EBS/03/152

November 11, 2003

To: Members of the Executive Board

From: The Secretary

Subject: **Semi-Annual Review of PRGF, PRGF-HIPC, and SDA Investments**

Attached for the **information** of Executive Directors is a paper on the semi-annual review of PRGF, PRGF-HIPC, and SDA investments.

It is not intended that this paper will be published on the Fund's external website.

Questions may be referred to Mr. Lin (ext. 37299) and Mr. Clarke (ext. 34086) in FIN.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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Department Heads

INTERNATIONAL MONETARY FUND

Semi-Annual Review of PRGF, PRGF-HIPC, and SDA Investments

Prepared by the Finance Department

In consultation with the International Capital Markets, Legal, and Policy Development and Review Departments

Approved by Eduard Brau

November 11, 2003

I. Introduction and Summary

1. **This paper presents, for the information of the Executive Board, an overview of the investment of PRGF, PRGF-HIPC, and SDA resources during the six months through end-September 2003.**[1] The source of these investments and the key features of the investment strategy are summarized in Box 1.

2. **The paper makes the following key points**:

- Market developments in April–September 2003 were dominated by a sharp sell off in global bond markets in July and August following an abrupt change in expectations for economic growth and monetary policy in the United States.
- The total portfolio of SDR 9.8 billion earned 87 basis points during this period. The rise in market interest rates constrained bond performance but boosted the return on SDR-denominated deposits (51 percent of the total portfolio) to 96 basis points.
- Bond manager performance was mixed, as expected in an environment of unusually low and flat yield curves in all major money markets.
- Following the termination in August of the FFTW management contract, all assets in the SDR 398 million bond portfolio formerly under its management were transferred to the two remaining private portfolio managers (JPMorgan and UBS) in equal shares.
- The current short-duration strategy remains under continuous review but no change is proposed at this time.

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[1] The investment performance of the portfolio was last reviewed in *Annual Review of PRGF, PRGF-HIPC, and SDA Investments* (EBS/03/106, 7/17/03), and the next such review will be issued in the spring of 2004.

Box 1. The Investment Strategy

The assets under investment consist of contributions from members and the Fund for the financing of PRGF and HIPC operations. Bilateral contributions from members take the form of grants and deposits or loans at below-market interest rates for the benefit of the PRGF Trust or the PRGF-HIPC Trust. Contributions from the Fund are channeled through the Special Disbursement Account (SDA) and are comprised of the net proceeds of off-market gold transactions conducted in 1999 and 2000 (SDR 2,226 million), earning investment income earmarked for the PRGF-HIPC Trust, and other transfers. All contributions are subject to the separate legal requirements of the Trusts and the SDA. At end-September 2003, the total portfolio had a market value of nearly SDR 9,817 million and was structured as follows:

- 60 percent in the PRGF Trust and related accounts;
- 13 percent in the PRGF-HIPC Trust and related accounts; and
- 27 percent in the SDA.

The investible assets of the Trusts and the SDA had long been held in the form of SDR-denominated deposits at the BIS. In March 2000, the Executive Board endorsed a new investment strategy aimed at enhancing the return on these investments in order to supplement the resources available to support PRGF and HIPC operations.

The new strategy centered on an extension of the maturity of investments. This was achieved initially by shifting three quarters of the assets that had been invested in short-term deposits with the BIS into fixed-income securities with an average maturity of 1–3 years. The fixed-income securities are limited to those issued by governments and international financial institutions. In order to minimize currency risk, only securities denominated in the four currencies of the SDR basket are held, with the currency composition of the portfolio weighted to reflect the currency weights of the SDR basket.

The maturity of the portfolio was shortened significantly in January 2002. This measure was taken to protect the investment gains that were generated by the decline in interest rates in all four currencies of the SDR basket to historically low levels at that time. The portfolio restructuring effectively reduced the share of fixed-income securities in the total portfolio from 79 percent to 49 percent, with a corresponding increase in the share of SDR deposits at the BIS, and lowered the duration of the portfolio from 1.4 years to about 4 months.

Four external investment managers—Fisher Francis Trees & Watts (FFTW), JPMorgan Fleming (JPMorgan), UBS Global Asset Management (UBS), and the World Bank—were charged with managing the bond portfolio in a manner consistent with the risk limits in the investment mandate (see EBS/00/26, 2/15/00) and pre-determined benchmark indices. The contract with FFTW was terminated in August 2003. The current benchmarks are: (i) a 3-month index based on the London Interbank Bid Rate (LIBID) in the case of JPMorgan and UBS; and (ii) a Merrill-Lynch 0–1 year government bond index for the World Bank. A different benchmark was chosen for the World Bank because the SDA assets under its management cannot be invested in commercial bank deposits, which are the basis of the LIBID index.

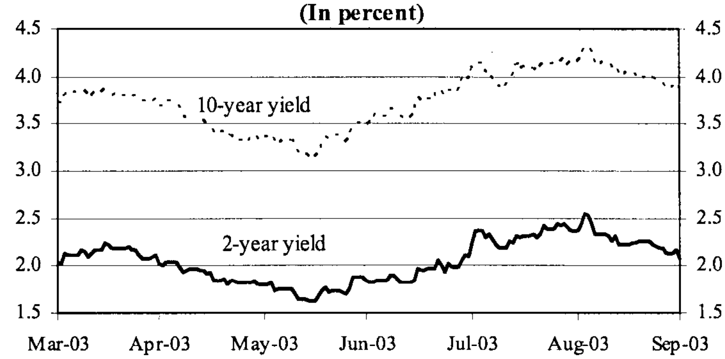
II. RECENT DEVELOPMENTS

Market review

3. **The downward trend in government bond yields continued through mid-June.** Beginning in May, the weaker-than-expected recovery in economic activity in the aftermath of the Iraq war and rising concerns about the possible onset of a deflationary spiral in the United States and Germany drove government yields lower in all four markets that make up the SDR basket (Figure 1). By mid-June, U.S. Treasury securities recorded new historic lows, with the two-year note briefly yielding only 1.10 percent.

4. **Bond markets sold off in July and August, pushing yields sharply higher**. The expected monetary policy in the United States shifted in late June when the Federal Reserve surprised markets by lowering its target for the federal funds rate by 25 basis points, against widespread expectations of a 50 basis point cut, and signaled that it would not resort to "extraordinary" disinflation measures such as purchasing U.S. government securities. The abrupt change in market sentiment was supported by strong data releases in July and August, which pointed toward a more robust economic environment in the second half of 2003. This triggered a rally in major equity markets and a severe sell off in bond markets, with the yield on two-year U.S. Treasury securities surging by 93 basis points through early September, as market participants reallocated portfolios in line with the expectation of a sustainable global economic recovery. On the strength of a modest decline in subsequent weeks, government bond yields in the United States and the euro area ended the period more or less where they began (Attachment 1). By contrast, yields ended higher in Japan and the United Kingdom, reflecting the significant shift from bonds into equities in Japan and the more advanced position of the U.K. economy in the economic cycle.

Figure 1. Nominal Yields for SDR Composite Government Securities, April-September 2003
(In percent)



Source: Bloomberg for government yields, and IMF for SDR basket weights.

Portfolio structure

5. **The management contract with FFTW was terminated in August 2003**. As noted in the most recent annual investment review (EBS/03/106), the staff placed FFTW on its watchlist in June 2002 owing to its poor performance. The staff met with the firm's senior management on several occasions to discuss the reasons for its underperformance and to ensure that the portfolio would be supervised closely. Performance over the year continued to be disappointing. Based on this experience, the staff concluded that FFTW's performance was no longer consistent with the low risk tolerance of the Fund acting as Trustee for the resources of the PRGF and PRGF-HIPC Trusts, and the management contract was terminated on August 25.

6. **Assets formerly managed by FFTW are being transferred to other managers**. At the beginning of September, the cash and fixed-income securities in the portfolio formerly managed by FFTW were transferred in equal amounts to the two other private investment managers retained by the Fund, JPMorgan and UBS. In consultation with the custodian bank, and in order to minimize transaction costs and avoid interest penalties, the remaining assets in the form of time deposits with commercial banks are being transferred as these deposits

mature in October, November, and December, when the transfer will be completed. As a result, the currency weights of these assets do not match the SDR basket weights, giving rise to temporary currency exposure on this residual part of the portfolio. The reallocation of assets to JPMorgan and UBS was designed to preserve the initial 3:1 portfolio allocation between the World Bank and private managers (Box 2). These two managers have continued to perform well under their investment mandates and, in return for the allocation of additional assets, agreed to reduce their management fees, from an annual average of 10 basis points for JPMorgan and 9 basis points for UBS to 8 and 7½ basis points, respectively.

Box 2. External Managers—Institutional Arrangements

Three types of external managers were engaged to invest assets on the Fund's behalf. The selected managers were the BIS, the World Bank, and three private investment managers: Fischer Francis Trees & Watts (New York), JPMorgan (London and New York), and UBS (Zürich and Chicago). This portfolio structure was designed to benefit from the distinct institutional advantages of each type of manager: the investment vehicles offered by the BIS; the congruent investment objectives, its performance track record, and low cost of the World Bank; and the market insight and potential for value added afforded by private investment managers. This diversified structure fosters competition among the various external managers, spreads the risk of performance shortfalls, and provides insight into a variety of approaches to asset management. At the same time, the administrative cost of external investment management and custody under the new investment approach is about 8–8½ basis points, lower than the 12–14 basis points charged (in spreads) by the BIS on short-term SDR-denominated deposits.

Portfolio performance

7. **The portfolio generated positive returns over the period under review.** The total portfolio of SDR 9.8 billion earned 87 basis points during April-September 2003 (Table 1). The bond portfolio, which accounts for 49 percent of the total portfolio, generated a return of 77 basis points, underperforming the combined benchmark by 5 basis points. Deposits at the BIS denominated in SDRs earned 96 basis points, well in excess of the six-month SDR rate.

Table 1. Investment Summary as of end-September 2003
(in percent unless otherwise noted)

	Valuation			Performance		
	Net Asset Value (in SDR millions)	Bond Duration/ Deposit Maturity (in months)	Yield	April - September 2003 (cumulative)	April - September 2003 (annualized)	Inception to Date (annualized)
Bond Portfolio	**4,789.8**	**4.5**	**1.9**	**0.77**	**1.55**	**4.2**
FFTW Residual [1]	233.7	---	---	-0.72	-1.43	3.5
JPM	484.2	1.8	1.5	0.75	1.50	4.3
UBS	483.1	2.3	1.5	0.80	1.60	4.2
World Bank	3,588.9	5.4	2.1	0.87	1.74	4.3
Deposits	**5,027.1**	**2.1**	**1.5**	**0.96**	**1.93**	**3.4**
Total	**9,816.9**	**3.3**	**1.7**	**0.87**	**1.74**	**3.8**
Memorandum Items:						
Private manager benchmark		1.5	1.5	0.81	1.62	4.1
World Bank benchmark		5.4	1.6	0.82	1.65	4.2
6-month SDR rate		...	...	0.80	1.60	3.0

[1] SDR 161 million was transferred on September 2 to JPM and UBS. During September the portfolio comprised time deposits at commercial banks, primarily in U.S. dollars, which will be transferred to JPM and UBS as they mature.

8. **The investment strategy continues to meet its financing objectives.** With an annualized rate of return of 4.2 percent since the inception of the investment strategy, the bond portfolio continues to outperform deposits held at the BIS by a substantial margin (Table 1). On an annualized basis, the investment strategy has added 113 basis points (net of fees) to the previous strategy of maintaining only SDR-denominated deposits, generating in total about SDR 270 million in additional income to support PRGF and HIPC operations.

Portfolio compliance

9. **The risk limits established for the bond portfolio were observed.** Regular rebalancing of each of the four bond portfolios ensures that their currency composition closely matches that of the SDR basket, thereby limiting exposure to currency risk (Attachment 2). The deviation from the SDR basket was somewhat larger than normal at end-September due to the pending transfer of assets denominated primarily in U.S. dollars (see paragraph 6). The duration of the bond portfolios was kept within the limits established in their respective investment mandates and, in aggregate, stood at 4.5 months at end-September 2003. All securities and deposits held in the bond portfolio conformed to the credit and issuer limits established in the investment guidelines.

Manager performance

10. **The performance of investment managers in April-September 2003 was mixed.** During the period under review, the World Bank outperformed its 0–1 year government bond benchmark, while the private managers fell short of the three-month LIBID benchmark. In an environment of very low interest rates, and with money market yield curves essentially flat, it has become increasingly difficult for managers to consistently outperform short-duration benchmarks.

- The **World Bank** earned positive excess returns in four out of six months, with a high of 3 basis points in May and a low of about -1 basis point in August. On a cumulative basis, the World Bank outperformed its benchmark by 5 basis points over this period.

- **UBS** outperformed its benchmark three times over the past six months. Poor performance in August (more than 9 basis points below benchmark) hurt its overall return and resulted in a small shortfall of 1 basis point compared to the benchmark.

- **JPMorgan** underperformed the benchmark in four months, generating a cumulative shortfall of 6 basis points against the benchmark.

- **FFTW** earned 74 basis points through August 25. The residual portfolio comprises only time deposits established by FFTW prior to August 25, denominated primarily in U.S. dollars, which cannot easily be liquidated. These deposits generated a small return in September. However, the depreciation of the U.S. dollar against other currencies in September more than offset investment gains, resulting in a negative return to the portfolio.

11. **Over a longer horizon, the performance of most managers remains strong**. The performance of external managers continues to offer an attractive risk-reward tradeoff based on standard metrics (Table 2).

Table 2. Performance Metrics [1]
(Annualized, in percent)

	Tracking Error		Information Ratio	
	(Apr 2000–Dec 2001)	(Jan 2002–Sep 2003)	(Apr 2000–Dec 2001)	(Jan 2002–Sep 2003)
JPM	0.41	0.19	0.24	0.65
UBS	0.24	0.16	-0.59	1.12
World Bank	0.14	0.12	0.12	1.61

[1] Tracking error is a measure of the risk profile of a portfolio relative to a benchmark index, based on the standard deviation of monthly excess returns. The information ratio measures the risk-reward profile of a portfolio by expressing the average monthly excess return in terms of the tracking error.

III. NEXT STEPS

12. **The investment strategy is kept under continuous review.** The ongoing analysis of the risks facing the bond portfolio in the current environment of historically low yields for government securities suggests that the short duration of the bond portfolio remains appropriate.[2] The staff does not therefore propose any change for the time being. Looking forward, the staff is formulating a framework for changing duration to allow the bond portfolio to benefit from rising yields while preserving the Fund's low tolerance for risk.

13. **The next paper reviewing PRGF, PRGF-HIPC, and SDA investments will be issued to the Executive Board in May 2004.** The fourth annual review of these investments will report on portfolio performance over the full year through March 2004 and the status of ongoing work.

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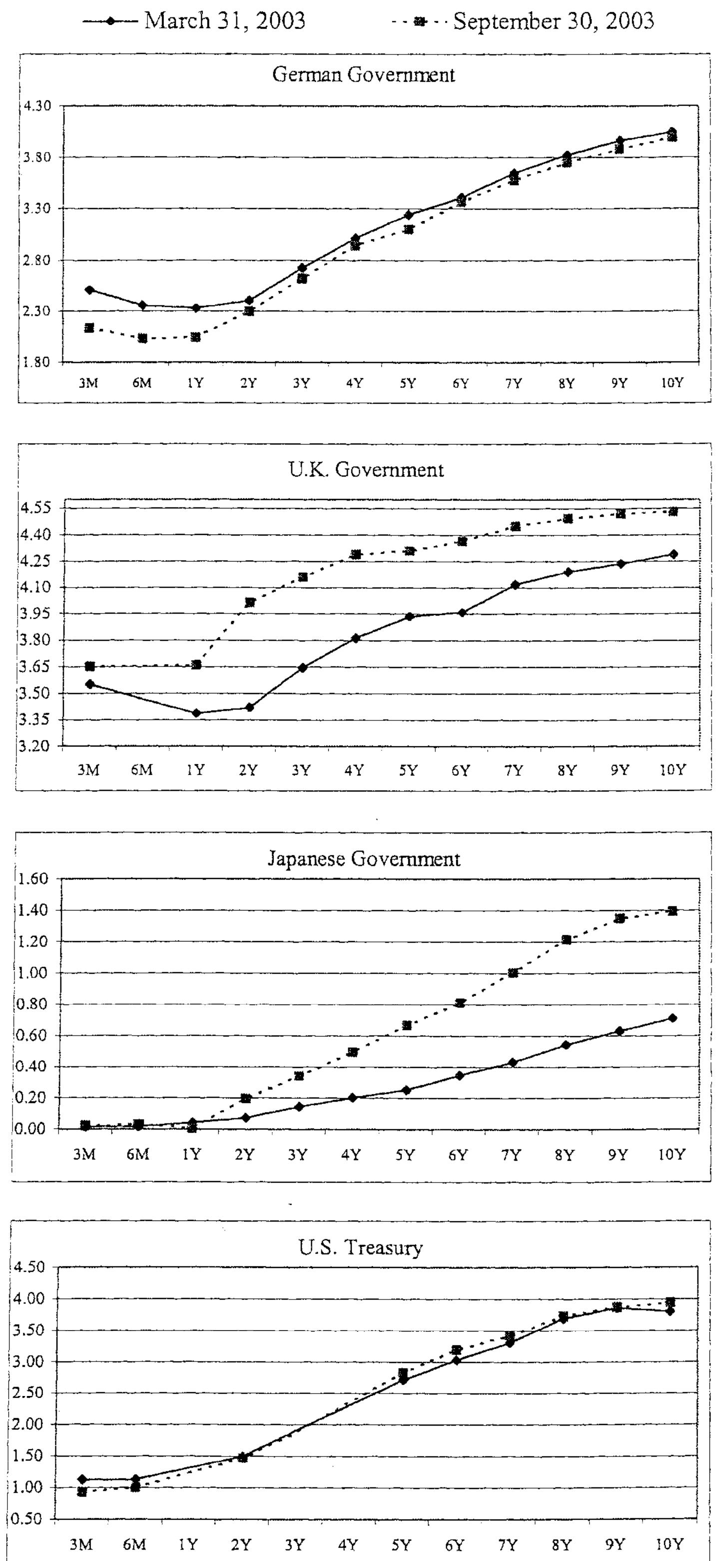
[2] The current opportunity cost of shortening portfolio duration in January 2002 is estimated at SDR 194 million. In practice, access to these potential gains would have exposed the portfolio to an unacceptably high risk of loss. After several decades of near-zero risk, the long decline in bond yields to historic lows caused a sharp spike in the risk of loss for 1–3 year government bond portfolios in early 2002. This changed environment led the Fund and many central banks and other institutional investors that place a high premium on capital preservation to reduce this risk by shortening portfolio duration.

Attachment 1. Yield Curve Changes, March 31 – September 30, 2003



Attachment 2. Bond Portfolio Exposure, September 30, 2003
(In percent)

Currency Exposure

	Benchmark	Portfolio
Euro	34.8	33.3
Japanese yen	13.3	12.5
Pound sterling	11.5	11.5
U.S. dollar	40.4	42.7
Total	100.0	100.0

Country Exposure

	Rating 1/	Portfolio
Belgium	AA+	1.4
European Union		1.6
France	AAA	8.1
Germany	AAA	6.2
Italy	AA	14.2
Japan	AA-	12.5
Luxembourg	AAA	3.4
Netherlands	AAA	1.4
Portugal	AA	1.0
Spain	AA+	0.1
United Kingdom	AAA	11.6
United States	AAA	38.5
Total		100.0

Maturity Exposure

	Portfolio
Cash	30.4
< One Year	59.1
1 to 3 Years	9.8
3 to 5 Years	0.1
5 to 10 Years	0.5
Total	100.0

1/ S&P long-term local currency sovereign rating.