

Petroleum Fund of Timor-Leste

Quarterly Report

30 June 2016

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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 and custodial reports and has not been independently audited 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 as amended on 28 September 2011. The law gives the Central Bank of Timor-Leste the responsibility for the operational management of the Fund.

This report covers the period from 1 April 2016 to 30 June 2016.

Key statistics for the quarter include:

- The capital of the Fund at the end of the previous quarter was \$16.58 billion while the current quarter was \$16.47 billion.
- Gross cash inflows to the fund from royalties and taxes were \$26.79 million.
- Outflows for the quarter were \$343.29 million, being transfers to the state budget were \$340 million while \$3.29 million was for management costs.
- The profit/loss for the quarter was \$201.47 million, representing a gross of fees return of 1.24% compared with the benchmark return of 1.34%.

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

Table 1

	QTR	FYTD	1 Year	3 Years	5 years	Since Inc
Total Fund	1.24	3.37	2.06	4.00	3.63	3.95
Benchmark	1.34	3.51	2.28	4.06	3.58	3.95
<i>Excess</i>	<i>-0.10</i>	<i>-0.13</i>	<i>-0.22</i>	<i>-0.06</i>	<i>0.04</i>	<i>0.00</i>
International Fixed Interest	1.32	4.97	4.91	2.48	1.85	3.08
Benchmark	1.41	5.13	5.16	2.53	1.84	3.10
<i>Excess</i>	<i>-0.09</i>	<i>-0.16</i>	<i>-0.25</i>	<i>-0.05</i>	<i>0.01</i>	<i>-0.02</i>
International Equities	1.09	0.90	-2.28	7.34	7.15	8.50
Benchmark	1.01	0.66	-2.78	6.95	6.63	7.81
<i>Excess</i>	<i>0.08</i>	<i>0.24</i>	<i>0.50</i>	<i>0.40</i>	<i>0.53</i>	<i>0.69</i>

1. INVESTMENT MANDATE

A revised Management Agreement between the Ministry of Finance and the Central Bank was signed on 25 June 2009. Annex 1 was further updated subsequently to reflect the latest developments. The benchmarks as of June 2016 were as follows:

Table 2

	30-Apr-16	31-May-16	30-Jun-16
BOA Merrill Lynch 3-5 Years Treasury Bond Index	40.00%	40.00%	40.00%
BOA Merrill Lynch 5-10 Years Treasury Notes and Bond	10.00%	10.00%	10.00%
Barclays Global Treasury Developed Market ex US, 30%	10.00%	10.00%	10.00%
Total Fixed Income	60%	60%	60%
MSCI World Index Dividends Reinvested	40.00%	40.00%	40%
Total Equities	40%	40%	40%
Total	100%	100%	100%

2. MARKET TRENDS DURING THE QUARTER

Global Market Trend

Global markets made a confident start to the second quarter and indeed ended the quarter in positive territory, despite finishing in negative territory in June after the UK's vote to leave the EU prompted widespread volatility. The vote to leave surprised financial markets; the subsequent shock reverberated across currency markets and most equity indices declined. Central banks on both sides of the Atlantic moved to shore up investor confidence after the vote. UK economic and political uncertainty is now elevated. This heightened uncertainty alone is likely to have a substantial negative domestic economic effect as some hiring decisions are likely to be stalled and investment in the UK may likely to fall.

Equities

The UK equity market sold off sharply following the country's surprise decision to leave the EU. Unsurprisingly, stock markets in the rest of Europe suffered amid the uncertainty generated by the UK's Brexit vote, reversing more positive performance in April and May. At the sector level, financials across the UK and Europe were very weak.

The US equity market outperformed the broader market, after instability at the end of June failed to dislodge the quarter's earlier gains. The volatility created by Brexit was interpreted as a fresh impediment to a rate

hike in the near future. Such view acted as a significant support to the equity market as well as weakening the US dollar. Commodities also benefited from a softer US dollar, in addition to supply side concerns.

Japanese equities posted considerable declines in local currency terms in June and over the quarter, but a sharp appreciation of the yen kept them in line with the broad index when viewed from the perspective of the USD or other major currencies. The Brexit vote sparked a surge of capital into the yen, a traditional perceived “safe haven” asset. The yen rose nearly 10% over Q2 and is now up 17% year to date.

In China, this quarter has seen a stabilisation in growth, aided by stimulus and a reduction in concerns about the authorities’ management of the currency as capital outflows slowed and FX reserves stabilised. Expected Chinese growth to fluctuate in mini-cycles around the trend for structurally lower but still impressive growth as the economy continues its transition towards an increased focus on domestic consumption

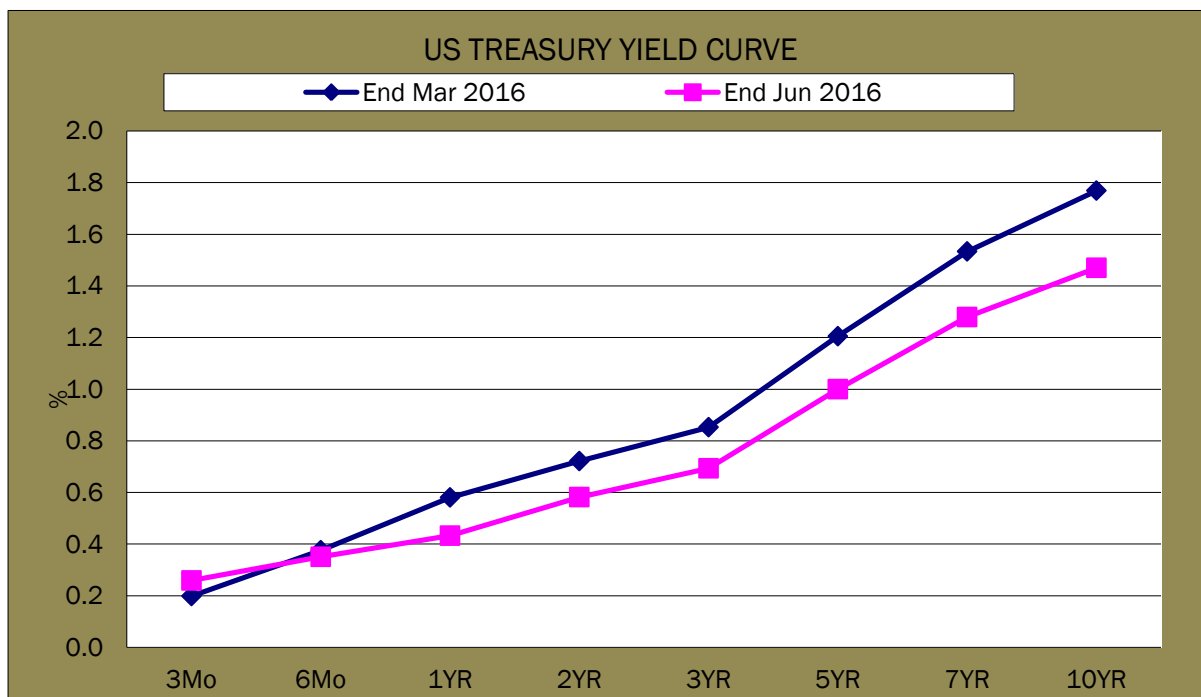
Bonds including US Treasuries

The market impact has already been meaningful, with Sterling down 10% against the dollar this year and 7% over the quarter. It could still fall further. Government bonds are up, with the UK 10-year gilt yield down very sharply to 0.8%, having started the year close to 2% and the quarter at 1.4%

In US where the labor market recovery is well advanced. In May, US seasonally adjusted payroll growth and the job growth picked up in June, as consensus expects, is critical to the economic outlook. Still, low initial jobless claims and high job openings suggest consensus is probably right. Given the rebound in oil prices and the halt in the rise of the dollar, it is reasonable to expect a rebound in US corporate profits. If this materialises then job and economic growth should continue.

The graph below shows the US Government yield curve out to 10 years compared to the previous quarter-end. Short term yields were almost remain the same as previous quarter, while 5, 7 and 10 years yield decreased by 21, 25 and 30 basis points to 0.99%, 1.27% and 1.47% respectively at the end of the quarter. Bond prices and yield move in opposite direction.

Figure 1



3. MANAGEMENT DURING THE QUARTER

Objectives

The Central Bank, as operational manager of the Fund, has implemented the investment mandates through a combination of internal and external management.

The following table shows how the investment mandates have been implemented.

Table 3

Mandate	Management Style	Authorised Managers	Tracking Error	Outperformance Target	Commencement date
BOA Merrill Lynch 3-5 Years US Treasury Bond Index	Passive	BCTL	n/a	Nil	19-Jan-12
BOA Merrill Lynch 5-10 Years US Treasury Notes & Bond index	Enhanced Passive	Bank for International Settlements	0.50%	0.25%	15-Dec-11
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country Capped	Enhanced Passive	Alliance Bernstein	0.50%	Nil	3-Jul-14
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country Capped	Enhanced Passive	Wellington Management	0.50%	Nil	4-Dec-14
MSCI World Index Net Dividends Reinvested	Passive	State Street Global Advisors	0.35%	Nil	18-Jan-12
		BlackRock	0.35%	Nil	21-Feb-13
	Enhanced Passive	Schroders Investment Management	1.00%	1.00%	7-Oct-10

Operational Implementation

The allocation of the capital of the Fund to the various mandates as at the end of the quarter was as follows:

Table 4

Managers	Benchmark	Tolerance	Actual	Lower Boundary	Upper Boundary
BOA Merrill Lynch 3-5 Years Treasury Bond Index	BCTL	40%	± 2.5%	38,68%	37,50% 42,50%
BOA Merrill Lynch 5-10 Years Treasury Notes and Bond Index	Bank for International Settlements	10%	± 1%	9,76%	9,00% 11,00%
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country Capped	Alliance Bernstein	5%	± 0.5%	4,82%	4,50% 5,50%
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country Capped	Wellington Management	5%	± 0.5%	4,82%	4,50% 5,50%
Total Fixed Income		60%		58,08%	55,50% 64,50%
MSCI World Index Net Dividends Reinvested	State Street Global Advisors	35%	± 4.0%	16,73%	15,50% 19,50%
	BlackRock			16,74%	15,50% 19,50%
	Schroders Investment Management	5%	± 1.5%	4,91%	3,50% 6,50%
Total Equities		40%		38,38%	34,50% 45,50%

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, which is compared with the performance of the corresponding benchmark. The benchmark represents the investment strategy established by the Minister and is used as a goal against which the performance of the actual investments is measured. The Minister's benchmarks for the Petroleum Fund are described earlier in this report.
- The excess is the difference (which may be 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 balance was \$16.47 billion as follows:

Capital Account	\$'000
Opening book value (31 March 2016)	16,577,819
Receipts during the period	26,786
Transfer to General State Budget	-340,000
Investment Return	201,468
Closing book value (30 June 2016)	16,466,073

The Fund was invested as follows:

Assets	\$'000
Cash and Cash Equivalents	711,160
Other Receivables	36,969
Financial assets held at fair value through profit or loss	15,759,278
Less:	
Payable for Securities Purchased	-34,905
Accounts Payable	-6,429
Total	16,466,073

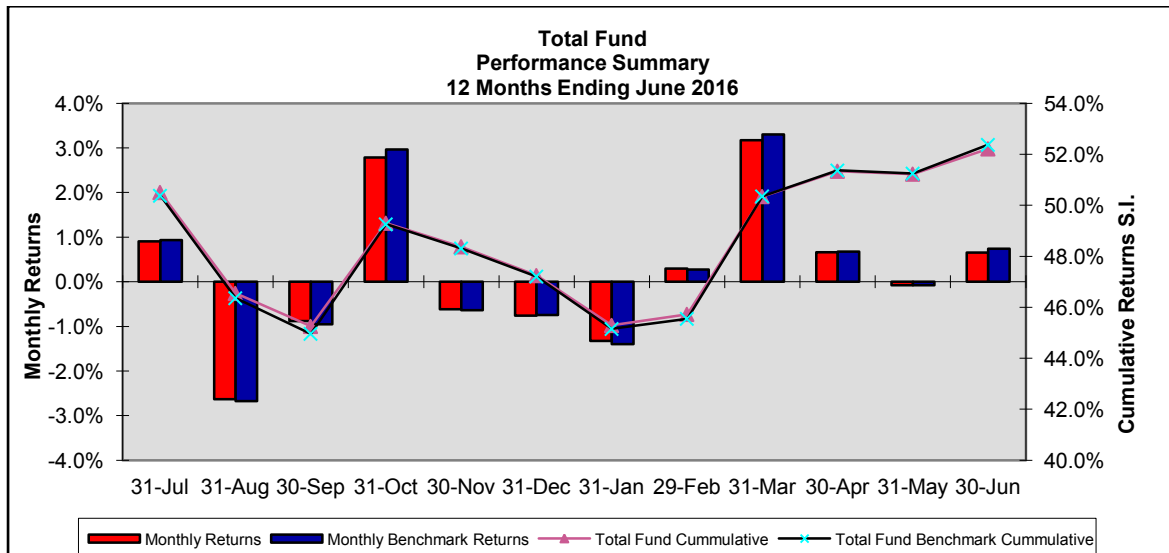
The income for the quarter was as follows:

Table 7

Income	\$'000
Interest income	38,844
Dividend income	57,151
Unit Trust distributions	1,869
Other Investment income	31
Net gains/(losses) on Financial Assets at fair value	154,542
Net foreign exchange gains/(losses)	-41,949
Less:	
External manager, custody fees	-2,136
Central Bank management expenses	-1,109
IAB Expenses	-49
Other expenses	-3
Withholding taxes	-5,722
Total Investment Income	201,468

Global Benchmark over the same period is shown in the following graph.

Figure 2



FIXED INTEREST

The performance of the investments in Fixed Interest for the quarter, including the performance of the managers responsible for those investments, was as follows:

Table 8

%	Qtr	FYTD	1 Year	3 Years	5 Years	Since Inc
International Fixed Interest	1,32	4,97	4,91	2,48	1,85	3,08
Benchmark	1,41	5,13	5,16	2,53	1,84	3,10
<i>Excess</i>	<i>-0,09</i>	<i>-0,16</i>	<i>-0,25</i>	<i>-0,05</i>	<i>0,01</i>	<i>-0,02</i>
BCTL 3-5 yr US Treasury	1,10	3,54	3,58	2,54	n.a	1,77
BoA Merrill Lynch 3-5 Years US Treasury Passive	1,18	3,66	3,92	2,57	n.a	1,76
<i>Excess</i>	<i>-0,08</i>	<i>-0,11</i>	<i>-0,34</i>	<i>-0,03</i>	<i>n.a</i>	<i>0,01</i>
Bank for International Settlements	2,18	6,17	7,34	4,24	n.a	2,90
BoA Merrill Lynch 5-10 Years US Treasury Enhanced Passive	2,22	6,31	7,52	4,33	n.a	2,93
<i>Excess</i>	<i>-0,04</i>	<i>-0,15</i>	<i>-0,19</i>	<i>-0,09</i>	<i>n.a</i>	<i>-0,04</i>
Alliance Bernstein	1,26	9,50	7,32	n.a	n.a	-2,44
Barclays Global Treasury DM ex US Enhanced Passive	1,47	9,80	7,54	n.a	n.a	-2,45
<i>Excess</i>	<i>-0,22</i>	<i>-0,31</i>	<i>-0,22</i>	<i>n.a</i>	<i>n.a</i>	<i>0,01</i>
Wellington Management	1,43	9,74	7,43	n.a	n.a	0,54
Barclays Global Treasury DM ex US Enhanced Passive	1,47	9,80	7,54	n.a	n.a	0,64
<i>Excess</i>	<i>-0,05</i>	<i>-0,06</i>	<i>-0,11</i>	<i>n.a</i>	<i>n.a</i>	<i>-0,10</i>

INTERNATIONAL EQUITIES

The performance of the investments in global developed market equities for the quarter, including the performance of the managers responsible for those investments, was as follows:

Table 9

	Qtr	FYTD	1 Year	3 Years	5 Years	Since Inc
International Equities	1.09	0.90	-2.28	7.34	7.15	8.50
Benchmark	1.01	0.66	-2.78	6.95	6.63	7.81
<i>Excess</i>	<i>0.08</i>	<i>0.24</i>	<i>0.50</i>	<i>0.40</i>	<i>0.53</i>	<i>0.69</i>
Schroders Investment Management	1.40	1.55	-1.34	7.71	7.60	8.85
MSCI World Enhanced Passive	1.01	0.66	-2.78	6.95	6.63	7.81
<i>Excess</i>	<i>0.39</i>	<i>0.90</i>	<i>1.44</i>	<i>0.77</i>	<i>0.97</i>	<i>1.04</i>
SSgA International Equity	1.03	0.79	-2.40	7.30	n.a	9.59
MSCI World Passive	1.01	0.66	-2.78	6.95	n.a	9.20
<i>Excess</i>	<i>0.02</i>	<i>0.14</i>	<i>0.38</i>	<i>0.35</i>	<i>n.a</i>	<i>0.40</i>
BlackRock Investment Management	1.06	0.82	-2.41	7.28	n.a	7.61
MSCI World Passive	1.01	0.66	-2.78	6.95	n.a	7.31
<i>Excess</i>	<i>0.05</i>	<i>0.16</i>	<i>0.37</i>	<i>0.33</i>	<i>n.a</i>	<i>0.30</i>

5. MANAGEMENT COSTS

A management fee of \$3.29 million for operational management costs was charged to the fund during the quarter.

The fee covered the following services (in thousands \$):

Table 10

External Management and Custody expenses	2,136
Central Bank management expenses	1,109
IAB expenses	49
Other Expenses	3
Total Cost	3,298

6. TRANSFERS TO STATE BUDGET

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. an amount of \$340 million was transferred to the State Budget account during the quarter. The transfers are summarized in table 11.

Table 11

In Thousand (\$)

Transfer April 2016	100,000
Transfer May 2016	0
Transfer June 2016	240,000
Transfer for this Quarter	340,000
Total Transfers previous quarters	100,000
Total Transfers this fiscal year to June 2016	440,000

7. COMPLIANCE STATEMENT

Banco Central de Timor-Leste 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 universes specified in the various mandates at all times during the quarter.

Modified Duration

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

Tracking Error

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

External Managers

The Central Bank has received representations from the external managers, that external managers' investments were within their mandates during the quarter.

Internal Audit

The provisions of Article 22 of the Petroleum Fund law no. 9/2005 require the Central Bank's Internal Auditor to perform an audit of the Fund every six months. The Internal Auditor has performed an audit up to quarter ended 31 December 2015.

8. 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.

Table 12

BALANCE SHEET		
In thousands of USD	2016 June	2015 June
ASSETS		
Cash and Cash Equivalents	709,559	93,073
Receivables	36,969	25,221
Financial assets held at fair value through profit or loss	15,759,278	16,787,039
TOTAL ASSETS	16,505,806	16,905,333
LIABILITIES		
Payables for securities purchased	-34,905	-35,683
Accounts payable	-4,828	-6,923
TOTAL LIABILITIES	-39,733	-42,606
NET ASSETS	16,466,073	16,862,727
CAPITAL		
Opening Balance	16,217,573	16,538,617
PF Law Art. 6.1 (a) Revenue receipts	70,420	263,841
PF Law Art. 6.1 (b) DA receipts	81,665	304,064
PF Law Art. 6.1 (e) Other receipts	0	0
PF Law Art 7.1 Transfers to State Budget	-440,000	-445,000
Income for the period	536,416	201,205
CAPITAL	16,466,073	16,862,727

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME - QUARTER				
In thousands of USD				
	Quarter		Year to Date	
	Jun-16	Jun-15	Jun-16	Jun-15
INVESTMENT INCOME				
Interest income	38,844	39,845	78,762	75,271
Dividend income	57,151	53,329	100,043	95,712
Trust income	1,869	2,456	3,810	3,743
Other investment income	31	14	36	19
Net gains/(losses) on Financial Assets at fair value	154,542	-203,995	254,921	190,933
Net foreign exchange gains/(losses)	-41,949	92,910	115,054	-148,959
Total Investment Income	210,488	-15,441	552,627	216,717
EXPENSES				
External management, custody fees	2,136	2,378	4,502	4,785
Internal operational management fees	1,109	1,671	2,713	3,324
IAB Expenses	49	5	49	5
Other expenses	3	1	1,215	3
Total expenses	3,298	4,055	8,480	8,116
Profit before tax	207,190	-19,496	544,147	208,601
Withholding taxes on investments	5,722	5,543	7,731	7,397
Profit/loss for the period	201,468	-25,039	536,416	201,205
Other comprehensive income	0	0	0	0
Total comprehensive income for the period	201,468	-25,039	536,416	201,205

Notes:

1. 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.
2. The revenue receipts is Net of \$20 thousand tax refund.

Dili, 21 July 2016



Venancio Alves Maria
Executive Director



Abraão de Vasconcelos
Governor