Millennium Global Currency Management Update

Addressee

This paper is addressed to the Officers of Suffolk County Council as administering authority for the Suffolk County Council Pension Fund ("the Fund"). It relates to Millennium's active currency mandate. The paper reviews the manager, the manager's active currency strategy and performance over the period of the Fund's mandate.

Background

Suffolk County Council funded the Millennium Global Currency Program on 1st April 2008. The objective of the mandate (which represents 2½% of Fund assets) is to achieve a positive return from the active management of currency exposures in both developed and emerging market currencies.

In July 2012 we provided a detailed review of Millennium and its Global Currency programme. We were concerned with the continued underperformance of the fund. Our view was that a change in financial conditions would be necessary for Millennium to achieve its performance target (and therefore add value) to the Fund. Taking this into account, we recommended that the Committee consider termination of Millennium's mandate.

This paper provides an update on the performance of the fund in the 6-month period following the July 2012 review paper. We also re-visit the advice we provided in that paper.

Recommendation

We recognise that Millennium's underperformance is partly attributable to the unfavourable environment for active currency, particularly with elevated volatility in developed currency markets where the Global Currency Fund is focused. However we felt that Millennium could have adapted to the financial environment by taking more tactical positions in currency pairs expected to benefit from short-term market movements. Instead the portfolio was positioned to its longer-term strategic themes, despite acknowledging this was contributing to underperformance. Although performance over the last quarter of 2012 has been strong, we do not believe this is a reflection of an improvement in Millennium's approach or of any significant change in the environment for active currency. For this reason we continue to recommend that the Committee consider termination of Millennium's mandate.

Corporate perspective

Millennium saw relatively significant net outflows from its Global Currency Programme in 2012. As at end of December 2012 their pooled fund (in which Suffolk invests) had assets under management of £60.9m, down from £125.8m as at end of July 2012. Millennium highlight that they manage £164m in the strategy in total since they also manage segregated accounts. The rationale for investors' redemptions may be the disappointing performance of the fund combined with a lack of confidence in the strategy going forward. Many institutional investors have also been strategically shifting away from active currency management towards broader management of currency risk. Suffolk County Council's investment in the fund now represents over half of the pooled fund's assets and this might give rise to investor concentration risk. This risk is mitigated because the fund is trading in highly liquid markets; the Fund could redeem its investment under the pooled fund's terms and conditions without liquidity issues. We could nevertheless speculate on the firm's commitment to the strategy going forward, if it continues to represent an increasingly smaller proportion of Millennium's revenue.

Investment performance review

Millennium targets a performance of LIBOR + 10-15% at a target volatility of 15% per annum. Performance has disappointed over the four-year life of the Fund's investment in Millennium's Global Currency Program, with the manager returning -1.79% p.a. since inception in 2008. The pattern of delivery of return has been uncorrelated with equities and so has provided some diversification benefit.

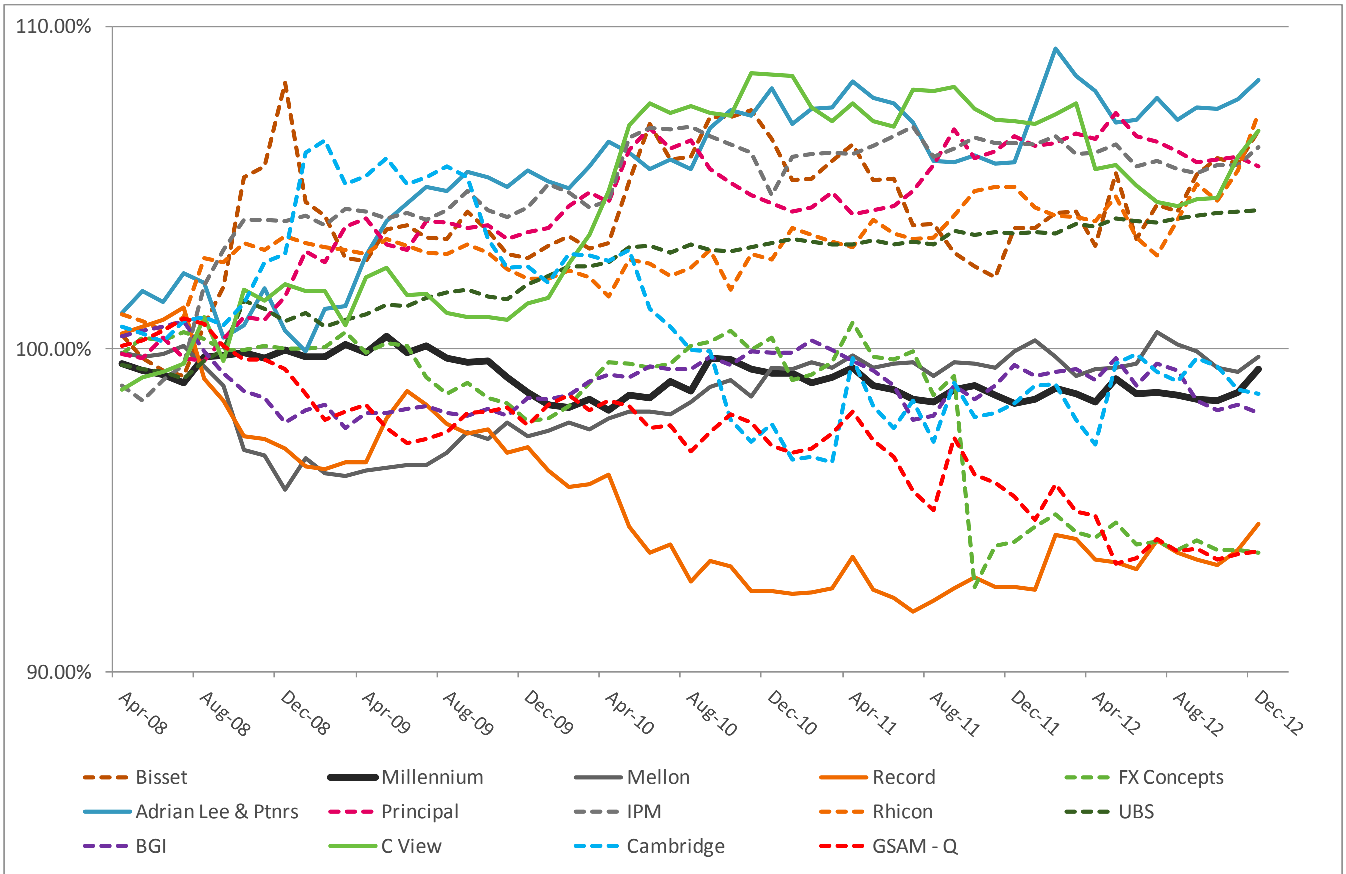
In Q4 2012 the fund returned 4.3%, although this is strong performance it can almost entirely be attributed to a single decision, the long US$ / Short Yen trade, which contributed 4.67% over the quarter.

At the end of October 2012, the Yen reached a post-war high against the dollar. This led to Japanese intervention at the start of November to weaken the Yen, with the Bank of Japan confirming that it will take necessary measures to ensure the Yen better reflects fundamentals going forward. The Yen has therefore weakened considerably since, down 15.3% against the Dollar over the 3 months to end of January 2013. This level of assurance from Japan's central government to intervene to weaken its currency has provided an easy trade for Millennium to exploit. It does not however equate to a particularly high level of manager skill since the intentions and consequent impact on the currency were clearly signalled.

By end October 2012, Millennium's fund had returned -0.99% year-to-date. Millennium had long maintained the view that the instability in Europe would lead to a considerable weakening of the Euro. Over the 18 month period to end August 2012, Millennium was strategically short of the Euro to reflect this view. This detracted from performance last year as positive actions from the ECB prevented further depreciation of the Euro. Millennium now holds a neutral position on the Euro and admits to having been too slow to shift from its short bias stance.

Chart 1 below shows Millennium's performance relative to its peer group of active currency funds. The environment has been very challenging for active currency management generally with many managers in the universe having failed to deliver positive performance over the period.

Chart 1: Performance[1] of managers from Hymans Robertson's database (Apr 08 - Dec 12)



Source: Managers, Hymans Robertson

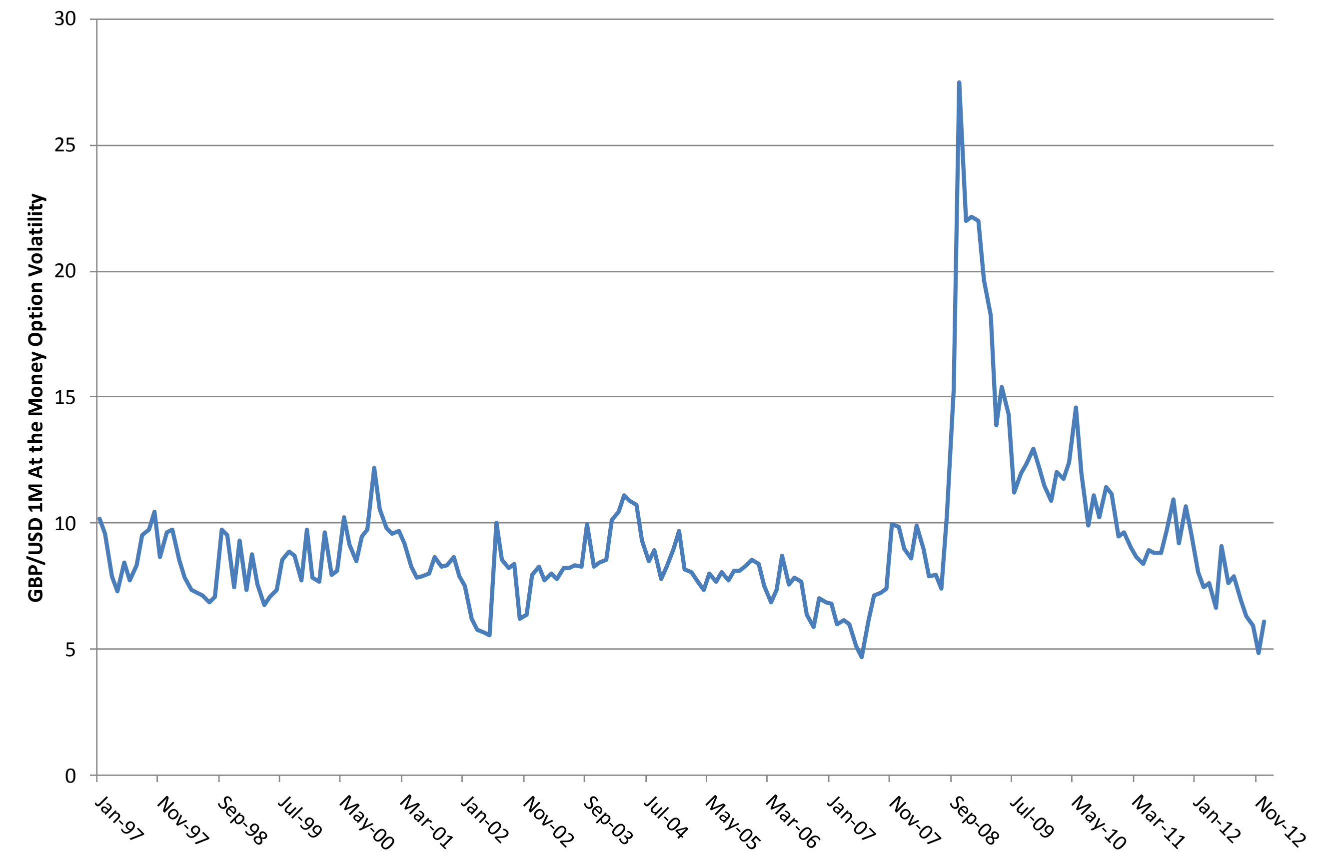
Conditions throughout 2012 continued to prove difficult for Millennium's approach. The strategy has a structural bias towards long-term strategic views, driven by fundamental analysis, whereas the market environment has been characterised by "risk-on / risk-off" investor sentiment over this period, which led to short, sharp moves in developed market currencies in particular.

[1] Performance of the managers has been scaled to a 2% risk target so that the return patterns are consistent.

Millennium manages the portfolio in such a way that its views on currencies are expressed either short or long against the Euro or USD; therefore, seemingly irrational volatility of these currencies has had a detrimental impact on performance. However, as highlighted by Chart 2, we did see developed currency market volatility continue to decrease in the second half of 2012, as the systemic risks associated with the Eurozone and US fiscal cliff dissipated.

Although Millennium can invest in both Developed and Emerging market currencies with strategic limits of 70% and 30% respectively, the fund is currently allocating 99% of the portfolio to developed market currencies since it expects that the macro environment going forward will be conducive to trading these currencies on a fundamental basis. The rationale is the expectation that we will start to see discrimination across developed market currencies at a macro level, in particular in the Euro and USD, as the European Central Bank implements contractual monetary policy and the US continues quantitative easing and expansion. This should be positive for Millennium's approach which is reliant on USD and Euro valuations being primarily influenced by macro fundamentals.

Chart 2: Volatility in the exchange rate between GBP-USD, measured by 1mth at the money option pricing

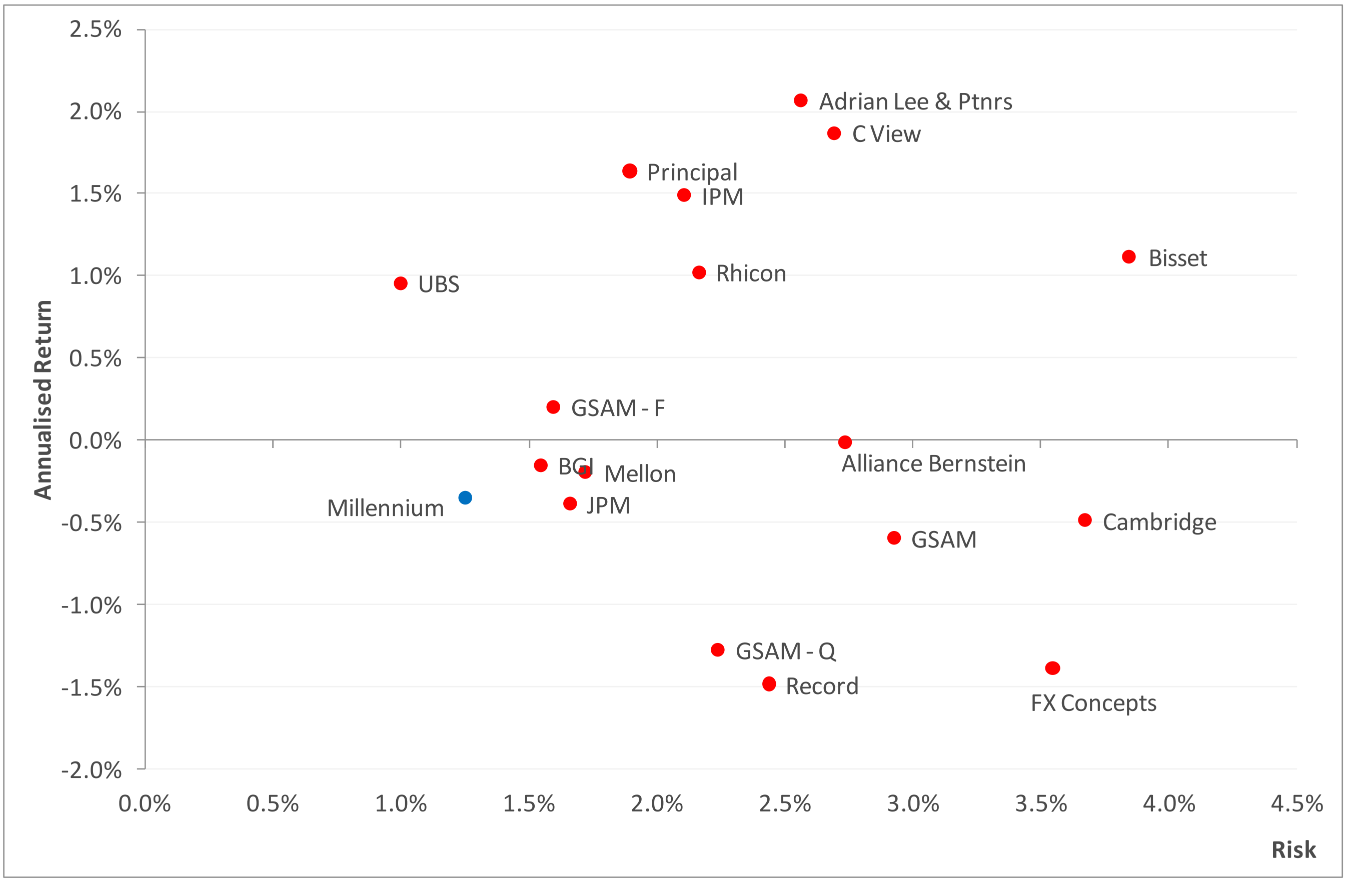


Source: Datastream, Hymans Robertson

At our review last year, we commented that Millennium had been managing the portfolio below its risk target. This was clearly a reflection of the firm's lack of clarity over the market resulting in the decision to manage the portfolio highly defensively. This is evidenced in Chart on the following page. Millennium has exhibited a significantly lower level of risk than many of its peers over the period, despite having the same risk target. Although we understand the rationale for Millennium's defensive stance during this period and would not encourage excessive risk taking, we still conclude that this has dampened their fund's return potential. Over the past 3 months, Millennium has gradually been increasing risk and the portfolio is now being managed to a 20% annualised VaR (Value at Risk) measure, which is well above their average level of 9.4% (since inception of the mandate).

This has also contributed to the recent outperformance as the higher risk tolerance means the fund has been able to fully exploit favourable currency market moves. We may expect Millennium to continue to manage the fund to this level of risk going forward.

Chart 3: Risk vs. Return[2] of managers from Hymans Robertson's database (Apr 08 - Dec 12)



Source: Managers, Hymans Robertson

Conclusion and recommendation

As we stated in the previous paper (July 2012), we do not believe that Millennium's core investment philosophy is wrong – the investment team has historically shown the ability to generate alpha from actively managing a currency portfolio within a fundamental and discretionary framework. However, the market environment for active currency management over the past 5 years has been challenging, particularly with developed market currency valuations more highly impacted by the 'risk-on/risk-off' investor sentiment than fundamental factors. This has not been conducive to Millennium's approach which has focused on long-term strategic themes, many of which did not play out. Millennium admits that, in hindsight, its performance would have been better with a more dynamic process, i.e. with a greater allocation of the risk budget given to tactical positions.

We are sceptical of drawing any conclusions from the strong performance in the last quarter of 2012 since the positive return can be attributed almost entirely to a single decision (short Yen versus USD), which has benefitted from the Bank of Japan putting downward pressure on its currency. We do not therefore think this performance reflects a marked improvement in Millennium's strategy or a structural shift in market conditions for active currency management. Millennium's justification for more favourable market conditions going forward appears reasonable, but we are still not convinced that such a change in conditions is imminent.

[2] Performance of the managers has been scaled to a 2% risk target.

The recent outperformance does not change our view on Millennium's ability to add value through its present approach to active management of currency exposures, not least because of prevailing market conditions. For this reason we continue to recommend that the Committee consider termination of Millennium's mandate.

We do still believe that outperformance can be generated through active currency management, but this might potentially require a more tactical approach or a change in conditions. The Suffolk Fund will be exposed to modest elements of active currency within Winton Capital's Futures Fund and BlueCrest Capital's AllBlue Fund. Both managers will dynamically trade developed and emerging market currencies on a tactical basis, as part of their managed futures programmes.

We look forward to discussing this update at the Committee meeting on 27 February 2013.

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