2015

ANNUAL REPORT FINANCIAL COMMITTEE

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

This publication corresponds to the 2015 Annual Report of the
Ministry of Finance's Financial Committee.

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ANNUAL REPORT
FINANCIAL COMMITTEE

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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 ninth prepared by the Committee—describes its work and activities in 2015.

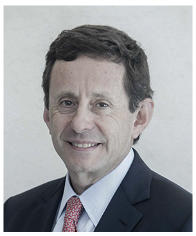
The publication of this Report fulfills the requirement established under Decree N° 621, issued by the Ministry of Finance in 2007, which stipulates that the Committee must present an annual report on its work to the Finance Minister and submit a copy of this report to the Finance Commissions of the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

The Committee

Executive Summary

At the close of 2015, the market value of the funds was US$ 22.078 billion, of which US$ 13.966 billion was in the Economic and Social Stabilization Fund (ESSF) and US$ 8.112 billion was in the Pension Reserve Fund (PRF). The net return in dollars in the year was -1.78% for the ESSF and -3.62% for the PRF, while the net return in pesos was 14.68% and 12.84%, respectively. In the case of the ESSF, the strategic asset allocation was 15% in bank deposits, 74% in sovereign bills and bonds, 3.5% in inflation-indexed sovereign bonds and 7.5% in stocks. For the PRF, the portfolio allocation was 48% in sovereign bonds, 17% in inflation-indexed sovereign bonds, 15% in stocks and 20% in corporate bonds.

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 (SOFOFA 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 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 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 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 Igal Magendzo Weinberger

Mr. Magendzo holds a Ph.D. in Economics from University of California, Los Angeles, and a Bachelor's degree in Arts from the Hebrew University of Jerusalem. Currently, he is Chief Economist at Pacífico, Macroeconomía y Finanzas. He was Chief Economist for Hispanic America at Itaú, Manager of Macroeconomic Analysis at the Central Bank of Chile, Member of the Technical Advisory Committee of Investment, and Professor at Universidad Adolfo Ibáñez and Universidad de Chile. Mr. Magendzo has published his work in specialized financial journals. He joined the Committee in September 2014.

Member Eduardo Walker Hitschfeld

Mr. Walker holds a Ph.D in Finance from the Haas Business School, University of California at Berkeley, and a degree in Business Administration from Universidad Católica de Chile. He currently works as a Full Professor at the School of Business of Universidad Católica de Chile and also serves on the Boards of Directors of private companies and as an International Consultant. He has been a Visiting Associate Professor in the Finance Department of the McCombs School of Business of the University of Texas at Austin; Head of Research at AFP Habitat; Member of the Capital Market Committee, the Risk Rating Commission and Member of the Technical Advisory of Investment established by the Pension Reform. He joined the Committee in January 2007.

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.[1]

Since 2001, Chile's fiscal policy is guided by a structural balance rule or, more precisely, a cyclically adjusted balance rule,[2] which mitigates the effect on public finances of fluctuations in economic activity, the copper price and other secondary factors. This implies saving in boom times and then using the 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 Pension Reserve Fund (PRF) and authorized the President of the Republic to create the Economic and Social Stabilization Fund (ESSF), which was then officially established in February 2007. These two funds receive resources resulting from the application of the structural balance rule.

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, copper and other sources. 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).[3]

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).

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1 Decree N° 892 de 2014, which establishes the basis of fiscal policy, in accordance with the provisions of Article 1° of Law N° 20,128.

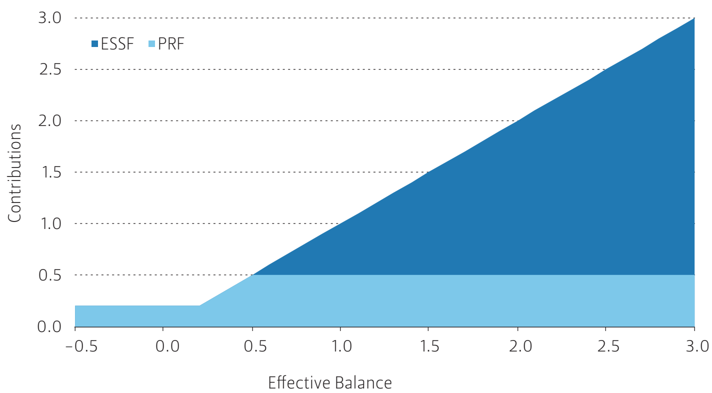
2 The structural balance rule (or cyclically adjusted balance rule) has undergone some changes since it was first implemented. For a detailed discussion of its design, modifications, application and results, see Marcel, Tokman, Valdés and Benavides (2001); García, García and Piedrabuena (2005); Rodríguez, 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); and Velasco and Parrado (2012).

3 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.[4]

FIGURE 1

Fiscal savings rule
(percent of GDP)



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. From that point, 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. Prior to 2016, withdrawals from the PRF are allowed equivalent to the returns generated in the previous year.

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.

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.

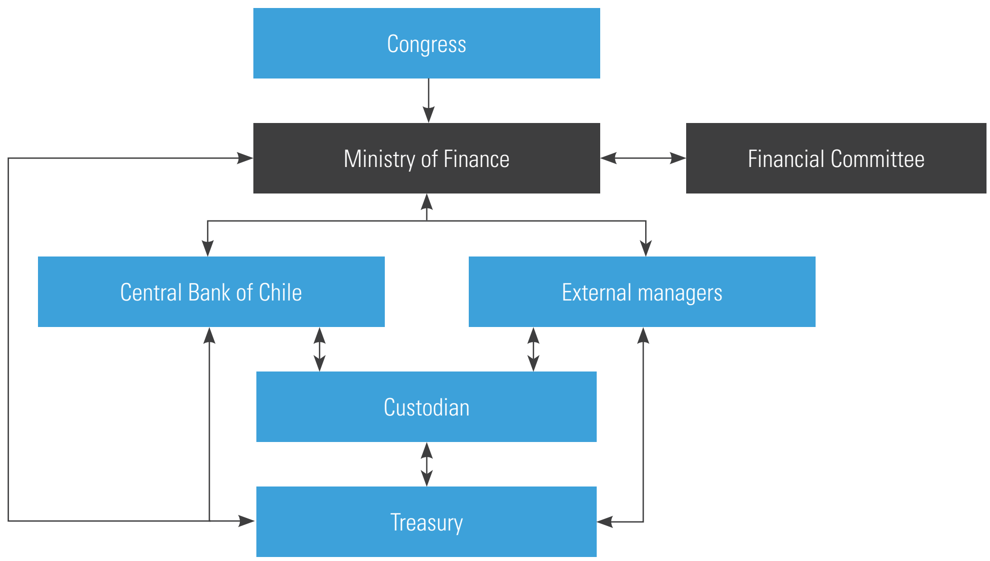
4 The current legislation allows the pay down of public debt and advance contributions to the ESSF using resources from the fiscal surplus of the current year, which must be deposited into the fund in the current or subsequent years.

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 diagram 1).

DIAGRAM 1

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

Executive Decree N° 1,383 (the Agency Decree), issued by the Ministry of Finance in 2006, appoints the Central Bank of Chile (CBC) to act as fiscal agent in the management and investment of the resources in both funds. In carrying out these functions, the CBC must strictly follow the investment guidelines issued by the Finance Minister. The CBC is authorized to delegate part of the management of the sovereign wealth funds to external managers.

Following a careful selection process carried out in 2011, the CBC contracted BlackRock Institutional Trust Company N.A., Mellon Capital Management Corporation and Rogge Global Partners PLC to manage the investment of 35% of the PRF portfolio starting in January 2012. In 2013, based on the recommendation of the Financial Committee, the Ministry of Finance instructed the CBC to contract BlackRock Institutional Trust Company N.A. and Mellon Capital Management Corporation to manage the ESSF stock portfolio, equivalent to 7.5% of the fund, taking into account that their mandate would be identical to the PRF's and that they were recently chosen from the selection process carried out for that fund.

Decree N° 1,618 of 2012 modified the Agency Decree to relieve the CBC of the management of the corporate fixed-income and stock portfolios of the ESSF and the PRF, whose management had been delegated by the CBC, in representation of the Fisco, to the aforementioned companies. In accordance with Decree N° 1,618 of 2012, the CBC's responsibilities with regard to the externally managed portfolios were significantly reduced as of 1 January 2014, being mainly limited to reconciling daily positions. With these changes, the contractual relationship with the external managers and other tasks previously carried out by the CBC were transferred to the Ministry of Finance and the General Treasury.

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 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.

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.

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.[5]

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 passive investment policies. That is, their investment strategy aims to achieve the benchmark return.

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

D. Investment policy

To support the competitiveness of the Chilean economy, the ESSF and the PRF are invested exclusively in foreign currency instruments, in accordance with the investment policy outlined in this section.

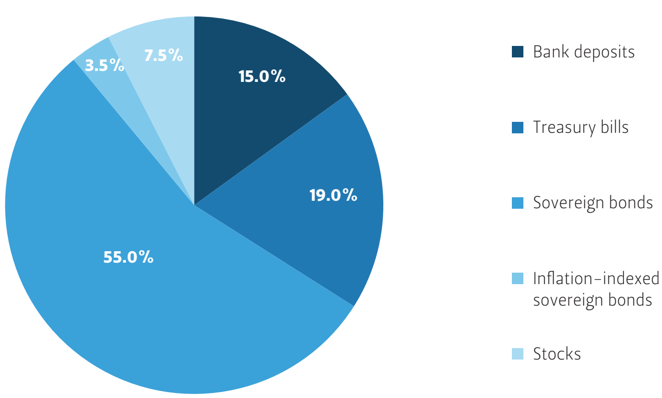
Economic and Social Stabilization Fund

In line with the objectives described above, the main goal of the ESSF investment policy is 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.

From its inception through July 2013, the ESSF investment policy centered on investment in fixed-income instruments denominated in reserve currencies, which typically perform well in times of crisis. However, a new investment policy was implemented in August 2013, which was defined by the Ministry of Finance on the basis of the Financial Committee's recommendations in 2012.[6] This investment policy establishes a portfolio allocation of 15% in bank deposits, 74% in sovereign bills and bonds, 3.5% in inflation-indexed sovereign bonds and 7.5% in stocks (see figure 2). For the fixed-income portfolio, the currency allocation is defined as 40% in U.S. dollars (USD), 25% in euros (EUR), 20% in yen (JPY) and 7.5% in Swiss francs (CHF), expressed as a percentage of the total portfolio. The new policy also increases the duration of the fixed-income portfolio to approximately 4.8 years (see box 2).

FIGURE 2

ESSF: Strategic asset allocation
(percent of portfolio)



SOURCE: Ministry of Finance of Chile

6 The Financial Committee's recommendation was founded on the review and analysis of different sources, including Eduardo Walker's study on portfolio allocation commissioned by the Ministry of Finance, comments on the study contained in three external peer reviews and additional simulations using market data from the last 20 years, carried out by the Ministry of Finance's International Finance team. For more information, see Chapter 3 of the Financial Committee's 2012 Annual Report.

BOX 2: Main elements of the Economic and Social Stabilization Fund (ESSF) investment policy

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% in bank deposits, 74% in sovereign bills and bonds, 3.5% in inflation-indexed sovereign bonds and 7.5% in stocks. 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.

Portfolio benchmarks: A benchmark has been defined for each component of the strategic asset allocation, using a representative market index:

Asset class		Percentage of portfolio	Benchmarks
1. Bank deposits		5.0	Merrill Lynch Libid 3 Month Average USD
		6.0	Merrill Lynch Libid 3 Month Average EUR
		4.0	Merrill Lynch Libid 3 Month Average JPY
		15.0	**Subtotal bank deposits**
2. Treasury bills and sovereign bonds	2.1. Treasury bills	6.0	Merrill Lynch Treasury Bills Index USD
		7.0	Merrill Lynch Treasury Bills Index EUR
		6.0	Merrill Lynch Treasury Bills Index JPY
		19.0	**Subtotal treasury bills**
	2.2. Sovereign bonds	26.5	Barclays Capital Global Treasury: U.S. 7-10 Yrs
		11.0	Barclays Capital Global Treasury: Germany 7-10 Yrs
		10.0	Barclays Capital Global Treasury: Japan 7-10 Yrs
		7.5	Barclays Capital Global Treasury: Switzerland 5-10 Yrs
		55.0	**Subtotal sovereign bonds**
		74.0	**Subtotal treasury bills and sovereign bonds**
3. Inflation-indexed sovereign bonds		2.5	Barclays Capital Global Inflation-Linked: U.S. TIPS 1-10 Yrs
		1.0	Barclays Capital Global Inflation-Linked: Germany 1-10 Yrs
		3.5	**Subtotal inflation-indexed sovereign bonds**
4. Stocks		7.5	MSCI All Country World Index ex Chile (unhedged con dividendos reinvertidos)

The ESSF has implemented a passive management strategy since May 2011, allowing only marginal deviations from the strategic asset allocation.

Management: The ESSF is largely managed by the CBC, which, acting as fiscal agent, manages the fixed-income portfolio (92.5% of total assets). The stock portfolio is managed by external management companies contracted by the CBC following a tender process.

Ex ante tracking error[1]: The ex ante tracking error is capped at 50 basis points for the fixed-income portfolio and 60 basis points for the stock 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 the elegibility criterias used by the CBC in order to invest the internacional reserves and according 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 stock exposure, 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 is also allowed.

Leveraging and the use of derivatives: Leveraging is not allowed.[2] 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.
- Stock portfolio: The use of forwards and swaps is only allowed for foreign currency hedging. In addition, the use of stock 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 consists in restoring the strategic allocation once a year and whenever the share of stocks exceeds the range of 5.5% to 9.5% of the total portfolio. The annual rebalancing is coordinated with fund contributions, to the extent possible.

Investment guidelines: The investment guidelines, which are published in Spanish and available online at the Ministry of Finance website,[3] 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.

1 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.

2 Leveraging is the purchase of assets through debt.

3 http://www.hacienda.cl/english/sovereign-wealth-funds/economic-and-social-stabilization-fund/investment-policy.html.

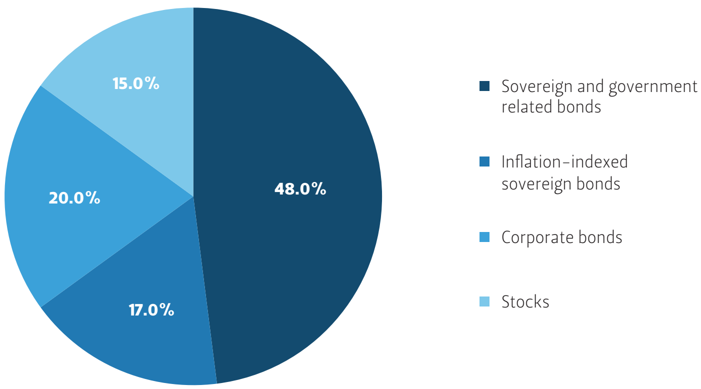
Pension Reserve Fund

The main objective of PRF investment is to generate resources for financing part of the government's pension liabilities. To achieve this, the investment policy incorporates the specific objective of maximizing expected returns while keeping risk within a 95% probability that the fund will not lose more than 10% of its value in dollars in a given year. The investment horizon is medium to long term, given the size and timeline of the liabilities that the fund has to finance.

The PRF investment policy was similar to that of the ESSF from its inception through year-end 2011; a new investment policy was then implemented in early 2012 (see box 3). The new policy stipulates a portfolio allocation of 48% in sovereign and government related bonds, 17% in inflation-indexed sovereign bonds, 15% in stocks and 20% in corporate bonds (see figure 3). The policy was defined by the Finance Minister based on recommendations by the Financial Committee in late 2010.[7]

FIGURE 3

PRF: Current strategic asset allocation
(percent of portfolio)



SOURCE: Ministry of Finance of Chile

BOX 3: Main elements of the Pension Reserve Fund (PRF) investment policy

Investment objectives: The main objective of PRF investment is to generate resources for financing part of the government's pension liabilities. To achieve this, the investment policy incorporates the specific objective of maximizing expected returns while keeping risk within a 95% probability that the fund will not lose more than 10% of its value in dollars in a given year. The investment horizon is medium to long term, given the size and timeline of the liabilities that the fund has to finance.

Strategic asset allocation: The current PRF investment policy, which was implemented in January 2012, stipulates a portfolio allocation of 48% in sovereign bonds, 17% in inflation-indexed sovereign bonds, 15% in stocks and 20% in corporate bonds. The previous investment policy only considered investments in sovereign fixed income and bank deposits.

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

7 The Financial Committee's recommendation was based on a study carried out by the Mercer consulting firm in 2008 (Strategic Assest Allocation Analysis), which is available online at http://www.hacienda.cl/english/sovereign-wealth-funds/relevant-studies.html.

Asset class	Percentage of portfolio	Benchmarks
Sovereign and government related bonds [(a)]	48	Barclays Capital Global Aggregate: Treasury Bond Index (unhedged)
		Barclays Capital Global Aggregate: Government-Related (unhedged)
Inflation-indexed sovereign bonds	17	Barclays Capital Global Inflation-Linked Index (unhedged)
Corporate bonds	20	Barclays Capital Global Aggregate: Corporates Bond Index (unhedged)
Stocks	15	MSCI All Country World Index ex Chile (unhedged con dividendos reinvertidos)

(a) Each subindex of this asset class is added in accordance with its relative capitalization.

Management: The sovereign and government-related bonds and inflation-indexed sovereign bond portfolios are managed directly by the CBC, acting as fiscal agent. The stock and corporate bond portfolios are managed by external management companies contracted by the CBC following a tender process.

Ex ante tracking error: The ex ante tracking error is capped at 50 basis points for the aggregate portfolio of sovereign and government-related bonds and inflation-indexed sovereign bonds; 60 basis points for the stock portfolio; and 50 basis points for the corporate bond portfolio.

Eligible currencies and issuers: For each asset class, only currencies and issuers that make up the benchmark are eligible for investment. In the case of issuers, only those that make up the corresponding benchmark are allowed. However, for stock exposure, the investment in exchange traded funds, mutual funds, American depositary receipts, global depositary receipts, and futures is also permited.

Leveraging and the use of derivatives: Leveraging is not allowed. Derivatives use is differentiated by portfolio:

- Portfolio managed by the CBC: Forwards and swaps can only be contracted for foreign currency hedging. The nominal value of the forwards or swaps contracted with a given eligible counterparty cannot exceed 1% of the market value of the portfolio. The notional amount of all current forward or swap contracts, in sum, can not exceed 4% of the portfolio managed by the Bank.
- Stock and corporate bond portfolios: Each external manager can only contract forwards or swaps for foreign currency hedging, and stock or fixed-income futures for hedging purposes or to gain exposure to part of the benchmark. The nominal value of the forwards or swaps contracted by an external manager with a given eligible counterparty cannot exceed 1% of the market value of the portfolio managed by that external manager. The aggregate nominal amount of futures, forwards and swaps cannot exceed 10% of the portfolio managed by a given external manager.

Rebalancing policy: The rebalancing policy consists in restoring the strategic allocation whenever contributions are received by the fund and whenever any of the asset classes exceeds the following shares of the total portfolio: 45–51% for sovereign and government-related bonds, 14–20% for inflation-indexed sovereign bonds, 17–23% for corporate bonds and 12–18% for stocks.

Investment guidelines: The investment guidelines, which are published and available online at the Ministry of Finance website,[1] provide additional information on the PRF investment policy, such as the rebalancing policy, the permissible range of deviation, eligible instruments and other relevant limits, as well as other aspects of portfolio management.

1 http://www.hacienda.cl/fondos-soberanos/fondo-de-reserva-de-pensiones/politica-de-inversion.html

CHAPTER 2

State of the Sovereign Wealth Funds

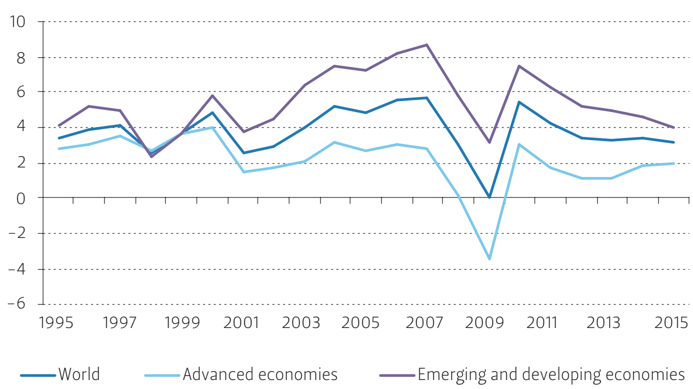
A. Market analysis

Main developments

World growth was moderate in 2015, with an uneven performance among advanced, emerging and developing economies (see figure 4). The estimated GDP growth of low- and medium-income countries was around 4% in 2015, continuing the downward trend that started in 2011.[8] Expected growth for the advanced economies is 2%.[9] Within this group, the United States, the Eurozone and Japan are expected to post higher growth than in 2014 (see figure 5).

FIGURE 4

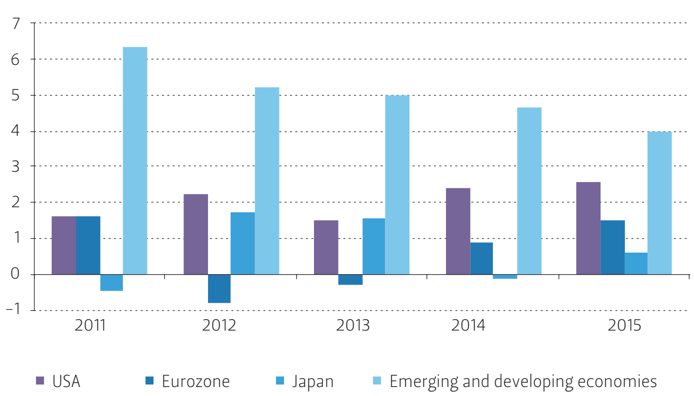
GDP growth, 1995–2015
(percent)



SOURCE: International Monetary Fund

FIGURE 5

GDP of selected economies, 2011–2015
(percent)



SOURCE: International Monetary Fund

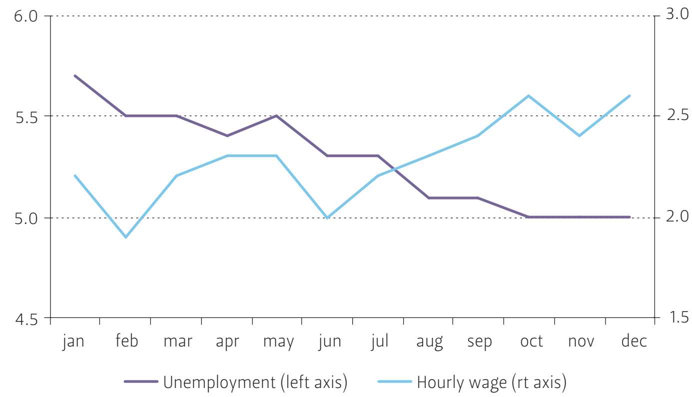
8 International Monetary Fund (IMF) estimates (World Economic Outlook, October 2015).

9 IMF estimates (World Economic Outlook, October 2015).

The U.S. economy grew 2.5% in 2015,[10] with a particularly strong second quarter (3.9%). The unemployment rate fell to 5%, and hourly wages increased relative to the start of the year (see figure 6). Core inflation was relatively stable around the 2% target defined by the U.S. Federal Reserve (the Fed), although it increased slightly in the last quarter (see figure 7). In this context, the Fed decided to increase its reference rate by 25 basis points at its December meeting, thereby starting the monetary policy normalization process.

FIGURE 6

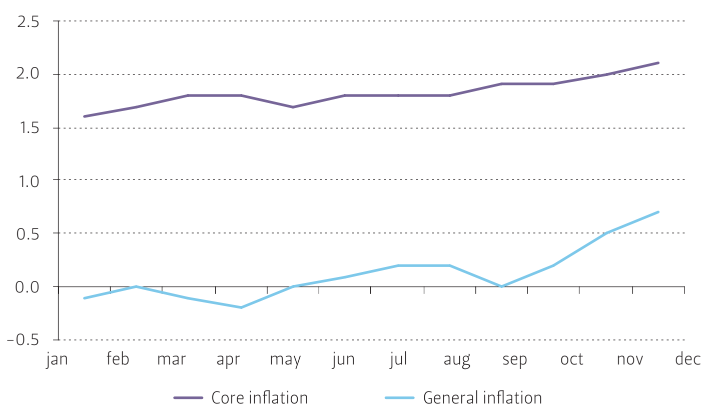
Unemployment rate and wage growth in the United States, 2015
(left: percent)(rt: year-on-year change, percent)



FUENTE: Bloomberg

FIGURE 7

U.S. consumer price index, 2015
(year-on-year change, percent)



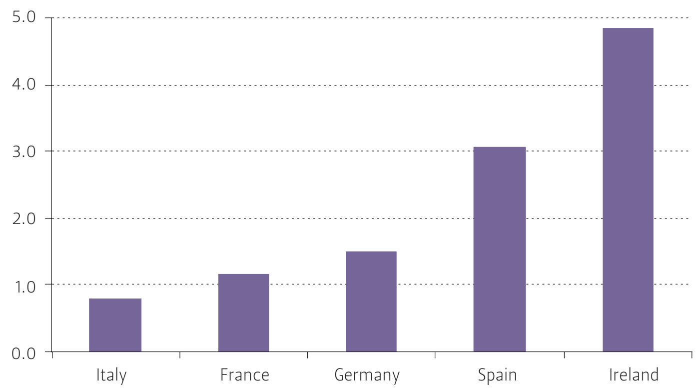
FUENTE: Bloomberg

10 IMF estimates (World Economic Outlook, October 2015).

The Eurozone grew 1.5% in the year. In Germany and France, the largest economies in the Eurozone, GDP grew 1.5% and 1.2% respectively, versus 0.8% in Italy, 1.2% Spain and 4.8% Ireland (see figure 8).[11] Inflation was below the target set by the European Central Bank (ECB), which led to an extension of the quantitative easing program until inflation has returned to its expected path (see figure 9).[12]

FIGURE 8

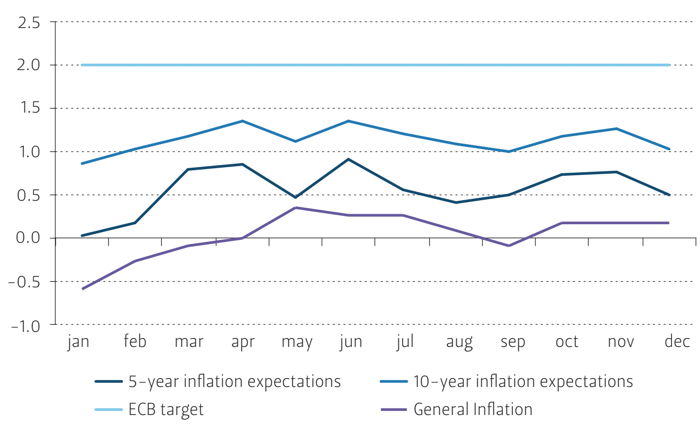
GDP growth in the Eurozone: Selected countries, 2015
(percent)



SOURCE: International Monetary Fund

FIGURE 9

Breakeven inflation expectations (Germany) and actual inflation in the Eurozone,[13] 2015
(year-on-year change, percent)



SOURCE: Bloomberg, European Central Bank, Eurostat

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11 All growth estimates for the Eurozone and its constituent economies are based on IMF estimates (World Economic Outlook, October 2015).

12 In January 2015, the ECB President announced the expansion of the asset purchase program to include debt issued by euro area central governments, agencies and European institutions. Monthly purchases will not exceed 60 billion euros and will be extended through March 2017 or until the price index returns to the inflation target range.

13 Inflation is the Harmonised Index of Consumer Prices, reported by Eurostat.

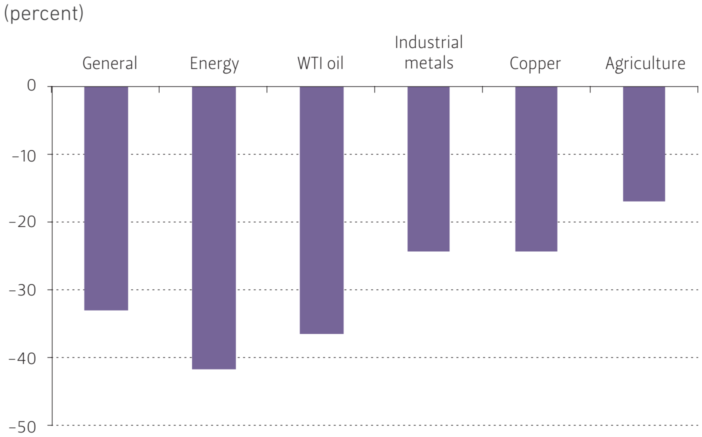
Japan grew 0.6% in 2015,[14] explained by lower external demand, mainly from China, and the difficulties the authorities have encountered in implementing the structural reforms introduced in 2014. In late 2015, the Bank of Japan announced a new 300 billion yen purchase program for exchange-traded funds composed of stocks issued by firms investing in physical and human capital. The central bank also maintained its monetary policy rate and reaffirmed its commitment to the 2% inflation target and to increasing the base monetary base by 80 trillion yen a year.

The growth rate of China in 2015 was 6.9%. This is in line with the authority's target of 7% annual growth, as well as with the government's effort to reorient economic growth toward domestic consumption and services, in a shift away from the previous growth model centered on foreign trade and investment.

With regard to commodities, prices were negatively affected by the uncertainty surrounding the depth of the slowdown in China (see figure 10), which had a depreciation effect on the currencies of commodity exporters. In this context, the U.S. dollar strengthened against the majority of the world's currencies, especially the emerging economies (see figure 11).

FIGURE 10

Commodity yields in 2015: Standard & Poor's, WTI oil and copper (percent)

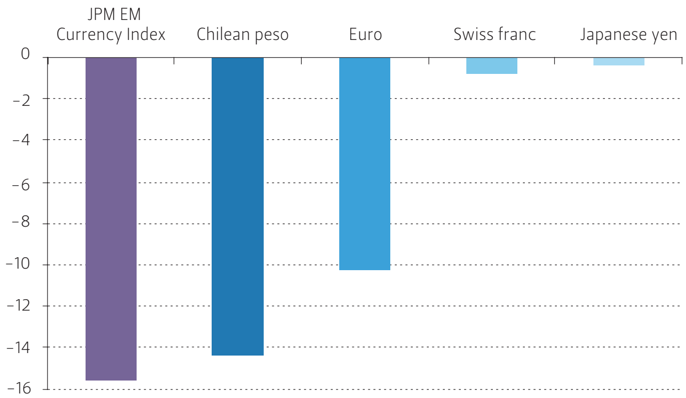


FUENTE: Bloomberg

14 IMF estimates (World Economic Outlook, October 2015).

FIGURE 11

Exchange rate fluctuations against the dollar in 2015: Selected currencies[15]
(percent)

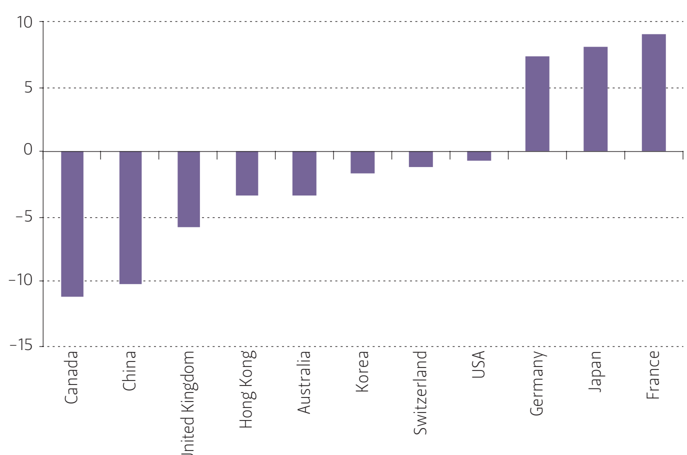


FUENTE: Bloomberg

With regard to the financial markets, a number of stock indexes fell sharply in 2015. In a selected sample (see figure 12), the stock markets with the worst performance in the period were Canada and China, which posted returns in local currency of −11.1% and −10.1%, respectively. The highest returns in local currency were recorded by Japan (8.1%) and France (8.9%).

FIGURE 12

MSCI stock index yields 2015
(percent, measured in local currency)



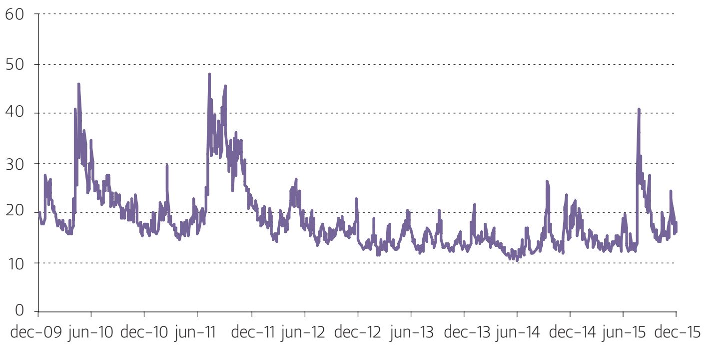
FUENTE: Barclay's

15 The J.P. Morgan EM Currency Index is a tradable index that incorporates ten emerging market currencies against the dollar.

During 2015, the stock market volatility (S&P 500), measured as the Chicago Board Options Exchange (CBOE) Volatility Index (VIX Index), recorded a wider dispersion relative to 2014. The index peaked in August, when China implemented foreign exchange measures aimed at devaluating the Chinese renminbi in order to strengthen productive output (see figure 13).[16]

FIGURE 13

Volatility (VIX) in the stock market (S&P 500), 2010–2015
(level)

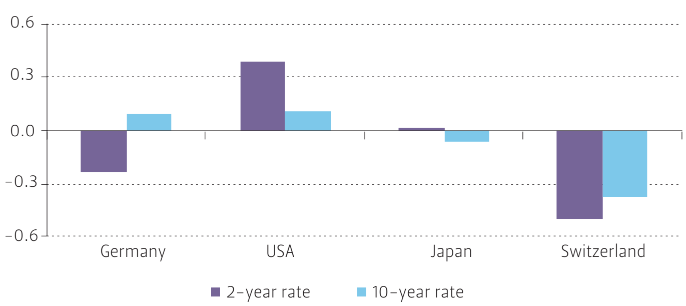


FUENTE: Bloomberg

In the developed economies, two-year sovereign rates increased in the United States and Japan and decreased in Germany and Switzerland relative to 2014, while ten-year rates rose in Germany and the United States and fell in Japan and Switzerland (see figure 14). In the corporate market, spreads generally increased in 2015 relative to the previous year. By sector, the increase was sharpest in the industrial sector, largely due to wider spreads in the energy subsector (see figure 15).[17]

FIGURE 14

Internal rate of return (IRR) on 2- and 10-year bonds: Selected countries, 2015
(percent)



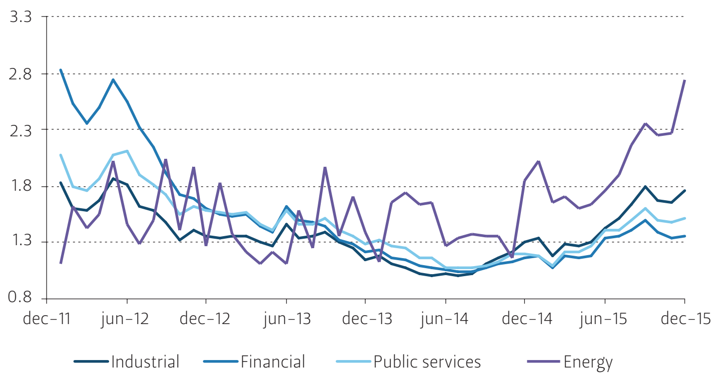
FUENTE: Bloomberg

16 In August, China carried out a series of currency devaluations to promote exports and thus prop up the economic growth rate. This required US$113.7 billion in sales of the Chinese currency. Under the same objective, the People's Bank of China cut its short-term lending and deposit rates by 25 basis points, to 4.6% and 1.75%, respectively. Due to the currency intervention policy, the off-shore currency depreciated 2.7% in August.

17 The industrial sector comprises commodities, capital goods, communications, cyclical consumption, noncyclical consumption, energy, technology, transport and other sub-sectors.

FIGURE 15

Corporate spreads by industry, 2012–2015
(percent)

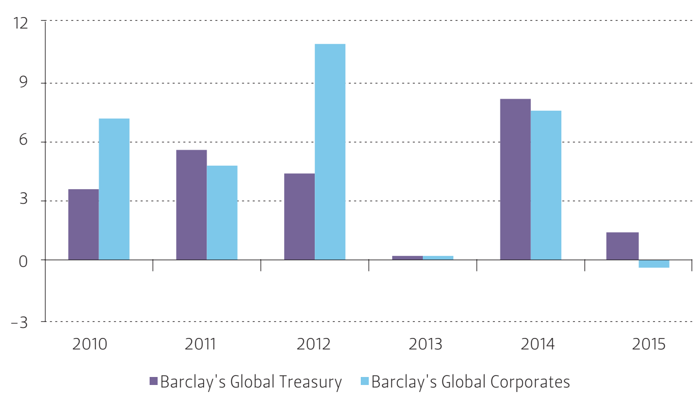


FUENTE: World bank

In this scenario, the return on sovereign bonds, in local currency, were positive in the year, mainly due to the performance of the United States and Japan, while corporate bond yields, also in local currency, were slightly negative (see figure 16).

FIGURE 16

Return on Barclays Global Treasury and Global Corporate indexes (hedged), 2010–2015
(percent, measured in local currency)



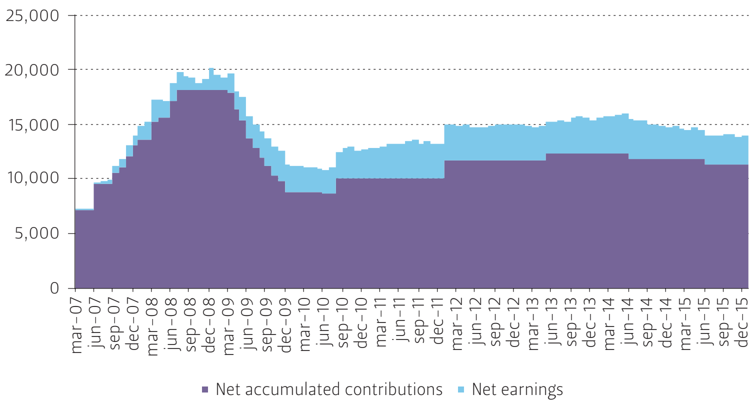
FUENTE: Barclays

B. Market value

At year-end 2015, the market value of the ESSF was US$ 13.996 billion, versus US$ 14.689 billion at year-end 2014, while the PRF had a market value of US$ 8.112 billion, versus US$ 7.944 billion at the close of 2014. The decrease in the value of the ESSF was due to a withdrawal of US$ 464 million, to finance the annual contribution to the PRF, and net investment losses of US$ 259 million (see figure 17). The PRF, in turn, received the aforementioned contribution of US$ 464 million and recorded net losses of US$ 295 million (see figure 18).

FIGURE 17

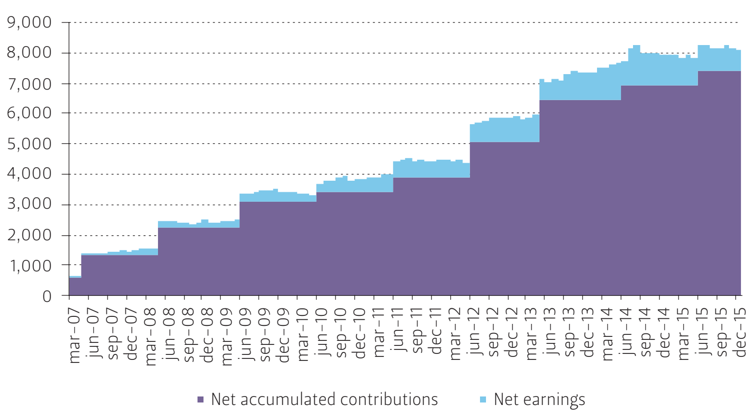
ESSF: Market value, March 2007–December 2015
(millions of dollars)



SOURCE: Ministry of Finance of Chile

FIGURE 18

PRF: Market value, March 2007–December 2015
(millions of dollars)



SOURCE: Ministry of Finance of Chile

C. Returns

1. Conceptual definitions

The return on the sovereign wealth funds' investments reflects a number of factors that affect the different types of instruments included in the EESF and PRF portfolios.

The ESSF portfolio is largely invested in fixed-income securities, so the most important factors affecting total portfolio returns are the level and changes in interest rates and exchange rate fluctuations.[18] The return on short-term fixed-income securities is basically determined by the interest rate, which tends to be stable in the local currency. For medium- and long-term fixed-income securities, the yield primarily depends on interest rate levels and movements in the investment country. For example, an increase in interest rates reduces the market value of bonds, whereas an interest rate reduction increases it. The fund's return also depends on exchange rate movements relative to the currency used to measure performance. For example, because both funds express their return in U.S. dollars, the market value of investments denominated in another currency, expressed in dollars, increases (decreases) as a result of an appreciation (depreciation) of that currency against the U.S. dollar. Given the currency allocation of the ESSF fixed-income portfolio, the main countries that influence the ESSF returns are the United States, Germany, Japan and Switzerland. In the case of the ESSF stock portfolio, the return largely depends on the market's perception of the income-generation capacity of the companies in the different industries where the ESSF is invested and their risk ratings, as well as market financial conditions.

The return on the PRF portfolio is affected by additional factors, as well as those that determine the ESSF return, because the portfolio is more complex, with a larger number of issuers, currencies and types of financial instruments. For the sovereign debt asset class, the factors are similar to the ESSF, but for a larger set of countries: the return depends, to a large extent, on interest rates in the countries where the fund is invested and the corresponding exchange rates. However, because the PRF does not invest exclusively in sovereign instruments from countries with a minimal credit risk, it is more exposed to the credit trend of the larger number of sovereign issuers in the portfolio.[19] For example, an increase in the credit risk of a sovereign instrument will generally be associated with a higher interest rate demanded by investors and a reduction in the market value of the securities. For the corporate bond asset class, not only are the instruments affected by sovereign interest rates and exchange rates, but their prices also depend on the evolution of the spread, or the difference between the corporate debt security's internal rate of return and the interest rate on sovereign bonds from the respective countries. Thus, an increase (decrease) in the corporate bond spread is associated with a decrease (increase) in the value of the bond. For stocks, the relevant factors are the same as those cited for the ESSF.

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18 Bond yields also depend on the creditworthiness of the issuer and their evolution over time. The ESSF has not been affected by this variable because it mainly invests in securities with a high credit quality.

19 Whereas the ESSF only invests in sovereign debt instruments issued by the United States, Germany, Japan and Switzerland, the PRF sovereign portfolio includes debt instruments issued by a large number of countries, as well as public and semi-public agencies, state-owned companies, municipalities, multilateral financial institutions, and other issuers. This reflects the fact that one of the objectives of the fund's benchmark is to take on exposure to the global market for investment-grade sovereign debt (that is, a credit rating of BBB–/Baa3 or better).

2. Returns in 2015 and in 2007–2015

In 2015, the net return in dollars, measured by the time-weighted rate of return (TWR), was –1.78% for the ESSF and –3.62% for the PRF (see table 1). Using the internal rate of return (IRR), the yield was –1.78% for the ESSF and –3.58% for the PRF.

In the case of the ESSF the negative yield is mainly explained by the return on the fixed-income portfolio (–1.82%) and, to a lesser extent, stock returns (–1.73%). The negative fixed-income return primarily reflects exchange rate fluctuations, which contributed –2.88% mainly due to the depreciations against the U.S. dollar of 10.22% for the euro, 0.47% for the yen, and 0.80% for the Swiss franc. This was partially offset by a return of 1.07% due to interest rate fluctuations and accrued interest on the financial instruments included in the portfolio. The negative yield on the stock portfolio was due to the poor performance in dollars of the countries that make up the index, mainly the United States (–0.76%), the United Kingdom (–10.99%), and Canada (–25.29%).

The PRF return reflects negative results in all asset classes. The fixed-income portfolio recorded negative yields on inflation-indexed bonds (–5.22%), sovereign and government-related bonds (–3.69%), and corporate bonds (–3.67%). As in the case of the ESSF, these negative fixed-income returns were strongly influenced by exchange rate fluctuations. Also like the ESSF, the stock portfolio posted negative returns of–1.98%.

CUADRO 1

ESSF and PRF: Determinants of returns (TWR) in dollars, 2015
(percent)

Fund	Component	Quarter				2015
		I	II	III	IV	
ESSF	Fixed-income[(a)]	-1.69	-0.26	1.49	-1.34	-1.82
	Local currency	1.12	-1.16	1.33	-0.32	1.07
	Exchange rate fluctuation	-2.82	0.90	0.16	-1.01	-2.88
	Stocks	2.39	0.76	-9.32	5.03	-1.73
	Total return (USD)	**-1.37**	**-0.18**	**0.69**	**-0.91**	**-1.78**
	Total return (CLP)	1.84	1.05	11.74	-0.53	14.68
PRF	Sovereign bonds and government-related bonds	-2.26	-1.65	1.12	-0.91	-3.69
	Inflation-indexed bonds	-1.57	0.24	-1.37	-2.62	-5.22
	Corporate bonds	-1.17	-1.63	-0.10	-0.81	-3.67
	Stocks	2.38	0.50	-9.32	5.06	-1.98
	Total return (USD)	**-1.21**	**-0.98**	**-1.10**	**-0.37**	**-3.62**
	Total return (CLP)	2.00	0.25	9.95	0.01	12.84

(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.

SOURCE: Ministry of Finance of Chile

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 2015, the peso depreciated substantially against the dollar, resulting in a return in pesos of 14.68% for the ESSF and 12.84% for the PRF.

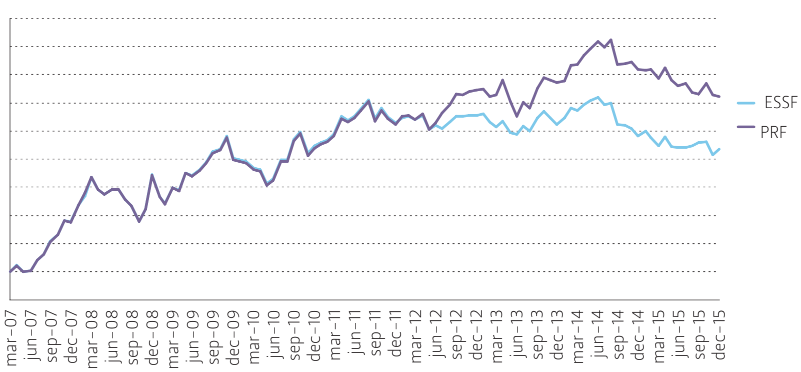
Since the inception of the funds, the annual return in dollars as of year-end 2015 was 2.28% for the ESSF and 3.14% for the PRF. Expressed in pesos, the annual return for this full period was 5.42% for the ESSF and 6.28% for the PRF.

In 2015, both funds earned lower returns than the benchmark, by 3 basis points in the case of the ESSF and 19 basis points in the case of the PRF. Since 31 March 2007, the difference between the average annualized return of the funds and their respective benchmarks was –9 basis points for the ESSF and –34 basis points for the PRF.[20, 21]

Figure 19 shows the evolution of the index of accumulated returns for each fund. For the ESSF, the index increased from 100 on 31 March 2007 to 121.9 at year-end 2015; for the PRF, it increased from 100 to 131.1 in the same period. The figure illustrates how the evolution of the two funds' returns began to differentiate in 2012, when the PRF investment policy was changed.

FIGURE 19

ESSF and PRF: Index of accumulated returns, April 2007 to December 2015
(March 31, 2007 = 100)



SOURCE: Ministry of Finance of Chile

20 This implies that the manager's portfolio generated lower returns, on average, than the implicit benchmark portfolio in the full period from 2007 to 2015.

21 These figures do not take into account the waiver period granted to managers for both the ESSF and the PRF, when the investment portfolio was set up.

CHAPTER 3

Activities and recommendations of the Financial Committee

A. Changes to the ESSF and PRF investment guidelines

Based on suggestions by the external managers and the CBC, the Financial Committee analyzed a series of possible changes to the ESSF and PRF investment guidelines, aimed at giving the managers more flexibility to invest the funds' capital. The following changes were approved:

PRF: Investment in financial institutions in the portfolio managed by the CBC

A recommendation was made to change the cap on investment in financial institutions, as follows: up to 1% of the portfolio managed by the CBC can be invested in banks with a minimum rating of AA– and 0.5% in banks with a minimum rating of A– . This limit would be applied to the aggregate exposure of cash deposited in a given bank and forward transactions with the same entity. The incorporation of time deposits with up to 15 days was approved for the set of instruments eligible for cash in foreign currency.

PRF: Sovereign and corporate fixed-income portfolios

For both portfolios, the recommendation was made to allow investment in instruments that are not included in the benchmark but that differ from other securities which are currently included in the benchmark or which will be included at the end of the month solely by having been issued under different regulatory rules.[22]

Another recommendation for both portfolios was to allow investment in reopened securities, as long as the prospectus indicates that the International Securities Identification Number (ISIN) will be harmonized to a security that is already included in the benchmark. It was recommended that investment in these securities be allowed during the time necessary for harmonization. If the security is not harmonized as expected, the portfolio manager will have a pre-established period in which to sell the security.[23]

For the corporate bond portfolio, the cap on exposure to BBB+, BBB and BBB– bonds was raised from 45% to 50%.

ESSF: Supranational institutions, agencies and eligible entities with an explicit government guarantee

A proposal was made to expand the eligible instruments for the Treasury Bills and Sovereign Bonds asset class, incorporating securities issued by supranational institutions, agencies and eligible entities with an explicit government guarantee, while respecting the terms and currency of the ESSF strategic allocation. Issuers will be subject to the eligibility criteria used by the CBC for investing its international reserves. Securities from these issuers with a residual maturity of less than a year will have an investment cap of 3.5% (expressed as a percentage of the total portfolio) for securities denominated in EUR and 3.0% in USD. Securities with a residual maturity of one to ten years will have an investment cap of 2.65% of the total portfolio for securities denominated in USD, 1.10% in EUR, 1.00% in JPY and 0.75% in CHF. The Treasury Bills and Sovereign Bonds benchmarks were not modified. In the case of supranational institutions, agencies and entities with an explicit government guarantee, eligibility is restricted to discount bills and notes (including Euro Commercial Papers); callable and noncallable bullet bonds; with a residual maturity, in all cases, of less than or equal to 10 years.

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22 Different types of regulatory rules can be applied to fixed-income securities. For example, securities issued under Rule 144(a) are considered private issues, are not registered in the Securities Exchange Commission (SEC), and are sold exclusively to qualified institutional buyers. In this case, the ISIN code is generally included in the benchmark. In contrast, securities issued under Regulation S (RegS) are issued outside the United States and are exempt from registration in the SEC. Despite being identical to 144(a) securities, which are included in the benchmark, the ISIN codes of the RegS securities are not included in the benchmark.

23 Seven days for the CBC and one month for external managers.

Securities lending program

The Financial Committee recommended approval of the proposal put forth by the custodian bank, J.P. Morgan, with regard to the use of cash as collateral in the securities lending program under exceptional circumstances deriving from the inability of counterparties to transfer securities as collateral due to time constraints. The custodian bank will be asked to report periodically to the Ministry of Finance on the occurrence of such situations, in order to monitor their frequency and make decisions in the event they become recurrent.

Portfolio rebalancing policy

With regard to rebalancing the two funds, it was recommended that the ESSF be allowed to rebalance whenever a withdrawal is made to fund contributions to the PRF. It was further recommended that in the event of rebalancing, this should be carried out between the portfolios managed by different managers in each fund, but the CBC should not be required to converge to the strategic asset allocation that has been defined for the subportfolios it manages in each fund.

Forwards rollover

The suggestion was made to allow forwards rollover, with the consequent increase in exposure to a given counterparty for two days, as long as the increased exposure to the counterparty stems directly from a contract roll.

B. Investment policies and active management of other sovereign wealth funds

The Financial Committee analyzed the experience of other sovereign wealth funds in terms of their investment policies, in particular the incorporation of active management and the associated decision-making process. Given the very limited availability of detailed information about the investment policies of some sovereign wealth funds, the analysis was restricted to the cases of Australia, the United States (Alaska), New Zealand and Norway, which are recognized for their transparency and the public release of information. For each of these funds, the Committee analyzed the institutional framework, objectives (why they were created), investment policy and main characteristics, including the decision-making process and how active management has been incorporated into the funds.

The Financial Committee concluded that the sovereign wealth funds have very different investment policies depending on their defined objectives and the mandate of the different government organizations to achieve those objectives. In the cases of Australia, the United States and New Zealand, the investment policy allows some flexibility in deviating from the strategic asset allocation (that is, overweighting one asset class versus another) so as to take advantage of investment opportunities and to control portfolio risk. Such deviations are generally proposed by the fund's operational management area and approved by the Board of Directors, sometimes with support from external consultants. In these three funds, the Board considers whether the long-term investment horizon allows them to invest in less liquid investments that should generate higher returns in the long term. Additionally, depending on the asset class, sector or region, these three funds can use active managers in order to obtain excess returns over their benchmarks. In the case of Norway, fund management seeks to stay in line with its strategic asset allocation. Although the fund's size and investment horizon would naturally support investment in less liquid instruments, it has only recently begun to incorporate these assets (real estate sector). With regard to active management, the ex ante tracking error defined for fund is tight and thus limits strong deviations in each asset class. However, the Norwegian Central Bank, which manages the fund, has stated that it uses a more active approach than simply replicating the benchmark in order to generate higher relative returns. Finally, based on its analysis, the Financial Committee recommended that the Chilean sovereign wealth funds continue to be operated under a passive management approach, because it is more in line with the institutional framework under which they are managed.

C. Investment policy review process of other institutional investors

The Financial Committee analyzed the experience of other sovereign wealth funds and the CBC in terms of their investment policy review processes and institutional framework. The analysis covered the CBC, the Australian Future Fund, the Alaska Permanent Fund Corporation (United States) and the New Zealand Superannuation Fund. The conclusion was that, in general, most of these entities carry out a periodic review of their investment policies and will also undertake an exceptional review if the situation merits it. Consequently, the Committee recommended a review of the current ESSF and PRF investment policies in the second half of this year,[24] with a focus on explaining the rationale behind the current investment policies for each fund. Based on this analysis, a formal review process will be established for the investment policies.

D. PRF investment policy review

Given that the Financial Committee members have changed since the PRF investment policy was defined in 2008, and that a new policy study is being considered for the fund in 2016, the Financial Committee decided to review the study commissioned from Mercer Investment Consulting (Mercer) in 2007, which provided the basis for defining the fund's strategic asset allocation.

The Committee analyzed the investment objectives that the Finance Ministry outlined for Mercer on commissioning the study, the mean-variance analysis, the main assumptions defined by the consultant, in terms of both assets and liabilities, and the results of both asset-only and asset-liability management models. The Committee also examined the main results of the Monte Carlo simulations carried out by the consultant, as well as the simulated correlations and a historical analysis to demonstrate whether the asset classes chosen in Mercer's recommendation had a low correlation with the copper price and GDP, which was one of the investment objectives outlined by the Finance Ministry. Other analytical tools employed included backtesting, sensitivity analysis and stress tests. The Committee also reviewed Mercer's estimated correlations between Chilean GDP and the copper price, with quarterly lags, and found that, according to the consultant, there is no significant correlation between the two variables.

Mercer's preferred recommendation comprised 50% in stocks, 35% in corporate bonds and 15% in alternative investments, which would maximize the size of the fund and was consistent with the proposed risk parameters. Mercer recommended converging to this recommendation over a period of 13 quarters.

At the time, the acting Financial Committee recommended a strategic asset allocation that combined elements of the different alternatives proposed by Mercer and the then-current investment policy. However, this policy was considered temporary and was expected to later converge to a policy more in line with Mercer's recommendation.

Despite having been designed in 2008, the PRF policy was only implemented in early 2012. The delay in implementation was due to the economic and financial crisis that escalated in late 2008, the change in government in 2010 and the earthquake that same year.

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24 The ESSF investment policy review took place in the first quarter of 2016.

Considering that more than five years have passed since the policy was defined and that it was originally intended to be temporary, the Financial Committee recommends studying the long-term investment policy of the PRF. To this end, an international consultant will be contracted in 2016 to carry out a formal policy review.

E. Contracting of Strategic Investment Solutions

One of the Financial Committee's activities in en 2015 was related to the selection process carried out by the Finance Ministry to contract an international consultant for the provision of support services in monitoring the ESSF and PRF managers. The Financial Committee reviewed the terms of reference that would define the activities to be performed by the consultant and the information that would be requested from firms participating in the process.

In early April, the Finance Ministry sent a Request for Proposal (RFP) to seven firms: AON Hewitt Investment Consultant, Callan Associates, Mercer Investment Consulting, McKinsey & Company, Strategic Investment Solutions, Towers Watson Investment Services and Wilshire Consulting. Of the seven companies that were invited to participate, five submitted proposals, while McKinsey & Company and Wilshire Consulting abstained. The submitted responses were evaluated by the Finance Ministry, taking into account aspects such as the product and service offered, the experience of the firm and its personnel, and the associated costs of the service. Likewise, the references provided for the best candidates were also reviewed. The process culminated in early June with the selection of Strategic Investment Solutions (SIS), while the remaining consultants were notified that were not selected and thanked for their participation.

The Financial Committee was in agreement with the result of the selection process carried out by the Finance Ministry. SIS will be responsible for the qualitative and quantitative review of the fund managers; the preparation, in conjunction with the Finance Ministry, of an annual questionnaire to be sent to each external manager; the provision of support to the Finance Ministry on visits to the offices of the external managers; and preparation of quarterly and annual reports on the managers' performance. The Consultant submitted the first reports in the late 2015, which were being reviewed by the Finance Ministry at the time of writing.

The contracting of this consultant is in compliance with the Fiscal Responsibility Law, which requires that external managers undergo a performance audit.

F. Monitoring of the sovereign wealth fund managers

In the final meeting of 2015, held in the Finance Ministry offices, the Financial Committee received delegations from Rogge Global Partners Plc and BlackRock Institutional Trust Company, N.A., who introduced their fund management teams and described their investment processes, portfolio performance, attribution analysis of earnings and other issues related to the investment of the sovereign wealth funds.[25] These presentations are among the reporting requirements imposed on the external fund managers.

25 Mellon Capital Management Corporation and the CBC gave their presentations to the Financial Committee on 14 January 2016.

APPENDIX SUMMARY OF MEETINGS IN 2015

MEETING 1 | 5 JANUARY

At its first meeting of the year, the Committee concluded the series of presentations given annually by the managers responsible for investing the funds, which were initiated in late 2014. On this occasion, Mellon Capital Management Corporation described the main aspects of the company, introduced its investment teams and gave a presentation covering its investment processes, the 2014 portfolio performance and attribution analysis and a brief market review. They also discussed some new investment trends in the markets. The Committee members thanked Mellon Capital Management Corporation for its presentation and expressed satisfaction with the company's management. The Committee then discussed several issues related to monitoring the fund managers and evaluated proposals from the CBC and the external managers on potential changes to the funds' investment guidelines. For the PRF portfolio managed by the Bank, the formula for establishing the limit on investment in bank issuers was changed, and the maximum length of time deposits was increased to 15 days. For both funds, the managers were authorized to double the credit exposure to a given issuer, for up to two days, for the purpose of executing forwards rollover. Finally, the Committee analyzed the structure and general content of the Financial Committee's Annual Report for 2014 and reviewed the state of the funds as of end-November 2014.

MEETING 2 | 20 MARCH

At this meeting, the Committee discussed the key terms for the possible contracting of an international consultant to assist the Finance Ministry in monitoring the fund managers. The Committee also analyzed current events affecting international markets and economies at that point in time, the possible effects on the funds' investment policies and how the latter should be revised in the face of significant changes in the global scenario. In other matters, the Committee discussed and recommended some changes to the funds' investment guidelines that would give more flexibility to the portfolios managed by the CBC. In particular, a recommendation was made for the ESSF to allow investment in supranational institutions, agencies and eligible entities with an explicit government guarantee, and for the PRF to allow investment in reopened securities and in equivalent instruments that differ from securities in the benchmark solely by having been issued under different regulatory rules. Finally, the Committee reviewed the final details of the 2014 Annual Report and the state of the funds as of end-February 2015.

MEETING 3 | 4 MAY

The Committee members analyzed the experiences of sovereign wealth funds in Australia, Alaska, Norway and New Zealand, which are recognized for their transparency and the public release of information, in order to learn more about their investment policies and the incorporation of active management. The Committee also gave an update on the selection process for an international consultant. The Committee advised in favor of accepting the proposal by the custodian bank to allow the use of cash as collateral in the securities lending program under exceptional circumstances deriving from the inability of counterparties to transfer securities as collateral due to time constraints; and also recommended increasing the cap on corporate bonds rated BBB– and BBB+ from 45% to 50%, expressed as a share of the total corporate bond portfolio. The state of the funds as of end-March 2015 was reviewed. Finally, the Committee was informed on the PRF contribution and rebalancing to be carried out in late June 2015. In this context, the Committee was in agreement with the Finance Ministry's proposal to use this opportunity to rebalance the ESSF, without requiring the CBC to converge to the strategic asset allocation for the ESSF portfolios under its management.

MEETING 4 | 24 JULY

At this meeting, the Committee was informed of the outcome of the selection process carried out by the Finance Ministry to contract an international consultant. The Committee expressed its satisfaction with the process and its agreement with the choice of Strategic Investment Solutions, out of a total of five international firms that participated in the selection process. The Committee also reviewed the experiences of other sovereign wealth funds and the CBC with regard to their procedures for reviewing their investment policies. Additionally, the Committee members discussed the main points of their 2016 work plan, including commissioning a study on the PRF investment policy, discussing the new PRF actuarial study and analyzing the feasibility of incorporating socially responsible investments in the fund portfolios. Finally, the Committee reviewed the state of the funds at end-June 2015 and the details of the contribution to the PRF on the last day of June.

MEETING 5 | 5 OCTOBER

The Committee analyzed the study carried out by Mercer Investment Consulting in 2008, which provided the basis for defining the fund's current investment policy. The review was conducted in order to apprise the newer Committee members of the roots of that policy. In other matters, the members analyzed whether the conclusions of the Bravo Commission would have a direct impact on the PRF in the short term. They concluded that there is a lot of uncertainty about which recommendations will be implemented and when, and it is therefore advisable to continue moving forward on the review of the fund's investment policy. The Committee also analyzed the proposal by the custodian bank that manages the current securities lending program to include stocks in the set of instruments that are authorized for lending, taking into account that the current program only allows lending sovereign bonds. The Committee members requested additional information prior to making a recommendation to change the current program. Finally, the Committee reviewed the state of the funds as of end-August.

MEETING 6 | 2 DECEMBER

At the last meeting of the year, the Committee received delegations from Rogge Global Partners Plc and BlackRock Institutional Trust Company, N.A., who presented an update on the main characteristics of their firms, introduced the investment teams dedicated to managing their respective portfolios, and described their investment strategies and the 2015 portfolio performance and attribution analysis. The presentations included a discussion of the behavior of the main markets where the funds are invested. The Committee members thanked the companies for their presentations and expressed their satisfaction with their management performance.

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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 (stocks 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 stocks, 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 stocks 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 stock 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.

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.

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.

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

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.

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 — Stocks.

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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