

Petroleum Fund of Timor-Leste

Quarterly Report

30 September 2010

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INTRODUCTION

This report is produced in accordance with Article 13 of the Petroleum Fund Law which requires the central bank to report on the performance and activities of the Petroleum Fund of Timor-Leste, referred to in this report as the Fund unless the context suggests otherwise.

All monetary references in this report are to United States dollars as the official currency of Timor-Leste.

While every effort has been made to ensure accuracy, the information is based on management reports and has not been independently audited or reviewed and is subject to change, in which case the changes will be incorporated into subsequent reports.

Executive Summary

The Petroleum Fund was formed by the enactment of the Petroleum Fund law promulgated on 3 August 2005. The law gives the Banking & Payments Authority (BPA) of Timor-Leste the responsibility for the operational management of the Fund.

This report covers the period from 1 July to 30 September 2010.

Key statistics for the quarter include:

- The capital of the Fund grew from \$ 6.299,13 million to \$ 6.603,63 million.
- Gross cash inflows to the fund from royalties, taxes and other receipt were \$ 376.72 million.
- Cash outflows were \$175.88 million in which \$175.00 million for transfers to State Budget while \$0.88 million for direct external and internal management costs.
- Net cash inflows during the period were \$ 200.84 million.
- The portfolio return in the period was 1.62 % compared with the benchmark return for the quarter of 1.68 %.¹

¹ All performance numbers in this report are based on Modified Dietz method.

The returns by quarter, one year, FYTD, three years and since inception of the Fund up to 30 September 2010 as follows.

Currency \$USD	(%)				
	QTR	FYTD	1 Year	3 Years	Since Inc
Total Fund	1.62	4.16	4.06	4.72	4.61
Benchmark	1.68	4.08	3.98	4.77	4.64
<i>Excess</i>	<i>-0.06</i>	<i>0.08</i>	<i>0.08</i>	<i>-0.05</i>	<i>-0.03</i>

1. PETROLEUM FUND MANAGEMENT MANDATE

An updated revised management agreement including a new investment mandate between the Ministry of Finance and the Banking & Payments Authority was signed on 25 June 2009. The complete investment mandate was published in the updated management agreement and the benchmarks may be summarized as follows:

Global Benchmark

US Government 0-5 years	90.4%
US Government 5-10 years	2.0%
Governments/Supranationals USD AAA	2.6%
Governments/Supranationals USD AA	1.4%
Australian Government	1.4%
Euro Governments	1.4%
United Kingdom Gilts	0.4%
Japan Government	0.4%

Subsidiary Benchmarks

BPA Internal Management (80% of global portfolio)

US Government 0-5 years	100.0%
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Bank for International Settlements (20% of global portfolio)

US Government 0-5 years	52.0%
US Government 5-10 years	10.0%
Governments/Supranationals USD AAA	13.0%
Governments/Supranationals USD AA	7.0%
Australian Government	7.0%
Euro Governments	7.0%
United Kingdom Gilts	2.0%
Japan Government	2.0%

2. MARKET TRENDS DURING THE QUARTER

Global Market

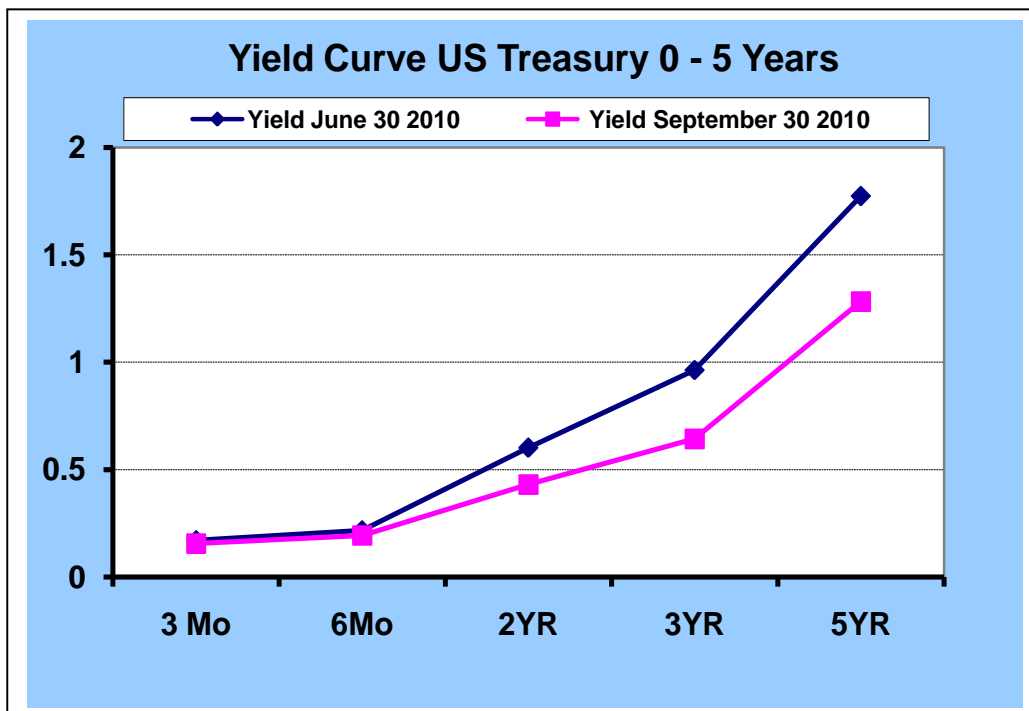
Direct currency interventions as well as increasing likelihood of further quantitative easing by major central banks were the main themes in financial markets during September. Concern regarding stresses on sovereign balance sheets persisted in the month of September.

US Treasury Market

During the period from 30 June 2010 to 30 September 2010 US Treasury bonds 0 to 5 years yields decreased significantly. At the short end 3 months US Treasury benchmark reference bills decreased by 2 basis points and 6 months US Treasury benchmark reference bills decreased by 2 basis points, while 2 year bond yields decreased by 17 basis points. The 3 and 5 year US Treasury benchmark reference notes decreased by 32 and 49 basis points respectively compared to the previous quarter end. Bond prices and yields move in opposite directions.

The graph below shows the 0-5 year US Government yield curve on 30 September 2010 compared to the previous quarter end 30 June 2010.

US Treasury bond yields decreased significantly. The 3 and 6 month US Treasury benchmark reference bills decreased by 2 and 2 basis points, 2 years yields decreased by 17 basis points. The 3 and 5 years yield decreased by 32 and 49 basis points respectively.



There has been no change to the U.S. Federal Reserve Bank's key overnight lending rate (the US Federal Funds target rate), with the current level target range remaining at 0 – 0.25% as of September 2010.

3. MANAGEMENT DURING THE QUARTER

Objectives

For the Internal Mandate, the BPA's objective in managing the portfolio is to achieve a portfolio return close to the return of the agreed benchmark; while the BIS's portfolio will be managed in an active manner and the objective is the expected outperformance of the portfolio gross of management fees is 25 basis points over the Benchmark performance, on an annual basis over a rolling three year period, while maintaining the ex ante tracking error within 100 basis points.

For the BPA's internal mandate, cash received by the Fund has been invested in the portfolio in a timely manner, normally within two working days. This policy is consistent with the passive investment mandate given to the BPA by the Ministry of Finance. For the BIS portfolio, cash received by the BIS has been invested in the portfolio within the instruments allowed in the composite benchmark as described in the updated management agreement summarized in Subsidiary Benchmark section in page 2 of this report.

The objective of the internal mandate is to achieve the portfolio return close to the benchmark within +/- 25 bps while the objective of BIS mandate is the expected outperformance of the portfolio gross of management fees is 25 basis points over a rolling 3 yrs period.

Operational Implementation

The BPA internal mandate is operationalised by holding ten of the approximately 123 US Treasury Securities that form the defined benchmark index. The bonds are selected to best replicate the risk and return characteristics of the benchmark.

The BIS mandate is operationalised by holding bonds issued by supranational organisations and sovereign states, including the United States, European Union, Australia, Japan, United Kingdom.

Regular financial reports on the performance of the Fund under BPA management are produced for BPA management and regular position reports for the total Fund including the BIS mandate are produced by the Fund's custodian as part of the management process.

External Managers

In 2009, the Ministry of Finance requested the BPA to commence the process of appointing an external manager for the management of an equity mandate of 4% of the Fund. As the result, Schroder Investment Management Ltd ("Schroders") was selected and the contract has been signed with Schroders on 7th September 2010 for the management of about \$260 million. The portfolio was implemented in early October 2010. ¹

4. PORTFOLIO PERFORMANCE

This section contains a number of tables and charts describing the performance of the Petroleum Fund.

The following notes are intended to assist in interpreting this information:

- The percentage figures show the return of the Fund, or a part of it, and compare the result with a benchmark. The benchmark represents the investment strategy established by the Minister and is used to set a goal against which the

performance of the actual investments is measured. The Minister's benchmarks for the Petroleum Fund mandates are described earlier in this report.

- The excess is the difference (even if negative) between the benchmark and the portfolio being measured. In general a portfolio and its benchmark will respond in a similar manner to movements in the financial markets. The excess occurs because the benchmark does not recognise transaction costs, and because the actual portfolio usually contains a different mix of financial instruments to the benchmark.

GLOBAL PORTFOLIO

In the course of the quarter the Petroleum Fund increased from \$6,299.13 million, million to \$6,603.63 million, as follows:

Return, Quarter July - September 2010	Amount (In million \$)
Opening book value (1 July 2010)	6,299.13
Receipts during the period	376.72
Transfer to General State Budget during the period	-175.00
Management fees	-0.88
Return in the period	103.66
Closing book value (30 September 2010)	6,603.63

Total receipts during the quarter were \$376.72 consisting of tax receipts \$222.74m, Royalties \$153.99m. The gross return was \$103.66m of which \$53.27m was coupon & interest and market valuation was \$50.39

This balance was invested in the following financial assets:

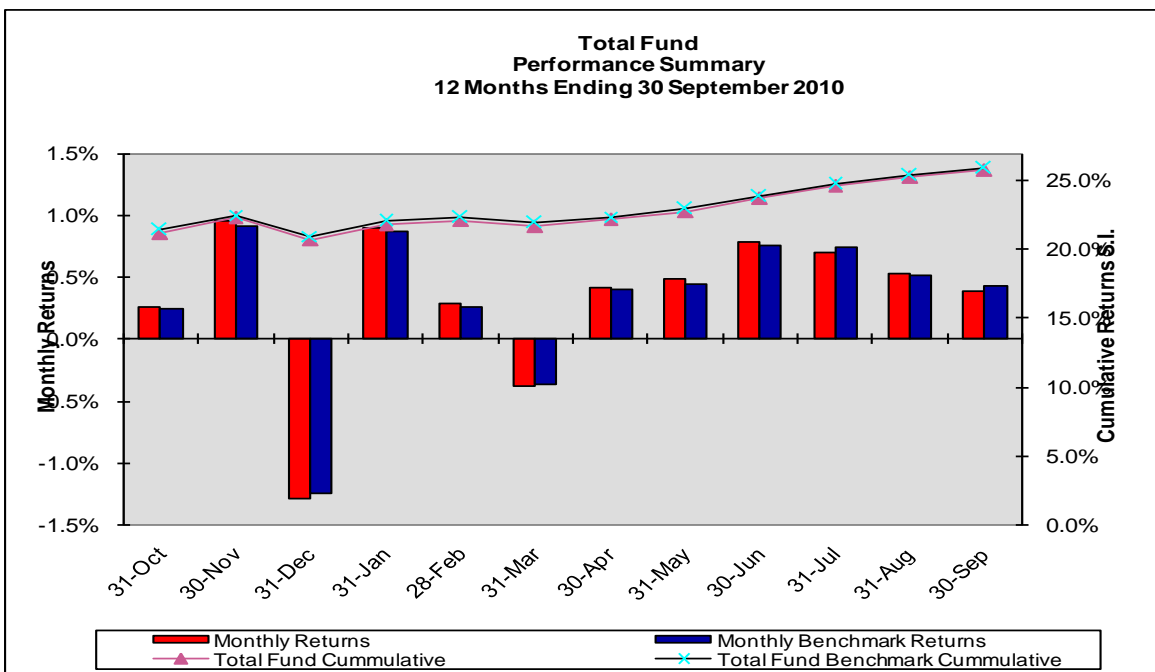
NET ASSETS	In thousand \$
Cash and Cash Equivalent	10,421
Marketable Debt Securities	6,514,283
Receivable and Other Assets	99,195
Less: Pending Purchase of Securities	(20,270)
Total	6,603,629

The Net Income for the quarter comprised the following:

INCOME	In Thousand \$
Investment Income	53,270
Income	53,270
Market Revaluations	50,387
Less: Management Fees	-879
Net Result for the Period	102,778

The performance of the Fund for the quarter, including the performance of the relative asset classes, was as follows:

Currency \$USD	QTR				
	QTR	FYTD	1 Year	3 Years	Since Inception
Total Fund	1.62	4.16	4.06	4.72	4.61
Benchmark	1.68	4.08	3.98	4.77	4.64
<i>Excess</i>	<i>-0.06</i>	<i>0.08</i>	<i>0.08</i>	<i>-0.05</i>	<i>-0.03</i>
International Fixed Interest	1.62	4.16	4.06	4.72	4.61
Benchmark	1.68	4.08	3.98	4.77	4.64
<i>Excess</i>	<i>-0.06</i>	<i>0.08</i>	<i>0.08</i>	<i>-0.05</i>	<i>-0.03</i>



The cumulative performance of the Petroleum Fund compared with the performance of the Global Benchmark over the same period is shown in the above graph.

Currency \$USD	QTR				
	QTR	FYTD	1 Year	3 Years	Since Inc
International Fixed Interest	1.62	4.16	4.06	4.72	4.61
Benchmark	1.68	4.08	3.98	4.77	4.64
<i>Excess</i>	<i>-0.06</i>	<i>0.08</i>	<i>0.08</i>	<i>-0.05</i>	<i>-0.03</i>
BPA Internal Mandate	1.12	3.68	3.61	4.41	4.42
Benchmark	1.11	3.59	3.53	4.48	4.47
<i>Excess</i>	<i>0.01</i>	<i>0.09</i>	<i>0.08</i>	<i>-0.07</i>	<i>-0.04</i>
Bank for International Settlement	3.67	6.17	5.93		6.97
Benchmark	3.99	6.06	5.79		6.95
<i>Excess</i>	<i>-0.32</i>	<i>0.11</i>	<i>0.14</i>		<i>0.02</i>

5. MANAGEMENT COSTS

A management fee of 878,624 for operational management costs was deducted from the fund during the quarter to cover the direct external expenses and internal operational expenses.

The fee covered the following services:

	US\$ Thousand
External management & Custody expenses	\$463,638
BPA Internal management expenses	\$405,750
LAB expenses	<u>\$9,236</u>
Total	\$878,624

6. TRANSFERS FROM THE PETROLEUM FUND

According to Article 7.1 of the Petroleum Fund law transfers from the Fund may only be made to the credit of a single State Budget account. During the quarter, there has been transfer of \$175 million from the Fund to the State Budget. A summary of transfers to the State Budget Account is as follows:

	US\$ Million
Transfers - July 2010	-
Transfers - August 2010	\$100
Transfers - September 2010	\$75
Total transfer for this quarter	\$175
Transfers for previous quarters	<u>\$200</u>
Total Transfers for this Fiscal Year to September 2010	\$375

7. RISK EXPOSURE OF PORTFOLIO

7.1 Tracking Error

The tracking error illustrates the manner in which the Fund portfolio tracked the benchmark index. The "Excess Return" measures the difference between the return of the Fund's portfolio and the benchmark. The excess return for the Fund's global portfolio is -0.6% (or -6 basis points) while the excess return of the BPA internal mandate and the BIS mandate were 0.01 % (or 1 basis point) and -0.33% (or -33 basis points) respectively.

7.2 Duration

The modified duration of the BPA internal portfolio shall be managed within ± 0.2 years of the modified duration of the benchmark. The Modified duration of the BIS portfolio shall be less than six years. The duration was within the mandate during the quarter.

7.3. Credit Risk

The investments by the Petroleum Fund in US Treasury Securities with the highest credit rating (AAA) while the investments in other sovereign states and supranational fixed interest securities with the

credit ratings of (NR-Not Rated to AAA) within the limit as provided in the BIS mandate. All investments reflected the new investment mandate as provided in the updated Management Agreement.

Cash received by the Petroleum Fund pending investment is invested at overnight money market interest rates in an overnight repurchase pool operated by the Federal Reserve Bank of New York.

8. COMPLIANCE STATEMENT

The BPA asserts the following statements relating to compliance with the mandates given by the Minister:

Qualifying Instruments

The Fund was invested in instruments within the investment universe specified in the mandate at all times during the quarter.

Return

The performance on the global portfolio for the quarter was 162 basis points compared with the benchmark performance of 168 basis points.

Modified Duration

The modified duration of the Fund's fixed interest investment portfolio remained within the mandate during the quarter.

Tracking Error

The tracking error of the Fund's investment portfolio was within the mandate during the quarter.

Internal Manager

The BPA portfolio complied with the mandate throughout the quarter.

External Managers

The external manager investment was within the mandate during the quarter. An equity external manager was hired in September 2010 for the management of about \$260 million (4% of the Fund) and its operation commenced in early October 2010.

Internal Audit

In accordance with the provisions of Article 22 of the Petroleum Fund law number 9/2005 that requires BPA's Internal Auditor to perform an audit of the Fund every six months. The Internal Auditor has performed an audit on the Fund to 30 June 2010.

9. FINANCIAL INFORMATION

The following financial information is presented for the purpose of assisting the Minister to review the quarterly performance of the Petroleum Fund as set out in this report. The figures have not been audited.

Balance Sheet

In thousand\$			
NET ASSETS	Set-10	Jun-10	Set-09
Cash and Cash Equivalent	10.421	7.684	1.172
Marketable Debt Securities	6.514.283	6.252.744	5.239.215
Receivable and Other Assets	99.195	83.088	61.080
Less: Pending Purchase of Securities	-20.270	-44.387	-
TOTAL	6.063,629	6.299.129	5.301.568
CAPITAL			
Opening Balance	5.376.626	5.376.626	4.196.972
PF Law Art. 6.1 (a) Revenue Receipts	628.873	406.139	505.935
PF Law Art. 6.1 (b) DA Receipts	719.153	565.166	760.227
PF Law Art. 6.1 (e) Other Receipts	7.042	7.042	--
PF Law Art. 7.1 Transfer to General State Budget	-375.000	-200.000	-200.000
Net Income	246.934	144.156	38.435
TOTAL	6.603.629	6.299.129	5.301.568

Profit & Loss Statement

In thousand\$

INCOME	Quarter		Year To Date (YTD)	
	Sep-10	Sep-09	Sep-10	Sep-09
Investment Income	53.270	52.875	152.656	135.906
Income	53.270	52.875	152.656	135.906
Market Revaluations	50.387	15.224	96.356	-96.196
Less: Management Fees	-879	-352	-2.077	-1.275
Net Result for the Period	102.778	67.747	246.935	38.435

Note:

The accounting policies and method of computation used to prepare the above figures are the same as disclosed in the most recent annual financial statements of the Petroleum Fund.

Dili, 18 October 2010



Venâncio Alves Maria
Executive Director
of PF Management



Abraão de Vasconcelos
General Manager