ANNUAL REPORT
FINANCIAL COMMITTEE

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

2012

This publication corresponds to the 2012 **Annual Report of the Finance Ministry's Financial Committee**

The electronic version of this document is available on the Ministry of Finance website:
http://www.hacienda.cl/english/sovereign-wealth-funds.html

ISSN: 0718-5790

April 2013, Santiago, Chile

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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 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 sixth prepared by the Committee—describes its work and activities in 2012.

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 lower house of Congress and to the Joint Budget Commission of Congress.

The Committee

Members of the Financial Committee

PRESIDENT

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 University of Chile, an international consultant and company director. He has served as chief economist of the OECD in Paris and as director of its Economics Department and previously worked as head of economic research at the Central Bank of Chile and principal economist at the Research Department of the World Bank in Washington. In addition, he has chaired the Chilean Economics Society. He joined the Committee in August 2009.

VICE-PRESIDENT

Cristián Eyzaguirre Johnston

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

MEMBER

Arturo Cifuentes Ovalle

Cifuentes studied civil engineering at the University of Chile and holds a Ph.D. in applied mechanics from the California Institute of Technology (Caltech) and an MBA in finance from New York University. He is currently a member of the Academic Committee of the Center for Micro-financial Stability and Regulation of the University of Chile's Economics and Business Department and member of the governing board of the Humanities and Social Sciences Division of the California Institute of Technology (Caltech). He previously worked as a researcher at the IBM T.J. Watson Research Center in New York and as an executive for different Wall Street companies (Triton Partners, Wachovia Securities, Ambac Assurance Corporation and R.W. Pressprich). He has also served as a consultant to private sector companies and government bodies in the United States, Chile and Australia and as a professor at the University of Chile, California State University and the University of Southern California. He joined the Committee in August 2011.

MEMBER

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. He joined the Committee in January 2007.

MEMBER

Eric Parrado Herrera

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

MEMBER

Eduardo Walker Hitschfeld

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

CHAPTER 1

Fiscal policy and 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 policy helps prevent drastic changes in the level of public spending in the face of cyclical or unexpected economic events, by saving in boom times and then using the savings during cyclical downturns in gross domestic product and/or the international copper price.[3]

To ensure the sustainability of public spending over time and contribute to the competitiveness of the economy, the Fiscal Responsibility Law (Law No 20,128) 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.

B. Objectives and rules on the use of the funds

Objectives

The funds created by the Fiscal Responsibility Law (henceforth, the sovereign wealth funds) have specific objectives: in the case of the ESSF, to accumulate resources to finance potential fiscal deficits, to amortize public debt and to finance the PRF if necessary; in the case of the PRF, to complement the financing of future fiscal liabilities deriving from the state pension guarantee.

Rules on Fund contributions

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

The PRF is increased each year by a minimum of 0.2% of the previous year's gross domestic product (GDP). If the effective fiscal surplus exceeds 0.2% of GDP, the PRF receives a contribution equivalent to the surplus, up to 0.5% of GDP. PRF contributions only have to be made until the fund reaches UF 900 million (unidad de fomento, UF).

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1 Schmidt-Hebbel (2012); Velasco and Parrado (2012).

2 See footnote N°1 in Larraín and others (2011).

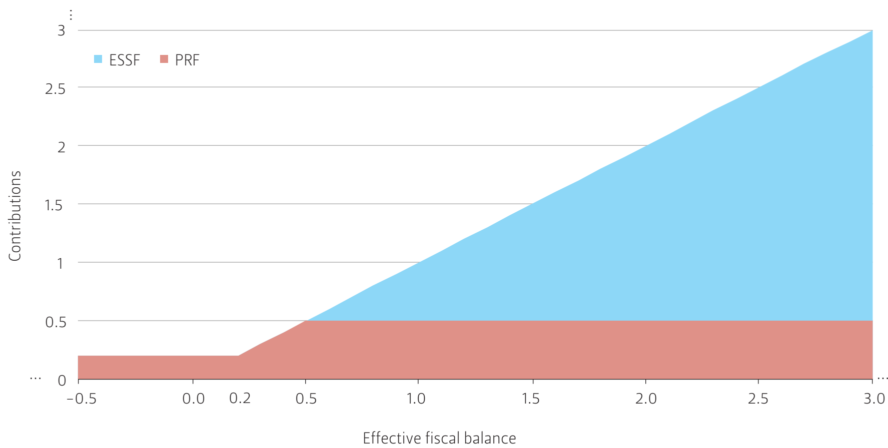
3 The structural balance rule (or cyclically adjusted balance rule) has been modified in several aspects since its establishment. For a detailed discussion of its design, modifications, application and results, see Marcel and others (2001); Rodríguez, Tokman and Vega (2006); Velasco and others (2010); Advisory Committee for the Design of a Second-Generation Structural Balance Fiscal Policy for Chile (2011); Larraín and others (2011).

4 For the PRF, the Fiscal Responsibility Law; for the ESSF, Decree with Force of Law (DFL) N° 1, issued by the Finance Ministry 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 amortizations and any advance contributions to the fund.[5]

FIGURE 1

Fiscal savings rule
(percent of GDP)



Source: Ministry of Finance.

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 amortization of public debt (including Recognition Bonds) and for financing the annual contribution to the PRF, when the Finance Minister so decides.

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

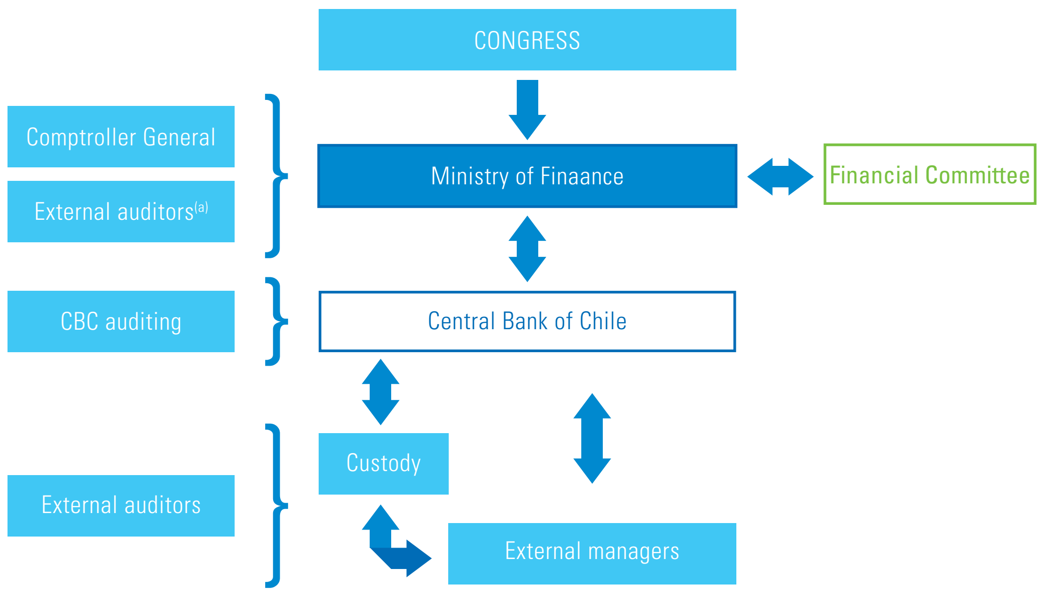
5 The current legislation allows the pay down of public debt and advance contributions to the ESSF using resources from the fiscal surplus of the current year, which must be deposited into the fund in the current or subsequent years.

C. Institutional framework

The legal framework establishes a clear division of roles and responsibilities in order to facilitate 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 their management (see Diagram 1).

DIAGRAM 1

Institutional framework for Chile's sovereign wealth funds



(a) External auditors are contracted to assess and verify the accuracy and consistency of the financial statements prepared by the General Treasury.

Source: Ministry of Finance.

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 Finance Ministry draws up the investment guidelines, which define the instruments and issuers that are eligible for investment, the investment limits, the use of derivatives and so forth; these guidelines must be respected by all agents authorized to invest the funds' resources. The Ministry monitors compliance with the investment guidelines and issues monthly, quarterly and annual reports on the state of the funds.

The Treasury is responsible for the funds' accounting and the preparation of their audited financial statements. The Budget Office is responsible for budgetary issues related to the funds.

Central Bank of Chile

Executive Decree Nº 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 Central Bank contracted Black Rock Institutional Trust Company NA, Mellon Capital Management Corporation and Rogge Global Partners PLC to manage the investment of 35% of the PRF portfolio starting in January 2012 (see Box 1).

Box 1:

External management selection process of 2011

In 2011, the CBC implemented a selection process for contracting external managers to handle the diversification of the PRF portfolio into corporate bonds and equities, which was implemented in early 2012.

The external managers were selected in five stages:

1. Contracting of the consultant. Based on recommendations from the Financial Committee, the Finance Ministry authorized the CBC to begin the process of selecting external managers by sending a Request for Proposal (RFP) to firms that reached this stage in the 2008 process and to contract a consultant to support the selection, in accordance with the CBC standard for this type of process. Thus, the assessment of potential external managers would be backed by specialized technical support, and the Bank would have access to the consultant's extensive databases. The CBC contacted several companies and ultimately hired Strategic Investment Solutions (SIS) as a consultant.

2. Request for proposals. In mid-August 2011, following instructions from the Finance Ministry, the CBC invited forty-six companies to participate in the new process, all of which had submitted proposals in the 2008 selection process.[1] Of the companies that received an invitation, fifteen submitted proposals for the equity investment program and twelve for corporate bond investments. Five firms were short-listed for each mandate (equities and corporate bonds) after evaluating qualitative and quantitative aspects of the proposals received.

3. Interviews in San Francisco, California, USA. The five firms selected for each mandate were invited to participate in a round of interviews held in San Francisco in early October. The interviews were conducted by representatives of the CBC, the Finance Ministry and SIS. In this stage, the field was narrowed to three firms for each mandate.

1 The list was updated to reflect corporate events occurring after 2008, such as mergers and acquisitions.

4. Interviews in Santiago and presentation to the Financial Committee. The finalists were interviewed in Santiago by the CBC, the Finance Ministry, members of the Financial Committee and SIS. Based on these interviews, and taking into account the opinion of SIS, the CBC submitted a proposal to the Financial Committee regarding which firms to contract.

5. Final selection. On consideration of the selection process conducted by the CBC and the recommendations made by the Financial Committee, the Finance Minister authorized the contracting of two firms for each mandate. The process came to a close with the approval of the Board of the Central Bank and the formal communication by the CBC to the chosen firms, namely, Black Rock Institutional Trust Company, N.A. and Mellon Capital Management Corporation for the equity portfolio and Black Rock Institutional Trust Company, N.A. y Rogge Global Partners PLC for the corporate bond portfolio. These companies began managing the new PRF mandate in January 2012.

Financial Committee

The Fiscal Responsibility Law stipulates that the Ministry of Finance must create an Advisory Committee to consult to the Finance Minister on the sovereign wealth funds (henceforth, the Financial Committee). The Committee monitors the investment of the funds' resources and advises the Minister on the definition of the investment policy. 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), 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 every six months, but in practice it has met at least 7 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 allocation by asset class, the incorporation of new investment alternatives, the specification of portfolio benchmarks, 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.[6]

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 policies outlined in this section.

Economic and Social Stabilization Fund (ESSF)

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.

The investment policy in force has been consistent with these objectives. Through year-end 2012, it exclusively stipulated investment in fixed-income instruments denominated in reserve currencies, which typically perform well in times of crisis. This maximizes not only the value of the fund's accumulated resources measured in foreign currency, but also their conversion into

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

pesos (in which most fiscal spending takes place) when their use is most needed. During the 2008 crisis, for example, their returns were not affected, but rather were very favorable in peso terms. This contrasts with the performance of other countries' sovereign wealth funds, whose more risky profile contributed to significant short-term losses (see Box 2). The current strategic asset allocation of the ESSF is 30% in money market instruments, 66.5% in nominal sovereign bonds and 3.5% in inflation-indexed sovereign bonds, with currency allocation of 50% in U.S. dollars, 40% in euros and 10% in yen.

At the request of the Finance Minister, the Committee undertook a review of the above policy in 2011 and 2012 in order to assess whether the ESSF investment policy fulfilled the objective for which it was created. The materials reviewed and analyzed included a study on portfolio allocation commissioned by the Finance Ministry and conducted by Eduardo Walker; a peer review of Walker's study by three external specialists; and additional simulations using market data for the last twenty years, conducted by the Finance Ministry's International Finance team. Based on its review, the Financial Committee recommended changing the ESSF investment policy (see chapter 3.A). The Finance Minister then used these recommendations to design a new policy (see Figures 2 and 3), which will be implemented in the first half of 2013.

Box 2:

Returns and risks of sovereign wealth funds

The results obtained by sovereign wealth funds (SWFs) mainly depend on the investment policy defined for a given fund, which reflect the objectives for which the fund was created. These objectives determine a number of factors, such as the fund's risk tolerance and investment horizon. For example, the investment policies of SWFs whose objectives are related to financing pensions (such as Australia's and New Zealand's funds or the PRF) or saving resources for future generations (as in Norway) have riskier investment policies, in line with their longer-term investment horizons and correspondingly greater risk tolerance. Other more conservative SWFs, such as economic stabilization funds (including the ESSF and East Timor's SWF), invest mainly in fixed-income assets, since their main objective is to finance public spending when fiscal revenues fall, which can occur in a shorter horizon.

Table 2.1 compares the main characteristics of different countries' SWFs, including their size, the type of fund, the asset allocation, their annual returns in dollars (measured by the time-weighted rate of return, TWR) for 2007–2012, the annualized average return in the same period and the standard deviation of their annual returns.

The table shows that the mean annual return in dollars since early 2007 was 1.0% for the SWF in Ireland; 3.5% in Alaska; 3.9% in Norway; 4.2% in East Timor; 4.3% in the ESSF and 5.0% in the PRF (both in Chile); 6.5% in Canada; 7.2% in New Zealand; and 9.0% in Australia. In 2011, the best performance was recorded by funds with larger shares of fixed-income assets, whereas in 2012 the highest returns were obtained by funds with more aggressive investment policies, that is, with a larger share of equities and alternative investments. Thus, the 2012 returns on the SWF in New Zealand were 27%; Canada, 16,7%; Australia, 14.8%; Norway, 14.6%; Alaska, 12.6%; and Ireland, 9.2%. All these funds had fixed-income shares of less than 40% of their portfolios. In Chile and East Timor, in contrast, the SWFs yielded returns were under 5%, in line with their more conservative investment policies. However, the volatility of these latter funds was also much lower than the higher-yielding group in the 2007–2012 period.

TABLE 2.1

Returns and risks of sovereign wealth funds [(a)]
(percent, unless otherwise indicated)

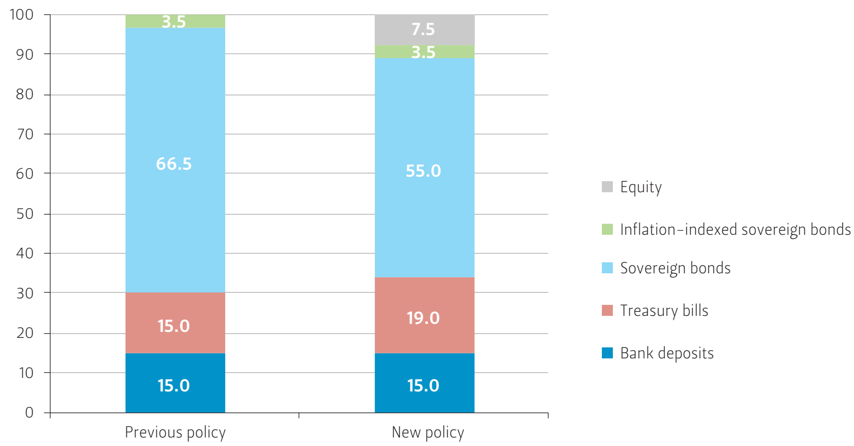
Found	Size (US$ billion)	Type of fund[(b)]	Asset allocation			Return in dollars							
			Fixed-income	Equities	Alternative investments [(c)]	2007	2008	2009	2010	2011	2012	2007-2012 (annualized) [(d)]	Standard deviation (annualized)[(e)]
Australia	86	P	29	35	36	-26.3	44.0	24.8	1.4	14.8	9.0	**26**	26
New Zealand	17	P	9	66	25	15.1	-44.2	48.4	24.3	0.8	27.0	**7.2**	32
Canada	17	SA	21	53	26	20.7	-31.7	28.7	15.7	1.8	16.7	**6.5**	22
Chile (PRF)	**6**	**P**	**84**	**16**	**0**	**8.9**	**7.6**	**2.3**	**1.8**	**3.4**	**4.9**	**5.0**	**3**
Chile (ESSF)	**15**	**S**	**100**	**0**	**0**	**8.9**	**7.6**	**2.5**	**1.8**	**3.4**	**1.0**	**4.3**	**3**
East Timor	12	S	74	26	0	7.4	6.9	0.6	3.8	2.8	3.7	**4.2**	3
Norway[(f)]	686	SA	38	61	1	10.2	-27.2	30.8	8.8	-4.0	14.6	**3.9**	20
Alaska	44	SA	21	45	34	8.8	-24.7	18.9	11.9	0.3	12.6	**3.5**	16
Ireland	15	P	22	41	37	14.2	-33.3	23.6	4.4	-1.1	9.2	**1.0**	20

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

(a) The information in the table was obtained from reports published by the funds and corresponds to year-end 2012.
(b) "SA" = savings; "P" = pensions; "S" = stabilization.
(c) Alternative investments mainly include private equity, hedge funds, commodities and real estate.
(d) The return for Australia is estimated using data from 2008 to 2012. Methodologically, 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.
(e) Calculated on the basis of annual returns.
(f) Government Pension Fund Global.

FIGURE 2

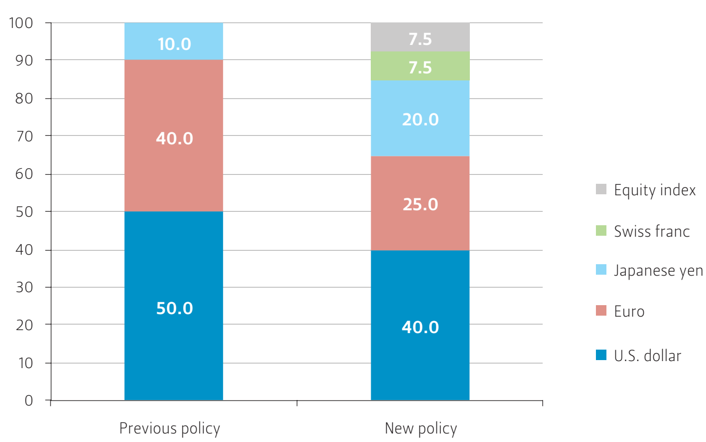
Previous and new investment policies of Economic and Social Stabilization Fund[7]
(percent of portfolio)



Source: Ministry of Finance.

FIGURE 3

Currency allocation under the previous and new investment policies of Economic and Social Stabilization Fund
(percent of portfolio)



Source: Ministry of Finance.

7 The new ESSF investment policy will be implemented in 2013.

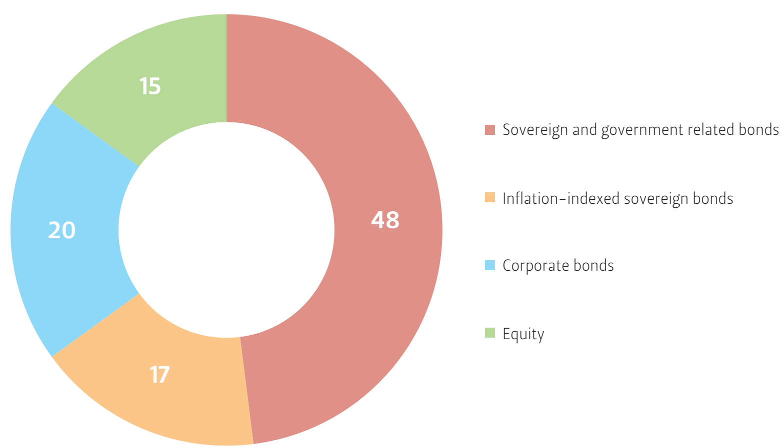
Pension Reserve Fund (PRF)

The main objective of PRF investment is to generate resources for financing a share 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 creation through year-end 2011; a new investment policy was then implemented in 2012 (see Box 3). The new policy stipulates a portfolio allocation of 48% in nominal sovereign bonds, 17% in inflation-indexed sovereign bonds, 15% in equities and 20% in corporate bonds (see Figure 4). The policy was recommended by the Financial Committee in late 2010, with the support of a study carried out by the Mercer consulting firm, using pre-specified risk and return parameters.

FIGURE 4

Current strategic asset allocation of Pension Reserve Fund
(percent of portfolio)



Source: Ministry of Finance.

Box 3:

Main elements of the PRF investment policy

Investment objectives: The main objective of PRF investment is to generate resources for financing a share 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 and government related bonds, 17% in inflation-indexed sovereign bonds, 15% in equities and 20% in corporate bonds. The previous investment policy was identical to the ESSF investment policy.

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

Asset class	Percent of portfolio	Benchmark
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)
Equities	15%	MSCI All Country World Index (unhedged with reinvested dividends)

(a) In this asset class the subindexes are weighted by their relative capitalization.

Management: The sovereign and government related, and inflation-indexed sovereign bond portfolios are managed directly by the Central Bank of Chile, acting as fiscal agent. The equity and corporate bond portfolios are managed by external managers contracted by the Central Bank of Chile following a tender process.

Ex ante tracking error: The ex ante tracking error is capped at 50 basis points for the aggregate portfolio of nominal sovereign bond, other related assets and inflation-indexed sovereign bond; 30 basis points for the equity 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.

Leveraging and the use of derivatives: Leveraging is not allowed. Derivatives can only be used for hedging purposes to minimize differences against the applicable benchmark.

- Forwards: The Central Bank of Chile and the external managers can contract forwards to minimize differences against the respective currency allocation benchmark. The total nominal value of the forwards contracted by each external manager cannot exceed 2% of the market value of the portfolio under management. For the portfolio managed by the Central Bank of Chile, the limit is 4%.
- Futures: The external managers can contract futures, with a maximum aggregate nominal amount of 2% of each manager's portfolio.

Investment guidelines: The investment guidelines are published and available online at http://www.hacienda.cl/english/sovereign-wealth-funds/pension-reserve-fund/investment-policy.html. The guidelines 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.

CHAPTER 2

Status of the funds

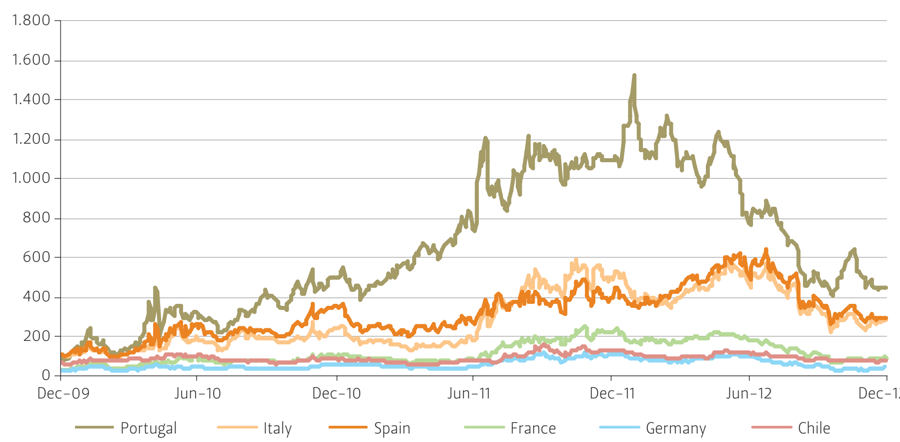
A. Market analysis

In 2012, the year was marked by the ongoing European crisis and by a series of events that affected the main financial variables with a direct impact on the performance of Chile's sovereign wealth fund portfolios.

In Europe, the fears associated with a Greek default, exacerbated by political uncertainty in the country, and the potential for a disordered Greek exit from the euro area generated a lot of tension in the international financial markets in the first part of the year. These factors had a negative effect on other countries in the region, which had to face increased financing costs, while the spreads on their credit default swaps (CDS)[8] peaked in late May (see Figure 5). However, the situation was partially resolved in the second half, after the Greek political situation improved and the European Central Bank (ECB) implemented a series of extraordinary measures, such as cutting its monetary policy rate to a new historical low of 75 basis points and undertaking outright monetary transactions (OMT),[9] to provide support to countries that were facing high financing costs. Nevertheless, the economic situation of the euro area countries remained very fragile, given that many of them did not record positive real growth in 2012.

FIGURE 5

Five-year credit default swaps (CDS): Selected European countries and Chile, 2010 – 2012 (basis points)



Source: Bloomberg.

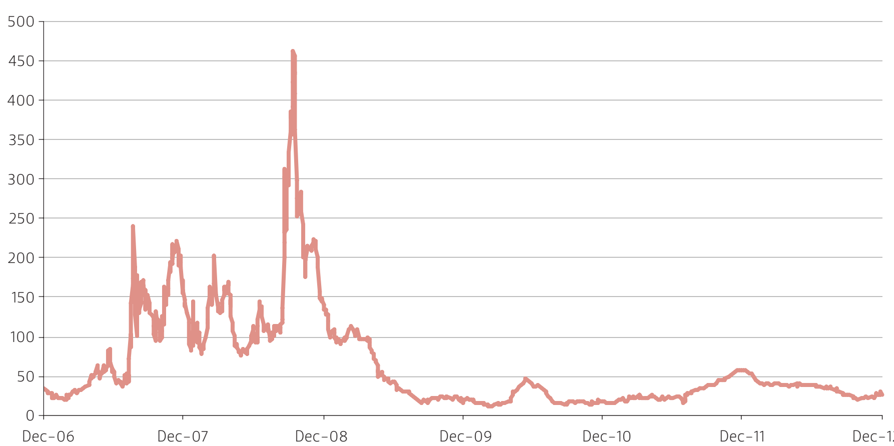
8 CDSs represent the cost of financial instruments to protect against default by an issuer.

9 A program for purchasing short-term sovereign bonds in the secondary market.

In the United States, the economy has shown some signs of recovery, but it remains below its pre-crisis growth rate, with growth of 2.2% in the year. This has hindered the reduction of the unemployment level, which was 7.8% at year-end 2012. Furthermore, political difficulties continued over the course of the year, such that the U.S. Congress was unable to reach an agreement on reducing its fiscal deficit and avoiding a series of automatic adjustments that would enter into effect in 2013 (the so-called fiscal cliff).[10] In September 2012, the U.S. Federal Reserve announced an asset purchase program (Quantitative Easing III), with the goal of supporting the mortgage market and holding down long-term interest rates, and it publically committed to keeping the monetary policy rate low at least through mid-2015.[11] This measure, together with the actions taken by the Central European Central Bank, contributed to an easing of financial uncertainty (on the part of banks) in the second half of 2012, which was reflected in reductions in the TED spread (see Figure 6).

FIGURE 6

TED Spread[12], 2007–2012
(basis points)



Source: Bloomberg.

With regard to Asia, the Japanese economy grew 2% in 2012, but it went into recession in the third quarter of the year. To stimulate the economy and to mitigate the appreciation of the yen and the strong deflationary pressures, the Bank of Japan expanded its asset purchase program to ¥ 120 trillion (equivalent to US$ 1.4 trillion) and held the interest rate in the range of 0.0–0.1%.

10 The fiscal cliff corresponds to a number of automatic adjustments (tax increases and fiscal expenditure reductions) that were scheduled for implementation starting in 2013 if the U.S. Congress had not been able to agree on measures to reduce the fiscal deficit by US$ 1.2 trillion over ten years. As of the publication of this report, the Congress had already agreed to a number of tax increases as part of the set of initiatives to reduce the fiscal deficit (the agreement was reached in January 2013). Nonetheless, the Congress was not able to agree on how to cut expenditures. As a result, several expenditure reductions were triggered automatically on March 1st, 2013 and would become effective as of March 27.

11 In December 2012, the U.S. Federal Reserve announced additional measures, explicitly stating, for the first time, that it would maintain an expansive monetary policy as long as the unemployment rate remains over 6.5% and two-year-ahead inflation expectations are below

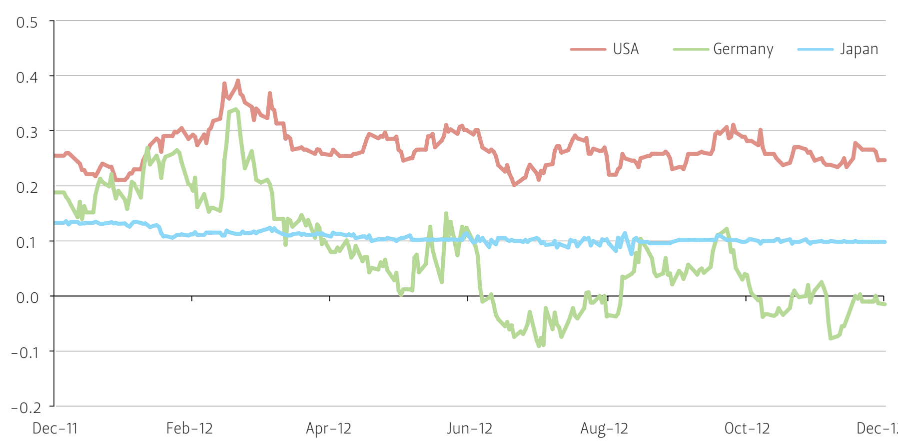
12 The TED spread is the difference between the interbank borrowing rate (LIBOR) and the risk-free rate (U.S. Treasury bills). A higher TED spread typically indicates a lower level of market liquidity.

In addition, the new government, elected in December 2012, is expected to implement a series of measures to stimulate the economy.[13] In China, the second-largest economy in the world, the growth rate was 7.8% in 2012, down from 9.3% in 2011. However, in the last quarter of 2012, the growth rate reversed the downward trend recorded quarterly since the close of 2010.

In this context, the interest rates on bonds issued by the United States, Germany and Japan in national currency have remained at historically low levels, and they have even dropped into negative territory in the case of German bonds (see Figure 7).

FIGURE 7

Yield to maturity on two-year sovereign bonds: United States, Germany and Japan, 2012
(percent)



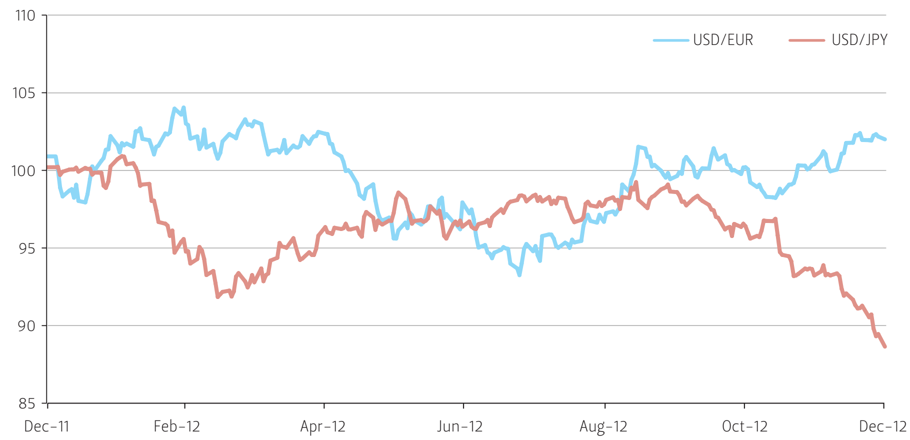
Source: Bloomberg.

13 In early 2013, a fiscal stimulus plan was announced for ¥ 10 trillion (US$ 116 billion).

With regard to exchange rates, the Japanese yen depreciated 12.8% in 2012, closing the year at 86.8 JPY/USD. In contrast, the euro hardly fluctuated at all, appreciating just 2% over the course of the year and ending at 1.319 USD/EUR (see Figure 8).

FIGURE 8

Exchange rates, 2012
(31 December 2011 = 100)

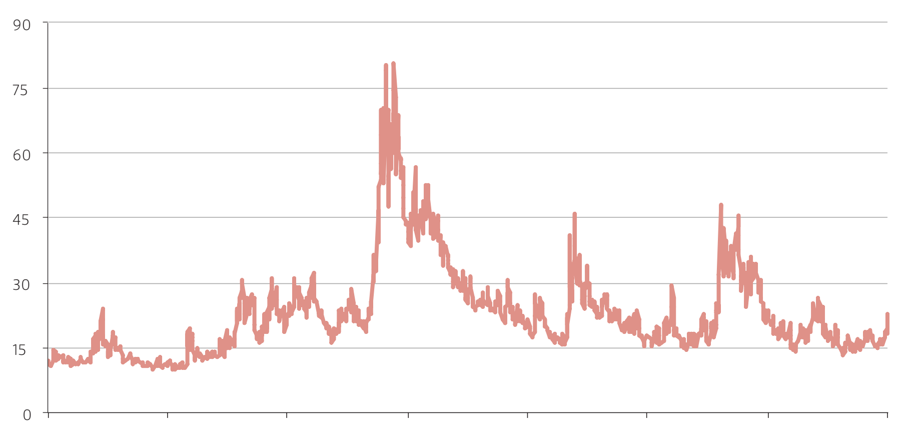


Source: Bloomberg.

The reduction in market volatility was reflected in the VIX Index, which represents the expected volatility of the Standard & Poor's 500 Index (S&P 500) in the United States. The current levels are far below the peaks recorded at the height of the financial crisis and the later European crisis (see Figure 9).

FIGURE 9

Stock market (S&P 500) volatility (VIX), 2006 – 2012
(percent)



Source: Bloomberg.

The corporate fixed-income market recorded a positive performance in 2012. This can be seen in the evolution of the Barclays Capital Global Aggregate: Corporates Bond Index,[14] which yielded returns of 11% in the year (see Figure 10).

FIGURE 10

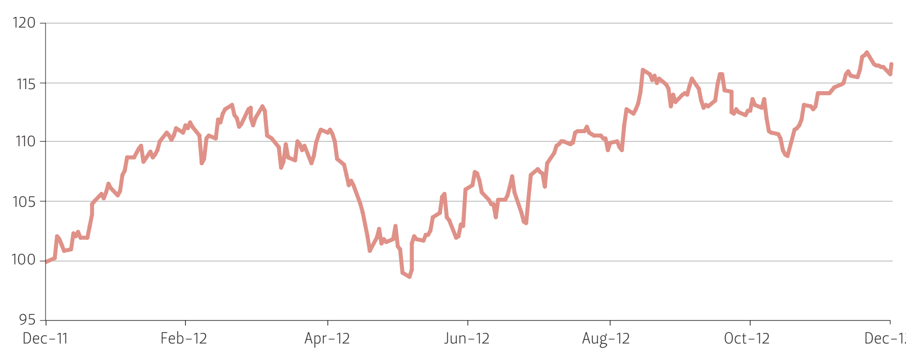
Evolution of the Barclays Capital Global Aggregate: Corporate Bond Index, 2012
(31 December 2004=100)

Source: Barclays Capital.

The MSCI ACWI index,[15] which captures the behavior of the global equity market, closed the year with a return of 16.6% (see Figure 11). The index's lowest value of the year was recorded at the worst point of the European crisis.

FIGURE 11

Evolution of the MSCI ACWI Index, 2012
(31 December 2011=100)



Source: Bloomberg.

14 The Barclays Capital Global Aggregate: Corporates Bond Index tracks the value of a portfolio made up of investment-grade fixed-income instruments issued by companies in different countries and economic sectors.

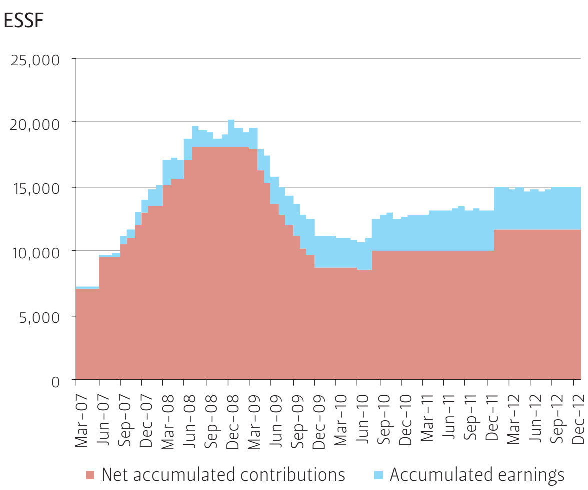
15 The MSCI All Country World Index (ACWI) includes stocks from 45 countries (24 developed and 21 emerging).

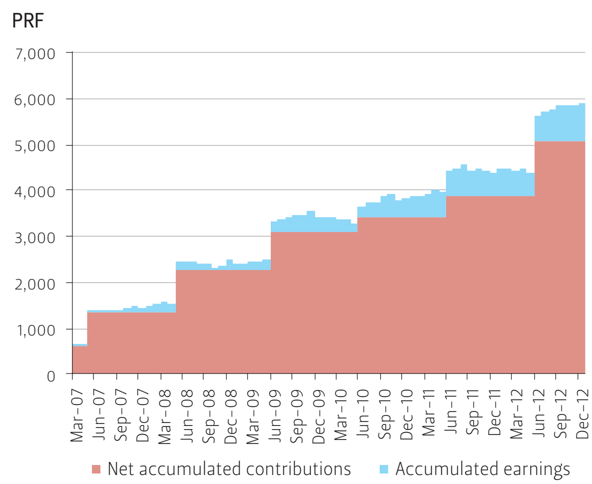
B. Market value

At the close of 2012, the market value of the ESSF was US$ 14.998 billion, versus US$ 13.157 billion at the close of 2011, while the PRF had a market value of US$ 5.883 billion, versus US$ 4.406 billion at year-end 2011. The increase in the value of the ESSF was due to a contribution of US$ 1.700 billion and net investment earnings of US$ 141 million. The PRF, in turn, grew mainly as a result of a contribution of US$ 1.197 billion, plus net financial gains of US$ 280 million (see Figure 12).

FIGURE 12

Evolution of market value, March 2007 to December 2012
(billions of dollars)





Source: Ministry of Finance.

C. Returns

1. Conceptual definitions

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

The ESSF portfolio is made up exclusively of sovereign instruments from the United States, Germany and Japan and time deposits in banks with a credit rating of A– or higher, that is, with a high creditworthiness. Therefore, the most important factors affecting returns are the level and changes in interest rates and exchange rate fluctuations.[16] The return on short-term fixed-income instruments is basically determined by the interest rate, which tends to be stable in its local currency. For medium- and long-

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

term instruments, 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 euros or yen increases (decreases) as a result of an appreciation (depreciation) of these currencies against the U.S. dollar.

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 investment countries 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.[17] 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 instrument. 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 instrument'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 equities, the return largely depends on the market's perception of the income-generation capacity in relevant industries and the risk associated with each firm.

2. Returns in 2012 and 2007–2012

In 2012, the net return in dollars, measured by the time-weighted rate of return (TWR), was 1.02% for the ESSF and 4.87% for the PRF. Using the internal rate of return (IRR), the yield was 0.96% for the ESSF and 5.55% for the PRF.

In the case of the ESSF, the total yield reflects a return of 1.44% from accrued interest and changes in the interest rates on the financial instruments included in the portfolio, which was reduced by 0.42% due to exchange rate fluctuations, mainly the depreciation of the yen against the dollar, which was partially offset by an appreciation of the euro against the dollar (see Table 1).

The PRF return is mainly explained by the return on equities (13.15%), inflation-indexed bonds (9.92%) and corporate bonds (9.41%), while nominal sovereign bonds and related assets only contributed 1.51%. These returns are consistent with the restoration of calm in the international financial markets following the adoption of measures by the main monetary authorities in the developed regions in 2012 to speed up the recovery and address the crisis in Europe.

17 Whereas the ESSF only invests in sovereign debt instruments issued by the United States, Germany and Japan, 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– or better).

TABLE 1

Determinants of returns (TWR) in dollars, 2012
(percent)

Fund	Component	Quarter I	Quarter II	Quarter III	Quarter IV	2012
ESSF	Local currency	0.03	0.76	0.47	0.16	1.44
	Exchange rate fluctuations	0.38	–1.57	0.84	–0.05	–0.42
	Total return (USD)	**0.41**	**–0.81**	**1.31**	**0.11**	**1.02**
PRF	Sovereign and government related bonds	–0.67	0.93	3.10	–1.79	1.51
	Inflation-indexed sovereign bonds	3.53	–0.44	3.51	3.03	9.92
	Corporate bonds	2.46	0.00	4.86	1.83	9.41
	Equities	8.59	–5.40	6.87	3.07	13.15
	Total return (USD)	**0.69**	**–0.46**	**4.10**	**0.52**	**4.87**

Source: Ministry of Finance.

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 2012, the peso appreciated substantially against the dollar, resulting in a return in pesos of –7.20% for the ESSF and –3.35% for the PRF.

In 2012, the ESSF earned lower returns than the benchmark by 7 basis points (see Box 4). The PRF return was 89 basis points below the benchmark. However, if the first quarter is excluded (when the new mandate was implemented), the PRF return was only 7 basis points below the benchmark.[18] Since 31 March 2007, the difference relative to the respective benchmark was –13 basis points for the ESSF and –32 basis points for the FRP.[19, 20]

Figure 13 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 127.8 at year-end 2012; for the PRF, it increased from 100 to 132.3 in the same period.

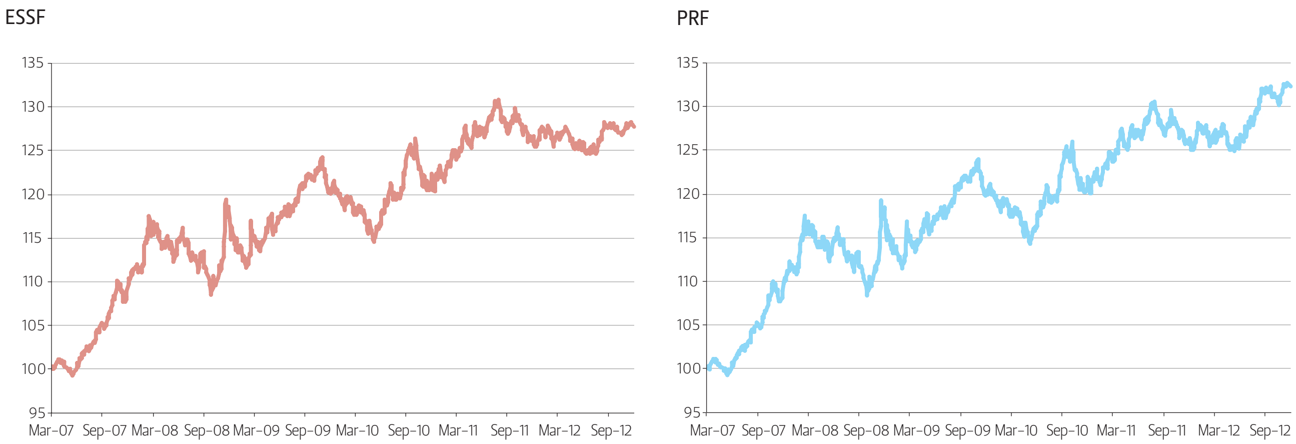
18 The transition period for the implementation of the new mandate was from 1 January to 15 March 2012.

19 This implies that the manager's portfolio generated lower returns, on average, than the implicit benchmark portfolio in the full period from 2007 to 2012.

20 For the PRF, the first quarter is excluded due to the implementation of the new investment policy.

FIGURE 13

Index of accumulated returns, April 2007 to December 2012
(31 March 2007 = 100)



Source: Ministry of Finance.

Box 4:

Benchmarks

Benchmarks are representative market indexes for different asset classes. In principle, they represent the passive investment performance of diversified portfolios invested in specific asset classes, where the return on each instrument is typically weighted by its relative share of market capitalization. These indexes are used as a reference for measuring the performance of the portfolio managers.

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

If the manager achieves a return above the benchmark, it implies that the selected instruments in the portfolio delivered higher returns, on average, than those included in the benchmark or that market timing produced positive ex post results. It is unusual, however, for managers to systematically obtain returns that exceed their benchmarks.

The ESSF and the PRF both have passive investment policies. That is, their investment strategies are aimed at achieving the same return as the benchmark.

CHAPTER 3

Activities and recommendations of the Financial Committee

A. Investment policy of the Economic and Social Stabilization Fund

In the second half of 2010, the Finance Minister decided to undertake an assessment of the ESSF investment policy to ensure that it complies with the fund's original objectives. The Ministry of Finance commissioned Eduardo Walker, one of the members of the Financial Committee, to carry out the study.

The ESSF investment policy must take into account the primary objective of maximizing the fund's accumulate value in order to partially cover cyclical reductions in fiscal revenues, while maintaining a low level of risk. The study thus analyzed possible investment policies, without considering alternative mechanisms for covering fiscal revenues, such as the advance sale of copper or the purchase of copper sale options.

A financial model was developed and calibrated for deriving the main parameters to be factored into the investment policy. The study sought an optimal strategic asset allocation for maximizing a given expected welfare level (earnings) associated with the average consumption level in a given horizon. Consumption was defined as the (average) fiscal revenue and the balance of the fund, plus accumulated earnings at each horizon. The study evaluated different horizons.[21]

The main conclusions of the study were as follows:

- In the medium- and long- term, the volatility of total fiscal revenue is largely determined by the volatility of mining income,[22] despite the fact that mining represents less than 20% of total revenue.
- The results indicate that, by their nature, the portfolios that help provide risk coverage for fiscal revenue are highly volatile (measured in UFs), on a level similar to equity investments. This volatility is necessary for covering a liability (fiscal revenue) that is, in turn, highly volatile. Consequently, there is a trade-off between short-term volatility (which implies a potential reputational or headline risk) and better hedging against a negative surprise to fiscal income.
- Short- and long-term investments in yen and, to a lesser extent, investments in long-term Swiss franc bonds and long-term euro bonds are the main asset classes that can help provide risk coverage for fiscal revenue.
- The practical recommendations deriving from this study point to increasing the relative weight of the yen and other currencies and reducing the relative weight of the U.S. dollar and the euro.

In line with academic best practices, the Financial Committee invited three external analysts to undertake a peer review of Professor Walker's study in early 2012. To this end, the study was sent to professors Luis Vieira (Harvard University), Eduardo Schwartz (University of California) and Luis Reyna (Swiss Re Capital Markets Corporation).

The Committee was satisfied with the comments received from the peer review and with Professor Walker's responses.

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21 A summary of the study is available online at http://www.hacienda.cl/english/sovereign-wealth-funds/relevant-studies.html.

22 Mining revenues are almost entirely from the sale of copper.

The Financial Committee also asked the Ministry of Finance's technical team to carry out additional simulations using the same model as the study. The objective of these new simulations was to complement the study's conclusions, in order to obtain more information for making recommendations on the ESSF investment policy. These simulations were used to evaluate the impact of incorporating sovereign bonds denominated in Norwegian kroner as a new asset class, tightening the limit on exposure to yen-denominated sovereign instruments, establishing minimum investment levels for dollar- and euro-denominated sovereign instruments and reducing the size of the ESSF. The Committee concluded that krone-denominated bonds would not improve the hedging ability of the investment portfolio and that for a low to medium risk tolerance, the optimal asset allocation had a share of yen-denominated sovereign bonds around the maximum allowed for that currency. In contrast, the dollar and euro allocations were adjusted downward to the established minimums. These results are consistent with the results of the study. As risk tolerance decreases, the model allocates an increasing share to yen because, according to the data used in the model, yen-denominated sovereign instruments offer the most risk coverage for fiscal revenue. With regard to the impact of a possible reduction in the size of the fund, the Committee concluded that, as expected, the optimal solution was to increase the yen allocation, in the absence of the aforementioned restrictions. This is because a smaller fund goes hand in hand with a lower risk tolerance, which heightens the importance of hedging fiscal revenue. This impact was not seen, however, when there was a ceiling on exposure to the yen.

Based on the Financial Committee's recommendations, the Finance Minister established a new investment policy for the ESSF. Table 2 outlines the strategic asset allocation.

TABLE 2

New strategic asset allocation and benchmarks for the Economic and Social Stabilization Fund
(percent)

Benchmark	Percent
1. Bank deposits	**15.0**
Merrill Lynch LIBID 3 Month Average USD	5.0
Merrill Lynch LIBID 3 Month Average EUR	6.0
Merrill Lynch LIBID 3 Month Average JPY	4.0
2. Treasury bills and sovereign bonds	**74.0**
2.1. Treasury bills	**19.0**
Merrill Lynch Treasury Bills Index USD	6.0
Merrill Lynch Treasury Bills Index EUR	7.0
Merrill Lynch Treasury Bills Index JPY	6.0
2.2. Sovereign bonds	**55.0**
Barclays Capital Global Treasury: U.S. 7-10 Yrs.	26.5
Barclays Capital Global Treasury: Germany 7-10 Yrs.	11.0
Barclays Capital Global Treasury: Japan 7-10 Yrs.	10.0
Barclays Capital Global Treasury: Switzerland 5-10 Yrs.	7.5
3. Inflation-indexed sovereign bonds	**3.5**
Barclays Capital Global Inflation-Linked: U.S. TIPS 1-10 Yrs.	2.5
Barclays Capital Global Inflation-Linked: Germany 1-10 Yrs.	1.0
4. Equities	**7.5**
MSCI ACWI	7.5
5. Total	**100.0**

Source: Ministry of Finance.

B. Review of the Pension Reserve Fund rebalancing policy

In the second half of 2012, the Financial Committee reviewed the rebalancing policy for the PRF, as part of an ongoing process to refine the framework that guides PRF investments.

The policy under review stipulated that if, at the close of a given business day, the deviation by asset class resulting from price variations or market revaluations exceeds the range of ±5% for any asset class (see Table 3), then the fiscal agent must bring about convergence to the benchmark or instruct the relevant party to do so, as applicable. The fiscal agent has 10 bank business days to achieve said convergence, although the period can be extended by the Finance Minister at the request of the fiscal agent, when justified. In addition, the fiscal agent must also converge to the benchmark in the event of contributions to the fund.

After analyzing the historical performance of various alternatives, transaction costs and the experiences of other institutional and international investors, the Financial Committee recommended reducing the permissible range of deviation from ±5% to ±3%. With this change, the investment portfolio is expected to stay more in line with its strategic asset allocation, but without incurring the excessive transaction costs associated with very frequent rebalancing.

TABLE 3

Deviation ranges for the Pension Reserve Fund investment policy
(percent)

Asset class	Benchmark (midpoint)	Range of deviation (± 5%)	Committee's recommendation (± 3%)
Sovereign and government related bonds	48	43–53	45 –51
Inflation-indexed sovereign bonds	17	12–22	14 –20
Corporate bonds	20	15–25	17 –23
Equities	15	10–20	12 –18

Source: Ministry of Finance.

C. Review of the Economic and Social Stabilization Fund bank limits

Toward the end of the year, the Financial Committee decided to review the limits on exposure to bank deposits by bank credit rating. According to the guidelines in force at the time of the review, the ESSF can only be invested in time deposits in banks with a long-term credit rating of A– or better from at least two of the international rating agencies (Fitch, Moody's and Standard & Poor's). Table 4 lists the investment limits for eligible credit rating categories, which are calculated quarterly using the ending value of the investment portfolio at the close of the last quarter.

TABLE 4

Limits on bank exposure by credit rating
(percent of the investment portfolio)

Credit rating	Maximum limit
AAA	3.0
AA+ AA AA–	2.0
A+ A A–	1.5

Source: Ministry of Finance.

The analysis studied the limits at different fund sizes, the experience of the Central Bank of Chile and other factors considered in September 2010, when the recommendation was made to eliminate the minimum equity requirement for banks. The Committee proposed keeping the current limits in place and re-evaluating them if the size of the fund were to exceed US$20 billion.

APPENDIX | Summary of Meetings in 2012

MEETING 1
(24 JANUARY)

At this meeting, a representative of the Central Bank of Chile (CBC) gave a presentation on the management of the fiscal agency in 2011 and the implementation of the new PRF mandate. The Committee selected some of the CBC's recommendations to facilitate the implementation of the new PRF mandate. There was a preliminary discussion of the feasibility of implementing the recommendations from the study "An Asset Allocation for the ESSF," which the Finance Ministry commissioned from Professor Eduardo Walker. The Committee agreed to submit the study for peer review and to ask Finance Ministry staff to analyze new simulation scenarios using the model developed in the study. The new scenarios would limit the share of some currencies and assess the incorporation of the Norwegian kroner as a new investment alternative. The first draft of the Financial Committee's 2011 Annual Report was discussed. Finally, the status of the funds was analyzed, and the market conditions were reviewed.

MEETING 2
(6 MARCH)

Based on the new scenarios provided by the Finance Ministry, the Committee decided against including the Norwegian kroner as an additional investment alternative in the ESSF. The Ministry was asked to conduct new simulations excluding the pound sterling, high-yield bonds and corporate bonds and to analyze the impact with a fund size of US$3 billion. The Financial Committee's 2011 Annual Report was also discussed.

MEETING 3
(20 APRIL)

At this meeting, a representative of the Treasury presented the financial statements for the sovereign wealth funds, prepared in accordance with International Financial Reporting Standards (IFRS) and audited by Deloitte. The Committee commended the work and the accompanying audit. Professor Eduardo Walker presented his responses to the comments received from the independent peer review of his study on the ESSF investment policy. The Committee agreed with Professor Walker that the comments received did not substantially change the study's conclusions. The Committee then discussed the results of the additional scenarios prepared by the Finance Ministry to complement the study. Based on all the information analyzed, the Committee decided on a recommendation for the ESSF asset class allocation and asked the Ministry to prepare a memorandum outlining its recommendation for the Finance Minister.

MEETING 4
(8 JUNE)

A CBC representative gave a report on the Bank's management of the ESSF and PRF from January to May 2012, with an emphasis on the implementation of the new PRF policy. The memorandum outlining the Committee's recommendation for the new ESSF investment policy was presented to the Finance Minister, Felipe Larraín, who acknowledged the Committee's work and indicated that he would analyze the implementation of the recommendation.

MEETING 5
(31 JULY)

The Finance Ministry's International Finance Coordinator reported to the Committee on the Finance Minister's decision regarding the ESSF investment policy, which was in line with the Committee's recommendations. The suggestion was made to incorporate bank deposits in the ESSF's short-term portfolio, and additional information was requested from the Finance Ministry to determine whether to incorporate inflation-indexed bonds. A preliminary analysis was made of the PRF rebalancing policy, and the Finance Ministry was asked to undertake further analysis to determine whether the current policy is adequate. Finally, the Committee analyzed two draft documents prepared by the CBC, one on crossing operations carried out during the implementation of the PRF mandate and one on structured notes.

MEETING 6
(1 OCTOBER)

In this meeting, the Committee recommended that the ESSF maintain the current shares of time deposits (15.0%) and inflation-indexed sovereign bonds (3.5%). It further recommended that the currency allocation for time deposits and inflation-indexed sovereign bonds should be consistent with the general parameters defined in the strategic asset allocation. With regard to equity investments, the Committee was informed that the Finance Ministry, based on a suggestion from the CBC, was studying the use of exchange-traded funds (ETFs) as an alternative to the use of external managers or the simplification of the benchmark, mainly to eliminate some countries where operations are difficult, in order to alleviate the CBC's workload without sacrificing exposure to a global equity portfolio. Further analysis of these alternatives was requested, for a later decision. Finally, the Committee recommended reducing the range of deviation of the PRF rebalancing policy from 5% to 3%.

MEETING 7
(7 NOVEMBER)

After analyzing the experience of the CBC and the Custodian in implementing the PRF equity mandate, the Committee recommended not investing in some countries that can be difficult from an operational perspective. The Finance Ministry will draw up a list of countries for exclusion. Information was requested on the tax treatment of the ESSF and PRF investments. The ESSF investment limits by bank issuer were analyzed, and the conclusion was to maintain the current limits. However, these limits are to be reviewed again should the size of the fund exceed US$20 billion. A preliminary analysis was made of the possibility of calculating an ex post tracking error for the new PRF portfolios.

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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 (equity and fixed-income); they mainly include private equity, venture capital, hedge funds, commodities and real estate.

Asset class — a specific investment category such as equity, 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 term deposits.

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

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

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

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

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

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

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

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 present value of all net cash flows as zero.

Investment Policy — the set of 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 the LIBOR minus 0.125%.

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

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

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

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

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

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

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

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.

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

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

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

Sovereign bond — a bond issued by a government.

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

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.

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

Design:
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Edition:
Department of Communications Ministry of Finance

Print:
QuadGraphics

Edition of 250 copies ©

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