Bank of Israel
Monetary Committee Secretariat

Report of the monetary discussions held at the Bank of Israel regarding management of the foreign exchange reserves

Asset Allocation in the Monetary Committee Benchmark for 2023

The discussions were held on December 21 and 28, 2022.

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 its goals, the basic benchmark is comprised of government bonds in the currency-benchmark 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 that reflects the strategic asset allocation that the Monetary Committee has selected for the reserves portfolio. The asset allocation in the benchmark is set with the aim of maximizing the reserves portfolio return, 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 essentially 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 actual investment of the portfolio within the degrees of freedom it has been granted by the Monetary Committee, while also staying within the risk profile. Therefore, 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 2023 began with an assessment of the expected 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 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. The scenarios are derived from the main risks (to the upside/downside) inherent in the baseline scenario
2. The realization of these risks would be expected to have a marked 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 using discretion. This composition meets the goals of the investment policy and complies with the risk profile set by the Committee, including:

1. The limitation of investment in equities of up to 27 percent of the total reserves;
2. The maximum risk, in CVaR terms, of 900 basis points per year;
3. The limitation of investment in risk assets (equities and corporate bonds) of up to 35 percent of the total reserves;
4. The limitation of investment in corporate bonds rated HY of up to 5 percent of total reserves;

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.

Discussion:
The Markets Departments presented the macroeconomic and financial forecast, and the forecast for returns on the assets in the MC benchmark.

Following is the recommendation of the Markets Department for the asset allocation in the Committee benchmark in 2023:

- 67 percent in government bonds in currencies of the currency benchmark with a duration of 2 years in all the currency benchmark currencies.
- 23 percent in equities
- 9 percent in investment grade corporate bonds, of which 6.75 percent shall be traded in the US market and 2.25 percent traded in the European market.
- 1 percent in corporate bonds rated below investment grade (HY), of which 0.75 percent shall be traded in the US market and 0.25 percent traded in the European market.

This is in contrast to the MC benchmark allocation that was approved in 2022:

- 69 percent in government bonds in currencies in the currency benchmark with a duration of 2.3 years in the US, 1.5 years in Europe, and 2.1 years in the other benchmark currencies.
- 21 percent in equities.
- 8 percent in investment grade corporate bonds, of which 6 percent shall be traded in the US market and 2 percent that shall be traded in the European market.
- 2 percent in corporate bonds rated high yield, of which 1.5 percent shall be traded in the US market and 0.5 percent traded in the European market.

The Department's recommendations were discussed.

Decision of the Monetary Committee:

The Committee approved the recommendations of the Markets Department. In addition, the increase in the share of equities from 21 percent to 23 percent in parallel with a decrease in the share of investment in government bonds at the approved allocation shall be carried out gradually, during the year, in accordance with market conditions and with the approval of the Governor.

The decision was reached unanimously.

Participants in the discussion:

Members of the Monetary Committee

Prof. Amir Yaron, Governor of the Bank of Israel, and Monetary Committee Chairperson
Mr. Andrew Abir, Deputy Governor of the Bank of Israel
Prof. Naomi Feldman
Prof. Zvi Hercowitz
Prof. Moshe Hazan

Other participants in the discussion:

Ms. Shiran Azarzar, Markets Committee (in the Dec. 21, 2022 meeting)
Mr. Yaakov Ashkenazi, Markets Committee (in the Dec. 21, 2022 meeting)
Mr. Nadav Eshel, Governor's office
Mr. Tal Biber, Head of the Markets Division in the Markets Department
Mr. Mickey Blank, Markets Department (in the Dec. 21, 2022 meeting)
Dr. Golan Benita, Director of the Markets Department
Ms. Francoise Ben-Zur, Head of the Financial Division in the Markets Department
Mr. Uri Barazani, Bank Spokesperson (in the Dec. 28, 2022 meeting)
Dr. Adi Brender, Head of the Macro and Policy Division, Research Department (in Dec. 28, 2022 meeting)
Mr. Hanoch Danenberg, Markets Department (in the Dec. 21, 2022 meeting)
Mr. Oren Hadjes, Markets Department (in the Dec. 21, 2022 meeting)
Mr. Asaf Zilbershtein, Markets Department (in the Dec. 21, 2022 meeting)
Mr. Mark Yohai, Markets Department

Dr. Oded Cohen, Chief of Staff to the Governor
Mr. Dor Lev, (in the Dec. 21, 2022 meeting)
Mr. Roee Levy, Markets Department (in the Committee meeting on Dec. 21, 2022)
Mr. Arad May, Secretariat of the Monetary Committee and Supervisory Council
Ms. Michal Sinai Livyatan, Legal Division (in the Dec. 28, 2022 meeting)
Mr. Lior Farbman, Markets Department (in the Dec. 21, 2022 meeting)
Dr. Amit Friedman, Advisor to the Markets Department Director
Mr. Ran Tzion, Markets Department (in the Dec. 21, 2022 meeting)
Mr. Idan Sneer, Markets Department (in the Dec. 21, 2022 meeting)