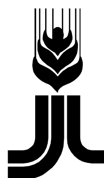
Distribution: Restricted EB 2002/75/R.34 26 March 2002
Original: English Agenda Item 3(b)(ii) English



IFAD
INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT
Executive Board – Seventy-Fifth Session
Rome, 22-23 April 2002

REPORT ON THE IMPLEMENTATION OF IFAD'S NEW INVESTMENT POLICY

I. BACKGROUND

1. At its Seventy-Second Session, the Executive Board was advised that a review of IFAD's investment policies would be undertaken by an expert group consisting of three highly qualified experts selected from the three Lists of Member States. The terms of reference for the Review of IFAD's Investment Policies were drafted in May 2001 in consultation with the convenors of Lists A, B and C and additional Members from each List designated by the convenors.

2. The following three experts were appointed following that consultation:

(a) Mr Bernard Cochemé, Administrator of the United Nations Joint Staff Pension Fund. He was formerly financial attaché at the French Mission to the United Nations in New York; and director of the Retirements Branch of the *Caisse des dépots et consignations* in Paris;

(b) Mr Mohammed Al-Shumrani, Director-General of the Investments Department of the Saudi Arabian Monetary Agency and board member of a number of Saudi Arabian financial institutions; and

(c) Mr Roberto Zahler, President of Zahler & Co. and board member of a number of Chilean financial institutions. From 1991 to 1996, he was Governor of the Central Bank of Chile.

Mr Rachid Ghozali, who assisted the experts in their work, was formerly a senior manager in the Investments Department of the World Bank and a managing director of Chase Manhattan Bank.

3. The expert group had an initial meeting with the List convenors on 7 June 2001 and presented its summary conclusions to the convenors on 4 July 2001. The Group's report was then finalized and presented to the President of IFAD on 6 July 2001 and was forwarded to members of IFAD's Executive Board together with management's comments as part of the document entitled Report of the President on IFAD's Investment Policy.

Document # 11285
Library: VT

Due to resource constraints and environmental concerns, IFAD documents are produced in limited quantities.
Delegates are kindly requested to bring their documents to meetings and to limit requests for additional copies.

4. A seminar was held in IFAD on 11 and 12 September 2001 in order to review the report on the investment policy prepared by the expert group. The report contained recommendations on a wide range of issues, and included a proposal for a new asset allocation that would substantially reduce the volatility of the investment portfolio.

5. The expert group proposed that IFAD's portfolio should be split into a fairly large short-term subportfolio, which would consist of short duration instruments in order to cover net disbursements for loans and grants over a three-year period, and an investment subportfolio with longer-term instruments. In the latter, the allocation to equities would be reduced to 18% of total assets.

6. On the basis of an analysis of the level of net disbursements over the next five years, after taking into account the proceeds of drawdowns of Members' contributions, management concluded that there is no need for a large short-term subportfolio, as current receipts of interest, bond coupons and dividends should be adequate to cover such needs.

7. Many speakers at the seminar favoured a reduction in the level of equities in the investment portfolio, while some called for a total withdrawal from investing in equities. Some representatives preferred maintaining the 45% level of equities. There was a generally held view that any reduction in the allocation to equities should be done in the context of a carefully managed transition in order to avoid unnecessary losses.

8. The President undertook to formulate a new investment policy in the light of the discussions at the seminar and to consult with the List convenors prior to the Seventy-Fourth Session of the Executive Board in December 2001.

9. Two meetings were held with the List convenors and with additional Members designated by the convenors from each List on 26 October and 27 November 2001.

10. On the basis of the expert group report and the various consultations with members of the Executive Board, a number of conclusions were reached, which were presented in document EB 2001/74/R.4/Rev.1, IFAD's Investment Policy. This document was discussed in a seminar on the day preceding the Seventy-Fourth Session of the Executive Board and at the Board session itself.

11. A number of alternative asset allocations were presented in the paper, which showed the expected nominal return and expected volatility for each of these.

12. While various views were expressed on the central issue of exposure to equities, a broad consensus was reached to reduce investments in equities to a level of 10% of the investment portfolio.

13. Accordingly, the new asset allocation is presented in Attachment I. It will be noted that while the potential average rate of return has been reduced from 7.0% under the former policy to 5.6% under the new policy, the expected volatility of the portfolio has been almost halved from 8.2% to 4.2%.

14. Attachment II provides definitions of risk measurements and the return and risk assumptions that have been used in producing the portfolio characteristics found in Attachment I.

15. The expert group report noted that IFAD is the only international financial institution that invests in fixed-interest instruments with credit ratings lower than AA-. In the interests of reducing the volatility of the portfolio, the new investment policy also includes a credit floor of AA-. Definitions of long-term credit ratings are found in Attachment III.

II. IMPLEMENTATION OF THE NEW INVESTMENT POLICY

16. Implementation of the new investment policy began in January 2002 with the introduction of dividend repatriation, whereby all dividends earned on equity investments are paid into a cash account instead of being reinvested by the external investment managers in stocks.

17. In early March, the equity markets rallied strongly on the expectation of an early recovery in the United States economy, and on stocks becoming eligible instruments for certain state-run pension plans in Japan. The rally provided an opportunity to liquidate five equities portfolios without incurring losses. The initial funding of the mandates amounted to USD 384.5 million equivalent, and the sales proceeds amounted to USD 424.5 million equivalent.

18. Consequently equities mandates have been reduced in number from 15 to 10 mandates, and the proportion of equities in the investment portfolio from 41% at 31 December 2001 to approximately 18% at 12 March 2002.

19 . The Investment Guidelines for the diversified fixed-interest mandates have been amended to reflect the credit floor of AA- included in the new investment policy, and it is foreseen that this will largely be implemented by the end of March.

20. The cash realized from the sale of the above-mentioned equities mandates will be used to partly fund the new allocation to inflation-protected bonds, and the higher allocation to diversified fixed-interest investments under the new investment policy.

Transitional Arrangements

21. While the remaining ten equities mandates rose in value during the recent rally, they did not rise sufficiently to be sold without incurring losses. In order to facilitate the daily monitoring of their value in the coming months, it is intended to consolidate the remaining ten mandates into three mandates, corresponding to Emerging Market, North American and European equities, utilizing IFAD's existing manager for Emerging Market equities and the best performing existing managers for North American and European equities. In this way individual managers who have a poor track record with IFAD will be eliminated. IFAD will use expert advice and highly qualified transition managers in this process.

22. When market circumstances permit, the proportion of equities will be further reduced to 10%, bearing in mind the criterion of avoiding unnecessary losses.

Other Recommendations of the Expert Group

23. Besides addressing the issue of overall asset allocation, the expert group report addressed a number of important issues on which management commented both in the Report of the President on IFAD's Investment Policy, and during the various consultations and seminars. Progress on these issues is reported below.

Operational Risk

24. The expert group report emphasized the need to strengthen Treasury procedures. This is already taking place with respect to the implementation of recommendations regarding risk management, the recording and evaluation of key indicators and the production of a comprehensive procedures manual. A comprehensive review of staffing issues and training requirements is currently underway.

Socially, Ethically and Ecologically Acceptable Investing

25. As part of the transitional arrangements, it is intended to modify the Investment Guidelines for both equities and diversified fixed-interest mandates, to ensure that the managers concerned employ screening techniques to ensure that IFAD only invests in companies whose products and employment and environmental policies conform to socially, ethically and ecologically acceptable principles.

Investments Advisory Committee

26. The expert group noted that membership in the Investments Advisory Committee is restricted to IFAD management and staff members. It was recommended that the internal membership should be reduced and that one or two external members with broad experience in the investment management business should be added.

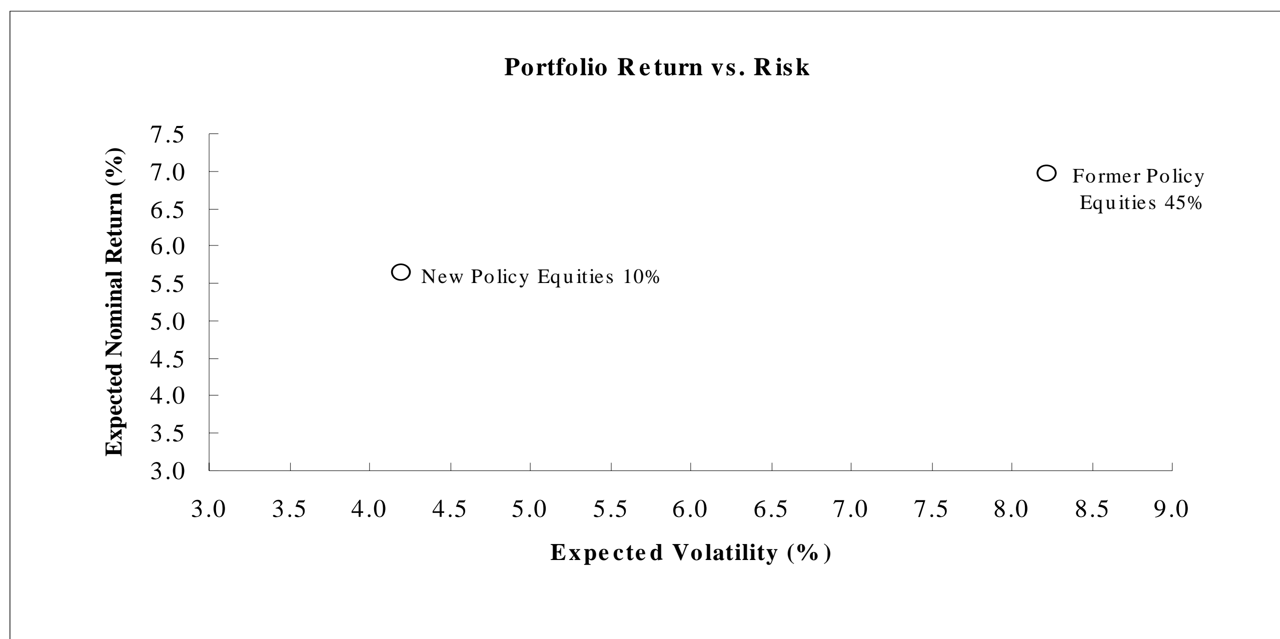
27. The principle of external membership is not new to IFAD, and IFAD's financial advisors routinely participate in meetings of the Investments Advisory Committee. Whether new expertise is needed will be determined following an internal review.

Reporting to the Executive Board

28. The expert group suggested that in addition to the quarterly reports on IFAD's investment portfolio, members of the Executive Board should be sent monthly bulletins on the status of the portfolio. This recommendation will be put on the agenda of the Audit Committee for further discussion.

ATTACHMENT I

SUMMARY OF PORTFOLIO CHARACTERISTICS



Asset Class [b]	Assumptions [a]		New Policy	Former Policy
	Nominal Return %	Volatility %		
Cash (%)	3.0	2.9	5.0	5.0
Global government bonds (%)	5.3	5.6	44.0	40.0
Diversified fixed-interest (%)	5.6	6.0	23.0	10.0
Global inflation indexed bonds (%)	5.3	2.8	18.0	-
Global equities (%)	9.2	15.9	10.0	45.0
Total (%)			100.0	100.0
Return				
(i) Expected coupon/dividend payments (USD million)[c]			98	74
(ii) Expected nominal return (%)			5.6	7.0
(iii) Probability % of achieving in 3 years a minimum average return of 3 %			88	82
(iv) Cumulative returns 3 years:				
Expected cumulative return (%)			17.9	22.4
Expected minimum cumulative return % (95% confidence level)			3.4	-6.1
Expected maximum cumulative return % (95% confidence level)			32.5	50.9
Risk				
(v) Expected volatility (%)			4.2	8.2
(vi) Expected value-at-risk (USD million)[d]			139	271
Risk-adjusted return				
(vii) Sharpe ratio			0.63	0.48

[a] The basis of the assumptions on returns of the various asset classes is explained in Attachment II.
[b] The credit floor for fixed-interest investments is AA-.
[c] Calculated for a total portfolio of USD 2 billion.
[d] Calculated in USD million with a one-year horizon and 95% confidence level, on the basis of a total portfolio of USD 2 billion.

ATTACHMENT II

DEFINITIONS OF RISK MEASURES, AND RETURN AND RISK ASSUMPTIONS

A. Definitions of Risk Measures

Volatility	A risk measure that indicates how much the portfolio's return is fluctuating over time. A higher volatility means a higher uncertainty in returns. *Calculated as the historical standard deviation of portfolio returns from their mean. A volatility of for example 5% indicates that the annual return will, with a probability of 67%, fall within +/- 5% from the mean.*
Value-at-risk (VaR)	A risk measure that indicates the maximum amount the portfolio could lose over a certain time horizon, with a given level of confidence. *Several estimation methodologies exist. IFAD uses a methodology in which each asset class has a benchmark index assigned to it as a proxy for its risk. The risk of each asset class is calculated as the volatility of several years of the index returns. The value-at-risk of the overall portfolio takes into account the correlation among the asset classes composing the portfolio.*
Sharpe ratio	A measure for risk-adjusted return that compares the portfolio's return to its risk level. The Sharpe ratio is useful for comparing portfolios with different risk levels. The more positive the Sharpe ratio, the better the risk-adjusted return. *Calculated as the portfolio's return less risk-free return and divided by the portfolio's volatility.*

B. Return and Risk Assumptions

The table on page 7 shows historical yearly returns together with average return and risk figures for the asset classes composing the three portfolio options. The applied assumption for average future returns is shown together with average historical return, average bond yields and equity returns for the last ten years as well as current bond yields.

Regarding equities, the assumed average future return equals the historical average return for the past 30 years.

Unlike equity returns, bond returns are not mean reverting according to empirical research. The current bond yield level, which effectively is the expected average return on bonds, is at a historically low level. The assumption for future bond returns is thus above the current bond yield level but below the historical nominal returns, particularly due to the prevailing lower inflation environment.

IFAD has been in contact with a number of investment managers to obtain their best estimates of future bond returns. Estimates differed according to varying economic scenarios. Those eventually selected were based on the assumption of a return to moderate growth.

The standard deviations presented in the table were calculated on the historical data and were applied when computing the three portfolio options.

ATTACHMENT II

Yearly Asset Class Returns 1970-2000 and Average Return and Risk
(Nominal Local Currency Terms)

Asset Class	Cash	Global Government Bonds	Diversified Fixed-Interest [a]	Global Inflation Indexed Bonds	Global Equities
Benchmark index	91-Days Treasury Bills	JP Morgan Global Government Bonds Index	Salomon Brothers Broad Investment Grade (BIG) Index	Bridgewater Inflation Linked Data	MSCI World (1988 onwards: MSCI AC World)
1970	6.8	-	-	-	-6.1
1971	4.7	-	-	12.2	13.0
1972	4.3	-	-	11.8	19.6
1973	7.6	-	-	9.2	-19.9
1974	8.5	-	-	10.9	-28.6
1975	6.1	-	-	15.1	32.3
1976	5.3	-	-	19.4	11.0
1977	5.7	-	-	12.4	-6.9
1978	8.1	-	-	14.1	5.8
1979	11.3	-	-	9.7	9.4
1980	13.1	-	-	16.0	19.4
1981	16.0	-	6.5	11.5	-2.3
1982	11.8	-	31.8	12.0	11.6
1983	9.6	-	8.2	11.1	21.6
1984	10.6	-	15.0	9.0	7.5
1985	8.2	-	22.3	9.6	25.3
1986	6.4	13.5	15.4	8.9	27.2
1987	6.2	4.5	2.6	9.9	-1.5
1988	7.4	7.1	8.0	8.2	25.9
1989	9.0	9.1	14.4	10.6	24.0
1990	8.2	7.0	9.1	9.4	-22.7
1991	5.7	14.9	16.0	9.3	15.5
1992	3.6	9.7	7.6	8.8	-1.7
1993	3.2	14.5	9.9	9.5	23.9
1994	4.6	-3.5	-2.8	9.9	-0.1
1995	5.9	17.1	18.5	5.3	15.1
1996	5.4	7.6	3.6	8.2	14.3
1997	5.5	9.5	9.6	8.1	20.0
1998	5.1	10.1	8.7	10.1	16.6
1999	5.1	-1.2	-0.8	12.2	28.3
2000	6.3	8.3	11.6	8.7	-11.7
Return					
Average historical return (%)	7.3	8.5	10.8	10.7	9.2
Average bond yield/equity return last 10 years (%)	4.7	5.7	6.6	5.9 [b]	12.0
Current bond yield (%) [c]	2.4	3.8	5.0	5.2 [d]	-
Assumption for average future return (%)	3.0	5.3	6.3	5.3	9.2
Risk					
Standard deviation (%)	2.9	5.6	8.0	2.8	15.9

[a] The benchmark index used for estimating return and risk includes securities with credit ratings below AA. Diversified fixed-interest securities with a minimum credit quality of AA- has an estimated average future return at 5.6% and an estimated standard deviation at 6.0%.

[b] Historical bond yields not available. Average bond yield 5.9 calculated as (average global bond return last 10 years/average global inflation indexed bond return last 10 years) * average global bond yield last 10 years.

[c] As of 30 September 2001.

[d] The current yield represents the real yield of 3.2% on United States treasury inflation indexed bonds plus 2% inflation assumption to make the return nominal.

ATTACHMENT III

DEFINITIONS OF LONG-TERM CREDIT RATINGS

AAA Bonds rated AAA are judged to be of the best quality. They carry the smallest degree of investment risk. Interest payments are protected by a large or by an exceptionally stable margin and the principal is secure. While the various protective elements are likely to change, such changes are most unlikely to impair the fundamentally strong position of such bonds.

AA Bonds rated AA are judged to be of high quality by all standards. They are rated lower than AAA bonds because margins of protection may not be as large as for AAA bonds or fluctuation of protective elements may be of greater amplitude or there may be other elements present that make the long-term risk appear somewhat larger than for AAA bonds.

A Bonds rated A possess many favorable investment attributes and are to be considered as upper-medium-grade obligations. Factors giving security to principal and interest payments are considered adequate, but elements may be present that suggest a susceptibility to impairment some time in the future.

BBB Bonds rated BBB are considered as medium-grade obligations, i.e. they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and have speculative characteristics as well.

BB Bonds rated BB are judged to have speculative elements, i.e. their future cannot be considered well assured. Often the protection of interest and principal payments may be very moderate and thus not well safeguarded during both good and bad times in the future.

B Bonds rated B generally lack the characteristics of a desirable investment. Assurance of interest and principal payments or of maintenance of other terms in the contract may be small over any long period of time.

C Bonds rated C are the lowest rated class of bonds and can be regarded as having extremely poor prospects of ever attaining any real investment standing.