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Enabling the rural poor
to overcome poverty

Report on IFAD's investment portfolio for the third quarter of 2006

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For: **Information**

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Report on IFAD's investment portfolio for the third quarter of 2006

I. Introduction

1. This report on IFAD's investment portfolio covers the three-month period ended on 30 September 2006 and consists of four sections: asset allocation, investment income, rate of return and performance comparison, and risk measurement. Additional information on the period's performance attribution and currency composition that will become available only after the dispatch of this document will be tabled at the session.
2. Additional information on the performance attribution, currency composition and risk measurement for the second quarter of 2006 is presented in the annex.

II. Asset allocation

3. During the third quarter of 2006, IFAD implemented a number of tactical short-term measures intended to protect the investment portfolio from unfavourable market movements and to lock in positive returns for the remainder of 2006. As part of these measures, US\$449,320,000 equivalent of the externally managed diversified fixed-interest and inflation-indexed bond portfolios was liquidated and reinvested in money market instruments.
4. Tactical short-term investments generated net investment income of US\$6 million equivalent in the third quarter of 2006. It is estimated that the total income from these investments through year-end will be US\$12 million equivalent. These investments – it should be noted – are not subject to market movements.
5. The asset allocation in IFAD's investment portfolio is currently under review. As the tactical short-term investments will mature in early 2007, the ground will be ready for the reinvestment of the funds in the most advantageous asset classes in line with the outcome of the review and prevailing market conditions.
6. Table 1 shows the movements affecting the investment portfolio's major asset classes in the third quarter of 2006 and compares the portfolio's asset allocation with the investment policy allocation. During the quarter, a total of US\$495,320,000 equivalent (US\$396,172,000 equivalent from the diversified fixed-interest portfolio and US\$99,148,000 equivalent from the inflation-indexed bond portfolio) was transferred from the externally managed portfolios to the internally managed portfolios. Of the amount transferred, US\$449,320,000 equivalent was placed in tactical short-term investments and US\$46,000,000 equivalent was moved to the short-term liquidity portfolio to cover disbursement needs.
7. During the period, there was a net outflow of US\$41,775,000 equivalent from the short-term liquidity portfolio, representing disbursements for loans, grants and administrative expenses net of cash receipts and encashment of Member States' contributions.
8. In addition, US\$4,436,000 equivalent, representing coupon payments, was transferred from the held-to-maturity portfolio to the internally managed short-term liquidity portfolio, as proceeds of coupon payments are not reinvested in the held-to-maturity portfolio.
9. Changes in the portfolio's allocation ratios also reflected positive net investment income of US\$31,708,000 equivalent and negative movements on exchange of US\$15,760,000 equivalent as major currencies depreciated against the United States dollar.

Table 1
**Summary of movements in cash and investments by portfolio,
 third quarter 2006**

(Thousands of United States dollars equivalent)

	<i>Short-term liquidity^a</i>	<i>Tactical short-term investments^b</i>	<i>Held-to- maturity</i>	<i>Government bonds</i>	<i>Diversified fixed-interest</i>	<i>Inflation- indexed bonds</i>	<i>Total</i>
Opening balance (30 June 2006)^a	83 022	-	408 351	986 862	495 543	438 864	2 412 642
Net investment income/(loss)	1 269	5 692	3 539	13 644	693	6 871	31 708
Transfers due to allocation	50 436	449 320	(4 436)	-	(396 172)	(99 148)	-
Transfers due to expenses	(803)	-	34	445	136	188	-
Other net flows ^c	(41 775)	-	-	-	-	-	(41 775)
Movements on exchange	(407)	(148)	(1 798)	(3 854)	16	(9 569)	(15 760)
Closing balance (30 September 2006)	91 742	454 864	405 690	997 097	100 216	337 206	2 386 815
Actual portfolio allocation	3.8%	19.1%	17.0%	41.8%	4.2%	14.1%	100.0%
Reclassification of the held- to-maturity (HTM) portfolio ^d	-	-	(405 690)	141 991	263 699	-	-
Closing balance with HTM portfolio reclassified	91 742	454 864	-	1 139 088	363 915	337 206	2 386 815
Actual asset allocation with HTM portfolio reclassified	3.8%	19.1%	-	47.7%	15.2%	14.1%	100.0%
Investment policy allocation	5.5%	-	-	49.0%	25.5%	20.0%	100.0%
Difference in asset allocation	(1.7%)	19.1%	-	(1.3%)	(10.3%)	(5.9%)	-

^a Cash and time deposits held with banks, readily available for disbursements for loans, grants and administrative expenses. net of cash receipts and encashment of Member States' contributions.

^b Short-term instruments (time deposits and commercial papers) providing locked-in returns for the remaining part of 2006.

^c Disbursements for loans, grants and administrative expenses. net of cash receipts and encashment of Member States' contributions.

^d The assets in the held-to-maturity portfolio were reclassified into the government bonds (US\$141,991,000 equivalent) and diversified fixed-interest (US\$263,699,000 equivalent) portfolios, according to the investment guidelines of these two asset classes.

10. As a result of the tactical short-term investments implemented at the beginning of the quarter, the actual asset allocation differs from the policy allocation. However, these tactical short-term investments satisfy all major policy requirements, including credit rating and asset class designation. The overall asset allocation will revert to the investment policy allocation levels early next year.

III. Investment income

11. During the third quarter of 2006, fixed-interest markets performed positively as signs of economic slowdown in the United States of America reduced inflation concerns around the world. Additionally, declining real yields favoured inflation-indexed bonds.
12. Table 2 provides details on net investment income for the quarter by portfolio. The overall net investment income during the quarter amounted to US\$31,708,000 equivalent, to which all portfolios contributed positively.

Table 2
**Net investment income by portfolio,
 third quarter and year-to-date 2006**

(Thousands of United States dollars equivalent)

	Third quarter						Year-to-date	
	Short-term liquidity	Tactical short-term investments	Held-to-maturity	Government bonds	Diversified fixed-interest	Inflation-indexed bonds	Total	Total
Interest from fixed-interest investments and bank accounts	1 268	2 536	3 927	10 155	1 938	2 798	22 622	70 821
Realized capital gains/(losses)	-	-	-	(1 802)	(8 597)	(57)	(10 456)	(23 565)
Unrealized capital gains/(losses)	-	-	-	5 736	7 490	4 326	17 552	(5 389)
Amortization/accretion ^a	-	3 156	(354)	-	-	-	(2 802)	(2 019)
Income from securities lending and commission recapture	-	-	13	93	1	20	127	507
Subtotal: gross investment income/(loss)	1 268	5 692	3 586	14 182	832	7 087	32 647	44 393
Investment manager fees	-	-	-	(420)	(119)	(165)	(704)	(2 363)
Custody fees	(11)	-	(2)	(9)	(7)	(6)	(35)	(228)
Financial advisory and other investment management fees	-	-	(45)	(109)	(11)	(37)	(202)	(611)
Taxes	12	-	-	-	-	-	12	12
Other investment expenses	-	-	-	-	(2)	(8)	(10)	(44)
Net investment income/(loss)	1 269	5 692	3 539	13 644	693	6 871	31 708	41 159

^a A period's amortization amount represents a portion of the difference between the purchase price and the final redemption value of held-to-maturity investments as per the International Financial Reporting Standards. The amount of US\$3,156,000 represents accretion on commercial papers.

IV. Rate of return and performance comparison

13. Performance is measured against preassigned 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, the Lehman Brothers United States aggregate index for diversified fixed-interest bonds and the Barclay customized inflation-linked index for inflation-indexed bonds.
14. Table 3 compares the return on each portfolio with its corresponding benchmark return. Overall, the portfolio returned a positive 1.32 per cent in the third quarter of 2006, net of investment expenses and excluding the impact of foreign exchange movements. This represented an underperformance of 13 basis points against the aggregate benchmark, due mainly to the government bonds and diversified fixed-interest portfolio managers' conservatively short durations strategy – which somewhat curtailed their returns when fixed-interest markets performed well in the third quarter.
15. On a year-to-date basis, the portfolio returned a positive 1.75 per cent, underperforming the aggregate benchmark by 4 basis points.

Table 3
**IFAD investment portfolio performance compared with benchmarks,
 third quarter and year-to-date 2006**

(Percentage in local currency terms)

Portfolio	Third quarter			Year-to-date		
	Rate of return		Out/(Under) performance	Rate of return		Out/(Under) performance
	Portfolio	Benchmark		Portfolio	Benchmark	
Short-term liquidity ^a	1.23	1.23	0	3.31	3.31	0
Tactical short-term ^a	1.25	1.25	0	1.25	1.25	0
Held-to-maturity ^a	0.89	0.89	0	2.65	2.65	0
Government bonds	1.44	1.59	(0.15)	2.09	1.72	0.37
Diversified fixed-interest	2.00	2.17	(0.17)	1.36	1.64	(0.28)
Inflation-indexed bonds	2.07	2.00	0.07	1.94	2.10	(0.16)
Overall portfolio gross rate of return^b	1.34	1.47	(0.13)	1.84	1.88	(0.04)
Less expenses	(0.02)	(0.02)	0	(0.09)	(0.09)	0
Overall portfolio net rate of return^b	1.32	1.45	(0.13)	1.75	1.79	(0.04)

^a No specific benchmark assigned.

^b The overall benchmark was based on actual portfolio weights at the end of each month during the quarter.

V. Risk measurement

16. With the exception of the short-term liquidity, tactical short-term and held-to-maturity investments, the investment portfolio's performance is subject to market movements. 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 30 September 2006, the standard deviation of IFAD's investment portfolio was 1.0 per cent, compared with 1.7 per cent under the investment policy (as opposed to 1.4 per cent for the portfolio and 1.8 per cent for the policy at 30 June 2006).
17. 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 per cent confidence level. Table 4 shows the VaR of IFAD's investment portfolio and policy as at 30 September 2006 and for previous quarters in 2005 and 2006.

Table 4
**Value-at-risk of IFAD's investment portfolio,
 by quarter, 2005-2006**

(Forecast horizon of three months, confidence level of 95 per cent)

	Investment portfolio		Investment policy	
	VaR (percentage)	Amount (thousands of U.S. dollars)	VaR (percentage)	Amount (thousands of U.S. dollars)
30 September 2006	0.8	19 100	1.4	33 400
30 June 2006	1.1	26 500	1.5	36 200
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

18. At 30 September 2006 the investment portfolio's VaR was 0.8 per cent, 0.3 percentage points lower than at the previous quarter's end. The driving factor behind the lower portfolio risk was the tactical short-term investments, which are not subject to market volatility and, as such, have zero VaR. The investment portfolio VaR at 30 September 2006 was well below the investment policy VaR of 1.4 per cent. It should be noted that the investment policy VaR reflects the investment policy allocation, which sets lower cash balances and larger weights to non-cash asset classes.

Additional information on IFAD'S investment portfolio for the second quarter of 2006

I. Introduction

1. This annex contains additional information for the second quarter of 2006 on performance attribution, currency composition and risk measurement.

II. Performance attribution

2. Table A.1 compares the return on each portfolio with the pre-assigned benchmark return.¹ The overall portfolio returned a positive 0.47 per cent 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.
3. On a year-to-date basis, the overall portfolio returned a positive 0.43 per cent, outperforming the aggregate benchmark by 9 basis points.

Government bonds portfolio

4. This portfolio returned 0.51 per cent, for an outperformance of 19 basis points over the benchmark return. The outperformance was mainly due to the investment managers' short duration strategy, which protected the portfolio against the ongoing trend of rising interest rates.

Diversified fixed-interest portfolio

5. This portfolio returned a negative 0.23 per cent, for an underperformance of 24 basis points against the benchmark. The investment managers' sector allocation contributed positively to the portfolio performance, but this was more than offset by their overall long-duration strategy for most of the quarter, which had a negative impact when interest rates rose during the quarter, as well as by unfavourable securities selection.

Inflation-indexed bonds portfolio

6. This portfolio returned 0.78 per cent, for an underperformance of 22 basis points against the benchmark. The investment managers' country allocation strategy of overweighting the United States of America and underweighting the euro zone contributed positively but was partly offset mainly by the investment managers' conservatively short duration strategy, which curtailed returns somewhat when inflation-indexed bonds rallied towards the end of the quarter.

¹ See paragraph 13 of the main report.

Table A.1

IFAD investment portfolio performance compared with benchmarks, second quarter and year-to-date 2006

(Percentage in local currency terms)

Portfolio	Second quarter			Year-to-date		
	Rate of return		Out/(Under) performance	Rate of return		Out/(Under) performance
	Portfolio	Benchmark		Portfolio	Benchmark	
Short-term liquidity	0.95	0.95	0	2.06	2.06	0
Held-to-maturity ^a	0.91	0.91	0	1.75	1.75	0
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	(0.06)	(0.06)	0
Overall portfolio net rate of return	0.47	0.51	(0.04)	0.43	0.34	0.09

^a No specific benchmark assigned.**III. Currency composition**

- As the majority of IFAD's commitments are expressed in special drawing rights (SDRs), its 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 that same currency.
- 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 reweighing of the basket.
- The new units for each of the four currencies composing the SDR 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 and the new units, which became effective on 1 January 2006. The applicable units, together with their weights as at 1 January and 30 June 2006, are shown in table A.2.

Table A.2

Units and weights applicable to the SDR valuation basket, at 1 January and 30 June 2006

Currency	1 January 2006		30 June 2006	
	Units	Percentage weight	Units	Percentage weight
U.S. dollar	0.6320	43.7	0.6320	42.6
Euro	0.4100	34.3	0.4100	35.3
Yen	18.4000	10.9	18.4000	10.8
Pound sterling	0.0903	11.1	0.0903	11.3
Total		100.0		100.0

10. At 30 June 2006, assets in the form of cash, investments, promissory notes and amounts receivable from Member States under the fourth, fifth and sixth replenishments, net of provisions, amounted to US\$2,671,775,000 equivalent, as indicated in table A.3 (compared with US\$2,651,820,000 equivalent at 31 March 2006).

Table A.3

**Currency composition of assets
at 30 June 2006**

(Thousands of United States dollars equivalent)

	<i>Cash and investments^a</i>	<i>Promissory notes^a</i>	<i>Amounts receivable from contributors</i>	<i>Total</i>
U.S. dollar	1 128 054	76 449	5 871	1 210 374
Euro	725 301	70 328	10 229	805 858
Yen	270 334	15 991	-0	286 325
Pound sterling	243 276	6 104	44 638	294 018
Other	44 958	19 813	10 429	75 200
Total	2 411 923	188 685	71 167	2 671 775

^a Only assets in freely convertible currencies are included. The excluded assets in non-convertible currencies amounted to US\$719,000 equivalent for cash and investments and US\$1,399,000 equivalent for promissory notes.

11. Holdings of assets denominated in currencies not included in the SDR valuation basket amounted to US\$75,200,000 equivalent at 30 June 2006 (compared with US\$70,955,000 equivalent at 31 March 2006) and were allocated to the SDR currency groups as indicated in table A.4.

Table A.4

**Allocation of non-SDR-denominated assets to SDR currency groups
at 30 June 2006**

(Thousands of United States dollars equivalent)

	<i>Currency included in the SDR basket</i>	<i>European currencies not included in the SDR valuation basket</i>	<i>Other currencies not included in the SDR valuation basket</i>	<i>Total currencies per group</i>
U.S. dollar	1 210 374	-	28 209	1 238 583
Euro	805 858	46 991	-	852 849
Yen	286 325	-	-	286 325
Pound sterling	294 018	-	-	294 018
Total	2 596 575	46 991	28 209	2 671 775

12. The alignment of assets by currency group against the SDR valuation basket as at 30 June 2006 is shown in table A.5. The balance of the commitments denominated in United States dollars at 30 June 2006 amounted to US\$171,825,000 equivalent, composed of the General Reserve (US\$95,000,000) and the commitments for grants denominated in United States dollars (US\$76,825,000).

Table A.5
Alignment of assets per currency group with the currency composition of the SDR valuation basket at 30 June 2006

(Thousands of United States dollars equivalent)

	<i>Asset amount</i>	<i>Less commitments denominated in U.S. dollars</i>	<i>Net asset amount</i>	<i>Net asset amount (percentage)</i>	<i>SDR weight (percentage)</i>	<i>Difference in weights (percentage)</i>
U.S. dollar	1 238 583	(171 825)	1 066 758	42.6	42.6	-
Euro	852 849	-	852 849	34.1	35.3	(1.2)
Yen	286 325	-	286 325	11.5	10.8	0.7
Pound sterling	294 018	-	294 018	11.8	11.3	0.5
Total	2 671 775	(171 825)	2 499 950	100.0	100.0	-

13. As at 30 June 2006, there was a shortfall in euro currency group holdings (-1.2 per cent), which was offset by an excess of yen (+0.7 per cent) and pound sterling (+0.5 per cent).

IV. Risk measurement

14. At 30 June 2006, the standard deviation of IFAD's investment portfolio² was 1.4 per cent, compared with 1.8 per cent for the investment policy (as opposed to 1.7 per cent for the portfolio and 1.8 per cent for the policy at 31 March 2006).
15. Table A.6 shows the value-at-risk (VaR) of IFAD's investment portfolio and policy as at 30 June 2006 and for previous quarters in 2005 and 2006.

Table A.6

**Value-at-risk of IFAD's investment portfolio,
by quarter, 2005-2006**

(Forecast horizon three months, confidence level of 95 per cent)

	<i>Investment portfolio</i>		<i>Investment policy</i>	
	<i>VaR (percentage)</i>	<i>Amount (thousands of U.S. dollars)</i>	<i>VaR (percentage)</i>	<i>Amount (thousands of U.S. dollars)</i>
30 June 2006	1.1	26 500	1.5	36 200
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

16. At 30 June 2006, the investment portfolio showed a lower VaR than at the previous quarter's end, whereas the investment policy VaR was unchanged. The portfolio's VaR decrease vis-à-vis 31 March was driven by a shorter duration held in the inflation-indexed portfolio and by the shortening of duration in the diversified fixed-interest portfolio executed toward the end of the quarter. A shorter duration results in less sensitivity to yield curve movements, hence a lower VaR.
17. The investment portfolio's VaR at 30 June 2006 was also lower than the investment policy's VaR, owing mainly to its shorter duration (2.4 years) compared with the overall benchmark duration (3.8 years).

² See paragraph 16 of the main report.