London Borough of Harrow Pension Fund ('the Fund')

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Currency hedging

Background

Since the EU referendum on 23 June 2016, Sterling has fallen by 11% against the US dollar (US$1.48 to US$1.31 currently) and a little less against the euro, with a 10% drop (€1.3050 to €1.18 currently).

The Fund has a 62% strategic allocation to global equities invested across four managers. The purpose of this paper is to examine the impact of Sterling weakness on the Fund's equity holdings and whether the current currency hedging arrangements remain appropriate in the current economic environment.

Equity holdings and currency exposure

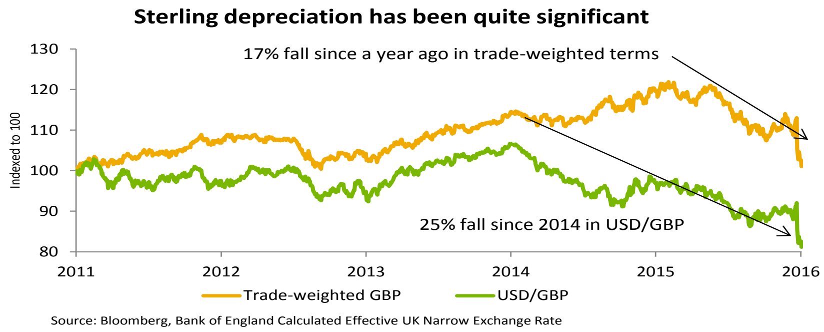
The table below summarises the Fund's currency exposure within the equity portfolio as at 30 June 2016.

	Longview	**State Street**	**GMO**	**Oldfield**	**Total Fund Exposure**
Strategic weighting	*11%*	*31%*	*10%*	*10%*	*62%*
US Dollar		53.2%	5.2%	24.8%	19.5%
GBP	100.0%	6.6%	3.2%	18.3%	15.2%
Japanese Yen		8.1%		33.0%	5.8%
Euro		9.5%	1.2%	13.0%	4.4%
Indian Rupee		1.1%	22.3%		2.6%
Thai Baht		0.2%	14.6%		1.5%
Canadian Dollar		2.8%		5.4%	1.4%
South Korean Won		1.5%	2.7%	5.4%	1.3%
Chinese Yuan			11.0%		1.1%
Philippine Peso		0.2%	10.3%		1.1%
Hong Kong Dollar		3.4%			1.0%
Swiss Franc		3.1%			1.0%
Brazilian Real		0.8%	5.6%		0.8%
Australian Dollar		2.4%			0.8%
New Taiwan Dollar		1.3%	3.2%		0.7%
Russian Ruble			7.1%		0.7%
Mexican Pesos		0.5%	3.7%		0.5%
South African Rand		0.8%	1.6%		0.4%
Turkish Lira		0.1%	2.6%		0.3%
Swedish Krone		0.9%			0.3%
Indonesian Rupiah		0.2%	2.0%		0.3%
Malaysian Ringgit		0.4%	0.9%		0.2%
Danish Krone		0.7%			0.2%
Vietnamese Dong			1.6%		0.2%
Singapore Dollar		0.5%			0.1%
Qatari Rial			1.2%		0.1%
Israeli New Sheqel		0.2%			0.1%
Norwegian Krone		0.2%			0.1%
Polish Zloty		0.1%			0.0%
UAE Dirham		0.1%			0.0%
Chilean Peso		0.1%			0.0%
New Zealand Dollar		0.1%			0.0%
Colombian Peso		0.1%			0.0%
Hungarian Forint		0.0%			0.0%
Czech Republic Koruna		0.0%			0.0%
Egyptian Pound		0.0%			0.0%
	100%	**100%**	**100%**	**100%**	**62%**

Source: managers, data as at 30 June 2016, developed market countries marked in bold

- The Fund's equity holding with Longview is 100% hedged to Sterling.
- Additionally, the Fund has a passive currency hedging mandate with Record Currency Management whereby the manager hedges 50% of all developed market overseas equity currency exposure across all four managers.
- This therefore implies that approximately 45% of the Fund's global equity holdings are hedged back to Sterling based on 30 April 2016 asset values. Emerging Market currency is left unhedged.

What has happened to Sterling?



Sterling's weakness pre-dates the EU referendum. The pound has now depreciated by 25% against the US dollar since 2014, due to a tighter US monetary stance, concern over a widening UK current account deficit and, in the past year, by Brexit worries. In broad trade-weighted terms, the fall is smaller but still a sizeable 17% since its 2015 peak (see chart).

How much further can Sterling fall?

- Sterling will remain at the mercy of uncertain economic and political developments for several years which obscures the outlook.
- Even though sterling has fallen significantly already on the back of a negative outlook for UK growth and inflation under a Brexit scenario, we expect that sterling could continue to weaken in the wake of the decision by the UK to leave the European Union (EU). Negative news flow and reduced capital inflows will keep sterling weak.
- However, limited monetary easing implications and some valuation support indicate that the greater part of sterling's depreciation has now occurred.

How does Sterling weakness / strength impact the Fund's holding?

- When Sterling weakens, the value of an unhedged overseas holding increases (as the amount of foreign currency equivalent to one British pound falls).
  - Since the EU referendum, Sterling weakness has pushed up the value of overseas equity portfolios so investors with unhedged exposures have benefited.
  - Investors with hedged overseas exposure (like the Fund) will not have participated in this value increase however, it should be noted that the Fund's equity exposure is not 100% currency

  - hedged and therefore it would have experienced a proportion of this upside from its unhedged exposure.

- By contrast, when Sterling strengthens, the value of an unhedged overseas holding falls (as the amount of foreign currency equivalent to one British pound increases).
  - Therefore, investors with unhedged overseas exposures will suffer a loss.
  - If Sterling were to strengthen from its current position and revert back to its pre referendum levels (c. 11% higher versus the USD), the Fund's currency hedged position would offer protection against some of the potential losses.

Recommendation

- Strategic currency hedging (which the Fund has in place) is typically implemented to reduce portfolio volatility and remove the impact of negative currency movements from manager performance. Similarly, a strategic hedge also removes any upside participation in currency movements as it is not intended to facilitate tactical positions.
- Given the size of Sterling's fall to date, we believe the majority of Sterling weakness has already come through. High levels of uncertainty around the Brexit process makes the extent of further sterling weakness also highly uncertain.
- Whilst we think that there is more risk of further sterling weakness than strength, we are in fact recommending that clients without hedging arrangements in place start to prepare to hedge their overseas exposure.
- Should Sterling weaken further, the Fund would not participate in the full extent of this however some upside is expected to come through due its underhedged position in global equities. Similarly, should Sterling experience an appreciation in its value, only the unhedged portion of the Fund's global equity holdings would be expected to fall in value.
- Based on the above, we believe the Fund's slightly less than 50% hedged position within global equities is likely to allow some upside participation whilst also offering a sufficient level of protection.
- **We therefore believe that the Fund should not amend its current currency hedging arrangements.**

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