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Enabling poor rural people
to overcome poverty

Report on IFAD's investment portfolio for 2007

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For: **Information**

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Report on IFAD's investment portfolio for 2007

I. Executive summary

1. IFAD's investment portfolio performed very positively during 2007 with a net investment return of 6.10 per cent. IFAD's prudent investment policy and the high-quality instruments in the portfolio secured it against the turmoil in global capital markets during the second half of the year. Investors' flight-to-quality triggered by the subprime market crisis favoured the performance of IFAD investments.

2. During the second quarter of 2007, US$300,000,000 of short-term tactical instruments matured and were reinvested in the diversified fixed-interest asset class. This proved to be a successful and timely decision as this asset class performed very strongly during the second half of the year.

3. In aggregate, the net investment income from IFAD's investment portfolio amounted to US$142,572,000 equivalent in 2007, equal to an overall net return of 6.10 per cent, representing an outperformance of 25 basis points against the overall benchmark.

4. The value of the investment portfolio in United States dollar terms increased by US$142,458,000, from US$2,358,602,000 equivalent at 31 December 2006 to US$2,501,060,000 equivalent at 31 December 2007. The major contributors to this growth were net investment income and foreign exchange movements, which offset the net disbursement outflows.

II. Introduction

5. This report on IFAD's investment portfolio covers the year ended 31 December 2007 and includes comparative figures for the year ended 31 December 2006.

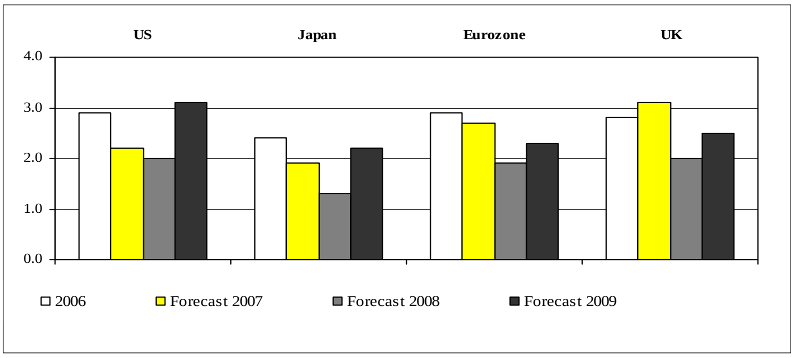
6. The report consists of the following sections: market conditions; asset allocation; investment income; rate of return and performance comparison; composition of the portfolio; and risk management.

III. Market conditions

7. The following charts show trends for three key economic indicators: real GDP growth rate, consumer prices and unemployment rate. These indicators are shown for the countries whose currencies make up the valuation basket for special drawing rights (SDRs): Eurozone countries, Japan, the United Kingdom of Great Britain and Northern Ireland, and the United States of America.

8. GDP growth rates in 2007 decreased from the 2006 level in all SDR countries except the United Kingdom (see chart 1). A sharp contraction in the United States housing market, turmoil in credit markets and rising oil prices weakened economic growth worldwide. The United Kingdom was an exception, where unexpected strong consumption supported economic growth throughout the year. The current outlook for 2008 indicates that the economy will slow down in all SDR zones.

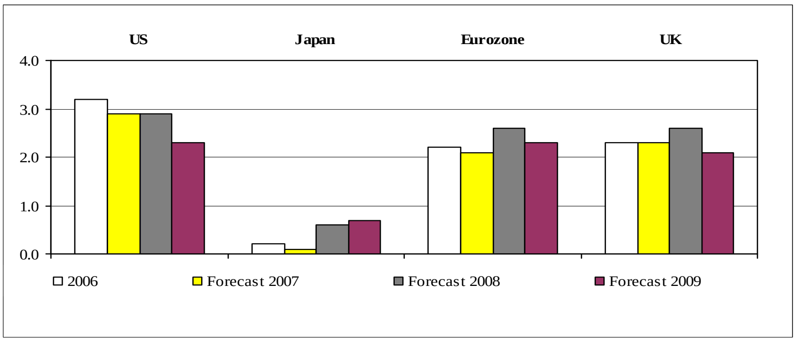
Chart 1
GDP growth rates



Source: J.P. Morgan

9. Inflation – as represented by the consumer price index (CPI) – abated in 2007, reflecting the economic slowdown worldwide and tightening monetary policies by the majority of central banks (see chart 2). In 2008, it is estimated that the inflation rate will remain unchanged in the United States while a slight increase is expected in other SDR countries. Inflation remains a concern due to increasing energy and food prices. Furthermore, an easing in monetary policy in the United States in response to the credit market crisis may fuel inflationary pressures and also influence other central banks to follow suit.

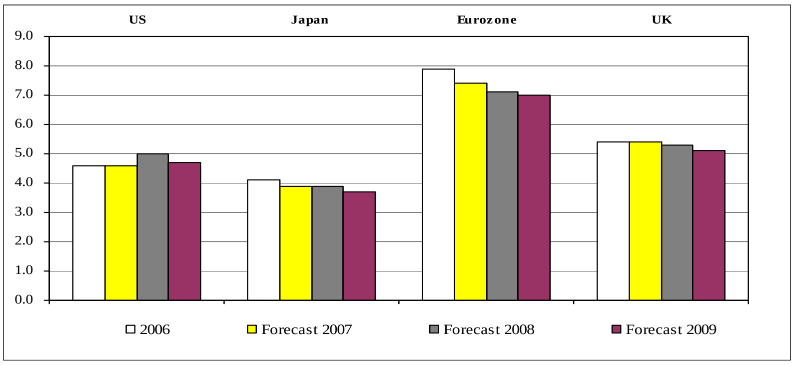
Chart 2
CPI index



Source: J.P. Morgan

10. Unemployment rates decreased slightly in 2007 in the Eurozone and in Japan, while remaining unchanged in the United States and the United Kingdom (see chart 3). Unemployment rates are forecast to be lower in 2008 with the exception of a small rise in the United States, reflecting an economic slowdown.

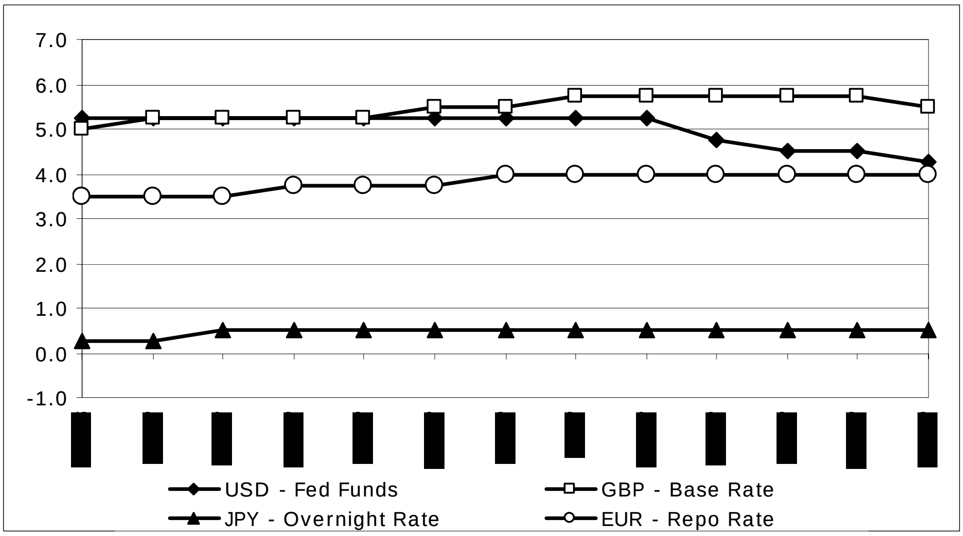
Chart 3
Unemployment rates



Source: J.P. Morgan

11. Chart 4 shows the evolution of central bank interest rates for SDR countries. The Federal Reserve Bank of the United States decreased the federal funds rate three times in 2007, from 5.25 per cent to 4.25 per cent, to counter the financial crisis triggered by rising defaults on subprime mortgages. The European Central Bank raised its refinancing rate twice, from 3.50 per cent to 4.00 per cent, during the first half of the year to counter inflationary pressures and kept it on hold for the rest of the year. The Bank of England raised its base rate three times to 5.75 per cent and cut it once, in December 2007, to 5.50 per cent to ease the liquidity squeeze in the aftermath of the capital market turmoil. The Bank of Japan raised its target rate only once in 2007, from 0.25 per cent to 0.50 per cent.

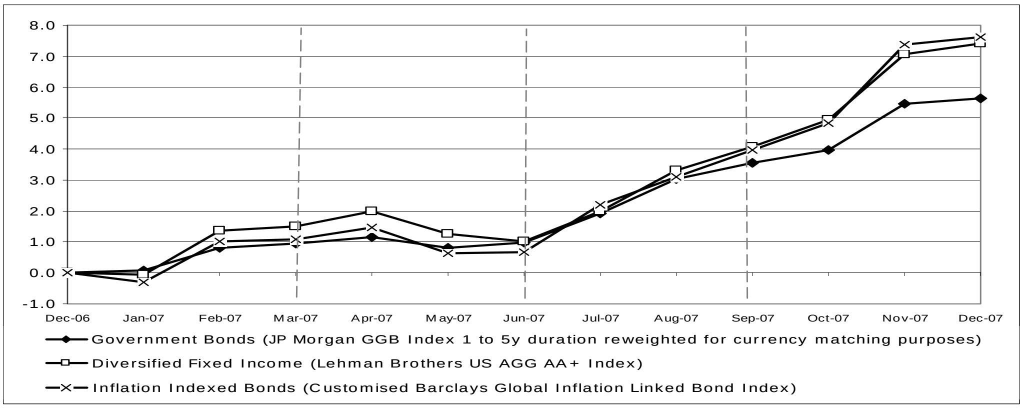
Chart 4
Central Bank interest rates



Source: Bloomberg

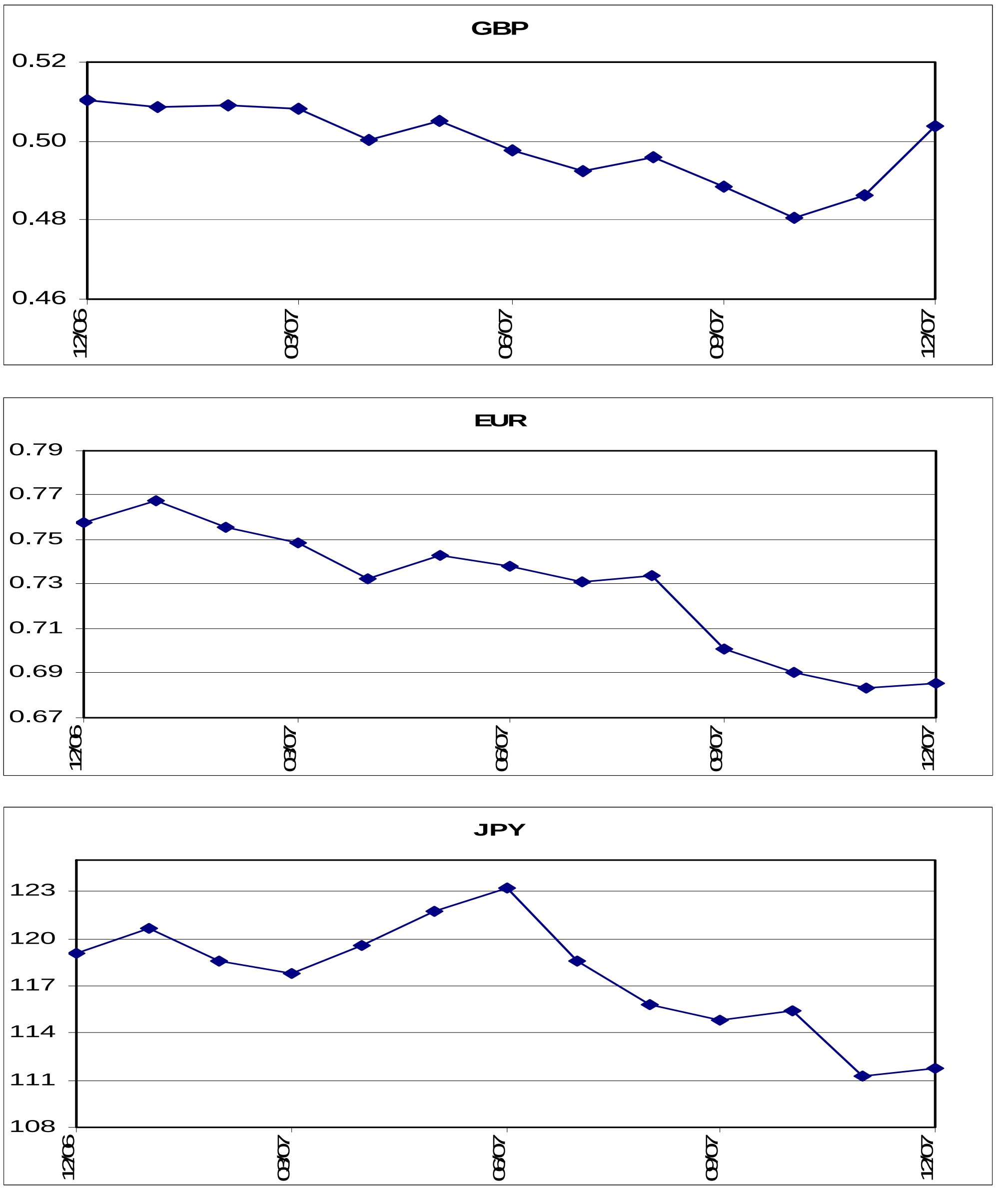
12. Chart 5 shows the performance in 2007 of fixed-income markets where IFAD's investment portfolio was invested and managed. Each line represents one of the benchmark indexes used by IFAD for global government bonds, diversified fixed-interest bonds and inflation-indexed bonds portfolios. Fixed-interest markets showed a very positive performance particularly during the second half of the year, benefiting from investors' flight-to-quality that followed the credit market turmoil. The inflation-linked market recorded the highest performance during the fourth quarter due to declining real yields, which reflected the economic slowdown and expectations of rising inflation.

Chart 5
Fixed-interest market developments in 2007
(Percentage in local currency terms)



13. Chart 6 illustrates month-end exchange rates for the United States dollar against three other SDR composite currencies, i.e. the pound sterling (GBP), euro (EUR) and Japanese yen (JPY).

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



Source: Bloomberg

14. In 2007, the United States dollar continued to depreciate against all other SDR currencies. The main reason for this was the falling demand for United States dollars, as United States yields became less attractive than yields in the United Kingdom, and even less attractive than Eurozone yields.

15. The weakening United States currency, however, helped increase IFAD's overall investment portfolio value in United States dollar terms, as described in section IV.

IV. Asset allocation

16. Table 1 shows the movements affecting the investment portfolio by asset class in 2007 and compares the portfolio's year-end asset allocation with the policy allocation.

Table 1
Movements in cash and investments by portfolio in 2007
(Thousands of United States dollars equivalent)

	Operational cash[a]	*Short-term tactical instruments*[b]	*Held-to-maturity*	*Government bonds*	*Diversified fixed-interest bonds*	*Inflation-indexed bonds*	*Total*
Opening balance (1 January 2007)	**89 574**	**462 351**	**413 501**	**956 055**	**100 540**	**336 581**	**2 358 602**
Net investment income	4 988	14 707	16 656	57 083	24 559	24 579	142 572
Transfers due to allocation	162 218	(439 817)	(19 561)	-	299 825	(2 665)	-
Transfers due to expenses	(1 807)	101	(221)	1 083	271	573	-
Net disbursement[c]	(89 933)	-	-	-	-	-	(89 933)
Movements on exchange	4 479	3 009	17 593	53 579	(10)	11 169	89 819
Closing balance by portfolio (31 December 2007)	169 519	40 351	427 968	1 067 800	425 185	370 237	2 501 060
Actual asset allocation (percentage)	6.8	1.6	17.1	42.7	17.0	14.8	100.0
Investment Policy asset allocation[d]	5.5	-	17.1	43.5	13.9	20.0	100.0
Difference in asset allocation (percentage)	1.3	1.6	-	(0.8)	3.1	(5.2)	-

[a] Cash and time deposits held with banks, readily available for disbursing loans, grants and administrative expenses.
[b] Short-term investments in time deposits and commercial papers.
[c] Disbursements for loans, grants and administrative expenses net of cash receipts and encashment of Member State contributions.
[d] The investment policy allocation includes the 17.1 per cent allocation to the held-to-maturity portfolio, which is fixed at the principal amount of US$400,000,000.

17. The short-term tactical instruments – initially purchased in July 2006 and rolled over in January 2007 – matured in July 2007. The majority of the maturing proceeds – approximately US$300,000,000 – was reinvested in diversified fixed-interest bonds and approximately US$117,000,000 was transferred into the operational cash portfolio to cover disbursement needs. As at 31 December, a balance of US$40,351,000 was still in short-term tactical instruments.

18. An amount of US$19,561,000 equivalent representing coupon income from held-to-maturity investments was transferred to the operational cash portfolio during 2007.

19. There was a net outflow of US$89,933,000 equivalent, representing disbursements for loans, grants and administrative expenses net of cash receipts and encashment of Member State contributions.

20. These movements – combined with a net investment income of US$142,572,000 equivalent and positive foreign exchange movements of US$89,819,000 equivalent – increased the overall investment portfolio value in United States dollar terms by US$142,458,000 equivalent during 2007.

21. The refunding of the diversified fixed-interest portfolio has brought the overall asset allocation of IFAD’s investment portfolio closer to its policy allocation.

V. Investment income

22. In 2007, the aggregate net investment income amounted to US$142,572,000 equivalent. Both realized and unrealized gains and losses are included in the investment income. Table 2 presents a summary of the 2007 investment income broken down by asset class. All asset classes contributed to the higher investment income as compared with US$57,906,000 in 2006.

Table 2
Net investment income by asset class in 2007
(Thousands of United States dollars equivalent)

	Operational cash	*Short-term tactical instruments*	*Held-to-maturity*	*Government bonds*	*Diversified fixed-interest bonds*	*Inflation-indexed bonds*	*Total*
Interest from fixed-interest investments and bank accounts	4 768	11 728	17 329	43 074	11 945	11 997	100 841
Realized capital gains/(losses)	310	9 168	-	(10 265)	5 436	2 183	6 832
Unrealized capital gains/(losses)	22	(6 088)	-	25 355	7 478	10 996	37 763
Amortization/accretion[a]	-	-	(893)	-	-	-	(893)
Income from securities lending	-	-	360	926	296	307	1 889
Subtotal: gross investment income/(loss)	**5 100**	**14 808**	**16 796**	**59 090**	**25 155**	**25 483**	**146 432**
Investment manager fees	-	-	-	(1 670)	(463)	(734)	(2 867)
Custody fees/bank charges	(102)	(16)	(37)	(97)	(60)	(64)	(376)
Financial advisory and other investment management fees	-	(85)	(103)	(240)	(44)	(83)	(555)
Taxes	(10)	-	-	-	-	-	(10)
Derivatives expenses					(29)	(23)	(52)
Net investment income/(loss)	**4 988**	**14 707**	**16 656**	**57 083**	**24 559**	**24 579**	**142 572**

[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.

VI. Rate of return and performance comparison

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

24. 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 index for diversified fixed-interest bonds and Barclays customized inflation-linked index for the inflation-indexed bonds.

25. Table 3 compares the actual net return on the overall portfolio with the overall benchmark return. The portfolio returned a positive 6.10 per cent in 2007, net of investment expenses and excluding the impact of foreign exchange movements. This represented an outperformance of 25 basis points against the aggregate benchmark return.

Table 3
IFAD investment portfolio performance compared with benchmarks for 2007
(Percentages in local currency terms)

	Rate of return		*Out/(under) performance*
	Actual	*Benchmark*	
Gross rate of return	**6.24**	**5.99**	**0.25**
Less expenses	(0.14)	(0.14)	-
Net rate of return	**6.10**	**5.85**	**0.25**

VII. Composition of the portfolio

A. Composition of the investment portfolio by instrument

26. Table 4 shows the major asset classes of the overall portfolio. Following the reinvestment of matured short-term tactical instruments into diversified fixed-interest assets, the allocation of fixed-income securities increased, particularly high-grade mortgage-backed and corporate securities, whereas the portion of time deposits and other obligations of banks in the portfolio decreased.

Table 4
Composition of investment portfolio by instrument
(Thousands of United States dollars equivalent)

	31 December 2007	*31 December 2006*
Cash[a]	264 530	156 720
Time deposits and other obligations of banks[b]	85 897	507 875
Global government bonds/government agencies	1 686 657	1 470 323
Mortgage-backed securities[c]	284 678	77 961
Asset-backed securities	19 108	14 093
Corporate bonds	323 535	192 736
Unrealized market value gain/(loss) on forward contracts	(136)	(5 145)
Unrealized gain on futures	2 456	585
Options	182	-
Subtotal: cash and investments	**2 666 907**	**2 415 148**
Receivables for investments sold	53 489	22 883
Payables for investments purchased	(219 336)	(79 429)
Total	**2 501 060**	**2 358 602**

[a] Includes cash in non-convertible currencies amounting to US$79,000 equivalent (US$79,000 in 2006).
[b] Includes time deposits in non-convertible currencies amounting to US$627,000 equivalent (US$634,000 in 2006).
[c] Mortgage-backed securities in IFAD's investment portfolio are high-quality instruments bearing an AAA government guarantee and their risk profile is very low.

B. Composition of the investment portfolio by currency

27. 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 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 reweighting of the basket.

29. The new units for each of the four currencies making up 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 2007, are shown in table 5.

Table 5
Units and weights applicable to SDR valuation basket

	1 January 2006		*31 December 2007*	
Currency	*Units*	*Percentage weight*	*Units*	*Percentage weight*
United States dollar	0.6320	43.7	0.6320	40.1
Euro	0.4100	34.3	0.4100	38.0
Yen	18.4000	10.9	18.4000	10.5
Pound sterling	0.0903	11.1	0.0903	11.4
Total		**100.0**		**100.0**

30. At 31 December 2007, assets in the form of cash, investments, promissory notes and contribution receivables from Member States under the Fifth, Sixth and Seventh Replenishments, net of provisions, amounted to US$3,062,214,000 equivalent, as summarized in table 6 (compared with US$2,865,429,000 equivalent at 31 December 2006).

Table 6
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*
United States dollar group[a]	1 122 771	101 650	102 160	1 326 581
Euro group[b]	788 076	124 188	127 047	1 039 311
Yen	294 914	24 408	-	319 322
Pound sterling	294 594	8 299	74 107	377 000
Total	**2 500 355**	**258 545**	**303 314**	**3 062 214**

[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 2007 is shown in table 7. The balance of commitments denominated in United States dollars at 31 December 2007 amounted to US$172,760,000 equivalent, composed of the General Reserve (US$95,000,000) and commitments for grants denominated in United States dollars (US$77,760,000).

Table 7
Alignment of assets per currency group with the SDR valuation composition as at 31 December 2007
(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)*
US dollar group	1 326 581	(172 760)	1 153 821	39.8	40.1	(0.3)
Euro group	1 039 311	-	1 039 311	36.0	38.0	(2.0)
Yen	319 322	-	319 322	11.1	10.5	0.6
Pound sterling	377 000	-	377 000	13.1	11.4	1.7
Total	**3 062 214**	**(172 760)**	**2 889 454**	**100.0**	**100.0**	0.0

32. As at 31 December 2007, there was a shortfall in the euro currency group holdings (-2.0 per cent) and in the United States dollar currency group (-0.3), which was offset by an excess allocation in the pound sterling (+1.7 per cent) and in the Japanese yen (+0.6 per cent).

33. IFAD's Office of the Treasurer has already taken active measures to bring the currency allocation more in line with the SDR basket. In early January 2008, US$22,892,000 equivalent was converted from pound sterling into euro, thereby reducing the euro currency group shortfall from -2.0 per cent to -1.2 per cent, and the pound sterling excess allocation from +1.7 per cent to +0.9 per cent.

C. Composition of the investment portfolio by maturity

34. Table 8 provides details on the composition of the overall investment portfolio by maturity as at 31 December 2007 and compares this with the maturity composition at 31 December 2006. The average duration of the overall investment portfolio at 31 December 2007 was 2.9 years, greater than the previous year-end. This was a consequence of the refunding of the diversified fixed-interest asset class which has a longer duration than the previously held short-term tactical instruments.

Table 8
Composition of the investment portfolio by maturity
(Thousands of United States dollars equivalent)

	31 December 2007		*31 December 2006*	
Period	*Amount*	*Percentage*	*Amount*	*Percentage*
Due in one year or less	377 542	15.1	962 477	40.8
Due after one year through five years	1 579 607	63.2	1 092 640	46.4
Due from five to ten years	155 222	6.2	165 785	7.0
Due after ten years	388 689	15.5	137 700	5.8
Total	**2 501 060**	**100.0**	**2 358 602**	**100.0**
Weighted average duration		**2.9 years**		**1.8 years**

VIII. Risk management

35. With the exception of operational cash, tactical short-term instruments 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 2007, the standard deviation of IFAD’s investment portfolio was 0.9 per cent, compared with 1.6 per cent for the investment policy.

36. 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 forward time horizon, with a 95 per cent confidence level. Table 9 shows the VaR of IFAD’s investment portfolio and that of the investment policy as at 31 December 2007 and for previous periods.

Table 9
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 2007	1.3	32 500	1.4	35 000
30 September 2007	1.4	33 900	1.4	33 900
30 June 2007	0.9	21 400	1.4	33 200
31 March 2007	0.7	16 600	1.3	30 800
31 December 2006	0.8	18 000	1.4	32 300

37. At 31 December 2007, the investment portfolio’s VaR was 1.3 per cent, almost unchanged from the end of the previous quarter, and slightly below the investment policy VaR of 1.4 per cent. It should be noted that the investment policy VaR is based on the policy allocation (see table 1).