

Petroleum Fund of Timor-Leste

Quarterly Report

30 June 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.
8. 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 April 2018 to 30 June 2018.

Key statistics for the quarter include:

- The capital of the Fund at the end of the previous quarter was \$16.85 billion while the current quarter was \$16.93 billion.
- Gross cash inflows to the fund from royalties and taxes were \$113.26 million.
- Outflows for the quarter were \$74.50 million, being transfers to the state budget were \$70 million while \$4.50 million was for management costs.
- The profit/loss for the quarter was \$37.26 million, representing a gross of fees return of 0.26% compared with the benchmark return of 0.28%.

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	0.26	-0.21	4.28	4.22	4.52	4.17
Benchmark	0.28	-0.40	4.05	4.10	4.44	4.12
<i>Excess</i>	<i>-0.01</i>	<i>0.19</i>	<i>0.23</i>	<i>0.13</i>	<i>0.09</i>	<i>0.05</i>
International Fixed Interest	-0.65	-0.97	-0.47	1.03	1.13	2.46
Benchmark	-0.74	-1.11	-0.59	0.96	1.07	2.44
<i>Excess</i>	<i>0.09</i>	<i>0.15</i>	<i>0.12</i>	<i>0.07</i>	<i>0.06</i>	<i>0.02</i>
International Equities	1.77	0.47	11.22	8.77	10.25	10.08
Benchmark	1.73	0.43	11.09	8.48	9.94	9.52
<i>Excess</i>	<i>0.03</i>	<i>0.03</i>	<i>0.13</i>	<i>0.29</i>	<i>0.31</i>	<i>0.56</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 2018 were as follows:

Table 2

	1-Apr-18	31-May-18	30-Jun-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%
Total Fixed Income	60%	60%	60%
Total Equity (MSCI World Index Net Dividends Reinvested)	40%	40%	40%
Total	100%	100%	100%

2. MARKET TRENDS DURING THE QUARTER

Global Market Trend

The U.S economy continues its growth momentum during the second quarter. Rebound in consumption and retails sales data during second quarter confirming that the soft data in first quarter was only a temporary brake. U.S labor market carried on its strength momentum, added 200,000 jobs on average each month during the quarter. Consequently, the unemployment rate went down to multiyear lows. Tight labor market gradually boosted the inflation, which allowed U.S Federal Reserve to add 0.25% to its policy rate in June. It is the second time increase after the first raise in March. The Fed also lifted their projection for two more rate hikes this year instead of once as projected previously.

After a series of soft economic data from the Eurozone, the officials of European Central Bank stated that the interest rate in the Zone would not increase until summer next year. On the other hand, the ECB decided to reduce the amount of its bond purchasing program from current pace of euro 60 billion to 15 billion euros starting September to December and cease the program afterwards. At the end of last quarter market had expected the Bank of England would raise interest rate during the second quarter. The BoE left their interest rate unchanged during the quarter. However, the multiyear low unemployment, which is believed to push up wage growth in near term according to surveys. Consequently, it could drive up inflation even more, and coupled with bouncing back in retail sales,

could trigger the BoE to raise interest rate later this year, unless Brexit negotiations create unexpected adverse effect to the market.

In the wake of consistent weak inflation in Japan, deputy governor of Bank of Japan Wakatabe stated that Bank of Japan's policy makers do not need to cut the policy rate further. He said that the benefit of current yield curve control policy outweigh any potential negative impact on commercial banks. Wakatabe, however acknowledged that the yield curve control policy flatten the yield curve, which hurt commercial banks that rely on income from lending and saving activities. The unemployment rate in Japan is at 2.2% May, the lowest level since 1992 and it should be seen as inflationary expectation.

Equities

Performance of global equity market varied across the regions during the quarter as most developed market equity advanced while emerging market declined due to the USD strength.

Overall, the U.S equity market posted positive gains during the quarter as surging oil prices and strong corporate earnings overshadowed the China-U.S trade disputes. Energy was the best performing sector as oil prices rose more than 14% from last quarter. Improving global economy has boosted the demand for oil and crisis in Libya posed supply concerns. Industrial sector is the one most affected by the ongoing trade dispute among U.S and its trade partners. While the financial sectors underperformed during the quarter as Fed's projection to raise more rates couple with strong economic data in the country flattened the yield curve during the quarter.

Generally, equity market in Europe advance in the second quarter led by information technology, the energy and healthcare sector. The political uncertainty in Italy in May affect banks in Italy, which dragged down the financial sector performance in the region. Moreover, the share price of auto fell during the quarter as U.S President threatened in many occasions to levy tariffs to vehicles imported to the U.S from Eurozone. Equity market in U.K posted robust gain for the quarter with FTSE 100 index rose more than 8% in local currency term. The BoE's decision to hold the interest rate intact was positive to equity market of the country. The depreciation of the U.K's sterling against generally strong USD made the internationally exposed large companies fare better than the domestic oriented companies.

Emerging market equity posted a sharp decline during the quarter due to the strong U.S dollar and escalation in global trade disputes. The MSCI Emerging Market Index declined more than 8% for the quarter weighted down by the shares in Brazil, Argentina, and Turkey. The decline mostly attributed to the trade dispute between U.S and China as U.S has made move to levy tariffs for aluminum and steels imported from country such as Mexico and China. On the other hand, Australia equity market rose sharply during the quarter as MSCI Australia posted 8% gain driven by the raise in commodity price and acceleration in exports.

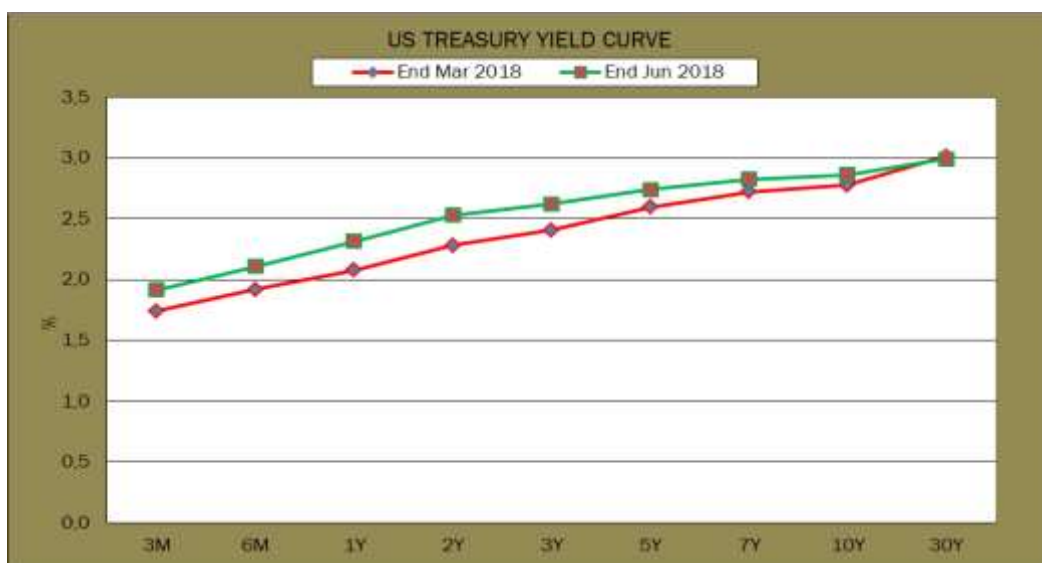
Bonds including US Treasuries

The yields of sovereign bonds across Europe were mixed during the quarter. Formation of populist coalition government in Italy in May raise concerns that the future relationship between Italy and European Union may face uncertainties. The sentiment triggered selloff in Italian Government bonds as yield of government 10-year bond increase 0.89%. On the other hand, the yields of German, France and U.K government 10-year bond declined 0.20%, 0.06%, and 0.07% respectively for the quarter.

The graph below is yield curve illustrates U.S Treasury bond yield movement ranges from 3-month to 30-years compared to the previous quarter end. The graph indicates the yield curve is somewhat flat as the short-term to medium-term bond yield increased more than the longer maturity. The yield of short-term notes range from three months to one year rose on average of 0.20%, the medium term bond

yields two-five year each increased on average of 0.25%. The yield of 10-year rose 0.12%, for the long end of the curve was muted as yield 30-year only rose 0.02%. Bond yield moves inversely to price.

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.

Tabela 3

Mandato	Estilo de Gestão	Gestores Autorizado	Tracking Error	Meta de desempenho	Data início
BOA Merrill Lynch 3-5 Years US Treasury Bond Index	Passivo	BCTL	n/a	Nil	19-Jan-12
BOA Merrill Lynch 5-10 Years US Treasury Bond Index	Passivo melhorado	Bank for International Settlements	0.5%	0.25%	15-Dec-11
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country Capped	Passivo melhorado	Alliance Bernstein	0.5%	Nil	03-Jul-14
	Passivo melhorado	Wellington Management	0.5%	Nil	04-Dec-14
MSCI World index ex Australia Net Dividends Reinvested	Passivo	State Street Global Advisors	0.4%	Nil	18-Jan-12
		BlackRock	0.4%	Nil	21-Feb-13
MSCI World index Net Dividends Reinvested	Passivo melhorado	Schroders Investment Management	1.0%	1.00%	07-Oct-10
MSCI Australia	Passivo	BCTL	0.5%	Nil	04-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%	40.07%	37.50%	42.50%
BOA Merrill Lynch 5-10 Years Treasury Notes and Bond Index	Bank for International Settlements	10%	± 1%	10.15%	9.00%	11.00%
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country Capped	Alliance Bernstein	5%	± 0.5%	4.95%	4.50%	5.50%
	Wellington Management	5%	± 0.5%	4.98%	4.50%	5.50%
Total Fixed Income		60%		60.15%	55.50%	64.50%
MSCI Index ex Australia Net Dividends Reinvested	State Street Global Advisors	34%	± 4.0%	16.87%	13.00%	21.00%
	BlackRock			16.88%		
MSCI World Index Net Dividends Reinvested	Schroders Investment Management	5%	± 1.5%	4.93%	3.50%	6.50%
MSCI Australia Index	BCTL	1%	± 0.5%	1.17%	0.50%	1.50%
Total Equities		40%		39.85%	30.00%	50.00%

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 \$16.93 billion as follows:

Table 5

Capital Account	\$'000
Opening book value (01 April 2018)	16,846,811
Receipts during the period	113,257
Transfer to General State Budget	-70,000
Investment Return	37,256
Closing book value (30 June 2018)	16,927,324

The Fund was invested as follows:

Table 6

Assets	\$'000
Cash and Cash Equivalents	893,561
Other Receivables	32,856
Financial assets held at fair value through profit or loss	16,011,070
Less:	
Payable for Securities Purchased	-6,566
Accounts Payable	-3,597
Total	16,927,324

The income for the quarter was as follows:

Table 7

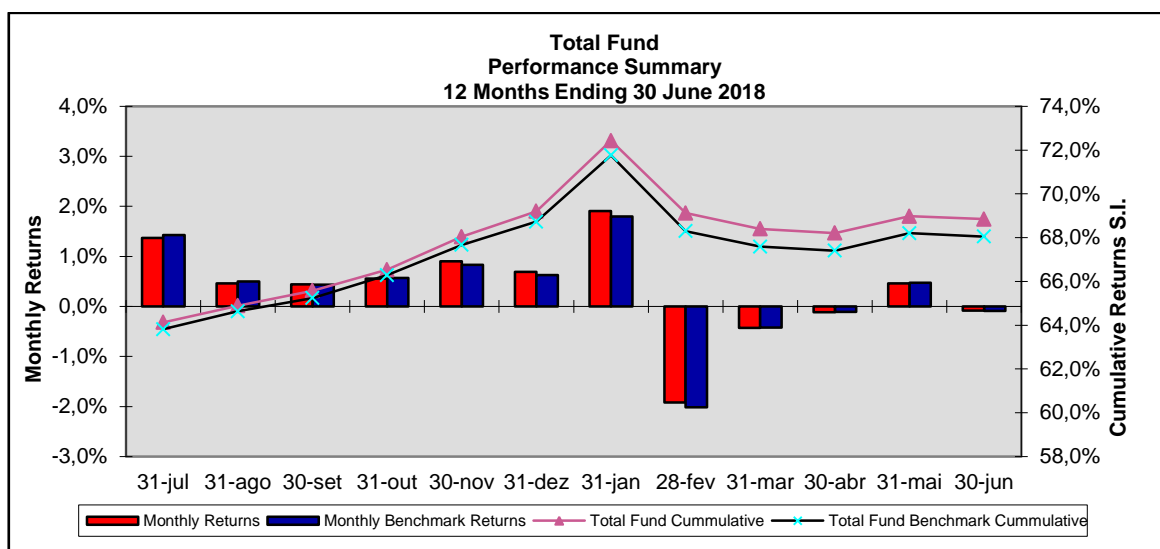
Income	\$'000
Interest income	47,049
Dividend income	51,169
Unit Trust distributions	1,816
Other Investment income	5
Net gains/(losses) on Financial Assets at fair value	109,767
Net foreign exchange gains/(losses)	-162,631
Less:	
External manager, custody fees	-2,645
Central Bank management expenses	-1,683
IAB Expenses	-69
Other expenses	-104
Withholding taxes	-5,418
Total Investment Income	37,256

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
International Fixed Interest	-0.65	-0.97	-0.47	1.03	1.13	2.46
Benchmark	-0.74	-1.11	-0.59	0.96	1.07	2.44
<i>Excess</i>	0.09	0.15	0.12	0.07	0.06	0.02
BCTL Cash Management (TLCM)	0.45	0.85	1.39	n.a	n.a	1.24
3 Months USD Libor	0.58	1.05	1.76	n.a	n.a	1.72
<i>Excess</i>	-0.13	-0.20	-0.37	n.a	n.a	-0.48
BCTL 3-5 yr US Treasury	0.01	-0.67	-0.93	0.55	1.14	0.93
BoA Merrill Lynch 3-5 Years US Treasury Passive	-0.01	-0.73	-0.95	0.59	1.11	0.89
<i>Excess</i>	0.02	0.06	0.02	-0.04	0.02	0.04
Bank for International Settlements	-0.03	-1.49	-1.42	0.98	1.68	1.37
BoA Merrill Lynch 5-10 Years US Treasury Enhanced Passive	-0.09	-1.57	-1.55	0.94	1.67	1.35
<i>Excess</i>	0.06	0.08	0.13	0.05	0.01	0.02
Alliance Bernstein	-4.29	-2.29	1.63	2.25	n.a	-1.32
Barclays Global Treasury DM ex US Enhanced Passive	-4.28	-2.27	1.72	2.25	n.a	-1.38
<i>Excess</i>	-0.01	-0.02	-0.08	0.00	n.a	0.05
Wellington Management	-4.32	-2.36	1.62	2.15	n.a	0.02
Barclays Global Treasury DM ex US Enhanced Passive	-4.28	-2.27	1.72	2.25	n.a	0.12
<i>Excess</i>	-0.04	-0.09	-0.09	-0.10	n.a	-0.10

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	1.77	0.47	11.22	8.77	10.25	10.08
Benchmark	1.73	0.43	11.09	8.48	9.94	9.52
<i>Excess</i>	0.03	0.03	0.13	0.29	0.31	0.56
Schroders Investment Management	1.30	-0.26	10.04	8.55	10.13	10.12
MSCI World Enhanced Passive	1.73	0.43	11.09	8.48	9.94	9.52
<i>Excess</i>	-0.44	-0.69	-1.05	0.07	0.19	0.60
SSgA International Equity	1.71	0.59	11.40	8.82	10.28	11.20
MSCI World Passive	1.65	0.48	11.15	8.50	9.95	10.84
<i>Excess</i>	0.06	0.11	0.25	0.33	0.33	0.37
BlackRock Investment Management	1.73	0.66	11.53	8.88	10.31	10.29
MSCI World Passive	1.65	0.48	11.15	8.50	9.95	9.95
<i>Excess</i>	0.08	0.18	0.38	0.39	0.36	0.34
BCTL Investment Management	5.19	-1.24	8.82	n.a	n.a	12.34
MXAU AU Index Passive	5.20	-1.27	8.73	n.a	n.a	12.31
<i>Excess</i>	-0.01	0.04	0.09	n.a	n.a	0.03

5. MANAGEMENT COSTS

A management fee of \$4.50 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	2,645
Central Bank management expenses	1,683
IAB expenses	69
Other Expenses	104
Total Cost	4,502

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 \$70 million was transferred to the State Budget account during the quarter. The transfers are summarized in table 11.

Table 11	In Thousand (\$)
Transfer April 2018	0
Transfer May 2018	70,000
Transfer June 2018	0
Transfer for this Quarter	70,000
Total Transfers previous quarters	0
Total Transfers this fiscal year to December 2018	70,000

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 2017.

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	June	June
ASSETS		
Cash and Cash Equivalents	893,561	586,383
Receivables	32,856	40,599
Financial assets held at fair value through profit or loss	16,011,070	15,911,011
TOTAL ASSETS	16,937,487	16,537,993
LIABILITIES		
Payables for securities purchased	-6,566	-31,640
Accounts payable	-3,597	-1,766
TOTAL LIABILITIES	-10,163	-33,406
NET ASSETS	16,927,324	16,504,588
CAPITAL		
Opening Balance (January)	16,799,313	15,844,327
PF Law Art. 6.1 (a) Revenue receipts	105,029	95,527
PF Law Art. 6.1 (b) DA receipts	146,877	104,502
PF Law Art. 6.1 (e) Other receipts	0	0
PF Law Art 7.1 Transfers to State Budget	-70,000	-420,000
Income for the period	-53,895	880,232
CAPITAL	16,927,324	16,504,588

Table 13

STATEMENT OF PROFIT OR LOSS	Quarter		Year to Date	
In thousands of USD	Jun-18	Jun-17	Jun-18	Jun-17
INVESTMENT INCOME				
Interest income	47,049	42,116	95,302	81,035
Dividend income	51,169	51,170	89,865	93,259
Trust income	1,816	1,762	2,728	3,864
Other investment income	5	5	33	6
Net gains/(losses) on Financial Assets at fair value	109,767	168,684	-133,357	510,544
Net foreign exchange gains/(losses)	-162,631	128,840	-91,933	205,938
Total Investment Income	47,176	392,576	-37,362	894,647
EXPENSES				
External management, custody fees	2,645	2,041	5,339	3,077
Internal operational management fees	1,683	1,635	3,353	3,270
IAB Expenses	69	113	97	113
Other expenses	104	149	352	378
Total expenses	4,502	3,938	9,141	6,838
Profit before tax	42,674	388,638	-46,503	887,809
Withholding taxes on investments	5,418	5,609	7,392	7,577
Profit/loss for the period	37,256	383,029	-53,895	880,232
Other comprehensive income	0	0	0	0
Total comprehensive income for the period	37,256	383,029	-53,895	880,232

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, 18 July 2018



Venancio Alves Maria
Deputy Governor



Abraão de Vasconcelos
Governor