

# CAMBRIDGESHIRE PENSION FUND



## INVESTMENT SUB COMMITTEE

Date: 12<sup>th</sup> September 2019

Report by: HEAD OF PENSIONS

<b>Subject</b>	<b>Currency Hedging</b>
<b>Purpose of the Report</b>	The aim of this paper is to explore options available with current managers to provide a pragmatic currency hedging solution.
<b>Recommendations</b>	<p><b>That the Investment Sub Committee:</b></p> <ol style="list-style-type: none"> <li>1. Approves the adoption of a currency hedging strategy using hedged share classes of the UBS passive mandate;</li> <li>2. Approves the Head of Pensions in consultation with Mercer to agree the timing of the transfer to GBP hedged asset classes and make any arrangements necessary to implement the transfer.</li> </ol>
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### 1 Purpose of the report

- 1.1 The aim of this paper is to explore options available with existing managers to provide a pragmatic currency hedging solution.

### 2 Background

- 2.1 The Fund has overseas investments that are non-sterling denominated. The Fund has benefited from a weakening in Sterling for a number of years providing the Fund with gains on these overseas currency denominated assets. Whilst there may be further weakness in the coming months providing a further boost to investment valuations when measured in pounds sterling, the Investment Sub Committee may wish to consider putting in place an arrangement that can be implemented at the appropriate time to lock in some of these gains, reflecting the likelihood of a strengthening of Sterling.
- 2.2 The Fund's investment strategy was reviewed by the Investment Sub Committee (ISC) during 2018 which included discussion on the use of a risk management framework to help manage the Fund's most significant investment risks i.e. equity, long term interest

rates and inflation volatility. A paper on currency hedging was tabled at the meeting of the ISC in November 2018 but was deferred pending further work on a comprehensive risk management framework.

- 2.3 Following approval by the ISC in February 2019 for officers to work with Mercer to implement a risk management framework, at the May 2019 meeting the ISC selected River & Mercantile to be appointed as Risk Manager, initially focusing on a Protected Equity strategy.
- 2.4 This paper revisits the option for a simple currency hedging using currency hedged share classes of the Fund's passive equity funds at UBS.

### **3 The currency issue**

- 3.1 Broadly 66% of the Fund's assets are non-sterling which comprise around 56% of unhedged global equities (both public and private) and around 10% of hedged assets held in the Schroder Strategic Bond mandate and the Loan fund managed by M&G.
- 3.2 The value of sterling is currently trading below the average pricing of the last 10 years which has provided beneficial returns and valuations on currency denominated assets which the Fund could now "lock in". Compared to a fully currency hedged position the Fund has 'gained' c. £90m over the last three years from not hedging its overseas developed market equity exposure.
- 3.3 The Fund could instruct the Risk Manager to implement a currency overlay structure but the arrangement is in its infancy and is initially focusing on Protected Equity. A simpler solution is to use an existing manager by switching to hedged share classes. Currently only UBS offers a GBP hedged share class as Dodge & Cox, whilst offering a hedged class on a standalone basis, is not available through the ACCESS sub-fund. The Fund's other global equity manager, JO Hambro, does not offer a GBP hedged asset class.

### **4 Background - the UBS passive mandate**

- 4.1 The Fund has 20% of its strategic asset allocation in passive global equities invested with UBS. At 30 June 2019 the value of global equities of £1,900m (57.3% of the Fund assets).
- 4.2 UBS were appointed the Fund's passive provider following completion of a mini competition by the ACCESS funds in 2017, which resulted in substantial fee savings for the Fund compared to the previous provider, State Street.
- 4.3 The ISC agreed to restructure its UK and global passive allocations into a series of regional allocations and alternative beta funds with UBS which was completed in June 2018.
- 4.4 UBS also advised the ISC that for many of the passive funds on offer, a GBP hedged share class was also available which could provide a simple and inexpensive option for hedging currency exposure, which could be transacted at any month end.

### **5 Currency hedging**

- 5.1 Hedged share classes are typically used as a risk mitigation tool rather than to make opportunistic gains on currency. It is assumed that this is the objective of the ISC rather than to actively look to make gains through taking views on future currency movements. Nonetheless, recent, levels of sterling makes the adoption of a hedging strategy at this time more beneficial than ever.
- 5.2 UBS offer hedged share classes for the majority of the sub-funds held by the Fund.
  - 5.2.1 Transition to hedged share classes would cost around 0.02% or £110k;

5.2.2 The cost of hedging would be a drag on performance of approximately 0.1% or £560,000 per annum.

- 5.3 In the context of asset pooling, the UBS passive arrangement which operates outside the Approved Contractual Scheme (ACS) allows the Fund flexibility to restructure its holdings without impacting other ACCESS funds.
- 5.4 By utilizing the hedged UBS passive funds, Mercer estimate that the exposure to foreign currency assets would be reduced from 56% to 40%. The costs noted in paragraph 5.2 are considered to be reasonable in the context of gains on currency of c. £90m over the last three years.
- 5.5 In summary, Mercer believe that the flexibility offered by UBS to provide currency hedging represents a relatively low-cost and pragmatic way of crystallising the gains that have come from sterling weakness.

## 6 Recommendation

That the Investment Sub Committee:

- 6.1 Approves the adoption of a currency hedging strategy using hedged share classes of the UBS passive mandate;
- 6.2 Approves the Head of Pensions in consultation with Mercer to agree the timing of the transfer to GBP hedged asset classes and make any arrangements necessary to implement the transfer.

## 7 Relevant Pension Fund Objectives

<i>Objective 1</i> Have robust governance arrangements in place, to facilitate informed decision-making, supported by appropriate advice, policies and strategies, whilst ensuring compliance with appropriate legislation and statutory guidance.
<i>Objective 3</i> Ensure the relevant stakeholders responsible for managing, governing and administering the Fund, understand their roles and responsibilities and have the appropriate skills and knowledge to ensure those attributes are maintained in a changing environment.
<i>Objective 5</i> Continually monitor and manage risk, ensuring the relevant stakeholders are able to mitigate risk where appropriate.
<i>Objective 18</i> Put in place a Strategic Asset Allocation ensuring it is appropriately maintained taking into account the Funding Strategy.

## 8 Finance & Resources Implications

- 8.1 The switch to hedged share classes is expected to incur a one-off cost of around £110,000 and a drag on performance of 0.1% per annum or £560,000 based upon current holdings, but the UBS annual management charges would be unchanged. The switch to hedged share classes provides reduced exposure to foreign currency from 56% of total assets to 40% of total assets.
- 8.2 The Fund has gained approximately £90m over the last three years from not hedging its overseas developed market equity exposure. It is considered financially prudent to recommend currency hedging, as the value of sterling is currently trading below the

average pricing of the last 10 years. Therefore should Sterling strengthen the gains made to date would unwind.

- 8.3 The gain the Fund has benefited from is measured in millions against the increase annual charges in the proposal being measured in thousands of pounds. To implement hedging now should significantly benefit the Fund over time.

## **9 Risk management**

- 9.1 The ISC have the Authority to review and maintain the asset allocation of the Fund within parameters agreed with the Pensions Committee and the authority to appoint and terminate investment managers to the Fund. In both proposing the strategy to the Pension Committee and implementing the strategy the ISC are advised by external profession Investment Consultants, Mercer Ltd.
- 9.2 The risks associated with implementing the strategy have been captured in the Fund's risk register as detailed below.

<b>Risk register</b>	<b>Risk mitigated</b>	<b>Residual risk</b>
Investment (Risk 4)	Fund assets are not sufficient to meet obligations and liabilities.	Amber
Investment (Risk 19)	Failure to act appropriately upon expert advice and/or risk of poor advice.	Green
Investment (Risk 23)	Investment decisions and portfolio management may not achieve the return required or be performed in accordance with instructions provided.	Green

- 9.3 The Fund's full risk register can be found on the Fund's website at the following link:  
<https://pensions.cambridgeshire.gov.uk/app/uploads/2012/11/Risk-Register---Funding-and-Investment.pdf>

## **10 Communication Implications**

- 10.1 Not applicable.

## **11 Legal Implications**

- 11.1 Legal advice will be sought as required.

## **12 Consultation with Key Advisers**

- 12.1 This paper has been produced in conjunction with the Fund's Investment Consultants, Mercer.

## **13 Alternative Options Considered**

- 13.1 Included in the paper.

## **14 Background Papers**

- 14.1 None.

## **15 Appendices**

- 15.1 Appendix A – Mercer paper – Currency hedging – Exempt paper.

<b>Checklist of Key Approvals</b>	
Is this decision included in the Business Plan?	Not applicable.
Will further decisions be required? If so, please outline the timetable here	Not applicable.
Is this report proposing an amendment to the budget and/or policy framework?	No.
Has this report been cleared by Chief Finance Officer/Section 151 Officer?	Yes. Sarah Heywood.
Has this report been cleared by Head of Pensions?	Yes. Mark Whitby.
Has the Chairman of the Pension Fund Committee been consulted?	Yes. Cllr Rogers.
Has this report been cleared by Legal Services?	Yes. Fiona McMillan.