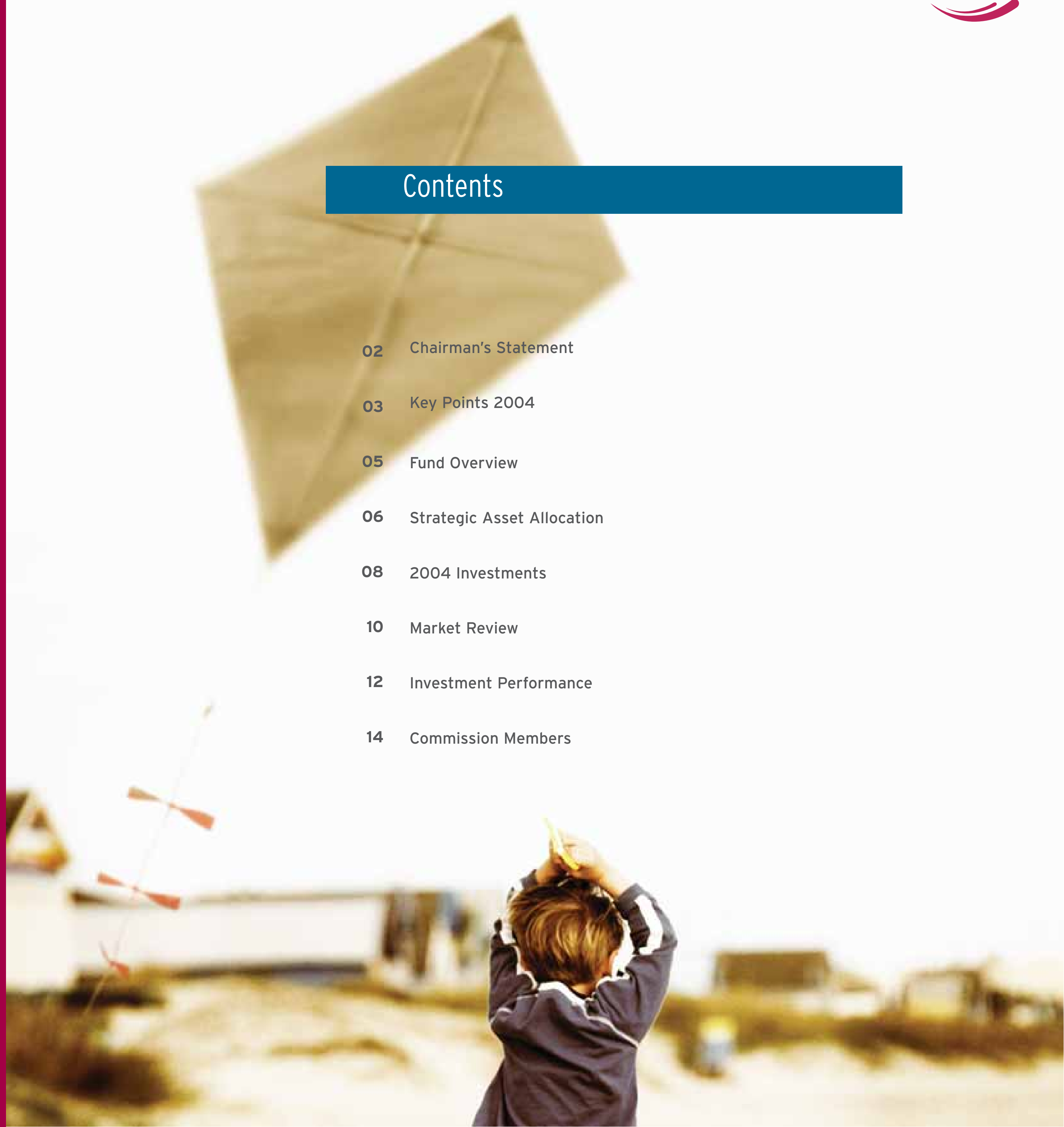
National Pensions Reserve Fund

Review 2004



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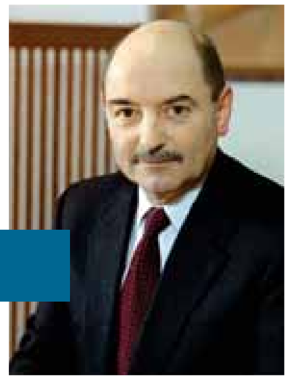
Note: The financial results and performance figures for 2004 set out in this Review are unaudited. Audited figures for 2004 will be published in the NPRF Commission's Annual Report and Accounts in mid 2005.

CHAIRMAN'S STATEMENT



"The Commission is determined to ensure Ireland reaps the full rewards of the Government's early establishment of the Fund"

2004 was another good year for the National Pensions Reserve Fund with its investments earning a return of 9.3% and making a healthy contribution towards meeting Ireland's future pension liabilities. It also marked a milestone in the life of the Fund as its phased entry or averaging in process to the global equity markets was completed.

Over the three years of its operation, the averaging in process has proved highly successful enabling the Fund to invest at attractive valuations as the recovery in financial markets took hold. These three years have also vividly illustrated the volatility that can occur in financial markets over short timescales.

The Commission has recognised from the start that, as a long-term project with no medium-term liquidity requirement, the Fund is ideally placed to exploit the additional return available from holding more volatile and less liquid assets. This approach has the added advantage of diversifying the sources of the Fund's risk.

During 2004 we carried out a major evaluation of what mix of additional asset classes could make the most meaningful contribution in these ways. As a result of the evaluation we have decided on an allocation of 18% of the Fund to what one might term alternative assets – property, private equity and commodities. The Commission will be adopting a phased approach to investment in property and private equity, increasing its holdings over time, as it seeks to build up high quality diversified portfolios in these areas.

In last year's Review I noted how the ageing of the European population and the increased costs of pension provision figured prominently in the headlines during the year. The prominence of these issues was, if anything, even more noticeable in 2004 and it is salutary to consider the speed with which they have moved up policymakers' agendas across Europe since the Government made its first contribution to pension prefunding in 1999.

The Commission is determined to ensure Ireland reaps the full rewards of the Government's early establishment of the Fund. It is for that reason we have developed our investment strategy by adding asset classes that will maximise long-term performance. The implementation of this strategy in line with international best practice will set the agenda for the work of the Commission and the NTMA, in its capacity as the Fund's Manager, over the next five years. It represents a challenging but exciting task that is central to the Commission's objective of generating the maximum return from the assets entrusted to it by today's workforce.

Donal J. Geaney
Chairman
February 2005

KEY POINTS 2004

"2004 was another good year for the National Pensions Reserve Fund with its investments earning a return of 9.3%"

- 9.3% return on investments.
- An end year Fund value of €11,689m (equivalent to 9.6% of GNP).
- An appreciation of €951m in Fund value in 2004 (excluding the Exchequer contribution of €1,177m).
- The investment of €1,415m in global equity markets through the year, effectively completing the averaging in market entry approach adopted by the Commission since 2002.
- The expansion of the Fund into new asset classes – small cap equity and property.
- A significant diversification of the Fund's strategic asset allocation, primarily through an 18% allocation to alternative asset classes - property, private equity and commodities.
- An end-year holding by asset class as follows:

ASSET	€M	% OF FUND
Large Cap Equities	8,662	74.1
Small Cap Equities	231	2.0
Bonds	1,485	12.7
Property	12	0.1
Cash*	1,299	11.1
Total	**11,689**	**100.0**

*includes other net current assets

FUND OVERVIEW

"The Fund is intended to reduce and smoothen the Exchequer burden arising from Ireland's additional pension commitments over a lengthy period"

The National Pensions Reserve Fund

The objective of the National Pensions Reserve Fund is to meet as much as possible of the costs of social welfare and public service pensions from 2025 until at least 2055 when these costs are projected to increase dramatically due to the ageing of the population.

There are currently more than five people of working age to every pensioner in Ireland. By 2030 this ratio is projected to fall to three to one and by mid-century there are likely to be fewer than two working people to each pensioner.

This is due to a decline in the birth rate and increased life expectancy. It will inevitably lead to significantly increased pension costs, in particular in the social welfare area, as more pensioners have to be supported by proportionally fewer workers. These increased costs may be met through higher taxation, reduced pension benefits, an increase in the retirement age or by moving from complete reliance on pay as you go to a part pre-funded pension system as represented by the establishment of the Fund.

The Government invests 1% of GNP annually to meet part of the cost of future pensions. No money can be taken from the Fund before 2025 and, from then on, drawdowns will continue until at least 2055 under rules to be made by the Minister for Finance. The Fund is intended to reduce and smoothen the Exchequer burden arising from Ireland's additional pension commitments over a lengthy period.

The Fund is controlled, managed and invested by a seven member Commission which is independent of Government in the exercise of its functions. The Commission is required to operate the Fund on a commercial basis so as to secure the best possible financial return subject to prudent risk management. The National Treasury Management Agency (NTMA) acts as the Manager of the Fund and the Commission performs its functions through the NTMA.

STRATEGIC ASSET ALLOCATION

The initial strategic allocation of the Fund's assets decided by the Commission in 2001 was 80% to equities and other real assets and 20% to bonds. While this initial strategy setting exercise focused on large-cap equities and bonds, it was recognised at the time that other real assets, such as property and private equity, were valid investment categories for the Fund and would be evaluated by the Commission.

During 2003 the Commission began considering new asset classes making allocations to small cap equities (2%), corporate bonds (2%), property (4%) and Public Private Partnerships (PPPs) in Ireland (an initial allocation of €200m). It also decided to invest in private equity but did not make an allocation to the asset class.

The Commission accelerated the diversification process in 2004 and evaluated all potential asset classes together with the aim of exploiting potential sources of additional long-term return without substantially altering the Fund's risk profile. As a result of this evaluation, the Commission decided to allocate 18% of the Fund to alternative asset classes (property, private equity and commodities).

Private equity offers the prospect of substantial additional return while property and commodities also markedly improve diversification. Taken together, the inclusion of these alternative asset classes in the Fund should increase prospective return for a similar level of risk.

The Commission also decided to increase its small cap equity allocation from 2% to 4% and to allocate 2% of the Fund to emerging market equities. The €200m allocation to PPPs will be invested on an opportunistic basis. The diversification effect of the new asset classes reduces the Fund's dependence on the performance of any single asset class and has allowed the Commission to reduce the Fund's bond allocation (its least risky asset class but the one with the lowest potential return) from 20% to 13% while broadly maintaining the Fund's existing risk profile.

The target strategic asset allocation will set out the framework within which the Fund will operate over the next five years. Investment in property and private equity will take place on a phased basis due to the need to perform detailed due diligence on potential investment vehicles and in order to build up high quality diversified portfolios through time. The Commission does not expect to reach its target allocations in respect of these asset classes until the end of 2009.

The Fund's long-term investment horizon and lack of a liquidity requirement with no drawdowns before 2025, as well as its strong cash flow from the annual Exchequer contribution, were key factors in both the initial 2001 investment strategy and the 2004 diversification. They allow the Fund to exploit both the short-term volatility and lack of liquidity inherent in some of its chosen asset classes in anticipation of the excess return available to long-term investors as compensation for these factors.

TARGET NPRF STRATEGIC ASSET ALLOCATION (END 2009)

	% Asset Allocation
Large Cap Equity	63
Small Cap Equity	4
Emerging Markets Equity	2
Total Quoted Equity	**69**
Property	8
Private Equity	8
Commodities	2
Total Alternative Assets	**18**
Bonds	**13**

"Investment strategy implementation represents a challenging but exciting task that is central to the Commission's objective of generating the maximum return from the assets entrusted to it by today's workforce"

ALTERNATIVE ASSET CLASSES

Private Equity

Private equity, i.e. the provision of equity finance to unquoted firms, has the potential to generate significant additional return due to investor compensation for such factors as longer investment horizons, lack of liquidity and the relatively greater risk of investment in unquoted companies. Returns are realised either through a trade sale or a market flotation.

Property

Property has both equity and bond characteristics. While over the long-term property valuations should increase ahead of inflation (akin to equity investment), rental income is akin to bond income. The potential return from property investment can be enhanced through the use of leveraged investment structures (with a corresponding increase in risk).

Property offers substantial diversification benefits as returns are not closely correlated with equities.

Commodities

Commodities (oil and gas, industrial and precious metals, agricultural produce and forestry) offer attractive return prospects. Forestry, for example, can be an attractive investment for pension funds as mature trees can be left in place during economic downturns and harvested when business improves. Like property, commodities provide substantial diversification benefits with returns being negatively correlated with equities. These diversification benefits can be achieved through small allocations to the asset class.

2004 INVESTMENTS

> "The Fund committed €1,415m to global equity markets through 2004. This effectively completed the averaging in or phased approach to investment adopted in order to reduce the Fund's market entry risk by spreading it over time"

The Fund committed €1,415m to global equity markets through 2004. This effectively completed the averaging in or phased approach to investment in the capital markets adopted by the Commission in order to reduce the Fund's market entry risk by spreading it over time.

The Fund's Market Entry Programme

On its establishment in April 2001, the Fund received an initial Exchequer contribution of €6,515m comprising the net receipts of the Telecom Eireann flotation and 1% of GNP contributions for 1999 and 2000. The Commission was then faced with a decision – whether to commit funds to the markets in one fell swoop or whether to average in over time.

An averaging in approach leads to a fund underperforming its benchmark in a rising equity market due to its holding less equities and more cash than the benchmark. Conversely, it leads to outperformance in a falling market.

Despite widespread expectations of a US led global recovery in early 2002, the Commission decided that the economic and financial markets outlook was not certain. Therefore it pursued an averaging in approach which would reduce the Fund's market entry risk by spreading its market entry over time. This enabled the Commission to delay its investment strategy as market conditions deteriorated through 2002 and to mitigate the worst effects of the bear market.

As markets recovered from their lows of early 2003, the pace of investment increased with the entry programme being effectively completed by end 2004 when the Fund's equity and other real assets holding stood at 76.2% compared with a benchmark allocation of 80%.

At 12.7% the Fund remains underweight its benchmark bond allocation. This is as a result of a tactical decision by the Commission not to commit additional moneys to bonds at the current stage of the interest rate cycle. The Commission's view is that the yields currently available on bonds are insufficient to meet emerging pension liabilities and do not justify further investment in the asset class at this stage. In addition, there is a strong likelihood that the price of bonds will fall as interest rates return to more normal levels.

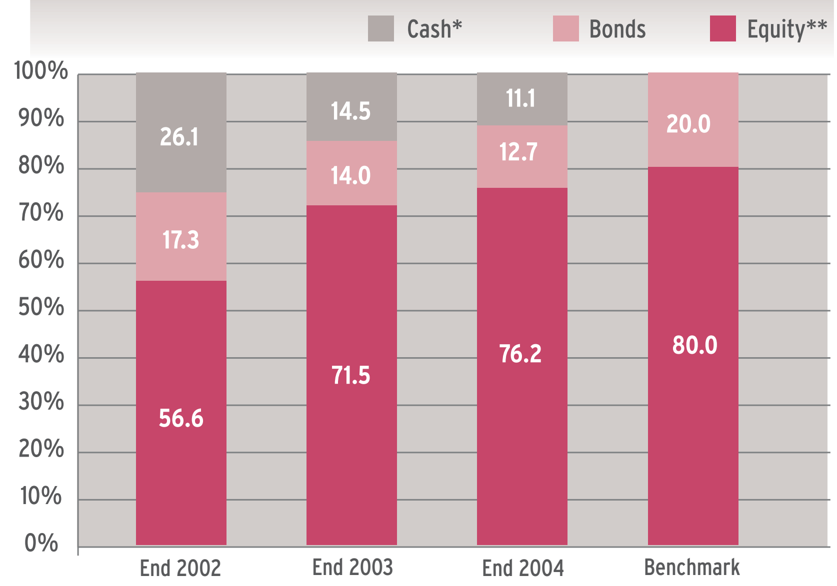
In 2004 the Commission continued its policy of hedging 50% of the Fund's foreign currency exposure, arising from its non-euro equity investments, into euro in line with its long-term investment strategy.

Managers were appointed to new investment mandates in the areas of small cap equities and corporate bonds during the year. Acadian Asset Management (Boston) were appointed to the EAFE (Europe, Australasia, Far East) small cap mandate while UBS Global Asset Management (Chicago) were appointed to the US small cap mandate. Deutsche Asset Management (Frankfurt) were appointed to the eurozone corporate bond mandate. The two small cap mandates have each been allocated 1% of the Fund and have been funded. The corporate bond mandate has been allocated 2% of the Fund and has not yet been funded.

The Commission commenced its property investment programme in December 2004. The Fund will access the market indirectly through property investment vehicles rather than through acquiring and holding land and buildings. This approach will help to achieve significant diversification in a reasonable timescale and also offers the opportunity to exploit leveraged structures in order to enhance return.

In the area of PPP, the Fund has joined a consortium which has been qualified to tender for the M50 motorway upgrade.

FUND INVESTMENTS 2002-2004



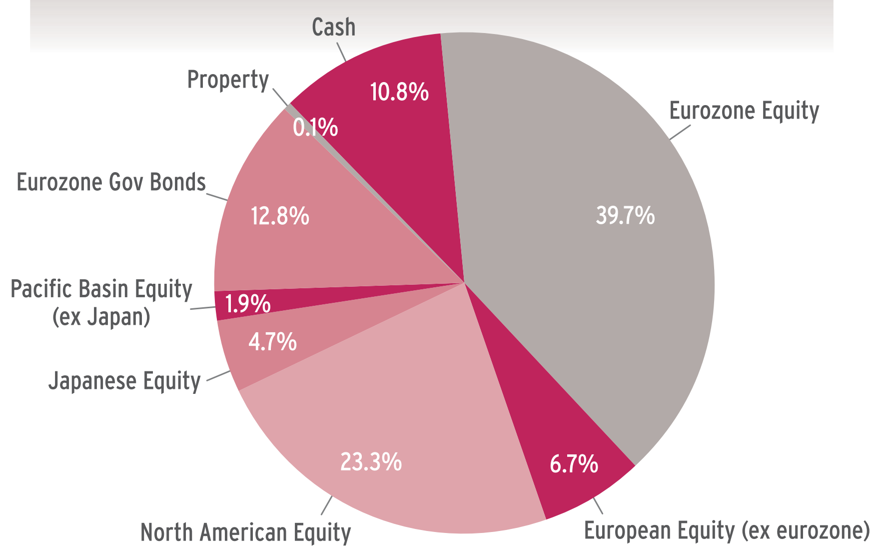
* includes other net current assets
** includes other real assets (a 0.1% holding in property at end 2004)

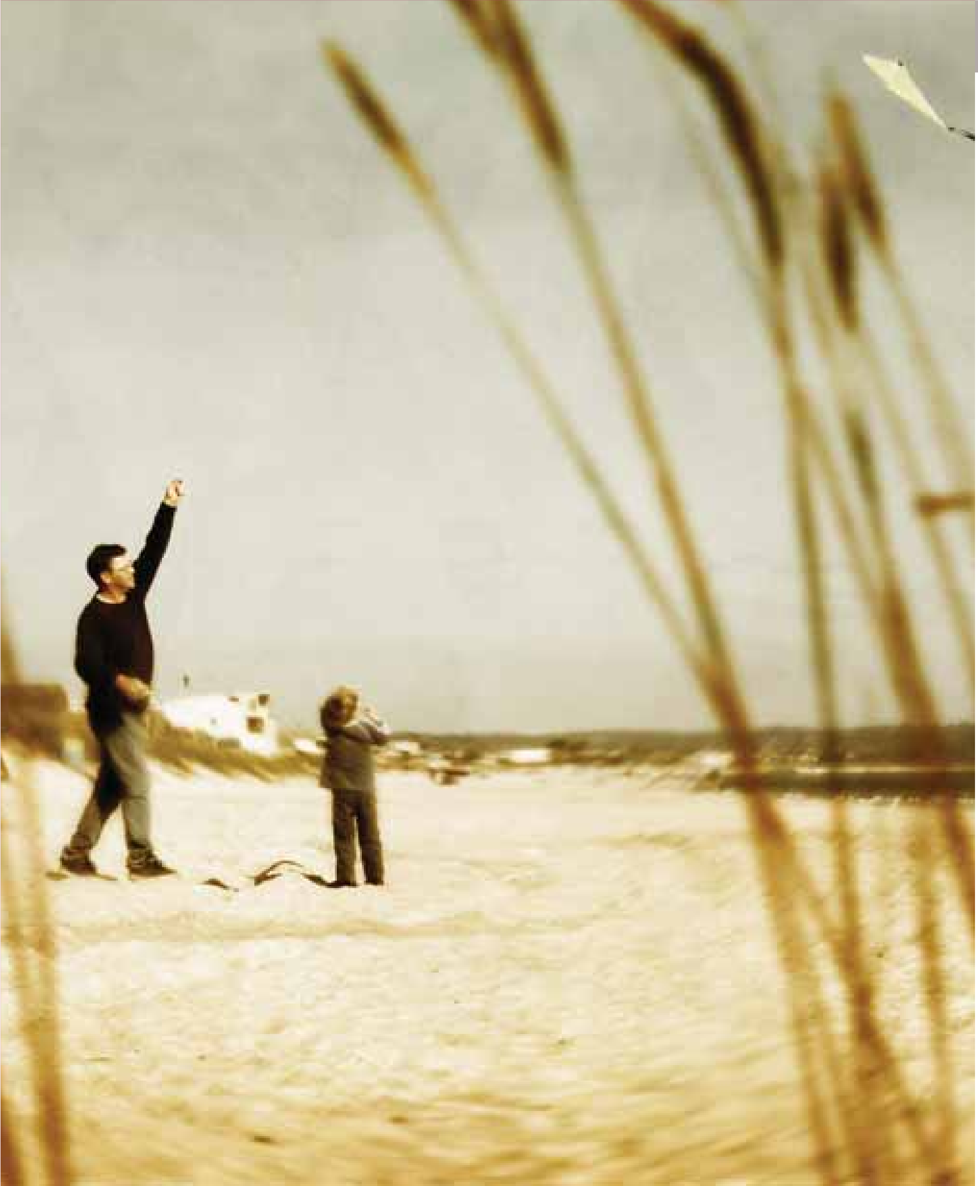
FUND HOLDINGS BY ASSET CLASS - 31 DECEMBER 2004

Asset	€m	% of Fund
Large Cap Equities	8,662	74.1
Small Cap Equities	231	2.0
Bonds	1,485	12.7
Property	12	0.1
Cash*	1,299	11.1
Total	11,689	100.0

*includes other net current assets. Uninvested cash at the Central Bank was €1,127m (mainly comprising money earmarked for bonds but not yet invested).

DISTRIBUTION OF FUND INVESTMENT ASSETS - 31 DECEMBER 2004





MARKET REVIEW

Economic Environment

The global recovery which began in 2003 continued during 2004. A strong performance by the US economy permitted the Federal Reserve to raise interest rates from very low nominal levels as the year progressed. While Europe continued to underperform the US, it did benefit from the US recovery and limited evidence of an increase in domestic European economic activity emerged as the year progressed. China continued to expand at a rapid pace, giving rise to a surge in commodity prices and a regional recovery in Japan and the Pacific Rim. The pace of Chinese growth moderated later in the year removing some inflationary pressures.

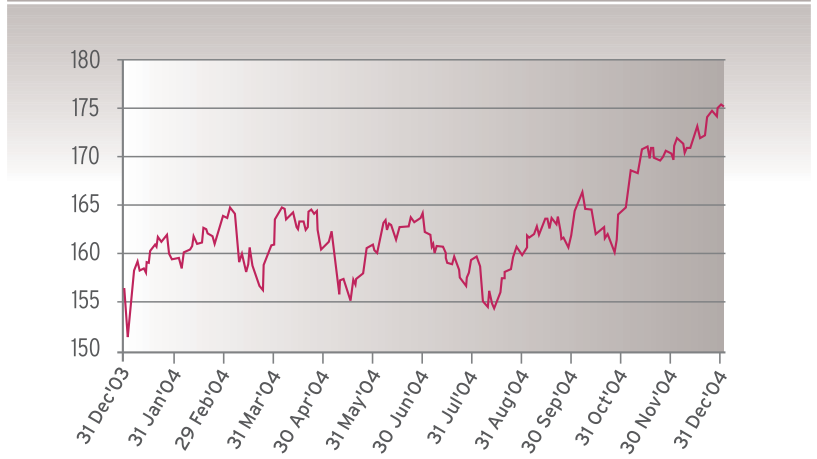
The effect of the US monetary and fiscal stimulus and the uneven nature of the global recovery resulted in the US budget and current account deficits increasing substantially. This, in turn, raised doubts about the willingness of overseas investors to finance these deficits and resulted in downward pressure on the US dollar. The fall in the dollar substantially reduced upward pressure on eurozone inflation and allowed the European Central Bank to maintain unchanged interest rates.

As year-end approached, global markets' performance reflected the view that 2005 would be a year of solid economic growth, with inflation remaining subdued.

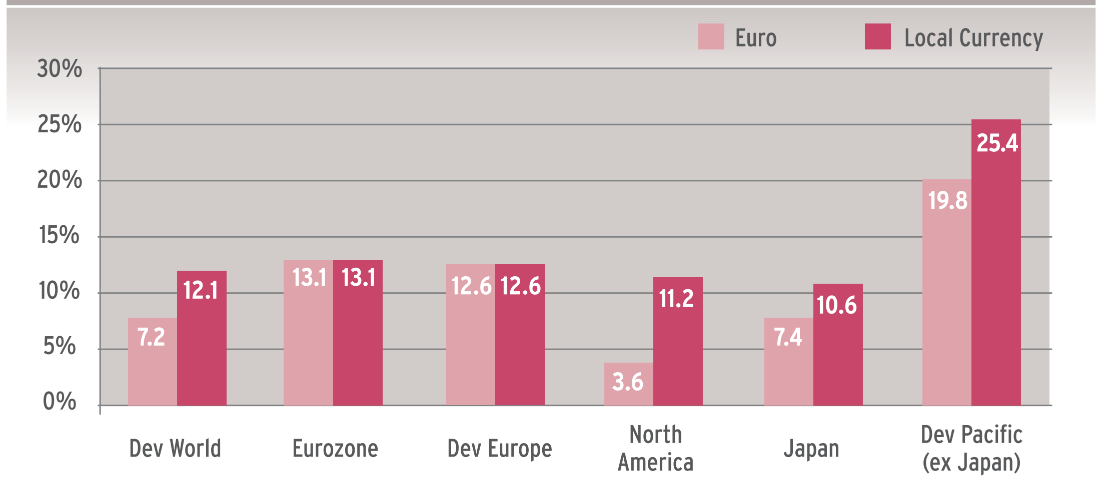
Equities

In 2004 global equity indices posted solid, if unspectacular, returns. For much of the year, investor concerns focused on a range of issues, including the sustainability of the US economic recovery, the oil price and the situation in the Middle East, and markets traded within narrow ranges. As the year progressed, these uncertainties were at least partially resolved and markets responded with an end year rally following the clear-cut result in the US presidential election and a dramatic fall in the oil price.

FTSE ALL WORLD DEVELOPED INDEX 2004 (LOCAL CURRENCY)



RETURNS TO FTSE EQUITY INDICES 2004



In local currency terms, the major indices posted broadly similar returns over the year as corporate earnings continued to recover. The Pacific Basin outperformed significantly with these economies being major beneficiaries of Chinese growth.

As in 2003, gains on international equities were eroded substantially in euro denominated terms by the appreciation of the currency, in particular against the dollar.

Bonds

After a positive start to the year, bond markets reversed direction amid concerns that the short-term outlook for inflation had worsened. As these fears subsided in the latter half of the year bond performance improved steadily. Overall, the fact that eurozone interest rates did not change, whereas substantial increases had been discounted, meant that longer-term eurozone bonds were major beneficiaries. This resulted in the Merrill Lynch Euro Sovereign >5 year index posting a total return of 10.7%.

INVESTMENT PERFORMANCE

Overall Fund Performance

In 2004 the Fund achieved a return of 9.3% on its investments as the averaging in or phased entry programme to the capital markets was completed.

The averaging in programme has seen the Fund outperform its strategic benchmark by a cumulative 8.9% over the period since its inception in 2001. However, in 2004, there was an underperformance of 2.0% against the benchmark (11.3%) as the Commission adopted a cautious tactical approach to the timing of the commitment of funds to the market in the uncertain climate which was a feature of the year and some investment managers underperformed their benchmarks.

With regard to manager underperformance, the Commission's policy is that active management (where a manager seeks to outperform a given index) can only be justified where there is a reasonable expectation that it can, taking into account the extra costs incurred, add value over and above passive management (where a manager seeks to track a given index). While even the best managers can underperform over the short-term, ongoing underperformance would give rise to concern. Given that the initial investment managers appointed to the Fund have now been in place for nearly three years, this is an area which will be closely scrutinised by the Commission to ensure that the Fund maintains an appropriate mix of active and passive investments.

Both equities and bonds were strong contributors to Fund performance in 2004 achieving double digit returns in each case. Bonds outperformed equities as a result of the impact of the euro's appreciation on the Fund's non-euro denominated equity investments. 50% of the Fund's foreign currency exposure arising from these investments is hedged into euro in line with the Commission's long-term investment strategy. All of the Fund's bond investments are denominated in euro.

Due to the continuation of the averaging in market entry approach through 2004 and the tactical decision to underweight bonds, the Fund held significant cash holdings throughout the year. The return earned on the Fund's cash deposits reflects the fact that unallocated cash is deposited with the Central Bank where it earns the overnight interest rate.

> "Both equities and bonds were strong contributors to Fund performance in 2004 achieving double digit returns in each case"

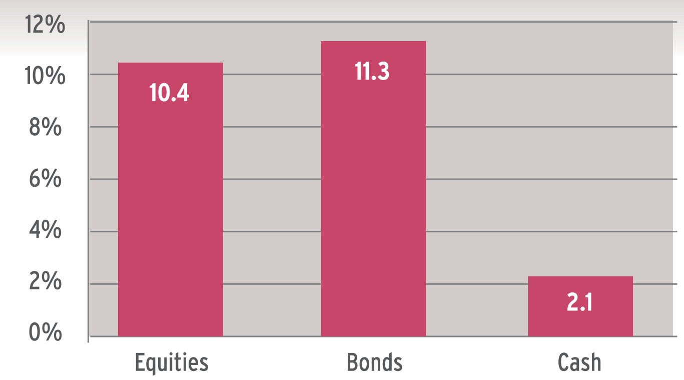
The Fund's Strategic Benchmark

Since 2001 the Fund's benchmark has reflected the Commission's strategic allocation of 80% to equities and other real assets and 20% to bonds.

40.0%	FTSE Eurozone
20.0%	FTSE All World Developed ex Eurozone (in euro terms)
20.0%	FTSE All World Developed ex Eurozone (in local currency terms)
14.8%	Merrill Lynch EMU Gov't Bond Index ex Ireland over 5 years
5.2%	Merrill Lynch EMU Gov't Bond Index ex Ireland over 10 years

The diversification of the Fund's strategic asset allocation as described on page 6 will necessitate modifications to the above benchmark from 2005 to take account of allocations to new asset classes.

PERFORMANCE BY ASSET CLASS 2004



Performance in Monetary Terms

The Fund's market value at end 2004 was €11,689m. Excluding the 2004 Exchequer contribution of €1,177m, there was an appreciation of €951m in the value of the Fund during the year.

CHANGE IN THE FUND'S FINANCIAL POSITION IN 2004

		€m
Net Assets of Fund at 1 January 2004		**9,561**
Contributions		**1,177**
Net Investment Return		
Investment Income	***275***	
Change in market value of investments	***694***	
Fees and Expenses	***(18)***	**951**
Net Assets of Fund at 31 December 2004		**11,689**

COMMISSION MEMBERS

Mr Donal J Geaney – Chairman
Chairman of Irish Aviation Authority, Automsoft International Ltd and Clinical Grid Ltd and Member of the Court of Directors of the Bank of Ireland.

Mr Robert J Curran
Former Second Secretary in the Department of Finance.

Dr Brian Hillery (from July 2004)
Chairman of Independent News & Media plc, UniCredito Italiano Bank (Ireland) plc and Providence Resources plc.

Ms Brid Horan
General Manager Pensions, ESB.

Dr Martin Kohlhaussen
Chairman of the Supervisory Board, Commerzbank AG.

Mr Donald C Roth
Managing Partner, EMP Global LLC and former Treasurer of the World Bank.

Dr Michael J Somers
Chief Executive of the National Treasury Management Agency (ex-officio member).

Mr Daniel P Tully (to April 2004)
Chairman Emeritus of Merrill Lynch & Co. Inc.

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