Trinidad and Tobago

Heritage and Stabilisation Fund

Annual Report
2014-2015

Central Bank of
Trinidad & Tobago

PURPOSE

The Heritage and Stabilisation Act, No. 6 of 2007 (hereinafter called "the Act") established the Heritage and Stabilisation Fund (hereinafter called "the Fund") with effect from March 15, 2007, for the purpose of saving and investing surplus petroleum revenues derived from production business in order to:

(a) Cushion the impact on or sustain public expenditure capacity during periods of revenue downturn whether caused by a fall in prices of crude oil or natural gas;

(b) Generate an alternate stream of income so as to support public expenditure capacity as a result of revenue downturn caused by the depletion of non-renewal petroleum resources; and

(c) Provide a heritage for future generations of citizens of Trinidad and Tobago from savings and investment income derived from the excess petroleum revenues.

CONTENTS

HERITAGE AND STABILISATION FUND ANNUAL REPORT 2015

	Page
Chairman's Foreword	2
Board of Governors	5
Governance	6
Overview of Activities	8
Investment Report	
Executive Summary	11
Macroeconomic Environment	13
Financial Market Review	20
Strategic Asset Allocation	31
Portfolio Performance	35
Portfolio Risks	39
Outlook & Risks to the Portfolio	42
Appendices	
Appendix I – Financial Year Portfolio Valuation	43
Appendix II – Historical Performance Since Inception	44
Financial Statements	
Report of the Auditor General	
Financial Statements	
Notes to Financial Statements	

CHAIRMAN'S FOREWORD

FOREWORD

On behalf of the Board of Governors, I am pleased to present the Annual Report of the Trinidad and Tobago Heritage and Stabilisation Fund for the year ending September 2015.

The deep consciousness among the population of the reliance of the Government on the oil and energy sector as a significant source of revenue has focused attention on the performance of the Heritage and Stabilisation Fund over the year.

The stark reality of the dependence of the country on earnings and revenues from its hydro-carbon resources was brought home to the population by the dramatic fall in the price of marker crude oil immediately following the adoption of the budget of 2014/2015.

In September 2014, the Minister of Finance had based the expected revenues of the Government for the fiscal year 2014/2015 on a projected oil price of US $80.00 per barrel. The country was to witness the start of an inexorable decline in energy prices during the course of the year, as Saudi Arabia sought to restore itself to a position of price-setter among the OPEC countries and in the energy markets generally, and to undermine the emerging players in shale oil in the United States.

Accretions to the Heritage and Stabilsation Fund derive from two sources:

- The excess of actual revenue over projected revenue, based on the oil and energy prices set in the Budget of the Government for the period, and
- Returns on the investments from the Fund.

The collapse in energy prices put paid to any expectation of placements by the Government of Trinidad and Tobago in the Heritage and Stabilisation Fund in the financial year.

Notwithstanding the inability of the Government to make allocations to the Fund, there was growth in the asset. The Fund, which was valued at US $5,533.4m, at the beginning of October 1, 2014, increased modestly to US$5,563.3m at September 30, 2015, registering an increase of 0.54 percent. This was much below the performance of the Fund in the period October, 1, 2013 to September 30, 2014, when the Fund grew by 7.7 percent.

This slower growth masks an underlying volatility in the market place. Indeed, the asset valuation of the Fund increased over the first two quarters of the financial year, and stood at US$5,779.4m at the end of March 2015, but declined over the next two quarters. Significantly, throughout the entire year, the Fund outperformed its bench-mark, and, even in decline, performed better by registering decreases lower than the bench-mark.

During the year, the Board met regularly to receive reports on the performance of the Fund and to provide its recommendations to the Bank on adjustments within the parameters set in the regulations for the management of the Fund.

During the period, three major issues engaged the attention of fund-managers:

- The date at which the Federal Reserve Bank of the United States would implement a change in its policy of *quantitative easing*, and in triggering an increase in interest rates;
- The Greek Government fiscal crisis and the treatment of its debt within the European Union; and
- The weak performance in the European economies, the United Kingdom excepted, and the slowing of economic growth in China and among the other BRICs, in the global trading system.

This is quite apart from the geo-politics of the widening impact of the Syrian Civil War and the conflict between the Ukraine and Russia.

In this crisis riddled environment, US equities performed well up until the middle of the calendar year, as the United States economy resumed on a path of lead economy in the world.

The Board ensured that the HSF maintained the weighting of the fund to the allowable limits, adjusting in time just before equities slipped relative to other instruments. The result was that the Fund performed above average relative to the overall benchmark.

In keeping with its commitment to improve national capacity in the management of funds held externally, the Board hosted a lecture/presentation by international experts in fund management. Attendees included members of the Board itself, managers of the Fund drawn from the Central Bank and personnel from a number of agencies of the Government of Trinidad and Tobago which make placements of funds on the international financial market.

The Board was represented at the World Investment Forum of UNCTAD held in Geneva in October 2014, at which the issue of investment of Sovereign Wealth Funds in a widening group of countries was examined and discussed. As a country of the South, Trinidad and Tobago has an abiding interest in the development of such countries, including among its neighbours in the Caribbean.

The Board also hosted a visit by representatives of the Central Bank of Uganda, which has established a sovereign wealth fund, and is seeking to learn from the experience of Trinidad and Tobago.

The Board registers its appreciation of the work of the Central Bank of Trinidad and Tobago in the management of the Fund, and records its thanks to the Ministers who have held the portfolios of Minister of Finance during the course of the financial year, to whom the Board reported, and who provided advice on the thinking of the Government.

In my capacity as Chairman, I thank the members of the Board whose term of office ended in September 2015, and who provided sterling service in their oversight of the Fund in a year that was, by no means, uneventful.

BOARD OF GOVERNORS

Dr. Ralph Henry	**–**	**Chairman**
Mr. Vishnu Dhanpaul	**–**	**Member**
Mr. Jwala Rambarran	**–**	**Member**
Mr. Ramcharan Kalicharan	**–**	**Member**
Mr. Michael L. Raymond	**-**	**Economic Policy Analyst performing the functions of Corporate Secretary to the Board**

GOVERNANCE

The Board of Governors

- The Heritage and Stabilisation Fund Act provides that the Fund be governed by a Board of Governors who under Section 9, has the responsibility for the management of the Fund. Section 10, however, provides for the Board to delegate its management responsibility to the Central Bank of Trinidad and Tobago.

- The Board decides on the investment objectives, and approves the manner in which the funds are to be invested by the Central Bank.

- The Board submits to the Minister of Finance, quarterly and annual investment reports on the operation and performance of the Fund.

The Minister of Finance

- The Minister of Finance advises the President on the appointment of the Board in accordance with the Act, and is responsible for approving deposits and withdrawals from the Fund in accordance with the provisions of the Act.

The Trinidad and Tobago Parliament

- Parliament passed the enabling legislation and continues to have ultimate oversight of the Fund, which is exercised through the review of annual reports and audited financial statements, no later than four months following the end of the financial year.

- This reporting requirement gives the people of Trinidad and Tobago an opportunity to assess the Fund's performance, thereby fostering transparency and accountability, and ensuring effective ownership of the Fund by the population.

The Management of the Fund

- The Central Bank is responsible for the day-to-day management of the Fund (to meet Investment Objectives of the Board) and reports quarterly and annually to the Board.
- The Schedule to the Act details the responsibilities of the Central Bank.

DEPOSITS AND WITHDRAWALS

The Act outlines the deposit and withdrawal rules, which the Ministry of Finance must apply regarding the Fund.

Deposits

Sections 13 and 14 of the Act detail the conditions under which excess petroleum revenues must be deposited in the Fund.

Quantum:

- A minimum of sixty per cent of the total excess (difference between estimated and actual) revenues must be deposited to the Fund during a financial year.
- Estimated petroleum revenues are calculated based on defined international sources.

Timing:

- Deposits to the Fund are to be made quarterly, no later than one month following the end of the quarter in which the deposit was calculated. Quarter under the Act refers to the three-month period ending December, March, June and September of each year.

Withdrawals

Section 15 of the Act outlines the conditions under which amounts may be withdrawn from the Fund.

Quantum:

- Where the petroleum revenues collected in any financial year fall below the estimated petroleum revenues for that financial year by at least ten per cent, withdrawals may be made from the Fund.

Limitations on Withdrawals

- The withdrawal is limited to sixty per cent of the amount of the shortfall of petroleum revenues for the relevant year; or

- Twenty five per cent of the balance of the Fund at the beginning of that year, whichever is the lesser amount.

- The Act precludes any withdrawal where the balance standing to the credit of the Fund would fall below one billion US dollars if such withdrawal were to be made.

OVERVIEW OF ACTIVITIES

Reports to the Parliament

The Annual Report 2014 and the Audited Financial Statements for the period ending September 30, 2014 were presented to the Parliament in February 2015.

Deposits to the Fund

There were no deposits to or withdrawals from the Fund during the financial year 2014/2015.

HSF Review

The Board completed its policy proposal on the review of the Fund and communicated with the Ministry of Finance at the end of the calendar year 2014. The Government has proposed to treat with all policy related to the Fund in the new Parliamentary session.

Governance

The Board of Governors of the HSF met all legal and statutory requirements in the discharge of its functions and maintained its governance oversight as required by law during the review period. As prescribed by legislation, the Board held seven ordinary meetings during the financial year 2013/2014.

INVESTMENT REPORT

Executive Summary

The Heritage and Stabilisation Fund (HSF) generated positive portfolio performance for the financial year 2015, albeit at a smaller magnitude relative to prior years. The Fund's performance was attributed primarily to the performance of fixed income markets globally, as yields for sovereign bonds declined over the 12 month period. Actual and anticipated policy decisions from the major Central banks were a main contributor to falling yields as the European Central Bank (ECB) and the Bank of Japan (BoJ) maintained an accommodative stance whilst the Federal Reserve (the Fed) ended its bond buying program but kept its policy rate low. Investors' expectation as to the timing of the first increase in the Federal Funds rate since June 2006 also impacted bond yields. Furthermore, the economic slowdown in China weighed on investment performance.

Equity market volatility spiked significantly in the last quarter of the financial year, when China's financial market and currency issues dominated global headlines. During this quarter, major global equity indices plunged into negative territory, resulting in the worst quarterly performance for the asset class for the financial year.

Economic activity was mixed among the advanced economies as the US and UK exhibited relatively robust growth, while growth in the Euro zone and Japan remained subdued. Japan entered a technical recession at the end of the financial year as global demand waned.

For the financial year 2014/2015, the Fund returned 2.5 per cent, compared with gains of 1.1 per cent for the strategic asset allocation (SAA) benchmark. The equity portion of the Fund contributed approximately 1.0 per cent to the total return, while the fixed income portion added 1.5 per cent to total return. The strongest performing mandate was the US Core Equity mandate, which generated an absolute return of 3.5 per cent. The US Core Fixed Income portfolio also posted a relatively solid gain of 2.7 per cent.

As at the end of September 2015, the Fund's Net Asset Value stood at US$5,655.1 million, up from US$5,533.4 million as at the end of September 2014. During the financial year, there were no contributions made to the Fund.

Macroeconomic Environment

Over the financial year 2014/2015, global financial markets exhibited elevated levels of volatility mainly as a result of concerns surrounding Greece, the slowdown in economic activity in China and uncertainty about the timing of the US Federal Reserve's (Fed) first interest rate increase since June 2006. These factors contributed to investors' increased demand for US government debt. US Treasuries gained 3.8 per cent over the period and was the best performing fixed income sector according to the Barclays US Aggregate Index.

China's economic woes came to the fore during the month of August, as the People's Bank of China (PBoC) opted to amend its method of pegging the yuan against the US dollar, which precipitated a selloff in the yuan, an outflow of capital and spillover effects to Chinese equity markets and other financial markets.

Global growth however remained on a positive trajectory, albeit at a moderate pace and uneven across regions. Downside risks to growth rose during the review period, particularly for emerging market economies amidst declining commodity prices, reduced capital flows, the ongoing economic adjustment in China and weaker global demand. Meanwhile, inflation settled to near zero per cent across advanced economies, particularly in the US and UK and output gaps narrowed, as evidenced by improvements in labour markets.

In the **United States** (US), the economy expanded at a measured pace over the course of the financial year at 2.1 per cent, despite the negative impact of a stronger US dollar on the export and manufacturing sectors. Even though the housing market strengthened and personal expenditures increased, financial markets were disappointed that economic activity was not more robust. Nonetheless, investors remained optimistic regarding domestic consumption given improved household balance sheets. In the labour market, job prospects improved over the period as the unemployment rate fell to 5.1 per cent in September 2015 from 6.1 per cent a year ago. Lower energy prices, as oil hovered around $40-$50 per barrel, contributed to a subdued inflation environment.

While the Fed concluded its asset purchases program in October 2014, the central bank maintained its target range for the Federal Funds rate at 0 to ¼ per cent. Global financial markets were rife with expectations of an imminent rate hike in the US. In fact this expectation together with concerns in Europe and the energy market increased volatility in bond markets. For most of the year the Federal Open Market Committee (FOMC) tried to calm the market, stressing that any move would be data driven and gradual.

Current economic data in the world's largest economy points to steady growth and stable prices. In the jobs market, the unemployment rate continues to decline, hitting multi-year lows, while non-farm payrolls increase at a significant pace. The Fed in its October meeting noted the improvement in the US economy and signaled the possibility of the much anticipated rate hike in December 2015.

Growth in the **Euro zone** remained low at 1.6 per cent during the twelve months ended September 2015, which reflected an improvement over the prior financial year's reading. A weaker euro and declining energy prices throughout the financial year, helped to buoy growth in the currency union. However, across member states GDP growth remained uneven as evidenced by economic expansions in peripheral states like Ireland, Spain and Italy compared to lower growth in the traditional drivers of the region, Germany and France, which continued to face significant headwinds.

Over the financial year, the threat of deflation was a main concern for the Euro zone, as prices declined to its lowest level in five years in December 2014. Meanwhile, unemployment, although structural in nature, improved during the 12 months to September 2015, dropping just below 11 per cent at the end of the period.

The ECB launched its Quantitative Easing (QE) program in March 2015, after implementing several measures to ease financial market and economic conditions, including its Targeted Long-Term Refinancing Options (TLTRO). The ECB's Asset Purchase Program (APP), which consists of monthly purchases of public and private sector securities amounting to €60 billion, is expected to be carried out until September 2016 or until the ECB sees a sustained adjustment to inflation consistent with its aim of achieving inflation rates below, but close to, 2 per cent in the medium term.

Greece's credit conditions remained a concern for both domestic and global financial markets, as the sovereign nation defaulted on its debt payment to the IMF during the month of June and Greek citizens rejected additional austerity measures in a July 5th national referendum. After intense talks, the Greek government and its creditors agreed on a third bailout package in the amount of €7 billion, which brought a temporary calm to financial markets at the end of July.

Whilst the inflation rate in the Euro zone increased in October, it still remains below the ECB's target of 2 per cent. Unemployment, although high in some countries in the currency bloc, continues to decline in the region as a whole and economic growth looks promising, as both the manufacturing and services sectors improved in October.

Over the financial year, economic growth slowed to 2.1 per cent in the **United Kingdom** (UK) economy, although other economic fundamentals improved. Labour market conditions continued to progress steadily as unemployment ended the period at 5.3 per cent, its lowest level since the 2008 crisis and well below 7 per cent, which was widely believed to be the Bank of England (BoE) trigger for increasing its benchmark interest rate.

Like the Euro zone, inflation in the UK declined further during the year, reaching negative territory for the first time since 2009 and remained well below the BoE's 2 per cent inflation target.

The BoE kept its policy rate and the size of its asset purchase programme unchanged. As the year progressed, BoE Governor, Mark Carney, signaled that the time for a rate rise was nearing, but maintained that any action would depend on economic data. Moreover, UK policymakers expressed concerns about the increasing downside risks to global growth and inflation, including the spillover effects from China.

The inflation rate in the UK remains in negative territory, based on readings to October 2015. However, there are signs of improvement in other economic fundamentals with increases in the manufacturing and services Purchasing Manager Indices (PMI) and a further reduction in the unemployment rate.

Japan emerged from a technical recession in the first quarter of the 2014/2015 financial year, but the economy struggled to maintain a positive growth trajectory over the 12 month period. Despite continued progress in the labour market and the government's decision to delay the second increase in the consumption tax, household spending has yet to recover following the April 2014 sales tax hike. Moreover, the weaker yen failed to materially boost exports, as the uncertainty stemming from the Greek debt crisis and China's slower growth outlook dampened global demand. As a result, the economy re-entered a recession during the fourth quarter of the financial year.

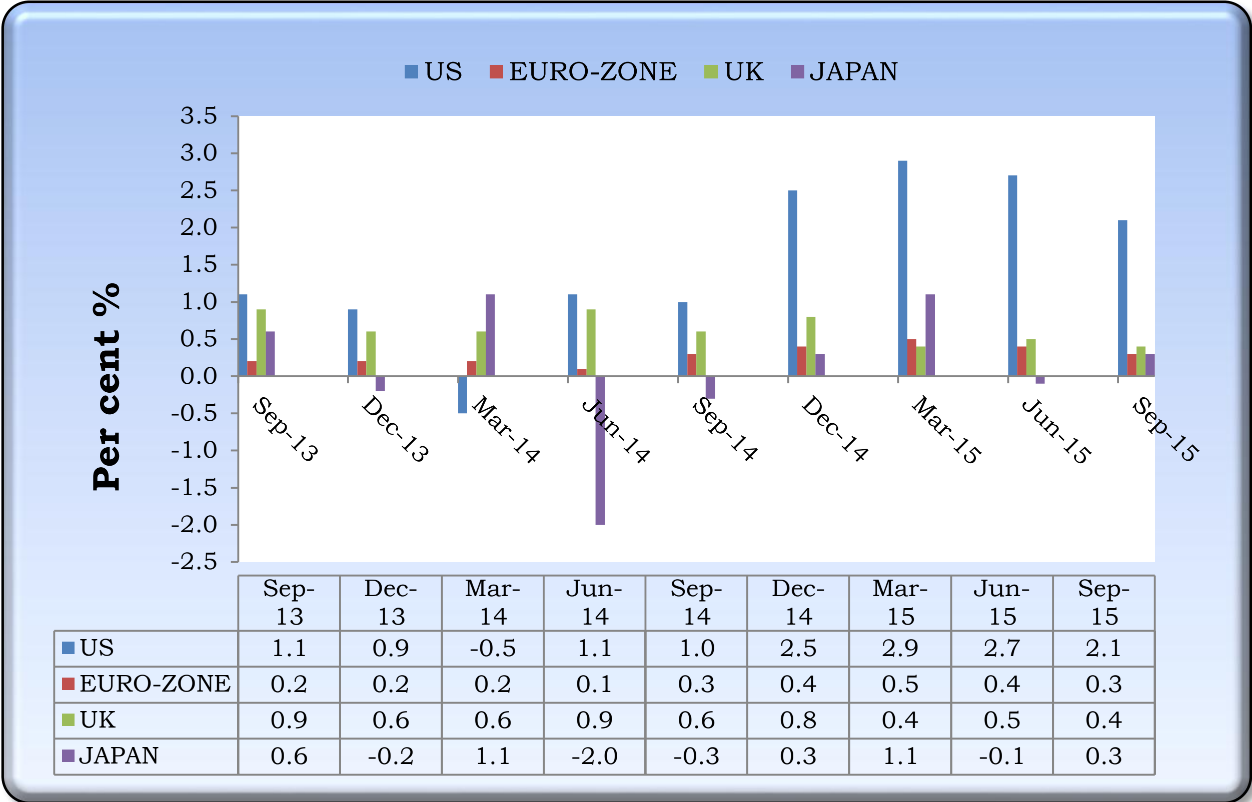
The Bank of Japan (BoJ) surprised markets in November 2014 by expanding its stimulus program from an annual pace of 60-70 trillion yen to 80 trillion yen in an attempt to bolster inflation and economic growth. Nonetheless, consumer prices declined over the financial year and the BoJ extended the timeline for reaching its 2.0 per cent inflation target by six months to March 2017.

Consumer prices, however, has improved so far for the current financial year, rising to 0.5 per cent in October 2015 from a flat reading in September 2015. The labour market continues to progress with the unemployment rate hitting a 12 month low of 3.1 per cent in October 2015 and the jobs-to-applicants ratio remaining constant. Furthermore, activity in the manufacturing and services sectors improved, signaling that Japan may exit a technical recession in this first quarter of the current financial year.

CHART 1

GDP GROWTH: SELECTED DEVELOPED ECONOMIES

QUARTER OVER QUARTER

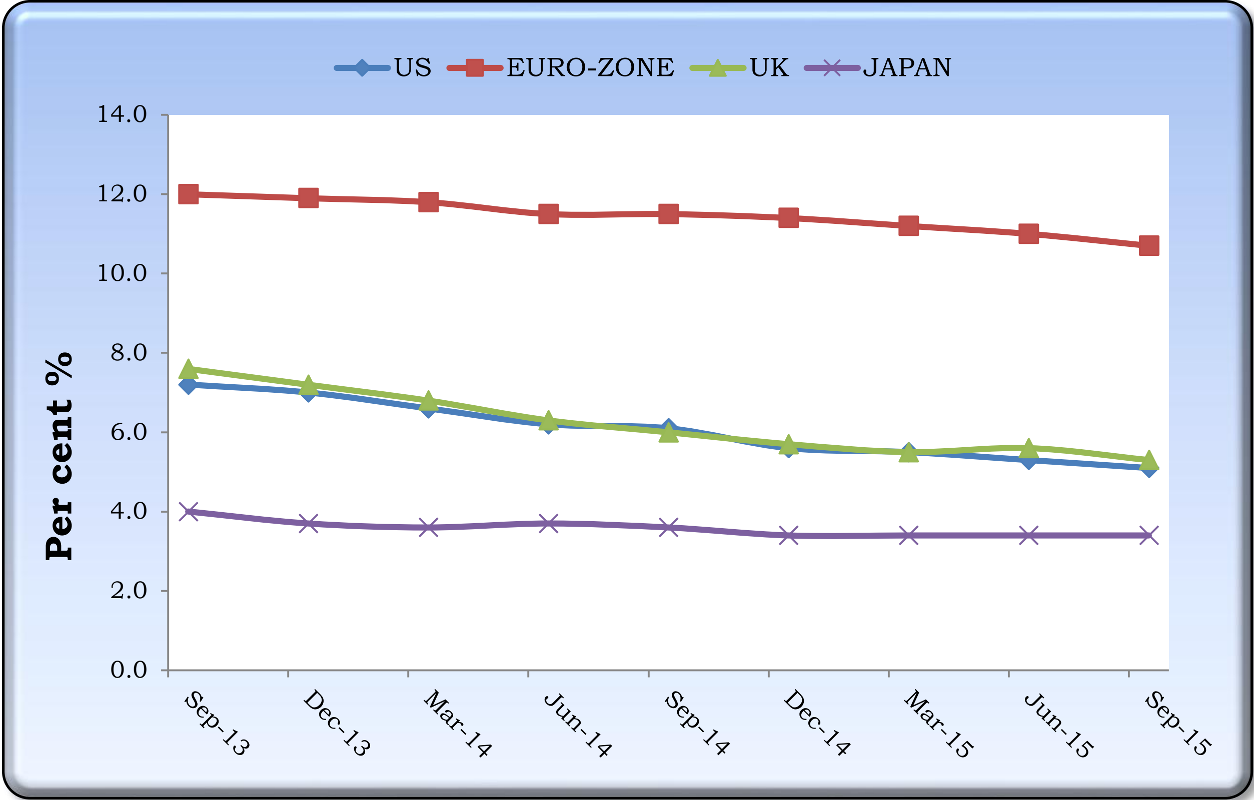


	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
US	1.1	0.9	-0.5	1.1	1.0	2.5	2.9	2.7	2.1
EURO-ZONE	0.2	0.2	0.2	0.1	0.3	0.4	0.5	0.4	0.3
UK	0.9	0.6	0.6	0.9	0.6	0.8	0.4	0.5	0.4
JAPAN	0.6	-0.2	1.1	-2.0	-0.3	0.3	1.1	-0.1	0.3

Source: Bloomberg.
September 2015 data are preliminary and may be subject to revisions. US data is annualized.

CHART 2

UNEMPLOYMENT RATES: SELECTED DEVELOPED ECONOMIES

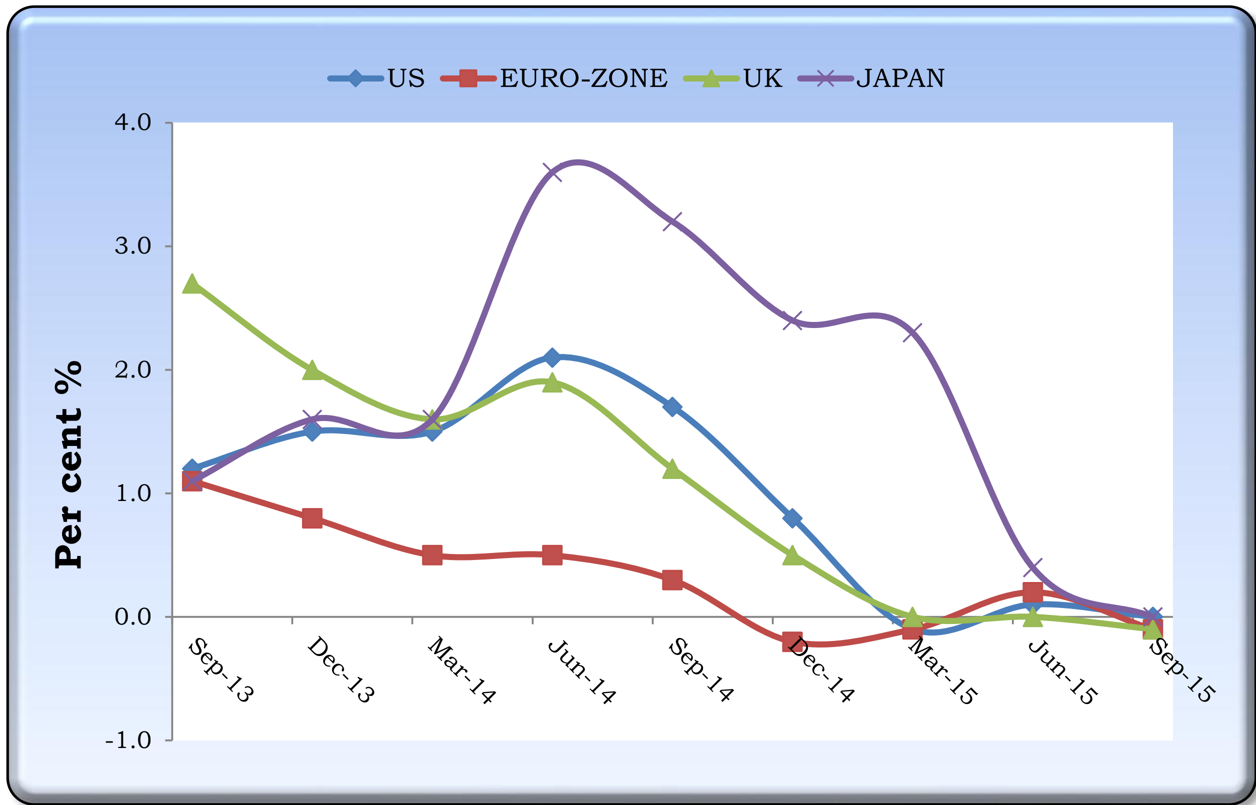


Source: Bloomberg.

CHART 3

INFLATION RATES: SELECTED DEVELOPED ECONOMIES

YEAR-ON-YEAR



Source: Bloomberg.

2. Financial Market Review

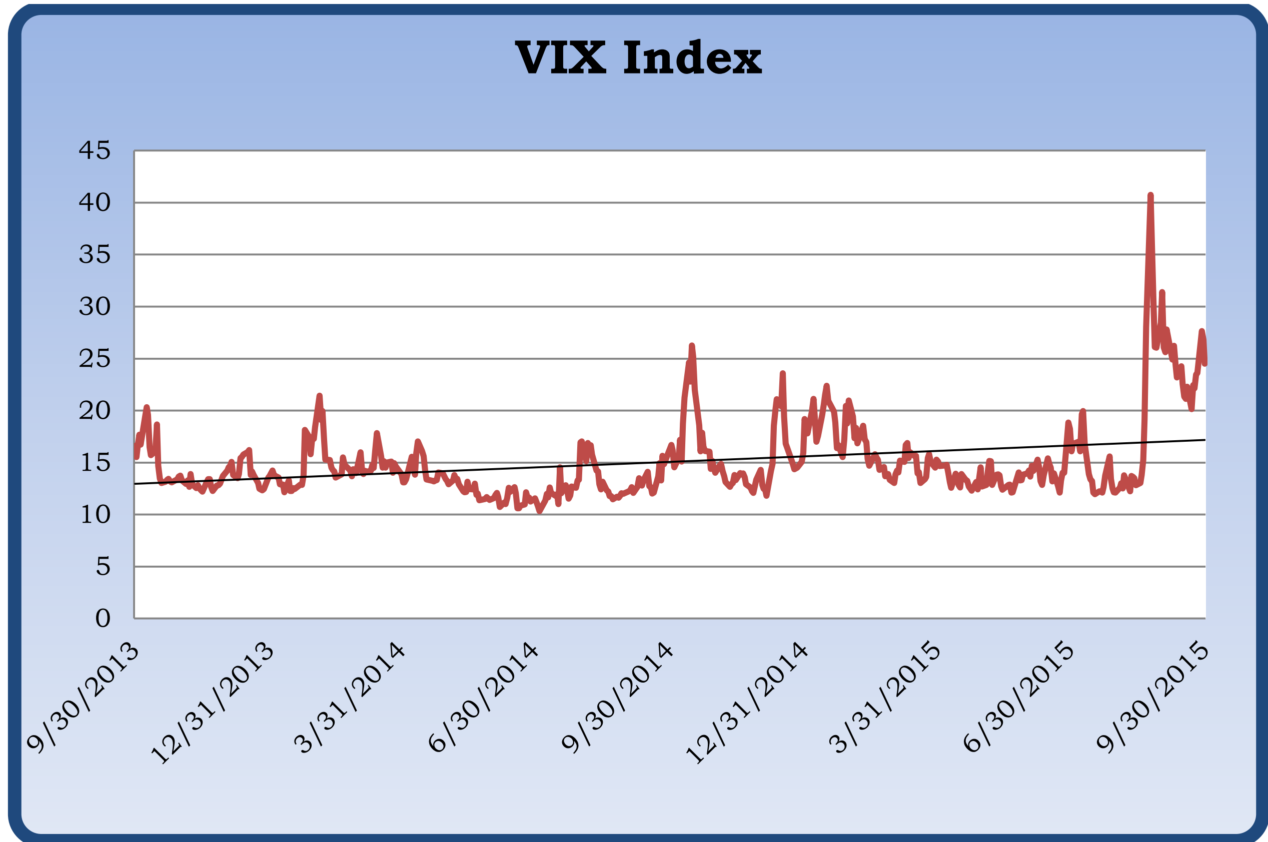
During the financial year ended September 30, 2015 fixed income investors benefitted from falling benchmark 10-year yields in many G-10 countries. Chinese currency and financial market volatility, improving economic conditions in the US and UK, growth concerns in China, Japan and the Euro zone, in addition to further accommodative monetary policies in Japan and Euro zone, impacted markets. During the review period fixed income asset classes generally enjoyed positive returns for most of the year, while equity markets rallied to new highs despite a difficult final quarter.

In the US, the Standard and Poor's (S&P) 500 index declined over the year ended September 2015, despite forging new record highs during the period, while equity markets in other developed economies also posted lower returns, with the exception of the Japanese Nikkei 225. Despite a slowdown in economic activity in Japan, the equity market outperformed its global counterparts as the Nikkei 225 index advanced by 9.42 per cent. The Japanese index was buoyed by the depreciating yen over the year, which helped the exporting companies.

The Chicago Board Options Exchange Volatility Index (VIX), a widely used measure of market risk, often referred to as the "investor fear gauge", pointed to a slightly elevated overall level of volatility on average in the US during the 12 months to September 2015, when compared to the previous year. Concerns over Greece and China, combined with anxiety over the Fed's policy normalization scheme impacted investor confidence. Over the period, the index averaged 16.43 points, reaching a high of 40.74 points at the end of August, as the price of West Texas Intermediate (WTI) crude oil plunged below the US $50 mark, alongside weak economic data from China and Chinese financial market instability. US equity markets also experienced elevated levels of volatility in October 2014, December 2014 and then again in June 2015.

CHART 4

STOCK MARKET VOLATILITY



Source: Bloomberg.

(a) Money Market

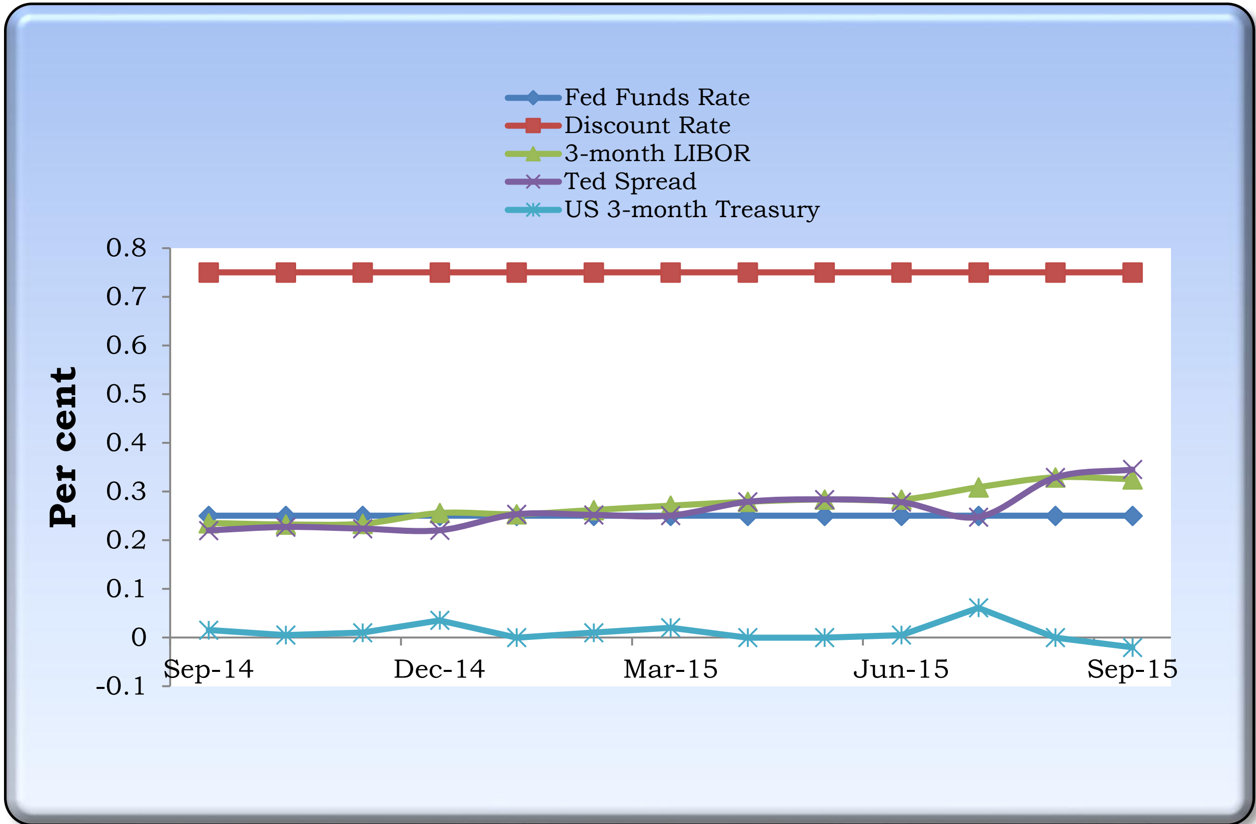
Persistently low yields continued to characterise money markets over the financial year ended September 2015 as the central banks in advanced economies maintained their accommodative monetary policy stance. The Federal Funds rate remained in the range of 0 to 0.25 per cent for the twelve-month period, while short-term rates fluctuated somewhat during the year, but remained low. The US 3-month London Inter-Bank Offered Rate (LIBOR) rose slightly to 0.33 per cent in September 2015, from 0.24 per cent in September 2014, while the US 3-month Treasury bill rate declined to -0.02 per cent, its lowest rate since October 2011. Accordingly, the spread between the 3-month US

Treasury bill rate and the 3-month LIBOR rate, narrowed to 34.53 basis points from 21.99 basis points over the financial year (Chart 5 below refers).

CHART 5

SELECTED MONEY MARKET RATES IN THE US

/per cent/



Source: Bloomberg.

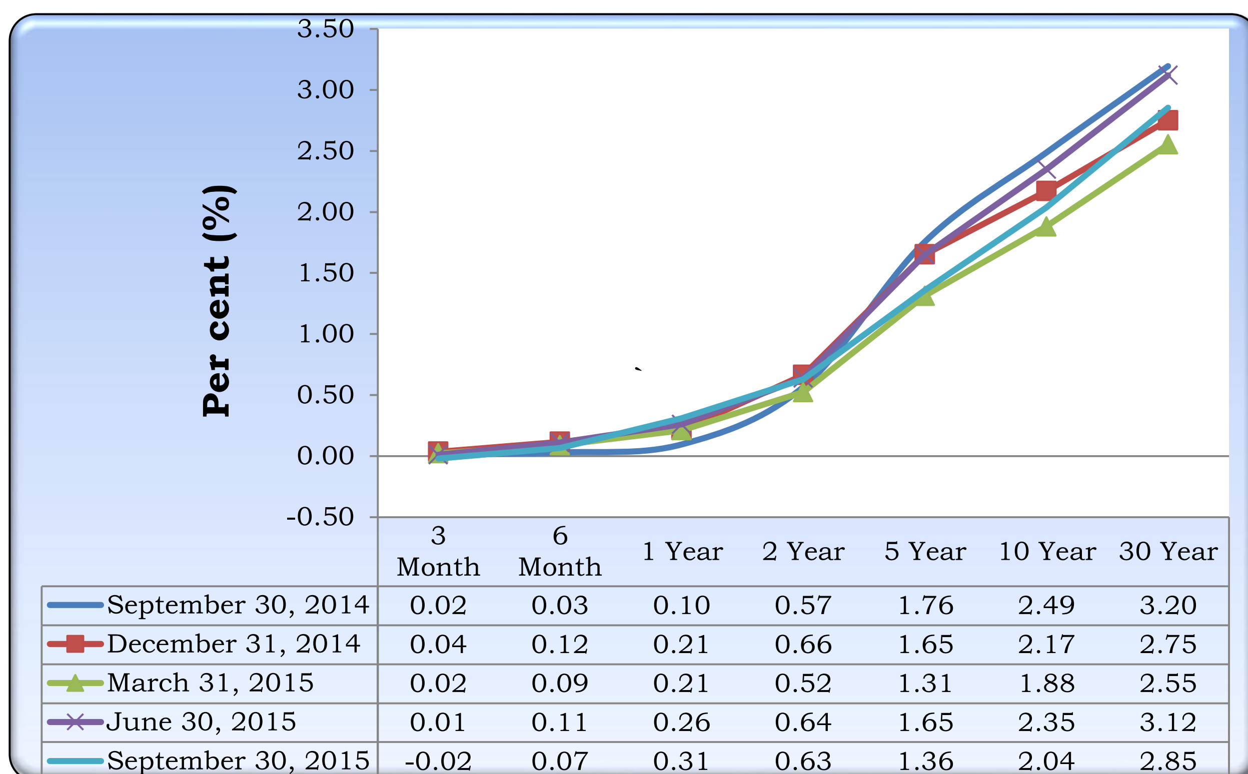
(b) Fixed Income Market

Over the financial year 2014/2015, the US Treasury market was dominated by discussions around the exact timing of the US Federal Reserve's (Fed) first interest rate increase. Expectations for the first rate hike were continually mired throughout the period due to a mix of domestic as well as external factors. Moreover, the US Treasury market experienced bouts of volatility due to a myriad of factors which spurred safe haven demand and broadly weighed on yields. Concerns around geopolitical tensions, the Greek debt crisis as well as increasing evidence of a slowdown in the Chinese economy prompted investors to seek the safety of US Treasuries. In addition, the diverging monetary policies among central banks increased the appeal of US Treasuries relative to other developed market sovereign bonds.

The US treasury curve flattened and the spread between the 2-10 year portion of the curve fell 51.4 basis points over the year to 140.7 basis points. The 2-year yield rose modestly given the Fed's indications that it would most likely be appropriate to raise rates in 2015. However, falling commodity prices and the subdued inflation outlook helped to push rates lower at the longer-end of the curve. The 10-year ended the 12 month period 45.2 basis points lower at 2.04 per cent.

CHART 6

US TREASURY YIELD CURVE



	3 Month	6 Month	1 Year	2 Year	5 Year	10 Year	30 Year
September 30, 2014	0.02	0.03	0.10	0.57	1.76	2.49	3.20
December 31, 2014	0.04	0.12	0.21	0.66	1.65	2.17	2.75
March 31, 2015	0.02	0.09	0.21	0.52	1.31	1.88	2.55
June 30, 2015	0.01	0.11	0.26	0.64	1.65	2.35	3.12
September 30, 2015	-0.02	0.07	0.31	0.63	1.36	2.04	2.85

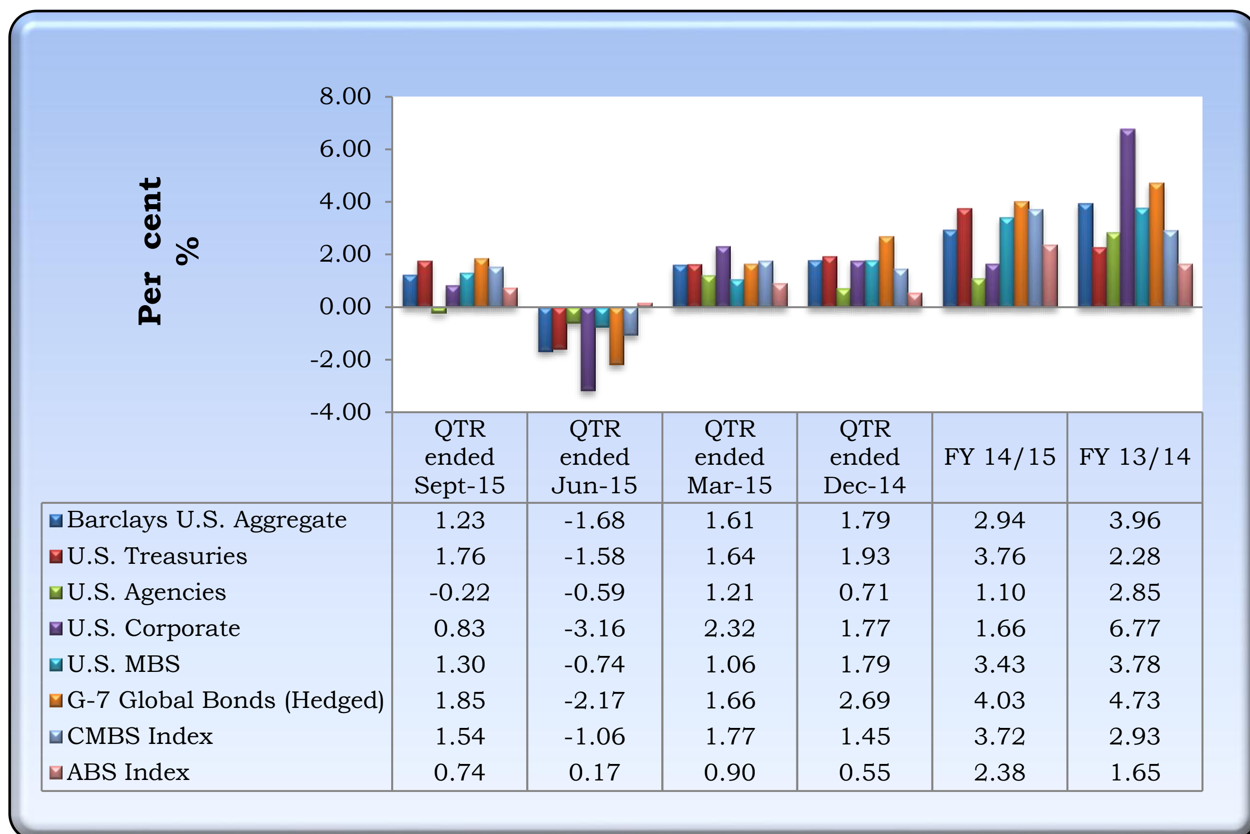
The broader US Fixed income market as measured by the Barclays US Aggregate Index generated a total return of 2.94 per cent for the year ended September 30, 2015. The index delivered positive returns for most of the financial year, except for the three months to June, when improving economic fundamentals brought forward expectations for the Fed's first interest rate increase.

Spread product performance was somewhat mixed but generally underperformed similar-duration treasuries as credit spreads widened modestly, given the appeal of U.S. Treasuries following periods of risk aversion. The U.S. Investment grade corporate sector was also hurt by greater supply, whereas Puerto Rico's struggle to raise cash and eventual default negatively impacted market sentiment.

However, the Asset Backed Sector outperformed similar duration treasuries despite the uncertainty surrounding the rating of a large number of bonds in the student loan Federal Family Education Loan Program (FFELP) Asset Backed Securities (ABS) market, which were placed on downgrade watch by Moody's and Fitch.

CHART 7

RETURNS ON FIXED INCOME INDICES



	QTR ended Sept-15	QTR ended Jun-15	QTR ended Mar-15	QTR ended Dec-14	FY 14/15	FY 13/14
Barclays U.S. Aggregate	1.23	-1.68	1.61	1.79	2.94	3.96
U.S. Treasuries	1.76	-1.58	1.64	1.93	3.76	2.28
U.S. Agencies	-0.22	-0.59	1.21	0.71	1.10	2.85
U.S. Corporate	0.83	-3.16	2.32	1.77	1.66	6.77
U.S. MBS	1.30	-0.74	1.06	1.79	3.43	3.78
G-7 Global Bonds (Hedged)	1.85	-2.17	1.66	2.69	4.03	4.73
CMBS Index	1.54	-1.06	1.77	1.45	3.72	2.93
ABS Index	0.74	0.17	0.90	0.55	2.38	1.65

The sovereign bond yields of the G7 countries generally fell over the year, except for an increase in the third quarter of the financial year when oil prices temporarily rebounded and the appreciation in the US dollar began to slow. In the fourth quarter of the financial year, there was a significant flight to quality trade, which was positive for global sovereign bonds, as China's currency was devalued and Chinese equity market volatility spiked

significantly. Furthermore, the Fed's decision not to hike rates and its citing of developments abroad as the reason for its decision, heightened market fears that the slowdown in China and falling commodity prices will pull global growth lower.

The 10-year Canadian sovereign bond yield declined the most among the G-7 nations over the financial year, falling by 71 basis points to close the year at 1.43 per cent. The 10-year German sovereign bond yield remained at depressed levels ending the year at 0.59 per cent falling 36 basis points over the year, while French sovereign bond yields fell by 30 basis points to close the year at 0.98 per cent. UK Gilt yields fell by 66 basis points to 1.76 per cent at the end of September 2015, as broader global macro concerns weighed on yields and inflation remained subdued. Meanwhile, yields on 10-year Japanese government bonds (JGBs) fell by 18 basis points to end the period at 0.35 per cent, as the Bank of Japan continued its accommodative monetary policy.

c) Equity Market

US and non-US developed equity markets declined over the financial year ended September 2015, compared to the year ended September 2014, as investor risk appetite waned due to widespread concern over heightened downside risks to global growth, inflation and economic and geopolitical stability. Divergent monetary policy of developed central banks also continued to create volatility in markets over the period, especially as the Federal Reserve prepared to tighten while the ECB and BoJ expanded their reflationary monetary policies. Macro events in China also weighed on investor sentiment as the People's Bank of China (PBoC) executed policies aimed at stabilizing its financial markets and stemming the devaluation of the Chinese renminbi, both of which actually served to create even more market volatility.

For the year ended September 2015, **US markets** posted negative returns as economic headwinds, the decline in the energy sector and the strong dollar hurt performance. Returns in the US markets peaked in the first quarter as optimism over the Greek debt negotiations supported equity markets but faded thereafter, as renewed uncertainty over

Greece, geopolitical concerns, increasing anxiety over the Fed's first rate hike and declining commodity prices weighed on investors' risk appetite.

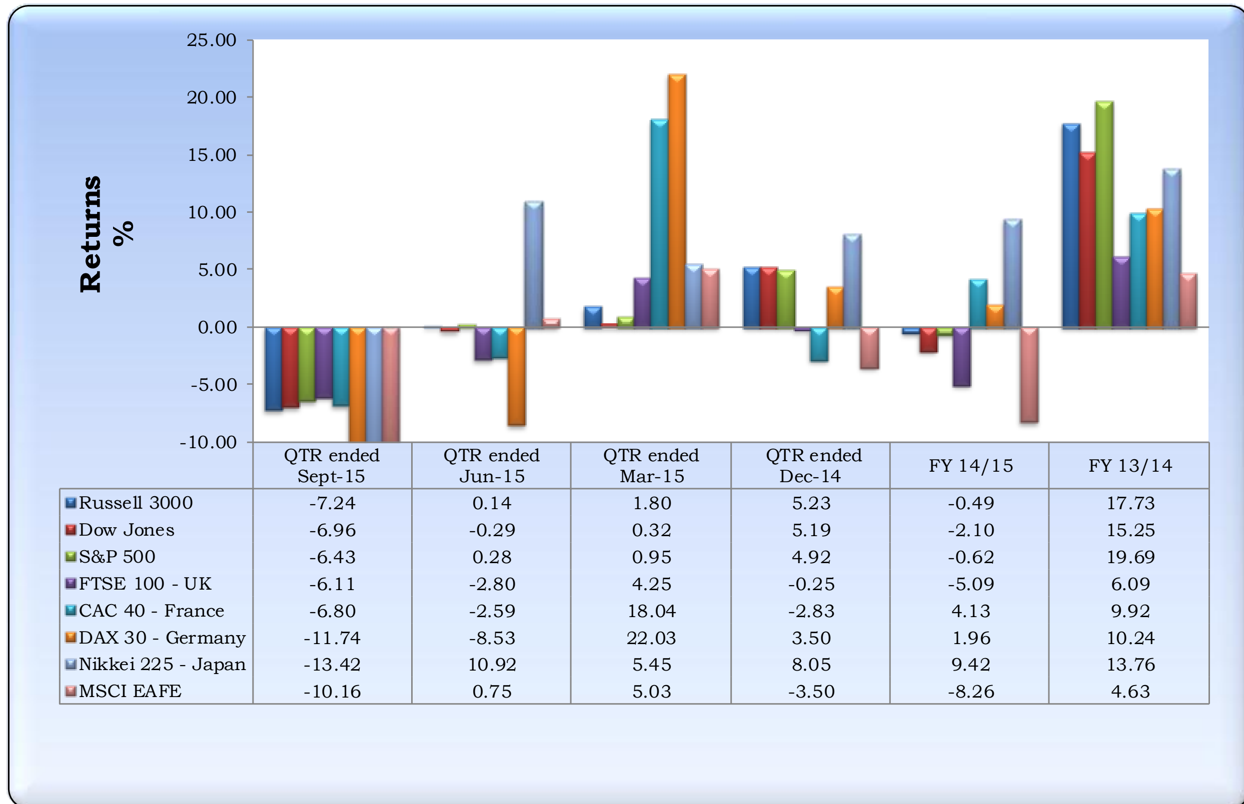
During the financial year, **global equity markets** outperformed its US counterparts, with the exception of the energy heavy FTSE 100. The strongest non-US market was **Japan**, as equities were supported by the coordinated efforts of the Bank of Japan's expansionary monetary policies and deepened allocation to equities in the Japanese Government Pension Fund. Moreover, as the effects of the April 2014 consumption tax hike had dissipated and despite a somewhat fragile pace of economic recovery, fundamentals were still encouraging enough to boost consumer confidence throughout the year. After almost a year-long rally, Japanese stocks fell over the final quarter of the financial year with a decline of 13.42 per cent, as China's economy and heightened anxiety over a Fed hike weighed on markets.

Equity markets in the **Euro zone** posted positive returns, with the exception of London's FTSE 100. German and French equity markets continued to be supported by further accommodative policies announced by the ECB in October 2014, especially as growth faltered in Germany and France.

For the twelve month period, the Dow Jones Industrial Average (DJIA) led the decline in US markets with a loss of 2.10 per cent, while the S&P 500 and Russell 3000 declined 0.62 per cent and 0.49 per cent, respectively. This was a reversal of the returns posted in the prior financial year, as market participants opted to take gains on their investments due to an uncertain Fed policy rate hike path, declines in the energy sector and economic concerns in Europe and China. In non-US developed markets, Japan's Nikkei 225 outperformed other non-US markets during the period, with a relatively stellar 9.42 per cent return. In the Euro zone, the French CAC index added 4.13 per cent, whilst Germany's DAX 30 index advanced 1.96 per cent. Overall performance of non-US developed markets, as measured by the MSCI EAFE, declined 8.26 per cent for the financial year ended September 2015, primarily pulled down by European equity markets and the impact of a strong dollar. (see Chart 8).

CHART 8[1]

TOTAL RETURN ON EQUITY INDICES



	QTR ended Sept-15	QTR ended Jun-15	QTR ended Mar-15	QTR ended Dec-14	FY 14/15	FY 13/14
Russell 3000	-7.24	0.14	1.80	5.23	-0.49	17.73
Dow Jones	-6.96	-0.29	0.32	5.19	-2.10	15.25
S&P 500	-6.43	0.28	0.95	4.92	-0.62	19.69
FTSE 100 - UK	-6.11	-2.80	4.25	-0.25	-5.09	6.09
CAC 40 - France	-6.80	-2.59	18.04	-2.83	4.13	9.92
DAX 30 - Germany	-11.74	-8.53	22.03	3.50	1.96	10.24
Nikkei 225 - Japan	-13.42	10.92	5.45	8.05	9.42	13.76
MSCI EAFE	-10.16	0.75	5.03	-3.50	-8.26	4.63

(d) Currency Market

Over the 2014/2015 financial year, the US dollar continued its upward trend as the United States economy strengthened albeit at a slower pace. The US trade weighted broad dollar index rose 13.91 per cent driven by diverging monetary policies as the Fed moved closer to increasing its target rate, while the European Central Bank and Bank of Japan announced additional easing during the financial year in an effort to achieve their inflation mandates.

The euro weakened significantly during the first two quarters of the financial year as the ECB alluded to and finally engaged in full scale quantitative easing. The euro fell to a low

[1] Equity returns in previous Annual Reports were price returns. December 2014 – June 2015 and financial year 2014 returns have been re-stated to reflect the total returns of these indices.

of 1.0496 in March 2015 but recovered somewhat as risk aversion in the market prompted traders to cover their short euro positions. In addition, the euro found some support as Greece was finally able to secure its third bailout package and there were some signs that the economy was improving and that there was low but positive price inflation. Nonetheless, the euro depreciated over the period, falling 11.51 per cent as risks to the region remained to the downside.

The pound depreciated 6.69 per cent over the period. Most of the decline occurred in the first two quarters, as concerns around May 8th general elections in the UK, as well as the stalling recovery in the Euro zone highlighted the downside risks to the UK economy. The pound gained some traction as the political uncertainty abated and the outlook for the Euro zone stabilized. However, pricing pressures weakened over the 12 months and the growing likelihood that the Federal Reserve would tighten ahead of the Bank of England weighed on the pound.

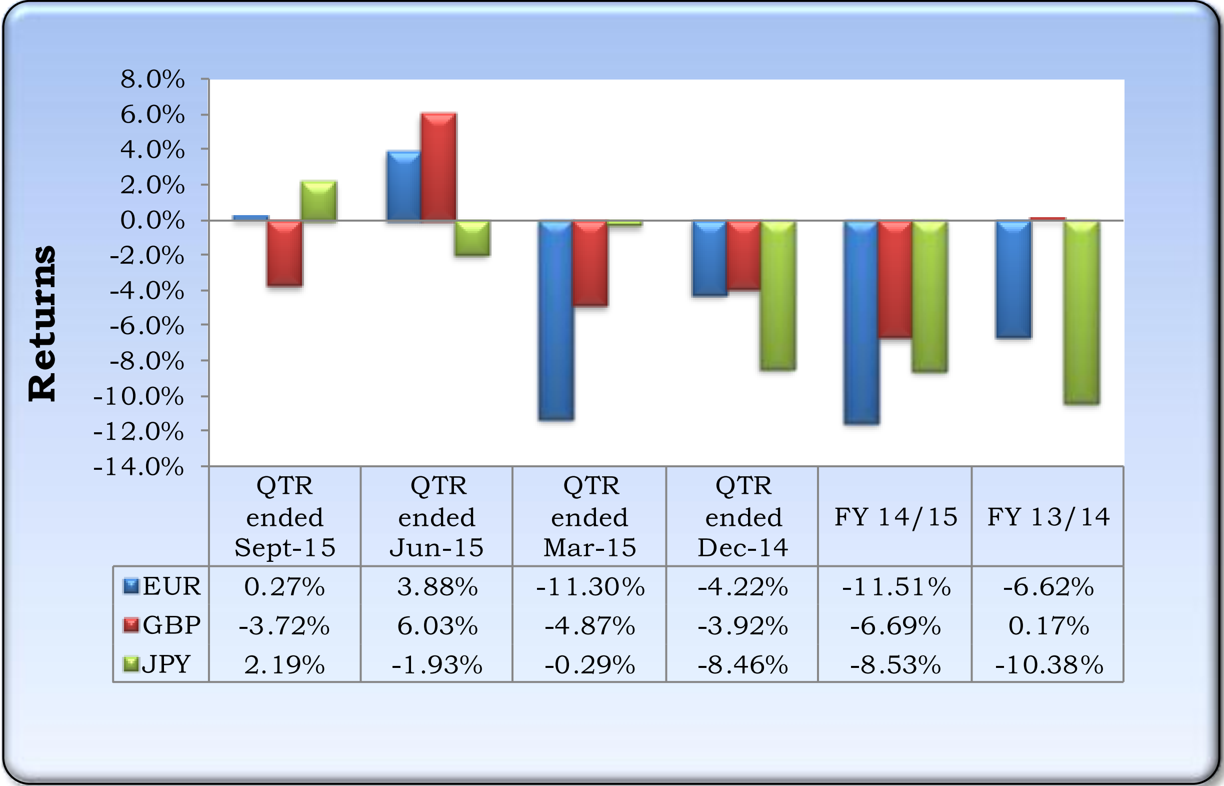
The Yen fell 8.53 per cent with most of the decline captured during the fourth quarter of 2014, when the Bank of Japan surprised markets at its November meeting by expanding the annual target for its monetary base to 80 trillion yen from 60 to 70 trillion yen. Moreover, slowing economic growth and waning price inflation supported a weaker Yen. However, periods of risk aversion and the global stock market rout during the third quarter of 2015 helped to stem further Yen weakness.

CHART 9

FOREIGN EXCHANGE RETURNS:

MAJOR CURRENCIES VIS-À-VIS THE US DOLLAR

/per cent/



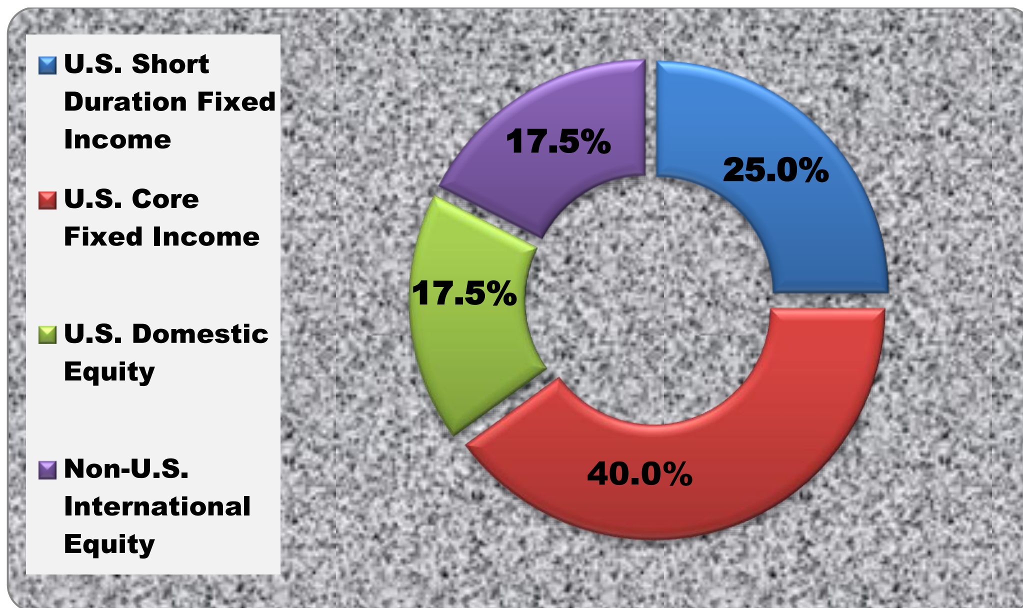
3. Strategic Asset Allocation

a) Portfolio Desired Allocation

In 2008, the Board of Governors approved the Strategic Asset Allocation (SAA)[2] for the Fund. Given the onset of the financial crisis, the three-year implementation of the SAA was delayed until August 2009. By January 2011, the Fund's investment portfolio[3] was fully invested in the four major asset classes shown in Chart 10 below.

CHART 10

THE FUND'S STRATEGIC ASSET ALLOCATION



[2] The approved Strategic Asset Allocation (SAA) is considered to be the optimal mix of assets that is expected to meet the long term investment objective of the Fund, both in terms of risk and return.

[3] Section 4 of the HSF Operational and Investment Policy states that the Central Bank may hold cash and cash equivalent in order to cover day-to-day liquidity needs and the remaining portion called the Investment Portfolio would be invested in accordance with the strategic asset allocation (SAA) approved by the Board.

b) *Portfolio Composition*

During the financial year ended September 2015, the asset classes of the Fund deviated from their Strategic Asset Allocation (SAA) and at certain times these deviations were outside the allowable range (+/- 5 per cent) stipulated in the investment policy statement. Such deviations occurred as a result of changes in assets' market values. Throughout the financial year, the Fund had an overweight allocation to US Core Domestic Equities and Non-US Core International Equities.

The specific months in which the deviations outside the allowable range occurred were as follows:

- February 2015: US Core Domestic Equity Mandate deviated from its SAA allocation by +5.15 per cent.
- May 2015: US Core Domestic Equity Mandate deviated from its SAA allocation by +5.13 per cent.
- June 2015: US Core Domestic Equity Mandate deviated from its SAA allocations by +5.08 per cent respectively.

During the month of July 2015, the portfolio was re-balanced to within the permitted SAA range for each of the mandates. A total of US$407.6 million was withdrawn from the two equity mandates and deposited with the two fixed income mandates by the end of July 2015.

As at September 30, 2015, the underweight allocations to the US Core Domestic Equities and Non-US Core International Equities were 0.92 per cent and 1.34 per cent respectively. Conversely, the fixed income asset classes carried allocations above their target weights, specifically 1.32 per cent for US Core Fixed Income and 0.94 per cent for US Short Duration Fixed Income.

The Fund's SAA and the portfolio composition over the 2014/2015 financial year are shown below (Table 1, refers).

TABLE 1

PORTFOLIO COMPOSITION RELATIVE TO THE APPROVED SAA

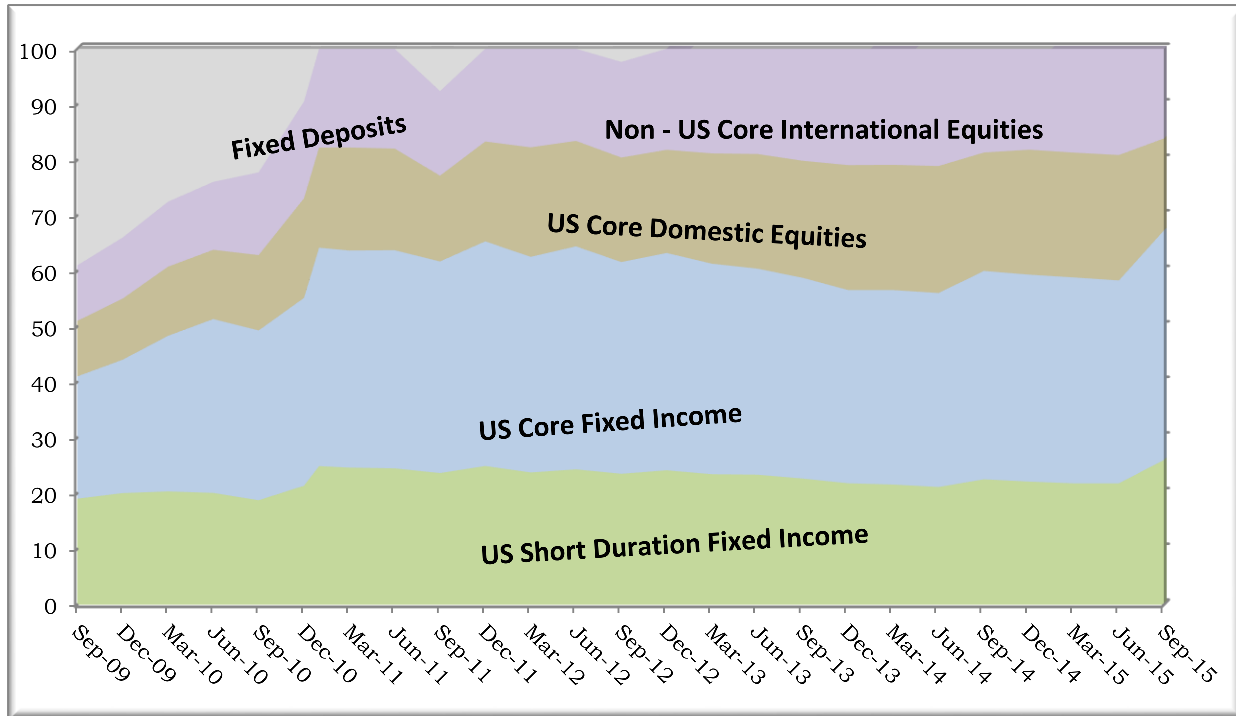
/per cent/

	Asset Class		***Dec-14***	***Mar-15***	***Jun-15***	***Sep-15***
		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	22.06	21.74	21.75	25.94
	US Core Domestic Fixed Income	40.00	37.26	37.08	36.53	41.32
	US Core Domestic Equity	17.50	22.50	22.48	22.58	16.58
	Non-US Core International Equity	17.50	18.17	18.70	19.13	16.16

CHART 11

ASSET COMPOSITION OF THE PORTFOLIO

/per cent/



c) *Fund Value*

As at September 30 2015, the Fund's Net Asset Value stood at US$5,655.1 million, compared with US$5,533.4 million as at the end of September 2014. The increase in the value of the Fund reflected positive investment returns.

4. PORTFOLIO PERFORMANCE

Over the financial year ended September 2015, the Fund's investment portfolio gained 2.5 per cent, compared with returns of 1.1 per cent for the SAA benchmark. The modest performance of US equity markets on a total return[4] basis helped the US Core Domestic equity mandate to be the main driver of the overall portfolio return. The fixed income portion also added 1.5 per cent to the overall portfolio performance.

TABLE 2

CONTRIBUTION TO ANNUAL RETURN

FY 2014/2015

/per cent/

	Percentage of Portfolio as at September 30 2015	Portfolio Weighted Return	Benchmark Weighted Return
COMPOSITE PORTFOLIO	**100.00**	**2.47**	**1.13**
FIXED INCOME:			
• US Short Duration Fixed Income	25.94	0.41	0.53
• US Core Fixed Income	41.32	1.05	1.18
EQUITY:			
• US Core Domestic Equity	16.58	1.13	0.56
• Non US Core International Equity	16.16	-0.11	-1.11

**Portfolio and Benchmark returns may not sum to the Composite Return as they are geometrically-linked.

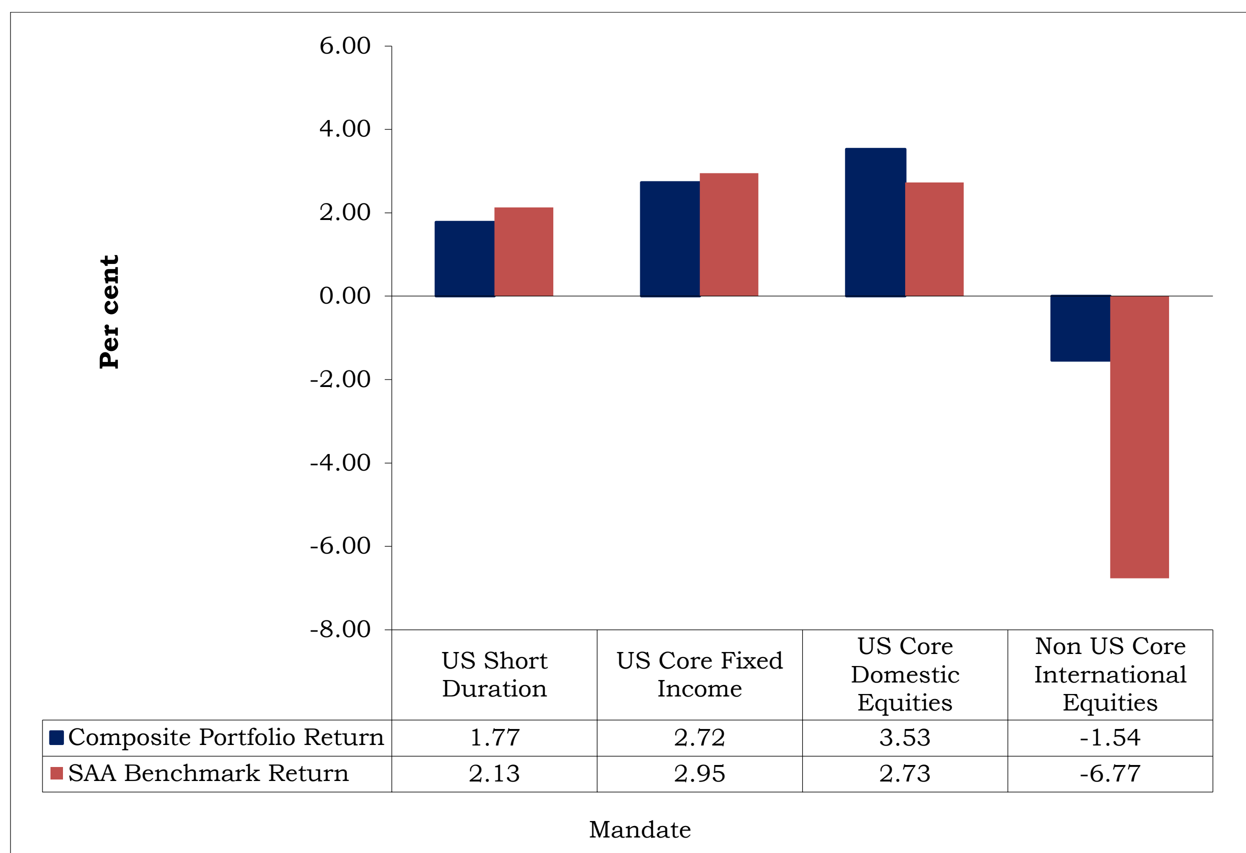
[4] Total return includes interest income, capital gains (price gains), dividends and distributions realized over a period.

CHART 12

ABSOLUTE RETURNS BY ASSET CLASS

FY 2014/2015

/per cent/



	US Short Duration	US Core Fixed Income	US Core Domestic Equities	Non US Core International Equities
Composite Portfolio Return	1.77	2.72	3.53	-1.54
SAA Benchmark Return	2.13	2.95	2.73	-6.77

The **Equity portion of** the Fund posted yet another positive period of performance over the financial year ended September 2015, albeit significantly smaller in magnitude relative to the prior financial year. There was a divergence within developed market equity returns over the financial year, as US equities rallied over the period, while non-US developed equities declined, even though both regions were affected by macro events in China, Greece and the Federal Reserve posturing. As at September 30, 2015, the net asset value of the equity holdings were US$1,851.1 million, compared with a value of US$2,213.2 million one year earlier. This change in value reflected in part, the

rebalancing process which occurred in July 2015, in which $407.6 million was transferred from these mandates to the fixed income mandates.

The **US Core Domestic Equity** portfolio gained 3.5 per cent, compared with a total return of 2.7 per cent for its benchmark, the Russell 3000 ex Energy Index. During the financial year, the Russell 3000 index fell 0.5 per cent, while the Russell 3000 ex Energy index increased 2.7 per cent. This variance is due to the steep fall in energy prices during the year. The outperformance of the portfolio relative to its benchmark was as a result of both stock selection and sector allocation decisions. Allocations to the Technology and Consumer Discretionary sectors proved beneficial to overall portfolio returns.

The other equity mandate, the **Non-US International Equity portfolio,** declined 1.5 per cent to outperform the MSCI EAFE ex Energy Index, which fell 6.8 per cent in total return terms. For the 12 months to September 2015, the MSCI EAFE index fell 8.1 per cent, while the MSCI EAFE ex Energy index fell 6.8 per cent as a result of the steep fall in energy prices during the year. The excess returns of the portfolio can mainly be attributed to favourable stock selection decisions and currency hedged country allocations over the financial year. Country allocations to Ireland, Denmark and Israel were especially beneficial to the portfolio. Additionally, security selection in Europe and Japan also helped outperformance.

The **Fixed Income portion** of the Fund continued its two-year trend of positive returns although both mandates underperformed their respective benchmarks. Government bond yields generally declined over the financial year, however, spreads widened as uncertainty and volatility returned to the fixed income market especially in the latter months of the year. The US treasury curve flattened over the financial year as longer term yields fell, including the US 10 year yield which declined 45 basis points. As at the end of September 2015, the net asset value of the two fixed income mandates totaled US$3,803.8 million, up from US$3,318.8 million one year earlier. This increase in value reflected in part, the rebalancing process which occurred in July 2015, when $407.6 million was transferred to this mandate from the equity mandates.

The **US Short Duration Fixed Income** mandate returned 1.8 per cent, compared with a gain of 2.1 per cent for its benchmark, the Bank of America Merrill Lynch 1- 5 year US Treasury Index. The under-performance of the portfolio relative to its benchmark was attributed to the portfolio's interest rate strategy particularly with respect to a short positioning on the 10-year sector of the curve. Exposure to breakeven inflation products also benefitted performance as spreads between real and nominal yields declined.

The other fixed income mandate, the **US Core Domestic Fixed Income** portfolio, gained 2.7 per cent over the financial year ended September 2015. The portfolio lagged behind its benchmark, the Barclays Capital US Aggregate Bond index, which returned 3.0 per cent. The portfolio's exposure to corporate bonds as spreads widened, was a significant detractor to performance. More specifically, corporate bonds in the Industrials and Utilities sectors hurt performance. Finally, the portfolio's tactical duration positioning over the period also detracted from performance, as the Fed held off on its decision to hike rates over the financial year, while the portfolio was positioned to take advantage of a rate hike (i.e. a short duration positioning relative to the benchmark).

The Fund received no cash contributions during the financial year. The cash balance held to meet the day-to-day expenses arising from the management of the Fund, amounted to US$0.7 million as at September 30, 2015.

5. Portfolio Risks

The main risks for the HSF portfolio are Credit, Concentration, Interest rate, and Currency risks. The exposition below indicates how these risks are mitigated.

(a) 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. Over the financial year, the average credit quality was "AA+" and "AA" for the US Short Duration and US Core Fixed Income Portfolios, respectively.

(b) 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 minimised 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.

(c) 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 benchmarks. Table 3 shows the weighted average duration for the **US Short Duration** and **US Core Domestic Fixed Income** portfolios as at September 30, 2015.

TABLE 3

WEIGHTED AVERAGE DURATION

/Years/

Mandate	Portfolio	Benchmark
US Short Duration	2.43	2.68
US Core Domestic Fixed Income	5.51	5.39

(d) Currency Risk

Currency risk is managed by containing and managing the exposure to non-US dollar instruments. The Fund is invested in twelve currencies in addition to the US dollar. These currencies include the Euro, Japanese Yen, Pound Sterling, Australian dollar, Swiss Franc dollar and Swedish Krona. 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.

TABLE 4

PORTFOLIO CURRENCY EXPOSURE

CURRENCY	Per Cent
US DOLLAR	84.54
EURO CURRENCY	5.22
JAPANESE YEN	4.47
POUND STERLING	2.59
DANISH KRONE	0.91
SWISS FRANC	0.71
SWEDISH KRONA	0.54
AUSTRALIAN DOLLAR	0.39
HONG KONG DOLLAR	0.28
NEW ISRAELI SHEQEL	0.18
SINGAPORE DOLLAR	0.09
NORWEGIAN KRONE	0.06
NEW ZEALAND DOLLAR	0.03
COMPOSITE TOTAL	100.00

6. Outlook & Risks to the Portfolio

In the financial year 2015-2016, the HSF investment managers' will employ differing strategies to take advantage of current and expected market conditions and their interpretations of such. For the fixed income managers, the main risks they face over the next year include the tightening policies of the Federal Reserve relative to the accommodative policies of the European Central Bank and the Bank of Japan, headwinds faced by emerging market economies as commodity prices fall and continue to have a knock-on effect on global demand and the potential of a slowdown in China and its spillover effects into global financial markets.

China also continues to be at the forefront of our equity managers' minds, as the potential for a hard landing looms. It is especially vital to monitor Chinese policymaker decisions in relation to the slowdown in growth as it has been observed that industrial companies in China have not been doing as well as technology and consumer companies, recently. Additionally, there are political risks to keep abreast of especially in Europe which include the potential for rising nationalism to affect an integrated Europe, unforeseen obstacles threatening to derail the Greek bailout, a shift in attitude from the U.K. in relation to its European Union membership and tensions resulting from the refugee influx into Europe from Syria.

APPENDIX I

HERITAGE AND STABILISATION FUND

FINANCIAL YEAR PORTFOLIO VALUATION

/USD/

Valuation Date	Net Asset Value	Financial Year Total Comprehensive Income	Accumulated Surplus & Unrealized Capital Gains/Losses	Contributions
September 30, 2007	1,766,200,701	41,966,361	41,966,361	321,706,043
September 30, 2008	2,888,421,556	68,412,770	110,379,131	1,054,174,457
September 30, 2009	2,964,686,478	76,248,691	186,755,766	-
September 30, 2010	3,621,984,041	177,645,460	364,361,226	477,344,263
September 30, 2011	4,084,016,158	9,715,841	374,074,067	451,400,519
September 30, 2012	4,712,376,278	420,693,705	794,770,772	207,550,846
September 30, 2013	5,154,027,747	399,007,950	1,193,778,722	42,519,782
September 30, 2014	5,533,425,248	379,167,024	1,572,945,746	-
September 30, 2015	5,655,143,565	120,639,605	1,693,585,351	-

APPENDIX II

HSF PORTFOLIO

HISTORICAL PERFORMANCE SINCE INCEPTION

Financial Year End	Financial Year Return			Annualised Return Since Inception		
	Portfolio %	Benchmark %	Excess bps	Portfolio %	Benchmark %	Excess bps
September 2007*	2.97	2.95	1.89	5.48	5.44	3.50
September 2008	3.62	3.50	12.12	4.34	4.25	9.37
September 2009	2.80	3.18	-37.81	3.81	3.91	-10.01
September 2010	6.07	5.75	31.93	4.61	4.59	2.29
September 2011	0.79	1.14	-34.89	3.80	3.87	-7.13
September 2012	10.73	10.18	55.01	5.38	5.33	5.20
September 2013	8.63	7.26	137.06	5.40	5.16	24.01
September 2014	7.65	5.60	204.51	5.69	5.22	47.69
September 2015	**2.47**	**1.13**	**134.06**	**5.31**	**4.73**	**58.12**

Note: * These returns are for the period March 2007 to September 2007.

(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.

(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%).