

Petroleum Fund of Timor-Leste

Quarterly Report

31 December 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 October 2016 to 31 December 2016.

Key statistics for the quarter include:

- The capital of the Fund at the end of the previous quarter was \$16.60 billion while the current quarter was \$15.84 billion.
- Gross cash inflows to the fund from royalties and taxes were \$36.21 million.
- Outflows for the quarter were \$601.91 million, being transfers to the state budget were \$600 million while \$1.91 million was for management costs.
- The profit/loss for the quarter was -\$197 million, representing a gross of fees return of -1.14% compared with the benchmark return of -1.41%.

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	-1.14	4.71	4.71	2.63	3.66	3.89
Benchmark	-1.41	3.98	3.98	2.43	3.45	3.82
<i>Excess</i>	<i>0.27</i>	<i>0.73</i>	<i>0.73</i>	<i>0.20</i>	<i>0.21</i>	<i>0.08</i>
International Fixed Interest	-3.32	2.38	2.38	1.54	1.03	2.72
Benchmark	-3.56	1.31	1.31	1.20	0.78	2.62
<i>Excess</i>	<i>0.24</i>	<i>1.07</i>	<i>1.07</i>	<i>0.34</i>	<i>0.25</i>	<i>0.09</i>
International Equities	2.07	8.12	8.12	4.24	10.83	8.99
Benchmark	1.86	7.51	7.51	3.80	10.41	8.30
<i>Excess</i>	<i>0.21</i>	<i>0.61</i>	<i>0.61</i>	<i>0.44</i>	<i>0.42</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 December 2016 were as follows:

Table 2

	30-Sep-16	30-Nov-16	31-Dec-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 Index	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%	39.00%	39.00%
MSCI Australia Index		1.00%	1.00%
Total Equities	40%	40%	40.00%
Total	100%	100%	100%

2. MARKET TRENDS DURING THE QUARTER

Global Market Trend

The fourth quarter of 2016 was full of uncertainties, yet the market proved resilient again with equity markets performed very well in most markets. U.S economy grew in moderate pace due to supportive market fundamentals. Job market is steady, consumer confidence is robust, manufacturing, and service activities are booming. High expectation on inflation and growth in years ahead have influenced the Fed to move their interest rate forecast to more hawkish stance next year. In Eurozone, despite bank crises and fear of referendum vote in Italy, the markets cope well during the quarter with good performance in equity market. The emerging markets were doing well until the U.S election in November, which caused the selloff leading to the end of the quarter. However, emerging market still ended the year in positive territory.

Equities

Overall, equity markets performed well during the fourth quarter of the year, despite the turbulences along the way.

In U.S, the S&P 500 Equity index gained 3.8% during the quarter, mostly driven by the gains in financial sector. Most bank shares in U.S rallied after the U.S election, reacted to incoming U.S president policy to ease regulation in financial sector.

In Europe, the MSCI Europe equity index gained 6% during the quarter due to the supportive economy data throughout the quarter. The unemployment rate fell consistently; consumer confidence is high and business activities gaining momentum.

Despite coping with Brexit uncertainties, the U.K equity market performed well during the quarter as U.K FTSE 100 equity index closed the quarter with 4% gain.

Japan led the way in Asia with Japan Topix gained 15% during the quarter. The underline data supported this gain is the export, which was helped by the weak yen during the quarter.

Emerging market equity was doing well until the U.S election in November. The MSCI EM closed at negative 1.4 during the quarter, though still ended the year with 10.01% gained. The reverse in return in the Emerging market after the Donald Trump victory was attributed to his campaign to lean toward more trade protectionism to levy heavy tax on EM's goods and services imported to the U.S.

Bonds including US Treasuries

The fourth quarter of this year was not a good one for fixed income assets, especially the government bonds. Government bond yields rose in most developed country caused the bond price to fall.

Most of the government bonds across the globe ended up in negative territory during the quarter. U.S government bond led the selloff caused the return fell -4.1% during the quarter. This selloff was triggered by the high expectation of inflation and high growth under the incoming U.S president Donald Trump. Donald Trump has pledged to cut tax on corporate, individual consumer and to spend big to overhaul the country's infrastructure. His policy is believed to lead to higher inflation and faster growth, which eventually will lead to faster interest rate increase in coming years.

The Japanese Government Bond outperformed the other government bond, benefit from the Bank of Japan's policy to control the 10-year yield curve hover around zero. High yield credit also managed to deliver positive returns in the quarter, capping off a good year for the asset class.

The uncertainties in the year ahead remain high. The investors still await details of incoming U.S president's economic and foreign policies. U.K will start Brexit negotiation at the end of the first quarter. However, the detail of the negotiation is still unclear. In Europe, the election in France, Germany, Netherlands, and potential early election in Italy may cause market unrest.

The graph below illustrates the U.S Government yield curve ranges from 3 month to 10 years compared to the previous quarter end. The U.S Fed decided to raise its target rate from the range of 0.25%–0.50% to the range of 0.5%–0.75% in December. As a result, the yields moved significantly during the quarter. The short terms yield such as 3, 6 and 12 months increased by 20 basis points on average. In the medium tenor 2, and 3 and 5 years yield increased 43, 58 and 78 basis points respectively. While, 7 and 10-year yield increased in average of 80 basis points. Bond price moves inversely with the yield.

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 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%	1.00%	7-Oct-10
MSCI Australia Index	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%	38.97%	37.50%	42.50%
BOA Merrill Lynch 5-10 Years Treasury Notes and Bond Index	Bank for International Settlements	10%	± 1%	9.59%	9.00%	11.00%
Barclays Global Treasury Developed Market ex US, 30% Eurozone and 10% Country	Alliance Bernstein	5%	± 0.5%	4.57%	4.50%	5.50%
	Wellington Management	5%	± 0.5%	4.56%	4.50%	5.50%
Total Fixed Income		60%		57.69%	55.50%	64.50%
MSCI World Index Net Dividends Reinvested	State Street Global Advisors	34%	± 4.0%	17.92%	13.00%	21.00%
	BlackRock			17.94%		
	Schroders Investment Management	5%	± 1.5%	5.47%	3.50%	6.50%
MSCI Australia Index	BCTL	1%	± 0.5%	1.00%	0.50%	1.50%
Total Equities		40%		42.32%	30.00%	50.00%

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 \$15.84 billion as follows:

Table 5

Capital Account	\$'000
Opening book value (30 September 2016)	16,604,911
Receipts during the period	36,211
Transfer to General State Budget	-600,000
Investment Return	-196,795
Closing book value (31 December 2016)	15,844,327

The Fund was invested as follows:

Table 6

Assets	\$'000
Cash and Cash Equivalents	108,985
Other Receivables	27,853
Financial assets held at fair value through profit or loss	15,715,654
Less:	
Payable for Securities Purchased	-3,212
Accounts Payable	-4,953
Total	15,844,327

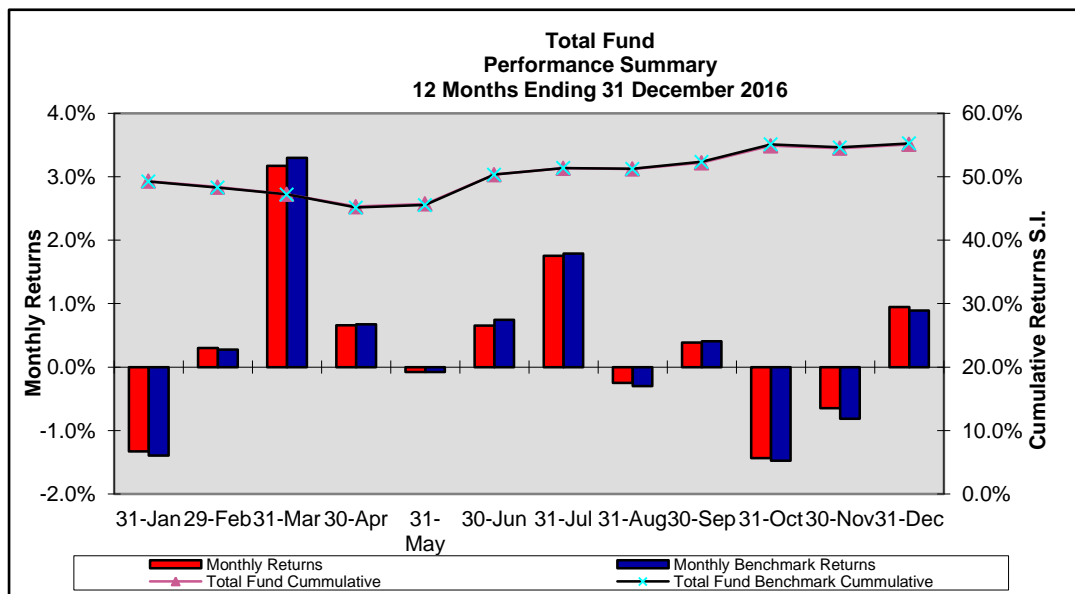
The income for the quarter was as follows:

Table 7

Income	\$'000
Interest income	39,504
Dividend income	35,751
Unit Trust distributions	1,671
Other Investment income	-0
Net gains/(losses) on Financial Assets at fair value	-27,912
Net foreign exchange gains/(losses)	-242,641
Less:	
External manager, custody fees	-1,812
Central Bank management expenses	0
IAB Expenses	-92
Other expenses	-4
Withholding taxes	-1,260
Total Investment Income	-196,795

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	-3.32	2.38	2.38	1.54	1.03	2.72
Benchmark	-3.56	1.31	1.31	1.20	0.78	2.62
<i>Excess</i>	0.24	1.07	1.07	0.34	0.25	0.09
BCTL Cash Management (TLCM)	-1.52	n.a	n.a	n.a	n.a	0.05
BCTL 3-5 yr US Treasury	-1.89	1.34	1.34	1.66	n.a	1.15
BoA Merrill Lynch 3-5 Years US Treasury Passive	-1.96	1.34	1.34	1.69	n.a	1.12
<i>Excess</i>	0.07	0.00	0.00	-0.03	n.a	0.03
Bank for International Settlements	-4.36	1.17	1.17	2.94	1.56	1.64
BoA Merrill Lynch 5-10 Years US Treasury Enhanced Passive	-4.41	1.22	1.22	3.03	1.60	1.65
<i>Excess</i>	0.04	-0.05	-0.05	-0.09	-0.03	-0.02
Alliance Bernstein	-8.76	1.03	1.03	n.a	n.a	-5.06
Barclays Global Treasury DM ex US Enhanced Passive	-8.96	0.99	0.99	n.a	n.a	-5.19
<i>Excess</i>	0.19	0.03	0.03	n.a	n.a	0.13
Wellington Management	-8.96	0.90	0.90	n.a	n.a	-3.56
Barclays Global Treasury DM ex US Enhanced Passive	-8.96	0.99	0.99	n.a	n.a	-3.47
<i>Excess</i>	-0.01	-0.09	-0.09	n.a	n.a	-0.09

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	2.07	8.12	8.12	4.24	10.83	8.99
Benchmark	1.86	7.51	7.51	3.80	10.41	8.30
<i>Excess</i>	0.21	0.61	0.61	0.44	0.42	0.69
Schroders Investment Management	3.03	10.11	10.11	4.88	11.55	9.52
MSCI World Enhanced Passive	1.86	7.51	7.51	3.80	10.41	8.30
<i>Excess</i>	1.18	2.60	2.60	1.08	1.14	1.23
SSgA International Equity	1.96	7.82	7.82	4.17	n.a	10.07
MSCI World Passive	1.89	7.46	7.46	3.78	n.a	9.66
<i>Excess</i>	0.07	0.36	0.36	0.39	n.a	0.40
BlackRock Investment Management	1.96	7.86	7.86	4.15	n.a	8.46
MSCI World Passive	1.89	7.46	7.46	3.78	n.a	8.14
<i>Excess</i>	0.07	0.41	0.41	0.36	n.a	0.33
BCTL Investment Management	0.67	n.a	n.a	n.a	n.a	6.49
MXAU AU Index Passive	0.69	n.a	n.a	n.a	n.a	6.52
<i>Excess</i>	-0.02	n.a	n.a	n.a	n.a	-0.03

5. MANAGEMENT COSTS

A management fee of \$1.91 million for operational management costs was charged to the fund during the quarter.

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

External Management and Custody expenses	1,812
Central Bank management expenses	-
IAB expenses	92
Other Expenses	4
Total Cost	1,908

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 \$600 million was transferred to the State Budget account during the quarter. The transfers are summarized in table 11.

	In Thousand (\$)
Transfer October 2016	150.000
Transfer November 2016	150.000
Transfer December 2016	300.000
Transfer for this Quarter	600.000
Total Transfers previous quarters	644.800
Total Transfers this fiscal year to December 2016	1.244.800

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 30 June 2016.

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 December	2015 December
ASSETS		
Cash and Cash Equivalents	108,985	135,177
Receivables	27,853	26,891
Financial assets held at fair value through profit or loss	15,715,654	16,076,302
TOTAL ASSETS	15,852,492	16,238,370
LIABILITIES		
Payables for securities purchased	-3,212	-15,627
Accounts payable	-4,953	-5,170
TOTAL LIABILITIES	-8,165	-20,798
NET ASSETS	15,844,327	16,217,573
CAPITAL		
Opening Balance	16,217,573	16,538,617
PF Law Art. 6.1 (a) Revenue receipts	90,494	435,871
PF Law Art. 6.1 (b) DA receipts	127,136	537,099
PF Law Art. 6.1 (e) Other receipts	6,242	5,897
PF Law Art 7.1 Transfers to State Budget	-1,244,800	-1,278,500
Income for the period	647,682	-21,412
CAPITAL	15,844,327	16,217,573

Table 13

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME - QUARTER				
In thousands of USD				
	Quarter		Year to Date	
	Dec-16	Dec-15	Dec-16	Dec-15
INVESTMENT INCOME				
Interest income	39,504	40,568	157,797	156,790
Dividend income	35,751	30,964	175,313	163,014
Trust income	1,671	1,800	7,215	6,887
Other investment income	-0	1	546	20
Net gains/(losses) on Financial Assets at fair value	-27,912	219,559	446,990	-21,296
Net foreign exchange gains/(losses)	-242,641	-60,551	-115,796	-302,027
Total Investment Income	-193,627	232,342	672,065	3,387
EXPENSES				
External management, custody fees	1,812	2,138	8,257	9,584
Internal operational management fees	0	581	4,934	5,606
IAB Expenses	92	11	204	164
Other expenses	4	73	1,220	77
Total expenses	1,908	2,803	14,615	15,431
Profit before tax	-195,535	229,539	657,450	-12,044
Withholding taxes on investments	1,260	1,218	9,768	9,367
Profit/loss for the period	-196,795	228,321	647,682	-21,412
Other comprehensive income	0	0	0	0
Total comprehensive income for the period	-196,795	228,321	647,682	-21,412

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, 19 January 2017



Venancio Alves Maria
Executive Director



Abraão de Vasconcelos
Governor