2010 Annual Report on WFP Investment Management

1. Introduction

This document is presented in response to a request made by the Board at its 2010 Annual Session for further details of the management of WFP investments and complies with the External Auditor recommendation to present on an annual basis a summary of investment performance, risks and policy compliance.

The document sets out:

- the background to WFP's investment management;
- the governance structure and access to external expertise;
- overview of WFP investment portfolios[1] and annual performance; and
- overview of risk management, investment monitoring and compliance procedures used to provide assurance on investment policy implementation

The report was reviewed by both the Investment Committee and the Audit Committee in March 2011 and feedback from both Committees has been reflected in this report.

2. Background

The Secretariat assumed responsibility for the management of WFP financial resources in 1999, which led to the development of WFP investment policy and cash and investment management strategies. The management of financial resources is governed by Financial Regulation 11.2 which states: "Monies not required immediately may be invested by the Executive Director, bearing in mind the need for safety, liquidity and profitability". In line with Financial Rule 111.3, the Executive Director issues investment policy circulars from time to time and may employ outside expertise.

Since February 2000, WFP has used external investment managers for its short-term investment portfolio and the long-term employee benefit fund portfolio. They are appointed after competitive selection and operate under strict guidelines. Four investment managers currently manage the short-term investment portfolio, while the employee benefit fund portfolio is entrusted to two investment managers.

The first Executive Director's circular on investment policy came into effect on 30 September 1999. It was amended in the fourth quarter of 2006 on the basis of advice from the World Bank Treasury with effect from 1 January 2007; the amendments were reported to the Board in "Report on Changes to WFP's Investment Policy" (WFP/EB.2/2006/5-I/1). A further update on WFP investment policy and guidelines was presented to the Board in November 2009 (WFP/EB.2/2009/5-F/1) and is still applicable.

[1] This report does not include long-term investments in United States Treasury bonds ('STRIPS') held to maturity to meet interest and principal repayment obligations relating to a once-off long-term loan structure. This investment portfolio is reflected in the Annual Accounts at amortized cost of USD 85.5 million and the only activity during the year was the maturity of one bond to meet annual interest repayment obligation.

3. Governance structure and access to external expertise

The Investment Committee was created in September 1999 by the Executive Director (ED1999/003) and the mandate of the Committee was last renewed in July 2010 (ED2010/009). The Investment Committee performs a strategic advisory and monitoring role to the Executive Director. The mandate of the Investment Committee is to make recommendations to the Executive Director on the formulation and implementation of policy and strategy regarding investment management, foreign exchange management, and the formulation of policy and strategy on the use of financial services providers. The membership consists of senior directors representing a broad section of functional areas of the Programme. In 2010 the Investment Committee met on four occasions and reviewed amongst others the liquidity portfolio asset allocation, investment performance review, foreign exchange exposures and Employee Benefit Fund investment policy.

In the recent past the Audit Committee recommended that WFP appoint external investment experts to support the Investment Committee and the Executive Director in its deliberations on investment management issues. During 2010 the Investment Advisory Panel was created and is composed of five external investment experts with wide ranging expertise in investment management, banking and corporate treasury. The membership includes senior directors with board level expertise in pension fund management, endowments, sovereign wealth management, investment banking and multinational corporation. The first Investment Advisory Panel meeting was held at WFP in November 2010. The Panel met with the Executive Director to discuss developments in financial markets that could impact the management of WFP's financial resources. In addition the Panel held a joint session with the WFP Investment Committee to discuss specific issues such as investment policy and guidelines, investment management mandates, asset allocation and funding models. The expert opinions from the Panel members are considered by the Investment Committee and included in its advice to the Executive Director, where applicable.

Since 2004 WFP has availed of the services of the World Bank to obtain technical advisory services in the areas of investment management and related activities. During 2010 it was decided to expand the co-operation via the participation in the Reserve Advisory and Management Programme of the World Bank Treasury. This programme allows WFP to access the knowledge base of the institution as well as ensuring the cost efficient solution for WFP to obtain advisory and capacity building services by linking such to a new short-term investment management mandate which will commence in 2011.

4. WFP Liquidity Portfolio

The Liquidity portfolio comprises cash balances related to programme category funds, bilateral operations and trust funds, and the General Fund and special accounts. The primary objective of the investment policy for this portfolio is preservation of the value of resources in US dollar terms. The main considerations for investment management are security of principal, liquidity and rate of return, in line with Financial Regulation 11.2.

The investment policy aims to optimize the management of WFP's liquidity portfolio in line with WFP's investment objectives, investment horizons and risk tolerance levels. To make the best use of WFP's risk-bearing capacity and to add value, the liquidity portfolio is separated into three tranches with different investment timeframes:

- o Portfolio tranche 0 (P0), the working-capital portfolio, accommodates working-capital funds that may be required in the very near future.
- o Portfolio tranche 1 (P1), the short-term portfolio, accommodates operational funds with a three-month investment horizon.
- o Portfolio tranche 2 (P2), the medium-term portfolio, accommodates funds and reserves with an investment horizon of about one year.

The allocation of funds to different tranches is conservative: 17 percent are maintained in P0, 68.8 percent in P1, 12.5 percent in P2 and 1.7 percent in the legacy portfolio[2]. Allocation is based on WFP's underlying funds and reserves and their expected cash-flow profiles. Asset allocation is reviewed by the Investment Committee before proposals are presented to the Executive Director for decision. In view of the continued uncertainty in global financial markets, most funds are currently maintained in P0 and P1 to limit interest rate and liquidity risks.

The investment policy includes a framework for reviewing asset allocations, the policy itself and risk-tolerance levels at least once every three to five years. It has been a continuous process since the start of the global financial crisis, in cooperation with the investment adviser. The last full review of the investment policy with the World Bank Treasury was completed in August 2009 and a new review exercise is planned for 2011.

Table 1: Asset allocation across portfolio tranches

Portfolio Tranche	31 December 2009		31 December 2010	
	Market Value	% of Total	Market Value	% of Total
P0 / Money Market (3 funds)	603,462,421	42.6%	203,413,590	17.0%
P1 (4 portfolios)	621,307,932	43.8%	825,769,928	68.8%
P2 (1 portfolio)	147,280,513	10.4%	149,944,627	12.5%
Legacy (2 portfolios)	45,970,483	3.2%	20,349,332	1.7%
TOTAL *	**1,418,021,349**	**100%**	**1,199,477,477**	**100%**
* Market values include accrued interest which is recorded separately in the Audited Accounts				

P0 is invested in three USD denominated money market funds that invest in securities issued or guaranteed by the United States Government. WFP holds a participation in the funds, which can be accessed on a day-to-day basis, so no investment guidelines are applicable. Trust fund balances are maintained in P0.

The main change to asset allocation during the year occurred in April 2010 when US$ 200 million was transferred out of the Money Market funds and into the P1 tranche of the Liquidity Portfolio. The rationale behind the change in asset allocation was to improve interest income whilst maintaining overall investment risk at levels acceptable under the Investment Policy guidelines.

[2] This portfolio was established in November 2008 and holds securities that are no longer in compliance with new more conservative investment guidelines and which are divested gradually.

The legacy portfolio was created in November 2008 following a change to more conservative guidelines, which made certain securities with higher volatility held in the Liquidity Portfolio no longer compliant. In order to avoid high transaction costs due to the difficult market environment and limited liquidity prevailing at the time, two investment managers were instructed to manage this portfolio class and liquidate the portfolio gradually in order to maximise proceeds. The legacy portfolio initial holdings amounted to US$ 184 million and reduced to US$ 46 million at year end 2009. During 2010 the portfolio reduced to US$ 20.3 million and US$ 33 million of cash was transferred to Money Market funds. Unrealised gains of US$ 13.9 million more than offset realised losses of US$ 7.4 million for the year. The divestment timeline is for a complete liquidation of the Legacy portfolio by year-end 2011.

The short-term investment portfolio (P1, P2 and Legacy) 2010 return was 1.63%, resulting in another significant outperformance of 1.50% versus the primary benchmark (US T-Bill 3 month) of the P1 portfolio holding the majority of funds. Fixed income markets saw a continuation of the price normalisation in non-government Treasury fixed income sectors. The resilient performance of holdings in asset-backed securities, agency debt and corporate bonds were all contributing factors to this year's outperformance. Relative to 2009 the extent of the outperformance diminished mainly due to the base effect of bond markets being considerably depressed at the beginning of 2009 and their subsequent recovery not being matched in 2010. Since inception (February 2000), the annualized return is 3.17%. The 2010 return on the working capital portfolio was 0.06% bringing the total 2010 return on the liquidity portfolio to 0.93% at the end of December 2010.

Table 2: Investment Performance Liquidity Portfolio as of 31 December 2010

Investment Manager	Market Value as at 31/12/10	2010 Performance	2009 Performance
Total Portfolio Tranche P1	**825,769,927**	**0.61%**	**2.35%**
Benchmark: US 3 month T-Bill index		*0.13%*	*1.45%*
Total Portfolio Tranche P2	**149,944,627**	**1.81%**	**3.78%**
Benchmark: ML US Treasury 0-3 year		*1.83%*	*0.78%*
Total Legacy	**20,349,333**	**19.88%**	**23.72%**
Total Short Term Investments	**996,063,887**	**1.63%**	**4.53%**
Total Money Market Accounts - P0	**203,413,590**	**0.06%**	**0.20%**
Benchmark: US 0-3 month T-Bill index		*0.13%*	*0.14%*
Total Liquidity Portfolio *	**1,199,477,477**	**0.93%**	**2.33%**

* Market values include accrued interest which is recorded separately in the Audited Accounts

2010 saw continuing economic recovery around the world with growth accelerated throughout the year, but for many developed countries it was insufficient to bring down the rate of unemployment. This backdrop triggered a new round of monetary stimulus via bond purchases in the US forcing yields to remain exceptionally low for a prolonged period. Improved liquidity and risk appetite made credit and structured bonds outperform US Treasuries.

Interest rates are expected to stay at low levels in 2011 as monetary policy remains accommodative. Short-term investment returns are expected to be in the range of 0.25-0.75%.

Main financial risks of the Liquidity portfolio are credit, interest rate and liquidity risks. Following the implementation of stricter investment guidelines and a significant reduction of the Legacy portfolio in 2009, the overall financial risks across the WFP investment portfolios were further reduced. The portfolios remain very conservative with the primary objective being capital preservation. The Liquidity Portfolio holds very high quality securities. The average credit rating for the short-term portfolio (excluding legacy assets) is AAA, the highest rating assigned by independent rating agencies.

The short-term portfolio interest rate (or effective duration) risk is low at 0.44, meaning that a 1% rise in interest rates would lead to a 0.44% decline in the overall value of the portfolio. The overall liquidity of the portfolios remains extremely high and has continued to improve over the year. The percentage of assets classified as highly or fairly liquid increased from 88% at the beginning of the year to 91% as of 31 December 2010. These assets can be liquidated immediately or at very short notice to meet WFP operational requirements.

5. WFP Employee Benefit Fund Portfolio

The employee benefit funds represent funds set aside to cover long-term employee benefits liabilities that consist of the After-Service Medical Plan, Separation Payments Scheme, Compensation Plan Reserve Fund, and Other Separation Related Benefits.

The Employee Benefit Funds portfolio was funded in 2003 with an original amount of US$ 65 million and reached a level of US$ 165 million by year end 2010, with contributions of US$ 62.3 million taking place in the period 2006-2010.

The Employee Benefits Fund portfolio is made up of two portfolios, an actively managed fixed income portfolio and a passive equity portfolio. The bond portfolio equates to 47% of the Employee Benefit portfolio with the remaining 53% invested in global equity index funds. The market values and relative weights across each asset class as at 31 December 2010 are shown below:

Table 3: Employee Benefit Fund Market Values Across Asset Classes

Asset Class	31 December 2009		31 December 2010	
	Market Values US$	% Total	Market Values US$	% Total
Cash & equivalents	547,539	0%	870,271	1%
Government Bonds	46,009,222	37%	51,343,117	31%
Government Agency	6,754,227	5%	3,981,457	2%
Corporate & Municipal	22,253,753	18%	21,675,254	13%
Equities	48,428,203	39%	87,576,239	53%
TOTAL *	**123,992,944**	**100%**	**165,446,339**	**100%**

* Market values include accrued interest which is recorded separately in the Audited Accounts

The effective duration of the Global bond portfolio is 5.94 years and has an average Moody's and Standard & Poor's credit rating of Aa1 / AA+ respectively.

As part of the move to IPSAS, WFP has fully recognized all employee benefit liabilities since 31 December 2007 in the Statement of Financial Position. Although all employee benefit liabilities are recognized, not all of them are funded. As of 31 December 2010, total long-term employee benefit liabilities were US$ 286.4 million, of which US$ 166.3 million were funded (58% funding ratio). WFP approach is that only those long-term employee benefit liabilities that have been funded, meaning they have been charged against relevant funds and projects, will have investments set aside in the Employee Benefit Funds portfolio.

In early 2010 a new asset-liability study (ALM study) for Employee Benefit Funds was completed by Ortec Finance, a leading global provider of solutions for holistic risk/return management for pension funds, insurance companies and asset and wealth managers. The study increased the understanding of the liabilities, developed an updated asset allocation policy for the funds and, in line with a recommendation from the External Auditor, formulated funding targets and made recommendations for policy options to achieve such targets.

The report made three main recommendations:

1. Increase the equity asset allocation weighting from 40% to 50% and decrease the bond allocation from 60% to 50%.
2. Change the currency composition of the asset portfolio from 75% US$ and 25% EUR split to a new 50% US$ and 50% EUR in order to closely match the distribution of future liabilities.
3. Secure additional funding of US$ 7.5 million per annum in order to achieve a fully funded status over a 15 year period starting in 2011.

The asset allocation and currency composition decisions were approved by the Executive Director in January 2010 and the new funding policy was approved by the Executive Board in June 2010 to address recommendation 3.

In 2010 an investment of cash in the amount of US$ 31.3 million (representing amounts charged to funds and projects in relation to the employee benefit liabilities) was performed to implement the new asset allocation as per the first recommendation above. The revised currency composition will be implemented in 2011 as part of a comprehensive review of the Employee Benefit Fund mandates and guidelines.

Table 4: Investment Performance Employee Benefit Funds Portfolio as of 31 December 2010

Investment Manager	Market Value as at 31/12/10	2010 Performance	2009 Performance
Global Bonds	77,828,282	3.05%	5.63%
Benchmark: 60% Barclays Global Aggregate / 40% Citi World Government t Bonds Index		*1.87%*	*4.69%*
Global Equities	87,618,057	11.38%	29.98%
Benchmark: MSCI World		*12.34%*	*30.79%*
Total Employee Benefit Funds *	**165,446,339**	**7.51%**	**13.98%**

* Market values include accrued interest which is recorded separately in the Audited Accounts

The actively managed fixed income portfolio outperformed the benchmark index of 60% Barclays Global Aggregate Index / 40% Citi World Government Bond Index (euro holdings un-hedged) by 1.18%. Interest rates positioning, sector allocation and currency selection all contributed to relative returns. The passive equity portfolio rose by 11.38% on the back of resilient corporate earnings, positive outlook statements and a return of risk appetite in financial markets. Since inception, the Employee Benefit Fund portfolio has returned 4.79% on an annual basis.

Main financial risks of the Employee Benefit Fund portfolio are credit, interest rate and market risks. The average credit rating for the Global Bond portfolio is AA+, the second-highest rating assigned by independent rating agencies. The rating is conformably above the minimum weighted average rating of A stipulated in the investment guidelines. The long-term nature of the Bond portfolio means it is more sensitive to interest rate changes compared to the Liquidity portfolio. At year-end the effective duration was 5.94, in line with the benchmark duration of 6.02. The Bond portfolio is a diversified portfolio allowing credit and currency exposure under specific guidelines consistent with the objective of long term returns to fund employee benefit liabilities and therefore could show higher level of volatility over shorter time periods. Investments in equities are made through five regional funds which track the composition and performance of the Morgan Stanley Capital International (MSCI) World Index, a recognised index of stocks to all developed world markets. This investment structure provides exposure to global equities markets on a passive basis with risks and returns that mirror the MSCI World Index.

6. Risk Management, Investment Monitoring and Compliance

WFP uses a global custodian bank that provides global safe keeping of securities with its network of sub-custodians and depositories. Securities' trade settlement and interest collection are also processed through the custodian. Other important services include monthly valuations and accounting reports, performance and risk measurement, compliance monitoring as well as other ancillary services like money market funds. Importantly, the global custodian bank provide its valuation and reporting services independently from the organizations' external and internal investment management functions and therefore the custodian bank helps ensure independent and consistent valuations across all investments. Northern Trust provides custody services to WFP and assets held under custody amount to approximately US$ 1,200 million as of 31st December 2010. The custody services contract with Northern Trust was renewed for a further three year period in January 2010 following a joint selection process with FAO and IFAD.

The performance of the investment managers and their compliance with the investment guidelines are monitored daily, monthly and quarterly. An online compliance monitoring system provided by the custodian is used on a daily basis; potential discrepancies are investigated and where necessary investment managers are instructed to take corrective action. Guideline breaches are a rare occurrence and usually stem from differences in asset classification. During 2010 there were no compliance breaches that caused any material or negative impact. On a monthly basis the reports from the investment managers and performance and risk reports from the custodian are analysed in a summary report to the Investment Committee. A report on the main performance indicators of the investment managers is reviewed quarterly by the Investment Committee.

WFP performs annual due diligence visits to all the investment managers. Senior WFP staff visited all four managers in 2010 with positive feedback on all occasions. In addition, as per the Investment Management Agreements, the investment managers meet with the Investment Committee at WFP headquarters at least once a year, which presents an opportunity for the Investment Manager to update Committee members on investment strategy, portfolio composition, performance and market outlook.