Scottish Borders COUNCIL

CURRENCY HEDGE

Report by Chief Financial Officer

PENSION FUND COMMITTEE/PENSION FUND BOARD

23 March 2016

1 PURPOSE AND SUMMARY

1.1 **The purpose of this report is to update the Committee and Board on the current position of the Fund's currency hedging and review the short term position of the hedge.**

1.2 Aon Hewitt prepared a paper for the pension fund investment sub committee on the 2 February 2016 which recommended changes to the current 50% passive currency hedge against the dollar and the Euro with no change in the value of the hedge against the Yen.

1.3 The sub Committee accepted the recommendations in principle but asked that a further paper be brought back to pension Fund Committee following a further review by Aon and Council officers to determine the optimum hedging position following David Cameron's meeting in Brussels and the commencement of carrying on the Brexit referendum.

1.4 Recent movements in the value of sterling against the dollar and a review of how sterling is likely to perform in the foreseeable future indicates a reduction in the Fund's passive equity hedge to 25% against the US Dollar. The hedge ratio against the other overseas currencies, including the Euro and Yen, would remain at 50%.

1.3 The currency hedge results in a receipt or payment of cash on an actual basis. The latest quarter resulted in a payment of £8.3m from the Fund. Due to the liquidity position of the Fund the full value of the required payment was disinvested from the global equity portfolios. It is worth highlighting that due to currency movements the Fund's equities will have increased in value by c£16.6m over the quarter.

2 RECOMMENDATIONS

2.1 **It is recommended that the Pension Fund Committee:-**

(a) Note the current position of the currency Hedge

(b) Approve the reduction of hedging on the US Dollar from 50% to 25%

3 BACKGROUND

3.1 Investing in overseas equity markets introduces currency risk, in that returns may be increased or decreased depending on movements in currency markets. Consequently the volatility in currency market introduces an element of volatility into the investment returns when they are measured in sterling.

3.2 The currency hedge is part of the Pension funds risk management strategy. The hedge, managed by State Street Global Advisors covers 50% of all overseas currency exposure. The hedge was put in place in 2009 to protect the pension fund from extreme variations in the value of its oversees equity investments as the pound fluctuates in value against a range of major currencies including the US dollar, the Euro and the Japanese Yen. Overseas investments are valued in their country of origin and then converted to sterling. Variations in the value of sterling on foreign currency markets thereby has a material impact on the value of the Fund's overseas equity investments. The hedge protects the Fund from exposure to 50% of these variations whether they are positive or negative.

3.3 The Committee agreed in March 2012 to refine the mandate approach to implement half of the current 50% hedge on a passive approach and the other half on an active approach, so that overall the currency hedge ratio for a currency will be moved between 25% and 75% rather than always fixed at 50%. Work has been delayed due to the prioritisation of other activity including the setup of the new pension fund arrangements required in response to legislation changes which took effect from March 2015, the 2014 triennial valuation and the Investment consultancy mandate. While work on the currency hedge has commenced, with the development of an Investment Management Agreement, due to pressures of other procurements this has not yet gone to the market. The procurement is currently planned to commence upon completion of the live Investment Advisor and planned Custodian procurements.

3.4 The currency hedge requires the Fund to realise on a quarterly basis the value of the loss or gain as at quarter end. This results in either actual cash being received or paid from the Fund. The current cash position, excluding the currency hedge requirements, of the Fund is fairly neutral except when large retirements or transfers are required, with the monthly income from active members broadly in-line with the out goings to pensioners. The result of this is there is no cash balances held by the Fund to pay the currency hedge without requiring the Fund to disinvest from its investments.

4 CURRENT POSITION

4.1 The recent quarter has required the fund to pay in cash £8.3m. This has resulted in the full £8.3m being disinvested from the three Global Equity portfolios. It should be remembered however that this means the value of the Fund's oversees equity portfolio has increased by £16.6m before the cash hedge reduced this value by 50%.

4.2 A paper was prepared by Aon Hewitt and discussed at the Investment and Performance Sub Committee on 22 February (report attached as Appendix 1). It was agreed a report be refined and be presented to the Committee and Board for further discussion.

4.3 A telephone conference call has also been held, following the £8.3m cash requirement, between Officers and Aon Hewitt. Aon Hewitt believe there are a number of issues which need to be considered

- Aon Hewitt believe that there is now an increased risk of Brexit, but it is not their central outcome, placing a 30% chance on Brexit and a 70% chance of no Brexit.
- Brexit uncertainty has caused Sterling to weaken recently, and will increase Sterling volatility until the referendum, with Sterling expected to fall if the expectation of Brexit increases.
- Ignoring the impact of Brexit Aon do not expect much Sterling movement over the near term against the US Dollar as currently trading near fair value, but some further moderate appreciation of the US Dollar on economic grounds is expected and Aon expects the Euro to weaken in the short term
- If Brexit does happen would expect large drops in Sterling against the US Dollar (perhaps 10% to 15% from present levels) and smaller drop of Euro (perhaps 3% to 4% from present levels).
- The Brexit risks are greater relative to the Dollar because the Dollar is still the fundamentally stronger currency given the structural economic weakness of the Eurozone, which requires a prolonged period of ultra-easy monetary policy, and Brexit would be expected to weaken the EU as well.
- If Brexit does not happen then some moderate rebound of the recent weakening of Sterling against the Dollar in particular is expected which will offset any further appreciation of the Dollar relative to Sterling on economic grounds.
- Sterling has strengthened relative to the Yen recently brining some of the gains that had driven the previous recommendation to increase the hedge ratio to 60% so maintaining the hedge at 50% is now recommended.

4.4 Taking into account the Aon Hewitt's views on the future currency movements, the 30% probability of Brexit and the desirability of maintaining currency hedging as a form of risk mitigation, Officers and Aon Hewitt recommend changing the current hedging to the following

- Reduce hedging on US Dollar from 50% to 25%
- Maintain hedging on Euro at 50%
- Maintain hedging on all other currencies at 50%

This reduction should reduce the cash requirement fluctuations and still maintain an element of risk mitigation.

4.5 Officers and Aon Hewitt recommend the movement in Sterling is monitored regularly, at least monthly, by Officers and Aon Hewitt over the next few months until the active currency hedge manager is appointed.

5 IMPLICATIONS

5.1 Financial

(a) The fees for the current hedging average around £54k per annum. A reduction in the hedging would reduce the fees to around £36k. However the current contract with State Street Global has a minimum annual fee of £45k. This means the saving would be around £9k per annum.

(b) The reduction in the cash hedge against the dollar will reduce the need for the fund to sell its investments to pay for adverse movements the cash hedge on a quarterly basis,

5.2 Risk and Mitigations

(a) This is a complex area and hedging is designed to manage the risk of adverse currency fluctuations. Members have previously approved the appointment of an active currency manager to replace the current entirely passive arrangement. In which case it is acknowledged that maximising returns and minimising losses will be subject to the skill of the appointed currency hedge manager.

(b) It should be noted that an alternative strategy of completely removing any form of cash hedging and allowing the value of the overseas equity portfolio to fluctuate over time has been adopted by a number of the Scottish Funds managing the LGPS. This strategy introduces volatility into the value of pension fund investments and could increase risk at the triennial valuation but does recognise the very long term nature of pension fund investment.

5.3 Equalities

It is anticipated that there are no adverse impacts due to race, disability, gender, age, sexual orientation or religion/belief arising from the proposals in this report.

5.4 Acting Sustainably

There are no direct economic, social or environmental issues with this report which would affect the Council's sustainability policy.

5.5 Carbon Management

It is anticipated there will be no adverse impact on the rural area from the proposals contained in this report.

5.6 Rural Proofing

This section should only be completed if this is a new or amended policy or strategy.

5.7 Changes to Scheme of Administration or Scheme of Delegation

No changes to the Scheme of Administration or Scheme of Delegation are required as a result of this report.

6 CONSULTATION

6.1 The Monitoring Officer, the Chief Legal Officer, the Chief Officer Audit and Risk, the Chief Officer HR and the Clerk to the Council have been consulted and any comments received have been incorporated into the final report.

Approved by

David Robertson **Signature**
Chief Financial Officer

Author(s)

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Background Papers:
Previous Minute Reference: Pension Fund Investment and Performance Sub Committee, 22 February 2016.

Note – You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. The Treasury & Capital Team can also give information on other language translations as well as providing additional copies.

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