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Adaptation Fund Board
Ethics and Finance Committee
Eighth Meeting
Bonn, 14 March, 2012

Agenda Item 10 e)

INVESTMENT MANAGEMENT BY THE TRUSTEE

Introduction

1. The purpose of this report is to:

   i. Provide additional information to the Adaptation Fund Board (the "AF Board") on the trustee's investment management activities in response to the request made by the AF Board at its sixteenth meeting held in December 2011 (Decision B.16/24) for advice on investment options.
   ii. Inform the AF Board that if at least $100 million in AF Trust Fund resources will remain undisbursed in the Trust Fund for a period of at least one year, the trustee can invest AF Trust Fund cash balances in longer term investments. Cash transfer projections provided by the AF Secretariat indicate that this criteria is likely to be met.

Investment Strategy

2. The International Bank for Reconstruction and Development (the "World Bank") as the trustee (the "Trustee") of the Adaptation Fund receives and holds CER proceeds and all other contributions in the Adaptation Fund Trust Fund. Assets held in trust by the World Bank are maintained in a commingled investment portfolio (the "Pool") for all trust funds administered by the World Bank. The assets in the Pool are managed in accordance with the investment strategy established for all of the trust funds administered by the World Bank.

3. The investment objectives for the Adaptation Fund Trust Fund are established in the trustee's Terms and Conditions of Service with the CMP, as discussed and agreed with the AF Board in 2008. The Terms and Conditions of Services between the Trustee and the CMP state:

> "*20. The Trustee shall invest the funds held in the Trust Fund, pending their transfer under paragraphs 15 and 22, in accordance with the Trustee's policies and procedures for the investment of trust funds administered by the World Bank, including commingling of the resources of the Trust Fund for administrative and investment purposes with other trust fund assets maintained by the World Bank. The commingling of Trust Fund resources for administrative and investment purposes should not affect the amount of resources from proceeds of CER monetization available in the Trust Fund for transfer of funds for Adaptation Fund operations, activities, projects and programmes. The Trustee shall credit all income from such investment to the Trust Fund to be used for the same purposes as other funds held in the Trust Fund. The CMP acknowledges that no warranty is given by the Trustee as to the performance or profitability of the investment of the funds held in the Trust Fund."*

4. The investment objectives for the trust fund liquid balances are to: (i) maintain adequate liquidity to meet foreseeable cash flow needs, (ii) preserve capital, and (iii) maximize investment returns. The return maximization objective is subject to risk tolerance criteria established in the Terms and Conditions (para 20), and the liquidity and operational requirements of the Adaptation Fund.

5. The Adaptation Fund Trust Fund undisbursed balances are presently allocated to a cash portfolio with an investment horizon of less than 3 months (the Bank's "Tranche 0", further described below). This reflects: i) the risk tolerance established in the Terms and Conditions, ii) the interim nature of the Trustee's mandate as reflected therein, and iii) the requirement for resources to be available for transfer to Adaptation Fund projects on an uncertain schedule, and at short notice.

6. AF resources are not currently invested in other, longer term Tranches, on the expectation that all funds would be required for projects and programs before the end of the one-year horizon period applicable to the next available investment tranche (Tranche 1).

7. If, however, the cash transfer rate for projects and programs will be such that at least $100 million in fund resources may remain in the Trust Fund for a period of at least one year, the trustee could invest the balances in other, longer term investment tranches, eg, *Tranche 1*, as further described below. ***Cash transfer projections provided by the AF Secretariat indicate that this criteria is likely to be met.***

The Investment Pool

8. The Bank's investment of trust fund balances (the "Pool") is made up of three sub-portfolios (called tranches): a cash portfolio (Tranche 0) that comprises bank deposits and investments in primarily money market instruments with an investment horizon of less than 3 months; a short horizon portfolio (Tranche 1) which increases security selection and has an investment horizon of up to one year; and a longer horizon portfolio (Tranche 2) which adds more instruments and has an investment horizon of up to three years. The Pool is actively managed so that the probability of incurring negative returns in Tranches 1 and 2 is no more than 1% over the applicable investment horizon. The objective of the tranche structure is to actively manage liquidity and to optimize investment returns for trust funds, which have disparate risk profiles. For any given trust fund therefore, allocations of the cash balances are made to one or more of the Pool tranches based on fund-specific investment horizons, risk profiles and other criteria set by the Bank. The investment universe across the three tranches comprises but is not limited to (i) deposits, (ii) money market instruments guaranteed by financial institutions whose senior debt securities are rated AA- or higher (iii) government bonds or agency obligations rated at least AA-, (iv) mortgage-backed securities, asset-backed securities and corporate securities rated at least rated AAA and (v) derivatives related to the risk management of securities in the investment pool.

Asset Allocation

Figure 1: Asset Allocation for Trust Fund Portfolio (in USD Equivalent percentages) as at 31-Dec-2011

	Tranche 0	Tranche 1	Tranche 2	Tranche 3
Govt	15%	45%	30%	25%
MBS	0%	0%	32%	0%
ABS	0%	6%	6%	14%
Agency	0%	8%	7%	13%
Sov Gtd	0%	22%	16%	26%
MM/Fin. Inst	84%	14%	4%	9%
Corporates	0%	5%	5%	11%
Swap/FX Swap	1%	0%	1%	2%
	100%	**100%**	**100%**	**100%**

Please see Figure 5 for more details on types on instruments that could be included

9. Historically, trust funds invested in a combination of Tranche 0 and Tranche 1 (the default strategy for trust funds) have had higher investment returns than trust funds invested solely in Tranche 0. This is primarily due to the longer duration assets forming part of Tranche 1 compared to the cash and near cash assets in Tranche 0. This longer duration also means Tranche 1 has more interest rate risk than Tranche 0 albeit Tranche 1 is managed to very conservative risk limits (probability of negative return of no more than 1% over a 12 month investment horizon).

10. To ensure Tranche 1 participants benefit from the risk mitigation measures in the investment strategy, participation in this investment tranche would require the Adaptation Fund Trust Fund to maintain cash balances for a period of not less than 12 months. The trustee would then allocate those funds between Tranche 0 and Tranche 1 as needed.

Investment Portfolio Summary

11. Within the overall commingled Trust Fund portfolio, the performance of individual trust funds is also tracked and the Adaptation Fund Trust Fund (in the table below) performance can be seen in the table below with performance of the overall Pool provided for comparative purposes.

Figure 2: Summary performance statistics for Adaptation Fund Trust Fund and Trust Fund Pool

	Size 31-Dec-11 (million)	Investment Returns CY11 %	 CY10 %
Adaptation Fund Trust Fund	**239**	**0.25%**	**0.32%**
Trust Funds	**25,655**	**1.21%**	**1.71%**
of which			
USD			
- *Tranche 0*	5,906	0.25%	0.30%
- *Tranche 1*	7,697	0.55%	1.00%
- *Tranche 2*	8,580	2.35%	3.13%
- *Tranche 3*	839	0.50%	0.52%
EUR			
- *Tranche 0*	847	0.86%	0.41%
- *Tranche 1*	1,029	1.67%	1.16%
Other (USD Eq)	756	2.30%	1.50%

Investment Portfolio Performance Highlights

12. The Adaptation Fund Trust Fund liquid portfolio returned 0.25% through the 2011 calendar year. In keeping with the Tranche 0 investment strategy, Adaptation Fund assets were primarily invested in short dated deposits in highly rated global financial institutions. As global policymakers retain an accommodative monetary policy stance, deposit rates remain low, meaning investment returns are projected to stay at modest levels for the foreseeable future.

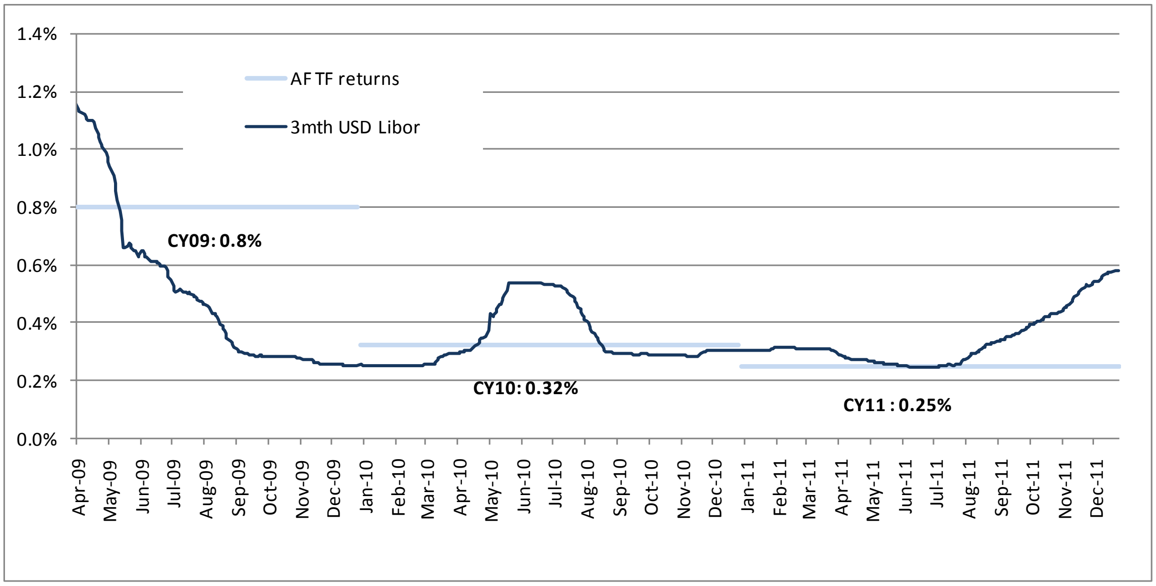
Investment Climate

13. 2011 was a tumultuous year for financial markets as concerns over sovereign debt, concerns over bank liquidity; geopolitics and economic worries have variously taken centre stage at one point or another to cause uncertainty and volatility. For most financial assets, the path of returns through the year was volatile although concerns about sovereign debt and banking sector stress were dominant factors for much of the latter half of the year, leading to positive performance for investment vehicles seen as "safe haven" plays, such as some government bonds.

14. From a fundamental perspective, the drive lower in bond yields over the past couple of years leaves the risks skewed towards underperformance for fixed income assets going forward. This was more than offset through 2011 by the situation described above and until that is resolved to the markets' satisfaction, a defensive strategy (owning assets towards the least risky end of the spectrum) appears to be the most prudent strategy.

Historical Trust Fund Returns

Figure 3: Adaptation Fund Trust Fund returns vs. 3mth USD Libor



15. Figure 3 above highlights the fact that historically, Adaptation Fund Trust Fund returns have been close to that of the average level of 3mth USD Libor. The portfolio returned 0.8% in CY09, 0.32% in CY10. For the calendar year 2011, returns were 0.25%.

Asset Allocation

16. Figure 4 below shows the distribution of the Adaptation Fund Trust Fund's liquid assets by type of asset as at end-December 2011. The same distribution is shown for end-Dec 2010 for comparison (see Figure 5 for some special considerations concerning the assets). It should be noted that the Bank's Treasury manages the money market instruments, bonds, securities and other instruments with specific banks and other institutions ("names") on a dynamic basis, in accordance with the Bank's policies and procedures for risk management for IBRD, IDA and trust funds.

Figure 4: Adaptation Fund Trust Fund Asset Allocation

		Dec-11	Dec-10	Change
Govt	Domestic Government Bonds	15%	6%	9%
MBS	Mortgage-Backed Securities	0%	0%	0%
ABS	Asset-Backed Securities	0%	0%	0%
Agency	Agency Bonds	0%	0%	0%
Sov Gtd	Sovereign Guaranteed Bonds	0%	0%	0%
MM/Fin. Inst	Money Market Instruments	84%	94%	-10%
Corporates	Corporate Bonds	0%	0%	0%
Swap	Deposit Currency Swaps	1%	0%	1%
		100%	100%	

Figure 5: Types of instruments that could be contained in the investment pool

Asset Type	Special Considerations
Government Securities	Rated at least AA-
Government Agency, Other Official Entity and Multilateral Organization Securities	Rated at least AA-
Corporate Securities	Rated AAA
Asset Backed Securities	Rated AAA
Bank/Financial Institution Obligations (e.g. Securities, CD, Deposits)	Rated at least A-
Repo & Reverse Repo	
Exchange Traded Futures & Options	
Forward Rate Agreements	Related to investments
Swaps	Related to investments
OTC Options	Related to investments

Note that derivatives and instruments such as Forward Rate Agreements (FRA), Swaps and Options are used for risk management purposes and not as assets or investments in their own right.

Summary

17. If the Adaptation Fund expects a slower cash transfer rate for projects and programs such that at least $100 million in AF Trust Fund resources will remain in the AF Trust Fund for a period of at least one year, the Trustee can employ an investment management strategy using longer term investments. The applicable investment tranche that would fit the Adaptation Fund is Tranche 1.

18. Cash transfer projections provided by the AF Secretariat indicate that the above criteria is likely to be met, therefore the Trustee will allocate the AF Trust Fund balances between Tranche 0 and Tranche 1 based on the above, and liquidity requirements of the AF.