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IFAD
INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT
Enabling the rural poor to overcome poverty

Report on IFAD's investment portfolio for 2006

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For: **Information**

Note to Executive Board Directors

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

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Munehiko Joya
Treasurer
telephone: +39 06 5459 2251
e-mail: m.joya@ifad.org

Queries regarding the dispatch of documentation for this session should be addressed to:

Deirdre McGrenra
Governing Bodies Officer
telephone: +39 06 5459 2374
e-mail: d.mcgrenra@ifad.org

Report on IFAD's investment portfolio for 2006

I. Introduction

1. This report on IFAD's investment portfolio covers the year ended 31 December 2006 and includes comparative figures for the year ended 31 December 2005.

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

II. Highlights

3. During the first half of 2006, IFAD's investment portfolio was negatively impacted by an increase in interest rates worldwide. Against this backdrop, management adopted short-term tactical measures to protect the investment portfolio and to enhance investment return for the remainder of 2006. In July 2006, US$449,320,000 was shifted from externally managed portfolios to internally managed money market investments. These investments contributed to the overall investment return for 2006 by generating income of US$11,711,000 equivalent.

4. In the aggregate, net investment income on IFAD's investment portfolio amounted to US$57,906,000 equivalent in 2006 for an overall net return of 2.46 per cent, representing an outperformance of 1 basis point against the overall benchmark.

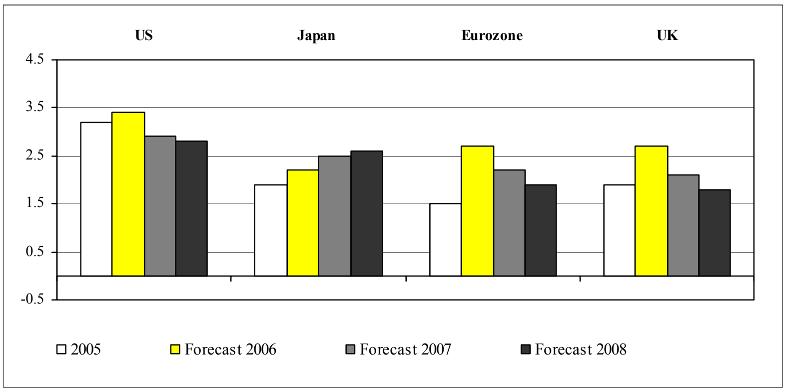
5. The value of the investment portfolio in United States dollar terms increased by US$10,837,000, i.e. from US$2,347,765,000 equivalent at 31 December 2005 to US$2,358,602,000 equivalent at 31 December 2006. The major contributors to this growth were foreign exchange movements and investment income, which more than offset disbursement outflows.

III. Market conditions

6. The following charts show trends in three key economic indicators: real GDP, consumer prices and the unemployment rate. The indicators are shown for the countries whose currencies make up the valuation basket for the special drawing right (SDR): euro zone countries, Japan, the United Kingdom of Great Britain and Northern Ireland, and the United States of America.

7. GDP grew steadily in all SDR countries during the first half of 2006 (see chart 1), underpinned by a healthy corporate sector and a recovery in global capital spending and hiring. These favourable factors enabled the global economy to absorb the impact of rising oil prices. During the second half of the year, all these economies except Japan slowed down.

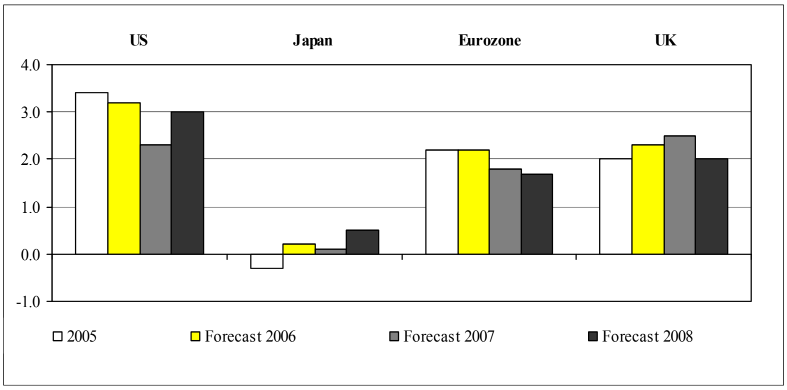
Chart 1
GDP growth rates



Source: J.P. Morgan

8. Inflation in the euro zone, the United Kingdom and the United States, as represented by the consumer price index, remained rather stable during 2006 under central banks' tightening monetary policy (see chart 2). Inflation concerns are expected to be attenuated in 2007 as further interest rate increases slow down economic growth. Consumer prices in Japan increased somewhat during 2006, signalling an end to the long period of deflation.

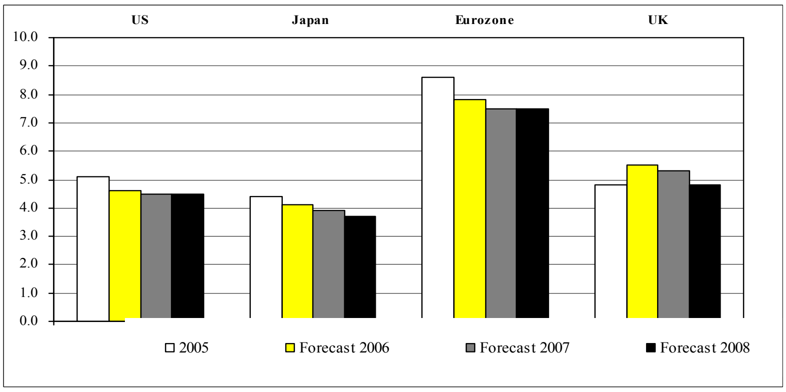
Chart 2
CPI index



Source: J.P. Morgan

9. Unemployment rates decreased in 2006 everywhere except for the United Kingdom (see chart 3). The drop was most notable in the euro zone, driven by the zone's economic recovery. These trends are forecasted to continue in 2007.

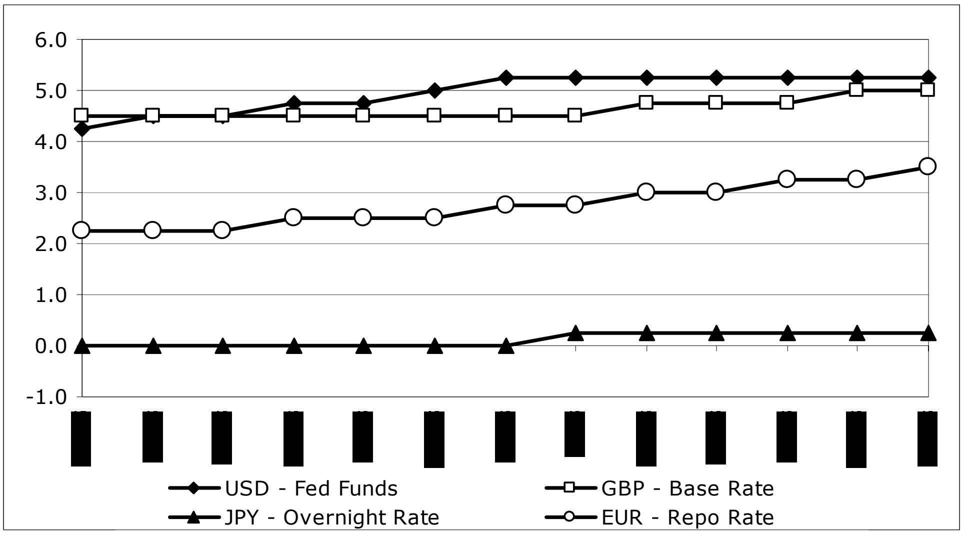
Chart 3
Unemployment rates



Source: J.P. Morgan

10. Chart 4 shows the evolution of central bank interest rates for SDR countries. The Federal Reserve Bank of the United States of America increased the federal funds rate three times in 2006 – from 4.50 per cent to 5.25 per cent – to pre-empt inflationary pressure. Similarly, the European Central Bank raised its refinancing rate five times: from 2.25 per cent to 3.50 per cent. The Bank of England also raised its base rate twice in 2006, from 4.50 per cent to 5.00 per cent. The Bank of Japan abandoned its zero-rate policy by raising its target rate from 0 per cent to 0.25 per cent in 2006.

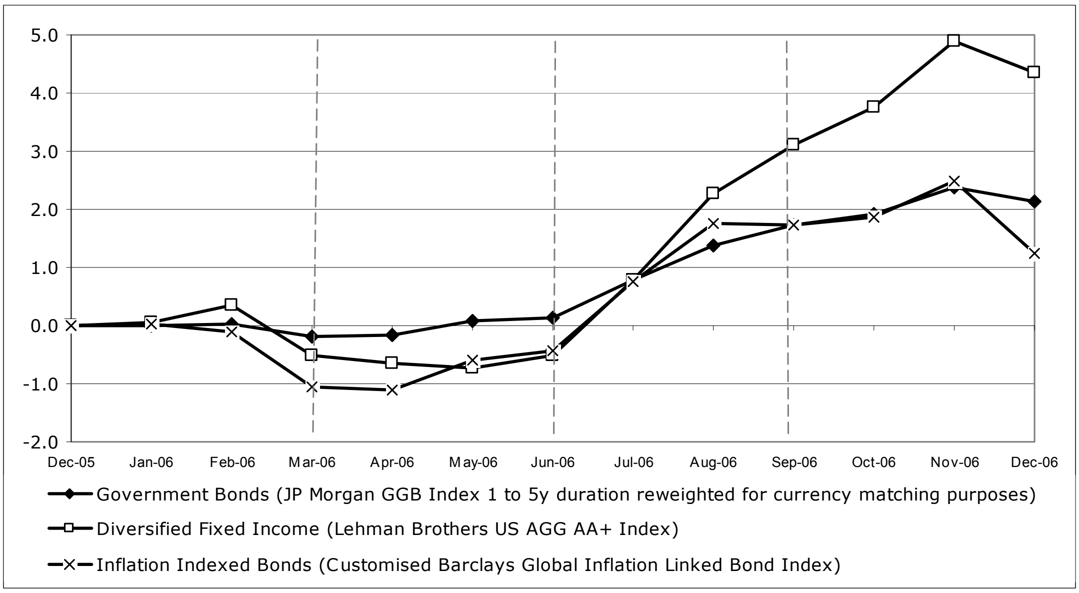
Chart 4
Central Bank interest rates



Source: Bloomberg

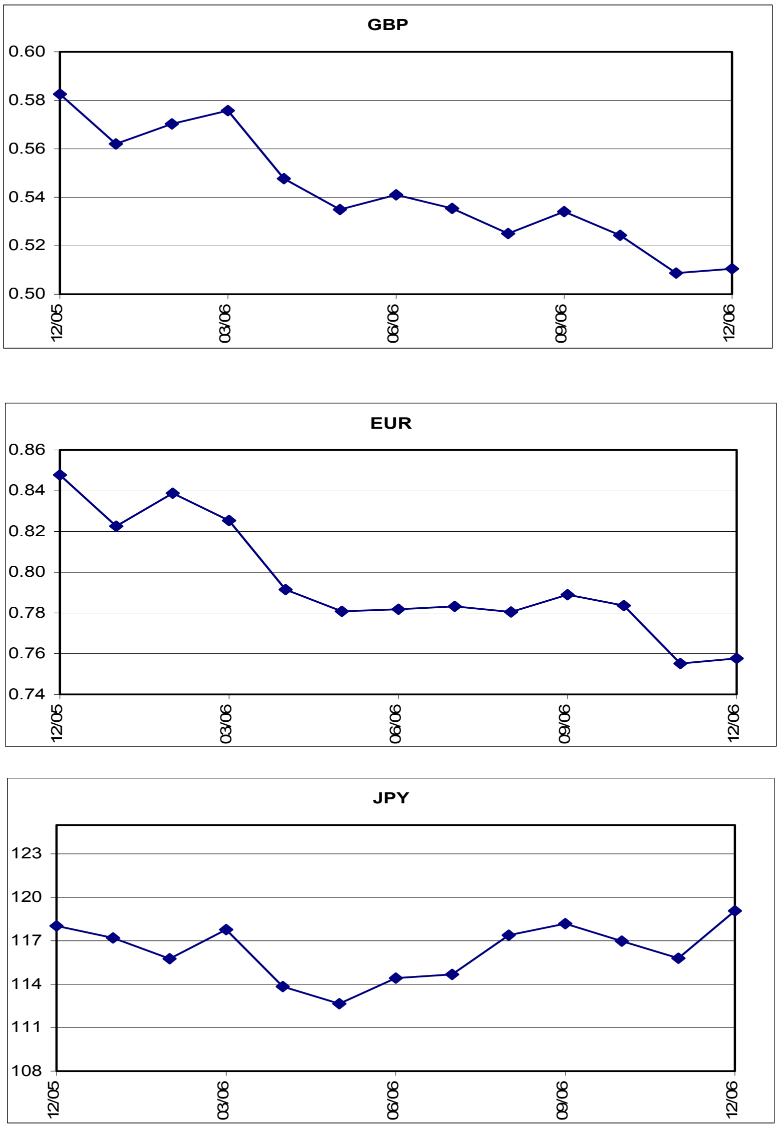
11. Chart 5 shows the performance in 2006 of fixed-interest markets where IFAD's investment portfolio was invested during the year. Each line represents the performance of the benchmark indices used by IFAD for the global government bonds, diversified fixed-interest bonds and inflation-indexed bonds portfolios. The performance of the fixed-interest markets as a whole was negatively impacted by globally rising interest rates during the first half of the year. Following a pause in interest rate increases by central banks, bond markets recovered throughout the third and most of the fourth quarter. During that period, the diversified fixed-interest bond market put in a strong performance due to investor demand for credit products, in particular corporate bonds underpinned by a good business outlook and very low default rates.

Chart 5
Fixed-interest market developments in 2006
(Percentage in local currency terms)



12. Chart 6 illustrates month-end exchange rates for the dollar against three other currencies in the SDR valuation basket, namely the pound sterling (GBP), euro (EUR) and Japanese yen (JPY).

Chart 6
Value of US$ vs. other SDR currencies at month-end exchange rates



Source: Bloomberg

13. In 2006, the dollar depreciated strongly against the euro and the pound sterling. This was the result of the slowdown in the United States economy, particularly during the second half of the year, and the narrowing interest rate spreads between the United States and Europe. The dollar's depreciation against the other SDR currencies, however, helped increase the overall investment portfolio value in dollar terms, as detailed in section IV below.

IV. Asset allocation and investment policy

14. Table 1 shows the movements affecting the investment portfolio’s major asset classes in 2006 and compares the portfolio’s asset allocation with the policy allocation.

Table 1
Movements in cash and investments by portfolio in 2006
(Thousands of United States dollars equivalent)

	Operational cash[a]	*Tactical short-term investments*[b]	*Held-to-maturity*	*Government bonds*	*Diversified fixed-interest*	*Inflation-indexed bonds*	*Total*
Opening balance (31 December 2005) [a]	**103 530**	-	**390 880**	**930 960**	**498 461**	**423 934**	**2 347 765**
Net investment income	4 520	11 711	14 335	23 622	(1 286)	5 004	57 906
Transfers due to allocation	130 439	449 320	(12 973)	(70 000)	(397 382)	(99 404)	-
Transfers due to expenses	(3 469)	-	111	1 779	736	843	-
Other net flows[c]	(148 798)	1	-	(1)	(1)	(1)	(148 800)
Movements on exchange	3 352	1 319	21 148	69 695	12	6 205	101 731
Closing balance by portfolio (31 December 2006)	**89 574**	**462 351**	**413 501**	**956 055**	**100 540**	**336 581**	**2 358 602**
Actual allocation (Percentage)	3.8	19.6	17.5	40.5	4.3	14.3	100.0
Policy allocation (Percentage)	5.5	-	-	49.0	25.5	20.0	100.0
Difference in allocation (Percentage)	**(1.7)**	**19.6**	**17.5**	**(8.5)**	**(21.2)**	**(5.7)**	**-**

[a] Cash and time deposits held with banks, readily available for disbursing loans, grants and administrative expenses.
[b] Short-term instruments (time deposits and commercial papers) providing locked-in returns for the remainder of 2006.
[c] Disbursements for loans, grants and administrative expenses net of cash receipts and encashment of Member State contributions.

15. During the third quarter of 2006, IFAD implemented tactical short-term measures to protect the investment portfolio from unfavourable market movements and to lock in positive returns for the remainder of the year. As part of these measures, US$449,320,000 equivalent was liquidated from the externally managed diversified fixed-interest and inflation-indexed bonds portfolios and reinvested internally in money-market instruments.

16. During the year, US$70,000,000 equivalent from the government bonds portfolio and US$46,000,000 equivalent from the diversified fixed-interest bonds portfolio was encashed to cover disbursements.

17. An amount of US$12,973,000 equivalent representing coupon income from the held-to-maturity portfolio was transferred to the operational cash portfolio.

18. The year saw a net outflow of US$148,800,000 equivalent, representing disbursements for loans, grants and administrative expenses net of cash receipts and encashment of Member State contributions.

19. These movements – combined with net investment income of US$57,906,000 equivalent and positive foreign exchange movements of US$101,731,000 equivalent – led to an increase in dollar terms of US$10,837,000 in the overall investment portfolio during 2006.

20. The asset allocation in IFAD's investment portfolio is currently under review by the Investment Advisory Committee, which has been restructured into a high-level policy committee (Investment and Finance Advisory Committee) and a technical and operating committee (Investment, Finance and ALM [Asset Liability Management] Committee). The tactical short-term investments, maturing in mid-2007, will be reinvested in the most advantageous way based on the outcome of the review and prevailing market conditions.

V. Investment income

21. In 2006, aggregate net investment income amounted to US$57,906,000 equivalent (compared with US$68,230,0000 in 2005). Both realized and unrealized gains and losses are included in the investment income. Table 2 presents a summary of the year's investment income broken down by portfolio. All portfolios except for the diversified fixed-interest bonds portfolio performed positively.

Table 2
Net investment income by portfolio in 2006
(Thousands of United States dollars equivalent)

	Operational cash	*Tactical short-term investments*	*Held-to-maturity*	*Government bonds*	*Diversified fixed-interest*	*Inflation-indexed bonds*	*Total*
Interest from fixed-interest investments and bank accounts	4 411	5 312	15 925	40 791	14 567	12 984	**93 990**
Realized capital gains/(losses)	22	-	-	(11 160)	(15 706)	(485)	**(27 329)**
Unrealized capital gains/(losses)	-	-	-	(4 230)	608	(6 625)	**(10 247)**
Amortization/accretion[a]	-	6 399	(1 479)	-	-	-	**4 920**
Income from securities lending	133	-	52	278	97	80	**640**
Subtotal: gross investment income/(loss)	**4 566**	**11 711**	**14 498**	**25 679**	**(434)**	**5 954**	**61 974**
Investment manager fees	-	-	-	(1 651)	(662)	(733)	**(3 046)**
Custody fees	(59)	-	(31)	(91)	(66)	(64)	**(311)**
Financial advisory and other investment management fees	-	-	(131)	(315)	(106)	(126)	**(678)**
Tax recoverables	13	-	-	-	-	-	**13**
Other investment expenses	-	-	-	-	(19)	(27)	**(46)**
Net investment income/(loss)	**4 520**	**11 711**	**14 336**	**23 622**	**(1 287)**	**5 004**	**57 906**

[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. The amount of US$6.399 million represents accretion on commercial papers to pro-rate the difference between their face values and discounted purchase prices.

VI. Rate of return and performance comparison

22. The performance of IFAD's investment portfolio is calculated in local currency terms without reflecting the impact of foreign exchange movements.

23. 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 index for diversified fixed-interest bonds and Barclay customized inflation-linked index for the inflation-indexed bonds.

24. Table 3 compares the actual net return on the overall portfolio to the overall benchmark return. The overall portfolio returned a positive 2.46 per cent in 2006, net of investment expenses and excluding the impact of foreign exchange movements. This represented an outperformance of 1 basis point against the aggregate benchmark.

Table 3
Actual performance vs. benchmark in 2006
(Percentages, in local currency terms)

	Rate of return		*Out/(under) performance*
	Actual	*Benchmark*	
Gross rate of return	**2.57**	**2.56**	**0.01**
Less expenses	(0.11)	(0.11)	-
Net rate of return	**2.46**	**2.45**	**0.01**

25. The externally managed portfolios performed differently vis-à-vis benchmarks depending on the duration strategies taken by the respective managers (see table 4), as follows:

(a) **Global government bonds portfolio.** The portfolio outperformed its benchmark by 44 basis points. This positive result was due mainly to the managers' conservative short-duration strategy, which protected the portfolios against the rising interest rate environment.

(b) **Diversified fixed-interest bonds portfolio.** This portfolio underperformed its benchmark by 7 basis points. The slight underperformance was due to the managers' long-duration position, in particular in the second quarter, when interest rates rose most significantly.

(c) **Inflation-indexed bonds portfolio.** This portfolio underperformed its benchmark by 23 basis points. This performance gap was attributed to the managers' overall short-duration strategy as short-dated inflation-indexed instruments underperformed the longer-dated securities.

Table 4
Duration of fixed-interest portfolios and benchmarks at 31 December 2006 and 2005
(Years)

	31 December 2006		*31 December 2005*	
	Portfolio	*Benchmark*	*Portfolio*	*Benchmark*
Government bonds	2.1	2.5	1.9	2.6
Diversified fixed-interest	3.5	4.1	4.2	4.0
Inflation-indexed bonds	4.1	4.8	2.2	5.4

VII. Composition of the portfolio

A. Composition of the investment portfolio by instrument

26. Table 5 shows the major asset classes of the overall portfolio. Following the short-term tactical measures undertaken in July 2006, the allocation for mortgage-backed and asset-backed securities was reduced and shifted to time deposits and other obligations of banks.

Table 5
Composition of investment portfolio by instrument
(Thousands of United States dollars equivalent)

	31 December 2006	*31 December 2005*
Cash[a]	156 720	235 211
Time deposits and other obligations of banks [b]	507 875	101 092
Global government bonds	1 470 323	1 636 754
Mortgage-backed securities	77 961	339 398
Asset-backed securities	14 093	56 322
Corporate bonds	192 736	133 782
Unrealized market value gain/(loss) on forward contracts	(5 145)	2 303
Unrealized gain on futures	585	306
Options	-	14
Subtotal: cash and investments	**2 415 148**	**2 505 182**
Receivables for investments sold	22 883	87 437
Payables for investments purchased	(79 429)	(244 854)
Total	**2 358 602**	**2 347 765**

[a] Includes cash in non-convertible currencies amounting to US$79,000 equivalent (US$69,000 in 2005).
[b] Includes time deposits in non-convertible currencies amounting to US$634,000 equivalent (US$655,000 in 2005).

B. Composition of the investment portfolio by currency

27. The majority of IFAD's commitments are expressed in special drawing rights (SDR). Consequently, the Fund's overall assets are maintained in such a way as to ensure that commitments for undisbursed loans and grants denominated in SDR 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.

28. 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 re-weighting of the basket.

29. 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 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 December 2006, are shown in table 6.

Table 6
Units and weights applicable to SDR valuation basket

	1 January 2006		*31 December 2006*	
Currency	*Units*	*Percentage weight*	*Units*	*Percentage weight*
U.S. dollar	0.6320	43.7	0.6320	41.9
Euro	0.4100	34.3	0.4100	36.0
Yen	18.4000	10.9	18.4000	10.3
Pound sterling	0.0903	11.1	0.0903	11.8
Total		**100.0**		**100.0**

30. At 31 December 2006, assets in the form of cash, investments, promissory notes and contribution receivables from Member States under the Fourth, Fifth, Sixth and Seventh Replenishments, net of provisions, amounted to US$2,865,429,000 equivalent, as summarized in table 7 (compared with US$2,688,417,000 equivalent at 31 December 2005).

Table 7
Currency composition of assets in the form of cash, investments and other receivables
(Thousands of United States dollars equivalent)

Currency	*Cash and investments*	*Promissory notes*	*Contribution receivables from Member States*	*Total*
U.S. dollar group[a]	1 062 403	69 369	100 638	1 232 410
Euro group[b]	794 979	150 240	95 417	1 040 636
Yen	263 865	22 927	15 256	302 048
Pound sterling	236 641	6 459	47 235	290 335
Total	**2 357 888**	**248 995**	**258 546**	**2 865 429**

[a] Includes assets in Australian, Canadian and New Zealand dollars.
[b] Includes assets in Swiss francs, Swedish kronor, Danish kroner and Norwegian kroner.

31. The alignment of assets by currency group against the SDR valuation basket as at 31 December 2006 is shown in table 8. The balance of commitments denominated in United States dollars at 31 December 2006 amounted to US$179,821,000 equivalent, composed of the General Reserve (US$95,000,000) and commitments for grants denominated in United States dollars (US$84,821,000).

Table 8
Alignment of assets per currency group with the SDR valuation composition
(Thousands of United States dollars equivalent)

Currency	*Asset amount*	*Less: commitments denominated in U.S. dollars*	*Net asset amount*	*Net asset amount (percentage)*	*SDR weights (percentage)*	*Difference (percentage)*
U.S. dollar group	1 232 410	(179 821)	1 052 589	39.3	41.9	(2.6)
Euro group	1 040 636		1 040 636	38.7	36.0	2.7
Yen	302 048		302 048	11.2	10.3	0.9
Pound sterling	290 335		290 335	10.8	11.8	(1.0)
Total	**2 865 429**	**(179 821)**	**2 685 608**	**100.0**	**100.0**	**-**

32. As at 31 December 2006, there was an excess allocation in euro currency group holdings (+2.7 per cent) and yen (+0.9), which was offset by a shortfall in the dollar currency group (-2.6 per cent) and the pound sterling (-1.0 per cent).

C. Composition of the investment portfolio by maturity

33. Table 9 provides details on the composition of the overall investment portfolio by maturity as at 31 December 2006 and compares this with the maturity composition at 31 December 2005. The average life to maturity of the overall investment portfolio at 31 December 2006 was three years, compared with seven years at 31 December 2005. This reflects the external managers’ duration strategies but also the result of the short-term tactical measures taken in July 2006.

Table 9
Composition of the investment portfolio by maturity
(Thousands of United States dollars equivalent)

	31 December 2006		*31 December 2005*	
Period	*Amount*	*Percentage*	*Amount*	*Percentage*
Due in one year or less	962 477	40.8	545 217	23.2
Due after one year through five years	1 092 640	46.4	1 181 197	50.3
Due from five to ten years	165 785	7.0	169 883	7.3
Due after ten years	137 700	5.8	451 469	19.2
Total	**2 358 602**	**100.0**	**2 347 765**	**100.0**

VIII. Risk management

34. With the exception of operational cash, tactical short-term and held-to-maturity investments, the investment portfolio 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 31 December 2006, the standard deviation of IFAD's investment portfolio was 0.9 per cent, compared with 1.6 per cent for the investment policy.

35. 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 10 shows the VaR of IFAD's investment portfolio and that of the investment policy as at 31 December 2006 and for previous periods.

Table 10
Value-at-risk (VaR)
(Forecast horizon of three months, confidence level at 95 per cent)

	Investment portfolio		*Investment policy*	
Date	*VaR (Percentage)*	*Amount (Thousands of U.S. dollars)*	*VaR (Percentage)*	*Amount (Thousands of U.S. dollars)*
31 December 2006	0.8	18 000	1.4	32 300
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

36. At 31 December 2006, the investment portfolio's VaR was 0.8 per cent, unchanged from the previous quarter's end, and well below the investment policy VaR of 1.4 per cent. It should be noted that the investment policy VaR reflects the policy allocation (see table 1).