

Petroleum Fund of Timor-Leste

Quarterly Report

30 SEPTEMBER 2008

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During the quarter the Fund grew from \$3.2bn to \$3.7bn and the portfolio return in the period was 1.6% while benchmark return was 1.7%. Excess return was -7 bps.

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 has not been independently audited or reviewed and is subject to change, in which case 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. The law gives the Banking & Payments Authority (BPA) of Timor-Leste the responsibility for the operational management of the Fund.

This report covers the period from 1 July to 30 September 2008.

During this period, the BPA continued to invest all funds received according to the investment mandate agreed with the Ministry of Finance in which a benchmark index of United States Treasury Securities with maturities up to five years is specified together with defined performance measures.

In the course of the quarter the capital of the Fund grew from \$3,203.07 million to \$3,738.35 million, including gross **cash inflows to the fund of \$619.87 million** comprising **taxpayer contributions to the fund of \$256.83 million and royalty contributions of \$363.04 million**. The cash outflow was \$140 million transferred to the State Budget, while the net cash inflow was \$479.87 million.

The portfolio return in the period was 1.64 %. Or 164 basis points while the benchmark return for the quarter was 1.71% or 171 basis points. The excess return was 7 basis points below the benchmark within the mandated target ± 25 basis points¹.

¹ In common with standard investment practice figures relating to performance reporting may be slightly different to those used for accounting purposes, arising from the use of different pricing sources and the calculation methodology adopted by the global custodian. To date the BPA has calculated performance using the time weighted rate of return (TWR) based on fair price/ 1st price which adhere to IFRS and which have provided consistency between performance and financial reporting. It will not be practical to continue this policy in a multi-manager environment. Global custodian calculates investment performance returns based on the last price valuation which is consistent with Global Investment Performance Standards (GIPS). Performance figures in this and future reports will be based on the custodian's performance calculations. The Fund's financial reports are unaffected by this change.

Historical Return

	Quarter	Annual*	2-years*	3-years*
Portfolio	1.64%	6.29%	6.09%	5.23%
Benchmark	1.71%	6.33%	6.19%	5.26%
Excess return	-0.07%	-0.04%	-0.10%	-0.03%

* Annualised

The performance numbers calculation methodology has been changed from the time weighted rate of return (TWR) based on fair valuation to the Modified Dietz Method based on last price valuation. This new basis is consistent with Global Investment Performance Standards (GIPS) widely adopted by major investment funds.

1. Petroleum Fund Management Mandate

The Banking and Payments Authority has been appointed to undertake the operational management of the Fund in accordance with Article 11.3 of the Petroleum Fund Law which states that the Minister shall enter into an agreement with the Central Bank for the operational management of the Petroleum Fund and the Central Bank shall be responsible for the operational management of the Petroleum Fund.

The management agreement was negotiated and agreed between the Ministry of Finance and the Banking & Payments Authority, and signed on 12 October 2005.

This mandate set out in the Management Agreement has not changed since the previous report, and is as follows:

QUALIFYING INSTRUMENTS

The assets of the Fund shall be invested in the classes of instruments as described below. The indices indicated with each asset class shall be used to measure the performance of the Fund.

Debt instruments issued by the United States and other qualifying sovereign governments:

Index: Merrill Lynch 0-5 year government bond index

Short-term liquidity instruments maintained by the Fund limited to budgeted monthly appropriations from the Fund to the state budget account described in Article 13 based on cash projections supplied to the Central Bank by the Minister shall be excluded from the Fund for the purpose of benchmark comparison, but the Central Bank shall otherwise be accountable for the return on these instruments.

MANDATE

1. The nature of the mandate established by the Minister shall be to passively manage the Fund close to the benchmark, so that in normal circumstances the objective shall be to achieve a return within 25 basis points of the benchmark.
2. The difference in the modified duration between the portfolio and the benchmark shall be less than 0.2 years.

To enable the orderly acquisition of suitable investments, the parameters in this Annex 1 shall apply only from thirty (30) days after the date of entering into force of this Management Agreement.

Mandate is to passively manage the fund close to the benchmark to achieve a return within 25 bps of the benchmark with the modified duration of less than 0.2 years

All royalty payments and funds received from taxpayers, other than small amounts that do not collectively reach the minimum investment threshold set by the BPA, have been invested in the mandated benchmark from the day following receipt.

2. Market Trends during the Quarter

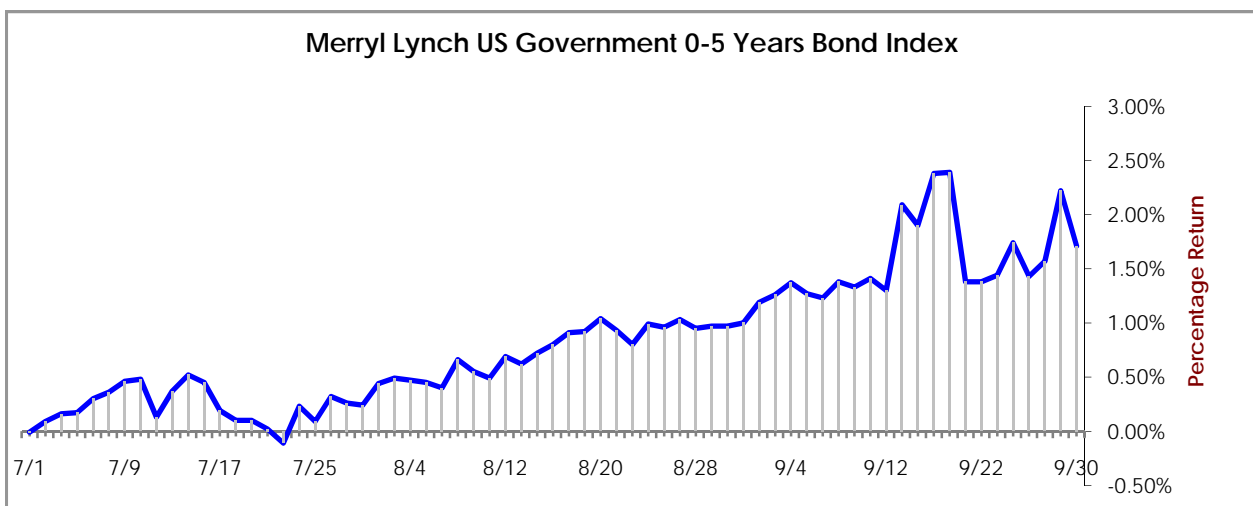
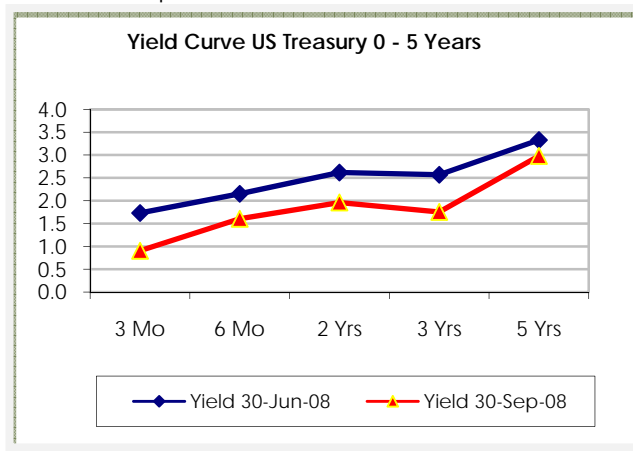
The Lehman Brothers bankruptcy and AIG bail-out have triggered further doubts in the financial system forcing the Federal Reserve Bank (Fed) to take dramatic steps to calm the market.

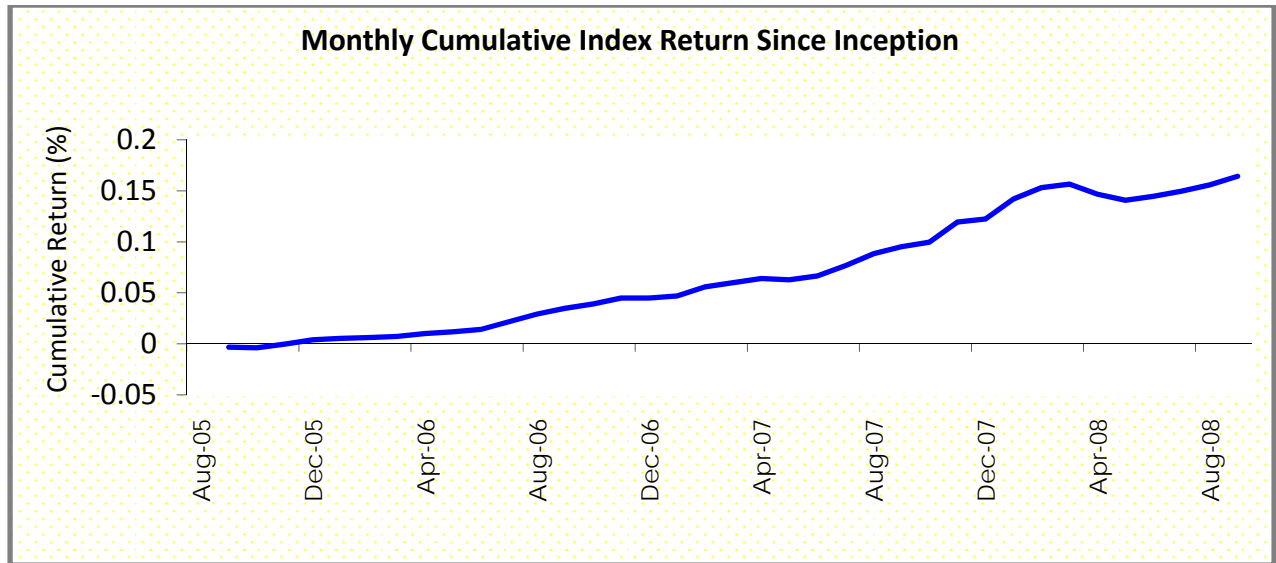
The developments in the US financial market led Treasury yields to trade at a wider range during the quarter particularly the month of September 2008. Overall, US Treasury bond yields decreased significantly. At the short end 3 and 6 month US Treasury benchmark reference bills decreased by 83 and 55 basis points respectively, while 2 year bond yields down by 66 basis points. The 3 and 5 year US Treasury benchmark reference notes decreased by 81 and 35 basis points respectively compared to the previous quarter end. Bond prices and yields move in opposite directions. Lower yields in the Treasury market were due to strong demand for Treasury assets as the economy remains vulnerable. The changes in the yields during the quarter have therefore resulted in higher prices for the securities held in the PF portfolio and a higher capital value of the bonds held in the investment portfolio. The graph below shows the 0-5 year US Government yield curve on 30 September 2008 compared with the previous quarter end 30 June 2008.

During the period, there has no changes to the U.S. Federal Reserve Bank’s key overnight lending rate (the US Federal Funds target rate), therefore the target rate remain at 2.00% as of 30 September 2008.

The following graphs show firstly, the daily performance of the Merrill Lynch US Government bond 0-5 year index during the quarter and secondly, the monthly cumulative performance of the Merrill Lynch US Government Bond 0-5 years index since inception of the Fund.

US Treasury bond yields decreased significantly. The 3 and 6 month US Treasury benchmark reference bills decreased by 83 and 55 basis points respectively, 2 year yields down by 66 bps. The 3 and 5 year yield by 81 and 35 bps respectively





3. MANAGEMENT DURING THE QUARTER

3.1. Objectives

The objective is to achieve the portfolio return close to the benchmark within +/- 25 bps

The BPA's objective in managing the Fund is to achieve a portfolio return close to the return of the agreed benchmark. Cash received by the Fund has been invested in the portfolio in a timely manner, normally within two working days. This policy is consistent with the passive investment mandate given to the BPA by the Ministry of Finance.

3.2. Operational Implementation

The mandate is operationalised by holding ten of the approximately 102 US Treasury Securities that form the defined benchmark index. The bonds are selected to best replicate the risk and return characteristics of the benchmark.

Daily financial reports on the performance of the Fund are produced for BPA management as part of the management process.

3.3. Strategic Review

During the quarter, a project on implementation options has been developed in collaboration with Ministry of Finance officials and with support from an international consultancy company in response to the Investment Advisory Board's recommendation based on Minister's request to explore the full potential use of the Petroleum Fund Law to diversify the Petroleum Fund asset for a higher yield.

Following the appointment of JPMorgan as the global custodian for the Petroleum Fund, the Petroleum Fund's US Treasury securities were successfully transferred from the Federal Reserve Bank of New York (FRBNY) to JPMorgan Chase Bank N.A. in late August 2008. These securities are now in the custody of JPMorgan Chase Bank N.A while the FRBNY will continue to execute trades of US Treasury Bonds for the Fund and hold the earmarked receipts account for petroleum revenues.

A project on implementation options been conducted during the quarter.

The securities were transferred successfully from the Fed to JPMorgan and are now at the Custody of JPMorgan

The global custodian also prepares regular management reports for the Fund, such as custody, performance, compliance and accounting services for the BPA in late August 2008 and the BPA intends to review the format of its future quarterly reports to take advantage of these new reporting services.

3.4. External Managers

Contract negotiations with the Bank for International Settlements as a non-commercial external manager are in progress.

3.5. Capacity Building

Staff assigned to the related Petroleum Fund operational management continued to engage in capacity building, primarily in the form of on-the job training in various institutions including other Central Banks, and the long term capacity building programs.

4. PORTFOLIO PERFORMANCE

The performance of the Fund relative to the benchmark is calculated and reported using the same basis as the benchmark.

The opening value of the Fund at the beginning of the quarter was \$3,203.07 million and the closing value as at 30 September 2008 was \$3,738.35 million. The

petroleum revenue during the quarter was \$619.87 million consisting of petroleum taxpayers contribution to the fund of \$256.83 million and royalty contributions to the fund of \$363.04 million. The dollar returns

(gross of fees) was \$55.41 million during the quarter, of which the coupon and interest received was \$32.08 million and the change in the market valuation was positive \$23.33 million. This represents a return to the Fund based on the Modified Dietz Method of 1.64 percent or 164 basis points for the quarter.

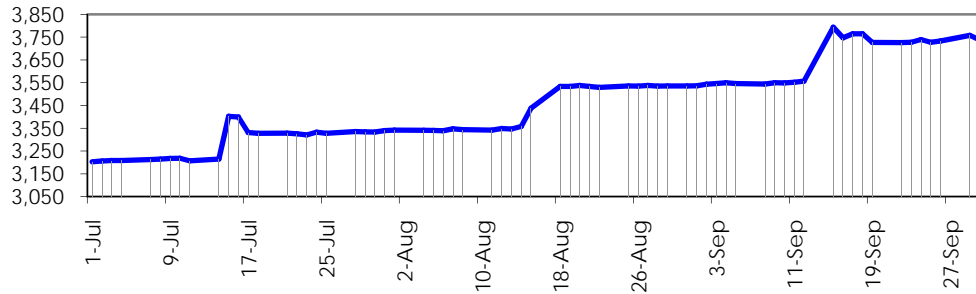
A graphical presentation of the growth in the NAV (Net Asset Value) of the Fund during the quarter is as follows:

Total receipts during the quarter was \$619.9m consisting of tax receipts \$256.8m & Royalties \$363.0m.

The returns was \$55.4m of which \$32.0m was coupon & interest and market valuation was \$23.3m

In million \$	
Absolute return for the Quarter Jul – Sep 08	
Opening book value (30-Jun-08)	3,203.07
Receipts during the period	619.87
Transfer to General State Budget	(140.00)
Management Fees	-
Return in the period	55.41
Closing book value (30-Sep-08)	3,738.35

Petroleum Fund Net Asset (NAV)



The major movements in the value of the Fund took place as a result of the taxpayer receipts that are usually received around the middle of each month.

5. MANAGEMENT COSTS

The means by which the management costs of the Fund are to be recognized is determined in the Petroleum Fund law. Article 6.3 of the law states "From the amount received in accordance with Section 6.1, the Central Bank shall be entitled to deduct, by direct debit of the Petroleum Fund account, any reasonable management expenses, as provided for in the operational management agreement referred to in Section 11.3".

The management fee is intended to cover the actual expenses incurred by the BPA in managing the Fund. There has been no deduction from the Fund for the management fee during the period.

6. TRANSFERS FROM THE PETROLEUM FUND

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. During the quarter, at the request of government and within the amount appropriated by parliament an amount of \$140 million has been deducted from the Fund and transferred to the General State Budget account during the quarter.

7. RISK EXPOSURE OF PORTFOLIO

7.1. Tracking Error

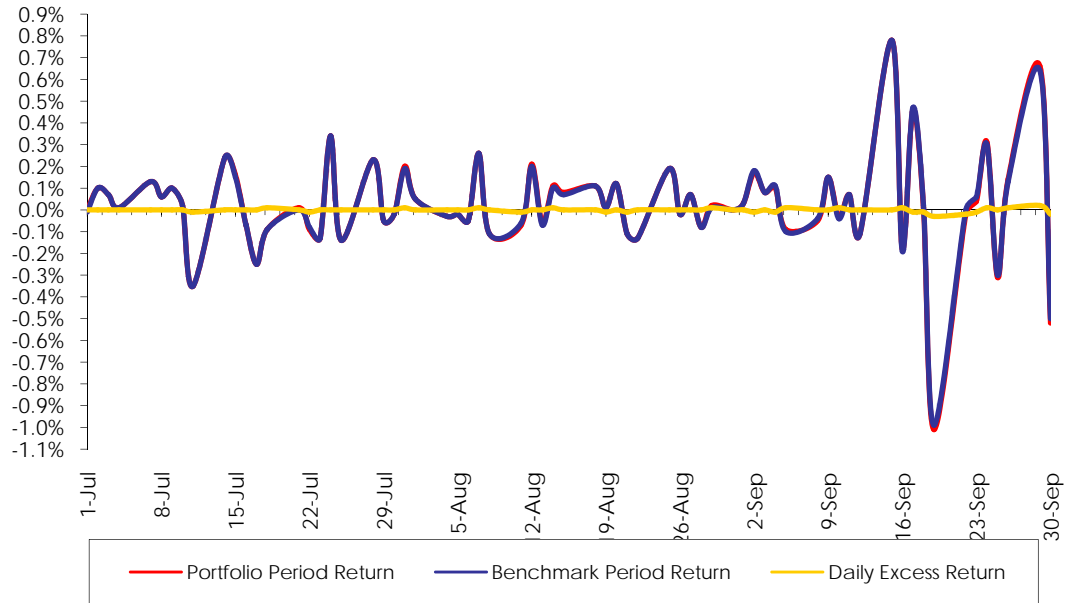
The following graphs illustrate the manner in which the Fund portfolio tracked the benchmark index. The line "Daily Excess Return" measures the difference between the return of the Fund's portfolio and the benchmark. The excess return for the quarter was 7 basis points below the benchmark, within the ± 25 basis points in the investment mandate. The increase in the excess return compared with previous quarters arose from extreme volatility in world financial markets.

No management fee deducted during the quarter reported

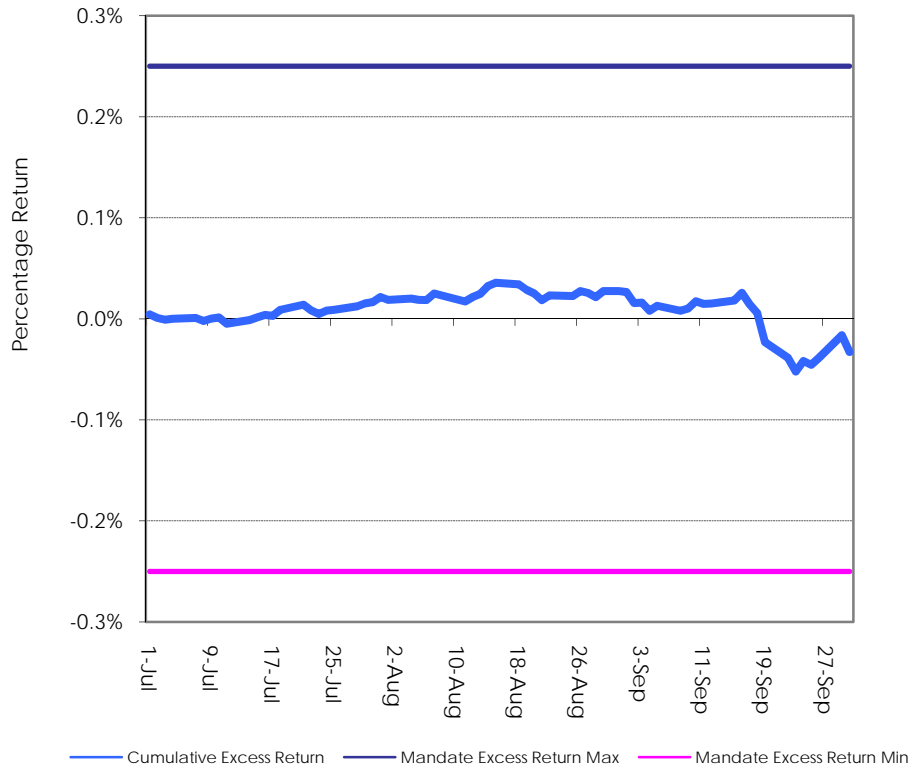
An amount of \$140 million been deducted and transferred to the State Account

The excess return for the quarter was 7 basis points below the benchmark, within the ± 25 basis points in the investment mandate

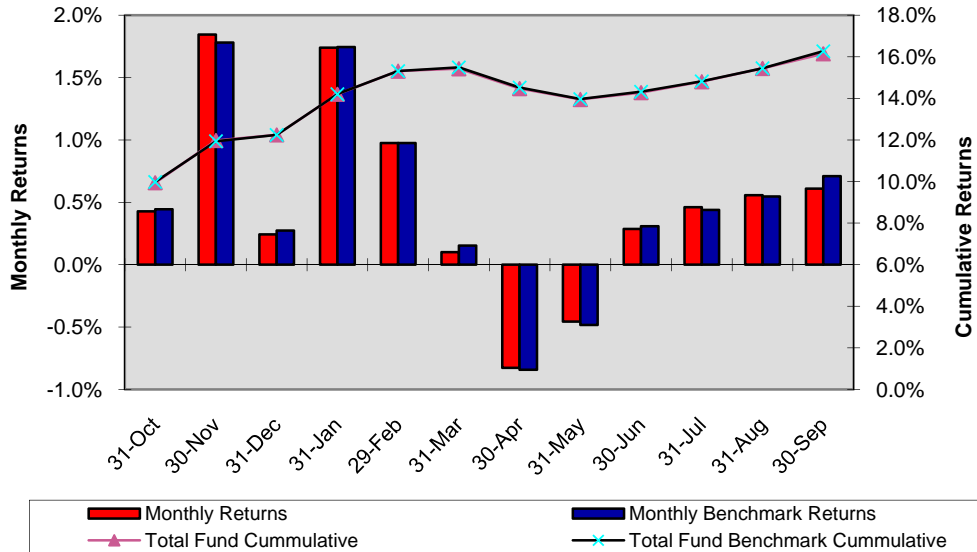
Daily Absolute and Excess Return



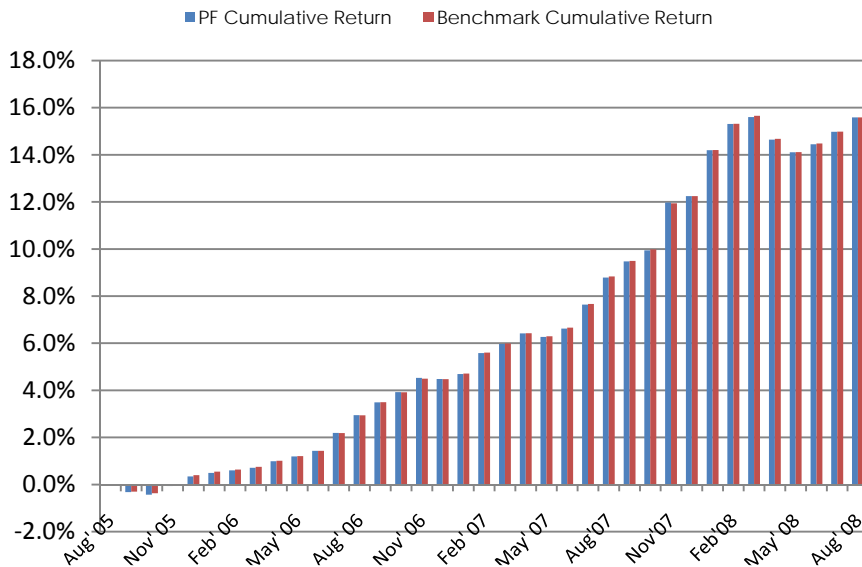
Cumulative Excess Return July -September 2008



**Total Fund
PERFORMANCE SUMMARY
12 Months Ending 30 Sep 2008**



**Petroleum Fund Cumulative Return
September 05 - September 08**



The cumulative performance of the Petroleum Fund compared with the cumulative performance of the benchmark over the same period is shown in the graph.

The graph indicates that the cumulative performance of the portfolio is almost identical to the cumulative performance of the benchmark with almost zero point tracking errors. A zero tracking

error means that the Petroleum Fund portfolio is performing exactly the same as the benchmark performance over the period.

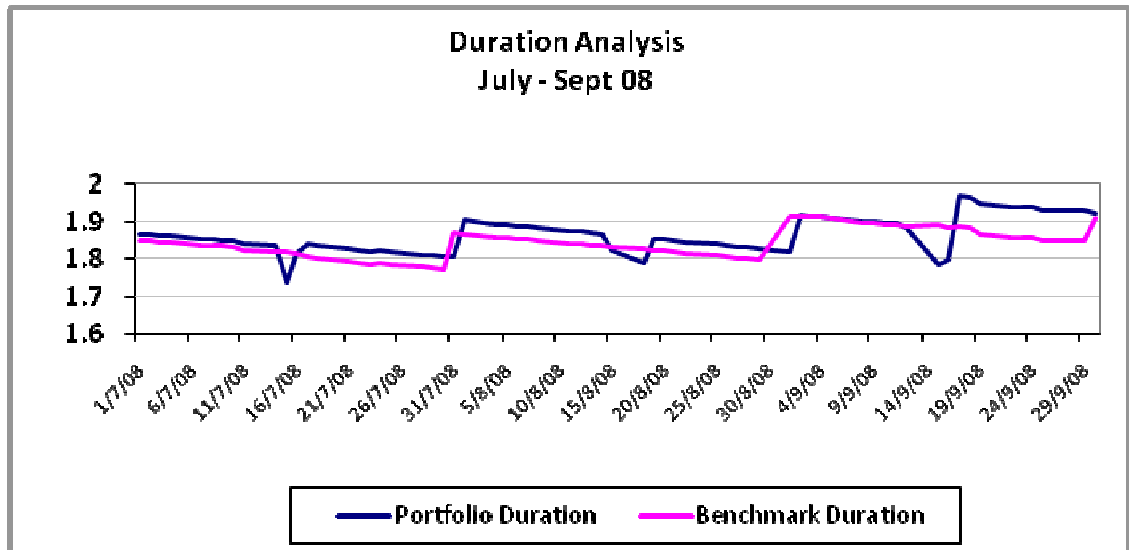
Cumulative Performance Numbers since Inception

Period	Cumulative Portfolio Return	Cumulative Benchmark Return	Cumulative Excess Return
Dec-05	0.3431%	0.3973%	-0.0540%
Dec-06	4.4811%	4.4744%	0.0064%
Dec-07	12.2451%	12.2451%	0.0000%
Jan-08	14.1971%	14.2033%	-0.0054%
Feb-08	15.3103%	15.3171%	-0.0059%
Mar-08	15.5996%	15.6538%	-0.0468%
Apr-08	14.6433%	14.6799%	-0.0319%
May-08	14.1082%	14.1152%	-0.0061%
Jun-08	14.4472%	14.4778%	-0.0268%
Jul-08	14.9744%	14.9803%	-0.0017%
Aug-08	15.5872%	15.5865%	-0.0620%
Sep-08	16.3615%	16.4309%	-0.0674%

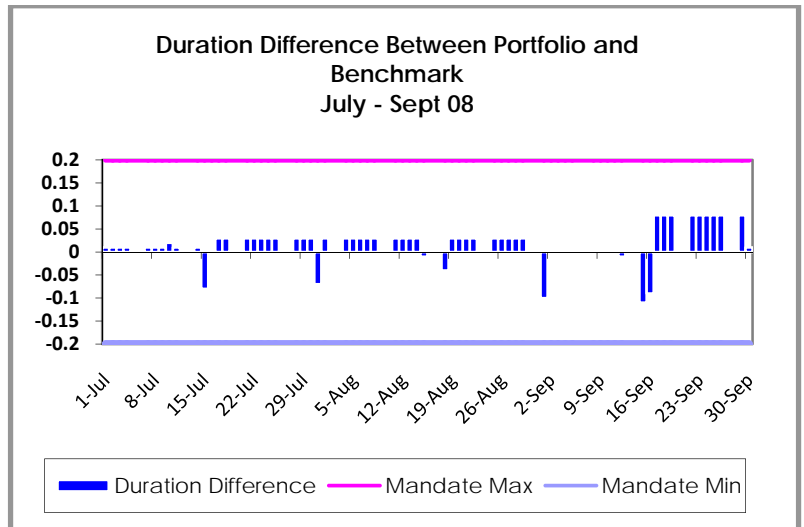
7.2. Duration

The mandate given by the Ministry of Planning and Finance to the BPA specifies that the Fund portfolio shall have a Modified Duration within 0.2 years of the benchmark index. The following graphs show, *firstly*, the modified durations of the portfolio and the index, and *secondly*, the difference between the portfolio and the index compared with the mandated maximum of ± 0.2 years.

The graph shows the modified duration of the Petroleum Fund investment portfolio compared with the modified duration of the benchmark index.



The graph shows the daily difference in modified duration between the investment portfolio and the benchmark. The Management Agreement states that the modified duration of the portfolio shall be managed within ± 0.2 years of the modified duration of the benchmark. The duration was within the mandate during the quarter.



*US Government Securities which is rated
AAA*

*The BPA has managed the Fund in
compliance with the terms of the mandate*

7.3. Credit Risk

The Merrill Lynch index comprises Treasury Securities issued by the United States Government, which is rated AAA. All investments by the Petroleum Fund were also in US Treasury Securities with the highest credit rating (AAA). Cash received by the Petroleum Fund pending investment is invested at overnight money market interest rates in an overnight repurchase pool operated by the Federal Reserve Bank of New York.

8. COMPLIANCE STATEMENT

The BPA has undertaken the operational management of the Petroleum Fund within the terms of the mandate set out in the Management Agreement.

8.1. Qualifying Instruments

The Fund was invested in the qualifying instruments within the investment universe specified in the mandate at all times during the quarter. At no time was the Fund invested in instruments other than those disclosed in this report.

8.2. Return on the Portfolio

The performance on the portfolio for the quarter was 164 basis points compared with the benchmark performance of 171 basis points. The difference of 7 basis points lower than the benchmark is within the mandated target of ± 25 basis points.

8.3. Modified Duration of the Portfolio

The modified duration of the Fund's investment portfolio and the mandated index are measured by the BPA daily. The modified duration of the Petroleum Fund portfolio was within the mandate during the quarter.

8.4. Internal Audit

In accordance with the provisions of Article 22 of the Petroleum Fund law number 9/2005 that requires BPA's Internal Auditor to perform an audit of the Fund every six months. The Internal Auditor has performed an audit on the Fund to 30 June 2008.

9. SUMMARY 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.

Balance Sheet

	in thousands \$		
NET ASSETS	Sep-08	Jun-08	Sep-07
Cash and Cash Equivalents	979	385	1,198
US Treasury Notes (Market Value)	3,683,115	3,185,709	1,791,223
Accrued Interest	54,259	16,978	25,488
Less: Pending Purchases of Securities	-	-	-
TOTAL	3,738,353	3,203,073	1,817,908
CAPITAL			
Opening Balance as at 1 January 2008	2,086,157	2,086,157	1,394,223
PF Law Art. 6.1(a) Revenue Receipts	712,038	455,205	116,217
PF Law Art. 6.1(b) DA Receipts	986,386	623,350	265,330
PF Law Art. 7.1 Transfer to General State Budget	(140,000)	-	-
Net Income	93,772	38,362	42,139
TOTAL	3,738,353	3,203,073	1,817,908

Profit and Loss Statement

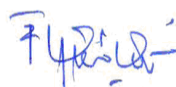
	in thousands \$			
INCOME	Quarter		Year to Date (YTD)	
	Sep-08	Sep-07	Sep-08	Sep-07
Money Market Interest	75	139	344	139
Treasury Note Coupons	32,004	10,326	78,621	14,326
Income	32,078	10,465	78,965	14,465
Market Revaluations	23,332	27,935	15,328	27,935
Less: Management Fees	-	(261)	(521)	(261)
Net Result for the Period	55,411	38,139	93,772	42,139

Note: 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. The year to date figures in 2007 and 2008 are based on the 30 June balance date and 31 December balance date respectively.

Dili, 21 October 2008



Venâncio Alves Maria
Executive Director



Abraão de Vasconcelos
General Manager