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**IFAD**

**INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT**

**Executive Board – Eighty-First Session**

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# REPORT ON IFAD'S INVESTMENT PORTFOLIO FOR 2003

## I. INTRODUCTION

1. The following report on IFAD's investment portfolio covers the year ending 31 December 2003 and includes comparative figures for the year ending 31 December 2002 and earlier years. In addition, Annex X contains a report on the investment portfolio for the fourth quarter of 2003.

2. The report consists of the following eight sections: highlights, investment conditions, investment policy, asset allocation, investment income, rate of return and performance comparison, composition of the portfolio, and risk measurement.

## II. HIGHLIGHTS

3. Investment conditions in 2003 initially favoured the safe haven of government bonds due to the risk of, and later the commencement of, a war in Iraq, and due to the prevailing uncertainty about the global economy. As certainty about the strength of the recovery increased, equity markets rallied strongly from the second quarter of 2003 onwards. With interest rates on government bonds having reached very low levels, there was also an incentive for investors to look for higher returns offered by fixed-interest asset classes other than government bonds.

4. In aggregate, net investment income on IFAD's investment portfolio amounted to USD 107 962 000 equivalent in 2003. This represented an overall net rate of return of 4.90% and an outperformance of 55 basis points against the aggregate benchmark.

5. The fixed-interest portion of the investment portfolio contributed USD 61 524 000 equivalent to the overall net investment income. The income from fixed-interest investments corresponded to a rate of return of 3.20%, which included an outperformance of 51 basis points against the aggregate fixed-interest benchmark.

6. The equities portion of the investment portfolio contributed USD 46 438 000 equivalent to the overall net investment income. The income from equities corresponded to a rate of return of 24.16%, which included an outperformance of 109 basis points against the aggregate equity benchmark.

7. The amount of the investment portfolio increased from USD 2 093 993 000 equivalent at 31 December 2002 to USD 2 356 921 000 equivalent at the end of 2003. The significant increase during the year was due to positive movements from investment income and, in particular, foreign exchange due to the appreciation of other major currencies against the United States dollar. The positive movements were to some extent counterbalanced by a net outflow from the portfolio, representing disbursements for loans, grants and administrative expenses, offset by Member States' contributions.

8. IFAD's current investment policy, adopted in December 2001, was fully implemented in 2002 with the exception of the asset class of inflation-indexed bonds. In 2003, two investments were made in inflation-indexed bonds, and this brought holdings of this asset class to approximately 10% of the overall investment portfolio, as compared to their allocation of 18% as per the investment policy. The remaining unfunded amount was held in time deposits and government bonds as of 31 December 2003.

9. The transition to IFAD's new global custodian took place on 1 April 2003, following their selection in 2002.

10. Additionally, a new financial advisor was selected in October 2003, and the contractual agreement was finalized in February 2004.

## III. INVESTMENT CONDITIONS

11. This section reviews the economic and financial market development in 2003.

### A. Economic Background

12. Annex I shows the development of four key economic indicators: real gross domestic product (GDP), consumer prices, unemployment rate and budget deficits or surpluses. The economic indicators are shown for the countries whose currencies make up the Special Drawing Rights (SDR) valuation basket: the United States, Japan, euro-zone countries and the United Kingdom.

13. GDP rates generally rose in year 2003, and there was an increased certainty about the strength of the global economy. The United States economy, which is supported by low interest rates and tax cuts, is expected to lead the expansion in 2004 together with emerging Asian economies. However, the upturn in growth is expected to be broad-based. Japan's economy recovered in 2003, and is forecast to grow further in 2004, as exports remain solid and business spending is improving. Also the euro-zone economy is expected to pick up in 2004, although its GDP fell to a forecast rate of 0.4% in 2003 (2002: 0.9%) as the appreciation of the euro curbed exports and household spending stagnated. Meanwhile, forecasts show that growth continues to accelerate in the United Kingdom.

14. There is yet little evidence that the recovery in the global economy is leading to faster inflation as reflected in consumer prices. Inflation forecasts for 2004 show a downward trend in the United States and the euro zone, while inflation is forecast to remain nearly unchanged in the United Kingdom during 2004. In Japan, inflation is still expected to remain slightly negative although the underlying trend indicates that deflation is receding.

15. As per estimates for 2003, unemployment rates fell slightly during the year in Japan and the United Kingdom due to improved economic conditions. In the United States, however, unemployment

rose somewhat in 2003 due to aggressive cost-cutting by corporates. Also, the euro zone showed higher unemployment, but in this case due to lower economic activity. The general forecast for 2004-2005 is that unemployment rates will fall slightly as the global economy continues to grow.

16. In 2003, budget deficits grew in the United States, Japan and the euro zone, and this trend is forecast to continue in 2004 with the exception of the euro zone, where the deficit may shrink somewhat in 2004. The United Kingdom, on the other hand, showed an increased surplus in 2003, but a smaller surplus is expected for 2004.

17. Annex II shows the evolution of central bank interest rates for the countries whose currencies are included in the SDR valuation basket. The United States Federal Reserve Bank lowered the federal funds rate once in 2003, from 1.25% to 1.00% in June. The European Central Bank lowered its refinancing rate twice in 2003, from 2.75% to 2.50% in March 2003 and from 2.50% to 2.00% in June 2003, in response to the appreciation of the euro and to support business and consumer confidence. In the United Kingdom, the Bank of England also lowered its base rate twice in 2003, from 4.00% to 3.75% in February 2003, and from 3.75% to 3.50% in July 2003, to stimulate economic activity. However, the Bank of England also raised its base rate back to 3.75% in November 2003, amid accelerating global growth and concerns about growing consumer spending and soaring house prices in the United Kingdom. The Bank of Japan continued its zero-rate policy in 2003.

18. Annex III illustrates month-end exchange rates for the United States dollar against the three other currencies included in the SDR valuation basket. In 2003, the three other currencies, i.e. the Japanese yen (JPY), the British pound sterling (GBP) and in particular the euro (EUR), appreciated strongly against the United States dollar.

## B. Financial Markets Background

19. Annex IV shows the evolution in 2003 of short- and long-term interest rates for the countries whose currencies are included in the SDR valuation basket. Overall, short-term rates fell somewhat in the United States and the United Kingdom, and to a larger extent in euro-zone countries, as central banks in those countries lowered their interest rates. Short-term rates, however, turned upward in the United Kingdom in the second half of the year, as the Bank of England raised its interest rates. In Japan, short-term rates remained around zero all year. In the three countries and the euro zone, long-term rates trended downward in the first half of the year, but overall the rates turned upward again in the second half of the year, and particularly in Japan, while exhibiting notable volatility.

20. Annex V shows government bond market returns in 2003 for individual countries included in the JP Morgan global government bond index. The benchmark index includes both coupon and capital gains and losses, in line with market practice. With the exception of the Japanese bond market, which had a negative return due to clearly rising long-term rates, the other government bond markets posted positive returns and particularly Canada and European countries, with the exception of the United Kingdom, outperformed the overall bond market.

21. Annex VI shows the development in 2003 of fixed-interest and equity markets where IFAD's investment portfolio was invested during the year. The fixed-interest market development is reflected in the performance of representative benchmark indices used by IFAD for government bonds, diversified fixed-interest bonds and inflation-indexed bonds. Until the beginning of the third quarter, government bonds outperformed diversified fixed-interest bonds as investors tended to favour government bonds as a safe haven. However, the difference in performance was eliminated during the last months of the year as interest rates on government bonds reached very low levels and there was an incentive for investors to look for higher returns offered by diversified fixed interest. IFAD invested in inflation-indexed bonds in the second half of 2003, and the asset class outperformed relative to the two other fixed-interest asset classes in this period. Inflation-indexed bonds were favoured by relatively stable interest rates in real terms, while nominal interest rates were affected by

somewhat rising inflation expectations. Inflation-indexed bonds also benefited from a structural increase in demand as many large investors decided to include them in their asset allocations.

22. As is also shown in Annex VI for North American and European equities, i.e. the two equity markets in which IFAD had invested in 2003, equity markets performed negatively in the first quarter as market conditions were driven by the risk of, and later in the quarter, commencement of a war in Iraq and by the then prevailing uncertainty about the global economy. Starting from the second quarter, equity markets exhibited a strong rally amid optimism that economic growth in the United States would accelerate and spark a global recovery. The equity rally continued for the remainder of 2003, fuelled by increased certainty about the strength of the global economy, growing corporate profits and a surge in third quarter GDP in the United States.

## IV. INVESTMENT POLICY

23. IFAD's current investment policy, adopted in December 2001, was fully implemented in 2002 with the exception of the asset class of inflation-indexed bonds. The unfunded amount of inflation-indexed bonds was held in the internally managed portfolio and in the government bonds portfolio until June 2003.

24. In June 2003, two investments were made in inflation-indexed bonds in the total amount of USD 218 964 000 equivalent. The investments brought holdings of inflation-indexed bonds to approximately 10% of the overall investment portfolio, as compared to their allocation of 18% per the investment policy.

25. In the third quarter of 2003, it was decided to shorten the duration of the government bonds portfolio in order to reduce its exposure to potential losses in the event of rising interest rates. The decision was implemented by the end of September 2003. The timing of the duration change was opportune, considering that interest rates rose in the beginning of the fourth quarter of 2003, thereby causing losses, in particular, on bonds with a long duration. Cumulatively at year-end, the portfolio had benefited by approximately USD 2.6 million in gains from the shortened duration.

26. A new global custodian was selected in 2002, following an international tender and an internal evaluation process. Following completion of preparatory work, the transition to the new custodian took place on 1 April 2003.

27. Additionally, a new financial advisor was selected in October 2003 and the contractual agreement was finalized in February 2004.

## V. ASSET ALLOCATION

28. Table 1 shows the movements affecting the investment portfolio's major asset classes in year 2003 and compares the portfolio's actual asset allocation to the policy allocation. As part of the implementation of the current investment policy, transfers were made in the second quarter of 2003 from the internally managed portfolio to the inflation-indexed bonds portfolio in the total amount of USD 218 964 000 equivalent, as noted in the previous section. There were no other reallocations between the portfolio's asset classes in year 2003, besides the normal dividend repatriations from the equities portfolio to the internally managed portfolio, whereby IFAD avoids reinvesting its dividend gains into equities. From the internally managed portfolio, however, there was a net outflow of USD 30 745 000 equivalent, representing disbursements for loans, grants and administrative expenses, less cash receipts and encashments of Member States' contributions.

**Table 1: Summary of Movements in Cash and Investments – Year 2003**
(USD '000 equivalent)

| | Internally Managed Portfolio | Government Bonds Portfolio | Diversified Fixed-Interest Portfolio | Inflation-Indexed Bonds Portfolio | Equities Portfolio | Overall Portfolio |
|---|---|---|---|---|---|---|
| **Opening balance (31 December 2002)** | **408 137** | **1 022 378** | **464 218** | **–** | **199 260** | **2 093 993** |
| Net investment income | 4 086 | 36 735 | 16 038 | 4 665 | 46 438 | 107 962 |
| Transfers due to allocation[a] | (214 865) | – | – | 218 964 | (4 099) | – |
| Transfers due to expenses/other income | (4 697) | 2 259 | 1 258 | 294 | 886 | – |
| Other net flows[b] | (30 745) | – | – | – | – | (30 745) |
| Movements on exchange | 23 410 | 129 461 | (641) | 19 880 | 13 601 | 185 711 |
| **Closing balance (31 December 2003)** | **185 326** | **1 190 833** | **480 873** | **243 803** | **256 086** | **2 356 921** |
| Actual allocation (%) | 7.9 | 50.5 | 20.4 | 10.3 | 10.9 | 100.0 |
| Policy allocation (%) | 5.0 | 44.0 | 23.0 | 18.0 | 10.0 | 100.0 |
| **Difference in allocation (%)** | **2.9** | **6.5** | **(2.6)** | **(7.7)** | **0.9** | **–** |

[a] Transfers from the equity portfolio reflect the repatriation of dividends.
[b] Member States' contributions, less disbursements for loans, grants and administrative expenses.

29. Changes in the portfolio's allocation ratios in 2003 also reflected positive movements in investment income and large movements on exchange as other major currencies appreciated strongly against the United States dollar. Particularly the government bonds portfolio increased in value as non-United States dollar investments made up almost 80% of its average holdings in 2003.

30. Following these movements, as at 31 December 2003, the investment portfolio showed excess allocations to the government bonds portfolio and, to a lesser extent, the internally managed portfolio and the equities portfolio. The excess allocations mainly reflected the fact that the asset class of inflation-indexed bonds had not been fully funded, but also that the diversified fixed-interest portfolio was showing a shortfall. The diversified fixed-interest portfolio is almost entirely invested in bonds denominated in United States dollars and therefore, unlike the investment portfolio's other asset classes, the market value of the diversified fixed-interest portfolio did not benefit from the positive movements on exchange.

31. Annex VII provides further details on the movements in the two equities sub-portfolios and on their respective balances within the overall equities portfolio at year-end.

## VI. INVESTMENT INCOME

32. In year 2003, aggregate net investment income amounted to USD 107 962 000 equivalent (2002 – USD 26 186 000). Both realized and unrealized security gains and losses are recognized in the period to which they relate and are included in the investment income. Table 2 shows net investment income for year 2003 and prior years for the investment portfolio's major asset classes.

**Table 2: Net Investment Income by Asset Class – Year 2003 and Prior Years**[a]
(USD ’000 equivalent)

| Portfolio | 2003 | 2002[b] | 2001 | 2000 | 1999 | 1998 | 1997 |
|---|---|---|---|---|---|---|---|
| Internally managed portfolio | 4 086 | 4 098 | 2 050 | 3 654 | 3 114 | 4 834 | 18 633 |
| Government bonds portfolio | 36 735 | 85 541 | 41 471 | 74 625 | (43 977) | 195 506 | 154 228 |
| Diversified fixed-interest portfolio | 16 038 | 22 925 | 13 783 | 17 615 | 3 832 | 6 130 | – |
| Inflation-indexed bonds portfolio | 4 665 | – | – | – | – | – | – |
| Equities portfolio | 46 438 | (86 378) | (100 286) | (143 744) | 231 500 | (18 571) | (8 921) |
| **Overall portfolio** | **107 962** | **26 186** | **(42 982)** | **(47 850)** | **194 469** | **187 899** | **163 940** |

[a] Net investment income earned in prior years 1997 to 2001 reflect the previous investment policy.
[b] Restated in line with the Financial Statements for year 2003. The restatement increased overall net investment income by USD 16 000 equivalent.

33. Table 3 provides details on net investment income earned in 2003 by the two main portfolio categories, i.e. fixed-interest and equity investments, together with net investment income for the overall portfolio in the prior years 1997 to 2002. Both fixed-interest and equity investments contributed positively to the net investment income in 2003.

**Table 3: Net Investment Income of the Overall Portfolio by Main Portfolio Category – Year 2003 and Prior Years**[a]
(USD ’000 equivalent)

| | 2003 | | | 2002 Overall Portfolio[b] | 2001 Overall Portfolio | 2000 Overall Portfolio | 1999 Overall Portfolio | 1998 Overall Portfolio | 1997 Overall Portfolio |
|---|---|---|---|---|---|---|---|---|---|
| | Total Fixed-Interest Portfolio | Total Equities Portfolio | Overall Portfolio | | | | | | |
| Interest from fixed-interest investments and bank accounts | 69 932 | 6 | 69 938 | 61 541 | 59 241 | 68 819 | 90 253 | 112 668 | 128 779 |
| Dividend income from equities | – | 4 709 | 4 709 | 7 652 | 13 614 | 11 760 | 8 684 | 5 654 | 94 |
| Realized capital gains/ (losses) | 43 810 | (1 631) | 42 179 | (89 120) | (74 793) | 8 264 | 3 861 | 40 846 | 21 535 |
| Unrealized capital gains/ (losses) | (48 286) | 44 507 | (3 779) | 53 541 | (31 400) | (125 724) | 101 272 | 36 111 | 19 657 |
| Income from securities lending and commission recapture | 303 | 127 | 430 | 436 | 841 | 440 | 539 | 905 | 463 |
| **Subtotal: gross investment income/(loss)**[c] | **65 759** | **47 718** | **113 477** | **34 050** | **(32 497)** | **(36 441)** | **204 609** | **196 184** | **170 528** |
| Investment manager fees | (3 244) | (1 032) | (4 276) | (4 866) | (7 037) | (7 993) | (7 192) | (5 660) | (3 708) |
| Custody fees | (569) | (111) | (680) | (1 621) | (2 103) | (2 581) | (1 870) | (1 469) | (1 066) |
| Financial advisory and other investment management fees | (422) | (53) | (475) | (791) | (688) | (515) | (508) | (610) | (683) |
| Taxes | – | (84) | (84) | (365) | (606) | (167) | (286) | (129) | (1 131) |
| Other investment expenses | – | – | – | (221) | (51) | (153) | (284) | (417) | – |
| **Net investment income/(loss)** | **61 524** | **46 438** | **107 962** | **26 186** | **(42 982)** | **(47 850)** | **194 469** | **187 899** | **163 940** |

[a] Investment income earned in prior years 1997 to 2001 reflect the previous investment policy.
[b] Restated in line with the Financial Statements for year 2003. The restatement increased interest income by USD 16 000 equivalent.
[c] Gross income for current and prior years has been recalculated in line with the Financial Statements for year 2003. Now gross income includes income from securities lending and commission recapture, which were reported as part of net investment income in earlier reports on the investment portfolio to the Executive Board.

34. Table 4 shows net investment income in year 2003 from the fixed-interest portfolio's four sub-portfolios, namely the internally managed portfolio, and the externally managed government bonds, diversified fixed-interest and inflation-indexed bonds portfolios. In aggregate, net investment income from fixed-interest investments in 2003 amounted to USD 61 524 000 equivalent. All four sub-portfolios contributed positively to income, with the government bonds portfolio showing the largest contribution.

**Table 4: Net Investment Income on the Fixed-Interest Portfolio by Sub-Portfolio – Year 2003**
(USD '000 equivalent)

| | Internally Managed Portfolio | Government Bonds Portfolio | Diversified Fixed-Interest Portfolio | Inflation-Indexed Bonds Portfolio | Total Fixed-Interest Portfolio |
|---|---|---|---|---|---|
| Interest from fixed-interest investments and bank accounts | 4 174 | 50 716 | 12 654 | 2 388 | 69 932 |
| Dividend income from equities | – | – | – | – | – |
| Realized capital gains | – | 32 405 | 10 591 | 814 | 43 810 |
| Unrealized capital gains/(losses) | – | (44 120) | (5 924) | 1 758 | (48 286) |
| Income from securities lending and commission recapture | – | 230 | 65 | 8 | 303 |
| **Subtotal: gross investment income** | **4 174** | **39 231** | **17 386** | **4 968** | **65 759** |
| Investment manager fees | – | (1 982) | (1 037) | (225) | (3 244) |
| Custody fees | (88) | (236) | (185) | (60) | (569) |
| Financial advisory and other investment management fees | – | (278) | (126) | (18) | (422) |
| Taxes | – | – | – | – | – |
| Other investment expenses | – | – | – | – | – |
| **Net investment income** | **4 086** | **36 735** | **16 038** | **4 665** | **61 524** |

35. Net investment income in year 2003 from the two sub-portfolios of the equities portfolio is shown in Table 5. In aggregate, net investment income from equities amounted to USD 46 438 000 equivalent. Both the North American and, to a lesser extent, the European equities sub-portfolios contributed strongly to income in year 2003.

**Table 5: Net Investment Income of the Equities Portfolio by Sub-Portfolio – Year 2003**
(USD ’000 equivalent)

| | Emerging Markets Equities[a] | North American Equities | European Equities | Total Equities Portfolio |
|---|---|---|---|---|
| Interest from fixed-interest investments and bank accounts | – | 5 | 1 | 6 |
| Dividend income from equities | – | 2 193 | 2 516 | 4 709 |
| Realized capital gains (losses) | 7 | 5 014 | (6 652) | (1 631) |
| Unrealized capital gains | – | 30 099 | 14 408 | 44 507 |
| Income from securities lending and commission recapture | 27 | 20 | 80 | 127 |
| **Subtotal: gross investment income** | **34** | **37 331** | **10 353** | **47 718** |
| Investment manager fees | – | (702) | (330) | (1 032) |
| Custody fees | (3) | (69) | (39) | (111) |
| Financial advisory and other investment management fees | – | (32) | (21) | (53) |
| Taxes | – | – | (84) | (84) |
| Other investment expenses | 1 | – | (1) | – |
| **Net investment income** | **32** | **36 528** | **9 878** | **46 438** |

[a] The portfolio was liquidated in the fourth quarter of 2002. Income and expenses in 2003 refer to transactions that could not be effected in 2002.

36. Annex VIII shows annual gross income from 1997 to 2003 for the major categories of the investment portfolio, i.e. fixed-interest and equities investments, and indicates the amounts of income earned through capital gains, interest income, dividends and income from securities lending and commission recapture.

## VII. RATE OF RETURN AND PERFORMANCE COMPARISON

### Overall Rate of Return

37. There was an overall positive return of 4.90% in year 2003 (2002 – positive 1.26%), net of investment expenses and movements on exchange. Both fixed-interest and equities investments contributed positively to the overall return in 2003.

### Portfolio Performance Compared with Benchmark

38. The performance of the various mandates of the investment portfolio is measured against preassigned independent benchmarks, indicating the return that would be expected through passive management of defined sectors of the market. The indices used are the JP Morgan customized global government bonds index for government bonds, Lehman Brothers United States aggregate index for diversified fixed-interest bonds, Barclays customized inflation-linked index for the inflation-indexed bonds portfolio, Standard & Poor’s 500 index for North American equities and Morgan Stanley capital international (MSCI) index for European equities.

39. Table 6 compares the return on each major sub-portfolio with the appropriate benchmark return. The overall portfolio showed an outperformance of 55 basis points in 2003 (2002 – underperformance 125 basis points). It can be noted that both fixed-interest and equity investments contributed to the outperformance.

**Table 6: Performance Compared with Benchmarks – Year 2003**
(percentage in local currency terms)

| | Rate of Return % | | Out/(Under) |
|---|---|---|---|
| **Portfolio** | **Portfolio** | **Benchmark** | **Performance** |
| Internally managed portfolio | 1.61 | 1.61 | 0.00 |
| Government bonds portfolio | 3.31 | 2.88 | 0.43 |
| Diversified fixed-interest portfolio | 3.68 | 2.95 | 0.73 |
| Inflation-indexed bonds portfolio | 2.09 | 1.42 | 0.67 |
| **Total fixed-interest portfolio** | **3.20** | **2.69** | **0.51** |
| North American equities portfolio | 31.05 | 26.39 | 4.66 |
| European equities portfolio | 12.55 | 16.53 | (3.98) |
| **Total equities portfolio** | **24.16** | **23.07** | **1.09** |
| **Overall portfolio gross rate of return** | **5.12** | **4.57** | **0.55** |
| **Less expenses** | **(0.22)** | **(0.22)** | **0.00** |
| **Overall portfolio net rate of return** | **4.90** | **4.35** | **0.55** |

40. As indicated in Table 6, the total fixed-interest portfolio returned 3.20% in 2003, which included an outperformance of 51 basis points compared to the aggregate fixed-interest benchmark. The externally managed sub-portfolios of the fixed-interest portfolio performed as follows:

- **Government bonds portfolio.** The portfolio returned 3.31%, which included an outperformance of 43 basis points against its benchmark. The outperformance was largely due to the investment managers' decision to underweight the negatively performing Japanese bond market. The outperformance was somewhat curtailed by the managers' duration management, mainly because managers on average kept a shorter duration than the benchmark towards the end of the year and therefore did not benefit fully from gains in some government bond markets. The duration of the government bonds portfolio and its benchmark is shown in Table 7, together with the duration of the diversified fixed-interest and inflation-indexed bonds portfolios.

**Table 7: Duration of Fixed-Interest Portfolios and Benchmarks**

| | **31 December 2003 (Years)** | **31 December 2002 (Years)** |
|---|---|---|
| Global government bonds portfolio | 2.7 | 5.7 |
| Global government bonds benchmark | 2.9 | 6.2 |
| Diversified fixed-interest portfolio | 4.0 | 2.2 |
| Diversified fixed-interest benchmark | 4.0 | 4.4 |
| Inflation-indexed bonds portfolio | 6.9 | n/a |
| Inflation-indexed bonds benchmark | 7.2 | n/a |

- **Diversified fixed-interest portfolio.** The portfolio returned 3.68%, which included an outperformance of 73 basis points against its benchmark. The outperformance stemmed mainly from the investment managers' selection of government bonds, since their selection of mortgages tended to contribute negatively. The overall, positive impact from security selection was somewhat negatively offset by managers' sector allocations.

- **Inflation-indexed bonds portfolio.** From its inception in June to the end of 2003, the portfolio returned 2.09%, which included an outperformance of 67 basis points against its benchmark. The outperformance was generated in the third quarter of 2003 as the investment manager benefited from slowly entering the market at a time of negative market returns.

41. As was also indicated in Table 6, the total equities portfolio returned 24.16% in 2003, which represented an outperformance of 109 basis points compared to the aggregate equities benchmark. The two equity sub-portfolios performed as follows:

- **North American equities portfolio.** The portfolio returned 31.05%, which included an outperformance of 466 basis points against its benchmark. The outperformance stemmed entirely from the investment manager's stock selection, which was positive in a majority of sectors for most of the year. There was a small negative contribution from sector allocation, mainly as the manager was modestly overweighting one of the weaker sectors in 2003, namely health care, but the negative allocation impact was well compensated by the manager's superior stock selection within the same sector.

- **European equities portfolio.** The portfolio returned 12.55%, but the return represented an underperformance of 398 basis points against its benchmark. The portfolio's investment style, which focuses on quality growth stocks in mostly large capitalization stocks, did not pay off in 2003. Compared with its benchmark, the European equities portfolio produced negative stock selection in many industry sectors, and particularly in financials and consumer staples. Sector allocation also contributed negatively, but to a lesser extent. (NB: The portfolio's return of 12.55% could be compared to the growth-style MSCI European equities benchmark, which returned 10.56% in 2003. The portfolio's assigned, standard MSCI European equities benchmark returned 16.53%, while the value-style MSCI European equities benchmark returned 22.58%.)

**Portfolio Performance Compared with Manager Universe**

42. Table 8 shows a comparison of the 2003 performance of IFAD's externally managed mandates against universes of investment managers provided by IFAD's global custodian. The comparison uses returns in United States dollar terms, and therefore includes an element of exchange gain and loss, instead of returns in local currency terms, which are used elsewhere in this report. The universe comparison is of an indicative nature, since all portfolios have their own specific investment guidelines, which do not precisely match the guidelines used by IFAD. As indicated in Table 8, the government bonds mandate underperformed slightly against its universe in 2003; however, it outperformed against its own benchmark (2002 – the government bonds mandate outperformed against both its universe and benchmark). Also the diversified fixed-interest mandate underperformed against its universe in 2003, but outperformed against its own benchmark (2002 – the diversified fixed-interest mandate outperformed against its universe but underperformed against its benchmark). For equity investments, the North American equities mandate outperformed significantly against both its universe and benchmark; however, the European equities mandate underperformed against both comparisons (2002 – overall North American and European equities mandates underperformed against both their universes and benchmarks, but several managers within the mandates were liquidated during 2002 and only one manager remained from each mandate in 2003).

**Table 8: Portfolio Performance Compared with Manager Universe for Year 2003**

| Type of Mandate | Number of Managers in the Universe | Return-% in USD terms[1] | | | | |
|---|---|---|---|---|---|---|
| | | Median Universe Performance | IFAD Investment Portfolio | IFAD Benchmark | IFAD Out/(Under) Performance against Universe | IFAD Out/(Under) Performance against Benchmark |
| Government bonds[2] | 34 | 17.1 | 16.5 | 15.3 | (0.6) | 1.2 |
| Diversified fixed-interest[3] | 171 | 5.3 | 3.6 | 3.0 | (1.7) | 0.6 |
| Inflation-indexed bonds[4] | n/a | n/a | n/a | n/a | n/a | n/a |
| North American equities[5] | 148 | 26.1 | 31.1 | 26.4 | 5.0 | 4.7 |
| European equities[6] | 59 | 38.1 | 30.9 | 34.8 | (7.2) | (3.9) |

1 The differences between returns on IFAD's investment portfolio and its benchmark in this table compared with those in other tables in this report are due to movements on exchange rates.
2 Universe performance comparison for global government bonds is the Russell global fixed unhedged universe, which comprises 34 discretionary separate accounts, commingled funds and mutual funds managed for United States dollar-oriented investors. The universe portfolios are managed against a global unhedged benchmark in United States dollars and have no significant currency or bond-market restrictions.
3 Universe performance comparison for diversified fixed-interest is the Northern Trust core fixed-income manager universe, which comprises 171 managers invested primarily in United States fixed income of investment grade quality.
4 Currently no manager universe is available for inflation-indexed bonds. Also, IFAD’s mandate for inflation-indexed bonds was not funded for the full calendar year, but as of 27 June 2003.
5 Universe performance comparison for North American equities is the Northern Trust large cap core equity universe, which comprises 148 managers.
6 Universe performance comparison for European equities is the Russell European equity manager universe, which comprises 59 managers.

## VIII. COMPOSITION OF THE PORTFOLIO

### Composition of the Portfolio by Instrument

43. An analysis by the type of instruments found in each of the two main sections of the investment portfolio, i.e. fixed-interest and equity investments, is shown in Table 9. A more detailed analysis of the fixed-interest portfolio is found in Annex IX.

**Table 9: Composition of the Portfolio by Type of Mandate and by Instrument at 31 December 2003**
(USD '000 equivalent)

| | Total Fixed-Interest Portfolio 31.12.2003 | Total Equities Portfolio 31.12.2003 | Overall Portfolio 31.12.2003 | Overall Portfolio 31.12.2002[c] |
|---|---|---|---|---|
| Cash[a] | 241 612 | 2 400 | 244 012 | 322 289 |
| Time deposits and other obligations of banks[b] | 233 244 | – | 233 244 | 383 993 |
| Global government bonds | 1 453 997 | – | 1 453 997 | 1 023 394 |
| Mortgage-backed securities | 256 426 | – | 256 426 | 317 012 |
| Asset-backed securities | 88 510 | – | 88 510 | 56 718 |
| Corporate bonds | 22 061 | – | 22 061 | 32 275 |
| Equities | – | 253 306 | 253 306 | 195 378 |
| Unrealized market value gain/(loss) on forward contracts | 191 | – | 191 | (77) |
| Futures | 3 936 | – | 3 936 | 1 916 |
| Options | (350) | – | (350) | (226) |
| **Subtotal cash and investments** | **2 299 627** | **255 706** | **2 555 333** | **2 332 672** |
| Receivables for investments sold | 29 628 | 1 805 | 31 433 | 78 047 |
| Payables for investments purchased | (228 420) | (1 425) | (229 845) | (316 726) |
| **Total** | **2 100 835** | **256 086** | **2 356 921** | **2 093 993** |

[a] Includes cash in non-convertible currencies amounting to USD 394 000 equivalent (2002 – USD 355 000).
[b] Includes time deposits in non-convertible currencies amounting to USD 400 000 equivalent (2002 – USD 397 000).
[c] Restated in line with the Financial Statements for year 2003. Accordingly, accrued interest, dividend receivables and cash held by derivatives broker have been included with fixed-interest investments, equities and futures respectively.

## Composition of the Portfolio by Currency

44. The majority of IFAD's commitments are expressed in Special Drawing Rights. Consequently, the Fund's overall assets are maintained in such a way as to ensure that commitments for undisbursed loans and grants denominated in SDRs are matched, to the extent possible, by assets denominated in the currencies and in the ratios of the SDR valuation basket. Similarly, the General Reserve and commitments for grants denominated in United States dollars are matched by assets denominated in the same currency.

45. 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 which percentage weight should apply to each currency at the date of the reweighting of the basket.

46. New units for each of the four currencies comprising the valuation basket were determined on 29 December 2000 in such a way that the value of the SDR was precisely USD 1.30291 in terms of both the old and the new units, which became effective on 1 January 2001. The units applicable, together with their weights as of 1 January 2001 and 31 December 2003, are shown in Table 10.

**Table 10: Units and Weights Applicable to the SDR Valuation Basket**

| | 1 January 2001 | | 31 December 2003 | |
|---|---|---|---|---|
| **Currency** | **Units** | **Percentage Weight** | **Units** | **Percentage Weight** |
| USD | 0.577 | 44.3 | 0.577 | 38.8 |
| EUR | 0.426 | 30.4 | 0.426 | 36.1 |
| JPY | 21.000 | 14.0 | 21.000 | 13.2 |
| GBP | 0.0984 | 11.3 | 0.0984 | 11.9 |
| **Total** | | **100.0** | | **100.0** |

47. As at 31 December 2003, assets in the form of cash, investments, promissory notes and amounts receivable from contributors under the Fourth, Fifth and Sixth Replenishments amounted to USD 2 817 778 000 equivalent, as indicated in Table 11 (compared with USD 2 662 193 000 equivalent at 31 December 2002).

**Table 11: Currency Composition of Assets at 31 December 2003**
(USD '000 equivalent)

| Currency Group | Cash and Investments[a] | Promissory Notes[a] | Amounts Receivable from Contributors | Total |
|---|---|---|---|---|
| USD | 945 755 | 31 003 | 87 882 | 1 064 640 |
| EUR | 670 675 | 64 593 | 79 838 | 815 106 |
| JPY | 360 775 | – | – | 360 775 |
| GBP | 279 472 | 11 811 | 30 488 | 321 771 |
| Other | 99 450 | 75 479 | 80 557 | 255 486 |
| **Total** | **2 356 127** | **182 886** | **278 765** | **2 817 778** |

[a] Includes assets in freely convertible currencies. The excluded assets in non-convertible currencies amounted to USD 794 000 equivalent for cash and investments and USD 1 399 000 equivalent for promissory notes.

48. Holdings of assets denominated in currencies not included in the SDR valuation basket amounted to USD 255 486 000 equivalent at 31 December 2003 (compared with USD 169 996 000 equivalent at 31 December 2002). These are allocated to currency groups as indicated in Table 12.

**Table 12: Allocation of Assets to Currency Groups at 31 December 2003**
(USD '000 equivalent)

| Currency Group | Currencies Included in SDR Basket | European Currencies not Included in the SDR Valuation Basket | Other Currencies not Included in the SDR Valuation Basket | Total Currencies per Group |
|---|---|---|---|---|
| USD | 1 064 640 | – | 90 804 | 1 155 444 |
| EUR | 815 106 | 164 682 | – | 979 788 |
| JPY | 360 775 | – | – | 360 775 |
| GBP | 321 771 | – | – | 321 771 |
| **Total** | **2 562 292** | **164 682** | **90 804** | **2 817 778** |

49. The alignment of assets by currency group against the SDR valuation basket at 31 December 2003 is shown in Table 13. The balance of the General Reserve at 31 December 2003 and the commitment for grants denominated in United States dollars on the same date amounted to USD 95 000 000 and USD 57 124 000 respectively.

**Table 13: Alignment of Assets per Currency Group with the Currency Composition of the SDR Valuation Basket at 31 December 2003**
(USD '000 equivalent)

| Currency Group | Amount per Currency Group | Less: Commitment Denominated in USD | Net Assets per Currency Group | Net Assets as a Percentage at 31.12.2003 | Compare SDR Weights as a Percentage at 31.12.2003 |
|---|---|---|---|---|---|
| USD | 1 155 444 | (152 124) | 1 003 320 | 37.6 | 38.8 |
| EUR | 979 788 | – | 979 788 | 36.8 | 36.1 |
| JPY | 360 775 | – | 360 775 | 13.5 | 13.2 |
| GBP | 321 771 | – | 321 771 | 12.1 | 11.9 |
| **Total** | **2 817 778** | **(152 124)** | **2 665 654** | **100.0** | **100.0** |

50. As at 31 December 2003, there was a shortfall in the USD currency group holdings, which was offset by some excess of euro currency group holdings, Japanese yen and British pound sterling. The currency deviations were the result of government bond managers' underweighting of United States dollar currency group holdings against mainly euro currency group holdings and Japanese yen.

**Maturity of Investments**

51. Table 14 provides details of the composition of the overall investment portfolio by maturity as at 31 December 2003 and compares this to the maturity composition at 31 December 2002. The average life to maturity at 31 December 2003 was seven years and 11 months (31 December 2002 – ten years and nine months). The decrease in the overall, average maturity of the investment portfolio in 2003 was due to the government bonds portfolio whose duration IFAD had shortened by the end of September 2003 in order to reduce its exposure to potential losses in the event of rising interest rates.

**Table 14: Composition of the Investment Portfolio by Maturity of Investments**

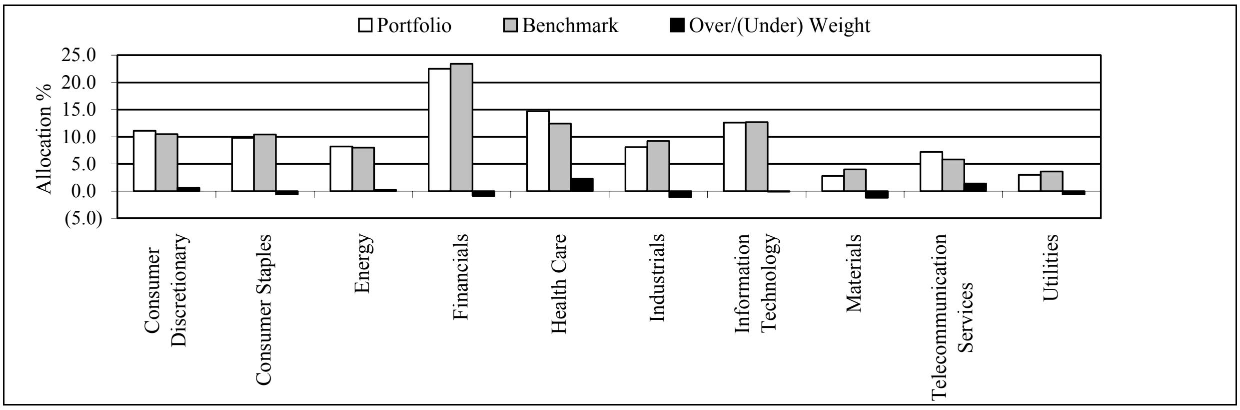
| Period | 31 December 2003 | | 31 December 2002 | |
|---|---|---|---|---|
| | Amount USD '000 Equivalent | % | Amount USD '000 Equivalent | % |
| Due in one year or less | 398 593 | 17.0 | 508 462 | 24.4 |
| Due after one year through five years | 1 032 801 | 43.8 | 450 615 | 21.5 |
| Due from five to ten years | 268 688 | 11.4 | 373 420 | 17.8 |
| Due after ten years | 403 840 | 17.1 | 566 313 | 27.0 |
| No fixed maturity[a] | 252 999 | 10.7 | 195 183 | 9.3 |
| **Total** | **2 356 921** | **100.0** | **2 093 993** | **100.0** |

[a] Equities excluding dividend receivables amounting to USD 307 000 equivalent that are due in one year.

**Sector Allocation of the Equities Portfolio**

52. Figure 1 shows the sector allocation by industry of the total equities portfolio at 31 December 2003 and also compares this allocation to the sector allocation of the aggregate benchmark. The sectors refer to sector classifications applied by the portfolio's two benchmark indices, i.e. Standard & Poor's 500 for North American equities and MSCI for European equities.

**Figure 1: Sector Allocation of the Total Equities Portfolio at 31 December 2003**




53. As illustrated in Figure 1, the three major sectors of the total equities portfolio and its aggregate benchmark were financials, health care and information technology, which together constituted approximately half of both the portfolio and its aggregate benchmark. Other major sectors were consumer discretionary and consumer staples. At 31 December 2003, the overall equities portfolio did not show significant over- or underweights relative to the aggregate benchmark; the biggest sector deviation was a 2.3% overweight in the health care sector.

54. Table 15 shows the sector allocations of the two sub-portfolios, i.e. North American and European equities, and also compares these to the sector allocations of their respective benchmarks.

**Table 15: Sector Allocation of the Equities Portfolio by Sub-Portfolios at 31 December 2003**
(percentage)

| Industry Sector | North American Equities | | | European Equities | | | Total Equities Portfolio | | |
|---|---|---|---|---|---|---|---|---|---|
| | Portfolio | Benchmark | Over/(Under) Weight | Portfolio | Benchmark | Over/(Under) Weight | Portfolio | Benchmark | Over/(Under) Weight |
| Consumer Discretionary | 13.0 | 10.9 | 2.1 | 8.4 | 10.1 | (1.7) | 11.1 | 10.5 | 0.6 |
| Consumer Staples | 8.1 | 11.0 | (2.9) | 12.4 | 9.6 | 2.8 | 9.8 | 10.4 | (0.6) |
| Energy | 5.4 | 5.9 | (0.5) | 12.5 | 11.2 | 1.3 | 8.2 | 8.0 | 0.2 |
| Financials | 20.0 | 20.8 | (0.8) | 26.3 | 27.4 | (1.1) | 22.5 | 23.4 | (0.9) |
| Health Care | 16.3 | 13.5 | 2.8 | 12.2 | 10.8 | 1.4 | 14.7 | 12.4 | 2.3 |
| Industrials | 9.0 | 10.6 | (1.6) | 6.6 | 6.9 | (0.3) | 8.1 | 9.2 | (1.1) |
| Information Technology | 17.9 | 17.8 | 0.1 | 4.4 | 4.6 | (0.2) | 12.6 | 12.7 | (0.1) |
| Materials | 2.8 | 3.1 | (0.3) | 2.9 | 5.5 | (2.6) | 2.8 | 4.0 | (1.2) |
| Telecommunication Services | 4.3 | 3.5 | 0.8 | 11.7 | 9.3 | 2.4 | 7.2 | 5.8 | 1.4 |
| Utilities | 3.2 | 2.9 | 0.3 | 2.6 | 4.6 | (2.0) | 3.0 | 3.6 | (0.6) |
| **Total** | **100.0** | **100.0** | **–** | **100.0** | **100.0** | **–** | **100.0** | **100.0** | **–** |

55. The North American equities portfolio was almost sector-neutral in many sectors at 31 December 2003. The main overweight was in health care (+2.8%), which was offset by an underweight mainly in consumer staples (-2.9%). As noted in Section VII, in 2003 there was a small negative contribution from sector allocation and mainly the overweighting of health care, but this negative allocation impact was well compensated by the manager's superior stock selection within the same sector.

56. The European equities brought its sector allocations more in line with the benchmark in the fourth quarter of 2003. The remaining main overweights were in consumer staples (+2.8%) and telecommunications (+2.4%), which were offset by underweights mainly in materials (-2.6%) and utilities (-2.0%). As noted in Section VII, the portfolio's sector allocation had a smaller, negative impact in 2003.

**Diversification by Country**

57. The diversification of the investment portfolio by developing countries, developed countries and development institutions is shown by type of instrument in Table 16. Due to the AA- credit floor implemented in 2002 for fixed-interest investments and the simultaneous reduction in equity holdings as part of the current investment policy, the allocation to developing countries remained low in 2003. The allocation to fixed-interest investments issued by development institutions was somewhat higher at 31 December 2003 than a year previously, due mainly to IFAD's investment in June 2003 in a placement issued by the European Investment Bank.

**Table 16: Diversification of the Investment Portfolio by Country**
(USD '000 equivalent)

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| **31 December 2003** | | | | | | | |
| | Cash | Time Deposits | Fixed-Interest Securities | Equities[b] | Other Assets | Total | % |
| Latin America and Caribbean | 30 | – | – | – | – | 30 | 0.0 |
| North Africa, Near East | - | 47 942 | – | – | – | 47 942 | 2.1 |
| Sub-saharan Africa | 13 | – | – | – | – | 13 | 0.0 |
| East and South Asia | 351 | 400 | – | – | – | 751 | 0.0 |
| **Subtotal developing countries** | **394** | **48 342** | **–** | **–** | **–** | **48 736** | **2.1** |
| Developed countries | 243 618 | 184 902 | 1 712 794 | 253 306 | (194 635) | 2 199 985 | 93.3 |
| International development institutions | – | | 108 200 | – | – | 108 200 | 4.6 |
| **Total** | **244 012** | **233 244** | **1 820 994** | **253 306** | **(194 635)** | **2 356 921** | **100.0** |
| **31 December 2002[a]** | | | | | | | |
| | Cash | Time Deposits | Fixed-Interest Securities | Equities[b] | Other Assets | Total | % |
| Developing countries | 355 | 50 397 | – | – | – | 50 752 | 2.4 |
| Developed countries | 321 934 | 333 596 | 1 370 118 | 195 378 | (237 066) | 1 983 960 | 94.8 |
| International development institutions | – | – | 59 281 | – | – | 59 281 | 2.8 |
| **Total** | **322 289** | **383 993** | **1 429 399** | **195 378** | **(237 066)** | **2 093 993** | **100.0** |

[a] Restated in line with the Financial Statements for year 2003. Accordingly, accrued interest, dividend receivables and cash held by the derivatives broker have been included with fixed-interest investments, equities and futures (i.e. other assets) respectively.
[b] Equities are aggregated under the region/country of the stock exchange in which they are listed and purchased.

## IX. RISK MEASUREMENT

58. The investment portfolio is subject to fluctuations in returns due to economic and market conditions. Historically, different asset classes have shown different levels of volatility, often referred to as 'risk'. Volatility is measured in terms of standard deviation of returns from their mean. At 31 December 2003, the standard deviation of IFAD's investment portfolio was 2.1%, compared with 2.4% for the investment policy (as against 2.2% for the investment portfolio and 2.9% for the investment policy at 31 December 2002).

59. Value-at-risk (VaR) is the measure of risk that IFAD uses to estimate the maximum amount the portfolio could lose over a three-month time horizon, with a 95% confidence level. Table 17 shows the VaR of IFAD's investment portfolio and policy. At 31 December 2003, both the investment portfolio and the policy showed a lower VaR percentage than at previous year-end, which indicates a risk reduction in 2003 for both the portfolio and the policy. (NB: due to the bigger size of the investment portfolio at 31 December 2003 compared with that at the previous year-end, the portfolio's United States dollar equivalent of the VaR percentage in fact increased somewhat between the year-ends.) The major reason for the risk reduction was IFAD's decision to shorten the duration of its government bonds in the third quarter of 2003. The shortened duration diminished the interest rate sensitivity of both the portfolio and the policy, and thus lessened the possibility of losses.

**Table 17: Value-at-Risk**
(forecast horizon three months, confidence level 95%)

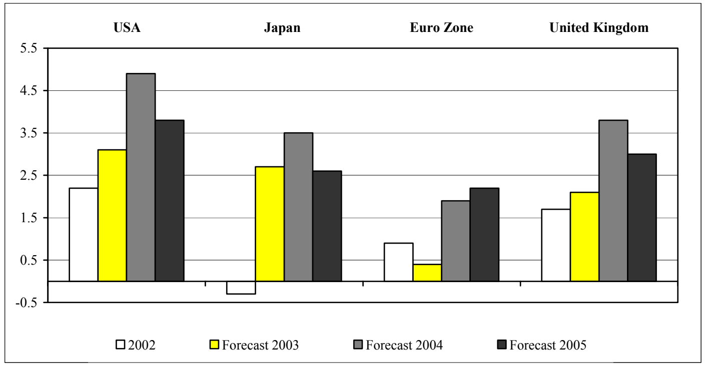
| Date | Investment Portfolio[a] | | Investment Policy[b] | |
|---|---|---|---|---|
| | VaR % | Amount USD '000 | VaR % | Amount USD '000 |
| 31 December 2003 | 1.7 | 40 800 | 2.0 | 46 700 |
| 30 September 2003 | 1.7 | 39 000 | 2.0 | 46 200 |
| 30 June 2003[c] | 2.1 | 46 100 | 2.3 | 51 500 |
| 31 March 2003 | 1.7 | 36 200 | 2.4 | 50 800 |
| 31 December 2002 | 1.8 | 38 100 | 2.4 | 50 300 |
| 30 September 2002 | 2.1 | 42 500 | 2.4 | 49 100 |
| 30 June 2002 | 2.5 | 49 000 | 2.4 | 46 800 |
| 31 March 2002 | 2.9 | 54 700 | 2.4 | 45 700 |
| 31 December 2001 | 5.5 | 105 100 | 6.2 | 119 100 |

[a] The current investment policy was implemented in 2002, with the exception of the asset class of inflation-indexed bonds. Changes in VaR during 2002 reflect the gradual implementation of the current investment policy.
[b] The current investment policy is reflected in the policy VaR as of 31 March 2002, while 31 December 2001 still reflected the VaR of the previous investment policy.
[c] IFAD's transition to its new global custodian took place on 1 April 2003. Variations in VaR between 31 March 2003 and 30 June 2003 therefore reflect some differences in VaR methodologies used by the two different custodians providing risk measurement services on these dates.

60. As also indicated in Table 17, at 31 December 2003 the investment portfolio's VaR remained below the investment policy VaR of the same date, indicating that the portfolio had a lower risk than the policy. The portfolio's lower risk is partially explained by its somewhat higher cash allocation compared with the policy. In addition, all externally managed asset classes within the investment portfolio, i.e. government bonds, diversified fixed-interest, inflation-indexed bonds and equities, showed a lower VaR than the policy. This indicated that in all asset classes, IFAD's external investment managers were taking less risk than implied by their respective benchmark indices.

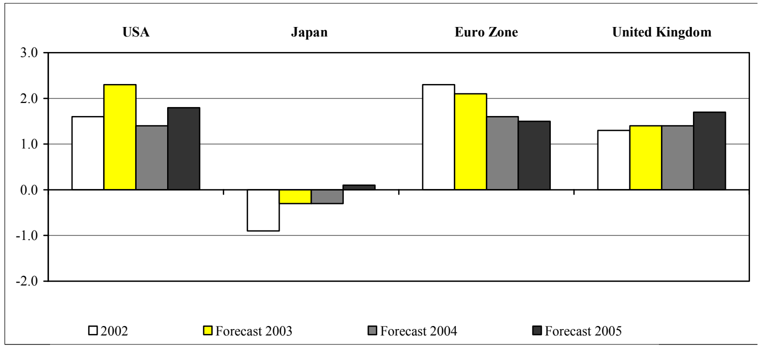
# KEY ECONOMIC INDICATORS

## Figure 1: Percent Change in Real Gross Domestic Product (GDP)



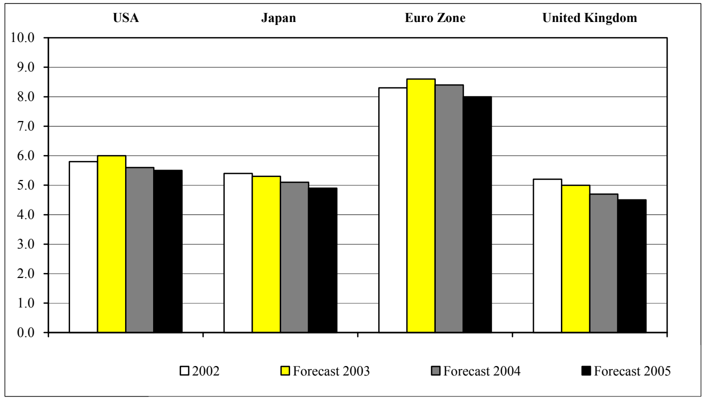

Source: J.P. Morgan ("MorganMarkets" at 29 February 2004)

## Figure 2: Consumer Prices - Annulized Rates



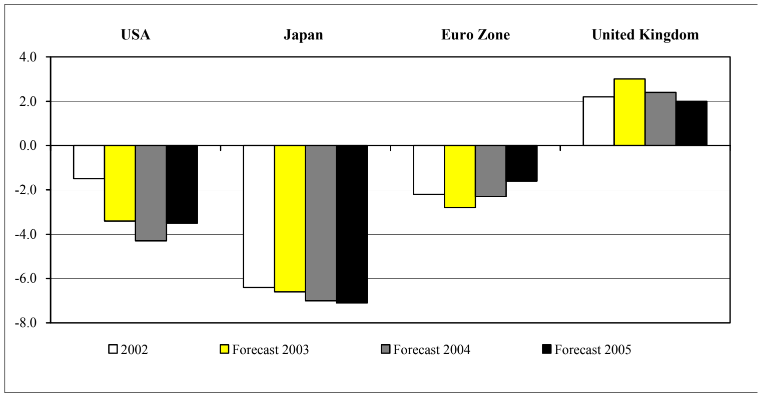

Source: J.P. Morgan ("MorganMarkets" at 29 February 2004)

## Figure 3: Unemployment Rate - Annual Average




Source: J.P. Morgan ("MorganMarkets" at 29 February 2004)

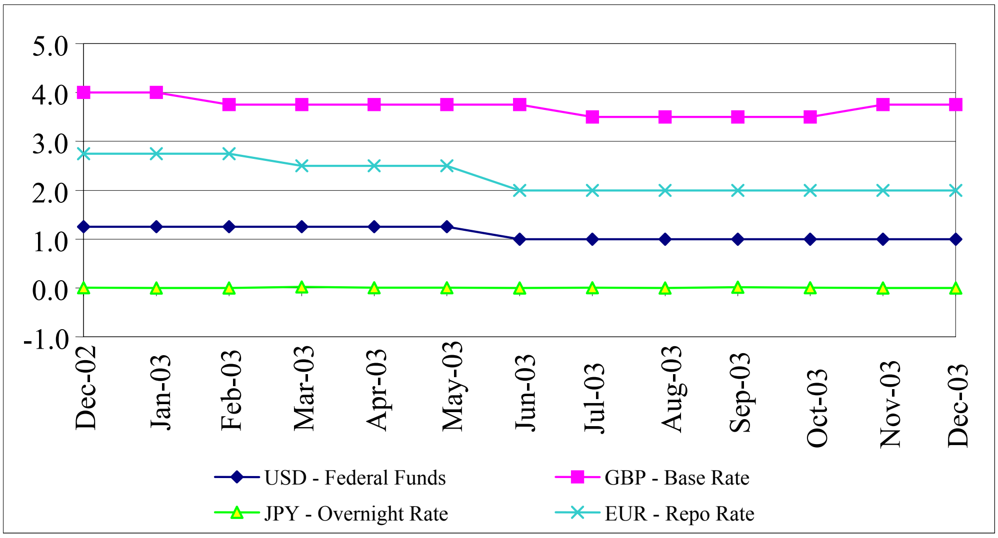
## Figure 4: Budget Deficits and Surpluses - Percentage of GDP




Source: J.P. Morgan ("World Financial Markets" at 10 December 2003)

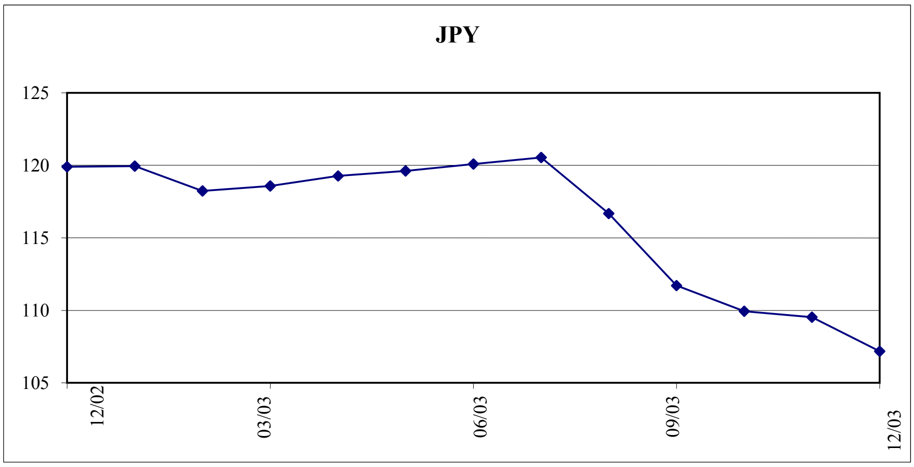
ANNEX II

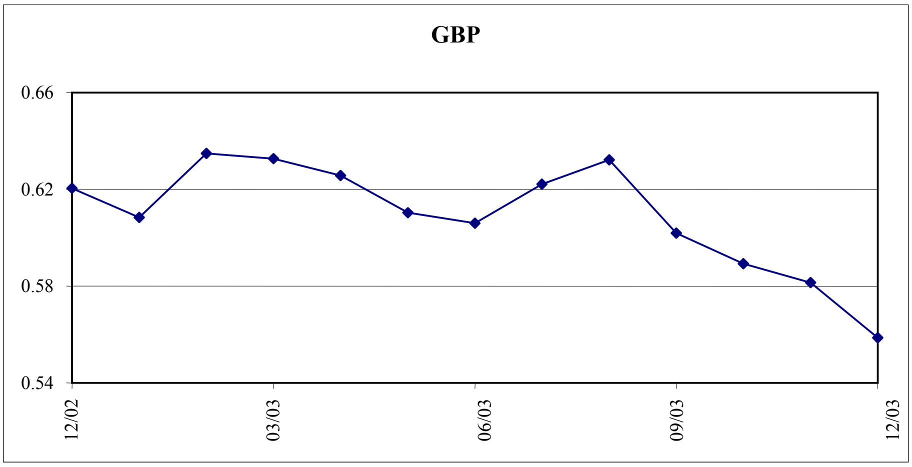
**CENTRAL BANK INTEREST RATES**

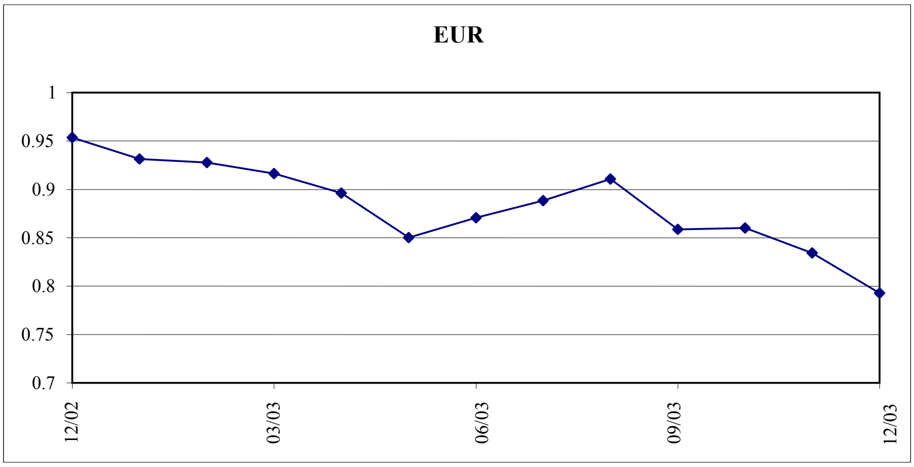



Source: Bloomberg

## VALUE OF THE UNITED STATES DOLLAR AT MONTH-END EXCHANGE RATES



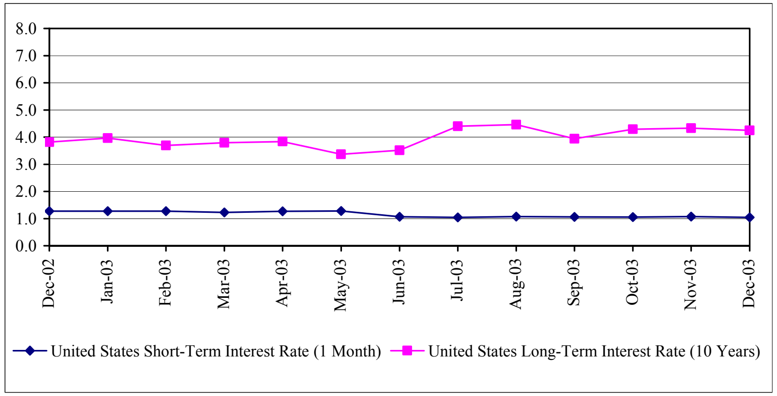



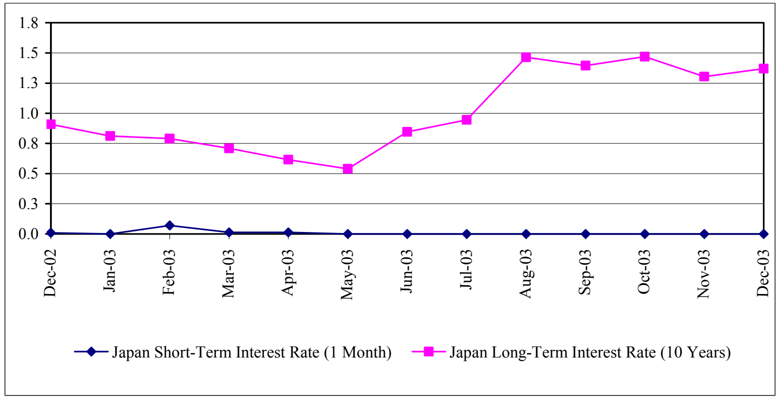

Source: Northern Trust

## SHORT- AND LONG-TERM INTEREST RATES

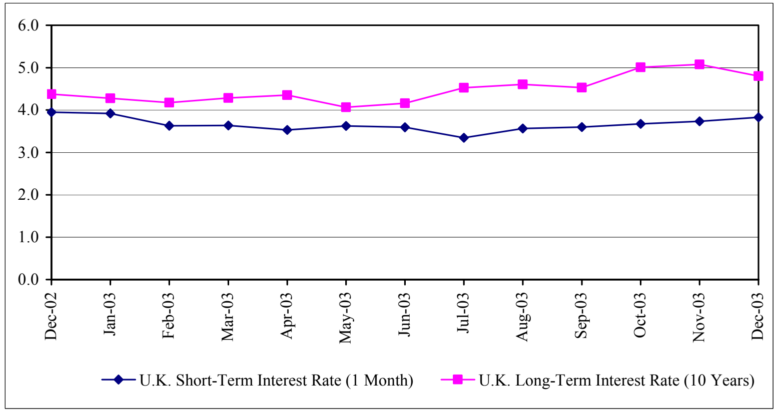
### United States



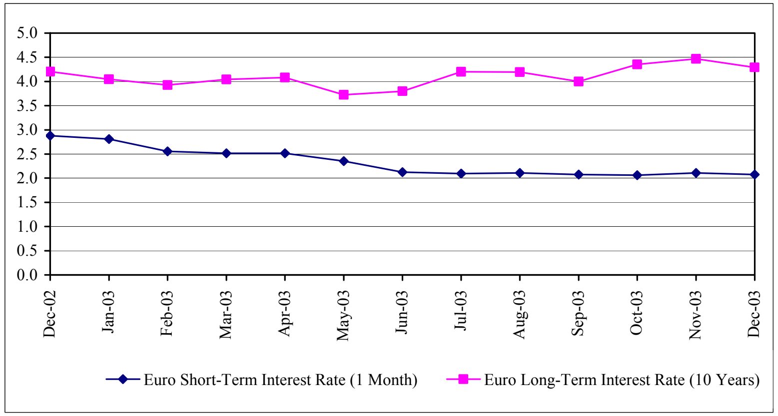

### Japan




### United Kingdom




### Euro Zone




Source: Bloomberg

## GOVERNMENT BOND RETURNS PER COUNTRY INCLUDED IN THE JP MORGAN GLOBAL GOVERNMENT BOND INDEX

(percentage in local currency terms)

| Country | Fourth Quarter 2003[1] | Third Quarter 2003 | Second Quarter 2003 | First Quarter 2003 | Year 2003 | Year 2002 |
|---|---|---|---|---|---|---|
| Australia | 0.52 | (0.47) | 2.36 | 0.65 | 3.08 | 9.59 |
| Belgium | (0.02) | 0.15 | 2.40 | 2.10 | 4.69 | 10.43 |
| Canada | 0.74 | 1.01 | 4.94 | (0.72) | 6.01 | 8.31 |
| Denmark | 0.03 | 0.16 | 2.39 | 1.91 | 4.55 | 9.64 |
| France | (0.03) | 0.21 | 2.11 | 1.82 | 4.15 | 9.68 |
| Germany | 0.02 | 0.32 | 2.11 | 1.72 | 4.22 | 9.31 |
| Italy | 0.05 | 0.02 | 2.41 | 1.80 | 4.33 | 9.75 |
| Japan | 0.52 | (2.13) | (0.45) | 1.09 | (0.99) | 3.38 |
| Netherlands | (0.04) | 0.25 | 2.13 | 1.93 | 4.32 | 9.96 |
| Spain | 0.00 | 0.15 | 2.33 | 2.01 | 4.55 | 10.43 |
| Sweden | 0.11 | 0.20 | 2.98 | 1.68 | 5.04 | 9.05 |
| United Kingdom | 0.36 | (0.84) | 1.47 | 1.47 | 2.46 | 9.11 |
| United States | (0.18) | (0.99) | 2.94 | 1.04 | 2.80 | 12.21 |
| **Total Return[2]** | **0.10** | **(0.59)** | **1.96** | **1.40** | **2.88** | **8.54** |

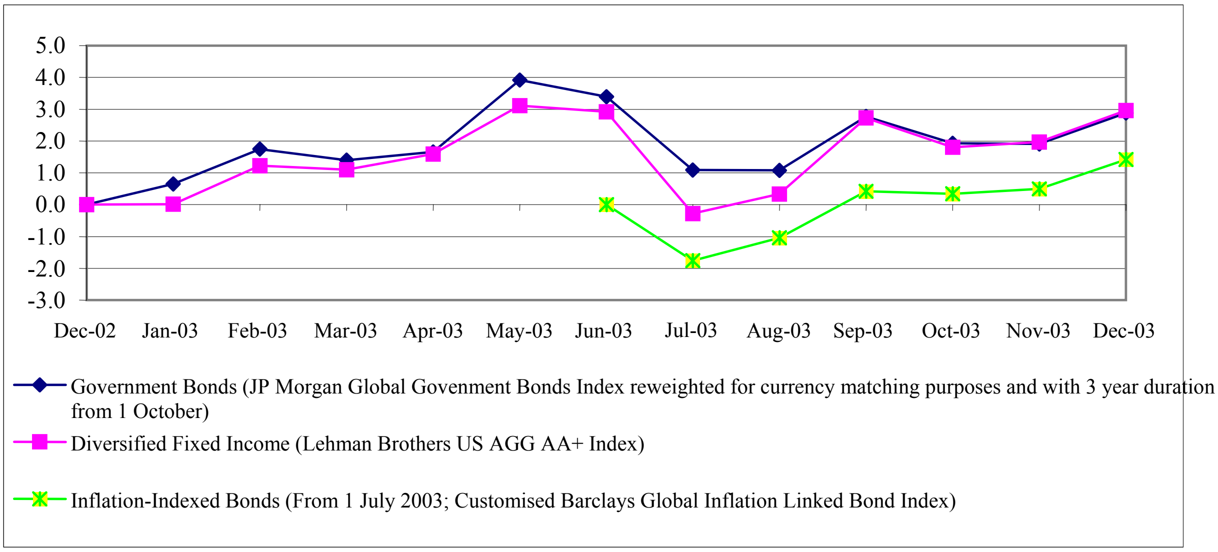
1 The index had a customized duration of approximately three years as of 1 October 2003. Index duration was approximately six years in the first nine months to 30 September 2003.

2 The total return is calculated by applying customized country weights due to IFAD's currency matching needs.

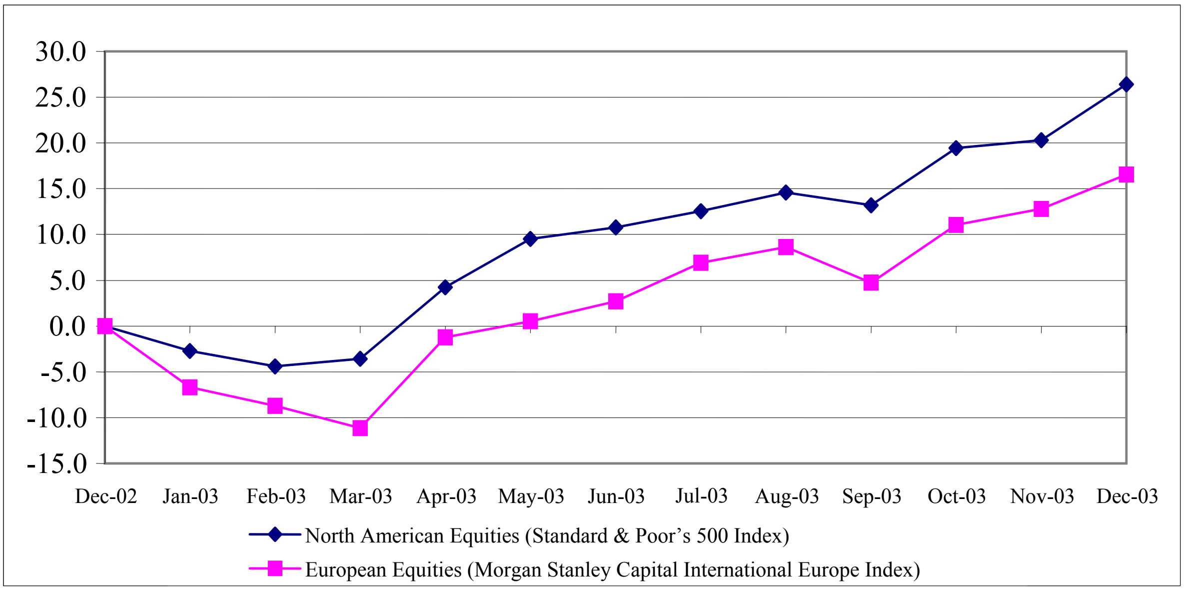
ANNEX VI

**FIXED-INTEREST AND EQUITY MARKET DEVELOPMENT IN 2003**
(percentage in local currency terms)

**Fixed-Interest Markets**




**Equity Markets**




Source: Northern Trust

**SUMMARY OF MOVEMENTS IN CASH AND INVESTMENTS IN THE EQUITIES PORTFOLIO – YEAR 2003**
(USD ’000 equivalent)

| | Emerging Markets Equities[a] | North American Equities | European Equities | Total Equities Portfolio |
|---|---|---|---|---|
| **Opening balance (31 December 2002)** | **5** | **121 411** | **77 844** | **199 260** |
| Net investment income | 32 | 36 528 | 9 878 | 46 438 |
| Transfers due to allocation[b] | (9) | (2 104) | (1 986) | (4 099) |
| Transfers due to expenses/other income | (24) | 783 | 127 | 886 |
| Other net flows | – | – | – | – |
| Movements on exchange | (4) | – | 13 605 | 13 601 |
| **Closing balance (31 December 2003)** | **–** | **156 618** | **99 468** | **256 086** |
| Actual allocation (%) | – | 61.2 | 38.8 | 100.0 |

[a] The portfolio was liquidated in the fourth quarter of 2002. Income and expenses in 2003 refer to transactions that could not be effected in 2002.
[b] Transfers from the equity portfolio reflect the repatriation of dividends.

## GROSS INCOME 1997-2003[a]
(USD ’000 equivalent)

### Overall Portfolio

| | 2003 | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
|---|---|---|---|---|---|---|---|
| Capital gains/(losses) | 38 400 | (35 579) | (106 193) | (117 460) | 105 133 | 76 957 | 41 192 |
| Interest income | 69 938 | 61 541 | 59 241 | 68 819 | 90 253 | 112 668 | 128 779 |
| Dividends | 4 709 | 7 652 | 13 614 | 11 760 | 8 684 | 5 654 | 94 |
| Securities lending and commission recapture | 430 | 436 | 841 | 440 | 539 | 905 | 463 |
| **Total gross income** | **113 477** | **34 050** | **(32 497)** | **(36 441)** | **204 609** | **196 184** | **170 528** |

### Fixed-Interest Portfolio

| | 2003 | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
|---|---|---|---|---|---|---|---|
| Capital gains/(losses) | (4 476) | 55 177 | 2 136 | 31 959 | (121 637) | 104 229 | 50 315 |
| Interest income | 69 932 | 61 241 | 58 356 | 67 228 | 89 333 | 108 773 | 128 779 |
| Dividends | - | - | - | - | 114 | - | - |
| Securities lending and commission recapture | 303 | 113 | 155 | 326 | 424 | 825 | 463 |
| **Total gross income** | **65 759** | **116 531** | **60 647** | **99 513** | **(31 766)** | **213 827** | **179 557** |

### Equities Portfolio

| | 2003 | 2002 | 2001 | 2000 | 1999 | 1998 | 1997 |
|---|---|---|---|---|---|---|---|
| Capital gains/(losses) | 42 876 | (90 756) | (108 329) | (149 419) | 226 770 | (27 272) | (9 123) |
| Interest income | 6 | 284 | 885 | 1 591 | 920 | 3 895 | - |
| Dividends | 4 709 | 7 652 | 13 614 | 11 760 | 8 570 | 5 654 | 94 |
| Securities lending and commission recapture | 127 | 323 | 686 | 114 | 115 | 80 | - |
| **Total gross income** | **47 718** | **(82 497)** | **(93 144)** | **(135 954)** | **236 375** | **(17 643)** | **(9 029)** |

[a] Net investment income earned in prior years 1997 to 2001 reflects the previous investment policy.

ANNEX IX

## COMPOSITION OF THE FIXED-INTEREST PORTFOLIO BY TYPE OF INSTRUMENT AT 31 DECEMBER 2003

(USD ’000 equivalent)

| | **Internally Managed Portfolio** | **Government Bonds Portfolio** | **Diversified Fixed-Interest Portfolio** | **Inflation-Indexed Bonds Portfolio** | **Total Fixed-Interest Portfolio 31.12.2003** |
|---|---|---|---|---|---|
| Cash[a] | 89 570 | 57 631 | 74 448 | 19 963 | 241 612 |
| Time deposits and other obligations of banks [b] | 95 886 | 25 341 | 112 017 | – | 233 244 |
| Global government bonds | – | 1 100 823 | 126 902 | 226 272 | 1 453 997 |
| Mortgage-backed securities | – | – | 256 426 | – | 256 426 |
| Asset-backed securities | – | – | 88 510 | – | 88 510 |
| Corporate bonds | – | – | 22 061 | – | 22 061 |
| Equities | – | – | – | – | – |
| Unrealized market value gain/(loss) on forward contracts | – | 4 358 | (1 395) | (2 772) | 191 |
| Futures | – | 2 680 | 916 | 340 | 3 936 |
| Options | – | – | (350) | – | (350) |
| **Subtotal cash and investments** | **185 456** | **1 190 833** | **679 535** | **243 803** | **2 299 627** |
| Receivables for investment sold | (130) | – | 29 758 | – | 29 628 |
| Payables for investments purchased | – | – | (228 420) | – | (228 420) |
| **Total** | **185 326** | **1 190 833** | **480 873** | **243 803** | **2 100 835** |

[a] Includes cash in non-convertible currencies amounting to USD 394 000 (2002 – USD 355 000).
[b] Includes time deposits in non-convertible currencies amounting to USD 400 000 (2002 – USD 397 000).

# REPORT ON IFAD'S INVESTMENT PORTFOLIO FOR THE FOURTH QUARTER OF 2003

## I. INTRODUCTION

1. The following report on IFAD's investment portfolio covers the three-month period ending 31 December 2003 and includes comparative figures for the year to date and earlier years. The report comprises the following four sections: investment policy, asset allocation, investment income, and rate of return and performance comparison.

## II. INVESTMENT POLICY

2. In the fourth quarter of 2003, there were no changes relating to the investment policy.

3. In the third quarter of 2003, it was decided to shorten the duration of the government bonds portfolio in order to reduce its exposure to potential losses in the event of rising interest rates. Since interest rates rose in the beginning of the quarter, cumulatively at year end the portfolio had benefited by approximately USD 2.6 million on gains from the shortened duration

4. A new financial advisor was selected in October 2003 and the contractual agreement was finalized in February 2004.

## III. ASSET ALLOCATION

5. Table 1 shows the movements affecting the investment portfolio's major asset classes in the fourth quarter of 2003 and compares the portfolio's actual asset allocation to the policy allocation. There were no reallocations between the portfolio's asset classes during the period, besides the normal dividend repatriations from the equities portfolio to the internally managed portfolio, whereby IFAD avoids reinvesting its dividend gains into equities. From the internally managed portfolio, however, there was a net outflow of USD 22 905 000 equivalent, representing disbursements for loans, grants and administrative expenses, less cash receipts and encashments of Member States' contributions.

**Table 1: Summary of Movements in Cash and Investments**
(USD '000 equivalent)

| | Internally Managed Portfolio | Government Bonds Portfolio | Diversified Fixed-Interest | Inflation Indexed Bonds Portfolio | Equities Portfolio | Overall Portfolio |
|---|---|---|---|---|---|---|
| **Opening balance (30 September 2003)** | **196 262** | **1 125 513** | **479 372** | **230 846** | **223 041** | **2 255 034** |
| Net investment income (loss) | 720 | 1 687 | 1171 | 2 128 | 26 410 | 32 116 |
| Transfers due to allocation[a] | 765 | – | – | – | (765) | – |
| Transfers due to expenses | (1 334) | 512 | 433 | 149 | 240 | – |
| Other net flows[b] | (22 905) | – | – | – | – | (22 905) |
| Movements on exchange | 11 818 | 63 121 | (103) | 10 680 | 7 160 | 92 676 |
| **Closing balance (31 December 2003)** | **185 326** | **1 190 833** | **480 873** | **243 803** | **256 086** | **2 356 921** |
| Actual allocation (%) | 7.9 | 50.5 | 20.4 | 10.3 | 10.9 | 100.0 |
| Policy allocation (%) | 5.0 | 44.0 | 23.0 | 18.0 | 10.0 | 100.0 |
| **Difference in allocation (%)** | **2.9** | **6.5** | **(2.6)** | **(7.7)** | **0.9** | **–** |

[a] Transfers from the equity portfolio reflect the repatriation of dividends.
[b] Member States' contributions, less disbursements for loans, grants and administrative expenses.

6. Changes in the portfolio's allocation ratios in the fourth quarter of 2003 also reflected positive movements in investment income, especially in the equities portfolio, and large movements on exchange as other major currencies appreciated strongly against the United States dollar. Particularly the government bonds portfolio increased in value as non-United States dollar investments made up almost 80% of its holdings during the fourth quarter of 2003.

7. The movements in the fourth quarter of 2003 increased the excess allocation to the government bonds portfolio and also created a small excess allocation to the equities portfolio. The excess allocations mainly reflected the fact that the asset class of inflation-indexed bonds had not been fully funded, but also that the diversified fixed-interest portfolio showed an increased shortfall. The diversified fixed-interest portfolio is almost entirely invested in USD-denominated bonds and therefore, unlike the investment portfolio's other asset classes, the market value of the diversified fixed-interest portfolio did not benefit from the positive movements on exchange.

## IV. INVESTMENT INCOME

8. There was an increased certainty about the strength of the global economy, and the consequent equity market rally contributed largely to the fourth quarter's positive investment income. Also fixed-interest markets contributed somewhat positively, with mainly diversified fixed-interest and inflation-indexed bonds gaining as investors had increased incentives to invest in these asset classes.

9. Table 2 shows net investment income for the fourth quarter of 2003, year to date 2003 and earlier years for the investment portfolio's major asset classes. Aggregate net investment income in the fourth quarter of 2003 amounted to USD 32 116 000 equivalent, which, added to the net income of USD 75 846 000 equivalent for the first nine months of 2003, resulted in a cumulative net income of USD 107 962 000 equivalent in 2003 (2002 – USD 26 186 000).

**Table 2: Net Investment Income by Asset Class – Fourth Quarter of 2003 and Prior Periods[a]**
(USD '000 equivalent)

| Portfolio | Fourth Quarter 2003 | Nine Months to 30.9.2003 | 2003 | 2002[b] | 2001 | 2000 | 1999 | 1998 | 1997 |
|---|---|---|---|---|---|---|---|---|---|
| Internally managed portfolio | 720 | 3 366 | 4 086 | 4 098 | 2 050 | 3 654 | 3 114 | 4 834 | 18 633 |
| Government bonds portfolio | 1 687 | 35 048 | 36 735 | 85 541 | 41 471 | 74 625 | (43 977) | 195 506 | 154 228 |
| Diversified fixed-interest portfolio | 1 171 | 14 867 | 16 038 | 22 925 | 13 783 | 17 615 | 3 832 | 6 130 | – |
| Inflation-indexed bonds portfolio | 2 128 | 2 537 | 4 665 | – | – | – | – | – | – |
| Equities portfolio | 26 410 | 20 028 | 46 438 | (86 378) | (100 286) | (143 744) | 231 500 | (18 571) | (8 921) |
| **Overall portfolio** | **32 116** | **75 846** | **107 962** | **26 186** | **(42 982)** | **(47 850)** | **194 469** | **187 899** | **163 940** |

[a] Net investment income earned in prior years 1997 to 2001 reflect the previous investment policy.
[b] Restated in line with the Financial Statements for year 2003. The restatement increased overall net investment income by USD 16 000 equivalent.

10. Table 3 provides details on net investment income earned in the fourth quarter of 2003 by the two main portfolio categories, i.e. fixed-interest and equity investments. A major part (82%) of net investment income stemmed from the equities portfolio.

### Table 3: Net Investment Income of the Overall Portfolio by Main Portfolio Category – Fourth Quarter 2003
(USD ’000 equivalent)

| | Total Fixed-Interest Portfolio | Total Equities Portfolio | Overall Portfolio |
|---|---|---|---|
| Interest from fixed-interest investments and bank accounts | 18 928 | 2 | 18 930 |
| Dividend income from equities | - | 1 032 | 1 032 |
| Realized capital gains | 4 581 | 4 214 | 8 795 |
| Unrealized capital gains (losses) | (16 690) | 21 635 | 4 945 |
| Income from securities lending and commission recapture | 120 | 34 | 154 |
| **Subtotal: gross investment income** | **6 939** | **26 917** | **33 856** |
| Investment manager fees | (1 095) | (292) | (1 387) |
| Custody fees | (150) | (24) | (174) |
| Financial advisory and other investment management fees | (38) | (4) | (42) |
| Taxes | - | (187) | (187) |
| Other investment expenses | 50 | - | 50 |
| **Net investment income** | **5 706** | **26 410** | **32 116** |

11. Table 4 shows the net investment income in the fourth quarter of 2003 from the fixed-interest portfolio’s four sub-portfolios. In aggregate, net investment income from fixed-interest investments amounted to USD 5 706 000 equivalent and all four sub-portfolios contributed positively.

### Table 4: Net Investment Income of the Fixed-Interest Portfolio by Sub-Portfolio – Fourth Quarter 2003
(USD ’000 equivalent)

| | Internally Managed Portfolio | Government Bonds Portfolio | Diversified Fixed-Interest Portfolio | Inflation Indexed Bonds Portfolio | Total Fixed-Interest Portfolio |
|---|---|---|---|---|---|
| Interest from fixed-interest investments and bank accounts | 741 | 13 427 | 3 307 | 1 453 | 18 928 |
| Dividend income from equities | – | – | – | – | – |
| Realized capital gains | – | 2 595 | 1 303 | 683 | 4 581 |
| Unrealized capital gains/(losses) | – | (13 825) | (3 006) | 141 | (16 690) |
| Income from securities lending and commission recapture | – | 91 | 25 | 4 | 120 |
| **Subtotal: gross investment income** | **741** | **2 288** | **1 629** | **2 281** | **6 939** |
| Investment manager fees | – | (552) | (426) | (117) | (1 095) |
| Custody fees | (21) | (35) | (63) | (31) | (150) |
| Financial advisory and other investment management fees | – | (22) | (11) | (5) | (38) |
| Taxes | – | – | – | – | – |
| Other investment expenses | – | 8 | 42 | – | 50 |
| **Net investment income** | **720** | **1 687** | **1 171** | **2 128** | **5 706** |

12. Net investment income in the fourth quarter of 2003 from the two sub-portfolios of the equities portfolio is shown in Table 5. In aggregate, net investment income from equities amounted to USD 26 410 000 equivalent. Both the North American, in particular, and the European equities sub-portfolios contributed positively.

**Table 5: Net Investment Income of the Equities Portfolio by Sub-Portfolio – Fourth Quarter 2003**
(USD ’000 equivalent)

| | North American Equities | European Equities | Total Equities Portfolio |
|---|---|---|---|
| Interest from fixed-interest investments and bank accounts | 1 | 1 | 2 |
| Dividend income from equities | 614 | 418 | 1 032 |
| Realized capital gains/(losses) | 4 366 | (152) | 4 214 |
| Unrealized capital gains/(losses) | 12 974 | 8 661 | 21 635 |
| Income from securities lending and commission recapture | 12 | 22 | 34 |
| **Subtotal: gross investment income** | **17 967** | **8 950** | **26 917** |
| Investment manager fees | (198) | (94) | (292) |
| Custody fees | (18) | (6) | (24) |
| Financial advisory and other investment management fees | (2) | (2) | (4) |
| Taxes | – | (187) | (187) |
| Other investment expenses | – | – | – |
| **Net investment income** | **17 749** | **8 661** | **26 410** |

## IV. RATE OF RETURN AND PERFORMANCE COMPARISON

13. There was an overall positive return of 1.33% in the fourth quarter of 2003, net of investment expenses and movements on exchange. Cumulatively, the overall return for 2003 was 4.90%.

14. The performance of the various mandates of the investment portfolio is measured against preassigned independent benchmarks, indicating the return that would be expected through passive management of defined sectors of the market. The indices used are the JP Morgan customized global government bonds index for government bonds, Lehman Brothers United States aggregate index for diversified fixed-interest bonds, Barclays customized inflation-linked index for the inflation-indexed bonds portfolio, Standard & Poor’s 500 index for North American equities and the Morgan Stanley capital international (MSCI) index for European equities.

15. Table 6 compares the return on each major sub-portfolio with the appropriate benchmark return. The overall portfolio showed an outperformance of 1 basis point in the fourth quarter of 2003, as fixed-interest investments underperformed slightly and equities outperformed.

**Table 6: Performance Compared with Benchmarks – Fourth Quarter and Year 2003**
(percentage in local currency terms)

| | Fourth Quarter 2003 | | | Year 2003 | | |
|---|---|---|---|---|---|---|
| | Rate of Return % | | Out/(Under) | Rate of Return % | | Out/(Under) |
| **Portfolio** | **Portfolio** | **Benchmark** | **Performance** | **Portfolio** | **Benchmark** | **Performance** |
| Internally managed portfolio | 0.46 | 0.46 | 0.00 | 1.61 | 1.61 | 0.00 |
| Government bonds portfolio | 0.03 | 0.10 | (0.07) | 3.31 | 2.88 | 0.43 |
| Diversified fixed-interest portfolio | 0.34 | 0.22 | 0.12 | 3.68 | 2.95 | 0.73 |
| Inflation-indexed bonds portfolio | 0.91 | 0.99 | (0.08) | 2.09 | 1.42 | 0.67 |
| **Total fixed-interest portfolio** | **0.23** | **0.27** | **(0.04)** | **3.20** | **2.69** | **0.51** |
| North American equities portfolio | 12.92 | 11.64 | 1.28 | 31.05 | 26.39 | 4.66 |
| European equities portfolio | 10.23 | 11.27 | (1.04) | 12.55 | 16.53 | (3.98) |
| **Total equities portfolio** | **11.89** | **11.49** | **0.40** | **24.16** | **23.07** | **1.09** |
| **Overall portfolio gross rate of return** | **1.39** | **1.38** | **0.01** | **5.12** | **4.57** | **0.55** |
| **Less expenses** | **(0.06)** | **(0.06)** | **0.00** | **(0.22)** | **(0.22)** | **0.00** |
| **Overall portfolio net rate of return** | **1.33** | **1.32** | **0.01** | **4.90** | **4.35** | **0.55** |

16. The total fixed-interest portfolio returned a positive 0.23% in the fourth quarter of 2003, underperforming its benchmark by 4 basis points. The slight underperformance was due to the government bonds and inflation-indexed bonds portfolios, which both showed a small underperformance, but their underperformance was partially offset by a small outperformance in the diversified fixed-interest portfolio.

17. The total equities portfolio returned a positive 11.89% in the fourth quarter of 2003 and outperformed its aggregated benchmark by 40 basis points. The overall equity outperformance was due to the North American equities portfolio, which outperformed its own benchmark by 128 basis points. As per the past trend, the portfolio’s stock selection was the main contributing factor, while sector allocation only had a smaller, negative impact. The European equities portfolio, however, underperformed against its assigned, standard European equities benchmark by 104 basis points. The portfolio’s investment style, which focuses on quality growth stocks in mostly large capitalization stocks, caused both sector allocation and stock selection to contribute negatively. (NB: The European equities portfolio’s fourth quarter return of 10.23% could be compared to the growth-style MSCI European equities benchmark, which returned 9.90%. The portfolio’s assigned, standard MSCI European equities benchmark returned 11.27%, while the value-style MSCI European equities benchmark returned 12.63%.)