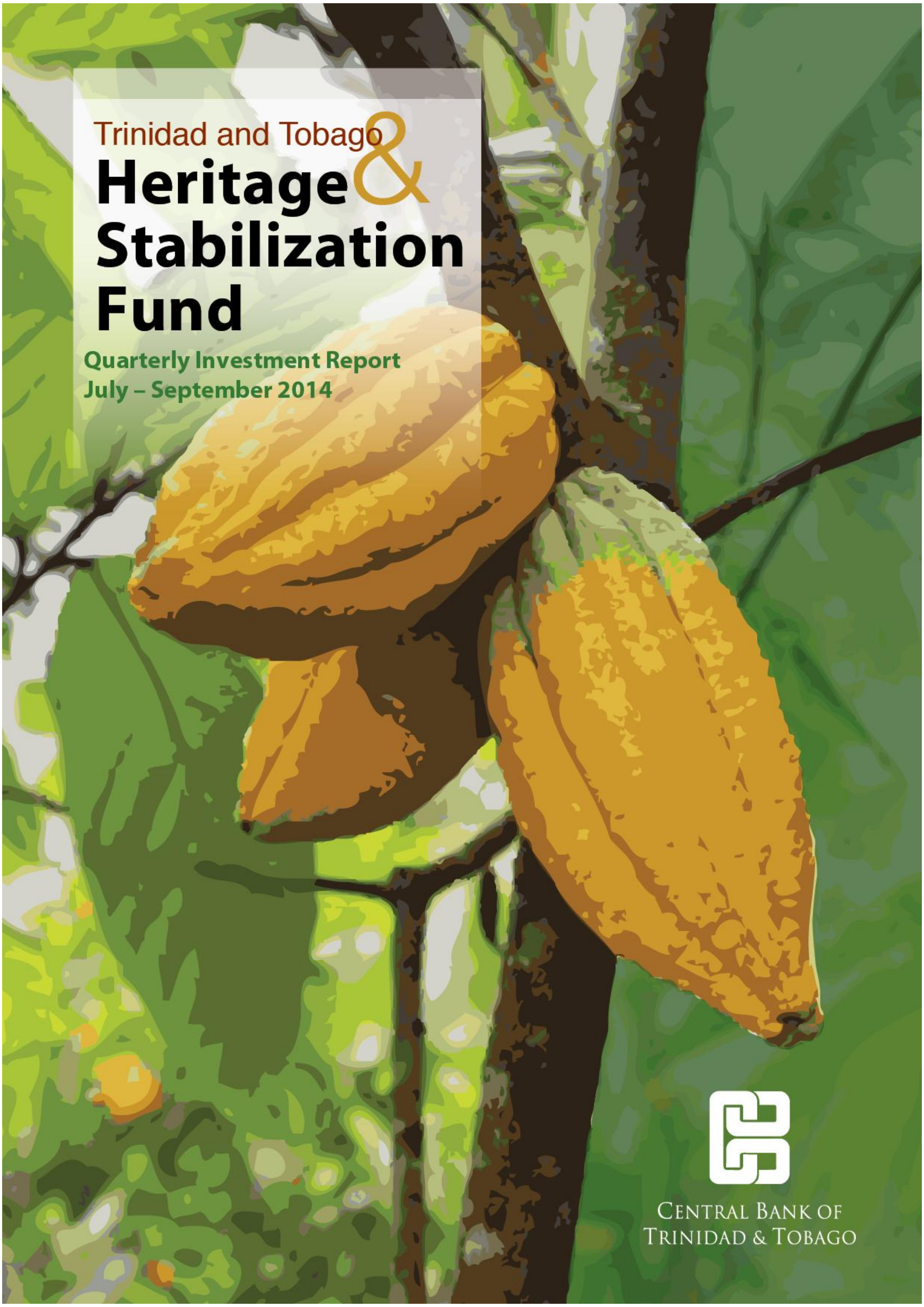
Trinidad and Tobago

# Heritage & Stabilization Fund

## Quarterly Investment Report
## July – September 2014



CENTRAL BANK OF
TRINIDAD & TOBAGO

**TABLE OF CONTENTS**


| | | Page |
|---|---|---|
| | Executive Summary | 1 |
| Section 1: | International Economic Environment | 5 |
| Section 2: | Capital and Money Market Review | 9 |
| Section 3: | Portfolio Performance | 16 |
| Section 4: | Compliance and Portfolio Risks | 22 |
| Appendix I: | HSF Portfolio Historical Performance since Inception | 25 |
| Appendix II: | Quarterly Portfolio Valuation | 26 |
| Appendix III: | Summary Characteristics of Composite Benchmarks | 27 |
| Appendix IV: | Summary of the Fund's Net Asset Value by Mandate | 28 |
| Appendix V: | HSF Portfolio Quarterly Returns | 29 |

**EXECUTIVE SUMMARY**

Economic data releases for the third quarter point to an improvement in economic activity in the **United States**. The unemployment rate fell from 6.1 per cent in June to 5.9 per cent in September. Notwithstanding this positive trend in unemployment, wage gains have been subdued and the labor-force participation rate was at a multi-decade low, standing at 62.7 per cent as of September.

On the policy front, the Federal Reserve (Fed) continued to pare its asset purchases by US$10 billion monthly. It is expected that the Fed's tapering will end at its October meeting with a final reduction of US15 billion.

In the **Euro zone**, the economy expanded by 0.10 per cent quarter-on-quarter in the second quarter, with the usual stalwart of Germany recording a contraction in GDP of 0.2 per cent. The periphery generally outperformed the core; Spain, Ireland and the Netherlands were bright spots in the region, however, France stagnated and both Germany and Italy contracted 0.2 per cent.

In its latest policy meeting, the ECB cut its benchmark interest rate to a record-low of 0.05 per cent and lowered its deposit rate to negative -0.20 per cent. The central bank also pledged to start buying covered bonds and asset backed securities, to spur economic growth.

Growth in the **United Kingdom** began to slow as an advanced reading showed that GDP grew by 0.7 per cent in the third quarter versus 0.9 per cent in the three months prior. Despite expectations for the U.K. to be the fastest growing economy in the G-7, investors remain cautious given potential headwinds in the form of sluggish growth in the euro zone and China.

In **Japan**, the economy surprised to the downside, contracting at an annualized rate of 7.1 per cent in the second quarter of 2014 versus an expected contraction of 7.0 per cent. This contraction, the largest in five years, was significantly influenced by the increased sales tax that was implemented in April. Bank of Japan (BOJ) Governor Haruhiko Kuroda continued however to reiterate his pledge to maintain the central bank's pace of monetary easing, especially in light of weak economic growth.

In the **currency market**, the British pound, the Euro and the Japanese yen all depreciated during the third quarter of 2014. Of these, the Euro was the weakest performer, depreciating by 7.75 per cent vis-à-vis the US dollar as deteriorating growth prospects and weak economic data prompted the ECB to expand its range of easy monetary policies. The Japanese yen depreciated by 7.59 per cent relative to the US dollar. The currency was influenced by Japanese investors seeking to increase their holdings of overseas stocks and bonds during the quarter.

The **US fixed income market** continued to add modest returns in the third quarter, especially on the long end of the US Treasury curve as the demand for safe haven assets increased following rising geopolitical risks. The 10-year US Treasury yield declined to 2.49 per cent by the end of the quarter from 2.53 per cent at the end of the previous quarter. The broader fixed income market, as measured by the Barclays Capital US Aggregate Bond index, returned 0.17 per cent over the quarter. This compares with a return of 2.04 per cent in the second quarter of 2014.

In **equity markets**, returns were mixed as markets in the US reached record highs during the quarter buoyed by improved economic data, while in Europe, markets declined as growth disappointed in the area. Equity markets continued to be supported by the ongoing accommodative monetary policies of developed nation central banks. In the US, the Standard and Poor's (S&P) 500 index rose by 0.62 per cent for the quarter while other developed market equities, as measured by the MSCI EAFE index, fell by 6.39 per cent over the quarter.

The HSF investment portfolio declined 0.48 per cent for the quarter ended September 2014, compared with a decline of 0.73 per cent for the Strategic Asset Allocation (SAA) benchmark. The Fund's exposures to fixed income contributed positively to absolute returns, while its equity exposure detracted from absolute returns. At the end of September 2014, the net asset value of the HSF was US$5,533.3 million, a decrease from the US$5,563.3 million reported at the end of June 2014.

## Contribution to Quarterly Return, For the period July 2014 – Sept 2014 /per cent/

| | SAA Weights | Portfolio Weights as at 30-Sept-2014 | Weighted Return HSF | Weighted Return Benchmark |
|---|---|---|---|---|
| **Composite Portfolio** | 100.00 | 100.00 | -0.48 | -0.73 |
| **US Core Domestic Fixed Income** | 40.00 | 37.52 | 0.06 | 0.07 |
| **US Core Domestic Equity** | 17.50 | 21.33 | 0.22 | 0.19 |
| **Non US Core International Equity** | 17.50 | 18.68 | -0.74 | -0.97 |
| **US Short Duration Fixed Income** | 25.00 | 22.47 | 0.00 | -0.01 |

NB: Differences in totals are due to rounding.

## Comparative Quarterly Returns
## For the Quarters ended March 2014 – September 2014
## /per cent/

| | 3 Months Weighted Return as at 30-Sept-2014 | | 3 Months Weighted Return as at 30-Jun-2014 | | 3 Months Weighted Return as at 31-Mar-2014 | |
|---|---|---|---|---|---|---|
| | **HSF** | **Bench-mark** | **HSF** | **Bench-mark** | **HSF** | **Bench-mark** |
| **Composite Portfolio** | -0.48 | -0.73 | 2.56 | 2.30 | 1.46 | 1.30 |
| **US Core Domestic Fixed Income** | 0.06 | 0.07 | 0.78 | 0.81 | 0.72 | 0.74 |
| **US Core Domestic Equity** | 0.22 | 0.19 | 0.89 | 0.72 | 0.39 | 0.37 |
| **Non US Core International Equity** | -0.74 | -0.97 | 0.75 | 0.62 | 0.28 | 0.14 |
| **US Short Duration Fixed Income** | 0.00 | -0.01 | 0.12 | 0.14 | 0.08 | 0.06 |

## Comparative Financial Year to Date Returns
## For the periods Sept 2013 & Sept 2014
## /per cent/

| | Financial Year to Date Return as at 30-Sept-2014 | | Financial Year to Date Return as at 30-Sept-2013 | |
|---|---|---|---|---|
| | **HSF** | **Bench-mark** | **HSF** | **Bench-mark** |
| **Composite Portfolio** | 7.65 | 5.60 | 8.63 | 7.26 |

## SECTION 1 – INTERNATIONAL ECONOMIC ENVIRONMENT

***United States***

The United States (US) economy rebounded in the second quarter of 2014 as gross domestic product (GDP) grew at an annualized rate of 4.6 per cent, following a severe first quarter contraction of 2.1 per cent. During the second quarter, household spending and greater business investment on equipment and properties spurred activity. Over the past three months, broad based manufacturing gains, rising consumer confidence and lower unemployment bode well for U.S. economic conditions. Growth is expected to follow a more moderate path going forward with the Federal Reserve's GDP forecast for 2014 currently at 2.0 – 2.2 per cent.

After a disappointing August, nonfarm payrolls increased by 248,000 in September and the unemployment rate declined from 6.1 per cent in June to 5.9 per cent in September. Despite a lower unemployment rate, concerns persist regarding the state of the labour market as wage gains have been subdued and the labor-force participation rate is at a multi-decade low, standing at 62.7 per cent as of September.

On the policy front, the Fed continued to taper its bond buying program, lowering its purchases by an additional $10 billion in September. The bond purchase program is expected to conclude in October, with a final reduction of $15 billion. At the Fed's September meeting, the committee continued to believe that "it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends". Though the phrase "considerable time" is widely translated to mean mid-2015, there is some speculation that the Fed could delay the timing of its first rate hike. Pricing pressures waned over the third quarter, as the consumer price index (CPI) decreased from 2.1 per cent in June to 1.7 per cent in September. In addition, concerns about the global slowdown and the appreciating U.S. dollar, strengthen the case for the Fed to maintain its low interest rate environment.

***Euro zone***

In the second quarter, the Euro Area economy expanded 0.10 per cent quarter-on-quarter under the new ESA 2010 rules. Household consumption rose over the April-June period but a fall in fixed capital investment detracted from GDP. The periphery generally outperformed the core. Spain, Ireland and the Netherlands were bright spots in the region, however, France stagnated and both Germany and Italy contracted 0.2 per cent. Germany, often considered Europe's growth engine, experienced negative growth for the first time in over a year. The slowdown was partly due to weather-related factors and a sharp fall in exports, which stemmed from sanctions against Russia and a general slowdown both in the euro region and globally.

During the third quarter, the outlook for the area worsened. The Markit Euro Area Composite PMI fell from 52.8 in June to 52 in September, with both the Manufacturing and Services PMI posting declines. Inflation in the region continued to deteriorate, falling from 0.5 per cent in June to 0.3 per cent in September, its lowest level in five years.

There has been little overall improvement in the labour market, as unemployment in August was unchanged from June at 11.5 per cent. There continued to be a disparity among member states, with the jobless rate in Spain at 24.4 per cent, whereas Germany recorded an unemployment rate of 4.9 per cent.

On the policy front, the European Central Bank (ECB) has taken several steps towards expanding credit conditions in the region. In September, the ECB surprised markets by cutting deposit rates by an additional 10 basis points to -0.20 per cent; it also unveiled plans to acquire asset-backed securities and covered bonds. At the October meeting, the ECB disappointed markets, as they failed to provide additional clarity on the size of its private sector asset purchase program. Though president Mario Draghi had previously suggested that the ECB would like to expand its balance sheet by approximately 1 trillion euros, markets are dubious whether this can be achieved without engaging in sovereign bond buying. However, given the existing range of policies, many investors believe that the ECB will wait to assess the efficacy of their current measures before introducing any additional stimulus.

### *United Kingdom*

The preliminary estimate of third quarter GDP confirmed that pace of growth in the United Kingdom was moderating. GDP rose 0.7 per cent in the three months to September compared to 0.9 per cent in the second quarter. Though activity was widely expected to ease during the second half of 2014, the softening of economic data added to concerns about potential risks to the U.K. economy. Despite expectations for the U.K. to be the fastest growing economy in the G-7, investors remain cautious given likely headwinds in the form of sluggish growth in the euro zone and China.

In the labor market, the unemployment rate fell to 6.0 per cent as at August 2014, the lowest since late 2008, compared to the end of the previous quarter when it was 6.4 per cent. Despite a pick-up in hiring, wage growth is expected to remain muted without significant productivity gains. In August, wages grew 0.7 per cent from a year earlier, whereas pay excluding bonuses was 0.9 per cent higher.

Inflation continued to be subdued, with the Consumer Price Index falling from 1.9 per cent in June to 1.2 per cent in the year to September. Lower food and fuel costs as well as a fall in recreational goods prices contributed to weaker inflation.

At its October Monetary Policy meeting, the Bank of England (BOE) left its benchmark interest rate unchanged. However, the committee has been split since August, with two members voting for a 25 basis point rate hike. The Bank of England Governor, Mark Carney, signaled in September that the time for a rate rise is nearing, but the exact date will depend on the data. The minutes of the meeting revealed that policymakers had concerns about the slowdown in Europe, and the absence of inflationary pressures in the U.K. Many investors were expecting an interest rate increase around spring 2015, but the dovish tone of the minutes has strengthened the case for the BOE to wait a little longer.

### *Japan*

The Japanese economy contracted at an annualized rate of 7.1 per cent in the second quarter of 2014, as capital expenditures and household spending suffered deep declines following the April sales tax increase.

In other economic developments, the anticipated third quarter rebound appears less likely. Industrial production unexpectedly fell in August and Japan's trade deficit widened in September, as a weaker Yen boosted exports, but also increased the import bill by a greater margin. In addition to the sales tax, weather related events may have dampened consumer demand in the third quarter, with household spending falling 4.70 per cent year on year in August. Though an additional sales tax increase is currently scheduled for October 2015, Prime Minister Shinzo Abe has suggested that a delay may be warranted depending on the data.

Overall, the labor market in Japan remains tight, with the job-to-applicant ratio at 1.10 as at August 2014. The jobless rate fell from 3.7 per cent in June to 3.5 per cent in August but wage growth continued to lag inflation, placing additional pressure on the consumer.

There was little development on the monetary policy front as the Bank of Japan (BOJ) left policy unchanged in October. While the BOJ reiterated its belief that the economy will continue to recover moderately, the Policy Board acknowledged that there was "some weakness particularly on the production side". While a weakening Yen could be positive for exports, the recent soft economic data call into question the Bank of Japan's general optimism. Markets are less certain about Japan's prospects, especially given slowing inflation, which the BOJ indicated could potentially fall below 1.0 per cent. Excluding the tax increase, consumer prices rose 1.1 per cent in August compared to 1.3 per cent in June. Though the BOJ has not formally adjusted the timeframe for achieving its 2.0 per cent inflation target, Governor Haruhiko Kuroda suggested that the bank will maintain its commitment to expand the monetary base by 60-70 trillion yen annually, for as long as necessary.

## SECTION 2 – CAPITAL AND MONEY MARKET REVIEW

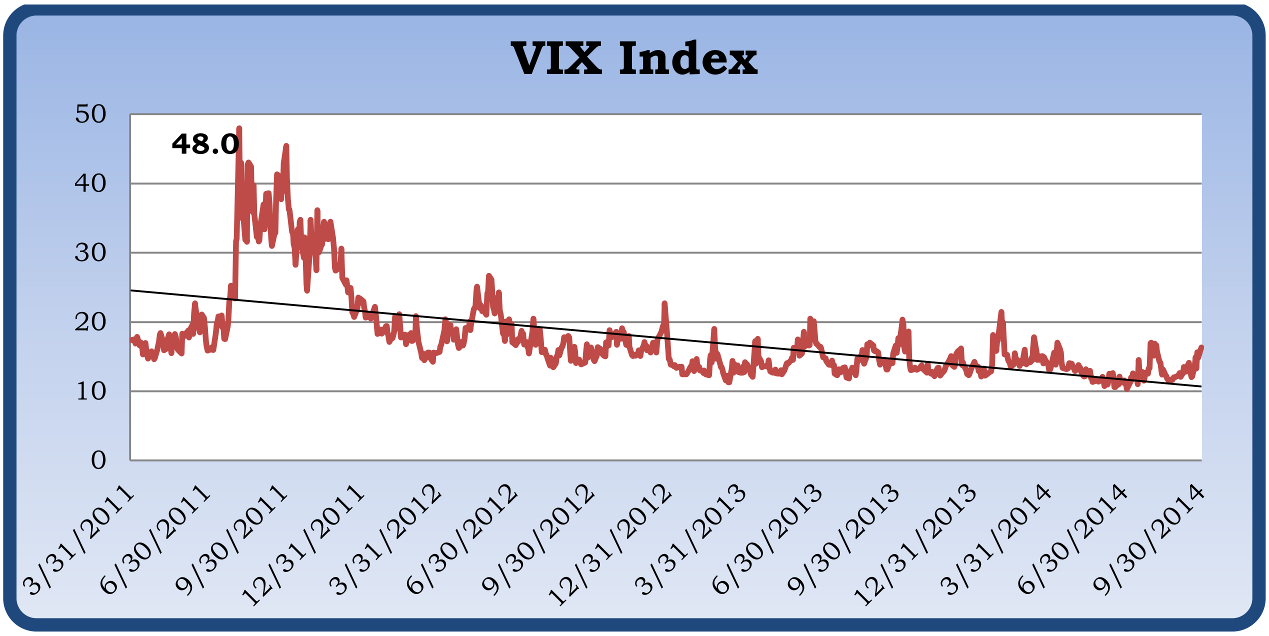
During the third quarter of 2014, the U.S. Treasury curve twisted as the 2-7 year section of the curve tilted upward, while the long end of the curve flattened as 10-year and 30-year yields declined. Accordingly, the demand for safe haven assets meant that the longer-term Treasuries rates declined, while shorter-term rates crept up in anticipation of the Federal Reserve hiking rates as early as mid-2015.

Other developed sovereign bond yields continued to trend lower over the quarter. European yields had the greatest declines, as some central banks continued to move further into negative reference rate territory (the European Central Bank) and others left their accommodative stances unchanged. Italian 10-year rates declined the most among the G-7 nations, falling by 51.30 basis points to end the quarter at 2.33 per cent. In the UK, Gilt yields headed lower early in the quarter but reversed course in September, as the economy improved over the period and a Central Bank rate hike became more probable in the future.

After a strong performance in the second quarter, developed equity markets posted mixed results in the third quarter of 2014. In the US, equity markets rallied modestly with the only outlier being the Russell 3000, which dipped slightly for the quarter. Developed markets in Europe were also mixed, as Germany, UK and Italy lagged behind the forerunners in Japan, Switzerland and the Netherlands. Overall, developed equity markets as measured by the MSCI EAFE declined over the third quarter.

The Chicago Board Options Exchange Volatility Index (VIX), which is a proxy for investor anxiety and market risk, spiked during the third quarter of 2014 ending the period at 16.31 points, up from 11.57 points at the end of the second quarter of 2014. The VIX reached a high for the quarter of 17.03 points at the beginning of August, over ongoing violence in the Middle East and a resumption of tensions between Ukraine and Russia.

**Figure 1**
**Market Volatility in the US**
**/points /**

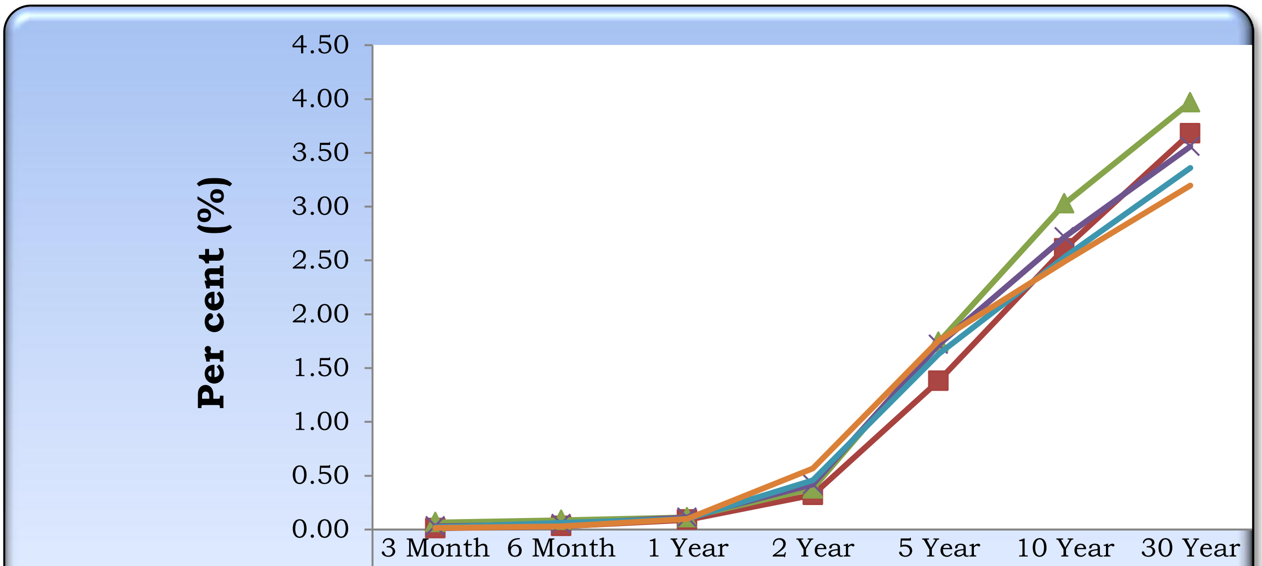



Source: Bloomberg.

***U.S. Fixed Income***

During the third quarter, heightened anxiety about the timing of the Fed's first rate hike and the volatile geopolitical landscape resulted in greater rate movements over the period. The U.S. Treasury curve flattened further and spreads narrowed 15.10 basis points in the 2-10 year portion of the curve. Yields at the long end of the curve were suppressed with the 30-year falling 16.3 basis points to 3.20 per cent. Geopolitical tensions, deteriorating fundamentals in Europe and falling global bond yields increased the appeal of long-dated U.S. treasuries. However, yields in the 2-7 year portion of the curve increased modestly, reflecting fears that the Fed may increase rates earlier than anticipated. At the short-end of the curve, quarter-end funding pressures coupled with a limited supply of short-term safe assets resulted in lower yields.

**Figure 2**
**US Treasury Yield Curve**
**/per cent/**



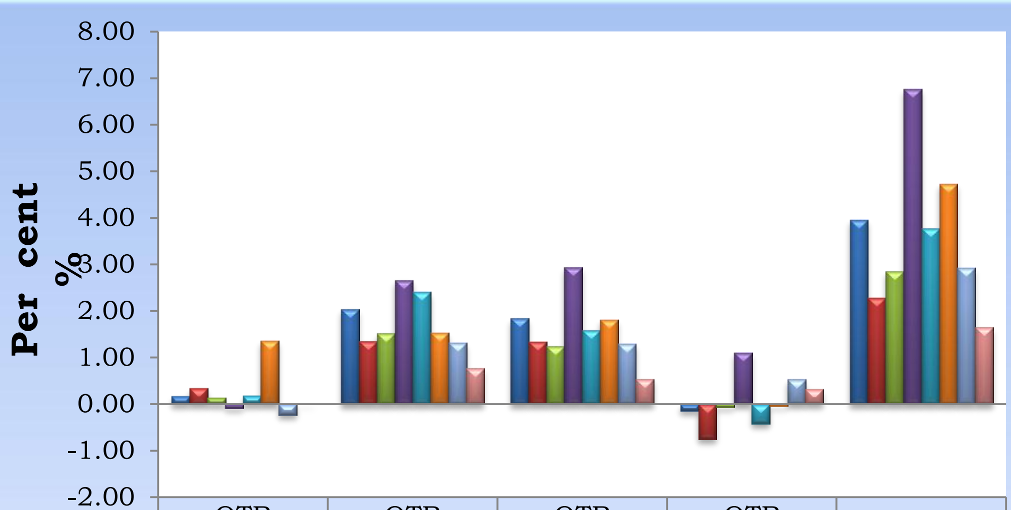

| | 3 Month | 6 Month | 1 Year | 2 Year | 5 Year | 10 Year | 30 Year |
|---|---|---|---|---|---|---|---|
| September 30, 2013 | 0.01 | 0.03 | 0.09 | 0.32 | 1.38 | 2.61 | 3.68 |
| December 31, 2013 | 0.07 | 0.09 | 0.11 | 0.38 | 1.74 | 3.03 | 3.97 |
| March 31, 2014 | 0.03 | 0.05 | 0.11 | 0.42 | 1.72 | 2.72 | 3.56 |
| June 30, 2014 | 0.02 | 0.06 | 0.10 | 0.46 | 1.63 | 2.53 | 3.36 |
| September 30, 2014 | 0.02 | 0.03 | 0.10 | 0.57 | 1.76 | 2.49 | 3.20 |

Source: Bloomberg.

The broader US fixed income, as measured by the Barclays Capital US Aggregate Bond index returned 0.17 per cent over the third quarter. The general risk-off environment hurt spread product performance; spreads widened modestly amid heightened volatility, slowing global growth and geopolitical risks overseas. Spread products underperformed similar-duration treasuries and in the U.S. Corporate Investment grade sector, lower-quality Baa corporates generally underperformed higher quality A-rated issues.

US Corporates declined 0.08 per cent versus 0.34 per cent increase for US Treasuries. CMBS securities declined 0.23 per cent, while ABS securities were relatively flat for the quarter. G-7 Global Sovereign bonds returned 1.36 per cent as global developed bond yields declined over the quarter.

**Figure 3**
**Returns on Fixed Income Indices**
**/per cent/**




| | QTR ended Sept-14 | QTR ended Jun-14 | QTR ended Mar-14 | QTR ended Dec-13 | FY 13/14 |
|---|---|---|---|---|---|
| Barclays U.S. Aggregate | 0.17 | 2.04 | 1.84 | -0.14 | 3.96 |
| U.S. Treasuries | 0.34 | 1.35 | 1.34 | -0.75 | 2.28 |
| U.S. Agencies | 0.13 | 1.52 | 1.24 | -0.06 | 2.85 |
| U.S. Corporate | -0.08 | 2.66 | 2.94 | 1.11 | 6.77 |
| U.S. MBS | 0.18 | 2.41 | 1.59 | -0.42 | 3.78 |
| G-7 Global Bonds (Hedged) | 1.36 | 1.53 | 1.81 | -0.04 | 4.73 |
| CMBS Index | -0.23 | 1.31 | 1.29 | 0.53 | 2.93 |
| ABS Index | 0.01 | 0.77 | 0.54 | 0.32 | 1.65 |

Source: Barclays Capital.

***Global Fixed Income Markets***

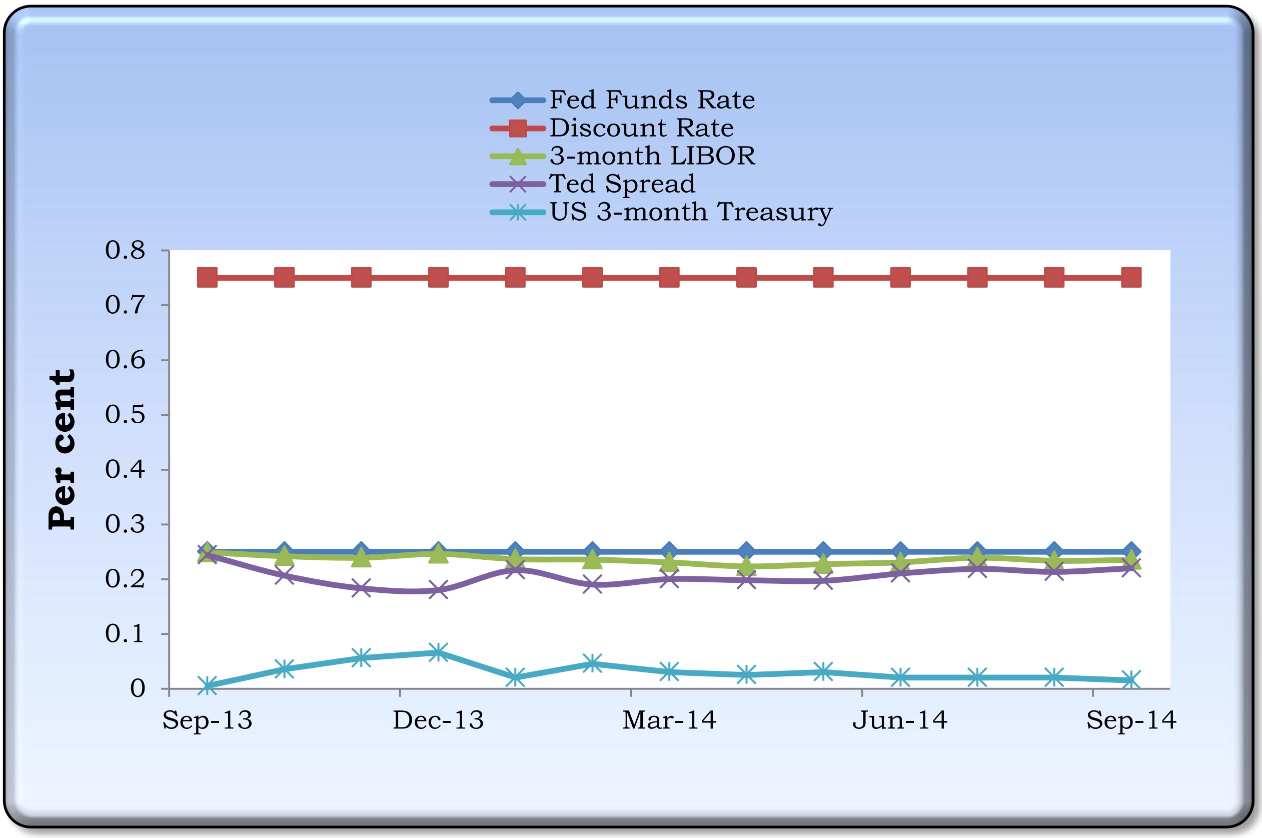
Developed sovereign bond yields continued to trend lower over the quarter. In the Eurozone, the ECB announced several initiatives during the quarter targeted at the anemic growth and waning inflationary pressures in the region. The additional 10 bps rate cut as well as the Asset Backed Securities and Covered Bond purchase programs pushed euro-area bond rates lower. In addition to the region's deteriorating fundamentals, the escalating conflict between Russia and Ukraine resulted in near term headwinds as harsher sanctions hampered countries with export driven economic growth. German 10-year bunds fell below 1.00 per cent to 0.95 per cent and Italian 10-year bonds fell 51.30 bps over the period to end the quarter at 2.33 per cent.

In the UK, broader global macro concerns weighed on yields into the end of August. Once a cease-fire was reached between Ukraine and pro-Russian rebels, rates moved modestly higher but gains were somewhat tempered by the Scottish referendum for independence and general euro area malaise.

***Money Market***

Short-term interest rates declined during the second quarter of 2014 as the major central banks maintained their accommodative monetary stance. The 3-month US Treasury bill rate remained relatively flat at 0.02 per cent at the end of the third quarter while the 3-month London Inter-Bank Offered Rate (LIBOR) was also relatively unchanged at 0.23 per cent.

**Figure 4**
**US Money Market Rates**
**/per cent/**




Source: Bloomberg

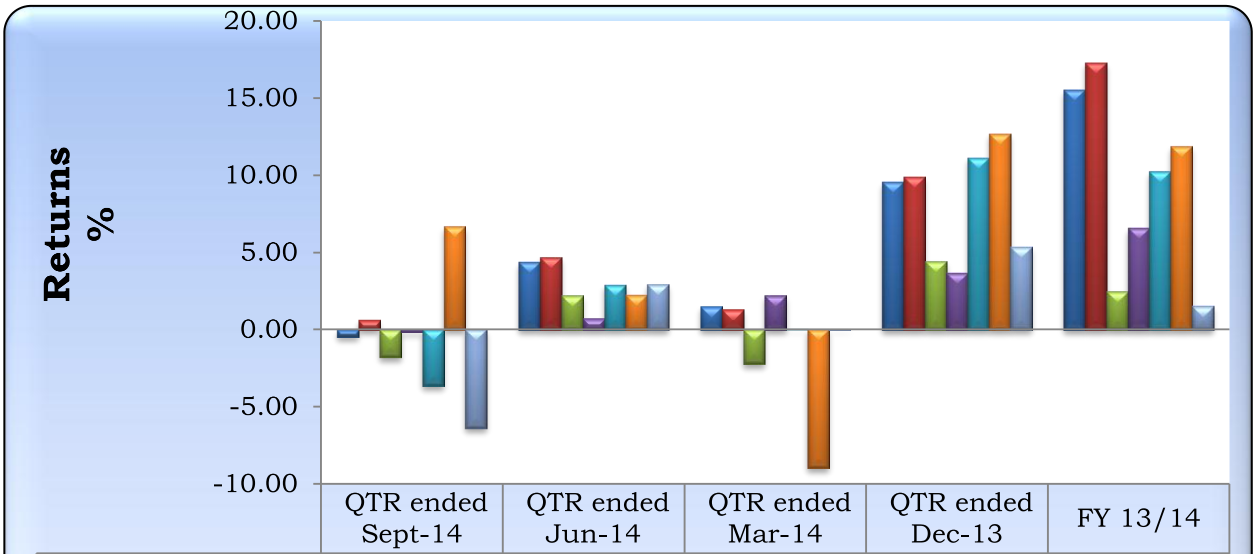
### *Equity Markets*

Following a strong second quarter, equity markets were mixed during the third quarter of 2014 as volatility was re-introduced into the market after a relatively sanguine first half. In the U.S., following a sell-off at the end of July, equity markets recovered in August, only to incur losses again in September. In addition to the turmoil in various parts of the world, the recent U.S. dollar strength as well as the improving outlook for the U.S. economy and the implications for that on U.S. monetary policy drove equity markets over the quarter. Large cap companies outperformed small cap companies with the S&P 500 gaining 0.62 per cent while the Russell 3000 declined 0.46 per cent. There was a wide divergence among sectors in the S&P 500 index; Healthcare was the best performing sector returning 5.45 per cent over the period, whereas Energy lost 8.62 per cent.

The MSCI EAFE (USD) fell 6.39 per cent mostly due to negative currency returns in the Euro and the Yen. The German DAX 30 was down 3.65 per cent over the quarter, as disappointing economic data weighed on investor sentiment. In the UK, most of the losses occurred in September, when slowing growth in China and a strengthening U.S. Dollar resulted in significant underperformance in the energy and material sectors.

In Japan, the Nikkei rose 6.67 per cent over the quarter. A weaker Yen lifted the outlook for exporters and a potential change to Japan's Government Pension Investment Fund allocation was generally supportive of equities.

**Figure 5**
**Price Returns on Equity Indices**
**/Per cent/**




| | QTR ended Sept-14 | QTR ended Jun-14 | QTR ended Mar-14 | QTR ended Dec-13 | FY 13/14 |
|---|---|---|---|---|---|
| Russell 3000 | -0.46 | 4.37 | 1.50 | 9.56 | 15.54 |
| S&P 500 | 0.62 | 4.69 | 1.30 | 9.92 | 17.29 |
| FTSE 100 - UK | -1.80 | 2.21 | -2.23 | 4.44 | 2.48 |
| CAC 40 - France | -0.15 | 0.71 | 2.22 | 3.68 | 6.58 |
| DAX 30 - Germany | -3.65 | 2.90 | 0.04 | 11.14 | 10.24 |
| Nikkei 225 - Japan | 6.67 | 2.25 | -8.98 | 12.70 | 11.88 |
| MSCI EAFE | -6.39 | 2.95 | 0.00 | 5.36 | 1.53 |

Source: Bloomberg

***Currency Markets***

The U.S. dollar's rally against other major currencies was the main narrative in the FX markets during the third quarter. The Euro, pound and Yen all weakened relative to the U.S. dollar (USD), with the greatest losses occurring in September. The improving economic outlook for the U.S. and expectation that the U.S. Fed would start to raise rates by mid-2015 provided the impetus for USD strength.

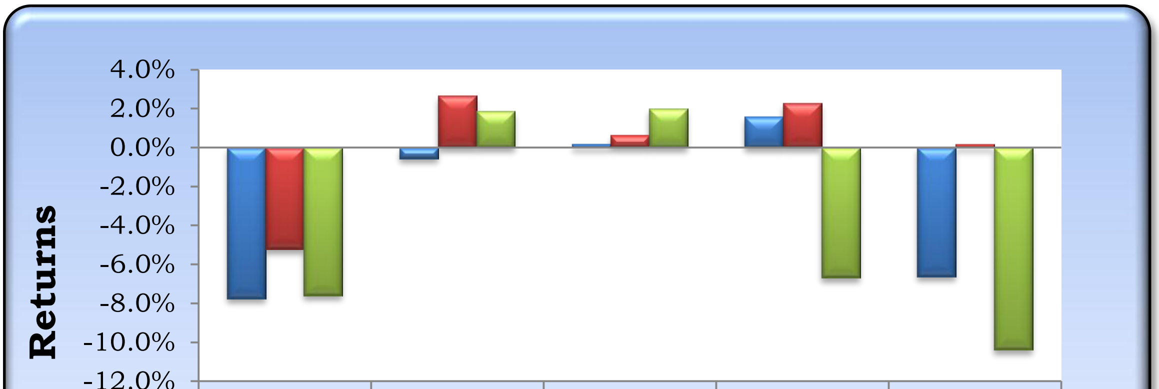
The Euro currency fell 7.75 per cent as deteriorating growth prospects and weak economic data prompted the ECB to expand its range of easy monetary policies.

Following a strong second quarter, the pound depreciated 5.22 per cent in the third quarter. After bringing forward expectations for a rate rise, the BOE adjusted its message, pushing the timing for the first rate hike into spring 2015. In September, the sterling experienced short-term selling pressure ahead of the Scottish independence referendum. Though the currency quickly recovered, the trend was still lower as investors digested the idea that the U.K. economy had lost some of its momentum at a time when the euro zone appeared to be stagnating.

After benefitting from safe haven flows early in the year, the Yen declined 7.59 per cent in the third quarter. As the Japanese economy struggles to recover from its April sales tax increase, investors believe that the Bank of Japan will need to provide additional stimulus ahead of the second sales tax increase, which is currently scheduled for October 2015. The Yen also came under pressure as Japanese investors sought to increase their holdings of overseas stocks and bonds during the quarter.

**Figure 6**

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




| | QTR ended Sept-14 | QTR ended Jun-14 | QTR ended Mar-14 | QTR ended Dec-13 | FY 13/14 |
|---|---|---|---|---|---|
| EUR | -7.75% | -0.56% | 0.19% | 1.60% | -6.62% |
| GBP | -5.22% | 2.66% | 0.63% | 2.29% | 0.17% |
| JPY | -7.59% | 1.88% | 2.01% | -6.69% | -10.38% |

Source: Bloomberg

## SECTION 3 – PORTFOLIO PERFORMANCE

***Strategic Asset Allocation***

During the period July 2014 to September 2014, the asset classes of the Fund deviated from their Strategic Asset Allocation (SAA) and the US Core Domestic Equity mandate exceeded permitted (+/- 5 per cent) range. As at July 31, 2014, the US Core Domestic Equity Mandate had an allocation of 22.65 per cent, or 5.15 per cent above the SAA of 17.50 per cent. 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 historically when compared with their fixed income counterparts. At the end of August, the portfolio was re-balanced to within the permitted SAA range for each of the mandates. A total of US$202.6 million was withdrawn from the two equity mandates and deposited with the two fixed income mandates as at the end of August 2014.

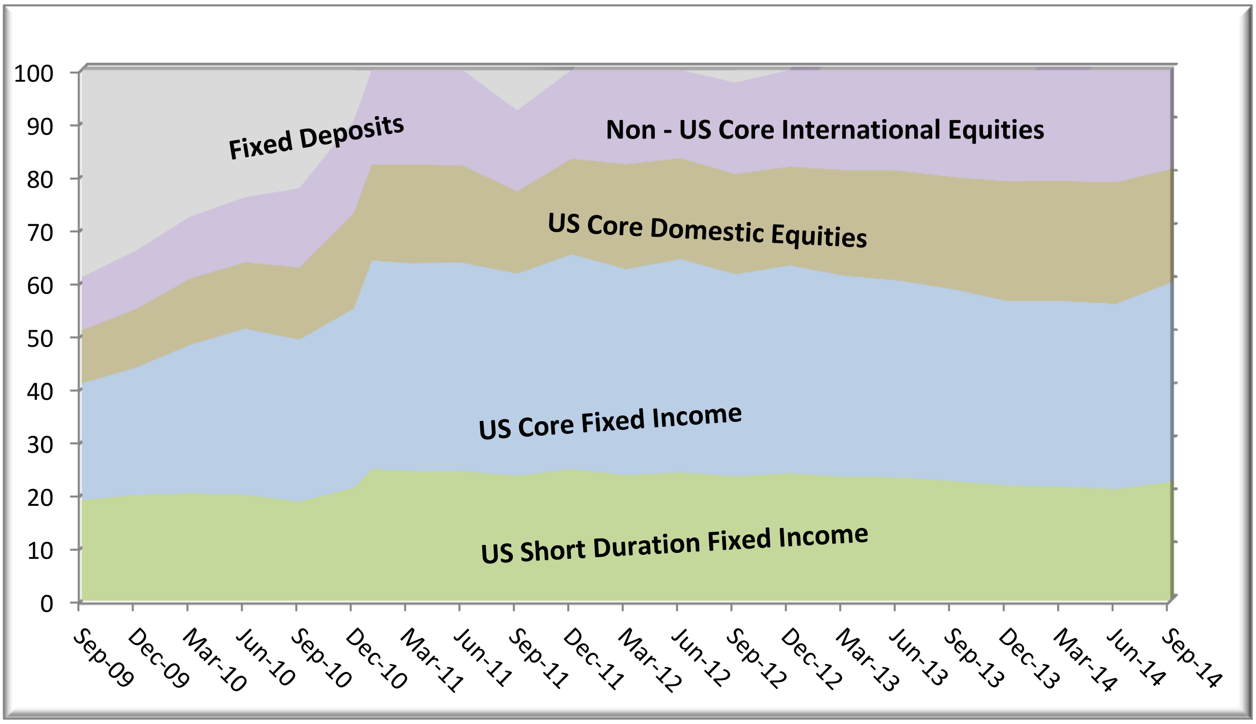
By the end of the quarter, the asset class with the largest overweight was the US Core Domestic Equity mandate while the US Core Fixed Income mandate had the largest underweight position. All mandates were within the permitted SAA range at the end of the quarter.

The total net asset value of the Fund as at the end of September 2014 totaled US$5,533.3 million, compared with US$5,563.3 million at the end of the previous quarter. Of this total, the investment portfolio was valued at US$5,531.9 million, while the remaining portion (US$1.5 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 weightings for the period September 30, 2013 to September 30, 2014 are shown in Table 1, overleaf.

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

| | Asset Class | | Dec-13 | Mar-14 | Jun-14 | Sept-14 |
|---|---|---|---|---|---|---|
| | | Target Weight SAA | Actual % of Fund | Actual % of Fund | Actual % of Fund | Actual % of Fund |
| Portfolio Weights | Cash | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| | US Short Duration Fixed Income | 25.00 | 21.76 | 21.53 | 21.09 | 22.47 |
| | US Core Domestic Fixed Income | 40.00 | 34.80 | 35.01 | 34.93 | 37.52 |
| | US Core Domestic Equity | 17.50 | 22.49 | 22.56 | 22.87 | 21.33 |
| | Non-US Core International Equity | 17.50 | 20.95 | 20.90 | 21.12 | 18.68 |

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



***Performance of the Investment Portfolio***

For the third quarter of 2014, the HSF investment portfolio declined 0.48 per cent, compared with a decline of 0.73 per cent for the SAA benchmark[1]. This outperformance of 25 basis points can be attributed to favorable security selection while the deviation between the portfolio and SAA weightings detracted from overall performance. The HSF portfolio's quarterly return was primarily impacted by the equity mandates which detracted 0.52 per cent, while the fixed income portion of the Fund contributed 0.06 per cent.

The **US Short Duration Fixed Income** portfolio posted decline of 0.02 per cent during the third quarter of 2014, outperforming its benchmark, the Bank of America Merrill Lynch US Treasury 1-5 year index, by four basis points. This outperformance was attributed to the portfolio's exposure to spread products and non-US government bonds as well as interest rate decisions made during the quarter (i.e. the portfolio having a duration less than that of the benchmark). Slightly detracting from performance were the portfolio's breakeven inflation positions. The net asset value of this mandate as at September 30, 2014 was **US$1,243.1 million,** compared with US$1,172.8 million at the end of the previous quarter. A contribution of US$70.9 million was added in August 2014.

The longer duration fixed income mandate which consists of **US Core Fixed Income** securities, posted a return of 0.17 per cent during the third quarter of 2014, outperforming its benchmark, the Barclays Capital US Aggregate Bond index, by one basis point. The outperformance of this portfolio relative to the benchmark was due to security selection of the Mortgage Backed and Corporate securities as well as sector allocation. Interest rate decisions however, detracted from performance during the quarter. The net asset value of this mandate as at September 30, 2014 increased in comparison to the previous quarter, totaling **US$2,075.6 million** compared with US$1,942.1 million as at June 30, 2014. A contribution of US$131.7 million was added to this mandate in August 2014.

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[1] The SAA benchmark is a blended benchmark which comprises, Bank of America/Merrill Lynch US Treasury 1-5 Years Index (25%), Barclays US Aggregate Bond Index (40%), Russell 3000 ex Energy Index (17.5%), and MSCI EAFE ex Energy Index (17.5%).

The **Non-US International Equities** mandate declined 3.78 per cent for the third quarter of 2014, compared with a decline of 5.46 per cent for its benchmark, the MSCI EAFE ex Energy index. This outperformance was due to positive stock selection, favourable currency hedging against the euro and yen and positive sector allocation. The largest impact from stock selection stemmed from holdings in the Health Care and Consumer Discretionary sectors. Additionally, allocations to Japan and Norway also benefited the portfolio. The net asset value of the Non-US Core International Equity mandate as at September 30, 2014 shrank to **US$1,033.4 million**, from US$1,174.2 million at the end of June 2014. US$98.4 million was withdrawn from this mandate in August 2014.

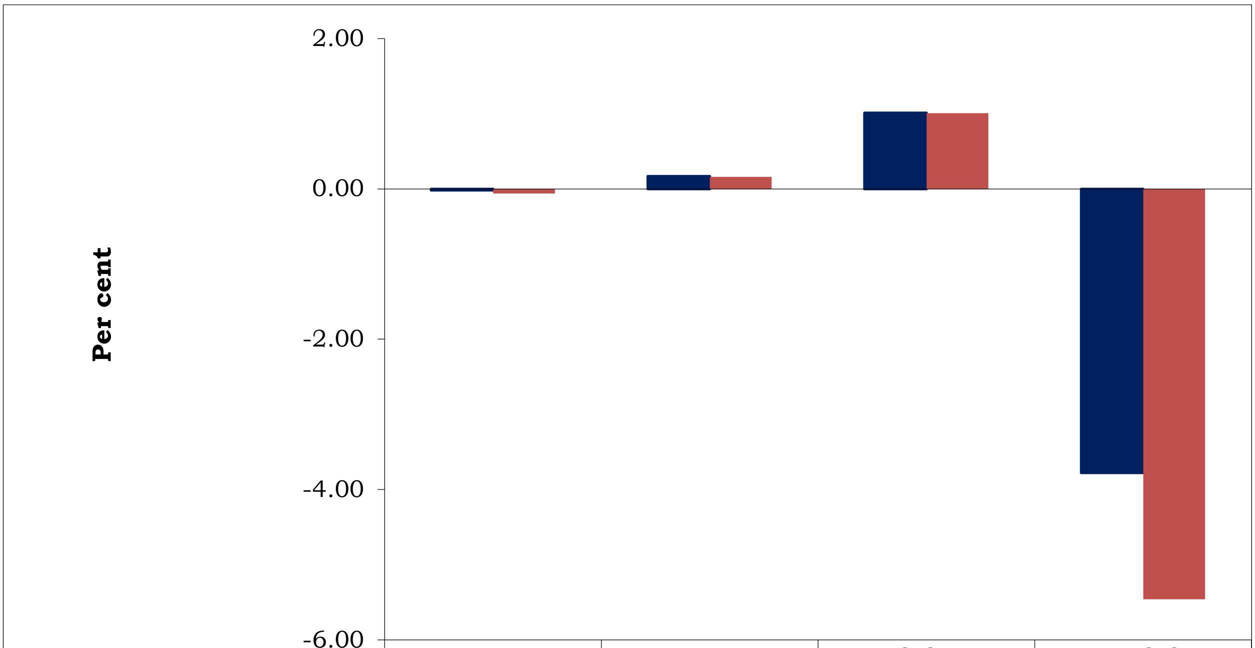
The **US Core Domestic Equities** mandate returned 1.01 per cent, compared with a benchmark return of 1.01 per cent. Sector allocations to the Financial Services and Consumer Discretionary sectors during the period contributed positively to performance, while stock selection detracted from performance. The net asset value of this mandate, as at September 30, 2014, was **US$1,179.8 million**, compared with US$1,271.7 million at the end of June 2014. US$104.6 million was withdrawn from this mandate in August 2014.

**Table 2**
**Contribution to Quarterly Return,**
**For the period July 2014 – Sept 2014**
**/per cent/**

| | SAA Weights | Portfolio Weights as at 30-Sept-2014 | Weighted Return HSF | Weighted Return Benchmark |
|---|---|---|---|---|
| **Composite Portfolio** | 100.00 | 100.00 | -0.48 | -0.73 |
| **US Core Domestic Fixed Income** | 40.00 | 37.52 | 0.06 | 0.07 |
| **US Core Domestic Equity** | 17.50 | 21.33 | 0.22 | 0.19 |
| **Non US Core International Equity** | 17.50 | 18.68 | -0.74 | -0.97 |
| **US Short Duration Fixed Income** | 25.00 | 22.47 | 0.00 | -0.01 |

NB: Differences in totals are due to rounding.

**Figure 8**
**Absolute Returns by Asset Class**
**For the period July 2014 – Sept 2014**
**/per cent/**




| | US Short Duration | US Core Fixed Income | US Core Domestic Equities | Non US Core International Equities |
|---|---|---|---|---|
| Composite Portfolio Return | -0.02 | 0.17 | 1.01 | -3.78 |
| SAA Benchmark Return | -0.06 | 0.16 | 1.01 | -5.46 |

Mandate

## SECTION 4 –COMPLIANCE AND PORTFOLIO RISKS

### Compliance

At the end of July 2014, the US Core Domestic equity mandate exceeded the maximum 5.0 per cent variation from the Strategic Asset Allocation. Following a review of the maximum allowable variation from the SAA given current market conditions and the outlook for the various asset classes, the Fund was rebalanced to within the allowable 5.0 per cent variation for all mandates by the end of August 2014.

During the month of August 2014, one of the managers of the US Core Fixed Income mandate breached the maximum threshold for private placements/144A bonds in the portfolio. This breach was due to voluntary participation in a bond exchange program, where at initiation of the program the portfolio was in compliance with the threshold for private placements. Subsequent activity in the portfolio between the initiation and execution of the bond exchange program caused the threshold to be breached during the month. This breach which did not adversely impact the portfolio, was corrected the following day as a result of an increase in the overall portfolio value which consequently increased the maximum threshold for this type of security.

One of the managers of the US Core Fixed Income mandate breached the maximum threshold for outstanding debt for a security in the portfolio. This breach was due to pay-downs in an ABS/MBS trust reducing the overall trust ending balance at the end of August. Because of the breach, the manager sold the position at a gain to bring the portfolio back into compliance.

One of the managers of the US Core Domestic Equity mandate purchased shares in a drug company that was subsequently acquired by another entity for a combination of cash up front and an additional amount payable and contingent upon the regulatory approval of a new drug. The contingent portion of the purchase price is not tradable until the regulatory approvals are completed at which time the position will be fully liquidated.

### 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***

Within 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, 2014.

**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 over a range of market conditions and lowering 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, 2014.

**Table 4**
**Weighted Average Duration**
**/Years/**

| Mandate | Portfolio | Benchmark |
|---|---|---|
| **US Short Duration** | **2.36** | **2.70** |
| **US Core Domestic Fixed Income** | **4.92** | **5.36** |

***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 2014, the currency exposure for this portfolio was 98 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 |
| **FY 2014** | | | | | | | | | |
| December | 3.95 | 2.66 | 129.38 | 3.95 | 2.66 | 129.38 | 5.80 | 5.37 | 42.67 |
| March | 1.46 | 1.30 | 16.28 | 5.47 | 4.00 | 147.73 | 5.80 | 5.37 | 43.52 |
| June | 2.56 | 2.30 | 25.90 | 8.17 | 6.38 | 178.44 | 5.96 | 5.51 | 45.76 |
| September | -0.48 | -0.73 | 25.31 | 7.65 | 5.60 | 204.51 | 5.69 | 5.22 | 47.69 |

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
# Portfolio Valuation (USD)

| Valuation Date | Net Asset Value | Quarterly Income | Accumulated Surplus & Unrealized Capital Gains/Losses | Contributions |
|---|---|---|---|---|
| **Annual Portfolio Valuation** | | | | |
| September 30, 2007 | 1,766,200,701 | 41,966,361 | 41,966,361 | 321,706,043 |
| September 30, 2008 | 2,888,421,556 | 67,177,392 | 110,379,131 | 1,054,174,457 |
| September 30, 2009 | 2,964,686,478 | 34,782,418 | 186,755,766 | - |
| September 30, 2010 | 3,621,984,041 | 87,931,196 | 364,361,226 | 477,344,263 |
| September 30, 2011 | 4,084,016,158 | 179,748,798 | 374,074,067 | 451,400,519 |
| September 30, 2012 | 4,712,376,278 | 125,221,977 | 794,770,772 | 207,550,846 |
| September 30, 2013 | 5,154,027,747 | 312,776,304 | 1,193,778,722 | 42,414,251 |
| September 30, 2014 | 5,533,325,279 | 392,680,521 | 1,572,945,746 | - |
| **Quarterly Portfolio Valuation** | | | | |
| 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 |
| December 31, 2013 | 5,354,721,875 | 77,853,526 | 1,393,727,735 | - |
| March 31, 2014 | 5,429,643,570 | 86,362,097 | 1,467,996,676 | - |
| June 30, 2014 | 5,563,339,006 | 90,809,342 | 1,602,500,838 | - |
| September 30, 2014 | 5,533,325,279 | 137,655,556 | 1,572,945,746 | - |

## Appendix III
## Summary Characteristics of Composite Benchmarks
## Fixed Income Benchmarks

| Key Characteristics | Barclays US Aggregate Index | Merrill Lynch 1-5 Index |
|---|---|---|
| **Total Holdings** | 8,930 | 150 |
| **Coupon (%)** | 3.35 | 1.84 |
| **Duration (Years)** | 5.36 | 2.70 |
| **Average Life (Years)** | 7.30 | 2.74 |
| **Yield to Maturity (%)** | 2.27 | 0.94 |
| **Option Adjusted Spread (bps)** | 34 | 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** | 2,812 | 855 |
| **Earnings Per Share (EPS Growth 3-5y fwd)** | 12.1 | 9.29 |
| **Price Earnings (P/E fwd)** | 15.7 | 14.3 |
| **Price / Book (P/B)** | 2.5 | 1.71 |
| **Weighted Average Market Capitalization* (Bn)** | $97.07 | $60.0 |

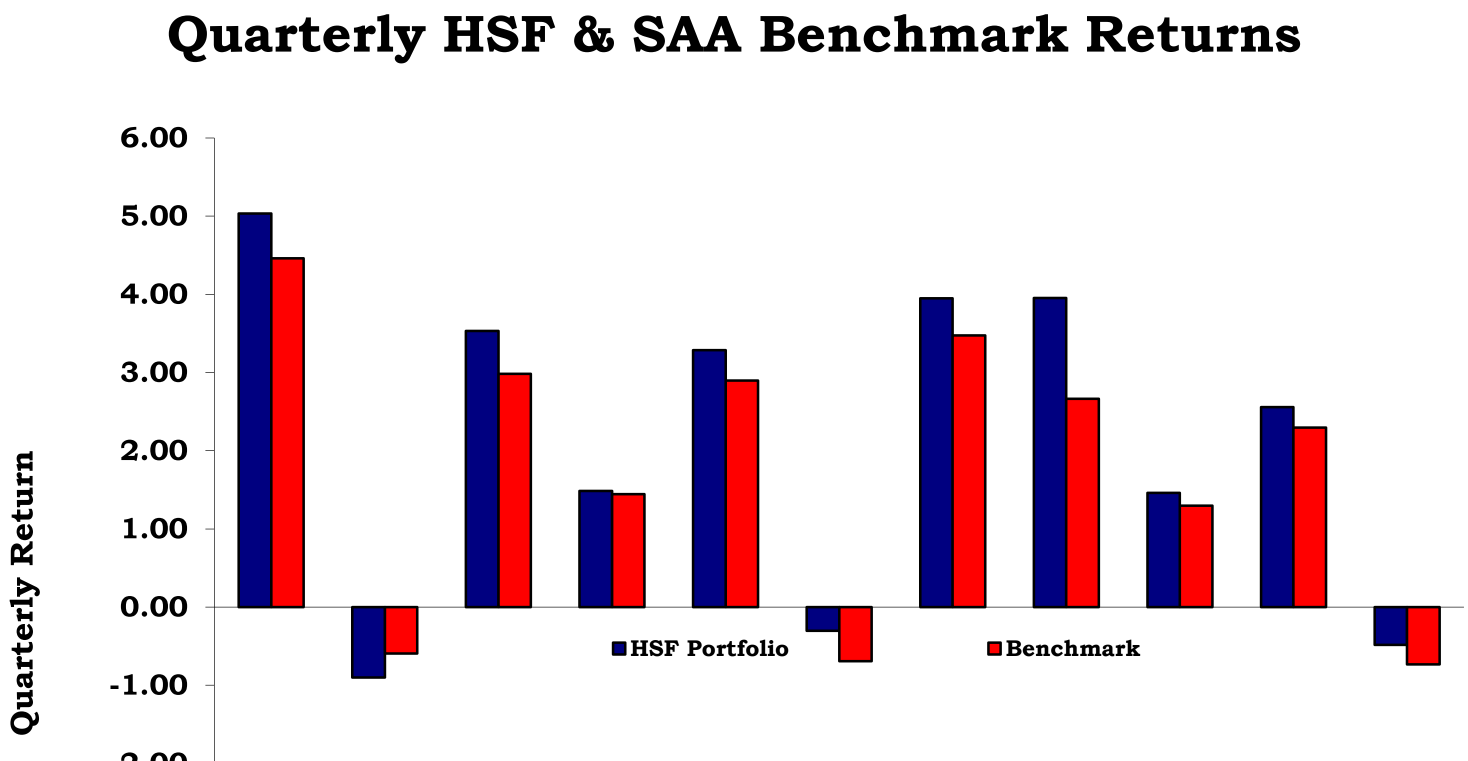
*Market capitalization is a measurement of the size of a company (share price x the number of outstanding shares). The weighted average market capitalization of a stock market index represents the average size of the firms comprising the index where each is weighted according to its market capitalization.

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

| | September 2013 | December 2013 | March 2014 | June 2014 | September 2014 |
|---|---|---|---|---|---|
| **Total Fund Value** | **5,154** | **5,355** | **5,429** | **5,563** | **5,533** |
| **Total Value of Equity** | **2,125** | **2,325** | **2,359** | **2,446** | **2,213** |
| US Core Domestic Equity | 1,086 | 1,204 | 1,225 | 1,272 | 1,180 |
| Non-US Core International Equity | 1,039 | 1,122 | 1,135 | 1,174 | 1,033 |
| **Total Value of Fixed Income** | **3,027** | **3,028** | **3,070** | **3,115** | **3,319** |
| US Short Duration Fixed Income | 1,165 | 1,165 | 1,169 | 1,173 | 1,243 |
| US Core Domestic Fixed Income | 1,863 | 1,863 | 1,901 | 1,942 | 2,076 |
| **Total Value of Cash or Cash Equivalents** | **2** | **1** | **1** | **3** | **1** |

NB: Differences in totals are due to rounding.

**Appendix V**
**HSF Portfolio Quarterly Returns**
**/per cent/**




| | FY2012 Q2 | FY2012 Q3 | FY2012 Q4 | FY2013 Q1 | FY2013 Q2 | FY2013 Q3 | FY2013 Q4 | FY2014 Q1 | FY2014 Q2 | FY2014 Q3 | FY2014 Q4 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| HSF Portfolio | 5.04 | -0.90 | 3.53 | 1.49 | 3.29 | -0.30 | 3.95 | 3.95 | 1.46 | 2.56 | -0.48 |
| Benchmark | 4.46 | -0.60 | 2.98 | 1.44 | 2.90 | -0.69 | 3.47 | 2.66 | 1.30 | 2.30 | -0.73 |