PENSION FUND

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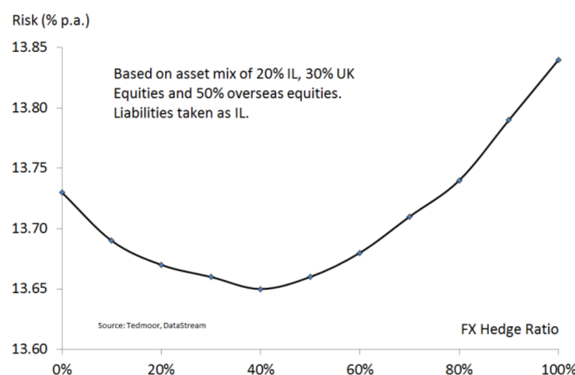
Note: Reviewing the neutral currency hedge ratio

This note is addressed to the Local Pension Committee of the Leicestershire County Council Pension Fund (the 'Fund') as part of the general review of the Fund's investment strategy. The note focuses on the neutral hedge ratio provided to the manager of the existing currency hedging programme.

Background

The Fund maintains a significant weighting to non-UK financial markets; this generates foreign currency exposures that are often secondary to main investment rationale. To manage these associated risks, the Fund retains Kames Capital (the 'Manager') to operate a foreign currency hedging programme. Within the programme the Manager has full discretion to hedge all or none of the exposure generated by the Fund's overseas equity benchmark weighting based on their prevailing currency views and considering the risk impact on the Fund. Hitherto the Fund has advised the Manager that they should apply a neutral (or benchmark) hedge ratio of 50%.

The rationale for a neutral half-hedge ratio is illustrated in chart opposite (which applies to a simpler asset structure than that of the Fund). In short, maintaining some degree of currency exposure is appropriate though, from a risk perspective, precision is spurious (note the narrowness of scale risk scale). The principle factor against fully hedging all exposure is that, in 'risk events' (i.e. sharply falling markets), defensive currencies (often those with substantial current account surpluses) rise in value against £ (which is burdened by a substantial current account deficit).



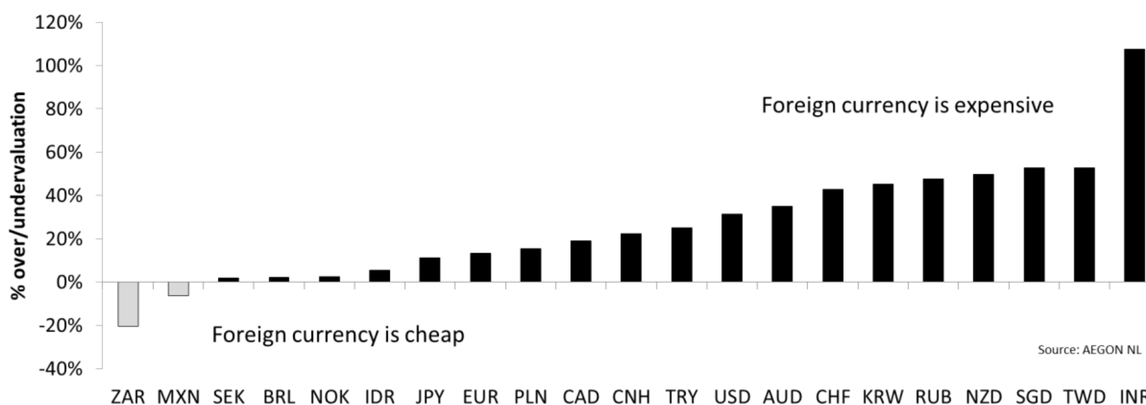
The 50% hedge ratio is widely used within currency hedging programmes for the reason discussed above. In addition and put simply, 50:50 (or half-right, half-wrong) summarises most investors view on the likelihood of success from trying to manage currency risk (although the Fund can demonstrate that its currency hedging programme has been a success). After the sharp decline in the broad, trade-weighted value of £ (shown opposite), the 'odds' based on experience look to be skewed to the upside.

In this context the Fund would appear to be better served by a higher hedge ratio i.e. by increasing the default weighting of £ exposure. The remainder of this note examines this proposition.

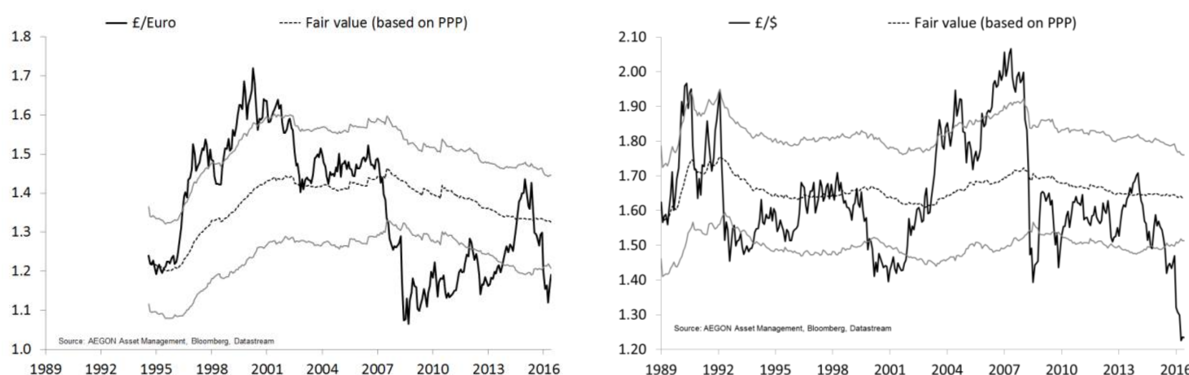
Discussion

Just because its price has fallen does not mean that an investment has become cheaper; there could be myriad good reasons for the price decline. The Appendix to this note repeats views provided by Kames Capital on the medium term outlook for £. In it the Manager highlights the political and economic issues that lie behind the sharp slide in £ in 2016 and which will continue to confront the UK going forward.

In setting any programme's benchmark position, valuation should be the principle consideration (beyond the broader assessment of risk contribution and objective attainment). Valuation, in currencies as in all asset classes, is notoriously problematic. In this context nonetheless the chart overleaf summarises the latest valuation measurements of a wide range of foreign currencies (relative to £). The calculations have been based on purchasing power parity (PPP) and attempt to capture the interplay between currency movements and evolving inflation differentials. The inference echoed across a range of other valuation approaches is clear: against almost all other currencies, £ is cheap – and materially so against the major exposures of the Fund.



Currencies can remain mis-aligned for long periods - shown in the two charts below which plot the evolution of £/$ and £/€ against their 'PPP' fair value since 1989 (also shown are the +/- 10% deviation bands). Reversion to fair value does occur but it can be a multi-year process – this should be the timescale upon which the benchmark should be set. The charts also highlight the extent of the current mis-valuation of £ against both currencies – the pricing of £ against US$s looks particularly extreme[1].



The inference is clear: looking beyond the issues that are currently weighing heavily on £, the prospect is for £ to recover naturally from current levels, unless economic fundamentals alter materially and durably; the hedge ratio should be therefore be increased. Of course developments in 2016 – involving Brexit and Trump's victory in the US, have the potential to ultimately deliver these material and durable changes but at the current time it is not possible to be certain that these changes will occur; it is this lack of certainty that has seen markets refuse to give £ the benefit of the doubt. Evidence that shows that Trump's fiscal expansion will be less extreme than proposed or that European politics will deliver sharp changes in 2017 will see markets take a more balanced view on £ that should lead £ higher.

Beyond the investment wisdom of maintaining a higher currency hedge proportion, there are practical implications to be considered. Most importantly a higher hedge ratio means larger forward currency positions used to neutralise the exposure in the underlying assets. The value of these contracts will oscillate each day according to the fluctuation of currency rates; the Fund is subject to these profit & loss swings. In practice these cash movements are handled by the Manager and the cash balances they maintain are for this purpose. If the movements are large then the Fund could be required to sell assets to fund marked-to-market losses. The Manager acts to minimise these strains by managing the hedge exposures on a discretionary basis, trying to avoid owning foreign currencies that are rising in value. Perfect foresight cannot however be guaranteed! Officers are confident that this issue is manageable.

[1] It should also be noted that fair value itself evolves (in line with contrasting inflation experience) – the 'fair value' of £/€ has fallen because inflation in the UK has been persistently greater than that in the EuroZone.

Lincolnshire County Council PENSION FUND

Summary

As the Manager's note in the Appendix reminds, there are still risks to £ but unless those risks develop and deepen then £ should be cheap enough to support a higher hedge ratio. The Manager's caution offers some protection against a premature increase in the neutral weight to £ in the Fund. The Manager could prove too cautious however and they could mis-time a broad revival in £. A higher neutral ratio, set by the Fund in recognition of the long term valuation support, would better serve the Fund in this scenario.

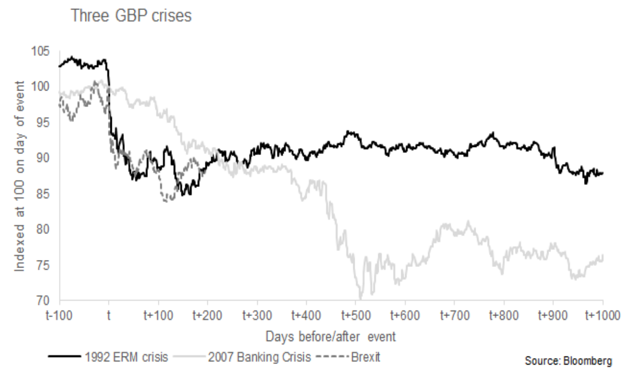
Out of the above the question is then, to what level should the neutral hedge ratio be increased? The calculation of the optimal risk calculation (first chart) argues against spurious precision and a ratio of 2/3rds is suggested. This ensures that some non-£ exposure is maintained (delivering a risk offset) and retains scope to increase the ratio further should £ fall even further.

Appendix – the outlook for £ (provided by Kames Capital)[2]

This note is addressed to the Members and Officers of the Leicestershire County Council Pension Fund (LCCPF) and relates to the currency hedging programme operated by Kames Capital. Below we discuss the strategic outlook for sterling over the medium term against US dollar, euro, yen and emerging markets.

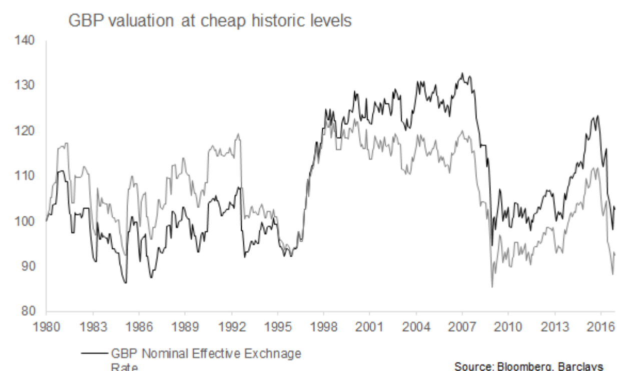
Detail

The vote to leave the European Union ('Brexit') has induced the second worst Sterling (GBP) crisis of the last four decades, currently in between the ERM crisis of 1992 and the banking crisis of 2007-08 (chart 1). Whilst the currency is ending the year on a slightly better note, the GBP remains one of the weakest major currencies this year.



Five months after the vote, the prospects for GBP are still shrouded in legal and political uncertainties. The major factor putting pressure on GBP exchange rates is uncertainty about how the UK and the EU-27 will work together in the future, in particular access to the single market, and therefore sterling will remain sensitive to the distinction between a 'hard' and a 'soft' Brexit.

Valuation is the second most relevant factor after politics in formulating the outlook for the Pound over the medium term. Sterling does look cheap over the long term on a both the Real Effective Exchange Rate (REER), the exchange rate adjusted for inflation (chart 2) and on a trade weighted basis. Sterling's REER fell to a recent low in October after the Conservative Party Conference, and is approximately 15% below its average since 1980 despite the recent modest rebound. However, in isolation this is not sufficient reason to believe in a recovery in the currency over the medium term, as UK economic growth will probably not be powerful enough to justify a bounce in GBP, particularly as the Brexit-related uncertainties will restrain growth and suppress investor appetite for GBP assets. For example the UK economy is currently growing at a 2.3% p.a., a growth rate, based on consensus forecasts, that is expected to fall to 1.1% in 2017 before rising slightly in 2018 to 1.3%. Finally the triple deficit (in budget, current account and domestic savings) will sustain downward pressure on the currency.



The UK economy is entering the later stages of the economic cycle with unemployment falling and capacity utilisation increasing - this should increase inflationary pressures in the future. We expect interest rates to be at the current level for some time, as monetary policy should act as a stabiliser for the exchange rate, for example inflation will be too high for the Bank of England to tolerate a further easing in rates, and growth too weak to warrant a tightening.

The overall message for sterling is consolidation, and we remain negative of the currency given the growth risks, reduced capital inflows and political uncertainty. Whilst sterling is cheap, we do not believe it is cheap enough to attract inflows amid the risks mentioned.

Overleaf we provide a short summary on sterling verses US dollar, Euro, Japanese Yen and Emerging Markets (the major exposures within the LCCPF currency hedging programme).

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[2] The standard disclaimers apply

US dollar

We judge that the US dollar will generally remain strong. In the medium term the US economy should strengthen further once the Trump administration enacts significant fiscal stimulus measures (albeit we expect this to be lower than what was announced in Trump's campaign) and US bond yields to climb marginally higher with rising inflation expectations. Against sterling the dollar is likely to trade in a relatively tight range of 10 cents between 1.20 and 1.30 over the medium term. There will be sporadic periods of instability and the pound could reverse direction several times driven by political developments in the UK, US and Europe; we are wary of dips in £/$ below 1.20. Whilst the current programme has a neutral US$ hedge there will be opportunities to trade between these two extremes over the medium term.

Euro

The euro is back to where it was in early July following the surprising Brexit vote. The monetary policy of ECB remains very accommodative, and recently, the Governing Council extended the ECB`s buying programme from March to December 2017, although at a reduced pace. The ECB also expanded the scope of securities eligible for purchase. Thus easy monetary policy will continue to be a headwind for the Euro and this should be supportive for sterling.

The biggest concern for the euro continues to be political uncertainty, as such we see two scenarios that are very difficult to predict given the surprising political developments in the UK and US in 2016. Firstly there is scope for a sharp sell-off in EUR/GBP should European electorates embrace their own populists; the risk premium in GBP/EUR might vanish and the currency pair could rise towards 1.35 (from 1.17 currently). Secondly, there is a strong possibility of a rebound in EUR/GBP as UK suffers from higher inflation, and political headwinds facing the euro fade. Therefore over 2017 we will continue to monitor this closely and adjust the currency mandate accordingly.

Yen

Monetary policy will likely continue to be accommodative for the foreseeable future. For example, the Bank of Japan's willingness to anchor the 10-year yield around zero in September while global bond yields were still close to their lows. The recent surge in global bond yields is now causing a sharp widening in rates differentials, pushing the Yen lower. Also the current account surplus has been increasing since 2014; this should provide support for the yen as demand for Japanese exports also means demand for yen.

We expect sterling to outperform yen over the medium term however we are cautious of a rise in US and European political risks that could make the markets more volatile and lead the Yen to strengthen. The hedge programme is currently neutral on yen.

Emerging markets

Fed rate hikes, rising US Treasury yields and the strengthening US dollar are all likely to reverse the strong flow into emerging markets seen in 2016 – we have already witnessed negative outflows on EM assets. We are bearish on Asian emerging markets as they will be negatively impacted by moves towards trade protectionism, de-globalisation, an unfavourable trend on policy rate differentials, and proximity-to-China macro risks, for example Taiwan and South Korea. We are also alert to those currencies that have global trade policy uncertainties and growing domestic risks, for example Mexico, and those currencies with heighted domestic political risks including Turkey and Philippines. There will be pockets of opportunity. Those countries that have high interest rates and which will benefit from improvements in commodities, one example is Brazil, should perform well particularly if there is a reduction in the political risk.

As such over the medium term we expect sterling to outperform those currencies (typically Asian) that are low yielding and are highly dependent on exports, and favour those currencies against sterling that are high yielding, face limited impact on global trade and have increasing political stability.

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