LOCAL PENSION COMMITTEE – 2ND SEPTEMBER 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

BREXIT AND IMPACT ON ASSET VALUES

Purpose of the Report

1. To provide information to the Committee in respect of the short-term impact of the UK's decision to leave the European Union on the value of the Fund's assets. A summary of action taken by the Fund in the run-up to the referendum is also included.

Background

2. In February 2016 the Prime Minister announced that, in line with an election manifesto promise, a referendum in respect of the UK's continued membership of the European Union (EU) would be held on 23rd June 2016. The referendum would be a straightforward remain/leave vote and the outcome of the referendum would be advisory only; it did not legally bind the government to the outcome, although there was a clear expectation that the outcome would be honoured.

3. When campaigning commenced opinion polls suggested that there was a meaningful majority in favour of remaining in the EU, and the odds at bookmakers reflected this. During the campaign there were inevitable swings in opinion polls, although the bookmakers always had odds that remained significantly weighted towards remain, and investment markets were volatile depending on the latest news and opinion polls. Investors hate uncertainty more than anything else and this volatility was fully expected.

4. The outcome of the referendum came as a shock to almost everyone, with 51.9% of voters favouring the UK leaving the EU. Given the uncertainty that this outcome gives to both the UK and also the rest of the world, the initial reaction of markets was sharp falls in equity prices, a significant devaluation of sterling (by about 10%) and a flight towards the safety of bonds. This reaction is entirely logical and could have been predicted if the outcome of the referendum had been known in advance; however, if the outcome had not been a shock the result would have been factored into markets already.

Action taken in lead up to referendum

5. The Fund's strategic benchmark includes a 50% hedge back to sterling of the currency exposures that come as a result of overseas equity holdings. The currency risk that overseas equity holdings bring is 'accidental' – it is the equities that the Fund is seeking exposure to, and not the currency – and as a result the default position is to reduce some of this risk by hedging half of the currency exposure.

6. The Fund does not, however, have a ‘blanket’ 50% hedge on this currency exposure. Kames Capital manages the currency exposures actively and takes account of their view of ‘fair value’ and also correlations with other assets when implementing the actual hedge. There have been occasions when they have maintained a 100% hedge to the Euro (believing that it will weaken relative to Sterling) whilst simultaneously having no hedge in the US Dollar.

7. In the immediate lead up to the referendum Kames Capital formed the view that markets were far too relaxed about the probability of a remain vote. They felt that if this was the outcome there would be a relatively small rally in Sterling (perhaps 1 – 2%), but that this would soon dissipate given their view that Sterling would remain under pressure as a result of the twin budget and balance of payments deficits. A leave vote, whilst not expected, would be likely to bring a significant devaluation of Sterling. In effect, for a vote with a binary outcome (remain/leave) there were far-from binary outcomes for sterling.

8. The manner in which Kames Capital carry out currency hedges means that the profit/loss positions are ‘marked-to-market’ on a daily basis, and a cash adjustment is made to reflect the revised position. From a practical perspective if sterling were to depreciate significantly when hedges were in place, the Fund would need to find cash to reflect the loss. Given that the Fund holds relatively small amounts of cash – there is no cash in the strategic asset allocation of the Fund – this would require the sale of assets. As it would be a leave vote that brought about the sterling depreciation, and as it could reasonably be assumed that this outcome would bring market chaos and significant falls in the value of most assets, finding the cash to make good the payment required for the losses on the forward foreign exchange transactions would mean selling assets in difficult market conditions at depressed prices. Clearly this was not an attractive option.

9. Given Kames’ views it was agreed that it was sensible, from a risk-management perspective, to take off all currency hedges and this was done just over a week before the referendum. Sterling then rallied in the week leading up to the referendum and it looked as if the action taken would turn out to be sub-optimal, despite the fact that it had neutralised a significant risk to the Fund. The outcome of the vote and the depreciation of sterling made the move look like something of a masterstroke, although it should be stressed that the action was mainly a risk-management issue and there was never any strong view that there would be a leave vote.

10. It is not really possible to calculate how much the decision to take off all the currency hedges saved the Fund, as there would not have been default (50% hedged) positions in each currency anyway. But *if* the default hedge had been in place, a loss of circa £65m would have been made. In reality this actually means that the value of the Fund’s overseas equities would have increased by £130m as a result of the currency impact (i.e. not including any equity market movements), but this would have been offset by a £65m currency hedge loss.

11. In mid-June the Fund was beginning preparations to fund a $90m investment in the JPMorgan Infrastructure Investments Fund, which would bring the Fund’s investment up to the higher benchmark level of 5% that was agreed at the January 2016 Annual Strategy Meeting of the Committee. Given the discussions with Kames that took place about the currency hedge it was considered sensible to take action

to purchase the US$ in advance of the referendum, despite the fact that the 'drawdown' was not due until the beginning of July. This action meant that the cost of purchasing the dollars was £4.7m less than it would have been if the purchase would have been made shortly before the payment was required, which would have been the normal procedure.

<u>Impact of referendum outcome onto asset values</u>

12. In the immediate aftermath of the referendum equity markets across the world fell sharply, with the UK and Europe being particularly badly hit. Within a week, however, most equity markets had started to rise towards their previous levels and they have continued this rise since. At the time of writing this report (11th August) most equity markets are close to – or above – their post-referendum levels, and the currency impact on overseas equities means that the sterling value of these assets is now much higher than it was prior to the referendum. At the end of July the value of the passive equity portfolio managed for the Fund by Legal & General Investment Management (which includes all geographic regions, including the UK) was almost 12% higher than the value at the end of May, the Fund's two 'dividend-focused' global equity portfolios are 13% up from the end of May, and the specialist emerging market equity portfolio is 18% higher. To date, Brexit has actually been positive for equities, but there are clearly risks ahead and it will take a good few years until it is possible to be able to analyse the long-term impact of the decision.

13. The Fund has a relatively low exposure to UK equities in comparison to many other UK pension funds, and they account for only about 20% of all quoted equity holdings (including the weighting that is included within the global equity portfolios). Although the UK equity market has performed much better than might have been considered possible given the referendum outcome (partly assisted by the boost to earnings that many of the largest UK-listed companies will receive from the fact that the majority of these earnings are in overseas currencies), its increase between the end of May and the end of July has 'only' been 7%.

14. Of the Fund's other assets, most have done well post-referendum. The Fund is mainly exposed to overseas infrastructure assets so has benefitted from currency gains, although capital values are also generally higher in local currency terms. Timberland and private equity will also have benefitted from currency gains, and index-linked bonds have produced returns of around 15% between the end of May and the end of June. The only major negative has been UK property.

15. The Fund has a 10% benchmark exposure to UK property and there was plenty of publicity in the immediate aftermath of the referendum about the wave of redemption notices that pooled property funds had received from investors wanting to get their money out of the asset class. Most of this selling pressure appears to have come from individual, rather than institutional, investors and most managers have mechanisms in place to protect remaining investors from the need to sell assets at 'firesale' prices in order to meet the redemption requirements.

16. Whilst the press coverage was rather sensationalist, there is no doubt that there will be properties that require selling in the coming months and years. Economic facts dictate that if there are more sellers than buyers, prices will fall to a point at which the two are in balance and there is realism in the commercial property market that prices will fall. Valuers have not yet, however, marked down prices to any significant

extent as there is a lack of transactional evidence to justify this – it is probable that this will emerge in due course and that prices will face a slow and steady decline in the months ahead. Although the Fund's property holdings have not yet suffered any meaningful reduction in value it is highly likely that this will happen. This does not, however, appear to be another post Global Financial Crisis-type situation when prices fell by about 30% from peak-to-trough.

17. The general feeling within the property market is that prices may well fall 10% and this this will come via a gradual trickle-down rather than in big chunks. This is, however, just a forecast and only time will tell whether it has any basis in reality. With about £300m of property assets, it does not seem unreasonable to suggest that price falls of about £30m will come through in due course and that current valuations do not reflect reality.

18. Because the Fund has a number of investments in illiquid assets where the valuations take some time to receive, it is only currently possible to estimate an asset value at the end of July but it is expected to be almost £3.5bn. This is an increase of just over 10% from the value at the end of May.

Impact onto liability values

19. The assets of a pension fund exist for one reason only – to pay the benefits due to individual members. The value of these future benefits takes into account a number of things but one key factor is gilt yields, which are the starting point for assessing the Fund's future investment return. Future investment returns are important as they will pay for some of the benefits and if they are likely to be lower than previously expected it means that more money is needed now to pay for the benefits. Although it is a little complicated, with other things being equal, a fall in gilt yields (which has occurred post-referendum) increases the value of the Fund's current liabilities.

20. Therefore although the Fund has seen a significant increase in asset values in recent months, it will have also seen a significant (although somewhat lower) increase in its liabilities. As it is almost impossible to manage these liabilities there is no real point in trying to estimate the impact on the Fund's value. This liability increase is only mentioned to bring some balance to the matter – a £350m increase in assets over two months does not mean that the Fund's deficit has shrunk by this amount.

Recommendations

21. The Committee is recommended to note this report.

Equality and Human Rights Implications

22. None specific to this report.

Background Papers

None

Officers to Contact

Colin Pratt
Investments Manager
Corporate Resources Dept.
Telephone (0116) 305 7656

Chris Tambini
Director of Finance
Corporate Resources Dept.
Telephone (0116) 305 6199

This page is intentionally left blank