



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

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The discussions were held on January 17 and 23, 2018

### **Asset Allocation in the Monetary Committee Benchmark—2018 recommendation**

The Monetary Committee approved the recommendation of the Market Operations Department for 2018 concerning the allocation of assets in the Committee's benchmark.

The approved composition of the benchmark is:

- 81.5% in government bonds, with an average duration of 2 years in the US and 1.5 years in Europe.
- 12.5% in the equities benchmark.
- 6% in investment grade corporate bonds, of which 4.5% shall be in the US market and 1.5% in the European market.

This is in contrast to the composition of the Committee's benchmark for 2017, which was:

- 79.5% in government bonds, with an average duration of 1.8 years in the US and 1.5 years in Europe.
- 12.5% in the equities benchmark.
- 8% in investment grade corporate bonds, of which 6.5% shall be in the US market and 1.5% 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 Market Operations 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 Market Operations 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 a low level of risk. To achieve these goals, the basic benchmark is comprised of government bonds with a currency composition identical to the composition of the numeraire<sup>1</sup>

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<sup>1</sup> US, UK, Germany, France and Netherlands government bonds.

with a short target duration.<sup>2</sup> **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 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 Market Operations 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 Committee benchmark for 2018 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 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. The scenarios were derived from the main risks (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 tests, and judgment. This composition meets the investment policy targets and is subject to the Monetary Policy Committee's risk profile.

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 developments in the markets.

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<sup>2</sup>A duration of 6 months.

### **Decision of the Monetary Committee:**

The Committee approved the recommendations of the Market Operations Department.

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

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

Dr. Karnit Flug, Governor of the Bank of Israel and Chairperson  
Dr. Nadine Baudot-Trajtenberg, Deputy Governor of the Bank of Israel  
Mr. Andrew Abir, Director of the Market Operations Department  
Prof. Reuben Gronau  
Prof. Zvi Hercowitz  
Prof. Moshe Hazan

#### **Other participants in the discussion:**

David Ettun, Economist in the Market Operations Department (in the discussion on January 23)  
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  
Hanoch Danenberg, Head of the Surveillance and Analysis Unit, Market Operations Department (in the discussion on January 23)  
David Hoffman, Economist, Market Operations Department  
Hagit Waknin, Economist, Market Operations Department (in the discussion that took place on January 23)  
Amir Veler, Economist, Market Operations Department  
Daniel Hahiashvili, Chief of Staff to the Governor  
Mark Yohai, Senior Economist, Market Operations Department  
Dor Lev, Economist, Market Operations Department  
Mark Nulman, Senior Economist, Market Operations Department (in the discussion on January 17)  
Dr. Amit Friedman, Advisor to the Director of the Market Operations Department  
Dr. Sigal Ribon, Head of the Monetary Division, Research Department  
Esti Schwartz, Secretary of the Monetary Committee and the Supervisory Council