Ministry of Finance

Gobierno de Chile

ANNUAL REPORT
FINANCIAL COMMITTEE

Advisory Committee to the Ministry of Finance for Chile's Sovereign Wealth Funds

2014

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http://www.hacienda.cl/english/sovereign-wealth-funds.html

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for Chile's Sovereign Wealth Funds

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Preface

As stipulated in the Fiscal Responsibility Law of 2006, the Financial Committee was created in 2007 to advise the Finance Minister on the investment of Chile's two sovereign wealth funds: the Economic and Social Stabilization Fund (ESSF) and the Pension Reserve Fund (PRF). The Financial Committee is an independent external advisory board, whose members have a vast experience in economic and financial areas. The Committee meets periodically to analyze matters relating to the investment of the funds. This Report—the eighth prepared by the Committee—describes its work and activities in 2014.

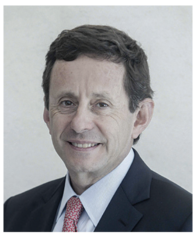
The publication of this Report fulfills the requirement established under Decree N° 621, issued by the Ministry of Finance in 2007, which stipulates that the Committee must present an annual report on its work to the Finance Minister and submit a copy of this report to the Finance Commissions of the Senate and the House of Representatives and to the Joint Budget Commission.

The Committee

Executive summary

At the close of 2014, the market value of the funds was US$ 22.633 billion, of which US$ 14.689 billion was in the Economic and Social Stabilization Fund (ESSF) and US$ 7.944 billion was in the Pension Reserve Fund (PRF). The net return in dollars in the year was –1.67% for the ESSF and 1.75% for the PRF, while the net return in pesos was 14.30% and 17.72%, respectively. In the case of the ESSF, the strategic asset allocation was 15% in bank deposits, 74% in sovereign bills and bonds, 3.5% in inflation-indexed sovereign bonds and 7.5% in stocks. For the PRF, the portfolio allocation was 48% in sovereign bonds, 17% in inflation-indexed sovereign bonds, 15% in stocks and 20% in corporate bonds.

Members of the Financial Committee



President José De Gregorio Rebeco

Mr. De Gregorio holds a Ph.D. in Economics from the Massachusetts Institute of Technology, a Master's degree in Industrial Engineering and a degree in Civil Industrial Engineering, both from Universidad de Chile. Currently, he is Professor at the Faculty of Economics and Business of Universidad de Chile, and Nonresident Senior Fellow at the Peterson Institute of International Economics. He has been President, Vice-President and Counselor of the Central Bank of Chile, Minister of Economics, Mining and Energy for the Chilean Government, and Economist at the International Monetary Fund. He joined the Committee in September 2014.

Vice President Cristián Eyzaguirre Johnston

Mr. Eyzaguirre holds a MA in Economics from University of California, Berkeley, and a degree in Business Administration from Universidad de Chile. He was CEO at Banco Bice and CFO at CMPC Enterprises. He has been Deputy Director of Chile's Tax Service (SII for its acronym in Spanish), advisor at Federation of Chilean Industry (SOFOFA for its acronym in Spanish) and Professor at Universidad de Chile. He currently participates in the Board of Directors of Cencosud, Besalco, E-CL S.A., GTD Group companies and Infrosa, among other companies, and is a Member of the Investment Committee of Hogar de Cristo. He joined the Committee in March 2010.

Member Jaime Casassus Vargas

Mr. Casassus holds a Ph.D. in Finance from Carnegie Mellon University and a degree in Civil Industrial Engineering from Universidad Católica de Chile. Currently, he is Professor at the Institute of Economics of Universidad Católica de Chile, Managing Editor at the journal "Quantitative Finance", Deputy Director at FinanceUC, and Director of the Economics Society of Chile. He was Visiting Professor at University of California, Berkeley. His research has been published in Journal of Finance, Review of Financial Studies, and Journal of Banking & Finance. He joined the Committee in September 2014.

Member Martín Costabal Llona

Mr. Costabal holds an MBA from the University of Chicago and a degree in Business Administration from Universidad Católica de Chile. He has performed as Finance Minister and Budget Director, executive of Empresas Pizarreño and Infraestructura Dos Mil, CEO of AFP Habitat and Member of the Technical advisory of Investment established by the Pension Reform. Currently he serves on the Boards of Directors of private companies. He joined the Committee in January 2007.

Member Igal Magendzo Weinberger

Mr. Magendzo holds a Ph.D. in Economics from University of California, Los Angeles, and a Bachelor's degree in Arts from the Hebrew University of Jerusalem. Currently, he is Chief Economist at Pacífico, Macroeconomía y Finanzas. He was Chief Economist for Hispanic America at Itaú, Manager of Macroeconomic Analysis at the Central Bank of Chile, Member of the Technical Advisory Committee of Investment, and Professor at Universidad Adolfo Ibáñez and Universidad de Chile. Mr. Magendzo has published his work in specialized financial journals. He joined the Committee in September 2014.

Member Eduardo Walker Hitschfeld

Mr. Walker holds a Ph.D in Finance from the Haas Business School, University of California at Berkeley, and a degree in Business Administration from Universidad Católica de Chile. He currently works as a Full Professor at the School of Business of Universidad Católica de Chile and also serves on the Boards of Directors of private companies and as an International Consultant. He has been a Visiting Associate Professor in the Finance Department of the McCombs School of Business of the University of Texas at Austin; Head of Research at AFP Habitat; Member of the Capital Market Committee, the Risk Rating Commission and the Technical Advisory Committee of Investment. He joined the Committee in January 2007.

CHAPTER 1

Fiscal policy and the funds' objectives, institutional framework and investment policy

A. Fiscal policy

Chile's fiscal policy is aimed at contributing to macroeconomic stability and providing public goods that increase opportunities and social protection for Chilean citizens.[1]

Since 2001, Chile's fiscal policy is guided by a structural balance rule or, more precisely, a cyclically adjusted balance rule,[2] which mitigates the effect on public finances of fluctuations in economic activity, the copper price and other secondary factors. This implies saving in boom times and then using the savings during cyclical downturns. As a result, the fiscal rule has a stabilizing effect on public finances and the economic cycle and improves access to financing for both the public and private sectors.

B. Objectives and rules on the use of the funds

To ensure the sustainability of public spending over time and contribute to the competitiveness of the economy, Law 20,128 on Fiscal Responsibility was passed in September 2006. This law created the Pension Reserve Fund (PRF) and authorized the President of the Republic to create the Economic and Social Stabilization Fund (ESSF), which was then officially established in February 2007. These two funds receive resources resulting from the application of the structural balance rule.

Objectives

The funds created by the Fiscal Responsibility Law (henceforth, the sovereign wealth funds) have specific objectives. In the case of the ESSF, the objectives are to accumulate resources to finance potential fiscal deficits and to amortize public debt, thereby contributing to cushioning fiscal spending against fluctuations in the world economy and the volatility of revenues from taxes, copper and other sources. The ESSF resources can also be used to finance the PRF if necessary. In the case of the PRF, the objective is to support the financing of fiscal liabilities deriving from the state pension guarantee for old-age and disability solidarity pension benefits, as well as old-age and disability solidarity pension contributions established by the Pension Reform. The PRF thus complements the financing of future pension-related contingencies.

Rules on fund contributions

The rules on establishing the funds and accumulating resources therein are established by law (see figure).[3]

The PRF is increased each year by a minimum of 0.2% of the previous year's gross domestic product (GDP). If the effective fiscal surplus exceeds 0.2% of GDP, the PRF receives a contribution equivalent to the surplus, up to 0.5% of GDP. PRF contributions only have to be made until the fund reaches UF 900 million (unidad de fomento, UF).

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1 Decree N° 892 of 2014, which establishes the basis of fiscal policy, in accordance with the provisions of Article 1° of Law N° 20,128.

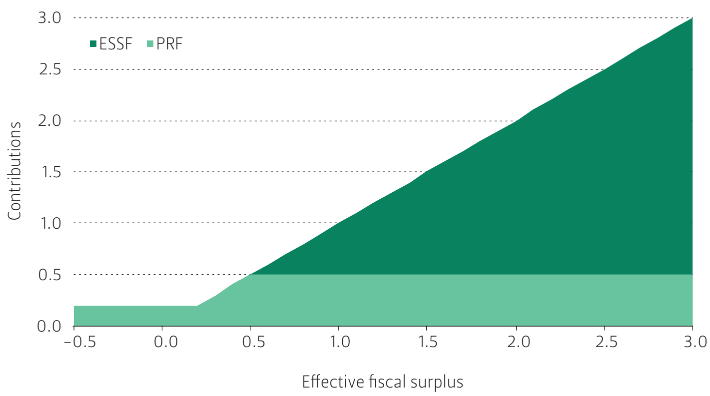
2 The structural balance rule (or cyclically adjusted balance rule) has undergone some changes since it was first implemented. For a detailed discussion of its design, modifications, application and results, see Marcel, Tokman, Valdés and Benavides (2001); García, García and Piedrabuena (2005); Rodríguez, Tokman, and Vega (2006); Velasco, Arenas, Rodríguez, Jorratt and Gamboni (2010); Comité Asesor para el diseño de una política fiscal de balance estructural de segunda generación para Chile (2011); Larraín, Costa, Cerda, Villena and Tomaselli (2011); Schmidt Hebbel (2012); and Velasco and Parrado (2012).

3 For the PRF, the Fiscal Responsibility Law; for the ESSF, Statutory Decree (DFL) N° 1, issued by the Ministry of Finance in 2006.

The yearly contribution to the ESSF corresponds to the balance of the effective fiscal surplus (if positive) after subtracting the PRF contribution, less public debt pay downs and any advance contributions to the fund.[4]

FIGURE 1

Fiscal savings rule
(percent of GDP)



SOURCE: Ministry of Finance of Chile.

Rules on the use of the funds

Starting in 2016, the PRF resources can be used to complement the financing of fiscal liabilities deriving from the state guarantee for old-age and disability solidarity pension benefits, as well as old-age and disability solidarity pension contributions. From that point, the annual withdrawal of PRF resources cannot exceed one-third of the difference between expenditures on pension liabilities in the current year and the pension expenditure in 2008, adjusted for inflation. Prior to 2016, withdrawals from the PRF are allowed equivalent to the returns generated in the previous year.

As of 2021, the PRF will cease to exist if the withdrawals in a calendar year do not exceed 5% of the fiscal pension expenditure established in that year's budget. When the PRF is eliminated, the remaining balance will be transferred to the ESSF.

The ESSF resources can be used at any time to complement fiscal revenues as needed to finance authorized public spending in the event of a fiscal deficit. These resources can also be used for the regular or extraordinary pay down of public debt (including Recognition Bonds) and for financing the annual contribution to the PRF, as per a decision by the Finance Minister.

Withdrawals from the ESSF and the PRF are effectuated through a decree from the Ministry of Finance.

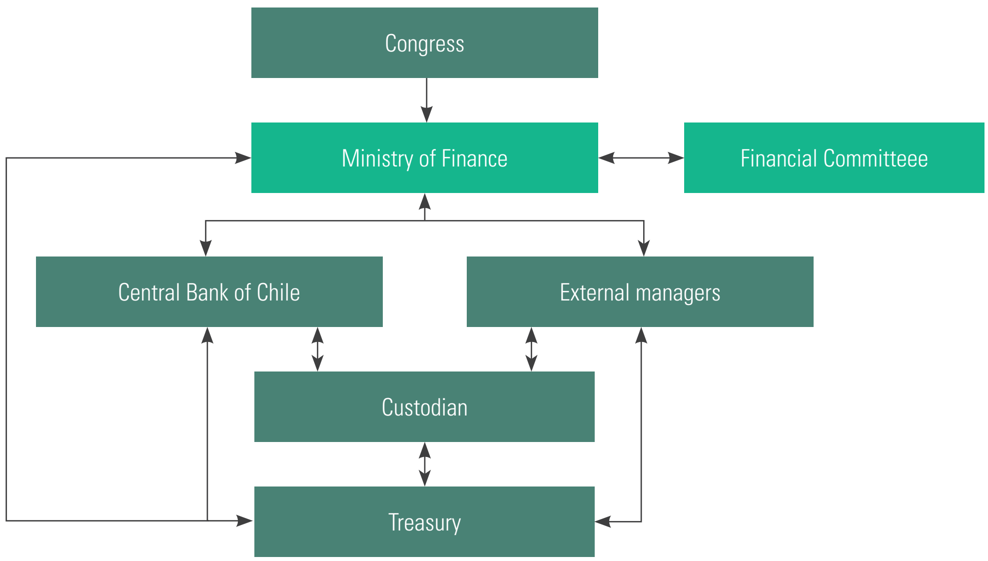
4 The current legislation allows the pay down of public debt and advance contributions to the ESSF using resources from the fiscal surplus of the current year, which must be deposited into the fund in the current or subsequent years.

C. Institutional framework

The legal framework establishes a clear division of roles and responsibilities in order to ensure accountability and operational independence in the management of the funds. This section provides a brief description of the roles of each of the bodies involved in fund management (see diagram 1).

DIAGRAM 1

Institutional framework for Chile's sovereign wealth funds



SOURCE: Ministry of Finance of Chile.

Ministry of Finance and dependent bodies

The Fiscal Responsibility Law establishes that the funds are the property of the Fisco of Chile and that the General Treasury holds the legal title to the resources. The law authorizes the Finance Minister to make decisions on how the funds are managed and to dictate their investment policies. To this end, the Ministry of Finance draws up the investment guidelines, which define the criteria that must be followed by the funds' managers. The Ministry monitors the managers' performance and compliance with the investment guidelines and issues monthly, quarterly and annual reports on the state of the funds.

The General Treasury is responsible for the funds' accounting and the preparation of their audited financial statements, for monitoring compliance with the investment limits, for reconciling information on the portfolios from the managers and the custodian and for approving payments to the managers. The Budget Office is responsible for budgetary issues related to the funds.

Central Bank of Chile

Executive Decree N° 1,383 (the Agency Decree), issued by the Ministry of Finance in 2006, appoints the Central Bank of Chile (CBC) to act as fiscal agent in the management and investment of the resources in both funds. In carrying out these functions, the CBC must strictly follow the investment guidelines issued by the Finance Minister. The CBC is authorized to delegate part of the management of the sovereign wealth funds to external managers.

Following a careful selection process carried out in 2011, the CBC contracted BlackRock Institutional Trust Company N.A., Mellon Capital Management Corporation and Rogge Global Partners PLC to manage the investment of 35% of the PRF portfolio starting in January 2012. In 2013, based on the recommendation of the Financial Committee, the Ministry of Finance instructed the CBC to contract BlackRock Institutional Trust Company N.A. and Mellon Capital Management Corporation to manage the ESSF stock portfolio, equivalent to 7.5% of the fund, taking into account that their mandate would be identical to the PRF's and that they were recently chosen from the selection process carried out for that fund.

Decree N° 1,618 of 2012 modified the Agency Decree to relieve the CBC of the management of the corporate fixed-income and stock portfolios of the ESSF and the PRF, whose management had been delegated by the CBC, in representation of the Fisco, to the aforementioned companies. In accordance with Decree N° 1,618 of 2012, the CBC's responsibilities with regard to the externally managed portfolios were significantly reduced as of 1 January 2014, being mainly limited to reconciling daily positions. With these changes, the contractual relationship with the external managers and other tasks previously carried out by the CBC were transferred to the Ministry of Finance and the General Treasury.

Financial Committee

The Fiscal Responsibility Law stipulates that the Ministry of Finance must establish an Advisory Committee to give advice to the Finance Minister on the sovereign wealth funds (henceforth, the Financial Committee). This Committee monitors the investment of the funds' resources and advises the Minister on the definition of the investment policies consistent with the funds' objectives. In compliance with these provisions, on 23 December 2006, the Finance Minister announced the establishment of both the sovereign wealth funds and the Financial Committee. The Committee was then officially created through Decree N° 621, issued by the Ministry of Finance in 2007. In accordance with that decree, the Committee must be made up of six members who have experience in investment portfolio management, have held an executive position in a financial institution or have held or currently hold an academic post. The six Committee members are appointed for two years, with half the seats being renewed each year. The Committee's president receives a fee per session of 25.5 UTMs (unidades tributarias mensuales, UTM), with an annual cap of 127.5 UTMs. The remaining members receive a fee of 17 UTMs per session, with an annual cap of 85 UTMs. The Committee must meet at least once every six months, but in practice it has met at least five times a year.

Decree N° 621 also stipulated the Financial Committee's functions and the rules of procedure for its proper functioning. Thus, the duties and powers of the Committee are as follows:

- To advise the Finance Minister, when requested, on key issues related to the funds' investment policy, such as the distribution of investments by asset class (asset allocation), the incorporation of new investment alternatives, the specification of portfolio benchmarks (see box 1), the permissible range of deviation from the asset allocation and the limits on the funds' investment possibilities;
- To submit recommendations to the Finance Minister, when requested, on custody and investment instructions and on the tender and selection processes for the management of the funds' portfolios;
- To express an opinion at the request of the Finance Minister about the structure and content of the annual reports on the funds' portfolio management that are presented to the Ministry of Finance by the institution(s) responsible for their management or custody and, on the basis of these reports, to express an opinion about the funds' management and, particularly, its consistency with their investment policies;
- To express an opinion about the structure and content of the reports on the funds prepared quarterly by the Ministry of Finance;
- To advise the Finance Minister, when requested, on any matter related to the funds' investment;
- To express its views and recommendations regarding other matters related to the funds' investment policies, taking into account the principles, objectives and rules that govern the funds.

In order to promote transparency, the Financial Committee decided that the decree regulating its activities, the minutes of its meetings and the corresponding press releases should be publicly disclosed. The Ministry of Finance's website thus includes a special section containing all information on these issues.[5]

BOX 1: Portfolio benchmarks

Portfolio benchmarks are representative market indexes for the different asset classes. In principle, they represent the passive investment performance of diversified portfolios invested in certain asset classes, where the return of each instrument is typically weighted by its relative share of market capitalization. The indexes are used as a reference for measuring the performance of the managers in charge of investing the funds.

Each asset class in an investment portfolio is associated with a benchmark. The benchmark for the total portfolio is thus constructed by weighting the selected indexes by the percentage allocation of each class, as defined in the investment policy.

Both the ESSF and the PRF have passive investment policies. That is, their investment strategy aims to achieve the benchmark return.

5 www.hacienda.cl/english/sovereign-wealth-funds.html

D. Investment policy

To support the competitiveness of the Chilean economy, the ESSF and the PRF are invested exclusively in foreign currency instruments, in accordance with the investment policy outlined in this section.

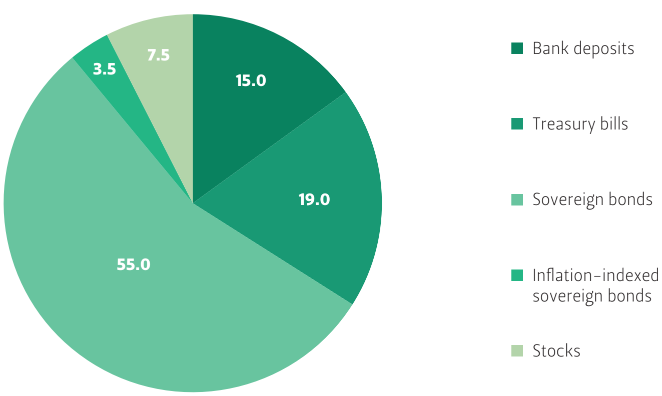
Economic and Social Stabilization Fund

In line with the objectives described above, the main goal of the ESSF investment policy is to maximize the fund's accumulated value in order to partially cover cyclical reductions in fiscal revenues while maintaining a low level of risk. Its aversion to risk is reflected in the choice of an investment portfolio with a high level of liquidity and low credit risk and volatility, thereby ensuring the availability of the resources to cover fiscal deficits and avoiding significant losses in the fund's value.

From its inception through July 2013, the ESSF investment policy centered on investment in fixed-income instruments denominated in reserve currencies, which typically perform well in times of crisis. However, a new investment policy was implemented in August 2013, which was defined by the Ministry of Finance on the basis of the Financial Committee's recommendations in 2012.[6] The new investment policy establishes a portfolio allocation of 15% in bank deposits, 74% in sovereign bills and bonds, 3.5% in inflation-indexed sovereign bonds and 7.5% in stocks (see figure 2). For the fixed-income portfolio, the currency allocation is defined as 40% in U.S. dollars (USD), 25% in euros (EUR), 20% in yen (JPY) and 7.5% in Swiss francs (CHF), expressed as a percentage of the total portfolio. The new policy also increases the duration of the fixed-income portfolio to approximately 4.8 years (see box 2).

FIGURE 2

ESSF: Strategic asset allocation
(percent of portfolio)



SOURCE: Ministry of Finance of Chile.

6 The Financial Committee's recommendation was founded on the review and analysis of different sources, including Eduardo Walker's study on portfolio allocation commissioned by the Ministry of Finance, comments on the study contained in three external peer reviews and additional simulations using market data from the last 20 years, carried out by the Ministry of Finance's International Finance team. For more information, see Chapter 3 of the Financial Committee's 2012 Annual Report.

BOX 2: Main elements of the new ESSF investment policy

Investment objectives: Consistent with the ESSF objectives, the investment policy aims to maximize the fund's accumulated value in order to partially cover cyclical reductions in fiscal revenues while maintaining a low level of risk. Its aversion to risk is reflected in the choice of an investment portfolio with a high level of liquidity and low credit risk and volatility, thereby ensuring the availability of the resources to cover fiscal deficits and avoiding significant losses in the fund's value.

Strategic asset allocation: The ESSF investment policy stipulates a strategic asset allocation of 15% in bank deposits, 74% in sovereign bills and bonds, 3.5% in inflation-indexed sovereign bonds and 7.5% in stocks. The fixed-income portfolio has a currency allocation of 40% in USD, 25% in EUR, 20% in JPY and 7.5% in CHF, expressed as a percentage of the total portfolio.

Portfolio benchmarks: A benchmark has been defined for each component of the strategic asset allocation, using a representative market index:

Asset class		Percent of portfolio	Benchmark
1. Bank deposits		5.0	Merrill Lynch LIBID 3 Month Average USD
		6.0	Merrill Lynch LIBID 3 Month Average EUR
		4.0	Merrill Lynch LIBID 3 Month Average JPY
		15.0	**Subtotal bank deposits**
2. Treasury bills and sovereign bonds	2.1. Treasury bills	6.0	Merrill Lynch Treasury Bills Index USD
		7.0	Merrill Lynch Treasury Bills Index EUR
		6.0	Merrill Lynch Treasury Bills Index JPY
		19.0	**Subtotal Treasury bills**
	2.2. Sovereign bonds	26.5	Barclays Capital Global Treasury: U.S. 7-10 Yrs
		11.0	Barclays Capital Global Treasury: Germany 7-10 Yrs
		10.0	Barclays Capital Global Treasury: Japan 7-10 Yrs
		7.5	Barclays Capital Global Treasury: Switzerland 5-10 Yrs
		55.0	**Subtotal sovereign bonds**
		74.0	**Subtotal Treasury bills and sovereign bonds**
3. Inflation-indexed sovereign bonds		2.5	Barclays Capital Global Inflation-Linked: U.S. TIPS 1-10 Yrs
		1.0	Barclays Capital Global Inflation-Linked: Germany 1-10 Yrs
		3.5	**Subtotal inflation-indexed sovereign bonds**
4. Stocks		7.5	MSCI All Country World Index ex Chile (unhedged with reinvested dividends)

The ESSF has implemented a passive management strategy since May 2011, allowing only marginal deviations from the strategic asset allocation.

Management: The ESSF is largely managed by the CBC, which, acting as fiscal agent, manages the fixed-income portfolio (92.5% of total assets). The stock portfolio is managed by external management companies contracted by the CBC following a tender process.

Ex ante tracking error:[1] The ex ante tracking error is capped at 50 basis points for the fixed-income portfolio and 60 basis points for the stock portfolio.

Eligible currencies and issuers: Only currencies in the benchmark are eligible for investment. In the case of sovereign and stock exposure, only the issuers that make up the corresponding benchmark are eligible for investment. With regard to bank exposure, the fund can only be invested in banks with a risk rating of A–/A3 or higher (Standard & Poor's, Moody's and Fitch) and in accordance with the limits stipulated in the investment guidelines.

Leveraging and the use of derivatives: Leveraging is not allowed.[2] The use of derivatives is defined according to the type of portfolio:

- Fixed-income portfolio: The use of forwards and swaps is only allowed for foreign currency hedging. The total notional amount cannot exceed 4% of the fixed-income portfolio.
- Stock portfolio: The use of forwards and swaps is only allowed for foreign currency hedging. In addition, the use of stock futures is allowed for hedging purposes or to gain exposure to part of the benchmark. The aggregate nominal amount of the futures, forwards and swaps cannot exceed 10% of the portfolio of each external manager.

Rebalancing policy: The rebalancing policy consists in restoring the strategic allocation once a year and whenever the share of stocks exceeds the range of 5.5% to 9.5% of the total portfolio. The annual rebalancing is coordinated with fund contributions, to the extent possible.

Investment guidelines: The investment guidelines, which are published in spanish and available online at the Ministry of Finance website,[3] provide additional information on the ESSF investment policy, such as special restriction on investment in specific countries and other relevant limits, as well as other aspects of portfolio management.

1 The ex ante tracking error is an estimate of the standard deviation of the difference between the portfolio and benchmark returns. The lower the ex ante tracking error, the more passive the portfolio management.

2 Leveraging is the purchase of assets through debt.

3 http://www.hacienda.cl/fondos-soberanos/fondo-de-estabilizacion-economica-y/politica-de-inversion.html.

Pension Reserve Fund

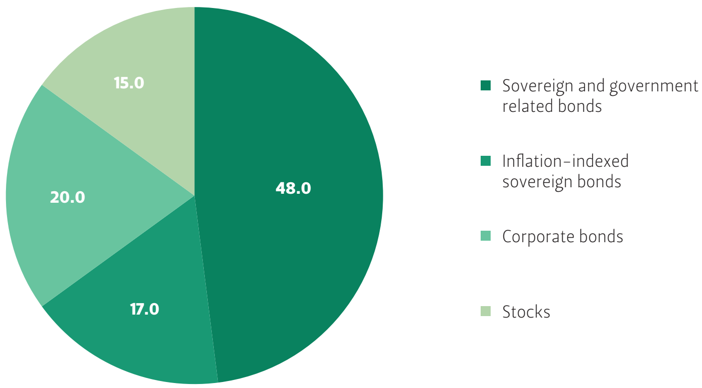
The main objective of PRF investment is to generate resources for financing part of the government's pension liabilities. To achieve this, the investment policy incorporates the specific objective of maximizing expected returns while keeping risk within a 95% probability that the fund will not lose more than 10% of its value in dollars in a given year. The investment horizon is medium to long term, given the size and timeline of the liabilities that the fund has to finance.

The PRF investment policy was similar to that of the ESSF from its inception through year-end 2011; a new investment policy was then implemented in early 2012 (see box 3). The new policy stipulates a portfolio allocation of 48% in sovereign and government related bonds, 17% in inflation-indexed sovereign bonds, 15% in stocks and 20% in corporate bonds (see figure 3). The new policy was defined by the Finance Minister based on recommendations by the Financial Committee in late 2010.[7]

7 The Financial Committee's recommendation was based on a study carried out by the Mercer consulting firm in 2008 (Strategic Assest Allocation Analysis), which is available online at http://www.hacienda.cl/english/sovereign-wealth-funds/relevant-studies.html.

FIGURE 3

PRF: Current strategic asset allocation
(percent of portfolio)



SOURCE: Ministry of Finance of Chile.

BOX 3: Main elements of the PRF investment policy

Investment objectives: The main objective of PRF investment is to generate resources for financing part of the government's pension liabilities. To achieve this, the investment policy incorporates the specific objective of maximizing expected returns while keeping risk within a 95% probability that the fund will not lose more than 10% of its value in dollars in a given year. The investment horizon is medium to long term, given the size and timeline of the liabilities that the fund has to finance.

Strategic asset allocation: The current PRF investment policy, which was implemented in January 2012, stipulates a portfolio allocation of 48% in sovereign bonds, 17% in inflation-indexed sovereign bonds, 15% in stocks and 20% in corporate bonds. The previous investment policy only considered investments in sovereign fixed income and bank deposits.

Portfolio benchmarks: A benchmark has been defined for each component of the strategic asset allocation, using a representative market index:

Asset class	Percent of portfolio	Benchmarks
Sovereign and government-related bonds [a]	48	Barclays Capital Global Aggregate: Treasury Bond Index (unhedged)
		Barclays Capital Global Aggregate: Government-Related (unhedged)
Inflation-indexed sovereign bonds	17	Barclays Capital Global Inflation-Linked Index (unhedged)
Corporate bonds	20	Barclays Capital Global Aggregate: Corporates Bond Index (unhedged)
Stocks	15	MSCI All Country World Index ex Chile (unhedged with reinvested dividends)

(a) Each subindex of this asset class is added in accordance with its relative capitalization.

Management: The sovereign and government-related bonds and inflation-indexed sovereign bond portfolios are managed directly by the CBC, acting as fiscal agent. The stock and corporate bond portfolios are managed by external management companies contracted by the CBC following a tender process.

Ex ante tracking error: The ex ante tracking error is capped at 50 basis points for the aggregate portfolio of sovereign and government-related bonds and inflation-indexed sovereign bonds; 60 basis points for the equity portfolio; and 50 basis points for the corporate bond portfolio.

Eligible currencies and issuers: For each asset class, only currencies and issuers that make up the benchmark are eligible for investment.

Leveraging and the use of derivatives: Leveraging is not allowed. Derivatives use is differentiated by portfolio:

- Portfolio managed by the CBC: Forwards and swaps can only be contracted for foreign currency hedging. The nominal value of the forwards or swaps contracted with a given eligible counterparty cannot exceed 1% of the market value of the portfolio. The notional amount of all current forward or swap contracts, in sum, can not exceed 4% of the portfolio managed by the Bank.

- Stock and corporate bond portfolios: Each external manager can only contract forwards or swaps for foreign currency hedging, and stock or fixed-income futures for hedging purposes or to gain exposure to part of the benchmark. The nominal value of the forwards or swaps contracted by an external manager with a given eligible counterparty cannot exceed 1% of the market value of the portfolio managed by that external manager. The aggregate nominal amount of futures, forwards and swaps cannot exceed 10% of the portfolio managed by a given external manager.

Rebalancing policy: The rebalancing policy consists in restoring the strategic allocation whenever contributions are received by the fund and whenever any of the asset classes exceeds the following shares of the total portfolio: 45–51% for sovereign and government-related bonds, 14–20% for inflation-indexed sovereign bonds, 17–23% for corporate bonds and 12–18% for stocks.

Investment guidelines: The investment guidelines, which are published and available online at the Ministry of Finance website,[1] provide additional information on the PRF investment policy, such as the rebalancing policy, the permissible range of deviation, eligible instruments and other relevant limits, as well as other aspects of portfolio management..

1 http://www.hacienda.cl/fondos-soberanos/fondo-de-reserva-de-pensiones/politica-de-inversion.html.

CHAPTER 2

State of the funds

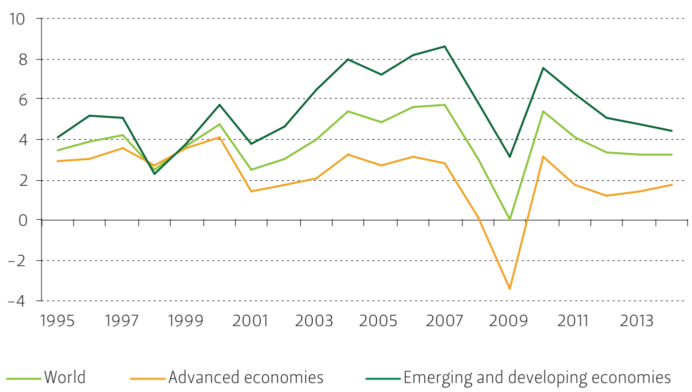
A. Market analysis

Main developments

World growth was moderate in 2014, still under the effect of the economic crisis that started in 2008 (see figure 4). The improvement in growth rates has been gradual, and performance has varied widely across countries. The recovery of world growth has mainly been driven by the United States and the United Kingdom, both of which have returned to their precrisis GDP levels. Low- and medium-income countries have also contributed substantially to world growth (see figure 5). In contrast, the Eurozone and Japan continue to grow at very low rates, accounting for a minimum share of world growth.

FIGURE 4

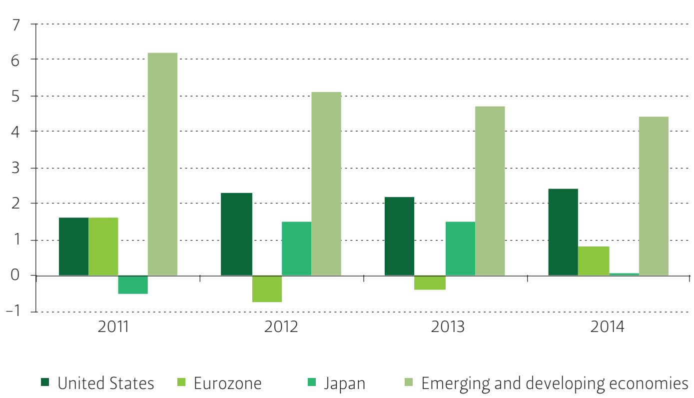
GDP growth, 1995–2014
(percent)



SOURCE: International Monetary Fund

FIGURE 5

GDP growth of selected economies, 2011–2014
(percent)

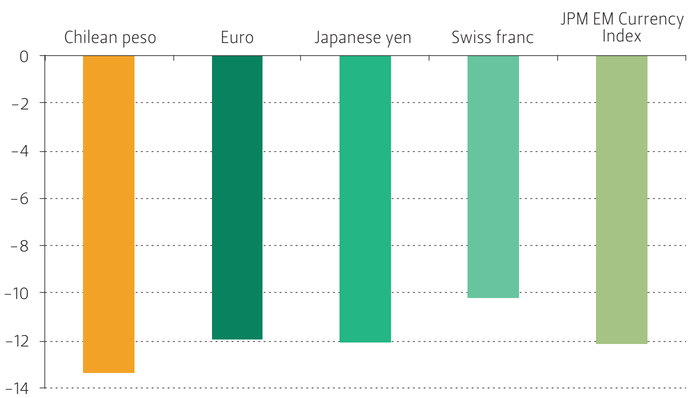


SOURCE: International Monetary Fund

The United States began to normalize its monetary policy by ending its Quantitative Easing program, while the Eurozone and Japan maintained expansive monetary policies in the face of deflationary pressures in their economies. In this context, the U.S. dollar strengthened against most of the world's currencies, especially in the advanced economies and commodity exporters (see figure 6).

FIGURE 6

Exchange rate fluctuations against the dollar in 2014: Selected currencies[8]
(percent)



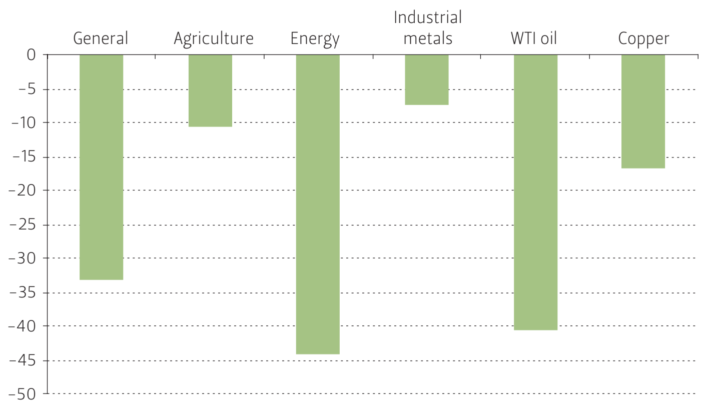
SOURCE: Bloomberg

International commodity prices recorded a widespread drop in the second half of 2014 (see figure 7). In particular, the WTI oil price fell around 41% over the course of the year.

8 The J.P. Morgan EM Currency Index is a tradable index that incorporates ten emerging market currencies against the dollar.

FIGURE 7

Commodity yields in 2014: Standard & Poor's, WTI oil and copper
(percent)

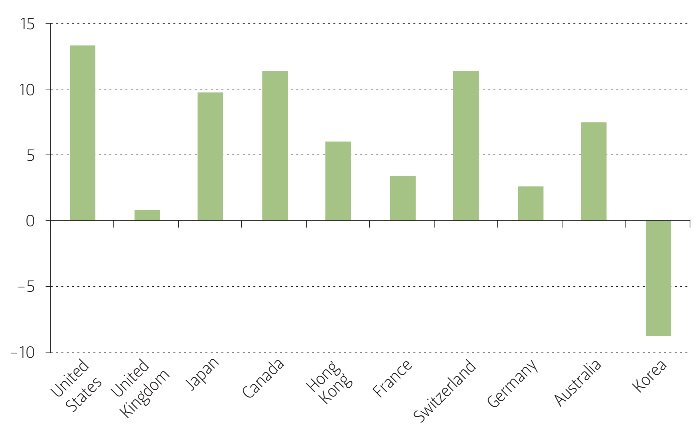


SOURCE: Bloomberg

With regard to the financial markets, various international stock indexes rose substantially in 2014, measured in local currency; corporate spreads were historically low; and volatility was generally limited (see figures 8, 9 and 10). Only in the last quarter of the year did emerging market sovereign spreads increase (mainly for commodity exporters), as did corporate spreads for companies exposed to energy prices. At the same time, the long-term interest rate in developed economies fell (see figure 11). Given this scenario, corporate and sovereign bond yields in local currency were positive for the year (see figure 12).

FIGURE 8

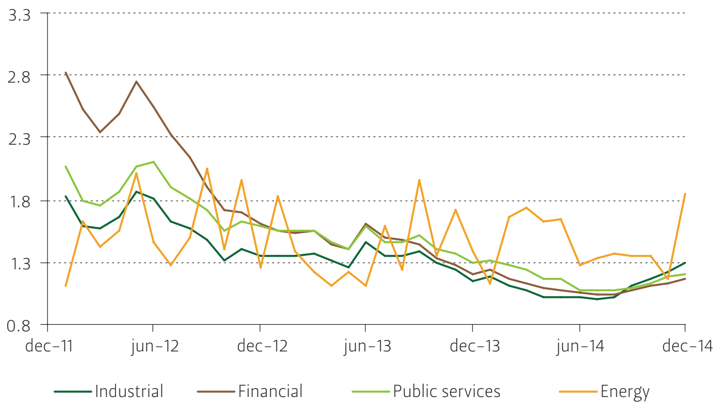
MSCI stock index yields, 2014
(percent, measured in local currency)



SOURCE: Bloomberg

FIGURE 9

Corporate spreads by industry, 2012–2014
(percent)



SOURCE: Barclay's

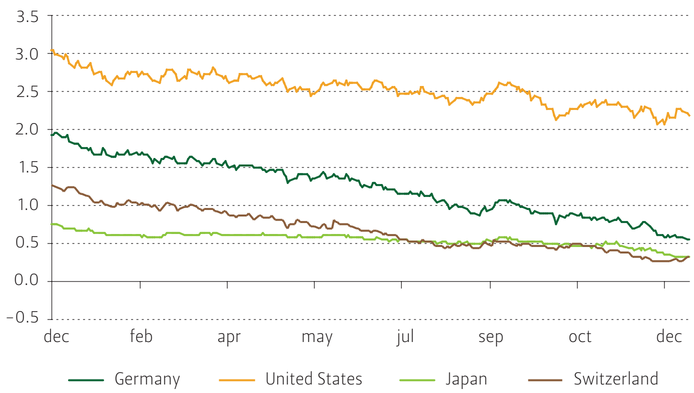
FIGURE 10

Volatility (VIX) in the stock market (S&P 500), 2010–2014
(percent)

SOURCE: Bloomberg

FIGURE 11

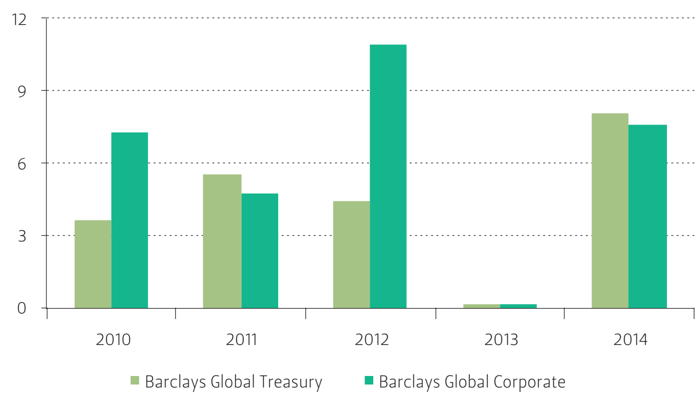
Internal rate of return (IRR) on ten-year bonds: Selected countries, 2014
(percent)



SOURCE: Bloomberg

FIGURE 12

Return on Barclays Global Treasury and Global Corporate indexes (hedged), 2010–2014
(percent, measured in local currency)



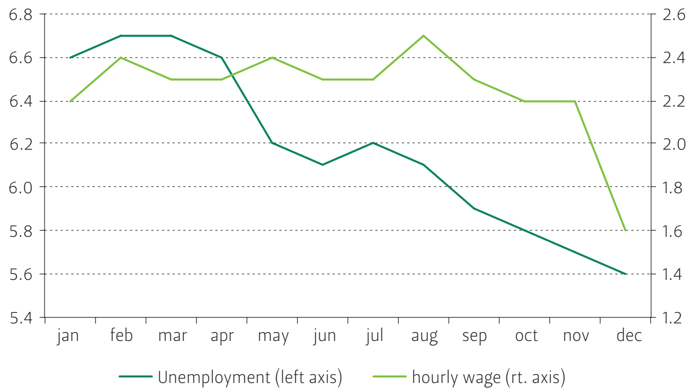
SOURCE: Barclay's

Regional developments

According to estimates, the United States grew 2.4% in 2014, mainly thanks to growth in the second half of the year (3.6%), after contracting in the first quarter (–2.1%). The growth in the year was accompanied by a reduction in the unemployment rate, which reached 5.6% (see figure 13). Based on the trend in output and inflation, in October the U.S. Federal Reserve System (Fed) ended its most recent Quantitative Easing program, which was initiated in 2012. Nevertheless, the Fed's monetary policy kept the federal funds rate at virtually zero (see figure 14).

FIGURE 13

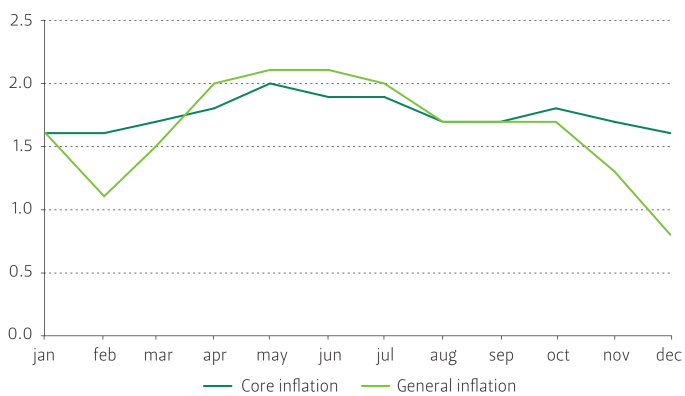
Unemployment rate and wage growth in the United States, 2014
(left: percent)(rt.: year-on-year change, percent)



SOURCE: Bloomberg

FIGURE 14

Consumer price index in the United States, 2014
(year-on-year change, percent)



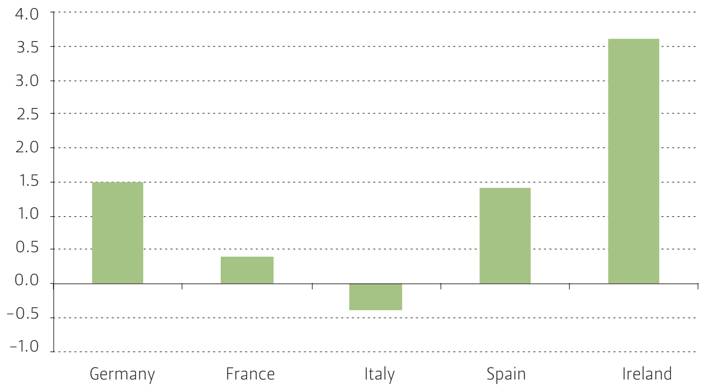
SOURCE: Bloomberg.

The Eurozone grew 0.8% in 2014, mainly due to the low growth of investment and exports. GDP growth rates varied considerably among countries: for example, Italy, –0.4%; France 0.4%; Spain, 1.4%; Germany, 1.5%; and Ireland 3.6% (see figure 15). Inflation was below the target of the European Central Bank (ECB), which led to the announcement and implementation of some monetary policy measures aimed at meeting the target (see figure 16).[9]

9 In September 2014, the President of the ECB announced the implementation of an asset-backed securities and covered bonds purchase program, which was initiated in mid-October.

FIGURE 15

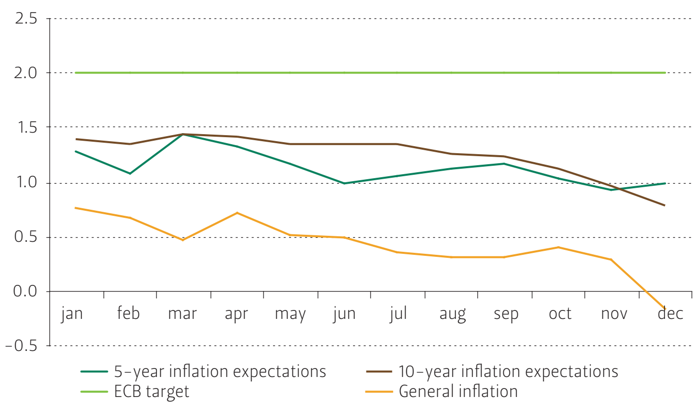
GDP growth in the Eurozone: selected countries, 2014
(percent)



SOURCE: World Bank.

FIGURE 16

Breakeven inflation expectations (Germany) and actual inflation in the Eurozone:[10] Year-on-year change, 2014.
(percent)



SOURCE: Bloomberg; European Central Bank; Eurostat.

Japan implemented a series of structural reforms in 2014, in addition to the Quantitative and Qualitative Monetary Easing program initiated by the Bank of Japan in 2013. In April 2014 the government increased the consumption tax as a measure for strengthening its fiscal position. According to estimates, the Japanese economy grew 0.2% in the year.

With regard to the emerging economies, China recorded a growth rate of 7.4% in 2014, while the Asia-Pacific region (excluding China) grew 4.6% in the year. The Russian economy expanded 0.6% in 2014. Latin America grew 0.9%, with practically zero growth in Brazil and contractions in Argentina and Venezuela.

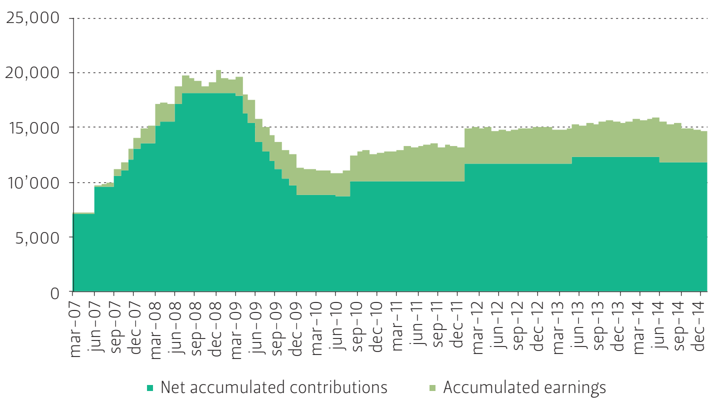
10 The inflation measure is the Harmonised Index of Consumer Prices, reported by Eurostat.

B. Market value of the sovereign wealth funds

At the close of 2014, the market value of the ESSF was US$ 14.689 billion, versus US$ 15.419 billion at the close of 2013, while the PRF had a market value of US$ 7.944 billion, versus US$ 7.335 billion at year-end 2013. The decrease in the value of the ESSF was due to a withdrawal of US$ 499 million, to finance the annual contribution to the PRF, and net investment losses of US$ 231 million (see figure 17). The PRF, in turn, received the aforementioned contribution of US$ 499 million and recorded net gains of US$ 110 million (see figure 18).

FIGURE 17

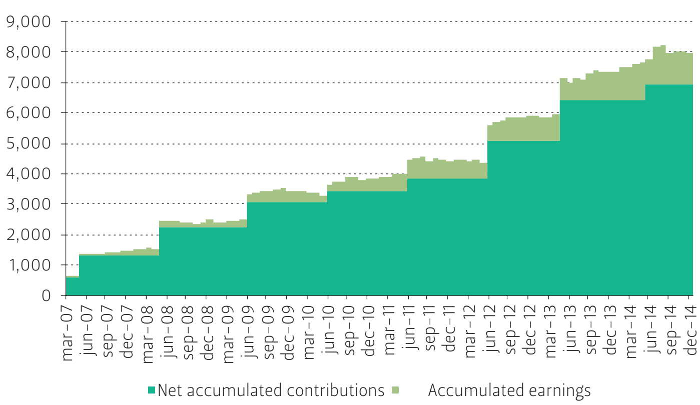
ESSF: Evolution of market value, March 2007 to December 2014
(millions of dollars)



SOURCE: Ministry of Finance of Chile.

FIGURE 18

PRF: Evolution of market value, March 2007 to December 2014
(millions of dollars)



SOURCE: Ministry of Finance of Chile.

C. Returns

1. Conceptual definitions

The return on the funds' investments reflects a number of factors that affect the different types of instruments included in the EESF and PRF portfolios.

The ESSF portfolio is largely invested in fixed-income instruments, so the most important factors affecting total portfolio returns are the level and changes in interest rates and exchange rate fluctuations.[11] The return on short-term fixed-income instruments is basically determined by the interest rate, which tends to be stable in the local currency. For medium- and long-term fixed-income instruments, the yield primarily depends on interest rate levels and movements in the country of investment. For example, an increase in interest rates reduces the market value of bonds, whereas an interest rate reduction increases it. The fund's return also depends on exchange rate movements relative to the currency used to measure performance. For example, because both funds express their return in U.S. dollars, the market value of investments denominated in euros, yen or Swiss francs, expressed in dollars, increases (decreases) as a result of an appreciation (depreciation) of these currencies against the U.S. dollar. Given the currency allocation of the ESSF fixed-income portfolio (40% USD, 25% EUR, 20% JPY and 7.5% CHF, expressed as a percentage of the total portfolio), the main countries that influence the ESSF returns are the United States, Germany, Japan and Switzerland. In the case of the ESSF stock portfolio, the return largely depends on the market's perception of the income-generation capacity of the companies in the different industries where the ESSF is invested and their risks, as well as market financial conditions.

The return on the PRF portfolio is affected by additional factors, as well as those that determine the ESSF return, because the portfolio is more complex, with a larger number of issuers, currencies and types of financial instruments. For the sovereign debt asset class, the factors are similar to the ESSF, but for a larger set of countries: the return depends, to a large extent, on interest rates in the countries where the fund is invested and the corresponding exchange rates. However, because the PRF does not invest exclusively in sovereign instruments from countries with a minimal credit risk, it is more exposed to the credit performance of the larger number of sovereign issuers in the portfolio.[12] For example, an increase in the credit risk of a sovereign instrument will generally be associated with a higher interest rate demanded by investors and a reduction in the market value of the instrument. For the corporate bond asset class, not only are the instruments affected by sovereign interest rates and exchange rates, but their prices also depend on the evolution of the spread, or the difference between the corporate debt instrument's internal rate of return and the interest rate on sovereign bonds from the respective countries. Thus, an increase (decrease) in the corporate bond spread is associated with a decrease (increase) in the value of the bond. For stocks, the relevant factors are the same as those cited for the ESSF.

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11 Bond yields also depend on the creditworthiness of the issuer and their evolution over time. This variable, however, hasn't had a major impact in the ESSF because it mainly invests in instruments with a high credit rating.

12 Whereas the ESSF only invests in sovereign debt instruments issued by the United States, Germany, Japan and Switzerland, the PRF sovereign portfolio includes debt instruments issued by a large number of countries, as well as public and semi-public agencies, state-owned companies, municipalities, multilateral financial institutions, and other issuers. This reflects the fact that one of the objectives of the fund's benchmark is to take on exposure to the global market for investment-grade sovereign debt (that is, a credit rating of BBB–/Baa3 or better).

2. Returns in 2014 and in 2007–2014

In 2014, the net return in dollars, measured by the time-weighted rate of return (TWR), was –1.67% for the ESSF and 1.75% for the PRF (see table 1). Using the internal rate of return (IRR), the return was –1.52% for the ESSF and 1.48% for the PRF.

In the case of the ESSF the negative yield is mainly explained by the return on the fixed-income portfolio (–2,18%), which was partially offset by stock returns (4.46%). The negative fixed-income return primarily reflects exchange rate fluctuations, which contributed –6.77% due to depreciations against the dollar of 12.02% for the yen, 11.97% for the euro and 10.20% for the Swiss franc in 2014. This was partially offset by a return of 4.59% due to a decrease on interest rates and accrued interest on the financial instruments included in the portfolio.

The PRF return is mainly explained by the positive performance of the stock portfolio (4.41%), inflation-indexed bonds (3.20%) and corporate bonds (3.18%), which was partially offset by the return of sovereign and government-related bonds (–0.21%). The strong stock performance is based on returns in the stock markets in the United States, Japan and, to a lesser extent, Europe, where the S&P 500, Nikkei 225 and FTSEurofirst 300 indexes had returns in local currency of 11.39%, 7.12% and 3.96%, respectively, in 2014. As in the case of the ESSF, the fixed-income returns were strongly affected by the generalized appreciation of the dollar.

TABLE 1

ESSF and PRF: Determinants of returns (TWR) in dollars, 2014
(percent)

Fund	Component	Quarter				2014
		I	II	III	IV	
ESSF	Fixed income[a]	2.06	1.55	–3.84	–1.84	–2.18
	Local currency	1.48	1.31	0.54	1.44	4.59
	Exchange rate fluctuation	0.58	0.24	–4.38	–3.29	–6.77
	Stocks	1.12	5.16	–2.24	0.49	4.46
	Total return (USD)	**1.98**	**1.84**	**–3.72**	**–1.67**	**–1.67**
	Total return (CLP)	7.09	1.85	5.55	–0.72	14.30
PRF	Sovereign and government-related bonds	2.59	2.32	–3.58	–1.41	–0.21
	Inflation-indexed bonds	2.72	3.45	–2.67	–0.22	3.20
	Corporate bonds	2.60	2.69	–2.18	0.11	3.18
	Stocks	1.09	5.15	–2.25	0.48	4.41
	Total return (USD)	**2.36**	**3.04**	**–2.94**	**–0.61**	**1.75**
	Total return (CLP)	7.47	3.05	6.33	0.34	17.72

(a) For the ESSF fixed-income portfolio, the table presents an estimate of the return in local currency and the return deriving from exchange rate fluctuations affecting the portfolio. The impact of exchange rate fluctuations is approximated and calculated using the benchmark currency allocation, taking into account that the ESSF is invested under a passive mandate. The return in local currency is calculated by subtracting that estimate from the fixed-income return.

SOURCE: Ministry of Finance of Chile.

Returns in Chilean pesos depend on the peso-dollar exchange rate: the value of the portfolio expressed in pesos increases (decreases) when the peso depreciates (appreciates) against the dollar. In 2014, the peso depreciated substantially against the dollar, resulting in a return in pesos of 14.30% for the ESSF and 17.72% for the PRF.

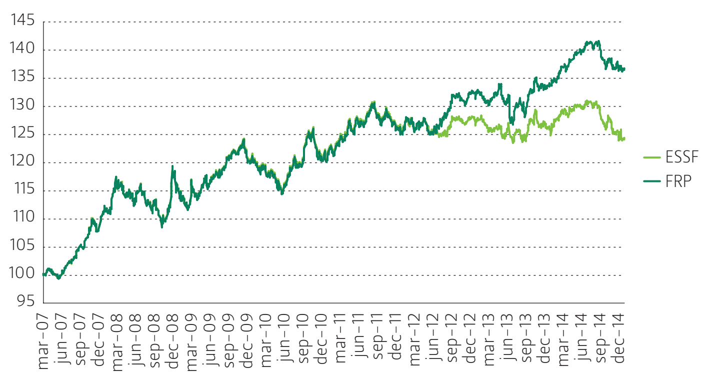
Since the inception of the funds, the annual return in dollars as of year-end 2014 was 2.82% for the ESSF and 4.04% for the PRF. Expressed in pesos, the annual return for this full period was 4.36% for the ESSF and 5.58% for the PRF.

In 2014, the ESSF earned lower returns than the benchmark by 3 basis points. The PRF return was 9 basis points above the benchmark. Since 31 March 2007, the difference between the average annualized return of the funds and their respective benchmarks was –9 basis points for the ESSF and –36 basis points for the PRF.[13 14]

Figure 19 shows the evolution of the index of accumulated returns for each fund. For the ESSF, the index increased from 100 on 31 March 2007 to 124.1 at year-end 2014; for the PRF, it increased from 100 to 136.0 in the same period. The figure illustrates how the evolution of the two funds' returns began to differentiate in 2012, when the PRF investment policy was changed.

FIGURE 19

ESSF and PRF: Index of accumulated returns, April 2007 to December 2014
(31 March 2007 = 100)



SOURCE: Ministry of Finance of Chile.

13 This implies that the manager's portfolio generated lower returns, on average, than the benchmark in the full period from 2007 to 2014.

14 Excluding the waiver period for both the ESSF and the PRF, when the investment portfolio was set up.

CHAPTER 3

Activities and recommendations of the Financial Committee

A. Review of the PRF and ESSF investment guidelines

Based on suggestions from the external fund managers, including the CBC, the Financial Committee analyzed a series of possible changes to the ESSF and PRF investment guidelines, in order to increase the managers' flexibility for investing the funds. The approved changes include the following:

For both funds:

- The Committee recommended lowering the minimum credit rating from AA– a A– for banks to be considered eligible counterparties for forwards and swaps.

For the PRF fixed-income portfolio managed by the CBC:[15]

- The limits by banking entity were adjusted as follows: up to 1% of the market value of the portfolio managed by the CBC can be invested in issuers with a minimum rating of AA– and up to 0.5% of the portfolio managed by the CBC in issuers with a minimum rating of A–. This limit would be applied to the aggregate exposure of cash deposited in a given bank and forwards and swaps with the same entity.

- The Committee approved the incorporation of time deposits with a maximum maturity of 15 days in the eligible instruments for cash in foreign currency.

B. Monitoring of the sovereign wealth fund managers

In the last quarter of 2014, the Financial Committee received delegations from the external portfolio managers and the CBC, who introduced their fund management teams and described their investment processes, portfolio performance, performance attribution analysis and other issues related to the investment of the sovereign wealth funds.[16] These presentations by the external portfolio managers to the Financial Committee are part of the activities that were transferred from the CBC to the Ministry on 1 January 2014.[17]

The Financial Committee also analyzed and established, in conjunction with the Ministry of Finance, the general guidelines for selecting new external managers for both funds, for monitoring the managers currently under contract and for identifying critical areas, among other issues. These internal guidelines were developed jointly with the Committee starting in late 2013. The Committee also decided to start the process of contracting an international consultant to support the Ministry of Finance in issues related to the continuous monitoring and selection of managers.[18] The contracting process will be carried out in 2015.

15 While these changes were evaluated in 2014, the final decision to approve them occurred at the Financial Committee's meeting on 5 January 2015.

16 Mellon Capital Management Corporation made its presentation to the Financial Committee on 5 January 2015.

17 For more information, see the 2013 Annual Report of the Sovereign Wealth Funds, prepared by the Ministry of Finance and available online at http://www.hacienda.cl/english/sovereign-wealth-funds/annual-report.html.

18 The final decision was made at the Financial Committee's meeting on 5 January 2015.

C. Review of the PRF investment policy

Given that the current PRF investment policy was defined in 2008, that its strategic asset allocation, as recommended by the Committee, was considered temporary, and that best practices suggest that the guidelines should be reevaluated periodically, the Ministry of Finance made the decision to commission a review of the investment policy from an international consultant in 2015. The Ministry asked the Committee to analyze the draft of the Terms of Reference for the contract to determine the scope of the activities to be carried out by the consultant. The Committee recommended that the Consultant propose an investment policy for the PRF consistent with the investment objectives established by the Ministry of Finance, which should in turn be consistent with the objectives for which the fund was created. The Committee further recommended that the review be made from an asset/liability management perspective and that the review of best practices in governance, included in the draft Terms of Reference, be commissioned as a separate study, considering that it would be difficult to find a consultant who was sufficiently qualified in both areas. Finally, it was decided to wait for the results of the study on the Pension System commissioned from the Presidential Advisory Commission, so as to take into account the potential implications of these results for the contingent liabilities of the PRF before initiating the review of the fund's investment policy.

APPENDIX: SUMMARY OF MEETINGS IN 2014

Meeting 1 :

13 JANUARY

In its first meeting of the year, the Committee reviewed different issues related to monitoring the fund managers, in particular analyzing the general guidelines presented by the Ministry of Finance aimed at assessing the performance of the current fund managers and specifying the selection process for possible new managers, among other matters. In addition, given the restrictions that some managers are facing due to the limited pool of eligible counterparties, and considering that the risk rating of the funds would not increase significantly, the Committee recommended lowering the minimum credit rating from AA– a A– for banks to be considered eligible counterparties for forwards and swaps under the current investment guidelines. The Committee also analyzed the general content of the 2013 annual report.

Meeting 2 :

5 MARCH

The Committee reviewed the final report and conclusions of the PRF sustainability study, commissioned by the Budget Office (DIPRES) in 2013. The Committee concluded that the study was highly useful for understanding the fund dynamics, but some members felt that the projections therein were based on overly optimistic assumptions. The Committee thanked the consulting team for its work, commending the rigorous study and the model developed. In other matters, a progress report was given on the 2013 Annual Report of the Financial Committee. The then Finance Minister, Felipe Larraín, attended part of the session to thank the Committee members for all their work, to congratulate Arturo Cifuentes on his new role as President of the Committee and to welcome the new member, Rodrigo Valdés. The Committee then took the opportunity to acknowledge the outstanding work of Leticia Celador, who was resigning as Legal Advisor in the International Finance Area of the Ministry of Finance and who was very involved in the legal aspects of the sovereign wealth funds since their inception.

Meeting 3 :

10 SEPTEMBER

At this meeting, the new Finance Minister, Alberto Arenas, attended part of the session to welcome the Committee members at their first meeting under the new administration. Specifically, the Minister thanked José De Gregorio, the new Committee President; Jaime Casassus and Igal Magendzo, the two new Committee members; and continuing members Cristián Eyzaguirre (Vice President), Martín Costabal and Eduardo Walker. In view of the fact that half the Committee seats had recently been renewed, the Ministry of Finance gave a presentation on the main characteristics of the investment policies and management of the sovereign wealth funds, including an analysis of their objectives and investment guidelines and the roles, responsibilities and costs of the entities involved in their management. The presentation further included a summary of the funds' performance as of late August and the most relevant characteristics of the portfolio allocations. The Committee then discussed the work plan for the coming meetings. Finally, the Committee expressed their recognition and appreciation of the work and commitment of Arturo Cifuentes (former President), Eric Parrado and Rodrigo Valdés, who had left their positions on the Committee.

Meeting 4 :

7 NOVEMBER

At the November meeting, the Committee received a delegation from the CBC, led by Beltrán de Ramón, Director of the Financial Operations Division, who described the Bank's organizational structure related to the management of the funds; outlined the investment processes, portfolio allocation and performance in 2013 and 2014; and also made some suggestions for adjusting the investment guidelines. The Committee members thanked the Director for the presentation, expressed satisfaction with the CBC's management performance, exchanged opinions on the proposed adjustments and requested additional information for analysis at the next meeting. The Committee then discussed the suggestion presented by an external manager to allow the stock portfolios to invest in initial public offerings, but decided against approving the change because, in their opinion, it moved away from the passive management strategy outlined for the funds. The Committee also recommended against allowing the ESSF to invest in dollar deposits in local banks, an alternative that had been considered in the past. In other issues, the Committee debated the objectives and structure of the PRF investment policy review that the Ministry intends to carry out in 2015. At the end of the meeting, the Committee was joined by the Finance Minister, Alberto Arenas de Mesa, who gave his opinion on the different topics covered in the session.

Meeting 5 :

10 DECEMBER

The Committee received delegations from Rogge Global Partners and BlackRock, who gave an updated presentation on the main characteristics of their firms and investment teams; reviewed their investment strategies in detail; described the performance of the portfolios under their management; presented a performance attribution analysis; and shared their outlook for the main markets in which the funds are invested. The Committee thanked the presenters and expressed their satisfaction with both firms' management performance.

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Glossary

Active management — an investment strategy that seeks to obtain a higher return than a given benchmark.

Alternative investments — investments other than those traditionally used (equity and fixed-income); they mainly include private equity, venture capital, hedge funds, commodities and real estate.

Asset class — a specific investment category such as equity, corporate bonds, sovereign bonds or money market instruments. Assets of the same class generally share characteristics that make them similar from a tax, legal and structural perspective, but this does not imply that they respond the same way to a given market event.

Basis point — one one-hundredth of a decimal point; 1 basis point = (1/100) de 1%.

Bond — a financial liability of an issuer (for example, a company or a government) to investors, under which the issuer undertakes not only to return the investors' capital, but also to pay an agreed interest rate on a specific date(s).

Cash — cash in hand and bank demand deposits.

Corporate bond — a bond issued by a corporation or company.

Credit default swap (CDS) — a financial instrument used by investors as protection against default on a bond; can also be used to take a speculative position on a bond covered by the CDS.

Credit rating — the level of solvency of the issuer of a financial instrument (company or country) as defined by a credit rating agency.

Duration — a measure of the sensitivity of a bond's price to changes in interest rates: the longer the duration, the farther the bond's price will fall in response to an increase in interest rates.

Equities — securities that represent the ownership or capital of a company; buyers of stocks become owners or shareholders of the company and thus have earnings or losses depending on the company's performance.

Ex ante tracking error — a measure of the difference between the return on an investment fund and its benchmark.

Exchange-traded fund (ETF) — a market-traded financial instrument that typically replicates a market index; traditionally used to obtain passive exposure to stock market indexes, but has expanded into fixed-income, commodities and even active strategies.

Fiscal Responsibility Law — Law N° 20,128, published in Chile's Official Gazette on 30 September 2006.

Fixed-income — investment instruments with a yield over a given period that is known at the time of their acquisition; sovereign and corporate bonds and bank deposits are fixed-income assets.

Headline or reputational risk — the risk of an adverse public perception of an entity's management.

Inflation-indexed bond — a bond whose value varies in line with an inflation index; in the United States, these securities are known as Treasury Inflation-Protected Securities (TIPS).

Internal rate of return (IRR) — the effective yield on an investment, calculated taking the net present value of all cash flows as zero.

Investment policy — the set of criteria, guidelines and instructions that regulate the amount, structure and dynamics of an investment portfolio.

Leverage — the level of debt carried by a firm or investment vehicle.

LIBID — London interbank bid rate; the interest rate paid on interbank deposits. By definition, this rate is equal to the LIBOR minus 0.125%.

LIBOR — London interbank offered rate; the interest rate charged on interbank borrowing.

Money market instrument — a short-term asset with a maturity of less than a year, which can readily be converted into cash and is less volatile than other asset classes.

Mutual fund — an investment vehicle managed by an entity that brings together the capital of different investors and provides them with exposure to different asset classes; unlike ETFs, mutual funds are not traded on the market.

Passive management — an investment strategy that seeks to replicate the return on a representative index of an asset class or combination of asset classes.

Portfolio — the combination of investments acquired by an individual or institutional investor.

Quantitative easing — an unconventional monetary policy tool used by some central banks to increase the money supply, usually through the purchase of the country's own government bonds.

Recognition bond (bono de reconocimiento) —an instrument issued by Chile's Pension Normalization Institute (Instituto de Normalización Previsional) representing a worker's contributions to the old pension system before joining the new (private) AFP system.

Return (total) — the combination of the return in local currency and the return generated by exchange rate fluctuations.

Return generated by exchange rate movements — the share of the return that is generated by variations in the value of the dollar against other currencies in which assets are held.

Return in local currency — the return generated by a financial instrument in the currency in which it is denominated; corresponds to the share of returns associated with the level of interest rates and their movements, creditworthiness and other factors.

Risk — the possibility of suffering a financial loss; the variability of the return on an investment.

Sovereign bond — a bond issued by a government.

Spread — the difference between the yield rate at maturity of two fixed-income instruments; used to measure their level of relative risk.

TED Spread — the difference between the interbank borrowing rate (LIBOR) and the risk-free rate (U.S. Treasury bills). A higher TED spread typically indicates a lower level of market liquidity.

Time-weighted rate of return (TWR) — a measure of return obtained by compounding or multiplying daily returns, excluding contributions and withdrawals; unlike the IRR, it excludes the effect of net cash flows.

Variable-income — Stocks.

VIX — the Chicago Board Options Exchange (CBOE) Volatility Index, which reflects market expectations for volatility over the next 30 days; based on the implied volatilities of a wide range of S&P500 index options.

Volatility — a measure of a financial asset's risk, representing the variation shown by its price over a period of time.

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