



## INTERNAL AUDIT DIVISION

### REPORT 2015/094

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Audit of management of external portfolio managers for small capitalization investments in the Investment Management Division of the United Nations Joint Staff Pension Fund

Overall results relating to effective management of external portfolio managers for small capitalization investments were initially assessed as partially satisfactory. Implementation of three important recommendations remains in progress.

**FINAL OVERALL RATING: PARTIALLY SATISFACTORY**

2 September 2015  
Assignment No. AS2015/801/01

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# AUDIT REPORT

## Audit of management of external portfolio managers for small capitalization investments in the Investment Management Division 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 portfolio managers for small capitalization investments in the Investment Management Division (IMD) of the United Nations Joint Staff Pension Fund (UNJSPF or the Fund).

2. In accordance with its mandate, OIOS provides assurance and advice on the adequacy and effectiveness of the United Nations internal control system, the primary objectives of which are to ensure: (a) efficient and effective operations; (b) accurate financial and operational reporting; (c) safeguarding of assets; and (d) compliance with mandates, regulations and rules.

3. The Fund invested in a global portfolio of investments comprising equities, fixed income, real assets, alternative assets and short-term instruments. As at 31 May 2015, the preliminary market value of the Fund's assets was \$54.2 billion, and the asset allocation was: 64.35 per cent in equities; 23.95 per cent in fixed income; 5.73 per cent in real assets; 2.97 per cent in alternative investments; and 3 per cent in cash and short-term position.

4. The external portfolio managers for small capitalization investments (also referred to as discretionary managers) were contracted to manage, on a discretionary basis with specific guidelines, a portion of the Fund's equity portfolio in small capitalization companies in specific geographic regions. As at 31 May 2015, IMD had four external managers from North America, Europe and Japan, who managed an equity portfolio of about \$2.3 billion. This amount was 6.5 per cent of the total equity portfolio of the Fund, or 4.2 per cent of the total portfolio (\$54.2 billion) as at 31 May 2015. Table 1 shows the break-down of the small capitalization portfolio.

Table 1  
Small capitalization portfolios as at 31 May 2015 (in United States dollars)

Region	Account No.	Value
North America	UM074	860,726,550
	UM075	497,212,167
Europe	UM073	650,255,715
Asia	UM076	185,056,718
<b>Total</b>		<b>2,193,251,150</b>

Source: Master Record Keeper

5. IMD investment guidelines, limitations and restrictions applied to small capitalization portfolios equally.

6. Comments provided by IMD are incorporated in *italics*.

## II. OBJECTIVE AND SCOPE

7. The audit was conducted to assess the adequacy and effectiveness of IMD governance, risk management and control processes in providing reasonable assurance regarding **effective management of external portfolio managers for small capitalization investments**.

8. This audit was included in the 2015 OIOS risk-based work plan due to the risk that ineffective management of external portfolios of small capitalization investments may lead to poor investment decisions and lower returns; and counterparty risk, or the risk that external portfolio managers may not comply with their contractual obligations.

9. The key control tested for the audit was regulatory framework. For the purpose of this audit, OIOS defined regulatory framework as controls that provide reasonable assurance that policies and procedures: (i) exist to guide IMD management of external portfolio managers for small capitalization investments; (ii) are implemented consistently; and (iii) ensure reliability and integrity of financial and operational information.

10. The key control was assessed for the control objectives shown in Table 2.

11. OIOS conducted this audit from March to June 2015. The audit covered the period from February 2013 to February 2015; however, to establish trends and patterns, OIOS used data pertaining to prior years. The audit covered the four external managers who actively managed small capitalization equity accounts.

12. OIOS conducted an activity-level risk assessment to identify and assess specific risk exposures, and to confirm the relevance of the selected key controls in mitigating associated risks. Through interviews, analytical reviews and tests of controls, OIOS assessed the existence and adequacy of internal controls and conducted necessary tests to determine their effectiveness.

## III. AUDIT RESULTS

13. The IMD governance, risk management and control processes examined were initially assessed as **partially satisfactory**<sup>1</sup> in providing reasonable assurance regarding **effective management of external portfolio managers for small capitalization investments**. OIOS made three recommendations to address issues identified in the audit. IMD did not have formal policy guidance on small capitalization investments and their external management. Consequently, there was no articulation of the objectives for investing in small capitalization markets and it was not possible to establish the value that was expected to be added by external portfolio managers. There was also a need to develop procedures and guidelines with established criteria for selecting, monitoring and terminating external portfolio managers. OIOS noted that controls relating to monitoring compliance with investment limits and payment of fees were adequate.

14. The initial overall rating was based on the assessment of key controls presented in Table 2 below. The final overall rating is **partially satisfactory** as implementation of three important recommendations remains in progress.

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<sup>1</sup> A rating of “**partially satisfactory**” means that important (but not critical or pervasive) deficiencies exist in governance, risk management or control processes, such that reasonable assurance may be at risk regarding the achievement of control and/or business objectives under review.

Table 2

**Assessment of key control**

Business objective	Key control	Control objectives			
		Effective and efficient operations	Accurate financial and operational reporting	Safeguarding of assets	Compliance with mandates, regulations and rules
Effective management of external portfolio managers for small capitalization investments	Regulatory framework	Partially Satisfactory	Partially Satisfactory	Satisfactory	Partially Satisfactory
<b>FINAL OVERALL RATING: PARTIALLY SATISFACTORY</b>					

**Regulatory framework**

There was a need to establish a risk/return objective and strategic direction for small capitalization investments

15. IMD was expected to define the objectives for small capitalization investments and develop a strategic plan to achieve these objectives.

16. IMD did not have formal policy guidance on small capitalization investments and there was no evidence showing why and how small capitalization investments were made. IMD Policy, Procedure and Risk Manual did not provide adequate clarity and specific guidelines as described below:

- The Fund's Strategic Asset Allocation, which allocated 60 per cent to global equity, did not make any allocation to the sub-category of small capitalization;
- Risk/return objective for investment in the small capitalization market, i.e. why the Fund was investing in this market and how such investments would contribute to the overall objective of the Fund and risk limits, was not defined; and
- Definition or guidance on investment factors, attributes or granularity such as investing for value, growth, dividend yield, quality, or low volatility was not provided.

17. In its presentation to the Investment Committee during the 213<sup>th</sup> meeting in May 2012, IMD mentioned some strategic objectives, e.g., it indicated that the strategy was to achieve enhanced returns and diversification. However, the presentation was not supported by a comprehensive review such as a business case study, and it was not translated into formal policies. Further, IMD did not implement some of the recommendations included in the presentation such as seeking further diversification of investment styles and managers. A further review of the Investment Committee minutes of meetings held in 2013 and 2014 showed that some members made comments relating to small capitalization investments such as a need for long-term justification for allocation to this market and having a minimum of two small capitalization managers for each region; however, there were no specific recommendations by the Investment Committee for the period under review.

18. The only guidance on small capitalization investments was in the IMD Procedures, which stated that "the strategic objective of the small capitalization manager was to obtain company exposure by closely tracking their designated benchmark index"; this statement was not clear. IMD set specific benchmarks for each region; however, no further guidance was provided. OIOS noted that small

capitalization investments doubled from 2009 to 2014; however, the justification for the increase was not explained and documented properly.

19. OIOS also noted that in the benchmark IMD adopted for its global equity, MSCI ACWI<sup>2</sup>, allocation to small capitalization was 0 per cent, while the Fund's allocation was 6 per cent. This gap was highlighted in the Fund's latest benchmarking study conducted in 2013, and the study recommended that Fund adopt new benchmarks, e.g., MSCI ACWI IMI<sup>3</sup> for the whole portfolio and Russel 3000 for North America region.

20. It was not possible to establish whether the Fund's overall return objective was aligned with that of small capitalization investments. The Fund's return objective, as mentioned in the IMD Investment Policy and strategic framework performance indicators, was to obtain a 3.5 per cent real return. The performance of external portfolio managers, as mentioned in the contractual agreements, was to beat their respective benchmarks but no risk/return targets were set for the managers.

21. There were no clearly defined goals, objectives and established targets regarding investments in small capitalization markets. IMD Management stated that it was not easy to set specific risk/return targets in a highly dynamic environment.

22. In the absence of clearly defined goals and risk/return targets, IMD may not be able to establish the value added by small capitalization investments.

<p><b>(1) The Investment Management Division should develop objectives and strategic direction for small capitalization investments and define the basis for allocation to the small capitalization investment category.</b></p>
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23. *IMD accepted recommendation 1 and stated that working with the IMD Risk Section, the IMD Investment Section would formalize the objectives and strategic direction for IMD small capitalization investments including its allocation basis.* Recommendation 1 remains open pending receipt of documentation on the objectives and strategic direction for small capitalization investments.

The Investment Management Division needed to develop necessary capacity for selecting external fund managers

24. According to IMD Risk Manual, the Fund should be aware of contract expirations and should initiate review or renewal processes in a timely manner. IMD was expected to provide the necessary tools and resources to implement its procedure for the selection of external funds and discretionary investment managers. Additionally, the procedures were expected to include an assessment of the managers' risk/return profiles.

25. Upon request by IMD, on 1 December 2011, the Representative of the Secretary-General established that the selection of discretionary funds and managers was to be treated as an investment rather than a procurement exercise. After this decision, IMD did not involve the United Nations Procurement Division in the selection of external managers and extension/amendment of the existing contracts. IMD developed a new procedure for the selection/extension of external funds and discretionary investment managers in 2013, but it did not implement this procedure. IMD did not hire any new external managers since 2011, but extended the term of the existing contracts multiple times.

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<sup>2</sup> Morgan Stanley Capital International All Country World Index

<sup>3</sup> Morgan Stanley Capital International All Country World Index Investable Market Index

26. OIOS noted that the selection/extension procedure required rankings of external funds/managers without specifying the qualification criteria, e.g., top 25<sup>th</sup> percentile in the last five years or higher Sharpe/Information ratios in the last five years, etc. Ideally, the desirable profile of external funds/managers needed to be defined in the small capitalization investment strategy and further elaborated in the selection procedure.

27. At the time of the audit, a consultant was assisting IMD to establish and use an institutional investment manager database in the selection and monitoring of external managers.

28. One of the main reasons for not implementing the new procedure was lack of global data services for the small capitalization universe that would provide essential information, various reports and analyses of the external managers in the market. This was already mentioned as a pre-requisite in the selection procedure to enable IMD to effectively apply it. The second reason was the lack of dedicated human resources as the selection process required time and efforts.

29. In the absence of an effective procedure and capacity, IMD may not be able to hire high-quality external managers who would add value to the Fund. Further, underperforming external managers may not be replaced in a timely manner in the absence of a well-established procedure. For example, IMD terminated the contract with an external manager for Japan in March 2008 due to poor performance; however, it took almost two years to establish a new contract (UM076), and higher return opportunities were lost in the interim. Finally, management fees in the old contracts may not reflect market trends, e.g. reduction in management fees, and hence the Fund could pay higher fees for the services rendered.

**(2) The Investment Management Division should enhance and develop the necessary capacity to implement the procedure for the selection of external portfolio managers.**

30. *IMD accepted recommendation 2 and stated that IMD would formally document a procedure for the selection of external portfolio managers, which would be incorporated into its Investment Procedures* Recommendation 2 remains open pending notification that IMD has enhanced and developed the necessary capacity to implement the procedure on the selection of external portfolio managers.

IMD needed to develop criteria and guidelines for effective monitoring and oversight of external portfolio managers

31. IMD Risk Manual required that Investment Teams evaluate manager performance annually based on contract terms. The Manual also stated that with the implementation of Risk Analytics tools, IMD could report various risk statistics as well risk adjusted performance quarterly, and assigned this responsibility to the Risk Management and Compliance Section.

32. IMD did not assess and document the performance of external portfolio managers periodically. Up until 2013, Senior Investment Officers prepared contractor performance reports by using standard templates developed by the United Nations Procurement Division, but this practice stopped due to the special treatment of hiring of external managers, i.e., investment versus procurement process. The old template, nevertheless, was not designed for the specific services provided by external managers and it only assessed contractual compliance rather than investment performance. After 2013, despite multiple contract extensions, IMD prepared a comprehensive performance assessment report only for the external manager for Europe before extension of the contract in September 2013.

33. In addition, IMD did not consider risk when measuring the performance of small capitalization portfolios. Senior Portfolio Managers compared the rate of return of investments with the return of the established benchmark in its monitoring and assessment of external portfolios. Neither the absolute risks,

i.e. the total variability in returns, nor relative risks were considered in the evaluation of the portfolio performance. In investments, higher returns may not be desirable if the risk exposure of the portfolio exceeds the risk tolerance.

34. In terms of monitoring, Senior Investment Officers prepared quarterly portfolio review reports, which included performance of small capitalization investments, and these reports were discussed during IMD quarterly portfolio reviews, but they did not include risk-adjusted performance. IMD Senior Portfolio Managers also met semi-annually with external managers for due diligence reviews and performance discussions; however, there were no established criteria for discussing and evaluating performance other than the rates of return figures.

35. Even though the Risk Management and Compliance Section provided rate of return figures for the whole portfolio, including small capitalization, the Section was not involved in the performance evaluation of small capitalization managers. The Section could provide an independent evaluation of small capitalization managers using various risk analytics tools and IMD Risk Management Manual already assigned the responsibility of performing risk-adjusted performance to the Section. OIOS noted that the Section possessed adequate tools and skills to provide statistical measures such as rolling risk and return ratios, capital asset pricing model statistics etc., but they were not utilized. The Representative of the Secretary-General stated that she had initiated a review to enhance the monitoring of external portfolio managers through the use of additional quantitative tools and techniques. A continuous review and analysis of these data and statistics would provide a solid basis for establishing whether the external managers were performing in a consistent manner and whether higher returns were a result of coincidence or manager skill.

36. The majority of Senior Investment Officers stated that they did not have the resources and appropriate tools to effectively monitor external portfolio managers. OIOS noted that IMD realized the need for dedicated resources for managing external portfolio managers, and was in the process of selecting an investment officer who would be responsible for managing external portfolio managers. Therefore, OIOS did not make a recommendation in this regard.

37. OIOS also identified other weaknesses in monitoring of contracts, including collection and review of audited financial statements; review of brokerage fees and contract extensions.

38. IMD did not develop a set of criteria against which it could assess the performance of external portfolio managers.

39. In the absence of criteria to evaluate the performance of external managers and continuous monitoring process, IMD may not be able to establish the value added by external portfolio managers. Further, IMD may not determine whether the external portfolio managers took absolute and relative risks above the Fund's risk tolerance. This could also prevent IMD from taking timely actions to replace an external manager who was taking very high risks or whose risk-adjusted performance was poor.

<p><b>(3) The Investment Management Division should develop guidelines to effectively evaluate and monitor the performance of external managers. Such guidelines should include criteria to conduct risk-adjusted performance assessment.</b></p>
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40. *IMD accepted recommendation 3 and stated that IMD Risk Section would formalize and document the needed criteria to better monitor and evaluate the performance of IMD external managers on a periodic basis.* Recommendation 3 remains open pending receipt of guidelines to effectively evaluate and monitor the performance of external managers.



There were adequate controls to ensure external managers complied with the Investment Management Division investment limits

41. According to the IMD Risk Management Manual, all external managers must comply with investment guidelines in their respective asset classes. This requirement was also included in the agreements with external managers.

42. IMD Compliance Unit conducted quarterly reviews to monitor compliance of external managers with investment limits and used the Compliance Analyst tool for this purpose. A review of quarterly compliance review reports prepared by the IMD Compliance Unit in 2013 and 2014 showed that there was no significant breach of investment limits except a few holdings exceeded market capitalization limits, but these were reported to the Representative of the Secretary-General and monitored periodically. OIOS concluded that controls for monitoring compliance with investment limits were adequate.

Controls to ensure that fees of external managers were paid in accordance with the contract provisions were adequate

43. Contractual agreements set forth the basis of fees payable to external managers.

44. OIOS noted that IMD established a procedure to verify the accuracy of fees payable to external portfolio managers and provided adequate segregation of duties in processing the payment of fees. Invoices from external managers were forwarded to the IMD Operations Section for verification and payment. One staff recalculated the amount of fee by taking the end-of month portfolio values from the Master Record Keeper and multiplying them with the established percentages in the contracts. After verification of the accuracy of the amount charged, another staff approved the invoices and directed wire transfer payment instructions to the United Nations custodian. OIOS selected and reviewed invoices from last quarters of 2013 and 2014, and verified that correct amounts were paid. Based on the review of the process and a sample of invoices, OIOS established that controls were adequate.

#### **IV. ACKNOWLEDGEMENT**

45. OIOS wishes to express its appreciation to the Management and staff of IMD for the assistance and cooperation extended to the auditors during this assignment.

*(Signed)* David Kanja  
Assistant Secretary-General for Internal Oversight Services

## STATUS OF AUDIT RECOMMENDATIONS

**Audit of management of external portfolio managers for small capitalization investments  
in the Investment Management Division of the United Nations Joint Staff Pension Fund**

<b>Recom. no.</b>	<b>Recommendation</b>	<b>Critical<sup>4</sup>/ Important<sup>5</sup></b>	<b>C/ O<sup>6</sup></b>	<b>Actions needed to close recommendation</b>	<b>Implementation date<sup>7</sup></b>
1	The Investment Management Division should develop objectives and strategic direction for small capitalization investments and define the basis for allocation to the small capitalization investment category.	Important	O	Receipt of documentation on the objectives and strategic direction for small capitalization investments.	30 June 2016
2	The Investment Management Division should enhance and develop the necessary capacity to implement the procedure for the selection of external portfolio managers.	Important	O	Notification that IMD has enhanced and developed the necessary capacity to implement the procedure on the selection of external portfolio managers.	30 June 2016
3	The Investment Management Division should develop guidelines to effectively evaluate and monitor the performance of external managers. Such guidelines should include criteria to conduct risk-adjusted performance assessment.	Important	O	Receipt of guidelines to effectively evaluate and monitor the performance of external managers.	30 June 2016

<sup>4</sup> Critical recommendations address significant and/or pervasive deficiencies or weaknesses in governance, risk management or internal control processes, such that reasonable assurance cannot be provided regarding the achievement of control and/or business objectives under review.

<sup>5</sup> Important recommendations address important deficiencies or weaknesses in governance, risk management or internal control processes, such that reasonable assurance may be at risk regarding the achievement of control and/or business objectives under review.

<sup>6</sup> C = closed, O = open

<sup>7</sup> Date provided by IMD in response to recommendations.

# **APPENDIX I**

## **Management Response**



TO: Muriette Lawrence-Hume  
A: Chief, New York Audit Service  
Internal Audit Division, OIOS

10 August 2015

THROUGH: Ms. Carolyn Boykin  
PAR: Representative of the Secretary-General  
Investment Management Division  
United Nations Joint Staff Pension Fund

A handwritten signature in blue ink, appearing to be 'C. Boykin'.

FROM: Mr. Daniel Willey  
DE: Compliance Officer  
Investment Management Division  
United Nations Joint Staff Pension Fund

A handwritten signature in purple ink, 'Daniel Willey', with the date '10 August 2015' written below it.

SUBJECT: **Draft report on an audit of management of external portfolio managers in the**  
OBJECT: **Investment Management Division of the United Nations Joint Staff Pension Fund**  
**(Assignment No. AS2015/801/01)**

1. Reference is made to your memorandum dated 13 July 2015 providing the report on the above-mentioned audit.
2. I am pleased to provide IMD's comments on the findings and recommendations as requested. Please find attached the Annex I to the audit recommendations which details IMD's response to the findings.

With reference to paragraph 23 in the draft report, IMD notes that in its selection process for external managers, it does use a documented assessment of a manager's risk/return profile as supported by the attached document.

3. I wish to thank you and OIOS for the recommendations made following the review and for the positive interaction with IMD staff regarding this matter.

cc: Mr. Toru Shindo, Deputy Director, Investment Management Division, IMD  
Mr. Daniel Willey, Compliance and Audit Focal Point, IMD  
Ms. Cynthia Avena-Castillo, Professional Practices Section, Internal Audit Division, OIOS  
Ms. Stara Khan, Senior Risk Assistant, IMD  
Ms. Wasantha Jayasinghe, Senior Compliance Assistant, IMD

## Management Response

**Audit of management of external portfolio managers for small capitalization investments  
in the Investment Management Division of the United Nations Joint Staff Pension Fund**

Rec. no.	Recommendation	Critical <sup>1</sup> / Important <sup>2</sup>	Accepted? (Yes/No)	Title of responsible individual	Implementation date	Client comments
1	The Investment Management Division should develop objectives and strategic direction for small capitalization investments and define the basis for allocation to the small capitalization investment category.	Important	Yes	Deputy Director of Investments, and Deputy Director of Risk & Compliance	30 June 2016	Working with the IMD Risk Section the IMD Investment Section will formalize the objectives and strategic direction for IMD small capitalization investments including its allocation basis.
2	The Investment Management Division should enhance and develop the necessary capacity to implement the procedure for the selection of external portfolio managers.	Important	Yes	Deputy Director of Investments	30 June 2016	IMD will formally document a procedure for the selection of external portfolio managers. This procedure will be incorporated into IMD's Investment Procedures Manual.
3	The Investment Management Division should develop guidelines to effectively evaluate and monitor the performance of external managers. Such guidelines should include criteria to conduct risk-adjusted performance assessment.	Important	Yes	Deputy Director of Investments, and Deputy Director of Risk & Compliance	30 June 2016	The IMD Risk Section will formalize and document the needed criteria to better monitor and evaluate the performance of IMD's external managers on a periodic basis.

<sup>1</sup> Critical recommendations address significant and/or pervasive deficiencies or weaknesses in governance, risk management or internal control processes, such that reasonable assurance cannot be provided regarding the achievement of control and/or business objectives under review.

<sup>2</sup> Important recommendations address important deficiencies or weaknesses in governance, risk management or internal control processes, such that reasonable assurance may be at risk regarding the achievement of control and/or business objectives under review.