



## **INTERNAL AUDIT DIVISION**

### **REPORT 2021/046**

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#### **Audit of management of external managers in the Office of Investment Management of the United Nations Joint Staff Pension Fund**

**There is need to develop a strategic plan for investments in small capitalization equities, strengthen the ownership of the small capitalization portfolio, and further refine the processes for selecting and monitoring the external managers**

**24 September 2021  
Assignment No. AS2021-801-02**

# **Audit of management of external managers in the Office of Investment Management of the United Nations Joint Staff Pension Fund**

## **EXECUTIVE SUMMARY**

The Office of Internal Oversight Services (OIOS) conducted an audit of management of external managers in the Office of Investment Management (OIM) of the United Nations Joint Staff Pension Fund (UNJSPF). The objective of the audit was to determine whether the selection, monitoring, and retention of external portfolio managers was effective to ensure that the investments managed by them contributed positively to the Fund's long-term investment objective. The audit covered the period from 1 January 2018 to 30 June 2021 and included a review of risk areas relating to: (a) strategic planning and portfolio ownership; (b) search and contracting of external managers; and (c) monitoring and retention of external managers.

The audit indicated that OIM needs to develop a strategic plan for investments in small capitalization equities, strengthen the ownership of the small capitalization (Small Cap) portfolio, and further refine the processes for selecting and monitoring the external managers.

OIOS made six important recommendations. To address the issues identified in the audit, OIM needed to:

- Develop a strategic plan, as part of the overall plan to implement the new Strategic Asset Allocation and benchmarks, to ensure there are adequate resources and a clear timeline with milestones to achieve the allocation target for Small Cap equities;
- Strengthen the ownership of the Small Cap programme to ensure alignment of its capacity and responsibilities with accountability for its performance;
- Develop a refined approach for selection of external managers based on best practices and lessons learned from past searches; and incorporate the refined approach into the External Manager Policy to serve as a baseline for future search exercises, with the requirement that justification for any deviations must be documented;
- Adopt appropriate benchmarks for external fund managers and conduct adequate analysis to ensure that the Fund's Small Cap managers' performance is driven by the desired style factors;
- Expand the scope of the quarterly Compliance Certificates to cover compliance with all the terms of the Investment Management Agreements with the external managers, including the clause on prohibited transactions; and
- Establish a process for monitoring the quality of trade execution and reasonableness of commissions paid by the external managers on a regular basis.

OIM accepted the recommendations and has initiated action to implement them.

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# Audit of management of external managers in the Office of Investment Management of the United Nations Joint Staff Pension Fund

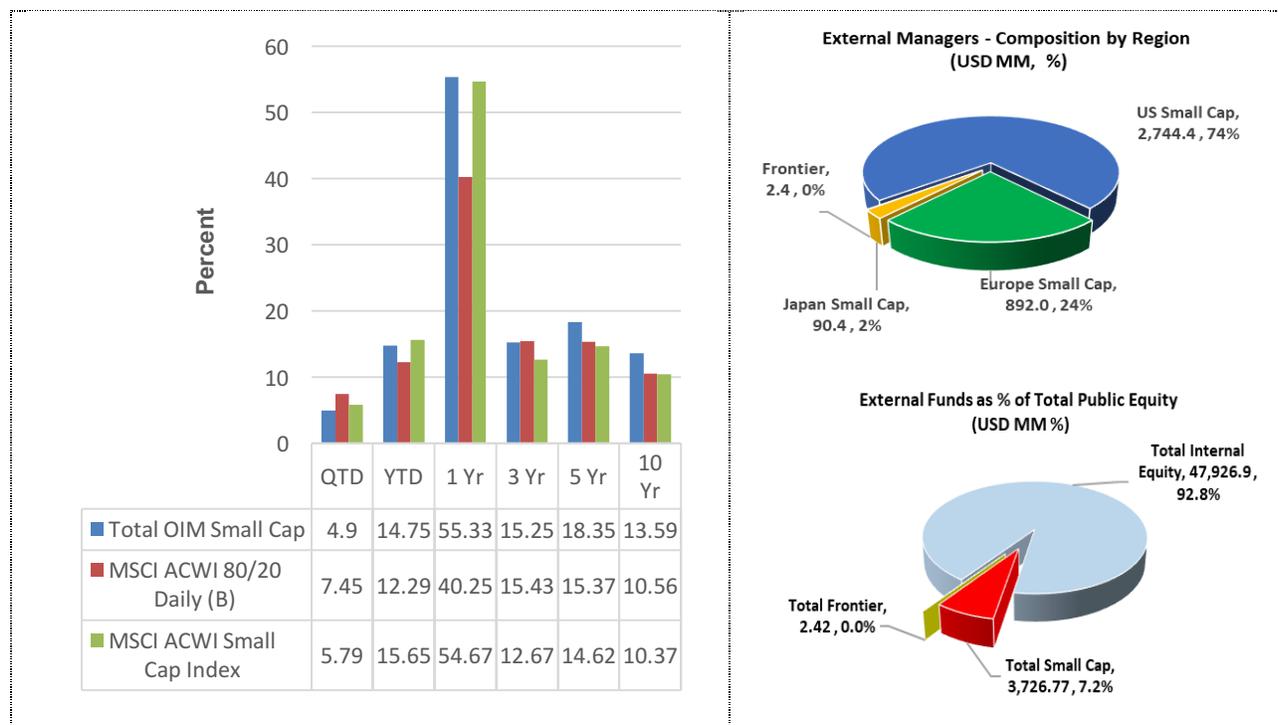
## I. BACKGROUND

1. The Office of Internal Oversight Services (OIOS) conducted an audit of management of external managers in the Office of Investment Management (OIM) of the United Nations Joint Staff Pension Fund (UNJSPF).

2. UNJSPF was established in 1949 by the General Assembly to provide retirement, death, disability, and related benefits for the staff of the United Nations and other international intergovernmental organizations admitted to the membership of UNJSPF. The investments of the Fund are managed by OIM with an asset portfolio of \$87 billion as of 30 June 2021. Under the authority of the Secretary-General, the Representative of the Secretary-General for the investment of the assets of the Fund (RSG) has a fiduciary responsibility to manage the investments in the best interests of the Fund’s participants and beneficiaries.

3. OIM has been managing most of the Fund’s assets internally, including global large capitalization equities (Large Cap) and Fixed Income. As the universe of global small capitalization (Small Cap) equities is very broad and consists of more than 6,000 stocks, OIM did not have the capacity to manage the portfolio internally. Therefore, OIM has been hiring external managers to do so since its inception in the 1990s. Chart 1 provides the performance of the Fund’s Small Cap portfolio for different periods and the regional composition of the external managers as of 30 June 2021.

**Chart 1: OIM Small Cap portfolio performance and manager composition as of 30 June 2021**



4. The Small Cap portfolio has been a net contributor to the Fund, with its 10-year annualized return exceeding the policy benchmark for public equities by 303 basis points (or 3.03 per cent) on gross basis, i.e., without deducting the investment management fees paid to the external managers. Its annualized return

also exceeded the Morgan Stanley Capital International (MSCI) All Country World Index (ACWI) Small Cap Index by 322 basis points (gross) during the same period. Currently, there are eight contracted Small Cap managers: five for the United States (US), two for Europe and one for Japan. The total market value of the investments managed by these managers amounted to \$3.7 billion as of 30 June 2021. The Investment Management Agreements (IMAs) with two new managers for Japan and one for Europe were yet to be concluded at the time of the audit. In 2019, OIM decided to search for external managers to manage part of its Large Cap investments in Brazil considering its inadequate internal capacity and long-term underperformance of the internally managed Brazilian portfolio. It was also envisioned that the selected external managers would complement the existing skillsets in house and inform the management of the Brazilian portfolio. At the time of the audit, OIM was in the process of contract negotiation with two selected managers for Brazil. OIM engaged two managers for Frontier Markets equities in 2010 and 2015 and decided to terminate them in 2020 due to poor performance and market outlook. Most of the investments were liquidated, with \$2.4 million remaining to be sold due to illiquidity.

5. In June 2017, OIM established an External Manager Team (EMT) by hiring an investment officer at P-4 level. Another P-4 investment officer joined the team on temporary basis from June 2018 to June 2020. A senior investment assistant (G-7) was assigned to the team in August 2019. At the time of the audit, EMT only consisted of two staff (one P-4 and one G-7).

## **II. AUDIT OBJECTIVE, SCOPE AND METHODOLOGY**

6. The objective of the audit was to determine whether the selection, monitoring, and retention of external portfolio managers was effective to ensure that the investments managed by them contributed positively to the Fund's long-term investment objective.

7. This audit was included in the 2021 risk-based work plan of OIOS due to the risks associated with hiring and retaining external managers, including their potential failure to fulfil their contractual obligations.

8. OIOS conducted this audit from May to August 2021. The audit covered the period from 1 January 2018 to 30 June 2021. Based on an activity-level risk assessment, the audit covered risks areas relating to: (a) strategic planning and portfolio ownership; (b) search and contracting of external managers; and (c) monitoring and retention of external managers.

9. The audit methodology included: (a) interviews with key personnel; (b) review of relevant documentation; (c) analytical review of data; and (d) sample testing based on judgemental sampling.

10. The audit was conducted in accordance with the International Standards for the Professional Practice of Internal Auditing.

## **III. AUDIT RESULTS**

### **A. Strategic planning and portfolio ownership**

#### Need to develop a long-term strategy for Small Cap investments

11. OIM has invested in Small Cap equities for more than 20 years. The policy benchmarks selected by the Fund for equities in the past were Large Cap stock indices. For instance, the current benchmark is

composed of 80 per cent MSCI World Developed Markets Customized<sup>1</sup> and 20 per cent MSCI Emerging Markets Customized. Consequently, the investments in Small Cap equities were off benchmark, and there was no allocation to Small Cap at the Strategic Asset Allocation (SAA) level. OIM set an arbitrary allocation range of 5 to 15 per cent of all public equities for Small Cap, and the Internal Investment Committee (IIC) established in 2018 has been deciding the actual allocation to the asset class and making rebalancing decisions to reduce or increase allocation to the Small Cap portfolio. On average, the actual allocation to Small Cap has been approximately 6 to 8 per cent of total public equities.

12. In May 2021, a consultant engaged by OIM completed its study of the Fund’s current asset allocation and benchmarks and recommended a new SAA to the Fund. As shown in Table 1, a roadmap was suggested to gradually implement the recommended SAA, considering resource constraints. Allocation to public equities will be gradually reduced to support increases in Private Equity, Real Assets, Absolute Return and Fixed Income<sup>2</sup>. The consultant also recommended to change the benchmark for Global Public Equities to MSCI ACWI Investable Market Index (IMI)<sup>3</sup>. The rationale was to capture the broadest scope of investable universe since IMI covers 99 per cent of the opportunity set including Small Cap equities, and it is most widely used by institutional investors. As of 31 December 2020, Small Cap accounted for 13 per cent of Global Public Equities, compared to 11 per cent for Global Emerging Markets (GEM) public equities.

**Table 1: OIM’s roadmap to implement the 2021 SAA (Figures in %)**

	Current SAA	Actual 3/2021 Allocation	Implementable SSA (2 Year)	Implementable SSA (5 Year)	Aspirational SAA (1)	Aspirational SAA (2)
Global Public Equity	45	60	53	43	29	24
Developed Large Cap	36	44	--	--	--	--
Developed Small Cap	--	4	6.7*	5.4*	3.7*	3*
Emerging Market	9	12	--	--	--	--
Private Equity	9	5	7	10	15	15
<b>Total Equity</b>	<b>54</b>	<b>65</b>	<b>60</b>	<b>53</b>	<b>44</b>	<b>39</b>
<b>Total Real Assets</b>	<b>15</b>	<b>7</b>	<b>9</b>	<b>14</b>	<b>15</b>	<b>15</b>
<b>Total Absolute Return</b>	<b>1</b>		<b>--</b>	<b>--</b>	<b>--</b>	<b>10</b>
<b>Total Fixed Income</b>	<b>29</b>	<b>26</b>	<b>29</b>	<b>31</b>	<b>39</b>	<b>34</b>
<b>Cash</b>	<b>1</b>	<b>2</b>	<b>2</b>	<b>2</b>	<b>2</b>	<b>2</b>

\*Estimated by OIOS assuming that Small Cap will continue to account for 13 per cent of MSCI ACWI IMI, and 98 per cent of Small Cap are from Developed Markets.

13. In response to the new SAA and benchmark, EMT assessed the implications of the recommended changes for the Small Cap portfolio and identified a need to reallocate \$2.9 billion from the Large Cap portfolios to the Small Cap portfolio for the Fund to align with the new benchmark. This represented a 73 per cent increase over the size of the current Small Cap portfolio. If the additional funding for three newly selected managers for Japan and Europe is completed, the Fund will still need to re-allocate \$2.6 billion from Large Cap to Small Cap. For the latter scenario, EMT estimated that a total of 16 new managers need to be hired, including managers that invest on a global instead of regional basis due to limited capacity and supply of Small Cap funds that invest in a single region. According to the projection, the Fund will have 27 external managers to manage the Small Cap portfolio of approximately \$5.6 billion by 2024 at the latest.

14. However, this assessment did not factor in the declining allocation to Global Public Equities as a whole. As shown in Table 1, all things remaining equal, while the Fund’s Small Cap portfolio needs to

<sup>1</sup> Customized for environment, social and governance (ESG) initiative, i.e., to exclude tobacco, armaments, and thermal coal securities.

<sup>2</sup> The Fund’s historical Asset and Liability Management studies consistently recommended to reduce allocation to public equities, but the long-term target of 24 per cent recommended by the recent study is the lowest.

<sup>3</sup> Recommended benchmark will be customized to reflect the UNJSPF’s ESG and fossil fuel divestment restrictions.

expand by almost 70 per cent (from 4 to 6.7 per cent) in two years to match MSCI ACWI IMI, its weight in the Fund's overall portfolio will decrease after that, together with the weight of Global Public Equities. If the timeframe for the Fund to achieve the same allocation as the new benchmark is extended to five years, the weight of the Small Cap investments in the Fund's overall portfolio will only need to grow to 5.4 per cent from 4 per cent as of 31 March 2021. As such, a strategic plan, including the funding, for the Small Cap programme will depend on the development and implementation progress of the overall plan of OIM to implement the new SAA and benchmarks, which is yet to be developed by the transition taskforce.

15. A feasible plan for expanding the Small Cap programme to catch up with the benchmark also has to take the internal capacity into consideration, especially that of EMT, which has to manage a total of 11 external managers when the agreements with three new managers for Japan and Europe are concluded. As borne out in the past, the search for managers is resource-intensive and time-consuming. On average, it took one to two years to complete one search exercise. The envisioned expansion of the programme will further stretch the two-person team. OIM's request for a new post for the team for 2021 was not approved. OIM initiated a process to hire an institutional advisor to help select and manage external managers for Small Cap in 2021. However, such advisory services may not be an effective substitute for internal capacity in the long run. In this connection, OIM is yet to implement an OIOS recommendation (Recommendation 5) made in a 2020 audit of governance mechanisms and related processes in OIM (A/75/215) to conduct a bottom-up workforce planning exercise to determine the capacity gap and develop an action plan to fill them in order to achieve the investment strategy in a cost-effective manner. Despite another resource benchmarking exercise completed by a consultant in 2021, a workforce planning exercise was yet to be conducted based on bottom-up analyses of the business plan, skillsets and capacity of each team.

**(1) OIM should develop a strategic plan, as part of the overall plan to implement the new Strategic Asset Allocation and benchmarks, to ensure that there are adequate resources and a clear timeline with milestones to achieve the allocation target for Small Cap equities.**

*OIM accepted recommendation 1 and stated that it is currently working on the development of the strategic plan for the Small Cap portfolio construction and will implement through the SAA transition project. OIM will review the adequacy of resources and will include in the budget request if needed. Recommendation 1 remains open pending receipt of evidence that a strategic plan has been developed to implement the new SAA and benchmarks, with adequate resources and a clear timeline with milestones to achieve the allocation target for the Small Cap portfolio.*

#### Need to strengthen ownership of the Small Cap portfolio and accountability for its performance

16. Traditionally, it was the responsibility of the four in-house regional Large Cap equity teams to select, monitor, retain or terminate the external managers for Small Cap investments. OIOS had in the past observed weaknesses in regular monitoring of external managers and timely termination of poor-performing managers.

17. The establishment of EMT, a dedicated team with relevant professional experience, has led to more rigorous screening and due diligence when searching for external managers and more robust monitoring of contracted external managers, as described in later sections of this report. While EMT was managing the Small Cap programme on a day-to-day basis, OIM decided that IIC would own allocation to (including rebalancing between Large and Small Cap) and the performance of the Small Cap portfolio. The role of the Large Cap portfolio managers was limited to providing advice through IIC and serving as members of ad-hoc panels set up for searching for external managers. Performance targets for Small Cap investments were not included in the performance goals of EMT staff even though "portfolio management" was listed as their first goal.

18. OIOS noted several shortcomings with the current arrangement. First, the existing ownership structure, together with the lack of a policy benchmark conducive to Small Cap investments, prevents the Small Cap programme from being managed holistically. Second, the performance of the overall Small Cap portfolio is not owned by investment managers like other portfolios, and the nominal ownership by IIC dilutes accountability. Third, it is not aligned with the day-to-day responsibilities of EMT as the de facto manager. Reassigning ownership back to the Large Cap teams may not be effective in addressing these shortcomings. It would also be impractical for any regional Large Cap team to manage the global Small Cap funds in which OIM plans to invest. Therefore, considering the adoption of the new policy benchmark that captures Small Cap equities, and the need to invest in the asset class through global funds, it is an opportune time to strengthen the ownership and accountability of the Small Cap programme.

**(2) OIM should strengthen the ownership of the Small Cap programme to ensure alignment of its capacity and responsibilities with accountability for its performance.**

*OIM accepted recommendation 2 and stated that it will clarify and assign the ownership when implementing the new SAA and will reflect in the External Manager Policy. Recommendation 2 remains open pending receipt of evidence that ownership for the Small Cap programme has been appropriately assigned.*

The External Manager Policy was under revision

19. OIM had developed an External Manager Policy in 2016 and updated it in 2018. The policy provides, inter alia, an outline of the processes for selection, monitoring, retention, or termination of external managers for Small Cap equities. At the time of the audit, EMT was revising the policy in response to recommendations from the Board of Auditors by incorporating details on how to conduct the selection process, establish a roster of potential managers, and rebalance the manager mix. The policy could be further enhanced by refining the selection process, including the quantitative and qualitative evaluation methodologies and responsibilities of various OIM staff involved in the process, as further explained below.

## **B. Search and contracting of external managers**

Need to refine the search process and evaluation methodologies

20. Since 2018, OIM has completed five manager searches: three by EMT for managers for Small Cap equities in the United States, Japan, and Europe, one by EMT for Frontier Markets, and another by GEM team for Brazilian Large Cap equities. At the time of the audit, the GEM team was finalizing its search for managers for China; EMT was also in the process of searching for two additional managers for US.

21. OIOS reviewed the three completed searches for Small Cap managers by EMT and the one by GEM for Brazil. In general, detailed documentation was kept for the screening, interviews and evaluations performed by the two teams, except for the US search which was the first conducted by EMT. Lessons learned were applied to later searches to enhance the process. Overall, the processes followed were similar, i.e., they all went through the same major steps, including determination of the universe, requesting for expression of interest, issuing short due diligence questionnaire (DDQ), longlisting, issuing detailed DDQ, shortlisting, interviews, onsite due diligence, fee negotiation, establishment of the final list, and selection.

22. However, there were variations in the sequence of the steps carried out. For instance, fee negotiation was conducted as part of the due diligence process before selection and funding recommendation was made to IIC by EMT when searching for Small Cap managers. According to EMT, doing so would help the team retain more bargaining power rather than negotiating with managers whose

selection was approved by IIC. In contrast, the GEM team negotiated with the managers only after IIC approval, believing that would ensure selection of the best managers by having the search panel members conduct qualitative evaluation without knowing the fee schedules.

23. There were other more substantial differences. First, the role and composition of the search panel was different. The panels set up for the searches for Small Cap managers consisted of the Deputy Director for Investments (Equity), one or more investment officers from the Large Cap teams, and EMT members. The panels oversaw the search process and participated in interviews, but the quantitative and qualitative evaluations were mainly done by the EMT members on the panel, including the scoring for the qualitative evaluation after the interviews. The panel for search of Large Cap managers in Brazil consisted of the Deputy Director for Investments (Equity), a legal officer, a risk officer, an investment officer from EMT, and the chief of the GEM team. The panel was more deeply involved in the whole process: all the panel members participated in onsite interviews, with the members keeping individual notes of the interviews, and all members except the legal officer participating in scoring using the qualitative evaluation matrix independently, with an average computed to arrive at the final score.

24. Second, different quantitative and qualitative evaluation methodologies were used. Table 2 shows the quantitative methodologies used for searches for external managers in Japan, Europe, and Brazil (the documentation for search of US managers did not provide details of the evaluation methodology). The parameters and periods used, and their weighting varied from one case to another. The GEM team had a clear rationale for selecting certain factors and periods, and for assigning weights in searching for managers for Brazil. In contrast, the rationale for using a unique factor – “technical charts<sup>4</sup>” – and assigning the highest weight to it (30 per cent) during the search for a Small Cap manager in Japan by EMT was unclear<sup>5</sup>.

**Table 2: Quantitative evaluation methodologies used by OIM in manager searches**

Factor	Weight for search (%)			Period	Weight for search (%)		
	Japan SC	Europe SC	Brazil LC		Japan SC	Europe SC	Brazil LC
Active Return	11.7	14	20	1 Year			10
Information Ratio	11.7	14	10	3 Year	20	15	20
Sortino Ratio		14		5 Year	30	20	40
Treynor Ratio		14		7 Year			
Jensen’s Alpha		14		10 Year	40	30	
Up-Market Capture	11.7	14	10	Since Inception	10	35	30
Down-Market Capture	11.7	14	15				
Maximum Drawdown	11.7		25				
Beta			20				
Technical charts*	30						
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>		<b>100</b>	<b>100</b>	<b>100</b>

25. Similarly, different factors were used for qualitative evaluation during the three searches. For instance, ESG was discussed with the shortlisted managers during the due diligence process for Japan but no weight was assigned for it. But in the other two cases, it was given a 10 per cent weight; risk management was given a 10 per cent weight for the Brazil search whereas in the other two, it was not given any weight. Fees were only incorporated into the methodology for the search for Europe even though the scoring was not fully proportionate to the fee rates quoted.

<sup>4</sup> Including cumulative monthly return, cumulative monthly excess returns, monthly excess return plots, Beta and R-squared, rolling 12-month excess return, rolling 12-month tracking error, rolling 12 months’ information ratio, drawdown.

<sup>5</sup> The EMT investment officer who contributed to the methodology has separated from OIM and this factor was no longer used in later searches.

26. The final ranking was used for recommending managers to be selected in all cases. But the way the final ranking was arrived at was different: EMT combined the quantitative and qualitative scores to establish the final ranking of short-listed managers but used different weights for Japan and Europe: 30 and 70, 40 and 60 per cent, respectively. The GEM team only used qualitative scores for the final ranking.

27. In OIOS' opinion, OIM needs to assess the relative strengths of the different processes and methodologies used in previous search exercises and develop a refined approach. Additionally, the role of the search panel and the responsibilities of the personnel involved need to be defined. For instance, having all the investment officers on the search panel participate in the scoring for qualitative evaluation may help address potential bias of the individual members. The refined approach needs to be incorporated into the External Manager Policy to serve as a baseline for future searches. It is understandable that the processes and evaluation methodologies may need to be tailored due to the unique objectives of hiring the external managers, and the circumstances surrounding the country or region for which the managers are to be selected. However, having a baseline approach and documenting the justification for any significant deviations should help assure discipline and quality.

**(3) OIM should: (i) develop a refined approach for selection of external managers based on best practices and lessons learned from past searches; and (ii) incorporate the refined approach into the External Manager Policy to serve as a baseline for future search exercises, with the requirement that justification for any deviations must be documented.**

*OIM accepted recommendation 3 and stated that it has implemented part (i) and will incorporate the refined approach in the revised External Manager Policy which is currently pending review and approval. Recommendation 3 remains open pending receipt of evidence that a refined approach for selection of external managers has been developed, reflecting best practices and lessons learned from past searches, and incorporated into the External Manager Policy.*

#### Need to select suitable benchmarks for external managers and conduct factor analysis

28. Investment style is the method and philosophy followed in selecting investments for a portfolio to achieve superior returns. Fund managers, especially those who invest in Small Cap equities, often follow a style either voluntarily or involuntarily. The two most prevalent styles are "growth" and "value". Managers with a growth orientation pick stocks with sustainable earnings growth and generally focus on companies' growth outlook, while those with a value orientation try to pick "undervalued" securities that fell out of favour with the market for some reason and focus on parameters such as book to price ratio, dividend yield, and price to earnings ratios. An in-between investment style that tilts toward growth but emphasizes reasonable prices as entry points is called "Growth at Reasonable Price". An investment strategy that does not have a specific style tilt or bias is referred to as "core strategy". In the investment industry, it is customary to select equity indices that match the investment styles of the funds as their benchmarks to achieve more accurate and insightful risk/performance measurement and attribution. Recent MSCI research<sup>6</sup> supports the view that using an appropriate style index would allow investors to assess fund managers' asset allocation (to different sectors) and stock picking skills more reliably.

29. OIM has purposefully sought external Small Cap managers with certain styles to diversify the portfolio and enhance returns. The style distribution among the 11 external managers selected by OIM as of June 2021 (three were yet to be funded) is as follows: four core managers, four growth managers and three value managers. For the five US managers, two indices (Russell 2000, or Russell 2000 Value) that match the designated styles of the managers are used as their benchmarks. For one value manager and two growth managers for Japan, MSCI Japan Small Cap Index will be used due to lack of style indices.

<sup>6</sup> <https://www.msci.com/www/blog-posts/what-really-drove-value-and/02502627875>

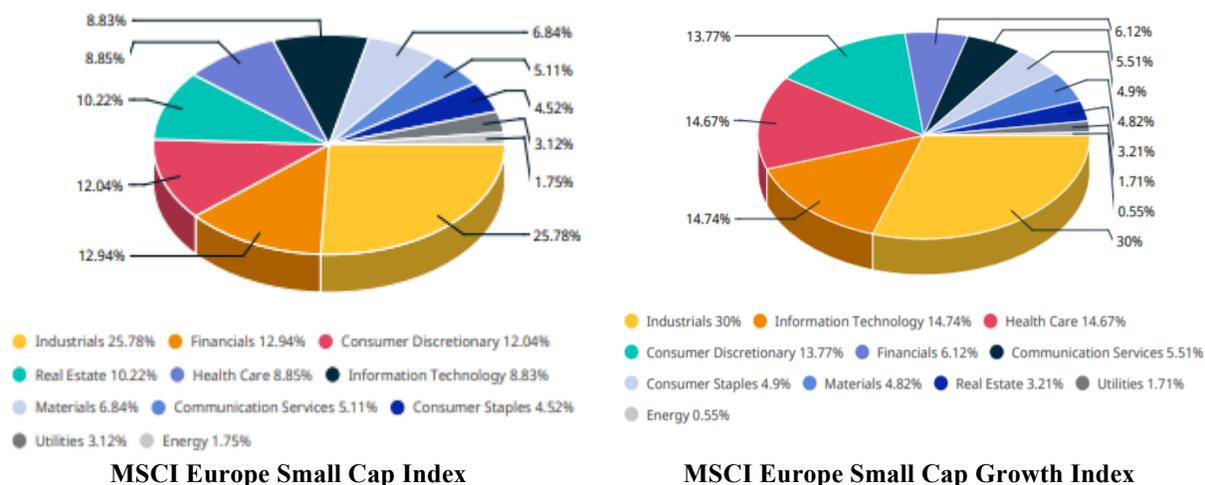
However, despite the existence of MSCI style indices for Europe Small Cap equities, the generic MSCI Europe Small Cap Index has been used as the benchmark for the two growth managers and one value manager for Europe. EMT stated that this was because the managers do not attempt to use any specific indices as their benchmarks in selecting stocks and managing their portfolios. In OIOS' view, it is necessary to choose corresponding style indices as benchmarks to measure managers' performance more accurately.

30. Table 3 provides the historical performance of one large European growth manager on-boarded on 31 December 2001 versus two different benchmarks as of 30 June 2021. The manager's performance more closely tracked MSCI Europe Small Cap Growth Index. Using the generic index would also result in inflating the manager's relative performance for longer periods because growth stocks outperformed value stocks (and the overall stock market) in the last decade, except from July 2020 to June 2021 when the trend reversed. As shown in Chart 2, the sector weights of the generic and growth indices as of 30 June 2021 were considerably different. Using the former as the benchmark to measure and analyze a growth manager's performance would result in unreliable attribution conclusions because the manager's sector under- or over-weights (industry bets) would be significantly different.

**Table 3: One Europe Small Cap growth manager's performance versus different index benchmarks (%)**

Index	1 Mo.	3 Mos.	YTD	1 Yr.	3 Yrs.	5 Yrs.	10 Yrs.
MSCI Europe Small Cap Index	-3.5	6.5	12.2	51.6	10.5	14.1	9.8
MSCI Europe Small Cap Growth Index	-2.5	6.8	9.6	48.5	13.0	16.2	11.0
OIM Europe Small Cap growth manager (Account: UNA80)	-1.0	6.2	3.9	45.7	15.0	19.3	12.8
Excess Return over MSCI Europe Small Cap Index	2.5	-0.2	-8.3	-5.9	4.5	5.1	3.0
Excess Return over MSCI Europe Small Cap Growth Index	1.5	-0.6	-5.7	-2.8	2.0	3.1	1.8

**Chart 2: Sector weights: MSCI Europe Small Cap Index versus MSCI Europe Small Cap Growth Index**



31. As the Fund moves to MSCI ACWI IMI, which is a parent index that consists of Small Cap indices, the Fund can replace Russell 2000 or Russell 2000 Value with MSCI Small Cap indices for the US Small Cap managers. As the MSCI indices need to be customized for ESG purposes, it will entail payment of a subscription fee. While external managers are open to be measured against new benchmarks, and some of

them expressed their willingness to absorb the subscription fee to gain access to the customized indices, other managers may pass at least part of the fee to OIM. For a manager that manages \$50 million for the Fund, the annual fee is approximately 6 basis points or 0.06 per cent of the assets under management.

32. Factor investing has been an established industry trend<sup>7</sup>. A factor is a security or portfolio characteristic that drives systematic returns. Liquidity, momentum (cumulative total local 11-month return), quality (profitability, efficiency, and earnings quality), size (market capitalization), volatility and dividend yield are among the commonly known factors. As demonstrated in the above-mentioned MSCI research, analyzing the exposures of a manager's portfolio to different factors against an appropriate style index can pinpoint the sources of its performance, including value- and growth-related factors. EMT has been using the system of the vendor that provides manager database services for ascertaining the style of managers during the search process and later regular monitoring, known as style mapping. EMT has also been using Bloomberg Terminal to perform factor attribution analysis. However, MSCI is an industry leader in factor analysis. The Risk team demonstrated to OIOS that it can use the MSCI BarraOne to perform more sophisticated factor analysis for risk and performance attribution. OIOS is of the view that the Risk team and EMT can collaborate on the initiative to conduct regular factor analysis to determine the individual Small Cap portfolio's exposure to various factors, especially value and growth factors that OIM is seeking through manager selection.

**(4) OIM should adopt appropriate benchmarks for external fund managers and conduct adequate analysis to ensure that the Fund's Small Cap managers' performance is driven by the desired style factors.**

*OIM accepted recommendation 4 and stated that as part of its initiative to adopt the new policy benchmark with incorporation of ESG, OIM is in process of reviewing the benchmarks for the Small Cap investments according to the results of the recent 2021 asset allocation and benchmark study. Regarding factor analysis, EMT has been using Bloomberg's but the Risk Team will run MSCI's to monitor managers' exposures. Recommendation 4 remains open pending receipt of evidence that appropriate benchmarks have been chosen for measurement and reporting of the performance of the Small Cap managers, and regular factor exposure reports are generated by the Risk Team.*

#### Fees agreed with the external managers were reasonable

33. The annual management fee agreed with the 11 selected external managers for Small Caps range from 35 to 70 basis points, or 0.35 to 0.7 per cent of the Fund's assets managed by the external managers. The fees are flat, i.e., there are no additional fees for performance exceeding the benchmarks. For the total amount of \$3.94 billion invested in Small Cap by OIM as of 30 June 2021 (including \$217 million yet to be funded), OIOS estimated the weighted average annual fee rate to be 45.7 basis points. This compares favourably against the global median fee for a \$100 million mandate of 55 basis points in 2019, and the final fees obtained by investors after a 5 to 15 per cent discount is applied through negotiations.

34. The GEM team was able to negotiate the fees of two managers selected for Brazil down to 1.5 and 1.75 per cent flat from 2 per cent, with an additional 20 per cent performance fee for returns above the benchmark and 2 per cent with no performance fee, respectively. Despite being much higher than the fees for Small Cap investments, the agreed fees are still lower than the median management fees for Brazil, which was assessed as 1.92 per cent per annum. Another study shows that large investors had to pay an average management fee of 1.8 per cent per annum in Brazil, mainly due to the unique structure of its capital market. Besides, the fees quoted by the six shortlisted managers for Brazil were generally above 2

<sup>7</sup> <https://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf>

per cent, plus performance fees. The manager that quoted a fee of 1 per cent fee insisted on a 15 per cent performance fee (for excess return above benchmark) and was therefore not selected.

#### Signed agreements with external managers were more robust but took long to conclude

35. Throughout the years, OIM had gradually enhanced and standardized the IMAs with the external managers with concerted efforts from EMT, the Risk and Compliance team and the Legal team, with the assistance of an external legal counsel engaged through the Office of Legal Affairs. Compared to similar agreements entered into by other organizations and by the Fund historically, the latest agreements signed by OIM with the external managers have comprehensive coverage of the important aspects of investment management, with detailed guidelines, restrictions, and requirements for the external managers. Also, the new agreements allow OIM to terminate the agreement at its sole discretion at any time, without having to give 30 days' notice as in previous agreements. When the need arises, OIM has the flexibility to communicate to the external managers updates on reporting requirements, permissible countries, and tax exemption without having to formally amend the agreements. Changes to the Investment Guidelines still require to be formally signed off by both parties.

36. OIOS noted that the contract negotiation usually took more than 6 months to conclude. The recommended selection of three Small Cap managers for Japan was approved by IIC in early November 2020, but only one contract was signed as of June 2021. Similarly, the selection of two new managers for Europe was approved in early December 2020 but only one contract was signed in May 2021. The contract negotiation with the two Large Cap managers for Brazil started in November 2020 but was yet to conclude. Delays in signing agreements could have a negative impact on implementing the investment mandate and incur significant opportunity costs. *OIM stated that the root causes for the delays in signing contractual agreements have been identified, and the recruitment of the new P-5 for Legal will help address these delays.*

### **C. Monitoring and retention of external managers**

#### Monitoring of external managers had been strengthened

37. Monitoring of contracted investment managers is critical to ensure that the investment mandate is successfully implemented, and that timely actions taken, if required. The External Manager Policy states that EMT should monitor the risk and performance of external managers proactively and recommend timely termination when appropriate. IMAs indicate the reports that external managers must submit to OIM on monthly, quarterly, and annual basis, with information on personnel and organizational changes, portfolio performance and characteristics, compliance certification and ESG report. The managers are also required to meet with OIM on a quarterly basis and upon ad-hoc request by OIM.

38. The establishment of EMT had significantly strengthened the monitoring of external managers and the portfolios they manage, especially since the appointment of the senior investment assistant in 2019. EMT developed an Excel-based tool named "Tracker" to track the submission of the required reports. The tool was effectively used since the second half of 2019. OIOS' review of 6 monthly, 13 quarterly and 8 annual reporting packages from 6 managers hired before 2020 showed that in general, the managers had complied with the reporting requirements.

39. The minutes of quarterly meetings with external managers indicate that comprehensive and in-depth discussions were held on a regular basis, covering substantive topics including portfolio performance, strategy, holdings, and market developments/prospects. EMT also developed an evaluation form template which was used to evaluate all external managers annually. The managers were evaluated on organizational

and personnel changes, performance and strategy and compliance with the reporting requirements. The same form is also used to determine whether the manager's contract should be extended.

40. The Risk and Compliance team conducted independent monitoring of the external managers regularly, including: (i) risk monitoring through the weekly Risk Dashboard and monthly report of tracking errors from the managers; (ii) post-trade compliance monitoring through the custodian bank; (iii) quarterly attestations/Compliance Certificates from the external managers attesting either that they are in compliance with the investment restrictions in the IMAs or disclosing any issues and related action plans; and (iv) reputational risk monitoring using the RepRisk tool. Prior to the renewal of the external manager's agreements, a compliance assessment was also conducted using a standard template covering the elements of ongoing compliance monitoring. External managers were recently required to submit ESG reports, including proxy and engagement efforts, on quarterly basis starting from the third quarter of 2021 to the ESG team of OIM to monitor proxy voting by the external managers.

#### Contract management needed to be strengthened

41. The audit showed that external managers' compliance with some clauses in the IMAs was not adequately monitored by OIM. According to the IMAs, the manager is prohibited from "recommending or making any investment in or disposal of securities in which the manager and its affiliated persons beneficially own, individually or in the aggregate, five per cent or more of the outstanding class thereof." The IMAs also stipulate that all broker selection shall be based on the principle of "best execution", without consideration of any direct or indirect benefit, such as "soft dollars" to the manager. As the managers may aggregate sales and purchase orders for different accounts including the Fund's, they shall ensure that the Fund is treated on a fair and equitable basis with the managers' other clients. Accordingly, the managers have the obligation to maintain and make available to the Fund upon request trade records, including the names of the brokers and dealers utilized as well as commissions paid in connection with transactions for the Fund. Despite the provision in the IMAs that OIM has the authority to approve exceptions to these requirements or direct the managers to use or not to use certain brokers, there was no mechanism to verify whether the managers adequately fulfilled these contractual obligations.

42. EMT stated that it is difficult to determine whether the external managers engaged in prohibited transactions because OIM does not have access to information on whether the managers or their affiliated persons have material interests in the underlying companies. The custodian bank's compliance tool cannot be used for this purpose either. OIOS concurs with EMT that the existing practice, self-certification of compliance with the Investment Guidelines by the managers, can be expanded to cover compliance with the terms of the IMAs, including the clause on prohibited transactions.

43. Monitoring of trade execution and commissions paid by the external managers is not just important to ensure their compliance with the terms of the IMAs, but also critical for ensuring that their performance is not negatively impacted by poor trade execution and unreasonably high commissions. There are two different ways OIM can monitor the external managers' trading, including the brokers used and commissions paid. OIM has an in-house Trading Execution team which has the expertise to review the quality of trade execution by the external managers and the reasonableness of the commissions they paid to brokers. EMT recently engaged the Trade Execution team to review the execution quality of the transition completed by a new Europe manager in 2021, which was funded with cash. However, such review has not been institutionalized as part of OIM's regular monitoring activities. Alternatively, EMT, with the assistance of the Trade Execution team, could use the Transaction Cost Analysis tool available in OIM to regularly review the managers' trading to have a more holistic and independent evaluation, as opposed to high level reviews.

- (5) OIM should expand the scope of the quarterly Compliance Certificates to cover compliance with all the terms of the Investment Management Agreements with the external managers, including the clause on prohibited transactions.**

*OIM accepted recommendation 5 and stated that the quarterly Compliance Certificate has been expanded to include all contractual provisions in the IMA. Recommendation 5 remains open pending receipt of evidence that the quarterly Compliance Certificate template developed by OIM is being put to use.*

- (6) OIM should establish a process for monitoring the quality of trade execution and reasonableness of commissions paid by the external managers on a regular basis.**

*OIM accepted recommendation 6 and stated that the Best Execution Committee can oversee the quality of trade execution and reasonableness of commissions paid by external managers. The meetings are held on a quarterly basis. Recommendation 6 remains open pending receipt of evidence that the Best Execution Committee reviews the quality of trade execution and reasonableness of commissions paid by the external managers on a regular basis.*

#### **IV. ACKNOWLEDGEMENT**

44. OIOS wishes to express its appreciation to the management and staff of OIM for the assistance and cooperation extended to the auditors during this assignment.

*(Signed)* Eleanor T. Burns  
Director, Internal Audit Division  
Office of Internal Oversight Services

## STATUS OF AUDIT RECOMMENDATIONS

## Audit of management of external managers in the Office of Investment Management of the United Nations Joint Staff Pension Fund

Rec. no.	Recommendation	Critical <sup>8</sup> / Important <sup>9</sup>	C/ O <sup>10</sup>	Actions needed to close recommendation	Implementation date <sup>11</sup>
1	OIM should develop a strategic plan, as part of the overall plan to implement the new Strategic Asset Allocation and benchmarks, to ensure there are adequate resources and a clear timeline with milestones to achieve the allocation target for Small Cap equities.	Important	O	Receipt of evidence that a strategic plan has been developed to implement the new SAA and benchmarks, with adequate resources and a clear timeline with milestones to achieve the allocation target for the Small Cap portfolio.	30 September 2022
2	OIM should strengthen the ownership of the Small Cap programme to ensure alignment of its capacity and responsibilities with accountability for its performance.	Important	O	Receipt of evidence that ownership for the Small Cap programme has been appropriately assigned.	30 September 2022
3	OIM should: (i) develop a refined approach for selection of external managers based on best practices and lessons learned from past searches; and (ii) incorporate the refined approach into the External Manager Policy to serve as a baseline for future search exercises, with the requirement that justification for any deviations must be documented.	Important	O	Receipt of evidence that a refined approach for selection of external managers has been developed, reflecting best practices and lessons learned from past searches, and incorporated into the External Manager Policy.	30 September 2022
4	OIM should adopt appropriate benchmarks for external fund managers and conduct adequate analysis to ensure that the Fund's Small Cap managers' performance is driven by the desired style factors.	Important	O	Receipt of evidence that appropriate benchmarks have been chosen for measurement and reporting of the performance of the Small Cap managers and regular factor exposure reports are generated by the Risk Team.	30 September 2022
5	OIM should expand the scope of the quarterly Compliance Certificates to cover compliance with all the terms of the Investment Management Agreements with the external managers, including the clause on prohibited transactions.	Important	O	Receipt of evidence that the quarterly Compliance Certificate template developed by OIM is being put to use.	31 March 2022

<sup>8</sup> Critical recommendations address those risk issues that require immediate management attention. Failure to take action could have a critical or significant adverse impact on the Organization.

<sup>9</sup> Important recommendations address those risk issues that require timely management attention. Failure to take action could have a high or moderate adverse impact on the Organization.

<sup>10</sup> Please note the value C denotes closed recommendations whereas O refers to open recommendations.

<sup>11</sup> Date provided by OIM in response to recommendations.

## STATUS OF AUDIT RECOMMENDATIONS

**Audit of management of external managers in the Office of Investment Management of the United Nations Joint Staff Pension Fund**

6	OIM should establish a process for monitoring the quality of trade execution and reasonableness of commissions paid by the external managers on a regular basis.	Important	O	Receipt of evidence that the Best Execution Committee reviews the quality of trade execution and reasonableness of commissions paid by the external managers on a regular basis.	31 March 2022
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# **APPENDIX I**

## **Management Response**



To: Mr. Gurpur Kumar  
Deputy Director Internal Audit Division OIOS

DATE: September 20, 2021

Reference: OIOS-2021-01343

THROUGH: Mr. Pedro Guazo  
Representative of the Secretary-General  
for the investment of UNJSPF assets

Signature:   
Pedro Guazo (Sep 21, 2021 14:42 EDT)  
Email: pedro.guazo@unoim.org

-and-

FROM: Mr. Toru Shindo  
Chief Investment Officer  
Office of Investment Management

Signature:   
Toru Shindo (Sep 21, 2021 10:09 EDT)  
Email: toru.shindo@unoim.org

SUBJECT: Draft report of an audit of management of external managers the Office of Investment Management of the United Nations Joint Staff Pension Fund (Assignment No. AS2021/801/02)

1. OIM acknowledges receipt of the draft report of an audit of management of external managers in the Office of Investment Management of the United Nations Joint Staff Pension Fund (Assignment No. AS2021/801/02).
2. OIM would like to take this opportunity to thank the Office of Internal Oversight Services and staff for their comprehensive effort including the on-going collaboration during the thorough review and analysis, and the detailed findings, observations and recommendations.
3. OIM has attached the completed form provided (APPENDIX I -Audit recommendations) including detailed responses and comments to the recommendations related to OIM.

c.c.: Ms. Isabela Perle Munch, Chief Risk and Compliance Officer  
Ms. Victoria Hui, Investment Officer for External Managers  
Ms. Maria Tsimboukis, Compliance Officer

### Management Response

#### Audit of management of external managers in the Office of Investment Management of the United Nations Joint Staff Pension Fund (Assignment No. AS2021-801-02)

Rec. no.	Recommendation	Critical <sup>1</sup> / Important <sup>2</sup>	Accepted? (Yes/No)	Title of responsible individual	Implementation date	Client comments
1	OIM should develop a strategic plan, as part of the overall plan to implement the new Strategic Asset Allocation and benchmarks, to ensure there are adequate resources and a clear timeline with milestones to achieve the allocation target for Small Cap equities.	Important	Yes	RSG, CIO	Q3 / 2022	OIM is currently working on the development of the strategic plan for the small cap portfolio construction and will implement through the SAA Transition Project. OIM will review the adequate resources and will include in the budget request if needed.
2	OIM should strengthen the ownership of the Small Cap programme to ensure alignment of its capacity and responsibilities with accountability for its performance.	Important	Yes	RSG, CIO	Q3 /2022	OIM will clarify and assign the ownership when implementing the new SAA and will reflect in the External Manager Policy.
3	OIM should: (i) develop a refined approach for selection of external managers based on best practices and lessons learned from past searches; and (ii) incorporate the refined approach into the External Manager Policy to serve as a baseline for future search exercises, with the requirement that justification for any deviations must be documented.	Important	Yes	CIO, Investment Officer, External Managers	Q3/ 2022	OIM has implemented recommendation (i) and will incorporate the refined approach in the revised External Manager Policy which is currently pending review and approval.
4	OIM should adopt appropriate benchmarks for external fund managers and conduct adequate analysis to ensure that the Fund's	Important	Yes	CIO Chief Risk & Compliance	Q3/ 2022	As part of OIM's initiative to adopt the new policy benchmark with incorporation of ESG, OIM is in process of reviewing the benchmarks

<sup>1</sup> Critical recommendations address those risk issues that require immediate management attention. Failure to take action could have a critical or significant adverse impact on the Organization.

<sup>2</sup> Important recommendations address those risk issues that require timely management attention. Failure to take action could have a high or moderate adverse impact on the Organization.

## Management Response

**Audit of management of external managers in the Office of Investment Management of the United Nations Joint Staff Pension Fund  
(Assignment No. AS2021-801-02)**

Rec. no.	Recommendation	Critical <sup>1</sup> / Important <sup>2</sup>	Accepted? (Yes/No)	Title of responsible individual	Implementation date	Client comments
	Small Cap managers' performance is driven by the desired style factors.					for the small cap investments according to the results of the recent 2021 Asset allocation and Benchmark study. Regarding factor analysis, EMT have been using Bloomberg's but Risk team will run MSCI's to monitor managers' exposures.
5	OIM should expand the scope of the quarterly Compliance Certificates to cover compliance with all the terms of the Investment Management Agreements with the external managers, including the clause on prohibited transactions.	Important	Yes	Chief Risk & Compliance	Q1/2022	Please see attached the revised quarterly Compliance Certificate which has been expanded to include all contractual provisions in the investment management agreement. Please consider this recommendation implemented.
6	OIM should establish a process for monitoring the quality of trade execution and reasonableness of commissions paid by the external managers on a regular basis.	Important	Yes	CIO	Q1/2022	The Best Execution Committee can oversee the quality of trade execution and reasonableness of commissions paid by external managers. The meetings are held on a quarterly basis.