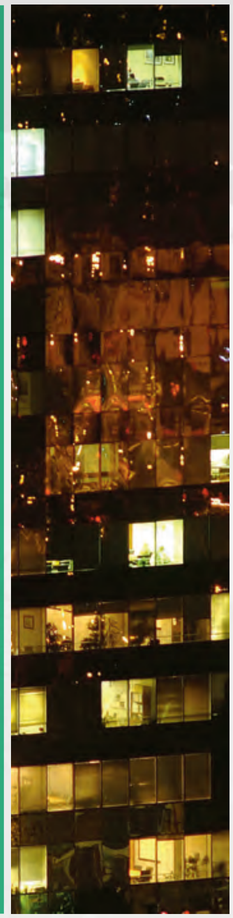
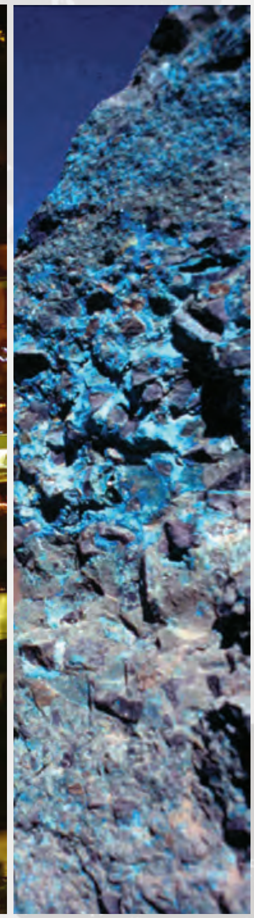
Annual Report
Financial Committee

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

2009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Preface

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

This report – the third prepared by the Committee – sets out its work and activities in 2009 and is part of a systematic effort to increase access to information about its deliberations and recommendations and the situation of the two funds. In this way, the Committee fulfills the requirement established under Decree N° 621, issued by the Ministry of Finance in 2007, which stipulates that 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 lower house of Congress and to the Special Budget Commission of Congress.

Members of the Financial Committee

Left to right:

President **Andrés Bianchi Larre**

Bianchi studied legal and social sciences at the Universidad de Chile and holds a masters degree in economics from Yale University. He was governor of the Central Bank of Chile (1989-1991) and Chile's ambassador to the United States (2000-2006). He has also served as president of Banco Crédit Lyonnais and Dresdner Banque Nationale de Paris and as joint executive secretary of the UN Economic Commission for Latin America and the Caribbean (ECLAC) and has worked as a consultant for the World Bank, the Inter-American Development Bank and the central banks of Bolivia, Colombia, Mexico and Venezuela. He currently sits on the board of a number of companies.

Vice-president **Ana María Jul Lagomarsino**

Jul studied economics at the Universidad de Chile and holds a Ph.D. in economics from the University of Pennsylvania. She worked at the International Monetary Fund (IMF) for 27 years where she rose to become assistant director and represented Chile and five other Southern Cone countries as executive director on the IMF's board. She has also worked as a consultant on fiscal affairs for the Ministries of Economy and Finance of Peru and Panama and the Inter-American Development Bank and as a private consultant in Chile.

Counselor **Martín Costabal Llona**

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

Counselor **Andrés Sanfuentes Vergara***

Sanfuentes studied economics at the Universidad de Chile and holds a masters degree in economics from the University of Chicago. He has served as president of BancoEstado (1990-2000) and has worked as a consultant and as a professor at the Universidad de Chile and the Ilades-Georgetown program.

Counselor **Klaus Schmidt-Hebbel Dunker**

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

Counselor **Eduardo Walker Hitschfeld**

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

** Andrés Sanfuentes resigned from the Committee in March 2010.*

CHAPTER **01**

Fiscal Policy and Funds' Objectives

A_ Fiscal policy

Chile's fiscal policy seeks to contribute to the country's macroeconomic stability and to provide public goods that increase opportunities and social protection for all Chileans. In order to comply with these objectives, emphasis has been placed on the efficient use of public resources and the transparency of their management.

Since 2001, fiscal policy has been anchored in a structural balance rule. This reflects the central government's trend finances and is designed to reduce the impact on public finances of cyclical fluctuations, principally in economic activity, the price of copper and other similar variables. To this end, it decouples public expenditure from cyclical changes in effective fiscal income, tying it instead to the estimated performance of the more permanent or structural component of revenues. This helps to avoid the need for drastic cuts in public expenditure in response to adverse economic events, with the government saving during booms, when it receives temporary income, and drawing on these resources during periods of weaker economic growth and/or relatively low copper prices. [1]

In order to provide a framework for the implementation of a fiscal policy that ensures the sustainability of public expenditure and contributes to the economy's competitiveness, a Fiscal Responsibility Law (Law N° 20.128) was introduced in September 2006. This created the Pension Reserve Fund (PRF) and empowered the President of the Republic to create the Economic and Social Stabilization Fund (ESSF), which was officially established in February 2007 under Decree with Force of Law (DFL) N° 1, issued by the Ministry of Finance in 2006. These two funds receive the resources that result from the application of the structural balance rule.

B_ Funds' objectives, rules and management

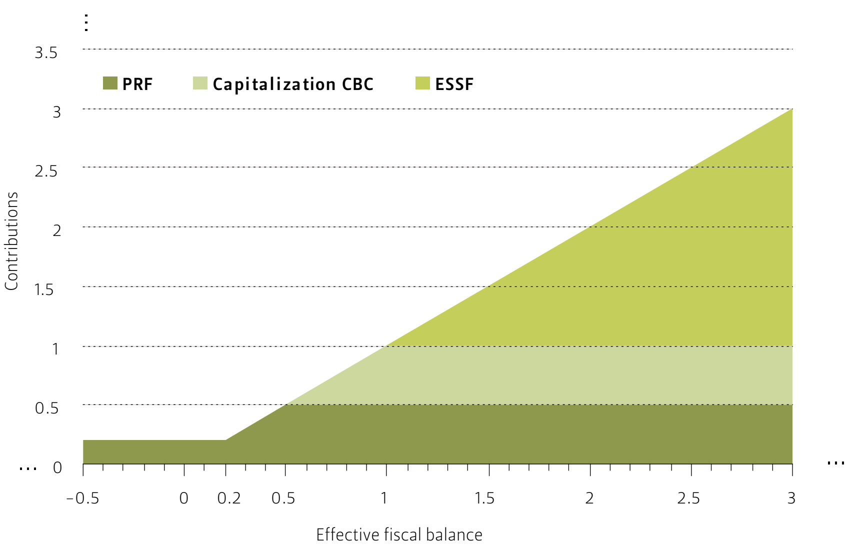
Objectives

The two funds created under the Fiscal Responsibility Law (the "Sovereign Wealth Funds" or "Funds") have clear but differing objectives. In the case of the PRF, its purpose is to serve as a complementary source of financing for future pension contingencies while the main purpose of the ESSF is to finance possible future fiscal deficits and to pay down public debt. In this way, the ESSF helps to isolate fiscal spending from the volatility of government revenues.

1 For a more detailed discussion of the application of the structural balance rule and its results, see Marcel et al. (2001) and Rodríguez et al. (2006).

Figure 1 Fiscal savings rule and capitalization of the CBC

(% of GDP)



SOURCE: Ministry of Finance.

Rules for contributions to funds

The Fiscal Responsibility Law established the rules for the creation of the ESSF and the PRF and for contributions to the funds as well as the option of capitalizing the Central Bank of Chile (CBC) during a period of five years. Figure 1 illustrates the operation of these rules for different levels of fiscal balance.

Under the law, the PRF increases each year by a minimum amount equivalent to 0.2% of the previous year's Gross Domestic Product (GDP). If the effective fiscal surplus exceeds this amount, PRF can receive that effective surplus up to a maximum of 0.5% of the previous year's GDP. This policy will remain in force until the PRF reaches the equivalent of 900 million *unidades de fomento* (*UF*).

The law also authorized the government to capitalize the CBC by an annual amount equivalent to the difference between its contributions to the PRF and the effective fiscal surplus, providing this difference is positive, with an upper limit of 0.5% of the previous year's GDP. This capitalization can take place over a period of five years as from September 2006.

Finally, the remainder of the effective surplus, after payment into the PRF and capitalization of the CBC, must be paid into the ESSF. Repayments of public debt and advanced payments into the ESSF during the previous year can, however, be deducted from this contribution. [2]

Rules on use of the funds

The PRF is designed exclusively to complement budget financing of fiscal liabilities arising from the state guarantee on basic old-age and disability solidarity pensions and old-age and disability solidarity pension contributions. Until 2016, annual withdrawals of up to the previous year's returns may be made and, as from 2016, of up to a third of the difference between expenditure on pension liabilities in the current year and expenditure on this item in 2008 adjusted by the change in the consumer price index during the intervening period.

The PRF will cease to exist in September 2021 if the withdrawals to be made in a calendar year do not exceed 5% of the sum of expenditure on the state guarantee on basic old-age and disability solidarity pensions and old-age and disability solidarity pension contributions as established in that year's budget. When the PRF ceases to exist, any balance in the fund must be transferred to the ESSF.

The ESSF is designed to finance government expenditure if there is a fiscal deficit and/or to make normal or extraordinary repayments of public debt (including bonos de reconocimiento).

Management policy

Under Decree N° 1.383 of 2006 (the "Agency Decree"), the Ministry of Finance appointed the CBC as fiscal agent to act in its name and on its behalf in the management and investment of the Funds' resources. The CBC must abide by specific instructions given by the Finance Minister ("Investment Guidelines") which establish the requirements and conditions necessary for the proper exercise of the functions entrusted to the CBC in its role as fiscal agent.

2 The law currently in force permits the use of resources from the current year's fiscal surplus, which must be deposited in the ESSF during the following year, to pay down public debt and make provisional contributions to the ESSF.

CHAPTER **02**

Financial Committee's Mandate and Role

A_ Functions

The Fiscal Responsibility Law specified the creation of a Financial Committee to advise the Finance Minister on the investment of the resources of the PRF and the ESSF and the definition of the guidelines needed for their implementation.

On December 23, 2006, the Finance Minister announced not only the creation of the Funds but also, in compliance with this requirement, the establishment of an external advisory committee – the Financial Committee – formed by professionals with important economic and financial experience.

This Committee was officially established by Decree N° 621, issued by the Ministry of Finance in 2007 and published in the Diario Oficial (Official Gazette) on August 11, 2007. The Committee's initial members – Andrés Bianchi Larre, Martín Costabal Llona, Ana María Jul Lagomarsino, Oscar Landerretche Moreno, Andrés Sanfuentes Vergara and Eduardo Walker Hitschfeld – were also appointed under this Decree. The Finance Minister appointed Andrés Bianchi as the Committee's president and its members elected Ana María Jul as its vice-president. In August 2008, the Ministry of Finance officially announced the appointment of Martín Costabal, Oscar Landerretche and Eduardo Walker for a further two-year period.[3] In June 2009, Oscar Landerretche resigned from the Committee for personal reasons and, in July 2009, the Finance Minister appointed Klaus Schmidt-Hebbel Dunker for the remainder of Landerretche's period. In August 2009, Andrés Bianchi, Ana María Jul and Andrés Sanfuentes were reappointed for two years.

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

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

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

3 Under Decree N° 621, three seats on the Committee must be filled each year for a period of two years. As a result, these three members were initially appointed only for one year.

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

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

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

In addition, the Committee can express its views on other matters relating to the Funds' long-term investment policy. Both these views and its recommendations must take into account the principles, objectives and rules of the Funds as set out above.

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 available to the public. For this purpose, a special section of the Ministry of Finance's website was created on which updated information on all these issues is available.[4]

4 *www.hacienda.cl/english/fondos_soberanos.*

B_ Meetings

In 2009, the Financial Committee held eight meetings. These are the main instances at which it agrees its recommendations about the Funds' investment policies to the Finance Minister. In the intervening periods, its members exchange information and analysis via e-mail.

Under Decree N° 621, the Committee must meet at least once every six months but, as in previous years, its members considered that more frequent meetings were necessary.

The Financial Committee is assisted by specialized Ministry of Finance staff, which was headed by Eric Parrado, the ministry's coordinator for international finance, who acted as its liaison with the Committee. This group also included two senior economists, two other economists and two lawyers as well as the head of the Financial Programming Area of the Budget Office's Public Finance Division and analysts from this area.

In general, the Financial Committee's meetings are divided into four parts. In the first, Ministry of Finance staff present a detailed report on, among other issues, the state of the Funds, including the amount of savings accumulated and their returns, as well as information, studies and international comparisons about the investment policies of other sovereign wealth funds (SWFs) and their results. In the second part, the Committee analyzes and assesses the performance of the ESSF and the PRF and its consistency with their investment policy. In the third part, the Committee's members – if they deem it necessary – discuss and draw up specific recommendations to be presented to the Finance Minister and, finally, approve a press release about the Committee's deliberations and recommendations.

The main topics analyzed in the meetings held in 2009 and a summary of the agreements adopted are presented below.

Meeting 1:

9 JANUARY

In its first meeting of 2009, the Financial Committee continued its analysis, begun at its last meeting in 2008, of the possibility of broadening the range of money-market instruments in which the Funds may invest. It agreed to recommend to the Finance Minister the inclusion of local banks as eligible issuers of foreign-currency term deposits on the grounds that they offered more attractive interest rates for a similar level of risk and represented a lower management cost in terms of credit risk analysis as compared to overseas banks. The Committee proposed that, in order to be eligible, local banks should have at least two N1+ short-term risk ratings and that the amount deposited in any one bank should not exceed US$150 million or 15% of its basic capital. In addition, the Committee carried out a detailed review of the situation of the PRF and the ESSF and their performance in 2008 as well as examined recent reports on the evolution of the international financial crisis and the outlook.

Meeting 2:

18 MARCH

The Committee's second meeting focused on analyzing the content of the report which the Committee must prepare annually about its activities. It accepted the Finance Ministry's recommendation to publish this together with the new annual report on the Funds to be prepared by the Ministry.[5] As regards their investment policy, the Committee agreed with the change in benchmarks[6] proposed by the Finance Ministry in order to improve control of operational risk. In addition, it carried out a detailed review of the Funds' situation and performance, the evolution of the international economic crisis and its impact on the stability and liquidity of the international financial system. Finally, it noted that the Funds were not exposed to institutions whose solvency and/or liquidity had been significantly affected by the economic crisis.

5 As legally required, this report was submitted to the Finance Minister at the end of April, and copies were submitted to the Finance Commissions of the lower house of Congress and the Senate and to the Special Budget Commission of Congress. In addition, 800 copies were distributed to different institutions, the media and key figures in the public and private sectors.

6 A benchmark is a market index representing an asset class that is used as a reference for measuring the performance of an investment manager.

Meeting 3:

19 JUNE

At its third meeting of the year, the Committee examined the results of the Linaburg-Maduell Index calculated by the Sovereign Wealth Fund Institute to measure the transparency of the world's principal SWFs. It noted that, in the first quarter of 2009, Chile's Funds obtained a score of 9 out of a maximum of 10, taking sixth place out of the 45 funds included in the ranking.[7] The Committee expressed its satisfaction with this result, observing that it was a recognition of Chile's institutional efforts to ensure that its sovereign wealth funds are well managed and all the relevant information about their performance and investment policy is systematically made available. In addition, the Committee examined the situation of the Funds and their returns through to May 2009. It also observed the positive impact of the increased stability and liquidity of the world financial system on international markets. Finally, it noted the resignation of Oscar Landerretche Moreno as a member of the Committee.

Meeting 4:

24 JULY

The Committee devoted its fourth meeting to an evaluation of the stages and timing that would be required if, on its recommendation, the Finance Minister decided to resume the process of implementing the investment policy proposed by the Committee at the end of 2007, but postponed at the end of 2008 in view of the deepening of the international financial crisis.[8] Representatives of the CBC explained the key factors involved, including the hiring of external managers for the Funds' future portfolios of equities and corporate bonds. In addition, the Committee reviewed the situation of the Funds, the performance of their investments and the state of international financial markets as well as the returns obtained by other SWFs.

7 For information about the SWF Institute and its transparency index, see *www.swfinstitute.org/research/transparencyindex.php*.

8 For further information about the investment policy recommended by the Committee at the end of 2007, see the Investment Policy section of Chapter 3 of this report.

Meeting 5: 7 AUGUST

At the Committee's fifth meeting, Finance Minister Andrés Velasco welcomed its new member, the economist Klaus Schmidt-Hebbel, and thanked Andrés Bianchi, Ana María Jul and Andrés Sanfuentes for their willingness to remain on the Committee for a further two years after completing the term for which they had initially been appointed. In this meeting, the Committee continued analyzing the feasibility of gradually incorporating new asset classes into the Funds' investment policy and, particularly, that of the PRF, given the longer time horizon of the liabilities it is designed to finance. In addition, it examined the Funds' portfolios and the return on their investments as compared to the benchmark.

Meeting 6: 28 AUGUST

At its sixth meeting, the Committee decided to recommend that, for the PRF, the Finance Minister resume implementation of the investment diversification policy it had proposed at the end of 2007. This recommendation was based on the improvement in expectations in the world's main economies, the marked decrease in the volatility of international financial markets and the evolution of different risk indicators. In addition, the Committee recommended that the new asset classes be administered by external managers chosen from the list of finalists in the selection process carried out in 2008.[9] In the case of the ESSF, the Committee recommended that its investment policy be left unchanged in view of its shorter investment horizon as compared to the PRF and because, given its nature and objectives, its resources can be used to finance fiscal deficits. In addition, the Committee analyzed the Funds' situation and recent performance.

9 This process is described in detail in Chapter 3, Section B of the Financial Committee's 2008 Annual Report.

Meeting 7:

13 OCTOBER

The Committee's seventh meeting focused on analyzing the principal conclusions of the meeting of the International Forum of Sovereign Wealth Funds held in Azerbaijan on October 8 and 9, 2009. The meeting was attended by the Finance Ministry's coordinator for international finance who informed the Committee of the main agreements reached. These included: to promote a favorable investment environment for SWFs in countries that receive their investments, to systematically assess the application of the Santiago Principles,[10] to continue to emphasize the importance of adequate risk control and to promote capacity building in the bodies responsible for managing SWFs. The Committee expressed its agreement with these objectives. Similarly, it noted that the transparency policies of Chile's SWFs are in line with the Santiago Principles and highlighted the international importance they have acquired. In addition, the Committee reviewed the Funds' investment portfolios, their performance and the situation of international markets, noting a sustained improvement in the most important financial indicators. However, it drew attention to the persistence of a certain level of uncertainty in the world economy, with a possible impact on the speed of economic recovery in some developed countries.

Meeting 8:

5 NOVEMBER

At its eighth meeting, the Committee noted that the Finance Minister had opted to leave to the future economic authorities the decision on whether to implement the new investment policy recommended by the Committee for the PRF. The Committee recommended that as much progress as possible be made in work to ensure that the future authorities would have the necessary information for taking this decision. The Finance Ministry's coordinator for international finance reported that Chile's sovereign wealth funds had obtained the maximum possible score in the Linaburg-Maduell transparency index published by the Sovereign Wealth Fund Institute in the third quarter of 2009. He also reported that, in 2008, the returns on Chile's two funds had led a ranking of 13 SWFs from different parts of the world.[11] The members of the Committee expressed their satisfaction with these results. The Committee also examined in detail the Funds' performance, their portfolios, the situation on international markets and the principal financial indicators.

10 The Santiago Principles are a set of principles and practices agreed upon by the world's main SWFs at a meeting in Santiago, Chile in September 2008. For further information about the Santiago Principles, see International Working Group of Sovereign Wealth Funds (2008), "Sovereign Wealth Funds Generally Accepted Principles and Practices".

11 This ranking used the returns published by the SWFs of Alaska (US), Australia, Azerbaijan, Canada, Chile, China, Ireland, New Zealand, Norway, Singapore, South Korea, Timor-Leste and Trinidad and Tobago.

CHAPTER **03**

Main Recommendations in 2009

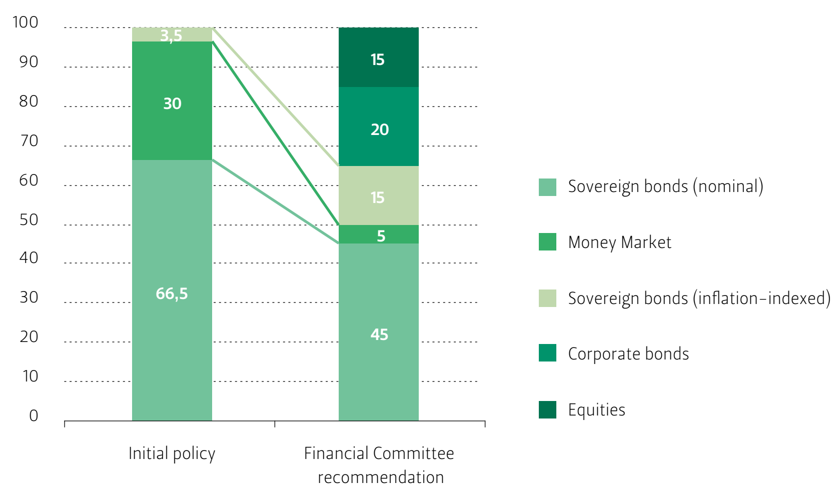
A_ Investment policy

Since March 2007, the PRF and the ESSF have been invested in asset classes similar to those in which the CBC holds international reserves. As a result, their initial portfolios comprised only short and medium-term low-risk financial instruments. Under this policy, 30% of their portfolios was invested in money market instruments, 66.5% in nominal sovereign bonds and 3.5% in inflation-indexed sovereign bonds. In addition, limits were placed on their currency exposure by establishing the following benchmark allocation: 50% in US dollars, 40% in euros and 10% in yens.

However, considering that the Funds' nature and purpose differ from those of international reserves, the Financial Committee recommended in its October 2007 meeting that the Finance Minister gradually modify their investment policy with a view to diversifying their portfolios. It suggested that, by late 2008, they have an allocation comprising 15% in equities, 20% in corporate bonds, 45% in nominal sovereign bonds, 15% in inflation-indexed sovereign bonds and 5% in money market instruments (*Figure 2*).

Figure 2 Initial investment policy and Financial Committee recommendation

(% of portfolio)



SOURCE: Ministry of Finance.

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In the Committee's opinion, this new asset allocation would offer higher returns in the medium and long term while still representing an acceptable level of risk. This proposed investment policy – although conservative in comparison to those adopted by other SWFs – would involve a higher level of risk than the initial policy. This would be reflected mainly in more volatile returns (losses or gains) particularly in the short term, due to the incorporation of equities and corporate bonds into the Funds' portfolios.

The Committee's recommendation was accepted by the Finance Minister and, in February 2008, a mandate was given to the CBC for the selection of external managers for the new components of the Funds' portfolios.

Despite the progress achieved in this process during 2008, the Committee agreed at its November 2008 meeting to recommend that the Finance Minister postpone implementation of the new investment policy. This recommendation was based on the almost unprecedented severity of the economic crisis and the extraordinary volatility and uncertainty prevailing in international financial markets. The Committee undertook to continue monitoring markets in order to propose to the Finance Minister the most appropriate strategy for diversifying the Funds' investments in the future.

As from mid-March 2009, there was a gradual but sustained improvement in international financial markets which meant a partial recovery in the market value of most asset classes after their large drop in the wake of the bankruptcy of Lehman Brothers in September 2008.[12]

In August 2009, in view of this improvement in international economic conditions and in the main indicators of financial risk, the Committee recommended that the Finance Minister resume the diversification policy it had proposed at the end of 2007. However, it recommended that its implementation be confined to the PRF, due particularly to the relatively long time horizon of the liabilities it is designed to finance. In the case of the ESSF, the Committee took the view that its current investment policy should remain in place. This recommendation reflected its different nature and objectives as well as the important drop in its assets in 2009 as a result of withdrawals to finance the government's stimulus plan and the fiscal deficit.

The Committee also proposed that external managers be hired for the new assets classes and that they be selected from the group of finalists who had prequalified in 2008.

12 The evolution of the indicators of the principal international financial markets is discussed in the Appendix.

As indicated above, the Committee was informed at its last meeting of 2009 that the Finance Minister had opted to leave to the future economic authorities the decision of whether to implement the new investment policy proposed by the Committee. The Committee took note of this decision and recommended that as much progress as possible be made in work to ensure that the new authorities would have the necessary information for defining the PRF's investment policy.

B_ Incorporation of new eligible investment instruments

Since the inception of the PRF and the ESSF, they have invested only in international financial instruments. Investment in assets in pesos on the local market was ruled out in favor of holding their assets abroad in a bid to reduce pressure for appreciation of the peso and the resulting loss of international competitiveness.

Box 1_ Dutch Disease*

The term "Dutch disease" has its origin in the effects that the discovery and development of large gas fields had on the Dutch economy in the 1950s. Gas exports resulted in a significant appreciation of the guilder to the detriment of other export sectors and industries competing with imports.

More generally, the term is used to refer to economic processes in which a sudden and marked inflow of foreign currency significantly reduces the competitiveness of the majority of a country's export industries and of those that compete with imports. This inflow is usually related to the rapid expansion of one export sector due, for example, to the discovery of natural resources or an increase in their price. The resulting abundance of foreign currency is damaging for other export industries whose competitiveness is undermined by the appreciation of the local currency.

In Chile's case, copper mining is the main source of foreign currency, particularly when its price is high. The policy of holding abroad an important fraction of the resources generated by a temporary increase in the copper price seeks to minimize the distortions that would otherwise affect other sectors of the economy. This is particularly important in an economy as open as that of Chile.

*For further information about Dutch disease, see Álvarez and Fuentes (2006).

However, at the beginning of 2009, in view of uncertainty about the financial situation of international banks, the Finance Minister asked the Committee to evaluate the inclusion of local banks among the institutions eligible for the ESSF to take foreign-currency term deposits. The Committee concluded that, given the detailed and timely information published by the CBC and the Superintendency of Banks and Financial Institutions, the management costs of analysis of credit risk would be lower for operations with local banks than for similar operations with overseas banks. In addition, the Committee took the view that local deposits would provide access to more attractive interest rates than available abroad for a similar risk level.

The Committee recommended that, in order to be eligible, local banks should have at least two N1+ short-term risk ratings and that the amount deposited in any one bank should not exceed US$150 million or 15% of the bank's basic capital.

This analysis and its conclusions were accepted by the Finance Minister and term deposits at local banks were included in the ESSF's investment guidelines. It should, however, be noted that no operations of this type took place in 2009.

CHAPTER **04**

Key Figures of Sovereign Wealth Funds

A_ Market value

At the end of 2009, the market values of the ESSF and the PRF reached US$11,285 million and US$3,421 million, respectively, as compared to US$20,211 million for the ESSF and US$2,507 million for the PRF at the end of 2008. The drop in the value of the ESSF was explained by withdrawals for US$9,278 million which were partially offset by net investment earnings of US$352 million. In the case of the PRF, the increase in its value was explained by net earnings of US$77 million and new contributions for US$837 million (*Figure 3*).

Figure 3 ESSF and PRF: Market value, March 2007–December 2009

(US$ million)

Net contributions correspond to contributions less withdrawals.

SOURCE: Ministry of Finance.

B_ Returns

Conceptual definitions

The return on the Funds' investments depends on a number of factors that have a positive or negative impact on the value of their portfolio. These include principally the level and movements of interest rates and movements in exchange rates.

The return on short-term fixed-income instruments is determined basically by their rate of interest and tends to be stable, while that on medium and long-term fixed-income instruments depends mainly on the level and movements of interest rates in the country where they are held. If, for example, a country's interest rates are low, bank deposits in that country and its sovereign bonds offer a lower return that can be obtained in countries where interest rates are higher. Movements in interest rates also affect the market value of fixed-income assets, particularly longer-term bonds. An increase in interest rates, for example, reduces bonds' market value while a drop in rates increases it. Returns that are the result of these factors are referred to as "return in local currency".

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

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

Box 2_ Rates of Return: Time-Weighted Rate of Return (TWR) vs. Internal Rate of Return (IRR)

There are two main methods of calculating the return on an investment portfolio: the Time-Weighted Rate of Return (TWR) and the Internal Rate of Return (IRR).

The former is used to measure returns that depend directly on the portfolio manager's investment decisions and excludes the effect of contributions and withdrawals since these are generally outside the manager's control. It is calculated using daily returns obtained from variations in the investments' market value. As a result, if contributions (withdrawals) are made on a particular day, the final value is adjusted by subtracting (adding) the contributions (withdrawals). The TWR, therefore, reflects the performance of an investor who makes all capital contributions at the beginning of the investment period and all withdrawals at the end of this period. The TWR is, for example, used to measure the return on pension and mutual funds in Chile and many other countries.

The IRR, on the other hand, is used to measure the returns actually obtained by an investor, taking into account the timing and amount of capital contributions and withdrawals. The IRR is the discounted rate at which the portfolio's final value is equal to the present value of all contributions and withdrawals. In most cases, the TWR is recommended to measure a fund manager's performance. There are, however, some cases in which the IRR is preferable as, for example, in the case of private equity funds where the manager is responsible for determining the timing of capital contributions and withdrawals.

Returns in 2009 and 2007-2009

In 2009, the ESSF's net return in dollars, measured using the time-weighted rate of return (TWR), was 2.47% while that on the PRF was 2.28%. Measured using the internal rate of return (IRR), it reached 2.17% for the ESSF and 2.65% for the PRF.

These results were explained mainly by the positive return (1.28%) generated by changes in the value of the euro and the yen against the dollar and, to a lesser extent (1.19% and 1.00% for the ESSF and the PRF, respectively), by interest earnings and changes in the interest rates on the financial instruments that form part of their portfolios (*Table 1*).

Table 1 **ESSF and PRF: Determinants of returns (TWR), 2009**

(%)

Fund	Component	Quarter				2009
		I	II	III	IV	
PRF	Local currency	0.58	-0.69	1.04	0.05	1.00
	Variations in exchange rates	-2.52	2.52	2.47	-1.09	1.28
	Total return (US$)	**-1.94**	**1.83**	**3.51**	**-1.04**	**2.28**
ESSF	Local currency	0.58	-0.57	1.03	0.13	1.19
	Variations in exchange rates	-2.52	2.52	2.47	-1.09	1.28
	Total return (US$)	**-1.94**	**1.95**	**3.50**	**-0.96**	**2.47**

SOURCE: Ministry of Finance.

In 2009, the Funds showed a positive, but relatively low, return in local currency. This reflected the low level of interest rates on international markets which reached close to historic minimums.

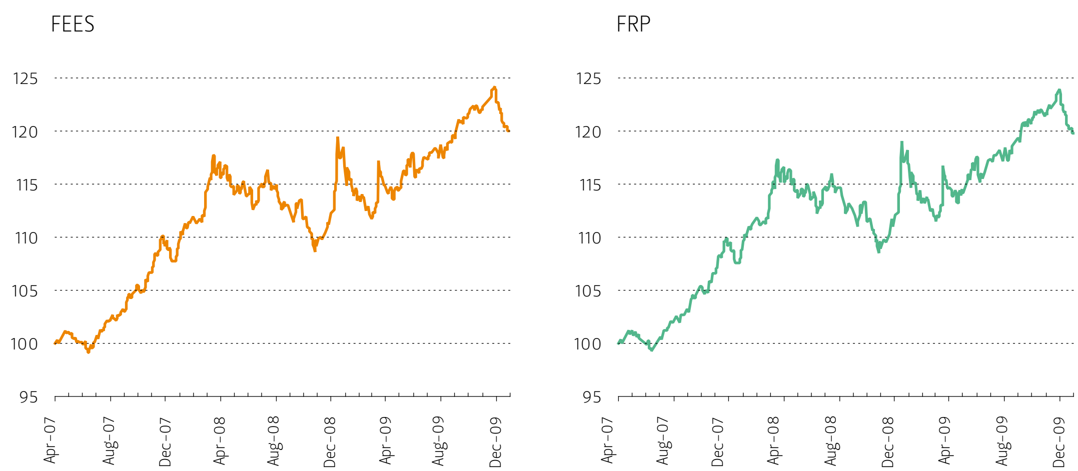
The overall impact of exchange-rate variations was also positive and was principally a result of the appreciation of the euro, which meant an increase in the dollar value of Funds' euro-denominated assets.

Although the returns of the ESSF and the PRF are monitored and reported in dollars, they can also be expressed in Chilean pesos. In this case, their return depends not only on the factors discussed above but also on the peso-dollar exchange rate, with the value of their portfolios in pesos increasing (decreasing) when the peso depreciates (appreciates) against the dollar. In 2009, the peso appreciated strongly against the dollar and their return in pesos was –17.5% for the ESSF and –17.7% for the PRF.

Measured using the TWR, their mean annual return in dollars since March 31, 2007 reached 6.88% and 6.78% for the ESSF and the PRF, respectively.[13] The indexes shown in Figure 4 are representative of each Fund's accumulated return. The index for the ESSF rose from 100 on March 31, 2007 to 120.1 at the end of 2009 while that for the PRF rose from 100 to 119.8 in the same period. The annualized IRR since the Funds' inception reached 6.16% for the ESSF and 5.70% for the PRF.[14]

Figure 4 Index of ESSF and PRF, April 2007–December 2009

(March 31, 2007 = 100)



SOURCE: Ministry of Finance.

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

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

The returns obtained by the ESSF and the PRF in 2009 were below their benchmarks[15] by 16 bps and 36 bps, respectively. Since March 31, 2007, the difference between their annualized returns and their benchmarks was -18 bps for the ESSF and -28 bps for the PRF.

Returns in 2007-2009: international comparisons

The mean annual return achieved by Chile's SWFs since their inception (6.9%) compares favorably with those of other countries' SWFs over the same period. Since the beginning of 2007, Ireland's fund, for example, obtained a return in dollars of -2.7% while other results include New Zealand (-1.6%), Alaska (-0.9%), Norway (1.8%), Canada (2.0%) and Australia (2.8%) (*Table 2*).

Table 2 **Strategic asset allocation and returns in dollars (selected SWFs)**

(%)

Fund	Asset allocation				Return in dollars[b]			
	Money market ins-truments	Fixed-income	Equities	Alternative Investments[a]	2007	2008	2009	2007-2009 (annual average)
Ireland	13	9	72	6	14.2	-33.3	22.0	-2.7
New Zealand	—	18	53	29	15.1	-44.2	48.4	-1.6
Alaska	—	21	54	25	8.8	-24.7	18.9	-0.9
Norway	—	38	62	—	10.2	-27.2	30.8	1.8
Canada	1	26	50	23	20.7	-31.7	28.8	2.0
Australia	16	25	40	19	—	-26.3	43.5	2.8
Chile	**30**	**70**	**—**	**—**	**8.9**	**7.6**	**2.4**	**6.9**

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

(b) In the case of Ireland, the figures correspond to the latest available information (September 2009). The return for Australia's SWF was estimated using information for 2008 and 2009. The return published by each SWF was converted into dollars using the variation of the dollar against the currency used to calculate the published return.

SOURCE: Reports of respective SWFs.

15 This means that the instruments acquired by the fund manager on average generated lower returns than those included in the benchmark.

The high returns achieved by Chile's SWFs were explained mainly by their conservative investment policy which stood them in good stead during the crisis while all other countries' funds suffered heavy losses in 2008, which were only partially recouped by their strong recovery in 2009. The returns in dollars obtained in 2009 by the SWFs of Canada, Ireland and Alaska (29%, 22% and 19%, respectively) were, for example, less than their losses in 2008 (32%, 33% and 25%, respectively). In the case of the New Zealand and Norwegian SWFs, their returns in dollars in 2009 (48% and 31%, respectively) were, in percentage terms, slightly above their losses in 2008 (44% and 27%, respectively), but their average return over the two years remained negative.[16] In the case of Australia's SWF, its return in dollars in 2009 (44%) more than offset its loss in 2008 (26%). Chile's SWFs, on the other hand, reported positive returns in both 2008 and 2009.

The volatility of the returns on SWFs depends mainly on their investment policy. These policies – more aggressive or more conservative – are adopted by each fund in accordance with factors that include its objectives, risk tolerance and investment horizon.

Norway's SWF, for example, allocates a significant part of its portfolio (62%) to equities. Other SWFs, such as those of Ireland, New Zealand, Alaska, Canada and, to a lesser extent, Australia, have also adopted policies that include important allocations of equities and alternative investments. By contrast, more conservative SWFs, such as Chile's, allocate a large part of their portfolios to less volatile asset classes such as fixed-income and money market instruments.

The results analyzed above are in line with empirical evidence suggesting that more conservative investment strategies produce better results at times of crisis and more modest results during periods of recovery.

16 In order to compensate for a negative return of, for example, 50% in one year, a return of 100% is required in the following year.

Appendix

Trends in Key International Financial Indicators, 2009

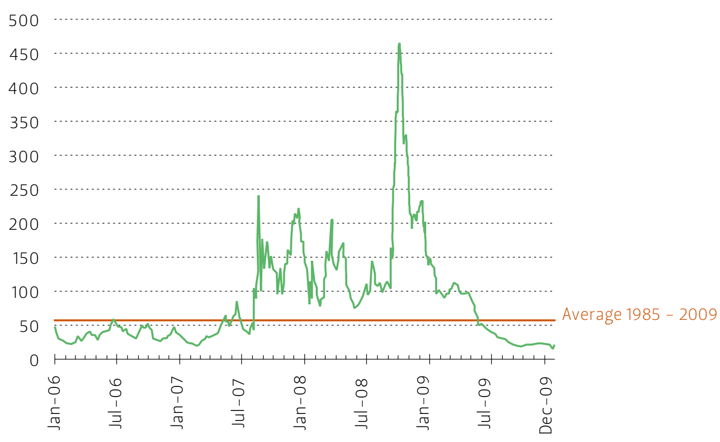
As from the middle of March 2009, the main international financial markets partially recouped the losses they had experienced in the previous 12 months. One of the factors in this improvement was the return of liquidity after its deep contraction during the worst moments of the crisis.

This recovery was the result of the expansive monetary policies implemented by central banks, their massive repurchases of financial assets and the increased availability of information about world mortgage markets which permitted a more accurate estimate of the scale of their potential losses. The combination of these factors helped to reduce financial market uncertainty and permitted a better assessment of the solvency of banks and other economic agents.

Increased liquidity was reflected in a marked drop in the difference between the interest rate on inter-bank lending (LIBOR) and the risk-free rate (US Treasury bills). This difference, known as the TED spread, was running at close to 20 bps (or 0.2 percentage points) at the end of 2009, below its average of 58 bps since 1985 and far below the 450 bps it had reached at the depth of the crisis (*Figure 5*).

Figure 5 **TED spread, 2006-2009**

(bps)

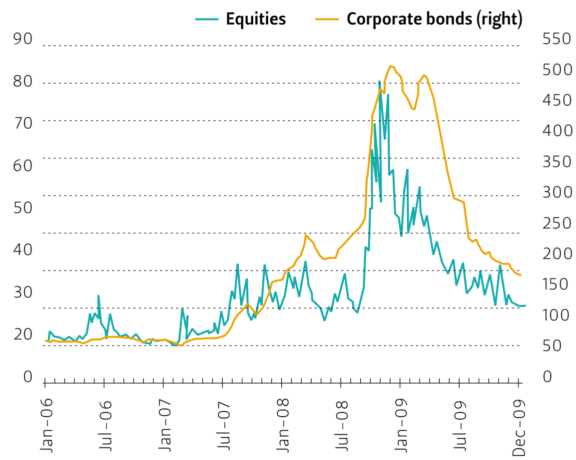


SOURCE: Bloomberg.

At the same time, the reduction in uncertainty meant that risk premiums and the volatility of stock and corporate bond prices dropped to closer to "normal" or long-term levels. As shown in Figure 6, stock market volatility as measured by the CBOE Volatility Index (VIX)[17] returned to levels similar to those seen before the collapse of Lehman Brothers in September 2008 and the spread between corporate bonds and US sovereign debt also dropped significantly, closing the year at around 175 bps.[18]

Figure 6 **Stock market volatility (VIX) and corporate bond spread, 2006-2009**

(left axis, %; right axis, bps)



SOURCE: Ministry of Finance, Bloomberg, Barclays Capital.

As a result of the drop in uncertainty and risk premiums, stock prices showed a strong recovery on most international markets. Over the course of the year, the Standard & Poor's 500 Index (S&P 500) rose by almost 24% while the Morgan Stanley Capital International All Country World Index (MSCI ACWI) showed an increase of 26% (Figure 7).[19]

17 Corresponds to the volatility in the S&P 500 expected by the market during the next 30 days.

18 Calculated using the Barclays Capital Global Aggregate: Corporate Bond Index.

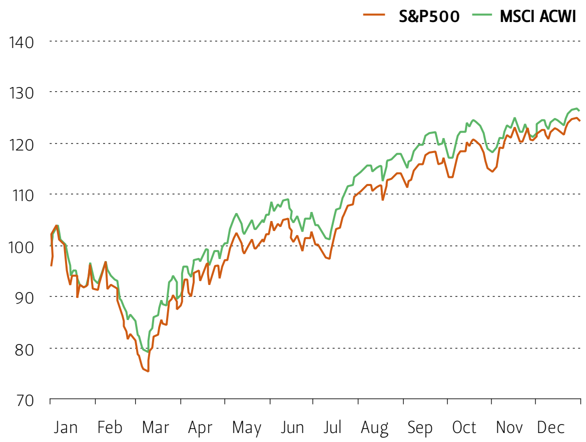
19 The S&P 500 measures the stock market performance of the 500 largest US companies while the MSCI ACWI measures the performance of stock markets in both developed and emerging economies. The return shown in this report is in local currency and, in other words, measures the return on equities without including the effect of the appreciation or depreciation of the currency in which they are denominated.

Figure 7

Stock market, 2009

S&P 500 and MSCI ACWI (in local currency)

(January 2009 = 100)



SOURCE: Bloomberg.

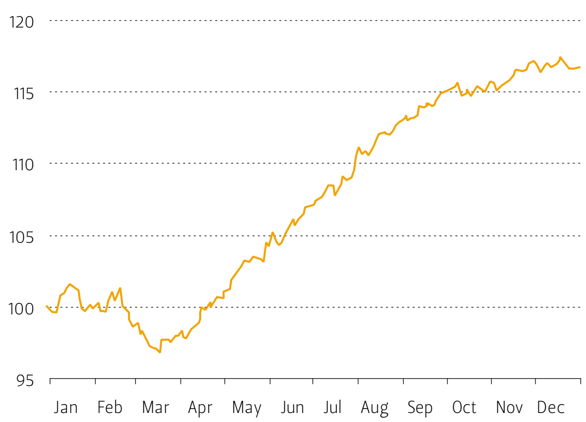
The recovery of markets was also reflected in the performance of corporate bonds, with the Barclays Capital Global Aggregate: Corporate Bond Index (hedged) showing an increase of 17% in 2009 (*Figure 8*).[20]

Figure 8

Corporate bond market, 2009

Barclays Capital Global Aggregate: Corporate Bond Index (hedged)

(January 2009 = 100)



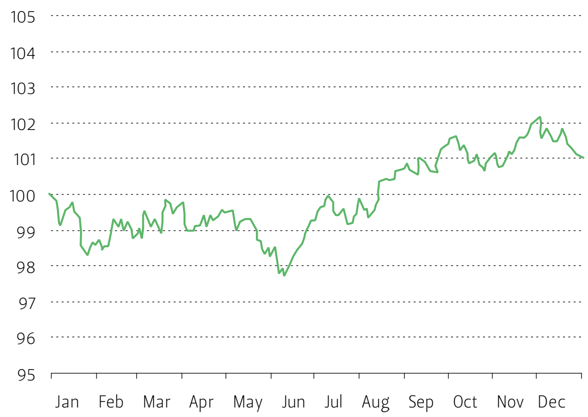
SOURCE: Barclays Capital.

20 The Barclays Capital Global Aggregate: Corporate Bond Index represents the value of a portfolio of fixed-income securities issued by companies in different countries and economic sectors. The hedged version of the Index is shown in order to exclude exchange-rate effect, thereby better reflecting the effect of movements in interest rates and spreads on the price of corporate bonds.

Figure 9 **Nominal sovereign bond market, 2009**

Barclays Capital Global Aggregate: Treasury Bond Index (hedged)

(January 2009 = 100)



SOURCE: Barclays Capital.

The return on nominal sovereign bonds in 2009 was significantly below that on other asset classes. This mainly reflected the fact that, at the beginning of the year, interest rates were already at a historically low level due to the very expansive monetary policies implemented by central banks. As a result, the Barclays Capital Global Aggregate: Treasury Bond Index (hedged) closed the year up by just 1% (Figure 9).[21]

However, the price of inflation-indexed bonds showed an important increase in response to the reduction in risk and liquidity premiums and the Barclays Capital Global Inflation-Linked Index (hedged) showed an annual increase of 9% (Figure 10).[22]

21 The Barclays Capital Global Aggregate: Treasury Bond Index measures the performance of the sovereign fixed-income securities of most investment-grade countries.

22 The Barclays Capital Global Inflation-Linked Index measures the performance of inflation-indexed bonds in the main markets.

Figure 10 **Inflation-indexed sovereign bond market, 2009**

Barclays Capital Global Inflation-Linked Index (hedged)

(January 2009 = 100)

SOURCE: Barclays Capital.

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Glossary

of Financial Terms

Glossary

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

Basis point —one hundredth of a percentage point.

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

Cash —cash in hand and bank demand deposits.

Corporate bond —a bond issued by a private company.

Duration —a measure of the exposure of a bond's price to changes in interest rates; the longer the duration, the greater its sensitivity to changes in interest rates.

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

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

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

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

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

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

LIBOR —London Interbank Offered Rate, the interest charged on interbank borrowing.

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

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

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

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

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

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

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

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

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

Sovereign bond —a bond issued by a government.

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

Stocks —securities that represent the ownership or capital of a company; buyers of stock become owners or shareholders of the company and, therefore, participate of its profits and losses.

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

US financial agency —a US mortgage institution with explicit or implicit government backing.

Variable-income —see Stocks.

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

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