Aon Hewitt
Consulting | Investment Consulting Practice

Scottish Borders Council Pension Fund
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Prepared for: The Officers
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Hedging the foreign currency exposure within the Fund's equities

Introduction

This paper is addressed to the Officers of the Scottish Borders Council Pension Fund ("the Fund"), and reviews the Fund's overseas equities' currency hedging position.

The Fund currently hedges 50% of its overseas currency exposure within the equity portfolio, and this has been in place since 1 July 2009. The Pension Fund Committee currently hedges passively, ie the appointed currency hedging manager hedges 50% of each overseas currency exposure, and does not try to add any additional value by adjusting the hedge ratio above or below 50% based on their views on future currency movements. However, the Fund is expected to procure an active currency hedging manager later this year to make these adjustments.

In the meantime the Officers have asked if the Fund should consider making any medium term changes to the current 50% hedge ratio based on Aon Hewitt's views. In particular, Officers asked for Aon Hewitt's views on whether the currency hedge should be removed i.e. the hedge ratios all reduced to 0%.

Background

The Fund started hedging 50% of its equities' overseas currency exposure on 1 July 2009. This followed a review of the Fund's equity portfolio which resulted in a reduction in the UK equity allocation, and an increase in the non UK equity allocation. To avoid a significant increase in currency risk from this change, it was agreed that 50% of equities' overseas currency risk should be hedged.

In the next chart we compare the performance of the MSCI AC World Index, hedged versus un-hedged, from 1 July 2009 to 31 December 2015.

We can note that the hedged index has outperformed the un-hedged version meaning pension schemes that were passively invested in global equities would have experienced a better return if their currency exposure had been hedged. A 50% hedged passive portfolio would have returned 10.1% p.a.

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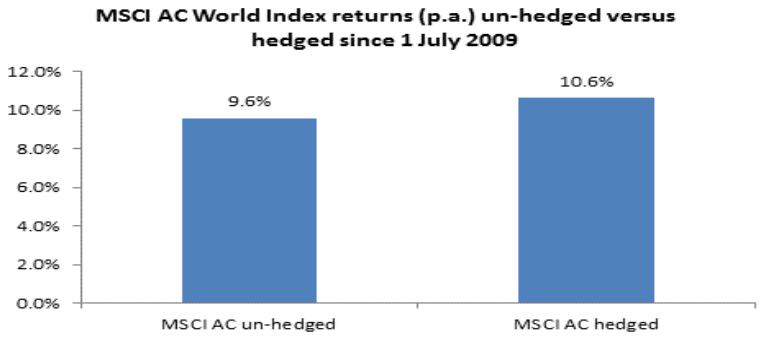


However, as the Fund's global equity managers manage active mandates where they try to outperform the benchmark, they will therefore have different regional and currency exposures relative to the benchmark which will impact the effect of the currency hedging position. In particular the Fund has had more exposure to the US Dollar than the index allocation, over a period when the US Dollar has strengthened by around 12% relative to sterling.

For the Fund it is therefore perhaps more meaningful to consider the total net payments made from the Fund on the currency hedging contracts over this period. The table below summarises the payments made on the currency hedging contracts on an annual basis since it was implemented.

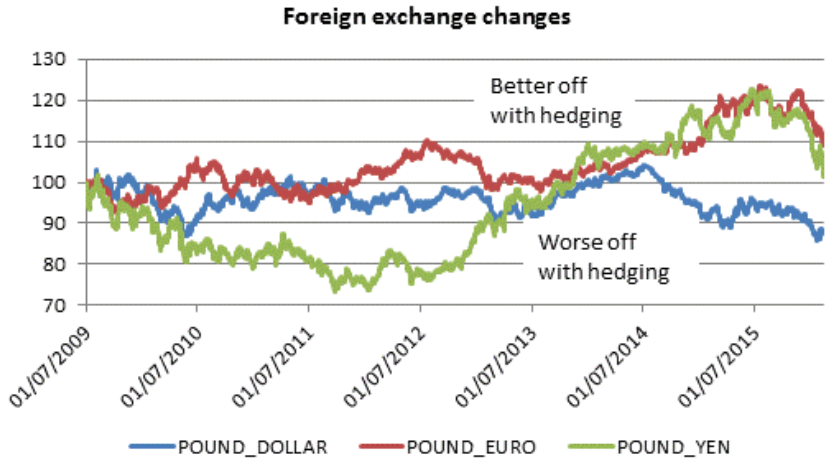
We can note that the total cumulative payment has been approximately £3.2m, which indicates the Fund's unhedged part of the Fund's equities has marginally outperformed the hedged part of the Fund's equities. This cumulative payment is small in the context of the Fund's cumulative equity market exposure of c £1,000m over the 7 year period.

Year	Return from currency hedging (£'m)
2009	(£2.7)
2010	(£2.9)
2011	(£2.2)
2012	£3.7
2013	£2.2
2014	(£0.8)
2015	(£0.5)
Total	(£3.2)

Over this period there have been some strong swings in the value of sterling. As we can note from the next chart sterling has weakened over the last 18 months relative to the US Dollar, and over the last 3 months

versus the Yen and Euro.

Hence, with hindsight the Fund value would be higher at the end of 2015 if the US Dollar position had been reduced (or removed) 18 months ago, and the same for the Yen and Euro position 3 months ago. Those are the types of trades that the active currency manager, once appointed, will look to anticipate, and implement, in order to improve the outcome for the Fund.



Aon Hewitt's forward looking views

Recent UK economic softness, the large external deficit and Brexit nerves are weakening sterling. Our view is that sterling will remain vulnerable and further downward pressure should continue given the uncertainty around the EU referendum and that expected increase in interest rates, which only a few months ago were expected to happen in 2016, have been pushed back further. However, although there are expected to be these downward pressures on sterling, there are also factors affecting other currencies we need to consider when considering the hedge ratio.

The US Dollar has strengthened over the past 18 months on the back of stronger growth in the US relative to other regions and tighter monetary policy - the Federal Reserve raised the US base rate in December 2015. However, the period of general US Dollar strength seems to have come to an end recently. As strains in the global economy have come to the fore this quarter, it has become more apparent that interest rates will remain low globally, including in the US. Expected policy rate increases have been pushed back in both the US and UK, but we think that the UK will be more reticent to hike rates, given political risks and the fact that the UK economic recovery will be hindered as investment plans are delayed against the background of this political uncertainty. On balance we expect some continued strengthening of the US Dollar relative to sterling. We therefore would recommend that some of the hedging of the US Dollar is removed and the hedge ratio reduced below 50%.

Further Eurozone monetary easing has become more likely but our view is that this will not necessarily significantly weaken the Euro against sterling, and on balance be offset by the reasons noted two paragraphs above.

We see the potential for further Japanese easing bringing the risk that the yen will give back more of its recent strengthening. We also think that Japan is more likely to surprise the market with an initiative to stimulate the economy and weaken the yen than in the Eurozone given the need to break Japan's deflationary trend.

We therefore would suggest some of the hedging of the Euro is removed and the hedge ratio reduced below 50%, but to increases the protection against the risk of yen depreciating relative sterling by increasing the hedge ratio above 50%.

Given their disparate nature we do not form views on individual emerging market currencies. Generally, over the medium term to long term, we expect emerging market currencies to appreciate as their economies continue to develop. This would be supportive of having a nil or low currency hedge ratio for their emerging market equities exposure over the long term. However, within emerging market currencies we do expect lots of short-term volatility especially from China, which could weaken emerging markets currencies, so emerging market currency appreciation may not happen straight away. Given this potential for short term volatility we would recommend retaining the hedge ratio at 50% for the present and review in say 6 months' time.

Recommendation

We recommend the Fund does not take a generic approach and remove the currency hedges as this would significantly increase risk and we would recommend the exposures to individual currencies are considered independently.

Our recommendations relate to the Fund's sterling exposure versus the US Dollar, Yen and Euro which accounts for around 80% of the Fund's non UK equity exposure and currency hedging positions (see Appendix).

We have also noted the exposures to the remaining currencies although for those countries, such as Brazil or the Swiss franc, we do not have a specific view on the individual currencies, and hence recommend the continuation of the 50% hedge ratio.

We recommend that from a **long term** risk management perspective the Fund retains a strategic long term base hedge ratio of 50% of its developed market overseas currency exposures, and periodically consider the base hedge ratio for emerging market overseas currency exposures.

However, given recent market moves, and Aon Hewitt's current medium term outlook for sterling, if the Officers and Pension Fund Committee

wish to adjust the currency hedge ratio in advance of an active currency hedging manager being appointed, we would recommend the following adjustments :

- Reduce the hedging position versus US Dollar from 50% to 40%
- Reduce the hedging position versus Euro from 50% to 40%
- Increase the hedging position versus Yen from 50% to 60%

As noted earlier, the US Dollar, Euro and Yen represent around 80% of the Fund's overseas equities' currency exposure. The remaining 20% exposure is primarily the Swiss franc (around 10%), developed Asia (Hong Kong Dollar and Australian Dollar) and emerging market currencies. As Aon Hewitt do not form individual views on these currencies we recommend retaining the 50% hedge ratio.

Appendix

Summary

The table below summaries the Fund's overseas currency exposure as at 30 September 2015.

Currency	Overseas Equities Value at 30/09/15	%
AUD	£849,335	0.4%
CHF	£23,220,848	11.2%
EUR	£28,568,581	13.8%
HKD	£2,446,823	1.2%
JPY	£12,471,527	6.0%
SEK	£3,349,868	1.6%
USD	£125,708,537	60.9%
BRL	£409,095	0.2%
CAD	£1,109,933	0.5%
DKK	£896,012	0.4%
IDR	£0	0.0%
KRW	£2,395,153	1.2%
NOK	£1,425,938	0.7%
SGD	£0	0.0%
ZAR	£3,620,913	1.8%
Total for hedged currencies	**£206,472,563**	**100.0%**

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