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to overcome poverty

Report on IFAD's investment portfolio for the third quarter of 2013

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For: **Information**

Report on IFAD's investment portfolio for the third quarter of 2013

I. Executive summary

1. During the first nine months of 2013, IFAD continued to focus on mitigating financial risks and invest within the approved risk measures used for risk-budgeting purposes as set out in the Investment Policy Statement (IPS). At 30 September 2013, the conditional value-at-risk (CVaR) was at 2.85 per cent and well within the risk budget level of 6 per cent.

2. The value of IFAD's investment portfolio in United States dollar terms increased by US$9.2 million, from US$2,021.8 million at 30 June 2013 to US$2,031.0 million at 30 September 2013. The main factors in this increase were positive foreign exchange movements and investment income that was offset with net outflows (as a result of increased disbursements).

3. As at 30 September 2013, the investment portfolio's year-to-date net rate of return was negative 1.11 per cent, translating into a negative investment income amount of US$24.4 million, net of all investment-related fees.

II. Market conditions

4. The **global government bonds asset class** ended the period positively, sustained by the reiterated support of key central banks that are currently maintaining very accommodative policies. For most of the third quarter, global government bonds lost ground as investors were expecting the United States Federal Reserve (the "Fed") to start "tapering" its quantitative easing in September. However the Fed surprised the markets by refraining from tapering, which resulted in a recovery of global government bonds and of other asset classes.

5. The **inflation-indexed bond asset class** had a positive return, especially as the Fed continued to contribute to inflationary expectations.

6. The **global diversified fixed-income** and **emerging market asset classes** also performed positively, supported by investors' revived interest in more risky assets following the Fed decision to continue its quantitative easing.

III. Investment policy statement

7. As required, the yearly review of the IPS will be presented for approval at the 110th session of the Executive Board in December 2013.

8. In 2013, IFAD reviewed how to best mitigate the prospects of negative performance on fixed-income investments while supporting IFAD's growing demand for liquidity in light of IFAD's increasing disbursement flows over the coming years. The strategies developed were based on an internal analysis in conjunction with an externally performed asset class study.

9. The outcome of the review was implemented in October 2013 and can be summarized as follows:

   (a) Adopt a strategic tranche approach for IFAD's investment portfolio in order to support IFAD's short- and medium-term liquidity needs;

   (b) Reduce the effective duration of the global government bond portfolio (as reported quarterly in section VII, table 4) with the objective of mitigating its negative outlooks;

   (c) Increase the investment policy asset allocation for the emerging market debt portfolio from 7 per cent (see table 1) to 10 per cent in view of its more favourable medium-term outlook, while reducing the global diversified fixed-income portfolio from 13 per cent to 10 per cent; and

(d) Eliminate the global government bond exposure in the global diversified fixed-income portfolio in order to streamline the exposures within this asset class and to improve overall portfolio diversification.

10. The fourth quarter 2013 changes will be captured and reported at the 111th session of the Executive Board in the annual report on IFAD's investment portfolio.

IV. Asset allocation

11. During the third quarter of 2013, the overall investment portfolio value in United States dollar terms increased by US$9.2 million – from US$2,021.8 million at 30 June 2013 to US$2,031.0 million at 30 September 2013. This increase was the result of positive foreign exchange movements of US$46.0 million together with investment income of US$8.2 million that was offset with net outflows of US$45.0 million.

Table 1
Movements affecting asset allocation within the portfolio during the third quarter of 2013
(Thousands of United States dollars equivalent)

	Operational cash[a]	*Global strategic portfolio*	*Global government bonds*	*Global diversified fixed-income bonds*	*Global inflation-indexed bonds*	*Emerging-market debt bonds*	*Total*
Opening balance (30 June 2013)	**145 070**	**376 654**	**684 610**	**302 990**	**366 233**	**146 241**	**2 021 798**
Investment income[b]	9	1 830	798	2 726	1 954	868	8 185
Transfers due to allocation	88 481	(58 481)	(30 000)	-	-	-	-
Transfers due to expense allocation	(807)	48	271	164	211	113	-
Net outflows[c]	(44 957)	-	-	-	-	-	(44 957)
Movements on exchange	2 444	10 360	18 110	4 652	9 802	616	45 984
Closing balance (30 September 2013)	**190 240**	**330 411**	**673 789**	**310 532**	**378 200**	**147 838**	**2 031 010**
Actual asset allocation (percentage)	9.4	16.3	33.1	15.3	18.6	7.3	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)	**2.4**	**(0.7)**	**(2.9)**	**2.3**	**(1.4)**	**0.3**	**-**

[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] Net outflows consist of disbursements for loans, grants and administrative expenses net of cash receipts and encashment of Member State contributions.

12. In order to cover disbursement needs during the third quarter of 2013, US$88.5 million was transferred into the operational cash portfolio during the months of July and September 2013. These funds were transferred from the global strategic portfolio (US$58.5 million) and the global government bonds portfolio (US$30.0 million).

V. Investment income

13. During the first nine months of 2013, net investment income amounted to minus US$24.4 million equivalent, inclusive of all investment-related fees. The net investment income of positive US$3.2 million and US$8.2 million equivalent generated during the first and third quarter of 2013 respectively was not enough to offset the losses incurred during the second quarter of 2013 of US$35.8 million equivalent.

14. Table 2 presents a summary of third quarter 2013 investment income broken down by asset class, together with a year-to-date total that captures the income generated during the first and second quarters of 2013.

Table 2
Breakdown of investment income by asset class during the third quarter of 2013
(Thousands of United States dollars equivalent)

	Operational cash	*Global strategic portfolio*	*Global government bonds*	*Global diversified fixed-income bonds*	*Global inflation-indexed bonds*	*Emerging-market debt bonds*	*Third quarter 2013*	*Year-to-date 30 Sept. 2013*
Interest from fixed-income investments and bank accounts	30	2 123	3 220	2 218	1 046	1 926	10 563	33 298
Realized market gains/(losses)	-	-	(3 448)	(2 255)	(2 617)	(901)	(9 221)	(9 391)
Unrealized market gains/(losses)	-	-	1 297	2 927	3 736	(44)	7 916	(44 661)
Amortization*	-	(245)	-	-	-	-	(245)	(698)
Investment income before fees	**30**	**1 878**	**1 069**	**2 890**	**2 165**	**981**	**9 013**	**(21 452)**
Investment manager fees	-	-	(176)	(121)	(154)	(92)	(543)	(1 844)
Custody fees/bank charges	(21)	(3)	(15)	(6)	(12)	(4)	(61)	(349)
Financial advisory and other investment-related fees	-	(45)	(80)	(37)	(45)	(17)	(224)	(711)
Investment income after fees	**9**	**1 830**	**798**	**2 726**	**1 954**	**868**	**8 185**	**(24 356)**

* A period's amortization amount represents a portion of the difference between the purchase price and the final redemption value of the global strategic portfolio, which is reported at amortized cost.

VI. Rate of return

15. The rate of return on 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 liabilities to the special drawing rights (SDR) currency ratios (see section VII.E.).

Table 3
Twelve-month quarterly performances with year-to-date (YTD) performance versus benchmark
(Percentages in local currency terms)

	2012	*2013*			***30 September 2013 YTD***		
	Fourth quarter	*First quarter*	*Second quarter*	*Third quarter*	***Portfolio***	***Benchmark***	***Difference***
Operational cash	0.01	0.03	0.01	0.01	**0.05**	**0.05**	**-**
Global strategic portfolio	1.00	0.57	0.55	0.48	**1.61**	**1.51**	**0.10**
Global government bonds	0.21	0.15	(0.20)	0.17	**0.12**	**0.14**	**(0.02)**
Global diversified fixed-income bonds	0.47	0.27	(1.84)	0.94	**(0.65)**	**(0.15)**	**(0.50)**
Global inflation-indexed bonds	0.79	0.97	(4.72)	0.59	**(3.22)**	**(3.03)**	**(0.19)**
Emerging-market debt bonds	2.19	(2.17)	(6.42)	0.66	**(7.85)**	**(6.86)**	**(0.99)**
Net rate of return	**0.58**	**0.18**	**(1.69)**	**0.40**	**(1.11)**	**(0.92)**	**(0.19)**

16. Despite the investment portfolio returning to a positive performance of 0.40 per cent during the third quarter of 2013, the year-to-date rate of return as at 30 September 2013 remained negative at 1.11 per cent, net of all investment-related expenses. For the same period, the year-to-date benchmark performance was minus 0.92 per cent.

17. Unlike the internally managed held-to-maturity global strategic portfolio, all externally managed portfolios underperformed their respective benchmarks, although being well within their authorized tracking error limits (see section VII.C.).

VII. Risk measurements

18. In accordance with the IPS, risk measures used for risk-budgeting purposes are the CVaR and the ex ante tracking error, which 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

19. Duration[1] 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 in 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 4
IFAD's investment portfolio and benchmark effective duration
(Duration in number of years)

	30 June 2013		*30 September 2013*	
	Portfolio	*Benchmark*	*Portfolio*	*Benchmark*
Global government bonds	1.81	1.85	1.62	1.05
Global diversified fixed-income bonds	4.60	4.19	3.92	4.23
Global inflation-indexed bonds	6.08	5.25	5.57	5.31
Emerging-market debt bonds	6.96	6.60	6.88	6.47
Total portfolio (including global strategic portfolio and operational cash)	**2.91**	**2.72**	**2.67**	**2.44**

Note: Total portfolio duration is lowered by the operational cash and global strategic portfolios, which are not subject to fluctuations in prices.

20. The total portfolio duration as at 30 September 2013 was 2.67 years (2.91 years as at 30 June 2013) which is an overall conservative position (table 4).

B. Market risk: Conditional value-at-risk

21. 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 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.

[1] 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 5
CVaR of current asset classes
(1-year CVaR with confidence level at 95 per cent, percentages, based on historical simulations over five-year history)

	30 June 2013		*30 September 2013*	
	Actual investment portfolio	*IPS risk budget level*	*Actual investment portfolio*	*IPS risk budget level*
Global government bonds	1.99	4.00	1.93	4.00
Global diversified fixed-income bonds	5.64	15.00	4.47	15.00
Global inflation-indexed bonds	7.79	9.00	7.43	9.00
Emerging-market debt bonds	13.53	27.00	11.56	27.00
Total portfolio (including global strategic portfolio and operational cash)	**2.85**	**6.00**	**2.70**	**6.00**

22. The CVaR levels of all the sub-portfolio and that of the overall portfolio were below the stipulated risk budget levels. The total portfolio CVaR decreased from 2.85 per cent as at 30 June 2013 to 2.70 per cent as at 30 September 2013.

C. Market risk: Ex ante tracking error

23. 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 the difference between an active strategy and 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 6
IFAD's investment portfolio ex ante tracking error
(Percentages)

	30 June 2013		*30 September 2013*	
	Actual investment portfolio	*IPS risk budget level*	*Actual investment portfolio*	*IPS risk budget level*
Global government bonds	0.64	1.50	0.77	1.50
Global diversified fixed-income bonds	0.69	3.00	0.75	3.00
Global inflation-indexed bonds	0.74	2.50	0.47	2.50
Emerging-market debt bonds	0.82	4.00	1.25	4.00

24. The current levels of ex ante tracking error are all below IPS risk budget levels. This indicates a close resemblance between the "active" portfolio strategy and the benchmark indices.

D. Credit risk: Credit-rating analysis

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

Table 7
Composition of the investment portfolio by credit ratings[a] as at 30 September 2013
(Thousands of United States dollars equivalent)

	Operational cash	*Global strategic portfolio*	*Global government bonds*	*Global diversified fixed-income bonds*	*Global inflation-indexed bonds*	*Emerging market debt*	*Total*	*Percentage*
AAA	-	112 207	453 442	152 534	271 385	1 310	990 878	58.2
AA+/-	-	102 497	197 123	80 995	102 981	31 341	514 937	30.3
A+/-	-	-	-	81 316	-	4 077	85 393	5.0
BBB+/-	-	-	-	-	-	107 780	107 780	6.3
BB+[b]	-	-	-	-	-	2 997	2 997	0.2
Cash[c]	190 240	457	23 234	3 792	2 909	1 094	221 726	n/a
Time deposits	-	115 250	-	-	-	-	115 250	n/a
Pending sales and purchases[d]	-	-	(10)	(8 105)	925	(761)	(7 951)	n/a
Total	**190 240**	**330 411**	**673 789**	**310 532**	**378 200**	**147 838**	**2 031 010**	**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 Standard and Poor's (S&P), Moody's or Fitch Ratings. The global strategic portfolio is more conservative and reports the lowest credit rating of the three agencies.
[b] On 20 September 2013 Fitch Ratings downgraded from BBB- to BB+ two government bonds that were held in the emerging market debt portfolio. As a result, the manager sold the two bonds on 2 October 2013 (within the required 30-day period of the downgrade) without generating any losses.
[c] Consists of cash equivalents and cash with central banks, corporate banks and cash held by external portfolio managers. These amounts are not rated by credit-rating agencies.
[d] Pending foreign-exchange purchases and sales used for hedging purposes and trades pending settlement. These amounts do not have an applicable credit rating.

E. Currency risk: Currency composition analysis

26. 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.

27. At 30 September 2013, the net asset amount consisting of cash, investments, promissory notes and contribution receivables from Member States (net of provisions), less commitments denominated in United States dollars, amounted to US$2,496.0 million.

Table 8
Currency composition of net assets in the form of cash, investments and other receivables
(Thousands of United States dollars equivalent)

	United States dollar group[a]	*Euro group*[b]	*Japanese yen*	*Pound sterling*	*Total*
Cash and investments[c]	946 281	654 898	169 995	259 425	2 030 599
Promissory notes	169 681	62 241	76 676	-	308 598
Contribution receivables from Member States	151 059	176 363	-	-	327 422
Less: commitments denominated in US$	(170 600)	-	-	-	(170 600)
Net asset amount	**1 096 421**	**893 502**	**246 671**	**259 425**	**2 496 019**
Net asset amount (percentage)	43.9	35.8	9.9	10.4	100.0
SDR weights (percentage)	43.0	37.3	8.1	11.6	100.0
Difference (percentage)	**0.9**	**(1.5)**	**1.8**	**(1.2)**	**0.0**

[a] Includes assets in Australian, Canadian and New Zealand dollars.
[b] Includes assets in Swiss francs, Swedish kronor, and Danish and Norwegian kroners.
[c] The difference in the "cash and investments" balance compared with other tables derives from the exclusion of assets in non-convertible currencies of US$411,000 equivalent (cash and investments).

28. As at 30 September 2013, there was a shortfall in the euro currency group and pound sterling of 1.5 per cent and 1.2 per cent respectively. This was offset by an excess allocation in Japanese yen of 1.8 per cent and in the United States dollar currency group of 0.9 per cent.

F. Liquidity risk: Minimum liquidity requirement

29. IFAD's liquidity risk is addressed through the minimum liquidity requirement (MLR). IFAD's liquidity policy,[2] together with the revised MLR for the Ninth Replenishment period (2013-2015), states that IFAD's investment portfolio should remain above 60 per cent of the projected annual gross disbursement level (outflows), including potential additional requirements due to liquidity shocks.

30. IFAD's latest financial model assumptions, incorporating the 2013 resources available for commitment under the sustainable cash flow approach, calculates a MLR of US$599.0 million. This is comfortably cleared by IFAD's investment portfolio balance of US$2,031.0 million (see table 1).

[2] EB 2006/89/R.40