EBS/07/155

December 28, 2007

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Semi-Annual Report on the Investment Account**

Attached for the **information** of Executive Directors is a paper on the semi-annual report on the Investment Account.

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

Questions may be referred to Mr. Ordoobadi (ext. 36935) and Mr. Price (ext. 38805), in FIN.

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

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

Semi-Annual Report on the Investment Account

Prepared by the Finance Department

(In consultation with the Legal, Monetary and Capital Markets, and Policy Development and Review Departments)

Approved by Michael G. Kuhn

December 26, 2007

I. Introduction and Summary

1. **This paper presents the semi-annual report on the Investment Account (IA), covering the period May-October 2007**.[1] [2] The investment objective of the IA is to achieve investment returns that exceed the SDR interest rate over time while minimizing the frequency and extent of negative returns and underperformance over a 12-month investment horizon. To achieve its investment objective, the IA's investment strategy is anchored by a 1–3 year government bond benchmark index, weighted to reflect the currency composition of the SDR basket.

2. **The main points of the paper are:**

- The bond and money markets of the SDR currencies have experienced unusually high volatility since July. The increased demand for liquidity and flight-to-quality generally benefited the portfolio. However, the repricing of credit risk caused swap spreads to widen, hurting the performance of BIS medium-term instruments (MTIs) relative to government bonds.

- The IA performed strongly during the six month period, returning 2.56 percent (non-annualized) and exceeding the SDR interest rate by 49 basis points.

- Although the IA return exceeded the SDR interest rate by a wide margin, its return fell 14 basis points short of the return of the 1–3 year benchmark (2.70 percent). This

[1] The first annual report to the Board on IA performance covered the transitional period since the IA was funded in mid-June 2006 through end-April 2007. See *Annual Review of Investment Account* (EBS/07/72, 6/26/07).

[2] Performance of the PRGF-ESF, PRGF-HIPC, and MDRI Trusts is reviewed in *Semi-Annual Report on the Investments of PRGF-ESF, PRGF-HIPC, and MDRI Trusts* (EBS/07/154, 12/28/07).

was primarily due to lower returns on MTIs and the underperformance of the two private managers, who were not positioned to fully benefit from the sharp drop in bond yields in August and September.

- The IA's earnings in FY 2007 of SDR 179.9 million were transferred to the General Resources Account on July 9. This transfer, which was in line with the Board decision on the disposition of the earnings of the IA, was effected through the BIS in the context of the monthly rebalancing of the MTI portfolio to minimize costs.

3. **The paper is structured as follows**. Section II briefly describes the investment strategy and funding of the IA. Section III analyzes portfolio returns against the background of market developments and reviews manager performance. Section IV reports on risk control measures and compliance.

II. Investment Strategy and Funding

4. **The Executive Board established the IA in April 2006, with the objective of contributing to the Fund's income over time by generating investment returns**.[3] The IA was funded through the transfer of currencies from the GRA in an amount equivalent to SDR 5.96 billion on June 20, 2006, which represented the level of the Fund's General and Special Reserves at April 30, 2006. For the members whose currencies were so transferred, the transfers resulted in increased reserve tranche positions subject to remuneration at the SDR interest rate.

5. **Consistent with its investment authority (Box 1), the IA portfolio is evenly divided between domestic government bonds, managed by external managers, and MTIs issued by the BIS.** Under this balanced allocation, both asset classes have similar durations, anchored to the 1–3 year benchmark index endorsed by the Executive Board. The bond portfolios are managed by the World Bank (35 percent of the total) and JPMorgan and UBS (8 percent each).[4]

---

[3] See *Establishment of the Investment Account* (EBS/06/57, 4/17/06), and *Establishment and Operation of the Investment Account* (SM/05/317, 8/15/05) and BUFF/05/147. The Executive Board established the IA and adopted Rules and Regulations for its administration on April 28, 2006 (*Decisions 13710-(06/40) IA and 13711-(06/40)*, both adopted 4/28/06).

[4] A similar structure is in place for investable assets of the PRGF-ESF, PRGF-HIPC, and MDRI Trusts, which also have a substantial liquidity tranche.

Box 1. Investment Authority of the Investment Account

The investment authority of the IA is specified in the Fund's Articles of Agreement. This authority stipulates that the assets of the IA may be invested in a member's currency "in marketable obligations of that member or in marketable obligations of international financial organizations. No investment shall be made without the concurrence of the member whose currency is used to make the investment. The Fund shall invest only in obligations denominated in special drawing rights or in the currency used for investment" (Article XII, Section 6(*f*)(iii)).

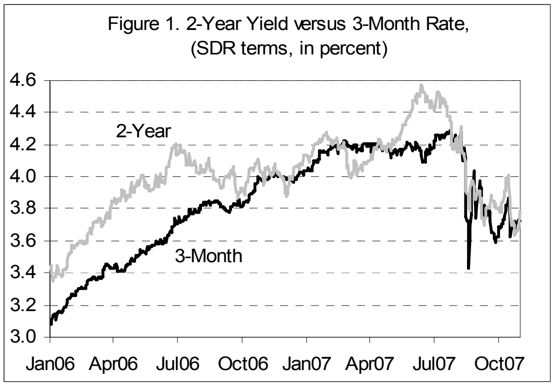
Accordingly, assets of the IA may be invested in marketable obligations of the members whose currencies are used for the investment (including the obligations of their central banks and official agencies) denominated in the currency of the member or SDRs, as well as marketable obligations of specific international financial organizations such as the World Bank, the European Investment Bank, regional development banks, and the Bank for International Settlements (BIS) denominated in the currency used for investment or in SDRs. The investment authority precludes investing in any marketable obligation that is not issued by an eligible issuer. The securities so excluded comprise a number of instruments included in the portfolios of reserve asset managers, such as commercial bank deposits, commercial paper, mortgage- and asset-backed securities, and corporate bonds. They also effectively exclude derivative securities, as such instruments are typically not issued by eligible issuers. The Rules and Regulations for the IA approved by the Executive Board provide for additional limitations, including with regard to the use of derivative securities, short selling, and any form of leverage.

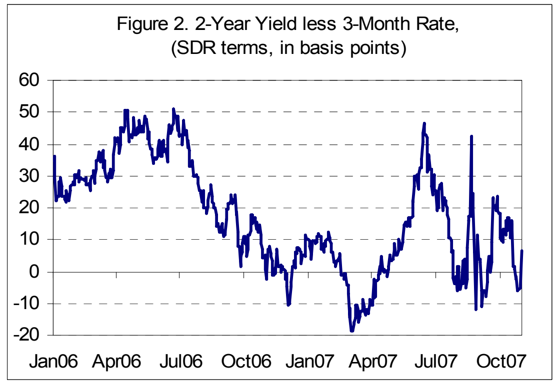
The legal authority does not impose any specific quantitative limit on the currency exposure of the eligible marketable obligations, other than being denominated in the currency used for investment or in SDRs. However, in order to limit currency risk, the benchmark for the IA portfolio is denominated in the SDR. IA assets are invested in marketable obligations denominated in SDRs or in the constituent currencies of the SDR weighted to reflect the share of each currency in the SDR basket.

III. Market Developments and Portfolio Returns

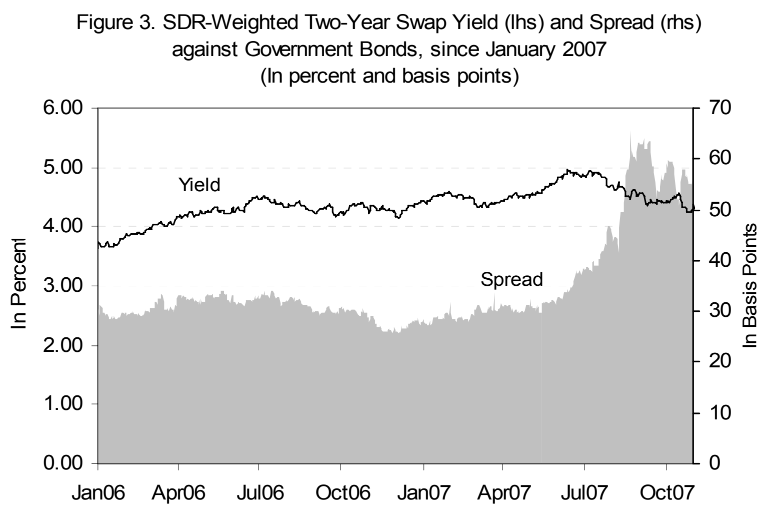
A. Market Developments

6. **Major bond and money markets experienced significant turbulence in the wake of the collapse of the U.S. subprime mortgage market.** Government bond yields in the four currencies of the SDR declined sharply beginning in July as investors sought to reduce exposure to credit risk (Figure 1 and Annex I). The decline in 2-year SDR bond yields—which broadly correspond to the average duration of the government bond portfolio—buoyed the performance of bonds relative to the SDR interest rate. The slope of the SDR yield curve between 3-month and 2-year maturities, which had steepened to a near term peak in mid-June, flattened sharply in the ensuing months, and the spread between 3-month and 2-year SDR yields exhibited considerable volatility (Figure 2).





7. **The turbulence in the credit markets pushed swap spreads higher as investors repriced credit risk.** Swap yields declined over the period (Figure 3), though not as rapidly as government bond yields. As a result, the SDR-weighted two-year swap spread against government bonds doubled from about 30–35 basis points in the first half of the year, to over 60 basis points in August.



B. Portfolio Returns

8. **During the six month period under review, the return of the total portfolio was 2.56 percent gross of fees, and 2.55 percent net of manager and custodial fees.**[5] The gross return on the portfolio exceeded the return on the three-month SDR interest rate by 49 basis points (Table 1).[6] The value of the IA at end-October was SDR 6.1 billion, reflecting returns during the period and a transfer to the General Resources Account of SDR 179.9 million on

---

[5] The investment management and custodial fees on the externally managed government bond portfolios now average about 6 basis points per year. There are no external asset management fees associated with MTIs. For the total portfolio, fees average about 3 basis points per year.

[6] All IA performance and benchmark data are cumulative unannualized returns.

July 9. The transfer, implemented in the context of the monthly rebalancing of the MTI portfolio to minimize costs, represented the earnings of the IA in FY 2007 and was in line with the Executive Board's decision on the disposition of the IA's FY 2007 earnings.[7]

9. **Although both the bond and MTI portfolios earned substantially more than the SDR interest rate, they underperformed the return of the 1–3 year benchmark.** The return on the bond portfolio fell 5 basis points short of Merrill Lynch (ML) 1–3 year benchmark, as a result of underperformance by the two private external managers (discussed below). The portfolio of MTIs held with the BIS returned 2.48 percent, underperforming the JPMorgan (JPM) 1–3 year benchmark by 24 basis points. This underperformance resulted from the widening of swap spreads (Box 2), which underpin the pricing of MTIs. Nevertheless, the return on MTIs exceeded the SDR interest rate by 40 basis points.

C. Manager Performance

10. **The two private external managers underperformed the index while the World Bank performed in line with the benchmark.** The Fund's external managers select eligible securities to construct portfolios that are consistent with specific investment guidelines. Private managers have a mandate to actively manage the portfolio around the benchmark and their main decision is the choice of portfolio duration.[8] In the expectation that market yields would rise, both UBS and JPMorgan maintained portfolio durations that were less than benchmark duration through much of the period. This short duration portfolio positioning resulted in significant underperformance in August and September as managers did not reap the full benefits of sharply declining bond yields in these months. For the full six month period, UBS underperformed by 12 basis points, while JPMorgan fell 24 basis points short of the benchmark. In contrast, the World Bank pursues a passive strategy that closely tracks the duration of the 1-3 year index. During the period, the World Bank exceeded the benchmark return by a single basis point.

---

[7] See Decision No. 1 in *Review of the Fund's Income Position for FY2007 and FY2008* (EBS/07/36, 4/9/07).

[8] Duration measures interest rate risk by approximating the sensitivity of a bond's value to changes in interest rates. Duration is computed assuming a flat term structure and a parallel shift in the yield curve. In addition to adjusting the portfolio's duration in an attempt to add value, external managers may also invest in eligible non-government securities (national agencies and international financial institutions), which implies taking on additional credit risk.

Table 1. Investment Summary as of October 31, 2007

(In percent; unless otherwise noted)

	Valuation		Performance 1/									
			(Non-annualized)								Annualized return since inception 2/ 3/	
	Net asset value (in SDR millions)	Duration (in months)	FY 2007 (11/06–4/07)	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	FY 2008 (5/07–10/07)	Portfolio	Benchmark
Bond portfolio	3,129	19	1.60	0.02	0.27	0.72	0.91	0.39	0.32	2.65	4.26	4.28
JPM	499	15	1.53	0.11	0.18	0.76	0.75	0.30	0.35	2.46	3.99	4.22
UBS	500	17	1.70	0.03	0.26	0.73	0.83	0.35	0.36	2.58	4.18	4.22
World Bank	2,130	21	1.60	0.00	0.29	0.71	0.96	0.42	0.30	2.71	4.31	4.28
MTI portfolio	2,983	21	1.58	-0.04	0.20	0.65	0.71	0.50	0.43	2.48	4.06	4.22
BIS deposits	…	…	…	…	…	…	…	…	…	…	3.16	…
Total	6,113 4/	20	1.59	-0.01	0.24	0.69	0.81	0.44	0.37	2.56	3.98	4.22 5/
Income return 6/			1.72	0.29	0.29	0.29	0.30	0.28	0.30	1.76	3.54	
Capital return 7/			-0.13	-0.29	-0.05	0.39	0.51	0.16	0.07	0.78	0.41	
Month-end market value (in SDR millions) 8/ 9/			6,140	6,139	6,153	6,015	6,063	6,090	6,113	6,113	6,113	
Memorandum items:												
ML 1–3 year government bond index		21	1.54	-0.01	0.30	0.75	0.94	0.39	0.30	2.70	…	…
JPM 1–3 year government bond index		21	1.52	-0.04	0.30	0.77	0.98	0.37	0.32	2.72	…	…
SDR 3-month rate		…	2.09	0.35	0.35	0.36	0.35	0.33	0.32	2.08	…	3.98
IA excess return over 3M SDR		…	*-0.50*	*-0.36*	*-0.12*	*0.32*	*0.47*	*0.12*	*0.05*	*0.49*	*0.00*	…

Source: State Street.

1/ Bond portfolio returns are gross of fees, while MTI returns are net of fees. Annual management and custodian fees average 3 basis points of the total portfolio.
2/ Inception-to-date return includes return on deposits.
3/ Inception date of June 20, 2006 for BIS deposits, June 23, 2006 for MTIs, August 2006 for The World Bank, and September 2006 for JPM and UBS.
4/ Net asset value includes income of $0.7 million from securities lending during the 6-month period under review. Incremental income is generated by the custodian through the short-term lending of securities against collateral to qualified counterparties.
5/ Benchmark return reflects a 50/50 weighting of the JPM and ML 1-3 year indices used for bonds and MTIs.
6/ Flow of coupon and interest earned.
7/ Marked-to-market valuation changes due to changes in the level of interest rates (includes transaction costs).
8/ Market value is net of fees.
9/ Market value in July 2007 reflects transfer of SDR 179.9 million to the GRA on July 9.

Box 2. The BIS' Medium Term Instruments

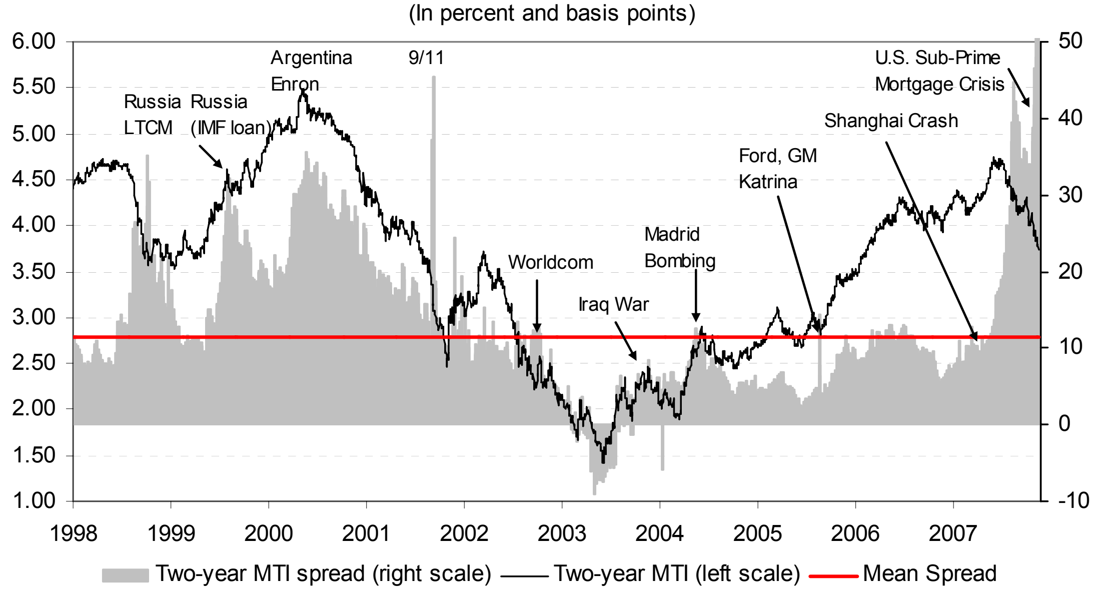
The Bank for International Settlements' Medium-Term Instruments (MTIs) are transferable book-entry claims on the BIS. MTIs, which are eligible securities for investment by over 50 central banks, were launched in 1998 in the U.S. dollar market, and progressively issued by the BIS in other currencies in subsequent years. As of end-September 2007, the outstanding amount of MTIs was about US$ 138 billion, approximately one-third of the BIS' liabilities, with dollar-denominated MTIs representing about 80 percent of the total.

While MTIs bear the same basic characteristics as a government bond and benefit from the BIS' triple-A rated credit quality, they are spread products which typically provide an ex-ante yield advantage over government securities of similar maturity. This yield pick-up originates from their pricing against the inter-bank swap yield curve, minus the intermediation margin of the BIS, and reflects the credit-risk premium embedded in the double-A rated swap curve (Figure).

MTIs will tend to perform better than comparable government bonds when the spread between the swap and the government rates is constant or declines, and perform less well when this spread widens. MTIs have performed less well than government bonds in the current fiscal year as a result of the widening of credit spreads experienced in the wake of the collapse of the U.S. subprime market.

Over the long run, SDR-weighted MTIs with maturities comparable to the 1–3 year government bond index have generated an excess return of about 15 basis points, while being very closely correlated to the performance of government bonds. However, over shorter-term horizons, some volatility in the performance of MTIs can be expected, arising from relative movements in swap rates and changes in the perception of the credit-risk premium.

Two-year MTI in SDR, Yield and Spread against Government Bonds, since 1998
(In percent and basis points)



IV. Risk Controls and Compliance

11. **Investments were kept within the risk limits and investment mandates agreed with each external manager.** Regular rebalancing of the bond and MTI portfolios ensured that their currency composition closely matched that of the SDR basket, thereby limiting exposure to currency risk (Annex II). The duration of the bond and MTI portfolios was kept within the limits established in their respective investment mandates and, in aggregate, stood at 20 months at end-October 2007.

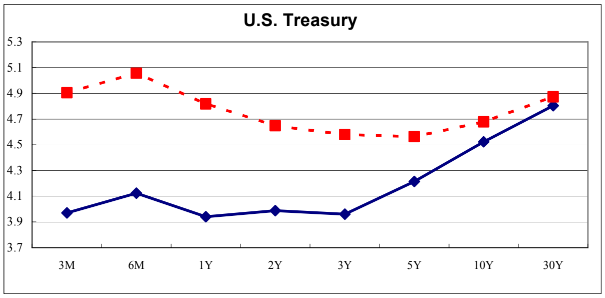
12. **There was a minor compliance breach by a private manager.** In August, UBS purchased a KfW security denominated in pounds sterling, which was ineligible because it was not denominated in the currency of the issuer. FIN staff detected the compliance breach during a regular monthly portfolio review. The security was liquidated and UBS reimbursed the IA for a small loss incurred as a result of its liquidation. UBS has since put in place additional pre-trade controls to ensure that portfolio managers verify compliance of proposed trades with investment guidelines. UBS has also initiated an automated compliance monitoring system to review all trades for compliance before securities are placed in the account. In addition, staff are negotiating with the custodian, State Street, the initiation of a daily automated compliance alert system, expected to be in place by end-2007. When implemented, the system will flag compliance breaches both on-line and via email to staff and the external managers.

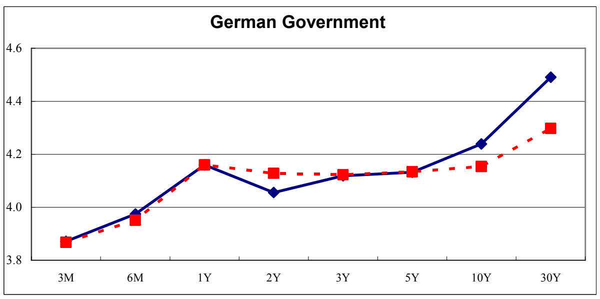
13. The next annual report of operations of the IA covering the period ending April 30, 2008 will be issued in June 2008.

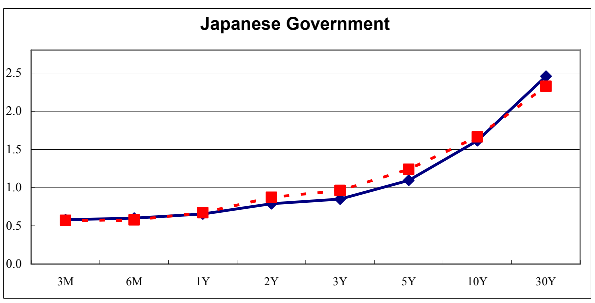
ANNEX I: CHANGES IN SDR YIELDS

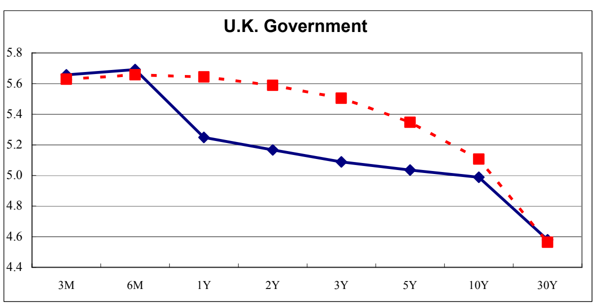
1. Yield curves at the start and at the end of the period (In percent)

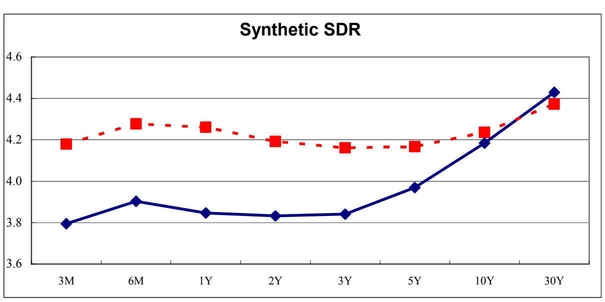
10/31/2007 4/30/2007



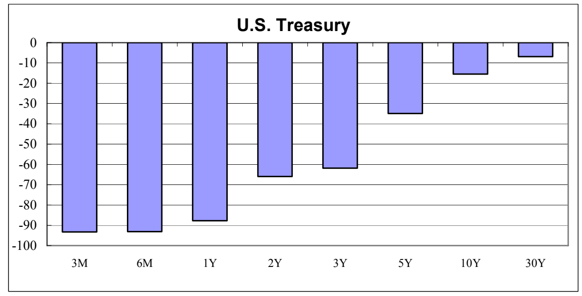


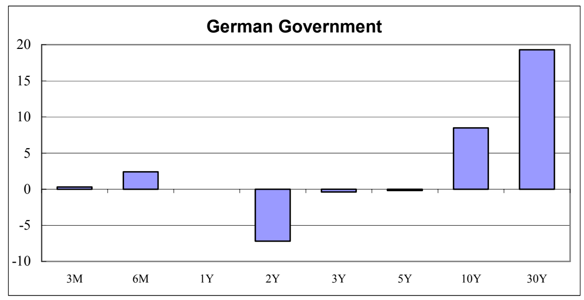


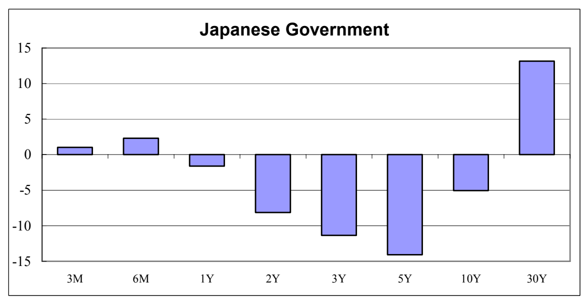


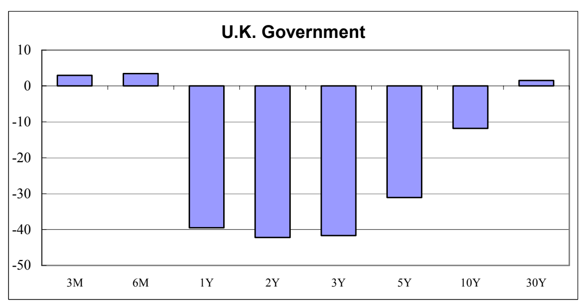


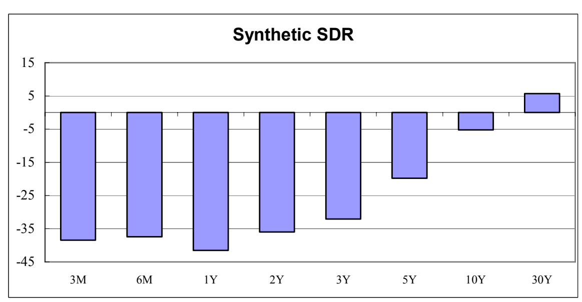
2. Yield Changes during the period (In basis points)











Annex II: Investment Account—Bond Portfolio Exposure

(As of October 31, 2007; in percent)

Currency Exposure

	Benchmark	Investment Account
Euro	37.7	37.5
Japanese yen	10.2	10.1
Pound sterling	11.9	12.0
U.S. dollar	40.2	40.4
Total	100.0	100.0

Country Exposure

	Rating 1/	Investment Account
African Development Bank	AAA	0.5
Asian Development Bank	AAA	1.0
European Union		0.2
France	AAA	3.8
Germany	AAA	33.4
Japan	AA	10.3
Luxembourg	AAA	10.5
United Kingdom	AAA	7.3
United States	AAA	33.0
Total		100.0

Maturity Exposure

	Investment Account
Cash 2/	0.5
< One Year	18.1
1 to 3 Years	77.4
3 to 5 Years	4.0
5 to 10 Years	0.0
Total	100.0

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

2/ Includes residual cash balances and custodian's short-term investment funds.