HYMANS ROBERTSON LLP

Currency hedging

Addressee

This note has been prepared by Hymans Robertson for the Pension Fund Committee of the Suffolk County Council Pension Fund. It relates to the Fund's passive currency hedging positions that have been implemented using Legal & General's hedged passive regional equity funds.

Purpose

The purpose of this note is to consider whether it is appropriate to continue to hedge any portion of the Fund's exposure to currencies through its holdings in overseas equities.

Background

When the Fund invests in assets denominated in overseas currencies, it introduces currency risk as well as asset related risk. Typically, bond investments are low risk assets with correspondingly low rates of return. If a bond manager invests in an overseas bond, the manager will typically hedge the currency exposure. This is because the currency volatility introduced is likely to be significant in relation to bond volatility. Unless hedged, the overseas bond would carry a high degree of volatility, although the expected return would still be low.

By comparison, equities are highly volatile and the combination of currency volatility with equity volatility does not add a great deal to the aggregate riskiness of equities. Accordingly, few equity managers consider hedging their currency exposure.

Currency is an unrewarded risk, i.e. over the long term, there is no strong reason why any currency will perform better than any other currency. So, one argument would be that it makes sense to hedge currencies, since this will reduce volatility with no impact on returns. Another argument is that over time, the net impact is small, so why bother hedging. Nevertheless, there are times when it can be prudent to be hedged and other times when there may be a strong opportunity cost involved in being hedged. So, a third argument is that being half-hedged strikes a middle ground. Having a degree of currency exposure provides some diversification away from sterling, but also mitigates some of the impact of adverse movements of overseas currencies.

When does hedging help

In terms of Fund returns, hedging is beneficial in terms of returns when sterling is appreciating against a currency where the Fund has exposure. For example, if the Fund has £10 million of exposure to US equities (with a currency cross rate of £1/£1.60), the US$ value would be $16 million. If sterling were to appreciate to £1/$1.65), the sterling value would fall to £9.7 million, unless the US$ exposure was hedged. However, if sterling were to depreciate, so the cross rate changed to £1/$1.50, the sterling value of the holding would increase to £10.7 million, unless the currency was hedged.

Why one currency might be expected to rise against another.

In relation to sterling, the principal reasons have in the past been:

1. Forward currency bias: the interest rate earned on £ is significantly higher than on another currency, such as the Japanese Yen, allowing currency speculators to benefit from selling yen (paying Yen overdraft rates) and buy sterling (earning £ deposit rates). If many people do this, they will not only earn the interest rate differential but also benefit from demand for sterling raising the value of sterling and supply of yen depressing the value of the yen.

2. Sterling has already depreciated significantly against the other currency and a rebound in value is likely.

3. Economic growth prospects for the UK are much better than in the other country and currency reflects this.

In an era of low interest rates in most developed countries, it is hard to see forward currency bias having much effect. Further, the economic growth prospects for sterling do not look that much different from other developed countries and may be worse than for (say) the US. Finally, there have not been particular currency dislocations that has made sterling particularly weak relative to countries or regions where there is significant equity exposure.

Risk

There is a further reason why currency hedging might be appropriate. Having unhedged exposure is a risk and, as identified above, this could lead to losses if sterling appreciated and the other currency was unhedged. If sterling depreciated and was hedged, the Fund would miss a gain it might otherwise have achieved, so this would be a loss of opportunity.

The greatest currency risk is likely to reside in the single currency (the Euro) because no one can predict what will happen to that currency. It is reasonable to take the view that the level of uncertainty is sufficiently great that it is appropriate to hedge a major proportion of that currency risk.

Current passive currency hedging positions

When currency hedges are in place, they are conventionally implemented using currency forward positions, set for rolling three-month periods. At the end of each period, the movement in the currency values over the period are cash settled and new currency forward positions are put in place. This means that there are regular occasions when the Fund will be asked to supply cash or will be given cash, which adds to an administrative burden.

Instead of this, the majority of the currency hedging undertaken by the Fund has been through hedged variations of the pooled regional equity funds offered by Legal & General (L&G). In essence, L&G takes its passive regional fund and puts a currency hedge on top, so that L&G becomes responsible for the cash flow management. L&G can switch the allocation between the hedged or unhedged approach on two occasions each month.

In early 2009, following a period of sharp sterling depreciation, currency hedges were put in place essentially for all of the L&G regional funds. To the extent that the Fund's overseas equity exposure was managed partly by L&G and partly by the active global equity managers, this led to a position where approximately half of the Fund's exposure to overseas currency arising from its equity holdings was hedged back to sterling.

In mid 2010, because of the concerns about a potential breakup of the Euro, the Euro hedge was increased to 90% of the Euro value. There was insufficient capacity within the L&G mandate to do this, and a passive hedge for the excess above the 50% hedge conducted by L&G was put in place with Millennium.

When the recent transition of assets from JP Morgan to L&G took place, we reviewed the L&G position. L&G now have an allocation which includes a mix of hedged and unhedged pooled regional funds, so that the half hedged position remains broadly as before. The only variation is in European equities, where the entirety of L&G's holding is in the hedged pooled fund. This is because of the specific risk relating to a Euro breakup.

The Euro hedge with Millennium has remained in place which means that the Euro is currently overhedged within the Scheme. This position should be addressed.

Why half hedge?

If we consider the risk arising from currency movements, some movements are positive and some negative. You can argue that maintaining some currency exposure adds to the diversification of the assets in the Fund. If we examine structural risk, we find that overseas currency exposure of 15% is diversifying but, beyond that level, further overseas currency exposure adds to risk. In broad terms, the risk arising from fully unhedged currency exposure is equivalent to holding about 4% more or less in equities. Of course, in periods when sterling appreciates meaningfully, the impact on the Fund from being unhedged can be significant. For example, in 2006, a hedged overseas equity portfolio would have delivered approximately 7% more than the unhedged portfolio. This was largely because of sterling appreciation against the US$ (driven principally by currency rate differentials). Over 2006, the US$ denominated return for US equities was 15.9% whereas the sterling based return was 1.7%.

Should the Fund continue to hedge currency?

The current positions held by L&G are as follows:

	% of Fund assets		
Regional equity fund	**Hedged**	**Unhedged**	**Fund hedge proportion**
North America	6.8	-	Approximately 50%
Europe	6.8	-	Approximately 75%
Asia ex Japan	2.0	0.9	Approximately 50%
Japan	1.5	0.4	Approximately 50%
Emerging Markets	-	3.2	Fully unhedged

To arrive at the fund hedge proportion, we have assumed that the remaining active equity manager, Newton, holds a regional allocation at benchmark weights. Historically, Newton has maintained an underweight position in North America and an overweight position in Europe. L&G do not offer a hedged Emerging Markets equity fund.

The Fund's hedged position in Europe reflects the maximum possible hedge that can be introduced for the Euro, using the L&G option. As explained earlier, however, there is still a hedge in place with Millennium for £57 million. Because of the retiral of JP Morgan, and the increase in the Euro hedge carried out within L&G's mandate, the Fund's Euro position is now approximately 124% hedged. We would recommend bringing the hedge back to a total level of 90% of Euro exposure (this is less than 100% to allow for variation in the value of assets denominated in Euros). This would involve reducing the value of the passive hedge managed by Millennium to £12 million.

Conclusion

It is relatively straightforward to maintain L&G's hedged funds. There is a modest additional fee over and above the fee for the unhedged fund which amounts to 3 basis points. It would be straightforward to switch any existing hedged fund position to unhedged, or to revert to hedged, at any time.

The hedging positions were put in place just after sterling had depreciated sharply against most currencies. Sterling has appreciated essentially into a relatively narrow trading range since that time. We do not see any particular reason why sterling should necessarily appreciate against any particular currency from here, while interest rates are floored and when economic growth remains subdued. However, we still perceive risk in the Euro and would maintain a Euro hedge.

There is a possibility that sterling might depreciate against other currencies, if markets took a negative view of the UK's growth prospects or the level of the deficit or the extent of quantitative easing. Accordingly, there may be a case to remove all of the hedges, other than for the Euro.

For the Euro, we would wish to extinguish the current over-hedged position and to reduce the aggregate Euro hedge to 90% of Euro exposure, by reducing the level of passive hedge managed by Millennium to £12 million.

Disclaimer

This paper should not be released or otherwise disclosed to any third party other than the Scheme sponsor except with our prior written consent, in which case it should be released in its entirety. We accept no liability to any other party unless we have especially accepted such liability in writing.

We will be pleased to answer any questions about this, at the forthcoming meeting.

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For and on behalf of Hymans Robertson LLP

Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.