Staffordshire
Pension Fund
Local Government Pension Scheme

Currency Hedging Policy

June 2022

The Currency Hedging Policy will be revised and republished following any material change in policy.

Introduction

1. Staffordshire Pension Fund ('the Fund) invests a large proportion of the Fund in non-Sterling (£) denominated assets. When the value of Sterling changes in the foreign exchange markets versus other currencies (i.e. the US Dollar $), this leads to volatility in the price of the assets the Fund owns and a subsequent financial gain or loss.

2. It is worth noting that foreign currency exposure does not always lead to increased volatility in investments. Exchange rates can sometimes move in the opposite direction to investment values in foreign currency, which reduces volatility.

3. Forecasting movements in currency markets is extremely challenging, therefore, to compensate for this uncertainty some investors use currency hedging as a form of insurance, to protect against currency volatility.

4. Pension Fund Officers have worked with the Fund's investment consultants, Hymans Robertson, in developing this policy. The intention of the policy is to set out the Fund's views on currency hedging in the major asset classes it invests in, in a concise format, to help guide future decision making.

What is currency hedging?

5. Currency hedging means buying (or selling) currency in advance so you 'fix' the exchange rate. In effect you enter into an agreement to exchange a fixed amount of currency at a future date and specified rate. The value of this contract (forward foreign exchange or 'FFX') will fluctuate and offset the currency exposure in the underlying assets which you are attempting to protect the value. The amount of currency to hedge must be based on an estimate of the future value of the investment that is being hedged at the end of the contract. Therefore, currency hedging tends to be more effective for less volatile, more predictable investments. An example of currency hedging is provided in Appendix 1.

Equity (public and private)

6. The majority of the Fund's assets are invested in global equities, listed in stock markets around the world and denominated in many different currencies. Public equity is a volatile asset class, with returns hard to predict. The relationship between equities and currency is also opaque, as many listed companies derive a proportion of their earnings and costs outside the country in which their stock is listed.

7. Currency hedging equities sometimes only has a marginal effect on reducing the overall volatility, therefore, due to the complexity and cost, the Fund is content to retain currency risk within its public equity assets and not currency hedge.

8. Private equity is investments in unlisted companies, which may be too small to be listed on a stock market. Private equity by nature is an illiquid asset class with returns that are incredibly hard to predict. Therefore, as for public equities, due to the complexity and cost of currency hedging private equity assets, the Fund does not believe currency hedging is appropriate.

Fixed Income (public and private)

9. Public fixed income assets are issued by governments and corporations and provide a known future stream of income. Compared to equities, these assets are generally lower returning and less volatile, which means that exchange rate fluctuations can become the dominant factor in determining the returns of foreign currency denominated fixed income investments. Therefore, the Fund believes it is appropriate to currency hedge fixed income assets.

10. Private fixed income assets (differing types of this asset class are sometimes referred to as private credit or private debt) is investing in the various forms of unlisted debt (typically from corporations). Private fixed income shares many of the same characteristics of public fixed income, therefore it could be seen to be suitable for currency hedging.

11. In the case of fixed income assets, the Fund will seek to protect returns from the fluctuations in exchange rates, though it should be noted that it is impossible in practice to achieve this fully, due to the limitations and cost of the hedging strategies employed. Where the Fund invests with a fixed income investment manager offering cost effective currency hedging, or a fixed income fund which offers currency hedging, the Fund's investments will be via this route as a first choice. Where no currency hedging option is offered, then it would likely be prohibitively expensive, both in terms of cost and governance to implement a separate solution, therefore the Fund feels it appropriate to accept currency risk in this situation.

Infrastructure

12. The infrastructure investment spectrum is wide, from lower risk 'core' funds, invested in established assets, with contracted and sometimes inflation-linked income, all the way through to 'opportunistic' funds, investing in the construction of new infrastructure assets in riskier jurisdictions (e.g., emerging markets).

13. Infrastructure funds, once established and with a high proportion of contracted revenue, meet the criteria where it could be considered appropriate to currency hedge in line with their stable income streams. Currency hedging their asset values is much more challenging due to the volatility in the asset valuations. Therefore, for its infrastructure allocation, of which the majority is exposed to overseas asset values, the Fund believes that on the grounds of efficiency, it is appropriate not to currency hedge this asset class.

Property

14. Currently, the Fund only invests in UK Property, so there is no direct currency risk. Should the Fund begin to consider the opportunities presented by investing in overseas property in the future, then like infrastructure, certain overseas long lease property funds would meet the criteria to currency hedge in terms of their income streams. Again, due to the volatility in property asset valuations and the cost of currency hedging, the Fund believes that for efficiency and simplicity, it would not be appropriate to currency hedge this asset class.

Quick reference table

Asset Class	Sub asset class	Currency hedge
Equity	UK	No
	Overseas	No
	Private Equity	No
Fixed Income	UK Conventional Gilts	No
	UK Index-linked Gilts	No
	Corporate Bonds	Yes – for foreign currency denominated fixed income assets.
	Private Debt	Yes – where a currency hedged share class is available.
	Multi-Asset Credit	Yes – where a currency hedged share class is available.
Alternatives	Infrastructure	No
Property	UK Commercial	No
	Overseas	No
Cash		No

Appendix 1

Currency hedging example

Imagine you have a fixed maturity loan of €50,000 with a European Bank. Hence, the amount you owe in Sterling will fluctuate with exchange rate movements between the two different currencies.

To manage this risk, you enter into a FFX contract with a third-party. On the contract date, the exchange rate was set at the current rate of £1 to €1.10. This means to settle the loan, regardless of the exchange rate on the maturity date of the loan, you require £45,455.

If on the maturity date, Sterling has devalued against the euro and the exchange rate is £1 to €1.05, it will cost you more to settle the loan; however, since you entered into a FFX contract, the eventual net cash outflow will be the same (£45,455). The payment to the European Bank would be more (£47,619), but the difference (£2,164) would be received from the FFX contract.

Conversely, if Sterling strengthens against the Euro to £1 to €1.15, the eventual net cash will also still be the same (£45,455). Your payment to the European Bank would be reduced (£43,478) but to settle the FFX contract you will be required to pay over the difference (£1,977).

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