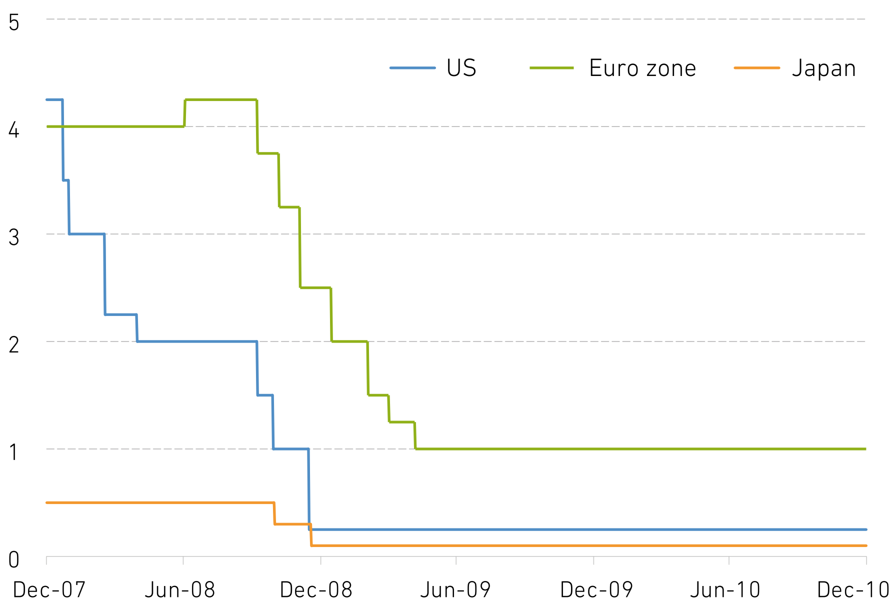


FIGURE 9

Monetary policy interest rates, 2008-2010

(%)

SOURCE:

Bloomberg

US

FIGURE 10

Sovereign interest rates (6-month, 2-year and 10-year), 2007-2010 (%)

SOURCE:

Bloomberg

EURO ZONE

JAPAN

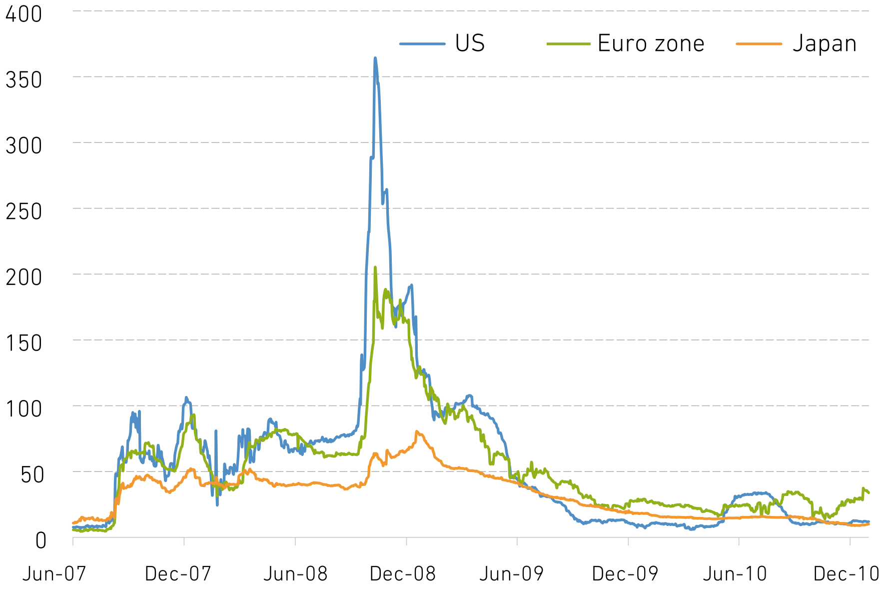


FIGURE 11

LIBOR-Overnight Index Swap spread, 2007-2010

(Bps)

SOURCE:

Bloomberg

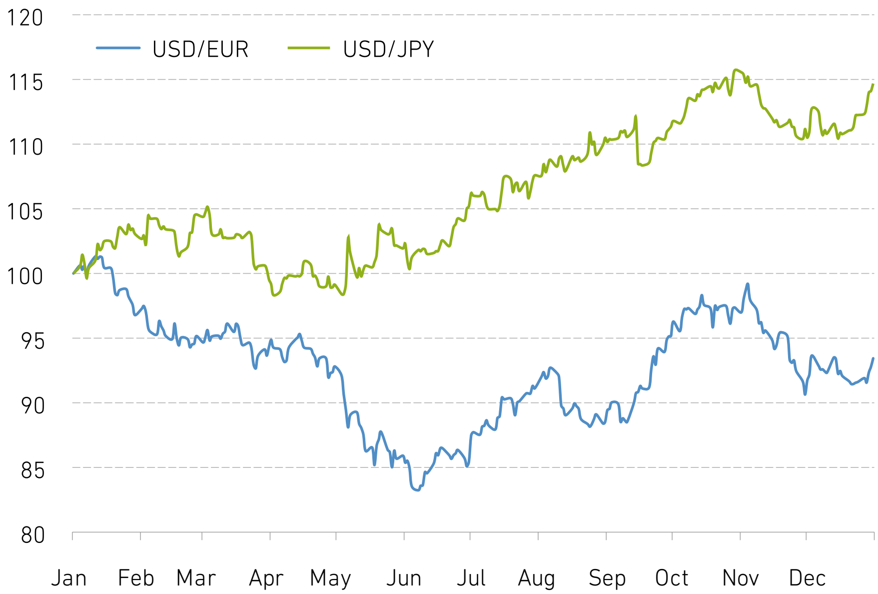


FIGURE 12

Exchange rates, 2010

(January 2010 = 100)

SOURCE:

Bloomberg

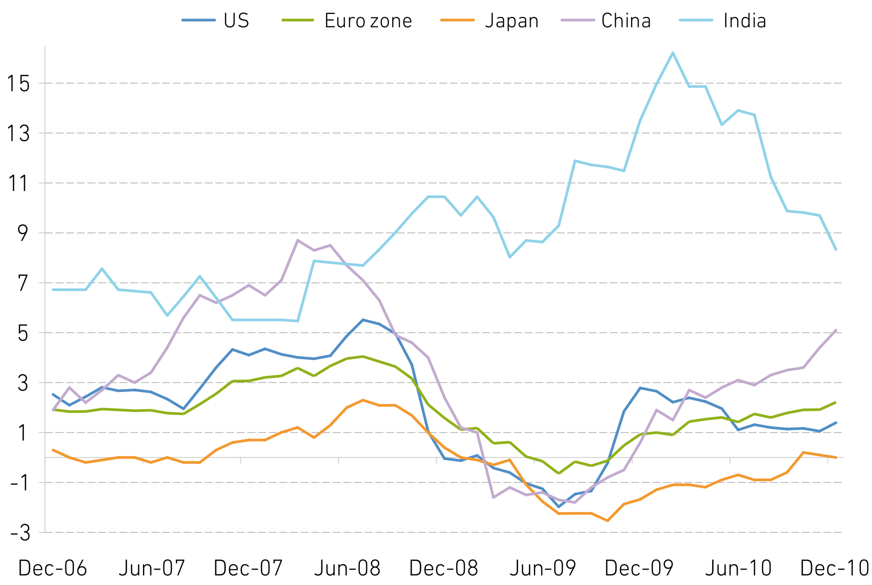


FIGURE 13

Inflation, 2007-2010
(%)

SOURCE:
Bloomberg

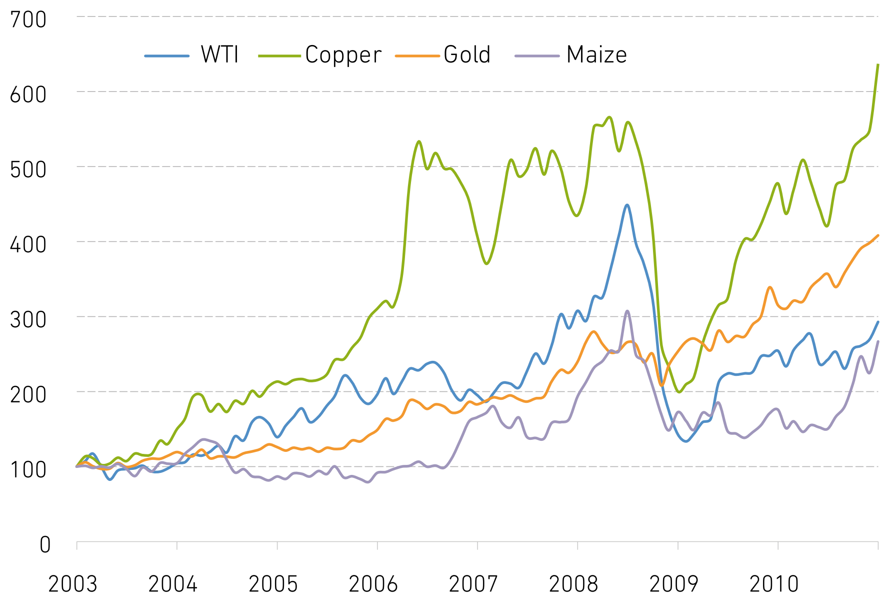


FIGURE 14

Commodity price indexes, 2003-2010
(January 2003 = 100)

SOURCE:
Bloomberg

5

PRF AND ESSF

5.1 INVESTMENT POLICY

The investment policy defined when the Pension Reserve Fund (PRF) and the Economic and Social Stabilization Fund (ESSF) were created involved asset classes similar to those used by the Central Bank of Chile (CBC) for international reserves. This policy was initially intended to be temporary, pending the recommendations of the Financial Committee, and was chosen principally because it was consistent with the ESSF's objectives as well as on the grounds of prudence and because of the CBC's vast experience in managing these asset classes.

In the first quarter of 2008, the Finance Minister defined a new investment policy, based on the Committee's recommendations and more closely aligned with the funds' characteristics. This policy would subsequently differ for the PRF and the ESSF in line with their different objectives and investment horizons. This proposed policy envisaged the incorporation into both funds of two new assets classes - equities and corporate bonds - and a greater diversification by country and currency. In view of the economic and financial crisis of late 2008, its implementation was, however, postponed. In mid-2009, with the improvement seen in international markets, the Financial Committee recommended that it be implemented but only for the PRF. This recommendation reflected the time horizon of the liabilities that the PRF is designed to finance. For the ESSF, the Committee recommended maintaining its current investment policy due to the fund's smaller size as compared to 2008, its shorter investment horizon and the fact that, given its nature and objectives, its resources could be used to finance fiscal deficits.

In the second half of 2010, Finance Minister Felipe Larraín accepted the Committee's recommendation not to make any changes to the ESSF's investment policy but decided that this should be re-evaluated in order to ensure its consistency with the ESSF's objective as a stabilization fund that serves to compensate the effect on fiscal revenues of cyclical fluctuations in economic activity, the prices of copper and molybdenum and other secondary factors. In January 2011, Minister Larraín also accepted the Committee's recommendation as regards the PRF's investment policy and decided that it should be implemented during the second half of 2011 *(Box 2).*

As of end-2010, the assets of both the PRF and the ESSF continued to be invested according to their initial investment policy, which stipulates only fixed-income instruments *(Figure 15)* and a currency allocation in dollars, euros and yens *(Figure 16).* The funds' manager is authorized to deviate from the strategic asset allocation subject to limits on the maximum exposure to each type of credit risk *(Section 6).* Ranges of deviations are also established with respect to the benchmark currency allocation (+/- 5% for each currency[9]).

9 For example, given that the reference allocation for the dollar is 50%, the deviation range allowed for this currency is between 45% and 55% of a fund's total assets.

In order to evaluate the CBC's management, benchmarks were defined comprising indexes representative of nominal sovereign bond markets, the money market and inflation-indexed bonds, specific to each currency *(Table 2).* These benchmarks reflect the strategic asset allocation of the funds' investment policy.

As indicated above in Section 2.2, the Finance Minister decided at the end of 2010 to increase the passive emphasis of the funds' management. As a result, the permitted ranges of deviation from the benchmarks narrowed significantly in the first half of 2011.

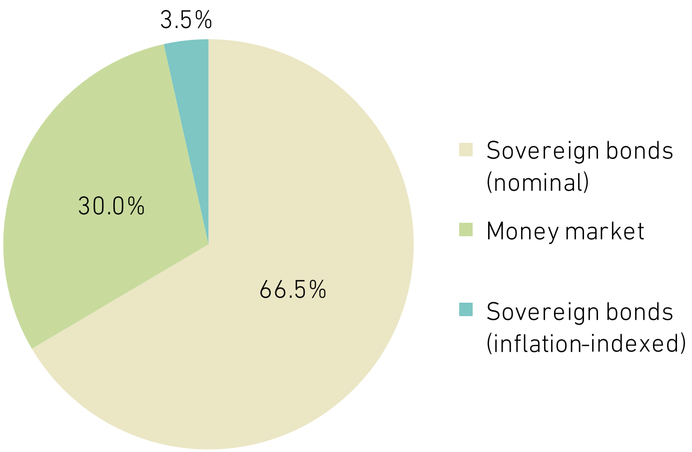


FIGURE 15
Strategic allocation by asset class
(% of portfolio)

SOURCE:
Ministry of Finance

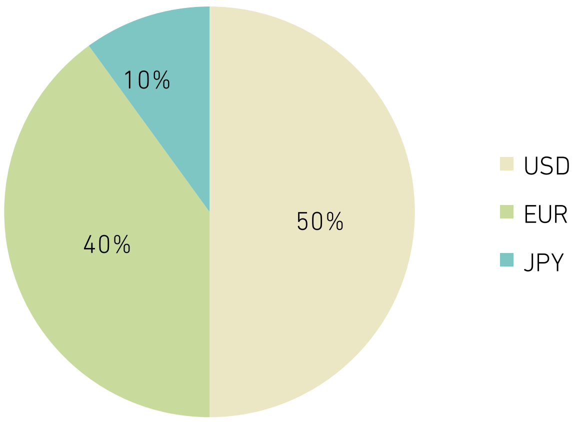


FIGURE 16
Strategic currency allocation[10]
(% of portfolio)

SOURCE:
Ministry of Finance

10 Under the funds' investment guidelines, they may hold assets denominated in another nine currencies providing these are hedged for exchange-rate risk against one of the strategic allocation currencies. The other eligible currencies are sterling, the Canadian, Australian, New Zealand and Singapore dollars, the Norwegian, Swedish and Danish krones and the Swiss franc.

Table 2: Benchmark indexes
(%)

Benchmark	USD	EUR	JPY	Total
Money market	**15.0**	**12.0**	**3.0**	**30.0**
Merrill Lynch Libid 6 Month Average	7.5	6.0	1.5	15.0
Merrill Lynch Treasury Bills Index	7.5	6.0	1.5	15.0
Sovereign bonds (nominal)	**31.5**	**28.0**	**7.0**	**66.5**
Barclays Capital Global Treasury: USA	31.5	—	—	31.5
Barclays Capital Global Treasury: Germany	—	28.0	—	28.0
Barclays Capital Global Treasury: Japan	—	—	7.0	7.0
Inflation-indexed sovereign bonds (real)	**3.5**			**3.5**
Barclays Capital U.S. Treasury: U.S. TIPS 1-10 years	**3.5**			
Total	**50.0**	**40.0**	**10.0**	**100.0**

SOURCE: Ministry of Finance

Box 2: New investment policy for the Pension Reserve Fund

Under the new investment policy, the PRF will be able to invest in a way more consistent with its objective of complementing financing of fiscal liabilities related to the pensions of the most vulnerable Chileans. This is because the new asset class are better aligned with the longer time horizon of these liabilities.

The investment objective defined for the PRF is to maximize its expected return for a certain level of risk. On the basis of these parameters, it was decided that the new investment policy would have a strategic asset allocation of 15% in equities, 20% in corporate bonds, 15% in inflation-indexed sovereign bonds, 45% in nominal sovereign bonds and 5% in money market instruments. The majority of these assets classes (except for money market instruments) will be invested in accordance with global market indexes.

The CBC will continue to manage most of the PRF. However, external managers will be used for its portfolios of equities and bonds and will be selected by the CBC with assistance from an international consultant and the participation of Finance Ministry staff.

It is expected that the PRF’s new investment policy will come into force in the second half of 2011.

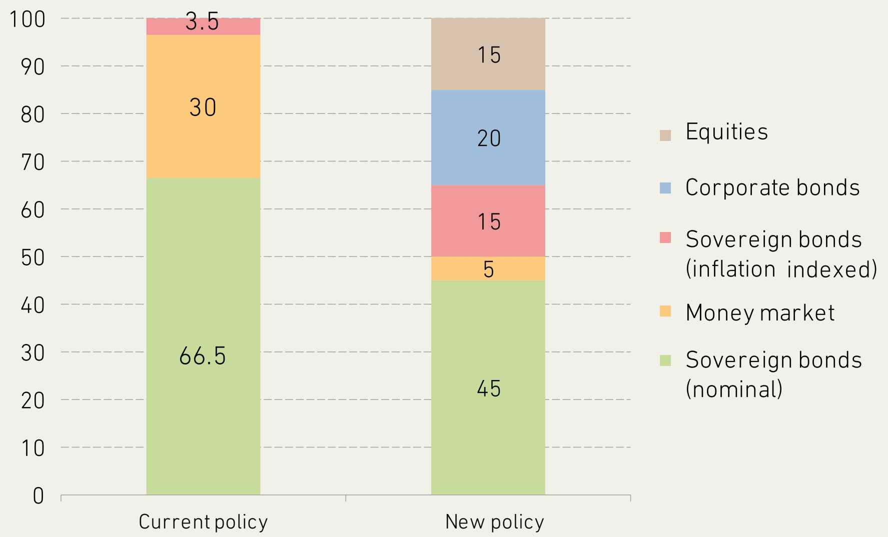


FIGURE B 2.1

Current investment policy vs. FC recommendation

(% of portafolio)

SOURCE:

Ministry of Finance

5.2 MARKET VALUE AND RETURNS[11]

Pension Reserve Fund (PRF)

As of December 31, 2010, the PRF had a market value of US$3,837 million, up by US$416 million on a year earlier. This increase was explained mainly by a contribution for US$337 million, equivalent to 0.2% of GDP in 2009 *(Table 3)* and net financial earnings of US$79 million *(Table 4).* Since the PRF's inception on December 28, 2006, it has received contributions for US$3,424 million while its investments have yielded net financial earnings of US$413 million *(Figure 17).*

In 2010, the PRF's return in dollars, net of management costs, reached 1.81% *(Table 5).* This reflected a gain in local currency of 2.92% which was partly offset by a 1.11% exchange-rate loss caused principally by the depreciation of the euro *(Figure 18).*[12] This factor, combined with low interest rates meant that the PRF's return in 2010 was lower than in previous years *(Figure 19).* Since March 31, 2007, the fund's net return in dollars was 5.43%. In 2010, the important appreciation of the peso against the dollar meant that it showed a net return in pesos of -5.71% while, since March 31, 2007, its net return in pesos was 1.74%. The PRF's IRR in dollars reached 2.19% in 2010 and an annual 4.42% since its inception.

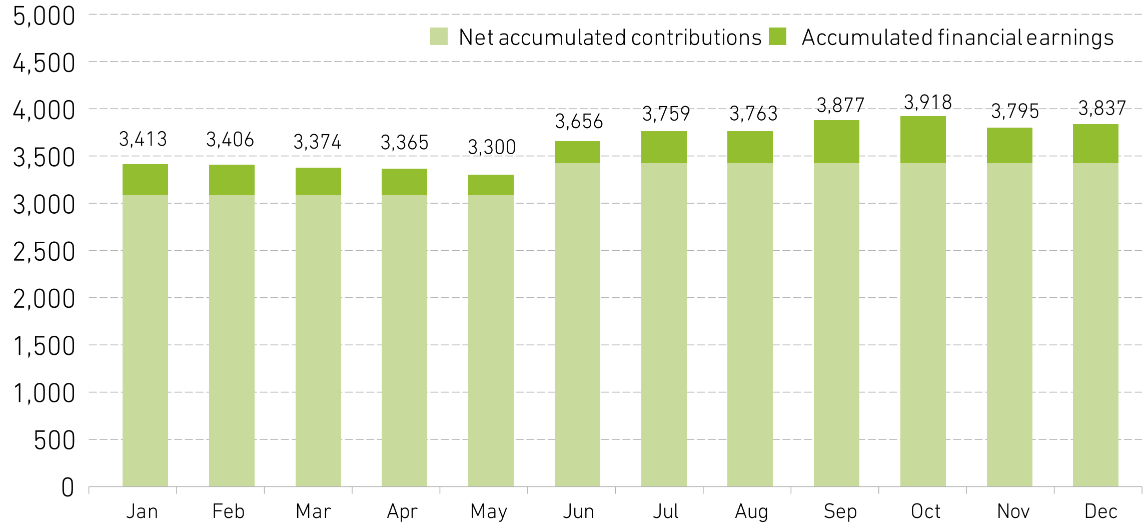
The PRF's performance can be illustrated using an index whose value varies according to daily returns on its portfolio *(Figure 20).* Despite the volatility shown by this index, it can be seen that its value again increased with respect to the close of previous years, reaching 121.98 points at the end of 2010.

The CBC's performance, measured as the difference between the PRF's return and its benchmark, was -18 bps in 2010 and -26 bps in annualized terms since March 31, 2007 *(Figure 21).*

11 This section examines the market value and returns of the PRF and the ESSF in 2010. 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 (TWR) unless use of the Internal Rate of Return (IRR) is specifically indicated. Returns for periods of more than one year are compound annualized rates while those for less than a year correspond to the change seen in the stated period..

12 Interest and exchange rates are the key factors in the funds' returns. The level and movements of interest rates largely determine the value of their financial instruments in local currency. However, given that they invest in dollars, euros and yens and that their return is measured in dollars, the exchange rate of the dollar against these other currencies also affects their results.

FIGURE 17
PRF: Contributions and net financial earnings, 2010
(US$ million)



SOURCE: Ministry of Finance

Table 3: PRF: Annual contributions
(US$ million)

Period	Amount	% of previous year's GDP
2006	604.5	0.5
2007	736.4	0.5
2008	909.1	0.5
2009	836.7	0.5
2010	337.3	0.2
Total	3.424.0	

SOURCE: Ministry of Finance

Table 4: PRF: Evolution and breakdown of market value
(US$ million)

Descomposición	2007	2008	2009	2010	Since inception (a)
Starting value	605	1,466	2,507	3,421	0
Contributions	736	909	837	337	3.424
Withdrawals	0	0	0	0	0
Interest income	46	71	72	70	259
Capital gains (losses)	80	60	6	9	155
Management, custody & other costs	0.0	-0.3	-0.3	-0.4	-1.1
Net financial earnings	125	131	77	79	413
Ending Value	1,466	2,507	3,421	3,837	3,837

(a) The PRF was created on December 28, 2006 with an initial contribution of US$604.5 million.

SOURCE: Ministry of Finance

Table 5: PRF: Net returns
(%)

Returns (a)	2010	Past 3 years (annualized)	Since inception (annualized) (b)
Local currency	2.92	3.67	4.11
Exchange-rate return	-1.11	0.19	1.32
Return in USD	**1.81**	**3.86**	**5.43**
Exchange rate CLP	-7.52	-1.88	-3.69
Return in CLP (c)	**-5.71**	**1.98**	**1.74**

(a) Time Weighted Return (return calculated as the growth rate of the funds that were invested throughout the period).
(b) Calculated as from March 31, 2007 when the CBC's performance began to be measured.
(c) The return in CLP corresponds to the sum of the percentage variation in the peso-dollar exchange rate.

SOURCE: Ministry of Finance

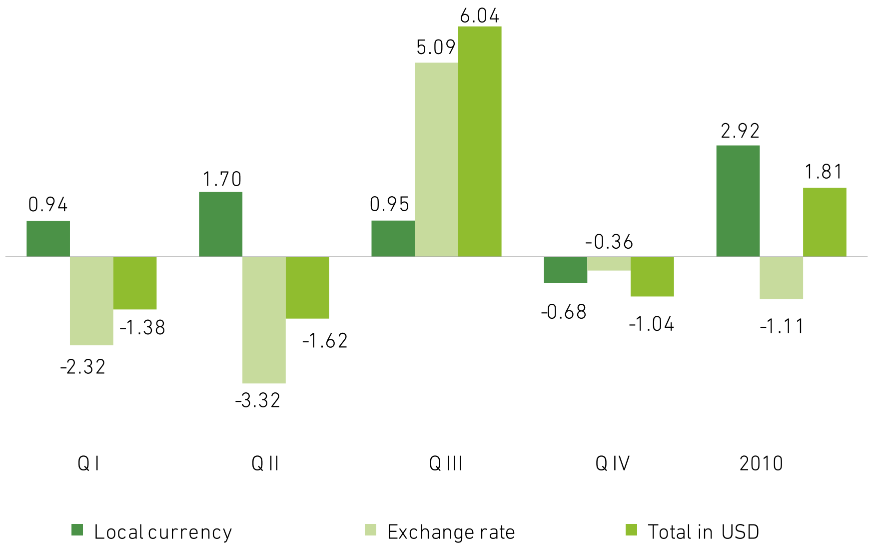


FIGURE 18

PRF: Net return in local currency and exchange-rate return (%)

SOURCE:
Ministry of Finance

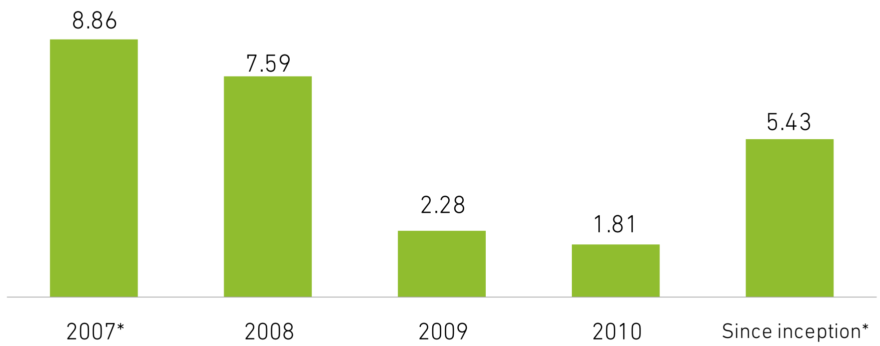


FIGURE 19

PRF: Annual TWR (%)

SOURCE:
Ministry of Finance

* Calculated as from March 31, 2007.

FIGURE 20

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

SOURCE:
Ministry of Finance

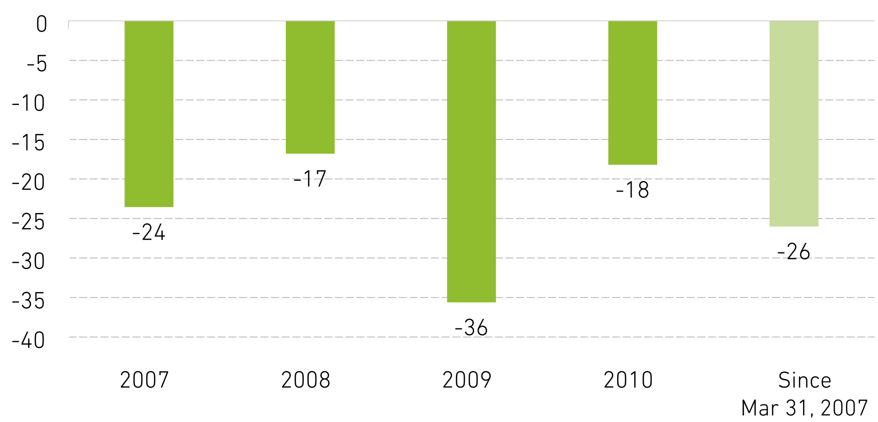


FIGURE 21

PRF: Excess Return
(Bps)

SOURCE:
Ministry of Finance

Box 3: Performance of investment-policy asset classes since inception of PRF and ESSF

The portfolios of the PRF and the ESSF comprise different asset classes whose combined performance determines the result of their investments. Given that the funds are invested passively, analysis of their benchmarks can be used to infer the origin of their returns *(Figure B 3.1).*

Since the funds' inception, US inflation-indexed bonds (TIPS) are the asset class to have shown the highest return, reaching an annual 6.1% in local currency and, in 2010, 5.2%. It is important to note that this asset class accounts for only a small percentage of the funds' portfolio (3.5%) and its impact on their overall returns is, therefore, limited.

These bonds were followed by nominal sovereign bonds with a return in local currency since the funds' inception of an annual 5.3%. This strong performance largely reflected the generalized drop in interest rates and the net flow of investments to more conservative assets seen during the economic and financial crisis of 2008. In 2010, nominal sovereign bonds returned 4.2%. This asset class represents over 65% of the funds' portfolios and is, therefore, a key factor in explaining their overall returns.

Money market instruments showed an annual return in local currency of 2.2% since the funds' inception and, in 2010, of just 0.5%. It should be noted that returns on these investments - Treasury bills and bank deposits - generally show little volatility and depend largely on short-term interest rates which have been historically low in recent years.

Finally, in the case of exchange rates, the appreciation of the euro and the yen since the funds' inception meant a positive return that reached an annual rate of approximately 1.3% but, in 2010, a loss of -1.1%, explained principally by the depreciation of the euro (6.5%).

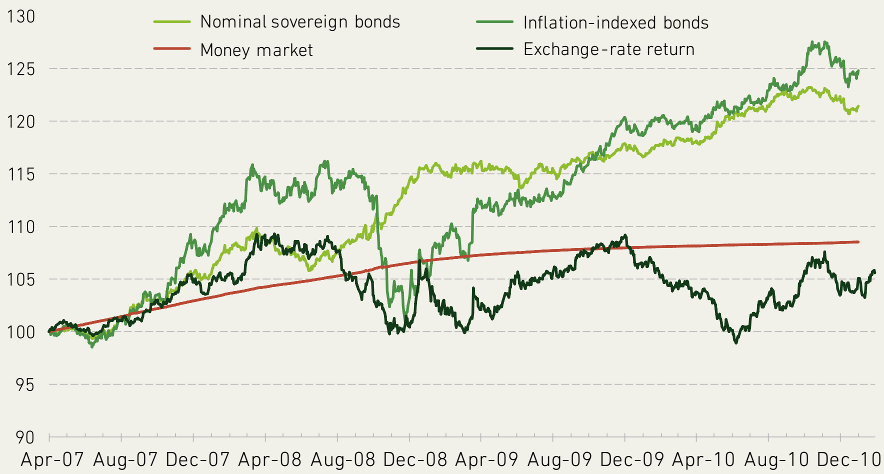


FIGURE B 3.1
Performance of asset classes in local currency and exchange-rate return (March 31, 2007 = 100)

SOURCE: Prepared by the Finance Ministry on the basis of indexes provided by Barclays Capital.

Economic and Social Stabilization Fund (ESSF)

As of end-2010, the market value of the ESSF reached US$12,720 million, up by US$1,435 million on a year earlier. This increase was explained by contributions for US$1,362 million made during the year *(Table 6)* and net financial earnings for US$223 million which were partly offset by withdrawals for US$150 million.[13] Since its inception on March 6, 2007, the ESSF has received contributions that total US$19,462 million *(Table 7)* while withdrawals have reached US$9,428 million - of which US$9,278 million corresponded to 2009[14] - and it has generated net financial earnings of US$2,685 million *(Figure 22).*

In 2010, the ESSF's return in dollars, net of management costs, reached 1.83% *(Table 8)* and comprised a return in local currency of 2.94% and a 1.11% exchange-rate loss. It should be noted that much of the volatility in quarterly returns is a result of variations in exchange rates *(Figure 23)*. As in the case of the PRF, the return on the ESSF in 2010 was lower than in previous years *(Figure 24)*.[15] Its net annual return in dollars since March 31, 2007 reached 5.51% while its net return in pesos in 2010 was -5.69% and, since March 31, 2007, reached an annualized 1.82%. Its IRR in dollars was 1.90% in 2010 and 5.26% since the fund's inception.

13 The withdrawal of US$150 million was used to finance part of a US$337 million contribution to the PRF.

14 Box 1 of the 2009 Annual Report on Sovereign Wealth Funds explains in detail the use of the withdrawals made during that year.

15 At the date of publishing this report, returns on the ESSF were very similar to those on the PRF given that they have had very similar investment policies since their inception.

The ESSF's performance can be illustrated using an index whose value varies according to daily returns on its portfolio. At the end of 2010, this index reached 122.32 points, comparing favorably with previous years *(Figure 25).*

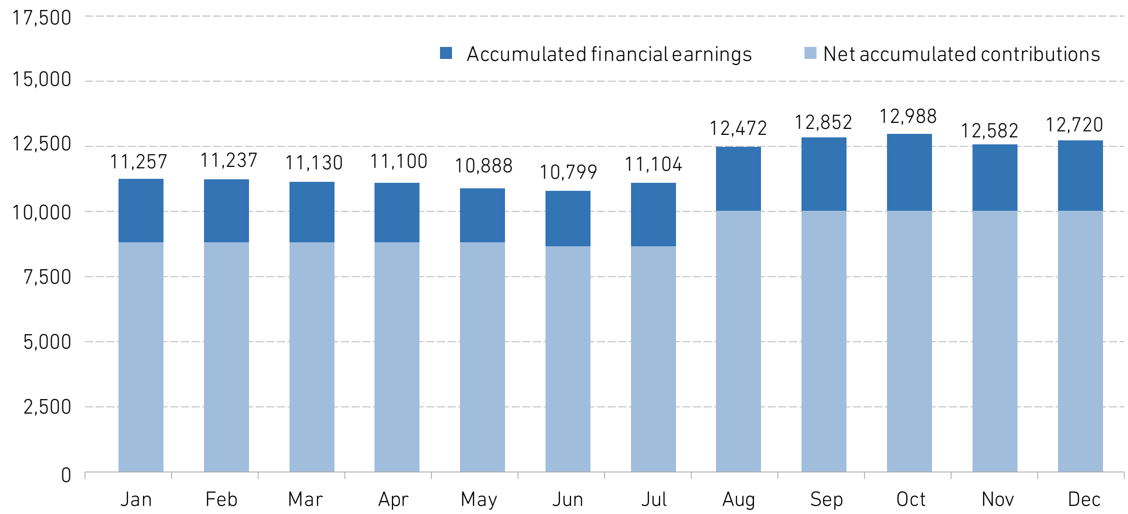
The CBC's performance, measured as the difference between the ESSF's return and its benchmark, was -16 bps in 2010 and -18 bps in annualized terms since March 31, 2007 *(Figure 26).*

Box 4: ESSF: Contributions and withdrawals in 2010

In 2010, contributions for US$1,362 million were made to the ESSF of which US$1,000 million corresponded to part of the proceeds of the international bonds placed by the government in August 2010. The remaining US$362 million corresponded to the balance of the Oil-Derivative Fuel Price Stabilization Fund which, on this fund's expiry, legally had to be transferred to the ESSF.

In 2010, US$150 million was withdrawn from the ESSF. Given the fiscal deficit in 2009, this was used, as established by DFL N° 1, to finance the minimum compulsory contribution to the PRF, equivalent to 0.2% of GDP in 2009.

FIGURE 22
ESSF: Contributions and net financial earnings, 2010
(US$ million)



SOURCE: Ministry of Finance

Table 6: ESSF: Contributions and withdrawals
(US$ million)

Period	Contributions		Withdrawals	
	Amount	% GDP	Amount	% GDP
2007	13,100	8.9	—	—
2008	5,000	3.1	—	—
2009	—	—	9,278	5.5
2010	1,362	0.8	150	0.1

SOURCE: Ministry of Finance

Table 7: ESSF: Evolution and breakdown of market value
(US$ million)

Decomposition	2007	2008	2009	2010	Since inception (a)
Starting value	0	14,033	20,211	11,285	0
Contributions	13,100	5,000	0	1,362	19,462
Withdrawals	0	0	-9,278	-150	-9,428
Interest income	326	624	404	228	1,582
Capital gains (losses)	607	556	-51	-4	1,109
Management, custody & other costs	-0,3	-2.0	-1.6	-1,1	-5
Net financial earnings	933	1,178	352	223	2,685
Ending Value	14,033	20,211	11,285	12,720	12,720

(a) The ESSF was created by merging into a single fund the fiscal assets saved under Decree Law N° 3.653 (1981) with those of the Copper Income Compensation Fund: The first payment into the new fund was made on March 6, 2007.

SOURCE: Ministry of Finance

Table 8: ESSF: Net returns
(%)

Returns (a)	2010	Past 3 years (annualized)	Since inception (annualized) (b)
Local currency	2.94	3.76	4.19
Exchange-rate return	-1.11	0.19	1.32
Return in USD	**1.83**	**3.95**	**5.51**
Exchange rate CLP	-7.52	-1.88	-3.69
Return in CLP (c)	**-5.69**	**2.07**	**1.82**

(a) Time Weighted Return (return calculated as the growth rate of the funds that were invested throughout the period).
(b) Calculated as from March 31, 2007 when the CBC's performance began to be measured.
(c) The return in CLP corresponds to the sum of the percentage variation in the peso-dollar exchange rate.

SOURCE: Ministry of Finance

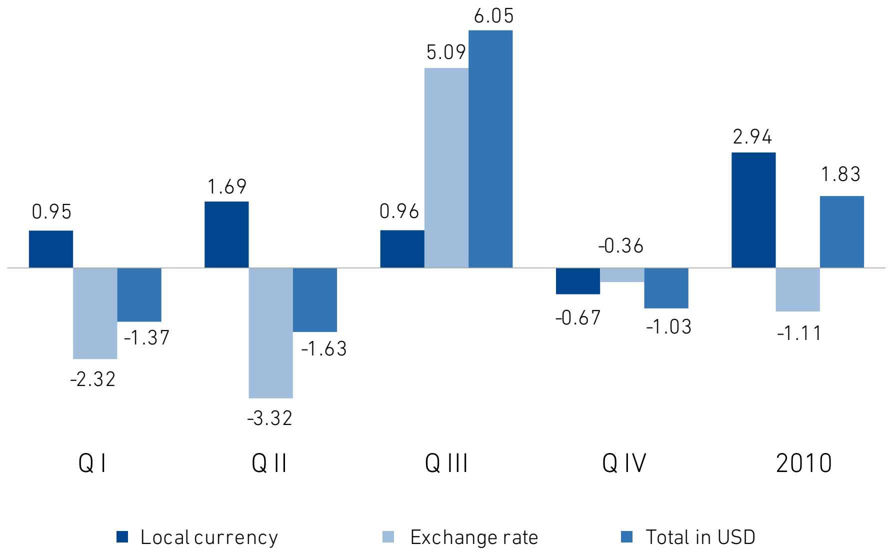
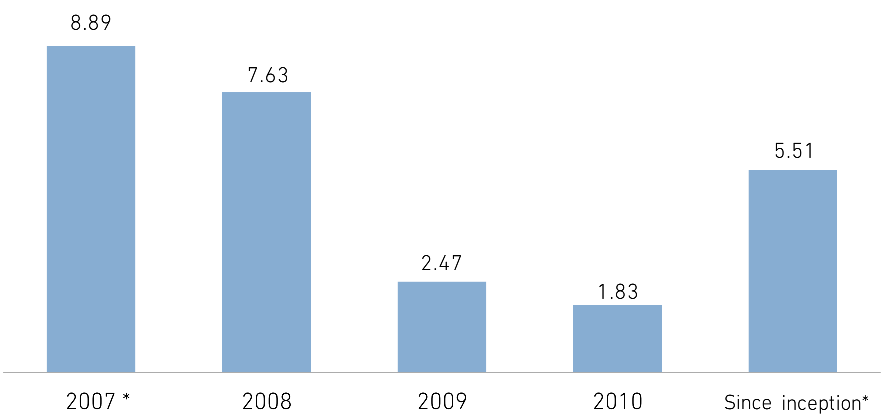


FIGURE 23
ESSF: Net return in local currency and exchange-rate return
(%)

SOURCE:
Ministry of Finance



* Calculated as from March 31, 2007.

FIGURE 24
ESSF: Annual TWR
(%)

SOURCE:
Ministry of Finance

FIGURE 25
ESSF: Index of returns
(March 31, 2007 = 100)

SOURCE:
Ministry of Finance

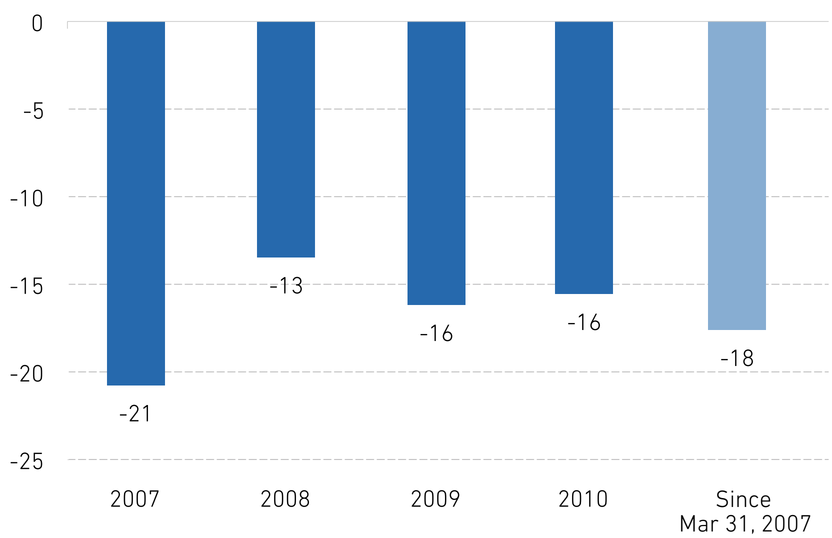


FIGURE 26
ESSF: Excess return
(Bps)

SOURCE:
Ministry of Finance

Box 5: Returns on other SWFs

The returns on Chile's SWFs since their inception compare favorably with those of other SWFs around the world (Figure B 5.1). This positive performance is explained mainly by their conservative investment policy which stood them in good stead during the recent international financial crisis. By comparison, other SWFs with more aggressive policies suffered considerable losses in 2008 although these were reversed - in part or totally - by the important recovery of international financial markets in 2009 and 2010.

SWFs have different investment policies depending on the purpose for which they were created. In general, funds with similar objectives also tend to have similar investment policies. Stabilization funds (Chile's ESSF and the SWFs of East Timor and Trinidad and Tobago) invest more conservatively and, typically, in fixed-income instruments whereas pension reserve funds (Australia, Ireland and New Zealand) and savings funds (Canada, Alaska and Norway)[1] have a greater tolerance of risk and their portfolios tend to include equities and alternative investments.

The more conservative SWFs suffered a lesser impact during the financial crisis but have benefitted less from the subsequent recovery. This suggests that more conservative strategies deliver better returns at times of crisis and more modest results during periods of recovery.

1 The objective of savings funds is to be able in future to replace income from non-renewable resources with earnings on the assets acquired with the resources accumulated in these funds.

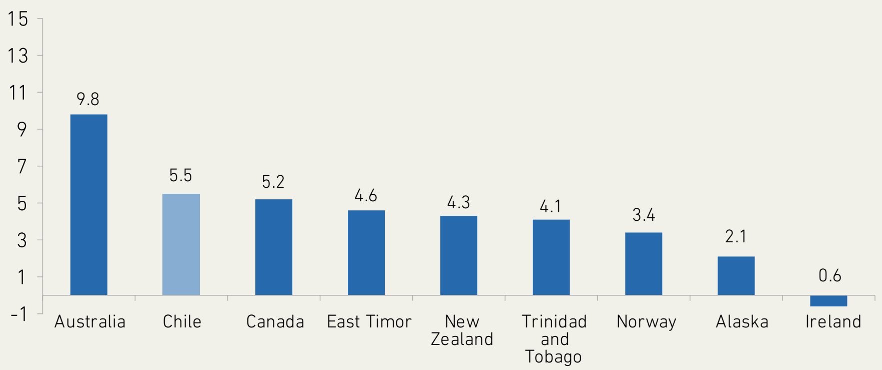


FIGURE B 5.1

Average returns on SWFs, 2007-2010 (*) (%)

SOURCE:

Estimated by Finance Ministry staff

(*) Annual returns measured since the inception of the PRF and ESSF (2007). For Trinidad and Tobago, the information used was the latest available (September 2010) and, for Australia, returns were estimated using the information available in 2008, 2009 and 2010. The returns used are those reported by the respective SWF and were converted into dollars using the exchange rate of the dollar to the currency in which the return was reported.

5.3 MANAGEMENT AND CUSTODY COSTS

The total cost of managing Chile's SWFs in 2010 amounted to US$1,534,858 of which US$406,387 corresponded to the PRF and US$1,128,471 to the ESSF. This expenditure was totally offset by income of US$1,690,090 from the funds' securities lending program.

In the case of the PRF, the total cost comprised US$252,787 for custody services and US$153,600 paid to the CBC for its management services, corresponding to 0.43 bps of the size of the fund's portfolio in 2010. Income from the PRF's securities lending program, at US$399,802, almost covered its management and custody costs *(Table 9).* In the case of the ESSF, the cost of custody services reached US$622,071 and US$506,400 was paid to the CBC for its management services, equivalent to 0.43 bps of the fund's size, while income from its securities lending program, at US$1,290,288, exceeded management and custody costs.

Table 9: PRF and ESSF: Management and custody costs and income from securities lending program (US$ thousand)

PRF		
Items	**2009**	**2010**
Custody (J.P. Morgan)	192.9	252.8
Management (CBC)	155.4	153.6
Other costs	—	—
Total costs	**348.3**	**406.4**
Securities lending program	**205.7**	**399.8**

ESSF		
Items	**2009**	**2010**
Custody (J.P. Morgan)	816.7	622,1
Management (CBC)	804.6	506.4
Other costs	—	—
Total costs	**1,621.3**	**1,128.5**
Securities lending program	**931.9**	**1,290.3**

SOURCE: Ministry of Finance

5.4 PORTFOLIO ALLOCATION AND CHARACTERISTICS

The allocation of the investment portfolios of the PRF and the ESSF showed little change in 2010 and the distribution of their investments by asset class, country and currency reflects the allocation of their benchmark which has not changed since the funds' inception.

As of December 2010, the PRF's allocation by asset class consisted of US$2,560 million in nominal sovereign bonds, US$1,142 million in money market instruments[16] and US$134 million in inflation-indexed sovereign bonds. In the case of the ESSF, its allocation consisted of US$8,501 million in nominal sovereign bonds, US$3,773 million in money market assets and US$445 million in inflation-indexed sovereign bonds. At the close of the year, both funds had an allocation by asset class and currency that was almost identical to that of their benchmark *(Figures 27 and 28).*

Their exposure by type of credit risk remained relatively stable in 2010. Close to 80% of their assets were invested in sovereign instruments and 20% in banks while, in some months, a small percentage corresponded to supranational instruments *(Figure 29).*

In the case of sovereign instruments, both funds invested principally in the United States, Germany and Japan. Investments in other countries were mainly the result of deviations from the benchmark and were within the ranges of deviation and limits permitted to the CBC under the investment guidelines drawn up by the Finance Ministry. At the end of 2010, the sovereign exposure of the PRF and the ESSF was US$3,025 million and US$10,112 million, respectively, representing 78.8% and 79.5% of their portfolios *(Table 10).*

Investments in banks during 2010 corresponded principally to time deposits with European banks. These were selected on the basis of their risk-return relation at the time of making the deposit *(Table 11).* At the end of 2010, the bank exposure of the PRF and the ESSF was US$812 million and US$2,608 million, respectively, representing 21.2% and 20.5% of their portfolios.

Supranational investments corresponded mainly to investments in multilateral organizations and represented only a small part of the funds' portfolios in some months of the year. At the close of 2010, neither fund held investments of this type.

The CBC actively monitored the exposure of the funds' assets to credit risk and preferred those institutions with a lower relative level of risk. In line with this, sovereign investments with a risk rating of less

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

than AAA represented only 8.8% of the PRF's portfolio and 8.0 % of the ESSF's portfolio at the end of 2010 *(Table 12).* Similarly, bank deposits in the lowest risk-rating range permitted - between A- and A+ - accounted for only 8.8% and 8.7% of the PRF and the ESSF, respectively *(Box 6).*

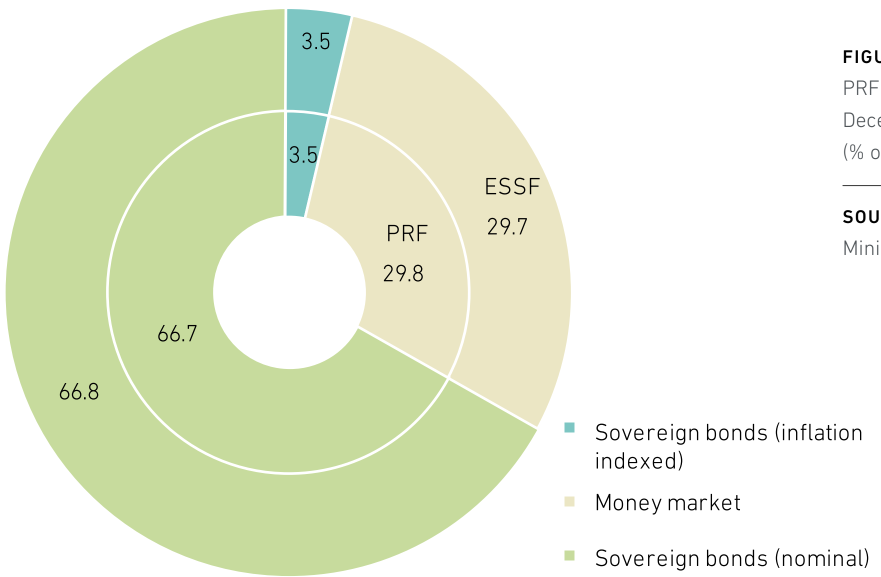


FIGURE 27
PRF and ESSF: Allocation by asset class, December 31, 2010
(% of portfolio)

SOURCE:
Ministry of Finance

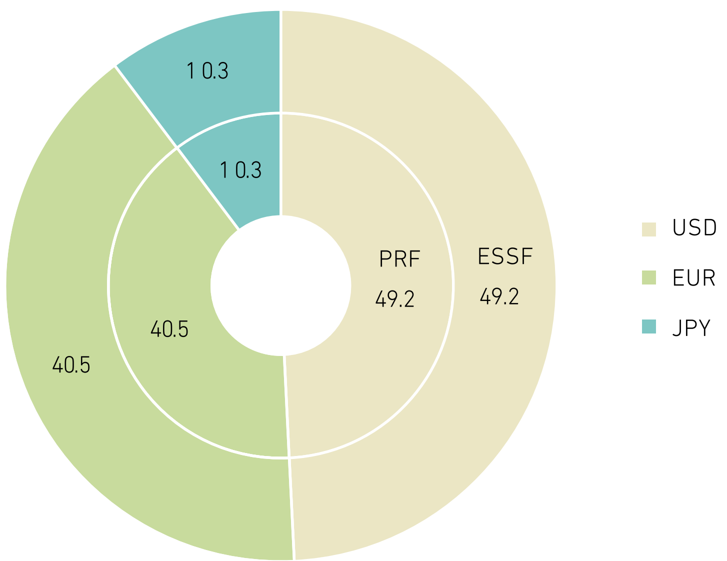


FIGURE 28
PRF and ESSF: Allocation by currency, December 31, 2010
(% of portfolio)

SOURCE:
Ministry of Finance

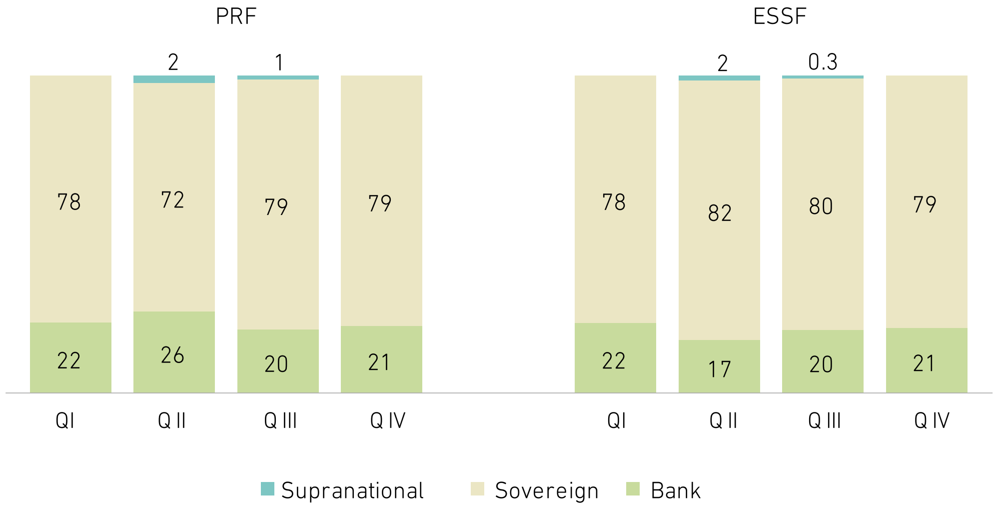


FIGURE 29

PRF and ESSF: Credit risk exposure, 2010
(% of portfolio)

SOURCE:
Ministry of Finance

Table 10: PRF and ESSF: Portfolio by type of credit risk, December 31, 2010 (US$ million and % of portfolio)

	Country	PRF		ESSF	
		US$ mill	% of Total	US$ mill	% of Total
Sovereign exposure	US	1,435.9	37.4	4,672.7	36.7
	Germany	1,176.7	30.7	3,807.8	29.9
	Japan	296.9	7.7	988.3	7.8
	France	57.2	1.5	329.3	2.6
	Belgium	26.9	0.7	26.9	0.2
	Spain	15.0	0.4	—	—
	Finland	15.0	0.4	162.9	1.3
	Austria	1.0	0.0	124.3	1.0
	Total	**3,024.6**	**78.8**	**10,112.2**	**79.5**
Bank exposure	United Kingdom	226.3	5.9	787.9	6.2
	Germany	224.7	5.9	704.0	5.5
	France	148.7	3.9	16.0	0.1
	Italy	89.7	2.3	393.3	3.1
	Austria	56.0	1.5	137.6	1.1
	Spain	28.4	0.7	205.9	1.6
	Switzerland	18.8	0.5	152.9	1.2
	Netherlands	18.7	0.5	187.1	1.5
	Sweden	—	—	22.5	0.2
	Others	0.8	0.0	0.6	0.0
	Total	**812.1**	**21.2**	**2,607.9**	**20.5**
	Total Fund	**3,836.7**	**100.0**	**12,720.1**	**100.0**

SOURCE: Ministry of Finance

Box 6: Investments in Spain, Ireland and Greece

The investment guidelines defined by the Finance Ministry for the PRF and the ESSF establish parameters that include the deviations permitted from their benchmarks, the minimum risk rating required and the upper limits on investments by risk rating and issuer.

As of the end of 2010, the CBC was allowed to make investments, within the permitted limits, that differed from the funds' benchmarks. Given that its mandate is for essentially passive management, the deviations incurred by the CBC were small and sought to obtain a return above that on the benchmark.

In this context, a small percentage of their portfolios was, at some points during the year, invested in banks in Spain, Ireland or Greece or in instruments issued by these countries *(Figure B 6.1).* These investment decisions were made on the basis of the corresponding risk-return relation and, at the time of making the investment, complied with the limits established by the Finance Ministry. It is important to note that, after a reduction in Greece's risk rating in December 2009 rendered it ineligible for the funds, the CBC, took the necessary measures, in coordination with the Finance Ministry, to reduce exposure and, by the end of the first quarter of 2010, they no longer held investments in this country.

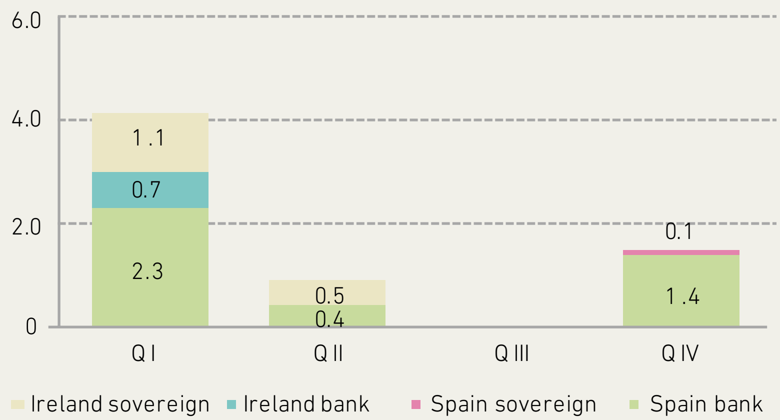


FIGURE B 6.1
Exposure to Spain and Ireland, 2010
(% of combined portfolio of PRF and ESSF)

SOURCE:
Ministry of Finance

Table 11: PRF and ESSF: Banks with deposits, December 31, 2010

Banks	Country	PRF	ESSF
Banco Bilbao Vizcaya Argenta	Spain	x	
Banco Santander	Spain	x	x
Bank of Scotland PLC	UK	x	x
Barclays Bank PLC	UK	x	x
Bayerische Landesbank	Germany	x	x
Bnp Paribas Sa	France	x	
Credit Industriel et Commercial	France		x
Erste Group Bank AG	Austria	x	x
ING Bank NV	Netherlands	x	x
Intesa Sanpaolo Spa	Italy	x	x
Landesbank Baden-Wuerttemberg	Germany	x	x
Lloyds TSB Bank PLC	UK	x	x
Norddeutsche Landesbank	Germany	x	x
Raiffeisen Zentralbank Oesterreich	Austria	x	
Royal Bank of Scotland (The)	UK	x	x
Svenska Handelsbanken	Sweden	x	
Unicredit Bank	Germany	x	x
Unicredit Spa	Italy	x	x
Zuercher Kantonalbank	Switzerland	x	x

SOURCE: Ministry of Finance

Table 12: PRF and ESSF: Credit exposure, December 31, 2010
(% of portfolio)

Issuer	Risk Rating						
	AAA	AA+	AA	AA-	A+	A	A-
PRF							
Sovereign	70.0	1.1	7.7	—	—	—	—
Bank	0.5	—	0.7	11.1	4.5	4.3	—
ESSF							
Sovereign	71.5	0.2	7.8	—	—	—	—
Bank	1.2	—	1.7	8.8	5.0	3.7	—

SOURCE: Ministry of Finance

6

DESCRIPTION OF FINANCIAL RISKS

The investments of the Pension Reserve Fund (PRF) and the Economic and Social Stabilization Fund (ESSF) in different financial instruments expose them to different types of risks which can be classified as market, credit, liquidity, active and operational risk. In order to limit their exposure, the investment guidelines provided by the Finance Ministry include restrictions that the Central Bank of Chile (CBC) must respect. Its compliance is monitored by an independent department within this institution, by the custodian institution and, ultimately, by the Finance Ministry. In addition, the CBC's institutional framework and infrastructure provide the controls required to mitigate operational risk.

6.1 MARKET RISK

Losses in the market value of financial instruments can arise as a result of changes in market conditions. In the specific case of international fixed-income investors, interest rates and exchange rates are the financial variables with the greatest impact on the prices of their assets.

Interest-rate risk

Changes in interest rates have a direct impact on the price of fixed-income instruments. An increase in interest rates means a drop in their price while a reduction in interest rates has the inverse effect. A portfolio's duration is the parameter that measures its sensitivity to a change in the structure of interest rates, with a longer duration implying a greater risk of a loss in the face of an increase in rates.

In the case of the PRF and the ESSF, a reference duration was defined on the basis of the indexes that comprise their benchmarks. At the end of 2010, this reached 2.47 years while their actual duration was 2.44 and 2.46 years, respectively *(Table 13).* The funds' investment guidelines stipulate that their actual duration must not exceed the benchmark by more than five months. The CBC complied with this restriction throughout 2010 and, as of December 31, the difference was no more than one month.

Exchange-rate risk

Since returns on the PRF and the ESSF are measured in dollars and both funds also 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 dollar/euro exchange rate, 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 measured in dollars due to their investments in euros (40%) and yens (10%).

6.2 CREDIT RISK

The issuer of a fixed-income instrument can default if prevented from meeting its obligations by a lack of liquidity or capital. As a result, the credit risk to which a fund is exposed increases with the probability of default by an institution or government whose securities it holds. Similarly, changes in market perception of an issuer's solvency lead to a drop in the market value of its instruments. Exposure to this risk is controlled by establishing minimum ratings requirements and limits on the amount and percentage of the total portfolio allocated to an asset class and/or issuer *(Tables 14 and 15).*

The risk arising from the execution of a transaction - or, in other words, the losses that may occur if the counterpart in the 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. Finally, the risk of holding the funds' securities at a custodian institution is addressed by registering them separately in the name of the Republic of Chile.

6.3 LIQUIDITY RISK

Liquidity risk arises from the losses that would occur from the premature sale of securities in order to cover cash-flow needs. This risk is exacerbated at times of economic uncertainty, investments can be exposed to important discounts as a result of a sharp drop in prices in response to lack of demand or market depth.

In the PRF and the ESSF, this risk is mitigated by maintaining a high percentage of liquid short-term assets. As of December 31, 2010, money market instruments accounted for 29.8% of the PRF and 29.7% of the ESSF. Liquid assets include Treasury bills, certificates of deposit and time deposits, all of which are less sensitive to changes in interest rates and the first two have a market in which they can be sold rapidly without heavy penalization while time deposits provide liquidity as they reach their expiry date.

6.4 ACTIVE RISK

A fund can be managed actively or passively, depending on the characteristics, objectives and orientation of its manager. Under a passive strategy, the manager invests in instruments that are very similar to those of its benchmark and, therefore, also similar in terms of risk and return. On the other hand, if the manager takes positions that are different to the benchmark - as regards, for example, duration or currency allocation - in a bid to achieve a higher return, this is considered an active strategy. This adds an additional element of risk that is referred to as active risk.

Active risk can be measured by the tracking error (TE)[17] 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 2010, the TE of the PRF and the ESSF was close to 19 bps which is consistent with passive management.

6.5 OPERATIONAL RISK

Operational risk refers to the losses that 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 has been mitigated by delegating their operation to the CBC and, specifically, its International Investments Division, thereby taking advantage of its 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.

6.6 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 2010, the annual volatility of the returns on the PRF and the ESSF was 6.1% and, measured as from March 31, 2007, reached 6.5% *(Table 16).* Exchange-rate fluctuations (6.5%) were a key cause of the funds' volatility in 2010.

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 -3.34% for the PRF and -3.31% for the ESSF (both in January 2009). 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 17).*

At the end of 2010, value-at-risk (VaR), an indicator used to quantify a fund's potential losses in a given period of time and with a given probability, was US$61 million for the PRF and US$203 million for the ESSF[18].

17 The TE corresponds to the standard deviation of the monthly deviations of returns from the benchmark over a period of three years and is expressed in annualized form.

18 Monthly VaR obtained from daily portfolio volatility with an 84% level of confidence.

Table 13: PRF and ESSF: Portfolio and benchmark duration, December 31, 2010 (years)

Fund	Portfolio	Benchmark
PRF	2.44	2.47
ESSF	2.46	2.47

SOURCE: Ministry of Finance

Table 14: PRF and ESSF: Minimum requirements and limits by issuer and credit risk

Credit Risk	Risk Rating (a) (b)							Minimum Requirements
	AAA	AA+	AA	AA-	A+	A	A-	
Sovereign	100%	90%			30%			A- over previous 24 months
Supranational	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

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

SOURCE: Ministry of Finance

Table 15: PRF and ESSF: Maximum allocation by type of credit risk
(%)

Issuer	Maximum permitted
Sovereign	100.0
Supranational	60.0
Bank	50.0
Agencies in US	30.0

SOURCE: Ministry of Finance

Table 16: PRF and ESSF: Annualized monthly volatility vs. benchmark
(%)

Volatility	2010	Since Inception
PRF	6.1	6.5
ESSF	6.1	6.5
Benchmark	6.0	6.5

SOURCE: Ministry of Finance

Table 17: PRF and ESSF: Historic maximum and minimum returns
(%)

Range	Monthly		Quarterly	
	PRF	ESSF	PRF	ESSF
Maximum	5.49	5.46	7.36	7.31
	(Dec-08)	(Dec-08)	(QI 08)	(QI 08)
Minimum	-3.34	-3.31	-2.51	-2.52
	(Jan-09)	(Jan-09)	(QIII 08)	(QIII 08)

SOURCE: Ministry of Finance

7 APPENDICES

Self-Assessment of Compliance with Santiago Principles

The Chilean government has decided to include a self-assessment of the compliance of the country's sovereign wealth funds with each of the Santiago Principles as part of the Finance Ministry's annual report on these funds. This initiative forms part of the government's systematic effort to improve the publicly available information about the funds and to demonstrate that they are managed in accordance with best international practices. This assessment is set out below for each individual Principle.

GAPP 1. Principle:

The legal framework for the SWF should be sound and support its effective operation and the achievement of its stated objective(s).

GAPP 1.1 Subprinciple:

The legal framework for the SWF should ensure the legal soundness of the SWF and its transactions.

GAPP 1.2 Subprinciple:

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.

Assessment:

The institutional framework for Chile's SWFs is established in a number of laws and decrees that define the rules for their operation. The most important piece of legislation is the Fiscal Responsibility Law (FRL) which sets out the norms and institutional framework for the saving and management of fiscal resources. The FRL created the Pension Reserve Fund (PRF) and permitted the creation of 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. The FRL also specifies that the Finance Ministry will define the SWFs' investment policies with the advice of a Financial Committee and may entrust their management to the Central Bank of Chile (CBC).

The uses to which the two funds may be put is defined in the FRL, DFL Nº 1 and the Pension Law. Withdrawals must be authorized by decree by the Finance Minister, are implemented by the CBC and the General Treasury and are subject to review by the Comptroller General's Office (CGR).

Supreme Decree N° 1.383, issued by the Finance Ministry in 2006, delegated the administration of the two funds to the CBC, as Fiscal Agent, and established the general framework for their management.

Supreme Decree N° 621, issued by the Finance Ministry in 2007, created the Financial Committee to advise the Finance Minister on all aspects related to funds' investment policy definition.

As a result, the legal framework for Chile's SWFs rests on sound foundations, favoring their effective operation and facilitating achievement of the objectives for which they were created. These laws and decrees were published in the Diario Oficial (Official Gazette) and are available on the SWFs' website at www.hacienda.cl/fondos-soberanos/legislacion.html.

GAPP 2. Principle:

The policy purpose of the SWF should be clearly defined and publicly disclosed.

Assessment:

The purpose of the PRF is established in the FRL and the Pension Law and, in the case of the ESSF, in the FRL and DFL Nº 1. All the corresponding legislation is posted at www.hacienda.cl/fondos-soberanos/legislacion.html. Their policy objectives are also clearly set out in the annual report prepared by the Finance Ministry which is available for public consultation at www.hacienda.cl/fondos-soberanos.html.

GAPP 3. Principle:

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.

Assessment:

The funds invest exclusively in overseas assets and their domestic macroeconomic implications are, therefore, minimal. Only the ESSF has direct domestic macroeconomic implications arising from its objective of financing the fiscal deficits that may occur during periods of low growth and/or low copper prices. The Finance Ministry makes the decision to withdraw resources from the fund and their timing since they could affect the peso-dollar exchange rate. In a bid to minimize this impact, withdrawals from the ESSF and their conversion into pesos have, in the past, been made using a system of auctions with a pre-set calendar.

GAPP 4. Principle:

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.

GAPP 4.1 Subprinciple:

The source of SWF funding should be publicly disclosed.

GAPP 4.2 Subprinciple:

The general approach to withdrawals from the SWF and spending on behalf of the government should be publicly disclosed.

Assessment:

The rules for contributions to the SWFs are clearly established in the FRL while the uses to which they can be put are established in the FRL, DFL Nº 1 and the Pension Law as part of their legal framework. As indicated above, this legislation is posted on the funds' website. Contributions and withdrawals as well as the expenses involved in the funds' operation are publicly disclosed in a clear manner, with contributions and withdrawals set out in the funds' monthly, quarterly and annual reports and expenses in their quarterly and annual reports.

GAPP 5. Principle:

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.

Assessment:

The CBC prepares daily, monthly, quarterly and annual reports on the state of the funds and the performance of their investments. These reports are supplied to staff of the Finance Ministry and to the General Treasury.

Based on the information supplied by the CBC and the custodian bank, the Finance Ministry publishes monthly reports that include information about the return on the funds' investments, their size, contributions, withdrawals and their portfolio composition. Quarterly reports prepared by the Finance Ministry complement the information that is publicly available. In addition, the Ministry publishes an annual report on the SWFs while the Financial Committee prepares its own annual report about its activities and recommendations which is presented to the Finance Minister, the Finance Commissions of both houses of Congress and the Joint Budget Commission of Congress. All these reports are available on the funds' website in both Spanish and English.

GAPP 6. Principle:

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.

Assessment:

The clear division of roles and responsibilities established by the funds' legal framework facilitates accountability and operational independence in their management. The FRL 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.

In defining their investment policies, the Finance Minister is supported by a Financial Committee which provides advice on all the aspects related to this decision. The Finance Ministry draws up investment guidelines defining the eligible instruments and issuers as well as other matters such as investment limits and the use of derivatives.

The CBC was appointed by the Finance Minister as the Fiscal Agent responsible for the funds' operational management. The CBC accepted this role and invests the funds' resources with complete independence in accordance with the instructions and restrictions established by the Finance Ministry in their investment guidelines.

The custodian bank, hired by the CBC on behalf of the government, is responsible for custody of securities and also provides a number of middle-office services such as monitoring compliance with investment limits, calculating the manager's performance and preparing financial and accounting reports on the funds.

Finance Ministry staff monitor the CBC's compliance with the funds' investment guidelines, using information provided by the custodian bank, and prepare monthly, quarterly and annual reports on the basis of information provided by the custodian bank and the CBC. In addition, Finance Ministry's staff acts as the Financial Committee's Secretariat and provides support in all tasks related to the funds' investment policies.

The General Treasury is responsible for the funds' accounting, for preparing their audited financial statements and for their incorporation into Chile's national accounts. The Finance Ministry's Budget Office is responsible for aspects of the SWFs related to the budget.

GAPP 7. Principle:

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.

Assessment:

The FRL establishes the funds' policy objectives and also defined the Finance Ministry as the body principally responsible for their governance and the Finance Minister as responsible for decisions about their management and investment policies. The FRL also named the General Treasury as the bearer of the resources. The Finance Minister is appointed by the President of the Republic while the members of the Financial Committee are appointed by the Finance Minister according to criteria established in Supreme Decree N° 621 issued in 2007 by the Finance Ministry.

In the case of oversight, Finance Ministry staff monitor compliance with the funds' investment guidelines, reviewing the reports on compliance with investment limits prepared by the custodian bank and also carrying out independent reviews of compliance with these limits.

The Comptroller General's Office, an autonomous body, is responsible for auditing public-sector finances and, therefore, the SWFs.

GAPP 8. Principle:

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.

Assessment:

The institutional framework for the SWFs is defined in the legislation discussed above. Under the FRL, the Finance Ministry is the body primarily responsible for their governance and the Finance Minister is responsible for decisions about their management and investment policies. To assist the Finance Minister in this task, the FRL also created the Financial Committee which advises him on the analysis and design of the funds' investment policies. Although the Finance Minister is not obliged to follow the Committee's independent recommendations, these are public and the government is publicly responsible for the Finance Minister's decisions. In addition, the Finance Minister has set up a unit within the Ministry for all activities relating to investment of the funds' assets and to provide support to the Financial Committee. All the staff of this unit have at least a master's degree and/or some specialized qualification in the area of investments such as that awarded by the CFA Institute.

GAPP 9. Principle:

The operational management of the SWF should implement the SWF's strategies in an independent manner and in accordance with clearly defined responsibilities.

Assessment:

The Finance Minister has defined the funds' investment policy and delegated their operational management to the CBC which invests their assets in accordance with the investment guidelines drawn up by the Finance Ministry. These guidelines are reviewed and accepted by the CBC which is an autonomous public body not related to the government. It has total independence to buy and sell instruments and make other operational decisions within the parameters established by the Finance Ministry in the funds' investment guidelines. The CBC provides the Finance Ministry with daily, monthly, quarterly and annual reports about its fulfillment of its role, including details of the funds' investments.

GAPP 10. Principle:

The accountability framework for the SWF's operations should be clearly defined in the relevant legislation, charter, other constitutive documents, or management agreement.

Assessment:

The accountability framework for the funds' operations is established in the laws and decrees discussed under Principle 1. They were published in the Diario Oficial (Official Gazette) and are available on the funds' website at www.hacienda.cl/fondos-soberanos/legislacion.html and from the Library of Congress (www.bcn.cl).

In order to ensure a proper and effective accountability framework, a range of reports are prepared by the different bodies involved in the funds' management.

Article 12 of the FRL and Article 7 of DFL Nº 1, which regulate the PRF and the ESSF, respectively, establish that monthly and quarterly reports about the funds must be presented to the Finance Commissions of both houses of Congress and to the Joint Budget Commission of Congress. In addition, and although not so required by law, the Finance Ministry publishes an annual report about the funds. All these reports are publicly available on the website indicated above.

Under Supreme Decree N° 1.383, the CBC is accountable to the Finance Minister for the funds' operational management and provides the Finance Ministry with daily, monthly, quarterly and annual reports. The Finance Minister is responsible for the funds' investment policies and decides how they should be managed.

The Financial Committee is an advisory body and is accountable for its obligations as established in Supreme Decree N° 624. Under Article 7 of this Decree, it must present an annual report on its work to the Finance Minister and send a copy of this report to the Finance Commissions of both houses of Congress and to the Joint Budget Commission of Congress. This report is also available on the funds' website.

In addition, the Comptroller General's Office, an autonomous body, is responsible for auditing public-sector finances and, therefore, the SWFs.

GAPP 11. Principle:

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.

Assessment:

The Finance Ministry prepares an annual report on the funds using the information supplied by the CBC and the custodian bank. This report includes financial information and is publicly available. However, it does not as yet include financial statements which are not required by law.

The CBC prepares financial statements for the funds using International Financial Reporting Standards (IFRS) and these are audited by external and independent auditing firms. However, these statements have not been published.

The General Treasury is in the process of preparing financial statements using IFRS, which will be independently audited and may be published in 2011.

GAPP 12. Principle:

The SWF's operations and financial statements should be audited annually in accordance with recognized international or national auditing standards in a consistent manner.

Assessment:

The funds' operations are audited by internal CBC auditors. The financial statements prepared by the CBC are audited by an external auditor in accordance with Chilean auditing norms.

The General Treasury is in the process of preparing financial statements using IFRS, which will be independently audited and may be published in 2011.

GAPP 13. Principle:

Professional and ethical standards should be clearly defined and made known to the members of the SWF's governing body(ies), management, and staff.

Assessment:

The authorities and staff involved in work relating to Chile's SWFs are subject to legally-established professional and ethical norms, such as the principle of probity, which call for impeccable professional conduct and efficient and loyal exercise of their functions in accordance with the common good.

In addition, the CBC has defined professional and ethical standards that are made known to its employees and are available on its website (www.bcentral.cl/transparencia/pdf/Manual_probidad/Manualdeprobidad.pdf). Members of the Financial Committee are subject to the ethical norms established in the Decree which created the Committee as well as to other internally-defined norms. Finance Ministry staff and advisors involved in the funds' management have internally adopted a code of ethics along the same lines of communicating and complying in the best possible way with the legally-applicable professional and ethical norms. They may, in addition, be subject to other codes of professional ethics (such as that of the CFA Institute).

GAPP 14. Principle:

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.

Assessment:

All transactions with third parties are based on economic and financial grounds. The Finance Ministry has rules and procedures that define the steps to be followed in acquiring or hiring services from third parties and the CBC also has a series of clearly defined rules and procedures for these situations.

GAPP 15. Principle:

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.

Assessment:

The procedures established by the CBC ensure that the funds' operations and activities are implemented in accordance with the applicable regulatory and disclosure requirements of host countries.

GAPP 16. Principle:

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.

Assessment:

The funds' institutional framework and objectives are defined by the legal framework discussed under Principle 1 above. Operational management is carried out by the CBC, a body independent of the government. The operational framework for management by the CBC is defined in Supreme Decree N° 1.383 which was published in the Diario Oficial (Official Gazette). All relevant legislation is published in the Official Gazette and is also available on the funds' website (www.hacienda.cl/fondos-soberanos/legislacion.html) and from the Library of Congress (www.bcn.cl).

GAPP 17. Principle:

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.

Assessment:

The size of the funds, their absolute returns and the countries where their assets are invested are reported monthly while a report on the CBC's performance is published quarterly. The funds' annual report contains additional financial information. All these reports are available on the funds' website.

GAPP 18. Principle:

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.

GAPP 18.1 Subprinciple:

The investment policy should guide the SWF's financial risk exposures and the possible use of leverage.

GAPP 18.2 Subprinciple:

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.

GAPP 18.3 Subprinciple:

A description of the investment policy of the SWF should be publicly disclosed.

Assessment:

In our view, the investment policy in force for the ESSF is consistent with its objectives and risk tolerance. In the case of the PRF, a new investment policy whose introduction was postponed at the end of 2008 in the light of the international financial crisis but is expected to come into force during the second half of 2011, will better reflect its objectives and nature.

The financial risks to which each fund is exposed are determined by its investment policy. Given their essentially passive management, these risks depend principally on their strategic portfolios and benchmarks. The use of leverage is not currently permitted while the use of derivatives is permitted only for hedging purposes. At present, the funds' operational management is exclusively in the hands of the CBC.

The information published about Chile's SWFs and, particularly, their strategic portfolios and benchmarks contains the principal elements of their investment policies. Their main investment limits are also disclosed in the annual report prepared by the Finance Ministry.

GAPP 19. Principle:

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.

GAPP 19.1 Subprinciple:

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.

GAPP 19.2 Subprinciple:

The management of an SWF's assets should be consistent with what is generally accepted as sound asset management principles.

Assessment:

The funds' operational management has been delegated to the CBC which implements investment decisions autonomously based only on economic and financial grounds. It applies the same operational standards as for the international reserves and the CBC has been audited and reviewed by international consultants. The funds' investment policies and guidelines are, moreover, established by the Finance Ministry, taking into account the opinion of the Financial Committee.

GAPP 20. Principle:

Principle: The SWF should not seek or take advantage of privileged information or inappropriate influence by the broader government in competing with private entities.

Assessment:

Investment decisions are implemented independently by the CBC which applies standards and operating procedures that meet high probity standards. In addition, when making recommendations, the members of the Financial Committee must do so using only public information.

GAPP 21. Principle:

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.

Assessment:

This does not apply to Chile's SWFs since they do not hold equities.

GAPP 22. Principle:

El FSI debe contar con un marco que identifique, evalúe y gestione los riesgos de sus operaciones.

GAPP 22.1 Subprinciple:

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.

GAPP 22.2 Subprinciple:

The general approach to the SWF's risk management framework should be publicly disclosed.

Assessment:

Although there is no single document that explicitly sets out the framework for the funds' risk management, the different bodies that comprise their organizational structure have procedures and controls in place that, together, constitute a proper framework for managing the risks to which they are exposed.

The investment guidelines defined by the Finance Ministry determine the funds' maximum permitted exposure to the main risks arising from investment of their assets. In addition, the CBC, as the body responsible for deciding and implementing financial transactions, monitors the funds' compliance with the limits established by these guidelines. Moreover, it applies the same operating framework as for investment of the international reserves which includes a series of procedures and controls that mitigate not only operational but also reputational and market risk. The custodian bank also reports to Finance Ministry staff on the CBC's compliance with investment limits and the level of portfolio risk while specialized Ministry staff oversee the CBC's compliance with the funds' investment guidelines and monitor the information supplied by the custodian bank. The daily, monthly, quarterly and annual reports presented by the custodian bank and the CBC contain relevant information for the funds' correct management and the principal risks to which they are exposed are publicly disclosed in the annual report prepared by the Finance Ministry.

GAPP 23. Principle:

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.

Assessment:

The methodology used to calculate the funds' return and performance is publicly disclosed in their quarterly reports. It is based on Global Investment Performance Standards (GIPS®).

GAPP 24. Principle:

A process of regular review of the implementation of the GAPP should be engaged in by or on behalf of the SWF.

Assessment:

This is the first self-assessment of compliance with the Santiago Principles and it will be updated every two years.

Index of Tables, Figures, Boxes and Diagrams

Glossary

Agency: a government financial agency or company 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 reactions and tend to be subject to the same regulation.

Basis point: it is equivalent to 0.01%.

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 a specific date(s).

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 pay-as-you-go 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 bond: a bond issued by a private company.

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

European Financial Stability Facility: a facility created under an agreement reached by 16 euro zone countries in order to provide assistance to those euro zone countries in financial difficulties. The Facility will be financed through the issue of debt guaranteed by the euro zone countries and worth € 440,000 million, it complements the resources contributed by the European Commission (€ 60,000 million) and the International Monetary Fund (€ 250,000 million) that together comprise the bail out announced in May 2010.

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 Nº 621 in 2007 to support and advise the Finance Minister in analyzing and designing Chile's sovereign wealth funds' investment policy.

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 the structural balance policy.

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 frameworks 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.

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.

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 asset 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.

Quantitative Easing 2: a bond acquisition program implemented by the US Federal Reserve in the last quarter of 2010 in order to stimulate the country's economy.

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, Chile 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 assets.

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

Supranational: see Multilateral

Time-weighted rate of return (TWR): 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.

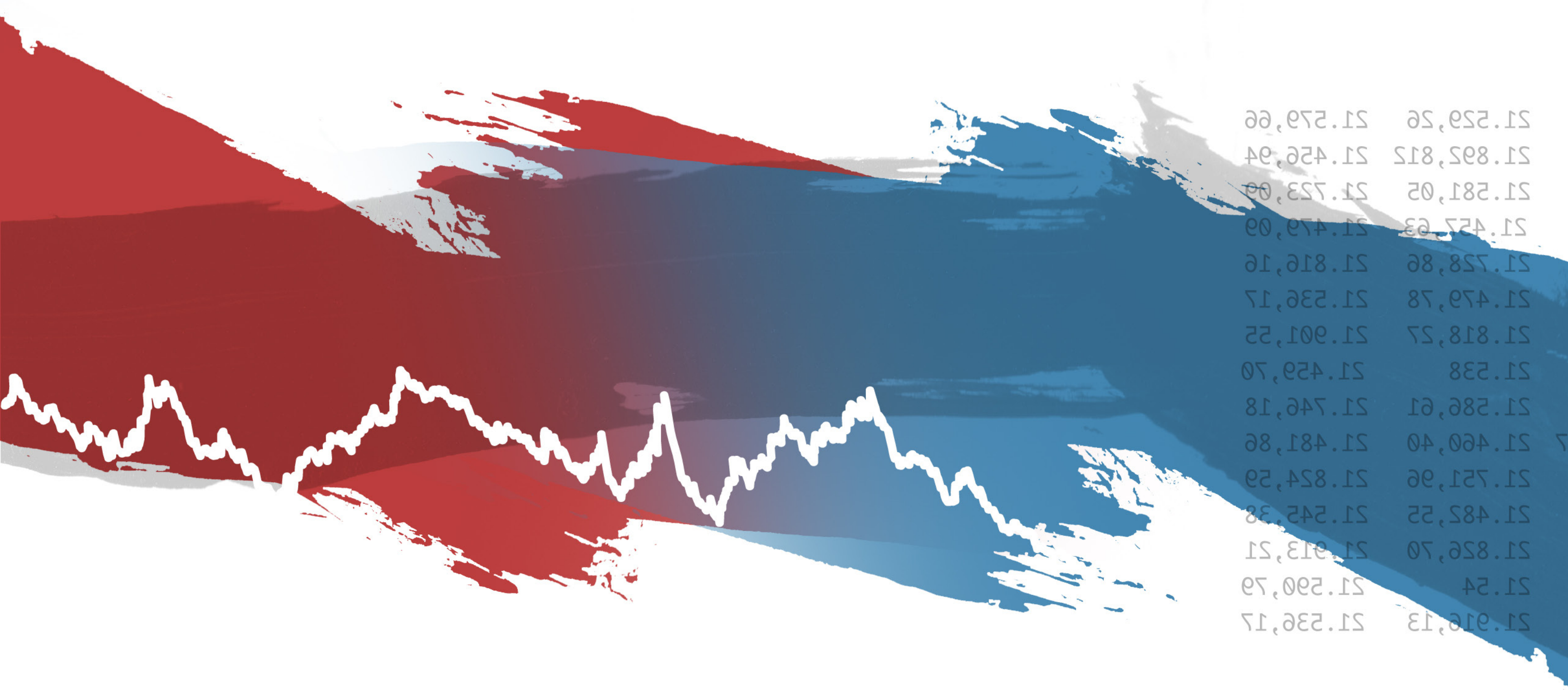
Treasury bill: a financial liability entered into by the US government with a maturity of less than a year which is sold at a discount on its face value.

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

Abbreviations

Bps	Basis points
BEA	Bureau of Economic Affairs
BJ	Bank of Japan
CBC	Central Bank of Chile
COJ	Cabinet Office of Japan
ECB	European Central Bank
ESSF	Economic and Social Stabilization Fund
EUR	Euro
FC	Financial Committee
Fed	US Federal Reserve
GDP	Gross domestic product
IMF	International Monetary Fund
IRR	Internal rate of return
IWG-SWF	International Working Group of Sovereign Wealth Funds
JPM	JPMorgan
JPY	Japanese yen
LIBID	London Interbank Bid Rate
LIBOR	London Interbank Offered Rate
PRF	Pension Reserve Fund
SWF	Sovereign wealth fund
TE	Tracking error
TWR	Time-weighted rate of return
UF	*Unidad de Fomento* (an inflation-indexed currency unit)
UK	United Kingdom
US	United States
USD	US dollar
US$	US dollar
VaR	Value at risk



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