

# CAMBRIDGESHIRE PENSION FUND

Agenda Item No: 6

To: Investment Sub Committee

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Subject: Use of Derivatives

Purpose of the report: To provide the Committee with information on what derivatives are and why and how the Pension Fund uses them.

Recommendations: That the Investment Sub Committee:

- a) Notes the report.

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## 1 Background

1.1 This paper is bought to Committee following a request for more information on derivatives at the July 2024 meeting.

## 2 Executive summary

2.1 During the Fund year to 31 March 2024, the Fund had direct exposure to a number of derivative contracts.

2.2 This report summarises what derivatives are and what they may be used for, either currently or in the future.

2.3 Further detail is provided in Mercer's paper at Appendix 1.

## 3 Derivatives – Definition and applications

3.1 Derivatives are financial instruments whose value is 'derived' from an underlying asset (i.e. a stock, bond, currency or commodity) or benchmark.

3.2 There are four main types of derivatives.

3.2.1 Options - Give the holder the right, but not the obligation, to buy or sell an asset at a specified price within a specific timeframe.

3.2.2 Futures - Standardised agreements to buy or sell an asset at a predetermined price and date.

3.2.3 Forward contracts - Customised agreements to buy or sell an asset at a predetermined future price and date.

3.2.4 Swaps - The exchange of cash flows or liabilities between two parties based on predetermined terms.

3.2 They have a range of potential uses, improving the efficiency of portfolio management and risk management, including hedging or speculation.

## 4 Fund's Use of Derivatives

4.1 During the Fund year to 31 March 2024 the Fund had direct exposure to derivative contracts through Options, Futures and Forward Contracts.

4.2 The below chart was included in the Fund's Annual Report and shows the amounts of derivatives over the year across each type of financial instrument:

	Market value 01-Apr-23	Purchases during the year and derivative payments	Sales during the year and derivative receipts	Change in market value during the year	Market value 31-Mar-24
	£000	£000	£000	£000	£000
• Purchased/written options	1,442	1,760	0	-3,202	0
• Futures	0	6	-152	173	27
• Forward Currency Contracts	0	71	0	-71	0

4.3 The Fund's use of derivatives has focused on risk management or 'hedging' purposes. All financial instruments included in the table above were direct exposures where the Fund was a named counterparty to the contract.

- 4.4 During the Fund year to 31 March 2024 the following activities resulted in direct derivatives exposure:
- 4.4.1 Equity Protection - The mandate, managed by Schroders (formerly River & Mercantile), sought to protect against equity downside risk by buying and selling options on underlying equity indices. The Fund's equity protection mandate expired in May 2023.
  - 4.4.2 Portfolio Management - UBS use futures for efficient portfolio management in the segregated Osmosis portfolio – specifically, residual cash balances are used to purchase index futures (e.g. S&P 500 index future) to gain economic exposure to equity markets and reduce tracking error vs the benchmark index.
  - 4.4.3 Transition Management - Forward Currency Contracts relating to a currency trade to manage US Dollar risk vs £ Sterling on c.£10m of cash balances involved in the transition from UBS passive equity to Osmosis in May 2023.
- 4.5 In addition, the Fund may have indirect exposure to derivatives where the Fund is not a named counterparty but has economic exposure to the contract e.g. in a pooled fund.
- 4.5 Further information on equity protection can be found in Appendix 1.

## 5 Potential Future Applications

### 5.1 Currency Hedging

- 5.1.2 A currency hedge overlay may be used to efficiently manage currency risk across the Fund's exposures. A segregated mandate would likely require the use of derivatives (e.g. currency forwards) to achieve the desired level of currency hedging, with regular trading to recalibrate the hedge profile.

### 5.2 Indirect Exposure

- 5.2.1 Underlying pooled fund managers will continue to use derivatives for efficient portfolio management purposes and for currency hedging.

## 7 Relevant Pension Fund objectives

- 7.1 To 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.
- 7.2 To manage the Fund in a fair and equitable manner, having regard to what is in the best interest of the Fund's stakeholders, particularly the scheme members and employers.
- 7.3 To 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.
- 7.4 To continually monitor and measure clearly articulated objectives through business planning.
- 7.5 To continually monitor and manage risk, ensuring the relevant stakeholders can mitigate risk where appropriate.
- 7.6 To ensure the long-term solvency of the Fund, taking a prudent long-term view, so that sufficient funds are available to meet all members'/dependants' benefits as they fall due for payment.
- 7.7 To maximise investment returns over the long term within agreed risk tolerances.

## 8 Implications (including financial implications)

### 8.1 Resources and financial

8.1.1 There are no resources or financial implications arising from the proposals.

### 8.2 Legal

8.2.1 No material issues have been identified which may give rise to legal liability and/or risk from an administering authority perspective.

8.2.3 Squire Patton Boggs have reviewed the paper for legal implications.

### 8.3 Risk management

8.3.1 The risks associated with implementing the strategy have been captured in the Fund's risk register as detailed below.

Risk	Residual risk rating
Fund assets are not sufficient to meet obligations and liabilities.	Amber
Failure to respond to changes in economic conditions	Amber
Information may not be provided to stakeholders as required.	Green
Failure to provide relevant information to the Pension Committee/Pension Board to enable informed decision making.	Green
Failure to act appropriately upon expert advice and/or risk of poor advice.	Green

8.3.3 The Fund's full risk register can be found on the Fund's website at the following link: [Fund Risk Register hyperlink](#)

### 8.4 Consultation

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

## 9 Background papers

9.1 None

## 10 Appendices

10.1 Mercer Report – Use of Derivatives - Appendix 1