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Enabling poor rural people
to overcome poverty

Report on IFAD's investment portfolio for the third quarter of 2012

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Report on IFAD's investment portfolio for the third quarter of 2012

I. Executive summary

1. This report consists of the following sections and subsections: implementation of the 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 third quarter of 2012, IFAD's investment portfolio continued to perform positively due to the flight-to-quality to United States and core European government bond markets during most of the period.

3. The value of the investment portfolio in United States dollar terms decreased by US$82,266,000 equivalent, from US$2,371,134,000 equivalent at 1 July 2012 to US$2,288,868,000 equivalent at 30 September 2012. The main factors for this decrease were 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 third quarter of 2012 was 1.19 per cent, translating into a net investment income amount of US$27,307,000 equivalent.

5. On a year-to-date basis, the net rate of return for the first nine months of 2012 was 2.52 per cent, which translates into a net investment income amount of US$58,592,000 equivalent.

6. During the third quarter of 2012, IFAD completed the implementation of the revised investment policy in accordance with the Investment Policy Statement approved by the Executive Board in December 2011[1].

II. Implementation of the investment policy

7. IFAD's Investment Policy Statement (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".

8. During the month of July 2012, all new external portfolio managers for the global government bond, global diversified fixed-income and emerging market debt asset classes[3] were funded. In addition to the implementation of the IPS, applicable benchmarks were constructed and implemented for the new global diversified fixed-income and emerging market debt asset classes (see table 3).

9. The in-house enhanced risk monitoring system has been extensively used to monitor and report the risk levels of various asset classes (both benchmarks and actual portfolios) in line with the risk budget parameters.[4] Section VII of this report presents the risk measures of the investment portfolio in place as at 30 September 2012.

10. The first review of the IPS has been submitted to the 107th session of the Executive Board, as stated in IPS section II, B., paragraph 8.

III. Market conditions

11. Market conditions during the third quarter of 2012 resulted in a favourable outcome for IFAD's investment portfolio.

[1] EB 2011/104/R.43.
[2] IPS Section II, A.
[3] IPS Section III, D.
[4] IPS Section II, I. and section IV.

12. The global government bonds asset class ended the period positively, supported by the flight to quality to United States and core European government bond markets, especially at the beginning of the quarter, owing to renewed concerns relative to the debt of several peripheral euro-zone countries. The "safe heaven" rally reduced its momentum at the end of August, and in early September the European Central Bank announced its intention to purchase unlimited quantity of bonds for Eurozone countries that requested it. The United States Treasury bonds only benefitted marginally from the United States Federal Reserve's announcement in September of the extension of its quantitative easing program.

13. The global diversified fixed-income asset class return increased strongly during the third quarter period with the United States Treasury bonds being the chief contributor, with United States agency mortgage-pass through securities and corporate bonds as second best sectors as the extended quantitative easing by the United States Federal Reserve sparked a further rally in risk assets towards the end of the period.

14. The inflation-indexed bond prices also registered a strong increase as investors sought refuge in safe havens such as the United States, United Kingdom and core European issuers. Performance from the asset class also benefited from a renewed investors' interest in the inflation protection element in response to the easing measures implemented by all major central banks.

15. The emerging market bond prices also registered a strong return on the back of a tightening of rate differentials versus United States Treasuries and accommodative measures implemented by various developed markets' central banks.

16. During the third quarter of 2012, the volatile foreign exchange markets saw an overall depreciation of the United States dollar against the euro (-1.36 per cent), the British pound sterling (-2.87 per cent) and the Japanese yen (-2.49 per cent).

17. The overall depreciation of the United States currency against the abovementioned currencies resulted in a positive foreign exchange movement (see table 1). It must be noted that the currency fluctuations affecting IFAD's assets are offset by similar fluctuations for IFAD's liabilities and are therefore neutralized on an asset liability level. For this reason, the income and performance of IFAD's portfolio are reported in local currency terms.

IV. Asset allocation

18. Table 1 shows the movements affecting the portfolio by asset class during the third quarter of 2012 and compares the portfolio's asset allocation with the policy allocation.

19. IPS implementation included a new investment policy asset allocation (see table 1) that resulted in a 7 per cent asset allocation for the emerging market debt asset class and a slight increase in the operational cash asset class. This was predominantly funded by the decrease in the global government bonds mandate.

Table 1
Movements affecting the asset allocation within the portfolio during the third quarter of 2012
(Thousands of United States dollars equivalent)

	Operational cash[a]	*Held-to-maturity*	*Global government bonds*	*Global diversified fixed-income*	*Inflation-indexed bonds*	*Emerging market debt bonds*	*Total*
Opening balance (1 July 2012)	**207 224**	**382 213**	**849 821**	**421 853**	**510 023**	**-**	**2 371 134**
Investment income[b]	2 450	2 449	5 438	2 666	8 289	6 015	27 307
Transfers due to allocation	101 633	(5 073)	(83 507)	(106 146)	(56 907)	150 000	-
Transfers due to expenses allocation	(973)	48	351	179	265	130	-
Net disbursement[c]	(134 157)	-	-	-	-	-	(134 157)
Movements on exchange	(9 367)	3 906	17 471	3 705	8 216	653	24 584
Closing balance (30 September 2012)	**166 810**	**383 543**	**789 574**	**322 257**	**469 886**	**156 798**	**2 288 868**
Actual asset allocation (percentage)	7.3	16.8	34.4	14.1	20.5	6.9	100.0
Investment policy asset allocation (percentage)	7.0	17.0	36.0	13.0	20.0	7.0	100.0
Difference in allocation (percentage)	**0.3**	**(0.2)**	**(1.6)**	**1.1**	**0.5**	**(0.1)**	**-**

[a] Cash and time deposits held with banks, readily available for disbursing loans, grants and administrative expenses. This asset class also included all income and foreign exchange movements that occurred during the implementation period pertaining to the new investment managers and Investment Portfolio Statement (IPS) in July 2012.
[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.

20. During the third quarter of 2012, the overall investment portfolio value in United States dollar terms decreased by US$82,266,000 equivalent. This decrease was the net result of the following flows:

- Net outflows of US$134,157,000 equivalent representing disbursements for loans, grants and administrative expenses net of cash receipts, loan reflows and encashment of Member State contributions;
- Net investment income of US$27,307,000 equivalent; and
- Positive foreign exchange movements of US$24,584,000 equivalent.

21. With the completed implementation of the IPS, IFAD's investment portfolio diversified into the new emerging market debt asset class. The US$150,000,000 equivalent emerging market debt portfolio was funded by:

- (Global) diversified fixed-income portfolio US$106,146,000 equivalent; and
- Global government bonds portfolio US$43,854,000 equivalent.

22. In order to cover net disbursement outflows and align the investment portfolio to the new IPS requirements, the following portfolios had funds transferred to the operational cash asset class:

- US$5,073,000 equivalent from the held-to-maturity portfolio. This consisted of coupon income generated by the bonds within the asset class;
- US$39,653,000 equivalent from the global government bond asset class; and
- US$56,907,000 equivalent from the inflation-indexed asset class. This consisted of a private placement that matured and was subsequently transferred into the operational cash portfolio.

V. Investment income

23. In the third quarter of 2012, the net investment income amounted to US$27,307,000 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 third quarter of 2012 investment income broken down by asset class, together with a year-to-date total.

Table 2
Breakdown of investment income by asset class for the third quarter of 2012
(Thousands of United States dollars equivalent)

	Operational cash	*Held-to-maturity*	*Global government bonds*	*Global diversified fixed-income*	*Inflation-indexed bonds*	*Emerging market debt bonds*	*Subtotal third quarter 2012*	*Total year-to-date 2012*
Interest from fixed-income investments and bank accounts	1 595	2 701	3 999	1 845	1 532	1 652	13 324	41 645
Realized market gains/(losses)	901	-	(187)	4 881	1 575	355	7 525	19 724
Unrealized market gains/(losses)	(22)	-	1 977	(3 881)	5 447	4 138	7 659	859
Amortization[a]	-	(204)	-	-	-	-	(204)	(566)
Investment income before fees	**2 474**	**2 497**	**5 789**	**2 845**	**8 554**	**6 145**	**28 304**	**61 662**
Investment manager fees	-	-	(233)	(134)	(201)	(102)	(670)	(2 270)
Custody fees/bank charges	(24)	(2)	(23)	(6)	(8)	(9)	(72)	(193)
Financial advisory and investment-related fees	-	(46)	(95)	(39)	(56)	(19)	(255)	(607)
Investment income after fees	**2 450**	**2 449**	**5 438**	**2 666**	**8 289**	**6 015**	**27 307**	**58 592**

[a] 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 in accordance with International Financial Reporting Standards (IFRS).

24. During the implementation process of the IPS and funding of various asset classes, including the emerging market debt portfolio, a temporary transition account was created. All investment income pertaining to this temporary account, including realized and unrealized market gains and losses, were reported in the operational cash portfolio. For this reason the operational cash portfolio in table 2 has an abnormally high level of income when compared to previous periods.

VI. Rate of return

25. 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 Special Drawing Rights (SDR) currency ratios.

26. The investment portfolio returned a positive 1.19 per cent for the third quarter of 2012, adding to the first half year performance of 1.31 per cent and achieving a year-to-date return of 2.52 per cent for the first nine months of 2012. This included all realized and unrealized market gains and losses and is net of all investment expenses.

27. In the first three quarters of 2012, the inflation-indexed bond portfolio was the best performing mandate, in absolute terms, followed closely by the (global) diversified fixed-income and new emerging market debt portfolios.

Table 3
Third quarter 2012 and year-to-date 2012 rates of return and applicable benchmark comparison
(Percentages in local currency terms)

	Third quarter 2012 performance			*Year-to-date 2012 performance*		
	Actual	*Benchmark*	*Over/(under) performance*	*Actual*	*Benchmark*	*Over/(under) performance*
Operational cash[a]	0.04	0.04	-	0.12	0.12	-
Held-to-maturity	0.64	0.66	(0.02)	2.39	2.30	0.09
Global government bonds	0.50	0.38	0.12	1.42	1.38	0.04
Global diversified fixed-income bonds	1.88	1.30	0.58	3.82	3.01	0.81
Inflation-indexed bonds	1.82	1.91	(0.09)	3.91	5.41	(1.50)
Emerging market debt bonds	3.74	2.98	0.76	3.74	2.98	0.76
Net rate of return	**1.19**	**0.96**	**0.23**	**2.52**	**2.55**	**(0.03)**

[a] Does not include income pertaining to transitional movements that occurred in relation to the implementation of the Investment Portfolio Statement (IPS) and funding of new managers in July 2012.

28. As required by the IPS, table 4 presents the historical comparison of the investment portfolio's performance for previous quarters in 2012 together with comparative annual performances.

Table 4
Previous quarter performances for 2012 and historical annual performances
(Percentages in local currency terms)

	2012 quarterly and year-to-date performances				*Historical annual comparisons*		
	Third quarter	*Second quarter*	*First quarter*	*Year-to-date 2012*	*2011*	*2010*	*2009*
Operational cash[a]	0.04	0.04	0.03	0.12	n/a	n/a	n/a
Held-to-maturity	0.64	0.51	1.22	2.39	2.91	4.00	4.36
Global government bonds	0.50	0.44	0.48	1.42	2.42	2.19	2.17
(Global) diversified fixed-income bonds	1.88	2.00	(0.09)	3.82	7.28	6.10	5.23
Inflation-indexed bonds	1.82	0.98	1.06	3.91	6.97	4.07	7.73
Emerging market debt bonds	3.74	n/a	n/a	3.74	n/a	n/a	n/a
Net rate of return	**1.19**	**0.77**	**0.54**	**2.52**	**3.82**	**3.26**	**4.45**

[a] Does not include income pertaining to transitional movements that occurred in relation to the implementation of the Investment Portfolio Statement (IPS) and funding of new managers in July 2012.

Note: n/a = not applicable.

VII. Risk measurements

29. In accordance with the IPS, the risk measures used for risk budgeting purposes are the conditional value-at-risk (CVaR) for the overall portfolio and single asset classes, and the ex-ante tracking error for single managers within the respective asset classes.

30. The current abovementioned CVaR and ex ante tracking error levels are reported in subsections B and C below. In addition, other risk indicators are reported in sections A, D, E and F.

A. Market risk: Duration

31. Within the fixed-income investment universe, one of the most important measures of market risk is a bond's duration.[5] Duration is defined as the weighted average of the time to each coupon and principal payment of a bond. As a result, the longer the duration, the more the bond's price is sensitive to movements of market interest rates. Thus a longer duration is normally associated with 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 5
IFAD's investment portfolio and benchmark effective duration as at 30 September 2012
(Duration in number of years)

	Portfolio	*Benchmark*
Global government bonds	1.64	1.93
Global diversified fixed-income bonds	3.99	4.09
Inflation-indexed bonds	5.55	5.41
Emerging market debt bonds	7.49	6.78
Total portfolio (including held-to-maturity and operational cash)	**2.78**	**2.79**

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

32. Table 5 shows the actual and benchmark durations for the single asset classes and the overall portfolio. The overall portfolio duration was 2.78 years, which is an overall conservative positioning. The emerging market debt and inflation-indexed bonds asset classes have the longest duration, in line with the nature of the issuances of the securities. The global government bonds have the shortest duration, thereby lowering the overall portfolio risk level.

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

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

34. 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 horizon with a 95 per cent confidence level. To derive this measure, the portfolio is revalued (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 there is a 95 per cent chance that the average loss of the portfolio will not exceed US$40,000 in one year.

[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.

Table 6
Conditional value-at-risk (CVaR) of current asset classes
(Confidence level at 95 per cent, percentages, based on historical simulations over 5-year history)

	Actual investment portfolio	*IPS budget level*
	1-year CVaR	*1-year CVaR*
Global government bonds	1.52	4.00
Global diversified fixed-income bonds	7.04	15.00
Inflation-indexed bonds	7.06	9.00
Emerging market debt bonds	13.43	27.00
Total portfolio (including held-to-maturity and operational cash)	**2.77**	**10.00**

35. As shown in table 6, the CVaR of single asset classes and of the overall portfolio were well below the risk budget levels.

C. Market risk: Ex ante tracking error

36. The ex-ante tracking error is calculated based on the expected portfolio and benchmark returns over a forward-looking one-year 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- 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 7
IFAD's investment portfolio ex ante tracking error as at 30 September 2012
(Percentages)

	Actual investment portfolio	*IPS budget level*
Global government bonds	0.50	1.50
Global diversified fixed-income bonds	0.51	3.00
Inflation-indexed bonds	0.40	2.50
Emerging market debt bonds	0.92	4.00

37. As shown in table 7, 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

38. IFAD's IPS establishes credit rating floors for all eligible asset classes. Credit risk is managed through the monitoring of securities in accordance with the investment guidelines. Should a security be downgraded below IFAD's minimum credit rating, procedures are in place to limit market losses through monitoring and divestment.

39. As at 30 September 2012, 75 per cent of IFAD's fixed-income investments were rated AAA; over 16 per cent were rated between AA+ and AA- and over 3 per cent were rated between A+ and A. With IFAD's investment portfolio diversifying into the new emerging market debt asset class, there was an exposure of securities rated between BBB+ and BBB- of 5.3 per cent which specifically reflects this asset class.

Table 8
Composition of the investment portfolio by credit ratings[a] as at 30 September 2012
(Thousands of United States dollars equivalent)

	Operational cash	*Held-to-maturity*	*Global government bonds*	*Diversified fixed-income bonds*	*Inflation-indexed bonds*	*Emerging market debt*	*Total*	*Percentage*
AAA	-	156 305	663 002	229 135	440 218	-	1 488 660	75.0
AA+/-	-	110 143	90 721	66 254	20 905	34 635	322 658	16.2
A+/-	-	8 495	-	45 471	-	14 563	68 529	3.5
BBB+/-	-	-	-	-	-	106 164	106 164	5.3
Cash[b]	166 810	-	19 303	4 647	12 225	4 697	207 682	n/a
Time deposits	-	108 600	-	-	-	-	108 600	n/a
Pending sales and purchases[c]	-	-	16 548	(23 250)	(3 462)	(3 261)	(13 425)	n/a
Total	**166 810**	**383 543**	**789 574**	**322 257**	**469 886**	**156 798**	**2 288 868**	**100.0**

[a] In accordance with 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), Moody's or Fitch ratings. The held-to-maturity portfolio is more conservative and reports the lowest credit rating of the three above-mentioned agencies.
[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

40. The majority of IFAD's commitments pertain to undisbursed loans and grants and are expressed in SDR. 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.

41. 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.

42. The applicable SDR units, together with their percentage weights as at 30 September 2012, are shown in table 9.

Table 9
Units and weights applicable to SDR valuation basket as at 30 September 2012

Currency	*Units*	*Percentage weight*
United States dollar	0.6600	42.9
Euro	0.4230	35.4
Yen	12.1000	10.1
Pound sterling	0.1110	11.6
Total		**100.0**

43. At 30 September 2012, assets in the form of cash, investments, promissory notes and contribution receivables from Member States under the Sixth, Seventh, Eighth and Ninth Replenishments, net of provisions, amounted to US$2,880,430,000 equivalent, as summarized in table 10.

Table 10
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]	974 912	147 908	209 664	1 332 484
Euro group[c]	831 276	-	62 591	893 867
Yen	204 909	40 972	76 221	322 102
Pound sterling	277 313	-	54 664	331 977
Total	**2 288 410**	**188 880**	**403 140**	**2 880 430**

[a] The difference in the cash and investments balance compared with other tables derives from the exclusion of assets in non-convertible currencies of US$458,000 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.

44. The alignment of assets by currency group against the SDR valuation basket as at 30 September 2012 is shown in table 11. The balance of commitments denominated in United States dollars at 30 September 2012 amounted to US$169,481,000 equivalent, composed of the General Reserve (US$95,000,000 equivalent) and commitments for grants denominated in United States dollars (US$74,481,000 equivalent).

Table 11
Alignment of assets by currency group with SDR valuation composition as at 30 September 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	1 332 484	(169 481)	1 163 003	42.8	42.9	(0.1)
Euro group	893 867	-	893 867	33.0	35.4	(2.4)
Yen	322 102	-	322 102	11.9	10.1	1.8
Pound sterling	331 977	-	331 977	12.3	11.6	0.7
Total	**2 880 430**	**(169 481)**	**2 710 949**	**100.0**	**100.0**	**0.0**

45. As at 30 September 2012 there was a shortfall in the euro currency group of 2.4 per cent and in the United States dollar currency group of 0.1 per cent. This was offset by an excess allocation in the Japanese yen of 1.8 per cent and the British pound sterling of 0.7 per cent.

46. The unusual shortfall in the euro currency group was due to Ninth Replenishment contributions that were received by the Fund and included as other receivables in table 10. IFAD takes proactive measures to minimize any variances against the SDR weights.

F. Liquidity risk: Minimum liquidity requirement

47. IFAD's liquidity risk is addressed through the minimum liquidity requirement (MLR). 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 MLR of US$518,000,000 equivalent over the Eighth Replenishment period.

48. Highly liquid assets in IFAD's investment portfolio as at 30 September 2012 amounted to US$956,384,000 equivalent, which comfortably clears the minimum liquidity requirement (table 12).

[6] EB 2006/89/R.40.

Table 12
Liquidity level in IFAD's investment portfolio as at 30 September 2012
(Thousands of United States dollars equivalent)

	Actual	*Percentage*
Highly liquid assets	**956 384**	**41.8**
Short-term	166 810	7.3
Government securities	789 574	34.5
Fairly liquid assets	**948 941**	**41.5**
Non-government securities	792 143	34.6
Emerging market debt securities	156 798	6.9
Partially liquid assets	**383 543**	**16.8**
Held-to-maturity	383 543	16.8
Total portfolio	**2 288 868**	**100.0**

49. In line with previous liquidity policies within their specific Replenishment period, a new MLR will be implemented for the Ninth Replenishment period (2013 – 2015) and will become effective from 1 January 2013 and reported accordingly.