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Enabling poor rural people to overcome poverty

Report on IFAD's investment portfolio for the first two months of 2012

Note to Executive Board representatives

Focal points:

Technical questions:

Iain McFarlane Kellet
Chief Finance Officer
Head of the Financial Operations Department
Tel.: +39 06 5459 2403
e-mail: i.kellet@ifad.org

Natalia Toschi
Investment Risk Officer
Tel.: +39 06 5459 2229
e-mail: n.toschi@ifad.org

Dispatch of documentation:

Deirdre McGrenra
Head, Governing Bodies Office
Tel: +39 06 5459 2374
e-mail: gb_office@ifad.org

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Report on IFAD's investment portfolio for the first two months of 2012

I. Executive summary

1. This report consists of the following sections and subsections: progress of implementation of investment policy; market conditions; asset allocation; investment income; rate of return and risk measurements. The latter includes subsections in relation to duration; conditional value-at-risk; ex-ante tracking error; credit rating analysis; currency composition analysis and minimum liquidity requirement.

2. During the first two months of 2012, IFAD's investment portfolio showed a positive performance. Announced reforms in Europe supported the performance of European government bonds, and encouraging economic news in the United States were a driver for the good performance of inflation protected securities.

3. The value of the investment portfolio in United States dollar terms decreased by US$10,464,000 equivalent, from US$2,455,516,000 equivalent at 31 December 2011 to US$2,445,052,000 equivalent at 29 February 2012. The main factors for this decrease were the net disbursement outflows which were partially offset by the net investment income and positive foreign exchange movements.

4. The investment portfolio's net rate of return for the first two months of 2012 was 0.67 per cent and this translates into a net investment income amount of US$17,087,000 equivalent.

5. IFAD started the implementation process of the revised Investment Policy in line with the Investment Policy Statement approved by the Executive Board in December 2011.[1] The progress on the implementation is reported in section II below.

[1] EB 2011/104/R.43

II. Progress of implementation of investment policy

6. IFAD's Investment Policy Statement (hereafter "IPS") was approved by the Executive Board at its 104th session held in December 2011. As stated in the IPS[2], "the implementation status of the IPS will be reported to the Executive Board at its regular meetings."

7. During the first two months of 2012 IFAD issued tenders for external portfolio managers for the funding of the new asset classes approved under the IPS[3], i.e. restructured diversified fixed-income and new emerging market debt asset classes. The tenders are foreseen to be completed within the second quarter of 2012 and the portfolios are expected to be fully funded by 1 July 2012 according to schedule.

8. IFAD already started monitoring and reporting the risk levels of existing asset classes in line with the risk budget parameters[4] (please refer to section VII) and is performing monthly tests on new benchmark indices to be used for the restructured diversified fixed-income and the new emerging market debt asset classes. The in-house enhanced risk monitoring system will be implemented as foreseen during the second half of the year.

III. Market conditions

9. Market conditions during the first two months of 2012 resulted in a favourable outcome for IFAD's investment portfolio. The global government bonds asset class ended the period positively, with Europe driving the returns on the back of Eurozone peripheral government announced reforms, as well as the second round of the three year long term refinancing operation by the European Central Bank. United States Treasury bond prices fell slightly, due to continued confidence in the United States economy. Within the diversified fixed-income asset class, United States agency mortgage-pass through securities were the chief contributor to performance, however this was somewhat mitigated by falling prices of United States Treasury bonds, the other main component of the asset class. The inflation-indexed bonds yielded the highest level of returns in the portfolio, due to an increase in inflation expectations in the United States on the back of continued encouraging economic news, which benefited the valuation of inflation-linked notes, together with a clearer picture for the resolution of the European crisis.

10. During January and February of 2012, the volatile foreign exchange markets saw an overall appreciation of the United States dollar against the Japanese yen (+5.20 per cent), while there was an overall depreciation of the United States dollar against the euro (-2.96 per cent) and the British pound sterling (-2.71 per cent).

11. IFAD's reporting currency is the United States dollar. Therefore, the overall depreciation of the United States currency against the euro and the British pound sterling, which has a relevant weight in the investment portfolio, resulted in a net positive foreign exchange movement as evidenced in table 1. It must be noted that the currency fluctuations affecting IFAD's assets are balanced by similar fluctuations on IFAD's liabilities and therefore neutralized on an asset liability level. For this reason, the income and performance of IFAD's portfolio is reported in local currency terms.

[2] IPS Section II, A.
[3] IPS Section III, D.
[4] IPS Section II, I. and section IV

IV. Asset allocation

12. Table 1 shows the movements affecting the portfolio by asset class during the first two months of 2012 and compares the portfolio's asset allocation with the policy allocation.

Table 1
Movements affecting the asset allocation within the portfolio during the first two months of 2012
(Thousands of United States dollars equivalent)

	Operational cash[a]	*Held-to-maturity*	*Global government bonds*	*Diversified fixed- income bonds*	*Inflation-indexed bonds*	*Total*
Opening balance by portfolio (31 December 2011)	**199 944**	**383 889**	**950 480**	**413 885**	**507 318**	**2 455 516**
Investment income[b]	48	3 511	4 012	1 567	7 949	17 087
Transfers due to allocation	17 529	(17 529)	-	-	-	-
Transfers due to expenses and income allocation	(732)	24	323	171	214	-
Net disbursement[c]	(49 407)	-	-	-	-	(49 407)
Movements on exchange	1 647	6 264	15 552	2	(1 609)	21 856
Closing balance by portfolio (29 February 2012	**169 029**	**376 159**	**970 367**	**415 625**	**513 872**	**2 445 052**
Actual asset allocation (percentage)	6.9	15.4	39.7	17.0	21.0	100.0
Investment policy asset allocation[d] (percentage)	5.5	15.4	43.6	15.5	20.0	100.0
Difference in allocation (percentage)[e]	**1.4**	**-**	**(3.9)**	**1.5**	**1.0**	**-**

[a] Cash and time deposits held with banks, readily available for disbursing loans, grants and administrative expenses.
[b] Investment income is further detailed in table 2.
[c] Disbursements for loans, grants and administrative expenses net of cash receipts, loan reflows and encashment of Member State contributions.
[d] The investment policy allocation for the held-to-maturity portfolio is set to match the current 15.4 per cent asset allocation in the investment portfolio.
[e] The differences between policy and actual asset allocations are impacted by fluctuations in market values of portfolios and foreign exchange movements.

13. During the first two months of 2012, the overall investment portfolio value in United States dollar terms decreased by US$10,464,000 equivalent. This decrease was the net result of the following flows:

- Net outflows of US$49,407,000 equivalent representing disbursements for loans, grants and administrative expenses net of cash receipts, loan reflows and encashment of Member State contributions;
- Investment income of US$17,087,000 equivalent; and
- Positive foreign exchange movements of US$21,856,000 equivalent.

14. During the two month period US$17,529,000 equivalent was transferred from the held-to-maturity portfolio into the operational cash portfolio. This represented accumulated coupon income together with funds pertaining to recently matured/sold bonds from the held-to-maturity portfolio pending re-investment.

15. The actual allocation shows some deviations compared to the policy allocation whereby an under allocation in the global government bonds asset class is counterbalanced by an over allocation in the other asset classes. This is mainly due to the decision in 2011 to provide cash for disbursements by liquidating funds from the global government bonds portfolio, which was the lowest performing asset class within the portfolio in 2011.

V. Investment income

16. During the first two months of 2012, the net investment income amounted to US$17,087,000 equivalent, inclusive of all realized and unrealized market gains and losses and net of all investment related fees. Table 2 presents a summary of the first two months of 2012 investment income broken down by asset class.

Table 2
Breakdown of investment income by asset class for the first two months of 2012
(Thousands of United States dollars equivalent)

	Operational cash	*Held-to-maturity*[b]	*Global government bonds*	*Diversified fixed-income bonds*	*Inflation-indexed bonds*	*Total*
Interest from fixed-income investments and bank accounts	65	2 351	4 286	1 751	1 042	9 495
Realized market gains/(losses)	-	1 294	(90)	2 654	1 854	5 712
Unrealized market gains/(losses)[a]	-	-	138	(2 667)	5 266	2 737
Amortization[b]	-	(110)	-	-	-	(110)
Investment income before fees	**65**	**3 535**	**4 334**	**1 738**	**8 162**	**17 834**
Investment manager fees	-	-	(249)	(140)	(178)	(567)
Custody fees/bank charges	(17)	(2)	(17)	(7)	(5)	(48)
Financial advisory and other investment related fees	-	(22)	(56)	(24)	(30)	(132)
Investment income after fees	**48**	**3 511**	**4 012**	**1 567**	**7 949**	**17 087**

[a] The held-to-maturity portfolio contains a realized gain of US$1,294,000 equivalent which pertains to the sale of an impaired security in February 2012.
[b] A period's amortization amount represents a portion of the difference between the purchase price and the final redemption value of the held-to-maturity investments as per the International Financial Reporting Standards (IFRS).

VI. Rate of return

17. The rate of return of IFAD's investment portfolio is calculated in local currency terms without reflecting the impact of foreign exchange movements, which is neutralized through the currency alignment of IFAD's assets and IFAD's liabilities to the SDR currency ratios.

18. The investment portfolio returned a positive 0.67 per cent for the first two months of 2012, including all realized and unrealized market gains and losses and net of investment expenses.

19. The inflation-indexed bonds portfolio was the best performing portfolio and was complemented by a solid performance from the held-to-maturity, global government and diversified fixed-income bond portfolios.

Table 3
Annual 2011 and January/February 2012 rates of return and applicable benchmark comparison
(Percentages in local currency terms)

	Performance for January/February 2012			*Annual performance for 2011*		
	Actual	*Benchmark*	*Over/(under) performance*	*Actual*	*Benchmark*	*Over/(under) performance*
Operational cash	0.02	0.02	-	0.56	0.56	-
Held-to-maturity	0.93	0.56	0.37	2.91	3.56	(0.65)
Global government bonds	0.41	0.69	(0.28)	2.42	2.36	0.06
Diversified fixed-income bonds	0.40	0.23	0.17	7.28	7.67	(0.39)
Inflation-indexed bonds	1.54	2.29	(0.75)	6.97	6.84	0.13
Net rate of return	**0.67**	**0.85**	**(0.18)**	**3.82**	**3.94**	**(0.12)**

VII. Risk measurements

20. As per the IPS, the risk measures used for risk budgeting purposes are the conditional value-at-risk (hereafter "CVaR") for the overall portfolio and single asset classes, as well as the ex-ante tracking error for single managers within the respective asset classes.

21. The in-house monitoring of the risk budget levels will start as soon as the enhanced risk management system will be fully implemented. In the meantime, in close collaboration with the Global Custodian, IFAD is monitoring and reporting on a monthly basis the risk levels of the existing portfolios and asset classes, to ensure compliance with the risk budget levels. The current CVaR and ex-ante tracking error levels are reported in sections B and C below. In addition, other main risk indicators are reported in sections A, D, E and F.

A. Market risk: Duration

22. Within the fixed-income investment universe, one of the most important measures of market risk is a bond's duration.[5] The duration indicates the effective maturity and represents the time needed to recuperate the initial investment through the cash flows expected by the bond (coupons and principal). The longer the duration, the more the bond's price is sensitive to movements of market interest rate because the investment will be exposed to market fluctuations for a longer time period. Therefore, a longer duration is normally associated to higher risk. IFAD assesses the optimal asset class duration in line with risk budget levels and IFAD's investment guidelines set duration limits versus benchmarks.

Table 4
IFAD's investment portfolio and benchmark effective duration as at 29 February 2012
(Duration in number of years)

	Portfolio	*Benchmark*
Global government bonds	1.9	2.0
Diversified fixed-income bonds	4.5	4.3
Inflation-indexed bonds	5.5	5.1
Total portfolio (including held-to-maturity and operational cash)	**2.6**	**2.4**

Note: The total portfolio duration is lowered by the operational cash and held-to-maturity portfolios which are not subject to fluctuations in prices.

[5] The measure of the price sensitivity of a fixed-income security to an interest rate change of 100 basis points. Calculation is based on the weighted average of the present values for all cash flows. Duration is measured in years.

23. Table 4 shows the actual and benchmark durations for the single asset classes and the overall portfolio. The overall portfolio duration was 2.6 years, which is an overall conservative positioning. The inflation-indexed bonds asset class has the longest duration, in line with the nature of the issuances of inflation-indexed securities. The global government bonds have the shortest duration, thereby lowering the overall portfolio risk level.

24. All portfolios are well within the duration limits versus benchmark established in IFAD's investment guidelines.

B. Market risk: Conditional value-at-risk (CVaR)

25. The one-year CVaR at 95 per cent is a measure of the potential average expected loss of a portfolio under extreme conditions (the so-called "left tail"). It gives an indication of how much value a portfolio could lose on average over a forward looking one-year time-horizon with a 95 per cent confidence level in highly adverse scenarios. To derive this measure, the portfolio is re-valued (stressed) assuming a large number of market condition scenarios affecting its value. For example, a CVaR of 4.0 per cent on a portfolio of US$1,000,000 means that there is a 5 per cent chance the average loss of the portfolio will be US$40,000.

Table 5
Conditional value-at-risk (CVaR) of current asset classes
(Confidence level at 95 per cent, percentage terms, based on historical simulations over 5-year history)

	Actual investment portfolio	*IPS budget level*
	1-year CVaR	*1-year CVaR*
Global government bonds	2.2	4.0
Diversified fixed-income bonds	11.3	15.0
Inflation-indexed bonds	6.9	9.0
Total portfolio (including held-to-maturity and operational cash)	**3.4**	**10.0**

26. As shown in table 5, the CVaR of single asset classes and of the overall portfolio are currently well below the risk budget levels.

C. Market risk: Ex-ante tracking error

27. The ex-ante tracking error is calculated based on the expected portfolio and benchmark returns over a one-year forward looking horizon. It gives an indication of how different an active strategy is from its benchmark. The more a portfolio differs from the benchmark upon which it is based, the more likely it is to under-perform or outperform that same benchmark. For example, a one-year forward-looking ex-ante tracking error of 0.2 per cent means that, over the coming year, the portfolio excess return over the benchmark is expected to be in the range of +/- 0.2 per cent of its mean value.

Table 6
IFAD's investment portfolio ex-ante tracking error as at 29 February 2012
(Percentages)

	Investment portfolio	*IPS budget level*
Global government bonds	0.4	1.5
Diversified fixed-income bonds	0.7	3.0
Inflation-indexed bonds	1.2	2.5

28. As shown in table 6, the current levels of ex-ante tracking error are well below the budget levels. This indicates a close resemblance of the portfolio strategy to the benchmark indices.

D. Credit risk: Credit rating analysis

29. IFAD manages credit risk mainly through the establishment of a minimum rating floor in the investment guidelines. Should a security be downgraded below IFAD's minimum credit rating, procedures to ensure monitoring and divestment by limiting market losses are in place.

30. As at 29 February 2012, over 85 per cent of IFAD's fixed income investments was rated AAA (compared to 85 per cent as at 31 December 2011); over 9 per cent was rated between AA+ and AA- (compared to 9 per cent as at 31 December 2011) and over 5 per cent was rated between A+ and A- (compared to 4 per cent as at 31 December 2011). Investments rated below BBB+ were reduced to 0.02 per cent (compared to 0.3 per cent as at 31 December 2011).

Table 7
Composition of the investment portfolio by credit ratings[a] as at 29 February 2012
(Thousands of United States dollars equivalent)

	Operational cash	*Held-to-maturity*	*Global government bonds*	*Diversified fixed-income bonds*	*Inflation-indexed bonds*	*Total*	*Percent age (%)*
AAA	-	257 298	817 476	382 720	492 316	1 949 810	85.2
AA+	-	21 542	-	15 271	-	36 813	1.6
AA	-	39 395	30 720	20 437	5 582	96 134	4.2
AA-	-	10 128	46 383	27 731	-	84 242	3.7
A	-	19 183	-	792	-	19 975	0.9
A-	-	28 613	57 315	-	15 607	101 535	4.4
BBB+ and below	-	-	-	488	-	488	0.0
Cash and cash equivalents[b]	169 029	-	22 172	20 365	7 960	219 526	n.a.
Pending sales and purchases[c]	-	-	(3 699)	(52 179)	(7 593)	(63 471)	n.a.
Total	**169 029**	**376 159**	**970 367**	**415 625**	**513 872**	**2 455 052**	**100.0**

[a] As per IFAD's current Investment Guidelines, the credit ratings used in this report are based on the best credit ratings available from either Standard and Poor's (S&P) or Moody's credit rating agencies. The diversified fixed-income bonds portfolio also applies Fitch Ratings.
[b] Consists of cash with central banks, corporate banks and cash held by external portfolio managers. These amounts are not rated by credit rating agencies.
[c] Pending foreign exchange purchases and sales used for hedging purposes and trades pending settlement. These amounts do not have an applicable credit rating.

Note: n.a.: not applicable

E. Currency risk: Currency composition analysis

31. The majority of IFAD's commitments pertain to undisbursed loans and grants and are expressed in special drawing rights (SDRs). In order to immunize IFAD's balance sheet against currency fluctuations, the Fund's assets are maintained, to the extent possible, in the same currencies and ratios of the Fund's commitments, i.e. in SDR. Similarly, the General Reserve and commitments for grants denominated in United States dollars are matched by assets denominated in the same currency.

32. The Executive Board of the International Monetary Fund reviews the SDR valuation basket every five years to determine which currencies should be part of the basket and what their percentage weight should be at the date of reweighting the basket.

33. The applicable SDR units together with their percentage weights as at 29 February 2012 are shown in table 8.

Table 8
Units and weights applicable to SDR valuation basket as at 29 February 2012

Currency	*Units*	*Percentage weight*
United States dollar	0.6600	42.6
Euro	0.4230	36.5
Yen	12.1000	9.6
Pound sterling	0.1110	11.3
Total		**100.0**

34. At 29 February 2012, assets in the form of cash, investments, promissory notes and contribution receivables from Member States under the Sixth, Seventh and Eighth Replenishments, net of provisions, amounted to US$2,740,335,000 equivalent, as summarized in table 9.

Table 9
Currency composition of assets in the form of cash, investments and other receivables
(Thousands of United States dollars equivalent)

Currency	*Cash and investments*[a]	*Promissory notes*[a]	*Contribution receivables from Member States*	*Total*
United States dollar group[b]	1 105 500	126 425	44 195	1 276 120
Euro group[c]	805 998	46 341	39 417	891 756
Yen	216 573	39 383	-	255 956
Pound sterling	316 503	-	-	316 503
Total	**2 444 574**	**212 149**	**83 612**	**2 740 335**

[a] The difference in the cash and investments balance compared to other tables derives from the exclusion of assets in non-convertible currencies of US$478,000 equivalent (cash and investments).
[b] Includes assets in Australian, Canadian and New Zealand dollars.
[c] Includes assets in Swiss francs, Swedish kronor, Danish kroner and Norwegian kroner.

35. The alignment of assets by currency group against the SDR valuation basket as at 29 February 2012 is shown in table 10. The balance of commitments denominated in United States dollars at 29 February 2012 amounted to US$186,675,000 equivalent, composed of the General Reserve (US$95,000,000) and commitments for grants denominated in United States dollars (US$91,675,000).

Table 10
Alignment of assets per currency group with the SDR valuation composition as at 29 February 2012
(Thousands of United States dollars equivalent)

Currency	*Asset amount*	*Less: commitments denominated in US dollars*	*Net asset amount*	*Net asset amount (percentage)*	*SDR weights (percentage)*	*Difference (percentage)*
US dollar group	1 276 120	(186 675)	1 089 445	42.7	42.6	0.1
Euro group	891 756	-	891 756	34.9	36.5	(1.6)
Yen	255 956	-	255 956	10.0	9.6	0.4
Pound sterling	316 503	-	316 503	12.4	11.3	1.1
Total	**2 740 335**	**(186 675)**	**2 553 660**	**100.0**	**100.0**	**0.0**

36. As at 29 February 2012 there was a shortfall in the euro currency group of 1.6 per cent. This was offset by an excess allocation in the British pound sterling of 1.1 per cent, the Japanese yen of 0.4 per cent and the United States dollar currency group of 0.1 per cent.

F. Liquidity risk: Minimum liquidity requirement

37. IFAD's liquidity risk is addressed through the minimum liquidity requirement. IFAD's liquidity policy[6] states that the amount of highly liquid assets in IFAD's investment portfolio should remain above 60 per cent of the projected annual gross disbursement level including the impact of liquidity shocks. This translates into a minimum liquidity requirement of US$518,000,000 over the Eighth Replenishment period.

38. Highly liquid assets in IFAD's investment portfolio as at 29 February 2012 amounted to US$1,139,396,000 equivalent which comfortably clears the minimum liquidity requirement (table 11).

Table 11
Liquidity level in IFAD's investment portfolio as at 29 February 2012
(Thousands of United States dollars equivalent)

	Actuals	*Percentage*
Highly liquid assets	**1 139 396**	**46.6**
Short-term	169 029	6.9
Government securities	970 367	39.7
Fairly liquid assets	**929 497**	**38.0**
Non-government securities	929 497	38.0
Partially liquid assets	**376 159**	**15.4**
Held-to-maturity	376 159	15.4
Total portfolio	**2 445 052**	**100.0**

[6] EB 2006/89/R.40