

Minutes of Meeting
Petroleum Fund of Timor-Leste
Investment Advisory Board

Held on 28th August 2009

At the Office of the World Bank

Present:

Olgário de Castro (Chairman)
Venancio Alves Maria, as alternate for Mr. Abraao de Vasconcelos
Tørres Trovik (via video conference)
Kevin Bailey

In attendance:

Vidar Ovesen, Fiscal Policy and Petroleum Fund Advisor, Ministry of Finance
Torgrim Roll, Advisor for PF Department, BPA
Sam Robinson, Advisor for BPA
Gastao de Sousa, Chief Economist, BPA (Secretary)

The Chairman declared the meeting open at 08.30 hours.

The agenda for the meeting was approved without amendment.

1. Apologies

Apologies were received from Mr. Abraao de Vasconcelos and Ms. Sara Lobo. Mr. Venancio Alves Maria was present as alternate for Mr. De Vasconcelos.

2. Minutes of Previous Meetings

The minutes of the previous meeting held on 3rd June 2009 were approved without amendments and adopted for publication.

3. Business arising from the minutes not otherwise included in the agenda

The Board resolved to adopt and authorize that the sections relating to the appointment of BIS as an external manager that had previously been declared confidential in earlier minutes be made available for publication.

4. Update information on the PF performance for quarter ended 30 June 2009

The return on PF portfolio in the quarter ended 30 June 2009 had been -0.76% while the return on the benchmark had been -0.63%. Cash received during the quarter was USD 383.98 million while the outflows were USD 200.92 million of which USD 0.92 million

was to cover the BPA operational management cost. The capital of the Fund therefore reached USD 4,901.52 million in the quarter, which 20.20% was under the BIS management. The annualized returns for the previous 12 months were 4.20% for the PF and 4.48% for the benchmark. The modified duration of the Petroleum Fund portfolio had been maintained within the mandate.

The Board noted the performance report for the quarter ended 30 June 2009 given by the BPA.

5. Report from the BPA (Review of the internal investment mandate)

The Board had requested the BPA in the previous meeting to report on its internal capacity to manage assets other than 0-5 year US Government bonds with a view to diversifying the fixed interest portfolio under BPA management.

In response to that request the BPA presented a paper outlining options for the enhancement of the BPA's internal investment mandate.

The BPA presented two approaches that could be implemented internally to improve the yield of the Petroleum Fund. First, the PF could be invested in Treasury Index Priced Securities (TIPS), which would improve the yield on the Fund's investment and protect the capital against US inflation. Secondly, the PF could be invested in longer duration US Treasury Notes which would provide a higher yield. In addition the report discussed the option to designate part of the portfolio as "Held to Maturity" (HTM), which would enable that part of the Fund to be reported on a constant income basis. The BPA advised in its report that it would use its existing systems, procedures and staff to manage a TIPS or a longer duration portfolio in addition to the current mandate.

The Board noted the report and agreed to recommend an investment mandate to the Minister involving TIPS. The IAB decided that before making any final recommendation there was a need for an independent assessment of the BPA's operational capacity to manage TIPS.

The IAB therefore decided to include a section about a TIPS mandate and the need for an assessment of the BPA in the proposed Terms of Reference for an external consultancy in the process of being engaged by the Ministry of Finance, ref. agenda item 6.

6. Request from the Minister for advice on the PF's long term investment strategy and PF Law amendments

The Minister requested the IAB in a letter dated 25 June 2009 to provide advice on issues related to the amendments of article 14 and 15 of the PF Law, taking into account the optimal strategic asset allocation and the implementation of the Santiago-principles for sovereign wealth funds.

The secretariat presented a draft letter to the Minister expressing the need for assistance and a deeper analysis on risk and return for various strategic assets allocation in order to provide the advice on the long term investment and the PF Law amendment to the Minister. As these issues are complex and required extensive knowledge, such analysis cannot be carried out internally. The secretariat proposed that the IAB write a letter to the Minister requesting the Minister to ensure that the external consultants, which the MoF is in the process of engaging, be made available to assist the IAB and the secretariat in carrying out the analysis. The draft letter included a Terms of Reference defining the analysis required to be carried out before the IAB could be in a position to provide a final recommendation to the Minister.

The Board agreed to send the letter to the Minister to request her to permit the Board and the secretariat to have access to the external resources that the Ministry of Finance is in the process of engaging, and to include a proposal to request the consultants to recommend an investment mandate related to TIPS and to carry out an assessment of the BPA with regard to management of TIPS, ref. agenda item 5.

7. Request from the Minister regarding the impact of financial crises

The Minister had requested the IAB to provide an opinion on the impact of the financial crisis on the US market and how it might affect the investment return of the Petroleum Fund in the short, medium and long term. She had also sought the Board's advice on how best to minimize the adverse effects, if any, on the Fund's investments.

Mr. Vidar presented a draft letter prepared by the Secretariat as a response to the Minister's request. The draft letter stated that recent increases in the US interest rate may result in further weak performance of the Petroleum Fund investments in the short term, while, it would be beneficial for the Fund's overall long term performance if the bonds are retained until maturity. It noted that the Fund had benefitted during the international financial crisis, because the investment strategy had been conservative in preserving the value of the Petroleum Fund.

The draft letter included a recommendation to continue the gradual diversification of the portfolio into other asset classes, subject to the Government's risk appetite, and recommended that the long term strategic asset allocation for the Fund be gradually implemented, taking into account the capacity, skills and the governance structure of the Fund. It was also recommended that the Minister disregard market timing and attempting to obtain profits from short term tactical decisions.

Mr. Torgrim presented a background paper to the IAB with an analysis of the financial crisis and potential impact of the performance of the Petroleum Fund, including a projection of the PF performance in 2009 and 2010, based on market forecasts of the US interest rate. The paper also discussed the issue of potential rise in US inflation.

Mr. Torres provided several draft amendments to the letter

The Board noted the report and resolved to adopt the draft letter provided by the Secretariat with inclusion of proposed amendments. The Board agreed to indicate in the letter that the Board had initiated a process to include TIPS in the portfolio and that it would submit a detailed investment mandate to the Minister addressing inflation linked bonds in due course.

8. Currency policy and hedging strategy

Mr. Torres presented a paper on the currency hedging strategy which outlined the reasons for the IAB having recommended an unhedged mandate be given to the BIS. He stated that the increase in risk when measured in USD relative to a hedged mandate is very small. If measured in the economically correct numeraire, i.e., a currency basket, the risk in an unhedged mandate could probably be less. Additionally he noted that the Fund was in a transition phase and the optimal currency policy would be affected by inclusion of equities into the portfolio, depending on the benchmark for equities to be chosen.

The Board agreed that the Petroleum Fund portfolio remain unhedged as long as the non-USD currency exposure is limited. The currency policy should be reviewed at a later stage, when more asset classes are included, as the share of non-USD holding increase and as more knowledge about the correct numeraire for the Fund had been obtained.

The Board noted the report presented by Mr. Torres.

9. Investment Philosophy

The Chairman requested all members to review and provide comments on a draft Investment Philosophy Paper tabled by Kevin Bailey as well as a summary document prepared by the IAB Secretariat within the following two weeks with the intention of discussing the issue further at the next IAB meeting.

10. Other Business

It was resolved that the next meeting would be held on September 18, 2009.

As there was no other business the Chairman declared the meeting closed at 12.10 hours

Chairman

Secretary