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**Annual Report
Financial Committee**

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

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This publication corresponds to the
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Contents

Preface	6
Executive Summary	7
Members of the Financial Committee	8
Chapter 1 Fiscal Policy and the Funds' Objectives, Institutional Framework, and Investment Policy	10
A. Fiscal policy	11
B. Objectives and rules on the use of the funds	11
C. Institutional framework	13
D. Investment policy	16
Chapter 2 State of the Sovereign Wealth Funds	23
A. Analysis of the international economy	24
B. Market value	34
C. Returns	35
Chapter 3 Activities and Recommendations of the Financial Committee	38
A. PRF forecasts	39
B. Changes to the ESSF and PRF investment policies	40
C. Selection process for external equity and corporate bond portfolio managers	41
D. ESSF investment policy study	42
E. Monitoring of ESSF and PRF external fund managers	43
F. Definition of the Strategic Contingency Fund investment policy	43
G. Impact of a PRF currency hedging program on the fiscal balance sheet	44
Appendix 1: Current and former Financial Committee's members	46
Appendix 2: Summary of Meetings in 2020	47
References	50
Glossary	51

Preface

As stipulated in the Fiscal Responsibility Law of 2006, the Financial Committee was created in 2007 to advise the Finance Minister on the investment of Chile's two Sovereign Wealth Funds: The Economic and Social Stabilization Fund (ESSF) and the Pension Reserve Fund (PRF). The Financial Committee is an independent external advisory board, whose members have a vast experience in economic and financial areas. The Committee meets periodically to analyze matters relating to the investment of the funds. This Report—the fourteenth prepared by the Committee—describes its work and activities in 2020.

The publication of this Report fulfills the requirement established under Decree N° 621, issued by the Ministry of Finance in 2007, which stipulates that the Committee must present an annual report on its work to the Finance Minister and submit a copy of this report to the Finance Commissions of the Senate and the House of Representatives and to the Joint Budget Commission.

The Committee

Executive summary

At the close of 2020, the market value of the funds was US\$ 19,112 million, of which US\$ 8,955 million was in the Economic and Social Stabilization Fund (ESSF) and US\$ 10,157 million was in the Pension Reserve Fund (PRF). The net return in dollars in the year was 8.03% for the ESSF and 9.26% for the PRF,¹ while the net return in pesos was 3.19% and 4.36%, respectively. In the case of the ESSF, the strategic asset allocation was 15.5% in bank deposits, 76% in sovereign bills and bonds, 3.5% in inflation-indexed sovereign bonds, and 5% in equities. As of 1 October 2020, the PRF is divided into a Short-Term Investment Portfolio and a Long-Term Investment Portfolio. At year-end, the strategic asset allocation of the former was 7% in U.S. sovereign bonds and 93% in U.S. treasury bills, while the latter's was 34% in sovereign and government-related bonds, 8% in inflation-indexed sovereign bonds, 6% in U.S. agency MBS, 13% in corporate bonds, 8% in high yield bonds and 31% in equities.

¹ Returns reported in this document correspond to the Time Weighted Rate of Return (TWR), unless otherwise stated. Returns for periods greater than one year are annualized. For periods of less than one year, the return corresponds to the change during the period. Net returns reported are net of management fees.

Members of the Financial Committee



President José De Gregorio Rebeco

Mr. De Gregorio holds a Ph.D. in Economics from the Massachusetts Institute of Technology, a Master's degree in Industrial Engineering and a degree in Civil Industrial Engineering, both from Universidad de Chile. Currently, he is Professor at the Faculty of Economics and Business of Universidad de Chile, and Nonresident Senior Fellow at the Peterson Institute of International Economics. He has been President, Vice-President and Counselor of the Central Bank of Chile, Minister of Economics, Mining and Energy for the Chilean Government, and Economist at the International Monetary Fund. He joined the Committee in September 2014.



Vice President Cristián Eyzaguirre Johnston

Mr. Eyzaguirre holds a MA in Economics from University of California, Berkeley, and a degree in Business Administration from Universidad de Chile. He was CEO at Banco Bice and CFO at CMPC Enterprises. He has been Deputy Director of Chile's Tax Service (SII for its acronym in Spanish), advisor at Federation of Chilean Industry (SOFOPA for its acronym in Spanish) and Professor at Universidad de Chile. He currently participates in the Board of Directors of several companies, and is a Member of the Investment Committee of Hogar de Cristo. He joined the Committee in March 2010.



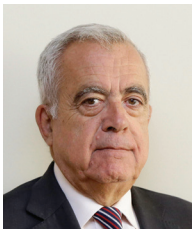
Member Ricardo Budinich Diez

Mr. Budinich holds a degree in Industrial Civil Engineering and a Bachelor's degree in Engineering Science, both from Universidad de Chile and holds a diploma in corporate governance from Universidad Católica de Chile. Currently, he serves on the Board of Directors of several companies and is member of Vigilance Committees of foreign private equity, global debt, small-mid cap equities and real estate funds. He was Chief Financial Officer of Copec, Director of Sonacol and many subsidiaries from the same company, Chief Financial Officer of Casaideas and advisor to its Board of Directors, member of the Consultative Counsel of Fundación Copec-UC, member of the Investment Committee of Compañía de Seguros Cruz del Sur and assistant professor of Universidad de Chile. He also performed several executive positions in companies from the financial sector. He joined the Committee in September 2016.



Member Jaime Casassus Vargas

Mr. Casassus holds a Ph.D. in Finance from Carnegie Mellon University and a degree in Civil Industrial Engineering from Universidad Católica de Chile. Currently, he is Professor and Postgraduate Director at the Institute of Economics of Universidad Católica de Chile, Managing Editor at the journal "Quantitative Finance", Deputy Director at FinanceUC, and Director of the Economics Society of Chile. He was Visiting Professor at University of California, Berkeley. His research has been published in Journal of Finance, Review of Financial Studies, and Journal of Banking & Finance. He joined the Committee in September 2014.



Member Martín Costabal Llona

Mr. Costabal holds an MBA from the University of Chicago and a degree in Business Administration from Universidad Católica de Chile. He has performed as Finance Minister and Budget Director, executive of Empresas Pizarreño and Infraestructura Dos Mil, CEO of AFP Habitat and Member of the Technical Advisory Committee of Investment established by the Pension Reform. Currently he serves on the Boards of Directors of private companies. He joined the Committee in January 2007.



Member Paulina Yazigi Salamanca

Ms. Yazigi holds a degree in Economics and a Master's degree in Macroeconomics from Universidad Católica de Chile. Besides, she holds a Master of Science in Mathematics in Finance from New York University. Currently, she serves as Chief Investment Officer (CIO) in a family office named Nogaleda Inversiones. She was Investment Manager, Strategy Manager, and Head of Fixed-Income and Economic Research at Credicorp Capital (formerly IMTrust), Vice president of Business Management at BBVA in New York, and co-portfolio manager at Compass Group LLC in New York. She has taught several courses at Universidad Adolfo Ibáñez since 2012. She joined the Committee in September 2018.

CHAPTER 1

Fiscal policy and the
funds' objectives,
institutional
framework and
investment policy

A. Fiscal policy

Chile's fiscal policy is aimed at contributing to macroeconomic stability and providing public goods that increase opportunities and social protection for Chilean citizens.²

Since 2001, Chile's fiscal policy is guided by a structural balance rule or, more precisely, a cyclically adjusted balance rule,³ which mitigates the effect on public finances of fluctuations in economic activity and the copper price. This implies saving in boom times and being able to use those savings during cyclical downturns. As a result, the fiscal rule has a stabilizing effect on public finances and the economic cycle and improves access to financing for both the public and private sectors.

B. Objectives and rules on the use of the funds

To ensure the sustainability of public spending over time and contribute to the competitiveness of the economy, Law 20,128 on Fiscal Responsibility was passed in September 2006. This law created the PRF and authorized the President of the Republic to create the ESSF, which was then officially established in February 2007. These two funds accumulate the resources resulting from the application of the structural balance rule as detailed below.

Objectives

The funds created by the Fiscal Responsibility Law (henceforth, the Sovereign Wealth Funds) have specific objectives. In the case of the ESSF, the objectives are to accumulate resources to finance potential fiscal deficits and to amortize public debt, thereby contributing to cushioning fiscal spending against fluctuations in the world economy and the volatility of revenues from taxes and copper. The ESSF resources can also be used to finance the PRF if necessary. In the case of the PRF, the objective is to support the financing of fiscal liabilities deriving from the state pension guarantee for old-age and disability solidarity pension benefits, as well as old-age and disability solidarity pension contributions established by the Pension Reform. The PRF thus complements the financing of future pension-related contingencies.

Rules on fund contributions

The rules on establishing the funds and accumulating resources therein are established by law (see Figure 1).⁴

The PRF is increased each year by a minimum of 0.2% of the previous year's gross domestic product (GDP). If the effective fiscal surplus exceeds 0.2% of GDP, the PRF receives a contribution equivalent to the surplus, up to 0.5% of GDP. PRF contributions only have to be made until the fund reaches UF 900 million (Unidad de Fomento, UF). In the framework of the current health crisis, Article 4 of Law N° 21,225, which establishes support measures for families and micro, small, and medium-sized businesses to address the impact of COVID-19, suspends contributions to the PRF in 2020 and 2021.

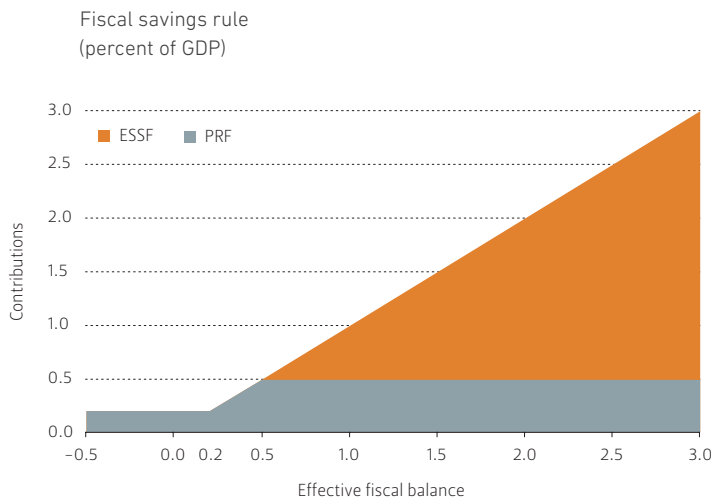
2 Decree N° 1,579 of 2020, which modifies Decree N° 743 of 2018, both from the Ministry of Finance, establishes the basis of fiscal policy, in accordance with the provisions of Article 1° of Law N° 20,128 on Fiscal Responsibility.

3 The structural balance rule (or cyclically adjusted balance rule) has undergone some changes since it was first implemented. For a detailed discussion of its design, modifications, application and results, see Marcel, Tokman, Valdés and Benavides (2001); García, García and Piedrabuena (2005); Rodríguez, Tokman, and Vega (2006); Velasco, Arenas, Rodríguez, Jorratt and Gamboni (2010); Comité Asesor para el diseño de una política fiscal de balance estructural de segunda generación para Chile (2011); Larraín, Costa, Cerda, Villena and Tomaselli (2011); Schmidt Hebbel (2012); Velasco and Parrado (2012) and the Budget Office (2013, 2014, 2015, 2016, 2017, 2018, and 2019).

4 For the PRF, the Fiscal Responsibility Law; for the ESSF, Statutory Decree (DFL) N° 1, issued by the Ministry of Finance in 2006.

The yearly contribution to the ESSF corresponds to the balance of the effective fiscal surplus (if positive) after subtracting the PRF contribution, less public debt pay downs and any advance contributions to the fund.⁵ Additionally the fund can receive extraordinary contributions from the sale of assets or debt issue.

FIGURE 1



SOURCE: Ministry of Finance of Chile

Rules on the use of the funds

Starting in 2016, the PRF resources can be used to complement the financing of fiscal liabilities deriving from the state guarantee for old-age and disability solidarity pension benefits, as well as old-age and disability solidarity pension contributions. The annual withdrawal of PRF resources cannot exceed one-third of the difference between expenditures on pension liabilities in the current year and the pension expenditure in 2008, adjusted for inflation.⁶

However, in the framework of the pandemic, Article 19 of Law N° 21,227, which facilitates access to unemployment insurance under Law N° 19,728, establishes that under exceptional circumstances, and without prejudice to the provisions of Article 8 of the Fiscal Responsibility Law, the amount of resources that will be withdrawn from the PRF in 2020 and 2021 will correspond to the totality of the difference between total expenditures classified as pension expense for each year and total expenditures for that expense item in 2008, adjusted for inflation.⁷

As of 2021, the PRF will cease to exist if the withdrawals in a calendar year do not exceed 5% of the fiscal pension expenditure established in that year's budget. When the PRF is eliminated, the remaining balance will be transferred to the ESSF.

5 The current legislation allows the pay down of public debt and advance contributions to the ESSF using resources from the fiscal surplus of the current year, which must be deposited into the fund in the current or subsequent years.

6 Prior to 2016, withdrawals from the PRF were allowed equivalent to the returns generated in the previous year.

7 On 1 October 2020, US\$ 1,576 million was withdrawn from the PRF, which is over three times the average withdrawals from 2017 to 2019 (US\$ 472 million).

The ESSF resources can be used at any time to complement fiscal revenues as needed to finance authorized public spending in the event of a fiscal deficit. These resources can also be used for the regular or extraordinary pay down of public debt (including Recognition Bonds) and for financing the annual contribution to the PRF, as per a decision by the Finance Minister.

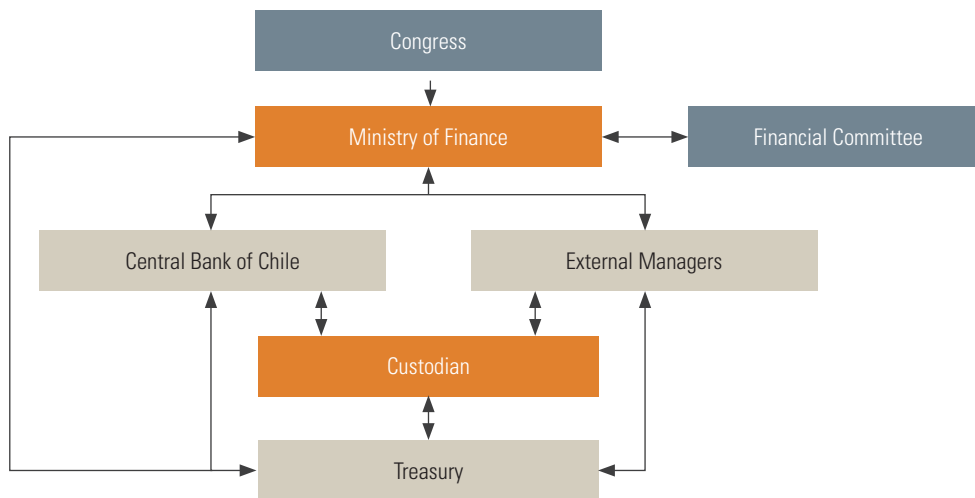
Withdrawals from the ESSF and the PRF are effectuated through a decree from the Ministry of Finance.

C. Institutional framework

The legal framework establishes a clear division of roles and responsibilities in order to ensure accountability and operational independence in the management of the funds. This section provides a brief description of the roles of each of the bodies involved in fund management (see Figure 2).

FIGURE 2

Institutional framework for Chile's Sovereign Wealth Funds



SOURCE: Ministry of Finance of Chile

Ministry of Finance and dependent bodies

The Fiscal Responsibility Law establishes that the funds are the property of the Fisco of Chile and that the General Treasury holds the legal title to the resources. The law authorizes the Finance Minister to make decisions on how the funds are managed and to dictate their investment policies. To this end, the Ministry of Finance draws up the investment guidelines, which define the criteria that must be followed by the funds' managers. The Ministry monitors the managers' performance and compliance with the investment guidelines and issues monthly, quarterly and annual reports on the state of the funds.

The General Treasury is responsible for the funds' accounting and the preparation of their audited financial statements, for monitoring compliance with the investment limits, for reconciling information on the portfolios from

the managers and the custodian and for approving payments to the managers. The Budget Office is responsible for budgetary issues related to the funds.

Central Bank of Chile

Through Decree N° 1,383 of 2006 (“Agency Decree”), modified by Decree N° 1,618 of 2012, the Ministry appointed the Central Bank of Chile (CBC) to the role of fiscal agent, with the following responsibilities: (i) manage portfolios comprising instruments that are eligible for investing the Bank’s International Reserves; (ii) delegate the management of these portfolios to external managers; (iii) select external portfolio managers; and (iv) manage the custodian, among other duties. In carrying out these tasks, the CBC must follow the guidelines issued by the Finance Minister.

External Managers

The external managers are international companies that have been contracted to manage a share of the sovereign wealth fund investments. These firms are chosen based on a selection process carried out by the CBC, with the support of international consultants and Finance Ministry personnel.

In most cases, the Ministry is responsible for supervising the external managers, with support from the Treasury; however, the CBC supervises external managers that invest in instruments that are eligible for its International Reserves.

Table 1 lists the external portfolio managers that were under contract at year-end 2020.

TABLE 1

Sovereign wealth fund external managers, 31 December 2020.

External Manager	Supervision	PRF	ESSF
BlackRock Institutional Trust Company, N.A. (BlackRock)	Ministry/Treasury	High-yield bonds	
BNP Paribas Asset Management (BNP Paribas)	CBC	U.S. agency MBSs	
Credit Suisse	Ministry/Treasury	Corporate bonds	
Mellon Investments Corporation (Mellon)	Ministry/Treasury	Equities	
Nomura Asset Management (Nomura)	Ministry/Treasury	High-yield bonds	
UBS Asset Management (Americas) Inc. (UBS)	Ministry/Treasury	Equities	Equities
		Corporate bonds	
Western Asset Management Company (Western Asset)	CBC	U.S. agency MBSs	

SOURCE: Ministry of Finance of Chile

Following a selection process carried out in 2020, the CBC contracted UBS and Credit Suisse to manage PRF corporate fixed-income portfolios and UBS and Mellon to manage PRF equity portfolios. Subsequently, considering that the ESSF equity mandate is identical to that of the PRF, though much smaller in size, and based on recommendations by the Financial Committee, the Ministry instructed the CBC to select one of the two firms contracted for the PRF equity

mandate to manage the corresponding portfolio in the ESSF. The CBC chose UBS due to its better cost proposal. All the managers contracted in 2020 began managing their portfolios on 1 December of the same year.⁸

Financial Committee

The Fiscal Responsibility Law stipulates that the Ministry of Finance must establish an Advisory Committee to give advice to the Finance Minister on the Sovereign Wealth Funds (henceforth, the Financial Committee). This Committee monitors the investment of the funds' resources and advises the Minister on the definition of the investment policies consistent with the funds' objectives. In compliance with these provisions, on 23 December 2006, the Finance Minister announced the establishment of both the Sovereign Wealth Funds and the Financial Committee. The Committee was then officially created through Decree N° 621, issued by the Ministry of Finance in 2007. In accordance with that decree, the Committee must be made up of six members who have experience in investment portfolio management, have held an executive position in a financial institution or have held or currently hold an academic post. The six Committee members are appointed for two years, with half the seats being renewed each year. The current and former members of the Financial Committee are presented in Appendix 1. The Committee's president receives a fee per session of 25.5 UTMs (Unidades Tributarias Mensuales, UTM), with an annual cap of 127.5 UTMs. The remaining members receive a fee of 17 UTMs per session, with an annual cap of 85 UTMs. The Committee must meet at least once every six months, but in practice it has met at least five times a year. A summary of the Committee's meetings during 2020 is presented in Appendix 2.

Decree N° 621 also stipulated the Financial Committee's functions and the rules of procedure for its proper functioning. Thus, the duties and powers of the Committee are as follows:

- To advise the Finance Minister, when requested, on key issues related to the funds' investment policy, such as the distribution of investments by asset class (asset allocation), the incorporation of new investment alternatives, the specification of portfolio benchmarks (see Box 1), the permissible range of deviation from the asset allocation and the limits on the funds' investment possibilities.
- To submit recommendations to the Finance Minister, when requested, on custody and investment instructions and on the tender and selection processes for the management of the funds' portfolios.
- To express an opinion at the request of the Finance Minister about the structure and content of the annual reports on the funds' portfolio management that are presented to the Ministry of Finance by the institution(s) responsible for their management or custody and, on the basis of these reports, to express an opinion about the funds' management and, particularly, its consistency with their investment policies.
- To express an opinion about the structure and content of the reports on the funds prepared quarterly by the Ministry of Finance.
- To advise the Finance Minister, when requested, on any matter related to the funds' investment.
- To express its views and recommendations regarding other matters related to the funds' investment policies, taking into account the principles, objectives and rules that govern the funds.

8 Based on the results of this selection process, on 30 November 2020 BlackRock and Allianz ceased to manage their PRF corporate bond portfolios and BlackRock its PRF equity portfolio. On the same date, BlackRock and Mellon ceased to manage their ESSF equity portfolios. For more information on the selection of external portfolio managers in 2020, see Chapter 3, Section C.

In order to promote transparency, the Financial Committee decided that the decree regulating its activities, the minutes of its meetings and the corresponding press releases should be publicly disclosed. The Ministry of Finance's website thus, includes a special section containing all information on these issues.⁹

BOX 1: Portfolio benchmarks

Portfolio benchmarks are representative market indexes for the different asset classes. In principle, they represent the passive investment performance of diversified portfolios invested in certain asset classes, where the return of each instrument is typically weighted by its relative share of market capitalization. The indexes are used as a reference for measuring the performance of the managers in charge of investing the funds.

Each asset class in an investment portfolio is associated with a benchmark. The benchmark for the total portfolio is thus constructed by weighting the selected indexes by the percentage allocation of each class, as defined in the investment policy.

Both the ESSF and the PRF have mainly passive investment policies. That is, their investment strategy aims to achieve the benchmark return.

D. Investment policy

Economic and Social Stabilization Fund

Investment objectives: Consistent with the ESSF objectives, the investment policy aims to maximize the fund's accumulated value in order to partially cover cyclical reductions in fiscal revenues while maintaining a low level of risk. Its aversion to risk is reflected in the choice of an investment portfolio with a high level of liquidity and low credit risk and volatility, thereby ensuring the availability of the resources to cover fiscal deficits and avoiding significant losses in the fund's value.

Strategic asset allocation: The ESSF investment policy stipulates a strategic asset allocation of 15.5% in bank deposits, 76% in sovereign bills and bonds, 3.5% in inflation-indexed sovereign bonds, and 5% in equities. The fixed-income portfolio has a currency allocation of 40% in USD, 25% in EUR, 20% in JPY and 7.5% in CHF, expressed as a percentage of the total portfolio.¹⁰

Portfolio benchmarks: A benchmark has been defined for each component of the strategic asset allocation, using a representative market index (see Table 2).

⁹ <https://www.hacienda.cl/english/work-areas/international-finance/sovereign-wealth-funds>.

¹⁰ On 1 April 2020, equities allocation was reduced from 7.5% to 5% compensated with small increments on the other asset classes. For more information, see Chapter 3, Section B.

TABLE 2

Benchmarks ESSF
(percent of portfolio)

Asset class		Percent of portfolio	Benchmark
1. Bank deposits		5.25	ICE BofA US Dollar 3 Month Deposit Bid Rate Average Index
		6.25	ICE BofA Euro Currency 3 Month Deposit Bid Rate Average Index
		4.0	ICE BofA Japanese Yen 3 Month Deposit Bid Rate Average Index
		15.5	Subtotal bank deposits
2. Treasury bills and sovereign bonds	2.1. Treasury bills	6.0	ICE BofA US Treasury Bill Index
		7.25	ICE BofA Germany Treasury Bill Index
		6.25	ICE BofA Japan Treasury Bill Index
		19.5	Subtotal Treasury bills
	2.2. Sovereign bonds	27.25	Bloomberg Barclays Global Aggregate -Treasury: U.S. 7-10 Yrs
		11.25	Bloomberg Barclays Global Aggregate - Treasury: Germany 7-10 Yrs
		10.25	Bloomberg Barclays Global Aggregate -Treasury: Japan 7-10 Yrs
		7.75	Bloomberg Barclays Global Aggregate -Treasury: Switzerland 5-10 Yrs
		56.5	Subtotal Sovereign bonds
		76.0	Subtotal Treasury bills and Sovereign bonds
3. Inflation-indexed sovereign bonds		2.5	Bloomberg Barclays Global Inflation-Linked: U.S. TIPS 1-10 Yrs
		1.0	Bloomberg Barclays Global Inflation-Linked: Germany 1-10 Yrs
		3.5	Subtotal inflation-indexed sovereign bonds
4. Equities	5.0	MSCI All Country World Index ex Chile (unhedged with reinvested dividends)	

SOURCE: Ministry of Finance of Chile

Management: The ESSF is largely managed by the CBC, which, acting as fiscal agent, manages the fixed-income portfolio (95% of total assets). The equity portfolio is managed by an external management company contracted by the CBC following a tender process.

Ex ante tracking error¹¹: The ex-ante tracking error is capped at 50 basis points for the fixed-income portfolio and 60 basis points for the equity portfolio.

Eligible currencies and issuers: Only currencies in the benchmark are eligible for investment. In the case of sovereign exposure, the issuers that make up the corresponding benchmark, supranational institutions, agencies and eligible entities with an explicit government guarantee according to the eligibility criteria used by the CBC in order to invest the International Reserves and according to the pre-established limits set in the investment guidelines. With regard to bank exposure, the fund can only be invested in banks with a risk rating of A-/A3 or higher (Standard & Poor's, Moody's and Fitch) and in accordance with the limits stipulated in the investment guidelines. For exposure to equities, only the issuers that make up the corresponding benchmark are eligible for investment, however the investment in exchange traded funds, mutual funds, American depositary receipts, global depositary receipts, and futures are also allowed.

11 The ex-ante tracking error is an estimate of the standard deviation of the difference between the portfolio and benchmark returns. The lower the ex-ante tracking error, the more passive the portfolio management.

Leveraging and the use of derivatives: Leveraging is not allowed.¹² The use of derivatives is defined according to the type of portfolio:

- Fixed-income portfolio: The use of forwards and swaps is only allowed for foreign currency hedging. The total notional amount cannot exceed 4% of the fixed-income portfolio.
- Equity portfolio: The use of forwards and swaps is only allowed for foreign currency hedging. In addition, the use of equity futures is allowed for hedging purposes or to gain exposure to part of the benchmark. The aggregate nominal amount of the futures, forwards and swaps cannot exceed 10% of the portfolio of each external manager.

Rebalancing policy: The rebalancing policy will be revised in 2021 to take into account both the reduction of the equity share in the strategic asset allocation defined in 2020 and the investment policy study, which could modify the strategic allocation.¹³ Any time there is a withdrawal or contribution, the portfolio must converge to the target allocation defined for the fund.

Investment guidelines: The investment guidelines, which are published in Spanish and English and available online at the Ministry of Finance website,¹⁴ provide additional information on the ESSF investment policy, such as special restriction on investment in specific countries and other relevant limits, as well as other aspects of portfolio management.

Pension Reserve Fund

In 2020, the PRF investment policy was modified to incorporate the impact of some legal reforms on the size of the fund and on current and projected disbursements in 2020 and 2021. These reforms were approved by Congress as part of the social agenda implemented in late 2019 and as a funding source for the fiscal policy response to the pandemic in 2020 (see Box 2).

¹² Leveraging is the purchase of assets through debt.

¹³ For more information, see Chapter 3, Sections B and D.

¹⁴ <https://www.hacienda.cl/english/work-areas/international-finance/sovereign-wealth-funds/economic-and-social-stabilization-fund/investment-policy>.

BOX 2: Legal reforms that affected the PRF in 2019–20

In 2019 and 2020, a series of legal reforms were passed that had an impact on the future evolution of the PRF. These include the following:

- The law on the Solidarity Pension System, passed in December 2019, introduced a 50% increase in the basic solidarity pension (PBS) and the maximum solidarity pension contribution (PMAS), defined in Articles 7 and 13 of Law N° 20,255. Additionally, it standardized the calculation rule for the old-age solidarity pension contribution (APS) for new beneficiaries; created a new rule on the use of capitalization account resources for funding the APS, using individual funds first; and incorporated a benefit for people who have a self-funded reference pension (PAFE) that is higher than the PMAS, but whose scheduled withdrawal potentially falls below the value of the PBS.
- In the framework of the pandemic, Law N° 21,225, passed in March 2020, which establishes support measures for families and micro, small, and medium-sized businesses to address the impact of COVID-19, suspends contributions to the PRF in 2020 and 2021 (Article 4).
- Law N° 21,227, passed in April 2020, which facilitates access to unemployment insurance under Law N° 19,728, established in Article 19 that under exceptional circumstances, and without prejudice to the provisions of Article 8 of the Fiscal Responsibility Law, the amount of resources that will be withdrawn from the PRF in 2020 and 2021 will be equivalent to the full difference between total expenditures classified as pension expense for each year and total expenditures for that expense item in 2008, adjusted for inflation.

Based on recommendations by the Financial Committee, the Finance Ministry divided the investment portfolio as follows: the short-term investment portfolio (STIP) and the long-term investment portfolio (LTIP).¹⁵

The main characteristics of the respective investment policies are described below.

Short-term investment portfolio

Investment objective: The main investment objective is to have exposure to highly liquid instruments, so as to preserve the value of the invested funds, within the risk standards specified in the investment guidelines.

Strategic asset allocation: The portfolio allocation is 93% U.S. Treasury bills and 7% U.S. Sovereign bonds.

Benchmarks: Each component of the strategic asset allocation has a defined benchmark, which corresponds to a representative index of the respective market (see Table 3).

¹⁵ In 2020, the Financial Committee recommended dividing the PRF portfolio into two sub-portfolios. The STIP will hold expected disbursements in 2020 and 2021; the LTIP will hold resources that will not be withdrawn in the short term, in order to invest the funds at a medium- to long-term investment horizon. For more information on this modification, see Chapter 3, Section B.

TABLE 3

Benchmarks: STIP
(percent of STIP)

Asset class	Percent of STIP	Benchmark
U.S. Treasury bills	93	ICE BofA US Treasury Bill Index
U.S. Sovereign bonds	7	Bloomberg Barclays Global Aggregate – Treasury: U.S. 1–3 Yrs

SOURCE: Ministry of Finance of Chile

Management: The entire portfolio is managed by the CBC, in its role as fiscal agent.

Benchmark duration: The effective duration of the total portfolio cannot deviate from the benchmark by more than +/- 0.5 years.

Eligible currencies, issuers, and instruments: Only currencies and issuers that are included in the corresponding benchmark are eligible for investment. Eligible instruments are those that are included in the benchmark and those that will be incorporated into the benchmark in the coming month.

Use of leverage and derivatives: The STIP does not allow the use of leverage or derivatives.

Long-term investment portfolio

Investment objective: The investment objective is to earn an expected annualized return in pesos of at least 2% over Chilean inflation in a ten-year period, with a probability of at least 60%. The risk tolerance establishes that the probability that the fund's real return will be less than -12%, expressed in pesos, must not be over 5% in any given year.¹⁶

Strategic asset allocation: The portfolio allocation is 31% equities, 34% sovereign and government-related bonds, 13% corporate bonds, 8% high-yield bonds, 6% U.S. agency MBSs, and 8% inflation-indexed bonds.¹⁷

Benchmarks: A benchmark has been established for each component of the strategic asset allocation, using a representative market index (See Table 4).

16 This objective was defined in the investment policy approved by the Minister of Finance in late 2017 but it will be revised in 2021 taking into account the Minister's decision to stop convergence to the strategic asset allocation of said policy (for more information see Chapter 3, Section B).

17 This strategic asset allocation has been in place for the fund since January 2020; the Finance Minister decided to maintain this allocation when the decision was made to stop convergence to the investment policy defined in late 2017.

TABLE 4

Benchmarks – LTIP
(percent of LTIP)

Asset class	Percent of LTIP	Benchmarks
Sovereign and government-related bonds ^(a)	34	Bloomberg Barclays Global Aggregate: Treasury Bond Index (unhedged)
		Bloomberg Barclays Global Aggregate: Government-Related (unhedged)
Inflation-indexed sovereign bonds	8	Bloomberg Barclays Global Inflation-Linked Index (unhedged)
Corporate bonds	13	Bloomberg Barclays Global Aggregate: Corporates Index (unhedged)
U.S. agency MBS	6	Bloomberg Barclays US Mortgage-Backed Securities (MBS) Index
High yield bonds	8	Barclays Global High Yield Index (unhedged)
Equities	31	MSCI All Country World Index ex Chile (unhedged, with reinvested dividends)

(a) The two subindexes of this asset class are added in accordance with their relative capitalization.

SOURCE: Ministry of Finance of Chile

Management: The sovereign and government-related bonds portfolio and the inflation-indexed bond portfolio are managed directly by the CBC, acting as fiscal agent. The equity, corporate bond, high yield, and agency U.S. agency MBS portfolios are managed by external portfolio managers selected by the CBC with support from the Ministry of Finance and a consulting firm (RVK, Inc.).

Ex ante tracking error: The ex-ante tracking error has been set at 50 basis points for the aggregate portfolio of sovereign and government-related bonds and inflation-indexed sovereign bonds, 60 basis points for the equity portfolio, 50 basis points for the corporate bond portfolio, and 150 basis points for the high yield bond portfolio. For the U.S. agency MBS portfolio, the monthly average cannot exceed 20 basis points, and the maximum daily value cannot exceed 30 basis points.

Eligible currencies, issuers, and instruments: For each asset class, only currencies that are included in the respective benchmarks are eligible for investment. Eligible issuers and instruments are mainly those included in the benchmark, but each asset class includes some eligible issuers and instruments that are not in the benchmark, so as to give the portfolio managers more flexibility in managing their portfolios. These include the following:

- U.S. agency MBS: debt instruments issued or guaranteed by the U.S. government or by MBS issuing agencies, interest rate futures, and TBAs.¹⁸
- Corporate bonds: market-traded futures and reopened issues that are comparable to the instruments included in the benchmark.
- High yield bonds: futures, reopened issues that are comparable to the instruments included in the benchmark, sovereign instruments, and investment-grade bonds that leave the benchmark.
- Equities: ETFs, mutual funds, American Depositary Receipts (ADRs), Global Depositary Receipts (GDRs), and futures.

18 To be announced (TBA): MBS forwards.

Leveraging and use of derivatives: The LTIP does not allow leveraging. The use of derivatives is differentiated by portfolio:

- Aggregate portfolio of sovereign and government-related bonds, and inflation-indexed sovereign bonds: forwards or swaps can only be contracted for the purpose of currency hedging. The nominal value of forwards or swaps that are contracted with a given eligible counterparty cannot exceed 1.0% of the market value of the portfolio if the counterparty has a credit rating of at least AA– and 0.5% if the credit rating is A– to A+. At the same time, the aggregate notional value of all current forward or swap contracts cannot exceed 4% of portfolio.
- U.S. agency MBS: Exposure to TBAs cannot exceed 30% of the portfolio. The nominal amounts of U.S. interest rate futures valued at market price and expressed in absolute value cannot exceed 10% of the market value of the portfolio.
- Equities, corporate bond, and high yield bond portfolios: Each manager can only contract forwards or swaps for the purpose of currency hedging; and futures—equities or fixed-income, as indicated—for hedging purposes or to gain exposure to part of the benchmark. The nominal value of the forwards or swaps that are contracted by a given manager with a given eligible counterparty cannot exceed 3% of the market value of the portfolio under management. The aggregate nominal amount of futures, forwards, and swaps cannot exceed 10% of the portfolio of any given manager.

Investment guidelines: The investment guidelines for both, the STIP and LTIP, which are published on the Ministry of Finance’s website,¹⁹ provide additional information on the PRF investment policy, including details on the admissible instruments and other key limitations, as well as other issues related to fund management.

19 <https://www.hacienda.cl/english/work-areas/international-finance/sovereign-wealth-funds/pension-reserve-fund/investment-policy>.

CHAPTER 2

State of the Sovereign
Wealth Funds

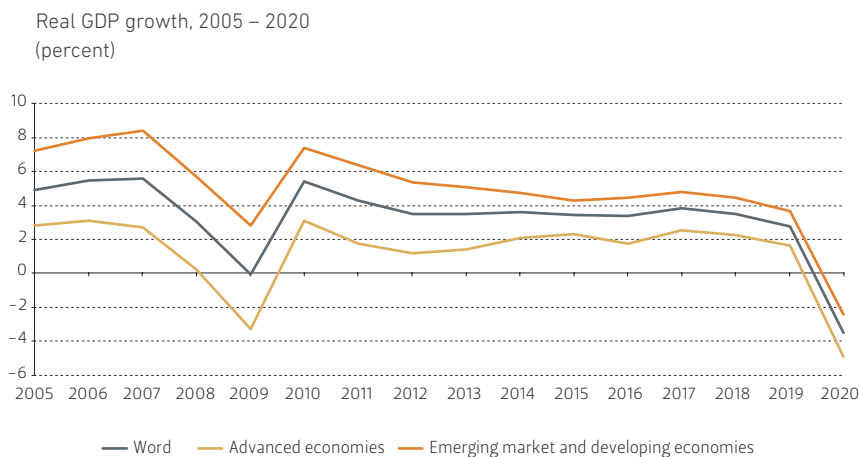
A. Analysis of the international economy

To better understand the recent performance of the sovereign wealth funds, this section reviews the main events and trends in the world economy in 2020.

The global spread of COVID-19 and the lockdown measures and border closures implemented in many countries to contain and reduce the speed of contagion had a major impact on the world's population and economies. This required the implementation of extraordinary support measures by governments and central banks to stimulate domestic consumption and economic activity. In this scenario, according to estimates by the International Monetary Fund (IMF),²⁰ the world economy contracted 3.5% in 2020, following growth of 2.8% in 2019.

Under this new economic context, the advanced economies, on aggregate, saw growth slow from 1.6% in 2019 to -4.9% in 2020. The emerging and developing economies recorded a contraction of -2.4% in 2020, down from growth of 3.6% the previous year (see Figure 3). In the advanced economies, the sharp contractions were led by the United Kingdom and Japan, where estimated growth was -10.0% and -5.1%, respectively (see Figure 4). Among the emerging and developing economies, key shifts included the slowdown in China and the contraction in India and Brazil (see Figure 5).

FIGURE 3

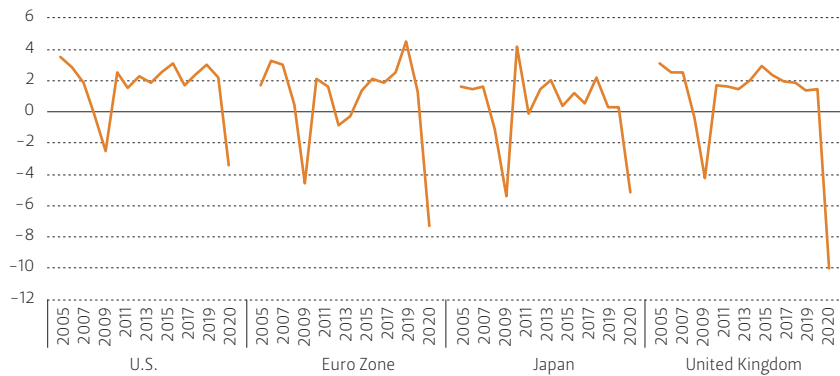


SOURCE: International Monetary Fund

²⁰ The growth figures in this section are extracted from the IMF World Economic Outlook Database (October 2020 and the January 2021 update).

FIGURE 4

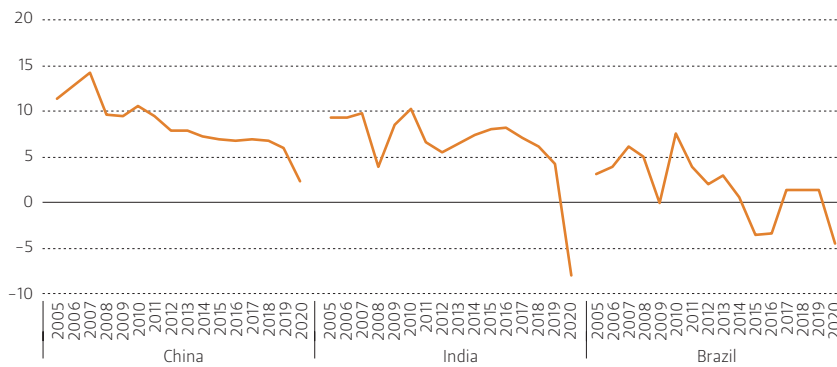
Real GDP growth in specific developed economies, 2005 - 2020
(year-on-year change, percent)



SOURCE: International Monetary Fund

FIGURE 5

Real GDP growth in specific emerging economies, 2005 - 2020
(year-on-year change, percent)



SOURCE: International Monetary Fund

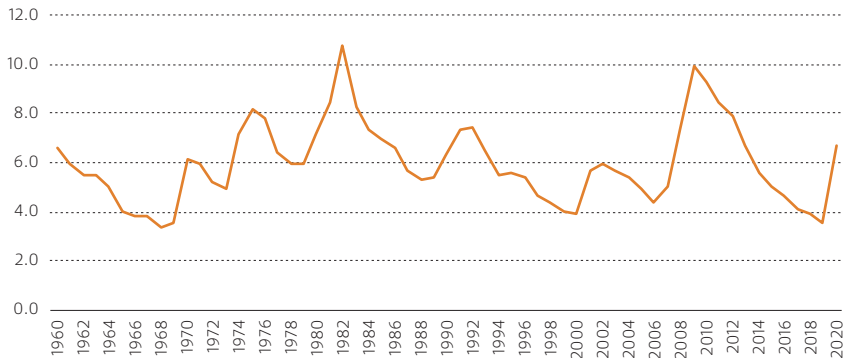
In the case of the United States, the economy is estimated to have contracted 3.4%, a major drop from the 2.2% growth of 2019. In December 2020, the unemployment rate rose to 6.7%, ending the downward trend recorded between 2010 and 2019 (see Figure 6). The nominal hourly wage at year-end was up 5.1% relative to the previous year (see Figure 7).²¹ In the case of inflation, the general price index ended the year up 1.4% relative to 2019, below the 2.0% annual target of the U.S. Federal Reserve (Fed), while core inflation, which excludes food and energy prices, was 1.6% in the year (see Figure 8). In a context in which both the global and U.S. economy contracted sharply, especially in the second quarter, the Fed lowered its policy rate range (the federal funds rate) in 2020, first by 50 basis points and then by 100 basis points, to 0.0–0.25%.²² Two fiscal stimulus plans were approved in 2020 in an attempt to contain the economic impact of the pandemic. The first was passed in March and totaled US\$ 2.2 trillion; the second, passed in December, was for US\$ 900 billion. They included direct transfers to households, small business loans, and an extension of unemployment benefits, among other measures.

21 The higher wages in April 2020 reflect the sharp reduction in low-wage jobs due to the pandemic.

22 The Fed lowered the fed funds rate twice in March 2020, first from 1.50–1.75% to 1.00–1.25% and then to 0.0–0.25%.

FIGURE 6

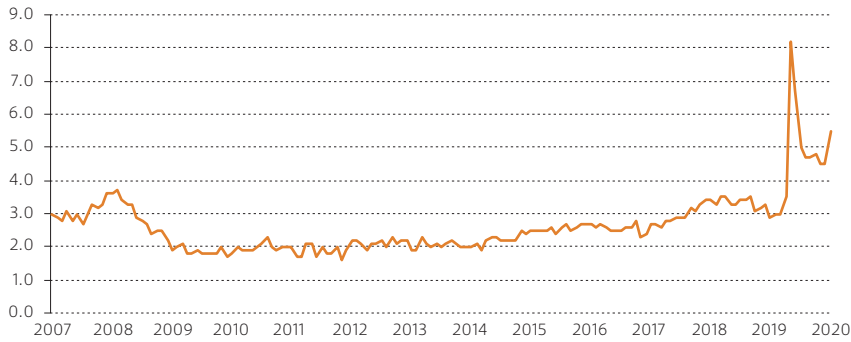
U.S. unemployment rate, 1960 - 2020
(percent)



SOURCE: Bureau of Labor Statistics

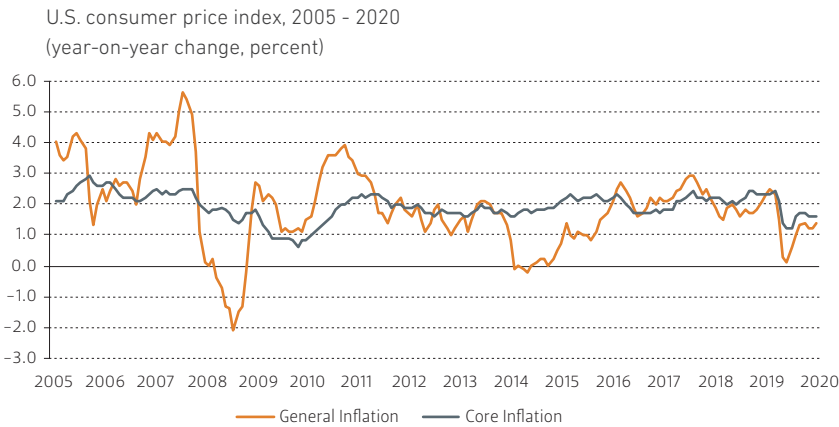
FIGURE 7

U.S. wage growth, 2007 - 2020
(year-on-year change, percent)



SOURCE: Bloomberg

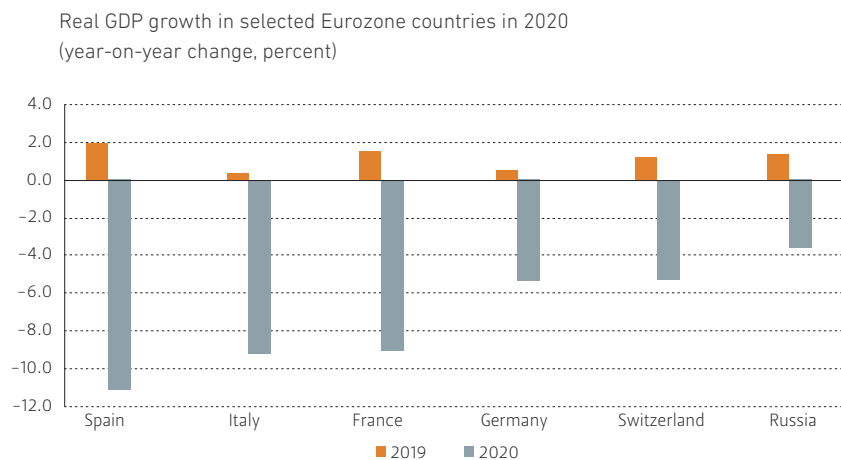
FIGURE 8



SOURCE: Bloomberg

The Eurozone went from annual growth of 1.3% in 2019 to an estimated contraction of 7.2% in 2020, reflecting the impact of the pandemic on the member economies. The biggest drops were in Spain and Italy, which recorded estimated growth rates of -11.1% and -9.2%, respectively. In Germany, GDP is estimated to have contracted by 5.4%. (see Figure 9). Inflation in the Eurozone ended the year at -0.3% (see Figure 10). Unemployment increased over the course of the year, ending at 8.3%, in a reversal of the downward trend recorded since 2013 (see Figure 11). In this scenario, to address the pandemic's impact on the economy, the European Central Bank (ECB) announced a new Pandemic Emergency Purchase Programme (PEPP) in March 2020,²³ with an initial fund of 750 billion euros, as a way to offset the risks to the monetary policy transmission mechanism and expectations of an economic contraction. The PEPP was increased by 600 billion euros in June and 500 billion euros in December, closing the year with a total of 1.85 trillion euros. In this context, the ECB held its deposit interest rates at -0.5%.

FIGURE 9

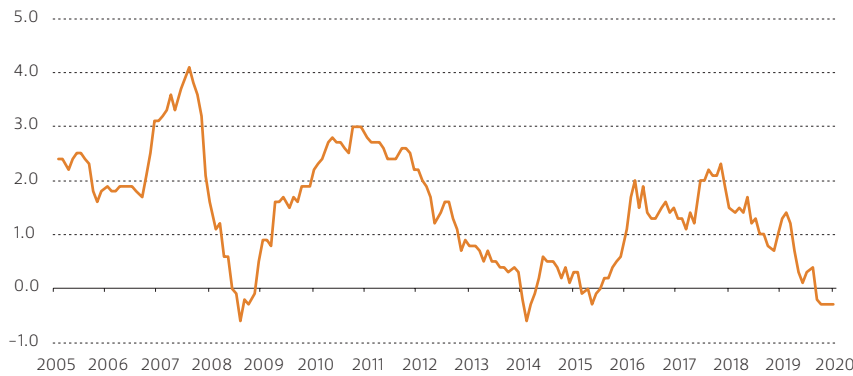


SOURCE: International Monetary Fund. Estimates

23 The PEPP is a temporary asset purchase program of private and public sector securities.

FIGURE 10

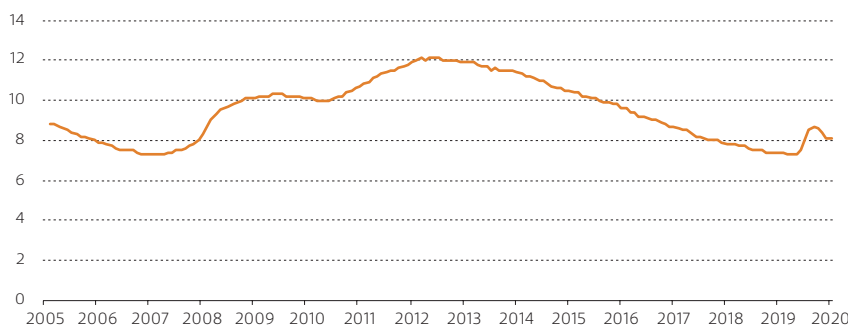
Eurozone annual inflation, 2005 - 2020²⁴
(percent)



SOURCE: Bloomberg

FIGURE 11

Eurozone unemployment rate, 2005 - 2020
(percent)



SOURCE: Bloomberg

Japan experienced an important contraction in the year, from a small growth rate of 0.3% in 2019 to -5.1% in 2020. The Central Bank of Japan kept its short-term interest rate target at -0.1% and expanded its ten-year bond purchase program to almost 80 billion yens with the aim of holding ten-year rates around 0%.

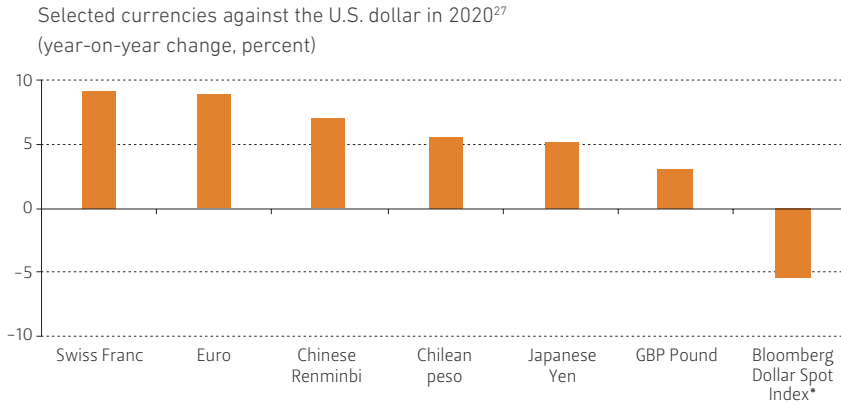
China grew 2.3% in 2020, far below the 6.0% recorded in 2019. Despite the strong contraction in the first quarter (-6.8%) due to the closure of factories and industrial plants, the country was able to recover after quickly implementing a series of strict lockdown measures to control the spread of the virus, together with stimulus measures to inject funds to support consumers and businesses.²⁵

24 The data corresponds to the HICP.

25 The People's Bank of China announced in May 2020 that it would ensure ample liquidity, using aggregate and structural policy measures, and that it would continue to deepen interest rate reforms to reduce the cost of loans. With regard to other economic stimulus measures, China focused on local government investment in infrastructure and increased production to supply goods to countries paralyzed by the pandemic.

In this global context, the U.S. dollar weakened against the main world currencies by 5.45% (see Figure 12).²⁶ Among the investment currencies of the sovereign wealth funds, the Swiss franc and the euro appreciated the most (9.2% and 9.0%, respectively). The Chilean peso appreciated 5.6%.

FIGURE 12



SOURCE: Bloomberg

In 2020, share prices fluctuated widely and returns were mixed for a selected sample of stock markets (see Figure 13). The best performing markets were South Korea, China, and the United States, which posted returns, measured in local currency, of 31.4%, 26.7%, and 19.2%, respectively. The indexes with the worst performance in relative terms, in local currency, were the United Kingdom, France, and Australia, with -16.1%, -6.0%, and -3.7%, respectively.

FIGURE 13



SOURCE: Bloomberg

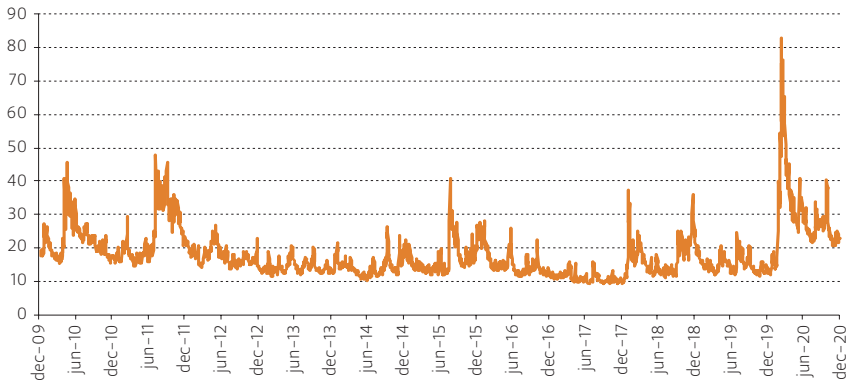
26 The Bloomberg Dollar Spot Index is a tradable index that shows the value of the dollar relative to the world's ten main currencies. Index returns above zero indicate that the dollar appreciated against the basket of currencies, while negative returns reflect a depreciation of the dollar vis-à-vis the value of the basket.

27 Negative performances indicate depreciation of the currency, while positive performance indicates appreciation.

Equity market volatility (S&P 500), measured by the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), was higher, on average, in 2020 than in the previous year. The maximum value was 82.7 which was registered in March (see Figure 14).

FIGURE 14

Equity market volatility (VIX): S&P 500, 2009 - 2020
(in levels)

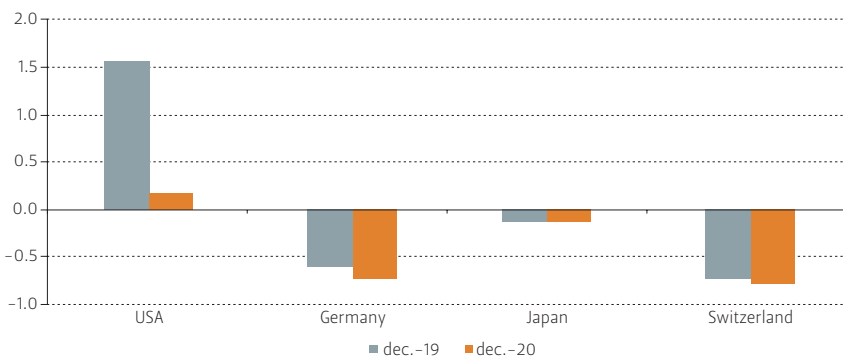


SOURCE: Bloomberg

At year-end, two-year and ten-year nominal sovereign interest rates had decreased in the United States, Germany and Switzerland relative to year-end 2019, while in Japan increased slightly (see Figures 15 y 16).

FIGURE 15

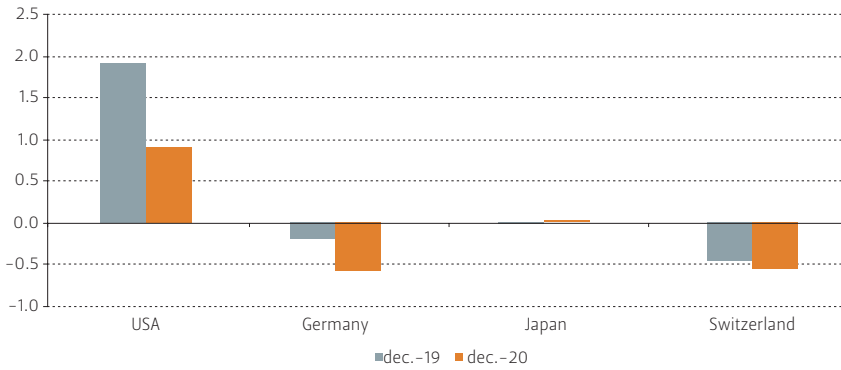
Internal rate of return (IRR) on two-year bonds in selected countries, 2019 - 2020
(percent)



SOURCE: Bloomberg

FIGURE 16

Internal rate of return (IRR) on ten-year bonds in selected countries, 2019 - 2020
(percent)

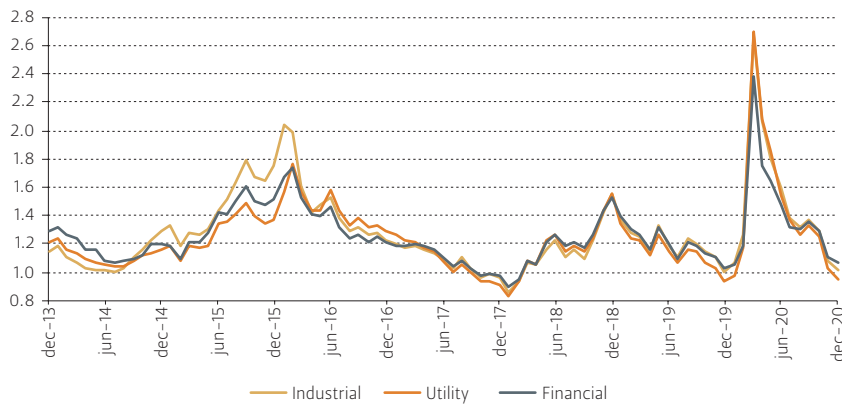


SOURCE: Bloomberg

With regard to the corporate market in 2020, the spreads of the industrial, utility, and financial sectors in the Bloomberg Barclays Global Aggregate Corporate Index peaked in March at 2.7%, 2.4%, and 2.7%, respectively, although they closed the year at around the level of year-end 2019 (see Figure 17). High-yield bond spreads, in turn, decreased relative to 2019: as measured by the Bloomberg Barclays Global High-Yield Index, spreads spiked to 10.1% in March but declined to 4.1% by year-end, versus 4.8% at the close of 2019 (see Figure 18).

FIGURE 17

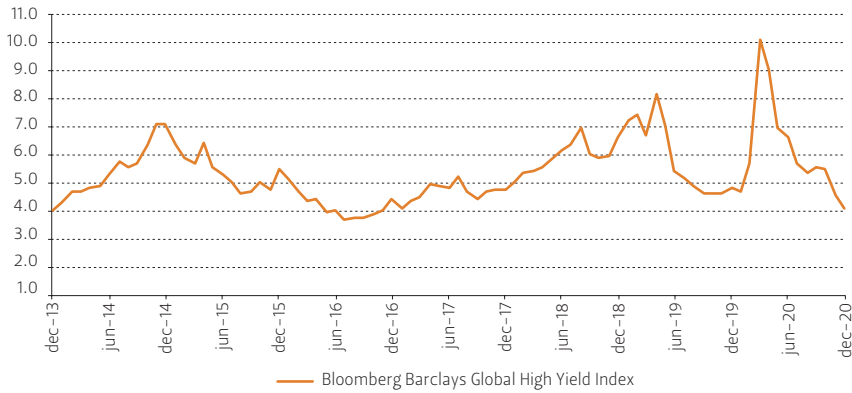
Investment grade corporate spreads by industry, 2013 - 2020
(percent)



SOURCE: Bloomberg Barclays

FIGURE 18

High yield bonds spreads, 2013 – 2020
(percent)

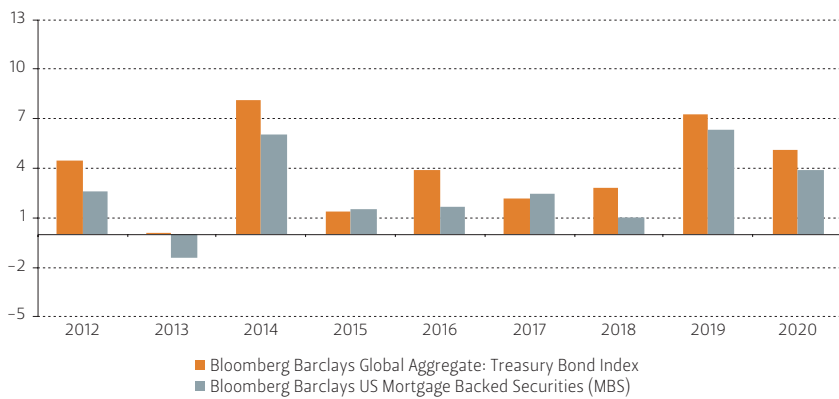


SOURCE: Barclays

In 2020, investment-grade sovereign bonds and U.S. agency MBS recorded positive returns in local currency. Thus, the Bloomberg Barclays Global Aggregate: Treasury Bond Index (hedged) and the Bloomberg Barclays U.S. Mortgage-Backed Securities (MBS) closed the year with yields of 5.1% and 3.9%, respectively (see Figure 19). Investment-grade corporate bonds, represented by the Bloomberg Barclays Global Aggregate: Corporates Index (hedged), and high-yield bonds (sovereign and corporate), represented by the Bloomberg Barclays Global High-Yield Index (hedged), closed the year with returns of 8.3% and 5.7%, respectively (see Figure 20).

FIGURE 19

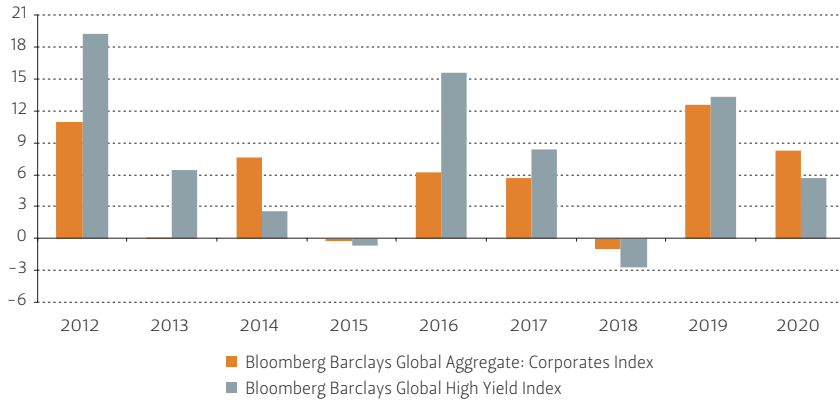
Bloomberg Barclays: Global Aggregate Treasury bonds (hedged) y US MBS (hedged), 2012 - 2020
(percent, measured in local currency)



SOURCE: Barclays

FIGURE 20

Bloomberg Barclays Global: Aggregate Corporates (hedged) y High Yield (hedged), 2012 – 2020
(percent, measured in local currency)

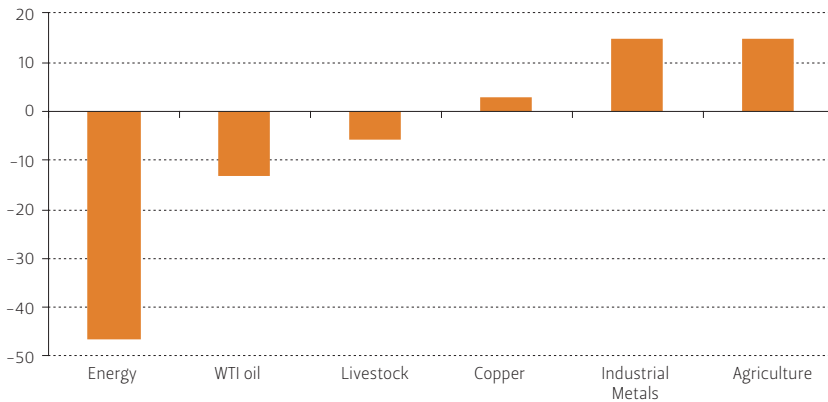


SOURCE: Barclays

A comparison of average commodity prices in 2020 versus 2019 reveals price hikes in agriculture, industrial metals, and copper, which rose 14.9%, 14.8%, and 3.0%, respectively. In the energy sector, the average price dropped sharply by 46.3% (see Figure 21).

FIGURE 21

Standard & Poor's commodity index in 2020
(year-on-year change, percent)



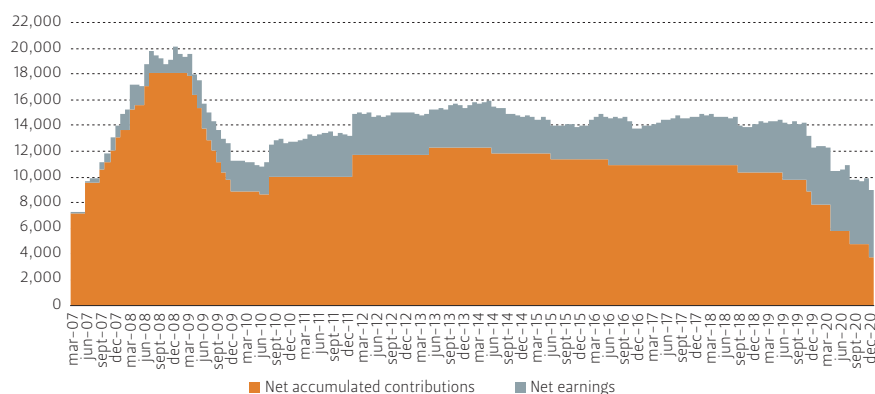
SOURCE: Bloomberg

B. Market value

At year-end 2020, the market value of the ESSF and the PRF was US\$ 8,955 million and US\$ 10,157 million, respectively, versus US\$ 12,233 million and US\$ 10,812 million, respectively, at year-end 2019. The decrease in the value of the ESSF was mainly due to withdrawals of US\$ 4,090 million, used to support the Treasury's funding needs deriving from the decrease in fiscal revenues in 2020 as a result of the social crisis in late 2019 and the pandemic in 2020. This was partially offset by net investment gains in the ESSF of US\$ 812 million (see Figure 22). The decrease in the PRF, in turn, was mainly due to withdrawals of US\$ 1,576 million, which were partially offset by net investment gains of US\$ 921 million (see Figure 23). As mentioned, no contributions were made to the PRF in 2020.²⁸

FIGURE 22

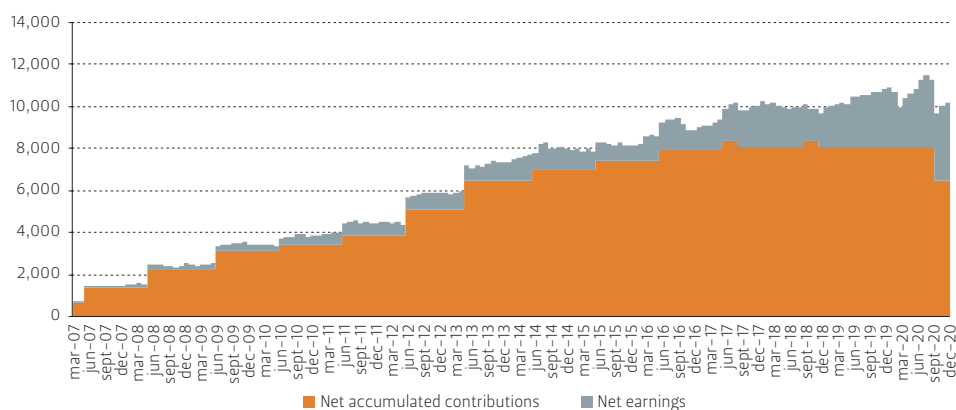
ESSF: Market value, March 2007 to December 2020
(millions of dollars)



SOURCE: Ministry of Finance of Chile

FIGURE 23

PRF: Market value, March 2007 to December 2020
(millions of dollars)



SOURCE: Ministry of Finance of Chile

28 See Chapter 1, Section B, and Box 2.

C. Returns

In 2020, the net return in dollars was 8.03% in the ESSF and 9.26% in the PRF (see Table 5).

For the ESSF, the positive return breaks down into a 7.94% return on the fixed-income portfolio, and 15.87% return on the equity portfolio. The fixed-income return is the sum of 3.44% yields on instruments in local currency and 4.35% due to exchange rate fluctuations against the dollar of the currencies in which these instruments are denominated (see Box 3).

The PRF return breaks down into the STIP, which recorded yields of 0.03%,²⁹ and the LTIP, which grew 11.36% in the year. The latter is explained by a positive performance in all asset classes. In fixed income, the returns were 10.23% for sovereign and government-related bonds, 12.68% for inflation-indexed sovereign bonds, 4.04% for U.S. agency MBS, 10.29% for corporate bonds, and 6.85% for high yield bonds. The PRF equity portfolio yielded 15.06% in the year.

TABLE 5³⁰

ESSF and PRF: Determinants of returns in dollars, 2020
(percent)

Fund	Component	Quarter				2020
		I	II	III	IV	
ESSF	Fixed-income ^(a)	2.66	1.26	2.12	1.67	7.94
	<i>Local currency</i>	3.13	0.43	0.19	-0.30	3.44
	<i>Exchange rate fluctuations</i>	-0.46	0.83	1.93	1.97	4.35
	Equities	-21.26	19.23	7.89	14.39	15.87
	Total return (USD)	0.82	2.22	2.44	2.33	8.03
	Total return (CLP)	14.59	-1.40	-1.56	-7.22	3.19
	Total return (Real in UF)	13.44	-1.74	-1.60	-8.38	0.49
PRF	Sovereign and government-related bonds	1.08	2.35	3.13	3.32	10.23
	Inflation-indexed sovereign bonds	-2.75	6.60	3.58	4.93	12.68
	U.S. agency MBS	2.66	0.79	0.25	0.31	4.04
	Corporate bonds	-5.89	9.18	2.99	4.22	10.29
	High yield bonds	-14.78	11.56	4.66	7.38	6.85
	Equities	-21.30	19.40	7.00	14.43	15.06
	Return LTIP (USD)	-8.23	8.72	4.20	7.12	11.36
	Return STIP (USD)^(b)	-	-	-	0.03	0.03
	Total return (USD)	-8.23	8.72	4.20	5.10	9.26
	Total return (CLP)	4.31	4.87	0.13	-4.71	4.36
Total return (Real in UF)	3.26	4.51	0.09	-5.90	1.63	

(a) For the ESSF fixed-income portfolio, the table presents an estimate of the return in local currency and the return deriving from exchange rate fluctuations affecting the portfolio. The impact of exchange rate fluctuations is approximated and calculated using the benchmark currency allocation, taking into account that the ESSF is invested under a passive mandate. The return in local currency is calculated by subtracting that estimate from the fixed-income return.

(b) STIP return measurement starts on 1 October 2020.

SOURCE: Ministry of Finance of Chile

29 The STIP was implemented on 1 October 2020.

30 Returns for periods of over one year are compound annualized rates. For periods of less than one year, the return corresponds to the change in the given period.

Returns in Chilean pesos depend on the peso-dollar exchange rate: the value of the portfolio expressed in pesos increases (decreases) when the peso depreciates (appreciates) against the dollar. In 2020, the peso appreciated against the dollar, which explains the lower returns in national currency of 3.19% annual in the ESSF and 4.36% in the PRF. The real returns of the funds, which is calculated from the nominal return in pesos, discounting the variation in the UF for the respective period, was 0.49% for the ESSF and 1.63% for the PRF.

BOX 3: Factors affecting returns in the Sovereign Wealth Funds

The investment returns in the Sovereign Wealth Funds depends on a number of factors that affect the different types of instruments included in the different fund portfolios.

For the fixed-income portfolios, the main factors are interest rates, the credit quality of issuers, default, prepayment, and exchange rate fluctuations. Market interest rates directly influence time deposit rates offered by financial institutions and sovereign bond rates at the time of issue. Moreover, changes in the interest rate level affect the price of fixed-income instruments that are traded in the market, especially in the case of medium- and long-term securities, where a rise has a negative effect, and a fall has a positive one. The credit quality of a fixed-income issuer also affects the price at which the security is traded in the market: a deterioration in quality causes the price to fall, while an improvement leads to an increase.¹ Additionally, all fixed-income instruments have some level of probability of default, that is, the probability that the issuer will not pay either the interest or the principal (or both). In investment-grade instruments, this probability is very low, but it increases with high-yield bonds.² Prepayment risk, in turn, mainly affects U.S. agency MBS, since the underlying assets are mortgage loans that can be refinanced if interest rates fall. If a mortgage is paid off early, the individual who refinances their mortgage loan returns the value of what is owed to the MBS investor, who loses the present value of future payments that would have been received, which are higher than the mortgages in which they can reinvest.³ Finally, since the funds' performance is measured in dollars and a large share of their portfolios are invested in instruments denominated in other currencies, exchange rate fluctuations against the dollar will have an effect on yields.

For the equity portfolios, returns will largely depend on the market's perception of the issuing corporation's income generation capacity and the risks associated with the company, as well as market financial conditions.

-
- 1 In the case of corporate bonds, credit quality is generally measured through the spread, that is, the difference between the bond's interest rate and the benchmark sovereign interest rate. An increase (decrease) in the spread on a corporate bond is associated with a reduction (increase) in the bond's value.
 - 2 To mitigate this risk in high-yield bonds, the contracted external managers carry out an exhaustive analysis of each issuer in order to avoid these defaults to the extent possible.
 - 3 Prepayment risk also affects some corporate bonds that give the issuer the option of paying off the issued debt early (i.e., callable bonds).

Since the inception of the funds, the annual return in dollars as of year-end 2020 was 2.98% for the ESSF and 4.27% for the PRF. Expressed in Chilean pesos, the annual return for this full period was de 5.07% for the ESSF and 6.38% for the PRF. Finally, the real annual return since inception was 1.62% for the ESSF and 2.89% for the PRF.

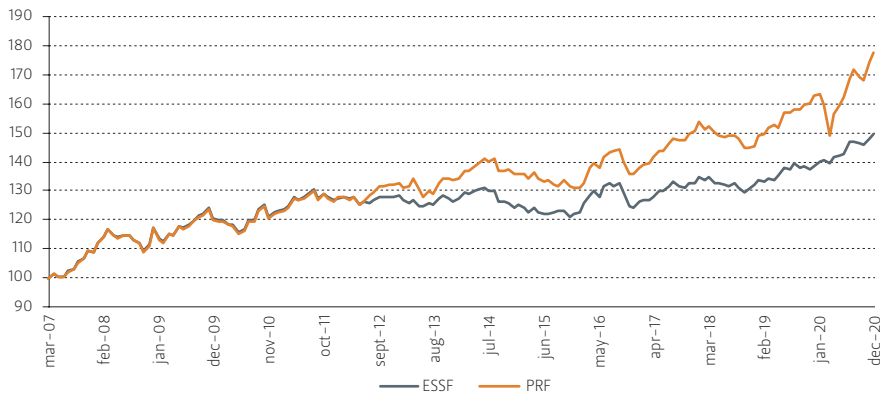
In 2020, the return for the ESSF was 12 basis points higher than its benchmark. For the PRF the return was 109 basis points lower than its benchmark. Since 31 March 2007, the difference between the average annual return of the ESSF and PRF and their benchmarks was -3 basis points and -29 basis points, respectively.³¹

Figure 24 shows the index of accumulated returns for each fund. For the ESSF, the index increased 49.7% between 31 March 2007 and year-end 2020; for the PRF, the increase was 77.6% in the same period. The figure illustrates how the two funds' returns began to differentiate in 2012, when the PRF investment policy was changed.³²

The internal rate of return in 2020 was 7.85% and 8.89% for the ESSF and PRF, respectively.

FIGURE 24

ESSF and PRF: Accumulated returns index, in dollars
(31 March 2007 = 100)



SOURCE: Ministry of Finance of Chile

31 This means that the manager's portfolio generated lower returns, on average, than the implicit benchmark portfolio in the full period (2007–2020).

32 The investment policies of both funds were identical before 2012.

CHAPTER 3

Activities and
Recommendations
of the Financial
Committee

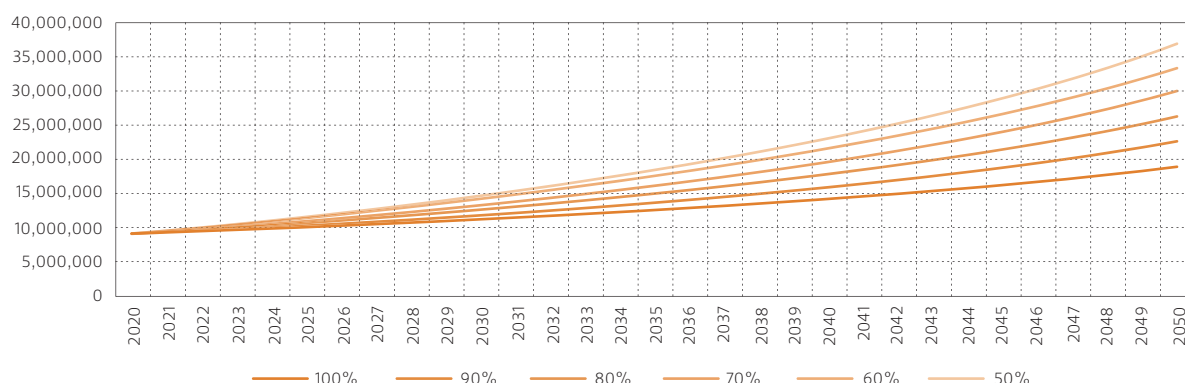
A. PRF forecasts

At its June meeting, the Financial Committee analyzed the most recent projections available for the PRF. These forecasts incorporate the legal modifications introduced in late 2019, which increase the Solidarity Pillar benefits, and in 2020, which suspend contributions to the fund in 2020 and 2021 and also increase the amount that can be withdrawn in those same years to support Fisco funding during the pandemic.³³

Figure 25 presents the pre-reform PRF forecast under different withdrawal assumptions, where fund contributions equal the minimum allowable (0.2% of the previous year's GDP). As the figure shows, whether the assumed withdrawal is equivalent to 50% or 100% of the maximum allowed under the Fiscal Responsibility Law, the PRF would have increased its value in the long term. Notably, in the scenario in which the allowed maximum is withdrawn, the annual contributions to the fund would largely have financed the projected withdrawals, and therefore the fund's capital would have remained relatively stable, increasing mainly due to the profitability of investments.

FIGURE 25

PRF value under a scenario of no reforms, by withdrawal percentage
(millions of 2020 pesos)



SOURCE: Budget Office.

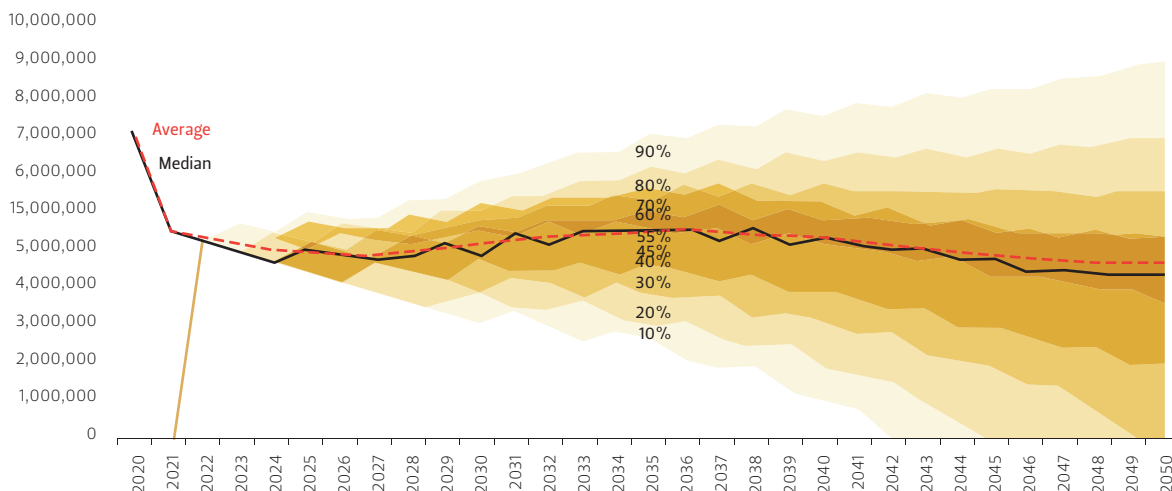
The aforementioned reforms had a significant impact on the expected evolution of the fund. To illustrate, Figure 26 presents the PRF forecasts incorporating randomness in the fiscal balance sheet performance such that, in given periods and with a given probability, the economy records fiscal deficits and surpluses.³⁴ Stochastic forecasts indicate that, assuming withdrawals equivalent to the maximum allowed under current legislation, the value of the PRF in 2050 is lower than year-end 2019 for 90% of the distribution, while the median value in 2050 is somewhat lower than year-end 2021. The fund runs out starting in 2043 for distributions below the twentieth percentile. For distributions above the seventieth percentile, the fund's equity is sustainable relative to year-end 2021.

33 For more information, see L. González and J. Rivera (2020), "Nota de investigación: proyección de la sostenibilidad fiscal del Fondo de Reserva de Pensiones, 2020-2050," Budget Office, Ministry of Finance, Chile.

34 As established in the Fiscal Responsibility Law, if the fiscal surplus is over 0.2% of the previous year's GDP, that surplus must be contributed to the PRF, up to a maximum of 0.5% of the previous year's GDP.

FIGURE 26

PRF value under a stochastic scenario with reforms
(millions of 2020 pesos)



SOURCE: Budget Office

B. Changes to the ESSF and PRF investment policies

Economic and Social Stabilization Fund

In late 2019, the Financial Committee was informed by the International Finance Coordinator that the ESSF would record withdrawals of around US\$ 4.0 billion dollars between 2020 and 2021, equivalent to about 33% of the fund's value in 2019. In this context, the Committee considered that it would be prudent to reduce equity exposure from 7.5% to 5.0%, taking into account the following observations:

- It is prudent and logical for an investor facing upcoming disbursements to maintain a less volatile portfolio than a longer-term investor.
- The ESSF portfolio was designed for an indefinite horizon of withdrawals tied to uncertain, but not immediate macroeconomic factors.
- In the scenario of expected withdrawals, the ESSF can be thought of as a set of two sub-portfolios:
 - The first contains expected disbursements in 2020 and 2021, in which the 7.5% equity share under the current strategic asset allocation is redistributed into the fixed-income component. This sub-portfolio accounted for approximately one-third of the ESSF in early 2020.
 - The remainder, equivalent to two-thirds of the fund, would continue to be invested according to the strategic asset allocation in place at the start of the year, which includes a 7.5% equity exposure.
- Reducing the portfolio share of equities from 7.5% to 5.0% in the consolidated ESSF is equivalent to segregating the two sub-portfolios.

This change was implemented on 1 April 2020.

Pension Reserve Fund

In the case of the PRF, after taking into account the impact on the fund of the reforms described in Section A of this Chapter, the Finance Minister considered it prudent to stop convergence to the new investment policy defined in late 2017.³⁵ The basis for this decision is that the PRF now has a lower risk tolerance because the size of the fund will contract by 40% in two years, while cash needs could increase considerably relative to fund size starting in 2022. In this scenario, the Minister asked the Financial Committee to review the PRF investment policy.

The Financial Committee recommended dividing the PRF portfolio into two sub-portfolios. The first, the STIP, would contain expected disbursements in 2020 and 2021 and would be invested in highly liquid, dollar-denominated instruments that are exposed to a very low probability of loss.³⁶ Thus, the Committee's recommendation was to invest primarily in U.S. Treasury bills, with a small share in bonds with a maturity between one and three years, issued by the government of the same country. The second portfolio, the LTIP, would continue to be invested at a longer-term investment horizon. In this scenario, the Financial Committee recommended maintaining the strategic asset allocation in place for the PRF since January 2020, taking into account that this is more conservative than the policy approved in 2017, since only 31% is invested in equities and not 40%, and it excludes the illiquid investments associated with the real estate sector. The Committee further recommended that the fiscal authorities should decide whether or not to implement currency hedging, which had been approved as part of the 2017 investment policy, taking into account the Budget Office's report on the impact of settling currency forwards on the fiscal balance sheet (see Section G in this Chapter).³⁷

C. Selection process for external equity and corporate bond portfolio managers

Based on the Financial Committee's recommendation, in early March 2020 the Finance Ministry asked the CBC to initiate a process for selecting external fund managers that would be responsible for managing equity and corporate bond mandates in the PRF, taking into account that the current managers of these portfolios—namely, BlackRock and Mellon for equities and BlackRock and Allianz for corporate bonds—had been contracted in January 2012.

The process began in March when a Request for Information was sent to 136 firms that might be interested in participating. The list of firms contacted was drawn up using a database provided by consulting firm RVK, together with information from the CBC and the Finance Ministry on firms that had shown interest in participating in a previous selection process. A total of 14 firms expressed interest in the equity mandate and 15 in the corporate bond mandate. Based on the responses received, the CBC worked with RVK to narrow the field to eight for each asset class. These firms were then sent a Request for Proposal, aimed at measuring their portfolio management capacity in both qualitative and quantitative terms. The CBC and RVK evaluated the proposals received and chose four firms for each asset class, which were interviewed remotely by the Bank, RVK, and personnel from the Ministry.

Subsequently, each firm was rated on their Request for Proposal, interview, and a due diligence carried out by RVK, using a weighted point system, and the Central Bank chose the three firms with the highest score in each mandate. Details on the selection process and the resulting finalists were presented to the Financial Committee at its meeting

35 For more information on the PRF investment policy that was approved by the Finance Minister in 2017 and the associated implementation plan, see the Financial Committee's 2019 Annual Report.

36 The STIP will be left without funds following the scheduled withdrawals in 2021.

37 For more information on the PRF investment policy, see Chapter 1, Section D.

in August 2020. The Committee gave its approval of both the selection process carried out by the CBC and the finalist firms. The CBC then proceeded to the final step in the selection process, reviewing the cost proposals to choose the two least expensive firms. The winning firms were Mellon and UBS for equities and Credit Suisse and UBS for corporate bonds.

With regard to equity managers in the ESSF, the Committee recommended that only one manager handle this asset class in the fund.³⁸ Because the size of the fund—and therefore its equity portfolio—will continue to shrink, maintaining two managers would result in their portfolios falling below the minimum size required for efficient management.³⁹ In this scenario, the Financial Committee recommended choosing one of the equity finalists from the PRF selection process, given that equity investments are identical in the two funds. Thus, in September 2020, the Finance Minister instructed the CBC to request a new cost proposal from UBS and Mellon, applicable solely to the ESSF, which resulted in UBS being selected based on their lower costs.

The transfer to the new portfolio managers was implemented on 1 December 2020 for both funds.

D. ESSF investment policy study

The ESSF investment policy was defined in 2012, based on recommendations from the Financial Committee and a study carried out by Eduardo Walker (2011). At that time, the currency mix was adjusted (with a reduction in the share of dollars and euros and an increase in yen), and the diversification of the investment portfolio was increased, adding sovereign instruments denominated in Swiss francs (7.5%) and a small equity share (7.5%). These changes were implemented in mid-2013. In addition, as described above, the equity share was reduced in 2020 from 7.5% to 5.0%, considering that the fund would record significant withdrawals in 2020 and 2021.

Based on best practices, which include a periodic review of investment policies, and the Committee's recommendation, the Minister commissioned a study from RVK, which has been contracted to support the Ministry on issues related to the investment of the sovereign wealth funds.

RVK made an initial presentation to the Committee at its April 2020 meeting. The team of presenters discussed possible fund objectives; suggested asset classes for consideration; explained the methodology for estimating return assumptions, volatility, and covariance between different asset classes; and provided their estimates of each. They also presented a preliminary exercise on the efficient frontier with different portfolios and Monte Carlo simulations to illustrate the methodology that would be used in a more advanced phase of the study to obtain the optimal portfolio. Finally, they explained how the fund's expected cash flows could be incorporated into the definition of the strategic asset allocation.

Based on this presentation, the Financial Committee submitted the following comments to RVK:

- They suggested that the study be carried out in Chilean pesos and in real terms; that the expected return, variance, and covariance parameters for the different asset classes be estimated in those terms; and that the study take into account the impact of the COVID-19 crisis.

³⁸ Since August 2013, the equity portfolio has had two managers: BlackRock and Mellon.

³⁹ With a very small portfolio, the fixed custody costs are relatively higher, and investment becomes more difficult since there are not sufficient resources to fully replicate the benchmark, which would require a larger sampling and risk budget.

- They proposed that the analysis should explicitly incorporate the currency composition that allows meeting the fund's investment objectives.
- They recommended running stress tests on financial and economic variables that could be affected by COVID-19 and analyzing the impact on the portfolios recommended by the consultant.
- They suggested that the consultant identify the main risks affecting the ESSF investment portfolio.
- Considering how sensitive mean-variance optimization models are to the entry parameters, they suggested sensitizing the estimated expected returns for each asset class by ± 50 bp and ± 100 bp.
- They proposed extending the deadline for submitting the study in order to give the consultant a little more time to better assess the impact of COVID-19.

RVK indicated that they would incorporate these recommendations in the next version of the study, and they agreed with pushing back the delivery date, given the uncertainty in the global economy due to the pandemic.

Finally, in December 2020 the Financial Committee agreed with RVK's suggestion to reinstate the study in January 2021, when the firm undertakes an annual review of the assumptions used in modeling each asset class. The study is expected to be finished in the first half of 2021.

E. Monitoring of ESSF and PRF external fund managers

The Financial Committee received delegations from the CBC, Mellon, BlackRock, Allianz, Nomura, BNP Paribas, and Western Asset, which are required to report annually on their portfolio management to the members of the Committee and the Finance Ministry. In their presentations, the different fund managers described their portfolio performance, explained the underlying reasons for that performance, described their investment methodologies and main positions, and reported on any organizational or team changes that could affect their portfolio management. They also analyzed the situation in the markets, which were strongly affected by the global pandemic. These visits are part of the mandatory activities through which the external fund managers are required to report on their performance.

F. Definition of the Strategic Contingency Fund investment policy

Law N° 21,174, published in September 2019, establishes a new mechanism for funding National Defense strategic capabilities. One of the main measures introduced by the law is the creation of the Strategic Contingency Fund (SCF), whose objective is to fund military equipment and infrastructure and the cost of maintaining a military to face events of an external war or international crisis that represents a serious threat to the external security of the Republic.

The law establishes that the fund will be invested in accordance with the same guidelines that regulate the investment of the sovereign wealth funds. Similarly, for the purposes of making financial investment decisions regarding the fund, the Finance Minister will receive advisory support from the Financial Committee.

In this capacity, after reviewing information provided by the Budget Office in relation to the currency in which the fund's resources will be used and the uncertainty surrounding the timing of fund contributions and withdrawals, the Committee recommended a conservative investment policy that prioritizes liquidity and capital preservation.

Thus, the Committee recommended investing 60% of the fund in money market instruments, with half invested in bank time deposits and the other half in U.S. Treasury bills, and 40% in U.S. government bonds with a maturity of 1–3 years. The strategic asset allocation of the SCF and the associated benchmarks are presented in Table 6.

TABLE 6

SCF: Strategic asset allocation and the benchmarks
(percent of portfolio)

Asset class	Percent of the SCF	Benchmarks
Money market	30.0	Bank assets: ICE BofA US Dollar 3-Month Deposit Bid Rate Average Index (ticker: Bloomberg L5US)
	30.0	Treasury bills: ICE BofA US Treasury Bills Index (ticker: Bloomberg GOBA)
	60.0	Subtotal
Sovereign bonds	40.0	Bloomberg Barclays Global Aggregate—Treasury: U.S. 1–3 Yrs (ticker: Bloomberg LT01TRUU)
	40.0	Subtotal
Total	100.0	

SOURCE: Ministry of Finance of Chile

The Committee recommended that the SCF be invested exclusively in dollars and in the issuers and instruments included in the benchmark. In the case of time deposits, only banks with a credit rating of A– or higher are eligible.

The CBC will manage the SCF portfolio and must comply with a risk budget defined as an ex-ante tracking error of 20 basis points.

Due to the economic effects of the pandemic, the period for transferring the resources to the SCF, which was originally set at six months starting on 31 December 2019, was extended to 24 months under Law N° 21,225.

G. Impact of a PRF currency hedging program on the fiscal balance sheet

The Budget Office gave a presentation to the Committee on its analysis of the potential impact of a currency hedging program in the PRF on the fiscal balance sheet. The conclusions of the analysis are as follows:

- At the start of a transaction, both the derivative contract and the fixed-income asset are recorded on the Treasury's balance sheet as a financial asset or liability, as appropriate. For the budget, they are recorded as a purchase or sale of financial assets, which does not affect the fiscal deficit or surplus in the period.
- According to the International Monetary Fund's guidelines, unrealized holding gains or losses must be recorded on the statement of other economic flows, which currently is not prepared with the fiscal statistics. In the current accounting records, changes in the market value of financial assets are recorded in balance sheet accounts (equity accounts).
- The collateral associated with the derivative contract must be recorded in balance sheet accounts, as either a financial asset or liability.
- On the expiration or settlement of a derivative contract, the payments associated with the contract are recorded in the budget as other income or expense on the statement of operations, as appropriate, with an impact on the deficit or surplus in the period. For example, if the dollar sale price in the derivative contract is higher than the market price, a cash settlement or payment will be received on the contract maturity date, which must be recorded as "other revenue" or "realized losses" on the statement of operations, reducing the fiscal deficit or increasing the surplus in the period.

- Interest earned on the maturity of a fixed-income asset must be recorded as revenue from state-owned assets on the statement of operations, with a positive impact on the deficit or surplus in the period. The recovery of capital is recorded as a sale of financial assets with an offsetting entry in the cash account, so there is no effect on the asset side of the fiscal balance sheet.
- Finally, the budget and accounting records that are currently maintained for the PRF fixed-income portfolio do not generate new impacts on fiscal statistics. However, the implementation of a currency hedging program will generate positive or negative impacts on the fiscal deficit or surplus for the period, given that new cash flows will have to be incorporated on the expiration or settlement of the derivative contracts.

The Committee thanked the Budget Office for the analysis while noting that choosing not to implement currency hedging in the PRF for purely accounting reasons would sacrifice some of the benefits, such as reducing the volatility of returns measured in pesos and improving the fund's risk-adjusted return. That said, the fiscal authorities are the ones to decide whether or not the implementation of the hedging program is merited.

APPENDIX 1 CURRENT AND FORMER FINANCIAL COMMITTEE'S MEMBERS

Members	Position	Incorporation Date	Departure Date
José De Gregorio Rebeco	President	September 2014	-
Cristián Eyzaguirre Johnston	Counselor Vice-President	March 2010 September 2011	
Ricardo Budinich Diez	Counselor	August 2016	-
Jaime Casassus Vargas	Counselor	September 2014	-
Martín Costabal Llona	Counselor	August 2007	-
Paulina Yazigi Salamanca	Consejera	September 2018	-
Igal Magendzo Weinberger	Counselor	September 2014	September 2018
Eduardo Walker Hitschfeld	Counselor	August 2007	August 2016
Arturo Cifuentes Ovalle	President Counselor	January 2014 August 2011	August 2014
Rodrigo Valdés Pulido	Counselor	February 2014	April 2014
Eric Parrado Herrera	Counselor	August 2011	March 2014
Klaus Schmidt-Hebbel Dunker	President Counselor	August 2011 September 2009	January 2014
Andrés Bianchi Larre	President	August 2007	August 2011
Ana María Jul Lagomarsino	VicePresident	August 2007	August 2011
Andrés Sanfuentes Vergara	Counselor	August 2007	March 2010
Oscar Landerretche Moreno	Counselor	August 2007	June 2009

APPENDIX 2 SUMMARY OF MEETINGS IN 2020⁴⁰

MEETING 1 | 24 JANUARY 2020

In its first meeting of the year, the Committee analyzed the final conclusions of the sustainability study for the Pension Reserve Fund (PRF) carried out by a consultant team led by Eduardo Fajnzyblber. The study found that the fund will face increasing pressure in the coming years, as shown by some sensitivity analysis exercises that include the impact of the short law on the Solidarity Pillar passed in late 2019. The Members discussed the Committee's work plan for 2020, in the context of the implementation of the PRF investment policy that was approved by the Finance Minister in November 2017. They recommended starting the selection process in 2020 to contract external managers for the PRF equity and corporate bond mandates, considering that the firms that were managing those mandates at that time had been contracted in late 2011. A suggestion was made to wait for the results of the tax review being carried out by Ernst & Young before deciding on the timing and method for implementing investment in the real estate sector. With regard to currency hedging in the fixed-income portfolio, the Committee recommended waiting for the Budget Office's report on the potential impact of hedging on the fiscal balance sheet. Additionally, they analyzed the advisability of maintaining the current strategic asset allocation of the ESSF, taking into account the fund's evolution in the coming years. In this scenario, they recommended reducing the equity exposure from 7.5% to 5.0% so as to reduce the risk of the total ESSF portfolio.

MEETING 2 | 13 MARCH 2020

In the second meeting of the year, the Financial Committee received the Finance Minister, Ignacio Briones, and a delegation from the CBC, headed by the Director of the Financial Markets Division. The Finance Minister opened the meeting by thanking the Committee for its work since the inception of the sovereign wealth funds, highlighting the role it has played in the definition of investment policies for both the ESSF and the PRF. The CBC then reported on its asset management performance for both funds in 2019, the main positions held, and the results of an internal assessment of the current custody services. Finally, the CBC presented a detailed timeline of the selection process for external equity and corporate bond portfolio managers for the PRF. Subsequently, the Committee expressed its agreement with the Technical Secretariat's recommendations on the strategic asset allocation for the Strategic Contingency Fund created by Law N° 21.174, which establishes a new mechanism for funding National Defense strategic capabilities. It also outlined the structure of the presentation on the ESSF strategic asset allocation study, to be made by the consulting firm RVK in April.

MEETING 3 | 24 APRIL 2020

In its third meeting, the Committee met with a delegation from BlackRock, which invests part of the ESSF and PRF investment portfolios. All external fund managers are required to give an annual presentation to the Committee Members to report on their performance. BlackRock described their organization, investment processes, and main investment results in 2019 and early 2020, in relation to their equity, corporate bond, and high-yield bond mandates. The presentation also addressed the situation in the markets, with a focus on the effects of the COVID-19 pandemic. Subsequently, RVK gave its first presentation on the ESSF stra-

40 Due to the pandemic, all the Financial Committee's meetings were held remotely starting in April 2020.

tegic asset allocation study. The Committee Members expressed their viewpoints, exchanged opinions on the methodology and assumptions used, and recommended extending the deadline for submitting the study in order to better incorporate the impact of the pandemic on the financial assets in which the fund is invested. Next, the Financial Committee's Technical Secretariat reported on recent legal changes that have been approved as part of the measures announced by the government to face the economic effects of the pandemic, which have implications for the sovereign wealth funds. Finally, the Committee reviewed the results of the Request for Information phase of the selection process for external equity and corporate bond portfolio managers for the PRF, being carried out by the CBC.

MEETING 4 | 19 JUNE 2020

The Financial Committee's fourth meeting featured a presentation by representatives of Nomura, which invests a share of the PRF high-yield bond portfolio. The discussion covered the firm's organization, investment processes, and main investment results in 2019 and the first half of 2020, together with an analysis of the current market situation, focusing on the effects of the COVID-19 pandemic. The Budget Office then presented the conclusions from its analysis of the potential impact on fiscal and budget accounting of the implementation of a currency hedging strategy in the PRF. Finally, the Committee analyzed the most recent forecasts for the PRF, which included the legal modifications approved by Congress in March and April 2020 to shore up the fiscal position in the context of the pandemic and its effects on the economy. The analysis showed that the size of the PRF will decrease significantly by year-end 2021, and it could continue to shrink thereafter if withdrawals continue to record the maximum allowed under the current legislation while contributions do not exceed the minimum allowed under the Fiscal Responsibility Law. In this scenario, the Committee was informed of the Finance Minister's decision to halt convergence to the PRF investment policy approved in late 2017 and his request that the Committee make recommendations on adjusting the policy to incorporate the most recent fund forecasts. Based on an analysis by the Technical Secretariat, the Committee recommended dividing the PRF into two sub-portfolios. The first would contain expected disbursements for 2020 and 2021, which would be invested in highly liquid, low risk assets. The remainder would be invested in a portfolio with a higher risk tolerance in line with the strategic asset allocation in place for the fund since January 2020.

MEETING 5 | 14 AUGUST 2020

At its fifth meeting, the Committee received the delegation from Allianz, an external manager that invests part of the PRF's corporate bond exposure. The firm first described its organization, strategy, and investment team; summarized its investment results in 2019 and the first half of the current year; and presented its analysis of the fixed-income market, with a special focus on the measures that have been adopted in the face of the COVID-19 pandemic. Subsequently, the CBC, in its role as fiscal agent, presented the results of the Request for Proposal phase of the selection process for external equity and corporate bond portfolio managers for the PRF. Based on the proposals, the Bank suggested three finalist firms for each asset class. The choice was based on a weighted point system that took into account the responses to the Request for Proposal, a round of interviews held jointly by personnel from the CBC, the Ministry, and RVK, and the due diligence carried out by RVK. In this context, the CBC reported to the Committee Members that the next phase in the selection process would consist in opening the finalists' cost proposals, and the mandates would then be awarded to the two firms with the lowest management fees. The CBC reported to the Committee that it expected to inform the winning firms of the results of the process in August 2020. Next, RVK gave a presentation on the pros and cons of the passive, semi-passive, and active management styles for investing global high-yield bonds, in the context of the strategies used by BlackRock and Nomura, two of the external fund managers. Finally, the Committee's Technical Secretariat reported that it was processing the new PRF investment guidelines, which incorporate a more conservative portfolio.

MEETING 6 | 23 OCTOBER 2020

At its sixth meeting, the Committee met with the team from Western Asset, one of the external managers responsible for investing a share of the PRF's U.S. agency MBS portfolio. The CBC participated in the meeting, as it is responsible for supervising the firm's performance. The presentation covered the firm's organization, investment processes, and main investment results from the start of the mandate in January 2019 to date. The Committee's Technical Secretariat then reported on the results of the selection process for external equity and corporate bond portfolio managers, indicating that in the case of the PRF, the winning firms were Mellon and UBS for equities and Credit Suisse and UBS for corporate bonds, based on their cost proposals. The Technical Secretariat further reported that following the Committee's recommendations, only one equity manager would be used for the ESSF, and that to this end, cost proposals had been requested from the firms contracted for the PRF. The Committee was informed that UBS had been chosen for this mandate. The Committee expressed its agreement with the process and results. Finally, the Technical Secretariat reported that a withdrawal of US\$ 1,576 million had been made from the PRF on 1 October to comply with obligations associated with the Solidarity Pillar and that on the same day the STIP had been constituted via a transfer of US\$ 2,805 million, which is the estimated amount that is expected to be disbursed in 2021. The remainder of the fund, approximately US\$ 6,950 million, continues to be invested in the LTIP, in accordance with the strategic asset allocation in place for the fund since January 2020.

MEETING 7 | 18 DECEMBER 2020

The final meeting of the year included presentations by representatives of BNP Paribas, one of the external managers responsible for investing part of the PRF's U.S. agency MBS portfolio, and Mellon, which invests a share of the PRF equity portfolio, and which had managed a share of the ESSF equity portfolio from August 2013 to late November of this year. The CBC also participated in the meeting, as it is responsible for supervising the performance of BNP Paribas. This latter firm discussed its organization, presented the main investment results from the start of its mandate in January 2019 to date, and explained its investment strategy. Next, Mellon gave a presentation on its organization and investment teams, its 2020 results and historical performance, and the main factors affecting its performance. The Technical Secretariat reported that on the first of December it had transferred the corresponding funds to the new PRF and ESSF external portfolio managers. Finally, the Committee recommended that the ESSF investment policy study, commissioned from the international consulting firm, RVK, should be reinitiated in January 2021.

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Glossary

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

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

American depositary receipts (ADR) — negotiable certificate issued by a U.S. bank representing a specified number of shares (or one share) in a foreign stock traded on a U.S. exchange.

Asset class — a specific investment category such as equities, corporate bonds, sovereign bonds or money market instruments. Assets of the same class generally share characteristics that make them similar from a tax, legal and structural perspective, but this does not imply that they respond the same way to a given market event.

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

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

Cash — cash in hand and bank demand deposits.

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

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

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

Duration — a measure of the sensitivity of a bond's price to changes in interest rates: the longer the duration, the farther the bond's price will fall in response to an increase in interest rates.

Equities — securities that represent the ownership or capital of a company; buyers of equities become owners or shareholders of the company and thus have earnings or losses depending on the company's performance.

Ex ante tracking error — a measure of the difference between the return on an investment fund and its benchmark.

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

Fiscal Responsibility Law — Law N° 20,128, published in Chile's Official Gazette on 30 September 2006.

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

Global depositary receipts (GDR) — bank certificate issued in more than one country for shares in a foreign company. The shares are held by a foreign branch of an international bank. The shares trade as domestic shares but are offered for sale globally through the various bank branches.

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

High Yield Bonds — non investment grade sovereign and corporate bonds.

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

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

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

Leverage — the level of debt carried by a firm or investment vehicle.

LIBID — London interbank bid rate; the interest rate paid on interbank deposits. By definition, this rate is equal to the LIBOR minus 0.125%.

LIBOR — London interbank offered rate; the interest rate charged on interbank borrowing.

Liquidity — The degree to which an asset or security can be quickly bought or sold in the market without affecting the asset's price.

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

Mortgage-backed securities (MBS) from U.S. agencies — instruments that are secured by a mortgage related to the purchase of mortgage properties. These instruments are issued by Ginnie Mae, Fannie Mae and Freddie Mac.

Mutual fund — an investment vehicle managed by an entity that brings together the capital of different investors and provides them with exposure to different asset classes; unlike ETFs, mutual funds are not traded on the market.

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

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

Quantitative easing — an unconventional monetary policy tool used by some central banks to increase the money supply, usually through the purchase of the country's own government bonds.

Recognition bond (bono de reconocimiento) — an instrument issued by Chile's Pension Normalization Institute (Instituto de Normalización Previsional) representing a worker's contributions to the old pension system before joining the new (private) AFP system.

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

Return generated by exchange rate movements — the share of the return that is generated by variations in the value of the dollar against other currencies in which assets are held.

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

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

Sovereign bond — a bond issued by a government.

Special Drawing Rights (SDR) — international reserve assets created by the IMF to supplement its member countries' official reserves. SDRs can be exchanged for freely usable currencies.

Spread — the difference between the yield rate at maturity of two fixed-income instruments; used to measure their level of relative risk.

Swift — Society for Worldwide Interbank Financial Telecommunication.

TED Spread — the difference between the interbank borrowing rate (LIBOR) and the risk-free rate (U.S. Treasury bills). A higher TED spread typically indicates a lower level of market liquidity.

To Be Announced (TBA) — denotes the forward mortgage-backed securities (MBS) trade, and pass-through securities issued by Freddie Mac, Fannie Mae and Ginnie Mae.

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

Variable-income — equities.

VIX — the Chicago Board Options Exchange (CBOE) Volatility Index, which reflects market expectations for volatility over the next 30 days; based on the implied volatilities of a wide range of S&P500 index options.

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

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