Practicalities of managing the Fund's currency exposure

Introduction

This note, addressed to the Pensions Committee of the Suffolk Pension Fund, discusses the practicalities of managing the Fund's exposure to overseas currencies. For illustrative purposes, we estimate the performance and cashflow impact over the recent past of implementing a currency hedge.

This note continues the Committee training and consideration of these issues in preparation for the Fund's strategy review later this year/early next. There are therefore no decisions required and the Committee should view this as an opportunity to further develop understanding and ask questions as part of the preparation to take decisions around these issues as part of the wider strategy review.

Strategic rationale for managing currency risk

A more detailed review of the strategic rationale for currency hedging was provided at the last meeting (included in the appendix for reference). However, as a brief reminder, the most significant risks in the Fund are strategic (the high level asset allocation) and structure (diversification and manager allocations). Currency risk tends to be less significant, but as changes in the strategy and structure of the Fund appear premature given the ongoing valuation discussions, we have an opportunity to consider other risks.

The Fund invests c1/3 of assets overseas, almost all in equities. The intention is to capture the underlying stock return, but the investment also brings exposure to foreign currencies. Given that currency movements will lead to profits or losses relative to sterling (the currency in which benefits are paid), this exposure represents a real risk to the Fund. Currently, the Fund accepts this risk – its exposure to foreign currencies is unhedged, apart from a small historic allocation to some passive hedged L&G funds. However, if there is no expectation that retaining the currency allocation will add value, there is an argument that this risk should be reduced/removed if it can be achieved at reasonable cost.

Assessing the performance impact of currency hedging

The effect of a currency hedge is to reduce/remove the effect of any currency moves in equity market returns. If sterling strengthens, returns from overseas equity markets are reduced by foreign currency weakness. The hedge makes money in these circumstances offsetting the loss. In contrast, if sterling weakens, foreign currency gains from overseas equity markets would be offset by a loss on the hedge.

It is informative to look at what would have happened over the recent past had the Fund implemented a currency hedge in understanding its operation. As always, a review of past performance should be treated with caution as the data is time-period specific and past market conditions do not necessarily reflect current market conditions.

In the following table we compare the sterling (unhedged) and local currency (approximately, hedged) total returns of the FTSE All-World Index (as a proxy for the Fund's global equity portfolio). We use this to estimate the payments to or from a separate currency hedge overlay designed to remove 50% of the currency exposure (this is the level of hedging we would typically suggest and the rationale for this is set out in the in the July paper attached) on index exposure of £700m (the approximate size of the Fund's global equity portfolio).

	Unhedged Global equity (%)	Hedged Global equity (%)	Difference (%)	Gain/loss from unhedged currency exposure (£m)	Cashflow to/from currency overlay based on 50% hedge of £700m (£m)
Q313	0.5	3.9	+3.4	-22.5	+11.3
Q413	0.6	1.8	+1.2	-8.0	+4.0
Q114	1.1	0.5	-0.6	+4.2	-2.1
Q214	0.0	1.6	+1.6	-10.8	+5.4
Q314	-0.8	-1.3	-0.5	+3.4	-1.7
Q414	-1.5	-1.0	+0.5	-3.4	+1.7
Q115	2.6	-0.3	-2.9	+20.0	-10.0
Q215	-5.2	-2.9	+2.3	-17.0	+8.5
Q315	-2.1	-3.3	-1.2	+9.0	-4.5
Q415	0.4	-2.0	-2.4	+17.0	-8.5
Q116	4.3	5.7	+1.4	-9.6	+4.8
Q216	8.3	-1.0	-9.3	+65.6	-32.8
3 yrs (p.a.)	11.3	8.8	-2.5	-	-
5 yrs (p.a.)	9.9.	8.6	-1.3	-	-
10 yrs (p.a.)	8.4	5.4	-3.0	-	-

Comment

1 To explain the figures in the table, in Q215 equity markets fell by 2.9%, ignoring currency impacts (as shown by the hedged return in the third column of the table). However, unhedged investors earned a lower return of -5.2% (second column) as sterling strengthened. This additional currency loss was equivalent to £17m (fourth column) on a £700m portfolio. If the Fund had implemented a 50% currency hedge over that period, the currency hedge would have earned £8.5m (fifth column) offsetting half the currency loss.

2 The opposite was the case in the quarter before (Q115). Sterling weakness boosted the unhedged return and would have led to a loss from a currency hedge.

3 The table indicates that the gains and losses from currency hedging could be substantial. There will be a need to manage the resulting cashflows – investing gains and realising assets to make payments to reflect losses[1].

4 As can be seen, over the longer term period shown, being an unhedged investor would have had a positive impact on performance. However, we caution on this being a reason not to hedge as the results are strongly biased to the impact of one quarter and the post-Brexit weakness of sterling.

Options for implementation

As noted in our last paper, the currency allocation is bespoke to the Fund and if the Committee would like to implement currency hedging, this will need to be a bespoke arrangement (even following LGPS pooling).

This could be achieved by either:

1 Appointing a manager to implement a segregated mandate of currency derivatives to hedge significant currency exposures[2] (US Dollar, Euro and Yen). The impact of other currencies would be so small as to make the management not worthwhile.

2 Utilising existing L&G overseas equity passive funds that are currency hedged. By utilising fully hedged passive overseas equity funds within L&G, the effect across the Fund's total overseas equity assets would be to achieve somewhere around a 1/3 currency hedge. This level of hedging would be less than our preferred target but a compromise to achieve easier governance and a lower fee.

Under option 1, there could be regular cash flows between the hedging mandate and the rest of the Fund and procedures to manage these cashflows would have to be set up. Under option 2, L&G would manage cashflows arising from currency hedges within the funds.

If 1 were the preferred option, L&G would appear an appropriate manager to consider, given they are experienced in this area and are an existing manager of the Fund. Management fees for a segregated mandate would likely be of the order of 0.05 to 0.1% p.a. of the notional value of the hedge. Transaction costs of implementation of the hedge (i.e. trading the underlying instruments) are very low as the instruments used are very liquid and highly traded.

If 2 were the preferred solution, this would require some switching within the existing L&G funds. Fees for currency hedged funds are c0.03% p.a. above unhedged, reflecting the additional costs of implementing hedges and managing cashflows. This is a cheaper approach than a bespoke hedge, but the funds (or equivalents) would also need to be available within the ACCESS pool.

These fees are obviously large in sterling terms (c£350k to £700k p.a. for a segregated mandate) but, in the context of total Fund fees, are much less significant and therefore, should the Committee wish to manage these risks, we do not view the increase in fee as unreasonable.

Other considerations

Prior to implementation an understanding of the Fund's overseas currency exposures would be required, to what extent they are hedged and to what extent active managers take views on currencies before making allocations (as we would not want to offset any active decisions taken by managers).

[1] It is important to note that the payments into and out of the currency hedge mandate in this example are illustrative. In reality, currency hedge managers diversify and stagger the implementation of currency hedges to smooth the volatility of payments required. However, the amounts noted provide a fair illustration of the value of the hedge if not an exact representation of the actual profile of payments.

[2] The details of this are beyond the scope of this paper. However, at a very high level, the currency hedge is implemented by swapping a proportion of the Fund's overseas currency exposure for Sterling in the derivatives market. This involves fixing the price of overseas currencies in advance on a rolling basis by entering into financial derivatives referred to as currency futures.

However, the majority of the Fund's overseas currency exposures reflect the Newton and L&G global/overseas equity mandates and our understanding is that neither of these managers use currency exposure as a major input to their selection process and therefore a pragmatic view would be to hedge the benchmark currency exposure.

Conclusion

The modelling undertaken in the previous paper (attached) suggested a relatively small reduction in overall risks from hedging the currency exposure relative to the overall asset risk within the Fund and therefore currency risk management is not expected to be a critical factor in the success of the Fund.

However, we remain of the view that currency is a real risk to the Fund and would, on balance, propose it was managed as long as this did not divert an inappropriate level of financial or governance resource from the consideration of management of more significant issues. Currency risk management would incur further fees, but these appear small in contrast to risk reduction.

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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, investment 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 investment. As a result, an investor may not get back the amount originally invested.

Past performance is not necessarily a guide to future performance.