Hedging foreign currency risk

Introduction

This paper is addressed to the Pensions Committee (the “Committee”) and Officers of the Gwynedd Pension Fund (the “Fund”). It sets out the rationale for hedging a proportion of the Fund’s foreign currency exposure, discusses implementation options and provides our recommendations on next steps.

Background

A large proportion of the Fund’s assets are invested overseas, with around 50% of assets invested in global equities. A summary of the Fund’s assets and associated currency exposures are shown in the appendix.

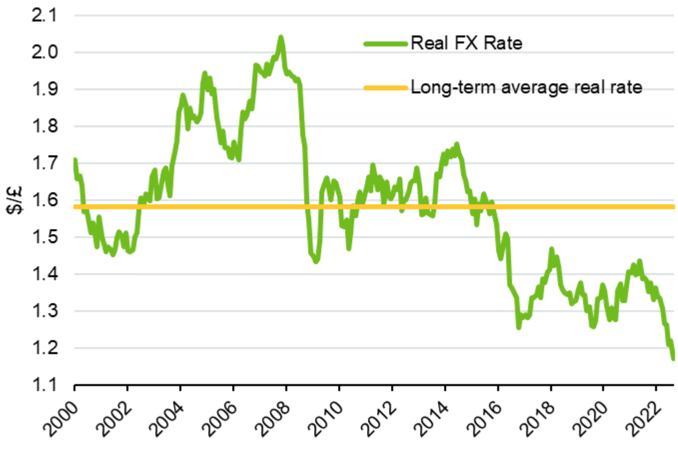
The returns from overseas investments are impacted by changes in the value of Sterling relative to foreign currencies. Currency movements have generally had a beneficial impact on Fund returns this year. This is illustrated by the example below, which shows that while returns on the US stock market have been significantly negative this year (-23.9%), the fall in the value of Sterling against the Dollar over the same period has helped to protect the value of these investments in Sterling terms (-7.6%). In this way, foreign currency exposure has provided a valuable source of diversification for the Fund this year.

This example is based on an investment of $1,000 in the US S&P 500 index at 1 January 2022.

	1 January 2022	30 September 2022
US Dollar value of investment	$1,000	$760 (down 23.9%)
USD:GBP exchange rate	$1.35	$1.12
Equivalent Sterling value of investment	£740	£680 (down c7.6%)

Source: spglobal.com, Bloomberg. Note Sterling return is not exactly -7.6% due to rounding.

The chart below shows Sterling is significantly below its long-term average exchange rate against Dollar. We can’t say which direction the exchange rate will move in future but if Sterling were to increase in value (i.e. move back towards the long-term average), this would have a negative impact on returns, all else being equal. Hedging a proportion of the Fund’s currency risk now would help to “lock in” some of the gains the Fund has made from currency movements this year.



Source: Datastream, to end August 2022

Strategic context

Currency exposure is not expected to be a long-term source of growth; it is a risk with no expected long-term benefit. Therefore, it is sensible to consider reducing this exposure if it can be achieved at low cost. The other point of view is that currency exposure provides a source of diversification and we have seen the benefits of this this year, as discussed above. More fundamentally, currency matters for a Sterling investor implementing a low risk investment strategy. However, for most LGPS funds it will look like a marginal risk over the longer term.

This said, the value of Sterling is low relative to long-term averages, particularly against the Dollar. We would support the Fund taking a tactical approach, which involves hedging a proportion of the Fund's currency exposure, provided this is supported by a clear strategy for removing the hedge as Sterling moves closer to its long-term average exchange rate.

What options are there to hedge currency risk within the Fund?

Currency hedging can be implemented at a total Fund level although this approach would likely require a specialist manager to look across all of the Fund's currency exposures. Given the Fund's objectives (which are to increase the level of currency hedging on a shorter term, tactical basis), we believe a more suitable and straightforward approach is to switch the BlackRock global equity funds to a currency hedged basis. Under this approach, BlackRock would implement currency hedging as part of their pooled fund structure.

What proportion of the Fund's currency risk should be hedged?

As noted above, currency risk is a source of diversification and this has proved beneficial this year. As such, we would not recommended to hedging all of the Fund's currency risk. Switching the BlackRock global equity funds to a currency hedged basis would allow the Fund to hedge c40% of its global equities allocation.

What are the risks associated with the proposed approach?

If Sterling were to fall in value from current levels, the Fund would not benefit from any foreign currency gains on the assets that are hedged. The operational aspects of the currency hedged versions of the BlackRock global equity funds will also need to be reviewed to determine whether these introduce any additional risks (although we do not anticipate any significant issues).

Next steps

We propose to work with Officers to expand on the high level comments set out in this paper to develop and implement a solution built around the following parameters:

- Hedge a proportion of the currency risk by switching BlackRock global equity funds to currency hedged basis.
- This would hedge the currency risk of c40% of the Fund's global equities allocation.
- Remove hedging when the Sterling moves to within perhaps 20% of its long-term average exchange rate. This would correspond to an exchange rate of $1.30 to $1.35 (about 15% to 20% above current levels).
- Recognising that the Fund also invests outside the US, we recommend the exchange rate is measured using the Purchasing Power Parity method, which looks at values of a range of currencies relative to Sterling.

We look forward to discussing this paper with the Committee and Officers.

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For and on behalf of Hymans Robertson LLP

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General Risk Warning
Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

Appendix – summary of Fund’s currency exposures

This table provides a summary of the Fund’s assets and associated currency exposures. Most of the currency exposure comes from the Fund’s overseas equities, which represent c50% of total assets. These are classed as “primary” currency exposures where the assets are denominated in overseas currencies. The Fund also has “secondary” exposures, e.g. a UK company that has material revenues from overseas and is therefore impacted by movements in Sterling. The Partners private equity and infrastructure mandates will likely have a mixture of primary and secondary exposures. The WPP absolute return bond fund employs currency hedging and this is implemented by the investment manager.

Fund	**Current target allocation**	**Currency exposure**
BlackRock UK equities	10.5%	Sterling denominated
BlackRock global equities (Fundamental Weighted)	7.0%	Unhedged
BlackRock global equities (World Low Carbon)	12.0%	Unhedged
WPP emerging markets	2.5%	Unhedged
WPP Global Growth	14.0%	Unhedged
WPP Global Opportunities	14.0%	Unhedged
Partners private equity	5.0%	Unhedged
Partners infrastructure	2.5%	Unhedged
UK property (UBS, Lothbury, BlackRock, Threadneedle)	10.0%	Sterling denominated
WPP multi-asset credit	7.5%	Unhedged
WPP absolute return bonds	15.0%	Currency hedged
Total	100.0%	