Investment Management of Trust Funds and Financial Intermediary Funds

WORLD BANK GROUP

INTRODUCTION

For over 50 years, development partners have entrusted the World Bank with the financial management of their resources through their contributions to World Bank trust funds and Financial Intermediary Funds (FIFs). These resources are used to complement the World Bank Group's mission to promote economic growth and reduce poverty in developing countries. Trust funds and FIFs allow for the scaling up of activities, notably in fragile and crisis-affected situations; provide immediate assistance in response to natural disasters and other emergencies; and pilot innovations that may be later mainstreamed into the Bank's operations.

On receipt of development partner contributions to trust funds and FIFs, the World Bank invests these resources in the international capital markets until funds are disbursed to final recipients for development projects. Such investment management services aim to preserve donor funds and enhance their value. With the growth of donor funding over time, increasing development partner contributions for multi-year projects, and an increase in the number of trust funds managed by the World Bank, the volume of liquid assets held by trust funds and FIFs reached $27.2 billion as of 30 April 2016.

This brochure provides information on the World Bank's investment management services for development partners. The Trust Funds and Partnerships Department (DFPTF) within the World Bank's Development Finance Vice Presidency (DFi) serves as the liaison between development partners and external/internal clients on strategy, policy, and program management, as well as financial and risk management oversight for trust funds and FIF assets managed by the World Bank Treasury.

The World Bank Treasury has substantial expertise in asset and liability management and a global reputation as a prudent and innovative borrower, investor and risk manager. In managing funds for development partners, the World Bank follows a well-defined investment process, applying a conservative risk approach with ongoing oversight through the World Bank's financial governance structure.

Sound investment management is an integral part of the value process to ensure the availability of development partners' funds for their intended purposes. As such, preservation of capital has historically been the primary objective when investing development partners' financial resources. Beyond this objective, the World Bank Treasury seeks to prudently add value by judiciously employing appropriate investment strategies within an efficient, flexible, industry leading investment platform. This allows investment management of trust funds and FIFs in a way that accommodates the varying investment requirements and risk tolerances of its development partners, thus providing opportunities for enhancement of investment returns.

The trust funds and FIFs' investment portfolios managed by the World Bank have seen solid investment performance over the past decade, and were able to weather the global financial crisis of 2008/2009 remarkably well. Over the past 5 years[1], the incremental investment income for the USD and EUR portfolios earned over their respective benchmarks[2], is estimated to be more than $303 million.

We hope that you will find this brochure informative and look forward to answering any questions that you may have on the investment management process for development partners' funds.

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Development Finance Vice Presidency (DFi)
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1. As of 31 March 2016
2. Refer to the summaries of each Model Portfolio at the back of this booklet for benchmark information.

BACKGROUND

The World Bank Treasury has extensive experience in managing and investing development partner financial resources. It has mobilized and managed development partner contributions since 1960 when the International Development Association (IDA) was created to support the poorest countries through interest free and long maturity loans. Since the 1980s, development partners have also provided bilateral aid resources and other contributions through trust funds managed by the World Bank, and over the past decade, have engaged the World Bank as trustee for Financial Intermediary Funds (FIFs). In this function, the World Bank takes on different financial management and advisory roles, while project implementation and oversight in developing countries is carried out by donor agencies or other entities.

All trust funds and FIFs assets administered by the World Bank are maintained in a commingled investment portfolio (the "Pool"). To accommodate varying investment horizons and risk tolerances of individual trust funds, the Pool comprises of sub-portfolios, called Model Portfolios, in which trust fund liquid assets can be invested.

Over the last ten years, the investment portfolio for combined trust funds and FIFs has seen substantial growth with the value of liquid assets increasing three-fold from $10.3 billion in April 2006 to reach $27.2 billion in April 2016. This growth is reflective of the World Bank's expertise in designing and establishing new trust funds and developing tailored financial solutions (including through FIFs) to address development challenges.

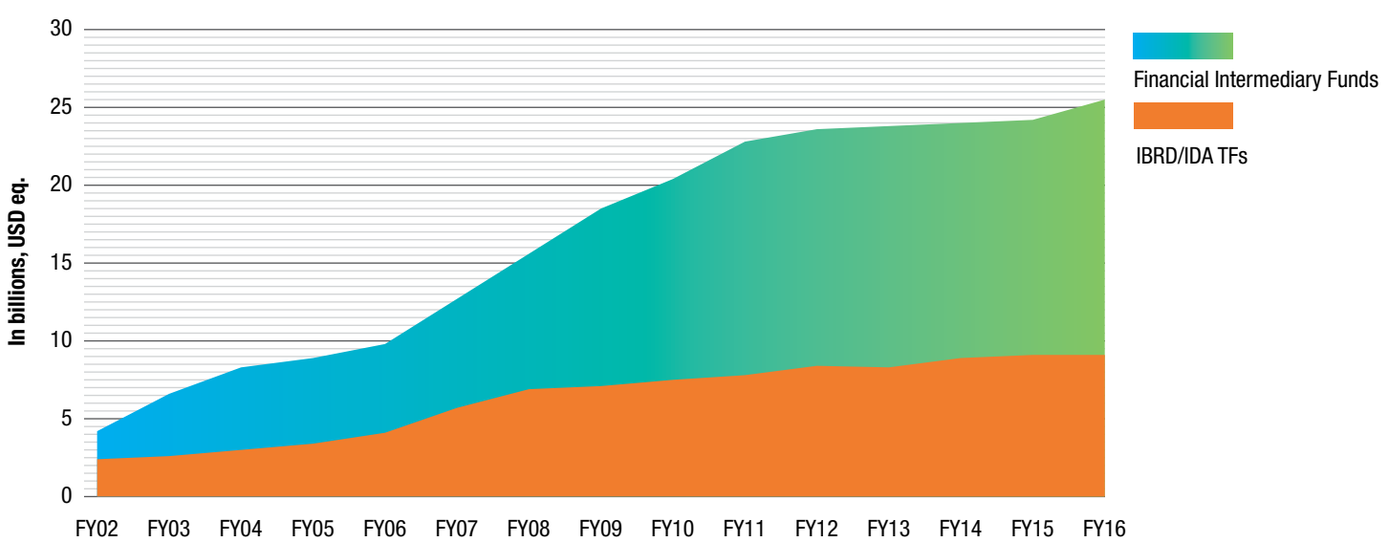
After development partners pay in their contributions, the World Bank Treasury invests these resources in the international capital markets until funds are disbursed to final recipients for development projects. Such investment services aim to preserve development partners' funds and enhance their value.

Trust funds and FIFs receive funds from development partners in multiple currencies. Upon receipt by the World Bank, these funds are typically invested in the currency of eventual disbursements to recipients in developing countries. The commitment authority for trust funds and FIFs are monitored in US dollars; as such, the investment portfolio is held primarily in US dollars.

The investment of development partners' funds in the international capital markets follows a well-defined process, involving different stages of review, approval and ongoing monitoring and controls. The process starts by establishing the appropriate investment strategy for the funds to be invested. This strategy is guided by liquidity profile of the development partners' funds and a defined set of investment objective and risk tolerance limits, to be reviewed and approved by appropriate departments and financial committees. To formulate the investment strategy for the investment portfolios of trust funds and FIFs, the World Bank Treasury develops an asset allocation which is designed to achieve the investment objectives and meet the specified risk tolerance.

The asset allocation process identifies the suitable types of investment instruments (asset classes) and their weights in the investment portfolio, and determines the appropriate portfolio benchmark for each asset class. These benchmarks closely guide the ultimate investments which are established through approved counterparties in the capital markets, based on investment guidelines that limit market risk (such as interest rate risk) and credit exposure. Credit limits for holding funds for investment with commercial banks are determined by the World Bank's Chief Risk Officer's Market and Counterparty Risk Department. Ongoing risk measurement and performance reporting for the investment portfolios of trust funds and FIFS are conducted on a daily basis within the Bank's Treasury.

DEVELOPMENT PARTNER FUNDS UNDER MANAGEMENT, FISCAL YEARS 2002 -2016[3]



3.FY16 data is as of 31 March 2016.

INVESTMENT OBJECTIVES & STRATEGY

AT A GLANCE - THE INVESTMENT PORTFOLIO OF TRUST FUNDS AND FIFS

The World Bank manages the liquid assets of trust funds and FIFs in a single, commingled investment pool which provides several benefits to its participants, such as:

- A selection of model portfolios to accommodate the varying liquidity needs and risk preferences of different funds, managed within a comprehensive risk management framework.
- Access to a wide variety of investment products and longer maturity investments to enhance returns and investment income over time.
- A cost-effective investment platform resulting in very low administrative costs to participants.
- Regular review of liquidity needs across funds to optimize investments over the longer term.

The assets of investment portfolios of trust funds and FIFs are separated into model portfolios with specific investment objectives, investment horizons and risk tolerances. The World Bank Treasury develops a separate asset allocation for each model portfolio to achieve these investment objectives.

The investment objective of each model portfolio is to optimize investment income subject to the preservation of capital and the liquidity requirements of the underlying funds. Preservation of capital is seen as the primary investment objective, reflecting perceived donor sensitivity to any potential losses of capital that could result from adverse movements in the international capital markets. Consequently, the investment portfolios are managed to conservative overall risk tolerance parameters.

Each model portfolio seeks to achieve this objective over distinct investment horizons, which range from daily up to three years. A model portfolio for longer term investments (5-year investment horizon or greater) is also available for trust funds and FIFs that have stable cash flows over that horizon, meaning they may take advantage of a more diversified allocation including an allocation to global developed market equities. Funds within the investment portfolio are periodically rebalanced to ensure that they are allocated to the most suitable investment mix, based on multi-year cash flow projections for each fund.

The photo includes World Bank staff from the Development Finance Vice Presidency and the Offices of the World Bank Treasurer and Chief Risk Officer. Front row from left: Arunma Oteh, Axel van Trotsenburg. Second row from left: Mei Leng Chang, Wendy Mendes, Suzanne Boughner, Wayne Schwartz; Ivana Pavlovic; Angela Williamson. Third row from left: Jaehyang So, Tapiwa Sikipa, Jean Xavier Bourre, Eric Bouye, Tao Wang.

MODEL PORTFOLIOS FOR INVESTMENTS OF TRUST FUNDS AND FIFS

	Model Portfolio 0 Cash Tranche	Model Portfolio 1 Capital preservation over a 1-year horizon	Model Portfolio 2 Capital preservation over a 3-year horizon	Model Portfolio 3 LIBOR based	Model Portfolio 4[6] Return optimization over a 5-year horizon	Model Portfolio 5 Return optimization over a 5-year horizon
Investment Objective	Enhance returns subject to ensuring liquidity and timely availability of cash when needed		Maximize returns subject to limiting negative returns over a three-year horizon	Maximize returns subject to 3-month interest rate sensitivity	Maximize returns over a five-year investment horizon subject to downside risk constraints	Maximize returns over a five-year investment horizon subject to downside risk constraints
Asset Allocation/ Benchmark	Overnight cash	Dynamic (Government bonds and money markets)	Dynamic (Government bonds, money markets and US Agency MBS)	LIBOR based	Various fixed income benchmarks and up to 20% global developed market equities	Various fixed income benchmarks and up to 20% global developed market equities
Currencies	USD and EUR	USD and EUR	USD	USD	USD	USD
Assets under management (US$ mill.)[4]	$5,082	$9,087	$8,327	$1,108	Nil	$2,865
Historical 1-yr Return (USD only)[5]	0.28% (Excess Return 8 bps)	0.39% (Excess Return 9 bps)	0.91% (Excess Return 17 bps)	0.52% (Excess Return 29 bps)	NA	0.92% (Excess Return 13 bps)
Historical 3-yr Cumulative Return (USD only)	0.71% (Excess Return 32 bps)	1.14% (Excess Return 55 bps)	2.75% (Excess Return 65 bps)	1.36% (Excess Return 87 bps)	NA	NA

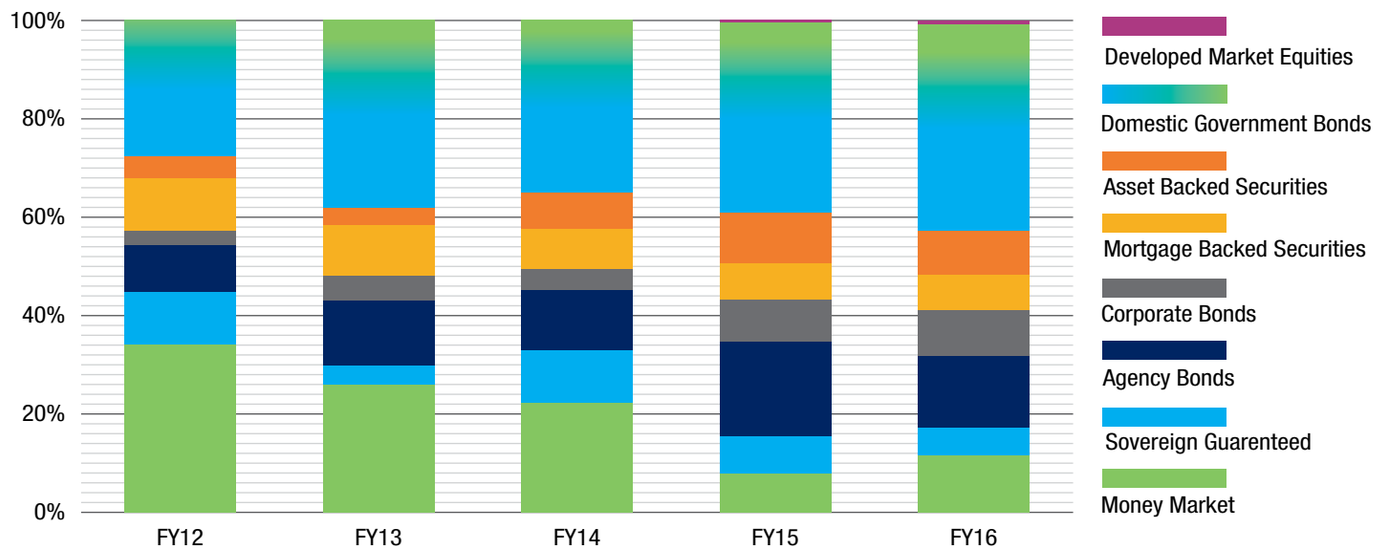
4. As of 31 March 2016
5. The performance shown here represents past performance and is not a guarantee of future results.
6. Participation in Model portfolio 4 is subject to specific instructions from the relevant trust fund or FIF governing body.

INVESTMENT SECTORS

The asset allocation for each model portfolio is implemented by selecting suitable benchmarks for the identified investment sectors. The Investment Guidelines for the trust funds investment portfolios specify the allowable range of instruments, for each investment sector, within the high grade fixed income category (such as government bonds) as well as money market securities (such as short-term investments with commercial banks).

Currently, these instruments includes high quality securities that are issued by sovereign governments, government agencies, as well as multilateral and other official institutions. In addition, eligible instruments include asset-backed and agency-guaranteed mortgage-backed securities, as well as swaps and a range of other derivative instruments that can be used to manage interest rate risk. Investments in synthetic short-duration USD assets, obtained by asset swapping longer duration bonds denominated in USD as well as non-dollar currencies, is also permitted.

ASSET COMPOSITION OF THE TRUST FUNDS AND FIFS PORTFOLIO, FISCAL YEARS 2012-2016[7]



7. FY16 data is as of 31 March 2016.

INVESTMENT SECTORS FOR TRUST FUNDS AND FIFS PORTFOLIOS

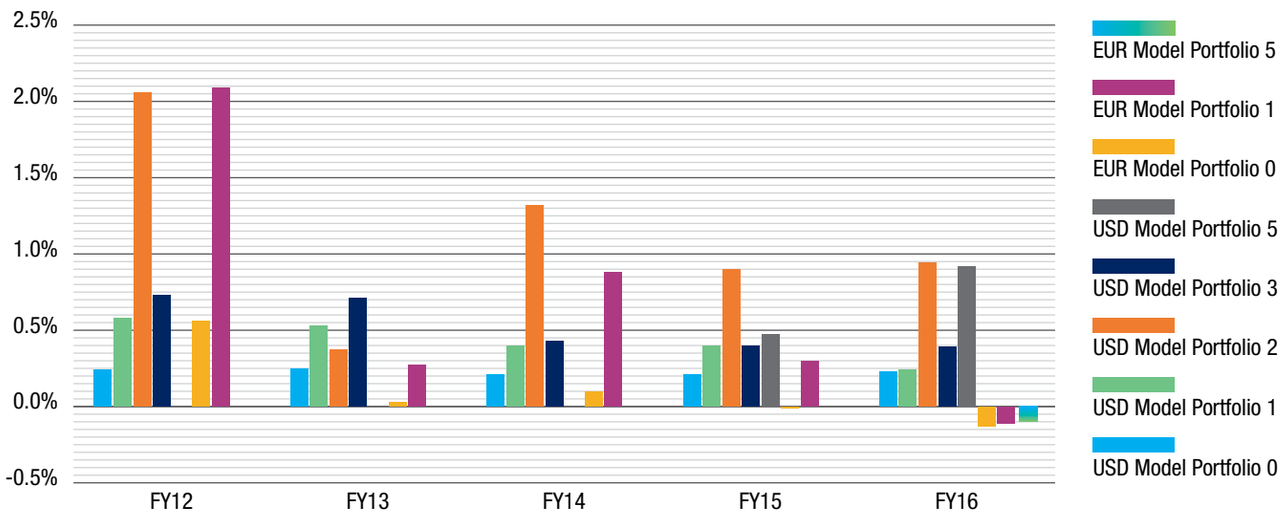
Asset Class	Asset Description
Domestic Government Securities	Marketable bonds, notes or other obligations issued or unconditionally guaranteed by the government of a country in its own domestic currency and approved by the World Bank's Credit Committee.
Mortgage-backed Securities (MBS)	US Agency-guaranteed residential mortgage-backed securities, including fixed-rate pass-throughs, adjustable rate mortgages (ARMs), interest-only (IO) and principal-only (PO) strips, and collateralized mortgage obligations (CMOs). Commercial Mortgage Backed Securities (CMBS) and non-agency MBS are not included.
AAA Corporate Securities (incl. Asset Backed Securities)	AAA-rated asset-backed securities (ABS), backed by student loans, auto and credit card receivables, public sector loans or prime first lien residential mortgages and domiciled in an eligible country, and any other AAA-rated obligations of a corporate entity.
Agency/ Sovereign/ Government guaranteed Securities	Marketable bonds, notes or other obligations rated at least AA- issued by a government agency, supranational institution or local authority domiciled in an eligible country as well as corporate debt guaranteed by the government of eligible countries.
Money Market Instruments/ Financial Institutions Securities	Time deposits, certificates of deposit, reverse repurchase agreements and other obligations issued or unconditionally guaranteed by a bank or other financial institution domiciled in an eligible country, whose senior debt securities are rated at least A- and maturing in 3 months or less.
Developed Market Equities	A stock or any other security representing an ownership interest.
Swaps and Derivatives	Financial futures and option contracts, other derivative and associated instruments, forward rate agreements, swap transactions, options to enter into swap transactions in the future, and foreign exchange transactions.

INVESTMENT PERFORMANCE

The market conditions over the past five years have been characterized by historically low fixed income yields and increased interest rate volatility. The investment portfolios for trust funds and FIFs have achieved returns that reflect these market conditions. When interest rates decrease in major markets, bonds providing a fixed coupon income will increase in market value, and this will increase the total return from coupon income plus market price changes from holding these bonds (see also technical box on "Impact of Market Yields on Fixed Income Portfolios"). With yields at low levels and uncertainty regarding a rise in market yields, returns are expected to remain modest over the near term.

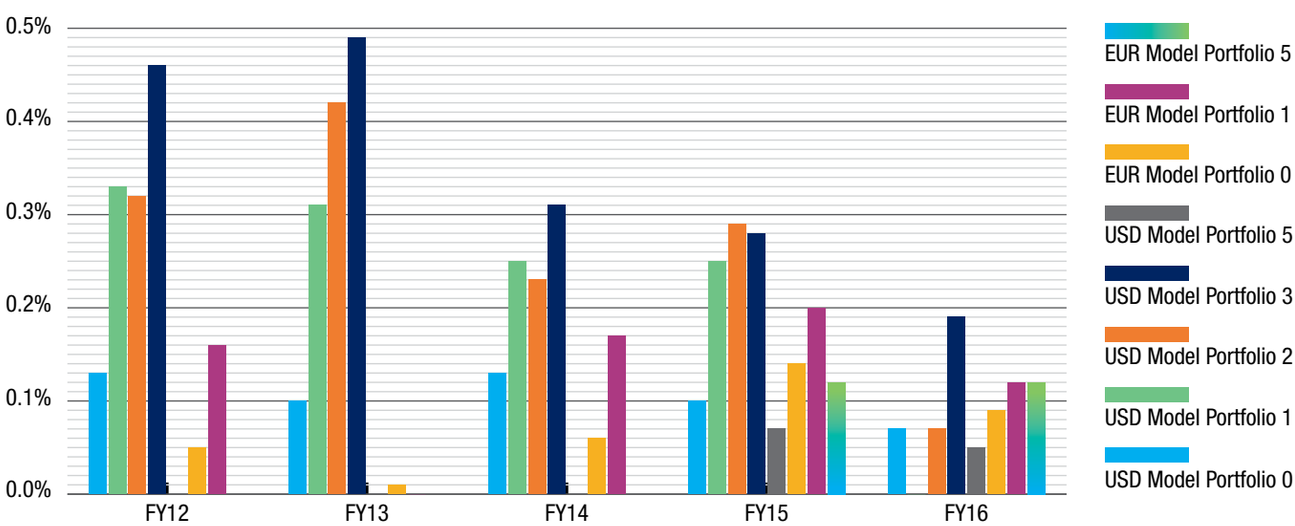
Over the past five years, the World Bank has been able to enhance investment returns over and above the primary capital preservation objective for investment portfolios of trust funds and FIFs. This was achieved through an effective asset allocation process as well as active portfolio management by the World Bank Treasury. For the return optimization portfolios (see technical box on "Defining Investment Objectives"), the incremental income can be illustrated by comparing actual returns to that of a typical benchmark combination for conservative portfolios, for example, a constant benchmark index of US Treasury securities in the 1-3 year range and cash. This type of comparison is shown in the accompanying chart and highlights the overall higher returns relative to risk of the actual portfolio compared to that of a typical allocation. For example, for the past five years, this incremental income is estimated at around $297 million for the investment portfolio of Trust Funds and FIFs.

PORTFOLIO RETURNS OF TRUST FUNDS AND FIFS, FISCAL YEARS 2012-2016[8]



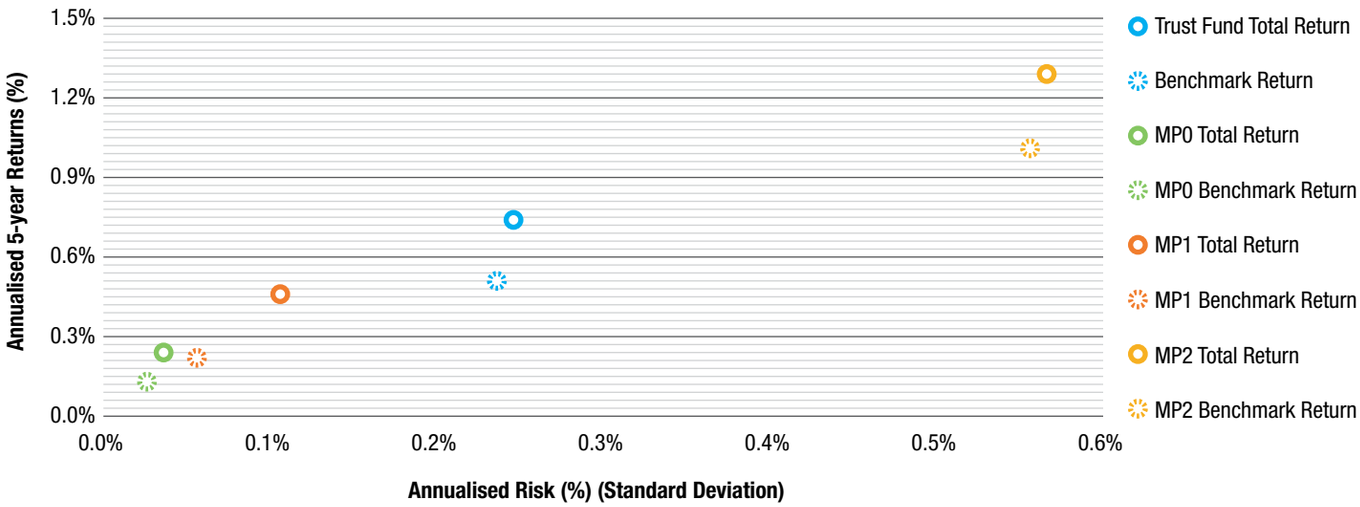
8. FY16 data is as of 31 March 2016.

EXCESS RETURNS OF MODEL PORTFOLIOS FOR TRUST FUNDS AND FIFS VERSUS BENCHMARKS, FISCAL YEARS 2012-2016[9]



9. FY16 data is as of 31 March 2016

TRUST FUND HISTORICAL TOTAL RETURN AND RISK CHARACTERISTICS FOR TRUST FUNDS AND FIFS[10]



10. Annualized 5-year returns as of 31 March 2016.

RISK MANAGEMENT

Generating enhanced investment returns while adhering to the investment objective of capital preservation and ensuring sufficient liquidity to meet foreseeable cash flow needs is undertaken within a conservative risk management framework which limits the estimated average loss to the portfolio in the worst 1% of loss events. This Conditional Value-at-Risk (CVaR) measure is the primary risk constraint used in the management of the model portfolios for trust funds and FiFs. The World Bank Model Portfolios have their overall market risk constrained by a CVaR measure as follows:

Model Portfolio 1 – 99% CVaR of no greater than -25 basis points

Model Portfolio 2 – 99% CVaR of no greater than -100 basis points

Model Portfolio 4 – 99% CVaR of no greater than -100 basis points

Model Portfolios 3 and 5 are further subject to separate sets of investment guidelines set forth in the contractual undertakings governing the relationships with the relevant entities.

This risk measure has been adopted by the World Bank because it quantifies an acceptable level of loss given the tail risk loss events being realized. In addition to the information embedded in the risk measure (which neatly captures the perceived risk preferences of trust fund clients), CVaR also has desirable statistical qualities that make it preferable to alternative risk constraint measures such as the probability of negative return or simple VaR. These qualities include the following:

- In general, CVaR is a superior risk measure to probability or the simple VaR measure. In normal market environments (i.e., expected returns are assumed to be normally distributed), the three measures are equivalent. In adverse environments, however, using CVaR enables investors to limit the magnitude of tail loss (i.e. the full spectrum of adverse scenarios beyond a simple confidence level), while probability of negative return does not address the magnitude of loss and the simple VaR measure only addresses losses at one confidence level.

- In addition, in the current low interest rate environment, the probability of negative return measure is very sensitive to small changes in yield levels and may signal frequent and unnecessary asset allocation changes which may result in unnecessary transaction costs. The CVaR measure is found to be less reactive to small yield changes and can significantly reduce unnecessary rebalancing transactions based on empirical studies.

GOVERNANCE AND OVERSIGHT

Institutional oversight for programs funded by development partners is provided by the World Bank's Executive Directors (Board), Committees of the Board such as the Audit Committee, the World Bank Group President as well as members of the senior management team. The oversight of the financial management arrangements for the investment portfolios of the Trust Funds and FIFs are undertaken by the Finance and Risk Committee (FRC), which is chaired by the World Bank Group Chief Financial Officer.

The World Bank Treasury is vested with the responsibility of managing the investment portfolios of trust funds and FIFs in a fiduciary capacity. The provisions of the World Bank Board approved General Investment Authorizations for the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA) also apply to the investment of World Bank administered trust funds and FIFs subject to any specific instructions provided by development partners or governing bodies thereof. This includes for example specification of an expanded range of eligible investments, such as equities.

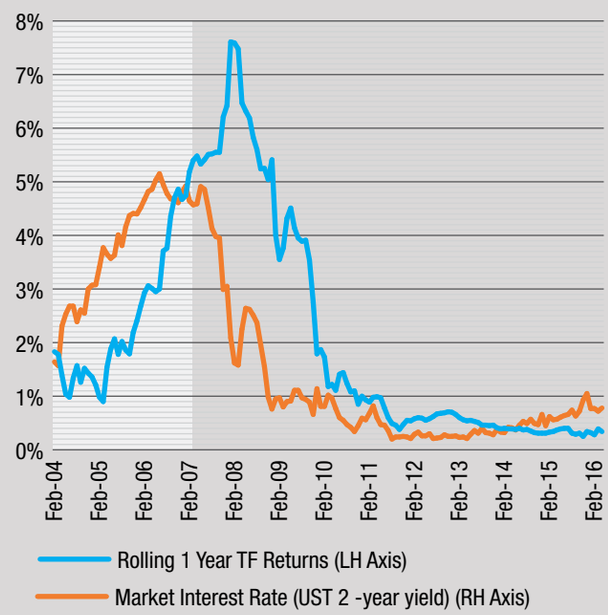
The investment strategies for investment portfolios for trust funds and FIFs are periodically reviewed and approved by the appropriate departments and financial committees. The Board's Audit Committee reviews these investment strategies, and regular management discussions take place to assess investment policy and asset allocations while investment returns are reported at least monthly. DFi approves the investment benchmarks, and conducts regular reviews of the liquidity requirements and allocation of investment balances to specific investment tranches.

IMPACT OF MARKET YIELDS ON FIXED INCOME PORTFOLIOS

Investment returns on high quality fixed income portfolios consisting of government securities are made up of two components: (i) periodic coupon income at the fixed contractual interest rate, and (ii) price changes, or change in market value of principal (appreciation or depreciation) on account of changes in interest rates in the capital markets. All other things being equal, an increase in interest rates results in a depreciation in the value of the original investment in fixed coupon bonds; conversely, a decrease in market interest rates results in an appreciation in the value of the original bond investment. If bonds are held until their maturity date, there will be no impact from these temporary price changes on the total investment return earned at maturity.

If the second component of investment returns (i.e. changes in price) is negative over a given period, and its magnitude exceeds the periodic coupon income, the total investment return over the reporting period can be negative, thus resulting in a decrease in the overall value of the bond investment. While longer maturity bonds typically carry a higher interest rate and thus generate higher coupon income relative to shorter maturity bonds, they are also more susceptible to market price changes as a result of a change in interest rates. Other things being equal, conservative portfolios with a limited tolerance for negative returns tend to have shorter portfolio durations; and the lower the level of market interest rates, the shorter the portfolio duration will have to be in order to preclude any reported losses.

The chart below shows the historical rolling 12-month returns of USD Model Portfolio 1 (as a proxy for the investment portfolio of trust funds and FIFs) against the yields on US Treasury 2-year bonds (as a proxy for the level of US interest rates). The declining interest rates in 2007-2008 were followed by increasing or high investment returns. In contrast, periods of rising rates,



Note: The shaded areas denote periods of generally rising vs. falling interest rates, respectively.

such as in 2004-2005, have seen declining or low reported total investment returns. However, during that period, the coupon income, as indicated by the level of yields, was high enough to cushion the negative impact from falling market prices, such that the total return of the investment remained positive. With interest rates remaining near historically low levels in the United States and other major markets following the global financial crisis since 2009, returns of USD Model Portfolio 1 (and the investment portfolios of trust funds and FiFs as a whole) remain low in historic terms. The World Bank Treasury has taken steps to reduce the sensitivity of the investment portfolio to the impact of potential future interest rate increases.


TRADING
BUSINESS
FINANCE
ESTMENT
MONE

+0.11%
+0.38%
-0.67%
+0.73%
+0.34%
-0.62%
-0.45%
-0.52%
+0.11%
-0.62%
-0.45%
+0.23%
+0.19%
-0.67%
+0.73%
+0.34%
-0.62%
-0.45%
-0.52%
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+0.38%
-0.67%
+0.73%
+0.34%
-0.62%

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