Strategic Currency Hedging
Managing sterling swings

Guidance for UK pension schemes
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- Currency movements can have a significant impact on portfolio volatility and can dominate returns at times. Trustees should consider their exposure and tolerance for currency risk.

- We believe currency hedging back to sterling will generally dampen overall portfolio volatility. We support hedging half of the currency risk associated with overseas equity. For asset classes with relatively stable underlying values, such as overseas bonds or absolute return strategies, we suggest full currency hedging.

- Following the recent depreciation of sterling, we think sterling has fallen to around reasonable levels for Trustees to prepare to introduce a strategic currency hedge, if not already in place.

- Implementation challenges can be material and options should be considered up front.

Why is currency management important?

Pension schemes increasingly invest on a global basis, using overseas assets to diversify returns and gain access to attractive assets outside the UK. While this is beneficial, it does expose schemes to exchange rate movements when valuing these assets in sterling terms and when selling overseas assets to pay benefits in sterling.

The chart below shows the difference between the returns to a UK investor on an unhedged overseas equity portfolio and one with currency hedging on an annual basis.

Annual difference between unhedged and currency hedged overseas equity returns

As the chart demonstrates, the impact of currency movements can be significant. An appropriate currency hedging policy reduces this currency impact and, most importantly for investors, constrains large drawdowns.
Whether to hedge against currency movements

Reducing currency risk has historically helped to reduce overall portfolio risk and, looking forward, some currency hedging makes sense from a risk reduction perspective. The significance of this risk will depend on specific circumstances. To provide general guidance, we have focussed our analysis on the two most common asset classes that give rise to currency risk; overseas bonds and equity.

For lower volatility asset classes, such as overseas bonds and most absolute return strategies, currency contributes a significant proportion to risk. Therefore, currency hedging considerably reduces volatility. The chart to the right shows how the historic volatility of a global bond portfolio varies with the level of hedging. As you can see, volatility continues to fall as hedging rises towards 100%. For overseas bonds and most absolute return strategies we therefore support full currency hedging.

Global equities, on the other hand, are more volatile. Therefore, a greater portion of the overall risk comes from equity markets rather than currency. Looking historically, most of the risk reduction is achieved by increasing the level of hedging from zero up to around half. Beyond this level, there are diminishing benefits to additional hedging (as shown in the chart to the right). Over the time period used in the analysis, risk would have been minimised with a currency hedge ratio of around 70% to 80%, but repeating this historical analysis over different time periods shows that this optimal point varies considerably. Looking forward, a single optimal level of hedging does not exist. We believe that in an effort to control volatility in a pragmatic way, rather than relying on historical precedence over a specific time period, hedging half of the currency exposure from overseas equities is reasonable.

These proposed hedges are recommended on a strategic basis and require a change to the hedge ratio expressed in the benchmark and passive implementation. Active views on currency moves can additionally be implemented around the strategic currency hedge ratio. Aon Hewitt’s asset allocation team provides medium-term views on currencies.

Global bond volatility across different hedge ratios
(1/90 – 7/16)

Source: Barclays Capital Global Aggregate Bond Index

Global equity volatility across different hedge ratios
(1/88 – 6/16)

Source: MSCI

However, trustees should consider their specific circumstances. In particular, currency hedging overseas equity may not be viewed as yielding enough risk reduction benefit based on the following three aspects:

- **Size of the risk**
  Schemes with only small levels of currency exposure, or schemes where currency provides some diversification with other investment risks, will see less risk reduction benefit through currency hedging.

- **Risk tolerance**
  Trustees may be happy to weather short term volatility in schemes with high funding levels or with strong company covenants. Additionally, schemes with a longer time horizon have more opportunity to recover from any currency losses and consequently may have a higher risk tolerance.

- **Implementation challenges**
  Trustees should consider which implementation options are available to them and whether the likely risk reduction is worth the increased complexity, governance burden and costs. Please see the “Implementation” section below.
Why now?

We believe that currency markets will be increasingly volatile over the next few years, particularly as Brexit uncertainty is reflected in sterling. Moreover, the US election result creates uncertainty over US monetary and fiscal policy which impacts the US dollar exposure that is so dominant in global equity and bond portfolios. At the same time, changes to US trade policy have a widespread impact on other currencies. Hedging currency helps to protect a portfolio from resulting currency swings.

Furthermore, from a return perspective, we believe that implementing currency hedges after recent significant sterling weakness, gives a good chance that the hedge will not be detrimental to overall portfolio performance. UK investors holding overseas assets with no currency hedging have benefited in the past from sterling weakness, gaining approximately 29% from unhedged equities since 2014 and a massive 48% since 2007 (see chart below).

Currency returns from overseas equities

![Currency returns from overseas equities chart](chart.png)

Source: MSCI. Currency cumulative return indices are approximated from the MSCI World ex UK hedged and unhedged indices. Blue shaded areas denote periods of currency gain.

We anticipate that sterling will remain vulnerable for the next couple of years as the UK’s weaker growth outlook post-Brexit, loose monetary policy stance and reduced capital inflows undermine the exchange rate. However, sterling is now reasonably close to the attractive levels of $1.20 and €1.10, as detailed in our July 2016 medium-term view note, ‘How much further can sterling fall? Therefore we propose pension schemes should prepare to hedge now.

Implementation

Implementation choices will typically start with what is readily available to each scheme. Our preference is to use the most operationally simple and cost efficient option.

For pooled fund investments, this may be as simple as switching to a hedged share class. For segregated mandates, the manager may be able to hedge currency on request.

Alternatively, a third party such as a custodian, LDI manager or currency manager could provide a passive overlay which is advantageous for schemes with various overseas funds since they can hedge currency at an overall portfolio level. An overlay is operationally more difficult for a scheme and requires more governance from Trustees and advisors. In particular, Trustees need to be aware that, not only must a third party be employed to calculate and transact the currency trades, but collateral requirements may also need to be managed as a result of new regulations which are expected to take effect over the next couple of years. There will also be some portfolio disruption from either needing to reinvest profits or raising funds to cover losses that result from the currency hedges. In the absence of hedged share classes, these complications are real, but need not dominate the benefits from hedging.

Crucially, Trustees should expect that currency hedges will result in losses at times which may potentially last for a sustained period. The currency gain from the underlying asset class offsets this loss but Trustees should be aware that this gain may be less visible than the amount that is paid out from the hedge.

Costs

There are different approaches to quoting costs and care should be sought when considering the true cost of hedging. However, generally speaking, management costs can be between 0.02% and 0.06% per annum, and transaction costs can be between 0.02% and 0.04% per annum. Interest rate differences between each country, encapsulated in the pricing of currency contracts, add another cost or benefit that should be taken into account.

Aon Hewitt has been working with investment managers of pooled funds and third parties to provide suitable and cost effective solutions that will help our clients meet their currency hedging requirements.
Conclusions

• Trustees should consider the currency risk to which their schemes are exposed and revisit their currency hedging policies.
• Currency will be volatile and could dominate portfolio returns particularly given uncertainty surrounding Brexit and US policy under a new President.
• Portfolio volatility can be dampened through strategic currency hedging, though the hedging treatment differs between the type of asset class, the size and tolerance for risk, and costs and complexity of implementation.
• There is no single optimal strategic currency hedging level. Consequently, over certain time periods currency hedging may actually cause more volatility in portfolios and schemes could experience losses from these positions. Trustees should be aware of the different outcomes from adding these hedges.
• However, we believe now is a reasonable time to prepare to strategically hedge overseas currency exposure after considerable sterling weakness.

Please get in touch with your Aon Hewitt consultant for more information.

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