



February 25, 2015

## Summary of Monetary Committee discussion on February 23, 2015 regarding the management of the foreign exchange reserves

### Asset allocation in the Monetary Committee's benchmark—recommendation for 2015

The Monetary Committee approved the Market Operations Department's recommendation for 2015 regarding the asset allocation in the Committee's benchmark. The approved allocation includes:

- 84 percent in government bonds of numeraire currencies
- 4 percent in investment-grade corporate bonds
- 8.5 percent in equities
- 3.5 percent in strategic currency exposures, invested in government bonds, with the following distribution: 2.8 percent in Asia, and 0.7 percent in Northern Europe.
- An average duration of 1.2 years for debt securities
- The main changes compared with the allocation for 2014 are: adding corporate bonds and increasing the exposure to government bonds in Asia.

The changes in the Committee's benchmark, and the resulting changes in foreign exchange reserves investment, will be carried out gradually, in accordance with market conditions and according to the judgment of the Market Operations Department.

### Background:

The risk management framework proposed by the Department is based on two benchmarks that fill different roles in managing the reserves portfolio: the basic benchmark and the Monetary Committee benchmark. A benchmark is a hypothetical, investable, portfolio that includes a range of assets and that is constructed according to known and fixed rules. The use of benchmarks is for measuring performance of investment decisions that will be made by the Monetary Committee and the Market Operations Department in accordance with their division of authorities:

**The basic benchmark** represents an asset composition which is conservative, investable, and which has minimal risk. It meets the first two goals of the foreign exchange reserves investment policy—maintaining the purchasing power of the reserves and managing the reserves with a high level of liquidity. To achieve the objectives of the basic benchmark, the following characteristics were set: (1) the currency composition is identical to the numeraire's composition; (2) only government bonds<sup>1</sup>; (3) short duration.<sup>2</sup> **The basic benchmark serves as a yardstick for the returns derived from the Committee's decisions.** Due to its conservative character, the basic

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<sup>1</sup> Bonds of the US, UK, Germany, France, and the Netherlands.

<sup>2</sup> 0.5 years for each currency portfolio, notes with 0–3 years to maturity.

benchmark represents a risk-free portfolio and therefore the excess return of the Committee's benchmark over the basic benchmark represents its risk premium.

**The Committee's benchmark** is a hypothetical, investable portfolio, which represents the strategic allocation chosen by the Committee. The benchmark's asset allocation is set with the goal of achieving an adequate return, subject to the risk profile established by the Monetary Committee, while meeting the first two goals of the reserves investment policy. The main objectives of the benchmark are: (1) to translate the Monetary Committee's preferences and risk profile into a strategic asset allocation in the reserves portfolio, subject to the guidelines; (2) to outline a framework for managing the reserves portfolio. Choosing the benchmark essentially determines the main characteristics of the reserves portfolio, including the currency composition, the asset composition, allocation of equities among markets, and the target duration for each currency benchmark. The Department will manage the portfolio within the framework of degrees of freedom granted it while adhering to the risk profile. **The Committee's benchmark provides a yardstick for the performance analysis of the reserves portfolio investment managers' actual returns.**

The strategic allocation is a complex process: It is based on a wide range of data and statistical models, and thus inherently contains some uncertainty.

In order to evaluate the returns of the various assets in 2015, the Market Operations Department took into account the forecasts of various entities, including the forecast of the Market Operations Department itself. Construction of the main scenarios for developments in the global economic environment in 2015 was based on an analysis of the current situation and identifying the main factors that are expected to drive the global economy, while assessing the direction of their development.

The Market Operations Department estimated—in various groups of limitations—the returns of a number of possible portfolio allocations. Afterwards, the Department chose the portfolio allocations in which the expected rate of return **was the highest return relative to the desired level of risk.**

At the end of the optimization process—after assessing the outcomes, including analysis of stress scenarios and utilizing judgment—the Market Operations Department recommended the allocation for the Monetary Committee's benchmark. This allocation meets the investment policy goals and is subject to the risk profile that the Committee set.

The Monetary Committee examines the allocation at least once per year, and whenever it deems it appropriate, in accordance with market developments.

#### **Monetary Committee Decision:**

The Committee approved the Market Operations Department's recommendations.

#### **Participants in the discussion:**

#### **Members of the Monetary Committee**

Dr. Karnit Flug, Governor of the Bank of Israel, Chairperson

Dr. Nadine Baudot-Trajtenberg, Deputy Governor

Prof. Alex Cukierman

Prof. Reuben Gronau

Prof. Nathan Sussman, Director of the Research Department

**Other participants in the discussion:**

Andrew Abir, Director of Market Operations Department

Dr. Golan Benita, Head of Strategic Management Unit in Market Operations Department

Francoise Ben-Zur, Head of Financial Division in Market Operations Department

Tal Biber, Head of Markets Division in the Market Operations Department

Mickey Blank, Deputy Head of Dealing Unit in Market Operations Department

Guenia De Mayo, Head of Risk Management Unit in Market Operations Department

Daniel Hahiashvilli, Chief of Staff to the Governor

David Hoffman, Economist in Strategic Management Unit in Market Operations Department

Ilan Socianu, Assistant to Secretary of the Monetary Committee and the Supervisory Council

Mark Yohai, Economist in Strategic Management Unit in Market Operations Department