Kiribati Government

5th Meeting of 12th Maneaba ni Maungatabu

16th August 2021 to 27th of August 2021

REPORT ON

REVENUE EQUILISATION RESERVE FUND (RERF)

31 March 2021– 31 July 2021

Ministry of Finance & Economic Development

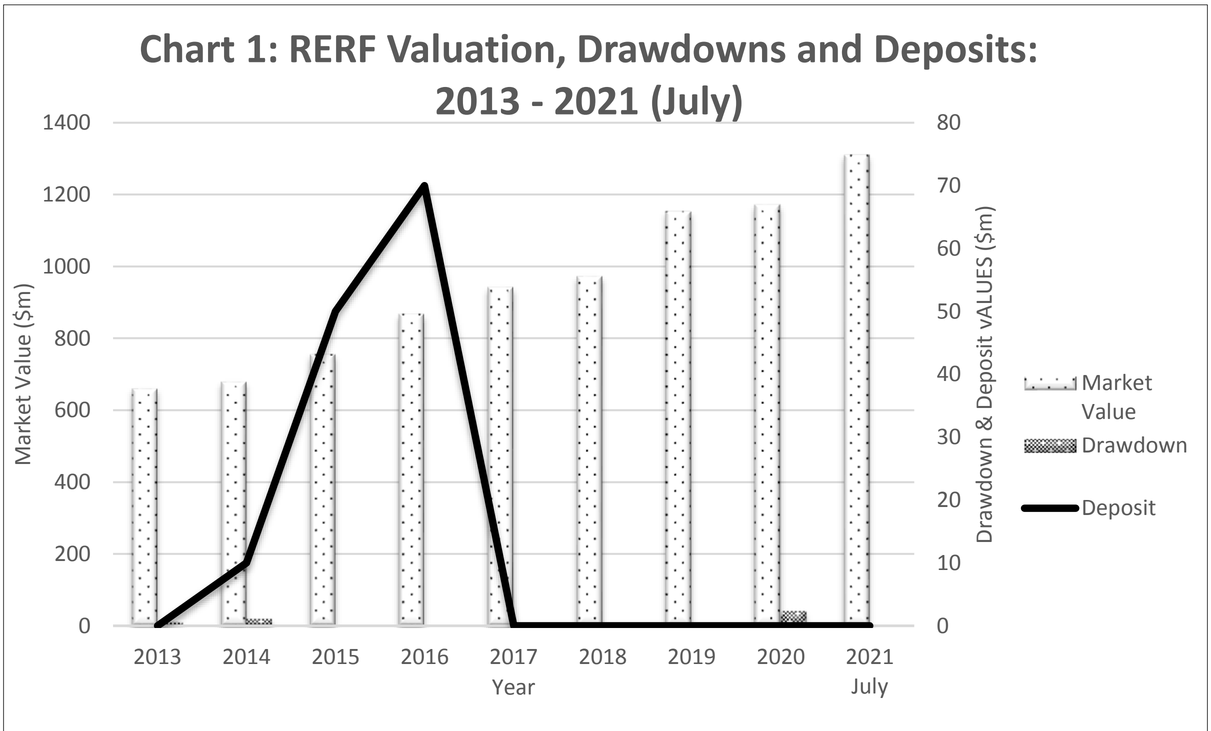
August 2021

Introduction

1. This Report focuses on the performance of the Revenue Equalisation Reserve Fund (RERF) over the last 5-month period, from 31 March 2021 to 31 August 2021. Parliament would note that this Report also includes an overview of the performance of the RERF since 2013 for comparison purposes. Table 2 of the Appendix 1 shows month-by-month valuations covering the period January 2016 to July 2021.

2. During the five-month period, the RERF increased in value from an opening balance of $1.193 billion to a closing value of $1.310 billion, an increase of $116.6 million (9.8%) with a positive performance in equities of 13.7% and 3.98% in fixed income. During this period, there were no deposits or drawdowns made as shown in the chart 1 below. Table 3 of the Appendix 1 provides further details on the RERF valuations, deposits and withdrawals by different administrations since 1979 to July 2021.

Chart 1: RERF Valuation and Drawdowns & Deposits: 2013 – 2021 (July)



Source: Investment Unit, National Economic Planning Office, Ministry of Finance and Economic Development

3. Despite the adverse impact of Covid-19 on the RERF during the month February and March 2020, global Equities picked up in April 2020. The Size, scale and scope of the global policy response to cushion the impact of Covid-19 has been extraordinary. The pace was remarkable, as the World's central banks swiftly acted to provide solutions in days which took months in previous crises. The global stimulus package exceeded that of the 2008 crisis. Financial markets responded positively to the massive stimulus efforts, despite the challenging backdrop, and recovered somewhat towards quarter end.

4. The global economic recovery continued in July with steady progress in the COVID-19 vaccine rollout, a pick-up in mobility indicators (especially in Europe) and ongoing support from a monetary and fiscal policy perspective. However, it was a more volatile month for financial markets due to increasing concerns around rising cases of the more transmittable Delta variant and signs of a peak in economic growth, especially in the US.

5. As of July 2021, the RERF currently stands at $1.310 billion showing an increase by $116.6 million since March 2021. The increase was largely driven from the Equity portfolio of 97.4 million and $19.3 million from the Fixed Income portfolio. The Monthly valuations are provided in Table 2 of Appendix 1.

Background (Reforms to the RERF)

6. Over the last decade, the structure and management of the RERF (the Fund) have undergone significant reforms. Following the adverse impact of the global economic and financial crises of the late 2000s on the Fund, it was decided that a thorough review of the RERF investment strategy and its management be undertaken.

An assessment of the RERF was conducted by the International Monetary Fund (IMF) and a report was issued in 2011. In summary, the report concluded that:

a) the levels at which drawdowns had been and were being made on the Fund would not be sustainable;

b) there was a misalignment between the level of investment risk adopted by fund managers and the RERF's tolerance for risk;

c) significant underperformance was being recorded in investment returns when compared to benchmarks over an extended period of time.

7. Following the publication of these findings, an engagement of World Bank Treasury Technical Assistance commenced in 2013 to assist the Ministry of Finance and Economic Development (MFED), the RERF Investment Committee and Cabinet in determining a set of reforms to the Fund. A revised investment strategy framework was developed to: -

a) limit the RERF investible asset types to government bonds and public equities;
b) maintain an allocation basis for these assets of 50% government bonds and 50% public equities;
c) remove the discretionary investment decision-making capacity previously enjoyed by the fund managers;
d) shift towards a strategy that leans more on benchmark performance, and finally;
e) ensure the impact of currency variance on investments is minimised.

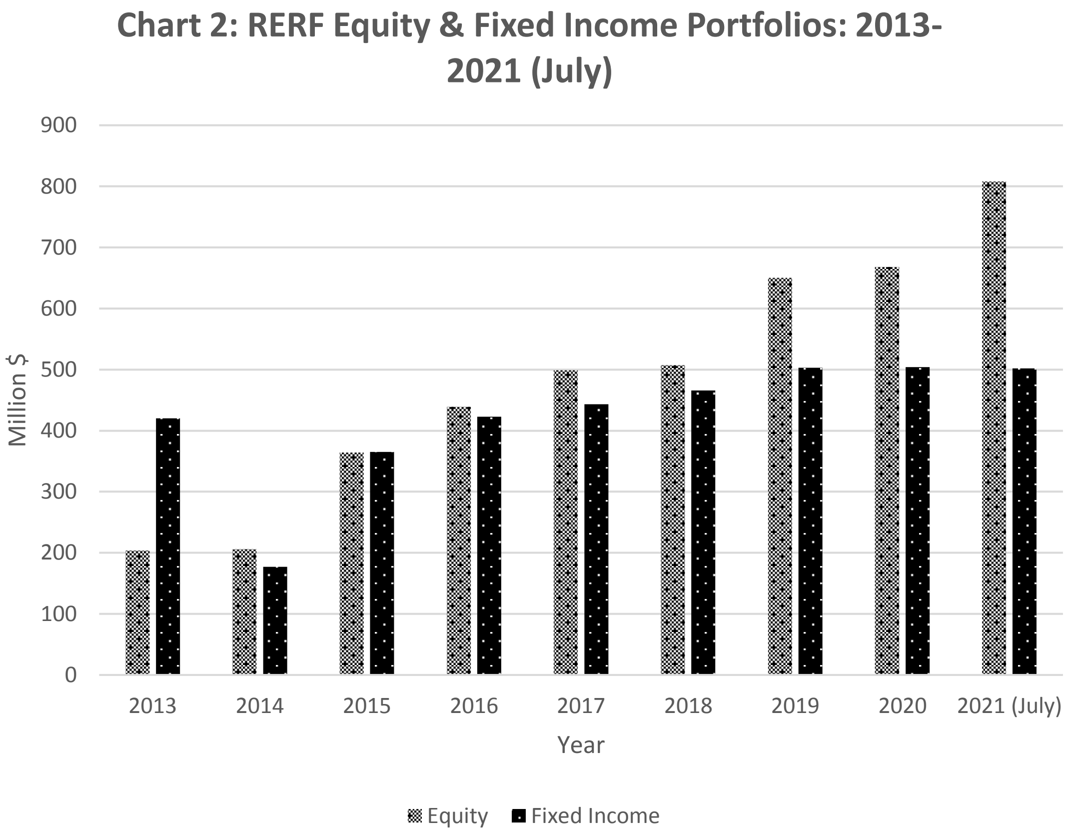
8. Implementation of the revised strategy commenced in 2014, initially with the termination of Nikko Asset Management and then with the issuance of a request for proposals (RFP) to the fund managers market in 2015. The Hong Kong and Shanghai Banking Corporation (HSBC), as the other incumbent fund manager, at the time, participated in the RFP but was not able to meet designated strategy requirements. In September 2015, Cabinet approved the appointment of Black Rock and Northern Trust to respectively manage the global equities and Australian government fixed income portfolios. Implementation of the portfolio investment strategy and the transition from the former to the newly appointed managers was completed in May 2016.

9. In November 2018, Bank of New York Mellon (BNYM) was appointed as the new custodian for the RERF replacing State Street (SS) Australia Limited. The transition to the new custodian was completed at the end of March 2019.

Portfolio Performance Summary

10. Under the newly implemented Reforms, the Fund is now weighted 50% in equities and 50% in fixed income within a tolerance threshold of +/-5%. The Chart below (Chart 2) shows the total value of the equity and fixed income components from 2013 to July 2021.

11. In 2013, at the beginning of the period, the fixed income component of the portfolio was materially higher than the equity component. At this point in time, the assets allocation was approximately 70% to fixed income and 30% to equities. Implementation of the portfolio restructure was completed in November 2015 when the desired assets allocation of 50% global equities and 50% Australian government fixed income was achieved.



Source: Investment Unit, National Economic Planning Office, Ministry of Finance and Economic Development

12. In terms of the Fund's portfolio-asset performance, the global equities component has outperformed the 14.25% benchmark, with a total return of 14.51% since inception. The Australian Government fixed income asset performance is in line or slightly lower compared with the Benchmark at 3.70%

since inception. The current assets allocation as at 31 July 2021 was 61.6% equity and 38.4% fixed income. The RERF's portfolio-asset performance summary is given in the Table 1a and 1b below.

Table 1a: RERF Portfolio – Asset Performance Summary: Global Equities

	1 Month	**QTR**	**6 Month**	**YTD**	**Since Inception**
Fund	3.97%	3.97%	21.45%	20.92%	14.51%
Benchmark	3.97%	3.97%	21.31%	20.80%	14.25%

Source: BlackRock as at 31 July, 2021
Benchmark: MSCI World Net Total Return Index (AUD)
Inception Date: 15 January 2016

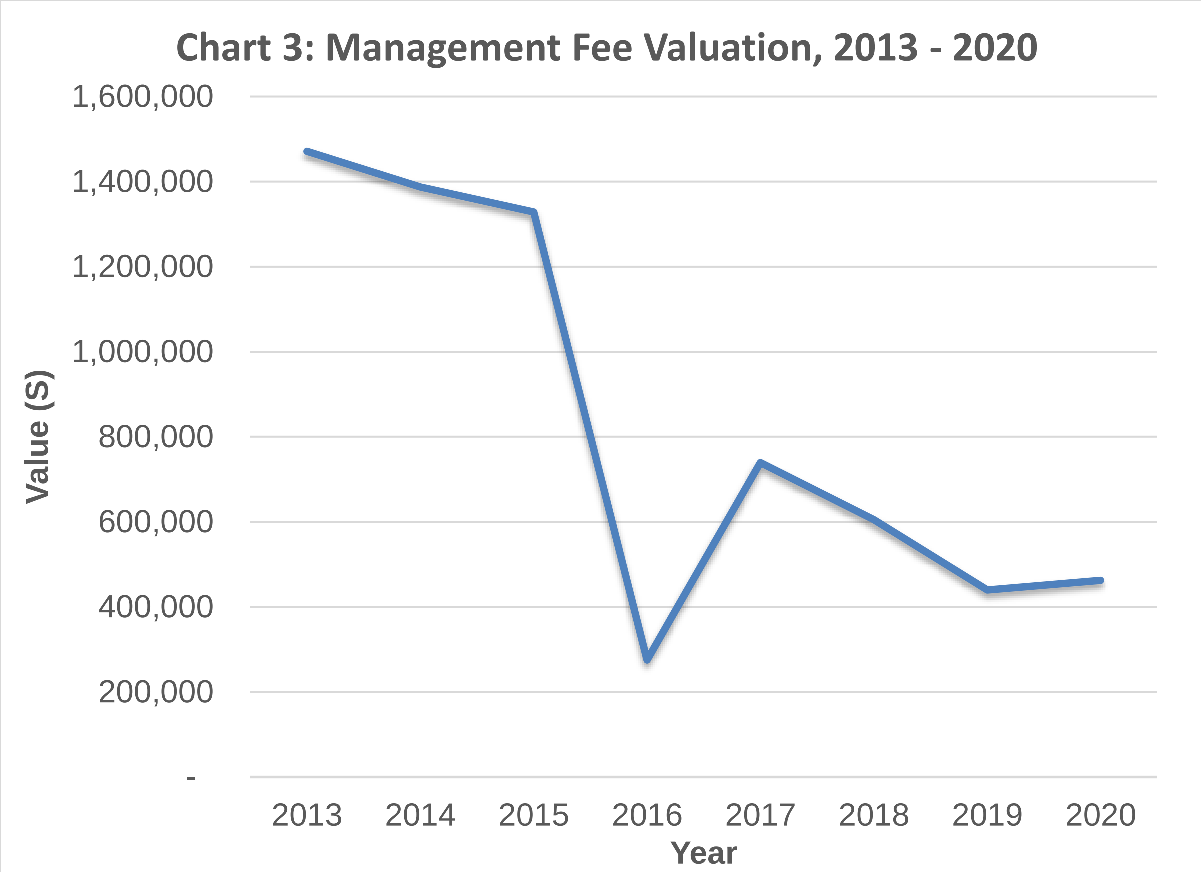
Table 1b: RERF Portfolio – Asset Performance Summary: Australian Government Fixed Income

	1 Month	**QTR**	**6 Months**	**YTD**	**Since Inception**
Fund	2.04%	3.38%	0.37%	-0.32%	3.67%
Benchmark	2.05%	3.39%	0.42%	-0.26%	3.70%

Source: Northern Trust as at 31 July, 2021
Benchmark: Bloomberg Barclays Australian Aggregate Treasury Index
Inception Date: 10 May 2016

Management Fees

13. An additional objective of the RERF reforms was to ensure the fund managers' fees in relation to the portfolio management costs incurred by the RERF were consistent with current market standards. Through the appointment of the new fund managers, a reduction in the average management fee was achieved from 0.21% to 0.075% per annum. This means a reduction in management fees by $1.58 million.



Source: Investment Unit, National Economic Planning Office, Ministry of Finance and Economic Development

14. A comparison of the previous management's fee rates with the new management's rates has been conducted to assess the expected savings in 2020 based on an average portfolio value for the year of $1.172 billion (being the 31 December 2020 balance). A cost saving of $1.58 million has been secured from the renegotiated rates, which was reinvested back into the portfolio. Please note that the management fees do not include custodial fees.

Market expectations from Fund Managers

<u>Northern Trust Outlook</u>

15. The Reserve Bank of Australia (RBA) left the cash rate at 0.10% at its July monetary policy meeting. The RBA retained the April 2024 bond for its yield target and reduced bond purchases to AUD 4 billion per week until at least mid-November. Economic recovery was stronger than anticipated and the RBA expects it to continue. The Labour and housing markets continued to fortify. The RBA said interest rates would remain unchanged until broader wage and inflation pressures emerged. The Bank's central scenario for the economy is that this condition will not be met before 2024. The RBA revealed its intent to conduct a further review in November, giving it time to assess the situation and respond as per the state of the economy.

16. Global equity markets continued to post positive returns in July. Virus case rose across the U.S., Europe and Asia while concerns over the Delta variant posing headwinds to recovery surged and weighed on sentiment. Yet, continued economic growth and robust second quarter corporate earnings buoyed investor sentiment. Major central banks remained accommodative in the face of uncertainty stemming from developments around the pandemic, while some began tapering asset purchases. The Federal Reserve noted the economy was continuing to progress towards the committee's goals but needed to see the labour market progress before deciding to taper asset purchases. The European Central Bank's (ECB) strategy review revealed that the inflation target had been altered to a symmetric level of 2% from the previous goal of just below 2%. Across economies, benchmark sovereign bond yields fell in July amid concerns over sustained recovery in the face of the fast-spreading Delta variant and rising prints of inflation. The U.S. credit universe posted positive returns in July. Investment Grade corporate bonds outperformed High Yield bonds with spreads continuing to widen.

BlackRock Outlook

Directional views

Strategic (long-term) and tactical (6-12 month) views on broad asset classes, July 2021

Asset	Strategic view	Tactical view	
Equities	+1	+1	We keep our overweight equities on a strategic horizon. We see a better outlook for earnings amid moderate valuations. Incorporating climate change in our expected returns brightens the appeal of developed market equities given the large weights of sectors such as tech and healthcare in benchmark indices. Tactically, we stay overweight equities as we expect the restart to re-accelerate and interest rates to stay low. We tilt toward cyclicality and maintain a quality bias.
Credit	-1	Neutral	We stay underweight credit on a strategic basis as valuations are rich and we prefer to take risk in equities. On a tactical horizon, we are neutral credit following the tightening in spreads in investment grade and high yield.
Govt Bonds	-1	-1	We are strategically underweight nominal government bonds given their diminished ability to act as portfolio ballasts with yields near lower bounds. Rising debt levels may eventually pose risks to the low rate regime. Tactically, we prefer inflation-linked bonds – particularly in the U.S. relative to the euro area on valuations. We add to our underweight on U.S. Treasuries on expectations of gradually rising yields.
Cash		Neutral	We are moderately pro-risk and keep some cash to potentially further add to risk assets on any market turbulence.
Private Markets	Neutral		We believe non-traditional return streams, including private credit, have the potential to add value and diversification. Our neutral view is based on a starting allocation that is much larger than what most qualified investors hold. Many institutional investors remain underinvested in private markets as they overestimate liquidity risks, in our view. Private markets are a complex asset class and not suitable for all investors.

Underweight | Neutral | Overweight | ● Previous view

Source: BlackRock July, 2021

APPENDIX 1

Table 2: Monthly RERF Valuations: January 2016 – July 2021				
Months	**Market Value ($)**		**Months**	**Market Value ($)**
Jan-16	749,533,716		Dec-18	973,207,277
Feb-16	748,705,446		Jan-19	997,153,488
Mar-16	744,175,726		Feb-19	1,031,816,243
Apr-16	752,998,994		Mar-19	1,050,159,555
May-16	779,931,598		Apr-19	1,076,550,173
Jun-16	773,162,527		May-19	1,062,280,760
Jul-16	855,470,664		Jun-19	1,097,643,323
Aug-16	862,141,401		Jul-19	1,116,860,182
Sep-16	855,036,183		Aug-19	1,128,440,823
Oct-16	840,762,698		Sep-19	1,137,403,309
Nov-16	850,071,275		Oct – 19	1,136,412,748
Dec-16	868,095,699		Nov-19	1,170,507,837
Jan-17	860,482,976		Dec-19	1,153,388,616
Feb-17	867,392,463		Jan-20	1,196,538,193
Mar-17	877,615,327		Feb-20	1,168,505,464
Apr-17	897,216,759		Mar-20	1,114,316,515
May-17	915,511,313		Apr-20	1,134,114,185
Jun-17	897,737,657		May-20	1,155,604,749
Jul-17	891,375,916		Jun-20	1,149,638,870
Aug-17	894,824,084		Jul-20	1,155,399,179
Sep-17	908,047,799		Aug-20	1,172,771,183
Oct-17	933,641,510		Sep-20	1,177,311,808
Nov-17	954,424,110		Oct – 20	1,170,980,750
Mar-18	950,841,642		Nov-20	1,217,409,835
Apr-18	962,115,941		Dec – 20	1,172,436,677
May-18	968,115,781		Jan – 21	1,166,063,389
June-18	982,433,568		Feb- 21	1,154,963,557
Jul-18	996,187,320		Mar-21	1,193,977,614
Aug-18	1,022,984,613		Apr-21	1,219,716,870
Sep-18	1,023,063,678		May-21	1,230,396,876
Oct-18	994,358,725		Jun-21	1,269,642,528
Nov-18	986,083,834		Jul-21	1,310,600,871

Source: Investment Unit, National Economic Planning Office-Ministry of Finance & Economic Development

Table 3: RERF Valuations,Deposits and Drawdowns (1978 - 2021 July)				
YEAR	DEPOSITS ($)	DRAWDOWNS ($)	VALUE AUD ($)	
1978			62,218,000	
1979		4,700,000	68,152,000	Ieremia Tabai (1979 - 1991)
1980		4,250,000	71,074,000	
1981		5,751,000	66,018,000	
1982		4,750,000	81,585,000	
1983		5,500,000	87,654,000	
1984		5,500,000	97,148,623	
1985		7,700,000	138,614,452	
1986		2,800,000	167,567,378	
1987		5,000,000	207,499,878	
1988		8,000,000	176,076,883	
1989		5,000,000	200,935,558	
1990		4,000,000	220,403,732	
1991		2,000,000	263,246,547	Teatao Teannaki (1991 - 1994)
1992	3,013,750	6,500,000	295,840,642	
1993		5,500,000	353,376,735	
1994		4,364,000	318,342,617	
1995		7,500,000	367,852,284	Teburoro Tito (1994 - 2003)
1996		13,600,000	371,768,284	
1997		8,000,000	458,874,181	
1998		-	570,094,475	
1999	5,000,000	-	601,530,015	
2000		-	658,002,993	
2001		8,000,000	635,887,114	
2002		-	575,986,969	
2003		5,100,000	562,577,167	Anote Tong (2003 - 2016)
2004		25,650,000	589,074,219	
2005		15,000,000	646,816,933	
2006		33,500,000	659,584,882	
2007		45,000,000	637,335,603	
2008		25,000,000	561,601,101	
2009		18,000,000	570,913,487	
2010	5,900,000	17,300,000	580,916,530	
2011		19,700,000	578,939,105	
2012		37,500,000	613,875,384	
2013		9,623,224	660,916,093	
2014	10,000,000	18,370,000	678,971,073	
2015	50,000,000	-	756,259,202	
2016	70,000,000	-	868,095,699	Taneti Maamau (Mar 2016-July 2021)
2017		-	942,657,858	
2018		-	973,207,277	
2019		-	1,153,388,616	
2020		40,000,000	1,172,436,677	
2021 July		-	1,310,600,871	
Source: Investment Unit, NEPO,MFED				

Source: Investment Unit, National Economic Planning Office-Ministry of Finance & Economic Development