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REPORT ON IFAD'S INVESTMENT PORTFOLIO FOR THE SECOND QUARTER OF 2006

For: **Information**

Note to Executive Board Directors

This document is submitted for the information of the Executive Board.

To make the best use of time available at Executive Board sessions, Directors are invited to contact the following focal point with any technical questions about this document before the session.

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REPORT ON IFAD'S INVESTMENT PORTFOLIO FOR THE SECOND QUARTER OF 2006

I. INTRODUCTION

1. The following report on IFAD's investment portfolio covers the three-month period ended on 30 June 2006 and consists of four sections: investment policy, asset allocation, investment income, and rate of return and performance comparison. Additional information on the period's performance attribution, currency composition and risk measurement will become available after the dispatch of this document and will therefore be included as an annex to the report on the third quarter of 2006.

2. The present report contains an annex that provides figures for the entire first quarter of 2006, together with information on the first quarter's performance attribution, currency composition and risk measurement.

II. INVESTMENT POLICY

3. Global yields continued to rise in the second quarter of 2006 and had a somewhat negative impact on the fixed-income assets in IFAD's investment portfolio.

4. Against this backdrop, IFAD management adopted a number of short-term tactics to enhance investment return for the remainder of 2006, while maintaining flexibility to discontinue those tactics and implement a new investment policy after a six-month period.

5. The short-term measures involved two seamless steps. The first was to liquidate a portion of the externally managed portfolios – namely the more interest-rate-sensitive diversified fixed-interest and inflation-indexed bonds – in the amount of US$500 million equivalent. The second step was to reinvest that amount in money market instruments, specifically time deposits and commercial paper, to lock in a positive return for 2006.

III. ASSET ALLOCATION

6. Table 1 shows the movements affecting the investment portfolio's major asset classes in the second quarter of 2006 and compares the portfolio's asset allocation with the policy allocation. During the period, there was a net outflow of US$34,056,000 equivalent from the internally managed portfolio, representing disbursements for loans, grants and administrative expenses net of cash receipts and encashment of Member State contributions. In addition, US$2,354,000 equivalent in coupons received was transferred from the held-to-maturity portfolio to the short-term liquidity portfolio.

7. Changes in the portfolio's allocation ratios also reflected positive movements on exchange of US$64,887,000 equivalent as all major currencies appreciated strongly against the United States dollar. The government bonds portfolio was the one that benefited the most from positive exchange movements.

Table 1: Summary of Movements in Cash and Investments – Second Quarter of 2006
(US$'000 equivalent)

	Short-term Liquidity	Held-to Maturity	Government Bonds	Diversified Fixed-Interest	Inflation-Indexed Bonds	Overall
Opening balance (31 March 2006)	**112 907**	**396 419**	**943 876**	**496 604**	**421 696**	**2 371 502**
Net investment income/ (loss)	847	3 633	3 876	(1 344)	3 297	10 309
Transfers due to allocation	2 354	(2 354)	-	-	-	-
Transfers due to expenses	(902)	29	415	263	195	-
Other net flows[a]	(34 056)	-	-	-	-	(34 056)
Movements on exchange	1 872	10 624	38 695	20	13 676	64 887
Closing balance (30 June 2006)	**83 022**	**408 351**	**986 862**	**495 543**	**438 864**	**2 412 642**
Actual portfolio allocation (%)	3.5	16.9	40.9	20.5	18.2	100.0
Reclassification of held-to-maturity portfolio by asset class[b]	-	(408 351)	145 332	263 019	-	-
Closing balance with held-to-maturity portfolio reclassified	**83 022**	**-**	**1 132 194**	**758 562**	**438 864**	**2 412 642**
Actual asset allocation with held-to-maturity portfolio reclassified (%)	3.5	-	46.9	31.4	18.2	100.0
Policy allocation (%)	5.5	-	49.0	25.5	20.0	100.0
Difference in asset allocation (%)	**(2.0)**	**-**	**(2.1)**	**5.9**	**(1.8)**	**-**

[a] Cash receipts and encashment of Member State contributions net of disbursements for loans, grants and administrative expenses.
[b] The assets of the held-to-maturity portfolio have been reclassified as part of government bonds (US$145,332,000 equivalent) and diversified fixed-interest (US$263,019,000 equivalent) according to the investment guidelines.

8. At 30 June 2006, the investment portfolio showed an excess allocation in the diversified fixed-interest portfolio that was offset by shortfalls in the other portfolios. The excess allocation in that portfolio was largely attributable to the reclassification of 64% of the held-to-maturity portfolio into this asset class. It is worth noting that the income and value of the held-to-maturity portion are not impacted by volatility in security prices.

IV. INVESTMENT INCOME

9. During the second quarter of 2006, persistent inflation concerns owing to strong growth figures led central banks in the United States and Europe to raise interest rates further, thereby impacting fixed-interest markets negatively. Only the inflation-linked asset class benefited from this inflation expectation, recovering especially towards the end of the quarter.

10. Table 2 provides details on net investment income for the second quarter of 2006 by main sub-portfolio. The diversified fixed-interest portfolio performance was somewhat unfavourable, but all other portfolios contributed positively to the quarter's overall net investment income.

Table 2: Net Investment Income by Sub-Portfolio – Second Quarter of 2006 and Year-to-Date 2006
(US$'000 equivalent)

	Second Quarter of 2006						Year-to-Date 2006
	Short-term Liquidity	**Held-to-Maturity**	**Government Bonds**	**Diversified Fixed-Interest**	**Inflation-Indexed Bonds**	**Overall**	**Overall**
Interest from fixed-interest investments and bank accounts	860	4 041	10 337	5 627	5 015	25 880	48 199
Realized capital gains/(losses)	-	-	(2 897)	(6 761)	(603)	(10 261)	(13 109)
Unrealized capital losses	-	-	(3 149)	67	(911)	(3 993)	(22 941)
Amortization[a]		(379)	-	-	-	(379)	(783)
Income from securities lending and commission recapture	-	16	103	45	33	197	380
Subtotal: gross investment income/(loss)	**860**	**3 678**	**4 394**	**(1 022)**	**3 534**	**11 444**	**11 746**
Investment manager fees	-	-	(410)	(242)	(188)	(840)	(1 659)
Custody fees	(14)	(9)	(21)	(20)	(1)	(65)	(193)
Financial advisory and other investment management fees	-	(36)	(87)	(46)	(39)	(208)	(409)
Taxes	1	-	-	-	-	1	-
Other investment expenses	-	-	-	(14)	(9)	(23)	(34)
Net investment income/(loss)	**847**	**3 633**	**3 876**	**(1 344)**	**3 297**	**10 309**	**9 451**

[a] A period's amortization amount represents a portion of the difference between the purchase price and the final redemption value of the held-to-maturity investments as per the International Financial Reporting Standards.

V. RATE OF RETURN AND PERFORMANCE COMPARISON

11. 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 the government bonds portfolio, the Lehman Brothers United States aggregate bond index for the diversified fixed-interest bonds portfolio and the Barclay customized inflation-linked index for the inflation-indexed bonds portfolio.

12. Table 3 compares the return on each sub-portfolio with the pre-assigned benchmark return. The overall portfolio returned a positive 0.47% in the second quarter of 2006, net of investment expenses and excluding the impact of foreign exchange movements. This represented an underperformance of 4 basis points against the aggregate benchmark.

13. On a year-to-date basis, the overall portfolio returned a positive 0.43%, outperforming the aggregate benchmark by 9 basis points.

Table 3: Performance Compared with Benchmarks – Second Quarter of 2006 and Year-to-Date 2006
(percentages in local currency terms)

	Second Quarter of 2006			Year-to-Date 2006		
	Rate of Return (%)		Out/(Under)	Rate of Return (%)		Out/(Under)
Sub-Portfolio	Portfolio	Benchmark	Performance	Portfolio	Benchmark	Performance
Short-term liquidity	0.95	0.95	0.00	2.06	2.06	0.00
Held-to-maturity	0.91	0.91	0.00	1.75	1.75	0.00
Government bonds	0.51	0.32	0.19	0.64	0.13	0.51
Diversified fixed-interest	(0.23)	0.01	(0.24)	(0.63)	(0.52)	(0.11)
Inflation-indexed bonds	0.78	1.00	(0.22)	(0.12)	0.10	(0.22)
Overall portfolio gross rate of return	**0.50**	**0.54**	**(0.04)**	**0.49**	**0.40**	**0.09**
Less expenses	**(0.02)**	**(0.02)**	**0.00**	**(0.06)**	**(0.06)**	**0.00**
Overall portfolio net rate of return	**0.47**	**0.51**	**(0.04)**	**0.43**	**0.34**	**0.09**

REPORT ON IFAD’S INVESTMENT PORTFOLIO FOR THE FIRST QUARTER OF 2006

I. INTRODUCTION

1. The present annex covers the three-month period ended on 31 March 2006 and updates the data on the first two months of the year presented to the Executive Board in April 2006. It comprises the following sections: investment policy; asset allocation; investment income; rate of return and performance comparison; currency composition; and risk measurement. Comparative data for the past four years are presented as appropriate.

II. INVESTMENT POLICY

2. There were no changes to the investment policy during the first quarter of 2006.

3. Since the beginning of the year, IFAD has initiated a review of the investment portfolio’s expected rate of return under different asset allocation scenarios. This analysis has been conducted with the World Bank in accordance with the terms of a service agreement signed with IFAD in September 2005.

III. ASSET ALLOCATION

4. Table 1 shows the movements affecting the investment portfolio’s major asset classes in the first quarter of 2006 and compares the portfolio’s asset allocation with the policy allocation. During the period, there was a net inflow of US$5,442,000 equivalent into the internally managed portfolio, representing cash receipts and encashment of Member State contributions, less disbursements for loans, grants and administrative expenses. In addition, US$2,659,000 equivalent in coupons received was transferred from the held-to-maturity portfolio to the short-term liquidity portfolio.

5. Changes in the portfolio’s allocation ratios also reflected positive movements on exchange of US$19,153,000 equivalent as both the euro and the pound sterling appreciated against the United States dollar. The government bonds portfolio in particular benefited from positive exchange movements.

Table 1: Summary of Movements in Cash and Investments – First Quarter of 2006
(US$'000 equivalent)

	Short-term Liquidity	Held-to-Maturity	Government Bonds	Diversified Fixed-Interest	Inflation-Indexed Bonds	Overall
Opening balance (31 December 2005)	**103 530**	**390 880**	**930 960**	**498 461**	**423 934**	**2 347 765**
Net investment income/(loss)	1 057	3 319	928	(2 102)	(4 060)	(858)
Transfers due to allocation	2 659	(2 659)	-	-	-	-
Transfers due to expenses	(952)	22	425	265	240	-
Other net flows[a]	5 442	-	-	-	-	5 442
Movements on exchange	1 171	4 857	11 563	(20)	1 582	19 153
Closing balance (31 March 2006)	**112 907**	**396 419**	**943 876**	**496 604**	**421 696**	**2 371 502**
Actual portfolio allocation (%)	4.8	16.7	39.8	20.9	17.8	100.0
Reclassification of held-to-maturity portfolio by asset class[b]	-	(396 419)	146 481	249 938	-	-
Closing balance with held-to-maturity portfolio reclassified	**112 907**	**-**	**1 090 357**	**746 542**	**421 696**	**2 371 502**
Actual asset allocation with held-to-maturity portfolio reclassified (%)	4.8	-	46.0	31.4	17.8	100.0
Policy allocation (%)	5.5	-	49.0	25.5	20.0	100.0
Difference in asset allocation (%)	**(0.7)**	-	**(3.0)**	**5.9**	**(2.2)**	-

[a] Cash receipts and encashment of Member State contributions net of disbursements for loans, grants and administrative expenses.
[b] The assets of the held-to-maturity portfolio have been reclassified as part of government bonds (US$146,481,000 equivalent) and diversified fixed-interest (US$249,938,000 equivalent) according to the investment guidelines.

6. At 31 March 2006, the investment portfolio showed an excess allocation in the diversified fixed-interest portfolio that was offset by shortfalls in the other portfolios. The excess allocation in that portfolio was largely attributable to the reclassification of 63% of the held-to-maturity portfolio into this asset class. The fact that the held-to-maturity portfolio is not subject to market volatility counterbalanced the increased percentage of the asset allocation.

IV. INVESTMENT INCOME

7. After rather neutral performance during the first two months of 2006, fixed-interest markets suffered a negative impact globally in March 2006. Favourable economic sentiment in the Eurozone, the United Kingdom of Great Britain and Northern Ireland, and Japan, and fears of increasing inflation turned investors away from fixed-interest markets. This scenario reinforced expectations of, and subsequent decisions on, further interest rate hikes by central banks and predictably caused real yields to rise, producing a negative impact on all fixed-interest markets, particularly the inflation-linked asset class.

8. Table 2 shows the net investment income for the first quarter of 2006 and prior years by the investment portfolio's major asset classes. Aggregate net investment income in the first quarter of 2006 was slightly negative, in the amount of US$858,000 equivalent.

Table 2: Net Investment Income by Major Asset Class – First Quarter of 2006 and Prior Periods
(US$'000 equivalent)

Portfolio	First Quarter of 2006	2005	2004	2003	2002
Short-term liquidity	1 057	4 316	2 701	4 086	4 098
Held-to-maturity	3 319	10 108	-	-	-
Government bonds	928	25 013	38 675	36 735	85 541
Diversified fixed-interest	(2 102)	13 501	22 114	16 038	22 925
Inflation-indexed bonds	(4 060)	10 086	21 386	4 665	-
Equities	-	5 206 [b]	23 786	46 438	(86 378)[a]
Overall portfolio	**(858)**	**68 230**	**108 662**	**107 962**	**26 186**

[a] In 2002, the equities allocation was reduced to 10% as per the investment policy decision in 2001.

[b] The remaining 10% of equities allocation was liquidated during the first quarter of 2005.

9. Table 3 provides details on net investment income for the first quarter of 2006 by main sub-portfolio. The diversified fixed-interest and inflation-indexed portfolios turned negative but were partially offset by gains in other portfolios. The reclassification of a large portion of the held-to-maturity portfolio into the diversified fixed-interest asset class contributed positively.

Table 3: Net Investment Income by Sub-Portfolio – First Quarter of 2006
(US$'000 equivalent)

	Short-term Liquidity	Held-to-Maturity	Government Bonds	Diversified Fixed-Interest	Inflation-Indexed Bonds	Overall
Interest from fixed-interest investments and bank accounts	1 071	3 745	9 527	5 611	2 365	22 319
Realized capital gains/(losses)	-	-	(2 680)	(659)	491	(2 848)
Unrealized capital losses	-	-	(5 494)	(6 786)	(6 668)	(18 948)
Amortization[a]	-	(404)	-	-	-	(404)
Income from securities lending and commission recapture	-	23	82	51	27	183
Subtotal: gross investment income/(loss)	**1 071**	**3 364**	**1 435**	**(1 783)**	**(3 785)**	**302**
Investment manager fees	-	-	(392)	(241)	(186)	(819)
Custody fees	(13)	(10)	(32)	(30)	(43)	(128)
Financial advisory and other investment management fees	-	(35)	(83)	(45)	(38)	(201)
Taxes	(1)	-	-	-	-	(1)
Other investment expenses	-	-	-	(3)	(8)	(11)
Net investment income/(loss)	**1 057**	**3 319**	**928**	**(2 102)**	**(4 060)**	**(858)**

[a] A period's amortization amount represents a portion of the difference between the purchase price and the final redemption value of the held-to-maturity investments as per the International Financial Reporting Standards.

V. RATE OF RETURN AND PERFORMANCE COMPARISON

10. 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 the government bonds portfolio, the Lehman Brothers United States aggregate bond index for the diversified fixed-interest bonds portfolio and the Barclay customized inflation-linked index for the inflation-indexed bonds portfolio.

11. Table 4 compares the return on each major sub-portfolio with the pre-assigned benchmark return. The overall portfolio returned a negative 0.04% in the first quarter of 2006, net of investment expenses and excluding the impact of foreign exchange movements. This represented an outperformance of 14 basis points against the aggregate benchmark. Specifically, the government bonds and diversified fixed-interest portfolios outperformed the benchmark while the inflation-linked portfolio underperformed it.

Table 4: Performance Compared with Benchmarks – First Quarter of 2006
(percentages in local currency terms)

	Rate of Return (%)		
Portfolio	**Actual**	**Benchmark**	**Out/(Under) Performance**
Short-term liquidity	1.10	1.10	0.00
Held-to-maturity	0.83	0.83	0.00
Government bonds	0.14	(0.18)	0.32
Diversified fixed-interest	(0.40)	(0.52)	0.12
Inflation-indexed bonds	(0.90)	(0.89)	(0.01)
Overall portfolio gross rate of return	**0.00**	**(0.14)**	**0.14**
Less expenses	(0.04)	(0.04)	0.00
Overall portfolio net rate of return	**(0.04)**	**(0.18)**	**0.14**

(a) **Government bonds portfolio.** The portfolio returned 0.14%, strongly outperforming by 32 basis points the slightly negative benchmark return. This outperformance was due mainly to the investment managers' short-duration strategy, which protected the portfolio against the large upward movements in interest rates. In terms of country allocation, the underweight exposure to Japan, which was the lowest-yielding market, coupled with the overweight exposure to Germany also contributed positively.

(b) **Diversified fixed-interest portfolio.** The portfolio returned a negative 0.40%, which represented even so an outperformance of 12 basis points against the benchmark. The investment managers' sector allocation contributed positively thanks to the overweight exposure to the best-performing asset classes of mortgage- and asset-backed securities.

(c) **Inflation-indexed bonds portfolio.** The portfolio returned a negative 0.90%, for an underperformance of 1 basis point against the benchmark. The investment managers' country allocation strategy of overweighting Australia (which was the only positively performing market) while underweighting the Eurozone contributed positively. The investment managers' short-duration strategy also contributed positively. However, overall performance was weakened by overweight exposure to cash holdings in the beginning of the quarter.

VI. CURRENCY COMPOSITION

12. The majority of IFAD's commitments are expressed in special drawing rights (SDRs). 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 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.

13. 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 what their percentage weight should be at the date of reweighting of the basket.

14. The new units for each of the four currencies composing the valuation basket were determined on 30 December 2005 in such a way that the value of the SDR was precisely US$1.42927, in terms of both the old units and the new units, which became effective on 1 January 2006. The applicable units, together with their weights as at 1 January 2006 and 31 March 2006, are shown in Table 5.

Table 5: Units and Weights Applicable to the SDR Valuation Basket

	1 January 2006		31 March 2006	
Currency	**Units**	**Percentage Weight**	**Units**	**Percentage Weight**
U.S. dollar	0.6320	43.7	0.6320	43.9
Euro	0.4100	34.3	0.4100	34.4
Yen	18.4000	10.9	18.4000	10.8
Pound sterling	0.0903	11.1	0.0903	10.9
Total		**100.0**		**100.0**

15. At 31 March 2006, assets in the form of cash, investments, promissory notes and amounts receivable from contributors under the Fourth, Fifth and Sixth Replenishments, net of provisions, amounted to US$2,651,820,000 equivalent, as indicated in Table 6 (compared with US$2,688,417,000 equivalent as at 31 December 2005).

Table 6: Currency Composition of Assets at 31 March 2006
(US$'000 equivalent)

Currency Group	Cash and Investments[a]	Promissory Notes[a]	Amounts Receivable from Contributors	Total
U.S. dollar	1 059 435	78 199	12 287	1 149 921
Euro	723 953	77 646	15 454	817 053
Yen	326 951	15 493	-	342 444
Pound sterling	223 861	5 724	41 862	271 447
Other	36 582	21 241	13 132	70 955
Total	**2 370 782**	**198 303**	**82 735**	**2 651 820**

[a] Includes assets in freely-convertible currencies. The excluded assets in non-convertible currencies amounted to US$720,000 equivalent for cash and investments and US$1,399,000 equivalent for promissory notes.

16. Holdings of assets denominated in currencies not included in the SDR valuation basket amounted to US$70,955,000 equivalent at 31 March 2006 (compared with US$99,020,000 equivalent at 31 December 2005). These assets are allocated to the SDR currency groups as indicated in Table 7.

Table 7: Allocation of Non-SDR-denominated Assets to SDR Currency Groups at 31 March 2006
(US$'000 equivalent)

Currency Group	Currency Included in the SDR Basket	European Currencies Not Included in the SDR Valuation Basket	Other Currencies Not Included in the SDR Valuation Basket	Total Currencies per Group
U.S. dollar	1 149 921	-	22 812	1 172 733
Euro	817 053	48 143	-	865 196
Yen	342 444	-	-	342 444
Pound sterling	271 447	-	-	271 447
Total	**2 580 865**	**48 143**	**22 812**	**2 651 820**

17. The alignment of assets by currency group against the SDR valuation basket as at 31 March 2006 is shown in Table 8. The balance of the General Reserve and the commitments for grants denominated in United States dollars as at 31 March 2006 amounted to US$95,000,000 and US$67,823,000, respectively.

Table 8: Alignment of Assets per Currency Group with the Currency Composition of the SDR Valuation Basket at 31 March 2006
(US$'000 equivalent)

Currency Group	Asset Amount	Less Commitments Denominated in USD	Net Asset Amount	Net Asset Amount (%)	SDR Weights (%)
U.S. dollar	1 172 733	(162 823)	1 009 910	40.6	43.9
Euro	865 196	-	865 196	34.7	34.4
Yen	342 444	-	342 444	13.8	10.8
Pound sterling	271 447	-	271 447	10.9	10.9
Total	**2 651 820**	**(162 823)**	**2 488 997**	**100.0**	**100.0**

18. As at 31 March 2006, there was a shortfall in dollars (-3.3%), which was offset by an excess of yen (+3.0%) and, to a smaller extent, by euro currency group holdings (+0.3%). This misalignment was mainly a result of comparing the portfolio's currency composition with the new SDR weights, effective from 1 January 2006. In the new SDR basket, the dollar's weight increased significantly thereby causing an underweight in the currency. Inversely, the yen's weight in the SDR decreased, resulting in the portfolio being overweighted in yen. The weights were rebalanced with a realignment of currencies at the beginning of the second quarter.

VII. RISK MEASUREMENT

19. With the exception of short-term liquidity and held-to-maturity investments, 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 March 2006, the standard deviation of IFAD’s investment portfolio was 1.7%, compared with 1.8% for the investment policy (as against 1.4% for the portfolio and 1.7% for the policy at 31 December 2005).

20. Value-at-Risk (VaR) is the measure of risk that IFAD uses to estimate the maximum amount that the portfolio could lose in value over a three-month time horizon, with a 95% confidence level. Table 9 shows the VaR of IFAD’s investment portfolio and policy as at 31 March 2006 and for previous periods.

Table 9: Value-at-Risk (VaR)
(Forecast horizon three-months, confidence level 95%)

	Investment Portfolio		**Investment Policy**	
Date	**VaR (%)**	**Amount (US$’000)**	**VaR (%)**	**Amount (US$’000)**
31 March 2006	1.4	33 200	1.5	35 600
31 December 2005	1.2	28 200	1.4	32 900
30 September 2005	1.1	26 500	1.5	36 200
30 June 2005	1.0	24 500	1.4	34 300
31 March 2005	1.2	29 900	1.6	38 700

21. At 31 March 2006, the investment portfolio and policy both showed a slightly higher VaR than at the previous quarter’s end. This variance was due primarily to longer durations of the inflation-indexed and diversified fixed-interest portfolios.

22. However, as indicated in Table 9, the investment portfolio’s VaR was slightly below the investment policy’s VaR at the same date, indicating that the portfolio had a lower risk than the policy. This was the result of most managers keeping the portfolio durations shorter than their benchmarks, thereby protecting the portfolios against the negative impact of rising interest rates.