



República Democrática de Timor-Leste  
Ministério das Finanças



*“Adeus Conflito, Bemvindo Desenvolvimento”*

# Mini Seminar on Fund Management and Changes to the PF Law

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Ministry of Finance

Saturday 23 October 2010

# Outline

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- Fund Management

- Asset classes
- Investment Strategy Options
- Diversification

*Peter Ryan-Kane, Head of Portfolio Advisory, Towers Watson*

- PF investment policy and draft amendments to the Petroleum Fund Law

- Current PF management and investment strategy
- Draft amendments to the PF Law

*Filipe Nery Bernardo and Vidar Ovesen, Ministry of Finance*



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Gabinete da Ministra



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PF investment policy and draft amendments to  
the Petroleum Fund Law

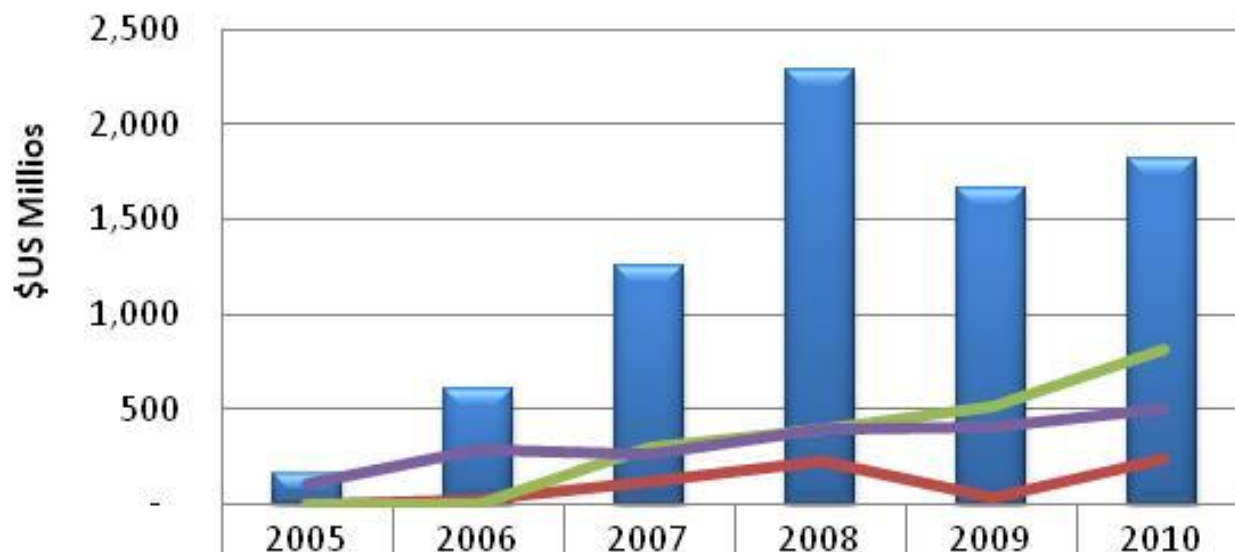
# The Management and Investment Policy 2005-2010

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- **US Government bonds from the outset**
  - due to lack of knowledge about the international financial market, a simple and prudent investment strategy was required to avoid exposure to risk and volatility in the first stage
  
- **Some, but limited, flexibility to invest in non-USD instruments**
  - 90% in cash deposits and high rated bonds denominated in US\$
  - 10% in equities and other financial instruments
  
- **Portfolio diversification along with increased capacity**
  - Investments in AUD, JPY, EUR and UK Government bonds from June 2009
  - Investments in global equities from Q4 2010
  - Currently the flexibility in the PF Law is fully exploited
  - Increased exposure to equities and further diversification as soon as the PF Law has been changed

# Petroleum Revenues, Return and Withdrawals

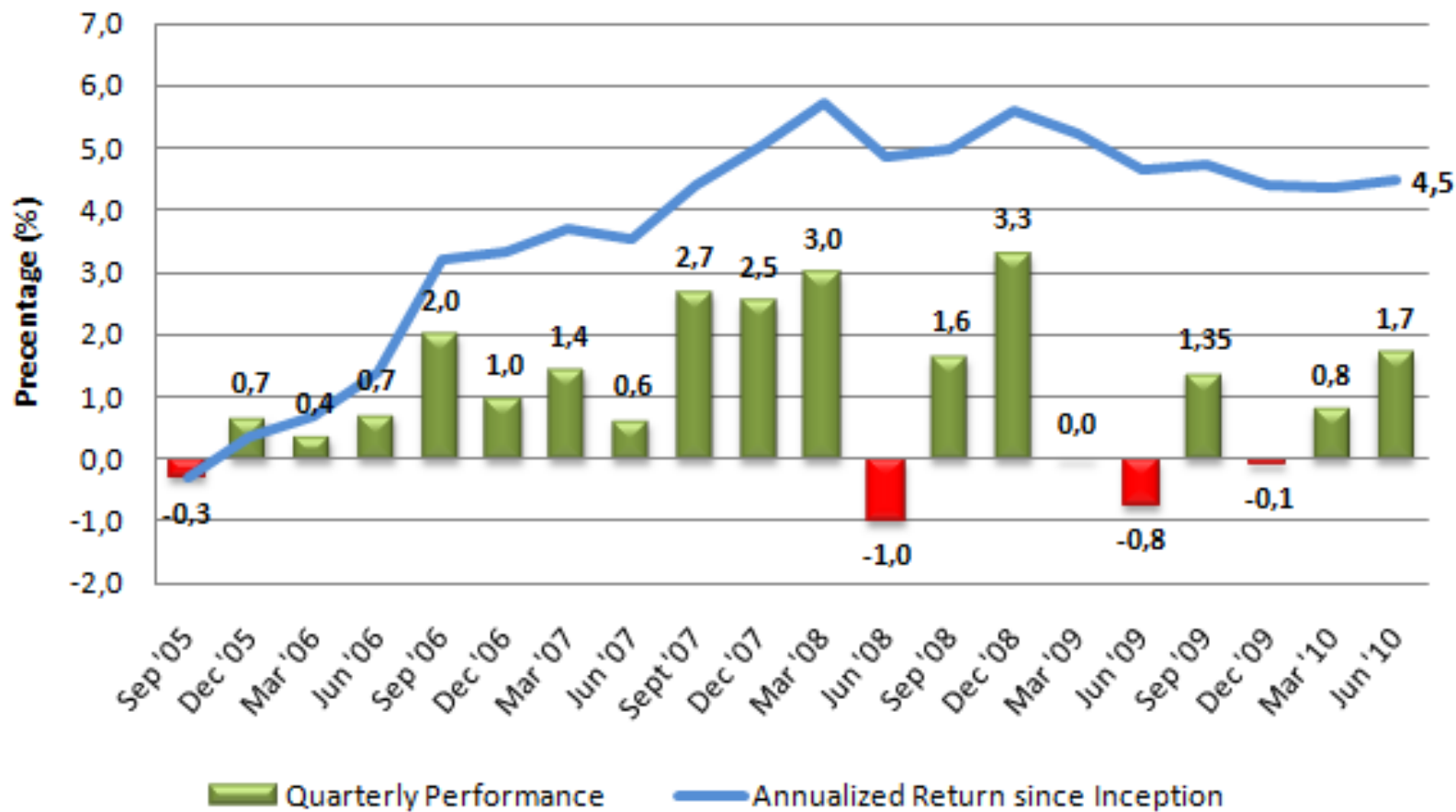
## Petroleum Revenues and Withdrawals



Petroleum Revenues	164	612	1,258	2,284	1,660	1816
Net Investment Returns	2	30	116	223	31	235
Withdrawals	-	-	300	396	512	811
ESI	103	283	266	396	408	502

# Investment Return

## Net Investment Return since Inception



	2005	2006	2007	2008	2009	2010 (YTD)
Nominal return (%)	0.4	4.1	7.2	6.9	0.6	2.5

# Petroleum Fund Portfolio

## Petroleum Fund Balance:

- \$6.6 billion
- 10 x non-oil GDP

## Investment Performance:

- 2005-2010: 4.5 % p.a.

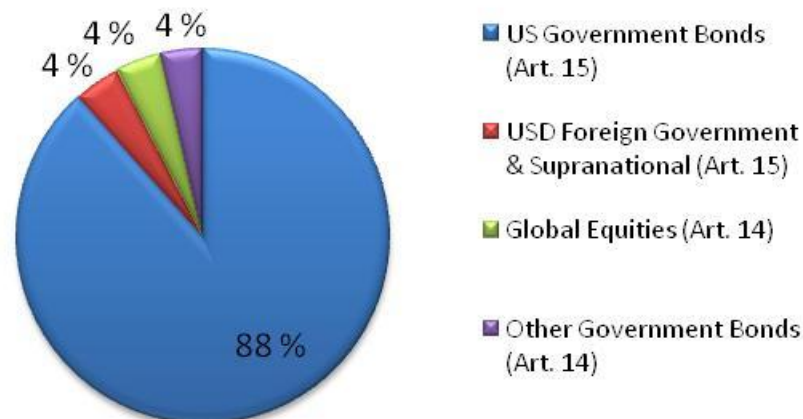
## Composition of the portfolio::

- 92% USD-denominated Government bonds
- 4% AUD, JPY, EUR and UK Government bonds
- 4% global equities

## Management structure:

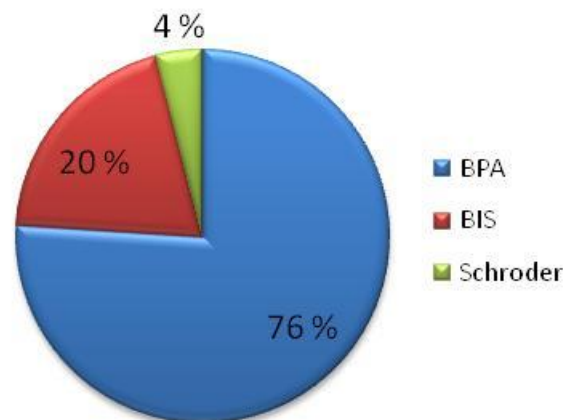
- 76% managed by the BPA
- 20% managed by the BIS
- 4% managed by Schrodgers

### PF Asset Allocation



Art. 14: 10% non-USD bonds and equities  
Art. 15: 90% USD bonds

### PF Managers



# The Equity Mandate

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## Investment Universe and Amount

- Global Equities
- Benchmark to MSCI World Index
- Listed investment in 23 developed countries
- 4% of Petroleum Fund = about \$260 million

## Investment Approach

- Enhanced indexing approach
- Tracking error no to exceed 100 basis points under normal circumstances
- Very limited use of derivatives permitted (will not be used in day-to-day management)



# The Investment Manager

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## Schroder Investment Management Limited

- Founded in 1804 with over 200 years of experience
- Public company listed on the London Stock of Exchange
- Asset management is Schroders' core business – i.e. no conflicts such as banking or brokerage services
- Funds under management £164.0 billion (€200.3 billion / \$245.4 billion) at June 2010
- Schroders employs about 2,700 staff operating from 32 offices in 25 countries



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# Draft amendments to the Petroleum Fund Law

# Draft PF Law Amendments

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1. Investment policy and Risk Profile (Art. 14, 15)
2. Transfers/Rules of Withdrawals (Art. 9)
3. Operational Management (Art. 11 & 12)
4. Investment Advisory Board (Art. 17)
5. Other Amendments (Art 2, 24, Schedule 1)

# Draft PF Law Amendments

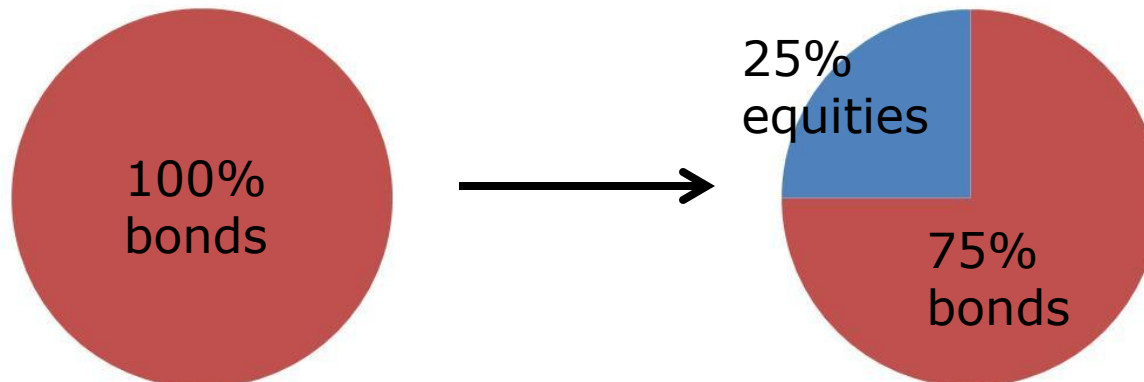
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# Advice from the Investment Advisory Board I

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- The Investment Advisory Board (IAB) has been requested to advice on PF Law amendments related to the investment policy and risk profile.
- Advice was provided on 15 Dec '09:
  - As soon as practical: increase the exposure to equities to 25%.
  - During the next five years: do not exceed 25-30% in equities.
  - Asset allocation limitations in the new PF Law:
    - At least 60% in bonds
    - Not more than 40% in equities
    - Not more than 5% in other eligible instruments



# Advice from the Investment Advisory Board II

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## Further advice from the IAB:

- Aligned Art. 14 & 15 with the Santiago Principles
  - International best practice agreed upon among SWFs throughout the world
- Expanded the range of instruments:
  - No currency restrictions (from 90% USD-denominated bonds)
  - Reducing the rating requirements (from AA- to above investment grade)
- Included diversification requirements:
  - Investment policy shall apply the principle of diversification
  - Max 5% holding of equities in each company
  - Max 3% of the PF can be exposed to one company/issuer (except for a sovereign state)
- Improved reporting to Parliament
  - Include a summary of the Investment Policy in the Annual Report
  - Inform Parliament prior to major asset allocation changes
- Allow security lending
- Requirements for investing in other financial instruments and derivatives

# PF Law amendments: Art. 14 & 15

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## ■ Current PF Law:

- Article 14 determines the Investment Rules:
  - 90% in qualifying instruments
  - 10% other financial instruments
- Article 15 describes the Qualifying Instruments:
  - Mainly USD-denominated highly rated Government bonds

## ■ Draft amendments to the PF Law:

- Article 14 outlines the overall Investment Policy:
  - Principle of Diversification
  - Requirements to the Investment Policy
  - Risk management
  - Reporting Mechanisms
- Article 15 outlines the Investment Rules:
  - Financial Investments abroad only
  - Max/Min levels in equities, bonds, alternative instruments
  - Criteria for mitigating the risks
  - Use of derivatives

# PF Law amendments: Art. 14

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14.1 The Minister shall establish the investment policy for the Petroleum Fund that shall apply the principles of diversification with the objective of maximising the risk-adjusted financial returns of the Petroleum Fund after taking into account the purposes for which the Fund is established, the constraints under which it operates, and Timor-Leste's ability to bear risk.

14.2. The investment policy must provide sufficient liquidity in the portfolio to ensure that funding is available whenever required for transfers to the State Budget or for rebalancing investments within the policy exposure.

14.3 The Minister and the Operational Manager shall develop and maintain policies, systems and procedures to ensure that the risks associated with the implementation of the investment strategy are identified, monitored and managed.

14.4. The management of the Petroleum Fund shall be conducted in compliance with all applicable regulatory and disclosure requirements of the countries in which investments are made.

14.5 The Minister shall present a summary of the proposed investment policy of the Petroleum Fund to the parliament in the Annual Report of the Petroleum Fund each year and prior to decisions on major asset allocation changes. The Annual Report shall also include a statement setting out how the provisions of Articles 14 and 15 have been applied during the year.



# PF Law amendments: Art. 15

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15.1 In order to qualify as an eligible investment under this Article an investment must be issued or situated abroad in an internationally recognised jurisdiction.

15.2 Not less than 50 per cent of the amounts in the Petroleum Fund shall be invested in eligible investments in the form of deposits or debt instruments that bear interest or a fixed amount equivalent to interest, provided that:

- (a) The debt instruments are determined to be of investment grade, or
- (b) The deposits are held with financial institutions with a rating corresponding to investment grade.

15.3 Not more than 50 per cent of the amounts in the Petroleum Fund shall be invested in eligible investments in the form of listed equities, provided that:

- (a) The equities are traded in a regulated financial market, and
- (b) No holding shall exceed five per cent of the issued capital of the issuing company.

15.4 Not more than 5% per cent of the amounts in the Petroleum Fund may be invested in other eligible investments provided that:

- (a) The Minister has included the asset class to which the eligible investments belong in the proposed asset allocation presented to Parliament in accordance with Article 14.5, and
- (b) The policies and criteria for selecting, managing and valuing individual financial instruments within the asset class have been approved by the Minister and published.

# PF Law amendments: Art. 15

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15.5 The exposure of the Petroleum Fund:

- (a) To any one company or issuer, except for a sovereign state, in the form of eligible investments, shall not exceed three per cent of the total value of the Petroleum Fund;
- (b) To any one asset class shall, on a net basis, be positive.

15.6 Notwithstanding the provisions of subarticles 20.1 and 20.2, charges arising in the course of market transaction management or participation in security lending programs that are of a short-term nature and consistent with prudent asset management principles shall not be regarded as encumbrances in the course of investing amounts in the Petroleum Fund by the Investment Manager.

15.7 A derivative instrument shall qualify as an eligible investment only if:

- (a) It is used for the purpose of reducing the risk to the Fund from the underlying instrument or instruments or to facilitate the efficient implementation of asset exposure; and
- (b) The risk from the derivative instrument is not larger than that which could be had by direct exposure to the underlying assets in accordance with this law; and
- (c) The Minister has established conditions with respect to the operational use of the derivative instrument.

15.8 The Minister shall determine the period within which Investment Managers shall dispose of instruments if they cease to be eligible investments because of a change in the rating of the financial instruments or the issuer of the instruments.

# Draft PF Law Amendments

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# PF Law amendments: Art. 9 (d)

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- The current PF Law provides sufficient flexibility to withdraw amounts in excess of the ESI, provided that a “detailed explanation why it is in the long-term interest of Timor-Leste” is provided to Parliament.
- However, there is uncertainty about what are the requirements for “a detailed explanation”. Hence, the following revision of the Art. 9 (d) is suggested:

- Current Law:

*“a detailed explanation of why it is in the long-term interests of Timor-Leste to transfer from the Petroleum Fund an amount in excess of the Estimated Sustainable Income.”*

- Draft amendment:

*“Justification as to the reasons why it is in the long term interest of Timor-Leste to transfer an amount exceeding the Estimated Sustainable Income.”*

# Draft PF Law Amendments

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1. Investment policy and Risk Profile (Art. 14, 15)
2. Transfers/Rules of Withdrawals (Art. 9)
- 3. Operational Management (Art. 11 & 12)**
4. Investment Advisory Board (Art. 17)
5. Other Amendments (Art 2, 24, Schedule 1)

# PF Law amendments: Art. 11 & 12

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- In the current PF Law the Central Bank is assigned the role as the Operational Manager of the Petroleum Fund.
- The Central Bank as the Operational Manager is a well recognized model internationally, although many Funds have chosen other models.
  - Common for all of them is the clear division of duties between the policy and operational level and full independency with regard to the operational management.
- The proposal provides flexibility to choose another Operational Manager in the future if deemed appropriate.
  - It is required that the Operational Manager shall be either the BPA or another public entity established by the National Parliament.
- Changes to the procedures of appointing external managers are also included, to ensure reasonable checks and balances between the overall owner of the Fund and the Operational Manager.
  - The Operational Manager select and appoint managers, while the Minister consent to the recommendation.

# Draft PF Law Amendments

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1. Investment policy and Risk Profile (Art. 14, 15)
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- 4. Investment Advisory Board (Art. 17)**
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# PF Law amendments: Art. 17

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- Appointment of IAB Members by the Prime Minister – not the Minister
  - Ensure full independence between the advisers and the one that is advised
- Excluding the General Manager of the BPA and Director of Treasury as voting members of the IAB
  - Ensure the Board consists of independent investment experts
  - GM and Director of Treasury will be ex-officio members
- Amended the IAB Members requirements re declaring assets and income:

*“The members of the Investment Advisory Board shall on the occasion of their appointment and as appropriate when providing advice to the Minister signify in writing an affirmation that their appointment or advice does not present a conflict with any of their other interests. The Minister may request members of the Board, as necessary, to submit a declaration concerning their assets to avoid any conflict of interest.”*



# Draft PF Law Amendments

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1. Investment policy and Risk Profile (Art. 14, 15)
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# PF Law amendments: Art. 2, 24 and Schedule 1

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## Art.2:

- Changing the Financial Year from 1 July-30 June to 1 January-31 December
- Defining the Operational Manager
- Defining the Investment Policy

## Art. 24:

- A Report on the Investment Policy in the PF Annual Report

## Schedule 1:

- Correct the formula for calculating the Petroleum Wealth (discounting principle)
- Amend the definition of the discount rate

Written comments are appreciated

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By Tuesday 2 November COB

Att:

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