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Investing in rural people

Report on IFAD's investment portfolio for the third quarter of 2014

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For: Information

Report on IFAD's investment portfolio for the third quarter of 2014

I. Executive summary

1. During the third quarter of 2014, the value of the investment portfolio in United States dollar terms decreased by US\$187.1 million, from US\$1,959.3 million at 30 June 2014 to US\$1,772.2 million at 30 September 2014. The main factors for this decrease were negative net flows,¹ foreign exchange movements and almost flat investment income (see section IV).
2. The performance of IFAD's investment portfolio during the third quarter of 2014, was almost flat with a rounded net rate of return of zero per cent, translating into an investment income of negative US\$0.5 million, net of all investment-related fees.
3. During the first nine months of 2014, the investment portfolio generated a performance of 2.28 per cent, translating into an investment income of US\$44.4 million, net of all investment-related fees.

II. Market conditions

4. The global government bond asset class registered a positive performance over the third quarter of 2014. Generally major government bond markets made gains, due to a mix of supportive developments such as ongoing geopolitical tensions, additional comments by the United States Federal Reserve that rates will remain low for a considerable time and renewed weakness in the European economy. In particular, slowing eurozone inflation prompted the European Central Bank to cut rates and commit to quantitative easing. The United States was the exception during September as yields rose substantially at the beginning of the month due to improving United States data, but this was corrected somewhat towards the end of the month following the Federal Reserve's continued forward guidance. Due to IFAD's short duration in this asset class the impact during these months was marginal.
5. The global diversified fixed-income asset class returned a positive performance over the third quarter of 2014, however credit markets registered a mixed performance. While during July and August credit spreads generally continued to tighten, during September corporate credit underperformed government bonds, particularly in the United States. European investment-grade corporate credit continued to perform marginally positively. Higher-rated issuers in general outperformed those with weaker credit profiles with the differential being greater in the United States than in Europe.
6. The global inflation-indexed asset class registered a negative performance over the third quarter with the positive performance in August more than offset by the negative performance during September. This was mainly due to a sharp increase in real yields in the United States.
7. The emerging market government bond asset class showed a modest performance, with strong returns in July and August being almost fully offset in September. The impacts of disappointing global growth, prospects of higher United States Treasury yields and geopolitical events combined for poor results in the emerging financial markets.

¹ Net flows consist of outflows for disbursements for loans, grants and administrative expenses and inflows from loan reflows and encashment of Member States' contributions.

8. During the third quarter of 2014, the United States dollar appreciated against the euro (+7.98 per cent), Japanese yen (+8.21 per cent) and British pound sterling (+4.96 per cent). These trends resulted in overall negative foreign exchange movement in IFAD's investment portfolio (see table 1).
9. 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. Consequently, the income and performance of IFAD's investment portfolio are reported in local currency terms.

III. Investment policy statement review

10. The 2014 annual review of the IFAD Investment Policy Statement (IPS) will be considered by the Audit Committee at its 134th meeting and subsequently submitted for approval to the 113th session of the Executive Board, accompanied by the updated Internal Control Framework, attached as an addendum for information only.

IV. Asset allocation

11. During the third quarter of 2014, the value of the investment portfolio in United States dollar terms decreased by US\$187.1 million. This was the result of net outflows of US\$115.9 million, investment income of minus US\$0.5 million and negative foreign exchange movements of US\$70.7 million.

Table 1

Movements affecting asset allocation within the portfolio during the third quarter of 2014 (Thousands of United States dollars equivalent)

	<i>Operational cash^a</i>	<i>Global strategic portfolio</i>	<i>Global government bonds</i>	<i>Global diversified fixed-income bonds</i>	<i>Global inflation-indexed bonds</i>	<i>Emerging market debt bonds</i>	<i>Total</i>
Opening balance (1 July 2014)	100 807	295 215	683 474	262 221	391 800	225 836	1 959 353
Net investment income ^b	8	1 166	925	1 309	(3 765)	(134)	(491)
Internal transfers	100 000	-	(100 000)	-	-	-	-
Transfers due to expense allocation	(725)	15	213	129	201	167	-
Net flows ^c	(115 916)	-	-	-	-	-	(115 916)
Movements on exchange	(2 125)	(10 968)	(28 740)	(8 023)	(18 472)	(2 370)	(70 698)
Closing balance (30 September 2014)	82 049	285 428	555 872	255 636	369 764	223 499	1 772 248
Actual asset allocation (percentage)	4.6	16.1	31.4	14.4	20.9	12.6	100.0
Investment policy asset allocation (percentage)	7.0	17.0	36.0	10.0	20.0	10.0	100.0
Difference in allocation (percentage)	(2.4)	(0.9)	(4.6)	4.4	0.9	2.6	-

^a Cash held with banks, readily available for disbursing loans, grants and administrative expenses.

^b Investment income is further detailed in table 2.

^c Net flows consist of outflows for disbursements for loans, grants and administrative expenses and inflows from loan reflows and encashment of Member States' contributions.

V. Investment income

12. Net investment income during the third quarter of 2014 amounted to negative US\$0.5 million, inclusive of all investment-related fees. Table 2 presents a summary broken down by asset class.
13. Combined with net positive investment income of US\$44.9 million generated during the first half of 2014, net investment income for the first nine months of 2014 was US\$44.4 million as shown in table 2 below.

Table 2

Breakdown of investment income by asset class during the third quarter of 2014 and year-to-date total for 2014

(Thousands of United States dollars equivalent)

	<i>Operational cash</i>	<i>Global strategic portfolio</i>	<i>Global government bonds</i>	<i>Global diversified fixed-income bonds</i>	<i>Global inflation-indexed bonds</i>	<i>Emerging market debt bonds</i>	Third quarter 2014	Total year-to-date 2014
Interest from fixed-income investments and bank accounts	30	1 352	2 487	2 097	804	2 735	9 505	30 360
Realized market gains/(losses)	-	-	(4 757)	(146)	240	(3)	(4 666)	(16 146)
Unrealized market gains/(losses)	-	-	3 409	(514)	(4 608)	(2 700)	(4 413)	33 399
Amortization*	-	(171)	-	-	-	-	(171)	(515)
Investment income before fees	30	1 181	1 139	1 437	(3 564)	32	255	47 098
Investment manager fees	-	-	(169)	(111)	(168)	(151)	(599)	(1 814)
Custody fees/bank charges	(22)	(8)	(31)	(10)	(23)	(9)	(103)	(353)
Financial advisory and other investment-related fees	-	(7)	(14)	(7)	(10)	(6)	(44)	(481)
Investment income after fees	8	1 166	925	1 309	(3 765)	(134)	(491)	44 450

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

VI. Rate of return

14. 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 liabilities to the special drawing rights (SDR) currency ratios (see section VII.E).
15. The investment portfolio performance net of all investment-related expenses was flat during the third quarter of 2014, generating a net performance of zero per cent (rounded) versus a benchmark of zero per cent (rounded) for the same period.
16. Table 3 shows the quarterly portfolio performances for the first three quarters of 2014 together with the performances on a year-to-date basis in comparison to the respective benchmark. The net performance for the first nine months of 2014 was 2.28 per cent versus a benchmark of 1.90 per cent for the same period.

Table 3

Quarterly performances and year-to-date performances versus applicable benchmarks for 2014
(Percentages in local currency terms)

	<i>Quarterly performances 2014</i>			<i>Year-to-date 2014</i>		
	<i>First quarter</i>	<i>Second quarter</i>	<i>Third quarter</i>	Actual	Benchmark	Difference
Operational cash	0.04	0.06	0.01	0.10	0.10	-
Global strategic portfolio	0.51	0.43	0.43	1.38	1.12	0.26
Global government bonds	0.14	0.25	0.24	0.63	0.30	0.33
Global diversified fixed-income bonds	1.97	1.89	0.63	4.54	3.90	0.64
Global inflation-indexed bonds	1.26	2.45	(0.84)	2.87	2.64	0.23
Emerging market debt bonds	4.16	4.17	0.05	8.55	8.09	0.46
Gross rate of return (excluding fees)	1.03	1.32	0.03	2.40	2.02	0.38
Net rate of return (including fees)	0.99	1.28	(0.00)	2.28	1.90	0.38

17. For comparative purposes, table 4 presents annual performances generated by the investment portfolio during the previous four years.

Table 4

Annual performances versus benchmarks from 2010 to 2013 for comparative purposes
(Percentages in local currency terms)

	2013		2012		2011		2010	
	Actual	Bench -mark	Actual	Bench -mark	Actual	Bench -mark	Actual	Bench- mark
Operational cash	0.07	0.07	0.12	0.12	0.56	0.56	0.25	0.25
Global strategic portfolio	2.13	1.94	3.41	2.94	2.91	3.56	4.00	3.81
Global government bonds	0.34	0.16	1.63	1.51	2.42	2.36	2.19	2.00
Global diversified fixed-income bonds	(0.04)	0.32	4.31	3.46	7.28	7.67	6.10	5.77
Global inflation-indexed bonds	(4.23)	(3.99)	4.73	6.13	6.97	6.84	4.07	5.00
Emerging market debt bonds	(7.49)	(6.54)	6.01	4.83	n.a.	n.a.	n.a.	n.a.
Gross rate of return (excluding fees)	(0.95)	(0.83)	3.28	3.16	4.01	4.13	3.40	3.34
Net rate of return (including all fees)	(1.11)	(0.99)	3.11	2.99	3.82	3.94	3.26	3.20

VII. Risk measurements

18. In accordance with the IPS, the risk measures used for risk-budgeting purposes are conditional value-at-risk (CVaR) and the ex ante tracking error, which are reported in subsections B and C below. In addition, other risk indicators are reported in subsections A, D, E and F.

A. Market risk: Duration

19. Duration is a measure of the sensitivity of the market price of a fixed-income investment to a change in interest rates. Duration is expressed as a number of years. 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 31 December 2013 and 30 September 2014

(Duration in number of years)

	31 December 2013		30 September 2014	
	Portfolio	Benchmark	Portfolio	Benchmark
Global government bonds	0.92	0.99	0.85	1.03
Global diversified fixed-income bonds	4.42	4.35	4.28	4.60
Global inflation-indexed bonds	5.42	5.11	5.69	5.33
Emerging market debt bonds	6.54	6.31	6.76	6.86
Total portfolio (including global strategic portfolio and operational cash)	2.59	2.44	2.92	2.58

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

20. The overall portfolio duration was 2.92 years (2.59 years in 2013), which is a conservative position.

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 6.0 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\$60,000 in one year.

Table 6

CVaR of current asset classes as at 31 December 2013 and 30 September 2014

(Confidence level at 95 per cent, percentages based on historical simulations over a five-year history)

	<i>Actual portfolio one-year CVaR</i>		<i>One-year CVaR IPS budget level</i>
	<i>31 December 2013</i>	<i>30 September 2014</i>	
Global government bonds	1.07	0.86	4.00
Global diversified fixed-income bonds	5.73	4.87	15.00
Global inflation-indexed bonds	6.87	6.04	9.00
Emerging market debt bonds	10.69	8.81	27.00
Total portfolio (including global strategic portfolio and operational cash)	2.76	2.62	6.00

22. The CVaR of single asset classes and of the overall portfolio were all below risk budget levels.

C. Market risk: Ex ante tracking error

23. The ex ante tracking error gives an indication of how different an active strategy is from its benchmark. The more a portfolio differs from the benchmark on 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 variance 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 31 December 2013 and 30 September 2014

(Percentages)

	<i>Actual investment portfolio</i>		<i>IPS budget level</i>
	<i>31 December 2013</i>	<i>30 September 2014</i>	
Global government bonds	0.37	0.40	1.50
Global diversified fixed-income bonds	0.94	0.59	3.00
Global inflation-indexed bonds	0.45	0.32	2.50
Emerging market debt bonds	1.19	0.78	4.00

24. The current levels of ex ante tracking error are below budget levels, indicating a close resemblance of the portfolio strategy to 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 8

Investment portfolio composition by credit ratings^a as at 30 September 2014

(Thousands of United States dollars equivalent)

	<i>Operational cash</i>	<i>Global strategic portfolio</i>	<i>Global government bonds</i>	<i>Global diversified fixed-income bonds</i>	<i>Global inflation-indexed bonds</i>	<i>Emerging market debt</i>	<i>Total</i>	<i>Percentage</i>
AAA	-	59 020	335 813	28 406	257 896	2 060	683 195	38.5
AA+/-	-	90 328	201 835	45 967	105 641	35 958	479 729	27.1
A+/-	-	-	-	181 631	-	35 343	216 974	12.2
BBB+/-	-	-	-	-	-	143 314	143 314	8.1
Cash ^b	82 049	1 522	18 536	3 970	11 998	7 236	125 311	7.1
P-1 (time deposits) ^c	-	134 558	-	-	-	-	134 558	7.6
Pending sales and purchases ^d	-	-	(312)	(4 338)	(5 771)	(412)	(10 833)	(0.6)
Total	82 049	285 428	555 872	255 636	369 764	223 499	1 772 248	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 the Standard and Poor's (S&P), Moody's or Fitch rating agencies. The global strategic portfolio is more conservative and reports the lowest credit rating of the three above-mentioned agencies.

^b 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.

^c Short-term as opposed to long-term credit ratings are applied to time deposits. All time deposits are within the highest credit rating available from Moody's (i.e. P-1) or the equivalent from S&P and Fitch rating agencies.

^d Pending foreign exchange purchases and sales used for hedging purposes and trades pending settlement. Although these amounts do not have an applicable credit rating, foreign exchange counterparties or banks used to purchase currencies also have the highest credit rating available from Moody's (i.e. P-1) or the equivalent from S&P and Fitch rating agencies.

E. Currency risk: Currency composition analysis

26. The majority of IFAD's commitments pertain to undisbursed loans and grants and are expressed in 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 as the Fund's commitments, i.e. in SDRs.
27. At 30 September 2014, 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\$2,030.3 million.

Table 9

Currency composition of net assets in the form of cash, investments and other receivables

(Thousands of United States dollars equivalent)

	<i>United States dollar group^b</i>	<i>Euro group^c</i>	<i>Yen</i>	<i>Pound sterling</i>	<i>Total</i>
Cash and investments ^a	900 449	572 409	95 604	203 362	1 771 824
Promissory notes	64 010	28 929	41 251	27 953	162 143
Contribution receivables from Member States	109 140	145 376	-	27 953	282 469
Less: commitments denominated in US dollars	(186 118)	-	-	-	(186 118)
Net asset amount	887 481	746 714	136 855	259 268	2 030 318
Net asset amount (percentage)	43.7	36.8	6.7	12.8	100.0
SDR weights (percentage)	44.5	36.1	7.4	12.0	100.0
Difference (percentage)	(0.8)	0.7	(0.7)	0.8	0.0

^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\$424,000 equivalent (cash and investments).

^b Includes assets in Australian, Canadian and New Zealand dollars.

^c Includes assets in Swiss francs, Swedish kronor, and Danish and Norwegian kroner.

F. Liquidity risk: Minimum liquidity requirement

28. IFAD's liquidity risk is addressed through the minimum liquidity requirement (MLR). IFAD's liquidity policy² 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.
29. IFAD's latest financial model assumptions, incorporating resources available for commitment for 2015 under the sustainable cash flow approach presented to the Audit Committee at its 134th meeting and to be subsequently submitted for approval to the 113th session of the Executive Board, calculate an MLR of US\$608.0 million,³ which is comfortably cleared by IFAD's investment portfolio balance of US\$1,772.2 million (see table 1).

² EB 2006/89/R.40.

³ EB 2014/113/R.15.