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FINANCE COMMITTEE

Hundred and Thirty-eighth Session

Rome, 21 – 25 March 2011

Report on Investments 2010

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EXECUTIVE SUMMARY

- Long-Term Investments: This USD 316 million portfolio represents the accumulated assets set aside over a period of decades to fund the Organization's share of staff-related liabilities, which amount to USD 1,141 million at 31 December 2010. The liabilities are comprised of: Staff Compensation Plan, Separation Payment Scheme, After Service Medical Coverage (ASMC) and the Termination of Service Payment Scheme. Invested assets are 50% in Equities and 50% in Fixed Income securities. In 2010, global financial markets began to recover from the extreme volatility of the previous year. The long-term portfolio returned 5.26% versus 4.86% for the benchmark.
- Short-Term Investments: This USD 1,023 million portfolio represents mainly unspent Trust Fund balances held pending disbursements on project implementation. Funds are diversified as to type and holdings among five specialized asset managers. FAO's conservative, low risk investment style and the near zero interest rate environment in 2010 kept returns very low, with a total return of 0.22% for the year. However, this exceeded the benchmark return of 0.13%.
- Investment Governance: The asset allocation of Short Term investments is designed in close collaboration with the Organization's technical advisor, the World Bank. Every few years, a detailed Asset and Liability study (ALM) is done by an external advisor on long-term assets. The last was completed at end December 2008. The asset allocation recommendations are reviewed and commented on by the internal Investment Committee and the external Advisory Committee on Investments with final authorization on implementation taken by the Director-General.
- Action and Events 2010, Outlook 2011
 - a) The Organization assigned a short-term investment mandate to the World Bank in 2010 in order to increase diversification and at the same time to leverage the Bank's highly sought advisory and training services.
 - b) Rollout began during 2010 of FAO's electronic banking in field offices, with a number of locations fully operational. Further rollout and implementation of electronic banking at Decentralized locations is planned in 2011.
 - c) The Organization continued to play a leadership role in the area of enhanced partnerships and collaboration amongst Treasury functions across the UN Common System and others. FAO's active engagement led to the selection of an external consultant to conduct a feasibility study on Common UN Treasury services and a report on selected areas of harmonization is expected in 2011.

GUIDANCE SOUGHT FROM THE FINANCE COMMITTEE

- The Finance Committee is invited to take note of this information document.

Draft Advice

- **The Finance Committee takes note of the Report on Investments 2010.**

BACKGROUND

1. This document is submitted to the Finance Committee for information, in accordance with Financial Regulation IX, which provides, in part, as follows: “*The Director-General may invest monies not needed for immediate requirements seeking, wherever practicable, the advice of an Advisory Committee on Investments. At least once a year the Director-General shall include in the financial statements submitted to the Finance Committee a statement of the investments currently held.*”

Long-Term Investments

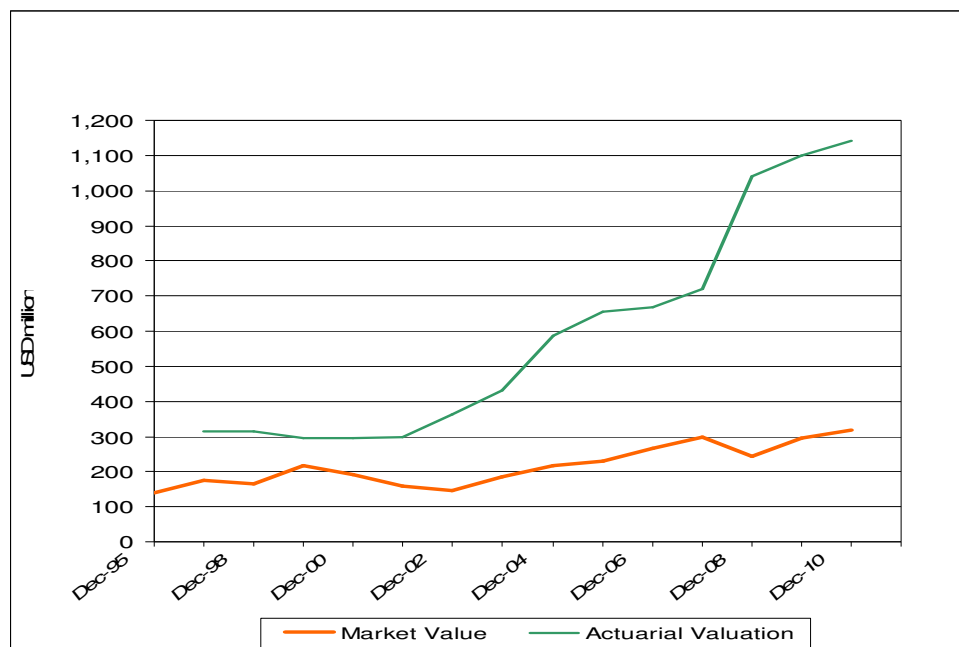
2. The long-term investment portfolio represents an accumulation in the value of securities and re-invested income over more than 30 years.

3. The principal objective of the portfolio is to fund the Organization’s share of staff-related liabilities:

1. Staff Compensation Plan – Provides benefits in the event of injury, illnesses or death attributable to the performance of official duties.
2. Separation Payment Scheme – In conformity with the Flemming principle adopted in the UN system regarding local employment conditions, this scheme for General Service staff is similar to the separation scheme provided under Italian labour legislation.
3. After Service Medical Coverage (ASMC) – A medical insurance plan for eligible retired staff and their families where the cost of insurance is shared between the retiree and the Organization.
4. Termination of Service Payment Scheme – Consists of benefits payable to staff upon separation from service; Repatriation Grant, Repatriation Travel and Removal, Commutation of Accrued Leave, Termination Indemnity.

4. The chart below shows the evolution of the long-term investment portfolio since 1996 compared to the actuarial valuations of the staff-related liabilities.

Long-Term Investment Portfolio
Market & Cost Value compared to Actuarial Valuation



5. An actuarial valuation of these liabilities has been performed each biennium since 1996-97. The last valuation as of 31 December 2010, carried out by a specialized firm, placed the Organization's share of total staff-related liabilities at USD 1.141 billion, only slightly above the figure for 2009 of USD 1.1 billion. Staff-related liabilities are under review by the Finance Committee in document FC 138/4 - *2010 Actuarial Valuation of Staff Related Liabilities*.

6. The latest actuarial estimation of all staff-related liabilities included USD 982.6 million representing the liability of After Service Medical Coverage (ASMC). The Conference authorized biennial funding towards the past-service ASMC liability of USD 14.1 million in 2010-11. The same amounts were authorized in 2004-05, 2006-07 and 2008-09. Proposals for funding in the 2012-13 biennium are under review by the Finance Committee in document C 2011/3 - *Medium Term Plan 2010-13 (Reviewed) and Programme of Work and Budget 2012-13*.

7. The ASMC Funding for 2010-11 was assessed in both EUR (67%) and USD (33%) in line with the currency mix of the liability. As agreed by the Finance Committee, assessed funds were transferred into the investment portfolio based on the percentage of total Member contributions actually received. Following this methodology, USD 0.54 million and EUR 4.9 million were transferred to the long term portfolio in 2010, representing approximately 93% of the annual assessed total.

8. The asset allocation of the portfolio provides for a 50/50 ratio between equities and bonds. The actual allocation at market value at 31 December 2010 was as follows:

	Invested (USD)	% Total	Investment Manager
Equity	158,737,927	50.2	PanAgora
Fixed Income	157,662,074	49.8	Western
Total	316,400,001	100	

9. Rebalancing of the funds occurs at month end if the ratio is out of balance by more than 5%. When possible, active rebalancing by FAO Treasury using ASMC contributions is carried out.

10. The measurement of performance is by comparison to the following benchmarks:

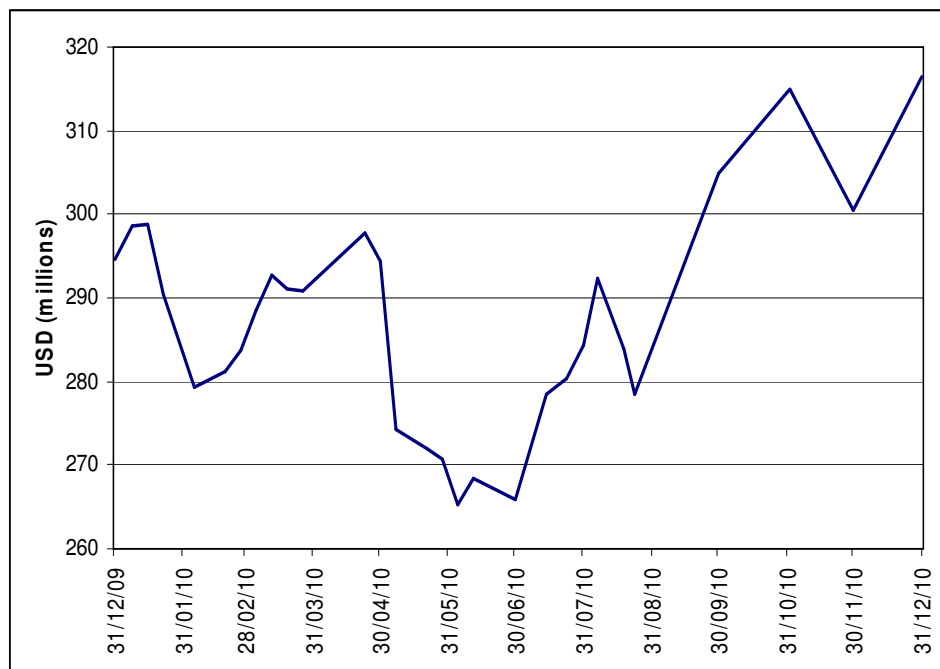
- For the equity portfolio: The Morgan Stanley Capital International Inc All Country Index
- For the fixed income portfolio: A blend of 80% Barclays World Inflation Linked Bonds Index + 20 % and Merrill Lynch Government AAA Bonds

It should be noted that the Organization changed the fixed income portfolio benchmark in the second quarter of 2010, following a decision by the Investment Committee to better align the benchmark to FAO's low risk approach (see paragraph 30).

11. These benchmarks fairly represent the geographical and sector allocation of the portfolio and have been reviewed by the Investment Committee and by the Organization's investment technical advisor, the World Bank.

12. The Chart below illustrates the evolution of the long-term investment portfolio in 2010.

Long-Term Investment Portfolio, Market Value 2010



13. Movements in the long-term portfolio during the year are summarized below. Non-USD values are expressed in USD using the exchange rate valid at 31 December 2010.

Cash Flow 2010	Amount in USD
Market Value at 31/12/2009	294,709,996.00
Net variance of unrealized gain/loss	-1,493,236.50
Realized gain/loss	10,221,533.77
Income, dividends and interest	7,350,709.85
Management, custodial and advisory fees	-1,182,321.86
ASMC Funding	7,019,626.69
Accrued Income Change	-226,307.08
Market Value at 31/12/2010	316,400,000.87

- a) It should be noted that equity investments are reported in USD, while fixed income investments are reported in EUR. Therefore, in order to arrive at an overall return, fixed income returns were converted to USD. Consequently, the combined return reflects both the returns of the two funds and the currency effect of USD/EUR movements over the year. This combined return in 2010 for the long term funds expressed in USD was 5.26% versus 4.86% for the benchmark.

2010 Performance	
<u>Equity</u>	
Pan Agora	13.75%
<i>MSCI World Benchmark</i>	<i>12.05%</i>
<u>Fixed Income</u>	
Western Asset Management	3.45%
<i>Benchmark</i>	<i>4.45%</i>
Total Portfolio	5.26%
<i>Benchmark</i>	<i>4.86%</i>

Note:

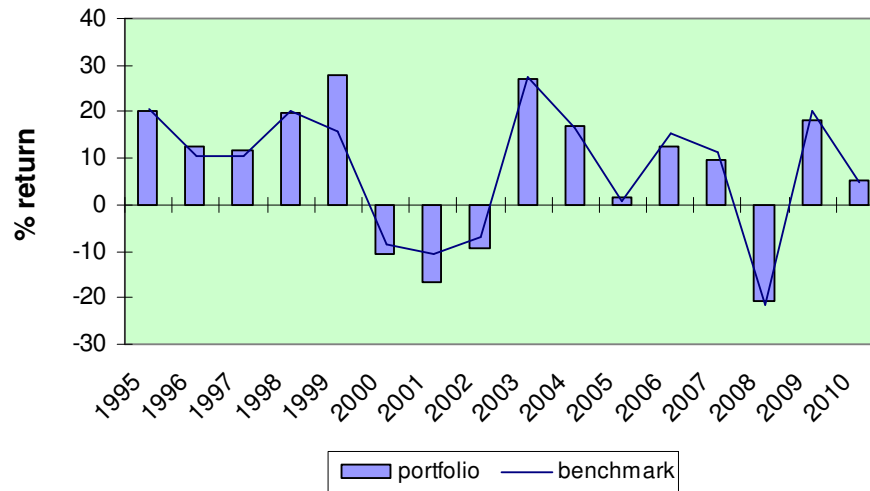
Equity Returns based in USD

Fixed Income returns based in EUR

Combined returns based in USD

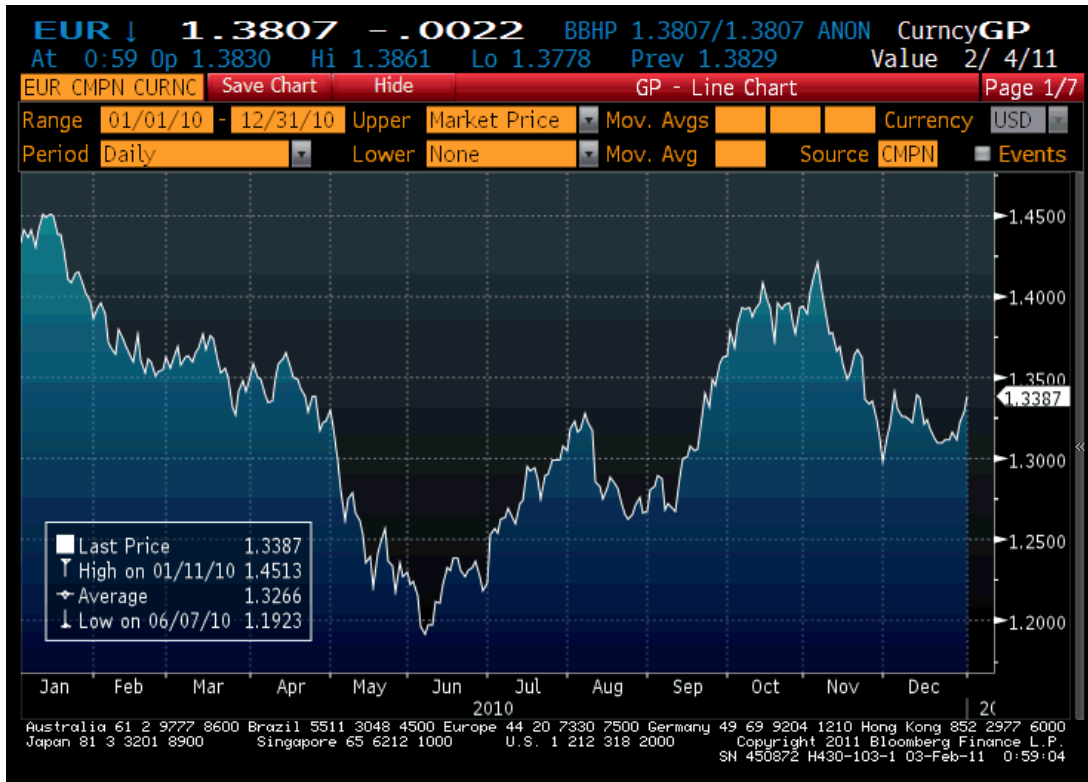
- b) Yearly performance figures of the long-term portfolio from 1995-2010 are shown below.

**Long-Term Portfolio
Performance since 1995**



- c) The below chart illustrates the movements in the USD/EUR rate over the course of 2010. USD/EUR volatility was less than in previous years. However, movement in the value of the EUR has a direct effect on USD measured returns.

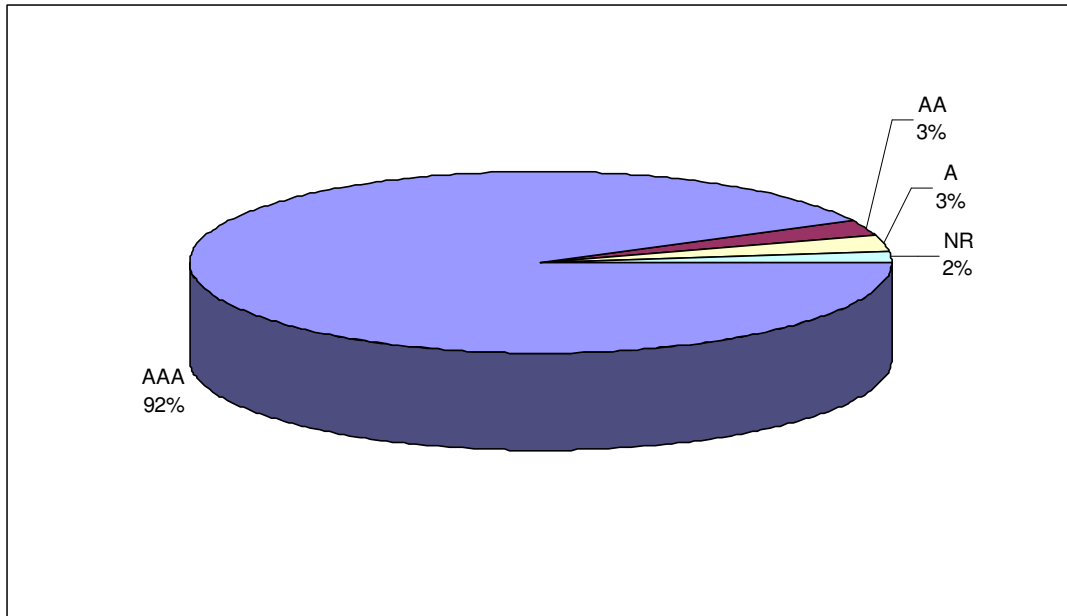
EUR/USD Foreign Exchange Rate, January - December 2010



(Source: Bloomberg)

14. The below chart provides a breakdown of the assets in the long-term fixed income portfolio by credit quality. During the year, the percentage of assets in AAA rated securities increased from 73% to 92% as the Organization continued to reduce the risk profile of the portfolio given the persistently adverse conditions of financial markets.

Long-Term Fixed Income Portfolio
Credit Quality Distribution of Assets at 31 December 2010



Short-Term Investments

15. Short-term investments consist largely of Trust Fund deposits held pending disbursements on project implementation and any cash representing the reserves of Regular Programme and other assets. The investments are managed by specialised asset managers in short-term investments: Wellington Management, the Northern Trust Company, HSBC and the World Bank or invested in deposits with the Bank for International Settlements.

16. The market value (in USD) in the short-term portfolios is illustrated in the table below:

	<u>At 31 December 2010</u>
Wellington Management	181,999,913
NT Government Select fund	40,495,569
HSBC USD Liquidity fund	44,679
HSBC EUR Liquidity Fund	11,754,645
Bank for International Settlements	590,016,813
World Bank	200,034,637
Total	1,024,346,256

17. During 2010, the Organization continued to keep a very low risk exposure of its short-term assets in light of the ongoing volatility and insecurity of financial markets and the very low interest rates in USD.

Specifically:

- a) Wellington Management: the Organization continued to impose very restrictive guidelines allowing only investments in very low risk instruments or instruments fully guaranteed by the US Government such as United States (US) Treasury Bills, US government agencies' and US government backed securities.
- b) Northern Trust: Holdings in the Northern Trust Government Select Fund were kept at low levels after the expiration on 18th September 2009 of the US Treasury Guarantee Programme for Money Market Funds.
- c) HSBC USD Liquidity Fund: The Organization continued to maintain very low holdings in this liquidity fund due to its exposure to securities in banks and the financial services industry.
- d) HSBC EUR Liquidity Fund: The Organization has traditionally had limited cash balances in EUR due to delays in the receipt of contributions. Consequently, balances invested in EUR remained proportionally low throughout 2010.
- e) BIS: Continuation of high level deposits at the BIS in view of its outstanding credit quality arising from its structural integration with 50 central banks and monetary authorities.
- f) World Bank: New portfolio with restrictive guidelines and tight risk limits allowing only investments in government securities, government agencies, other official entities and multilateral organization securities and high ranked bank and other financial institution obligations.

18. The end result of such risk mitigating measures implies that approximately 97.5 % of FAO's investment portfolio is currently secured in risk-free or very low risk instruments. The table below outlines the proportional distributions by asset-type as per 31 December 2010:

Type of Assets	Portfolio (USD millions)	Distribution (%)	Risk Profile
United States Treasury Bills/Notes	224	22	none
Funds fully guaranteed by US Government	100	10	none
Bank for International Settlements Agencies	590	58	negligible
	85	8	very low
Others (Cash/Bank Deposits, CDs)	26	2	low
Total	1,024	100	

19. The performance of short-term portfolios during the course of 2010 was dominated by the extremely low interest environment for very low risk USD investments. The overall performance was 0.22% for the year.

Fund Manager	Return, net of fees
Wellington Management	0.42%
World Bank (from November 2010)	0.02%
NT Government Select Fund	0.07%
HSBC USD Liquidity Fund	0.30%
HSBC EUR Liquidity Fund	0.55%
Bank for International Settlements (BIS)	0.18%
Overall Performance USD (weighted Average)	0.22%
Benchmark	
Merrill Lynch 3 Month T-Bills (USD)	0.13%

The benchmark returned 0.13% for this same period, and the chart below shows the progression of the rate through the year.



(Source: Bloomberg)

Investment Governance at FAO

20. A detailed strategic asset allocation review for Long Term investments is conducted by specialized firms within the context of an Asset and Liability study (ALM). Reviews are conducted approximately every five years. A last study was undertaken and finalized in December 2008.

21. Short Term asset allocation strategies are designed in close collaboration with FAO's technical investment advisor, the World Bank.
22. The results of asset allocation studies are reviewed by FAO's internal Investment Committee. Final recommendations are forwarded to the Director General for approval. The Investment Committee is made up of the heads of finance, budget, legal, audit, the treasurers of IFAD and WFP and is chaired by the Assistant Director-General of Corporate Services, Human Resources and Finance Department.
23. The Organization also seeks investment advice from the Advisory Committee on Investments in accordance with Financial Regulation 9.1. The ACI is an external committee composed of high level experts from organizations such as World Bank, IMF, BIS and the African Development Bank. The World Bank also serves as the Organization's technical investment advisor.
24. The management of assets in the equity and fixed-income markets is carried out by specialized external asset managers in accordance with FAO's detailed written guidelines. These managers are chosen through open, international call for tenders with a final selection process carried out with the assistance of the World Bank.
25. Day-to-day control over the external managers, including daily compliance monitoring, is done by the Organization's Treasury Branch in Finance Division. The Treasury unit also provides regular reporting to the Director of Finance, internal Investment Committee and Senior Management. On-site compliance visits to the external asset managers and the securities custodian are carried out by Finance Division annually.
26. Finally, a detailed report on FAO's investments is provided annually to the Finance Committee. This report is available on internet website of the Finance Committee.

Actions and Events 2010, Outlook 2011

27. The investment expense ratio further declined in both percentage and actual terms, dropping to 0.12% in 2010 from 0.16% in 2009. In 2008, the figure was 0.21%.

Investment Service Provided	2010 Expenditures in USD
Management, custodial and advisory fees	1,182,322
Treasury staffing (two professional posts)	434,928
Bloomberg Terminal	22,629
Advisory Committee on Investments Meetings	22,196
Annual Investor Compliance Meetings	11,896
Total Expenses	1,673,971
Total Invested Assets	1,340,746,257
Total Expense Ratio	0.12%

28. As short-term markets stabilized and volatility diminished, the Organization added another short-term investment mandate to further increase diversification. USD 200 million was allocated to the World Bank's investment arm. As part of this mandate, the Organization also participates in the Bank's RAMP (Reserves Advisory and Management Programme). As a RAMP participant, the Organization receives free access to World Bank advisory services as well as ten

training slots per year on a range of key topics of concern, including general treasury, investment management, accounting and legal issues.

29. The Organization terminated the mandate of one of its equity managers, Axa-Rosenberg, after the firm failed to disclose pertinent information regarding an error in their investment modelling process to all affected clients in a timely manner. The Organization consolidated its equity investments with its second manager, Pan Agora, pending further review of the investment allocation by the Investment Committee.

30. As noted in paragraph 10, the Organization changed the fixed income portfolio benchmark in the second quarter of 2010, following a decision by the Investment Committee to better align the benchmark to FAO's low risk approach. This decision was taken in view of the severe crisis in government bond markets culminating in a near-collapse of peripheral EURO inflation-linked bond issuers. Furthermore, it was recognized that a Europe-exclusive benchmark with its direct embedded exposure to the vulnerable southern Europe countries did not represent FAO's optimal risk appetite on long-term investments. Accordingly, the Organization's Investment Committee decided to change the benchmark for the fixed-income portfolio as follows:

- From: 80 % Barclays EURO Government Inflation-Linked bond Index + 20 % Merrill Lynch EMU Direct Government Index; to
- **To: 80 % Barclays Bank World Government Inflation-Linked Bond Index + 20 % BOFA Merrill Lynch EMU Direct Govt AAA Bond Index.**

This adjustment of the benchmark has led to:

- Greater diversification of country exposure with substantial reduction of Europe only exposure;
- Increased exposure to AAA rated countries.
- Greater diversification to inflation exposure worldwide instead of limited EUR area;
- Clear expression of FAO preference for diversification; and
- Substantial reduction of Europe contagion risk.

31. The Organization began its rollout of electronic banking to select field offices in 2010. Finance Division has tested and is currently working with the e-banking systems of five key regional partners. Electronic banking was set up in 8 offices during the year and a smooth transition from a manual, cheque based system to wire transfers has begun. The Organization plans to increase its efforts in electronic banking implementation in 2011 to take advantage of the new benefits of the Oracle Release 12 upgrade.

32. During the course of 2010, the Organization continued its key role in the Working Group on Common Treasury Services of the High-level Committee on Management's Finance and Budget Network aimed at improving the level of consistency and harmonization of practices and procedures governing treasury services across the UN system. During the fourth quarter of 2010, the Working Group selected an external consultant through a competitive procurement process to conduct a feasibility study on Common UN Treasury services. In this regard, the external consultant will review four key treasury areas: investment strategy, cash management and payments, banking structures and foreign currency management. The external consultant's final recommendations on harmonization, expected in mid-2011, are expected to consider the following items:

- Definition of common treasury services
- Prioritization of common service opportunities based on feasibility (legal, financial, infrastructure)
- Evaluation of costs / benefits of each potential service
- Identification of major divergences in existing UN treasury operations
- Identification of legal framework options for delivery of common services