## LB Harrow Pension Fund: Currency hedging and outlook for sterling

## Comment by Colin Robertson, Independent Adviser

## 18 July 2016

Leaving aside the relatively small private equity holdings, foreign currency exposure is derived through the equity holdings which have no specific allocation to UK equities. The emerging markets exposure is unhedged and 50% of the remaining equity exposure is hedged back into sterling. Using the strategic asset allocation target weightings, this produces foreign currency exposure of 10% in emerging markets plus 50% of the remaining 52% of the fund invested in overseas equities. This amounts to 36% of the fund.

In comparison, using the State Street 2015/16 survey, the average LGPS fund has 60% invested in equities, of which about 21% is invested specifically in the UK and 39% is invested overseas. Assuming the overseas equities of other LGPS schemes are currency unhedged, the LBH fund has 36% foreign currency exposure compared to an average figure of around 39%. Given it is likely that some other LGPs schemes will have hedged overseas equity holdings to some extent, I think it is fair to say that the LBH fund has a typical foreign currency exposure.

This analysis ignores the fact that a high percentage of UK company earnings are derived from overseas and that a proportion of overseas company earnings are derived from the UK. Furthermore, we do not know the extent to which companies hedge their own foreign currency exposure. Nevertheless, if we are just considering the performance of equity indices and exchange rates, then it seems reasonable to assume the LBH fund's sensitivity to movements in sterling is not atypical.

I will not cover the theoretical merits or otherwise of currency hedging in my comments since I assume I am commenting in the context of Brexit. However, I would say that as the fund has a particularly high 62% exposure to global equities, some level of currency hedging does not appear unreasonable.

Turning to the outlook for sterling, sterling has now fallen by close to 10% against both the US dollar and the euro since the Brexit vote. A major reason for the fall is the UK's very large current account deficit (about 7% of GDP and much greater than in the other major developed economies) and concerns over how this deficit will be financed post Brexit. How keen will foreigners be to invest in the UK when its future is so uncertain, not least with respect to our ability to trade with other countries? However this issue can be overstated since our *trade* deficit is very much smaller than our current account deficit and the difference between the current account and trade deficits consists of items which will shrink markedly because of the fall in sterling (for example investment income received from abroad will rise in sterling terms but the investment income we pay foreigners will remain unchanged).

Other factors which affect exchange rates have not moved in a manner favourable to sterling. UK interest rates will remain lower for longer but then this also applies elsewhere so the impact should be very limited. Economic growth will be hit in the short to medium term and forecasts for aggregate GDP growth over the next two years have come down by around 2% or so. This is meaningful but hardly disastrous.

Crucially, we need to consider the extent to which these negative factors are already priced in to the exchange rate. Against the US dollar, sterling is down some 15% from the range it has traded in since 2008. Against the euro, sterling is trading at fairly typical levels over the last 10 years, reflecting the poor performance and subdued prospects for the eurozone. Therefore, it appears that while bad news has been taken on board, there remains scope for sterling to fall further if political mistakes are made. On the other hand, policy making in the UK could turn out to be better than expected and developments in other countries could be perceived poorly (for example Trump as President).

This is all entering into the realm of tactical currency asset allocation, rather than strategic asset allocation which should be the focus of the Committee's attention. However I would say that it is not clear to me that the shorter term tactical outlook for sterling is sufficiently negative as to justify changing the strategic allocation at this juncture. Horses bolting and stable doors come to mind.