UBS Annual Reserve Manager Survey 2018

24th Reserve Management Seminar

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August 2018
24th Annual Reserve Management Seminar Survey

With 24 years of comprehensive surveys, we believe the following data is among the most authoritative depictions of official reserve management activities available.

- Central banks and sovereign wealth funds around the world have continued to adjust their reserve management practices to meet their goals while keeping a close eye on the risks and opportunities they see playing out on the global stage.

- That is one of the key takeaways from UBS Asset Management’s 24th annual Reserve Management Seminar survey of global central banks. This year’s survey was conducted during the first half of 2018 and collected responses from close to 30 central banks and sovereign wealth funds from all regions globally. Questions covered a range of topics related to official reserve management investment views.

- Results were presented at the 24th UBS Reserve Management Seminar, held June 24-28 in Thun, Switzerland. In addition, an on-site survey of current economic and market views was conducted during the seminar, which was attended by close to 70 sovereign investors from leading institutions. On-site voting results are included in the second part of this presentation.

Source: UBS Annual Reserve Manager Survey, results as of July 2018.
Nearly 90% of central banks consider their level of reserves as adequate given their mandate.

More than half of the respondents say that their level of reserves increased over the last 12 months, signaling that the period of falling reserves which started in 2016 with the drop in commodity prices, is now over.

Central banks use several measures to determine the adequacy of their reserves, with the majority measuring against short-term external debt, months of imports as well as GDP and monetary aggregate.

More than half of the respondents split their assets in different tranches to better tailor their asset allocation.

Three surveyed entities are planning to establish an SWF.

Source: UBS Annual Reserve Manager Survey, results as of July 2018.
The top three concerns this year all revolve around political developments, with the potential for trade wars ranking as the top concern. Not a single respondent cited worries about potential deflationary shocks. Fears of a hard landing in China have eased from previous surveys.

When it comes to the investment of FX reserves, the most-frequently mentioned concerns (50%+) among respondents are elevated asset price valuations and rising US interest rates.

The majority of central banks (75%) expect the ECB to raise interest rates in 2019 whilst only a quarter expect it to be later than 2019. More than half of respondents consider the combination of FED balance sheet reduction and rising US debt issuance a potential risk for the US Treasury market.

Our live poll among more than 70 on-site participants using our event app revealed that the vast majority of participants expects the terminal US policy rate to be no higher than 3.5% this cycle. At the same time, the majority does not believe the US to go into recession before 2021.

Source: UBS Annual Reserve Manager Survey, results as of July 2018.
• FX reserve diversification is continuing with the majority of central banks pursuing increased allocations to non-government-bond assets.

• Central banks continue to increase their holdings of corporate debt and mortgage- and asset-backed securities.

• Infrastructure as an investment gained traction with 15% saying they increased their holdings last year and 10% saying they plan to increase infrastructure holdings in the coming year.

• Central banks slightly reduced equity and emerging market debt holdings; still, already one in four of participating central banks is allowed to invest in equities.

• The biggest gainers when it comes to currency allocations by central banks last year were the Euro and the Renminbi, but the US dollar remains the default currency to invest new reserves.

Source: UBS Annual Reserve Manager Survey, results as of July 2018.
The average share of USD holdings among all the participants was about 71.5% which is slightly higher than IMF data on the currency composition of global reserves suggests.

The biggest net gainers in currency allocation by central banks last year were the Euro and Renminbi. This is the first time in several years that the Euro has seen an uptick once again.

The increased attractiveness of the RMB is also of importance, as over the last few years, and in particular following the mini-devaluation of 2015, interest in the Chinese currency cooled down, and reserve allocations stagnated.

The average long-term target allocation to the RMB is around 3.2% which means a doubling from current levels. With allocated reserves currently standing at around USD 145bn in 1Q 2018 (IMF COFER), this would translate roughly into additional USD 200bn flowing into RMB-dominated assets.

Source: UBS Annual Reserve Manager Survey, results as of July 2018.
Main concerns impacting the global economy

What are the main risks the global economy is currently facing?

- Trade wars (large-scale protectionist measures by several nations) 72%
- Political developments in the EU (Euro crisis, nationalism) 64%
- Political developments in the US (e.g. government crisis) 44%
- Inflation and/or uncontrolled rise in long-term yields 28%
- China hard landing 28%
- Oil price development 24%
- Central Banks raising rates too quickly (policy error) 20%
- Wars / significant geopolitical developments (including terrorism) 16%
- Central Bank balance sheet reduction (net selling of assets) 12%
- No fear of deflationary shocks... 0%
- Fear of China hard landing easing further (#3 last year) 0%

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Main concerns impacting the levels of FX reserves

What are currently your main concerns when it comes to the investment of FX reserves?

- Elevated asset price valuation (54%)
- Rising US interest rates / inflation (50%)
- Political uncertainty (50%)
- Low and negative yields in fixed income markets (42%)
- Asset price volatility across markets (33%)
- Exchange rate volatility (33%)
- Falling liquidity in fixed income markets (33%)
- Falling FX reserves (13%)

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
The end of unconventional monetary policy

By when do you expect the ECB to raise interest rates?

- 2019: 74%
- Later than 2019: 26%

Is the combination of Central Bank net asset sales and increased US debt issuances an underrated risk for the US Treasury market?

- Yes: 58%
- No: 42%

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Level and adequacy of FX reserves

Do you see your current level of FX reserves as adequate?

- Yes: 87%
- No: 13%

How has the amount of your FX reserves changed over the last 12 months?

- Increased: 52%
- Stable: 43%
- Decreased: 4%

How do survey participants assess their FX reserves?

- Percentage of survey participants that see their level of FX reserves as not adequate is slightly down from 15% last year
- The number of participants who reported increased FX reserves is up from 41% last year
- Majority of participants uses several measures to determine the adequacy of their reserves, with the majority measuring against short-term external debt, months of imports as well as GDP and monetary aggregate.

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Tranching and institutional setup

Do you segment / tranche your reserves (e.g. in liquidity, liability and saving/total return/wealth portfolios)?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.

Three survey participants indicated that they recently considered setting up a separate entity (e.g. Sovereign Wealth Fund) to manage assets
Key asset allocation objectives

What are your primary investment objectives?

- Capital preservation: 81%
- Liquidity: 62%
- Supporting monetary policy: 14%
- Return maximisation: 14%

In recent years, has your institution increasingly diversified away from traditional reserve assets?

- Yes: 50%
- No: 50%

Several participants stressed that they consider return objectives to be important, but only as long as liquidity and capital preservation targets are fulfilled.

Overall, half of the participants altered their Strategic Asset Allocation over the last 12 months and a further 48% indicated that they wish to implement further changes to their asset allocation in the next 12 months.

Half of all survey participants replied that their institution diversified away from traditional reserve assets recently.

21% indicated that they now consider investing in illiquid asset classes (for example infrastructure debt or real estate) to enhance returns.

Interestingly, 29% responded that they recently moved or considered moving passively-managed assets to active management strategies.

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
## Trends in approved asset classes

Which of the following instruments are approved at your institution?

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<td>Sovereign eurobonds</td>
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<td>Covered bonds</td>
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<td>61</td>
<td>49</td>
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<td>MBS / ABS</td>
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<td>52</td>
<td>40</td>
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<td>22</td>
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<td>Private Equity</td>
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<td>Hedge Funds</td>
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</tbody>
</table>

*In % of total respondents, multiple responses possible.*

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Trends in approved asset classes

Which of the following instruments are approved at your institution?

- Equities
- Inflation-protected bonds
- Corporates
- EM Debt
- Bank debt
- MBS/ABS

Corporates and MBS/ABS continuing their upswing after the financial crisis

Equity and EMD slightly lower but broadly stable over last years

In % of total respondents, multiple responses possible.

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Key changes in asset allocation

Which of the following instruments have you increased/decreased in your portfolio in the past year?
Which of the following instruments would you want to own more or less over the next year?

% of respondents that plan a decrease in the coming year

<table>
<thead>
<tr>
<th>Instrument</th>
<th>% of respondents that reported a decrease in the past year</th>
<th>% of respondents that reported an increase in the past year</th>
<th>% of respondents that plan an increase in the coming year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supranations</td>
<td>-20%</td>
<td>38%</td>
<td>50%</td>
</tr>
<tr>
<td>Sovereign eurobonds</td>
<td>-15%</td>
<td>31%</td>
<td>30%</td>
</tr>
<tr>
<td>US agencies</td>
<td>-15%</td>
<td>31%</td>
<td>40%</td>
</tr>
<tr>
<td>Inflation-protected bonds</td>
<td>-8%</td>
<td>23%</td>
<td>10%</td>
</tr>
<tr>
<td>Covered bonds</td>
<td>-8%</td>
<td>8%</td>
<td>20%</td>
</tr>
<tr>
<td>Bank debt</td>
<td>-8%</td>
<td>23%</td>
<td>30%</td>
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<tr>
<td>Corporates</td>
<td>-8%</td>
<td>31%</td>
<td>30%</td>
</tr>
<tr>
<td>MBS / ABS</td>
<td>-8%</td>
<td>8%</td>
<td>20%</td>
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<tr>
<td>EM hard currency debt</td>
<td>-8%</td>
<td>8%</td>
<td>20%</td>
</tr>
<tr>
<td>EM local currency debt</td>
<td>-8%</td>
<td>8%</td>
<td>30%</td>
</tr>
<tr>
<td>Equities passive</td>
<td>-8%</td>
<td>8%</td>
<td>10%</td>
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<tr>
<td>Equities active</td>
<td>-8%</td>
<td>8%</td>
<td>10%</td>
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<tr>
<td>Multi-asset products</td>
<td>-8%</td>
<td>8%</td>
<td>10%</td>
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<tr>
<td>Gold</td>
<td>-8%</td>
<td>15%</td>
<td>10%</td>
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<tr>
<td>Commodities (excl. Gold)</td>
<td>-8%</td>
<td>8%</td>
<td>10%</td>
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<tr>
<td>Hedge Funds</td>
<td>-8%</td>
<td>8%</td>
<td>10%</td>
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<tr>
<td>Private Equity</td>
<td>-8%</td>
<td>8%</td>
<td>10%</td>
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<tr>
<td>Infrastructure (equity &amp; debt)</td>
<td>-8%</td>
<td>15%</td>
<td>10%</td>
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<tr>
<td>Search-for-yield continues</td>
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<td></td>
<td>Search-for-yield continues</td>
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<tr>
<td>Venturing in new areas</td>
<td></td>
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<td>Venturing in new areas</td>
</tr>
</tbody>
</table>

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Currency focus: Changes in 2017/18

If you have altered your currency allocation during the last year in a significant way, please specify how!

The average share of USD holdings among all participants was about 71.5%

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Currency focus: Outlook

Going forward, how do you expect your currency allocation will be adjusted?

Like in 2017, survey participants remain convinced that the US Dollar will play an increasing role in their reserves going forward, but sentiment towards the Euro has improved, bringing allocation plans more in line with the SDR basket.

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Currency focus: RMB

Please describe your attitude towards the RMB!

% of survey respondents that are invested, or consider investing, in the RMB (last 5 surveys)

<table>
<thead>
<tr>
<th>Year</th>
<th>%</th>
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<tbody>
<tr>
<td>2014</td>
<td>51%</td>
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<td>2015</td>
<td>71%</td>
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<td>2016</td>
<td>54%</td>
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<td>2017</td>
<td>67%</td>
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<td>2018</td>
<td>85%</td>
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</table>

Significant increase in number of participants that are invested, or consider investing, in the RMB.

The average long-term target allocation to the RMB is around 3.2%, with values ranging from 0% to 15%.

Remaining challenges raised by survey participants

- Clarity on rules and regulations and access to onshore investments.
- Direct access to government bond trading and custody/safekeeping of securities with an international depository institution.
- 'Cross-border or offshore RMB liquidity and transaction/clearing infrastructure'.
- 'The capital account in RMB remains restricted, making direct investment into China still difficult'.

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Performance and Risk management

How do you measure risk in your portfolios?

- VaR: 78%
- Tracking error: 48%
- CVaR: 43%
- Max Drawdown: 35%

Do you take any tactical positions compared to benchmark?

- Yes: 78%
- No: 22%

Risk and performance measurement

- Slightly more than half of the survey respondents review their investment policy annually, with the other half using more frequent intervals or review on an ad-hoc basis.
- 2/3 of survey participants indicated that they rely only on internal risk management systems, a considerable change from last year where more than half of participants disclosed that they use external risk management systems as well.
- No survey participant increased maximum drawdown levels to enhance returns in the past year.
- Of those participants that are invested in equities, ~70% consider their fixed income portfolio as 'hedge' for the equity portion (due to the historical tendency to be negatively correlated in times of crisis)

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Do you use derivatives within your reserve portfolio?

- Yes: 94%
- No: 41%

If you use derivatives, what are the main objectives for using them?

- Hedging: 62%
- Trading: 38%
- Yield Enhancement: 24%
- Leverage: 5%

Additional survey participants reported the use of derivatives to reduce FX risk, but not to manage reserve assets.

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
External asset management

What percentage of your reserves are currently externally managed?

- No external fund managers: 30%
- 0 - 5%: 25%
- 5% - 10%: 15%
- 10% - 20%: 20%
- 20% - 30%: 5%

What asset classes of external fund management interests you the most?

- Total-return of return in fixed income
- Emerging market sovereign debt
- Equities (Emerging Markets)
- ABS/MBS/CMBS
- Developed market corporate debt
- Developed market sovereign debt
- Equities (Developed Markets)
- Absolute return products
- Short-term liquidity products
- Derivatives
- Private equity
- Emerging market corporate debt
- Hedging program
- Inflation-protected bonds
- High-yield debt
- Real estate
- Hedge funds

What assets are externally managed?

- External mandates currently exist mainly in the area of DM sovereign and corporate debt, as well as inflation-protected bonds, short-term liquidity products and ABS/MBS/CMBS.
- More than half of respondents indicated that they are interested in tail-risk hedging strategies.

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Sustainable investing: Is CB interest rising?

Have you considered sustainable and responsible investment aspects in your investment process?

The case for sustainable investing

- The concept of sustainability is one which is ideally placed to align the long-term mandate of Sovereign wealth entities with trends in society, as well as the evolving objectives of government sponsors and the public in general.
- In particular, in a world that is moving away from fossil fuels, sustainability can be considered a key tool in re-focusing the assets of Sovereign investors in a way that is consistent with long-term financial and social objectives of their nations.

Survey results

- While ideally suited for sovereign investors, only a small percentage of participants already actively allocate assets according to this concept.
- A small number of participants practices socially responsible investing (SRI), which traditionally has a narrower focus and mainly works via excluding assets and companies.

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Do you agree with the following statements about cryptocurrencies?

- They need stricter regulation: 52%
- They will not significantly affect our economy / banking system: 28%
- They will mainly be an opportunity for our economy: 16%
- It is not possible to regulate them in an effective way: 20%
- They will mainly be a threat for our currency and banking system: 16%
- They will ultimately replace established currencies & payment systems: 0%

In % of total respondents, multiple responses possible.

Will cryptocurrencies be included in the official reserves of some central banks in the next ten years?

- Ultimately yes, but it will take longer than 10 years: 28%
- Yes: 12%
- No: 60%

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
On-site voting results

24th Reserve Management Seminar
What's the probability of the US entering a recession before end 2020?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
What will the US terminal policy rate be at the end of the current Fed's hiking cycle?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
What will be the level of EUR/USD in a year's time?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
What do you expect the average annual return on a global bond portfolio over the next five years will be closest to?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
What do you expect the average annual return on a global equity portfolio over the next five years will be closest to?

- **2%-6%**
- **6%-8% (historical average)**
- **8%-12% (‘Goldilocks’)***
- **Negative (e.g. prolonged recession)**
- **Above 12% (e.g. Productivity boost scenario)**

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Will the historical 'natural hedge' correlation between equities and bonds continue to persist during the next 5 years (i.e. bonds going up during prolonged stock market corrections)?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
How do you expect the internationalization of the RMB to develop over the coming years?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Which benchmark do you use for Equity?

- Global (MSCI WORLD) - 80%
- Regional (S&P 500, Eurostoxx) - 10%
- Customized - 10%

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Do you believe that fixed income liquidity has declined post GFC?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Should central banks invest in illiquid asset classes such as real estate and infrastructure?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Do you invest in Smart Beta?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.

- Yes: 27%
- No: 73%
Do you use ETFs?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Are central banks too risk averse?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Which approach to sustainable investing are you considering?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
Do you invest in green bonds?

Source: UBS Annual Reserve Manager Survey, results as of June 2018.
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