Croydon Council

REPORT TO:	**Local Pension Board** **9 February 2017**
AGENDA ITEM:	**8**
SUBJECT:	**Currency Hedging**
LEAD OFFICER:	**Nigel Cook Head of Pensions and Treasury**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Treasury**
WARDS:	**All**
CORPORATE PRIORITY/POLICY CONTEXT: Sound Financial Management: This report provides the Board with context around the possibility of adopting a currency hedging strategy.	
FINANCIAL SUMMARY: A currency hedging strategy will come at a cost but may reduce volatility and be an effective risk management tool.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

1. RECOMMENDATIONS

1.1 The Board is asked to note the report

2. EXECUTIVE SUMMARY

2.1 This report covers the factors to be taken into account when considering a currency hedging strategy for the equity investment component of the Pension Fund portfolio.

3 DETAIL

3.1 The Pension Committee considered adopting a currency hedging strategy in 2009 (Minute A17/09 refers) and at that time took the view that hedging 50% of the overseas equity portfolio might be appropriate, given more propitious timing.

3.2 The factors considered at the time of that discussion remain relevant. The Pension Fund is exposed to movements in the value of overseas currencies against sterling: typically the US dollar and the Euro but also the Canadian and Australian dollar, the Chinese renminbi, Japanese yen and other minor world currencies like the Mexican peso. Currency hedging is a way of reducing this currency risk where this risk is not expected to add to expected returns materially in the long run. In this case currency risk is considered to be an unrewarded risk. In periods of currency volatility this risk is emphasized. At present sterling has fallen against the US dollar and the Euro which has benefitted the portfolio. It might be a reasonable view to assume this situation will persist over the period of negotiating the UK's exit from the European Union and the US re-negotiating trade deals.

3.3 As a strategy, currency hedging is only practical for asset classes such as equities and fixed interest and rather more challenging, and hence unrewarding, for alternate, more illiquid asset classes. The fixed interest portfolio is bench-marked against a sterling index and therefore currency hedging is already built in to their investment process.

3.4 When investing overseas, the investor can be considered to have bought two assets: exposure to the local market and exposure to the local currency. Currency hedging, when fully employed, strips out the foreign currency exposure in a portfolio. That is to say, if the Fund features a US equity position and fully covers it with a dollar to sterling hedge, the scheme will receive the return on the US equity market in dollar terms (less hedging costs). The additional effect of changes in the dollar / sterling exchange rate is removed. To implement a currency hedge, a series of transactions in forward foreign exchange contracts or in over the counter securities are made. Typically, the manager responsible for implementing the currency hedge will enter into a series of three-month contracts, against the net value of any overseas currency positions, in order to negate the effects of currency movements.

3.5 This hedge could be put in place by the fund manager, or the Fund's custodian, by an external service provider and in-house, by the Fund investment team.

3.6 The Board will be familiar with the concept that by having investments in a range of geographical regions the Fund achieves market diversification and currency diversification, which is a useful risk management device. Hedging this exposure back to sterling eliminates the risk associated with the volatility of overseas currencies relative to the sterling liabilities (i.e. pension benefits) but at the same time introduces a further risk which is the lack of diversification from sterling. As domestic inflation relates to relative movements in sterling – such as the cost of oil which is valued in US dollars – this diversification can be beneficial.

3.7 In summary, if the Fund's domestic currency (sterling) appreciates relative to the currencies of its overseas assets, hedging is beneficial. Should the domestic currency depreciate, hedging can have a negative effect on asset returns. Officers' current thinking is that sterling will only begin to appreciate when uncertainty around the removal of the UK from the European Union is resolved and this may take 5 to 10 years.

3.8 Hedging is one way of locking in some of the returns from equities achieved over the last couple of years. Another way is to liquidate some of the investments to invest in other asset classes: this latter approach has been adopted for the Croydon Fund.

3.9 Finally, any discussion around currency hedging must touch upon the question of timing and any prediction about the ultimate floor. AON Hewitt, the Fund's professional investment advisors, have drafted a note which discusses this point in more detail. This note is appended to this report.

4. RECOMMENDATIONS

4.1 The recommendation is the Croydon Pension Board note the report

5 FINANCIAL CONSIDERATIONS

5.1 There are no further financial considerations flowing from this report.

6. OTHER CONSIDERATIONS

6.1 Other than the considerations referred to above, there are no customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

7. COMMENTS OF THE SOLICITOR TO THE COUNCIL

7.1 . The Acting Council Solicitor comments that there are no additional legal implications arising by virtue of the recommendations in this report.

7.2 (Approved for and on behalf of Jacqueline Harris-Baker, Acting Council Solicitor and Acting Monitoring Officer)

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BACKGROUND DOCUMENTS: None

APPENDIX A: Currency hedging of equites, AON Hewitt, 23 November, 2016