EBS/08/84

July 3, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Annual Report of the Investment Account**

Attached for the **information** of Executive Directors is a paper on the 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. Gapen (ext. 37527) 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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INTERNATIONAL MONETARY FUND

Annual Report of 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 Andrew Tweedie

July 1, 2008

I. Introduction and Summary

1. **This paper presents, for information of the Executive Board, the annual report of the Investment Account (IA), covering the 12-month period ending April 30, 2008.**[1]

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

- The bond and money markets of the SDR currencies experienced unusually high volatility during the fiscal year, with the increased demand for liquidity and flight-to-quality pushing government bond yields down, thus providing favorable credit market conditions for the IA.

- The IA performed strongly during FY 2008, returning 5.32 percent during the period and exceeding the SDR interest rate by 162 basis points.[2] Net returns generated by the IA contributed SDR 316.7 million to the Fund's income which will be transferred to the GRA.[3] Since inception the IA has earned a cumulative return of 8.52 percent, or 4.48 percent annualized.

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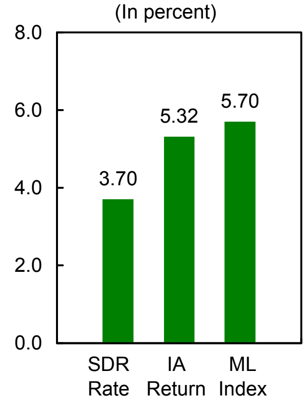
[1] The performance of the Investment Account was last reported in *Semi-Annual Report on the Investment Account* (EBS/07/155, 12/28/2007). The previous annual report (EBS/07/72) was issued in June 2007.

[2] Performance of the Trusts is reported in *Annual Report of PRGF-ESF, PRGF-HIPC, and MDRI Trust Assets* (EBS/08/85, 7/3/08). Trust assets earned 4.99 percent in FY2008. The 33 basis point differential in return between the Trusts and the Investment Account reflects the inclusion in the Trusts of short-term BIS deposits, which are held for liquidity purposes and to meet obligations under arrangements with contributors.

[3] See Decision No. 1 in *Review of the Fund's Income Position for FY2008 and FY2009* (EBS/08/45, 4/15/08).

Figure 1. FY 2008 Returns
(In percent)



- Although the IA's return exceeded the SDR interest rate by a wide margin, its return fell short of the Merrill Lynch (ML) 1–3 year benchmark index by 38 basis points (Figure 1). This shortfall was primarily due to two factors. First, the two private managers were not positioned to fully benefit from the sharp drop in bond yields and, second, persistent concerns over credit quality caused a widening of swap spreads, reducing returns on the MTI portfolio.

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

II. Investment Strategy and Initial 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**.[4] 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. **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 to a 1–3 year government bond benchmark index, weighted to reflect the currency composition of the SDR basket.

6. **Consistent with its investment authority (Box 1), IA assets are 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. The bond portfolios are managed by the World Bank (35 percent of the total) and JP Morgan and UBS (8 percent each).[5]

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[4] 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).

[5] The structure of the IA mirrors that 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.[1] This authority stipulates that a member's currency held in the IA may be invested "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 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, and corporate bonds. They also effectively exclude derivative securities and mortgage- and asset-backed 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.

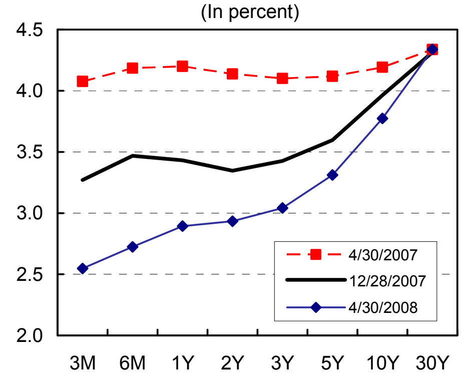
The legal authority does not impose any specific quantitative limit on the currency exposure of the eligible marketable obligations, other than being denominated in the currency used for investment or in SDRs. However, in order to limit currency risk, the benchmark for the IA portfolio is based on the 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.

[1] In May 2008, the Board of Governors adopted a resolution approving an amendment of the Articles of Agreement to expand the IA's investment authority. This amendment would eliminate the current specification of instruments in the Articles, and instead authorize the Fund to use currencies held in the IA for investment as it may determine, in accordance with rules and regulations adopted by the Fund by a seventy percent majority of the total voting power. The amendment will enter into force when it is accepted by three-fifths of the Fund's members having 85 percent of the total voting power. See SM/08/80, Re. 1, Sup. 1, 4/8/08.

III. Market Developments, Portfolio Returns, and Manager Performance

A. Market Developments

Figure 2. Synthetic SDR Yield Curve
(In percent)



7. **Short-term rates and government bond yields declined dramatically during the fiscal year, creating a favorable market climate for the IA's bond portfolio, whose returns exceeded the three-month SDR interest rate by a wide margin.** Three-month and two-year SDR interest rates fell by 153 and 120 basis points, respectively (Figure 2 and Attachment I). The decline in two-year SDR bond yields—which broadly corresponds to the duration of

the government bond portfolio—buoyed the performance of bonds relative to the SDR interest rate. The yield curve between three-month and two-year maturities closed the year with a modestly positive slope after having a flat or negative slope during much of the year.

8. **The two-year swap yield in SDR terms, which largely drives the performance of the MTI portfolio, also fell during the year.** However, two-year swap spreads in SDR terms, which provide an indication of the relative performance of MTIs against bonds, widened and closed the fiscal year at 48 basis points (net of the BIS intermediation margin), up 39 basis points during the period. As a result, while the MTI portfolio also generated higher returns than the SDR interest rate, the performance of MTIs lagged the return on the bond portfolio due to the widening of swap spreads. Market developments during the fiscal year are discussed below in greater detail.

- Beginning in July 2007, credit market concerns stemming from losses in the U.S. subprime mortgage market prompted an abrupt flight-to-quality, pushing two-year government bond yields sharply lower. Negative credit market sentiment and a preference for short-term, high-quality government bonds would dominate the remainder of the fiscal year and buoy returns in the IA.

- As credit market conditions worsened, short-term SDR yields declined from a series of policy rate cuts by the U.S. Federal Reserve and the Bank of England. The Federal Reserve lowered its policy rate on six occasions by a total of 300 basis points between September 2007 and March 2008. The Bank of England reduced its policy rate three times by a total of 75 basis points between December 2007 and April 2008.

- Declines in two-year government bond yields initially outpaced reductions in short-term SDR yields, leading to a flat yield curve for much of the fiscal year, and a substantial inversion of the yield curve in the first calendar quarter of 2008 (Figure 3). The positive term premium returned thereafter as credit conditions began to ease. The negative term premium, however, was not sufficient to offset returns generated from the large decline in two-year yields.

Figure 3. 2-Year SDR Yields Less 3-month Rates, 2007-08 (SDR terms, in basis points)

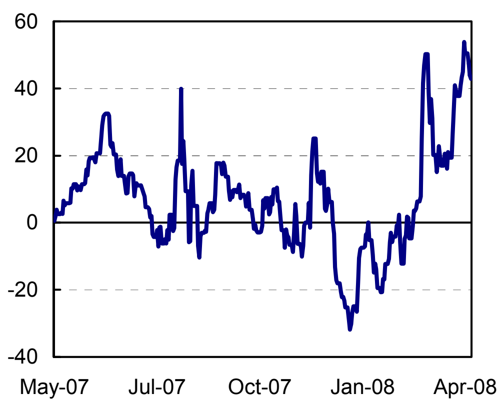
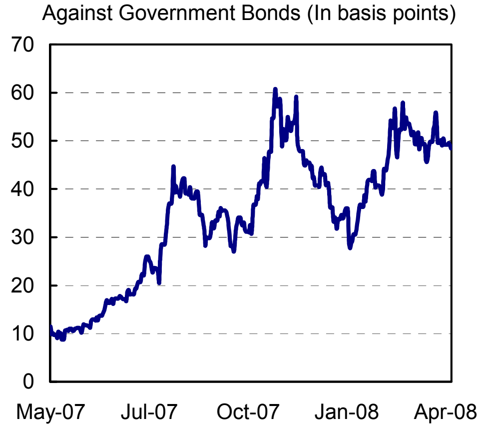


Figure 4. SDR Weighted Two-Year Swap Spread Against Government Bonds (In basis points)



- Swap spreads, which affect the performance of the MTI portfolio, widened steadily in 2007 as investors repriced credit risk in the wake of the subprime crisis (Figure 4). The swap spread narrowed substantially by end-January 2008 in response to policy rate reductions and the introduction of temporary liquidity facilities by the Federal Reserve and action by the ECB and the Bank of England to ease credit conditions, before widening again on concerns about banking sector weakness and a U.S. recession.

B. Portfolio Returns

9. **During the fiscal year under review, the return of the total portfolio was 5.32 percent gross of fees, and 5.30 percent net of manager and custodial fees (Table 1 and Annex II).** [6] The IA generated net returns of SDR 316.7 million, which contributed to the Fund's income in FY 2008 and will be transferred to the GRA.[7] The gross return on the portfolio exceeded the return on the three-month SDR interest rate by 162 basis points.

10. **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 short of the ML 1–3 year benchmark by 20 basis points, due to underperformance by the two external private managers (discussed below). The portfolio of MTIs underperformed the JPMorgan (JPM) 1–3 year benchmark by 61 basis points.[8] Underperformance of MTIs relative to the index resulted from the widening of swap spreads, which underpin the pricing of MTIs (Box 2). Nevertheless, the return on MTIs exceeded the SDR interest rate by 144 basis points.

11. Securities lending operations returned US$1.4 million, more than offsetting custodial fees paid to State Street.

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[6] 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.

[7] See Decision No. 1 in *Review of the Fund's Income Position for FY2008 and FY2009* (EBS/08/45, 4/15/08). Earnings of the IA in FY 2007 totaling SDR 179.9 million were transferred to the GRA in July 2007, in line with the Executive Board's decision on the disposition of the IA's FY 2007 earnings. See Decision No. 1 in *Review of the Fund's Income Position for FY2007 and FY2008* (EBS/07/36, 4/9/07).

[8] Effective January 28, 2008, the BIS widened the intermediation margin on newly issued MTIs denominated in dollars, euros, and sterling to 32 basis points from 24½ basis points. The BIS introduced this change to reduce recent strong demand for MTIs. When combined with previous changes introduced in August 2007, the higher intermediation margin will ultimately reduce the return on the MTI portfolios by about 9.4 basis points annually versus the original pricing structure. The impact on the portfolio will be phased over the next two years during regular rebalancing of the MTI portfolio.

C. Manager Performance

12. **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. External managers may also attempt to add value by investing in eligible non-government securities which implies taking on additional credit risk.

Table 1. Portfolio Summary as of end-April 2008
(In percent, annualized, unless otherwise noted)

	Valuation		Performance 1/			
					Since Inception 2/	
	Net Asset Value (In SDR millions)	Duration (in months)	FY 2007 3/	FY 2008	Portfolio	Benchmark
Bond Portfolio						
JPM	511.3	25	2.16	5.01	4.31	4.73
UBS	513.8	21	2.25	5.42	4.60	4.73
WB	2,190.5	20	2.64	5.62	4.72	4.74
Total	3,215.6	21	2.63	5.49	4.65	4.74
BIS MTI	3,060.7	21	3.24	5.14	4.50	4.81
Total	6,276.3	21	3.04	5.32	4.48	4.69
Income return 4/			3.24	3.55	3.64	...
Capital return 5/			-0.20	1.77	0.84	...
Month-end market value 6/			6,140	6,276	...	...
Memorandum items:						
ML1-3		21	2.60	5.70	…	…
JPM1-3		21	3.22	5.74	…	…
3M SDR		3	3.53	3.70	…	3.88
IA excess return over 3M SDR		...	*-0.49*	*1.62*	*0.60*	…

1/ Bond portfolio returns are gross of fees. Management and custodian fees average 3 basis points of the total portfolio.
2/ Inception date of June 23, 2006 for MTIs, August 1, 2006 for World Bank, and September 1, 2006 for external managers.
3/ Unannualized.
4/ Flow of coupon and interest earned.
5/ Marked-to-market valuation changes due to changes in the level of interest rates and includes transaction costs.
6/ Market value is net of fees in SDR millions. Includes $1.4 million in income from securities lending.

13. **The two private external managers underperformed the Merrill Lynch 1–3 year index while the World Bank more closely tracked the benchmark.** In expectations that market yields would rise, both UBS and JPM maintained portfolio durations that were less than the benchmark at the onset of the credit market turmoil in 2007 (Table 2). The short duration positions resulted in underperformance during a declining interest rate environment. JPM moved to a duration neutral position in November of 2007 and a net long duration position as of fiscal year-end. UBS, in contrast, maintained its short duration position throughout the fiscal year, a stance that ultimately benefited the IA in March and April of 2008 when two-year SDR government bond yields rose. For FY 2008, JPM underperformed

by 69 basis points while UBS fell 28 basis points short of the benchmark. The World Bank, which pursues a passive strategy that more closely tracks the duration of the 1–3 year index, underperformed the benchmark by 8 basis points, primarily due to the underperformance of assets placed in non-government bonds.

Table 2. Bond Portfolio Average Duration and Excess Returns 1/

	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08
Deviations from Benchmark Duration (In months)												
JPM	1.0	-1.2	-0.4	-5.4	-4.0	-5.6	-0.6	0.6	-1.0	0.6	4.2	4.0
UBS	-1.1	-1.5	-3.5	-3.1	-4.7	-4.2	-4.3	-3.6	-5.0	-5.7	-3.8	0.0
WB	-0.8	-1.0	-0.3	-0.3	-0.3	-0.2	-0.2	-0.3	-1.0	-0.7	0.0	-1.0
Monthly Excess Return (In percent)												
JPM	0.12	-0.12	0.01	-0.19	-0.10	0.05	-0.09	-0.01	-0.08	-0.06	-0.02	-0.16
UBS	0.05	-0.04	-0.03	-0.11	-0.04	0.06	-0.14	0.06	-0.19	-0.12	0.14	0.09
WB	0.02	-0.01	-0.05	0.02	0.02	0.00	-0.08	0.02	0.02	-0.05	0.00	0.00
2-Year SDR Yield - End of Month (In percent)												
	4.46	4.48	4.24	3.93	3.83	3.83	3.28	3.32	2.67	2.38	2.45	2.93

1/ Returns are expressed before management fees. The benchmark is the Merrill Lynch 1-3 year index.

IV. Risk Controls and Compliance

14. **Investments were kept within the risk limits and investment mandates agreed with each external manager.** Regular rebalancing of each 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 III). The duration of the bond and MTI portfolios was kept within the limits established in their respective investment mandates and, in aggregate, stood at 21 months for the IA at end-April 2008. Since the last semi-annual report, all securities and deposits held by the external managers conformed to the credit and issuer limits established in the investment guidelines.

15. **A daily automated compliance alert system was initiated with the custodian, State Street, on December 27, 2007.** The system, which provides daily automated reports on managers' compliance with the investment mandate and regulations, has been tested and implemented satisfactorily since early January 2008.[9]

16. The next semi-annual report of operations of the IA, covering the period ending October 31, 2008, will be issued in December 2008.

[9] As discussed in the previous semi-annual report (EBS/07/155), UBS purchased a KfW security denominated in pound sterling in August 2007. The security was ineligible because it was not denominated in the currency of the issuer. The breach was detected by staff during a regular monthly portfolio review, and the security was liquidated immediately. UBS has since put in place additional pre-trade controls to ensure compliance of investment guidelines.

Box 2. The BIS' Medium Term Instruments

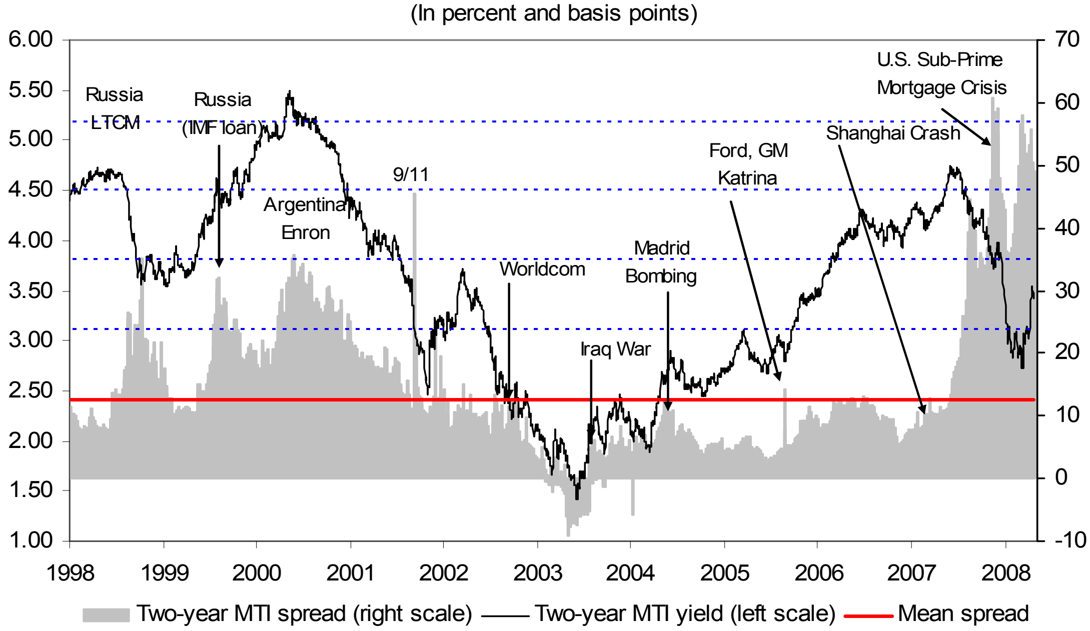
The BIS' Medium-Term Instruments (MTIs) are transferable book-entry claims on the BIS. MTIs, which are eligible securities for investment by over 50 central banks, were launched in 1998 in the U.S. dollar market, and progressively issued by the BIS in other currencies in subsequent years. As of end-April 2008, the outstanding amount of MTIs was about US$184 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)

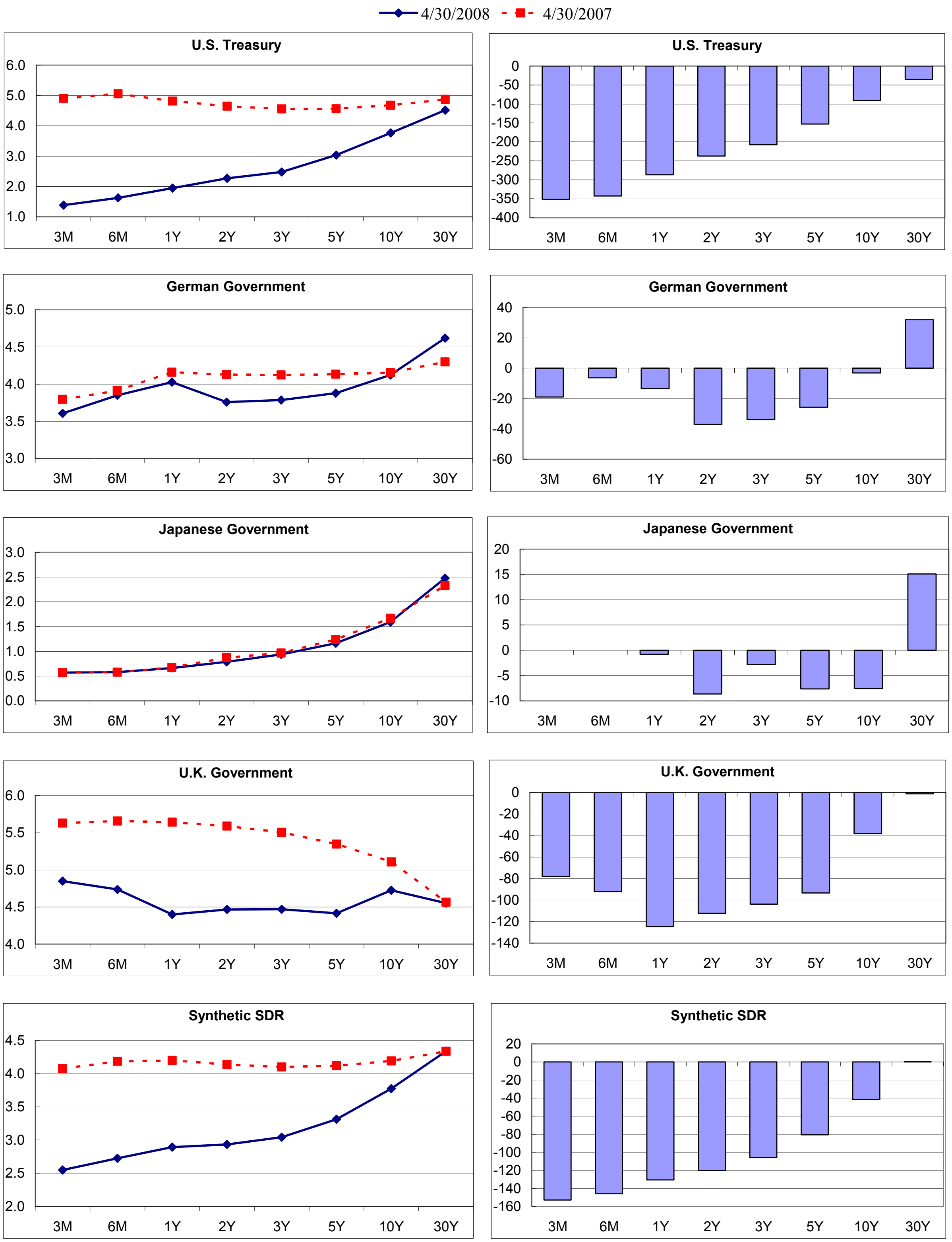


Note: Dotted lines indicate one, two, three and four standard deviations of spread over mean.

Annex I: Changes in SDR Yields

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

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



ANNEX II: PORTFOLIO PERFORMANCE AND COMPARATIVE RETURNS

Portfolio Performance and Comparative Returns
(In percent, annualized, unless otherwise noted)

	FY 2007 3/	FY 2008 Monthly Returns (Non-annualized) 1/												FY 2008	Since Inception 2/	
		May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08		Portfolio	Benchmark
Bond Portfolio																
JPM	2.16	0.11	0.18	0.76	0.75	0.30	0.35	1.08	0.03	1.30	0.59	0.08	-0.61	5.01	4.31	4.73
UBS	2.25	0.03	0.26	0.73	0.83	0.35	0.36	1.04	0.10	1.20	0.53	0.24	-0.36	5.42	4.60	4.73
WB	2.64	0.00	0.29	0.71	0.96	0.42	0.30	1.10	0.05	1.41	0.60	0.10	-0.44	5.62	4.72	4.74
Total	2.63	0.02	0.27	0.72	0.91	0.39	0.32	1.09	0.06	1.36	0.59	0.12	-0.46	5.49	4.65	4.74
BIS MTI	3.24	-0.04	0.20	0.65	0.71	0.50	0.43	0.79	0.22	1.56	0.37	0.11	-0.48	5.14	4.50	4.81
Total	3.04	-0.01	0.24	0.69	0.81	0.44	0.37	0.94	0.13	1.46	0.48	0.12	-0.47	5.32	4.48	4.69
Memorandum items:																
ML1-3	2.60	-0.01	0.30	0.75	0.94	0.39	0.30	1.18	0.03	1.38	0.65	0.10	-0.45	5.70	…	…
JPM1-3	3.22	-0.04	0.30	0.77	0.98	0.37	0.32	1.21	0.00	1.42	0.66	0.11	-0.49	5.74	…	…
3M SDR	3.53	0.35	0.35	0.36	0.35	0.33	0.32	0.31	0.29	0.28	0.25	0.23	0.22	3.70	…	3.88

1/ Bond portfolio returns are gross of fees. Management and custodian fees average aroung 3 basis points of the total portfolio.
2/ Inception date of June 23, 2006 for MTIs, August 1, 2006 for World Bank, and September 1, 2006 for external managers.
3/ Unannualized.

ANNEX III: INVESTMENT ACCOUNT—BOND PORTFOLIO EXPOSURE

(As of April 30, 2008; in percent)

Currency Exposure

	Benchmark	Investment Account
Euro	39.3	39.3
Japanese yen	10.9	10.9
Pound sterling	10.9	10.9
U.S. dollar	38.9	38.9
Total	100.0	100.0

Country/Issuer Exposure

	Rating 1/	Investment Account
African Development Bank	AAA	1.4
Asian Development Bank	AAA	0.5
France	AAA	3.0
Germany	AAA	36.1
Japan	AA	11.0
Luxembourg	AAA	8.2
United Kingdom	AAA	6.5
United States	AAA	32.4
Total		100.0

Maturity Exposure

	Investment Account
Cash 2/	0.6
< One Year	10.4
1 to 3 Years	81.1
3 to 5 Years	7.8
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.