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PENSION FUND MANAGEMENT BOARD – 13TH NOVEMBER 2009

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

CLOSURE OF PASSIVE HEDGE USING DELEGATED POWERS

Purpose of the Report

1. To inform the Board of action taken between meetings in respect of the closure of the passive hedge. This action was taken upon the advice of the Fund's investment consultants, and after having sought the views of one of the Fund's active currency managers. The decision was taken under powers available to the Chief Executive, after consultation with the Chairman, Vice Chairman and the Liberal Democrat Spokesperson.

Background

2. At the Board meeting held on 18th September 2009, the Fund's independent investment consultant stated his view that sterling was likely to weaken in the coming months and urged the Board to consider removing the passive hedge. If sterling did weaken the Fund's overseas equities would increase in value when they were converted back to a sterling value, but the passive hedge would lose a significant element of the value that had been added. Prior to its removal 70% of the currency exposure caused by the equity holdings was hedged back to sterling, except the Euro where all the exposure was hedged.

3. At the meeting there was little discussion about the removal of the currency hedge, and no proposal was put forward about changing it. The independent consultant felt that this matter was important and contacted the Director of Corporate Resources by email after the meeting to stress that he felt there was a significant risk of the hedge making further losses if it was not removed.

4. The passive hedge is sizeable and depreciation of sterling would bring a significant loss, which requires settling in cash just after the end of each quarter. A 1% sterling depreciation would cause a loss of approximately £5m, assuming that the depreciation was uniform across each currency. Even if the depreciation was against a single currency, it could still have a significant impact – if the Euro were to move from €1.15 to €1.10 to the pound, the loss would be about £6.5m. Currency movements of this size are normal and can, of course, go either way.

Action Taken

5. Given the strong views of the independent consultant (an active market strategist in his 'day job') about the urgency of removing the hedge, the Director of Corporate Resources consulted the Chairman, Vice Chairman and Liberal Democratic Spokesperson to seek their views on the issue. The views of Millennium Global Management (one of the Fund's active currency managers) were simultaneously sought and these supported the opinion of the independent consultant on a 3 – 6 month time horizon, although they were not as bearish.

6. The Board members who were consulted were all supportive of the removal of the hedge, given the strength of opinion held by the independent consultant. As a result the Director of Corporate Resources discussed the matter with the Chief Executive, who gave his approval to the removal of the hedge. Under Part 3 of Leicestershire County Council's constitution, only the Chief Executive has the power to take decisions between meetings.

7. Millennium (who operate the passive hedge for the Fund) were instructed to close the passive hedge, and this happened in the afternoon of Thursday 24th September.

Future Operation of the Hedge

8. The currency hedge was instigated in April 2006, and was expected to be a risk-reducing tool – in the long term it was expected that it would smooth some of the volatility (at a total fund level) caused as a result of the exposure to currency that comes as a result of the Fund's overseas equity holdings.

9. Sterling has historically been a high yielding currency (i.e. UK interest rates have been higher than in most other countries), and this has been an advantage in the past. Forward currency contracts (the mechanism by which hedging is carried out) simply use the current exchange rate, adjusted for the differential in interest rates between the two currencies for the period in question. If the UK 1 year interest rate was 5% and the Japanese equivalent was 0.5%, the adjustment to a 1 year forward contract would be 4.5% – or put another way, the Yen could appreciate by 4.5% against sterling over the year before a loss is actually incurred. The current interest rate environment does not give any yield advantage to sterling.

10. There is some evidence that sterling is a currency which tends to do well in periods when investors are willing to take risk, and less well when investors are risk averse. If this correlation is correct, it *generally* means that the hedge will be profitable when equity markets are rising and will be loss-making when investors are selling equities and prices are falling. In this sense a static hedge (i.e. one which hedges the same amount of exposure, regardless of the underlying economic and market conditions) could be seen as just another market exposure. There will always be occasions when the correlation does not hold, but it could be argued (and it is, by the Fund's independent consultant) that a hedge should be seen as a return-enhancing tool rather than one that seeks to reduce risk.

11. What is clear is that the passive hedge has not been risk-reducing during its period of operation – it has increased profits in rising markets, but compounded losses when markets have fallen. This does not invalidate the case for a currency hedge, but does suggest that the Board needs to consider the manner in which one is operated in the future. Given the nature of the consideration that is required, it is intended to bring a further paper on this matter to the annual strategy meeting to be held in January 2010.

Recommendations

12. The Board is ASKED TO NOTE this report.

Equal Opportunities Implications

None specific

Background Papers

None.

Circulation under the Local Issues Alert Procedure

None.

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