EBS/08/85

July 3, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Annual Report of PRGF-ESF, PRGF-HIPC, and MDRI Trust Assets**

Attached for the **information** of Executive Directors is a paper on the annual report of PRGF-ESF, PRGF-HIPC, and MDRI Trust Assets.

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.

Att: (1)

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INTERNATIONAL MONETARY FUND

Annual Report of PRGF-ESF, PRGF-HIPC, and MDRI Trust Assets

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 investment performance of PRGF-ESF, PRGF-HIPC, and MDRI Trust assets for the 12-month period ending April 30, 2008.** Additional information on market developments, manager performance, and compliance issues is presented in the annual report on the investment account (EBS/08/84, 7/3/08).

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

- Trust assets earned 4.99 percent from May 1, 2007 through April 30, 2008. The bond portfolio earned 5.49 percent, while the MTI portfolio earned 5.14 percent. Short-term BIS deposits, which are held for liquidity purposes and to meet obligations under arrangements with contributors to the Trusts, earned 4.13 percent.[1]

- The performance of the World Bank was broadly in line with the 1–3 year benchmark, while the two private external managers underperformed, as their portfolios were not fully positioned to benefit from the substantial declines in

[1] Performance of the Investment Account is reported in *Annual Report of the Investment Account* (EBS/08/84, 7/3/08). The IA returned 5.32 percent in FY2008 and exceeded the SDR interest rate by 162 basis points. 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.

bond yields during the period under review. The MTI portfolio also fell short of the benchmark index.

3. **The paper is structured as follows**. Section II describes the investment strategy and cash flows of Trust resources. Section III analyzes portfolio returns, and manager performance. Section IV reports on risk control measures and compliance.

Box 1. The Investment of Trust Assets

Trust assets consist of contributions from Fund members and the Fund itself for the financing of PRGF-ESF, PRGF-HIPC, and MDRI operations. Bilateral contributions from members take the form of grants and deposits or loans at below-market interest rates. Contributions from the Fund were channeled through the SDA and comprise the net proceeds of off-market gold transactions conducted in 1999 and 2000 (equivalent to SDR 2.226 billion), investment income from the gold proceeds, and other SDA resources. On January 6, 2006, all SDA resources were transferred to fund the MDRI-I Trust, the HIPC sub-account of the PRGF-HIPC Trust, and the PRGF-ESF Subsidy Account. At end-April 2008, the total portfolio of Trust assets had a market value of SDR 6.890 billion and was structured as follows:

- 76 percent in the PRGF-ESF Trust and related accounts;
- 19 percent in the PRGF-HIPC Trust and related accounts; and
- 5 percent in the MDRI-I and -II Trusts.

The investment strategy of Trust assets has fluctuated over time between SDR-denominated deposits at the Bank for International Settlements (BIS) and short-term government debt obligations. In March 2000, the Executive Board endorsed a new investment strategy to enhance the return on investments to supplement the resources available to support PRGF and HIPC operations by extending duration. This was achieved 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 duration of 1–3 years. From January 2002 through August 2006, all Trust assets were then shifted into short-term investments, mainly BIS deposits and short-term government debt obligations, in order 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.

A phased extension of the portfolio duration to the current 1–3 year benchmark was completed in FY 2007. Eligible investments are limited to fixed-income securities issued by members (including national official financial institutions) and international financial institutions. In order to minimize currency risk, such securities are denominated in SDRs or in a currency of the SDR basket. The currency composition of the portfolio is weighted to reflect the currency weights of the SDR basket.

II. Investment Strategy and Cash Flows

4. **Consistent with its investment strategy (Box 1), Trust assets comprise short-term deposits, government bonds, and MTIs issued by the BIS.** About one-third of Trust assets are held in short-term deposits with the BIS to meet liquidity requirements from operations and obligations under arrangements with contributors to the Trusts. The balance of the portfolio, comprising funds available for investment over longer horizons, is divided evenly between eligible government bonds denominated in the currencies of the SDR basket and MTIs issued by the BIS. Trust assets held in government bonds and MTIs are managed in

line with the 1–3 year benchmark index endorsed by the Executive Board.[2] The bond portfolios are managed by the World Bank (34 percent of investable assets) and JP Morgan and UBS (8 percent each).

5. **Trust assets remained relatively constant during the period,** as investment returns were largely offset by net outflows used to service bilateral lenders to the Trust. At end-April 2008, the net asset value of the portfolio stood at SDR 6.890 billion, up from SDR 6.837 billion at the start of the period.

III. Portfolio Returns and Manager Performance

A. Portfolio Returns

6. **Credit market conditions following the collapse of the U.S. subprime mortgage market generally provided a favorable return environment for Trust investments.**[3] SDR interest rates fell sharply during the fiscal year, as concerns over losses in the U.S. subprime mortgage market prompted an abrupt flight-to-quality, pushing two-year government bond yields sharply lower beginning in July 2007 (Annex I). Short-term SDR yields also declined following a series of policy rate cuts by the U.S. Federal Reserve and the Bank of England. However, swap spreads widened steadily due to concerns over credit risk, dampening the performance of the MTI portfolio.

7. **Trust assets earned 4.99 percent in the fiscal year under review, about 137 basis points more than the previous fiscal year (Table 1 and Annex II).**[4] Despite the relatively flat SDR yield curve for much of the fiscal year and the deterioration in credit spreads, the dramatic decline in two-year government bond yields meant that the bond and MTI portfolios significantly outperformed shorter-term SDR-denominated deposits.

- The bond portfolio, managed by external managers and comprising 36 percent of total assets, returned 5.49 percent. Nevertheless, the bond portfolio underperformed the benchmark by 21 basis points.

- The MTI portfolio, held with the BIS and comprising 35 percent of total assets, returned 5.14 percent, underperforming the JPMorgan 1–3 year benchmark by

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[2] See EBS/06/168, 12/19/06.

[3] Market developments during FY 2008 are reviewed in *Annual Report of the Investment Account* (EBS/08/84, 7/3/08).

[4] Returns are gross of fees. 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 BIS deposits and MTIs. For the total portfolio, fees average about 2 basis points per year.

60 basis points.[5] The underperformance of MTIs relative to the index resulted from the widening of swap spreads, which underpin the pricing of MTIs.[6] Nevertheless, the return on MTIs exceeded the return on BIS deposits by a wide margin.

- SDR-denominated deposits, with an average maturity of 1 month as of end-April 2008, earned 4.13 percent.

Table 1. Investment Summary as of April 30, 2008

(In percent, annualized, unless otherwise noted)

	Valuation		Performance	
	Net asset value (in SDR millions)	Duration (in months)	FY 2008 (5/07–4/08)	Since Inception (4/00–4/08)
Bond portfolio	2,465	21	5.49	3.66
JPM	401	25	5.12	3.68
UBS	399	21	5.40	3.66
World Bank	1,665	20	5.60	3.68
MTI portfolio	2,433	21	5.14	4.48 1/
Deposits	1,992	1	4.13	3.03
Total 2/	6,890 3/	15	4.99	3.52 4/
Memorandum items:				
Private manager benchmark		…	5.70	3.68
World Bank benchmark		…	5.70	3.65
ML 1–3 year government bond index		21	5.70	3.95
JPM 1–3 year government bond index		21	5.74	4.77 1/
SDR 6-month rate		…	4.00	3.10

Source: State Street.

1/ Since August 2006.

2/ Figures on return exclude the valuation effect of changes in the exchange rate between the euro and the SDR, related to a euro-denominated deposit of EUR 300 million. As the deposit is exactly matched by liabilities in euros, currency gains or losses associated with movements of the euro against the SDR will remain unrealized.

3/ Net asset value includes income of $1.1 million from securities lending in FY 2008.

4/ Total cumulative performance includes return on Medium-Term Instruments issued by the BIS, up to mid-January 2002, and FFTW, whose contract was terminated in 2003.

[5] 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.

[6] An analysis of MTI characteristics is provided in *Annual Report of the Investment Account* (EBS/08/84, 7/3/08).

8. Securities lending operations returned US$1.14 million, largely offsetting custodial fees paid to State Street.

B. Manager Performance

9. **The two private investment managers significantly underperformed the index, while the World Bank more closely tracked the benchmark** (Box 2 and Table 2). Private managers have a mandate to actively manage the portfolio around the benchmark and their main decision is the choice of portfolio duration.[7] External managers may also attempt to add value by investing in eligible non-government securities, which implies taking on additional credit risk.

Table 2. External Managers Performance
(In percent)

	FY 2008 (5/07–4/08) 1/		Since Inception (4/00–4/08)	
	Return	Excess return	Annualized return	Excess return
JPM	5.12	-0.57	3.68	0.01
UBS	5.40	-0.30	3.66	-0.02
World Bank	5.60	-0.10	3.68	0.03
Total	5.49	-0.21	3.66	0.01

1/ All bond portfolios are currently managed against the ML 1–3 year government bond index. Prior to September 2006, the benchmark for JP Morgan and UBS was the 3-month LIBID index; prior to October 2006, the World Bank managed two separate portfolios against a combined 3-month LIBID and ML 0–1 year benchmark.

- Before fees, JP Morgan and UBS underperformed the ML 1–3 year benchmark by 57 and 30 basis points, respectively. Each of these managers took active duration positions somewhat short of the benchmark, particularly during the first half of the period in the expectation that SDR interest rates would rise (Table 3). Thus, neither was positioned to fully benefit from the ensuing decline in SDR yields. JPMorgan moved to a neutral duration position versus the benchmark in late 2007 and a net-long duration position by fiscal year-end. UBS, however, maintained the short duration position throughout the period, which benefited Trust assets in March and April of 2008 when two-year SDR government bond yields rose.

- The World Bank maintained portfolio duration close to the benchmark throughout the year, and underperformed the index by 10 basis points before fees. One factor contributing to the underperformance was the persistent widening of credit spreads, which dampened returns in the Bank's holdings of non-government securities.

[7] Duration measures interest rate risk by approximating the sensitivity of a bond's value to changes in interest rates.

Table 3. 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	1.9	-1.2	-0.1	-5.5	-4.1	-5.9	-0.6	0.1	0.0	0.3	4.0	4.0
UBS	-0.9	-1.4	-3.4	-3.0	-3.4	-4.1	-4.3	-3.5	-5.0	-5.7	-3.7	0.0
WB	-0.8	-1.0	-0.3	-0.3	-0.3	-0.2	-0.1	-0.2	-1.0	-0.7	0.0	-1.0
Monthly Excess Return (In percent)												
JPM	0.09	-0.14	0.02	-0.18	-0.03	0.06	-0.09	-0.03	-0.03	-0.06	-0.02	-0.15
UBS	0.04	-0.02	-0.04	-0.11	-0.05	0.05	-0.14	0.06	-0.20	-0.12	0.15	0.09
WB	0.01	-0.02	-0.03	0.02	0.02	0.01	-0.10	0.03	0.03	-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

10. **The exposure limits agreed in each investment mandate were observed.** Regular rebalancing of the portfolio by managers ensured that the currency weights of their respective portfolios closely matched the SDR basket, thereby limiting exposure to currency risk (Annex III). The duration of the bond portfolios was also kept within the agreed limits and, in aggregate, stood at 21 months at end-April 2008, equal to that of the ML 1–3 year benchmark. The composition of the portfolio also conformed to the credit and issuer limits of the investment guidelines. In January 2008, the downgrading of one security caused its rating to fall below the minimum credit quality rating, and the security was promptly liquidated.

11. **The portfolio managed by the World Bank experienced a negative cash balance over a two-day period at fiscal year end.** The overdraft resulted from the improper classification of expected proceeds from the sale of a security. The overdraft position was identified the following day and corrected on the next trading day after the error was discovered. The World Bank reimbursed the Trusts for the small financing charge that resulted and instituted measures to avoid a recurrence.

12. The next semi-annual report of investment performance, covering the period May 1, 2008–October 31, 2008, will be issued to the Executive Board in December 2008.

Box 2. Additional Measures of Investment Performance

In addition to return, two measures widely used to evaluate portfolio performance are **tracking error** and the **information ratio**. Tracking error—the annualized standard deviation of the monthly excess returns relative to the benchmark index—is a measure of how much the performance of a portfolio has varied relative to the benchmark index over a given period. Managers closely replicating the risk profile of the benchmark will show low tracking errors. The information ratio—the ratio of excess return to excess risk incurred—measures the profitability of an investment strategy relative to the level of risk.

As shown in the table below, each of the external managers exhibited very low tracking errors during the period when duration was shortened (January 2002 through August 2006). Given the short portfolio duration and its narrow ranges, managers had relatively little scope to increase returns relative to their benchmark. On the other hand, information ratios also increased during this period, an indication that the small excess returns (before fees) did not come at the expense of added volatility.

The period since moving back to the longer duration 1–3 year benchmark has been too short to draw strong conclusions on relative performance, though the underperformance of the private external managers in the current fiscal year has resulted in negative information ratios.

Table. Performance Metrics
(Annualized; in percent)

	Apr 2000–Dec 2001	Jan 2002–Aug 2006	Sep 2006–Apr 2008	Since Inception
Tracking error 1/				
JPM	0.41	0.16	0.27	0.25
UBS	0.24	0.12	0.29	0.19
World Bank	0.14	0.09	0.11	0.11
Information ratio 2/				
JPM	0.24	0.49	-1.09	0.03
UBS	-0.59	0.66	-0.49	-0.08
World Bank	0.12	0.65	-0.38	0.27
Excess returns				
JPM	0.10	0.08	-0.29	0.01
UBS	-0.14	0.08	-0.14	-0.02
World Bank	0.02	0.06	-0.04	0.03
Proportion of months with positive excess returns				
JPM	52	55	40	52
UBS	48	59	50	55
World Bank	57	56	55	56

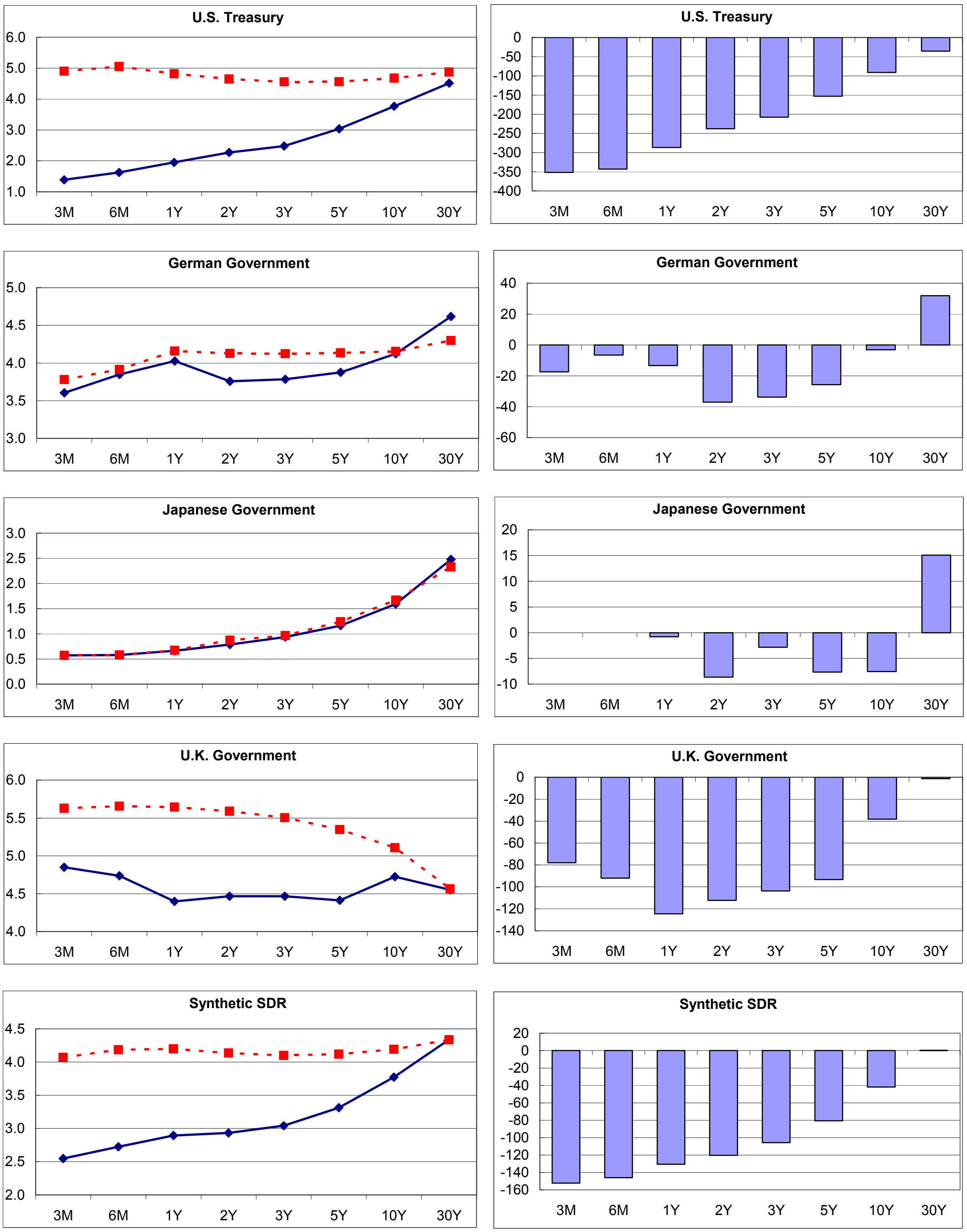
1/ Tracking error is a measure of the risk profile of a portfolio relative to a benchmark index. It is the annualized standard deviation of the monthly excess returns.
2/ The information ratio measures the risk-reward profile of a portfolio by expressing the average monthly excess return divided by the tracking error.

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)

4/30/2008 4/30/2007



ANNEX II: PORTFOLIO PERFORMANCE AND COMPARATIVE RETURNS

Portfolio Performance and Comparative Returns

(In percent, annualized; unless otherwise noted)

	FY 2006	FY 2007	FY 2008 Monthly Returns 1/												FY 2008	Since Inception
	(5/05-4/06)	(5/06-4/07)	May-07	Jun-07	Jul-07	Aug-07	Sep-07	Oct-07	Nov-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	(5/07-4/08)	(4/00-4/08)
Bond portfolio	2.75	3.41	0.02	0.25	0.73	0.91	0.39	0.33	1.08	0.05	1.36	0.58	0.12	-0.46	5.49	3.66
JPM	3.14	3.57	0.08	0.15	0.78	0.77	0.37	0.37	1.09	0.00	1.35	0.59	0.08	-0.60	5.12	3.68
UBS	3.03	3.57	0.02	0.27	0.72	0.83	0.34	0.35	1.04	0.10	1.18	0.53	0.25	-0.36	5.40	3.66
IBRD	2.69	3.38	0.00	0.27	0.72	0.96	0.41	0.32	1.08	0.06	1.41	0.60	0.10	-0.45	5.60	3.68
MTI portfolio 2/	...	2.69	-0.04	0.21	0.66	0.71	0.50	0.43	0.79	0.22	1.56	0.37	0.11	-0.48	5.14	4.48
Deposits	2.82	4.32	0.30	0.37	0.42	0.35	0.59	0.48	0.48	0.40	0.35	0.44	0.60	0.21	5.10	3.36
SDR-denominated	2.84	3.89	0.35	0.35	0.37	0.37	0.36	0.37	0.35	0.37	0.33	0.29	0.30	0.27	4.13	3.03
Euro-denominated	2.02	8.17	-0.05	0.52	0.78	0.22	2.18	1.23	1.31	0.59	0.48	1.35	2.44	-0.14	11.44	6.82
Total portfolio	2.79	3.62	0.09	0.26	0.60	0.68	0.42	0.37	0.77	0.20	1.16	0.43	0.16	-0.28	4.99	3.52
Including euro-deposit 3/	2.78	3.79	0.09	0.27	0.61	0.66	0.49	0.41	0.80	0.21	1.13	0.47	0.26	-0.27	5.25	3.64
Benchmarks:																
JPM 1-3 Year	...	2.61	-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	4.77
ML 1-3 Year	1.67	3.53	-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	3.95
3-month SDR	2.96	4.04	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	2.98
6-month SDR	3.11	4.18	0.36	0.37	0.37	0.37	0.36	0.35	0.33	0.33	0.30	0.26	0.26	0.27	4.00	3.10

Source: State Street.

1/ Unannualized.

2/ Fiscal year 2007 unannualized return and since inception return are based on partial period beginning August 2006.

3/ This includes the valuation effect of changes in the exchange rate between the euro and the SDR related to a euro-denominated deposit of EUR 300 million.

ANNEX III: TRUST ACCOUNTS—BOND PORTFOLIO EXPOSURE

(As of April 30, 2008; in percent)

Currency Exposure

	Benchmark	Trust Account
Euro	39.2	39.3
Japanese yen	10.8	10.9
Pound sterling	11.0	10.9
U.S. dollar	39.0	38.9
Total	100.0	100.0

Country/Issuer Exposure

	Rating 1/	Trust Account
African Development Bank	AAA	0.5
Asian Development Bank	AAA	0.7
Canada	AAA	0.0
France	AAA	2.2
Germany	AAA	36.3
Italy	A+	0.5
Japan	AA	11.0
Luxembourg	AAA	7.9
Netherlands	AAA	0.1
United Kingdom	AAA	6.5
United States	AAA	32.9
Total		100.0

Maturity Exposure

	Trust Account
Cash 2/	1.4
< One Year	8.1
1 to 3 Years	82.5
3 to 5 Years	8.0
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.