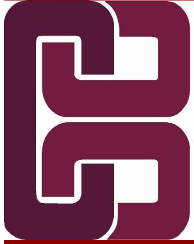


CENTRAL BANK OF TRINIDAD & TOBAGO

TRINIDAD AND TOBAGO HERITAGE & STABILISATION FUND

QUARTERLY INVESTMENT REPORT
JULY - SEPTEMBER, 2008

HERITAGE AND STABILISATION FUND
Quarterly Investment Report
July – September, 2008

INTRODUCTION

This Investment Report on the Heritage and Stabilisation Fund (HSF) covers the fourth quarter of the 2008 financial year, **July – September, 2008**. The report is organised in two sections. **Section I** deals with the international market environment focussing on those markets and sectors in which the HSF assets are invested. **Section II** provides details of the portfolio.

SECTION 1 - MARKET REVIEW

Fixed Income Markets. The US financial market experienced incredible volatility during the fourth quarter, highlighted by the dramatic changes within the financial industry in the last few weeks of September 2008. The market was undermined by investor uncertainty and unease over falling home prices, slower economic growth, labour market weakness, energy-driven inflation pressures and the still-unknown extent of the damage caused to the credit market and financial sector by the sub-prime meltdown.

Despite evidence of high inflation at its monthly meetings on June 25th 2008 and August 5th 2008, the US Fed left the Fed Funds rate unchanged at 2%. Commenting on its inaction the Fed cited the slowing economy and ongoing financial market turmoil.

In early September 2008, the severe economic strain of the sub-prime meltdown and rapid growth in investors' risk aversion signalled an intensification of the credit crisis which began in July 2007. These risks came to a head with the collapse of a number of global financial institutions. The US Federal Reserve (FRB) took control of Fannie Mae and Freddie Mac, bailed-out AIG and engineered the sale of Washington Mutual to JPMorgan & Chase. However, Lehman Brothers was allowed to fail and Merrill Lynch and Wachovia agreed to be acquired by Bank of America and Wells Fargo, respectively. In order to strengthen their balance sheets and restore confidence in

their operations Morgan Stanley sought a US$9 billion capital injection from Mitsubishi UFJ Financial Group, in return for a 21% ownership stake.

In addition, the FRB extended its balance sheet in order to inject much needed liquidity into the US money-market by:

- extending the Primary Dealer Credit Facility and the Term Securities Lending Facility through to January 30, 2009,
- increasing the number of auctions, as well as expanding types of collateral under the Term Securities Lending Facility,
- introducing an 84-day Term Auction Facility as a complement to the 28-day Term Auction Facility,
- increasing the Federal Reserve's swap line with European Central Banks to the value of US$ 277 billion,
- guaranteeing the holdings of mutual funds,
- financing the purchase of asset-backed commercial paper (ABCP) from money market mutual funds and issuers,
- entering into FX swap arrangements with foreign central banks in the sum of roughly US$ 277 billion and
- proposing to buy illiquid mortgage assets of the books of financial institutions.

By the end of September 2008, these measures had failed to alleviate the credit crunch and the risk of counterparty default. As a consequence investors took little comfort in the final official estimate of US second quarter GDP. Data released on September 26, 2008, revealed that second quarter SDP growth increased at an annual rate of 2.8% up from the (0.9%) recorded in the first quarter. Rather, investors remained disconcerted by the possibility that economic and market conditions could significantly deteriorate in the latter part of 2008 as the tax rebate stimulus package recedes.

The increasingly gloomy economic picture and persistent concerns about on the stability of the US financial system intensified investors' flight to quality during quarter. As a result, yields fell on US Government Treasury instruments with the 3-month bills declining by 81 basis points to 84 basis points and the 6-month by 60 basis points to 152 basis points. Accordingly, US Treasury prices soared with the Merrill Lynch US Government Treasury 1-5 Years Index returning roughly 2.47% in the quarter ending September, 2008.

In Europe, economic data on business confidence, consumer spending and manufacturing activities continued to point towards weaker economic growth and

increasing inflationary expectations. Also, the continued fall in home equity prices (particularly in Spain and The United Kingdom) and the protracted sub prime related credit crisis in the US began to undermine investors' confidence in the financial strength of European banks.

Despite heightened downside risks to economic growth, both the European Central Bank (ECB) and the Bank of England (BoE) kept rates unchanged at 4.25 per cent and 5 per cent, respectively, during the quarter. The ECB's primary focus remained dampening the upward movement in prices, which stayed above its 2 per cent targeted level, while the BoE indicated that the build-up of spare capacity in the economy would eventually mitigate further threats of price increases.

The September 2008 collapse of prominent or leading financial firms in the US led to increased investors' aversion to counterparty risk and tighter global markets for credit. As a result, a number of European banks found it increasingly difficult to finance their balance sheets and were bailed-out by their respective governments. Notable names were: HBOS in the United Kingdom, Fortis in the Benelux countries, Dexia in France-Belgium-Luxembourg and Hypo Real Estate in Germany, to name but a few.

Investors in Europe also sought safety in government treasury instruments causing yields to fall (and prices increase). The 3-month Gilt yield was trading 85 basis points lower at 400 basis points at the end of September 2008, while the Euro 3-month yield was down 50 basis points to 371 basis points.

In Japan, economic growth remained relatively sluggish due in part to the moderation in domestic business investment and a contraction in consumer spending arising from the continued surge in energy and other input prices. In this context, the Bank of Japan (BoJ) left its key benchmark rate unchanged at 50 basis points during

the period. Japan's financial system appears to have withstood the September 2008 global credit crisis with few banks reporting funding problems.

Equity Markets. Global equity markets remained volatile for much of the quarter as slowing growth and illiquid credit markets served to undermine investors confidence in the near term profitability of firms. On account of the sell off in markets, particularly during the month of September 2008 when the crisis intensified, global equity market ended the quarter substantially lower.

In the United States, the Dow Jones Industry Average lost roughly 18 per cent of its value declining to 10,345.56 by the end of September 2008. Similarly, the main indices in the United Kingdom, Germany, France and Japan all recorded loss of value (see Table 1). The level of stock market volatility as measured by the VIX index increased substantially during the quarter from a level of 23.95 at start of July 2008 to 39.39 at quarter end, reflecting investors increased market uncertainty.

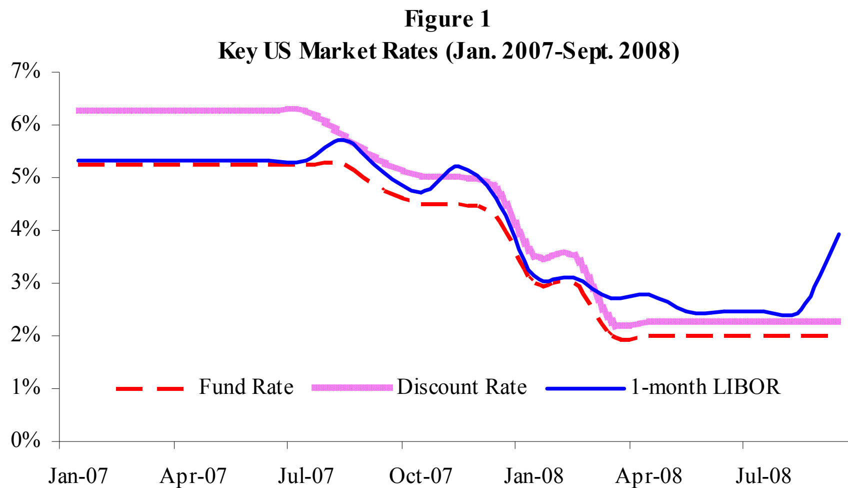
Table 1
Global Equity Market Returns (June-September 2008)

	Indices	**4th Qtr**	**3rd Qtr**	**2nd Qtr**	**1st Qtr**	**FY07**	**FY06**
United States	Russell 3000	-9.30%	-2.16%	-9.96%	-3.71%	14.49%	8.26%
	Dow Jones	-4.40%	-7.44%	-7.55%	-3.81%	14.13%	8.87%
	S&P 500	-9.00%	-3.22%	-9.90%	-5.10%	3.65%	11.78%
United Kingdom	FTSE 100	-12.86%	-1.33%	-11.69%	-0.15%	8.49%	8.82%
France	CAC 40	-2.30%	-5.78%	-16.16%	-1.55%	8.87%	14.13%
Germany	DAX30	-9.15%	-1.78%	-18.99%	2.62%	30.93%	19.04%
Japan	NIKKEI	-16.48%	7.63%	-18.18%	-5.79%	4.08%	18.81%

Money Market. The September 2008 financial crisis intensified investors' aversion to risk and led to a complete breakdown of global money markets as individuals and banks became increasingly reluctant to extend credit to each other. As a result, rates in the money markets soared to record highs. The US LIBOR rate closed the quarter

at 4.05 per cent up from 2.78 per cent at the start of the quarter. The TED Spread, the difference between what banks and the Treasury pay to borrow money for three months, widened by 209 basis points to a record of 3.14 per cent.[1] This reflected banks' general unwillingness to lend to each other and the heightened risk of counterparty default.[2] Figure 1 below shows the key short-term money market rates for the United States between the periods from January 2007 to September 2008.

Figure 1
Key US Market Rates (Jan. 2007-Sept. 2008)



Currency Markets. With the global economy showing signs of a slowdown, the unfolding financial crisis and oil prices retreating, the US dollar recouped some of its losses against the three major currencies during the period. Accordingly, the dollar was traded at US$ 1.4083 against the Euro towards the end of August, up from US$ 1.5751 at the end of June 2008. Similarly, the dollar strengthened by 0.28 per cent and 10.80 per cent against the Yen and GBP, respectively, during the period. The Yen stood at ¥106.3717, while the GBP was valued at 1.7784 at the end of the quarter.

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[1] TED is an acronym formed from *T-Bill* and *ED*, the ticker symbol for the Eurodollar futures contract

[2] The TED Spread is usually 50 basis points and the pervious record was set during Black Monday on October 19, 2007.

SECTION II – PORTFOLIO PERFORMANCE

The financial crisis that originated from concerns over the sub-prime mortgage market deepened into a global credit crisis during fourth quarter 2008. Elevated levels of concern over counterparty risk led to a cut-off in the flow of credit between banks, credit downgrades and the failure of a number of financial institutions.

Given the uncertain and extreme volatile environment, the Bank took defensive measures to ensure the preservation of the capital of the HSF. These measures included:

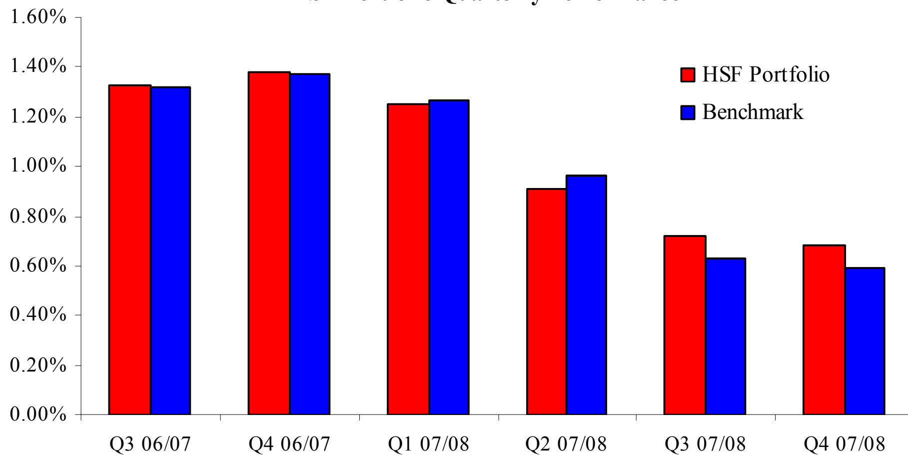
1. early expiration of deposits with banks that were deemed likely to fail or unstable;
2. shortening of the maturity term of deposits from the usual 1-3 months to 1-2 weeks;
3. spreading the credit exposure of the HSF over a larger number of counterparties and geographical regions;
4. more favourable treatment of banks backed by government guarantee of deposits and;
5. improved and more frequent monitoring of counterparties.

In this regard, USD deposits placed with Fortis (US$ 92,947,566.20) and Dexia (US$ 120,814,587.20) were broken when it became clear that both banks were in trouble or facing a credit downgrade. The HSF Portfolio only incurred charges for breaking deposits with Dexia Bank. However, all deposits were placed with more stable banks at higher rates and maturity terms not exceeding two weeks.

For the quarter, the **HSF Composite portfolio return** was 0.69 percent. This was better than the customised benchmark (5 percent Merrill Lynch US Government Treasury 1-5 Years Index and 95 percent US one-month LIBID) return of 0.59 percent, (see Figure 2 and Appendix I for historical Performance). The

outperformance was mainly driven by the overall better market timing decisions in the US money market sector.

Figure 2
HSF Portfolio Quarterly Performance



The **HSF US Fixed Deposit Portfolio** returned 0.62 percent, compared to the US one-month LIBID Index return of 0.51 percent, its benchmark. The **HSF US Treasury Short Duration Portfolio** slightly underperformed its benchmark (Merrill Lynch US Government Treasury 1-5 Years Index) returning 2.05 percent, compared with a return of 2.06 percent for the benchmark. The portfolio ended the quarter with a market value of approximately US$ 125.3 million.

The HSF ended the quarter with a **Net Asset Value of US$ 2,888.4 million**, an increase of roughly US$ 891.2 million from the pervious quarter valuation. The contributions by the Government for both the third and fourth quarters amounted to approximately US$ 874.0 million and were received during the fourth quarter of the financial year 2007/08. For the financial year as a whole, the Government added roughly US$ 1,054.2 million to the HSF, compared with US$ 321.7 million in the previous year. Appendix II shows the portfolio value as at September 30, 2008. Deposits for the fiscal year included US$ 415,833,667 received on September 30,

2008 which was invested subsequent to that date. These funds are included in the line item “accounts receivable” in the unaudited statement of financial position as at 30 September 2008.

Portfolio Risk

The *interest rate risk* of the portfolio is managed by strict adherence to the overall duration of the HSF portfolio, which is set at two (2) years. Also, the HSF US Treasury Short Duration Portfolio is passively managed with zero tracking error and as such, the risk of underperforming its benchmark (benchmark risk) or exposing the portfolio to greater market risk than the benchmark is minimised.

The portfolio’s *credit risk* is minimised by the strict adherence to: (1) credit quality and (2) concentration limit. First, all counterparties must have a minimum credit rating of either A1 from the Standard and Poor’s rating agency or P1 from Moody’s. Credit risk is further minimised by a maximum 5 percent exposure limit for counterparties. This means that no more than 5 percent of the market value of the portfolio can be invested with any single money market counterparty. All standards were complied with during the period under review.

All assets held in the HSF portfolio are invested in US dollars, the reporting or base currency. As a consequence, the portfolio is protected from fluctuations in value due to adverse foreign currency rate movements against the US dollar.

Central Bank of Trinidad and Tobago
October 17, 2008

Appendix I

HSF Portfolio
Historical Performance since Inception

Quarter End	Current Returns			Fiscal YTD			Annualised Return Since Inception		
	Portfolio %	Benchmark %	Excess bps	Portfolio %	Benchmark %	Excess bps	Portfolio %	Benchmark %	Excess bps
2006/07									
March	0.233	0.230	0.30						
June	1.327	1.316	1.04						
September	1.381	1.376	0.52	**2.966**	**2.947**	**1.89**	**5.475**	**5.440**	**3.50**
2007/08									
December	1.252	1.269	-1.80						
March	0.907	0.960	-5.28						
June	0.730	0.626	10.36						
September	0.685	0.592	9.27	3.614	3.491	12.30	4.337	4.242	9.48

Note: (1) In May 2008, US Treasury instruments were added to the HSF portfolio. As a result, the performance benchmark for the HSF portfolio became a blended benchmark, which comprised of 2.5% Merrill Lynch US Treasury 1-5 Years Index and 97.5% US One-month LIBID Index.

Appendix II

Heritage and Stabilisation Fund
Portfolio Valuation and Cash flows (USD)

Valuation Date	Net Asset Value	Income	Contributions
March 15th, 2007	1,402,178,155.01	0	
March 31st, 2007	1,405,448,567.24	3,270,412.33	
April 30th, 2007	1,411,478,932.10	6,030,364.86	
May 31st, 2007	1,417,875,123.07	6,396,190.98	
June 30th, 2007	1,424,094,965.45	6,219,841.89	
July 31st, 2007	1,510,286,135.41	6,477,228.26	79,713,942.22
August 31st, 2007	1,517,179,218.56	6,893,083.09	
September 30th, 2007	1,766,200,701.73	6,928,748.59	241,992,101.13[1]
October 31st, 2007	1,773,862,028.73	7,759,113.00	
November 30th, 2007	1,780,847,020.73	6,987,839.67	
December 31st, 2007	1,788,304,749.27	7,457,728.54	–
January 31st , 2008	1,795,307,089.20	7,003,928.24	
February 29th, 2008	1,799,941,409.88	5,019,474.67	
March 31st, 2008	1,804,531,743.56	4,590,333.68	
April 30th, 2008	1,988,785,132.77	4,042,772.01	180,210,617.20
May 31st, 2008	1,993,347,377.77	4,562,245.00	
June 30th, 2008	1,997,251,772.00	5,476,329.00	
July 31st, 2008	2,460,269,502.00	4,599,453.00	458,130,174.00
August 31st, 2008	2,466,193,072.00	5,461,046.00	
September 30th, 2008	2,888,421,556.00	5,699,080.57	415,833,666.53

[1] The last quarter contribution for the fiscal year 2006/07 was paid on September 28, 2007.