National Pensions Reserve Fund

Review 2003

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The financial results and performance figures for 2003 set out in this Review are unaudited. Audited figures for 2003 will be published in the NPRF Commission's Annual Report and Accounts in July 2004.

All performance figures are calculated in accordance with the Global Investment Performance Standards (GIPS).

Chairman's Statement

The ageing of the European population and the increased costs of pension provision figured prominently in the headlines in 2003. France, Austria and Italy all saw widespread industrial unrest on foot of Government proposals for pension reform. The pensions issue will inevitably attract more and more public attention across the continent in the coming years as changing demographics make pay as you go financing systems increasingly difficult to sustain.

In Ireland, we have taken the opportunity afforded us by our relatively young population and the more sustainable balance between public and private provision in our pension system to alleviate the hard choices others are now facing. Through the National Pensions Reserve Fund (NPRF) we have begun to set aside funds to supplement our pay as you go system while our dependency ratio is still low and before the fiscal effects of the ageing issue begin to bite. In this way, relatively modest contributions can make a real difference, enabling the Fund to play a significant role in securing the Irish population's pension entitlements in the less favourable demographic climate that lies ahead.

Every citizen of Ireland has a stake in the NPRF and an interest in its success: a fact of which I and the other Commissioners are acutely aware. The bulk of the annual 1% of GNP contribution to the Fund will go towards the financing of social welfare pensions where most of our future pension commitments will arise, while three out of every four people now of working age are likely to benefit from the Fund during their retirement.

I and my fellow Commissioners are pleased to have been entrusted with this important and exciting endeavour. I am confident that the long-term strategic perspective adopted by the Commission will enable the Fund to meet its goal of proper pension provision for our future senior citizens who, through their taxes, are contributing to the Fund and are its ultimate stakeholders.

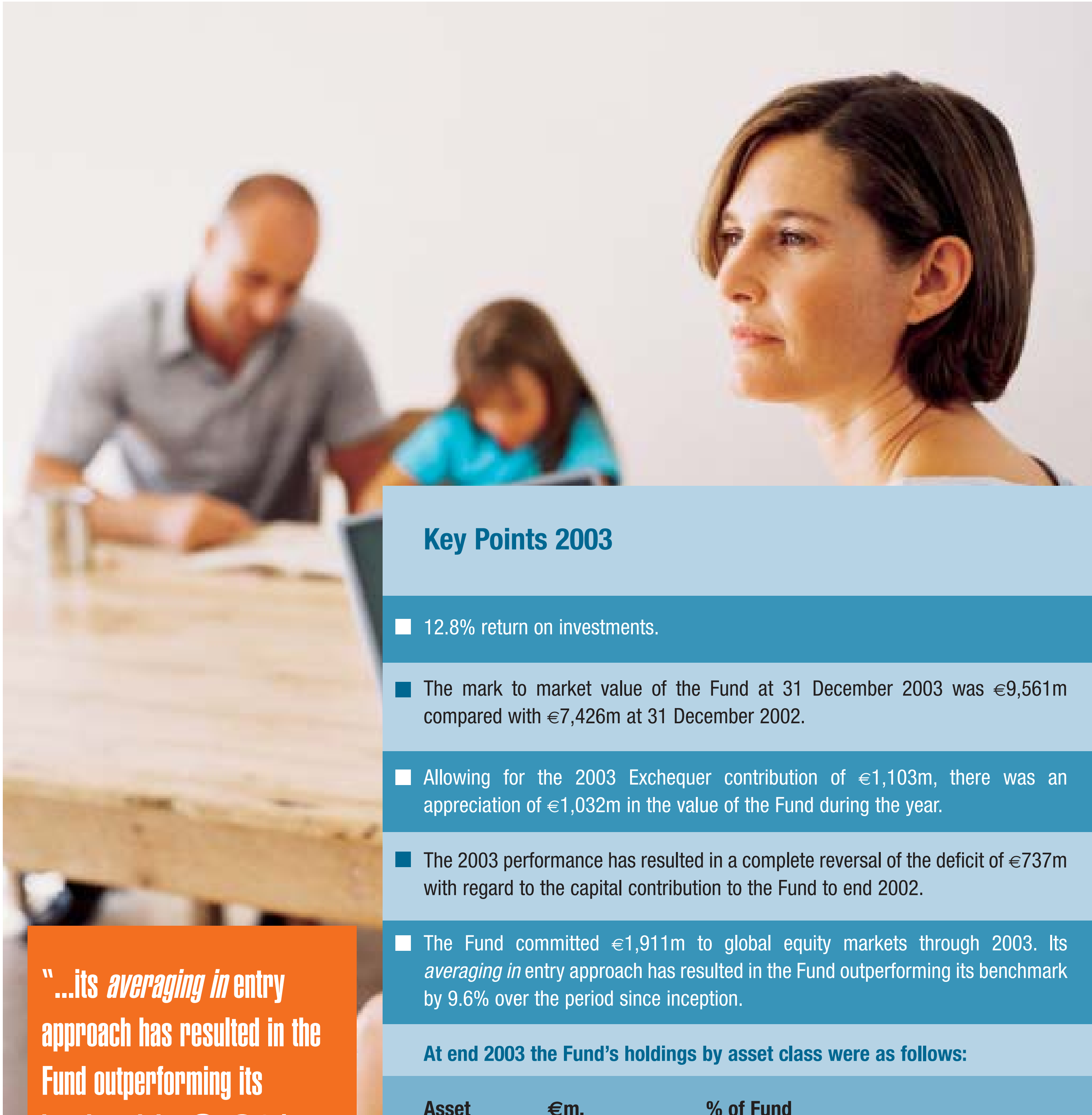
"...relatively modest contributions can make a real difference, enabling the Fund to play a significant role in securing the Irish population's pension entitlements"

I am very pleased to report that the Fund had a good year in 2003 earning a return of 12.8%. In monetary terms, the Fund's investments earned over €1 billion during the year. The Commission has also been considering additional asset classes in its continuing effort to maximise Fund returns. We have approved new mandates for small capitalisation equities and corporate bonds and are working on business entry plans for property and private equity.

Population ageing, and the profound issues it gives rise to, is emerging in the developed world as one of the major public policy concerns of this century. In establishing the NPRF, the Government has placed Ireland at the forefront of countries taking measures to prepare for these issues.

Donal J. Geaney
Chairman

April 2004



“...its *averaging in* entry approach has resulted in the Fund outperforming its benchmark by **9.6%** over the period since inception”

Key Points 2003

- 12.8% return on investments.
- The mark to market value of the Fund at 31 December 2003 was €9,561m compared with €7,426m at 31 December 2002.
- Allowing for the 2003 Exchequer contribution of €1,103m, there was an appreciation of €1,032m in the value of the Fund during the year.
- The 2003 performance has resulted in a complete reversal of the deficit of €737m with regard to the capital contribution to the Fund to end 2002.
- The Fund committed €1,911m to global equity markets through 2003. Its *averaging in* entry approach has resulted in the Fund outperforming its benchmark by 9.6% over the period since inception.

At end 2003 the Fund’s holdings by asset class were as follows:

Asset	€m.	% of Fund
Equities	6,832	71.5
Bonds	1,340	14.0
Cash[1]	1,389	14.5
Total	9,561	100.0

[1. includes other net current assets]

- In total, the Fund had shareholdings in 1,286 companies across 23 markets at end 2003.
- Its assets were equivalent to 8.7% of GNP.

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"...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 will be fewer than two working people to each pensioner"

The National Pensions Reserve Fund

The objective of the NPRF is to meet as much as possible of the costs of social welfare and public service pensions from 2025 onwards, 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 will be fewer than two working people to each pensioner.

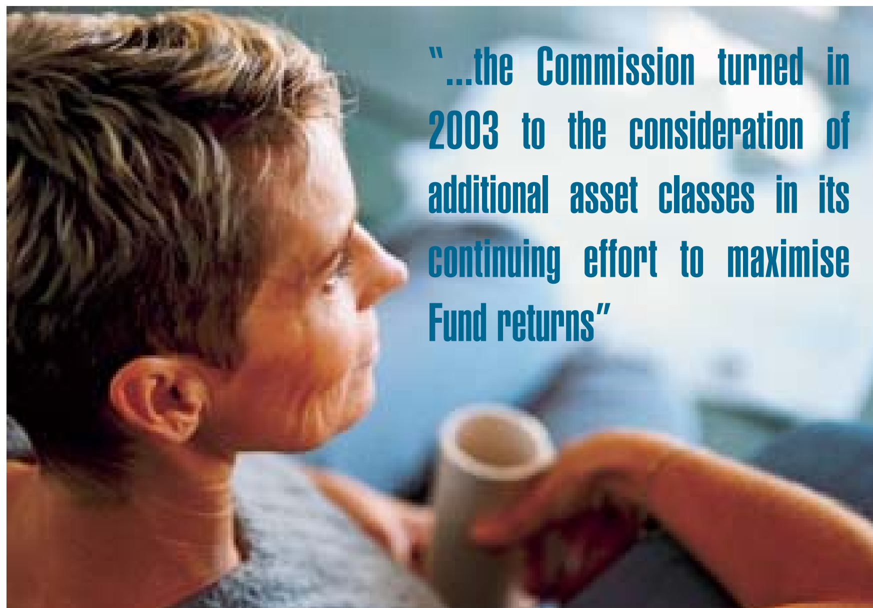
This changing ratio is due to two factors: a decline in the birth rate and increased life expectancy. It will inevitably lead to significantly increased public pension costs, in particular in the social welfare area, as a larger number of pensioners have to be supported by a proportionally smaller working population. 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 public pension system.

The NPRF represents a move to a part pre-funded public pension system. It involves the statutory setting aside and investing of 1% of GNP annually to meet part of the cost of future pensions. No money can be drawn down before 2025 and, from then on, drawdowns will continue until at least 2055 in accordance with Ministerial rules related to the growth of the percentage of over 65s in the population. In this way, the Fund will smooth the Exchequer burden arising from Ireland's additional pension commitments over a very long time.

Therefore the NPRF's focus is to maximise its returns within prudent risk parameters.

The NPRF Commission controls and manages the Fund and is independent of Government in the exercise of its functions including the implementation of the Fund's investment mandate. This mandate requires that the Fund operate 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.

Investment Strategy



Long-Term Investment Strategy

In 2003 the NPRF Commission maintained the broad asset allocation strategy it adopted in 2001: an 80% allocation to equities and other real assets and a 20% allocation to bonds. The 80/20 equity and other real assets/bond split was chosen by the Commission from a range of possible portfolios as it offers the most attractive balance between risk and reward.

The weighting afforded to equities and other real assets is based on the fact that equities have historically outperformed other asset classes. This extra return is known as the *equity risk premium* and compensates the investor for the increased risk of investment in equities as opposed to a more predictable asset class such as bonds. The Commission assumed an average equity risk premium of 3% p.a. in modelling the various investment strategies open to it.

Much of the risk associated with equities is in fact the volatility of returns from year to year: a risk that the NPRF can accept due its long-term investment horizon. While equity weightings substantially lower than 80% may result in a Fund that experiences less volatility from year to year, such greater stability would be achieved by sacrificing long-term return: an outcome that would not be in the interests of Ireland's future pensioners.

Additional Asset Classes

With the long-term investment strategy in place and the Fund's core managers appointed, the Commission turned in 2003 to the consideration of additional asset classes in its continuing effort to maximise Fund returns. The Commission approved mandates for small capitalisation equities and corporate bonds and commenced working on business plans for investment in property and private equity. Tenders to manage the small cap equity and corporate bond mandates were sought in late 2003.

Small Cap Equities

The Commission has made an initial allocation of 2% of the Fund to small cap equities: 1% to the United States and 1% to the EAFE region (Europe, Australasia, Far East).

Small cap equities are a risk diversifier. Over time, they offer a premium over large cap stocks for three reasons:

- the greater risk of investing in small companies due to their higher cost of capital and more volatile earnings;
- compensation for the lack of liquidity associated with investment in smaller companies;
- the smaller companies market is inefficient, leading to greater opportunities for discovering undervalued companies.

Corporate Bonds

The Commission has made an initial allocation of 2% of the Fund to eurozone corporate bonds.

The benefits of including corporate bonds in the Fund's portfolio are largely related to diversification and increased expected return. Corporate bonds trade at a spread over Government bonds: the size of the spread is largely driven by the quality of issuer. In a three-asset universe, equities might be expected to be the best performing asset class, followed by corporate bonds, followed by Government bonds.

Public Private Partnerships

The Commission is also keen to access PPP investments in Ireland where the risk/return characteristics are competitive with other investments and satisfy the Fund's statutory commercial investment mandate. In 2003 the Commission set aside €200m for this purpose and will increase this allocation if suitable opportunities arise. The Commission has explored a number of avenues through which the Fund might invest in PPPs.

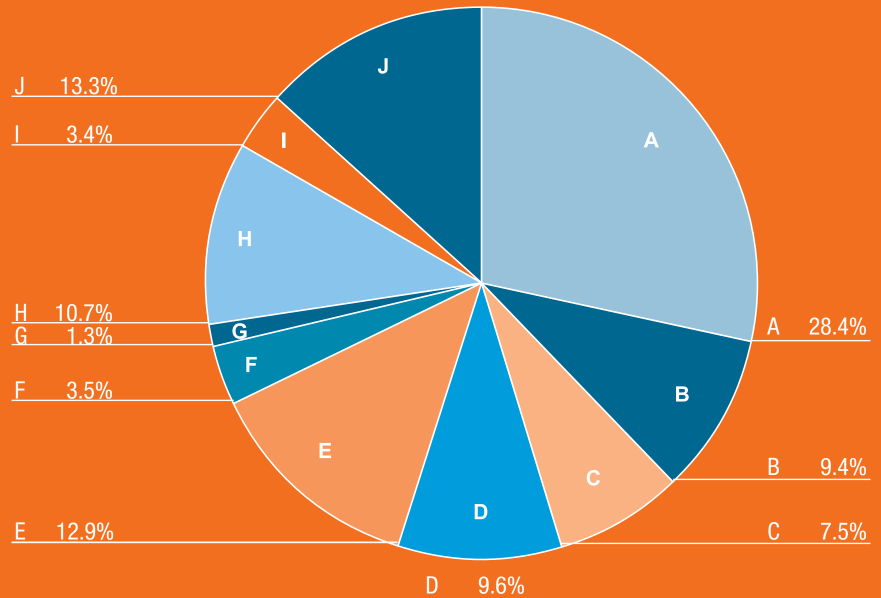
However, one issue to be resolved is deal-flow. In other words, there must be a reasonable expectation of sufficient projects, generating a return equivalent to returns available on PPPs internationally, coming on stream if the mechanisms through which the Fund might commit significant resources to this area are to become practicable.

Market Entry

The Commission has adopted an *averaging in* or phased approach to investment in the capital markets which reduces the Fund's market entry risk by spreading it over time. This approach enabled the Commission to slow the pace of investment as markets deteriorated in 2002. As a result the Fund held considerably less in equities than its long-term strategic benchmark at end 2002. As markets recovered from their lows of March 2003, the pace of investment accelerated with €1,911m being committed to the markets during the course of the year.

By end 2003 all the Fund's mandates had been funded (the Pacific Basin and Japanese equity mandates were unfunded at end 2002). Due to the low interest rate environment in 2003, the Commission decided not to commit any new money to bonds during the year and €340m allocated to the active bond mandate was transferred from the passive bond portfolio.

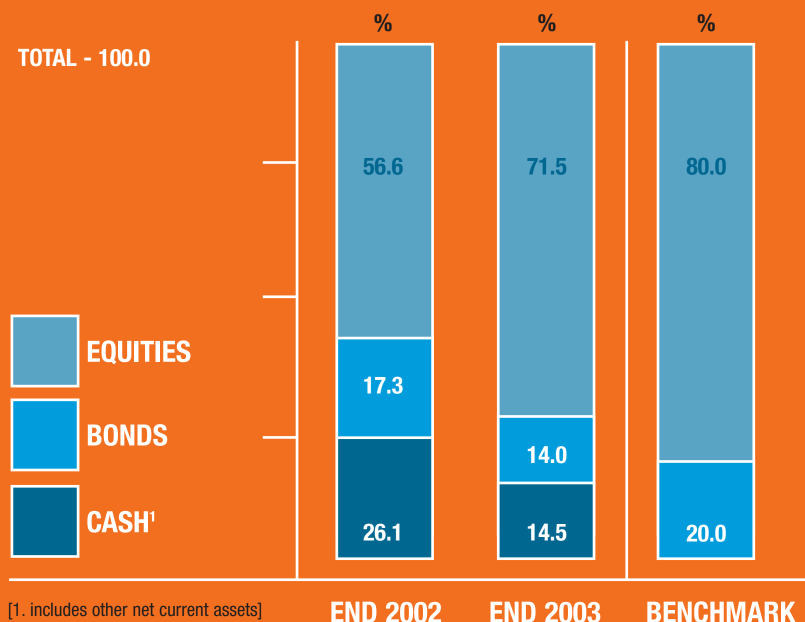
Investment Assets by Mandate 31 December 2003



A	Eurozone Equity - Passive
B	North American Equity - Passive
C	Pan European Equity - Active
D	Global Equity - Active
E	North American Equity - Active
F	Japanese Equity - Active
G	Pacific Basin Equity - Active
H	Eurozone Bonds - Passive
I	Eurozone Bonds - Active
J	Uninvested Cash and Currency Contracts

Each mandate includes any cash held by the investment manager/s appointed to that mandate at 31 December 2003.
Net current assets are excluded from the above analysis.

Total Asset Allocation



Investment Performance

Overall Fund Performance

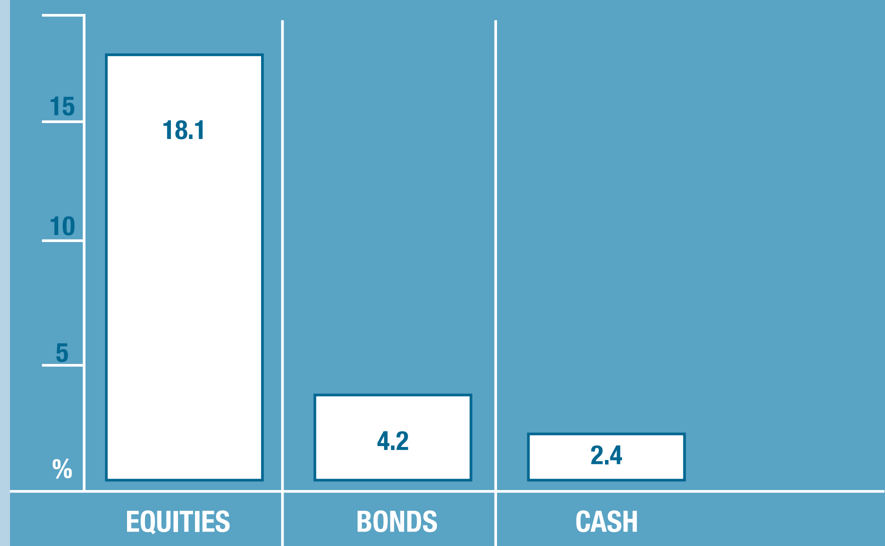
In 2003 the National Pensions Reserve Fund achieved a return of 12.8% on its investments as equities rebounded from the bear market of 2000 to 2002. This performance has resulted in a complete reversal of the deficit of €737m with regard to the capital contribution to the Fund by the Minister for Finance reported by the Commission for 2002. At end 2003, the Fund was €295m in the black by reference to this measure.

The 2003 performance lagged the Fund's long-term strategic benchmark by 3.8% due to the *averaging in* market entry strategy which resulted in the Fund having a lower equity weighting than that of the benchmark throughout the year. The *averaging in* approach has also meant that Fund weightings have differed to those of the benchmark in the various investment mandates as money was committed to these mandates. This has resulted in some underperformance against the Fund's specific equity and bond benchmarks in 2003. However, measured over the period since inception, the Fund has outperformed the long-term strategic benchmark by 9.6% as a result of the *averaging in* approach.

Overall Performance Summary

	2003	Since Inception (Cumulative)	Since Inception (Annualised)
NPRF (post fee)	12.8%	-2.2%	-0.8%
Benchmark	16.6%	-11.8%	-4.5%
Relative Return	-3.8%	9.6%	3.7%

Performance by Asset Class in 2003



Performance in Monetary Terms

The mark to market value of the Fund at 31 December 2003 was €9,561m. Allowing for the 2003 Exchequer contribution of €1,103m, there was an appreciation of €1,032m in the value of the Fund during the year. Details of the change in the Fund's financial position over the year are as follows:

		€m
Net Assets of Fund at 1 January 2003		7,426
1% of GNP Contribution		1,103
Investment Income	210	
Change in market value of investments	836	
Fees and Expenses	(14)	
Net Investment Return		1,032
Net Assets of Fund at 31 December 2003		9,561

The breakdown of the Fund by asset class at end 2003 is:

Equities	€6,832m
Bonds	€1,340m
Cash[1]	€1,389m

Uninvested cash at the Central Bank was €1,199m.

[1. includes other net current assets]

Equities

Equities were the real drivers of growth in the Fund in 2003 achieving an investment return of 18.1% compared with a return to the Fund's equity benchmark (the FTSE All World Developed Index) of 19.3%. This difference is due to a combination of factors including the different market weightings of the Fund and the benchmark as the market entry process continued, the impact of residual cash held by equity managers and the relative performance of some managers.

Equity returns reflect the fact that 50% of the Fund's foreign currency exposure is hedged in line with the Commission's long-term investment strategy.

Bonds

The Fund's bond investments earned a return of 4.2% in 2003 as opposed to 4.4% for the Fund's bond benchmark. The reason for this marginal difference in performance is a technical one relating to the fact that the passive and active components of the Fund's bond portfolio are run against slightly different indices. The passive portfolio (75% of the mandate) is run against the Merrill Lynch >5 year Eurozone sovereign index (ex Ireland) while the active portfolio (25% of the mandate) is run against the Merrill Lynch >10 year index (ex Ireland). The Fund's strategic benchmark combines these two indices proportionally. However, the weighting of the Fund differed to that of the benchmark in the early part of the year due to the fact that the active bond mandate was not funded until May.

Cash

Due to the continuation of the *averaging in* market entry approach and the receipt of the 1% of GNP Exchequer contribution, the Fund held significant cash holdings throughout 2003.

The return earned on the Fund's cash deposits was 2.4% - in line with its benchmark reflecting the fact that the Fund's uninvested cash is deposited with the Central Bank of Ireland where it earns the overnight interest rate.

"...equities were the real drivers of growth in the Fund in 2003 achieving an investment return of 18.1% "

Fees

The fees and expenses incurred by the Commission in the operation of the Fund in 2003, including investment manager fees, were €14m - taking just 0.2% from total Fund performance. This figure takes account of offsetting income earned by the Commission from value added activities such as the securities lending and brokerage recapture programmes.

Market Review

Economic Environment

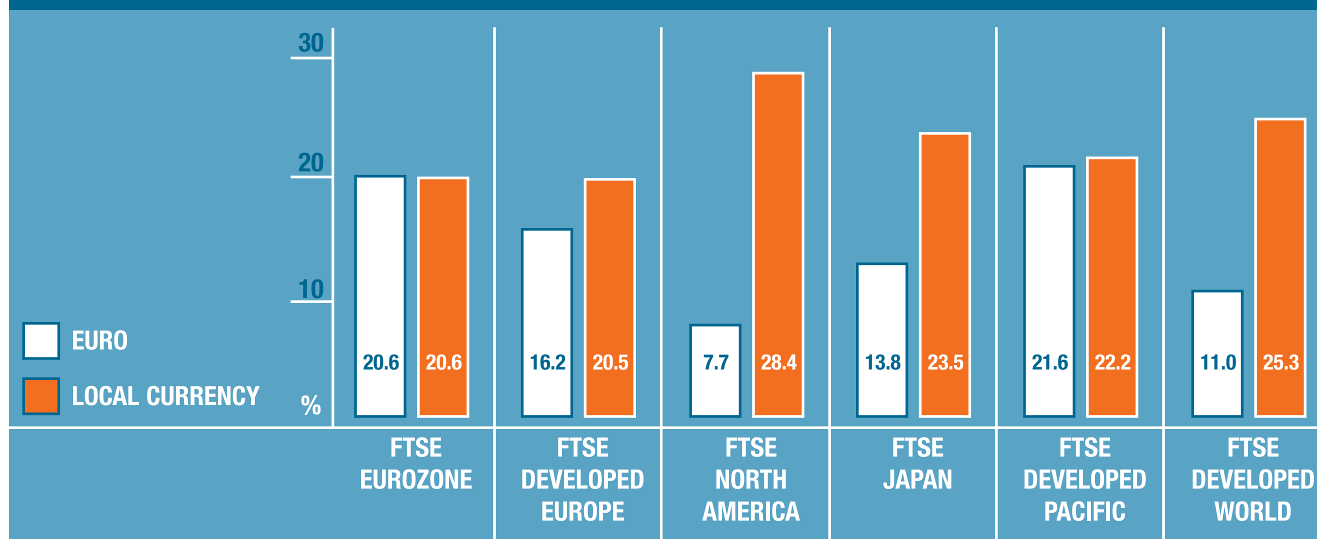
The first quarter of 2003 was marked by continuing geopolitical uncertainty due to the Iraq situation, declining consumer confidence and an absence of evidence that businesses had responded to the highly stimulatory monetary and fiscal environment in the United States. Economic activity in the eurozone remained subdued.

The cessation of major hostilities in Iraq was followed by sharp increases in confidence measures including an increase in business investment in capital equipment. In June the US Federal Reserve, citing a fear of deflation, cut interest rates from 1.25% to 1% and indicated that they would remain at that level for a considerable period of time. The ECB reduced rates from 2.75% to 2% during the year, cutting by 0.25% in March and 0.5% in June. Both the Federal Reserve and the ECB continued to adopt a relaxed attitude to interest rates through the rest of the year citing excess capacity, subdued inflationary pressure and the need for economic recovery to become firmly established. Indeed, the year closed with little sign of inflationary pressure in either the US or Europe.

In the stimulatory environment, the US economy began to pick up from the second quarter, spurred by the recovery in firms' capital spending. The US continued to act as the world's economic engine as economic activity in the eurozone also improved, albeit marginally, in the second half of the year. The expansion in global demand resulted in an export-led improvement in the Japanese economy and supported continued strong growth in the Pacific Basin.

The US trade and budget deficits widened substantially in 2003 maintaining downward pressure on the US dollar. Interest rate differentials continued to favour currencies other than the dollar. However, little concern was shown by either the Federal Reserve or the ECB despite evidence that exchange rate developments were having an impact on the price competitiveness of eurozone exporters. The euro appreciated by 20% against the dollar in 2003. Both China and Japan were dollar supportive, purchasing US treasuries and intervening in foreign exchange markets to recycle their substantial trade surpluses.

Returns to the FTSE Equity Indices for NPRF Investment Markets



Equities

After a poor first quarter, during which the downward trend of 2002 continued, markets reached a nadir in early March. Equities then rallied strongly in the remaining three quarters of 2003 and closed the year with sizeable gains in local currency terms. For eurozone based investors, gains on international equities were eroded substantially by the appreciation of the euro.

Europe

Strong 2003 returns in Europe and the eurozone lent credence to the perception that euro denominated markets were more oversold than their non-euro counterparts at end 2002. Equity markets responded to strong corporate earning results and, to a large extent, paralleled developments in the US markets. An improved economic performance in the second half of the year helped maintain the upward trend.

North America

Supported by the Fed's accommodative monetary stance, North American equities led the market rally responding to the more stable geopolitical outlook, strong first quarter earnings reports and the improving economic outlook. The rally continued as the year progressed and investor confidence increased.

Japan and the Pacific Basin

The market recovery in Japan and the Pacific Basin commenced later than in the other regions, due to some extent to the SARS outbreak in the case of the Pacific Basin, picking up in May and June as business sentiment improved and fuelled by positive corporate and economic data.

Bonds

Over the year eurozone bonds posted modest returns (4.4% to the Merrill Lynch Euro Sovereign >5 year index) underperforming equities in a reversal of the trend of recent years.

Bonds outperformed equities in the early months of the year as investors continued to seek safe asset classes in the light of geopolitical and economic uncertainty. They continued to post positive returns in the early stages of the equity recovery. However, these gains were reversed in the second half of the year as the recovery in equity markets continued, economic data improved and investors formed the view that the next move in interest rates would be upward.

Conclusion

Going into 2004 the financial markets still face considerable geopolitical and economic uncertainty. The Commission will take cognisance of these factors and continue to take a cautious approach in its commitment of funds to the market.

The experiences of 2002 and 2003 and the wide disparity in returns to the equity markets in these two years demonstrate the volatility that can occur over short timescales. However, the Fund can afford to bear this volatility in anticipation of excess returns from equity investment over the longer-term and this consideration is central to the Commission's investment strategy.

Members of the National Pensions Reserve Fund Commission

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

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

Ms Brid Horan
General Manager Pensions, ESB.

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

Mr Donald C. Roth
Managing Partner, Emerging Markets Partnership 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
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