Bank of Israel
Monetary Committee Secretariat

Summary of the Monetary Committee discussion held at the Bank of Israel regarding management of the foreign exchange reserves

The discussions were held on January 15 and 22, 2020.

Asset Allocation in the Monetary Committee Benchmark—2020 recommendation

The Monetary Committee approved the recommendation of the Markets Department for 2020 concerning the allocation of assets in the Committee's benchmark.

The approved composition of the benchmark is:
- 76 percent in government bonds in numeraire currencies, with an average duration of 2.3 years in the US and 1.5 years in Europe, and an additional 3 percent in government bonds in currencies of countries approved by the Committee.
- 15 percent in the equities benchmark.
- 6 percent in investment grade corporate bonds, of which 4 percent shall be in the US market and 2 percent in the European market.

This is in contrast to the composition of the Committee's benchmark for 2019, which was:
- 75.8 percent in government bonds, with an average duration of 2.3 years in the US and 1.5 years in Europe, and an additional 1.2 percent in government bonds in currencies of countries approved by the Committee.
- 15 percent in the equities benchmark.
- 8 percent in investment grade corporate bonds, of which 5.3 percent in the US market and 2.7 percent in the European market.

The changes in the Committee's benchmark, and the resulting changes in the foreign exchange reserves portfolio, shall be made gradually, in accordance with market conditions and at the discretion of the Markets Department.

Background:
The investment management framework of the foreign exchange reserves portfolio is based on two benchmarks that fill different roles: **the basic benchmark and the Monetary Committee (MC) benchmark**. A benchmark is a theoretical, investable portfolio that includes a wide variety of assets, constructed according to known and fixed rules. The use of benchmarks is intended to measure the

performance of the investment decisions made by the Monetary Committee and of those made by the Markets Department, in accordance with the division of authority between them.

The basic benchmark represents a conservative composition of investable assets, which meets the first two goals of the investment policy for the reserves: maintaining the purchasing power of the reserves and managing them at a high level of liquidity and low level of risk. To achieve these goals, the basic benchmark is comprised of government bonds in the numeraire currencies with a short duration. **The basic benchmark provides a basis for measurement of the performance of the Committee's decisions.** Due to its conservative nature, the basic benchmark represents a risk-free investable portfolio, and thus the excess return of the MC benchmark above the return of the basic benchmark represents the MC benchmark's risk premium.

The Committee's benchmark is a theoretical, investable portfolio which reflects the strategic allocation that the Committee has selected. The asset allocation in the benchmark is set with the aim of achieving a maximum return for the portfolio, subject to the risk profile established by the Monetary Committee, while also fulfilling the first two goals of the investment policy of the reserves. The main aims of this benchmark are: (**1**) to translate the Monetary Committee's preferences and risk profile into a strategic allocation of assets in the reserves portfolio, subject to the guidelines and based on an assessment of the expected macroeconomic and financial environment; and (**2**) to outline a framework for management of the reserves portfolio. The selection of the MC Benchmark establishes the main characteristics of the reserves portfolio, including its currency composition, asset composition, and the target duration of the benchmark in each currency. The Markets Department manages the portfolio within the degrees of freedom it has been granted by the Monetary Committee, while also staying within the risk profile. **The MC benchmark provides a basis for evaluating the performance of the managers of the actual portfolio.**

The process of choosing the recommended MC benchmark for 2020 began with an assessment of the factors expected to affect the macroeconomic environment. Based on that assessment, the Department constructed three scenarios of the macroeconomic environment: baseline, optimistic, and pessimistic. The construction of the **baseline scenario** was based on:

1. An analysis of the **current state** of the global economy
2. Identification of the **main factors** that are expected to drive the global economy, and assessment of the direction in which they will move and the degree of influence they will have in the most likely case.

Constructing the alternative scenarios was based on the following principles:

1. Realization of the main risks (upside/downside) inherent in the baseline scenario
2. The realization of these risks would be expected to have a considerable impact on the risk and return of the portfolio.

The Department then assessed the financial conditions expected under the three scenarios (changes in yield curves and in credit spreads, corporate profitability, etc.) based on internal models, investment houses' strategic reviews and its own assessments. Using this input, the Department derived its forecast for the returns on various assets under each scenario.

Given the Department's forecast of asset returns, and given their risk and the correlations between them, the Department examined various asset compositions that would maximize the portfolio's return at the desired risk level. The recommended composition of the benchmark portfolio was chosen based on analysis of the results, including sensitivity analyses, examining stress scenarios, and judgment. This composition meets the goals of the investment policy and complies with the risk profile set by the Committee.

The Monetary Committee examines the allocation at least once a year, as well as at any time it sees fit to do so, in accordance with market developments.

Decision of the Monetary Committee:

The Committee approved the recommendations of the Markets Department.

Participants in the discussion:

Members of the Monetary Committee
Prof. Amir Yaron, Governor of the Bank of Israel, and Chairperson
Mr. Andrew Abir, Director of the Markets Department
Prof. Reuben Gronau
Prof. Zvi Hercowitz
Prof. Moshe Hazan

Other participants in the discussion:
Tal Biber, Head of the Markets Division, Market Operations Department
Mickey Blank, Head of Dealing Unit, Market Operations Department
Francoise Ben-Zur, Head of the Financial Division, Market Operations Department
Dr. Golan Benita, Head of the Strategic Management Unit, Market Operations Department
Guenia De Mayo, Head of the Risk Management Unit, Market Operations Department
David Hoffman, Economist, Market Operations Department
Mark Yohai, Senior Economist, Market Operations Department
Dor Lev, Economist, Market Operations Department
Arad May, Monetary Committee and the Supervisory Council Secretariat
Prof. Michel Strawczynski, Director of the Bank of Israel Research Department
Michal Sinai Livyatan, Legal Department
Dr. Amit Friedman, Advisor to the Director of the Market Operations Department