Distribution: Restricted | EB 2005/84/R.33 | 18 April 2005
Original: English | Agenda Item 14(b)(ii) | English

a

IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

Executive Board – Eighty-Fourth Session

Rome, 18-20 April 2005

REPORT ON IFAD'S INVESTMENT PORTFOLIO FOR THE FIRST QUARTER OF 2005

I. INTRODUCTION

1. The following report on IFAD's investment portfolio presents final data relating to the first two months of 2005, inasmuch as the final data relating to March 2005 will become available from IFAD's Custodian only after finalization of this report. Accordingly, the information relating to the entire first quarter of 2005 will be presented as an annex to the report on the second quarter of 2005. The present report consists of five sections: investment policy, asset allocation, investment income, rate of return and performance comparison, and risk measurement. This report reflects the investment policy decisions implemented in March, with an annex showing the estimated cumulative proceeds from equities sales.

II. INVESTMENT POLICY: LIQUIDATION OF EQUITIES AND FUNDING OF A HELD-TO-MATURITY PORTFOLIO

2. The asset liability management (ALM) review presented to the Executive Board in December 2003 contained, among other items, an action point to reduce the market risk in the investment portfolio by holding a portion of investments until maturity. Following additional ALM analyses, a decision was taken in 2004[1] to fund the new held-to-maturity portfolio by liquidating the remaining equities portfolio and a portion of the government bonds portfolio in the first quarter of 2005.

3. In February 2005, IFAD appointed a transition manager mandated to liquidate the equities portfolio and a portion of the government bonds portfolio and to invest the proceeds in the new held-to-maturity portfolio. Both the liquidations and the funding of the held-to-maturity portfolio were carried out on 1 March 2005.

[1] See the Report on IFAD's Investment Portfolio for 2004 (document EB 2005/84/R.32).

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

4. The final liquidation proceeds will be known when the Custodian's final reports for March 2005 are received. However, equities markets continued their positive performance in the first two months of 2005 and the market value of the equities portfolio amounted to USD 286 112 000 equivalent on 28 February 2005. As at that same date, the estimated cumulative equities proceeds amounted to USD 835.8 million for equities sold in the period 2001 to 2002 and on 1 March 2005. This compares with an initial amount of USD 897.1 million invested in equities. The difference between the initial funding amount and the proceeds was due to investment losses and negative movements on foreign exchange. The estimated cumulative gross investment loss amounted to USD 25.4 million, equivalent to a cumulative loss of -2.8% vis-à-vis the initial funding amount. The amount of cumulative equities losses has been positively impacted by the strong gains of equities investments in 2003 and 2004. Estimated cumulative foreign exchange movements amounted to a negative amount of USD 35.9 million. These movements arose from non-United States dollar equities investments deriving from IFAD's need to maintain its overall assets, including its former equities portfolio, in the currencies of the SDR valuation basket. The need for currency alignment is due to IFAD's loan disbursements being denominated in SDR.

5. Annex I shows the estimated cumulative proceeds from equities portfolios sold on 1 March 2005 as well as prior liquidations. The final cumulative proceeds from equities sales, which may include some market price and currency movements on the liquidation day of 1 March 2005, will be reported together with the final figures on the entire first quarter of 2005.

6. Furthermore, an amount of USD 123 578 000 equivalent, as per market values on 28 February 2005, was liquidated from the government bonds portfolio, and a cash amount of USD 5 000 000 was withdrawn from the internally managed portfolio. Hence, the total amount resulting from equities and government bonds liquidations as well as withdrawn cash was USD 414 690 000 equivalent as per market values on 28 February 2005. This amount, with possible adjustments for market price and currency movements on 1 March 2005, was invested in high-quality bond instruments with a maximum maturity of five years, with quarterly tranches maturing and reinvested every quarter. The funding amount of the held-to-maturity portfolio was calculated to correspond to maturing bonds in the amount of USD 400 million equivalent plus periodical interest payments.

7. The held-to-maturity portfolio will be managed internally in terms of reinvesting the quarterly maturing amounts. The portfolio will be accounted for at amortized cost, in accordance with International Financial Reporting Standards, and will therefore not be impacted by future fluctuations in market prices.

8. Following the liquidations and the funding of the held-to-maturity portfolio on 1 March 2005, the former equities allocation (10%) will be proportionately redistributed among the investment policy's remaining asset classes. The redistributed policy allocation will be reviewed, in line with prior suggestions to review the policy allocation about every three years, and the Executive Board will be informed in due course.

III. ASSET ALLOCATION

9. Table 1 shows the movements affecting the investment portfolio's major asset classes in the first two months of 2005 and compares the portfolio's asset allocation to the policy allocation. As at 28 February 2005, an amount of USD 25 million equivalent had already been transferred from the government bonds portfolio to a new account created (and included within the internally managed portfolio in Table 1) for the new held-to-maturity portfolio. There were no other reallocations among the portfolio's asset classes during the period, besides the normal dividend repatriation from the equities portfolio to the internally managed portfolio, whereby IFAD avoided reinvesting its dividend gains into equities. During the first two months of 2005, there was a net outflow of USD 3 462 000 equivalent from the internally managed portfolio, 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 – First Two Months of 2005
(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 2004)	**147 521**	**1 155 549**	**504 174**	**469 587**	**283 144**	**2 559 975**
Net investment income/(loss)	501	1 221	1 041	(985)	4 630	6 408
Transfers due to allocation[a]	25 530	(25 000)	-	-	(530)	-
Transfers due to expenses/other income	(774)	270	135	154	215	-
Other net outflows[b]	(3 462)	-	-	-	-	(3 462)
Movements on exchange	(2 383)	(14 031)	6	(6 371)	(1 347)	(24 126)
Closing balance (28 February 2005)	**166 933**	**1 118 009**	**505 356**	**462 385**	**286 112**	**2 538 795**
Portfolio allocation (%)	6.6	44.0	19.9	18.2	11.3	100.0
Policy allocation (%)	5.0	44.0	23.0	18.0	10.0	100.0
Difference in allocation (%)	**1.6**	**-**	**(3.1)**	**0.2**	**1.3**	**-**

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

10. Changes in portfolio allocation ratios during the first two months of 2005 reflected the aforementioned transfer from the government bonds portfolio for the purpose of the new held-to-maturity portfolio account (included with the internally managed portfolio in Table 1) as well as negative foreign exchange movement mainly in the government bonds and inflation-indexed portfolios, as the euro depreciated against the United States dollar.

11. Prior to the equities liquidations on 1 March, a temporarily excess allocation was shown by the equities portfolio on 28 February 2005 and, to a smaller extent, by the internally managed and the inflation-indexed portfolios. The excess allocations were offset by a shortfall in the allocations of the diversified fixed-interest portfolio.

IV. INVESTMENT INCOME

12. During first two months of 2005, markets initially reflected expectations of slower economic growth and low inflation. Later in the period, the signs of an economic recovery, including growing consumer confidence in both the United States of America and Europe, favoured equities markets. At the same time, bond markets were slightly negatively influenced by expectations of rising inflation and further increases in central bank rates.

13. Table 2 shows the net investment income for the first two months of 2005 and prior years by the investment portfolio's major asset classes. Aggregate net investment income in the first two months of 2005 amounted to USD 6 408 000 equivalent.

Table 2: Net Investment Income by Asset Class – First Two Months of 2005 and Prior Calendar Years[a]

(USD '000 equivalent)

Portfolio	First Two Months of 2005	2004	2003	2002	2001	2000	1999	1998	1997
Internally managed portfolio	501	2 701	4 086	4 098	2 050	3 654	3 114	4 834	18 633
Government bonds portfolio	1 221	38 675	36 735	85 541	41 471	74 625	(43 977)	195 506	154 228
Diversified fixed-interest portfolio	1 041	22 114	16 038	22 925	13 783	17 615	3 832	6 130	-
Inflation-indexed bonds portfolio	(985)	21 386	4 665	-	-	-	-	-	-
Equities portfolio	4 630	23 786	46 438	(86 378)	(100 286)	(143 744)	231 500	(18 571)	(8 921)
Overall portfolio	**6 408**	**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) reflects the previous investment policy.

14. Table 3 provides details on the aggregate net investment income in the first two months of 2005 by the two main portfolio categories, i.e. fixed-interest and equities investments. Both investment categories contributed positively, although equities performed better.

Table 3: Net Investment Income of the Overall Portfolio by Main Portfolio Category – First Two Months of 2005

(USD '000 equivalent)

	Total Fixed-Interest Portfolio	Total Equities Portfolio	Overall Portfolio
Interest from fixed-interest investments and bank accounts	12 256	16	12 272
Dividend income from equities	-	750	750
Realized capital gains/(losses)	3 147	3 132	6 279
Unrealized capital gains/(losses)	(13 056)	962	(12 094)
Income from securities lending and commission recapture	112	33	145
Subtotal: gross investment income/(loss)	**2 459**	**4 893**	**7 352**
Investment manager fees	(581)	(213)	(794)
Custody fees	(75)	(15)	(90)
Financial advisory and other investment management fees	(25)	(3)	(28)
Taxes	-	(32)	(32)
Net investment income/(loss)	**1 778**	**4 630**	**6 408**

15. Table 4 shows the net investment income in the first two months of 2005 from the fixed-interest portfolio's four sub-portfolios. In aggregate, net investment income from fixed-interest investments amounted to USD 1 778 000 equivalent. Only the inflation-indexed sub-portfolio contributed slightly negatively to the net investment income.

Table 4: Net Investment Income of the Fixed-Interest Portfolio by Sub-Portfolio – First Two Months of 2005

(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	511	7 141	2 850	1 754	12 256
Dividend income from equities	-	-	-	-	-
Realized capital gains/(losses)	-	(258)	2 207	1 198	3 147
Unrealized capital gains/(losses)	-	(5 392)	(3 881)	(3 783)	(13 056)
Income from securities lending and commission recapture	-	69	36	7	112
Subtotal: gross investment income/(loss)	**511**	**1 560**	**1 212**	**(824)**	**2 459**
Investment manager fees	-	(301)	(142)	(138)	(581)
Custody fees	(10)	(24)	(23)	(18)	(75)
Financial advisory and other investment management fees	-	(14)	(6)	(5)	(25)
Taxes	-	-	-	-	-
Net investment income/(loss)	**501**	**1 221**	**1 041**	**(985)**	**1 778**

16. Table 5 shows the net investment income in the first two months of 2005 from the two sub-portfolios of the equities portfolio. In aggregate, net investment income from equities amounted to USD 4 630 000 equivalent. The income stemmed mostly from the European equities sub-portfolio, as the North American equities sub-portfolio contributed only slightly positively.

Table 5: Net Investment Income of the Equities Portfolio by Sub-Portfolio – First Two Months of 2005

(USD '000 equivalent)

	North American Equities Portfolio	European Equities Portfolio	Total Equities Portfolio
Interest from fixed-interest investments and bank accounts	13	3	16
Dividend income from equities	383	367	750
Realized capital gains	2 296	836	3 132
Unrealized capital gains/(losses)	(2 256)	3 218	962
Income from securities lending and commission recapture	16	17	33
Subtotal: gross investment income	**452**	**4 441**	**4 893**
Investment manager fees	(139)	(74)	(213)
Custody fees	(11)	(4)	(15)
Financial advisory and other investment management fees	(2)	(1)	(3)
Taxes	-	(32)	(32)
Net investment income	**300**	**4 330**	**4 630**

V. RATE OF RETURN AND PERFORMANCE COMPARISON

17. There was an overall return of 0.33% in the first two months of 2005, net of investment expenses and movements on exchange.

18. The performance is measured against pre-assigned independent benchmarks, indicating the return that would be expected through passive management of defined sectors of the market. The indexes used are the J.P. Morgan customized global government bonds index for government bonds, Lehman Brothers United States aggregate bond index for diversified fixed-interest bonds, Barclay customized inflation-indexed index for the inflation-indexed bonds portfolio, Standard & Poor's 500 index for North American equities and Morgan Stanley capitalization index for European equities.

19. Table 6 compares the return on each major sub-portfolio with the appropriate benchmark return. The overall portfolio outperformed its benchmark in the first two months of 2005 by 29 basis points.

Table 6: Performance Compared with Benchmarks – First Two Months of 2005

(percentage in local currency terms)

	First Two Months of 2005		
	Rate of Return (%)		Out/(Under)
Portfolio	Portfolio	Benchmark	Performance
Internally managed portfolio	0.53	0.53	0.00
Government bonds portfolio	0.25	(0.02)	0.27
Diversified fixed-interest portfolio	0.23	(0.03)	0.26
Inflation-indexed bonds portfolio	(0.16)	(0.39)	0.23
Total fixed-interest portfolio	**0.18**	**(0.07)**	**0.25**
North American equities portfolio	0.29	(0.69)	0.98
European equities portfolio	4.07	4.21	(0.14)
Total equities portfolio	**1.82**	**1.30**	**0.52**
Overall portfolio gross rate of return	**0.36**	**0.07**	**0.29**
Less expenses	**(0.03)**	**(0.03)**	**(0.00)**
Overall portfolio net rate of return	**0.33**	**0.04**	**0.29**

20. The total fixed-interest portfolio returned a positive 0.18% in the first two months of 2005 and outperformed its aggregate benchmark by 25 basis points. All three externally managed fixed-interest portfolios contributed to this outperformance.

21. The total equities portfolio returned a positive 1.82% in the first two months of 2005 and outperformed its benchmark by 52 basis points. This outperformance resulted from the North American equities portfolio, which was slightly offset by the underperformance of the European equities portfolio.

22. Further performance attribution against benchmarks will be included in the annex covering the entire first quarter of 2005 (to be included in the report on the second quarter of 2005).

VI. RISK MEASUREMENT

23. The investment portfolio is subject to fluctuations in returns due to economic and market conditions. Equities investments have historically shown higher return fluctuations, hence implying a higher risk compared to other securities. The liquidation of equities holdings on 1 March 2005 therefore significantly decreased the investment portfolio's market risk. The implementation of the held-to-maturity portfolio on the same day, which also entailed a partial liquidation of the government bonds portfolio, further reduced the investment portfolio's market risk. This is due to accounting rules that 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.

24. One of the most common risk measures is volatility. Volatility is measured in terms of standard deviation of returns from their mean. A higher standard deviation indicates higher return fluctuations in the portfolio and therefore a higher risk. The standard deviation of IFAD's investment portfolio as at 31 December 2004 was 1.8%. As a consequence of the equities liquidation and implementation of the held-to-maturity portfolio, the investment portfolio's standard deviation decreased to 1.5% as at 1 March 2005.

25. Value-at-Risk (VaR) is the risk measure that IFAD uses to estimate the maximum amount the investment portfolio could lose over a three-month time horizon, with a 95% confidence level. As at 31 December 2004 the investment portfolio's VaR was 1.5%. After the equities liquidation and implementation of the held-to-maturity portfolio, the investment portfolio's VaR decreased significantly to 1.2% as at 1 March 2005.

ANNEX

ESTIMATED CUMULATIVE PROCEEDS FROM EQUITY SALES[a]

(USD '000 equivalent)

	Initial Funding	Cumulative Gross Income/(Loss)	Cumulative Exchange Adjustments	Total Proceeds including Repatriated Dividends[d]	Repatriated Dividends[d]	Total Proceeds excluding Repatriated Dividends[e]
Subtotal: equities sold from August 2001 to October 2002[b]	**533.4**	**61.0**	**(59.7)**	**534.7**	**n.a.**	**534.7**
European equities portfolio[c]	133.1	(27.9)	21.1	126.3	(8.4)	117.9
North American equities portfolio[c]	230.6	(58.5)	2.7	174.8	(6.6)	168.2
Subtotal: equities sold in March 2005	**363.7**	**(86.4)**	**23.8**	**301.1**	**(15.0)**	**286.1**
Total	**897.1**	**(25.4)**	**(35.9)**	**835.8**	**(15.0)**	**820.8**

[a] The remaining equities portfolios were sold on 1 March 2005. The movements presented here reflect the Custodian's final reports as at 28 February 2005. Possible market price and currency movements on 1 March 2005 are not included pending the Custodian's audited reports for March 2005.

[b] Cumulative proceeds from equities sales in 2001 and 2002 as per the addendum to the Report on IFAD's Investment Portfolio for 2002 (document EB 2003/78/R.5/Add.1).

[c] The European and North American equities portfolios include initial funding amounts and movements of a number of portfolios that were consolidated in September 2002. As at 31 December 2002, cumulative gross losses on the remaining equities portfolio amounted to USD 163.9 million equivalent and cumulative positive foreign exchange movements amounted to USD 4.0 million equivalent.

[d] As from 1 January 2002, dividends were repatriated to the internally managed portfolio in order to avoid reinvesting into equities.

[e] The proceeds of equities sold in March 2005 refer to the market value of the remaining equities portfolio as at 28 February 2005, which excluded dividends already repatriated to the internally managed portfolio.