Trinidad and Tobago

Heritage & Stabilization Fund

Quarterly Investment Report

July – September 2013

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EXECUTIVE SUMMARY

The **United States (US)** economy continued to gain momentum in the second quarter of 2013 as GDP grew at an annualized rate of 2.5 per cent compared to 1.8 per cent in the previous quarter. The expansion was broad based and the nation's improved trade balance offset a slowdown in consumer spending and a reduction in government expenditures. During the third quarter, US economic data was mostly positive and pointed to a continued expansion, albeit at a slower pace. Market volatility moved higher during the quarter as there was heightened speculation around when the Federal Reserve (Fed) would reduce its asset purchase program. On September 18th, the Fed announced that it would maintain its existing monetary policies, resulting in a brief rally across both the fixed income and equity markets. The ongoing budget and debt ceiling debates in Congress will increase political risk during the fourth quarter, and the dysfunction in Washington could hamper investor and consumer sentiment.

The **Euro zone** emerged from its 18 month long recession during the second quarter. The region expanded by 0.3 per cent quarter over quarter, after contracting 0.2 per cent in the previous three months. The recovery was broad-based but economic conditions remained fragile with several headwinds on the horizon. Activity in the manufacturing and service sectors showed signs of improvement, but labour market conditions continued to be a challenge. Unemployment is stubbornly high at 12 per cent and wage growth slowed to an annual rate of 1.1 per cent in the second quarter. Inflationary pressures eased during the third quarter as the Consumer Price Index declined from 1.6 per cent in June to 1.1 per cent in September. In July, the ECB embarked on unprecedented "soft guidance" in an effort to address rising money market rates. ECB President, Mario Draghi, hinted at the bank's dovish stance given the nascent recovery. Though the euro zone appears to have stabilized, risks remain to the downside. High

unemployment, political uncertainty in Germany and Italy and the upcoming Asset Quality Review scheduled for October could hinder the region's economic outlook.

The **United Kingdom (UK)** economy grew by 0.7 per cent in the second quarter with construction, manufacturing and services all displaying strong growth. Though the recovery is robust, the Bank of England (BOE) expressed some concerns regarding the balance between exports and domestic consumption, as policymakers had hoped to become less dependent on consumer spending for growth. The preliminary third quarter reading came in at 0.8 per cent, but government officials remained cautiously optimistic as the recovery is still in its very early stages. Labour market conditions modestly improved during the third quarter and the recent sterling appreciation helped to ease inflationary pressures. In September, the Monetary Policy Committee decided to maintain the official rate at 0.5 per cent and the size of its asset purchase program at GBP 375 billion.

In **Japan**, GDP expanded by 3.8 per cent in the second quarter of 2013, following a strong first quarter annual GDP of 4.1 per cent. Economic data for the third quarter continues to be encouraging, buoyed by positive trends in both the manufacturing and services sectors. The unemployment rate rose to 4.1 per cent in August from 3.9 per cent in June, and concerns about wages and employment prospects helped to push consumer confidence lower. After much deliberation, Prime Minister Shinzo Abe announced that the consumption tax will be raised next April, and in an effort to combat any negative effects, its implementation will be coupled with a stimulus package. There was no change in monetary policy as the Bank of Japan will continue to increase its monetary base at an annual pace of about 60-70 trillion yen.

During the third quarter of 2013, the financial markets were mostly higher for the period. The main market drivers included macroeconomic data, concerns around the

Federal Reserve's plans to begin tapering, the possibility of a U.S.-led military strike on Syria and the upcoming budget and debt ceiling debates in Washington. The Chicago Board Options Exchange Volatility Index (VIX) traded in a wide range over the quarter and market uncertainty grew leading up to the Fed's September 18th meeting. On average, the VIX was higher in the quarter, with the mean at 16.0 points versus 14.8 points for the previous three months. Fixed income markets modestly recovered from its poor second quarter performance; the Barclays Capital US Aggregate Bond index gained 0.57 per cent compared to a decline of 2.43 per cent in the previous three months. Though the prospect of the US Fed tapering weighed on markets for most of the quarter, the major equity indices managed to end the period higher. The US Standard and Poor's (S&P) 500 index gained 4.69 per cent, the Japanese Nikkei 225 index advanced 5.69 per cent and the MSCI EAFE rose 10.94 per cent from the previous quarter.

The HSF investment portfolio returned 3.95 per cent for the quarter ended September 2013, compared with a return of 3.47 per cent for the Strategic Asset Allocation (SAA) benchmark. The Fund's exposure to equity and fixed income contributed positively to absolute returns. This brought the HSF investment portfolio return to 8.63 per cent for the financial year ending September 30, 2013, compared to 7.26 per cent for the benchmark. There was a deposit to the Fund of US$42.5 million in July.

At the end of September 2013, the net asset value of the HSF was US$5,154.0 million, an increase from the US$4,914.4 million reported at the end of June 2013.

Contribution to Quarterly Return,
For the period July 2013 – September 2013
/per cent/

	SAA Weights	Portfolio Weights as at 30-September-2013	Weighted Return HSF	Weighted Return Benchmark
Composite Portfolio	100.00	100.00	3.95	3.47
US Core Domestic Fixed Income	40.00	36.15	0.29	0.23
US Core Domestic Equity	17.50	21.07	1.36	1.12
Non US Core International Equity	17.50	20.17	2.21	2.01
US Short Duration Fixed Income	25.00	22.61	0.10	0.11

NB: Differences in totals are due to rounding.

Comparative Quarterly Returns
For the Quarters ended March 2013 – September 2013
/per cent/

	3 Months Weighted Return as at 30-Sep-2013		3 Months Weighted Return as at 30-Jun-2013		3 Months Weighted Return as at 31-Mar-2013	
	HSF	Bench-mark	HSF	Bench-mark	HSF	Bench-mark
Composite Portfolio	3.95	3.47	-0.30	-0.69	3.29	2.90
US Core Domestic Fixed Income	0.29	0.23	-0.90	-0.93	0.00	-0.05
US Core Domestic Equity	1.36	1.12	0.71	0.54	1.95	1.90
Non US Core International Equity	2.21	2.01	0.07	-0.11	1.27	1.00
US Short Duration Fixed Income	0.10	0.11	-0.15	-0.17	0.05	0.04

Comparative Financial Year to Date Returns
For the periods Sept 2012 & Sept 2013
/per cent/

	Financial Year to Date Return as at 30-Sept-2013		Financial Year to Date Return as at 30-Sept-2012	
	HSF	Bench-mark	HSF	Bench-mark
Composite Portfolio	8.63	7.26	10.73	10.18

SECTION 1 – INTERNATIONAL ECONOMIC ENVIRONMENT

United States

After a tepid expansion of 1.8 per cent in the first quarter, the US economy gained momentum during the second quarter of 2013. The final report by the Bureau of Economic Analysis showed that the economy grew at an annualized rate of 2.5 per cent versus an initial estimate of 1.7 per cent. The expansion was broad based with gains in consumer spending, exports and residential and nonresidential fixed investment. The nation's improved trade balance was the largest contributor to the upward revision, as exports exceeded imports by more than previously estimated. The pace of growth in consumer spending however slowed to 1.8 per cent compared to 2.3 per cent in the first quarter, while the reduction in government spending continued to drag on the economy. Residential fixed investment remained a bright spot during the second quarter, however the housing sector encountered headwinds during the third quarter, as rising borrowing costs hurt loan demand and existing home sales. At its September policy meeting, the Federal Reserve lowered its 2013 real GDP estimate to 2.0 - 2.3 per cent, compared to an estimate of 2.3 – 2.6 per cent in June.

For the quarter ending September 2013, US economic data was mostly positive and pointed to a continued expansion, albeit at a slower pace. The ISM Manufacturing and Non-Manufacturing indices both ended the third quarter several points higher at 56.2 and 54.4 respectively when compared to the previous quarter. Despite continued expansion in both sectors, there were signs of a slowdown in the services sector. US retail sales moderated during the third quarter; year-on-year sales in August rose 4.7 per cent compared to a year-on-year increase of 5.7 per cent in June.

Labour market conditions weakened as nonfarm payrolls trended down over the quarter. US employers added 148,000 jobs in September compared to 195,000 jobs in June.

Despite a slowdown in job growth, the unemployment rate dropped from 7.6 per cent in June to 7.2 per cent in September. A large part of the decline was attributed to a drop in the participation rate, which currently stands at 63.2 per cent compared to 63.5 per cent in June.

Inflationary pressures have been modest during the quarter. On average, the CPI remained unchanged from June's reading of 1.8 per cent. The Consumer Price Index (CPI) reflected a year-on-year increase in July and August of 2.0 per cent and 1.5 per cent respectively. Current inflation levels are below the Federal Reserve's 2.0 per cent target, thereby providing the bank with additional flexibility as it continues to contemplate tightening its accommodative monetary stance.

Concerns surrounding the Fed's quantitative easing program were ignited in May, when the Federal Reserve Chairman, Ben Bernanke, introduced the possibility of reducing the Fed's monthly bond purchases later this year. During the third quarter, speculation regarding Fed policy increased, as investors tried to predict when and by how much the Fed might taper. Markets grew increasingly anxious, but many of these fears were short-lived, as the bank decided to maintain its existing monetary policy at the September meeting, leaving the target rate, asset purchase program and forward guidance intact.

Mr. Bernanke indicated that it was the Committee's assessment that the U.S. economy was not strong enough to warrant a modest reduction in its $85 billion monthly bond purchase program. The Committee stated that the downside risks to the economy have moderated over the past year, but that "federal fiscal policy continues to be an important restraint on growth". The unresolved budget and debt ceiling issues are expected to heighten political risk over the short term. If the US Congress is unable to quickly resolve both these issues, the negative implications will likely extend internationally, especially given that countries such as Japan and China each hold over $1.1 trillion is US

treasuries. The more crucial of these two issues is the debt ceiling debate, as failure to reach an agreement in time, could once again call into question the perceived ‘safety’ of US Treasuries.

Euro zone

The Euro zone emerged from its 18 month long recession during the second quarter. The region expanded by 0.3 per cent quarter over quarter, after contracting 0.2 per cent in the previous three months. The recovery was broad-based, with consumer, government and investment spending, as well as both manufacturing and services sectors of the economy showing signs of growth. In September, the European Central Bank (ECB) revised its 2013 GDP growth forecast, raising it from -0.6 per cent to -0.4 per cent.

Economic conditions in the Euro zone continued to improve in the third quarter of 2013, but the recovery remains fragile with several headwinds on the horizon. The Markit Composite Purchasing Managers’ index for September rose to a 27-month high of 52.2, up from 48.7 in June, on the back of a strong increase in new orders. Germany, France and Italy all continued to show signs of improvement, but Spain disappointed, declining in September after expanding in August. Manufacturing activity was up quarter-over quarter; the Manufacturing PMI survey showed that growth slowed modestly in September, slipping to 51.1 after coming in at 51.4 in August. Outlook for the Euro zone service sector remains positive, with new business growth at 27-month highs and business confidence rising to levels not seen since March 2012.

Unemployment in the Euro zone decreased from 12.1 per cent in June to 12.0 per cent in July. Improvements in the labour markets have been slow and the unemployment rate was unchanged in August, coming in at 12.0 per cent. Among the member states, Spain and Greece continued to register the highest rates, of 26.3 per cent and 27.9 per cent

respectively. Meanwhile, the lowest rates were recorded in Austria (4.9 per cent) and Germany (5.2 per cent).

Wage gains in the second quarter slowed to an annual growth rate of 1.1 per cent compared to 1.8 per cent in the first quarter. Income growth slowed to almost a three-year low, as wages fell in some of the countries hardest hit by the fiscal crisis. Meanwhile, inflationary pressure further eased during the third quarter. The annual consumer-price growth slowed to 1.1 per cent in September from 1.6 per cent in June, partly due to lower energy prices and moderate price increases in food, alcohol and tobacco. The annual core inflation rate, which excludes volatile costs such as energy, alcohol and tobacco, was 1.0 per cent in September. The ECB target inflation rate stands below but close to 2.0 per cent. Easing inflationary pressures will provide the ECB with the flexibility to further loosen monetary policy if necessary. Despite easing pricing pressures, low wage growth could affect consumer spending and hurt economic growth prospects. Not all Euro zone officials see falling wages as a negative trend, some view it as a positive sign, as lower labour costs could boost the competitiveness of the economy's exports.

In July, the ECB embarked on unprecedented "soft guidance" in an effort to address rising money market rates, which had resulted from the prospect of the US Fed paring back its asset purchase program. During the ECB's October monthly meeting, the ECB President, Mario Draghi, mentioned that inflation projections should be used as the key metric in evaluating forward guidance. Inflation is expected to remain on the "very low side" and the bank's more recent remarks hinted at its dovish stance, and may be partly aimed at addressing the higher Euro. The Euro's recent strength has the ability to hurt exports and endanger the nascent economic recovery. The bank decided to leave its key interest rate unchanged at 0.5 per cent. The ECB stated that the region's economic

recovery is in its early stages but risks remain to the downside. Stubbornly high unemployment, political uncertainty in Germany and Italy, and the de-leveraging of both public and private sectors could weigh on the region's economic outlook.

United Kingdom

The UK's economy gained momentum in the second quarter. The third estimate from the Office of National Statistics showed that the economy grew 0.7 per cent after expanding 0.4 per cent during the first quarter. The economic recovery was broad-based, as construction, manufacturing and services all displayed strong growth. However, business investment disappointed, falling 2.7 per cent. In its October update, the IMF upwardly revised its growth forecast for the UK economy in 2013 to 1.4 per cent from 0.9 per cent.

The most recent third quarter data showed that the construction, manufacturing and service industries were all in expansionary mode. The latest Markit/CIPS Purchasing Managers' index (PMI) for the construction industry showed further improvement in the sector, with residential building leading the way. The August PMI came in at 59.1, its highest level since September 2007. The Markit/CIPS PMI for the manufacturing sector came in at 56.7 in September, after reaching a 2.5- year peak of 57.1 in August. The PMI survey showed strong growth in activity, with output and new orders rising at their fastest rate in 19 years. The monthly PMI for services declined slightly to 60.3 in September, from a near 7-year high in August of 60.5. The service sector continued to expand, with financial services, the housing market and the business sector all helping to spur activity.

The preliminary GDP estimate for the third quarter showed that the economy grew at 0.8 per cent, affirming much of the PMI survey data. Improvements continued across the major industries, with agriculture, construction, manufacturing and services all

expanding during the period. The service sector contributed to three-quarters of the growth and the construction sector was bolstered by the Government's Help to Buy scheme. The recovery is still in its early stages and government officials were cautiously optimistic, given that the first preliminary reading will be subject to revisions. There are also several headwinds with respect to the UK consumer, as high debt-to-income ratios, negative real wages and higher utility prices will hurt household disposable income and spending.

Labour market conditions continued to improve during the third quarter, as the unemployment rate fell to 7.7 per cent in the June – August period, compared to 7.8 per cent at the end of the second quarter. Jobless claims fell 32,600 in August to 1.402 million, the lowest level since February 2009. The Bank of England reported that improvements in the employment rate could be gradual, with low worker productivity levels, companies may be able to delay hiring as productivity increases.

Thus far, inflationary pressures have eased modestly in the third quarter. The Consumer Price Index (CPI) grew by 2.9 per cent in the year to June 2013, but fell over the quarter to 2.7 per cent in September. Though the rate is above the Bank of England's target CPI inflation of 2 per cent, the bank has pledged to keep rates low until labor markets have strengthened and unemployment falls below 7 per cent.

Short-term money market rates moved higher in the second and third quarter, on the expectation that the US Fed would begin tightening in September. Breaking from tradition, the Bank of England (BOE) utilized forward guidance in July, in an effort to communicate that the BOE's policies would not move in tandem with that of the US. The effectiveness of this forward guidance has been debated, as market participants appear unconvinced that the BOE would be able to keep rates low, especially given the recent pickup in economic activity.

During the Bank of England's September Monetary Policy Committee (MPC) meeting, members voted unanimously to keep the bank rate as well as the asset-purchase program unchanged. They stated that the interest rate will remain at 0.5 per cent, and the bank will maintain the stock of asset purchases financed by the issuance of central bank reserves at £375 billion.

The Committee expressed concern over certain aspects of the economic recovery, citing that some of the recent positive contributors to growth may be transient in nature. The strength in exports may not be sustainable going forward, as the pace was well ahead of world trade volumes in the second quarter of 2013. The members agreed that they needed to emphasize that the "7.0 per cent threshold for the unemployment rate was not a 'trigger' that was mechanically linked to subsequent movements in the Bank Rate".

Japan

Japan's economy grew at a faster rate than expected during the second quarter of 2013. After a preliminary reading of 2.6 per cent, the revised figure showed that the economy grew at an annual rate of 3.8 per cent. This robust growth followed a strong first quarter annual GDP of 4.1 per cent. The upward revision was mainly due to a significant improvement in capital expenditures, which came in at 5.1 per cent annually versus an initial reading of -0.4 per cent.

Macroeconomic indicators reported for the third quarter have generally been positive. New export orders helped push manufacturing activity higher in September. The Markit/JMMA Japan Manufacturing Purchasing Managers Index (PMI) rose from 52.3 in June to 52.5 at the end of the quarter. In addition, the Markit September Services PMI rose steadily during the quarter, coming in at 53.0 from 52.1 in June.

Business sentiment among Japanese large manufacturers increased markedly in the third quarter, as the Tankan survey diffusion index of current business conditions rose to 12 from 4 in the previous three months. In contrast, sentiment among Japanese consumers fell during the quarter. Concerns about wages and employment prospects helped to push consumer confidence lower for a third consecutive month; the confidence index fell from 44.3 in June to 43.0 in September.

Labour market conditions deteriorated in the quarter, as Japan's unemployment rate rose to 4.1 per cent in August compared to 3.9 per cent in June. The labour force participation rate was unchanged from August to June and remains at 59.4 percent. In August, Japanese salaries fell 0.6 per cent after rising 0.6 per cent in June.

The general price level, measured by the Consumer Price Index (CPI,) rose over the third quarter. Inflation was 0.9 per cent in August, up from 0.2 per cent in June. As Japan emerges from its 20-year battle with deflation, officials are wary of the risks of "bad inflation". Recent price increases have been mostly due to a weaker yen and rising commodity prices. Prime Minister Shinzo Abe has urged business leaders to raise wages, as economic growth will be unsustainable if income does not keep pace with inflation.

The Bank of Japan (BOJ) decided to maintain their current monetary policy during the most recent policy meeting. In an effort to reach 2.0 per cent inflation by March 2015, the BOJ will continue to increase the monetary base at an annual pace of about 60-70 trillion yen. The minutes revealed that the BOJ views the economy as recovering moderately, with exports and business fixed investment picking up.

Prime Minister Shinzo Abe's efforts to boost Japan's economy through fiscal and monetary expansion have been moderately successful thus far. After much deliberation, the Prime Minister recently announced that the consumption tax would be raised to 8

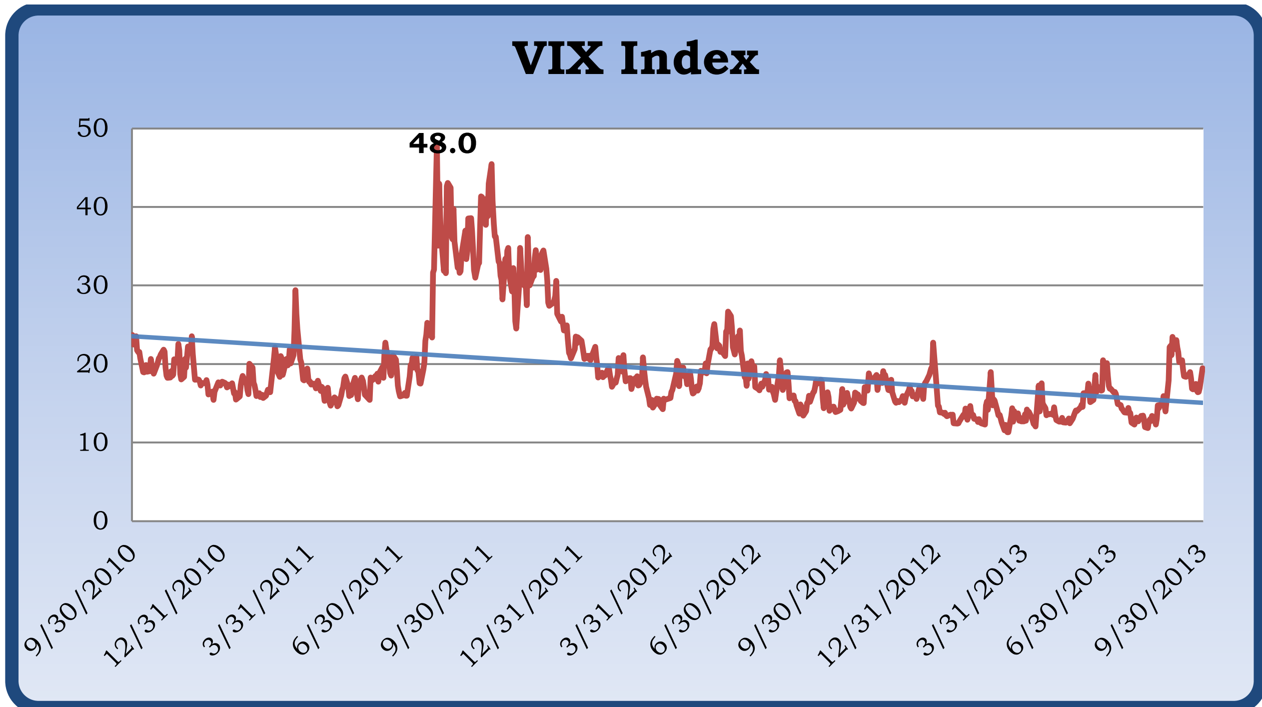
per cent next April. The current tax stands at 5 per cent, and in an effort to dampen any negative effects, he also stated that a new stimulus package would be rolled out in conjunction with the sales tax hike. The list of reform proposals unveiled earlier this year disappointed markets, given that it omitted much needed labour law and medical insurance reforms. Structural reforms are a critical part of “Abenomics”, as fundamental changes are necessary in order to increase Japan’s long-term growth potential.

SECTION 2 – CAPITAL AND MONEY MARKET REVIEW

Fixed income and equity markets generated positive returns for the third quarter, but month to month performance was mixed, as investors watched for signs whether the US Federal Reserve would taper in September. The Chicago Board Options Exchange Volatility Index (VIX), which is a proxy for investor anxiety and market risk, moved higher during the third quarter of 2013. The VIX averaged 16.0 points in the third quarter, up from an average of 14.8 points in the previous three months. The possibility of a U.S.-led military strike on Syria, concerns around the Federal Reserve's plans to begin tapering its $85 billion a month bond buying program, and the budget and debt ceiling debates in Washington, all helped push the VIX higher during the third quarter.

Positive economic data and the continuation of accommodative monetary policies in the US, Europe, UK and Japan, both helped to improve the outlook for risk assets. Equity markets ended the quarter higher, with the US Standard and Poor's (S&P) index hitting record levels in the third quarter. Companies in the S&P 500 index continued to show positive but slow earnings growth, with the blended earnings growth rate at 2.1 per cent for the second quarter. France and Germany were the best performing non-US developed markets, as the CAC 40 and DAX 30 advanced 10.82 per cent and 7.98 per cent respectively. Trends in benchmark 10-year yields for the G-7 nations were mixed in the third quarter, with yields falling in France, Italy and Japan. The yield on the 10-year GILT increased the most, ending the quarter up 28 bps at 2.7 per cent.

Figure 1
Market Volatility in the US
/points /



Source: Bloomberg.

U.S. Fixed Income

It was a challenging third quarter for US Treasury Fixed Income investors. Market movements were exacerbated, as investors closely dissected key economic readings for signs regarding the strength of the recovery. Some form of tapering of the Fed asset purchase program was priced into the market, with US Treasury yields moving higher throughout the third quarter. The curve steepened 22 basis points between the 2-year and the 30-year sectors, and the yield on 30-year treasuries peaked at 3.90 per cent on August 21st.

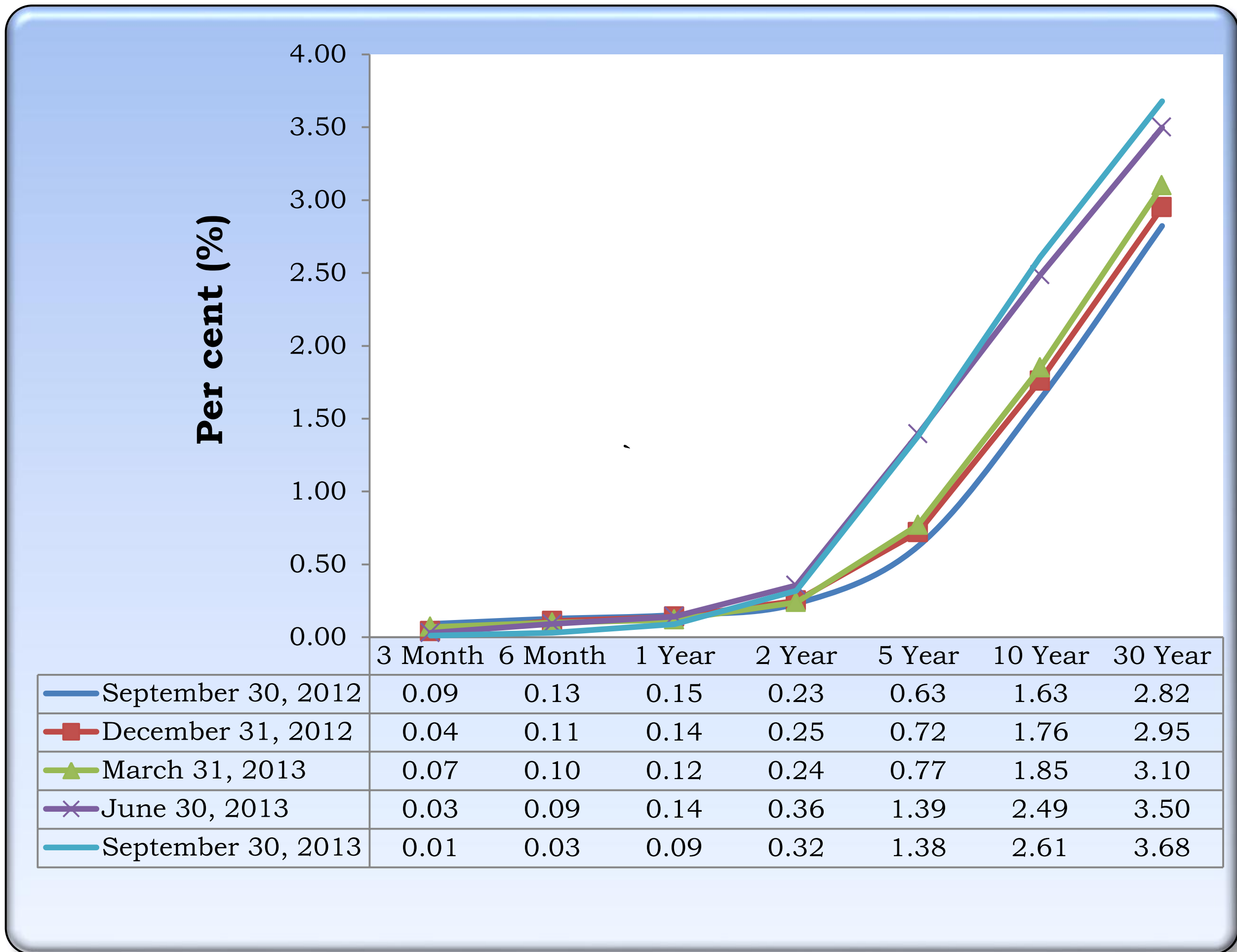
On September 18th, the Federal Reserve Bank surprised markets and sent yields lower by announcing that it planned to maintain its bond buying program. The fiscal gridlock in Washington caused additional downward pressure on yields into September, but 30-year

treasuries still managed to end the third quarter up by 18 basis points, when compared to the end of June.

Medium-term yields ended the quarter mixed. Both 5 and 10-year yields initially rose higher on the back of taper fears. Once it was announced that there were no immediate plans to reduce bond purchases, the 5-year yield fell faster than the 10-year, and ended the quarter down 1 basis point at 1.38 per cent. In addition to the Fed's decision to delay tapering, Lawrence Summers announcement to withdraw his name from consideration for the Fed Chairmanship also moved yields lower. The next likely candidate, Janet Yellen, was officially nominated on October 9th and is widely considered more dovish. As her nomination was somewhat anticipated, there was added downward pressure on yields, as markets grew increasingly confident that the Federal Reserve might keep rates lower for longer.

Front-end yields (less than one year) marginally declined, as the 3-month yield fell to 0.01 per cent from 0.03 per cent as of June 28th, 2013. 3-month yields ended the month lower, partly due to falling supply and debt-limit concerns, which have forced investors to seek maturities from November onwards. Fed taper talk may have also weighed on yields, as investors looked to place their money in shorter-term instruments.

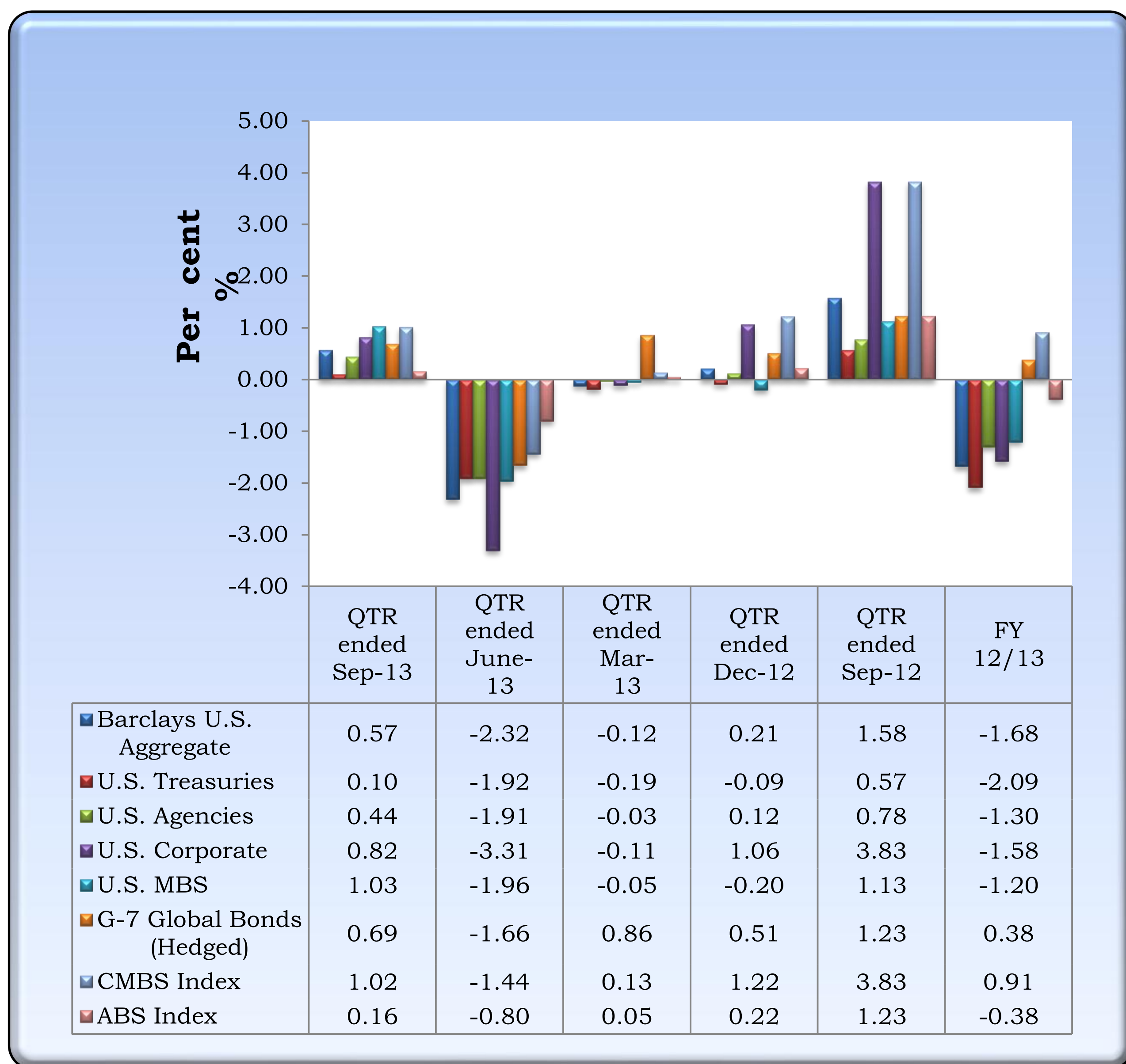
Figure 2
US Treasury Yield Curve
/per cent/



Source: Bloomberg.

All of the major fixed income sectors produced positive returns during the third quarter of 2013. The broader US fixed income market as measured by the Barclays Capital US Aggregate Bond index, gained 0.57 per cent in the third quarter, compared with a decline of 2.32 per cent in the previous three months. Spread products generally outperformed similar-duration Treasuries with US Mortgage Backed Securities (MBS) and Commercial Mortgage Backed Securities (CMBS) sectors returning 1.03 per cent and 1.02 per cent respectively. In the US Investment Grade Corporate Bond market, spreads tightened modestly and lower quality BBB rated bonds outperformed higher quality AAA and AA rated securities.

Figure 3
Returns on Fixed Income Indices
/per cent/



	QTR ended Sep-13	QTR ended June-13	QTR ended Mar-13	QTR ended Dec-12	QTR ended Sep-12	FY 12/13
Barclays U.S. Aggregate	0.57	-2.32	-0.12	0.21	1.58	-1.68
U.S. Treasuries	0.10	-1.92	-0.19	-0.09	0.57	-2.09
U.S. Agencies	0.44	-1.91	-0.03	0.12	0.78	-1.30
U.S. Corporate	0.82	-3.31	-0.11	1.06	3.83	-1.58
U.S. MBS	1.03	-1.96	-0.05	-0.20	1.13	-1.20
G-7 Global Bonds (Hedged)	0.69	-1.66	0.86	0.51	1.23	0.38
CMBS Index	1.02	-1.44	0.13	1.22	3.83	0.91
ABS Index	0.16	-0.80	0.05	0.22	1.23	-0.38

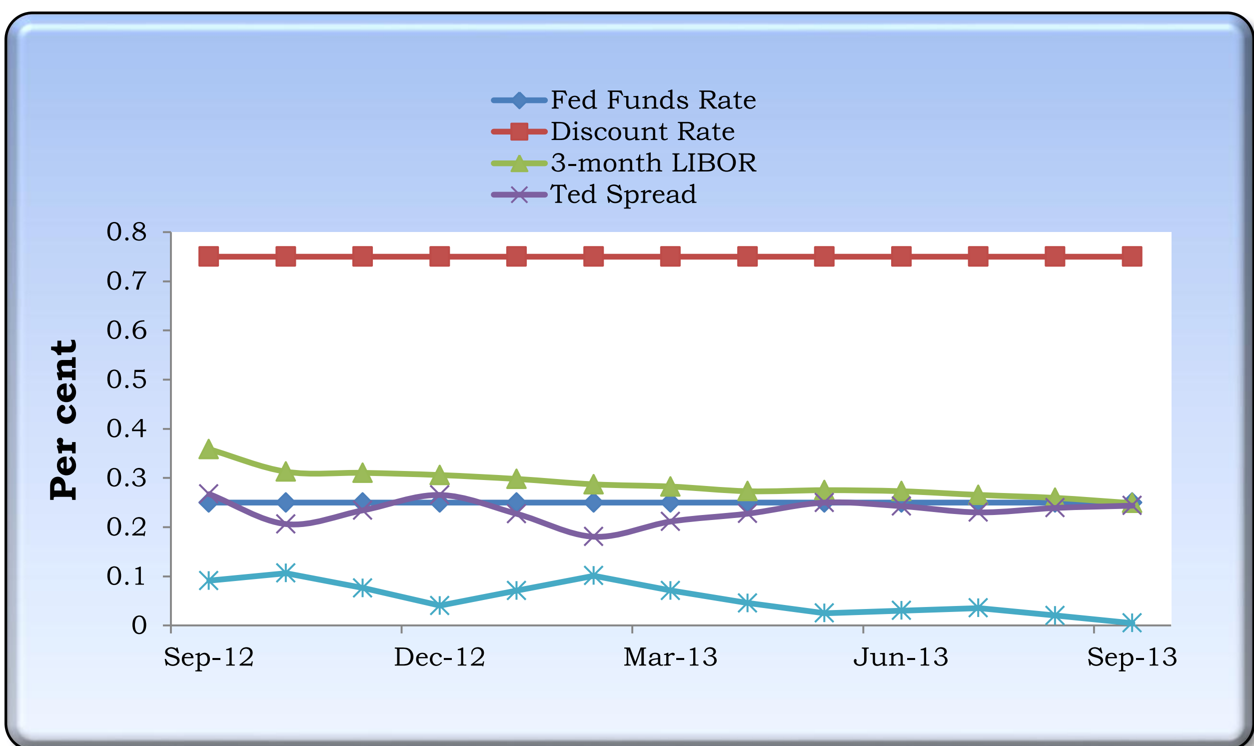
Source: Barclays Capital.

The performance of the sovereign bonds of other developed markets was mixed over the quarter. The benchmark UK Gilt yields rose by 28 basis points to 2.72 per cent, as gains in manufacturing, construction and services indicated that the UK economic recovery was gaining momentum. Meanwhile, yields on Japanese bonds moved lower over the period, as the Bank of Japan (BOJ) promised to maintain its pledge to purchase some $70 billion JGB bonds every month.

Money Market

Short-term interest rates remained at relatively low levels as the major central banks continued their accommodative monetary policy stance during the third quarter. The 3-month US Treasury bill rate declined 2.5 basis points to 0.005 per cent at the end of the quarter. Meanwhile, the 3-month London Inter-Bank Offered Rate (LIBOR) fell 2.4 basis points to 0.25 per cent.

Figure 4
US Money Market Rates
/per cent/



Source: Bloomberg.

Equity Markets

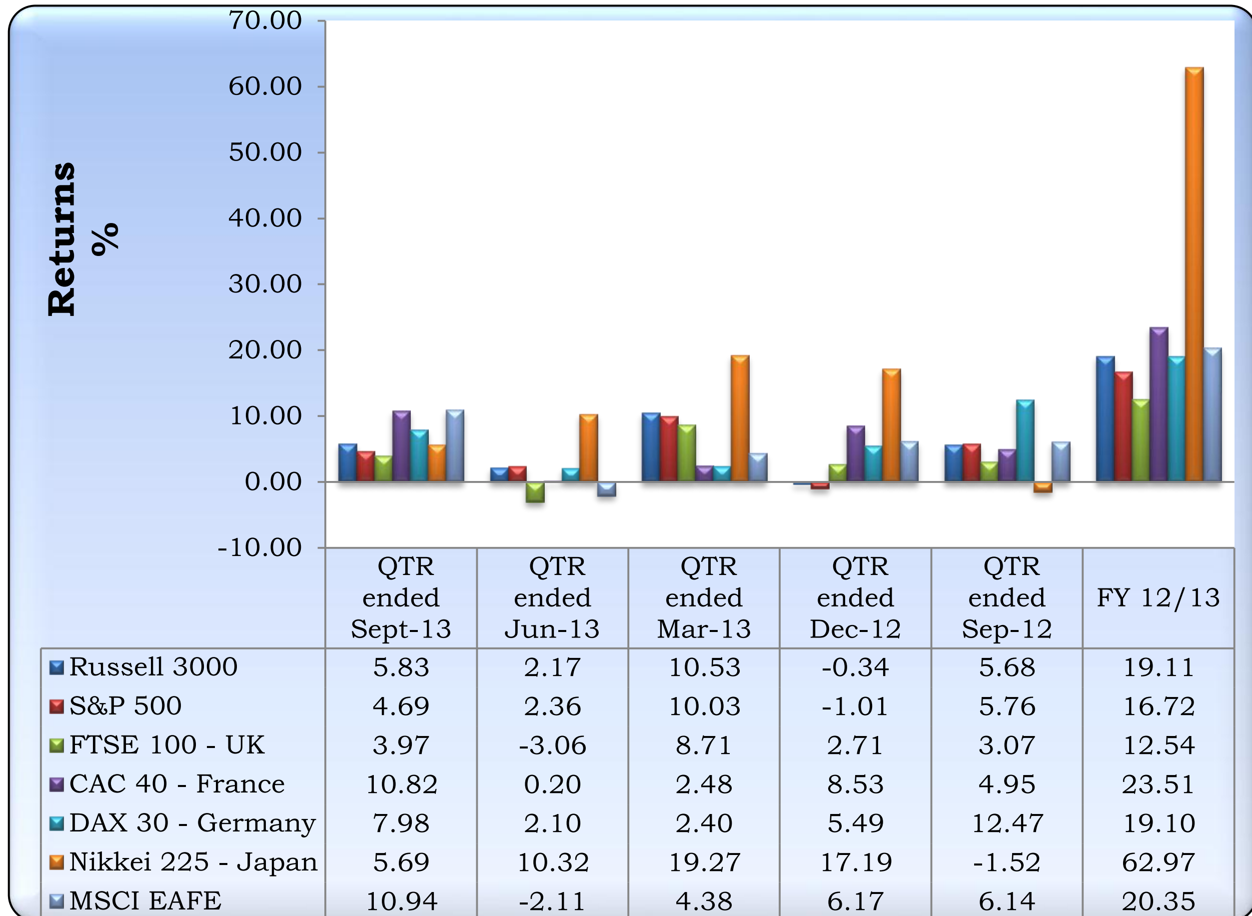
In the third quarter, monthly equity returns were mixed as investors tried to discern the amount and timing of a Fed taper. Despite a moderate decline in August, equity markets managed to end the quarter higher, as positive economic data in the UK and Euro zone

coupled with the Fed's decision to maintain its bond purchase program helped to lift markets. Political uncertainty in Italy, a potential US military strike on Syria and the fears leading up to the Fed's announcement regarding tapering on September 18th, all helped to moderate gains.

In the US, the S&P 500 index gained 4.69 per cent, compared with a gain of 2.36 per cent in the previous three months. Nine out of the ten sectors in the index recorded gains in the third quarter of 2013, with Materials and Industrials posting the highest returns. During the quarter, the Russell 3000 index returned 5.83 per cent, a significant increase when compared to the previous quarter's return of 2.17 per cent. The Russell 3000 Growth index outperformed the Value index while Small Cap stocks outperformed Large Cap stocks.

The MSCI EAFE returned 10.94 per cent over the third quarter as the United Kingdom, Japan and the Euro zone economies all added to the indices' performance. In the United Kingdom, the FTSE 100 increased 3.97 per cent over the period. Meanwhile in the Euro zone, the French CAC index advanced 10.82 per cent, whilst Germany's DAX 30 index returned 7.98 per cent over the three months ending September 30, 2013. Japan's Nikkei 225 rose 5.69 per cent, as equities continued to benefit from the Bank of Japan's stimulus policies, and the country's successful bid for the 2020 Olympic Summer Games.

Figure 5
Price Returns on Equity Indices
/Per cent/



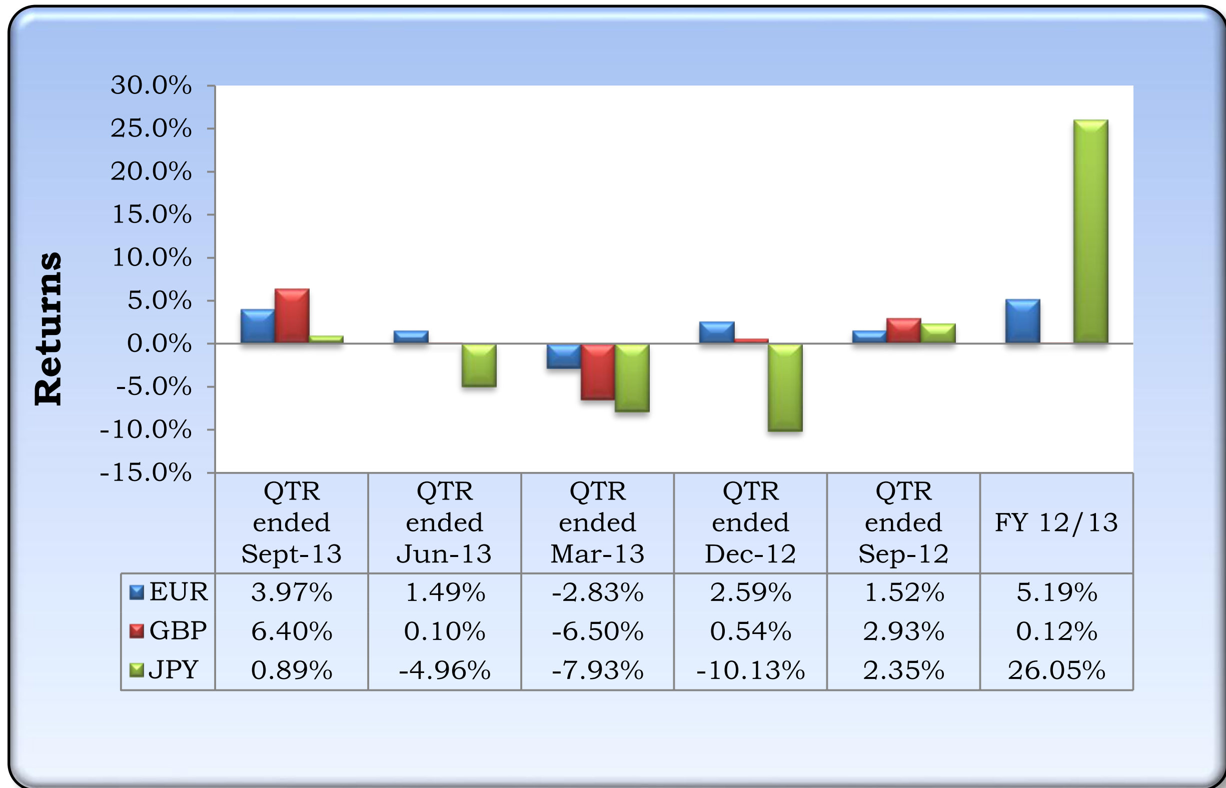
	QTR ended Sept-13	QTR ended Jun-13	QTR ended Mar-13	QTR ended Dec-12	QTR ended Sep-12	FY 12/13
Russell 3000	5.83	2.17	10.53	-0.34	5.68	19.11
S&P 500	4.69	2.36	10.03	-1.01	5.76	16.72
FTSE 100 - UK	3.97	-3.06	8.71	2.71	3.07	12.54
CAC 40 - France	10.82	0.20	2.48	8.53	4.95	23.51
DAX 30 - Germany	7.98	2.10	2.40	5.49	12.47	19.10
Nikkei 225 - Japan	5.69	10.32	19.27	17.19	-1.52	62.97
MSCI EAFE	10.94	-2.11	4.38	6.17	6.14	20.35

Source: Bloomberg.

Currency Markets

The US dollar weakened against the major world currencies. The Japanese Yen was the worst performing G10 currency, strengthening only 0.89 per cent vis-à-vis the US dollar over the quarter. The British Pound rose by 6.4 per cent in the quarter, mainly on improved growth for the UK economy and speculation that the Central Bank of England may be forced to raise rates earlier than its 2016 forecast. The Euro also appreciated over the quarter. The currency strengthened 3.97 per cent, as economic data confirmed that the Euro zone emerged from its 18 month long recession during the second quarter of 2013.

Figure 6
Foreign Exchange Returns for Major Currencies vis-à-vis the US Dollar
/per cent/



	QTR ended Sept-13	QTR ended Jun-13	QTR ended Mar-13	QTR ended Dec-12	QTR ended Sep-12	FY 12/13
EUR	3.97%	1.49%	-2.83%	2.59%	1.52%	5.19%
GBP	6.40%	0.10%	-6.50%	0.54%	2.93%	0.12%
JPY	0.89%	-4.96%	-7.93%	-10.13%	2.35%	26.05%

Source: Bloomberg

SECTION 3 – PORTFOLIO PERFORMANCE

Strategic Asset Allocation

Over the period July to September 2013, the asset classes of the Fund deviated from their Strategic Asset Allocation (SAA) but their weights were all within the permitted (+/- 5 per cent) range. The approved SAA for the HSF investment portfolio is as follows:

i.	***US Short Duration Fixed Income Mandate***	*25.0%*
ii.	***US Core Domestic Fixed Income Mandate***	*40.0%*
iii.	***US Core Domestic Equity Mandate***	*17.5%*
iv.	***Non US Core International Equity Mandate***	*17.5%*

Throughout the quarter, the two equity mandates carried overweight allocations relative to their SAA weights and these resulted from their stronger performance when compared with their fixed income counterparts. By the end of the quarter, the asset class with the largest overweight was the US Core Domestic Equity mandate while the US Core Fixed Income mandate had the largest underweight position.

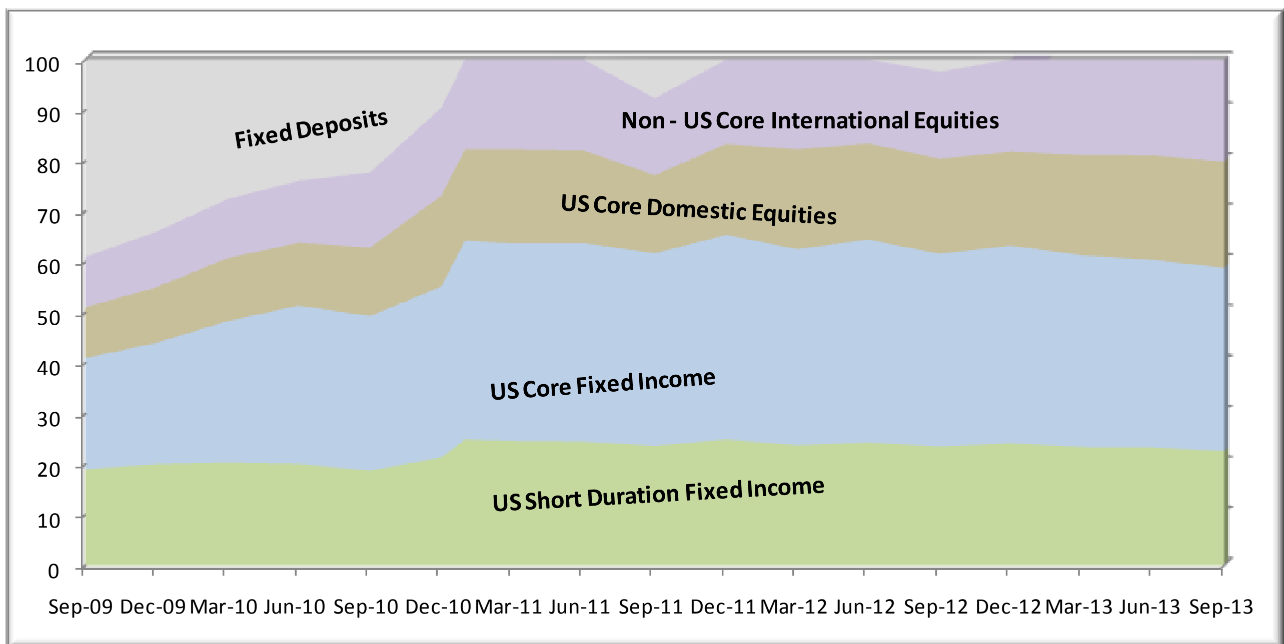
The total net asset value of the Fund as at the end of September 2013 totaled US$5,154.0 million, compared with US$4,914.4 million at the end of the previous quarter. Of this total, the investment portfolio was valued at US$5,152.1 million, while the remaining portion (US$1.9 million) was held in cash to meet the day-to-day expenses that arise from the management of the Fund. The Fund's target asset allocation and the portfolio weighting for the period September 30 2012 to September 30 2013 are shown in Table 1, overleaf.

Table 1
Portfolio Composition relative to the Approved SAA
/per cent/

Portfolio Weights	Asset Class	Target Weight SAA	Sep-12 Actual % of Fund	Dec-12 Actual % of Fund	Mar-13 Actual % of Fund	Jun-13 Actual % of Fund	Sep-13 Actual % of Fund
	Cash	0.00	2.37*	0.00	0.00	0.00	0.00
	US Short Duration Fixed Income	25.00	23.46	24.09	23.38	23.30	22.61
	US Core Domestic Fixed Income	40.00	38.13	39.14	37.92	37.11	36.15
	US Core Domestic Equity	17.50	18.82	18.57	19.86	20.64	21.07
	Non-US Core International Equity	17.50	17.22	18.20	18.84	18.95	20.17

*This cash represents the contribution made by the Government on September 28, 2012.

Figure 7
Asset Composition of the HSF Portfolio
/per cent/



Performance of the Investment Portfolio

For the third quarter of 2013, the HSF investment portfolio gained 3.95 per cent, compared with a return of 3.47 per cent for the SAA benchmark. This outperformance of 48 basis points may be attributable to favourable security selection as well as the deviation between the portfolio and SAA weightings. Most of the HSF portfolio's returns were generated by the equity portion of the Fund, which contributed 3.57 per cent to the overall performance, while the fixed income mandates added 0.39 per cent to the overall return.

On an asset class level, three of the four mandates outperformed their respective benchmarks during the quarter ended September 30 2013, with the exception of the US Short Duration Fixed Income mandate.

The **US Short Duration Fixed Income** portfolio posted an absolute return of 0.43 per cent during the third quarter of 2013, underperforming its benchmark, the Bank of America Merrill Lynch US Treasury 1-5 year index, by 3 basis points. This underperformance was attributed to the portfolio's exposure to spread products (Agency MBS and Agency CMBS) as spreads widened during the quarter. The net asset value of this mandate as at September 30 2013 was **US$1,164.8 million,** compared with US$1,145.0 million at the end of the previous quarter. For the financial year to September 2013, this mandate returned 0.02 per cent compared with a decline of 0.05 per cent for the benchmark.

The longer duration fixed income mandate which consists of **US Core Fixed Income** securities**,** posted a return of 0.77 per cent during the third quarter of 2013, outperforming its benchmark, the Barclays Capital US Aggregate Bond index which

gained 0.58 per cent. The outperformance of this portfolio relative to the benchmark resulted from its underweight allocation to US Treasuries and overweight allocations to investment grade securities particularly in the industrials and financials sectors. The portfolio also gained from positive movements in the pound and the euro as both currencies strengthened over the period. The net asset value of this mandate as at September 30 2013 increased in comparison to the previous quarter, totaling **US$1,862.6 million** compared with US$1,823.5 million in June 2013. For the financial year to September 2013, the US Core Fixed Income mandate declined 1.19 per cent compared with a decline in its benchmark of 1.67 per cent.

The **Non-US International Equities** mandate generated a gain of 11.73 per cent for the third quarter of 2013, compared with a return of 11.64 per cent for its benchmark, the MSCI EAFE ex Energy index. This outperformance was mainly on account of the managers' sector allocations which were favourable in Japan, Finland and Singapore. The managers' stock selection decisions were also positive for the portfolio, especially holdings in France, Germany, Japan, Australia and Hong Kong. The net asset value of the Non-US Core International Equity mandate as at September 30, 2013 grew to **US$1,039.0 million**, from US$931.1 million at the end of June 2013. For the financial year ending September 30, 2013, this mandate returned 28.64 per cent, compared with its benchmark's return of 25.53 per cent.

The **US Core Domestic Equities** mandate returned 6.54 per cent, compared with a benchmark return of 6.35 per cent. This outperformance was on account of the managers' favourable stock and sector selection decisions. On a sectoral level, the holdings in the Financial Services, Producer Durables and Health Care sectors added the most to excess returns. The net asset value of this mandate, as at September 30 2013, was **US$1,085.7 million**, compared with US$1,014.0 million at the end of June 2013.

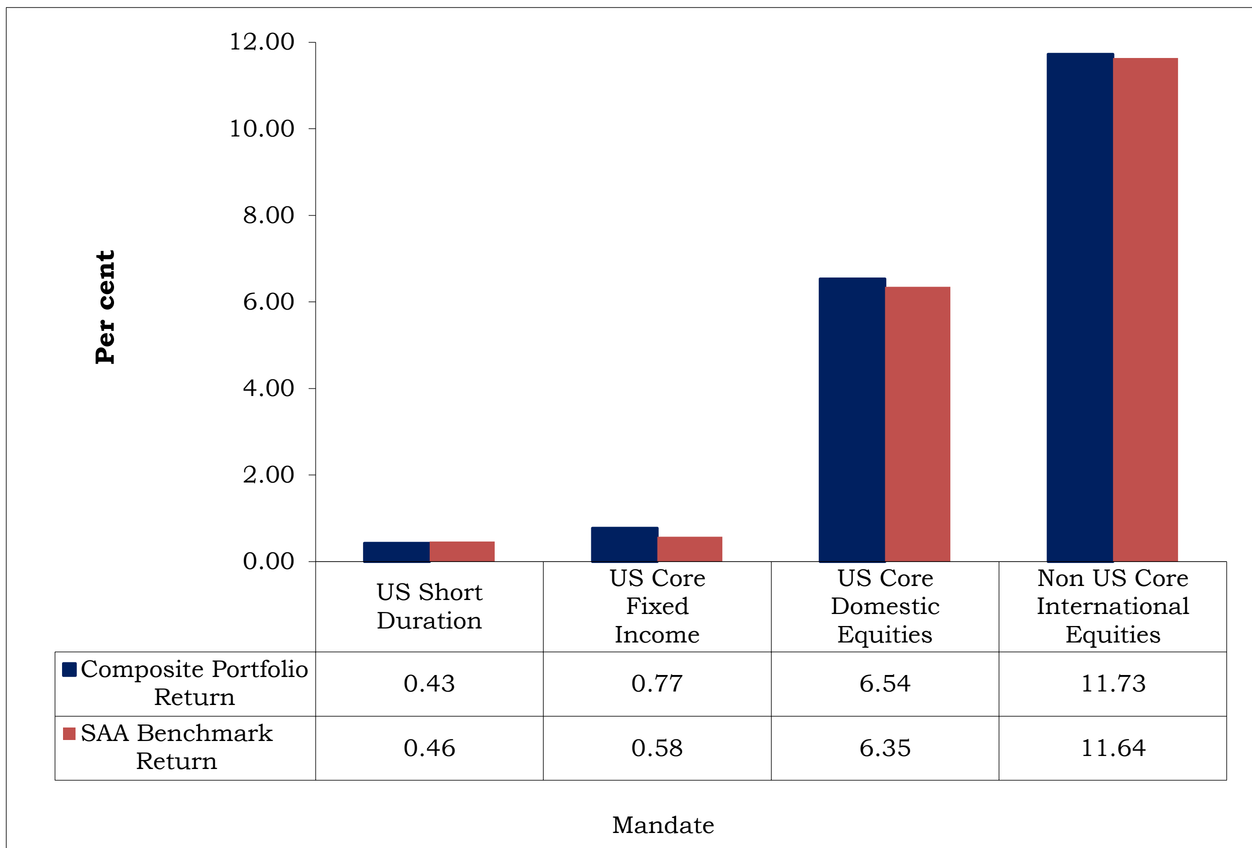
For the financial year to September 2013, this mandate returned 22.28 per cent compared with a return of 22.49 per cent for the benchmark.

Table 2
Contribution to Quarterly Return,
For the period July 2013 – September 2013
/per cent/

	SAA Weights	Portfolio Weights as at 30-Sept-2013	Weighted Return HSF	Weighted Return Benchmark
Composite Portfolio	100.00	100.00	3.95	3.47
US Core Domestic Fixed Income	40.00	36.15	0.29	0.23
US Core Domestic Equity	17.50	21.07	1.36	1.12
Non US Core International Equity	17.50	20.17	2.21	2.01
US Short Duration Fixed Income	25.00	22.61	0.10	0.11

NB: Differences in totals are due to rounding.

Figure 8
Absolute Returns by Asset Class
For the period July 2013 – Sept 2013
/per cent/



SECTION 4 –COMPLIANCE AND PORTFOLIO RISKS

Compliance

During the quarter ended September 30 2013, one of the Fund's fixed income managers sought clarification on the interpretation of the guideline limitation with respect to the permissible proportion of US agency mortgage back securities within the portfolio. It was agreed that the allocation to these securities be reduced and they were sold at a gain during the quarter.

Portfolio Risks

The main risks for the HSF portfolio are Credit, Concentration, Interest Rate, and Currency risks. The following paragraphs give a description of how these risks are mitigated.

Credit Risk

For the **money market portion** of the Fund, Credit Risk is minimized by the strict adherence to the following standards: (i) all counterparties must have a minimum credit rating of either A-1 from the Standard and Poor's rating agency or P-1 from Moody's; and (ii) a maximum exposure limit for counterparties of no more than 5.0 per cent of the market value of the portfolio.

For **fixed income instruments**, Credit Risk is mitigated by the use of credit concentration limits as well as minimum credit quality ratings. Bonds must have an implied investment grade rating as defined by Standard and Poor's, Moody's or Fitch. Should the required ratings on an existing fixed income security fall below the minimum standards, the security must be sold within an agreed upon timeframe. Table 3 below

shows the Average Credit Quality of the US Short Duration and US Core Fixed Income Portfolios as at September 30, 2013.

Table 3
Average Credit Rating

Mandate	Portfolio	Benchmark
US Short Duration	**AA+**	**AA+**
US Core Fixed Income	**AA**	**AA+**

Concentration Risk

Concentration or Diversification Risk is minimised by investing across various asset types. The portfolio is currently invested across four asset groupings as follows - US Short Duration Fixed Income, US Core Domestic Fixed Income, US Core Domestic Equity and Non-US Core International Equity. The Asset classes in which the Fund invests react differently under a given market condition. As such, it is likely that when one asset class has strong returns, another may have lower returns. The Fund's investments are also diversified across a number of assets with the aim of securing a positive return under a range of market conditions and to lower the total risk of the portfolio. In addition, Concentration Risk is minimized within asset groups. For the **equity portfolios**, this Risk is managed by imposing a maximum percentage holding of 3.0 per cent of any security's outstanding shares, as well as a maximum sector deviation relative to the benchmark of 5.0 per cent.

Interest Rate Risk

Interest Rate Risk is managed using a weighted average effective duration limit on the respective portfolios, with an allowable range of one (1) year longer or shorter than the weighted average duration of the respective benchmark. Table 4 shows the weighted

average duration for the US Short Duration and US Core Domestic Fixed Income portfolios as at September 30, 2013.

Table 4
Weighted Average Duration
/Years/

Mandate	Portfolio	Benchmark
US Short Duration	**2.69**	**2.64**
US Core Domestic Fixed Income	**5.40**	**5.30**

Currency Risk

Currency Risk is managed by containing and managing the exposure to non-US dollar instruments. For the Fixed Income and US Core Domestic Equity mandates, no more than 10 per cent of the market value of the portfolio can be invested in securities which are denominated in currencies other than the US Dollar. The Non-US Core International Equity Portfolio is comprised primarily of non-US dollar denominated securities, and the Fund accepts the currency risk inherent in the relevant benchmark. For this mandate, currency hedging is permitted up to 15 per cent of the market value of the portfolio using the US dollar as the base currency. At the end of September 2013, the currency exposure for this portfolio was 99 per cent of its market value. During the quarter, all the portfolios were within their respective limits.

Appendix I
HSF Portfolio
Historical Performance since Inception

Quarter End	Current Returns			Financial YTD			Annualised Return Since Inception		
	Portfolio	Benchmark	Excess	Portfolio	Benchmark	Excess	Portfolio	Benchmark	Excess
	%	%	bps	%	%	bps	%	%	bps
FY 2010									
December	0.96	0.89	6.65	0.96	0.89	6.65	3.72	3.78	-6.16
March	1.61	1.68	-6.20	2.59	2.58	0.49	3.95	4.03	-7.76
June	-1.83	-1.89	6.05	0.71	0.64	6.69	3.07	3.12	-5.18
September	5.33	5.08	24.73	6.07	5.75	31.93	4.37	4.35	2.06
FY 2011									
December	2.29	2.21	8.15	2.29	2.21	8.15	4.70	4.65	4.13
March	1.62	1.54	7.24	3.94	3.79	15.68	4.81	4.76	5.72
June	1.88	1.81	6.68	5.89	5.67	22.91	4.98	4.91	7.00
September	-4.82	-4.28	-53.66	0.79	1.14	-34.89	3.57	3.63	-6.29
FY 2012									
December	2.74	3.03	-28.52	2.74	3.03	-28.52	3.97	4.08	-12.00
March	5.04	4.46	57.50	7.92	7.63	29.29	4.78	4.78	-0.08
June	-0.90	-0.60	-30.42	6.95	6.98	-3.72	4.37	4.43	-6.13
September	3.53	2.98	55.03	10.73	10.18	55.02	4.68	4.65	2.07
FY 2013									
December	1.49	1.45	4.11	1.49	1.45	4.11	4.88	4.83	4.76
March	3.29	2.90	39.19	4.82	4.38	44.01	5.23	5.12	11.20
June	-0.30	-0.69	39.05	4.51	3.66	84.64	4.97	4.80	17.26
September	3.95	3.47	47.35	8.63	7.26	137.06	5.40	5.16	24.01

Notes:

(1) Differences in totals are due to rounding.

(2) In August 2009, International Equities and Fixed Income Securities were added to the HSF portfolio. The performance benchmark for the HSF portfolio became a blended benchmark which comprise, Bank of America/Merrill Lynch US Treasury 1-5 Years Index, US One-month LIBID Index, Barclays US Aggregate, Russell 3000 ex Energy, and MSCI EAFE ex Energy.

(3) In January 2011, the HSF Portfolio achieved its Strategic Asset Allocation where the portfolio was invested in four assets classes. US Short Duration Fixed Income (25), US Core Fixed Income (40), US Equity (17.5) and Non-US International Equity (17.5).

(4) With effect from the quarter ended December 2012, the Annualised Returns Since Inception were computed using a geometric average and not the previously used arithmetic average. For comparative purposes, prior period annualized returns since inception shown above were computing using a geometric average.

Appendix II
Heritage and Stabilisation Fund
Quarterly Portfolio Valuation (USD)

Valuation Date	Net Asset Value	Quarterly Income	Accumulated Surplus & Unrealized Capital Gains/Losses	Contributions
March 15, 2007	1,402,178,155	0	0	
March 31, 2007	1,405,448,567	3,270,412	3,270,412	-
June 30, 2007	1,424,094,965	18,646,398	21,916,810	-
September 30, 2007	1,766,200,701	20,301,027	41,966,361	321,706,043
December 31, 2007	1,788,304,749	22,204,785	64,035,501	-
March 31, 2008	1,804,531,743	16,631,853	80,514,798	-
June 30, 2008	1,997,251,772	13,715,988	93,124,304	180,210,617
September 30, 2008	2,888,421,556	15,341,508	110,379,131	873,963,840
December 31, 2008	2,909,717,167	16,296,264	131,638,985	-
March 31, 2009	2,911,075,318	4,492,667	133,066,161	-
June 30,2009	2,912,040,600	3,621,489	133,909,143	-
September 30, 2009	2,964,686,478	11,397,337	186,755,766	-
December 31, 2009	2,992,717,167	19,444,496	214,699,141	-
March 31, 2010	3,038,173,194	17,674,928	259,925,615	-
June 30, 2010	3,083,272,124	23,694,244	199,004,184	103,843,621
September 30, 2010	3,621,984,041	27,568,267	364,361,226	373,500,642
December 31, 2010	3,701,961,347	33,317,910	443,906,745	-
March 31, 2011	3,759,689,344	45,854,060	500,513,925	-
June 30, 2011	3,825,639,556	70,691,561	567,222,023	-
September 30, 2011	4,084,016,158	29,885,267	374,074,067	451,400,519
December 31, 2011	4,191,162,904	10,474,106	481,361,876	-
March 31, 2012	4,397,263,070	42,045,281	687,290,865	-
June 30, 2012	4,378,930,036	34,014,167	642,769,982	26,241,964
September 30, 2012	4,712,376,278	38,688,423	794,770,772	181,308,882
December 31, 2012	4,780,065,524	42,243,928	861,557,777	-
March 31, 2013	4,933,344,741	70,726,991	1,015,212,703	-
June 30, 2013	4,914,375,234	56,685,027	996,411,094	-
September 30, 2013	5,154,027,747	143,120,358	1,193,778,722	42,414,251

Appendix III
Summary Characteristics of Composite Benchmarks
Fixed Income Benchmarks

Key Characteristics	Barclays US Aggregate Index	Merrill Lynch 1-5 Index
Total Holdings	8,542	139
Coupon (%)	3.42	1.84
Duration (Years)	5.30	2.64
Average Life (Years)	6.93	2.72
Yield to Maturity (%)	2.24	0.60
Option Adjusted Spread (bps)	46	0
Average Rating (S&P)	AA+	AA+
Minimum Rating (S&P)	BBB-	AA

Equity Benchmarks

Key Characteristics	Russell 3000 (ex energy)	MSCI EAFE (ex energy)
Total Holdings	2,779	851
Earnings Per Share (EPS Growth 3-5y fwd)	10.24	10.45
Price Earnings (P/E fwd)	14.6	13.86
Price / Book (P/B)	2.47	1.70
Weighted Average Market Capitalization* (Bn)	$80.2	$59.3

*Market capitalization is a measurement of the size of a company (share price x the number of outstanding shares). The weighted average market capitalization of a stock market index represents the average size of the firms comprising the index where each is weighted according to its market capitalization.

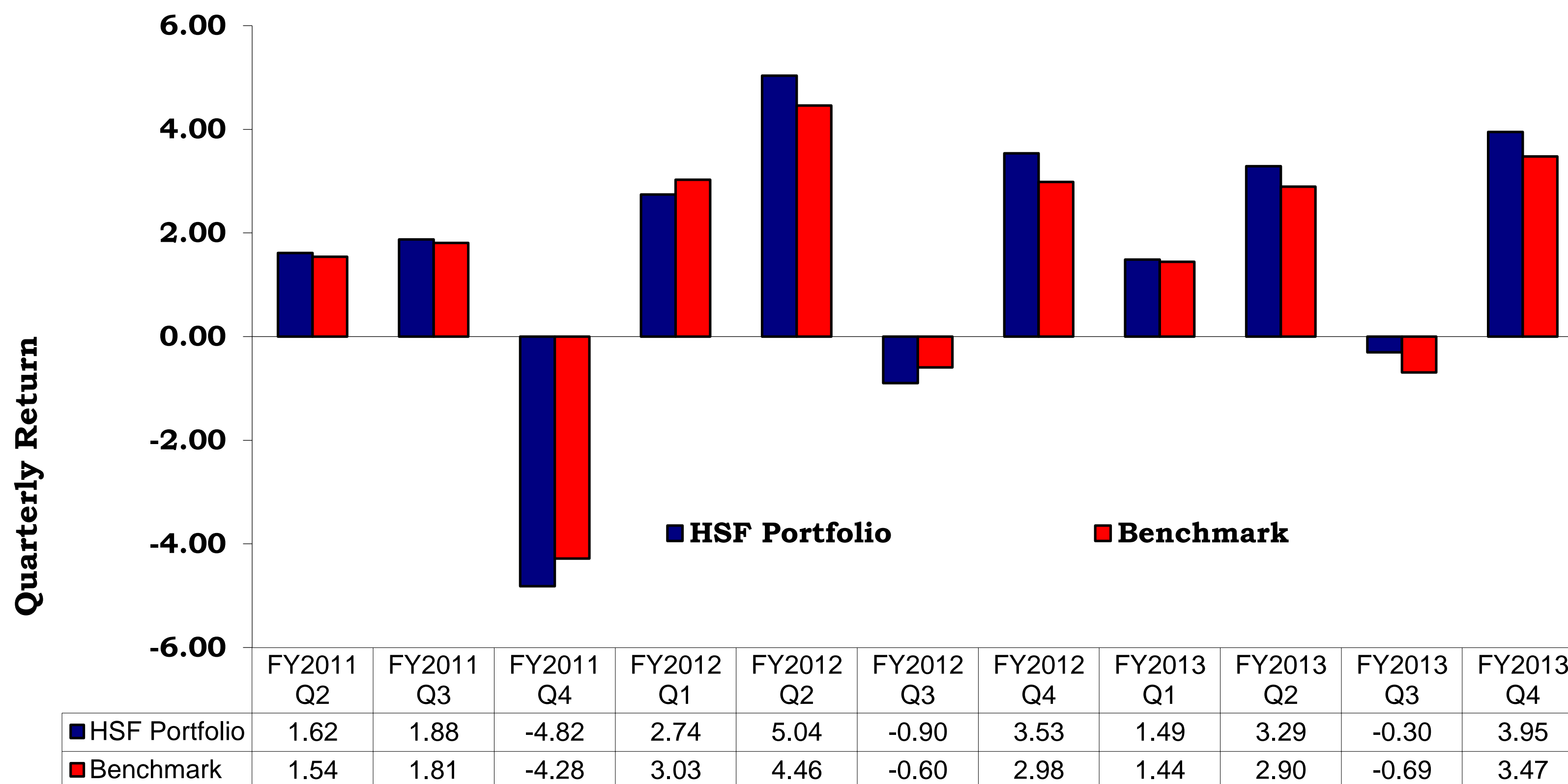
Appendix IV
Summary of the Fund's Net Asset Value by Mandate
/US$ Million/

	September 2012	December 2012	March 2013	June 2013	September 2013
Total Fund Value	**4,712**	**4,780**	**4,933**	**4,914**	**5,154**
Total Value of Equity	**1,697**	**1,757**	**1,909**	**1,945**	**2,125**
US Core Domestic Equity	886	887	980	1,013	1,086
Non-US Core International Equity	811	869	929	931	1,039
Total Value of Fixed Income	**2,901**	**3,021**	**3,023**	**2,969**	**3,027**
US Short Duration Fixed Income	1,105	1,151	1,153	1,145	1,165
US Core Domestic Fixed Income	1,796	1,870	1,870	1,823	1,863
Total Value of Cash or Cash Equivalents	**114***	**2**	**1**	**1**	**2**

NB: Differences in totals are due to rounding.
*This mainly represented the cash contribution (US$111.9million) made by the Government on September 28, 2012.

Appendix V
HSF Portfolio Quarterly Returns
/per cent/

Quarterly HSF & SAA Benchmark Returns



	FY2011 Q2	FY2011 Q3	FY2011 Q4	FY2012 Q1	FY2012 Q2	FY2012 Q3	FY2012 Q4	FY2013 Q1	FY2013 Q2	FY2013 Q3	FY2013 Q4
HSF Portfolio	1.62	1.88	-4.82	2.74	5.04	-0.90	3.53	1.49	3.29	-0.30	3.95
Benchmark	1.54	1.81	-4.28	3.03	4.46	-0.60	2.98	1.44	2.90	-0.69	3.47

Appendix VI
Summary of External Managers Performance

EXTERNAL MANAGERS' PERFORMANCE – QUARTER ENDING SEPTEMBER 2013			
Mandate	**Investment Manager**	**Portfolio Return (%)**	**Benchmark Return (%)**
US Short Duration Fixed Income	Fischer Francis Trees Watts	0.47	0.46
	Morgan Stanley Fixed Income	0.39	0.46
US Core Fixed Income	Goldman Sachs Asset Mgt.	0.82	0.58
	Babson Capital	0.73	0.58
US Core Domestic Equity	JP Morgan Asset Mgt.	6.99	6.35
	Morgan Stanley Equity	7.44	7.14
	Morgan Stanley Smith Barney	-0.64	-0.66
Non US Core International Equity	Wellington	11.99	11.64
	Bailard	11.45	11.64