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IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

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REPORT ON IFAD'S INVESTMENT PORTFOLIO FOR 2004

I. INTRODUCTION

1. The following report on IFAD's investment portfolio covers the year ended 31 December 2004 and includes comparative figures for the year ended 31 December 2003 and earlier years. Annex X contains a report on the investment portfolio for the fourth quarter of 2004.

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. In 2004, financial markets were influenced by the rising path of oil prices during most of the year. Fixed-interest markets gained especially in the second part of the year when economic growth had slowed somewhat, partially due to increased oil prices. Equities markets rallied strongly in the last quarter as oil prices then began to decline and investors regained their confidence in future economic expansion.

4. In aggregate, net investment income on IFAD's investment portfolio amounted to USD 108 662 000 equivalent in 2004. This represented an overall net rate of return of 4.54% and an outperformance of 12 basis points against the aggregate benchmark.

5. The fixed-interest portion of the investment portfolio contributed USD 84 876 000 equivalent to the overall net investment income. The income from fixed-interest investments corresponded to a rate of return of 4.15%, which reflected an outperformance of 7 basis points against the aggregate fixed-interest benchmark.

6. The equities portion of the investment portfolio contributed USD 23 786 000 equivalent to the overall net investment income. The income from equities corresponded to a rate of return of 9.76%, which was equivalent to an outperformance of 60 basis points against the aggregate equities benchmark.

7. The amount of the investment portfolio increased from USD 2 356 921 000 equivalent at 31 December 2003 to USD 2 559 975 000 equivalent at the end of 2004. The increase during the year was mainly due to positive movements from investment income and foreign exchange as other major currencies appreciated strongly against the United States dollar.

8. A remaining portion of the inflation-indexed bonds portfolio was funded on 1 June 2004, thereby bringing the portfolio's allocation to inflation-indexed bonds closely in line with the 18% allocation stipulated in the investment policy. Furthermore, the duration of this portfolio was shortened at the time of its additional funding on 1 June 2004. The shorter duration reduces exposure to losses in the event of rising interest rates.

9. As a follow-up to the asset liability management review presented to the Executive Board in December 2003, all external investment managers were requested to be fully hedged against their assigned benchmark in terms of currency weights as of 30 June 2004.

10. The review also contained an action point to further reduce market risk in the investment portfolio by holding a portion of investments until maturity. Following a series of analyses conducted during the third quarter of 2004, it was decided that a held-to-maturity portfolio amounting to USD 400 million would be funded by proceeds from the liquidation of the entire equities portfolio and a portion of the government bonds portfolio. The liquidation of the equities portfolio, together with the funding of the held-to-maturity portfolio, would be implemented in the first quarter of 2005 and would contribute to further reducing the portfolio's volatility.

III. INVESTMENT CONDITIONS

11. This section reviews the economic and financial market background in 2004.

A. Economic Background

12. Annex I shows the development of four key economic indicators: real GDP, consumer prices, unemployment rate, and budget deficits and surpluses. The economic indicators are shown for the countries whose currencies make up the special drawing right (SDR) valuation basket: the euro-zone countries, Japan, the United Kingdom of Great Britain and Northern Ireland, and the United States of America.

13. GDP rates generally rose strongly in 2004 although rising oil prices contributed to an economic slowdown during the second half of the year. Nevertheless, the United States economy accelerated solidly, supported by domestic demand, business investments and strong labour markets. Japan's economy also expanded strongly, depending more on exports and corporate investments as domestic demand remained rather low. Forecasts for both the United States and Japan reflect some slowdown in 2005. The euro zone continued on its more modest growth path, supported mainly by exports due to the accelerating growth in the United States and Asia, although an appreciating euro impacted exports negatively. Euro-zone forecasts for 2005 show broadly unchanged growth. The United Kingdom's economy expanded during 2004 driven by both corporate and governmental spending, but growth is forecast to slow in 2005.

14. In the United States, inflation rose as a consequence of record-high oil prices and higher production prices. Furthermore, continuing economic expansion, rising wage growth and more expensive imports due to a weaker dollar increased consumer prices in 2004. Nevertheless, pressure on price increases is expected to decline in 2005 as the Federal Reserve Bank is likely to continue raising interest rates in order to moderate domestic demand. Consumer prices remained stable in the euro zone due to weak domestic demand, and the strong appreciation of the euro against the dollar helped reduce the effect of rising oil prices. Forecasts for 2005 show falling inflation in the euro zone as consumer spending is foreseen to remain rather weak. Inflation in the United Kingdom declined slightly as the Bank of England raised interest rates, which increased borrowing costs and therefore

helped control spending and inflation. In Japan, inflation is expected to remain slightly negative also in 2005.

15. Unemployment rates fell in Japan, the United Kingdom and the United States. Only the euro zone showed a slightly higher unemployment rate as growth stagnated in the second half of the year and some companies cut jobs amid concerns about the economy because of the strong euro. The forecasts for 2005 show slightly falling unemployment rates in all four areas.

16. In 2004, the budget deficit grew slightly in the United States and Japan, but remained unchanged in the euro zone. While a somewhat reduced deficit is foreseen in 2005 for the United States and the euro zone, Japan's deficit is likely to increase slightly. The United Kingdom, on the other hand, showed a broadly unchanged surplus in 2004, although a smaller surplus is expected for 2005.

17. Annex II shows the evolution of central bank interest rates for the countries whose currencies are included in the SDR valuation basket. The impact of these rates on short-term interest rates and bond markets is further described in paragraphs 19 and 20. The United States Federal Reserve Bank increased the federal funds rate five times in 2004 (in June, August, September, November and December) from 1.00% to 2.25% in order to control spending. The European Central Bank kept its refinancing rate unchanged at 2.00% to support the economy. In the United Kingdom, the Bank of England increased its base rate four times during the year (in February, May, June and August) from 3.75% to 4.75%. The Bank of Japan maintained its target rate at 0% during 2004.

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 2004, the three other currencies, i.e. the Japanese yen, the British pound sterling and, in particular, the euro, appreciated strongly against the dollar as a significant supply of dollars was not fully absorbed by other countries and their currency reserves. The impact of exchange rate movements in 2004 on the investment portfolio is reflected in Table 1 and paragraph 31.

B. Financial Markets Background

19. Annex IV shows the evolution in 2004 of short- and long-term interest rates for the countries whose currencies are included in the SDR valuation basket. Short-term rates increased in the United States and the United Kingdom as a result of the rising central bank rates in these countries. In the euro zone and in Japan, short-term rates remained broadly stable during the year. Long-term interest rates generally rose slightly during the first half of the year, with the exception of the euro zone, and turned downwards in the second half of the year as bond markets regained the attraction of investors due to slower economic growth and lower inflationary pressures.

20. Annex V shows government bond market returns in 2004 for individual countries included in the customized JP Morgan global government bond index. The benchmark index includes both coupon and capital gains and losses, in line with market practice. Only the United States bond market showed a slightly negative return in 2004 as a consequence of rising central bank interest rates and as declining oil prices pushed investors more towards equities markets in the last quarter.

21. Annex VI shows the performance in 2004 of fixed-interest and equities markets where IFAD's investment portfolio was invested during the year. The performance of the fixed-interest market is reflected in the representative benchmark indices used by IFAD for government bonds, diversified fixed-interest bonds and inflation-indexed bonds. Fixed-interest markets performed well in the first quarter of the year due to still low inflation data and slower economic growth than forecast, while in the second quarter expectations of rising interest rates and increasing inflation influenced the markets negatively. Fixed-interest markets recovered during the second part of the year as the economy generally grew at a slower path and inflation remained low. Nevertheless, inflation remained a concern for investors, who continued to increase their investments in inflation-protected bonds, and

therefore returns on inflation-indexed bonds significantly outperformed returns on government bonds and diversified fixed-interest bonds.

22. Equities markets showed a mixed performance in the first half of the year as oil prices reached record-high levels, thereby increasing corporate costs and reducing earnings. However, both European and United States equities markets rallied strongly in the last quarter as oil prices started to decline and investors regained their confidence in the economic expansion.

IV. INVESTMENT POLICY

23. In March 2004, two external investment managers were selected to manage the remaining, unfunded portion of inflation-indexed bonds portfolio. The managers were funded on 1 June 2004 in the total amount of USD 180 million equivalent, previously held in the government bonds portfolio (USD 130 million equivalent) and in the internally managed portfolio (USD 50 million equivalent). The funding brought the portfolio's allocation to inflation-indexed bonds closely in line with the 18% allocation stipulated in the investment policy.

24. Furthermore, the duration of the inflation-indexed bonds portfolio was shortened from approximately eight to six years at the time of its additional funding in order to reduce exposure to losses in the event of rising interest rates.

25. The asset liability management review presented in December 2003 to the Executive Board contained two action points relating to the investment portfolio: deal with the unhedged currency exposures taken by some external investment managers, and reduce the market risk in the investment portfolio by holding a portion of investments until maturity. Accounting rules allow a designated held-to-maturity investment to be accounted for at amortized cost, and therefore a held-to-maturity investment is not impacted by fluctuations in market prices.

26. As a result of the first action point, all external investment managers were requested to be fully hedged against their assigned benchmark in terms of currency weights as of 30 June 2004.

27. With regard to the second action point, the financial impact of the held-to-maturity approach was further analysed during the second half of 2004. It was decided that an amount of USD 400 million would be allocated to the held-to-maturity portfolio. The portfolio will be managed internally and will be invested in high-quality bond instruments with a maximum maturity of five years, with USD 20 million maturing and rolled over every quarter.

28. Different funding scenarios for the held-to-maturity portfolio were analysed with regard to their impact on the investment portfolio's expected risk and return. Following a series of analyses, it was decided to liquidate the entire equities portfolio and a portion of the government bonds portfolio and to invest the proceeds in the held-to-maturity portfolio. The decision to disinvest from equities, together with the implementation of the held-to-maturity portfolio, will contribute to further reducing the portfolio's volatility.

29. The disinvestment from equities and the implementation of the held-to-maturity portfolio would take place in the first quarter of 2005 and be reported on in the Report on IFAD's Investment Portfolio for the First Quarter of 2005, to be tabled at the Eighty-Fourth Session of the Executive Board in April 2005.

V. ASSET ALLOCATION

30. Table 1 shows the movements affecting the investment portfolio's major asset classes in 2004 and compares the portfolio's actual asset allocation with the policy allocation. In June 2004, the funding of the remaining portion of the inflation-indexed bonds portfolio was completed with USD 130 million equivalent being transferred from the government bonds portfolio and USD 50 million equivalent being transferred from the internally managed portfolio. There were no other reallocations between the portfolio's asset classes in 2004, besides the normal dividend repatriations from the equities portfolio to the internally managed portfolio, whereby IFAD avoids reinvesting its dividend gains into equities. Additionally, there was a net inflow of USD 2 911 000 equivalent from Member States' contributions, less disbursements for loans, grants and administrative expenses.

Table 1: Summary of Movements in Cash and Investments – 2004
(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 2003)	**185 326**	**1 190 833**	**480 873**	**243 803**	**256 086**	**2 356 921**
Net investment income	2 701	38 675	22 114	21 386	23 786	108 662
Transfers due to allocation[a]	(44 673)	(130 000)	-	180 000	(5 327)	-
Transfers due to expenses/other income	(5 517)	2 309	1 313	893	1002	-
Other net flows[b]	2 911	-	-	-	-	2 911
Movements on exchange	6 773	53 732	(126)	23 505	7 597	91 481
Closing balance (31 December 2004)	**147 521**	**1 155 549**	**504 174**	**469 587**	**283 144**	**2 559 975**
Actual allocation (%)	5.8	45.1	19.7	18.3	11.1	100.0
Policy allocation (%)	5.0	44.0	23.0	18.0	10.0	100.0
Difference in allocation (%)	**0.8**	**1.1**	**(3.3)**	**0.3**	**1.1**	**-**

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

31. Changes in the portfolio's allocation ratios in 2004 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 and the inflation-indexed bonds portfolios increased in value as non-dollar investments made up about 75% and 95%, respectively, of their average holdings in 2004.

32. As at 31 December 2004, the investment portfolio showed a shortfall in the diversified fixed-interest portfolio as this portfolio is almost entirely invested in bonds denominated in United States dollars and therefore, unlike the investment portfolio's other asset classes, its market value did not gain from the positive movements on exchange. Offsetting, small excess allocations were shown by the portfolio's other asset classes.

33. 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

34. For the year 2004, aggregate net investment income amounted to USD 108 662 000 equivalent (compared with USD 107 962 000 in 2003). Both realized and unrealized security gains and losses are recognized in the period to which they relate and are included in investment income. Table 2 shows net investment income for 2004 and prior years for the investment portfolio's major asset classes.

Table 2: Net Investment Income by Asset Class – 2004 and Prior Years[a]
(USD '000 equivalent)

Portfolio	2004	2003	2002	2001	2000	1999	1998	1997
Internally managed portfolio	2 701	4 086	4 098	2 050	3 654	3 114	4 834	18 633
Government bonds portfolio	38 675	36 735	85 541	41 471	74 625	(43 977)	195 506	154 228
Diversified fixed-interest portfolio	22 114	16 038	22 925	13 783	17 615	3 832	6 130	–
Inflation-indexed bonds portfolio	21 386	4 665	–	–	–	–	–	–
Equities portfolio	23 786	46 438	(86 378)	(100 286)	(143 744)	231 500	(18 571)	(8 921)
Overall portfolio	**108 662**	**107 962**	**26 186**	**(42 982)**	**(47 850)**	**194 469**	**187 899**	**163 940**

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

35. Table 3 provides details on net investment income earned in 2004 by the two main portfolio categories, i.e. fixed-interest and equities investments, together with net investment income for the overall portfolio in 1997 to 2003. Both fixed-interest and equities investments contributed positively to the net investment income in 2004.

Table 3: Net Investment Income of the Overall Portfolio by Main Portfolio Category – 2004 and Prior Years[a]
(USD '000 equivalent)

	2004			2003	2002	2001	2000	1999	1998	1997
	Total Fixed-Interest Portfolio	Total Equities Portfolio	Overall Portfolio	Overall Portfolio	Overall Portfolio	Overall Portfolio	Overall Portfolio	Overall Portfolio	Overall Portfolio	Overall Portfolio
Interest from fixed-interest investments and bank accounts	76 716	52	76 768	69 938	61 541	59 241	68 819	90 253	112 668	128 779
Dividend income from equities	-	6 204	6 204	4 709	7 652	13 614	11 760	8 684	5 654	94
Realized capital gains/ (losses)	11 339	8 932	20 271	42 179	(89 120)	(74 793)	8 264	3 861	40 846	21 535
Unrealized capital gains/ (losses)	1 409	9 849	11 258	(3 779)	53 541	(31 400)	(125 724)	101 272	36 111	19 657
Income from securities lending and commission recapture	597	141	738	430	436	841	440	539	905	463
Subtotal: gross investment income/(loss)	**90 061**	**25 178**	**115 239**	**113 477**	**34 050**	**(32 497)**	**(36 441)**	**204 609**	**196 184**	**170 528**
Investment manager fees	(3 966)	(1 121)	(5 087)	(4 276)	(4 866)	(7 037)	(7 993)	(7 192)	(5 660)	(3 708)
Custody fees	(403)	(82)	(485)	(680)	(1 621)	(2 103)	(2 581)	(1 870)	(1 469)	(1 066)
Financial advisory and other investment management fees	(816)	(105)	(921)	(475)	(791)	(688)	(515)	(508)	(610)	(683)
Taxes		(84)	(84)	(84)	(365)	(606)	(167)	(286)	(129)	(1 131)
Other investment expenses	-	-	-	-	(221)	(51)	(153)	(284)	(417)	-
Net investment income/(loss)	**84 876**	**23 786**	**108 662**	**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.

36. Table 4 shows net investment income in 2004 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 2004 amounted to USD 84 876 000 equivalent. All fixed-interest sub-portfolios contributed positively to income. The government bonds portfolio showed the largest contribution, but also the diversified fixed-interest portfolio as well as the increased investments in inflation-indexed bonds contributed to enhancing the income from fixed-interest investments.

Table 4: Net Investment Income on the Fixed-Interest Portfolio by Sub-Portfolio – 2004
(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	2 663	49 330	14 529	10 194	76 716
Dividend income from equities	-	-	-	-	-
Realized capital gains	111	(6 654)	9 115	8 767	11 339
Unrealized capital gains/(losses)	-	(1 692)	(217)	3 318	1 409
Income from securities lending and commission recapture	-	363	179	55	597
Subtotal: gross investment income	**2 774**	**41 347**	**23 606**	**22 334**	**90 061**
Investment manager fees	-	(2 091)	(1 190)	(685)	(3 966)
Custody fees	(73)	(116)	(98)	(116)	(403)
Financial advisory and other investment management fees	-	(465)	(204)	(147)	(816)
Taxes	-	-	-	-	-
Other investment expenses	-	-	-	-	-
Net investment income	**2 701**	**38 675**	**22 114**	**21 386**	**84 876**

37. Net investment income in 2004 from the two sub-portfolios of the equities portfolio is shown in Table 5. In aggregate, net investment income from equities amounted to USD 23 786 000 equivalent. Both the North American equities sub-portfolio and, to a somewhat lesser extent, the European equities sub-portfolio contributed strongly to income in 2004.

Table 5: Net Investment Income of the Equities Portfolio by Sub-Portfolio – 2004
(USD ’000 equivalent)

	North American Equities	European Equities	Total Equities Portfolio
Interest from fixed-interest investments and bank accounts	39	13	52
Dividend income from equities	3 150	3 054	6 204
Realized capital gains (losses)	8 341	591	8 932
Unrealized capital gains	3 143	6 706	9 849
Income from securities lending and commission recapture	57	84	141
Subtotal: gross investment income	**14 730**	**10 448**	**25 178**
Investment manager fees	(814)	(307)	(1 121)
Custody fees	(57)	(25)	(82)
Financial advisory and other investment management fees	(64)	(41)	(105)
Taxes	-	(84)	(84)
Other investment expenses	-	-	-
Net investment income	**13 795**	**9 991**	**23 786**

38. Annex VIII shows annual gross income from 1997 to 2004 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. As in recent years, most of the income in 2004 stemmed from interest income, and to a lesser extent from capital gains, dividends and other income items.

VII. RATE OF RETURN AND PERFORMANCE COMPARISON

Overall Rate of Return

39. There was an overall positive return of 4.54% in 2004 (compared with a positive 4.90% in 2003), net of investment expenses and movements on exchange. Both fixed-interest and equities investments contributed positively to the overall return in 2004.

Portfolio Performance Compared with Benchmark

40. 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.

41. Table 6 compares the return on each major sub-portfolio with the appropriate benchmark return. The overall portfolio showed an outperformance of 12 basis points in 2004 (compared with an outperformance of 55 basis points in 2003). Both fixed-interest investments and, in particular, equities investments contributed to the outperformance.

Table 6: Performance Compared with Benchmarks – 2004
(percentage in local currency terms)

Portfolio	Rate of Return % Portfolio	Rate of Return % Benchmark	Out/(Under) Performance
Internally managed portfolio	2.12	2.12	0.00
Government bonds portfolio	3.56	3.53	0.03
Diversified fixed-interest portfolio	4.86	4.02	0.84
Inflation-indexed bonds portfolio	6.17	6.80	(0.63)
Total fixed-interest portfolio	**4.15**	**4.08**	**0.07**
North American equities portfolio	9.80	9.00	0.80
European equities portfolio	9.78	9.43	0.35
Total equities portfolio	**9.76**	**9.16**	**0.60**
Overall portfolio gross rate of return	**4.74**	**4.62**	**0.12**
Less expenses	**(0.20)**	**(0.20)**	**0.00**
Overall portfolio net rate of return	**4.54**	**4.42**	**0.12**

42. As indicated in Table 6, the total fixed-interest portfolio returned 4.15% in 2004, which reflected an outperformance of 7 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 3.56%, which reflected a slight outperformance of 3 basis points against its benchmark. The outperformance was due to the investment managers' tactical decision to underweight Japan and the United States, to overweight Europe and to remain neutral in the United Kingdom. This strategy helped to protect the portfolio from the rising yields in the United States and made it possible to take advantage of the bond market rally in Europe. The portfolio was also protected by underweighting Japan, which underperformed the overall benchmark. 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 and benchmarks.

Table 7: Duration of Fixed-Interest Portfolios and Benchmarks

	31 December 2004 (Years)		31 December 2003 (Years)	
	Portfolio	**Benchmark**	**Portfolio**	**Benchmark**
Government bonds	2.8	2.9	2.7	2.9
Diversified fixed-interest	4.3	3.9	4.0	4.0
Inflation-indexed bonds	4.3	5.6	6.9	7.2

- **Diversified fixed-interest portfolio.** The portfolio returned 4.86%, which reflected an outperformance of 84 basis points against its benchmark. Security selection and, to a lesser extent, asset allocation contributed to the investment managers' outperformance. This positive result was mostly generated by the investment managers' selection of government bonds (particularly non-United States fixed-interest bonds). The managers' exposure in mortgages and asset-backed securities instead reduced the outperformance.

- **Inflation-indexed bonds portfolio.** The portfolio returned 6.17%, which reflected an underperformance of 63 basis points against its benchmark. The underperformance was generated mostly by a negative impact from asset allocation, which offset the positive contribution of the managers' bond selection throughout the year. The main negative factors were the overweight positioning in Japan, and underweight in the United Kingdom and Europe.

43. As was also indicated in Table 6, the total equities portfolio returned 9.76% in 2004, which represented an outperformance of 60 basis points compared with the aggregate equities benchmark. The two equity sub-portfolios performed as follows:

- **North American equities portfolio.** The portfolio returned 9.80%, which reflected an outperformance of 80 basis points against its benchmark. The outperformance was generated by both stock selection and sector allocation. The main positive contributors were utilities and energy stocks, sectors where the manager was overweight or neutral. A small negative contribution was generated by consumer discretionary and health care stocks.

- **European equities portfolio.** The portfolio returned 9.78%, which reflected an outperformance of 35 basis points against its benchmark. Compared with its benchmark, the European equities portfolio produced a positive stock selection and, to a lesser extent, also a positive sector allocation. The main positive contributors to this outperformance were consumer staples and telecommunication stocks. A negative contribution came instead from the exposure to consumer discretionary stocks.

Portfolio Performance Compared with Manager Universe

44. Table 8 shows a comparison of the 2004 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.

Table 8: Portfolio Performance Compared with Manager Universe for 2004

Type of Portfolio Mandate	Number of Managers in the Universe	Percentage Return in USD terms[a]				
		Median Universe Performance	IFAD Investment Portfolio	IFAD Benchmark	IFAD Out/(Under) Performance against Universe	IFAD Out/(Under) Performance against Benchmark
Government bonds[b]	31	10.9	9.1	9.2	(1.9)	(0.1)
Diversified fixed-interest[c]	217	4.5	4.8	4.0	0.3	0.8
Inflation-indexed bonds[d]	n/a	n/a	n/a	n/a	n/a	n/a
North American equities[e]	181	10.6	9.5	9.0	(1.1)	0.5
European equities[f]	56	20.3	18.2	17.8	(2.1)	0.4

[a] 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.
[b] Universe performance comparison for government bonds is the Russell global fixed unhedged universe, which comprises 31 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.
[c] Universe performance comparison for diversified fixed-interest is the Northern Trust core fixed-income manager universe, which comprises 217 managers invested primarily in United States fixed income of investment-grade quality.
[d] Currently, no manager universe is available for inflation-indexed bonds.
[e] Universe performance comparison for North American equities is the Northern Trust large cap core equity universe, which comprises 181 managers.
[f] Universe performance comparison for European equities is the Russell European equity manager universe, which comprises 56 managers.

45. As indicated in Table 8, the government bonds portfolio underperformed against its universe and (slightly) against its benchmark in 2004 (in 2003 it had outperformed against its benchmark and slightly underperformed against its universe). The diversified fixed-interest portfolio outperformed against both its universe and its benchmark in 2004 (in 2003 it had underperformed against its universe, but outperformed against its benchmark). For equity investments, the North American and the European equities portfolios underperformed against their universes, but outperformed against their benchmarks (in 2003 the North American equities portfolio had outperformed against its universe and benchmark, while the European equities portfolio had underperformed against both comparisons).

VIII. COMPOSITION OF THE PORTFOLIO

Composition of the Portfolio by Instrument

46. An analysis by the type of instrument found in each of the two main categories of the investment portfolio, i.e. fixed-interest and equities investments, is shown in Table 9. An analysis of the fixed-interest portfolio by its four sub-portfolios is found in Annex IX.

Table 9: Composition of the Portfolio by Type of Instrument at 31 December 2004
(USD '000 equivalent)

	Total Fixed-Interest Portfolio	Total Equities Portfolio	Overall Portfolio	Overall Portfolio at Year-End 2003
Cash[a]	146 695	4 465	151 160	244 012
Time deposits and other obligations of banks[b]	207 111	-	207 111	233 244
Global government bonds	1 694 347	-	1 694 347	1 453 997
Mortgage-backed securities	258 892	-	258 892	256 426
Asset-backed securities	96 436		96 436	88 510
Corporate bonds	37 933	-	37 933	22 061
Equities	-	278 475	278 475	253 306
Unrealized market value gain/(loss) on forward contracts	(854)	(44)	(898)	191
Futures	(1 224)	-	(1 224)	3 936
Options	(59)	-	(59)	(350)
Subtotal: cash and investments	**2 439 277**	**282 896**	**2 722 173**	**2 555 333**
Receivables for investments sold	39 506	670	40 176	31 433
Payables for investments purchased	(201 952)	(422)	(202 374)	(229 845)
Total	**2 276 831**	**283 144**	**2 559 975**	**2 356 921**

[a] Includes cash in non-convertible currencies amounting to USD 332 000 equivalent (compared with USD 394 000 in 2003).
[b] Includes time deposits in non-convertible currencies amounting to USD 386 000 equivalent (compared with USD 400 000 in 2003).

Composition of the Portfolio by Currency

47. 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.

48. 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.

49. 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 2004, are shown in Table 10.

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

	1 January 2001		31 December 2004	
Currency	**Units**	**Percentage Weight**	**Units**	**Percentage Weight**
USD	0.577	44.3	0.577	37.2
EUR	0.426	30.4	0.426	37.4
JPY	21.00	14.0	21.000	13.2
GBP	0.0984	11.3	0.0984	12.2
Total		**100.0**		**100.0**

USD: United States dollar
EUR: euro
JPY: Japanese yen
GBP: British pound sterling

50. As at 31 December 2004, assets in the form of cash, investments, promissory notes and amounts receivable from contributors under the Fourth, Fifth and Sixth Replenishments amounted to USD 3 085 939 000 equivalent, as indicated in Table 11 (compared with USD 2 817 778 000 equivalent at 31 December 2003).

Table 11: Currency Composition of Assets at 31 December 2004
(USD '000 equivalent)

Currency Group	**Cash and Investments**[a]	**Promissory Notes**[a]	**Amounts Receivable from Contributors**	**Total**
USD	1 054 629	80 855	76 283	1 211 767
EUR	733 720	122 429	35 247	891 396
JPY	387 379	8 920	17 839	414 138
GBP	320 708	6 333	63 622	390 663
Other	62 821	49 716	65 438	177 975
Total	**2 559 257**	**268 253**	**258 429**	**3 085 939**

[a] Includes assets in freely convertible currencies. The excluded assets in non-convertible currencies amounted to USD 718 000 equivalent for cash and investments and USD 1 399 000 equivalent for promissory notes.

51. Holdings of assets denominated in currencies not included in the SDR valuation basket amounted to USD 177 975 000 equivalent at 31 December 2004 (compared with USD 255 486 000 equivalent at 31 December 2003). These are allocated to currency groups as indicated in Table 12.

Table 12: Allocation of Assets to Currency Groups at 31 December 2004
(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	1 211 767	–	48 211	1 259 978
EUR	891 396	129 764	–	1 021 160
JPY	414 138	–	–	414 138
GBP	390 663	–	–	390 663
Total	**2 907 964**	**129 764**	**48 211**	**3 085 939**

52. The alignment of assets by currency group against the SDR valuation basket at 31 December 2004 is shown in Table 13. The balance of the General Reserve at 31 December 2004 and the commitment for grants denominated in United States dollars on the same date amounted to USD 95 000 000 and USD 69 149 000, respectively.

Table 13: Alignment of Assets per Currency Group with the Currency Composition of the SDR Valuation Basket at 31 December 2004
(USD '000 equivalent)

Currency Group	Asset Amount	Less: Commitments Denominated in USD	Net Asset Amount	Net Asset Amount as a Percentage at 31 December 2004	Compare SDR Weights as a Percentage at 31 December 2004
USD	1 259 978	(164 149)	1 095 829	37.5	37.2
EUR	1 021 160	–	1 021 160	34.9	37.4
JPY	414 138	–	414 138	14.2	13.2
GBP	390 663	–	390 663	13.4	12.2
Total	**3 085 939**	**(164 149)**	**2 921 790**	**100.0**	**100.0**

53. As at 31 December 2004, there was a shortfall in the euro currency group holdings, which was offset by some excess of Japanese yen and British pound sterling and, to a small extent, of USD currency group holdings. The shortfall in euro currency group holdings was partially due to foreign exchange transactions executed towards year-end for the purpose of loans and grants disbursements. A currency realignment was to be undertaken in the first quarter of 2005, taking into consideration also the implementation of the held-to-maturity portfolio in the same quarter.

Maturity of Investments

54. Table 14 provides details of the composition of the overall investment portfolio by maturity as at 31 December 2004 and compares this with the maturity composition at 31 December 2003. The average life to maturity at 31 December 2004 was seven years compared with seven years and 11 months at 31 December 2003). The decrease in the overall average maturity of the investment portfolio in 2004 was due to the inflation-indexed bonds portfolio for which IFAD shortened its duration in June 2004 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

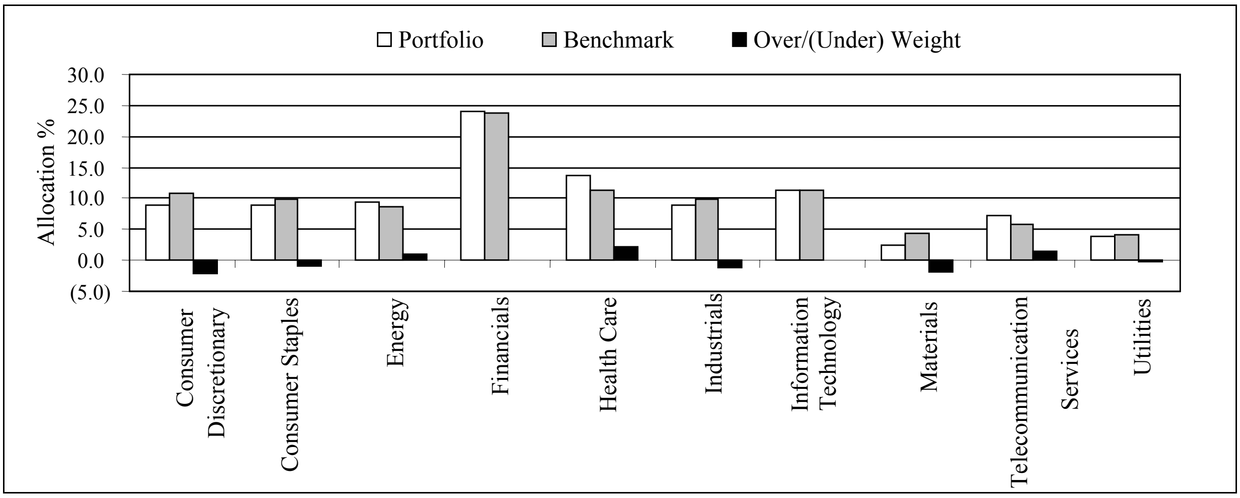
Period	31 December 2004		31 December 2003	
	Amount (USD '000 Equivalent)	%	Amount (USD '000 Equivalent)	%
Due in one year or less	446 029	17.4	398 593	17.0
Due in one year to five years	1 200 969	46.9	1 032 801	43.8
Due in five to ten years	230 875	9.0	268 688	11.4
Due after ten years	403 947	15.8	403 840	17.1
No fixed maturity[a]	278 155	10.9	252 999	10.7
Total	**2 559 975**	**100.0**	**2 356 921**	**100.0**

[a] No fixed maturity refers to equities securities, which here are shown net of dividend receivables amounting to USD 319 000. Table 9 shows the equities holdings amount including dividend receivables.

Sector Allocation of the Equities Portfolio

55. Figure 1 shows the sector allocation by industry of the total equities portfolio at 31 December 2004 and also compares this allocation with 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 2004



56. 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, consumer staples, energy and industrials. At 31 December 2004, the overall

equities portfolio did not show significant over- or underweights relative to the aggregate benchmark; the biggest sector deviation was a 2.2% overweight in the health care sector.

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

Table 15: Sector Allocation of the Equities Portfolio by Sub-Portfolios at 31 December 2004
(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	9.5	11.5	(1.9)	7.8	10.0	(2.1)	8.8	10.9	(2.1)
Consumer staples	8.8	10.6	(1.7)	9.4	9.0	0.4	9.0	9.9	(0.9)
Energy	6.6	7.1	(0.4)	13.6	11.0	2.7	9.5	8.6	0.9
Financials	20.5	20.8	(0.3)	28.8	28.1	0.7	23.9	23.8	0.1
Health care	14.4	12.8	1.6	12.6	9.4	3.2	13.6	11.4	2.2
Industrials	9.8	11.6	(1.7)	7.4	7.5	(0.2)	8.8	9.9	(1.1)
Information technology	17.0	16.1	0.8	2.7	4.1	(1.3)	11.2	11.2	0.0
Materials	3.0	3.2	(0.1)	1.6	6.2	(4.6)	2.5	4.4	(1.9)
Telecommunication services	4.4	3.3	1.1	11.5	9.5	2.1	7.3	5.8	1.5
Utilities	3.8	3.2	0.6	3.8	5.4	(1.6)	3.8	4.1	(0.3)
Cash	2.1	0.0	2.1	0.8	0.0	0.8	1.6	0.0	1.6
Total	**100.0**	**100.0**	**0.0**	**0.8**	**0.0**	**0.8**	**1.6**	**0.0**	**1.6**

58. The North American equities portfolio was almost sector-neutral in many sectors at 31 December 2004. The main overweight was in health care (+1.6%) and telecommunication services (+1.1%), which was offset by an underweight mainly in consumer discretionary (-1.9%), consumer staples (-1.7%) and industrials (-1.7%).

59. The European equities portfolio showed sector allocations that, in the fourth quarter of 2004, deviated slightly more from its benchmark. The main overweights were in health care (+3.2%), energy (+2.7%) and telecommunication services (+2.1%), which were offset by underweights mainly in materials (-4.6%), consumer discretionary (-2.1%) and utilities (-1.6%).

Diversification by Country

60. The diversification of the investment portfolio by developing countries, developed countries and development institutions is shown by type of instrument in Table 16. Allocations remained essentially unchanged compared with year-end 2003. The allocation to developing countries remained low due to the AA- credit floor implemented in 2002 for fixed-interest investments. The allocation to fixed-interest investments issued by developed countries increased slightly in 2004 due to the additional funding of the inflation-indexed bonds portfolio being partially undertaken with amounts previously held in time deposits also with developing countries. The allocation to fixed-interest investments issued by development institutions increased slightly compared with year-end 2003.

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

31 December 2004							
	Cash	Time Deposits	Fixed-Interest Securities	Equities[a]	Other Assets	Total	%
Latin America and the Caribbean		-	-	-	-	-	-
North Africa and the Near East	-	25 453	-	-	-	25 453	1.0
Sub-Saharan Africa		-	-	-	-	-	-
East and South Asia	332	386	-	-	-	718	0.0
Subtotal: developing countries	**332**	**25 839**	**-**	**-**	**-**	**26 171**	**1.0**
Developed countries	150 828	181 272	1 967 395	278 475	(164 379)	2 413 591	94.3
International development institutions	-	-	120 213	-	-	120 213	4.7
Total	**151 160**	**207 111**	**2 087 608**	**278 475**	**(164 379)**	**2 559 975**	**100.0**
31 December 2003							
	Cash	Time Deposits	Fixed-Interest Securities	Equities[a]	Other Assets	Total	%
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

[a] Equities are aggregated under the region/country of the stock exchange in which they are listed and purchased.

IX. RISK MEASUREMENT

61. 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 2004, the standard deviation of IFAD’s investment portfolio was 1.8%, compared with 2.0% for the investment policy (as against 2.1% for the investment portfolio and 2.4% for the investment policy at 31 December 2003).

62. Value-at-Risk (VaR) is the measure of risk that IFAD uses to estimate the maximum amount the portfolio could lose in value 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 2004, both the investment portfolio and the policy showed a lower VaR percentage than at previous year-end, which indicates a risk reduction in 2004 for both the portfolio and the policy. This was essentially due to the shortened duration in the inflation-indexed portfolio, which reduced the possibility of losses in the event of rising interest rates, but it also reflected the slightly lower volatility recently exhibited by the financial markets.

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

	Investment Portfolio		Investment Policy	
Date	VaR (%)	Amount (USD '000)	VaR (%)	Amount (USD '000)
31 December 2004	1.5	38 400	1.7	43 500
30 September 2004	1.5	36 900	1.7	40 700
30 June 2004	1.8	41 600	1.9	43 900
31 March 2004	1.7	40 400	2.0	48 200
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[a]	2.1	46 100	2.3	51 500
31 March 2003	1.7	36 200	2.4	50 800
31 December 2002[b]	1.8	38 100	2.4	50 300
30 September 2002[b]	2.1	42 500	2.4	49 100
30 June 2002[b]	2.5	49 000	2.4	46 800
31 March 2002[b]	2.9	54 700	2.4	45 700
31 December 2001	5.5	105 100	6.2	119 100

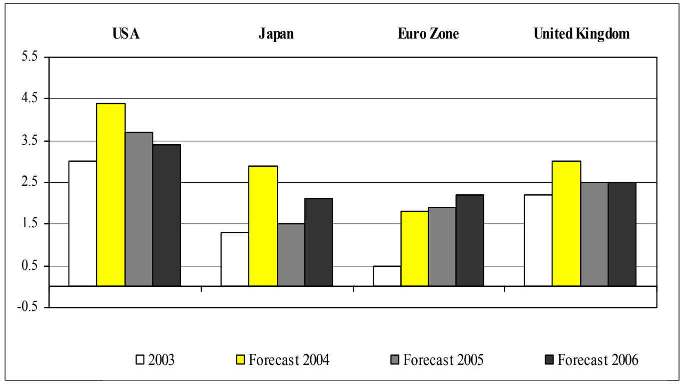
[a] IFAD's transition to its new global custodian took place on 1 April 2003. Variations in VaR between 31 March 2003 and 30 June 2003 therefore reflect some differences in VaR methodologies used by the two different custodians providing risk measurement services on those dates.

[b] The current investment policy was fully implemented in 2002, with the exception of the asset class of inflation-indexed bonds. Changes in the *investment portfolio* VaR during 2002 reflect the gradual implementation of the current investment policy. The *investment policy* VaR reflects the current investment policy as of 31 March 2002.

63. As also indicated in Table 17, at 31 December 2004 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 slightly 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 or very similar VaR compared with the policy VaR. This indicated that IFAD's external investment managers were taking a lower or similar level of risk compared with their respective benchmark indices.

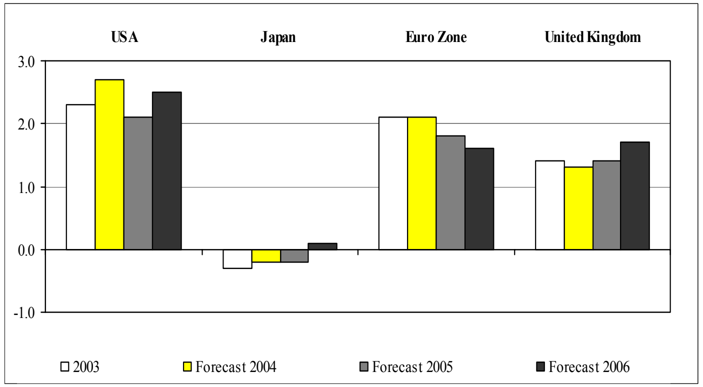
KEY ECONOMIC INDICATORS

Figure 1: Percent Change in Real GDP



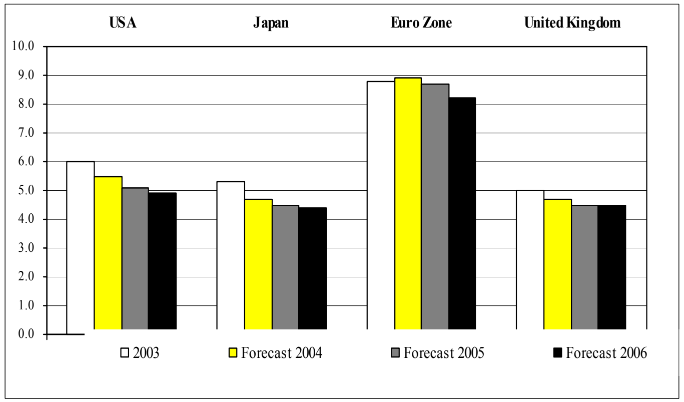
Source: J.P. Morgan ("MorganMarkets" at 15 December 2004)

Figure 2: Consumer Prices - Annulized Rates



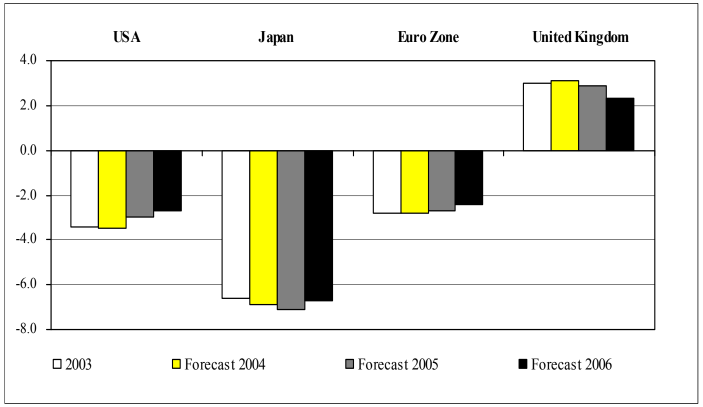
Source: J.P. Morgan ("MorganMarkets" at 15 December 2004)

Figure 3: Unemployment Rate - Annual Average



Source: J.P. Morgan ("MorganMarkets" at 15 December 2004)

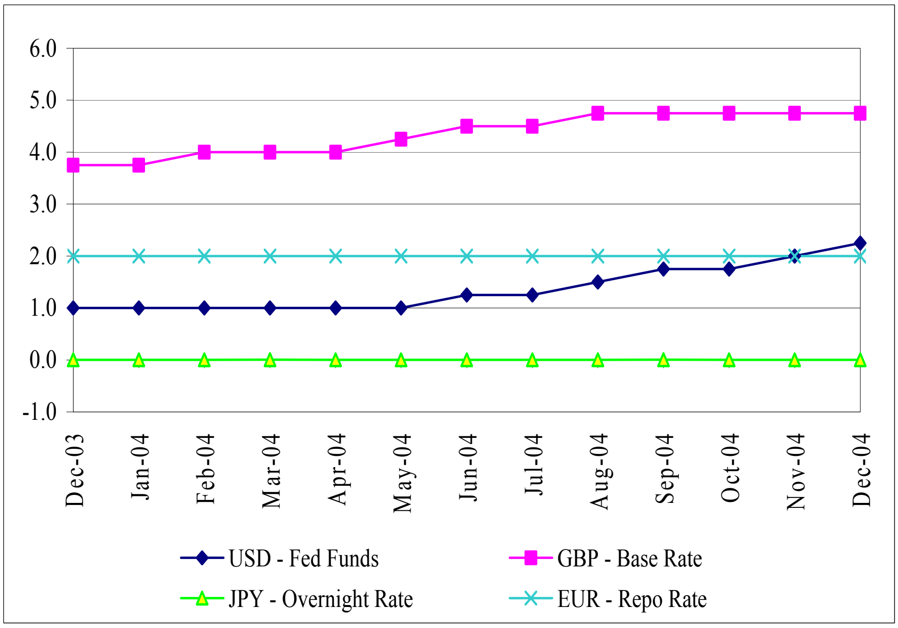
Figure 4: Budget Deficits and Surpluses as Percent of GDP



Source: J.P. Morgan ("World Financial Markets" at 15 December 2004)

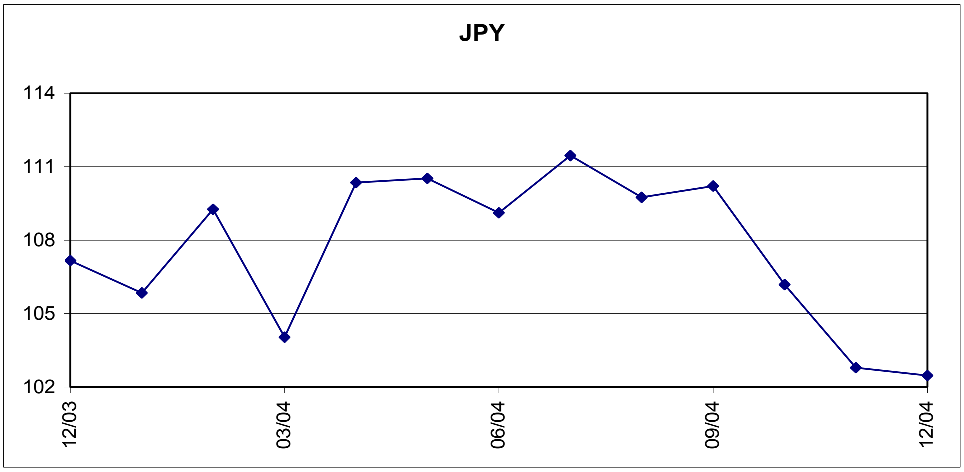
ANNEX II

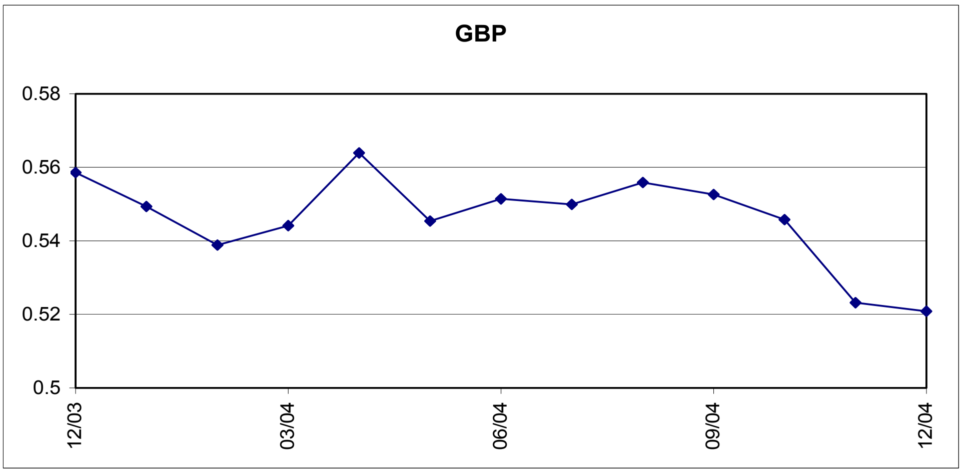
CENTRAL BANK INTEREST RATES

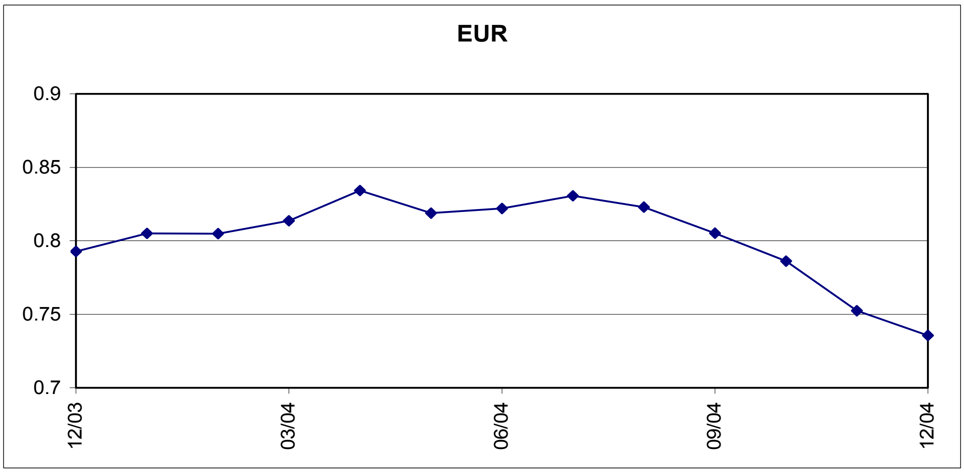


Source: Bloomberg

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



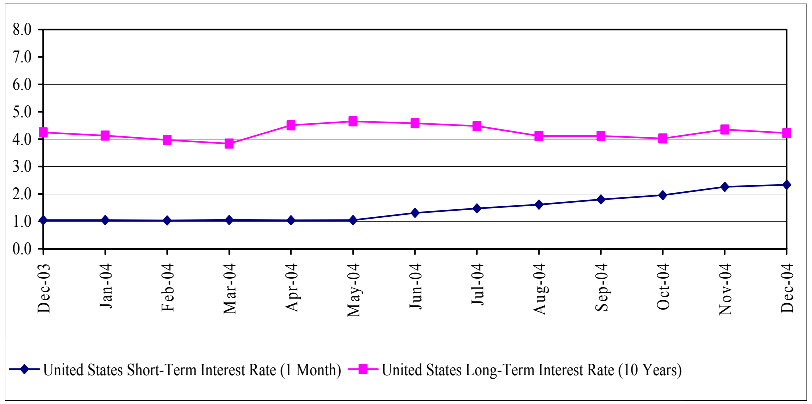




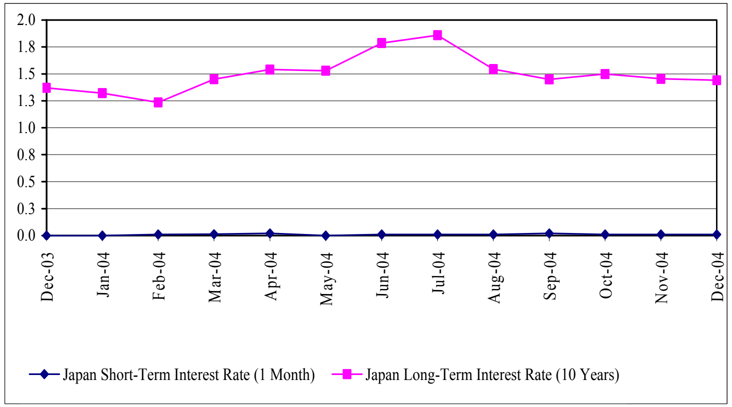
Source: Northern Trust

SHORT- AND LONG-TERM INTEREST RATES

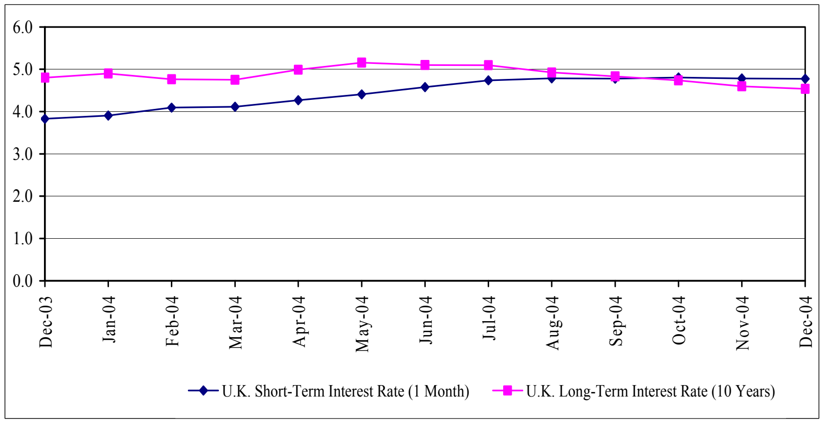
United States



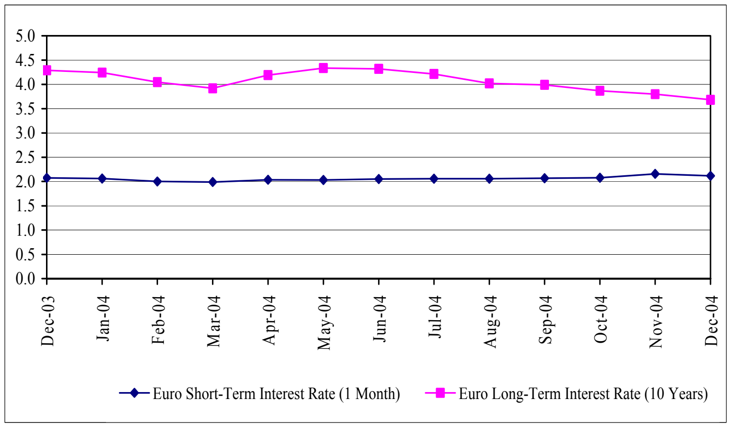
Japan



United Kingdom



Euro Zone



Source: Bloomberg

ANNEX V

GOVERNMENT BOND RETURNS PER COUNTRY INCLUDED IN THE CUSTOMIZED JP MORGAN GLOBAL GOVERNMENT BOND INDEX[1]

(percentage in local currency terms)

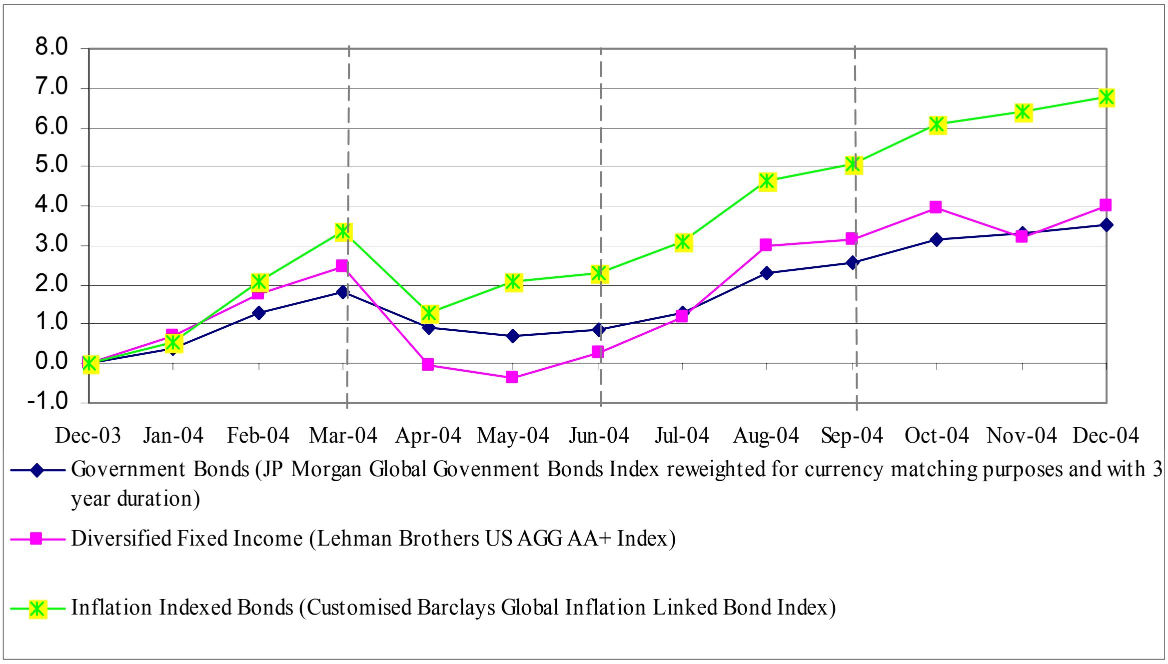
Country	Fourth Quarter 2004	Third Quarter 2004	Second Quarter 2004	First Quarter 2004	Year 2004	Year 2003
Australia	1.32	1.34	0.55	2.19	5.50	3.08
Belgium	1.43	1.61	(0.60)	2.39	4.90	4.69
Canada	1.99	1.65	(1.51)	2.87	5.03	6.01
Denmark	0.75	1.81	(0.60)	-	1.96	4.55
France	1.39	1.66	(0.68)	2.40	4.83	4.15
Germany	1.34	1.68	(0.70)	2.44	4.82	4.22
Italia	1.38	1.71	(0.69)	2.36	4.81	4.33
Japan	0.24	0.48	(0.08)	0.10	0.75	(0.99)
Netherlands	n/a [3]	1.60	(0.68)	2.32	3.25	4.32
Spain	1.32	1.73	(0.62)	2.17	4.65	4.55
Sweden	2.45	0.96	(0.77)	3.34	6.06	5.04
United Kingdom	1.89	2.15	(0.06)	1.03	5.09	2.46
United States	(0.08)	1.89	(2.35)	2.00	1.40	2.80
Total Return[2)]	0.96	1.68	(0.96)	1.83	3.53	2.88

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.
3 Not included in the customized JP Morgan index in fourth quarter 2004.

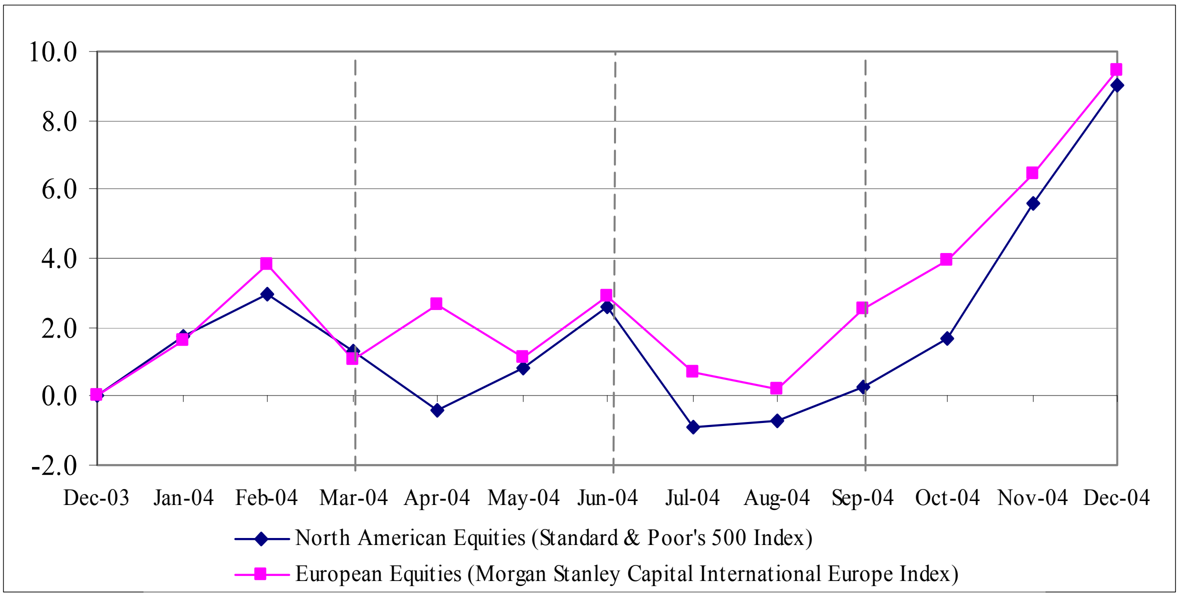
ANNEX VI

FIXED-INTEREST AND EQUITY MARKET DEVELOPMENT IN 2004
(percentage in local currency terms)

Fixed-Interest Markets



Equities Markets



SUMMARY OF MOVEMENTS IN CASH AND INVESTMENTS IN THE EQUITIES PORTFOLIO – 2004
(USD ’000 equivalent)

	North American Equities	European Equities	Total Equities Portfolio
Opening balance (31 December 2003)	**156 618**	**99 468**	**256 086**
Net investment income	13 795	9 991	23 786
Transfers due to allocation[a]	(3 168)	(2 159)	(5 327)
Transfers due to expenses/other income	878	124	1002
Other net flows	-	-	-
Movements on exchange	-	7 597	7 597
Closing balance (31 December 2004)	**168 123**	**115 021**	**283 144**
Actual allocation (%)	59.4	40.6	100.0

[a] Transfers from the equities portfolio reflect the repatriation of dividends to the internally managed portfolio.

ANNEX VIII

GROSS INCOME 1997-2004[a]
(USD ’000 equivalent)

Overall Portfolio

	2004	2003	2002	2001	2000	1999	1998	1997
Capital Gains/(Losses)	31 529	38 400	(35 579)	(106 193)	(117 460)	105 133	76 957	41 192
Interest Income	76 768	69 938	61 541	59 241	68 819	90 253	112 668	128 779
Dividends	6 204	4 709	7 652	13 614	11 760	8 684	5 654	94
Securities Lending and Commission Recapture	738	430	436	841	440	539	905	463
Total Gross Income	**115 239**	**113 477**	**34 050**	**(32 497)**	**(36 441)**	**204 609**	**196 184**	**170 528**

Fixed-Interest Portfolio

	2004	2003	2002	2001	2000	1999	1998	1997
Capital Gains/(Losses)	12 748	(4 476)	55 177	2 136	31 959	(121 637)	104 229	50 315
Interest Income	76 716	69 932	61 241	58 356	67 228	89 333	108 773	128 779
Dividends	-	-	-	-	-	114	-	-
Securities Lending and Commission Recapture	597	303	113	155	326	424	825	463
Total Gross Income	**90 061**	**65 759**	**116 531**	**60 647**	**99 513**	**(31 766)**	**213 827**	**179 557**

Equities Portfolio

	2004	2003	2002	2001	2000	1999	1998	1997
Capital Gains/(Losses)	18 781	42 876	(90 756)	(108 329)	(149 419)	226 770	(27 272)	(9 123)
Interest Income	52	6	284	885	1 591	920	3 895	-
Dividends	6 204	4 709	7 652	13 614	11 760	8 570	5 654	94
Securities Lending and Commission Recapture	141	127	323	686	114	115	80	-
Total Gross Income	**25 178**	**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.

COMPOSITION OF THE FIXED-INTEREST PORTFOLIO BY TYPE OF INSTRUMENT AT 31 DECEMBER 2004

(USD ’000 equivalent)

	Internally Managed Portfolio	Government Bonds Portfolio	Diversified Fixed-Interest Portfolio	Inflation-Indexed Bonds Portfolio	Total Fixed-Interest Portfolio 31.12.2004
Cash[a]	57 436	47 103	22 503	19 653	146 695
Time deposits and other obligations of banks [b]	90 238	8 638	106 461	1 774	207 111
Global government bonds	-	1 088 498	159 706	446 143	1 694 347
Mortgage-backed securities	-	-	258 892	-	258 892
Asset-backed securities	-	-	96 436	-	96 436
Corporate bonds	-	11 748	26 185	-	37 933
Equities	-	-	-	-	-
Unrealized market value gain/(loss) on forward contracts	-	(516)	(1 264)	926	(854)
Futures	-	78	(992)	(310)	(1 224)
Options	-	-	(59)	-	(59)
Subtotal cash and investments	**147 674**	**1 155 549**	**667 868**	**468 186**	**2 439 277**
Receivables for investment sold	(153)	-	17 000	22 659	39 506
Payables for investments purchased	-	-	(180 694)	(21 258)	(201 952)
Total	**147 521**	**1 155 549**	**504 174**	**469 587**	**2 276 831**

[a] Includes cash in non-convertible currencies amounting to USD 332 000 (2003 – USD 394 000).
[b] Includes time deposits in non-convertible currencies amounting to USD 386 000 (2003 – USD 400 000).

ANNEX X

REPORT ON IFAD'S INVESTMENT PORTFOLIO FOR THE FOURTH QUARTER OF 2004

I. INTRODUCTION

1. The following report on IFAD's investment portfolio covers the three-month period ending 31 December 2004 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. During the third quarter of 2004, the financial impact of the held-to-maturity approach was further analysed. It was decided that an amount of USD 400 million will be allocated to the held-to-maturity portfolio. The portfolio will be managed internally and will be invested in high quality, bonds instruments with a maximum maturity of five years, with USD 20 million maturing and rolled over every quarter.

3. Different funding scenarios for the held-to-maturity portfolio were analysed with regards to their impact on the investment portfolio's expected risk and return. Following a series of analyses, it was decided to liquidate the entire equities portfolio and a portion of the government bonds portfolio and to invest the liquidation proceeds in the held-to-maturity portfolio. The decision to disinvest from equities, together with the implementation of the held-to-maturity portfolio, will contribute to further reducing the portfolio's volatility. The disinvestment from equities and the funding of the held-to-maturity portfolio will take place in the first quarter of 2005.

III. ASSET ALLOCATION

4. Table 1 shows the movements affecting the investment portfolio's major asset classes in the fourth quarter of 2004 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 10 976 000 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 2004)	**149 873**	**1 077 229**	**499 133**	**434 001**	**253 930**	**2 414 166**
Net investment income (loss)	927	12 339	4 473	6 393	22 358	46 490
Transfers due to allocation[a]	1 496	-	-	-	(1 496)	-
Transfers due to expenses	(1 787)	674	580	280	253	-
Other net flows[b]	(10 976)	-	-	-	-	(10 976)
Movements on exchange	7 988	65 307	(12)	28 913	8 099	110 295
Closing balance (31 December 2004)	**147 521**	**1 155 549**	**504 174**	**469 587**	**283 144**	**2 559 975**
Actual allocation (%)	5.8	45.1	19.7	18.3	11.1	100.0
Policy allocation (%)	5.0	44.0	23.0	18.0	10.0	100.0
Difference in allocation (%)	**0.8**	**1.1**	**(3.3)**	**0.3**	**1.1**	**-**

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

5. Changes in the portfolio’s allocation ratios in the fourth quarter of 2004 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 and the inflation-indexed portfolios increased in value as non-United States dollar investments made up about 75% and 95%, respectively, of their average holdings in the fourth quarter of 2004.

6. The movements in the fourth quarter of 2004 increased the shortfall in the diversified-fixed interest portfolio since it 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 gain from the positive movements on exchange. The government bonds, inflation-indexed and equities portfolios showed slightly increased excess allocations compared to previous quarter while the excess allocation in the internally managed portfolio was slightly reduced due to disbursement outflows.

IV. INVESTMENT INCOME

7. In the fourth quarter for 2004, economic data indicated a somewhat slower growth than expected. However, declining oil prices as well as presidential election results in the United States contributed to a strong equities rally, while contained inflation supported fixed-interest investments.

8. Table 2 shows net investment income for the fourth quarter of 2004, year to date 2004 and earlier years for the investment portfolio’s major asset classes. Aggregate net investment income in the fourth quarter of 2004 amounted to USD 46 490 000 equivalent, which, added to the net income

of USD 62 172 000 equivalent for the first nine months of 2004, resulted in a cumulative net income of USD 108 662 000 equivalent in 2004 (2003 – USD 107 962 000).

Table 2: Net Investment Income by Asset Class – Fourth Quarter of 2004 and Prior Periods[a]
(USD '000 equivalent)

Portfolio	4th quarter 2004	First nine months 2004	2004	2003	2002	2001	2000	1999	1998	1997
Internally managed portfolio	927	1 774	2 701	4 086	4 098	2 050	3 654	3 114	4 834	18 633
Government bonds portfolio	12 339	26 336	38 675	36 735	85 541	41 471	74 625	(43 977)	195 506	154 228
Diversified fixed-interest portfolio	4 473	17 641	22 114	16 038	22 925	13 783	17 615	3 832	6 130	–
Inflation-indexed bonds portfolio	6 393	14 993	21 386	4 665	–	–	–	–	–	–
Equities portfolio	22 358	1 428	23 786	46 438	(86 378)	(100 286)	(143 744)	231 500	(18 571)	(8 921)
Overall portfolio	**46 490**	**62 172**	**108 662**	**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.

9. Table 3 provides details on net investment income earned in the fourth quarter of 2004 by the two main portfolio categories, i.e. fixed-interest and equities investments. Both categories contributed strongly, and the positive contribution from the portfolio's smaller equities portion was particularly strong.

Table 3: Net Investment Income of the Overall Portfolio by Main Portfolio Category – Fourth Quarter 2004
(USD '000 equivalent)

	Total Fixed-Interest Portfolio	Total Equities Portfolio	Overall Portfolio
Interest from fixed-interest investments and bank accounts	20 973	29	21 002
Dividend income from equities	-	1 801	1 801
Realized capital gains	3 881	2 625	6 506
Unrealized capital gains (losses)	830	18 405	19 235
Income from securities lending and commission recapture	179	35	214
Subtotal: gross investment income	**25 863**	**22 895**	**48 758**
Investment manager fees	(1 353)	(296)	(1 649)
Custody fees	(50)	(4)	(54)
Financial advisory and other investment management fees	(328)	(41)	(369)
Taxes	-	(196)	(196)
Other investment expenses	-	-	-
Net investment income	**24 132**	**22 358**	**46 490**

10. Table 4 shows the net investment income in the fourth quarter of 2004 from the fixed-interest portfolio's four sub-portfolios. In aggregate, net investment income from fixed-interest investments amounted to USD 24 132 000 equivalent. All four sub-portfolios, and especially the government bonds portfolio, contributed positively.

Table 4: Net Investment Income of the Fixed-Interest Portfolio by Sub-Portfolio – Fourth Quarter 2004
(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	834	13 061	4 268	2 810	20 973
Dividend income from equities	-	-	-	-	-
Realized capital gains	111	(2 202)	1 952	4 020	3 881
Unrealized capital gains/(losses)	-	2 154	(1 167)	(157)	830
Income from securities lending and commission recapture	-	93	60	26	179
Subtotal: gross investment income	**945**	**13 106**	**5 113**	**6 699**	**25 863**
Investment manager fees	-	(587)	(549)	(217)	(1 353)
Custody fees	(18)	(4)	(10)	(18)	(50)
Financial advisory and other investment management fees	-	(176)	(81)	(71)	(328)
Taxes	-	-	-	-	-
Other investment expenses	-	-	-	-	-
Net investment income	**927**	**12 339**	**4 473**	**6 393**	**24 132**

11. Net investment income in the fourth quarter of 2004 from the two sub-portfolios of the equities portfolio is shown in Table 5. In aggregate, net investment income from equities amounted to USD 22 358 000 equivalent. In particular the North American sub-portfolio, but also the European equities sub-portfolio, contributed positively.

Table 5: Net Investment Income of the Equities Portfolio by Sub-Portfolio – Fourth Quarter 2004
(USD ’000 equivalent)

	North American Equities	European Equities	Total Equities Portfolio
Interest from fixed-interest investments and bank accounts	24	5	29
Dividend income from equities	1 164	637	1 801
Realized capital gains/(losses)	2 339	286	2 625
Unrealized capital gains/(losses)	12 010	6 395	18 405
Income from securities lending and commission recapture	12	23	35
Subtotal: gross investment income	**15 549**	**7 346**	**22 895**
Investment manager fees	(211)	(85)	(296)
Custody fees	(1)	(3)	(4)
Financial advisory and other investment management fees	(25)	(16)	(41)
Taxes	-	(196)	(196)
Other investment expenses	-	-	-
Net investment income	**15 312**	**7 046**	**22 358**

IV. RATE OF RETURN AND PERFORMANCE COMPARISON

12. There was an overall positive return of 1.76% in the fourth quarter of 2004, net of investment expenses and movements on exchange. Cumulatively, the overall return for 2004 was 4.54%.

13. 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.

14. 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 2004, as the equities portfolio clearly outperformed its aggregate benchmark and also compensated for a small underperformance by the fixed-interest portfolio.

Table 6: Performance Compared with Benchmarks – Fourth Quarter and Year 2004
(percentage in local currency terms)

	Fourth Quarter 2004			Year 2004		
	Rate of Return %		Out/(Under)	Rate of Return %		Out/(Under)
Portfolio	**Portfolio**	**Benchmark**	**Performance**	**Portfolio**	**Benchmark**	**Performance**
Internally managed portfolio	0.61	0.61	0.00	2.12	2.12	0.00
Government bonds portfolio	0.94	0.96	(0.02)	3.56	3.53	0.03
Diversified fixed-interest portfolio	1.01	0.84	0.16	4.86	4.02	0.84
Inflation-indexed bonds portfolio	1.41	1.72	(0.31)	6.17	6.80	(0.63)
Total fixed-interest portfolio	**1.01**	**1.08**	**(0.07)**	**4.15**	**4.08**	**0.07**
North American equities portfolio	10.43	8.74	1.69	9.80	9.00	0.80
European equities portfolio	6.32	6.73	(0.41)	9.78	9.43	0.35
Total equities portfolio	8.78	7.93	0.85	**9.76**	**9.16**	**0.60**
Overall portfolio gross rate of return	**1.83**	**1.82**	**0.01**	**4.74**	**4.62**	**0.12**
Less expenses	**(0.07)**	**(0.07)**	**0.00**	**(0.20)**	**(0.20)**	**0.00**
Overall portfolio net rate of return	**1.76**	**1.75**	**0.01**	**4.54**	**4.42**	**0.12**

15. The total fixed-interest portfolio returned a positive 1.01% in the fourth quarter of 2004, underperforming its benchmark by 7 basis points. The small underperformance resulted principally from the inflation-indexed bonds portfolio, which showed an underperformance of 31 basis points as a result of a negative contribution from asset allocation, although somewhat mitigated by a slightly positive security selection. The underperformance was partially offset by an outperformance in the diversified fixed-interest portfolio.

16. The total equities portfolio returned a positive 8.78% in the fourth quarter of 2004 and outperformed its aggregated benchmark by 85 basis points. The overall equities outperformance was due to the North American equities portfolio whereas the European Equity portfolio underperformed its benchmark. The 4th quarter outperformance generated by the North American equities portfolio was mostly due to positive stock selection.