

# Petroleum Fund of Timor-Leste

## Quarterly Report

31 December 2018

### Inside This Report

1. Introduction.
1. Executive summary.
2. Investment mandate.
2. Market trends.
4. Management during the quarter.
5. Portfolio performance.
8. Management costs.
9. Transfers to state budget.
9. Compliance statement.
9. Financial Information.

### 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 October 2018 to 31 December 2018.

Key statistics for the quarter include:

- The capital of the Fund at the end of the previous quarter was \$17.16 billion while the current quarter was \$15.80 billion.
- Gross cash inflows to the fund from royalties and taxes were \$178.75 million.
- Outflows for the quarter were \$774.70 million, being transfers to the state budget of \$772.5 million while \$2.20 million was for management costs.
- The profit/loss for the quarter was -\$694.85 million, representing a gross of fees return of -4.08% compared with the benchmark return of -4.24%.

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	-4.08	-2.63	-2.63	3.82	2.93	3.82
Benchmark	-4.24	-2.98	-2.98	3.60	2.82	3.76
<i>Excess</i>	<i>0.17</i>	<i>0.35</i>	<i>0.35</i>	<i>0.21</i>	<i>0.10</i>	<i>0.06</i>
International Fixed Interest	2.10	0.78	0.78	1.64	1.43	2.50
Benchmark	2.22	0.67	0.67	1.56	1.39	2.48
<i>Excess</i>	<i>-0.12</i>	<i>0.11</i>	<i>0.11</i>	<i>0.09</i>	<i>0.04</i>	<i>0.02</i>
International Equities	-13.17	-8.33	-8.33	6.63	4.90	8.23
Benchmark	-13.42	-8.71	-8.71	6.30	4.56	7.66
<i>Excess</i>	<i>0.24</i>	<i>0.38</i>	<i>0.38</i>	<i>0.33</i>	<i>0.34</i>	<i>0.57</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 December 2018 were as follows:

Table 2

	1-Oct-18	30-Nov-18	12-Dec-18
BOA Merrill Lynch 3-5 Years Treasury Bond Index	40%	40%	40%
BOA Merrill Lynch 5-10 Years Treasury Notes and Bond Index	10%	10%	10%
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country Capped	10%	10%	10%
<b>Total Fixed Income</b>	<b>60%</b>	<b>60%</b>	<b>60%</b>
<b>Total Equity (MSCI World Index Net Dividends Reinvested)</b>	<b>40%</b>	<b>40%</b>	<b>40%</b>
<b>Total</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>

## 2. MARKET TRENDS DURING THE QUARTER

### *Global Market Trend*

A continued withdrawal of accommodative monetary policy by major central banks, and the prospects of a slowing global economic activity negatively affected the prices of all risky assets during the quarter.

A strong labor market in the U.S prompted the Fed to raise interest rate from 2.25 to 2.5% in December, which brought the total number of interest rate hikes in 2018 to four. Volatility rose sharply during the period as investors worried that the Fed might raise interest rate faster than the market could handle. As a result, the Fed changed its policy tone by revising down their projection to raise interest rate from three times to two times in 2019. At the same time, the Fed adjusted their economy and inflation forecasts downward. The Fed also reiterated lately that there is no preset policy path, implying that they would be more data dependent going forward. Moreover, the Fed would not hesitate to review their balance sheet reduction policy if it proved to be a problem for the markets.

The European Central Bank (ECB) ended their bond-purchasing program as expected, but assured it would not raise interest rates until mid-2019. Economic activity in the region continued to slow down during the fourth quarter as pointed out by the data. The flash composite purchasing manager index showed business activity in the region fell from 52.7 in November to 51.3 in December. The political

uncertainty in Italy and France also had a drag on market in the region during the quarter. The Bank of England maintained their interest rate at 0.75% but stand ready to cut interest rates should the Brexit negotiations disrupt the market. Britain set to leave the European Union at the end of March 2019 but both parties have not reached an agreement on future trade relations. Markets have priced in a high probability of the U.K leaving the E.U without a deal, which would be catastrophic for both parties, and, to some extent, to the global economy. The data that came out from the U.K during the quarter were mixed. The U.K's gross domestic product for the third quarter was at 0.6%, recovering from a very poor start in 2018. Retail sales fell -0.5% in October but rebounded sharply to 1.4% in November. U.K consumers enjoyed a higher wage growth and a lower rate of inflation during the fourth quarter of the year.

There were no changes to the Bank of Japan's monetary policy after the committee regular meeting during the quarter. The data from the Japanese government during the quarter were somewhat mixed as the country went through several natural disasters which decelerated the economic activity in the country. China's economy recorded its weakest quarterly growth since the global financial crisis as the trade tariffs started taking effect. Industrial production and retail sales also slowed more than expected, heightening growth concerns. Policymakers responded with stimulative measures to support the economy, including cutting the banks' reserve requirement ratios and boosting credit for small and private companies.

### *Equities*

Major global equity indices were down materially during the quarter as investors fear that global trade uncertainty and reduced liquidity in the market would slow global economic growth.

Major equity indices in the U.S posted sharp declines during the quarter as the tighter monetary policy and the trade uncertainty raised investor pessimism about economic activity expansion. The generic S&P 500 index was down more than -6% for the period. The U.S. - China Trade relations dominated the news during the quarter as the U.S set to increase tariffs from 10% to 25% at the beginning on 2019. However, both parties agreed to suspend tariffs until March 2019 in search for a trade deal. Big companies in sectors such as Information Technology have acknowledged that the earnings growth may be weaker in the coming months. Similarly, the companies in the energy sector downgraded their future earnings given the slowing economic activity in China would lower demand for oil. The Oil price has fallen more than 30% compared to the previous quarter. Equity markets were boosted by the fiscal stimulus in the U.S but investors believe the fiscal effect would fade away by the end of 2019.

The major equity indices across Europe also fell significantly during the quarter in response a weaker business activity in the region. The MSCI Europe index dropped around 12%. Business surveys from Italy and France had been weakening all along the period. Germany business activity is still growing but at a slower pace. Those weaknesses are attributed to the political instability in the region and a weaker demand from China, which dented exports in the region. Defensive sectors, such as communication services and utilities, which are often perceived as safe havens due to their stable earnings throughout the cycle, were the only sectors to register a positive return. Materials and information technology were among the worst performing sectors.

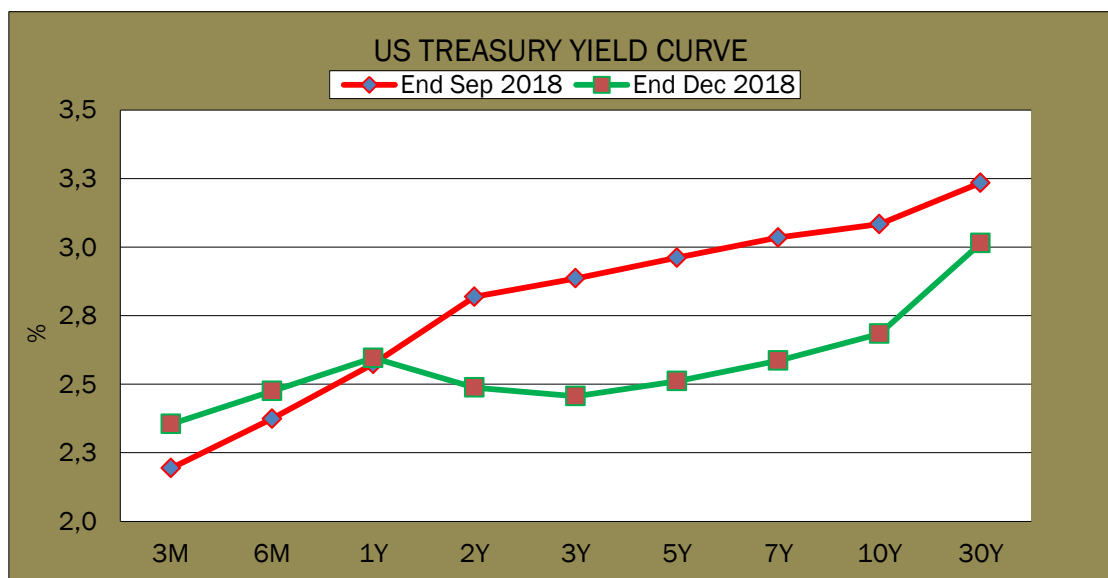
Equity markets across Asia reflected the global sentiment with the Japan's Topix index fell more than 17% during the quarter. The weaknesses particularly concentrated in October and December coinciding with the strength of the yen, which investors see as a safe haven during the time of uncertainty. Australian equity market index MSCI AU was also down around 8% during the quarter, partly due to the weakening demand from China.

### *Bonds including US Treasuries*

The yields on the long-term global treasury bonds declined for the quarter as investors were seeking safety in light of the falling price of risky assets and the prospects of a global economic slowdown. The Italian 10-year government bond yield fell 0.41% in reaction to the agreement reached by the Italian government and the E.U budget commission to lower the Italian budget deficit from 2.40% to 2.04%. The yield on the U.K's 10-year Gilts fell 0.30% during the quarter, as investors see Britain leaving the E.U without a trade deal highly probable.

The below graph illustrates a movement of the U.S Treasury yield curve from the 3-month to 30-years compared to the previous quarter end. The yields on the short-term U.S Treasury notes rose during the quarter, in response to the interest rate increase by the Fed. Tamed inflation data and the rising uncertainty in the market boosted demand for the longer-term U.S treasury bonds, which, in turn, pushed the yield curve down (Bond yields and prices move inversely to one another).

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 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
	Enhanced Passive	Wellington Management	0.50%	Nil	4-Dec-14
MSCI World index ex Australia Net Dividends Reinvested	Passive	State Street Global Advisors	0.35%	Nil	18-Jan-12
		BlackRock	0.35%	Nil	21-Feb-13
MSCI World index Net Dividends Reinvested	Enhanced Passive	Schroders Investment Management	1.00%	1.00%	7-Oct-10
MSCI Australia	Passive	BCTL	0.50%	Nil	4-Jul-16

### 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%	37.84%	37.50%	42.50%
BOA Merrill Lynch 5-10 Years Treasury Notes and Bond Index	Bank for International Settlements	10%	± 1%	10.95%	9.00%	11.00%
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country Capped	Alliance Bernstein	5%	± 0.5%	5.16%	4.50%	5.50%
	Wellington Management	5%	± 0.5%	5.19%	4.50%	5.50%
<b>Total Fixed Income</b>		<b>60%</b>		<b>59.14%</b>	<b>55.50%</b>	<b>64.50%</b>
MSCI Index ex Australia Net Dividends Reinvested	State Street Global Advisors	34%	± 4.0%	17.32%	13.00%	21.00%
	BlackRock			17.32%		
MSCI World Index Net Dividends Reinvested	Schroders Investment Management	5%	± 1.5%	5.13%	3.50%	6.50%
MSCI Australia Index	BCTL	1%	± 0.5%	1.10%	0.50%	1.50%
<b>Total Equities</b>		<b>40%</b>		<b>40.86%</b>	<b>30.00%</b>	<b>50.00%</b>

The weights in Table 4 and those in the benchmark portfolio's asset allocation (Table 2) do not account for the Cash mandate.

## 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 \$15.80 billion as follows:

Table 5

Capital Account	\$'000
Opening book value (01 October 2018)	17,155,577
Receipts during the period	178,750
Transfer to General State Budget	-772,500
Tax refund	-63,335
Investment Return	-694,855
<b>Closing book value (31 December 2018)</b>	<b>15,803,638</b>

The Fund was invested as follows:

Table 6

Assets	\$'000
Cash and Cash Equivalents	725,099
Other Receivables	25,799
Financial assets held at fair value through profit or loss	15,072,096
Less:	
Payable for Securities Purchased	-16,644
Accounts Payable	-2,711
<b>Total</b>	<b>15,803,638</b>

The income for the quarter was as follows:

Table 7

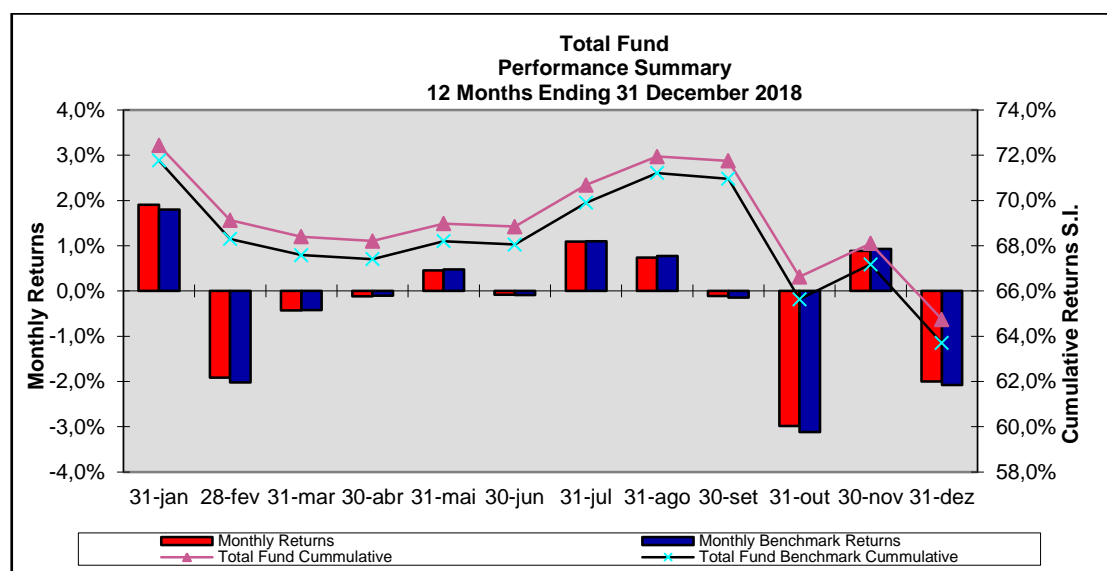
Income	\$'000
Interest income	55,487
Dividend income	30,245
Unit Trust distributions	1,583
Other Investment income	5
Net gains/(losses) on Financial Assets at fair value	-735,693
Net foreign exchange gains/(losses)	-42,957
Less:	
External manager, custody fees	-1,721
Central Bank management expenses	0
IAB Expenses	-111
Other expenses	-372
Withholding taxes	-1,321
<b>Total Investment Income</b>	<b>-694,855</b>

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

- Unit trust distribution is the income received from listed property investment entities.
- Other expenses relate to derivative trading costs which are deducted directly from the Fund.

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
<b>International Fixed Interest</b>	2.10	0.78	0.78	1.64	1.43	2.50
Benchmark	2.22	0.67	0.67	1.56	1.39	2.48
<i>Excess</i>	<i>-0.12</i>	<i>0.11</i>	<i>0.11</i>	<i>0.09</i>	<i>0.04</i>	<i>0.02</i>
<b>BCTL Cash Management (TLCM)</b>	0.53	1.89	1.89	n.a	n.a	1.41
3 Months USD Libor	0.66	2.31	2.31	n.a	n.a	1.97
<i>Excess</i>	<i>-0.13</i>	<i>-0.42</i>	<i>-0.42</i>	<i>n.a</i>	<i>n.a</i>	<i>-0.56</i>
<b>BCTL 3-5 yr US Treasury</b>	2.38	1.53	1.53	1.28	1.49	1.18
BoA Merrill Lynch 3-5 Years US Treasury Passive	2.38	1.47	1.47	1.24	1.49	1.14
<i>Excess</i>	<i>0.00</i>	<i>0.06</i>	<i>0.06</i>	<i>0.03</i>	<i>0.00</i>	<i>0.04</i>
<b>Bank for International Settlements</b>	3.35	1.26	1.26	1.54	2.46	1.66
BoA Merrill Lynch 5-10 Years US Treasury Enhanced Passiv	3.37	1.21	1.21	1.50	2.47	1.65
<i>Excess</i>	<i>-0.02</i>	<i>0.04</i>	<i>0.04</i>	<i>0.04</i>	<i>-0.02</i>	<i>0.01</i>
<b>Alliance Bernstein</b>	0.51	-2.91	-2.91	2.72	n.a	-1.32
Barclays Global Treasury DM ex US Enhanced Passive	0.47	-3.10	-3.10	2.68	n.a	-1.41
<i>Excess</i>	<i>0.05</i>	<i>0.19</i>	<i>0.19</i>	<i>0.05</i>	<i>n.a</i>	<i>0.09</i>
<b>Wellington Management</b>	0.55	-3.08	-3.08	2.62	n.a	-0.16
Barclays Global Treasury DM ex US Enhanced Passive	0.47	-3.10	-3.10	2.68	n.a	-0.10
<i>Excess</i>	<i>0.08</i>	<i>0.02</i>	<i>0.02</i>	<i>-0.05</i>	<i>n.a</i>	<i>-0.06</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
<b>International Equities</b>	-13.17	-8.33	-8.33	6.63	4.90	8.23
Benchmark	-13.42	-8.71	-8.71	6.30	4.56	7.66
<i>Excess</i>	<i>0.24</i>	<i>0.38</i>	<i>0.38</i>	<i>0.33</i>	<i>0.34</i>	<i>0.57</i>
<b>Schroders Investment Management</b>	-13.10	-8.44	-8.44	6.52	4.83	8.35
MSCI World Enhanced Passive	-13.42	-8.71	-8.71	6.30	4.56	7.66
<i>Excess</i>	<i>0.32</i>	<i>0.27</i>	<i>0.27</i>	<i>0.21</i>	<i>0.28</i>	<i>0.69</i>
<b>SSgA International Equity</b>	-13.26	-8.21	-8.21	6.70	4.95	8.93
MSCI World Passive	-13.50	-8.63	-8.63	6.34	4.58	8.54
<i>Excess</i>	<i>0.24</i>	<i>0.42</i>	<i>0.42</i>	<i>0.36</i>	<i>0.37</i>	<i>0.39</i>
<b>BlackRock Investment Management</b>	-13.32	-8.19	-8.19	6.74	4.96	7.69
MSCI World Passive	-13.50	-8.63	-8.63	6.34	4.58	7.34
<i>Excess</i>	<i>0.18</i>	<i>0.43</i>	<i>0.43</i>	<i>0.40</i>	<i>0.38</i>	<i>0.35</i>
<b>BCTL Investment Management</b>	-9.73	-11.69	-11.69	n.a	n.a	4.95
MXAU AU Index Passive	-10.01	-11.99	-11.99	n.a	n.a	4.80
<i>Excess</i>	<i>0.28</i>	<i>0.30</i>	<i>0.30</i>	<i>n.a</i>	<i>n.a</i>	<i>0.15</i>

**5. MANAGEMENT COSTS**

A management fee of \$2.20 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	1,721
Central Bank management expenses	-
IAB expenses	111
Other Expenses	372
<b>Total Cost</b>	<b>2,204</b>

**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 \$772.5 million was transferred to the State Budget account during the quarter. The transfers are summarized in table 11.



Table 11	In Thousand (\$)
Transfer October 2018	220,000
Transfer November 2018	220,000
Transfer December 2018	332,500
Transfer for this Quarter	<b>772,500</b>
Total Transfers previous quarters	210,000
<b>Total transfers this fiscal year to December 2018</b>	<b>982,500</b>

## 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 2018.

## 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	2018	2017
In thousands of USD	December	December
<b>ASSETS</b>		
Cash and Cash Equivalents	725,099	318,007
Receivables	25,799	31,422
Financial assets held at fair value through profit or loss	15,072,096	16,462,178
<b>TOTAL ASSETS</b>	<b>15,822,994</b>	<b>16,811,607</b>
<b>LIABILITIES</b>		
Payables for securities purchased	-16,644	-10,169
Accounts payable	-2,711	-2,125
<b>TOTAL LIABILITIES</b>	<b>-19,355</b>	<b>-12,294</b>
<b>NET ASSETS</b>	<b>15,803,638</b>	<b>16,799,313</b>
<b>CAPITAL</b>		
Opening Balance (January)	16,799,313	15,844,327
PF Law Art. 6.1 (a) Revenue receipts	260,154	181,295
PF Law Art. 6.1 (b) DA receipts	243,983	233,992
PF Law Art. 6.1 (e) Other receipts	5,944	6,410
PF Law Art 7.1 Transfers to State Budget	-982,500	-1,078,800
PF Law Art.10 Tax refund	-63,335	0
Income for the period	-459,921	1,612,088
<b>CAPITAL</b>	<b>15,803,638</b>	<b>16,799,313</b>

Table 13

STATEMENT OF PROFIT OR LOSS	Quarter		Year to Date	
In thousands of USD	Dec-18	Dec-17	Dec-18	Dec-17
<b>INVESTMENT INCOME</b>				
Interest income	55,487	44,549	201,534	169,503
Dividend income	30,245	30,765	156,845	162,787
Trust income	1,583	1,727	6,694	7,591
Other investment income	5	2	39	11
Net gains/(losses) on Financial Assets at fair value	-735,693	269,469	-642,694	982,968
Net foreign exchange gains/(losses)	-42,957	18,716	-157,388	312,405
<b>Total Investment Income</b>	<b>-691,329</b>	<b>365,228</b>	<b>-434,971</b>	<b>1,635,265</b>
<b>EXPENSES</b>				
External management, custody fees	1,721	2,183	9,329	7,649
Internal operational management fees	0	573	5,074	5,518
IAB Expenses	111	91	254	261
Other expenses	372	237	839	-6
<b>Total expenses</b>	<b>2,204</b>	<b>3,084</b>	<b>15,496</b>	<b>13,421</b>
Profit before tax	-693,534	362,144	-450,467	1,621,844
Withholding taxes on investments	1,321	1,413	9,454	9,756
<b>Profit/loss for the period</b>	<b>-694,855</b>	<b>360,731</b>	<b>-459,921</b>	<b>1,612,088</b>
Other comprehensive income	0	0	0	0
<b>Total comprehensive income for the period</b>	<b>-694,855</b>	<b>360,731</b>	<b>-459,921</b>	<b>1,612,088</b>

Notes: 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, 23 January 2019



**Venancio Alves Maria**  
Deputy Governor



**Abraão de Vasconcelos**  
Governor